

Is RAD Right for You?

An Analysis of the Rental Assistance Demonstration

by Dennis Mobley, Housing Solutions

The hot topic on just about everyone's lips, at least in the field of HUD public and assisted housing, is the Rental Assistance Demonstration (RAD). Indeed, Government Leasing News has published a half-dozen articles on the subject, and industry conferences and seminars are seemingly dominated by RAD. The name recognition of one Gregory A. Byrne skyrockets as he barnstorms every corner of the Nation, either in person or by proxy.

For those just joining the discussion, whether from the affordable/public housing arena or the GSA world, a quick summary of RAD is warranted: It is a HUD demonstration in which, initially, sixty thousand units (60,000) across the country will be converted from public housing to Section 8. The rationale is that public housing developments are currently forbidden by law from incurring debt secured by the property, whereas in the world of Section 8 (privately-owned properties receiving HUD rent subsidies) it is commonplace. RAD-converted properties will have immediate access to conventional or FHA-insured hard debt as a means of dealing with capital needs. In addition, RAD facilitates the legal ownership status needed to pursue Low-Income Housing Tax Credits (LIHTC) as explained further below.

The author of this article wishes to disclaim any intention of drumming up RAD-related business despite his long-time status as a consultant to public housing agencies (PHAs) and affiliated entities that some PHAs have created as their development arm. The intent is to share the beliefs borne of his "existential professional angst" as to whether and when RAD is a sensible strategy for those PHAs with whom he is already consulting. If this article helps others find their own answers to this quintessential question, so much the better.

Consistent with the Scientific Method, an initial hypothesis is posed as follows: *RAD is the best, and in some cases, the ONLY strategy for most PHAs wishing*

to redevelop, rehabilitate and/or refinance existing assets. For a small fraction of the nation's three thousand PHAs, it leaves money on the table, as will be explained below. The remainder of this article will attempt to refute or support that working hypothesis.

It should be noted the author has worked in and around PHAs since 1972, starting as a budget analyst for a very large East Coast PHA, and (as a private consultant) has been engaged since the mid-1990s in working with PHAs/affiliates committed to portfolio transformation. It is noteworthy that the topic of "transformation" has been kept in the forefront by this publication, as well as others like my associate Tom Nutt-Powell, NAHRO President Emeritus Betsy Martens, long-time housing practitioner Rod Solomon, and the likes of David Smith in his periodic "State of the Market" articles.

The preferred methodology used by this author and his associate in working with PHAs/affiliates interested in transformation is to begin with a three day on-site assessment of the owned-and-operated real estate, as well as the affordable rental market in which it competes and the stated (or tacit) organizational mission being pursued. The objective of this "strategic reconnaissance" is to provide an order-of-magnitude classification of the properties into groupings that guide the type and timing of future actions and decisions.

This practice has led to the conclusion that there are three kinds of properties that one encounters in assessing affordable rental portfolios. It would be cute (and a copyright infringement) to say they are "the Good, the Bad, and the Ugly." More accurately, they are:

- Properties that adequately serve the Mission of their public-spirited owner, that do reasonably well in the marketplace (with revenues exceeding expenses) and whose 20-year capital needs can be financed through a reserve for replacement, with monthly deposits that fit within the available revenue stream less

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actual reasonable expenses. These are indeed the "Good." (From the perspective of a 20-year capital plan using a "fix-as-is" approach, no outside financing would be needed. That is not to say "good" properties cannot and should not be refinanced when the opportunity presents itself.)

•Properties that do NOT serve the organizational Mission, that are viewed as "housing of last resort," that typically run in the red (unless the vagaries of HUD subsidy formulas prolong the result in operating surpluses that the property could never achieve on its own in the marketplace^{1*}), and whose physical and social attributes hold no hope of redemption. These are of course the "Ugly," with demolition and/or replacement the obvious course of action.

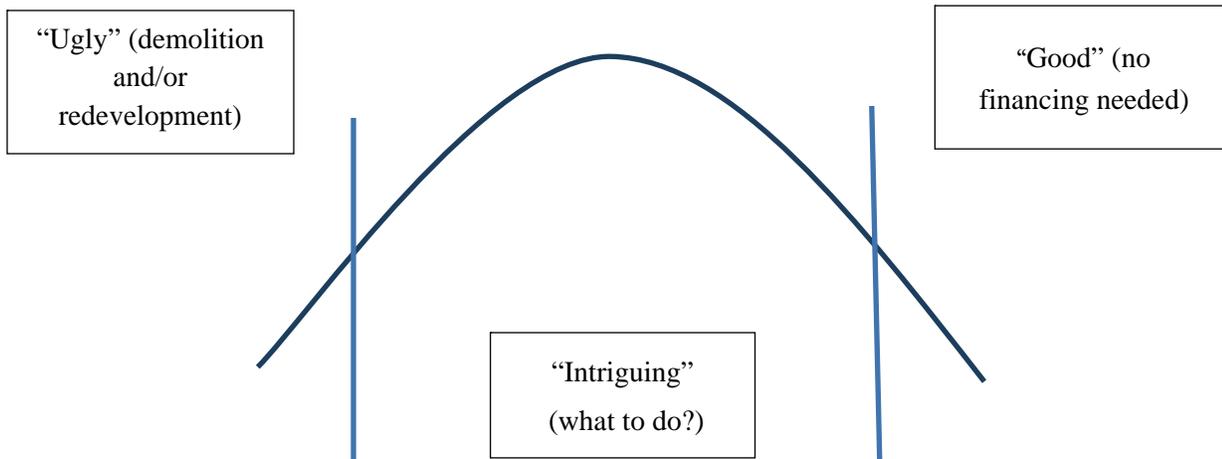
•Properties that lie in the middle of a continuum flanked by the "Good" and the "Ugly." These assets are not necessarily "Bad" but they engender the most angst and analysis in terms of what to do and how to do it. Their owners may uncertain as to whether these

assets are serving the Mission, and whether and how they can be "fixed," both physically and in terms of market acceptance. Some may call them marginal, others troubled, but it's safe to say these are the assets that are the most Intriguing.

I leave it to others to decide the number of properties and units within each category. In actual fact, a majority of existing public housing properties may fall in the "good" category. Much of the "ugly" has been attacked through the years via HOPE VI, Mixed-Finance, and now Choice Neighborhoods. For now, we consider these categories on a conceptual basis, and begin to apply the basic question, "Is RAD Right for You?" to each.

Good Properties (no financing needed). While it is true that converting from the age-old world of public housing may be a frightening thought, under the rubric "the devil you know is better than the devil you don't," for this author the quintessential question for this category of property becomes: "Will the assistance offered under RAD be better than the assistance Congress is likely to appropriate for the foreseeable future"? In

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*Numbered footnotes are found at the end of the article.

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other words, will the revenue stream being offered under RAD be more stable long-term than the Public Housing Operating Fund and/or the Public Housing Capital Fund? If the belief is “Yes,” and if the RAD Rents being offered are sufficient to cover adequate operating expenses of a property as well as to fund a replacement reserve adequate to cover its twenty-year capital needs, why not convert these “Good” properties under RAD?² Particularly if the resulting change in regulatory and related program compliance requirements (accomplished under RAD via either via HUD Multi-family’s Project Based Rental Assistance program or via the RAD Project-Based Voucher option) is not seen as any more onerous than existing Public Housing Requirements.

It is appropriate to explain here how the “revenue stream being offered under RAD” is computed. In a nutshell, the Housing Act of 1937 provides yearly Operating Fund subsidy, plus annual Capital Fund dollars as shown in the table on the previous stage, taken from Jaime Bordenave and Peter Shanley’s front page article in the Summer 2013 edition of GLN. These subsidies

supplement the rent being paid by tenants, based on 30% of their adjusted income. The example used shows existing subsidies of \$330 plus \$144 equals \$474, together with a tenant payment of \$318 means existing revenue per unit per month of \$792. RAD may only substitute Section 8 Housing Assistance Payments in the amount of the current subsidization of \$474 monthly.

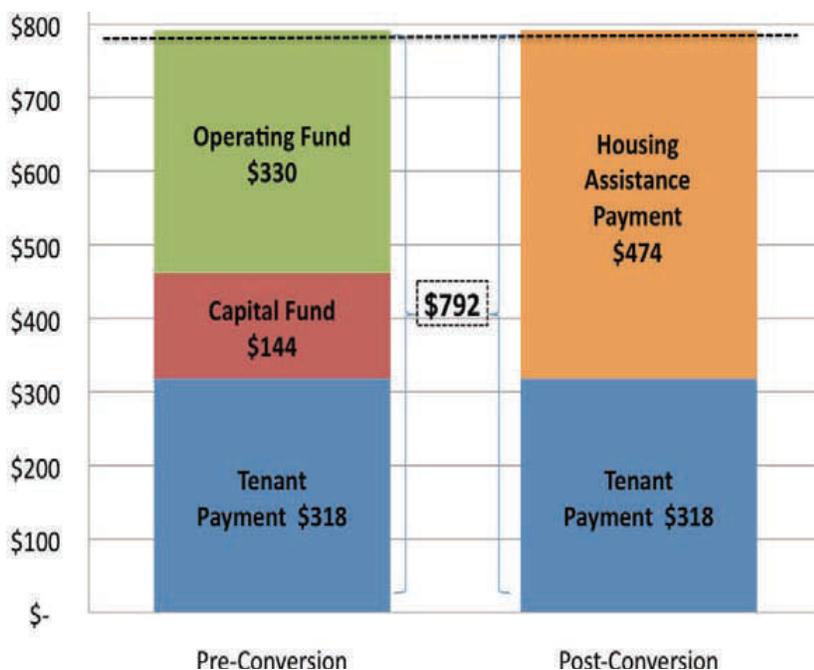
To aid in the reader’s soul-searching as to whether Public Housing Operating and Capital Assistance appropriations will be better or worse down the road, the charts on the following two pages are offered, with full attribution to the National Association of Housing and Redevelopment Officials (NAHRO) and its November 15, 2013, issue of the NAHRO Monitor:

A couple of things are striking about this chart. First, it becomes is obvious that the Operating Fund, so laboriously hammered out as part of an unprecedented Negotiated Rulemaking between HUD and the industry has been virtually avoiding asset management for the past decade and then some. Despite the fact that the Operating Fund Formula is intended to compute the amount of operating subsidy as it is a sad fact that Con-

gress appropriates only a fraction of the amount calculated by the very formula it mandated Act of 1998. This phenomenon has come to be known as “pro-ration,” and the term has, alas, become commonplace within the public housing industry.

It is illustrated graphically by the visual “gap” between the blue and the red trend lines. Second, whether in 2014 the House or the Senate prevails, or the Senate, or both houses again rely on a Continuing Resolution (CR), at best actual appropriations will be where they were four years ago. The volatility within the Capital Fund arena is no less dramatic and capricious. Here too Congress appropriates without regard to its own mandated

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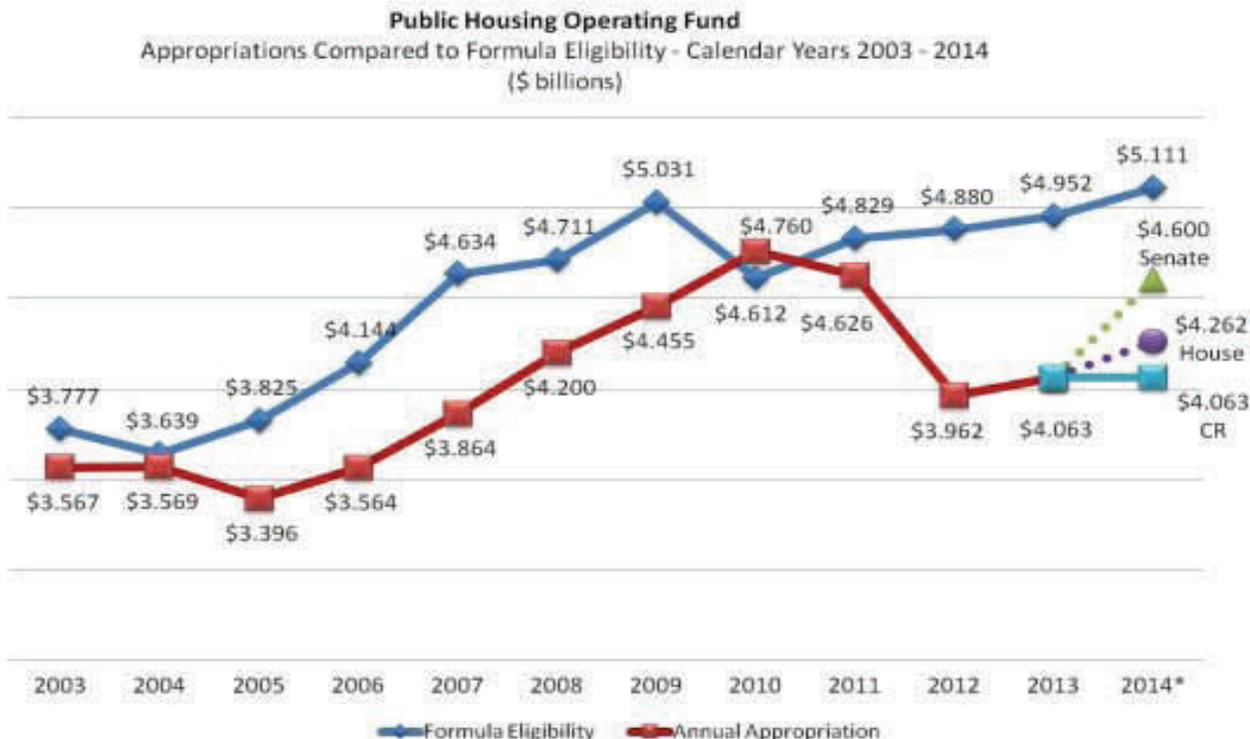
Capital Fund Formula, also a function of a Negotiated Rulemaking that in hindsight could make one cynical were that not already the case. The following chart is also provided compliments of NAHRO and its November 15, 2013, issue of the NAHRO Monitor.

Although the objective of the Capital Fund Formula is to compute each public housing property's share of the overall Capital Fund appropriation, it is evident to me and many other industry practitioners that the legislative intent was to enable the Congress to appropriate amounts that would not only keep up with newly-accruing capital needs of existing properties but also begin to attack the backlog of capital needs that most observers HUD-funded studies tally in the tens of billions of dollars. Begging the question of whether the bulk of backlogged needs are resident within the only "Ugly" properties discussed above, it is clear that the

actual level of appropriated Capital Funds is far below the level needed just to keep up with ongoing accruals. The latter is illustrated via the red trend line above, a result of the nationwide Capital Needs Assessment that HUD commissioned in 2010, that estimated annual accrual of new capital needs at \$3.4 billion per year.

Before moving on to the next category of property in the bell curve discussed above, we should acknowledge that, once deciding on a RAD conversion, the next hard decision will be which RAD option to choose, e.g., HUD Multi-family's Project Based Rental Assistance (PRBA) program or via the RAD Project-Based Voucher option. In the September/October issue of NAHRO's Journal of Housing, Rod Solomon (former HUD official and now an attorney at Hawkins Delafield and Wood LLP) penned an article entitled, "The 2013 Public Housing Investment Update." He acknowledged that each RAD option has advantages.

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“PHAs generally had more experience with PBV and the program structure allows the PHA to administer the subsidy and earn an administrative fee.” Voucher renewal appropriations, however, have been shakier historically than PBRA appropriations—for 2013, a funding pro-ration of 94 percent of voucher needs versus full funding for PBRA.

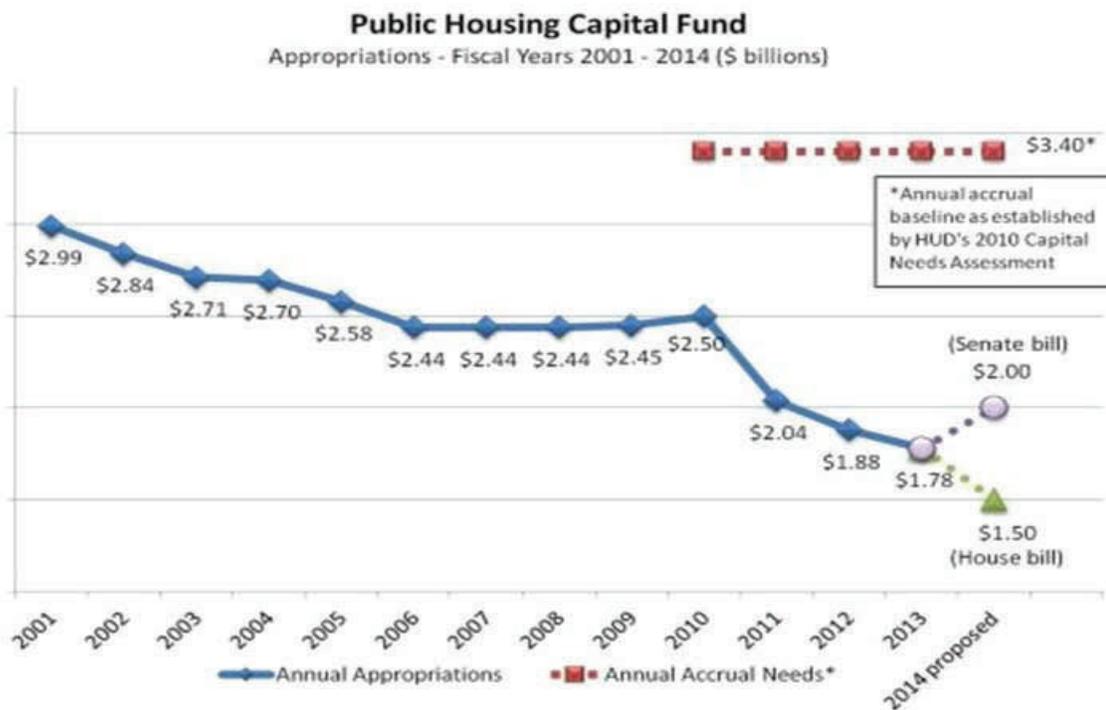
Recent voucher appropriations are depicted below, compliments of NAHRO and its November 15, 2013, issue of the NAHRO Monitor:

It is evident that the word “pro-ration” has also entered the Voucher lexicon, albeit at less severely-reduced levels compared to public housing appropriations. Nonetheless, the stability of appropriations under the selected RAD option must be taken into account when the time comes to make that crucial decision.

“Ugly” Properties (demolition and/or redevelopment needed). This category of property was defined

above as properties that do NOT serve the organizational Mission, that are viewed as “housing of last resort,” that typically run in the red, and for which there are no realistic strategies for improving physical and/or social conditions and removing the stigma that is usually associated with these types of properties. For many years a “one-for-one replacement” requirement – together with lack of resources – forced the industry to generally grin and bear it and struggle to maintain the difficult such properties within their mixed portfolios. With the 1998 passage of the Quality Housing and Work Responsibility Act (QHWRA), a promising set of tools evolved for the removal of public housing inventory. Many obsolete and distressed properties that were not able to win grant awards were able to be demolished upon approval of an application by Special Applications Center (SAC). A number of incentives evolved in the Portfolio Transformation tool-box to catalyze demolition and replacement for PHA proper-

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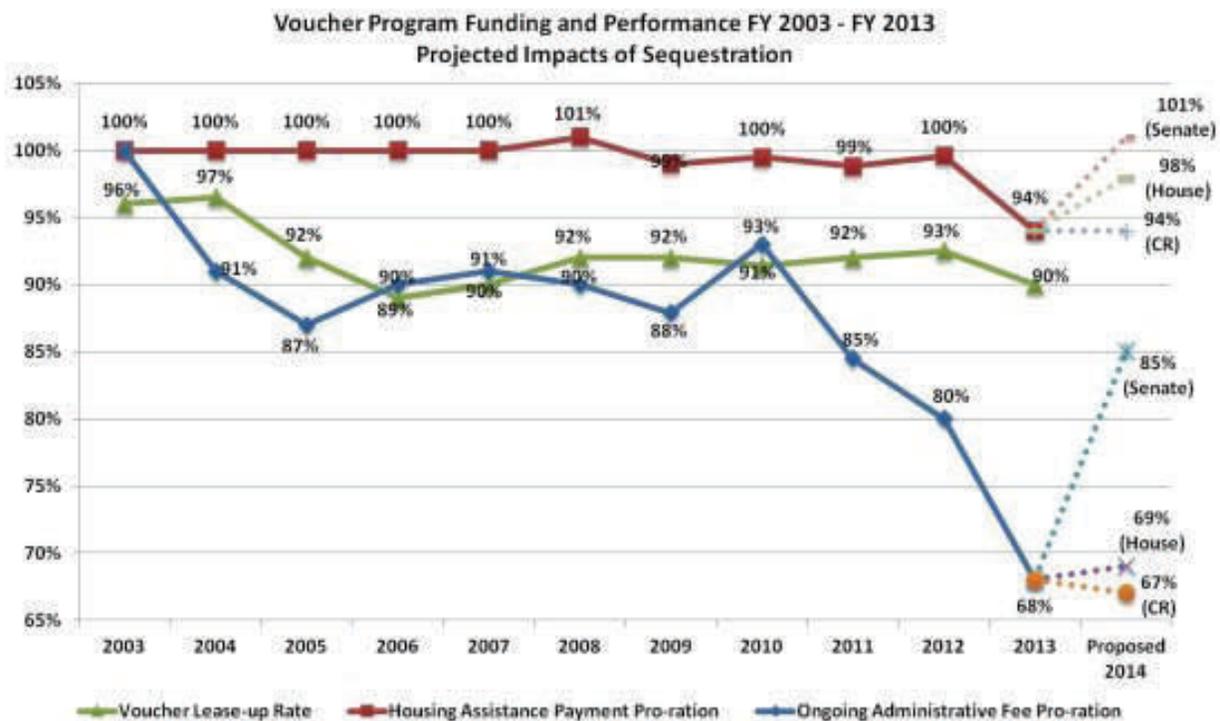
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ties. Besides the provision of a five-year Replacement Housing Factor flow of funds under the Capital Fund Formula, or a ten-year flow if one could promise HUD a leveraged (“Mixed-Finance”) deal, there also evolved the ability to obtain Tenant Protection Vouchers (TPVs) upon SAC approval of a demolition or disposition. It has been a long, long, time since PHAs were able to obtain new Housing Choice Voucher allocations, via any method other than SAC approval of a demolition/disposition application (“DDA”). Since the dollar value of TPVs, under a 15- or 20-year Housing Assistance Payments (HAP) contract is immense, and since RAD removes inventory outside of this regulation and therefore cannot grant TPVs for units being lost via RAD, the question “To RAD or Not to RAD”

becomes more difficult to answer for properties that can potentially obtain a SAC approval.

As an example, consider the medium-sized PHA shown in the photo on the next page that recently wrestled with this very question for 45 units of a 64-unit Asset Management Project (“AMP”). These are two-story red brick barracks-type buildings constructed in 1955. Estimates show that the property meets HUD’s criteria for approving demolition: “no reasonable program of modifications is cost-effective to return the public housing project or portion of the project to useful life.....” This is defined as modifications exceeding 57.14% of HUD’s Total Development Cost (TDC) benchmarks for non-elevator buildings.³ Note that the RAD Rents for these units (based on current Operating and Capital Fund subsidization) are \$429 (2-BRs) and

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\$575 (3-BRs) respectively. By contrast, the payment standards for Tenant Protection Vouchers (TPVs) for which the PHA could apply (upon SAC approval) are \$563 (2-BRs) and \$754 (3-BRs). When one crunches the numbers for properties for whom TPVs are potentially approvable, it is not simply a matter of calculating the differences between the RAD Rents and Fair Market Rent-based payment standards. We are talking upwards of 45 new vouchers whose value pencils out as follows, on top of the Operating Fund and Capital Fund subsidies the existing units would bring if they were re-introduced into the Annual Contributions Contract (ACC) as part of a traditional Mixed-Finance deal. The 20-year value of TPVs as shown in the table below, is immense.

Professionally speaking, I advised this client to

take the \$7 million and run (towards a traditional Mixed-Finance deal). It's just too much money to leave on the table.

On the other hand, this strategy may not work if the TPVs appropriated in a given fiscal year have been grabbed up by other PHAs since they are offered on a first-come, first-served basis. Also, HUD sources tell us that the Department is (as we speak) now actively considering policy revisions such that TPVs may no longer be automatic, but instead tied to imminent health/safety issues affecting residents of properties approved for demolition/disposition. Since the most coveted form of FMR-based assistance are TPVs or other vouchers that can be project-based, other factors to consider include whether the PHA in question is approaching the 20% cap on total number of vouchers in its pool that may be project-based under Part 983 of

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Bedroom Size	Number of Units	Monthly Pay Stds.	20-Year Value
2	22	\$563	\$2,972,640
3	23	\$754	\$4,162,080
Totals:	45		\$7,134,720

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the HUD regulations. Also, can the project meet HUD's income-mixing requirement (or satisfy the exceptions) provided therein?

If the PHA is indeed approaching its 20% cap, a related question is whether the rehabbed or redeveloped property could attract and retain enough tenant-based vouchers to provide the kind of revenue stream needed to make the deal work long-term.

If these conditions begin to make the traditional SAC-approval-leading-to-TPVs-leading to-traditional-Mixed-Finance-deal look less attractive, we should take heed that RAD is asserting its ability to transfer assistance from an obsolete property to a brand new property being constructed as replacement housing. HUD Multifamily historically has had two sources of statutory authority to do this, although it is by no means a commonplace occurrence.

This holds promise that the concept of obsolescence may yet become operative within HUD's PBRA world as it has within public housing. This means that RAD should not be counted out as a means of dealing with high-dollar "ugly" obsolete properties that can't obtain a better deal under the more traditional SAC-approval-leading-to-TPVs-leading to-traditional-Mixed-Finance-deal, for any or all of the reasons cited above.

Intriguing Properties (somewhere in the middle, still succeeding but at risk of eventual failure, and needing some creative real estate strategy). Again, we are begging the question as to whether in fact this category of property is the most commonplace, as implied by the Bell Curve shown previously. As anecdotal experience, after 41 years of working at, or consulting for, PHAs indicates this may be the case, but what. What is important here is to determine whether RAD is the right course of action for this category of property.

Let us define this category of property in light of the previous discussion. These are properties that are

not necessarily "Bad" but they engender the most anxiety in terms of what to do and how to do it. Their owners may disagree as to whether these assets are serving the Mission, and whether and how they can be "fixed," both physically and in terms of market acceptance. They might be breaking even, or turning a small surplus, but the trend-lines may be pointing in the wrong direction, such as increasing vacancies and/or turnover, decreasing revenues, increasing expenses, and ballooning capital needs that have begun to exceed what the property "earns" under the Capital Fund Formula.

One final operational definition: Assume for purposes of discussion that this category of property does not meet HUD's criterion for the approval of demolition or disposition. In other words, assume that the level of expenditure needed to "return the public housing project or portion of the project to useful life...." does not exceed 57.14% of HUD's Total Development Cost (TDC) benchmarks for non-elevator buildings. For specific PHA, this means no more than \$104,215 per unit for a 2-BR row house unit (based on \$182,386 x 57.14%) and \$127,684 per unit for a 3-BR row house unit (based on \$223,459 x 57.14%). In very round numbers, we're talking five-figure dollars per unit vs. six-figure dollars per unit. In very round numbers, units needing \$100,000+ in fixes are NOT in this "Intriguing" category. Those are "Ugly" numbers. Part of what makes a property "intriguing" is if it could be fixed for upward of, say, \$50,000 per unit.

RAD and its predecessor programs foresaw at least a portion of this category of properties when they envisioned meeting the backlogged capital needs of many thousands of units solely through a conventional or insured first mortgage made possible by the cash flow generated via RAD or predecessor rents. In very round numbers these are units needing, approximately thirty thousand dollars per unit. In most markets, this is new roofs, new windows, perhaps new HVAC but certainly not new kitchens, bathrooms, and unit finishes. What

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can be financed with these kinds of dollars will vary greatly from region to region and market to market, but suffice it to say this will probably not include unit re-configuration to provide a better mix of unit sizes, (such as eliminating studios and larger units in favor of 1- and 2-BR units) nor major wall and roof work.

Since those early days In response, the HUD staff has become much more savvy with regard to the blending of 4% Low-Income Housing Tax Credits (LIHTC) and in some cases 9% LIHTC into such deals, and in . In fact the RAD staff now has the authority to approve Financing Plans, authorize de-facto dispositions and approve transaction closings for units needing a combination of LIHTC, and hard or soft debt to meet capital needs on the order of high five-figures, say, \$50,000 per unit. Scopes of work for these transactions are indeed likely to include new kitchens, bathrooms, and unit finishes in addition to new roofs, windows, HVAC, perhaps some unit reconfiguration, and a range of energy-efficient capital improvements.

Given the recent SAC changes where public housing inventory removals either demolition or disposition can only be approved when the 57.14% cost test is failed,⁴ as part of SAC's effort to focus the process on addressing high-capital needs properties that could pose a risk to the continued well-being of tenants, and given the necessity to change legal ownership (read: disposition) when structuring LIHTC, the author has reached the following conclusions about this "intriguing" category of properties:

- If the property can meet its capital needs by structuring only a conventional or insured first mortgage (say, \$30,000 per unit) then the PHA owner will have to engage in all sorts of analysis and angst only as to whether it wants to retain ownership of these properties and saddle them with long-term debt only to remain within the regular PHA financing program and avoid RAD; or

- If the property needs the additional capital made possible by 4% or 9% LIHTC (but a disposition is required and therefore a HUD approval to do so) or wishes to go this route in lieu of use LIHTC to reduce or eliminate hard debt, it appears that RAD is the ONLY way to make this happen. Why? Because HUD approval of a disposition is required for LIHTC and the only other unit within HUD with that kind of authority (SAC) says these lower-dollar transactions no longer mesh with their policies.

To sum up, you may recall the initial working hypothesis: RAD is the best, and in some cases, ONLY strategy for most PHAs wishing to redevelop, rehabilitate and/or refinance existing assets. After completing the analysis embodied within this article, the author believes the working hypothesis is overly strong, and therefore refuted. In its place, the author posits an alternative

Conclusion: Each multifamily real estate asset (apartment complex) must be analyzed on its own, as to its unique attributes, needs, and potential, within the context of its market (existing and potential) and the organizational Mission of its owner, in order for the optimal Property Strategy to emerge for that unique asset. Many will say, "what a copout!" To which the author responds, "for my clients, the question "to RAD or not to RAD?" is perhaps the paramount question of the day, and. Remember RAD is not all-or-nothing. Rather, it must be answered property-by-property."

My gut tells me RAD will become the wave of the future, a future outside of regular PHA financing . And this author will urge his clients to consider RAD carefully, and frankly anticipates a future where RAD becomes the rule and not the exception (e.g., when anomalies like Tenant Protection Vouchers can be obtained)..

We also urge this august publication to continue its series on RAD, including in future a case-by-case assessment of what "Life under RAD" really means,

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once the initial RAD conversions going on as we speak have been fully consummated.

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thorities in forming or invigorating their own instrumentalities that serve as the developers in mixed-finance deals. This enables the instrumentality and its parent to reap the rewards of developer fee and cash flow, while retaining control over design, construction, and management. *Housing-Solutions* member firms are active in exploring and promoting affordable housing policies and initiatives that enable housing authorities to meet a public-spirited mission while thriving in the local affordable housing marketplace. Mr. Mobley may be contacted at Dennis.Mobley@Housing-Solutions.com.

Special thanks are owed GLN associate editor Peter Shanley of Phoenix Park Associates for the superb editing of this important paper—Ed.

Footnotes

[1] Translated: There are public housing properties whose share of subsidy per the complicated Operating Fund formula is unexpectedly high, and that (despite being, perhaps, World War II-era barracks generating high operating costs including high turnover) actually generate positive cash flow and serve as the proverbial "cash cow" even though they would never survive on their own in the "real" real estate market.

[2] The ability of a "Good" property to self-finance its long-term capital needs is not as implausible as it may sound. Capital needs experts such as Tom Nutt-Powell (President of Capital Needs Unlimited) use a rule of thumb of \$360 per unit per year as a target set-aside into a replacement reserve, as adequate for properties with typical capital needs backlogs and twenty-year accruals. The average Capital Funds grant per unit per year has historically attained a level of between \$1,000 and \$2,000 per unit per year, well above the benchmark.

[3] Citation is 24 CFR §970.15, Specific Criteria For HUD Approval Of Demolition Requests.

[4] Or 62.5% of total development cost benchmarks in the case of elevator units.