

NeighborWorks America Portfolio Strengthening Initiative

User Guide: Sustainability Analysis Report and Tool



COMPASS GROUP

Portfolio Strengthening Initiative: Guide to Reviewing, Understanding and Using the Sustainability Report and the Sustainability Tool

This Guide accompanies the portfolio summary report, and the property-based analysis tool, which have been created for your portfolio, by the NeighborWorks America Portfolio Strengthening Initiative (NREP-PS). These resources are based on your most recent year-end MF data submissions, and are intended to provide a framework for thinking about your properties' current financial condition, and the financial options and challenges of maneuvering them into long-term operational sustainability. The two resources, about which more detail is provided in this Guide, are as follows:

- Basic Analysis of Viability at Sustainable Reserve Level by NWO, provided as a single page PDF (henceforth we will refer to this as the "Report"); and,
- Portfolio Strengthening Analysis, provided as an Excel spreadsheet, with your property data loaded, and allowing you the opportunity to explore various scenarios for each property. Henceforth we will refer to this as the "Tool".

Any truly reliable analysis of sustainability will be based on recent, precise data, and will consider the myriad issues unique to each property, including its tenant population, mission, market, sponsor resources and capacity, and other considerations beyond the scope of this limited analysis. However, the outputs here should provide insights and a platform for further analysis and consideration by your asset management and executive leadership.

The Sustainability Principle

Too often, affordable properties have been developed that either:

- Sacrifice long-term sustainability for short-term viability by inadequately funding reserves; or,
- Reach for the mission goal of serving income levels beyond the financial capacity of the real estate.

We may say, "Yes, the property is paying its bills," but on deeper analysis, "No, there probably won't be enough to pay for long-term capital needs and the property will need some reinvestment eventually." The core of this exercise is to understand that the relationship between cash flow, debt and reserves forms a sustainable equation. We know that it is extremely difficult to increase rents on properties due to regulatory, market and mission conditions. So, the initial focus is to determine whether, after making a sustainable reserve deposit, the property still operates with a sufficient cushion. If so, it is 'Sustainable'. For purposes of both the Report and Tool, the following principles, standards and assumptions were used in the Report and Tool. Note that in the Tool, the standards below can be modified by the user to provide a more accurate picture (more on this later).

- Sustainable Reserve Deposit: This is the necessary reserve deposit for to ensure sufficient funds are available for the replacement of capital items, over the period of affordability. The correct amount would be established individually for a property, based on its actual needs, condition, and remaining period of affordability. For purposes of the Report, we relied upon an amount which was the greater of \$500 PUPA, or the amount being deposited (if we had such data). Eight

percent (8%) of properties had reserve deposits greater than \$500, which were used for the analysis; for the remainder we used \$500.

- **Sustainable Cushion:** To be determined to be Sustainable, a property had to produce cash flow—after accounting for the Sustainable Reserve Deposit—equal to the greater of (a) seven-percent (7%) of operating expenses (the “operating expense cushion”), or (b) a 1.15 Debt Service Coverage Ratio.
- **Refinanced Must-Pay Debt:** If the property couldn’t achieve a sustainable cushion with sustainable reserves, we explored whether a refinancing would help. We assumed that refinancings would use an interest rate of 7%, fully amortizing over thirty years. If the actual debt service was lower than the refinancing debt service, we relied upon the actual, lower debt service, and did not refinance (that is, doing so would result in more expensive debt, which was inconsistent with sustainability).¹

Report: Basic Analysis of Viability at Sustainable Reserve Level by NWO

Based on the Sustainability principles, and using the parameters and assumptions above, we defined five possible outcomes. These are as follows:

- **Inconsistent Loan Data**—We could not reconcile data showing a year-end 1st mortgage loan balance of greater than \$0 with data indicating debt service was equal to \$0. No further analysis could be performed on these; however, the Tool permits you to explore options on these properties with better data.
- **No Debt and Insufficient NOI:** These properties have no debt, and less than a sustainable operating expense cushion with sustainable reserves. Punchline: the solution is not refinancing (or additional capital), instead there is inadequate income relative to operating expenses. Revenue and subsidy will have to be the focus on these properties.
- **Sustainable Property: No Debt**—These properties have no debt, and have sufficient Net Operating Income (NOI) to fund Sustainable Reserves, and yield a Sustainable Operating Expense Cushion. The answer for these properties to increase reserves consistent with long-term sustainability (unless those reserves are already adequate).
- **Sustainable Property: Existing Debt**—With Sustainable Reserves, these properties can produce cash flow equal to the greater of a Sustainable DSCR or a Sustainable OpEx Cushion. Again, the answer for these properties to increase reserves consistent with long-term sustainability (unless those reserves are already adequate).
- **Simple Refi**—These properties are not sustainable as-is, but we calculate that they can refinance, and achieve sustainability (i.e., sustainable reserves and cushion). For these properties, the answer would be to refinance and increase reserves.

¹ If the debt service on the refinanced first mortgage was greater than the current debt service, this suggested that the property has probably refinanced recently, at a rate better than 7%.

- Workout with Additional Capital—These properties cannot produce both a Sustainable DSCR and a Sustainable OpEx Cushion, with Sustainable Reserves. Punchline: They can only be made sustainable through the investment of additional capital (or rent increases, which is discussed later as a feature of the Tool we have provided).

Guide to Columns in the Report:

The following provides a column-by-column explanation of the columns in the Report. Obvious columns are not discussed.

- Data Set < 12 Mo?—In most cases we had a full year of MFI data on which to perform the analysis. In some cases, however, we had partial-year data, and were forced to annualize it. We've denoted in the report ("Yes") the properties that have results based on annualized data.
- Current Reserve Deposit /U/Y—We acknowledge that there may be many properties that are making reserve deposits that are not shown here. If this is the case, our analysis may still be correct (remember, we use the larger of actual or \$500 for analysis purposes). Please use this as a reminder to ensure your MFI data is up-to-date.
- ANOI PUPA Current Reserves—Our calculation of the property's Adjusted (after current reserves) Net Operating Income. That is, Gross Potential Rents, less Rent Loss, less Operating Expenses, less Current Reserves.
- Sustainable Rsv Dep PUPA—The greater of \$500, or the actual reserve deposit from our data set.
- ANOI PUPA Sustainable Rsvs—this is ANOI, plus current reserves, less the sustainable reserve deposit. Put another way, this is what ANOI would be after paying sustainable reserve deposit.
- CF at Greater of Sustain OpEx Cushion or DSCR—We have calculated what the cash flow would be based on a 7% operating expense cushion and on a 1.15 DSCR, and we have applied the greater of these two as the required cushion.
- Supportable Debt Svc PUPA—ANOI at sustainable reserves, less cash flow at a sustainable cushion. This is, after accounting for long-term sustainability through reserves, and operating sustainability through cushion, the amount left for debt service.
- Actual Debt Service PUPA—the amount of actual debt service based on our data set.
- Equity (Gap) PER UNIT—various scenarios result, as follows:
 - If the supportable debt, as a sustainable property, is less than the current debt, the property falls into the category of 'Hard Debt, Requires Workout' (see above). The difference between the supportable debt and the current debt is shown as a gap. Note, if the ANOI is negative, the property has hard debt, and negative NOI. These properties not only need a workout to eliminate their debt, they need an operating subsidy.
 - If the supportable debt service is greater than the current debt service, the property can achieve Sustainability, still service its current debt, and is shown as category 'Hard Debt, Sustainable As-Is'. In some cases the existing debt is more efficient than the refinanced

debt at the assumed terms. In these cases, if the owner is forced to refinance, the deal is will have negative equity. Put otherwise: the deal is sustainable as-is, but if it refinanced, it would either have equity or a gap depending on the amount of current hard debt and the loan terms.

- If the supportable debt service is less than the current debt service, but with a refinancing (at the assumed terms) the property can pay off its current debt, then it is categorized as 'Hard Debt, Sustainable with Simple Refi', and the resulting equity from this refinance is shown.
- If ANOI is negative, after servicing a sustainable reserve deposit and sustainable cushion, then it is not sufficient to service any debt. These properties are categorized as 'No Hard Debt, Insufficient NOI' and require an operating subsidy to provide enough income to pay for sustainable reserves and cushion.
- If ANOI is positive and there is no hard debt, then the property is sustainable as-is, can service a sustainable reserve and cushion. The equity in the Equity (Gap) column is the amount of supportable debt that can be borrowed, in excess of the existing hard debt.

Portfolio Strengthening Analysis Tool (Excel)

Overview and Summary

The Report, provided as a PDF, has certain limitations. It provides the determinations discussed above, but does not permit you to either correct the data or revise the assumptions on which the analysis is based. Accordingly, we have created a Tool in Excel that allows you to select a property (each NWO's Tool is customized with a dataset of their own properties), refine/correct/update the relevant data for the analysis, and adjust the assumptions which define 'Sustainability'.

The Tool contains three worksheets. The following is a summary:

- Inputs—this worksheet allows you to select the property (pulling data from the 'Database' worksheet); modify the data inputs that drive the analysis (GPR, OpEx, Debt Service, etc.), and modify the assumptions concerning refinancing terms and cushion.
- Analysis—there are no user-inputs on this worksheet. It provides a 'report' on various sustainability options and scenarios.
- Database—This worksheet contains the key data from the model used to produce the Report (PDF). This is static, and is not user-modifiable.

Using the Tool

Start with the Inputs Worksheet. Note that this page is password protected to prevent inadvertent changes to the formulas (the user-modifiable data fields are not password protected). If you desire to change aspects of this worksheet, the password is " " (a single, blank character).

- Select a property from the drop-down menu, at Property (B5). The data fields under the headings 'Property Basics' and 'Current Property Revenues and Expenses (Per Year)' will autopopulate with data for the selected property from the Data Worksheet.
- Review the worksheet and adjust or update any data in the shaded boxes, if you have more accurate or current data.
- Review the 'Underwriting Assumptions' in the shaded boxes. You may run the Analysis on these variables, or you may overwrite these and input others. Note that these are the same Sustainability assumptions used in running the Basic Analysis of Viability at Sustainable Reserve Level by NOW Report (PDF).

Interpreting the Analysis

There are six scenarios (A-F), shown in columns. Each represents a different perspective and different options regarding the property's sustainability; each will be discussed below. For each scenario, there is a narrative at the bottom explaining the key determination.

A Note About 'GPR as a Percentage of AMI (Est)'

At the top row of each scenario, the rents for that scenario are expressed as a percentage of AMI. We were able to run this calculation based on the property's 2012 AMI, only if we had a full unit mix for the property. For other properties, this field will return as 'N/A'. Additionally, in order to perform this calculation, we assumed the following utility allowances: 0BR \$65, 1BR \$85, 2BR \$105, 3BR \$125, 4BR \$145, and 5BR \$165. If your utility allowances are generally higher, then your GPR is probably a higher percentage of AMI than is stated; if your allowances are lower, then the reverse is true.

If your GPR is 50% of AMI, this means that your rents are generally affordable to households at or above 50% AMI, but that households below 50% of AMI would probably be paying more than 30% of their income toward rent and utilities. This calculation is intended to aid in your overall considerations. A non-sustainable property may be addressed through refinancing, additional equity, a rent increase, or a combination of these approaches. By illustrating the affordability level of your rents, we hope to support your overall analysis.

Description and Explanation of Sustainability Scenarios

As discussed above, there are six scenarios, as follows:

- Scenario A: Current Operations—the current debt cover and operating expense cushion for the current operating scenario, with the current reserve deposit. The narrative will indicate: "(A) At current rents, with current reserves, DSCR is X.XX and cash flow is X.X% of operating expenses."
- Scenario B: Current Rents, Sustainable Reserves, No Refinancing—this illustrates how the property would operate if a sustainable reserve deposit (greater of current, actual from the dataset, or the amount entered on the Input Assumptions worksheet). To be Sustainable, the

property must achieve both the specified minimum DSCR and the minimum operating cushion. If one or both of these tests fail, it will be flagged with a yellow background. The narrative will state, *“(B) At current rents, with sustainable reserves, DSCR is X.XX and cash flow is X.X% of operating expenses.”*

- Scenario C: Minimum Rent for Sustainability in Scenario (B)—this scenario explores how much rent would have to change for Scenario B to be Sustainable. That is, if Scenario B is Sustainable, then rents could be reduced. If Scenario B is not Sustainable, then it indicates (at ‘GPR increase (decrease) versus current rents’) how much rents would have to increase to achieve both the indicated DSCR and Operating Expense Cushion. Note also, the ‘Rents as a Percentage of AMI’ will change. The supporting narrative for this scenario will read, *“(C) To achieve a cushion which is the greater of X.XX DSCR or X.XX% of operating expenses, with sustainable reserves and no refinancing, rents would have to [increase/decrease] X.X%.”*
- Scenario D: Current Rents, Sustainable Reserves, Refinancing—in some cases, refinanced hard debt will be less expensive than current debt service, and a refinancing may provide an avenue to sustainability. The Analysis will assume the lesser of current debt service or refinanced debt service (at the debt terms on the Input worksheet), and current rents, but does not consider transaction costs. The refinancing without a rent increase provides a viable option if both the Debt Service Coverage Ratio and Operating Expense Cushion can be achieved. If these are not, one or both will be shown with a yellow background. The narrative indicates, *“(D) With a refinancing*, and sustainable reserves, but no rent increase, the DSCR would be X.XX and the cash flow cushion would be X.X% of operating expenses.”*
- Scenario E: Minimum Rents for Sustainability in Scenario (D)—if sustainability cannot be achieved through refinancing alone, this scenario calculates the level of rent increase that would be necessary in addition to refinancing to achieve sustainability. Conversely, if the number is negative, this indicates that the property could be made sustainable with a refinancing, and reduce rents by this percentage of GPR. The narrative will state, *“(E) With a refinancing*, and sustainable reserves, a rent [increase/decrease] of X.XX% would achieve the greater of [the input sustainable] DSCR and [the input sustainable] operating expense cushion.”*
- Scenario F: Supportable Debt for Sustainability in Scenario (D)—if sustainability is not possible at current rents, with a refinancing, this means that the supportable debt is not sufficient to retire the current debt. In this case, there is an ‘equity gap’, requiring additional investment to achieve Sustainability. The narrative will read, *“(F) With no rent increase and sustainable reserves, and a refinancing* at the greater of [the input sustainable] DSCR and [the input sustainable] operating expense cushion, the property would [produce/require additional] equity of \$XXXX.”*

Conclusion

Please enjoy touring the Sustainability scenarios of your portfolio with this Tool. There will be a Webinar

in the near future to present these new resources, and respond to your questions. We may issue an FAQ document as an appendix to this Guide based on your input and questions.