How to Prepare a Supportive Housing Project Development Budget

Introduction

In projects that include building or developing new units of supportive housing, either through new construction or acquisition/rehabilitation, capital funding refers to costs associated with acquiring, creating and/or rehabilitating housing units. These costs sometimes are referred to as "bricks and mortar" costs.

The development budget is used to project the total capital requirements of the project. It provides a detailed analysis of all of the development costs — both hard (construction) and soft costs (all other project costs) — that will be incurred to complete the project. The generic components of the development budget are fairly constant across the country, but the terminology used to describe them sometimes varies. Even within the same locality different lenders, investors and government funders may use different descriptions. There are several considerations in preparing a development budget, including:

- Development costs vary greatly from place to place and from time to time (particularly construction costs)
- Funding sources determine the underwriting standards — the funding sources for the project will have their own requirements, which establish the methodology for projecting certain costs
- Every project is different; understand the details of the project, pay particular attention to acquisition costs, the allocation between residential and program space; unit configuration and size; construction methods, materials, amenities and site conditions
- Use actual costs or good comparables, when possible, since generic standards may not capture unique project features

Two important questions to ask in preparing or evaluating a development budget are:

1. Is the budget complete?

Does the budget include all of the costs that the developer/sponsor will incur to complete a fully operational project? This requires understanding the project in detail, including:

- Who is being housed? Does the project budget include all of the costs to ensure that proper unit configurations and amenities are provided for?
- The sources of financing and their requirements. For example, if lenders want appraisals, a marketing study, environmental studies, a relocation plan, etc., be sure these costs are included in the development budget.
- If non-residential functions will be included, are these costs included in the budget? And how will these costs be funded?
- The scale, site conditions and location may result in specific costs, such as the need for elevators if more than three stories; environmental cleanup, if the site was formerly a gas station or dry cleaner; or security during construction.
- The role of the project sponsor will impact your budget, as all of the costs associated with managing the project should be captured, whether in-house or via contractor.

Only by understanding these issues can you evaluate the completeness of the budget.

2. Is the budget accurate and reliable?

As a project nears construction, it becomes possible to refine cost projections and budgets. By the time a project has an identified site, preliminary funding commitments, and basic design, the development budget should be fairly refined. The key to a strong development budget is the use of reasonable and defensible underlying assumptions. The best numbers are actuals for that project (e.g., the architect's fee is based on the actual contracted fee; a construction cost is based on a contracted amount). If an actual cost is not available, then a cost based on recent comparable projects is useful. In the early stages of planning, a project will most likely need to use underwriting standards required by the funder(s) or widely used in the locality.

The following section describes the typical items found in a supportive housing development budget and provides guidance in preparing budgets. Note that when relevant, guidance on underwriting for Low-Income Housing Tax Credit equity has been included.

Development Costs and Cost Evaluation Approaches

Acquisition

For publicly owned property the acquisition cost is often a nominal amount (sometimes as low as $1 to evidence a sale versus a grant), or a per-unit cost (upon completion). Some agencies, such as HUD, can sell properties at below-market prices to non-profit sponsors. This can be determined by checking the policy of the agency that controls the site disposition.

With privately owned properties acquisition costs vary widely, and are generally negotiated prices based on market-value appraisals. Carrying costs for an interim ownership period (e.g., insurance, security and taxes) may be included here but should be broken out separately.

Tax Credits

Note that if the 4% acquisition credit is being used, equity investors will only accept the value supported by a qualified appraisal. The appraisal should separate out the land and building values, as only the building value is depreciable and can be included in "basis." "Basis" is the project costs that are subject to depreciation — like construction, appliances and traditional soft costs (e.g., professional fees).

Basic Construction

Ideally, a general contractor or cost estimator should prepare this estimate based on recent comparable projects. The projected construction cost should be compared on a per-unit and/or per-square-foot basis to recent projects similar in scope, scale specifications and location. The construction cost should include contractor's profit and overhead, and general conditions. It should not include a contingency, unless a funder disallows a separate contingency, in which case it can be wrapped into total construction cost. (See below). Verify that the contractor's price reflects the insurance and performance guaranties (e.g., bonding or letter of credit) required by the financing sources. Make certain that you have determined whether the federal Davis-Bacon Act or state prevailing wage rates apply, and that the estimate reflects this. Most federally funded rehabilitation or new construction projects that are eight units or more will fall under the Davis-Bacon Act. In these cases, the construction costs must reflect the current union wages, which generally increases costs. Independent of Davis-Bacon, some states and/or cities may have their own prevailing wage requirements.

Tax Credits
Check the equity investor's general contractor's contract and insurance requirements to ensure that the cost reflects all of their requirements (e.g., letter of credit or performance bond, asbestos removal, and penalties for delays).

Construction Contingency
Depending on the underwriting standards of the funding agency, a separate construction contingency may be allowed. Please note that CSH strongly discourages the use of moderate rehab, since it can have many more surprises than new construction or substantial rehab, and often does not provide for a 15-year useful life (something that may concern long-term lenders). This can be mitigated by obtaining a "Physical Needs Assessment," which may indicate that only a moderate level of rehab is needed. If the project involves rehabilitation, and demolition has already been completed, a 5% contingency can generally be used since hidden conditions (such as dry rot, mold, beam replacement) should have been exposed during demolition. Note that some agencies will use a "project contingency," which includes both hard and soft cost contingencies.

Engineering/Test Borings
Test borings generally apply only to new construction, where deep holes are drilled to determine the subsurface conditions (e.g., the presence of shale or other unstable conditions) and the soil type, in order to properly design the foundations and structural system. Civil engineers usually conduct these tests. Some architects will specify more test borings than standard in order to get a more reliable picture of subsurface conditions (particularly when there is a reason to expect problems/issues). In this case, the budget should allow for a higher cost, since the price is largely a function of the number of borings drilled.

A structural engineer may be used in the case of rehabilitation in which there are concerns about the structural integrity of the site. This evaluation and report can be charged to this budget line. (It also may be included in the scope of services that the structural engineer provides to the architect.)

Architect's Fee/Consultant's Fee
The architect's fee is almost always based on a percentage of basic construction cost (not including contingency). The fee may be set by the underwriting standards of the funding agency, or may be negotiated between the sponsor and the project architect. Check with the funding agencies to determine their approach. In principal, the fee should be based on a sliding scale, in which the larger the scale, the lower the percentage fee. Some agencies will provide charts with the scale thresholds and percentages.

The architect will retain one or more consultants to provide specialized services in connection with the design and construction of the project. There almost always will be a structural engineer, and a mechanical/electrical engineer, but there may be others used as well. Make sure that all professional fees related to design and construction oversight is included on this line, or elsewhere in the budget.

The fee is sometimes broken into two phases — design and construction — and the architect's contract will assign the fee to specific phases (e.g., schematic design, design development, construction documents, contract negotiations/bidding and construction oversight).

Tax Credits
Check the equity investor's and lenders' requirements for architects, including the architect's certification and insurance requirements to ensure that the fee reflects their requirements. It is especially important that the architect's "errors and omissions" insurance levels meet the equity investor's requirements.

Construction Management Fee
Some sponsors prefer to use a construction manager to monitor construction rather than the project architect. This cost is usually negotiated on a flat-fee basis. Rates will vary widely from region to region, so it is best to check with local funding agencies to compare costs. If a construction manager is used in lieu of an architect, the architect's construction period fee should be adjusted accordingly. The exact scope of services should be reviewed to make sure that there is no overlap or duplication that results in inefficiencies or additional costs.

Note: The term construction manager has a specific meaning in the construction industry — a firm that carries out a construction project on behalf of an owner for a fee based on a percentage of the value of the contracts with all required subcontractors, who, in turn, contracts directly with the owner. By comparison, a general contractor hires all of the subcontractors, and the owner, in turn, contracts with a single general contracting firm for all services. Very sophisticated owners for commercial projects generally use the construction management approach. (Most affordable housing projects use general contractors.)

Construction Period Insurance
This line is for builder's risk and liability insurance for the owner during the construction period. Rates vary significantly based on such factors as the location of the project (fire and crime rates), building type and condition, and the extent of rehabilitation. Since this is a particularly volatile cost, as industry rates and underwriting are always changing, it is recommended that the cost be based on an experienced broker's quote or estimate. Note that the general contractor should have their own insurance policy that is included in their contract, not funded from this budget line.

Tax Credits
Check the equity investor's insurance requirements for sponsor's insurance, and make sure that the quote includes all required types and levels of insurance.

Construction Period Water/Sewer

While there is typically no water or sewer use during construction, many municipalities will charge a flat fee based on the size of the building's frontage. This "frontage charge" may be included in the real estate tax bill or billed by a public works department. Some municipalities will waive this charge during construction, so try to determine their policy. Some localities do not have separate water/sewer charges, but include the costs in the real estate tax charges.

Construction Loan Interest and Fees

Private bank construction lenders, and some public lenders, will charge interest on their construction loan for the projected term of construction (typically 12 to 18 months). Ask the lender what their assumptions are on the interest rate, loan term, and loan drawdown schedule, and whether an interest reserve is included in the calculation.

A simple way to evaluate this cost is to assume level draw-downs, and factor the annual interest rate by the loan amount times 50%, and prorate for the number of years in the construction term (annual interest rate x loan amount x .5 x years in construction term). This ballpark interest cost will help gauge the amount that needs to be budgeted. An interest reserve may be separately budgeted, and is available to pay interest in the event of construction delays.

There also may be interest costs from bridge financing provided by CSH or other non-profit lenders. These costs are generally included in mortgages, and should be estimated for the development budget.

Private Lender's Fees

Private Lender's Fees generally include the costs of:

- Commitment fee — The bank guaranteeing the future availability of the undisbursed loan amount, usually a percentage of the mortgage amount
- Application fee — Submitting the application and demonstrating good-faith
- Lender architect/engineer —The bank hiring experts to review plans and monitor construction
- Lender legal — The bank hiring experts to review documents and represent them at closing
- Appraisal—Obtaining an appraisal, see below
- Environmental report—Obtaininng a "Phase 1" environmental report, see below.

When the private lender is also providing permanent financing, they also may charge some of the following fees:

- Mortgage insurance fee (usually only applies to permanent loan in which loan is sold on the secondary mortgage market, or sold as bonds to investors);
- Permanent conversion fee, for the cost of converting the loan from construction to permanent.

Check with the lender to determine whether these costs have been properly estimated. Lenders may be reluctant to estimate legal fees, since they are difficult to project. Some of these fees may be negotiable, and can be reduced or waived, particularly the commitment fee. Ensure that the lender knows that the project provides Community Reinvestment Act (CRA) credit, and that this is considered in setting the fees.

Public Lender Fees
In some localities, public lenders may charge commitment fees, legal fees, review and processing fees, and other charges that need to be included in the development budget. Sometimes these are charged only when the project is syndicated, and the costs are then charged against equity proceeds. These fees are quite variable, so check with the funding agencies to determine the applicable costs.

Furniture and Equipment
In supportive housing, units are often rented completely furnished. This line includes furnishings for the tenants' units (e.g., bed, dresser, chair, dining table and reading lamp), common areas (e.g., lounges/kitchen) and staff offices.

Look to recent comparably furnished projects to gauge these costs. Alternatively, you may want to have the project architect specify and price these items. Make sure that this cost is budgeted, as many funding agencies that have not financed supportive housing are not accustomed to paying furnishings and equipment costs.

This budget line should include the cost of office equipment, office furnishings (for any on-site staff), recreational equipment, outdoor furniture and furnishings for any common areas such as a meeting room. Compare these costs to comparable projects, or ask the project architect to evaluate.

Some of these items may be donated, but make sure that this is realistic and reliable before accepting this assumption. Also, in some localities, these costs are funded as start-up costs and included in operating or services contracts. If this is the case, do not apply the costs to the development budget.

Title and Recording Fees
This refers to the cost of a title search (to make sure that there is clear unencumbered ownership), title insurance (to insure against future claims against the title, such as outstanding liens or mortgages) and mortgage recording tax (the cost to record the loan and deed with the municipality). It is best to verify these costs with the project attorney, who can estimate the cost or contact their title company for an estimate. Verify that all relevant costs are included.

Appraisal

Real estate appraisals are needed if the lender requires one (all banks will, but many public agencies will not, especially if the site is publicly owned), or if the agency administering tax credits requires one. If one of the funding sources does not require an appraisal, you may want to order one, for the purpose of negotiating private real estate transactions. The cost of full appraisals will vary depending on the complexity of the task. Private lenders should be able to provide reliable estimates on the local cost of an appraisal. Limited appraisals or letters of value, which conduct the same analysis as full appraisals, but limit their narrative description, may be acceptable to the lender and can usually be obtained for less, though public funders do not allow them.

The appraisal should meet all of the requirements of potential lenders, governmental agencies and tax credit agencies likely to be involved in the project.

Tax Credits

An appraisal is required if the project is claiming the "acquisition credit" of the Low-Income Housing Tax Credits Program. This will become the method for establishing the "building value," which is included in basis.

Market Study

Market studies are only necessary if the lender or tax credit agency requires them in their application. Public funders are increasingly requiring market studies, since they will not necessarily assume a market for all projects, particularly those with little or no rental subsidy. Banks generally do not request formal market studies, unless the project is an untested model, which may be the case for supportive housing in some cities or neighborhoods.

Tax Credits

Equity investors are likely to request market studies for supportive housing projects in untested markets or when unsubsidized units are included.

Property Surveys

Professional surveyors establish the exact boundaries of the site through terminal points and degrees of latitude and longitude. The "metes and bounds" description is the narrative form survey used for legal descriptions (e.g., deed document), and the survey map is provided for legal and architectural uses. The cost of the survey can be verified with the project attorney, architect or directly with the surveyor. The architect also may help in soliciting proposals from surveyors.

Real Estate Taxes (during construction)

Real estate taxes during construction should be assessed at the preconstruction levels (not the completed value). In some jurisdictions where tax abatements are available, you may be able to get the taxes waived during construction. Or taxes may be charged for an initial period (e.g., six months) before the abatement filing takes effect. Check with the local department of finance or housing development agency to determine the amount of taxes and the policies for abatement or exemption programs. Consult the project attorney if there is any question regarding the project's eligibility for tax abatement or exemption programs.

Tax Credits
Tax exemption programs, which are only available to non-profit organizations, may not apply to tax credit projects, since they are owned by for-profit partnerships.

Environmental Study
Virtually all projects will be required by their lenders to have “Phase 1” environmental reports prepared. This preliminary report examines public records and conducts limited on-site analysis to determine whether there is any indication of environmental concerns (e.g., prior use as a gas station or dry cleaners). Make sure to solicit at least three bids since the prices can vary widely.

If the Phase 1 report indicates serious concerns, a Phase 2 report will likely be required, which investigates conditions more fully (e.g., more extensive asbestos or soil testing, or identifying underground storage tanks). This report should not be budgeted unless the need for one is fairly certain (i.e., the sponsor knows up front that the prior use caused contamination). In the event that a Phase 2 report indicates the need for addressing environmental conditions (e.g., removal of storage tanks), the additional remediation costs should be included in the construction budget under “site preparation cost.” If the project budget is already locked in, this would be considered a construction contingency cost. Investigation and remediation of environmental hazards is highly regulated and complex. It is essential that the sponsor retain experienced consultants that are acceptable to all parties involved.

Tax Credits
Most equity investors will require Phase 1 reports for all projects. Check their specific requirements to make certain that the environmental consultant has abided by their guidelines. Investors must review the firm’s qualifications, if they are not already pre-qualified, and determine whether they are acceptable. The report is usually issued to investors as well as the sponsor/developer.

Accounting/Post Construction Audit/Cost Certification
This generally applies to tax credit projects, in which an accountant must initially review development costs (to confirm basis assumptions), and when all development costs must be audited and certified at the end of construction. Sponsors may include this accounting cost in their agency’s operating budget rather than charging to the project, so it may not show up as a development cost. Check with local lenders or equity investors to determine what is considered reasonable.

Legal: Transaction & Organizational
This refers to the legal work for the real estate transaction (acquisition of property), project financing and organizational issues (e.g., creating a new corporation to own the property). If pro bono or reduced rate legal assistance is available, it should be reflected in the budget. A caveat on pro bono legal is that the attorneys may not be as responsive as paid legal assistance, and this should be considered if time is of the essence. This fee should be capped if possible, since the legal costs could easily exceed the projected cost if unanticipated legal issues are encountered. Local

lenders will generally provide maximum fees for this item, and they should be consulted when preparing the budget.

Syndication

Legal services related to the syndication of the project under the Low-Income Housing Tax Credits Program are covered in this budget line. The scope of services can be gleaned from the equity investor's closing checklist. Again, fees should be capped, as the syndication closing can incur substantially more time than originally projected if issues are encountered. The equity investor or other non-profit sponsors can advise you on typical fees in your locality.

Consulting Fees

Housing development consultants (or "developers," in some locales) are consultants who perform a variety of tasks depending upon the project, the financing and the sponsor's capacity and development team. Typical services include project planning, financial packaging and funding applications, and management of the development team. This cost varies widely depending upon the scope of services, complexity of project. Check with local lenders, especially city and state housing development agencies to determine expected costs.

Marketing and Leasing

This includes costs related to marketing and leasing the project to prospective tenants, including advertising in local newspapers, outreach to prospective tenants, staff costs for interviewing, screening and selecting tenants and the costs of leasing the units. A budget from the sponsor, detailing expected marketing/leasing expenses, should back up this cost. Certain government funding sources mandate specific procedures for outreach and selection. Make sure that the sponsor's marketing plan addresses all funder requirements.

Operating Reserve

Not all of your funders will be willing to capitalize operating reserves. On non-syndicated projects, an operating reserve is typically funded through the maintenance and *operating* budget rather than capitalized through the *development* budget. Make certain that an operating reserve is budgeted in the maintenance and operating budget if it is not capitalized in the development budget. And remember, it is not in the sponsor's interest to allow the reserves to be set too low, as this is the operating cushion against shortfalls.

Tax Credits

The operating reserve is capitalized in the development budget on syndicated projects, since investors want to know that the reserve will be available and not subject to operating performance. The amount of the reserve is typically sized based on equity investor's projections

Make sure that the investor's underwriting assumptions for capitalized operating reserves is consistent with the allocating agency's standards. Otherwise, the agency may disallow some of the operating reserve required by the investors.

The deficit resulting from this projection over 15 years (the investment period), less interest earned, is capitalized in the development budget. The amount of reserve varies widely among projects, depending on the availability and terms of rental subsidies and the project's operating expenses. Rely on the equity investor's projections for this budget item, since they include interest rate and pay-in schedule assumptions.

Soft Cost Contingency

A soft cost contingency covers unanticipated soft costs or higher than projected costs (e.g., construction period insurance — one of the more volatile costs). All projects should have this budgeted, even if the funding source's underwriting doesn't include it. Some funders are reluctant to allow this line in the budget. The amount of this contingency is a function of the stage of the project's development and the reliability of projections.

Developer Fee

The developer fee compensates the non-profit sponsor for the costs of developing the project (e.g., executive director's time, project management and fiscal staff) and, in theory, the risk of sponsorship. These funds are unrestricted and can be used by the organization for project-related costs (e.g., owner upgrades) or for other organizational purposes, though they also are often used to cover unanticipated development costs.

Tax Credits

State credit agencies (and city credit agencies, if this applies in your locality) generally have their own developer's fee policy for non-profit sponsors that sets maximum fees (per unit or as a percent of the total development cost). Check the state or city credit agency's policy for guidance on budgeting this cost.

Note: Since the developer's fee is "basis eligible," some equity investors may accept a higher fee that includes a "social services reserve" as a way of increasing equity.

Lease-Up Reserve

This reserve funds losses in expected income in the phase of the project, sometimes called "rent up", before all of the units are fully occupied. It also covers losses related to delays in receiving anticipated rental subsidies. This is a real cost, unless an operating contract covers these losses, and should be adequately budgeted. Typical reserve levels are based on 1.25 month's net rental income.

Costs Specific to Low-Income Housing Tax Credit Projects

There are several development costs that only apply to projects that are being syndicated through the Low-Income Housing Tax Credits Program:

Application Fee/Reservation/Compliance
State credit agencies may charge an application fee for the tax credit allocation request. The agencies may also charge a fee for reserving credits for the project, usually based on a percent of the annual allocation amount. Since state credit agencies are responsible for monitoring compliance with the IRS standards (i.e., income qualification), they also may charge a fee for monitoring. This fee can be capitalized in the development budget, or more typically, paid out as an annual operating cost. Check with the state credit agency to verify these costs, which are usually not significant.

Partnership Publication
This refers to the cost of publishing the announcement of the limited partnership formation (as required by securities laws) in the required publications (e.g., law journals). The project attorney, who generally takes responsibility for this publication requirement, can verify this cost.

Partnership Management Fee
This fee compensates the general partner (subsidiary of the non-profit sponsor) for the required reporting to the limited partners during the construction term.

Social Services Reserve
This reserve is intended to cushion the project against the potential reduction or loss of social services funding over the 15-year partnership compliance term. There is no universal rule for sizing this reserve, and it is often set at the amount of “surplus” tax credit proceeds after other required costs are funded. This cost needs to be carefully considered. Also consider the fiscal environment and the amount of cushioning already in the services budget. Equity investors will probably not accept assurances from services funders that are committed to services funding long-term, since they are almost always subject to annual appropriations. This reserve can also be established in a non-tax credit project.

Tax Opinion
An attorney qualified by the equity investor must render an opinion that the project meets the IRS code requirements under the Low-Income Housing Tax Credits Program. This legal fee is rarely offered on a pro bono basis, since most law firms insist on being compensated for the liability incurred in issuing a legal opinion.

Interest on Bridge Loan
If a predevelopment or construction loan is being provided by a bridge lender, make certain that the interest cost is budgeted, based on the applicable rate and term. Verify the interest rate with the lender, and project the term conservatively to account for delays.

Other Permanent Financing Fees
Certain programs that involve the sale of some or all of the project financing to a secondary market entity (e.g. Fannie Mae) or a pension fund may pass some of the associated costs through to the project. For example, a pension fund may charge administrative fees or require credit enhancement. Consult with the relevant financing sources to determine and evaluate these fees.

Tax Abatement/Exemption Filing Fees
This may apply if your locality has a tax abatement or exemption program that charges a filing fee. Check with the local housing or finance department to determine this fee.

Tax Abatement Consultant
Some local tax abatement programs are complex and require the use of a tax abatement consultant. This fee is variable and can be verified with the local housing agency or other non-profit housing developers.