RECAPITALIZATION ADVISORS, INC.
20 Winthrop Square, 4th Floor
Boston, MA 02110-1229
Tel: (617) 338-9484 Fax: (617) 338-9422
www.recapadvisors.com

David A. Smith
Adam I. Galowitz
Maria T. Maffei
Todd Trehubenko

Subcommittee on Housing and Community Opportunity
GAO Report: "Multifamily Housing: More Accessible HUD Data Could Help Efforts to Preserve Housing for Low-Income Tenants"

Tuesday, July 20, 2004

Testimony of Todd Trehubenko
Senior Vice President
Recapitalization Advisors, Inc.

Chairman Ney, Representative Waters, members of the Subcommittee, I am honored to be invited here today.

My name is Todd Trehubenko and I am Senior Vice President of Recapitalization Advisors, Inc. We are a private consulting firm based in Boston, specializing in the finance of existing affordable housing. In particular, we focus on Section 236, Section 221(d)(3), Section 8, and other types of "expiring use" housing -- assisted properties on which the original affordability protections are or will be ending.

We design and execute what we call "renewed affordability" transactions. These transactions lever an array of public and private resources to financially improve these properties and provide funds for renovation while still protecting low-income residents. I lead this practice area for Recap, and am proud that we have directly preserved over 450 properties totaling nearly 60,000 apartments in 39 states since the company's 1989 founding by David A. Smith.

Recap works closely with for-profit and non-profit owners, buyers, and sellers. Our clients include state housing finance agencies as well as other affordable housing lenders and investors, and we have been privileged to provide analysis and advice to Congress, HUD, GAO, CBO, the Millennial Housing Commission, and others concerned with housing policy in this country.

Our experience operating in this environment over the past 15 years teaches us that:

- The maturing mortgage problem is more significant and more immediate than the GAO report describes.
- This inventory consists of properties left out of other initiatives.
- Substantially all remaining properties in the portfolio are "at-risk" today.

- These properties should be preserved, but current tools are inadequate.
- Congress should act now to ensure preservation of these properties.

GAO's January, 2004 report on this inventory ("Multifamily Housing: More Accessible HUD Data Could Help Efforts to Preserve Housing for Low-Income Tenants") indicates that lack of data access is a significant issue with respect to this portfolio. We respectfully suggest it is not; the problem is lack of access to the tools and resources necessary to successfully recapitalize these aging properties. The problems with the portfolio are both greater in magnitude than suggested by the GAO report, and more immediate. We urge Congress to act now to create the necessary tools – such as those included in H.R. 4679 introduced by Representative Frank -- to preserve and improve these affordable housing assets.

1. The maturing mortgage problem is more significant and more immediate than the GAO report describes.

The GAO report found that HUD mortgages on 2,328 properties (236,650 apartments) will mature over the next ten years, through 2013. Virtually all of these properties were financed under the Section 236 and Section 221(d)(3) programs, although the total also includes some older Section 202 elderly housing properties.

While a ten-year horizon is a common and not inappropriate frame of reference, in this case it obscures the magnitude of the problem. A chart we have compiled using HUD source data, included as Exhibit 1, depicts the entire wave of maturing Section 236 and Section 221(d)(3) mortgages by year. The data shows that an additional 814 Section 236 or Section 221(d)(3) mortgages, on properties consisting of more than 93,000 apartments, will mature in the three years following the period GAO studied.

And the problem is upon us now, as mortgages on over 100 properties in this inventory, representing more than 13,000 apartments, will come due by the end of 2007. In many cases, even for properties with later mortgage maturities, owners are motivated to prepay their loans in order to capture Section 8 enhanced voucher resources that are not available to them on the day the mortgage otherwise comes due. These properties will exit the affordable portfolio early and never make it to mortgage maturity. While the residents will be protected through vouchers, project-based affordability is likely to be lost.

2. The maturing mortgage inventory consists of properties left out of other initiatives.

The inventory we are discussing today is what we have left after having selected out of the subsidized mortgage portfolio several previous groups of properties that each took advantage of particular programs:

- *Preservation.* From 1989 to 1996, we preserved many properties under ELIHPA and LIHPRHA. These properties increased their project revenues, captured new Section 8 to cover the increased rents, and funded rehab with a new combined acquisition or equity takeout loan.
- *Prepayment.* From 1996 to 1998 (and ongoing), many subsidized mortgages were prepaid. The residents were protected with Section 8 enhanced vouchers, newly created for the occasion, to cover the rents that increased to market. Enhanced vouchers have since become one of the principal tools in maintaining resident protections in properties originally financed with subsidized mortgages.
- *Mark-to-market.* From 1999 to 2004 (and ongoing), many properties went through mark-to-market. In these transactions, rents were reset down to market, debt was restructured (with new flexible soft loans provided under mark-to-market), and properties were rehabbed with proceeds from the newly reconstituted first loan.
- *Renewed affordability.* Starting in 1999 (and ongoing), we have used renewed affordability tools such as Mark Up to Market (MUM), Section 236 IRP decoupling, and flexible subsidy loan restructurings to help properties raise new capital for renovations and to address other needs.
- *Section 202 recapitalization.* In 2000, non-profit owners gained greater ability to refinance Section 202 mortgages to raise funds for property needs and to enter into new partnerships with private investors to revitalize these assets. These programs provide important new tools for Section 202 properties, but work best for properties developed after 1975. Earlier Section 202 properties, with subsidized below-market interest rates and little or no Section 8 assistance, struggle to take advantage of these initiatives.

Each of these previous programs addressed a particular cohort of properties within the subsidized mortgage inventory. With rare exception, each was the result of targeted legislation passed by Congress and was voluntary in the sense that project owners could elect to participate in the program or choose to do nothing. And each program stimulated property recapitalizations that delivered to successful participants the following benefits in exchange for extended affordability or resident protections:

- New rents, usually at or close to market.
- New financing commensurate with the revised Net Operating Income (NOI).
- New rehab funding out of the transaction.
- New or revitalized property ownership.

The portfolio at issue today consists of those properties that did not participate in previous programs. It is characterized by adverse selection, more easily summarized by negatives than by positives. These properties have been *unable* to access the new array of renewed affordability tools – increased rents, enhanced vouchers, new debt financing – available to the other groups. These properties have not been renovated or repositioned. The original owner groups, for-profit or non-profit, have not been reinvigorated or replaced.

These properties have been unable to do anything else. This is the group left behind.

3. Substantially all remaining properties in the portfolio are "at-risk" today.

Because of the adverse selection, the properties we confront today generally have these things in common:

- *No economics* (because of a contractual prohibition) or *low economics* (because their current rents are at or near market). They thus lack an essential economic fuel for revitalization.
- *Low rents*, because the budget-based rent structure and limited availability of Section 8 have held rents down.
- *Low upkeep*, because they have had no ability to access rehab-type tools available to the other cohorts.
- *Low debt*, because they are still carrying their original loans, which have been amortizing for 30 or more years. Many balances are now down below $10,000 per apartment.
- *Low reserves*, because coping with low rents and low upkeep have prevented the properties from accumulating capital. These properties typically have less than $1,000 per apartment in accumulated reserve balances.
- *Low owner energy*, because lacking a transaction, many of these owners have been emotionally carrying their properties for thirty-plus years. The business has become much tougher and more complex in that interval, and many of these owners are at a loss as to what can be done to revitalize their properties.

And yet these properties are good housing. Even if a bit dated, they provide a good quality of life and are genuine and successful communities of residents.

They serve a real and important need. Residents are glad to live there and think of these complexes as their homes of long standing.

And communities are glad to have them. These developments are well established. Cities and towns – even those that resist new affordable housing – are eager to retain these properties as assets in their communities.

We are at risk of losing these properties as quality affordable housing. As GAO points out, HUD does not offer any incentives to keep these assets in the affordable inventory upon mortgage maturity. HUD's commitment to the property once the loan is paid off and the FHA insurance liability is eliminated is unclear. From the owner's perspective, in the current environment there is little comfort can be taken that *any* Federal financial assistance will continue beyond maturity, or that subsidies that do continue will be sufficient to cover debt service on the new mortgage financing or rehabilitation loans these properties need.

This lack of certainty influences owner behavior even now, many years before actual maturity. Because Section 8 enhanced vouchers are available for most properties in the context of mortgage prepayment but not mortgage maturity, owners have an incentive to exit the portfolio before the end of the loan term if at all possible. We expect many owners of properties remaining in the portfolio to eventually prepay, once the current loan balance is low enough, if only to capture resources necessary to remain economically viable.

Other properties will not prepay, due to a contractual prohibition or because a transaction is not viable. These properties are at risk in a different sense – risk of owner disinvestment over the final years of the mortgage term, or complete physical deterioration due to lack of operating or rehabilitation funds.

4. These properties should be preserved, but current tools are inadequate.

These properties were built under the same programs and serve the same resident groups as many other properties that Congress has already acted to preserve as affordable housing. Reinvesting in these remaining properties prior to or at mortgage maturity is sound policy and financially attractive relative to the cost of new housing. Recapitalizing these properties with incremental resources will be much cheaper, and much better policy, than losing them and trying to replace them later.

The properties require modernization and financial recapitalization. We know what resources and tools are needed to accomplish these goals, because we use them now, on other properties already eligible for existing preservation programs. These include:

- *Section 8 enhanced vouchers.* Currently, these are not available to properties at mortgage maturity, or upon prepayment/preservation of non-profit owned properties, Rent Supplement properties, or early Section 202 properties without full Section 8 coverage.

- *Project-based rents at market* (with resident protections) through Section 8 Mark up to Market or related programs. These HUD programs work well for some properties but only those that meet fairly narrow criteria. For example, properties without full Section 8 coverage, or those with comparable rents much higher than current rents but less than the HUD "Fair Market Rent", are unable to derive significant benefits from these programs.

- *Replacing old debt with new financing on better terms.* Properties without a means to protect residents from necessary rent increases generally cannot support new debt sufficient to address property and ownership needs.

- *Rehabilitation funding within new financing.* Similarly, suitable rehab financing is difficult to support under the existing affordability structure. Some Section 236 properties, particularly those being sold, have been able to fund improvements through the IRP decoupling program. But this tool is relatively unattractive to owners wishing to retain ownership, because of HUD's effective prohibition on any owner equity takeout in conjunction with the preservation transaction (despite mandatory extension of affordability).

So for a variety of reasons, we are precluded from using effective renewed affordability tools on many properties remaining in the inventory. And that preclusion inhibits the revitalization of these assets, and is therefore bad for owners (for-profit and non-profit alike), bad for residents, and bad for the real estate.

Access to these tools, which can be effectively combined with other established private, federal, state, and local resources, should only be granted in exchange for extended affordability covenants from the owner or a mission-oriented purchaser. Many owners and purchasers would gladly make this trade in order to address the underlying needs of these aging properties.

5. Congress should act now to ensure preservation of these properties.

Congress has time and again passed legislation to ensure preservation of many property cohorts within the maturing mortgage portfolio. We urge Congress to act now to stimulate long-term preservation of worthy properties remaining in the portfolio – the portfolio of projects left behind that we have been discussing today. Specifically, we ask that Congress:

- *Adopt the measures outlined in H.R. 4679 filed by Representative Barney Frank.* These include Section 8 enhanced vouchers at mortgage maturity and targeted grants for properties willing to extend affordability protections for at least another 10 years beyond mortgage maturity.

- *Extend Section 8 enhanced voucher eligibility* to expiring use properties owned by non-profits, properties assisted by Rent Supplement, and Section 202 properties developed in the earliest stages of the program, provided that such enhanced vouchers are provided only in the context of a preservation transaction.

- *Encourage HUD to modify its administrative guidelines* to broaden eligibility for existing preservation initiatives such as Mark up to Market and IRP decoupling.

- *Encourage HUD to develop clear rent-setting policies* to recognize all legitimate operating and financial costs for properties achieving mortgage maturity, including debt service on replacement and/or renovation financing, to reduce owner and purchaser uncertainty on these issues.

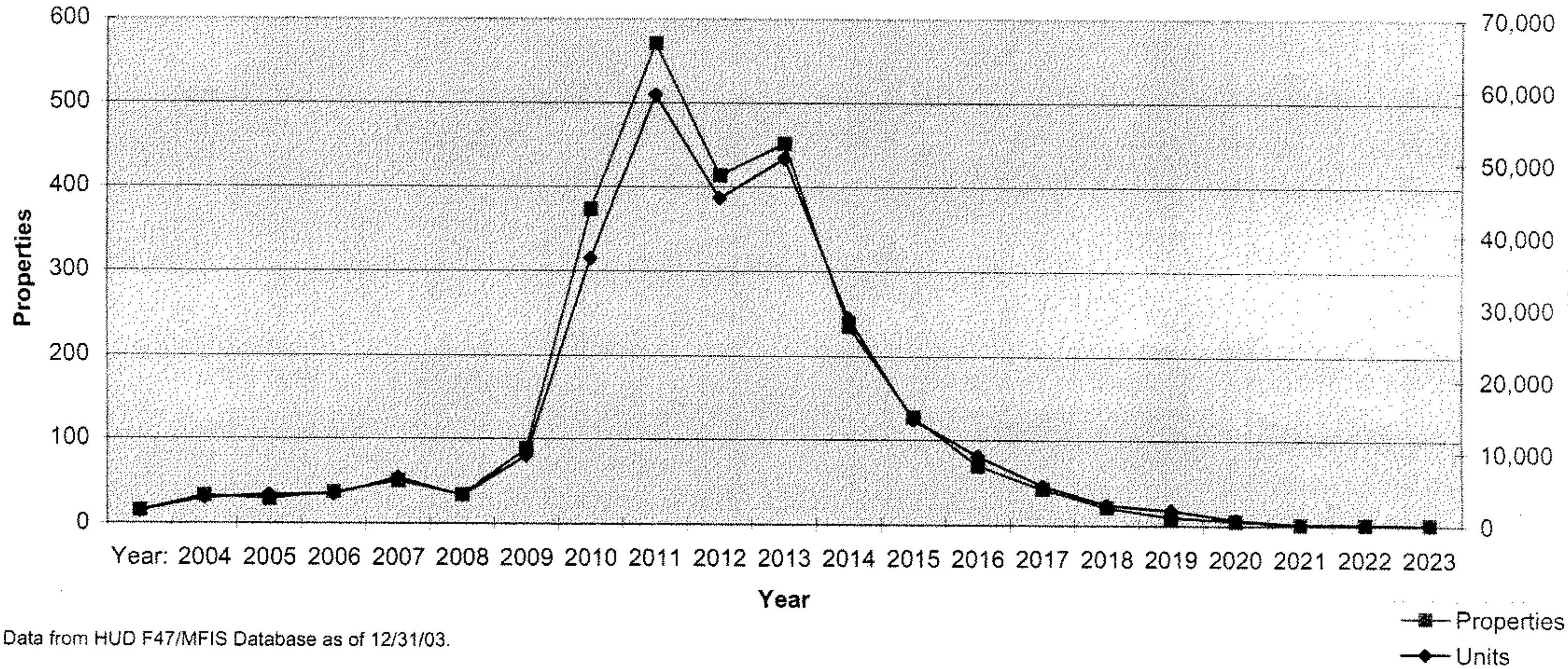
We need these measures to help preserve this housing stock and protect vulnerable low-income residents.

Mr. Chairman, Representatives, that concludes my remarks. I would be delighted to answer your questions.

RECAPITALIZATION ADVISORS, INC.
20 Winthrop Square, 4th Floor
Boston, MA 02110-1229
(617) 338-9484 Fax: (617) 338-9422
www.recapadvisors.com

David A. Smith
Adam I. Galowitz
Maria T. Maffei
Todd Trehubenko

Summary of Section 236 and 221(d)(3) mortgages by year of maturity



Data from HUD F47/MFIS Database as of 12/31/03.

For more information, contact Ethan Handelman, Associate, Recapitalization Advisors, Inc. at ehandelman@recapadvisors.com or (617) 338-9484 x218.

Recapitalizing and preserving existing affordable housing via innovative financial transactions.

RECAPITALIZATION ADVISORS, INC.
20 Winthrop Square, 4th Floor
Boston, MA 02110-1229
(617) 338-9484 Fax: (617) 338-9422
www.recapadvisors.com

David A. Smith
Adam I. Galowitz
Maria T. Maffei
Todd Trehubenko

Summary of Section 236 and 221(d)(3) BMIR mortgages by year of maturity

Year:	*Properties*	*Units*
2004	15	1,723
2005	33	3,495
2006	29	3,955
2007	37	4,016
2008	51	6,346
2009	34	3,917
2010	88	9,337
2011	373	36,750
2012	571	59,428
2013	414	45,103
2014	452	50,646
2015	235	28,530
2016	127	14,469
2017	70	9,480
2018	43	5,454
2019	21	2,810
2020	10	2,099
2021	5	795
2022	1	185
2023	1	217
2025	1	115
Total	**2,611**	**288,870**

Data from: HUD F47/MFIS Database as of 12/31/2003

For more information, contact Ethan Handelman, Associate, Recapitalization Advisors, Inc. at ehandelman@recapadvisors.com or (617) 338-9484 x218.

Recapitalizing and preserving existing affordable housing via innovative financial transactions.

RECAPITALIZATION ADVISORS, INC.
20 Winthrop Square, 4th Floor
Boston, MA 02110-1229
Tel: (617) 338-9484 Fax: (617) 338-9422
www.recapadvisors.com

David A. Smith
Adam I. Galowitz
Maria T. Maffei
Todd Trehubenko

Todd Trehubenko
Senior Vice President

Todd Trehubenko is a Senior Vice President of Recapitalization Advisors, Inc. Since joining Recap in 1992, he has structured and closed more than 65 transactions nationwide, including preservation sales and refinancings, Mark to Market debt restructurings, conventional refinancings, and workouts. These transactions involved approximately $425 million in real estate value and nearly 10,000 units of affordable housing located in about 20 different states and the District of Columbia.

Todd currently leads Recap's Renewed Affordability practice, specializing in transactions designed to help owners and acquirers recapitalize and preserve affordable housing properties through use of federal, state, and local resources. These transactions are highly customized, but often take advantage of current federal housing initiatives such as Section 236 IRP decoupling, Section 202 refinancing, and Section 8 renewal policies.

Todd also assists many of Recap's state and local housing finance agency clients in meeting their preservation objectives, including those in Puerto Rico, Connecticut, Michigan, and Texas. An experienced conference and workshop presenter, Todd formerly served as a member of the Editorial Advisory Board of Multi-Housing News and the Mark to Market moderator for Housing Professionals Online, an online discussion group for professionals in the affordable housing industry.

Prior to joining Recap, Todd was a Multifamily Housing Representative with the Boston HUD office, where he assisted in the development of new affordable housing properties through a broad variety of federal subsidy and mortgage insurance programs. He is a 1989 summa cum laude graduate of Fordham University.