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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D C 20548

RESOURCES AND ECONOMIC DEVELOPMENT DIVISION

JUL 27 1973

The Honorable Clifford W Graves
Acting Assistant Secretary for
Community Planning and Development
Department of Housing and Urban
Development

Dear Mr Graves

The General Accounting Office is reviewing certain areas of the New Community Development Program Our work is currently underway at the Department of Housing and Urban Development (HUD) headquarters and at four new community sites Jonathan, Minnesota, Park Forest South, Illinois, Flower Mound, Texas, and Riverton, New York. The information developed to date and presented in this report relates primarily to the Jonathan and Park Forest South projects At the completion of our work, we plan to report on the four projects reviewed

Our review is being focused on three pertinent aspects of the program

--determinations by HUD of the economic feasibility of the projects,

--type of security pledged for the federally guaranteed obligations, and

--HUD's monitoring efforts

Our review showed that weaknesses exist in these areas for both the Jonathan and Park Forest South projects

HUD did not adequately review the economic feasibility of the approved projects

We noted that HUD guaranteed a total of $51 million in bonds for the Jonathan and Park Forest South projects without adequately determining whether the projects were economically feasible For example, HUD did not, in our opinion,

--adequately evaluate the market potential for residential, commercial, and industrial development of the projects,

--adequately consider market studies which showed that the developers overestimated the ability of the projects to attain the expected rate of development, and

--determine if the proposed land development activities would generate sufficient revenue to recover the land acquisition and development costs and also be able to retire the federally guaranteed obligations

Market studies - Jonathan

In March 1966, an economic consultant for the developer forecasted that development of a new town was feasible at the Jonathan site When applying for Federal assistance in February 1969, the developer submitted this information as the principal justification for the market feasibility of the project Although the study lacked basic essential data required by HUD regulations, it was accepted by HUD in its evaluation of this project For example, the study did not include data on the current supply of and demand for land in the region, and the current inventory and vacancy rates of housing in the area

A HUD analyst found that, based upon historical data and discussions with area realtors, the developer would only be able to sell an average of 20 acres of industrial land each year The developer, on the other hand, had estimated that he would sell about 90 acres of such land annually. HUD officials told us that the former program director decided to accept the 90-acre estimate of the developer because he felt that the developer could market that number of acres

As of December 31, 1972, the developer has not attained the land sales expected to be attained during the first 2 years of the project

According to the HUD-approved project agreement, the developer was to develop and sell land for 494 residential units during 1971 and 1972 During this period, he developed land for 583 units and sold land for only 319 units, or about 65 percent of the total number of units estimated in the project agreement The developer also stated that he would develop and sell 227 acres of industrial land by December 31, 1972, as of that date, 157 acres were developed and of this number, 63 acres were sold or leased

Market studies - Park Forest South

HUD's determination of the market feasibility of the Park Forest South project was based primarily on a consultant's 1969 study of the housing demand for that location This study showed that the developer should be able to sell about 16,000 housing units during the period 1970-1976 The developer, however, subsequently advised HUD that he estimated that he could sell about 35,000 units over a 15-year period on the basis that a new university would be located within the project area Because the developer's subsequent estimate was not supported by a market feasibility study, HUD in June 1970 contracted with a consulting firm to evaluate the market feasibility of the project The consulting firm report indicated that over the same 15-year period the developer would be able to sell only about 14,000 dwelling units Subsequently, however, the developer and HUD negotiated a development schedule calling for the developer to sell 37,200 dwelling units over a 20-year period The developer was unable to provide us with documentation supporting the schedule.

During the first 2 years of the project, the developer did not attain the projected rate of residential and commercial development For example, the project agreement stated that the developer would develop and sell land for a total of 2,200 residential dwelling units during 1971 and 1972 As of December 31, 1972, the developer had sold land for 1,660 units We also noted that the builders who bought the developed land had limited success in marketing dwelling units For example, lots for 898 units were sold to builders At the end of 1972, the builders had constructed and sold only 69 units and expected to sell only 241 units in 1973 This level of sales may affect the developer's ability to meet the land development schedule included in the project agreement

The project agreement provided that the developer would develop and sell land for 160,000 square feet of space for commercial use by the end of 1972 As of December 31, 1972, the developer had sold land for only 69,000 square feet of space

In early 1973, the developer hired a consulting firm to complete a comprehensive market feasibility study of the project for the purpose of recommending future management action. This study is expected to be completed in August 1973.

Financial projections - Jonathan

The developer's financial projections, in our view, did not provide HUD with an adequate basis for concluding that the project would be financially feasible For example,

--the cash flow statements submitted by the developer did not show that he would be able to retire the federally guaranteed obligations with revenues generated by land development activities,

--the land sales projections covered only the first 10 years of the 20-year development period and this information showed that $15 2 million of HUD guaranteed bonds would still be outstanding at the end of the first 10 years In order to expedite the signing of the project agreement, HUD officials agreed to allow the developer to submit a revised financial plan after the project agreement had been signed. As of July 1973--almost 3 years later--HUD had not requested and the developer had not submitted the required financial projections.

Subsequent events have shown that the developer has experienced greater losses than he anticipated during the first 2 years of development The developer had projected net losses of $394,000 during 1971, and $373,000 during 1972, his actual losses have been $800,000 and $867,000, respectively, or $900,000 more than expected for the 2 years.

We found that such losses were primarily attributable to lagging level of sales of residential and industrial land During 1971 and 1972, revenue from land sales was only $1 7 million as compared to a projected revenue of $3.4 million

Financial projections - Park Forest South

As of July 16, 1973, the developer had not submitted the HUD-required financial projections to show how the $30 million in federally guaranteed obligations could be retired based on the HUD-approved project agreement which included a development plan to construct 37,200 residential units during a 20-year period Financial projections submitted were based on the marketing projections of a consulting firm which showed only that about 20,000 residential units could be sold during the same period. These financial projections, however, had, in our opinion, a number of serious deficiencies

--The projections were based on revenues and costs incurred in connection with residential land development and did not recognize commercial and industrial development

- --The projections were based on the assumption that the developer would receive $30 million from the sale of the federally guaranteed bonds during the first year of operation However, due to existing HUD procedures, the developer would have been limited to receiving significantly less than the entire $30 million during the first year of operation

- --Certain costs of water and sewer facilities were not included in the cash flow projections

We found that the developer has realized substantially less income from the project than was projected Net income for years 1971 and 1972 was $867,500 as compared to $2,699,000 projected by the developer

The developer's financial position as of December 31, 1972, was substantially below that projected Net working capital was $661,000, as compared to the projected balance of $7,828,000 The working capital balance was lower because of the large number of unsold residential units, a greater work in process inventory, failure to open commercial properties on schedule, and a large investment in the construction of water and sewer facilities.

In October 1972 a consultant advised the developer that if substantial changes were not made during 1972 and 1973, it would not be possible for the development to support the financial investments made or proposed through 1973

Federally guaranteed obligations not adequately secured

Under existing HUD regulations, assets such as real property are to be pledged by the developer as security for federally guaranteed obligations These assets and undisbursed proceeds from federally guaranteed obligations, according to HUD criteria, should amount to not less than 110 percent of the principal amount of the federally guaranteed obligations outstanding HUD requires that the value assigned to the real property be based on independent appraisals

We noted, however, that for the Park Forest South project HUD increased the value of the real property pledged without, in our view, adequate support or justification In February 1971, HUD established the value of 3,700 acres of land at about $19 8 million Three parcels of this land, totaling 602 acres, were assigned a valuation that was

$2 1 million greater than estimated by an independent appraisal firm. HUD based the increase on an agreement which required one of the developers' subsidiaries to purchase the land at the higher valuation In our opinion, HUD's action was not warranted in that the increase in the value of the land did not represent current independently appraised "as is" values based upon recent "arms length" transactions which is, according to HUD, the basis that should be used in estimating the value of property pledged.

Further, we found that HUD allows developers to include amounts for general overhead expenses, interest expenses, and HUD fees and charges in the computation of assets pledged as security for federally insured obligations We believe that HUD should not allow such items to be included as pledged security for the federally guaranteed obligations of the project because the items have little or no saleable value in case of liquidation

With respect to the Jonathan project, trustee records showed that as of January 15, 1973, $23 1 million was pledged as security for $21 million in federally guaranteed bonds However, this amount included $6 2 million for such items as interest expenses and HUD fees and charges

For the $30 million in federally guaranteed bonds for Park Forest South, trustee records showed a security value of $35 million as of December 31, 1972 This amount included, however, $2.1 million in increased real property values discussed above and $3.3 million in non-saleable items

Need to improve HUD's monitoring of the approved projects

HUD, in our opinion, has not adequately monitored the financial performance of the developers As indicated earlier, the 20-year financial projections of both developers contained certain deficiencies. Thus, HUD is unable to evaluate the financial data supplied by the developers during the year in terms of the developers meeting a financial plan that will ultimately result in retirement of the guaranteed bonds

Also, HUD has no requirement that the developers update their earlier financial projections to recognize the effect which subsequent financial performance may have on the remaining period of development Such data would, we believe, provide HUD with some indications that the impact of events such as lower sales revenues or higher development costs would have on the future financial condition of the developers

Conclusions

After 2 years of operation, the developers of the Jonathan and Park Forest South projects have not met the sales projections outlined in their HUD-approved development schedules Officials of these projects advised us in July 1973 that although they were generally optimistic about the long-term success of their projects, they were concerned about their current operating results Jonathan officials acknowledged certain weaknesses in their marketing program and were taking corrective actions such as hiring a new marketing director and making consumer surveys relating to housing preferences They also indicated that they may request that HUD increase the amount of federally guaranteed bonds or may explore other means of obtaining financing Park Forest South officials also acknowledged that they have problems in the marketing area but are awaiting the results of the consultant's report before taking any action to improve the situation

We recognize that some of the weaknesses we noted with regard to the two projects may be attributable to the fact that the projects were among those first approved by HUD We further recognize that since approving these projects HUD has made certain improvements in its management function and has recently entered into a contract with a consulting firm to assist it in the development of a computerized financial reporting system

However, we are of the opinion that our observations to date as discussed in this report clearly show the need for HUD to take certain immediate action to help insure that the Federal commitment to the Jonathan and Park Forest South projects is adequately safeguarded Such actions, in our view, should include development of current economic feasibility studies to ascertain whether any changes should now be made in the original HUD-approved development plan for the projects

Recommendations

We are recommending that HUD

--evaluate the current market and financial feasibility of the Jonathan and the Park Forest South projects. For each project, the Office of New Communities Development should (1) analyze the approved development plans in terms of present market conditions and revise the plans as appropriate, and (2) prepare a current financial plan to determine if the projects currently appear able to generate sufficient revenues to meet the anticipated costs and retire the federally guaranteed bonds

- --review the security pledge for the Jonathan and Park Forest South federally guaranteed obligations. The amounts pledged should be based on independent appraisals of market values of real estate and the liquidation values of items included as security Also, HUD should consider revising its current policy with regard to the type of items accepted as security for the federally guaranteed obligations

- --require that all developers submit financial projections each year for the entire development period.

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We shall be pleased to discuss with you or members of your staff, the matters discussed in this letter Copies of this letter are being provided to the Inspector General of HUD

We would appreciate your comments and advice as to the action taken or planned on the matters discussed in this report.

Sincerely yours,

B. E. Birkle

B. E Birkle
Associate Director