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July 14, 1997

The Honorable Connie Mack
Chairman, Subcommittee on Housing
Opportunity and Community
Development
Committee on Banking, Housing
and Urban Affairs
United States Senate

Subject: Portfolio Reengineering: Properties Unable to Cover Operating Expenses at Market Rents

Dear Mr. Chairman:

The Department of Housing and Urban Development's (HUD) insured Section 8 portfolio (properties that both receive project-based Section 8 rental assistance and have mortgages insured by HUD's Federal Housing Administration [FHA]) suffers from long-standing problems, including high subsidy costs. To address these high costs, your Committee recently approved the Multifamily Assisted Housing Reform and Affordability Act of 1997, which, among other things, proposes a reduction in existing subsidized rents to market levels at a large number of properties. Although many properties will continue to be financially viable with the reduced subsidy levels, some properties will likely be unable to cover their operating expenses, even if the existing debt on the mortgages is totally forgiven.

In a June 26, 1997, letter, you asked us to provide you with information concerning properties that would be unable to cover operating expenses with market-level rents, on the basis of our analysis of Ernst & Young LLP's 1996 study on the effects of a proposal by HUD for restructuring the insured Section 8 portfolio.[1] In May 1996, Ernst & Young reported on the results of a study

[1]We evaluated the results and reasonableness of Ernst & Young's study in our report entitled *Multifamily Housing: Effects of HUD's Portfolio Reengineering Proposal* (GAO/RCED-97-7, Nov. 1, 1996).

analyzing the effects of HUD's proposal, called "mark-to-market" (later revised and renamed "portfolio reengineering"), that was aimed at restructuring the insured Section 8 portfolio.[2] HUD's restructuring proposal was designed to lower subsidy costs, reduce HUD's risk of insurance losses, and improve the physical condition of many properties through a process that included resetting rents to market levels and reducing mortgage debt if necessary to permit a positive cash flow.

In response to your request, this product describes (1) the basic methodology used in Ernst & Young's study, (2) the data that the study developed on properties that would not be able to cover operating expenses (i.e., that would have a negative cash flow) after restructuring, and (3) the increase in rents above market-level rents that would be needed for these properties to achieve a positive cash flow and a comparison between the rent levels and the fair market rents (FMR) for the areas in which properties are located.

SUMMARY

Ernst & Young's study assessed how properties in the insured Section 8 portfolio would be affected by HUD's proposal by analyzing a stratified random sample of 558 out of 8,363 insured Section 8 properties. In assessing the effects of restructuring, Ernst & Young assumed, among other things, that project-based Section 8 assistance would be replaced with tenant-based assistance; vacancy rates would adjust to market-level rates; operating expenses for some properties would decrease by up to 15 percent of the difference between their historical levels and industry averages for properties in their area; funding would be provided for covering a property's immediate deferred maintenance and short-term capital needs when the property was subject to reengineering; and required deposits to replacement reserves would cover the estimated annual replacement costs for all of a property's major systems, regardless of the length of their remaining useful lives.

Our analysis of Ernst & Young's data shows that 60 of the 558 insured Section 8 properties in its sample would have a negative cash flow after restructuring even if their existing mortgage debt were written down to $0. By negative cash flow, we mean that the properties' adjusted net operating income (net operating

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[2]More specifically, Ernst & Young determined the amount of mortgage write-down needed for each property on the basis of the mortgage that the property could support after it was marked to market. This computation was based on the financing terms that Ernst & Young anticipated that lenders would provide for new mortgages on the properties.

income after deposits to replacement reserves) after restructuring would be negative.[3]

According to our analysis, rents for the units in these 60 properties would, on average, need to increase above market-level rents by about $113 per unit per month in order for the properties to achieve a positive cash flow.[4] If the restructured rents at these 60 properties were increased to the area's FMR, 25 properties (42 percent) would be able to achieve a positive cash flow, including deposits to replacement reserves. An additional 24 properties (40 percent) would be able to achieve a positive cash flow if their rents were increased to 120 percent of FMR. Of the 11 that would need rents higher than 120 percent of FMR, 4 could cover operating expenses with rents from greater than 120 to 130 percent of FMR; 5 would need rents from greater than 130 to 140 percent of FMR; and 2 would need rents greater than 140 percent of FMR. (Enc. I shows the rent levels that each property would need in order to achieve a positive cash flow.) It is important to note that although these higher rents would allow the 60 properties to cover operating expenses, many of the properties also have deferred maintenance and short-term capital needs that would probably need to be funded from a source other than mortgage write-downs or the properties' revenues after restructuring. According to Ernst & Young's data, deferred

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[3]Ernst & Young's study placed each sample property into one of four categories on the basis of the extent to which the property's net income would cover its expenses after restructuring. The study classified properties that would be unable to cover operating costs after restructuring as "nonperforming." However, the number of properties in the nonperforming category is somewhat larger than the 60 properties that would have a negative cash flow. This occurs because Ernst & Young classified properties as nonperforming on the basis of two tests that compared properties' adjusted net operating incomes with the amount of their existing mortgage payments and capital needs. As a result of these tests, Ernst & Young classified an additional 13 properties with slightly positive adjusted net operating incomes as nonperforming, whereas our analysis includes only those properties with negative adjusted net operating incomes.

[4]The $113 per unit per month average rent increase is a weighted average taking into account the number of units in each property. Also, it is important to note that in an analysis of a probability sample such as the one that Ernst & Young drew, it is normal practice for us to compute margins of error for all estimates. However, because of time constraints, we did not compute the margins of error for this report.

maintenance and capital needs at these properties range from $1,304 to $22,017 per unit.[5]

Equally important–to the extent that the actual effects of restructuring differ from the assumptions used by Ernst & Young–properties may perform differently than projected. For example, the adjusted net operating incomes for these properties could improve if operating expenses decrease by more than the 15-percent adjustment used by Ernst & Young and/or if deposits to replacement reserves are required only for properties' capital items whose lives expire within a set period of time rather than for all major systems regardless of the length of their remaining useful lives.[6] Furthermore, to the extent that project-based assistance is continued rather than converted to tenant-based assistance, vacancy rates at the properties may be lower, potentially resulting in higher adjusted net operating incomes. However, the continued use of project-based assistance also has policy implications, including restricting recipients' choice of housing.[7]

AGENCY COMMENTS

We provided the Department of Housing and Urban Development with copies of a draft of this report for review and comment. On July 10, 1997, the General Deputy Assistant Secretary, Office of the Assistant Secretary for Housing - Federal Housing Commissioner, informed us that the Department concurred with the information presented in the draft.

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[5]Our November 1996 report noted, however, that for most of the 10 properties that we reviewed in detail, Ernst & Young's study estimated substantially higher deferred maintenance needs than did the properties' owners and managers and the contract appraisers that we hired to review the properties.

[6]For example, as noted in our November 1996 report, if a property's hot water systems were evaluated to have a remaining useful life of 25 years, the annual replacement reserve would include prorated amounts for the full cost of replacing hot water systems. Lenders that we contacted noted that if restructured loans were for 15 years, funding for replacing the hot water systems would typically not be required.

[7]Our November 1996 report provides additional information on the policy implications associated with using tenant-based versus project-based Section 8 assistance.

SCOPE AND METHODOLOGY

The information provided is based on our prior review of Ernst & Young's study and on our analysis of the data developed as a part of that study.[8] We discussed the results of our analysis with cognizant Ernst & Young officials and with officials in HUD's Office of Multifamily Housing. We performed this review from June through July 1997 in accordance with generally accepted government auditing standards.

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Please call me on (202) 512-7631 if you or your staff have any questions. Major contributors to this report include Rick Hale, Christine Fishkin, Austin Kelly, Mark Egger, and Leigh Ward.

Sincerely yours,

Judy A. England-Joseph
Director, Housing and Community
Development Issues

Enclosure

[8]See footnote 1.

MONTHLY RENTS NEEDED PER UNIT FOR PROJECTS WITH NEGATIVE ADJUSTED NET OPERATING INCOMES

Count of properties with negative adjusted net operating income	Monthly shortfall in adjusted net operating income	Estimated average market rent	Rent needed for positive cash flow (sum of shortfall and estimated market rent)	Area's average FMR	Percentage of area's FMR needed for positive cash flow
1	($64)	$411	$475	$757	63
2	(34)	363	397	570	70
3	(12)	369	381	518	74
4	(86)	559	645	856	75
5	(4)	646	650	847	77
6	(28)	621	649	822	79
7	(9)	394	403	500	81
8	(37)	365	402	487	82
9	(9)	468	477	576	83
10	(6)	308	314	379	83
11	(70)	556	626	749	84
12	(2)	336	338	386	88
13	(24)	432	456	511	89
14	(42)	553	595	666	89
15	(<1)	348	348	388	90
16	(112)	614	726	808	90
17	(65)	688	753	827	91
18	(41)	270	311	329	95
19	(197)	480	677	713	95
20	(40)	401	441	463	95
21	(187)	281	468	488	96
22	(<1)	311	311	323	96
23	(170)	607	777	802	97

Count of properties with negative adjusted net operating income	Monthly shortfall in adjusted net operating income	Estimated average market rent	Rent needed for positive cash flow (sum of shortfall and estimated market rent)	Area's average FMR	Percentage of area's FMR needed for positive cash flow
24	(17)	397	414	425	97
25	(29)	260	289	294	98
26	(65)	489	554	550	101
27	(41)	299	340	335	102
28	(96)	321	417	409	102
29	(49)	519	568	556	102
30	(16)	496	512	498	103
31	(16)	590	606	587	103
32	(25)	296	321	310	104
33	(218)	574	792	756	105
34	(418)	564	982	937	105
35	(7)	283	290	277	105
36	(258)	674	932	886	105
37	(32)	579	611	579	105
38	(95)	863	958	905	106
39	(19)	403	422	387	109
40	(65)	295	360	329	109
41	(282)	692	974	890	109
42	(228)	639	867	792	109
43	(13)	411	424	383	111
44	(88)	343	431	388	111
45	(30)	450	480	414	116
46	(92)	310	402	341	118
47	(104)	682	786	665	118
48	(82)	344	426	359	119

Count of properties with negative adjusted net operating income	Monthly shortfall in adjusted net operating income	Estimated average market rent	Rent needed for positive cash flow (sum of shortfall and estimated market rent)	Area's average FMR	Percentage of area's FMR needed for positive cash flow
49	(85)	302	387	324	120
50	(27)	305	332	274	121
51	(55)	305	360	288	125
52	(40)	335	375	295	127
53	(187)	376	563	435	129
54	(155)	510	665	510	131
55	(165)	551	716	548	131
56	(127)	453	580	428	135
57	(190)	344	534	389	137
58	(47)	395	442	322	138
59	(314)	431	745	467	159
60	(535)	399	934	374	250

Legend:

FMR = fair market rent

Notes: Amounts shown are on a per unit, per month basis. The large increase in rents needed for property number 60 is due primarily to Ernst & Young's determination that substantial annual deposits to replacement reserves would be required for the property.

Source: GAO's analysis of data from Ernst & Young.

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