Vermont Housing Finance Agency
Appraisal Guidelines for Affordable Multi-family Housing Properties

March 22, 2010

Affordable multi-family residential rental housing has been created through a range of public funding programs, most of which impose restrictions that run with the land over time in exchange for some kind of rent or development subsidy. The restrictions and subsidies result in appraisal issues for affordable housing properties that differ from those of market-rate apartment properties. An understanding of the restrictions and incentives of the affordable housing is critical to proper appraisal methodology. For this discussion, the terms "affordable" and "subsidized" are used interchangeably.

Uniform Standards of Professional Appraisal Practice

The Uniform Standards of Professional Appraisal Practice establishes guidelines for the development and reporting of appraisals. The requirements of USPAP provide the framework for appraisals of all types of real estate. Licensed appraisers are compelled to comply with USPAP through state law.

Advisory Opinion 14 published by Appraisal Standards Board of The Appraisal Foundation specifically addresses the appraisal of subsidized housing. Advisory Opinions "are a form of guidance issued by the Appraisal Standards Board to illustrate the applicability of USPAP in specific situations and to offer advice from the ASB for the resolution of appraisal issues and problems". AO 14 states that "appraisals for subsidized housing require knowledge and experience beyond typical appraisal competency."

AO 14 affirms that in order to adequately address the valuation of subsidized properties, the appraiser must understand the programs, definitions and relevant tax considerations of subsidized housing, as well as local market conditions, and supply and demand characteristics of this property type. A lack of knowledge and understanding of the various restrictions and benefits associated with subsidized housing can result in misleading conclusions. Appraisers of this property type must not only understand existing subsidy programs and restrictions, but also be aware of anticipated changes that may affect the durability of the benefits and restrictions of subsidized housing projects.

Documents containing the restrictions and incentives that characterize subsidized housing are typically of public record and should be sought and reviewed by appraisers. In addition to reviewing the documents, consultation with affordable housing officials may be necessary. A recommended practice is to interview administrators of HUD properties to verify that the appraiser's understanding of the restrictions and incentives is correct, and to obtain any additional needed information.

Section 8 Subsidized Housing Background

These guidelines emphasize appraisal issues for properties in the Section 8 New Construction/Substantial Rehabilitation Program (NC/SR) of the United States Department of Housing and Urban Development (or other properties developed under similar programs with project-based assistance). Section 8 properties represent a large part of VHFA's portfolio. Since many of these properties are currently reaching the end of the original contract terms, the number of transfers involving Section 8 NC/SR properties has increased.

According to the U.S. Department of Housing and Urban Development, nearly 4 million American families live in rental housing that is owned, insured or subsidized by HUD. Privately owned multi-family housing properties were developed through the Section 8 NC/SR Program of the United States Department of Housing and Urban Development in the late 1970's and early 1980's. The Section 8 NC/SR Program provides subsidies for low- and very-low income tenants so that tenants pay no more than 30% of their adjusted household income for rent. The federal government pays the difference between contract rent and the tenants' contribution directly to the property owner. The subsidy and restrictions remain with the property during the contract period. The Section 8 NC/SR Program differs from the Section 8 Housing Choice Voucher program in that the Section 8 subsidy is paid directly to the owner of a Section 8 NC/SR property. The Housing Choice Voucher provides vouchers to tenants that allow them to acquire the rental housing of their choice. The Section 8 NC/SR Program is a project-based subsidy versus the voucher program, which is tenant-based.

Section 8 Housing Assistance Payments (HAP) contracts specify, among other things, the amount and timing of payments to the property owners. Some of the contracts, which are administered by HUD, put restrictions on the allowed uses of cash flows. Contracts for projects signed before February 29, 1980, "old regulation" contracts, are less restrictive in the allowed uses of cash flow. "New regulation" properties, those signed after February 29, 1980, are more restrictive*. The restrictions associated with new regulation properties typically specify the use of all project income. These restrictions require the creation of reserve funds and limit the amount of cash distributions the owner can take. Once the contract terminates, the restrictions on cash flow are eliminated.

These contracts typically extended 20 to 30 years, including renewal options. Once contracts terminate, owners may have the option of either renewing contracts or operating properties as unrestricted, market-rate apartment properties. The options for contract renewal are spelled out in the Section 8 Renewal Guide, a HUD publication available on-line. Renewal options are offered from one to twenty years. Every effort should be made to determine the most likely renewal option at contract expiration since the various options can have a significant impact on future cash flows. Contacting the housing finance agency and/or the contract administrator is advisable for help in making this determination.

*For State Agency uninsured projects, the dividing line is February 29, 1980. For HUD and insured deals the dividing date is November 5, 1979 for Section 8 New Construction and February 20, 1980 for Section 8 Substantial Rehabilitation.

Regulatory Agreements

Some Section 8 properties were acquired and/or developed with financing that included regulatory agreements restricting the use of project funds. Specific terms of regulatory agreements may vary, but typically transfer significant financial control of projects to mortgagees. Similarly with respect to certain regulatory restrictions, HUD agreements require among other things, the establishment and funding of reserves, restricted cash distributions to owners, and impose financial reporting requirements. Failure to comply with the terms and conditions of regulatory agreements can result in the default of the mortgage note. Mortgages with associated regulatory agreements often prevent prepayment of the note, meaning that restrictions will remain in force for the duration of the loan.

In cases in which cash distributions to owners are regulated, the distributions are typically calculated based on a percentage of the initial investment of the property developer. For many projects, the amount of the annual distributions is constant over time. In some cases, the amounts of the annual distributions have been increased in exchange for an extension of affordability and/or for additional investment in properties. Distributions are paid after other financial obligations are met. If insufficient funds are available during a given year, distributions may be taken in subsequent years if there is sufficient cash flow.

Regulatory agreements can result in cash flows that differ substantially from those of market-rate multi-family residential rental housing over time and therefore must be considered as part of the valuation process.

Valuation Methodology

It is generally accepted that the most reliable method of appraising subsidized multi-family housing is by the income approach. The sales comparison approach is generally not applicable because of the difficulty in finding truly comparable sales due to variations in income characteristics and property restrictions. If this approach is used, extra effort must be made to ensure the results are not misleading. Sales comparables should be used for overall rate selection as long as the income characteristics are correctly understood and analyzed. Use of rates derived from market-rate properties is preferred. The improvements on Section 8 properties are generally too old to warrant the completion of the cost approach, although the approach may be appropriate for Low Income Housing Tax Credit properties, as discussed later in these guidelines.

The income approach is premised on the idea that market value is equivalent to the present value of future benefits. Those benefits are largely monetary and may include a combination of cash flow to the investor, equity build-up through paying down the mortgage, property value appreciation, and tax benefits.

There are generally two acceptable techniques for estimating the value through an income analysis. The first of these techniques involves the application of an overall capitalization rate to a projected net operating income for the subject property. This technique is generally applicable when properties are unencumbered, or encumbered by short-term leases at rents that are reflective of the market conditions.

The second technique for the income approach involves yield capitalization. Yield capitalization converts future benefits to present value by discounting each future benefit at an appropriate yield rate or by developing an overall rate which reflects anticipated changes in value or income. Yield capitalization may be appropriate when current and future income patterns are irregular, which is usually the result of contract rent differing from market rent.

Income Patterns

The Uniform Standards of Professional Practice (Standards Rule 1-4 (c)) is specific about what steps must be taken to complete a credible appraisal when an income approach is necessary.

Standards Rule 1-4(c)(iv) requires that appraisers "base projections of future rent and/or income potential and expenses on reasonably clear and appropriate evidence." Current and future income patterns must be forecasted to provide the support for selection of the valuation methodology.

Subsidized properties including project-based Section 8 properties often have cash flow patterns that differ from those of market-rate multi-family residential rental housing. Irregular cash flow patterns typically result from Housing Assistance Payments Contracts that call for rent that differs from market rent. Many subsidized properties have rents that have remained stable for many years or have increased only slightly. If the current income stream is reflective of market, direct capitalization may be an appropriate valuation methodology. If the rate of cash flow can reasonably be expected to change at contract termination, the use of yield capitalization through a discounted cash flow analysis may be required.

When Housing Assistance Payments contracts terminate, owners may have the option of either renewing contracts or discontinuing participation in affordable housing programs. In some markets, rental conditions may be unfavorable for market-rate rental housing and owners may opt for contract renewal in order to maximize income. In other markets, rental rates and demand may be strong enough to warrant conversion to market-rate rental or other unassisted use. In cases where discounted cash flow analyses are the basis of the valuation, the appraiser must provide rationale and support for the reversionary value conclusion.

Valuation of properties with restrictions on equity distributions to owners represents a difficult appraisal problem. Typically, the rate of cash flow to owners of these restricted properties is significantly lower than the rate of unrestricted properties. The cash flow model should recognize that a profit-motivated owner would opt to terminate the restriction as soon as possible and the use of yield capitalization is indicated. Because a significantly lower percentage of the cash flow is available to owners of properties with equity distribution restrictions when compared with unrestricted properties, the rate of return on the restricted cash flows should be higher. Selection of a higher discount rate for the restricted cash flows has the effect of reducing the value of a restricted property when compared with an otherwise similar unrestricted property.

Estimation of Market Rent

Standards Rule 1-4(c)(i) specifies that appraisers must collect, verify, and "analyze such comparable rental data as are available and/or the potential earnings capacity of the property to estimate the gross income potential of the property". The rents called for by the Housing Assistance Payment Contract may be above, below or at market. A necessary step in the appraisal of affordable housing is to compare the rents of market-rate apartments with the contract rents of subsidized units. Estimation of market rent provides a basis to determine the relationship of contract and market rent, and is essential in projecting future potential income after termination of restrictions. The task of estimating market rent is complicated by the fact that in some markets, Section 8 subsidized properties are better maintained than market-rate rentals and there are no truly comparable market-rate apartments.

Because of the substantial tenant subsidies associated with Section 8 programs, this property type often have rates of occupancy that are higher than occupancy rates of market-rate multi-family rental housing. For other types of affordable housing such as Low Income Housing Tax Credit properties, occupancy is favorably influenced by rents that are below market rents. In some market areas, rental demand is limited and affordable housing experiences elevated rates of vacancy. Occupancy rates for both market-rate rental housing and affordable housing are relevant in the valuation of affordable housing and support for vacancy rates should be provided.

Operating Expenses

Standards Rule 1-4(c)(ii) specifies that appraisers must collect, verify, and "analyze such comparable operating expense data as are available to estimate the operating expenses of the property". A general observation is that subsidized projects incur greater expenses than market-rate housing. These additional expenses result from the restrictions and requirements of the administering agent of HUD. Management and audit expenses are usually higher. This property type is subject to periodic inspections by the Contract Administrator and through HUD's Real Estate Assessment Center (REAC) to ensure HUD's housing portfolio is adequately maintained. Housing that is subject to a rigorous periodic inspection program may result in higher maintenance and repair expenses when compared to market-rate housing. For subsidized housing properties with highly restricted cash flows, surplus receipts must be invested in property maintenance and reserve accounts since cash flow cannot be taken from the properties.

Accurate projection of operating expenses is important in the valuation of this property type. Multiple years of actual expenses of a property should be analyzed to provide support for the projection of expenses. Analyzing multiple years of expenses allows the appraiser to identify trends and atypical expenses. USPAP does not specify the number of years of operating expenses that should be analyzed; many commercial lenders require appraisers to analyze three years of expenses. The Standards Rule specifies that comparable operating expenses must be analyzed, so the expenses of similar affordable housing properties should be considered in support of the forecasted expenses of the subject property.

Rates of Return

Selected rates of return should be market-derived and reflective of the risk characteristics of the property as perceived by market participants. Standards Rule 1-4(c)(iii) specifies that "when an income approach is necessary for credible assignment results, the appraiser must: analyze such comparable data as are available to estimate rates of capitalization and/or rates of discount". The appraiser should recognize that property location, condition, and rate of cash flow all influence the perceived risk of a property and should be considered in the rate selection. Support for the selected rate of return must be provided.

Other Considerations:

Preservation Agreements

Preservation agreements seek to preserve affordable housing in exchange for consideration, usually in the form of a grant, a loan or a change in the terms of an existing agreement. In some cases preservation agreements are reached in return for increases in equity distributions. These agreements typically require the owner to renew HAP contracts at each opportunity and to seek other rental assistance that might be available at the expiration of the contract. Rights of first refusal and purchase options are also sometimes included. Preservation agreements may influence value since restrictions on cash flow are extended into the future.

Physical Needs Assessments and Property Condition

Physical needs assessments are periodically completed by qualified third party building inspectors on portfolio properties. PNAs can provide valuable information on the physical condition of properties that is not apparent from brief on-site inspections and can aid the appraiser in describing the property and the property condition. An important characteristic of affordable housing is that regulating agencies require properties to be well-maintained and can impose sanctions on properties that are deemed to be physically deficient. The primary way of controlling the physical condition of Section 8 NC/SR properties is through REAC, lender and Contract Administrator periodic inspections. Because of the need to meet to regulatory requirements, market participants in affordable housing may regard the physical condition of properties differently than those in the market-rate rental market. Information obtained from PNAs and regulator inspections may help in the projection of future maintenance expenses. The assessments provide cost estimates to repair or replace components. In cases in which properties require immediate repair, PNAs can provide a reason for adjusting value opinions to account for physical deficiencies. Adjustments to value for physical deficiencies that require immediate repair should be applied based on the estimated cost reported in the PNA, or based on estimated costs obtained from any other credible source.

Purchases of Affordable Housing Properties

Mission driven housing groups are increasingly the buyers and owners of affordable housing properties. By definition, they are concerned with providing good quality housing to low income tenants. Using these transactions for derivation of rates of

return or as comparable sales may be appropriate, but should be considered with caution. As with all comparables, verification should include an interview with a participant that confirms the price paid was reflective of perceived market value.

Assignment Conditions

Appraisals for VHFA require a market value opinion recognizing all property restrictions. In certain cases, restrictions may terminate on foreclosure and the lender may reasonably request a value opinion assuming an existing restriction is not in effect. Referred to by users of appraisals as "lender value", this assignment calls for a market value opinion with the hypothetical condition that one or more restriction is not in force. It is incumbent on the appraiser to provide an appraisal that is not misleading. Verification that the restriction(s) could be eliminated should be obtained from a reliable source.

Low Income Housing Tax Credit Valuation

New affordable housing properties are typically developed using Low Income Housing Tax Credits. Tax credits are allocated to developers who market the credits to investors and use the proceeds to develop multi-family rental housing. LIHTC properties are income-restricted meaning tenants must meet specific income criteria. Tenants pay rents that are usually below market. The restrictions are typically imposed through housing subsidy covenants, which are created as a condition of a grant, loan or contract and, in exchange, impose a restriction or requirement on the property for a stated period of time.

As in the case of Section 8 properties, the income approach is the primary valuation methodology. The minimum length of the restrictions is 15 years, but covenants can extend in perpetuity. Whether use of direct capitalization or a discounted cash flow analysis is appropriate depends in large part on the length of time between the date of valuation and the date the restrictions cease. As previously described, Standards Rule 1-4 (c) specifies the steps necessary to conclude credible assignment results by the income approach.

All tax credit projects that are in the "Extended Use Period" (i.e. after the initial 15-year Compliance Period) can have some of the targeting and other restrictions reduced or waived. Valuation of properties in this time period should take into account the actual restrictions in place at that time, not the initial restrictions outlined in the original Housing Subsidy Covenant. Furthermore, all tax credit projects developed between 1990 and 2002 could potentially have their Extended Use Period requirements completely terminated, if the owner gives VHFA a notice of their intent to leave the program. Upon receipt of such notice, VHFA has one year to find a buyer who will purchase the property for the sum of: 1) the fair market value, for the unrestricted units, and 2) a formula price for the tax credit units. If no buyer is found in that one year period, then after a subsequent three year transition period, the tax credit restrictions terminate. The "Year 15 Options" are described in detail in a document found at the following link: www.vhfa.org/documents/developers/year_15.pdf.

Because LIHTC properties are usually new or recently developed, the cost approach may be completed. The indications of value by the cost approach are typically higher than the results of the income approach for because the cost of development

typically far outstrip the value that can be supported by LIHTC contract rents. That this type of affordable housing in most market areas can only be developed by using grants and non-market financing is an indication that obsolescence exists. As a result, the cost approach is not considered central to the valuation of this property type. The income approach is therefore the recommended valuation methodology.

Tax credits are intangible assets that are not real property and require special care under USPAP. The Vermont Finance Housing Agency requires the valuation of real estate only and does not include the value of tax credit equity.

Appraiser Qualifications

Appraisers approved for completion of multi-family affordable housing appraisal assignments shall be currently licensed as a Certified General Commercial Appraiser by the State of Vermont and hold either the MAI or the SRPA designation of the Appraisal Institute.