

Non-profits can fund capital improvements via A Section 8 Mark Up to Budget (MUB) rent increase

(Notice H 2000-21 as updated by the Section 8 Renewal Guide)

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Summary

With the publication of Notice H 2000-21¹, HUD has extended the application of market-based principles into non-profit owned older assisted (236 and 221d3) properties that need capital improvements. Higher rents that enable owners to fund capital improvements can be achieved via Mark Up to Budget (MUB, as it has become known in the lexicon).

Notice H 2000-21 as updated in Chapter 15 of the Section 8 Renewal Guide recognizes that a non-profit owner is an owner too, and that all properties, not just for-profit properties, need capital improvements and sound operating cash flow. As with several other recent HUD initiatives, this is a step in a series of moves in the right direction, and an important new avenue for non-profit owners of these properties.

Eligibility

MUB supplements but does not supersede existing options for nonprofit owners. Instead, an owner can apply for a MUB rent increase if the property has all these characteristics:

- Expiring property-based Section 8 (other than Section 8 Moderate Rehab Contracts administered by PIH or Section 8 Moderate Rehab SRO Contracts administered by CPD).
- Acceptable nonprofit owner (as defined by HUD; for this purpose, an LIHTC limited partnership with a non-profit as controlling general partner is considered a non-profit).
- REAC score of 30+.
- Current rents below market as determined by a HUD-reviewed Rent Comparability Study (and post-MUB rents at or below market).
- Owner in good standing with HUD, in compliance with the terms of the Regulatory Agreement, Note, Mortgage, and current on its mortgage, replacement reserve deposits and other agreements. This is a preventive, not workout, device.

In some ways, MUB for non-profits is a corollary to Mark Up to Market (MUM), which is available only to for-profits or non-profit transfers. However, in MUM, comparable market

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rents must be equal to 100% of FMR² and the owner must demonstrate the legal ability to go market. Neither condition is required in MUB.

In short, MUM is a for-profit opt-out prevention device. MUB is a non-profit atrophy-prevention device.

Why MUB?

Unlike the standard budget-based rent increase, via MUB a non-profit can:

- Complete major capital improvements and recapitalize replacement reserves.
- Raise Section 8 rents to *post-rehab* market rents. In effect, the property can bootstrap itself to better operations by borrowing to fund rehab, supported by a MUB rent increase that is in turn achievable because rehab improves the property.
- Possibly improve its Section 8 renewal prospects by electing a 5-year or 20-year contract. (Of course, both contracts are subject to annual congressional appropriations, so the reliability of the longer term is at least questionable. Nevertheless, lenders seem to take comfort in the longer-term contracts so they may well be easier to finance against.)
- Have a chance to raise future maximum rents by submitting a new Rent Comparability Study (RCS) if market rents have risen.
- Generate *and distribute* a cash flow distribution equal to 6% of defined equity.

How to MUB

To apply for a MUB, the non-profit owner must submit:

- Rent Comparability Study (RCS);
- Budget-based rent increase request with a description of capital improvement needs;
- Project Capital Needs Assessment (PCNA); and
- Financing plan for funding the property's repair/replacement needs.

In general, pure non-profits are encouraged (but not required) to fund some of the up-front repairs with outside (non-project) sources. But a non-profit controlled limited partnership, though MUB-eligible, *must* raise at least 10% of the up-front repairs from such outside sources. (This is reasonable considering that the presence of LIHTC investors implies a risk of LIHTC recapture should the property fall out of LIHTC compliance.)

Section 8 Rent Increases

Budget-based rent increases will include standard operating and debt service expenses, debt service and debt service coverage for the capital repair loan, and an annual cash distribution of 6% of initial equity (not much but better than zero).

The post-MUB rents are capped in several ways:

- *Local market.* HUD must find that the post-MUB rents are at or below market. To do this, HUD will commission its own RCS and will reconcile HUD's RCS with the owner's RCS. HUD's decision is final.
- *150% of FMR.* Post-MUB rents are generally capped at 150% of FMR (but HUD can waive that ceiling in some cases, although we find it hard to imagine this will arise often.)
- *MUB rents reduced by current debt service savings.* To prevent properties from being effectively over-subsidized, market rents will generally be reduced by any debt service savings attributable to the HUD mortgage, that is either (i) the Section 236 IRP payments or, (ii) in a 221d3 BMIR, an imputed debt service subsidy calculated by HUD based on the difference between the current constant (at 3%) and a market-rate constant. On Section 236 IRP decoupling transactions, HUD can waive the rent reduction if deemed necessary.
- *Future rents set by OCAF.* In later years, post-MUB rents will rise generally at OCAF (although, as noted above, owners can submit new RCS's to recoup lost ground).

Since this is a new *option*, not an entitlement, HUD's final determinations of local rents and supportable MUB rents may not be appealed.

Rents generally become effective once the PCNA is done and financing is approved, but if the rehab is *substantial* (unlikely), HUD will actually structure a new AHAP (Agreement to enter into Housing Assistance Payments) Contract, and rents will become effective when the substantial rehab is done.

Rent in Unassisted Apartments

Meanwhile, if the property has partial Section 8, residents in the unassisted apartments can be assessed a rent increase. Those paying the so-called Section 236/221d3 'market' rents¹ have no cap on their rent increases; those paying basic or excess but less than 'market' can be assessed a rent increase of up to 10%; HUD can waive this 10% increase ceiling for good cause.

Owner Distributions

As noted above, non-profit owners can fold a small annual cash distribution in to their budgets. To obtain it, however, the owner must ask for a Headquarters waiver, which HUD will grant for 'good cause'. As examples of good cause, the notice suggests:

¹ Not in any sense a true market rent, rather a construct based on adding back debt service savings to the established budget-based rents. By definition, 236/221d3 'market' residents will currently be paying less than 30% of their income for rent.

- Non-project uses related to the entity's non-profit purposes. (Fairly broad, should be satisfiable for any multi-activity mission-driven non-profit.)
- Repayment of surplus cash or residual receipts notes from secondary financing.

We expect HUD will be receptive to other good causes proposed by reputable non-profits.

Use Agreement

To secure the MUB, however, the owner must accept a new² 20-year recorded use agreement designed to assure mutual affordability and viability:

- Subject to owner compliance, and to availability of appropriations, HUD pledges to provide ongoing Section 8. (Presumably, if HUD fails, then the use agreement lapses and the owner could seek other alternatives.)
- The owner must accept Section 8 assistance "in accordance with its terms³"

While the owner's commitment to accept Section 8 renewal is not terribly limiting, any form of 20-year use agreement will have some constraining effect, some of whose consequences may be impossible to foresee. Before closing a MUB, even mission-oriented owners who have no plans whatsoever to go market should give careful consideration and satisfy themselves that a MUB-based rent structure will address the property's long-term needs.

Conclusion

This new MUB guidance is clear progress. Moreover, since it is the non-profit owner's *option*, not an obligation, it can be only a good thing.

Non-profits whose property is slowly atrophying through inability to access capital should look hard at using MUB as a vehicle to complete needed capital improvements, but they should do so only if comfortable that MUB will solve their problem for the long term.

² Properties that already have use agreements must extend them for 20 more years.

³ This last phrase is troubling, since the terms of the MUB rent increase are not specifically grafted into the Use Agreement, instead requiring the owner to accept any type of Section 8 renewals offered. The new Section 236 IRP use agreement includes a similar provision requiring continued Section 8 renewals but helpfully specifies that such renewals shall be on the same terms and conditions of the existing HAP contract. We recommend owners pursue clarification along those lines, designed to assure property viability and HUD continuing fulfillment of the MUB rent structure.