

Small Buildings in Practice: A Case Study

The following case study provides a concrete example of the feasibility and predevelopment phases of a small building acquisition and rehabilitation project, as outlined in the guide. It is based on actual small buildings CPC has financed and borrowers we've worked with to illustrate how a project might (or might not) prove feasible.

YOU AND YOUR TEAM

Experience and Character

You are fairly new to development, with no previous multifamily experience. However, you are a homeowner and recently worked closely with a contractor to rehabilitate a single-family house that is now on the market. You're interested in taking the next step and, based on your recent project, are confident you can choose trustworthy partners and vendors, deal with construction timelines and budgets, and balance project costs to ensure you can make a profit.

Your brother-in-law is a plumber and your sister is an architect, and both worked for you on the single-family house project. You also had a good experience with your previous contractor and lawyer, and would like to add them to your team if you find a viable property.

You feel good about the character of your proposed team, but you need to find out more about the experience and capacity of its individual members to confirm they can handle a multifamily project.

- Is your sister familiar with the code and other requirements of the communities you're considering purchasing in?
- Your brother-in-law works for a plumbing company and did your project as a side job; Would he be able to take on a bigger project?
- Has your former contractor had past success with multifamily projects? Would the contractor work with your brother-in-law or do they have their own plumbing subcontractor already?
- Does your lawyer also have expertise in multifamily real estate transactions?

Property Management

Given your own level of experience, you've decided against new construction and have begun looking for small multifamily rehabilitation project opportunities in your hometown. Your sister and brother-and-law (both of whom have done some work on county land bank projects) tell you the land bank has a targeted redevelopment plan in an older neighborhood in a nearby city. The city is within a 20-mile radius, but since you were originally thinking you'd do the property management yourself, you need to think through the repercussions of the additional distance.

- In emergency situations when you might have to respond in person, what are the personal and economic costs of 40-mile round-trip drives?
- What are the estimated costs of having the property managed by a third party?
- Do you know of any reputable property management companies or do you need to go through a search process?

Financial Strength

You used part of an inheritance and some savings to cover the costs of your recent single-family rehabilitation project; this has left you short on cash until the property sells. You know you'll need some equity and liquidity for your next project, so you need to assess whether you have the financial strength to manage the project on your own or if you need additional partners.

- Are you confident that your single-family property will sell in the near future, or is there equity or liquidity you can leverage from your primary residence?
- Are there family members or friends you would consider bringing onto your team to bolster your financial strength?

THE PROJECT AND SITE

You meet with representatives from the land bank, who are working with owners and the city to figure out how to improve the neighborhood's rental housing stock. You're impressed with the land bank employees, who seem genuinely committed to revitalizing the neighborhood, and are excited by one of the properties on their targeted-for-rehabilitation list, a partially occupied, 16-unit building with historic importance in the community. The current owner has struggled with upkeep and is interested in a quick sale.

The land bank offers to take you on a walking tour, and you're pleased with the block on which the property is located. Although the building stock is definitely aging, most of the neighboring properties (a mix of single- and multifamily buildings) look well kept. There is a small park at one end of the street and a bus stop connecting the area to the city's downtown at the other.

To determine if the property makes financial sense, you collect relevant market and municipal information, such as comps and tax requirements. You also ask the land bank for help collecting building performance information from the current owner, who provides you with unit rent history and some old heat and electricity bills.

PUTTING IT ALL TOGETHER—DEVELOPING PRO FORMAS

Using the comps, market and building performance information you've collected, you begin to build out your draft income and expense statement.

Project Details

16 units, 48 rooms, \$1,250 rent per month (average per unit, after planned rehabilitation)

Income	Calculation	Annual Income
Residential Rent	\$1,250 rent income per unit x 16 units x 12 months	\$ 240,000
Other Income		
<i>Commercial or Other Rent</i>	No commercial or other rent income	\$ 0
<i>Laundry</i>	Assumed \$10 per unit x 16 units x 12 months	\$ 1,920
<i>Parking</i>	No parking income	\$ 0
<i>Storage</i>	No storage income	\$ 0
<i>Cell Tower</i>	No cell tower income	\$ 0
Total Other Income	Sum all other income	\$ 1,920
Gross Income	Total annual residential rent + total annual other income	\$ 241,920
Vacancy & Credit Loss, Rent (5%)	Total annual rent x 5%	\$ 12,000
Vacancy & Credit Loss, Other (10%)	Total annual other income x 10%	\$ 192
Effective Income (EI)	Gross income minus (rent vacancy and credit loss + other income vacancy and credit loss)	\$ 229,728

Expenses	Calculation*	Annual Expenses
Taxes	Average of actual taxes from CPC small building projects	\$ 34,677
Water & Sewer	\$150 x 48 rooms	\$ 7,200
Heat	\$270 x 48 rooms	\$ 12,960
Gas & Electric	\$130 x 48 rooms	\$ 6,240
Insurance	\$620 x 16 units	\$ 9,920
Repair & Maintenance	\$800 x 16 units	\$ 12,800
Property Management	Effective income x 6%	\$ 13,784
Legal	\$140 x 16 units	\$ 2,240
Accounting	\$1,300	\$ 1,300
Landscaping & Snow Removal	\$85 x 16 units	\$ 1,360
Cleaning Supplies & Exterminating	\$95 x 48 rooms	\$ 4,560
Staff Salaries	\$780 x 16 units	\$ 12,480
Total Annual Expenses	Sum of all expenses	\$ 119,521
	\$250 x 16 units	\$ 4,000

Effective Income	\$ 229,728
(Total Annual Expenses + Repair Reserves)	- \$ 123,521
Net Operating Income	\$ 106,207

* Expenses used are based on actual CPC project expenses or averages from CPC's maintenance and operations standards (ask your CPC mortgage officer if you'd like a copy of the most recent version of the standards).

You still need to put together a construction budget, so you call your contractor to see if they'd be willing to meet you for a walk through the building. During the tour, the contractor talks with you about some concerns—the possible presence of asbestos and lead paint, older wiring, and outdated fixtures and appliances. The contractor is generally enthusiastic about the building's condition and its historic charm. The contractor gives you some good information about projected rehabilitation costs and offers to arrange times for you to confer with subcontractors, if you would find that helpful.

Construction Budget

Acquisition and Refinance		Costs*
Acquisition		\$ 465,000
Refinance		\$ 0
Total Acquisition + Refinance		\$ 465,000
Hard Costs		Costs*
Construction		\$ 800,000
Construction Contingency (10%)		\$ 80,000
Total Hard Costs		\$ 880,000
Soft Costs		Costs*
Professional Fees		
Borrower's Architect + Engineer		\$ 40,000
Borrower's Legal		\$ 5,000
Bank's Engineer		\$ 15,000
Environmental		\$ 2,000
Lender's Commitment		\$ 19,233
Appraisal		\$ 3,500
Lender's Legal		\$ 14,000
Title		\$ 4,162
Mortgage Recording Tax (NYS-specific)		\$ 12,822
Survey		\$ 3,000
Carrying Costs		
Construction Interest		\$ 133,771
Real Estate		\$ 13,100
Water + Sewer		\$ 5,600
Insurance		\$ 24,300
Gas + Electric		\$ 6,600
Marketing		\$ 2,500
Total Soft Costs		\$ 304,588
Soft Cost Contingency (5%)		\$ 15,229
Total Soft Costs (Including Contingency)		\$ 319,818
Total Acquisition + Finance		\$ 465,000
Total Hard Costs		\$ 880,000
Total Soft Costs		\$ 319,818
Total Development Costs		\$ 1,664,818

*Costs used are based on costs from actual CPC projects.

You next work with a lender to determine if your project is financeable. Based on conversations with you and a review of the project details, your lender proposes the following as the best fit for your project's needs and your goals.

Lender's DCR: 1.25

Amount Available for Annual Payments: \$84,966

Amount Available for Monthly Payments: \$7,080

Interest Rate: 5.25%

Term: 30 years

Loan Size: \$1,282,220

Your Equity Contribution: \$382,597 (This amount is just under 23% of total development costs (TDC); most projects require a 20%–25% equity contribution.)

Your lender creates the following sources and uses statement, which assigns which line items the debt will pay for and which your equity contribution will need to cover.

	Uses	Sources	
	Costs	Equity	Debt
Acquisition	\$ 465,000	\$ 196,550	\$ 268,450
Refinance	\$ 0	\$ 0	\$ 0
Hard Costs			
Construction	\$ 800,000	\$ 0	\$ 800,000
Construction Contingency (10%)	\$ 80,000	\$ 0	\$ 80,000
Total Hard Costs	\$ 880,000	\$ 0	\$ 880,000
Soft Costs			
Professional Fees			
Borrower's Architect + Engineer	\$ 40,000	\$ 40,000	\$ 0
Borrower's Legal	\$ 5,000	\$ 5,000	\$ 0
Lender's Engineer	\$ 15,000	\$ 15,000	\$ 0
Environmental	\$ 2,000	\$ 2,000	\$ 0
Lender Commitment	\$ 19,233	\$ 19,233	\$ 0
Appraisal	\$ 3,500	\$ 3,500	\$ 0
Lender Legal	\$ 14,000	\$ 14,000	\$ 0
Title	\$ 4,162	\$ 4,162	\$ 0
Mortgage Recording Tax (NYS-specific)	\$ 12,822	\$ 12,822	\$ 0
Survey	\$ 3,000	\$ 3,000	\$ 0
Carrying Costs			
Construction Interest	\$ 133,771	\$ 0	\$ 133,770
Real Estate Tax	\$ 13,100	\$ 13,100	\$ 0
Water & Sewer	\$ 5,600	\$ 5,600	\$ 0
Insurance	\$ 24,300	\$ 24,300	\$ 0
Gas & Electric	\$ 6,600	\$ 6,600	\$ 0
Marketing	\$ 2,500	\$ 2,500	\$ 0
Total Soft Costs	\$ 304,908	\$ 170,818	\$ 0
Soft Cost Contingency (5%)	\$ 15,229	\$ 15,229	\$ 0
Total Soft Costs (Including Contingency)	\$ 319,818	\$ 186,047	\$ 133,770
Total Development Cost	\$ 1,664,818	\$ 382,597	\$ 1,282,220

Note: For the purposes of the case study, we assume that your pro formas need no adjustments and that the loan the project's NOI can support covers the cost of construction.

FINANCING GAPS

The case study assumes that the NOI of your project can support the debt you need to rehabilitate your building. But what if your projected numbers don't add up? You now have what is known as a financing gap, which you'll need to fill for your project to be viable.

The scenarios below are examples of ways that a gap in financing could occur in a project. The first assumes a change in NOI and, consequently, a decrease in your supportable loan amount. The second assumes an increase in the cost of acquisition that is not supported by the previously determined loan amount.

Scenario One:

You overestimated the amount of rent your building can generate; instead of an average of \$1,250 per unit, the reality is closer to an average of \$1,000 per unit. This means the amount your project has available for annual payments is only \$70,220 and your new supportable loan amount is around \$848,000. Because the new loan amount is smaller, fees that are dependent on either the loan size or the TDC decrease, as well, giving you a new, lower TDC of about \$1.6 million. Given your construction costs, you now have a little more than a \$400,000 gap.

New TDC>	\$ 1,638,518
New Loan Amount>	\$ 847,767
Equity> -	\$ 382,597
Gap		\$ 408,154

Scenario Two:

You have underestimated the cost to acquire your building; you will need to spend a bit more than \$535,000. This time, fees dependent on the TDC further push up costs and bring your TDC up to \$1.7 million. Your supportable loan amount isn't big enough to cover the difference and you now have a gap of just over \$70,000.

New TDC>	\$ 1,735,002
Original Loan Amount>	\$ 1,282,220
Equity> -	\$ 382,597
Gap		\$ 70,185

Filling the Gap

For these scenarios, a number of options exist for you to fill your gap and make your project feasible:

- Reducing your construction scope.
- Leveraging your existing properties to increase your equity contribution.
- Bringing in another equity investor.
- Talking to your lender about funding programs or subsidies for which your project may qualify.

For more detail on the range of options when faced with a gap, see page 32 of the Start Small Guide.



CPC is often able to increase supportable loan amounts based on projected utility savings for projects that integrate energy-efficiency measures. Talk with a CPC mortgage officer about energy-efficiency opportunities.