TOOLS FOR CO-OP HOME OWNERSHIP

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INTRODUCTION

So your Co-op needs some extra cash. We're not just talking about money to meet expenses. We're talking about Money to buy a new house, a car, maybe a new stove and refrigerator. But mainly we're talking about **borrowing** money, large amounts of money.

This course will focus on financing *Capital Expenditures* rather than *Revenue Expenditures.* Capital Expenditures (Improvements) usually have both value and life for more than just the current year. Revenue expenditures are usually for items which are used or consumed in the current year. Capital items are houses, cars & trucks, refrigerators and stoves. Revenue Expenditures are usually for food, utilities, payroll, maintenance and the like. For illustrative purposes this course will further focus on **borrowing money** to buy a **new house**. However, many of the concepts are applicable to other financing decisions.

Questions to ask prior to deciding whether or not to purchase a new building.

Do we have demand for this building? Do we have demand for our current houses? Do we have a waiting list? Will our own Co-opers support this building? Will they move in? Will they colonize the new house? What internal processes are required for a purchase of this type? What do our By-Laws require us to do to buy a building? Do we need a vote of the Membership to buy?

In addition, how will the new house impact other existing houses? Will it draw members away from other houses, thereby creating burdensome vacancies in your older buildings?

Is the new house in a desirable location? A desirable community? Is it in a student community? How far is it from campus? Is it a desirable size? Is the configuration (building layout) appropriate for a co-op?

In order to answer these and other questions, you probably will want to undertake a detailed **market analysis** prior to undertaking any major acquisition.

Can we operate this building as a Co-op under the current zoning codes? (e.g. number of unrelated people cohabiting, number of parking spaces)? New housing codes are passed all of the time. However, all zoning codes are not applicable in all situations. Some new codes are retroactive for all housing. Some new codes are only applied to changes of ownership or use. And some code changes apply only to new construction.

How much work (time & money) is needed before this house can become a Co-op? Is the building (configuration) suitable for a Co-op? Does it have to be extensively remodeled? Do living rooms and dining rooms and kitchens have to be converted to bedrooms? Does the household kitchen have to be converted to a

commercial kitchen? How about earthquake safety? Fire safety? What regional whether considerations should you take into account?

Do you need professional help? When do you need a lawyer? A Realtor? Not all Realtor are alike nor are all Realtor's commissions the same. Usually the buyer and the seller each have their own Realtors. While a Realtor can be your own best friend, he or she can also be your worst enemy. Do you have some-one on your board who can assist you? Do you have a qualified alumnus who can help? For free?

What will be the total costs of acquisition?

The next issue that you need to address is, what will be the total cost of the new building. So the owner is willing to sell you this fantastic house for $500,000. That's all there is to it. Isn't it? Oh No! There's more. Lots more!

What improvements will immediately be needed to open the Building?

Does the building have bugs? Termites? Check out the following. Does the building need (a) new:

- Building & Zoning Codes
- Roof
- Foundation
- Kitchen
- Plumbing: Main water supply or sewer systems.
- Electrical Service
- Heating systems
- Air Conditioning
- Painting: Interior & exterior.
- Fire Alarms and/or Fire Sprinklers
- Hazardous Waste Removal
- Other

What improvements will be immediately necessary to open the building? Again, is the building (configuration) suitable for a Co-op? Does it have to be exten-sively remodeled? Do living rooms and dining rooms and kitchens have to be converted to bedrooms? Does the household kitchen have to be converted to a commercial kitchen?

What additional improvements are needed in the short-run (3-5 years)? In the long-run (more than 5 years)?

What are the additional "closing costs?" In addition to the sales price, most Real Estate transactions include many, if not all, of the following costs or fees. While some fees can be quite trivial like filing fees, others like title insurance and legal fees can be in the thousands of dollars.

- Closing Costs
- Title Insurance
- Escrow
- Notary
- Recording/Filing
- Tax Service
- City or County Transfer Fees.
- Legal fees
- Points
- Appraisals
- Surveys
- Structural Pest Control (Termite) Reports
- Environmental Impact Reports (EIR)
- Other

Can you afford the new house?

Once you've decided that you can operate the new house. And you've decided that you want the new house. And you know how much the new house will actually cost, the next question is, can you afford it?

The next step is normally to prepare a pro forma operating statement for the new house. A pro forma operating statement is really just a profit and loss projection for the new house. Commonly, there are a couple of ways that an operating statement can be projected. One way is to get historical operating information about the new house from the seller. This information is then projected to the new house, as it would be operated by the co-op. Remember to adjust income and costs to reflect how your co-op operates. For example: Do your members pay social dues? Are you exempt from paying property taxes? Be sure to include the cost of debt service (principle and interest on the loan), if any, for the cost of acquisition.

A better alternative to this Historical not-as-a-cooperative projection is to simply take a look at the operating income and costs of your existing houses and project those costs to the new house. Most often these projections are based upon per person averages. Again, remember to include the cost of debt service (principle and interest on the loan), if any, for the cost of acquisition.

Does the projected income cover the projected expenses? If not, will your other members be willing to subsidize the new acquisition? Is the building of such high

quality (desirability) that you can charge more money (per person) than you can normally charge for your existing houses? If so, will your members still live there?

If you can't afford the house, does that mean you can't afford the house? Of course not. There are many ways to absorb costs or to otherwise defer expenses to the future in order to reduce operating costs in the short-run.

- Subsidies by Existing Co-op
- Deferment of Improvements
- Interest Averaging
- Alternative Purchase Agreements
- Other

Price Negotiating Strategies.

Seldom does the seller get his or her "asking price." Usually the buyer sells for less than the asking price. Sometimes the seller actually gets more than he or she asked for in the first place. There are a great many factors which finally combine to determine the price at which that the seller is actually willing to sell. Usually sales price negotiations involve more than just offer, counter-offer, until we agree or can't agree on a sales price.

Supply and Demand. This is probably the most import factor which will determine the price of the new house. Because most Co-ops charge below market rents for their housing, they can't afford market prices. If we're competing with some private developer, we're usually at a distinct disadvantage. When this happens, we need to look to other ways of negotiating prices.

Co-ops can appeal to the seller's social conscience. Co-ops are better than other rip-off housing types. Right? The seller should want to sell to co-ops.

Sellers can reduce sales price by taking less money and "donating" the difference to the co-op as a tax-deductible donation.

Often Sellers are faced with taxable Capital Gains on the sale of the property. You can suggest that some of the purchase price be deferred until the future to reduce the seller's immediate tax burden.

Sometimes (elderly) sellers are looking for current income, while wishing to maintain their estates for their heirs. Oftentimes senior citizens own income property. They rely upon the rent from the property to augment their retirement income, and plan to leave the property as an asset to their heirs when die. In these cases you might want to enter into a "rent-to-purchase" agreement with the sellers. In this agreement you negotiate an annual rent (inflation indexed or not) guaranteed until the surviving spouse dies at which time you have "first right of

refusal" to purchase the property (usually at a predetermined price). Then the proceeds of the sale accrue to the seller's estate for the sake of the heirs.

Often the Structural Pest Control Report will be quite expensive. This usually drastically impacts the seller's price. You can offer to buy the property "as is." The price will be reduced by the cost of the Report. Then you can either do the repairs at a much lower cost with co-op labor. Or you can defer the repairs until such time as the co-op can afford them.

Purchase Contingencies Once the seller and buyer have agreed upon the terms of the sale, they usually write up and sign a sales agreement. The agreement will usually have a number of conditions to be resolved subsequent to the signing of the agreement. These are called "contingencies."

The two most common contingencies are *financing* and *inspection.* Most sales contracts are contingent (dependent) upon the buyer obtaining acceptable financing for the building (acceptable is usually defined in the agreement). In other words, the sale is subject to the buyers getting the money. Buyers are released from the purchase agreement if they can't get financing. Be sure to include whatever you consider to be an acceptable interest rate and terms in this contingency. Otherwise, the seller may offer or produce "acceptable financing" thereby fulfilling this contingency. If you then chose not to buy the building, the seller may have a legitimate claim at keeping your purchase deposit.

In addition, most agreements provide for inspection contingencies. This contingency allows the buyer to further inspect the property in greater detail. Usually a contractor, engineer or architect will be engaged for this more extensive inspection. Buyers are released from the purchase agreement if they discover some structural problems which cause them to change their mind about buying the building.

There's a third contingency available to Student Co-ops which is much more important than any of the others: **Board Approval**. Make sure that any agreement to purchase is contingent upon the approval of your Board of Directors. While ostensibly, this contingency is there to allow you to get the appropriate political Board approval, this contingency allows the Co-op to change its mind for any reason whatsoever! **Always make sure that any agreement to purchase is contingent upon the approval of your Board of Directors**.

Financing Considerations.

Once you've decided to buy the building, you have to figure out how to pay for it. *Some Co-ops are sufficiently wealthy to just pay cash for new acquisitions.* You might decide to pay for the new building out of operating income (doubtful) or out of other reserves.

Some Co-ops raise money from many outside sources:

- Member Donations
- Member Assessments
- Member Loans
- Alumni Donations or Loans
- Other Co-op Donations or Loans
- Foundation Grants
- Faculty
- Borrowing
- Non-Traditional Lenders
- Owner Financing
- Second Deeds of Trust
- Sweat Equity

Borrowing. Most Co-ops, however, need to borrow money to buy new houses. Actually, buying a house usually requires a combination of monetary sources. Few banks, if any, will lend you the entire amount of money needed to purchase a building. Most banks will only loan you a portion of the purchase price and will require you to come up with the difference. Your share of the purchase price is usually referred to as the <u>down payment</u>. Your down payment is usually some percentage of the total price. Common down payment requirements vary between twenty and thirty per cent. Down payments as low as ten per cent are great, but rare. Down payment requirements as high as fifty per cent are unfortunately becoming more and more common. The percentage share between what the bank is willing to put up and what you have to put up is sometimes referred to in loan-to-value terms. A twenty-five per cent down payment might also be called a loan-to-value of seventy-five per cent. (The bank will loan you seventy-five percent of the purchase price (value)). These loans are usually first mortgage loans and are collateralized (guaranteed) by first liens on the property. A lien is a legal instrument which guarantees the bank that if you default on the loan; the bank can take the property.

Down payment money. Most older established co-ops come up with their down payment money out of reserves. However, any of the financing sources cited immediately above can be used for down payments. However, there are two additional sources of down payment money that can be exceptionally useful to Student Co-ops: Owner financing and other Co-ops.

Owner Financing. Often owners will be willing to loan the buyer some or all of the money necessary for the down payment. This money will have to be paid back over a fixed period of time and you will usually pay the owner a higher interest rate for the use of his or her money.

Other Co-ops. Often other student co-ops are willing to loan short-term money towards down payments. These loans are often for only three to five years and are designed to help get new co-ops started. Often these loans have fifteen-

year amortizations with "balloon payments" due in three to five years. (See the Amortization Section at the end of this Course outline)

Owner financing and other co-op loans are often referred to as subsidiary financing. These loans are usually secured by second or even third mortgages (secured by second or third liens). These second and third liens are "subordinate" to the first lien holders, and in the case of default, they get their money back only after the first lien holder has gotten their money out of the property. In cases of default, subordinate lenders are usually forced to buy out the primary lenders in order to protect their investments. Because of this higher risk, subordinate financing is usually at a higher interest rate than primary financing.

"*Sweat Equity Financing.*" Often significant improvements need to be made to the house prior to occupying. These improvements subsequently increase the value of the building. Often banks will take this increased value into account when determining the loan-to-value and therefore the down payment required. If the bank will do this, often you can perform the improvement as your down payment. When done with "co-op labor" this can significantly reduce the cash necessary to buy the building.

A note on using Reserves: Co-ops often use reserves for financing acquisitions. It is important to know whether these reserves are designated reserves which are designated for some specific use, or just regular reserves. In either case it is important to know how and if the reserves need to be replenished if depleted. It is wise to assume that all reserves need to be replenished after being when depleted or reduced. Most Co-op repay their reserve funds at roughly the same rate as they repay the other loans associated with the building purchase. For example, if you use $150,000 of your reserves for the down payment, you might replenish the reserve fund at $10,000 a year for 15 years or even $30,000 a year for 5 years.

Getting a Loan

All banks are not alike. Each and every bank will have different loan requirements, and different fees. Just like you would shop for a computer or a new car, you need to shop around for the best loan. While we recognize that there might not be that many banks willing to loan money to Student Co-ops, here are some things that you should consider in choosing a lender:

- Down Payment
- Loan-To-Value ratio
- Interest Rate
- Term
- Fixed vs. Variable Interest Rate
- Variable Interest Rate Index
- Loan Fee (Points)
- Legal Fees
- Pre-payment Penalties
- Late Charges

What are the hidden costs? All banks don't have the same pre-closing costs or requirements. Often these costs can be very substantial. And, often these costs don't surface until after you've committed to a lender and it's too late to change.

To be considered:

- Application Fees
- Commitment Fees
- Appraisals
- Surveys
- Engineering Reports
- Environmental Impact Reports
- Hazardous Waste Reports
- Legal Fees

The Loan

And finally, once you've agreed on the purchase price, determined how to come up with the down payment, and selected a bank; you need to get the best possible loan terms that you can.

Interest Rate. Usually you have a choice between a fixed interest rate which remains constant over the term (life) of your loan, or a variable interest rate which changes periodically based upon some agreed upon economic indicator. Assuming you can get either a fixed or variable interest loan, you need to compare the rates with a crystal ball's prediction of the future economy. Optimists usually chose variable rates while pessimists choose fixed rates.

Variable Interest Rate Index. Variable interest rates are indexed (anchored or tied) to common financial indicators. Indexes can be the prime interest rate, Treasury Bills of various terms, Federal Reserve Cost of Funds rates, and many others. Most of these indexes vary in their volatility, and you will again need your crystal ball to choose the best rate for your co-op.

Interest Rate Adjustment Caps and Adjustment Frequencies. If you choose a variable interest rate, how often does the interest rate increase or decrease? How high can it go (Cap)? How low?

Points. This is just a banker's way of disguising the fact that they are charging you a commission for granting you the loan. Often instead of calling something a loan fee, it's called points. Points are sometimes split between loan brokers and the banks. Points, referred to in terms of interest, range from one half point (per cent) to as much as three points (percent), and even higher. Points are paid up front, on top of the loan. Usually, it's well worth it if you can pay half of one point in exchange for reducing your interest rate by one fourth of one per cent or more.

Pre-payment Penalties. Sometimes you will sign a loan, and economic conditions or other conditions will make you want to change the loan to some other type, or to move to another bank with a better loan. Some loans will include a "pre-payment penalty" for paying off the loan before the end of its term. Some loans have pre-payment penalties which decline over time or end after a fixed number of years. Because economic and banking conditions change, pre-payment penalties should be avoided if possible.

Term. How many years do you have to pay back the loan? The longer the term, the lower the monthly payment. Unfortunately, the longer the term, also the greater the total amount of interest that you have to pay. We would argue that a fifteen-year term is optimal, if you can afford the monthly payments.

Amortization. Some loans have terms which are different from their amortization. This means you might be paying back a loan as if it were to be repaid over fifteen years, but the loan is actually due in five years. This keeps your monthly payment low, but it means a large unpaid portion of the loan suddenly becomes due at the end of five years. This is called a "balloon payment." Banks often make balloon payment loans because they are unsure of the borrower's long-term viability or the bank is unsure of future interest rates. Borrowers might choose balloon payment loans if the believe that interest rates will surely go down in the future. Unfortunately, balloon payments must be either paid off or refinanced when due. This means that the borrower must either convince the existing bank to renew the loan, get a new loan from a different bank, or somehow otherwise come up with the money to pay back the original bank. Usually balloon payment borrowers are hoping that either their financial situation will improve as they accrue "equity" in their building and develop an operating "track record," or that interest rates will go down by the time the loan becomes due.