Mixed Use Projects and FHA Financing

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HUD allows FHA-financed properties to have a commercial component and income, where commercial is defined as any space or facility permitted and acceptable for “Nonresidential Use” from which income is derived or anticipated. It should be noted that under this definition, income from residents for the use of community rooms and parking are not considered commercial even though fees may be collected. This income is considered ancillary income and is treated separately from commercial income. However, income from non-residents related to parking or other community facilities must be treated as commercial income.

Commercial Space Limitations

The table below summarizes the rules for various loan programs. For example, an Acquisition/Refinance loan under Section 223(f) allows for up to 25% of total Net Rentable Area (excluding common areas and hallways) to be allocated to commercial space. In other words, if you currently own a four-story apartment building and are considering converting the ground floor into retail, the property would qualify, but not if you have a three-story apartment building. That said, the income that counted towards the debt service/value calculation will be limited to 20% of Effective Gross Income. Since the reason for having a downstairs retail is typically higher rental rates per square foot than for apartments, it should be an important consideration and further analysis should be undertaken. Specifically, since FHA provides one of the industry’s best interest rates (as of 8/4/19 the all-in interest rate for a typical 1980’s vintage property for a $5MM loan would be approximately 0.54% lower for FHA than a FNMA loan), higher leverage (80% for a cash out refinance on FHA compared to 75% for FNMA) and a fully amortizing 35-year loan term (compared to 10 year term and 30 year amortization for FNMA). The difference is even more drastic when compared to other debt, such as banks, with higher rates, lower term and loan to value as well as recourse added in. Therefore, a careful analysis is needed to see if FHA is the best option for you and your property even if not all commercial income can be counted.

<table>
<thead>
<tr>
<th>Program</th>
<th>Acquisition/Refinance</th>
<th>New Construction/Substantial Rehab</th>
<th>Urban Renewal Area* New Construction/Substantial Rehab</th>
</tr>
</thead>
<tbody>
<tr>
<td>Max % of Total Net Rentable Area</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Max % of Effective Gross Income</td>
<td>20%</td>
<td>15%</td>
<td>30%</td>
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</tbody>
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*This program applies only to projects located in certain Urban Renewal Areas. Contact us for more details.

Waivers and Workarounds for Commercial Space Limitations

As with most rules, there are certain exceptions and workarounds that are possible to make a project that would not otherwise qualify work within the programmatic guidelines. Specifically, a waiver for the commercial space limitations may be issued so long as the amount does not reflect a property that is primarily commercial rather than residential. The project must contribute to meeting HUD’s Strategic Plan Goals, including promoting sustainable communities or supporting transit-oriented development.

Alternatively, an income limit waiver could be granted for a project with a long-term lease with a credit-worthy tenant, such as
a government agency or a well-established corporation. A waiver would also be feasible for a multi-tenant commercial space where the tenants have a long history of occupancy (five or more years) and full occupancy of this space is not needed to provide a break-even cash flow for the project.

Additionally, a net rentable area limit waiver may be granted for a project where there is ample market support to assure occupancy of the space within the projected absorption period.

Finally, if none of the waivers apply to the property there is always an option to create a condo regime for the property, where the commercial portion of the property is held in one entity and the residential portion is held in another. This option, however, will allow only the residential portion to be finance with an FHA loan, requiring a separate loan that, as outlined above, will likely not have all the advantageous terms that FHA provides.

**Underwritten Vacancy Requirements**

- **Acquisition Refinance** – Minimum underwritten commercial vacancy rate shall be the greater of:
  a. That indicated by the market, or
  b. 10%

- **New Construction/Substantial Rehab** – Minimum underwritten commercial vacancy rate shall be the greater of:
  a. That indicated by the market, or
  b. 20%

**Commercial Parking Income**

The space occupied by parking and community facilities for tenants is not included in the calculation for allowable commercial space, even if tenants are charged for it. On the other hand, parking income from commercial parking spaces reserved for non-tenants (i.e., public parking) must be included in the Commercial Space and Income limitations. Properties that provide parking to non-residents for a monthly fee must identify the percentage of monthly parkers who are non-tenants to include these in the commercial income limitations.

The minimum vacancy factor to be applied to the parking income attributable to non-tenants shall be the lower of:

- a. The amount indicated by the market and by the historic performance of the subject; or
- b. 50%