

To: **Acquisitions Committee of the Foreclosure Task Force**
From: Louise Elving, VIVA Consulting
Date: July 16, 2008
RE: **Challenges in the Renovation of Foreclosed Housing**

Many organizations working to redevelop foreclosed housing are finding that organizing and managing renovation presents unique challenges that do not arise in new construction or typical gut rehab projects. This report summarizes important issues that occur when CDCs or other developers seek to tackle multiple buildings, often including multiple small multi-family structures such as triple-deckers. Foreclosed properties that need moderate, rather than full gut rehabilitation, increase the challenges.

The report is based upon interviews VIVA Consulting has done for the Acquisitions Committee with seven CDCs and cities, as well as other conversations and work with CDCs seeking to acquire and restore distressed properties. The organizations include City of Boston, Brockton Housing Authority/Southern MA Affordable Housing Corporation, Coalition for a Better Acre in Lowell, Chelsea Neighborhood Developers, Homeowners Rehab, Inc. in Cambridge, Lawrence Community Works, City of New Bedford, Worcester Community Housing Resources and Greater Elmwood Neighborhood Services in Providence, Rhode Island.

The three major sections of this report are:

- Challenging Project Conditions
- Design and Construction Implementation Challenges
- Resulting Challenges with Project Funders

Challenging Project Conditions

- **Continually evolving project definition:** It usually takes a very long time to track the responsible owner of foreclosed housing (or housing in the process of foreclosure) and to negotiate its acquisition. This means that a CDC or other prospective owner seeking to restore more than a couple of buildings cannot know at the outset of project planning how large a project will be or the location of buildings that may become part of it. The developer will typically need to start buying buildings before knowing the eventual project size. This means it must figure out how to restore one or two buildings initially, while having the flexibility to tackle many more structures if and when they become available.
- **Scope of rehab:** Some foreclosed properties are very deteriorated and clearly need gut rehabilitation, and the acquisition prices of such structures should reflect their condition. Other properties are less deteriorated and so have higher prices. For them, funding resources will almost certainly not be sufficient to replace all systems or upgrade all kitchens and baths or finishes, so tough choices may need to be made about priorities, with some items deferred into the future. E.g., roofs that have 5-10 years remaining life may not be replaced; older kitchens in fair condition may be left as is rather than modernized.

Preliminary construction cost estimates, per unit, from several CDCs range from \$35-50,000 per unit for moderate rehab to \$100,000 or more per unit for gut renovation, all in small multi-family buildings such as triple-deckers. One CDC is hoping to find at least some buildings in very good condition where per unit rehab might be even less, closer to \$10-20,000 per unit. Renovations may need to include hazardous materials remediation such as removing lead paint, asbestos or leaking oil tanks.

- **Diverse building conditions:** Building conditions in a single project may vary substantially from fairly good to badly deteriorated. Some CDCs have decided to undertake only vacant

properties that require gut rehabilitation. Others are acquiring buildings in diverse conditions, including some occupied buildings. In the latter projects, the architect (or other person defining the rehab scope) and construction contractor must be able to respond to building-specific variations scope, rather than doing the same items repeatedly in multiple buildings.

- **Timing:** Properties are likely to be acquired over a period of time, and it may not be possible to hold them so that all are rehabbed simultaneously. Instead, buildings may be restored sequentially. In addition, some structures may need essential repairs as soon as they are purchased such as repairing leaks.

Design and Construction Implementation Challenges

Developers of foreclosed housing may confront all or many of the following issues in determining the most cost efficient way to renovate the property. These issues grow out of the challenging project conditions noted above.

1. Defining rehab scope, preparing design documents, and cost estimating

- a. **Defining scope.** Who is inspecting properties to determine their rehab needs and prepare work write-ups? These tasks need to be done by someone who understands old building systems and can evaluate quickly whether existing equipment (such as HVAC, plumbing, electrical) can remain or needs upgrading or replacement. Not all architects have this experience. A handful of CDCs and public agencies have in-house staff who can do this, but most need to rely on third party professionals. Thoughtful discrimination in each building is key for moderate rehab projects since costs can be controlled only by judicious retention of workable systems, equipment and finishes.
- b. **Defining rehab standards.** The developer needs to work with its project designer to define the level and types of finishes (e.g., types of flooring and cabinets, ceramic tile versus one-piece tub surrounds, etc.) and types of equipment (e.g., brands of appliances) that are required post-rehab. It is recommended that these standards be reviewed with the property management personnel to gain their perspective on how well they function long-term.
- c. **Design documents.** Will it be sufficient to prepare written work write-ups, along with sketch plans of unit and building lay-outs, rather than preparing full-scale architectural plans (although plans will be needed for unit reconfiguration or structural work)? This type of rehab documentation is sometimes paired with a matrix defining work scope, by unit. Several CDCs have reported that this documentation has been cost effective in completed projects, particularly in the case of moderate rehabilitation. Its merit is that it is less expensive, faster to prepare and may be more readily useable by small contractors than full architectural plans
 - i. Will funders, investors and city agencies accept this type of documentation, without requiring full architectural plans? Will it provide sufficient guidance for contractors?
- d. **Cost estimating.** Who is providing preliminary cost estimates? This needs to be someone with experience in the proposed level of rehab, whether moderate or gut. Several successful strategies are reported by various organizations.

- i. On at least one CDC project, this task is being done by the project architect who has experience doing other moderate rehab projects with the sponsor.
- ii. One CDC and one public agency have in-house staff who can do this.
- iii. Another CDC reported that it has brought one or two local contractors to its initial building walk-throughs and they have provided cost estimates.

2. Contractor selection

Since project size and rehab scope (that is, whether all gut or moderate rehab or a mix of the two) will evolve over time as buildings are acquired, selecting the best contractor or contractors is more challenging than picking a builder for a project whose scope is fully known at the outset.

- a. **Single versus multiple contractors.** Is it best to select a single general contractor which will renovate all the buildings that a developer hopes to acquire over time? Or is it better to select a contractor to do the building(s) which are rehabbed initially, and then to revisit contractor selection as a project proceeds and more buildings are acquired, based upon the builder's performance and future rehab scope? E.g., if one building requires gut and another moderate rehab, would it be appropriate to give them to separate contractors, each with appropriate skills for the specific building? One CDC with experienced in-house construction management staff reports that this approach works well for it.
- b. **Small versus large contractors.** What kinds of general contractors will undertake this work? If buildings will be renovated one at a time or in small groups, large contractors may not be a good fit because their overhead costs may overwhelm the budget. Smaller, perhaps local firms may be a better match in terms of their costs and scale of operation. For moderate rehab, it is important to select contractors with relevant experience that are prepared to do selective renovations, rather than assuming more easily defined and managed full-scale replacement of systems and equipment.
- c. **Managing repairs, as well as renovation.** Two other issues are related to the fragmentation in time and scope of renovation work in foreclosed housing. One is how to handle any critical repairs required immediately after acquisition to meet basic life safety standards (e.g., fixing broken stairs, installing smoke detectors), while the bulk of rehab needs to occur later once financing is assembled. This means managing two waves of work in a building and having resources for immediate repairs along with acquisition funding. While the scope of initial repairs is generally larger in occupied buildings that must be made safe for residents, even vacant properties can need urgent work such as boarding up and exterior life/safety work. A second issue is how to manage specific individual repairs that are identified while major renovation work is underway such as replacing one door, one window or one kitchen cabinet or repairing a small section of deteriorated wall.

Three different strategies for managing these two stages of repairs have been identified, and various CDCs have reported success with each.

- i. The contractor which is expected to do the entire project does the work.
- ii. The property manager for the owner does it, as it would other repairs needed during housing operation. The management agent might have in-house staff who can do repairs or might hire small contractors.
- iii. The owner's construction representative, who may be an in-house staff person or a third party consultant, manages the repairs, hiring specific trade contractors as needed.

3. Relocation

If buildings are occupied, can renovation be done with residents in place or will they need to be temporarily or permanent relocated? Relocation work flow is uneven over time. For example, when rehab is about to begin, the demand may be great as families are relocated, then slows down while rehab is underway, and accelerates again near project completion when residents will be moving back.

- a. **Who will manage relocation**, notifying residents, assisting them with packing, moving, and utility change-overs if relevant, paying relocation expenses, etc. Three strategies for this have been reported.
 - i. The management company does it.
 - ii. A separate specialist or firm hired by the owner takes care of relocation.
 - iii. Staff of the owner such as community organizers or social service personnel manage it. One CDC reported that it has hired a community resident to manage relocation in consultation with the development project manager.

4. Construction over-sight/management

Who oversees renovations and represents the owner in solving day-to-day problems? While a project architect will typically be involved, will anyone additional represent the owner, such as a third-party owner's construction representative? A handful of CDCs and agencies report having in-house staff with construction expertise who can do this, but many rely on third-party professionals. It is important to have someone who can be available quickly to respond to immediate problems, so the contractor is not delayed. Moreover, if multiple contractors will be used, construction over-sight becomes more extensive.

Resulting Challenges for Project Funders

The nature of foreclosed housing redevelopment projects means that many of the usual lender standards for design and contractors may not be met, especially in the case of moderate rehabilitation. The usual standards bring costs that will overwhelm project budgets and may be inconsistent with the sequential acquisition/renovation process.

1. Design-related challenges

- a. **Scope of renovations.** Will funders accept moderate rehabilitation that leaves in place some existing systems, equipment and finishes which are not fully modernized and whose remaining useful life is modest?
- b. **Design documentation.** Will funders accept less than full architectural plans and specifications, such as the documents described earlier (i.e., work write-ups, building sketch plans, with architectural plans only for structural work, etc.)?

2. Contractor and construction related challenges

As discussed earlier, it may be more appropriate and cost-effective to use small rather than large contractors for these projects. In addition, it may be necessary to retain contractors on a building-by-building basis (or perhaps for two or three buildings at a time) as acquisitions occur. Both drive the need to keep down costs, giving rise to the following issues.

- a. **Contractor selection process.** On larger-scale projects, funders often want evidence that the developer has competitively priced the project with at least several contractors to be sure that

- the lowest reasonable price has been obtained. However, the small scale of foreclosure projects or the need to retain a contractor which will work on multiple buildings as they are identified make this difficult. Will funders accept a flexible approach, consistent with an evolving project definition and the potential use of multiple small contractors or the engagement of a contractor to work on sequential buildings?
- b. **Contractor bonds or letters of credit** may not be obtainable from small, efficient contractors. Even larger contractors may have difficulty providing them if their contracts are organized in small bites, that is, for only one or a few buildings at a time. Will funders proceed without either of them?
 - c. **Monthly versus more frequent payment.** Conventionally, lenders in the housing industry process requisitions once a month. But small contractors may need to be paid more frequently because they don't have the cash flow to carry payroll and materials for thirty days or more. Will funders process payment twice a month? If not and developers need to find other resources to make interim payments, will funders repay developers for funds advanced to contractors?
 - d. **Funders' construction inspections.** Typically funders send their own inspectors to construction sites monthly and charge projects for this work, often around \$500-750 per monthly inspection. But these charges cannot be afforded by projects whose total development budget, for rehab of a triple-decker, may be under \$500,000. Will funders absorb these costs?
 - e. **Short form construction contracts.** The extent of contracts should match the scale of the work. Will funders accept short form contracts for projects (or phases of projects, contracted for separately) that are under, say, one million dollars?
 - f. **Short form change orders and quick approvals.** As in all rehab projects, change orders are inevitable since unknown conditions will be uncovered in the course of the work. As with construction contracts, the documentation needs to match the scale renovations and so needs to be simple with quick approvals. For example, the moderate rehab of a single triple-decker may be scheduled over four months; if change order documentation and approvals take sixty days, the project will be unreasonably delayed. How will lenders work with owners to simplify and accelerate the process?
 - g. **Labor and MBE/WBE requirements and reporting.** Small contractors do not have the wherewithal to meet specified goals for minority, local or women's employment or MBE/WBE utilization. They don't have the skill or overhead to undertake this or to report on it. Even larger contractors that might do this on multi-million dollar projects cannot afford its time and overhead on sequential buildings where a single rehab contract might be for hundreds of thousands of dollars. Will lenders proceed without it?
 - h. **Prevailing wage requirements.** Small and mid-sized contractors -- which generally appear to be the best match for foreclosed property rehabilitation projects -- are not organized to pay prevailing wages, nor are their networks of sub-contractors. Developers will be asking funders to work with them to structure financing so these requirements are not triggered.