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LEDAHF-East Cleveland LLC, Ohio Cleveland-Cuyahoga County Port Authority; Affordable Housing

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Long Term Rating	B-/Watch Neg	Downgraded
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Long Term Rating	B-/Watch Neg	Downgraded

Rationale

S&P Global Ratings lowered its ratings on the Cleveland-Cuyahoga County Port Authority, Ohio's series 2015A and B multifamily housing revenue bonds to 'B-' from 'A-'. We also lowered our ratings on the authority's series 2015C bonds seven notches to 'B-' from 'BBB'. These bonds were issued for LEDAHF-East Cleveland LLC to acquire the Forest Hill Park Apartments Project in East Cleveland. The ratings remain on negative CreditWatch, where they were placed on Dec. 14, 2016.

The ratings reflect our view of the following factors:

- Operating loss for the project in 2016, resulting in a zero debt service coverage (DSC) ratio on the bonds;
- Poor loss-coverage assessment, reflecting the limited liquidation value of the project;
- High vacancy rates, with 60 out of 174 units vacant as of June 2017; and
- Uncertainty regarding the project's ability to pay debt service in September 2017 based on current revenues and occupancy rates.

Project Update

The project has exhibited poor operational performance since it was acquired in September 2015. As of June 2017, 60 of the 174 units at the property were vacant. According to the current owner, Social Housing Inc., after the initial property acquisition in September 2015, the on-site property manager aggressively evicted nonpaying or problem tenants in the fall of 2015, resulting in an occupancy rate of 59% as of December 2015. The owner also discovered higher-than-expected levels of deferred maintenance in the project, including boilers, elevators, and plumbing systems. The initial project fund funded at closing for capital improvements has been depleted. As of June 28, 2017, $115,066 of the $176,853 September 2017 senior debt service payment for series 2015A and B bonds was funded, and $9,669 of the $22,218 subordinate debt service series 2015C debt service payment was funded. In our view, the likelihood of default on both the senior and subordinate bonds is similar, given the small debt service payment amount for the subordinate bonds. To date, the project has not drawn on its debt service reserve fund; a draw on the debt service reserve fund to pay debt service would result in a lowering of the ratings to 'CCC' or lower.

The bonds were issued to finance the cost of the acquisition, renovation, and equipping of a 174-unit multifamily residential rental housing project known as Forest Hill Park Apartments, in East Cleveland, Cuyahoga County. The property was built in 1949, and is about seven miles east of downtown Cleveland. It contains two eight-story apartment buildings connected by a parking garage. The property contains a total of 128,412 square feet of net rentable area. There are 174 total apartments, including 31 one-bedroom, 115 two-bedroom, and 28 three-bedroom units.

Enterprise Risk Profile

Industry risk

We currently view industry risk as low for the affordable housing industry. Residential rental markets typically pose less risk than other property classes, and the increased need for affordable housing during times of economic stress lends further stability. Competitive risk is fairly low owing to effective barriers to entry in many jurisdictions, the relatively low risk of substitution, and overall stable trends in growth and margins. In addition, ongoing governmental subsidies, other support, and oversight generally limit volatility, with the overall importance of the service delivered, thereby limiting the potential for negative government intervention.

Economic fundamentals and market dependencies

The project has what we consider good economic fundamentals and market dependencies. The project is in East Cleveland, about seven miles east of Downtown Cleveland. According to Reis Inc., rents are expected to increase at an average rate of 2.4% per year, and the market's average occupancy rate is 96.6%; we view both of these factors as strong. We understand that utilities are included in the monthly rent, which makes the property's rent very competitively priced.

Government support

The project benefits from minimal direct governmental support; however, a majority of the project's tenants receive vouchers from the Cuyahoga Metropolitan Housing Authority.

Strategy and management

In our view, the project's strategy and management are both poor, due to ongoing operational issues with the project. The current owner is Social Housing, which acquired the project from the previous owner LEDAHF Inc., a Virginia-based nonprofit corporation, in 2016. The project is the only project in the owner's portfolio. Alliance Fund Management LLC, an affordable housing developer founded in 2012, acts as asset manager. Social Housing and Alliance Fund Management are managed by the same principals. LEDIC Management Group LLC, which manages 26,000 multifamily units, serves as property manager.

Financial Risk Profile

Loss coverage

We consider the project's coverage of projected potential losses to be highly vulnerable, indicating limited recovery of principal to bondholders in the event of a default. We derive our net cash flow and DSC for the property in accordance with our commercial mortgage-backed securities property evaluation criteria. We derived our value by dividing net cash flow by a capitalization rate of 7.5%. Our overall loan-to-value ratio of 368% and average net cash flow of $119,945 (considering pro forma and 2016 audited financials), were the primary factors used to determine the transaction's credit enhancement levels.

Financial strength

We view the transaction's financial performance as highly vulnerable as reflected by the bonds' extremely weak DSC based on audited financials for the fiscal year-end December 2016. The primary revenue source to pay debt service on the bonds consists of rents from residents. In 2016, the project's expenses were 34% higher than pro forma while net rent collection was 22% below pro forma, which resulted in an operating loss of $177,010, and insufficient net operating income to cover the project's debt service payments, resulting in a DSC of zero on all classes of bonds. The original projected DSC ratios for the bonds were 1.25x on series A and B and 1.12x on series C, considering projected gross potential rent of $1.4 million, less economic vacancy of 8.5% and annual expense per unit of $5,110.

In our opinion, the bonds are highly vulnerable to nonpayment on September 1, 2017, the next interest payment date. We will re-evaluate the project within 90 days, and publish an update.

Asset quality

We believe the project's asset quality is below average overall, based on its age, condition, and curb appeal. According to a third-party physical needs assessment, the project had minimal immediate capital needs; however, the owner has reported that it had already spent the balance of the project fund's $522,000 for various property renovations. The owner has also reported a lack of available funds to turn over vacant units, which we believe may further hinder operating performance in the near-to-medium term.

Operating performance

In our view, the project's operating performance is poor compared with other rated multifamily housing developments. We base this on a relatively weak occupancy rate of 70% at the project as of December 2016. The project also has delinquent rent of $67,210 and a waiting list of 21 applicants for the same period.

Financial policies and practices

We view the owner's financial policies and practices as good. This is based on informal guidelines for approving loans, including internal credit and underwriting reviews, and a committee approval process prior to board approval.

Related Research

- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013
- Application Of CMBS Global Property Evaluation Methodology In U.S. And Canadian Transactions, Sept. 5, 2012