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CHATTANOOGA HOUSING AUTHORITY

Financial Recovery Plan



The Road to Recovery
July 3, 2008



Chattanooga Housing Authority

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The Road to Recovery

Overview of Current Operating Environment

The Chattanooga Housing Authority of Chattanooga, Tennessee (CHA or the Authority), is a body corporate and politic created and organized under the Tennessee Housing Authorities Act to engage in the acquisition, development, leasing, and administration of low-rent public housing and other federally assisted programs. The governing body of the Authority is its Board of Commissioners (the Board), which is appointed by the Mayor of the City of Chattanooga, Tennessee (the City). The Board is composed of seven members, who serve five-year terms on a rotating basis. The Board hires an Executive Director to administer the affairs of the Authority. CHA is responsible for overseeing an annual budget of approximately \$40 million. The Authority manages approximately 6,339 housing units of which 3,149 are Low Rent Public Housing units; 3,140 are Housing Choice Voucher units; and 50 units are funded under the Shelter Plus Care program. Of the 3,149 Low Rent Public Housing Units, 507 units are pre-approved for demolition or are non-dwelling units, leaving 2,642 units available for tenant occupancy. CHA also operates a homeownership program, several supportive services programs, manages an elderly property for the City, and oversees three mixed-finance housing developments.

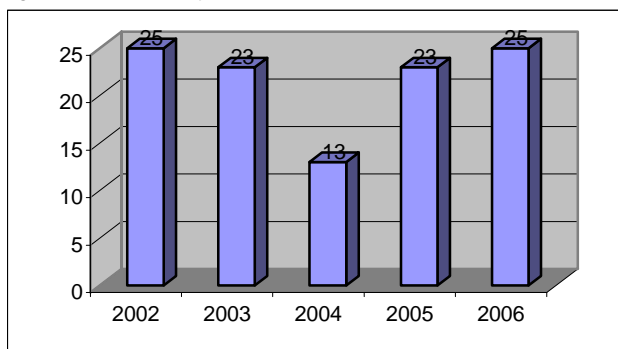
CHA Business Model. Over the past decade CHA has operated in an entrepreneurial manner, basing its business model on many of the key elements that comprise the future of public housing in the United States. For example, CHA was quick to embrace the concept of asset management and sought to implement this new management concept, in part, by contracting out its property management function to a private management company in October 2002. In addition, the Authority embraced the concept of maximizing leverage. Over the past decade CHA has entered into public/private partnerships designed to leverage federal awards, low-income housing tax credit equity, and state and local resources to develop affordable housing units for the citizens of Chattanooga. Moreover, CHA has utilized Energy Performance Contracting. Beginning in fiscal year 2005 the Authority entered into arrangements with an Energy Service Company (ESCO) to finance renovations designed to reduce energy consumption at its public housing developments.

While these efforts have been innovative, they have not resulted in the operational efficiencies and cost savings envisioned by CHA. For example, in an August 7, 2002 letter to the City's Mayor, the Authority's Executive Director estimated that the privatization of property management would result in operational savings of \$2.8 million for the Authority over a

three-year period. That projection was based on the estimated cost savings gained from reducing the Authority's work force by 137 employees.

Contrary to CHA estimates, in the first full year of the contract CHA's total operating expenses actually *increased* \$222,359. In the second year of the contract, the Authority's total operating expenses *increased* an additional \$1.3 million. As further illustrated in Figure 1, despite increasing costs during this timeframe, CHA's physical assessment score under the Public Housing Assessment System (PHAS) dropped 12 points, from 25 points (standard performer) at December 31, 2002 to 13 points (troubled performer) at December 31, 2004. Unhappy with the contractor's performance, CHA terminated the private management contract effective May 1, 2005, and brought this function back in house.

Figure 1 – CHA Physical Indicator Scores



In July 2000, CHA was awarded a \$35 million HOPE VI grant to revitalize the Spencer J. McCallie Homes public housing development and the surrounding community of Alton Park. The HOPE VI Revitalization Plan called for a multi-phase, multi-year mixed-financing, mixed income development approach, leveraging the HOPE VI grant proceeds with tax credit equity and other federal, state and local funding sources. In total, CHA has redeveloped or renovated three public housing sites utilizing this leveraged approach to redevelopment:

- **McCallie Homes (now known as The Villages at Alton Park)** was redeveloped in four phases leveraging \$35 million in HOPE VI grant proceeds with \$12.9 million of tax credit equity. The development currently includes 200 units covered under CHA's Annual Contributions Contract (ACC), an additional 75 "mixed income" rental units not covered under the ACC, and 44 homeownership units. The Authority anticipates that income generated from the sale of the first 44 homeownership units will help fund construction of an additional 48 homeownership units. The initial development plan included construction of 125 homeownership units. However, unanticipated environmental remediation costs for the property resulted in the need to reduce the total number of units developed. A private management company manages the rental units on behalf of the ownership entity.
- **Johnson Terrace (now known as The Oakes at Camden)** was redeveloped leveraging \$3.37 million of Capital Fund Program (CFP) grant proceeds with \$5.78 million of tax credit equity. The development consists of 37 rental units covered under CHA's ACC and an additional 20 "mixed income" rental units. A private management company manages the rental units on behalf of the ownership entity.
- **Greenwood Terrace** is in the process of being renovated. CHA is leveraging \$1.9 million of CFP grant proceeds with \$3.6 million of tax credit equity. The final development will include 98 renovated rental units covered under CHA's ACC. To

date, 70 units have been completed and final project completion is expected by November 2008. During fiscal year 2008, CHA improperly “borrowed” \$96,000 of funds earmarked for this transaction from Greenwood Terrace, L.L.C. to cover operating costs for the Authority’s low rent public housing program. The funds were repaid on May 2, 2008. This project is managed by CHA under contract with the ownership entity.

For each of the transactions discussed above, the Authority has pledged a percentage of the annual operating subsidy associated with the ACC units—typically 85% of the per unit amount—to subsidize rents at the redeveloped properties. Since CHA does not own the redeveloped properties, each dollar pledged decreases the amount of revenue available to fund the Authority’s operations. Further, for two of the three new developments, CHA did not retain the right to manage the rental units, resulting in forgone fee income that could have been used to offset the Authority’s operating costs.

This leveraged development approach has exposed the Authority to increased financial risks. For example, CHA recently concluded settlement negotiations with the Alton Park developer to resolve the sharing of cost overruns and revenue shortfalls associated with that development. As part of the agreement, CHA will defer its share of the remaining developer fees and forego the repayment of certain loans made to the developer for water connection fees. In addition, the Alton Park project has been scaled back due to unanticipated environmental remediation costs, as previously noted. Because of the improper borrowing of funds earmarked for Greenwood Terrace, financial risks associated with that project have increased as well. Finally, each of these new developments must remain in compliance with the provisions of Section 42 of the U.S. tax code over a 15-year period. If they fail to comply, the Authority will risk costly recapture of low-income housing tax credits.

During fiscal year 2008, CHA plans to redevelop two additional public housing sites using a mixed-financing development approach (if the Authority is awarded low-income housing tax credits for those sites):

- ***Mary Walker Towers*** would have one of its towers renovated using a combination of low-income housing tax credit equity, tax-exempt multifamily housing revenue bonds, and the Capital Fund Financing Program (CFFP) to finance the transaction.
- ***Boynton Terrace Apartments*** would be renovated using a combination of low-income housing tax credit equity, tax-exempt multifamily housing revenue bonds, and the CFFP to finance the transaction.

The Authority intends to finance predevelopment costs with the proceeds from the bond issuances. However, CHA must front these costs until such time as the bonds are issued—resulting in a further drain on the Authority’s cash flow. Further, there is no guarantee that the Authority will be awarded low-income housing tax credits, the absence of which could delay or halt the renovation plans.

In addition to the transactions described above, the Authority has entered into two real estate transactions that do not involve financing from U.S. Department of Housing and Urban Development (HUD) funding sources:

- ***Grove Street Center*** is a shopping complex located on Grove Street in the area of CHA’s College Park housing development. In February 2004, the Board passed a resolution to purchase the complex after the property had gone into bankruptcy. The Authority acquired the property in an effort to keep it viable and serving the needs of the community. In order to take title to the property, CHA created an entity called

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Grove Street Center, LLC. The Authority is the sole member of the entity. In August 2004, Grove Street Center, LLC obtained a loan and executed a promissory note in the amount of \$336,846 to acquire the shopping complex. The terms of the loan provided for no interest accrual or payment until September 1, 2005. Monthly payments of principal and interest began on October 1, 2005 in the amount of \$2,843, with a maturity date of August 2, 2009. Since the purchase, CHA has loaned Grove Street Center, LLC an additional \$29,950 to cover various costs associated with the shopping center.

- **Mayfair on Market** is a mixed-use development project located in Chattanooga’s Central Business District. Upon completion, the new structure will include three levels of underground parking, ground level commercial space, and five levels of one and two bedroom condominium homes. In August 2007 the Board passed a resolution approving the Authority’s participation in the transaction as an equity partner along with a private developer. In return for its participation in the project, CHA has received a guarantee that 18 of the housing units will be made available to eligible low-income individuals. The Authority financed its equity investment by securing a \$3.65 million loan from Fannie Mae’s affordable housing program. The loan agreement, dated December 21, 2007, restricts the use of loan proceeds to Mayfair on Market project development.

As with the HUD-subsidized transactions, these agreements have increased CHA’s risk exposure. In the case of Grove Street Center, the Authority has loaned the property nearly \$30,000. In the case of Mayfair on Market, the Authority has breached the covenants of its loan and security agreement with Fannie Mae and has been declared in default. As further discussed in the sections to follow, during fiscal year 2008 CHA improperly used \$1.2 million of loan proceeds restricted for the Mayfair project to cover operating shortfalls.

In March 2005, CHA entered into an Energy Performance Contracting arrangement with an ESCO to improve the energy efficiency of its low-income public housing units. Energy Performance Contracting is a financing technique that uses cost savings from reduced energy consumption to repay the cost of installing energy conservation measures. As further illustrated in Figure 2, CHA entered into two lease/purchase agreements and executed three promissory notes totaling \$15.04 million to finance these energy conservation measures.

Figure 2 – CHA Lease/Purchase Agreement Debt

Date	Term	Rate	Amount
April 27, 2005	144 months	4.88%	\$5.31 million
April 27, 2005	144 months	4.88%	5.49 million
July 17, 2006	144 months	4.238%	4.24 million
Total Debt			\$15.04 million

Provisions of the agreement with the ESCO guarantee energy savings at least equivalent to the cost of the program. The guarantee period begins on the first day after final acceptance of the retrofit work installation. At the end of the first 12-month period, and every 12 months thereafter (until the loan terms expire), a savings analysis will be performed to determine if the guaranteed savings have been obtained. On April 23, 2008, final acceptance documents were executed for all phases of the project.

Central Office Renovations. During fiscal year 2006, the Authority relocated its central operations from the Gateway Towers office facility and three satellite sites into its former

central maintenance warehouse building. The new location had undergone a \$3.8 million renovation to convert the warehouse into office space. Title to the property was conveyed to Holtzclaw Development, L.L.C., an instrumentality of the Authority. Proceeds from the sale of the Gateway Towers facility provided partial financing for the renovations. CHA loaned \$885,000 of those proceeds to Holtzclaw Development, L.L.C., and the rest of the improvements were financed with a \$3.1 million loan between Holtzclaw Development, L.L.C. and First Tennessee Bank. CHA leases the property from Holtzclaw Development, L.L.C. for \$348,386 annually and Holtzclaw pays its monthly debt service of \$29,000 with cash flow generated from the lease payments.

In a letter dated March 29, 2006, the City's Mayor questioned the wisdom and propriety of renovating the central warehouse and moving CHA's operations into the facility. In that letter, the Mayor stated that the cost of renovating an alternative site (which included the previously discussed Grove Street Center) was estimated at slightly less than \$1 million. The Mayor also noted that the warehouse was highly marketable.

Transition to Asset Management. HUD published a final rule, *Revisions to the Public Housing Operating Fund Program* (79 FR 54983), in the *Federal Register* on September 19, 2005. The new rule revised the Public Housing Operating Fund Program regulations at 24 CFR Part 990 and provided a new formula for determining the payment of operating subsidy to public housing agencies (PHAs). The new rule represents a fundamental change in the way the nation's PHAs are funded and has necessitated a substantial change to the Authority's business model.

The new rule introduces the following core reforms:¹

- ***Project-based funding.*** In contrast with the previous system, which funded PHAs at the entity level, the new rule establishes a system of project-based funding.
- ***Project-based budgeting.*** Under the new rule PHAs are required to prepare project-based budgets. These budgets must be approved by the PHA's governing board prior to the start of each fiscal year.
- ***Project-based accounting.*** The new rule requires PHAs to submit year-end financial statements for each project to HUD. Under the prior rule, PHAs only submitted entity-level financial statements.
- ***Project-based management.*** Under the new rule, PHAs must arrange property management services "in the best interests of each project." This means, for example, that a project must receive the same level of service from a central landscaping crew as could be obtained through the market or by handling the work with on-site staff. Additionally, PHAs must assign management personnel to each project. For example, each project must have a housing manager with primary responsibility for the day-to-day operations of that project.
- ***Project-based performance assessment.*** HUD is in the process of revising the Public Housing Assessment System (PHAS) to emphasize project-based performance monitoring and evaluation. Under the existing system, PHAS examines mostly PHA-wide and not project-specific activities. Under the new system, each project will be evaluated on its financial and management performance, as well as its physical condition. A key element of this new performance measurement structure will be a system of on-site management reviews of each project.

¹ Refer to the HUD publication *Preparing for Asset Management Under the Public Housing Operating Fund Rule*, dated June 1, 2006, page 3.

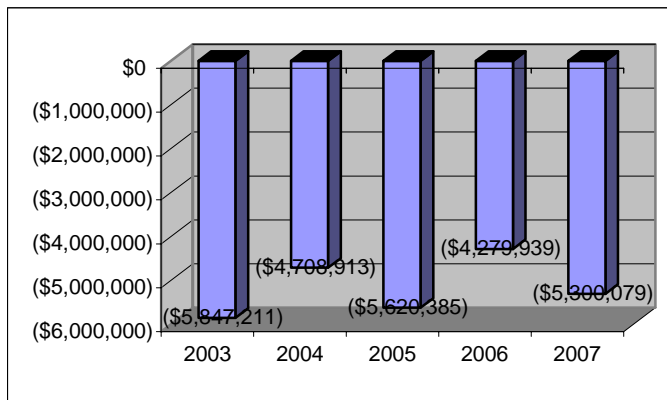
Transition to the new rule is already in process. Effective January 1, 2007, HUD started funding PHAs based on the new formula. For fiscal year 2008, CHA was required to comply with the rule's new project-based accounting and budgeting requirements. The Authority must comply with all additional requirements by fiscal year 2011.

Since returning property management to its in-house departments, CHA has made some progress toward implementing the provisions of the new rule. For fiscal year 2008, the Authority prepared budgets for each of its asset management projects (AMPs). The Authority also prepared a budget for its central operations, known as the central office cost center (COCC). However, CHA's initial fiscal year 2008 operating budget, approved by the Board at its October 16, 2007 meeting, was presented on an entity-wide basis only. Accordingly, the Board did not approve CHA's project-based budgets prior to the start of the fiscal year.

Further, CHA has not developed and maintained a system of budgeting and accounting for each project that 1) allows actual revenues and expenses associated with each AMP to be analyzed, and 2) complies with accounting principles generally accepted in the United States (GAAP). As such, the Authority is not currently in compliance with the budgeting and accounting requirements of the new rule.

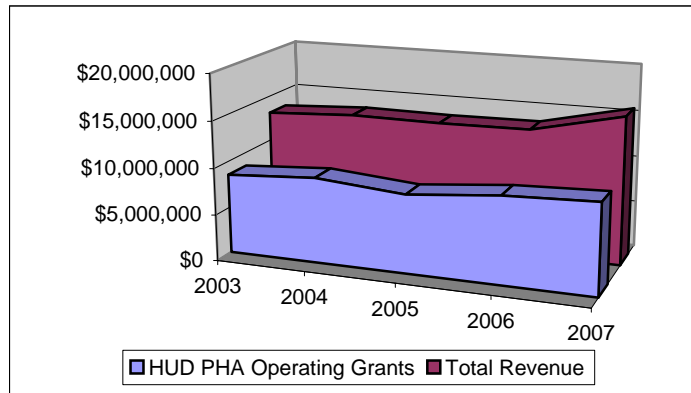
Public Housing Program Deficits. Over the past five years CHA has operated its low-income public housing program at an average annual deficit of approximately \$5.2 million per year. As further illustrated in Figure 3, the deficits ranged from a high of \$5.8 million in fiscal year 2003 to a low of \$4.3 million in fiscal year 2006. Even after the effects of depreciation expense are removed from the analysis, CHA still averaged an annual deficit of \$1.2 million for the past five years.

Figure 3 – CHA Low Rent Public Housing Program Deficits



During the last five reporting periods, the Authority's operating subsidy has remained fairly consistent, averaging about \$9 million annually. In fact, as further illustrated in Figure 4, CHA's total operating subsidy actually increased over the last three years, from \$8.4 million in fiscal year 2005 to \$9.68 million in fiscal year 2007. Total program revenue also increased during that period, from \$13.5 million in fiscal year 2005 to \$15.85 million in fiscal year 2007.

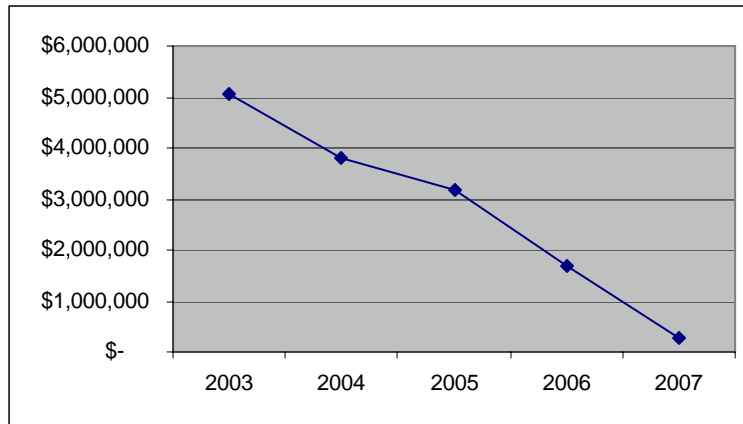
Figure 4 – CHA Low Rent Public Housing Program Revenue



During the same five-year period, the low rent program’s operating expenses fluctuated, averaging about \$15.26 million per year, with a high of \$17.69 million in fiscal year 2007 and a low of \$14.1 million in fiscal year 2006. Total operating expense increased by \$3.5 million from fiscal year 2006 to fiscal year 2007, after decreasing \$864,000 the year before. Depreciation expense and total expense for the low rent program also fluctuated, averaging \$3.97 million and \$19.3 million respectively.

As further illustrated in Figure 5, as the operating deficits mounted, CHA depleted the low rent program’s cash reserves. The Authority’s total unrestricted cash and investments decreased by \$4.76 million from December 31, 2003 to December 31, 2007. During that same period, the program’s total current liabilities increased \$1.95 million from \$847,000 at December 31, 2003 to \$2.79 million at December 31, 2007.

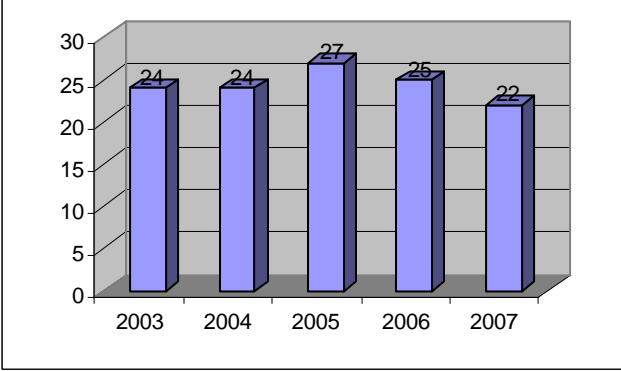
Figure 5 – CHA Low Rent Public Housing Program Cash & Investments



During this five-year period, the poor performance of CHA’s low rent program went largely undetected by PHAS. As further illustrated in Figure 6, during that timeframe the Authority received passing financial indicator scores ranging from a high of 27 (high performer) for fiscal year 2005 to a low of 22 (standard performer) for fiscal year 2007.

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Figure 6 – CHA Financial Indicator Scores



PHAS failed to detect the Authority’s impending financial decline for two primary reasons. First, PHAS generally performs the financial indicator portion of its assessments on the entity’s total operations, rather than on individual federal awards programs. CHA’s scores benefited greatly from the redevelopment activity that transpired at the Authority over the past five years. Those transactions temporarily increased the Authority’s capital grant revenue, cash, and net asset (e.g. fund balance) positions. Once the redevelopment was substantially complete, CHA’s cash flow and revenue streams declined significantly.

Second, financial reporting errors distorted the Authority’s PHAS scores. Specifically, in its financial filings with HUD the Authority reported certain current assets as unrestricted when they were, in fact, restricted. For example, during fiscal year 2007 CHA classified \$4.76 million in cash that was restricted for the payment of Housing Choice Vouchers (HCV) as unrestricted. When that cash balance is properly classified as restricted, CHA’s fiscal year 2007 financial indicator score drops from 22 (standard performer) to 10.16 (troubled).

Financial Position Deteriorates. Although CHA’s low rent program has experienced difficulties for some time, over the last eighteen months the Authority’s entity-wide financial position has also deteriorated dramatically. Financial reports filed with HUD indicate that from December 31, 2006 to December 31, 2007 CHA’s total operating expenses increased \$3.1 million while its total operating grant revenue decreased \$1.36 million. This resulted in a funding shortfall of approximately \$4.5 million. Further, the Authority’s revenue from other sources decreased by \$894,845 and revenue from capital grants decreased by \$8.1 million. Not surprisingly, as further illustrated in Figure 7, during fiscal year 2007 CHA’s total cash and investment position decreased by \$5.24 million, or 46% of the 2006 balance.

Figure 7 – CHA Cash and Investment Balances

Item	12/31/2006	12/31/2007	Decrease
Cash	\$9.61 million	\$5.83 million	\$3.78 million
Investments	1.75 million	289,086	1.46 million
<i>Total Cash and Investments</i>	<i>\$11.36 million</i>	<i>\$6.12 million</i>	<i>\$5.24 million</i>

As previously discussed, approximately \$4.76 million of CHA’s \$6.12 million cash and investments balance at December 31, 2007 was restricted for the payment of Housing Choice Vouchers. In addition, \$545,143 was restricted for modernization and development purposes and \$205,313 was restricted for tenant security deposits. The Authority’s unrestricted cash balance at December 31, 2007 totaled \$274,557. At that date the low rent public housing program (e.g. the operating fund) had an available cash balance of \$83,123.

Nearly 84 percent of the \$3.1 million increase in CHA's operating expenditures for fiscal year 2007 related to a \$2.6 million increase in salaries and benefit expense. In order to cover those costs, the Authority delayed paying its trade vendors. As a result, CHA's outstanding accounts payable balance ballooned 178% during fiscal year 2007, from \$491,285 at December 31, 2006 to \$1,364,428 at December 31, 2007. The remaining increase related to an escalation in interest expense, brought on by CHA's long-term borrowing activities. The Authority's reported interest expense increased from zero for fiscal year 2005, to \$575,495 for fiscal year 2007.

CHA's Board was informed of the fiscal year 2007 operating deficits at its November 13, 2007 board meeting. During that meeting the Board approved Resolution 07-039, which authorized a revised fiscal year 2007 operating budget that included a \$2.5 million deficit attributable to the low rent program. The Authority's former Chief Financial Officer (CFO) characterized the deficit as resulting from a "deliberate use of operating reserves" designed to bring CHA properties up to HUD standards.

CHA's deficit spending has continued through June 30, 2008. Surprisingly, the Authority's initial fiscal year 2008 budget—approved by CHA's Board on October 16, 2007 (Resolution 07-038)—projected an entity-wide surplus of \$3.7 million. Unfortunately, that projection proved to be overly optimistic. Faced with mounting deficits, on March 1, 2008 CHA reduced its workforce by 26 employees.

By April 2008, CHA's financial situation had become dire. During the Board's April 22, 2008 meeting, the former CFO reported that the actual fiscal year 2007 deficit had grown to \$5.3 million. Moreover, during the first quarter of fiscal year 2008, the public housing program had operated at a deficit of more than \$500,000.

One week later, in a letter dated April 29, 2008, CHA's former Executive Director notified HUD's Nashville, Tennessee field office of its deteriorating financial situation and requested HUD's assistance in effecting a reorganization of the Authority. In that document CHA reported that it expected a shortfall of \$1.05 million from its May 2008 operations. More alarming, CHA had used \$1.2 million of the proceeds from the Mayfair on Market loan to cover operating shortfalls. In addition, CHA reported that it used \$181,000 of HCV program funds, \$96,000 of funds from Greenwood Terrace, L.L.C. accounts, and \$166,112 of funds from Holtzclaw Development, L.L.C. to cover shortfalls. In total, the Authority reported that a cash infusion of approximately \$3.3 million was needed to return the organization to solvency. Further, CHA requested that it be allowed to use accumulated HAP funds to finance the turnaround.

CHA Reorganization Strategy. On May 14, 2008, CHA provided HUD's Nashville, Tennessee field office with a draft copy of its reorganization strategy (see Attachment A). In that document CHA proposed the following measures to restore the Authority's financial viability:

- Reduce CHA's workforce by an additional 30 employees. **Current Status:** On May 15, 2008 CHA laid off 30 employees. The Authority projects that the layoffs will result in \$1.7 million in annual cost savings in addition to \$1.64 million in estimated savings from the earlier layoff. As a result of the two layoffs, CHA reports that its staffing levels decreased by 56 employees, from 206 employees at January 1, 2008 to 150 employees on May 16, 2008.
- CHA temporarily suspended its 8% retirement contribution benefit. Under the plan, the retirement contribution will be increased from 0% to 2% effective November 1, 2008. Potential CHA funding participation for Calendar 2009 will be determined

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during a review of all CHA-provided employee benefits during the open enrollment period in December 2008. **Current Status:** CHA suspended payment of this employee benefit effective May 15, 2008.

- Reduce contract services by approximately 20% effective July 1, 2008. According to the plan, CHA will eliminate all non-essential contracts and increase cycle times for items such as grass cutting and indirect services. **Current Status:** CHA has identified 10 contracts that it has either suspended or modified. The Authority projects that these changes will result in \$374,000 of cost savings from June 2008 through December 2008.
- Suspend payment of principal and interest on its long-term debt if necessary and pay vendors on extended terms to maintain sufficient cash flow. **Current Status:** Action still pending.
- Attempt to sell all unencumbered properties in its portfolio including the Grove Street parcel, James A. Henry School and other scattered site parcels. **Current Status:** Action still pending.
- Use disposition proceeds to repay unauthorized borrowing plus interest. In the event that sales proceeds do not materialize, the unauthorized borrowing would be repaid from savings accumulated as the result of budget cuts. **Current Status:** Action still pending.

The Authority's CFO resigned, effective May 1, 2008. A local Certified Public Accountant (CPA)—formerly one of CHA's financial statement auditors—is currently serving in that capacity at the Authority. In conjunction with the May 15, 2008 layoffs, CHA's Executive Director also resigned his position. The Chief Operating Officer (COO) has been named the Authority's Acting Executive Director.

CHA's new management team, along with its Board, faces a difficult situation. In order for its recovery strategy to work, CHA must:

- Reduce the Authority's operating costs to a sustainable level.
- Raise sufficient capital to repay its outstanding obligations.
- Replenish the Authority's working capital.

CHA must accomplish these objectives as it struggles to implement HUD's *Revisions to the Public Housing Operating Fund Program*, Final Rule. In the sections to follow, this document will assess the strategies proposed by CHA and offer additional recommendations designed to help guide the Authority back to financial health. It also provides a summary analysis of CHA's monthly and annual cash flows, based on the anticipated savings resulting from those actions.

Reduce Operating Costs

In order for CHA to continue as a going concern, it must quickly reduce its monthly operating costs to a level sustainable from its monthly operating revenues. Prior to its reduction in force actions, CHA's monthly operating costs of \$1.93 million exceeded its monthly operating revenues of \$1.55 million. As further illustrated in Figure 8, during fiscal year 2007, CHA's salary and related benefits (51%), other administrative expenses (15%), and contract maintenance (7%) accounted for approximately 73% of those costs.

Figure 8 – FY 2007 Monthly Operating Costs

Item	Amount	Percent
Salary and Benefits	\$975,219	51%
Other Administrative	296,219	15%
Utilities	260,855	14%
Contract Maintenance	133,224	7%
Maintenance Materials	52,264	3%
Insurance	51,345	3%
Other Operating Costs	157,956	8%
Total Monthly Operating Costs	\$1,927,080	100%

Using the assumptions outlined above, CHA must reduce its monthly operating costs by approximately \$379,000 just to break even. However, a break-even cost structure will not provide sufficient cash flows to a) settle the Authority's outstanding obligations or b) replenish CHA's cash reserves. Figure 9 provides a summary of CHA's outstanding obligations as of July 1, 2008.

Figure 9 – Outstanding Obligations

Item	Amount
Repay Fannie Mae "borrowing"	\$1.2 million
Repay HCV Program "borrowing"	732,040
Accounts Payable	335,000
Total Outstanding Obligations	\$2.3 million

Unless CHA can raise capital from other sources, the Authority must generate operating surpluses to repay these obligations. Assuming its creditors will allow the repayments to be made over 12 months, CHA must reduce its monthly operating costs by an additional \$189,000 to generate the surpluses needed to service these obligations. Said another way, CHA has to cut its cost structure by approximately 29% (\$568,000 monthly or \$6.8 million annualized) in order to pay off its existing bills and keep from going further into debt.² Once

² This assumes, of course, that CHA does not incur additional unforeseen obligations.

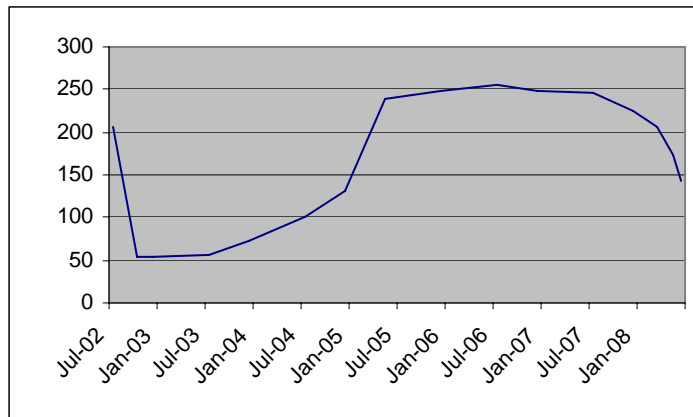
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its bills are current, CHA can use excess cash flow to replenish its cash reserves and provide a cushion to cover any unforeseen expenses.

Logically speaking, since salary and employee benefits represent the Authority's single largest monthly expenditure, those items present an opportunity for significant cost savings. Wisely, with the staff reductions previously discussed CHA has already taken measures to address this area. Nevertheless, the Authority must be careful to strike a balance between obtaining the necessary cost savings and retaining sufficient resources to carry out its mission. CHA also has the potential to reduce costs in the areas of miscellaneous administrative expenses and contract maintenance.

Reduce Salary and Benefits Costs. Over the past seven years, CHA's staffing levels have fluctuated. The Authority's staffing level reached its low point—54 employees—in October 2002, when the property management function was contracted out. As illustrated in Figure 10, CHA's staffing level peaked at 262 employees in April 2005. The levels decreased in March and May 2008 as a result of the Authority's reduction in force actions.

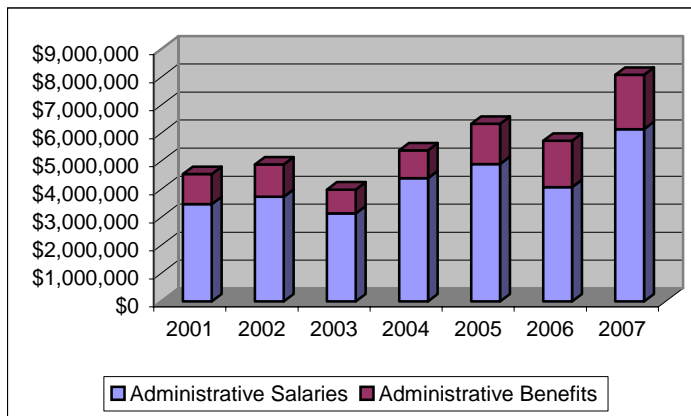
Figure 10 – CHA Staffing Levels



After bringing the property management function back in house, CHA increased its staffing levels to address the declining condition of its public housing units and other operational deficiencies identified in HUD reviews. While these increases were initially intended to be temporary, they ended up becoming permanent. The high staffing levels, in turn, contributed to the previously discussed operating deficits in CHA's low rent program.

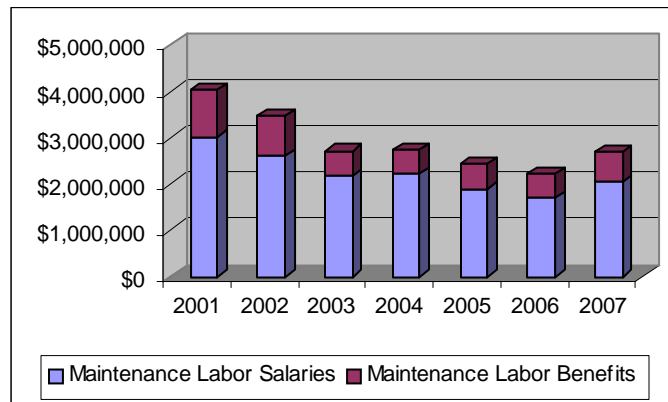
While the Authority's staffing levels remained essentially unchanged during fiscal year 2007, its salary and benefits expense increased by \$2.6 million. The majority of the increases benefited two departments: administration and maintenance. As further illustrated in Figure 11, from fiscal year 2006 to fiscal year 2007 CHA's administrative salary and benefits expense increased by \$2.36 million, from \$5.7 million in 2006 to \$8.1 million in 2007. This was a 41% increase.

Figure 11 – CHA Administrative Salary and Benefits



Similarly, CHA’s maintenance salary and benefits increased 22% in fiscal year 2007, up from \$2.2 million for fiscal year 2006 to \$2.5 million for fiscal year 2007. As further illustrated in Figure 12, the Authority’s maintenance labor costs have fluctuated over the past seven years. During that timeframe, CHA reduced its costs by 32% (from \$3.01 million in 2001 to \$2.04 million in 2007) and associated benefit contributions for maintenance employees declined by 35% (from \$1.01 million to \$655,000). Interestingly, for fiscal years 2002 through 2005 CHA included the private management company’s labor costs in its salary and benefits figures reported to HUD.

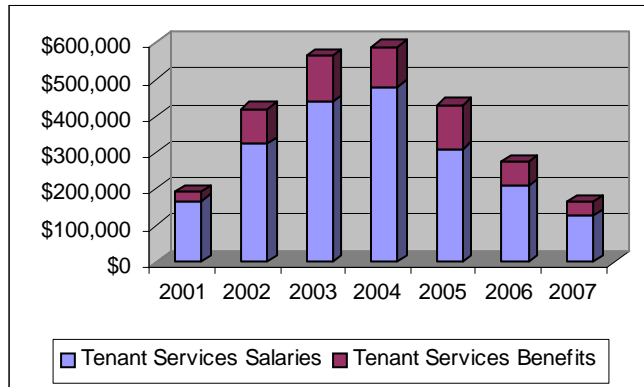
Figure 12 – CHA Maintenance Salary and Benefits



Conversely, the cost of tenant services salary and benefits decreased 40%, from \$274,513 for fiscal year 2006 to \$166,417 for fiscal year 2007. As further illustrated in Figure 13, tenant services labor cost fluctuated over the past seven years in direct correlation to the availability of funding from ROSS grants. Surprisingly, although salaries for tenant services employees declined by 24% from fiscal year 2001 to 2007 (from \$168,000 to \$127,000), the cost of benefit contributions for this account category actually increased by 47% (from \$26,000 to \$38,000).

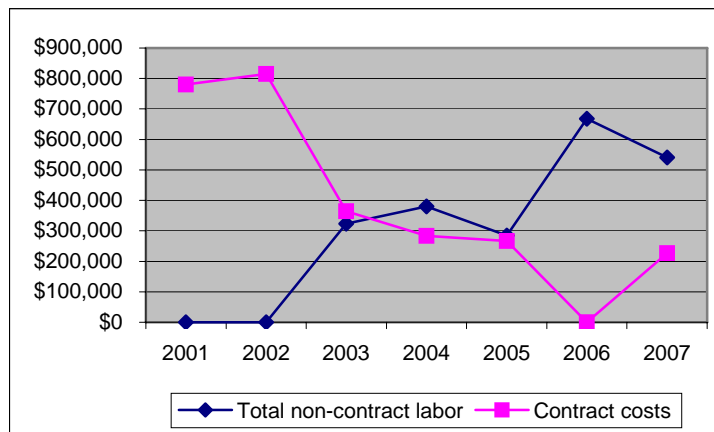
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Figure 13 – CHA Tenant Services Salary and Benefits



During fiscal year 2007, CHA’s in house protective service costs decreased by \$126,858, or 19% of the fiscal year 2006 amount. However, as further illustrated in Figure 14, as of December 31, 2007, CHA’s combined cost for protective services was approaching the 2001 level of approximately \$780,000. CHA created its own police department in 2002 and reduced its contract costs for protective services by 72%, a reduction of approximately \$588,000 (2002 to 2007). However, over time increased costs for the CHA police department began to offset cost savings realized by reducing CHA’s reliance on protective services contracts. From 2003 to 2007, CHA’s total protective services labor costs (contract and non-contract) increased by 12% from \$688,000 to \$767,000. Employee benefits costs for protective services increased by 94%, from \$67,000 to \$131,000.

Figure 14 – CHA Protective Services Cost



As previously discussed, during fiscal year 2008, the Authority initiated efforts to reduce its salary and employee benefits costs. In addition to the March 1 and May 15, 2008 layoffs, CHA temporarily suspended its 8% retirement contribution benefit. Since February 2008, CHA has realized additional savings through staffing attrition. As further illustrated in Figure 15, CHA projects that those moves will result in annual costs savings totaling \$3.3 million.

Figure 15 – Projected Cost Savings, Salary and Benefits

Item	Monthly	Annual
March 2008 reduction in force	\$121,289	\$1.46 million
May 2008 reduction in force	126,844	1.52 million
Employee attrition	29,381	352,572
Total Projected Savings	\$277,514	\$3.33 million

Even if CHA’s projected cost savings are realized, operating costs will need to be further reduced by an estimated \$101,486 per month for the Authority to break even (\$379,000 - \$277,514). If CHA is unable to raise additional capital and is forced to pay off its outstanding obligations (see Figure 9) with operating surpluses, that number jumps to an estimated \$290,486 (\$101,486 + \$189,000).

Clearly, over the past five years CHA has employed more staff and paid more benefits than it could afford. The Authority’s payroll report for the two-week period ended December 21, 2007 indicates that CHA issued paychecks to 226 employees. As illustrated in Figure 16, the gross payroll, excluding employee benefits, totaled \$356,967 (a monthly rate of \$773,429 or \$9.28 million annualized).

Figure 16 – CHA’s December 21, 2007 Payroll

Functional Area	Checks	Gross	Percent
General Operations and HCVP	35	\$54,201	15%
Site Management and Maintenance	103	127,926	36%
Executive, Accounting, IT and General Administration	20	61,044	17%
Development, Human Resources, Security and Planning	68	113,796	32%
Totals	226	\$356,967	100%

By the May 23, 2008 payroll cycle, the number of checks issued decreased by 52, down to 174. As illustrated in Figure 17, the gross bi-weekly payroll, excluding employee benefits, totaled \$280,018 (\$606,705 monthly or \$7.28 million annualized).

Figure 17 – CHA’s May 23, 2008 Payroll

Functional Area	Checks	Gross	Percent
General Operations and HCVP	18	\$34,553	12%
Site Management and Maintenance	102	136,619	49%
Executive, Accounting, IT and General Administration	16	43,845	16%
Development, Human Resources, Security and Planning	38	65,002	23%
Totals	174	\$280,018	100%

Accordingly, from the last payroll for fiscal year 2007 (pay period 26) to the May 23, 2008 payroll (pay period 11), CHA was able to decrease its bi-weekly gross salary expense by \$76,949 (\$166,724 monthly or \$2 million annualized). That number—which does not include

the savings generated from decreased benefits costs—equals approximately 44% (\$166,724/\$379,000) of the cost savings needed for CHA to reach the breakeven point.

CHA’s payroll records reflect that as of May 31, 2008, the Authority had reduced its staffing levels by 65 employees from the beginning of the year. Figure 18 illustrates that as of that date, 85 of its remaining employees were directly assigned to the 11 properties in CHA’s management portfolio. CHA uses the employees assigned to its scattered sites inventory to also provide management services at the privately owned Greenwood Terrace tax credit property. Moreover, CHA provides property management services at the City-owned Dogwood Manor elderly housing complex.

Figure 18 – CHA Front-Line Staffing Levels at May 31, 2008

Property	Units	Admin	Maint	Total
College Hill	497	5	8	13
East Lake Courts	417	4	7	11
Harriet Tubman	440	4	8	12
Mary Walker Towers	153	2	3	5
Emma Wheeler Homes	340	4	7	11
Boynton Terrace Apts.	250	3	5	8
Scattered Sites	213	3	6	9
Cromwell Hills Apts.	200	3	5	8
Gateway Towers	132	2	3	5
Greenwood Terrace*	98	0	0	0
Dogwood Manor*	136	1	2	3
Totals	2,876	31	54	85

* Not owned by CHA.

Historically, HUD guidelines have recommended that public housing agencies employ one maintenance staff person, including management, for every 40 units of inventory.³ Based on that criterion, CHA should have 72 employees assigned to the property maintenance function (2,876/40). Under the Authority’s latest staffing model, only 54 maintenance employees are assigned to its sites, resulting in a shortfall of approximately 18 workers.

Conversely, HUD guidelines recommend that public housing agencies employ one administrative employee for every 65 units of inventory.⁴ Based on that standard, CHA should have an administrative staffing level of approximately 44 employees (2,876/65). In general, that number would include the 31 positions allocated to the sites and all of the administrative positions at the central office except the HCV program staff.

³ This guidance was originally published in HUD Handbook 7460.7 REV, *Field Office Monitoring of Public Housing Agency Administration of the Low-Income Public Housing Program*, dated September 6, 1985.

⁴ This guidance was also originally published in HUD Handbook 7460.7 REV, *Field Office Monitoring of Public Housing Agency Administration of the Low-Income Public Housing Program*, dated September 6, 1985.

As illustrated in Figure 19, as of May 31, 2008, CHA has 57 employees assigned to its central office. Eleven of those employees are assigned to the Authority's HCV program. Those employees' salaries are paid out of the HCV program's administrative fee income. The remaining 46 employees constitute CHA's central office administrative staff. In total, the Authority currently has 77 administrative employees (31 at the sites plus 46 at the central office)—approximately 33 more than suggested by HUD guidelines (77 minus 44).

Figure 19 – Administrative Staffing Levels at May 31, 2008

Department	1/1/2008	RIF	5/31/2008
Accounting	7	2	5
Information Technology	4	2	2
Planning & Programing	17	6	11
Operations	5	1	4
HCVF	18	7	11
Program Compliance	11	5	6
Development	10	5	5
Human Resources	5	2	3
Purchasing	4	2	2
Executive Office	6	5	1
Public Safety	9	2	7
Totals	96	39	57

As of May 31, 2008, CHA's staffing level had been reduced to 142 employees, within 15 of HUD's historical staffing guidelines. Based on those standards, CHA is still overstaffed by approximately 15 employees. Moreover, the Authority's administrative offices are overstaffed by an estimated 33 employees while its maintenance department is understaffed by approximately 18 employees. This is especially significant given the public housing industry's impending focus on asset management.

The monthly cash flow savings generated from reducing the Authority's workforce by the 65 employees discussed above, including salary and benefits, totals \$239,500. That amounts to about 63% (\$239,500/379,000) of the projected savings needed for CHA to break even. However, CHA will not immediately realize that level of savings.

CHA's Personnel Policy Handbook (Section 8.1) provides for severance pay when an employee is terminated due to a reduction in force, in instances where the employee does not receive at least two weeks' notice prior to the termination. Under those circumstances, the employee is entitled to receive up to two weeks of pay at his or her normal rate. However, the Authority reserves the exclusive right to determine when and under what circumstances, if any, severance pay will be provided to any employee. Under the policy, the Executive Director is authorized to make that determination, in his/her sole discretion, which becomes final, binding and conclusive.

After discussing the matter with the Board, CHA's former Executive Director granted employees covered by the May 15, 2008 reduction in force either six or eight weeks of severance pay, depending on the employee's age. The total severance liability resulting from the May reduction of force is summarized in Figure 20.

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Figure 20 – CHA Severance Pay Liability

Type of Pay	Amount
Cost of 6 weeks severance pay	\$ 95,078
Cost of 8 weeks severance pay	197,511
Total Severance Pay	\$ 292,589

The difference between the cost of the severance pay contemplated in CHA’s policy manual (which totaled \$81,071) and the amount actually paid to employees covered by the reduction in force (\$292,589) was \$211,519. In addition, CHA’s former Executive Director received a severance package totaling \$86,804, even though he resigned his position. That benefit was the result of an agreement reached with the Board. CHA’s total severance liability as a result of these two actions is \$379,493, which temporarily reduces the Authority’s available cash flow.

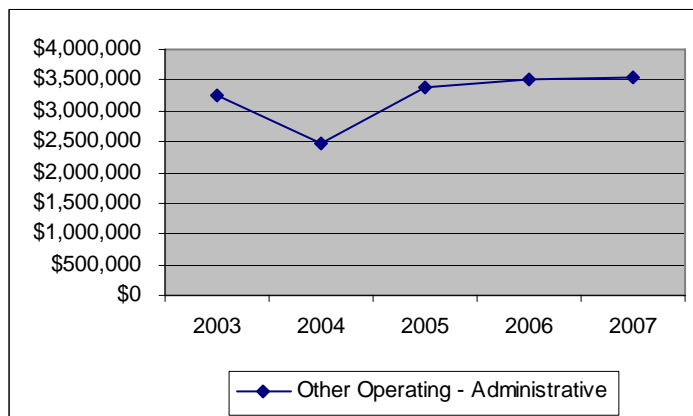
Effective May 15, 2008, CHA suspended its 8% elective retirement contribution benefit. The Authority plans to restore that benefit on November 1, 2008 at a reduced rate of 2 percent. The amount of CHA’s elective contribution, if any, after January 1, 2008 has yet to be determined. The Authority projects that it will save approximately \$824,056 for the remainder of fiscal year 2008 as a result of this action.

Recommendation 1: CHA should reduce its workforce by an additional 15 full-time employees (FTEs). Further, CHA should change its staffing allocation to allow for more front-line maintenance staff and less administrative staff.

CHA has already reduced its staffing levels significantly. However opportunities for additional cost savings remain. Over time, the Authority’s staff reductions to date should increase its cash flow by about \$239,500 per month. Of course this assumes that the cost of labor will remain constant (e.g. no raises or increases in employee benefits), which is likely an unrealistic assumption. Nevertheless, using the average cost savings per position already reduced, CHA could save an additional \$55,300 per month (15 x \$3,685) in salary and benefits if it follows this recommendation. That would bring the total monthly savings from staffing reductions to approximately 78% (\$55,300+\$239,500/379,000) of the estimated amount needed for CHA to reach breakeven.

Reduce Administrative Expenditures. As illustrated in Figure 21, CHA’s other administrative costs increased 44% from fiscal year 2004 (\$2,476,200) to fiscal year 2007 (\$3,554,628), roughly a \$1.1 million increase. During fiscal year 2007, other administrative expenses made up 15% of CHA’s total operating expenditures. Approximately \$2.37 million of the 2007 amount was charged to the Authority’s CFP. An additional \$871,230 of other administrative costs was charged to the low rent public housing program. During fiscal year 2007, other administrative expenditures resulted in a \$296,219 drain on CHA’s monthly cash flow.

Figure 21 – CHA Other Administrative Expense



CHA has already initiated actions designed to reduce other administrative costs. For example, the Authority has placed a moratorium on travel and training, except when necessary to preserve an employee’s certification or when the training is essential in order to deliver a service to its residents. The Authority also plans to modify its cell phone plan to incorporate a monthly reimbursement to employees required to have cell phones. CHA estimates that it will save \$20,000 annually from the latter measure alone. Further, CHA has begun a comprehensive review of all of its expenditures.

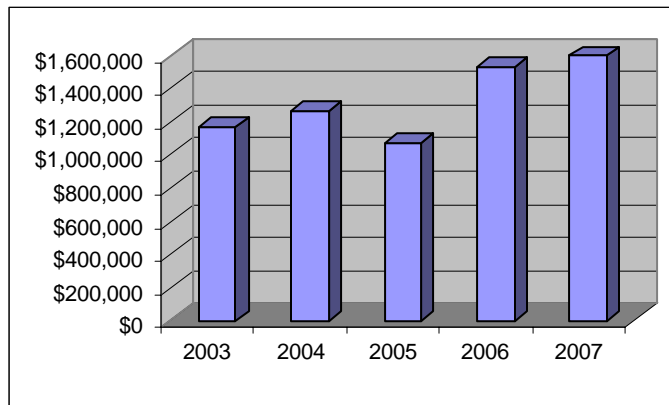
Recommendation 2: CHA should reduce its budget line item amount for other administrative expenditures to the fiscal year 2004 level. The Authority should review this line item and implement policies and cost controls to prevent cost overruns for administrative expenditures.

Just by reducing this line item to its fiscal year 2004 spending level, CHA would increase monthly cash flow by approximately \$89,800. As part of its ongoing comprehensive review, CHA should carefully examine the items that are charged to this account, including any credit cards, travel, consultants, and employee training. Based on the review’s findings, CHA should modify its existing policies in areas where significant potential savings are identified.

Reduce Contract Maintenance Expenditures. During fiscal year 2007, contract maintenance accounted for 7% of CHA’s total operating expenditures. As illustrated in Figure 22, over the past five years CHA’s contract maintenance expenditures have averaged \$1.3 million annually. Since fiscal year 2005, the year in which CHA brought property maintenance back in house, contract maintenance expense has increased 49%, from \$1.07 million for fiscal year 2005 to \$1.59 million for fiscal year 2007.

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Figure 22 – CHA Contract Maintenance Expenditures



Historically, CHA has entered into contracts with vendors to provide lawn care, pest extermination, UPCS inspections, and unit turnaround painting and cleaning services. Accordingly, the majority of the Authority’s contract maintenance expenditures are related to those items. During fiscal year 2007, this practice resulted in an average monthly drain on cash flows totaling \$133,224, even though CHA employed 62 maintenance workers during that timeframe.

Since lawn care and painting services are typically contracted out, CHA’s maintenance employees’ primary responsibilities are routine and emergency work orders, including unit turnaround and litter control. As previously illustrated in Figure 18, the Authority employs 54 maintenance workers. That count includes one Supervisor and eight Maintenance Service Managers. All maintenance employees except the Supervisor are currently assigned to perform maintenance services. As illustrated in Figure 23, the annual estimated maintenance payroll for the fiscal year ending December 31, 2008—excluding benefits, the employer’s share of FICA taxes,⁵ and overtime—will total \$1.9 million. The monthly estimated payroll expense under those parameters totals \$158,738.

Figure 23 – CHA 2008 Estimated Maintenance Payroll

Position	No.	Avg Hr.	Annual
Maintenance Supervisor	1	34.58	\$ 67,431
Maintenance Services Manager	8	23.02	359,171
Maintenance Services Tech I	23	14.53	651,554
Maintenance Services Tech II	10	17.14	334,211
Maintenance Services Tech III	12	21.05	492,492
Totals	54		\$ 1,904,858

As illustrated in Figure 24, CHA records reflect that over the past three years, on average, each maintenance employee processes 1.58 work orders per workday (based on a five day work week). The Authority’s records were not detailed enough to determine the average length of time it took an employee to process a work order.

⁵ FICA is the Federal Insurance Contributions Act, which is the statute under which Social Security payroll taxes are collected.

Figure 24 – CHA Maintenance Work Orders

Fiscal Year	Work Orders	*Est Working Days	Work Orders per Day	# of Main Techs/Mgrs	Work Orders per Employee per Day
2008	10,654	109	98	53	1.84
2007	25,320	260	97	62	1.57
2006	22,118	260	85	64	1.33
Average	19,364	210	93	60	1.58

This would suggest that CHA has sufficient resources in house to perform lawn care and unit turnaround services, especially if staffing resources are reallocated in accordance with Recommendation 1. Recently, CHA has initiated an examination of all of its contracts, including its existing maintenance service contracts. Based on that review, the Authority has already suspended its unit turnaround painting and cleaning contracts and decreased the frequency of its contracted lawn care service.

Recommendation 3: CHA should discontinue its contracts for lawn care and unit turnaround service, and should use CHA maintenance employees to provide those services. Alternatively, CHA should consider contracting out the entire property maintenance function.

CHA records indicate that in the last 12 months the Authority spent \$257,927 on painting and cleaning contracts and \$338,649 on lawn care contracts. By canceling these contracts and performing the services with in-house maintenance staff, CHA could increase its monthly cash flows by an estimated \$49,700 per month or \$596,600 per year.

Conversely, CHA could contract out the entire property maintenance function. The actual savings for the Authority would be the difference between its annual estimated payroll costs of \$1.9 million plus the annual average contract maintenance cost of \$1.3 million less the annual cost of the contract. Using a per unit month assumption of \$43.17⁶ and 2,876 total units in inventory (see Figure 18), the total annual cost for the property maintenance contract would be roughly \$1.5 million. That would result in an annual savings of \$1.7 million or about \$142,000 per month.

⁶ Taken from *Changes in Financial Management and Reporting Requirements for Public Housing Agencies Under the New Operating Fund Rule (24 CFR 990) Supplement to HUD Handbook 7475.1 REV., CHG-1, Financial Management Handbook Office of Public and Indian Housing (PIH)*, September 2006. Rates are for properties under the jurisdiction of the Knoxville, Tennessee, HUD field office.

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Settle Outstanding Financial Obligations

As previously illustrated in Figure 9, as of June 19, 2008, CHA's outstanding financial obligations totaled \$2.3 million. As of May 30, 2008, CHA's cash position was roughly \$200,000—\$2.1 million less than the amount needed to pay off those obligations. Accordingly, in order to obtain solvency within the next 12 months, the Authority must enter into workout agreements with its creditors while simultaneously reducing operating costs and raising sufficient working capital. An analysis of each of the Authority's significant obligations follows:

Fannie Mae Default. This is the Authority's most troublesome outstanding financial obligation, constituting 50% of the total unpaid balance. More importantly, as further described below, the Authority's default under this obligation has put the Mayfair on Market transaction and the Authority's unrestricted assets in significant financial peril.

As previously discussed, on or about December 21, 2007, CHA entered into a Loan and Security Agreement with Fannie Mae. Under the terms of that agreement Fannie Mae loaned CHA \$3.65 million to be used as the Authority's equity investment in the Mayfair on Market project. The loan documents also included a promissory note by and between CHA and Fannie Mae.

On December 31, 2007, CHA opened a bank account for the Mayfair on Market transaction and transferred \$3,603,700 from the Authority's general fund (where the loan proceeds were originally deposited) to the new Mayfair on Market account.

On January 4, 2008, CHA's accounting department wired \$2.1 million of the loan proceeds to the developer's account. Interestingly, the wiring instructions indicate that the developer had requested that \$3,385,000 be transferred. That amount was crossed out and the document contained a handwritten instruction to transfer only \$2.1 million. The written instruction was dated January 4, 2008 and appeared to be signed by CHA's former Executive Director.

On February 1, 2008, CHA transferred \$600,000 from the Mayfair on Market bank account to the Authority's general fund account. CHA's request was made via telephone to the bank and the justification on the in-house transfer request noted the following: "Loan from Mayfair on Market to CHA for payment of property and liability insurance, worker's comp insurance, and sewer taxes."

On February 22, 2008, CHA transferred an additional \$300,000 from the Mayfair on Market bank account to the Authority's general fund account. The purpose on the journal entry stated, "Post receipt of loan proceeds to general fund; transfer loan proceeds to Mayfair account; Legal fees-Mayfair loan; Commitment fee-Mayfair loan; Note payable-Mayfair."

On February 27, 2008 CHA transferred another \$300,000 from the Mayfair on Market bank account to the Authority's general fund account. The Authority's request was via telephone to the bank by CHA accounting staff. The purpose for the transfer was not explained in CHA's records.

In total, \$1.2 million was transferred from the Mayfair on Market bank account to CHA’s general fund. CHA’s Board minutes do not contain evidence that the Board was made aware of this improper use of the loan proceeds.

In a letter dated June 20, 2008, Fannie Mae provided CHA with a notice of default in accordance with the loan agreement. As the events constituting default, Fannie Mae cited CHA’s inappropriate use of the loan proceeds, its violation of certain financial covenants, and the Authority’s failure to comply with the agreement’s quarterly reporting requirement.

If CHA is unable to cure the Fannie Mae loan default, the entire amount of principal and interest outstanding under the agreement could be declared due and payable. Further, the Note is a full recourse obligation that it is backed by all assets of CHA that are not restricted by law or regulation. Accordingly, any real property owned by CHA that is not covered by a HUD Declaration of Trust—including the Authority’s Holtzclaw property—could be at risk if CHA is unable to cure the default

Recommendation 4: CHA and HUD should immediately begin negotiations with Fannie Mae to work out a resolution to the Mayfair on Market loan default. Any proceeds realized from the sale of the Authority’s assets or additional borrowing contemplated in this plan should first be applied to curing this default.

HCV Program Receipts. CHA’s Annual Contributions Contract (ACC) with HUD restricts the Authority’s use of HCV program receipts. In general, CHA must use program receipts to provide decent, safe, and sanitary housing for eligible families in compliance with the U.S. Housing Act of 1937 and all HUD requirements. Program receipts may only be used to pay program expenditures.⁷ As illustrated in Figure 25, during fiscal year 2007 CHA used \$732,040 of HCV program receipts to cover its operating shortfalls.

Figure 25 – HCVP Receipts Used for Ineligible Items

Item	Amount
Excess Administrative Fee	\$ 220,438
"Management" Fee	314,832
"Bookkeeping" Fee	196,770
Total	\$ 732,040

Administrative fees may only be used to cover costs incurred to perform administrative responsibilities for the program in accordance with HUD regulations and requirements.⁸ Since CHA has not fully implemented asset management, it was not eligible to charge the HCV program “management” and “bookkeeping” fees.

⁷ Refer to Section 11 of the ACC for further details.

⁸ Refer to 24 CFR § 982.152 (B) (3) Administrative fee, for further details.



Recommendation 5: CHA management should meet with HUD to negotiate a repayment plan for making the HCV program whole. CHA should work with HUD's Office of General Counsel to determine if the use of HCV program receipts constituted a violation of Federal law. If it is determined that the use only violated regulatory and/or contract provisions, CHA should request a waiver of repayment from HUD's Secretary.

Accounts Payable. As of June 19, 2008, CHA's reported outstanding accounts payable balance totaled \$335,000. As summarized in Figure 26, approximately 73% of that balance was payable to nine vendors.

Table 26 – CHA Accounts Payable at June 18, 2008

Vendor	Amount
Alton Park Housing Partnership, L.L.C.	\$ 53,818
The Villages Housing Partnership, L.L.C.	43,861
Arthur J. Gallagher	38,476
McCallie Homes Housing Partnership Phase I, L.L.C.	34,173
Wagner Nelson & Weeks	22,764
Tennessee American Water Company	14,755
Miller & Martin	12,480
CBR Property Maintenance	11,958
Home Depot Supply, Inc.	10,480
Total Payable	\$ 242,765

Three of the top four balances relate to the operating subsidy payable to the owners of CHA's three mixed-finance properties. In general, the regulatory and operating agreements for those transactions require CHA to provide the owners with monthly operating subsidy for each ACC unit equal to 85% of the amount received from HUD. For each of the three transactions, CHA owes the April, May and June installments. In total, CHA owes the three properties \$131,852. Non-payment of these obligations constitutes a breach of the projects' operating agreements and reduces the amount of cash flow available to operate those properties.

Recommendation 6: CHA should prioritize the repayment of trade payables. CHA should make curing the defaults under the tax credit property operating agreements a high priority. The Authority should use the increased cash flow obtained from its reorganization activities to bring those obligations current. CHA management should meet with its other significant creditors to negotiate repayment plans.

The next section will explore in detail CHA's options for raising capital in the short-term to help service the obligations described above.

Replenish Working Capital

In addition to reducing operating costs and settling its outstanding financial obligations, CHA must quickly generate working capital if it is to return to solvency. As previously discussed, as of May 30, 2008, CHA had a cash balance of approximately \$200,000 while its outstanding financial obligations totaled \$2.3 million. Further, during fiscal year 2007 CHA had a monthly operating deficit of roughly \$379,000. The Authority has continued to accumulate operating deficits during fiscal year 2008. As a result, as previously illustrated in Figures 5 and 7, the Authority has nearly depleted its working capital. In order to recapitalize its operations, the Authority must explore short-term options for raising capital.

The Harvard Cost Study estimates that PHAs should maintain working capital equal to about two months of operating costs.⁹ Using that measure, CHA requires approximately \$3.1 million of working capital—about \$2.9 million more than it had on May 30, 2008.¹⁰ Further, since CHA requires an additional \$2.3 million to pay off its existing financial obligations, the total amount required to recapitalize the Authority is \$5.4 million (\$3.1 million working capital plus \$2.3 million financial obligations).

CHA has identified the following possibilities for raising working capital.

Poss Homes Site. This property formerly housed the Poss Homes public housing development. CHA funded the demolition of the existing structures with the proceeds from a HOPE VI grant. The 20-acre site, which is located directly south of I-24 at Market Street in Chattanooga, is currently vacant. The site is restricted under a Declaration of Trust by HUD, thus any encumbrance or disposition of the property would require HUD approval. CHA has identified three potential options for this property.

- ***Sell the property.*** A February 2006 appraisal valued the property at approximately \$3 million. With the recent downturn in the Chattanooga real estate market, the estimated current value of the property is unclear without a new appraisal or market analysis. However, if CHA were able to realize the 2006 value, less 7% for broker commission and closing costs, CHA could net approximately \$2.8 million.
- ***Use the site as collateral.*** A smaller amount of capital could be generated to fund short-term needs by borrowing against the equity on the Poss Homes site. The amount obtained would depend on the percentage of equity borrowed. CHA used 20% of the 2006 value as an estimate, which would generate \$600,000.
- ***Use the property to generate lease revenue.*** Given its central location in the City, a commercial billboard operator has expressed interest in placing a large billboard on the Poss Homes site. CHA is currently conducting a Request for Proposal to solicit a proposal for a sign lease. CHA estimates it could earn \$10,000 to \$15,000 in annual revenue from this venture.

Alton Park Light Industrial Site. CHA owns an 11 acre site at the north edge of the Alton Park HOPE VI development. The site is zoned for light industrial, manufacturing,

⁹ Refer to *Public Housing Operating Cost Study, Harvard University Graduate School of Design, Final Report, June 6, 2003*, footnote 22, page 26.

¹⁰ Based on an estimated monthly operating budget of \$1.55 million.

office and warehouse uses. The original intent was to market to an entity that would bring residential friendly development and jobs into the neighborhood. CHA does not have a current appraisal or market analysis. There were attempts to market the property in 2005 at a price of \$300,000, but those attempts were unsuccessful. Given the recent downturn in the Chattanooga real estate market, it is unclear how marketable this property is, or its current value. If the prior \$300,000 asking price were obtained, less 7% for commissions and fees, CHA could net approximately \$280,000. HUD also holds a first position Declaration of Trust on this property. Accordingly, any disposition or encumbrance would require HUD approval. Further, any use of the funds other than for low income housing purposes would also require HUD approval.

Developer Fees from Mixed Finance Redevelopments. CHA earned developer fees as part of the provisions of the mixed finance redevelopment efforts for Alton Park, the Oakes at Camden, and Greenwood Terrace. For the Alton Park and Oakes at Camden developments, CHA has earned and received a total of \$279,691. CHA is also due a final payment of \$43,072 in developer fees after completion of all contractual provisions at the Oakes at Camden. Developer fees totaling \$390,807 for Greenwood Terrace are anticipated after completion of the redevelopment in the first quarter of 2010. CHA is also exploring the renegotiation of certain provisions of the Alton Park development involving payments and loans for connection fees to the Tennessee American Water Company. While there may be potential for recovery of some funds, CHA regards the possibility as low. These funds are contractually restricted for affordable housing purposes and would therefore require special HUD approval for any other use.

CHA Office on Holtzclaw. As discussed previously, CHA incurred significant debt in the process of refurbishing its former maintenance warehouse into its current central office facility. CHA proposes three alternatives for the Holtzclaw property: lease a portion of the facility to a third party, lease the entire facility to a third party, or sell the facility. CHA estimates that approximately \$180,000 per year in lease revenue could be generated (at a \$15 per square foot lease rate retaining all but 12,000 square feet of the space). Leasing all the space would generate \$403,995 in revenue. Although CHA does not have a current appraisal or market analysis, based on the to-be-built appraisal performed in April 2006, adding 15% for appreciation and deducting 7% for commissions and fees, CHA estimates net proceeds from sale of the property at \$5.026 million.

Sale of other real property. To generate needed working capital, CHA has identified certain other parcels of real property as candidates for disposition.

- **Fairmount Avenue and Gurley Street sites.** These sites are two of the three sites making up CHA's scattered site AMP No. 12. They have structural problems and low occupancy. However, they are located close to downtown in a revitalizing area. Thus, these properties could be very marketable to developers. CHA estimates that sale of these properties could generate net proceeds of approximately \$180,000 each, for a total of \$360,000. Again, since these sites are under declaration of trust, HUD approval would be required for disposition as well as any alternative use of funds once sold.
- **Scattered lots.** CHA owns several smaller vacant lots in Chattanooga, left over from older programs and activities. Three lots have been identified by CHA as not restricted by HUD as to sale or use of any proceeds. Value and prospects for quick sale are not known, but estimates indicate that sales would generate less than \$10,000 for the three lots identified.

Riverset Land Lease. In 1991, CHA purchased the land on which Riverset Apartments resides and gave back a long-term ground lease to the project owner with a 30-year option to purchase the land for \$350,000. CHA is pursuing negotiations with the project owner to determine if there is interest in exercising the option to purchase. It is CHA's position that any funds received from this sale would be unrestricted.

Energy Performance Contract Refinancing. As discussed previously, CHA has completed a two-phase energy conservation program through an ESCO. CHA is exploring the possibility of refinancing the current 12-year debt to a 20-year obligation. Preliminary analysis indicates potential savings through this process of \$40,000 to \$50,000 monthly.

Mayfair on Market Replacement Housing Factor Funds (RHF). As a means of curing the improper use of funds discussed previously, and to fulfill its obligation to the co-developer on this project, CHA is interested in pursuing the use of RHF funds to develop the for-sale condominiums contemplated in this development. CHA would submit a mixed-finance proposal to develop the condominiums under the Section 32 homeownership program.

Recommendation 7: CHA should explore the possibility of selling the Poss Homes property. If a suitable buyer is located, the Authority should discuss with HUD the possibility of having the Declaration of Trust removed. Further, CHA should request that HUD's Office of General Counsel determine if the proceeds from such sale could be used to cure the Fannie Mae default. CHA should use any excess proceeds realized from the sale to fund CHA's working capital needs. In addition, CHA should pursue the sale of the Holtzclaw property and obtain office space suitable for CHA's new organizational size and structure. CHA should use proceeds from the sale to retire the \$3.9 million outstanding debt. If allowable under HUD regulations, the Authority should use residual funds as necessary for configuration of new office space and moving expenses.

Of the options discussed above, selling the Poss Homes property appears to be the most viable method to raise sufficient capital in the short term to satisfy the Authority's \$2.3 million in outstanding obligations, as summarized at Figure 9.

Sale of the Holtzclaw property may provide additional working capital after debt on the property is retired, and expenses associated with obtaining and occupying new office space are incurred. An additional benefit of pursuing this option is a reduction in monthly expenses associated with the current property. CHA is currently obligated to pay \$29,000 in monthly rent to Holtzclaw, LLC. In addition, monthly utilities and insurance on the property are approximately \$5,050. CHA estimates its space needs at approximately 15,000 square feet, and estimates the rental cost at \$15 per square foot annually. Using those estimates, monthly rental of appropriately sized office space would be \$18,750 or \$10,950 per month less than CHA is currently paying to Holtzclaw, LLC.

The revenue earned from developer fees is from preexisting transactions and, therefore, does not bring any new capital to the Authority. The sale of the other real estate holdings discussed above would help, but would not generate enough capital to satisfy the Authority's outstanding obligations. CHA and HUD should also continue to explore the possibility of refinancing the energy performance contract debt to a term of 20 years. Refinancing would help the Authority's cash flow in the short term, but would not immediately generate sufficient capital to cure the Fannie Mae default.

Summary Analysis of Cash Flows

Figure 27 provides an analysis of the CHA's potential cash flows, based on the actions discussed in this plan. Both monthly and annualized cash flow results are presented. The projection is based on estimates and assumptions. Actual results will likely vary and may materially do so.

Figure 27 – CHA Cash Flow Projection

Item	Monthly	Annual
Estimated Operating Revenue	\$1,548,142	\$18,577,704
Less Estimated Operating Expense	1,927,080	23,124,964
Estimated Operating Surplus (Deficit) Subtotal	(\$378,938)	(\$4,547,260)
Increase cash flow from 65 employee RIF	239,500	2,874,000
Estimated Operating Surplus (Deficit) Subtotal	(\$139,438)	(\$1,673,260)
Increase cash flow suspension of 8% retirement benefit	68,671	824,056
Estimated Operating Surplus (Deficit) Subtotal	(\$70,767)	(\$849,204)
Increased cash flow proposed 15 employee RIF	55,300	663,600
Estimated Operating Surplus (Deficit) Subtotal	(\$15,467)	(\$185,604)
Cash flow from administrative expense cuts	89,800	1,077,600
Estimated Operating Surplus (Deficit) Subtotal	\$74,333	\$891,996
Cash flow from canceling lawn and unit turnaround contracts	49,700	596,400
Estimated Operating Surplus (Deficit) Subtotal	\$124,033	\$1,488,396
Cash flow from from obtaining appropriately sized office space	10,950	131,400
Total Estimated Increase in Cash Flow	\$134,983	\$1,619,796

Note that the two reduction-in-force actions, along with the suspension of the 8% elective employee benefit were not sufficient for CHA to reach breakeven. The projection shows the Authority reaching the breakeven point only after additional cost cutting measures are taken (e.g. some combination of a further reduction in force, other administrative expense spending cuts, and/or cancellation of lawn and unit turnaround service contracts).

Appendix A – CHA Draft Reorganization Strategy

CHATTANOOGA HOUSING AUTHORITY

BOARD OF COMMISSIONERS

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To: Honorable Chairperson and
Members of the Chattanooga Housing Authority Board

Charles T. Barnett, Program Center Coordinator
Nashville Field Office, Region IV

Karl H. Kucen
Director, Memphis HUB Office

From: Elizabeth A. McCright, Chief Operating Officer

Subject: Chattanooga Housing Authority FY 2008 Budget and Reorganization strategy

CURRENT SITUATION AND ITS EFFECTS

In 2001, the Chattanooga Housing Authority (CHA) transitioned from a traditional PHA to a streamlined agency that was under private management. In 2004, it became evident that this strategy was neither providing the results nor the level of service that was initially envisioned. Also during that time period, the Chattanooga Housing Authority received a Substandard rating in its Physical PHAS Inspection score (13 out of a possible 30 points). In response to these events, CHA increased personnel and resources to address all operational and service deficiencies identified from HUD's review. While these increases were initially intended to be temporary, the staffing and higher expenditure levels in effect became permanent. In fact, no significant cutbacks were addressed until the reduction in force that occurred in February 2008. While these cuts were initially characterized as sufficient to return the CHA to a break-even budgetary position, a review of the underlying analysis provided by the former CFO revealed that the revenue projections associated with that budget were overly optimistic and therefore, severely flawed.

2006 FINANCIAL POSITION AND 2007 OPERATING RESULTS

A fiscal snapshot review of the December 31, 2006 audited financial statements is presented as Exhibit A as a preliminary reference point. From this analysis, it was identified that the CHA had \$575,000 of excess working capital to facilitate operations. This level is well below HUD guidelines for an agency the size and complexity of CHA. A review of the 2006

financial statements does not readily identify this situation as \$5.6 million of Housing Assistance Payments that had been advanced, but remained unexpended as of December 31, 2006 were characterized as unrestricted net assets that substantially skewed the CHA's financial position and tended to distort the CHA's fiscal reality.

A preliminary analysis of the December 31, 2007 unaudited financial statements reveal a serious deterioration of available cash reserves and working capital. In addition, the accounts payable position on that date revealed a \$1.2 million increase over 2006 levels that suggest that the CHA deferred payment of obligations in response to the lack of available cash flow. A review of Calendar 2008 financial transactions to date revealed that the CHA has inappropriately utilized restricted cash reserves to fund general operations and to meet ongoing payroll obligations.

EFFECTS OF "UNAUTHORIZED" BORROWINGS

An analysis of expenditure activity in relation to available cash-flow funding has revealed two situations whereby the former CFO utilized inappropriate sources of available cash. These instances (as well as the statutory effect of the particular conversion) are as follows:

1. A review of Calendar 2008 financial transactions to date revealed that the CHA has utilized \$1.2 million of FNMA funds intended for the Mayfair at Market redevelopment for general operations. [While these funds are non-Federal Funds and do not trigger violations of Federal awards, the developer of this project is anticipating submission of a pay request to access these funds within the next 45 days]
2. The Housing Choice Voucher Program has experienced cumulative operational deficits of approximately \$710,000 as of March 31, 2008. This situation has caused the CHA to utilize funds that are restricted for Housing Assistance Payment Equity to meet ongoing cash flow obligations [While the inappropriate utilization of funds does not appear to involve any other Federal Programs nor has any fraudulent activity been uncovered, the program has experienced lost investment income (currently 1.56% - computed at a level of 50 basis points below the Federal Funds Rate) that CHA will be reimburse the program for all unrealized interest income earned prior to reimbursement].

2008-2010 WORKOUT STRATEGY

Initial discussions with HUD indicate that in addition to repaying the unauthorized borrowings, operational cutbacks must be sufficient to return the agency to financial viability. A review of the initial budget prepared in January 2008 identified an estimated shortfall of \$3.2 million for Calendar 2008 which, if not acted upon, would render the CHA financially non-viable [Exhibit B].

Consequently, the Chattanooga Housing Authority has insufficient reserves and anticipated revenue sources to maintain its existing business plan. In addition, current staffing levels remain at levels higher than many comparably-sized PHA's. CHA staff has performed an operational analysis and has identified that it needs to build its financial reserves to \$2.5 million to return to fiscal solvency and to adequately address cash flow considerations. Current projections indicate that this reserve level should be achieved during Fiscal Year 2010.

In light of this, CHA management has developed a staffing plan and targeted expenditure reductions to "right-size" the CHA in relation to its operating and financial requirements. We believe that the new staffing level will be sufficient to provide decent, safe, and sanitary housing and continue to provide a high level of service that CHA residents have come to expect.

SUMMARY OF PHASED IN CUTBACKS

In order to achieve the necessary budgetary savings, the following cuts are included in the CHA's "Analysis of Projected Cuts" [Exhibit D]. Phased-in implementation of these corrective measures should be sufficient for the CHA to return to financial viability by 2010.

Major provisions of the cost-savings measures associated with the reorganization plan are as follows:

1. CHA effected a reduction-in-force (RIF) on March 1, 2008 that reduces CHA's annual payroll and employee benefits by approximately \$1,600,000. CHA will execute an additional RIF on May 15, 2008 that will reduce CHA's annual payroll and employee benefits by an approximate additional amount of \$1,700,000. These reductions result in CHA's headcount being approximately 150 on May 16, 2008 compared to its January 1, 2008 headcount of 206.
2. Effective immediately, employee benefits of CHA will be reduced by the 8% retirement contribution. The retirement contribution will be increased from 0% to 2% effective November 1, 2008. Potential CHA funding participation for Calendar 2009 will be determined during a review of all CHA-provided employee benefits during the open enrollment period in December 2008.
3. Contract services are reduced by approximately 20% effective July 1, 2008. This will be obtained by elimination of all non-essential contracts and increasing cycle times for items such as grass cutting and indirect services.
4. CHA may be required to suspend payment of principal and interest on its long-term debt and pay vendors on extended terms to maintain sufficient cash flow.
5. Given that CHA does not have a source of funds to repay such borrowing and interest other than the net sale proceeds from real estate held for development, attempts will be made to sell all unencumbered properties. This includes the Grove Street parcel, James A. Henry School and other scattered site parcels.
6. Upon receipt of any disposition proceeds, these will be used to repay the \$1,200,000 FNMA unauthorized borrowing plus interest. In addition, the \$710,000 that CHA has incurred in HCV program operating expenses in excess of administrative fees will be paid out of excess sales proceeds. In the event that proceeds are not available, these funds will be repaid via savings accumulated via budget cuts. Imputed interest will be calculated and paid (based on the Federal Funds Rate less 50 basis points) which represents the amount that would have been earned had the amounts been on deposit as required.
7. In the absence of corrective action by the CHA, the estimated cash flow deficit as of December 31, 2008 was estimated to be a deficit of \$4,156,619 [Exhibit D]. Based upon initial estimates associated with the reorganization plan, it is anticipated that the agency will have approximately \$400,000 of excess cash flow as of December 31, 2008 that will enable CHA to be able to meet obligations on a timely basis and return to normal operations [Exhibit E].

While the above measures are indeed quite drastic, they are necessary to return the agency to fiscal health and "right-size" the agency in relation to other PHA's that have a comparable unit and program mix.

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Throughout this difficult process of reorganization service to the residents has been of utmost priority. I am confident that the ongoing dedication of CHA staff will continue to provide a level of excellence that our residents deserve and have come to expect.

Respectfully submitted,

Elizabeth A. McCright
Chief Operating Officer

Attachments:

Exhibit A: Summary of 12/31/2006 Consolidated Financial Position

Exhibit B: FY 2008 Consolidated Budget estimates

Exhibit C: Analysis of Projected Cuts in response to Budget crisis

Exhibit D: Original Estimated Cash Flow Deficit (prior to cuts)

Exhibit E: Projected Monthly Cash Flows CY 2008 & 2009

Exhibit F: Notes related to May 8, 2008 HUD Teleconference