paragraph 2-12-3. c.) and prime commercial paper. All these restrictions are designed to assure that debt proceeds (including Title VII funds disbursed from escrow), equity contributions and operating revenues will not be drained away by promoters in the face of project needs. In exceptional circumstances the use of surplus or paid-in equity capital to finance non-Title VII activities critical to success of the project and contemplated in the project agreement may be authorized through a nonrestricted subsidiary which is wholly owned. Cost certification procedures assure that no Title VII proceeds will be used for such purposes (see paragraph 2-12-3. a).

(b) Capital Inflow. No restrictions are imposed upon the sale of new equity by the developer except that any resulting change in control requires approval of the NCDC. Permitted long-term debt is strictly limited, however, pursuant to the applicable ratio of debt to equity, and generally consists of the following components: the Title VII guarantee or interest loan commitment; the indebtedness in respect of which any interest loan is made; an additional fixed amount of other debt for project purposes; debt subordinated to the satisfaction of the NCDC; and non-recourse debt in a specified amount to finance land acquisition or federally assisted housing activities. Additional borrowings may be authorized as a function of the recognition of equity represented by unrealized appreciation in land values over the development period. Sale and leaseback transactions, which may have the effect of debt financing, are prohibited. Lease obligations are restricted to a fixed annual rental reflecting the reasonable requirements of the developer for office space. All these restrictions are designed to assure that fixed capital charges incurred subsequent to project agreement execution.
will not unbalance the ratio of debt to equity.

(c) Operational Use of Funds. Without approval of the NCDC, the developer and restricted subsidiaries are permitted to engage only in activities which may be financed under Title VII. Separate accounting will be a condition for any such approval. Activities of all subsidiaries are in any event required to be in furtherance of the project. The cost certification procedure described in paragraph 2-12-3. a. assures that the proceeds of obligations guaranteed under the Act will be used to finance only Title VII activities and only that portion of the cost of such activities which is authorized by the Act.

(6) Restrictions on Change in Ownership or Assets. Without approval of the NCDC, any merger, consolidation, sale of any substantial portion of assets, or acquisition of substantially all the assets of another entity is prohibited. All transfers of any equity interest in the developer are subject to approval of the NCDC. Any transfer involving a change in control of the developer will be reviewed with particular care. Approval of the NCDC is also required for issuance by the developer of new equity if a change in control will result.

(7) Protection of General Assets. The developer is required to maintain its legal existence, rights and franchises; to pay all taxes and claims for labor or materials which might result in property encumbrance (or to maintain adequate reserves for claims contested in good faith); and to maintain its properties in good repair. Required insurance includes fire and extended coverage, public liability and workmen's compensation, providing coverage consistent with good business practice in the industry. The special requirements for protection of property subject to the government's lien are contained in subparagraph (b) of Section 6.05 and Section 6.06 of Appendix 6.
b. Results of Operations. If needed capital resources are assured, soundly balanced between debt and equity, the next question concerns the results which may be projected from the use of these resources in current operations throughout project development.

(1) Developer's Cash Flow Projections. The most meaningful measure of results of operations in land development is cash flow: an analysis of the source and application of all funds (including both capital and current payments) received and disbursed during any accounting period. Where the principal asset and product is land, adjustments (such as depreciation) required for traditional profit and loss accounting are generally not of great significance, and where fixed capital charges represent a high proportion of total costs, liquidity becomes the secret of success. In community-scale land development, success breeds success more than in most other businesses since an initial accepted product not only induces subsequent market demand but also favorably affects the price of subsequent sales quite apart from supply and demand. The developer, by successfully bringing initial acreage into more intensive use, will usually increase the value of the extensive remaining project acreage to be developed. Both the special risk and opportunity of large-scale land development derive from this boot-strap effect. It is obvious that the margin of error in any cash flow projection is increased by the uncertainty of assumptions as to price as well as demand. Performance in the initial marketing years thus becomes critical in maintaining projected liquidity: the favorable balance of receipts and disbursements of funds.

(2) Sources of Funds.

(a) Land Sales. Projected revenues from sales of land are based on assumed capture rates and assumed prices. Capture rates must be supported by the studies outlined in Section 3-6. Assumed prices must be supported by factual data from the market
area on competitive or similar properties. Assumptions should reflect pioneering aspects of the project but should also reflect, on a conservative basis, appreciation resulting from successful development. Breakdown of revenues should be based on categories of land use and, within the residential category, on at least three subcategories defined by price range.

(b) Other Operating Sources. There may be other categories of revenues derived from interim use of undeveloped land (e.g. timbering, agricultural, extractive or recreational uses) which may be included. Revenues and costs relating to building construction, sale or lease (except for public facilities) or any other non-Title VII activities should be excluded.

(c) Government or Foundation Grants. If funds may be anticipated from Federal, state or local government sources or from private foundations, an alternative projection should be prepared reflecting the receipt of such grants and identifying all consequent adjustments in cash flow. Public developers should, however, reflect any estimated interest differential grant under Title VII as a reduction of net interest cost and need not submit alternative projections for this purpose.

(d) Capital Receipts. Proceeds required from sale of equity or debt will be determined on the basis of the deficit in net operating revenues in any year, adjusted for resulting financing costs and subject to cost certification limitations in the case of proceeds from debt guaranteed under the Act. A segregated analysis of the Title VII escrow account should be included.

(3) Application of Funds.

(a) Real Property Acquisition. Acreage remaining to be acquired must be correlated
with the physical plan (Section 3-3) and the assumed prices must be reconciled with values reflected in the appraisal report (subparagraph c. below). Prices for land proposed to be acquired from equity participants and related persons must be approved by the NCDC and all such prices and other terms of acquisition must be fixed by contract or option no later than the date of project agreement execution. Option costs, principal payments and closing costs are included as costs of real property acquisition, but mortgage interest and other holding costs are classified under other applications of funds. For private developers, this distinction determines whether 80% (for land acquisition) or 90% (for land development) of cost becomes eligible for escrow disbursement (see paragraph 2-12-3. a).

(b) Improvement Costs. Estimates must be supported by detailed engineering data, including assumed unit quantities and price and the factual basis for such assumptions. Lump sum estimates (such as dollars per road-mile) will generally not be acceptable. Construction costs should be allocated between town-wide and in-tract categories. Any costs not eligible for Title VII financing must be segregated.

(c) Non-Construction Development Costs. The rationale and factual basis for all assumptions must support estimates of real estate taxes and assessments, planning and engineering expense, legal and auditing fees, costs of promotion and sales and management and other overhead expense.

(d) Financing Costs. Interest rates should be based on market conditions prevailing at the time of application and may require adjustment (with sensitivity analysis) prior to execution of the project agreement. Interest costs will also, of
course, be a function of projected issuance and amortization of debt on a feedback basis. Included as financing costs should be all HUD fees and estimated underwriting and other costs of securities marketing.

(e) Capital Disbursements. Loans or contributions to community associations, utility companies or related entities (whether or not subsidiaries) should be itemized. Principal repayment of non-recourse debt should be shown separately, and other repayments itemized by lender. Amortization of Title VII debt in any year should be determined in the light of projected positive cash flow (after taxes) in such year and in future years, subject to 10-year or other call protection expected to be accorded holders of guaranteed obligations (see paragraph 2-10-1. a (1) (c)).

(4) Other Financial Projections. Cash flow projections for any community association, utility company or other entity involved in Title VII activities will be reviewed by the NCDC in determining the adequacy of forecasts of results of operations. Profit and loss projections will also be considered. Studies of expected fiscal impact on affected governmental jurisdictions (see Section 3-8) will be reviewed for consistency with all these financial projections.

(5) Project Viability. For purposes of guarantee or interest loan assistance, the test of project viability in assessing "financial risk" is whether, on the basis of reasonable and thoroughly documented financial projections of results of operations, all debt (including Title VII debt) in the developer's proposed capital structure will be amortized during the development period with a reasonable additional margin of revenues for contingencies or return on equity investment. This test differs from the test of "economic feasibility" discussed in Section 3-6, only with respect to
the focus and scope of documentation. A finding of "economic feasibility" requires thoroughly documented market projections but other elements of the developer's financial projections may be based upon gross assumptions deriving from a reasonable and explicit rationale but without the extensive documentary base discussed in this Section. The distinction is important only for applicants seeking a determination of general eligibility but no guarantee or interest loan assistance. For such projects, a finding of "economic feasibility" is required under the Act, but not a finding as to "financial risk".

(6) Operating Tests During Development. Operating performance is closely measured against projections by means of the financial and statistical reporting requirements and auditing initiatives discussed in Section 2-13. Projections are continuously revised in the light of performance. The NCDC may at any time propose measures to the developer designed to resolve potential financial problems revealed by the monitoring process. In addition, the project agreement sets forth two formal tests measuring liquidity and operating performance which must be met at all times during development. If they are not met, the NCDC may not only propose corrective measures but may invoke the full range of remedies described in Section 2-15 for financial default. The two tests are designed to provide an early warning of impending serious financial difficulties threatening payment defaults or project viability and to make available legal remedies by which the government's interest may be protected.

(a) Liquidity. The developer is required to maintain at all times working capital at least equal to 10% of outstanding obligations guaranteed under the Act or of outstanding interest loans under the Act plus outstanding indebtedness in respect of which the interest loans have been made. Since no payment of principal and interest will ordinarily
exceed the 10% figure until late in the development period, this test provides, during the critical early years, advance warning of a liquidity squeeze threatening payment default. Working capital is measured by deducting current liabilities from current assets, as defined in the project agreement (Section 6.01 of Appendix 6).

(b) Operating Performance. The developer is required in any year to maintain an excess of revenues over costs which is no less than 20% below the most current revised projections of revenues over costs for such year and a cumulative excess no less than 10% below cumulative projections. Shortfall of revenues may be corrected by equity contribution in no more than two consecutive years. A revised projection for any year in which costs exceed revenues constitutes a default, but correction by equity contribution is authorized. For purposes of this test, revenues arise from any land sale subject to purchase money mortgage, any contract of deed or any net lease in the full amount of the purchase price or aggregate fixed rent, subject to appropriate discounts in the current year and to appropriate deductions in any subsequent year of default.

c. Security. If results of operation fall so short of projections as to threaten project viability and if all other measures fail, the government must protect its financial interest by assuring adequate security for its risk of guarantee liability or loss on interest loans.

(1) Coverage. The government's security interest consists of a lien on property of the developer, including (in the case of guarantee assistance) all project real property, subject to release without substitution so long as security value is at least 110% of the outstanding principal amount of guaranteed obligations or interest loans. The figure of 110% is designed to
provide full coverage of principal liability plus coverage of one year's interest liability plus a small margin for contingencies. The coverage is somewhat less than prevailing ratios of debt to value in the commercial market for secured credit, reflecting the burden of non-financial objectives placed by the government upon the developer, the importance in achieving these objectives of liquid working capital rather than a swollen security pool, and the conservative nature of appraisal instructions (Appendix 2).

(2) Valuation. All real property values are determined initially by the NCDC and are subject to subsequent adjustment based on development costs. Reappraisals by the NCDC may be made at the request of either party every two years. For a full discussion of the valuation process, see paragraph 2-13-3. b.

3-7-3. PRE-APPLICATION PROPOSAL. It is recognized that detailed financial projections will ordinarily not be available in the pre-application stage, but the developer's pre-application proposal should contain tentative information on proposed capital structure, potential sources of financing, gross estimates of project costs and revenues, and available security. Unusual features should be identified, such as anticipated high costs for innovative or other aspects of the developer's plan. The developer should supply a summary of the means and resources relied upon to achieve viability of the project notwithstanding any such unusual features.

3-7-4. APPLICATION. Material on the financial component submitted with a full application responsive to the instructions to applicants (contained in Part B of Appendix 1) must include the following:

a. Financial Statements. Historical information must be supplied as to the financial condition and results of operations of the developer and subsidiaries, or in the case of a developer to be created, similar information as to each of the controlling equity participants, including:

(1) A balance sheet as of the end of the most recent fiscal year, audited by independent certified
b. **Financial Projections.** Forecasts must be supplied of the financial condition and results of operations of the developer and subsidiaries, including:

(1) A balance sheet pro forma and analysis of the Title VII ratio of debt to equity as of the date of the first Title VII closing and a balance sheet pro forma as of the end of each fiscal year thereafter during the development period; and

(2) A statement of source and application of funds, a statement of profit and loss and a statement of surplus, in each case pro forma for the period subsequent to the most recent fiscal year and ending with the first Title VII closing and for each fiscal year thereafter during the development period.

c. **Standards.** All such financial statements and projections must be prepared in accordance with generally accepted accounting principles consistently applied and with standards prescribed in the Title VII regulations, instructions to applicants and this Handbook. The prescribed format for statements and projections of source and application of funds is contained in Exhibit 1 to Appendix 1, "Suggested Format for Title VII Cash Flow Analysis". The NCDC plans to issue uniform standards for financial reporting which will be applicable to all applications and financial reports.

d. **Land Acquisition Record and Projections.** As more fully described in Appendix 1, the application must include land ownership maps, a schedule of new community property owned, a schedule of new community property under option or contract, a
plan for acquisition of additional new community property, a schedule of other land in which any principal or equity participant has an interest and which is located in the market area of the new community project. See Section 3-9 for a discussion of the policy against competitive ventures by promoters of new community projects.

e. Analysis of Security. The application must contain an analysis demonstrating that adequate security values will be maintained without infringement of working capital requirements throughout the development period (see item P of Exhibit 1 to Appendix 1).

f. Real Property Appraisal. A report of an independent appraiser must be submitted with the application as to the value before development of (i) real property currently owned by the developer; (ii) the portion of such property to be developed under Title VII; (iii) real property proposed to be acquired for the project; and (iv) improved land ready for marketing. The date of appraisal should be as close as possible to the date of application but in any event no earlier than 60 days prior thereto. A supplementary report may be required either to correct deficiencies or to update values prior to execution of the project agreement. Appraisal instructions are contained in Appendix 2.

3-7-5. PROJECT AGREEMENT AND MONITORING. Financial covenants included in the project agreement restrict (i) payment of dividends and stock redemptions; (ii) extensions of credit; (iii) investments; (iv) creation of equity interests affecting control or transfers of equity interests, mergers, sale of assets, etc.; (v) borrowings; (vi) sale and leaseback transactions; (vii) leases; (viii) business activities; (ix) working capital; and (x) variations in revenues and costs. These restrictions are described in paragraph 3-7-2, subparagraphs a. (5) and (6) and b. (6), and are set forth in full in Article VI of Appendix 6. By means of the financial and statistical reporting mechanisms described in Section 2-13, the NCDC maintains continuous monitoring of the financial condition and results of operations of the developer and relevant subsidiaries.