The 2020 Affordable Multifamily Rental Market Conundrum – Record Closing Volume in the Midst of a Pandemic – The Overwhelming Role of Declining Interest Rates

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The 2020 Strong Affordable Multifamily Rental Market Conundrum

- Reports of continued increasing demand for private activity bond volume in California, Washington State, Colorado, Texas, Georgia and other high growth markets raises an interesting question – **why are we all even busier in 2020 than in 2019, even though we are eight months into a major U.S. health pandemic** and economic downturn?

- We would submit there are two primary driving factors:

    - Last spring and summer, Congress pumped **$3 to $4 trillion of fiscal stimulus** (almost 20% of $21 trillion U.S. GDP in 2019), into the U.S. economy, which enabled many renters to continue paying rent, notwithstanding horrific job losses in many major industries.

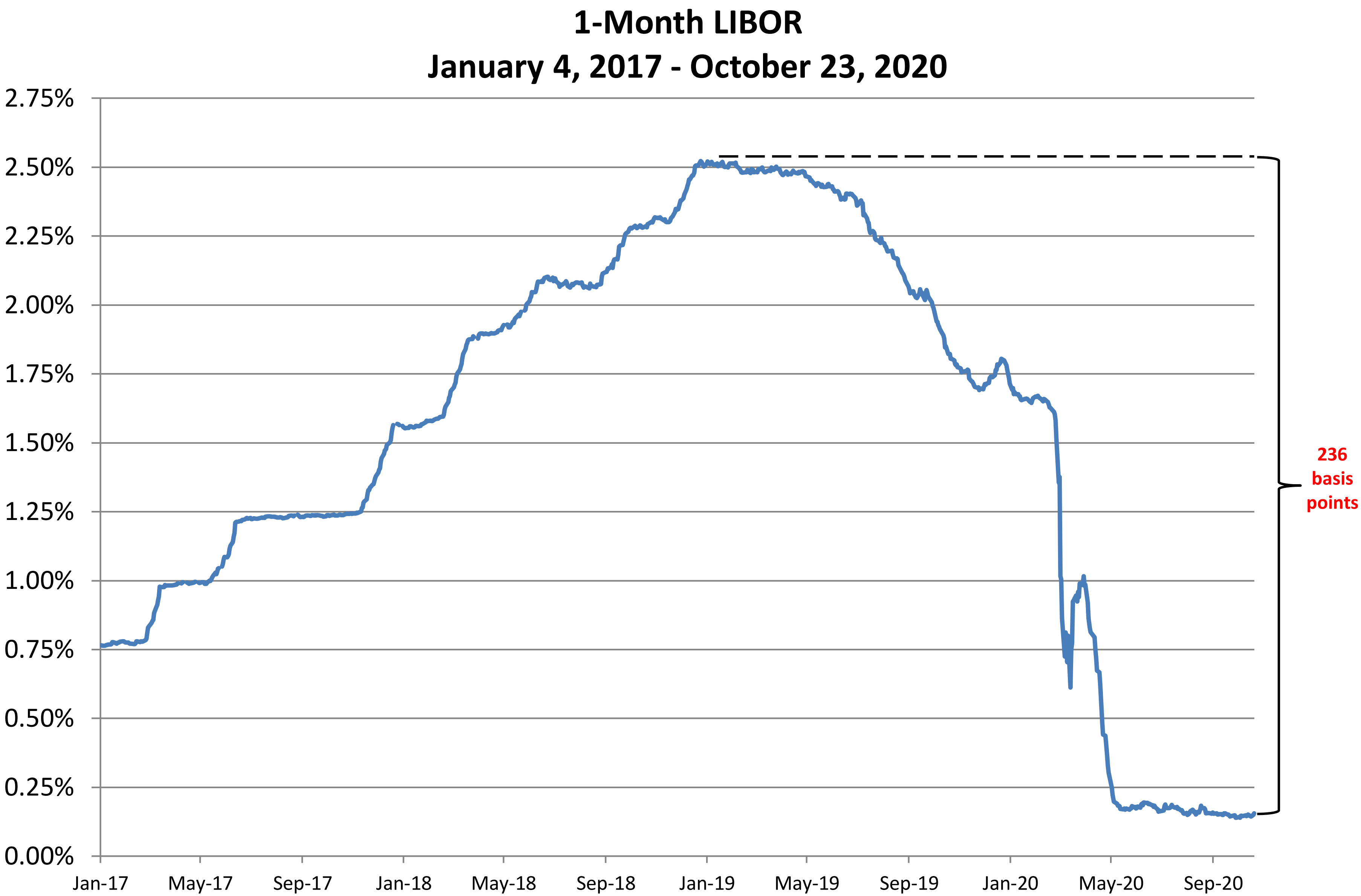
    - We are benefiting from **a major continuing decline in long-term interest rates**, which is a fundamental valuation driver of long-duration assets, which include not only common stocks, but also rental apartments and other income producing properties.

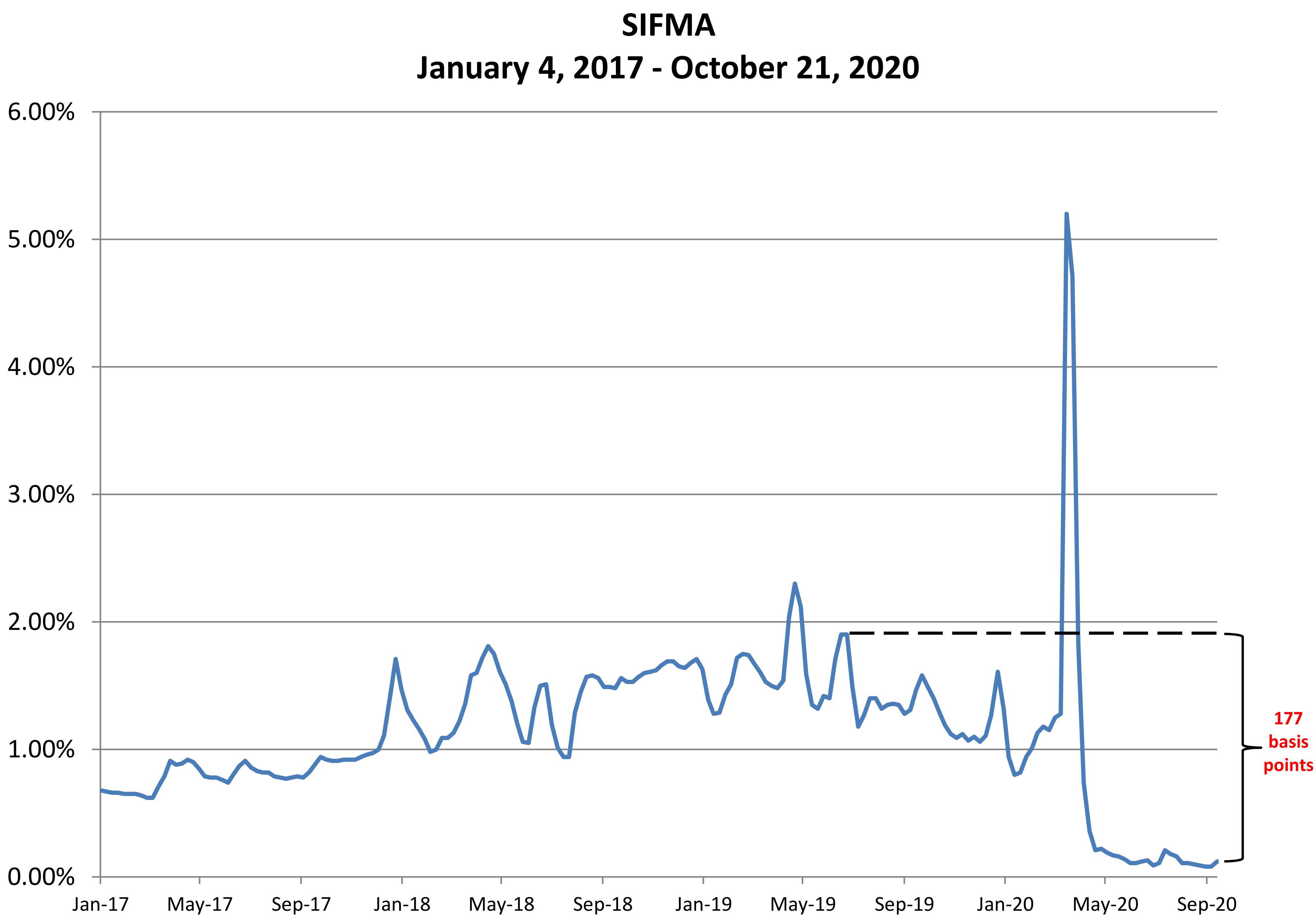
- This PowerPoint explores the scope and impact of the continuing permanent interest rate decline on tax exempt/4% LIHTC transactions.

The 2020 Strong Affordable Multifamily Rental Market Conundrum

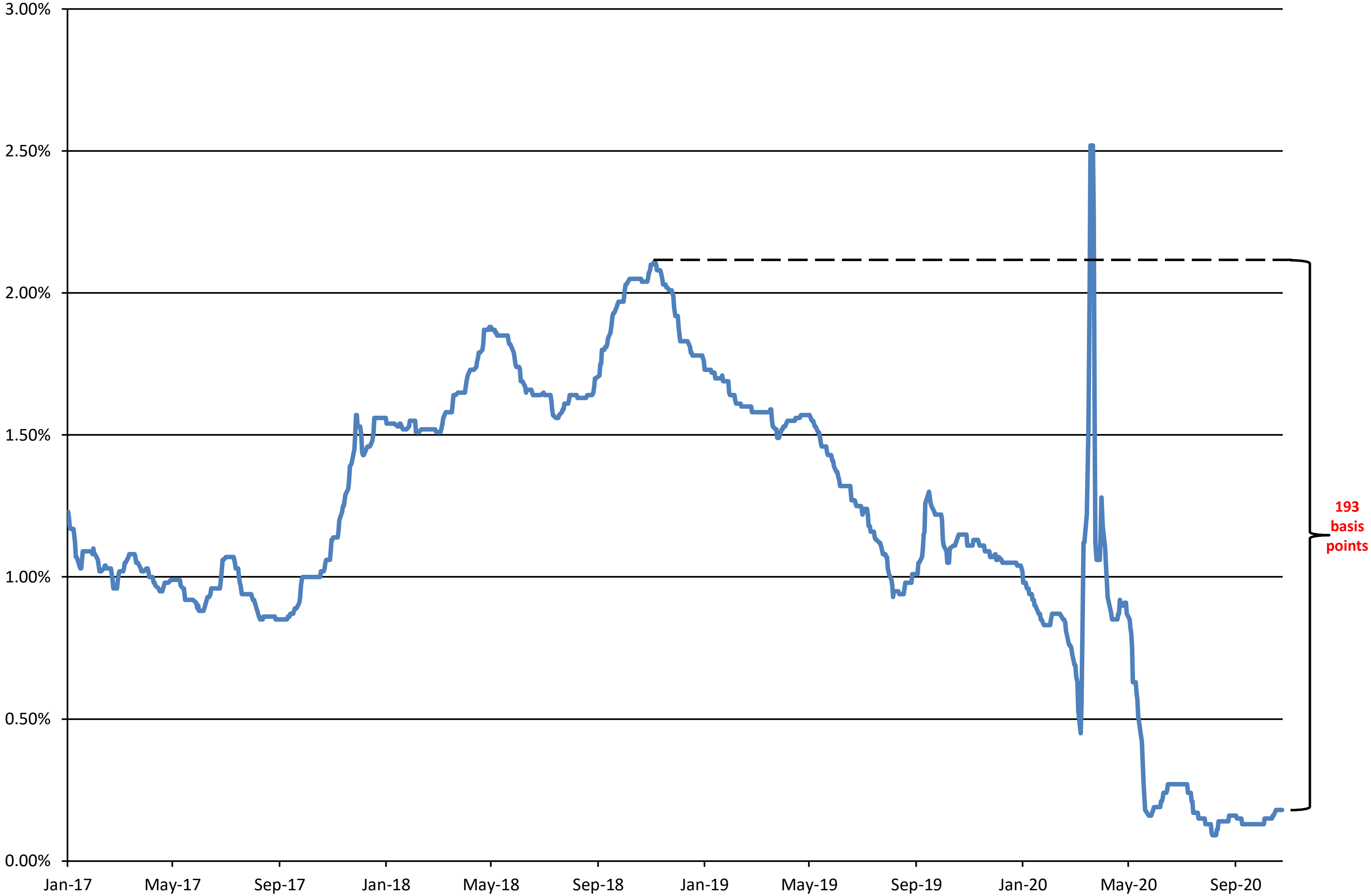
- The charts in the following five slides demonstrate vividly the remarkable drop in short-term and long-term interest rates which has occurred over the past two years.

- **Short-term Interest Rates:** After a horrifying spike in some short-term rates following the emergence of the COVID-19 pandemic in early March, **short-term rate indexes have fallen** even further, **from** levels in the **2.0% to 2.50%** range two years ago, **to a level of 10 to 20 basis points** today.


1-Month LIBOR
January 4, 2017 - October 23, 2020
2.75%
2.50%
2.25%
2.00%
1.75%
1.50%
1.25%
1.00%
0.75%
0.50%
0.25%
0.00%
Jan-17
May-17
Sep-17
Jan-18
May-18
Sep-18
Jan-19
May-19
Sep-19
Jan-20
May-20
Sep-20
236
basis
points


SIFMA
January 4, 2017 - October 21, 2020
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
Jan-17
May-17
Sep-17
Jan-18
May-18
Sep-18
Jan-19
May-19
Sep-19
Jan-20
May-20
Sep-20
177
basis
points

2-Year MMD
January 3, 2017 - October 26, 2020



The 2020 Strong Affordable Multifamily Rental Market Conundrum

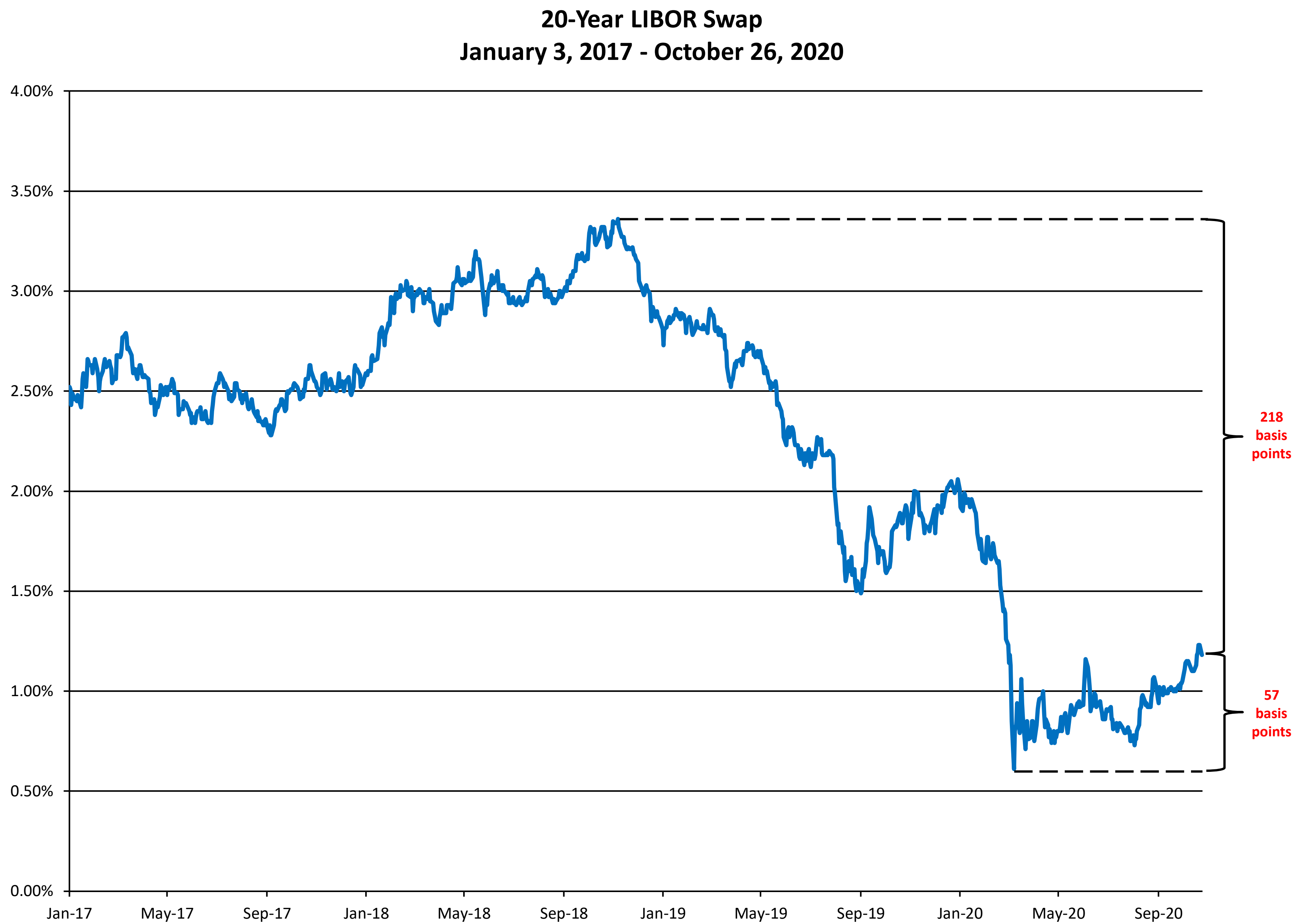
- **Long-Term Interest Rates. Much more important** is the **huge decline in the 10-year U.S. Treasury rate**. This rate sets the base for many permanent lending rates, which is a major determinant of permanent loan size. **The 10-year U.S. Treasury rate has fallen** about 273 basis points, **from** a recent high of **3.24%** in early November of 2018 **to a recent low of 52 basis points on August 4, 2020 – an 80% decline – and a level 88 basis points today**.

- Similarly, **20-year LIBOR**, a proxy for base permanent lending rates in many tax exempt loan private placements (which generally price at a spread to 17- or 18-year LIBOR), **fell** from a high of about 3.30% two years ago **by 230 basis points to 1.0%**, or **a 70% decline in early August, and to a level of about 1.2% today**.

- These are **huge percentage declines in long-term base lending rates**.

10-Year U.S. Treasury Rates
January 3, 2017 - October 23, 2020

Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, October 27, 2020



20-Year LIBOR Swap
January 3, 2017 - October 26, 2020
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
Jan-17
May-17
Sep-17
Jan-18
May-18
Sep-18
Jan-19
May-19
Sep-19
Jan-20
May-20
Sep-20
218 basis points
57 basis points

- **Partially offsetting** this has been a **slight widening of loan spreads** since the fall of 2019.
  - **Bank and other private placements** have also recently seen permanent loan spreads to 17 or 18-year LIBOR (currently about 1.20%) rise from 200 to 220 basis points or so to a range of 230 to 240 for many financings and **all-in permanent borrowing rates of 3.20-3.60%** for many executions.
  - Similarly, on **Freddie Mac TEL executions**, spreads on Freddie Mac TEL executions widened from around 200 basis points to 260-280 to the 10-year U.S. Treasury rate for many executions, but have subsequently declined to **about 220 to 260 basis points today to produce similar all-in permanent borrowing rates in the mid 3.0% range.**
  - **On Fannie Mae M.TEBs**, the spread of the **bond coupon** rose to a level about 150 to 160 basis points over the 10-year Treasury this spring and early summer, but now trades at about 110 to 120 basis points over the 10-year U.S. Treasury bond. After the FHFA's September, 2019 release constraining Fannie Mae and Freddie Mac multifamily volume, **guaranty and servicing fees** on Fannie Mae M-TEBs rose from around 100 basis points to about 140-160 basis points but generally range from about 120 to 140 basis points today. Together, these trends produce **mid 3.0% all-in borrowing rates on Fannie Mae M.TEBs in today's markets**.

- As the following chart shows, this still leaves the **permanent lending rates for many** Bank and Freddie Mac TEL **private placements**, as well as Fannie Mae M.TEBs, at a level of about **3.50%** or 150 basis points **(30%) lower than** the **5.0%** borrowing rates which prevailed on those executions only two years ago.

- Permanent lending rates on **FHA and Rural Development financings** have seen similar declines over this period, and today stand in the **mid 2.0% range for moderate rehab financings** and in the **low 3.0% range for new construction/sub rehab financings.**

Estimated All-in Borrowing Rates

Bank Private Placements

Pre-Conversion ("**Construction**") **Borrowing Rates**	Jan. 2019	October 2020	
1-Month LIBOR	2.50%	0.50*%	• **Down about 200 Basis Points since Jan. 2019**
Spread (now typically, 170-225)	1.70-2.50%	2.00-2.25%	
	4.20-5.00%	**2.50-2.75%**	

Post-Conversion **("Permanent")** **Borrowing Rates**	Fall 2018	October 2020	
17-YearLIBOR	2.80%	1.20**%	• **Down about 165 basis points since Fall 2018**
Spread (now typically, 190-225)	2.00-2.50%	2.00-2.40%	
	4.80-5.30%	**3.20-3.60%**	

* 1 Month LIBOR = 0.15%; assume 0.50% floor; we are now seeing floors applied in light of low rates.

** 17-Year LIBOR = 1.00%; we are also seeing floors here of around 0.85%.

Freddie Mac TEL Loans

Pre-Conversion ("**Construction**") **Borrowing Rates**	Jan. 2019	October 2020	
1-Month LIBOR	2.50%	0.50*%	• **Down about 200 Basis Points since Jan. 2019**
Spread (now typically, 170-225)	1.70-2.50%	2.00-2.25%	
	4.20-5.00%	**2.50-2.75%**	

Post-Conversion **("Permanent")** **Borrowing Rates**	Fall 2018	October 2020	
10-Year U.S. Treasury	2.90%	0.90**%	• **Down about 145 basis points since Fall 2018**
Spread (now typically, 230-260)	1.80-2.00%	2.30-2.60%	
	4.70-4.90%	**3.20-3.50%**	

* 1 Month LIBOR = 0.15%; assume 0.50% floor; we are now seeing floors applied in light of low rates.

** Freddie Mac imposes a 0.65% floor on the 10-Year UST.

Other Estimated All-in Borrowing Rates in Today's Market

Fannie Mae M.TEBs

10-Year Treasury	0.90%
Spread	1.20
Tax-Exempt Bond Coupon/MBS Pass-Through Rate	2.10%
Guaranty/Servicing	1.20 – 1.40
All-in Borrowing Rate	**3.30% – 3.50%**

Estimated All-in Borrowing Rates (Cont'd)

FHA and Rural Development Loans
– Once again producing even lower rates.

	§223f (Mod Rehab)	§221(d)(4) (Sub Rehab/New Construction)
10-Year Treasury	0.90%	0.90%
GNMA to 10-Year Treasury Spread	1.20	1.75
Taxable GNMA Pass-Through Rate	2.10%	2.65%
Servicing/GNMA Guaranty Fee	.25	.25
Stated Mortgage Loan Rate	2.35%	2.90%
Mortgage Insurance Premium (Affordable)	.25	.25
All-in Borrowing Rate	**2.60%**	**3.15%**

HUGE POSITIVE IMPACT OF DECLINING LONG-TERM RATES

- On the finance side, the **major factor underlying the record volume of closings** we continue to see on tax exempt debt/4% LIHTC projects is **increased loan sizes driven by significantly declining long-term interest rates**.
- **Two factors** have materially increased tax exempt loan proceeds over the past two years:
  - **Dropping the long term interest rate** from 5.0% to 3.5% on a 40-year level amortization loan **increases loan proceeds**, all other factors equal, **by a whopping 25%** on a debt service constrained loan.
  - **Think about that**. On average, o**ver** the past two years, tax exempt loan size has increased about **1% for every six basis points drop in rates**, and **that has happened, on average, once per month over the past two years**.
  - Oh! Your deal doesn't work? **Wait 3 months and your loan size will go up 3%!** Yes. That's the math.
  - In addition, over the past two years, most programs have **shifted from a 35-year to a 40-year loan amortization**. This **increases loan proceeds** on a debt service constrained loan by **5.0%**.
  - If the tax exempt debt funds 60% of total development cost ("TDC"), then a **30% loan size increase** from these two factors above **can offset an increase of up to 18 points in TDC**.

PARTIALLY OFFSETTING NEGATIVE FACTORS

- Of course, a good deal of this is **offset by other negative factors**:
  - A 10 cents **decrease in 4% LIHTC pricing** is a hit equal to **3-4% of TDC**.
  - **Increases debt service and operating reserves** due to COVID-19 concerns may represent a hit equal to **2-3% of TDC**.
  - And in most high demand markets, **construction costs and other costs are rising** at rates well above the rate of inflation (2.3% in 2019; 1.3% so far in 2020). Assume 5%/year and construction is 70% of total development cost. That's **another 7% of TDC*.**
- Let's **assume these offsets equal 12-15% of TDC*. At an estimated 18% of TDC, the major improvements on the tax exempt debt side of these financings appear to have offset, or more than offset, these and other negative factors** over the past two years.
- It seems inescapable that **more than any other factor, this major improvement in the tax exempt debt side of the financings explains why the pace of closings appears not to have abated**, and perhaps to have even accelerated, in pandemic stricken 2020 over 2019.

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* Of course, these factors can vary substantially form project to project and market to market.

WHAT COULD SPOIL THE PARTY?

- It now appears that this **decline in long-term rates is slowing or bottoming out** and may be reversing a bit.

- A quick examination of the right hand side of the charts on slides 8 and 9 shows that **long-term rates have basically been going side ways** since hitting recent lows last **March,** and that more **recently these rates have began to rise**.

- **Thus, the strong wind we have had at our backs from declining long-term rates may no longer provide the huge level of support we have seen over the past two years.**

- **If Congress fails to provide significant additional fiscal support** for lost incomes associated with lost jobs, the percentage of potential gross apartment revenue actually realized by owners could fall from the low 90% range today into the 80's or even lower.

- In recent monthly updates, **Dominion Development**, the nation's fourth largest affordable multifamily housing provider with 30,000 units under management, **reports** that **a significant deterioration in rent collections began in September** with September collections falling 4% from August to a level of about 89%, and slipping another 1% in October.

WHAT COULD SPOIL THE PARTY?

- According to the July 15, Wall Street Journal, three **major U.S. banks** (Wells Fargo, JPMorgan Chase, and Citi) **posted significant loan loss reserves** in Q2 2020 which were 7 times the amount of the loan loss reserves in the last three quarters of 2019. The **August 14, 2020** issue of the Wall Street Journal reports that **Warren Buffett**, one of the most successful investors of all time, **significantly sold off his bank stock holdings**. While a number of major banks posted improved results in the third quarter of 2020, **if bank and insurance company profitability declines, the demand for 4% LIHTC could also fall substantially.**

- The economy could see further shutdowns from the **current resurgence and/or subsequent resurgences of the COVID-19 pandemic**, which could also impair construction, inspection and other critical aspects of the development process.

- **State and local budgets strained by the COVID-19** pandemic could result in **falling** versus rising **state and local government affordable rental housing subsidies**, which have been an important "gap filler" over much of the last 2-3 years.

- **Continuing increases in construction and other costs** could continue to put pressure on funding sources.

MAJOR TAKEAWAYS

- In light of the plateauing and recent rise in long-term rates, it is **hard to believe that the powerful tailwind of declining rates** we have enjoyed over the past two years **will continue** at the pace we have recently seen to offset these potential negative factors.
- Perhaps the best general takeaway, given the recent challenges we now face, **time is your enemy, not your friend**. Many developers seem to be following this strategy, even accepting reduced tax credit equity and lower or deferred developer's fees to assure that deals stay on track to close. For the immediate future, **certainty and timeliness of execution may become the most important hallmarks of a successful project financing**.
- Of course, the increasingly **unmet demand for affordable rental housing in the United States continues to grow**.
- **We should all support continued federal assistance of families and lenders during the months ahead.** As we saw in the spring of 2009 when the federally mandated infusion of additional equity in the major banks broke the downwardly spiraling financial panic which arose in the fall of 2008, the **current major uncertainties could quickly and dramatically abate**.
- The key over the next six to twelve months may be managing exposure and financings to **be in a position to meet the challenges and opportunities which this will present when it occurs.**

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