NEW TAX-EXEMPT BOND FINANCING STRUCTURE FOR AFFORDABLE WORKFORCE HOUSING AND THE IMPACT OF RISING INTEREST RATES*

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Presented by:

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* **Cautionary Note**: The interest rates and other data set forth in this analysis are **estimates only**. **All markets today** – for bonds, tax credits, swaps, caps, investment agreements and other products – **are often thin and volatile**. These **interest rates, fees and other variables can vary dramatically** depending on state, timing, market conditions and other factors, and the other variables may vary significantly depending on project, developer and other factors. Borrowers should check with their investment banker or financial advisor before conducting a detailed assessment of any of these structures or programs.

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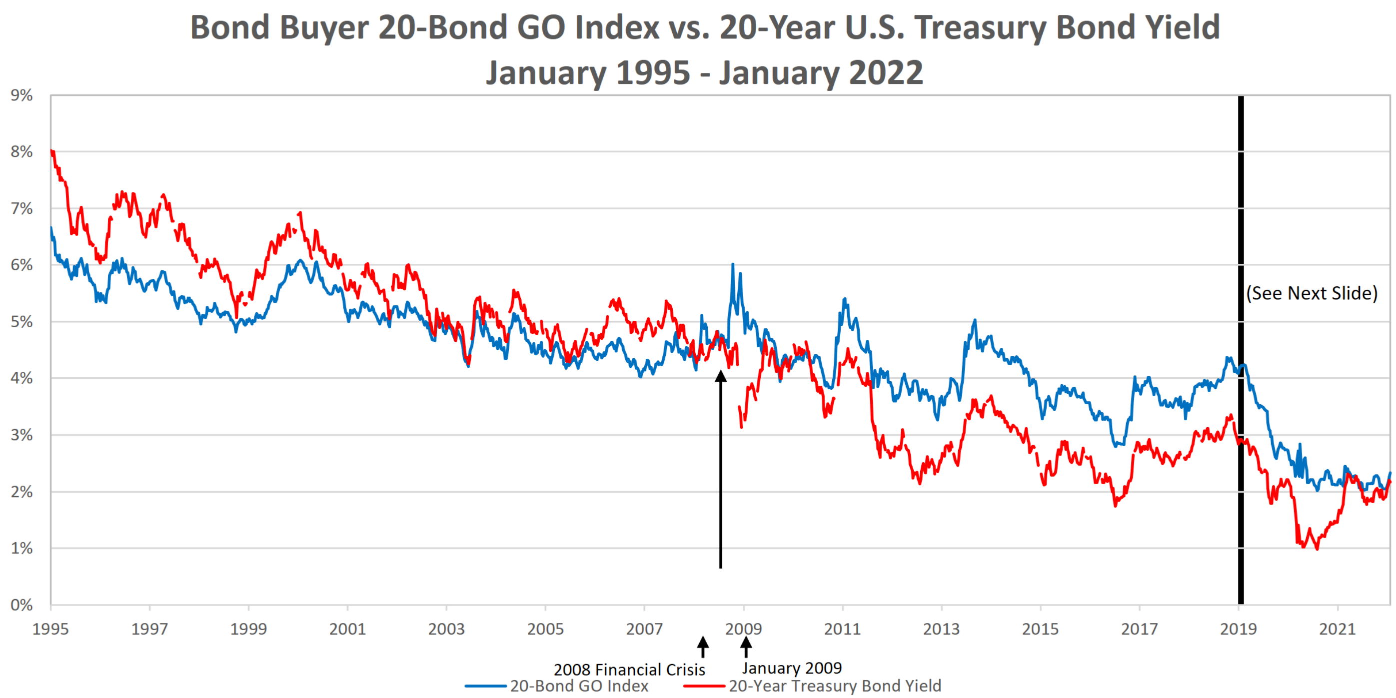
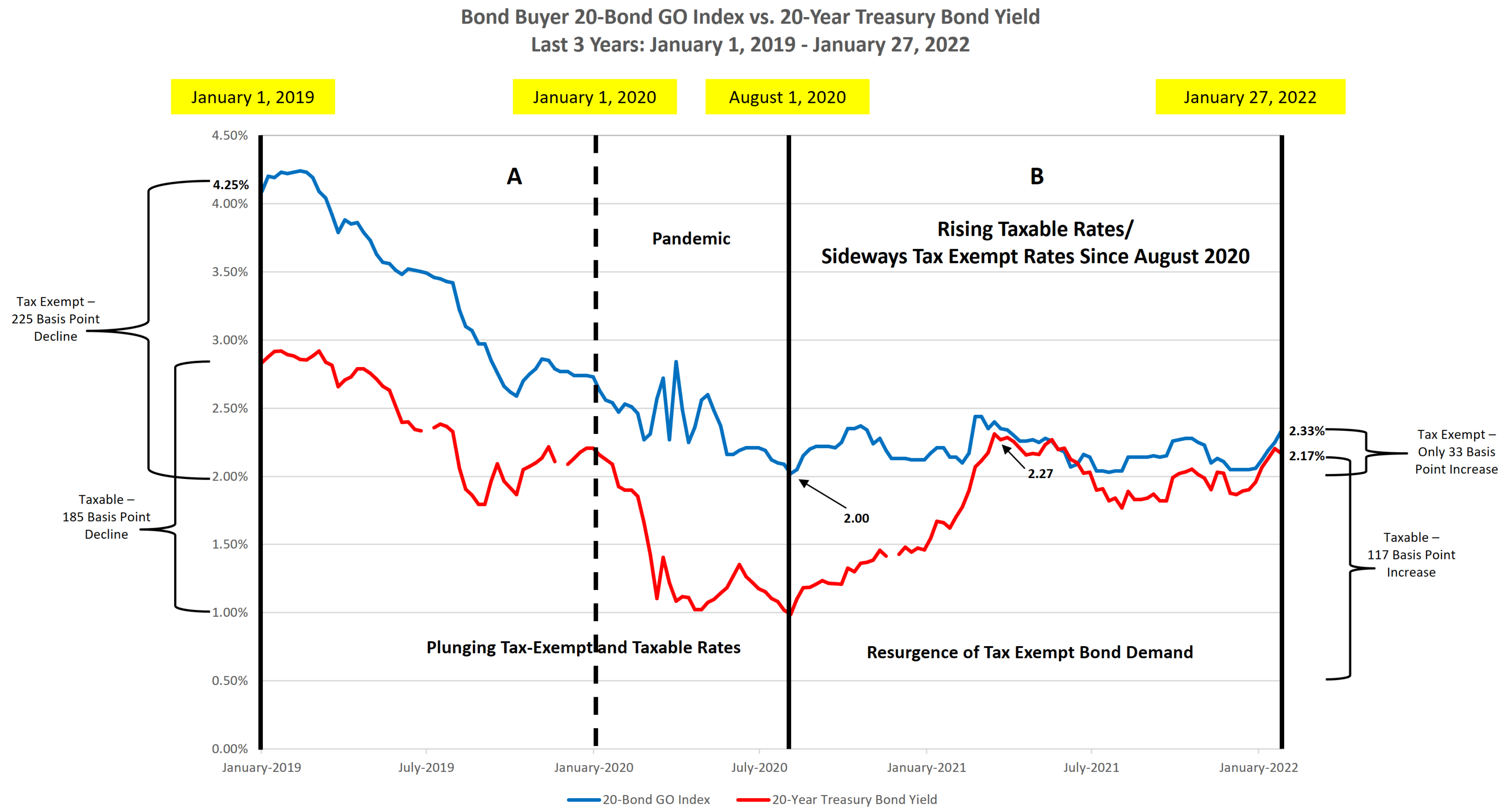
A BRIEF REVIEW OF TAXABLE AND TAX EXEMPT INTEREST RATES
The Post-2008 World of "Upside-down," But Declining Interest Rates



- **Post-2008 Financial Crisis: Major Long-Term surge in Demand for Taxable U.S. Treasury Bonds versus all other debt**, including Tax-Exempt Muni Bonds.
- **January 2009** (Upward arrow) – **Rates 300 basis points "upside down."**
- This distrust of all other forms of debt versus U.S. Treasury Bonds is easing but still exists today – almost 13 years after the 2008 financial crisis.
- But, note that **both taxable and tax-exempt rates have continued a strong decline (until very recently).**


Bond Buyer 20-Bond GO Index vs. 20-Year Treasury Bond Yield
Last 3 Years: January 1, 2019 - January 27, 2022
January 1, 2019
January 1, 2020
August 1, 2020
January 27, 2022
A
B
Pandemic
Rising Taxable Rates/
Sideways Tax Exempt Rates Since August 2020
Plunging Tax-Exempt and Taxable Rates
Resurgence of Tax Exempt Bond Demand
Tax Exempt – 225 Basis Point Decline
Taxable – 185 Basis Point Decline
Tax Exempt – Only 33 Basis Point Increase
Taxable – 117 Basis Point Increase
4.25%
2.00
2.27
2.33%
2.17%
4.50%
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
January-2019
July-2019
January-2020
July-2020
January-2021
July-2021
January-2022
20-Bond GO Index
20-Year Treasury Bond Yield

INTEREST RATES OVER THE PAST THREE YEARS – Two Major Phases

A. January 2019 Through August 2020 – Declining Tax Exempt and Taxable Rates

- These **dramatic drops in borrowing costs raised loan proceeds at a rate of more than 1% per month** to help offset rising project costs – a more than 20% increase in loan proceeds over this period.
- This continued expansion of loan proceeds together with the several trillion dollars of Pandemic subsidies explains how we all stayed so busy during the Pandemic!

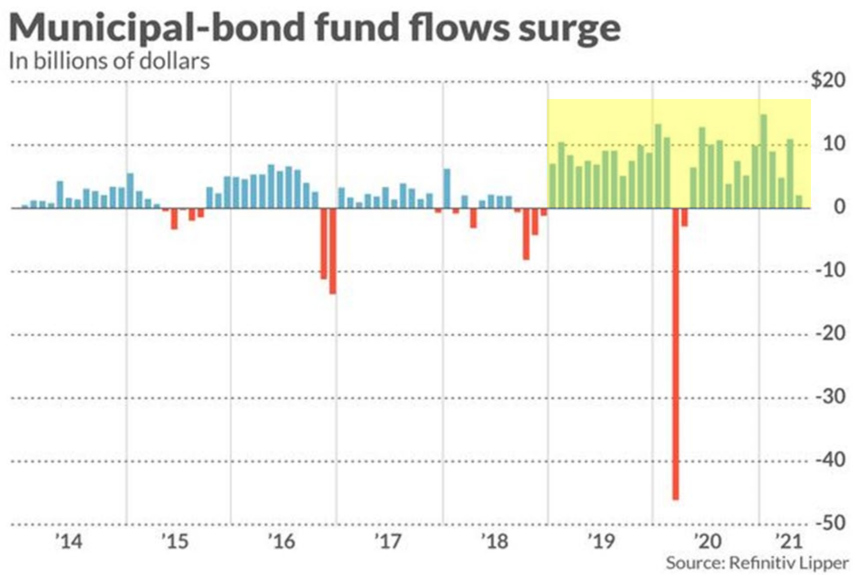
B. Rise in Taxable Rates from **August 2020 Through Present**.

- U.S. Treasury rates rose substantially – 133 basis points.
- But, **20 Bond Tax Exempt GO Index** was almost flat – up only 33 basis points**.**

What happened here? What explains this?

Tax-Exempt Municipal Bond Fund Inflows – A Recent Major Positive Underlying Trend

- The right hand side of following chart from Refinitiv Lipper evidences an **acceleration over the two-years prior to January 2022 of a very favorable 7-year trend: Inflows into tax-exempt municipal bond funds have been especially strong for the past two years**. **This has significantly lowered tax-exempt versus taxable rates**.



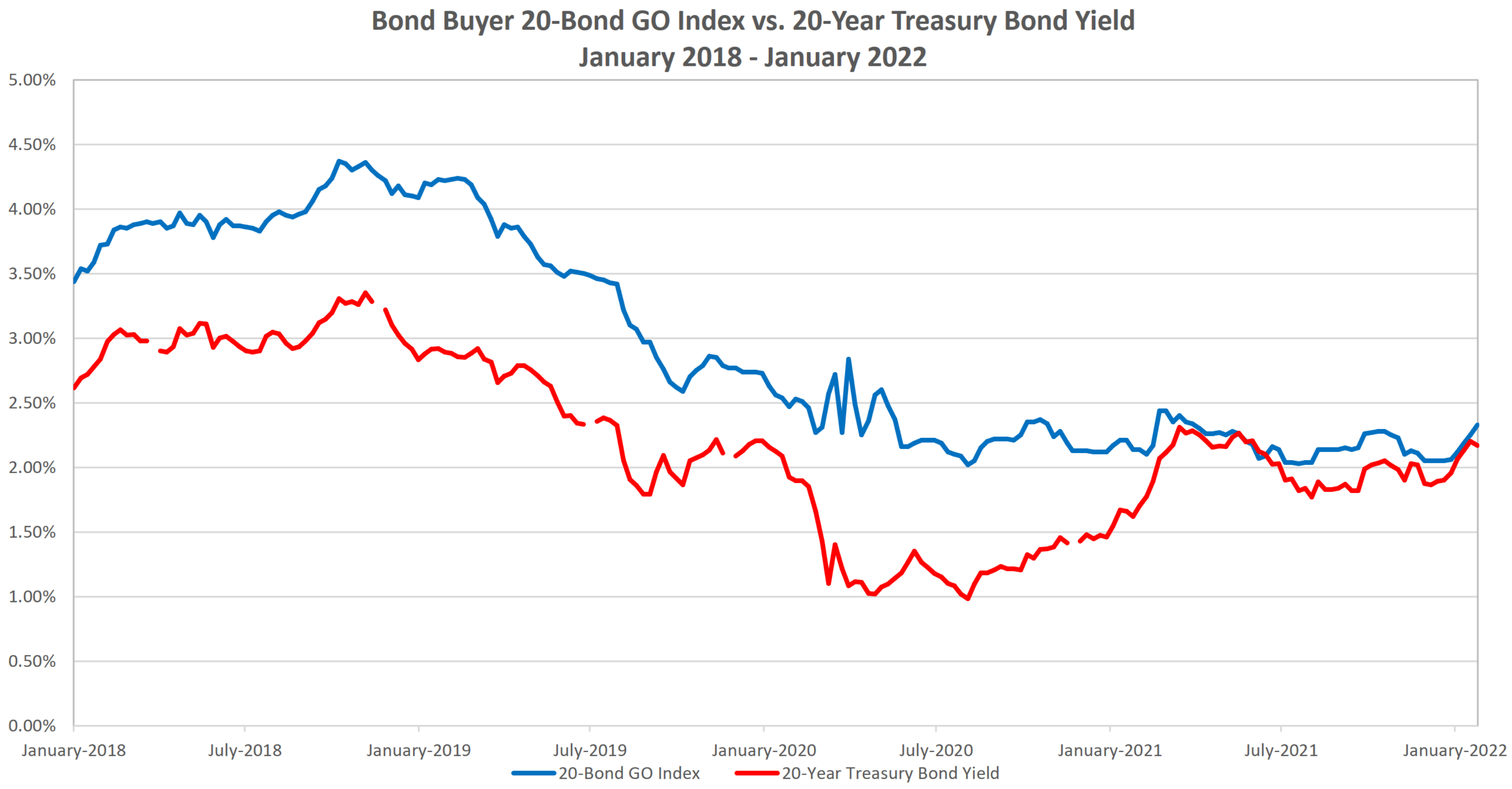
Andrea Riquier
(First Published: May 21, 2021)

- According to a recent SIFMA report, **municipal bond funds** held 27% of municipal bonds at the end of 2020; **Individuals 44.5%;** meaning **high income taxpayers,** purchasing directly or through bond funds, **comprise 75% of the market.** *

* Banking Institutions 12.3%; Insurance Companies 12.3%; Other Holders 3.9%.

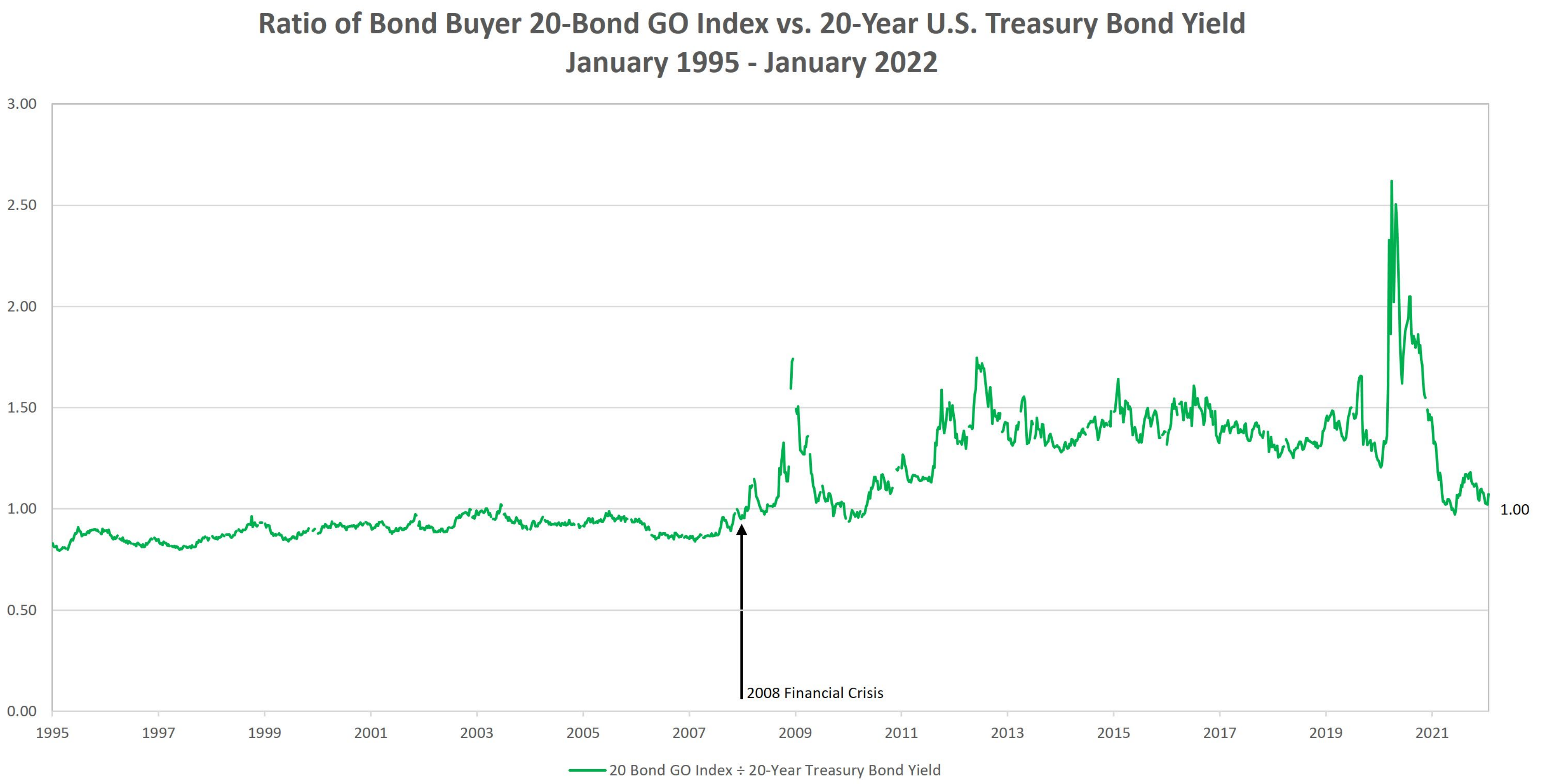
- These major, sustained municipal bond inflows explain why **tax-exempt rates remained relatively flat** from the low point in rates in the summer of 2020 through January 2022, **while taxable rates moved up substantially during this period**.
- This produced the **best conditions we have seen in the tax-exempt debt markets in decades!!!**

The Post-2008 World of "Upside-Down" Interest Rates



- **This dramatically enhanced demand for tax-exempt municipal bonds** may be **pushing us back in the direction of a "right-side up" interest rate world**.
- **The Bond Buyer 20-Bond GO Index, at a very recent yield of 2.80%,** is about **even with the 20-year U.S. Treasury rate at around a 2.60% yield, or slightly "upside-down."**

- The following chart shows the same thing in a different way: the **ratio of 20-Bond GO Index to the 20-year U.S. Treasury rate plunged dramatically back down to about 1.0**, the **lowest ratio since rates went "upside down"** following the financial crisis **in 2008**.



- **The Bond Buyer 20-Bond GO Index, very recently,** is about **even with the 20-year U.S. Treasury rate at around a 2.60% yield, or slightly "upside-down" at 2.80%.**

A Dramatic Demonstration of Very Low Muni Rates: Tax-Exempt "Essential Function" or "Governmental Purpose" Bonds and "Section 501(c)(3)" Bonds for Workforce Housing

- In 2021 was a **dramatic surge** in a **relatively new structure** involving the issuance of tax-exempt high yield **"essential function" bonds for public owners** under Section 103 of the Code **and similar tax-exempt bonds** issued **for Section 501(c)(3) nonprofit borrowers** under Section 145 of the Code.
- The foregoing major tax-exempt bond inflows produced a startling, **truly remarkable result**.
- They allowed the issuance of **unrated, non-credit enhanced tax-exempt bonds** at such **low yields** as to **provide 100% financing** for **moving** relatively new, stabilized, **conventionally financed apartment buildings into public or nonprofit ownership**.
- **This creates real estate tax relief** in many jurisdictions, which, of course, is a **cost to the cities, counties and school districts involved.**

A Dramatic Demonstration of Very Low Muni Rates: Tax-Exempt “Essential Function” or “Governmental Purpose” Bonds and “Section 501(c)(3)” Bonds for Workforce Housing

- However, the **freed up cash flow enables** the **public borrowers** using this structure to **make the units available** to teachers, first responders and other **families whose income does not exceed 80-140% of Area Median Income** generally at **rents somewhat below** prevailing **market** rents.
- There is a **strong likelihood** at reasonable assumed growth rates in income and expenses, that **after 10-15 years** the governmental entity borrowers pursuing these financings will be able to refinance the debt and **have sufficient funds**, if desired, **to repay real estate taxes foregone** with interest, **and maintain public or non-profit ownership in perpetuity**.
- The income **targeting is generally deeper under IRS Rev. Proc. 96-32*** which applies to most of these **issues** for Section 501(c)(3) borrowers under Section 145 of the Code, but these financings can also produce perpetual ownership for the Section 501(c)(3) borrower. Moreover, under some Section 501(c)(3) ownership structures, Rev. Proc. 96-32 may not apply.
- A **major advantage** of both of these structures is that, while they do not trigger 4% LIHTC, **they require no allocation of private activity bond volume!!!** This is becoming increasingly important, especially in oversubscribed high growth states such as California and Texas.

* Rev. Proc. 96-32 requires 20% of the units to be targeted at or below 50% of AMI or 40% at 60% or below of AMI, a percentage of units above that level up to 75% of units to be targeted at 80% or below of AMI and allows 25% of the units to be rented to tenants at any income level.

California JPA Essential Function Workforce Housing Financings
Incentives (+) / Costs (-) For Major Participants

- California law **allows cities and counties to join a "joint powers authority" or "JPA"** which can issue bonds and/or own properties in a city or county's jurisdiction, where the city or county values the public purpose served but does not itself want to serve as the bond issuer and/or project owner.
- For the **City** joining the JPA.
  - – City, county, and school district **foregoes real estate tax revenue for 15 years**.
    - \+ **Affordable workforce housing** cuts down on often monstrous (100+ miles) roundtrip commutes for teachers, first responders and others at 80%/100%/120% of AMI.
    - \+ City has **option to purchase the project after 15 years** at price sufficient to pay bonds.
    - \+ Projections based on reasonable assumptions (e.g., 3% growth in revenue and expenses) generally show sufficient project value at year 15 to allow **repayment of real estate taxes foregone** and **substantial residual value to City**.
    - \+ **Bond principal amortization, based on a "turbo amortization" soft sinker structure** versus mandatory sinking fund and/or serial bond maturity structure, together with substantial upfront reserves, **lowers the risk of default.**
- For the **JPA and its Advisor**.
  - – Substantial efforts are required before deal assured; must lead complex financing, **serving as issuer and borrower**.
    - \+ Assisting City in affordable workforce housing objectives above.
    - \+ Upfront fees of about 1% (or lower on large deals) and ongoing fees of 10 – 12 basis points.

California JPA Essential Function Workforce Housing Financings
Incentives (+) / Costs (-) For Major Participants

- For the **Project Administrator**.
  - The Project Administrator is a **real estate development firm** which locates project, negotiates Purchase-Sale Agreement with Seller and goes at risk on deposit, works with underwriter to develop favorable financing structure, engages and pays for all third party reports, helps negotiate terms with City.

  – Goes at risk for time, deposit under Purchase-Sale Agreement, third party and other costs – typical development type functions.

  – Loses deposit (1% or more of purchase price) if bond issue fails to close on time, often just 60-90 days.

  + Up front cash fee of 1% or more; receives subordinate tax-exempt bonds with 8-10% coupon equal to 3 to 4% of purchase price as part of front-end compensation, ongoing Project Administrator fee of 10 basis points or so for ongoing asset management services.

- For the **Underwriter**.

  – With counsel assembles complex disclosure (750+ page offering document), performs due diligence, conducts road show presentation with investors and bears the risk associated with sale of high yield unrated paper.

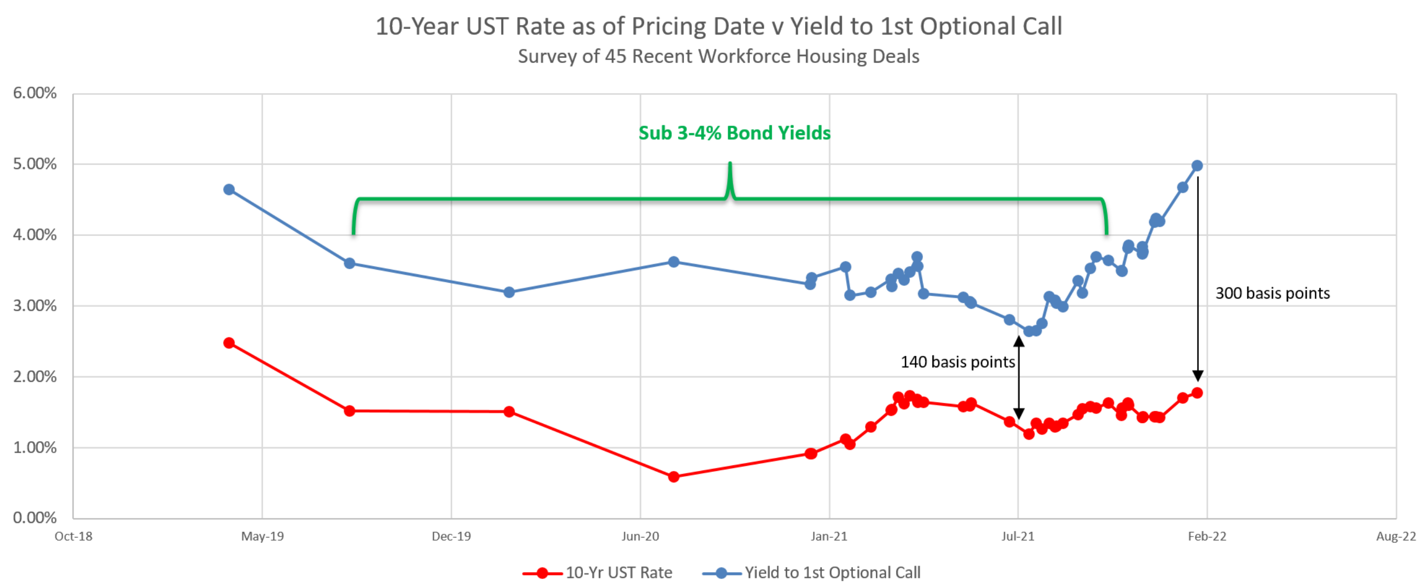
  + Underwriter fee equal to 1% or more – typical for unrated high yield non-credit enhanced bonds.

Tax Exempt “Essential Function” and “Section 501(c)(3)” Bonds for Workforce Housing – Contd. Remarkable Growth in Volume

- Over the **past 2.5 years**, there have been **over $8.0 Billion** of these **bonds issued by California Joint Powers Authorities (“JPAs”)** in **over 45 financings** to create **almost 14,000 units** of **publicly owned** affordable workforce housing. **Almost $7.0 billion** of these bonds were issued **in 2021 alone**. **Our firm has been heavily involved in about $1.5 Billion of these financings with four major underwriter clients**.
- Think about that for a moment. This **new category comprising $7.0 Billion in 2021 of** JPA workforce housing bond volume **compares to $3.5 Billion of tax-exempt private activity bonds issued each of the past two years** for multifamily in California or about **30% of the private activity bonds issued for the entire United States** for multifamily housing in 2021.
- There is no question that this constitutes a **vitally important new major tax-exempt multifamily bond sector**.
- This has allowed cities and counties to **provide affordable workforce housing for families with incomes above 60% of AMI for the first time in decades**.

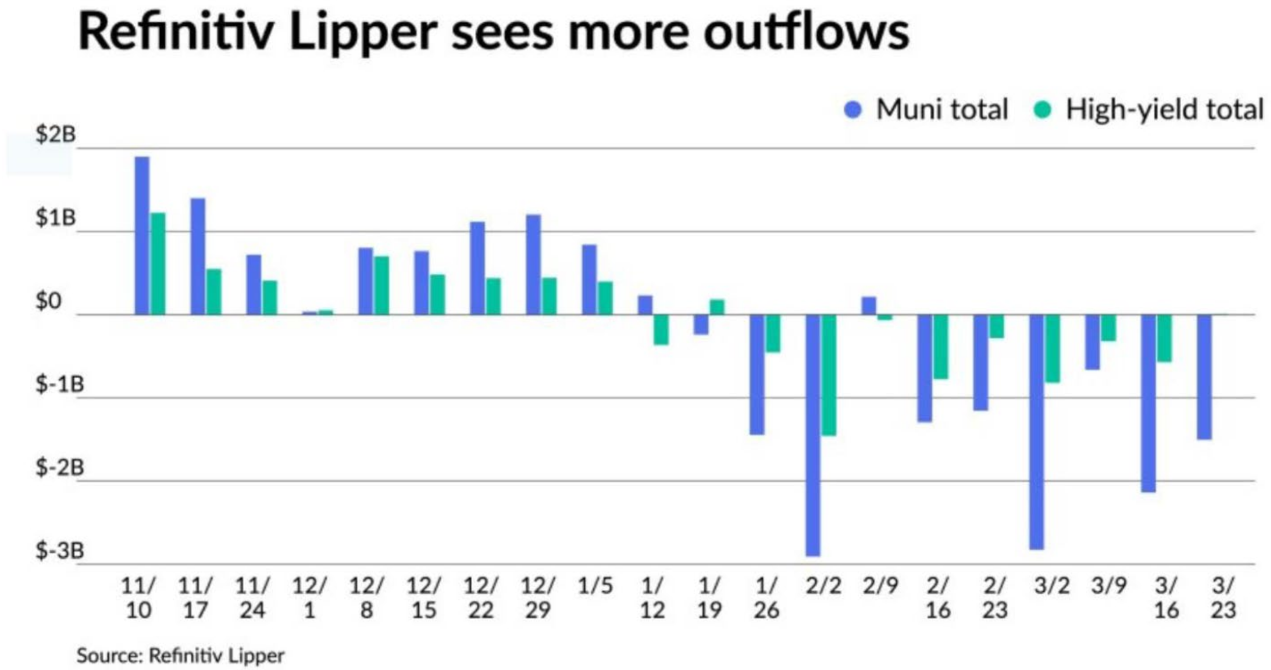
Tax Exempt “Essential Function” and “Section 501(c)(3)” Bonds for Workforce Housing – Contd.
Interest Rates and Spreads

- The chart below plots the weighted average yield of these issues (almost all of them to date) against the 10-year U.S. Treasury bond rate.
- During the **summer of 2021**, these **unrated high yield tax-exempt bonds** were trading at **yields of around 3.0%**, or only about 140 basis points above the 10-year U.S. Treasury yield.
- When you can **buy a project at a cap rate of around 4.0%** or higher and **finance it at a 3% yield**, everything works!
- We will look back on this as the **golden age of affordable workforce housing financing** in California.
- **In 2021, the spread** on these bonds to 10-year Treasuries **began to widen** with increasing inflation fears and greater prospects of Fed balance sheet deleveraging, and general concerns about federal reserve discount rate increases.
- However, **most financings worked well with some adjustments** through the end of 2021.



The January 2022 COLD SNAP!!!

- In the **last two weeks of January 2022**, the spread of these tax-exempt high yield bonds to U.S. Treasuries widened – it **soared to over 300 basis points,** versus 140 last summer.
- **Why have these spreads widened so dramatically?**
- The **January announcement of multiple** (by some estimates up to 7 or more) **discount rate increases in 2022** have created turmoil in the high yield debt markets. Rapid increases in rates always "freeze" the long term debt buy-side, as buyers are reluctant to deploy funds only to see the value of the holdings decline substantially right after the closing.
- **Since late January the strong muni bond fund inflows** for 2020 and 2021 (shown in the chart on slide 5) **have been replaced by substantial outflows.**



WHERE DO HIGH YIELD WORKFORCE HOUSING BOND FINANCINGS GO FROM HERE?

- **In periods of very low rates and low volatility, as we had last summer, high yield spreads** to Aa or Aaa paper **always compresses**, and **then widen again when rates and volatility increase. This is exactly what we have seen over the past two months.**
- Will we see yields on these bonds around 3.0% in 2022? We doubt it. The **10-year U.S. Treasury rate has risen almost 100 basis points from around 1.50% to 2.50% since the first of the year.**
- **If high yield tax-exempt rates were around 4.0% in early January, then this increase alone would suggest a yield of 5.0% today.**
- **Widening spreads could suggest that tax-exempt high yield rates** may have risen further.
- Goldman Sachs priced an issue on March 8 at a yield of about 4.90% where the 10-year U.S. Treasury yielded about 1.90%, or 20 basis lower than today.
- **For the moment** we think yields on these bonds may be perhaps **5.25% to 5.50%**.

WHERE DO HIGH YIELD WORKFORCE HOUSING BOND FINANCINGS GO FROM HERE?

- As a result, **few of these deals work in the current market without some adjustments.**
- However, **financing structures are already being adjusted** to reflect these market developments.
  - Financing conditions were so favorable in 2021, **there was room for financing and other costs to be lowered** substantially. This **has been a major criticism** of these financings in California.
  - Since rates began to move up last fall, **fees and costs have already begun to be lowered** to offset the impact of higher rates and in part in response to these criticisms.
  - Underwriters are also beginning to look at **various ways to vary the debt structure to lower rates** and create **different incentives** for financing participants.
  - The underwriter community is also beginning to **focus sales efforts on banks, insurance companies and municipal bond buyers other than tax-exempt bond funds who have been attracted to these issues by the higher yields.**

WHERE DO HIGH YIELD WORKFORCE HOUSING BOND FINANCINGS GO FROM HERE?

- It is also important to remember, the **2021 volume** of these financings in California volume **was huge**. Even if it fell to one fourth or one half in 2022, it would represent **$2-3 billion** of affordable multifamily workforce rental housing.
- In addition, this major new financing structure is **now becoming available for** workforce housing financings **in others states**.
- In December, we **closed the first** financing using this structure **in Texas** and we **closed the second Texas financing in mid-February.** We believe Texas may be even a stronger market for these financings than California, and that some financings may work in that market, as well as California, even at today's interest rates.
- We are **also beginning to look at similar financings in several other states.**
- **Finally, a return of municipal bond inflows could occur** to the extent headlines of Fed rate increases, Fed deleveraging and elevated inflation levels begin to abate and/or if the situation in Europe improves. If and when these types of developments occur, one would expect lower tax-exempt rates to emerge and result in a possibly substantial increase in the flow of deals.

Conclusion

- The bottom line? For the two years ending in late January, **there were very strong underlying forces which substantially increased the demand for tax-exempt municipal debt and dramatically lower tax-exempt versus taxable rates,** and which enabled the creation of this new major tax-exempt bond-financed category of affordable workforce housing**.**
- **We believe there is a good chance these forces will return to some degree in 2022** to support a strong demand for tax-exempt debt, including tax-exempt bonds for affordable workforce housing**.**
- As a result, **we believe that even if interest rates in general continue to rise a bit further in 2022, this is a major new category of tax-exempt multifamily housing bond finance which is not going to disappear, and that these new workforce multifamily rental workforce housing bond financings will continue to see a substantial level of volume in a number of states in 2022.**

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R. Wade Norris, a partner at Norris George & Ostrow PLLC and is widely recognized as one of the country's leading experts in the field of multifamily housing bond finance. Since 1977, Mr. Norris has been involved in over 3,000 tax exempt multifamily housing bond and loan financings totaling billions of dollars in every state in the United States, primarily as underwriter's counsel or tax exempt debt counsel to banks and other private placement purchasers of tax exempt debt. Mr. Norris played a major role in the design and development of the country's leading bank private placement program, tax exempt short term cash backed bonds used with low rate taxable FHA insured and USDA rural development loans, the Freddie Mac TEL structure, the Fannie Mae M.TEBs structure, and, more recently, the use of tax exempt high yield bonds to create affordable workforce housing for both public and Section 501c3 borrowers.

Mr. Norris has been a frequent speaker panel moderator or speaker member on multifamily housing bond finance over the past 40 years, now speaking at over a dozen industry housing conferences each year. Mr. Norris' paper entitled "Introduction to Tax-Exempt Multifamily Housing Bonds" is widely regarded as one of the industry's leading introductory articles on tax-exempt multifamily housing bond finance, and Mr. Norris regularly authors a number of other papers on various aspects of tax-exempt multifamily housing bond finance, which are available on the firm's website: www.ngomunis.com.

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Ethan Ostrow is a founding partner of Norris George & Ostrow PLLC. Prior to founding Norris George & Ostrow PLLC and continuing to the present, Mr. Ostrow has served as underwriter's counsel, purchaser's counsel and issuer's counsel in a range of tax-exempt and taxable affordable multifamily housing bond and loan transactions, including public offerings and private placements of rated as well as unrated bonds. These financings have involved loans and mortgage-backed securities backed by FHA, USDA Rural Development, Ginnie Mae (GNMA), Fannie Mae, Freddie Mac and other credit providers.

Mr. Ostrow is a leading underwriter's counsel on financings that use short-term cash-backed tax-exempt bonds to provide 4% low income housing tax credits on projects using low-rate taxable FHA, USDA Rural Development and other taxable loans in the current interest rate environment. He also worked with Fannie Mae and its counsel and other parties in developing the structure and documentation for the Fannie M.TEBs tax-exempt bond product, and served as underwriter's counsel in the first transaction for a project in Chicago called Fullerton Court Apartments, which closed in January 2015, and in more than 60 such financings closed over the ensuing seven years and counting.

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