TAX-EXEMPT ESSENTIAL FUNCTION BONDS PROVIDING 100% FINANCING FOR PUBLICLY OWNED AFFORDABLE WORKFORCE HOUSING QUICK SUMMARY *

April 25, 2023

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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.

A Major New Category of Tax-Exempt Multifamily Housing Bond Finance: Tax-Exempt "Essential Function" Bonds for Workforce Housing

- New structure – Issuance of **unrated, non-credit enhanced tax-exempt "essential function" bonds** under Section 103 of the Code for governmental owners to **provide 100% financing** for **converting** relatively new, stabilized, **privately owned apartment projects to 100% public governmental ownership**.*

- The tax-exempt bond **proceeds cover** (i) the **project purchase price**, (ii) the **funding of substantial reserves** and (iii) **costs of issuance and underwriting discount**.

- **<u>No</u> equity contribution is required**.

- **Bonds are non-recourse to the Issuer and the Governmental Owner**; solely secured by and repayable from Project and Project revenues.

- **Requires no allocation of increasingly scarce private activity bond volume!!!**

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* Tax-exempt bonds using this model can also be issued under Section 145 of the Code for certain Section 501(c)(3) borrowers.

How It Works

Public Benefits and Costs

- Projects moved to public (or Section 501c3) ownership creating real estate tax relief.
- Freed up cash flow used to make units affordable to tenants usually in the 80% to 120% or 140% of AMI levels.*
- **Benefits:**
  - **Lower rents than market to tenants** in lower part of 80% - 120% of AMI range, increasing differential over time.
  - **Public body owner gets 100% of appreciation** in value of project, with **no equity contribution**; **100% public ownership from day one**.
- Costs: Real estate taxes foregone.
- Our analyses suggest **benefits outweigh costs by 4 or 5 : 1** or more in many financings.

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* Federal tax law requires no AMI limits for publicly owned projects, but state laws may impose limits to achieve real estate tax relief. In California, no such limits. In Texas, generally at least 50% of units ≤ 80% AMI; 40% ≤ 120%

Two Main Drivers

1. Extremely Low Interest Rates 2019 – 2021
   - Unrated high yield bond yields as low as 3.0 % in July 2021
2. More Generous Underwriting Assumptions by Tax-Exempt Bond Fund Buyers
   - “Turbo” soft principal amortization.
   - Assumed 3%/year growth in rents and expenses
   - Both discussed below

Volume – 2019 to Early 2022 – The Golden Age

- From 2019 – early 2022, **over $8.0 Billion** of these **bonds were issued by California Joint Powers Authorities (“JPAs”)** in **over 45 financings** to create **almost 14,000 units** of **publicly owned** affordable workforce housing.
- **Concept introduced in Texas late 2021. Three closings through early 2022**.
- This has allowed cities and counties to **provide affordable workforce housing for teachers, first responders and other middle-income families with incomes above 60% of AMI for the first time in decades**.

2022 Interest Rate Run-Up: The Big Freeze

- Yields on high yield bonds soared to over 6.5% in 2022; now just a bit lower.
- Deal flow has almost disappeared in California, where real estate tax rates are about 1.10 – 1.2% per year and cap rates on project sales have not significantly declined.
- In Texas, which has no state income tax and thus real estate tax rates may be 2.0% per year or higher, some financings still work. We closed two more financings in December 2022, and four or five more financings are currently being pursued.

Role of the Project Administrator

The Project Administrator is a **real estate development firm**.

- Locates project.
- Negotiates the Purchase-Sale Agreement with the Project seller.
- Goes at risk on a 1.0% to 1.5% deposit.
- Works with underwriter to develop feasible financing structure in light of the purchase price.
- Engages and pays for all third party reports.

- Helps negotiate terms with the JPA and the City or the Housing Finance Corp or other governmental issuer/owner – typical development type functions.
- Loses deposit and upfront costs if bond issue and sale of Project fails to close on time, often just 60-90 days.
- Receives (1) up-front cash fee of 1%-2% or more of Project purchase price (depending in part on deal size); (ii) subordinate tax-exempt bonds with yield of 7-10% equal to 5% or 6% of Project purchase price as part of front-end compensation and (iii) is paid ongoing Project Administrator fee of 10-12 basis points or so for ongoing asset management services.

Two Main Drivers: Where Are We Now?

1. **Record low interest rates: GONE**.

2. **Acceptance by the Muni Bond Funds of** a (i) **“Turbo” Soft Principal Amortization Structure** and (ii) **3% Assumed Rent/Expense Growth** for Projects in High Growth Markets: **STILL HERE!**

    - New **“turbo” soft principal amortization structure**. **Requires repayment of principal in any six-month period only from any cash available, after payment of operating expenses and interest on the Bonds**. If there is no cash for principal amortization in any six-month period, it is simply deferred to a later period – there is no default. **This allows more effective securitization of cash flows and substantially lowers default risk.**

- **Underwriting assumptions which assume 3% annual rent and expense growth** in high growth markets, versus 0-2% in most loan underwritings – **raises proceeds 35 – 60%.**
- For projects in high growth states like California, Texas and Florida, the bond fund buyers continue to **accept these assumptions, in light of 5-10% rent growth or higher in recent years.**
- This is a **major reason why we can provide 100% financing and 100% public ownership** from the tax-exempt debt issue for these projects **with no requirement of an equity contribution** by the governmental (or Section 501(c)(3)) borrower or any other party.

Future Prospects

- As the above discussion makes clear, one of the major factors which drove the incredible volume of these financings in 2019-2021 – record low tax-exempt rates – has now suffered a major reversal.

- **However, the other two positive factors described above** – acceptance by the muni bond fund buy side of **the "turbo" soft principal amortization structure and** the related **3%/3% growth assumption** in high growth markets – **which produces significantly greater loan proceeds – remains intact**.

- This factor **has enabled us to provide 100% financing** for some of these Projects, **even though bond yields now exceed conventional cap rates** for these projects in this high interest rate market.

- These financings **still work in states with high real estate tax rates**, and potentially **other states like Florida, Colorado and others where state or local subsidies for affordable workforce housing may be available**.

- We have been involved in over a dozen of these financings in California and Texas with five major underwriter clients aggregating well over $1.0 billion. **We would welcome inquiries from interested parties to set up a call to discuss this exciting major new affordable workforce housing structure.**

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