TAX-EXEMPT SHORT-TERM CASH BACKED BONDS CONVERTING TO TAX-EXEMPT LOAN – A PRODUCT WHOSE TIME IS NOW!

Quick Summary

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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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Background

- **Since 2008 Tax-Exempt Short-Term Cash Backed Bonds ("Cash Backed Bonds") have been widely used to satisfy the 50% Test** under Section 42 of the Code to prime 4% LIHTC on projects where a lower loan rate can be achieved through a taxable loan execution – *e.g.*, FHA insured and USDA guaranteed rural development ("RD") loans.

- About four years ago, a structure emerged that **combined the use of Cash Backed Bonds** (and a taxable draw-down bank loan) to fund construction or rehabilitation **with a forward commitment** from a permanent lender (*e.g.*, Freddie Mac or a bank) **to fund a permanent tax-exempt loan** at stabilization (often referred to as "Conversion").

- We refer to this as the **"Cash Backed Bond to Tax-Exempt Loan" structure**.

- **When Cash Backed Bond coupons** and other short-term rates **were around 1%** and involved negative or little positive arbitrage, **the cost** of **adding a taxable draw-down construction loan and Cash Backed Bonds** to what could otherwise be a simple tax-exempt draw-down loan **often outweighed the benefits** of this structure.

- **A possible exception: A developer's bank desires to be both the construction lender and also the 4% LIHTC investor where the Issuer charges more than 1/8 of 1% (or 12.5 "basis points") per year in upfront and ongoing fees.**
  - In this case, the Borrower cannot represent and covenant that "No person related to the borrower will have an arrangement to acquire tax-exempt debt in an amount related to the amount of the tax-exempt loan," which is necessary to use the alternative "150 basis points" limitation on allowable issuer and other fees.
  - Where Issuer fees exceed 12.5 basis points per year and the bank is simultaneously on the tax-exempt loan and 4% LIHTC sides of the deal, this alternative test would not be available and, **the tax-exempt debt would be treatable as a taxable "arbitrage"** bond which would render the financing infeasible.
  - The **use of the Cash Backed Bond to Tax-Exempt Loan Structure avoids this problem**, and thus has been used for this purpose, but historically at a somewhat elevated cost.

What Has Changed?

- The **U.S. Treasury yield curve is now higher and quite inverted**.
- Short term cash backed **bond yields are now MUCH HIGHER: 3.5% or so, versus 1% or lower.**
- This difference **makes this structure VERY attractive** at this time.
- As is explained below, **adding Cash Back Bonds to the pre-Conversion phase of a “forwards” tax exempt permanent loan structure can, on some financings, produce extra financing proceeds equal to 2.5% to 4.0% or more of total development cost (“TDC”) in the current interest rate environment.**

How It Works

- Assume we have a large new construction project. We will probably set, say, a 4-year maturity and **sell the bonds to a 3-year mandatory tender date** – **current coupon about 3.40%.**
- **We will generally reserve the right to trigger the mandatory tender earlier** (say month 24 or after), if the conditions to Conversion to stabilized occupancy have been satisfied and the U.S. Treasury escrow can be liquidated at par or any loss on liquidation is made up with a deposit of bankruptcy remote funds.
- **At Conversion** the **purchase price of the Cash Backed Bonds paid to Bondholders on the mandatory tender is paid from the proceeds of the U.S. Treasury securities** in the escrow securing those Bonds.

- Typically, a **portion of the tax-exempt debt will be paid down at Conversion from fixed tax credit equity installments** and other permanent funding sources. These funds are **used to pay off a corresponding portion of the taxable bank draw down loan**, and that portion of the tax-exempt debt is retired.
- The **balance of the tax-exempt debt will remain outstanding** at Conversion and the **terms of the tax-exempt debt from that point forward will be governed by the escrowed permanent tax-exempt loan documents**.
- That **permanent portion of the tax-exempt loan will then be delivered to the permanent lender** against payment, the **proceeds** of which are **used to retire the balance of the taxable bank construction loan** which funded the construction or acquisition and rehabilitation of the Project.

A SMALL POTENTIAL BENEFIT: POSSIBLY RETAINING NET POSITIVE ARBITRAGE

- At the current time, the **3-year U.S. Treasury securities in our escrow will yield about 3.70%**. This represents about **30 basis points per year of positive arbitrage**, or about **1.0% of our Bond issue** over 3 years (more than 2.0% on some recent issues).
- If this positive arbitrage can be retained (see below), it **can offset or today slightly more than offset the cost of adding the Cash Backed Bonds**.
- **Most bond counsel firms** will be comfortable that **if all the terms of the tax-exempt permanent loan are set at initial closing, there will be no "reissuance" of the debt at Conversion to the permanent tax-exempt loan phase**.

- **We believe most bond counsel firms** will compute the yield on the single tax-exempt issue to be a blend of the Cash Backed Bond yield of, say, **3.40%** for 3 years **and** the permanent loan yield of, say, **6.0%**, or an **overall yield which in all likelihood will exceed the estimated 3.70% yield on our investments**.*
- We believe most bond counsel firms who are comfortable with a “no reissuance at Conversion” concept will also treat this blended yield as the Bond yield for all purposes and **allow the Borrower to retain most or all of any positive arbitrage in the financing**.**
- The net benefit may be **0.5% to 1.0% of Total Development Cost (“TDC”)** on some financings.

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* The computation of Bond yield on these issues is very complex and we believe poorly understood. We are glad to walk through this with interested parties.

* *A minority of firms may conclude that, even though they are comfortable with a “no reissuance at Conversion” conclusion, any positive arbitrage, taking into account only the yield on the Cash Backed Bonds and not the permanent tax exempt loan yield, must be rebated to the U.S. Treasury or a yield reduction payment must be made.

THE MAJOR BENEFIT: SUBSTANTIAL ENHANCEMENT OF TAX CREDIT BASIS AND TAX CREDIT SYNDICATION PROCEEDS

- On a new construction or substantial rehabilitation project, the **Borrower may realize substantial benefit from having two sets of construction period interest**: (i) that on the **taxable draw-down bank construction loan and** (ii) that on the **fully funded Cash Backed Bonds**, in each case accruing before the certificate of occupancy is obtained or rehab is complete.

Summary of Potential Benefits from Additional Basis
(as % of TDC)

Calculation of Additional Basis from Cash Backed Bonds

		% of TDC
Extra Cons Period Interest	2.5 yrs X 3.4% X 50%*	4.25%
Project in QCT or DDA:	X 1.3	5.50%
If state tax credits available:		6-8%

* Assuming our bond issue is approximately 50% of TDC

Adjustment for Section 266 Election

- In today's market, **most borrowers will elect to capitalize interest under Section 266 of the Code** to support including it in basis and will allocate to one or more constituent entities in the borrower *responsibility to pay federal income tax on the interest earnings in the escrow*. Creative approaches to this on the front end of the financing, which we can discuss, can minimize any adverse impact of this to a point or less of TDC.

  Negative effect probably about 1% of TDC deduction

	% of TDC
Adjusted additional basis per above: minus 1% of TDC	5-7%

Translation of Additional Basis to Additional Tax Credit Proceeds

- Assume the Tax Credits sell for up front proceeds equal to, say 40% of the additional eligible basis:

Cash Benefit to Borrower: 40% of 5-7% of TDC =	2.0-3.0% of TDC

- Note that this benefit is independent of the potential benefits from retaining positive arbitrage, if available.

Add Back: Possible Retention of Net Positive Arbitrage	0.5-1.0%
Total Potential Benefits to Borrower	**2.5%-4.0% of TDC**

CONCLUSION

- Note: **We expect the benefit of this structure to decline from current levels if interest** rates fall further and **the inversion in the yield curve attenuates or disappears**. This could occur very quickly.
- However, **for now, these benefits continue to be quite substantial**, and **many developers** and their tax credit investors **are using this structure to close significant financing gaps on their deals**.
- As with many structures involving tax-exempt debt and tax credits, **even the most highly regarded** law firms, accounting firms, and other **experts involved in these financings may draw different conclusions** about certain aspects.
- A **key** is for borrowers and their tax credit limited partners contemplating the use of this structure in the current environment to **discuss the proposed financing plans with the Issuer and Bond Counsel at the outset** of the proposed financing.
- **We are also glad to set up calls** to discuss all aspects of this structure and to **assist Borrowers in assessing the potential benefits** of adding cash backed bonds to the pre-Conversion phase of these financings in the current environment.

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