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

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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 and reflect a generalization of interest rate levels over the past several months. Short-term tax-exempt and taxable rates have recently been extremely volatile.** The calculation of the benefits and costs of using this and any other structure based on short-term rates can therefore **vary significantly from week to week**. Borrowers should check with their investment banker or financial advisor before conducting a detailed assessment of any of this and other structures dependent upon short-term rates.

THE OPPORTUNITY

- Over the past year, both taxable and tax-exempt **yield curves have risen several hundred basis points or more** and are **severely inverted**.
- Short term cash backed **bond yields are now MUCH HIGHER: very generally 4.2% or a bit higher in recent months, versus 1% or lower as recently as late 2021.**
- This has created a **unique, substantial opportunity**.
- **Adding Tax-Exempt Short-Term Cash Backed Bonds ("Cash Backed Bonds") to the pre-Conversion phase of a "forwards" tax-exempt permanent loan structure from a bank, Freddie Mac or another permanent lender can produce extra financing proceeds up to 3.0% to 3.5% of Total Development Cost ("TDC")!!!**

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BACKGROUND

- **Since 2008 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 Cash Backed Bonds and a taxable draw-down construction loan** to what would otherwise be a simple tax-exempt draw-down loan **often outweighed the benefits** of this structure.

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- A **possible exception** to this has been a fact pattern where a **developer's bank desires to be both the construction lender and also the 4% LIHTC investor** on the equity side under circumstances **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 is one of several approaches which can be used to avoid this problem**, and thus the structure has been used for this purpose, but historically at a somewhat elevated cost without substantial additional benefit.

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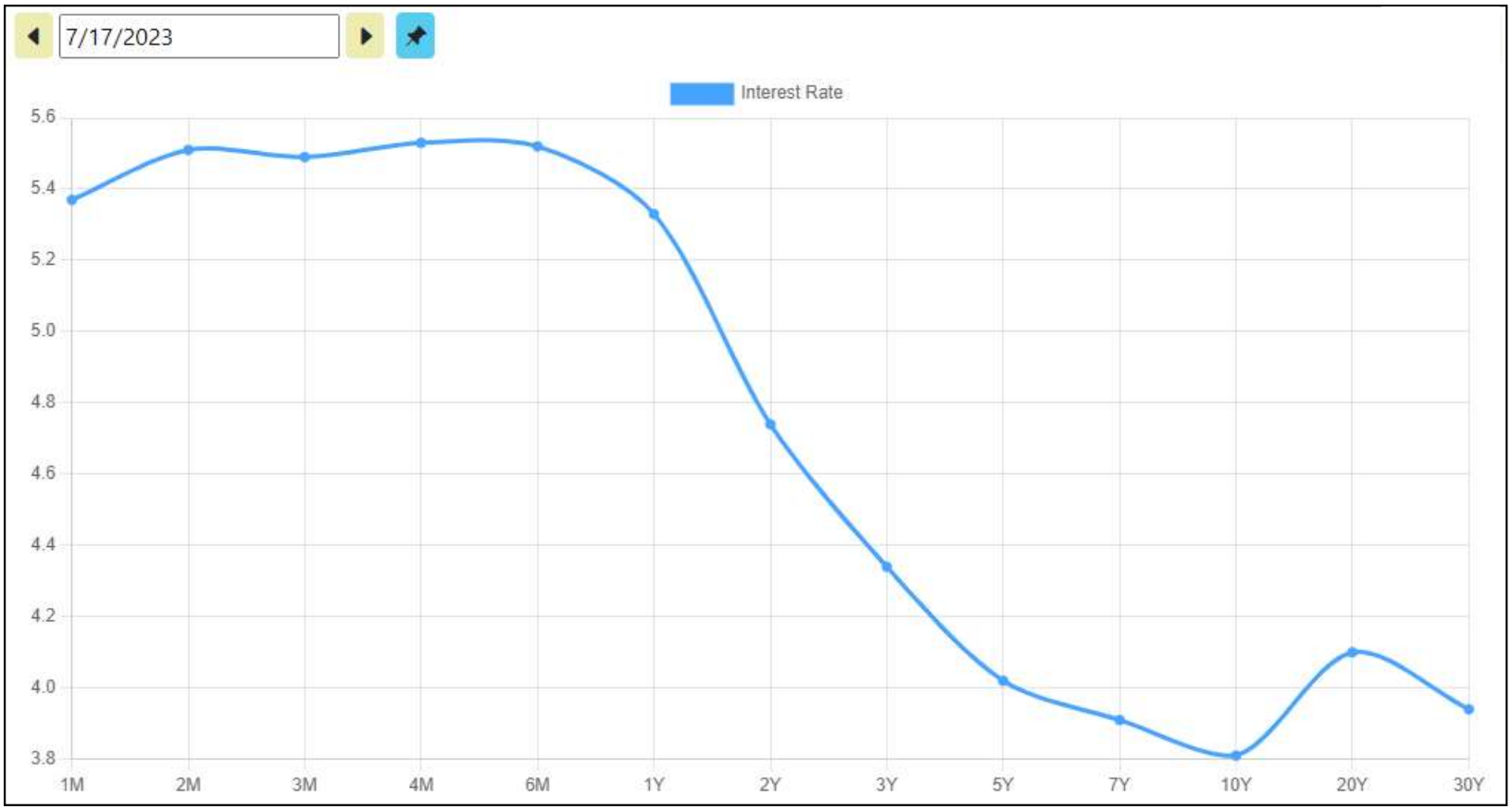
- As we are all now painfully aware, **interest rates in general have more than doubled** over the past year.
- Moreover, **short-term rates have gone up even more than long-term rates** – and the **U.S. Treasury yield curve is now quite inverted**, as is the yield curve for short-term Cash Backed Bonds.

U.S Treasury Yield Curve



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QUESTION: "WHAT DOES THIS MEAN FOR CASH BACKED BONDS?"

ANSWER: "A LOT!!!"

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 – recent current coupon about 4.20%** (not 1.0% or so less than two years ago).
- **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.

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- 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.

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Potential Benefits – Assumptions

The following example will help us assess the potential benefits of the structure based on a generalization of market conditions which have prevailed the last several months:

- Let's assume a $60.0 Million Total Development Cost ("TDC") New Construction Project.
- 2.5-year construction period; 3.0 years to stabilization / "Conversion."
- We will issue $32 Million of 4.2% Short-Term Cash Backed Bonds (53% of TDC).
    - (4-year maturity; sold to 3-year mandatory tender),
- Assume a 4.60% interest rate on 3-year U.S. Treasury escrow investments.
- Assume a 6.0% permanent interest rate on the forward bank, Freddie Mac TEL or other permanent tax-exempt loan.

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

- On a new construction or substantial rehabilitation project, the **Borrower can 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.

- If our construction period is 2.5 years on our large new construction project, and our Cash Backed Bond coupon is 4.20%, this **increases 4% LIHTC basis by** 2.5 X 4.2% or an amount equal to 10.5% of our Bond issue, as shown in the chart below.

- Of course, if the project is in a qualified census tract **("QCT")** or difficult to develop area **("DDA")**, one would multiply by 1.3, making this **increase in basis about 13.8% of the Bond amount.**

- **If the Project is eligible for state tax credits, this increase in tax credit proceeds may** be even larger – **as high as 15.7 to 17.7% of the bond amount.** If our Cash Backed Bonds are slightly over 50% of Total Development Cost, **this is 8.0-9.0% of TDC.**

Summary of Potential Additional Basis

Extra Cons Period Interest:	2.5 yrs X 4.2%	10.5% of Bond Amount
If Project in QCT or DDA:	Multiply by X 1.3	+ 3.2%
If state tax credits available, add another:		+ 2.0-4.0%
Total Gross Additional 4% LIHTC Basis		15.7-17.7% of Bond Amt, or **˜8.0-9.0% of TDC**

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- Now, let's assume our tax credits sell for 45% of our additional eligible basis.

Summary of Potential Additional Syndication Proceeds

Additional Syndication Proceeds to Borrower: 45%* of 8.0-9.0% of TDC	**3.6-4.0% of TDC**

- In our next step, let's adjust for certain costs which may be associated with the structure versus a simple tax-exempt drawn-down private placement bond or loan execution.
    - From our additional gross syndication proceeds it is reasonable to deduct the cost of issuance of the Cash Backed Bonds (perhaps 1.0% of the bond amount or 0.5% of TDC). In addition, 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.
    - Finally, there may be some incremental costs of the construction loan interest being taxable rather than tax-exempt, but a bank acquiring the 4% LIHTC (if that's the fact pattern) would be a related person, and thus construction loan interest would be taxable to it in any event.

* If Bonds slightly > 50% of TDC.

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- Let's assume these costs are 1% of TDC, so we will reduce our projected additional syndication proceeds by this amount as shown in the chart below.
- **Note that this may be conservative. Any costs associated with these items may be more than offset by better pricing offered to the borrower on the equity and the construction loan side of the financing as a result of the same bank being able to participate in both of these financing components.**

Less: COI on Cash Backed Bonds, Additional Interest from **Taxable** Construction Loan, and Payment of federal income tax on escrow earnings under Section 266 election	1.0% of TDC
Total Potential Net Benefits to Borrower From Additional Syndication Proceeds	**Roughly 2.5-3.0% of TDC**

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II. A SMALLER POTENTIAL ADDITIONAL BENEFIT: POSSIBLY RETAINING NET POSITIVE ARBITRAGE

- We have assumed, based on recent rates, that the **3-year U.S. Treasury securities in our escrow will yield about 4.60%**. In **some recent executions**, the amount of this positive arbitrage has been **as high as 111 basis points, which in our example would be 2-3 points on the Bond amount (1.0-1.5% of TDC), but this spread is very volatile and we believe 40 basis points or so is a better general representation of the recent past.** A 40 basis points spread in our example represents about **40 basis points per year of positive arbitrage**, or about **1.0% of our Bond issue** over 3 years.
- We believe that **most bond counsel firms** will now be comfortable that **if all the terms of the tax-exempt permanent loan are set at initial closing** (typically through a binding forward commitment and escrowed permanent loan documents), **there will be no "reissuance" of the debt which remains outstanding at Conversion to the permanent tax-exempt loan phase**.
- **We believe most bond counsel firms** who are comfortable with a "no reissuance at Conversion" concept will compute the yield on the single tax-exempt issue to be a **blend** of the Cash Backed Bond yield of, say, **4.20%** for 3 years **and** the permanent loan yield of, say, **6.0%**, for an **overall yield which in all likelihood will exceed the estimated 4.60% yield on our escrow investments and will allow the Borrower to retain most or all of the positive arbitrage in the financing.***

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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.

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- **What we believe may be a minority of firms** may conclude that, even though they are comfortable with a "no reissuance at Conversion" conclusion, they are not comfortable with the "blended yield" approach and may require that **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** on or before the date 60 days following the 5th anniversary of the original issuance.
- Of course, these are questions the developer should explore with Bond Counsel in advance.
- To summarize, **the potential benefit of retaining positive arbitrage may be** 1.0% to 2.0% of the Bond amount or perhaps **0.5% to 1.0% of Total Development Cost ("TDC") or a bit more.**

Potential Benefit of Retaining Positive Arbitrage

Positive Arbitrage:	**3.0 yrs X $32.0 Million Bonds X (4.60% - 4.20%) = $384,000**	**1.2% of Bond amount or 0.6% of TDC**

Total Potential Benefit of Structure

Cash Benefit to Borrower from Additional Syndication Proceeds Net of Costs	**2.5-3.0% of TDC**
Plus: Potential Retained Positive Arbitrage	**0.6% of TDC**
Total Potential Benefits to Borrower	**Roughly 3.0-3.5% of TDC**

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QUALIFYING COMMENTS

- Actual benefits in a given project financing can often be expected to be a somewhat lower percentage of total development cost than that shown above, but in some cases could be even a bit higher.

- Our assumptions assumed a large new construction project with a substantial construction period in a DDA or QCT with some state tax credits and a bond counsel firm comfortable with a “blended yield” approach, all of which increase the benefits of the structure.

- But even if benefits in a given case are somewhat lower, the net benefits in the current market can substantially improve the results for the developer and help close financing gaps.

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CONCLUSION

- Note: **The benefit of this structure is likely to decline from current levels if interest** rates decline from their current high levels 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 to **discuss the proposed financing plans with the Issuer and Bond Counsel at the outset** of the proposed financing.

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