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THE POSITIVE OUTLOOK FOR TAX-EXEMPT MULTIFAMILY HOUSING BOND FINANCING – POWERFUL UNDERLYING TRENDS AND A POTENTIAL NEW DAWN FOR THE GSEs*

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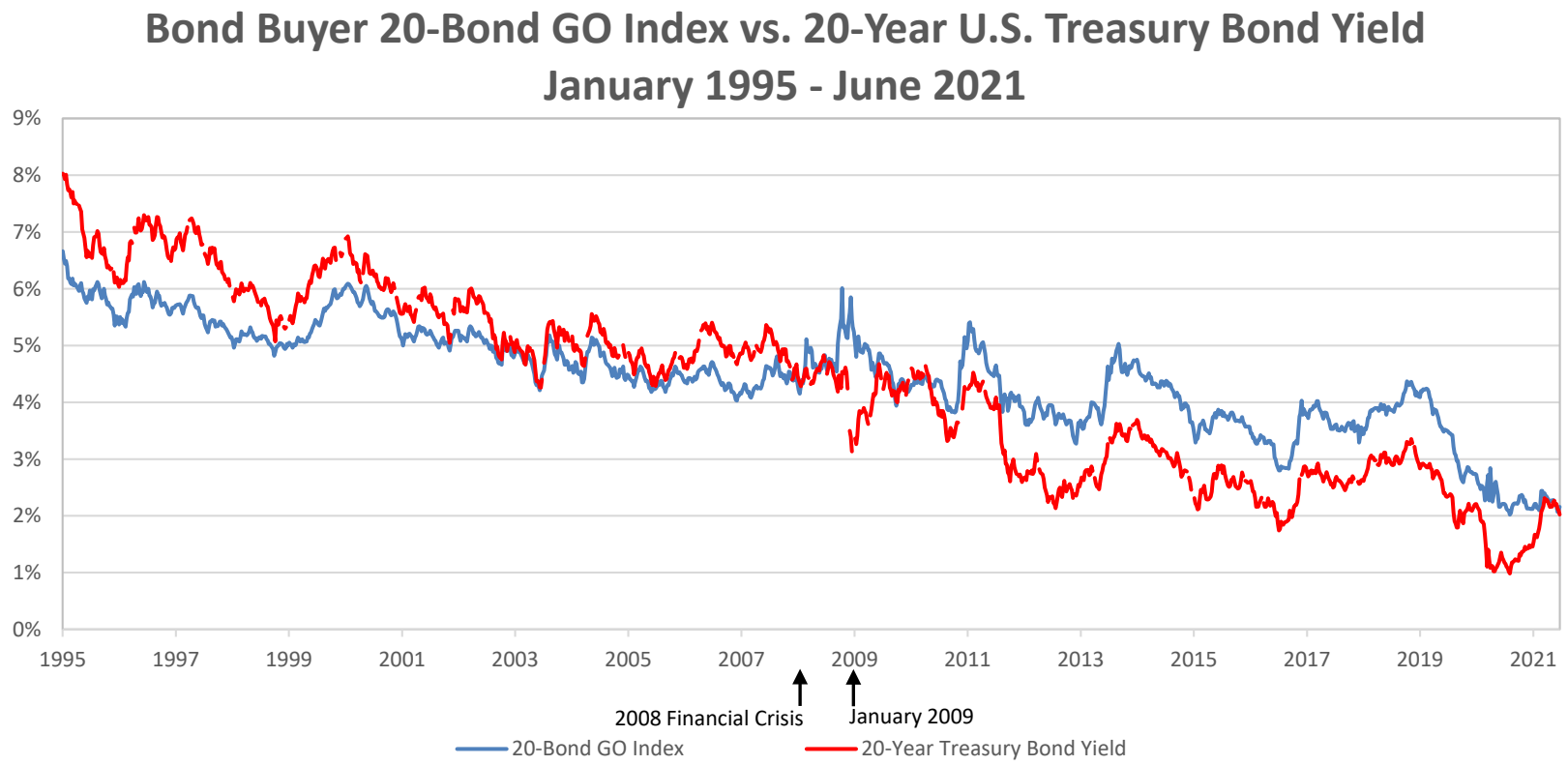
† **Cautionary Note**: The interest rates and other data set forth in this analysis are **estimates only**. **All markets today** – for bonds, tax credits, swaps, caps, investment agreements and other products – **are often thin and volatile**. These **interest rates, fees and other variables can vary 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.

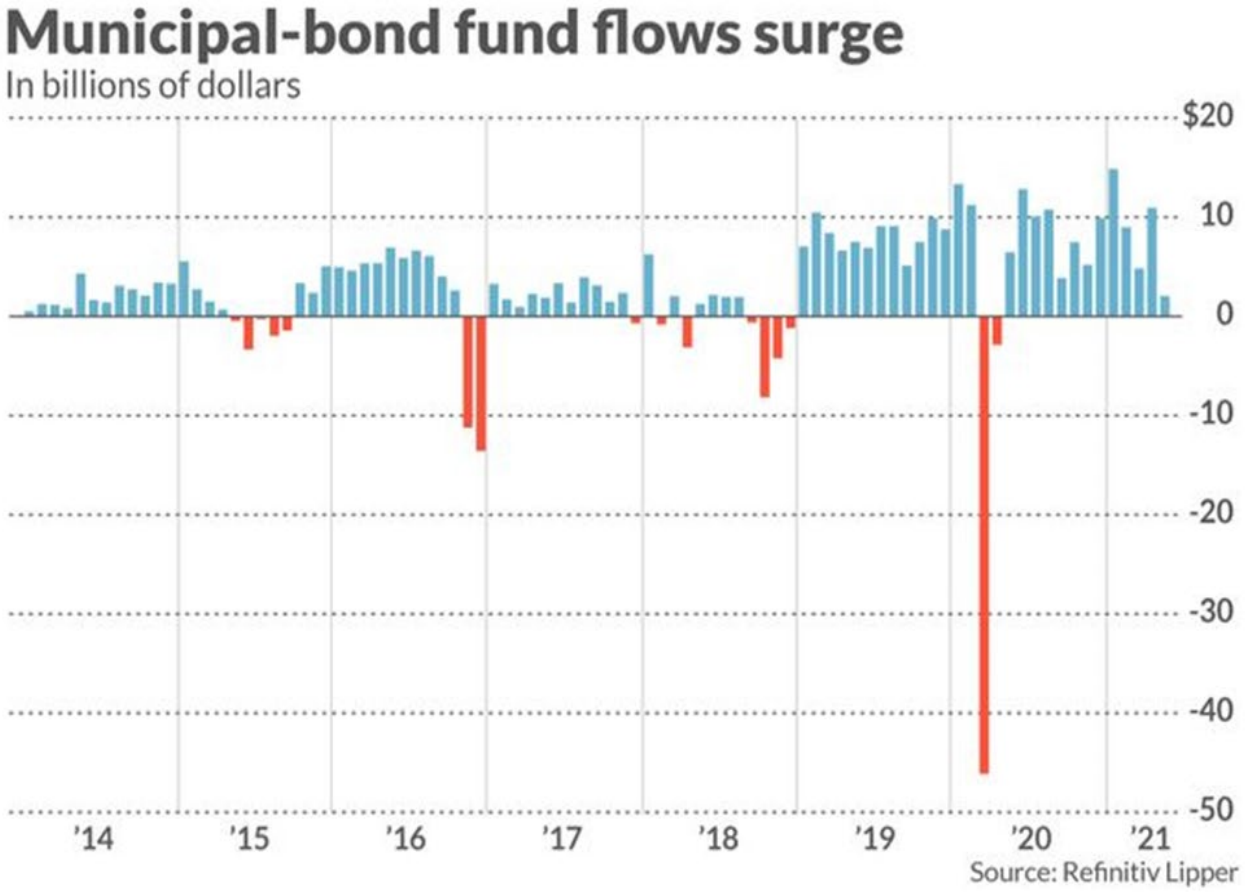
The Post-2008 World of "Upside-down" Interest Rates



- **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 financial crisis.
- **Over the past two years, a dramatically enhanced demand for tax-exempt municipal bonds.**
- This may be pushing us back in the direction of a "right-side up" interest rate world.
- The Bond Buyer 20-Bond GO Index **very recently** is about even with the 20-year U.S. Treasury rate.

Tax-Exempt Municipal Bond Fund[1] Inflows – A Recent Major Positive Underlying Trend

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



Andrea Riquier
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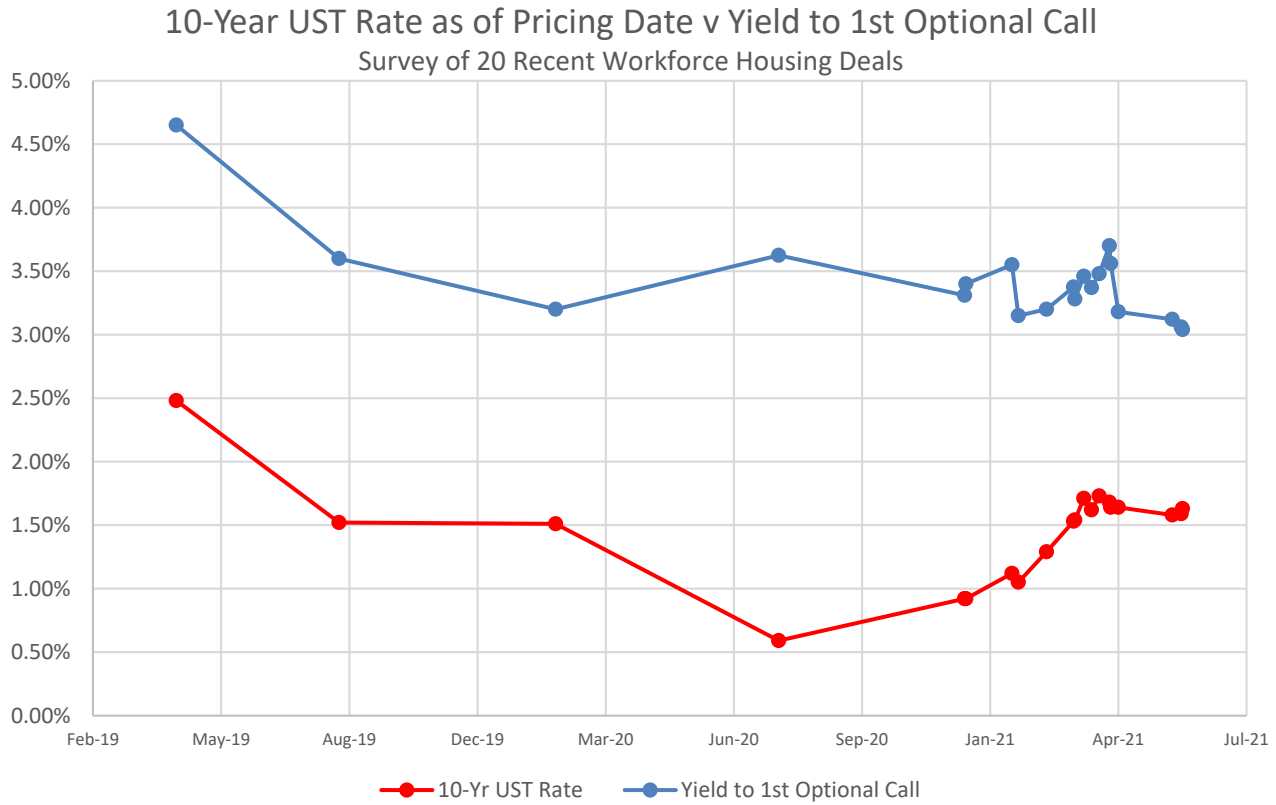
1 According to a recent SIFMA report, **municipal bond funds** held 27% of municipal bonds at the end of 2020; **Individuals 44.5%**; Banking Institutions 12.3%; Insurance Companies 12.3%; Other Holders 3.9%.

A Dramatic Demonstration of Very Low Muni Rates

- The following chart tracks the yields on large unrated bond issues sold by California Joint Powers Authorities ("JPAs") over the past two years to create affordable workforce housing. Our firm is heavily involved in these financings.
- The chart plots the weighted average yield of 20 of these issues (substantially all of them to date) against the 10-year U.S. Treasury rate. After starting out at spread above 200 basis points in December of 2020, the spreads have closed up to about 150 basis points in the more recent offerings – a 3.10% tax-exempt bond yield versus a 1.60% rate on the 10-year Treasury.



- **This is 100% financing** to create desperately needed affordable workforce housing in very high cost rental markets where many of these residents would otherwise have to live 20 or 30 or 50 miles or more away from their jobs.
- This incredibly strong tax-exempt bond market has enabled California to create over **$2.5 billion of such housing in the last two years alone**.

Recent All-In Borrowing Rates on Major Tax Exempt Debt 100% Affordable Housing Debt Executions

Bonds and Other Private Placements; Freddie Mac TEL Structure

- The following chart compares the permanent lending rates on about a dozen bank and other private placements in which our firm was involved in the October-November period last fall to a similar number which we just closed in May and June. While hardly a scientific sample, it suggests all-in permanent lending rates on those executions may be up about 90 basis points, or just a bit more than the 70 basis point increase in the 10-year U.S. Treasury Rate.

Estimated All-In Permanent Loan Rates*

	October - November 2020	May - June 2021	Difference
Approx. 10-Year U.S. Treasury Rate	0.80%**	1.50%***	0.70%
Bank & Other Private Placements	3.40%****	4.30%*****	0.90%

* The rates shown below are generally for "forwards" executions on strong projects pursued by experienced borrowers in key CRA or other strong markets. Rates for less experienced buyers on more challenging projects in other markets would generally be 50-75 or more basis points higher. **Also, it goes without saying that these are substantial generalizations. Rates and other terms can vary quite substantially from one financing to another, depending on the market, the project, the developer and other participants and a host of other factors.**

** Ranged from 0.68% to 0.90%

*** Ranged from 1.45% to 1.63%

**** Ranged from 3.20% to 3.60%

***** Ranged from 4.09% to 4.66%

Recent All-In Borrowing Rates on Major Tax Exempt Debt 100% Affordable Housing Debt Executions

Fannie Mae M.TEBs

- **Public offerings appear to have done even better**. For example, the spread to the 10-year U.S. Treasury on Fannie Mae M.TEBs bonds seems to have held firm at around 70 basis points (and sometimes lower) in most of the markets we have seen since last summer. Today, this produces very compelling all-in borrowing rates. Today, this all-in borrowing rate is approximately as follows:

10-Year U.S. Treasury Bond	1.50%
Spread	0.70%
	2.20%[3]
Guaranty/Servicing Fee	1.20% - 1.40%
	3.40% - 3.60%
Average	3.50%
Trade-off for Negative Arbitrage on "Forwards" M.TEBs	0.40%
	3.90%

- While this rate is lower than our 4.30% estimate on private placements, including Freddie TEL, it is important to remember that many private placements involve only one lender not two, as under the Fannie Mae Forwards M.TEBs structure, only one lender's counsel and also avoid the expenses associated with a public offering.

[3] It is important to remember that all-in borrowing rates on Fannie M.TEBs can also be lowered even further through:

- Discounts on Guaranty/Servicing for:
  - Healthy Housing Design: Up to 15 basis points.
  - Enhanced Resident Services: Up to 30 basis points.
- Green/Social/Sustainable Designation: Lowers coupon 5-10 basis points?

Recent All-In Borrowing Rates on Major Tax Exempt Debt 100% Affordable Housing Debt Executions

Short-Term Cash Backed Tax-Exempt Bonds

- This is still **the way** to satisfy the 50% Test on affordable 4% LIHTC projects using FHA-insured, rural development and other low rate taxable loans. The recent strength of the tax-exempt short-term bond market means that negative arbitrage has now, after about two years, once again all but disappeared on these executions:

2-Year Tax-Exempt Bond Coupon:	0.25%
2-Year U.S. Treasury Reinvestment Rate:	0.15%
Negative Arbitrage Per Year:	0.10%
x 2 Years =	0.20%
	(Only 20 basis points!)

- **Moreover,** the borrower gets back 40% of this very small negative arbitrage through additional 4% tax credit basis. **The result: Negative arbitrage ≈ 12 basis points, $16,666 on a $20 million bond deal. This is a rounding error!** The Borrower pays the bond costs of issuance and the 50% Test is satisfied.
- In these financings, the effective all in permanent lending rate to the borrower is established by the FHA or RD Lender's selling GNMA securities in the taxable GNMA markets. Recently, the all-in borrowing rates in these market executions have been very roughly 3.25% for new construction and moderate rehabilitation **40-year level amortization loans** (with no balloon) on 100% affordable rental housing – 4% LIHTC financings, and even lower at around 2.50% for moderate rehabilitation 35-year level amortization (with no balloon) loans.

Will This Surge in Demand for Tax-Exempt Bonds Continue?

- In a word, we believe it will continue. Indeed, we believe it will accelerate. As noted in footnote 4 above, at the end of 2020, according to the SIFMA data, 44.5% of the holders of municipal bonds were individuals and another 27% were investment industrial holders through mutual funds. That suggests that **individuals, the vast majority of whom are undoubtedly in the higher income brackets, directly or indirectly, comprise at least three quarters or more of the municipal market.**
- If even a portion of the Biden tax code revisions are adopted, there is little question that higher income taxpayers, i.e., municipal bondholders, will see their federal income tax rates increase. Among other things, the Biden plan would:

  1. **Increase the top ordinary income tax bracket** for taxpayers with income above $400,000 **from 37%** back **to 39.6%**.
  2. Cause **"carried interest"** of the general partners in private equity firms to be **taxed at ordinary income tax** rather than at capital gains **rates**.

Will This Surge in Demand for Tax-Exempt Bonds Continue?

3. Eliminate **most like kind real property exchanges under Section 1031** of the Code, which currently shelters many real estate capital gains.

4. **Raise the capital gains rate for tax payers with income over $1.0 million, from 24% to 44%, effective last April!**

- We believe there is a substantial likelihood that the Democrats will push very hard to implement at least some portion of this agenda before mid-term elections in 2022. If even only a compromised version of one or more of these proposals are adopted, **we believe this will further strengthen the already strong and growing demand we are now seeing for tax-exempt municipal bonds.**

A New Dawn for the GSEs?

- A startling, truly remarkable event occurred on June 23. The U.S. Supreme Court ruled that the President had the authority to immediately replace the head of the Federal Housing Financing Agency – the federal government's overseer of HUD, Fannie Mae and Freddie Mac. By the end of the day, the President had replaced Mark Calabria, a Trump appointee on record as a strong advocate of downsizing and ultimately privatizing the GSE's, with Sandra Thompson, who had been serving the FHFA's Deputy Director of the Division of Housing Mission and Goals and who is widely viewed as a strong affordable housing advocate.

- Think back to 2013. Barack Obama has been elected President in 2012, and he appointed Mel Watt to replace the head of FHFA, Edward DeMarco, a conservative republican, in 2013. What happened after that? We introduced the Freddie Mac TEL structure in 2014[4], and we then closed the first deal under the Fannie Mae M.TEBs structure in January of 2015[5]. Suddenly, if you worked for a GSE and you had a new idea which would support the production of affordable rental housing and which was financially sound for the federal government, the handcuffs were off!

- **We believe the recent replacement of Mark Calabria as the head of the FHFA with Sandra Thompson means that handcuffs reflected in the September 2019 FHFA Release on Fannie Mae and Freddie Mac's affordable housing lending operations may have once again come off or at least been substantially loosened. We can't wait to see the result!**

[4] Our NGO colleague, **Kim Griffith**, was Vice President of Affordable Sales and Investments in Freddie Mac's Multifamily Division from 2003 to 2015, and oversaw the development of the TEL Structure at Freddie Mac. **Wade Norris** and **Ryan George**, as **special outside counsel** to Freddie Mac, assisted in the drafting of program memoranda, model documents and other materials relating to the development and implementation of the Freddie Mac TEL structure.

[5] **Wade Norris** and **Ethan Ostrow**, together with their prior colleague, **Ad Eichner**, worked with Fannie Mae and other participants to develop the structure and documentation for the Fannie Mae M.TEBs product. This led to the closing of the first M.TEBs financing in February, 2015. Messrs. Norris and Ostrow then served as underwriter's counsel on the first seven M.TEBs financings which closed over the next two years, and NGO has served as underwriter's counsel on many subsequent M.TEB financings.

Conclusion

- The bottom line? **There are very strong underlying forces which have substantially increased the demand for tax-exempt municipal debt, especially over the past two years.**
- **We expect these forces to accelerate**, further increasing the demand for tax-exempt debt, **over the next two years.**
- **The recent replacement of Mark Calabria with Sandra Thompson as the Executive Director of the FHFA is another extremely important positive development** which we expect to support the vital role of Fannie Mae and Freddie Mac in affordable multifamily rental housing finance.
- As a result, **we believe that even if interest rates in general rise a bit further as 2021 unfolds,** the role these positive prospects for the tax-exempt debt side of these financings suggests that **the financial feasibility of these financings should be strong in the years immediately ahead.**

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