NORRIS GEORGE & OSTROW PLLC

SUMMARY OF BORROWING/ UNDERWRITING RATES
PRINCIPAL TAX EXEMPT DEBT PRODUCTS FOR 100% AFFORDABLE PROJECTS

	Estimated Actual All-In Borrowing and Perm Period Underwriting Rate		
	November 2021	Today	Approximate Increase (Basis Points)
1. Bank or Other Private Placement			
-Mod Rehab	**3.10% to 3.50%**	**4.50% to 4.85%**	**+138**
-Sub Rehab/New Cons			
Cons Period	**2.50% to 2.75% Floating**	**3.80% to 4.20% Floating***	**+138**
Perm Period	**3.50% to 4.10%**	**5.00% to 5.50%**	**+145**
2. Freddie Mac "TEL" Program (Mod Rehab, Sub Rehab, New Cons)	**Similar to Bank or Other Private Placements above**	**Similar to Bank or Other Private Placements above; perhaps a bit lower for mod rehab**	
3. Fannie Mae "M.TEBS" Structure	**3.30% to 3.50%****	**4.90% to 5.30%**	**+170**
4. Short-Term Cash Backed Tax Exempt Bonds with Taxable Loan Sale			
FHA §223f or RD Mod Rehab	**2.60%**	**4.25%**	**+165**
FHA §221(d)(4) or RD Sub Rehab / New Cons	**3.15%**	**4.80%**	**+165**

In November of 2021, the 10-year U.S. Treasury rate hovered around a 1.50% level, versus about 3.0% in recent weeks, or about 150 basis points higher. The all-in borrowing/underwriting rates all of the affordable executions have increased by similar amounts. In the case of Fannie Mae M.TEBs and FHA executions, they have increased a bit more, reflecting widening spreads, which could come back down a bit if the 10-year plateaus in the months ahead.

* 200 to 225 basis points over 30-day SOFR.

** The "Forwards" M.TEBs structure entails about 2 points of negative arbitrage, most of which is offset by higher 4% LIHTC Basis.

R. Wade Norris, Esq. wnorris@ngomunis.com (202) 973-0110 (d) (202) 744-1888 (c)

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

July 12, 2022

Presented by:

R. WADE NORRIS, ESQ.
NORRIS GEORGE & OSTROW PLLC
1627 Eye Street, N.W., Suite 1220
Washington, D.C. 20006
wnorris@ngomunis.com
(202) 973-0110 (O)
(202) 744-1888 (C)

---

* **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

- Over the past three years, **two major, remarkable industry developments** have enabled us, through the issuance of **unrated, non-credit enhanced tax-exempt "essential function" bonds*** under Section 103 of the Code, to **provide 100% financing** for **converting** relatively new, stabilized, **privately owned apartment projects to 100% public governmental ownership**.**

- **This is not 15% or 20% ownership** with a profit motivated equity partner; under this new structure **a joint powers authority, housing authority or other municipal entity is the 100% owner** of the Project from day one. **<u>No</u> equity contribution is required**.

- A **major advantage** of this structure is that, while it does not trigger 4% LIHTC, **it requires no allocation of private activity bond volume!!!** This is becoming increasingly important, especially in oversubscribed high growth states such as California and Texas.

---

* Sometimes also called "governmental purpose" bonds, these bonds for publicly owned facilities derive their tax exemption from Section 103 of the Internal Revenue Code.

** Section 145 of the Code also allows tax-exempt bonds, including these high yield "workforce housing" bonds, to be issued on a tax-exempt basis for certain types of Section 501(c)(3) non-profit borrowers. These bonds are sometimes called "Section 501c" bonds. However, the vast majority of these financings to date have been "governmental purpose" financings for public entity borrowers.

Tax Exempt "Essential Purpose" Bonds for Workforce Housing
Remarkable Growth in Volume

- Over the **past 3 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 the $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. **In 2021**, it was **about 3.5 times the roughly $2.0 billion of private activity bonds issued for multifamily housing in Texas**.

- 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 teachers, first responders and other middle income families with incomes above 60% of AMI for the first time in decades**.

- **This is just now getting started in Texas. Three** of these **issues** aggregating just over $200 million and 1,034 units **have now closed** in three different Texas cities (El Paso, Plano and San Antonio) **since last December**.

Major Benefits Far Outweigh the Costs

Essential Function Affordable Workforce Housing Bond Financings– Issuer/Owners and Real Estate Tax Exemptions

- **A joint powers authority, housing authority,** or other authorized issuer of multifamily housing bonds and owner of multifamily housing, either directly or in some cases through an **affiliate**, **issues tax-exempt "essential function"** or "governmental purpose" **bonds** to fund the acquisition (or new construction) of a project it will own.
- **In California**, the public ownership described above, as a matter of state law*, creates the exemption from real estate taxes. As a matter of policy, a regulatory agreement is entered into under which, most typically, 1/3 of the units will be rented to tenants whose income does not exceed 80% of AMI, 1/3 not exceeding 100% AMI and 1/3 not exceeding 120% AMI.
- In California, the City is typically a joint powers authority, of which the City in which the project is located is a member (a "JPA") and has a right to acquire the project for an amount equal to the outstanding debt in Year 15.
- **In Texas**, the issuer/owner is typically a housing authority or a housing finance corporation or a controlled affiliate where the project is located.
- In Texas, to create real estate tax relief*, at least 50% of the units must be leased to tenants with incomes not exceeding 80% of AMI; 10% of the units can be market rate units and the remaining 40% are rented to families at or below 140% or 160% of AMI.
- **In both states, as a matter of policy, rents are generally 10% or so or more below market rents**.

---

* The requirements to create real estate tax relief are typically a matter of state law. They will vary from state to state.

Major Benefits Far Outweigh the Costs

Essential Function Affordable Workforce Housing Bond Financings– Issuer/Owners and Real Estate Tax Exemptions

(continued)

- While every financing differs, an analysis of the financings that have previously closed in California and Texas indicates that **the rent savings to middle income tenants from these financings generally equals the real estate taxes foregone**, **or exceeds** the real estate taxes forgone **by a ratio of up to 1.5:1**.

- **Moreover, when one factors in** very conservative assumed rates of **appreciation** (*e.g.*, **3% per year**), the **combination of public benefits from reduced rents to tenants and appreciation in value of the project over the debt outstanding generally exceeds the real estate taxes foregone by a ratio of 4- or 5-to-1 or higher**.

How does it work? Who are the players?

Essential Function Affordable Workforce Housing Bond Financings

California

- In California, the issuer and initial project owner is typically a JPA.
  - It leads complex financing (together with its advisor).
  - It assists the City in meeting the City's affordable workforce housing objectives.
  - It typically changes upfront fees of about 1% (or lower on large deals) and ongoing fees of 10 – 12 basis points.
- The City joining the JPA (California).
  - The City, county, and school district **forego 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.
  - The City has **option to purchase the project after 15 years** at a price sufficient to pay bonds.

How does it work? Who are the players?

Essential Function Affordable Workforce Housing Bond Financings

(continued)

<u>Texas</u>

- In Texas, the Issuer/Owner is a Housing Authority, Housing Finance Corporation or similar municipal entity or its Affiliate.
  - It issues the Bonds and Owns the Project from Day 1; No separate political subdivision is involved.
  - It may have an independent advisor who assists the Governmental Issuer/Owner in evaluating the financial feasibility of the issue, the reasonableness of the terms and conditions of the financing under current market conditions, and the potential benefits of the proposed financing.
  - It may charge ongoing monitoring fee and have a small share in cash flows while bonds are outstanding.

How does it work? Who are the players?

Essential Function Affordable Workforce Housing Bond Financings

(continued)

<u>**California and Texas**</u>

- The **Project Administrator**.

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

  - Locates project.
  - Negotiates the Purchase-Sale Agreement with the 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 City or Housing Authority or other governmental owner – typical development type functions.

How does it work? Who are the players?

Essential Function Affordable Workforce Housing Bond Financings
(continued)

  - Loses deposit and upfront costs if bond issue fails to close on time, often just 60-90 days.
  - Receives up-front cash fee of 1%-2% (depending in part on deal size); receives subordinate tax-exempt bonds with 8-10% coupon equal to 5% or 6% of purchase price as part of front-end compensation, is paid ongoing Project Administrator fee of 10-12 basis points or so for ongoing asset management services.

- 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%-2% (depending in part on deal size) – typical for unrated high yield non-credit enhanced bonds.

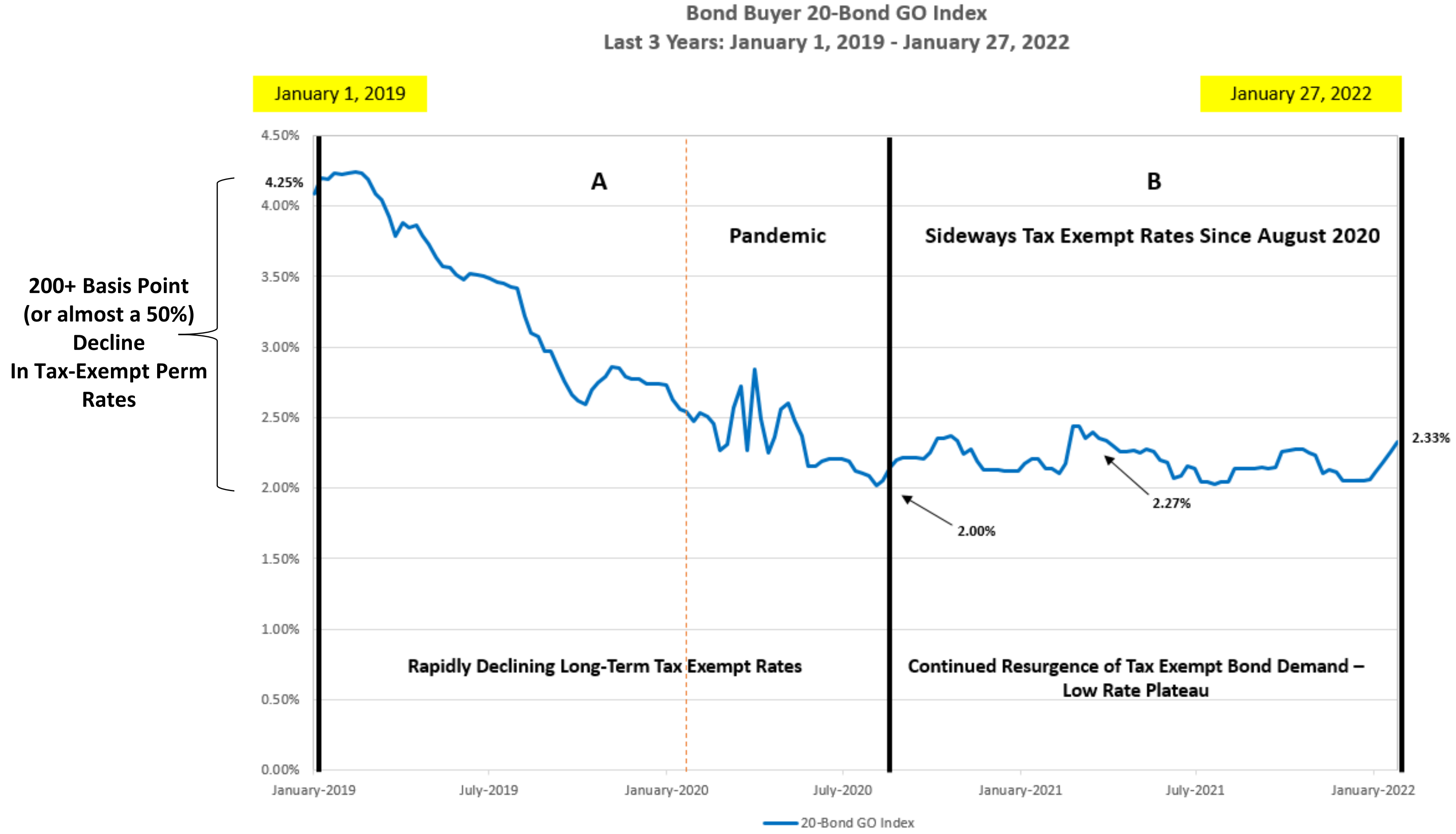
"So, What were the Two Major Industry Developments which Led to this Tsunami of Affordable Multifamily Rental Workforce Housing Finance?"

1. **Record municipal bond inflows** and correspondingly **low tax-exempt interest rates**.

2. Acceptance by the muni bond funds of a **new "turbo" soft principal amortization structure** in high growth markets, **which substantially increases bond proceeds**.

1. Tax-Exempt Low Rates

Record Muni Bond Fund Inflows and Resulting Record Low Tax-Exempt Rates
The Recent Golden Age of Tax-Exempt Municipal Bond Finance
2019-2021



Interest Rates Over the Past Three Years – Two Major Phases

January 2019 Through August 2020 – Declining Tax Exempt Rates

- Long-term tax exempt **rates declined about 50%**!
- These **dramatic drops in borrowing costs raised loan proceeds at a rate of more than 1% per month** to help offset rising project costs – **over a 25% 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!

After the initial decline, long-term tax-exempt rates remained at a very low level for the rest of 2020 through 2021.

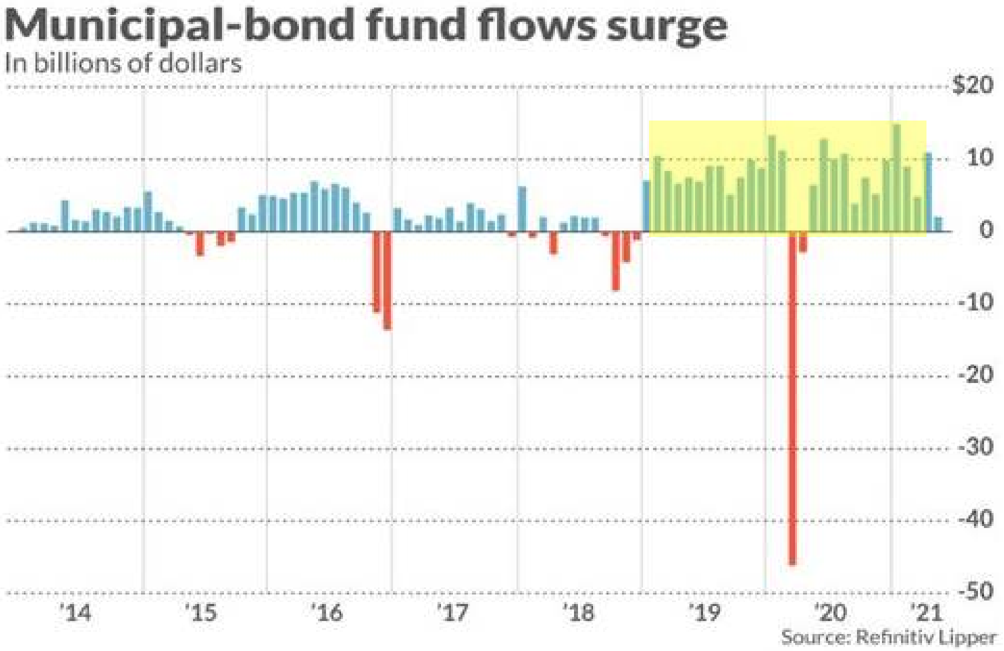
What happened here? What explains this?

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*: major inflows into tax-exempt municipal bond funds**.**

- Each upward pointing bar represents **$5-15 billion more money flowing into muni bond funds than flowing out each month**. **They had to put this money to work!**

- This produced the **best conditions we have seen in the tax-exempt debt markets in decades!!!** Unrated high-yield muni bonds traded as low as 3% last July!



Andrea Riquier
(First Published: May 21, 2021)

---

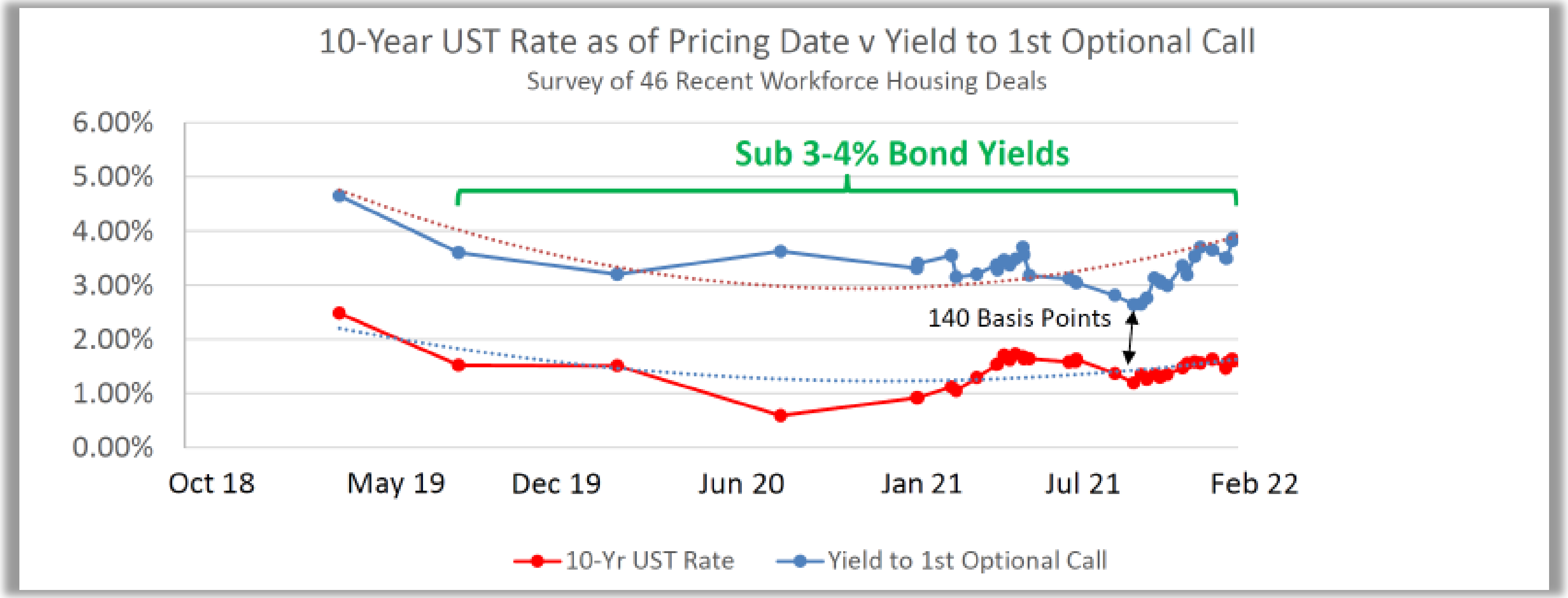
* Except for the downward spike in outflows in first 3 months of the Pandemic.

** 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 comprise 12.3%, insurance companies 12.3%, and other holders 3.9%.

Tax Exempt "Essential Function" Bonds for Workforce Housing

Interest Rates and Spreads: 2019-2021

- 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**, the 3.0% yield on these **unrated tax-exempt bonds was a spread of only 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 **2019-2021** as the **golden age of affordable workforce housing financing**.
- **Most financings worked well with some adjustments** through the end of 2021.



2. A Second Major Industry Development:

Acceptance by Bond Funds of a Soft Principal Amortization Structure for Projects in High Growth Markets

- The second major factor that supported this remarkable volume was the acceptance by the muni bond fund purchasers of a soft **"turbo" amortization of bonds, which 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 flexible principal amortization structure **allows loan underwriting in high growth markets to be based on the assumption that rental income and expenses will grow over time** – generally **at** a rate of **3% per year**.

- This is **significantly different from traditional** commercial real estate **underwriting** (*e.g.*, Freddie Mac, Fannie Mae, FHA, banks and other private placements and the mortgage loan on your home), **which typically assume 0% growth or lower growth** in rental income and expenses in the underwriting.

- Why would these most sophisticated of all investors agree to this on over $8.0 billion of paper?

Acceptance of a Soft Principal Amortization Structure for Projects in High Growth Markets
(continued)

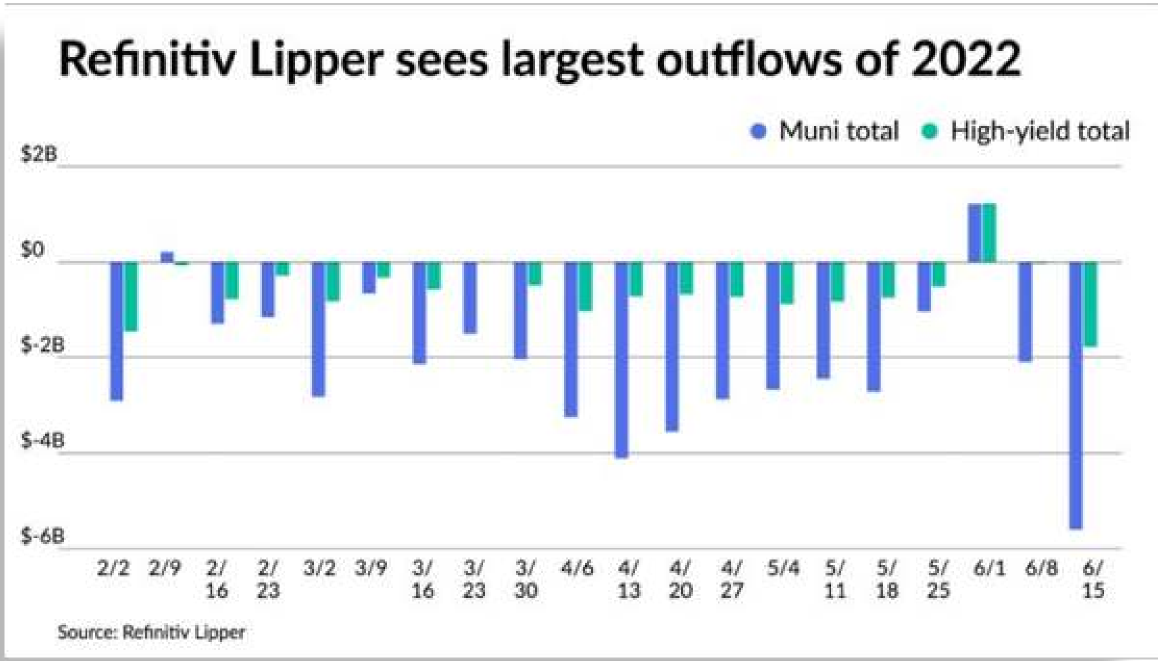
- Answer: They have agreed that **it is very reasonable to assume rents (and expenses) will grow at a 3% rate over a 35- or 40-year period prior to bond maturity in high growth markets like many of those in Texas and California**, where historical growth in rents has been 4% or 5% or higher; it is unlikely to work nearly as well, if at all, in lower growth markets.
- **This soft principal amortization structure provides a substantially higher level of bond proceeds**. We believe that this major positive addition to loan proceeds may **outweigh** the roughly 25% **gain in loan proceeds we experienced from the decline in interest rates** from the fall of 2018 to the lows in the summer of 2021.
- These two factors, but especially the second, are what **enables the governmental entity to acquire the project with no equity contribution**.
- As compared to a traditional mandatory sinking fund and/or serial bond maturity structure, this flexible principal amortization structure also **substantially lowers the risk of default**.
- This structure also involves **very substantial funding of upfront reserves** for debt service (up to 18 months!), operating and capital costs, which **lowers the risk of default even further**.

The 2022 Cold Snap!!!

Is the Party Over?

A Huge Reversal to Muni Bond Fund Outlfows

- Since January of 2022, the strong municipal bond inflows we had enjoyed in 2020 and 2021 turned into **outflows**. Note: Almost all of these bars are pointing **down!!!** (Not <u>up</u>, as in 2021-22, per slide 12)

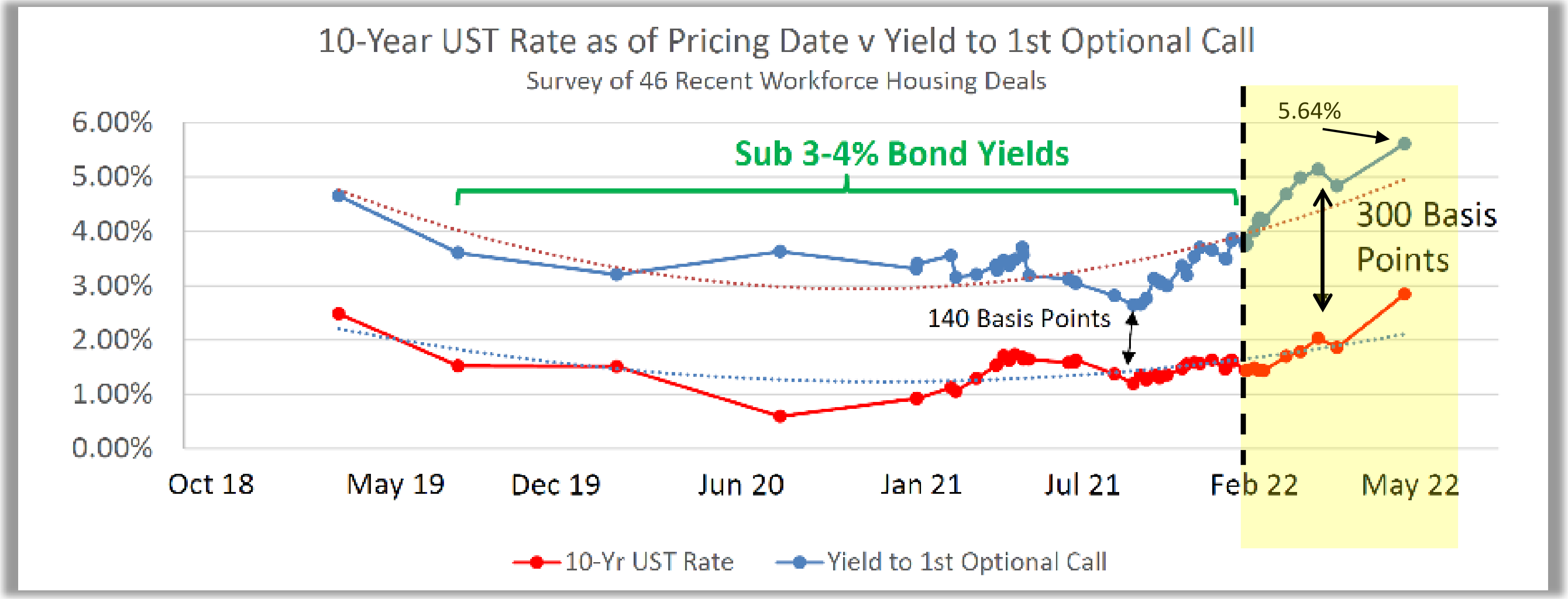


- Outflows had hit $4 Billion in mid-April. They had been shrinking and turned back to inflows on June 1. However, recent the Fed actions on interest rates combined with disappointing inflation reports to produce a spike in interest rates and outflows of $5.6 billion as of June 15, the highest in 2022. The market remains very challenging.

R. Wade Norris | wnorris@ngomunis.com | (202) 744-1888 (C) | (202) 973-0110 (O)

And a Resulting Spike in High Yield Bond Spreads

- This has produced the **worst high yield municipal bond market we have seen in many years**.



Interest Rates Have Almost Doubled

- **By March of 2022**, the spread of these tax-exempt high yield bonds to U.S. Treasuries had widened dramatically – it **soared from 140 basis points last summer to over 300 basis points in February**.

- 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.

- The war in Ukraine and soaring inflation have further added to the volatility and risk.

- **In periods of very low rates and low volatility, as we had last summer, high yield spreads** to Aa or Aaa paper **always compress**, and **then widen again, when rates and volatility increase. This is exactly what we saw in early 2022.**

- Since the jump in spreads in February, tax-exempt bond rates have followed the continuing rise in the 10-year U.S. Treasury rate; **the spread has remained at about 300 basis points**.

- This has led to an **almost doubling in tax-exempt high yield interest rates from 3.0% last summer to around 5.5%** today.

However…
Financing Structures Are Already Being Adjusted to Reflect These Adverse Market Developments

- Financing conditions were so favorable in 2021, **there was room for financing and other costs to be lowered** a bit. They have already begun to be lowered in part to offset the impact of higher rates.

- It is also important to remember, the **2021 volume** of these financings **was huge**. Even if it fell to one fifth or one fourth in 2022, it would represent **$1-2 billion** of affordable multifamily workforce rental housing in high growth states like Texas and California.

- Underwriters are also beginning to look at **various ways to vary the debt structure to lower rates** and create **different incentives** for financing participants. These steps include shifting from premium to **discount pricing**, including **one or more tranches of bonds with higher coverages** and lower LTV ratios, **incorporating capital appreciation bonds** to accelerate the amortization of the current interest bonds and other innovations.

- These techniques **can lower overall yields into the 5.00-5.50% range**.

- Several financings have priced and closed in the mid-5.0% range since the run-up in rates earlier this year.

Future Prospects

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

- **But the second, even more important major factor** – acceptance by the muni bond fund buy side of **the "turbo" soft principal amortization structure** and the related assumptions **producing significantly greater proceeds – remains intact**.

- **We believe** a number of these financings may work, even at today's interest rates. These financings are just getting started in Texas, and we are **also beginning to look at similar financings in several other high growth 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, if the situation in Europe improves, and/or if fears of a recession continue to build. 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 these deals.

Conclusion

- The bottom line? For the three years ending in late January, **there were two very strong underlying forces that substantially increased the demand for tax-exempt municipal debt, dramatically lowered tax-exempt rates, and introduced a breakthrough principal amortization structure.** This enabled the creation of this **new major tax-exempt bond-financed category** of tax-exempt essential function bond affordable workforce housing financing**. What we believe is that the more important of these two major positive forces remains intact.**
- **We believe there is a good chance market conditions will improve to some degree in 2022** to support an even stronger 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 major new category of tax-exempt multifamily housing bond finance is not going to disappear and that these new multifamily rental housing bond financings will continue to see a substantial level of volume in California, Texas and a number of other states in 2022 and beyond.**
- **We believe the cities, housing authorities** and other governmental players **who have acquired top tier projects using this structure** over the past three years **will look back** on their doing so **as a grand slam home run**.
- But we are living in a volatile, unpredictable world, and **100% financing** from the debt side **is a very rare phenomenon**. **This major new** governmental affordable workforce housing **opportunity continues to be viable. Opportunity knocks! But** there is **no guarantee that it will last forever**.

Refinitiv Lipper reports inflows

Source: Refinitiv Lipper

R. Wade Norris | wnorris@ngomunis.com | (202) 744-1888 (C) | (202) 973-0110 (O)