NH&RA TENNESSEE DEVELOPERS COUNCIL SYMPOSIUM (2022)

TAX EXEMPT DEBT ROUNDTABLE - OVERVIEW OF CURRENT EXECUTIONS

December 6, 2022

Presented by:

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THREE MAJOR TYPES OF TAX-EXEMPT MULTIFAMILY RENTAL HOUSING BONDS

- There are **three different categories of tax-exempt multifamily residential housing bonds**, each with its own set of rules, **depending on the nature of the owner** of the residential rental housing facility:

   1. **Tax-Exempt Volume Limited Section 142(d) Private Activity Bonds** for **profit motivated owners**, the vast majority of which are paired with 4% LIHTC. By far the most complex rules, but also **by far the biggest category** – probably 90-95% of annual volume or more.

   But as private activity bond volume has grown increasingly scarce, two other categories have seen increased volume:

   2. **Tax-Exempt "Section 501(c)(3)" Bonds** under Section 145 of the Code for **certain nonprofit owners**. No private activity bond volume required, but cannot be paired with 4% LIHTC.

   3. **Essential Function Bonds under Section 103 of the Code** for facilities **owned by a state or political subdivision** – *e.g.*, a city, county, housing authority or housing finance corporation or a controlled affiliate. Simplest rules – no PAB volume required and no 4% LIHTC. Traditionally, very small percentage of annual volume. Recent surge in volume in California and Texas for affordable "middle market" or "workforce housing."

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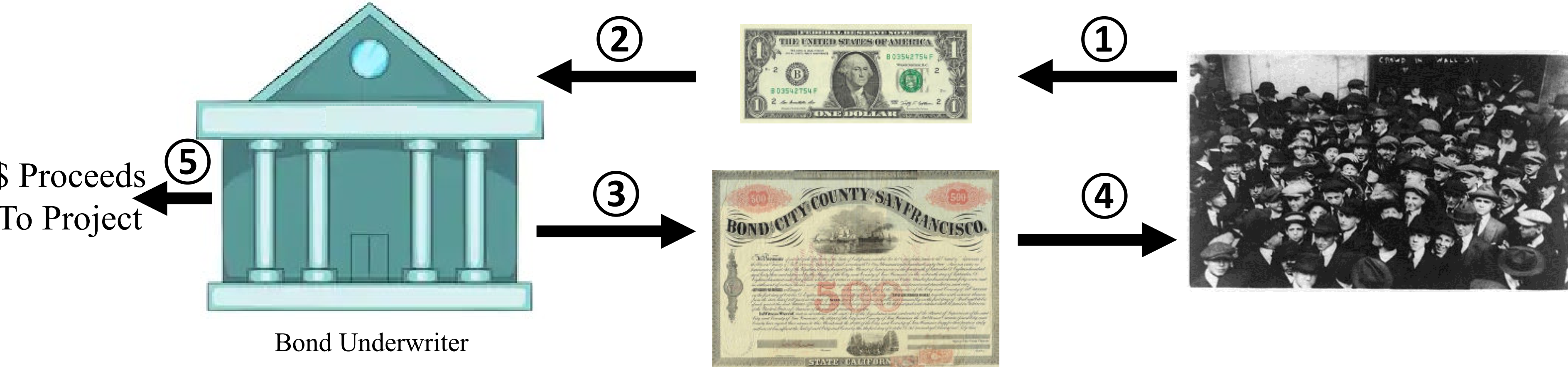
QUICK SURVEY OF TAX-EXEMPT MULTIFAMILY HOUSING BOND STRUCTURES

PUBLIC OFFERINGS

- A registered broker-dealer firm or "underwriter" sells Bonds to public retail investors.



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A. SHORT-TERM CASH BACKED TAX-EXEMPT BONDS

- These are Aaa or AA+ rated, credit enhanced tax-exempt bonds used to satisfy the 50% Test for 4% LIHTC on projects using low rate taxable FHA insured or USDA Rural Development guaranteed loans.
- For many years on **FHA Insured or RD financings,** we would **pledge the GNMAs to secure long-term tax-exempt muni bonds** to get the lowest borrowing rate – see the left side of the following chart.
- This all changed in the **2008 financial crisis**, when **taxable rates like those on GNMAs fell *below*** the rates on **long term tax-exempt muni bonds** by 50-100 basis points or more – see the right side of the following chart.

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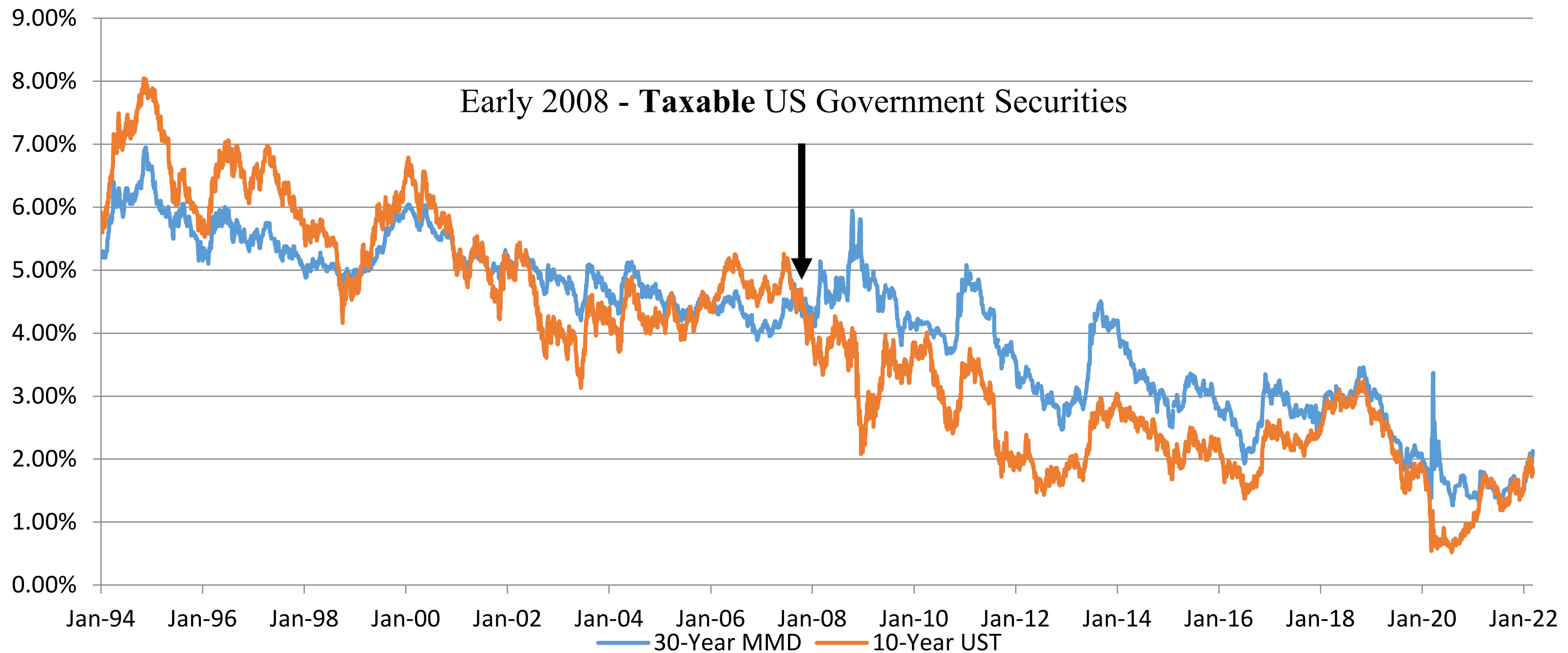
LONG-TERM RATE COMPARISON: 30-YEAR MMD (TAX-EXEMPT) VERSUS 10-YEAR CONSTANT MATURITY TREASURY (TAXABLE)



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THE ALL-IMPORTANT 50% RULE

- “So if I can do a simple taxable conventional GNMA sale on my FHA insured loan at a lower rate, **why would I use muni bonds?**”
- **The 50% Rule:** To be eligible for 4% LIHTC, without which these projects probably will not be an affordable multifamily rental project, **you have to finance at least 50% of “aggregate basis” of the building(s) plus land with volume limited tax-exempt private activity bonds** under Section 142(d) of the Code **and keep them outstanding until the project’s placed-in-service date**.*

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* Generally completion of construction (or “COO”) for a new construction project or completion of rehab on an acquisition/rehab financing.

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HOW IT WORKS

- Issue **short-term tax-exempt bonds equal to 50% of the project's aggregate basis of the building(s) plus land* priced to a mandatory tender date 6-12 months following the targeted placed-in-service date** (to provide for construction delays). **Stated maturity will be 6-12 months** later, **allowing a remarketing** of bonds if more time is needed to place project in service.
- **Two funds** established under Bond Trust Indenture and **invested in U.S. Treasury securities**:
  - A "**Project Fund**" in which all the tax-exempt bond proceeds are deposited, and
  - A "**Collateral Fund**" in which FHA or RD lender taxable loan advances are deposited.
- Financings are structured so that as each dollar of tax-exempt bond proceeds is disbursed from the Project Fund to pay project costs, an equal amount of lender advances on the taxable loan must be simultaneously deposited into the Collateral Fund. **The principal of the Bond issue thus remains 100% "cash collateralized"** with U.S. Treasuries. Receive Aaa or AA+ rating and **no other credit enhancement is required**.

Note: This may be greater than or lower than the taxable loan amount. Most developers aim for 52-55% of such aggregate basis to provide a cushion. The **short-term cash backed bond structure often produces a lower bond amount than other executions**, which lowers bond financing costs.

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- **In today's market**, **U.S. Treasury securities** at 36 months yield about 4.3%, roughly equal to the bond coupons at 36 months of about 4.2%. As long as this holds, it eliminates any **negative arbitrage** under the structure.
- **When** the project loan has been fully funded, rehabilitation or construction has been completed and **the project has been placed in service, the tax-exempt bonds are redeemed**.

Sample Short-Term Cash-Backed Tax-Exempt Transaction

New Construction/Sub Rehab – 4-Year Bonds, with 36-Month Mandatory Tender

Expected Placed-In Service Date	24 Months
Initial Mandatory Tender Date	36 months*
Stated Bond Maturity	48 Months
Bond Sale	Public offering (only) of S&P AA+ rated or Moody's Aaa—rated Bonds
Interest Earnings from Eligible Investments	4.30%
Initial Bond Coupon Rate	4.20%
Net Negative Arbitrage	$0

* Bonds are sold to the 36-month mandatory tender date. If delays are encountered on placing project in service then bonds can be remarketed to new buyers providing up to 12 additional months before tax-exempt debt goes away.

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ALL-IN BORROWING RATES ON FHA INSURED AND RURAL DEVELOPMENT LOANS

		Moderate Rehab/	**Sub Rehab-New Cons/**
Mortgage Loan Interest Rate			
	GNMA Pass Through Rate	**5.00%**	**5.60%**
	3rd Party Fees	N/A	N/A
	Servicing + GNMA Fee	0.25%	0.25%
	Total **ML Rate**	**5.25%**	**5.85%**
	Add: MIP	0.25%	0.25%
	Total **All-in Borrowing Cost**	**5.50%***	**6.20%***

- There is **no re-underwriting of the loan at the permanent loan stage** and **no balloon on a 35 or 40-year loan amortization**. On the other hand, FHA and RD take a great deal of time and Davis Bacon wage rates apply on new construction and substantial rehabilitation loans.

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* Note: bonds are sized to 52 – 54% of Tax Credit basis; under long-term muni bond structures used before 2009, bond issue would be larger (equal to taxable loan amount) with higher costs.

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B. FANNIE MAE "M.TEBs" STRUCTURE

- In 2015, we worked with Fannie Mae to pioneer a new long-term (16-18 years), **fixed rate publicly offered tax-exempt Fannie Mae monthly pay MBS pass-through** structure.

- **Under this structure, the Trustee simply passes through the monthly Fannie Mae MBS payment** securing the Bonds to the Bondholder on **next business day** on a **tax-exempt basis**.

- **Bond coupon rates are around the 10-year U.S. Treasury rate plus 1.10%: 3.50% + 1.10% = 4.60% bond coupon in today's market.**

- **Fannie Mae also offers very competitive guaranty and servicing fees of roughly 120-140 basis points to promote this program.**

- **Result: All-in borrowing rates as low as 5.80% to 6.00%.**

- **35 to 40-year loan amortization to 16 to 18-year balloon, 1.15 DSCR; 85-90% LTV.**

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- On **new construction and sub rehab** financings, Bonds are **“cash backed” for 1st 2-3 years**.
  - This results in gross **negative arbitrage** cost of **around 5 points** or so.
  - However, having **two sets of construction period interest** raises 4% LIHTC sufficiently to offset 60-80% of this, so **net negative arbitrage is 1-2 points**.
  - Requires a **taxable draw down construction loan**, which may carry a slightly higher rate than in a tax-exempt draw down private placement.

- The program **may allow more lenient waivers** for certain loan underwriting criteria such as larger rehab per door for mod rehab loans with low tenant relocation risk, and the potential for **earn-out provisions for certain loans** and other features typically associated with Fannie Mae DUS loans.

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PRIVATE PLACEMENTS

- In a private placement, **a bank or other** private placement **sponsor funds the bonds or loans out of its own funds** – there is no offering to the public at the time of tax-exempt debt origination.*

- The tax-exempt bonds or "tax-exempt loans"** are backed by a first deed of trust and construction period guarantees but **no credit enhancement**.

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* Some bonds or loans, or interests therein, may later be sold off by program sponsors to institutional investors, in securitizations, once "Conversion" of the loan to stabilized occupancy is obtained.

** For Community Reinvestment Act ("CRA"), accounting and regulatory purposes, many private placements are styled as "tax-exempt loans" rather than "bonds" and use "loan" versus "bond" or securities terminology. The terminology does not matter; if the applicable rules are built into the documents, either can be a "tax-exempt private activity bond" under Section 142(d) of the Code.

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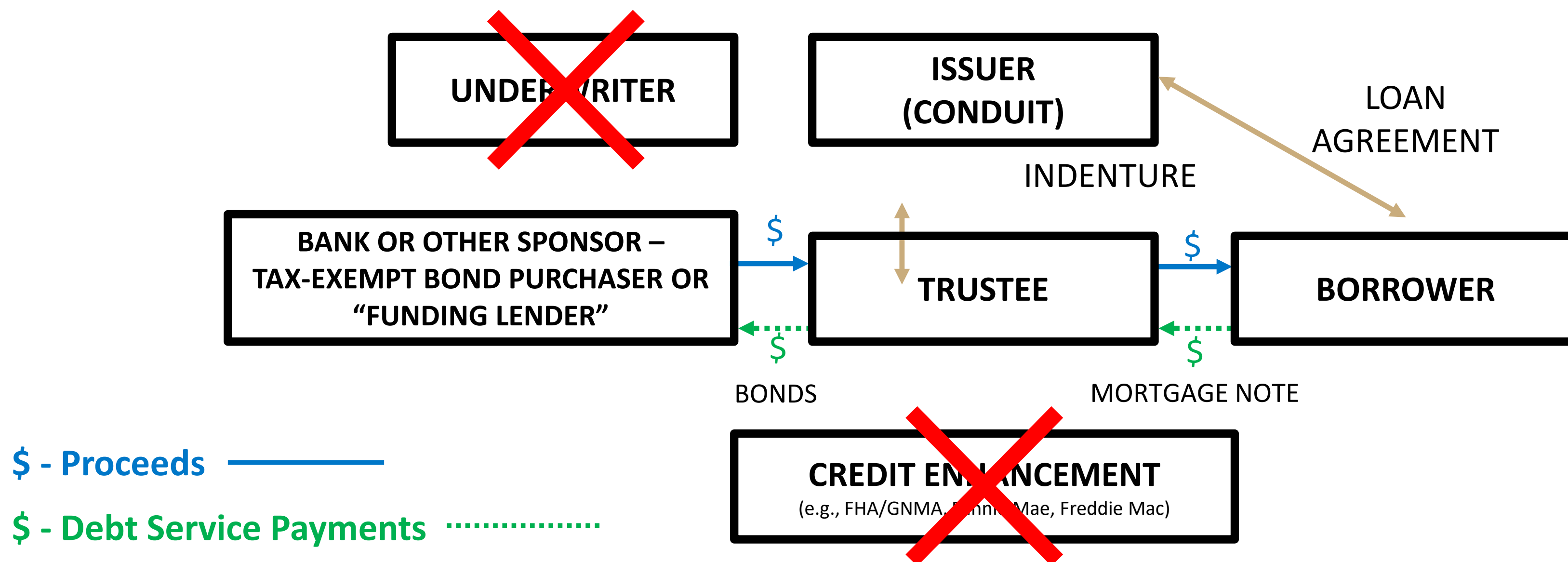
- We believe that of the **$21 billion of tax exempt multifamily private activity bonds issued in 2021, perhaps $15 billion (or 70-75%) were private placements.**

Private Placement Bond Structure



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PRIVATE PLACEMENTS – ADVANTAGES

- **Lower financing costs** – No rating fees and other costs associated with a public offering – can save 2 or 3 points in costs.
- **Flexibility** – Terms can be modified as agreed by the Issuer, the Borrower and the Bank or other program sponsor.
- **Speed** – Faster loan underwriting in some cases and no delays associated with rating and public offering.
- **Draw-down Funding**: Tax-exempt debt is funded as loan advances are made – **eliminates construction period negative arbitrage** on new construction sub-rehab deals – can result in **up to 2-4 points or more of savings** on new construction/sub rehab versus "fully-funded" publicly offered bonds.
- **Until very recently, low variable rate during construction**/rehab/rent-up – e.g., 1-Month LIBOR (0.50%) plus spread of ~2.00% to 2.50% = **2.50% to 3.00% "pre-Conversion" rate. Today, much higher 4.95% to 5.50%**, but this is a result of our presently inverted yield curve, which is **probably short-lived**.
- **Locks in low permanent rate** (e.g., 16 to 18-year LIBOR swap (3.40%) plus ~2.00%-2.50% spread or around **5.40% to 5.90% perm rate**) at initial loan closing.

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- **"Built-in" Tax Exempt Bridge Loan between Closing and Conversion.** Since the bank funding the loan has a first deed of trust on the project and other guarantees, these programs also allow the pre-Conversion phase of the tax-exempt loan to be "upsized" to fund project costs incurred prior to the receipt of tax credit equity, subordinate loans, and other permanent funding sources, which may not be available until after the related costs have been incurred.
- **Underwriting Terms Very Attractive**
- **35 or, now most often, 40-year loan amortization** to a 16 – 18 year balloon
- **Very large (85 – 90%) loan-to-value,** and
- **Very low debt service coverage (1.15).**

C. FREDDIE MAC TAX-EXEMPT LOAN OR “TEL” PRIVATE PLACEMENT STRUCTURE

- In 2014, we helped **Freddie Mac** introduce its **Tax Exempt Loan or “TEL”** structure. Since then, several billion dollars in loans have closed. Structure basically the same as Bank and Other Sponsor Private Placements, with a few differences.
- **Requires a separate bank (probably with separate counsel) to take pre-Conversion risk** on the tax-exempt loan versus most other private placements, thus perhaps entails slightly higher costs.
- Freddie Mac also **always requires a “Fiscal Agent,”** some bank and other sponsor private placements do not, lowering expenses.
- Freddie Mac tends to agree to permanent interest rate locks further in advance than many competitors.

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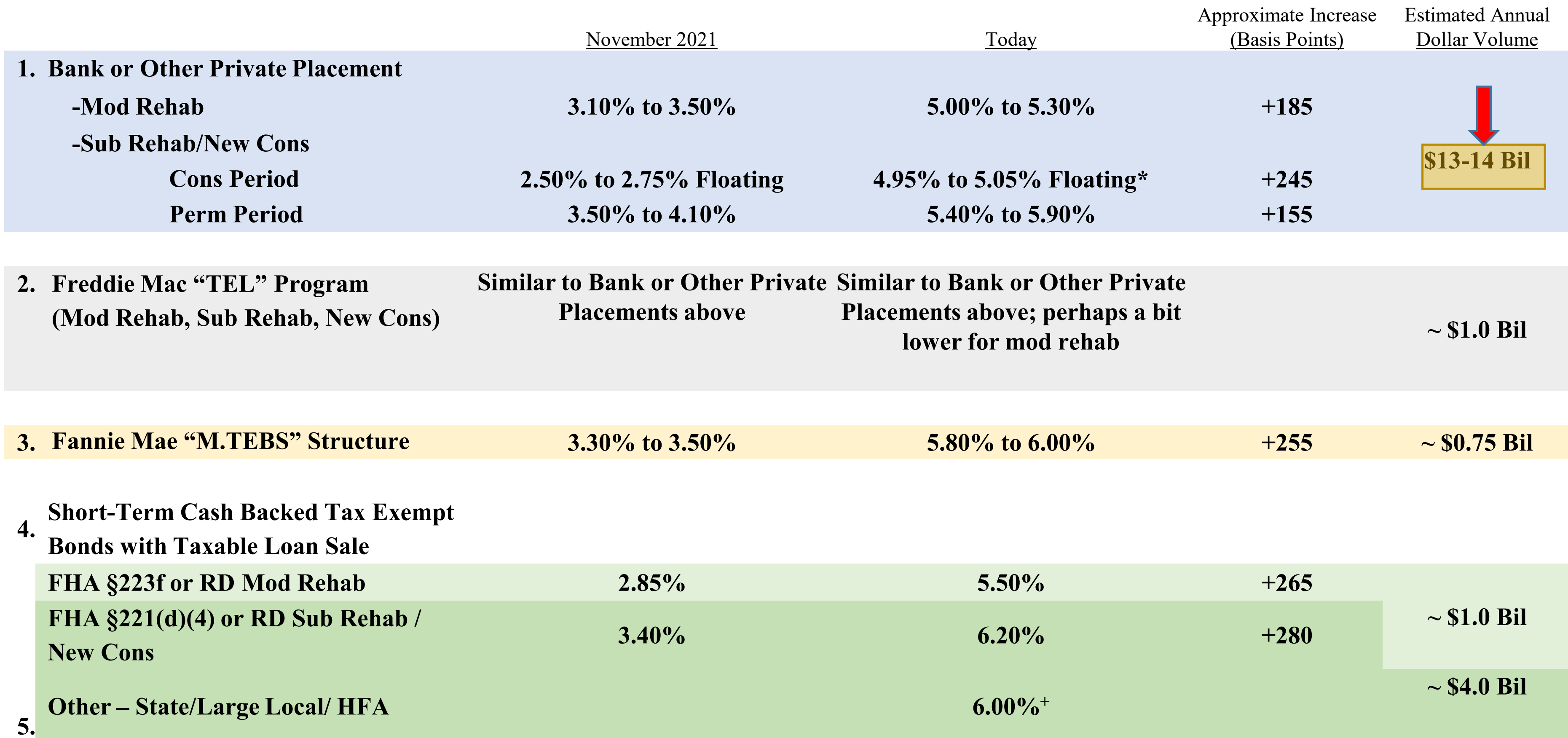
D. SHORT-TERM CASH BACKED TAX-EXEMPT BOND TO FREDDIE MAC TEL OR OTHER TAX EXEMPT PERM LOAN STRUCTURE

- This structure incorporates the issuance of **short-term cash backed tax-exempt bonds** as described above to satisfy **the critical 50% Test for the 4% LIHTC**.
- **Construction** or acquisition and rehabilitation **is funded by a taxable bank construction lender**, which often may also acquire the 4% LIHTC.
- The **terms of a permanent Freddie Mac TEL or other Tax Exempt Perm Loan are agreed upon in a forward commitment** and tax-exempt permanent phase loan documents embodying these terms are placed in escrow, to be executed and delivered upon "Conversion" of the tax-exempt debt to stabilized occupancy.
- This structure entails some very remote "black swan" types of **tax risks** and **some extra costs** associated with the publicly offered short-term cash backed tax-exempt bonds, but these may be **offset, or more than offset, through additional 4% tax credit basis**.
- This structure **allows the same bank to be both the construction lender and 4% LIHTC tax credit equity provider** and avoid an arbitrage violation where the issuer charges more than 12.5 basis points in upfront and ongoing fees.

SUMMARY OF BORROWING/ UNDERWRITING RATES AND VOLUME ESTIMATES
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)	Estimated Annual Dollar Volume
1. Bank or Other Private Placement				
-Mod Rehab	**3.10% to 3.50%**	**5.00% to 5.30%**	**+185**	
-Sub Rehab/New Cons				**$13-14 Bil**
Cons Period	**2.50% to 2.75% Floating**	**4.95% to 5.05% Floating***	**+245**	
Perm Period	**3.50% to 4.10%**	**5.40% to 5.90%**	**+155**	
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**		**~ $1.0 Bil**
3. Fannie Mae "M.TEBS" Structure	**3.30% to 3.50%**	**5.80% to 6.00%**	**+255**	**~ $0.75 Bil**
4. Short-Term Cash Backed Tax Exempt Bonds with Taxable Loan Sale				
FHA §223f or RD Mod Rehab	**2.85%**	**5.50%**	**+265**	**~ $1.0 Bil**
FHA §221(d)(4) or RD Sub Rehab / New Cons	**3.40%**	**6.20%**	**+280**	
5. Other – State/Large Local/ HFA		**6.00%+**		**~ $4.0 Bil**

In November of 2021, the **10-year U.S. Treasury rate** hovered around a 1.50% level, versus about 3.50% today, or **about 220 basis points higher**. The all-in borrowing/underwriting rates all of the affordable executions have increased by slightly lower 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 one month SOFR.

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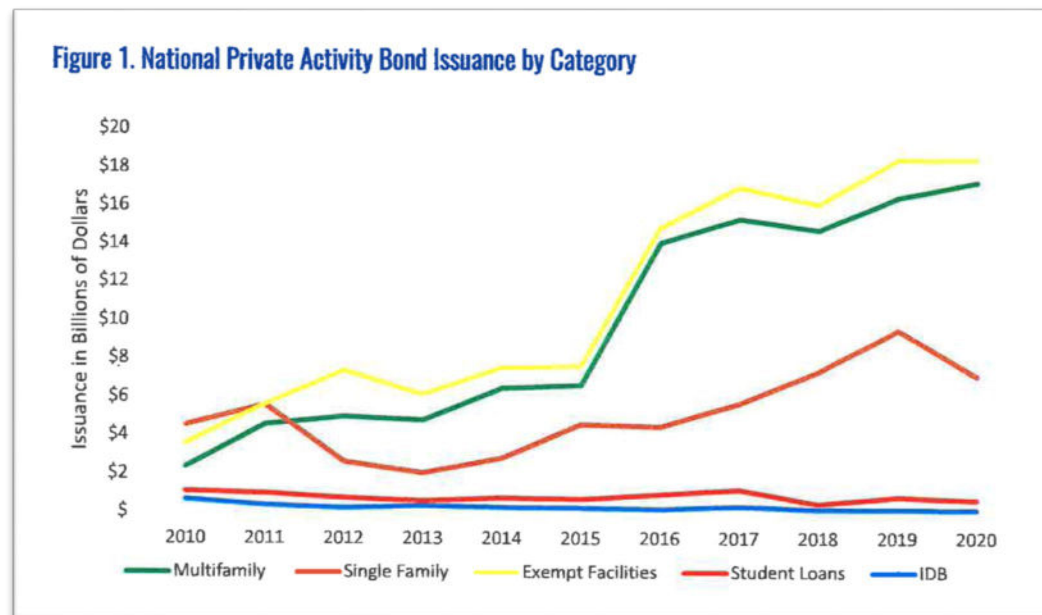
MULTIFAMILY PRIVATE ACTIVITY BOND VOLUME: INCREASING SCARCITY IN US

- According to the Council of Development Finance Agencies ("CDFA"), tax exempt multifamily bond volume rose from just over $6 billion in 2015 to about $17 billion in 2020, as shown in the chart below.
- This was an annual **increase in the use of PAB volume for multifamily of over 25% per year** over this **five-year period**.



- This means that in a rapidly **increasing number of states**, the **demand** for multifamily volume now **exceeds** any carryforward PAB volume in the state and the state's **annual PAB allocation**.

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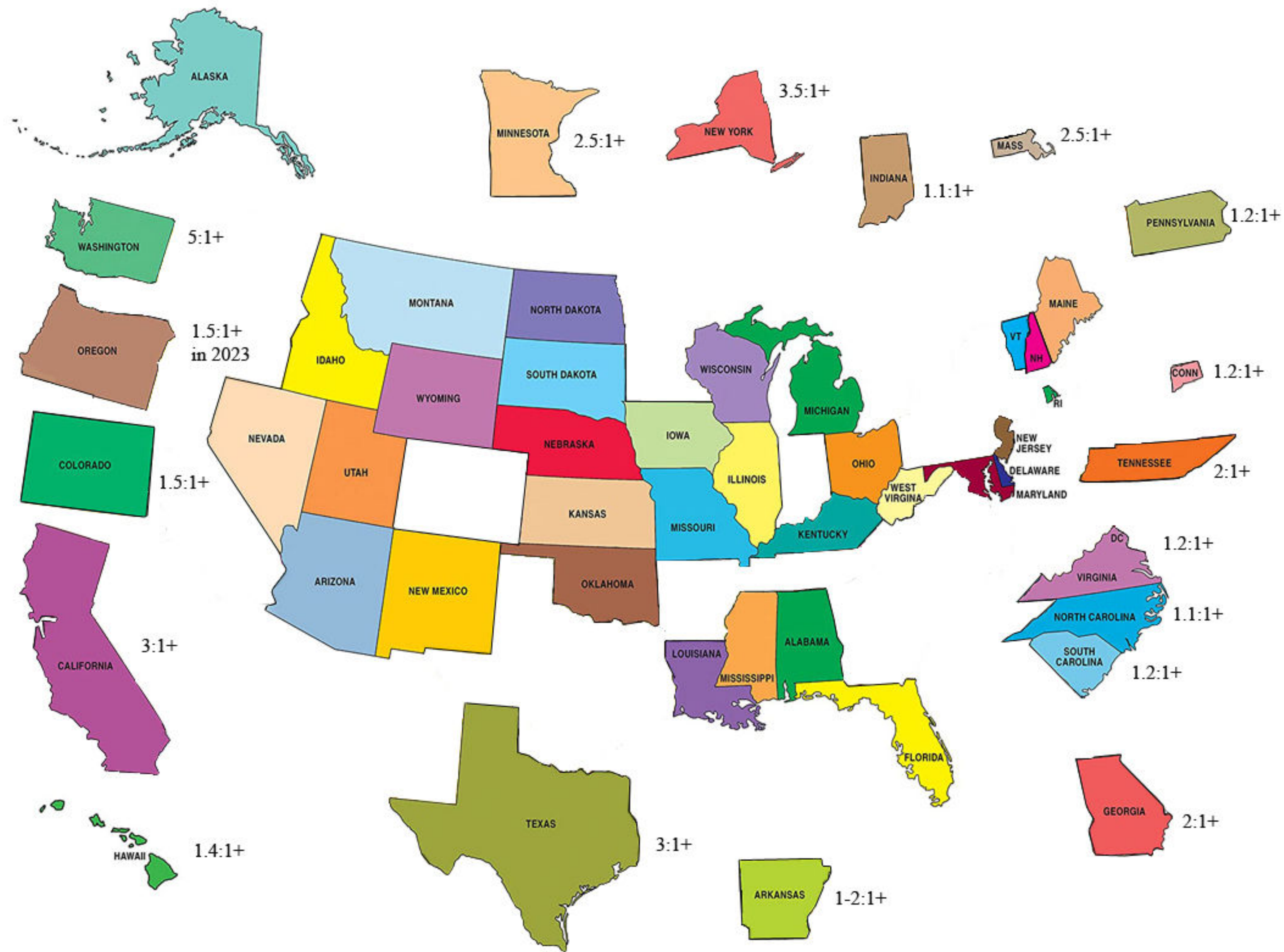
December 6, 2022



* NGO estimates based on published data, supplemented by conversations with industry colleagues active in tax-exempt multifamily bond and loan financings in our nationwide practice.

*** It is quite possible that the higher interest rates which have immerged in 2022 will lower the oversubscription in many of these states in 2023, and thus obtaining a PAB volume allocation may become less competitive in 2023 than in 2020-2021; however, it is likely that substantially over subsidized states will remain over subsidized**

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CURRENT LOBBYING EFFORTS

- **Possibility of reducing the 50% Test to a 25% Test.**
  - **Uncertain at this time;** anyone's guess.
  - Is one of 18 or 20 provisions in the Affordable Housing Credit Improvement Act originally introduced in 2016.
  - Two provisions have been previously adopted:
    - Making 4% LIHTC a true 4%.
    - Income averaging (but IRS regulations still forthcoming).
  - Remaining provisions died with Build Back Better last fall.

- **Two main outstanding lobbying goals:**
  - **Increase the 9% tax credit by 50%.**
  - **Lower the 50% Test to 25%.**
- Current version co-sponsored by over one-third of House and Senate.
- Hope to attach to an "extenders" bill late fall or early 2023.
- Anyone's guess as to whether this will be successful.
- If not, try to include in any tax legislation later in 2023.
- For now, probably best not to assume passage.

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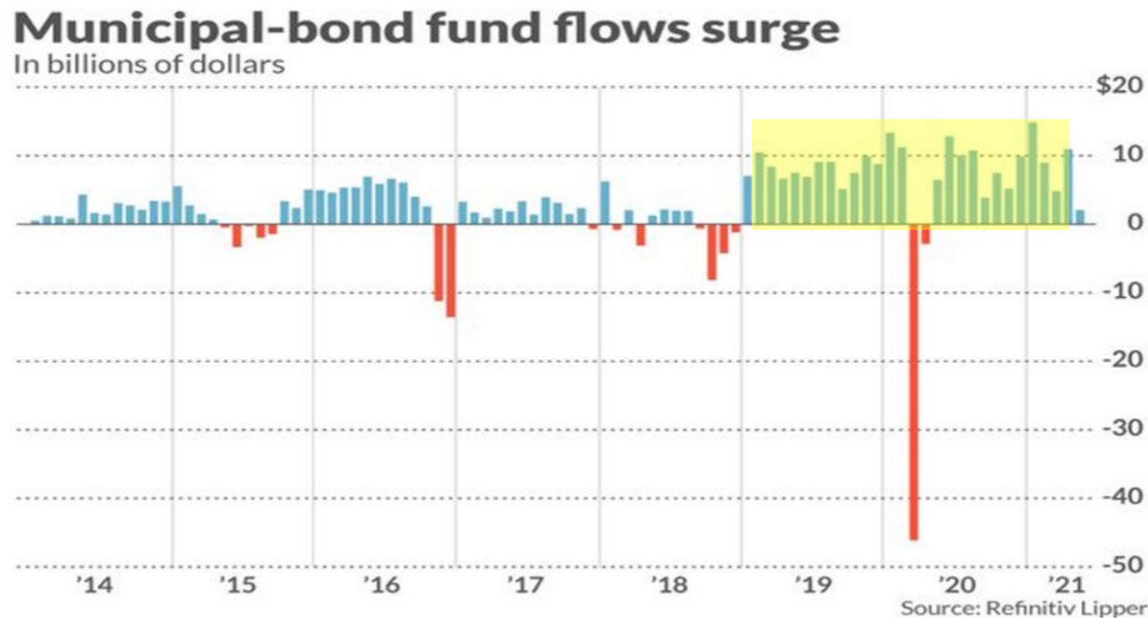
NEW OPPORTUNITIES FOR SECTION 501(C)(3) AND ESSENTIAL FUNCTION BOND FINANCINGS THROUGH PRIVATE PLACEMENTS TO TAX EXEMPT MUNICIPAL BOND FUNDS

- The three years from 2019 – 2022 saw record **inflows into tax exempt municipal bond funds** which comprise about **30% of the** $450 billion per year annual **municipal bond market**.
- Each upward pointing bar from 2019-2021 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% in July of 2021.



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- This lead to **acceptance by the muni bond fund buyers of a new financing model:**

  - A new **“turbo” soft principal amortization structure**. This new soft **“turbo” amortization of bonds 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 substantially lowers default risk.

  - For projects in high growth states like California, Texas and Florida, **underwriting assumptions which assume 3% annual rent (and expense) growth in high growth markets.**

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- 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 (*e.g.*, 2%) growth** in rental income and expenses in the underwriting.

- **These generous underwriting assumptions raise proceeds 25 -60%!!!**

- **Why would these most sophisticated of all investors agree to this?**

    - Answer: They believe **it is very reasonable to assume that 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 Texas, California**, **and Florida,** where historical rent growth has been 4% or 5% or, very recently, much higher.

- **These two developments,** which substantially increase loan proceeds, **have plugged the funding gap** on financings for section 501(c)(3) borrowers and governmental lenders under the second and third categories of tax exempt bond financing mentioned on slide 2, where 4% LIHTC proceeds are not available, but where no PAB volume allocation is required.

SURGE IN TAX EXEMPT ESSENTIAL FUNCTION AND 501(c)(3) FINANCINGS FOR MIDDLE INCOME OR "WORKFORCE" HOUSING

- As a result, **over the past three years, we have seen a substantial increase in tax exempt issues for Section 501(c)(3) and governmental borrowers** for both lower income housing and especially for middle income or "workforce housing' for tenants at 80% to 120% AMI.
- **In many states, exemption from real estate tax is often available** to section 501(c)(3) and governmental borrowers, often if some percentage of units are set aside for low to moderate income tenants.

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- The freed up cash flow has often been used to make units affordable for tenants at 80% - 120% of AMI.
- 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**.
- This $7.0 Billion is **over one third of the total tax exempt multifamily housing bond volume in the entire United States!!!**
- Due to the financial model described above, **these tax exempt bond financings have provided 100% of tax exempt proceeds required (i) to pay the purchase price to move projects from private to governmental or section 501(c)(3) ownership, (ii) to fund very substantial reserves, and (iii) to pay all costs of issuance.**
- **This format is just now getting started in Texas. Three** of these **issues** aggregating just over $200 million and 1,000 units **closed** in late 2021 and early 2022. After an eight month hiatus, **we just closed a fourth $100 million Texas financing** with **other financings in the pipeline**.

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WHERE ARE WE NOW?

- It is no secret that **municipal bond inflows turned into outflows in 2022**, and **borrowing rates have almost doubled in the past year.**
- However, there is no question that this constitutes a **vitally important new major tax-exempt multifamily bond sector**.
- **Our underwriter clients have adjusted the financing model** to enable financings to close, even at today's higher rates.
- 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**.
- While the volume of these financings has fallen dramatically in light of the surge in interest rates in 2022, **financings of this type are once again being closed and processed** in Texas and other states, even at today's rates.
- The 10-year U.S. Treasury yield has fallen 75 basis points from a recent high of 4.20% on October 24 to 3.50% on December 2.
- If this recent decline in interest rates holds, **we expect a renewed increase in the volume of these two major new categories of affordable multifamily bond financings in 2023 and beyond.**

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