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Fort Worth, Texas

## Combining Tax-Exempt, Short-Term Bonds with Taxable GNMA Sale for Affordable Apartment Financings*

Presented by:


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Fort Worth Skyline

**I.** Quick Review: **Basics** of Affordable Multifamily Rental Housing Financings and **Recent Huge Near Miss**

**II.** General **Interest Rate Trends** – Yield Curve **Moving Up and Flattening**

**III.** Recent Developments on Tax Exempt Short-Term Cash Backed Bonds – **No Negative Arbitrage!**

**IV. Three Other Debt Structuring Techniques** to Meet the Competition

**V. Forward Refinancing Opportunities** for Affordable Housing Projects Approaching Year 15

# I. Quick Review: Basics of Affordable Multifamily Rental Housing Financings and Recent Huge Near Miss!

- The Borrower agrees to rent 100% of units to tenants whose income is ≤ **60% of AMI** (family of 4) – and – to **cap rents at 30%** of that amount.
- Obviously depresses revenues versus market rate apartments.
- **BUT,** eligible to **sell 4% LIHTC (and maybe state tax credits)**, which finance **25% to 45% of total development cost** with little give up by general partner on cash flow or residual.
- **50% Test.** To be eligible for full 4% LIHTC, the Borrower **must finance at least 50% of basis in land and buildings** with volume limited **tax-exempt private activity bonds** under Section 142(d) and **keep these outstanding until** the project's **placed-in-service date** (receipt of certificate of occupancy for new construction or completion of rehab for acq/rehab financings.

# Satisfying 50% Test – Since 2008 – Combine Taxable FHA Loan Sales with Short-Term Cash Backed Tax-Exempt Bonds and 4% LIHTC

- Post-2008 Solution: No longer pledge GNMAs to secure long-term municipal bonds. Instead; **flow FHA Lender Funds through Indenture on Tax Exempt Short-Term Cash Backed Bonds**.
- **"Magically" converts FHA Lender Funds into tax exempt bond proceeds,** which are used to cover project costs.
- **Satisfies 50% Test** with, in most cases, **no negative arbitrage** and **50-100 basis points lower** all-in borrowing **rates**.

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# A HUGE NEAR MISS!!!

- **HR1**, the **House version of tax reform**, was a huge meteor which, if adopted, **would have wiped out** tax exempt bonds and 4% LIHTC and **two thirds of the affordable housing** (about 75,000 units per year) **in the United States**.

- **Thanks to the U.S. Senate**, both private activity **bond financing and 4% LIHTC survived** in the Tax Cut and Jobs Act last December.
- So while tax credit equity pricing is down 10-12% due primarily to lower corporate tax rates, the above **financing model is still fundamentally intact**.

- **Major Advantages of Tax Exempt Short-Term Cash Backed Bonds:**
    1. **Qualifies the Project for 4% LIHTC.**
    2. **Still lowers Mortgage Rate by 50 to 100 basis points.**
    3. **Avoids huge (4-8%) negative arbitrage deposit** on new construction/sub rehab (§221(d)(4)) deals.
    4. **Eliminates on-going issuer/administrative fees after 1-3 years; huge benefit** where issuers charge major (25-50 basis points) ongoing fees as long as bonds are outstanding.
    5. **Flexible Financing Alternatives:** Can sell bonds in public offering or private placement and can finance multiple loans in one tax exempt bond issue as long as loans close at the same time.
- Major Disadvantages:

    0. **None** (ok, in a very small percentage of cases, a small negative arbitrage deposit).

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# II. General Interest Rate Trends – Yield Curve Moving Up and Flattening
How Does This Affect….

A. The FHA Mortgage Loan Execution?

B. The Tax Exempt Short Term Cash Backed Bonds?

A 35-Year Down Cycle in Interest Rates may be Ending

**10-Year U.S. Treasury**

**1964 - 2018**


Source: http://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart

- The preceding chart above shows that the **10-year Treasury yield peaked at a rate just under 15.0% in September of 1981 and then declined over three decades to a low of around 1.65% in late June of 2012. We are now 135 basis points above that level**.

# BORROWING RATES ARE UP!

- Since the first of the year, due to the **50 basis point increase in the 10-year treasury yield to 3.0%, all-in borrowing rates are up on all executions.**
- Long term borrowing rates hit a recent low around October, 2017.
- The following table gives approximate recent and current permanent borrowing rates for **Bank private placements and Freddie Mac "TEL"** financings, which comprise 70-80% or more of the tax-exempt debt financings in many affordable multifamily rental markets.

Bank Private Placements and Freddie Mac TEL

| Post-Conversion **("Permanent")** **Borrowing Rates** | October 2017 | **Early May 2018** | |
|---|---|---|---|
| 17-Yr LIBOR | 2.10% | 3.10% | **Up about 100 Basis Points from Fall 2017** |
| Spread (typically 200-250) | 2.00 – 2.50 | 2.00 – 2.50 | |
| | 4.10 – 4.60% | **5.10 – 5.60%** | |

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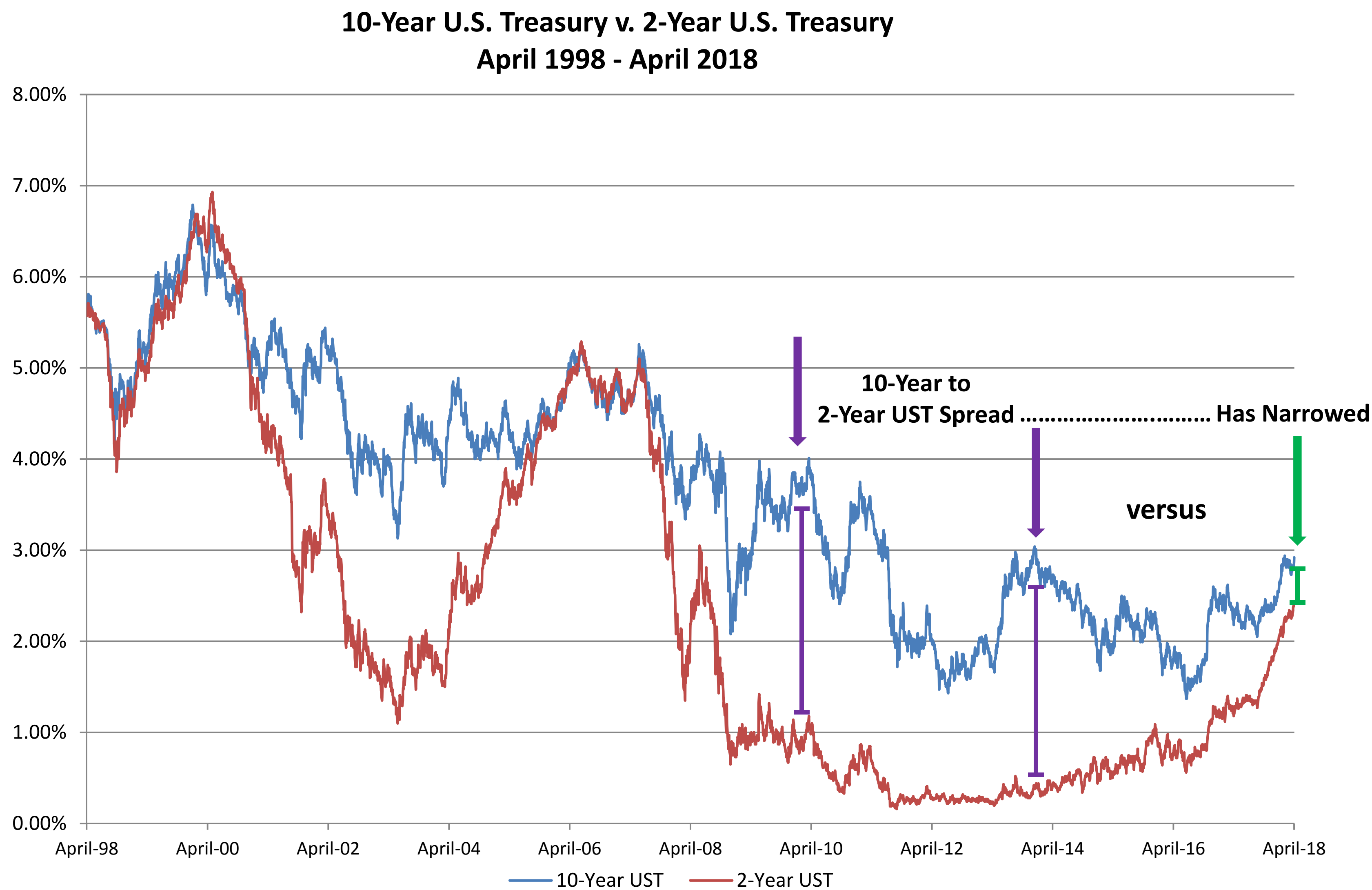
# **BUT FHA** BORROWING **RATES** ARE **UP LESS**!

| | §223(f) (Mod Rehab) | | §221(d)(4) (Sub Rehab/New Construction) | |
|---|---|---|---|---|
| | October 2017 | Early May 2018 | October 2017 | Early May 2018 |
| 10-Year Treasury | 2.30% | 3.00% | 2.30% | 3.00% |
| GNMA to 10-Yr TSY Spread | .75 | .75 | 1.20 | 1.20 |
| Taxable GNMA Pass-Through Rate | 3.05% | 3.75% | 3.50% | 4.20% |
| Servicing/GNMA Guaranty Fee | .25 | .25 | .25 | .25 |
| Stated Mortgage Loan Rate | 3.30% | 4.00% | 3.75% | 4.45% |
| Mortgage Insurance Premium (Affordable) | .25 | .25 | .25 | .25 |
| All-In Borrowing Rate | 3.55% | **4.25% (up about 70 basis points)** | 4.00% | **4.70% (up about 70 basis points)** |

- Comparison with the preceding table shows that all-in permanent **borrowing rates for FHA insured loans have increased about 30 basis points less** than those for **the major competitive platforms.**

# General Interest Rate Trends
# As Rates Increase the Yield Curve is Flattening – i.e., Short-Term Yields have Moved Up Faster (More) than Longer Term Yields

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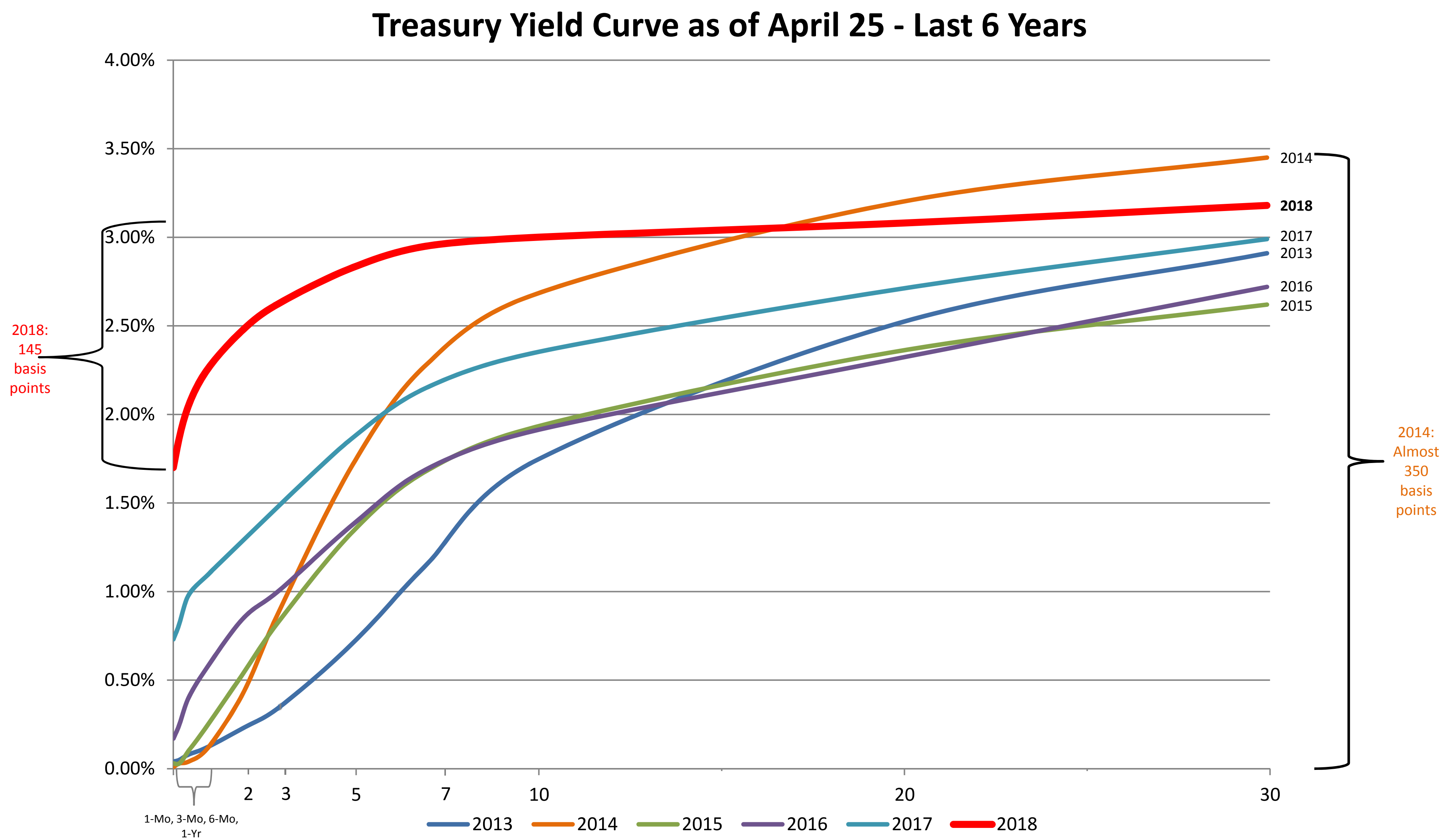


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# Where are Long-Term Rates Headed?

1. No one really knows.

2. Our bet? Somewhat higher – see separate Article.

   a. **"Real" rates still low.** A "normal" 10-year U.S. Treasury yield is 200 basis points above inflation, which recently has been 2.0%. This implies that the 10-year Treasury yield should be 4.0%, 100 basis points above today's 3.0 level.

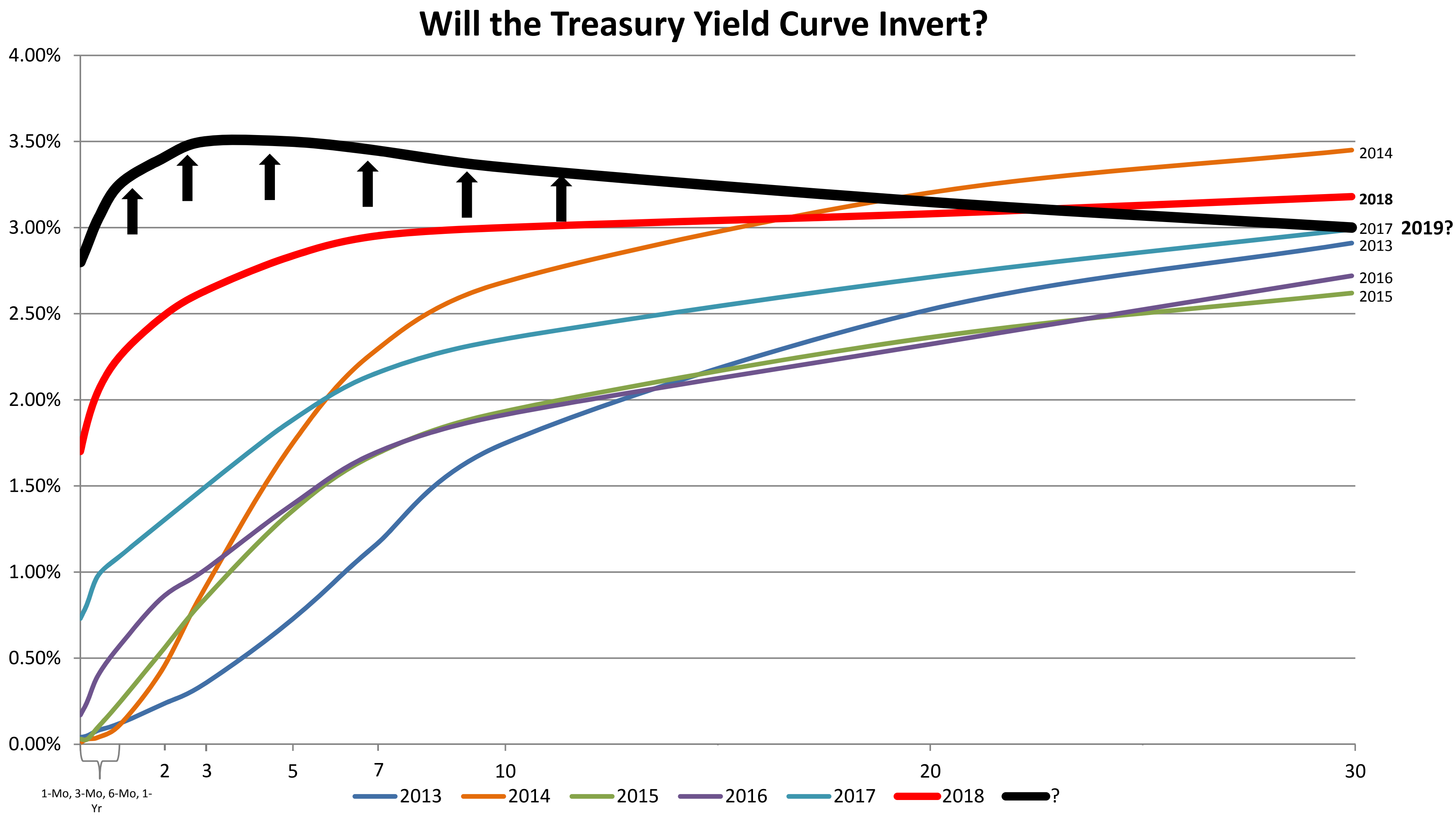
   b. **$3.0 TRILLION Fed Balance Sheet Deleveraging.** The Federal Reserve is just starting $300 billion of MBS and Government Agency securities sales/year (≈ 10% of annual volume) to shrink its balance sheet from the 2008 financial crisis over the next 10 years.

# Where are Long-Term Rates Headed?

c. **Recent Increases in the Federal Deficit.** Tax Cuts & Jobs Act added $1.5 trillion plus Congress has added well over another $500 billion in the last 4 months alone. **Borrowings by the U.S. Treasury are expected to triple** from about $500 billion in the fiscal year ended 9/30/17 to $1.5 trillion in the fiscal year ending 9/30/19.

d. **Borrowers with Poor Credit Pay More.** U.S. Debt to GDP ratio is 72% today; projected to be 100% in 2027.

- And now, New York Fed **Inflation Gauge** (advanced 18 months) has **moved from just under 2.0%** in January to **over 3.0% today! This is a major new development.**

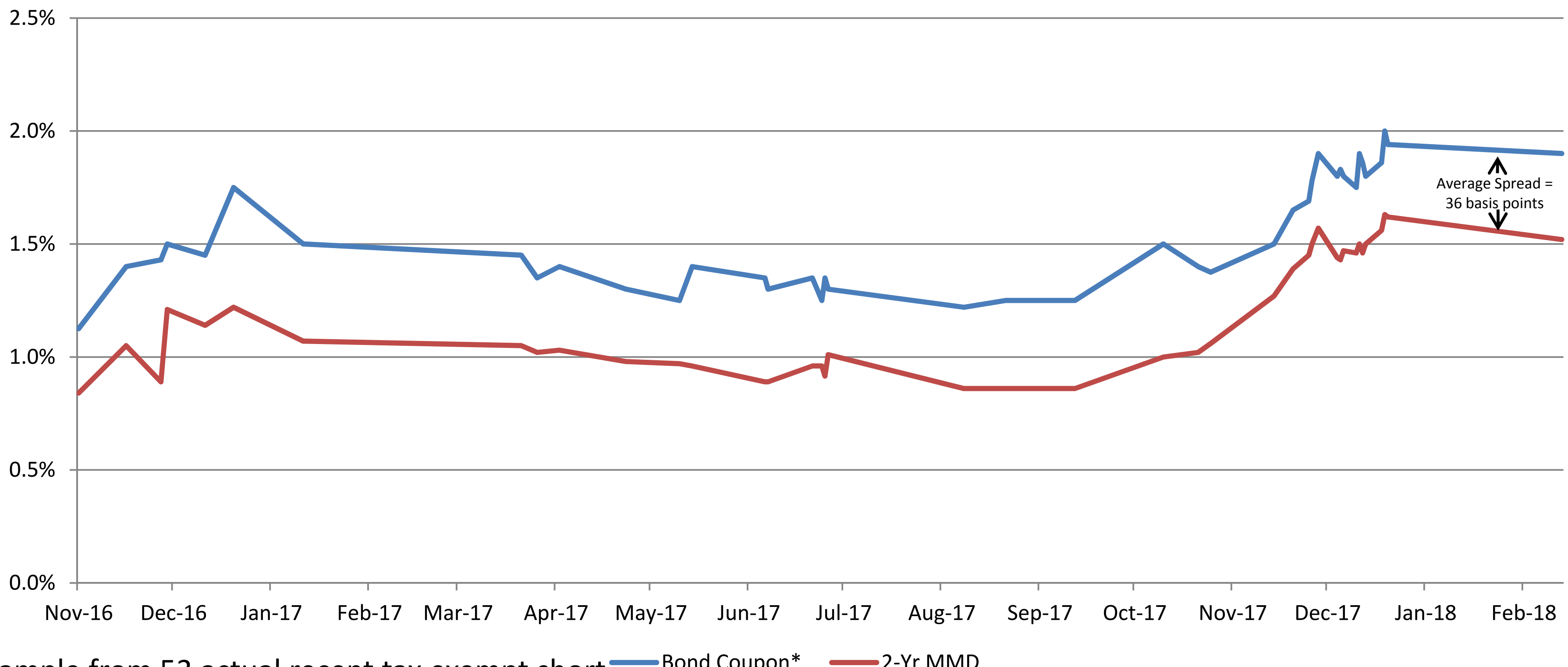



- As the yield curve moves up, it sometimes inverts, meaning short term yields exceed long term yields.
- When this happens a recession often follows within 1 to 1.5 years.
- Something for developers and lenders to watch.

# III. Recent Developments on Tax Exempt Short-Term Cash Backed Bonds – No Negative Arbitrage!

Short-Term **Tax Exempt** Interest Rates **Have Also Begun to Move Up**

**Actual Short-Term Cash Backed Bond Coupons and 2-Year MMD (General Muni Index) November 2016 - February 2018**




*Sample from 53 actual recent tax exempt short term cash backed bond issues in past 18 months.

**But…**

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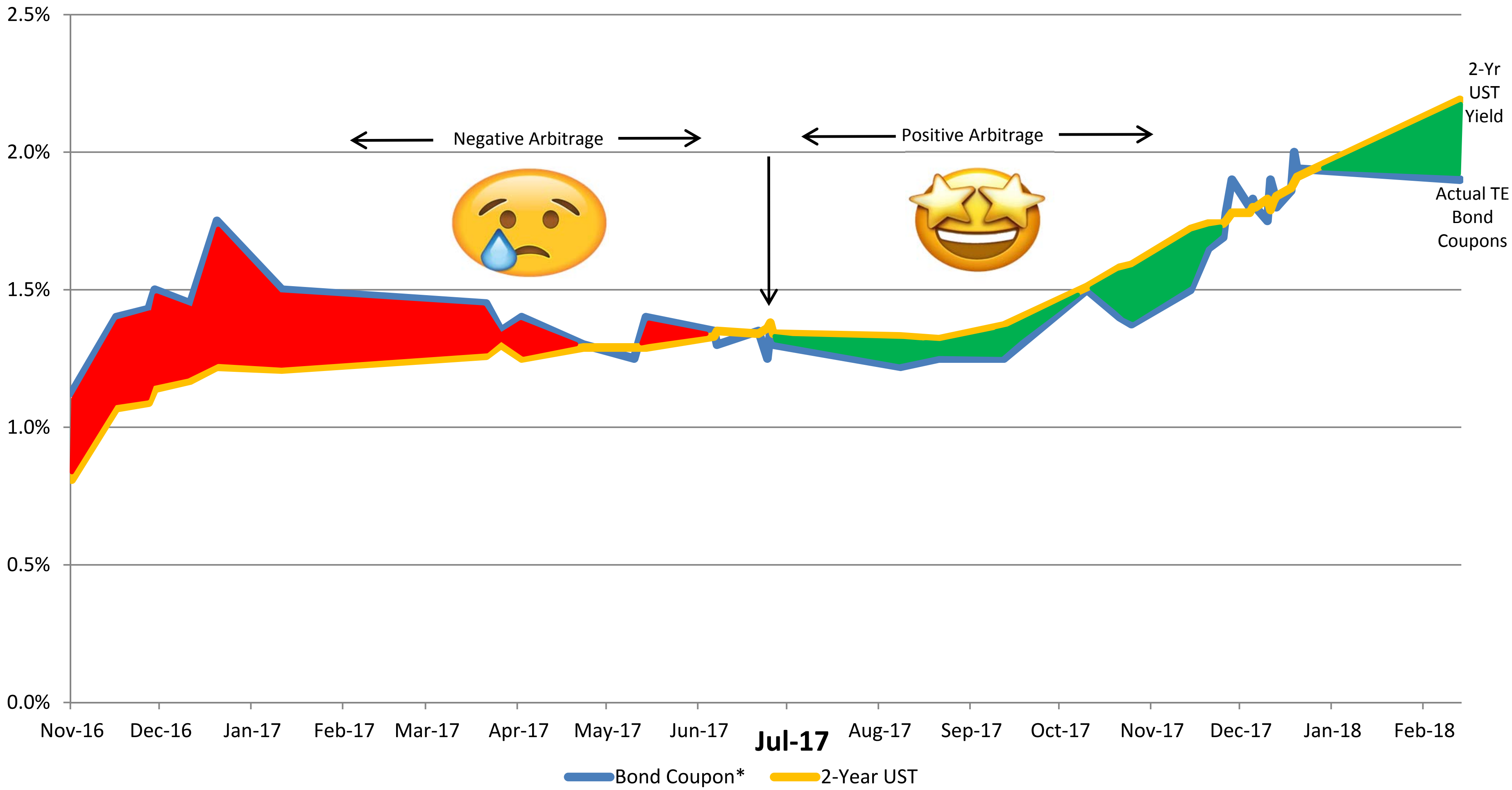
# …**GOOD NEWS!!!**… SHORT-TERM **TAXABLE RATES HAVE RISEN EVEN MORE**!!! → **POSITIVE**, NOT NEGATIVE, **ARBITRAGE**

**Actual Bond Coupons* v. MMD v. 2-Year U.S. Treasury**
**November 2016 - February 2018**




*Sample from 53 actual recent tax exempt short term cash backed bond issues in past 18 months.

# This means… **NO NEGATIVE ARBITRAGE!!!**
# **ON DEALS INVOLVING §223(f)** AND MOST §221(d)(4) **LOANS**


**Example: §223(f)**

| | |
|---|---|
| Expected Placed in Service Date | 12 Months |
| Recommended Tax Exempt Bond Maturity (No Mandatory Tender; No Optional Call) | 18 Months |
| Invest Collateral Fund in 18-Month U.S. Treasury | 2.35% |
| 18-Month Tax Exempt Bond Coupon | 2.05% |
| **POSITIVE!!!** (Not Negative) **Arbitrage** | **+0.30%** |

- **Net Defeasance:** Moreover, if the Borrower makes arrangements for the U.S. Treasuries to be bid and purchased for delivery to the Trustee at closing, **NO DEPOSIT to cover capitalized interest is required** since the investment earnings are locked in at closing!*
- The Trustee, on behalf of the Borrower, simply makes a small yield reduction payment to the U.S. Treasury from the locked-in positive arbitrage (Sorry! Since 1986, you can't keep the positive arbitrage ☹) and you are done!**
- **Only cost on Bond side is** 2-3 points of **costs of issuance**.
- **The best conditions we have had since we played a major role in introducing the structure in 2008!!!**

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*Or invest in SLGS issued by the U.S. Treasury equal to the bond yield, now that the SLGS "window" has reopened.

**Not needed with SLGS investment.

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# How Short-Term Cash Backed Bond Issues Differ when coupled with Section 221(d)(4) versus Section 223(f) Loans

## Much Greater Capitalized Interest!!!

- Section **221(d)(4) loans now make up a very large percentage** of FHA loans we see.
- Have **longer expected placed-in-service dates,** e.g., 1.5 – 2 years, versus 12 months for Section 223(f) loans.
- Thus **the Bonds stay out longer, e.g., 2 – 3 years**.
- Thus **the bond coupons are higher, e.g., 2.0 – 2.10%**.
- Thus **much greater capitalized interest** to be funded at closing **– potentially 4.0 – 5.0% of Bonds**. **Critically important to be able to invest the cash securing the bonds at a rate above the yield on the Bonds.**

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# Sample §221(d)(4) New Construction/Sub Rehab Financing

- Assume: 18-month Construction Period.
- **Recommended Bond Structure**: 36 Month Maturity
  24 Month Mandatory Tender
  No Optional Call

**This is Key: We need a clean Bond Counsel "Reallocation" Opinion**

- **Majority Bond Counsel view. Well over 20-30 bond counsel firms will allow us to invest moneys in** Project Fund and Collateral Fund – i.e., an amount equal to the Bond issue – **in 24 month U.S. Treasuries.***

*Or invest in SLGS issued by the U.S. Treasury equal to the bond yield, which has the same effect.

## Sample §221(d)(4) New Construction/Sub Rehab Financing

- **As the FHA Lender presents monthly FHA Lender advances to Trustee** for deposit to Collateral Fund against disbursement of an equal amount of tax exempt Bond proceeds from the Project Fund to the Borrower/FHA Lender to cover project costs, they will allow us to **reallocate** ownership of this **fixed portfolio** of Treasuries **from the Project Fund to the Collateral Fund without liquidating the investments**.
- We call this a **"Reallocation with No Liquidation" opinion,** or, for short, a **"Reallocation Opinion."**
- Bond Counsel's willingness to give a **Reallocation Opinion** allows us to lock our reinvestment rate and thus is **critical to eliminating negative arbitrage on issues involving §221(d)(4) loans**, **especially** for **new construction**.

*Or invest in SLGS issued by the U.S. Treasury equal to the bond yield, which has the same effect.

# Where a Reallocation Opinion is available…
# NO NEGATIVE ARBITRAGE

§221(d)(4) Loan Example

| | |
|---|---|
| Yield on 24-Month U.S. Treasury | 2.50% |
| Tax Exempt Coupon on Bonds Priced to 24-Month Mandatory Tender | 2.10% |
| **POSITIVE ARBITRAGE** | **0.40%** |

**SAME GREAT RESULT AS ABOVE!!!**


- **Zero capitalized interest cost to Borrower.**

# Where a Reallocation Opinion is available…
# NO NEGATIVE ARBITRAGE

- **We at NG&O are very proud of our record here**. In the last 18 months, we have persuaded over a dozen major bond counsel firms to give a clean Reallocation Opinion. In the **last 6 months alone**, we have persuaded **three major Bond Counsel firms**, including two of Texas' largest, to give a clean "Reallocation Opinion." The resulting **savings to** the borrowers was **$5.1 million on five bond financings aggregating $115 million**. **Yee ha!!!** (Sorry.)

## **POTENTIAL NEGATIVE ARBITRAGE** ON **A SMALL NUMBER OF DEALS** INVOLVING **§221(d)(4) LOANS**

- A very small number of bond counsel firms are not comfortable giving the Reallocation Opinion. ☹
- This can **force** the **investment** of a substantial portion of the cash securing the bonds **into liquid taxable government backed money market funds** which currently **yield only** about **30-40 basis points versus 250 basis points above.**
- Moreover, **this yield cannot be locked in at closing**.
- **Gross Funding of Capitalized Interest:** As a result, instead of making no upfront deposit and making **no** negative arbitrage deposit at closing, on these transactions a substantial portion of the full capitalized interest – **as much as 2.0 or 3.0 points or more** – **must be deposited in bankruptcy remote funds at closing** (i.e., the capitalized interest must be "gross funded," assuming 0% investment earnings).

## **SUBSTANTIAL NEGATIVE ARBITRAGE** ON **A SMALL NUMBER OF DEALS** INVOLVING **§221(d)(4) LOANS**

- **On a $20.0 million bond issue, this is a $500,000 or $600,000 of negative arbitrage or more deposit at closing!**
- On a **substantial rehab loan with a large first draw** to cover project purchase price and other upfront costs, the amount of this negative arbitrage and the size of the upfront deposit **can be dramatically reduced**.
- Even on a new construction loan, **with creative steps**, the issue can be structured so that much of this deposit can be reduced.
- But the **expected negative arbitrage may still be in the hundreds of thousands under this scenario versus $0 above with a reallocation**.
- **Conclusion: Managing reinvestment UPFRONT on bond issues with §221(d)(4) loans becomes critically important.**

- **On a §221(d)(4) financing, especially new construction**, if the **Borrower** has a choice of Issuers and Bond Counsel (**there are often 2 or more choices**), it **should discuss alternatives carefully with the bank or investment bank** structuring the tax-exempt debt and with the bond purchaser's or underwriter's counsel **at the very outset of the financing (i.e., before selecting the issuer and applying for bond volume).**
- Again, **the savings can be hundreds of thousands of dollars.**

## IV. THREE OTHER DEBT STRUCTURING TECHNIQUES TO MEET THE COMPETITION

- Especially in high cost markets, **many projects require a construction loan** that is **much larger than** the supportable **permanent debt**. As noted above, **bank private placements and Freddie Mac's Tax Exempt Loan or "TEL" program** provide 70-80% of the tax exempt debt side executions in many of these markets. A portion of the larger **construction loan often provides critical "bridge" financing** which enables the borrower to pay project costs incurred during the construction/rehab phase which are ultimately reimbursed later from tax credit equity installment pay-ins and later subordinate loan pay-ins.

- **These debt program sponsors will readily provide such a larger construction loan,** since the entire construction loan is secured by a first deed of trust; **with FHA**, on the other hand, **no lien on real estate is permitted to secure a tax credit backed or other bridge loan**.

# IV. THREE OTHER DEBT STRUCTURING TECHNIQUES TO MEET THE COMPETITION

- **Three debt structuring techniques** can make FHA loans more competitive with these competitive executions:
  1. Taxable and Tax Exempt **Tax Credit Equity Backed Bridge Loans**
  2. Taxable and Tax Exempt **Seller Take Back Debt**
  3. Tax Exempt **Cash Surplus Backed Bonds**

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# 1. TAXABLE AND TAX EXEMPT **TAX CREDIT EQUITY BACKED BRIDGE LOANS AND BONDS**

- **On** financings involving an **FHA loan, any bridge loan** must be **secured by a pledge of tax credit equity installments, deep pocket general partner guarantees of completion and payment and/or possibly a pledge of general and/or limited partnership interests**. Such debt can have no claim on the Project and is subordinate to the FHA Loan and payable only from the sources described above.
- Such tax credit equity bridge loans may take one of **two forms**:

**A.Taxable Bridge Loan**

- A taxable bridge loan is sometimes provided by the **tax credit syndicator,** backed by the collateral described above.

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# 1. TAXABLE AND TAX EXEMPT TAX CREDIT EQUITY BACKED BRIDGE LOANS AND BONDS

## B.Tax Exempt Tax Credit Equity Backed Subordinate Bonds

- **A Tax Exempt** Tax Credit Equity Backed Subordinate Bond issue, secured by the collateral described above can also be used.
  - If meeting the 50% test is a challenge, Tax Exempt Tax Credit Equity Backed Subordinate Bonds can sometimes be **delivered to the syndicator** to help meet that test*.
  - A number of our underwriter clients can also structure a **Publically Offered** Tax Exempt Tax Credit Equity Backed Subordinate Bond issue to provide this type of bridge financing on relatively attractive terms.
  - Such a separate series of tax exempt bonds can involve **additional documentation costs** and, if publically offered, will not reduce selling costs, but in the **few cases** where a short-term cash backed tax exempt issue involves **negative arbitrage**, **such an issue can substantially lower the amount of tax exempt cash bonds needed and thus substantially lower the negative arbitrage**.

*These bonds may be taxable to the syndicator, but they will nonetheless count for purposes of meeting meet the 50% test.

# 2. TAXABLE AND TAX EXEMPT **SELLER TAKE BACK DEBT**

The **need for** taxable or tax exempt **bridge loan** financing can often be **eliminated or reduced,** and other financing gaps can be closed, through the use of **"Seller Take-Back Debt."**

**A.Taxable Seller Take Back Note**

- Under this approach, a simple "**Taxable Seller Take Back Note**" is executed by the Borrower and **delivered to the Seller** in lieu of cash, in payment of a portion of the project purchase price. This is often used to **maximize the purchase price** on **RAD transactions and other preservation deals,** where the **new borrower** has been set up by or **has a close relationship with the housing authority or profit-motivated project seller**.
- A **robust purchase price** also **increases the** federal and state **tax credits** available to the purchaser.
- A **simple Taxable Seller Take Back Note** can **dramatically reduce the need for cash at closing.**
- The **proceeds** of a simple taxable Seller Note **may sometimes be escrowed and delivered to the Bond trustee at closing to immediately collateralize part of a short-term cash backed tax exempt bond issue and reduce both selling costs and, in the small number of cases where negative arbitrage is an issue, negative arbitrage**.

# 2. TAXABLE AND TAX EXEMPT **SELLER TAKE BACK DEBT**

**B.Tax Exempt Subordinate Seller Take-Back Bonds**

- As an **alternative**, the seller take-back note or a portion thereof can also be effectively **converted to tax exempt debt by having** the **issuer** of the other tax exempt bonds issued to meet the 50% test also **issue Tax Exempt Subordinate Seller Take-Back Bonds,** backed by a surplus cash note from the Borrower. **Disadvantage: 2 sets of tax-exempt bond documents. Advantage: No underwriting or origination fee on these tax-exempt bonds** since they are acquired by the seller.
- Especially **if the Seller is a for-profit entity**, this also **makes the seller take-back terms more attractive** to the Seller (interest is tax exempt), and these Bonds count as tax exempt debt for **satisfying the 50% Test**, if needed. This **can reduce the size of a Series A Tax Exempt Cash Backed Bonds**, lowering the associated costs and reducing negative arbitrage on those bonds if that is an issue.
- Moreover, the subordinate tax exempt bonds can be **delivered to the Seller** as partial consideration of the transfer of the project **without cash changing hands,** reducing or eliminating the need for bridge financing and putting the FHA execution on a more even footing with private placements and other competitive executions.
- Where ongoing issuer fees are substantial and/or the tax exemption is not valuable to the seller (e.g., a housing authority on a RAD deal), such Tax Exempt Subordinate Seller Take-Back Bonds **can be structured to be exchanged for a simple Taxable Seller Take Back Note** after a specified date by which the parties are confident that the project will have been placed in service.

# 3. TAX EXEMPT **CASH SURPLUS BACKED BONDS**

- With both construction costs and interest rates rising in 2018, and tax credit equity pricing being impaired by lower corporate tax rates adopted in the recent Tax Cuts and Jobs Act, a number of **affordable housing developers are seeking additional funding sources** to plug the gaps left in their financing plans.
- To address these gaps it is possible to structure and sell **tax exempt subordinate bonds secured by a pledge of surplus cash from the Project** as defined in the FHA Regulatory Agreement. Such bonds typically also entail a debt service reserve fund typically sized to cover the maximum annual debt service on the bonds and/or a guaranty of the bonds by a deep pocket general partner of the Borrower.
- **Such bonds are generally structured as term bonds** set to mature, depending on the availability of moneys available from surplus cash term bonds, after the FHA insured loan has been fully amortized. In today's market, they might be expected to bear interest at tax exempt rates of 6.0 to 10.0%. While these rates are higher than most tax exempt bond rates, they are much lower than the yields which would be required to fill these gaps from equity funding sources.

- We are currently considering one financing plan **which would incorporate all three types of the above subordinate tax exempt bonds** – and no tax exempt short term cash backed bonds – to both meet total funding requirements and satisfy the 50% test.

# REMEMBER AND SELL!!!
# UNIQUE ADVANTAGES OF FHA LOANS

- **FHA** insured loan is the **only available credit enhancement which is non-recourse during pre-Conversion phase** – all others (Private Placement, Fannie Mae, Freddie Mac) require deep pocket General Partner guarantees during this phase.*
- On an **FHA 221(d)(4)** sub rehab/new construction loan, there is a cost certification at final endorsement, but **no post closing new loan underwriting**; differs from sub rehab/new construction private placement deals and sub rehab/new construction Fannie/Freddie deals where there is a **new loan underwriting and possible loan downsizing** based on DSC or LTV **at "Conversion." This feature put many borrowers into default in the 2007-2009 downturn.**
- **FHA loans offer a 35 year (§223(f) or a 40 year (§221(d)(4) level payment loan amortization with no balloon; versus a 16 to 18 year balloon** on a private placement, Fannie or Freddie deal.
- **FHA offers greater prepayment flexibility** – e.g., closed for 2 years to 108% decreasing 1% per year thereafter to par versus a 16-18 year lock out (e.g., private placements) or yield maintenance of 12% or higher declining over a longer period (e.g., 15 years) for others (Fannie Mae, Freddie Mac).

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*Note: One cannot avoid guarantees altogether; some guaranties will be required in connection with the 4% LIHTC on these financings.

WITH RATES MOVING HIGHER, CONSIDER…

# V. FORWARD REFINANCING FOR AFFORDABLE HOUSING PROJECTS APPROACHING YEAR 15


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# FACT PATTERN

- Affordable housing developer has a number of **projects approaching Year 15 – 1,2 or 3 years left to run on original QPP; or developer has opportunity to purchase such a project**.
- Believes rates are finally starting to move up (see above).
- Wants to:
    1. Refinance at today's rates – e.g., FHA 223(f) loan at all-in 4.25% rate, 35-year level amortization.
    2. Do a transfer of physical assets (TPA) at no premium or fee and transfer project and today's "low rate" refi loan to new borrower affiliate in Year 15.
    3. Issue short-term tax-exempt cash-backed bonds in Year 15 to prime 50% test; and
    4. Syndicate 4% LIHTC and recapitalize the project in the hands of the new borrower.

# DILEMMA

If too large a loan is transferred, cannot spend the amount of tax-exempt bond proceeds in Year 15 required to satisfy the 50% test.

# YEAR 15

**Uses**

| | | |
|---|---|---|
| Acquisition Cost | $15.0mm | |
| Rehabilitation & Other Costs | $6.0mm | |
| Total Development Costs (Yr. 15) | $21.0mm | → $11.0mm TE Bonds for 50% Test |

**Sources**

| | | |
|---|---|---|
| 4% LIHTC & Other Funds | $8.0mm | |
| Assumed 223(f) Refinancing Loan | $13.0mm | |
| Total Sources | $21.0mm | |

| | |
|---|---|
| Required Tax-Exempt Bond Proceeds Expenditure | $11.0mm |
| Costs to be Paid from Tax-Exempt Bond Proceeds (4% LIHTC & Other Funds Flowed Through Tax-Exempt Bond Indenture) | $8.0mm |
| **"Use of Tax-Exempt Bond Proceeds Gap"** | **$3.0mm** |

# 2 SOLUTIONS

**1. Orrick, Herington & Sutcliffe LLP "look through" theory.**

- Take appropriate steps contemplating Year 15 bonds before taxable refi.
- Can effectively treat part of taxable refi loan as expenditure by new borrower of Year 15 tax-exempt bond proceeds to acquire project in Year 15.
  - Uses 18-month reallocation rules; cannot close refi more than 18 months before new bonds are issued.
  - Section 42 bar has yet to get comfortable with reallocation theory on Section 42 side, but several syndicators and Section 42 counsel considering.

# 2 SOLUTIONS

**2. Available now: Partially Prepayable Refi Loan + Supplemental Loan in Year 15.**

- In above example, split 223(f) refi loan into two components: (i) $10.0mm component with standard prepayment lock out; (ii) $3.0mm component prepayable at par in Year 15 (sold at discount).
- Close $3.0mm Section 241(a) supplemental FHA loan for new borrower in Year 15. $3.0mm supplemental loan and $8.0mm of LIHTC (and perhaps other Year 15 funds) will collateralize the $11.0mm short-term cash-backed issue, freeing up $11.0mm in tax-exempt bond proceeds to acquire and rehab the project as the 50% Test requires.
- Permanent debt financing now consists of original $10.0mm standard 223(f) FHA loan and new $3.0mm supplemental 241(a) loan. "Use of tax exempt bond proceeds gap" disappears.

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# ADVANTAGES AND DISADVANTAGES

- Disadvantages:
  - Difficult to lock pricing/rate on $3.0mm section 241(a) loan in advance of Year 15.
  - Must fit expenditures in Year 15 to be financed from Section 241(a) loan into permitted categories.
  - Costs and funding sources in Year 15 may be difficult to predict.

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# ADVANTAGES AND DISADVANTAGES

- Advantages:
  - Have still locked today's low rates on 70% to 80% of the loan.
  - Substantial Interest Rate Savings

    Assume 3.0% 10-Yr UST → 5.0% 10-Yr UST at Year 15 (200 basis point increase)

    Annual Debt Service on $13.0mm of Debt

| | | |
|---|---|---|
| $13.0mm @ 6.25% ML Rate | $812,500 | |
| $13.0mm @ Split ML Rate ($10.0mm @ 4.25%; $3.0mm @ 6.25%) | 612,500 | |
| **Annual DS Savings:** | **$200,000** | **(25%)** |

**Almost $7,000,000 debt service savings on $13,000,000 loan over 35 years!**

  - Refinance can occur > 18 months before new bonds are issued.
  - Tax analysis very straight forward; should not raise issues on tax-exempt debt or syndication side.

# RESULTS

- Available mechanism for many projects to lock in today’s rates for substantial part of debt needed to recapitalize project at Year 15.
- Not all projects will work; careful analysis of projected sources and uses at refi and Year 15 required.
- But, the locked in **future debt service savings** may be **50% or more** of the refi loan amount and in a higher interest rate environment this **may become a major, transferable project asset.**

The time to refinance is **now!!!**

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