

MATERIALS FOR

**HOUSING CALIFORNIA 2003-  
THE LATEST IN TAX EXEMPT BOND FINANCING**

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**TAX-EXEMPT MULTIFAMILY HOUSING BOND FINANCING  
OPPORTUNITIES**  
**Basic Rules and Financing Structures**

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## TAX EXEMPT MULTIFAMILY HOUSING BOND FINANCING OPPORTUNITIES

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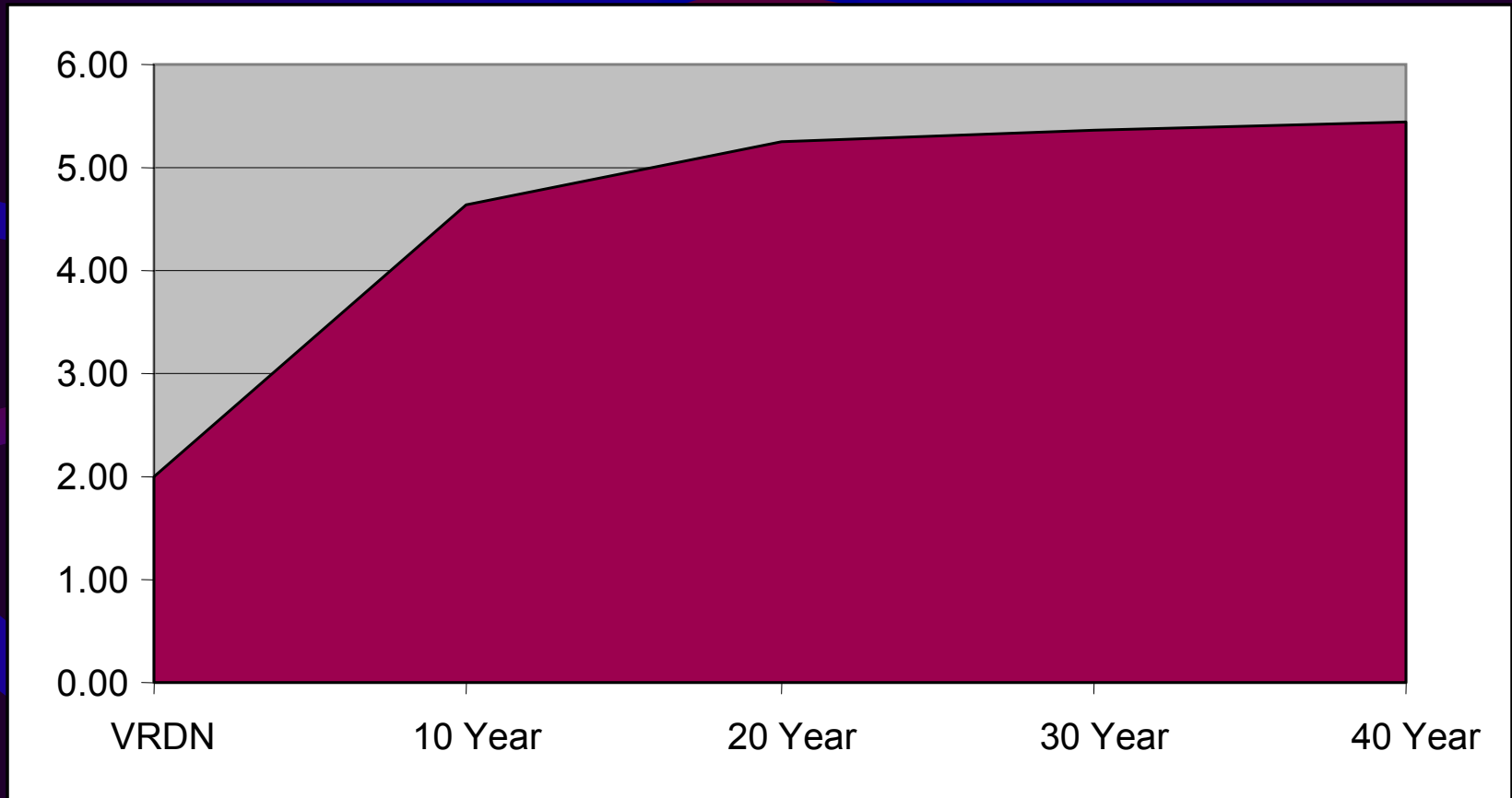
# PART I

INTRODUCTION,  
FINANCING TEAM AND  
TIMETABLE

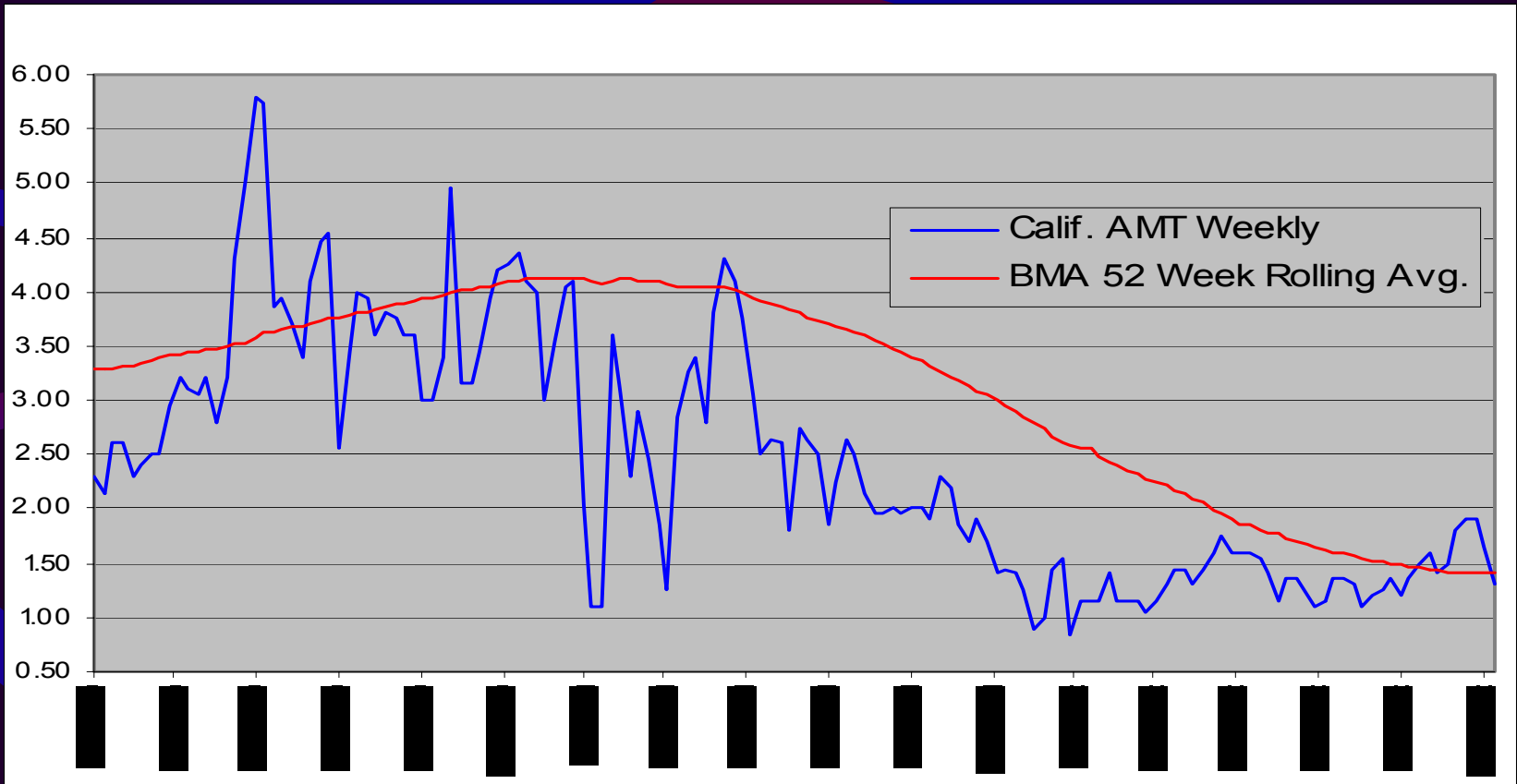
# INTRODUCTION

- **Why do housing developers use tax-exempt bonds?**
  - Long-term
  - Low rate
  - Structuring flexibility
  - “Automatic” tax credit equity

# AAA Tax-Exempt Multifamily Rates



# Variable Interest Rates



## **(2) Additional Equity Proceeds from 4% Low Income Housing Tax Credits.**

- Applies only to new money “private activity bonds” under Section 142(d) for profit-motivated buyers
- Eligible to receive “4%” low income housing tax credits = 25-30% more proceeds

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# BASIC TYPES OF FINANCINGS



- **Financings fall into two categories:**

### **(I) “New Money” Issues**

- Proceeds are used to **finance the construction, acquisition** and, in some cases, **rehabilitation** of a multifamily rental housing project
- This is where substantial majority (75-85%) of current activity is – main focus of today’s panel
- **Three categories, depending on the nature of the borrower:**
  - (1) **Private Activity Bond** issues under **Section 142(d)** -- for **profit motivated owner**, generally combined with 4% Low Income Housing Tax Credits (“LIHTC”) – **This is the big “new money” category** – generally represents 85-90% of “new money” deals

- (2) **“Section 501(c)(3)” Bond** issues under **Section 145** -- for **charitable organization** having a designation under **Section 501(c)(3)** of the Code primarily to
- (a) provide **affordable housing** for persons of lower income, or
  - (b) provide appropriate housing for the **elderly or handicapped,**
- (3) **“Essential Function” or “Governmental Purpose” Bond** issues under **Section 103** -- project to be owned by a **public body**

## (II) “Refunding” Issues

- Proceeds used to **pay off bonds previously issued** to finance a multifamily rental housing project, generally to achieve significant savings in interest rates or due to expiration or change of credit enhancement
- Rules are generally much less restrictive than for “new money” deals
- Cannot be issued on tax-exempt basis more than 90 days before old bonds are retired (unless the project is owned by a Section 501(c)(3) corporation or a public body)

- Typical “New Money” “Private Activity” Bond Financing Structure:

- Has several major financing components:

1. Rated, Credit Enhanced Tax-Exempt (and possibly Taxable) Bonds	~70%
2. Low Income Housing Tax Credit (“LIHTC”) Equity Syndication	~25%
3. Subordinated City or Redevelopment Agency Loan	~5%
Total Proceeds	<hr/> 100%

•Panel will discuss some of the basic rules relating to each of these components, as well as financing structures used

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# FINANCING TEAM

# The Financing Team

- Issuer
- Bond Counsel
- Issuer's Counsel/Financial Advisor
- Underwriter
- Underwriter's Counsel
- Owner
- Owner's Counsel
- Owner's Financial Advisor
- Credit Enhancer
- Credit Enhancer's Counsel
- Construction Phase Credit Enhancer and Counsel
- Tax Credit Equity Provider and Counsel
- Subordinate Loan Provider and Counsel
- Trustee and Trustee's Counsel
- Rating Agency





# FINANCING TEAM

## – The Issuer

- A **key participant**; only public, governmental bodies of type discussed above
- Generally serves as “conduit” in these financings -- doesn’t put its own credit behind the bonds
- Must have authority to issue the bonds for the type of project, given its location – can be redevelopment agency if the project is located in redevelopment area or finding needs that project will benefit the project area



## – **Bond Counsel**

- Passes on the validity of the Bonds under state law and the tax-exempt status of the Bonds under federal and state law
- Drafts the main financing documents such as the Indenture, Loan Agreement and Regulatory Agreement, and the closing papers

## – **Issuer's Counsel/Financial Advisor**

- Advises the issuer on various legal or financial matters relating to the financing
- Not present on all deals, since issuer generally serving as “conduit”

– **Underwriter**

- Assembles the financing team
- Assists project owner (the “Owner”) in choosing optimal financing structure, including credit enhancement, if any
- Assists Owner in assessing availability of private activity bond volume, if applicable
- Coordinates financing participants – Quarterbacks the deal
- Prepares cash flows (for fixed rate financing)
- Obtains rating
- Sells bonds
- May arrange investment agreement, caps and/or swaps, if applicable
- Together with Bond Counsel, coordinates closing

## – Underwriter’s Counsel

- Assists Underwriter in above matters
- Drafts Official Statement to be used in sale of Bonds and prepares Bond Purchase Agreement, Remarketing Agreement (if any), and Continuing Disclosure Agreement (if any)
- Reviews and comments on Bond documents and closing papers for Underwriter
- May assist Underwriter with cash flows
- Clears sale of bonds under various state securities or “Blue Sky” laws

## – Owner

- Develops, builds or renovates, owns and often manages the project
- May be a **profit motivated entity, Section 501(c)(3) corporation, the Issuer itself or another public body**
- Responsible for complying with rules to maintain tax exempt status of bonds (use of proceeds, set-asides, rebate, etc.) and to preserve 4% tax credits, if applicable

## – Owner's Counsel

- Passes on legal matters for the Owner
- **Should be experienced in real estate matters, in Bond financings and, if applicable, in tax credit equity**

## – Owner's Financial Advisor

- Advises Owner on matters relating to interest rates, alternative financial structures, issuer requirements, credit enhancements, LIHTC equity and other aspects of the tax-exempt financing
- May not have on all financings

## – Credit Enhancer

- Like Issuer - **Key participant** - Its requirements **will largely determine the basic terms of the financing**
- Most multifamily bond issues use; assures repayment of Bonds if project revenues insufficient
- Gives Bond issues their AA or AAA rating, which results in the lowest interest rates and lowest borrowing costs for the Owner
- Typical Credit Enhancers include FHA/Ginnie Mae, Fannie Mae or Freddie Mac, Bond insurers (*e.g.*, MBIA, FSA, Ambac, American Capital Access); larger domestic and foreign banks (through letters of credit), and others

## – Credit Enhancer's Counsel

- Drafts credit enhancement documents and passes on legal matters for Credit Enhancer
- Reviews and comments on Bond Documents and closing papers for Credit Enhancer

## – Construction Phase Credit Enhancer and Counsel

- Some highly competitive long-term **credit enhancers** (such as Fannie Mae, Freddie Mac and most bond insurers) generally **will not accept the risk of default during construction or rehabilitation and rent-up** (most banks and FHA will accept this risk)
- Where such a credit enhancer is chosen, a **construction phase credit enhancer (most often the Owner's bank)** will provide a credit facility (often a letter of credit or cash deposit)
- Top tier credit enhancer can draw upon this credit facility if a default occurs before stabilized occupancy (*e.g.*, 90 days' operation at 1.25% or greater debt service coverage) and other permanent loan "conversion" requirements are met
- Almost always represented by outside counsel and are **also key players** in the financing

## – Tax Credit Equity Provider

- Key player on Section 142(d) private activity issues (only)
- Have separate timetable which must be coordinated with Bonds; important for Owner to **select early in the process (at least 2 weeks before Bonds sold)**
- Also represented by inside and/or outside counsel

## – Trustee and Trustee's Counsel

- Administers trust Indenture; makes payments to Bondholders and often disburses bond proceeds
- May be represented by counsel; involve them at an early stage
- Also serves as dissemination agent under the Continuing Disclosure Agreement on most fixed-rate financings

## – Rating Agency

- Rates the Bonds
- “Major” Rating Agencies: Generally Standard & Poor’s or Moody’s
- Most credit enhanced bonds are rated “AAA” or “AA” (Standard & Poor’s) or “Aaa” or “Aa” (Moody’s) (top 2 categories - produce lowest interest rates for an issue of a given maturity)

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# FINANCING TIMETABLE



# FINANCING TIMETABLE

- **General Rule** – May require **4-6 months or more** from outset; some require less time
- Two types of special scheduling requirements for “New Money” issues:
  - (1) **Private Activity issues under 142(d)** – require private activity bond volume allocation
    - Allocation procedures differ widely among states, but
    - Most allocate only once or twice per year
    - Lead time from initial application **to allocation** may be 3 or 4 months, or more
    - Generally need 1 to 2 months, or more, **after** allocation to close – **total process may span 4 or 5 to 6 or 7 months, or more**

**(2) Other “New Money” Issues** - Schedule is flexible, depending primarily upon **Time** required to **obtain Credit Enhancement** Commitment and usually at least **60-90 days** (Fannie Mae, Freddie Mac, Bond Insurance) or at least **90-120 days** or more (FHA, especially new construction or sub rehab)  
**Time to mail POS, price and close** after Credit Enhancement Commitment received (and other critical steps completed, as discussed below)

**Fixed rate deals:** Probably 30-45 days on most -- **total time 4-1/2 to 6 months**, or more

**Floating rate deals:** Probably 15-30 days -- **4-5 months total**, or more

# Timetable – Key Obstacles

- Inducement resolution, TEFRA hearing
- Allocation process
- Permanent & construction loan underwriting
- Tax credit equity solicitation & approval
- Securing other sources of funding
- Official actions
- Document Production

# Timetable – Key Obstacles

- Inducement resolution, TEFRA hearing
  - Good/Bad costs
  - Advertising & publishing
- Allocation process
  - Application windows
  - Closing deadlines
- Permanent & construction loan underwriting
  - Appraisal
  - Plans & specs
  - Approval process
- Securing other sources of funding

# SAMPLE TIMETABLE

# Sample Timetable

## Week(s)

1

- Owner selects Underwriter and works with Underwriter to determine:
  - Appropriate Issuer
  - Availability of private activity bond volume allocation, if applicable
  - Optimal financing structure and possible forms of credit enhancement, if applicable
  - Various other financing participants

# Sample Timetable (cont'd)

## Week(s)

2-6

- Owner and Underwriter finalize proposed financing structure and team
- Application filed with credit enhancer, which begins loan underwriting process
- “Official action” or “reimbursement” resolution passed by Issuer (for “new money” issue)
- Owner applies for private activity Bond volume allocation (on Section 142(d) new money financing --- possible 1-4 month allocation process)

# Sample Timetable (cont'd)

## Week(s)

8-9\*

- Underwriter prepares and circulates initial financing participants list, rough financing timetable and basic term sheet
- “All hands” organization meeting or conference call to review financing

\* These steps may be deferred until volume allocated, if process not predictable



# Sample Timetable (cont'd)

## Week(s)

9-10

- Bond Counsel circulates draft of Bond Documents (e.g., Indenture, Loan or Financing Agreement, Regulatory Agreement)
- Credit Enhancer's Counsel and Construction Phase Credit Enhancer's Counsel (if any) circulate(s) initial draft of credit enhancement commitment(s) and documents
- Underwriter's Counsel prepares and distributes initial drafts of Preliminary Official Statement, Bond Purchase Agreement, Rule 15c2-12 Continuing Disclosure Agreement, if any and Remarketing Agreement, if any (variable rate transactions)

# Sample Timetable (cont'd)

## Week(s)

11-12

- “All Hands” meeting or conference call to obtain comments on initial draft documents
- Draftpersons prepare revised drafts reflecting first round comments
- Underwriter submits documentation and cash flows to Rating Agency

# Sample Timetable (cont'd)

## Week(s)

13-14

- Obtain private activity Bond volume allocation (if applicable) -- **key event** – Starts clock – In California, owner must normally close in 90, 100 or 110 days, or lose allocation
- In past, short extensions (e.g.. 5 business days) sometimes granted, but rarely more
- Notice published (minimum 14 days) for TEFRA hearing by the Issuer
- Initial comments received from Rating Agency
- Documents in “substantially final form” submitted to Issuer

# Sample Timetable (cont'd)

## Week(s)

14-15

- **TEFRA hearing held**
- **Issuer passes Bond Resolution** and approves TEFRA hearing
- **Credit enhancement commitment** (both permanent and, if applicable, construction) **received**
- **Rating received** from Rating Agency
- **4% LIHTC equity commitment** delivered and basic equity structure finalized
- **Objective/Result: Preliminary Official Statement** finalized, “deemed final” by the Issuer and/or Owner for SEC Rule 15c-212 purposes and **mailed**

# Sample Timetable (cont'd)

## Week(s)

15-16

- **Underwriter prices and sells Bonds**
- Bond Purchase Agreement executed
- Parties commence preparation of final documents, including pricing information
- Bond Counsel circulates Closing Papers

16-17

- Conference call to discuss comments on final Closing Papers and Documents prior to Closing
- Final Official Statement printed and mailed

17-18

- Transaction **preclosed** one day and **closed** and funded on the following day or the second following day

# PART II

BASIC LEGAL (TAX) RULES  
APPLICABLE TO BONDS  
AND 4% TAX CREDITS



# BASIC TAX LAW REQUIREMENTS

“NEW MONEY” ISSUES

# BASIC TAX LAW REQUIREMENTS: THREE MAJOR TYPES OF NEW MONEY ISSUES

New Money: Bonds issued to construct or acquire (and rehab) projects

Three major types of “New Money” issues, depending on the nature of the **borrower**:

- **Private Activity Bond issues under Section 142(d).** Bond proceeds loaned to a **profit motivated owner** to build or to acquire and rehabilitate qualified residential housing facilities
  - This is the **BIG Category** – accounts for 85-90% or more of all “New Money” financings
  - Only type of Bonds which entitle borrower to 4% Tax Credit Equity
- **“Section 501(c)(3)” Bond issues under Section 145 of the Code.** Bond proceeds loaned to a **charitable organization** having a designation under Section 501(c)(3) of the Code to build or acquire facilities for its mission of
  - Providing **affordable housing for persons of lower income**
  - Providing appropriate housing for the **elderly or handicapped**



# BASIC LEGAL REQUIREMENTS TO ACCESS TAX-EXEMPT BOND MARKET

- **“Essential Function” or “Governmental Purpose” Bond issues.** Bond proceeds used by a state, city, county, redevelopment agency, housing authority or other **public entity**, or by an instrumentality of such a public governmental body, to provide **facilities to be owned by the public body** in the pursuit of its public functions

# **“PRIVATE ACTIVITY BONDS” FOR PROFIT MOTIVATED SPONSORS WITH 4% TAX CREDITS**

## **Major Tax Exempt Bond Rules Under Section 142(d) (Rules Under Section 142(d) Very Similar to Those for Tax Credits under Section 42)**

- **Residential Rental Housing Facility**
  - “Rental”: Tenant must rent unit; no condos
  - No transient use (no hotels, rooming houses)
  - Complete living units (minimal kitchen and bath); no “SRO’s”

# “PRIVATE ACTIVITY BONDS” FOR PROFIT MOTIVATED SPONSORS WITH 4% TAX CREDITS

## Major Tax Exempt Bond Rules Under Section 142(d)

- **20/50 or 40/60 Income Targeting**
  - Rent 20% of units to families with incomes  $\leq$ 50% area median, or rent 40% of units to families with income  $\leq$ 60% area median income
  - Above limits for family of 4; **adjust up or down for family size** (like HUD under Section 8)
  - **Annual recertification:** If income rises above **140%** of applicable income limit, next unit of equal or smaller size must be rented to qualifying tenant
  - Lasts **at least 15 years**, or as long as Bonds outstanding (if longer)

# “PRIVATE ACTIVITY BONDS” FOR PROFIT MOTIVATED SPONSORS WITH 4% TAX CREDITS

## Comparison to Targeting Rules under California Redevelopment Law

- Federal Targeting rules differ slightly from rules applicable where Redevelopment Agency in California (i) issues bonds for multifamily project, (ii) pledges low or moderate income set-aside or other tax increment revenues to support the bonds or (iii) makes a loan for such a project
- Requires at least 20% (15% in targeted area) of units to be occupied by or made available to persons of **low or moderate income** (generally **80%** of area median income), adjusted for family size, but based on following occupancy assumptions (rather than actual occupancy, as under federal law):

Unit Size	Assumed Number or Occupants
Studio	1
1 – Bedroom	2
2 – Bedroom	3
3 – Bedroom	4
4 – Bedroom	5

# “PRIVATE ACTIVITY BONDS” FOR PROFIT MOTIVATED SPONSORS WITH 4% TAX CREDITS

- One half of **above** units must be occupied by, or made available to, persons of **very low income** (generally 50% of area median income), adjusted for family size based on assumptions in table from previous slide, **and**
- **Rents charged** on these **very low income units** may **not exceed 30% of 50%** of area median income, adjusted for family size, based on assumptions set forth in the table from the previous slide
- Bond financed multifamily property where (redevelopment agency is issuer or makes loan) must satisfy **both** federal and California redevelopment agency law requirements

# “PRIVATE ACTIVITY BONDS” FOR PROFIT MOTIVATED SPONSORS WITH 4% TAX CREDITS

## Major Tax Exempt Bond Rules Under Section 142(d)

- **Private Activity Bond Volume Allocation Requirement**
  - In 1986 Congress placed volume limits (now greater of \$75.00 per person or minimum of \$225 million per state) on quasi-public “private activity bonds” – In California, total is over \$2.6 billion
  - Such bonds include wide range of uses, including pollution bonds, student loan bonds, single family mortgage revenue bonds and other categories, as well as multifamily housing bonds

# “PRIVATE ACTIVITY BONDS” FOR PROFIT MOTIVATED SPONSORS WITH 4% TAX CREDITS

## Major Tax Exempt Bond Rules Under Section 142(d)

- In recent years much more private activity bond volume has become available, including more volume for multifamily housing
  - Multifamily share in all of U.S. has grown from about \$1.0 billion or 7% of all volume in 1995 to 30% or about \$6.5 billion in 2002
  - **California - \$1.4 Billion** – California leads the nation in allocation to Multifamily
  - New York - \$600 Million
  - Florida - \$400 Million
  - Texas - \$380 Million
  - Georgia - \$250 Million
- But some states allocated no private activity bond volume to multifamily
- Important to determine availability of bond volume for your project up front



# CALIFORNIA PRIVATE ACTIVITY BOND VOLUME FOR MULTIFAMILY

- *California has allocated approximately \$1.434 billion or almost 55% of its total private activity bond volume to multifamily for 2003*
- *Getting an Allocation*
  - *Private activity bond caps*
  - *State allocation of cap*
  - *Methods of allocation*
  - *Minimum requirements*
  - *Timing considerations*



# CALIFORNIA PRIVATE ACTIVITY BOND VOLUME FOR MULTIFAMILY

- *California's Allocation Schedule - \$1.434 billion*
  - *Round 1 - \$430mm*
    - *January 15th application, March 26th award*
    - *\$290mm General, \$66mm Mixed-Income, \$15mm Rural*
  - *Round 2 - \$430mm*
    - *April 16th application, June 25th award*
    - *\$290mm General, \$125mm Mixed-Income, \$15mm Rural*
  - *Round 3 - \$574mm*
    - *July 16th application, September 24th award*
    - *\$387mm General, \$167mm Mixed-Income, \$20mm Rural*

# CALIFORNIA PRIVATE ACTIVITY BOND VOLUME FOR MULTIFAMILY

- *California's First Round – Final Results*
  - *General Pool - \$290mm available*
    - *33 of 34 qualifying applications totaling \$387mm in requests*
    - *High score 125, Low score 60, Cutoff 70*
  - *Mix-Income Pool - \$66.4mm available*
    - *3 of 4 qualifying applications totaling \$75mm*
    - *High score 78, low score 68*
  - *Rural Pool - \$15mm*
    - *3 qualifying applications totaling \$8mm*
    - *High Score 94.5, low score 77*

# CALIFORNIA PRIVATE ACTIVITY BOND VOLUME FOR MULTIFAMILY

- *California Application Prerequisites*
- *Site Control*
- *Entitlements*
- *Inducement Resolution*
- *TEFRA Hearing*
- *Enhancement commitment or private placement letter*
- *Market Study*

# CALIFORNIA PRIVATE ACTIVITY BOND VOLUME FOR MULTIFAMILY

Category	Points
At Risk	20 (10 for below mkt. rent)
Affordability	15 Mixed Income, 35 General
Term of affordability	10
Below market rate rents	10 (coordinate with at risk)
Gross Rents	5
Large family units	5

# CALIFORNIA PRIVATE ACTIVITY BOND VOLUME FOR MULTIFAMILY

Category	Points
Leveraging	10
Sustainable Development	15
Site characteristics	10
Site amenities	10
New Construction	10
Energy efficiency	7
<b><i>TOTAL</i></b>	122 Mixed Income, 142 General

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

## Good News:

- Eligible for 4% LITC equity – 25-30% more proceeds

## Bad News:

- Private Activity Bond Volume Allocation Requirement – Takes time and may not be available

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

## OTHER TAX EXEMPT BOND REQUIREMENTS UNDER SECTION 142(d)

### 15% Rehab Requirement on Acquisition Financings

- Spend 15% of portion of depreciable cost of buildings and fixtures financed with Bonds for rehab within 24 months

### No tax-exempt refinancing for existing owner

### Other Requirements

- Bonds subject to AMT
- Official Action; 95% Good Cost Test; 2% Cost of Issuance Limitation
- Public Approval or “TEFRA” requirement (“NIMBY” problems)

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

## MAJOR 4% TAX CREDIT EQUITY RULES (SECTION 42)

- How does Low Income Housing Tax Credit Equity work?
  - Section 42 permits investors in qualified projects to claim an **annual credit against federal income tax for a 10-year period** after the project is placed in service
  - **Amount of credit which can be taken each year** is a specified percentage (e.g., approximately 4% or approximately 9%) of the “**qualified basis**” of the property
  - Example: If qualified basis = \$10.0 million, 4% x \$10.0 million = \$400,000/yr. for 10 years = \$4.0 million = 80¢/\$1.00 (discount to net present value plus risk) = \$3.2 million/yr. proceeds from sale of 4% credits



# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

- This is a **tax credit** – better than an income tax deduction: **Each dollar of credit offsets one dollar of tax liability**, not just 15 to 40+¢ as is the case with an income tax deduction
- Award of “9%” credits (which can’t be used with tax exempt bonds) is generally **much more valuable** than combination of tax exempt bonds and “4%” credits (roughly 70% of development costs versus roughly 30%), **but the borrower must compete** for “9%” credits in a very competitive state pool. Getting a private activity bond volume allocation is generally much easier. **Bond volume allocation carries with it a separate almost “automatic” allocation of 4% credits** if proper steps are followed
- In California, it involves a separate application and approval process with TCAC, but the primary issues are ones of timing if the proper steps are taken

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

- **10-Year Holding Period:** Generally speaking, project must have been owned by prior owner for at least 10 years to be eligible for 4% credits
- **50% Test:** At least 50% of aggregate basis of the building and land must be financed from **tax exempt** bond proceeds to get full value for 4% credits

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

- **Generally same 20/50 or 40/60 income targeting** as Bond test under Section 142(d) of the Code, but most tax credit projects are 100% affordable to maximize tax credits – tax credits are only paid on the targeted units
- Unlike bond rules, **tax credit rules limit rents charged on targeted units to 30% of the applicable income limit** for the targeted unit, similar to rent caps on very low income units under California Redevelopment Law, but with federal (not California) family size adjustment mechanism

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

- Tax credit units must continue to comply with above limitations for at least **15 years after placed in service**, or tax credit investors subject to “recapture” of tax credits claimed
- **If project loan defaults and credit enhancer forecloses, remaining years’ credits convey with the property**, even though original tax credit investor paid for the entire stream of credits in first one or two years. Thus the tax credit investor, like the credit enhancer, will take various steps to minimize possibility of a loan default

# “PRIVATE ACTIVITY BONDS” WITH 4% TAX CREDITS (cont’d.)

## Conclusion

- Where private activity bond volume allocation is available for a project, a combination of private activity bonds and 4% Tax Credits will produce by far the greatest amount of proceeds to finance the project.
- **Note:** Non-Profit sponsors can use this mechanism. They simply become the sole general partner of a partnership which applies for private activity bond volume, but must have financial wherewithal to provide guarantees of completion, rent-up and stabilization required by syndicator of 4% LIHTC equity

# BASIC RULES – SECTION 501(c)(3) FINANCINGS UNDER SECTION 145

## Good News:

- No Volume Allocation Requirement

## Bad News:

- No LITC equity

## Two Major Charitable Purposes

- **Affordable Housing** – Generally same as 142(d) targeting, plus additional requirements:
  - 75% at no more than 80% of area median; 25% can be market rate
  - Rents no greater than 30% of applicable income limit

# SECTION 501(c)(3) FINANCINGS

- **Two Charitable Purposes (cont'd)**

- **Appropriate Housing for Elderly or Handicapped**; does **not** have to meet rules, if:
  - New construction or very substantial rehab
  - Facility does not have complete living units
  - Continual or frequent nursing, medical or psychiatric care is provided (Revenue Ruling 98-47)
  - Governmental entity puts its credit behind the Bonds
- **Does** have to meet 142(d) lower income targeting if an **acquisition** and none of above exceptions apply.

# SECTION 501(c)(3) FINANCINGS

- **Need established 501(c)(3) or must go through Internal Revenue Service**
- **Various Roles for Private Parties**
  - Fees/prices must be competitive to avoid “private inurement” or “excess private benefit”
  - Must leave some economic ownership (surplus cash flow/residual) in Section 501(c)(3)
  - Even if fees and prices competitive, numerous and substantial commercial benefits to private parties outweighing a marginal public purpose may trigger “excess private benefit”



# SECTION 501(c)(3) FINANCINGS

- **Closing “Equity Gap”**
  - Creative Seller Take Back and/or Developer Fee financing through Subordinated Bonds

# BASIC RULES – ESSENTIAL FUNCTION/GOVERNMENTAL PURPOSE BONDS

- Free of almost all of the above restraints
- Public body must be true owner; no private inurements
- Equity gap financing possible problem, as with Section 501(c)(3)  
Bonds



# BASIC TAX LAW REQUIREMENTS

## REFUNDINGS

# Federal Tax Law Requirements – Refundings

- Refundings: Bonds issued to pay off an existing tax-exempt bond issue on a project
- Two Primary Rationales
  - Reduction in interest rates
  - Expiration or other replacement of prior credit enhancement

- **More Liberal Rules than “New Money” Deals**
  - **No volume allocation**, but “issue price” of tax-exempt refunding cannot exceed outstanding balance of prior bond issue (any excess generally will be structured as taxable bonds)
  - **“Old” targeting requirements** – *i.e.*, **80/20** with **no adjustment** for family size (if original bonds are pre-1986)
  - **No 15% rehab requirement**
  - **Not subject to AMT** (if original bonds are pre-1986)



PART III

FINANCING STRUCTURES  
AND  
CREDIT ENHANCEMENTS

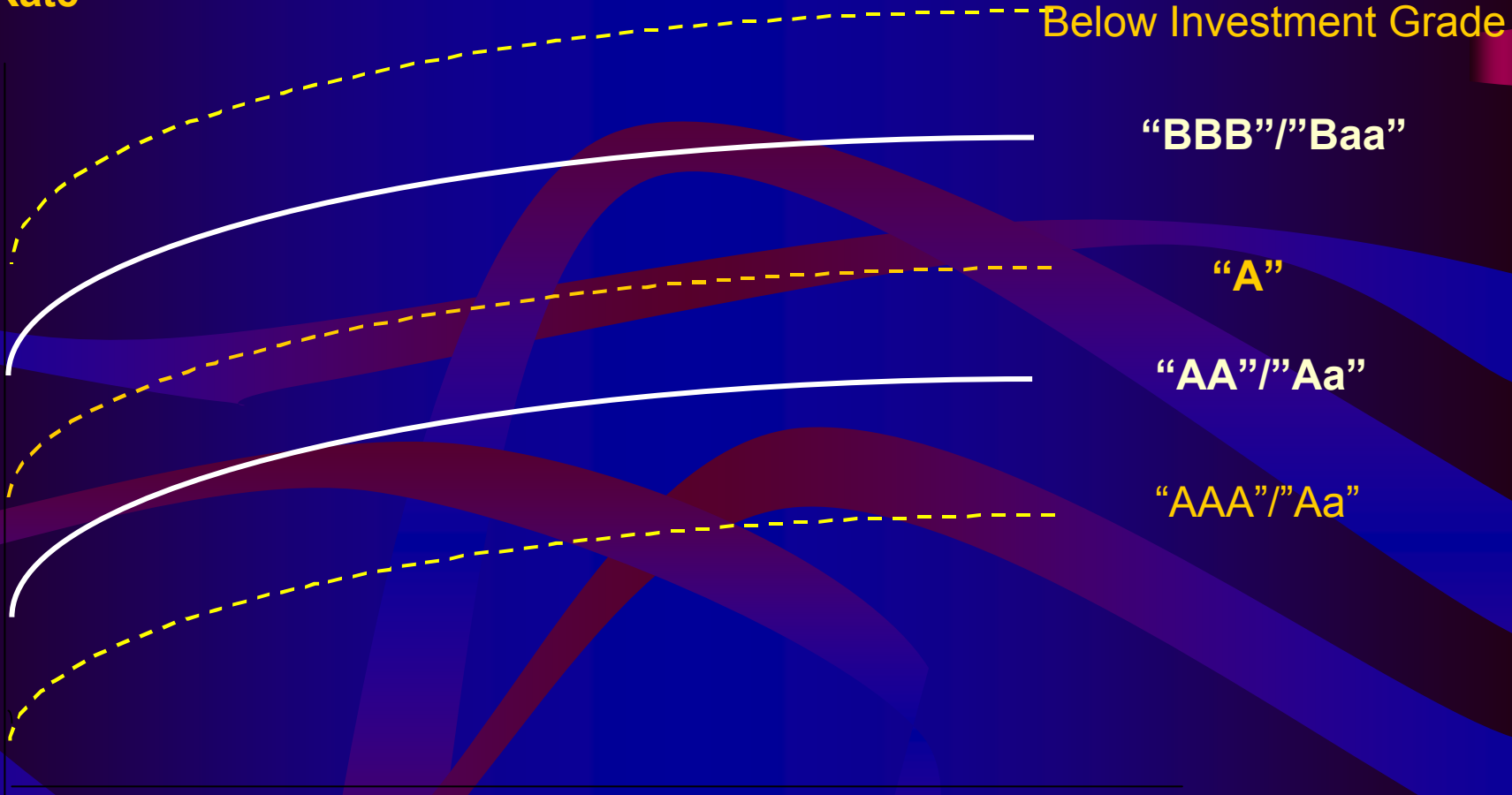
# Alternative Financing Structures

- General – numerous financing structures used
  - **Most credit enhanced, AA or AAA rated**
  - **Some** issues may have **lower rating**, usually “BBB” or “A” (lowest two tiers of “investment grade”), based on project cash flows and/or loan-to-value
  - **Unrated, non-credit enhanced** issues or series sometimes also sold in large minimum denominations to sophisticated individual or institutional investors, where issuer is willing
  - **“Senior/sub”** structure may be used in these situations where payment of debt service on one series is made in full before any debt service is paid on the subordinated series (usually “Series B” and/or “Series C”)

# YIELD CURVES

## Quality of Debt

Interest  
Rate



Time



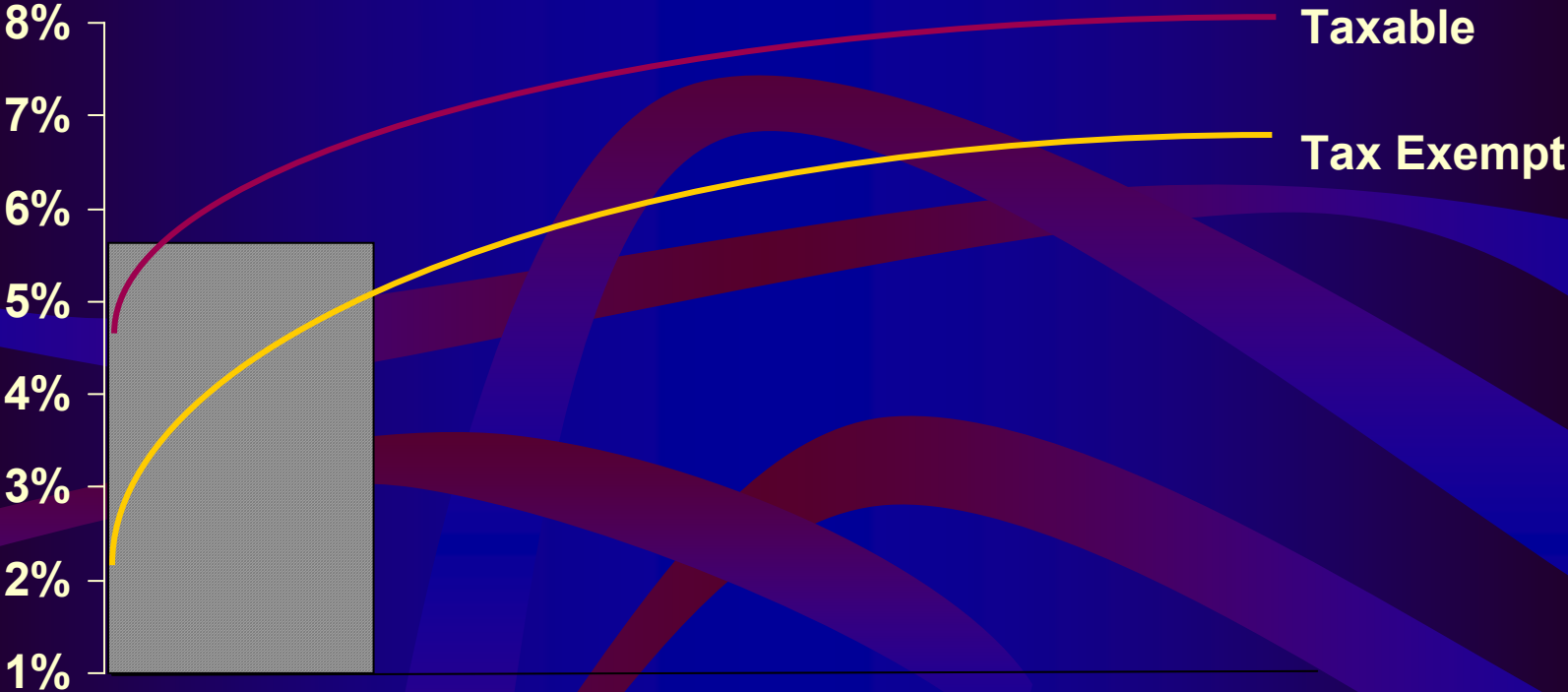
# • Fixed Rate versus Variable Rate Financings

## – General

- Tax-exempt yield curve almost always is significantly “upward sloping,” especially for first ten years
- Recent rates: 1.0% to 2.0% for AAA/A-1+ rated, 7-day demand “lower floater” bonds
- Recent rates for 30 to 40-year tax-exempt, AAA rated multifamily bonds: 5.00% - 5.50% or less
- In many markets, differential has been 300 basis points or higher; currently closer to 400 basis points.

# YIELD CURVES Taxable and Tax Exempt

Interest  
Rates



Time

## – Variable Rate Financings

- May enable borrower to achieve **lowest financing rate** over time
- Carries with it **risk of interest rates rising** above level which project cash flow will support
- Most credit enhancers will require developer to **purchase an interest rate “cap” or enter into “swap”** for at least the first **five to seven years** of the financing
- Borrower **annually escrows** a pro rata portion of the estimated cost of purchasing **successor cap or swap**

## – Fixed Rate Financings

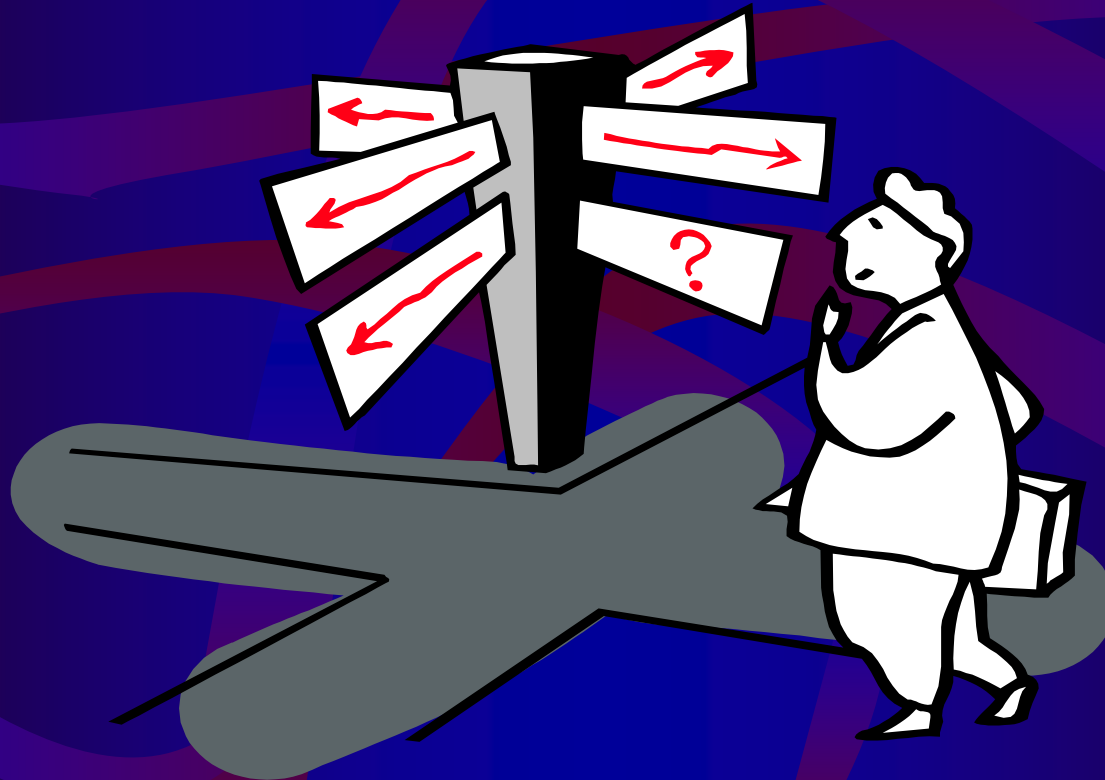
- **To avoid risk of resetting interest rates**, many developers and credit enhancers prefer “fixed rate” structure, where the interest rate(s) on the bonds are fixed for the entire life of the issue
- **Most conservative approach**

## – Hybrid Structures

- **“Put bonds,”** where interest rate is set for fixed number of years (*e.g.*, one, five, seven or ten, after which the yield curve becomes rather “flat”), with a mandatory tender and remarketing of bonds at end of initial fixed rate marketing period
- **On some new money private activity bond issues under Section 142(d)**, interest rate may be fixed to a mandatory tender date after the end of 15-year tax credit compliance period under Section 42 (*e.g.*, **18 to 21 years**), with remarketing of Bonds to maturity contemplated at that time
- Some variable rate financings allow Owner, with consent of Credit Enhancer, to **shift among any number of these modes** (*e.g.*, daily floating, seven-day floating, monthly, quarterly, yearly, reset (longer than one year but less than maturity)) and fixed (remarketing to maturity).

- A major role of the Underwriter in a tax-exempt multifamily housing bond financing is to assist the Owner in selecting the financing structure and credit enhancement (if any) most appropriate for his project

# Alternative Transaction Structures



# Which is the Right Structure?

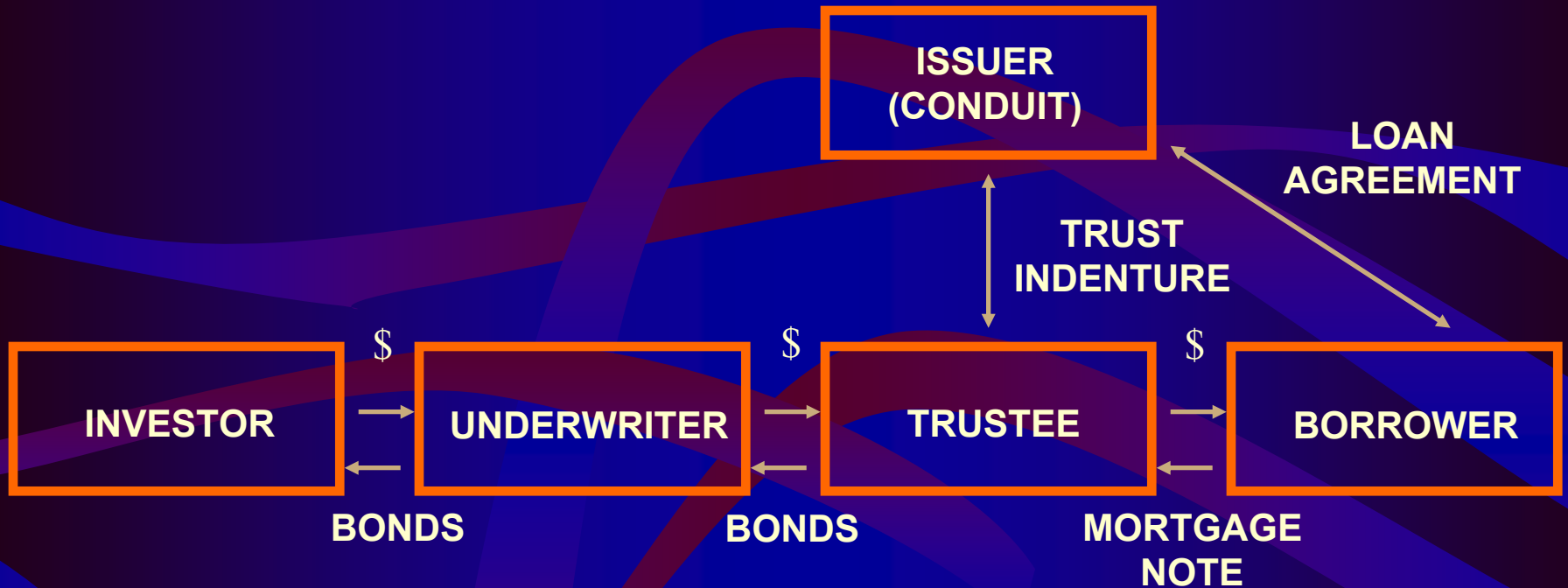
- Project Type
- Development Costs
- Capital Structure
- Borrower Financial Strength
- Timeframe
- Rates
- Fees



# Financing Alternatives

- **Non-Credit Enhanced**
  - **Private Placement**
    - **Conduit (e.g. Newman Capital)**
    - **Bank portfolio**
  - **Stand-Alone Bond Rating**
    - **Standard & Poor's Affordable Housing Program**
    - **Moody's Affordable Housing Program**

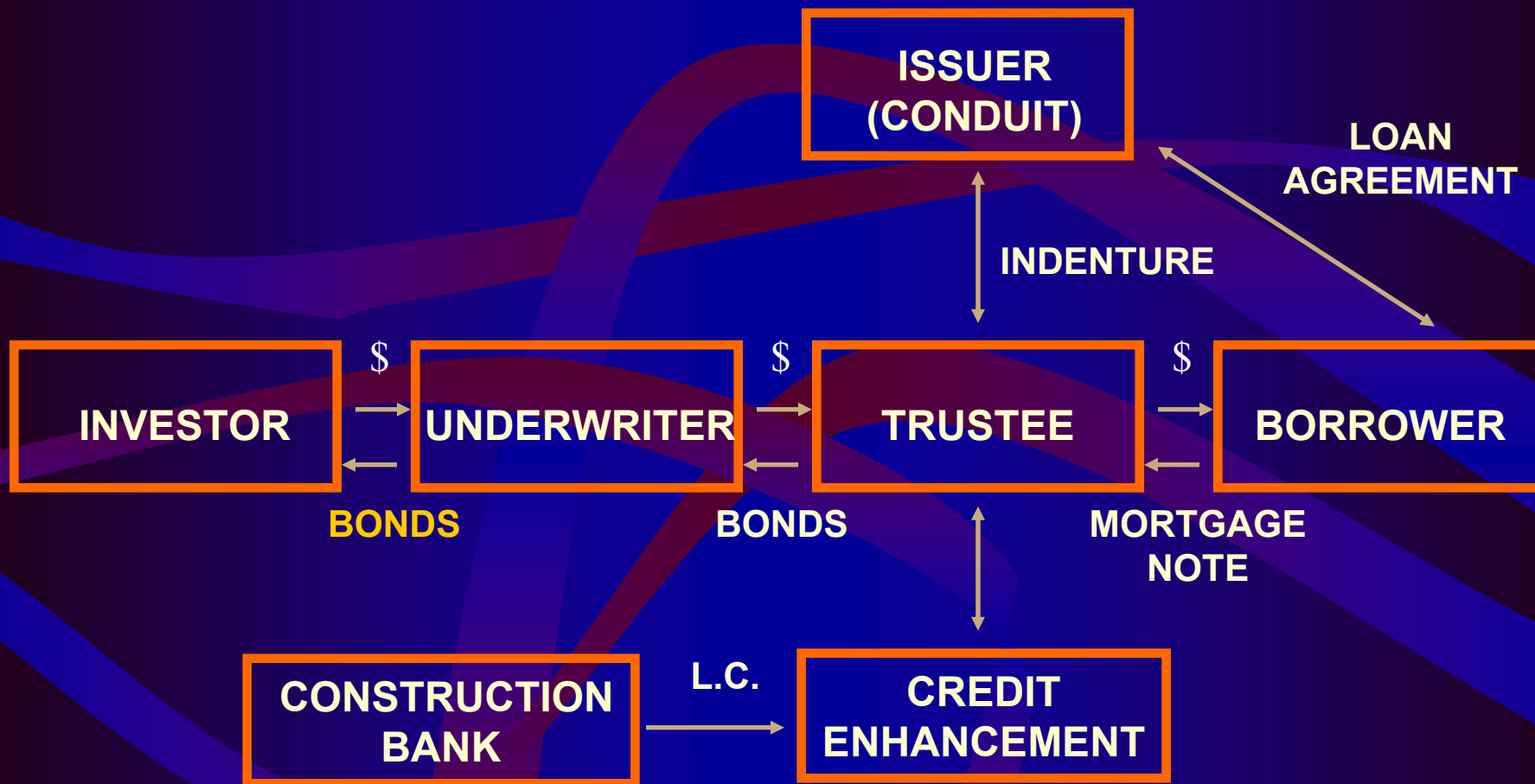
# Non-Credit Enhanced Structure



# Financing Alternatives

- Credit Enhanced
  - **FHA / GNMA**
  - **Fannie Mae and Freddie Mac**
  - **Bank Letters of Credit**
  - **Bond Insurers**

# Credit Enhanced Structure



# Credit Enhanced Structures

## *FHA 221(d)(4) / GNMA*

### **Program for New Construction/Substantial Rehab**

- Qualified Projects
  - New construction
  - Substantial rehab
    - (i) rehab cost > 15% of replacement cost,
    - (ii) \$6,500+/unit (adjusted for high cost factor), or
    - (iii) 2 or more major building components (i.e., roofing, siding, etc.)
- Underwriting Terms
  - Debt service coverage requirements 1.11x
  - 40-year amortization
  - 90% of FHA replacement cost (including land)
  - Fixed rate only

**FHA/GNMA may comprise 10-20% of all multifamily credit enhancements**

# Credit Enhanced Structures

*FHA 221(d)(4) / GNMA*

**Program for New Construction/Substantial Rehab**

## Rate Calculation

Tax-Exempt 40-yr Bond Rate	5.25%
Ginnie Mae	.25
Trustee Fee	.05
Issuer Fee	.13
Mortgage Rate	5.68
Mortgage Insurance Premium (MIP)	.5
<b>Total effective Interest Rate</b>	<b>6.18%</b>

## Fees (est.)

Lender Origination	1.0-2.0%
MIP due at Closing	.5
Bond Costs of Issuance	2.0-3.0
FHA Application Fee	.3
FHA Inspection Fee	.5
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	4.3-6.3%

## Negative Arbitrage Deposit

Actual – Cash	1.5%
Worst Case – LOC	4.0
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	5.5%

# Credit Enhanced Structures

## *FHA 221 (d)(4) / GNMA*

### **Program for New Construction/Substantial Rehab**

- Advantages
  - Provides both construction and permanent financing
    - one origination fee/one underwriting process
    - No conversion/stabilization requirements
  - Highest proceeds-senior debt programs
  - Lowest credit enhancement cost
  - Non-recourse construction loan
- Disadvantages
  - Process and timing issues
  - Subject to Davis-Bacon wages
  - Significant Negative Arbitrage Deposit
  - Very limited structuring flexibility
  - No variable rate option
  - No balloon option

# Credit Enhanced Structures

## *FHA 223 (f) / GNMA*

### *Program for Refinance, Purchase, Mod. Rehab. of Existing Apartments*

- Qualified Projects
  - (i) Rehab < \$6,500/unit (adjusted for high cost factor)
  - (ii) No more than one major building component
  - (iii) < 15% of improved value
- Underwriting Terms
  - Debt service coverage requirements 1.17x
  - 35-year amortization
  - 85% LTV
  - Fixed rate only



# Credit Enhanced Structures

*FHA 223(f) / GNMA*

<u>Rate Calculation</u>		<u>Fees (est.)</u>	
Tax-Exempt 40-yr Bond Rate	5.25%	Lender Origination	.5-1.5%
Ginnie Mae	.25	MIP due at Closing	1.0
Trustee Fee	.05	Bond Costs of Issuance	2.0-3.0
Issuer Fee	.13	FHA Application Fee	.3
Mortgage Rate	5.63		3.8-5.8%
Mortgage Insurance Premium (MIP)	.5		
<b><i>Total effective Interest Rate</i></b>	<b><i>6.13%</i></b>		

# Credit Enhanced Structures

## *FHA 223(f) / GNMA*

### *Program for Refinance, Purchase, Mod. Rehab. of Existing Apartments*

- Advantages
  - Lowest credit enhancement cost
  - May do projects unsuitable for Fannie Mae/Freddie Mac
  - May have highest leverage due to 35-year amortization and 1.17x DSCR
- Disadvantages
  - Process and timing issues
  - Limited structuring flexibility
  - No variable rate option
  - No balloon option

# Credit Enhanced Structures

## *Agency Forward – Fannie Mae and Freddie Mac*

- Qualified Projects
  - New construction
  - Substantial Rehab
- Underwriting Terms
  - Debt service coverage requirements 1.20x – 1.25x
  - 30-year amortization
  - 80% - 85% LTV
  - No construction/lease-up risk

**Fannie Mae and Freddie Mac may comprise 30-40% of all multifamily credit enhancements**

# Credit Enhanced Structures

*Agency Forward – Fannie Mae and Freddie Mac*

- Construction Credit
  - LOC or guaranty from credit financial institution
  - Recourse construction facility
  - LOC released at:
    - 90 days @ 90% occupancy and 1.25x DSCR for 3 consecutive months or 6-month average
    - Must convert within 30 days

# Credit Enhanced Structures

## *Agency Forward – Fannie Mae and Freddie Mac Fixed Rate*

### Rate Calculation

#### ***Permanent Rate***

Tax-Exempt 30-yr. Bond Rate	5.15%
Guarantee & Servicing	.9
Trustee	.05
Issuer	.13
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Mortgage Rate	6.23%

#### ***During Construction***

Guarantee & Servicing Fee	.25%
LOC Annual Fee	1.0-1.5

### Fees (est.)

DUS Lender Origination	1.0%
Construction Lender Origination	1.0
Bond Costs of Issuance	2.0-3.0
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	2.0-3.0%

# Credit Enhanced Structures

## *Agency Forward – Fannie Mae and Freddie Mac Variable Rate*

### Underwriting

52-Week BMA Average	3.0%
Guarantee & Servicing	.9
Liquidity Fee	.15
Trustee Fee	.05
Issuer Fee	.125
Remarketing Fee	.125
Interest Cap Escrow Fee	.125
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	4.48
Underwriting Cushion	2.0
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	6.48%

### Fees (est.)

DUS Lender Origination	1.0%
Construction Lender Origination	1.0
Bond Costs of Issuance	2.0-3.0
5-yr. Cap @ BMA + 3.0%	.45
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	5.45%

### Actual Mortgage Rate - Current

BMA	1.4%
Stack	1.48
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***Total Current Actual Borrowing Rate 2.88%***

# Credit Enhanced Structures

## *Agency Forward – Fannie Mae and Freddie Mac*

- Advantages

- 60 –90 day underwriting process – predictable
- Somewhat flexible/negotiable underwriting
- Not subject to David-Bacon wages
- Variable-rate option available

- Disadvantages

- Involves two credit enhancers
  - Construction and permanent
- Recourse during construction and lease up
- Lower leverage financing

# Credit Enhanced Structures

## *Bank LOC*

- 1.15x – 1.25x DCSR
- 75% - 80% LTV
- Variable or fixed
- Construction/permanent
- May be aggressive for certain CRA eligible deals
- Prefer deals located in bank's regional area
- Credit enhancement fees usually > 1.0% annually
- Can be competitive for bank "relationships"

**Letter of Credit transactions may comprise 10-15% of all multifamily credit enhancements**



# Non-Credit Enhanced Structures

- Longer Amortization
- Lower Debt Service Coverage Ratios
- Higher Loan to Value
- Higher Interest Rates

**Non-Credit Enhanced financings may comprise 25-30% of all multifamily transactions**

# Variable Rate Financing

- Interest rate reset every 7-days
- Bondholders can “put” bonds back with 7-days notice
- Remarketing agent resets rates and remarkets “puts”
- Credit enhancer provides “liquidity” for failed remarketings

# Fixed versus Floating Loan Underwriting Rates

	<u>Fixed Rate</u>	<u>Floating Rate</u>
<i>Interest Rate</i>	5.15%	3.00%
<i>Trustee</i>	0.04	0.04
<i>Issuer</i>	0.13	0.13
<i>Guarantee &amp; Servicing</i>	0.90	0.90
<i>Liquidity</i>	0.00	0.15
<i>Interest Rate Cap</i>	0.00	0.10
<i>Remarketing</i>	0.00	0.13
<i>Risk Premium</i>	<u>0.00</u>	<u>2.00</u>
<b>TOTAL</b>	<b>6.22%</b>	<b>6.45%</b>

# Fixed versus Floating Loan Amounts

## *Variable Rate*

<b>Net Rental Income</b>	<b>\$885,000</b>	<b>DSC (fixed)</b>	<b>1.25</b>
<b>Expenses</b>	<b>325,000</b>	<b>DSC (variable)</b>	<b>1.20</b>
<b>NOI</b>	<b>560,000</b>	<b>Amortization</b>	<b>30</b>
<b>NOI available for DS (fixed)</b>	<b>448,000</b>	<b>Variable Bond Rate</b>	<b>6.44%</b>
<b>NOI available for DS (variable)</b>	<b>466,667</b>	<b>Fixed Bond Rate</b>	<b>6.22%</b>
<b>Floating Rate Bond Amt</b>	<b>\$6,132,147</b>		
<b>Fixed-Rate Bond Amount</b>	<b>\$6,024,156</b>		
<b><i>Difference</i></b>	<b><i>-\$107,991</i></b>		

# Bond Costs of Issuance

*(\$10 mm transaction)*

Issuer	\$25,000
Bond Counsel	40,000
Financial Advisor	25,000
Underwriter	100,000
Underwriter's Counsel	25,000
Rating Agency	12,500
Printing	7,500
Trustee	6,000
Permanent Loan Origination	100,000
Permanent Lender Counsel	35,000
Mortgage Banker Counsel	20,000
Due Diligence	25,000
Construction Lender Origination	100,000
Construction Lender Counsel	<u>20,000</u>
<b><i>TOTAL</i></b>	<b><i>\$541,000</i></b>

# Roles for Redevelopment Agencies

- Three Major potential roles:
  1. Serve as issuer of bonds, generally as “conduit,” where project is owned by another entity
  2. Make a loan, to the borrower, to provide a portion of the funds necessary to cover the total development costs, and/or
  3. Pledge a portion of Agency’s tax increment revenues to secure repayment of the Bonds
- Any of the above 3 roles will trigger the Redevelopment Law targeting requirements described above, in addition to any applicable federal targeting requirements

# Serving as Issuer of the Bonds

- Generally the Agency serves as a “conduit” issuer, where project is owned by another borrower (limited partnership, LLC or Section 501(c)(3) corporation) who is solely or primarily responsible for repayment of the bonds
- Agency may play a role in monitoring compliance with the Regulatory Agreement required by the bonds and/or LIHTC equity and be compensated for that function, or the monitoring function may be performed by the trustee or another party.

# Making a Grant or Loan to Borrower to Cover a Portion of Development Costs

- Will generally come from Agency's low and moderate income set-aside funds
- In the case of an Agency loan, senior Credit Enhancer will generally require that the Agency loan be subordinated to Senior Bonds and credit enhancement in a number of regards:
  - Loan will be secured only by a **second** (or in some financings, a third or fourth) **deed of trust**, junior to that or those securing more senior debt
  - **Maturity** of loan will be no earlier than, and generally at least **1 month after**, maturity of **senior debt**
  - **The loan will be repayable only out of a specified percentage (e.g. 75%) of net cash flow** (unless percentage restriction is waived) remaining after payment of operating expenses and debt service on senior debt and funding of all reserves (tax, insurance, replacement, etc.) required by senior debt
  - The Loan may have an amortization schedule following construction and rent-up, but **failure pay scheduled principal and interest will generally not trigger a default** (on senior debt or Agency Loan), but instant will simply trigger a deferral in payment until cash flow is available (with or without payment of additional interest on deferred payments)
  - Agency Loan will generally **accrue interest at a below market rate** (e.g. 0% to 3% or 4%)
- **It is important that the Agency Loan terms and form of required Subordination Agreement to agreed upon between Agency and its counsel and the Senior Credit Enhancer(s)/Lender(s) and its or their counsel at a very early stage of the financing**



# Pledge of Low or Moderate Income Set-Aside or Other Tax Increment Revenues

- Has been used on a number of multifamily housing bond financings in the recent past
- Agency may pledge all of a portion of its low or moderate income set-aside and/or other unrestricted tax increment revenues to secure repayment of the bonds
  - While separate series of subordinate bonds may be issued and secured by tax increment pledge, most efficient structure is likely to involve having this income stream “wrapped” by senior bonds credit enhancer and considered, together with the project net operating income, in sizing the senior debt
  - Not all senior debt credit enhancers will do this:
    - Fannie Mae, Freddie Mac and Bond Insurers will
    - FHA generally will not

# Pledge of Low or Moderate Income Set-Aside or Other Tax Increment Revenues

## (Cont.)

- In wrapping the income stream the senior debt credit enhancer will generally require a representation that the **ratio of tax increment revenues pledged is at least 1.35 to 1.45 times the debt service** on the portion of the bonds expected to be repaid from that source
- The senior debt credit enhancer will also typically require a claim on the tax increment revenues pledge that is prior to any other claims (except for normal set-asides generally applicable to such revenues and in place on the date of the financing) and a covenant that
  - Future claims against the tax increment revenues pledged will be subordinate to the senior bonds' claim on such revenues and
  - That any such **additional debt will not cause the above described coverage ratio to be violated**
- The following requirements, together with the affordability and other restrictions agreed to by the borrower, will typically be embodied in an Owner Participation Agreement and Pledge Agreement on the financing

# PART IV

SAMPLE SECTION 142(d)

and

SECTION 501(c)(3)

FINANCINGS

# Sample Financing Combining “New Money” Tax-Exempt Private Activity Bond Financing under Section 142(d) with “4%” Low Income Housing Tax Credits

- Assumption:
  - New 200-unit multifamily residential rental housing facility
  - Targeted to persons of lower income (*i.e.*, not greater than 60% of median area income, adjusted for family size) (*i.e.*, 100% affordable)
  - Total project cost of \$75,000 per unit, or \$15 million
    - \$10 million represents construction costs
    - \$3.5 million is the cost of the land
    - \$1.5 million is the cost of development fees, financing fees and other “soft” costs

- Preliminary Steps; Major Participants

- Issuer/Volume Considerations

- Before incurring substantial expenditures, Owner selects an investment banking firm experienced in tax-exempt multifamily housing bond finance, and they
    - Identify the Issuer
    - Determine the likely availability of a private activity bond volume allocation for that project through the Issuer
    - Identify Issuer's charges and any special Issuer regulatory requirements
    - Obtain passage by the Issuer of an “official action” resolution confirming Issuer's general intent to provide tax-exempt bond financing for the project

## – Determine Bond Structure

- Underwriter works with Owner to identify the financing structure (fixed or variable rate; level amortization or amortization to a “balloon” and so forth)
- Identify credit enhancement program (*e.g.*, FHA insurance with a GNMA “wrap,” Fannie Mae “DUS” or Freddie Mac “program plus” loan, bank letter of credit or municipal bond insurance) to be used

# Sources and uses for the financing might be as follows:

<u>Sources</u>		<u>Uses</u>	
Tax-Exempt		Land	\$ 3,500,000
Bond Proceeds	\$11,000,000	Construction	
	(73%)	Costs	10,000,000
4% Tax		Financing	
Credit Equity	3,312,000	Fees	500,000
	(22%)	Other	
Subordinated		“Soft” Costs	<u>1,000,000</u>
City or Redevelopment		<b>Total:</b>	<b>\$15,000,000</b>
Loan	788,000		
	(5%)		
<b>Total:</b>	<b>\$15,000,000</b>		

# Sample Section 501(c)(3) and Essential Function Bond Financings – Closing the Equity Gap

- Since 4% low income housing tax credit equity not available in 501(c)(3) or “essential function” bond financings, these types of transactions may suffer significant disadvantages in generating proceeds sufficient to cover total project costs
  - Most credit enhancers will impose debt service coverage (“DSC”) and loan-to-value (“LTV”) tests which will effectively limit amount of financing available through the credit enhanced tax-exempt bonds to 80% or 90% of total project costs



- In some cases, nonprofit or public borrowers may receive larger loans or other more lenient loan terms than profit-motivated borrowers receive
  - FHA may insure larger loan
  - Fannie Mae may waive cash flow restrictions on sub debt
- Grants or loans from HUD or other federal, state, or local sources, or subordinated loans from such sources, which are much more likely to be available if Owner of facility is a Section 501(c)(3) corporation, or, in the case of an essential function or governmental purpose financing, a public body or controlled subsidiary

- Finally, not unusual for investment bankers to structure one or more series of subordinated tax-exempt bonds
  - May be sold or delivered to cover the fees of various private participants involved in the financing
  - May be delivered to the seller of a property, in lieu of cash consideration for the property
    - Counsel will carefully test to see that the above guidelines of reasonableness of compensation and true ownership by the 501(c)(3) nonprofit or public entity owner have not been violated, but such devices are frequently used to close the financing gap which would otherwise apply to these deals

# Sample Financings Using Subordinated Bonds

- Total costs of financing (hard and soft costs): \$10.0 million

# Example 1 – Hypothetical Source of Funds

– Series A Credit Enhanced, Rated Senior Tax-Exempt Bonds (\$5,000 minimum denominations, publicly offered; first lien; 1.20:1 DSC; 80% LTV)	\$7,500,000
– Series B Non-Credit Enhanced, Unrated Subordinate Tax-Exempt Current Interest Bonds (\$100,000 minimum denominations, institutionally placed; second lien; 1.10 to 1.15:1 DSC; 85-90% LTV)	1,500,000
– Series C Non-Credit Enhanced, Unrated Junior Subordinated Tax-Exempt Compound Interest Bonds (\$250,000 minimum denominations or single bond, institutionally placed; third lien; 1.05:1 DSC; 95% or greater LTV) – (“Seller Take-Back” or “Fee for Services” Bonds)	600,000
– State or City (Fourth lien) Loan or Grant	<u>400,000</u>
<b>Total:</b>	<b>\$10,000,000</b>