HOUSING BOND REPORT

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Affordable Housing Developers Take Advantage of Record-Low Interest Rates

By Richard Gerwitz, Newman & Associates

Interest rates have declined steadily over the past year, with the bellweather 10-year Treasury rate dropping about a full point. The Treasury bond yield, which is generally reflective of what's happening in all longer-term interest rate markets, ends 2002 flirting with a yield of 4 percent. This has been wonderful news for all developers, both in terms of the amount of debt they can raise, as well as for cash flow on existing projects financed with floating rate debt. Interestingly, those affordable housing developers using tax-exempt debt have not benefited quite as much as those relying on conventional lending, as the taxable markets have outperformed tax-exempts.

While tax-exempt bond rates tend to track the general level of interest rates, they are also very sensitive to the overall need for tax-exempt income, and the volume of bonds issued. Furthermore, in times of uncertainty – financial, political and international - money tends to flow to the financial instrument that is perceived to have the least risk, U.S. Treasuries. So, while Treasury yields have fallen as economic activity has slowed, the Federal Reserve has eased rates, and the general level of discomfort has risen from the possibility of a war with Iraq, yields on tax-exempt bonds have not declined proportionally.

For example, at the end of last year, the 10-year Treasury yield was about 5.10 percent. The yield on a generic 10-year triple-A rated general obligation (GO) bond at that time was at about 4.55 percent. Therefore, the ratio of tax-exempt to taxable rates at that time was about 88 percent. Compare that to where we were in the first part of December 2002, when the 10-year Treasury yield was about 4.10 percent and 10-year GO rates were 3.95 percent, resulting in a ratio of 97 percent. This substantially higher ratio indicates that Munis have underperformed the taxable interest rate markets.

Affordable housing developers don't borrow at municipal GO rates. Tax-exempt bonds issued to finance multifamily housing, known as "private activity bonds," trade substantially "cheaper" than GOs. That is, they carry higher interest rates. When the 10-year GO rate is 3.95 percent, as it was at the beginning of December, a 10-year housing bond might be priced to yield 4.45 percent, 50 basis points higher. Why? There are several reasons. First, even though housing bonds may be guaranteed by a highly rated third-party financial institution, they still carry the perception that they are a greater credit risk, thereby narrowing the market of buyers and driving up rates.

The adage that buyers of municipal bonds are "widows and orphans" isn't far from the truth in terms of risk appetite, so any complexity is viewed with skepticism. Secondly, new issue private activity bonds are subject to alternative minimum tax. In essence, to the extent that an individual falls into this category, the bonds are really not fully tax-exempt. This further narrowing of the market of potential investors has a negative impact in terms of supply and demand. Finally, housing bonds have a shorter average life than do other types of municipal bonds, due to prepayment risk and principal amortization, and investors don't want the bonds they purchase called away from them.

(continued on page two)

Interest Rates

(continued from page one)

While we've been comparing the 10-year Treasury to 10-year municipals, let's further complicate matters: most tax-exempt housing bond issues are financed using longer-term bonds. Conventionally financed real estate projects often secure loans which, while amortized over 30-years, have balloons and are priced off the 10-year Treasury. Projects financed in the tax-exempt market, on the other hand, generally have interest rates assigned based on 20- to 40-year balloons or maturities. This happens for several reasons, including that certain popular credit enhancement programs, like FHA, do not allow for balloon payments. If a Fannie Mae or Freddie Mac guarantee is used, neither the guarantor nor the tax credit equity partner wants a balloon payment that will result in an interest rate reset prior to the 15-year qualified compliance period. When the construction period is added on a new construction transaction, this means the earliest a balloon payment can be structured is about 18-years.

Rates out in the 20- to 40-year maturity range for high-grade housing bonds subject to AMT ranged from about 5.30 percent to 5.50 percent in early December. When credit enhancer guarantee fees, issuer fees, and trustee fees are added to this base rate (amounts which are often referred to as "the rate stack"), the affordable housing developer's all-in permanent mortgage rate is about 6.25 percent to 6.60 percent. While very attractive, look what's happened to conventional rates that are priced off the 10-year Treasury. The highest quality conventional projects can probably find permanent funds at a spread of about 175 basis points off the Treasury index. That's a 5.75 percent permanent mortgage rate. Even at a 225 basis point spread, a conventional developer might be able to find a 6.25 percent mortgage.

Even given the above interest rate anomaly, which is atypical in terms of historic tax-exempt/taxable interest rate relationships, affordable developers benefit from the 4 percent tax credits that go along with an allocation of private activity bonds, the ability to put long-term fully amortizing debt in place, and extraordinary flexibility in terms of the ability to structure their debt package to best suit the particular project.

Affordable housing market developers are often specialists, that is, they are focused on producing housing using 9 percent tax credits, or 4 percent tax credits plus tax-exempt bonds. On occasion, we see conventional developers come into the market, most often with 80/20 deals, where 20 percent of the units are reserved for families having median incomes of 50 percent of AMI or below, and 80 percent of the units are at market. This is often the case where they are working under some sort of inclusionary housing requirement.

Given the present ability of conventional developers to find cheap conventional financing, virtually the only reason they want to use tax-exempt bonds is to take advantage of the extraordinarily low rates available through the use of variable rate demand notes. An increasing number of affordable developers are also utilizing floaters, but find it harder in that there are very few tax credit equi-

(continued on page three)

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HOUSING BOND REPORT INFORMATION

Address all correspondence and editorial submissions to:
Jane Bowar Zastrow
Housing Bond Report
Novogradac & Company LLP
246 First Street, 5th Floor
San Francisco, CA 94105
Telephone: 415.356.8034
E-mail: cpas@novoco.com
Visit us on the web:
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Interest Rates

(continued from page two)

ty buyers willing to participate in transactions structured in this manner.

Short-term rates started off the year low, increased somewhat in the spring and fall, and are ending the year at very low levels. Variable-rate notes access the shortest part of the yield curve. They are the tax-exempt market's equivalent of taxable commercial paper. The Bond Market Association (BMA) publishes a national weekly index of tax-exempt variable rates. At the beginning of December the index stood at just above 1 percent, and the 52-week rolling average was just under 1.40 percent. When the "rate stack" of about 150 basis points on a typical variable rate transaction is added to the base interest rate, the borrower's overall mortgage rate over the last 52-weeks averaged about 2.90 percent. Clearly, there is interest rate risk with this type of instrument. However, that risk is mitigated by both the history of variable interest rate levels, and the fact that guarantors require that the developer purchase a series of interest rate caps. In today's market, the developer would be required to buy a cap that would prevent the all-in mortgage rate from ever exceeding 7.50 percent.

All other real estate underwriting criteria being equal, lower interest rates mean more proceeds from bond issues, as credit enhancers and private placement purchasers lower the interest rates they use in their models. Using typical agency fixed-rate underwriting criteria, a project with $1 million in net operating income will generate about $500,000 in additional proceeds with a 50 basis point decline in the bond rate, resulting in a bond issue of about $10.6 million.

Predicting interest rates is a dangerous profession. However, given the continued economic sluggishness, and the current tendency of the Federal Reserve toward easing, it would appear that rates are not headed up, at least the first part of 2003. Given historic interest rate relationships, it is also feasible that tax-exempts may outperform taxables, bringing further declines to long-term rates. ❖

Richard Gerwitz is an investment banker with Newman & Associates, where he specializes in the financing of affordable rental housing projects using municipal bonds and low-income tax-credits. He can be reached at (310) 393-6737.

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