

HOUSING BOND REPORT

A MONTHLY PUBLICATION ON THE LOW-INCOME HOUSING TAX-EXEMPT BOND INDUSTRY

May 2004, Volume VII, Issue V, Published By Novogradac & Company LLP

Not Your Average Housing Bond Transaction: Military Privatization Offers New Market for Experienced Developers

By Alex Ruiz, Staff Writer, Novogradac & Company LLP

The Department of Defense (DOD) estimates that 183,000 military family housing units are inadequate, lack modern amenities and are in need of major renovation and replacement. And after a relatively slow start, developers in the private sector are beginning to take an interest in a program approved in the mid-90s to build and renovate military housing.

DOD currently faces two significant housing problems. First, the condition of department-owned housing is poor and, second, there is a shortage of affordable, quality private housing available to service members and their families. DOD estimates that, worldwide, it owns approximately 257,000 family housing units on and off base. Many of these units need to be renovated or replaced because they have not been sufficiently maintained or modernized in the past 30 years.

According to DOD, completing the necessary work using traditional military construction methods would take more than 20 years and cost \$16 billion. Furthermore, traditional military construction requires contractors to adhere to military specifications, which costs significantly more than building to local standards. Thus, to improve housing more quickly and economically, Congress in 1996 authorized the Military Housing Privatization Initiative (MHPI).

This MHPI includes a series of powerful authorities that allow the DOD to work with the private sector, building and renovating military housing by employing a variety of financial tools that includes direct loans, loan guarantees, equity investments, conveyance or leasing of property or facilities and rental guarantees. It is important to note that while many of these transactions

involve debt financing, they are not financed with tax-exempt private activity bonds used for multifamily housing.

According to the Government Accounting Office (GAO), the services plan to privatize 72 percent of the total family housing inventory, representing about 183,000 units. As of March 2003, the services had contracts privatizing about 28,000 family housing units and planned to privatize 140,000 units by fiscal year 2005. About 7,600 units have been constructed or renovated as a result of this privatization. After a relatively slow start in the program's early years, the GAO reported that at the end of 2003, the Air Force was planning 53 family housing privatization projects and the Army and the Navy were planning on 27 and 37 projects, respectively.

As it has developed, the MHPI has provided a mutually beneficial relationship between the DOD and the private sector. For the DOD, the results are the construction of more housing built to market standards, and for less money than through the military construction process. Commercial construction is not only faster and less costly than military construction, but private sector funds stretch and leverage the department's limited housing funds significantly. Privatization opens the military construction market to a greater number of development firms and there are important venture capital opportunities in DOD housing for private sector developers and financiers. Moreover, DOD housing projects can provide a continuous inflow of capital to an investor over a long period of time.

Case Study: Alaska

In late February, the Alaska Housing Finance

(continued on page two)

Not Your Average Housing Bond

(continued from page one)

Corporation (AHFC) board of directors approved as much as \$100 million in term loan funding to Aurora Military Housing LLC for housing units located on Elmendorf Air Force Base (AFB) located in Anchorage, Alaska. AHFC anticipated the loan amount to be approximately \$96 million; total development cost of the project is \$230,032,381. However, at the time of AHFC's announcement, negotiations with the Air Force had not been finalized. As the *Housing Bond Report* went to press, the financing for the transaction had yet to be resolved.

"This is the largest Air Force privatization project to date," JL Properties Jon Rubini, a principal of the development team, said. "AHFC's involvement helped make the Elmendorf project one of the first of its kind in the nation. It was exciting to be part of an effort that benefited not just military personnel but the local economy as a whole."

The project involves an approximately four-year real estate transaction under which 1,194 housing units will be completed. The Air Force will convey 986 existing housing units and provide a 50-year lease for 254 acres of improved land on which the units are located.

Of the existing units, 552 will be demolished, 552 units will be newly constructed to replace the demolished units, 310 units will be renovated and 124 will remain as is. To achieve the 1,194 required housing units, an additional 208 units will be constructed. A total of 760 units will be new construction.

The loan was AHFC's third request for financing of military housing. The first occurred in the mid-1990s when AHFC provided a \$54 million, 30-year term loan for the construction of 366 units occupied by military personnel on Eielson AFB. The second request occurred in 2001 when AHFC provided a \$48 million, 30-year term loan to Aurora Military Housing LLC, for the development of Phase I housing for military personnel on Elmendorf AFB. At the completion of the project, there were 828 units.

AFHC says Phase I at Elmendorf has been widely identified as one of the most successful housing privatization projects in the Air Force. In its annual site visit report, the Air Force cited Phase I as exceeding expectations in a number of areas. Phase I also received the Air Force's highest overall rating in its quarterly report and has earned that rating throughout 2003. Pacific Air Force Command selected "Dallas" housing project in Phase I as the residential project of the year, and Headquarters Air Force selected Phase I as its nominee for the National Association of Installation Developers residential project of the year for 2003.

Debt Ratings for MHPI Transactions

Standard & Poor's Ratings Services recently reported that it has

(continued on page three)

HOUSING BOND REPORT EDITORIAL BOARD

Publisher

Michael J. Novogradac,
CPA

Editor

Jane Bowar Zastrow

Associate Editor / Staff Writer

Alex Ruiz

Technical Editor

Robert S. Thesman, CPA

Production

Alona Harrison

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:

www.taxcredithousing.com

ISSN 1536-6847

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding tax-exempt bonds or any other material covered in this publication can only be obtained from your tax advisor.

No portion of this material may be reprinted without written permission of Novogradac & Company LLP.

© Novogradac & Company
LLP, 2004

All rights reserved.

**HOUSING BOND REPORT
ADVISORY BOARD**

Margaret Allen
AGM Financial Services,
Inc.

Mark Appelbaum
US Bancorp Piper
Jaffray

Scot Barker
Newman and
Associates, Inc.

Charles Cardall
Orrick, Herrington &
Sutcliffe

Anthony Cinquini
Red Capital Markets,
Inc.

Wendy Dolber
Standard & Poor's
Corporation

Steven Fayne
GMAC Commercial
Mortgage

Anthony Freedman
Hawkins, Delafield &
Wood

William Hirsch
Foundation For Social
Resources, Inc.

Susan Juroe, Esq.

Tom Kasper
PW Funding/Kasper
Mortgage Capital

Robert Klein
Klein Financial Corp.

Phil Melton
Collateral Mortgage
Capital

Kipling Sheppard
Simpson Housing
Solutions, LLC

Sheldon Schreiber
Pepper Hamilton LLP

Arnold Schuster
Sonnenschein Nath &
Rosenthal

Thomas Tracy
Hunter Chase &
Company

Not Your Average Housing Bond

(continued from page two)

received requests to rate debt obligations secured by privatized military housing transactions. To evaluate debt obligations for a rating, S&P says it will make a site visit to the military base and military housing project securing the debt prior to the rating process. "Due to the complexity of these transactions, there are a number of issues that Standard & Poor's likes to address during the site visit, including the essentiality of the military base, to properly evaluate the debt," the rating agency says.

Prior to the site visit, S&P indicates it would like to see the project's Request for Proposals and a summary of the base's vital statistics. In addition, the agency would prefer to receive the market study before the site visit so that comparable housing for the visit can be selected in advance.

During the site visit, S&P says, the developer, financing team or DOD personnel should be prepared to:

- ♦ Conduct a tour of the military housing project — Standard & Poor's will visit each military neighborhood, rank each neighborhood, do interior site visits of a representative sample of units and take photographs of each neighborhood;
- ♦ Conduct a tour of comparable off-base civilian housing and make a presentation addressing the off-base civilian housing market and how housing allowance rates and housing on base compare to civilian housing and rents off base;
- ♦ Conduct a tour of military facilities on base to assist in determining military essentiality;
- ♦ Make presentations on topics, including military activities of the base and addressing base essentiality; each military housing neighborhood, including location, pay grades housed there, date of construction or rehabilitation and current occupancy rate; the developer and general contractor and their companies' previous experience; the development plan for the project; environmental conditions and issues; mitigating construction risk for bondholders; and how property management and property asset management, including debt compliance, is to be handled.

BRAC: Mitigating the Risk of Base Closure

S&P reported in February that a new round of military base realignment and closures (BRAC) is scheduled for 2005, which will have ramifications for investors in military housing transactions. Although the DOD has published a list of what it deems militarily essential, S&P says an independent credit analysis of base essentiality and privatization remains critical to predicting which bases could be closed, or partially closed, and how military housing on or near the base could remain viable.

During the Standard & Poor's Ratings Services panel, moderated by S&P credit analyst Christopher Moriarty, several military and military

(continued on page four)

Not Your Average Housing Bond

(continued from page three)

housing transaction experts discussed the next round of BRAC. "The upcoming political risk of base closures will be an important consideration in the debt financing for future military housing privatization projects," said Moriarty.

Base closure risk is critical to the agency's analysis, noted credit analyst Ryan Fitzpatrick. "It's one of the main criteria points we look at when determining whether a military housing transaction will be investment grade," he said.

Upcoming Developments

Last month Moody's Investors Service reported that a \$275 million military privatization transaction is expected to sell next quarter. It will upgrade Navy housing in the Pearl Harbor area in Hawaii. This sale is expected to be the first public military housing transaction, as most deals have either been privately placed or insured with no public underlying ratings. Another military privatization transaction in Hawaii is coming up later this year. The \$1.4 billion sale for the Army is expected to be issued later in the year to build and rehabilitate approximately 8,000 units of family housing for military personnel in Oahu, Hawaii. ❖

This article first appeared in the May 2004 issue of Novogradac & Company's Housing Bond Report and is reproduced here with the permission of Novogradac & Company LLP.

© Novogradac & Company LLP 2004 - All Rights Reserved.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.taxcredithousing.com.