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Sub Debt Market Crashes: Investment Monetizations Seen as Alternative

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As long-term Treasury prices have rallied dramatically due to a perceived lack of supply, corporate credit spreads have widened significantly. Combined with the general flight to quality sentiment prevailing in the market, spreads for below-investment grade paper have widened even more significantly. This has been most evident in the subordinate multifamily housing debt market.

The subordinate multifamily housing debt market is being crippled by the combination widening spreads and a recent string of defaults in the Southeast. Current market quotes for subordinate debt are ranging from 14 percent to as high as 18 percent, including strict covenants and debt service coverage levels as high as 1.25. Furthermore, execution time is increasing as debt buyers have lengthened their due diligence process. Today, typical execution ranges from 60 days up to 120 days. Many developers who are short on equity and can no longer access the subordinate debt market have seen their deals fail to close and put on hold as a result of this severe market condition.

Developers, however, can look to leverage their existing deals to extract equity to apply to their new deals. Most developers, in order to ensure timely payment of principal and interest to bondholders, fund a debt service fund ongoing each month in their existing deals. The monthly deposit is made to the bond trustee and held until payment is made to the bondholders. Generally, the interest earned from these deposits is not significant. However, the interest is equity in the deal and should be maximized by the developer. The best way for a developer to maximize the interest earned is to invest in an investment contract that "monetizes," or pays upfront in one lump sum, all the future interest earned.

Monetizations are generally executed using a structure known as the forward purchase contract. Under this contract, the developer will contract with an investment provider to invest the monthly deposits in a series of short-term securities to be delivered as the deposits are made.

For example:

- ▲ The developer deposits monthly, on the first day of each month, to their debt service fund.
- ▲ The deposits accumulate and are used to pay debt service semi-annually.
- ▲ Each monthly deposit will be invested, pursuant to the contract, in a security maturing on the next succeeding semi-annual debt service payment date.
- ▲ The par amount of the security will equal the deposit amount.
- ▲ On each debt service payment date, the trustee will use the proceeds of the matured bond to pay debt service.

In return for the right to deliver the securities, the investment provider will pay all of the future interest earned on the securities to the developer in one lump sum cash payment at closing of the contract. Forward purchase contracts have been widely used throughout the municipal finance industry for various applications. The benefits of the contract including the following:

- ▲ The developer maximizes the equity of the deal.
- ▲ The proceeds generated by the monetization are not restricted in any way and the developer can use the money for any purpose.
- ▲ The cash payment is made on a nonrecourse basis.
- ▲ There are no covenants or debt service coverage requirements.
- ▲ There is limited documentation and legal costs.

Investment monetizations, as evidence by their increasing use, are a true alternative to subordinate debt in the multifamily housing market. ❖

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