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Section 202 Prepayment Opportunities

**Tax Exempt Bonds for Nonprofit Sponsors under Section 145
of the Internal Revenue Code**

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Background on Section 202

- Direct Loans from HUD to nonprofit sponsors of elderly housing projects (mainly high rises) from 1959 through 1990 (in 1991, program converted to grants).
- Thousands of loans made, many at 8.50% to 9.25% interest rates.
- Historically, HUD refused to permit prepayment – yet many properties now have market values far in excess of loan balances and are now in need of some rehab.
- HUD Notices H-2002-16 and H-2004-21 set forth rules under which 202 project loans can be prepaid.

Prepayment Opportunities

Two Major Types of Opportunities:

1. Issue new tax exempt Bonds under §145 of the Internal Revenue Code to refinance the property for the existing nonprofit owner or a nonprofit affiliate.
 - » Proceeds will greatly exceed existing loan balance because:
 - Currently achievable loan rates of 5.5-6.5% are much lower than the 8.5-9.0% rates on many existing §202 loans,
 - Property values of these projects are much larger than current loan balances, and
 - Term of new debt can be as long as 30-40 years with level amortization.
 - » Benefits include generating funds for rehab and/or improvements, improved project cash flow and, subject to HUD approval, release of residual receipts (above \$500 per unit) and/or replacement reserves (above \$1,000 per unit).

2. For the first time, regulations permit properties to be owned by a ***profit-motivated*** entity, such as limited partnerships or LLCs, as long as ***sole general partner*** or ***managing member*** is a qualified nonprofit corporation.
 - » This raises the possibility of transferring property to such a borrower and using tax exempt private activity bonds under §142(d) ***plus*** 4.0% LITC equity.
 - » This has all of the benefits of Alternative 1 above, but even greater proceeds from 4.0% tax credit equity.

- The Bad News:
 - » Requires processing of HUD approval of prepayment at both local and National levels, somewhat like early §236 decouplings.
 - May take 3-4 months or more (longer if HUD approval of prepayment required, as with most loans other than 1977 through 1982 loans; shorter if not – but still have to get HUD approval due to requirements of Section 8 subsidy and other factors).
 - » Borrower must execute HUD Use Agreement for remaining term of original 202 loan.
 - » Most deals approved so far are §145 deals for nonprofit borrowers as in Alternative 1.
 - » Many projects do not need the greater level of proceeds from private activity bonds and 4% tax credits. This alternative also imposes substantial additional complexity and expense, and will usually require substantial borrower guarantees for syndication of tax credits, which many nonprofits will be reluctant to give.

Three Main Financing Structures

1. Use new **FHA-insured loan** under §223(f) or §221(d)(4) and **GNMA wrap** with or without tax exempt bonds.
2. Use tax exempt bonds back by **other credit enhancement** such as **Fannie Mae**.
3. Issue **rated, non-credit enhanced tax exempt bonds** using Moody's or S&P's affordable housing rating criteria.

Examples of Tax Exempt Bonds under §145 for Nonprofit Sponsors

1. Rated, Non Credit Enhanced Tax Exempt Bonds

- » Issuer: Illinois Finance Authority
- » Project: Bethel Terrace
- » Bond Amt: \$6,045,000 Tax Exempt Bonds maturing 2015, 2025 and 2035; \$250,000 Taxable Bonds maturing 2008
- » Closing: August, 2007
- » Borrower: Englewood Cooperative Apartments (Nonprofit)
- » Underwriter Client: Zeigler Capital Markets Group
- » Eichner & Norris Lawyer: Kent Neumann
- » Rating: Moody's Baa3
- » Bond Yield: ~5.35% Tax Exempt, ~6.0% Taxable
- » No major rehab (otherwise credit enhancement needed through stabilized occupancy)
- » 1.15 DSCR, stressed underwriting; No LTV Test
- » 5 Year HAP Contract with Covenant to Renew
- » 1 Year Max Annual Debt Service Revenue Fund
- » HAP Contract Rents = 1.50+ FMR

- » Advantages:
 - **Very** Low Borrowing Rate
 - Can cross-collateralize multiple projects
 - Now well established product in the market place
 - Can release excess proceeds annually over minimum (e.g. \$40,000 minimum retainage) at 1.10 DSCR

- » Disadvantages:
 - Cannot use without construction/rent-up L/C if significant rehab/relocation is required

2. **Rated, Fannie Mae Credit Enhanced Senior Variable Rate Tax Exempt Bonds combined with Rated, Non Credit Enhanced Fixed Rate Subordinate Tax Exempt Bonds**
- » Issuer: IDA of the County of Maricopa, AZ
 - » Project: Christian Care Retirement Apartments
 - » Primary Purpose of Issue: Refunding
 - » Bond Amt: \$30,750,000 AAA-rated Fannie Mae Senior VR TE Bonds maturing 2035 sold at 3.75% coupon to 5-year Mandatory Tender Date; \$7,600,000 BBB-rated Subordinate Non-Credit Enhanced Bonds maturing 2036 sold at 6.50% coupon at par. Use of "super-sinker" funded from excess project earnings and inverse lower floater from Senior Bonds shortened projected average life to under 10 years.
 - » Closing: September, 2005
 - » Borrower: Christian Care, Inc. (Nonprofit)
 - » Underwriter Client: GMAC Commercial Holding Capital Markets Corp. (Newman)
 - » Eichner & Norris Lawyers: Ad Eichner and Rob Wrzosek

» Advantages:

- Low Borrowing Rate from Senior VR TE Bonds
- Maximize proceeds by securitizing excess project revenues and use of inverse floater to super-amortize Subordinate FR TE Bonds
- Maximum liquidity / marketability of Subordinate Bonds through BBB rating

» Disadvantages

- Interest Rate Risk for Senior Bonds
- Requires substantial project cash flow coverage of all Bonds (1.35+) for BBB rating on Subordinate Bonds