COUNCIL AGENDA: 6/14/16
ITEM: 4-2

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: June 2, 2016

Approved D. DSyL Date 6/2/16

COUNCIL DISTRICT: 4

SUBJECT: APPROVE REFINANCING CONDITIONS FOR RINCON DE LOS ESTEROS APARTMENTS

RECOMMENDATION

Adopt a resolution authorizing the Director of Housing to:

a. Negotiate and execute amendments to the City's existing loan documents on the Rincon de los Esteros Apartments, a 246-apartment affordable property located at 1780 Old Oakland Road ("Property"), to enable refinancing of the Property's senior loan and withdrawal of no more than $3,000,000 in refinancing proceeds by the Property's owner, Rincon de los Esteros, Inc. ("Owner"), an affiliate of the San José-based nonprofit developer First Community Housing ("Sponsor"); and

b. Negotiate and execute amendments to the City's other development-related documents to implement the changes described in this Memorandum to Council.

OUTCOME

Approval of the this action will authorize the Owner of Rincon de los Esteros Apartments to refinance the Property's senior loan and to spend $2.5 million in property rehabilitation, to pay down $3 million on the City's existing loan balance, and to use $3 million to bolster the financial strength and liquid net worth of First Community Housing, the Property's local nonprofit Sponsor. In addition to the $3 million payment, the City will benefit by longer affordability and strengthened loan documents. This action would also enable the Sponsor to progress toward development of 198 new apartments in San José for the homeless and formerly-homeless veterans. Finally, this approval would provide a framework by which other similar transactions would be considered.

EXECUTIVE SUMMARY

This action allows the City to subordinate its deed of trust to a new senior loan for an existing restricted affordable rental property (Rincon de los Esteros) and allows the property's owner to take a portion of refinancing proceeds out of the transaction. First Community Housing, the sponsor that wholly owns the property, will use its cash to strengthen its financial liquidity in order to meet requirements of lenders and investors for their two forthcoming developments in San José. This action explains staff's rational for recommended approval and further defines the framework by which other similar requests would be analyzed.

BACKGROUND

Property

Rincon de los Esteros ("Rincon" or "Property") is a 246-apartment affordable rental property located at 1780 Oakland Road. First Community Housing ("FCH" or "Sponsor") is the developer and sponsor of Rincon de los Esteros, Inc. ("Borrower"). Built in 1994, Rincon has 12 one-bedroom units, 151 two-bedroom units and 83 three-bedroom units. Overall, 135 apartments are required to be affordable to households under 50% of the Area Median Income ("AMI"), 62 are affordable at 60% AMI, and 49 are affordable at 80% AMI. Given these income restrictions and unit sizes, maximum resident incomes for each type of apartment range from approximately $44,000 to $128,000, although actual incomes are generally lower.

The Property was originally financed with: equity derived from the sale of low income housing tax credits ("LIHTCs") of $15.3 million; a City loan of $10.6 million; and a senior conventional loan of $8.6 million. The combined City and senior permanent debt on the property originally constituted approximately 89% of the property's value (89% loan-to-value ("LTV") ratio), and the original senior loan's underwritten income exceeded annual mortgage payments plus expected expenses by 10% (debt coverage ratio ("DCR" was 1.10:1).

The City's loan has a current balance of $12.8 million, is paid by 50% of annual net cash flow after payment of expenses, bears 4% annually compounded interest, and is due in full at maturity in August 2025. The City's loan was funded with 20% redevelopment funds, and the City's affordability restriction expires in August 2024.

Prior Refinancing

In April 2010, through the Delegation of Authority to the Director of Housing ("Director") under the City's Municipal Code, the Director approved the Borrower's refinancing of the Property's original senior loan and the exit of its tax credit limited partner from the Property's ownership structure. Prior to the economic recession of 2008, FCH incurred predevelopment expenses for future affordable rental developments. When the recession occurred, FCH's liquidity suffered as real estate closings were delayed. Therefore, the Borrower refinanced this property to obtain a much lower interest rate—going from 9.375% to 5.6%—and passed through some proceeds to the Sponsor in order to fund FCH's financial liquidity needs.

Proceeds from the Property's 2010 senior loan of $12.9 million were used to: pay off the original senior loan balance of approximately $5.7 million; pay for closing costs; and fund operating reserve accounts. The remaining refinancing proceeds of approximately $6.5 million were equally split between the Borrower/Sponsor and the City. The payment to the City of $3.27 million paid down the Borrower's loan balance, while FCH used its share of $3.27 million to fund its liquidity/net worth reserves. The 2010 senior loan's LTV was 94%. This relatively higher LTV was somewhat reflective of the economy conditions at the time. Besides lowering real estate values, the recession also caused local incomes to drop, which decreased rental incomes for restricted affordable properties.

<u>Current Refinancing Request</u>

FCH has proposed to refinance Rincon in June 2016 in order to take advantage of the current low interest rates to augment its financial strength. The proposal is obtain a new senior loan of $22.4 million, which would be used to pay off the existing senior loan balance of approximately $13.5 million (including prepayment costs of $1.7 million); spend $2.5 million in rehabilitation to the Property, and, pay $3 million to the City to be applied against Rincon's City loan balance.

FCH would use $3 million in refinancing proceeds to strengthen its financial position. Half the funds would be held to meet investors' liquid net worth requirements to support financing on their forthcoming San José developments. The other $1.5 million would pay for staff and predevelopment costs on these deals.

The proposed new senior loan of $22.4 million will bear an interest rate of approximately 3.775% with a maturity of 10 years. Loan payments will be interest-only rather than fully amortized like the current loan. The refinancing will make available approximately $2.5 million to fund rehabilitation costs (slightly more than $10,000 per unit). The City would need to subordinate its existing deed of trust to the new senior loan, and would need to slightly delay the exercise of its remedies in the case of noncompliance under its affordability restrictions.

Rincon's planned rehabilitation scope consists of repairs and improvements to interior housing components such as plumbing, electrical, heating, kitchen appliances, bathroom fixtures, flooring and painting. It would also enhance energy efficiency and make accessibility upgrades. Exterior repairs and improvements are limited to the existing structures or improvements required to bring the property into code compliance. Rehabilitation of potentially historic properties will conform to the Secretary of the Interior's Standards for the rehabilitation of Historic Properties. FCH does not expect any permanent tenant relocation in order to accommodate the rehabilitation.

ANALYSIS

While the Delegation of Authority under Chapter 5.06 of the City's Municipal Code would permit the Director to approve the proposed transaction, staff elected to bring this action before the City Council in order to provide a framework for staff's future refinancing decisions involving loan repayments to developers when there is an outstanding City loan balance.

It is expected that affordable rental developments will periodically refinance their senior loans in order to take advantage of lower rates or to generate funds for rehabilitation. Senior lenders require the City to subordinate its loan to the new senior loan. The City has no obligation to subordinate; therefore, the City has the right to place conditions on its willingness to subordinate. This allows the City to increase the length of its affordability restrictions and obtain additional benefits.

Historically, the Housing Department's position on senior loan refinancings has been to agree to subordinate to new senior loans that reduce operating costs and/or provide sufficient cash to complete necessary rehabilitation of the property. The City has strongly discouraged transactions that result in cash being taken out by borrowers ("cash-out refinancings") while City loans remain outstanding.

In the few instances where staff has approved cash-out refinancing, it has only been in cases of demonstrated financial hardship. In these situations, staff's main requirement has been that the City's loan be paid down in an amount equal to any refinancing proceeds taken out by the Borrower/Sponsor. This prudent approach is in the public interest because it helps to protect the City's loan and ensures that the property's maintenance and replacement reserves are well funded. Even though restricted affordable rental properties are privately-owned, existing debt obligations to a third party such as the City generally have legal priority over distributions to the owners.

Given current low interest rates and the aging of many of the properties funded with City loans 15 to 20 years ago, staff expects more cash-out refinancing proposals in the future. Therefore, the following analysis of FCH's proposal forms a framework for how staff would consider similar proposals for senior loan refinancings resulting in cash out to the borrower if the City has an outstanding loan balance.

Policy Framework for Cash-out Refinancing Requests

Below are five core issues that are germane to cash-out refinancings, and the City's policy approaches to each of these issues. At the end of each section, there is a description of how the Rincon proposal meets the City's objectives in each of these framework issues:

- General principles
- Sponsor characteristics
- Liquidity requirements
- Approved uses of refinancing proceeds, and
- Senior loan characteristics.

General principles: The City's general principles when considering affordable housing transactions that generate value such as refinancings are that the property and its tenants should be the first priority. Therefore, rehabilitation should be part of all proposals. Further, owners of City-subsidized properties should prioritize their legal obligation to the City, but should also ensure their own continued organizational health.

This proposal: The Rincon transaction is consistent with these general principles: it will enable \$2.5 million in rehabilitation, with a scope acceptable to the City; it will result in a 50/50 split of \$6 million in cash paid to the City; and, FCH has demonstrated to the City's satisfaction that \$3 million is needed to strengthen its financial condition to an adequate level.

Sponsor characteristics: In order for the City to subsidize operations for an affordable housing developer by allowing a cash-out refinancing, the developer must share the City's mission orientation and focus on San José, and have recently demonstrated consistency with the City's policy priorities. Nonprofits that are designated as local CHDOs (Community Housing Development Organizations) under federal HOME regulations meet all of these criteria. Becoming a CHDO and following HOME regulations can be challenging for some agencies. However, any nonprofit could approach the City about becoming a CHDO. Therefore, staff recommends that approvals of cash-out refinancings will only be considered for San José CHDOs.

Sponsors also must have a track record of production in San José of at least three City-subsidized affordable properties, such that its ongoing financial health is material to the City both as a lender and as the holder of recorded affordability covenants. The Sponsor also must be in good standing with the City currently, with no issues of material non-compliance or non-payment on any of its deals.

Finally, as the City should only prioritize local owners focused on serving San José, the sponsor must indicate its willingness to retain an ownership in the refinancing property for at least the following five years.

CHDO Operating Subsidy: It should be noted that as a CHDO, FCH is authorized to receive HOME funds for operating costs if they demonstrate the need for such a subsidy. FCH requests and receives \$100,000 in HOME funds from the City on an annual basis. Going forward, when the City authorizes a cash-out refinance to assist a CHDO with operating costs, the City's policy will be to not provide the annual operating subsidy in the same year as the transaction. Accordingly, if this refinancing transaction is approved by City Council, FCH will not receive the operating subsidy in
FY 2016-17.

This proposal: FCH meets all of these sponsor criteria—it is a San José CHDO currently in good standing; it has shifted populations in all three of its forthcoming San José developments' to focus on the City's homeless population; it is headquartered in San José and has 13 existing subsidized affordable developments located in San José; it has no issues of material noncompliance on any of its deals; it has submitted its financial documents for review by the City; and, it plans to retain the sole ownership stake in Rincon for the foreseeable future.

Liquidity requirements: Developers need ongoing liquidity not only to cover organizational expenses, but also to meet lender and investor requirements in order to finance new developments. For the City to forego repayments in order to support a developer's liquidity, it only makes sense if future developments are likely to proceed within the City's boundaries. Further, to meet the City's policy priorities, a developer's future developments must contain a significant portion of apartments that are affordable to extremely-low income residents. It is in the City's interest to support future developments that are its highest priority. The presence of City subsidy, and site control, are both necessary ingredients for such developments to proceed.

Finally, sponsors must also demonstrate a financial need for the funds requested. While most nonprofit developers will be able to meet this requirement, a review of audited financial documents must be performed. Staff's analysis of the liquidity requirements, and of the developer's current and projected liquidity, must support the projected cash-out amount to the developer.

This proposal: Staff has determined that the FCH proposal meets these standards regarding liquidity. FCH currently has full site control and land use entitlements for three affordable rental developments in San José. Second Street Studios, North San Pedro Apartments, and Leigh Avenue Senior Apartments are currently in the predevelopment stage. Both Second Street and North San Pedro are expected to start construction in the coming 12 months and have existing City funding commitments. Potential lenders and investors for these developments have requirements that developers' liquid assets be $1-1.5 million in order to mitigate their lending and investing risks. Staff's analysis of the FCH corporate financials and its future projections of cash assets concluded that $3 million is necessary to meet their liquidity requirements and to ensure adequate staffing levels.

Approved uses of refinancing proceeds: The City will prioritize rehabilitation as the first use of loan proceeds, with a scope of work approved by the City. Transaction costs that involve prepayment penalties are an inefficient use of scarce funds that otherwise would be used to support new affordable housing creation. Therefore, financing penalties associated with earlier-than-expected senior loan repayments should be as small as possible. In no case shall they exceed the amount of rehabilitation for the property. Finally, the amount of proceeds to be taken out of the deal by the owner must be matched by an equal pay-down of the City's loan (i.e., a 50/50 split of cash proceeds), unless the City opts against prepayment and instead requests alternative consideration.

This proposal: The Rincon transaction meets these guidelines: $2.5 million will be spent on rehabilitation, while a lesser amount of $1.7 million will be spent on a prepayment penalty; and, the remaining $6 million in cash out will be split 50/50 with the City.

Senior loan characteristics: For the City to subordinate to a new senior loan, it needs to ensure that the new financing structure will not result in the property being overleveraged. Underwriting for the senior loan should be prudent, with a maximum expected senior loan LTV of 75% and a combined LTV of the new senior loan plus the City's loan amount at closing of no more than 90%. In addition, there should be a debt coverage ratio of at least 1.25 times after refinancing, preferably higher. The senior loan and the City loan must meet City underwriting standards and therefore demonstrate they can be repaid within their terms. The financing structure plus initial pay-down of the City's loan should also result in an overall net positive financial position for the City.

Finally, the City's policy is that it does not subordinate its existing affordability restrictions to new senior debt. However, the City may agree to a brief 'standstill' period, giving a senior lender 2-3 months and right to cure any default conditions that might exist before the City would exercise its remedies.

This proposal: The Rincon proposal incorporates these principles of prudent underwriting and a net positive financial benefit to the City. The senior loan LTV is 60% and the combined LTV is 86%, with a debt coverage ratio of 2.4:1, meeting the City's parameters. Both LTV and DCR—measures of loan safety—are improved relative to the original loan underwriting in 1995. The combined LTV will be somewhat higher with the new loan than that for the existing loan prior to closing. However, because the senior loan is conservatively underwritten, the size of the loan does not present additional risk to the City. At maturity in 10 years, the senior loan will need to again be refinanced in order to retire the full principal amount. However, the financial projections show that such refinancing can comfortably be achieved at that time. The interest-only new senior loan will lower annual new debt service payments, which will in turn increase the Property's annual net cash flow. This is expected to accelerate repayment of the City's loan by approximately six years. Finally, the City's affordability restrictions will not be subordinated to the new debt.

Summary of Proposed Transaction's Compliance with Cash-out Refinancing Framework:

In summary, staff supports the proposed Rincon transaction for the many ways in which it meets the City's framework on cash-out refinancings, as described above. It is in the City's best interest to support FCH as a capable local nonprofit developer who is focused on San José's needs and is a productive development partner with a mission closely aligned to the City's. The Rincon transaction is consistent with these general principles: it will enable $2.5 million in rehabilitation, with a scope acceptable to the City; it will result in a 50/50 split of $6 million in cash paid to the City; and, FCH has demonstrated to the City's satisfaction that $3 million is needed to strengthen its financial condition to an adequate level.

Consideration

This action delegates to the Director of Housing the authority to negotiate and execute all documents necessary to complete the financing transaction and manage rehabilitation disbursements. As consideration for making the recommended changes, Borrower has agreed to give the City the following:

1. An extension of the Property's term of affordability by an estimated six years; and,
2. Edits to the City's documents to reflect the Housing Department's current practices, including enhanced operating covenants for the Borrower and payment of annual monitoring fees to help recoup City staff costs.

EVALUATION AND FOLLOW-UP

Following the closing of the subject refinancing, the Housing Department will ensure that all property rehabilitation is successfully completed. Also, because the Department is involved in the Sponsor's other developments, it will follow up on the financing efforts and the predevelopment expenditures for these developments.

POLICY ALTERNATIVES

In developing the recommendations set forth in this memorandum, the following alternative was considered:

Alternative #1:	***Deny the Borrower's request to refinance the Rincon property and to take a distribution of funds from that refinancing***
Pros:	Allowing an owner to take cash out of refinancing proceeds before repaying its City loan in full does not maximize the City's loan repayments in the near-term.
Cons:	Maximizing the City's loan repayments is only one of the City's objectives. Not permitting the Borrower to take cash out of the refinancing would jeopardize FCH's ability to successfully close financing on 268 new affordable apartments in two developments within the City of San José, 189 of which will serve the homeless and formerly homeless veterans—one of the City's highest priorities at this time. Failure to allow the refinancing would preclude the ability to invest in the rehabilitation of the property, and would preclude the owner from taking advantage of current low interest rates. Further, preventing the Borrower's cash distribution would leave more equity in the property, which would have no immediate benefit to the City.
Reason for not recommending:	It is warranted to permit the refinancing of the Rincon property with a cash out distribution to the Borrower/Sponsor because it would resolve several issues without additional risk to the City. Denial of this request would leave issues of property rehabilitation and Borrower financial strength unresolved in search of other solutions which are not readily available.

PUBLIC OUTREACH

This Memorandum will be posted on the City Council Agenda website for the June 14, 2016 meeting.

COORDINATION

Preparation of this report was coordinated with the City Attorney's Office.

FISCAL/POLICY ALIGNMENT

These actions allow FCH to move forward with development of 198 new apartments for the homeless and formerly-homeless veterans—one of the City's highest priorities. Further, these actions are consistent with the City's *Envision 2040 General Plan, The 2014-23 Adopted Housing Element* and with the City's *2015-20 HUD Consolidated Plan* in that they will help to preserve existing affordable housing opportunities for very low- and extremely low-income households through lengthened and strengthened affordability restrictions.

COST SUMMARY/IMPLICATIONS

Approval of the recommended actions would allow the City to receive a pay down of its loan on the property in the approximate amount of $3,000,000. No additional City funds are being disbursed for this transaction.

The anticipated revenue will be deposited in the Low and Moderate Income Housing Asset Fund (Fund 346) and will be used for future affordable housing opportunities.

CEQA

Categorical Exemption, Guidelines Section 15301(d) Existing Facilities. File No. PP16-066.

/s/
JACKY MORALES-FERRAND
Director, Housing Department

For questions, please contact Kristen Clements, Division Manager at (408) 535-8236.

Attachment

ATTACHMENT A

Site Map
Rincon de los Esteros
1780 Old Oakland Road
Council District 4