COUNCIL AGENDA: 11/15/16
ITEM: 4.2

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand
Julia H. Cooper

SUBJECT: **SEE BELOW**

DATE: October 24, 2016

Approved D.DSyL Date 11/4/16

COUNCIL DISTRICT: 7

SUBJECT: APPROVAL OF THE ISSUANCE OF A TAX-EXEMPT MULTIFAMILY HOUSING REVENUE NOTE AND LOAN OF NOTE PROCEEDS AND RELATED DOCUMENTS FOR THE DON DE DIOS APARTMENTS, AND APPROVAL OF AMENDED CITY LOAN TERMS FOR THE DON DE DIOS APARTMENTS

RECOMMENDATION

Adopt a resolution:

a. Authorizing the issuance of a tax-exempt multifamily housing revenue note designated as "City of San José Multifamily Housing Revenue Note (Don de Dios Apartments), Series 2016A (the "Series 2016A Note") in a principal amount not to exceed $20,000,000;

b. Approving a loan of Series 2016A Note proceeds to Don de Dios L.P., a California limited partnership created by EAH, Inc., a California nonprofit public benefit corporation, to finance the acquisition and rehabilitation of the Don de Dios Apartments located at 987 Fair Avenue, in San José (the "Property");

c. Approving in substantially final form the Funding Loan Agreement, Borrower Loan Agreement and Regulatory Agreement and Declaration of Restrictive Covenants (the "Series 2016A Documents");

d. Authorizing and directing the City Manager, Director of Finance and Director of Housing, or their designees, to execute and, deliver the Series 2016A Documents and related Series 2016A Documents as necessary; and

e. Authorizing the Director of Housing to negotiate and execute amendments to existing City loan documents relating to the Don de Dios Apartments consistent with the terms described below.

OUTCOME

Approval of the recommended actions will enable the issuance of a multifamily housing revenue note for the purpose of financing the acquisition and rehabilitation of an existing 70-apartment rental property, all apartments in which are and will continue to be affordable for a period of at least 55 years. This Property serves and will continue to serve low- and very low-income families with current annual incomes up to $77,700 for an assumed family size of up to six people.

EXECUTIVE SUMMARY

In accordance with the City's Policy for Issuance of Multifamily Housing Revenue Bonds, EAH, Inc., a California nonprofit public benefit corporation (the "Developer"), has requested that the City issue a tax-exempt multifamily housing revenue note in an amount not to exceed $20,000,000 (the "Series 2016A Note"). The Series 2016A Note will be purchased and funded by MUFG Union Bank, N.A. ("Union Bank").

The proceeds of the Series 2016A Note will be loaned to Don de Dios L.P., a California limited partnership (the "Borrower") formed by the Developer. These proceeds, together with other funds, will be used by the Borrower to finance the acquisition and rehabilitation of an existing 70-apartment rental housing complex (the "Project") known as Don de Dios Apartments (the "Property"). This financing is intended to ensure the Property's long-term physical and economic viability and, in so doing, enable it to lengthen the period for which it will be an affordable housing resource for the City's residents. The Note will **not** be paid from or secured by the general taxing power of the City or any other City asset.

The City has an outstanding loan in the amount of $1,626,224, which will be recast as a new loan at Note closing. The City will amend and restate the loan documents with respect to the Property incorporating the amended terms discussed below.

BACKGROUND

Borrower. The Borrower is a California limited partnership. The Borrower will consist of: (1) Don de Dios EAH, LLC, a nonprofit subsidiary of the Developer, as General Partner and (2) Red Stone Equity Partners, or an affiliate thereof, as the tax credit investor limited partner.

The Developer has requested that the City issue the Series 2016A Note for the purpose of lending Series 2016A Note proceeds to the Borrower. The proceeds of the Series 2016A Note, together with other funds, will be used by the Borrower to finance the acquisition and rehabilitation of the Property.

Property Overview. The Project involves the acquisition and rehabilitation of 70 one-, two, three- and four-bedroom rental apartments. Upon completion of the Property's rehabilitation:

- 58 apartments of one to four bedrooms (approximately 85 percent) will continue to be rented to households with incomes up to 50 percent of the area median income ("AMI"), with current incomes up to $64,750 for a six-person family in a four-bedroom apartment, with the limit varying by apartment and household size;
- 10 apartments of one to four bedrooms (approximately 15 percent) will continue to be rented to households with incomes up to 60 percent of AMI, with current incomes up to $77,700 for a six-person family in a four-bedroom apartment, with the limit varying by apartment and household size; and
- Two apartments will continue to be restricted at moderate-income levels for resident managers or other property workers with incomes up to 110 percent of AMI, which limits are currently $106,040 (three-person household in a two-bedroom apartment) and $122,513 (five-person household in a three-bedroom apartment).

The Property is currently owned by Don Avante Associates I, L.P. ("Don Avante"), a California limited partnership created by the Developer. Don Avante purchased the Property in June 1999. The Property, originally built in the early 1970's, consists of 14 one- and two-story garden style/townhouse residential buildings, each containing four to six apartments. The Borrower will be acquiring the Property to recapitalize it and to provide funds for its rehabilitation. Because of the number of years that the Property has been owned by Don Avante, the Borrower can qualify for new tax-exempt financing and a new allocation of Low Income Housing Tax Credits – the major sources of funding for acquisition and rehabilitation of existing affordable multifamily properties.

The current scope of Property rehabilitation is intended to: (a) upgrade major building systems that have become obsolete, (b) reduce operating and maintenance expenses, (c) improve energy efficiency and, (d) improve the safety, functionality, accessibility of the apartments and common areas. Specific improvements will be made to the:

- Site – repair asphalt in parking lot; create additional disabled parking spaces; revise pathways to common areas; install drought-resistant landscaping; repair/replace the irrigation system.
- Structure – replace exterior stucco wall, back patio wood fences, roofing and gutters, windows, exterior doors; repair dry rot.
- Common areas – enlarge community building; improve the laundry room, kitchenette and restroom; replace flooring; repaint; add signage.

- Electrical – upgrade existing electrical panels; install arc fault current interrupters and GFCI protected receptacles in all apartments.
- Mechanical and Plumbing – replace all hot water plumbing lines; replace existing furnaces and water heaters; install low flow toilets, faucets and showerheads; replace bathroom exhaust fans; replace/repair tubs; provide ADA-compliant tubs and showers.
- Interiors/Finishes – replace appliances, kitchen sinks, disposals, counter tops; install new flooring, energy efficient light fixtures, and window coverings and remodel several apartments to provide full accessibility.

The Property rehabilitation will involve temporary relocation of existing tenants, but no households are expected to be relocated permanently. This rehabilitation work will take approximately eight weeks per unit, which will require off-site temporary relocation of the affected households during this period. The Developer's staff will interview households to determine their needs, and will administer the relocation in accordance with a Relocation Plan prepared by a third-party firm that specializes in relocation law. All temporary relocations will be carried out in phases versus vacating all occupied units at once. The Developer has budgeted $1.5 million for relocation. Any and all obligations to accommodate relocation of residents will be the responsibility of the Borrower.

City Loan for the Property. In June 1999, the City made a loan of $1,740,000 in connection with the original acquisition and rehabilitation of the Property by Don Avante. The loan was funded from housing set-aside tax increment funds and is currently outstanding in the amount of $1,626,444.

City as Issuer of Multifamily Housing Bonds. The City's Policy for Issuance of Multifamily Housing Revenue Bonds (the "City's Policy") is that the City shall be issuer of any tax-exempt multifamily housing bond for affordable housing projects which it has made or will be making a loan. The Series 2016A Note is the equivalent of a multifamily housing revenue bond.

Sources of Project Funding. Series 2016A Note proceeds will fund a portion of the total Project costs, which are currently estimated to be $30,680,789. The Series 2016A Note will be purchased/funded by Union Bank.

During the acquisition and rehabilitation period, the Series 2016A Note will be variable rate in an estimated amount of $17,017,031 but not to exceed $20,000,000. Following the rehabilitation of the Property and its lease-up and stabilization ("at permanent"), the Series 2016A Note will be reduced to an estimated principal amount of $7,020,000, with Note interest remaining variable rate. The Borrower, however, will enter into a variable rate to fixed rate interest rate swap with Union Bank, which will have the effect of fixing the permanent loan rate to the Property for the length of the swap. The permanent Note will have a 15-year term with a 35-year amortization schedule.

The sources of funding for the Property's acquisition and rehabilitation phase and permanent phase are estimated as follows:

City of San José
Don de Dios Apartments
Plan of Finance – Sources of Funding[1]

Source	Acquisition-Rehabilitation	Permanent
Note Proceeds	$ 17,017,031	$ 7,020,000
City of San Jose Loan	1,626,444	1,626,444
Seller Carryback	7,440,308	7,440,308
Construction Period Deferred Interest	330,916	330,916
Tax Credit Equity	1,235,143	12,351,427
General Partner Equity	0	500,000
Withdrawal from Project Reserves	190,954	190,954
Deferred Costs	1,834,558	0
Deferred Developer Fee	1,005,555	1,005,555
Income from Operations	0	215,405
Total	$ 30,680,789	$ 30,680,789

Financing History of the Property – Key Dates. The following are the key dates relating to the financing history of the Property:

• May 10, 2016	TEFRA Hearing held by Director of Finance
• May 19, 2016	Application submitted to California Debt Limit Allocation Committee ("CDLAC") for $20 million private activity bond allocation
• July 20, 2016	City received $20 million private activity allocation from CDLAC
• August 20, 2016	Project received annual allocation of federal tax credits from the California Tax Credit Allocation Committee ("CTCAC") of $1,165,579 which will be sold in exchange for Tax Credit Equity

ANALYSIS

This portion of the report is divided into several sections to address the items in staff's recommendation to proceed with the financing for the Project. These sections describe the financing structure, financing documents, financing team participants, and financing schedule.

1 Estimated as of the date of this report. The actual amounts may vary from these estimates.

Note Financing Structure

Overview of the Multifamily Note Financing

General. Multifamily housing financing historically has involved the issuance of tax-exempt bonds on behalf of private developers of qualifying affordable rental apartment properties. The City would issue tax-exempt bonds and loan the proceeds to the developer/ borrower. The advantages of tax-exempt financing to developers include below-market interest rates and compatibility with low income housing tax credits – features that are not available with a conventional multifamily housing mortgage loan. The bonds are limited obligations of the City, payable solely from loan repayments by the borrower and not by the general taxing power of the City or any other asset of the City.

The Series 2016A Note operates in a very similar manner to tax-exempt multifamily housing bonds. The City Charter provides that the City may issue revenue bonds and execute and deliver revenue notes pursuant to California law. The City is authorized to issue the Series 2016A Note pursuant to California Health and Safety Code Sections 52075-52098, as amended (the "Act"), which authorize cities to issue revenue bonds and execute and deliver revenues notes for the purpose of financing the acquisition and rehabilitation of multifamily rental housing. Section 52011 of the California Health and Safety Code defines "Bonds" to include notes for purposes of the Act. The Series 2016A Note uses a portion of the State's federal tax-exempt private activity cap allocated by CDLAC. The Series 2016A Note also allows the Property to qualify for tax credits provided through CTCAC. The Series 2016A Note is a limited obligation of the City, payable solely from loan repayments by the Borrower and is not secured by the general taxing power of the City or any other asset of the City.

The note financing structure is being utilized because of a ruling of the Office of the Comptroller of the Currency ("OCC") that has seemed to distinguish loans from bonds for purposes of counting maximum Community Reinvestment Act ("CRA") credit. OCC is said to treat tax-exempt bond financing activity as an investment rather than as a loan for CRA purposes. For the past several years, many banks have been utilizing the note financing approach based on a belief that it meets OCC's definition of a CRA loan as well as CDLAC's requirements for tax-exempt financing.

Requirements for Tax-Exemption. For a multifamily housing revenue note or bond to qualify for tax-exemption, federal law generally requires that one of two restrictions must apply: either (1) at least 20% of the apartments in the housing development must be reserved for occupancy by individuals and families whose income is 50% or less of area median income or (2) at least 40% of the apartments must be reserved for occupancy by individuals and families whose income is 60% or less of area median income. The second restriction will be incorporated into the Regulatory Agreement for the Series 2016A Note.

Structure of the Series 2016A Note

Direct Purchase/Funding Structure. The Series 2016A Note will be structured as a non-rated and non-credit-enhanced obligation that is directly purchased/funded by Union Bank as the initial purchaser/lender. Pursuant to the City's policies regarding non-credit enhanced notes, Union Bank will sign an Investor Letter acknowledging that it is a "qualified institutional buyer" or an "accredited investor" – that is, a large institutional investor who understands and accepts the risks associated with an unrated note secured solely by the Property rents. If Union Bank wishes to transfer the Series 2016A Note, the new Series 2016A Note holder must sign and deliver a similar Investor Letter to the Fiscal Agent. The 2016A Note may only be transferred in whole, although Union Bank may sell participation interests in minimum amounts of $250,000.

Principal Amounts and Terms. Based on current projections, the Series 2016A Note is anticipated to be issued in the amount of $17,017,031 but in no event to exceed $20,000,000. After the Property is rehabilitated and leased up, and conversion to the permanent loan phase occurs (the "Conversion Date"), the principal balance of the Series 2016A Note is expected to be paid down to approximately $7,020,000 with tax credit equity funds. The Conversion Date is anticipated to be in approximately 15 months after Note closing.

The maturity of the Series 2016A Note is 15 years after the anticipated Conversion Date. Principal of the Series 2016A Note remaining on the Conversion Date will amortize on a 35-year basis commencing on the Conversion Date. At maturity, the Borrower will need to refinance the remaining balance of the Series 2016A Note or repay the remaining balance from another funding source.

Interest Rates. During the acquisition and rehabilitation period, the Series 2016A Note will pay interest only at a variable rate equal to 65% of 30-day LIBOR (London Inter-Bank Offered Rate) plus a margin of 1.65%.

After the Conversion Date, interest on the Series 2016A Note will remain variable at a rate equal to 65% of 30-day LIBOR plus a margin of 2.40%. However, the Borrower will enter into an interest rate swap that will have the effect of fixing the permanent loan rate for its term. That fixed rate, which will be set before closing, is estimated to be 3.80% based on current market conditions.

Financing Documents

The following is a brief description of each document the City Council is being asked to approve and authorize its execution. Copies of these documents will be available in the City Clerk's Office on or about October 29, 2016.

Funding Loan Agreement. The Series 2016A Note will be issued under a Funding Loan Agreement (the "Agreement") among the City, Union Bank, as funding lender, and U.S. Bank, as the fiscal agent (the "Fiscal Agent"). The Agreement will be executed by the Director of Finance, or another authorized officer, on behalf of the City, and attested by the City Clerk. Pursuant to the Agreement, the Fiscal Agent is authorized to receive, hold, invest, and disburse Series 2016A Note proceeds and other funds established under the Agreement; to authenticate the Series 2016A Note; to apply and disburse payments to the Series 2016A Note holders; and to pursue remedies on behalf of the Series 2016A Note holders. The Agreement sets forth the guidelines for the administration, investment and treatment of investment earnings generated by each fund and account, and restrictions relating to any subsequent transfer of a Series 2016A Note. The Borrower Loan Agreement (described below) obligates the Borrower to compensate the Fiscal Agent for services rendered under the Agreement.

Borrower Loan Agreement. This document (the "Loan Agreement") is between the City and the Borrower. The Loan Agreement will be executed by the Director of Finance, or another authorized officer, on behalf of the City. The Loan Agreement provides for the loan of Series 2016A Note proceeds to the Borrower for the acquisition-rehabilitation and permanent financing of the Property, and for the repayment of such loan by the Borrower. The loan will be evidenced by a Note (the "Loan Note") in an amount and with terms that mirror the Series 2016A Note. The City's rights to receive payments under the Loan Note will be assigned to the Fiscal Agent, along with certain other rights under the Agreement, the Loan Agreement and the Series 2016A Note; however, certain reserved rights have been retained by the City, such as the City's right to indemnification.

Regulatory Agreement and Declaration of Restrictive Covenants. This agreement (the "Regulatory Agreement") is among the City, the Fiscal Agent and the Borrower. The Regulatory Agreement contains certain covenants and restrictions regarding the Property and its operations intended to assure compliance with the Internal Revenue Code of 1986. The Regulatory Agreement is executed by the Director of Finance and Director of Housing, or other authorized officers, on behalf of the City. The Regulatory Agreement restricts the rental of 68 of the Property's apartments to low-income and very low-income residents for a period of at least 55 years.

Financing Team Participants

The financing team participants for the Series 2016A Note consist of:

- City's Financial Advisor: Ross Financial
- Bond Counsel: Jones Hall, A Professional Law Corporation
- Fiscal Agent: U.S. Bank National Association
- Funding Lender: MUFG Union Bank, N.A.

All costs associated with the Financial Advisor, Bond Counsel, and Fiscal Agent are contingent upon the sale of the Series 2016A Note and will be paid from Series 2016A Note proceeds, tax credit equity, and/or Borrower funds.

Financing Schedule

The current proposed schedule is as follows:

• Council Approval of Series 2016A Note/Note Documents	November 15, 2016
• Pre-close Series 2016A Note	November 28, 2016
• Close Series 2016A Note	November 29, 2016
• CDLAC Deadline for Series 2016A Note Closing	January 20, 2017

City Funding/Loan

The City currently has an outstanding loan with respect to the Property in the amount of $1,626,444, as well as existing affordability restrictions (in aggregate, "City Loan"). At closing of the Series 2016A Note, the City Loan terms will be amended as follows:

1. Affordability Restrictions – The term of the City's Affordability Restriction will be extended to start a new 55-year period commencing at the date of the Notice of Completion for the rehabilitation work, expected in 2018. This new affordability period represents a net increase of 19 years to the existing City affordability period. In addition, the affordability level for 14 of the 60% AMI apartments will be reduced to 50% AMI, which will benefit qualifying tenants by lowering the maximum rent for those apartments.

2. Interest Rate – The compounded interest rate will be the greater of 3% or the Applicable Federal Rate ("AFR") at the time of closing, as is required for affordable properties that do not pay off existing City financing at the time of obtaining new tax credits. Since the current AFR is in the low 2% range, it is expected that the City Loan will bear a 3% rate, which is the City's current interest rate.

3. Loan Term – The restated City Loan term will start at the close of financing and will mature in 55 years. The City's current Note matures in 2040. This extension, 33 years, is typical of resyndications with new awards of tax credits in that investors desire co-terminous City loans and affordability restrictions.

4. Subordination –The City's Deed of Trust and its Affordability Restriction will be subordinated to the new Bond loan. However, in the unlikely event that Union Bank forecloses on the Property, existing residents at that time would be protected from the imposition of market-rate rents. Those residents in compliance with their leases would be permitted to stay and to continue to pay restricted rents until they chose to vacate voluntarily.

5. Other – The City will incorporate additional provisions in the Affordability Restriction that provide for City loan monitoring and loan servicing fees, Borrower operating and reporting covenants, and certain City approval rights. Also, together with the senior lender, the City will oversee rehabilitation using the assistance of an external construction consultant, to ensure the quality of rehabilitation.

The proposed resyndication will reduce the amount of loan repayments the City would have otherwise expected for the next 10-12 years. However, as the City Loan has compounding 3% interest rate and will retain its 75% share of annual net cash flow, the City will realize a return that is greater than most City loans that carry simple interest on the amounts outstanding. The City's bond fees and its annual monitoring and collections fees will enhance the City's housing revenues. Additionally, the lengthened period of affordability and the use of improved City loan documents benefit the public and the City's interests.

Given that the Property will undergo significant, needed rehabilitation and will start a new 55-year period of restricted affordability through this resyndication, it is recommended that the City support these requested actions. Overall, these changes are reasonable and will preserve this affordable rental asset for many additional years.

EVALUATION AND FOLLOW-UP

This Memorandum presents the set of recommendations related to the City Council's approval of the issuance of the Series 2016A Note and requires no follow-up to the City Council. Once the Series 2016A Note closes, anticipated in mid-November 2016, and the acquisition and rehabilitation of the Property commences, the Housing Department will provide updates in its Quarterly Construction Reports posted at www.sjhousing.org under "Reports & Data."

PUBLIC OUTREACH

The method of notifying the community of the City's intent to issue the tax-exempt private activity Note is the Tax Equity and Fiscal Responsibility Act (TEFRA) Hearing. The TEFRA Hearing was held on May 10, 2016 with the Director of Finance. The public hearing notice for the May 10, 2016 hearing was published in the *San José Post - Record* on April 21, 2016.

This Memorandum and the Series 2016A Note Documents will be posted on the City's website for the November 15, 2016 meeting.

COORDINATION

This report has been prepared by the Finance Department and the Housing Department in coordination with the City Attorney's Office and the Budget Office.

COMMISSION RECOMMENDATION / INPUT

This item was not heard by the Housing and Community Development Commission, as approvals of affordable development financing do not fall under the functions, powers and duties of the Commission delineated in Section 2.08.2840 of the San José Municipal Code.

FISCAL/POLICY ALIGNMENT

This action is consistent with the City's *Consolidated Plan 2015-2020,* adopted by City Council on May 5, 2015, to provide homes for very low- and extremely low-income households; and with Goal H-2 of the City's *Housing Element 2014-2023,* adopted by City Council on January 27, 2015, to "increase, preserve, and improve San José's affordable housing stock."

COST SUMMARY/IMPLICATIONS

All issuance costs will be paid from proceeds of the Series 2016A Note, tax credit equity and/or Borrower funds. The Series 2016A Note is a tax-exempt obligation secured by a mortgage loan payable from the Property. The Series 2016A Note will not be paid from, nor secured by, the general taxing power of the City or any other City asset.

City Fees

Based on the currently estimated initial size of $17,017,031 for the Series 2016A Note, the City will receive an upfront issuance fee of $67,543. The City will also receive an annual fee for monitoring the Property and reporting its compliance to CDLAC. Upfront bond and ongoing monitoring fees will be deposited into the Housing Trust Fund.

Under the City's Policy, nonprofit sponsors such as EAH are allowed a lower annual fee after the Conversion Date than before the Conversion Date. Before the Conversion Date, the annual fee is equal to one-eighth of a point (0.125%) of the initial principal amount of the bonds (or Note); after the Conversion Date, the annual fee is equal to one-eighth of a point (0.125%) of the principal amount of the bonds (or Note) on the Conversion Date, with a minimum fee of $7,500. Based on this formula, an initial $17,017,031 principal amount of Series 2016A Note prior to the Conversion Date and an expected $7,020,000 principal amount of Series 2016A Note to be outstanding on the Conversion Date, the annual fee will be $21,271 prior to the Conversion Date and $8,775 after the Conversion Date.

The Borrower is obligated to pay this fee throughout the 55-year Regulatory Agreement term; if the Series 2016A Note matures or is redeemed prior to maturity, the City has the option to require the Borrower to prepay the annual fee due for the remainder of the Regulatory

Agreement term. In addition, the City will receive its standard $43,795 transaction fee to compensate for staff time involved with the City Loan restructuring.

Compensation for the financing team participants (Financial Advisor, Bond Counsel and Fiscal Agent), as well as the costs of the Series 2016A Note, are contingent on the sale of the Series 2016A Note and will be paid from Series 2016A Note proceeds, tax credit equity and/or Borrower funds through escrow according to invoices submitted for the Project's closing costs.

CEQA

Exempt, File No. PP16-120, Section 15301 (d) Existing Facilities.

/s/	*/s/*
JULIA H. COOPER	JACKY FERRAND-MORALES
Director of Finance	Director, Housing Department

Please contact Derek Hansel, Assistant Director of Finance, at (408) 535-7041 for bond related questions and Kristen Clements, Housing Division Manager at (408) 535-8236 for Housing loan related questions.

ATTACHMENT A: Site Map

Attachment A

ATTACHMENT A

SITE MAP

987 Fair Avenue, San José
Council District 7