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October 1, 2020

MEMO TO: SELECTED CLIENTS, COLLEAGUES AND FRIENDS

FROM: R. WADE NORRIS, ESQ.
RYAN GEORGE, ESQ.
ETHAN OSTROW, ESQ.

RE: NGO MATERIALS ON THE MAJOR IMPACT OF THE HUGE TWO-YEAR DECLINE IN LONG-TERMS INTEREST RATES ON AFFORDABLE MULTIFAMILY RENTAL HOUISNG FINANCINGS

Ladies and Gentlemen,

As you know, at Norris George & Ostrow PLLC we continuously focus on major developments and trends which impact the tax-exempt debt side of affordable multifamily rental finance, and we work with our clients to develop and implement innovative financing structures in light of our ever-changing environment. Last July, given the dramatic changes in the financing markets triggered by the COVID-19 Pandemic, we sent many of you an article assessing its impact on our tax-exempt debt executions.

Here is a quote from our July 15 letter:

> In the first two months of 2020 both short and long-term interest rates were dramatically lower (by 200 basis points or more) than the recent highs reached in 2018 and 2019, and financing conditions were among the best we have seen in recent times. Of course, this changed very abruptly in mid-March. We all vividly remember the market freeze and interest rate spike which occurred when the nation panicked over the potential adverse impacts of the COVID-19 Pandemic. After that harrowing experience, both short-term and long-term interest rates have once again declined substantially and today generally stand even a bit lower than the very low levels which prevailed in early March. Even though some weakness has developed on the 4% LIHTC side and private activity bond volume continues to be an issue in a number of high growth markets, the pace of closings and new loan applications has held up much more strongly than we would have anticipated this spring in light of the widespread adverse impact of the Pandemic.

We have just completed an update of that assessment. It has only been two and a half months. Quite frankly, we were quite surprised. The data confirm a profound continuing downtrend in long-term permanent interest rates over the past two years. The **10-year U.S. Treasury is down 80%** from 3.25% in October 2018 to 0.70% today. **The 20-year LIBOR Swap Index is down about 70%** from 3.30% to 1.00%. While some widening of loan spreads has partially offset these declines, **all in tax-exempt borrowing rates** on most executions **have declined about 30% from around 5.0% two years ago to around 3.50% today**.

Our calculations strongly suggest that this has driven a 25% increase in tax-exempt loan proceeds over this period. Shifting from a 35 to 40 year loan amortization has added another 5% to loan proceeds. We believe this **increase in potential loan proceeds of over 1% per month over the past two years**, driven mainly by lower long-term rates, **is the most important factor explaining why our business has remained so robust**, notwithstanding the challenges present by the COVID-19 pandemic and other challenges which have emerged in the past year. We wanted to share some of our most recent thoughts and analyses with you.

We have enclosed three items which we hope will be helpful to you in assessing where we are in these financings, the optimal financing structures and current all-in borrowing rates under the major financing structures we use, and how our industry may fare in the months ahead:

1. Our October 1, 2020 PowerPoint entitled The 2020 Affordable Multifamily Rental Market Conundrum – Record Closing Volume in the Midst of a Pandemic – The Overwhelming Role of Declining Interest Rates.

2. A June 12, 2020 PowerPoint entitled Fannie Mae Tax-Exempt MBS Pass-Through Bonds ("M.TEBs").

3. A June 16, 2020 PowerPoint entitled Combining Tax-Exempt, Short-Term Bonds with Taxable GNMA Sale on FHA and Rural Development Loans for Affordable Apartment Financings – Executive Summary. (Note that short term cashed backed tax-exempt bond coupons are now around 30 basis points down from about 60 basis points, and negative arbitrage on these bonds is now well under ½ a point on most deals.)

We think there are storm clouds on the horizon, and that over the next 6 to 12 months could see a slowdown in our industry. However, we think increasing gap between the demand and supply for affordable multifamily rental housing and a strong rebound when the Pandemic abates will present substantial opportunities for those who are positioned to respond.

We hope you will find these items to be helpful and informative. These items are also available on our website at www.ngomunis.com. We look forward to working with you on many of these financings as this challenging year continues to unfold. We would love to discuss any aspect of these financings with you.

Best regards,

Wade Norris
Ryan George
Ethan Ostrow

Enclosures

The 2020 Affordable Multifamily Rental Market Conundrum – Record Closing Volume in the Midst of a Pandemic – The Overwhelming Role of Declining Interest Rates

October 1, 2020

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The 2020 Strong Affordable Multifamily Rental Market Conundrum

- Reports of continued increasing demand for private activity bond volume in California, Washington State, Colorado, Texas, Georgia and other high growth markets raises an interesting question – why are we all even busier in 2020 than in 2019, even though we are seven months into a major U.S. health pandemic and economic downturn?

- We would submit there are two primary driving factors:

  - Last spring and summer, Congress pumped $3 to $4 trillion of fiscal stimulus (almost 20% of $21 trillion U.S. GDP in 2019), into the U.S. economy, which enabled many renters to continue paying rent, notwithstanding horrific job losses in many major industries.

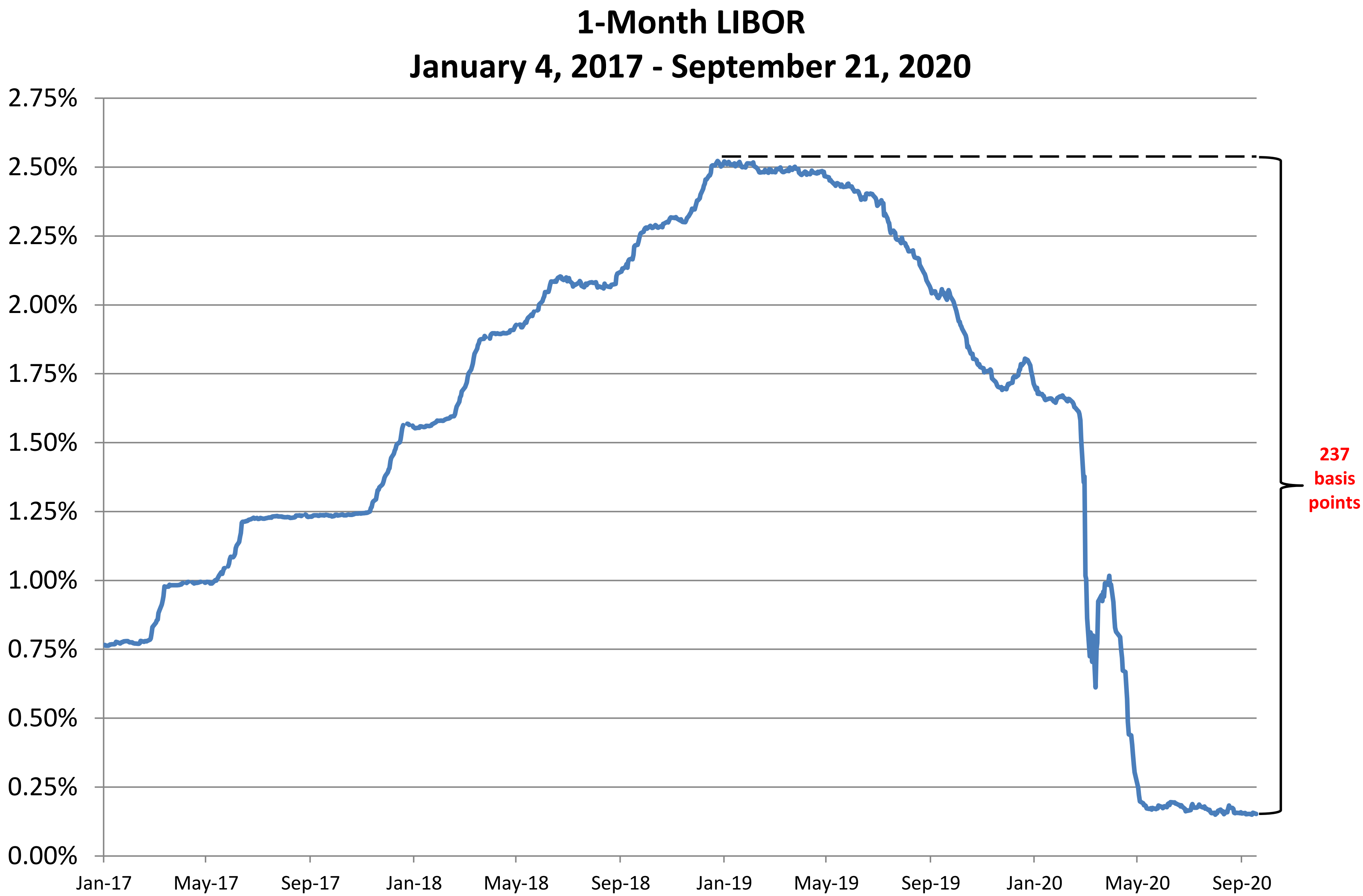
  - We are benefiting from a significant continuing decline in long-term interest rates, which is a fundamental valuation driver of long-duration assets, which include not only common stocks, but also rental apartments and other income producing properties.

- This PowerPoint explores the scope and the impact of the continuing interest rate decline on tax exempt/4% LIHTC transactions.

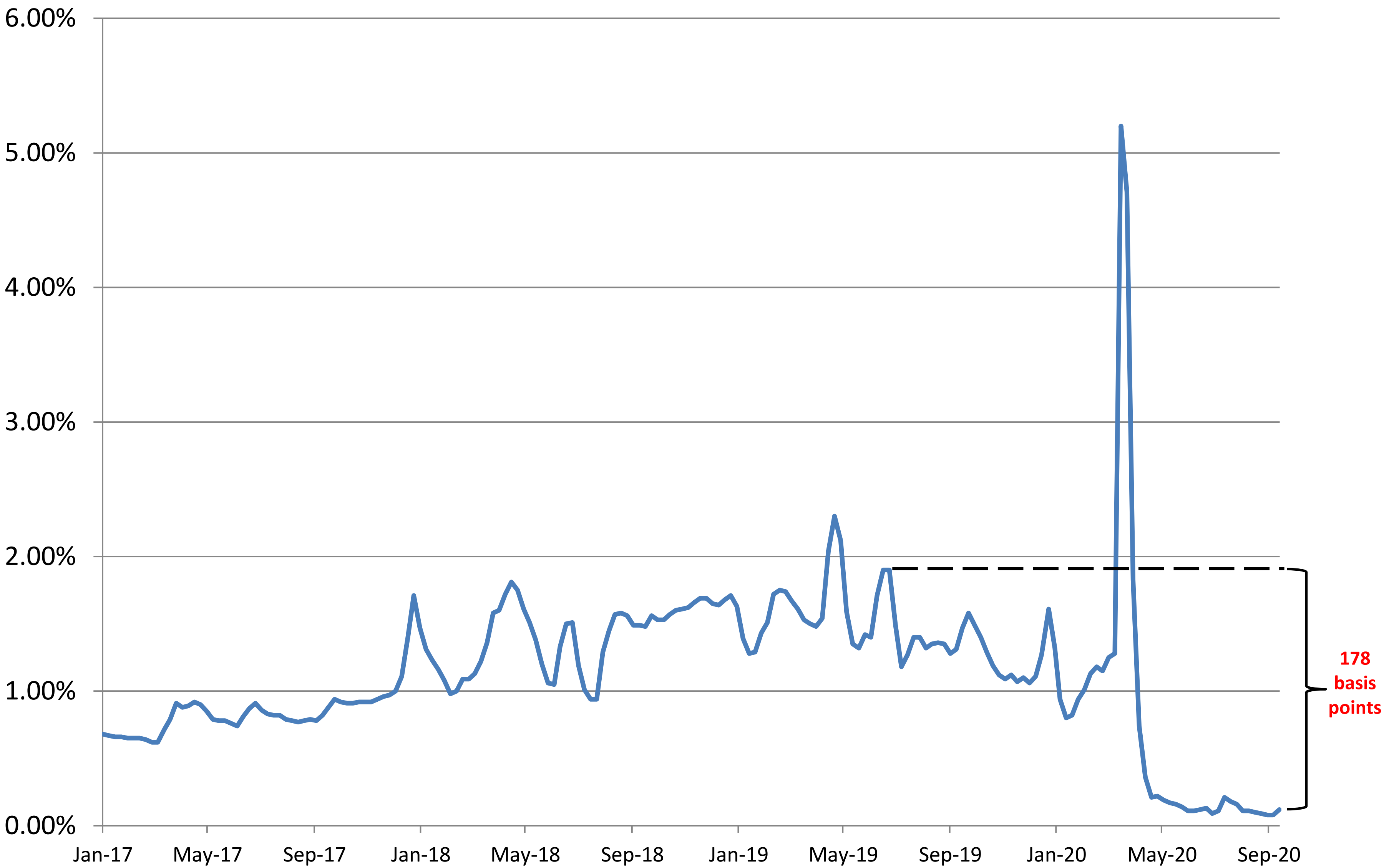
The 2020 Strong Affordable Multifamily Rental Market Conundrum

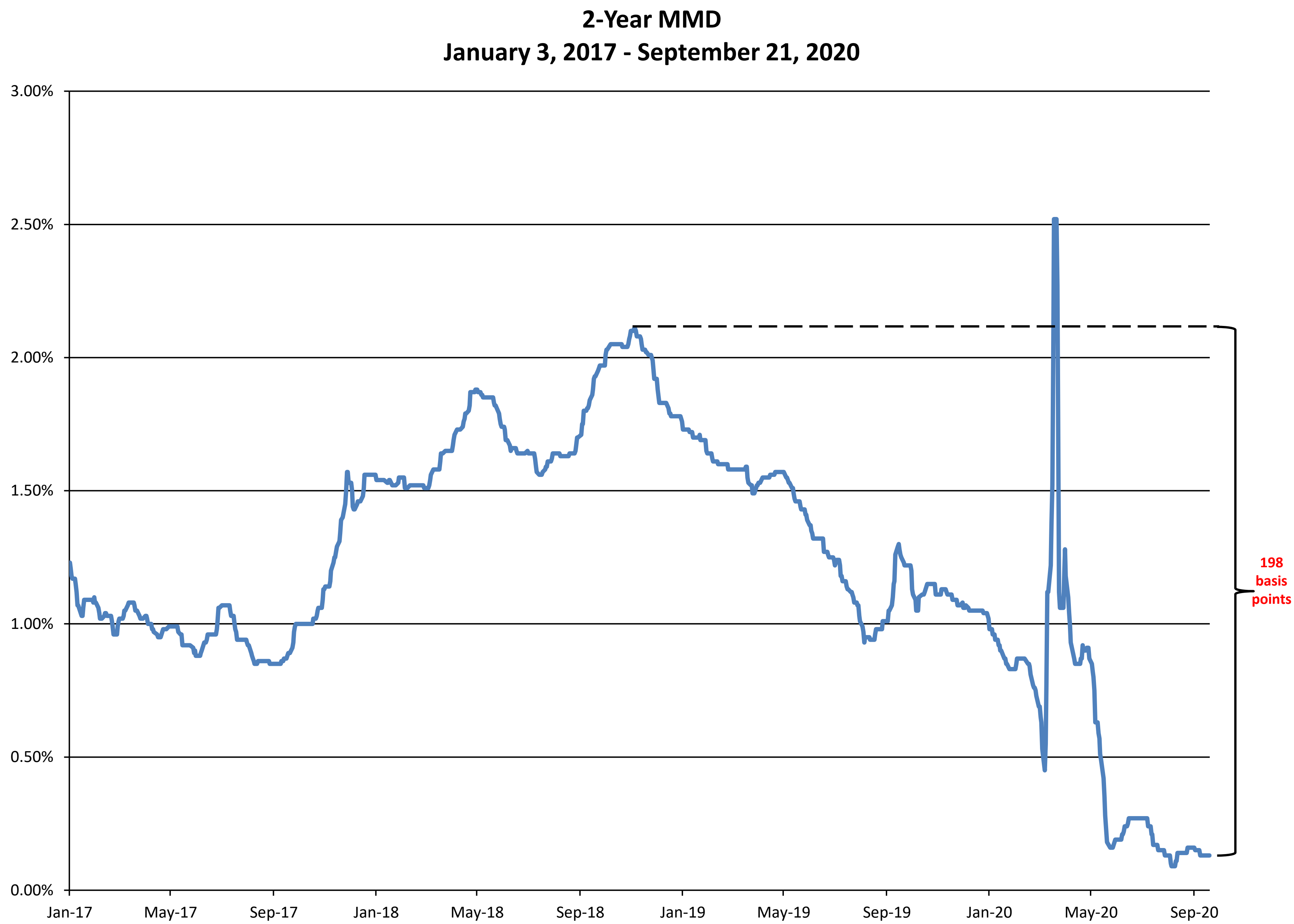
- The charts in the following five slides demonstrate vividly the remarkable drop in short-term and long-term interest rates which has occurred over the past two years.

- **Short-term Interest Rates:** After a horrifying spike in some short-term rates following the emergence of the COVID-19 pandemic in early March, short-term rate indexes have fallen even further, from levels in the 2.0% to 2.50% range two years ago, to a level of 10 to 20 basis points today.


1-Month LIBOR
January 4, 2017 - September 21, 2020
2.75%
2.50%
2.25%
2.00%
1.75%
1.50%
1.25%
1.00%
0.75%
0.50%
0.25%
0.00%
Jan-17
May-17
Sep-17
Jan-18
May-18
Sep-18
Jan-19
May-19
Sep-19
Jan-20
May-20
Sep-20
237
basis
points

SIFMA
January 4, 2017 - September 16, 2020




2-Year MMD
January 3, 2017 - September 21, 2020
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
Jan-17
May-17
Sep-17
Jan-18
May-18
Sep-18
Jan-19
May-19
Sep-19
Jan-20
May-20
Sep-20
198
basis
points

The 2020 Strong Affordable Multifamily Rental Market Conundrum

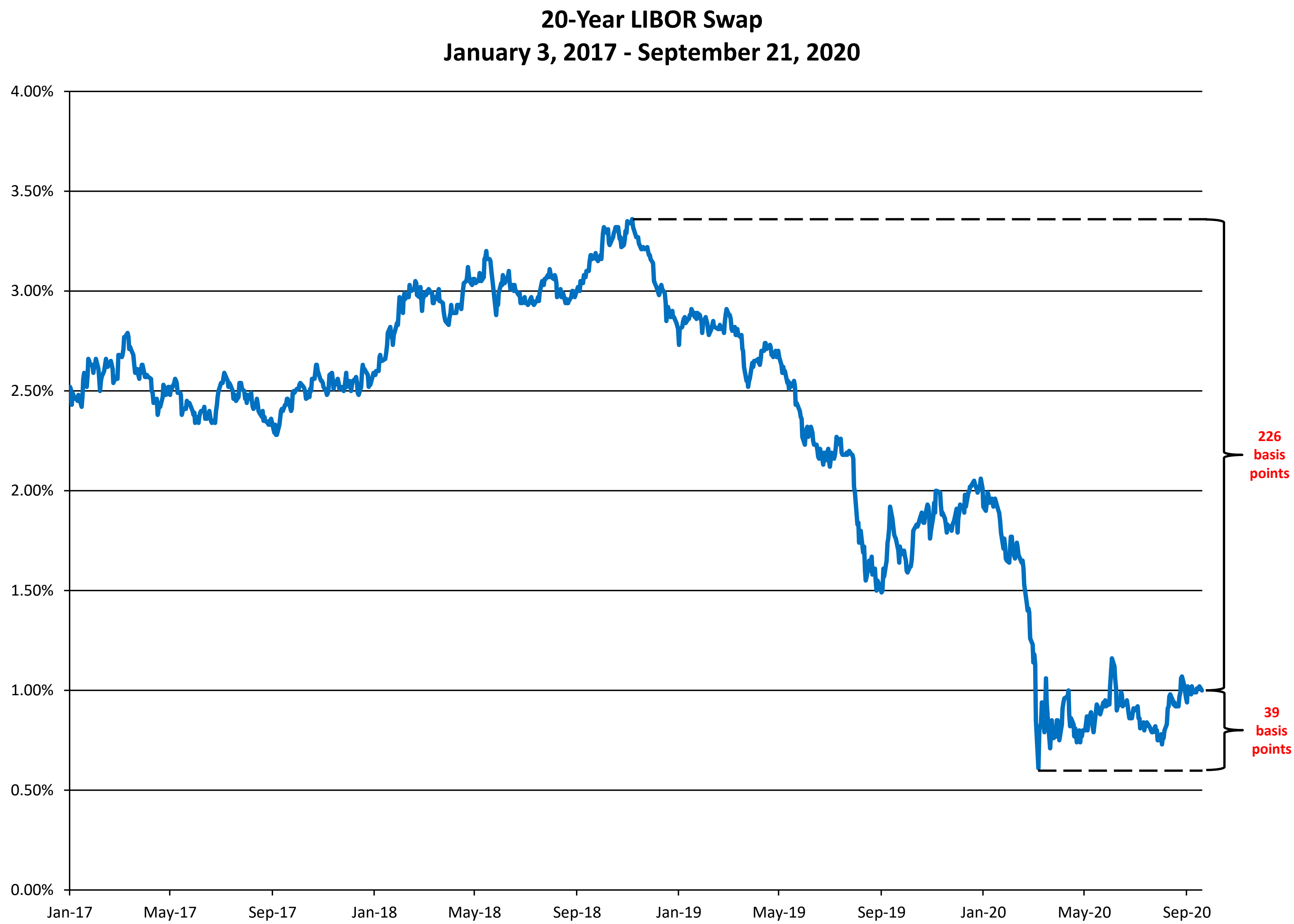
- **Long-Term Interest Rates.** Much more important is the significant decline in the **10-year U.S. Treasury rate**. This rate sets the base for many permanent lending rates, which is a major determinate of permanent loan size. **The 10-year U.S. Treasury rate has fallen** about 255 basis points, **from** a recent high of **3.25%** in the fall of 2018 **to about 70 basis points** today. This is almost an **80% decline** in the most important long-term rate.

- Similarly, **20-year LIBOR**, a proxy for base permanent lending rates in many tax exempt loan private placements (which generally price at a spread to 17- or 18-year LIBOR), **has fallen** from a high of about 3.30% two years ago by 230 basis points, or **about 70%**, to about 1.0% today.

- These are **huge** percentage declines in long-term base lending rates.

10-Year U.S. Treasury Rates
January 3, 2017 - September 21, 2020

Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, September 22, 2020


20-Year LIBOR Swap
January 3, 2017 - September 21, 2020
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
Jan-17
May-17
Sep-17
Jan-18
May-18
Sep-18
Jan-19
May-19
Sep-19
Jan-20
May-20
Sep-20
226 basis points
39 basis points

- **Partially offsetting** this has been a **slight widening of loan spreads** since the fall of 2019.
  - After the FHFA's September 2019 release constraining Fannie Mae and Freddie Mac multifamily volume, guaranty and servicing fees on Fannie Mae M-TEBs rose from around 100 basis points to about 140-160 basis points today. Similarly, spreads on Freddie Mac TEL executions widened from around 200 basis points to 260-280 for many executions.
  - Bank private placements have also recently seen permanent loan spreads to 17 or 18-year LIBOR rise from 200 to 250 basis points or so to a range of 220 to 275 for many financings.
- As the following chart shows, this still leaves the **permanent lending rates for many** bank and Freddie Mac TEL **private placements** at a level of about **3.50%**, or 150 basis points **(30%) lower than** the **5.0%** borrowing rates which prevailed on those executions only two years ago.
- Permanent lending rates on Fannie Mae, FHA and Rural Development financings have seen similar declines over this period.

Estimated All-in Borrowing Rates

Bank Private Placements

Pre-Conversion (“**Construction**”) **Borrowing Rates**	Jan. 2019	September 2020	
1-Month LIBOR	2.50%	0.50*%	• **Down about 200 Basis Points since Jan. 2019**
Spread (now typically, 170-225)	1.70-2.50%	2.00-2.25%	
	4.20-5.00%	**2.50-2.75%**	

Post-Conversion **(“Permanent”)** **Borrowing Rates**	Fall 2018	September 2020	
17-YearLIBOR	2.80%	1.00**%	• **Down about 155 basis points since Fall 2018**
Spread (now typically, 190-225)	2.00-2.50%	2.20-2.75%	
	4.80-5.30%	**3.20-3.75%**	

* 1 Month LIBOR = 0.15%; assume 0.50% floor; we are now seeing floors applied in light of low rates.

** 17-Year LIBOR = 1.00%; we are also seeing floors here of around 0.85%.

Freddie Mac TEL Private Placement Loans

Pre-Conversion (“**Construction**”) **Borrowing Rates**	Jan. 2019	September 2020	
1-Month LIBOR	2.50%	0.50*%	• **Down about 200 Basis Points since Jan. 2019**
Spread (now typically, 170-225)	1.70-2.50%	2.00-2.25%	
	4.20-5.00%	**2.50-2.75%**	

Post-Conversion **(“Permanent”)** **Borrowing Rates**	Fall 2018	September 2020	
10-Year U.S. Treasury	2.90%	0.70**%	• **Down about 140 basis points since Fall 2018**
Spread (now typically, 260-280)	1.80-2.00%	2.60-2.80%	
	4.70-4.90%	**3.30-3.50%**	

* 1 Month LIBOR = 0.15%; assume 0.50% floor; we are now seeing floors applied in light of low rates.

** Freddie Mac imposes a 0.65% floor on the 10-Year UST.

Other Estimated All-in Borrowing Rates in Today's Market

Fannie Mae M.TEBs

10-Year Treasury	0.70%
Spread	1.60
Tax-Exempt Bond Coupon/MBS Pass-Through Rate	2.30%
Guaranty/Servicing	1.20 – 1.40
All-in Borrowing Rate	**3.50% – 3.70%**

Estimated All-in Borrowing Rates (Cont'd)

FHA and Rural Development Loans

	§223f **(Mod Rehab)**	§221(d)(4) **(Sub Rehab/New Construction)**
10-Year Treasury	0.70%	0.70%
GNMA to 10-Year Treasury Spread	1.25	2.10
Taxable GNMA Pass-Through Rate	1.95%	2.80%
Servicing/GNMA Guaranty Fee	.25	.25
Stated Mortgage Loan Rate	2.20%	3.05%
Mortgage Insurance Premium (Affordable)	.25	.25
All-in Borrowing Rate	**2.45%**	**3.30%**

HUGE POSITIVE IMPACT OF DECLINING LONG-TERM RATES

- On the finance side, the **major factor underlying the record volume of closings** we continue to see on tax exempt debt/4% LIHTC projects is **increased loan sizes driven by significantly declining long-term interest rates**.
- **Two factors** have materially increased tax exempt loan proceeds over the past two years:
  - **Dropping the long term interest rate** from 5.0% to 3.5% on a 40-year level amortization loan **increases loan proceeds**, all other factors equal, **by a whopping 25%** on a debt service constrained loan. Think about that. On average, o**ver** the past two years, tax exempt loan size has increased about **1% for every six basis points drop in rates**, and **that has happened, on average, once per month over the past two years**.
  - Oh! Your deal doesn't work? Wait 3 months and your loan size will go up 3%! Yes. That's the math.
  - In addition, over the past two years, most programs have **shifted from a 35-year to a 40-year loan amortization**. This **increases loan proceeds** on a debt service constrained loan **5.0%**.
  - If the tax exempt debt funds 60% of total development cost ("TDC"), then a **30% loan size increase** from these two factors above **can offset an increase of up to 18 points in TDC**.

PARTIALLY OFFSETTING NEGATIVE FACTORS

- Of course, a good deal of this is **offset by other negative factors**:
  - A 10-15 cents **decrease in 4% LIHTC pricing** is a hit equal to **3-5% of TDC**.
  - **Increases debt service and operating reserves** due to COVID-19 concerns may represent a hit of **similar magnitude**.
- And in most high demand markets, **construction costs and other costs are rising** at rates well above the rate of inflation (2.3% in 2019; 1.3% so far in 2020).
- However, even after these offsets, the **major improvements on the tax exempt debt side of these financings appear to have offset, or more than offset, these and other negative factors** over the past two years. This explains why the pace of closings appears not to have abated, but perhaps to have even accelerated in pandemic stricken 2020 over 2019.

WHAT COULD SPOIL THE PARTY?

- It is **possible** that this **decline in long-term rates is slowing or bottoming out**, and this will no longer provide the huge level of support we have seen over the past two years.
- **If Congress fails to provide significant additional fiscal support** for lost incomes associated with lost jobs, the percentage of potential gross apartment revenue actually realized by owners could fall from the 90% range today into the 80's or even lower. In an October 1, 2020 update, **Dominion Development**, the nation's fourth largest affordable multifamily housing provider with 30,000 units under management, **reports** that **a significant deterioration in rent collections began in September** with September collections falling 4% from August to a level of about 89%.
- According to the July 15, Wall Street Journal, three **major U.S. banks** (Wells Fargo, JPMorgan Chase, and Citi) **posted significant loan loss reserves** in Q2 2020 which were 7 times the amount of the loan loss reserves in the last three quarters of 2019. The August 14, 2020 issue of the Wall Street Journal reports that Warren Buffett, one of the most successful investors of all time, significantly sold off his bank stock holdings. **If bank and insurance company profitability decline, the demand for 4% LIHTC could also fall substantially.**
- The economy could see further shutdowns from one or more **resurgences of the COVID-19 pandemic**, which could also impair construction, inspection and other critical aspects of the development process.
- **State and local budgets strained by the COVID-19** pandemic could result in falling versus rising state and local government affordable rental housing subsidies, which have been an important "gap filler" over much of the last 2-3 years.
- **Continuing increases in construction and other costs** could continue to put pressure on funding sources.

MAJOR TAKEAWAYS

- While rates do not appear to be headed up any time soon, it is **hard to believe** that the powerful tailwind of **declining rates** we have enjoyed over the past two years **will continue** at the pace we have recently seen to offset these potential negative factors.
- Perhaps the best general takeaway, given the recent challenges we now face, **time is your enemy, not your friend**. Many developers seem to be following this strategy, even accepting reduced tax credit equity and lower or deferred developer's fees to assure that deals stay on track to close. For the immediate future, **certainty and timeliness of execution may become the most important hallmarks of a successful project financing**.
- Of course, the increasingly **unmet demand for affordable rental housing in the United States continues to grow**.
- **We should all support continued federal assistance of families and lenders during the months ahead.** As we saw in the spring of 2009 when the federally mandated infusion of additional equity in the major banks broke the downwardly spiraling financial panic which arose in the fall of 2008, the **current major uncertainties could quickly and dramatically abate**.
- The key over the next six to twelve to eighteen months may be managing exposure and financings to **be in a position to meet the challenges and opportunities which this will present when it occurs.**

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