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By Nushin Huq / Issue: February 2023

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Developers Turn to Additional Types of Bonds for Funding

In an industry where projects often require multiple sources of financing, bonds can be a valuable and often necessary part of the capital stack for affordable housing developments. Different types of bonds have their own requirements, and it is important to know not only what is available but the requirements and restrictions of each type of bond.

In the multifamily affordable housing development space, developers utilizing the four percent Low Income Housing Tax Credit are most familiar with tax-exempt private activity bonds (PABs), the use of which is a requirement for access to the credit. But as demand for affordable housing has increased in recent years and the number of developers seeking bonds has grown dramatically, the ability to access this type of funding has become a challenge in many markets. Developers are turning to other types of bonds, such as 501(c)(3) bonds, essential-function bonds, voter-approved municipal bonds and corporate bonds.

Private Activity Bonds
Certain types of PABs, including those under Section 142(d) of the Code ("Section 142(d) Bonds") are volume capped by the federal government based on the state's population size. The state decides how to allocate its annual volume cap to various projects (affordable housing, public transit, water treatment, etc.) that help meet its objectives.

"In order to access the four percent LIHTC, at least 50 percent of the aggregate basis in a project must be financed with the proceeds of this type of tax-exempt municipal bond," says Kent Neumann, founding member of Tiber Hudson LLC.

The Washington, DC-based law firm specializes in affordable housing, including the creation of debt financing structures for affordable multifamily housing transactions. While the firm works with developers to structure deals for cost efficiency and compliance with various tax rules and regulations, its clients include many of the banks and underwriters that buy these bonds. Neumann says that multifamily four percent LIHTC transactions constitute most of the firm's business.

Some states, like Virginia, have both state and local issuers that can issue tax-exempt PABs. Neumann says that other states, such as Georgia, allocate all their funds to local issuers.

"Each state takes a unique approach to the amount of volume cap it allocates to multifamily transactions, how it awards volume cap to projects, whether local and state issuers can be utilized, the availability of soft funds and the possible real estate tax abatement along with many other aspects," says Allison King, another partner in Tiber Hudson's affordable housing practice group.

In the last three or four years, not only has the demand for affordable housing grown tremendously, but the number of for-profit developers in the space has also grown, increasing the competition for PAB volume cap for multifamily developments, traditionally a relatively straightforward process, according to King.

"More deals have been getting done in each state, which means competition now has increased to the point where there are no longer, in many jurisdictions, enough bonds from this limited pool to satisfy all the demand," King says.

This has led to a shift in the mindset of and timing for developers, King and Neumann both observe. What previously would not have been a concern—the ability to obtain the bonds needed to build their project and qualify for the four percent LIHTC—has become an important factor for timing and structuring purposes. Without an award of volume cap, accessing the four percent tax credits is not possible.

"There is a lot of complexity in these deals," Neumann says. "Build out your legal and financing teams with folks that are experienced and know what they are doing in the space, not just on a national basis, but at the local level as well. This will increase the likelihood of a successful closing."

King also advises that developers come in with the appropriate expectations. Historically low-interest rates are no longer available, and what may have worked in terms of financial modeling, even a year ago, may not reflect current market conditions. "Not all of the rate increases have been detrimental," King says. "We have been able to develop some creative structures recently using the current, inverted yield curve, to generate additional sources in these transactions."

For some projects, that may mean PABs may not be in the cards. As volume cap constraints are increasing, developers are looking to other financing options.

"Almost no states were volume cap constrained up until three or four years ago," Wade Norris, a founding partner of Norris George & Ostrow PLLC, says. "Prior to 2019 or so, almost everything we did used Section 142(d) Bonds and four percent LIHTC."

The Washington, DC-based law firm specializes in tax-exempt municipal bond and loan transactions throughout the United States.

"Since 2016, the utilization of the nation's PAB volume supply, primarily due to demand from multifamily, began climbing dramatically and has grown at a rate of 25 percent per year," Norris says.

About 20 states are seeing constraints, as demand for PAB volume has begun to exceed supply. These include high-growth states, such as California, Texas, Colorado, Washington, Tennessee and Georgia, as well as other states, like Massachusetts, New York and Minnesota.

501(c)(3) Bonds and Essential Function Bonds

Over the last couple of years, Norris's team has seen increased utilization of two other types of tax-exempt bonds – 501(c)(3) bonds and essential function bonds.

The tax-exempt 501(c)(3) bonds, under section 145 of the Internal Revenue Code for certain charitable nonprofit owners, are also PABs but do not require a private activity bond volume allocation. Like Section 142(d) Bonds, they are issued by governmental entities and have a conduit structure, in which the borrower, rather than the issuer is the obligated party with respect to the debt. The bonds are largely secured by the project and project revenues. Generally, a certain percentage of the units must be for low- or moderate-income tenants or for senior housing.

"Since there is no PAB volume required, in states that have been volume constrained, we've begun to see a material increase in these financings," Norris says.

On the downside, these bonds cannot be paired with four percent LIHTC, says Norris.

"You can get some forms of tax relief, which help, but it's much harder to make these deals work because we just don't have this other huge subsidy available that we have on Section 142(d) private activity deals using four percent tax credits," Norris says.

"The third category of bonds, which has seen dramatic growth is essential function or governmental purpose tax-exempt bonds," Norris says. These financings are similar to 501(c)(3) bond issues, but the owner is a state or political subdivision. Over the past three years, we have been involved in a dramatic surge in these financings in California and now Texas. Most of these financings are for "missing middle" or workforce housing (i.e., for tenants above 60 percent and below 120 or 140 percent of the area median income).

In these issues, the state or political subdivision not only issues the bonds, but uses the bond proceeds, or distributes the proceeds to a controlled subsidiary, to build or acquire a project, which will be governmentally owned," Norris says.

The surge in deals using 501(c)(3) or essential function bonds worked, in part, because of major inflows into the tax-exempt municipal bond funds and resulting low-interest rates in 2019 through 2021.

"The powerful combination of record low interest rates, cash flow freed up from real estate tax relief and more flexible loan underwriting criteria adopted by the tax-exempt municipal bond funds, enabled us, for the first time in my 40-plus year career, to provide 100 percent financing for such section 501(c)(3) or governmentally owned rental housing, even though we didn't have the huge 35 or 40 percent tax credit subsidy or other equity coming in," Norris says.

Norris adds, "While interest rates have more than doubled in the past year and make these financings much more challenging, we have just closed two more of these financings in Texas and one in Florida with three major clients at yields well above six percent. If interest rates remain at current levels or decline further in 2023, we expect to see a significant increase in these greatly expanded new categories in tax-exempt multifamily housing bond financing in the year ahead. These categories are not going to go away."

For developers, Norris advises first seeing if a project can qualify for the always oversubscribed nine percent LIHTC, and then see if its project might be a good candidate for Section 142(d) bonds and the four percent LIHTC. That means considering if the project is located where it can compete successfully for PAB volume allocation. Volume-constrained states allocate different amounts to multifamily and have different priorities and allocation mechanisms. For example, California favors new construction over rehabilitation projects; Texas allocates multifamily volume largely by lottery Norris says. Every state is different.

A developer may consider being a part of a 501(c)(3) or essential function bond financing – it cannot have any ownership, but it can serve in various roles and be compensated on a competitive basis. “A major question becomes, is there a nonprofit or governmental borrower who will undertake this financing, and are there enough sources of funding that can be put together to make the project financings work,” Norris says.

Corporate Bonds

In 2020, the San Francisco-based BRIDGE Housing, a nonprofit affordable housing developer, became the first such organization to issue corporate bonds. The $100 million general obligation bond gave the housing developer more access to capital and flexibility to use those funds.

BRIDGE Housing is a large nonprofit developer and is publicly rated, but the best it could get from a bank was a $10 million line of credit, says Jim Mather, BRIDGE’s chief investment officer. BRIDGE had two $10 million lines of credit and several smaller ones from foundations. That in turn meant there were a dozen different reporting requirements and different interest rates to pay.

“We had all these little pieces that didn’t add up to a $100 million,” Mather says. “By doing a $100 million bond issuance, we got access to more capital, more flexible capital than we had, and we only had one reporting requirement to our bond investors. So not only did it give us more capital, but it eased our administrative burden a bit.”

Since the proceeds from the bond sale are general obligation, BRIDGE has more flexibility in how it uses the proceeds than it would from a PAB. BRIDGE’s bond is a sustainable bond and is rated according to environmental, sustainability and governance, or ESG, standards. In recent years, the demand for ESG-rated bonds has gone up, Mather says.

In BRIDGE’s case, to comply, the developer must meet two out of three sustainability goals – low-income housing, green technology building and/or transit-oriented development.

BRIDGE was able to use funds from the bond issue on predevelopment funding, to recapitalize projects and project equity for acquisitions of new projects. In two years, BRIDGE has been able to cycle through the $100 million twice.

For developers interested in issuing a corporate bond, the first step is getting rated by a rating agency, Mather says. While a developer doesn’t have to be large, they should have good financials and a substantial track record. Mather encourages developers to reach out to the rating agency S&P and set up a time to talk.

“There’s a cost to get rated, but if it gets you $100 million, it’s small,” Mather says.

The board should also be involved, and then talk to investment banks and find one you are comfortable working with, Mather says. BRIDGE Housing worked with Morgan Stanley.

Voter-Approved Bonds

In 2016, voters in Los Angeles approved Proposition HHH, which enabled city officials to issue $1.2 billion in bonds for the development of permanent supportive housing units for people experiencing homelessness. HHH funds subsidize approximately 30 percent of a project’s total development cost.

In California, not only is there a high demand for affordable housing, but the projects can be expensive, averaging around a $700,000 per unit range currently. Even with a four percent tax credit, developers need to find other sources of financing, says Elizabeth Selby, director of Finance and Development at the Los Angeles Housing Development Bureau.

The passage of HHH dramatically increased the city’s capacity to finance affordable housing developments, quadrupling it, Selby says. There are guidelines for HHH funds, including that the project is for permanent supportive housing, as well as limitations on how much can apply for project readiness.

“This a soft source, a low-interest loan,” Selby says. “I think of it almost as equity.”

Before her current role, Selby was in acquisitions for a nonprofit and says as an acquisitions person, you think you are going to figure out where would be a great place to build affordable housing, but what really drives where we build is where financing is available.

“Is it a high resource area where I’m going to score more competitively for financing and is my building in a city or a municipality that has a soft source of financing that they can contribute to my capital stack?” Selby asks. “In the case of Los Angeles, the people voted for this bond measure, and it is in the process of generating these funds that come into the housing department.”

The limit is $140,000 per unit. If a project is $700,000 per unit, with a four percent tax credit plus financing through HHH, developers would probably still need to find additional sources of funding, Selby says.

"The trick is to coordinate all of those pieces and applications and build your capital stack until you get to the point where you have enough sources to pay for your project," she says.

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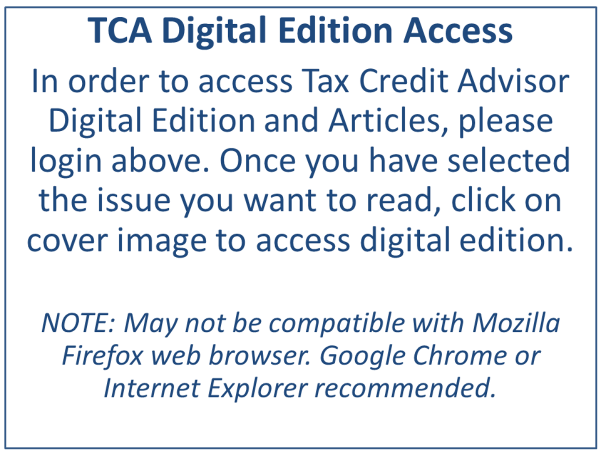

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