MSHDA Below Market Rate Bond Program

Michigan State Housing Development Authority

Rental Housing: Encouraging New Construction

HFA Staff Contact

Mark Garcia

garciam8@michigan.gov

Michigan State Housing Development Authority
Below Market Rate Bond Program
Rental Housing – Encouraging New Construction

ENTRY

For years, foundations, nonprofits, communities, and social-impact investors have shown interest in bringing a multifamily development to feasibility. These investors typically were looking at making a soft loan into the capital stack, to fill a shortfall, or gap. It is the definition of "soft" that often begins the slow path to not making the investment in the development. Making an investment into the capital stack of a tax-exempt bond, Low-Income Housing Tax Credit (LIHTC) financed multifamily development can be a daunting task, even for the "experts." The challenges start when the potential soft loan investor learns that repayment is based on excess revenues, can only begin after LIHTC basis items are completely paid, and federally subsidized programs come with requirements that can and will produce obstacles to raising revenues if the development's operating projections don't come to fruition. In the experience of the Michigan State Housing Development Authority (MSHDA), it is these obstacles that prevented the above-mentioned investors from participating, every single time.

When bringing a development to feasibility, the task is to ensure that there are enough sources (funding/capital) for the uses (cost of the development). The revenues produced by the development will justify the amount of the mortgage. After tax credit equity and other sources, there is often a gap. This is where a social-impact investor might show interest in filling the gap with a soft second loan. As described above, this approach has not been successful. Until now.

The Below Market Rate Bond (BMRB) program eliminates both the complicated development underwriting and the risk of the development's failure. MSHDA created the BMRB program to allow a potential investor to purchase MSHDA-issued debt as a private placement at interest rates below the tax-exempt market. The interest rate savings is passed on to the development through a lower mortgage rate, giving the development the ability to afford a higher mortgage; thereby, eliminating the gap and bring the development to feasibility.

In 2018, MSHDA was contacted by a social impact investor and a local unit of government interested in providing gap financing as a second position, soft loan to help advance a 48-unit development in Kalamazoo, Michigan. The Creamery project was designed to be a mixed-use development with 48 residential units and 7,500 square feet of commercial space. The City of Kalamazoo wanted to create workforce housing options, so nine of the units were targeted to income levels up to 120% of area median income (AMI). The remaining 39 units offered affordable housing in the range of 30% to 80% of AMI. The local YWCA had signed a 20-year lease for 6,300 square feet of the commercial space.

When The Creamery requested tax-exempt bond financing, MSHDA's lending rate was 5.25%. Underwriting revealed a more than $1.025 million gap. This is where the social impact investors were interested in providing low interest rate funds to bring the deal to feasibility. MSHDA staff were determined to come up with a creative solution that would work for the investor, the developer and our agency.

Michigan State Housing Development Authority
Below Market Rate Bond Program
Rental Housing – Encouraging New Construction

Capital Stack Table

	Typical Financing @ 5.25%	BMRB @ 3.67%
MSHDA Mortgage	$4,028,300	$5,053,614
MSHDA "Soft" Funds	2,555,047	2,555,047
MEDC "Soft" Funds	1,305,047	1,305,047
Local HOME	325,000	325,000
YWCA Contribution	400,000	400,000
Other Inc & Solar Tax Credits	62,249	62,249
Deferred Developer Fee	567,346	567,346
Gap (Shortfall)	1,025,314	0
Total Development Cost	$10,268,303	$10,268,303

The BMRB program brings needed funding to the development while dramatically reducing the complexity and risk to the investor. Rather than providing a soft second, third or even fourth position loan, the investor can directly purchase MSHDA's Rental Housing Revenue Bonds at an interest rate below tax-exempt market rates. Given that the IRS restricts the issuer to a 1.5% spread, all the interest rate relief is passed on to the development. With a lower mortgage rate, the development can afford a larger mortgage, thereby shrinking or eliminating the gap.

The Creamery investors purchased $2.75 million of MSHSA's Rental Housing Revenue Bonds, 2019 Series A-2, 40-year, Term Bonds with a 1% coupon. MSHDA then added its 1.5% allowable spread to bring the lending rate to 2.50%. With a total mortgage amount of $5.1 million, MSHDA blended the market rate mortgage with the $2.75 million of below market rate bonds to come up with the 3.67% mortgage lending rate.

Selling Points/Benefits to the Social Impact Investor

- The investor no longer must underwrite the individual development. The investor is getting the credit of the bond indenture and, in MSHDA's case, the general obligation of MSHDA. If the development fails, MSHDA will still be required to meet its obligation with other assets/resources.
- The investor will begin to have the bonds pay down immediately through the semi-annual debt service. This brings much more certainty than making a soft loan that is dependent on excess cash flow.
- The bonds are marketable and can be sold at any time. If the investor wants to raise cash and liquidate its investment in the development, this is possible. It should be noted that these bonds will most likely be sold into a market that requires a higher yield, so the bonds would have to be sold at a discount.

Michigan State Housing Development Authority
Below Market Rate Bond Program
Rental Housing – Encouraging New Construction

When working with foundations and social impact investors, it is important to be as transparent as possible. One concern we addressed several times was assuring the investor that the benefit of their bond purchase is to bring the development to feasibility, as apposed to going to a state agency, in this case MSHDA, or creating more profit to the developer.

Structure and Timeline

- Identify the investors and agree on the purchase terms and develop a Term Sheet (amount, rate, maturity, etc.)
- Draft and agree on the Bond Purchase Agreement. This document will need to be signed at the time market rate bonds are priced, if applicable.
- Draft a Bond Purchase Agreement Acknowledgement Form if the bonds are sold after the initial closing of the development mortgage. This is to be sure that the investor does not back out when it is time to sign the Bond Purchase Agreement (BPA). As an alternative, there could be an escrow closing so that the investment proceeds come in at the same time as the initial closing of the mortgage. This way, the funds to purchase the bonds, when issued, will be on hand before construction begins.
- If there is a market rate component, a Preliminary Official Statement (marketing document to be share with potential investors) will be created.
- The market rate bonds are priced and the BPAs for the market rate and privately placed bonds are signed.
- The Official Statement is created.
- Investors wire funds to the trustee and the bonds are authenticated.

The BMRB program was successful in allowing MSHDA to close a multifamily development with a socially minded investor. This creative approach helped get the investment into a development and meet the requirements needed to close complicated multi-source financed developments. The great thing about the BMRB program is its replicability. MSHDA has been approached about using the BMRB program to finance additional developments, and we are soon closing our second BMRB program financed multifamily development.

MSHDA has more demand for its limited soft funds than is available for all affordable developments presented in any given year. By creating the BMRB program, MSHDA has created a new funding source, and in doing so, has encouraged new construction and increased the number of affordable housing units available for individuals and families. Providing this new vehicle for the social impact investor to have a seat at the table has engendered a sense of pride, new champions for the creation and preservation of affordable housing in their communities, and even more broadly, strong advocates for the important work of MSHDA and other housing finance authorities.