COUNCIL AGENDA: 6/3/08
ITEM: 4.3

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Leslye Krutko
Director of Housing

SUBJECT: SEE BELOW

DATE: May 1, 2008

Approved [signature] Date 5-1-08

COUNCIL DISTRICT: 6
SNI AREA: None

SUBJECT: APPROVAL TO INCREASE THE CITY'S PERMANENT LOAN IN AN AMOUNT UP TO $506,652 AND TO GRANT AN EXCEPTION TO THE COUNCIL POLICY LIMITING THE LOAN-TO-VALUE RATIO FOR THE CINNABAR COMMONS APARTMENTS PROJECT

RECOMMENDATION

It is recommended that the City Council adopt a resolution:

1. Approving an increase to the City permanent loan to Cinnabar Commons, a California limited partnership, or an affiliated entity ("Sponsor") for up to $506,652 to capitalize interest on the City's loan for the Cinnabar Commons Family Apartments project, located on Stockton Avenue between Cinnabar Street and Lenzen Avenue.

2. Approving of up to 120% Loan-to-Value (LTV) as an exception to the City Council policy limiting LTV to 100%.

OUTCOME

The City Council's approval of the proposed increase in loan amount will allow the project to finally convert to its permanent period financing, will extend the project's term of affordability, and will positively affect the City's overall financial position in the project.

BACKGROUND

Project

The subject property, the Cinnabar Commons Family Apartments, is a 245-unit rental project located at 875 Cinnabar Street. The project sponsors are Seven Hills Properties and BRIDGE

Housing (collectively, "Sponsor"). Construction of this project was completed in December 2005, and the project attained 90% occupancy in October 2007. The project offers 29 units affordable to extremely low-income (ELI) households at or below 30% AMI, 51 units affordable to very low-income (VLI) households at or below 50% AMI, 163 units currently affordable to low-income (LI) households at 60% AMI, and two unrestricted managers' units.

Legal History

The project's long history includes a mediated dispute between the Sponsor and the City in 2004 and the execution of a Settlement Agreement between the City and Sponsor dated September 23, 2004. As a condition of the Settlement Agreement, the nonprofit BRIDGE Housing ("BRIDGE") was selected as the managing general partner of the partnership, being admitted to the partnership in June 2006, and project leasing agent.

As the parties agreed under the terms of the Settlement Agreement that the Sponsor would not request any further City assistance for the Project, the City is under no obligation to increase its loan amounts.

Financing

The project is partially financed by two City loans: 1) a land loan to the legal entity, Lenzen Associates L.L.C., that owns the land and leases it to the project partnership that is currently approved for $12,978,250 during construction and up to $12,578,250 for the permanent period ("Land Loan"); and, 2) a loan to the project's limited partnership, Cinnabar Commons L.P., that is currently approved for up to $15,354,000 during construction and up to $13,537,521 for the permanent period ("Partnership Loan").

On September 28, 2004, the City Council approved an increase of $4,484,000 in the Partnership Loan at the permanent period in order to fund construction cost overruns. This increase was part of the Settlement Agreement negotiations and is included in the approved amounts listed above.

On August 7, 2007, the City Council approved an increase in the permanent loan amount of $2,084,521 in order to fund increased affordability for 39 of 245 units and to support faster leasing of the project's units in order to convert to permanent financing in early 2008. This increase is also included in the approved amounts listed above.

The deeper affordability enabled by the City's June 2007 action was successful in supporting the project's leasing, and the project reached 90% occupancy in October 2007—a hurdle required to be achieved for 90 days by Freddie Mac, the bonds' credit enhancer, in order to convert to the permanent period financing.

A total of approximately $7.0 million in principal and interest is due to be paid to the City at conversion to the permanent period.

Current Request

Given the current weaknesses in the financial markets, many financiers have grown increasingly cautious in issuing approvals without doing more due diligence than has been traditionally conducted at conversion to the permanent period. Therefore, while the project's performance was on target to convert in January or February 2008 as planned, conversion has been delayed while the various parties have worked to reaffirm their financial commitments to the project.

Accordingly, these delays have further increased the amount of interest due to the City on its two loans, producing a small funding gap. Specifically, this request would increase the Partnership Loan in the permanent period from $13,537,521 to $14,044,173. As the construction loan amount already approved for the project is $15,354,000 and was supposed to be paid down to $13,537,521 at the time of conversion to the permanent period, this request would result in the City accepting a pay-down at conversion that is $506,652 smaller than originally anticipated. No new outlay of funds would be required.

The small amount of this loan increase request would ordinarily be approved by the Director of Housing under the City' Delegation of Authority, as the increase is less than 20% of the Council-approved loan amount. However, given this project's history, the existence of the Settlement Agreement, and the need for the City Council to approve LTVs of over 100%, staff is seeking the City Council's approval for this item.

ANALYSIS

Rationales

Although the City is not obligated to approve this request, there are several reasons why it makes sense to do so.

First, there are no project funds available to fill the project's funding gap. The Sponsor has already worked with Citibank and Capmark, the project's tax credit syndicator, in order to maximize the amounts available from the conventional loan and the tax credit investor equity. The Sponsor has also already deferred $1,930,000 of its $2,500,000 developer fee, which will be taken from project cash flow over time. The developer fee already taken was paid to financial consultants per the City's requirement. Further, the Sponsor has also paid extension fee costs out of pocket, and therefore is at a net loss thus far. For the Sponsor to fill this funding gap, it would have to take out a loan at interest rates higher than the City's rate and charge it back to the project. These additional costs would put the City at a financial disadvantage as it would reduce the cash flow available to the City to repay its loans.

By contrast, staff has negotiated "consideration" to more than compensate for the foregone interest that would have been collected at conversion under this request. By amending the City's share of cash flow in years 11-20, the City actually will come out net positive by more than $150,000, even adjusting for the time value of money. Further, by renegotiating the City's share of cash flow, staff will simplify the very complicated existing cash flow split schedule that changes every one to three years, keeping the schedule stable for 10 years and therefore reducing the City's long-term loan administration costs.

In addition, staff has negotiated an additional five years of affordability, which would result in a total of 60 years of restricted affordability.

Loan-to-Value

Per City Council policy, the Loan-to-Value (LTV) ratio on an affordable housing project should not exceed 100%. The project's current LTV ratio is 119% as approved by City Council in August 2007. The proposed City permanent loan increase will result in a permanent period Loan to Value (LTV) ratio of 120%. Staff believes this LTV is justifiable given the benefits to the project, as stated in the Rationale section above, and given that granting this request would result in only a 1% increase to the project LTV.

EVALUATION AND FOLLOW-UP

Assuming this request is approved, there is no follow-up needed. Cinnabar Commons will convert to its permanent period and become one of the City's many subsidized projects in ongoing operations to serve ELI, VLI and LI households in the City of San José.

POLICY ALTERNATIVES

Staff analyzed the following option in arriving at its recommendation:

Alternative #1: Deny the funding request and force the Sponsor to instead make a loan to the partnership to fill the funding gap.

Pros:	City funds that would otherwise be collected at conversion to permanent period could be expended to build other new affordable housing projects, and the project's Settlement Agreement supports this position.
Cons:	By foregoing the payment of some interest, the City creates the opportunity to create a net positive effect on repayment, to simplify its loan administration duties, and to gain five years of additional affordability. The Sponsor making a loan to the partnership would instead put the City in an inferior financial position which would still necessitate a negotiation to gain sufficient consideration, so it would not alone solve the problem.
Reason for not recommending	The City will strengthen its financial position, simplify its loan administration, and gain additional affordability if the requested action is approved.

PUBLIC OUTREACH

- □ **Criterion 1:** Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**

- □ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

- □ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This item does not meet any of the above criteria, but this Memorandum will be posted to the City's website for the May 20, 2008 City Council Agenda.

COORDINATION

Preparation of this memorandum was coordinated with the Office of the City Attorney.

FISCAL/POLICY ALIGNMENT

This expenditure is consistent with the Housing Department's *Five-Year Housing Investment Plan for FY 2007-08 through 2011-12,* adopted on June 19, 2007, in providing units for a range of incomes.

COST SUMMARY/IMPLICATIONS

1. **AMOUNT OF RECOMMENDATION:**

   The proposed action will reduce the amount of repayment of the City construction loan and increase the amount of the City's permanent loan to the partnership by $506,652.

2. **COST ELEMENTS OF INCREASE TO CITY LOAN AMOUNT:**

USES		AMOUNT
Capitalized City construction loan interest		$506,652
	TOTAL	$506,652

3. **SOURCE OF FUNDING:**

No additional f,unds are required, as the City's construction loan to the project already exceeds the proposed permanent amount; therefore, the request is to accept a smaller pay-down to the City at conversion to the permanent period.

The project was originally funded from Fund 443—Low- and Moderate-Income Housing Fund.

4. **FISCAL IMPACT:** No ongoing fiscal impact.

CEQA

EIR Resolution No. 71174.

LESLYE KRUTKO
Director of Housing

For questions, please contact Leslye Krutko, Director of Housing at 408-535-3851.