COUNCIL AGENDA: 06-24-08
ITEM: 4.5

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Leslye Krutko
Julia H. Cooper

SUBJECT: **SEE BELOW**

DATE: June 2, 2008

Approved [signature] Date 6-4-08

COUNCIL DISTRICT: 6
SNI AREA: N/A

SUBJECT: APPROVAL OF THE ISSUANCE OF REFUNDING BONDS, EXECUTION OF RELATED DOCUMENTS, AND INCREASE IN THE CITY'S PERMANENT LOAN AMOUNT FOR THE LAS VENTANAS (FORMERLY KNOWN AS EVANS LANE) APARTMENTS PROJECT

RECOMMENDATION

It is recommended that the City Council:

a. Hold a Tax Equity and Fiscal Responsibility Act (TEFRA) hearing for the issuance of up to $31,000,000 in tax-exempt public activity bonds to refund a portion of the City's $31,000,000 of City of San Jose Variable Rate Demand Multifamily Housing Revenue Bonds (Evans Lane Apartments) Series 2002H; and

b. Adopt a Resolution of the Council of the City of San José:

   1. Authorizing the issuance of tax-exempt multifamily housing revenue refunding bonds designated as "City of San José Variable Rate Demand Multifamily Housing Revenue Refunding Bonds (Las Ventanas Apartments) Series 2008B" in a principal amount not to exceed $31,000,000 (the "Refunding Bonds");

   2. Approving a loan of Refunding Bond proceeds to Evans Lane Apartments, L.P., a California limited partnership, to fund a permanent loan for Las Ventanas Apartments (formerly known as Evans Lane Apartments) located at 1848 Evans Lane in San Jose (the "Development");

3. Approving in substantially final form the Bonds, Trust Indenture, Financing Agreement, First Amendment to Regulatory Agreement, Intercreditor Agreement and Bond Purchase Agreement;

4. Authorizing the City Manager, Director of Finance, Deputy Director of Finance, and Director of Housing to execute and, as appropriate, to negotiate, execute and deliver these bond documents and other related bond documents as necessary; and,

5. Approving an increase of $687,108 in the City's permanent loan amount resulting in a total permanent loan amount of $16,232,773 to Evans Lane Apartments, L.P. (the "Borrower") for the Las Ventanas Apartments.

OUTCOME

Approval of these recommendations will allow the issuance of the City of San José Variable Rate Demand Multifamily Housing Revenue Refunding Bonds (Las Ventanas Apartments) Series 2008B for the purpose of refinancing $31,000,000 of City of San José Variable Rate Demand Multifamily Housing Revenue Bonds (Evans Lane Apartments) Series 2002H (the "2002 Bonds").

The proposed actions will allow Las Ventanas to proceed to its permanent period of operations and continue to provide 239 units of rental housing units affordable to City of San José residents for at least 55 years.

EXECUTIVE SUMMARY

This memorandum requests approval of the tax-exempt financing structure and bond issuance, as well as an increase to the City's subordinate permanent loan amount, for the Las Ventanas Apartments project.

On October 8, 2002, the City issued the 2002 Bonds, the proceeds of which were loaned to the Borrower to finance the construction of a 239-unit multifamily housing development (the "Development") then known as Evans Lane Apartments (renamed to Las Ventanas Apartments) located at 1848 Evans Lane in San José.

The 2002 Bonds are secured by a direct draw letter of credit from Bank of America. The 2002 Bonds were publicly offered and were rated AA-/A-1+. The final maturity of the 2002 Bonds is April 1, 2036.

At the time of issuance of the 2002 Bonds, the Borrower expected that Fannie Mae would replace Bank of America as the entity providing credit enhancement to the 2002 Bonds following construction and lease-up of the project. One of Fannie Mae's conditions to replacing Bank of

America was that the outstanding par amount of the 2002 Bonds be reduced from $31,000,000 to $25,200,000. The source of such reduction was to have been a portion of approximately $11,000,000 in tax credit equity funds scheduled to be paid at that time.

Due to construction cost increases, a longer lease-up period with lower than projected rents, and changes in financial structures over time; this project experienced a higher overall development cost since its approval in 2002. If the above recommendation is approved, the higher development cost will be offset by an increase in the par amount of the Refunding Bonds, an increase in tax credit equity funds, deferral of a portion of the developer fee, revenue from operations to-date, and the City's capitalization of $687,108 of unpaid but accrued interest into the permanent loan amount.

The Borrower has requested the City issue the Refunding Bonds; however, because the par amount of Refunding Bonds will be increased to $25,900,000, Fannie Mae will not be providing credit enhancement as previously contemplated. Instead, the Refunding Bonds will be secured by a direct pay Credit Enhancement Agreement to be provided by the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The Refunding Bonds will be rated "AAA/A-1+" by Standard & Poor's. The final maturity of the Refunding Bonds is expected to be July 1, 2038, but in no event will be later than December 1, 2047.

The Tax Equity and Fiscal Responsibility Act ("TEFRA") hearing must be conducted to notify the community of the City's intent to issue the Refunding Bonds because they extend the maturity of qualified tax-exempt private activity bonds.

BACKGROUND

On October 8, 2002, the City issued $31,000,000 of Multifamily Housing Revenue Bonds (Evans Lane Apartments) Series 2002H (the "2002 Bonds"), the proceeds of which were loaned to Evans Lane Apartments L.P. (the "Borrower"), to finance the construction of a 239-unit multifamily housing development (the "Development"), then known as Evans Lane Apartments, located at 1848 Evans Lane in San José. The Borrower is a California limited partnership created by Community Home Builders & Associates and JSM Enterprises, Inc.

The Development consists of 85 one-bedroom, 106 two-bedroom and 48 three-bedroom units in one four-story and three three-story buildings. With the exception of three managers' units, 35 units are set aside for rental to families with incomes that do not exceed 30% of Area Median Income (AMI), 39 units are set aside for rental to families with incomes that do not exceed 50% AMI, and 162 units are set aside for rental to families with median incomes that do not exceed 60% AMI. These restrictions will remain in place for at least 55 years. The Development was completed in 2005, started to rent its units that year, and has been fully occupied since 2006.

The 2002 Bonds were issued as variable rate demand bonds secured by a direct draw letter of credit issued by Bank of America. Under the plan of finance contemplated for the Development, the 2002 Bonds were to be secured by the Bank of America letter of credit until April 20, 2005, covering the Development's anticipated construction and lease-up period. Once the Development was stabilized (i.e., 90% of the units after construction were rented for 3 consecutive months and the net operating income from the Development achieved the required debt service coverage of 1.20 times) and assuming a reduction in the outstanding par of the 2002 Bonds to $25,200,000, Fannie Mae was anticipated to replace Bank of America as the credit enhancement provider for the 2002 Bonds. In essence, Bank of America was the construction lender for the Development and, after stabilization, when the financing would "convert" to permanent, Fannie Mae would serve as the permanent lender.

The original estimated cost of the Development was $60.9 million when the 2002 Bonds were issued. The final development cost was $68.3 million – an increase of more than $7 million. These increases were due to construction cost increases, a longer lease-up period than projected with lower than projected rents, and fees from changes in senior lenders. To help offset the higher cost of the Development, the Borrower has sought a higher permanent bond amount than available with Fannie Mae. In the meantime, the Borrower has delayed the conversion to permanent financing and has obtained multiple extensions of the Bank of America letter of credit. The current Bank of America letter of credit expires on June 30, 2008, but an additional one-month extension to July 30, 2008 is anticipated.

The Borrower has obtained a commitment from Federal Home Loan Mortgage Corporation ("Freddie Mac") to provide credit enhancement for approximately $25,900,000 of variable rate demand bonds for the Development (the "Refunding Bonds") – a $700,000 increase over the amount approved by Fannie Mae. This approach would require a refunding of the 2002 Bonds. Whereas the 2002 Bonds were issued with a rating of AA-/A-1+, the Refunding Bonds will be rated "AAA/A-1+".

Because the Refunding Bonds will extend the maturity of the 2002 Bonds by approximately 26 months, Federal tax law requires the City to hold a TEFRA hearing to provide individuals or parties the opportunity to comment on any matters relating to the Refunding Bonds, including the nature or location of the Development. The TEFRA hearing is being noticed for June 24, 2008, and will be held concurrently with the City Council meeting to consider the issuance of the Refunding Bonds.

Because the expected extension of Bank of America letter of credit is only through July 30, 2008, the Refunding Bonds must close by that date. It is anticipated that the Refunding Bonds will be issued and the transaction will close on or about July 15, 2008.

ANALYSIS

This portion of the report is divided into several sections to address the items in staff's recommendation to proceed with the Refunding Bond issuance. These sections include a discussion of the TEFRA hearing requirement and descriptions of Refunding Bond financing structure, Refunding Bond financing documents, financing team participants, financing schedule, and the impact on the City's subordinate loan amount.

TEFRA Hearing

Section 147(f) of the Internal Revenue Code requires that, before private-activity bonds may be issued, including the issuance of refunding private activity bonds which extends the final maturity of the prior bonds, the City first must conduct a public hearing known as a Tax Equity and Fiscal Responsibility Act (TEFRA) hearing. That hearing is scheduled as part of the action items on the June 24, 2008 Council Agenda, and is intended to provide an opportunity for all interested persons to express their views both orally and in writing on the proposed issuance of the Refunding Bonds. A TEFRA hearing is required because the final maturity date of the 2008B Bonds will likely be 26 months later than the final maturity date of the 2002 bonds. The City previously held a TEFRA hearing on May 7, 2002 for the 2002 Bonds.

The notice for the public hearing, which is scheduled to be published on or before June 6, 2008 in the *San Jose Mercury News*, states the City's non-binding intent to issue up to $31 million of tax-exempt private-activity bonds for the purpose of refunding the 2002 Bonds.

Bond Financing Structure

Overview of Multifamily Bond Financing

General As a brief summary, multifamily housing revenue bonds are issued to finance the development of affordable rental housing projects by private developers. The City issues the bonds and then loans the proceeds to the developer/borrower. The bonds are typically issued as tax-exempt securities. For the bonds to qualify for tax-exemption, among other requirements, the rental housing development being financed must meet one of two restrictions: (1) at least 20 percent of the units in such housing development must be reserved for occupancy by individuals or families of very low income (no more than 50% AMI) or (2) at least 40 percent of the units must be reserved for occupancy by individuals or families of low income (no more than 60% of AMI).

The current affordability requirements applicable to the Development exceed the minimum Federal standards and apply for a period of 55 years. The Refunding Bonds will maintain the current requirements.

The advantages of tax-exempt bonds to developers include below-market interest rates, long-term fixed rate financing and low income housing tax credits – features not available in the conventional multifamily housing construction loan mortgage market. The bonds are limited obligations of the City, payable solely from loan repayments by the borrower and any credit enhancement.

Structure of the Bonds

Variable Rate Demand Bonds The Refunding Bonds will be structured as variable demand bonds secured by a direct pay Credit Enhancement Agreement from Freddie Mac. The Refunding Bonds will be issued in denominations of $100,000 and will be rated "AAA/A-1+" by Standard & Poor's.

Principal Amount and Term The Refunding Bonds will be issued as a single series of tax-exempt bonds in the estimated amount of $25,900,000. The final maturity of the Refunding Bonds is estimated to be approximately 30 years, but may not exceed December 1, 2047.

Interest Rate The Refunding Bonds will bear a variable rate that will be reset weekly by Citigroup Global Markets Inc. as remarketing agent. To mitigate against the risk of higher interest rates, the Borrower will be entering into an interest rate swap for a period of approximately 13 years. Under the interest rate swap, the Borrower is expected to receive an interest rate equal to the USD-SIFMA Municipal Swap Index (formerly known as "BMA") and the Borrower will pay a fixed rate, currently expected to be approximately 3.65%. The Borrower's payments under the interest rate swap also will be credit enhanced by Freddie Mac. The City will not be party to the interest rate swap.

Bond Financing Documents

The following is a brief description of each document the City Council is being asked to approve and authorize the execution of. Copies of these documents will be available in the City Clerk's Office on or about June 10, 2008.

Trust Indenture The Refunding Bonds will be issued under a Trust Indenture (the "Indenture") between the City and Wells Fargo Bank, National Association, as the trustee (the "Trustee"). The Indenture is executed by the City Manager, Deputy Director of Finance and Director of Housing or other authorized officers on behalf of the City, and attested by the City Clerk. Pursuant to the Indenture, the Trustee is given the authority to receive, hold, invest and disburse Refunding Bond proceeds and other funds established under the Indenture; to authenticate the Refunding Bonds; to apply and disburse payments to the Bondholders; and to pursue remedies on behalf of the Bondholders. The Indenture 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 the Refunding Bonds. The Financing Agreement (described below) obligates the Borrower to compensate the Trustee for services rendered under the Indenture.

Financing Agreement This agreement (the "Financing Agreement") is among the City, the Trustee and the Borrower and is executed by the City Manager, Deputy Director of Finance and Director of Housing or other authorized officer on behalf of the City. The Financing Agreement provides for the loan of the Refunding Bond proceeds to the Borrower for the purpose of redeeming the 2002 Bonds. The loan is evidenced by a Note (the "Note") in an amount that corresponds to the Refunding Bonds. The interest of the City in receiving payments and other rights under the Indenture, the Financing Agreement and the Note, will be assigned to the Trustee; however, certain reserved rights have been retained by the City, such as the City's right to indemnification.

First Amendment to Regulatory Agreement This agreement (the "First Amendment to Regulatory Agreement") is among the City, the Trustee and the Borrower and is executed by the City Manager, Deputy Director of Finance and Director of Housing or other authorized officer on behalf of the City. The First Amendment to Regulatory Agreement confirms the terms of the Regulatory Agreement and Declaration of Restrictive Covenants (the "Regulatory Agreement") that was executed in connection with the 2002 Bonds. That Agreement restricted the rental of units in the Development to the appropriate percentage of low or very-low income individuals or families for a period of years required to maintain the tax-exempt status of the 2002 Bonds. The First Amendment to Regulatory Agreement makes those restrictions applicable to the Refunding Bonds.

Intercreditor Agreement This agreement (the "Intercreditor Agreement") is among the City, the Trustee and Freddie Mac and is executed by the City Manager, Deputy Director of Finance and Director of Housing or other authorized officer on behalf of the City. The Intercreditor Agreement prioritizes certain rights and remedies among the City, Trustee and Freddie Mac in the event that the Borrower defaults under the Freddie Mac documents.

Bond Purchase Agreement This agreement (the "Purchase Agreement") is among the City, the Borrower and Citigroup Global Markets Inc. ("Citi") and is executed by the City Manager, Deputy Director of Finance and Director of Housing or other authorized officer on behalf of the City. The Purchase Agreement sets forth the requirements of Citi to purchase the Refunding Bonds, contains certain representations and warranties of the City, the Borrower and Citi, identifies the documents to be executed at closing, and specifies the conditions that allow Citi to terminate the Purchase Agreement.

Financing Team Participants

The financing team participants consist of:

- City's Financial Advisor: Ross Financial
- Bond Counsel: Orrick, Herrington & Sutcliffe LLP
- Trustee: Wells Fargo Bank, National Association
- Underwriter: Citigroup Global Markets Inc.

All costs associated with the Financial Advisor, Bond Counsel and Trustee are contingent on the sale of the Refunding Bonds and will be paid by the Borrower.

Financing Schedule

The current proposed schedule is as follows:

• Council Approval of Refunding Bond Documents:	June 24, 2008
• Mail Official Statement:	July 7, 2008
• Pre-Close Refunding Bonds:	July 14, 2008
• Close Refunding Bonds:	July 15, 2008

Impact on the City Loan Amount

The City Housing Department has previously funded a grant of $4,025,000 and a construction loan of $19,395,949 (the "City Loan") for the Development. The City Loan required that the Borrower pay interest during construction (which interest may be accrued) and pay down the City Loan principal to a permanent loan amount of $15,545,665 at the time Project converted to the permanent phase and the 2002 Bond amount was reduced to $25,200,000. Because of the higher Development costs, longer lease-up period and lower rents, the Borrower owes approximately $2.5 million of interest that has accrued on the City Loan during construction. While the Borrower intends to use tax credit equity funds to reduce the City Loan to $15,545,665 as scheduled, the Borrower has requested that the City increase the permanent City Loan amount by $687,108 to cover a portion of the accrued but unpaid interest during construction. Consequently, the total amount outstanding on the City's loan will be $16,232,773. In consideration for the increase, the City will receive between 50% and 75% of the project's cash flows and years of affordability in addition to the 55 years currently approved.

The approval of specific business terms that the City will receive as consideration for this increase in the City Loan amount is delegated to the Director of Housing by Chapter 5.06 of the San José Municipal Code.

EVALUATION AND FOLLOW-UP

Assuming this request is approved, there is no follow-up needed. Las Ventanas will convert to its permanent period financing and will become one of the City's many subsidized rental projects in ongoing operations to serve households at a range of incomes in the City of San José.

PUBLIC OUTREACH

This action meets Criterion 1: Requires Council action on the use of public funds equal to $1 million or greater. The method of notifying the community of the City's intent to issue tax-exempt private activity bonds is for the City Council to hold a Tax Equity and Fiscal Responsibility Act (TEFRA) Hearing. The TEFRA Hearing will be held on June 24, 2008 at the City Council meeting scheduled for that date. The public hearing notice will be published in the *San José Mercury News* on or before June 6, 2008.

☐ **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)**

COORDINATION

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

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 by $687,108.

2. COST ELEMENTS OF INCREASE TO CITY LOAN AMOUNT:

USES		AMOUNT
Capitalized City construction loan interest		$687,108
	TOTAL	$687,108

3. SOURCE OF FUNDING:

No additional funds are required to be committed at this time.

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.

All bond-related costs will be paid by the Borrower. The Refunding Bonds are tax-exempt obligations secured by a mortgage loan payable from Development revenues. No payment of the Refunding Bonds will be paid from or guaranteed through the general taxing power of the City or any other City asset. The City will receive an issuance fee of approximately $89,750. The City will also continue to receive the same annual fee ($38,750) for monitoring the Refunding Bonds as it did for monitoring the 2002 Bonds. Compensation for the financing team participants (Financial Advisor, Trustee and Bond Counsel), as well as the costs of the financing, are contingent on the sale of the Refunding Bonds and will be paid by the Borrower.

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

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

BUDGET REFERENCE

This section is not applicable to the issuance of the Refunding Bonds requested in this Staff Report, but pertains to the increase in the permanent loan amount requested. No new funds will be disbursed, but the amount of the City Construction Loan to be repaid will be reduced by $687,108 and the amount of the City Permanent Loan will be accordingly increased.

Fund #	Appn. #	Appn. Name	Total Appn.	Amt. for Contracts	2007-2008 Adopted Operating Budget (Page)	Last Budget Action (Date, Ord. No.)
443	0070	Loans and Grants	$52,240,000	$687,108	XI-48	3/18/2008, 28275

CEQA

Mitigated Negative Declaration file number PDC01-096.

Julia H Cooper
JULIA H. COOPER
Deputy Director, Finance

Leslye Krutko
LESLYE KRUTKO
Director, Housing Department

For questions, please contact Julia H. Cooper, Deputy Director at Finance, at 408-535-7011.