COUNCIL AGENDA: 5-11-10
ITEM: SJFA#2

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL
CITY OF SAN JOSE FINANCING AUTHORITY BOARD

FROM: Julia H. Cooper
Leslye Krutko

SUBJECT: **SEE BELOW**

DATE: April 12, 2010

Approved

Date 4-20-10

COUNCIL DISTRICT: 3
SNI AREA: N/A

SUBJECT: **APPROVAL OF THE ISSUANCE OF BONDS, LOAN OF BOND PROCEEDS, AUTHORIZATION OF A GROUND LEASE, AND RELATED DOCUMENTS, FOR THE FOURTH STREET APARTMENTS PROJECT**

RECOMMENDATION

Adoption of a resolution of the City Council:

a. Authorizing the issuance of two series of tax-exempt multifamily housing revenue bonds designated as "City of San José Multifamily Housing Revenue Bonds (Fourth Street Apartments Project), Series 2010A-1" and , "City of San José Multifamily Housing Revenue Bonds (Fourth Street Apartments Project), Series 2010A-2" in a combined aggregate principal amount not to exceed $26,775,000 (the "Bonds");

b. Approving a loan of Bond proceeds to Fourth Street Apartments, L.P. (the "Borrower"), a California limited partnership created by First Community Housing, Inc. (the "Developer") to finance the construction of Fourth Street Apartments located at 1460 North Fourth Street in San José (the "Site");

c. Approving in substantially final form the Bonds, Trust Indenture, Loan Agreement, and Regulatory Agreement and Declaration of Restrictive Covenants; and

d. Authorizing the City Manager, Assistant Director of Finance, Treasury Division Manager, Debt Administrator, and Director of Housing, or their designees, to execute and, as appropriate, to negotiate, execute and deliver these Bond documents and other related Bond documents as necessary.

Adoption of a resolution of the City of San José Financing Authority Board:

a) Authorizing the Executive Director of the City of San José Financing Authority, or designee, to acquire the Site from the Borrower and negotiate and execute a Ground Lease of the Site back to the Borrower for a term of up to 75 years with an annual rent of $1.00 for the first 65 years, to be increased at the time of full repayment of the City's construction/permanent loan; and

b) Authorizing the Executive Director of the City of San José Financing Authority, or designee, (i) to negotiate and execute an agreement with the City of San José related to the ground lease revenues from the Project and the ultimate disposition of the Project Improvements and the Site, and (ii) to negotiate and execute a Declaration of Restrictive Covenants for the Development and Operation of Affordable Housing, given to and on behalf of the California Department of Housing and Community Development (HCD), an agency of the State of California, and any other documents reasonably required by HCD.

OUTCOME

Approval of the recommended actions will allow for the issuance of multifamily housing revenue bonds for the purpose of constructing 100 rental units, composed of 99 units that will be affordable for a period of at least 55 years and one unrestricted manager's unit. These apartments will serve residents with current annual incomes of $21,100 to $63,300, which are equivalent to 25% of area median income ("AMI") to 60% of AMI, adjusted for the number of bedrooms in each unit and the household sizes.

EXECUTIVE SUMMARY

The Developer has requested that the City issue tax-exempt multifamily housing revenue bonds in an aggregate principal amount not to exceed $26,775,000 for the purpose of lending the Bond proceeds to the Borrower, a California limited partnership created by the Developer. The Bonds will be neither rated nor credit-enhanced and will be structured as a private placement with U.S. Bank as the initial purchaser during the construction period. Upon meeting certain conditions to conversion, the California Community Reinvestment Corporation ("CCRC") will purchase up to $5,684,000 of the Series 2010A-1 Bonds in order to fund the permanent loan to the Borrower. The balance of the outstanding bonds will be redeemed as a condition to conversion. The Bond proceeds, together with other funds, will be used by the Borrower to finance the construction of 100 rental units to be known as Fourth Street Apartments (the "Project"). The project will also employ a ground lease structure between the City of San José Financing Authority (the "Authority") and the Borrower.

BACKGROUND

The Developer has requested that the City issue tax-exempt multifamily housing revenue bonds in an aggregate principal amount not to exceed $26,775,000 for the purpose of lending the Bond proceeds to the Borrower, a California limited partnership. The Bond proceeds, together with other funds, will be used by the Borrower to finance the construction of 100 rental units to be known as Fourth Street Apartments. The land upon which the improvements will be constructed will be owned by the Authority (the "Lessor"), a joint exercise of powers authority agency created by an agreement between the City of San José and the Redevelopment Agency of the City of San José. The Lessor will lease the site to the Borrower (the "Lessee") for a term of sixty-five (65) years with an option to extend for an additional ten (10) years.

Upon completion of the Project, the occupied rental units will be subject to the following affordability restrictions:

- 35 units at or below 25% of AMI;
- 15 units at or below 45% AMI;
- 25 units at or below 50% AMI;
- 15 units at or below 55% AMI;
- 9 units at or below 60% AMI; and
- 1 unrestricted manager's unit.

Of the Project's 100 units, 35% will be dedicated to occupancy by developmentally disabled individuals. The affordability and occupancy restrictions will remain for a period of at least 55 years. These affordability restrictions are inclusive of the affordability restrictions required under the ground lease between the Borrower and the Authority.

Given the financial market difficulties over the past year and a half, this project has endured many delays and is assembled with seven financing sources. The project originally was approved to close in fall 2008 with tax-exempt bonds to be issued through the California Housing Finance Agency ("CalHFA"). CalHFA stopped offering that product due to market stresses; thus, the Borrower has restructured the financing to issue bonds through the City.

On June 4, 2009, the Director of Finance, pursuant to Municipal Code Section 5.06.430, held a public hearing pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") to receive public comment on the City's expressed intent to issue up to $30,000,000 in tax-exempt multifamily housing revenue bonds to finance the construction of the Project. On June 5, 2009, the Mayor approved Certificate No. 2009-4 which, among other things, authorized the Director of Housing to file an application with the California Debt Limit Allocation Committee ("CDLAC") for an allocation of up to $30,000,000 in private activity bonds. On July 24, 2009 the City submitted a request to CDLAC for an allocation of $26,775,000. On September 23, 2009, the City received an allocation from CDLAC for this amount.

The Bonds will be issued in two series: Series 2010A-1 and Series 2010A-2, in the respective approximate amounts of $5,684,000 and $17,316,000, for a total issuance amount of

$23,000,000, but in any event not to exceed $26,775,000. Bond proceeds will fund a portion of the total Project costs, estimated to be approximately $44.0 million. The estimated sources of funding during the construction, completion and lease-up period ("construction") versus the permanent period are shown in the following table. The permanent sources exceed the construction sources because some of the sources are available only for permanent financing.

City of San José
Fourth Street Apartments
Plan of Finance – Sources of Funding

Source	Construction	Permanent
Bonds Proceeds	$ 23,000,000	$ 5,684,000
City Loan	8,283,215	12,958,684
State of California – 1C Infill Grant	1,513,561	1,513,561
Tax Credit Equity	2,796,000	13,977,500
Deferred Developer Fee		637,469
Deferred Construction Interest	250,228	0
Income from Operations and General Partner Equity	250,000	250,000
TCAP Loan (1)	6,592,384	0
General Partner	100	100
HCD Multifamily Housing Program (MHP)	0	8,789,846
CalReuse	175,376	175,376
Total	$ 42,860,864	$ 43,986,536

(1) A loan of funds by the California Tax Credit Allocation committee pursuant to the American Recovery and Reinvestment Act. These funds act as "guarantee" of the MHP fund i.e., should the MHP loan not fund, the TCAP Loan funds will remain in the project.

These numbers reflect the approved City loan amount but do not include land cost, and assume that the Authority owns the land and enters into a long-term ground lease with the Developer as described below. The Developer is currently making decisions on business terms for the project's CCRC permanent bond loan and the outcome of these decisions will result in slight changes to the above amounts. Ground lease revenues and eventual ownership of leasehold improvements will accrue to the City. Site ownership will transfer from the Authority to the City upon repayment of all senior encumbrances.

A portion of the tax credit equity funds received at the permanent conversion of the bond loan and a portion of the City Loan will be used to retire the Series 2010A-2 Bonds at conversion. Upon meeting certain conditions of conversion, the Series 2010A-1 Bonds will be purchased by CCRC and will remain outstanding as a permanent loan after conversion and will be amortized over 30 years. The Borrower will, by Closing, elect to either 1) fix the permanent rate for 30 years, or 2) fix the permanent rate for 15 years where the rate would reset in year 16 (not to exceed the 15 year rate plus 4%). One of CDLAC's requirements is that the Bond closing must occur within the time period set by CDLAC. The Bond closing for this Project must occur by August 25, 2010. It is anticipated that the Bonds will close on or about May 13, 2010.

ANALYSIS

This portion of the report is divided into several sections to address the items in staff's recommendation to proceed with the Project financing. These sections include descriptions of Bond financing structure, Bond financing documents, City subordinate funding, Site ownership and ground lease structure, economic development benefits, financing team participants, and financing schedule,.

Bond Financing Structure

Overview of Multifamily Bond Financing

General As a brief summary, multifamily housing revenue bonds are issued to finance the development of certain rental apartment projects by private developers. The City issues the bonds and then loans the proceeds to the borrower. The bonds are typically issued as tax-exempt securities. The advantages of tax-exempt bonds to the borrower include below-market interest rates and long-term fixed rate financing – 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.

Requirements for Tax-Exemption For multifamily housing revenue bonds to qualify for tax-exemption, federal law generally requires that either: (1) at least 20% of the units in the housing development must be reserved for occupancy by individuals and families whose income is 50% or less of area median income, or (2) at least 40% of the units must be reserved for occupancy by individuals and families whose income is 60% or less of area median income. This last restriction will be incorporated into the Regulatory Agreement for the Bonds.

Structure of the Bonds

Private Placement Structure The Bonds will not be rated or credit-enhanced and will be structured as a private placement with U.S. Bank ("Construction Lender") as the initial private placement purchaser during the construction period, and CCRC (the "Permanent Lender") as the private purchaser during the permanent period. CCRC will purchase the Series 2010A-1 Bonds upon meeting certain conditions to conversion to the permanent period. Pursuant to the City's policies regarding non-credit enhanced bonds, each Private Placement Purchaser will sign an Investor's Letter acknowledging that it is a "qualified institutional buyer" or an "accredited investor", that is, a large institutional investor who understands and accepts the risks associated with unrated bonds secured solely by the Project revenues. If the Private Placement Purchaser wishes to transfer the Bonds, the new bondholder must sign and deliver a similar Investor's Letter to the Trustee, unless the Bonds are assigned a rating of "AA" or higher by Standard & Poor's or "Aa" or higher by Moody's Investors Service ("Minimum Rating"). Pursuant to the Indenture, so long as the Bonds have not received the Minimum Rating, the Bonds will be held by a single bondholder (which shall also be the Bondholder Representative) in Authorized Denominations, for each series, equal to the amount of bonds outstanding for the respective series.

Principal Amount and Term Initially, the Bonds will be issued as interest-only floating rate tax-exempt bonds in an aggregate amount not to exceed $26,775,000. The Bonds will be issued in two Series: Series 2010A-1 and Series 2010A-2, in the respective approximate amounts of $5,684,000 and $17,316,000, for an estimated total issuance amount of $23,000,000, but in any event not to exceed $26,775,000. The date upon which the Project meets certain conditions of conversion to the permanent phase (the "Conversion Date"), including construction completion and lease-up, a portion of the tax credit equity and a portion of the City Loan will be used to payoff the Series 2010 A-2 Bonds. The Series 2010 A-1 Bonds, in the anticipated principal amount of $5,684,000, will be purchased by CCRC and will remain as a permanent loan to be fully amortized over 30 years from the Conversion Date.

Interest Rate During the construction period, anticipated to be 24 months, the Bonds will pay interest only at a variable rate. The interest rate will be equal to the greater of: a) 4.5%, or b) 1-month LIBOR plus 3.5% converted to Lender's non-bank qualified tax-exempt rate.

On and after the Conversion Date, interest will accrue on the Series 2010 A-1 Bonds at a fixed rate. That rate, depending upon the election of the Borrower, will remain in effect for either 30 years or for 15 years with rate adjustment in year 16. In either case, the initial fixed rate will be determined immediately prior to Bond closing.

Draw-Down Bond Structure The Bonds are structured as draw-down bonds for each Series of Bonds. Only a portion of Bond proceeds will be released to and held by the Trustee on the issuance date. U.S. Bank will purchase the Bonds incrementally as the Project is constructed and requests for payment are received, for an estimated total amount of $23,000,000, but in any event not to exceed $26,775,000. Series A-1 Bonds shall be funded before any Series A-2 Bonds are purchased.

Bond Financing Documents

The following is a brief description of each document the City Council and the Authority Board 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 April 23, 2010.

Trust Indenture The 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, 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 the Bond proceeds and other funds established under the Indenture; to authenticate the 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 Bonds. The Loan Agreement (described below) obligates the Borrower to compensate the Trustee for services rendered under the Indenture.

Loan Agreement This agreement (the "Loan Agreement") is among the City, U.S. Bank, and the Borrower. The Loan Agreement is executed by the City Manager or other authorized officer on behalf of the City. The Loan Agreement provides for the loan of the Bond proceeds to the Borrower for the construction of the Project and for the repayment of such loan by the Borrower. The loan is evidenced by two notes (the "Notes") in an amount that corresponds to the respective principal amount of each series of Bonds. The City's rights to receive payments under the Notes will be assigned to the Trustee, along with certain other rights under the Indenture, the Loan Agreement and the Note; however, certain reserved rights have been retained by the City, such as the City's right to indemnification.

Regulatory Agreement and Declaration of Restrictive Covenants This agreement (the "Regulatory Agreement") is among the City, the Trustee, and the Borrower. The Regulatory Agreement is executed by the City Manager, or other authorized officers on behalf of the City. The Regulatory Agreement contains certain covenants and restrictions regarding the Project and its operations intended to assure compliance with the Internal Revenue Code of 1986. The Regulatory Agreement restricts the rental of Project units (except for the one manager's units) to low-income residents for a period of at least 55 years as previously described.

City Subordinate Funding

An initial funding commitment of $9,875,000 was approved by the City Council on March 20, 2007 (Resolution No. 72768, File No. PDC06-022). On August 11, 2009, the City Council approved an increase in the total construction/permanent commitment amount to $13,984,579, including up to $1,186,123 in construction-period interest (Resolution No. 72768, File No. PCD06-022). That amount also takes into account that $2,190,000 is committed to reimburse the Borrower for land costs, assuming the City Council and the Authority approve the site acquisition and ground lease as described below. Per these approvals, the Housing Department will provide a loan to the Borrower in an amount not to exceed $13,894,579. The current estimated City loan amount of $12,958,684 is a source of funding as shown in the Plan of Finance Table above.

Site Ownership and Ground Lease Structure

The City proposes that the Authority take ownership of the Site from the Borrower and lease it to the Borrower at the time of Bond closing. This structure is proposed because of the potential long-term benefits of a ground lease, as discussed below, and because the City cannot allow encumbrances on its fee interest if it takes ownership of the Site and subsequently leases the ground back to the Borrower. The senior lender has indicated that it desires a security interest in both the fee and leasehold interests. The City is considering this request and is currently negotiating business terms in an effort to preserve project-specific affordability for the long-term. The Authority is permitted to allow encumbrances on land to which it takes title. Of the City's total approved commitment amount, $2,190,000 is allocable to the purchase of the Site, which the Borrower acquired with the City's acquisition loan funds. At the time of the Site's transfer to the Authority and the execution of the agreement between the City and the Authority, the City's loan commitment amount would then be reduced by the cost of the land.

The Authority would enter into a long-term ground lease of up to 75 years with the Borrower. Although terms of the lease would be finalized by the Executive Director, or designee, it is expected that the ground lease rent will be (a) $1 per year payable in advance at closing, plus (b) annual residual payments from Project cash flow commencing at repayment of the City's permanent loan.

It is to the City's benefit for the Authority to own the land and lease it to the Borrower. Such benefits include the potential for long-term control of the Site, including ownership of both the land and the building at the end of the lease term, provided there is no foreclosure by the senior lender. There is also the potential for future ground lease payments as revenues to the Housing Department. These potential benefits will be agreed to between the City and the Authority in the agreement to be entered into by both parties. Further, it is easier to enforce long-term affordability restrictions that are senior to other encumbrances with a ground lease structure than were the land owned by the Borrower, so the lease will likely enhance the City's ability to enforce long-term affordability on the Site.

Economic Development Benefits

By enabling the Project to start construction, San José will benefit economically. The Developer will pay City fees of approximately $1.4 million. The total local impacts for communities in the area are defined as benefits of the direct construction activity itself as well as the impact of local residents who earn money from the construction activity and spend part of it within the area. According to a 2009 study on the economic benefits to local areas for multifamily construction by the National Association of Homebuilders ("NAHB"), 100 units of this type of family housing are estimated to generate over $8 million of local benefits in the first year and approximately $2.6 million each year thereafter.

According to the NAHB metrics, it is also anticipated that proceeding with and completing the development of the Project will create 151 local jobs in San José in the first year, directly and indirectly, and 38 local jobs each year thereafter.

Financing Team Participants

The financing team participants consist of:

• City's Financial Advisor:	CSG Advisors, Inc.
• Bond Counsel:	Jones Hall
• Trustee:	Wells Fargo Bank, National Association
• Lender:	U.S. Bank, CCRC

All costs associated with the financial advisor, bond counsel and trustee are contingent on the sale of the Bonds and will be paid from Bond proceeds, City loan proceeds, and/or Borrower equity.

Financing Schedule

The current proposed schedule is as follows:

• Council Approval of Bond Documents	May 4, 2010
• Pre-Close and Close/Issue Bonds	May 11 and May 13, 2010
• CDLAC Deadline for Bond Issuance	August 25, 2010

EVALUATION AND FOLLOW-UP

This Memorandum presents the set of recommendations related to the City Council's approval of the issuance of the Bonds for the Fourth Street Apartments and requires no follow-up to the City Council. Once the Bonds close and construction of the Project commences, the Housing Department will provide updates in its Quarterly Production Updates to the City Council.

PUBLIC OUTREACH/INTEREST

☐ **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 request does not meet any of the above criteria because a tax-exempt bond issuance specifically for a multifamily project does not use public funds the same way that a loan of City funds would. Instead, 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 was held on June 4, 2009 by the Director of Finance. The public hearing notice was published in the *San José Mercury News* on May 22, 2009.

COORDINATION

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

FISCAL/POLICY ALIGNMENT

This action is consistent with the City's *2007-2012 Five-Year Housing Investment Plan*, adopted by City Council on June 12, 2007, to increase the supply of affordable housing, and with the City's *Consolidated Plan 2005-2010* to provide housing units for very low- and extremely low-income households. This action is also consistent with the City's Policy 1-16, Policy for the Issuance of Multifamily Bonds, which requires the City to issue tax-exempt multifamily housing revenue bonds for projects within the City limits that also have a City loan or grant commitment, with certain limited exceptions.

COST SUMMARY/IMPLICATIONS

All issuance costs will be paid from Bond proceeds, City housing loan proceeds, and/or Borrower equity. The Bonds are tax-exempt obligations secured by mortgage loans payable from Project revenues. No payment of the 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 $82,500. The City will also receive an annual fee for monitoring the Bonds and the Regulatory Agreement. Under the City's Policy for the Issuance of Multifamily Housing Revenue Bonds, the annual fee is equal to one-eighth of one percent (0.125%) of the original principal amount of tax-exempt bonds issued during the construction period, or approximately $28,750. Upon conversion to permanent financing, the annual fee is reduced to the greater of 0.125% of the permanent bond amount ($7,105) or a flat fee of $7,500.

No appropriation of funds is required at this time. Compensation for the financing team participants (financial advisor, bond counsel, and trustee), as well as the costs of the financing, are contingent on the sale of the Bonds and will be paid from Bond proceeds, City loan proceeds, and/or Borrower equity.

CEQA

Addendum to Final EIR for the North San José Area Development Policy, Resolution No. 72768, File No PCD06-022.

/s/
JULIA H. COOPER
Assistant Director of Finance

/s/
LESLYE KRUTKO
Director, Housing Department

For questions, please contact Julia Cooper, Assistant Director of Finance, at (408) 535-7011.