AFFORDABLE HOUSING FINANCE

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CAPITAL MARKETS OUTLOOK

Lucky Stars Aligned for ’13

Active pipeline of new construction and preservation deals to continue in year ahead

By Brad Berton

Notwithstanding frustration with the pace of the nation’s economic recovery going into 2013, something of a consensus has emerged among affordable housing finance experts.

Next year’s continuing low-interest rate marketplace will witness robust demand for debt to help refinance, rehab, preserve, purchase, and construct affordable units. And project sponsors for the most part can expect to see plentiful public and private programs aimed at satisfying their capital requirements.

With debt supply and demand in sync amid an unprecedented interest rate environment, the aligned stars should generate brisk transaction volume next year, pros generally agree. For example, developers willing to wade through Department of Housing and Urban Development (HUD) bureaucracy should secure short- and long-term debt at costs one veteran describes as downright “ridiculous”—with note rates in the mid-2 percent range in select cases.

Preservation efforts

As an active pipeline of affordable housing construction and rehab continues, efforts to preserve affordability should drive considerable demand for debt in year 11 and year 15 situations, in particular.

Capital stacks will need rejiggering as low-income housing tax credit (LIHTC) investors look to redeploy equity while write-off periods close, and as various partners pull out when compliance periods expire.

“We’re seeing plenty of demand out there for the year 11 and year 15 deals,” observes Neil Socquet, founder of tax credit syndicator IFG Capital. “And a lot of new construction deals are also penciling out” with development financing rates so attractive and construction costs still well off the mid-2000s’ bubble levels, he adds.
With interest rates (and cap rates) at historically compressed levels, it’s no surprise that investors would look to “monetize” their interests at the end of the tax credit period, but before the end of the compliance period, adds Patrick Martin, president of Pembrook Capital Management’s multifamily division. Given the abundance of such situations at tax credit developments, Martin perceives plentiful demand in 2013 for bridge and permanent solutions supporting preservation.

“We’re seeing a lot of selling and refinancing occurring well before compliance periods end”—in some cases including LIHTC investors looking to redeploy equity after the 10-year tax credit period. “So there will be an active pipeline of projects coming full circle that will be good candidates for refinancing,” Martin adds.

Attractive rates

On the supply side, public-sector programs from HUD and the Federal Housing Administration (FHA), the government-sponsored enterprises (GSEs), and tax-exempt bond issues are expected to continue funding various affordable activities. But more and more private players aiming to supply debt more efficiently than public sources will continue targeting the affordable space, including through new preservation programs, Martin and others note.
Attractive rates for construction facilities, bonded debt, and subsidized lending programs—combined with generally strong tax credit pricing—should help developers and owners in 2013 even though equity pricing of 4 percent credits

has softened somewhat in recent weeks, says Tom Pereira, the director of structured finance who manages Boston Capital's Affordable Housing Mortgage Fund.

Sponsors of solid projects seem bound to attract competitive offers from private and taxpayer-subsidized construction lending programs, Pereira continues. And he's in a pretty good position to make that call, given that Boston Capital's debt funds in many cases provide a combination of construction financing and permanent debt to tax credit developments—in some cases via fixed-rate forward commitments.

Another continuing trend to keep an eye on: Resilient investor demand for federally guaranteed debt is making taxable Ginnie Mae bonds a lower-cost alternative to local- and state-issued tax-exempt bonds.

Indeed, the supply of, and demand for, affordable housing debt will bring a lot of borrowers and lenders to the negotiating table in the coming year. While developers have long lamented lengthy processing times seen with popular FHA programs (the ongoing pilot accelerated program for tax credit projects notwithstanding), many just won't be able to resist the rate structures.

With the Federal Reserve committed to keeping interest rates low by purchasing Treasury bills into 2014, note rates on FHA-insured loans seem destined to remain "ridiculously low," predicts Ray Landry, vice president of commercial lending with Davis-Penn Mortgage Co. Pereira, for one, mentions a recent Sec. 221(d)(4) preservation/rehab transaction coming in at 2.76 percent over a fully amortizing 40-year term. "You can't get much lower than that." Accordingly, rates quoted for (d)(4) and 223(f) loans are prompting a lot of affordable developers to favor the FHA programs over bonded debt, IFG Capital's Socquet observes. "When you're looking at 3s (or better) rather than bond financing at 5 percent or so, it's going to be very enticing."

As he and others point out, where it's viable to tap taxable Ginnie Maes as a permanent financing alternative to tax-exempt bonds, the rate savings might likewise amount to 150 basis points (bps) or more. Nevertheless, with the 10-year Treasury yield still well below 2 percent and unlikely to move much in 2013, there's considerable investor demand for tax-exempt bonds mostly paying in the high-4s or low-5s these days, Pereira relates.

Going forward, Landry says he'd be surprised if permanent debt rates generally waver by more than a few bps in 2013—with a move of even 25 bps highly unlikely. And soothsayers at the Mortgage Bankers Association (MBA) appear to agree.

As of September, MBA's research group is forecasting that the benchmark 10-year Treasury yield will go into 2013 at about 1.9 percent and will average 2.1 percent over the course of the year. That's a bit above 2012's expected average of 1.8 percent, but still well below last year's 2.8 percent.

And as RealtyRates.com reports, the debt market favors multifamily generally over other income-property categories. The average spread over the 10-year Treasury for permanent debt closing in the second quarter came to 274 bps for apartments: solidly tighter than industrial (296 bps), retail (303 bps), office (339 bps), and hospitality (376 bps).

Construction financing continues rebound

Experts don't anticipate any notable adjustments ahead in rates on construction loans—what with the one-month LIBOR adjustable-rate index still sitting at a minuscule 0.20 percent at press time.

But as always, it's a tale of two markets: Sponsors of projects in primary markets will for the most part continue seeing more aggressive quotes than will be the case in smaller metros.

Demand for construction financing will continue rebounding modestly next year—with a bigger bounce likely in 2014. The National Association of Home Builders is projecting multifamily construction starts will end up at 224,000 this year, followed by 238,000 in 2013 and by a stronger jump to 275,000 in 2014 (still a bit behind 2008's 284,000). Individual banks and banking consortiums should remain quite aggressive in quoting construction loans, especially for sizable transactions. Quotes on 12- to 24-month construction facilities are often in the 3 percent to 3.5 percent range these days—with loan fees getting compressed amid the heavy competition.

But that competition grows more heated as the loan size grows. "It's tough to compete with banks" in the construction lending arena, says Pereira, "but some of them have limited interest in $2 million transactions."

Many developers logically prefer the better rates and terms they can get on construction debt if they secure a forward commitment for a permanent mortgage. And Boston Capital competes in that space, with its forward commitment program typically quoting permanent rates in the 5 percent range today, Pereira notes.

Quotes on forward commitments from Fannie Mae and Freddie Mac have come down over the past year, but at 6 percent-plus, those rates still aren't particularly compelling, Landry observes.

The FHA's waiver of the rule requiring a property to be operating for three years before being eligible for a 223(f) loan will also drive the market Some developers are taking advantage of the accelerated processing and retiring construction loans with a highly attractive 35-year 223(f) loan once the final certificate of occupancy has been issued, Landry continues.

He adds that the note rate can be in the 2.5 percent vicinity. "That has generated great interest; we are looking at deals all across the country today."

As Martin and Pereira relate, nimble private lenders continue devising alternatives to FHA preservation programs and the popular Fannie and Freddie programs recapitalizing projects between year 11 and expirations of compliance periods.

In today's rate environment, alternatives such as Pembrook's bridge loans offer speed and flexibility at only slight premiums to the more cumbersome programs offered by the FHA, Fannie, and Freddie, Martin relates. In some cases this might entail infusing mezzanine-type capital subordinate to the first-priority financing as new equity takes out original sponsors, he continues. In those cases, many of the new ownerships are likely to refinance again tapping GSE or FHA programs within a few years.

Pereira adds that Boston Capital likewise perceives resilient demand ahead for preservation lending and expects to offer sponsors needing year 11 recapitalization debt in the low-5 percent range.
Martin is quick to acknowledge that, given the strong borrower demand, other private capital sources may jump into the space in coming months. In fact, in the prevailing interest-rate and tax credit pricing environment, Martin suggests that when proposed sales or preservation-related recapitalizations don't pencil out, owners are probably overvaluing the property.

"It's a good time to be in the affordable apartment business—and market-rate as well," Martin continues. "The low-rate environment is helping affordable housing owners and operators more easily recycle transactions that a year or two ago would not have been feasible, thus helping preserve more affordable units."