COUNCIL AGENDA: 5/11/21
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ITEM: 3.7

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand
Julia H. Cooper
Nanci Klein

SUBJECT: **SEE BELOW**

DATE: April 29, 2021

Approved D. DSyL

Date **4/29/2021**

SUPPLEMENTAL

SUBJECT: PUBLIC PURPOSE BONDS ISSUED BY A JOINT POWERS AUTHORITY FOR MODERATE-INCOME RENTAL HOUSING

REASON FOR SUPPLEMENTAL

This supplemental memorandum includes the term sheet discussed in the staff report issued on April 16, 2021 for this item, now scheduled for the May 11, 2021 Council meeting. It was necessary to submit after the main memorandum so that staff could meet with one of the City's financial advisors on the recommendations so that proposed business terms could be finalized.

The City's proposed business terms are designed to address the concerns noted in the Council memo and promote the following objectives:

- Reasonably-sized debt able to be paid off within 30 years;
- Preservation of the City's option to purchase the property, and a reasonable likelihood the City can take ownership by year 30 with a minimal outlay of funds;
- Long-term sound property condition;
- Meeting of the City's policy objectives;
- No adverse impact to real estate markets due to local tax subsidy; and
- Creation of sufficient public value through use of this product.

/s/
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Director, Office of Economic Development

/s/
JACKY MORALES-FERRAND
Director, Housing

/s/
JULIA H. COOPER
Director, Finance

For questions, please contact Jerad Ferguson, Office of Economic Development, Housing Catalyst, (408) 535-8176; Kristen Clements, Housing Department, Division Manager, at (408) 535-8236.

Attachment:
Attachment A: Proposed Terms for Request for Proposals

ATTACHMENT A

Proposed Terms for Request for Proposals

1. **General.** There should be no terms in the Joint Powers Agreement or the form documents that preclude the implementation by the City of the following standards with respect to any project.

2. **Underwriting Standards**: As a partner and member of any proposed Joint Powers Authority (JPA), the City of San Jose requires certain prudent underwriting parameters, based on best practices and further detailed below for each transaction that it authorizes.

    a. Debt service coverage ratio for Series A debt no less than 1.10 in year one, providing a 10% cushion to cover expenses and pay required debt service, with level debt service payments each year.

    b. Series A debt must be fully-amortizing over the maximum of a 30-year period, to maximize the likelihood the City can obtain a subject property by year 30 that has no remaining debt obligations.

    c. Acquisition prices must be based on a third-party appraisal from a City-approved appraisal firm to validate purchase prices and prevent over-bidding for properties that can result in a misuse of public subsidy.

    d. Replacement Reserves shall be a minimum of $350 per unit per year escalating at no less than 3% per year, based on the type and age of property and supported by a third-party physical needs assessment with a 30-year horizon submitted to the City prior to requested City Council approval. Replacement reserves shall be part of Net Operating Income calculations and used in sizing Series A debt.

    e. Maximum rents shall be defined by number of bedrooms and level of affordability per rules in State Health and Safety Code Section 50053 , based on a standard of 30% of gross income by household size paid for rent including a reasonable utility allowance for the property's specific set of utilities as determined annually by the Santa Clara County Housing Authority. Occupancy assumption per unit shall be one person per bedroom plus one person. Income limits are determined annually based on data issued by the State Department of Housing and Community Development and posted to the Housing Department's website at sjhousing.org.

    f. Rents charged on all units shall not increase more than 4% per year, regardless of increases in area median incomes.

    g. Rents for each type of unit in a property shall be set annually, or at the renewal of tenants' leases if less than 12 months, at a rent which is at least 10% below unrestricted market-rate rents for that unit type in that submarket, and which is in compliance with that unit's income and rent restrictions. Ensuring that rents remain below market-rate rents will ensure healthy unit demand and low vacancy rates, which is particularly important for moderate-income units given real estate market cycles.

Evidence of discounts to market-rate rents including market data surveyed shall be included in annual reporting to the City (see Reporting to the City).

h. The City's Annual Administrative Fee (see below) shall be payable as an obligation senior to payment of Series B bonds, escalating annually at CPI (the rate of the Consumer Price Index Report for San Francisco-Oakland-San José All-Items/All Urban Consumers).

i. The JPA must provide to the City a certification of tax-exempt status by experienced tax counsel.

3. **City required approvals for Series B bonds and additional subordinate debt**: In addition to the general underwriting approvals specified, the City shall place additional parameters around the B bonds and any additional subordinate debt associated with each transaction, as their size, terms and conditions may affect the schedule and price for the City's future acquisition of a property, or whether the City receives any revenue at sale of a property.

   a. The City shall approve the amount of Series B bonds for each deal, per analysis conducted by a consultant for each transition, in order to limit ongoing payments, lower the overall debt on the property, and offer more affordability within each project.

   b. The asset management fees, paid through the Series B bond, should escalate at 3% only if high performance standards are met, and should escalate at lower rates for lower performance levels. For example, escalation at 3% per year is allowable if economic vacancy rates are under 5% and tenant satisfaction survey scores of 'outstanding' are obtained at the property. Allowed escalation rate would be lowered to 2% for vacancy rates of 5-6% and tenant satisfaction survey scores of 'very good,' and escalate at 1% for vacancy rates of 6% or higher and tenant satisfaction survey scores of 'good' or lower.

   c. Reserves for asset management fees, which contribute to a property's overall debt load, shall be initially funded at 3 years' worth of payments and not replenished.

   d. Net cash flow available after required payments are made must be used to pay B bonds if available in a given year, so as to minimize the accrual of B bonds' balances.

   e. Payments on B bonds shall be applied to principal first, then accrued interest. No capitalization of accrued interest is allowed.

   f. The Bond Regulatory Agreement and the City's option to purchase a property shall be senior to the Series B bonds in priority, so as to preserve affordability and the City's rights to purchase in case of foreclosure by the B series bondholders.

   g. Payments to B bonds shall be based upon performance of the property. If insufficient net cash flow is available to pay the B bonds payment due, the asset management fee may be accrued and payable in a succeeding year. Accruals will be limited to three years of unpaid B Series bonds payments.

   h. Interest rates on the B Series bonds, so-called "preferred equity payments," should be lowered from 10% to the extent that fees relative to public benefit need to be lowered per the Public Cost/Benefit Analysis (see below).

i. After the initial issuance of bonds, the City shall have the right to approve the amount and terms of additional subordinate debt prior to the property owner's entering into any agreements over a $50,000 minimum threshold. This approval right is necessary to avoid debt products that could contain 'call' provisions that would jeopardize the provision of long-term affordability, or greatly lessen the City's ability to recoup its foregone tax receipts and acquire a property.

4. **Affordability of properties**: Although project feasibility will vary based on the specifics of an individual transaction, the City desires the maximum level of affordability achievable within each project:
    a. A desirable affordability mix would be one-third of units at rents at 30% of 80% Area Median Income (AMI), one-third of units at rents for households at 30% of 100% AMI, and one-third at rents for households at 30% of 110% AMI.
    b. No less than one-third of units shall be reserved for low-income tenants earning 61% to 80% of AMI, with partial units rounded up. Rents will be set at levels affordable to households at 80% AMI (not as required by Health & Safety Code Section 50053, but instead at 30% of 80% AMI).
    c. No greater than one-third of units shall be reserved for tenants earning between 100% and 120% AMI, with partial units rounded up.
    d. No units shall be rented to new tenants earning over 120% AMI.
    e. At least 5% of units should be designated to prospective tenants with portable rental subsidies such as Section 8/Housing Choice Vouchers or VASH vouchers for veterans to the extent that rents are acceptable under the programs' guidelines and that tenants meet leasing standards. If one of the units designated for voucher holders remains vacant for more than 30 days, this requirement is suspended and transferred to the property's next vacant unit.
    f. When a unit becomes available, it should be restricted to the lowest income level that needs additional units to meet the required affordability balance.
    g. Changes to the Bond Regulatory Agreement require City prior approval.

5. **Transaction fees**: To impart more value in transactions toward public benefit and less toward private fees, deal team members agree to negotiate lower private and JPA fees for San Jose transactions.

6. **Public Cost/Benefit Threshold Test prior to approval**: Prior to City Council approval, the City shall engage a consultant analysis that analyzes whether the subject property's aggregate reduction in rents below market-rate rent levels for that submarket exceeds the forgone annual property tax revenue ("public cost/benefit analysis"). Costs for the consultant analysis shall be paid by check from the sponsor with the project proposal and related due diligence. The City will only consider projects for approval in which aggregate rent reductions meet or exceed foregone tax proceeds within the first 10 years.

7. **Approval process**: The sponsor shall submit a detailed budget and 30-year pro forma with broken out expenses and projected annual debt balances to the City and to the City's

identified consultant for review. Approval will be a two-step process. First, staff and the consultant will review the transaction and submitted due diligence for feasibility and adherence to the city's terms. If terms comply with the City's standards, the City's consultant will then conduct a public cost/benefit analysis. If the analysis meets the Public Cost/Benefit Threshold Test (see above), the City's consultant and staff will create an approval memorandum and documents for the City Council's consideration. Staff will make every effort to agendize expeditiously a complying property for Council consideration after receipt of a proposal and all required due diligence. The City Council shall have final approval over each transaction to occur in the City, with recommendations and guidance from the City Manager and Director of Housing.

8. **Closing City Administrative Fee**: The City will charge a one-time fee for each transaction, due prior to approval by the City Council, to cover consultant cost for proposal review and public cost/benefit analysis and estimated cost of staff time to engage and review consultant reports, hold the City Council hearing, complete the City Council memo and documents, and perform other related activities associated with the approval of each transaction. The fee will be defined in the City's schedule of Fees and Charges and indexed to increase over time based on CPI.

9. **Annual City Administrative and Monitoring Fee:** An annual administrative fee payable annually on the date of closing to the City as an obligation senior to payment of Series B bonds, defined at closing by the City's schedule of Fees and Charges and escalating annually at CPI to reimburse staff costs associated with public inquiries, reviewing reports, verifying annual reporting, and associated work.

10. **Ensuring sound long-term property condition:** The City requires any property built or acquired with these bonds be held to the highest standard for ensuring a safe, habitable, and well-maintained property within its jurisdiction without resorting to the use of Code Enforcement powers.
    a. The City requires competent and professional asset managers, property managers, developers, and other staff to serve based on industry standard practices.
    b. The City will require a San Jose-specific rider to the Bond Regulatory Agreement that enables the City to enforce a safe, habitable and well-maintained property in its role as the jurisdiction providing authority for the issuance, the regulator in the jurisdiction where the property is located and as an Additional Member to the JPA in cases that the property owner is informed of problem conditions and does not cure problems after a standstill period during which time the City agrees not to act.
    c. Property management contracts will require property management companies to enter into Memoranda of Understanding with the City for subject properties, in which the companies agree to work diligently and cooperatively with the City to solve condition and safety problems that arise.
    d. Property management contracts will require property management companies to have written tenant appeal processes disseminated to all tenants and their availability posted in a prominent place.

11. **Joint Powers Authority Staff / Team**: The City requires the following parameters for all team members, or staff, associated, or affiliated, with the origination and operation of the properties for the Joint Point Powers authority to be included in the JPA's team:

    a. At least two asset managers operating in Santa Clara County, and at least two property managers with existing operations in Santa Clara County as well as extensive experience with affordable housing administration.

    b. Asset management companies will evidence no less than 40 years of combined experience of key principal staff in the following areas: identifying real estate properties for acquisition, negotiating terms, conducting due diligence, documenting, and closing acquisitions; borrowing or underwriting debt and/or equity investments in multifamily transactions; developing properties from the ground up; overseeing substantial rehabilitation of multifamily projects of 100 units and up; and performing high-quality full asset management of properties under control, including hiring and overseeing reputable property management companies experienced with affordable housing compliance and operations, as well as financial workouts and restructuring.

    c. The deal team for any project will also include an independent, MSRB-registered municipal advisor selected by the City that has a fiduciary obligation to the City to ensure the transaction closes per the City's guidelines for each transaction.

    d. The City expects that bond underwriting fees and property management fees would be subject to accelerated bidding processes from a pool of pre-qualified (i) investment bankers and (ii) property management bidders and overseen by the City for projects within the City, just as the City does for all projects undertaken by the City with City resources and all City JPA bonds. This is appropriate as neither developers nor JPAs are contributing resources to the projects, and all resources added to the transaction are coming from the City and other public agencies contributing property taxes involuntarily, and given the fee levels have a material impact on the City's ability to afford to purchase projects upon exercising the purchase option.

12. **Transparency of bond issuance**: Information and documents related to transactions approved under the program within the City shall meet the following minimum standards:

    a. All project documents will be posted on Joint Powers Authority web site and meeting agendas no less than 5 days before meetings.

    b. Ability for the public to subscribe to the Joint Powers Authority's notifications.

    c. Posting required to the MSRB's EMMA website (https://emma.msrb.org/) that is used for publicly-sold bonds.

    d. Other clear location for posting for public review of information for privately-placed bonds, if not on EMMA.

13. **Anti-Displacement efforts**: The City requires that the owner take the following measures to combat involuntary displacement of existing tenants within the 12 months following a property's acquisition:

a. Strive to underwrite and to acquire property in a way that results in no excessive rent increases, significant changes in terms and conditions of residents' leases, or difficulties with new property management companies.

b. Existing tenants who meet income requirements should be transitioned first into more deeply affordable units at their option, prioritizing those with the highest proportion of income spent on rent payments.

c. If the City elects not to purchase a property by year 30, the owner must define minimum relocation benefits that a market-rate purchaser in year 30 would have to meet or exceed for existing tenants, and notification requirements to tenants.

14. **Implementation of City policy priorities**: In addition to avoiding tenant displacement, the City requires properties using this product to accommodate other City policy priorities:

    a. Properties shall implement all Council-approved tenant preferences on eligible apartments, and administration in accordance with City direction, and state and federal law including Fair Housing law.

    b. The sponsor agrees to cooperate with the City regarding the desired number and location of properties using these financial products in a given geographic area. City reserves the right to focus use of the product in particular geographic area(s) to achieve the goal of a range of housing choices and price points.

15. **Reporting to the City**: The City will require the following reporting to the Housing Department on an annual or ongoing basis:

    a. Annual report on submarket rents and discounts to submarket rents, tenant satisfaction survey results, household size, income and rents information, and all information required for administration of any applicable City-approved tenant preferences.

    b. Annual financial report from the Joint Powers Authority regarding the status of remaining debt associated with each property.

    c. Property owner and management shall respond within 10 days in writing to any request in writing from the City for other information.

    d. After the first 12 months following acquisition, property owner agrees to remedy any non-compliance in agreed-upon affordability targeting within 3 months or other term agreed upon by the City.

    e. Property manager shall post all upcoming vacancies and waiting list openings to the Housing Department's apartments portal (Doorway).

    f. Disclosure shall be made within 3 days of incurring additional debt and other reportable events as defined by the Securities and Exchange Commission (SEC) 15c2-12 disclosure rules.

16. **Property transfer price and process**:

a. City will require the ability to assign its Option to Purchase to nonprofit developer/owner or affiliate, another JPA in which the City has membership, or another public entity.

b. Any amount equal to foregone tax revenues that was not directly offset by affordability conveyed to tenants, as calculated by the City's consultant prior to year 30, shall be repaid to the City in a distribution prior to retirement of the B Series bonds at the time of property disposition if the City declines to purchase a property and it is sold at the end of the 30-year period. This payment could take the form of a Payment In Lieu of Taxes obligation if otherwise restricted by tax definitions.

c. At the time of property refinancing or sale to a party other than the City or the City's designated assignee, the payment of revenue to the City under any purchase agreement or benefits agreement shall be paid subordinate to Series A bonds but in priority before Series B bonds.

d. If the City elects to purchase a property before the Series B bonds are paid off, to discourage unintended incentives and possible moral hazard, the amount to be paid on the Series B bonds will be net of any compensation that had been anticipated in years after the City purchases, and no yield maintenance shall apply to the Series B bonds' anticipated returns.

17. **No recourse to the City:** No parties associated with a potential transaction under this product shall have recourse to the City for any costs or liabilities associated with transactions that do not progress to the City Council for approval, or are not approved by the City Council.

18. **Report on foregone tax revenues**: To fully inform the City Council so that it may limit the amount of property tax revenues and transfer tax revenues foregone under this product, each transaction's consultant analysis must disclose the cumulative existing estimated property taxes foregone under these products for all taxing entities, as well as the subject transaction's estimated impact. The staff's reports to the City Council also will include this information.