Tax Supported
New Issue

Hudson Yards Infrastructure Corporation, New York

Rating

Hudson Yards Senior Revenue Bonds ... A–
Rating Outlook .... Stable

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New Issue Details

Approximately $1,500,000,000 Hudson Yards Senior Revenue Bonds, Fiscal 2007 Series A, are scheduled to sell during the week of Dec. 4 via negotiation with a syndicate led by Goldman, Sachs & Co. The bonds are due Feb. 15, 2047. Call provisions are yet to be determined. This is the first offering of Hudson Yards Infrastructure Corporation bonds.

Security: The bonds are payable from revenues expected to be generated from development in the Hudson Yards area of Manhattan. New York City is obligated, subject to appropriation, to make interest payments on the bonds in cases where such revenues are insufficient for that purpose.

Outlook

The 'A–' rating is based on the historical strength of the midtown Manhattan real estate market, the expectation of strong demand for commercial and residential development in the Hudson Yards area that will support the bonds, and, significantly, New York City's obligation, subject to appropriation, to pay interest on up to $3 billion of Hudson Yards Infrastructure Corporation (HYIC) bonds when project revenues are insufficient for this purpose. The rating also reflects the risks inherent in a security that relies on prospective development and the successful completion of a major subway extension. The bonds have a nominal 40-year final maturity, and no principal repayment is scheduled until the project has demonstrated self-support. This maturity structure, in conjunction with the city's interest payment commitment, allows time for development and the phase-out of tax incentives and provides a cushion in the event of construction delays.

Rating Considerations

The HYIC bonds are ultimately secured by revenues expected to be generated from development in Hudson Yards, a roughly 45-square-block area on the west side of midtown Manhattan. The city has rezoned this underdeveloped area, which had been zoned primarily for manufacturing and low-density commercial use, to allow for a medium- to high-density (office building, hotel, and residential) extension of the midtown central business district.

To foster private development in Hudson Yards, the city has committed to fund the extension of the No. 7 subway line west and south to a new station at 11th Avenue and 34th Street. (The current terminus of the line is at Seventh Avenue and 41st Street.) The subway extension is critical to the Hudson Yards project; office building development in Manhattan is dependent on subway access, and the area is currently underserved. The city will use HYIC bond proceeds to pay the costs of property acquisition associated with the extension and provide the Metropolitan Transportation Authority (the MTA) with $2.1 billion to carry out construction. The MTA considers this funding, which includes a $100 million contingency, sufficient to cover project costs. There is no commitment to cover construction cost overruns. Construction is expected to begin in summer 2007, and the project is scheduled to be completed in 2013. Whether the subway extension can be completed on time and on budget is one of the largest risks to the success of Hudson Yards.

The subway extension is the largest public infrastructure component of the Hudson Yards project, and the bulk of HYIC bond proceeds will be used for this purpose. However, HYIC bond proceeds will also be used to fund public amenities in the area and purchase 50% of the transferable development rights (TDRs) associated with the eastern railyard that the MTA owns in the area.

Consistent with the city's demonstrated support of the project, the New York City Industrial Development Agency (IDA) has adopted tax incentives for the area to encourage commercial development. Other initiatives in the area, including the expansion of the Jacob K. Javits Convention Center (the Javits Center), are expected to support Hudson Yards development. Cushman & Wakefield Inc. has performed a study that projects strong commercial and residential demand in Hudson Yards over 30 years.

HYIC bonds are payable from both recurring and one-time project revenues. Recurring property tax revenues are generated through payments in lieu of taxes (PILOTs) on commercial development in the Hudson Yards area and tax equivalency payments (TEPs) on noncommercial development. PILOT agreements provide property tax discounts for the first 19 years and are secured by a first mortgage that will be assigned to the trustee. TEPs equal the amount of real property taxes received by the city from new Hudson Yards development that is not covered by a PILOT agreement (primarily residential). PILOTs flow directly to the bond trustee; TEPs must be appropriated by the city. One-time development-related revenues include payments in lieu of mortgage recording taxes (PILOMRTs; made as part of PILOT agreements), district improvement fund bonus (DIB) payments (made in exchange for approval of greater density than base zoning allows), and proceeds from the sale of the TDRs of the eastern railyard (up to $200 million plus interest).

The fiscal 2007 series A bonds are due on Feb. 15, 2047. No scheduled principal is required until after the conversion date, which occurs when the recurring revenue sources (PILOTs and TEPs) for each of the preceding two fiscal years, less capped HYIC expenses, equal 1.25 times (x) senior maximum annual debt service (MADS) and 1.05x combined senior and subordinate MADS. For this test, MADS is calculated assuming level or declining debt service amortization beginning in the fiscal year after conversion. Once the conversion test has been met, debt is amortized on this basis. In the HYIC's cyclical revenue base case, the city pays bond interest for about 10 years, and conversion occurs in about 20 years. Over the long term, PILOTs represent about 60% of project revenues and TEPs about 40%.

No project revenue flows to the city until after conversion, except for reimbursement for bond interest paid by the city in that fiscal year, if any. The city's interest support commitment is for the life of the bonds and remains in place even once principal payments commence. Interest is subordinate to principal to take maximum advantage of this benefit.

Strengths

- Demonstrated New York City commitment to the Hudson Yards project.
- Obligation of the city (general obligation debt rated 'A+' by Fitch Ratings), subject to appropriation, to pay interest on up to $3 billion of bonds when projected revenues prove insufficient.
- Historical strength of the midtown Manhattan real estate market and the expectation of strong demand for commercial and residential development in the Hudson Yards area.
- Principal maturity structure that allows time for development and phase-out of tax incentives and provides a cushion for construction delays.

Risks

- Development of the area is prospective; the project is not self-supporting in the near term.
- Possible delay in completion of/cost overruns for the subway extension that is critical to commercial development in the area. There is no commitment to cover construction cost overruns.
- Possible weakening of the New York City economy or softening of the midtown Manhattan commercial and residential market over time, which could reduce the attractiveness of Hudson Yards.

Hudson Yards Project

The Hudson Yards project seeks to develop a large portion of midtown Manhattan that has been underutilized. The plan includes commercial, residential, hotel, and retail space in the area, roughly from West 43rd Street, between Seventh and Eighth avenues, to 30th Street, between 11th and 12th avenues. In 2005, the New York City Council completed a comprehensive rezoning of the area that provides for about 24 million square feet of office space, 13,500 units of housing, 2.0 million square feet of hotel, and 1.0 million square feet of retail space. Formerly, 70% of the area was zoned for manufacturing.

The project is managed by the Hudson Yards Development Corporation (HYDC). The HYIC is a local development corporation that was created by the city to finance the Hudson Yards project. The majority of the members of the boards of directors of

both HYIC and HYDC are appointees of the New York City mayor.

If successful, the Hudson Yards project will provide much-needed capacity to address the demands of a growing city, particularly for large office space. Cushman & Wakefield performed a demand and development study that projects strong demand for commercial and residential development in the district over 30 years. The report notes the lack of development capacity in Manhattan and the competitive advantages of the Hudson Yards area, including tax incentives for investment. Residential development that has already taken place in Hudson Yards and recent acquisitions in the area by major developers are positive signs. In addition, there are several complementary initiatives that could support development in Hudson Yards, most prominently the renovation of the Javits Center, which will double the size of its facilities and includes a new 1,000-room hotel.

The Hudson Yards project philosophy is that the public sector will fund infrastructure improvements that will then allow for private sector development of the area. Among these improvements are the extension of the No. 7 subway line and certain new public amenities, including a midblock park and boulevard between 33rd and 36th streets, as well as the purchase of eastern railyard TDRs to promote development. No construction contracts have yet been entered into for the undertakings, although property acquisition has begun. The project plan anticipates entering into negotiated deals for necessary property acquisition where possible and then turning to condemnation as a last resort; all condemnation would be for public use.

Subway Extension

The most significant infrastructure component of the Hudson Yards project is the extension of the No. 7 subway line west and south to 11th Avenue and 34th Street from its current terminus at 7th Avenue and 41st Street. The project includes a new station at 11th Avenue and 34th Street, as well as a shell station at 10th Avenue and 41st Street that could be built out later.

Commercial development in the Hudson Yards area is contingent on the successful extension of the No. 7 subway line. Office buildings in Manhattan require subway access. Currently, the area is not in adequate proximity to a station. Once the extension is completed, most of the area will be suitable for office development. The No. 7 line provides a connection to most major subway lines in Manhattan.

The city and the MTA have executed a memorandum of understanding for the subway extension project. The city will pay for the extension from $2.1 billion in HYIC bond proceeds (including a $100 million contingency); no MTA funds will be used. It is not clear what party, if any, would cover project costs above $2.1 billion, although bond funds could be diverted from public amenities projects to support the subway extension, and/or the bonding plan could be increased with an expansion of the city interest commitment.

Preliminary design work is complete. Construction is expected to begin in summer 2007, and the project is scheduled to be completed in 2013. A six-member project committee — consisting of three MTA representatives, two HYDC representatives, and one HYIC representative — will select a management company and approve budgets and schedules, among other tasks. The committee will receive project updates and meet at least once a month. Environmental reviews have been completed.

Public Amenities

To make the Hudson Yards area more attractive for development, the project plan includes completion of a midblock boulevard and park between West 33rd and 36th streets (by 2012), extending to 42nd Street over the longer term. Currently, the area has no public parkland. Other amenities, including additional parks, are expected to be funded by developers. The project plan also includes a below-ground 950-space parking garage to be built at the cost of, and owned and operated by, a private developer.

Railyards Development

The eastern and western railyards cover about 26 acres in the southwest corner of Hudson Yards. The railyards are owned by the MTA. Development of the railyard sites will require construction of platforms over the railyard operations. Currently, the eastern railyard is part of the rezoned Hudson Yards area, whereas the western railyard has not yet been rezoned. To facilitate development, HYIC will use $200 million in bond proceeds to purchase 50% of the TDRs to the eastern railyard pursuant to an agreement with the MTA. The MTA will retain ownership of on-site development rights for both the eastern and western railyards and, working with the city and HYDC, release a request for proposals from potential master developers next year. The developer

is expected to fund the costs of building the platforms. HYIC will receive all moneys from the sale of eastern railyard TDRs up to $200 million plus interest; all proceeds thereafter will flow to the MTA.

■ Plan of Finance

The current planned $3 billion HYIC senior bond program includes $2.1 billion for the No. 7 subway extension, $700 million for parks, streets, and property acquisition, and $200 million to buy 50% of the eastern railyard TDRs from the MTA. There is no cap on individual project components, although funds cannot be transferred out of the subway extension subaccount prior to completion.

The fiscal 2007 series A issuance will be used primarily for the subway project (about 62%) and property acquisition and condemnation (about 23%). HYIC expects a second issuance of $1.5 billion in senior bonds in 2010, for a total matching the city's current $3 billion interest payment commitment. HYIC has the option to issue up to $2 billion in additional senior bonds if the city agrees to increase its interest commitment by $500 million (to $3.5 billion). Capitalized interest is permitted but not anticipated for the initial offering.

■ Security

HYIC bonds are payable from a combination of recurring and one-time project revenues. The one-time revenues are most important in the early years of the project, while the recurring revenues are the primary security over the longer term.

Recurring property tax revenues are generated through PILOTs on commercial development in the Hudson Yards area and TEPs on development not covered by PILOT agreements (primarily residential). PILOT payments, mostly made pursuant to agreements with the IDA that will be assigned to the HYIC bond trustee, provide property tax discounts for the first 19 years and are secured by a first mortgage that also will be assigned to the trustee. TEPs equal the amount of real property taxes received by the city from new Hudson Yards development that is not covered by a PILOT agreement. PILOTs flow directly to the bond trustee and are pledged and payable with no further government approvals required. TEPs must be appropriated by the city.

One-time development-related revenues include PILOMRTs (made as part of PILOT agreements), DIB payments (made in exchange for approval of greater density than base zoning allows), and proceeds from the sale of the TDRs of the eastern railyard (up to $200 million plus interest). All these revenues are pledged and payable with no further government approvals required.

A key credit strength is the commitment of New York City, subject to appropriation, to pay interest for the life of up to $3 billion in bonds (senior or subordinate) in cases where project revenues are not sufficient. The mechanism for this backstop, which is laid out in an agreement between the HYIC and the city, provides that by April 1 of each year, HYIC will provide the city with the expected amount of interest support needed in the following fiscal year. This amount will be included in the executive budget. No later than 15 days prior to each interest payment date, HYIC will notify the city of the actual amount of support needed for that payment, which must be paid no later than four days before the interest payment date. If the appropriation proves to be insufficient, the mayor commits to seek an increase.

Amortization: The amortization structure allows time for the project to achieve self-sufficiency and maximizes the benefits of the city's interest support commitment. The fiscal 2007 series A bonds will be sold with a single bullet maturity on Feb. 15, 2047. No principal payments will be scheduled until conversion, which occurs when the recurring revenue sources (PILOTs and TEPs) for each of the preceding two fiscal years (per audited financial statements) less HYIC expenses (capped at $1 million in fiscal 2007, rising 3% per year thereafter) equal: a) 1.25x senior bond MADS, assuming level or declining debt service amortization beginning in the fiscal year after conversion; and b) 1.05x senior and subordinate bond MADS. The level or declining debt service amortization commences in the fiscal year after conversion has been achieved. In HYIC's cyclical revenue base case, which assumes issuance of $3.5 billion in senior bonds and $400 million in subordinate bonds, all maturing in 2047, the city pays interest for about 10 years, and conversion occurs in about 20 years.

Prior to conversion, no bond may mature before the Feb. 15, 2047 maturity of the initial senior bond issuance, there can be no scheduled amortization prior to maturity, and no senior bonds may be issued as tender option, variable-rate, capital appreciation, or deferred income bonds. There can be no sinking fund

installment on a subordinate bond before senior bonds are amortized.

Flow of Funds: The flow of funds changes once conversion has occurred. Prior to conversion, all project revenues must be used first to pay bond interest and HYIC expenses and then, if any excess revenues are available after interest has been retained for the subsequent fiscal year, to pay down principal once bonds are callable. No project revenue flows to the city, except for reimbursement for bond interest paid by the city in that fiscal year, if any. After conversion, principal and interest are paid on the level or declining debt service sinking fund schedule, and excess project revenue flows to the city. In the HYIC cyclical revenue base case, conversion occurs in about 20 years, and the amount of annual excess revenue flowing to the city rises to about $1.5 billion by the expiration of the bonds in 40 years.

The city's interest support commitment is for the life of the bonds. Interest payments are subordinate to principal payments to take maximum advantage of this benefit once principal payments have commenced.

Additional Bonds Test: Like the flow of funds, the HYIC's ability to issue additional bonds changes after conversion. Prior to conversion, HYIC can issue up to $3.5 billion of new money senior bonds without meeting any other test as long as all bonds are covered by the city interest support commitment (currently $3 billion). Refunding bonds are not included in the issuance cap. Also, prior to conversion, the annual interest payments on subordinate debt cannot exceed $30 million. After conversion, the additional bonds test requires that recurring revenues less capped HYIC expenses equal at least 1.25x senior bond MADS and 1.05x senior and subordinate bond MADS. Refunding bonds may be issued at any time as long as refunding MADS does not exceed refunded MADS; this allows some flexibility to restructure or extend the debt.

■ Project Revenues

Payments in Lieu of Taxes

PILOT agreements provide tax incentives to spur major capital investment. The IDA has adopted tax incentives for the Hudson Yards area (except for the western railyard), pursuant to a uniform tax exemption policy (UTEP) specific to qualifying new developments in Hudson Yards. This policy, which divides the area into three zones, provides maximum benefit to initial developers in the areas farthest west and a declining level of tax abatement as the areas become more developed. The maximum real property tax discount is 40%. Taxes are discounted for the first 19 years of the PILOT agreement term, with taxes paid increasing by the lesser of 3% or the actual increase in assessed valuation annually from years five through 15. The discount is phased out from years 16–19, and after 20 years, the PILOT payments equal 100% of real property tax. As an additional incentive, developers entering into PILOT agreements receive exemption from the sales tax on construction and tenant improvement materials. Almost all commercial development meets the criteria for a PILOT arrangement through the IDA.

PILOTs continue even after the expiration of the discounts in year 20. PILOT agreements are expected to have initial 35-year terms and must be extended for at least the life of the bonds. The IDA has agreed not to modify the UTEP without prior written consent of HYIC, unless required to comply with state law. PILOTs flow directly to the trustee. PILOT obligations are also secured by a first mortgage to the IDA, which will be assigned to HYIC and then by HYIC to the trustee. The MTA will charge PILOTs on all eastern and western railyard development and assign such PILOTs to HYIC. In addition, the city agrees to pay to HYIC any PILOTs it receives from other governmental entities related to development in the area, using the same appropriation procedures as will be used for TEPs. As such, HYIC will capture the benefits of such development.

Payments in Lieu of Mortgage Recording Taxes

PILOMRTs are part of the PILOT agreements discussed above. The UTEP includes an exemption from the mortgage recording tax for mortgages securing construction and permanent financing for commercial developments in the area; however, PILOMRTs must be paid in the equivalent amount. HYIC will be assigned all PILOMRT revenues in the area and the right to receive and enforce such payments.

Tax Equivalency Payments

TEPs will be appropriated by the city to the HYIC in an amount equal to real property taxes received by the city from new development in the Hudson Yards area that is not covered by a PILOT agreement (primarily residential, as well as some hotel). New development is defined as the construction or substantial rehabilitation of a building or other

improvement in the area evidenced by the issuance of a temporary certificate of occupancy on or after Jan. 19, 2005. TEPs will be included in the executive budget. The city will make TEPs in two installments no later than Aug. 1 and Feb. 1 of each year. Although not specific to the Hudson Yards area, there are existing significant incentives to develop new affordable housing in the city that are expected to be used in Hudson Yards residential development. Notably, the 421-A program, which provides residential tax abatement for 10–25 years, must be renewed prior to expiration in December 2007; reforms have been proposed.

District Improvement Fund Bonus Payments

DIB payments are made by developers to achieve greater density than base zoning allows. Such payments were provided for in the rezoning of the Hudson Yards area and flow directly to the trustee. A property owner applies to the New York City Department of City Planning for certification, with certification granted only once payment has been made or guaranteed; $11.1 million has been received to date.

Eastern Railyard Transferable Development Rights

In exchange for purchasing a 50% share of the eastern railyard TDRs from the MTA for $200 million, HYIC will receive all revenues from the sale of such rights, up to $200 million plus interest. MTA receives all subsequent revenues. HYDC will manage the sale of the rights until HYIC has received the amount it is owed. TDR sale revenues flow directly to the trustee.

In HYIC's cyclical revenue base case, PILOT revenue commences with subway extension completion, while TEP revenue is realized at small levels even prior to completion. Both revenue streams grow substantially over time as tax incentives are phased out and development is realized. PILOTs represent about 60% of project revenues over the longer term and TEPs 40%. PILOMRTs are a meaningful component of project revenues only around the time of the completion of the subway extension. DIB payments are part of project revenues for about 30 years, although at low levels after year 20, and are most important in the early years. The sale of the eastern railyard TDRs is forecast to generate revenue in about years three through 14. The cyclical revenue base case used a long-term outlook of 0.7% annual growth in city office-using employment, personal income increases of 3.4% a year, and slow population growth. The case assumes three recessions about the size of the 1990s recession, occurring about once per decade.

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