

TRENDS FOR TAX EXEMPT BONDS AND 4% CREDIT DEALS  
AND STRATEGIES TO ATTRACT INVESTORS

Attracting investor interest will be a challenge for all transactions in 2010, but particularly for acquisition-rehab transactions financed with tax exempt bonds and the related 4% low income housing tax credits. This memo outlines recent trends the affordable housing industry has experienced in terms of investor demand and concerns with bullets on potential means to address those concerns to improve investor interest in your project.

Trends

- Demand for credits has fallen from \$9 billion in prior years to what is anticipated to be approximately \$4 billion in 2010, allowing investors to “cream” for desired transactions and dictate terms.
- 2010 “Desired” Transactions are:
  - In markets with strong demand for affordable rental units
  - In markets that satisfy CRA needs
  - For deals with 9% credit allocations
  - For new construction projects with fast absorption/rent up/credit delivery
  - Deals with strong sponsors/guarantors
- Some upper tier investors have shifted to investing on a deal by deal basis (rather than through a fund generally), resulting in more stringent underwriting of specific deals rather than based on satisfying broader parameters that a fund syndicator would use to place deals into the appropriate fund.
- Syndicators are facing diminishing transactions and are increasing loads and other fees (shared cash flow, etc.) to sustain profitability/viability.

The objective is to attract investor interest to your transaction, 4% deal remains attractive by (a) making the investor’s “benefit stream” (of credits, losses, and depreciation) as comparable to 9% deals as is feasible, (b) by addressing specific risk areas of bond transactions, and (c) by improving overall yields to investors.

The general areas of concern for investors evaluating tax credit investments, particularly related to deals using 4% credits associated with tax exempt bond financing, include:

- Assessing the Real Estate
- New Construction versus Acquisition-Rehab
- Leveraging on Bond Deals
- Tax Losses/Depreciation
- Investment Efficiency
- Underwriting, Operations, Rent Subsidies
- Special Needs Housing Considerations

The following includes a summary of each of those areas of concern, potential strategies to address them, and additional bullets with related issues to consider.

1. Assessing the Real Estate—the real estate and location are primary concerns for investors that are increasingly focused on demand in the rental market and submarket, as well as regional CRA needs. When prospecting for deals to put into a development pipeline, these are paramount concerns, but there is little that can be done to address these issues for existing projects.

**Strategies:**      **Considering attracting equity investors to 4% deals that are not located in ideal markets with premium yields to the investor.**

- Currently, funds in the market are priced at a yield of 8% to 8.5% on an after tax basis (and rising). A significant premium, such as a 200 basis point yield premium, which translates to investor yields of 10% to 10.5% for a 4% project (with the capital structure of a 9% deal, discussed below).
  - Creating these target yields may necessitate pricing in the high 60's, which will require access to significant subsidy funds.
2. New Construction versus Rehab—Generally, investors favor new construction compared to acquisition rehabs from a risk perspective—this is primarily due to studies indicating that statistically there are greater asset management problems due to deferred maintenance and related costs for acquisition-rehab properties.

**Strategies:**      **For projects that are not new construction, the scope of rehab should target \$50,000 per unit. For new construction, identify bridge loans for tax credit equity to remove construction risks for investors and improve yields.**

- The scope of rehab should be highlighted to avoid perceptions that the increased scope is to generate developer fees rather than to make the property similar to new construction.
- Acquisition-rehab deals typically provide accelerated credit delivery given current occupancy and for light “tenant in place” rehab projects. More substantial rehab and related displacement will delay credit delivery, but will address a significant risk concern of investors.
- For acquisition-rehab deals with substantial rehab, budget significant relocation funds for existing residents.
- New construction bond deals typically use higher set asides (60% AMI) or include market rate units (to compensate for less equity), which investors perceive as more risky due to lower demand for these units versus units for lower income persons.

3. Over Leveraging Bond Deals. Investors target transactions with a ratio of hard “must-pay” debt to total development costs of 30% or less or otherwise have limits on per unit hard debt. Tax exempt bond and 4% deals must meet the 50% test (funding at least 50% of basis plus land with tax exempt bond proceeds); furthermore, tax exempt bond transactions usually have debt ratios exceeding 70%.

**Strategies:**      **Soft subsidy loans are necessary to make bond and 4% deals attractive—targeting that desired 30% hard debt to TDC ratio.**

**Structure transactions with cash collateralized bonds or with tax credit contributions redeeming bonds after placement in service to meet the 50% test.**

- The additional bond proceeds necessary for the 50% test can benefit a project by allowing deferral of tax credit installments until after completion, which reduces investor risks and improves investor yields.
  - Careful tax structuring is necessary for bond issuances to meet the 50% test.
  - Soft debt should carry little interest to ensure excess losses are not generated.
  - Convention suggests that investors should view 1.15 DSC the same for a 9% credit project or a bond and 4% project. In reality, investors assess (a) absolute debt amounts, (b) debt per unit, and (c) debt ratios as significant risks even with a good DSC ratio. Investors fear the potential need to put in additional deficit funds beyond their required capital contributions if the project has financial difficulties and is concerned that projects with greater absolute debt will require much larger deficit funding.
4. Other Tax Losses/Depreciation—Investors are no longer interested in projects that generate significant losses, which can impact their balance sheets adversely. This is of particular concern for non-bank, publicly held investors that want the tax credits but not the impacts of excessive losses on their published financial statements. Current investors appear to be targeting a ratio of 75% or more of the benefits from their investment to come from the actual credits, with the remainder coming from tax losses.

**Strategies:**      **Determine if it is feasible to switch to 40-year depreciation rather than an accelerated 27.5-year schedule.**

- Investor evaluations consider the interest rate on soft financing and the depreciation period (27.5 or 40 years) to get the right mix of credits and losses for their investor.
- Reducing losses makes a transaction more attractive to investors, but reduces the internal rate of return, and, consequently, the pricing per credit.

5. Efficiency in Credit Investment—similarly sized projects generate more credits for a 9% deal and have smaller overall transaction costs.

**Strategies:** Targeted bond-financed transactions should be of a sufficient scope to have comparable efficiencies to smaller 9% investments.

- The syndicator's profit is a function of the size of the equity investment, so as prices drop, larger deals sustain syndicator profits.
- Bond and 4% deals yielding annual credit of \$400,000 or more will be attractive to investors skimming for 9% deals based on efficiency.

6. Underwriting, Operations, and Subsidies—Bond and 4% projects typically have been aggressively underwritten to support higher debt amounts. For example, Section 8 projects typically had rents at tax credit maximum rents rather than at the lower of tax credit rents or market.

**Strategies:** Stress the underwriting assumptions and demonstrate the project is strong without rent subsidies or with significantly discounted rents (3 – 5%).

- Fund significant reserves related to any aggressive underwriting.
- Strengthen guarantors (joint venture) and guaranty provisions; select proven property management firms as part of development team.

7. Special Needs Housing & Service-Enhanced Properties—Investors assess properties that include a tenant population with a need for special social services for their reliance on those services and for the flexibility of the program requirements. To summarize, the investor's analysis essentially involves removing the services or special aspects of the project that serves a specific population to determine if the project remains feasible without those services or that tenant population.

**Strategies:** Negotiate flexibility with other subsidy providers or program managers.

- Include the permission to rent units to tenants outside of the special needs population after efforts to identify qualified special needs tenants.
- If service-related subsidies are lost, can the owner rent to higher income populations (i.e. 60% AMI).
- Assess significant of regulatory failures (flexibility to cure defaults) and quality/experience of property management in screening qualified residents/enforcement of related lease provisions.
- Consider flexibility in project design to ensure project is marketable to other, non-special needs tenants (for example, investor bias against single room occupancy units given concerns regarding weak market demand if the affordable project fails).