Combining NMTCs and Section 108 Loans

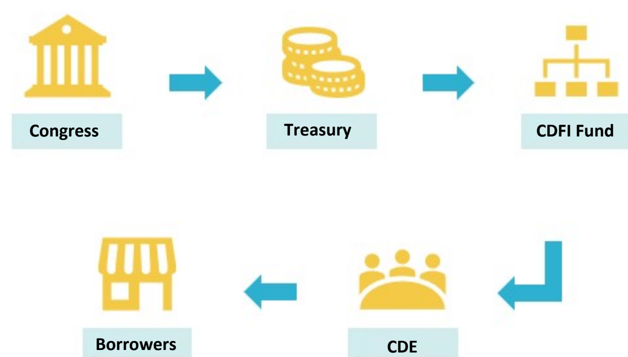
Objective: Provide community development practitioners, including cities and CDEs, a deeper understanding of the intricacies of combining Section 108 loans with New Markets Tax Credits and the key points to think about in structuring, closing, monitoring and unwinding projects with both financing sources.

Introduction

New Markets Tax Credits ("NMTC") and Section 108 guaranteed loans are two powerful financing tools for community development projects in the United States, providing projects with gap financing or low-cost debt to get projects completed. Combining these financing sources can boost their impacts by leveraging NMTC equity with low interest rate loans and allowing borrowers to invest savings back into projects directly serving low-income communities ("LICs") or low-income persons ("LIPs"). In this case study, we will discuss the benefits of pairing these two financing sources, important considerations for structuring these kind of deals and lessons learned from real projects to assist cities, developers, NMTC investors, and community development entities ("CDEs") in bringing these projects to life.

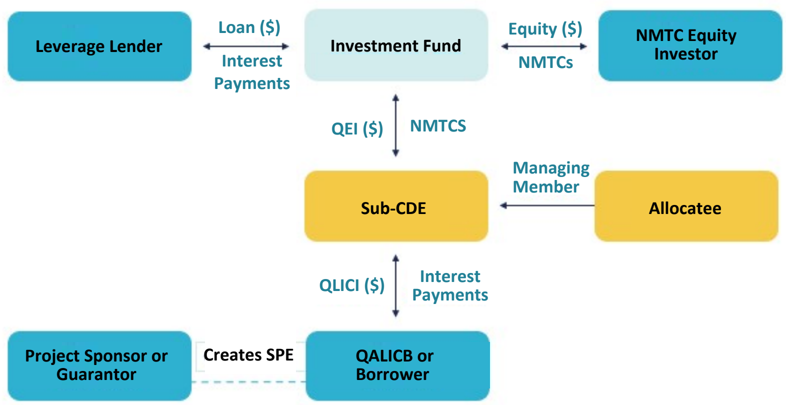
New Markets Tax Credits

The NMTC program is administered by the Community Development Financial Institutions Fund ("CDFI Fund"). The CDFI Fund awards CDEs (also known as allocatees), which can include community development financial institutions ("CDFIs") and banks, with NMTC allocation annually. CDEs serve as the intermediary between NMTC investors and borrowers looking for capital for community and economic development projects. NMTC investors, frequently banks or other financial institutions, receive a tax credit for their Qualified Equity Investment ("QEI") in an eligible project. Most NMTC transactions use a leveraged structure, where equity from the NMTC investor is combined with a leverage loan in an investment fund that is majority-owned by the equity investor. NMTC equity is a key source of gap financing for transformative community development projects – it can provide up to 30% of project costs, bringing down financing costs during the NMTC compliance period (CDEs must hold and monitor NMTC investments for seven years) and in many cases can be forgiven at the end of compliance, lowering refinance costs and providing equity to project sponsors.



The QEI from a NMTC investment fund is invested in a sub-CDE, managed by the CDE, which makes a qualified low-income community investment ("QLICI") to qualified active low-income community business ("QALICB"). QLICIs can be structured as equity investments or loans as long as loans have flexible rates and features as defined by the CDFI Fund, including lower than standard interest rates, longer than standard interest only periods and higher than standard loan-to-value ratio requirements.

NMTC projects include a variety of partners, including the CDE, the NMTC investor, the borrower/QALICB and the leverage lender. The QALICB is typically a special purpose entity (SPE) created



by the project sponsor to receive the NMTC loans. Leverage loans can come from many different sources, including the project sponsor, a bank, CDFI, foundation or, as this case study will explain in more detail, cities through the Section 108 loan guarantee program.

NMTCs can fund many different types of projects, ranging from manufacturing businesses to mixed-use retail. NMTCs can also finance housing developments or social service organizations providing job training, medical care or homelessness prevention. CDEs choose projects based on their community outcomes including job creation, community goods or services (such as education or health projects), environmental sustainability, healthy food options and financing for minority-owned or controlled businesses. The goal of the NMTCs program is to encourage and support projects that will provide jobs, goods or services to low-income persons (LIPs) and residents of LICs.

Section 108 Loan Guarantee Program

The Section 108 Loan Guarantee Program ("Section 108") provides communities with low-cost, long-term financing for economic and community development projects. Section 108 financing provides an avenue for communities to undertake larger, more costly projects. Section 108 is the loan guarantee component of the Community Development Block Grant Program (CDBG) utilizing the same program framework such as national objectives, eligible activities, and public benefit standards. Communities seeking to utilize Section 108 must include Section 108 in their HUD Comprehensive Action Plan/Annual Action Plans.

Section 108 can fund economic development, housing rehabilitation, public facilities, infrastructure and other physical development projects, including improvements to increase resilience against natural disasters. This flexibility of uses makes it one of the more versatile and important public investment tools that HUD offers to states and local governments.

Section 108 financing can be deployed directly by the community or a community can relend the Section 108 proceeds to a developer or business to undertake an eligible project.

Section 108 has a rolling and non-competitive application process. HUD finances Section 108 obligations through a variable rate lending facility that provides funds between public offerings and underwritten public offerings that provide borrowers with permanent, fixed-rate financing.

A community can borrow up to five times the annual amount of its CDBG allocation in Section 108 financing, enabling communities to leverage CDBG while conserving the limited grant dollars for non-revenue generating projects. HUD does require a pledge of current and future CDBG allocations as security. Diligent underwriting is critical with Section 108 because if the identified repayment source does not perform as expected, HUD will apply a portion of the CDBG allocation to make the debt service payments.

The variable interest rate for Section 108 is based on the 90-day London Inter Bank Offered Rate ("LIBOR") plus 20 basis points (0. 20%). (Note that LIBOR will be replaced by another reference rate by July of 2021.) The permanent interest rate is fixed after Section 108 loans are sold as part of a large-scale public offering. The permanent interest rate is determined during the public offering but is based on 10-year Treasury Notes plus approximately 50 basis points (0.50%). There is also a one-time financing fee that has to be paid to HUD to cover the credit subsidy cost. Key players include the local or state Entitlement, HUD Field Office, HUD's Financial Management Division, and the nonprofit or for-profit project sponsor (if applicable).

Commonalities and Differences Between HUD 108 and NMTC

Both Section 108 and NMTC are powerful federal economic development tools that share many of the same eligible uses such as private for-profit or nonprofit development – creating jobs or providing goods and services, which can include commercial and mixed-use real estate development/redevelopment and operating for-profit and nonprofit businesses. Both programs target projects that cannot attract conventional financing: Section 108 require an applicant to certify it has made efforts to obtain financing without the Federal guarantee; NMTC is a "but for" program - but for NMTC, the project could not be completed due to lack of financing. Like Section 108, the NMTC program requires regular Community Outcome and other reporting requirements.

The HUD National Objective of principally benefiting LMI people/LMI area benefit is another area of commonality with NMTC. Basic geographic eligibility under NMTC is a census tract with poverty levels of at least 20% and household incomes of 80% or less of AMI. As an alternative to geographic eligibility, NMTC Projects may directly benefit Targeted Populations, which translates to projects where at least 40% percent of employees are LIP (80% of Area Median Income or "AMI") at time of hire (51% for Section 108 National Objective) or at least 50% of gross income is derived from sales, rentals or services to LIP (for Section 108 – funding is typically directed towards activities that principally benefit (51%) LMI persons).

There are a few important differences between Section 108 loans and the NMTC Program as well. The NMTC Program is competitive, accepting applications once per year from certified CDEs for a set amount of allocation authority. (For 2021-2025, Congress has set this limit at $5B per year). Section 108 applications are noncompetitive, accepted on a rolling basis. Additionally, as mentioned above, NMTC investments typically rely on census tract eligibility, though Targeted Populations, which is more similar to Section 108 eligibility requirements, is an allowable source of eligibility.

Other Resources

For a more depth introduction to Section 108 loans or the NMTC Program, reference these other training resources.

- Section 108 Loan Guarantee Program
    - HUD Exchange
- New Markets Tax Credit
    - CDFI Fund
    - NMTC Coalition
    - Novogradac Resource Center

Case Study Format

This case study will go through the lifecycle of a community development project intending to combine Section 108 guaranteed loans and NMTCs, including structuring transactions, closing financing, monitoring projects throughout the NMTC compliance period and unwinding the NMTC structure. Real projects that have utilized these financing sources will be used as examples of best practices to model and potential issues to avoid.

Structuring Transactions

The first step of structuring a NMTC transaction is identifying the project's funding. Before engaging in a NMTC transaction, it is also important to know:

- the CDE's fee schedule
- the regulations are governing leverage loans
- the Investor tax credit pricing (sometimes referred to as Internal Rate of Return ("IRR") or yield requirement)
- the relationship between NMTC equity and leveraged debt in a leveraged transaction.

NMTC is a tax credit, not an initial source of capital. To convert the tax credit to capital, the tax credits must have a purchaser/Investor. In a leveraged transaction, the NMTC equity only makes up a portion of the QEI. The QEI is equal to the amount of NMTC allocation that a CDE sub-allocates to a Project. The balance of the QEI not met by the NMTC is leveraged debt.

The NMTC equity should equal the funding gap plus CDE fees and other NMTC-specific expenses. As an example, assume an eligible Project with $10,000,000 in total project costs including CDE fees and NMTC-specific expenses such as tax credit counsel and financial modeling performed by a tax credit accountant. An interested CDE is willing to sub-allocate up to $10,000,000 in NMTC allocation for the Project. The NMTC Investor is willing to pay $0.70 on the $1.00 for the tax credits. NMTC is a 39% tax credit so, the NMTC Investor will receive $3,900,000 in federal income tax credits over a seven-year compliance period for which the Investor will pay $2,730,000 ($3,900,000 * 0.70).[1] Therefore, the Project will need to raise $7,270,000 to act as leverage.

Leverage Lender

Leveraged debt must remain in place during the full NMTC compliance period of seven years. Consequently, the Leverage Lender will be asked to sign a forbearance agreement agreeing not to foreclose on its loan to the NMTC Investment Fund. Additionally, no principal payments can be made during the compliance period as a reduction in leverage debt is a redemption of QEI and would result in a default. NMTC cannot be prorated based on length of compliance like historic tax credits or Low-Income Housing Tax Credits ("LIHTC"). Under an uncurable default, the NMTC Investor must repay the IRS for tax credits that it has received to date, even if the uncurable default occurs during the Project's 6th year of compliance. An additional regulation impacting a Leverage Lender is that it cannot take a lien position against the Project assets that are being financed via NMTC Qualified Low-Income Community Investment ("QLICI"). Leverage loans are made to the Investment Fund owned by the Investor so there is no direct relationship/privity between the Leverage Lender and the Project that is receiving the NMTC financing. (Reference diagram on Page 2).

[1] Five percent is taken in years 1, 2 and 3; 6% is taken in years 4, 5, 6 and 7.

Section 108 – A Great Source of NMTC Leverage

Several factors make Section 108 a great source of NMTC leverage and leverage source loans (also known as "sub-leverage" loans); commonality in eligibility criteria is merely the beginning. Section 108 guaranteed loans provide a reasonable and low-cost alternative for development projects that either cannot access market rate financing or for projects for which market rate interest rates would be cost prohibitive or for which market debt does not offer a sufficient interest-only period. When Section 108 is combined with NMTC as either a leverage loan or a leverage source loan, those loans may remain interest-only for the seven-year compliance period. Section 108 notes that are structured with interest-only payments during the NMTC compliance period cannot convert to permanent interest rates until the compliance period is over and the NMTC structure is unwound.

Section 108 Reporting Requirements & Delivery

As mentioned above, both NMTC and Section 108 have Project reporting requirements. The NMTC reporting requirements are incorporated into the NMTC financing documents. However, when Section 108 is combined with NMTCs as a leverage loan to the Investment Fund, additional documentation is required to pass along the Section 108 reporting requirements to the QALICB, the borrower/beneficiary of NMTC financing.

Entitlement Communities must collect prevailing wage (if it is a construction project), jobs, and other community outcome data, and share that information with HUD. When Section 108 financing is used as leverage in a NMTC structure, there is no direct relationship between the Entitlement and the Project and therefore other strategies and legal documents must be utilized to ensure that the Entitlement receives job and community goods and services information. Obligating the QALICB to report the needed information to the Entitlement is approached in one of three ways.

1) Collateral Agency Agreement. This is a non-NMTC legal document between the QALICB and the Entitlement Community that obligates the QALICB/Project Sponsor to meet HUD reporting requirements.
2) Community Benefits Agreement (CBA). CBAs have become a standard way for CDEs to outline Community Outcome expectations and reporting requirements for QALICBs. NMTC counsel can include HUD reporting requirements in the list of deliverables in the CBA and make the Entitlement Community a party to the agreement, resulting in a single document that incorporates both NMTC and Section 108 reporting requirements.
3) QLICI Loan Agreement. The Section 108 Loan Agreement can be attached as an exhibit to the QLICI Loan Agreement, assigning the investment fund's reporting responsibilities to the QALICB.

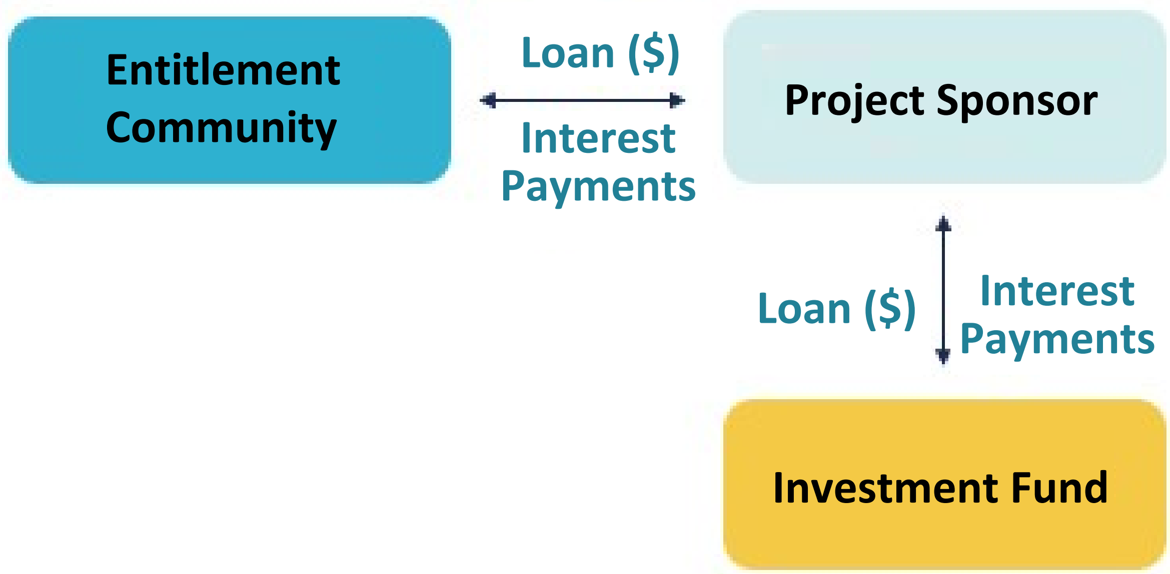
Direct Leverage vs. Source Loans

	Direct Leverage	Source Loans
Pros	• Simpler • Direct relationship between entitlement community and NMTC structure	• Ability for entitlement community to take additional collateral (if available) • Leverage Lender can combine Section 108 with other sources of capital to make one loan
Cons	• Entitlement community can only take interest in sub-CDE as collateral	• Entitlement community can feel separate from NMTC transaction

	• Must be very clear about borrowers' reporting requirements to entitlement community in closing documents	

There are two ways for Entitlement Communities to provide leverage loans to NMTC projects – as a direct loan from the Entitlement Community to the NMTC investment fund or as a source loan to the project sponsor or affiliate, which is in turn lent by this borrower to the NMTC investment fund. Each method has pros and cons and implications for reporting obligations, collateral and the NMTC unwind.

1 Direct Leverage



2 Source Loan to Project Sponsor

Direct Leverage

The National Development Council's ("NDC") CDE provided $7. 7 MM in NMTC allocation from two allocation rounds for a Project to restore a historic pier on the Hudson River in New York state and construct space on the top of the pier to house a 260-seat restaurant, a concession stand, public recreation space and provide a port for ferry and water taxi service between the Entitlement Community and the Financial District in Manhattan. The Project was a key component of the community's waterfront redevelopment plan, as well as its plan to reposition the community as a lower cost residential alternative to Manhattan for individuals that work in New York City. NDC's first QEI was in the amount of $4.2 MM and total project costs, comprehensive of soft costs, $0.5 MM in construction contingency, capitalized interest and NMTC expenses, were $8.6 MM. The Entitlement Community approved a $111,000 EDI grant (a grant program no longer active) and a $697,000 Section 108 guaranteed loan direct to the QALICB.

Despite the conclusions of the engineering study and report, early construction revealed far more deterioration below the waterline than what could be accommodated under the GMP construction contract and the additional restoration costs increased Project costs to $11.8 MM. The Project needed additional NMTC allocation to close the new gap, but NDC had already committed all of its allocation on hand. Construction, funded solely through QLICI proceeds, was halted until additional funding sources could be secured.

A year later, NDC received an award of additional NMTC allocation from the CDFI Fund and committed an additional $3.5 MM in QEI to the Project. As the project had not been able to secure sufficient additional funding sources to leverage the 2nd QEI, NDC worked with the Entitlement, HUD and the QALICB to restructure the Section 108 loan to serve as leverage for the 2nd QEI. The Entitlement increased the Section 108 loan to $950,000 and loaned the proceeds directly to the Investment Fund.

The capitalized interest set aside from the 1st QEI was only sufficient to cover the original projected construction period, after such time the rents from the commercial tenants were to provide the QALICB with the revenue to make its debt service payments. Unfortunately, construction had not been completed according to schedule and there was no rent coming in from tenants. During the closing of the 2nd QEI, the QALICB defaulted on its QLICI interest payments, which caused the Investment Fund to default on its interest payments to the original Leveraged Lender, a nonprofit public benefit corporation.

In structuring the 2nd QEI, the QALICB, NDC and the original Leverage Lender all supported using proceeds from the new QLICI loans to bring the QALICB current on its missed debt service payments so the Investment Fund could get current on its debt service payments. The tax credit accountant pointed out to the rest of the closing team that any funds in excess of a year’s interest, as outlined in the QLICI loan agreement, passed up through the NMTC structure to the Investment Fund would constitute a redemption of the QEI and trigger a tax credit recapture. Based on the accountant’s input, the plan then became to get the QALICB current on its QLICI debt service but NDC would hold the funds at the sub-CDE level and not distribute them to the Investment Fund until after the NMTC compliance period expired. This illustrates how experienced tax credit accountants, in addition to experienced NMTC counsel, are critical to every NMTC transaction.

The Investment Fund agreed to assign a portion of its 99.99% interest in the sub-CDE to the Entitlement Community to satisfy HUD collateral requirements. HUD reporting requirements were passed along to the QALICB by making the Section 108 loan agreement an exhibit to the QLICI loan agreement. The Project performed as expected during the compliance period, which now extended out seven years from the date of the 2nd QEI. When the NMTC structure was unwound, distributed its assets, the QLICI loan and security to the Investment Fund and the Entitlement paid $1,000 for the NMTC Investor’s Interest in the Investment Fund. The Section 108 loan began to amortize and QALICB started making direct principal and interest payments to the Entitlement.

Source Loan to a Nonprofit CDC

One benefit to structuring a Section 108 loan as a source loan to a project sponsor is the ability for the sponsor to combine the Section 108 funds with other sourcing of funding, including cash on hand, other government grants or loans or philanthropic dollars and provide one single loan to the NMTC investment fund. In addition to simplifying the transaction by reducing the number of lenders to the NMTC investment fund, structuring the Section 108 loan as a source loan clearly documents the relationship between the Project sponsor and Entitlement community, removing the NMTC investment fund and investor from the reporting relationship, and provides an opportunity for additional collateral, as discussed in the next section.

In one Local Initiatives Support Corporation ("LISC") NMTC project, the Entitlement Community provided the Project sponsor, a nonprofit CDC developing a neighborhood retail center co-located with affordable housing (financed separately) in a severely distressed census tract. The $2.4 MM Section 108 loan was combined with $550,000 of cash on hand to make a subordinate leverage loan to the NMTC investment fund; senior leverage was provided via a direct loan from a local CDFI to the investment fund. $5.5 MM of leverage was combined with $1.9 MM of NMTC equity to provide a $7.4 MM QEI to the LISC sub-CDE.

3 A laundromat for neighborhood residents included in the LISC-financed retail center

Structuring Section 108 Collateral

Depending on how the NMTC leverage loan is structured, Entitlement Communities have option on the collateral they take to secure their Section 108 investment. For direct leverage loans, collateral is most often an assignment of the investment fund's interest in the sub-CDE. For source loans, Entitlement Communities have the option of taking additional collateral, if the project sponsor has other assets to offer as security.

Assignment of Investment Fund Interest in Sub-CDE

NDC provided $8.5 MM in NMTC allocation to a real estate project built on a former Brownfield in a severely distressed census tract in Ohio. The sole tenant of the QALICB was a worker-owned, hydroponic food production greenhouse. The local Entitlement Community provided an $8 MM Section 108 leverage loan to the Investment Fund and also provided a BEDI grant. In order to meet HUD's collateral requirements, the Investment Fund agreed to assign a portion of its 99.99% interest in the sub-CDE to the Entitlement Community and a Collateral Agency Agreement was used to ensure reporting requirements were met.

There were several lessons learned associated with this Project. The first hurdle was encountered during the NMTC closing process. The $8 MM Section 108 leverage loan exceeded HUD regulations related to creating one job for every $50,000 in Section 108 assistance. The Entitlement requested and received a waiver from HUD for this requirement but because this waiver was not secured before the NMTC closing began, the waiver process delayed the NMTC closing. The average NMTC Financing takes at least three months to document and fund. During closing, the Project is incurring ongoing accounting and legal fees therefore it is important for all Project financing, including Section 108, to be properly structured and committed before the NMTC closing process begins.

The next lesson learned took place during the compliance period and is related to the underwriting of the Section 108 loan. The greenhouse was a start-up enterprise. Prior to requesting financing, the CEO of the tenant contacted the leadership of area colleges and hospitals to gauge their interest in purchasing herbs and lettuces from the co-op. The leadership of these institutions indicated full support of the Project and agreed to purchase its produce. Unfortunately, the institutions' procurement departments already had long term vender contracts in place for produce. The co-op found other outlets for its produce but the volume of the produce that it sold did not provide sufficient income to make its lease payments to the QALICB. The QALICB's sole source of revenue was the co-op's lease payments so it in turn did not have sufficient funds to make its QLICI interest payments. Insufficient loan payments translate to insufficient funds to pass up through the NMTC structure to enable the Investment Fund to make its interest payments on the Section 108 leverage loan.

4 NDC's urban agricultural project

Outside Collateral

In some cases, Section 108 may require a pledge of additional collateral outside of the NMTC project structure. In NMTC transactions where Entitlement Communities provide source loans to project sponsors or other affiliates, they have the option of taking an interest in other assets. For example, in one LISC NMTC project, the city provided a $3.2 MM Section 108 loan to an affiliate of the project sponsor and the master tenant of the NMTC project, a food production facility providing flexible kitchen space to small entrepreneurs. The affiliate combined these funds with loans from two local CDFIs to loan a total of $9.8 MM to the NMTC investment fund. Because the entitlement community lent its funds to the master tenant, it was able to take a security interest in the master tenant's leasehold mortgage in addition to the assignment of the leverage loan to the investment fund and the investment fund's interest in the sub-CDE.

5 NMTC financing and Section 108 allowed this food manufacturing facility to complete construction and create 274 jobs in a severely distressed census tract

Direct Section 108 Loan

In addition to acting as a source of leverage in a NMTC structure, an Entitlement can make a direct loan to a QALICB. As a direct lender, an Entitlement Community can take direct lien on the assets being financed and the loan can also start amortizing during the NMTC compliance period.

Closing Transactions

It can take an average of three to six months to document and fund a NMTC transaction. Investor counsel and CDE counsel draft most of the legal documents. The QALICB has a long list of due diligence Items. See Exhibit 1 for an example of a NMTC closing checklist that includes borrower deliverables and typical legal documents that will need to be prepared for closing.

Required parties for a NMTC closing include the NMTC Investor and its counsel, CDE(s) and their counsel, Leverage Lender(s) and their counsel, QALICB/Project Sponsor and its counsel, and a tax credit accounting firm. The CDE(s) and Investor may have multiple staff that participate in a closing representing underwriting, asset management and construction monitoring. This large group traditionally has weekly closing calls during which participants status document preparation and due diligence plus, resolve issues/open items with all the parties to the transaction present.

Project Example – Grocery-anchored Shopping Center in Washington State

NDC provided $10.6 MM in QEI for a $10.5 MM infill retail project (the difference between the QEI and TPC represents the sub-allocation fee paid by the sub-CDE to its parent CDE) bringing needed goods and services to a severely distressed neighborhood. The local Entitlement Community made a $5.2 MM Section 108 loan to the Investment Fund, with the Project sponsor providing the balance of the leverage through a junior leverage loan subordinate to the Section 108. The subordinate position meant that if the Investment Fund did not have sufficient funds to make interest payments on both leverage loans, the Section 108 leverage loan would be paid first. The process for closing the NMTC structure went reasonably smooth and the NMTC financing closed within four months. A Collateral Agency Agreement was used to obligate the QALICB to provide HUD reporting information to the Entitlement and the Entitlement received a portion of the Investor Fund's interest in the sub-CDE as security for the Section 108 leverage loan.

Project construction also proceeded without any significant issues. The Project successfully leased up but ran into difficulties during the compliance period when the husband and wife team that owned the QALICB divorced. The spouse that remained involved with the Project found it challenging to manage a 61,000 SF shopping center in addition to the Asian food market and restaurant that he owned. The Project fell behind on its QLICI debt service and the Entitlement Community performed a site visit and found residential tenants living in some of the retail spaces. Both NDC and the Entitlement strongly encouraged the QALICB to retain a professional commercial broker to take over the leasing responsibilities.

At the end of the NMTC compliance period, the Project was still behind on its QLICI loan payments and the Investment Fund was behind on its debt service payments to both the senior and junior Leverage Lenders. Over the compliance period, there was staff turnover at the Entitlement, which was the entity that was supposed to purchase the Investor's ownership interest in the Investment Fund for $1,000. The new staff were not familiar with NMTC and were hesitant to pay the $1,000 to acquire the Investment Fund, a necessary act that would allow NDC and the Investor to exit the NMTC structure.

The NMTC Investor had received its seven years of tax credits and was eager to exit the deal. NDC agreed to a staged exit where NDC paid the $1,000 put price to the Investor. It was assumed that NDC would only remain in deal a short while longer during which time the QALICB would get caught up enough on its QLICI debt service to make the Entitlement whole on the Section 108 leverage loan and provide time to educate Entitlement staff about NMTC. Thirty-months later with the assistance of the HUD Office of Community Planning and Development, NDC assigned the QLICI A-note, representing the Section 108 leverage loan, and its collateral to the Entitlement and was able to exit the deal.

The lesson learned with this Project is that a seven-year compliance period is a long time and parties should anticipate possible staff turnover at the Project, CDE, Leverage Lender and even the Investor. NDC has closed more than one Project with an Investor that was acquired by another banking institution during the compliance period. CDEs need to reach out to NMTC Project partners at least six months prior to the end of the compliance period and review with them the steps involved in unwinding a NMTC transaction. This six-month period also affords the QALICB time to consult with its accountant and prepare for any forgiveness of debt related to the QLICI B note, which represents the NMTC equity. Forgiveness of debt is a taxable event for a for-profit QALICB but not for a nonprofit QALICB.

Monitoring Transactions

It is important that all parties understand the agreements signed at closing, discussed above, including reporting obligations and the flow of interest payments. In addition, just as any investment, careful monitoring and asset management can anticipate and catch any issues early and allow parties to work together to mitigate problems.

Project Example – Mixed-use Development in Michigan

In 2009, LISC provided $6.9 MM of NMTC allocation to a mixed-use project that included retail, office and residential space (with two of eight units reserved for individuals making less than 80% of AMI). The local Entitlement Community provided a $3.3 MM loan direct to the investment fund.

LISC's investment was the second round of NMTC financing, with the first investment closing with a different CDE in 2006 (the local Entitlement Community also provided the leverage loan for the first NMTC closing). During construction, a wall collapsed, drastically increasing construction costs. Thanks to the close monitoring and involvement of the original CDE and the Entitlement Community, parties were able to work together to bring in LISC as a second investor to allow the project to finish construction and start operating.

Throughout the compliance period, LISC worked closely with the other CDE, NMTC investor and Entitlement Community to make sure the project was performing to expectations and delivering on both projected community outcomes and required reporting. Collaboration and cooperation are key to project success – communication between parties allows for creative problem solving, like bringing in additional NMTC investment to complete the project and makes sure the borrower is meeting the needs of all parties in their reporting.

Unwinding Transaction

Most NMTC transactions unwind at the end of the seven-year compliance period through a put agreement executed at closing. Once the NMTC investor executes its put option, the project sponsor or other affiliate of the QALICB purchases the NMTC investment fund, typically for $1,000. At closing, the entitlement community should ensure that the unwind procedures are covered in the leverage loan documentation. It is important to include entitlement communities in unwind discussions, especially when collateral needs to be reassigned.

Unwinding NMTC Transactions

NMTC transactions are typically unwound in a series of steps. Note, these steps can happen in a different order depending on the preferences of the CDE(s) and NMTC investor, but it does not affect the final result.

1. NMTC investor executes its put option and the project sponsor (or other designated purchaser) purchases the NMTC investment fund.
2. If required, the QALICB repays all or a portion of the QLICIs to the sub-CDE.
3. The sub-CDE assigns its QLICIs to the investment fund and transfers any funds not needed to pay fees or expenses to the investment fund.
4. If required, the investment fund pays off any leverage loans due at the end of the compliance period.
5. The project sponsor now owns the investment fund which holds loan to its affiliate/subsidiary, the QALICB.

In NMTC-Section 108 transactions with direct leverage, as described above, the entitlement community's borrower, the NMTC investment fund, is now owned by the project sponsor and holds the underlying collateral. If necessary, especially if the project sponsor intends to dissolve any of the NMTC entities, the borrower and entitlement community should work together to ensure the loans and collateral are properly reassigned and secured. As lender to the investment fund, the entitlement community should be involved in exit conversations with the CDEs, NMTC investor and other NMTC parties.

In NMTC transaction with Section 108 loans used as source loans, HUD may not be involved in exit discussions but should still be consulted by the project sponsor. For example, in the neighborhood retail project discussed above, the original collateral for the Section 108 loan was an assignment of the subordinate leveraged loan note between the project sponsor and the NMTC investment fund. After the NMTC unwind, which included bringing a new senior lender into the financing stack to refinance the original senior leverage loan, the entitlement assumed the sub-CDE’s mortgage on the property which became a second priority mortgage loan.

Conclusion

NMTCs and Section 108 loans are powerful tools to provide low-cost, patient capital to transformative community development projects across the United States. Both financing sources come with their own intricacies and requirements – it is imperative that CDEs, investors, Entitlement Communities, HUD and borrowers work together, from before closing until the NMTC unwind, to make sure that projects stay in compliance. Clear expectations (documented in closing documents), careful monitoring and frequent communication between all parties is key to ensuring successful projects for all involved.