Using Section 108 as a Financing Tool with NMTCs

December 3, 2020

TRAINING SESSION

U.S. Department of Housing and Urban Development

NDC 50 YEARS

LISC LOCAL INITIATIVES SUPPORT CORPORATION

Overview of Webinar

- Review of Section 108 Loan Guarantee Program
- Review of New Markets Tax Credit (NMTC) Program
- Use of the 108 Programs with a NMTC Transaction
- Case Study: Food Manufacturing in Massachusetts
- Case Study: Recreation Pier & Retail in Yonkers
- Questions

OVERVIEW

SECTION 108 PROGRAM

- CDBG Grantees receive direct access to the program; non-entitlement communities can access Section 108 through the state. Businesses and non-profits can access the program by partnering with their local government or state.
- Project must meet National Objective requirements of CDBG program
  - LMI Benefit
  - Elimination of Slum and blight
  - Urgent need

OVERVIEW

SECTION 108 PROGRAM

- Grantee must pledge its CDBG funds to secure the Section 108 loan
  - CDBG pledge is statutory
  - Other collateral typically will be required, such as a lien on the project property, other City owned property or assignment of the NMTC Investment Fund interest in the sub-CDE
- Grantee must propose a financially feasible transaction
- Grantee can access Section 108 loans in an amount up to 5 times the most recent annual CDBG allocation

OVERVIEW

SECTION 108 PROGRAM

Section 108 loans can be used for multiple purposes:

- Economic Development; Housing; Public Facilities; Infrastructure
- Limitations on use of Section 108 funds for construction of new housing
- Section 108 funds can be used to support new housing development:
    - Site acquisition, demolition, relocation costs
    - Infrastructure on publicly-owned land, provided the improvements are undertaken while the property is still in public ownership

Process of Applying for HUD Section 108 Guaranteed Loan

- Confirm eligibility of use of Section 108 funds
  - Program Requirements – National Objective, Eligible Activity, Public Benefit Standards (if applicable)
- Obtain all appropriate grantee governmental approvals
- Section 108 application coordinated with local field office
  - Submitted to Both Field and HUD National Offices
- Complete HUD required environmental review (24 CFR Part 58)

Funding of HUD Section 108 Guaranteed Loans

- Loan term – Up to 20 years
- Initial loan disbursements have variable interest rate
  - Variable interest rate: 3-month LIBOR plus 20 basis points
- Upon aggregation of sufficient size of Section 108 portfolio; HUD arranges for sale of obligations with serial maturities guaranteed under the Section 108 program
  - Bond Market Sale With HUD Guarantee
  - Rate Fixed Based on Market Conditions

OVERVIEW

NMTC

TRAINING

- In 2000, Congress passed legislation encouraging investment in Census Tracts Located in urban & rural Low-Income Communities (LICs)
- Investors receive a federal tax credit
- Businesses and real estate projects get equity or below market loans
- Primarily for economic development but can also be used for community facilities

OVERVIEW NMTC

For every $1 invested by the federal government, the NMTC Program generates over $8 of private investment

TRAINING

OVERSIGHT

- **Administered by the CDFI Fund, a Division of the U.S. Treasury**

ACCESS

NMTCs are awarded to qualified Community Development Entities (CDEs) – not to states or projects

INVESTMENT

CDE's then make investments in Qualified LICs

OVERVIEW NMTC

NMTC Program has supported the construction of 57 million SF of manufacturing space, 94 million SF of office space, and 67 million SF of retail space

TRAINING

Investors provide up front equity to projects in exchange for receiving tax credits worth 39 percent of their investment over a 7-year period

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
5%	5%	5%	6%	6%	6%	6%

A substantial portion of this investment reaches businesses or projects as equity or low-interest loans

NMTC ELIGIBLE PROJECTS

MOST COMMON

- Loans and investments in operating businesses located in LICs
- Development of commercial, industrial and retail real estate in LICs
- Mixed-use projects where commercial income exceeds 20 percent of the gross income of the property

LESS COMMON

- Development of for-sale housing in LICs
- Loans purchased from another CDE that have been made to eligible projects in LICs
- Financial counseling and other services to businesses and residents located in LICs

NMTC INELIGIBLE PROJECTS

- Investment real estate where more than 80 percent of its income is derived from the residential dwelling units in the property
- Golf courses, country clubs, massage parlors, hot tub or tanning facilities
- Gambling facilities
- Farming businesses
- Stores whose principal business is the sale of alcoholic beverages

NMTC GLOSSARY

CDE – Community Development Entity

- Entity that can apply for and receive an award of NMTC allocation

QEI – Qualified Equity Investment

- Qualified investment into a CDE that triggers the flow of tax credits to the investor
- Equal to the amount of allocation

QALICB – Qualified Active Low-Income Community Business

- Eligible borrower/beneficiary of a NMTC transaction

QLICI – Qualified Low-Income Community Investment

- Debt or equity investment to the QALICB by the CDE

IF – Investment Fund (Leveraged Transactions only)

- Legal entity, owned by the NMTC investor that borrows non-recourse debt from the leverage lender and makes the QEI

NMTC
ELIGIBILITY
LOW-INCOME COMMUNITY

- Must meet basic eligibility at a minimum for all NMTC deals
  Poverty level of at least 20 percent, or
- Median household income below 80 percent of state or area median income, whichever is greater
- Or, benefitting Targeted Populations as permitted by IRS and related CDFI Fund guidance materials

NMTC
ELIGIBILITY
TARGETED POPULATIONS

- Must be in place at QEI and maintained at the below minimum levels for the entire seven-year compliance period:
  - Such projects are 50 percent owned by low-income (LI) persons; or
  - At least 40 percent of employees are LI persons (household income at hire); or
  - At least 50 percent of gross income is derived from sales, rentals or services to LI persons
- Documentation is required throughout entire NMTC compliance period

NMTC
ELIGIBILITY
DEEPER DISTRESS

The QALICB's Census Tract Has the Following Characteristics

- Poverty rates greater than 30 percent
- Median family income does not exceed 60 percent of statewide or metropolitan median family income, whichever is greater
- Unemployment rates at least 1.5 times the national average
- Located in a census tract not contained in a Metropolitan Statistical Area

Must meet 1 of the above or 2 of the following:

NMTC
ELIGIBILITY
DEEPER DISTRESS

- Census tracts with one of the following; Poverty rate greater than 25 percent; median family does not exceed 70 percent AMI; or unemployment rates at least 1.25 times the national average
- Area designated as distressed by the Appalachian Regional Commission or Delta Regional Authority
- SBA designated HUB Zones
- Designated as Native American or Alaskan Native areas, Hawaiian Homelands, Off-Reservation Trust Lands, or redevelopment areas by the appropriate Tribal or other authority
- Colonial area as designated by HUD
- Brownfield site as defined under 42 USC 6201 (39)

NMTC
ELIGIBILITY
DEEPER DISTRESS

- Encompassed by a HOPE VI redevelopment plan
- Located in a medically underserved area
- Federally designated Promise Zones, Impacted Coal Counties, Base Realignment and Closure Areas, State Enterprise Zone programs, or other similar state/local programs targeted towards particularly economically distressed communities
- FEMA Disaster County
- High Migration Rural County
- Businesses certified by the Department of Commerce as eligible for assistance under the Trade Adjustment Assistance for Firms (TAA) Program
- A Food Desert

DIRECT INVESTMENT MODEL

Investment Capital
(Bank Holding Company)

↓ Makes an Investment

This is the Qualified Equity Investment (QEI)

CDE Fund with NMTC Allocation

↓ Makes a Loan or Investment

This is the Qualified low-income Community Investment (QLICI)

Eligible Business
(Active Business or Real Estate)

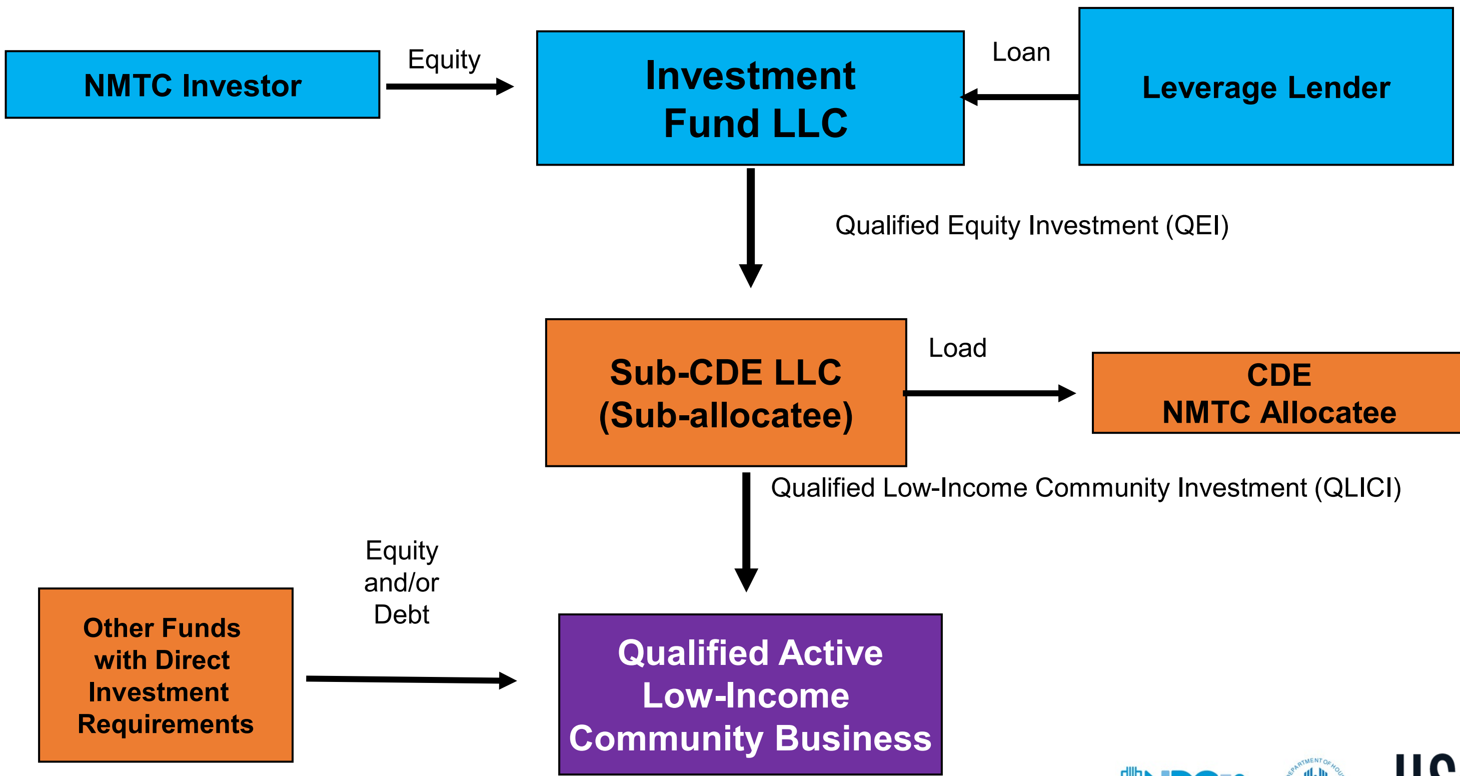
This is the Qualified Active Low-Income Community Business (QALICB)

LEVERAGE MODEL

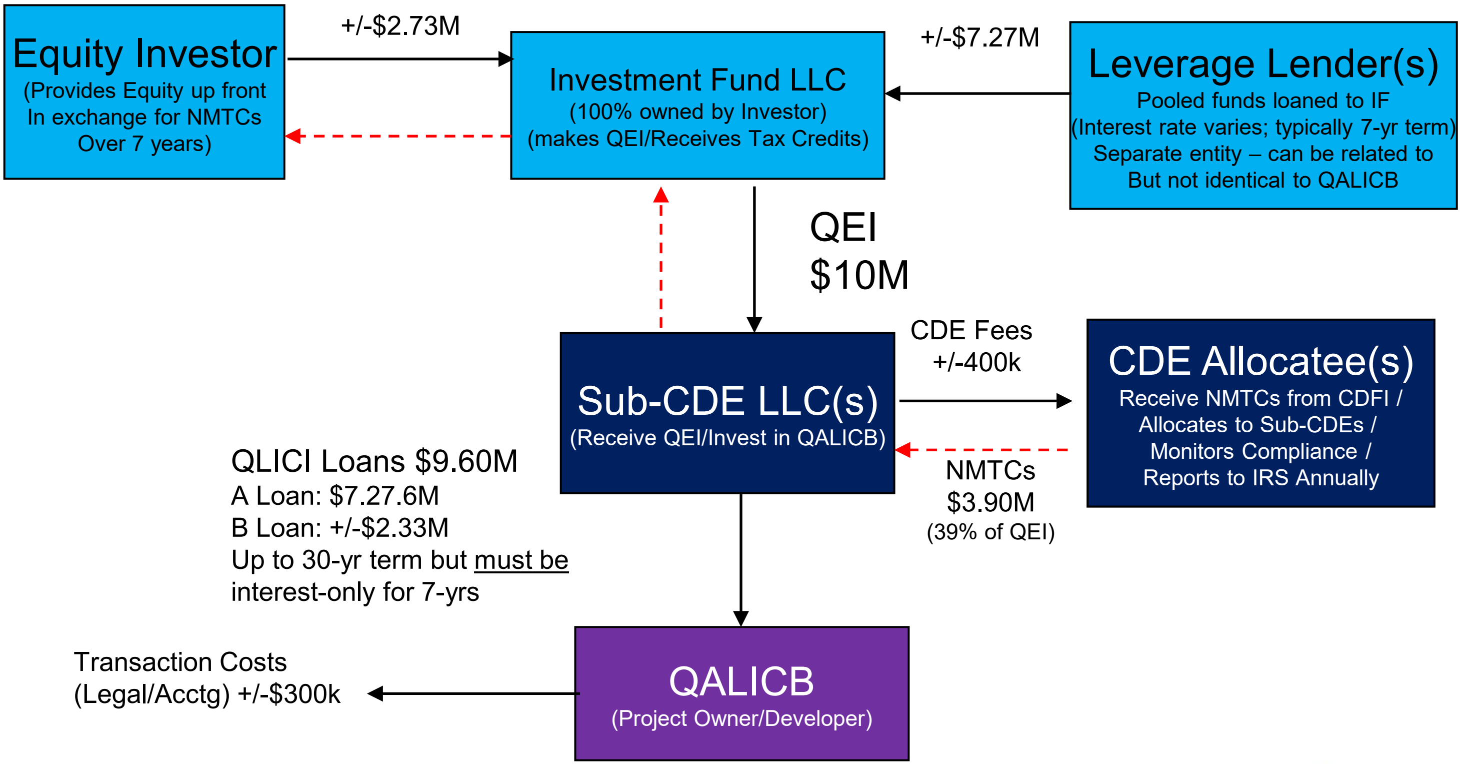
IRS Revenue Ruling 2003-20

A partnership/LLC can borrow non-recourse debt and invest as equity into a CDE

100% of the investment is recognized as a QEI



LEVERAGE MODEL



LEVERAGE LOAN CHALLENGES

- No direct security in real estate
- Typically required to forbear foreclosure for seven years
- Typically no principal repayments for seven years
- Loan is made to Investment Fund owned by Investor – not to project borrower
- Any special funder requirements typically need to be effected through a separate agreement
- No direct link with project borrower (QALICB)

LEVERAGE LOAN SOURCES

Great Sources

- Cash!
- HUD Section 108 Loans (flexible terms)
- Foundation grants
- Developer equity
- Public “soft” loans (flexible terms)
- RTC equity
- USDA B&I Guaranteed Debt

Challenging Sources

- Conventional banks
- Equity requiring a high yield or property ownership
- Certain Federal Programs (FTA, EDA)
- Pledges (if not bridgeable)
- Land value (must be able to capitalize it for closing)

NMTC UNWIND

Equity Investor

Investment Fund LLC
100% owned by Leverage Lender

Junior Leverage Lender LLC
(Project Sponsor)

Sub-CDE LLC(s)
(Lender)

QALICB
(Project Owner/Borrower)
Non-profit is preferred

Exit Strategy with Hard Debt and Sponsor Debt as Leverage

NMTC UNWIND

Equity Investor

Investment Fund LLC
100% owned by Leverage Lender

Junior Leverage Lender LLC
(Project Sponsor)

1. Investor may put (sell) its interest in IF to junior leveraged lender for established put price ($1,000) or leveraged lender may call investor's interest for fair market value at the time of the call.

Sub-CDE LLC(s)
(Lender)

QALICB
(Project Owner/Borrower)
Non-profit is preferred

Exit Strategy with Hard Debt and Sponsor Debt as Leverage

NMTC UNWIND

Equity Investor

$1,000 put price or fair market call price

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(Project Sponsor)

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100% owned by Leverage Lender

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Exit Strategy with Hard Debt and Sponsor Debt as Leverage

NMTC UNWIND

Junior Leverage Lender LLC
(Project Sponsor)

Investment Fund LLC
100% owned by Leverage Lender

Junior LL becomes sole owner of IF

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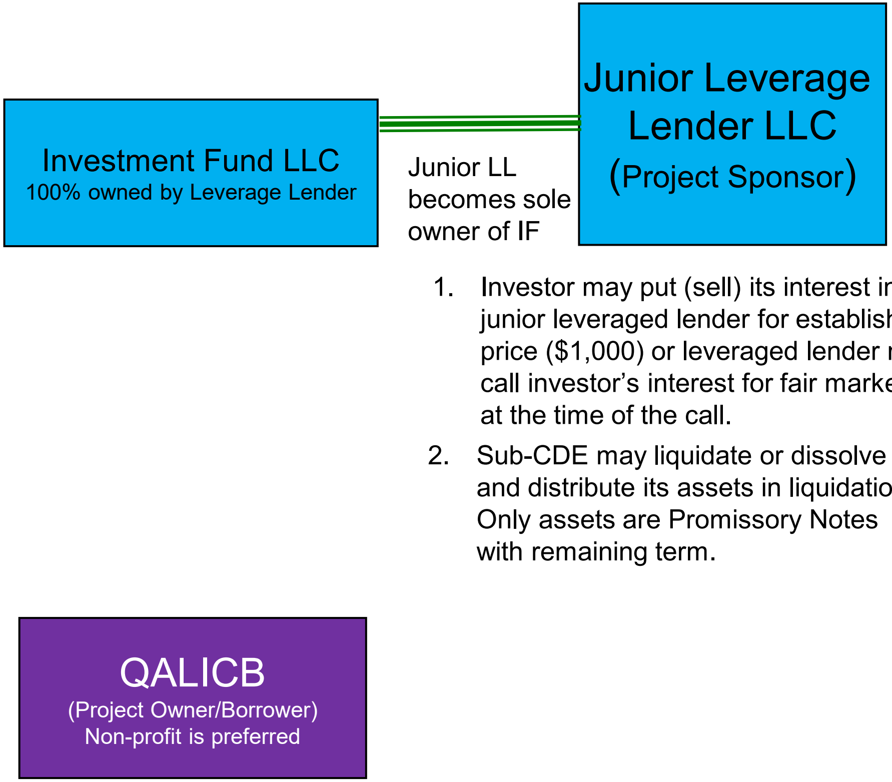
Exit Strategy with Hard Debt and Sponsor Debt as Leverage

NMTC UNWIND



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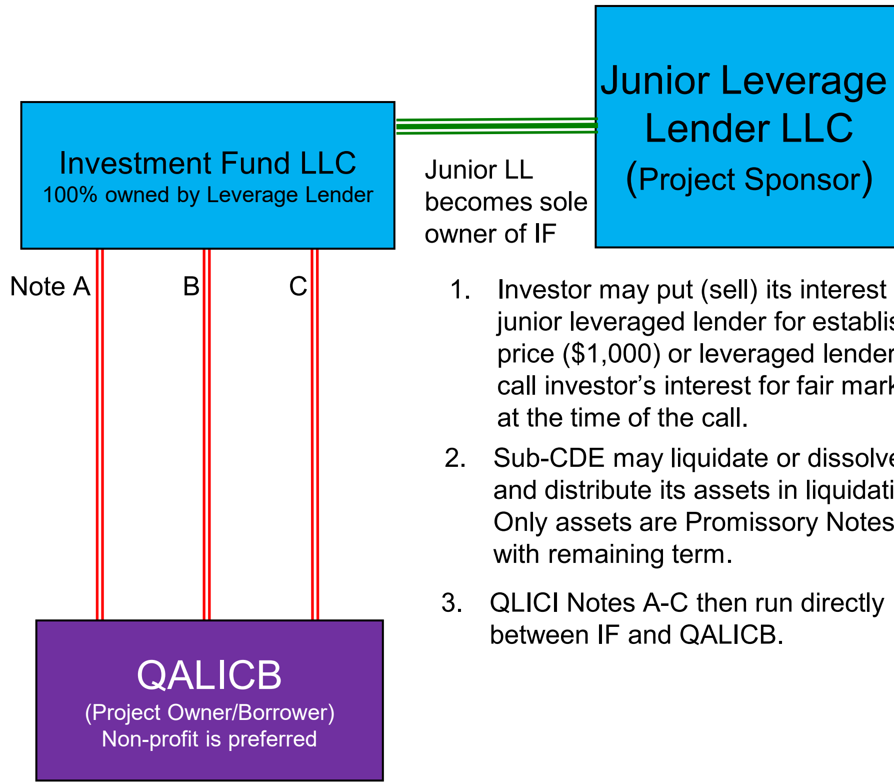
2. Sub-CDE may liquidate or dissolve and distribute its assets in liquidation. Only assets are Promissory Notes with remaining term.

Exit Strategy with Hard Debt and Sponsor Debt as Leverage

NMTC
UNWIND



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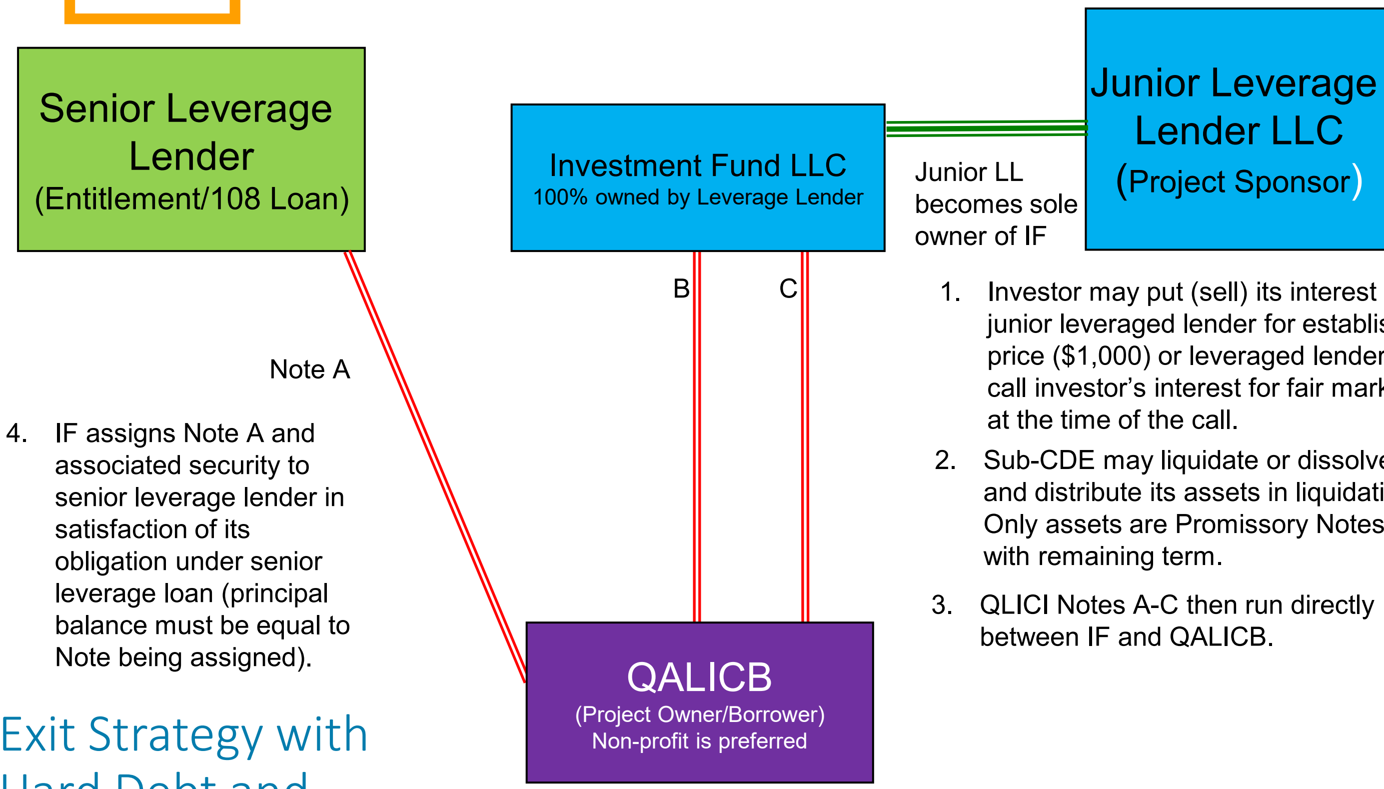
3. QLICI Notes A-C then run directly between IF and QALICB.

Exit Strategy with Hard Debt and Sponsor Debt as Leverage

NMTC UNWIND



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2. Sub-CDE may liquidate or dissolve and distribute its assets in liquidation. Only assets are Promissory Notes with remaining term.
3. QLICI Notes A-C then run directly between IF and QALICB.
4. IF assigns Note A and associated security to senior leverage lender in satisfaction of its obligation under senior leverage loan (principal balance must be equal to Note being assigned).

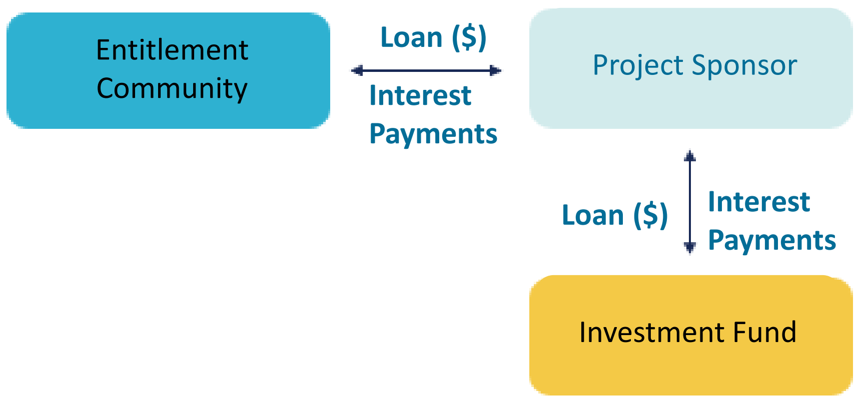
Exit Strategy with Hard Debt and Sponsor Debt as Leverage

Section 108 & NMTC Commonalities

- Powerful federal economic development tools
- Same eligible uses
  - Private for-profit or nonprofit development
  - Job-creating businesses
  - Organizations delivering community goods and services
- Community outcome and other reporting requirements

Combining Section 108 and NMTCs

- Source Loan to Project Sponsor/Leverage Lender
  - Ability for entitlement community to take additional collateral
  - Leverage Lender can combine Section 108 with other sources of capital and make one loan to IF



Combining Section 108 and NMTCs

- Leverage Loan Direct to NMTC Investment Fund
  - Simpler, direct relationship between entitlement community and NMTC structure

- Direct Loan Outside NMTC Structure

Questions?

Case Study 1: Food Manufacturing Space in Boston

- 36,000 square foot facility
- Flexible kitchen and food storage space for food trucks, small wholesalers and other small and growing food manufacturers
- Supported 42 construction jobs
- Tenants have created 274 permanent jobs; in 2019, 37% of new hires were from surrounding low-income community

Case Study 1: NMTC Capital Stack

- $14 MM Project
  - $14 MM of NMTC Allocation
    - $4.2 MM NMTC Equity
    - $9.8 MM Sponsor Leverage Loan
      - **<u>$3.2 MM Section 108 Guaranteed Loan</u>**
      - $3.1 MM CDFI Loans
      - $3.5 MM Grants & Sponsor Equity

Case Study 1: Project Budget

Project Development Costs	
Acquisition:	$1,330,248
Hard Costs:	$7,780,712
Soft Costs:	$1,868,091
NMTC Fees & Reserves:	$2,392,203
NMTC Closing Costs:	$616,246
Total Uses:	$13,987,500

QALICB Sources	
QLICIs:	$13,557,500
Owner Equity:	$408,500
Tenant Contribution:	$21,500
Total Sources:	$13,987,500

Key Players:
Local Entitlement Community
Project Sponsor & Leverage Lender
PNC (NMTC Investor & CDE)
LISC (CDE)

Case Study 1: Food Manufacturing Space in Boston

- Section 108 Considerations
  - Loan to Project Sponsor allows Entitlement Community to take additional collateral
  - Project Sponsor able to combine multiple loans and grants into one loan to IF
  - Project Sponsor responsible for ongoing reporting to Entitlement Community and NMTC parties

Case Study 1: Challenges & Lessons Learned

- Challenges
  - Master Tenant/Operator experienced cash flow problems
  - Unable to make ongoing rent payments from operations
  - Sponsor had to contribute to master lease payment after reserves were exhausted
- Lessons Learned
  - Closely underwrite all parties in transaction – sponsor, borrower AND master tenant
  - Ensure Sponsor has sufficient other sources of income to keep project current
  - Establish reserves at closing, especially in projects that are not 100% leased prior to financing

Case Study 2: Recreational Pier & Retail in Yonkers

- Redevelopment of historic pier on the Hudson River built in 1890
- Tenants include a 260-seat restaurant, ferry operator connecting Yonkers to Manhattan, concession stand, and water taxi
- Supported 90 construction jobs
- Tenants have created 58 permanent jobs, 95% LIP accessible

Case Study 2: NMTC Capital Stack

- $11.8 MM Project
  - QEI 1 $4.30 MM of NMTC Allocation
  - QEI 2 $3.40 MM of NMTC Allocation
    - $2.23 MM NMTC Equity
    - $4.55 MM Sponsor Leverage Loan
    - **$950,000 Section 108 Guaranteed Loan**

Case Study 1: Project Budget

Project Development Costs	
Hard Costs:	$6,517,724
Change Orders:	$3,286,367
Soft Costs:	$1,452,048
NMTC Fees & Reserves:	$ 317,650
NMTC Closing Costs:	$ 300,000
Total Uses:	$11,873,789

QALICB Sources	
QLICIs:	$7,289,840
Tenant Contribution:	$ 300,000
NY State	$1,725,000
Yonkers LDC	$1,190,000
City of Yonkers	$1,368,949
Total Sources:	$11,873,789

Key Players:
Local Entitlement Community
Project Sponsor & Leverage Lender
Chase (NMTC Investor)
NDC (CDE)

Case Study 2: Recreational Pier & Retail in Yonkers

- Section 108 Considerations
  - $950,000 Section 108 Guaranteed Loan loaned to Investment Fund as portion of leverage for QEI2
  - Collateral Agency Agreement made Project Sponsor responsible for ongoing reporting to Entitlement Community
  - Investment Fund assigned a portion of its 99.99% membership share in the Sub-CDE to the Entitlement Community as collateral for the Section 108 Guaranteed Loan

Case Study 2: Challenges & Lessons Learned

- Challenges
  - An additional $3.3 MM in project costs identified during construction due to decay below the waterline
  - Took 2 years to attract and close 2^{nd} QEI
  - Only 1 year of capitalized interest was reserved at the close of the 1^{st} QEI
  - QALICB was therefore delinquent on its debt service
- Lessons Learned
  - Good accounting and legal counsel is critical
  - NDC wanted to use a portion of the 2^{nd} round of QLICIs to get the QALICB current on debt service
  - NDC could not distribute the past due debt service to the investment fund without triggering a tax credit recapture
  - So, that delinquent debt service payment was held at Sub-CDE until the compliance period expired before making the distribution to make the original leverage lender whole

Questions?

Additional Resources

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

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