# LIHTC Bootcamp

**PHADA National Conference**
**Seattle, Washington**
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## Meet your presenters


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## Session goals

- **LIHTC basics:** Navigating the essentials
- **Investor perspective:** Key market trends and risks
- **Housing authority action plan:** Steps to LIHTC development success
- **Washington watch:** Key LIHTC policy updates

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# LIHTC basics:
## Navigating the essentials

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LIHTC BASICS

## Low Income Housing Tax Credits (LIHTC)

Established in 1986 under Section 42 of the Internal Revenue Code as a federal program

Jargon: "Section 42", "Credits", "lye-tech"

**Low Income Housing Tax Credits (LIHTC) is now the dominant affordable rental housing production program in the U.S.**

Made permanent in 1993, LIHTC became a successful program for:

- Efficiency
- Reliability, produces good quality, well-managed rental units
- Extremely low foreclosure rate
- Serving the intended population/miniscule recapture for non-compliance

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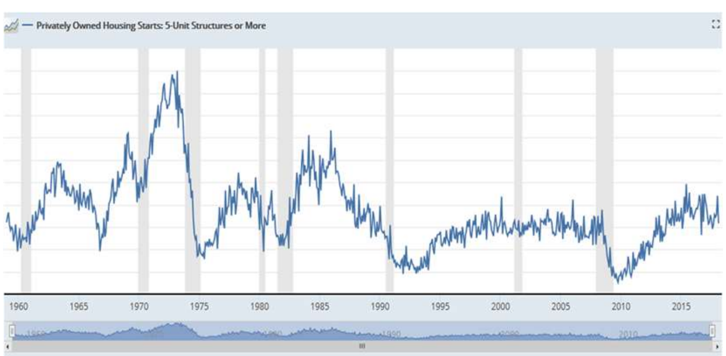
LIHTC BASICS

## Shortage of affordable rental




- Pre-1986, periods of robust production, incented by tax policy (steeper depreciation and passive loss treatment)
- HUD's Section 8 construction ends early 1980's
- Post-1986
  - Apartment production declines
  - Greater focus on high end of market (emphasis on cash flow; easier to finance)
  - Less market production of middle – lower market rental product

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LIHTC BASICS

# Examples Of LIHTC projects


Housing on top of public library
Good Hope Library

Historic adaptive re-use
Phyllis Wheatley School

New construction
Eighteen87

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LIHTC BASICS

# Low Income Housing Tax Credits (LIHTC)

Who does LIHTC Serve?

Income limits and rent maximums are set annually for each county by HUD

Designed to encourage private (institutional) investment to construct or rehabilitate rental housing for the middle-lower market

The Credit is received over 10-year period, but affordability extends 15 to 30 years

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LIHTC BASICS

## What are Credits?

**The Credit reduces federal income tax liability**

- Note: a tax *deduction* reduces your taxable income, but a *credit* is 1 for 1 off your actual tax liability
- An investor will pay today for the benefit of the Credit over 10 years
- Investor supplies the cash equity, not the developer

**For a project, a large equity investment**

- Less debt
- Less debt service
- Therefore, the project can sustain itself with lower rents
- **This is the essence of the program**

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LIHTC BASICS

## How the tax credit program operates

**Federal government allocates credits to states**

Tax credit ↓

**State housing agencies allocate credits to housing development**

Tax credit ↓

**Residential rental development for qualified residents**

Tax credit ↓ ↑ $

**Limited partnership**

Tax credit ↓ ↑ $

**Corporate investors**

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LIHTC BASICS

# Low-income housing tax credits (LIHTC)

## Two types of federal credit:

**9%**

(aka "competitive")

Allocated to states on a per capita basis. Scarce and powerful

**4%**

Tied to state's tax-exempt bond volume cap authority

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HOW CREDITS WORK

# 9%: 50-unit example

| | | Comment |
|---|---|---|
| Total development cost | $10,500,000 | |
| Eligible cost basis | $10,000,000 | Land, reserves excluded |
| LI units (45 of 50 units) | 90% | "Applicable fraction" |
| Qualified basis | $9,000,000 | |
| Credit percentage "9%" | 9.0% | |
| Annual credit | $810,000 | |
| Total credit | $8,100,000 | 10 years |
| Price per credit dollar | $0.86 | Varies by deal |
| Total equity raised | $6,966,000 | ~66% of project |

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HOW CREDITS WORK

## 4%: 50-unit example

| | | Comment |
|---|---|---|
| Total development cost | $10,500,000 | |
| Eligible cost basis | $10,000,000 | Land, reserves excluded |
| LI units (45 of 50 units) | 90% | “Applicable fraction” |
| Qualified basis | $9,000,000 | |
| Credit percentage “4%” | 4.0% | |
| Annual credit | $360,000 | |
| Total credit | $3,600,000 | 10 years |
| Price per credit dollar | $0.86 | Varies by deal |
| Total equity raised | $3,096,000 | ~29% of project |

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HOW CREDITS WORK

## 50-unit example

Total development cost $10,500,000

| Sources | 9% scenario | 4% scenario |
|---|---|---|
| LIHTC equity | $ 6,966,000 | $ 3,096,000 |
| Bank loan | $ 3,000,000 | $ 3,100,000 |
| Gap | $ 534,000 | $ 4,304,000 |
| | $10,500,000 | $10,500,000 |

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LIHTC BASICS

## What Credits can do

| | |
|---|---|
| What Credits can do **for** a developer | Raise significant amounts of equity |
| | Lower project debt load |
| | Target an under-served market segment |
| | Receive developer fee (but cash flow is sometimes minimal) |
| What Credits can do **to** a developer | Complicated transaction |
| | Competitive process (the 9% credit or gap funding) |
| | Investor relations and guarantees (investor owns 99.99%) |
| | Compliance intensive |
| | Severe repercussions for non-compliance |

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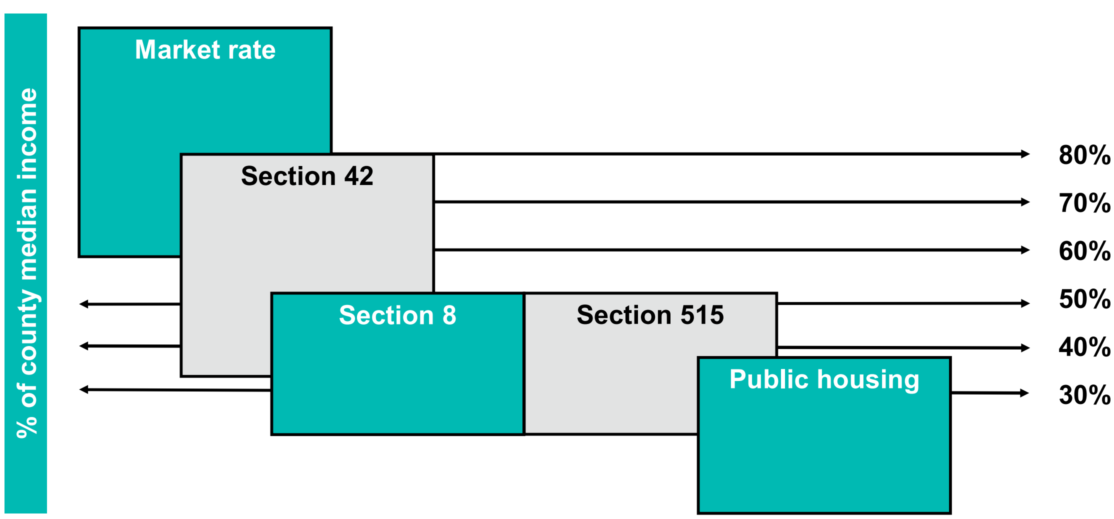
LIHTC BASICS

## Understanding Section 42 markets

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# Low Income Housing Tax Credits (LIHTC)

- Project selects Either “20% at 50%” or “40% at 60%” as its minimum set aside
- Most projects are actually 90–100% LI
- The “20% at 50%” means 20% of the units will be set aside for households not exceeding 50% of the County Median Income (CMI)
- HUD sets the maximum rents, based on 30% of the CMI

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# Section 42 vs. Section 8

| Section 42 | Section 8 |
|---|---|
| Governed by the IRS/Treasury | Governed by HUD |
| Indirect capital subsidy to the project | Direct rent subsidy to the owner |
| Renter pays full rent. Must income-qualify | Renter pays 30% of their income, say $300. HUD also pays the owner something, so the two approximate a “market rent”. Renter must income-qualify |

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LIHTC BASICS

## Developer’s role and responsibilities

Forms project team

Develops concept, finds site, makes application, awarded credit, finds lender and investor, soft sources

Completes construction, lease up and ongoing reporting

Provides multiple guarantees: construction, lease-up, credit delivery, operations and compliance

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LIHTC BASICS

## Developer motivation

- Developer fee is primary financial incentive (as opposed to tax losses, robust cash flow, or refinance equity-take-out)
- Mission incentive (usually some, varies widely)
- Wants quality to satisfy local officials and investors, and to minimize guarantee risk

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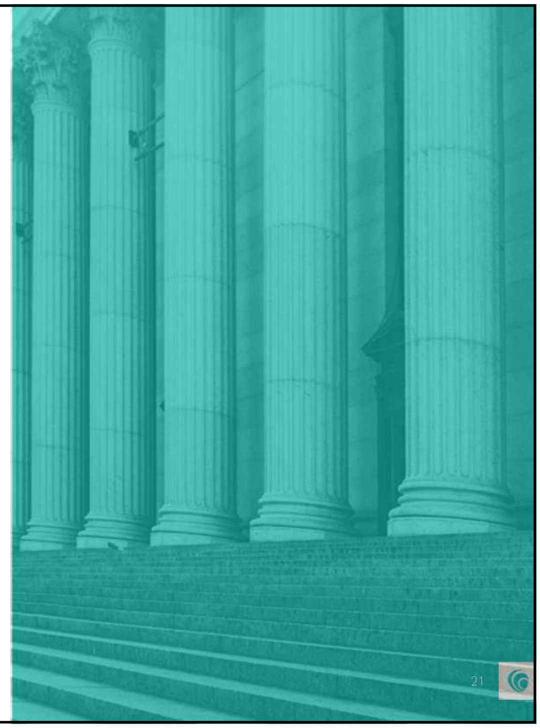
LIHTC BASICS

## Federal government role/motivation

- Creates framework
- Cedes project-level detail and control to states
- US Treasury: provides reliable future Credit stream
- IRS can force recapture of credit if out of compliance
- Wants safe, secure, quality affordable housing production



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## State housing agency role

- Creates **local** priorities/rulebook for developers to follow (Qualified Allocation Plan-"QAP")
- Evaluates projects; allocates the credit
- Conducts compliance after construction (physical and file inspections)
- Reports violations to IRS (potential recapture)
- Wants safe, secure, quality affordable housing production
- "LURA"

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LIHTC BASICS

## Local government role/motivation

- Provides local zoning and permit approvals
- Might assist with gap financing
- Wants safe, secure, affordable housing
- Wants housing for local workforce or seniors
- Wants competent property management
- Wants quality, attractive housing…that pays property taxes

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LIHTC BASICS

## Lender role/motivation

Provides construction and/or permanent debt financing

Wants risk mitigation:

- Experienced team
- Quality location and construction
- Strong market
- Secure coverage (DCR and LTV)
- Secure asset class (very low foreclosure risk for LIHTC)

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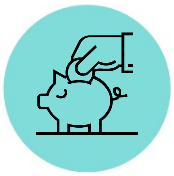
LIHTC BASICS

# Lender role/motivation



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- Experienced team
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LIHTC BASICS

# Investor role/motivation

- Primary motivation: Financial yield or CRA Credit (via Credit delivery for 10 years)
- Syndicator's project evaluation is second only to the state housing agency
- Focus on risk mitigation in underwriting

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# Investor perspective:
## Key market trends and risks

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# Low-Income Housing Tax Credits (LIHTC) Syndication 101

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# What do you do once you have the tax credits?

Once awarded credits, a developer sells them to an individual investor or, more commonly, to a tax-credit syndication fund made up of equity from one or from many investors. In return, the investors receive a credit against their federal income tax based on the size of their investments. They can also realize losses, which provide an additional tax benefit.

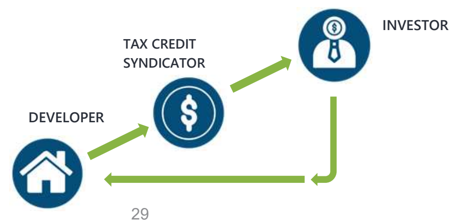
## What is the Syndicator's Role?

Tax credit syndicators help bridge the gap between the various parties to affordable housing transactions. Syndicators raise money from investors and identify low-income housing projects in which to invest that capital. Non-profit syndicators, like National Equity Fund, are mission driven and impact focused.

The developer sells the credits to a tax credit syndicator.

The return to the investor is based on the tax credits in addition to the tax savings from the project's operating losses.

The investor's equity enhances the developer's ability to charge lower rents and keep units affordable.

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# What does a syndicator offer?

- Actively in the market connecting investors and developers.
- Local and national market expertise.
- Origination, Underwriting, Credit Committee, Fund/Asset Management, and Disposition staff.
- Predevelopment and other financing products.

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# Types of LIHTC Investment Placements

**Direct Investor:** a single investor buys an entire LIHTC deal without an intermediary or syndicator.

**Proprietary Fund**: a single investor establishes a fund to buy an entire LIHTC deal for their sole purposes.The fund is assembled and managed by a syndicator and includes multiple deals as they are closed over time.

**Multi-Investor Fund**: multiple investors buy a pool of LIHTC deals assembled and managed by a syndicator.

**Club Fund**: a hybrid between a proprietary fund and multi-investor fund assembled and managed by the syndicator.

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# PARTNERSHIP STRUCTURE

- LIHTC Project is owned by a single-purpose aka single-asset LP, LLP, LLLP, or LLC legal entity.
- Developer owns 0.01%, but controls and operates the project
- Investor is a passive partner and gets its return almost exclusively from tax credits and losses


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## Who are LIHTC investors and why do they invest?

**Who?**

- Banks
- Insurance Companies
- Pension Funds

**Why?**

- Community Reinvestment Act ("CRA")
- Debt Execution
- Community Impact / Impact Story
- Financial Return
- Risk

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## What are syndicators/investors analyzing when considering your project?

People. Credit. Real Estate.

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## People

**Development Team**
- Sponsor
- Developer
- General Contractor
- Property Manager
- Architect
- Engineer

**What is being considered?**
- Track record of development and operations (REO Schedule)
- Experience in market and/or with property type
- Staffing and size of organization
- Other lines of business?

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## Credit

**Financial Capacity**
- Unrestricted Liquidity
- Unrestricted Net Worth
- Unsecured Lines of Credit

**Portfolio**
- REO Schedule (evaluate performance metrics i.e. DSCR, ECR, and occupancy)

**Guarantees**
- Completion
- Repayment/Repurchase
- Credit Delivery
- Services

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# Real Estate

**Market**
- Location
- Achievable Affordable and Market-Rate Rents.
- Vacancy Rates (physical and economic)
- Capture and Penetration Rates
- Median Income/AMI, Economic, Job Market, Population, Crime Trends
- Unit and Common Area Amenities Compared to Comparable Properties

**Environmental**
- USTs
- Soil Contamination
- Radon and Vapor Intrusion
- LBP/ACM in Existing Building(s)
- Demolition

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# Real Estate

**Income Assumptions**
- Project's rents compared to market rate rents. (industry standard is a 10% advantage to market)
- Rental Subsidies and Overhang (i.e. project-based or tenant-based; federal or local; i.e. Section 8)
- Utility Allowances (PHA or energy consultant based?)
- Other Income (i.e. laundry, vending, cable/internet, late fees, pet fees, parking, etc.)
- Commercial Income (owned or separate condo?)
- Vacancy Rate (5%, 7%, 10%)
- 2% Trending

**Operating Expense Budget Assumptions**
- In-line with comparable properties? (sponsor's, syndicator's, and/or property manager's portfolio, market study, appraisal)
- Real Estate Taxes (Calculation Methodology; Exemption; Abatement; PILOT; other)
- Management Fee (comparable to market-going fee)
- Replacement Reserves (threshold based on industry standard for tenancy, a funder, or a PNA for acq/rehabs )
- 3% Trending

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# Real Estate

**Development Budget Assumptions**

- Capital Sources
  - Debt: Private, Local, Federal… funders, term, interest rates, when funded, requirements (i.e. requires: repayment? wage rates? rent restrictions? retention holdback? reserves? DSCR/ECR)
  - Equity: Other Tax Credits? (i.e. State LIHTC, Federal or State Historic, Energy/Solar, 45L)
- Hard Costs
  - Tie to GC Contract? (supported by plan and cost review? PNA, for acq/rehabs?)
- Contingencies
  - Hard Cost (5% for new construction; 10% for acq/rehab and adaptive reuse)
  - Soft Cost
  - Relocation
  - Other
- Reserves
  - Construction Loan Interest (based on a flow of funds or term and average outstanding balance)
  - Operating Deficit (6 months OERDS)
  - Replacement (Sponsor preference or required to capitalize)
  - Transition
  - Revenue Deficit (negative trending DSCR or ECR?)
  - Guarantor
  - Other

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# Underwriting Considerations

- Affordable Housing Investors Council (AHIC) Guidelines: https://ahic.org/Acquisitions_Underwriting
  - DSCR, ECR, and Vacancy
  - Market-Rate Development
- Applications for Funding
  - Points v. Flexibility
- Lease-Up
  - Realistic Timelines for Identifying Tenants (i.e. Coordinated Entry and Local Preference Policies)
- Insurance
  - Premiums
  - Prioritize during Underwriting
- New Programs, Income/Rent, and Tenancy Targeting, Service Requirements
  - Need to know…
  - Planned v. Minimum Required

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# Underwriting Considerations (cont'd)

- Subsidy Commitment Term
- Loss of Rental and/or Operating Subsidy
- Financials
- REO Schedules
  - Focus on PSH and operating/rental subsidies supporting PSH.
  - Explanations for properties below breakeven (1.00x) / 90% occupancy; plan to improve operations.
  - No older than prior year end; preferably no older than 180 days.
- Anticipate Follow-Up Questions from Investors/Syndicators
  - If you don't think the answer(s) you or your teammate is giving is clear…

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# WHAT DETERMINES TAX CREDIT PRICING?

- Strength of the development team and guarantors
- Economic Return aka Yield (IRR)
- 4% or 9% LIHTC? Other Credits?
- LIHTC equity investment size
- Debt opportunity available?
- Timing of the equity investment and delivery of benefits to investor
- Strength of the market, including demand from income qualified households and likely achievable rents given income restrictions and asking rents at competing properties.
- Deal Structure
- Attractiveness of the property location for regulated investors (Bank's Federal Community Reinvestment Act)
- The impact story

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# FOR MORE INFORMATION

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# Housing authority action plan:

## Steps to LIHTC development success

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HOUSING AUTHORITY ACTION PLAN

## Housing preservation: 9% LIHTC and RAD

**Total units preserved = 120**
**Total development cost = $16,435,480**

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HOUSING AUTHORITY ACTION PLAN

## Neighborhood transformation: Choice neighborhoods initiative


- Demolition of 394 public housing units
- New construction of 708 units broken into 8 LIHTC transaction
- Total investment +$200 million
- 9%, 4%, CNI, CFP, AHP, ARPA

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HOUSING AUTHORITY ACTION PLAN

## Post RAD conversion recapitalization

**Mixed income community including:**

- 20 market rate units
- 51 tax credit only units
- 51 RAD PBV units
- 122 total units

**Total development cost:** $24,468,872

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HOUSING AUTHORITY ACTION PLAN

## Housing authority developer role

To address the redevelopment needs of their portfolio, housing agencies need to utilize the development model that best fits their experience and expertise

**PHA level of responsibility risk vs. Reward**

*Minimum* ⟷ *Maximum*

**Private developer *(Turnkey)*: Option 1**

- **Ownership** partnership that includes developer's affiliate: Lowest
- **Financial benefit** (Developer fee, cash flow, residual): Lowest
- **Control:** Lowest

**PHA as co-developer: Option 2**

- **Ownership** partnership that includes PHA affiliate: **Medium**
- **Financial benefit** (Developer fee, cash flow, residual): **Medium**
- **Control:** **Medium**

**PHA as sole developer: Option 3**

- **Ownership** partnership that includes PHA affiliate (not-for-profit): **Maximum**
- **Financial benefit** (Developer fee, cash flow, residual): **Maximum**
- **Control:** **Maximum**

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HOUSING AUTHORITY ACTION PLAN

## Project assessment and financial feasibility

- Preliminary financial structing, budgeting and modeling
- Evaluation of project needs and scope of work
- Development team procurement and engagement

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HOUSING AUTHORITY ACTION PLAN

## LIHTC application process

**1**

**PRE-APPLICATION PHASE**

Developers research QAP requirements, prepare feasibility studies and engage stakeholders

**2**

**APPLICATION SUBMISSION**

Applicants submit detailed proposals, including financing structure, site control and affordability commitments

**3**

**REVIEW AND SCORING**

HFAs score applications based on the QAP's priorities, financial viability and long-term affordability impact

**4**

**AWARD AND COMPLIANCE**

Successful applicants receive tax credits, with ongoing monitoring by HFAs to ensure continued compliance

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HOUSING AUTHORITY ACTION PLAN

## Development timeline and milestones


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# Washington watch:
## Key LIHTC policy updates

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## Let's stay in touch

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## How can we help?

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# Thank you!



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