

## Case Study from Application to Construction: Clearinghouse CDFI Puts New Markets Tax Credits to Work

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The New Markets Tax Credit (NMTC) program, managed by the U.S. Department of Treasury's Community Development Financial Institutions (CDFI) Fund, has a reputation as a difficult program to use. The laborious application, fierce competition, and expensive legal costs have scared off all but the most dedicated community development practitioners. It has been equally challenging for some to find equity investors for qualifying projects, known as Qualified Low Income Community Investments (QLICIs). But for all of its real and exaggerated challenges and obstacles, the program has enabled groups like ours, the Clearinghouse CDFI, to make community-enhancing loans in low-income areas that otherwise would not have been considered.

The concept behind the program is simple: attract new and increased investment capital to projects in low-income neighborhoods by giving investors a federal tax credit in return for their equity investment in a community lender. For the sake of the program, the community lender is required to be a Community Development Entity, or CDE.

### **The Application Process**

The Clearinghouse CDFI, which is a certified CDE, has been successful in obtaining allocations in two of the first three rounds of NMTC competition for a total of \$131 million. Of the total of 824 applicants in all three rounds, only 170 (20 percent) have been successful. This ratio of winners to losers has fostered the impression that successful applicants have accomplished something really special.

While many applicants have used outside consultants to assist in writing the NMTC application, the Clearinghouse CDFI did not. We concluded that no one could tell our story, and make our case for NMTCs, as well as we could. We were also not excited about paying tens of thousands of dollars for assistance that would not necessarily result in a winning application. There are many horror stories of expensive consultants that provided minimal assistance in the NMTC application process.

In essence, an application to the CDFI Fund is like a proposal to an investor. You must demonstrate that you have good management and a viable business strategy. You also must show how your projects will further the goals of the Fund. While there are many aspects to the application, we think there are three areas that clearly distinguish the successful applicant from the also-rans: (1) track record of lending; (2) ability to raise equity investments; and (3) level of impact in low- and moderate-income communities.

### **Community Lending Track Record**

As a community lender since 1990, we viewed the New Markets Tax Credit program as an extension of our existing lending effort. In the years prior to the first NMTC round, 74 percent of all of our loans were made in communities that qualified as eligible under the NMTC program criteria. In other words, we already had an established track record of serving the low-income communities that the New Markets Tax Credit program is designed to assist.

The sections of the application stressing track record and previous experience clearly benefit certified CDFIs over many other types of applicants for NMTCs. Conventional lenders, particularly those with community development banks, that can demonstrate previous commitments and experience in making commercial and economic development loans in low-income communities should also score well in this area. It is surprising how many NMTC applicants apply for credits, yet have never made a community development loan prior to submitting their application. Mortgage bankers, developers and real estate speculators are prime examples in this category.

### **Ability to Raise Equity**

The applicant's ability to raise equity is also scrutinized in the application. An applicant must show past experience in raising both equity and debt, as well as provide letters of interest and intent for the amount of tax credits requested. The CDFI Fund wants to make sure the CDE can raise the funds from investors that it claims it can in its application. Some successful awardees have struggled in raising equity after receiving an allocation under the program. Of the 52 first round NMTC winners, several have not raised the equity authorized to them through their award under the program.

Applicants with little or no background in raising equity will have trouble with this part of the application. Several applicants with experience in raising equity for low-income housing or historic tax credit programs have been able to parlay their experience into successful NMTC applications.

The success of the Clearinghouse CDFI in the first round in both raising equity and funding worthwhile projects has greatly helped us attract investors in our subsequent award. All of the \$56 million in our first round award has been raised and 70 percent has been deployed into projects. Over half (\$40 million) of the \$75 million from our second award has also already been raised.

### **Community Impact**

The application awards more points for positive economic and community development impact. Applicants are asked to specify what percentage of their award will be directed to communities with higher levels of distress than the minimum poverty/income criteria required by the program guidelines. The higher the percentage indicated, the better off the applicant will score. Of course, if granted an award, the applicant is held to this requirement under a binding agreement, known as the allocation agreement.

In addition to identifying what specific types of impacts will be obtained through the program, the Fund also requires the applicant to explain the extent to which the impacts would not be obtained without the incentives of the New Markets Tax Credit program. In this way, the Fund is striving to ensure that deals done through the program are a good use of the allocation and not just providing duplicative loan dollars that could be obtained through conventional means.

Once again, a track record of providing loans with strong community impact is asked for and viewed as favorable under this section of the application. Every applicant CDE is required to have a governing or advisory board of low-income community representatives that provide a direct tie to the low-income community.

The applicant's business model or structure is another key component required to be addressed in the NMTC application. We attribute much of our New Markets success to the structure we created and a straightforward business plan for implementing the program. This is unique in the complex world of New Markets, particularly as more complicated "leveraged" transactions often have dual sources of investment, bringing with it more attorneys, accountants, consultants, and fees. We are aware of at least three NMTC transactions in which legal fees alone exceeded \$100,000. We decided early on that our typical transaction would have one investor in one fund with one or more qualifying projects (QLICIs). This decision has served us well.

In general, our investor's return is derived from three sources: (1) the tax credits; (2) a portion of the cash flow as paid by the borrower; and (3) a residual split of the remaining income from the project after all expenses have been paid. The result has been after-tax internal rates of return (IRRs) ranging from 5.1 to 6.75 percent.

## **Financing Projects**

With the New Markets Tax Credit program rapidly approaching legislative phase-out in 2007, and the move for re-authorization getting underway, the ability to show impact is critical for the continuation of the program. All twenty projects we have funded under the NMTC program have some strong social or economic benefit that fit the program's goals. But finding QLICIs that make a difference in communities is an ongoing challenge for mission-driven CDEs.

The job of the CDE is to balance the community benefits of the projects with the economic and risk tolerance requirements of the NMTC investor. The ability to satisfy both parties is not always easy.

The ideal New Markets Tax Credit loan for the Clearinghouse CDFI is one that we identify and underwrite. Then, with a fully-formed deal, we look for an investor. This approach ensures that our mission of impact and community benefit is well served. We also seek to find projects sponsored by nonprofit organizations whenever possible.

Another part of our strategy is to fund loans in areas the U.S. Department of Treasury has designated as having "greater economic distress." This means projects that are located in a census tract with one or more of the following characteristics: poverty rates greater than 30

percent; unemployment rates at least 1.5 times the national average; or a median income of less than 60 percent of the area median income. To date, 18 of our 20 NMTC projects are in areas that have one or more of these “greater economic distress” characteristics.

Our loans typically have a balloon payment at the end of seven years because that is the term of the NMTC program and most investors require a return of their equity at that point. All projects must demonstrate the ability to be refinanced at the end of seven years. The inability to refinance an NMTC loan or the inability to sell the loan at that time could seriously jeopardize the return of an investor’s equity investment.

Who finds the deal? Sometimes the investor brings the loan request to the CDE for consideration. As long as the project is providing clear benefit to the community and the CDE supports the project, there is no problem. Alternatively, we have had to tell investors we would not do a proposed project even though the loan technically met the requirements of the NMTC program because those projects did not meet our standards for community impact. The best projects we have funded under the program have been Clearinghouse CDFI projects where we handpicked investors. One project that fit this profile was Market Creek Plaza, a high-impact project that could not have been done without the New Markets Tax Credit program.

### **Case Study: Market Creek Plaza**

In 1998, a non-profit organization, Jacobs Center for Neighborhood Innovation (JCNI), purchased a former aerospace factory, which for many years was abandoned and overgrown with weeds. Numerous investors lacked any interest in transforming the location into a shopping mall, calling it high risk and “unbankable.” JCNI is the development arm of the Jacobs Foundation, which was started by the late Joe Jacobs, founder of Jacobs Engineering in Pasadena. A project like Market Creek fit the philosophy of Mr. Jacobs who believed in creating sustainable community projects instead of simply writing checks through his foundation. He challenged the foundation staff to make a lasting economic difference in low-income communities.

Thousands of residents from many backgrounds and cultures joined teams to work on community outreach, design, construction, business development and the leasing and marketing of Market Creek Plaza. Even the neighborhood’s children were involved – over 1,300 kids helped decorate a 150-foot retaining wall along the bordering Chollas Creek.

At the early stages of construction, JCNI began working with California Southern Small Business Development Corporation (SBDC) to assist them by helping tenants secure the financing needed to open businesses in the plaza. JCNI wanted local entrepreneurs from the community to become tenants in the plaza so every effort was made to assist them. California Southern made working capital and equipment loans to several of the start-up businesses.

One of the things JCNI did to assist the community tenants was to provide leases that allow payments based on residual income or monthly profit as opposed to a fixed amount each month. This flexibility was wonderful for the start-up businesses, but hard for us because it was extremely difficult to underwrite future income for the overall project.

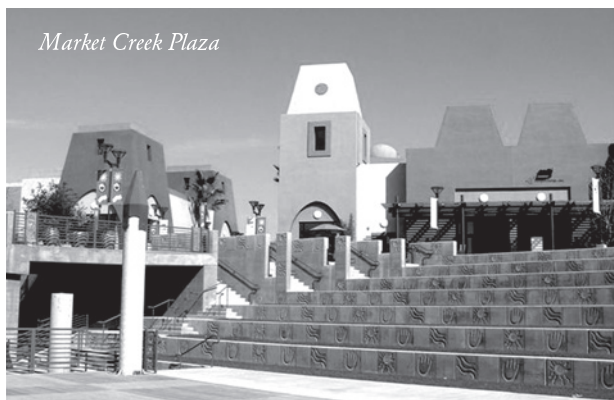
JCNI created Market Creek Partners LLC to own and operate the development, and began seeking permanent financing for the project under construction. JCNI applied for and received a total of \$1.5 million in program-related investments from the Rockefeller Foundation, and the F.B. Heron Foundation provided low interest subordinate debt on the project.

The project required more financing, however, and Mike McCraw, president of California Southern SBDC, contacted the Clearinghouse CDFI seeking a \$15 million permanent loan with a below market interest rate. Mr. McCraw was aware of the Clearinghouse CDFI's first round \$56 million NMTC award as he had previously worked with our staff on other projects and has since been named to our NMTC Advisory Board.

We worked for months with JCNI staff to analyze the project and submitted it to the Clearinghouse CDFI loan committee for approval. The committee approved the project with the below market interest rate, and we then went searching for an NMTC investor.

We solicited several financial institutions to be investors, but the first four lenders turned down the project. Finally, Wells Fargo Bank agreed to pursue the deal and began their due diligence. Bob Taylor, who heads Wells Fargo's tax credit investment department, was already somewhat familiar with JCNI as they had a depository relationship with the bank. Mr. Taylor also had been approached about opening a bank branch at the Market Plaza. Alva Diaz, who works with Mr. Taylor in the Wells Fargo Tax Credit Investment Department, crunched the numbers for them and worked through the difficult issues regarding the residual leases.

Within three months the project was fully approved by Wells and the borrowers received a three percent fixed rate loan for seven years. The three percent rate loan was at an even



lower interest rate than what was approved by the Clearinghouse CDFI Loan Committee. Wells Fargo agreed to help the Market Creek project because they recognized the tremendous benefit the project would have on the low-income community. The project would not have been feasible at that rate without the New Markets Tax Credit program.

Today Market Creek Plaza is fully leased and open for business. Among the tenants are Starbucks, Wells Fargo Bank, Cold Stone Creamery, and a 57,000 square-foot Food 4 Less supermarket as the anchor. Ninety-one percent of the employees hired for the supermarket were local residents trained through a local workforce agency. Local entrepreneurs with restaurants and small businesses are also among the plaza's tenants. Market Creek's focal point is a 500-seat outdoor amphitheater available for cultural performances and special events.

To date, Market Street Plaza has created nearly 200 jobs. That number is expected to increase to 300 when a planned three-story, 75,000 square-foot office building is completed

on the site. Furthermore, the discounted loan ensured the center's success, allowing JCNI to free up capital for the future development of a mixed-use center adjacent to Market Creek Plaza. This future project will include 400 residential units and an additional 100,000 square feet of commercial space.

In addition to Market Creek, Clearinghouse CDFI has financed many other worthwhile projects through the New Markets Tax Credit program. We recently funded a \$7.5 million NMTC loan for an acute health care facility for infants and small children needing specialized intensive care hospitalization. This project provides invaluable health care services to low-income residents in Los Angeles, while also creating relatively high-paying medical jobs.

In spite of its challenges, expenses, and competitiveness, the New Markets Tax Credit program is a great investment for community development practitioners and investors alike. It is vital that both NMTC awardees and investors continue to direct the resources and benefits of the program to those in this country that need them the most.

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