Case Study from Application to Construction: Lenders for Community Development Puts New Markets Tax Credits to Work

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Introduction

To the outside world, the San Francisco Bay Area is known as a center of the high-tech economy and a place where millionaires are made every day. But skyrocketing prices and a growing disparity between the haves and have-nots make the Bay Area one of the hardest places in the nation to be poor.

Lenders for Community Development (LCD) is a nonprofit community development financial institution (CDFI) that provides financial tools and training to benefit low-income individuals, families, and communities, helping them to move beyond poverty and toward self-sufficiency. Founded in 1993, LCD channels resources into San Francisco Bay Area communities that have been underserved by conventional financial institutions. Our programs include: small business, affordable housing, and community facilities loan programs; one of the nation's largest Individual Development Account programs; and the New Markets Tax Credit program.

Through these programs, LCD has directed over $73 million in community investment into economically challenged neighborhoods and has improved the lives of more than 5,000 households. The core of LCD's support comes from its 24 member banks, with additional support coming from foundations and government.

In 2003, LCD joined 65 other NMTC allocatees (out of a pool of 345 applicants) in receiving a tax credit allocation in the first round of this new program. Utilizing part of its first $25 million NMTC allocation, to date LCD has financed two innovative, high community-impact projects in the San Francisco Bay Area:

- a $9.7 million new campus facility at The National Hispanic University in East San Jose; and
- the $8.3 million tenant purchase of Preservation Park, a nonprofit and small business office complex located in Oakland.

LCD worked with 13 different lenders and equity investors for these two deals.

This year, LCD was again honored to join 40 other Community Development Entities (CDEs) in receiving allocations and was awarded an additional $25 million in credits.

Application Process and Allocation Phases

Anyone who has submitted an application to the Fund can attest that the process of preparing and submitting an application can be time consuming and expensive. Our effort to earn an NMTC allocation was no exception, as we estimate that we spent some 160 hours and nearly $100,000 in staff, consulting, and legal fees preparing the application and securing the award. (Fortunately for LCD, most of these fees were donated by the City of San Jose or provided by our pro bono attorneys.) Some of the challenges in preparing the application included gathering and reconstituting data, obtaining letters of interest from potential investors, and identifying potential NMTC deals. The strengths of our application included a significant track record of community development finance as a CDFI, a healthy pipeline of deals, and excellent backing from potential investors.

In March 2003, the first round NMTC allocatees were announced by the Secretary of the Treasury. In November 2003, along with many other NMTC first round allocatees, we executed our NMTC allocation agreement. While many of the potential investors we approached had a lengthy record of investing in our loan pools, the NMTC program represented a much larger and more complicated capital commitment to LCD than in the past.

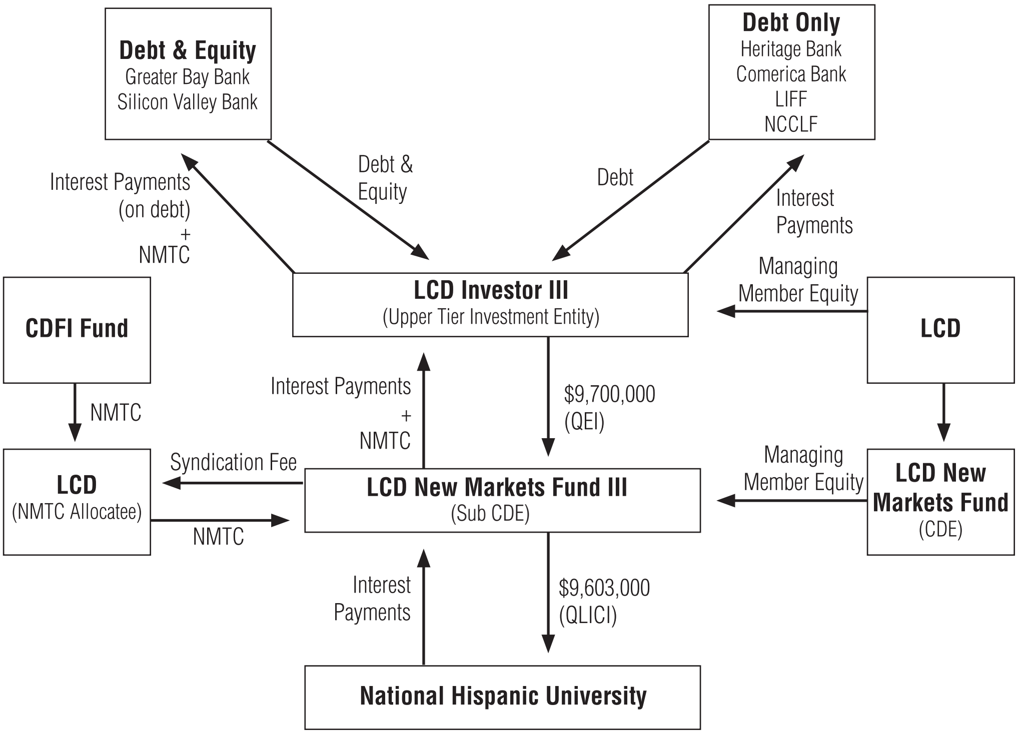
While still a considerable time commitment, the preparation of our second NMTC application in 2004 took less time and money than the first one for a number of reasons. We saved time and money on legal documents and financial models because we had developed these for our first round application. We had a better understanding of which deals would work with the NMTC guidelines and a number of potential projects that we could discuss in our application. Finally, we had existing relationships with NMTC investors, which was important because they understood the program and we had already negotiated key business points.

Program Development Phase

Developing the program and bringing our first deals to fruition took us longer than we expected, mostly due to the complexity of government guidelines and the relative inexperience of all parties involved.

We engaged in extensive negotiations with 29 potential investment entities. We had expected that the investors, many of whom were investors in LCD's existing loan pools, would consent to invest capital into a "blind pool" for New Markets Tax Credit projects. Over months of negotiations, however, we realized that investors would require a review of each deal. We also had to overcome a fair amount of initial investor uncertainty, which was exacerbated by the delay of the release of final IRS NMTC regulations in December 2004.

Our discussions with potential investors and other allocatees convinced us that the "leveraged" investment model was the most attractive and profitable way to utilize the NMTC program (see chart on next page). In this model, investors make equity and debt investments into an upper-tier entity, which in turn makes a qualified equity investment (QEI) into a sub CDE. The introduction of debt into this model effectively supercharges the NMTC, providing a greater return to the equity investor. One drawback to the leveraged model, however, is its complexity, which added significantly higher fees for consultants.



During this period, we worked very closely with our pro bono attorneys, Wilson, Sonsini, Goodrich & Rosati, whose extensive experience representing venture capitalists was instrumental in the program development phase. They assisted us with the allocation agreement, including the provision of an extensive legal opinion. To create the infrastructure necessary to receive leveraged investments, we formed and provided the initial capitalization for nine distinct upper-tier investment entities. In addition to this legal preparation, we also worked with Novogradac & Company to develop an accounting template for investments.

The combination of the multi-investment tiered structure, the New Markets Tax Credits themselves, the specific tax consequences, and the distribution of excess cash flow, produces a staggeringly complex financial model (the models for our leveraged transactions each contained 38 inter-related spreadsheets). However, these financial models were a critical tool for educating and negotiating with investors.

Finding the Right Project

With the legal and accounting framework formed and a number of potential investors lined up, we commenced the search to find a qualifying project that would also meet LCD's high standards for community impact. With our finite allocation of NMTC, we did not want to make loans to "bankable" projects. At the same time, due to the newness of the program and some uncertainty with the interim IRS regulations, we learned that investors were not interested in investing in really tough deals. This narrowed our window of opportunity to "near-bankable" deals and reduced the size of our pipeline dramatically.

According to the New Markets guidelines, each potential NMTC deal must be reviewed to determine if the project meets a number of key qualifying criteria including geographic location of: sources of revenues, employee services, tangible assets, and future plans. While all of these tests seemed reasonable, some of them resulted in unexpected consequences. For instance, NMTC tests require that at least 40 percent of employee services and 50 percent of revenues be generated in qualified NMTC census tracts. We had hoped to finance a new homeless services center for a prominent local nonprofit. This nonprofit has 17 sites where it provides transitional housing services to more than 15,000 very low-income men, women, and mentally ill adults annually. Nearly all of their sites are in NMTC-qualified census tracts, including the proposed NMTC project. Their administrative office, however, is located in a non-NMTC-qualified census tract, disqualifying the organization from receiving an investment using NMTC-eligible funds.

We also learned that mixed-use projects, especially those involving Low Income Housing Tax Credits, are difficult to finance through NMTC unless the commercial portion of the project represents at least 80 percent of the revenues. Additionally, because a business must remain within an NMTC qualifying census tract for the duration of the investment, the tax credit recapture provisions bias investors toward real estate-secured deals, reducing the potential of investing in small businesses.

Putting the Credits to Work

After over a year of developing the program, we were finally ready to convert the NMTC into investments into the community we serve.

Located in an urban, low-income census tract, The National Hispanic University (NHU) is a private university with an affiliated charter school and a bilingual childcare center. NHU is one of only three accredited universities in the U.S. specializing in Latino education. NHU offers credentials ranging from business administration to computer information systems, bilingual teacher education, and math and science. NHU's tuition is less than the local public state university thanks to the support from foundations, government, and corporate sponsors. More than 90 percent of the university's students work full or part time, 85 percent are Hispanic, and 81 percent are low- or moderate-income.

When NHU approached LCD for financing, the university was located in a former elementary school built in 1958. With the promise of an NMTC loan, LCD and one of LCD's member banks, Comerica Bank, provided interim financing for the construction of a new 66,000 square foot state-of-the-art facility. The project was completed in August 2004, with "take-out" financing provided by LCD's NMTC program in November 2004. The terms of the NHU NMTC financing included unconventional features such as a below-market interest rate, interest-only payments and an agreement to provide a substantial grant (estimated to be $800,000) to NHU at the conclusion of the tax credit period. Herb Stevens, an attorney with Nixon, Peabody, referred to this last feature as the "Mother Teresa CDE" model. In this deal, the QEI was capitalized by the following: two upper-tier equity investors

(Greater Bay Bank and Silicon Valley Bank); four bank debt investors (Greater Bay Bank, Silicon Valley Bank, Heritage Bank of Commerce, and Comerica Bank); and two CDFI debt investors (Low Income Investment Fund and Northern California Community Loan Fund).

Some of the eligibility tests associated with the NMTC program resulted in unintended consequences. The university had plans to increase its scholarship endowment fund for low-income students, but these plans potentially would run afoul of the IRS NMTC requirements limiting non-working capital assets, including this scholarship endowment, to less than five percent of total assets. After months of delay, we were able to develop a legitimate strategy to address this issue.

With its loan closure in November 2004, the NHU deal became the first NMTC loan in the San Francisco Bay Area. We would not have been able to close this deal as quickly without the tremendous help of our investors, our attorney, Scott Lindquist of Sonnenschein, Nath & Rosenthal, and our accountants, Novogradac and Company. Equally important, we found the CDFI Fund to be very accessible and professional, with staff providing ready responses for the many questions arising from the program.

Clearly, the most important part of this project is the thousands of low-income students who will receive a first-class education in this wonderful facility, but the physical juxtaposition of the "before" (shabby elementary school) and "after" (modern, state-of-the-art facility) is truly stunning as well. This facility instills a tremendous sense of pride for the current NHU students, their families and the thousands that will follow them, and signifies the importance and value of higher education for the working poor families of San Jose.

In the short time since its new facility was built, NHU's freshman student enrollment has grown by 300 percent. The number of first-time undergraduate students has grown from 57 last year to 250 for the semester starting August 2005. The new library is ten times the size of the old library and new labs have permitted the science and math programs to expand dramatically. In addition, the school's new athletic field and community spaces have been widely utilized by the surrounding community.

Lessons Learned

The first few years of the NMTC program have taught much to practitioners, investors, and borrowers alike. With the right type of project, the NMTC program can truly be a tremendous catalyst for community change in our nation's low-income communities. The challenges we faced included what one would expect with the implementation of a new federal initiative: considerable ramp up time, lack of clarity regarding the IRS code, substantial professional fees, and investor reticence requiring extensive education.

We learned that willing and NMTC-savvy investors are a critical component of success. It also appears that the most viable NMTC projects need to be near-bankable, single real estate asset entities. And we found that when new IRS regulations bump up against real project conditions, potential program difficulties are revealed. Modifying the regulations based upon these experiences will be critical to the program's success.

We believe that Congress intended the New Markets Tax Credit program as a vehicle to encourage new private and public capital investment in low-income communities. As long as the NMTC industry stays true to the mission focus of the original NMTC legislation, the future looks bright for this program.

Jeff Wells has worked in the community development finance field for more than thirty years at a community development credit union, as a banker, and as a consultant for CDFIs and regulators. Currently, he is the Manager of the LCD New Market Fund and serves as Chair of the Capitalization Committee for the National Federation of Community Development Credit Unions. More information on Lenders for Community Development and its programs can be found at www.L4CD.com or by contacting Jeff Wells at jeffwells@L4CD.com.