

Great Expectations

Different Investors, Different Motives By Mark Fogarty

Investors have different takes on what to do at Year 15 and Year 30 of Low Income Housing Tax Credit deals, and it isn't quite as simple as the divide between mission-driven and financially-driven backers.

John Gahan, partner at Sullivan & Worcester LLP, Boston, can list a number of different investor scenarios he has seen come into play with the maturity of the tax credit compliance and/or extended use periods involved with LIHTC properties, depending, in large measure, on the underlying documents and identity of the investor.

Among the factors that affect an investor's perspective on how to deal with Year 15/30: the first, obviously, is what do the documents permit/require. Can the investor force a sale? Must they consent to a refinancing and/or a sale? In addition, it matters how deeply involved the investor is in the business. "Is the investor an 'industry investor'? Are they in lots of LIHTC deals, or are they an organization that is in a few deals and may not be looking to stay in the LIHTC world for a long time?"

Drilling deeper, the extent of the investor's relationship with the particular developer makes a difference as well. "Is the investor working with a developer in multiple properties?" Gahan asks. "If you are a developer negotiating with an investor on the only deal you have with them, that one-off investor may have a different perspective than if it thinks it is going to do business with you next week, next month, next year."

Another relevant factor is whether the asset is held in a proprietary fund or a multi-investor fund. "That goes to the issue of whose consent is needed," he says.

The location of the project can affect an investor analysis as well. "There are different expectations in different locations," he says. "In some jurisdictions, there are laws that affect what is going to happen to an affordable housing property as the expiration of affordability restrictions. Preservation laws affect the decision-making mix at 15 and 30."

Another wrinkle is that the identity of the investor at Year 15 may not be the same as when the project started. Successor investors often have radically different expectations from the original investors.

The Aggregators

"Some tax credit equity providers went out of business

in 2008-2009. When the LIHTC investor market returned they were joined by other people," says Gahan, "a group known as aggregators." Aggregators "have money and by buying LP interests from the original tax credit investor usually after the ten-year credit period has expired, their business model is to turn that investment into a return at sale or refinancing. To them, it's merely a monetary interest."

Solutions involve choices among refinancing or selling the property, re-syndicating into another tax credit deal that might also involve a sale to a "kissing cousin" of the original developer or pursuing market-rate sales transactions.

In the early years of LIHTC properties coming to Year 15 or 30, investors and developers tended, in some cases, to focus on the disposition issues as they went along.

"Industrywide, what happened years ago was neither developers nor investors paid a lot of attention at the outset of their relationship to what was going to happen after the tax credits had been used. Because of increases in real estate values, and because of federal and state programs that have subsidized the rents, value beyond expectation was created," says Gahan. "At Year 15, instead of arguing about relatively small amounts of money, the potential transaction proceeds could be multiple hundreds of thousands or even millions of dollars."

Even greater tension exists if the documentation allows investors to force a sale, Gahan notes. Developers tended to think of the asset as theirs and chafe at the conclusion the investor controls any disposition decision.

These factors may play out differently depending on whether the investor is mission-driven or financially-driven.

Mission- vs. Financially-Driven

Mission-motivated developers generally want to keep the property affordable, says Gahan. Many mission-driven developers, for profit or nonprofit, might look to recapitalize properties in Year 15/30, making needed upgrades or incorporating new improvements, like community rooms, computers for residents or new amenities. These developers plan to stay in the affordable housing world and make their property more attractive to the potential residential pool, as well as their lenders and investors.

In contrast, financially-driven investors may see an

opportunity to sell to another buyer, to turn their investment into a windfall.

Derek DeHay, director at Newmark Knight Frank's Affordable Housing Group, spelled out who the various Year 15 purchasers/investors are, as well as their underwriting sensitivities, at a recent National Council of Housing Market Analysts meeting in Atlanta.

Purchasers/investors include local LIHTC developers/operators targeting yield investments or scale within the market; local or regional private capital investors (could be a 1031 tax exchange, where investors can defer paying capital gains on a sale); national/institutional real estate funds; LIHTC developers for an acquisition/rehab execution; nonprofit owners; and housing authorities (typically partnering with a LIHTC developer).

DeHay told TCA that most of these investment groups are yield-driven with exception to those that are targeting a re-development opportunity or more of a mission-driven investment. In major markets on larger properties, DeHay says the market is seeing cap rates at historic low levels on Year 15 product. This is a factor of low-interest rates, the overall consistent performance of LIHTC properties, especially in markets where the market rent far exceeds the maximum LIHTC rent and the push from larger institutional investors to enter the space. DeHay says the increase in 2019 AMLs across the country will likely only give these investment groups more of an appetite for Year 15 product.

In recent months, DeHay says they are seeing aggressive pricing on LIHTC properties in the extended-use period that qualify for re-syndication. Oftentimes, properties with major capital receive the strongest pricing from a LIHTC developer that can cover those rehab costs under a re-syndication.

The nonprofit community has also been active in Year 15 acquisitions, including both local and more national nonprofits. In certain states, nonprofits can receive property tax exemptions or have a Right of First Refusal outlined in the LURA creating advantages over for profits.

DeHay told the meeting investor underwriting sensitivities include the physical condition and immediate capital needs of the project; the ability to finance; maximum LIHTC rents, the level of rent subsidy; the potential for new LIHTC developments in the market; pre-Year 15 transactions like a compliance guarantee or recapture bond; and current property tax assessed values.

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In many states, affordability restrictions extend even beyond Year 30. Jerome Breed, attorney at Miles & Stockbridge, Washington, DC, notes that these can extend up to 55 years, in the case of California. So far, “There has not been a wave of 30 Year deals coming on to the market,” he says, though he sees a potential bulge coming in 2020, 2021 and 2022.

“There clearly are differences in approaches investors have. Investors can have different intentions, you can’t mandate everyone should be mission driven. You can’t force people to sell for a nominal price.”

Investor Expectations

The expectation of the investor generally is they will exit the deal and would get paid an amount that has some relationship to the fair market value of their interest. The FMV, when there are no more tax credits, in many cases, would be relatively small.

“Where there have been substantial losses claimed (especially for tax-exempt bonds) in those transactions it’s not uncommon for investors to have a significant negative capital account when they leave,” Breed says. “In that context, the investor is going to expect a substantial payment from the general partner.

“GPs have gotten more sophisticated about their view. The typical view of the developer is the property is theirs, the investor got their tax credit and they should just get out for nothing. That view is inconsistent with the nature of the LIHTC program, as a tax program that depends on the success of allocating the LIHTC to the investor. If the investor has a negative capital account, there’s first going to be an amount of gain recognized equal to the amount by which their capital account is negative,” says Breed.

To date, more attention has been paid to Year 15 properties than to Year 30. But Year 30 is getting increased interest, because there are going to be a lot of properties coming due, and soon.

“As many as 8,420 LIHTC properties accounting for 486,799 affordable rental units will reach Year 30 between 2020 and 2029, and do not receive other types of subsidies that extend their affordability restrictions,” according to a report from the National Low Income Housing Coalition and the Public Affordable Housing Research Corp.

Regardless of what an investor may want to do, “It isn’t always easy to convert a LIHTC property at the end of its compliance period or extended use period,” says

Regulatory Factors Impacting Pricing

- Limitations on owner/purchaser – For example, nonprofit priority.
- Support services – Does the requirement for these services terminate at the end of the compliance period and are they valuable to the residents?
- Tenant right to purchase (single-family communities) – What does that process look like and does the requirement continue after being sold to a third party?
- Qualified Contract Eligible – Is the property eligible for QC? Does current ownership have all the files needed to calculate the QC price and submit to the HFA? Is the QC price above the market value? What does the QC process look like in that state and how much does it cost? Does the QC process create any value for the property?
- Additional restrictions to LIHTC – For example, HOME restrictions, bond restrictions. Are those more restrictive or less restrictive? Will the additional restrictions reduce your buyer pool?
- Does the HFA require a purchaser to fund operating reserves?
- HFA LURA assignment process – Does the HFA require previous LIHTC ownership or management experience?

Source: Derek DeHay, Newmark Knight Frank

Gahan. “It may not be as simple as saying, ‘I’m through with it, now I can do whatever I want with my property.’ There may be a process a developer has to go through before the property is free from restrictions.”

In Massachusetts, for instance, there is a process of giving notice to tenants and municipalities well before the maturity of the affordable restrictions, he points out. And, that process also limits rent increases for a period of time post maturity.

Resolutions of the Year 15/30 options need to be thought about well in advance. How far in advance? “What I’ve been saying for a long time now is the day to think about the exit is day one. It’s not year ten, not year 15, it’s day one. Because those investment documents really describe the relationship between the developer and whoever holds the LP interest,” says Gahan. **TCA**

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