Real Estate Finance Tool Box

Presented by
National Development Council

National Development Council

- Nation's oldest not-for-profit organization specializing in community and economic development finance
- Mission: Increase the flow of capital to underserved communities
- Provides technical assistance and training, and financial and development services
- Works with more than 80 municipalities and local development organizations across the U.S.

Real Estate Finance

- Why Are We Here?
  - To learn about the economic development programs that can help fill the financing gap on community development real estate projects
  - Two kinds of capital
    - Debt – from lenders
    - Equity – from investors
      - Rehabilitation Tax Credits (RTCs)
      - Low-Income Housing Tax Credits (LIHTCs)
      - New Markets Tax Credits (NMTCs)
      - Conventional

Three Benefits of Owning Real Estate

- Cash Flow
- Tax Benefits
- Appreciation

  - To most investors, cash flow is the most important benefit – it’s the most tangible and immediate of the three benefits

Cash Flow

    Annual Rental Income
\- Annual Operating Expenses
\- Annual Debt Service (payments to lenders)
= Cash Flow

Tax Benefits

- Tax Deferral: Depreciation
  - Protects passive income from taxation
  - Postpones payment of taxes
  - Converts ordinary income to capital gains
  - Residential: 27.5 years
  - Commercial/Industrial: 39 years
- Tax Reduction: Tax Credits
  - Rehabilitation Tax Credits
  - Low-Income Housing Tax Credits
  - New Markets Tax Credits

Appreciation

- Appreciation Represents the Increase in Value over Time

  Current Value
  - Purchase Price
  - Improvements
  = Appreciation in Value

  - In the long run, real estate almost always increases in value
  - In the short run, real estate is a cyclical business with peaks and valleys

Economic Development Real Estate Deals

- Economic Development Professionals Do Deals that Are Weak on Benefits
  - Rural areas
  - Declining urban area
  - Inner-city
  - Investors/lenders are reluctant because
    - Low rents, low cash flow
    - Appreciation very uncertain
    - Difficult to recruit tenants
    - Difficult to borrow money
    - Inadequate collateral

Economic Development Real Estate Deals (cont.)

- Economic Development Professional's Job Is to Make Deals Happen in Distressed Areas
  - Get lender to lend by reducing risk
  - Encourage developers and investors to invest by increasing return on investment to acceptable level
  - Fair return on investment but no undue enrichment

Economic Development Finance Tools

- Rate: Reduce the cost of funds
- Term: Extend the repayment period
- Leverage: Increase debt, reduce equity
- Substitution: Alternate equity sources

Real Estate Development Finance Process: Major Actors

- Investor
- Lender

Investor

- Provides Capital for Equity in Real Estate Development Projects
- Requires Return on his or her Investment due to Three Factors
  - Risk
  - Inflation
  - Opportunity

Lender

- Provides the Bulk of the Financing
  - Construction lender
  - Permanent lender
- Risk Averse
- Desired Benefit: Adequate Return with Minimal Risk

Development Budget

- Preparing the Development Budget: Sources and Uses of Funds

Sources	
Bank	$1,271,000
Equity Cash-on-Cash	280,000
Equity RTC	408,000
Public Funds	541,000
	$2,500,000
Uses	
Acquisition (1/2 Land)	$100,000
Construction	2,100,000
Architect and Engineer	100,000
Developer Fee	200,000
	$2,500,000

Operating Budget (cont.)

- Example: 10,000 Square Foot Building
  - Rent $16 per square foot
  - Tenant contributions $4 per square foot
  - Vacancy rate 10 percent
  - Operating expenses $4 per square foot

	Gross Rent		$160,000
+	Tenant Contributions	+	40,000
=	Gross Income	=	200,000
-	Vacancy	-	20,000
=	Effective Gross Income	=	180,000
-	Operating Expenses	-	40,000
=	NOI	=	$140,000

Operating Budget (cont.)

- Net Operating Income (NOI) Is the Most Important Number in a Real Estate Project
  - Represents overall cash return on capital
  - Determines loan amount
  - Determines value
  - Determines cash return on equity

Annual Operating Pro Forma

	Gross Rent	Rent Collected at 100% Occupancy
	Tenant Contributions	Contribution for Operating Expenses
	Gross Income	Total income at 100% Occupancy
-	Vacancy	Vacancy and Collection Loss
=	Effective Gross Income	Expected Cash Collected
	Effective Gross Income	
-	Annual Operating Expenses	
	Taxes	
	Insurance	
	Maintenance	Cash Expenses
	Utilities	
	Management	
	Reserves	
+	Net Operating Income	Cash Generated by Property
-	Debt Service	Return to Lender
=	Cash Flow	Return to Owner

Permanent Lender Ratio Analysis

- Two Primary Permanent Lender Underwriting Ratios
  - Loan to value ratio (LVR)
  - Debt coverage ratio (DCR)
    - Debt coverage ratio used primarily to determine the maximum amount of debt that a permanent lender will provide for a real estate development

Equity Attracted

- Equity Attracted Is Based on Cash Flow and Desired Return by Investors

  Equity Attracted = Cash Flow / Cash-on-Cash Required

- Example

NOI	$140
Debt Service	- 112
Cash Flow	=$28

  - Investor demands 10 percent COC rate of return
  - Equity Attracted = $28 / .10 = $280

Equity Attracted (cont.)

- Example

	Total Project Cost	$2,500
-	Loan	1,271
-	Equity COC	280
-	Equity RTC	408
=	Gap	$541

Tax Credits

- A Direct, Dollar-for-Dollar Reduction of Tax Liability
- Three Kinds of Tax Credits
  - Rehabilitation Tax Credits (RTCs)
  - Low-Income Housing Tax Credits (LIHTCs)
  - New Market Tax Credits (NMTCs)
- Investors pay equity for the right to claim federal tax credits -- the equity becomes another source of cash for the project

Rehabilitation Tax Credits

The Basics

- Two Tier Federal Tax Credit
  - 20% (historic)
  - 10% (non-historic)
- One-time Credit
- Decreases both depreciable and adjusted basis
- Can offset taxes on an unlimited amount of passive income, on only a limited amount of non-passive income
- Building must be held for five years to avoid recapture

Rehabilitation Tax Credits

- Historic Rehabilitation
  - 20 percent, one-time credit on rehabilitation costs
  - Must qualify
    - Certified historic structure – Individually listed in National Register or contributing building in NR historic district
    - Commercial, industrial or rental housing
    - Substantial rehabilitation: spend greater of $5,000 or property's adjusted depreciable basis
    - Follow Secretary of Interior standards: National Park Service (NPS)

Rehabilitation Tax Credits

- Non-Historic Buildings
  - 10%, one-time Credit on Rehabilitation Costs
  - To Qualify:
    - Placed in service before 1936
    - Commercial (including mixed use), or Industrial only
    - Substantial rehabilitation required
    - Building must NOT be a "certified historic structure"
    - Building must not have been moved
    - Exterior/Interior Wall requirements
      - 50% of exterior walls to remain exterior walls
      - 75% of exterior walls to remain
      - 75% of interior walls to remain

Basis for Calculating RTC

- Include
  - All costs that are part of the depreciable basis <u>except</u> building acquisition
    - Construction costs
    - Interim financing (loan fees and interest)
    - Property taxes and insurance during construction
    - Architectural, engineering and design fees
    - Builder, contractor, developer fees
    - Appraisal fees

Basis for Calculating RTC (cont.)

- Exclude
  - Acquisition costs: no credit for <u>buying</u> the building, only for <u>rehabilitating</u> the building
  - Intangible assets: reserves, permanent loan fees, marketing expenses, some legal and accounting, etc.

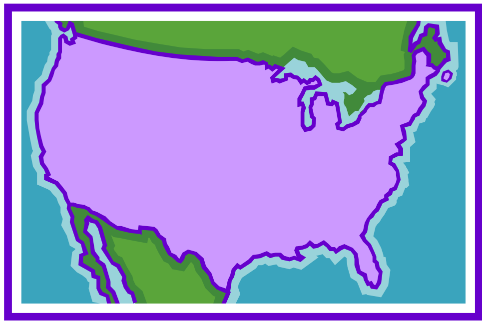
RTCs Generate Equity

$2,100,000	Rehabilitation
100,000	Architectural and Engineering
200,000	Developer Fee
$2,400,000	RTC Basis
x .20	Credit Rate
$480,000	RTC

$480,000	RTC
x .85	Credit Price
$408,000	Equity

Low-Income Housing Tax Credits

- Annual Credit for 10 Years
- Project Must Qualify on Three Criteria
  - Income/occupancy
  - Rent
  - State approval



New Construction / Substantial Rehabilitation

- Annual Credit for 10 Years
  - New construction
  - Substantial rehabilitation ($6,000 per unit)
  - 9.0 percent on all improvement costs not funded with tax-exempt financing, or grants
  - 4.0 percent on all improvement costs, regardless of financing source
  - 30 percent basis increase for difficult development areas and qualified census tracts

Improvement Costs (Eligible for 9% Credit)

Include	Exclude
▪ Construction Costs ▪ Permits and Fees ▪ Construction Financing Expenses (interest, fees, appraisal, inspections) ▪ Property Taxes and Insurance ▪ Architectural and Engineering ▪ Performance Bonds ▪ Furnishings ▪ Environment Assessment ▪ Developer Fee ▪ Contingency (if any) ▪ Development Consultant	▪ Permanent Financing Expenses ▪ Reserves ▪ Marketing ▪ Tax Credit Application Fee ▪ Syndication Costs (legal, audit, consultant, etc.) ▪ Acquisition ▪ Off-site Improvements ▪ Costs for Non-Residential ▪ Costs for Market-Rate Residential ▪ Organizational Expense ▪ Any Expense Paid for with “Bad” Money

Example

New Construction Project in Difficult Development Area

Uses

$100	Land
900	Residential Construction
200	Commercial Construction
$1,200	Total Uses

Sources

$300	Conventional Loan
92	CDBG
808	Equity
$1,200	Total Sources

LIHTCs

$900	Residential Construction
x 1.3	
1,170	Credit Basis
x .09	Credit Rate
$105	Maximum Annual LIHTCs

Equity Raised

$105	Annual LIHTCs
x 10	Number of Years
1,050	Total LIHTCs
x .77	Purchase Rate
$808	Equity Raised

LIHTC for Rehabilitation

- Annual Credit for 10 Years
- 4.0 Percent of Building Value Only
- Previous Owner Must Have Owned Building for 10 Years
- Available only with Substantial Rehabilitation
- No 30 Percent Basis Increase on Building

Example #2
Rehabilitation Project

Uses

$300	Acquisition (1/2 building)
1,000	Rehabilitation
$1,300	Total Uses

Sources

$200	Conventional Loan
361	CDBG
739	Equity (see below)
$1,300	Total Sources

LIHTCs

$1,000	Rehabilitation
x .09	Credit Rate
90	LIHTCs
150	Building
x .04	Credit Rate
6	LIHTCs
90	Credit on Rehabilitation
6	Credit on Building Value
$96	Maximum Annual LIHTCs

Equity Raised

$96	Maximum Annual LIHTCs
x 10	Number of Years
960	Total LIHTCs
x .77	Purchase Rate
$739	Total Equity Provided

New Markets Tax Credit Program

- What Is It?
  - Designed to generate new, private sector investment in targeted distressed areas
  - Tax credits passed through to investors
- Who Administers?
  - CDFI Fund, division of the U.S. Treasury
  - CDFI allocates tax credit authority over seven years to Community Development Entities (CDEs)

New Markets Tax Credit Program (cont.)

- CDEs
  - Applicants for NMTCs
  - Must be a corporation, limited liability company, or partnership
  - Primary mission of servicing or providing investment capital to low-income communities
  - Must maintain accountability to residents
  - Existing Community Development Financial Institutions (CDFIs) and Small Business Investment Companies (SBICs) are automatically designated under law

New Markets Tax Credit Program (cont.)

- The Process
  - Apply to CDFI for CDE designation
  - Prepare five-year strategic plan to get allocation of credits
  - Line up investors
  - Make qualified low-income community investments
  - Report use of credits to investors and the IRS

New Markets Tax Credit Program (cont.)

- The Tax Payer/Investor Will Be Eligible to Claim a Tax Credit Equal to 39 Percent of the Qualifying Equity Investment over a Seven-year Period Equal to:
  - 5.0 percent of equity investment for the first three years
  - 6.0 percent per year thereafter
- So How Much Will an Equity Investor Pay in Cash Today to Receive this Stream of Future Benefits?

NMTC Value

Yield	7%	8%	9%
Equity / $1.00 of Tax Credit	76.18	73.51	70.95

New Markets Tax Credit Program (cont.)

- Eligible Investors
  - Banks
  - Insurance companies
  - Investment banks
  - Venture capital and investment funds
  - Corporations

New Markets Tax Credit Program (cont.)

- Eligible Projects
  - Geographical location is key – Check by census tract
  - Commercial real estate projects (office, industrial, retail, hotel, etc.)
  - Business ventures (start-ups, existing businesses, micro-enterprises, etc.)
  - Mixed-Use (housing and other) -- Must qualify project as "commercial" according to IRS

Local Structuring Tools

- Community Investment District
- Tax Increment Financing
- Neighborhood Revitalization Area
- Downtown Topeka Grant Program

Local Structuring Tools (cont.)

- Community Investment District (CID)
  - Financing for eligible projects which will enhance the quality of like in Topeka
    - Facilities that promote cultural, historical and artistic elements, and tourism,
    - Unique commercial, office, industrial and mixed use facilities
    - Promote economic development, investment or reinvestment in the community
    - Enhance retail base, capturing sales moving to other markets
    - Upgrade older real estate through redevelopment or rehabilitation

Local Structuring Tools (cont.)

- Tax Increment Financing (TIF)
  - Bonds issued and then repaid with increases in real estate or sales taxes
  - Tax base for a district is estimated and "frozen"
  - Tax revenues beyond this amount or tax increment is used for payments to bond holders
  - May only be used for eligible public purposes
  - Provides public funding for
    - Off-site or eligible public uses (reduces project budget or
    - Allocates project payments to fund improvements (expands sources of funds

Local Structuring Tools (cont.)

- Neighborhood Revitalization Program (tax abatement)
  - Reduction of portion of new taxes attributable to improvements
  - Increases net operating income
  - Can increase debt capacity
  - Can increase cash-on-cash return

Local Structuring Tools (cont.)

- Downtown Topeka Redevelopment Grant Program
  - Permanent Improvements to BID properties (routine maintenance not eligible)
  - Residential Properties (income producing)
    - 25% of eligible cost, $10,000 max per unit, $30,000 total
  - Commercial properties (can be leasehold)
    - 25% of eligible costs, $50,000 maximum.
  - Façade improvements
    - 50% of project costs, $5,000-$10,000 max depending on width of building.

Real Estate Financing Programs

- Federal Home Loan Bank (FHLB) Programs
- Tax-Exempt Bonds
- HUD Community Development Block Grant (CDBG)
- Other State and Local Financing Programs

Federal Home Loan Bank Programs

- Sponsored by Federal Home Loan Bank Board (FHLBB)
- Administered through District Offices of FHLBB
- Affordable Housing Programs (AHP)
- Community Investment Programs (CIP)

Affordable Housing Program

- Can Be Used for Rental Projects – all Units for 80 percent AMI or below and at Least 20 percent of Units at 50 percent AMI
- Program Tends to Be Targeted at Projects at 50 Percent AMI or below
- Relatively Modest Subsidies – typically $5,000 per Unit

Community Investment Program

- Each FHLB offers below market rate loans (advances) to members for long-term financing
- Eligible projects include Affordable Housing and Economic Development that benefit low- and moderate income families and neighborhoods

FHLB Topeka Community Programs

- Community Development Program (CDP)
  - Commercial and Small Business Loans for Real Estate
  - Community loans for infrastructure, public facilities or equipment
  - Nonprofit lending for churches, schools, daycares, and museums

- Community Housing Program (CHP)
  - Single-family home loans
  - 1-4 family rental properties
  - Multifamily rental projects
  - Purchasing low-income housing tax credits

Tax-Exempt Financing

- Funding through State and Local Bond Issues
- Interest Exempt from Federal Income Taxes Results in Lower Borrowing Rates

Tax-Exempt Financing (cont.)

- Types of Tax-Exempt Financing
  - Industrial Revenue Bonds (IRBs)
  - 501(c)(3) Bonds
  - 63-20 Bonds

Tax-Exempt Financing (cont.)

- IRBs
  - Only for manufacturing uses
  - $10 million project cap (large projects are not eligible)
  - Bonds are issued by a public entity but have no recourse to the public entity
  - Credit security is provided by the borrower

Tax-Exempt Financing (cont.)

- 501(c)(3) Bonds
  - Non-profit entity must own assets
  - Cannot be used for limited partnerships
  - Issuers: financing agencies, housing authorities, etc.
  - Cannot be used for projects outside the public purpose of the 501(c)(3)

63-20 Bonds

- Issued on Behalf of a Government Agency so no Need for an Issuing Agency, Can Place Directly
- Must Be Used for Public Purpose
- Property eventually Reverts to Agency
- May not Require Use of Public Bidding or Prevailing Wage Requirements so Development Costs May Be Lower

Community Development Block Grant

- Provided as Federal Grant Funds
  - Entitlement cities (population over 50,000)
  - Urban counties
  - States
- Jurisdictions Prepare an Annual Plan to Guide Funding Decisions
- Must Meet a National Objective
  - Benefit to low and moderate income persons
  - Removal of slums and blight
  - Urgent need

CDBG (cont.)

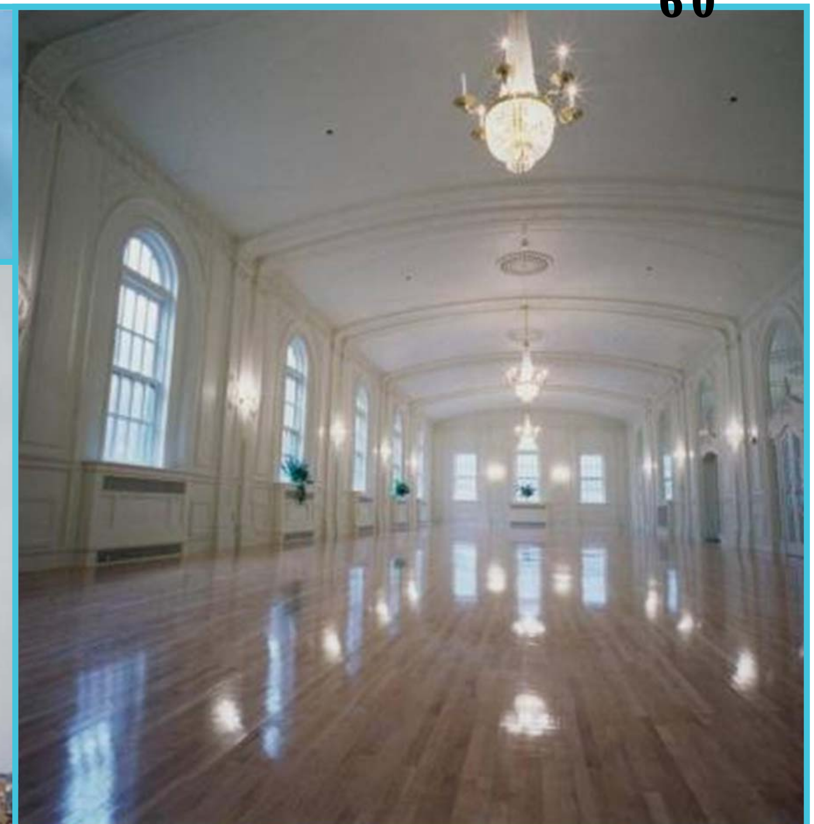
- Wide Variety of Eligible Activities
  - Acquisition
  - Rehabilitation
  - Tenant improvements
  - New construction
- Davis-Bacon
  - Required when used for construction, renovation or installation of equipment
- Reasonable Cost per Job Requirements

Structuring Tips

- Always Look First at the Operating Pro Forma and Sources and Uses
- Rents, Expenses, Vacancy
- Development Costs, Value of Property Contributed by Developer, Developer Fees
- Adequate Participation by Bank

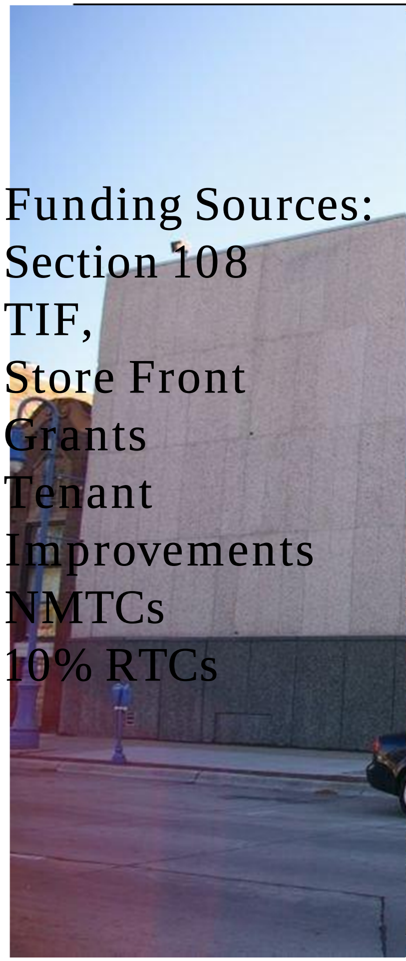
RTC Examples

Combined LIHTC & RTC Windsor Hotel Abilene, TX



Funding Sources:
LIHTC & RTC Equity,
Section 108 HUD Loan
Bank Loan
TIF, Home Investment Partnership

NMTC



Funding Sources:
Section 108
TIF,
Store Front
Grants
Tenant
Improvements
NMTCs
10% RTCs

Nonpareil Building, Council Bluffs

RTC and NMTC

Chamber of Commerce,
Restaurant &
18 Loft Apartments,
Council Bluffs, IA

Funding Sources:
- Foundation Grants
- Bank Loan
- RTCs (state & federal)
- NMTCs
- TIF
- Store Front Grants

Examples, Topeka

Contact

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Case Study – Santa Rita

- Vacant Warehouses
- Deteriorated Commercial District
- Local Developer
- Potential Grocery Store Tenant