Filling the Gap with New Markets Tax Credit Financing

An Introduction to the New Markets Tax Credit Program

Presented by:

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NMTC Agenda

- Introductions
- Federal NMTC Introduction
- Project qualification
- Assembling the deal
- Structuring the deal
- Capital that complements
  - Real Estate Transactions
  - Operating Businesses
  - Mergers and Acquisitions
- Case studies
- Summary
- Q&A
Introductions

Jim Seiffert
Jamie Cox

Aaron Seybert

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Steven LeBlanc

Legal Counsel
• Mitigate risk by ensuring the transaction is structured and documented in accordance with IRS and NMTC regulations

Investor
• Will invest in tax credits provided by the CDE and provide equity to the project

Accountants
• Ensure the structure and transaction are documented in accordance with the NMTC Program

Community Development Entity (CDE)
• Recipient of NMTC allocation, ultimately project lender
Why New Markets Tax Credits?

- The New Markets Tax Credit (NMTC) Program is an alternative financing complement to conventional capital sources.

- NMTCs are a tool that can be used to assist in the financing of middle market projects between $5-$50 million.

- NMTC financing typically provides a 7 year, below market interest only loan that is approximately 15%-20% of the allocation amount.
  
  > A $10 million project that utilized a $10 million allocation can anticipate approximately $2 million in subsidized financing.

- Fill a gap in a capital stack.
The federal New Markets Tax Credit (NMTC) Program was established with support from a bi-partisan Congress in 2000. The NMTC Program is administered by the CDFI Fund, a department of the U.S. Treasury.

Program objective – attract private sector investment to spur economic growth in low-income communities that have traditionally had inadequate access to capital due to the perceived greater risk.

The NMTC Program is authorized by section 45D of the Internal Revenue Code.
1. A CDE submits an application to the CDFI fund to be considered for an allocation of NMTCs.

2. After a competitive review of applications, the CDFI Fund awards an allocation of NMTCs to a CDE. The CDE works with various partners to identify operating businesses and real estate projects that are in need of investment.

3. Once the project has been qualified and all documentation prepared, an investor will make an equity investment into the CDE.

4. In exchange for the investment, the CDE provides the investor with tax credit authority equal to 39% of the investment.

5. The CDE traditionally provides a loan to the qualified business.
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Federal NMTC Introduction

$26.4 billion

2003-2011 YE
Qualified low income community
Investment by state
Source: CDFI Fund QALICBs financed by CDEs through 2010

$240MM
$221MM
$577MM
$1.3B
$46MM
$513 MM
Project qualification

Location

**Project location** – must be located in a qualified census tract that meets the determination of a low income community (LIC) as per the 2000 or 2006-2010 American Community Survey data

- LIC - Census tract where the poverty rate exceeds 20% or the family median income is below 80% of the statewide family income

- There must be a “reasonable expectation” that the company will continue to be located in a LIC for the term of the loan
Project qualification

Location

- Approximately 39% of all census tracts in the U.S. are eligible; about 36% of the US population lives in eligible census tracts

- 39% of the 191 census tracts in Jefferson County qualify
- 28% of the 18 census tracts in Bullitt County qualify
- 22% of the 9 census tracts in Shelby County qualify

Source: 2006 – 2010 American Community Survey Data

Source: Novogradac & CO., LLP
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Project qualification

Project type

- Federal NMTC Projects in KY
  - Mixed use hotel development
  - Higher education facility expansion
  - Commercial development
  - Athletic facility

- Different Types of NMTC Projects
  - Office
  - Retail/Office
  - Mixed use with 80/20 Housing Requirement
  - Entertainment/Theater/Museums
  - Grocery Store
  - Hotel
  - Non-profit organizations
  - Industrial
  - Manufacturing
  - Operating Business
  - Renewable energy
  - Health care
Project qualification

Project type

Ineligible Activities

- Non Qualified Businesses
  - Golf courses
  - Race tracks
  - Gambling facilities
  - Spa/suntan facilities
  - Stores where the principal business is the sale of alcoholic beverages
  - Development of or holding of intangibles for sale or license

- Certain Farming Activities

- Residential rental property
  - Buildings which derive 80% or more of income from residential dwelling units
Project qualification

Project type

1. **Gross income** - must derive at least 50% of gross income from activities in low income community

2. **Tangible Property Test** - 40% of the tangible property (owned or leased) is used within the LIC

3. **Services Performed** - 40% of the services performed by the business must be in a LIC

4. **Collectibles Test** - Less than 5% of the average of the *aggregate unadjusted basis* of the property is attributable to collectibles

5. **Nonqualified Financial Property Test** - Less than 5% of the average of the *aggregate unadjusted basis* of the property is attributable to NQFP which includes debt, stock, etc.
• **NMTC Consultant** – Not required or represented in all NMTC transactions. Primarily works with a QALICB in locating allocation and bringing all participants together.

• **Accountants** – Required in an NMTC transaction. Works with all participants to finalize transaction structure and projections.

• **Legal Counsel** – Required in an NMTC transaction. Prepares and reviews all documents required to satisfy the represented participant. Number of firms will vary depending on the complexity and structure of the transaction.
Structuring the deal

Structures

Investor-operated CDE model

Leveraged structure
Structuring the deal

Structures

- **Investor-operated CDE model**
  - Investors have the ability to establish a wholly owned CDE
  - Once the CDE is established the Investor will use the CDE subsidiary to invest directly in QALICBs

  **Benefit to Investor** – Satisfies tax credit appetite, provides commercial customers with favorable rates/terms, strengthen customer relationships and satisfaction of community and economic development programs

  **Benefit to QALICB** – reduced interest rate

- **Leveraged structure**
  - An Investor will make an equity-like investment in a CDE
  - **Benefit to Investor** – Satisfies tax credit appetite, rely on underwriting and compliance management of the CDE, and reduce exposure to recapture
  - **Benefit to QALICB** – Can include but is not limited to the following: debt cancellation, flexible rates/terms, and no principal amortization
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Structuring the deal
Understanding the variables

Allocation \times Credit \% \times Pricing = Gross NMTC Benefit

Assumptions:
1. Total project cost = $10MM
2. Project is located in a LIC
3. Project qualifies as a QALICB
4. Project located $10MM allocation

Program

$10,000,000 allocation \times 39\% \times 0.78 = $3,042,000
Structuring the deal

Leverage loan

Total Project Cost  $10,000,000
Gross NMTC Benefit  $3,042,000
$6,958,000

The leverage loan (LL) allows equity and debt sources to be aggregated by the Leverage Lender affiliate who will make a LL to the investment fund. The aggregated funds will be treated as an equity investment in the CDE. The LL is not limited to but is typically a combination of the following:

- Traditional debt
- State or City loan
- Grants
- Affiliate leverage loan
- Cash
- State NMTC equity
- Historic/Renewable TC equity

- Each LL source can add an additional layer of complexity to a transaction, structuring the LL should be carefully considered
- All leverage loan sources are required to be on account with the Leverage Lender affiliate the day of closing
Structuring the deal: Representative of a federal $10MM transaction on a gross basis

**Investment Fund, LLC**
(SPE created on behalf of transaction)
Total fund = $10,000,000
Tax Credit Equity = $3,042,000
Leverage loan = $6,958,000

- **Bank loan**
  - $6,958,000 non-recourse loan with market or below market rates

- **Cash**
  - $6,958,000 leverage loan

- **Tax Credit Investor**
  - Assume – $0.78 per credit
  - Receiving $3,900,000 in tax credits
  - Providing $3,042,000 in TC equity

- **Community Development Entity, LLC**
  - Annual interest payments (or cash flow)

- **QALICB**
  - A Loan
    - Reflection of leveraged loan
    - $6,958,000 with market or below market rates
    - 1st Mortgage
  - B Loan
    - Reflects monetization of TC equity
    - $3,042,000 with a below market rate (typically 1-2%)
    - Subordinate debt or equity

- **QLICI A** = $6,958,000
- **QLICI B** = $3,042,000

- **QEI** - $10 million equity
- **$3,900,000 in tax credits**
- **$3,042,000 NMTC equity**
Real Estate Investments are eligible under the Federal NMTC program regulations.

- NMTC investments can be used to finance commercial, retail, industrial, mixed-use and community facilities.

- NMTCs are excluded from being used in financing residential rental housing; however, if more than 20% of the gross income is generated from the rental of commercial space, then the building is not residential rental property.

- QLICI proceeds are typically required to be spent by the QALICB within 12 months of the investment. Construction timeline should be discussed in detail with CDE representatives and legal counsel.
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Capital that complements Operating Businesses

- Investments in or loans to Operating Businesses are eligible under Federal NMTC program regulations

- Investments in or loans to Operating Businesses can be used for but are not limited to the following:
  - Plant expansion
  - Capital Equipment purchase (any tangible assets – parts, inventory, FF&E)
  - Satisfy short term working capital needs

Through 2011, CDEs have disbursed $26.4B in QEI proceeds

- Real estate QALICBs received $17.6B in NTMC financing (66%)
  - Principal activity is the development or leasing of real estate
- Operating Business QALICBs received $8.0B in NMTC financing (30%)
Capital that complements
Mergers and Acquisitions

- M & A deals are eligible under the Federal NMTC program regulations; however, they are seldom executed

- An asset purchase is the most executable form of an M&A deal

- The entity that would execute the asset purchase would be subject to satisfying the NMTC guidelines related to Project Location, Non-Qualified Businesses, and satisfy each criteria of the QALICB Determination
  - Gross Income
  - Tangible Property
  - Services Performed
  - Non-qualified financial property or NQFP

- A stock acquisition is problematic as it may create a NQFP issue for the QALICB
  - \( NQFP = \text{Less than 5\% of the average of the aggregate unadjusted basis of the property is attributable to NQFP which includes debt, stock, etc.} \)
Case study # 1

Detroit Thermal Systems

- **Location** – Romulus, MI
- **Project size** – $20,000,000
- **NMTC Allocation**
  - Stonehenge: $10,000,000 federal
  - Urban Atlantic: $5,000,000 federal
  - Chase Community Equity: $5,000,000 federal
- **Investor** – JP Morgan Chase
- **Closed** – September 20, 2013

- NMTC financing assisted DTS with the purchase of new and used equipment and the retrofit of a 375,000 square foot building.
- The project will retain 350 jobs and create an additional 166 new jobs with the potential to create an additional 100 full-time jobs at full production over the 7-year NMTC period. The average wage of these jobs will be $39,000 annually with health benefits.
- DTS is a newly formed joint venture, which will qualify as a Tier 1 automotive supplier. The joint venture is led by a successful, Detroit-based African American automotive entrepreneur.

**Benefits** –
- Longer than standard amortization
- Below market interest rates
- More lenient credit standards
- NMTC debt to be acquired through put/call
Case study #2

Le Centre on Fourth - Rehabilitation of the Stewart Dry Goods Building

- **Location** – Louisville, KY
- **Project size** – $79 million
- **NMTC Allocation**
  - Stonehenge: $21.5 million federal
  - Stonehenge: $10 million of KY NMTC allocation
- **Investor** – U.S. Bancorp Community Development Corporation
- **Closed** – 10/18/2013

- The renovation and rehabilitation of the Stewart Dry Goods Building into a multi-use building with a 270 room Embassy Suites, 100,000 square feet of commercial space and 25,000 square feet of retail space.
- The NMTC financing supported the construction of the facility and will support the creation of 200 new jobs.
- Due to the costs associated with historic rehabilitation, the Developer was unable to satisfy lender’s loan to cost requirements.

**Benefits** –
- Longer than standard amortization
- Below market interest rates
- More lenient credit standards
- NMTC debt to be acquired through put/call
Case study # 3

Rebuild Morgan County
- **Location** – West Liberty, KY
- **Project size** – $17.8 million
- **NMTC Allocation**
  - Pacesetters CDE
  - People Incorporated Financial Services
  - Chase Community Equity (JPMorgan/Chase)
- **Investor** – JPMorgan/Chase
- **Closed** – 1/7/2013

- The NMTC financing supported the Renovation of the Morgan County Courthouse and new construction of the Morgan County Health & Wellness Center.
- Despite a variety of financing sources, a gap remained in the capital stack that was required to complete construction and renovations necessary to rebuild facilities that provide critical services in a rural area.

**Benefits** –
- Leveraged other financing sources
- Longer than standard amortization
- Below market interest rates
- More lenient credit standards
- NMTC debt to be acquired through put/call
Summary

- NMTC financing can fill a gap in project’s capital stack
- Flexible financing terms
- NMTCs can be used to create jobs, encourage expansion, and attract and retain businesses in the state of Kentucky
- The project must be located in a qualified census tract
- Used by for-profit and non-profit organizations
Questions & Answers
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