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Strategic Tax Credit Investments

BEACON HILL CAPITAL

LIHTC Market Update

July 20, 2018

Friends & Colleagues,

The goal of this newsletter is to provide a LIHTC market update in the context of multi-investor fund pricing and yields. Due to investor interest, we've decided to provide updates on a roughly semi-annual basis to coincide with typical fund cycles with additional updates circulated at significant market inflection points, as necessary. As always, this update is a collaborative effort with our colleagues at Beacon Hill Capital.

Together Strategic Tax Credit Investments and Beacon Hill Capital represent nearly a dozen LIHTC syndicators of various sizes including both for-profit and non-profit sponsors. Combined, our syndicator partners account for more than 50% of the syndicated LIHTC market. Broad market representation is the foundation of our information-based approach to the brokerage and advisory services we provide, and it is the basis of the commentary that follows.

Contents:

I. Supply and Demand
II. Tax Reform
III. Base Erosion Anti-Abuse Tax
IV. CRA Reform
V. Opportunity Zones
VI. Rising Interest Rates
VII. 10 Yr. Treasury & BBB's
VIII. Secondaries
IX. 2018 – Second Half Outlook
X. Yield Analysis Charts

Preface

We hope you find this update informative and helpful and welcome your comments and perspective.

This issue follows our January 2018 newsletter. In addition to revisiting pricing, spreads to treasuries and BBB bonds, and a number of topics from the January newsletter, this edition introduces new topics including the prospect of CRA reform, Opportunity Zones, and the passing of the Consolidated Appropriations Act, 2018 (the "Act"), which included important changes for the LIHTC program.

Photo Courtesy: CREA, LLC

Supply & Demand

The substantial drop in the corporate tax rate from 35% to 21% begged the question as to how demand for credits would be affected.

We can report that demand for credits remains stable for two primary reasons: 1) robust CRA needs from banks, which account for about 85% of all LIHTC buyers, and 2) certain provisions in the Tax Cut and Jobs Act ("TCJA") that broaden the tax base, particularly for insurance companies, resulting in greater tax liability despite the lower rate.

While there has been some loss of demand from investors as they reassess their tax appetite in the wake of TCJA, Fannie Mae and Freddie Mac ("GSEs") have returned to the LIHTC market as equity buyers in 2018, and as the GSEs ramp up their activity, they could account for up to 10% of the market by year-end.

Lastly, most if not all tax credit syndicators would like to grow their annual syndication volume if possible. When demand is stable or increasing, competition for transactions is intense. All of our syndicator partners currently report upward pressure on tax credit prices to secure new transactions indicating a declining yield trend if the investor market will bear it.

On the supply side, it is important to point out that the size of the equity market is a function of tax credit pricing. As pricing adjusted downward 12-15 cents in 2017, and another 3-4 cents over the first half of 2018 to account for the difference between the 25% tax rate consensus and the actual 21% tax rate, the total size (market capitalization) of the equity market is down 15% or more since the end of 2016.

On March 23, however, the President signed the $1.3 trillion FY 2018 omnibus spending bill into law. The Act included a 12.5% allocation increase for the next four years for the 9% low income housing credit, which partially offsets the smaller market size (and fewer housing units produced) from the lower equity prices.

In addition, the Act includes several other provisions that support the LIHTC program including an income averaging option for LIHTC properties (making it easier to find income qualified tenants), a $4.7 billion annual budget increase for HUD and an extension through 2024 with an increase to the cap to 455,000 units for HUD's Rental Assistance Demonstration (RAD) program.

Tax Reform – Outstanding Issues

Many investors took the better part of Q1 to get direction from their tax departments to determine potential appetite for credits. For many non-programmatic investors, a reevaluation of their legacy portfolio was needed.

The new law allows real property and site improvements, assets with depreciable lives less than 20 years, to be expensed 100%. Furthermore, TCJA has capped interest expense deductions at 30% of adjusted taxable income unless you elect to opt out as a real estate business. It is expected that instead of depreciating real property at 27.5 and capping interest expense deductions at 30%, LIHTC projects will opt out and consequently be required to utilize the Alternative Depreciation System ("ADS") and depreciate real property over 30 years (which was reduced from 40 years by TCJA). Please note the bonus depreciation provisions begin to phase out in 2023. In general, 2017 funds did not assume any change in depreciation or expensing.

Base Erosion and Anti-Abuse Tax (BEAT)

In January, we highlighted that the Base Erosion and Anti-Abuse Tax ("BEAT") component of tax reform could negatively impact demand for LIHTC for a substantial cohort of LIHTC investors who are foreign-owned corporations or U.S. corporations with substantial foreign operations. BEAT is essentially an alternative minimum tax that applies to certain taxpayers and is calculated in such a way that it would reduce the value of LIHTC for these firms by 20% through 2025 and 100% (zero value) after 2025.

There are continued rumblings from several BEAT-affected investors as tax departments continue to analyze the implications. To date, however, for the reasons stated below, BEAT has had minimal impact on LIHTC demand.

While there are a significant number of banks and insurance companies (20 or more) that are active LIHTC investors that have had to evaluate their tax appetite in the context of BEAT, it seems that CRA requirements have prevailed over BEAT considerations for CRA investors. Non-CRA investors also seem to have figured out a way to minimize the impact of BEAT or restructure around it, at least for the time being. While there are investors whose demand for credits has been impacted by BEAT, it has not been significant enough to date to move market pricing materially.

CRA Reform

There has been some conceptual discussion of CRA reform over the last several years, but recent moves by the Office of the Comptroller of the Currency ("OCC"), who regulates a number of banks that are also LIHTC investors, has brought the issue to the fore. Joseph Otting, who was appointed by the Trump Administration to lead the OCC, has been a vocal proponent of CRA reform for banks and appears willing to act unilaterally from other bank regulators toward that end.

A recent letter sent by the OCC to a member bank, reclassified this particular bank from a Wholesale Bank to a Special Purpose Bank apparently because it has suspended its lending activities. As a reclassified Special Purpose Bank, it was informed by the OCC that it is now exempt from CRA requirements.

While this bank is a small LIHTC equity investor and its circumstances may be unique, its reclassification as a Special Purpose Bank got the industry's attention. We are part of a working group formed by the Affordable Housing Tax Credit Coalition to stay on top of this issue. We are now focused on upcoming guidance expected to come from the OCC in the coming weeks.

Opportunity Zones

As part of the TCJA, the new Opportunity Zones program was designed to direct capital into economically distressed communities across the country. Governors in each state have recently designated certain low income census tracts as Opportunity Zones. For more information, please see:
https://www.enterprisecommunity.org/opportunity360/opportunity-zone-eligibility-tool
https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

The incentive is designed as a capital gains tax deferral and elimination. It requires investors to place capital gains from previous investments in new Qualified Opportunity Funds (funds investing at least 90% of capital in qualified businesses within the designated zones). The deferral and elimination of these capital gains taxes applies only to the gains accrued after the initial investment.

To achieve this capital gains tax deferral, basis is increased by 10% after holding the investment for five years. There is an additional 5% increase in basis after the investment is in an Opportunity Fund for seven years. Finally, all capital gains are eliminated if the investment is held for at least 10 years.

We are members of an active working group within the industry, led by Novogradac & Co., which currently has over 45 industry participants. This week, the group is sending a letter to the IRS and treasury to request guidance on, among many other specifics, whether residential rental property businesses can qualify as 'Opportunity Zone Businesses'.

LIHTC projects that are in designated Opportunity Zones may ultimately command higher pricing over time if LIHTC equity funds can successfully conflate Opportunity Zone gain deferral benefits. However, at this time the ultimate impact Opportunity Zones will have on the LIHTC program is still unclear.

Rising Interest Rates

The prospect for rising interest rates and the continued flattening of the yield curve remains a factor in the consideration of LIHTC yields in 2018. While further increases in short-term rates through the overnight federal funds rate are expected for 2018 and beyond, long-term treasury rates are also expected to rise as the Fed continues to look to reduce its balance sheet through quantitative tightening.

10 Yr Treasury & BBB's

Due to the industry's size and specific characteristics, LIHTC yields do not correlate directly with Treasury yields; however, the 10-Year remains a common and important reference point. Over the past 15 years, the spread between LIHTC yields (non-CRA yields in national funds) and the 10-year Treasury yields (on an after-tax basis) has ranged from approximately 135 bps in 2006 to 900 bps in 2010, averaging approximately 435 bps. Just after the Presidential election in 2016, the spread was approximately 400 bps. Using a non-CRA 5.75% after-tax QIRR from the most recent round of closed multi-investor funds, that spread today is approximately 350 bps.

A slightly better historical correlation can be seen between LIHTC yields and BBB corporate bond yields. Looking at the historical spread between LIHTC yields (non-CRA yields in national funds) and the BBB corporate index (option-adjusted and on an after-tax basis) over the last 15 years, multi-investor LIHTC funds have been approximately 300 bps higher on average. For additional context, the spread to BBB got as low as 50 bps in 2006, and as high as 675 bps in 2010. Most relevant perhaps is 2016, where the average spread on an after-tax basis (assuming a 35% tax rate) was approximately 200 bps in July, and increased to roughly 220 bps after the election. Again, using a 5.75% QIRR, that spread today has decreased slightly to just over 200 bps.

The spreads between LIHTC and the 10-year Treasury and BBB corporate bond yields, indicate current LIHTC yields should remain acceptable in the near-term and that demand should remain steady.

Secondary Market Offerings

Secondary sales of LIHTC portfolios have been relatively limited over the past few years. Due to BEAT, we had anticipated increased secondary market activity in 2018, but as of mid-year, we are not seeing a substantial number of secondary portfolios coming to market. We are aware of about a half dozen secondary transactions that have come to market, or are coming to market in 2018, some of which have already found buyers. The largest of these was approximately $200M in size and the rest are generally in the $50-100M range. Most, if not all, are expected to transact between banks. As a result, secondary activity is currently having no measurable impact to primary market pricing.

Fund Pricing

It must be emphasized that there is always a range in LIHTC yields throughout the market. Reasons for this include, but are not limited to, an inefficient market, differences in portfolio composition, sponsor strength, load, and use of bridge financing.

Our pricing summary focuses on three specific segments: multi-investor national funds; CRA versus non-CRA pricing; and California regional fund pricing. Below, we discuss 2018 pricing since January.

As was the case in 2017, it took some trial and error in Q1 and Q2 for funds to settle into a new pricing equilibrium. If the 21% corporate tax rate translated into an additional three to four cent decline in credit prices to be yield neutral, it is fair to say that most syndicators tried to split the difference initially by bringing funds to market with about a two-cent loaded price per credit reduction from previous funds. This approach allowed them to remain competitive acquiring transactions while satisfying a cohort of fund level investor demand. However, as more funds came to market and competition for investor equity increased, national funds had to further reduce pricing to access most economic investor demand and sell their funds.

At mid-year, most national funds seeking to attract non-CRA equity were priced in the $.95-.98 range on a fully loaded basis with after-tax IRRs in the 5.50-6.00% range. Prices were higher for CRA-only funds. These funds were generally broken into 'CRA tiers' with transactions, or groups of transactions, priced individually depending on their geographic location.

One variable affecting IRR and price per credit ranges is the amount of bridge financing. In general, nearly all national funds assume some modest level of bridge financing to manage capital calls, while most use additional bridging to enhance yield. For investors that are focused on the lowest price per credit and little or no bridging, a number of funds offer an unbridged investment class option, which results in a lower IRR. Conversely, some offer bridged returns for investors focused on a higher IRR, which increases the gross price per credit. These options appeal to different investors based on their internal investment models.

Investors with CRA needs are less price sensitive than non-CRA buyers. As a result, there is often bifurcated pricing in the market where there may be downward yield pressure generally, but non-CRA investors may be resistant to lower yields or even require higher yields (due to rising rates, alternative investment returns, etc.).

For syndicators and funds reliant on non-CRA equity, they have little choice but to deliver the returns necessary to attract that equity and this is usually accomplished by reducing the load they realize on the fund. Furthermore, during times, when the spread between non-CRA and CRA yields is growing, we tend to see smaller national funds and more state specific regional funds.

As we go to press, funds for the second-half of 2018 that will be closing by year-end, or early 2019, are just coming to market. We expect the first of those funds to officially launch by the end of July, and for others to follow by summer's end. In general, our expectation is for pricing to stay consistent with the most recent fund closings despite continued pricing pressure at the property level. For the second-half of 2018, we expect non-CRA national fund yields to hold steady and range from 5.50% to 6.00% and loaded price per credit in the mid-90s with a limited number of exceptions at both ends of the range. We expect CRA yields to hold steady as well and generally range between 4.00% and 5.00% with the most competitive CRA areas (e.g. Bay Area, NYC 5 boroughs, Utah, etc.) selling below that.

For California regional funds, we expect the market to be highly competitive this fund cycle due to an increase in the number of fund offerings. The timing of the closings of these various offerings will be important. If supply exceeds demand, we could see yields rise and/or see more California product layered into national funds. To the extent that syndicators are willing to push off closings into Q1, they can potentially access 2019 investor equity allocations and help to balance this supply and demand imbalance and avoid having to raise yields.

Why are more CA funds coming to market? A number of syndicators have substantial CA originations capacity and are looking to segregate the higher priced CA fund product from their national funds. This lowers the overall pricing of the national fund and allows those funds to be more competitive for non-CRA equity whereas typically 100% of CA regional fund equity comes from CRA investors. It is also important to remember that California has the most 9% credit allocation due to its population size and also a very active and aggressive use of private activity bond allocation, increasing supply of 4% transactions. It also has a number of markets with very strong real estate fundamentals and a large number of banks.

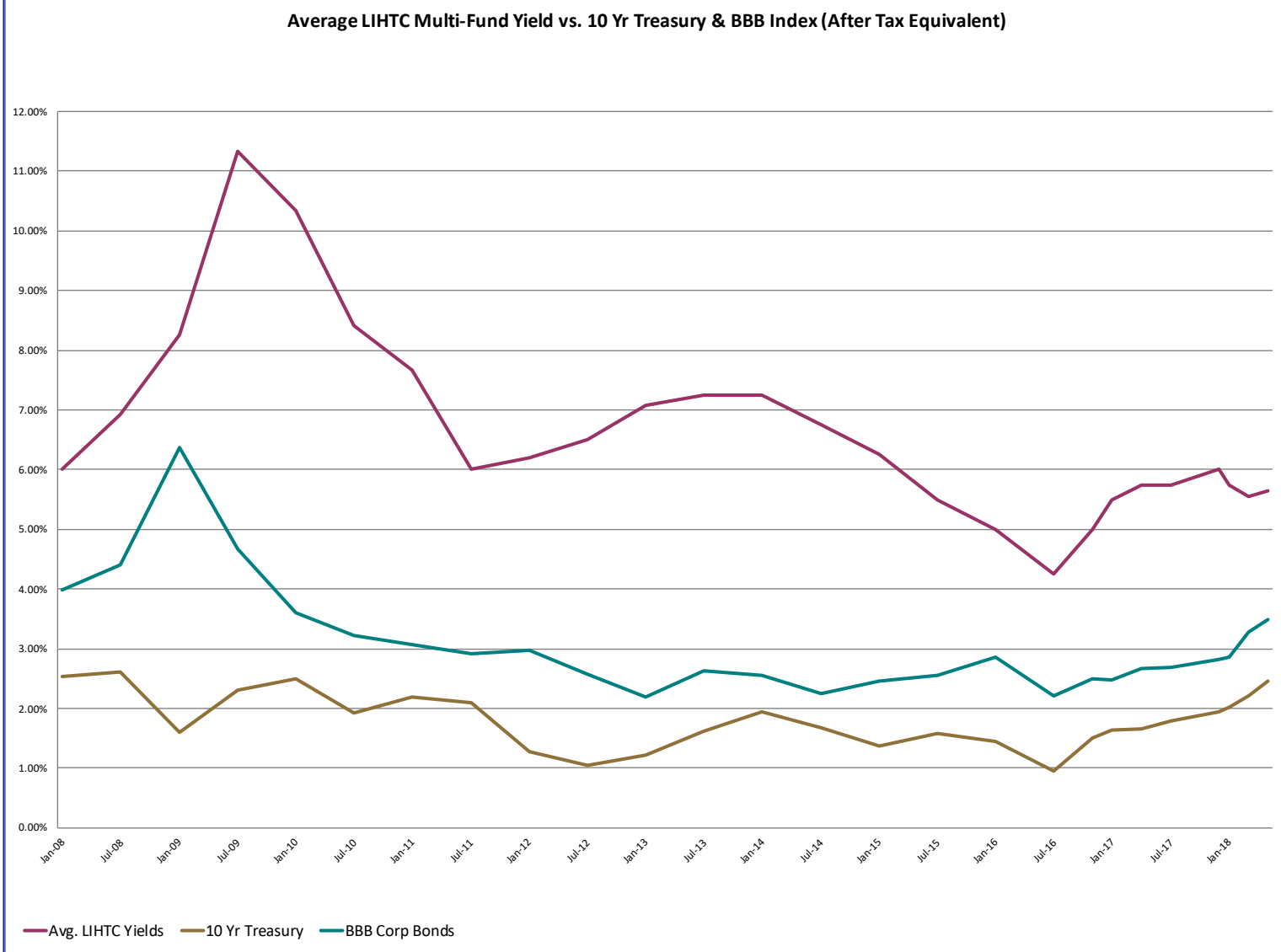
At mid-year, most CA regional funds are priced in the 4.00% to 5.00% range. A fairly limited amount of equity is raised outside that range – below 4% is typical for the Bay Area and above 5% can be found occasionally for less competitive CRA portions of the state.

Our next market update will be in January and as always welcome your feedback and comments. Please feel free to contact us with any follow up questions, or if you'd like to discuss the LIHTC market and fund offerings in more detail.

You can reach Dave Robbins at 617-340-7040 and Brian Rajotte at 503-575-9232.

Again, our thanks to John McDonald, Mike Connolly, Chris McCarthy and Garret Daigler at Beacon Hill Capital for their contributions and insights to this market update. You can reach them at (781) 740-8981.

LIHTC Yields Against BBB Corp. Bonds & 10 yr Treasuries



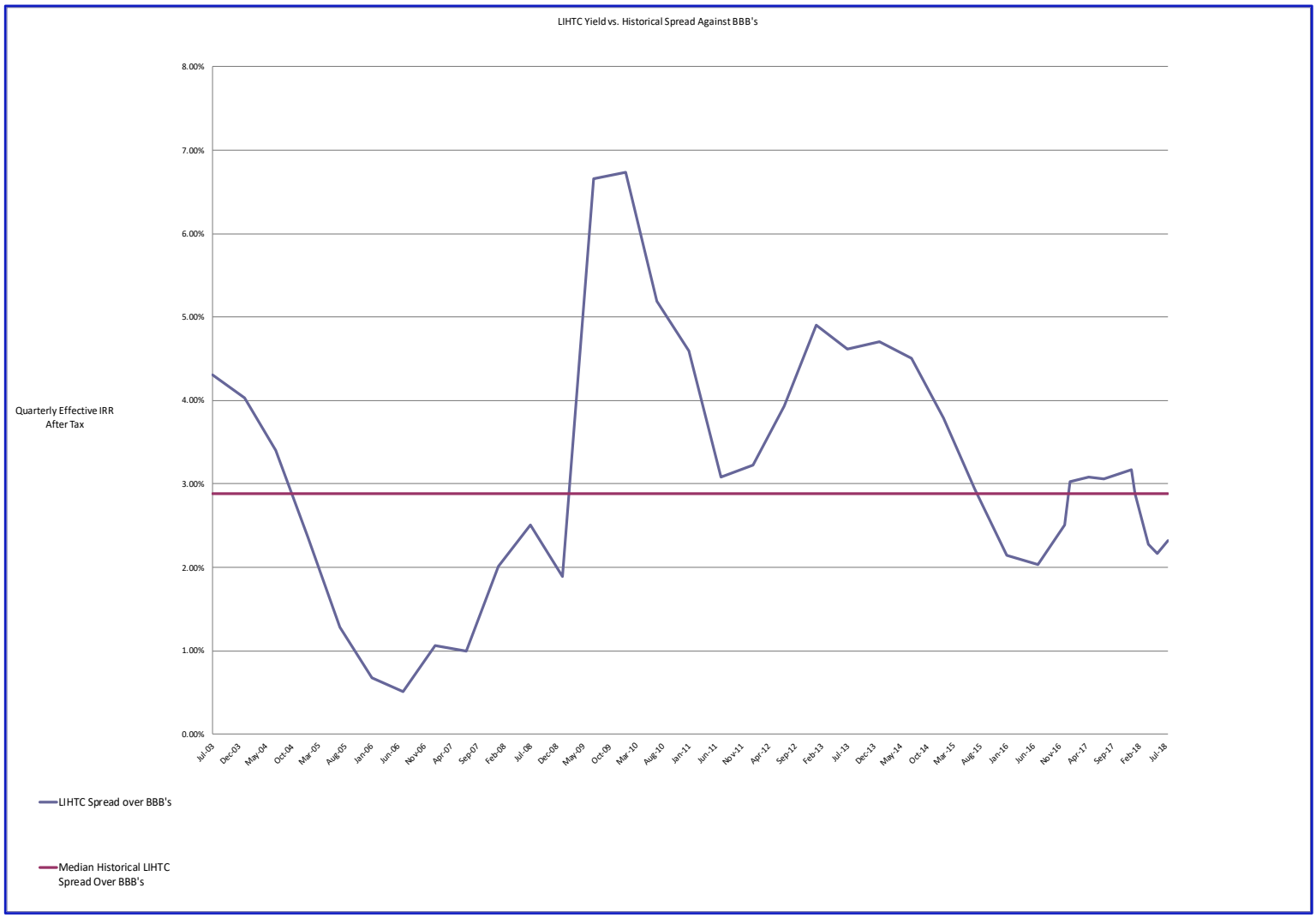
Notes:

Avg. LIHTC Yields: informal survey of non-CRA economic sell yields for multi-investor national LIHTC funds on a quarterly effective after tax basis.

10 yr treasury: Yields adjusted to represent an after tax yield **Source**: treasury.gov

BBB Yields: OAS adjusted to represent an after tax **Source:** BofA Merrill Lynch, BofA Merrill Lynch US Corporate BBB Effective Yield© [BAMLC0A4CBBBEY], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY

Historic Spread Against BBB Corp. Bond Index



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BBB Yields: OAS adjusted to represent an after tax **Source:** BofA Merrill Lynch, BofA Merrill Lynch US Corporate BBB Effective Yield© [BAMLC0A4CBBBEY], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY