Affordable Housing Market Update

February 4, 2019

Friends & Colleagues,

The goal of this newsletter is to provide our syndicator and investor clients a market update with respect to both low-income housing tax credits (LIHTC) and affordable housing preservation and workforce housing funds (preservation funds). While our LIHTC analysis considers pricing across the entire equity market, including direct investments, proprietary funds, guaranteed funds, and secondary sales, our primary focus is on multi-investor fund pricing and yields.

Our commentary on preservation funds is a new addition. Preservation funds in this context are non-tax advantaged real estate equity funds that make investments in Class B and C multifamily properties and they generally qualify under the Community Reinvestment Act (CRA) as public welfare investments (PWIs) by targeting low- and middle-income renters. This segment of the affordable housing market has continued to grow over the last five years and a number of the fund sponsors we represent offer these funds in addition to their LIHTC funds.

In addition to our discussions on pricing, supply and demand, and the interest rate environment, other topics in this newsletter include the recent Federal government shutdown, Opportunity Zones, CRA reform, and the Base Erosion and Anti-abuse Tax (BEAT) as it relates to demand and secondary market activity.

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 a wide range of affordable housing 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.

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

This issue follows our July 2018 newsletter, which is available upon request.

Contents:

Charts:

I. Preservation Fund Market Overview

Preservation funds, sometimes referred to as workforce housing funds, constitute a segment of the multifamily market that is typically comprised of existing, older multi-family rental properties with rents at or below 80% of Area Median Income (AMI). These properties may or may not have some form of government subsidy. Those without rent restrictions or subsidy are often referred to as naturally occurring affordable housing (NOAH). These funds can be attractive to investors that have less appetite for tax advantaged product. An additional point of differentiation is a shorter hold period; 5-8 years for preservation compared to 11-17 years for LIHTC.

Over the last five years, the number of preservation funds have proliferated and pricing and terms have started to coalesce.

There are a range of fund sponsors with differing goals (some are more mission based, some are not), different investment models, different product sourcing strategies, and these funds fall along a spectrum as it relates to qualifying as PWIs. Currently, banks make up the majority of investor equity as investments in these funds can qualify for the CRA investment test (and CRA lending test if a lending opportunity exists). Other preservation fund investors include endowments, charitable foundations, family office and high net worth individuals. Investments by insurance companies have been limited presumably because of risk-based capital charges relative to target returns.

We currently work with a number of fund sponsors, and since last year, pricing seems to have settled into equilibrium. Across these sponsors, multi-investor fund sizes range from $50M to $750M with $100-200M being typical. Preferred returns have generally fallen in the 6.00 - 7.00% range on a **pre-tax basis** with total returns falling between 8.00 and 11.00%. It looks like this pricing will continue into the first half of 2019.

Where many sponsors of LIHTC funds are able to launch and close two multi-investor funds per year, the fund cycle for preservation funds is considerably longer than LIHTC funds. Preservation funds typically have multiple equity closings over a year or more and take longer to deploy that capital into property acquisitions.

II. LIHTC Market Overview

With the drop in the corporate tax rate from 35% to 21% now behind us, the LIHTC market found equilibrium in the second half of 2018. The California regional fund submarket was the exception as supply exceeded demand at year-end.

Nationally, there was some loss of demand in 2018 from investors as they reassessed their tax appetite in the wake of tax reform. However, Fannie Mae and Freddie Mac (GSEs) returned to the LIHTC market as equity investors in 2018 and roughly offset that demand. The GSEs will continue to ramp up their equity investment activity in 2019 and are expected to account for roughly 7% of the market this year ($1B of a roughly $14B equity market).

It should also be noted that supply continues to exceed demand for LIHTC investment in Puerto Rico and other non-contiguous U.S. territories. The appetite for equity investments in these areas continues to be very limited even for properties with no hard debt and strong developers. Some of the supply has been picked up by the GSEs (notably Freddie Mac), a good example of GSEs providing equity (and debt) to underserved markets in line with their mandate.

In addition, several corporations have made news by announcing commitments to affordable housing over the past year including Microsoft (previous LIHTC equity investor, $500M debt program announced in 2019); Facebook (2019 announcement through the Chan Zuckerberg Initiative along with other organizations for a $500M debt program); and Kaiser Permanente ($200M equity announced in May 2018). While this is positive for the affordable housing industry, we don't anticipate these commitments to move the equity market pricing in the near-term. The majority of these commitments will be in the form of loans and focused in the San Francisco Bay Area.

A. Pricing Outlook

It is important to emphasize 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 the outlook for pricing during the first half of 2019.

In general, investors with CRA needs are less price sensitive than non-CRA investors. CRA pricing can apply to investors who require a CRA letter on individual transactions, or groups of transactions depending upon their geographic location. As a result, there is often bifurcated pricing in the market. Where there may be upward pressure on pricing in general (a downward yield trend), non-CRA investors typically require higher yields.

The influence that the non-CRA component of the equity market has on property-level pricing is limited. However, this segment of the investor market can move market pricing at the fund level. When returns are inadequate for non-CRA investors, fund sponsors who rely on them will cut fees and raise yields as necessary to clear their funds.

Lastly, during times of steady or declining yields we tend to see larger multi-investor funds and that is what we are seeing now. Currently, national funds are ranging from $100M to $250M in size.

B. National Funds

For the broader LIHTC market, post-tax reform pricing settled out in the second half of 2018 and has carried over into the first half of 2019 as several funds have come to market in Q1 and have traction at those pricing levels.

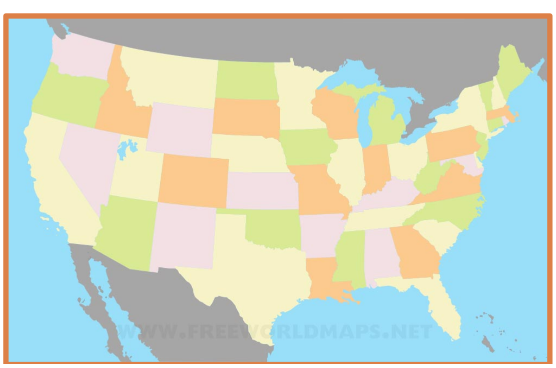
At this time, national funds seeking to attract non-CRA equity generally have after-tax yields in the 5.50% to 6.00% range on a quarterly effective IRR basis. This correlates to a fully loaded price per credit in the $.93-.98 range.

Pricing is generally higher (yields lower) for funds with CRA-tiered pricing or CRA-only funds as discussed below. Within the above range, many funds offer higher returns for larger investments, what we refer to as break-point pricing. Leverage is an important point of differentiation among funds. Funds with higher hard-debt ratios often have higher yields or a lower price per credit than funds with lower leverage, but not always. Generally, fund hard debt ratios (hard debt to total development cost) range from 20% to 40%.

Investors seeking higher returns can sometimes find them in funds with higher leverage ratios, or different risk profiles, such as exceptionally large transactions, or those with extraordinary subsidy risk (Section 8 overhang), mixed-income transactions (e.g. 80/20 deals), assisted living projects, or transactions in Puerto Rico and U.S. territories such as Guam or Saipan.

We expect CRA yields to generally hold steady or trend down slightly and range between 4.00% in higher demand areas to around 5.00% for less competitive CRA markets. There will be some yields below this range in the most competitive areas (e.g. Bay Area, NYC 5 boroughs, Utah, etc.), and above this range in certain funds. For multi-investor funds, our expectation is that 3.75% will be the lowest yield we will see in the first half of the year (down from 4.00% in the previous fund cycle) and we are aware of CRA yields as high as 5.50% currently being offered.

One variable affecting yield 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. A majority of syndicators use additional bridging to enhance yield, which increases the gross price per credit. For investors that are focused on the lowest price per credit with little to no bridging, a number of funds offer an unbridged investment class option, which results in a lower yield. These options appeal to different investors based on their internal investment models. It should be noted that the ability of syndicators to enhance investor returns with bridge financing has diminished as interest rates have risen.



C. California Regional Funds

One exception to price stability in 2018 was the California regional fund market. In our July newsletter we highlighted the likelihood for yields to increase in CA fund offerings. Several factors contributed to a temporary dislocation of that segment of the LIHTC market and the increase in yields ultimately came to fruition.

In 2018, the supply of 4% bond transactions in California increased substantially from 2017 levels. This increased supply combined with relatively high pricing, which if placed in national funds can skew pricing metrics upward, prompted a number of syndicators to offer CA regional funds. At the same time, there was a decrease in demand as several investors had less appetite for credits following tax reform.

As a result, a number of funds ended up being smaller than their initial target sizes and yields rose to attract investors. In years past, it would have been typical for CA fund yields to be 100 basis points lower than national funds. During the second half of 2018, several funds offered premium yields to large, anchor investors that approached national fund yields.

This prompted us to discuss the opportunity of anchoring CA regional funds with several investors as a way for them to realize above market returns. One challenge in being a larger investor in these funds ($20M or more) is ownership percentage. CA regional funds are usually less than $100M in size and often times investors are internally limited to less than 25% ownership of any fund.

Because of the recent volatility, we are less confident in our outlook for CA regional funds over the first half of 2019, but initial indications are that pricing has stabilized for the time being. One of our syndicator partners came to market with a relatively large CA fund in January and has circled commitments of nearly $100M at pricing generally consistent with the pricing outlined below.

For the first half of 2019, we anticipate CA regional funds to generally be priced in the 4.00% to 5.00% range on an after-tax basis. 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. We expect that larger investors ($20M or more) will be able to achieve yields above 5.00%.

As always, given the more limited number of investors who participate in the CA regional fund market, we see more volatility in pricing as the CRA cycles ebb and flow and the number of offerings from syndicators expand and contract. If too many funds come to market simultaneously, we could see a repeat of Q4 with smaller funds and rising yields, particularly for anchor investors.

III. Interest Rates

The prevailing consensus for rising interest rates and a continued flattening of the yield curve has been challenged recently. Global trade negotiations, the impact of tariffs, slowing economic growth both here and abroad, the impact of the recent government shutdown as well as the risk of another one, have all contributed to greater volatility in the stock and bond markets. Add to this the most recent comments by the Federal Reserve which indicates they have no plans to increase short-term rates further, and may even reduce them if necessary. All of these factors seem to be contributing to investors acceptance of current LIHTC yields.

IV. 10 Yr Treasury &

Due to the industry's size and specific characteristics, LIHTC yields do not correlate directly with Treasury yields; however, the 10-Year Treasury yield remains a common and important reference point. For those that follow it closely, the 10-year recently crested 3.20% in Q4 2018, then dipped below 2.60% due to the factors mentioned above. That it currently stands under 2.70% is one factor giving LIHTC yields some breathing room to interest rate concerns.

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 415 bps**. Using a non-CRA 5.75% after-tax QIRR as a proxy for LIHTC funds for economic investors, that spread today is **358 bps**, consistent with declining spreads that come with long-term economic expansion.

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 fund returns have been approximately 290 bps higher on average. For additional context, during a particularly high demand period for LIHTC, the spread to BBB got as low as 50 bps in 2006, and conversely, as high as 675 bps in 2010 when demand was low. Again, using a 5.75% QIRR, that spread today has decreased slightly to just over 215 bps.** This 215 bps spread is reflective of a relatively stable LIHTC market combined with lower yields offered on alternative investments.

The spreads between LIHTC and the 10-year Treasury and BBB corporate bond yields help support our view that LIHTC yields should remain acceptable in the near-term and that demand should remain steady in the first half of the year.

V. Base Erosion Anti-Abuse Tax

Last year we highlighted that the 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 companies by 20% through 2025 and 100% (zero value) after 2025.

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. Economically motivated, non-CRA investors also seem to have figured out a way to minimize the impact of BEAT or structure 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 materially impact market pricing.

VI. Secondary Market Offerings

Secondary sales of LIHTC portfolios have been relatively limited over the past few years. Due to BEAT, we anticipated increased secondary market activity and we are finally starting to see it. We are aware of about six secondary transactions that are under agreement or have closed totaling about $500M. Most if not all of these transacted directly between banks and did not impact the primary market. There is also a large, national syndicator that intends to gradually sell off nearly $1B of LIHTC product through its fund offerings over the next several years. It is expected that this secondary volume should differentiate the sponsor's fund offerings (seasoned product, more immediate credits) rather than impact broader primary market pricing.

VII. CRA Reform

While there has been some conceptual discussion of CRA reform over the last several years, proposals in 2018 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 has been willing to act unilaterally from other bank regulators toward that end.

The potential for CRA reform, and its potential impact on demand, seems to have moved to the back burner for the time being as Otting has subsequently been designated the concurrent Acting Director of the FHFA in addition to his responsibilities at the OCC. Furthermore, the OCC is busy reviewing approximately 1,500 letters they received to their Advanced Notice of Proposed Rulemaking. The recent partial Federal Government shutdown as well a reversal by the OCC with respect to the position it had taken with a member bank (discussed in our July, 2018 newsletter) removed some of the momentum the effort had last year. Talk of CRA reform is expected to remain quiet for the first half of 2019, but may return in the second half of 2019.

VIII. Opportunity Zones

As part of the Tax Cut and Jobs Act (TCJA), the new Opportunity Zones program was created to direct capital into economically distressed communities across the country. Governors in each state have designated certain low income census tracts as Opportunity Zones (OZs). 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 to defer and eliminate capital gains tax. It requires investors to invest capital gains from previous investments in new Qualified Opportunity Funds (funds investing at least 90% of capital in qualified investments 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 held 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.

Conceptually, OZs were not specifically designed to dovetail with LIHTC, therefore, OZs are not significantly impacting the LIHTC market at this time. There do seem to be some situations where LIHTC & OZ benefits can be realized together, however, there are still a number of open questions that need to be answered by the IRS. To date, only a relatively limited subset of investors have expressed interest in OZs or are looking for potential yield enhancement from OZs. Nonetheless, a subset of industry participants are very focused on finding the synergy between these two programs and developers with affordable housing on parcels in OZs are focused on their potential value. Some syndicators are attempting to structure funds so that they may capture any potential future value for qualifying projects. It is also important to note that unless the program is extended, the window to take full advantage of OZ program benefits will only apply to properties acquired through 2019, and partial advantage of OZ program benefits will apply to properties acquired through 2021.

LIHTC projects located 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.

IX. Federal Government Shutdown

With the partial Federal government shutdown over, at least until February 15th, the immediate threat to federally funded affordable housing programs has been suspended. Given the political risks associated with another shutdown, hopefully a budget deal will be reached and that there will be no further risk to affordable housing programs.

Still, the recent shutdown prompted some investors to ask us to summarize how affordable housing could be impacted so we have decided to include that summary here for your reference.

Many affordable housing properties have some form of federal rental subsidy, including Section 8. The Section 8 voucher program is funded on a calendar year basis. Monthly payments for November and December of 2018 were made. HUD's contingency plan, summarized below, did not clearly state where the funding for the Section 8 voucher program will come from in January 2019 and beyond. An ongoing shutdown would affect some 3,000 public housing agencies (PHAs), which needed to tap into reserves in order to continue making Section 8 housing payments. If a shutdown is prolonged, local housing authority reserves could be insufficient to continue making payments to properties. Below is the National Low Income Housing Coalition's summary of HUD's Contingency Plan along with a link thereto. Please note that this summary was issued while the shutdown was still active:

- **Public Housing.** Local public housing agencies (PHAs) are not federal government entities and thus will not shut down. But, PHAs receive significant federal funding and their hours and capacities may be impacted by the federal shutdown. Depending on the length of the shutdown, some PHAs may not be able to maintain normal operations. HUD recommends that local PHAs be contacted for information as to their operating levels.
- **Tenant-Based Rental Assistance.** According to HUD's plan, housing assistance payments (HAP) and administrative fees will be disbursed. However, any funding action which requires HUD staff will not be processed during the government shutdown. Obligated HAP funds (HUD-held reserves) are available for draw. HUD will not process requests for tenant protection vouchers for public housing or multifamily actions during the shutdown. PHAs are not required to cease issuing vouchers during a government shutdown. PHAs should assess their financial ability to make payments on behalf of currently assisted households as well as those potentially to be served when considering their ability to issue vouchers.
- **Project-Based Rental Assistance.** HUD plans to draw on advanced appropriations to continue housing payments for project-based contracts. According to HUD's plan, it will make payments under Section 8 contracts, rent supplement, Section 236, and project rental assistance contracts (PRACs) on an as needed basis to ensure ongoing viability of assets and preservation of affordable housing. Payments will be contingent on budget authority being available from prior appropriations or recaptures.
- **Homeless Assistance Grants.** According to the contingency plan, HUD homeless assistance grants, including supportive housing for veterans and housing for people with AIDS, will continue to be funded to protect life.
- **HOME Investment Partnerships Program, CDBG.** HUD will continue to disburse CDBG, HOME, and other block grant funds where prior year funds have been obligated. CDBG-DR will continue to be funded through multi-year appropriations.

https://www.hud.gov/sites/documents/HUDCONTINGENCYPLANFINAL.PDF

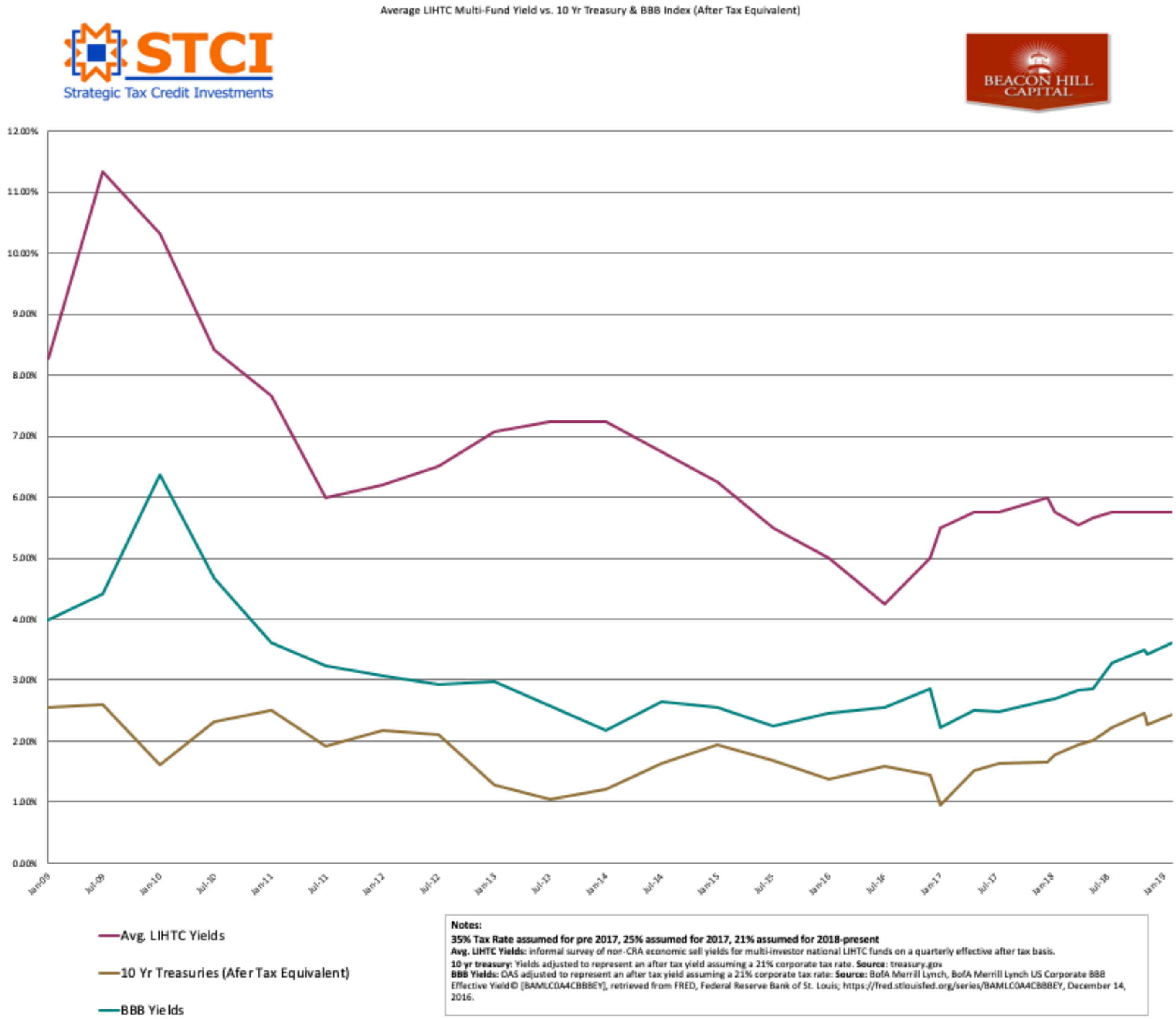
Our next market update will come out mid-year in sync with the second-half multi-investor fund cycle and as always welcome your feedback and comments. Please feel free to contact us with any follow up questions, or if you'd like to discuss the LIHTC market and fund offerings in more detail.

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.

A.

LIHTC Yields Against BBB Corp. Bonds & 10 yr Treasuries



B.

Historic Spread Against BBB Corp. Bond Index