Friends,

As we approach year-end, we want to take this opportunity to provide a post-election LIHTC market update. This update is provided in cooperation with our colleagues and frequent partners at Beacon Hill Capital. Together, STCI and Beacon Hill Capital are able to provide a more comprehensive view of the market today and what you can expect for early 2017.

The 2016 election results have brought swift change to the LIHTC industry. While significant market corrections in the past have usually taken many months to work their way through, this correction is different. Syndicators, lenders and investors started adjusting their assumptions about pricing and fund structures within days of the election results. This includes large, direct investors, who dictate tax credit pricing in some segments of the market. As a result, we have already seen re-trading of pricing and terms on a large number of transactions across the market at various stages of the closing process. There is no doubt that developers have received the message, and are adjusting their assumptions for all transactions yet to close.

While abrupt change always presents its challenges, there are several positive takeaways in this market correction. First, the market is adjusting rapidly. We are not only seeing the vast majority of investors following through on existing commitments for 2016, but investors moving forward with closings slated for Q1 2017. Second, LIHTC pricing was near all-time highs before the presidential election and there was evidence of the market hitting pricing ceilings for non-CRA and CRA investors alike. The inevitable reduction in LIHTC pricing of the post-election world will restore some breathing room at a new equilibrium point that works for both buyers and sellers. Third, historically high tax credit pricing has resulted in a large number of transactions that were overfunded, or certainly very well funded relative to historic levels. The result, in many cases, are properties that have little or no deferred development fees which can provide a source of capital as the market derives solutions to the prospect of tax reform. Lastly, unlike the immediate aftermath of the global financial crisis, there is still demand for LIHTC, and investors seem willing to move forward if the potential impact of tax rate reform is addressed.

There is no shortage of prognostications as to what the timing and details of tax reform will be and it will be some time until we have a better idea of what the legislation may look like. The good news is that we are already seeing an early consensus among market participants on how to mitigate the risk of corporate tax rate reform and move forward with new structures and pricing. The following is a summary of what we are seeing for funds and transactions closing in Q1 2017. Keep in mind that some of these points are *our* best educated guesses. While funds may not look exactly like this, these bullets provide an outline of things to look for and questions to ask as you consider new investments.

- **A 25% tax rate is the early consensus for underwriting** for the following reasons: in the event of tax reform, most believe corporate tax rates will end up at 25% or higher; and most transactions still "work" assuming a 25% tax rate.
- Investors (and lenders) **can't ignore the possibility of a 20% corporate tax rate**, so we expect funds to provide mechanisms to mitigate that by including one or more of the following:
  - Downward/upward adjusters
  - IRR maintenance structure or guarantees
  - Revised cash flow splits to investors at the property level (limited potential as this is very transaction/portfolio specific)
- **Pricing/Yields**: Tax credit prices are adjusting downward by about 10 to 15 cents to account for the prospect of tax reform. As a result, the fully loaded price per credit on LIHTC national funds should drop into the $.95 to $1.05 range depending on load, portfolio composition and bridging. In general terms, expect after-tax IRRs to match or exceed pre-election targets but with investors being insulated from tax rate risk down to a 20% rate. See more granular discussion of rising interest rates below.
- **Upside**: Investors should capture an upside to their IRR if tax reform doesn't happen if the rate ends up being above 25%, or if new tax rates are phased in over time.
- **Timing:** Underwriting will likely assume that a change in corporate tax rate is effective 2018. While a phase-in of lower tax rates is a real possibility, and perhaps even a likelihood, we believe most funds will model a worse case, cliff-like, scenario.
- **Deal terms -** Likely to become more favorable to investors as developers scramble to get their transactions done.

- **Depreciation/expensing -** Expect no modification to depreciation, interest deduction, or expensing assumptions in syndicator models, although all are possibilities as part of tax reform.
- **Fund specification -** This could be lower than recent funds. As transactions that can't withstand re-underwriting fallout, market disruption will create opportunities for syndicators and investors to identify new transactions at more favorable pricing and terms.
- **Fund Bridging:** Lower tax credit prices will allow syndicators to reduce fund level bridging and rising interest rates make bridging less attractive. As a result, we expect bridging levels to trend lower, although as with recent funds, we expect bridging levels across funds to vary.
- **Rising interest rates**: LIHTC yields not only need to take tax reform into account, but also rising interest rates and the increased attractiveness of non-tax advantaged alternative investments as well. Rising rates affect the sizing of debt on many transactions, particularly tax exempt bond deals. See expanded discussion below as well as attached file showing LIHTC yields and key rates graphically.
- **Opportunities:** There will be transactions that can not be easily restructured to account for tax rate risk and rising interest rates. The result should be a larger market correction for certain cohorts of deals which will result in buying opportunities for opportunistic investors. Bond financed transactions, with particularly high-losses, are one example.

Rising interest rates and the outlook for LIHTC yields (see attached file for graphical comparison)

In addition to the prospect of tax reform, the next round of LIHTC funds will be affected by rising interest rates. The 10-year U.S. Treasury yield has increased more than 100 basis points since July 2016. LIHTC yields, due to the industry's size and specific characteristics, do not correlate directly with Treasury yields, but the 10 Year remains a reference point. Over the past 15 years, the spread between LIHTC (non-CRA yields in national funds) and the 10-year treasury (on an after-tax basis) has ranged from about 135 bps in 2006 to 900 bps in 2010, and averaged approximately 435 bps. Just before the election, the spread was about 400 bps.

A better historical correlation can be seen between LIHTC national fund yields and BBB corporate bonds. 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 about 300 bps higher on average. For additional context, the spread to BBB got as low as about 50 bps in 2006, and as high as approximately 675 bps in 2010. Most relevant perhaps is 2016, where the average spread on an after-tax basis (assuming a 35% tax rate) was around 220 bps in July, and increased to 250 bps after the election.

So, where will non-CRA yields be on LIHTC national funds in Q1 and the first half of 2017 given everything that has transpired in the last 5 weeks? First, it must be emphasized that there is always a range in LIHTC yields in the market, not one yield. Reasons for this include and inefficient market, differences in portfolio composition, sponsor strength, load, and bridging to name several. What we can say is that we are seeing traction at 5.25% with tax rate risk mitigated down to a 20% or 25% rate for the first couple funds slated to close in Q1. Looking at the latest spreads to BBB corporate bonds also seems to support LIHTC yields in the low to mid 5s while the higher 15 year average spread suggests yields may trend higher over the course of 2017. When differences in sponsor strength, portfolio composition, and fund level bridging are factored in, we expect the next round of national funds to be priced from 5.25% to 6.50% (excluding lower CRA pricing) and assuming a 25% tax rate.

Thanks again to John McDonald, Mike Connolly, Chris McCarthy and Garret Daigler at Beacon Hill Capital for their collaboration on this update. You can reach them at (781) 740-8981.

We hope you found this update informative and helpful and welcome you comments and perspective. We will follow up with our LIHTC Market Update summary charts in January. We look forward to working with you in 2017, and wish you a successful closing to 2016 as well as happy holidays.

Warmest regards,