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Strategic Tax Credit Investments

BEACON HILL CAPITAL

Affordable Housing Market Update

July 12, 2019

Contents:

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Friends & Colleagues,

The goal of this newsletter is to provide our syndicator and investor clients a market update with respect to both the low-income housing tax credit (LIHTC) and preservation affordable housing funds.

For LIHTC funds, our focus is on multi-investor fund pricing and yields, but it also considers pricing across the entire market, including proprietary funds, guaranteed funds, secondary sales, and direct investor activity.

Preservation funds (sometimes also called workforce housing funds, or naturally occurring affordable housing (NOAH), in the context of this newsletter, are non-tax advantaged real estate equity funds in the Class B and C multi-family rental markets generally qualifying under the Community Reinvestment Act (CRA) as public welfare investments (PWIs) by targeting low- and middle-income households.

This segment of the affordable housing market has continued to grow and a number of the fund sponsors we represent offer these funds in addition to their LIHTC funds. Furthermore, a growing number of our investor clients have interest in these types of funds.

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 syndicators of affordable housing of various sizes including both for-profit and non-profit sponsors. Our combined 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.

This issue follows our February 2019 newsletter which, along with previous newsletters, are available on our website: www.StrategicTaxCreditInvestments.com

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

Disclaimer: The information provided in this market update is primarily for informational purposes only and is not a prediction or guaranty of actual events or outcomes and may not be relied upon by the recipient or any other persons for any reason.

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LIHTC Market Overview

Photo Courtesy: CREA, LLC

The headline story of this edition of our newsletter is the relative calm in the market after several years of change, or the specter of change during the lead-up to comprehensive tax reform. The LIHTC market has remained in equilibrium since our February update and we expect it to remain so through year-end with the exception of some unforeseen market shock. All indications are that supply and demand will remain in balance, while pricing and yields will remain largely unchanged.

The secondary headline is the dramatic decline in the 10-year U.S. Treasury and accompanying reversal in the consensus view that the trend for long-term rates is upward. Yields on the 10-year are down approximately 18% since February, and about 37% from late 2018. As a result of the decline in long-term rates, the spread between current LIHTC fund yields and long-term rate benchmarks are very close to their historic averages.

LIHTC Pricing Outlook

As always, we emphasize that there is a range in LIHTC yields across the market. Reasons for this include, but are not limited to, differences in portfolio composition, sponsor strength, load, the use of bridge financing as well as inefficiencies in the market.

Our pricing summary focuses on three specific segments: multi-investor national funds; CRA versus non-CRA; and California regional funds. Below, we discuss the outlook for pricing during the second half of 2019.

In general, investors with CRA needs are less price-sensitive than non-CRA buyers. 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 downward yield pressure generally, at times non-CRA investors may be resistant to declining yields, or even require higher yields (due to rising rates, alternative investment returns, etc.).

The influence the non-CRA component of the equity market has on lower-tier pricing (property level) is limited because it comprises only about 15-20% of the total market. However, this segment can move market pricing at the fund level. When non-CRA investors pull back, fund sponsors who rely on non-CRA investor equity will typically cut fees and raise yields as necessary to obtain the investor equity needed to clear their funds.

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Fund vs. Property Level Pricing Trends

Our pricing outlook for the next six months is based on both fund level and property level information from syndicators and investors. It is important to look at both because property level and fund level pricing do not always move in concert in the short-term.

For fund level pricing through year-end, syndicator assumptions are remarkably consistent. All syndicators we partner with indicate that their fall funds will have the same or similar pricing to their spring funds. Similarly, indications from investors are that demand will remain steady at current yields.

To confirm whether the fund level outlook is in sync with property level pricing trends, six syndicators, whose combined annual volume totals more than 25% of the market, contributed property level pricing data. Based on this data, pricing at the property level during the first half of 2019 has trended flat or downward slightly from 2018. This indicates both little or no pressure for syndicators to test lower sell yields in the coming fund cycle and that yields should remain steady through year-end.

National Funds

For the broader LIHTC market, pricing has remained relatively stable since the second half of 2018 and it seems that pricing will carry through Q4 2019 based on conversations with our syndicator partners regarding their fall funds. That said, we have seen declining yields in certain CRA markets.

At this time, national funds seeking to attract non-CRA equity are generally priced in the $0.95-$1.00 range on a fully loaded basis with after-tax IRRs in the 5.50-6.00% range. Pricing can fall outside of this range based on investment size and is generally higher (lower yields) for funds with CRA-tiered pricing or for CRA-only funds. See our attached Market Overview for National Funds.

At the higher-end of the yield spectrum, there are a number of economic investors that will make larger investments to secure premium yields within national multi-investor funds. There are also larger CRA-motivated banks that are making blended investments that mix both CRA selections at lower yields with non-CRA allocations in funds to achieve higher overall returns. Outside mainstream LIHTC multi-investor funds, some investors who require higher returns are willing to invest in funds with higher risk profiles, including mixed-income developments, assisted living properties, or LIHTC transactions with higher leverage.

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National Funds Cont'd

Overall, we generally see a yield range between 4.00% for higher demand metropolitan statistical areas and counties to 5.00% for less competitive CRA markets. The most competitive CRA areas (e.g. Boston, NYC five boroughs, Utah, etc.) have yields in the 3% range and periodically we hear about the odd investment, often on a direct basis, with a return in the 2% range for the most sought after investments, which often also include a combined CRA debt opportunity.

One variable affecting IRR and price per credit ranges is the amount of bridge financing being utilized by the fund sponsor. In general, most national funds assume at least some modest level of bridge financing to manage capital calls, and a number of syndicators use additional bridging to more effectively compete for product and enhance yield. For investors that are focused on the lowest price per credit and little or no bridging, some funds will offer an unbridged investment class option ("cash needs"), which results in a lower IRR.

Conversely, some syndicators offer bridged returns for investors focused on a higher IRR, which generally increases the gross price per credit. These options appeal to different investors based on their internal investment models. It should be noted that the use of bridging by syndicators varies depending on the spread between the cost of bridging and fund yields.

California Funds

One exception to price stability over the past 12 months was the California regional fund market. In our Q1 2019 newsletter we discussed a supply-demand imbalance that contributed to a temporary dislocation of that segment of the LIHTC market.

As previously discussed, the supply of tax-exempt bond financed transactions in California has increased substantially since 2017. The increase in supply and high price per credit at the property level has prompted a number of syndicators to offer California regional funds and the number of offerings continues to expand. At the same time, demand was somewhat reduced as several investors had less appetite for credits following tax reform. It should also be noted that, in late June, California Governor Newsom signed a budget that includes a $500M annual increase for California state LIHTC credits, any impact of which may be a topic for a future newsletter.

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California Funds Cont'd

Historically, California fund yields are approximately 100 basis points lower than national funds. However, over the last two fund cycles (approximately 6 months each), larger "anchor" investors have been able to achieve yield premiums approaching or equal to national fund pricing levels. CRA pricing across the country is now basically identical to the CA fund range of 4.00%-5.00% QIRR.

Because of this recent volatility, we are less confident in our outlook for California regional funds over the second half of 2019. Given the number of California fund offerings and the relatively limited investor demand, equilibrium is more delicately balanced than national funds so the timing of funds becomes more important. If a number of funds come to market simultaneously in the second half of the year, we could see yields rise, fund sizes shrink, and closings pushed off into Q1 2020 to clear the market.

For the second half of 2019, we anticipate California regional fund pricing to generally hold steady in the yield ranges stated above. Furthermore, we continue to expect that larger investors ($20M or more) will be able to achieve yields of 5.50% and perhaps higher.

See our attached Market Overview for California regional funds. Please note, while we make every effort to present accurate information in these summaries, we erroneously reported an incorrect price per credit for CREA's California regional fund in our February newsletter.

Secondary Market Transactions

Secondary sales of LIHTC portfolios are up substantially in 2019 with over $1 billion expected to close this year, or about 6-7% of the total equity market. We are aware of transactions ranging from $50M to $250M in size and a large, national syndicator that is selling off about $250M this year through its proprietary and multi-investor fund offerings.

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Interest Rate Environment

Since the financial crisis of 2008, the consensus view has generally been that both short and long-term interest rates would rise from their historic lows. The impact of rising interest rates expectations can be felt two-fold in the LIHTC market. First, at the property level where debt service ratios and loan sizing can be impacted by increased rates. Second, on the investor demand side where returns on alternative investments increase along with rising interest rates. This puts upward pressure on yields at the fund level and ultimately lowers credit pricing at the property level.

The prevailing consensus for rising interest rates and the continued flattening of the yield curve has been challenged recently. The ongoing impact of global trade negotiations, slowing global economic growth, the impact of the recent government shutdown, the rising risk of recession (and recent yield curve inversion), as well as commentary by the Federal Reserve Board of Governors, and most recently Fed Chairman Powell has upended this view.

10-Year U.S. Treasury (10-Year) & Corporate Bonds

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. For those that follow it closely, the 10-year recently crested 3.20% in Q4 2018, had dropped to 2.70% at the time of our February newsletter and has since plummeted to just over 2.00% due to the factors mentioned above. To date, the dramatic reversal in long-term interest rates has not impacted LIHTC fund yields, but the spread has certainly become more favorable and closer to the historic average.

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 widely from a low of approximately 135 bps in 2006 to a high of around 900 bps in 2010. This historic average has been approximately 435 bps. For context, just after the Presidential election of 2016, the spread was roughly 400 bps, close to the historic average. Using a non-CRA 5.75% after-tax QIRR from the most recent round of closed multi-investor funds, that spread today is somewhat below historical norms at approximately 412 bps.

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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 increased slightly to just over 291 bps. This 291 bps spread is reflective of a relatively stable LIHTC market combined with lower yields offered on alternative investments.

LIHTC Foreclosure vs Rated Bond Default Risk

While foreclosures and defaults are not an exact risk profile match for various reasons, we compared cumulative default rates of LIHTC properties with Global Averages Default Rates on S&P rated bonds. We analyzed data provided by our colleagues Cindy Fang and Matthew Barcello at CohnReznick from a survey of 22,993 LIHTC properties over the years 1997-2016. Notably, the LIHTC cumulative foreclosure rate is less than the cumulative default rates on AAA rated corporate bonds over a ten-year period. It is important to keep in mind, however, the vastly different size and efficiency of the bond market relative to the LIHTC industry and also, like the 10-Year, to not overstate the correlation between these asset classes. (see Exhibit A below).

Preservation Funds

Preservation funds constitute a segment of the multi-family market that is typically comprised of existing, older multi-family rental properties with rents at or below 80% of area median income (AMI) and may or may not have some form of government subsidy, but they generally cater to renter households with incomes at or below 80% of median income.

Over the last five years, the number of these funds have proliferated and pricing and terms have started to coalesce. The fund sponsors range from those with stated missions to preserve affordable housing, to those that see value-add plays for older multi-family real estate with strong occupancy and cash flow history.

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Preservation Funds Cont'd

These funds have different investment models (e.g. acquisition versus joint venture) and sourcing strategies (existing developer networks, on-market transactions, off-market transactions, etc.) and fall along a spectrum as it relates to qualifying as a PWI. Currently, banks make up the majority of investor equity as investments in some of these funds qualify for their CRA investment test (and lending test if also providing debt to the fund). Other investor cohorts include a limited number of insurance companies as well as endowments, foundations, family offices and high net worth individuals. Investments by insurance companies has been limited presumably because of risk-based capital charges relative to returns.

Unlike LIHTC funds where properties are largely specified to the fund prior to investor equity closing, preservation funds are typically less specified during the marketing period. As a result, CRA investors may have to get comfortable making capital commitments without specific properties for CRA identified at closing. Subsequent geographic CRA targeting by the fund sponsor is often done on a best-efforts basis.

We currently work with a number of fund sponsors and, similar to the LIHTC market, pricing appears to have settled into an equilibrium and looks to remain stable through year-end barring unforeseen shocks to the industry or economy.

Across these sponsors, multi-investor fund sizes range from $50M to more than $600M with $100-200M being more typical. Preferred returns are generally in the 6.00 - 7.00% range on a pre-tax basis with total returns in the 8.00 – 11.00% range and it looks like this pricing will hold through 2019.

Whereas many sponsors of LIHTC funds are able to launch and close two funds per year, the fund cycle for preservation funds has been considerably longer than LIHTC funds. Preservation funds typically have multiple closings over a year or more, and take longer to deploy that capital into property acquisitions due to strong competition for multi-family rental properties from both domestic and international investors.

Looking ahead, it does not appear that competition for multi-family properties will abate and a downward yield trend is expected across the broader U.S. multi-family sector. According to the Pension Real Estate Association's second-quarter Consensus Forecast survey, total returns in the apartment sector of 5.2 % and 4.3% are expected in 2020 & 2021 respectively. While we expect preservation fund yields to hold steady through 2019, assuming continued strong performance of the US rental market overall, it is likely that the increased competition in the preservation/workforce housing equity market may drive down yields at the fund level over time.

https://www.spglobal.com/marketintelligence/en/news-insights/trending/h114zcaCKezNAUjn45kh-w2

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CRA Reform

CRA reform has been somewhat on the back burner over the past 6 months given the recent government shutdown and then subsequent review of the roughly 1,800 letters the OCC received in response to its reform proposals. The current sentiment in the industry, seems to be that CRA reform is more likely than not to occur, and perhaps as soon as late 2019 or early 2020, while others feel the effort is bogged down and no longer moving that quickly. Below is a summary of commentary made by the Governor of the Federal Reserve Bank - Lael Brianard following interagency meetings, and feedback from their bank members in February, which gives some insight into where the regulatory agencies might find consensus on the broader aspects of reform.

- Support for the Community Reinvestment Act is broad and deep;
- There is an opportunity for modernizing the procedures for setting the area in which the agencies assess a bank's CRA activities while retaining the core focus on place;
- There is support for tailoring CRA regulations for banks of different sizes and business models—CRA regulations cannot be one-size-fits-all;
- Ensuring that any modernization of assessment areas should keep in focus the goal of encouraging banks to seek out opportunities in underserved areas while addressing concerns about CRA hotspots and credit deserts;
- Evaluate how to increase the consistency and predictability of CRA evaluations and ratings;
- Ensure that all creditworthy borrowers have fair access to credit, and, guard against discriminatory or unfair and deceptive lending practices;
- The Federal Reserve System is committed to strengthening CRA with an aim to promote more CRA activity, not less. We think that simplifying and clarifying the regulations while strengthening local community engagement will help us accomplish that goal.

Predicting the effects of CRA reform on the LIHTC market is difficult at best. However, with the loosening of geographic restrictions for branchless banks and other nontraditional financial institutions, 'CRA Hot' markets like some major metropolitan areas, Utah and contiguous states, may see an overall decrease in demand and eventual downward pricing trend.

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The Affordable Housing Credit Improvement Act of 2019

The most recent presidential election and subsequent turmoil in the LIHTC market regarding tax reform greatly impacted the market. After tax reform, the equity market decreased in size with the value of losses generated in LIHTC equity investments devalued as a result of the corporate tax rate decreasing from 35% to 21%. In March of 2018, Congress provided some relief with the temporary increase in LIHTC allocation of 12.5% for 9% credits for four successive years.

More comprehensive legislation is required to get LIHTCs back to pre-tax reform levels. The AHCIA was reintroduced in both houses of Congress with the support of the following congressional leaders: Senators Maria Cantwell (D-WA), Todd Young (R-IN), Ron Wyden (D-OR), and Johnny Isakson (R-GA), and Representatives Suzan DelBene (D-WA), Kenny Marchant (R-TX), Don Beyer (D-VA), and Jackie Walorski (R-IN).

Two significant impacts of the proposed bill: (i) gradually increase the amount of 9% credits awarded over a five-year period by 50% and (ii) eliminate the floating rate at which 4% credits are calculated. This rate, which has recently hovered around 3.25-3.30%, would increase the floor to 4.00%, eliminating some of the guess work on behalf of developers and providing increased certainty in structuring affordable housing projects financed with tax-exempt bonds.

Both provisions would increase the amount of available tax credits to the private market and consequently increase the supply of much needed affordable housing. We will continue to monitor the progress of the AHCIA and how it may impact the LIHTC equity market.

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Opportunity Zones

Traction for investments combining LIHTCs and OZs has been limited to date for a number of reasons. Multi-investor funds have proven a difficult vehicle for OZ investments. As a result, interest from investors who prefer larger, diversified funds and a minority ownership stake has been limited. Proprietary funds (single investor) seem to be a better fit, as it is easier to manage the timing of a single investor's capital gains. However, the transactions that work best with OZs are tax-exempt bond transactions that have higher losses and higher leverage. This type of transaction is often less desirable to some investors, particularly insurance companies.

Additionally, the benefit to investor IRRs from OZ-related benefits is largely offset by the upfront capital contributions required to qualify for OZs. For most transactions, stripping out the OZ benefits results in returns from the LIHTC benefits that are unacceptable relative to LIHTC transactions with OZ benefits.

Lastly, while a number of insurance companies have ongoing capital gains to offset and therefore have strong potential interest in OZs, many report that demand for OZ qualifying investments has driven down returns to unacceptable levels. Others find that combining OZs with LIHTC is just too challenging. Instead, a number of potential investors are coordinating their efforts to find OZs through their real estate investment groups that can potentially realize OZ benefits throughout various asset classes (office, industrial, retail) without the added complexity of LIHTC.

For background information on the Opportunity Zones program, please refer to the February 2019 edition of our newsletter available on our website at: www.StrategicTaxCreditInvestment.com.

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Wrap Up

We anticipate circulation of our next market update in mid- January to coincide with the multi-investor fund cycle. 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. We thank you, as always, for your feedback on our February 2019 market update and continue to welcome questions and comments. Hearing from you is the best way for us to continue to deliver the most relevant updates and information.

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

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.

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Exhibit A:

Year of Investment	1	2	3	4	5	6	7	8	9	10
Cumulative LIHTC Foreclosure Rate										
	0.00%	0.00%	0.01%	0.03%	0.04%	0.07%	0.13%	0.20%	0.26%	0.29%

Source: *CohnReznick LIHTC Industry Survey of 22,993 LIHTC properties (1997-2016)*

Year of Investment	1	2	3	4	5	6	7	8	9	10
Global Corporate Average Cumulative Default Rates by Rating Modifier (1981-2017)										
AAA	0.00%	0.03%	0.13%	0.24%	0.35%	0.46%	0.51%	0.60%	0.65%	0.71%
AA+	0.00%	0.05%	0.05%	0.10%	0.16%	0.21%	0.27%	0.33%	0.39%	0.45%
AA	0.02%	0.03%	0.08%	0.22%	0.36%	0.48%	0.61%	0.72%	0.81%	0.91%
AA-	0.03%	0.09%	0.18%	0.25%	0.33%	0.45%	0.52%	0.57%	0.63%	0.69%
A+	0.05%	0.09%	0.20%	0.34%	0.45%	0.55%	0.66%	0.79%	0.93%	1.08%
A	0.06%	0.15%	0.24%	0.36%	0.49%	0.68%	0.86%	1.03%	1.23%	1.47%
A-	0.07%	0.17%	0.28%	0.40%	0.57%	0.74%	0.98%	1.16%	1.30%	1.42%
BBB+	0.11%	0.31%	0.53%	0.77%	1.03%	1.32%	1.54%	1.78%	2.04%	2.30%
BBB	0.17%	0.43%	0.68%	1.05%	1.42%	1.80%	2.15%	2.49%	2.85%	3.23%
BBB-	0.25%	0.77%	1.39%	2.11%	2.84%	3.50%	4.09%	4.65%	5.11%	5.53%
BB+	0.34%	1.11%	2.02%	2.94%	3.86%	4.74%	5.50%	6.05%	6.70%	7.33%
BB	0.56%	1.71%	3.38%	4.94%	6.52%	7.77%	8.89%	9.85%	10.75%	11.53%
BB-	1.00%	3.13%	5.37%	7.66%	9.66%	11.62%	13.24%	14.80%	16.04%	17.12%
B+	2.08%	5.71%	9.23%	12.21%	14.53%	16.33%	17.98%	19.43%	20.77%	21.97%
B	3.60%	8.29%	12.29%	15.46%	17.89%	20.15%	21.66%	22.76%	23.77%	24.81%
B-	7.15%	14.28%	19.62%	23.37%	26.18%	28.31%	29.99%	31.13%	31.84%	32.40%
CCC/C	26.82%	36.03%	41.03%	43.97%	46.22%	47.13%	48.33%	49.23%	50.08%	50.71%
Investment Grade	0.10%	0.26%	0.45%	0.68%	0.92%	1.17%	1.40%	1.61%	1.82%	2.03%
Speculative Grade	3.75%	7.31%	10.39%	12.90%	14.95%	16.64%	18.05%	19.23%	20.27%	21.21%
All Rated	1.50%	2.95%	4.22%	5.29%	6.18%	6.94%	7.57%	8.12%	8.60%	9.05%

Source: *Standard & Poor's Global Research*

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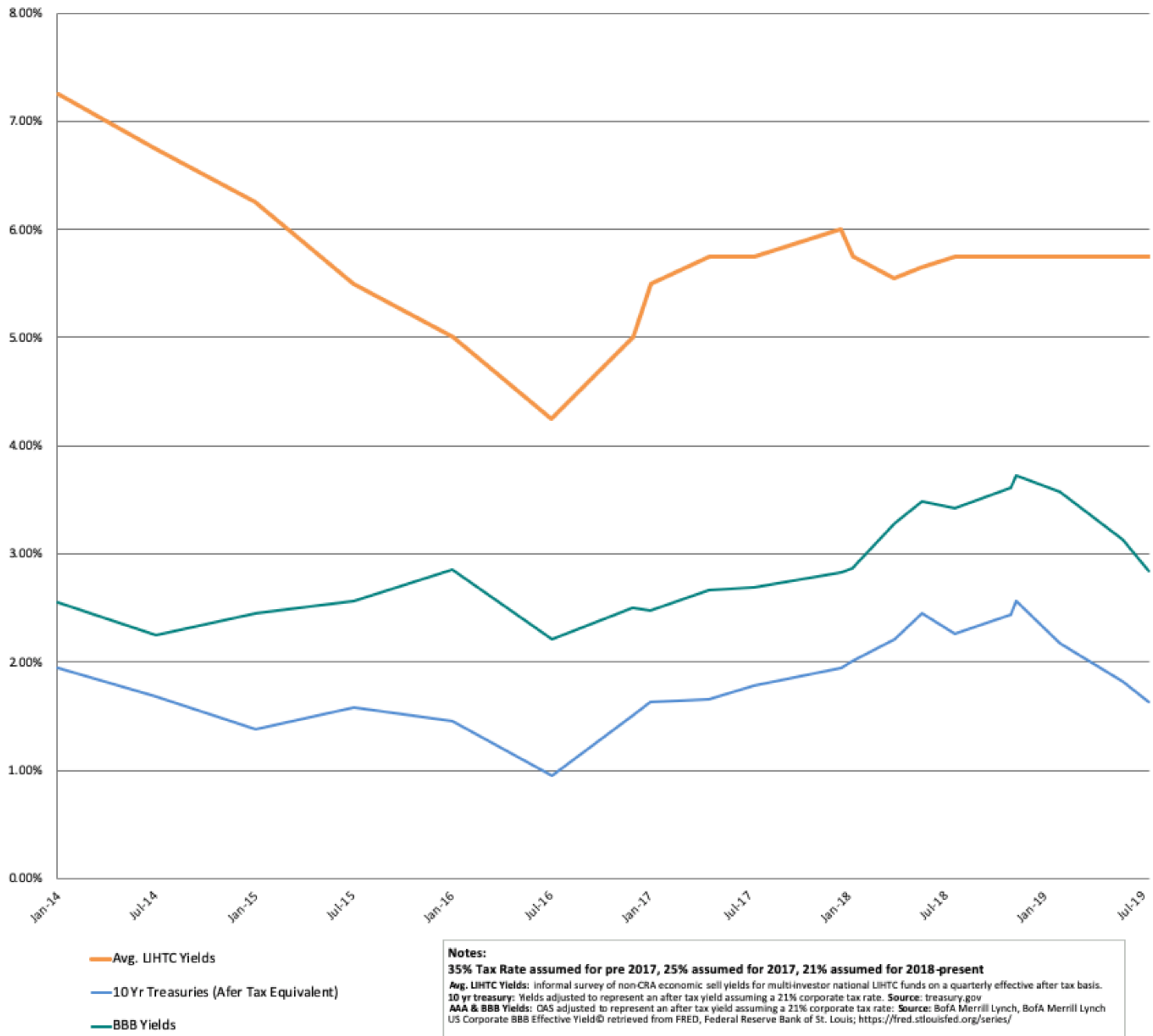
Exhibit B:

STCI
Strategic Tax Credit Investments

Average LIHTC Multi-Fund Yield vs. 10 Yr Treasury & BBB Index (After Tax Equivalent)

BEACON HILL CAPITAL



Notes:

35% Tax Rate assumed for pre 2017, 25% assumed for 2017, 21% assumed for 2018-present

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 assuming a 21% corporate tax rate. **Source**: treasury.gov
AAA & BBB Yields: OAS adjusted to represent an after tax yield assuming a 21% corporate tax rate: **Source:** BofA Merrill Lynch, BofA Merrill Lynch US Corporate BBB Effective Yield© retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/

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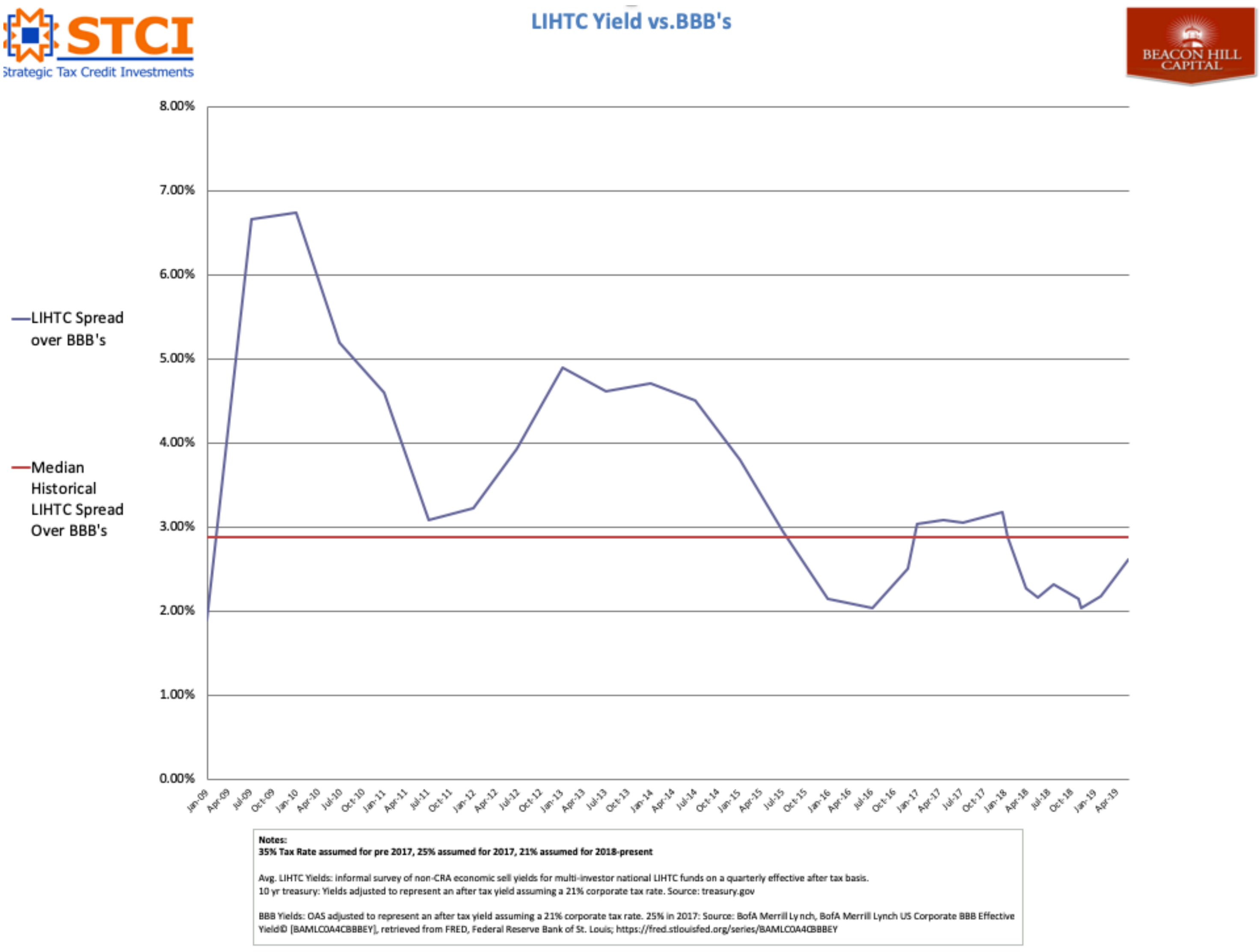
Exhibit C:



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