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Strategic Tax Credit Investments

BEACON HILL CAPITAL

# Affordable Housing Equity Market Update

## July 13, 2023

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Friends & Colleagues,

The intent of this newsletter is to provide our investor and syndicator clients a market update with respect to low-income housing tax credit (LIHTC) funds, and to a lesser extent, preservation and workforce housing funds. *We use italics for text that has been carried forward from previous issues.* This makes it easier for regular readers to quickly identify new material while providing important context for readers new to the newsletter, or the industry.

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 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.

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

In the context of this newsletter, preservation funds (or naturally occurring affordable housing (NOAH)) and workforce housing funds are non-tax advantaged multi-family real estate equity funds generally comprised of Class B and C properties or developments. Investments in these funds may qualify under Regulation H (12 CFR Part 208) as public welfare investments (PWIs) by targeting low- to moderate-income households, which can help attract equity from CRA investors. These types of funds fall along a spectrum depending upon how oriented they are toward PWI criteria. In terms of portfolio composition, some include a component of new construction workforce housing while others do not.

This issue follows our January 2023 newsletter. Previous newsletters are available on our websites: StrategicTaxCreditInvestments.com and BHCapital.com.

We hope you find this update informative and useful. As always, we welcome your questions, comments and perspective.

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# Headlines

Despite the historic rise in interest rates over the last 15 months, a banking crisis resulting in the collapse of three U.S. banks as well as Credit Suisse and an 11th hour resolution to the U.S. debt ceiling negotiation, the LIHTC equity market has remained relatively stable over the past six months. Overall, the consensus seems to be that pricing has declined by 1-2 cents over the past six months and yields have improved incrementally with the usual caveats for certain very competitive CRA markets.

As we've stated previously, the market's stability seems to be the result of the counterbalance between some opposing factors:

- Reduced credit supply: 12.5% fewer nine-percent credits as the four-year boost that began in 2018 expired at the end of 2021 and has not been renewed.
- Substantially reduced transaction feasibility due to rising interest rates, higher borrowing costs and higher construction costs which has constrained the supply of viable transactions.
- Relatively stable demand: Despite the rapid rise in interest rates, LIHTC equity investments have remained attractive for CRA as well as non-CRA investors relative to alternatives. However, there is some mounting pressure on smaller and regional banks to increase their liquidity levels in anticipation of potential regulatory adjustments, which has decreased demand from intermittent LIHTC bank investors. Additionally, a number of non-CRA investors paused or slowed the pace of equity investments in the first half of 2023 given the uncertainty following the banking crisis, and to a lesser extent ongoing general concerns about the interest rate environment and economic outlook.

If the first half of 2023 was characterized by smaller funds and increased caution from investors, we expect LIHTC yields to remain largely unchanged as the tension between these forces continues. Contributing to our outlook is a consensus view that the worst of the regional banking crisis is behind us, interest rates are close to their expected peak, and the worst-case inflation and recessionary fears are receding. Furthermore, the economic investors that elected a go-slow approach in the first half are expected to bolster demand going into the second half of the year.

As interest rates have risen and LIHTC spreads to benchmark yields have narrowed, investors are more focused on portfolio quality, specification, and certainty of execution at the property level in addition to consideration of the usual fund metrics such as pricing, yield, leverage, and sponsorship. Closing timelines remain difficult to maintain as projects continue to experience delays in the closing process due to myriad issues including delays at the state agencies, labor force deficiencies and difficulty obtaining key due diligence items such as market studies and environmental reviews in a timely fashion. Funds with competitive metrics coupled with a higher percentage of transactions secured or closed continue to see greater demand.

In January, we highlighted both the proposed Global Minimum Tax (GMT) and CRA reform for their potential to impact investor demand when implemented. Nothing has materially changed on either front in the past six months and CRA reform changes are now expected to be delayed to year-end or early

2024. Presumably, the banking crisis earlier this year led regulators to move more cautiously on CRA reform. These topics remain on our radar for their potential future impact on investor demand, and we provide commentary on the Inflation Reduction Act (IRA) below.

While many industry advocates were optimistic about legislative enhancements to LIHTC in 2022, Congress ultimately passed a Consolidated Appropriations Act of 2023 that did not include any provisions to enhance LIHTC production. Many were anticipating, or at least hoping for, a renewal of the 9% credit boost as well as a reduction of the '50% test' to 25%, the latter of which would significantly increase the allocation and/or feasibility of tax-exempt bond financed transactions. These program improvements have been introduced again in the Affordable Housing Credit Improvement Act (AHCIA) of 2023 and with broad bipartisan sponsorship. The AHCIA 2023 retains the same key priorities (a significant increase in the 9% allocated credit and a reduction in the 50% Test for bond financed (4%) credit properties to 25%; however, we view the probability as low that legislation containing the AHCIA will pass before 2025 given the presidential election cycle.

# Inflation Reduction Act (IRA) of '22 & 15% Corporate Minimum Tax

*Signed into law in August 2022, the Inflation Reduction Act establishes a 15% minimum corporate tax rate for large companies on "book" income (those that average more than $1 billion in adjusted financial statement income, before taxes, over three taxable years). For most companies, the Act protects certain tax incentives and allows general business credits, including LIHTC, to be taken against the minimum tax. In addition, adjustments such as accelerated depreciation and amortization are allowed.*

*Despite these positive aspects of the law, additional guidance from the Treasury Department is needed to address certain technical questions and provide clarification. Without this guidance, the economic benefits of tax advantaged investments such as LIHTC could be called into question and potentially impact investor demand. While at least one large economic LIHTC investor has curtailed their investment activity pending this guidance, it has not materially impacted overall demand to date.*

*According to the Baker Institute for Public Policy, "the 15% minimum tax in the IRA does not align the U.S. corporate income tax mechanism with the Organization for Economic Cooperation and Development's (OECD) Global Minimum Tax, although both use a 15% rate and apply to book income. For instance, the income threshold for in-scope companies under the OECD agreement is much lower threshold than the U.S. minimum tax. In addition, the OECD agreement aims to stop corporate profit shifting to low-tax jurisdictions through global harmonization, with U.S. companies likely paying more taxes in foreign jurisdictions as an end-result. However, the objective of U.S. Inflation Reduction Act is to increase domestic corporate tax revenue. Finally, details — such as loss carryforward, depreciation deduction, and treatment of certain credits — are inconsistent across the two systems."*[1]

[1] https://www.bakerinstitute.org/research/inflation-reduction-act-2022-corporate-minimum-tax-faces-major-issues



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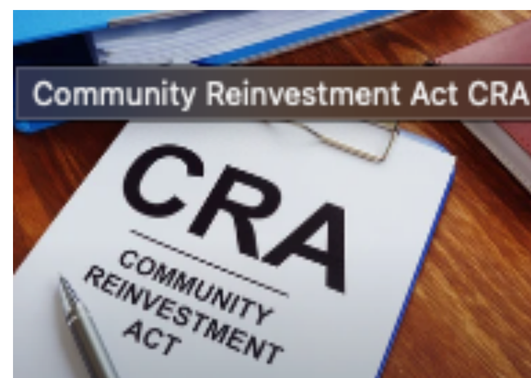
# Community Reinvestment Act
# Reform & Modernization

*In May of 2022, the three banking regulators; the Federal Reserve Board of Governors (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC), released a joint Notice of Proposed Rulemaking (NPR) to modernize the Community Reinvestment Act (CRA). Public comment was due by August 5th 2022 and we had previously wrote that the agencies would like to finalize the new regulations by the end of Q1 2023. Any significant changes to CRA regulation could impact the affordable housing industry as equity investment by banks comprise approximately 80% of the market.*

*The Community Reinvestment Act, or CRA, became law in 1977 and encourages banks to help meet the credit needs of the entire community in which they do business, with a particular focus on low- and moderate-income communities, consistent with safe and sound operations. The last significant interagency revision to CRA occurred in 1995.*

*Stated goals of the proposed rule changes include:*




- *Expand access to credit, investment, and basic banking services in low- and moderate-income communities*
- *Adapt to changes in the banking industry including internet and mobile banking*
- *Provide greater clarity, consistency, and transparency*
- *Tailor CRA evaluations and data collection to bank size and type*
- *Maintain a unified approach among the three banking regulatory agencies*

*In concept, these goals all sound like positive changes, but there are many details within the 680-page interagency proposal that give the affordable housing industry concern. Chief among them is the proposed elimination of the Investment Test, which many banks satisfy in large part by making equity investments in affordable housing. Under existing rules, the Investment Test comprises 25% of a bank's CRA rating. Under the proposed rule, the Investment Test is combined with the Lending Test into a single community development finance test which would comprise 30% of the CRA rating. The industry's primary concern is that this change will reduce banks' incentive to make equity investments and the result could significantly undermine the production of affordable housing in the U.S.*

*Most banks insist that they make equity investments in housing credits for several reasons beyond CRA requirements including support for all aspects of affordable housing finance, higher rates of return than comparable debt opportunities, tax appetite, and client banking relationships. However, there is concern that smaller banks (i.e. state and regional) may prefer loans due to the increased cost and complexity of underwriting equity investments. There is also concern this change will discourage banks from staffing up to make equity investments and may simply make loans instead.*

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*Another concern is that the new rules provide no CRA credit for serving households with incomes above 60% of Area Median Income (AMI). This would make preservation and workforce housing that serve households above 60% AMI, ineligible for CRA credit going forward. As a result, the industry is lobbying to allow for full CRA credit up to 80% of AMI.*

*There are also some changes that would potentially have other effects on the affordable housing market. First, banking assessment areas would be expanded to include areas of virtual banking activity where they do not have physical branch locations. In addition, CRA eligible activities for a bank's examination purposes would not be geographically restricted to their assessment areas. Both elements should reduce competition among banks in so-called "CRA hot" areas and distribute affordable housing finance activities more evenly across the U.S. In turn, this should lead to a narrower range of housing credit equity prices. On the other hand, the feasibility of transactions and the amount of affordable housing produced in formerly "CRA hot" markets would likely suffer if equity prices decline in those markets. Second, as proposed, the threshold for community development loans would be raised from $2M to $5M. Given the relatively small sizes of affordable housing loans, this would reduce the number of loans that qualify for CRA, and potentially encourage equity investment instead.*

*Various industry groups provided comments to the agencies in August (2022) so it remains to be seen what the final CRA rules will look like. However, so far it sounds like regulators are not inclined to favor any one industry or product over another and that they believe the housing credit industry will not be disrupted by the proposed rule changes. If CRA rule changes do impact equity investments and housing credits, it seems likely the new rules will be phased in, and banks will complete their current CRA cycles under the existing rules. As a result, we expect any impact will be felt over several years as banks digest the new rules and potentially alter their behavior for future examination cycles.*

*In other CRA news, the OCC, the FRB and the FDIC published a statement that extends for 36 months the period for favorable CRA regulation consideration for bank activities that help revitalize or stabilize disaster areas in Puerto Rico and the U.S. Virgin Islands hit by Hurricane Maria. The extension now lasts through September 20, 2023, and applies to institutions located outside of the areas. This allows investors to take advantage of above average market returns that are available on transactions in these geographies while also potentially receiving special CRA consideration.*

# Average Income Test (aka Income Averaging)

Investors have shown limited appetite for transactions using the Average Income Test (AIT) since 2020 when proposed regulations by the IRS suggested a "cliff event" risk. Since that time, industry working groups have been asking the IRS to respond to their concerns and provide clarifying guidance. This guidance was finally published October 12, 2022, by the IRS in the Federal Register.

The final regulations limit the impact of one unit's noncompliance on the project's ability to satisfy the average income test. It allows for the average income test to be satisfied if at least 40% of the building's units collectively average 60% or less of AMI (Area Median Income). The IRS states "It is no longer necessary to consider all low-income units in a project for residential rental property when determining whether the average income test is met."

While this is welcome news, several law firms have focused on language in the final regulations that implies yet another compliance risk scenario and they have since submitted proposed language to the IRS to address the issue. For its part, the IRS states that no "cliff test" was intended and that the hypothetical scenario put forth by the industry was not considered. At a minimum, the issue in the new language can be solved by a waiver and would have 180 days from identifying the issue to reclassify the unit designation.

For a summary of the origins of the AIT issue, please refer to our January 2023 newsletter which is available at StrategicTaxCreditInvestments.com along other past issues.

# Economic Outlook

Many of the global headwinds we highlighted back in January remain in place: rising interest rates, inflation concerns, the potential for economic recession, and the war in Ukraine. We can now add the biggest banking crisis in 15 years to the list of challenges faced in the first half of 2023. All of these have contributed to unusual volatility in the capital markets and beyond.

Global inflation concerns, in the aftermath of unprecedented fiscal stimulus around the pandemic, continue to drive monetary policy and central banks continue to raise rates in response. Along with it, the consensus continues to be that at least a mild economic recession is more likely than not in late 2023 or 2024 as rising interest rates reduce economic growth globally.

The consumer price index increased 0.4% in April, and the year-over-year CPI increased 4.9% down slightly from the 5.0% over the prior 12 months. More encouraging, the rate of inflation on essential goods is declining more quickly. While annual grocery costs were up 7.1%, that rate has declined to 2.6% on an annualized basis for the past 6 months. Gasoline prices are down 12.2% over the past year. However, shelter costs remain elevated and increased 8.1% over the past 12 months, even though existing home prices have moderated from their peak and private rent surveys show rents have eased. Some of these trends have yet to show up in the CPI shelter indexes.[2]

While various inflation rates continue to decline and show improvement, overall inflation has remained stubbornly high and above policy targets. For example, U.S. wages were up 4.4% in June over the past 12 months, more than double the Fed's target inflation rate of 2%. Furthermore, the economy continues to show resilience, with Q1 GDP revised upward from 1.3% to 2.0%, while unemployment remains very low at 3.6%. As a result, interest rates look like they will top out higher than previously projected. The Federal Funds rate currently sits at 5.00 – 5.25% and another one or two 25 basis point increases are expected between now and year end with a consensus peak rate of 5.625%.

[2] Bob Brinker's Marketimer Vol. 38 No 6, June 2023



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# National Funds

Due to a number of factors, we believe that LIHTC yields will remain generally stable in the second half, but on the margin, are likely to continue to trend slightly upward. With the belief that the worst of the banking crisis is behind us and given that a cohort of investors took a go-slow approach in the first half, we believe demand for LIHTC equity funds will be stable in the second half of the year.

As stated in January, the various developments we flagged that could upset market equilibrium and result in substantial changes to investor yields are currently viewed as unlikely. Current assumptions are that the 15% corporate minimum tax will be resolved favorably with respect to accounting treatment of housing credits and other equity investments, and any potential impact on demand from CRA reform is both delayed and likely to take place over several years rather than immediately.

# 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.*

*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. Furthermore, there has been an increasing trend to pair equity with debt on transactions. Developers who are considering equity offers that are contingent with a specified bank securing the debt can often see higher equity pricing as a result.*

*While the influence of the non-CRA component of the equity market on lower-tier pricing (property level) is limited because it comprises only about 15-20% of the total market, this segment can still move the market. 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. If this pricing pressure persists at the fund level, ultimately lower tier pricing will follow suit.*

*Our pricing summary focuses on three specific segments: multi-investor national funds; CRA versus non-CRA; and regional funds. Our pricing outlook for the next six months is based on both fund-level and*

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*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. Historically, there has been a pricing lag of at least six months in the LIHTC market.*

*Tax credit pricing can be somewhat inelastic due to a number of factors including the long project lifecycle from conception to construction, and the protracted negotiations between syndicators and developers over terms and pricing. There is also a lag in feedback from investor demand to resulting adjustments in property-level negotiations with developers.*

Currently, national funds seeking to attract economically motivated non-CRA equity are generally priced in the $0.89-$0.96 per credit range on a fully loaded basis with after-tax QIRRs in the 6.00-7.40% range with some exceptions both above and below. The range reflects a reduction in price per credit of two cents since our newsletter in January, while the yield range remains essentially unchanged. This can be largely explained by rising interest rates and the corresponding ineffectiveness of bridge financing to enhance yields.

With supply somewhat constrained and higher borrowing costs severely challenging project feasibility, we are assuming that property-level (lower-tier) pricing is on a flat to downward trend into the second half of 2023 with the usual exception for certain high demand CRA markets. For more detailed metrics on current offerings, please see the attached LIHTC Fund Summary Exhibit.

Given the rise in interest rates, several large CRA investors have raised yield requirements over the past year. In the most competitive CRA areas (e.g. NYC, Boston, Utah, etc.) investors can expect yields to dip into the 3% range for certain transactions. Conversely, some syndicators can secure product at more favorable pricing in less competitive markets and can then offer yields to CRA investors above 6.00%. Funds may be able to achieve this depending upon the specific composition of the fund, investment size and the syndicator's investor base.

*Pricing can fall outside of these ranges based on geographic location of properties, investment size and other special circumstances (e.g. a sponsor replacing a lost equity commitment). At the higher end of the yield spectrum, there are several economic investors that will make larger investments to secure premium yields within national multi-investor funds. We have seen those break point levels increase over the last couple years with the highest returns now typically linked to investment sizes in the $40-50 million range. There are also larger CRA-motivated banks that are making blended investments that mix both CRA selections at lower yields with non-CRA selections to achieve higher overall returns.*

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*Outside mainstream LIHTC multi-investor funds, some investors who require higher returns are willing to invest in funds and projects with higher risk profiles including mixed-income developments, assisted living properties, LIHTC transactions with higher leverage, and locations such as Puerto Rico and other U.S. territories.*

*One variable affecting the IRR and price per credit ranges above is the amount of bridge financing being utilized by the fund sponsor. In general, fund bridging becomes more prevalent as interest rates decline and arbitrage opportunities increase. Most national funds assume at least some modest level of bridge financing to manage capital calls. When the interest rate environment permits, a number of syndicators use additional bridging to more effectively compete for product and enhance yields. 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, when positive arbitrage exists, 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.*

# Regional Funds

Given how the recent banking crisis directly impacted the market for California regional funds, it is worth revisiting what we wrote in January:

> *In recent years, California regional fund yields continued to rise due to the increased supply of both federal disaster and state credits. As a result, California fund yields nearly achieved par with National funds. At the end of 2022, we began to see this trend reverse as the additional credit supply has been absorbed…Roughly eight to ten California Regional LIHTC Funds are now marketed by syndicators on an annually, and this may increase with one large syndicator a potential new entrant in 2023.*

What a difference six months can make. We now expect the California regional fund market to shrink rather than expand, with smaller and fewer fund offerings going forward given the collapse of Silicon Valley Bank and First Republic Bank which were programmatic anchor investors in CA regional funds. While it remains to be seen how the acquiring banks, First Citizens and JPMorgan Chase respectively, will invest and meet their CRA needs in the former assessment areas of these two banks, we do not expect them to fully replicate past demand for CA regional funds. Furthermore, the recent relocation of another important California regional fund investor's headquarters to Texas, has contributed to a reduction in the number of potential large investors for CA specific funds.

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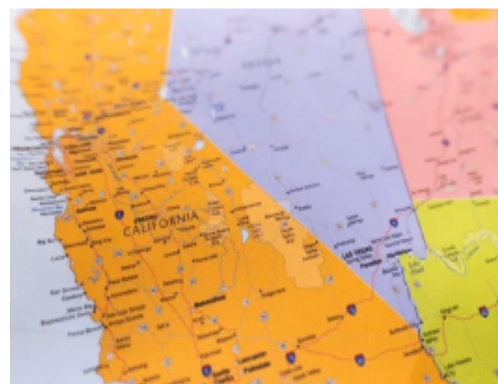
Given the CA regional fund market had been characterized by a large number of fund offerings relative to a limited number of investors, the collapse of these institutions has syndicators rethinking their plans for CA regional funds this year. Some syndicators have shifted significant portions of their CA pipeline to their national fund offerings, while others have delayed or are reconsidering their plans for CA regional funds.

Historically, First Citizens (which acquired Silicon Valley Bank) has made equity investments both through proprietary and multi-investor funds. While Chase (which acquired First Republic) is primarily a proprietary fund investor, but also participates in multi-investor funds with a limited number of syndicators. Signature Bank had recently expanded their assessment areas to include the San Francisco Bay Area but had invested only on a proprietary basis. New York Community Bank (which acquired Signature) has historically invested in proprietary funds, not multi-investor funds. Taken together, it seems there will be fewer investors for CA regional funds. We are starting to see more "western regional" fund offerings that include CA as well as other western states.




As syndicators look to launch new funds in 2023, several groups report increased competition for transactions and a smaller number of deals in the pipeline compared to prior years. For California market returns more specifically, properties in San Francisco proper still command premium pricing from 3.75%- 4.50%, given the limited number of transactions and high demand. For the greater Bay Area, yields are leveling off around 5.00%. For Los Angeles, we are seeing pricing stabilize in the low 5's after spiking as high as 5.75%. In smaller metro and rural areas throughout the state, yields are expected to hold steady in the 5.75-6.25% range.

Predicting the market for the second half of 2023 is difficult in California in light of the recent volatility on the demand side. Given this uncertainty, credit pricing bids at the property level vary greatly from project to project. Historically, LOI credit pricing bids from multiple syndicators and direct buyers are typically within a couple cents of each other. However, recently we are hearing the delta among LOI pricing bids to be as high as eight to ten cents on a single transaction. That difference in pricing at the project level roughly translates to 100-200 bps on upper tier yield to investors. Developers who can line up proprietary investors via a syndicator or a direct buyer for a combined debt and equity offer are generally able to see increased credit pricing. We would expect this pricing disparity to narrow over the coming months as the California market settles.

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# Supply

As of 2023, the LIHTC equity market is estimated at around $25 billion. However, the size of the market does not accurately account for the reduced feasibility of many transactions, or the fact that several states continue to forward allocate credits to make transactions work as previously mentioned. As a result, the effective supply in 2023 remains somewhat constrained.

In the broader context of tax credits, the Inflation Reduction Act increased and expanded many existing energy credits and also created new climate credits. The timing and allocation of this additional credit supply is tied to guidance yet to come from the IRS, but the market for renewable energy credits could grow from being slightly smaller than LIHTC to double the size of the LIHTC market. This potentially large increase in the supply of credits could impact pricing in the LIHTC market going forward.

Mike Novogradac has been highlighting the potential increase in total credit supply since the IRA came out and his article, cited below, is an excellent resource. Essentially, the IRA also allows for refundability, or direct payment for certain clean energy credits and the IRS & Treasury department released guidance allowing for more flexibility on the transferability of green energy tax credits. Essentially 'certificating' the energy credit by allowing project developers to sell the credits to an unrelated party. [3]

Lastly, at the end of Q1, the Financial Accounting Standards Board (FASB) issued an update allowing for the expanded use of the Proportional Amortization Method (PAM) of accounting for certain tax credit equity investments. Previously, the PAM was only available for LIHTC investments as an alternative to either the cost or equity method.[4]

These changes may increase the attractiveness of renewable credits for some investors, although the transferability component may be less appealing to ESG-focused investors. These changes are significant in the world of tax equity finance and may substantially increase the size and amount of tax equity transactions in the years to come, but it remains to be seen how these changes will ultimately impact the LIHTC market.[5]

[3] https://www.novoco.com/periodicals/articles/tax-credit-equity-pricing-supply-and-demand-analysis
[4] https://www.bdo.com/insights/tax/emerging-issues-task-force-issue-no-21-a,-accounting-for-investments-in-tax-credit-structures-using
[5] https://www.akingump.com/en/insights/alerts/clean-energy-tax-credit-transferability-guidance-issued#:~:text=Eligible%20credits%20are%20transferable%20under,of%20the%20filing%20of%20the



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# Demand

In January, we stated that early indications were that investor demand was likely to rebound in the first half of 2023 in part because the 10-year treasury had receded from recent highs in Q4 of 2022. Instead, the economic landscape was shaken by the bank crisis that resulted in the collapse of four banks in 2 months. Combined with continued concerns about rising rates and the possibility of an economic recession instead of the hoped for "soft landing," a number of investors, particularly non-CRA investors, shifted to a wait-and-see posture.

The collapse of Signature Bank, Silicon Valley Bank, First Republic Bank and Credit Suisse combined to represent the largest banking failures since the "Great Recession" and impacted the LIHTC market as all but Credit Suisse were programmatic and significant LIHTC investors. Initially these failures caused immediate concern from investors about their counter-party risk, and syndicator exposure to future capital calls from these institutions. At the same time, investors grappled with contagion fears and uncertainty about the possibility of other institutions failing. Public reassurances from the Federal Reserve about the commitments and ongoing operations of the affected institutions enabled all impacted LIHTC funds to proceed with fund closings, albeit at reduced fund sizes. During this time, some non-CRA investors elected to proceed cautiously or stay on the sidelines for the first half while the dust settled.

We continue to monitor the growing interest in ESG related investments. While there remains some level of uncertainty around what "qualifies" as an ESG investment, both LIHTC and Preservation funds seem to incorporate adequate characteristics. There has been a marked increase in investors asking for ESG related statistics on their investments, and a material, though not yet impactful, increase in the volume being invested to satisfy internal ESG objectives. More recently there have been a number of LIHTC fund offerings comprised of transactions that are BIPOC (black, indigenous, and other people of color) owned and developed. These funds vary in specifics but are generally targeting developers who otherwise would not meet traditional investor requirements for track record, net worth & liquidity. Most of the funds offer some type of yield enhancement or guaranty provision to further attract impact minded investors. Interestingly, there are reports that demand for these types of transactions from competing syndicators can drive equity pricing premiums. We would expect this segment of the LIHTC market to continue to evolve as corporate ESG initiatives develop further.

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# Interest Rate Environment: 10 Yr Treasury & Corporate Bonds

The Federal Reserve has tried to tame an inflation rate that reached a 40-year high by raising rates at the fastest pace since 1980. One year ago, the Federal Funds rate stood at 0.0 – 0.25%. In our January newsletter, the rate stood at 4.25 – 4.50% and today it stands at 5.00 – 5.25% with one or two 25 basis point increases expected later this year before the Fed is anticipated to shift from a hiking-cycle to hold-and-modify cycle.

Due to the industry's size and specific characteristics, LIHTC yields do not correlate directly with Treasury yields. However, the U.S. 10-Year Treasury bond rate (10-year) remains a common and important reference point. Over the last six months, the 10-year U.S. Treasury rate has increased roughly 60 basis points but is still down from its recent peak of 4.20% in Q4 of 2022. While it had been holding in the 3.75-3.85% range for much of the first half, it recently rose above 4% as the latest economic data continues to support the belief that the Federal Open Market Committee (FOMC) will raise the Federal Funds rate again in July.

Over the past 15 years, the spread between LIHTC yields (non-CRA yields in national funds) and the 10-year yields (on an after-tax basis) has ranged widely from a low of approximately 133 basis points (bps) in 2006 to a high of around 925 bps in 2010. The historic average has been approximately 442 bps. Using a non-CRA 6.75% after-tax QIRR from the most recent round of closed multi-investor funds, today that spread continues to be below historic averages at approximately 355 bps. This spread is 50 basis points narrower than we reported six months ago. It is worth noting that although the current spread is below the historic average, there is precedent for the market clearing at similar or narrower spreads in the past ten years. It is also worth noting that US Treasury yields are at a 15-year high and with slower growth due to restrictive monetary policy, there is an expectation in the market that the 10-Year should trend down, to 3.25% by year-end. In that scenario, the spread would likely return closer to the historic average.

Over the years, many investors have indicated that BBB rated corporate bonds may be the best credit proxy for LIHTC investments. Historically, LIHTC yields have maintained a spread approximately 300 bps over BBBs after-tax equivalent. Currently, BBBs are roughly 4.75% with the resulting after-tax equivalent spread to LIHTC at 200 bps, or about 100 bps below the historical average.

*Please see our attached exhibits for graphical representations of our yield data.*

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# State LIHTC

*Due to growing interest from investors in state LIHTC, we've included a summary reference of state LIHTC programs below. Investors often focus on states where the state credit is bifurcatable (can be purchased separately or disproportionally allocated) from the federal credit. States with bifurcatable state LIHTC include AR, CA, CO, CT, D.C., GA, HI, IL, IN, KS, MA, MO, NM, NY, OK, UT, and VT as well as all the new programs and proposals mentioned below.*

*Legislative initiatives for state affordable housing credits continue their steady march in 2023. States that currently enjoy the benefit of a state affordable housing credit have proven far more attractive to developers amid recent finance and labor headwinds. With more than half of the states now offering a state credit incentive, this resource has become a permanent and critical piece of the country's affordable production engine.*

*Strong initiatives in large, bellwether states like Texas and Ohio and even Montana have been years in the making. Texas' Governor just signed into law a state LIHTC with a $25M annual cap beginning in 2024. Ohio's current budget calls for state LIHTC with a $100M annual cap.*

**State Credit Programs' Annual Funding Authorization**

# Secondary Transactions

*Secondary market activity occurs in a few different ways. We think of a traditional secondary sale as when a LIHTC investor simply decides to sell part or all their portfolio due to reduced need for credits. This happens sporadically and can impact the primary market if the secondary volume is large enough that it reduces a significant amount of demand for primary product.*

*Alternatively, an investor, typically a bank, may buy and sell LIHTC programmatically. They may purchase more credits than they need as part of meeting their on-going CRA goals and then choose to sell down a portion of their portfolio to free up capacity. Usually this is part of a strategy around banking relationships, securing debt and other CRA opportunities. These transactions are typically bank-to-bank and account for some portion of secondary activity every year.*

In 2022, secondary market activity was dominated by a single large offering of more than $2 billion from one major bank. Such a large secondary would typically create concern around potential impact to pricing in the primary market, but we did not see a significant impact to the primary market for several reasons. First, approximately 50% of the secondary was reportedly purchased by a single large investment bank. Second, the secondary was being offered with a pay-as-you-go structure producing an exceptionally high IRR which really isn't comparable to primary-market returns. Furthermore, it was "enhanced" with the seller providing top loss protection and a guaranty to buy back a portion of the sold credits if the buyer was unable to use the full amount. The pay-go structure also eliminated the 15-year holding term which attracted interest from some investors that are not programmatic primary-market participants.

Secondary market activity in 2023 has been relatively limited due to uncertainty caused by rising interest rates and the regional banking crisis. However, we are aware of a portfolio of approximately $280M that is being readied for sale by one regional bank as well as some other smaller potential secondaries being considered for sale.

# Preservation & Workforce Housing

*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) which may or may not have some form of government subsidy, and generally cater to renter households with incomes at or below 80% of median income. 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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Interest in the preservation and workforce housing fund sector grew in the years leading up to the pandemic as investors looked for value in the multifamily sector (non-tax credit) coupled with an increased corporate focus on social impact investing. As a result of these factors and the establishment of successful track records, the size of the fund offerings continued to increase through 2022. Competition from institutional investors for quality transactions has kept property acquisition competitive and yields steady despite increasing interest rates.

In 2023, due in part to higher interest rates (i.e. borrowing costs) as well as continued disruption to the capital markets, the preservation fund market is currently characterized by fewer offerings and smaller fund sizes than in recent years. As sponsors of preservation funds proliferated, there has been some shakeout. Some were unable to deploy capital, others have decided to exit the business and still others are busy deploying previously raised equity.

Similar to LIHTC funds, yields and terms have remained relatively stable over the past 6 months and are projected to remain in a similar range for the remainder of 2023. Investor interest remains strong for multifamily, and for affordable multifamily rental housing in particular. Like the LIHTC market, there were some investors who paused or at least slowed the pace of their commitments as interest rates continued to climb. The reduction in demand reportedly helped bring about an overdue market correction and led to more reasonable valuations and underwriting assumptions according to one major syndicator.

Since the preservation fund market began to gain momentum in the mid-2010's many investors enjoyed above target returns mainly due to rapidly rising rents and favorable cap rates. While healthy returns are still anticipated, most market participants do not see those favorable trends continuing. Underwriting of these properties has tightened recently with more modest rental growth expected as well as increased expenses at the property level.

One headwind that is plaguing developers of both market rate and affordable rental housing is the cost of insurance. There are many factors contributing to the rapid increase in insurance costs, but higher premiums are mainly a result of greater impact from natural disasters such as floods, hurricanes and fires.[6]

Looking ahead, one caveat to investor demand in early 2024 could be the proposed CRA rule changes which could potentially impact demand over the longer-term. Like housing credit investments, preservation and workforce funds continue to demonstrate resilience during challenging economic times due to the general shortage of housing supply and relatively low rent levels.

Across our sponsors, multi-investor fund sizes range from $50 million to $1.74 billion. Preferred returns have generally been in the 7.00%-8.00% range on a pre-tax basis with total returns in the 10.00%–14.00% range. Please refer to our attached summary of current offerings.

[6] https://www.housingfinance.com/management-operations/industry-insurance-challenges-worsen_s



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# Wrap Up

Please look for our pricing update coming out early Q4 when we send out our updated summary of fund offerings to capture any pricing changes before our next newsletter in January 2024. Please feel free to contact us with any questions or if you'd like to discuss the LIHTC market and fund offerings in more detail.

As always, we appreciate your feedback and welcome your questions and comments.

You can reach Dave Robbins at 617-340-7040

& Brian Rajotte at 503-575-9232.

You can reach Mike Connolly, Chris McCarthy and Garret Daigler of

Beacon Hill Capital at 781-740-8981.


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Exhibit A

# LIHTC Market Update: July 2023

An Institutional Division of Compass Securities Corp.

## LIHTC Fund Market Overview

## Q3 2023

| National Funds | | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sponsor | Fund | Close | Approx Size ($MM) | Status | Investment Pricing<br>After Tax Quarterly Effective IRR (%)<br>Price Per Credit ($)<br>Investment Class | | | | | | | Hard Debt % | 9% / 4% | Repeat Developer | New Const / Rehab | Loss Ratio | Family / Senior | Notes |
| Alliant | 117 | June | 146 | Closed | 7.15%<br>$0.934<br>>=$35M | 7.00%<br>$0.939<br>>=$25M | 6.75%<br>$0.946<br>>=$15M | 6.50%<br>$0.953<br><$15M | | Various<br>TBD<br>CRA | | 32% | 44% / 56% | 81% | 80% / 20% | 98% | 87% / 13% | 100% closed or under LOI. 12 properties in 10 states. 87% Repeat Developer. 55% of equity has supoortive services for formerly homeless or special needs individuals |
| CREA | 103 | June | 180 | Closed | 7.25%<br>$0.92<br>>=$50M | 7.10%<br>$0.92<br>>=$30M | 6.70%<br>$0.93<br><>=$20M | 6.20%<br>$0.96<br><$20M | 5.50%<br>$0.98<br>CRA 1 | 4.75%<br>$1.00<br>CRA II | 4.25%<br>$1.01<br>CRA III | 22% | 65% / 35% | 89% | 90.5% / 9.5% | 86% | 77% / 23% | 100% specified; 60% closed or under LOI. 23 properties in 13 states. 25% of equity in census tracts that are 90% or greater minority. |
| Enterprise | 41 | June | 278 | Closed | 7.00%<br>$0.927<br>>=$35M | 6.25%<br>$0.960<br>>=$15M | | N/A<br>N/A<br>CRA | N/A<br>N/A<br>CRA | | | 28% | 33% / 67% | 70% | 60% / 40% | 100% | 78% / 22% | 26 properties across 15 states. 100% of portfolio closed or under LOI. 48% of equity has rental subsidy. |
| Enterprise | 42 | October | 180 | Available | 7.00%<br>N/A<br>>=$25M | 6.50%<br>N/A<br>>=$20M | 6.25%<br>N/A<br>>=$15M | 5.75%<br>N/A<br>CRA | 3.75%<br>N/A<br>CRA | | | 25% | 27 / 73% | 75% | 60% / 40% | TBD | 56% / 44% | Primarily CA fund plus some additional states including TX and MA. 15 properties across 7-8 states. 50% of portfolio closed or under LOI. 79% of equity with subsidy. |
| PNC | 87 | June | 190 | Closed | 7.00%<br>$0.900<br>>=$35M | 6.50%<br>$0.918<br>>=$25M | 6.25%<br>$0.927<br>>=$20M | 6.00%<br>$0.939<br><=$10M | Various<br>TBD<br>CRA | | | 31% | 38% / 62% | 56% | 69% / 31% | 99% | 82% / 18% | Accelerated credit delivery , 45% of properties stabalized or already in construction, 42% of equity include supportive services, 63% benefit from rental assistance, 10% Co-investment by PNC Bank |
| RBC | 35 | September | 180 | Available | 7.00%<br>TBD<br>>=$30M | 6.50%<br>TBD<br>>=$20M | 6.25%<br>TBD<br>>=$10M | 6.00%<br>$0.960<br><$10M | 5.50%<br>TBD<br>CRA I | 4.75%<br>TBD<br>CRA III | 3.75%<br>TBD<br>CRA VI | 21% | 23% / 77% | 76% | 74% / 26% | TBD | 51% / 49% | 100% Specified – all deals will be under RBC control via LOI or closed into RBC inventory in advance of Fund closing; 7 properties on current property list are closed at lower tier |
| Red Stone | 99 | May | 206.5 | Closed | 7.10%<br>$0.923<br>>=$30M | 6.70%<br>$0.935<br>>=$20M | 6.25%<br>$0.950<br>>=$10M | 5.40%<br>$0.980<br>< $10M | 4.35%<br>$1.022<br>CRA | | | 21% | 60% / 40% | 68% | 73% / 27% | 133% | 80% / 20% | 20 properties in 12 states and D.C. Portfolio 96% identified and 96% LOI or closed. Rental subsidy on 41% of units. 3.25% fund reserves. 0.25% deferred fee. |
| Richman | 144 | October | 200 | Available | 7.40%<br>$0.900<br>>=$30M | 7.00%<br>$0.910<br>>=$20M | 6.75%<br>$0.920<br><$20M | Various<br>~$0.96<br>CRA | | | | 32% | 24% / 76% | 82% | 53% / 47% | 128% | 70% / 30% | 100% specified, 80% under LOI 80% repeat developer, 25 properties in 11 states, 70% of units benefit from rental assistance contract for entire 15-year compliance period |
| WNC | 55 | Aug | 220 | Circled | 7.25%<br>$0.947<br>>=$35M | 7.00%<br>$0.950<br>>=$25M | 6.75%<br>$0.961<br><$25M | Various<br>Various<br>CRA | | | | 32% | 15% / 85% | 65% | 59% / 41% | 110% | 66 / 34% | 100% under LOI. 16 properties in 11 states. Resident population: previously homeless,Veterans , individuals with mental/physical disabilities, sensory impairment and extremely low income |

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Loss Ratio: Tax losses before dispoition as a percentage of capital invested
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## LIHTC Fund Market Overview

Q3 2023

### Regional and Impact Funds

| Sponsor | Fund | Close | Approx Size ($MM) | Status | Investment Pricing<br>After Tax Quarterly Effective IRR (%)<br>Price Per Credit ($)<br>Investment Class | | | | | Hard Debt % | Notes |
|---|---|---|---|---|---|---|---|---|---|---|---|
| CREA | 90 | Jun-22 | 143.2 | Closed | 6.65% | 6.50% | 6.25% | 5.75% | 5.00% | 34% | 100% specified; 82% closed and 18% under LOI. 7 properties all in CA. 82% repeat developer, 18% senior |
| | | | | | $0.960 | $0.970 | $0.980 | $0.990 | $1.010 | | |
| | | | | | >=$35M | >=$30M | >=20M | CRA 1 | CRA 2 | | |
| **CREA** | **EDF** | **September** | **50** | **Available** | **5.25%** | | | | | **25%** | **Emerging Developer Fund which is credit enhanced. Property Locations in Cleveland OH, Erie PA, St. Louis MO** |
| | | | | | **$0.97** | | | | | | |
| RBC | CA 8 | February | 102 | Closed | 6.00% | 5.50% | 4.50% | | | 32% | San Francisco, Ventura, Los Angeles, Imperial, and Kern Counties. 4 of 5 properties closed |
| | | | | | $0.990 | $1.000 | $1.040 | | | | |
| | | | | | Base | LA CRA | Bay Area | | | | |
| Red Stone | CA-2022 | Nov-23 | 137 | Closed | 6.80% | 6.45% | 5.80% | 5.30% | | 19% | 10 properties: 95% specified and closed or under contract; Rental subsidy on 31% of units. 22% senior properties. 67% repeat developer. 100% new construction, and 4% tax exempt bond transactions. |
| | | | | | $0.946 | $0.955 | $0.974 | $0.989 | | | |
| | | | | | >=$30M | >=$20 <$30 | >=$10 <$20 | <$10M | | | |
| **Richman** | **Western Regional 3** | **November** | **100** | **Available** | **6.20%** | **TBD** | **4.50%** | | | **30%** | **Third Western Regional fund from Richman Group. Primarily Bank investors with targeted CRA in Utah and surrounding states, plus CA, OR, WA. 78% repeat developers** |
| | | | | | **$0.930** | **TBD** | **$0.980** | | | | |
| | | | | | | | | | | | |
| **WNC** | **CA 20** | **22/23** | **150** | **Available** | **6.50%** | **6.25%** | **6.00%** | | | **33%** | **Initial closing in August 2022. Second in Dec 2022 and final close by August 31, 2023.11+ properties located in 7 separate CA markets. 75% specified, 70% under LOI. 35% of units have rental assistance. 22% senior tenancy. PPC reflects inclusion of state and energy credits and 3% upper-tier reserves** |
| | | | | | **$1.005** | **$0.996** | **$0.870** | | | | |
| | | | | | **>$15M** | **>$10M** | **<$10M** | | | | |

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## Market Overview
Q2 2023

| Preservation & Workforce Housing Funds | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Pre-Tax IRR % | | | | | |
| Sponsor | Fund | Close | Commitment Period/Hold (in Yrs) | Asset Mgmt Fees | Approx. Size (millions) | Pref Return | Net/Residual | Co Investment | Minimum Investment Size | Approx. Available $MM | Notes |
| Bridge Investment Group | 2 | Closed | 4 / 10-12 | 1.5-2.0% | 1740 | 7.00% | 10-12% | 2% up to $10M | $250K | 0.00 | Approx $940M deployed as of end Q3. PWI compliant, tenant programs & svs, 65-85% acquisition of Class B&C, 10-20% new development, 5-15% manuf. housing. Target leverage of 60-65%. |
| **Enterprise** | **5** | **2022-23** | **3 / 10** | **1.5%** | **300** | **7.00%** | **9-11%** | **2.5% <= $2.5M** | **$500k** | **300.00** | **Target returns for CRA investors are 100 basis points lower. Preferred Return of Capital. 50/50 until yields hit, then 20% after preferred return & 30% after net return to LP's thereafter. Max 15% of equity in 1 transaction** |
| **RBC** | **1** | **2023** | **2 / 10** | **1%** | **75** | **7.00%** | **10-12%** | **3.00%** | **$5M** | **75.00** | **PWI Compliant. Target Fund level leverage of 65% to 80%. Max 20% equity in single transaction; 100% of cash flow to investors until pref return and return of capital, then 75/25 split. Three properties identified out of an expected 8-10.** |
| **WNC** | **3** | **2023** | **3 / 8** | **1.5%** | **300** | **8.00%** | **11-13%** | **5% up to $1.5M** | **$2.5M** | **25.00** | **PWI compliant, 100% return of capital to LPs; next 100% to LPs until cumulative 8% pref., 50% to LPs until 20% catch up to GP, then 80/20 split** |

* Funds **shown in bold** are open to investors.

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LIHTC Yields vs. Tax Adjusted Alternatives

| Spreads to LIHTC<br>Jan 2000 - Present | | | | | | |
|---|---|---|---|---|---|---|
| | Date | 10 Yr | Date | BBB | Date | AAA |
| All Time Low: | 6/26/06 | 1.33% | 10/31/08 | 0.27% | 6/28/06 | 0.91% |
| All Time High | 10/1/09 | 9.25% | 12/17/09 | 7.87% | 11/27/09 | 9.21% |
| Current: | 7/6/23 | 3.55% | 7/6/23 | 2.00% | 7/6/23 | 2.89% |



**Notes**: 35% Corp. Tax Rate 2000-2017, 25% for 2017, 21% 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.

**AAA, BBB & 10 Yr:** Yields adjusted to represent an after tax yield

**Source:** https://fred.stlouisfed.org/series/

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## Tax Adjusted BBB Spread to LIHTC vs. Rolling Average

All Time High 7.84%

All Time Low 0.27%

Current 2.00%

9.00% 8.00% 7.00% 6.00% 5.00% 4.00% 3.00% 2.00% 1.00% 0.00%

1/3/00 7/3/00 1/3/01 7/3/01 1/3/02 7/3/02 1/3/03 7/3/03 1/3/04 7/3/04 1/3/05 7/3/05 1/3/06 7/3/06 1/3/07 7/3/07 1/3/08 7/3/08 1/3/09 7/3/09 1/3/10 7/3/10 1/3/11 7/3/11 1/3/12 7/3/12 1/3/13 7/3/13 1/3/14 7/3/14 1/3/15 7/3/15 1/3/16 7/3/16 1/3/17 7/3/17 1/3/18 7/3/18 1/3/19 7/3/19 1/3/20 7/3/20 1/3/21 7/3/21 1/3/22 7/3/22 1/3/23 7/3/23

LIHTC Spread over BBB    Rolling Ten Year Average    *10 Yr Average Starts in 2011

**Notes**: 35% Corp. Tax Rate 2000-2017, 25% for 2017, 21% 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.

**BBB & 10 Yr:** Yields adjusted to represent an after tax yield

**Source:** https://fred.stlouisfed.org/series/

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