Friends & Colleagues,

It's been almost 5 months since we sent out a post-election LIHTC market update. Since then, the market has stabilized and found new equilibrium pricing. As before, 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, and what you can expect looking ahead in 2017.

As we have seen in past market corrections, falling tax credit pricing encourages syndicators to put product into proprietary funds where pricing is agreed to on a deal-by-deal basis. As a result, the multi-investor fund component of the market tends to shrink as a percentage of the total market. Conversely, when prices are rising syndicators are more comfortable acquiring product and multi-investor funds tend to be both larger and comprise a higher percentage of the total market.

Currently, demand for LIHTC has remained robust with the direct and proprietary segments remaining strong while multi-investor funds, which still garner substantial demand from non-CRA investors, have seen the biggest pricing adjustment. While the 2016 election brought swift change to the LIHTC industry, **the widespread potential for re-trading that seemed imminent in December started to fade by January as market participants tempered their most pessimistic views of tax reform.**

The positive aspects of this market correction that we mentioned in December have materialized - less so for the most competitive projects and CRA locations, and more so in multi-investor funds that are seeking to attract non-CRA investor equity. In national funds, **the loaded price per credit has generally fallen below $1.00 for national funds closing in Q2 and Q3, down about 7 to 8 cents from before the presidential election.** As we discussed previously, historically high tax credit pricing in 2016 resulted in a large number of transactions that were overfunded, or certainly very well funded, relative to historic levels. As a result, we are seeing an increasing percentage of the developer's cash development fee being deferred to achieve new pricing levels. Lastly, we are seeing demand strengthen as pricing and terms improve and the prospect of sweeping tax reform recedes.

In general, we are seeing a consensus that corporate tax rates will settle at 25% or higher (if they change at all) and many seem to believe that if corporate tax reform is enacted, corporate tax rates will end up at 28% or higher. Given this view, investors are keen to capture the potential upside above 25%. With respect to downside risk, many investors are either running sensitivity analyses assuming a 20% tax rate, or are looking for some downside protection. The potential for a 15% corporate tax rate seems very unlikely despite Trump's recent tax proposal.

- **New pricing -** Most current multi-investor funds seeking to attract non-CRA investor equity are underwritten at a 25% tax rate. Roughly half the funds include some form of downside yield protection to a 20% tax rate. Those that do not provide explicit downside protection still generally stress-test to an after-tax IRR of about 5% at a 20% tax rate. Nearly all provide upside yield to the investor should tax rates stay above 25%. Several multi-investor funds that are CRA focused are underwritten at a 20% tax rate. In comparing funds underwritten at 25% vs. 20%, as a general rule, the after-tax IRR increases about 100 bps moving from a 20% to 25% tax rate. **Putting current fund yields in context with the previous round of funds, yields are up 200 bps or more when compared using equivalent tax rates.**
- **Timing of tax reform -** There is the potential for additional IRR upside in current funds with respect to timing. Most funds assume a lower tax rate effective in 2017, but a later implementation, or phased implementation seem more likely and provide further potential upside for investors.
- **Terms -** As with other market corrections, syndicators have been able to secure transactions with improved terms in many cases, and fund metrics have held or improved as well.

- **Depreciation/Expensing -** We have seen no modification to depreciation, interest deduction, or expensing assumptions in syndicator models, although all are possibilities as part of tax reform.
- **Fund specification -** While generally lower than the last round of funds, as always, we are seeing funds with the most specificity getting the most traction with investors.
- **Bridge financing -** Lower tax credit prices have allowed syndicators to reduce fund level bridging. As expected, we are seeing lower levels of bridging than the last round of funds - generally in the range of zero to 50 bps enhancement to the IRR.
- **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.
- **Opportunities -** With demand strong and the prospect of dramatic and sweeping tax reform fading, we are hearing of fewer transactional opportunities than we thought there would be back in December. Syndicators report strong competition for deals, and the proprietary and direct segments of the market remain robust. Recently in the multi-investor fund segment, we have seen several large investors come off the sidelines to take advantage of opportunistic fund pricing in the first two quarters of 2017.
- **CA regional funds -** These funds are almost exclusively CRA oriented, but we are seeing a similar dynamic and pricing adjustment as in the national funds due to the number of competing funds for a limited pool of investors.

Rising interest rates and the outlook for LIHTC yields

In addition to the prospect of tax reform, this LIHTC market correction is reflecting a rising interest rate environment. The highlight as of this report is that long-term rates have, for the time being, settled below their year-end levels. The **10-year U.S. Treasury** yield had increased more than 100 basis points between July and December of 2016, but have receded to about 75 bps over their July levels. 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 after the election, the spread was about 350 bps, and **as of mid-April 2017 it has increased to just over 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. **The spread has increased further and as of mid-April has returned to the historical average at just over 300 bps.** If you would like a graphical representation of these spreads, we would be happy to send it to you upon request.

Looking back at the first round of funds in 2017, yields continued to rise to stimulate demand. Rather than the 5.25% (at a 25% tax rate) that we were seeing get early traction in December, **the first round of funds for non-CRA investors generally cleared (and are still clearing) in the 5.50% to 6.00% range (at a 25% tax rate).**

So, where do we think non-CRA yields will be on LIHTC national funds the second half of 2017? First, it must be emphasized that there is always a range in LIHTC yields throughout the market. Reasons for this include, but are not limited to, an inefficient market, differences in portfolio composition, sponsor strength, load, and bridge financing.

The most recent investor sentiment seems to indicate that current funds represent a relatively good value and we think their actions reflect both the potential upside to IRR with respect to the timing and extent of tax reform as well as a return to historical spreads against the benchmark interest rates. If current funds have overshot the mark just a bit, it could indicate that yields will be flat or down slightly in the second half of the year. Continued strong demand for CRA transactions also supports the prospect of declining yields.

Alternatively, we have seen a number of non-CRA investors front-load their LIHTC investing activity to take advantage of the market correction. This may leave funds in the second half of the year that typically rely on economic investors scrambling to find enough equity. If that happens, we could see yields hold or even rise. It wouldn't be the first time that we've seen a bifurcated market - where national fund yields move independently from proprietary and direct funds.

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 your comments and perspective. If you no longer wish to receive these updates, reply to this email and type **unsubscribe.**

Best Regards,

David Robbins & Brian Rajotte
Strategic Tax Credit Investments
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