Recap Update

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How should states best use their 2009 affordability resources?

By David A. Smith and Ethan Handelman

"If we do not hang together, assuredly we shall all hang separately."
-- Benjamin Franklin, who was born and raised in Massachusetts

EXECUTIVE SUMMARY: A TIME OF GREAT URGENCY

In the most tumultuous financial environment in at least thirty years, the controlling factor of affordable housing production via LIHTC is now equity—many pipeline properties have an allocation of credits, but lack an equity investor. To help their pipelines, states need to change their rules, and quickly, lest the credits be lost to other, faster-responding states.

THE RECOMMENDATIONS FOR MASSACHUSETTS

At the request of the Massachusetts housing Partnership (MHP, www.mhp.net), Recap surveyed the state and nation and prepared a white paper (copy attached) listing strategic recommendations. Here's what we advised Massachusetts' resource allocators to consider:

1. **Participate with stakeholders in a collective response to the crisis**. Shared interests should trump parochial or competitive interests.
2. **Allow strong, equity-backed applicants to apply and win.** Viability is key, as is reliable execution.
3. **Make non-critical transaction features optional, for points**. Thresholds can be counterproductive when demand is less than supply.
4. **Keep the competitive process.** It harnesses market forces, even in weaker markets.
5. **Collect and disseminate reliable data on LIHTC markets**: allocations, awards, pricing.
6. **Break the equity bottleneck using QAP criteria**. Give substantial extra points for reliable and ready equity.
7. **Provide an underwriting cushion to handle equity price drops.** Stress-test applications with lower-than-expected equity prices.
8. **Have resources available to assist pipeline properties to close**. They represent a sunk cost (by somebody) and an affordability opportunity.
9. **Avoid incentives that align against equity markets.** Rather than lose credits to a national pool, spend your resource in your state.
10. **Maximize flexibility with gap-filler resources**. Plus-up any other LIHTC-compatible resources available to you.

IMPLICATIONS FOR EVERY STATE

Every state is different, but the LIHTC equity crisis is nationwide. Read our report with that in mind, and apply it to your own situation. But whatever you do, do it openly, cooperatively, and quickly.

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How Massachusetts can best use its 2009 affordability resources

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1. A. The crisis in LIHTC and affordable housing today

As the nation and the Commonwealth come to grips with the most tumultuous financial environment in at least thirty years, the LIHTC industry is facing:

- A sudden and pervasive withdrawal of credit and global repricing of risk.
- The largest downward correction in LIHTC pricing in the program's history.
- Massive and ongoing consolidation in the banking sector, which until recently was the all-but-exclusive consumer of LIHTC equity investments.

Put these factors together and it is clear that the LIHTC and affordable housing world in 2009 will be vastly different than the equilibrium which prevailed through the end of 2007. Further, no one can say with any certainty when equilibrium will return and at what price levels.

Roughly 60% of the previous investment demand for LIHTC has evaporated, at least for the near term. New investment will flow in, but only as the market reaches a new equilibrium. The controlling factor in the LIHTC market is now equity—many pipeline properties have an allocation of credits, but lack an equity investor.

For example, of 39 Massachusetts pipeline properties allocated in 2007 and 2008, only 8—barely over 20%—have closed with firm equity. That means roughly 80% of pipeline properties are still lacking in solid equity, with a whole new round of allocations coming up in 2009. For the first time in the LIHTC's history, not only will there be a substantial pool of unused credits to be redistributed nationally, but there will be $2-4 billion of 2008 LIHTC without an equity investor, even as another $8 billion or so of new LIHTC will be allocated to states.

Competition for equity will be fierce, with LIHTC pricing settling out in the $0.80 to $0.60 range. In our judgment, the market will fragment into pricing tiers based on deal attributes: location, financing complexity, agency support, and developer strength. Based on pricing adjustment alone, Massachusetts' allotment of credits will go only 77% as far as it did last year. Fewer pipeline properties will get done in the new reality. Unless we change the process to concentrate subsidy resource effectively, we will allocate LIHTC that will go unused, thereby wasting federal resources designated for Massachusetts.

1. B. What Massachusetts can do

Despite that markets are changing faster than government can generally react, major stakeholders in the Massachusetts affordable housing arena, in particular governmental bodies, can take swift action to guide the market to a new equilibrium while helping Massachusetts residents, developers, and investors weather the economic storm.

Today, the Low Income Housing Tax Credit (LIHTC) is the nation's most important affordable housing financial resource. Historically, Massachusetts has been among the nation's leaders in innovative use of the Low Income Housing Tax Credit; the state has always consumed its full allocation and its allocating agencies have garnered numerous NCHSA awards of excellence.

All of Massachusetts's major stakeholder groups, including particularly arms of government, need to recognize that with the value chain disrupted, they all have a shared interest in re-engineering the working relationships to pull together to spend and place Massachusetts' full LIHTC allocation, thereby maximizing use of the federal subsidy. Procedures and approaches that worked when LIHTC equity investors could be found for virtually any award of credits have led to an imbalance that fails miserably when LIHTC equity is undersubscribed.

Recommendations

1. ***Participate with stakeholders in a collective response to the crisis.*** Sponsors, syndicators, and lenders know as well as anyone the specific barriers to quick deployment of LIHTC. Since we no longer have the luxury of a rising market that allows all deals to eventually get funded, we need to collectively reevaluate the allocation process. More than one of our sources told us, in the plainest possible terms, that it would not review LIHTC properties in one or more states because the state had a reputation for being procedurally difficult. Massachusetts should build on its tradition of effective public-private partnerships in responding to this crisis.
2. ***Allow strong, equity-backed applicants to apply and win in the first round.*** This will mean streamlining the LIHTC allocation and award process and setting realistic, clear expectations. Many of the LIHTC allocation processes—some of them of many years' standing—represent hurdles that sponsor and equity investors would surmount when demand exceeded supply, but which they now will not. Allow applicants to cure administrative deficiencies, rather than forcing them to reapply. Remove pre-application requirements that will be obsolete by closing. Be flexible particularly on bond pipeline properties, both during application and through to closing.
3. ***Make non-critical deal features optional***. Threshold requirements that add cost may prevent pipeline properties from closing. Optional-for-points features that add cost may be sacrificed for cost savings when pipeline properties run into trouble, so keep points for such features low to avoid painful rescoring later.
4. ***Keep a competitive process***. We have heard calls for handing out credits on a first-come, first-served basis on the theory that competition among developers is a thing of the past. Such calls miss the central role competition has in the success of the LIHTC program. Competitive allocation harnesses market forces to the efficient allocation of scarce resources. What Massachusetts must do, however, is focus the competition on the aspects critical to the success of pipeline properties—provision of equity.
5. ***Collect data on LIHTC markets.*** In this changing market, Massachusetts needs more than ever to have accurate, available data on the pipeline of LIHTC properties, both 4% and 9% deals. It is clearly a governmental function to provide this public good to inform policy decisions and help the market reach equilibrium.
6. ***Break the equity bottleneck using QAP criteria***. The single biggest factor impeding the effective deployment of Massachusetts' LIHTC is the lack of equity investment. Massachusetts should therefore make the most important factor in its allocation of 2009 the commitment of an equity investor. For example, the 2009 QAP could award substantial extra points (say, 80 points, roughly equivalent to all of the special project characteristics in the 2008 QAP) for properties with a credible equity commitment. Credibility could be established by transparency past the syndicator to the investor level and a cash deposit by the investor. Few properties could provide that, but those that did would certainly close.
7. ***Provide underwriting cushion for equity price shifts***. Stress test applications at lower-than-average equity prices, at least until the market settles at an equilibrium price. That will avoid having pipeline properties come back for additional credits because markets have moved during the allocation process.
8. ***Have resources available to assist pipeline properties to close***. As discussed above, recently awarded pipeline properties are struggling to close because markets have shifted faster than allocations can adjust. Recognize that gap-filler resources—soft debt, grants, additional credits—will be needed on those pipeline properties.
9. ***Avoid incentives that align against equity markets***. State allocation criteria will not be able to overcome the pressure from investors, at least in the short term. So, making allocations to deals that are unattractive to investors will simply mean allocations go unused for lack of an investor. Unused LIHTC means wasting federal subsidy dollars. Massachusetts should avoid scoring criteria that, for instance, advantage weaker sponsors, favor complicated financing structures, or unnecessary deal costs.
10. ***Maximize flexibility with gap-filler resources***. Recognize explicitly that state tax credits complement, rather than substitute for, federal credits. Reduce through legislative and agency action constraints on soft money sources, enlisting stakeholder and private donor support along the way.

2. The new reality for affordable housing

2. A. Macroeconomic flux

The world of affordable housing finance will look very different in 2009.

> "We are going through a financial crisis more severe and unpredictable than any in our lifetimes."
> --Treasury Secretary Henry M. Paulson, Jr.[1]

This year has brought unprecedented flux, each element of which has specific negative impacts on affordable housing:

	Element of flux	*Impact on affordable housing*
1.	The worst financial crisis since the Great Depression	Shortage of liquidity in all sectors, including multifamily housing. Specific negative attention to subprime lending, with some spillover to affordability programs.
2.	Decline of housing prices, accompanied by waves of foreclosures	Some upward pressure on rents as marginal homeowners return to the rental market, so little relief for low-income tenants. Neighborhood-wide declines that can spill over to multifamily properties
3.	Federal takeover of Fannie Mae and Freddie Mac	Elimination of two largest LIHTC investors, representing at least 40% of the previous investor market
4.	Massive and ongoing consolidation in the banking sector	Further elimination of many CRA-motivated LIHTC investors
5.	Recession, officially beginning in December of 2007[2]	Financial pressure on residents, property operations, syndicators, developers, lenders, and government funding sources

2. B. Federal actions amidst flux

In the midst of this flux, the federal government is acting, but with the usual blunt, time-delayed instruments available:

- The Housing and Economic Recovery Act of 2008 (HERA) adopted many long-awaited improvements to LIHTC such as removal of the recapture bond requirement, harmonization with other subsidy programs, and granting states the flexibility to apply a 130% Difficult-to-Develop-Area (DDA)-style basis boost. It also, however, added 10% to the supply of LIHTC—a commodity facing falling demand.[3]
- Federal block grant funds are flowing to communities to combat foreclosure and its effects, but focused mostly on single-family housing.
- Treasury's Troubled Asset Relief Program (TARP) has pivoted from buying so-called toxic assets to acquisition of equity in banks, with more twists likely to come as markets react, but with an overall focus on maintaining confidence by flooding financial markets with liquidity.

[1] Secretary Henry M. Paulson, Jr., "Fighting the Financial Crisis, One Challenge at a Time," *New York Times* op-ed, November 18, 2008, republished as Treasury release HP-1280.
[2] "U.S. Entered a Recession A Year Ago, NBER Says" *Wall Street Journal*, December 1, 2008, http://www.wsj.com.
[3] Housing and Economic Recovery Act of 2008, Public Law No: 110-289.

- Federal regulators are encouraging consolidation in the banking sector, effectively subsidizing acquisitions of weaker financial institutions by stronger ones.

None of these actions, however helpful in the macroeconomic context, will do much to counteract the effects on affordable housing.

2. C. Decrease in investor demand for LIHTC

Even a simple listing of the largest 2006 investors in LIHTC equity reveals the critical point the LIHTC equity market has crossed. What had been an $8 billion investment industry may be as little as $4-5 billion in 2008, even though the total amount of LIHTC available will increase, indexed to population.

The chart below lists investors, as distinct from the syndicators who structure and package LIHTC investments. Estimates are our own, based on a variety of confidential sources and presented to characterize tiers of investment levels rather than specific enumeration.

Table 1
Large LIHTC equity investors in 2006 … and their appetite today
(An informal estimate compiled by Recap Advisors – all figures approximate)

Investor	*Pre-crisis share, still investing*	*Pre-crisis share, not investing*	*Current status*
Fannie Mae		25%	No immediate plans to sell portfolio of LIHTC equity, but has substantially written down LIHTC value.
Freddie Mac		15%	Same as Fannie Mae regarding LIHTC
Bank of America	8%		
Citibank		8%	Substantial TARP customer.
JP Morgan Chase	8%		Reported to have increased.
Wachovia		4%	Acquired in distress by Wells Fargo.
U.S. Bancorp	4%		Reported to have increased.
Verizon	4%		Reported to have increased.
Washington Mutual		4%	Acquired in distress by J.P. Morgan.
Merrill Lynch		2%	Acquired in distress by Bank of America.
GE Real Estate	2%		Not subject to CRA.
Capital One	2%		Reported to have increased.
National City		2%	Acquired in distress by PNC.
PNC	2%		
Other investors	10%		Varied.
Total	40%	60%	

Roughly 60% of the previous investment demand for LIHTC has evaporated, at least for the near term. New investment will flow in, but only as part of the market reaching a new equilibrium.

2. D. Syndicators struggling, under pressure

Pressure on syndicators during this disruption is intense. After a 20-year-long run of rising LIHTC prices, falling yields, and seemingly endless investor appetite, the market was not surprisingly unprepared for a sudden reversal. Syndicators are facing rising demands for assistance from troubled past pipeline properties, thinner margins, unsold inventory, and a slowdown or halt in the sales pipeline.

Shakeout in such an environment is only to be expected. Financial news has been full of reports of the financial struggles of the two largest syndicators—MMA and Centerline—who together represented more than 20% of all LIHTC done in 2006. Other syndicators are less subject to financial journalism but are facing similar struggles.

The result will be less capacity (and for syndicators exiting the business, less motivation) on the equity side to assist pipeline properties that are struggling.

2. E. Investors reevaluating, LIHTC prices falling, yields rising

The result of these changes is the largest correction in LIHTC prices the program has ever seen. Prices that in some desirable coastal markets were above $1 per dollar of LIHTC (observed by Recap to be "hyperactivity" back in 2006[4]) are now below $0.80 in some cases. Observable prices now are legacy deals—properties in the pipeline from before the disruption. Much lower price are not registering yet because fewer pipeline properties are feasible at those prices and markets have yet to accept the few that will.

> "Returning credits is the last, final step… It's an admission of failure, an admission that they can't get the deal done."
>
> --Garth Rieman, director of housing advocacy for the National Council of State Housing Agencies[5]

Investors are reevaluating the risks that attend LIHTC investments. The assumption that state allocating agencies, and other stakeholders will cooperate to support struggling properties is being tested and will be further tested if this recession deepens. Investors that previously treated LIHTC like a yield-based bond investment are recognizing that it is indeed a real estate equity investment, with all of the attendant risks.

Yields are rising to attract new investors into the market, and as yields rise, each dollar of LIHTC translates into less equity for affordable housing development.

2. F. The unprecedented overhang of unsold LIHTC

As noted above, best expert estimates suggest that, whereas in every year from 1988 through 2007 all allocated LIHTC was sold and closed, the nation as a whole will end 2008 with a substantial inventory of unsold LIHTC—perhaps $3-4 billion worth, or 40% of the 2008 allocations—where allocating agencies have awarded LIHTC to developers, but developers have been unable to secure a firm equity commitment much less close.

This situation is without precedent, and its consequences are likely to prove troublesome to the stabilization of 2009 LIHTC equity prices. Trouble will intensify as the sponsors (and their allocating agencies) of properties with overhanging unsold LIHTC realize that if they do not sell the commodity, at any price, then they will simply lose it back to the national pool.

3. LIHTC in 2009: toward a new equilibrium in LIHTC markets

Eventually, even the fastest falling markets stabilize. Because our LIHTC pricing situation is unprecedented, no one can predict how long stabilization will take to occur, although the median result of our informal survey projects that stability will not emerge until late 2009 at the earliest.

Since the Commonwealth (like other states) faces an urgent situation, it is worth charting what we speculate may happen during 2009.

[4] "Relieving LIHTC hyperactivity by removing artificial barriers to resales," David A. Smith and Ethan Handelman, Recap Update 53, March 22, 2006, http://www.recapadvisors.com/pdf/wu53.pdf.
[5] "Affordable Housing Deals Are Stalling," Terry Pristin, *New York Times*, November 11, 2008, http://www.nytimes.com/2008/11/12/realestate/commercial/12housing.html?_r=1&scp=1&sq=affordable%20housing%20todd%20crow&st=cse.

3. A. Emergent new buyers will place negligible value on CRA considerations

As Recap documented two years ago,[6] by the mid 2000's LIHTC pricing had reached its apex and its ultimate buyer: the profitable financial institution which also placed meaningful monetary value on maintaining an Outstanding CRA rating and hence consumed substantial LIHTC equity to assure itself of that Outstanding.

In a market where CRA equity investment had a measurable monetary value, all non-CRA-motivated buyers—such as profitable Fortune 500 industrials, insurance companies, utilities, and so on—were largely priced out, a concentration by investor type that only now is revealed to have been dangerous for the industry as a whole.

New buyers likely to emerge in 2009 will be precisely those Fortune 500 entities with reliable earnings, of which, recession notwithstanding, there are plenty. However, the emergence of such buyers will provide little short-term relief, because of:

- *Time delay.* It takes a fair interval of time to educate a corporation to LIHTC and to move that education through to an actual equity investment check. If past experience (the early 1990's) is any guide, 6-9 months is a typical decision interval. Given the recent correction and overall reevaluation of financial risk, the interval may be longer this time.
- *Pricing at lower levels*. Entities that are not financial institutions will place no premium on CRA consideration, so they will enter the space only at prices competitive with other CFO earnings management tools, such as other tax credits.

In this, unfortunately, the LIHTC will suffer in competition with other tax credits. When LIHTC was enacted in 1986, it was virtually the only such tax credit.[7] In the 22+ years since then, other tax credits have emerged as investment vehicles: historic, New Markets, energy, and so on. Compared to these new credits, LIHTC has a long delivery period (10 years), a longer risk period (recapture, 15 years), and greater relative complexity (it is the longest section of the Internal Revenue Code).

The market clearing price for new LIHTC, therefore, must be at levels well below the 2007 equilibrium, and probably below the 2008 asks of $0.85 or so.

3. B. The LIHTC market will find a new equilibrium

The LIHTC program is the primary federal program for production of new affordable rental housing. Since its inception in 1987, it has gradually accumulated bipartisan political support, increasing sophistication in its investor base, a community of effective developers, and a track record of low-risk, socially responsible investment creating millions of affordable homes. In recent years, it has been an important tool for federal policy responses to natural disasters and economic slowdown, because LIHTC development is both economic stimulus and neighborhood revitalization.

All those factors will support a new equilibrium that effectively channels private investment into the development and preservation of affordable housing. That new equilibrium must take into account the changed environment for investors.

Of key importance in the short term is how quickly we reach the new equilibrium. In other words, how quickly developers, investors, lenders, regulators, and community stakeholders recognize that it will take more resources to produce fewer units in this environment. Policy decisions by state allocating agencies can have profound effects on how quickly markets recognize the new reality.

[6] "Relieving LIHTC hyperactivity by removing artificial barriers to resales," David A. Smith and Ethan Handelman, Recap Update 53, March 22, 2006, http://www.recapadvisors.com/pdf/wu53.pdf.
[7] Except historic tax credits, which were quite often used in conjunction with LIHTC.

3. C. Equity is the controlling element

Until the end of 2007, LIHTC funding was supply constrained—that is, demand for LIHTC equity vastly exceeded supply of awards, and demand for LIHTC allocations vastly exceeded supply of allocations. During 2008, that polarity completely reversed. Now, supply of awarded LIHTC equity greatly exceeds demand.

This is a gigantic challenge, because sellers have to sell, whereas buyers do not have to buy.

- A 'seller' of LIHTC equity—that is, a sponsor with an award—must convert the LIHTC into cash through equity syndication in a limited time window or lose the LIHTC entirely.
- A 'buyer' of LIHTC equity—that is, a corporation with pre-tax earnings seeking to manage after-tax earnings and cash flow—can either buy something or do nothing.

This imbalance was tolerable only when demand vastly exceeded supply. Now that it is not, something akin to desperation is setting in among some categories of developers.

Many pipeline properties have an allocation of credits, but lack an equity investor. Data on Massachusetts 9% LIHTC applications illustrates this starkly:

Table 2
The Massachusetts pipeline properties, as of December, 2008

	Dollars Allocated	*Deals Allocated*	*Closed*	*Equity Price **
2007	13,035,617	21	6	0.80
2008, Round 1	14,797,792	18	2	0.82
Total	**27,833,409**	**39**	**8**	**0.81**

* Equity price based on 6 and 11 properties reporting in 2007 and 2008 respectively
Source: Massachusetts Department of Housing and Community Development, November 2008. Allocations from 2007 through 2008 Round 1, including some forward commitments.

- **Of 39 pipeline properties allocated in 2007 and 2008, only 8 have closed**. That means roughly 80% of pipeline properties are still looking for equity, with a whole new round of allocations coming up in 2009.
- **Of just the 21 pipeline properties allocated in 2007, only 6 have closed.** We can expect 2008 statistics to look even worse at the same time next year.
- **Only 17 pipeline properties have reported an equity price, the average of which is $0.81.** That average is certainly skewed upwards by a) pipeline properties that closed early in the crisis, b) pipeline properties that will close at a lower than reported price or simply fall apart, c) exclusion of 22 pipeline properties that haven’t reported any equity price.

More detailed statistics appear in Exhibit 1.

3. D. Markets are changing faster than government can react

From the standpoint of efficient processing, LIHTC capital assembly is backwards—the most important and least controllable element arrives last, not first.

In an LIHTC underwriting of allocated credits, the LIHTC equity is normally the largest chunk of the capital stack, typically 45-60% of total sources. However, it becomes a firm commitment last in the development sequence, specifically:

1. Sponsor secures site control. This requires expenditure of funds.
2. Sponsor sizes debt and/or secures permanent debt commitment.
3. Sponsor secures preliminary commitment for soft gap-filling funding.
4. Sponsor applies for LIHTC, stating an expected LIHTC equity price.
5. Sponsor wins LIHTC competition.
6. Sponsor places LIHTC at an actual LIHTC equity price.
7. If the actual equity price is 'too far' below projections, then sponsor returns to Step 2 and iterates until success.
8. Sponsor closes the property transaction.

The significance here is that Steps 1 through 4 involve expenditure of non-recoverable costs, and that the transaction does not work—in the sense of sources matching uses—until Step 6. If the actual equity price is below the level needed to align sources and uses and the transaction lacks the necessary cash cushions, then the sponsor returns to an earlier stage and repeats the entire process, with no guarantee that prices will not further erode in the next cycle.

Until recently, this reversed-logic sequence was manageable, because sponsors and state allocating agencies have been able to take the presence of equity—and a minimum price—for granted. All the optionality was positive: the equity would get placed, and it would meet or exceed the minimum bid.

The gradual increase in credit prices fueled by competition among investors meant allocators could make gradually increasing demands on applications. Requirements that increased costs could be absorbed, aided by the bootstrap levitation effect of 130% basis boost applied to 70% credits. Pipeline properties could wait year to year to be funded in an environment where most pipeline properties eventually got funded.

Now all the optionality is negative: placement is uncertain, and prices are un-firm. Credit prices are dropping even as previously-allocated pipeline properties are searching for equity. Some rental markets are weakening as the recession continues, reducing rent expectations. Financing costs have risen as credit markets seized up. All of these are happening on a week-by-week schedule, rather than the year-by-year schedule of credit allocations.

These shifts mean that extensive pre-application underwriting may well be overtaken by events. Previously, in an ever-improving market, rent studies and financing quotes had a long shelf life. To the extent they changed, it was often enough for the better. Now, few pipeline properties will look at closing like they did at the application stage. Investors are sensitive to these shifts, even if allocations are not.

The application process should recognize this reality. Application requirements should be reduced, eliminated or deferred to speed closings, although without sacrificing necessary quality control. The fewer procedural barriers to putting LIHTC to work in this environment, the better. Doing so will have the added side benefit of easing the application cost burden on sponsors.

3. E. Investors will spurn marginal properties in favor of robust underwriting

Investors are looking for pipeline properties that provide reliable yields and dovetail with CRA and similar non-economic investment incentives. More attractive pipeline properties will be:

- ***Located in stable or growing markets***. Given recent volatility in housing, stable markets have more luster than in past years.
- ***Uncomplicated***. Fewer layers of financing, multi-year subsidy streams without annual renewal risk, short rehab or construction period, no losses arriving before credits flow.

> "Investors don't like deals with hair."
>
> *-- A top-twenty syndicator who invests nationally*

- ***Matched to banks' footprint and acquisition targets.*** Banks aiming to bolster their CRA rating focus on footprint. Although the impact of CRA has declined recently as acquisitions occur in extremis, financial institutions with a longer time horizon will compete for investments in their footprint or in areas into which they aim to expand.
- ***Supported by state agencies.*** This operates mostly in the negative—investors who perceive a state as unable or unwilling to sustain struggling properties may simply refuse to invest in that state.

> "Some states need to recognize that failing to participate in solutions for struggling deals could be scaring off investors from future investment in their state."
>
> --*Todd Crow, PNC Multifamily Capital*

- ***Backed by well-capitalized developers.*** Overshadowing all other factors is the developer's ability to sustain the property through adverse changes. Weak, poorly capitalized developers will not be able to get equity investment.

> "The good deals are getting done, but others on the margins are not getting done… You want to pick a developer who can be on time and on budget."
>
> -- *Robert D. Taylor, Wells Fargo Community Development Corporation*[8]

3. F. Even after new bid prices stabilize, they will not rise fast, if at all

At some point, equilibrium will emerge and executions will be reliable at a particular price. Prices should then rise. However, they will not rise quickly, because of downward pressure from latent sellers, including:

- The GSEs, Fannie Mae and Freddie Mac. With no practical appetite for LIHTC (with deferred tax assets estimates at 12 years' worth and 25 years' worth respectively), they have recently written down their LIHTC equity positions by a substantial amount. Thus GSEs, at any time they chose, could offer attractive customized pools of resale LIHTC.
- Large financial institutions whose reverses and writedowns have eliminated their CRA and tax appetites for some time to come.

In short, the bid price will not rise significantly.

Right now (December 2008), the spread between 'ask' (the prices which LIHTC developers need to make their transactions feasible) and 'bid' (what new LIHTC could be placed at in volume) is as wide as we have ever seen. In such an environment, sooner or later, ask drops to bid.

And it does not recover rapidly.

3. G. Pricing will tier by attribute

Given new investor sensitivity to deal attributes and an investor-centric pricing market, we can expect greater price differentials to emerge. A likely spectrum appears to be from $0.60 to $0.80. Pipeline properties at the high end of the pricing range will have four or five of the features in Section 3.E.—strong markets, uncomplicated financing, well-capitalized developers, agency support, and CRA area. Pipeline properties at the lower end, to the extent they are feasible, are likely to have only one or two features. Pipeline properties with just one or none of those features will not close.

We thus foresee roughly a four-tier pricing structure conceptually as follows:

[8] "Affordable Housing Deals Are Stalling," *op. cit.*

Tier	*Attributes*	*Representative areas*
1	Strong rental markets; good long-term demography; ongoing presence of expanding and ambitious financial institutions	Coastal CA; NYC; Chicago
2	Solid-to-strong rental markets and demography; significant financial institutions	CT, MA, MD, OR, WA
3	Stable market fundamentals, favorable demography, area of likely banking expansion/ consolidation	Southeast coasts, TX, UT
4	Weak rental markets, weak long-term demographics, no strong financial institution demand	The Missouri and Ohio river valleys

If this tiering shakes out, not only will better tiers command more favorable prices, their prices will stabilize first. With some exceptions, properties in lower-tier markets will be disfavored by national investors, who can tacitly redline entire states and regions because they are interested in yield without being bothered by CRA footprint considerations. LIHTC in disfavored areas may not clear at all, being lost to the national pool, or may clear only if it is in guaranteed funds—but guaranteed funds require a balance sheet, and these are in short supply.

Relative to other states, Massachusetts is generally well-placed: it is a solid Tier 2 market with strong economic fundamentals (though concentrated on the coast), acceptable demography (level population), desirable CRA footprint for banks competing on the East Coast, and a community of well-capitalized, experienced for- and non-profit developers. It also has a long-standing commitment to public support of affordable housing and public sector professionals with the skills and knowledge to guide the Commonwealth through this crisis.

3. H. Sponsor and portfolio consolidation are likely

Evidence is proliferating that, as one would expect, the backup in pricing and the logjam in pipeline properties is placing great stress on sponsors, who have built their business plans and organizational budgets on the historically plausible premise that they can win 1-2 LIHTC allocations annually and then rapidly close their LIHTC equity syndications. If they cannot, such entities can find themselves out of cash, leading to a deteriorating spiral where staff cutbacks lead to capacity atrophy which in turn leads to portfolio weakness.

Smaller sponsors, particularly non-profits, are especially vulnerable.

The same consolidation that is happening elsewhere in the LIHTC value chain—in investor financial institutions, in intermediary syndicators—will soon hit sponsors. When a sponsor exits the business, however, its portfolio lives on, and the operating and managerial responsibility must be transferred to a survivor entity.

Resource allocators need to develop a strategy to address sponsor shakeout and consolidation, and to have flexible, fact-acting resources to facilitate property and portfolio control and ownership transfer so as not to lose the valuable inventory already developed.

4. Increased need, decreased efficiency require pipeline triage

4. A. Need in three cohorts: past, present, and future

We can divide LIHTC properties into three cohorts, each of which will need additional resources:

- ***Past*** – Properties with pre-2007 allocations should all be closed (though there are always exceptions), but they will be under stress as resident incomes fall. Properties expecting to refinance to address capital needs or with maturing debt to repay may turn to public sources if private capital markets remain frozen.

- ***Present*** – Properties with 2007-2008 allocations but no equity investor may need intervention with additional credits or gap fillers to stay alive. Some will fail to attract investment and will turn back their allocation.
- ***Future*** – Properties with 2009 allocations will need more credits, given the slump in pricing. They will also likely require more gap-fillers in the form of soft loans or grants.

All of this implies a greater concentration of affordability resources per unit of housing. In other words, triage.

4. B. Use LIHTC flexibility to concentrate subsidy in fewer pipeline properties

The recent HERA act gave state allocating agencies the ability to apply a 130% basis boost at their discretion—in other words, to concentrate credits in particular properties. If we do the math, that means the concentration of credits can, roughly, provide properties the same level of subsidy they would have received at $0.90 pricing:

	Pre-crisis	*Post-crisis with basis boost*
Basis	1,000,000	1,000,000
Credit percentage	70%	70%
Basis boost adjustment?	100%	130%
Adjusted credit percentage	70.0%	91.0%
Credit allocated	700,000	910,000
Credit price	$0.90	$0.70
Equity raise	630,000	637,000

Just on this factor alone, Massachusetts' allotment of credits will go only 77% as far as it did last year. Massachusetts should be prepared to use its discretion to apply the 130% basis boost to potentially every deal as a way to concentrate resources. Fewer pipeline properties will get done in the new reality.

For many years, the LIHTC market had the luxury that every deal would eventually be funded. Sponsors could queue up, equity would always be ready to invest, and allocators could pick and choose while stretching credits dollars ever thinner. In a rising market, that is a rational and efficient use of subsidy dollars.

Now, the market is contracting. Many deals will not close. Unless we change the process to concentrate subsidy resource effectively, we will allocate LIHTC that will go unused, thereby wasting federal resources designated for Massachusetts.

4. C. Implications for volume-cap bonds and 4% credits

The 4% credits that accompany tax-exempt private activity bonds will become even more difficult to use in this environment. The three main value elements are greatly weakened by the crisis:

- Tax exempt financing is less valuable when interest rates are low and the spread between taxable and tax-exempt financing is compressed.
- Credits are worth less, but the asset management overhead is the same as that for a more valuable 9% deal.
- Financial institutions that used to be indifferent to taxable losses (which also flow through on GAAP accounting into GAAP losses) are newly sensitized. The result is that volume-cap bond transactions, which offer a low LIHTC-to-loss ratio, have suffered demand drops even more severe than allocated 9% LIHTC.

When set against the higher transaction costs of bond properties versus other financing, these value elements will not be enough to make as many bond pipeline properties work as have done previously.

To adjust, bond pipeline properties will concentrate in investor-friendly forms, which will privilege acquisition pipeline properties with low to moderate rehab needs in strong market areas. If investors can achieve quick flow of credits in CRA-valuable areas with stronger underlying economic factors, they may be willing to commit. Agency support will be critical, both in making the application process easier and in providing flexibility to get pipeline properties done.

4. D. Gap-filler resources must be faster and more efficient

Massachusetts needs the flexibility to respond to market shifts faster than even a streamlined LIHTC allocation process will allow. Gap-fillers—soft debt, grants, and state tax credits—are the obvious source for that flexible assistance. The more Massachusetts can do to allow those resources to move quickly and flexibly to adapt to market needs, the more efficient will be its use of all affordability resources.

Part of that flexibility can come from recognition that simpler financing will help pipeline properties get done. Currently, political incentives are such that funding providers are encouraged to provide a little help to many pipeline properties—that shows they are supposedly leveraging contributions from others and allows claims to large numbers of units funded. The result, however, is complex, multi-source financing subject to many different timetables, and leading to rickety, vulnerable deal structures.

In 2007 and 2008, 80% of pipeline properties required two or more additional funding sources beyond LIHTC and first mortgage financing. Exhibit 1 provides statistics.

Gap-filler resources exist in a complex web of regulations and legislation. Many are explicitly targeted to specific areas, stakeholders, or deal types, making concentration difficult. Action may be needed from agencies, legislators, federal regulators, stakeholders, and private donors to overcome barriers to flexibility.

Massachusetts can be a leader in the soft funding world by demonstrating clearly the advantages of concentrating gap-filler resources. By achieving additional (if not perfect) flexibility in gap fillers and doing 3-source pipeline properties—hard debt, LIHTC equity, and one gap-filler—Massachusetts can encourage other funding sources and policy-makers to follow suit.

4. E. LIHTC equity should not be stretched to solve every problem

Although LIHTC is the primary federal subsidy for production of rental housing, it cannot be made to serve all possible needs, particularly in this new environment. Attempting to do so will merely make it harder to put the LIHTC resources to use. This means further triage—focusing LIHTC subsidy on the production and preservation of rental housing, with less specialization or targeting than has been done in the past.

Deep income targeting is a useful illustration but no means the only example. LIHTC is a capital subsidy designed for properties serving residents at 40-60% of area median income (AMI). Rents affordable to that 40-60% AMI income tier can, just barely, sustain operations given the low debt service that follows the heavy capital subsidy. Attempting to target residents at lower income levels, particularly 30% of AMI and below, means that rents will not be sufficient to cover operating costs, even with no debt service at all. That means a sinking fund up front or ongoing income subsidy to tenants. That has always been difficult to do, but some pipeline properties have been done, much to the credit of those worked to structure and fund them.

Put differently, LIHTC can stretch, but is being asked to stretch beyond its limits.

In the current environment, such pipeline properties will be even harder to fund, as subsidy resources are stretched thinner. Similarly, pipeline properties that target constrain the rental market by targeting specific populations or require high-cost services or construction elements will simply be harder to do. They can still be done, but not at the scale or depth we would have expected even last year.

4. F. Massachusetts should aim to be a net consumer of the national pool

Triage will occur across states, not just within them. LIHTC unused by some states is eventually reallocated to a national pool for consumption by states that used their full allocation. Although the process is slow (and may get slower as all parties cling to unusable allocations), credits should eventually flow. By making changes that use its allocation efficiently, Massachusetts can position itself to capture a share of the national pool.

5. What Massachusetts can do

Whether they realize it or not, states are now competing with each other on their 'equity syndication friendliness.' When there are more properties chasing less capital, the easiest to close have an advantage. Thus, although in economic terms Massachusetts is well-placed to weather this storm with a real estate market more stable than many, stronger economic base than most states, and a deep public commitment to affordable housing, that will not be enough. State entities have to reinvent their business processes with a view to accelerating the promising properties and parties to closing.

In this, the Commonwealth can and should make allies of its development, syndication, and investment communities. Per capita, Massachusetts is among the nation's richest states in terms of affordable housing talent, with a broad and deep wellspring of experienced, sophisticated, committed people and companies who we believe are willing to put aside their parochial or private interests in light of the common challenge facing us all.

> "If we do not hang together, assuredly we shall all hang separately."
>
> *-- Benjamin Franklin, who was born and raised in Massachusetts*

Allocating agencies should see themselves as a critical link in an aggregate value chain that works only if the awards are funded and closed. The private sector—syndicators, developers, investors—in Massachusetts will certainly invest their efforts in crafting a revised operating protocol if they have reason to believe the public sector will approach in the same spirit.

Such leadership by Massachusetts government officials will not only help the state's stock and stakeholders, it can help lead LIHTC allocators in other states to rethink their own procedures and policies. There is no time to lose, else national players will perform their own unsympathetic triage and cross off their lists states whose agencies are hidebound by a delivery paradigm that is two years out of date.

The Commonwealth can show leadership and enhance the value of its LIHTC with changes such as these:

1. ***Participate with stakeholders in a collective response to the crisis.*** Sponsors, syndicators, and lenders know as well as anyone the specific barriers to quick deployment of LIHTC. Since we no longer have the luxury of a rising market that allows all deals to eventually get funded, we need to collectively reevaluate the allocation process. More than one of our sources told us, in the plainest possible terms, that it would not review LIHTC properties in one or more states because the state had a reputation for being procedurally difficult. Massachusetts should build on its tradition of effective public-private partnerships in responding to this crisis.
2. ***Allow strong, equity-backed applicants to apply and win in the first round.*** This will mean streamlining the LIHTC allocation and award process and setting realistic, clear expectations. Many of the LIHTC allocation processes—some of them of many years' standing—represent hurdles that sponsor and equity investors would surmount when demand exceeded supply, but which they now will not. Allow applicants to cure administrative deficiencies, rather than forcing them to reapply. Remove pre-application requirements that will be obsolete by closing. Be flexible particularly on bond pipeline properties, both during application and through to closing.

3. ***Make non-critical deal features optional***. Threshold requirements that add cost may prevent pipeline properties from closing. Optional-for-points features that add cost may be sacrificed for cost savings when pipeline properties run into trouble, so keep points for such features low to avoid painful rescoring later.
4. ***Keep a competitive process***. We have heard calls for handing out credits on a first-come, first-served basis on the theory that competition among developers is a thing of the past. Such calls miss the central role competition has in the success of the LIHTC program. Competitive allocation harnesses market forces to the efficient allocation of scarce resources. What Massachusetts must do, however, is focus the competition on the aspects critical to the success of pipeline properties—provision of equity.
5. ***Collect data on LIHTC markets.*** In this changing market, Massachusetts needs more than ever to have accurate, available data on the pipeline of LIHTC properties, both 4% and 9% deals. It is clearly a governmental function to provide this public good to inform policy decisions and help the market reach equilibrium.
6. ***Break the equity bottleneck using QAP criteria***. The single biggest factor impeding the effective deployment of Massachusetts' LIHTC is the lack of equity investment. Massachusetts should therefore make the most important factor in its allocation of 2009 the commitment of an equity investor. For example, the 2009 QAP could award substantial extra points (say, 80 points, roughly equivalent to all of the special project characteristics in the 2008 QAP) for properties with a credible equity commitment. Credibility could be established by transparency past the syndicator to the investor level and a cash deposit by the investor. Few properties could provide that, but those that did would certainly close.
7. ***Provide underwriting cushion for equity price shifts***. Stress test applications at lower-than-average equity prices, at least until the market settles at an equilibrium price. That will avoid having pipeline properties come back for additional credits because markets have moved during the allocation process.
8. ***Have resources available to assist pipeline properties to close***. As discussed above, recently awarded pipeline properties are struggling to close because markets have shifted faster than allocations can adjust. Recognize that gap-filler resources—soft debt, grants, additional credits—will be needed on those pipeline properties.
9. ***Avoid incentives that align against equity markets***. State allocation criteria will not be able to overcome the pressure from investors, at least in the short term. So, making allocations to deals that are unattractive to investors will simply mean allocations go unused for lack of an investor. Unused LIHTC means wasting federal subsidy dollars. Massachusetts should avoid scoring criteria that, for instance, advantage weaker sponsors, favor complicated financing structures, or unnecessary deal costs.
10. ***Maximize flexibility with gap-filler resources***. Recognize explicitly that state tax credits complement, rather than substitute for, federal credits. Reduce through legislative and agency action constraints on soft money sources, enlisting stakeholder and private donor support along the way.

Massachusetts has an opportunity to lead other states in adapting to the coming new equilibrium in LIHTC markets. It should take that opportunity, and by doing so help Massachusetts residents, developers, and investors weather the economic storm.

6. Exhibits

1. Summary of DHCD Allocations
2. About Recap Advisors

Exhibit 1: DHCD 9% LIHTC Allocations (2007 - 2008 Round 1)

Data as of November 2008

Tax Credit Allocations by Sponsor, Deal, and Resident Profile Type

	Total Dollars	*Deals*	*Affordable Units*	*Credit per Unit*
Non-Profit	14,190,109	25	1,119	12,681
For-Profit	11,880,650	11	686	17,319
Joint Venture	1,762,650	3	106	16,629
Preservation	9,055,665	7	529	17,118
Production	18,777,744	32	1,382	13,587
Family	24,569,665	34	1,636	15,018
Elderly	0	0	0	N/A
SRO	2,183,244	4	212	10,298
55+	1,080,500	1	63	17,151
All	**27,833,409**	**39**	**1,911**	**14,565**

Average Equity Price by Type**

	Average Equity Price	*Sample Size*
Non-Profit	0.81	12
For Profit	0.81	2
Joint Venture	0.82	3
Preservation	0.83	2
Production	0.81	15
Family	0.82	14
Elderly	N/A	-
SRO	0.79	3
55+	N/A	-
All	**0.81**	**17**

Syndication Status by Round

	Dollars	*Deals*	*Closed*	*10% Met*
2007 - 1	6,665,952	12	4	9
2007 - 2	6,369,665	9	2	5
2008 - 1	14,797,792	18	2	5
Total	**27,833,409**	**39**	**8**	**19**

Average Equity Price by Round**

	Average Equity Price	*Sample Size*
2007 - 1	0.79	2
2007 - 2	0.81	4
2008 - 1	0.82	11
Total	**0.81**	**17**

Additional Financing Sources *

	Count	*Share*
None	5	13%
One	4	10%
Two	14	36%
Three	11	28%
Four	5	13%
Total	**39**	**100%**

* Additional financing source are all financing sources that are neither federal tax credit equity nor first mortgage debt.

** Equity prices are self-reported, not necessarily closed.

Note: Data include forward allocations, categorized in the round the allocations were made.
Data source: Massachusetts Department of Housing and Community Development, November 2008

Recap Advisors

Recap Advisors

COMPREHENSIVE FINANCIAL SERVICES FOR RESIDENTIAL REAL ESTATE

Recap Advisors is one of the nation's acknowledged experts in the finance, asset management, and restructuring of multifamily residential properties. If you own or invest in these properties, we can enhance your position. We assess your portfolio value and your options, monitor and manage your assets, develop strategic plans to increase value, and execute transactions to realize that value.

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- Fix troubled assets through restructuring or workout
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- Union Bank of California
- Starrett City Associates
- Centerline Capital Group
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- Michigan State Housing Development Authority

For anyone with a significant position in multifamily housing, Recap Advisors is the place to turn for professional services and solutions.

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