

## A Recap on the Impact of Response to the Capital Markets

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Darryl Jacobs, partner, was a recent panelist at the New Market Tax Credit conference in San Diego, CA where the panel held a lively discussion regarding capital markets. Below is a recap of the panel discussion which highlights some of the key takeaways and the affects of capital markets.

### How did capital markets affect New Markets Tax Credit (“NMTC”) transactions during 2009?

The near paralysis of the debt and equity markets during 2009 made it very difficult to close NMTC transactions. The deals that did get closed often were funded with developer loans rather than conventional loans. The difficulty in getting deals closed is evidenced by the amount of NMTC allocation that remains unused. In past years, most of the NMTC allocations were placed in transactions prior to the government’s announcement of the next year’s allocations. Out of the last \$10 billion in allocations spanning two years, it is estimated that as much as \$8 billion remains to be placed.

### How do you foresee capital markets shaking out in 2010?

At the end of 2009, we began to see a thaw in debt and private equity markets. However, lenders are reducing leverage ratios substantially. In recent years, lenders often loaned as much as 80% of the capital necessary for a transaction. However, leverage ratios for the near future will range from 50% to 65%. Similarly, the returns that private equity investors are demanding are significantly higher (3% to 5%) than recent years. This creates a difficult environment for funding transactions; to increase private equity returns, developers typically need to increase leverage in a transaction. The decreased leverage ratios available currently will result in increased funding gaps for transactions. Additionally, leveraged lenders in NMTC transactions now will require significant amortization during the seven year NMTC period.

### Can NMTC’s help close these funding gaps?

NMTC’s should be a great financing source for 2010. The average funding benefit from a leveraged NMTC transaction ranges from 20% to 25% of the NMTC allocation. Consequently, using NMTC financing might reduce the required equity for a transaction from 40% to 50% of the total budget to 20% to 25%. This reduction together with the reduced interest rate on the forgivable “B” loan in a leveraged NMTC transaction should allow developers to pay the returns demanded by private equity investors. The one caveat to this feel-good scenario is that the recent downward pressure on NMTC pricing has led to an increase in the minimum deal size for leveraged NMTC transactions. Due to significant transaction costs, only deals of at least \$7.5 million will work typically.

### How can a developer use NMTCs in a smaller transaction?

For a deal smaller than \$7.5 million, the costs of a leveraged NMTC transaction often eat up to much of the benefit. However, an unleveraged NMTC transaction can be a reasonable alternative. In an unleveraged transaction, a lender will buy down the interest rate with the tax benefit from the NMTCs. Developers in an unleveraged transaction might borrow at rates from 300 to 400 basis points under market. Often, the net

economic benefit in an unleveraged transaction will equal or exceed the benefit that would accrue in a leveraged NMTC transaction (the forgiving of the “B” loan).

### What do you expect to happen to NMTC pricing in 2010?

NMTC pricing in 2009 suffered from a limited investor pool. Banks and large corporations had little need for tax credits as significant tax losses sheltered taxable income. The improvement in corporate profits that began occurring in late 2009 should lead to an increased investor pool for NMTCs. This should lead to a corresponding increase in NMTC pricing resulting from the increased competition for credits.

*Darryl is a frequent speaker on NMTC related topics and regularly counsels developers, investors, syndicators and lenders in New Markets Tax Credits, rehabilitation credits, low-income housing credits and preservation easements.*

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