CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: **LOW INCOME HOUSING TAX CREDIT MARKET**

DATE: January 6, 2017

Approved D-DSyl Date 1/10/17

INFORMATION

The recent U.S. Presidential election has caused some uncertainty in the low-income housing tax credit investment market due to the president-elect's announced intention to substantially lower corporate tax rates. This has placed increased pressure on local subsidy providers to fill funding gaps created by wary investors. This memorandum provides background on tax credits, discusses the current state of the market and explains its relevance to the City.

Background on Low Income Housing Tax Credits

Low Income Housing Tax Credits ("LIHTCs" or "tax credits") are federal tax credits that fund the production and preservation of restricted affordable rental housing.[1] The LIHTC program, operated by the U.S. Treasury, has produced over 28,000 developments and 2.2 million rent- and income-restricted apartments since 1995. Approximately 200 of the 234 affordably-restricted apartment complexes in San José have used LIHTC funding. Each state administers its allocation of federal credits, which are awarded per the population of each state.

Investors purchase the credits in exchange for equity that is used to fund construction and permanent-period financing for tax credit developments. Investors and development teams (which include nonprofit general partners) enter into privately-owned limited partnerships which own individual LIHTC properties. In return for the equity provided, investors receive a 10-year tax credit that reduces their federal tax liabilities. The tax compliance period is 15 years. This is the period for which investors (the limited partner) typically remain in the partnerships. The limited partner usually sells their interest to their developer (the general partner) toward the end of the compliance period.

The federal Community Reinvestment Act ("CRA") requires banks to serve community development needs in the markets in which they have customers. The combination of San José's strong real estate market and its banks' significant CRA obligations has produced high tax credit pricing, with investors willing to routinely pay 10-15% over the amount of credit they receive.

[1] While many states such as California have created robust LIHTC programs analogous to the federal program, as this memorandum focuses on the federal tax credit market instability. State tax credits are not discussed.

Recent federal tax credit pricing in the San José market has ranged from approximately $1.12 to $1.16 per $1.00 of LIHTC purchased. Such high pricing generates millions in equity for affordable developments.

Some investors, such as Citi and Bank of America, directly underwrite and make their own LIHTC equity investments. However, investors that prefer not to directly underwrite individual real estate properties use companies called "syndicators" to analyze tax credit equity investments, make equity commitments, and sell their equity interests to investors. Syndicators in our market include Red Stone, Raymond James, Boston Capital, Enterprise Communities, Merritt Community Capital, and California Equity Fund. Investors in our market commonly include financial institutions such as Chase, Citi, Bank of America, Fannie Mae, and Nationwide Insurance, as well as a smaller number of non-financial sector corporations such as Pacific Gas & Electric and Google.

<u>The City's Role in Tax Credit-funded Developments</u>

The City's roles in tax credit developments typically include those of subordinate lender, tax-exempt bond issuer, and ground lessor. The City is typically required to provide subordinate or "soft" loans for affordable housing development because the conventional mortgage size that can be supported by lowered rents, together with tax credit equity, is insufficient to finance the project.

LIHTC equity, permanent conventional debt, and other subordinate loans and grants together typically provide 70-85% the total cost of a development, with the City's subordinate financing covering the remaining 15% to 30%. The City's role as a "gap lender" is critically important, as its funds cover the final portion of total costs not paid for by other sources. Without any one funding source, or with a funding gap in the budget, developments cannot proceed and do not get built. The less tax credit equity a development has, the more the City needs to subsidize.

<u>The Presidential Election and Tax Credit Market Instability</u>

During the U.S. Presidential campaign, candidate Donald Trump had announced his intentions to streamline the tax code and slash corporate tax rates from 35% to as low as 15%. The election caught the market by surprise. Several investors and syndicators put a hold on their tax credit transaction closings until they could reassess what a reduction in the corporate tax rate could mean for their future need for federal tax credits to offset federal corporate tax liability. This freeze due to uncertainty was a national phenomenon, not confined to California.

As a result, pricing for LIHTCs has decreased significantly. Housing Department staff received reports in November and early December of equity pricing decreases ranging from $0.10 to $0.16 (in other words, 10 to 15%) in markets across the U.S., including in the South Bay.

Impact on Local Affordable Housing Developments

We are very fortunate that the Bay Area is an area of strong LIHTC investment demand. There are developments in California and across the U.S. that currently are simply unable to garner any investors' interest. Even in this market, however, three of San José's transactions have experienced significant difficulties because of the uncertainties surrounding tax reform.

First Community Housing's Second Street Studios, the City's first 100% permanent supportive housing development for the chronically homeless, successfully obtained highly-competitive 9% LIHTCs in mid-2016. The development was about to close construction in mid-November when its investor, Chase, halted the closing the day before document signing, and then dropped it's pricing by $0.1225 per $1.00 of tax credit. Chase's decrease in the amount it was willing to pay for this development's tax credits immediately produced a funding gap of almost $2.5 million.

Charities Housing, a San José nonprofit affordable housing developer, received its 9% LIHTC award in mid-2016 for its 30-apartment Metropolitan Apartments South development. After spending more than nine years trying to construct this last part of a two-phase development, Charities had identified an investor and lender and had hoped to close construction financing in February 2017. However, as of December 6th, its likely LIHTC investor indicated that its equity pricing would decrease by $0.16 per $1.00 of credit, resulting in a $1.4 million gap in the development budget.

A third San José tax credit transaction, Don de Dios, experienced a three-week closing delay due to investor pricing uncertainty, but its investor decided to hold its agreed-upon pricing. This existing affordable residential development, sponsored by nonprofit developer EAH, closed its financing on December 22 and rehabilitation has commenced. As the City is issuing tax-exempt bonds for Don de Dios, Housing and Finance staff delayed the City Council item until the investor and lenders had all recommitted to proceed and close the transaction at the original pricing.

Industry experts are currently indicating that the first half of 2017 will be a challenging environment in which to obtain investor and syndicator interest on new deals. As a result, LIHTC transactions may experience significant delays. For those deals that are able to garner investor interest at a lowered equity price, the City will need to fill higher-than-usual funding gaps. Pricing for 9% LIHTCs is expected to be affected more than for 4% LIHTCs.

Next Steps

Given the funding gaps that are arising from decreases in equity pricing, the City will need to increase its funding for developments in which the City has already made commitments, so that projects can start construction by State deadlines, thereby retaining their tax credit allocations. However, in the event that corporate tax rates do not increase by the end of project construction, staff will negotiate increases in final equity amounts to be paid to the City at that time. These "upward adjusters" will not be accepted by every syndicator, as this business term will not be attractive to some investors. Staff may have more success in negotiating upward adjusters on transactions involving direct equity investors.

The Director of Housing has the authority under Section 5.06.340.4 of the City's Municipal Code to increase Council-approved loan amounts of up to 20% if certain findings are made. In the coming months, the Director will use this authority to increase loan amounts if the required findings can be made and if the timing to close is urgent. In order to fill the new funding gap on Second Street Studios, the Director recently used her delegated authority to increase the existing City loan by $2,463,713 to enable the development to meet the State deadline.

The Director's Delegation of Authority actions are summarized quarterly in Information Memos to the City Council, which are also posted on the Department's website at http://www.sanjoseca.gov/index.aspx?nid=3294. The next quarterly summary of the Director's delegated actions will include the Second Street Studios loan increase.

/s/
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