YEAR 15 EXIT STRATEGIES AND OPPORTUNITIES for 2017 Homes Within Reach Conference

MODERATOR

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PANELISTS

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Asociación Puertorriqueños En Marcha (APM)

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National Equity Fund

Celia D. Smoot
LISC Housing

December 12, 2017
<table>
<thead>
<tr>
<th>Year Placed in Service</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Projects</td>
<td>1,499</td>
<td>1,425</td>
<td>1,598</td>
<td>1,621</td>
<td>1,662</td>
</tr>
<tr>
<td>Number of Units</td>
<td>113,736</td>
<td>119,584</td>
<td>136,209</td>
<td>139,498</td>
<td>135,429</td>
</tr>
</tbody>
</table>

Notes: This dataset includes 23,449 projects and 2,531,246 units placed in service between 2001 and 2014. The average number of units per property and the distribution of projects data are both calculated based on the 25,121 properties with known number of units, and not the full universe of 35,791 properties. The distribution column missing data for 80% of units (99%), qualifying units percentage of tax credit units (7%), and bedroom units (15%). Totals may deviate to 42% because of rounding.

Visual Description:
- Number of Projects: 1,499, 1,425, 1,598, 1,621, 1,662
- Number of Units: 113,736, 119,584, 136,209, 139,498, 135,429

www.huduser.org/portal/datasets
**Tax Credit Period:**
Begins on first day of taxable year in which owner claims credits
(Building-by-building calculation!!!)

**Be careful about non-calendar year-ends**
(Those funky dates for compliance periods carry over, even if the owner subsequently changes year-ends)
Outline:
- Option to Buyout LP in Year 15
- Early Buyout of LP
- Refinance in Year 15
- Resyndication
- Qualified Contract
Outline:

- Option to Buyout LP in Year 15
- Early Buyout of LP
- Refinance in Year 15
- Resyndication
- Qualified Contract
Begin At the Beginning

• Focus on Year 15 in LPA Negotiations
• Who Will Investor Be in Year 15?
• Plan Ahead
• Calendar Key Dates
Revisit in Years 11 - 15

- Review Partnership Agreement
- Understand Alternatives Under LPA
Case by Case Analysis

• Capital Needs Assessment
• Valuation and Marketability Assessments
• Capital Account Projections
• Waterfall Analysis
• Don’t be Caught By Surprise
Qualified Contract

- LIHTC properties are required to meet initial 15-year compliance period
- Extended use agreement requires an additional 15-year compliance period
- Qualified contract allows building to transition to market after the initial 15-year compliance period
Qualified Contract in 30 Seconds...

• Most projects have waived their right to the QC, so it’s not available at LIHTC application

• Process differs a bit by state – get to know your state’s process and formula

• Complicated calculation sets the price at which the state must find a buyer

• QC process doesn’t eliminate all contractual restrictions – only eliminates extended use agreement; other restrictions from soft debt, promises to city, etc. would not be eliminated
Qualified Contract

Owner can submit request after Year 14

Time for state to find buyer based on QC

If no buyer found, property can go to market on a phased-in basis over 3 years
YEAR 15 EXIT STRATEGIES & OPPORTUNITIES.
HOW TIME FLIES!
HOW TIME FLIES!
THE GOOD TIMES
(While it lasts...)

Project Approved
Groundbreaking
Construction
Ribbon Cutting
15 YEAR TIMELINE

1
YEAR 1
Units fully occupied
15 YEAR TIMELINE

1 YEAR 1
Units fully occupied

2 YEAR 2
Routine Maintenance

10 YEAR 10

TICK, TICK, TICK
15 YEAR TIMELINE

1 YEAR 1
Units fully occupied

2 YEAR 2

10 YEAR 10
Capital Needs + Repairs Start +Warranties Expire

15 YEAR 15
Exit

TICK, TICK, TICK
15 YEAR TIMELINE

1 YEAR 1
Units fully occupied

2 YEAR 2
Routine Maintenance

10 YEAR 10
Capital Needs
+ Repairs Start
+ Warranties Expire

15 YEAR 15
Exit

TICK, TICK, TICK
• I loved the $1.50 equity raise. Did I look closely at the exist strategy listed in the partnership agreement?
• Over the 15 years did I look closely at the project 8609, K-1, audits to determine there was sufficient loses within the capital account?
• Did I check with the equity investor during the course of the project to determine if adjustments needed to be made to avoid Negative Capital reserve?
• YIKES! Is there a possibility of a negative capital hit?
• Did I plan for hefty exit taxes? OH NO!

**Purchase Option Right of First Refusal**

DON’T FORGET, WE AGREED TO A REGULATORY AGREEMENT TO KEEP THE PROJECT LOW INCOME FOR 30 YEARS!

WHAT’S NEXT?
EXIT COMPLETED!
PRESEVATION/ RE CAPITALIZATION

<table>
<thead>
<tr>
<th>4% LIHTC</th>
<th>9% LIHTC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Floating Rate</strong></td>
<td><strong>Fixed Rate</strong></td>
</tr>
<tr>
<td><strong>Available Credits</strong></td>
<td><strong>Highly competitive process</strong></td>
</tr>
<tr>
<td></td>
<td><strong>1-3 years for approval</strong></td>
</tr>
<tr>
<td><strong>75 or more units</strong></td>
<td><strong>50 units</strong></td>
</tr>
<tr>
<td><strong>Rents provide adequate cash flow to cover debt</strong></td>
<td><strong>Rents provide cash flow to pay the bills and operate but may not be able to carry debt</strong></td>
</tr>
<tr>
<td><strong>Subsidies required; RAD, Section 8, project based or others</strong></td>
<td><strong>Subsidies a plus</strong></td>
</tr>
<tr>
<td><strong>GAP financing may be needed due to corporate tax reform</strong></td>
<td><strong>GAP financing may be needed due to corporate tax reform</strong></td>
</tr>
</tbody>
</table>
## APM Preservation Project

<table>
<thead>
<tr>
<th><strong>Development Financing</strong></th>
<th><strong>USES</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer Reserves</td>
<td>Construction Costs $10,710,306</td>
</tr>
<tr>
<td>Sellers Note</td>
<td>Fees $799,246</td>
</tr>
<tr>
<td>PRA Home Funds</td>
<td>Development Charges $222,820</td>
</tr>
<tr>
<td>TD BANK</td>
<td>Construction Financing $504,250</td>
</tr>
<tr>
<td>Equity $.97</td>
<td>Land &amp; Building Purchase $6,072,000</td>
</tr>
<tr>
<td>Reinvested Developer Fee</td>
<td>Development Reserves $809,243</td>
</tr>
<tr>
<td>PHFA debt Assumption</td>
<td>Developer Fee $1,451,791</td>
</tr>
<tr>
<td>PHDC Debt Assumption</td>
<td>Syndication Fee $60,000</td>
</tr>
<tr>
<td>PHARE</td>
<td>Other $65,500</td>
</tr>
<tr>
<td><strong>TOTAL Financing</strong></td>
<td><strong>Total uses $20,695,156</strong></td>
</tr>
</tbody>
</table>
LESSONS LEARNED:

DO NOT DEFER MAINTENANCE
The Housing Credit Portfolio: The Next Preservation Battle?

In coming years, preservation of Housing Credit stock will become an urgent preservation focus
What’s the big deal about Year 15?

• First opportunity to transfer ownership with no risk of tax credit recapture

• No more reporting to the investor

• Opportunity to recapitalize, rehab as needed, restructure financing, and reposition property for the next 15+ years

• Opportunity to sell to third party or acquire
Preservation Options Year 15

• Sponsor acquires and continues operations, assuming all existing debt

• Sponsor acquires, refinances and rehabs

• Sponsor acquires, re-syndicates and rehabs

• Sale to third party as rental or homeownership: lease-purchase or condominiumization
National Equity Fund – Distribution of 346 projects in y15 2011 to 2016

Extraordinary things happen when you have great partners

www.nefinc.org
National Equity Fund – Sponsor intentions for y16 and beyond

- 53% Hold and Operate
- 34% Refinance or 4% LIHTC with New Gap debt
- 10% Sold
- 3% 9% recapitalization
If you want to re-syndicate:

- Related party issues
- No early exit
- Rental subsidies probably needed
- Acquisition basis
- Relocation issues
- Lender approvals
Lehigh Park Apartments – Philadelphia PA

Existing Exterior- Lehigh Park Apts.

Extraordinary things happen when you have great partners

www.nefinc.org
# Lehigh Park Apartments – Uses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$530,000</td>
</tr>
<tr>
<td>Building</td>
<td>$4,170,000</td>
</tr>
<tr>
<td>Construction</td>
<td>$4,660,000</td>
</tr>
<tr>
<td>Developer Fee</td>
<td>$1,259,915</td>
</tr>
<tr>
<td>Operating Reserve</td>
<td>$415,000</td>
</tr>
<tr>
<td>Soft Costs</td>
<td>$1,412,085</td>
</tr>
<tr>
<td><strong>Total Uses</strong></td>
<td><strong>$12,447,000</strong></td>
</tr>
</tbody>
</table>
## Lehigh Park Apartments – Sources

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax exempt mortgage</td>
<td>$3,200,000</td>
</tr>
<tr>
<td>Assumed Debt</td>
<td>$4,422,000</td>
</tr>
<tr>
<td>GP Capital</td>
<td>$28,100</td>
</tr>
<tr>
<td>Deferred Developer Fee</td>
<td>$353,000</td>
</tr>
<tr>
<td>NEF Equity</td>
<td>$4,444,000</td>
</tr>
<tr>
<td><strong>Total Sources</strong></td>
<td><strong>$12,447,000</strong></td>
</tr>
</tbody>
</table>
Creating the Project Plan

• When is Year 15?

• When and under what terms can my organization buy out the investor?

• What will the purchase price be?

• What are the properties’ capital needs?

• How is the property’s financial health?

• What lender approvals must be secured?

• What do I do with the property after the investor exits?
Year 15: Getting Organized

- Partnership documents
  - Is there a Right of First Refusal and/or Purchase Option?
  - If yes, who has that right?

- Loan documents
  - Are lender approvals required to change ownership?
  - Can the loans be restructured?
Year 15: Getting Organized

• Tax returns, K-1s and 8609s
  • Determining end of compliance period
  • Capital account balances

• All property regulatory agreements

• Physical Needs Assessment or in-house assessment of capital needs

• Property cash flow projection
Determining Year 15... or more accurately, Year 16!

• Tax credit compliance for each building begins: The first year tax credits are reported on tax returns for that building. Can be either:
  • the first year a qualified building is PIS, or
  • the year after the building was placed in service

• Tax credit compliance ends:
  • The last day of the 15th year since credits were first claimed on the tax return
  • May be different for different buildings
  • Building is eligible for disposition without recapture potential on Jan. 1 of Year 16

• Consult 8609s
Could have more than one of these forms available if the project includes more than one building and they were placed in service at different dates.
What is the Capital Account?

• The **partnership capital account** is an equity **account** in the accounting records of a **partnership**.

• Most Capital Accounts are structured to follow the safe harbor rules under 704(b) which states that all partners in a partnership have capital accounts.

• Capital accounts start at zero, are increased by capital contributions and income allocations, and are decreased by distributions and loss allocations. Most importantly, upon liquidation of the partnership, all capital accounts must return to zero.
Schedule K-1

- Filed annually with the tax return by business corporations and other entities which use pass-through taxation.

- The K-1 shows you the LP capital account and the losses for the tax year.
Assessing the Properties’ Financial Health

• What are the terms of current debt?
  • Most LIHTC properties have at least 18 year term debt
  • Interest rate hikes? Higher than current market interest rates?
  • Balloon payments due soon?

• How is the project’s cash flow?
Assessing the Properties’ Physical Health

• What is the property’s physical condition?
  • Big ticket items coming to the end of their useful life?
  • Energy/water efficiency opportunities?

• Internal evaluation or third party Physical Needs Assessment may be appropriate
A Note About Property Reserves

• Reserves are an asset of the Limited Partnership

• Limited partners may require that, upon exit, remaining reserves be distributed in accordance with partnership allocation rules and terms of the Limited Partnership Agreement

• Property lenders may require that reserves stay with the property

• Bottom line: get familiar with lender and LP expectations related to reserve distribution at LP exit and plan ahead!
Understanding the Purchase Opportunity

• Purchase Option and/or Right of First Refusal will be included in separate document(s) or in Limited Partnership Agreement.

• This is your road map: terms such as the Option Period and how purchase price will be determined, are included.

• Note: Everything is negotiable. Sometimes.
Variations of the “buy out”

• Sponsor purchase of the real estate and improvements
• Sponsor purchase of the limited partner interest
• Donation of the limited partner interest to the sponsor and dissolution of the partnership
• Withdrawal of the limited partner interest
Determining the Purchase Price

• Right of First Refusal
  • Omnibus Budget Reconciliation Act of 1989 allowed the sale of LIHTC projects through Right of First Refusal to certain qualified groups at a bargain price
  • Formula price = debt plus exit tax
  • Not actionable until the end of year 15

• Formula price is available to:
  • Tenants
  • Resident management corporations
  • Qualified nonprofits
  • Government agencies
Determining the Purchase Price

• Market value purchase
  • Common in most agreements
  • Example option prices:
    • Fair Market Value
    • 94% of FMV
    • Greater of FMV or Debt Plus Taxes
Market Value Purchase

• A market value purchase typically includes an assumption of existing debt.

• Any cash payment due as part of a market value purchase price is equivalent to the residual value: market value exceeding the debt balance.
### Residual Value

<table>
<thead>
<tr>
<th>Residual Value Analysis</th>
<th>201X Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI:</td>
<td>42,316</td>
</tr>
<tr>
<td>Cap Rate:</td>
<td>8.00%</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated Market Value:</td>
<td>528,945</td>
</tr>
<tr>
<td>Operating Reserve</td>
<td>50,000</td>
</tr>
<tr>
<td>Replacement Reserves</td>
<td>50,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Value of Partnership Assets</td>
<td>628,945</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Outstanding Partnership Debt as of 201X audit:</td>
<td>577,945</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Value Less Debt plus Reserves:</td>
<td>51,000</td>
</tr>
</tbody>
</table>
What is an “Exit Tax”? 

- Cumulative tax losses exceed the investor’s invested capital 
- Result is a negative capital account 
- Disposition results in a tax liability
Right of the First Refusal
Purchase Price

Purchase price:
Assumption of existing debt plus exit tax = $236,250
## Early Exit vs. Year 16 Exit Differences

<table>
<thead>
<tr>
<th>Early Exit</th>
<th>Year 16 Exit</th>
</tr>
</thead>
<tbody>
<tr>
<td>RoFR is not Actionable so all LP interest sales/transfers are for market value</td>
<td>If it is in the LPA either a RoFR to acquire the property for assumption of debt plus exit taxes or for market value</td>
</tr>
<tr>
<td>Appraisal required</td>
<td>Probably not required if RoFR exists</td>
</tr>
<tr>
<td>Indemnification against recapture is required</td>
<td>Indemnification not required</td>
</tr>
<tr>
<td>60% of exits require negotiating an investor distribution</td>
<td>Approx. 26% of exits require negotiating an investor distribution or exit tax payment</td>
</tr>
</tbody>
</table>
Source of Funds for the Buyout Price

• New loan sufficient to pay off existing debt and buyout price
• New subordinate loan to finance buyout
• Resyndication with purchase price by new partnership sufficient to finance buyout
• Apply cash reserves to pay buyout price
Distribution of Cash at Sale

• The Limited Partnership Agreement delineates the distribution of cash from a sale or refinance event.

• There is a list of priorities for the order in which cash payments are applied. Examples: Amounts due to the LP; LP tax liability associated with the sale; disposition Fees due to the LP; deferred Developer Fee; loans made by LP or GP to the partnership...

• Remaining cash flow will be distributed by a set allocation to each partner. This may be a set percentage (i.e., 10% to the GP/90% to the LP) or may be based on the relative balances of the partner's capital accounts.
Disposition Fee

• The Limited Partnership Agreement may specify that the Limited Partner is due a fee at disposition of the property.

• Example: LP is due a $75,000 Disposition Fee from net proceeds. This fee appears as the third priority distribution of cash at sale.

• NEF does not charge a disposition fee for an end of compliance period exit but does charge for early exits because more analysis and negotiating is required.
## Exit Tax Estimation

<table>
<thead>
<tr>
<th>A: Limited Partner Capital Account balance as of 12/31/13:</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>B: Estimated Annual Losses:</td>
<td>$500,000</td>
</tr>
<tr>
<td>C: Number of Years to End of Compliance Period:</td>
<td>2</td>
</tr>
<tr>
<td>D: Projected Losses to End of Compliance Period (B x C):</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>E: Projected LP Capital Account balance at End of Compliance Period (A – D):</td>
<td>$(800,000.00)</td>
</tr>
<tr>
<td>F: Assumed LP Tax Rate:</td>
<td>35%</td>
</tr>
<tr>
<td>G: Projected Exit Taxes with One-Time Gross Up (E x F x (1+F)):</td>
<td>$378,000</td>
</tr>
</tbody>
</table>