Real Estate
Finance Tool Box

Presented by
National Development Council
National Development Council

• Nation’s oldest not-for-profit organization specializing in community and economic development finance
• Mission: Increase the flow of capital to underserved communities
• Provides technical assistance and training, and financial and development services
• Works with more than 80 municipalities and local development organizations across the U.S.
Real Estate Finance

• Why Are We Here?
  • To learn about the economic development programs that can help fill the financing gap on community development real estate projects
• Two kinds of capital
  • Debt – from lenders
  • Equity – from investors
    • Rehabilitation Tax Credits (RTCs)
    • Low-Income Housing Tax Credits (LIHTCs)
    • New Markets Tax Credits (NMTCs)
    • Conventional
Three Benefits of Owning Real Estate

- Cash Flow
- Tax Benefits
- Appreciation

- To most investors, cash flow is the most important benefit – it’s the most tangible and immediate of the three benefits
Cash Flow

Annual Rental Income
- Annual Operating Expenses
- Annual Debt Service (payments to lenders)
= Cash Flow
Tax Benefits

• Tax Deferral: Depreciation
  • Protects passive income from taxation
  • Postpones payment of taxes
  • Converts ordinary income to capital gains
  • Residential: 27.5 years
  • Commercial/Industrial: 39 years

• Tax Reduction: Tax Credits
  • Rehabilitation Tax Credits
  • Low-Income Housing Tax Credits
  • New Markets Tax Credits
Appreciation

- Appreciation Represents the Increase in Value over Time

\[
\text{Current Value} = \text{Current Value} - \text{Purchase Price} - \text{Improvements} = \text{Appreciation in Value}
\]

- In the long run, real estate almost always increases in value
- In the short run, real estate is a cyclical business with peaks and valleys
Economic Development
Real Estate Deals

- Economic Development Professionals Do Deals that Are Weak on Benefits
  - Rural areas
  - Declining urban area
  - Inner-city
  - Investors/lenders are reluctant because
    - Low rents, low cash flow
    - Appreciation very uncertain
    - Difficult to recruit tenants
    - Difficult to borrow money
    - Inadequate collateral
Economic Development Real Estate Deals (cont.)

- Economic Development Professional’s Job Is to Make Deals Happen in Distressed Areas
  - Get lender to lend by reducing risk
  - Encourage developers and investors to invest by increasing return on investment to acceptable level
  - Fair return on investment but no undue enrichment
Economic Development
Finance Tools

• Rate: Reduce the cost of funds
• Term: Extend the repayment period
• Leverage: Increase debt, reduce equity
• Substitution: Alternate equity sources
Real Estate Development 
Finance Process: Major Actors

- Investor
- Lender
Investor

• Provides Capital for Equity in Real Estate Development Projects
• Requires Return on his or her Investment due to Three Factors
  • Risk
  • Inflation
  • Opportunity
Lender

- Provides the Bulk of the Financing
  - Construction lender
  - Permanent lender
- Risk Averse
- Desired Benefit: Adequate Return with Minimal Risk
Development Budget

Preparing the Development Budget: Sources and Uses of Funds

**Sources**

- Bank: $1,271,000
- Equity Cash-on-Cash: 280,000
- Equity RTC: 408,000
- Public Funds: 541,000

**Uses**

- Acquisition (1/2 Land): $100,000
- Construction: 2,100,000
- Architect and Engineer: 100,000
- Developer Fee: 200,000

Total: $2,500,000
Operating Budget (cont.)

- Example: 10,000 Square Foot Building
  - Rent                 $16 per square foot
  - Tenant contributions $4 per square foot
  - Vacancy rate         10 percent
  - Operating expenses   $4 per square foot

\[
\begin{align*}
\text{Gross Rent} & \quad \text{\$160,000} \\
+ \text{Tenant Contributions} & \quad + \quad \text{\$40,000} \\
= \text{Gross Income} & \quad = \quad \text{\$200,000} \\
- \text{Vacancy} & \quad - \quad \text{\$20,000} \\
= \text{Effective Gross Income} & \quad = \quad \text{\$180,000} \\
- \text{Operating Expenses} & \quad - \quad \text{\$40,000} \\
= \text{NOI} & \quad = \quad \text{\$140,000}
\end{align*}
\]
Operating Budget (cont.)

• Net Operating Income (NOI) Is the Most Important Number in a Real Estate Project
  • Represents overall cash return on capital
  • Determines loan amount
  • Determines value
  • Determines cash return on equity
Annual Operating Pro Forma

Gross Rent
Tenant Contributions
Gross Income
- Vacancy
= Effective Gross Income

Effective Gross Income
- Annual Operating Expenses
  Taxes
  Insurance
  Maintenance
  Utilities
  Management
  Reserves

+ Net Operating Income
- Debt Service
= Cash Flow

Cash Expenses
Cash Generated by Property
Rent Collected at 100% Occupancy
Contribution for Operating Expenses
Total income at 100% Occupancy
Vacancy and Collection Loss
Expected Cash Collected
Return to Lender
Return to Owner
Permanent Lender Ratio Analysis

- Two Primary Permanent Lender Underwriting Ratios
  - Loan to value ratio (LVR)
  - Debt coverage ratio (DCR)
    - Debt coverage ratio used primarily to determine the maximum amount of debt that a permanent lender will provide for a real estate development
Equity Attracted

- Equity Attracted is based on cash flow and desired return by investors.

\[
\text{Equity Attracted} = \frac{\text{Cash Flow}}{\text{Cash-on-Cash Required}}
\]

- Example

  NOI $140
  Debt Service - 112
  Cash Flow = $28

- Investor demands 10 percent COC rate of return.
- Equity Attracted = $28 / .10 = $280
Equity Attracted (cont.)

- Example
  - Total Project Cost $2,500
  - Loan 1,271
  - Equity COC 280
  - Equity RTC 408
  - Gap $541
Tax Credits

• A Direct, Dollar-for-Dollar Reduction of Tax Liability

• Three Kinds of Tax Credits
  • Rehabilitation Tax Credits (RTCs)
  • Low-Income Housing Tax Credits (LIHTCs)
  • New Market Tax Credits (NMTCs)

• Investors pay equity for the right to claim federal tax credits -- the equity becomes another source of cash for the project
Rehabilitation Tax Credits

The Basics

• Two Tier Federal Tax Credit
  • 20% (historic)
  • 10% (non-historic)
• One-time Credit
• Decreases both depreciable and adjusted basis
• Can offset taxes on an unlimited amount of passive income, on only a limited amount of non-passive income
• Building must be held for five years to avoid recapture
Rehabilitation Tax Credits

• Historic Rehabilitation
  • 20 percent, one-time credit on rehabilitation costs
  • Must qualify
    • Certified historic structure – Individually listed in National Register or contributing building in NR historic district
    • Commercial, industrial or rental housing
    • Substantial rehabilitation: spend greater of $5,000 or property’s adjusted depreciable basis
    • Follow Secretary of Interior standards: National Park Service (NPS)
Rehabilitation Tax Credits

- Non-Historic Buildings
  - 10%, one-time Credit on Rehabilitation Costs
  - To Qualify:
    - Placed in service before 1936
    - Commercial (including mixed use), or Industrial only
    - Substantial rehabilitation required
    - Building must NOT be a “certified historic structure”
    - Building must not have been moved
    - Exterior/Interior Wall requirements
      - 50% of exterior walls to remain exterior walls
      - 75% of exterior walls to remain
      - 75% of interior walls to remain
Basis for Calculating RTC

• Include
  • All costs that are part of the depreciable basis except building acquisition
    • Construction costs
    • Interim financing (loan fees and interest)
    • Property taxes and insurance during construction
    • Architectural, engineering and design fees
    • Builder, contractor, developer fees
    • Appraisal fees
Basis for Calculating RTC (cont.)

- Exclude
  - Acquisition costs: no credit for buying the building, only for rehabilitating the building
  - Intangible assets: reserves, permanent loan fees, marketing expenses, some legal and accounting, etc.
RTCs Generate Equity

$2,100,000  Rehabilitation
100,000  Architectural and Engineering
200,000  Developer Fee
$2,400,000  RTC Basis
\[ \times 0.20 \]  Credit Rate
$480,000  RTC

$480,000  RTC
\[ \times 0.85 \]  Credit Price
$408,000  Equity
Low-Income Housing Tax Credits

- Annual Credit for 10 Years
- Project Must Qualify on Three Criteria
  - Income/occupancy
  - Rent
  - State approval
New Construction / Substantial Rehabilitation

- Annual Credit for 10 Years
  - New construction
  - Substantial rehabilitation ($6,000 per unit)
  - 9.0 percent on all improvement costs not funded with tax-exempt financing, or grants
  - 4.0 percent on all improvement costs, regardless of financing source
  - 30 percent basis increase for difficult development areas and qualified census tracts
# Improvement Costs
(Eligible for 9% Credit)

<table>
<thead>
<tr>
<th>Include</th>
<th>Exclude</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Construction Costs</td>
<td>• Permanent Financing Expenses</td>
</tr>
<tr>
<td>• Permits and Fees</td>
<td>• Reserves</td>
</tr>
<tr>
<td>• Construction Financing Expenses</td>
<td>• Marketing</td>
</tr>
<tr>
<td>(interest, fees, appraisal, inspections)</td>
<td>• Tax Credit Application Fee</td>
</tr>
<tr>
<td>• Property Taxes and Insurance</td>
<td>• Syndication Costs (legal, audit, consultant, etc.)</td>
</tr>
<tr>
<td>• Architectural and Engineering</td>
<td>• Acquisition</td>
</tr>
<tr>
<td>• Performance Bonds</td>
<td>• Off-site Improvements</td>
</tr>
<tr>
<td>• Furnishings</td>
<td>• Costs for Non-Residential</td>
</tr>
<tr>
<td>• Environment Assessment</td>
<td>• Costs for Market-Rate Residential</td>
</tr>
<tr>
<td>• Developer Fee</td>
<td>• Organizational Expense</td>
</tr>
<tr>
<td>• Contingency (if any)</td>
<td>• Any Expense Paid for with “Bad” Money</td>
</tr>
<tr>
<td>• Development Consultant</td>
<td></td>
</tr>
</tbody>
</table>
**Example**

New Construction Project in Difficult Development Area

<table>
<thead>
<tr>
<th>Uses</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100 Land</td>
<td>$300 Conventional Loan</td>
</tr>
<tr>
<td>$900 Residential Construction</td>
<td>92 CDBG</td>
</tr>
<tr>
<td>$200 Commercial Construction</td>
<td>808 Equity</td>
</tr>
<tr>
<td>$1,200 Total Uses</td>
<td>$1,200 Total Sources</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LI HTCs</th>
<th>Equity Raised</th>
</tr>
</thead>
<tbody>
<tr>
<td>$900 Residential Construction</td>
<td>$105 Annual LI HTCs</td>
</tr>
<tr>
<td>x 1.3 Credit Basis</td>
<td>x 10 Number of Years</td>
</tr>
<tr>
<td>1,170 Credit Basis</td>
<td>x 1,050 Total LI HTCs</td>
</tr>
<tr>
<td>x .09 Credit Rate</td>
<td>x .77 Purchase Rate</td>
</tr>
<tr>
<td>$105 Maximum Annual LI HTCs</td>
<td>$808 Equity Raised</td>
</tr>
</tbody>
</table>

National Development Council
LIHTC for Rehabilitation

- Annual Credit for 10 Years
- 4.0 Percent of Building Value Only
- Previous Owner Must Have Owned Building for 10 Years
- Available only with Substantial Rehabilitation
- No 30 Percent Basis Increase on Building
**Example #2**
**Rehabilitation Project**

<table>
<thead>
<tr>
<th><strong>Uses</strong></th>
<th><strong>Sources</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$300</td>
<td>$200</td>
</tr>
<tr>
<td>Acquisition (1/2 building)</td>
<td>Conventional Loan</td>
</tr>
<tr>
<td><strong>1,000</strong></td>
<td>361</td>
</tr>
<tr>
<td>Rehabilitation</td>
<td>CDBG</td>
</tr>
<tr>
<td><strong>$1,300</strong></td>
<td><strong>739</strong></td>
</tr>
<tr>
<td>Total Uses</td>
<td>Equity (see below)</td>
</tr>
<tr>
<td></td>
<td><strong>$1,300</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>LI HTCs</strong></th>
<th><strong>Equity Raised</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>$1,000</strong></td>
<td>$96</td>
</tr>
<tr>
<td>Rehabilitation</td>
<td>Maximum Annual LI HTCs</td>
</tr>
<tr>
<td>x .09</td>
<td>x 10</td>
</tr>
<tr>
<td>90</td>
<td>Number of Years</td>
</tr>
<tr>
<td><strong>90</strong></td>
<td><strong>960</strong></td>
</tr>
<tr>
<td>LI HTCs</td>
<td>Total LI HTCs</td>
</tr>
<tr>
<td>150</td>
<td>x .77</td>
</tr>
<tr>
<td>Building</td>
<td>Purchase Rate</td>
</tr>
<tr>
<td>x .04</td>
<td><strong>$739</strong></td>
</tr>
<tr>
<td>6</td>
<td>Total Equity Provided</td>
</tr>
</tbody>
</table>

- **Credit on Rehabilitation:** 90 LI HTCs
- **Credit on Building Value:** 6 LI HTCs

**National Development Council**
New Markets Tax Credit Program

• What Is It?
  • Designed to generate new, private sector investment in targeted distressed areas
  • Tax credits passed through to investors

• Who Administers?
  • CDFI Fund, division of the U.S. Treasury
  • CDFI allocates tax credit authority over seven years to Community Development Entities (CDEs)
New Markets Tax Credit Program (cont.)

• CDEs
  • Applicants for NMTCs
  • Must be a corporation, limited liability company, or partnership
  • Primary mission of servicing or providing investment capital to low-income communities
  • Must maintain accountability to residents
  • Existing Community Development Financial Institutions (CDFIs) and Small Business Investment Companies (SBICs) are automatically designated under law
New Markets Tax Credit Program (cont.)

• The Process
  • Apply to CDFI for CDE designation
  • Prepare five-year strategic plan to get allocation of credits
  • Line up investors
  • Make qualified low-income community investments
  • Report use of credits to investors and the IRS
New Markets Tax Credit Program (cont.)

- The Tax Payer/Investor Will Be Eligible to Claim a Tax Credit Equal to 39 Percent of the Qualifying Equity Investment over a Seven-year Period Equal to:
  - 5.0 percent of equity investment for the first three years
  - 6.0 percent per year thereafter
- So How Much Will an Equity Investor Pay in Cash Today to Receive this Stream of Future Benefits?
## NMTC Value

<table>
<thead>
<tr>
<th>Yield</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity / $1.00 of Tax Credit</td>
<td>76.18</td>
<td>73.51</td>
<td>70.95</td>
</tr>
</tbody>
</table>
New Markets Tax Credit Program (cont.)

- Eligible Investors
  - Banks
  - Insurance companies
  - Investment banks
  - Venture capital and investment funds
  - Corporations
New Markets Tax Credit Program (cont.)

- Eligible Projects
  - Geographical location is key – Check by census tract
  - Commercial real estate projects (office, industrial, retail, hotel, etc.)
  - Business ventures (start-ups, existing businesses, micro-enterprises, etc.)
  - Mixed-Use (housing and other) -- Must qualify project as “commercial” according to IRS
Local Structuring Tools

- Community Investment District
- Tax Increment Financing
- Neighborhood Revitalization Area
- Downtown Topeka Grant Program
Local Structuring Tools (cont.)

• Community Investment District (CID)
  • Financing for eligible projects which will enhance the quality of life in Topeka
    • Facilities that promote cultural, historical and artistic elements, and tourism,
    • Unique commercial, office, industrial and mixed use facilities
    • Promote economic development, investment or reinvestment in the community
    • Enhance retail base, capturing sales moving to other markets
    • Upgrade older real estate through redevelopment or rehabilitation
Local Structuring Tools (cont.)

• Tax Increment Financing (TIF)
  • Bonds issued and then repaid with increases in real estate or sales taxes
  • Tax base for a district is estimated and “frozen”
  • Tax revenues beyond this amount or tax increment is used for payments to bond holders
  • May only be used for eligible public purposes
  • Provides public funding for
    • Off-site or eligible public uses (reduces project budget or
    • Allocates project payments to fund improvements (expands sources of funds
Local Structuring Tools (cont.)

- Neighborhood Revitalization Program (tax abatement)
  - Reduction of portion of new taxes attributable to improvements
  - Increases net operating income
  - Can increase debt capacity
  - Can increase cash-on-cash return
Local Structuring Tools (cont.)

• Downtown Topeka Redevelopment Grant Program
  • Permanent Improvements to BID properties (routine maintenance not eligible)
  • Residential Properties (income producing)
    • 25% of eligible cost, $10,000 max per unit, $30,000 total
  • Commercial properties (can be leasehold)
    • 25% of eligible costs, $50,000 maximum.
• Façade improvements
  • 50% of project costs, $5,000-$10,000 max depending on width of building.
Real Estate Financing Programs

- Federal Home Loan Bank (FHLB) Programs
- Tax-Exempt Bonds
- HUD Community Development Block Grant (CDBG)
- Other State and Local Financing Programs
Federal Home Loan Bank Programs

- Sponsored by Federal Home Loan Bank Board (FHLBB)
- Administered through District Offices of FHLBB
- Affordable Housing Programs (AHP)
- Community Investment Programs (CIP)
Affordable Housing Program

• Can Be Used for Rental Projects – all Units for 80 percent AMI or below and at Least 20 percent of Units at 50 percent AMI
• Program Tends to Be Targeted at Projects at 50 Percent AMI or below
• Relatively Modest Subsidies – typically $5,000 per Unit
Community Investment Program

- Each FHLB offers below market rate loans (advances) to members for long-term financing
- Eligible projects include Affordable Housing and Economic Development that benefit low- and moderate income families and neighborhoods
FHLB Topeka Community Programs

- Community Development Program (CDP)
  - Commercial and Small Business Loans for Real Estate
  - Community loans for infrastructure, public facilities or equipment
  - Nonprofit lending for churches, schools, daycares, and museums

- Community Housing Program (CHP)
  - Single-family home loans
  - 1-4 family rental properties
  - Multifamily rental projects
  - Purchasing low-income housing tax credits
Tax-Exempt Financing

- Funding through State and Local Bond Issues
- Interest Exempt from Federal Income Taxes
- Results in Lower Borrowing Rates
Tax-Exempt Financing (cont.)

• Types of Tax-Exempt Financing
  • Industrial Revenue Bonds (IRBs)
  • 501(c)(3) Bonds
  • 63-20 Bonds
Tax-Exempt Financing (cont.)

- IRBs
  - Only for manufacturing uses
  - $10 million project cap (large projects are not eligible)
  - Bonds are issued by a public entity but have no recourse to the public entity
  - Credit security is provided by the borrower
Tax-Exempt Financing (cont.)

• **501(c)(3) Bonds**
  • Non-profit entity must own assets
  • Cannot be used for limited partnerships
  • Issuers: financing agencies, housing authorities, etc.
  • Cannot be used for projects outside the public purpose of the 501(c)(3)
63-20 Bonds

• Issued on Behalf of a Government Agency so no Need for an Issuing Agency, Can Place Directly
• Must Be Used for Public Purpose
• Property eventually Reverts to Agency
• May not Require Use of Public Bidding or Prevailing Wage Requirements so Development Costs May Be Lower
Community Development Block Grant

• Provided as Federal Grant Funds
  • Entitlement cities (population over 50,000)
  • Urban counties
  • States
• Jurisdictions Prepare an Annual Plan to Guide Funding Decisions
• Must Meet a National Objective
  • Benefit to low and moderate income persons
  • Removal of slums and blight
  • Urgent need
CDBG (cont.)

- **Wide Variety of Eligible Activities**
  - Acquisition
  - Rehabilitation
  - Tenant improvements
  - New construction
- **Davis-Bacon**
  - Required when used for construction, renovation or installation of equipment
- **Reasonable Cost per Job Requirements**
Structuring Tips

• Always Look First at the Operating Pro Forma and Sources and Uses
• Rents, Expenses, Vacancy
• Development Costs, Value of Property Contributed by Developer, Developer Fees
• Adequate Participation by Bank
RTC Examples
Combined LIHTC & RTC
Windsor Hotel
Abilene, TX

Funding Sources:
LIHTC & RTC Equity, Section 108 HUD Loan
Bank Loan
TIF, Home Investment Partnership
NMTC

Funding Sources:
Section 108
TIF,
Store Front
Grants
Tenant
Improvements
NMTCs
10% RTCs
RTC and NMTC

Chamber of Commerce, Restaurant & 18 Loft Apartments, Council Bluffs, IA

Funding Sources:
- Foundation Grants
- Bank Loan
- RTCs (state & federal)
- NMTCs
- TIF
- Store Front Grants
Examples, Topeka
Contact

• For More Information, Please Contact:

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Case Study – Santa Rita

- Vacant Warehouses
- Deteriorated Commercial District
- Local Developer
- Potential Grocery Store Tenant