# Innovative Strategies for Community Redevelopment Projects: Minimizing Risk While Maximizing Returns

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**For today's investors, adopting new strategies that reduce risk can result in projects that pay off for themselves and the communities they serve.**

Without question, all investments involve a certain amount of risk. Depending on the project, the risk may be real or perceived, but either way investors have too much at stake to throw caution to the wind. As a result, many avoid opportunities in low-income communities (LICs) assuming the risks are particularly high. Concerns over uncertainties, such as will the population sufficiently support a fledgling business, are valid when undertaking a new business venture even in the most favorable environments.

Incentives such as new markets tax credits (NMTCs) are challenging these views and redefining high risk when analyzing projects in LICs. By taking full advantage of these opportunities, investors can significantly reduce investment risk and increase financial returns. But, NMTCs are just the first step in rethinking smart investment strategies. By utilizing the multi-borrower model to combine several qualified active low income community businesses (QALICBs/NMTC borrowers) into one transaction, investors save additional time and money. Furthermore, by aggregating multiple borrowers and funding several projects in the same location, investors can increase their influence, while breathing fresh air and bringing renewed hope into the communities they serve.

## Challenges to Investing in LICs

Investing in LICs has always presented certain challenges. To begin with, lenders are reluctant to provide conventional financing to developers in these communities for a variety of reasons. Many fear project failure in LICs may be greater in comparison to more affluent areas. There's the question of population stability. Will there be sufficient cash flow? Successfully launching a business is one thing, sustaining it over time requires consistent financial support from the community it serves. Reliability of the project developer may send up a red flag. LICs have a tendency to attract smaller businesses and/or non-profit businesses, so in many cases developer balance sheets are not as strong as those of larger organizations. Investors hesitate to provide capital for projects in LICs for

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the same reasons. Overall, they want to be repaid.

Yet, reluctance on the part of lenders and investors trap LICs in a vicious circle. To be worthy of capital investment the communities must first show improvement. But before they can improve—provide the jobs and establish essential services necessary to support a growing population—they need sufficient funding for their projects.

## NMTC Program

Recognizing a need to encourage investments into operating business and real estate projects located in LICs, Congress established the NMTC Program in 2000. Through a competitive process, this program provides allocations to certified Community Development Entities (CDEs). CDEs partner with investors to provide capital to LIC developers.

Key aspects of the NMTC Program include:

- Incentives are restricted to projects in LICs/distressed communities.
- Investors receive tax credits against their federal income tax liability in exchange for making an equity investment into an entity certified as a CDE.
- The tax credit totals 39% of the original investment amount and is claimed over seven years. This is broken down into 5% the first three years and 6% for the remaining four years.
- The investment cannot be redeemed before the end of the seven year period.

Investors who take advantage of the NMTC Program receive significant savings as this simplified example demonstrates. A project uses a $10 million NMTC allocation. Three million comes from the entity that is investing to receive the tax credit. The remaining $7 million (leverage) is supplied by either, or a combination of, equity the developer has in the project, grants or donations, or conventional debt. The $3 million investor benefits from the NMTC Program by receiving $3.9 million in tax credits over the seven year period. The leverage lender benefits by loaning only $7 million on a $10 million project, thus providing a cushion should the project encounter any difficulties. The project benefits from the low interest rates, a seven year interest only period and other favorable terms it receives.

Since inception, the NMTC Program has been well received by both investors and LICs alike. The Community Development Financial Institutions Fund (CDFI), an agency within the U.S. Treasury Department, has made 749 awards, allocating a total of $36.5 billion in tax credit authority to various CDEs throughout the U.S. In addition, more than 72% of all NMTC investments to date have been in communities with unemployment rates 1.5 times the national average, poverty rates of 30% or more and a median income at or below 60% of the area median.[1] Furthermore, in the NMTC allocation round following Hurricane Katrina, which struck the Gulf of Mexico in 2005, the government provided an additional $1.5 billion NMTC allocation specifically designated to use for those communities hardest hit by the storm.

The program also pays for itself. NMTC investments between 2003 and 2010 generated over $5.3 billion in federal tax revenue, while the revenue loss to the federal government over the same time period was $5.4 billion. In 2010 alone, NMTC investments generated almost $1.1 billion in federal tax revenue, offsetting the federal government's estimated $720 million cost for the program and providing a 50% return on investment. Similar state NMTC programs now offered in18 states have produced over $3 billion in state and local tax revenue.[2]

## Encourage Alignment of For-Profit and Non-Profit Arms

In addition to actively seeking projects with NMTCs, investors can further lower risk by adopting additional investment strategies. One that is often overlooked is encouraging alignment of profit-driven and non-profit driven arms in large corporations. When it comes to investments, communication between these two sides is often sparse. Generally speaking, the for-profit branch makes decisions independently of the mission driven side. But this situation is far from ideal when considerable advantages and benefits can be gained from approaching investments as a team effort.

For starters, a combined approach to investing allows the non-profit side to donate additional funding to NMTC projects, which further lowers the overall risk—including the risk to the for-profit arm of the company. With a more visible presence in the community, the non-profit raises the awareness of their mission, advancing their success. Synchronized strategies additionally provide more opportunities to make targeted investment decisions regarding where and how to best spend the combined dollars of the two groups within the organization. When this happens, the organization on the whole is more effective in the LIC community it serves, increasing chances for more news media coverage and more positive PR. At the same time, a team approach to investing offers greater opportunities to receive Community Reinvestment Act (CRA) credits if the organization is an FDIC regulated banking institution.[3] To satisfy CRA credit requirements, a bank must invest, lend and provide services in all of its service areas, including a proportionately sufficient amount within those service areas located in LICs.

## Embrace the Multi-Borrower Model

To further reduce risk and increase financial gain, investors can adopt the multi-borrower model. Ideal for funding smaller QALICBs, this method of investing enhances the benefits of the NMTC program by opening the door to projects that traditionally could not have accessed NMTCs in the past. It succeeds by allowing more than one QALICB to be funded through a single transaction, cutting the individual project costs considerably and making smaller projects more appealing to investors.

The reason smaller projects are more difficult to fund using NMTCs is because estimated total costs, which include but are not limited to, closing costs, CDE audit, compliance and tax costs, investment fund costs, as well as leverage lender audit and loan servicing costs through the seven year NMTC compliance period, typically exceed $1 million. In a small transaction the remaining net benefit to the QALICB and project is not sufficient to make the NMTC complexity worthwhile. Because of these costs, many CDEs will not participate in NMTC transactions totaling less than $5 million. Using the multi-borrower method opens the door to NMTC funding for smaller projects.

By utilizing the multi-borrower model, QALICBs split the closing and ongoing compliance costs, providing substantial savings for the borrowers, thus enabling even smaller projects to receive substantial financial benefits from the NMTCs. For instance, consider this basic example: Five $1 million projects are bundled into the same transaction, where the cost of the transaction would be in the neighborhood of $1 million. With each borrower now only responsible for 20% of the total costs, their portion is reduced to $200,000 apiece, rather than $1 million. These dramatic savings are just the tip of iceberg. Further reductions are realized with the need for only one investment fund, one CDE and one leverage lender. In the same respect, QALICBs can often share the same attorneys, significantly reducing legal fees. For instance, similar projects within the same transaction can be streamlined and replicated by the same lawyers, regardless of whether the projects are located in the same area, or even in the same state. In the same respect, QALICBs in the same area with different models save because they fall under one set of state laws, making the documentation less complicated, and less expensive.

## Community Benefits

Providing funding for projects through the multi-borrower method is also a boon for LICs. This is particularly true when the projects, representing several different types of businesses, are all located in the same area, creating "mosaic communities." The mosaic community approach to economic development can exponentially increase the impact of the investment effort by addressing several community needs simultaneously. For instance, a single investment opportunity may lead to the construction of a manufacturing center. On the other hand, by utilizing the multi-borrower model, investors can take it up a notch and bring in an industrial park. This alone creates more jobs; both temporary construction and permanent positions in the businesses created. Or, a grocery store that offers healthy food choices can be financed alongside two new restaurants, affordable for sale housing and a community center, increasing the quality of life for the residents in the community. There is no limit to the possibilities.

Overall, mosaic communities increase the rate of success for all businesses financed under the same transaction. Areas that offer a wide variety of shopping and employment opportunities draw more people. This fresh approach, which encourages investors, banks and large organizations to work together for the betterment of disadvantaged communities, provides a more immediate, positive social impact to the community. Mosaic communities better serve the needs of the residents by expanding opportunities for entrepreneurs and consequently, accelerating growth. In turn, successful projects attract new investors. With improved sales and tax revenues, a once neglected area experiences new life and eventually becomes a vibrant, healthy community that people flock to, which over time, further increases the value of the investment.

Additionally, studies indicate revitalized communities that receive funding through NMTCs significantly improve the quality of life in surrounding areas. In a survey taken during the initial years of the NMTC Program (2003–2007), respondents stated that on the area-wide impact of NMTC projects, 70% of NMTC projects resulted in positive changes in the surrounding area. In fact, more than one-third of project stakeholders reported "strong evidence that surrounding areas had experienced new business creation, improved property appearance, and/or increased local tax revenues as a result of NMTCs." Furthermore, respondents stated "improved neighborhood safety, reduced crime, increased community pride and morale, or sustained improvement in inter-organizational relationships."[4]

## Reducing Risk

Investing will always be a risky business. Even with new tax incentives alleviating some of the risk, many of today's investors may still shy away from projects that challenge them to step out of their comfort zones. Yet, as NMTCs continue to reduce investor and lender risk on projects in disadvantaged areas by funding innovative projects that will improve these communities, helping them to become mosaic communities becomes less risky. Those who are willing to jump in with both feet find the opportunities ripe and the rewards plentiful. Continued success will incentivize other investors, and through a ripple effect, communities in need of significant TLC will ultimately reap the benefits.

## NOTES:

[1]Executive Summary of the NMTC Coalition 2012 report.

[2]Executive Summary of the NMTC Coalition 2012 report.

[3]The Community Reinvestment Act (CRA), enacted by Congress in 1977 encourages depository institutions to help meet the credit needs of the communities in which they operate.

[4]New Markets Tax Credit Coalition response to Urban Institute Report, "New Markets Tax Credit Program Evaluation," Urban Institute, (2013) 134–137.