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NMTC Model Answers CDFI's Call for Innovation for QLICs under \$2 Million

By Donna Smith, Smith NMTC Associates LLC

In the 2012 New Markets Tax Credit (NMTC) Application, the Community Development Financial Institutions (CDFI) Fund asked applicants to describe how they would use an NMTC allocation to make innovative investments, citing as one example, providing qualified low-income community investments (QLICs) of \$2 million or less to qualified active low-income community businesses (QALICBs). QLICs of \$2 million or less are not commonly provided because the closing and ongoing costs often exceed the net benefit to the QALICB.

To deploy \$42 million of NMTC allocation in 21 QLICs of just under \$2 million each, while keeping the net benefit to the QALICBs high, Smith NMTC Associates LLC recently partnered with U.S. Bancorp Community Development Corporation (USBCDC), CEI Capital Management LLC (CCML), Novogradac & Company LLP, Polsinelli Shughart, Husch Blackwell, Elkins PC and Johnson & McCaa LLC to close the 21 QLICs in a series of two transactions, with two tranches each, over a five month period from April to August 2012.

Smith, USBCDC, Novogradac, Polsinelli, Husch and Elkins had already worked together to deploy over \$270 million in NMTC allocation using the multi-QALICB model (described below) that reduces the per QALICB cost, thereby increasing their net benefit by combining multiple QALICBs in a single transaction with individual qualified equity investments (QEIs) and QLICs per QALICB. To further increase efficiencies, Smith and its partners used a multi-tranche approach layered on top of the multi-QALICB model to deploy the \$42 million in CCML's allocation over



Photo: Courtesy of Habitat for Humanity Saint Louis
This property is one of many Habitat for Humanity projects that benefitted from NMTC financing.

a series of two transactions with two tranches in each, for a total of four closings with five or six QALICBs participating in each closing (multi-tranche/multi-QALICB model). The resulting high efficiencies translated into greater benefits for the QALICBs, even for QLICs of less than \$2 million.

Multi-QALICB Model

The multi-QALICB model was developed to enable Habitat for Humanity affiliates to benefit from the NMTC program, keeping their costs low and their benefits high. Habitat for Humanity affiliates vary greatly in size and sophistication. This model made it possible for a Habitat affiliate that builds only a few for-sale affordable homes a year to benefit significantly from the NMTC program, thus expanding

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NMTC access beyond those larger scale Habitat affiliates that build more than 100 homes per year.

Beginning in 2008, Smith used this multi-QALICB model to combine several QALICBs into one transaction, using separate QEIs and QLICIs for each QALICB to isolate the risk. In this model, the QALICBs self-fund the leverage lender by monetizing the value of their construction in progress through a one-day loan, thereby eliminating the need for a conventional lender. The QALICBs are the joint owners of the leverage lender – with each owning a proportionate share of the entity based on their contribution to it. The QALICBs in this model also make use of the portion of the business (POB) rule and keep separate books and records for the NMTC transaction. For example, in a 2009 multi-QALICB transaction, six Habitat affiliates shared one leverage lender, investment fund and sub-CDE, rather than having six of each entity. Splitting all costs six ways resulted in substantial savings for everything from closing costs to CDE audit/tax costs, to investment fund costs, to leverage lender audit costs and even loan servicing costs (all as outlined below).

Costs and Expenses	1 QALICB/\$10 million QEI	6 QALICBS— Figure per QALICB (assuming even participation) \$22 million
CDE Tax/Audit	\$471,491	\$138,305
Investment Fund Costs	\$60,000	\$13,333
Leverage Lender Audit	\$28,000	\$2,761
Miscellaneous	\$38,500	\$0
Closing Costs	\$268,000	\$57,611
Loan Servicing	\$52,500	\$11,667
State Taxes	\$6,400	\$0
Per QALICB Cost	\$924,891	\$223,677

The closing costs were further reduced by some of the features of the multi-QALICB model itself. For example, because the QALICBs had similar business models and structures, they shared the same attorneys, further reducing legal costs. Closing costs were further reduced at the front end by collecting and reviewing all due diligence before involving any attorneys and using streamlined documentation that was refined over the course of deploying \$270 million in NMTC transactions. The savings using the multi-QALICB model with six QALICBs (compared to a single QALICB transaction) resulted in a per QALICB savings of almost \$700,000. As shown below, the per QALICB cost for each of the six affiliates using the multi-QALICB model averaged just over \$223,000 per QALICB, while a single QALICB incurred more than \$900,000 in costs.

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Multi-Tranche/Multi-QALICB Model

While it is clear that the multi-QALICB model can result in substantial cost savings to the QALICB, the Smith team believed even greater savings could be achieved by closing a single transaction over two or more tranches, so that more than six QALICBs could share costs, further increasing each QALICB's net benefit. Achieving the maximum savings possible was critical to making QALICBs under \$2 million work for both the QALICB (in terms of maximizing return) and for the CDE (in terms of managing risk). The multi-tranche/multi-QALICB model maximizes a QALICB's return because it allows 10 or more QALICBs to participate in a transaction by closing the transaction in two tranches of five or six QALICBs per tranche. Limiting the number of QALICBs that participate in each tranche to six maintains the efficiencies of the model by keeping the number of QALICBs per closing to a manageable number.

A single transaction can be closed in two or more tranches because under the multi-tranche/multi-QALICB model, the leverage lender documents are drafted to allow expansion to include additional members and the investment fund and sub-CDE operating agreements are drafted to anticipate and accept additional capitalizations through amendment and restatement. Novogradac aggregates the schedules so that the successive tranches reflected the aggregated funding of fees, reserves and benefits.

Cost Savings

Using this model, CCML deployed \$42 million in total QEIs in a five-month period in 21 QALICBs of just under \$2 million each to 21 Habitat for Humanity affiliates located in 16 states. There were two transactions of two tranches each for a total of four closings, which resulted in savings of more than \$789,000 per QALICB compared to a single QALICB closing and \$88,000 compared to the multi-QALICB model alone.

Costs/Fees Expenses	1 QALICB/\$10 million QEI	6 QALICBS— Per QALICB	21 QALICBs/ \$42 million QEI
		\$22 million QEI	2 transactions
CDE Tax/Audit	\$471,491	\$138,305	\$77,898
Investment Fund Costs	\$60,000	\$13,333	\$6,000
Leverage Lender Audits	\$28,000	\$2,761	\$4,200
Miscellaneous	\$38,500	\$0	\$11,985
Closing Costs	\$268,000	\$57,611	\$35,521
Loan Servicing	\$52,500	\$11,667	\$8,000
State Taxes	\$6,400	\$0	\$0
Per QALICB Cost	\$924,891	\$223,677	\$135,234

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The cost savings were realized in the same areas discussed above for the multi-QALICB model. The only difference is that the savings were greater because the costs were split among 21, rather than six, QALICBs.

Managing Risk

QALICBs that need smaller QLICs of \$2 million or less can be thought of as higher risk, because these QALICBs are perceived to be less sophisticated than larger QALICBs in handling the NMTC compliance requirements and/or ill-equipped (in terms of staffing) to deal with the extra burdens of NMTC compliance. When a CDE has to manage multiple QALICBs, all of whom are perceived to have this greater level of risk, the burden of making multiple QLICs under \$2 million seems to outweigh its benefits.

However, a CDE is better able to manage this risk through the multi-tranche/multi-QALICB model (as well as through the multi-QALICB model alone) because Smith provides financial counseling and other services to each QALICB before, during and after each closing (and throughout the seven-year compliance period). Before the closing, Smith educates the QALICB's board, staff and finance committees on the NMTC program, the multi-tranche/multi-QALICB model and the compliance requirements. During the closing process, Smith continues to work with the QALICB to collect and review due diligence requests and identify and resolve any due diligence issues before the attorneys get involved. Also, during the closing process, Smith's finance department works closely with the QALICB's

finance staff and outside auditors to explain the pending NMTC transaction and the effect of keeping POB books on both the POB books themselves as well as the QALICB's books. After closing, Smith's finance department provides actual POB opening entries and sample entries for typical transactions a QALICB would see and need to book. On the compliance end, Smith's staff regularly works with the QALICB to assist in collecting information required by the CDE for reporting purposes. This ongoing education and communication is especially important with smaller QALICBs that are most in need of QLICs of \$2 million or less. Ongoing education and communication with smaller, less sophisticated QALICBs is the key to effectively managing the risk of smaller QLICs.

Building on the success of the multi-tranche/multi-QALICB model, even more QALICBs can be funded with QLICs under \$2 million. Pursuing innovative investments with NMTC allocation not only answers the CDFI's call for innovation, but also brings much needed financing to areas of the greatest need. ❖

Donna Smith is executive vice president and co-founder of Smith NMTC Associates LLC. Donna is the lead writer of all NMTC certification and allocation applications that Smith NMTC writes on behalf of its partners and its own CDE. Among her other responsibilities, Donna monitors the QALICBs and provides reporting, compliance and financial counseling assistance to them for reporting purposes. As compliance officer, she also completes the Community Investment Impact Systems (CIIS) reporting. She can be reached at (314)974-7858 or dasmith@smithnmtd.com.

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