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NMTC Practitioners Finding Ways to Complete Small Deals

BRAD STANHOPE, SENIOR EDITOR, NOVOGRADAC & COMPANY LLP

In the new markets tax credit (NMTC) world, size is significant: Smaller deals are more difficult.

"[Cost] is the issue," said Donna Smith, executive vice president of Smith NMTC Associates. "From the borrower's point of view, the static costs of doing a small [qualified low-income community investment] QLICI of $2 million or less is the same as the cost of doing a $10 million transaction. … But with a $10 million QLICI, the net benefit to the [qualified active low-income community business] QALICB–the portion of the tax credit equity it receives–is substantially higher, and therefore, can offset those static costs."

However, for many in the NMTC industry, the combination of the Community Development Financial Institutions Fund's (CDFI Fund's) emphasis on smaller deals and an organizational mission makes smaller transactions attractive.

"The CDFI Fund is pushing for innovative QLICIs," said Brynn Sanders, vice president of fund management at New Markets Support Company, part of the Local Initiatives Support Corporation. "They put that [the innovative issue] in the application to get people to stop doing the easiest ones. The industry was turning into something that builds $20 million community facilities, but the [NMTC] program was designed to go into small communities. The majority of business growth is in small businesses, not in large real estate."

The CDFI Fund rewards small deals and they are a significant focus among NMTC practitioners.

Defining 'Small Deal'

Beginning with the 2012 NMTC program allocation round, the CDFI Fund added preferential scoring for six different innovative investments, including QLICIs under $2 million. That gave official sanctioning to what makes a small deal. "I would say most people will look at the CDFI Fund definition," Smith said. "Doing small QLICIs gets you extra points for innovation and a lot of people promise that in their applications."

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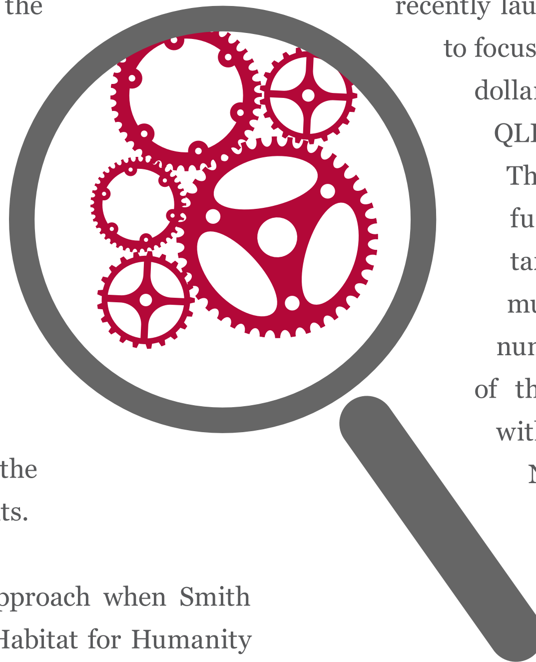
Sanders agreed. "Before that, we would have said less than $5 million, but now we usually mean under $2 million," Sanders said.

Patrick Vahey, president of Greenline Ventures in Denver, said his organization goes with the $2 million standard, but not just because of the CDFI Fund definition. Vahey said that Greenline has historically viewed transactions above $2 million as generally not being "small business" and that many small businesses are underserved by the NMTC program.

Cutting Costs

While the economies of scale favor larger transactions–after all, many NMTC-related fees are static, so they constitute a much larger percentage of a small QLICI–practitioners have found ways to spread the costs and increase the availability for smaller investments.



Smith previewed the modern approach when Smith NMTC Associates worked with Habitat for Humanity during the Gulf Opportunity Zone (GO Zone) days a decade ago, splitting a $25 million NMTC allocation among projects with five QALICBs. QLICIs ranged from $13 million to less than $1 million.

"What we did at that time is what we still do–with some complexities," Smith said. That approach involves combining several QALICBs (typically, Smith said, five or six) in one transaction and grouping each as a single transaction–qualified equity investments and one QLICI for each QALICB, to silo the risks.

"You minimize the risk to investors, too," Smith said. "You take the fees and static costs and divide them among the QALICBs."

Smith cited an example in which a $4 million allocation has $300,000 in closing costs. If you divide that among five QALICBs, that's just $60,000 per QALICB, rather than one QALICB bearing the entire $300,000.

Others use similar approaches. Greenline Ventures recently launched a small business loan fund to focus exclusively on originating smaller-dollar ($2 million and below), short-term QLICIS to non-real estate QALICBs. The closing costs of the $20 million fund were paid out of the gross tax credit equity proceeds and the multi-asset fund structure enables numerous QLICIs over the course of the seven-year compliance period without having to incur any additional NMTC-related closing costs. Due to that, the QALICB is able to receive a substantially below-market-rate loan without having to pay any of the upfront NMTC-related expenses.

"That's what makes it work," Vahey said. "The vast majority of closing costs in NMTC transactions involve the formation/documentation of the fund, CDE [community development entity], leverage lender, etc. as well as the various legal opinions. In a 'blind pool' structure, we absorb all these costs at one fund-level closing and are then able to originate numerous QLICIs without having to incur any of the typical NMTC costs. It involves more work on our end to manage compliance, but it substantially reduces the cost of closing QLICIs.

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"We can provide loans most banks can't do," Vahey said. "There are not a lot of places for small businesses to go to get capital between $200,000 and $2 million."

Partners, Simplification Crucial

Sanders said partners are key. "The biggest hurdle I see is that people partner with the wrong parties," Sanders said. "I know what investors and funds are best. I know it's easier, for instance, to work with a small bank than a large one. I've found attorneys who know small business lending and how to keep costs low. It takes a lot of work to push costs down. We just closed on a $2 million project and there was only $4,000 in closing costs."

Simplification is also crucial, according to Tracey Gunn Lowell, vice president of U.S. Bancorp Community Development Corporation. "A lot of times, it's hard to do four or five distinct deals," Lowell said. "We try to make sure to the extent possible that there are fewer leverage sources, that deals are done in a box as far as eligibility criteria and that there aren't a bunch of exceptions."

Where Small Deals Happen

Among the beneficiaries of smaller NMTC transactions are non-metro areas and underserved states. "I would say there is overlap between the non-metro and underserved states," Smith said. "There is some correlation there. It absolutely is harder to do new markets tax credits in non-metro areas because they lack the population mass to make things happen. And there is a desperate need in those communities."

Finding the need isn't easy. "The hard thing is finding them," Sanders said. "Large real estate developers know the new markets tax credit exists, but small manufacturing businesses in rural areas don't know about the program. You have to do networking. … It's a struggle if people don't know about it."

Sanders cited two current transactions for NMSC in Minnesota featuring small manufacturers as examples of the program working.

"They're doing expansions and they're not huge companies," Sanders said. "One needed $1.2 million, the other needed $1.8 million."

However, smaller NMTC transactions aren't limited to underserved states and non-metro areas. Smith said nonprofits and startups are likely to participate in small NMTC transactions. "I think I see it with nonprofits a lot," Smith said. "That's the reason it's a struggle. They have to ask what they get out of it. We developed a model to help nonprofits use smaller QLICIs to meet their real estate development needs because the loan funds we've discussed usually fund operating businesses."

That is Greenline Ventures' approach. "It's all [loans to] operating businesses in NMTC-qualified areas," Vahey said. "We also aim to have 100 percent in higher-distress areas."

Smith said combining QALICBs is more often based on sharing mission or focus, rather than sharing space. She cited nonprofit housing groups and national organizations with multiple affiliates or members as examples.

Lowell cited some specific types of businesses that benefit from smaller NMTC deals. "I think there's a range of types," Lowell said. "There are certain organizations that focus on nonprofits and they have big deals, but they have smaller ones. It's generally the smaller capacity businesses, things like grocery stores and smaller businesses."

CDFI Fund Plan Working?

Thanks to the problem-solving on the front lines, the CDFI Fund's strategy of incentivizing smaller NMTC deals appears to be successful.

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"I absolutely think so. CDEs aren't as familiar with it, so it's pushing people out of their comfort zones," Sanders said. "You have to find the right attorneys, investors, lenders. You have to have the right deal team."

Vahey said the demand still far outstrips the supply. "We turn down the vast majority of deals based on credit/underwriting purposes," Vahey said. "We look for sustainable businesses with good strategies and management teams to gain comfort with the credit risk of loans to smaller businesses. It's a balancing act between maximizing community impact while maintaining credit quality. The supply of new markets tax credit allocation is in the billions and the demand for financing by small businesses is in the trillions."

Lowell revealed a hidden benefit–the advantages required to do smaller deals are applicable elsewhere. "It has kind of helped us to continue to think about how to be flexible, to find effectiveness and streamline without getting expensive," Lowell said. "The industry had been going to larger deals because it's easier to absorb the cost, but I also think some of the things we find [in smaller transactions] could be applied to larger transactions, too." ❖

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