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What's in Store for the Tax Credit Equity Markets in 2012

By Michael J. Novogradac, CPA

As we prepare to enter a new year, it's a good time to survey the land and consider what lies ahead for the tax credit industry.



The equity markets for the low-income housing tax credit (LIHTC), new markets tax credit (NMTC) and historic tax credit (HTC) will share some common challenges in the year to come.

For example, tax reform would likely have a measurable effect on the tax credit equity markets even if these tax credit programs are not directly altered. In addition, as banks continue to dominate the field of tax credit investors, regulatory changes such as the Volcker Rule and the implementation of Basel 3 capital requirements will have ripple effects. It's too soon to tell how deep those ripples will be because the changes will be phased in over the course of several years and will affect individual banks differently. We do know that the larger banks that have been designated as systemically important will face higher Basel 3 capital charges; at the time of this writing the specific increases for each bank had not been set. Once those amounts are known, and as banks adjust their holdings to meet the new requirements, there are significant implications for their interest in tax credit investments.

In terms of supply in 2012, the LIHTC market will remain the largest; approximately \$7 billion in newly minted LIHTCs will be added to the supply for 2012. The NMTC mar-

ket currently has just a little more than \$5 billion of unissued qualified equity investments and \$3.5 billion in NMTC will be allocated in January or February, which translate to about \$3 billion of NMTCs, but not all \$3 billion of credits will be available in 2012. Current estimates place the size of the 2012 HTC market between \$550 million and \$650 million credits.

One of the greatest uncertainties in the 2012 tax credit equity markets is whether the Section 1603 cash grant program will be extended. If the grant is allowed to expire, a multi-billion dollar increase in renewable energy tax credits (RETCs) will be hitting the market in 2012. The current level of the Section 1603 program activity is about \$5 billion a year, but because of the ability for energy projects that meet the safe-harbor requirements of the program to pursue the grant beyond the program's expiration, large amounts RETCs may not hit the market until mid- to late-2012, if at all.

The good news is that most predictions are cautiously optimistic about near-future conditions for the tax credit equity markets. Nonetheless, each segment of the market will be affected by various factors specific to each tax credit.

LIHTC Market Outlook

The LIHTC equity market has been volatile for the past few years, to say the least. LIHTC prices since the collapse of 2008 and 2009 and the rebound in 2010 trended steadily upward in 2011. As prices climb and yields decline, there is some decrease in demand from economic investors. At the time of this writing, yields were hovering around 6 percent in much of the country and for multi-investor funds; yields in certain coastal markets have fallen below 6 percent, but a number of

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market experts agree that the pace of yields' decline has begun to slow.

Early indications suggest many investors plan to invest in 2012 at levels similar to those of 2011. While several insurance companies reentered the LIHTC market in recent years, the largest constituency of 2012 investors will continue to be banks. Few new investors have been reported, and some believe the LIHTC market's recent track record of dramatic pricing swings will prevent a significant number of new investors from entering the LIHTC market in the near future.

Because of banks' large share of the LIHTC equity market, changes to Community Reinvestment Act (CRA) regulations could potentially create significant benefits for the LIHTC market. Specifically, some bank investors suggest that creating fewer, larger CRA assessment areas would improve market conditions and increase the creation of affordable housing. Advocates of this type of change say it would allow banks to cast a wider net, which could increase diversity in their LIHTC portfolios and narrow the gap that exists between high credit prices in high-demand, major CRA assessment areas and prices in lower or no demand in non-CRA or minor CRA assessment areas.

In addition to national-level factors, state and local issues will also figure into conditions in certain markets in 2012. For instance, the challenge to redevelopment agency funding will likely have a significant bearing on the types of transactions funded in California.

Legislatively, there will be continued interest in and activity around tax reform in 2012. Several lawmakers have called for the top corporate tax rate to be lowered from the current rate of 35 percent to 25 percent. Under this scenario, assuming the LIHTC was left intact, we estimate that LIHTC yields would fall approximately 50 to 100 basis points due to the reduced tax savings from tax losses. This means that lower top corporate tax rates would create downward pressure on LIHTC pricing.

NMTC Market

For the NMTC community, all eyes are on extension of the program. It's widely expected that the program will be renewed – if not before it expires at the end of 2011, then possibly retroactively some time in 2012. Still, uncertainty about the NMTC's future is having a noticeable effect on the number of active investors as well as tax credit pricing.

Prices for NMTCs may increase in the months following the next round of allocation awards, which is expected in late January or early February. Active NMTC investors are echoing some of the trends of the LIHTC market; many NMTC investors indicate they plan to sustain the level of investment in 2012 that they executed

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in 2011. And like the LIHTC market, the field of NMTC investors is also dominated by large banks.

Cents per dollar pricing for NMTC transactions is considerably lower than that for LIHTC investments, but that pricing difference is driven principally by a key structural difference between the two credits, specifically that LIHTCs don't reduce basis and NMTCs do. Primarily for this reason, investors can pay 30 to 40 percent more for LIHTCs than for NMTCs.

The difference in basis reduction between the LIHTC and NMTC also means that tax reform that results in a decrease in the marginal corporate tax rate would have the opposite effect on NMTC yields than it would for LIHTC yields; after-tax yield for an NMTC strip investor would actually increase. Based on current pricing for the credits, a drop to a 25 percent marginal rate from the current 35 percent marginal rate would result in an increase to the NMTC strip investor's after-tax yield of approximately 50-100 basis points. This means that lower top corporate tax rates would create upward pressure on NMTC pricing.

Other than providing more certainty about the program's future by way of an extension, it's generally agreed that allowing the NMTC to offset the alternative minimum tax (AMT) could widen the investor field by increasing the number of taxpayers that could benefit from the credit. This change would give NMTCs the treatment already applied to the LIHTC, HTC and RETCs. However, the cost of these provisions will make them more difficult to pass. The Joint Committee on Taxation (JCT) estimated the two-year NMTC extension approved in December 2010 to cost approximately \$1.8 billion over 10 years. The AMT provision has a considerably lower impact on revenue; in July 2010, the JCT estimated it would cost approximately \$444 million over 10 years.

HTC Market

The HTC equity market has been quieter relative to the LIHTC or NMTC markets; HTC prices have not seen the same level of pricing fluctuation as has the LIHTC market nor is the HTC market faced with expiration of the program. But, like that of its peers, demand in the HTC market is expected to remain relatively steady in 2012.

Perhaps the most significant unknown for the HTC sector is the impact of the IRS's appeal in the Historic Boardwalk Hall case. Many in the HTC community see the case as a potential "game changer" for the historic equity market. As John Leith-Tetrault discusses in detail on page 61, the appeals court decision in the Boardwalk Hall case may have a widespread impact as it addresses whether traditional HTC structures that rely on managing member guaranties, fixed priority returns and standard put and call exit strategies to attract limited partner capital can meet

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the requirements for characterization as a federal tax partnership. Another key issue in play is the question of how much economic substance is “enough” in an HTC transaction in relation congressional intent for the HTC.

On the tax reform front, because HTCs have a 100 percent basis reduction similar to NMTCs, if the top tax rate is lowered, yields for HTCs will increase. We estimate that with a top corporate tax rate of 25 percent, HTC yields for direct investments could rise 50 to 100 basis points. For HTC investments that involve a pass-through lease structure, however, HTC yields would drop. This means that lower top corporate tax rates would create upward pressure on straight equity HTC pricing, but downward pricing pressure on lease pass-through HTC investments.

RETC Market

For the renewable energy community, there are two main challenges looming: the expiration of the Section 1603 cash grant exchange program at the end of 2011 and the expiration of the production tax credit (PTC) for wind at the end of 2012. The effect of the Volcker Rule may also cause ripples for RETC equity investors

Most estimates put the number of active RETC investors between 15 and 20 and it’s likely that some of those will drop out of the market with the expiration of the grant. However, those investors that do remain are expected to sustain levels of investment activity in 2012 similar to those of 2011. Also, as this year winds down, a number of renewable energy developers are actively working to “safe harbor” projects that won’t be placed in service by the end of 2011. Because of those efforts, Section 1603 related development will continue well into 2012, possibly as long as the third quarter of the year. Moreover, even though the Section 1603 cash grant option was available in 2011, there were still some investors looking for tax equity deals. In addition, rumors indicate there may

be a handful of new investors considering entry to the RETC equity market. Specifically, it’s possible that other tech companies could follow Google’s lead and invest in renewable energy equity. Taken together, this could mean the transition from the Section 1603 grant could be relatively gradual and less of a shock to the system than some might have feared.

Another key challenge for the 2012 RETC equity market is the future of the PTC. The American Wind Energy Association (AWEA) warns that failure to extend the PTC before it expires next year will lead to job losses. Without a timely extension of the tax credit, wind project developers will hesitate to plan or will simply stop planning future projects. Reports suggest that manufacturers have already seen a marked decrease in orders. AWEA reports that in previous years when the PTC was allowed to expire, installations dropped by between 73 and 93 percent and resulted in significant job losses.

While the LIHTC and NMTC qualify as public welfare investments and HTCs were explicitly excepted from the Volcker Rule, RETC investors will have to weigh the rule’s implications. Some RETCs may qualify as public welfare investments while others will not. For those RETCs that do not fall under public welfare investments, there is some thought that banks could invest in them as “operating” companies rather than as “investment” companies.

Conclusion

Each sector of the tax credit equity market faces its own unique challenges and opportunities in 2012. It’s clearly too soon to be sure of what’s in store for tax credit investment, but by keeping these issues in mind the affordable housing, community development, historic preservation and renewable energy communities can enter the new year better prepared to navigate these hurdles, and even thrive. ❖

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