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Turmoil in the Equity Markets: What Does It All Mean?

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Attend any low-income housing tax credit conference or speak with anyone involved in the low-income tax credit industry and the number one topic is the decline in housing tax credit pricing. As housing tax credit prices decline, the variety of views about where tax credit pricing will settle and how the market will get there rises.

In order to address this question, I believe one must begin with a review of basic market economics, and then look to the various ways in which participants in the market are likely to react.

Supply and Demand

The price of tax credits is governed by economic laws of supply and demand. As we learned in economics class, the price for any good is based on the point where supply and demand intersect. If demand increases, then prices rise. If demand falls, then prices fall. For most goods, there generally is a correlative effect; when supply increases then demand increases and when supply falls then demand falls.

However, in applying the laws of supply and demand to housing tax credits, we quickly identify that the annual new supply of housing tax credits is not affected by the demand for those credits. Every year there is a relatively fixed supply of housing tax credits, as housing tax credits are allocated among the states based on their populations, which generally experience relatively small changes year to year. Since the supply of new housing credits is relatively fixed, changes in demand for housing tax credits result in a steeper change in the price of those credits, steeper than if the supply of tax credits was not relatively fixed. For goods that do not have a fixed supply, changes in demand have less of an impact on prices because changes in the supply mute some of the effects of the change in demand. Therefore, in a rational, efficient market, we can expect that the current downward trend in demand will result in lower prices for housing tax credits.

Many commentators are concerned that due to the steep drop in demand for housing tax credits, the industry will not be able to raise enough equity to purchase the total supply of available credits. Often, these fears are raised due to a simple analysis of the fact that of the approximately $8 billion invested annually nationwide in recent years, existing investors are expected to trim their future investments by some $3 billion to $4 billion. This simple analysis leaves many industry participants wondering where the industry can possibly raise the capital to replace these capital sources. As a result, many participants worry that demand for housing tax credits will fall to the point that sellers of the credits (either developers or syndicators) will not be able to find buyers at any reasonable price. However, as outlined in the following explanation, this outcome is unlikely due to two primary factors: first, as housing tax credit prices fall, yields rise, and new or returning investors are enticed by higher yields; and second, as housing tax credit prices fall, the aggregate housing tax credit equity that needs to be raised to fund new housing tax credits also falls.

Currently, approximately $6.5 billion of 9 percent housing tax credits are allocated annually, and roughly $1 billion of 4 percent tax-exempt bond housing tax credits are available, resulting in a relatively stable and fixed supply of housing tax credits of roughly $7.5 billion each year. Over the last few years, investor credit prices have topped out at $1 (or more) per credit, which results in an aggregate annual equity raised of about $7.5 billion. If investor equity pricing averaged 80 cents to 85 cents per credit, the aggregate annual equity that needs to be raised is noticeably lower, at just $6 billion to $6.5 billion. As a result, a drop in equity pricing of 15 cents to 20 cents reduces the need to

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raise anywhere from $1 billion to $1.5 billion in housing tax credit equity each year.

In addition to the shrinking of the aggregate equity market due to the drop in credit price, the heretofore relatively small pool of existing investors should also increase. In recent years, as credit prices soared to levels approaching and often exceeding $1 per credit, many investors exited the market in search of better risk adjusted yields, leaving behind fewer investors, such as large financial institutions and government sponsored entities, many of which invest in the housing tax credit market for reasons other than yield. Not surprisingly, we have seen that as housing tax credit yields have been rising, many investors from other industries, such as companies from the insurance, energy and high-tech world, are entering the market, attracted by the now-higher returns.

These investors are being lured to housing tax credit investments because as equity prices decrease, the attractiveness of housing tax credits as an investment increases, often dramatically, vis-à-vis alternative investment vehicles. As an illustration, an after-tax yield to investors of approximately 4.5 percent results in a credit price of about 93 cents to 96 cents to a developer. However, as the yield rises to 6 percent, the credit price to developers falls to 86 cents to 83 cents. Similarly, a further rise in the yield to 7 percent drops developer pricing to less than 80 cents (and a yield of 8 percent would drop credit prices to less than 75 cents). Absent similar significant upward movement in the expected yield to be generated by alternative investments, investors will be inclined to invest more capital in housing tax credits and less capital in other, less lucrative investments. The expected result of an expansion of the pool of potential investors, coupled with a drop in the aggregate capital to be raised due to the drop in credit prices should help the industry to raise the capital necessary to place the full $7.5 billion in annual credits generated under the housing tax credit program.

Future Effect on the Industry

While the drop in equity pricing benefits investors, the housing tax credit projects (and, by inference, their de-

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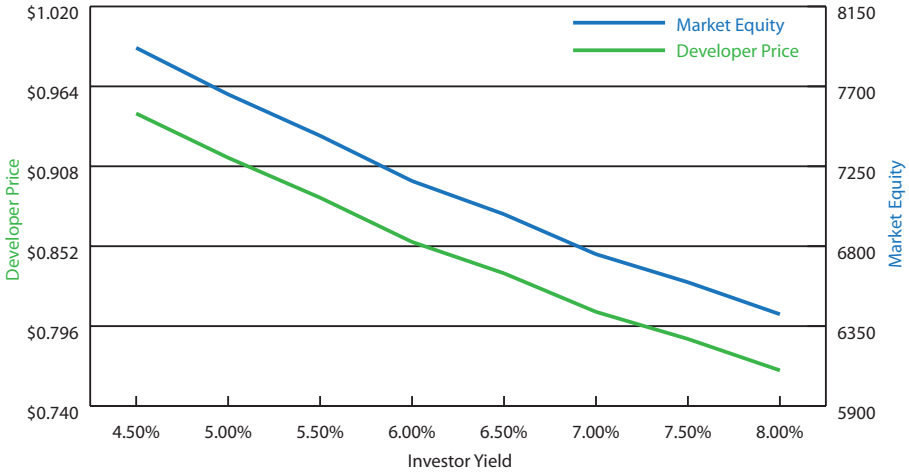

Prices	$ 0.921	$ 0.892	$ 0.864	$ 0.838	$ 0.814	$ 0.790	$ 0.768	$ 0.747
Target yield	6.50%	7%	7.50%	8%	8.50%	9%	9.50%	10%
Calculated yield	6.499%	6.998%	7.509%	8.009%	8.496%	9.009%	9.505%	10.001%
Total credits (in millions)	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
Equity raised (in millions)	6,908	6,690	6,480	6,285	6,105	5,925	5,760	5,603

velopers) bear the direct brunt of the decrease in equity raised. In the immediate future, the drop in pricing will have a significant detrimental impact on two groups: syndicators that have committed to purchase credits at historically high prices but not yet placed those credits with investors, and developers whose projects are structured with high reliance on historically high credit prices to balance their sources and uses. To avoid a negative impact on their standing in the market, these syndicators will likely have to take significant losses on those investments. Developers suddenly facing a large financing gap will need to take the steps outlined in the following two paragraphs, which may or may not be feasible depending on the flexibility of the state housing agency to renegotiate the preexisting commitments made by the developer regarding the financing structure and particular features to be delivered by a given project.

Going forward, a drop in equity pricing opens a significant gap in project financing, which may be filled by either raising additional capital or reducing the project costs. To raise additional capital, developers may find additional soft loans or grants from not-for-profits or through state and local government programs. Alternatively, for projects still in the planning stage, developers may choose to adjust the targeted rent levels such that rents no longer target extremely low-income levels as low as 25 percent or 30 percent of area median income, instead targeting rents closer to the statutory minimum of 60 percent of area median, so long as maximum tax credit rents stay at or below market rents. This will generate additional rental income, which can be used to increase the size of the debt the property can service.

Alternatively, the gap in project financing could be filled by reducing project costs through various means. One possible solution is the selection of more economically priced land that might boast fewer of the highly desirable features targeted in the application process, such as proximity to public transit, parks, libraries, schools, supermarkets or hospitals. Moreover, the gap could be filled by reducing total development costs attained by offering fewer amenities on-site, such as child care, after-school programs, community space, or use of sustainable building materials.

In addition to possible adjustments that might be made by developers, state housing agencies may elect to modify current restrictions on the amount of housing tax credits allocated to each project, such as threshold basis limitations or other caps that effectively increase the amount of development costs that must be financed through sources other than housing tax credit equity.

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These changes would result in additional per-unit subsidy, decreasing the number of units completed each year. However, given the alternative of having housing tax credits go unused or used to develop fewer units and projects with fewer desirable features, state housing agencies may choose to go down this path.

As developers implement the changes outlined in the previous two paragraphs, these modifications should reduce the competitive position of the application for an allocation of housing tax credits for any given project. However, because all developers are now faced with the same need to adjust their projects to compensate for lower equity prices, the average scores received in each application round will be lower overall, enabling these historically less competitive projects to receive an allocation of housing tax credits and move forward to completion. Because developers will still face competitive pressures to keep the scoring on their housing tax credit allocation applications high, they will likely wield all of these solutions to some degree, while attempting to moderate the adjustments as much as possible to minimize the impact of these modifications to the project's overall scoring.

Impact on Projects in Process

For projects that received a recent housing tax credit allocation but now are unable to get the equity financing needed to finance the project, many of the possible solutions will be very difficult or even impossible without assistance from the state housing agency. For these projects, which now may face a significant financing gap, there is a real possibility that if the project cannot be restructured and made feasible, it may not be completed. Although this may result in a temporary reduction in the number of projects completed, these credits will be recycled into different projects because such credits are returned to the state and reallocated to other projects.

However, to stave off the dark specter of failed projects created by the looming threat of financial infeasibility, many state housing agencies are taking a proactive approach by reaching out to developers with recent allocations to discuss solutions to keep projects on track, which may include implementing some of the solutions outlined above, including a modification of the commitments made by the developer related to planned project features.

Conclusion

As the industry adjusts to the new paradigm being set by the changing housing tax credit equity market, we must all focus on finding and implementing innovative gap closing solutions. Through these efforts we can ensure that existing and proposed projects will be financially feasible even in the face of an equity market that is still seeking its supply and demand equilibrium.

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