

# Kestrel Brunswick Corporation

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## COMMENTS ON NEW MARKET TAX CREDIT PROGRAM

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### INTRODUCTION:

As an operating company that has recently been the beneficiary of the New Market Tax Credit Program (“NMTC Program”), we appreciate the opportunity to comment on the NMTC Program. We believe that the NMTC Program has the potential for providing the nation with a strong basis for job creation through a true public sector-private sector effort.

We also believe it is essential that the program guidelines be clarified so that Operating Companies that create long term jobs and economic activity be allowed to participate in the NMTC program; a program that has previously favored Real Estate transactions. Now is the time to change the focus of the NMTC program towards job creation and away from highly leveraged “bubble type” real estate transactions.

These comments are based on our experiences during a closing of a \$20.7MM NMTC transaction in April 2011. These comments are based on the application of the regulations associated with the NMTC Program during this closing not on the regulations themselves. Any expert in NMTC regulations reading our comments may easily dismiss our comments as simply an uninformed misunderstanding of the regulations. Indeed, we clearly do understand the maze of regulations but we can report on how the regulations were interpreted by the Allocatee, CDE, and NMTC investor in our transaction. The interpretation of the regulations by the participants in the NMTC program is “reality” regardless of the wording of the regulations and dictates the use of NMTC allocation and the cost of closing a NMTC transaction.

*The purpose of the following comments is to suggest ways that the program can be improved to turn the NMTC Program into a more effective engine for the creation of long term quality jobs.*

### PROGRAM RISK AS PERCEIVED BY A NMTC INVESTOR:

Since the NMTC program only provides Tax Credits it is necessary to “sell” these Credits to an investor to provide the cash input for the Operating Company. And, obviously, the risk to the investor is a large part of the pricing of the transaction.

If one reads a summary of the program it is easy to assume that this is a low risk program from the view point of an NMTC investor. It is also easy to assume from reading the regulations that an equity investor in the NMTC Investment Fund Single Purpose Entity could be assured of receiving tax credits over a 7 year period by simply structuring the transaction according to the regulations. Since these are US Treasury Tax Credits it is easy to assume that such a transaction would be an AAA rated investment for the NMTC investor.

This is not the case.

Our transaction was rated by Moody’s based on a return of principal to the NMTC Investor in the form of 7 years of tax credits. The rating we received was independent of any operating risk associated with the underlying enterprise. The rating was Moody’s view of the probability of the NMTC Investor receiving the full tax credits for the transaction (i.e. \$8.1MM in tax credits for the \$7.3MM invested). It did not take into account any risk associated with the debt portion of the transaction.

Based on Moody’s understanding of the transaction and the supporting legal documentation required by the CDE, Allocatee, and NMTC Investor advisors, Moody’s was only able to provide a **Baaa** rating for the transaction. The perceived risk of the NMTC Investor not only losing the tax credits but also being

# Kestrel Brunswick Corporation

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burdened with tax penalties and interest resulted in the lowest possible investment grade rating for the transaction. This added risk of tax penalties and interest also increased the pricing of the transaction.

During the documentation of our transaction it became very apparent that common position among the advisors was that the Tax Credits could be lost for a variety of ways. Even more disturbing was the comment made by several professionals that the IRS was looking for “technicalities” to revoke the Tax Credits.

This perceived risk based on the perception and interpretation of the regulations by the legal and professional advisors to the CDE, Allocatee, and NMTC Investor resulted in increasing the structuring cost, operating constraints and reporting. This resulted in reduced funding available to the operating company to create jobs.

**SUMMARY:** Assuming the NMTC investor is truly independent of the Operating Company; once the transaction is completed the NMTC Investor should be assured of the flow of tax credits. Assuming independence, this risk should be eliminated by the CDFI and IRS by clearly stating that if a structure is valid at closing and the NMTC Investor takes no action contrary to the NMTC Regulations, the flow of tax credits is guaranteed for the full 7 years. The penalties associated with the Operating Company violating the NMTC Regulations should be imposed on the Operating Company not the NMTC Investor.

## **INVESTMENT SAFE HARBOR:**

At this time the IRS provides a safe harbor if NMTC funds are invested with 12 months. This fact results in NMTC investors imposing terms on the Operating Companies to invest their funds within 12 months. Depending on the nature of the Operating Company, this is not necessarily the most effective use of capital nor does it necessarily increase the chances of business success and the creation of long term permanent jobs. This interpretation drives Allocatees and investors to Real Estate transactions.

**SUMMARY:** For operating companies this investment period should be extended. Any penalties with not spending within a reasonable period should be borne by the Operating Company not the NMTC investor.

## **USE OF ALLOCATIONS:**

The NMTC allocation is a scarce and valuable resource. We believe that the program can be an invaluable tool in the creation of new companies and jobs in many underserved areas. At this time the program, as stated above, forces an Operating Company to quickly invest NMTC funds. However, the Program allows Allocatees to hold onto allocations for up to 5 years. The allocation we received at closing in April 2011 was issued by the CDFI in November 2006. Current US economic conditions as seen in the high unemployment rates should suggest a more rapid deployment of these assets.

**SUMMARY:** Allocations should be employed by the CDE within 24 months of being issued. If a CDE cannot utilize the allocation within that period the allocation should be put in a common pool for use by Operating Companies ready to utilize the allocation.

## **TRANSACTION COST:**

The perceived risk has a direct bearing on the cost of the transaction. In our transaction, out of an Allocation of \$20.7 million, the US Treasury department issued approximately \$8.1 million in tax credits. The tax credits will be issued over a 7 year period resulting in the time adjusted cost to the US Treasury Department of approximately \$7.3MM using a 2.5% discount rate. Based on this allocation the operating company was able to generate, before deal expenses, \$7.2MM of new Investor funding into a qualified

# Kestrel Brunswick Corporation

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investment, Kestrel Brunswick. Out of the \$7.2MM received by Kestrel Brunswick (through the NMTC structure) by the sale of NMTC Tax Credits the following expenses were paid:

CDE Sub Allocation Purchase Fee	\$725,000	
CDE Origination Fee	\$1,244,000	\$622,000 paid at Closing
CDE Loss Reserve for IRS Audit	\$300,000	
Legal and Professional Expenses	\$666,000	Including Moody's fee
Total Fees and Expenses	\$2,935,000	\$622,000 deferred to 7 years
Total Cash out of Pocket	\$2,313,000	

In our case, we had identified the NMTC Investor, NMTC debt holders and finalized the business plan. For a fee of over \$2.2MM the CDE provided access to \$20.7MM of allocation granted to the CDE by the US Treasury Department while taking no risk associated with the transaction other than the loss of staff time if the deal did not close.

In addition to the direct cost paid to the CDE and professional advisors, the perceived risk associated with the transaction resulted in the NMTC investor's advisors requiring an escrow account for all interest associated with the senior NMTC debt. This resulted in another \$488K not being available to the operating company for job creation. Following the closing the Operating Entity had approximately 61% or \$4.5MM of the original \$7.3 (present value of \$8.1MM in tax credits provided by CDFI) for business growth including job creation.

**SUMMARY:** Fee should be based on the risk being assumed. If a CDE is acting as an administrator for the NMTC program they should receive a flat fee for administration. If the CDE or its parent chooses to take a risk position by providing additional capital they should be compensated similar to other risk investors independent of the NMTC allocation.

## **PUBLIC REPORTING:**

As a Federal program, the use of the NMTC Allocations should open to public scrutiny. Instead the decision to provide NMTC Allocations to operating companies is made by CDE's without clear public input. Their decision of whether or not to make an allocation is not transparent, and cannot be appealed. The decisions made by a CDE are not open to the public and the books and records are not subject to public inspection.

Not only are decisions as to allocations made without public disclosure, the fees and cost and the resulting income to the Allocatee are not disclosed. As a matter of fact in many cases the public information given is misleading in that it omits fees paid to the Allocatee by simply giving professional fees incurred in the transaction.

**SUMMARY:** The decision on all allocations should be made public with full fee disclosure on the part of all participants. All allocation decisions should be subject to public comment. In addition the relationship between all parties in the transaction should be clearly stated.

## **RESULTS OF KESTREL ALLOCATION:**

Kestrel Brunswick received an allocation of \$20.7MM on April 21, 2011. In the first 90 days we have created over 35 jobs with an average salary in excess of \$50,000 per year plus benefits including health insurance. These jobs are full time positions and are not tied to any construction completion schedule. We anticipate that these jobs will continue to exist as long as Kestrel Brunswick is open for business. These jobs were created with only \$4.5MM of the \$8.1MM associated with the \$20.7MM allocation.

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If Kestrel Brunswick had been able to obtain the full allocation it requested and for which the NMTC investor has committed to purchase, we project the creation of over 350 full time permanent jobs with average salaries in excess of \$40,000 per year.

**THE COMMENTS ABOVE ARE MADE BY KESTREL BRUNSWICK CORPORATION AND REPRESENT THE VIEW OF KESTREL BRUNSWICK CORPORATION ONLY.**