EXCERPT

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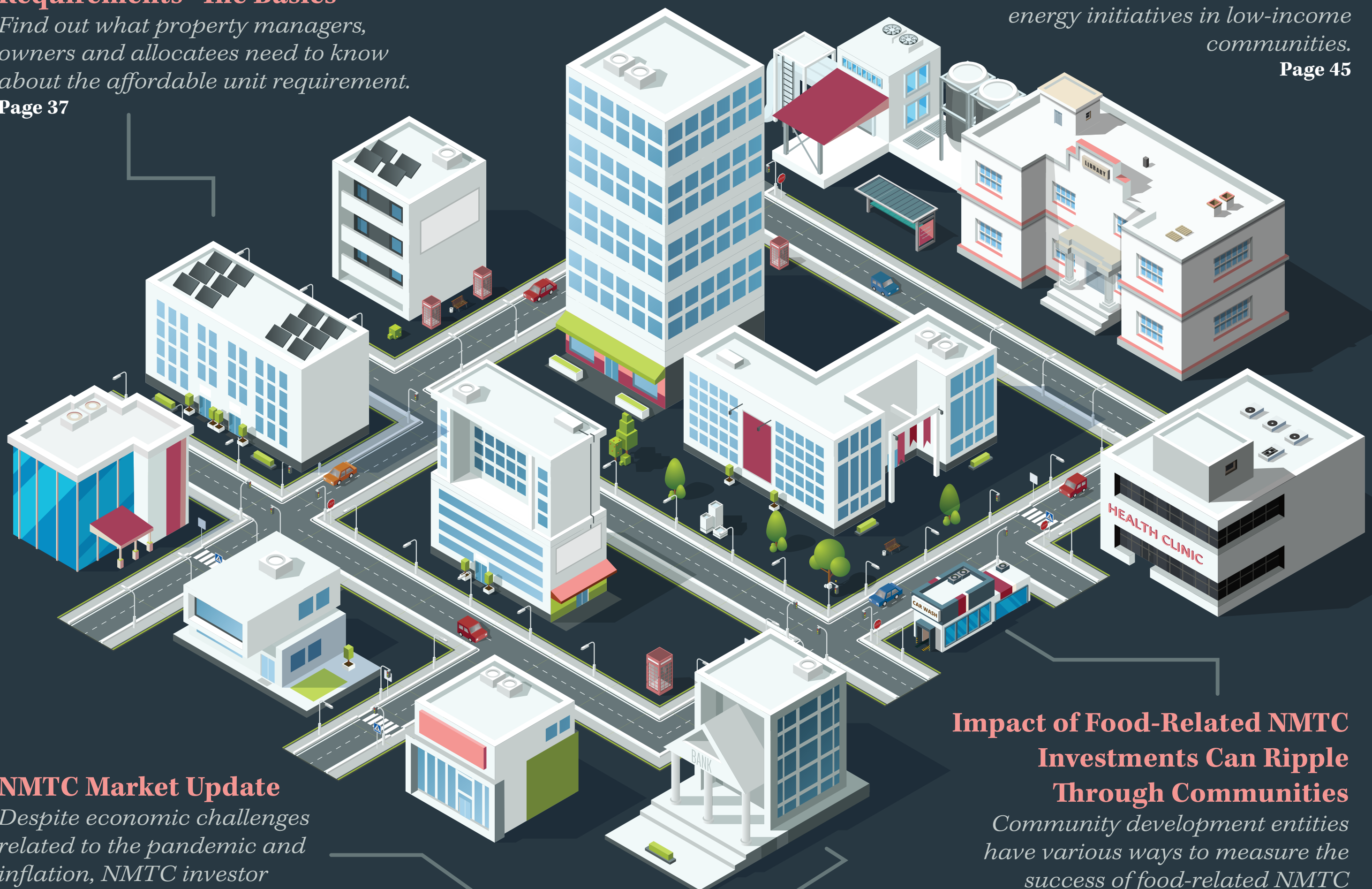
The New Markets Tax Credit *Issue*

Environmental Justice: Key Provisions of the Inflation Reduction Act
The Inflation Reduction Act provides a variety of funding sources to advance renewable energy initiatives in low-income communities.
Page 45

NMTC Housing Properties with Affordable Compliance Requirements–The Basics
Find out what property managers, owners and allocatees need to know about the affordable unit requirement.
Page 37



NMTC Market Update
Despite economic challenges related to the pandemic and inflation, NMTC investor demand remains strong.
Page 49

Impact of Food-Related NMTC Investments Can Ripple Through Communities
Community development entities have various ways to measure the success of food-related NMTC allocations.
Page 52

NMTC Market Steady Despite Effects of Pandemic, Inflation

BRAD STANHOPE, SENIOR EDITOR, NOVOGRADAC

The investor market for new markets tax credits (NMTCs) is solid, but supply is still ahead of demand and properties financed with NMTC equity are struggling with the effects of the COVID-19 pandemic and inflation.

"The state of the new markets tax credit is strong, meaning we continue to see high interest in new markets tax credits from a wide variety of for-profit and nonprofit organizations and we see ample available in the marketplace," said William Carson, vice president and business development officer at U.S. Bank, the nation's leading NMTC investor. "We continue to see a strong pipeline of projects and sufficient investment activity."

William Turner, senior vice president at Wells Fargo, agreed–with a caveat.

"Because most of the investor market is CRA (Community Reinvestment Act)-driven banks, I think there's still a great deal of interest in new markets tax credit investments," said Turner. "Over the past couple of years, as people looked closely at their balance sheets, tax appetites and earnings relative to other tax credit programs, they've sharpened their pencils a little bit, which likely impacted pricing. But in general, there remains a strong appetite."

NMTC stakeholders say that the incentive continues to meet the needs for which it was created, but that events of recent years–the COVID-19 pandemic, an increase in demands for social justice, inflation and even the boost from $3.5 billion to $5 billion in annual NMTC allocations–are having an effect.

Pandemic, Repercussions and Inflation

Like with everything, the pandemic had a major effect on NMTC projects.

"It slowed down materials and the supply chain," said Frank Altman, head of the Community Reinvestment Fund, a community development entity (CDE) and community development financial institution (CDFI) active in the NMTC space. "The pandemic caused bottlenecks and slowdowns in completion of construction. It's getting better, but it's still not fixed."

Elaine DiPietro, president of NMTC consultant Blooming Ventures, said the first obvious effect of the pandemic was a longer time for basics: Such things as survey work, appraisals, title work, assistance from county and state offices. Now, she said, the same thing is happening because so many projects are going at the same time. But DiPietro said the pandemic showed the need for such investment.

"COVID created an increased need," DiPietro said. "We know that low-income communities and communities of color were disproportionally negatively affected by COVID. Those are the areas we were already working in, and the need increased."

Some types of NMTC properties–such as office and retail–became less attractive because of the pandemic and the related economic difficulties.

"Retail projects with third-party tenants was the more heavily affected piece," said Leah Rogan, managing director, NMTC, at Enterprise Community Investment, a CDE that has received more than $1 billion in allocations over the history of the

NMTC incentive. "A lot of times they're small, local businesses going into these spaces. They were hoping to expand and move to their first brick-and-mortar, but they couldn't, so we did see a lease-up issue."

Rogan said community facilities–a focus for Enterprise–also suffered from the pandemic.

"A big part was operations," Rogan said. "They could serve fewer low-income people. If you have a Boys and Girls Club or a YMCA and you have to shut down operations, you have less programming and services available to lower-income people. That's where we've seen a severe reduction in impact."

Turner said the pandemic was another link in a chain.

"I think COVID accelerated some market trends that were already underway," Turner said. "Pricing was already starting to fall and COVID, with the uncertainty of where the economy was headed, accelerated the fall in pricing. … It's hard to look at COVID in a silo–it occurred along with this expansive social movement. They began in unison to have an impact on the types of deals that CDEs were focusing on and the types of stories investors wanted to tell around their response to COVID and communities in need."

Inflation's Effect

In recent months, the highest inflation in a generation and rising interest rates amplified the challenges in the NMTC world.

"From a cost-of-goods perspective, inflation definitely has impacted the entire capital stack and project timelines," said Carson. "We're seeing projects across the board reporting having a 15% to 30% increase in overall construction costs, which can sometimes delay project timelines."

Turner said inflation is creating funding gaps.

"If you think of new markets tax credits as gap financing for conventional financing, the gap is larger due to higher rates and the resulting lower supportable loan amounts," Turner said. "There's also a rise in property costs and construction costs, so the cost of the project is higher. With lower NMTC prices per credit, it becomes more difficult to fill the growing funding gap. One good thing about the new markets tax credit is there's no official cap on allocation per project, so some of the gap with lower pricing can be made up with more allocation."

Rogan said inflation has changed how properties look at financing.

"I think the biggest thing I've seen is that previously, commercial bank debt was more favorable than CDFI debt," Rogan said. "Now, with rising interest rates, capital from CDFIs and CDFI programs make that debt more attractive."

More Credits, Fewer Investors?

The upside of that calendar-year 2020 increase in the allocation amount (which is approved through the calendar year 2025 round) is more credits to be allocated for gap financing. The downside is an imbalance in investors and credits.

"Even if there were only $3.5 billion of credits, I think some of the investor demand would have gone down," said DiPietro. "There are two factors: Decreases in investor demand and the increase in available allocation."

Carson said the industry is adjusting.

"I think we're still in an adjustment period," Carson said. "There are $2.5 billion of credit allocations remaining from prior rounds [as of August] and another $5 billion in allocation will become available after the calendar year 2021 award announcement."

DiPietro holds an optimistic view.

"We're in a great place because we have more allocation authorized now than ever," she said.

“There’s lots of supply and lots of competition. The investor market seems a little soft–we don’t have as many players as we used to. I don’t know that demand is really going to match the supply, but I’m also confident that we won’t have unused credits.”

Popular Investments

The type of transactions popular in the NMTC world is evolving.

“There’s still a lot of focus on nonprofit facilities,” Altman said. “When you think about the tools available for financing nonprofits, the NMTC is a really good tool. But ‘nonprofits facilities’ is a large definition. It includes Boys and Girls Clubs, YMCAs, community centers, federally qualified health care facilities.”

Carson said small businesses are benefiting.

“We continue to see new interest in new markets tax credits from small businesses and nonprofits, especially those that are led by persons of color, which traditionally have not had as much access as larger organizations,” Carson said. “In turn, there seems to be a greater interest among CDEs in providing allocations to be more inclusive of minority-led organizations and other groups who have less access to capital.”

Manufacturing is also growing in popularity.

“I’m starting to see an increase in manufacturing projects, especially companies that prioritize environmental sustainability,” Carson said. “We’ve also seen a rise of ‘onshoring’ of businesses that may have had portions of their supply chains based overseas and now they’re seeing the benefit of bringing manufacturing back to the United States.”

DiPietro sees the same trend.

“I think we’ve been seeing the popularity of manufacturing-job-creation type projects and that’s increased with supply-chain issues and people trying to be innovative and having things made in the United States, along with things like energy-related projects,” DiPietro said. “Hospitality, retail and office projects are less popular. … There’s always a constant popularity for health care-related projects and I think we’ll see an increase in education projects as people start realizing the negative effects of COVID.”

Renewable and clean energy provisions in the Inflation Reduction Act, signed into law in August, could blend with NMTC financing.

“There’s going to be increased focus on climate resilience in transactions,” Altman said. “There will be a nexus between NMTC deals and how they incorporate decarbonization. Even domestic manufacturing of components for solar and wind are things we ought to be able to focus on as an industry.”

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