

Evaluating Equity Offers – Considering Structure, Price and Fit

*by John C. Bell IV,
Managing Director, Winslow Financial Company LLC*

*(Winslow Financial is an independent advisor, consultant, and placement agent for
developers of and investors in Section 42 and Section 47 properties.)*

The good news for developers is that it's a seller's market for tax credits – competition is keen and is keeping prices high. In most instances, developers can choose from attractive alternative proposals. The good news for investors is that there are some great projects out there.

Here's a three-step game plan we often use in structuring and evaluating equity proposals:

1. Identify factors that drive a particular pay-in schedule.
2. Evaluate the financial aspects of a proposal – including “hard” dollar flows such as price and pay-in, cash flow and residual splits, reserves and fees; contingent liabilities such as guarantees; and the conditions that trigger various partnership events.
3. Evaluate non-financial aspects of a proposal with both the short and long terms in mind.



A discussion of each of these steps appears below.

The proof of the success of a partnership is that both parties get where they think they're going when they think they're going to get there. In my opinion, the likelihood of this happening rests with how well both the developer and the investor have analyzed what the other party is offering, and explained to the other party what they expect and how they expect to deliver on their commitments.

Step 1. Identify factors that drive you to a particular pay-in schedule.

Factors can include:

1. a lender's requirement for equity;
2. a limit on the total amount of construction financing available from construction lenders;
3. the “hard costs” of tapping various construction financing; (This would include interest, lenders' points, report costs and closing costs.)
4. a need for basis-eligible interest to insure full use of a tax credit reservation¹; and,

¹ A bit more about basis-eligible interest: if a developer has a reservation that because of reduced applicable rates (and they are near their historic lows), each dollar of qualifying construction interest (as well as construction loan points) can be “worth” between about 60 cents and 65 cents for projects in non-qualifying tracts and between about 78 and 85 cents for projects in bonus tracts. The math of this is

- the “soft cost” of utilizing various construction financing: administrative costs, draw request related issues such as process and timing, and (frequently undervalued) the “looking-over-your-shoulder” presence of a party whose funds are at risk. (Construction lenders are often less intrusive than equity providers based primarily on their collateral standing.)

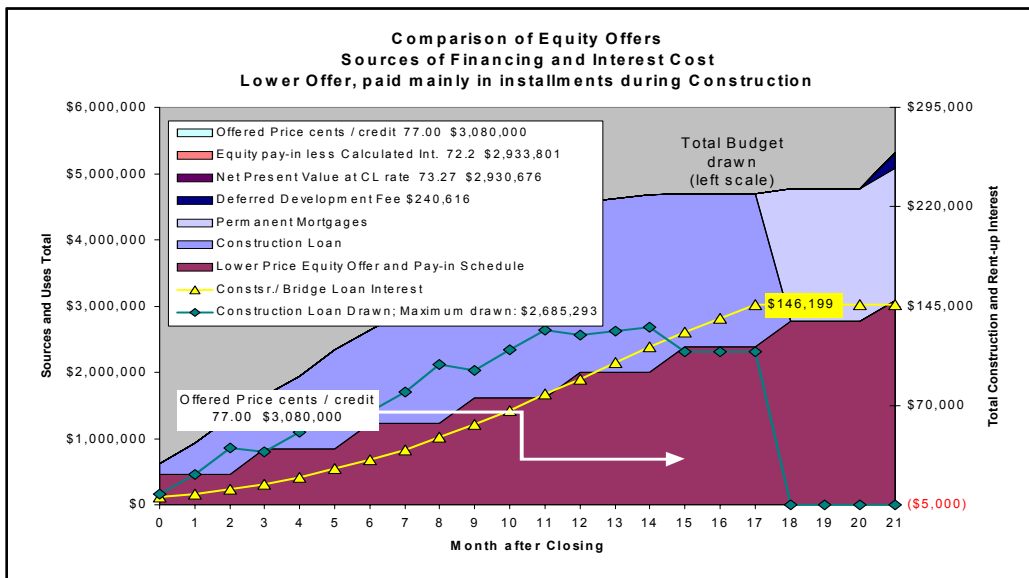
Every project has aspects that are unique, but structuring a deferred pay-in to take advantage of otherwise unusable tax credits and the lower cost of construction borrowing vs. the cost of equity should be high on every investor’s and developer’s list of priorities.

Step 2. Evaluate the financial aspects of a proposal – look particularly at cash paid to the developer
Equity offers can be structured to maximize tax credit proceeds or, stated another way, to minimize the amount of deferred fee or equity a developer may have to contribute to the project.

Though facts and circumstances alter results for every project, the analysis presented here can be applied any development. In this hypothetical case, the results of the analysis should spur the developer to action.

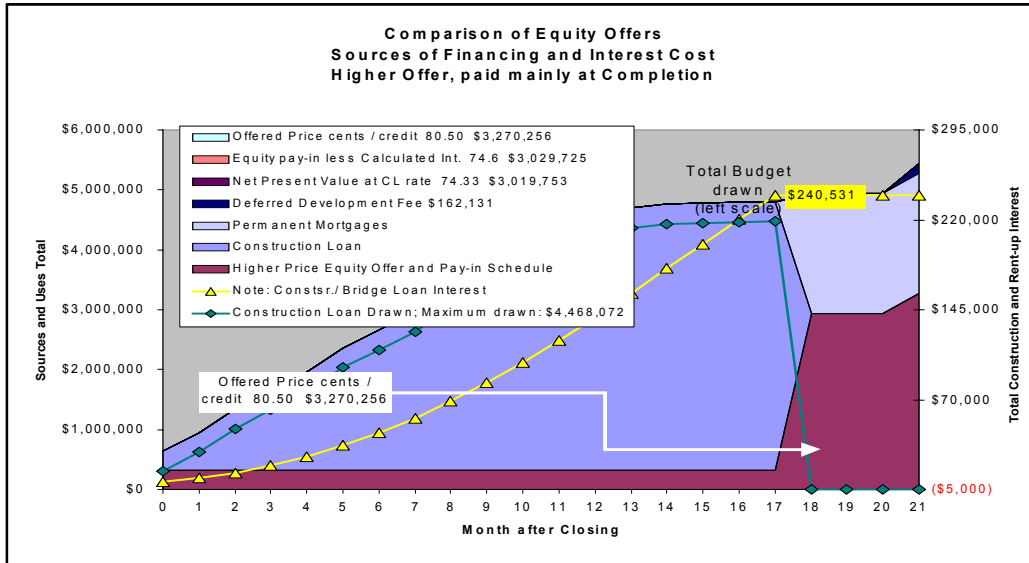
By minimizing his cost of capital and optimizing his use of available tax credits, the developer can finish his project with an additional \$78,485 in his pocket. This is a notable **30.25% increase** in his cash-paid developer fee compared to a traditional and common investor equity pay-in schedule.

The two structuring alternatives can be presented graphically. The project’s sources of financing would look like this charted over its construction and rent up period. The alternative below portrays a traditional investor capital contribution schedule. Note the gradual increase in the lowest (maroon) area. This represents cumulative investor capital payments.



simple: \$1.00 of interest at an 8.00% applicable tax credit rate times a tax credit price from 75 cents per credit to 81.25 cents per credit will generate tax credit equity of 60-65 cents (and 1.3 times that amount in a bonus tract.)

The alternative recommended as a result of our analysis calls for slowing down the schedule of investor capital contributions to avoid expensive over-funding during construction. Depicted below is the recommended restructuring reflecting a delayed equity contribution schedule, and a yield-neutral increased equity contribution². More equity invested later produces the same yield to the investor as less equity invested earlier. Note the jump in equity contributed after the 17th month.



The illustrative project’s budget under a traditional equity pay-in.

This analysis portrayed above assumed a new construction project with a budget of \$5.32 million shown to the right. The budget was carefully modeled to reflect actual month-by-month construction loan and bridge loan interest based on a projected monthly draw schedule. The project is assumed to have a 15-month construction period and a 21-month-to-stabilization period.

In this example, the project is assumed to have been granted a reservation of \$410,000 of annual tax credits. Actual projected “qualified tax credit basis” however (and the current applicable federal rate) qualifies the project for only \$400,000 of tax credits (\$4,000,000 over the 10-year credit period).

| Installment Pay-in Structure | |
|------------------------------------------------------|-------------------------------------------|
| Uses | |
| Acquisition Cost | \$ 150,000 |
| Hard Construction & related costs & contingency | \$ 4,180,400 |
| Soft costs including construction loan interest | \$ 359,004 |
| Capitalized Costs to pay expenses during rent-up | \$ (4,404) |
| Development Fee | \$ 500,000 |
| Reserves (expense, D/S & replacement) | \$ 120,000 |
| Closing | \$ 15,000 |
| Total costs | \$ 5,320,000 |
| Sources | |
| First Mortgage | \$ 2,000,000 |
| Secondary Financings | \$ - |
| Cash Flow Note/Def. Dev. Fee | \$ 240,616 |
| Ltd. Partnership Equity | \$ 3,079,384 |
| State Credit Proceeds | \$ - |
| Other Grant/Sources | \$ - |
| GP Capital | \$ 0 |
| Total Sources | \$ 5,320,000 |
| Total Interest through permanent mortgage: \$146,222 | |
| Notes: | Construction Interest in Basis: \$107,166 |
| | Contingent Interest in Basis: \$245 |
| | Construction Points in Basis: \$27,250 |
| | Total from above: \$134,660 |
| | Deductible Rent-up Interest: \$39,057 |
| | 9% Tax Credit Basis: \$5,000,000 |
| | Tax Credits assumed: \$400,000 |

²Yield-based calculations result in equity pricing for a traditional pay-in schedule of 77 cents per credit. For the restructured project with a slower equity pay-in schedule, a price of 80.5 cents per credit would result in the same return to the investor as the pricing in the original structure at 77 cents per credit.

Based on the investor's yield requirements and assuming a more or less pro rata pay-in of equity during construction, the investor will contribute \$3,079,384 of capital for 99.98% of the tax credits at a price of 77 cents per credit.

The project restructured.

When the investor's capital contribution is delayed, the developer must borrow from his bank to financing ongoing construction. As a result, the total budget increases to \$5,431,734 because of higher construction loan and bridge loan interest and higher construction loan points. These additional budget items increase "eligible tax credit basis" and thereby allow the project to qualify for a larger amount of tax credits – in this case, credits increase from \$400,000 to \$406,243.

In addition to the higher basis-eligible interest, the deferred pay-in schedule creates higher deductible interest during the assumed 4-month rent-up period before the closing of the permanent mortgage.

Though increases in total interest (\$94,284) and points (\$17,450) increase the budget by \$111,734, the additional equity of \$190,218, which comes from selling more credits at a higher price, more than offsets this \$111,734 and, in fact, allows the deferred developer fee to fall from \$240,616 to \$162,131³.

| Deferred Pay-in Structure | | |
|--------------------------------------------------|--|---------------------|
| Uses | | |
| Acquisition Cost | | \$ 150,000 |
| Hard Construction & related costs & contingency | | \$ 4,180,400 |
| Soft costs including construction loan interest | | \$ 437,042 |
| Capitalized Costs to pay expenses during rent-up | | \$ 29,292 |
| Development Fee | | \$ 500,000 |
| Reserves (expense, D/S & replacement) | | \$ 120,000 |
| Closing | | \$ 15,000 |
| Total costs | | \$ 5,431,734 |
| Sources | | |
| First Mortgage | | \$ 2,000,000 |
| Secondary Financings | | \$ - |
| Cash Flow Note/Def. Dev. Fee | | \$ 162,131 |
| Ltd. Partnership Equity | | \$ 3,269,602 |
| State Credit Proceeds | | \$ - |
| Other Grant/Sources | | \$ - |
| GP Capital | | \$ 0 |
| Total Sources | | \$ 5,431,734 |
| Total Interest through permanent mortgage: | | \$240,536 |
| Notes: | | |
| Construction Interest in Basis: | | \$167,783 |
| Contingent Interest in Basis: | | \$214 |
| Construction Points in Basis: | | \$44,700 |
| Total from above: | | \$212,698 |
| Deductible Rent-up Interest: | | \$72,753 |
| 9% Tax Credit Basis: | | \$5,078,038 |
| Tax Credits assumed: | | \$406,243 |

This total net savings of \$78,485 equals 1.96 cents based per dollar of tax credit on the un-restructured total of \$4,000,000 in tax credits.

Step 3. Evaluate non-financial aspects of a proposal under both a short (the development period) and long (the 15 year tax credit compliance period) time frame.

In spite of all the quantitative analysis described above, determining the "best" offer requires looking beyond price. There are specific aspects of a project that most developers understand are that project's "challenging aspects." There are certain underwriting issues that are "hot buttons" for the investor. It

³ A somewhat less complex method exists to compare the value of differing cash flows such as those of the alternative equity capital contribution flows described above. The method is imperfect and subject to certain assumptions, which are merely analogs for personal preferences, but it is revealing. The method is "net present value" which is a kind of fancy way of looking at the interest you pay or save based upon how you finance your spending. Using the construction loan rate as a rate to discount scheduled payments, the higher priced (80.5-cent), slower pay-in structure has a present value (cash today) on a per credit basis about 1.2 cents higher than that of the lower-priced (77-cent), quicker pay-in structure. Stated another way, even excluding the extra credits that the higher basis-eligible interest would allow should a developer have the opportunity to use more credits, the lower offer would have to be 1.2 cents higher to be preferable to the higher offer. Net present value analysis can be used without having to establish detailed draw schedules, but it does require using consistent schedules for satisfaction of the conditions that trigger payments.

is in the interest of both developer and investor to be confident that the investor understands all of the financial and real estate related angles of the development and that the developer understands that the threshold underwriting issues have been covered.

Particular attention should be paid to why an offer's terms may change. Assumptions drive not only price and pay-in but also the establishment of reserves and details of guarantees. Have you and your potential investor identified important issues that have yet to be resolved and agreed on a procedure for resolving them?

I often tell developers and investors with whom we work to think about "fit" – is there a cultural sympathy? a personal chemistry? a slight underwriting prejudice in favor of or against a particular project's size, type, location or sponsor? Though it becomes a hard dollar issue when un-vetted issues arise or third party reports or internal procedures cause delay, there are also "benefits" that manifest themselves in efficiency and a lack of stress that can be ascribed directly to compatibility. Questions of fit and responsiveness often arise when developers consider having a direct investor as their partner.

There are good reasons to look for and choose a particular investor for a particular project. A good executive will consider, in addition to price, the benefits of diversifying financing sources, of ancillary services (e.g. pre-development loans or a permanent mortgage program) or development or programmatic expertise. A good executive will also respect an investor's yield and underwriting requirements.

Having been involved with many and diverse negotiations between investors and developers over the years, I believe that the best results are achieved when both sides take the time to understand what makes a project work and focus on agreeing on a structure, terms and documents that reasonably correlate risk and responsibility. In terms of getting to and beyond the closing table, there is much to be said for having the individuals responsible for the investor's underwriting and closing decisions and who can and will respond quickly when issues arise, deal knowledgeably with the individuals responsible for the development and who can and will respond quickly when issues arise. Such is the stuff of which successful partnerships are made.

For a copy of the details of the analysis upon which this article and these charts are based, please see the Winslow Financial website at www.winslowfinancial.com.

If you are interesting in having us perform an analysis that compares two equity offers based upon a proposed payment schedule, please send an email to johnbell@winslowfinancial.com.