Friends & Colleagues,

The goal of this newsletter is to provide a LIHTC market update in the context of fund pricing and yields. We release them only periodically at important market inflection points. As always, this update is provided in cooperation with our colleagues and frequent partners at Beacon Hill Capital.

After the Republicans won control of Congress and the Presidency in the November 2016, the likelihood of tax reform greatly increased which created instability in the market. We sent out an update that December and our last market update was released the following May, once the market found a new equilibrium. We are in a similar situation this year with another market correction on tap for Q1, as the market adjusts to the Tax Cuts and Jobs Act (the "Act").

Highlights in this summary include the potential impact of rising interest rates, the Base Erosion and Anti-Abuse Tax (BEAT), the return of Fannie Mae and Freddie Mac as equity investors, and as in previous updates, a discussion of LIHTC yields relative to 10-year Treasuries and BBB corporate bonds.

Tax Reform – Major Components and their Potential Impact on LIHTC

The first comprehensive tax reform in more than 30 years was a victory of sorts for the LIHTC program. Not only was it retained without change, but private activity bonds (PAB), which account for approximately half of all affordable rental housing units produced, were also retained. The retention of PABs became the primary legislative focus of the affordable housing industry after a version of the bill from the House of Representatives included their elimination.

The Low Income Housing Tax Credit program remains the most successful housing program in U.S. history and the only source of new affordable rental housing in the United States. Thanks to industry advocacy efforts, it continues to enjoy strong bipartisan support in both houses of Congress.

Highlighted below are some key elements of the Act as they relate to LIHTC funds:

- **Corporate Tax Rate:** The new rate of 21% is lower than the consensus view of 25% in 2017. The consensus view was based on the assumption that changes in the tax code would have to be budget neutral. Once Congress decided to increase the deficit by $1.5 trillion over 10 years, budget neutrality was no longer a constraint. The good news is that most investors stress tested fund returns to a 20% rate. To put the new rate in context of pricing, credit prices would have to decline approximately 3-4 cents to deliver the same IRR.

- **Timing:** The consensus view correctly forecasted that the new tax rate would take effect immediately rather than delayed or phased in. The Act became effective January 1, 2018.

- **Depreciation/Expensing:** In general, 2017 funds did not assume any change in depreciation or expensing. The Act allows real property and site improvements, assets with depreciable lives less than 20 years, to be expensed 100%. Interest expense deductions are capped at 30% of adjusted taxable income, however, real estate businesses have the option to opt out. It is expected that most LIHTC projects will elect to opt out and consequently utilize the Alternative Depreciation System (ADS) and depreciate real property over 30 years (which was reduced from 40 years by the Act) instead of 27.5 years. We are seeing roughly 20-25 basis point increase in IRR with these net changes. Please note the bonus depreciation provisions begin to phase out in 2023.

- **Corporate Alternative Minimum Tax (AMT):** Repealed under the Act. There is no indication yet if the repeal of the AMT will impact the demand for credits.

Additional Information

Given the scope of this newsletter, we wanted to provide some links for more information on the Act that you may find helpful. Novogradac has provided an excellent summary, click here to view.

Cohn Reznick's latest newsletter also has a good summary with respect to accounting and impairment. Click here to view. If you experience trouble with this link you can find the article at www.cohnreznick.com under "events & insights". Look for the article titled *Change in Tax Rates and Qualified Affordable Housing Project Investments* by Michael Beck.

Base Erosion and Anti-Abuse Tax (BEAT)

The BEAT provision of the Act could negatively impact demand for LIHTC for a substantial cohort of LIHTC investors. Essentially, BEAT is an alternative minimum tax that applies to certain taxpayers - foreign owned corporations or U.S. corporations with substantial foreign operations.

There are a significant number banks and insurance companies (20 or more) that are active LIHTC investors that may be subject to BEAT. BEAT is calculated in such a way that it would reduce the value of LIHTC for these firms by 20% through 2025 and 100% (zero value) after 2025.

The calculations for BEAT are complex enough that it may take several months for companies to figure out if BEAT is applicable to them, or if they can restructure in such a way as to avoid the BEAT. Ultimately, it may prohibit these companies from making additional LIHTC investments or may prompt them to sell part or all of their existing LIHTC portfolios on the secondary market, which could impact demand for and pricing of primary LIHTC funds.

The impact of BEAT is a significant concern and has already resulted in some investors stepping back, at least initially. However, the impact to demand may be less than first anticipated. Over the past week or so, a number of investors, both banks and insurance companies that may be subject to BEAT, have indicated a business-as-usual posture with respect to LIHTC investing in 2018.

Additional Information

If you are not familiar with BEAT and would like more information, click here for an article from Nixon Peabody.

The return of the GSEs

While BEAT is likely to reduce demand for LIHTC, the return of Fannie Mae and Freddie Mac to LIHTC equity investment in 2018 should help, at least partially, to offset such loss. Before the financial crisis of 2008, Fannie Mae and Freddie Mac accounted for more than 25% of investor equity in the LIHTC market. Fannie Mae primarily invested in single investor (proprietary) funds and Freddie Mac primarily invested in national multi-investor funds.

Over the past several years, Fannie and Freddie have been petitioning the Federal Housing Finance Agency (FHFA), to allow a return to making equity investments under their Duty to Serve mandate. In late 2017, the FHFA announced that Fannie and Freddie will be allowed limited re-entry into the affordable housing market as equity investors with an annual investment limit of $500M. Furthermore, any investments above $300M a year will be in areas identified by the FHFA as underserved markets, or markets that have difficulty attracting equity investment. To put this target in context, together they could be 5% to 10% of the equity market once their investment activities are up to speed.

With regard to the return of Fannie and Freddie, it is important to note several things. First, not all their equity investment authority is expected to go into LIHTC investments. Investments in non-LIHTC preservation funds, among other investments, are also considered to be an important component of their investment plan and Duty to Serve. Also as mentioned above, a substantial component of their LIHTC equity investments will also be focused on rural and underserved markets where LIHTC prices are lower. The impact of their return will not be felt immediately. It will take some time to ramp up their investment activities.

Rising interest rates

The prospect for rising interest rates remains a factor of consideration for LIHTC returns in 2018. While further increases in short-term rates through the overnight federal funds rate are expected for 2018 and beyond, long-term treasury rates are also expected to rise as the Fed continues to look to reduce its balance sheet through Quantitative Tightening.

The 10-year U.S. Treasury

Due to the industry's size and specific characteristics, LIHTC yields do not correlate directly with Treasury yields; however, the 10-Year remains a common and important reference point. Over the past 15 years, the spread between LIHTC yields (non-CRA yields in national funds) and the 10-year Treasury yields(on an after-tax basis) has ranged from approximately 135 bps in 2006 to 900 bps in 2010, averaging approximately 435 bps. Just after the Presidential election in 2016, the spread was approximately 400 bps. Using a non-CRA 5.75% after-tax QIRR from the most recent round of closed multi-investor funds, that spread today would be approximately 375 bps.

BBB Corporate Bonds

A better historical correlation can be seen between LIHTC national fund yields and BBB corporate bond yields. Looking at the historical spread between LIHTC yields (non-CRA yields in national funds) and the BBB corporate index (option-adjusted and on an after-tax basis) over the last 15 years, multi-investor LIHTC funds have been approximately 300 bps higher on average. For additional context, the spread to BBB got as low as 50 bps in 2006, and as high as 675 bps in 2010. Most relevant perhaps is 2016, where the average spread on an after-tax basis (assuming a 35% tax rate) was approximately 200 bps in July, and increased to roughly 220 bps after the election. Again, using a 5.75% QIRR, that spread today has decreased slightly to just over 200 bps.

Due to firewall considerations, we have not attached graphical representations of these spreads. If you would like us to send them separately, we would be happy to do so upon request.

Alternative Investments

The decline in the federal tax rate results in a lower equivalent pre-tax yield because the tax deductions are worth less. Using a 5.75% after-tax IRR, the pre-tax equivalent yield has dropped nearly 160 basis points since the end of 2016. While most of that decline was factored into the market in 2017, the drop in the tax rate to 21% for 2018 results in another 40 basis point decline in pre-tax equivalent yield.

Supply & Demand

The substantial drop in the corporate tax rate from 35% to 21% begs the question as to how demand for credits will be affected by the lower tax rate. It is equally important to point out that the size of the equity market is a function of tax credit pricing. As pricing adjusted downward 12-15 cents in 2017 and needs to adjust another 3-4 cents based on the 21% tax rate, the total size of the equity market will be down 15% or more (from the end of 2016) as we head into 2018.

Early indications are that demand for credits will remain strong for two primary reasons: 1) robust CRA needs from banks which account for about 85% of all LIHTC buyers, and 2) certain provisions in the Act that broaden the tax base, particularly for insurance companies, resulting in greater tax liability despite the lower rate.

Outside of the potential impact from BEAT, conversations this year with a number of bank and insurance company investors indicate steady demand for LIHTC in 2018.

Secondary Market Offerings

Secondary sales of LIHTC portfolios have been relatively scarce over the past few years. With the prospect of tax reform in 2017, we heard of two or three portfolios of size that were being marketed last year although at least one remains available for 2018.

This year we expect there will be a number of secondary offerings, primarily due to BEAT. At this time, we count at least four potential secondary offerings that could come to market.

If a secondary purchase or sale is something you are considering, we would be happy to work with you. We have extensive experience with secondary market offerings and can provide both analysis and advice in the context of our extensive investor and syndicator relationships to ensure you achieve the best execution for your sale or purchase.

Fund Pricing

It must be emphasized that there is always a range in LIHTC yields throughout the market. Reasons for this include, but are not limited to, an inefficient market, differences in portfolio composition, sponsor strength, load, and bridge financing.

Our discussion will focus on four specific areas: multi-investor national fund pricing; CRA versus non-CRA pricing; California regional fund pricing; and state credit pricing. Below, we recap 2017 pricing and fund closings and then discuss 2018 pricing in the context of so-called "carry-over" funds and "new funds." We define carry-over funds as funds that were marketed during 2017 and were fully circled by investors prior to the signing of the tax law change, but that are scheduled to close in Q1. New funds refer to funds that will be marketed in 2018, whether or not some of the product in those funds was signed or closed in 2017.

2017 Year-End Funds

Toward year-end 2017, prior to passage of the Act, LIHTC pricing for national funds was generally holding steady with the prospect of declining yields due to increased demand from new, existing, and returning investors.

National funds were generally priced between 5.50% and 6.00% on a QIRR after-tax basis assuming a 25% tax rate for non-CRA investors while CRA pricing was generally in the 4.00% to 5.00% range. CA regional funds were generally between 5.00% and 5.75%. Nearly all 2017 funds, including those at year-end, closed on their existing assumptions despite the Act being signed by the President on December 22.

Carry-Over Funds

Similar to last year, there are a number of carry-over funds that were marketed and fully subscribed in 2017, but that will close later in Q1 2018. For these funds that were underwritten at a 25% tax rate, IRRs generally dropped about 75-100 basis points after applying the 21% tax rate and bonus depreciation. Over the past week, we have seen the beginning of a pricing trend for these funds to roughly split the difference with investors between the original target IRR and the resulting IRR after applying the lower tax rate. For example, if the drop in IRR was roughly, 100 basis points, then we are seeing syndicators making adjustments and reducing fee if necessary to increase the IRR by 50 basis points. So far, this seems to be gaining early acceptance from investors.

2018 Funds

As was the case last year, it may take some trial and error in Q1 for new funds to settle into a new pricing equilibrium. We will send out a follow up newsletter in a few months at that time. As of today, there are essentially no new funds on the market, and very little data to indicate where pricing will stabilize, but that doesn't me we can't speculate.

It is important to highlight the bifurcation between CRA and non-CRA pricing and investors. Some syndicators and funds are more reliant on non-CRA investors than others. For those funds, supply can exceed demand when several new funds offerings come to the market around the same time and yields can move up quickly and sometimes independently of broader LIHTC pricing. At times, it only takes a few large economic investors to move to the sidelines to drive yields up as funds compete for equity.

Based on a number of conversations with a range of investors and syndicators, and using historical data as a guide, our best guess is that new funds in 2018 will have to be priced close to 2017 year-end yields but at the 21% tax rate rather than 25%.

For early 2018, we expect non-CRA national fund pricing to again range from 5.50% to 6.00%; CRA pricing to range from 3.50% to 5.50%; and California regional funds to be in the 4.00% to 4.50% range. All yield ranges assume the new 21% corporate tax rate and are on a quarterly IRR, after-tax basis. The reduction in the federal tax rate also increases the value of state LIHTC credits, so all else being equal, state LIHTC yields will increase in 2018.

Again, our thanks to John McDonald, Mike Connolly, Chris McCarthy and Garret Daigler at Beacon Hill Capital for their collaboration on this update. You can reach them at (781) 740-8981.

We hope you found this update informative and helpful and welcome your comments and perspective. If you no longer wish to receive these updates, just reply to this email and type **unsubscribe.**