AHIC AFFORDABLE HOUSING INVESTORS COUNCIL

Investment Decisions: Affordable Housing Investors Council Tax Reform Report

The November presidential election increased the possibility of substantial tax reform being enacted in the coming years and renewed concerns about the effects changes to the tax code would have on the benefits of investing in Low-Income Housing Tax Credit ("LIHTC") properties. In response to these concerns, AHIC engaged Novogradac & Co. to survey its members to gauge how they are assessing and responding to proposed tax reform changes.

Novogradac surveyed AHIC members and received sixteen responses (the "Respondents"). In the aggregate, the Respondents represent approximately $8.5 billion of the $16 billion in LIHTC equity committed in 2016. Respondents were asked a series of questions including, what type(s) of investment vehicles they use to invest in LIHTC properties, how they fund their LIHTC investments, what investment valuation metrics are used to evaluate and compare potential LIHTC investments, what tax rate they use to value tax losses, and whether equity contribution adjustments were being considered in the event of a decline in the corporate tax rate. Respondents were also asked to rank five different hypothetical LIHTC investment options, each option based on a different assumed tax reform scenario. The current House Tax Reform Task Force Blueprint ("House Blueprint") was used as the baseline for the hypothetical LIHTC investment options.

Type of Investment Vehicles Used

Respondents were asked whether they made direct investments in LIHTC properties and/or make investments through one or more LIHTC fund structures.

Number of Respondents	Type of Investment Vehicle(s) Used
2	Direct Investment only
2	Multi-Investor Fund only
2	Proprietary Investor Fund only
2	Direct Investment and Multi-Investor Fund
2	Multi-Investor Fund and Proprietary Investor Fund
2	Direct Investment and Proprietary Investor Fund
2	Direct Investment, Multi-Investor Fund, and Proprietary Investor Fund
2	Direct Investment, Multi-Investor Fund, Proprietary Investor Fund, and Guaranteed Investment Fund

Investment Funding Method

Respondents were asked what cash funding method(s) they use to make their LIHTC investments.

Number of Respondents	Investment Cash Funding Method
6	True Cash Needs
4	Modified Cash Needs
1	Bridge Financing
2	True Cash Needs and Bridge Financing
1	Modified Cash Needs and Bridge Financing
2	True Cash Needs, Modified Cash Needs, and Bridge Financing

Investment Valuation Metric

In determining investor preferences, the Respondents were asked if an Internal Rate of Return ("IRR") analysis was used as part of their investment evaluation decisions. Fourteen of the Respondents indicated that IRR is used as part of their investment evaluation decisions. Of the fourteen who use IRR in their investment evaluation decisions, ten of the Respondents base investment evaluation decisions on a hurdle rate or target rate IRR and four Respondents do not have an identified IRR rate.

Four of the sixteen Respondents identified IRR as the most important valuation metric. The remaining twelve Respondents noted the following decision metrics as the most important when evaluating an investment:

- Return on capital/equity (5)
- CRA needs/goals (3)
- Return on assets (2)
- Overall cash returns (1)
- Shareholder value analysis (1)

Ranking Evaluation Methodology of Potential Investments

Respondents were asked to rank a set of seven investment evaluation methodologies from most important to least important. **Overall, return on equity was ranked as the most important methodology**, followed by IRR, shareholder value analysis, risk-adjusted return analysis, credit to capital or loss ratios, discounted cash flow/net present value analysis and "other" methods. Respondents provided "other" methods of evaluation as follows: CRA needs/goals, overall cash returns, residual value, future marketability, annual revenue stream, return on assets, and risk analysis.

Value of Loss Benefits

Under current tax law, the top corporate tax rate in the United States is 35%. The House Blueprint targets a lower corporate tax rate of 20%. Respondents were asked to indicate the tax rate that they were using at the time of the survey to calculate the value of tax losses generated by a LIHTC investment.

Number of Respondents	Corporate Tax Rate Used
3	Less than 20%
9	Greater than or equal to 20% but less than 30%
1	20% - 35%
2	Less than 30%
1	No specified percentage

Adjusting Contributions for Tax Reform

Given the uncertainty around tax reform, when the survey was conducted in March 2017 some LIHTC investors anticipated incorporating language into letters of intent and partnership agreements to adjust future equity contributions for a potential change in corporate tax rates. **The market appears to be settling in a different place now, with less interest in adjusters**. Respondents listed the following options for adjusting equity contributions to address declines in corporate tax rates:

- Establish a true-up date and solve for the original IRR;
- Calculate a fixed adjuster amount to be used if tax rates decrease by a specified date;
- Agree on a tax rate and do not adjust for a change in tax rates;

- Underwrite at a 25% tax rate with no upward or downward adjuster;
- Underwrite at a 25% tax rate, with no upward adjuster for tax reform and adjust downward if tax rates decrease by a specified date;
- Underwrite at a 20% tax rate with an upward adjuster based on tax rates at a specified date.
- Underwrite at a 20% tax rate with a provision for an upward adjuster in the fifth year with the amount of the adjuster being capped at the lesser of either 1) to maintain the original yields or 2) the deferred developer fee.

Expensing of Fixed Assets

The House Blueprint includes a provision that would allow LIHTC property owners to immediately expense fixed assets, rather than capitalize and depreciate the assets over their tax lives. Respondents were asked if this provision in the House Blueprint would increase demand for an LIHTC investment. **Thirteen of the sixteen Respondents stated that immediate expensing of fixed assets would *not* increase their investment demand** because it would: (1) result in a less desirable GAAP profile of an investment, (2) create volatility in the tax benefit stream, and (3) have a negative impact on internal profitability measures. The remaining three Respondents stated the immediate expensing of fixed assets would modestly increase their demand for investment.

Ranking of Investor Modeling Scenarios

Respondents were asked to evaluate and rank an LIHTC investment using five different hypothetical tax reform scenarios based on provisions in the House Blueprint and an alternative tax credit percentage. The provisions in the House Blueprint include a corporate tax rate of 20%, immediate expensing of fixed assets and deductibility of interest only to the extent of interest income. The underlying assumptions of the five scenarios were generally consistent with the exception of the assumptions listed below. The capital contributions in each scenario were adjusted to achieve the same IRR. Respondents ranked the tax reform scenarios in the following order:

Ranking	Scenario
1 (Most Favorable)	20% tax rate, 10.3% tax credit rate, current depreciation rules, interest fully deductible
2	20% tax rate, 10.3% tax credit rate, current depreciation rules, interest deductible only to extent of interest income
3	20% tax rate, 9% tax credit rate, current depreciation rules, interest fully deductible
4	20% tax rate, 9% tax credit rate, 100% asset expensing in first year, interest fully deductible
5 (Least Favorable)	20% tax rate, 9% tax credit rate, 100% asset expensing in first year, interest deductible only to extent of interest income

The most favored scenario had the highest return on capital and highest credit to loss ratio. The second most favorable scenario had the lowest price per credit and a favorable impact on the income statement and net present value of cash flows. Large losses in the first year and a diminishing return on equity were characteristics of the second least favorable scenario. Finally, Respondents noted that the least favorable scenario presented the lowest net benefit, return on capital, and credit to equity ratio, as well as the least amount of revenue. The least favorable investment ranked by Respondents includes all of the provisions in the House Blueprint.

Analysis of Results

Overall the following observations were noted.

1) 75% of Respondents didn't use IRR as the principal determinate in making LIHTC investment decisions. Those Respondents primarily use balance sheet metrics as their most important investment decision metric when making an LIHTC investment.

2) 25% of Respondents use IRR as the principal determinate in making LIHTC investment decisions and 75% of those Respondents stated the immediate expensing of fixed assets would modestly increase demand for an LIHTC investment.
3) 80% of Respondents that use IRR as an investment decision metric stated that the immediate expensing of fixed assets has a detrimental impact and would not increase demand.
4) Respondents view an increased tax credit rate as being highly preferable to the acceleration of tax losses.
5) The investment scenario including all of the provisions in the House Blueprint was the least favorable to Respondents.