NEW MARKETS TAX CREDIT FINANCING

A financing tool intended to encourage investments in communities and rural areas that have had poor access to capital is now available throughout the U.S. New Markets Tax Credits (NMTC) encourages investments or loans to qualified businesses in those target areas. Eligibility is determined by census tract; roughly half of Minnesota census tracts are eligible for NMTC.

Most businesses types are eligible, although a handful are not:

> *golf courses, race tracks, gambling facilities, farming businesses > $500k in assets, establishments >50% off-sale alcohol, businesses >50% intangibles for sale or license*

A qualified business may borrow funds through the program for expenses that a bank will approve for financing. Loan terms will be favorable in many respects, lowering the cost of borrowing by 25% or more overall. First of all, the interest rate may be 1% to 2% below market, and the project may be eligible to receive principal reduction at the end of the seven-year compliance period if they do not cause a default with the Loan Agreement. Additionally, these loans are commonly interest-only for seven years, although a debt sinking fund may be required for part of that time. The loan-to-value ratio may be higher than usual for the project, and other underwriting terms may be favorable.

The underlying bank providing the debt to the NMTC structure will have a market rate loan according to the risk criteria for the project. The bank will receive its full principal back at the end of the seven year loan. The bank will not receive principal payments during the seven years, but a sinking fund or other tools can reduce the risk involved. The principal reduction available to the project usually approximates the principal reduction for a 24 to 28 year amortization.

The bank loan generally includes forbearance language applying to the loan term, but this does not apply in the event of negligence or refusal to pay interest from available funds. The forbearance does not apply to the project; if it defaults, the NMTC lender is responsible to follow servicing protocol and collect on the loan if necessary. If the principal is collected it must be relent to a replacement project. In the event that a replacement is needed, the bank will be consulted regarding the quality and terms of the new loan.

Regarding collateral, the bank will receive a Security Agreement assigning interests in the single-purpose LLC combining the tax credit equity with their loan, which is then invested in the NMTC lender. The NMTC lender will hold typical collateral on the project. Because the tax credit equity is about 25-30% of the total project financing, and is included in the assignment to the bank, the bank will have an immediate reduction in its loan-to-value of about 25%.

For example, a business seeking a $10 million loan for a new building in a qualified area would apply to an NMTC lender. If the risk-based interest rate for that project were 8%, then an

NMTC-enhanced loan might be lent at 6.5%. If the business remains in compliance for the seven-year NMTC period, they may also receive perhaps $1.5 million reduced debt at the refinance after the seven years, through a put-call option established with the loan. The legal and other costs associated with this program are paid in part through the proceeds to the CDE, and in part by the borrower. The size of NMTC loans is usually $4 million or more because of the structuring costs. However, smaller transactions may be combined to share those costs. Overall, the business will see a decrease in their effective borrowing cost of 25% or more.

The CDE is able to provide these benefits because of their funding sources – usually 25-30% comes from an equity investor interested in the tax credits. That investor will be repaid their capital and return on capital through the 39% New Markets tax credits, spread over the seven years. That investor does not assume the economic risk of the lender, but does carry some compliance risk. The remaining 70-75% of the CDE's funds come from a loan. These funds are combined into an investment fund LLC that makes an equity investment into the CDE. The investment fund is owned by the equity investor, and the debt is borrowed by the fund.

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