



U.S. Department of Treasury  
New Markets Tax Credit (NMTC) Program  
Minority CDE Training & Technical Assistance  
Contract # TFSACDF15C0004

# TRAINING CURRICULUM

## Module 4

# Module #4

*Underwriting a NMTC Project – for Leverage Lender and Allocatee*

**Goal:** Cover the primary aspects of underwriting a NMTC project: financial analysis/due diligence, compliance, and community impacts.

# The Seven C's of Lending

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1. Character
2. Capacity
3. Capital / Cash Flow
4. Collateral
5. Conditions
6. Control
7. Compliance

# Character

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## Know your customer (QALICB, Sponsor, Guarantor, Board of Directors)

- Usually the most important component of the underwriting process. Helps to answer the question, “Will you pay the loan back?”, not just “Can you pay the loan back?”
- Does the sponsor of the QALICB have a reputation for integrity and fairness? Sponsors may include business owners, land owners, investors, or promoters.
- Character is a matter of Trust.
- The NMTC is a federal government program. The Sponsors should, generally, be able to provide the same assurances and certifications as required of the CDE by the CDFI Fund.

# Capacity

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## Capacity

- Is the borrower/investee eligible to engage in this project?
- Is it a valid entity (does the borrower/investee qualify as a NMTC QALICB)?

## Forbidden Activities

- Residential rental property
  - Buildings or structures that derive 80% or more of their gross rental income from renting dwelling units
- “Sin” businesses

# Capacity

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## Certain types of “sin” businesses – NOT ALLOWED:

- Golf courses
- Massage Parlors
- Race tracks
- Hot tub facilities
- Gambling facilities
- Suntan facilities
- Certain farming
- Principal business is the sale of alcoholic beverages
- Country clubs

## Qualified Active Low-Income Community Business (QALICB)

### A QALICB must meet these requirements:

- At least 50% of the total **gross income** is from the active conduct of a qualified business in Low-Income Communities (LICs); and
- At least 40% of the **use of tangible property** of the business is within LICs; and
- At least 40% of the **services preformed** by the business' employees are performed in LICs; and
- Less than 5% of the average of the aggregate unadjusted basis of the property is attributable to **collectibles**(e.g. art and antiques), other than those held for sale in the ordinary course of business; and
- Less than 5% of the average of the aggregate unadjusted basis of the property is attributable to **non-qualified financial property** (e.g. debt instruments with a term in excess of 18 months)

# Capital/Cash Flow

## Cash Flow

- Financial Statement Analysis
- Cash Flow, not Sales or Net Income, repays loans

## Sources & Uses

- Finding/Funding the right amount –What is the Gap? What is the best way to close it?
- NMTC financing should pass the “but for” test. “But for” the use of NMTC, the project, or the impactful outcomes of the project, would not be achievable

## Interest only/Amortizing?

- Because the CDE may provide a return on the QEI, but not a return of any portion of the QEI during the compliance period of 7 years, most NMTC transactions are underwritten with a periodic Interest-Only payment for 7 years. Some transactions are underwritten with principal and interest payments being made to the CDE, but only dividend payments being made from the CDE to the Investment Fund.

## End of Transaction Cash Flow

- What happens at the end? refi/buyout/amortize
- Must underwrite project such that it will be able to refi/buyout/amortize



# Collateral

## CDE

- Traditional First Deed of Trust, Assignment/lien on specific or all business assets. CDE may subordinate its interest to a prime lender, or accept non-traditional forms of collateral.

## Leverage Lender

- **Assignment of Interests**
  - Because the Leverage Fund (composed of the Tax Credit Investor's equity and the Leverage lender's debt) injects Equity (the QEI) into the CDE, and therefore owns the CDE, it also "owns" the CDE's assignment against the QALICB's collateral. The Leverage Lender's (LL) debt, then, can only take an assignment of the Investment Fund's interest in the CDE, as opposed to a direct assignment against the QALICB's assets.
- **Forbearance**
  - The LL agrees to "forebear" its foreclosure rights for the term of the compliance period to give the CDE and Tax Credit Investor the opportunity to redeploy any proceeds recovered from a defaulted QLICI into another eligible project, thus avoiding Recapture of the NMTC.

## Establishing Collateral Value

- Sometimes, due to the conditions of the surrounding LIC, a completed project may be appraised for less than the cost to develop the project, but the benefits of the project to the community are "priceless"!
- NMTC Recovery Strategy – With a traditional defaulted loan, the lender would look to foreclose, and recover as much as possible as soon as possible. Because bankruptcy of a NMTC QLICI is not a recapture event, and redeployment of recovered assets may be difficult, there is less haste to foreclose.

# Market Conditions

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- Is the timing right – Are market conditions conducive to QALICB's success?
- Discussion: Is there a "wrong" time for good community development?
- Economic Environment – Availability of capital; Interest Rates
- Political Considerations – Permit process, local "turf wars"
- Community Considerations – Community readiness, desires, perception

# Control

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Ability to properly document and monitor the transaction, perfect Collateral and Security Agreements.

- Does the CDE have everything in place to secure this deal?
- Can you “control” the deal, legally, community-wise?
- Is the Long-Term Lease long enough; too long?
- See NMTC Transaction Closing Checklist

# Compliance

## **Compliance:**

- Front-End Compliance Underwriting – Ensuring the transaction starts off correctly, and has a good chance of staying on track
- Reasonable Expectations Test
- Regulatory requirements for Lenders
  - The NMTC Program is a federal government program, and as such the CDE must be non-discriminatory in its lending practices

## **Traditional:**

- Lender – any jurisdictional regulatory agencies
- Borrower – Good Standing; No violations;

## **NMTC:**

- Programmatic – CDFI Fund
- Regulatory – IRS

## **Other:**

- QALICB (health care/day care/grocery), State, Federal

# Underwriting Considerations

## NMTC Structure Underwriting Considerations:

- Who takes the lead?
  - Leverage Lender - “At Risk” Lender
  - Tax Credit Investor – Recapture Risk
  - CDE – Capital may not be at risk, but allocation is.
  - All entities should do some level of underwriting
- Important legal issues
  - Forgiveness of Debt
  - Original Interest Discount (OID)
  - True Debt Test
- Long-Term Lease between QALICB and Sponsor
- Likelihood of successful Closing & Wind-up

# Underwriting Considerations

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- Underwriting reasonableness, timeliness, and “enforceability” through Community Benefits Agreement
- Establishing Accountability before and after funding
- Financial Sanctions – fees; incentives
  - Charging/Waiving an Exit Fee

## New CDFI Fund Requirements – FAQ 43\*

- What are the restrictions on the use of **QLICI proceeds** to
  - **repay or refinance** any
  - **debt or equity provider**, or an Affiliate of any debt or equity provider,
  - whose **capital was used**, directly or indirectly, **to fund a QEI?**
- Beginning with the CY 2015-2016 round, only **documented reasonable expenditures** that are **directly attributable to the qualified business of the QALICB** can be **repaid or refinanced with QLICI proceeds**. These expenditures must either
  - have been incurred no more than 24 months prior to the date on which the QLICI transaction closes, or
  - represent no more than 5 percent of total QLICI proceeds from QEI.

## New CDFI Fund Requirements – FAQ 43\*

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Only under these two restrictions can QLICI proceeds be used to repay or refinance any debt or equity provider, or Affiliate of any debt or equity provider, whose capital was used, directly or indirectly, to fund a QEI.



## New CDFI Fund Requirements – FAQ 43\*

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### Example 1

Within 24 months prior to the closing of the QLICI, an entity uses funds for predevelopment (permits, begin construction, acquire or install equipment, etc.) The entity has documentation (i.e. invoices, receipts, proof of payment, etc.) totaling \$1,000,000.

Out of \$10,000,000 in total QLICIs, up to \$1,000,000 of the QLICI proceeds can be used to repay the entity for these expenditures and to directly or indirectly repay sources used to fund the QEI (e.g. a leverage loan).

# New CDFI Fund Requirements – FAQ 43\*

## Example 2

Same facts as Example 1, except an additional \$700,000 of documented, reasonable expenditures incurred by the entity were incurred **greater than 24 months** prior to the closing of the QLICI transaction.

**The QALICB may use no more than 5% of QLICI proceeds to reimburse documented, reasonable expenditures that are directly attributable to the qualified business of the QALICB regardless of when those expenditures were incurred.**

# New CDFI Fund Requirements – FAQ 43\*

## Summary

The QALICB may elect to either

- reimburse the **full amount** of reasonable expenditures incurred within 24 months of the QLICI closing date as in the first example (\$1,000,000) or
- reimburse reasonable expenditures that represent **up to 5% of the QLICI proceeds** incurred at any time prior to the QLICI closing date (\$500,000).

It may not do both.

# Underwriting Native American Projects

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- Sovereign Immunity
  - Tribes and Native Corporations are sovereign and cannot be sued without consent (“limited waiver”).
  - Sovereign immunity is an important issue and must be treated with due respect.
  - Some projects created in a separate entity that may be able to grant limited waivers without affecting the tribe as a whole.
  - Ensure that contracts are binding, enforceable, and have duly authorized limited waivers.

# Native American Projects (continued)

- **Forum Selection**
  - Choice of forum may be Tribal, State, or Federal court.
  - Federal jurisdiction may not be available under diversity doctrine.
  - Exhaustion of remedies doctrine may limit court jurisdiction.
- **Choice of Law**
  - Specify Tribal or State, and choice of state law.
- **Cultural and Community Relationships**
  - Tribes are unique socially, culturally, and economically
  - Priorities, needs, and methods of community involvement need to be understood
  - Governance and decision-making methods differ and must be respected.

## Native American Projects (continued)

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- **Security and Collateral**
  - Trust lands controlled by the Bureau of Indian Affairs
  - Leasehold mortgages
  - Usually diminished creditors' remedies
  
- **Due Diligence**
  - Title
  - Tribal legislation (taxes, environmental, use, etc.)

# In Summary

- Seven C's of Credit
  1. Character
  2. Capacity
  3. Capital / Cash Flow
  4. Collateral
  5. Conditions
  6. Control
  7. Compliance
- NMTC Considerations
- NMTC Structural Considerations
- Guiding Community Outcomes
- New CDFI Fund Considerations
- Underwriting Native American projects