Report on Investor Consents for Energy and Water Efficiency Improvements

The benefits of energy and water conservation in the affordable multifamily industry have been documented thoroughly over the past several years. From the reduction in utility costs to the federal government; to the preservation of affordable housing by decreasing operating costs and thus keeping rents affordable and properties viable; and to the improvements to resident health and comfort, it is easy to see how important the reduction in energy and water usage is to our properties housing low income households. Yet only a minor fraction of affordable multifamily housing developments have benefited from energy and water efficiency improvements. This leads to the question that if energy and water conservation is so important to affordable housing, why has so little been accomplished?

The answer is not a simple one. Successful efficiency efforts face many challenges and hurdles. These include the difficulty of finding financial resources to fund the retrofits; convincing property owners and managers of the benefits of energy upgrades; locating qualified auditors and installers of equipment; and obtaining approvals from property lenders and investors to undertake energy retrofits.

This paper focuses on one of these hurdles: the achievement of investor consents for the performance of energy and water retrofits on affordable multifamily developments funded through the Low Income Housing Tax Credit (LIHTC) Program. For this report, we interviewed property owners, investors and syndicators, experts in the fields of multifamily energy retrofits and/or investor protocols and processes. The list of individuals interviewed is shown in Appendix 1 and their involvement in this process is greatly appreciated.

The importance of receiving investor approval and receiving it in a timely manner is critical to the energy efficiency process. When requesting investor consent, the owner has already invested time and money to arrive at that point. If the investor takes considerable time to respond or does not provide approval at all, energy efficiency improvements in the nation's LIHTC housing stock will not be realized. This holds true whether we are looking at energy efficiency upgrades or the installation of renewables, such as solar panels.

Through the next few pages, we describe why the achievement of investor consents is considered a challenge; what the owner and investor viewpoints are when it comes to energy and water improvements to a property; the review process followed by investors; how the type of investor will impact the decision process; and considerations for improving the approval process. It should be noted that much of what will be stated are generalities, common to most investors, but not all. Each investor is different and each has its own goals and purposes for investing that impact decisions to allow energy and water improvements to proceed.

Before we can do that, however, it is worth taking a few minutes to discuss the LIHTC Program.

Low Income Housing Tax Credits

The LIHTC Program was enacted by Congress in 1986 to provide incentives for the private market to invest in affordable rental housing, and has been the mainstay of the development of affordable multifamily properties over the last 25 years. Section 42 of the Internal Revenue Code describes, in detail, the requirements of this program. It is not our intention to give a lengthy discussion on the many nuances and rules of using LIHTCs, but to provide relevant background to the issue of investor consents.

LIHTCs are awarded by state LIHTC administrators, through a very competitive process, to developers of qualified properties. The developers then sell these credits to investors to raise capital for the construction of affordable multifamily properties. This equity allows for, and is required by the program to provide, affordable rents for low income occupancy at the apartment complex. Affordability in this case means rents are affordable to families with incomes at or below 50 or 60 percent of area median income.

Assuming the property remains compliant with the rules of the LIHTC program (basically, serving residents needing the affordable units), the investor can receive a dollar-for-dollar credit against their federal tax liability each year over a period of 10 years. The LIHTC Program requires a minimum affordability period of 30 years, unless a longer compliance period is required by the state tax credit administrator. The first 15 years of the affordability period are known as the "initial compliance period" with the subsequent 15 years known as the "extended use period."

The annual LIHTC amount is calculated by multiplying the qualified basis by the applicable credit percentage. The "credit percentage" is either a 9 percent credit rate or a 4 percent credit rate, depending on the type of financing involved. The "qualified basis" is calculated by multiplying the eligible basis by the applicable fraction. The "applicable fraction" is the number of qualified low income units in the property divided by the number of total units. The "eligible basis" is the amount of all depreciable development costs that go into building the development. Eligible basis does not include such costs as acquisition costs for land, permanent financing costs, and initial deposits to reserves.

Additionally, eligible basis cannot include any costs financed with proceeds from a federally funded grant. Prior to the passage of the Housing and Economic Recovery Act of 2008 (HERA), any federal grant received by the property would reduce the eligible basis in the year in which the grant was received and applied to all succeeding years through the term of the compliance period. HERA modified the language to state that federal grants will only impact the eligible basis at initial financing of the development. Any federal grants received for energy retrofits after occupancy has commenced for post 2008 properties will not cause reductions in eligible basis.

For this discussion, it is important to note that if the amount of qualified basis is decreased during the initial compliance period, the tax liability of the LIHTC property owner, and therefore the investor, will increase by the tax credit recapture and any interest charges from the IRS.

Decreases in qualified basis generally result from a reduction in eligible basis, a reduction in the applicable fraction due to a decrease in the low income occupancy of the project, or the disposal of an interest in a low income building during the initial compliance period.

The Investor Consent Hurdle

When a property developer is awarded LIHTCs for his or her property, he or she is awarded the ability to claim the LIHTC annually for a 10 year period. The developer sell the rights to the future tax credits to investors at a negotiated price and uses these proceeds to partially fund construction of the development. In order to claim the credits, the credit purchaser must be part of the property ownership entity. This is usually accomplished by creating a limited partnership (in which the credit purchaser is a 99+ percent limited partner) or a limited liability company (in which the credit purchaser is a 99+ percent non-managing member). The developer, or a wholly owned subsidiary of the developer, typically becomes the general partner (GP) and the investor(s) becoming the limited partner(s) (LP). The limited partnership agreement (or LLC operating agreement) governs the relationship between the partners, and delineates the GP's and LP's roles, responsibilities, and authorities. The GP is responsible for managing the property while the LP is limited to a more passive role. However, to protect its investment, the LP will insist the partnership agreement dictate certain areas that require the approval of the LP before a GP can move forward with a desired transaction.

When the LIHTC program was in its early stages in the late 1980's and 1990's, the limited partnership agreements had less detail and investor requirements than they do today. At that time, the thought of future energy improvements was never a consideration. As the LIHTC program advanced and investors became more sophisticated and knowledgeable about the program, more and more restrictions were placed on the owner to protect the investment of the limited partners.

Most energy retrofits, for reasons outlined later in this paper, will require investor approval before the GP can move forward. Thus investor consents can become a hurdle if such consents are not provided in a timely manner, or, worse, not provided at all.

Requirements of a Typical Limited Partnership Agreement

Limited partnership agreements stipulate how operating profits and losses, tax benefits, cash flow, and sales proceeds will be allocated between the GP and the LP. Investors take these into account when negotiating the price or amount of the investment they are willing to make.

<u>Allocation of Tax Benefits</u> – This is referring to the annual tax credits received through the LIHTC program and is the most significant benefit provided to the investors. Typically, 0.01 percent of tax benefits are allocated to the GP while 99.99 percent goes to the LP. Since this is the area with the greatest benefit to investors, it is the area where they do not want to see any procedure that may cause a reduction to qualified basis. Improvements to pre-2008 developments financed using a form of federal grant can reduce basis to a level that adversely affects tax benefits.

Distribution of Operating Profits and Losses – Operating profits and losses are those recognized for tax purposes. Due to depreciation, operating losses are expected during the depreciation period of a property's existence. The typical distribution of operating profits and losses is 0.01 percent to the GP and 99.99 percent to the LP. Investors benefit from operating losses as it reduces their overall tax liability. Efficiency improvements may decrease operating losses due to reduced utility expenses and therefore increase the investor's tax liability.

Distribution of Sales (Capital) Proceeds – Upon the sale or refinancing of a property, and after the payment of all outstanding debt, remaining proceeds typically go first to pay any outstanding deferred developer fees to the general partner, then loans or fees due the limited partners, loan repayments to the general partner, then finally a distribution to the GP and LP. The percentage allocation of this payment varies greatly among partnerships. Energy retrofits that incur debt, either from an outside lender or the general partner, will have the debt repaid prior to the distributions to the GP and LP. Investors may object to the transaction on grounds that it will negatively impact their capital distribution.

Excess Cash – Excess cash is the cash remaining from operations at the end of each fiscal year after paying all operating expenses and making all debt payments and reserve deposits. Excess cash typically goes first to cover any partner loans and deferred developer fee outstanding and then is distributed to the GP and LP. The percentages of distribution vary by partnership agreements with each transaction. To the extent that the energy and water efficiency measures will increase excess cash and the investor shares in a substantial portion of the excess cash, then the investor is more likely to look favorably on the proposed retrofit. Most LIHTC deals do not generate much excess cash and after paying debt service, including the sharing of cash flow with soft secondary debt lenders, reserve deposits and deferred developer fees, there may not be much in the way of excess cash remaining.

To protect the investors' interests as described above, typical limited partnership agreements will require the general partner to receive limited partner approval for:

- New capital improvements or replacement of existing capital improvements costing in excess of a stated amount, generally $10,000 to $20,000.
- The acceptance by the partnership of any grants.
- The incurrence by the partnership of any debt in excess of a stated amount, typically $20,000 to $25,000.
- The release of funds from the property's replacement reserve (unless such reserve is held by a third party lender to the property) in excess of a stated amount, typically $5,000 to $10,000.
- The incurrence by the partnership of any expenses out of the ordinary course of business.
- The acceptance of any liens on the property.

It should be noted that consent can be withheld at the sole discretion of the investor. In some instances, the investor may want to be reimbursed in some manner for even considering the request.

Understanding the Viewpoints of the GP and LP

When negotiating with another party, more success will be achieved if one understands the viewpoint of the other, thus allowing for better compromise so that both parties may benefit. When considering energy improvements, one would naturally assume that approval by all concerned would be simple because of the obvious benefits to the property, but it is much more complicated than that.

What's in it for the GP?

Stewards of Affordable Housing for the Future (SAHF) represents 11 high capacity mission-driven not-for-profit members who acquire, preserve and are committed to long-term, sustainable ownership and continued affordability of multifamily rental properties. As nonprofit GPs, their primary motivation for performing energy improvements is to benefit the low income residents they are providing housing for. The performance of energy and water efficient upgrades allows for:

- Improved cash flow for the development which can provide resources to:
  - Maintain the property
  - Maintain rents that are affordable to the very low income
  - Provide relief to the nonprofit GP for the funding of operating losses in an underperforming property
  - Assist in the provision of supportive services to the residents of the property

- The preservation of the affordable housing by decreasing operating costs and thus keeping rents affordable and properties viable; and

- Improvements to resident health and comfort.

What's in it for the Investor?

When it comes to the improvement of energy efficiency at an affordable multifamily development, the answer may be "not much." As the primary motivation for the nonprofit GP was the continued service to their low income residents, the primary motivator of an investor for investing in a LIHTC property is the return on the investment.

Of course there are some benefits to an LP by improving the energy efficiency of the property, but it is important to note that with little upside, most investors will look at a transaction with an eye towards assuring there is also little downside. Some of these benefits include:

- Sustained viability of the property during the remaining term of the partnership agreement. It should be noted that the preservation of the affordable housing from the investor point of view may differ from others in the industry. In general, an investor wants a development to be preserved during the term of its investment, typically not much longer than the compliance period of the LIHTC program, because it is hopeful of exiting the partnership at that time. The GP wants the property to be sustained past the extended use period.

- In some cases, increased cash flow distributed to the LP.

- In some cases, increased distributions of sales proceeds due to a higher market value of the property caused by the energy improvements.

- In the case of investors that that may provide other services to the GP, perhaps banks or insurance companies, the increase of goodwill with their client.

Upon receiving a request from a GP for energy or water efficiency improvements, the LP will consider the following:

- The investors are most protective of the low income housing tax credits they receive. Therefore, an investor does not want to see any transaction that could possible reduce their qualified basis and create a tax credit recapture event. Generally, efficiency retrofits themselves do not create noncompliance events for the properties. However, for a pre-HERA property, the receipt of a federal grant for such retrofits may trigger such noncompliance. For example, if a pre-HERA property receives funding from the Weatherization Assistance Program, which is a federal grant, this may cause a reduction in basis. There are methods to diminish this problem as discussed below.

- Additionally, any grants provided directly to the property could be considered operating income and, therefore, cause an operating profit for that year, thus increasing the tax liability of the investor.

- Likewise, energy improvements that reduce operating expenses, and therefore recordable losses, may not be seen in a positive light by some investors.

- If retrofits are funded by a loan, whether from a third party or general partner, and debt service payments are required each year, investors may have financial concerns regarding the ability of the property to support the added debt service. With the exception of high rent areas such as New York City, the greater Boston area, Northern New Jersey and California, most LIHTC properties do not generate significant cash flow. Sixty percent rents are not that high in most areas and with the additional deeper rent skewing typically required by an allocating agency (the agency providing the LIHTCs to the property), excess cash flow may already be squeezed and the new debt might further stress cash flow. While investors benefit for tax purposes from operating losses, they do not want to see the viability of a property in jeopardy due to additional debt.

Importantly, investors, similar to lenders, are hesitant to consider the potential utility cost savings from the energy retrofit as a source of loan repayment due to the fact that they are based only on projects and that they do not take into account the volatility of energy costs. In some cases, the fact that a loan could cause an increase in operating expenses could be viewed positively from the investor.

- If a third party loan for energy retrofits requires a lien position, this increases the foreclosure risk. This third party could cause a foreclosure on the property thus impacting the other lien holder(s).

- As indicated above, a loan from the general partner to pay for retrofits may impact the distribution of the capital proceeds to the investor at the time of sale or refinancing of the property. As with a third party loan, depending on the terms of the GP loan, there may be an increase to the operating expenses, which could be viewed positively by investor.

- If an investor does not have a large asset management staff and with limited benefit to be received, some investors may not want to take the time to review capital requests since significant staff time may be required.

- On the other hand, given that investors have very few opportunities to influence a development once their investment is made, an investor may take such a request as an opportunity to take a closer look at the property. The investor may want to negotiate with the owner to receive some additional benefit for the approval of the retrofit. This could include a fee for reviewing the approval or a change in the distribution percentages of cash flow or sales proceeds.

Review Process of Investors

It became evident during the interview process that while there are similarities between investors, there is not a standard approach to the review and approval of requests for investor consents. Each investor has its own requirements, processes, goals and objectives that need to be understood and addressed by the GP.

In general, investors want to receive an information package that provides the full story. Discussions with the investor should determine whether the investor desires the information piecemeal or all at one time. The information required by an investor includes, but is not limited to:

- Information about the development, including name, location, number of units, year it comes off compliance, etc.
- Narrative outlining the proposal, including benefits to the partnership and investors along with how the savings from the improved efficiencies will be used.

- Scope of the work, how much it is going to cost and how it is going to be funded (a detailed sources and uses), and what restrictions may be placed on the deal by the funders.
- Energy analysis, including the energy audit.
- Most recent audit and tax return and unaudited balance sheet and income statement of the property.
- Information regarding the loan, if applicable, including terms, amortization schedule, loan commitment, and loan agreement.
- Information regarding the grant, if applicable, including grant commitment, grant agreement and discussion of what terms must be followed to receive the grant.
- Information regarding any GP loan or capital contribution.
- Use, if any, of reserve balances.

If grants are part of the financing package, several approaches were suggested by interviewees that could mitigate the impact of grants on the tax credit basis and/or taxable income. (Before adopting any of these approaches, tax advisors should be consulted.)

- Have the grant issued to the general partner, if the general partner is a nonprofit. The general partner could then provide either a loan or capital contribution to the partnership;

- Have the grant paid directly to the contractor and other professionals, never going through the accounts of the property; or

- As followed by at least one investor, have the partnership accept the grant, and then expend out all of the improvements rather than capitalizing them. It is important to note that the grant acceptance and improvements all must occur in the same taxable period.

Other observations of the review process include:

- When considering the acceptance of a loan, investors are much more comfortable if the property is already generating a positive cash flow, there is a third party guarantor of the loan, or there is another source to repay the loan, such as foundation grants or guaranteed payments from projected savings.

- General partner loans or capital contributions seem easiest for most investors to consider, but there has to be an awareness of the potential impact on capital accounts and the impact on distributions at the time of sale or refinancing of the property. Some investors will be hesitant to approve the retrofit if it reduces their projected distribution.

- Several investors suggested that when there is a question regarding basis or other tax impacts, it would be helpful for the general partner to include comments from their legal counsel.

- Several investors and owners indicated that if a general partner has a number of deals with the same investor, once the process has been approved for the first retrofit transaction, future requests using the same model should receive quick approval from the investor.

Responses Vary by Investor Type

While individual transactions will vary, there are some generalities that became evident during the interview process:

- Multi-investor funds, with the syndicators retaining most of the authority for LP approvals, have more flexibility than single investors or single-investor funds since the operations of any one property does not have a dramatic impact on the economics of the larger pool.

- Single investors or single-investor funds review the information much more closely and are more concerned about operating losses, cash flow and sales proceeds than multi-investor funds, since every aspect of this property may have a material impact on their return.

- The more recently a property was developed, the more restrictions and approvals will be included in the limited partnership agreement. This is due to the increased knowledge gained by investors over the years, along with lessons learned from the 2008 housing crisis.

- Large investors do not focus on the reduction in operating losses. While it may be used as a comparison when first determining investments, it is not significant for energy retrofit approvals. Their focus is on the tax credits, as operating profits and losses may not have a material impact on their overall investment portfolio.

- Medium banks, on the other hand, look closely at both the tax credit and operating losses. There are a few banks that will not approve retrofits because of reductions in operating losses, even if the current losses are greater than what were originally anticipated when the investment was first made.

- Small local banks that may not have extensive knowledge of the LIHTC program, or even an asset management staff, may not require any approval process, just notification that the improvements have been made.

- For the large banks, the general partners tend to also be their clients or have other relations. Therefore, they may be predisposed to assist as best they can.

- Larger investors and syndication firms have large asset management staff, and thereby requests for energy retrofits should be responded to more quickly than others. Other investors may have fewer asset management staff, and therefore requests are put off due to other priorities.

Possibility of Modifying New Agreements to Improve the Process

As a developer is putting together the financing package for the financing of a LIHTC property (this could be for new construction, substantial rehabilitation, or acquisition rehab) he or she is negotiating with possible investors regarding their willingness to participate in the deal and the amount of investment they are willing to make. It would be beneficial, as part of the negotiation, to include language in the limited partnership agreement that would allow for automatic or faster approval of future energy efficiency improvements.

However, while the developers interviewed appreciated the idea, those who have tried even minor modifications with limited partners, have had little success in getting the language modified. The investors and syndicators we interviewed felt there would not be any flexibility in this area.

Investors are always going to want the ability to review and consider such requests in their sole discretion. Besides the economic reasons discussed earlier, investors understand the future is unknown regarding tax implications and other influences on the partnership, and they will always want to take a look at a request and its possible implications in a changing environment.

However, if a developer is putting together a new LIHTC partnership and has a desire to perform an energy improvement in the near future, such as installing solar panels, investors and syndicators would encourage that developer to discuss this from the onset. They would want assurance that the design of the property would sufficiently handle the panels. While not eliminating the review and approval process when the time comes, such up front preparation may make the process move more quickly.

It appears that in the current environment, modifications to new limited partnership agreements to allow for automatic or faster approval of future energy efficiency improvements are not worth pursuing at this time.

Recommendations for Improving the Investor Consent Process

It is evident that the approval process for energy efficiency improvements is still in its formative stage. Our interviews with developers and investors/syndicators indicate that only a few energy deals had been completed. Many more requests will be occurring in the future and it is imperative that this process gets easier. Towards this end, we recommend the following:

- While every investor has different goals and requirements, one operating principal that became evident is that the more information that is provided to the investor from the start, the faster approval (or disapproval) will occur. This is at least a two-step process. First, the owner should contact the investor to discuss his or her intentions regarding the improvement of energy efficiency at the development. An overview of the plan should be provided including efficiencies to be made, outcomes to be expected and sources for retrofits. From there, the owner should inquire of the investor as to the type and format of additional information to be provided to the investor to make the

approval process easier. The owner should always bear in mind the investor's prospective and seek to address his or her concerns.

Investors/syndicators have their own internal approval process and the general partner should work on making this as easy for them as possible.

- Along with the submission of information, it is imperative that the general partner show the expected impact the energy and water retrofit and upgrade will have on the property and on the return to the investor. If possible, it is best if it can be shown that the return to the investor is improved. If not, then show that the investor's return is only marginally impacted.

- Education for both the GPs and LPs involved in LIHTC properties on the benefits of and processes for energy and water efficiency improvements is needed. There should be meetings arranged between the SAHF members and investors to illuminate each other on these matters and to mutually agree in ways to improve the process.

Appendix 1

The following very knowledgeable individuals were interviewed for this report:

Katie Alitz	Boston Capital
Thom Amdur	National Housing and Rehabilitation Association
Toby Ast	Preservation of Affordable Housing
Gina Bender	Bank of America Merrill Lynch
Steve Bodkin	National Church Residences
Jim Bowman	National Affordable Housing Trust
Darien Crimmin	Winn Development
Tony DiBlasi	Ohio Capital Corporation for Housing
Tom Eastman	Enterprise
Jeanne Engel	Stewards of Affordable Housing for the Future
Merydith Greene	National Affordable Housing Trust
Daniella Greville	Sunwheel Energy
Julie Hertzog	Affordable Housing Investors Council
Donna Hoffman	Cobler Realty
Todd Nedwick	National Housing Trust
Jenny Netzer	TCAM Asset Management
Nancy Rase	Homes for America
Stephen Roger	Affordable Housing Preservation Advisors, LLC
Becky Schaaf	Stewards of Affordable Housing for the Future
Judy Schneider	National Equity Fund
Marianne Votta	Bank of America Merrill Lynch
Wayne Waite	U.S. Department of Housing and Urban Development
Jonathan Welty	Ohio Capital Corporation for Housing