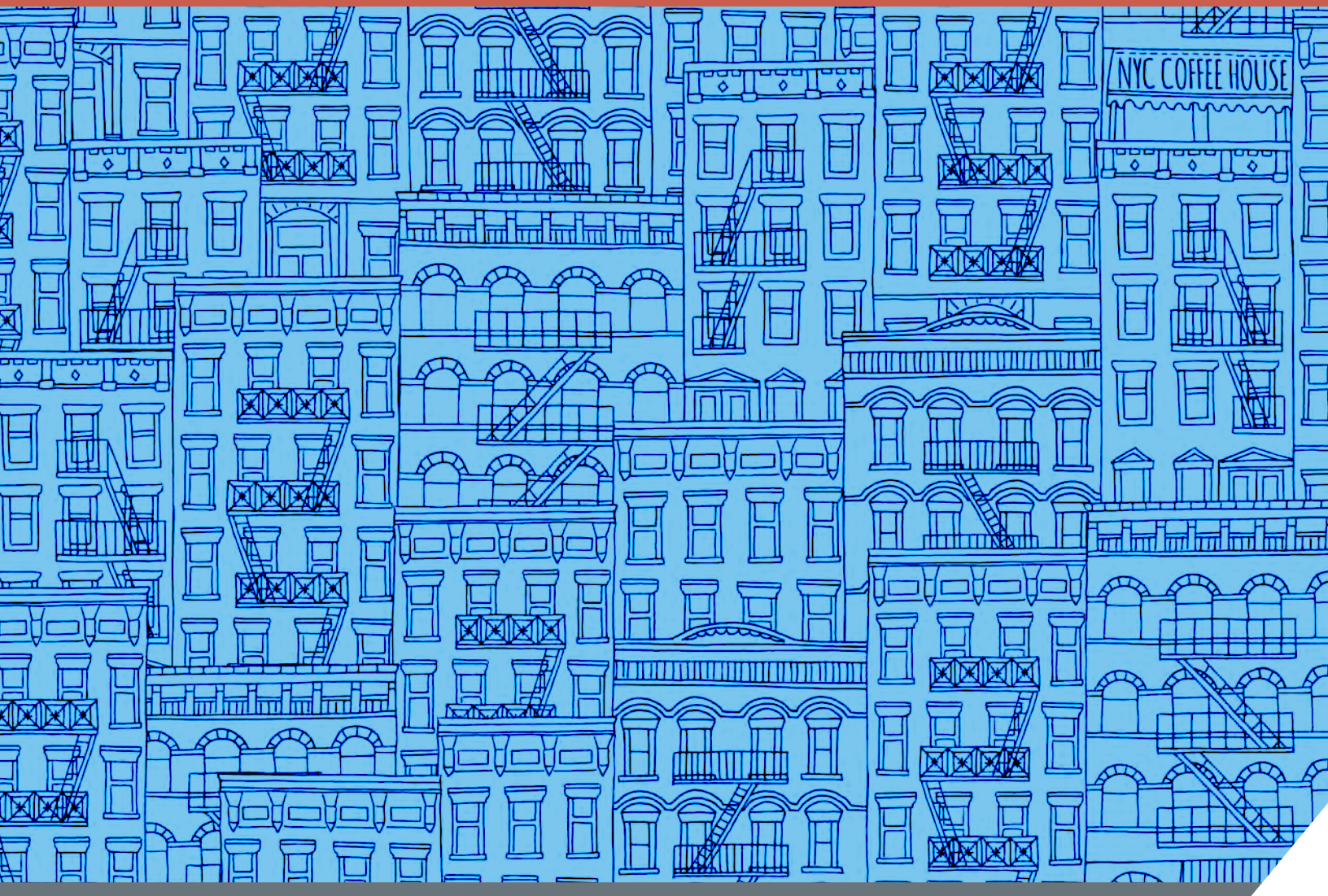
summit

U.S. DEPARTMENT OF THE TREASURY: CDFI FUND

COMPLIANCE REVIEW OF NEW MARKETS TAX CREDIT PROGRAM

AUGUST 2017



complexity simplified.

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This report was commissioned by the U. S. Department of the Treasury's Community Development Financial Institutions Fund.

Summit is a specialized analytics advisory firm that guides Federal agencies, financial institutions, nonprofits, and law firms. Summit's staff use quantitative techniques to assist our clients as they model risk, evaluate & optimize program performance, and measure impact.

Summit's mission-oriented financial services group comprehensively designs and manages lending and capital deployment programs for mission-oriented financial intermediaries, nonprofits, and government agencies. Additionally, this team provides due diligence underwriting services to assess lending compliance and credit-worthiness.

Every reasonable effort has been made to ensure that the analyses and data contained in this report are timely and accurate.

This report is for informational purposes only and is not intended, in any manner, to provide advice, endorsements, representations, or warranties.

The views expressed in this report are those of the author(s) and do not necessarily represent those of the Community Development Financial Institutions Fund, U.S. Department of the Treasury, or Treasury policy.

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Commonly Used Acronyms and Abbreviations

To assist those not familiar with the New Markets Tax Credit Program, the following non-technical definitions and acronyms are being provided. For the technical definition, please see *https://www.cdfifund.gov/Documents/CDEcertificationGlossary.pdf* on the CDFI Fund's website.

APR: Annual Percentage Rate

ATS: Allocation Tracking System
A web-based data collection system used by CDEs to report to the CDFI Fund information on the issuance of CDEs' Qualified Equity Investments.

CCME: The Certification, Compliance Monitoring and Evaluation office within the CDFI Fund

CDE: Community Development Entity
A financial intermediary certified by the CDFI Fund that may apply to receive an Allocation Award of New Markets Tax Credits to make qualified investments in low-income communities.

CDFI: Community Development Financial Institution

CDFI Fund: Community Development Financial Institutions Fund

CIIS: Community Investment Impact System
A web-based data collection system used by CDEs and CDFIs to report required performance and compliance data on their investment activities to the CDFI Fund.

EZ: Empowerment Zone
A highly distressed community that may be eligible for a combination of grants, tax credits for business, bonding authority, and other benefits. HUD administers the federal EZ Initiative, which was enacted in 1993 and subsequently extended.

FS&R: The Financial Strategies & Research office within the CDFI Fund

GAO: Government Accountability Office

HTC: Historic Tax Credits
A federal tax credit program that gives tax credit incentives for the preservation and restoration of historic architecture.

HUD: U.S. Department of Housing and Urban Development

ILR: Institution-Level Report
A report within CIIS that CDEs and CDFIs use to provide summary organizational, financial, lending and impact data about the institution submitting the report.

IRR: Internal Rate of Return

LIC: Low-Income Community
In the NMTC context, this refers to an NMTC-qualified census tract that meets certain criteria based on poverty rates, unemployment, and median household income.

NMTC: New Markets Tax Credit

QALICB: Qualified Active Low-Income Community Business
A nonprofit or for-profit entity in an NMTC-eligible census tract that receives an investment from a CDE through the NMTC Program.

QEI: Qualified Equity Investment
An equity investment made into an eligible CDE that generates New Markets Tax Credits for the investor, equal to 39% of the investment over a seven-year period.

QLICI: Qualified Low-Income Community Investment
Any investment from a CDE into a QALICB that uses and complies with the NMTC Allocation Award.

Summit: Summit Consulting, LLC

TIF: Tax Increment Financing
A public financing method in which municipalities typically divert future property tax revenue increases from a defined area or district toward an economic development project or public improvement project in the community.

TLR: Transaction Level Report
A report within CIIS that CDEs and CDFIs use to provide detailed information on the loans and investments made by the institution in low-income communities.

Executive Summary

The U.S. Department of the Treasury's Community Development Financial Institutions Fund (CDFI Fund) expands economic opportunity for underserved people and communities by supporting the growth and capacity of a national network of community development lenders, investors, and financial service providers. The United States Congress established the New Markets Tax Credit Program (NMTC Program) within the CDFI Fund in 2000 to use tax credits to spur investment in low-income communities.

The NMTC Program attracts private sector investment capital to underserved markets by permitting individual and corporate investors to receive a credit against their federal income taxes in exchange for equity investments in specialized financial institutions called Community Development Entities (CDEs). These CDEs, in turn, make flexible debt or equity investments in for-profit or non-profit operating businesses and real estate projects in low-income communities—referred to as Qualified Active Low-Income Community Businesses (QALICBs). QALICBs represent an array of social infrastructure projects and businesses, including community health centers, commercial real estate projects, charter schools, manufacturing plants, energy production plants, and retail and service businesses. Investors claim tax credits totaling 39 percent of the original investment amount over a seven-year period. The investment in the CDE cannot be redeemed before the end of the seven-year period. Since 2002, the CDFI Fund has allocated more than $50 billion in tax credit authority to CDEs.

Each NMTC Program Allocation Agreement specifies compliance and reporting requirements that ensure that CDEs use the tax credits to provide public benefits. To achieve maximum benefit while allowing CDEs to respond to market opportunities, Allocation Agreements contain flexible requirements that allow CDEs to provide financing that best meets the needs of businesses in low-income communities. When applying for an Award through the NMTC Program, CDEs craft unique strategies and can select from a menu of commitments regarding service areas[1], financing products, non-metro investments, and targeted distressed communities. If a CDE receives an Award, these commitments become binding in the Allocation Agreement.

While the program's flexibility allows for a market-driven approach to community development, the resulting complexity of investment structures and the variation in project types make it challenging to determine specific programmatic outcomes and to verify compliance.

The CDFI Fund engaged Summit Consulting LLC (Summit) in September 2015 to gain a deeper understanding of compliance risks. In addition to the CDFI Fund's own questions, the Government Accountability Office (GAO) and other interested entities have posed questions about CDE compliance, as well as other questions related to the NMTC Program that require further research to answer, such as the distribution of benefits among the stakeholders and the role that other forms of public investment play in these transactions. To answer these and other research questions described more fully in this report, Summit conducted a quantitative review of the NMTC program and CDE compliance. This report outlines the areas of Summit's research, describes the methodologies used to answer the CDFI Fund's research questions, and presents the key findings.

Summit found that current Allocatee practices for deploying NMTC Allocations align with the objective of the NMTC Program. Summit evaluated a representative sample of projects[2] and found that every project in the sample complied with the corresponding Allocation Agreements. This report also provides insights for potential programmatic improvements through enhanced reporting and highlights areas where future research could provide additional guidance to the CDFI Fund. The key findings, organized by each topic addressed in this report, follow.

Summit found that current industry practices for deploying NMTC Allocations align with the objective of the NMTC Program. Summit evaluated a representative sample of projects and found no instances of noncompliance.

1. HOW DO CDES ADHERE TO THEIR ALLOCATION AGREEMENTS AND IRS STATUTE? DO THEY EXCEED REQUIREMENTS?

- *Summit found no instances of noncompliance; however, the CDFI Fund should issue further guidance to ensure reporting consistency, particularly regarding the flexible products portion of the Allocation Agreement.*
- *NMTC financing is invested in highly distressed areas, generally exceeding the minimum thresholds mandated by IRS statute.*

2. WHAT PROJECT CHARACTERISTICS AFFECT RESIDUAL EQUITY, CDE FEES, COST OF CAPITAL, AND INVESTOR RETURN?

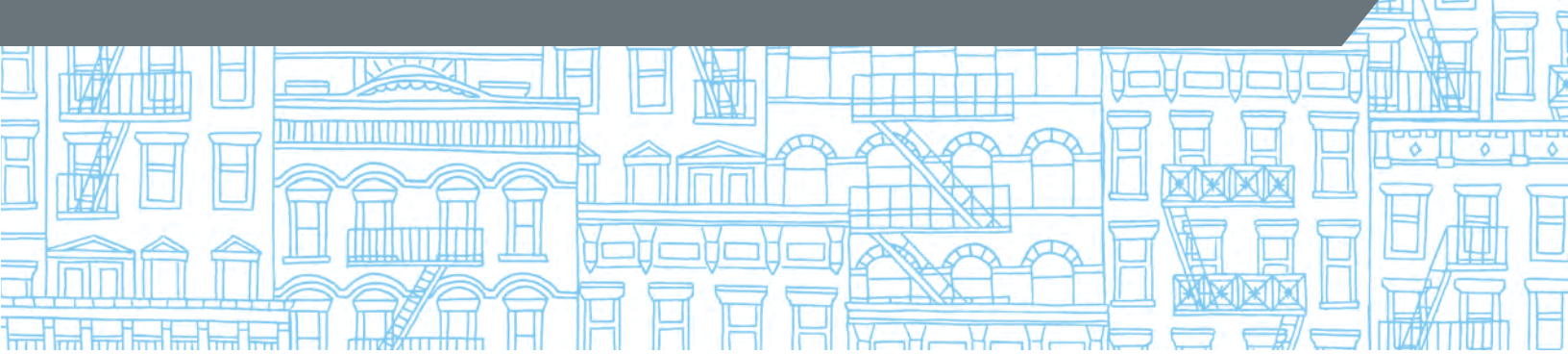
- *CDEs provide flexible financing to QALICBs in a variety of ways, all of which reduce the net cost of capital for these borrowers.*
- *The amount of residual equity largely depends on the financial structure used. Leveraged financial structures typically have an A note that provides the debt financing for the QALICB, and a B note to leave residual equity in the QALICB, further reducing cost of capital (see definition in Appendix A for more detail). Other structures leave residual equity with CDEs, which typically redeploy the funds for similar investments in other businesses, extending the benefit beyond the life of the Allocation.*
- *CDEs do not appear to charge higher fees in multi-CDE transactions than in single-CDE transactions, contrary to the hypothesis that greater transaction complexity results in higher fees.*
- *CDEs that comply with flexible products requirements using below-market interest rates tend to charge higher fees; however, this does not appear to impact the QALICB's net cost of capital.*
- *Investor return depends on the market for tax credits rather than on project characteristics.*

3. HOW MUCH PUBLIC FUNDING IS NECESSARY TO ATTRACT PRIVATE INVESTMENT TO HIGHLY DISTRESSED AREAS?

- *Summit's research provides the CDFI Fund two new quantitative methods, based on financing gaps and implied capitalization rates, to analyze the depth of public investment in NMTC transactions.*
- *According to these analyses, approximately two-thirds of reviewed projects received public funding commensurate with financing gaps and/or industry benchmark capitalization rates.*
- *Self-leveraged projects, projects using non-NMTC public funding to leverage the equity investment, and projects using both state and federal NMTCs appear more likely to receive higher-than-expected rates of public funding. The U.S. Department of the Treasury should further review how these project characteristics influence the depth of public investment and the distribution of benefit in NMTC transactions.*

4. WHAT CDE BEST PRACTICES WERE OBSERVED DURING SUMMIT'S RESEARCH?

- *Summit observed several CDEs employing a rigorous project selection process; a defined, quantitative, and consistently implemented "but-for" analysis; and effective loan policies and procedures.*



Introduction

The CDFI Fund's NMTC Program benefits low-income communities through the use of tax credits that attract and leverage private investment capital for financing businesses located in some of the nation's most distressed areas.

The NMTC Program allows CDEs to use a range of methods and tools to provide financing to businesses and communities that often lack access to affordable credit and capital. The program's flexible nature enables CDEs to deploy capital in a way that best fits the needs of low-income businesses and their surrounding communities and residents.

The variety of methods and financing structures used to deploy the NMTCs has led to questions, both from within the CDFI Fund and from other interested stakeholders, about how CDEs implement the program. The GAO,[3] the Urban Institute,[4] and members of Congress have posed questions and made recommendations about the program regarding a variety of topics such as the level of fees charged to QALICBs, investor returns, the total public funding going to NMTC projects, CDE compliance, and reporting. In response to these and other compliance and programmatic questions posed internally, the CDFI Fund formulated a research project to provide further guidance to the NMTC Program. The CDFI Fund's research questions center on the following areas:

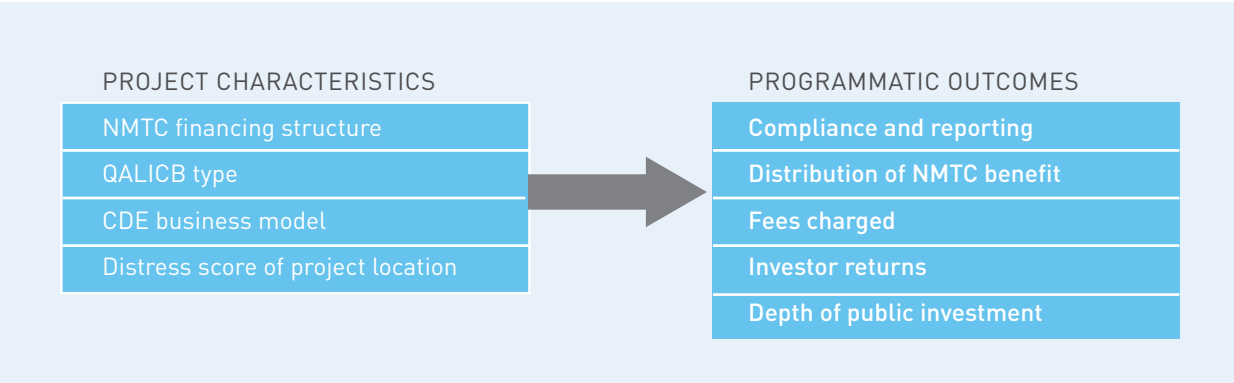
- How do CDEs adhere to their Allocation Agreements, and how can the CDFI Fund improve the compliance monitoring process? To what extent, if any, do CDEs exceed Allocation Agreement requirements?
- How do financing structures used in NMTC projects, particularly leveraged financing, affect specific outcomes, including the residual equity to the QALICB, CDE fees, compliance, and reporting?[5] How do other project characteristics, such as project location, QALICB type, and CDE business model affect project outcomes and the distribution of benefit?
- How much public funding is necessary to attract private investment to highly distressed areas?
- Which CDE best practices ensure that the objectives of the program are met?
- How can the CDFI Fund enhance reporting requirements to increase efficiency, reduce the burden of reporting, and increase understanding of the use of the tax credits?

In September 2015, the CDFI Fund engaged Summit to address these research questions about the NMTC Program. The research focused on measuring community distress, evaluating financing structures used in NMTC transactions, analyzing flexible financing provided by CDEs, quantifying the depth of public investment in NMTC transactions, providing guidance for compliance reporting enhancements, and measuring fees charged and reported. To address these issues and to answer the CDFI Fund's research questions, Summit completed the following key tasks:

- **Developed an in-depth research framework.** Summit reviewed existing research, outlined methods for answering the CDFI Fund's research questions, and developed desk review procedures.

The detailed methodologies that Summit used for the analyses in this report are included in *Appendix B*.

- **Constructed and analyzed Administrative Dataset.** The CDFI Fund provided Summit with NMTC transaction-level data as well as data from the Allocated Tracking System collected annually from CDEs, which Summit combined to construct the *Administrative Dataset*. Summit used this dataset to perform preliminary analyses and to select a sample of projects for desk reviews.
- **Defined Sampling Frame and Selected NMTC projects for desk reviews**. Summit defined the sampling methodology and drew a stratified random sample of 53 projects involving 61 CDEs from more than 4,500 projects closed since the NMTC's Program's inception. The relatively small sample allowed for more in-depth, detailed reviews of project documentation and financial structures than was possible in previous research. However, the small sample limits the ability to extrapolate some results of this study to the universe of NMTC projects. This report indicates which results are statistically significant and which are limited to observations within the sample (see sampling methodology Appendix E).
- **Performed desk reviews.** Summit reviewed project documentation submitted by CDEs, analyzed these individual projects, reviewed compliance with key aspects of the Allocation Agreement, and conducted follow-up phone conferences with CDEs to discuss their projects, procedures, and perspectives on the NMTC program. This task included 53 projects financed by 61 CDEs and produced an aggregate dataset for research, which Summit compared against data collected by the CDFI Fund where possible.
- **Conducted site visits to 10 CDEs.** Summit conducted site visits to 10 CDEs representing different business models. These site visits included full compliance testing of Allocation Agreements, facility tours, and discussion with key management regarding CDE practices and perspectives on the NMTC Program.
- **Analyzed the CDFI Fund's NMTC compliance data and data systems.** Summit compared fees, flexible loan terms, and other information reported in the CDFI Fund's data systems to the information observed during site visits and in the desk review materials. In response to the CDFI Fund's request for guidance in this area, Summit made recommendations to improve the CDFI Fund's reporting requirements and processes.
- **Analyzed aggregate dataset.** The stratified random sampling of projects was conducted such that statistically significant results of analyses using this aggregate dataset could confidently be extrapolated to all NMTC projects. However, due to the small sample size, some of the results cannot be interpreted as representative of all NMTC projects. Summit quantitatively analyzed the aggregate dataset produced during desk reviews to provide insight into how project-related characteristics influence programmatic outcomes of interest, as shown below.



This report has four sections and describes Summit's findings in the following areas:

1. **CDE compliance with NMTC Allocation Agreements.** Summit tested key components of the Allocation Agreement and found no instances of noncompliance. This section reports how CDEs comply with the flexible products requirement specifically and recommends enhancements to compliance reporting. It also provides an analysis of distress using the Administrative Dataset.
2. **Distribution of overall NMTC Program benefit.** Reports the distribution of the tax credit among each stakeholder involved in the NMTC structure, fees charged, and investor returns.
3. **Degree of public investment in NMTC transactions.** Prior to this research, the CDFI Fund, the NMTC industry stakeholders, the GAO, and researchers lacked a quantitative framework to conduct such analysis. At the request of the CDFI Fund, Summit developed a quantitative method for analyzing the depth of public funding in NMTC projects and the role of other sources of public funding.
4. **CDE best practices.** Provides examples of the best practices in CDE operations that promote the core objectives of the NMTC Program.

These four sections include the results of Summit's quantitative analysis. The report does not include detailed findings for project aspects that do not appear to affect the areas of interest, unless the finding was particularly counterintuitive. Summit also provided the CDFI Fund separate, detailed recommendations for potential reporting enhancements after a full review of the CDFI Fund's data collection systems, as well as the NMTC Application data. Many of these recommendations are referenced throughout this report.

Section 1: CDE Compliance with NMTC Allocation Agreements

The CDFI Fund's objectives for Summit's compliance research centered on understanding how CDEs adhere to their Allocation Agreements, how the CDFI Fund can improve the compliance monitoring process, and to what extent, if any, CDEs exceed Allocation Agreement requirements.

Each Allocation Agreement specifies compliance and reporting requirements that ensure that CDEs use the tax credits to provide public benefits. To achieve public benefits while allowing CDEs to respond to market opportunities, Allocation Agreements allow CDEs to choose from a variety of possible programmatic requirements that allow CDEs to provide financing options that best meets the needs of businesses in low-income communities. When applying for the program, CDEs craft unique strategies and can select from a variety of commitment options regarding service areas, financing products, and targeted distressed communities. Once a CDE receives an Award to carry out the strategy described in its NMTC Application, its commitments become binding in the Allocation Agreement. Due to the flexibility of options available to Allocatees in the Allocation Agreements, Allocatees use varied approaches to meet these compliance requirements.

Summit reviewed CDEs' adherence to key aspects of their Allocation Agreements and found no compliance violations. Summit reviewed project documentation concerning aspects of the Allocation Agreement observable on the project-level, including eligible activities, service area, unrelated entities, flexible products, and affordable housing. During site visits, Summit reviewed compliance for all aspects of the Allocation Agreement.

One central compliance requirement that Summit reviewed is the requirement for CDEs to offer flexible financing products to QALICBs. CDEs provide flexible and patient capital to QALICBs in the form of equity investments or loans with lower interest rates and more flexible terms than what is available to the QALICBS on the market.

Additionally, the statute governing the NMTC Program requires CDEs to invest in census tracts that exceed a 20% poverty rate have a median family income that does not exceed 80% of the area median family income.[6] The CDFI Fund asked Summit to research if CDEs exceed these statutory requirements by investing in areas of even higher distress.

This section specifically discusses how CDEs carry out and report the flexible products provided to QALICBs, and examines Summit's distress analysis.

1.1 FLEXIBLE PRODUCTS COMPLIANCE OVERVIEW

The NMTC Program requires CDEs to use the NMTC equity to offer QALICBs financing that is more flexible than the financing that is available to the QALICB in the market. As such, CDEs must demonstrate that their qualified investments, known as Qualified Low-Income Community Investments (QLICIs), satisfy at least one of the following criteria:[7]

- **Equity or equity-equivalent financing.** Equity-equivalent financing includes debt with equity features (e.g., debt with royalties, debt with warrants, convertible debt).
- **Debt with interest rates a designated percentage below market interest rates.** These loans carry interest rates at a specific percentage (designated in the Allocation Agreement) below either the prevailing market rates for the particular product or the Allocatee's current offerings for the particular product.
- **Debt that has a designated number of the following flexible features, referred to as *indicia* in the Allocation Agreement:**
  - Below-Market Interest Rates (or rate of return in the case of equity investments)

- Lower-than-Standard Origination Fees
- Longer-than-Standard period of Interest-Only Loan Payments
- Higher-than-Standard Loan-to-Value Ratio
- Longer-than-Standard Amortization Period
- More Flexible Borrower Credit Standards
- Non-traditional Forms of Collateral
- Lower-than-Standard Debt Service Coverage Ratio
- Subordination

CDEs indicate in their NMTC Applications the percentage below-market interest rates and number of flexible features that they can commit to for their QLICIs. If the CDE receives an Award, then the commitment made in the NMTC Application is transferred to the Allocation Agreement. Thus, each Allocation Agreement specifies the required percentage below-market interest rate and the number of flexible features that each QLICI must meet, based on commitments made by the CDE. Most Allocation Agreements that Summit encountered require the CDE to offer interest rates at least 50% below market rates or a minimum of five flexible features. Both of these values are the maximum commitment a CDE can make in the Application. During desk reviews and site visits, CDEs expressed the view that making these maximum commitments increases their chances of receiving an Award.

Figure 1 shows which of these three *Flexible Products* criteria each sampled project satisfied: the required number of flexible features, interest rates at a designated percentage below-market, or equity. CDEs that meet more than one of these criteria provided financing that is more flexible than the minimum standards indicated in the Allocation Agreement.

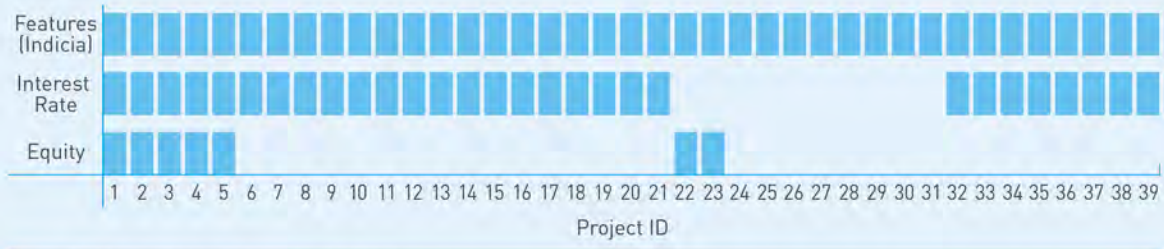
Figure 1 shows that 23 of the 39 projects included in this analysis, or nearly 60%, went above the minimum one flexible product criterion by satisfying either two or three criteria. Most projects that met multiple criteria provided sufficient flexible features and an interest rate below the specified discount to the market. All equity investments in a project were accompanied by loans that met at least one of the other criteria. This indicates that NMTC financing from CDEs is often more flexible than minimum requirements outlined in the Allocation Agreement.

CDES BLEND QLICI INTEREST RATES FOR PROJECTS WITH EQUITY QLICIS

The current guidance in the NMTC FAQs published by the CDFI Fund's Office of Certification, Compliance, Monitoring and Evaluation allows CDEs to blend interest rates of QLICI loans for compliance

Figure 1

HOW EACH PROJECT SATISFIED THE FLEXIBLE PRODUCTS REQUIREMENT



Source: NMTC Research Aggregate Dataset

Note: This chart excludes projects with 2002 and 2003 Allocation Agreements because these Allocation Agreements were structured differently.

purposes. The instructions and examples in the current NMTC guidance are unclear as to whether it is also permissible for Allocatees to calculate a blended interest rate for an equity investment and a loan that are part of the same project.

The CDFI Fund was interested in understanding industry practices with regard to blending interest rates. During the desk review process, Summit observed that approximately half of CDEs calculate a blended interest rate for compliance purposes. When CDEs provide equity and debt to a QALICB, the CDE typically calculates a blended interest rate that considers the equity portion to have 0 percent interest. However, this approach makes it possible for the debt portion to have market interest rates or even above-market interest rates, while allowing the combined QLICI to achieve below-market interest rates for compliance purposes.

Summit recommends that the CDFI Fund should consider revising the instructions and examples listed in the FAQ to clarify allowable uses of blended interest rates to meet flexible product requirements.

THIRD-PARTY LEVERAGE DOES NOT ALLOW COMPLIANCE THROUGH INTEREST RATES

During the desk review research, several Allocatees noted that they perceive that the CDFI Fund prefers third-party leverage, which the CDFI Fund clarified is not the case. CDEs also noted that providing interest rates 50% below market is not possible when using third-party leverage in an A/B Note structure.[8] QLICIs that comply with interest rates 50% below market are most often financed through a self-leveraged structure.

CDEs generally cannot offer interest rates at 50% below market in a third-party leveraged structure due to the independent, market-driven pricing of the outside leverage loan. The leverage typically comprises 70% of the financing in a leveraged A/B Note structure.[9] In these cases, a CDE can issue QLICIs with interest rates that are at most 30% below market if the third-party leverage is at market rates. The typical Allocation Agreement requires interest rates 50% below market for compliance using interest rate alone. Sometimes, to achieve compliance through a loan with a 50% below market interest rate, the QALICB receives a third-party loan for the project at market rates and then uses this loan to leverage the NMTC equity, on-lending these funds to the NMTC financing structure at very low interest rates.

Transactions leveraged by a third party comply by providing equity (third row of Figure 1) and/or by meeting the requisite number of flexible features (first row of Figure 1). Among the sampled projects, this finding corresponds with Allocatee feedback that it is not possible to offer a loan with an interest rate 50% below market while also using third-party leverage.

TREATMENT OF RESIDUAL EQUITY IN LEVERAGE A/B NOTE TRANSACTIONS VARIES

Most projects financed through a leveraged A/B Note structure include a legal agreement between the NMTC investor and the QALICB that results in the B Notes being converted into residual equity for the QALICB at the end of the compliance period. When using this financing structure, Allocatees do not have a consistent approach for reporting on compliance of the B Note.

When the loan documents allow for the B Note to convert to residual equity for the QALICB at the end of the compliance period, some Allocatees consider the B Note to be equity-equivalent financing. No principal payments are made over the life of the loan, and, typically, the investment fund balances transfer to the QALICB at the end of the compliance period. Other CDEs consider the B Note to meet one of the flexible products features, *Debt with Equity Features*, but do not consider this note to be true equity. Some CDEs do not consider it to be equity-equivalent or *Debt with Equity Features*, reporting the B Note as compliant using other, non-equity-related features.

CDEs maintain different interpretations of how to treat the B Note with regard to NMTC compliance, but Summit did not identify any instances where these differences affected the compliance status of a QLICI.

Summit recommends that the CDFI Fund should consider issuing further guidance to ensure that CDEs have a clear and consistent approach to the B Note, for compliance purposes.

MOST COMMON FLEXIBLE FEATURES

For QLICIs that satisfy the flexible products requirement by meeting a certain number of flexible features, Summit analyzed the types of flexible features offered by the CDEs.

The most common flexible features provided by CDEs are the following (rank-ordered from most common to least common):

1. Below-Market Interest Rates
2. Longer-than-Standard Period of Interest-Only Loan Payments
3. Lower-than-Standard Origination Fees
4. Higher-than-Standard Loan-to-Value Ratio
5. Longer-than-Standard Amortization Period

Below-Market Interest Rates is the most common flexible feature CDEs use to meet the flexible products requirement. The Allocation Agreement does not list a minimum percentage below market interest rates for compliance eligibility when considered with other flexible features; the rates must simply be lower than the market rate. Therefore, CDEs meet this requirement at any rate below a self-identified market rate. CDEs must identify the market rate due to the range of possible QALICBs and their differing financing needs. Some CDEs use the underwriting standards of their parent for similar products, some CDEs use the terms of the leverage loan if provided by a third party, and others ask the QALICB to write a letter certifying what type of financing would otherwise be available to them.

The second most commonly used flexible feature is *Longer-than-Standard Period of Interest-Only Loan Payments*. In most NMTC transactions, especially leveraged transactions, the QALICB makes interest-only payments for the entire compliance period. Any significant principal repayment by QALICBs could trigger a regulatory compliance risk for the CDE, requiring the CDEs to reinvest the capital in another compliant project. Consequently, the interest-only payments are often an inherent part of leveraged NMTC transactions. The notable exceptions are projects financed through pooled loan funds (a financing structure explained in Appendix A) which regularly amortize and redeploy QLICIs during the compliance period.

Some CDEs Consider Loan Features to be "Borrower Credit Standards"

To comply with the flexible products requirement using the minimum number of flexible features, CDEs can use *More Flexible Borrower Credit Standards*. Different CDEs have different interpretations of this feature. Sometimes the CDE considers borrower characteristics, such as the QALICB's cash flows, for compliance using this feature. However, CDEs often determine if a QLICI satisfies the *More Flexible Borrower Credit Standards* criterion by considering loan characteristics rather than borrower characteristics.

For example, Summit observed CDEs considering a QLICI to meet *More Flexible Borrower Credit Standards* based on the following loan characteristics:

- The total loan amount is greater than what would have been available on the market.

Recommendations

FLEXIBLE PRODUCTS

- *Clarify if an equity QLICI can be used to calculate a blended interest rate for compliance purposes.*
- *Clarify treatment of B Note (residual equity) for compliance purposes.*
- *Clarify* More Flexible Borrower Credit Standards *option.*

- The loan does not have a pre-leasing requirement.
- The loan does not require security interest in the real estate.
- The loan is a non-recourse loan offered for a QALICB, where the market would offer only recourse loans.
- The loan is more flexible than what would have otherwise been available to the QALICB on the market, as evidenced by the other four flexible features.

Summit recommends that the CDFI Fund should clarify instructions to indicate whether the More Flexible Borrower Credit standard should be allowed to represent the characteristics of the borrower or focus exclusively on the loan's characteristics. Even without the *More Flexible Borrower Credit Standards* index option, all transactions analyzed during desk reviews would comply with their respective Allocation Agreements.

Key Finding

NMTC CAPITAL DEPLOYED IN DISTRESSED NEIGHBORHOODS

- *Almost 80 percent of NMTC capital is invested in neighborhoods that are at least moderately distressed, and the majority is invested in highly distressed neighborhoods.*
- *Summit found no evidence that NMTC investments are concentrated in areas adjacent to affluent areas. Conversely, CDEs appear to make NMTC investments in highly distressed census tracts surrounded by other distressed areas.*

1.2 DISTRESS ANALYSIS

The IRS statute governing the NMTC Program defines a Low-Income Community as a census tract with a poverty rate greater than 20% or a Median Family Income (MFI) less than 80% of its state's or metropolitan area's MFI.[10] NMTC investments must occur in census tracts that meet this definition of a Low Income Community.[11] However, the CDFI Fund has noted that community distress is more nuanced than any one indicator in a census tract and therefore asked Summit to answer the following key questions related to distress:

1. How distressed are communities in which CDEs deploy their NMTC Allocations? Do CDEs go beyond the minimum statutory requirements?
2. Are investments occurring on the border of distress, e.g., distressed census tracts adjacent to affluent neighborhoods?

To answer these questions, Summit developed a distress score that considers five different indicators and places community distress on a spectrum to permit an analysis of the spatial distribution of investments. The result is a distress score between 0 and 100 that corresponds to a tract's percentile of distress relative to all other census tracts in the United States. For example, a census tract with a distress score of 60 is more distressed than 60% of the country. To ensure the most accurate representation of a community at the time of investment, Summit matched each transaction in the CDFI Fund's Administrative Dataset with a distress score calculated using data from the year the transaction was closed.[12]

Based on the foregoing distress spectrum, which differs from the statutory and programmatic definitions, Summit found that almost 80% of NMTC financing is deployed in neighborhoods that are at least moderately distressed, and over 50% is deployed in highly distressed neighborhoods, as measured by the distress score index developed for this analysis.[13] Additionally, Summit found no evidence that NMTC investments are concentrated in areas adjacent to affluent areas. Conversely, CDEs appear to make NMTC investments in highly distressed census tracts surrounded by other distressed areas.

RESULTS

Figure 2 shows the total NMTC investment dollar amount by census tract distress score from 2010-2014. The most highly distressed census tracts received the highest amount of NMTC investment. More than $15 billion (79% of total investment) was invested in neighborhoods that are at least moderately distressed (distress score > 60), and more than $10 billion (53%) was invested in highly distressed neighborhoods (distress score > 80).

Distress Spatial Distribution Analysis

The CDFI Fund also asked Summit to investigate the possibility that investments occur in distressed census tracts directly adjacent to affluent census tracts. Summit found NMTC investments typically occur in areas that are spatially separated from prosperous areas, as indicated by two methods that Summit developed.

The first method measures the distress level of the area surrounding the census tract where the CDE made the NMTC investment, using the population-weighted average distress score for all census tracts within a certain radius of the investment location.

The second method provides spatial context using an alternative method, calculating the distance between the location of an NMTC investment and the nearest extremely distressed or extremely affluent census tract. Census tract categorizations were defined as follows:

- **Extremely prosperous census tract.** Among the 10% least distressed census tracts in the country, as indicated by a distress score of 10 or lower
- **Extremely distressed census tract.** Among the 10% most distressed census tracts in the country, as indicated by a distress score of 90 or higher

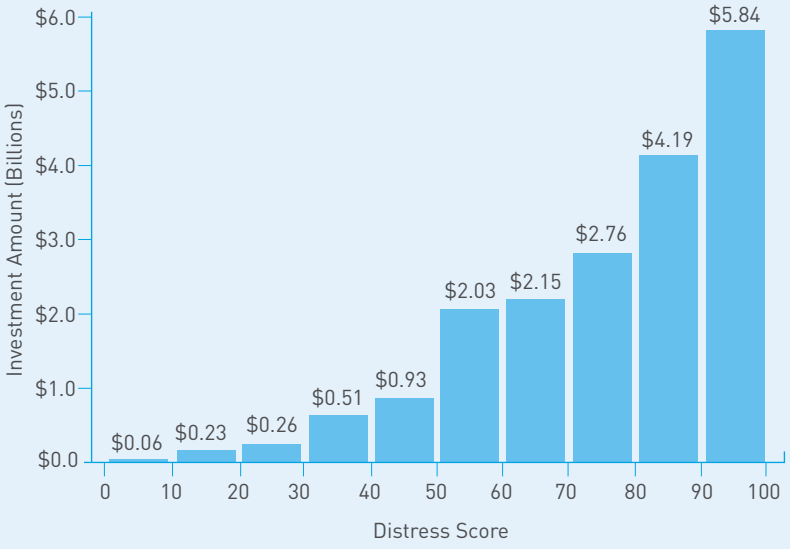
For each investment, Summit calculated the distance to the nearest extremely prosperous census track and extremely distressed census tract to determine how far NMTC investments are from census tracts characterized by these extremes. Summit also examined the ratio between these distances, which shows how much closer each investment is to a highly distressed neighborhood than a highly prosperous one.

Medians for spatial measurements of distress are listed in Table 1. Distances are listed in miles.

The median investment is located in a census tract with a distress score of 81.68 and an area distress score of 77.33. This indicates that NMTC investments are made in census tracts more distressed than neighboring areas, but that the surrounding areas are

Figure 2

INVESTMENT AMOUNT BY DISTRESS SCORE



Source: Administrative Dataset, distress scores calculated from American Community Survey

Note: This chart shows investments closed 2010 – 2014, excluding CDE-to-CDE investments, Targeted Populations investments, and any transactions where a distress score was not available.

also distressed. This analysis shows no evidence that NMTC investments are concentrated in distressed census tracts near prosperous census tracts.

The distance metrics also provide context for each NMTC investment. The median NMTC investment is located 4.18 miles from the nearest prosperous census tract and is nearly five times closer to highly distressed tracts than highly prosperous tracts.

To illustrate the distress analysis spatially, Figure 3 shows a map of Chicago with 2011 distress scores and NMTC investments closed in 2011. Red represents the most distressed neighborhoods, and blue represents the most affluent neighborhoods or census tracts with the lowest distress scores. As expected, the map shows that most NMTC investments are in highly distressed neighborhoods.

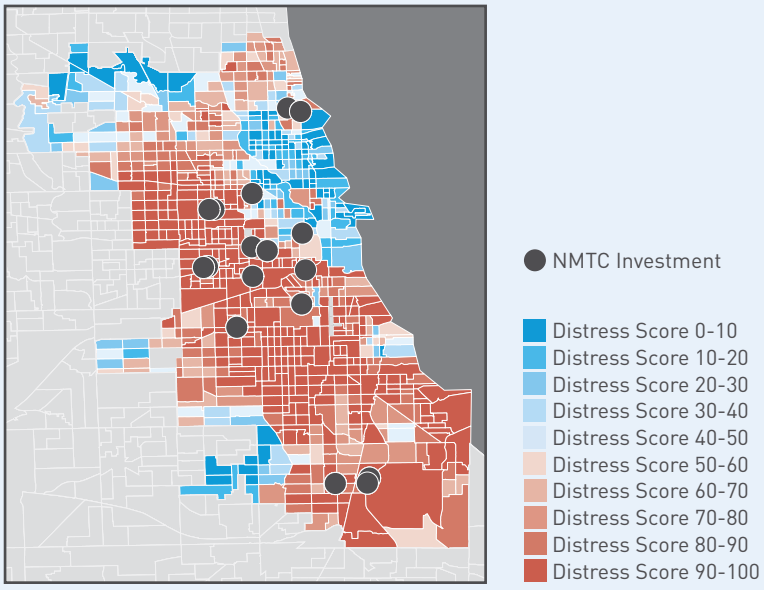
Table 1

DISTRESS SCORE AND INDICATORS OF DISTRESS FOR AREA OF NMTC INVESTMENTS[14]

Variable	Median Value
Distress Score	81.68
Area Distress Score	77.33
Distance to Highly Prosperous Tract (Miles)	4.18
Distance to Highly Distressed Tract (Miles)	0.73
Ratio of Prosperous to Distressed Distance	4.96

Figure 3

2011 CHICAGO DISTRESS MAP AND NMTC INVESTMENTS



Section 2: Distribution of Overall Program Benefit

As described in *Section 1: CDE Compliance with NMTC Allocation Agreements,* CDEs use NMTCs to provide flexible financing to QALICBs in a variety of ways, including offering below-market interest rates, flexible loan products, and equity or equity-like financing. Some NMTC financing structures go beyond the required flexible criteria and result in the QALICBs receiving residual equity generated by the tax credits at the end of the compliance period.

To help the CDFI Fund understand the full benefit of tax credits provided through the NMTC Program to all stakeholders, Summit analyzed cash flows to and from all entities involved in the sampled NMTC transactions. Summit also analyzed which fees and expenses charged in these transactions the CDFI Fund currently does not measure and provided recommendations for specific reporting enhancements that would capture these fees and expenses.

Summit's analysis shows that CDEs provide flexible financing to QALICBs in a variety of ways, all of which reduce the net cost of capital for these businesses. The fees that CDEs and other parties charge do not appear to significantly affect QALICBs' cost of capital. Additionally, CDEs often use these fees to capitalize loan funds that provide similar flexible financing to other businesses in low-income communities, extending the benefit beyond the initial use of the Allocation during the compliance period.

The Urban Institute[15] and the GAO[16] have raised questions about whether the fees charged by CDEs, the NMTC Investor, and other parties may diminish program benefits to QALICBs. The GAO also suggested NMTC investors may be receiving outsized returns for certain types of projects. The CDFI Fund recognized that the lack of information collected about leveraged financing and third-party fees and expenses might result in incomplete information about the distribution of benefits among the stakeholders. Thus, the CDFI Fund included questions for this research on how financing structures, project attributes, and CDE characteristics influence any residual equity received by QALICBs.

This section outlines the desk review findings in the following areas:

- **Residual equity in NMTC transactions.** Analyzes cash flows for disbursement of QLICI loans, interest and principal payments, fees, and put payments[17] to measure the residual equity remaining with the QALICB. This analysis does not consider other benefits CDEs are able to provide to the QALICBs because of the tax credits, such as below-market interest rates or interest-only periods on loans.
- **Fees and third-party expenses.** Examines how much of the funds that enter the NMTC financing structure is used to pay fees and third-party expenses and whether project characteristics might influence fees. This section also provides guidance for potential reporting enhancements that would increase the CDFI Fund's understanding of fees charged in NMTC transactions.
- **Investor rate of return and indemnification agreements.** Analyzes investor Internal Rate of Return (IRR) for the NMTC equity investor and provides additional information to the CDFI Fund around the risk/reward for these investors.
- **QALICB cost of capital.** Measures all NMTC-related cash flows into and out of QALICBs to understand the true cost of the NMTC financing for QALICBs.

Key Finding

DISTRIBUTION OF NMTC BENEFIT

CDEs provide flexible financing to QALICBs in a variety of ways, all of which reduce the cost of capital for these businesses

2.1 RESIDUAL EQUITY

OVERVIEW

NMTC transactions frequently result in residual equity from the NMTC equity investment remaining invested in the QALICB or the CDE at the end of the compliance period. This injection of equity typically serves to fill funding gaps in projects that market financing cannot and significantly reduces the cost of capital to QALICBs.

Per recommendations from the GAO, the CDFI Fund now collects data from CDEs about the amount of residual equity remaining with the QALICBs at the end of compliance period through the Close-Out Report. The CDFI Fund asked Summit to further analyze how financial structures influence residual equity and the net benefit to the parties in the various types of transactions. Summit did not review any projects that have reported residual equity to the CDFI Fund through the Close-Out Report due to the recent deployment of the report and lack of available data. This section provides an analysis of residual equity in NMTC transactions based on project-level documentation.[18]

The financing structure of an NMTC transaction largely dictates which parties will receive residual NMTC equity at the end of compliance period. Leveraged A/B Note transactions often transfer part of the residual equity to QALICBs at the end of the compliance period. By design, non-leveraged structures and pooled loan funds generally do not leave any of the residual NMTC equity to the QALICB. In these cases, the CDE often uses the repaid loans to make similar flexible-term loans to other low-income community businesses. CDEs are not obligated to reinvest these funds in businesses that technically qualify as QALICBs, because these reinvestments are not part of the NMTC Program; however, these reinvestments often serve purposes that are similar to NMTC investments. Therefore, because of the flexible loan criteria offered by CDEs in the NMTC loans, an analysis of the distribution of the residual equity among the parties does not, by itself, fully capture the distribution of the benefit of the NMTC funding.

RESULTS

The section below reports the residual equity received by QALICBs or CDEs in three basic financing structures, which are representative of NMTC projects in general:

- Leveraged A/B Note Financing Structures[19]
- Direct Loans/Non-Leveraged Structures
- Pooled Loan Funds

These financing structures are further described in Appendix A.

Leveraged A/B Note Transactions

The leveraged A/B Note financing structure was the most common financing structure in the sample, accounting for 62% of sampled projects. In leveraged A/B Note transactions, the leverage typically finances the A Note and the NMTC investor equity finances the B Note through an intermediary investment fund (see Appendix A for further details). In this structure,

In transactions using the leveraged A/B Note structure, the NMTC investor typically transfers the residual equity to the QALICB (the B Note) through a put option exercised at the end of the seven-year compliance period.

In direct loans and pooled loan funds, the CDE typically uses repaid NMTC loans to make similar flexible-term loans to other low-income community businesses, extending the benefit beyond the initial borrowers.

the NMTC investor typically receives a positive return from the tax credits alone and does not expect a return of equity at the end of the compliance period.

In a leveraged A/B note transaction, the investor receives the tax credits in exchange for equity invested into the CDE. That equity is then used by the CDE to provide flexible financing to the QALICB. The QALICB also often receives *part or all* of the residual equity remaining at the end of the compliance period in addition to the flexible rates and terms provided by the CDE. At closing, the CDE or the QALICB typically enters into a put and call agreement with the NMTC investor, in which the investor agrees to sell its ownership of the investment fund to the QALICB at the end of the compliance period for a nominal price. When the investor exercises the put option, the B Note executed by the QALICB is canceled, and the NMTC investor equity effectively transfers to the QALICB.

Figure 4 shows the distribution of the percentages of residual equity that the QALICB received across the 33 transactions in the sample that used the Leveraged A/B Note financing structure.

Most projects that used the A/B note structure resulted in 20-70 percent of the tax credit amount being left to the QALICB in the form of residual equity, with an average of 42 percent.

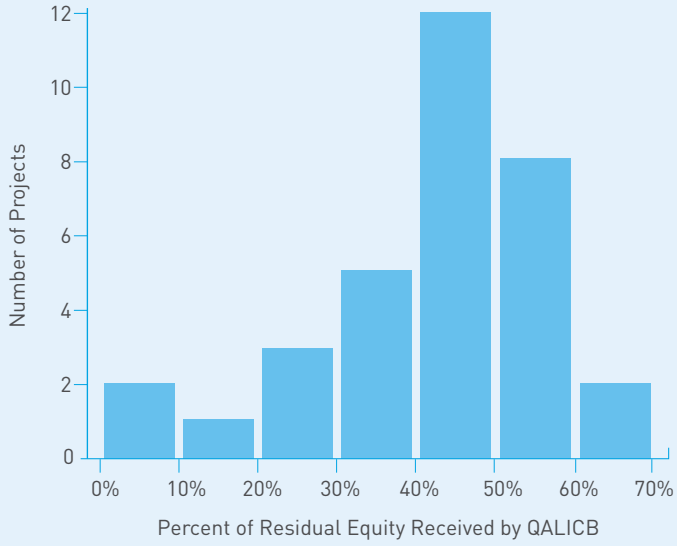
In order to understand what influences the amount of residual equity that goes to QALICBs in transactions that use the leveraged A/B note structure, Summit further analyzed this category to look for differences across QALICB type, CDE type, and source of leverage. Summit found that QALICBs in non-metro locations tended to receive more residual equity than did QALICBs in metro locations, and the result is statistically significant. Additionally, whether a CDE is also a CDFI appears to lower the amount of residual equity left in the QALICB (due to higher fees charged). However, Summit found no significant difference between multi-CDE transactions and single-CDE transactions in terms of the distribution of NMTC benefit between the parties. The source of leverage (QALICB or other) does not appear to have influenced the distribution of NMTC benefit between the parties.

Pooled Loan Funds

While few CDEs employ the pooled loan fund model, these CDEs deploy a higher number of loans relative to other financing structures due to the smaller size of the loans; thus, the pooled loan fund financing structure was observed in 30% of sampled projects.

Figure 4

DISTRIBUTION OF RESIDUAL EQUITY RECEIVED BY QALICB IN LEVERAGED A/B NOTE TRANSACTIONS



Source: Aggregate Dataset from NMTC Desk Reviews
N=33 projects with Leveraged A/B note structure.

Recommendation

FINANCING STRUCTURE

The CDFI Fund should consider collecting information regarding financing structure associated with QEIs in ATS.

In NMTC pooled loan funds, also known as revolving loan funds, QLICI loans are fully amortized, so no equity transfers to the QALICB. Unlike direct loans, the NMTC investor *does* receive a net benefit from the tax credits alone, and the leverage lender to the pooled investment fund typically charges origination fees and other fees. In these transactions, the NMTC investor enters the aforementioned put and call agreement with the CDE, and the CDE uses the residual NMTC equity received to continue making flexible-term loans to other low-income community businesses. Revolving loan funds typically provide capital to QALICBs in the form of smaller loans with terms shorter than seven years, and they tend to serve small businesses that would not otherwise access the NMTC Program. Once the QLICI loans are repaid, the funds are redeployed. There are typically multiple redeployments, and the funds are often deployed beyond the seven-year compliance period.

Pooled loan funds typically do not transfer residual equity from the NMTC equity investment to the QALICB. Instead, the CDE uses this equity to provide flexible loans at below-market interest rates to QALICBs that would often otherwise not be able to access capital. Upon repayment of these loans, the CDEs often redeploy the capital to other businesses in low-income communities.

Direct Loan/Non-Leveraged Structures

The direct loan/non-leveraged structure was least common in the sample, accounting for only eight percent of sampled projects. In the reviewed transactions using the Direct Loan/Non-Leveraged financing structure, the NMTC investor and the CDE are related parties.

Because these NMTC loans fully amortize, the NMTC equity remains invested in the CDE at the end of the compliance period. The lack of leverage results in the NMTC equity invested being more than the tax credits received. Therefore, the NMTC investor does not receive a net positive return from the tax credit alone and relies on the addition of interest and principal repayments to the related CDE to realize a positive aggregate return.

CDEs using the direct loan/non-leveraged structure do not typically transfer residual equity to the QALICB. Due to the lack of leverage, the CDE and related NMTC investor rely on the repayment of loan principal and interest to realize a financial benefit. The QALICB benefits through access to capital with better rates and terms than would otherwise be available from the market.

Reporting Enhancements

The financing structures described above are not clearly observable using the data currently collected by the CDFI Fund, and only become clear upon reviewing specific project documentation. Summit recommends that he CDFI Fund consider using ATS to collect information on the leverage lender, amount of leverage and equity entering a financing structure, and whether CDEs financed projects using a pooled structure. This would allow the CDFI Fund to more easily identify the basic financing structure used for a project and use this information for further research.

2.2 FEES AND THIRD-PARTY EXPENSES

OVERVIEW

Summit's evaluation of fees had two primary purposes, as requested by the CDFI Fund:

1. Determine the amount of fees charged by CDEs and other parties and evaluate if fee levels differ according to different project characteristics
2. Identify potential areas for fee reporting enhancements

Summit's approach to the first issue built on previous work by the GAO and the Urban Institute, which

found no issue with the fees CDEs charge in NMTC transactions. However, the GAO concluded that more complex financial structures are associated with higher fees and lower fees are correlated with higher interest rates.[20] In speaking with QALICBs, the Urban Institute noted that several QALICBs were concerned with the administrative costs of NMTC financing, in particular legal and accounting costs.

Summit examined all fees evidenced in project documentation, fees reported to the CDFI Fund in CIIS, and fees reported to the QALICB in the QALICB Fee Disclosure Forms to further shed light on these research areas.

An analysis of fees evidenced in project documentation shows that CDEs charged fees averaging a total of 8.7 percent of the QEI over the seven-year compliance period, in line with the fee levels found by the GAO and the Urban Institute. Summit also analyzed what project characteristics, if any, led to higher or lower fees. In speaking with CDEs, Summit found that CDEs typically described the fee structure in their Application and used a consistent fee structure for all projects in a given Allocation. A CDE might occasionally have adjusted the structure for specific project circumstances. For example, CDEs that normally required QALICBs to reserve some of the QLICI proceeds for fees at closing may have relaxed these requirements for non-profit QALICBs.

To address the second issue, Summit expanded upon work done by the GAO and the CDFI Fund. In a 2010 report, the GAO recommended that the CDFI Fund collect more data points on fees.[21] As a result, the CDFI Fund added 13 new fee fields to CIIS to better measure CDE fees. In its most recent report, the GAO recommended the CDFI Fund consider collecting the QALICB Fee Disclosure Form and determine if it should also collect other fee data. To comply with the Paperwork Reduction Act (PRA), the CDFI Fund asked Summit to assess the additional data points before requiring CDEs to report more data. The CDFI Fund also asked Summit to evaluate alignment between current data collection and the QALICB Fee Disclosure Form, as well as provide recommendations for reporting enhancements for different financing structures.

To identify which additional data points to collect, Summit compared the fees that CDEs reported to the CDFI Fund in CIIS to the fees evidenced in the desk review materials. As anticipated by the CDFI Fund, the research found that current fee data points collected did not represent all fees CDEs charged. For example, CIIS did not capture fees such as pre-QEI fees, leverage lender fees, investor fees, some back-end fees, and third-party expenses. Summit recommends that the CDFI Fund consider adjusting reporting requirements to collect this information and issue additional guidance on reporting of certain fees to ensure consistency across the industry.

Key Findings

FEES

- *CDEs typically use a consistent fee structure for all projects, as outlined in the Application, regardless of project size or partnership with other CDEs.*
- *CDEs related to the NMTC investor typically do not charge CDE fees.*
- *As requested by the CDFI Fund, this research has identified additional data points to record third-party expenses, fees paid to the leverage lender, fees paid to the investor, and pre-QEI fees to incorporate into its compliance reporting systems.*

FEES ANALYSIS

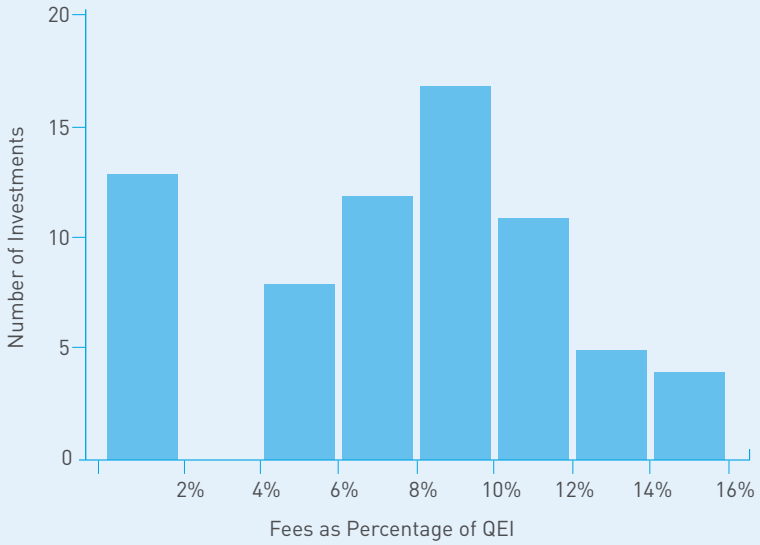
Summit analyzed the fees charged by CDEs at all levels of the NMTC structure, calculating fees at the CDE-project level as a percentage of the QEI amount. Any fees or transfers that occurred outside the NMTC structure and not reported by the CDE were not a part of this analysis, since they were not observable in the desk review materials.

Summit found that the CDE fees for projects in the desk review sample average 8.7% of the total QEI.[22] The minimum fees were 0%, and the maximum fees charged by a CDE were 15.9% of the QEI.[23] Figure 5 presents the summary data graphically to show the distribution of fees charged by the CDE as a percent of QEI.

Figure 5 shows that the CDE fees in NMTC transactions typically ranged between 4 and 16% of the total QEI. Investor-affiliated CDEs generally relied on the tax credits received from equity investment and the principal and interest payments made on QLICIs for their financial return, rather than fees. Therefore, these investor-affiliated CDEs typically charged fees ranging from 0 to 2% of the QEI amount, as represented by the leftmost bar in Figure 5. Investor-affiliated CDEs usually charged CDE fees much lower than the fees charged by other CDEs.

Figure 5

NUMBER OF INVESTMENTS AT DIFFERENT FEE RANGES



Source: NMTC Research Aggregate Dataset

FEES ACROSS PROJECT AND CDE CHARACTERISTICS

The analysis below examines how interest rates, CDE type, and QEI size correlated with the fee levels across the NMTC Program. Summit tested a variety of project-related factors, shown in Table 2, to understand if certain project or CDE characteristics

Table 2

FEES ACROSS PROJECT AND CDE CHARACTERISTICS

Attribute	Trend
Interest Rate	CDEs that satisfy the flexible products requirement by providing interest rates 50% below market (or otherwise designated percentage) tend to charge higher fees. The apparent trade-off between interest rates and fees does not affect the net cost of capital for QALICBs.
CDE Type	CDEs related to the NMTC investor charge the lowest fees, often 0%.
Multi-/Single-CDE	No statistically significant difference at the individual CDE level
QEI Size	No statistically significant difference at the individual CDE level

Source: NMTC Research Aggregate Dataset

resulted in higher fees charged to QALICBs. These trends are discussed in further detail throughout this section.

Fees by Flexible Product Criteria

The GAO report suggested low CDE fees may be offset by higher interest rates. The GAO analyzed the CDFI Fund's administrative data and found "projects with higher average interest rates were more likely to charge no fees and retentions."[24] To further analyze this finding, Summit compared CDE fees for transactions that met flexible products requirements through low interest rates with those that did not, as shown in Table 3.

Transactions with interest rates low enough to meet flexible products criteria through interest rates alone charged an average 2.6 percentage points higher fees than projects where the QLICI loans did not meet flexible interest rate requirements. However, the research shows that the effective cost of capital to the QALICB was not statistically different between the two groups, and the cost of capital was low for both.

administrative data and found that higher fees are associated with increasing transaction complexity, as measured by the number of transactions associated with a project. The CDFI Fund tasked Summit with evaluating whether increasing transaction complexity results in higher fees.

During desk reviews and site visits, CDEs noted that they often use multi-CDE financing structures to finance larger projects that may require too large a commitment from any one CDE's NMTC Allocation, such as infrastructure rehabilitation and commercial development. This is supported by the CDFI Fund's observation that administrative data on multi-CDE projects seemed to be correlated with large projects, as well as the observations from this research. Among the projects reviewed, most CDEs did not invest more than $12.5 million in any one project, and no single-CDE project was greater than $20 million. The ability of multiple CDEs to contribute parts of their Allocation to a project makes it possible for larger projects to receive financing through the NMTC Program. CDEs also expressed the view that multi-

Table 3

FEES BY INTEREST RATE

Flexible Products Satisfied by Low Interest Rate	Yes	No	Difference	P-Value[25]
Average Fees as % of QEI	9.7%	7.1%	2.6%	0.008**
Average Cost of Capital (APR)	-22.3%	-15.2%	7.1%	0.372

Source: NMTC Research Aggregate Dataset

Note: P-Value measures the statistical significance of the difference between means using tests described in Appendix B.

Fees by Multi-/Single-CDE and Project Size

The CDFI Fund hypothesized that involving more entities in a transaction could lead to higher legal and accounting fees, protracted negotiations, and more administrative costs throughout the transaction. Additionally, the 2014 GAO report[26] analyzed

CDE transactions diversify risk and help to stretch an Allocation across several impact areas.

The research considered all fees, not only those reported in CIIS, and directly measured if CDEs charge higher fees when participating in multi-CDE

Table 4

FEES BY TRANSACTION COMPLEXITY

Characteristic	Multi-CDE	Single-CDE	Difference	P-Value[27]
Observations	18	20	-	-
Average Fees as % of QEI	9.1%	8.0%	1.1%	0.797

Source: NMTC Research Aggregate Dataset

Note: P-Value measures the statistical significance of the difference between means using tests described in Appendix B.

transactions, which Summit used as an indicator of increased transaction complexity. There was no significant difference between fees charged by each CDE in multi-CDE transactions and single-CDE transactions. Summit also found that a CDE's QEI size had no effect on fees. Summit did not evaluate the total project fees as a percentage of total project QEI since fees are charged and reported by each CDE financing a project. However, Summit did evaluate third-party expenses charged for the entire project as a percentage of the total QEI invested and found no significant difference between multi- and single-CDE transactions.

Table 4 shows the average fees as a percentage of QEI among CDEs in multi-CDE transactions versus single-CDE transactions. CDEs in multi-CDE transactions did not appear to charge significantly higher fees than did those in single-CDE transactions. This observation shows that added complexity did not necessarily result in higher CDE fees charged to the QALICB. Although sample CDEs financing multi-CDE projects demonstrated slightly higher fees than in single-CDE projects, the difference is not statistically significant.

Summit also analyzed the impact of a CDE's QEI size on fees as a percent of the QEI, shown in Figure 6.

The scatterplot shows no significant correlation between the change in the fees as a percent of the QEI and a CDE's investment size.[28]

Summit also examined third-party expenses as a percent of the total project QEI and found no significant difference between third-party expenses charged in multi-CDE transactions and single-CDE transactions. While the nominal expense amount for multi-CDE projects was higher than for single-CDE projects, multi-CDE projects also tended to be larger than single-CDE projects. In general, third-party expenses as a percentage of QEI were the same for multi-CDE and single-CDE projects.

FEE REPORTING

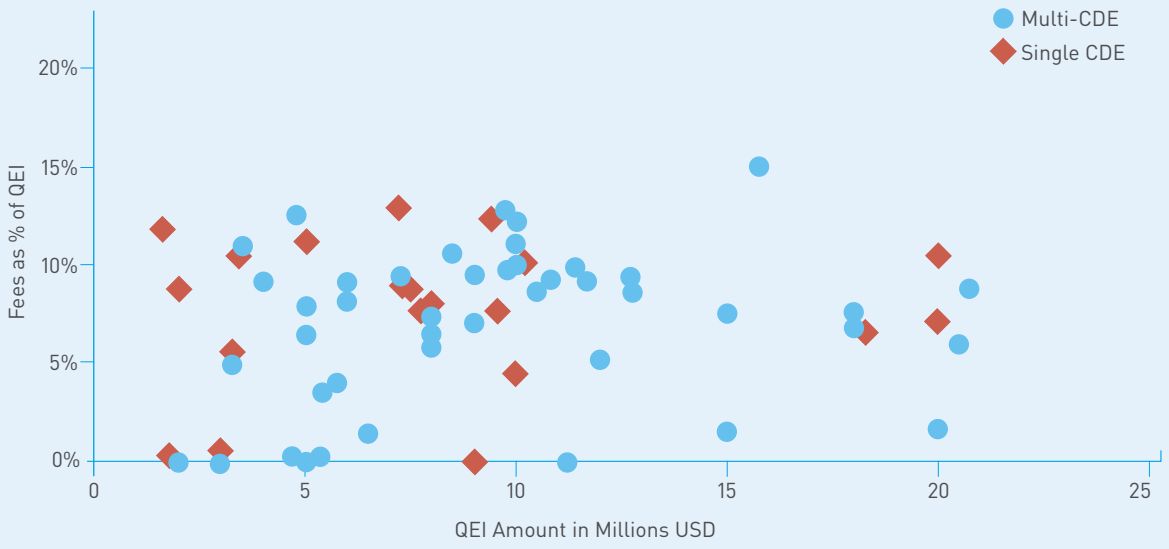
The CDFI Fund tasked Summit with identifying ways to improve the reporting of fees. Since 2011, the CDFI Fund has required CDEs to report 13 CDE fee data points on an annual basis through CIIS, based on the recommendations of the 2010 GAO report.[29] Summit compared the fees reported in CIIS to the fees documented in the desk review materials and calculated the difference between the reported fees and the documented fees as a percentage of each CDE's QEI contribution to a project.

According to the documentation CDEs provided, 25 CDEs appeared to have under-reported fees in CIIS, 21 CDEs reported within 10% of the actual fees, and 14 CDEs appeared to have over-reported fees, as Table 5 shows.

The fees in project documentation can differ from those reported to the CDFI Fund for several reasons, including definitional discrepancies. Some CDEs categorize certain payments from QALICBs as business expenses rather than fees. For example, a CDE might charge the QALICB to reimburse a consultant fee incurred outside the NMTC structure, and this expense could go unreported. CDEs often

Figure 6

FEES ACROSS QEI SIZE



Source: NMTC Research Aggregate Dataset

require the QALICB to reimburse the CDE for all third-party expenses, such as legal or accounting expenses. CDEs do not typically report these payments as fees in CIIS, but they sometimes report them in the QALICB Fee Disclosure Forms.

RECOMMENDATIONS

The investor or leverage lender may collect fees, and these are not currently reported to the CDFI Fund.

Additionally, various parties sometimes collect fees from the NMTC equity or leverage before these funds are invested as a QEI. Current reporting does not capture these pre-QEI fees, and Summit recommends adding then to ATS reporting requirements. To more accurately measure all NMTC financing costs, Summit recommends that the CDFI Fund consider requiring CDEs to report fees collected from the leverage and equity used for NMTC financing before the QEI is

Table 5

REPORTED FEES AS PERCENT OF FEES EVIDENCED IN DOCUMENTATION PROVIDED

Fee Reporting Status	Percent of Sampled Projects
Under-Reported (< 90% of actual fees)	42%
Accurately Reported (≥ 90% and ≤ 110% of actual fees)	35%
Over-Reported (> 110% of actual fees)	23%

Source: NMTC Research Aggregate Dataset

issued, as well as fees paid to the leverage lender or investor. As tasked by the CDFI Fund, Summit finds that information on third-party expenses, as described in the *QALICB Fee Disclosure Forms* section, should be collected by the CDFI Fund.

Additionally, Summit recommends that the CDFI Fund should clarify instructions for the ongoing fees fields in CIIS. Some CDEs report the amount of ongoing fees charged annually, while others report the total amount of ongoing fees to be collected over the NMTC compliance period. The CDFI Fund should clarify TLR instructions to ensure ongoing fees are reported consistently.

Recommendations

FEES REPORTING

- *Include information on third-party expenses, fees collected by the leverage lender, and fees collected by the investor*
- *Include information on pre-QEI fees*
- *Clarify whether the amount reported for ongoing fees should be cumulative over the seven-year period or the amount charged each year*

QALICB Fee Disclosure Forms

In addition to identifying reporting improvements to collect more complete fee data and expenses and clarify instructions, the CDFI Fund tasked Summit with evaluating the alignment between the QALICB Fee Disclosure Forms and the current reporting in CIIS. Since the 2012 NMTC Allocations, the CDFI Fund has required Allocatees to provide a Fee Disclosure Form to the QALICB that details all fees and expenses that are expected to be charged to QALICBs by CDEs, NMTC investors, leverage lenders, and third parties. The CDFI Fund instituted the QALICB Fee Disclosure Form to ensure that the CDE clearly identifies all costs associated with the NMTC financing to the QALICB before closing. The forms were implemented with input gathered during a listening session with the industry, the results of which the CDFI Fund also provided to Summit.

The Allocation Agreement requires CDEs to use the QALICB Fee Disclosure Form to disclose all fees and expenses paid by the QALICB during the seven-year compliance period, although most forms also include some fees not charged directly to the QALICB. For example, some ongoing fees collected by the CDEs are drawn from the interest payments made to the sub-CDEs by the QALICB on the NMTC loans. While these payments from the sub-CDE to the parent CDE are reported as fees in CIIS, they are not charged as fees to the QALICB. Therefore, the QALICB Fee Disclosure Forms are a useful way to quantify the expenses and fees charged directly to QALICBs in NMTC transactions.

The GAO has commented that because the CDFI Fund does not collect the QALICB Fee Disclosure Forms, there is no way to verify if CDEs are accurately portraying the full cost of NMTC financing to QALICBs. To help the CDFI Fund determine whether to collect these forms, Summit analyzed 17 Fee Disclosure Forms from nine different projects that collectively involved 15 CDEs to understand whether the QALICB Fee Disclosure Forms accurately reflect the fees and expenses charged to the QALICB. The relatively recent implementation of the QALICB Disclosure Form requirement limited the available sample for this analysis.

The analysis found the largest discrepancies between actual and disclosed fees appear to result from third-party expenses associated with NMTC financing. These expenses could potentially include NMTC advisory consultant, legal counsel, and accounting fees charged to the QALICB. Sometimes, CDEs do not report these fees or expenses to the CDFI Fund but do include them in the QALICB Fee Disclosure Form. Other CDEs do not disclose these fees or expenses in the QALICB Fee Disclosure Form or in CIIS.

RECOMMENDATION

Because the QALICB Fee Disclosure forms inconsistently report fees, Summit recommends that the CDFI Fund provide additional guidance on how to measure and report third-party expenses in the QALICB Fee Disclosure form. In addition, the CDFI should ensure that such data guidence and collection changes are reflected in ATS and CIIS reporting. As a cross check, the CDFI Fund should consider collecting the QALICB Fee Disclosure Form from CDEs as recommended by the GAO.

2.3 INVESTOR RETURN AND INDEMNIFICATION AGREEMENTS

OVERVIEW

Qualified Equity Investments (QEIs) into CDEs generate a federal tax credit to investors that is worth 39% of the QEI over the seven-year compliance period. NMTC investors can leverage the QEI with additional funds so that the tax credits generated by the leveraged QEI provide a positive return for the equity investor. The GAO recommended that the CDFI Fund require CDEs to report investor return and "justify rates of return above a certain threshold by explaining why this project was so risky that it required a greater-than-market rate of return."[30] However, Summit found the investor internal rate of return (IRR) for NMTC projects does not depend on project characteristics, such as the financing structure, QALICB type, distress score of the project location, or CDE type. The investor IRR appears to be driven more by a market for tax credits rather than by specific project risks and fluctuates within a small band around 9.8%.

Investors typically use indemnification agreements to mitigate the financial risk associated with a potential recapture of tax credits due to CDE or QALICB noncompliance with IRS statute requirements.[31] In these agreements, CDEs and/or QALICBs often agree to indemnify the NMTC investor in the event of NMTC recapture, sometimes for the full amount of the NMTCs generated in the transaction. These indemnification agreements, combined with the fact that the remittance of tax credits from the CDE to the NMTC investor does not depend on the success or failure of the QALICB, explain why project-specific characteristics have little influence on NMTC investor return. For this reason, developing benchmarks for investor IRR for specific project attributes does not seem necessary or prudent.

Key Findings

INVESTOR RETURN

- *Investor return depends on the market for tax credits*
- *NMTC investors generate financial return from tax credits rather than the QALICB itself*
- *NMTC investors minimize financial risk associated with noncompliance using indemnification agreements*

Table 6

INVESTOR IRR AND TAX CREDIT PRICE DESCRIPTIVE STATISTICS

Average	Median	St. Dev.	Min	Max	Observations
9.76%	9.12%	3.50%	4.03%	22.01%	53

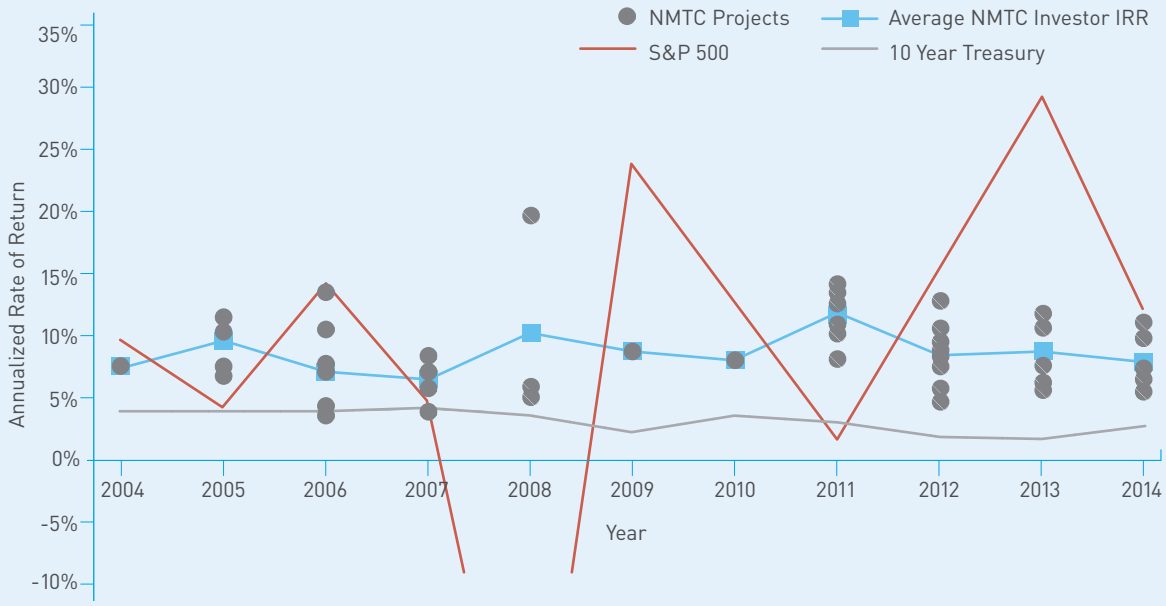
Source: NMTC Research Aggregate Dataset

RESULTS

Table 6 shows descriptive statistics for investor IRR for all projects in the desk review sample. The average investor IRR measured among the reviewed projects is 9.76%.

Figure 7

AVERAGE NMTC INVESTOR IRR OVER TIME



Source: NMTC Research Aggregate Dataset

Summit reviewed the average investor IRR by the type of NMTC financial structure used, the use of other public sources of funding, the use of one-day loans or bridge loans, and the QALICB type. This review was intended to identify any project characteristics associated with greater financial returns for the NMTC equity investors. However, Summit did not observe any differences in investor IRR across these characteristics, suggesting that project attributes did not drive the financial return to investors.

The NMTC investor IRR did not appear to depend on the QALICB type or other project-specific characteristics, and the NMTC investor IRR varied only slightly over time. As shown in Figure 7, the average NMTC investor IRR for the reviewed projects was less volatile than the S&P 500 annual return and potentially counter-cyclical.

This result suggests that there is a market for New Markets Tax Credits that fluctuates as the market at large fluctuates, although in the opposite direction and with lower volatility. While there were instances of higher and lower investor IRR in the desk review sample, Figure 7 shows the reviewed projects generally tightly cluster around the mean for any given year. These findings support the hypothesis that NMTC investors look to generate financial return from tax credits, not financial returns from the project.

INVESTOR INDEMNIFICATION AGREEMENTS

Invariably, investors require NMTC participants to execute specific indemnification agreements in which the QALICB and/or CDE indemnify the investor against the recapture of tax credits due to noncompliance. Typically, CDEs must indemnify the NMTC investor against any recapture event in the CDE's control, such as failing to deploy the QEI or no longer qualifying as a CDE. QALICBs are typically responsible for any recapture event in the QALICB's control, such as moving to a non-NMTC qualified location or performing an activity not allowed under IRS statute.

In Summit's discussions with CDEs, some noted that they negotiate the indemnification agreements to limit potential liability to the fees collected by the CDE. Some NMTC investors insist that CDEs indemnify them for the entire amount of the tax credit. Some CDEs emphasized that indemnification agreements could essentially eliminate financial risk for the investor. However, some NMTC investor-related CDEs noted that the indemnification agreements serve to ensure that CDEs take compliance with IRS statute seriously.

2.4 QALICB COST OF CAPITAL

OVERVIEW

NMTC loan interest rates do not by themselves reflect a complete picture of the terms and flexibility of the loans offered by CDEs through the NMTC Program. The financing structure used and the terms of the loan as a whole—including the interest rate, amortization period, fees, and residual equity—influence a borrower's cost of capital in the NMTC Program. Summit measured all NMTC-related cash flows into and out of QALICBs to determine the true NMTC financing cost, then analyzed which project-related characteristics affect the QALICB's cost of capital.[32]

RESULTS

Projects funded through direct loans and pooled loan funds typically fully amortize, and the cost of capital generally approximates the interest rate of the loans. However, in many NMTC financings using the leveraged A/B Note structure, the cost of the NMTC financing to the borrower is actually negative because the borrower receives residual equity at the end of the compliance period. The transfer of residual equity results in a drastic reduction in the QALICB cost of capital.

The low or negative cost of capital apparent in self-leveraged transactions can obscure the true cost of financing to the QALICB. When transactions are self-leveraged, a QALICB-affiliate originates the leveraged loan to the NMTC structure at below-market interest rates. However, the QALICB affiliate sometimes uses third-party loans to source the financing for the self-leveraged loan, and these third-party loans are often at or near market rates. The use of the outside funds to finance self-leverage to the NMTC financing structure results in additional equity to the project and a reduction of the true cost of capital. However, without information on the cost of the financing used to source the self-leverage, the true cost of capital for the QALICB proves difficult to measure. The true cost of capital to the QALICB would be higher than the interest rate indicates, but it is not possible to ascertain to what extent since these funds are not part of the NMTC financing structure.

Key Findings

COST OF CAPITAL

- *In projects financed through direct loans or loan funds, the cost of capital generally approximates the interest rate of the loans.*
- *Leveraged A/B Note transactions that transfer residual equity to QALICBs greatly reduce the cost of capital.*
- *If self-leveraged funds are originally financed through market-rate third-party loans, the low NMTC interest rates do not reflect the QALICB's true cost of capital. The true cost of capital to the QALICB is higher than the interest rate indicates, but it is not possible to ascertain to what extent because these funds are not part of the financing structure.*

Section 3: Degree of Public Investment in NMTC Transactions

Low-income communities face significant barriers in attracting private investment, and public incentives can help overcome these barriers. Investment in low-income communities can spur job creation, business development, new community services and amenities, real estate rehabilitation, new construction, and an increase in the local tax base.[33] However, the exact amount of public investment necessary to attract private capital is often difficult to pinpoint.

This report is the first to provide a quantitative method for systematically measuring the depth of public investment in NMTC transactions. Based on QALICB surveys, the Urban Institute's report concluded that the NMTC financing represented full substitution of private investment in 30% of NMTC projects.[34] The Urban Institute describes full substitution as an instance when an NMTC investment substitutes completely for other funds that could have been used to produce a project, at about the same time and/or in about the same location. Based on surveys of CDEs and QALICBs, the GAO report raised questions about potential unnecessary duplication of government programs in NMTC-funded projects.

3.1 TWO QUANTITATIVE METHODS

To better understand these topics, the CDFI Fund requested that Summit develop a quantitative approach for measuring the depth of public funding in NMTC transactions and analyze how this is influenced by different project characteristics, such as community distress of project location and financing structure.

The two quantitative methods Summit developed to examine these issues consider the amount of public funding that a project receives, evaluates that amount relative to expectations, and situates the difference between actual public funding amounts and expected public funding amounts on a spectrum. These expectations are derived from the stated financing gap or net operating income and project costs. Projects past certain thresholds are flagged for further analysis to determine why the project received more public funding. The thresholds chosen are somewhat arbitrary but serve to identify projects that might warrant further review, allowing for a buffer around benchmarks. For the purposes of this report, Summit considered all tax credits and government grants associated with the NMTC project to be public funding, and did not consider government loans to be public funding.[35] See Appendix C for a full list of other public funding sources observed in the sample.

The two methods Summit developed are briefly described below, and Appendix B includes a full explanation of the methodologies and sources of industry benchmarks.

Method 1: Capitalization Rate Method. This method compares the implied capitalization rate of a project to the benchmark for its industry, derived using methods described in *Appendix B*. The analysis flags projects for further review to understand the role of public funding in the project if the implied capitalization rate is three percentage points greater than the relevant industry benchmark. A negative implied capitalization rate indicates the project received less public funding than required to bring capitalization rates to the industry benchmark.

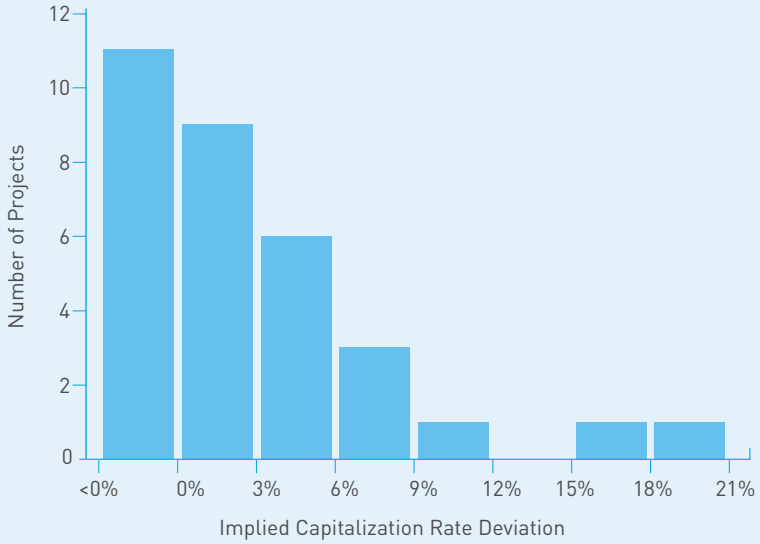
Method 2: Financing Gap Method. This method measures the percent of the total public funding above the stated financing gap, where 0% means the public funding is equal to or less than the financing gap. A value of 100% means the project had no financing gap and therefore all the public funding was above the financing gap. If 15% or more of the public funding exceeds the financing gap, the analysis flags the project for further review to fully understand its specific circumstances.

Both methods show that close to two-thirds of sampled projects have capitalization rates close to industry benchmarks or public funding amounts commensurate with identified funding gaps. The analysis flagged the remaining one-third of projects for further review to understand the role of public funding in the transaction.

This analysis provides the CDFI Fund with a useful tool for measuring the depth of public funding in NMTC transactions and allows the NMTC Program to develop additional guidance and/or compliance requirements that ensure CDEs provide the amount of public funding necessary for a project's success. However, understanding the reasons projects receive public funding that pushes the corresponding metrics above the benchmark capitalization rate or identified financing gap often requires further quantitative and qualitative analysis of projects.

Figure 8

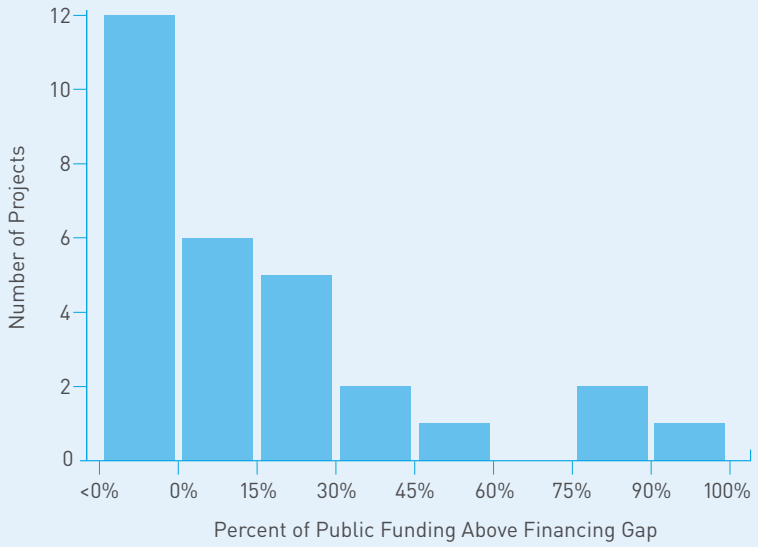
DISTRIBUTION OF IMPLIED CAPITALIZATION RATE DEVIATION IN THE SAMPLE



Source: Aggregate Dataset from NMTC Desk Reviews

Figure 9

DISTRIBUTION OF PERCENT OF PUBLIC FUNDING ABOVE FINANCING GAP



Source: Aggregate Dataset from NMTC Desk Reviews

3.2 OVERALL RESULTS

This section presents the overall findings of the analysis.

Figure 8 shows the results of the *Capitalization Rate Method*. Of the 32 projects analyzed, 20 projects, or 62%, had capitalization rates below the 3% threshold. The average capitalization rate deviation was 2.2%, and the median was 0.9%, showing that projects tend to fall near the industry benchmarks.

Figure 9 shows the results of the *Financing Gap Method*. Similar to the results of the *Capitalization Rate Method*, the results of the *Financing Gap Method* show that for 18

of the 29 projects analyzed, or 62%, the public funding received was below or close to the identified financing gap. The average percent of public funding above the financing gap was 19%, and the median was 7%.

Once a project is flagged for further review, it is necessary to examine the specific needs and other sources of financing available to the project. This examination helps explain why the project received a greater level of public funding and if the amount received was necessary.

Upon closer review, four themes explained why projects received greater-than-expected public funding:

- **A project located in a highly distressed census tract may need more public funding to attract private investment.** For example, one project flagged by the quantitative analysis is a primary and specialty healthcare facility that served as anchor tenant in a development project in a highly distressed urban community. For details regarding the relationship between distress scores and implied capitalization rate deviations on aggregate, see Appendix C.
- **Additional public funding enhances community benefits.** Two projects in rural areas received both state and federal NMTCs, resulting in higher-than-expected public funding amounts according to the quantitative analysis. Both projects used the additional funding to establish community loan funds for small businesses in the areas, which provided additional community benefits not possible without the additional public funding.
- **Financing Gap Method flags additional public funding used for project operating costs.** Sometimes the funding that is greater than the initial project costs goes toward ongoing operating expenses in the initial years after project completion. This was observed more frequently for non-profits, including one community theater. *The Implied Capitalization Rate Method* considers net operating income post-completion.
- **Some projects potentially received more public investment than appears was needed.** The NMTC Program relies on CDEs to select projects that enrich their communities and depend on the NMTC funding for success. From the QALICB's perspective, if a project relies on public funds, it will apply for multiple sources of public funding at once, not knowing which it will receive. The process of attempting to make use of all available sources of public funding to complete a project may result in the project receiving more public funding than initially needed. Additionally, some states offer additional subsidies to attract federal NMTC funding to their state.

3.3 RECOMMENDATIONS

Many CDEs have a strong "but-for" analysis included in their project selection process, meaning that the CDE selects projects with clear evidence that the projects would not succeed *but for* the federal NMTC financing. An example of a best practice template for the "but-for" analysis is included in Section 4: CDE Best Practices. Summit recommends that the CDFI Fund should consider developing guidance to ensure that CDEs incorporate this analysis in project selection and financing. The CDFI Fund also should consider the merits of creating a tool that is based on the analyses described in this report and would allow CDEs to input project details and to receive quantitative feedback regarding the appropriate level of public funding, including New Markets Tax Credits, for the project.

Recommendations

BUT-FOR ANALYSIS

- *Consider elevating the "but-for" analysis to a compliance requirement.*
- *Provide tools for CDEs to quantitatively conduct the "but-for" analysis.*
- *Consider conducting further research on the relationship between distress and depth of public funding*

Summit also examined several project-related factors that might influence the degree of public funding in NMTC transactions, including:

- The financial structure of these transactions
- The distress score of the community
- The non-profit status of the QALICB
- CDFI involvement in the transaction (as parent to the CDE, etc.)

The only factor resulting in a statistically significant difference in the degree of public funding is the financial structure, which is detailed below. The analysis also suggests a substantial difference for sampled projects when state NMTCs are combined with federal NMTCs, or when public funding is used to finance the leverage loan. However, the sample size for each of these is too small to extrapolate to all NMTC projects. The analysis shows that a relationship may exist between the distress score of a project's location and its level of public funding, but the results are inconclusive. Summit also recommends that the CDFI Fund consider conducting further research on the relationship between distress and depth of public funding. This analysis would require the CDFI Fund to collect additional data from CDEs on projects' net operating income and projects' financing gaps.

3.4 FINANCIAL STRUCTURE OF NMTC TRANSACTIONS

The IRS approved the leveraged financing structure for NMTC projects in Ruling 2003-20, which has since allowed CDEs to use the self-leverage structure to finance NMTC transactions. Summit's analysis shows that self-leveraged projects are more likely to be above the identified thresholds using the two methods than projects that are not self-leveraged.[36,37] Since the two quantitative analyses come to the same conclusion, this section only presents the results of the *Financing Gap Method*. *Appendix C* shows the results of the *Capitalization Rate Method*.

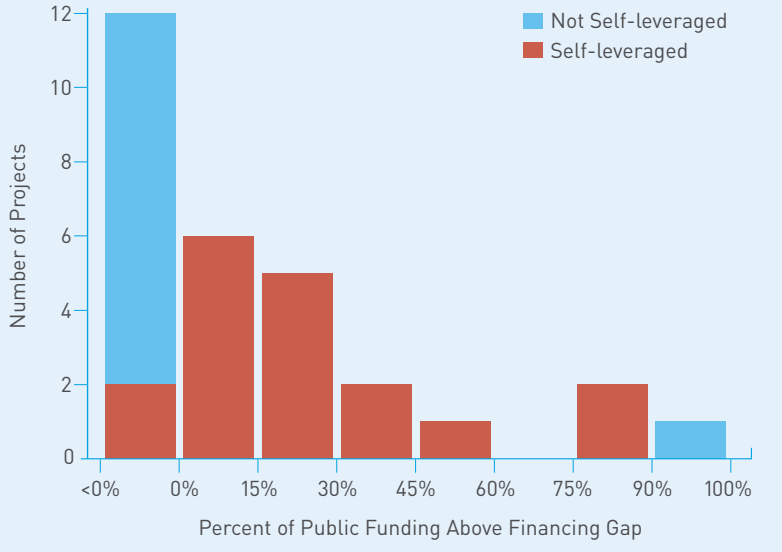
Figure 10 shows the results of the *Financing Gap Method*, color-coded by the leverage source. The distribution shows that self-leveraged projects are more likely to receive public funding exceeding the identified financing gap than projects that are not self-leveraged. All but one of the projects in the sample that received public funding greater than the identified financing gap were self-leveraged.

Table 7 shows the results of the *Financing Gap Method* by financing structure.

Of the 18 self-leveraged projects where the analysis was possible, 10 projects (56%) received public funding that is more than 15% above the identified financing

Figure 10

DISTRIBUTION OF PERCENT OF PUBLIC FUNDING ABOVE FINANCING GAP BY SOURCE OF LEVERAGE



Source: Aggregate Dataset from NMTC Desk Reviews

Table 7

FINANCING GAP ANALYSIS BY LEVERAGE CATEGORIZATION

Characteristic	Self-Leveraged	Not Self-Leveraged	Difference	P-Value[38]
Observations	18	11	-	-
Percent of Projects with Public Funding Greater than 15% above Financing Gap	55.56%	9.09%	46.47%	0.019**
Average Public Funding Above Financing Gap	25.13%	9.09%	16.04%	0.005**

Source: Aggregate Dataset from NMTC Desk Reviews

Note: P-Value measures the statistical significance of the difference between means using tests described in Appendix B.

Key Findings

SELF-LEVERAGE MERITS FURTHER REVIEW

Both methods suggest that self-leveraged projects are more likely to receive higher-than-expected rates of public funding than projects that do not use self-leverage. All projects with the QALICB as the only source of leverage received more public funding than the financing gap.

Eliminating self-leverage could have significant effects on the types of projects financed through the NMTC Program. Several CDEs stated that many non-profits would be unable to participate in the NMTC Program without the ability to leverage existing grant funds to generate NMTC equity. That said, Summit did not find a relationship between non-profit status and the degree of public funding for NMTC projects.

gap, compared with only one of nine projects financed through other financial structures (9%).[39] All projects with the QALICB as the only source of leverage received more public funding than the financing gap.[40] Approximately half of these projects are within the 15% threshold and were not flagged for further review.

These findings suggest that self-leveraged projects are more likely to receive higher rates of public funding than projects that do not use self-leverage. These results are not surprising given the nature of the self-leverage financing structure. In a third-party-leveraged structure, the QALICB accesses additional capital in the form of both investor equity and third-party debt. In the self-leveraged structure, the project uses existing funds available to attract additional equity from the NMTC investor.[41]

In leveraged A/B Note transactions, the NMTC investor purchases the tax credits at a discount, investing less equity than the total tax credits received. When the NMTCs are used to attract only equity, as they are in the self-leveraged structure, rather than both equity and new debt, the financing gap for the project is often very close to the amount of equity provided. Because the equity provided is less than the amount of tax credits received by the NMTC investor, these self-leveraged transactions result in a public funding amount greater than the financing gap.

Approximately half the projects in the sample employ the self-leveraged financing structure. Any

consideration of limiting the use of self-leverage should be viewed cautiously, as eliminating self-leverage could have significant effects on the types of projects financed through the NMTC Program. For example, several CDEs stated that many non-profits would be unable to receive NMTC financing without the ability to leverage existing grant funds to generate NMTC equity. That said, Summit did not find a relationship between non-profit status and the degree of public funding for NMTC projects.

These findings indicate the self-leveraged financing structure merits further evaluation. Summit recommends that the U.S. Department of the Treasury should consider analyzing the effect of self-leverage on the degree of public financing in NMTC projects as well as the benefits to low-income communities this financing structure uniquely affords.

3.5 ROLE OF OTHER PUBLIC FUNDING

QALICBs serving distressed communities often face financing gaps that make it difficult to complete projects, and they may seek multiple sources of public funding at once. Often, the needs of the business, the distress of the communities, and the process of financing result in the combination of NMTCs with other subsidies. The GAO noted that NMTC projects frequently receive multiple sources of public funding and asked whether this represented unnecessary duplication of government funds. The other public sources of funds that the GAO most frequently observed being paired with federal NMTCs were state new markets tax credits and state historic tax credits. The CDFI Fund asked Summit to further research the pairing of federal NMTCs with other sources of public funding. This section describes the ways that CDEs and QALICBs combine public funds with NMTC financing and the effect on the depth of public funding in these transactions.

The analysis shows that employing other forms of public funding in conjunction with NMTC does not necessarily lead to a greater likelihood that projects will fall above the quantitative thresholds in the quantitative analysis. However, projects are more likely to fall above selected thresholds if they use other sources of public funding to leverage the NMTC financing.

Key Findings

USE OF OTHER PUBLIC FUNDING

Projects that use other, non-NMTC public funding to fund leverage in the NMTC financing structure receive higher rates of public funding.

Table 8

FREQUENCY OF USE OF PUBLIC FUNDING AND PUBLIC FUNDING USED AS LEVERAGE IN SAMPLE

Project Category	Number of Projects	Percent of Projects
Project receives no other public funding	27	50.94%
Project receives other public funding	26	49.06%
Non-NMTC public funding used as leverage	*12*	*22.64%*
Non-NMTC public funding not used as leverage	*14*	*26.42%*

Source: Aggregate Dataset from NMTC Desk Reviews.
Note: This table includes all sampled projects, while the projects included below are limited to those where the analysis was possible.

Approximately half the reviewed projects received additional public funding (besides NMTC) to reach financing goals. Of those that received additional public funds, approximately half used a financing structure where the additional public funds finance the leverage.

MECHANICS OF COMBINING NMTC WITH OTHER FORMS OF PUBLIC FUNDING

Other forms of public funding typically enter the NMTC financing structure in one of two ways. One option is for the other public funding to leverage the QEI; the other is for the QALICB to receive the public funding directly. Appendix D shows a generalized diagram of an NMTC transaction structure with the two ways non-NMTC public funding enters the financing structure.

Approximately half the reviewed projects receive other public funding in addition to NMTC. Of those that receive additional public funding, approximately half use a financing structure in which the other public funding finances the leverage. Table 8 shows the frequency of each category in the sample.

Most projects that use other forms of public funding as leverage are also self-leveraged. In these instances, the QALICB receives some form of non-NMTC public funding and then uses the proceeds to leverage the QEI. Also, if a project qualifies for state-level NMTCs, the state tax credits can be used to generate funding used as leverage for the federal QEI.

RESULTS

The analysis does not flag projects that receive multiple forms of public funding more frequently than projects that only receive federal NMTCs.[42] However, both quantitative methods show that projects that leverage the QEI using other public funds are more likely be flagged for further review.[43] Table 9 shows a summary of these results, further discussed below.

The *Capitalization Rate Method* shows that sampled projects that receive other public funding have higher capitalization rate deviations than those that do not receive other public funding. However, the *Financing Gap Method* shows that there is effectively no difference between projects that receive other public funding and those that do not.

Table 9

SUMMARY RESULTS BY USE OF OTHER PUBLIC FUNDING

Project Category	Percent of Projects Flagged for Further Investigation	
	Capitalization Rate Method	Financing Gap Method
Project receives no other public funding	26.7%	38.5%
Project receives other public funding	47.1%	37.5%
Public funding used as leverage	*62.5%*	*50.0%*
Public funding not used as leverage	*33.3%*	*16.7%*

Source: Aggregate Dataset from NMTC Desk Reviews.

While the use of public funding alone does not appear to result in higher rates of public funding, the use of additional public funding as leverage appears to have an effect. Both methods suggest that projects that use other public funding as leverage are more likely to have implied capitalization rates higher than industry benchmarks than projects that do not leverage the QEI using other public funds. Although this difference cannot be extrapolated to all NMTC projects due to the small sample size, the large difference suggests a potential underlying relationship between using other public funding as leverage and the depth of public funding for the transaction.

Five of the 10 projects leveraged with other public funding received total public funding amounts greater than 15% above the project's financing gap. Only one of the six projects that received direct public funding (17%) and five of the 13 projects that received no other public funding (39%) had total public funding amounts greater than 15% above the project's financing gap.

Recommendation

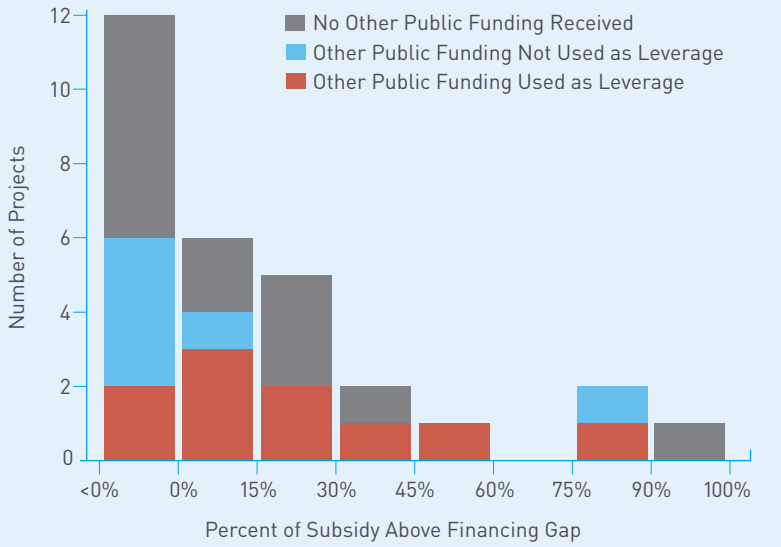
THE USE OF OTHER PUBLIC FUNDING AS LEVERAGE MERITS FURTHER REVIEW

Both methods suggest that projects where other subsidies are used to fund the leverage loan are more likely to receive higher-than-expected rates of public funding than other projects. Due to the small sample size, this difference is not statistically significant.

This finding merits further evaluation by the U.S. Department of the Treasury.

Figure 11

PERCENT OF PUBLIC FUNDING ABOVE FINANCING GAP BY USE OF OTHER PUBLIC FUNDING



Source: Aggregate Dataset from NMTC Desk Reviews

Figure 11 displays the results of the Financing Gap Method, and Appendix C shows additional figures and tables for both methods for this analysis.

RECOMMENDATIONS

Both methods suggest that projects where other public funding enters the NMTC financing structure as leverage are more likely to fall above the identified thresholds. Due to the small sample size, these findings are not statistically significant; however, these findings indicate the use of other public subsidies to leverage NMTC transactions merits further evaluation by the U.S. Department of the Treasury.

Table 10

RESULTS FOR PROJECTS THAT RECEIVED STATE NMTC

Project ID	State	Financial Structure	Capitalization Rate Deviation*	Percent of Public Funding above Financing Gap*
1	AR	Self-leverage	18.7%	79.6%
2	FL	Self-leverage	5.7%	N/A
3	LA	Pooled Loan Fund	N/A	N/A
4	LA	Pooled Loan Fund	3.3%	0.0%
5	MS	Self-leverage	8.2%	15.5%
6	OR	Self-leverage	N/A	49.9%
7	OR	Leveraged A/B Note	4.2%	0.0%

Source: Aggregate Dataset from NMTC Desk Reviews
Note: Projects are flagged for further examination if the Capitalization Rate Deviation > 3% or if more than 15% of the public funding provided is above the identified financing gap. Summit was unable to perform the corresponding analysis for projects listed as N/A due to lack of information.

Recommendation

THE COMBINATION OF STATE AND FEDERAL NMTCS WARRANTS FURTHER REVIEW

- *All reviewed projects that use both state and federal NMTCs received public funding amounts above the threshold for at least one analysis.*
- *The sample size is too small to extrapolate; this finding merits further evaluation by the U.S. Department of the Treasury.*

STATE NMTC

The desk review sample contained seven NMTC projects also involving state NMTCs. Table 10 shows the financial structures and results of the quantitative analysis for these projects.

These results show that each project in the sample that uses state and federal NMTC[44] fall above the thresholds for at least one analytical method. The sample of projects receiving state NMTCs is too small to draw any broad conclusions. However, the analysis suggests that projects that receive state NMTCs are more likely to be flagged for further review than projects that do not receive state NMTCs. Summit recommends that he U.S. Department of the Treasury consider further review and guidance for combining both state and federal NMTCs for the same project.

Section 4: CDE Best Practices

The success of the NMTC Program rests largely on CDEs' ability to source worthwhile projects that both genuinely need public funding and demonstrate a high potential for community impact. To better understand the criteria used by CDEs to select NMTC projects and monitor the investments, Summit completed the following tasks:

- Reviewed CDE policies and procedures
- Evaluated the project narratives provided by the sampled CDEs
- Examined the meeting minutes of CDE's advisory boards
- Discussed operations and best practices with Allocatees in follow-up phone conferences
- Visited several Allocatees on-site

These materials and discussions revealed how CDEs source projects, conduct a "but-for" analysis, and consider potential for community impact when deciding which projects should receive NMTC financing.

In reviewing each CDE's policies and procedures, speaking with CDEs, and performing site visits, Summit observed several best practices regarding loan policies and procedures, project selection, and the "but-for" analysis that ensure that selected projects align with the spirit of the NMTC Program. The following section highlights these best practices.

4.1 CDE POLICIES AND PROCEDURES

In addition to sound project selection procedures, CDEs need strong loan policies and procedures to manage the loans. Effective CDE policies and procedures observed during desk reviews included the following elements:

- Initial project selection. Initial project selection involves having clear criteria that includes mission-related factors, compliance with Allocation Agreement requirements, and descriptions of staff and advisory board member involvement at specific stages of the process.
- **Underwriting/credit approval.** Underwriting/credit approval includes specific underwriting criteria, risk rating definitions and tools, and all the necessary processes for carrying out the underwriting, including which staff members are involved at which stages.
- **Loan origination, closing, and loan documentation.** This documentation outlines the process for loan origination and closing, including which documents are required to close a transaction, how the documents are stored, and which staff member is responsible for this process.
- **NMTC compliance and CDFI Fund reporting procedures.** Compliance and reporting guidance details the CDE's procedures for evaluating compliance, including sources for market interest rates and market loan terms. This guidance outlines the process for managing Allocation-level compliance topics and procedures for identifying and rectifying any potential compliance issues. Reporting guidance covers the CDE's procedures for Transaction Level Reporting and Institutional Level reporting to the CDFI Fund.
- **Portfolio monitoring/asset management.** Portfolio monitoring/asset management guidance defines the CDE's portfolio monitoring practices, including how frequently the portfolio is reviewed, how ratings are updated, which events or ratings trigger review by the advisory board, and what the CDE's policies and procedures are surrounding default.
- **Internal controls.** Internal controls explain the CDE's accounting practices, including the staff members who are responsible for each parts of the process, the review and approval procedures, and any relevant trainings required to operate the accounting systems.

4.2 PROJECT SELECTION

Strong project selection criteria include the following components:

- **Strong "but-for" analysis.** The CDE performs an analysis to determine if the project would not have occurred in the same place, time, and scope "but-for" the NMTC subsidy. Such analysis is quantitative where possible but is also flexible enough to account for the different types of QALICBs.
- **Community benefits consideration.** The CDE quantitatively and qualitatively measures the potential community benefits of a project for comparison against other pipeline projects and considers these benefits when scoring potential projects for investment. The CDE documents clear community support for the project, either with a letter from a local government official or other entity representative of the local community.
- **Advisory board involvement.** The advisory board is heavily involved both with the community they represent and the selection of projects. The advisory board has the authority to approve or reject projects. In the case of pooled loan funds, which finance more projects with smaller loan amounts, it may not be feasible for the advisory board to offer an opinion on every single project. In these instances, the advisory board has a significant role in setting the objectives and project selection criteria for the pooled loan fund.

Recommendation

BUT-FOR ANALYSIS

- *Consider elevating the "but-for" analysis to a compliance requirement.*
- *Provide tools for CDEs to quantitatively conduct the "but-for" analysis.*

Further details regarding best practices for the "but-for" analysis and community benefits are provided below.

4.3 "BUT-FOR" ANALYSIS

An effective approach to the "but-for" analysis both identifies a specific project's financing need and allows for flexibility for different types of QALICBs. Many different types of businesses and projects receive funding through the NMTC Program, and the evaluation of need for financing is just as varied. Due to the diversity of projects and communities served by NMTC financing, CDEs could consider approaches that allow flexibility across different investment types. In general, CDEs should look for a demonstrated financing gap that other financing sources cannot feasibly fill. For example, a QALICB that wants to provide a community center in an underserved, low-income community may not be able to support market-rate debt, evidenced by an insufficient projected debt-service coverage ratio. Another QALICB may be able to receive mezzanine debt from the market, but the cost would be so high that they would not be able to support the projected community benefits.

CDE approaches to the "but-for" analysis vary widely across the NMTC industry, but CDEs that exhibited best practices in conducting the "but-for" analysis almost always included the following components:

- Project development cost documentation
- Clear documentation evidencing the existence of a financing gap to meet project costs
  - Documentation from the QALICB of the market rates and terms available and how the project's impact would be materially affected by using market financing
  - Pro-forma financial statements reflecting total financing needs
  - An analysis of the pro-forma to determine whether the flexible NMTC financing offered by the CDE is necessary for the QALICB to operate successfully during and beyond the compliance period

  - Schedule of public and private financing available to the QALICB
  - Documentation of any outstanding debt
  - Confirmation and documentation from the QALICB attesting its inability to obtain or qualify for adequate financing from market rate lenders
- The incremental financing to the QALICB that the tax credits generate
  - This information is most important in self-leveraged structures where the actual accretive value of the NMTC financing may be small compared with the overall NMTC financing

The CDFI Fund does not require CDEs to demonstrate the "but-for" analysis for NMTC compliance. However, many CDEs have implemented policies and procedures to quantitatively and qualitatively test the necessity of the NMTC subsidy to the success of the project. Other CDEs place less emphasis on the "but-for" test, opting to focus more on compliance aspects alone, such as project location. Summit recommends that the CDFI Fund should consider issuing additional guidance and tools for performing the "but-for" test, as well as consider the merits of elevating the "but-for" analysis to a mandatory compliance requirement. The aspects above provide an initial list of components to serve as a foundation for such a requirement.

Template For Conducting The "But-For" Analysis

Problem Statement.
Information on what community-level problem or issue the project will help resolve, including why the project needs NMTC financing instead of other potential sources of funding, including grants, loans, and equity investments.

Project Costs.
Clear documentation that provides evidence of the total project costs.

Additional Financing Received.
A list of all public and private financing secured by or available to the QALICB.

Gap in Financing.
Based on the project costs and available sources of financing, show how much additional funding the project needs to complete the project. How much of the NMTC subsidy goes to the QALICB to close this funding gap?

Evidence of Need for Gap Financing. *Evidence could include a rejection letter from a bank or other reasonable evidence that other funding sources cannot fill the financing gap while achieving the same community benefits.*

Use of NMTC Proceeds.
A summary of how the project will use the NMTC proceeds, including a sources and uses table.

TEMPLATE FOR CONDUCTING THE "BUT-FOR" ANALYSIS

Above all else, any analysis should answer the question: *Would this project have continued and succeeded in providing the projected community benefits without NMTC financing?* The template on the previous page serves as high-level guidance for conducting the "but-for" analysis. There is no one-size-fits-all approach for evaluating and confirming a project's need for NMTC financing. Therefore, this framework is limited to the common elements that an effective "but-for" analysis includes.

COMMUNITY BENEFITS BEST PRACTICES

To help gain a better understanding of community impact, many CDEs, with the help and guidance of their advisory boards, designed impact scoring systems that quantify several measures of positive community impacts and weight them by perceived importance. Typically, CDEs require prospective borrowers to complete written responses about the potential community benefits of the project. CDE staff members then translate those responses into scores based on their proprietary impact measurement tool.

These systems for scoring impact establish benchmarks for individual categories such as community support, LIC distress level, job creation, and targeted impacts. Each section includes a variety of independently scored factors. For example, one CDE's impact matrix tracks targeted impacts by accounting for minority ownership, environmental benefits, minority hiring practices, and LIC resident services, such as options for healthy food or medical services. Another CDE created a structured definition and benchmark requirements for "quality jobs" provided by the QALICB that must meet the following criteria:

- Be full-time (40 hours)
- Provides employee wages that are greater than the average salary for a similar job in the region
- Provides medical benefits
- Offers a retirement plan
- Offers a profit sharing/stock ownership
- Offers advanced educations, skills, and/or technical training
- Provides opportunities for further career advancement

CDEs primarily develop these structures for internal use during the project selection process. However, they often leverage the results of community impacts from prior NMTC Awards externally, specifically in future NMTC Award Applications to the CDFI Fund. These metrics confirm an active history of involvement in impactful projects and dedication to the NMTC Program mission.

Best practices in community impact analyses focus on quantifying commonly overlooked factors and deepening the analysis on existing data points. For example, few CDEs examine job creation as a singular value. Instead, they also consider job permanence, accessibility, and quality. Other CDEs include environmental and cultural aspects of prospective projects in the analysis, thereby giving CDEs, advisory boards, and the CDFI Fund a comprehensive understanding of the potential investment impacts.

Conclusion

Current industry practices are largely aligned with the NMTC Program's objectives. The success of the NMTC Program rests largely on the ability of CDEs to source worthwhile projects that both genuinely need public financing and demonstrate a high potential for community impact. Additional reporting enhancements from the CDFI Fund in these areas could further encourage CDEs to implement these best practices as policy.

CDEs that receive New Markets Tax Credit Allocations use a variety of financing structures and instruments to provide flexible financing in some of the nation's most distressed communities. Most of these projects would not be possible without the NMTCs.

The projects reviewed and CDEs visited showed no instances of noncompliance. The research also found that many CDEs go beyond the compliance requirements, with most providing capital that is more flexible than required by the Allocation Agreement and investing in communities that are more highly distressed than mandated by statute.

In addition, the CDFI Fund requested that Summit evaluate the strength of current reporting and recommend areas for improvement. The desk reviews demonstrated varying industry practices to comply with the flexible products requirement of the Allocation Agreement. Summit recommends that the CDFI Fund should issue further guidance in areas described in this report to ensure consistency in reporting and a clearer understanding of the distribution of benefits derived from the tax credit. Summit also identified several areas where additional data could be helpful, and most recommendations involve adjusting reporting to accommodate different financing structures used by CDEs to finance projects. Collecting this additional information would ensure CDE alignment with the program's objectives and ensure that the benefits to low-income communities are measured accurately and systematically.

The CDFI Fund also requested that Summit quantitatively evaluate the depth of public funding in NMTC transactions. Summit developed two new methods for conducting this analysis, which the CDFI Fund and other researchers can use in the future to evaluate projects. Both methods show a range of public funding used in NMTC transactions, with two-thirds of projects having implied capitalization rates close to industry benchmarks and amounts of public funding close to identified financing gaps. Self-leveraged projects, projects that use other subsidies to finance the leverage, and projects that combine state and federal NMTCs appear more likely to receive higher-than-expected levels of public funding. Summit believes that each of these topics merits further evaluation by the U.S. Department of the Treasury.

Lastly, many CDEs demonstrate a deep commitment to quantitatively analyzing a project's need for public funding and the potential for community benefits. Because the CDFI Fund relies on CDEs to evaluate a project's need for public funds, Summit recommends that the CDFI Fund consider the merits of elevating the "but-for" analysis to a compliance requirement and providing tools to help CDEs to execute this analysis rigorously and quantitatively.

Community investments facilitated by NMTCs are largely aligned with the NMTC Program's objectives, and reporting improvements and additional research could increase the ability to better promote measure these positive programmatic outcomes.

ENDNOTES

1 "Service Area" refers to the geographic area encompassing Low-Income Communities in which the Allocatee is authorized to make Qualified Low-Income Community Investments using the proceeds of Qualified Equity Investments.

2 Summit defined the sampling methodology and drew a stratified random sample of 53 projects from more than 4,500 projects closed since the NMTC Program's inception.

3 White, James R. et al. *New Markets Tax Credit: Better Controls and Data Are Needed to Ensure Effectiveness.* GAO 14-500. Washington, DC: United States Government Accountability Office, 2014.

4 Urban Institute. *New Markets Tax Credit (NMTC) Program Evaluation: Final Report, a report prepared for U.S. Department of the Treasury, Community Development Financial Institutions (CDFI) Fund.* April 2013.

5 CDE fees refers to revenue collected by the CDE from the QALICB or within the NMTC financing structure.

6 Investments can also be located in a census tract that does not meet the Low-Income Community requirement if the entity serves a Targeted Population. An entity qualifies as a QALICB by Targeted Populations if located in a census tract not exceeding 120% of the area median family income and is at least 50% owned by low-income persons, at least 50% of its gross income is derived from low-income persons, or at last 40% of its employees are low-income persons.

7 This list is from the 2015–2016 NMTC Program General Allocation Terms and Conditions.

8 See Appendix A for details on financing structures typically used.

9 Sometimes this leverage is also provided at below-market rates to the NMTC structure, but there is no legal obligation for the leverage lender to provide below-market rates in these transactions. Further, the CDE may have no ability to control the pricing of the leverage lender.

10 The greater of either the state or metropolitan area is used.

11 Investments can also be located in a census tract that does not meet this definition if invested in an entity that serves a Targeted Population. An entity qualifies as a QALICB by Targeted Populations if it is located in a census tract not exceeding 120% of the area median family income and is 50% owned by low-income persons, 50% of its gross income is derived from low-income persons, or 40% of its employees are low-income persons.

12 The necessary data was available on the census-tract level starting with the 2010 American Community Survey, so this analysis only includes transactions closed 2010-2014.

13 For the current NMTC Program factors for determining Severe Distress, see Part II, Community Outcomes section of the FY2017 NMTC Application, question 24, targeting the use of QLICIs: https://www.cdfifund.gov/Documents/2017%20NMTC%20Allocation%20Application%20-%20For%20Public%20Release_May24.pdf

14 Medians for census tracts where NMTC investments occurred, weighted by the original amount of the investment. These numbers exclude transactions for targeted populations, since those transactions qualify for NMTC on a basis other than economic distress of the location. If a transaction had multiple addresses, the original amount of the loan/investment was divided across all associated addresses.

15 Urban Institute. *New Markets Tax Credit (NMTC) Program Evaluation: Final Report, a report prepared for U.S. Department of the Treasury, Community Development Financial Institutions (CDFI) Fund.* April 2013.

16 White, James R. et al.

17 The put payment is typically a nominal amount paid by QALICBs or CDEs in exchange for the investor's equity in the investment fund.

18 Summit did not review any projects that have reported residual equity to the CDFI Fund through the QEI Close-Out Report because of the recent deployment of the report and a lack of available data.

19 "The CDE may make two loans into the QALICB: an A-note in the amount of the leverage lender's debt contribution to the Investment Fund, and a B-note at below-market rates equal to the amount of the equity investor's contribution less any fees retained by the CDE." Typically the A note is a loan and the B note may include a residual left behind as equity for the business financed by the NMTC project. U.S. Office of the Comptroller of the Currency, Community Development Insights. "New Markets Tax Credits: Unlocking Investment Potential". June 2013.

20 White, James et al.

21 *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified.* GAO 10-334. Washington, DC: United States Government Accountability Office, 2010.

22 Summit conducted the analysis at the CDE-project level. Loan funds were excluded from this analysis because fees attributable to the project level were almost always unavailable in the desk review materials. Averages are weighted across CDE-level project investments by QEI amount.

23 Although this amount is greater than 15%, it does not trigger a compliance concern on the basis of the "substantially all" test because most of these fees were invested in the QALICB as QLICIs and collected over the course of the seven-year compliance period as ongoing fees.

24 White, James R. et al.

25 **Result is statistically significant, $p \leq 0.1$

*Result is not statistically significant but suggests a potential underlying relationship, $0.1 < p \leq 0.2$

No symbol: Result is not statistically significant, $p > 0.2$

26 White, James R. et al.

27 **Result is statistically significant, $p \leq 0.1$

*Result is not statistically significant but suggests a potential underlying relationship, $0.1 < p \leq 0.2$

No symbol: Result is not statistically significant, $p >$ 0.2

28 Summit also performed a regression analysis measuring the expected effect of a percent change in QEI amount on the fees as a percent of QEI and found no statistically significant relationship between the variables.

29 *New Markets Tax Credit: The Credit Helps Fund a Variety of Projects in Low-Income Communities, but Could Be Simplified.* GAO 10-334

30 White, James et al. Page 14.

31 *Credit recapture* occurs when a recapture event, as stipulated in the statute, occurs. *Credit recapture* means the investor who initially claimed the tax credit now must pay the specified amount along with their taxes for the year.

32 *See Section 2: Distribution of Overall Program Benefit* for more detail on residual equity left to the various parties at the end of the compliance period.

33 Abravanel, Martin D., Nancy M. Pindus, and Brett Theodos. "What Makes for a Smart Community or Economic Development Subsidy? A Program Evaluation Perspective." *Smart Subsidy for Community Development*, The Federal Reserve Bank of Boston and The Aspen Institute (2011): 104–121.

34 Urban Institute. *New Markets Tax Credit (NMTC) Program Evaluation: Final Report, a report prepared for U.S. Department of the Treasury, Community Development Financial Institutions (CDFI) Fund.* April 2013.

35 Summit did not consider government loans to be public funding for this analysis because the documentation for these loans was not available. Therefore, it wasn't possible to analyze the difference between market rates and the interest rates granted in these government loans to establish the extent of government subsidy for the loan.

36 Results are presented as self-leveraged projects and not self-leveraged projects without further differentiation of the latter category because there are no notable differences in results between financial structures that are not self-leveraged.

37 The difference between self-leveraged projects and projects that are not self-leveraged persists even when considering the use of other public funding as leverage.

38 **Result is statistically significant, $p \leq 0.1$

*Result is not statistically significant but suggests a potential underlying relationship, $0.1 < p \leq 0.2$

No symbol: Result is not statistically significant, $p > 0.2$

39 This result is statistically significant and supported by the implied capitalization rate findings.

40 There were two projects categorized as self-leveraged in the tables of this report that received an amount of public subsidy less than the financing gap. Both these projects also received larger leverage loans from the investor in addition to the self-leverage loans.

41 The QALICB may also receive a loan from a third party or the CDE outside the financing structure, which is then used to finance the leverage loan and ultimately QLICI A.

42 The Capitalization Rate Method flags projects that receive other forms of subsidy more frequently for further review, although this difference is not statistically significant. The *Financing Gap Method* shows no difference between projects that receive other forms of subsidy and those that do not.

43 The small sample size for this analysis limits the ability to generalize these findings to all NMTC projects.

44 Note there was one state NMTC project in the sample where neither analysis was available.

Appendices

APPENDIX A: FINANCIAL STRUCTURES USED IN NMTC TRANSACTIONS

CDEs execute NMTC transactions using one of three basic financial structures. This section explains how each of these structures—leveraged A/B Notes, direct loans, and pooled loan funds—operates. In general, leveraged A/B Note structures and direct loans fund individual projects, while pooled loan funds fund multiple projects. Table 11 summarizes the structures used in NMTC transactions as a percentage of the Aggregate Dataset.

LEVERAGED A/B NOTE STRUCTURE

Of the projects Summit sampled, 63% received financing through leveraged A/B Note structures. Leveraged A/B Note structures receive equity financing from the NMTC equity investor and can receive leverage from a number of sources. The sources of leverage could include the NMTC investor, the CDE, or a third-party lender provides the leverage. Additionally, in many cases the QALICB or an affiliate of the QALICB provides the leverage for "self-leveraged" structures. Regardless of the entity providing the leverage, this structure can result in either the CDE or the QALICB retaining residual equity from the NMTC investor at the end of the compliance period through a put and call option, which the NMTC investor exercises at the end of compliance.

In transactions involving a put and call option, the NMTC investor sells its equity stake in the NMTC investment fund to the QALICB or CDE at the end of the compliance period for a nominal amount, usually $1,000. Exercising this option transfers ownership of the equity from the NMTC investor to either the QALICB or the CDE. If the QALICB receives the residual equity, the CDE may require the QALICB to repay a portion of the QLICI funds invested before the end of the compliance period, thus transferring to the CDE some of the residual equity that would have otherwise transferred to the QALICB.

Figure 12 diagrams a sample leveraged A/B Note transaction, with the following flow of funds:

- The NMTC investor makes a $3.1 million equity investment into a wholly owned investment fund.
- The leverage lender then leverages that equity investment with a $6.9 million loan to the investment fund.
- This combined $10.0 million is used to make a QEI into a subsidiary of the CDE (sub-CDE), which generates $3.9 million in federal NMTCs to the NMTC investor over the seven-year compliance period.
- The sub-CDE pays a $0.3 million fee to the parent CDE, and then uses the remaining funds to make two interest-only, seven-year QLICI loans, QLICI A and QLICI B, to the QALICB.

Table 11

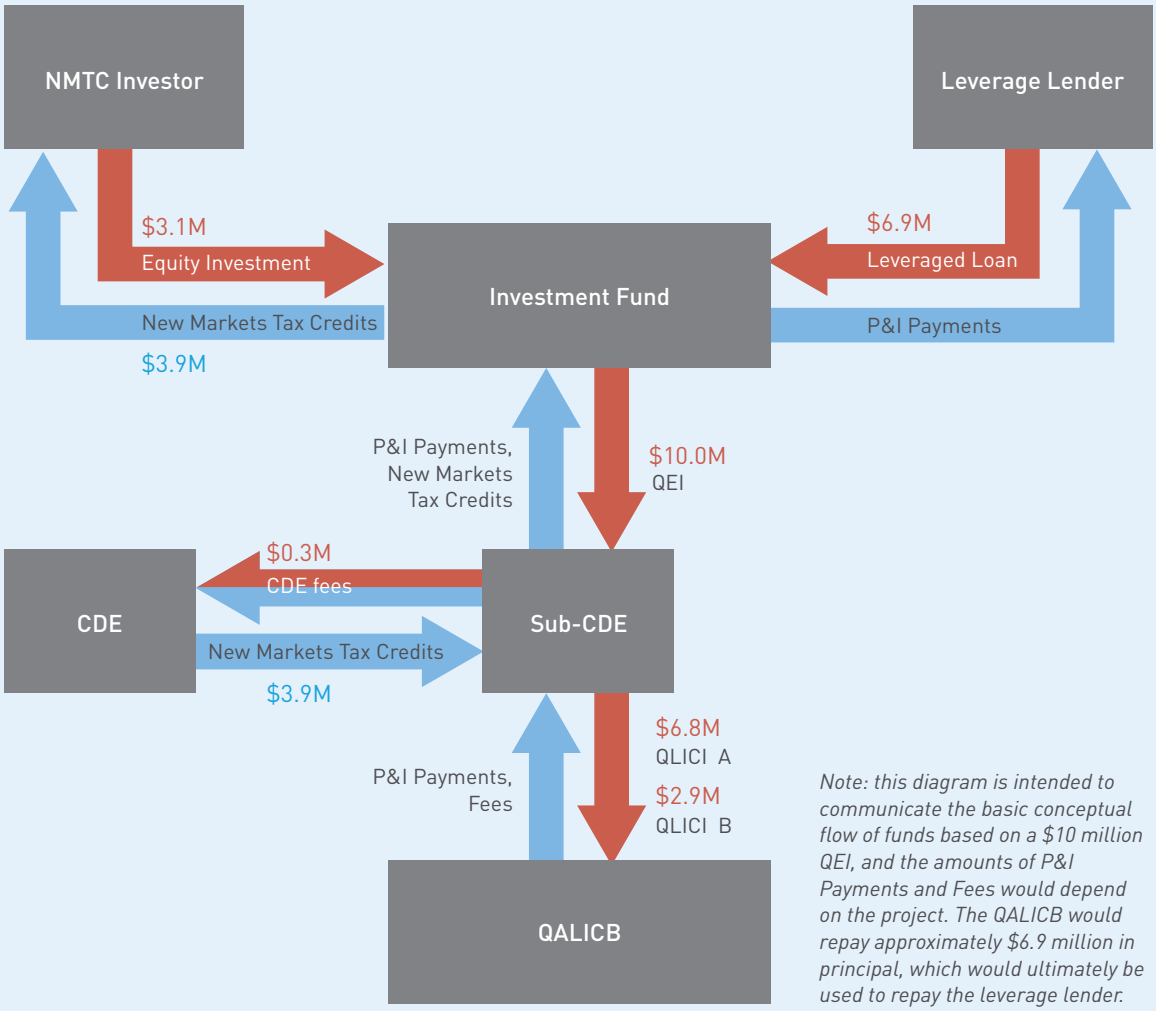
SUMMARY OF TYPICAL NMTC TRANSACTION STRUCTURES

Characteristic	Leveraged A/B Note		Direct Loan	Pooled Loan Fund
	Self-Leveraged	Not Self-Leveraged		
Percent of Sampled Projects	49%	14%	9%	28%

Source: Aggregate Dataset from the NMTC Desk Reviews.

Figure 12

DIAGRAM OF LEVERAGED A/B NOTE NMTC STRUCTURE



- The leveraged loan provides the financing for QLICI A, and the NMTC investor's equity provides the financing for QLICI B.
- The QALICB typically only pays interest payments and fees during the compliance period, although it may also pay principal payments.
- After the compliance period ends, the NMTC investor exercises the put option, selling its stake in the investment fund to the QALICB for $1,000.
  - This sale essentially nullifies the QALICB's obligation to repay the loans to the sub-CDE.
  - The QALICB assumes the direct obligation to repay the $6.9 million leverage loan, which financed QLICI A, if still outstanding.
  - Since the QLICI loans are essentially nullified and the QALICB assumes the liability of the leverage loan, the $2.9 million B Note essentially converts to residual equity for the QALICB.

Self-Leverage

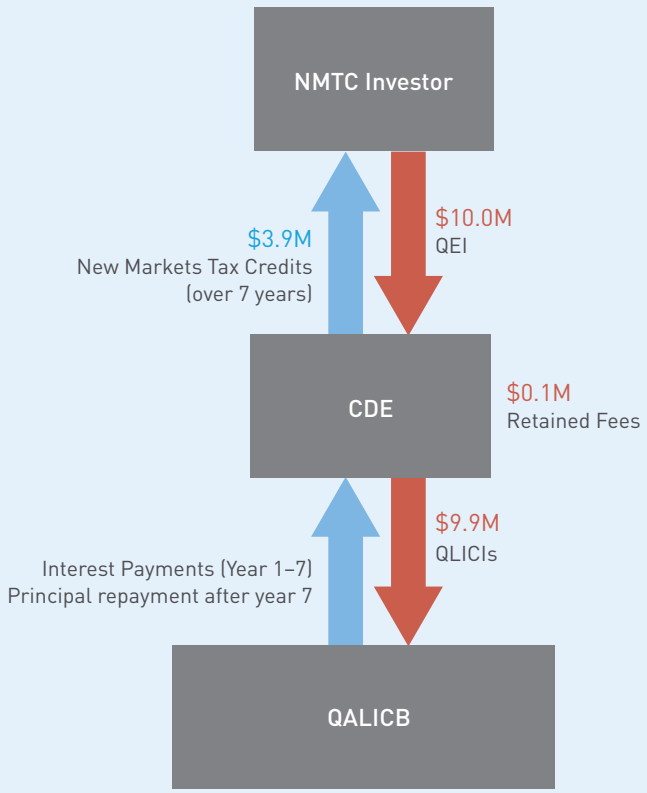
Self-leverage occurs when the QALICB uses cash, debt, grants, or other funds to leverage the NMTC equity investment. Non-profit QALICBs frequently rely on self-leverage to generate NMTC equity to close an identified financing gap for a project. In transactions involving for-profit businesses, the source of self-leverage may be a third-party loan, if the lenders are unwilling to lend directly into the NMTC structure. In these instances, the QALICB receives the loan and then on-lends these funds to the NMTC investment fund at minimal interest rates to generate NMTC equity for the QALICB. This results in the QALICB paying the third-party loan interest rate in practice while allowing the resulting QLICI to meet the 50% below-market-rates requirement even though the original source of the loan to the QALICB is at or near market rates.

Occasionally, self-leverage comes in the form of a one-day loan or bridge loan, in which the NMTC investor makes a one-day loan to the QALICB to use as NMTC leverage. Upon closing the NMTC transaction, the QALICB repays the loan in full. The one-day or bridge loans serve to size the total QEI amount such that the investor pays a tax credit price in line with the market for tax credits.

The diagram for a self-leveraged structure is the same as the general leveraged A/B Note structure, with a QALICB-affiliate serving as the leverage lender.

Figure 13

DIAGRAM OF NON-LEVERAGED/DIRECT LOAN NMTC STRUCTURE



Note: this diagram is intended to communicate the basic conceptual flow of funds based on a $10 million QEI, and the amounts of P&I Payments and Fees would depend on the project. The QALICB would repay the entire principal to the CDE in a balloon payment at the end of the compliance period.

DIRECT LOANS

Projects that use a direct loan, or non-leveraged structure, almost always involve an investor and CDE that are related. The NMTC investor makes a QEI directly into a CDE, and the CDE uses the QEI to make a QLICI loan to a QALICB. The QALICB typically repays the loan in full and thus does not retain the NMTC investor's equity. Unlike other transaction structures, the QEI is 100% investor equity and does not include leverage. Most projects using this structure closed in the early years of the NMTC Program; this structure is now less common.

Figure 13 shows an example of a direct loan NMTC structure

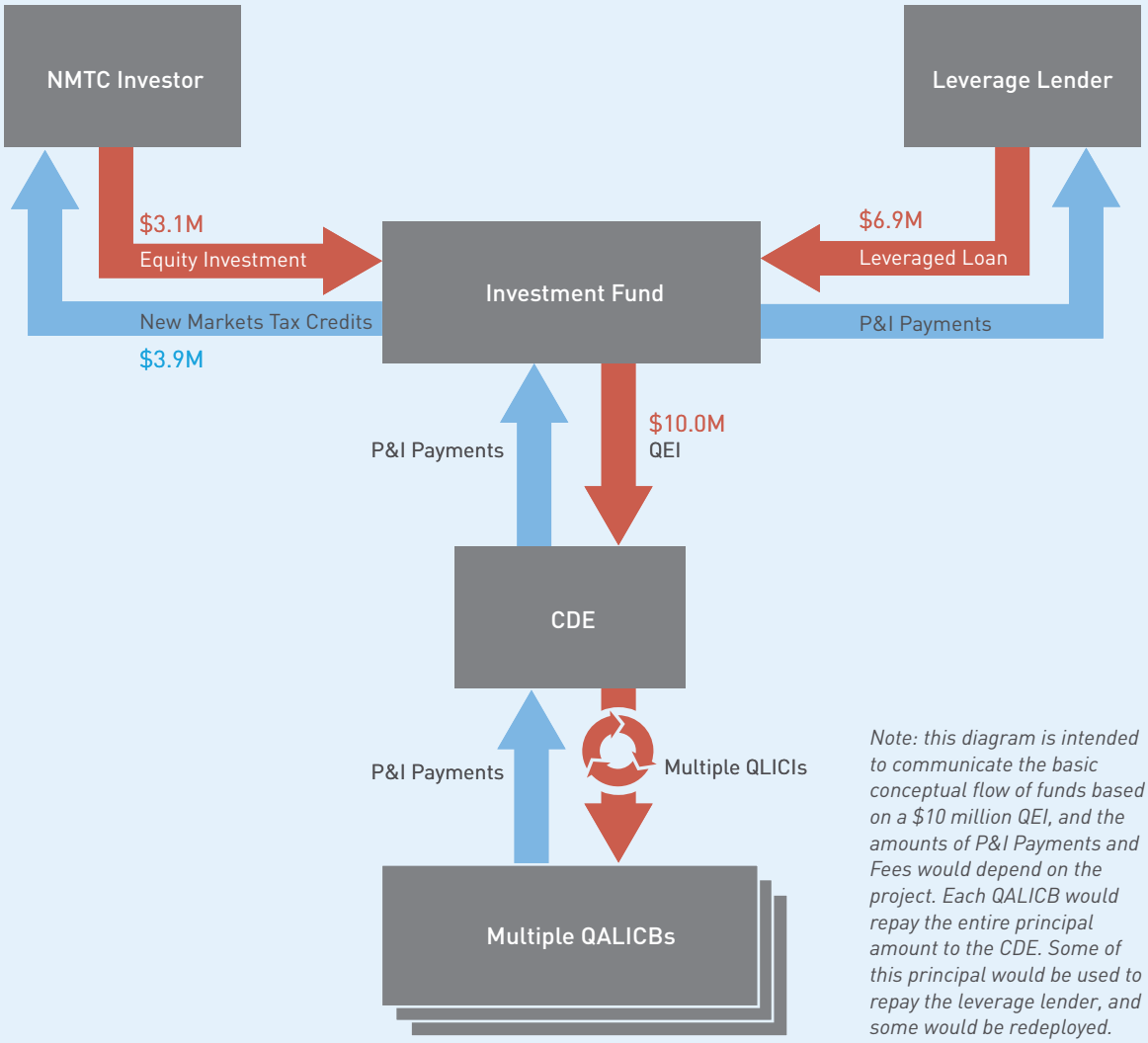
Pooled Loan Funds

Typically, each project has a separate NMTC structure. However, some CDEs deploy their NMTC Allocation using

a pooled fund structure, also known as a revolving loan fund, which allows a CDE to finance multiple businesses through smaller, individual loans. NMTC pooled loan funds typically take one of two structures. The first and simplest structure involves a bank making a QEI into an affiliated CDE, which then uses those funds to make small, fully amortizing loans to QALICBs. The second, more complex structure leverages the NMTC equity investment with outside loans or CDE capital. Similar to the leveraged A/B Note structure, in a leveraged loan fund, the NMTC investor contributes an equity investment into an investment fund. The leverage lender then makes a loan to the same investment fund. The investment fund uses this leverage loan and the NMTC equity to make a QEI into a CDE, which uses the proceeds to make many small QLICIs to QALICBs. Both types of NMTC loan funds typically provide capital to QALICBs in the form of smaller loans with a term shorter than seven years. Once the QLICI loans are repaid, the funds are redeployed. There are typically multiple redeployments, and the funds are typically deployed for longer than the seven-year compliance period. Figure 14 shows an example of a leveraged pooled loan fund structure.

Figure 14

NMTC POOLED LOAN FUND STRUCTURE



Note: this diagram is intended to communicate the basic conceptual flow of funds based on a $10 million QEI, and the amounts of P&I Payments and Fees would depend on the project. Each QALICB would repay the entire principal amount to the CDE. Some of this principal would be used to repay the leverage lender, and some would be redeployed.

APPENDIX B: METHODOLOGIES

This appendix details the different methodologies used to conduct the analysis presented throughout this report. The methodologies section and the report findings reference analyses conducted at the following three levels:

- **Project level.** Most projects involve multiple QLICIs, and may involve multiple CDEs. These findings correspond with data about each project.
- **CDE level.** These findings correspond with multiple projects financed by the same CDE or focus on specific findings independent of specific projects.
- **CDE-project level.** This level of analysis includes the fees charged by each CDE to a QALICB and analyses that report on accuracy of CDE reporting.

DISTRESS SCORE METHODOLOGY

Summit developed the census tract-level distress score for the purposes of considering multiple indicators of community distress on a spectrum. The following five metrics determine the distress score:

- **Poverty rate.** Percent of population living below the poverty line.
- **Unemployment rate.** Percent of civilian labor force unemployed.
- **Median family income ratio.** Ratio of tract median family income to state or metropolitan statistical area[i] median family income.
- **Educational attainment.** Percent of population 25 years and older without a high school degree.
- **Housing vacancy rate.** Percent of habitual housing that is vacant, excluding housing that is vacant for seasonal, recreational, or occasional use.

Summit selected the first three indicators (i.e., poverty rate, unemployment rate, median family income ratio) because the CDFI Fund uses these same indicators to determine program eligibility and classify census tracts as severely distressed. The other two indicators (educational attainment, housing vacancy rate) are among those the Economic Innovation Group uses in their Distressed Communities Index.[ii] These indicators measure aspects of community distress that the CDFI Fund indicators do not otherwise capture. Additional metrics used by the Economic Innovation Group are either duplicative of a CDFI Fund indicator already considered in the distress score (proportion of adults not working, individual income) or require analysis at the zip code-level rather than census tract-level (change in employment, change in business establishments).

Consistent with the Economic Innovation Group's methodology, Summit calculated distress scores by ranking all census tracts in the United States on each of the five variables, averaging the ranks, and normalizing them to be equivalent to percentiles.[iii] The resulting distress scores are equally distributed between 0 and 100, corresponding to a tract's percentile of distress relative to all other census tracts in the United States. The higher the distress score, the more distressed the census tract. For example, a census tract with a distress score of 60 is more distressed than 60% of the country.

Summit calculated distress scores for 2010, 2011, 2012, 2013, and 2014 using data from the American Community Survey 5-year Estimates for that year, and matched NMTC transaction addresses with the distress score for the year the transaction was closed. Transactions that meet any of the following criteria were excluded from the *Distress Analysis* described in the *Compliance*:

- Transaction closed before 2010 (distress indicators not available on tract-level for year transaction was closed)
- Transaction represents a CDE-to-CDE loan
- ACS data is unavailable for any of the five distress indicators
- Population in census tract is less than 500

Summit also calculated distress scores using Census 2000 data and used these distress scores for transactions closed before 2010 in the desk review analyses.

For the border analysis, Summit also calculated the area distress score indicating the distress level of the area surrounding an NMTC investment. It is the population-weighted average distress score for all census tracts within a certain radius of the investment location. The radius is adjusted based on whether the investment was located in a central city, in a metropolitan area outside of a central city, or in a non-metropolitan area. These area sizes are listed below:

- Central city – 0.5 mile
- Metropolitan location, not in a central city – 1.5 miles
- Non-metropolitan location – 10 miles

METHODS FOR FEES MEASUREMENT

Summit's CDE fee analysis began by compiling all documentation of fees from the desk review materials provided for each sample project. Each fee was attributed to the party collecting the fee from the QALICB, even if the collecting party referred to the fee as a reimbursement for third-party expenses.

After measuring the fees and expenses collected by all parties, Summit used a one-way ANOVA test to determine if the difference in average fees between categories of interest (e.g., CDE type, QALICB type) was statistically significant.

To measure discrepancies in fees reported and fees charged, Summit compared the fees described in the desk review documentation to the fees reported in CIIS. Where possible, Summit also compared the documented fees and third-party expenses to the fees and expenses included in the QALICB Fee Disclosure Form, required by the CDFI Fund since 2012.

METHODS FOR MEASURING THE DISTRIBUTION OF NMTC BENEFIT

This section outlines the different project characteristics influencing the distribution of residual equity among the parties to NMTC transactions. There is a particular focus on what affects the residual equity to the QALICB. This analysis includes:

- Initial NMTC equity invested
- Tax credits generated for the benefit of the investor
- Total amount of fees charged in the financing structure by third-party, CDE, leverage lender, and investor entities
- Put payments
- Any transfers of NMTC equity between parties at the end of the compliance period

In cases where the CDE and the leverage lender or the CDE and the investor are the same entity, the combined distribution of benefits is reported for the CDE. In cases where a transaction was self-leveraged, the distribution of public funding to the leverage lender is reported for the QALICB.

METHODS FOR ANALYZING THE DEPTH OF PUBLIC INVESTMENT IN NMTC TRANSACTIONS

The two quantitative methods Summit developed consider the public funding that a project receives, evaluates that amount relative to expectations, and situates the difference between actual public funding amounts and expected public funding amounts on a spectrum. These expectations are derived from the stated financing gap in project documentation or net operating income and project costs. Projects past certain thresholds are flagged for further analysis to determine why the project received more public funding. The thresholds chosen are somewhat arbitrary but serve to establish thresholds for projects that might warrant further review, allowing for a buffer around benchmarks. For the purposes of this report, Summit considered all tax credits and government grants associated with the NMTC project to be public funding, and did not consider government loans to be public funding. Summit did not consider government loans to be public funding for this analysis because the documentation for these loans was not available. See Appendix C for a full list of other public funding sources observed in the sample. These two methods are described below.

Method 1: Implied Capitalization Rate Calculation

The *Capitalization Rate Method* is based on the calculation of the *Feasibility Gap*, which is equal to the *Total Project Costs* less the *Project Cash Value*, as shown in Equation 1.

If the *Total Project Costs* exceed the *Total Project Value*, the result is positive and a *Feasibility Gap* exists. In this case, the total amount of public funding should cover, but not exceed, the amount of the gap to attract private investment into the project, while minimizing public funding.

Conversely, if the *Total Project Costs* are less than the *Project Cash Value*, the result is negative and no *Feasibility Gap* exists. In this case, any amount of public funding used in the project is considered unnecessary, as the private sector should view it as an attractive investment without public funding.

As inputs to this equation, *Total Project Costs* and *Annual Net Operating Income* are found in the accountants' projections, pro forma, or investor underwriting documents. *Project Cash Value* is calculated using Equation 2.

The desk reviewer calculates the *Implied Capitalization Rate*, assuming the public funding matches the *Feasibility Gap*. Comparison of the *Implied Capitalization Rate* to industry data, derived from Moody's, the Census, and the IRS, provides insight into the reasonability of the amount of public funding. Additional analysis of distress factors and other project-specific facts also shed light on cases of higher implied capitalization rates.

To complete this calculation, the desk reviewer first determines the total public funding used in the project. This sum adds all sources of public funding used in the project from federal, state, or local government, provided in Equation 3.

After calculating the *Total Public Funding,* the Desk Reviewer uses Equation 4 to calculate the *Implied Capitalization Rate*.

The desk reviewer then compares the resulting *Implied Capitalization Rate* to the average industry capitalization rate for the QALICB business purpose (e.g., multifamily housing, office space, manufacturing – see below for additional explanation).

Equation 1

FEASIBILITY GAP

$$\text{Feasibility Gap} = \text{Total Project Costs} - \text{Project Cash Value}$$

Equation 2

TOTAL PROJECT VALUE

$$\text{Project Cash Value} = \frac{\text{Annual Net Operating Income}}{\text{Capitalization Rate}}$$

Equation 3

TOTAL PUBLIC SUBSIDY

$$\text{Total Public Subsidy} = \text{NMTC} + \text{Any Additional Sources of Public Funding}$$

Equation 4

IMPLIED CAPITALIZATION RATE

$$\text{Implied Capitalization Rate} = \frac{\text{Net Income}}{\text{(Total Project Cost} - \text{Total Public Funding)}}$$

Limitations and Sample Size

The Capitalization Rate Method has two primary limitations. First, the method relies on comparison to an industry benchmark and does not account for the socioeconomic factors of the project location. As a result, Summit allowed for deviations of up to three percentage points before flagging a project for further review. The three percentage

point threshold is arbitrary, but allows for a buffer around the industry benchmark, recognizing that the comparison may not be exact in some cases. Additionally, Summit compared these projects to distress scores to account for socioeconomic factors.

Second, this method relies on the projects having a projected net operating income that is positive and directly attributable to the NMTC financing. This need made the analysis impossible for projects with a negative projected net operating income or where the NMTC financing was used for working capital, refinancing, or additions to existing facilities. After excluding the projects where this analysis was not feasible, the sample size is 32 (60% of the total sample).

Flagging of Projects for Further Review

The analysis flags a project for further review when the implied capitalization rate is three percentage points greater than the relevant benchmark. This threshold allows for differences from the benchmark potentially caused by the limitations described above, although it is arbitrary.

Where possible, Summit performed a chi-squared test to detect for significant differences between categories of the frequency that projects flagged. Summit used Fisher's exact test for any tables with expected frequencies less than five. When comparing two means, Summit performed a t-test to detect significant differences in nominal implied capitalization rate deviation. For comparing more than two means, Summit performed a one-way ANOVA analysis.

Method 2: Financing Gap Comparison

The Financing Gap Method compares the financing gap the CDE reported in desk review materials to the total amount of public funding provided to the project[iv] Summit flagged projects for further review if the percent of public funding above the financing gap was 15% or greater, and the calculation for this analysis is shown in Equation 5.[v] The 15% threshold allows for a buffer around the identified financing gap in the project documentation, although it is arbitrary.

Equation 5

PERCENT OF PUBLIC SUBSIDY USED TO CLOSE FINANCING GAP IF PUBLIC FUNDING > FINANCING GAP

$$\textit{Public Funding above Financing Gap} = 1 - \frac{\textit{Financing Gap}}{\textit{Total Public Funding}}$$

As is the case with the *Capitalization Rate Method*, this analysis is not possible for working capital or refinancing projects. It is possible for projects that have a negative net operating income, if the CDE provided documentation showing the amount of the financing gap.

If the financing gap exceeds the total public funding, the percent of the public funding above the financing gap is zero. If the CDE indicated the project had no financing gap, then 100% of the public funding provided is above the identified financing gap.

Because all frequency tables for this analysis had expected frequencies less than five, Summit performed Fisher's exact test to detect significant differences in potential over-subsidization frequencies. When comparing two means, Summit performed a t-test to detect significant differences in percent of public funding above the financing gap. When comparing more than two means, Summit conducted a one-way ANOVA.

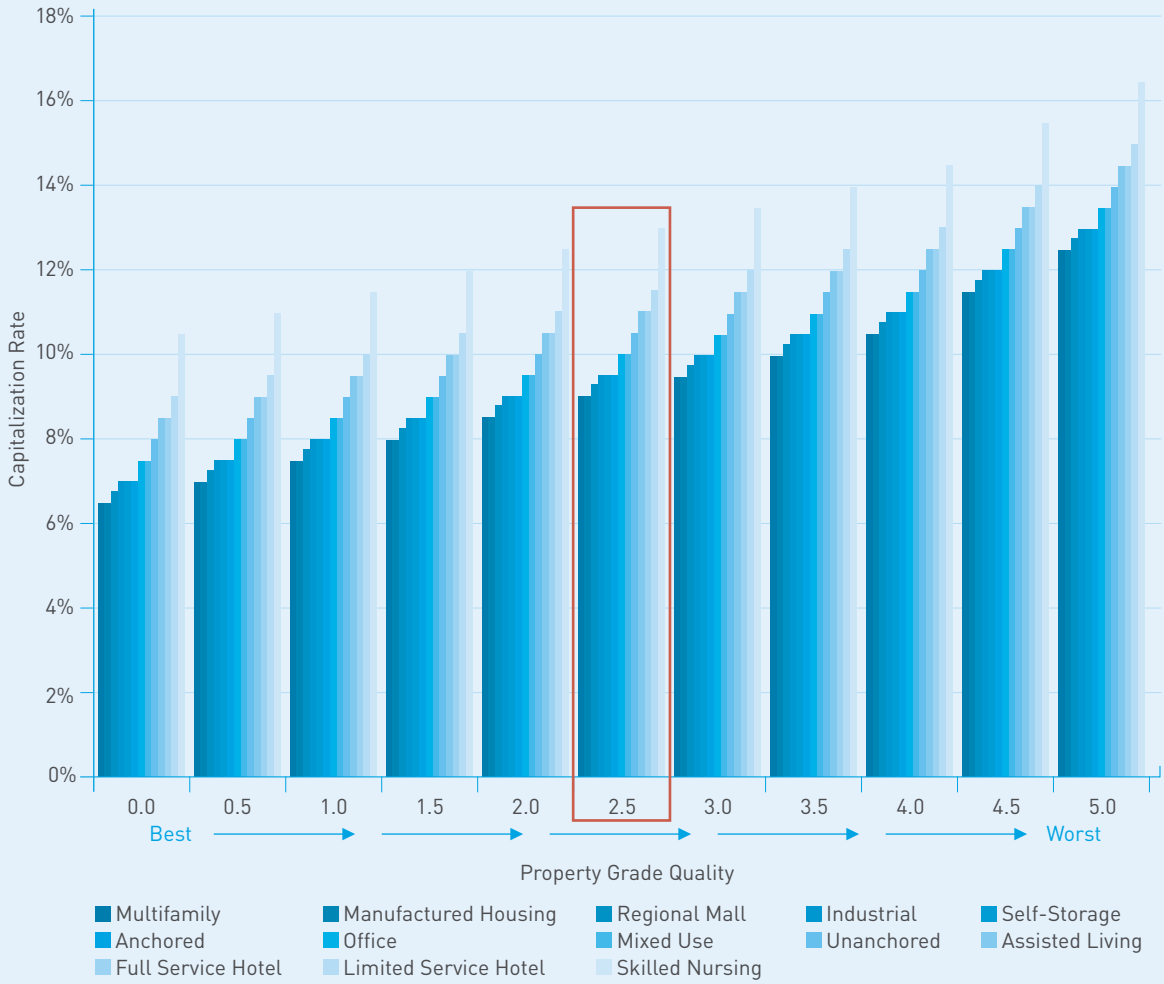
This analysis was possible for 29 projects (55% of the sample).

Reconciliation of Methods

To confirm the accuracy of both methods, Summit compared results for projects where both analyses were available. The two methods provide consistent flagging for 77% of the projects where both analyses were available. Differences between the two methods may result from the financing gap analysis being very specific to each project, while the implied capitalization rate methodology relies on industry-wide benchmarks.

Figure 15

REAL ESTATE CAPITALIZATION RATES BY PROPERTY QUALITY GRADE



Source: Moody's Investors Service, 2014

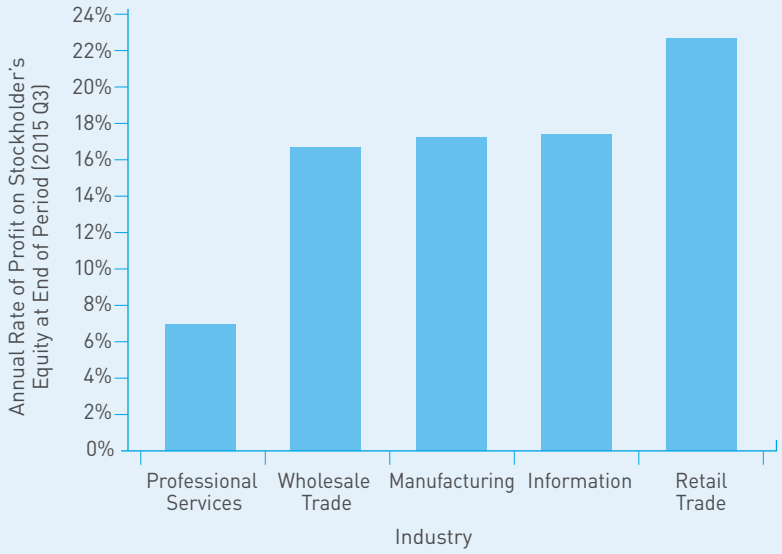
Industry Benchmarks for Real Estate Projects

For real estate benchmarks, Summit used the Moody's data on real estate capitalization rates by property quality grade, displayed in Figure 15.

Figure 15 shows the capitalization rates for various property types across different property qualities, ranked on a 0–5 scale (best to worst). According to Moody's, the scale considers factors including property age, quality of construction, location, market, and tenancy.[vi] The highest quality properties, those that rarely encounter issues attracting tenants or capital, receive grades on the lower end of the spectrum. Properties that receive grades on the higher end of the spectrum face significant long-term challenges in attracting tenants or capital. Based on this data, skilled nursing properties have the highest capitalization rates, and multifamily and manufactured housing have the lowest capitalization rates across all property qualities. For the purposes of this analysis, Summit used the property grade quality of 2.5 as an average benchmark for real estate capitalization rates. Using a lower

Figure 16

ANNUAL RATE OF PROFIT ON STOCKHOLDER'S EQUITY AT END OF PERIOD (2015 Q3) BY INDUSTRY



Source: U.S. Census Bureau, Quarterly Financial Report, 2015

Equation 6

ANNUAL RATE OF PROFIT ON STOCKHOLDER'S EQUITY

$$\textit{Annual Rate of Profit on Stockholder's Equity} = \frac{\textit{Quarterly Income (Loss) before Taxes} \times 4}{\textit{Shareholders' Equity}}$$

property grade (rating higher than 2.5) would have resulted in fewer projects being flagged by the analysis; using a higher property grade would have resulted in more projects being flagged by the analysis.

Industry Benchmarks for Businesses

For business benchmarks, Summit used the census data on the Annual Rate of Profit on Stockholder's Equity at End of Period (2015 Q3) by Industry, displayed in Figure 16.

To calculate the *Annual Rate of Profit on Stockholder's Equity,* Summit multiplied Quarterly Income (Loss) before Taxes by four. Summit then divided this number by Shareholders' Equity, as shown in Equation 6, using the data from the most recent quarter (2015 Q3).[vii]

This rate is a proxy for the capitalization rate, which is typically used in real estate to calculate the expected return on a real estate investment. The Annual Rate of Profit on Stockholder's Equity similarly calculates the expected return on an equity investment in a business. As displayed in Figure 16, the Annual Rate of Profit on Stockholder's Equity ranges from 6.9% to 22.7% depending on the industry.[viii]

APPENDIX C: ADDITIONAL FIGURES FOR DEGREE OF PUBLIC INVESTMENT

Table 12 shows descriptive statistics of the analysis of sampled projects using the *Capitalization Rate Method*. Of the 32 projects analyzed, 12 projects (38%) have capitalization rates three or more percentage points greater than the industry benchmark. The low average and median implied capitalization rate deviations suggest that, on average, the sampled NMTC projects have capitalization rates close to industry benchmarks.

Table 13 summarizes the analysis using the *Financing Gap Method.*

Both methods suggest that 38% of projects warrant further review to understand the higher amounts of public funding received.

DISTRESS SCORE OF PROJECT LOCATION

The CDFI Fund tasked Summit with evaluating if there is a relationship between public funding levels and community distress. Summit found no clear evidence for such a relationship, although it may exist.

Summit compared the implied capitalization rate deviation of the sampled projects to their community distress scores. This comparison provides socioeconomic context for projects receiving higher rates of public funding, as Figure 17 depicts.

The chart suggests a possible relationship between distress score and the amount of additional public funding a project may need. The implied capitalization rate shows greater deviation from the benchmark as distress scores go above 80. However, the sample also includes projects in highly distressed areas that received relatively low rates of public

Table 12

IMPLIED CAPITALIZATION RATE DESCRIPTIVE STATISTICS

Characteristic	Value
Sample Size	32
Percent of Projects with Greater than 3% Deviation	37.50%
Average Capitalization Rate Deviation	2.23%
Median Capitalization Rate Deviation	0.88%
Standard Deviation	5.75%
Minimum	–8.30%
Maximum	18.72%

Source: Aggregate Dataset from NMTC Desk Reviews.

Table 13

FINANCING GAP DESCRIPTIVE STATISTICS

Characteristic	Value
Sample Size	29
Percent of Projects with Subsidy Greater than 15% above Financing Gap	37.93%
Average Subsidy above Financing Gap	19.05%
Median Subsidy above Financing Gap	6.97%
Standard Deviation	27.38%
Minimum	0.00%
Maximum	100.00%

Source: Aggregate Dataset from NMTC Desk Reviews.

funding. Consequently, there is no clear indication that projects in more highly distressed census tracts necessarily require more public funding.[ix]

Summit also attempted to provide insight into this question using the Administrative Dataset. This analysis included 3,586 observations with the following data points available: total project costs, amount of public funds the project received, and amount of private funds the project received. Summit calculated the public funds received as a percentage of the total project costs and compared this to the distress score of the project's location. This analysis showed a slightly positive correlation between distress score and public funds as a percentage of project costs, although the relationship was not statistically significant. However, higher public funding as a percentage of total project costs is not equivalent to public funding amounts greater than expectations. It is possible that an analysis of a larger sample using the two quantitative methods developed in this report could reveal a relationship between distress and greater-than-expected public funding amounts.

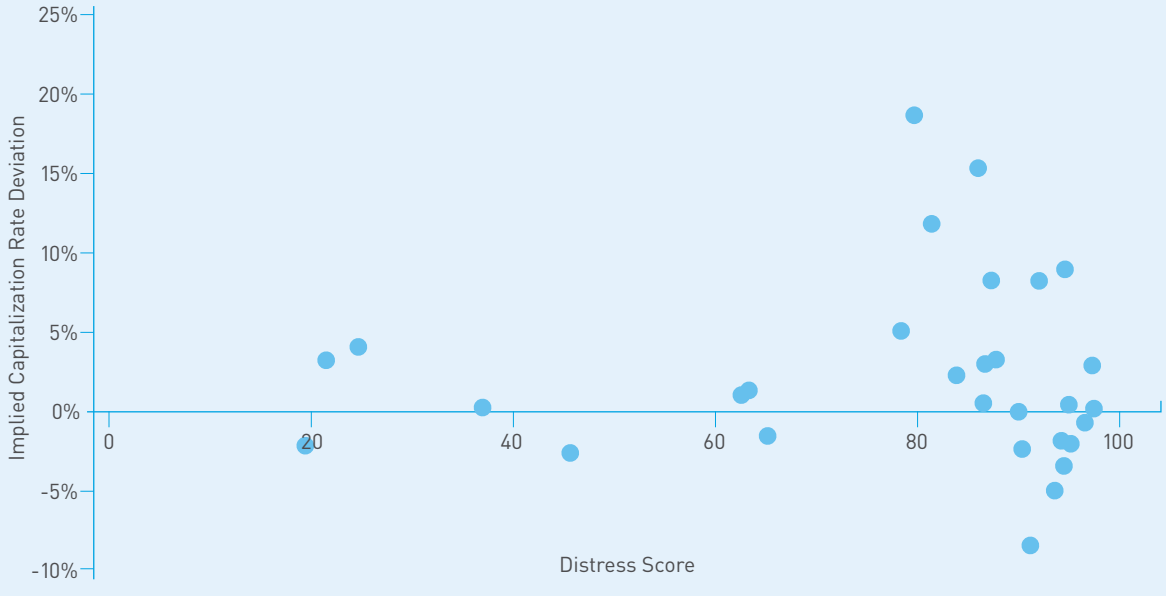
RESULTS OF CAPITALIZATION RATE METHOD BY FINANCIAL STRUCTURE

Figure 18 shows the results of the *Capitalization Rate Method* analysis, color-coded by the leverage source. The distribution shows self-leveraged projects are more likely to have higher rates of deviation from industry benchmark capitalization rates than projects that are not self-leveraged.

In the desk review sample, 47% of self-leveraged projects had capitalization rate deviations greater than 3%, as compared to only 24% of projects leveraged by third parties, as Table 14 shows. These results corroborate the results of the *Financing Gap Method*.

Figure 17

IMPLIED CAPITALIZATION RATE DEVIATION IN RELATION TO DISTRESS SCORE



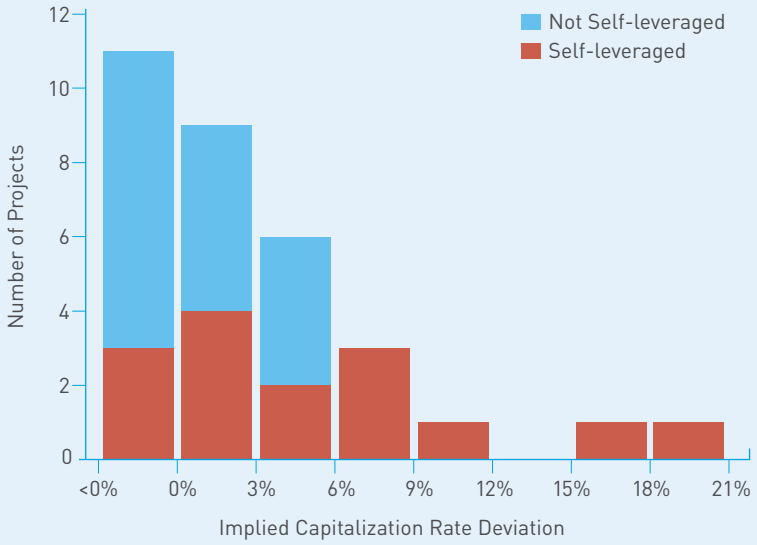
Source: Aggregate Dataset from NMTC Desk Reviews

RESULTS OF CAPITALIZATION RATE METHOD BY USE OF OTHER PUBLIC FUNDING AS LEVERAGE

The Capitalization Rate Method shows a difference in implied capitalization rate deviations between projects that receive other public funding and those that do not. This difference is explained by further differentiating between projects that use public funding as leverage and projects where the QALICB receives the public funding directly. Figure 19 shows the results for the *Capitalization Rate Method,* color-coded by the use of other public funding and how it enters the financing structure. The distribution shows that projects using other public funding as leverage are more likely to have higher deviation rates than projects with additional public funding provided directly to the QALICB and projects that do not receive non-NMTC public funding. For example, if a QALICB uses a federal grant to fund a leverage loan into a project's NMTC structure, that project is more likely to have an implied capitalization rate 3% higher than the industry benchmark than if another source financed the leverage loan or if the project did not receive additional public funding.

Figure 18

DISTRIBUTION OF IMPLIED CAPITALIZATION RATE DEVIATION BY SOURCE OF LEVERAGE



Source: Aggregate Dataset from NMTC Desk Reviews

Table 14

IMPLIED CAPITALIZATION RATE DEVIATION BY LEVERAGE CATEGORIZATION

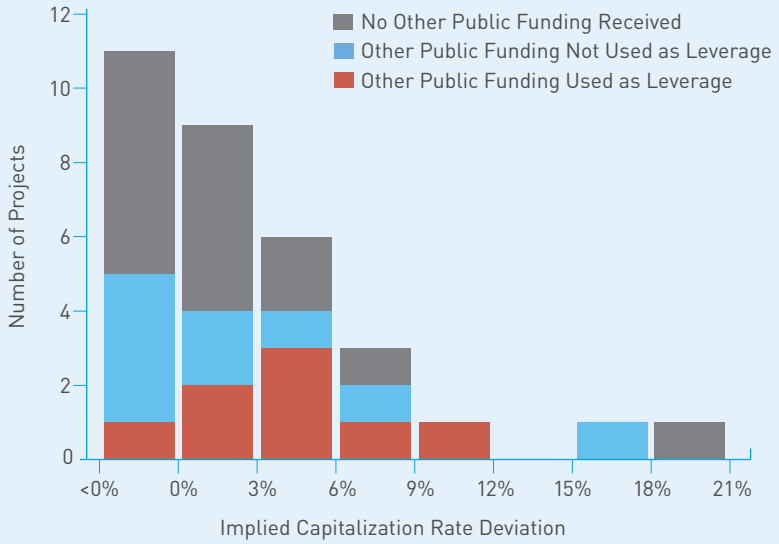
Characteristic	Self-Leveraged	Not Self-Leveraged	Difference	P-Value[x]
Observations	15	17	-	-
Percent of Projects with above 3% deviation from industry benchmark	53.33%	23.53%	29.80%	0.144*
Average Implied Capitalization Rate Deviation	4.96%	–0.19%	5.15%	0.014**

Source: Aggregate Dataset from NMTC Desk Reviews

Note: P-Value measures the statistical significance of the difference between means using tests described in Appendix B.

Figure 19

DISTRIBUTION OF IMPLIED CAPITALIZATION RATE DEVIATION BY USE OF OTHER PUBLIC FUNDING



Source: Aggregate Dataset from NMTC Desk Reviews

Table 15 shows 63% of projects leveraged with other public funds had capitalization rate deviations greater than 3%, as compared to only 33% of projects that received public funds directly and 27% of projects that received no other public funds.

Table 15

CAPITALIZATION RATE METHOD RESULTS BY USE OF OTHER PUBLIC FUNDING

Characteristic	No Other Subsidy	Received Other Subsidy		P-Value[xi]
		Used as Leverage	Not Used as Leverage	
Observations	15	8	9	
Percent of Projects with above 3% deviation from industry benchmark	27%	63%	33%	0.265
Average Implied Capitalization Rate Deviation	1.85%	3.81%	1.45%	0.674

Source: Aggregate Dataset from NMTC Desk Reviews.

Note: P-Value measures the statistical significance of the difference between means using tests described in Appendix B.

LIST OF OTHER SOURCES OF PUBLIC FUNDING USED BY PROJECTS IN DESK REVIEW SAMPLE

Public funding sources other than federal NMTCs observed in the sampled projects include the following:

- Federal public funding sources
  - Federal Historic Tax Credit
  - U.S. Department of Agriculture – Other Grants
  - U.S. Department of Agriculture – Rural Utility Service
  - U.S. Department of Energy – Bioenergy Technology Office
  - U.S. Department of Health and Human Services – Health Resources and Services Administration
  - U.S. Department of Health and Human Services – Office of Community Services
  - U.S. Department of Housing and Urban Development – Community Development Block Grant
  - U.S. Department of Housing and Urban Development – Economic Development Initiative
  - U.S. Department of Housing and Urban Development – Other Grants
  - U.S. Department of the Treasury – Section 1603 Grant
  - U.S. Economic Development Administration
  - U.S. Environmental Protection Agency
- State public funding sources
  - Alaska Regulatory Commission
  - Florida New Markets Tax Credits
  - Louisiana Historic Tax Credit
  - Louisiana New Markets Tax Credits
  - Michigan Brownfield Tax Credit
  - Michigan Department of Environmental Quality
  - Michigan Single Business Tax Credit
  - Mississippi New Markets Tax Credits
  - Missouri Brownfield Tax Credit
  - New Hampshire Community Development Finance Authority - Community Development Investment Program
  - Oregon New Markets Tax Credits
- Local public funding sources
  - City of Boston
  - DC Department of Health – District of Columbia Primary Care Association Grant
  - DC Department of Housing and Community Development
  - DC Department of Parks and Recreation
  - Detroit Empowerment Zone Grant
  - Wayne County

In addition to the subsidies listed above, some projects received the following subsidized loans:

- Bonds backed by U.S. Department of Agriculture
- NMTC Leverage Loan provided by City of Detroit
- U.S. Department of Agriculture Loans
- U.S. Department of Housing and Urban Development Loans – Lean Section 232/223(f)

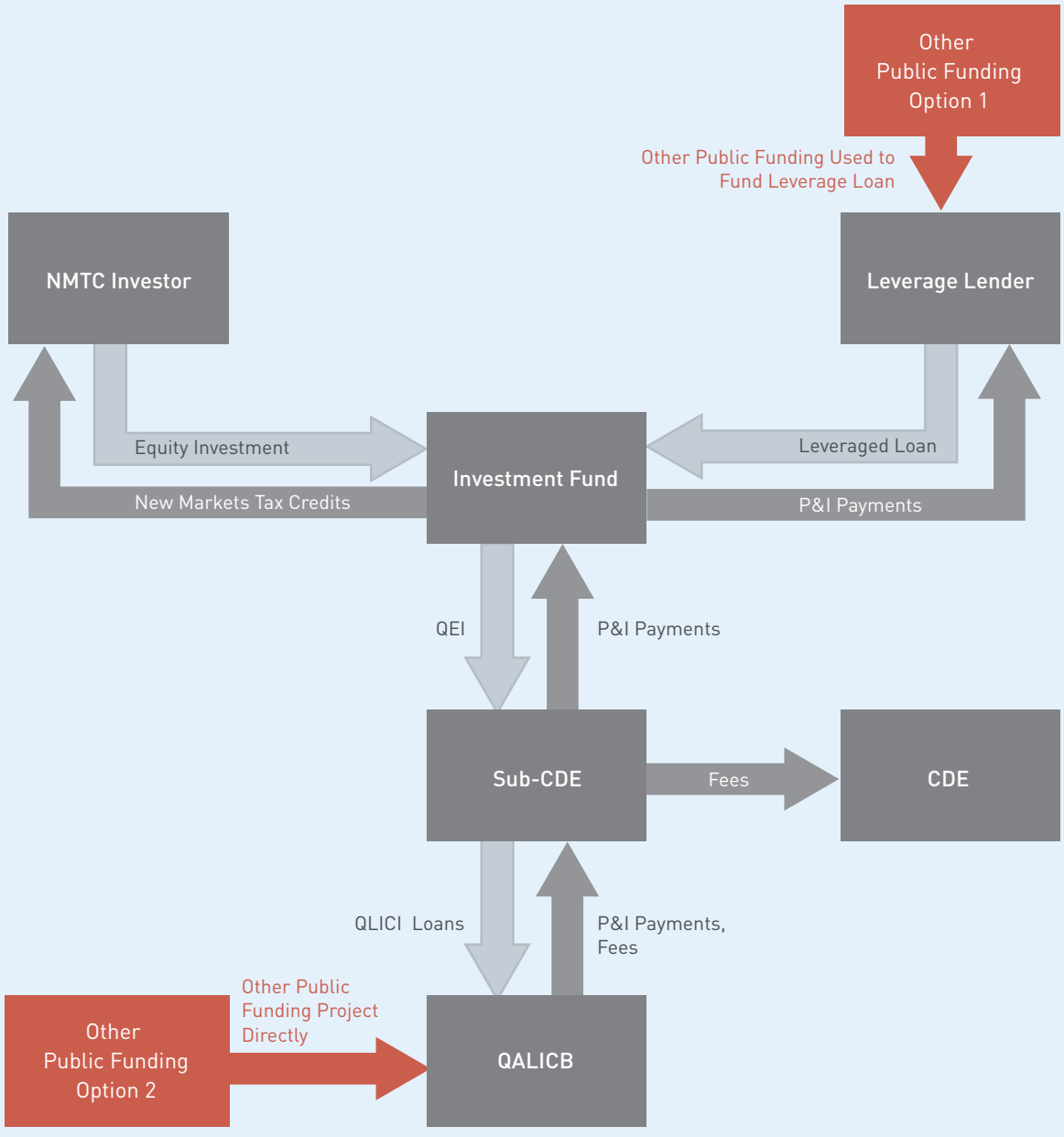
For the purposes of the *Depth of Public Investment* analysis, these loans were not considered to be public funding.

APPENDIX D: MECHANICS OF COMBINING NMTC WITH OTHER FORMS OF PUBLIC FUNDING

Other forms of public funding typically enter the NMTC financing structure in one of two ways. One option is for the public funds to finance the leverage loan; the other option is for the QALICB to receive the public funding directly. Figure 20 is a generalized diagram of an NMTC transaction structure showing the two ways non-NMTC public funds enter the financing structure.

Figure 20

HOW OTHER FORMS OF PUBLIC FUNDING ENTER FINANCING STRUCTURE



APPENDIX E: SAMPLING METHODOLOGY

Summit conducted the sampling of NMTC projects with the goal of providing relevant insights into the NMTC Program to the CDFI Fund and addressing the research questions described in the Executive Summary and the Introduction of this report.

The sampling methodology drew a sample of 60 projects from the 4,498 projects that had been funded since the NMTC program's inception. The sample design was a Stratified Random Sample (StRS) with Modified Proportional Allocation, which allowed for representation of all subgroups of interest and allowed for some projects to be sampled with certainty. The three criteria used for stratification were selected based on the data available, strata used by previous NMTC studies, and research parameters provided by the CDFI Fund:

- Project Purpose – business, real estate, or mixed
- Metropolitan Status – metropolitan or non-metropolitan project location
- CDE Type – at least one CDE associated with the project is a CDFI, or none are CDFIs

The combinations of the possible values for each of these three criteria result in 12 strata. In addition to these, there were eight projects specifically selected for review by the CDFI Fund, comprising the certainty stratum and resulting in 13 total strata.[xii]

Summit then calculated each stratum's proportion in the overall population of NMTC projects, modified the proportions to ensure representation of each stratum, and drew the modified proportionally distributed

Table 16

STRATA SAMPLE DESIGN

Purpose	Metro Status	CDFI Status	Count	Population Percentage*	Sample Allocation	Sample Percentage
Real Estate	Metro	Non-CDFI	1,709	37.9%	12	20.0%
Business	Metro	Non-CDFI	979	21.8%	8	13.3%
Real Estate	Metro	CDFI	477	10.6%	4	6.7%
Business	Non-Metro	Non-CDFI	416	9.3%	4	6.7%
Business	Metro	CDFI	267	5.9%	3	5.0%
Real Estate	Non-Metro	Non-CDFI	185	4.1%	3	5.0%
Business	Non-Metro	CDFI	142	3.2%	3	5.0%
Mixed	Metro	Non-CDFI	113	2.5%	3	5.0%
Real Estate	Non-Metro	CDFI	73	1.6%	3	5.0%
Mixed	Metro	CDFI	72	1.6%	3	5.0%
Mixed	Non-Metro	Non-CDFI	37	0.8%	3	5.0%
Mixed	Non-Metro	CDFI	20	0.4%	3	5.0%
		Sample With Certainty	8	0.8%	8	13.3%
		TOTAL	4,498	100%	60	100%

** Percentages do not add to 100 due to rounding.*

sample of 60. First, all 8 projects from the certainty sample stratum were selected. The remaining projects were selected from strata in numbers approximately proportional to the strata sizes, with a minimum of 3 projects drawn from any given stratum. Imposing the minimum of 3 projects from a given stratum ensured representation in smaller strata.

Table 1 shows the allocation for the 60-project sample.

As Desk Reviews were conducted, the sample size needed to be reduced to 53 projects due to limitations in time and budget, given the large amount of material reviewed. Additionally, detailed documentation for the oldest projects in the sample was often unavailable. Therefore, all remaining projects closed before 2010 were substituted with projects that were closed more recently. Substitutions were made so that projects from the original strata replaced projects within the same strata to maintain representation of the different strata in the sample.

Summit measured the confidence with which statistically significant findings in the research could be extrapolated to the NMTC project population by testing the precision of estimates of a project interest rate based on a simulation of 1,000 samples from the entire population of NMTC projects. The results for this specific variable, chosen because of its availability both within the sample and the entire population, evidenced that the findings based on the small sample used in this research could be extrapolated to the entire sample. However, the precision estimates were only conducted for the variable of interest rates due to its availability both within the sample and the full population. However, much of the analysis used in the research resulted from in-depth analysis of project documentation and is not currently collected for all NMTC projects. Therefore, while interest rates exhibit a similar level of variance to the parameters of interest in this study, the exact precision of the estimates for variables in this study could not be measured, which could potentially attenuate the ability to extrapolate the findings of this research to the entire population of NMTC projects.

ENDNOTES: APPENDICES

i For census tracts in a metropolitan statistical area, the higher median family income of either the state or metropolitan area was used. Negative median household income ratio were ranked, so that a higher rank indicated a lower median household income, and thus a higher level of distress.

ii The Economic Innovation Group. "The 2016 Distressed Communities Index: An Analysis of Community Well-Being Across the United States." 2016. Web. May 2016.

iii Census tracts with unavailable data for any of the five indicators or with a population less than 500 were excluded from the rankings and did not have a distress score assigned.

iv If the financing gap reported did not consider other public funding, Summit added the amount of other public funding to the reported financing gap to be consistent across projects.

v This margin accounts for the fact that the financing gap reported is the gap for the projects itself and closing the gap via NMTC incurs additional costs not included in the project's financing gap.

vi Moody's Investors Service. *Approach to Rating US and Canadian Conduit/Fusion CMBS.* December 2014.

vii U.S. Census Bureau. *Quarterly Financial Report*. http://www.census.gov/econ/qfr/definitions.html.

viii Professional Services includes computer systems design, management and technical consulting, and scientific research. Wholesale Trade includes wholesale trade of nondurable and durable goods. Manufacturing includes all nondurable manufacturing (e.g., food, beverage and tobacco products, textile mills, apparel and leather products) and durable manufacturing (e.g., wood products, nonmetallic mineral products, primary metals). Information includes publishing industries, motion picture and sound recording industries, and telecommunications. Retail Trade includes food and beverage stores and clothing and general merchandise stores.

ix Summit tested the relationship between distress score and implied capitalization rate deviation using linear regressions and probability models to test the effect of an increase in distress score on the likelihood that a project would have implied capitalization rates above certain deviation thresholds from the benchmark. None of these statistical tests showed clear relationships between distress score and implied capitalization rate deviation.

x **Result is statistically significant, $p \leq 0.1$

*Result is not statistically significant but suggests a potential underlying relationship, $0.1 < p \leq 0.2$

No symbol: Result is not statistically significant, $p > 0.2$

xi **Result is statistically significant, $p \leq 0.1$

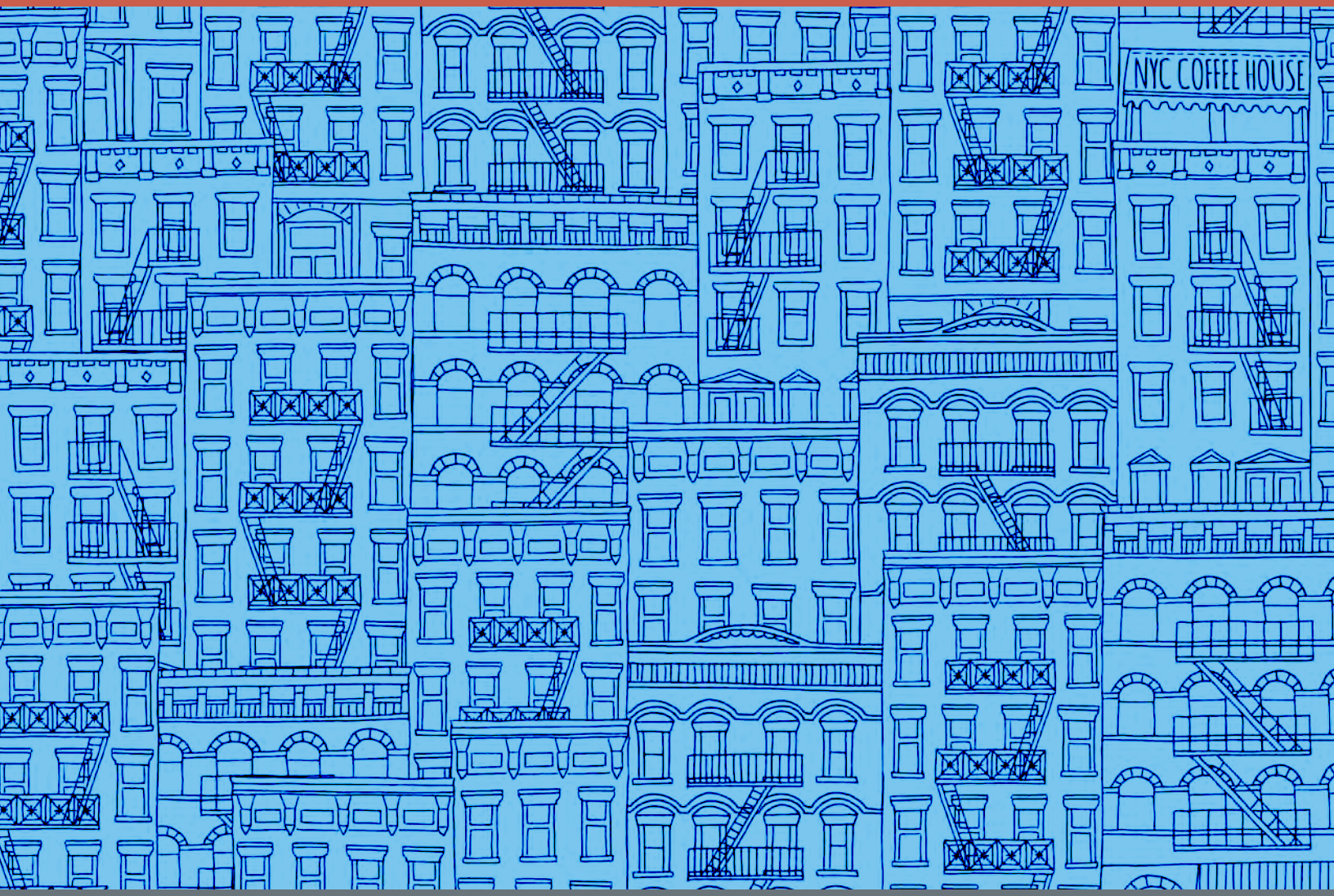
*Result is not statistically significant but suggests a potential underlying relationship, $0.1 < p \leq 0.2$

No symbol: Result is not statistically significant, $p > 0.2$

xii The CDFI Fund included specific projects using targeted population criteria, multi-census tract projects such as broad band infrastructure, multi-CDE investments projects, and projects that "twinned" with other public sources of funding. The certainty sample was not meant to represent a certain "strata" but was instead selected to examine specific compliance documentation procedures for such projects.


NYC COFFEE HOUSE

summit



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