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AFFORDABLE HOUSING FINANCE

The Hybrid: A New Deal Design

Developers are combining 9% and 4% credits in the same development.

By Donna Kimura

Bellwether Housing has built a development that achieves both size and depth to provide needed affordable housing in Seattle. At 133 units, Arbora Court is the nonprofit's largest construction project to date. The development also digs deep to serve many of the city's most vulnerable households, including 40 families transitioning out of homelessness.

Robert Wade

Bellwether Housing developed the 133-unit Arbora Court in Seattle with the help of twinning 9% and 4% low-income housing tax credits.

To develop the ambitious project, Bellwether Housing combined 9% and 4% low-income housing tax credits (LIHTCs) in the same project, a move that more developers are eyeing to finance their developments.

"We could not have created a capital stack that would allow us to create that many extremely low-income units and be able to accommodate those families without the 9% credit or some other off-scale investment from other public soft funders that would have funneled those resources away from other projects," says Susan Boyd, CEO of Bellwether Housing.

Traditionally, LIHTC projects have utilized either 9% credits or 4% credits, not both. That's because the tax-exempt bonds that come with 4% credits are prohibited from being used with 9% credits. However, developers and their financial partners have recently been able to utilize both credits by splitting a project into separate deals, but it requires careful planning and documentation.

This "twinning" of credits helped Bellwether Housing create a financially sustainable project, and it was a useful tool when creating a deeply targeted mixed-income development, including units for families leaving homelessness, Boyd says.

The residential portion of Arbora Court cost approximately $39.8 million and is financed with $12.1 million in 9% credit equity and about $10.2 million in 4% credit equity from investor U.S. Bancorp Community Development Corp. Additional funders include the city of Seattle and King County.

Bellwether Housing, with partner Plymouth Housing, is looking to combine credits at another development that is expected to break ground in 2020. The project will be the first nonprofit-developed high-rise in Seattle.

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On the other side of the country, the Virginia Housing Development Authority (VHDA) has been providing an incentive for developments that combine 9% and 4% LIHTCs in its qualified allocation plan (QAP) since 2015.

The move allows the agency to stretch its limited 9% credits further while using an abundant supply of 4% credits to finance affordable housing developments. VHDA funded five hybrid projects in 2015, two in 2016, four in 2017, 14 in 2018, and another nine projects have been reserved credits this year. Together, these projects provide nearly 5,700 affordable units.

In its QAP, VHDA provides a point incentive for developments that combine the two credits. The points, which are awarded on a sliding scale, are enough to be a difference-maker in the competition for credits, says Art Bowen, VHDA's managing director of rental housing.

The program has worked well, but the deals are complex, requiring developers to divide a project into two separate transactions—one with 9% credits and another with 4% credits and tax-exempt bonds.

This requires developers to think about what would happen if they have to run the two projects independently of one another.

As an example, a development may have one building financed with 9% credits and another with 4% credits. However, only one of the buildings will likely have the amenities, including the leasing office, the fitness center, and other community space. Developers may need to have a legal agreement in place so residents in the other building will have access to the amenities in the other.

Despite the complexities, there are many benefits to twinning. For developers, the structure will allow them to access additional credits to make deals financially feasible.

For VHDA, twinning is a way to maximize the agency's resources by reducing the use of 9% credits by bringing in 4% credits and bonds into deals. VHDA officials estimate they are able to squeeze out one additional 9% credit development each year under the program. That's significant because it means more affordable homes are being built.

More Hybrid Deals

Other states also are looking at ways to combine the credits to help developers build affordable housing.

Following the 2016 presidential election, the threat of tax reform caused LIHTC prices to plummet, which made many deals across the country no longer financially feasible. To help these projects, the California Tax Credit Allocation Committee (CTCAC) passed an emergency regulation change allowing developers with an existing allocation of 9% credits to reapply and monetize excess tax credit eligible basis (i.e., basis in excess of the amount needed to support the original allocation of 9% credits). CTCAC accomplished this by issuing 4% credits on the excess basis, which resulted in several million dollars of additional tax credit equity proceeds for the developers who were able to utilize the regulation change, says Matt Grosz, director of acquisitions at Red Stone Equity Partners. In their regulations, CTCAC has since defined the combination of 4% and 9% credits as the hybrid.

Grosz was familiar with the hybrid structure after using it to finance a large development in downtown San Diego years earlier in his previous role as chief investment officer at Chelsea Investment Corp., a prominent affordable housing developer in the state. That experience led to conversations with CTCAC leadership about employing the structure to help projects that were struggling after 2016 and since has resulted in a permanent regulation change, which now provides for a competitive scoring incentive for hybrid transactions, he says.


Courtesy Meta Housing

Meta Housing and Western Community Housing are utilizing a hybrid structure to develop the 65-unit Main Street Plaza Apartments in Roseville, Calif.

"We're seeing more hybrid deals happening and people choosing to pursue the structure either to increase the competitiveness or purely for project feasibility where there's a limited amount of local resources," he says. "The basic concept is the following: If you're not taking 9% credits on 25% of your eligible basis, then you can carve that 25% piece of the project or building off and access 4% credits, which gets you

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35 cents on the dollar back in equity. Absent the hybrid structure, 100% of those excess basis costs are financed with soft money, perm loan proceeds, or deferred developer fee."

Red Stone Equity Partners, a national LIHTC syndicator, recently closed on the financing for a 65-unit hybrid community with Meta Housing and Western Community Housing in Roseville, Calif.

In order to execute on hybrid transactions, it's critical that developers draw clear lines between the different ownership structures for the 9% and 4% components. The documentation is a bit more intensive, and some investors may be more leery of these transactions depending on how clear the delineation is between the two ownership structures, according to Grosz.

"When you build your pro forma to finance the deal, you have to figure out how you want to allocate the costs between the 4% and 9% components," he says. "There are a handful of methodologies you can employ, but more important than the methodology you choose is that the allocation method is consistently applied across the development budget."

Issues to Watch

In addition to separate ownership structures, other aspects of the development plan will need to be split into separate parts—even if the project involves a single building. This includes the construction contract, financing plans, and other third-party reports, says Kent Neumann, founding member of Tiber Hudson, a law firm experienced in affordable housing and bond deals.

"Tax credit deals are already complicated, and adding both 4% and 9% tax credits to the same development plan only adds to that complexity," he says. "It is also important to set things up as far in advance as possible with the twinning aspects of the deal. Having to make adjustments later in the schedule can create significant delays and in some cases require substantial changes to certain reports, contracts, or agreements."

Hybrid deals have become more common in the last few years as developers and investors have become more familiar and more comfortable with the structure. It's also notable that some states have either explicitly permitted or, in some cases, incentivized it in their QAPs, says Daniel Rosen, a partner at Klein Hornig. His law firm has closed on a number of twinned deals in multiple states.

Each state has a limited amount of 9% credits to allocate each year, and many states also have a cap on how much in 9% credits a project can receive. These limits often mean deals have "excess" basis that's not generating credits, especially for larger projects, according to Rosen. Twinning allows developers to monetize that excess basis with 4% credits. As a result, how much more equity a project can derive from this structure varies from deal to deal. "It's a question of how much bigger is your deal than your 9% credit allocation," Rosen says. "That's where the decision begins."

Combining the credits usually makes more sense on a large deal because you are monetizing the extra basis and you have to reach a certain scale to justify the complexity and costs, he says, noting that twinning has been used in deals over 300 units as well as in deals with as few as 60 units overall.

While the structure's main promise is to monetize "wasted" basis, it's also been used to serve other purposes, ranging from providing incentives to using expiring tax-exempt bond volume cap to encouraging additional density of affordable units on a particular site, or even reducing the amount of local subsidy gap financing, according to Klein Hornig partner Erik Hoffman. He says twinning is often a way to separate your financing application from the pack of competitors given it demonstrates that the developer is working to better leverage public resources to provide more housing. Hoffman observed a significant increase in developers pursuing twinned project structures and in state allocating agencies permitting or incentivizing them. For example, Hoffman says that in Maryland's recent 2019 funding round, of the 47 applications submitted, eight of the 15 projects that received awards employed the twinning structure.

When a development team decides to move ahead with a hybrid structure, it will have to create a legal framework for the separate ownerships that are required for the 9% and 4% credit portions of the project. This often involves splitting a project with a condominium or an air-rights structure.

Hoffman dubbed these "Noah's Ark" deals because they require two of everything, including two plans of financing, two budgets, and two loans. Rosen notes that construction contracts sometimes are the exception and can be a single contract for both projects, but that even these often require extra attention because the costs and scope of the work will have to be split among the two different projects even though there may only be one building involved, he says.

Close monitoring and documentation is also required after construction, says Boyd of Bellwether Housing, noting that a property will get one utility bill but that will have to be split between the two projects.

Twinning adds significant complexity and business risks, all of which should be evaluated with counsel and accountants before pursuing, says Hoffman. He explains that the main risk comes if the tax-exempt bond proceeds "taint" the 9% credits, resulting in a potential adjuster of 50% to 60% of the tax credit equity, which would be catastrophic for most projects and sponsors. That taint, Hoffman says, can be direct, wherein the tax-exempt bond proceeds subsidize the construction of the 9% project, or indirect, such as by cross collateralizing the projects or inappropriately blending the two project financings when they should be separated.

While the twinning of 9% and 4% LIHTCs is still relatively new and poses potential risks, a similar structure has been used in other transactions, including in deals that combine LIHTCs and New Markets Tax Credits, Rosen says. "We do a number of transactions that combine those credits," he says. "The technical rules are different, but the results and structuring issues are very similar because there's a similar concern. In that case, it's not allowing the New Markets financing be used to finance the residential project."

ABOUT THE AUTHOR

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Donna Kimura is deputy editor of Affordable Housing Finance. She has covered the industry for more than 20 years. Before that, she worked at an Internet company and several daily newspapers. Connect with Donna at dkimura@zondahome.com or follow her @DKimura_AHF.

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