



## NMTC Investment in Operating Businesses Complex, Beneficial

**BRAD STANHOPE, SENIOR EDITOR, NOVOGRADAC & COMPANY LLP**

It's not simple to invest new markets tax credits (NMTCs) in operating businesses, but it's impactful.

**A** “It comes down to permanent, quality and accessible jobs,” said Jonathan Goldstein, managing director at Advantage Capital, an investment adviser and community development entity (CDE) that invests solely in operating businesses. “There are definitely benefits [to investing in real estate], but what's incredible about operating businesses is that they can continually grow. ... An operating business is constantly looking for a reason to grow, so if we pick a business that does that, it has a catalytic impact on the community.”

Catalytic impact is one of the goals of the NMTC program, but for much of its history, an overwhelming percentage of investments were in real estate. Only through influence by the Community Development Financial Institutions (CDFI) Fund did more emphasis switch to operating businesses.

### **Real Estate is Easier**

The main reason real estate transactions are easier is simple: Simplicity.

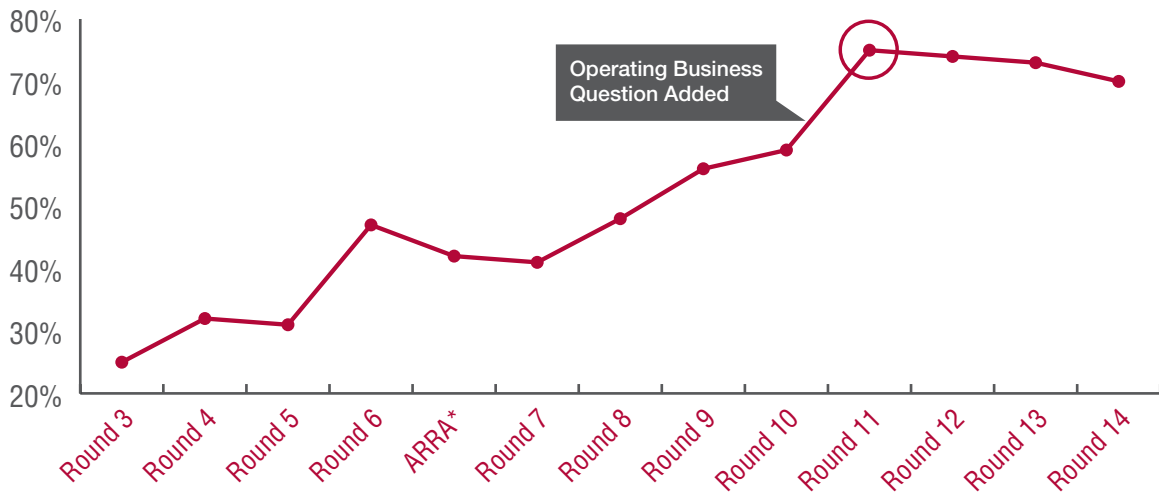
“When you think about a real estate transaction from the perspective of a financing party, it's a lot like a bond,” said Nathan Ware, partner at Baker Hostetler, a global law firm that works in the community development space. “You have determinable stream of future payments that can be easily modeled and financially engineered. From the inception of the [NMTC] program, it's catered to those deals. As a consequence, everything from underwriting to form transaction documents are based on that model.”

That means CDEs that focus their NMTCs on operating businesses face hurdles that real estate transactions might not face. Goldstein cited four specific reasons that operating businesses are more difficult than real estate to finance with NMTCs:

- Financing options: “In the [NMTC] real estate world, there's a predominant product, the A/B loan with a seven-year structure,” Goldstein said. “For some businesses that works ... but a lot of

## ADDITION OF QUESTION BOOSTS OPERATING BUSINESS INVESTMENT

Before the 11<sup>th</sup> round of the new markets tax credit allocation, the CDFI Fund added an unscored question to encourage innovating investments, including non-real-estate financing such as working capital or equipment loans to operating businesses. The question doesn't affect whether a community development entity (CDE) gets an allocation, but can affect the size of allocation for successful CDEs. The change sparked an upsurge in investments in operating businesses:



Figures not available for Round 1 and Round 2.

\* In 2008, there was an extra round, due to the American Recovery and Reinvestment Act.

Source: Novogradac & Company LLP

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operating businesses don't fit in that category. They may only need a two- or three-years loan. Or they may want to raise true equity."

- Sourcing: "By and large, the real estate world understands the New Markets Tax Credit program and knows how to attract investment," Goldstein said. "In operating businesses, you're talking about a universe of 10 million operating businesses or more, and 90 percent of them have no idea what the NMTC is or how this program can help them. You have to be more proactive in funding them." He said sourcing is Advantage Capital's largest single expense.
- Underwriting: "Real estate developers are terrific at structuring their projects around the requirements of the NMTC program," Goldstein said. "When it comes to an operating business, you get what you get."
- Asset management: "After you've closed the transaction, an operating business is a much more dynamic organism than a single-purpose real estate

site," Goldstein said. "Look at an operating business and it's constantly taking on new business lines and raising capital."

### General Hurdles

The structure of the NMTC program—in which principal repaid within seven years must be redeployed by the CDE on another NMTC-eligible investment—creates a fundamental hurdle for operating businesses.

"In real estate, it's easy to make the loan interest-only for the first seven years," said Amanda Read, partner in Novogradac & Company LLP's Cleveland office. "But with working capital or equipment, the business wants to pay it back. And for CDEs, that means you have to redeploy it."

Read specified the difficulty of an NMTC-backed loan for equipment that has a life of five years. In that case, the operating business wants to repay principal on the loan in less than seven years.

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Read said it's easiest for banks that are CDEs to redeploy NMTCs because they have a pipeline of potential customers. "The minute you get money back, you have to start to think about redeploying it," Read said. "Nonprofits and community development organizations sometimes have a hard time with that."

Another issue is the size of the financing. Operating business investments tend to be smaller. With higher transaction costs often associated with NMTC transactions, smaller transactions offer a lower net benefit to the project.

"When you don't figure in real estate, you're talking about smaller [qualified low-income community investments] QLICs," said Bob Ibanez, senior public policy manager at Novogradac Consulting LLP, who spent 13 years at the CDFI Fund, including the final six as the program manager of the NMTC and Bank Enterprise Award programs. "It's easier to stay in compliance with real estate projects that are larger-size deals and fixed in location. Financing operating businesses for working capital, inventory or equipment purchases with a seven-year term is more challenging than real estate projects that typically are longer-term investments, so reinvestment of the funds during the seven-year compliance period is typically not an issue."

### Role of the CDFI Fund

The move to encourage more NMTC investment in operating businesses took hold after a February 2010 meeting involving Treasury Secretary Tim Geithner in Durham, N.C. After a tour of a facility in Durham, Geithner participated in a roundtable discussion about the challenges to get new investment in distressed communities.

"The Treasury secretary oversees the CDFI Fund and the IRS," said Ibanez. "So the IRS was first out of the box to try and do something. It published a notice of proposed rulemaking, inviting the public to comment

on potential changes to the NMTC program to support greater investment in non-real-estate businesses."

That led to Treasury Decision 9600 (TD 9600) in 2012, which encouraged investment in non-real-estate QALICBs. Although TD 9600 modified the reinvestment requirements of the NMTC program in hopes of relieving one of the perceived obstacles, it largely failed to increase such investment.

The CDFI Fund simultaneously tried to encourage operating business investment through the application process. In 2012, it added a question to promote innovative investments, including providing non-real-estate financing such as working capital or equipment loans, etc., to the NMTC application.

"The CDFI Fund decided to encourage more investments in operating businesses without assigning priority points to that financing activity," Ibanez said. "There is not a statutory mandate to assign more points for investing in operating businesses than real estate businesses, so the CDFI Fund decided to put something in the application to signal to the industry that this is important and to encourage more investment."

Ibanez points out that the emphasis on operating businesses comes through an unscored question. Promising to make innovative investments doesn't help a CDE get an allocation, but it can affect the size of allocations that successful CDEs receive.

It worked.

"From the beginning of the [NMTC] program, we interpreted the ideal NMTC beneficiaries to be smaller operating businesses," said Patrick Vahey, president of Greenline Ventures, a financial services company that has championed the use of revolving NMTC loan funds for small businesses. "However, our parent company at the time [Capmark Financial Group] was exclusively

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focused on commercial real estate, so that was our initial strategy. As our company changed and we gained experience with the program, we began migrating our focus to operating businesses as we thought it to be a more impactful NMTC strategy. When the CDFI Fund began incentivizing operating business investments, it reaffirmed our decision and caused us to speed up our transition.

“In the early days, we believed there was probably an over allocation of new markets tax credits to real estate. We viewed the CDFI Fund’s efforts at encouraging more investments in operating business to be very positive for the overall NMTC industry and, more importantly, for low-income communities.”

Robert Labes, a partner at global law firm Squire Patton Boggs, said changes were obvious.

Labes said that the CDFI Fund made it known that it would view applicants more favorably if they indicated they were investing a percentage in innovative products. “They were trying to encourage investments in operating businesses and even in that, the CDFI Fund is making an assumption of a type of operating business,” said Labes.

Labes stressed that small businesses aren’t the only beneficiaries of NMTC investments, citing work he’s done with Fortune 100 companies.

### Benefits to Businesses

While increasing the diversity of the program, NMTC investments in operating businesses have another beneficiary: the businesses themselves.

“Sometimes we impact the business model clients pursue in a favorable way, along the lines of job creation,” Ware said. “We counsel clients to sharpen their pencils on job creation and to think about what they can do proactively to make jobs available to [low-income people] LIPs, to form relationships with technical schools or local colleges and to consider what they can do to encourage upward mobility so people can move up through the ranks.”

The challenges of investing in operating businesses are offset by the benefits, according to practitioners.

“It’s really laudable to broaden the program,” said Goldstein. “I feel like the past five to seven years, the CDFI Fund has tried to shift the balance, emphasizing the creation of more permanent jobs, though certainly not to the exclusion of community facilities or other real estate-centric investments.” ❖

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