Equity Capital for Affordable Housing:  
A Systems View of the Housing Tax Credit Industry  

by  

Bruce Kiernan  

Submitted to the Department of Urban Studies and Planning  
in Partial Fulfillment of the Requirements for the Degrees of  

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Chair, Master of City Planning Program Committee  

Page 1
EQUITY CAPITAL FOR AFFORDABLE HOUSING: 
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by

BRUCE KIERNAN

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ABSTRACT

This work explains and evaluates the actors and processes at work in the industry of raising equity capital for affordable housing using the low income housing tax credit ("LIHC"), and the relationships between the actors and processes. The particular focus is on the role of corporate investors, which have, in the past 24 months, become the dominant source of equity capital in the industry.

There are three principal reasons why an industry analysis of the housing tax credit industry is of particular interest. First, a substantial majority of the measurable affordable multifamily housing starts in the United States are financed, in part, by equity raised with Federal tax credits. Second, although the industry is important to achieving the nation's housing objectives, the industry is unusual and fairly complex. As a result, the industry is not well understood, even by participants in the industry. Third, the industry is currently undergoing rapid change and evolution.

The thesis begins by providing a brief discussion of the multifamily housing market and policy contexts for the LIHC. The history and provisions of the LIHC program are summarized. An overview of the housing tax credit industry is provided. The two major submarkets which make up the housing tax credit industry are the equity capital market, in which intermediaries raise capital from investors, and the property market, in which intermediaries invest capital with developers into properties which generate tax credits. The equity capital market and the property market are each described. Then, the housing tax credit industry is described and analyzed. The two submarkets are again drawn together to form a complete picture of the industry as a system.

The principal aims of the work are threefold: first, to illustrate the elements of industry structure in the housing tax credit industry; second, to develop an industrywide perspective which shows the interrelationships between various parts of the industry and allows us to see the industry as a system; and third, to discuss and understand how the dynamics of the industry operate.

There are three principal conclusions. First, some of the major participants in the equity capital market - corporate investors and brokers - did not have an adequate understanding of the industry as a system and therefore did not understand the
system-wide implications of their decision to invest large sums of capital with many intermediary firms. The dynamics of the industry structure rapidly led to lower yields for investors and lower profits for brokers, results which they did not anticipate. Second, the investment of large sums of capital has transformed the equity capital market in the past twenty-four months. The types of investors and products have changed substantially. The pace of change is still rapid. Third, this transformation has not only changed the equity capital market, but has substantially changed the economics of the industry and the LIHC program. The efficiency of the program, from a public policy point of view, has substantially improved.

Thesis Supervisor: Dr. Joseph Ferreira, Jr.
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The opinions expressed in this work are those of the author and do not necessarily represent the views of any firm or individual discussed herein.
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Chapter 1

Introduction

This work explains and evaluates the actors and processes at work in the industry of raising equity capital for affordable housing using the low income housing tax credit ("LIHC"), as well as the relationships between the actors and processes. The particular focus is on the role of corporate investors, which have, over the past twenty-four months, become the dominant source of equity capital in the industry.

There are three principal reasons why an industry analysis of the housing tax credit industry is of particular interest. First, a substantial majority of the measurable affordable multifamily housing starts in the United States are financed, in part, by equity raised with Federal tax credits. Overall Federal expenditures on other housing programs have been sharply reduced in the past decade. The LIHC program has become the nation's principal program for generating new affordable housing production.

Second, although the industry is important to achieving the nation's housing objectives, the industry is unusual and fairly complex. As a result, the industry is not well understood, even by participants in the industry. In part, that is because this is a relatively young industry. The low income housing tax credit was created by the Tax Reform Act of 1986, and the program became effective January 1, 1987. Substantial sales to corporations were not achieved until late 1992. In effect, the industry has not yet matured.

Another reason why the industry is not well understood has to do with the legislative history. The program was initially given a three year term. Congress later
passed three separate extensions. Because of the uncertainty about whether the program would continue, the industry has not been well analyzed. Congress recently made the housing tax credit permanent.

The third reason why an analysis of the industry is of interest is that the industry is currently undergoing rapid change and evolution. The process of maturation is beginning. Largely as a result of the increased investment by corporations, the industry has changed tremendously during the past 24 months, and more change is coming. The future of the industry will be shaped by market and competitive forces.

Viewing the industry as a system is a particularly useful approach, for two reasons. First, although the industry is unusual and complex, its scope can be fairly well defined and the important subsystems can be defined. (By subsystem or submarket I mean a portion of the overall industry system which can be delineated functionally from other portions of the industry.) Furthermore, the industry is to some degree a closed system, because there is a limited amount of tax credit which is authorized each year. For these reasons, it lends itself to a systems view.

There is a second reason why a systems view is effective. Part of the reason why the industry is not well understood is because many of its participants tend to have a "local" view - that is, a view which is limited to the actors with which they have immediate contact. Individual industry participants appear to operate without an understanding of how the actions of all industry participants interact and indirectly influence each other. This is precisely the sort of system which can have dynamics that are unpredictable in the context of any particular subsystem and may therefore be surprising to industry participants.
Chapter 2 discusses the current multifamily housing market, and briefly discusses some of the policy considerations around the LIHC program. The broader market and policy issues provide a context for understanding the housing tax credit program and industry.

Chapter 3 briefly outlines the history of the tax credit program and summarizes the material provisions of the law and regulations. These define the Federal low income housing credit program and influence key characteristics of the industry. This provides the reader with the necessary background to understand the chapters which follow.

Chapter 4 is a brief overview of the housing tax credit industry, to provide an overall perspective. This chapter also defines the two major submarkets which make up the housing tax credit industry: the equity capital market, in which intermediaries raise capital from investors; and the property market, in which intermediaries invest capital with developers into properties which generate tax credits.

In Chapters 5 and 6, the equity capital market and the property market are each described. In addition, the actors in the industry are generally described.

In summary, within the equity capital market one set of actors is investors. In a broad sense, there are individual investors and corporate investors. The principal focus is on describing the corporate investors. These investors have clearly come to dominate the market in the past 24 months. In addition, they are somewhat more complex actors than individual investors. Generally the funds raised in the capital market flow through a second set of actors, referred to herein as channels (that is, channels of distribution). These channels include broker/dealer firms, such as Wall Street firms and regional broker/dealers; specialty firms who focus on selling this
particular product; and individuals who operate as brokers or "finders." Finally, the intermediaries who package and sponsor these investments also function in part in the equity capital market. These intermediaries include both for-profit and non-profit entities.

The funds raised in the capital market are put to work in the property market, where they are exchanged for ownership interests in particular property investments. One set of actors provides the funds to the property market. These include the intermediaries as well as, to a limited degree, finders. The other principal set of actors is the developers. Developers have the responsibility for selecting and initiating property developments. They obtain equity capital by selling a portion of their ownership interests to the intermediaries. The primary emphasis of this work is on understanding the equity capital market and the industry as a whole, so the discussion of the property market in Chapter 6 is limited to the extent needed to achieve that understanding.

In Chapter 7, the housing tax credit industry is described and analyzed, again with an emphasis on the equity capital market in general and corporate investors in particular. Drawing upon developed techniques of industry and competitive analysis, notable features of the industry will be highlighted and explored.

Chapter 8 draws the detailed view of the two submarkets together to form a complete picture of the industry as a system. Some implications and observations regarding the industry are discussed. This chapter will also make observations as to the history of the industry, policy implications of industry structure, and trends.

Finally, a brief summary of the principal conclusions and areas for further research will be presented.
Chapter 2
The Low Income Housing Credit in Context:
Housing Market Conditions and Policy Considerations

Congress created the low-income housing tax credit in order to encourage the production of rental housing which is affordable to low-income households. Therefore, to understand the LIHC program, it is essential to begin with some context. This chapter discusses the current condition of the rental housing market, and outlines some of the basic policy considerations surrounding the program.

Section 2.1 Multifamily Rental Housing Production

Production of rental housing has varied dramatically in the past decade. (See Figure 2-1, Multifamily Rental Housing Starts.) Recent years have seen a dramatic drop to historically low levels. Production fell from a peak of 515,000 units in 1985 to just 117,000 starts in 1993.1 Multifamily starts "hit a 35-year low in 1991 and are still restrained ... Current production levels are insufficient to replace units lost to demolition or conversion, and multifamily inventory actually declined in 1991 and 1992."2 This is the first time since World War II that the number of rental units has declined from one year to the next.3

---


Figure 2-1
Multifamily Rental Housing Starts

Privately owned units.
It appears that 1991-1993 represents the bottoming out of the trend and that production will slowly trend upward. The housing tax credit program is an important reason why:

The multifamily housing market ended 1993 in far better shape than it entered the year. The first quarter of 1993 was the worst since the inception of multifamily housing start statistics, with a seasonally adjusted annual rate of a mere 134,000 units. By the fourth quarter this had increased to 186,000 units, an increase of 39 percent. The prospects for 1994 and 1995 appear to be better, with strengthening of the economy and the low income housing tax credit (LIHTC) kicking in. ... [However,] production is still running around 40 percent below the 300,000-unit level, a level that was once thought to be a floor that the market could not fall below.  

The issuance of building permits rose dramatically in late 1993. As a result, economists are forecasting that multifamily construction will rise to 200,000 units annually for 1994. "This is largely due to the renewal of the low income housing tax credit. ... the multifamily market appears to have finally turned the corner, and begun a period of modest, but nonetheless, positive growth. Government assistance, in the form of the LIHTC has been essential to this turnaround."  

Section 2.2 Housing Supply and Demand

Of course, housing production is only the supply side of the equation for the rental housing market. It is worth reviewing the supply/demand balance as well, which is influenced both by current levels of demand as well as historical levels of

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Figure 2-2
Rental Starts and Vacancy

supply. As Figure 2-2 illustrates, at least part of the reason why housing production is down is the market's response to the oversupply of multifamily housing in general. The relatively high levels of production in the mid-1980s led to rising vacancy rates. Those vacancy rates have remained at relatively high levels until very recently. However, "the overall rental vacancy rate fell to an eight year low of 6.9 percent during the fourth quarter of 1993."6

Vacancy statistics are often used to suggest that there is no need for housing production programs. Of course, these statistics measure nationwide vacancy, but housing is a locally supplied commodity. Furthermore, these statistics measure broad market vacancy rates, but do not reflect the balance of supply and demand in the affordable segment of the housing market.

The downturn in the rental housing market has received a great deal of attention from housing market analysts and in the popular press. In the first half of the 1980s, multifamily construction was buoyed not only by the overall expansion of the economy but also by extremely favorable treatment under the federal tax code. There is no doubt that construction activity ran well ahead of demand in many parts of the country, and in some places, it oversaturated the market. But although there is an oversupply of rental units in many markets, it is important to note that much of that surplus is at the high end. In many markets, there is a strong demand for but an insufficient supply of good-quality, low-cost units for low- and moderate-income households.7

The Joint Center for Housing Studies of Harvard University reports that, even with the weakness in the national economy and the low levels of production, rents remain close to their highest historical levels, and rents as a fraction of income hit a

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25-year high in 1992. They attribute this, in part, to continued losses in the stock of affordable housing. "[D]espite a 33% increase in the overall inventory of rental housing since 1974, the stock of affordable units (subsidized and low-cost unsubsidized units combined) has steadily eroded." There were fewer affordable housing units nationwide in 1991 than there were in 1974. Clearly, then, providing affordable housing is an issue which should remain on the nation’s political agenda.

Section 2.3 Subsidies for Housing Production

As many observers have noted, Federal housing subsidies for producing new housing units have been substantially reduced since 1980. For example, the number of new or rehabilitated units funded through the programs of the Department of Housing and Urban Development fell from 215,000 units in 1980 to 20,000 units in 1993. The Section 8 production program, which produced several hundred thousand new affordable units during the 1970's and early 1980's, was eliminated under the Reagan administration. In general, the Section 8 subsidy program became a tenant-based rental subsidy program rather than a new production program. Other than the low income housing tax credit, no major new housing production programs have been implemented.

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9 Joint Center for Housing Studies, p. 15.

Many state governments are active in housing programs, and play a central role in the housing tax credit program, as will be discussed in Chapter 3.

Most states administer their housing programs through state line agencies, state housing finance agencies (HFAs), or both. HFAs promote a state's housing goals mostly by issuing tax-exempt bonds backed by mortgages and by allocating federal tax credits to for-profit and non-profit developers. In addition to these federally supported programs, many HFAs have made enough money off of past investments to establish unsecured agency reserve accounts and use them to fund a variety of specialized housing programs. ... Line agencies typically administer the CDBG program and DOE's home weatherization program. Some of these agencies also administer HUD Section 8 and public housing assistance. In about 20 states, they also administer the HOME program.\(^{11}\)

At one time, it was thought that state and local governments might become more active in funding affordable housing production. "Some observers hope ... that increases in state funding will compensate for cuts in incremental federal housing assistance."\(^{12}\) However, state expenditures on housing remain low. Most states spend less than $2 per capita annually on housing and community development. Between 1985 and 1990, federal expenditures on housing and community development rose by 21.8%, in real terms. In fiscal year 1990, of total governmental expenditures on housing and community development (net of tax expenditures and expenditures for loans), Federal spending accounted for 82%, local spending for 14%, and state spending for only 4%. Note that these amounts do not include tax expenditures, such


\(^{12}\) Belsky, Eric S., "The States and Housing Assistance," *Housing Economics*, Volume XXX1, No. 5, May 1993, pp. 5.

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as the low-income housing tax credit, so the percentages actually understate the proportion of spending which flows from Federal sources.

State and local governments assist in many ways in facilitating the provision of housing. However, clearly state and local governments are not becoming, by themselves, a significant source of new production for affordable housing.

**Section 2.4 Policy Considerations and the Low-Income Housing Credit**

As with many Federal housing programs, there has been debate about whether the low-income housing credit is the best vehicle for meeting the nation’s housing needs. Of course, there is great debate about the relative priority of the many programs contending for scarce Federal budget dollars. More narrowly, however, there has also been debate about in what manner Federal housing funds should be used. This debate has three major dimensions. First, there is a debate about production programs as opposed to tenant-based subsidy programs. In other words, should subsidies be provided to produce new rental housing, or should rent subsidies should be provided to tenants who would then go into the market and find housing?

William Apgar responded to that question as follows:

> The recent increase in market rents challenges the proposition that demand subsidies are a cost-effective method of housing assistance. First, rent increases have raised the cost of subsidizing households through the use of the existing stock and have made new construction programs relatively more attractive. In addition, by expanding the supply of rental housing, subsidized new construction programs may limit future rent increases, benefiting not only recipients, but others in the form of reduced rent payments. Although overlooked in recent housing policy literature, the price effects of housing supply programs may be important and certainly must be included in any complete assessment of alternative housing assistance approaches. ... Rather than continue the futile debate as to whether future housing assistance efforts should involve mostly vouchers or mostly production subsidies,
the nation would do well to undertake the business of developing flexible programs that offer appropriate choices to state and local decision makers.\textsuperscript{13}

Second, production programs can be delivered through direct expenditures of Federal dollars, or through tax expenditures such as the LIHC. There have been many arguments made about the relative efficiency, in practice, of these alternative approaches. Third, there is much debate about the roles of the Federal government, state and local governments, non-profit groups, and for-profit developers.

Not only must the policy considerations be balanced, but housing programs must also face political and operational realities. What programs will be able to obtain funding? Which programs will actually deliver a supply of well-managed affordable housing for tenants?

While the debate can and should continue, there are three facts which help to put that debate into context. First, expenditures for the low-income housing credit program are relatively small. The maximum annual cost to the Treasury is about $3.2 billion. (That is, $1.25 per capita for each of the 255 million residents of the United States, times 10 years.) To put that figure in context, the incentives for homeownership provided by allowing the deduction of interest on home mortgages costs the Federal Treasury approximately $41 billion annually. Furthermore, the Federal government estimates that 85\% of that benefit went to the most affluent quarter of American taxpayers.\textsuperscript{14} Second, the low-income housing credit is currently

\textsuperscript{13} William C. Apgar, Jr., "Which Housing Policy Is Best?," \textit{Housing Policy Debate}, 1:1, p. 17, 28.

delivering a significant amount of affordable housing. Since the inception of the program in 1987, approximately 600,000 units have been produced, including both newly constructed units and rehabilitated units. At full utilization, the program produces between 100,000 and 120,000 such units each year. In recent years the LIHC program has been responsible for approximately 85% of total multifamily rental housing production in the United States and an estimated 94% of affordable rental housing production. The program has been successful in delivering housing to the target population of the program. Finally, no alternative Federal production program has been identified. Until a substitute program is established and fully implemented, it would be wise to continue the housing tax credit program.

Chapter 3

A History and Summary of the Low Income Housing Credit Program

In order to understand the housing tax credit industry, it is necessary to first understand the low income housing credit (LIHC) program itself. The LIHC program is a creation of Federal legislation and regulations. This body of laws and regulations together define the program. In addition, the specific features and characteristics of the program have significant implications which influence key characteristics of the housing tax credit industry. This chapter will summarize the material and relevant provisions of the law and regulations, and interpret and discuss, to the extent necessary to understand the industry, the implications of those laws and regulations.

Section 3.1 Earlier Tax Incentives for Affordable Housing

"[The] trend of U.S. tax policy since the end of World War II had been to expand old preferences and to introduce new ones to achieve various economic and social objectives." 2 Until the Tax Reform Act of 1986, the Federal tax code included a variety of incentives to construct real estate in general and affordable housing in particular. The two most significant incentives were as follows.

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1 Congress, of course, passes the legislation. This legislation is then interpreted and implemented by the regulations and rulings issued by the Internal Revenue Service of the Department of the Treasury.

Deduction of Interest and Taxes during Construction. Prior to 1976 (for all real estate) and after 1981 (for low-income housing), interest and real estate tax payments incurred during the construction period were deductible. This provided substantial deductions, which were of particular value in attracting investment because they were available during the initial years.

Accelerated Depreciation. The Economic Recovery Tax Act of 1981 created the Accelerated Cost Recovery System (ACRS) for depreciation. All property was depreciable over 15 years. In addition, for low-income housing 200% declining balance depreciation, a form of accelerated depreciation, was available. Rehabilitation expenditures for low-income housing could be amortized over five years.

Note that the 1981 tax act provided significant incentives for real estate, as well as serving as a stimulus for other economic activity. Figure 2-1, if reviewed keeping in mind the stimulative effect of the 1981 tax act and the removal of incentives in the 1986 tax act, is a useful illustration of the effect of tax policy on housing production. "In fact, particularly in the last decade, federal tax policy has so dominated the underlying economics of rental housing deals that many analysts have concluded that rental housing investments have been tax driven."³

Section 3.2 The Tax Reform Act of 1986

"The Tax Reform Act of 1986 is the most significant piece of tax legislation enacted since the income tax was converted to a mass tax during World War II."4 The 1986 tax act eliminated many exemptions from tax as well as many deductions and credits that were used to reduce taxable income and tax.

In particular, for individual investors, the ability to use losses and tax credits from certain investments to offset other income was substantially eliminated.5 The 1986 act created the concept of passive activities, which are trade or business activities in which the taxpayer does not materially participate. Losses from passive activities generally cannot be used to offset income from other sources such as wages, salaries, and portfolio investments (for example, stocks or bonds). Any rental activity is considered a passive activity, as are all activities engaged in as a limited partner.

At the same time, Congress eliminated accelerated depreciation for real property and substantially lengthened the periods for depreciating real property. Residential real estate was to be depreciated over 27.5 years and all other real estate was to be depreciated over 31.5 years. (The 1993 tax act extended the depreciable life for non-residential real estate to 39 years.)

Finally, individual and corporate tax rates were substantially reduced. This had the effect of reducing the value of tax deductions. However, because the

4 Pechman, p. 170.

limitations on the use of losses from passive activities substantially eliminated the use of losses by individuals, this was material principally for corporations. (The maximum corporate tax rate was reduced from 46% to 34%.)

These provisions obviously substantially eliminated all of the incentives in the tax code for the production of real estate, and particularly for the production of affordable housing. The notable exceptions to this statement were the low-income housing tax credit and the rehabilitation tax credit. Individuals were allowed to annually offset up to $25,000 of income using these credits. (For example, an individual in the 28% tax bracket could use 28% times $25,000, or $7,000 per year of tax credit.) Corporations were allowed to use losses and credits without limit, subject to the provisions of the alternative minimum tax which required a minimum level of tax payments by each corporation.

The low income housing credit program was created by the Tax Reform Act of 1986. Internal Revenue Code Section 42 provides a tax credit for owners of qualified low-income housing properties, which are placed into service after December 31, 1986. The staff of the Senate Finance Committee had interesting comments on their motives for the creation of the housing tax credit:

[A] more efficient mechanism for encouraging the production of low-income rental housing can be designed than the variety of subsidies existing under present law. ... These subsidies operate in an uncoordinated manner, result in subsidies unrelated to the number of

---

6 The rehabilitation tax credit is an incentive for restoring residential and commercial properties, generally properties which are on the National Register of Historic Places, in historic districts, or were originally constructed prior to 1936. Individuals with direct ownership of real estate can also utilize up to $25,000 of deductions, in certain circumstances.
low-income individuals served, and fail to guarantee that affordable housing will be provided to the most needy low-income individuals.\textsuperscript{7}

Congress noted that, in former subsidy programs, income ceilings at 80\% of median income were relatively high when compared with the income of typical renters; household incomes were not adjusted for family size; none of the existing tax subsidies limited the rents which could be charged; and the degree of subsidy was not linked to the number of units serving low-income tenants.

**Section 3.3 The Low-Income Housing Tax Credit**

Section 42 of the tax code, and the regulations which interpret it, have a number of important provisions which give the program, as well as the industry, its shape.

**Tenant Income and Rent Limitations**

To qualify for the LIHC, a property must meet one of two tests, typically referred to as the "set-aside requirement": a minimum of 20\% of the apartment units must be set aside for families with incomes no higher than 50\% of the median income for the area; or a minimum of 40\% of the apartments must be set aside for families with incomes no higher than 60\% of median income for the area. Median incomes are adjusted for family size. In calculating family size, it is assumed that 1.5 persons occupy each bedroom. (The actual family size was used until 1989, but this proved unwieldy. For example, because the rent is based on family income, using actual

family size provided unintended incentives to rent to the largest possible family, and it required an increase or decrease in the rent when family size changed.)

Note that the income limits and the family size adjustments achieve an important policy goal: the subsidy is clearly directed toward the target population. This was a response to previous tax incentives, which benefitted properties that could rent to higher income tenants and for which there were no adjustments for family size. (The practical implication of this latter feature, under the former tax law, was that a one-person household and a four-person household might qualify at the same income level, even though their ability to pay was markedly different.)

In addition, rents (including tenant-paid utilities) may not exceed 30% of the income limit used to qualify (that is, the 50% or 60% of median levels). Further, if tenants pay for utilities this maximum must reduced by an allowance for the amount of utilities (other than telephone). Table 3-1 shows, for illustrative purposes, the maximum monthly housing costs for various metropolitan areas around the country.

The determination of whether tenants are qualified must be repeated annually. This is in contrast with some of the programs which were eliminated, under which a tenant needed only to qualify initially. If a tenant's income rises above 140% of the income limits, that unit will no longer qualify unless the unit remains rent-restricted and the next vacant unit is rented to a qualifying tenant. Note that, as long as the rent restriction requirement is met, this provision only has practical effect in a property which rents less than 100% of its apartments to qualifying tenants, because in a 100% qualifying property the next apartment will always be rented to a qualifying tenant. Most properties are 100% qualified; therefore, as a practical matter tenant incomes may rise with without causing a unit to become nonqualified. This is
Table 3-1

1993 Median Income for a Family of Three and Maximum Costs for a Two-Bedroom Apartment for Selected Metropolitan Statistical Areas

<table>
<thead>
<tr>
<th>City</th>
<th>60% of Median Monthly Costs (1)</th>
<th>Maximum Monthly Costs (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlanta, GA</td>
<td>25,080</td>
<td>627</td>
</tr>
<tr>
<td>Boston, MA</td>
<td>27,660</td>
<td>692</td>
</tr>
<tr>
<td>Chicago, IL</td>
<td>25,680</td>
<td>642</td>
</tr>
<tr>
<td>Cincinnati, OH-KY-IN</td>
<td>22,920</td>
<td>573</td>
</tr>
<tr>
<td>Cleveland, OH</td>
<td>22,860</td>
<td>572</td>
</tr>
<tr>
<td>Dallas, TX</td>
<td>24,540</td>
<td>614</td>
</tr>
<tr>
<td>Denver, CO</td>
<td>25,080</td>
<td>627</td>
</tr>
<tr>
<td>Detroit, MI</td>
<td>25,200</td>
<td>630</td>
</tr>
<tr>
<td>Hartford, CT</td>
<td>28,020</td>
<td>701</td>
</tr>
<tr>
<td>Houston, TX</td>
<td>22,920</td>
<td>573</td>
</tr>
<tr>
<td>Indianapolis, IN</td>
<td>23,100</td>
<td>578</td>
</tr>
<tr>
<td>Kansas City, MO-KS</td>
<td>23,340</td>
<td>584</td>
</tr>
<tr>
<td>Las Vegas, NV</td>
<td>21,840</td>
<td>546</td>
</tr>
<tr>
<td>Los Angeles-Long Beach, CA</td>
<td>26,100</td>
<td>653</td>
</tr>
<tr>
<td>Memphis, TN-AR-MS</td>
<td>19,080</td>
<td>477</td>
</tr>
<tr>
<td>Miami-Hialeah, FL</td>
<td>22,620</td>
<td>566</td>
</tr>
<tr>
<td>Milwaukee, WI</td>
<td>24,000</td>
<td>600</td>
</tr>
<tr>
<td>Minneapolis-St. Paul, MN-WI</td>
<td>26,760</td>
<td>669</td>
</tr>
<tr>
<td>New Orleans, LA</td>
<td>18,180</td>
<td>455</td>
</tr>
<tr>
<td>New York, NY</td>
<td>22,500</td>
<td>563</td>
</tr>
<tr>
<td>Norfolk-Newport News, VA</td>
<td>21,000</td>
<td>525</td>
</tr>
<tr>
<td>Orlando, FL</td>
<td>21,600</td>
<td>540</td>
</tr>
<tr>
<td>Philadelphia, PA-NJ</td>
<td>25,140</td>
<td>629</td>
</tr>
<tr>
<td>Phoenix, AZ</td>
<td>22,440</td>
<td>561</td>
</tr>
<tr>
<td>Portland, OR</td>
<td>21,960</td>
<td>549</td>
</tr>
<tr>
<td>Raleigh-Durham, NC</td>
<td>25,080</td>
<td>627</td>
</tr>
<tr>
<td>Sacramento, CA</td>
<td>22,980</td>
<td>575</td>
</tr>
<tr>
<td>Salt Lake City-Ogden, UT</td>
<td>21,900</td>
<td>548</td>
</tr>
<tr>
<td>San Diego, CA</td>
<td>23,700</td>
<td>593</td>
</tr>
<tr>
<td>San Francisco, CA</td>
<td>31,560</td>
<td>789</td>
</tr>
<tr>
<td>Seattle, WA</td>
<td>25,920</td>
<td>648</td>
</tr>
<tr>
<td>Washington, DC-MD-VA</td>
<td>32,700</td>
<td>818</td>
</tr>
</tbody>
</table>

Notes:


(2) The maximum allowable amount of the rent and utility payments is 30% of the qualifying income level.
important to achieving the intent of Congress, which was that tenants not be evicted in order to maintain the compliance of the property.

It is also important to note that a unit which becomes vacant continues to qualify for tax credits, as long as reasonable efforts are made to rent the apartment and it is not rented to a non-qualifying tenant (or, in a property for which less than 100% of the apartments are rented to qualifying tenants, as long as the next available unit is not rented to a qualifying tenant).

This provision, which helps make the program more workable in practice, is reflective of much of the overall design of the tax credit program, as it has been revised through subsequent legislation and regulation since the 1986 act. Similarly, should a property or a building be lost to a casualty such as fire, the tax credits continue to be available as long as the building is reconstructed within a reasonable period of time. Another helpful provision states that, should unintentional violations of the income or rent guidelines occur, the property has a reasonable period of time to correct them without triggering recapture of the tax credits.

**State Allocation of Tax Credits**

In general, tax credits must be allocated to a property by designated state housing agencies or, in a limited number of areas, local housing agencies. (The exception is properties which are financed with tax-exempt bonds; those properties are eligible for a tax credit without an allocation.)

Each state is authorized to allocate to properties in that state a total amount of tax credit equal to $1.25 for each resident of the state. For example, a state such as Massachusetts, with an estimated 1993 population of 5,998,000 persons, was
authorized to allocate $7,497,500 of annual tax credits in 1993. (The amount of tax exempt bonds that may be issued are also limited within each state.)

The allocating agencies must develop allocation plans which include their criteria for evaluating projects, as well as a plan for monitoring the properties which receive allocations for compliance with the regulations of the program. These allocation plans are intended to ensure that credit is allocated to those proposed properties which will best address the housing needs of that state most efficiently. Agencies must evaluate projects so that they do not allocate more tax credit to a property than is necessary for the property to be feasible. This is an important feature, in that it helps to limit actual or perceived abuses of the program. State review improves the efficiency of the program, as well as helping to maintain the political support needed to see that the program is continued.

States are permitted to carry over credits which are not allocated in a particular year into the following year. Credits not allocated in that subsequent year become available for allocation to other states which fully utilized their credits for the preceding year.

The state allocation process is one of the defining features of the tax credit program. It reflects the political principles of the 1980s in that it is a decentralized program. Within the limits of the program, states can make determinations about what type of housing to allocate credits to, as well as which localities require additional housing. The different policy agendas of states are clearly reflected in the different ways in which they implement the program. This is a significant evolution in Federal housing programs, and will likely serve as a model for future Federal programs.
Of course, the state allocation process helps to ensure that only properties which receive some level of review and which to some degree achieve the policy objectives of the program are actually awarded credits. This is in sharp contrast to former housing incentives, which were available to any property which complied with the tax law guidelines.

However, the critical defining feature is simply the overall limitation on the amount of tax credit. This has two important implications. First, the cost of the program to the Federal treasury is limited and predictable. In this era of extreme budget-consciousness, this is essential to maintaining the political support needed for the program. Because former housing incentives were available to any property which met certain guidelines, the cost of the incentives was difficult to predict and often far exceeded the expectations of Congress.

The second important implication of the limit on the amount of the tax credits is simply that it limits the size of the program. As will be discussed in subsequent chapters, this has had a profound effect on the dynamics of the industry, particularly as increasing amounts of corporate capital have been invested.

**Amount and Timing of Tax Credits**

The tax credit is generated each year for a ten year period. This period is referred to as the "credit period." During the first year, the credit must be pro-rated to reflect, in effect, both the weighted average fraction of the year during which apartment units were occupied by qualifying tenants and the fraction of units which were occupied by qualifying tenants. Any credit not available in the first year as a result of this proration become available in the eleventh year. In most cases, properties lease over several months and this rule is applied. The tax credits are then
generated over an eleven year period, with a partial amount in the first and eleventh years.

The amount of the credit is equal to the product of three factors: the depreciable basis of the property; the fraction of the property which is rented to qualifying tenants at restricted rents; and a percentage rate set by the Treasury. (See the example below.) As a practical matter, the depreciable basis of the property includes most costs related to the development of the property, including personal property and developer fees; land and permanent mortgage financing fees are the major exceptions. For most properties, 100% of the apartments qualify, so that the "qualified basis" (that is, the depreciable basis times the fraction of the property rented to qualifying tenants) is equal to the depreciable basis.

The percentage rate is calculated monthly by the Treasury. There are two percentages: a credit percentage which, over the ten year period if discounted at the Treasury's borrowing rates, is equal in present value to 70% of the qualifying basis; and a credit percentage which is equal to 30% of the qualifying basis. For April, 1994, the percentage is 8.48% for the former credit and 3.63% for the latter. As interest rates rise (or fall), these percentage amounts are adjusted upwards (or downwards) to maintain a present value equal to the target 70% or 30% amounts. The 70% credit is available for new construction or substantial rehabilitation. The 30% credit applies to costs of acquiring an existing property and to non-substantial rehabilitation costs, as well as to new construction or substantial rehabilitation if the property also benefits from certain other Federal subsidies, such as below-market loans or tax-exempt bond financing. (Note that rental assistance payments, such as Section 8, are not deemed Federal subsidies for this purpose.)
A property which qualifies for the 70% present value credit will generate approximately 233% of the credit that a property which qualifies for the 30% credit will generate. (That is, 70%/30% = 233\%.) The amount of equity capital which a property will receive is approximately proportional to the amount of tax credit. Therefore, the 70% present value credit property will attract 233% of the equity capital of the 30% present value property.

These much larger tax credit therefore equity capital amounts, in most cases, far outweigh the economic advantages of most Federal financing programs. For example, the debt service savings on a typical tax-exempt bond financing contribute much less to the feasibility of a development than would the additional equity. As a result, the vast majority of properties are structured to take advantage of the 70% present value credit.

Finally, note that while the credit is referred to as a 70% present value credit or a 30% present value credit, those present values are calculated at the Treasury's borrowing rates. As a result, the actual present value of the benefits to any other user is, of course, less than these stated amounts. Chapter 8 discusses this further, in the context of evaluating the efficiency of the tax credit as a means of producing affordable housing.

**Effect on Basis of Utilizing Credit**

Unlike the historic rehabilitation tax credit, the tax basis of property is not reduced by the amount of LIHC taken with respect to the property. This has profound implications for corporate investors. Corporations are measured by using accounting rules. Specifically, the earnings reported in their financial statements drive their stock price, which for most public corporations is the single most important measure
of their performance. The features of the tax code for the LIHC have ramifications for the accounting impact on the corporation.

The effect can be explained by comparing the historic tax credit and the low income housing tax credit. The historic tax credit reduces the tax basis of the property, which has the effect of generating additional taxable gain upon the sale of the property. For tax purposes, the gain is equal to the sales price less the basis. All other things being equal, one dollar less of basis creates one dollar more of taxable gain. Because of this, a corporate investor who saves one dollar of tax by using a dollar of historic tax credit incurs a future tax liability on the gain that is created. That reduces the net benefit of the credit. For example, if the corporation’s effective tax rate is 40%, it saves $1.00 of current tax, but incurs a future tax liability of $0.40. As a result, it can book only an addition $0.60 of increased earnings.

The LIHC, on the other hand, does not reduce the basis of the property, as noted above. Therefore, using $1.00 of housing tax credit can generate $1.00 of increased earnings for a corporation. This is the fundamental force motivating corporate investors to provide capital for affordable housing.

Finally, note that tax deductions also generate a tax liability on sale. However, in contrast to the tax credit, tax deductions (that is, tax losses) merely reduce taxable income and not tax. Using a dollar of tax deductions saves a corporation only about $0.40 in taxes, an amount which is offset by the future tax liability which is created.

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8 As might be expected, the complete accounting implications are far too complex to discuss in detail in this work. It is worth noting that, depending on the accounting methods used by a corporation, $1.00 of housing tax credit may not always result in $1.00 of increased earnings for a corporation. However, the ability to increase earnings is a strong draw for corporate investors.
Therefore, the use of tax deductions will at best have no impact on earnings and may in some circumstances reduce earnings. This helps to explain why other forms of tax incentives have been of far less interest to corporations than the housing tax credit has been.

**Compliance and Recapture**

The income and rent limitations must be met for a fifteen year period, beginning with the year in which the tax credit is first claimed. Should the property cease to qualify during this period, owners lose their ability to receive tax credits and a portion of the credits received in prior years is recaptured. Note that this, again, helps to ensure that the housing serves the intended public purpose. Furthermore, because the program is administered by the Treasury through the income tax system, they have wide and effective enforcement procedures available.

**Extended Restriction to Use as Low-Income Housing**

The 1989 tax act which extended the program also substantially modified it. One of the more significant modifications was the addition of a requirement designed to increase the likelihood that the property would be utilized as affordable housing for an extended period of time. In order to qualify for tax credits, a property must be subject to an agreement which requires that the property be used as low-income housing for at least an additional 15 year period, or 30 years in total. The owner of the property may terminate this use restriction after 15 years by offering the property to the credit allocating agency at a restricted sales price. The sales price is effectively equal to enough to provide the owners of the property with an amount equal to the capital invested in the project, adjusted upward for inflation as measured by the increase in the consumer price index, and adjusted downward by any cash
distributions received from the project. If the agency is unable to find a buyer, the extended use restrictions may be terminated.

In addition, the 1989 act added certain tenant protections. Should the restrictions be terminated, then-existing tenants are permitted to occupy their units at restricted rents for a period of up to three years. At the earlier of the date the tenant vacates the apartment or three years, the apartment units become free of the requirements that they be rented to qualifying tenants at restricted rents.

Expiration of the Program

As originally enacted, the LIHC program had a term of three calendar years. States' authority to allocate credits began on January 1, 1987 and ended on December 31, 1989. The program was extended, somewhat intermittently, for the following three years. In November, 1989, the program was extended through 1990. In November 1990, the program was extended through 1991. In December, 1991 the tax credit was extended through June, 1992. The Omnibus Budget Reconciliation Act of 1993 made the LIHC program permanent in August, 1993. Although the tax credit program itself had wide political support, the extension was generally part of either a package of similar provisions or a broad tax bill. As a result, the fate of the program was tied to other tax provisions. For example, an extension of the tax credit program was included in a bill passed by Congress but vetoed by President Bush in October, 1992.

As might be imagined, eleventh hour extensions just before the program was scheduled to expire, as well as the hiatus in the program from July, 1992 until August, 1993, have made it difficult for developers and state agencies to plan projects.
In addition, the pattern of enabling legislation has probably affected the structure of the housing tax credit industry, as discussed in Chapter 8.

**Administration of the LIHC Program**

The LIHC program provides a tax incentive for investment in affordable housing. As discussed at the beginning of this chapter, tax incentives for housing production have been a feature of the tax code for many years. The principal incentive had been accelerated depreciation, which generated additional tax deductions for owners of affordable housing.

However, from the 1930s until the 1980s, significant expenditures for housing production were made through direct expenditures, not tax expenditures. These direct expenditures were typically administered by the Department of Housing and Urban Development (HUD) and its predecessor agencies, or by the Farmers Home Administration (FmHA) of the Department of Agriculture. Generally, these agencies provided annual operating or financing subsidies to the properties, or provided rental subsidies to the properties and/or to the tenants. Examples of financing subsidy programs include the Section 236 and Section 221(d)(3) programs. Examples of rental subsidy programs include the Section 8 program (which provides for monthly payments to the owners of the property on behalf of the tenants) and the Farmers Home Administration Rental Assistance program.

The LIHC marks a significant departure from those past programs, because it is administered through the tax code by the Department of the Treasury. Failure to comply with the regulations of the program results in increased tax liability for investors. Obviously, the Treasury department is in a position to strongly enforce the
collection of that additional tax liability should they become aware of a failure to comply with the regulations.

**Section 3.4 An Example of a Typical Development**

To illustrate the key features of the LIHC program, Tables 3-2 through 3-4 present an example of a sample housing tax credit property. Table 3-2 presents the development budget for the property, in the form of a sources and uses of funds table. The provisions of the tax law determine whether the costs incurred to develop a property are eligible to be included in the calculation of the amount of tax credit. As shown, the eligible costs are multiplied by the credit percentage to determine the available amount of tax credit.

Table 3-3 shows the income and expenses for the same sample property. The maximum monthly rents are calculated, using the requirements discussed above. This determines the maximum potential amount of income the property can expect.

Finally, Table 3-4 presents the property from the point of view of a corporate investor. The various benefits of tax credits, tax deductions, and cash flow are shown.
Table 3-2
Sample Property
Development Budget and Tax Credit Calculation

<table>
<thead>
<tr>
<th>Investment Partnership</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor Capital (1)</td>
<td>3,271,342</td>
<td></td>
</tr>
<tr>
<td>Fees and Expenses</td>
<td>(315,854)</td>
<td>-9.66%</td>
</tr>
<tr>
<td>Working Capital Reserves</td>
<td>(180,488)</td>
<td>-5.52%</td>
</tr>
<tr>
<td>Net Capital</td>
<td>2,775,000</td>
<td>84.83%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Property Partnership</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital from Investment Partnership</td>
<td>2,775,000</td>
<td></td>
</tr>
<tr>
<td>First Mortgage Loan</td>
<td>2,240,000</td>
<td>At 9.95%, 30 year amortization.</td>
</tr>
<tr>
<td>Second Mortgage Loan</td>
<td>1,000,000</td>
<td>At 5.0%, 30 year amortization.</td>
</tr>
<tr>
<td>Other Items</td>
<td>322,056</td>
<td></td>
</tr>
<tr>
<td>Developer Capital</td>
<td>319,893</td>
<td></td>
</tr>
<tr>
<td>Total Sources</td>
<td>6,656,949</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Development Costs</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ineligible</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Development Costs</td>
<td>5,120,697</td>
<td>5,120,697</td>
</tr>
<tr>
<td>Other Items</td>
<td>45,400</td>
<td>5,700</td>
</tr>
<tr>
<td>Permanent Loan Fees</td>
<td>322,056</td>
<td>322,056</td>
</tr>
<tr>
<td>Legal and Organizational</td>
<td>45,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Land</td>
<td>420,000</td>
<td>420,000</td>
</tr>
<tr>
<td>Development Fee</td>
<td>681,396</td>
<td>681,396</td>
</tr>
<tr>
<td>Total Uses</td>
<td>6,656,949</td>
<td>6,157,849</td>
</tr>
<tr>
<td></td>
<td>92.50%</td>
<td>8.37%</td>
</tr>
</tbody>
</table>

Calculation of Tax Credit

| Eligible Basis         | 6,157,849 |       |
| Credit Percentage      | 8.37% |       |
| Maximum Annual Tax Credit | 515,412 |       |
| Credit Allocation      | 514,250 |       |
| Annual Tax Credit      | 514,250 |       |
| (Lesser of allocation or calculated amount) |       |       |

Notes:
(1) Investor Capital is discounted to a present value.
(2) Maximum monthly cost is equal to 1/12th of 30% of the maximum income.
Table 3-3  
Sample Property  
Income and Expenses

Location: Roanoke, Virginia  
Unit Amenities: Two baths, dishwasher, balcony or patio, air conditioning.  
Property Amenities: Clubhouse, swimming pool, tot lot.  
Notes: 23 units have rents set for 50% of median income tenants.

<table>
<thead>
<tr>
<th>Calculation of Maximum Rents Under Section 42</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units Bedrooms</td>
</tr>
<tr>
<td>19</td>
</tr>
<tr>
<td>77</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Property Income and Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum Monthly Proforma Rent</td>
</tr>
<tr>
<td>Units Bedrooms</td>
</tr>
<tr>
<td>77</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>20</td>
</tr>
</tbody>
</table>

| Gross Potential Rent | 596,940 |
| Other Income | 14,400 |
| Gross Income | 611,340 |
| Vacancy Expenses | (42,794) |
| Replacement Reserves | (18,990) |
| Net Operating Income | 308,414 |
| Debt Service | (299,317) |
| Net Cash Flow | 9,097 |

Notes:  
(1) 1.5 persons per bedroom.  
(2) Maximum monthly cost is equal to 1/12th of 30% of the maximum income.
### Table 3-4

#### Sample Property

**Benefits to the Investors**

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor Capital (1)</th>
<th>Fraction Of Credit Available (2)</th>
<th>Tax Credits (3)</th>
<th>Tax Deduction</th>
<th>Cash Flow</th>
<th>Total Benefit (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>3,271,342</td>
<td>0%</td>
<td>0</td>
<td>(112,396)</td>
<td>0</td>
<td>(42,710)</td>
</tr>
<tr>
<td>1995</td>
<td>38%</td>
<td>192,506</td>
<td>135,815</td>
<td>0</td>
<td>0</td>
<td>244,116</td>
</tr>
<tr>
<td>1996</td>
<td>99%</td>
<td>500,516</td>
<td>257,820</td>
<td>0</td>
<td>0</td>
<td>598,488</td>
</tr>
<tr>
<td>1997</td>
<td>100%</td>
<td>504,016</td>
<td>244,758</td>
<td>0</td>
<td>0</td>
<td>597,024</td>
</tr>
<tr>
<td>1998</td>
<td>100%</td>
<td>504,016</td>
<td>227,999</td>
<td>0</td>
<td>0</td>
<td>590,656</td>
</tr>
<tr>
<td>1999</td>
<td>100%</td>
<td>504,016</td>
<td>211,178</td>
<td>0</td>
<td>0</td>
<td>584,264</td>
</tr>
<tr>
<td>2000</td>
<td>100%</td>
<td>504,016</td>
<td>206,735</td>
<td>0</td>
<td>0</td>
<td>582,575</td>
</tr>
<tr>
<td>2001</td>
<td>100%</td>
<td>504,016</td>
<td>195,052</td>
<td>1,217</td>
<td>0</td>
<td>579,353</td>
</tr>
<tr>
<td>2002</td>
<td>100%</td>
<td>504,016</td>
<td>176,831</td>
<td>10,546</td>
<td>0</td>
<td>581,758</td>
</tr>
<tr>
<td>2003</td>
<td>100%</td>
<td>504,016</td>
<td>160,236</td>
<td>7,732</td>
<td>0</td>
<td>572,638</td>
</tr>
<tr>
<td>2004</td>
<td>100%</td>
<td>504,016</td>
<td>147,375</td>
<td>10,359</td>
<td>0</td>
<td>570,378</td>
</tr>
<tr>
<td>2005</td>
<td>62%</td>
<td>311,510</td>
<td>134,525</td>
<td>15,238</td>
<td>0</td>
<td>377,868</td>
</tr>
<tr>
<td>2006</td>
<td>1%</td>
<td>3,500</td>
<td>118,479</td>
<td>20,263</td>
<td>0</td>
<td>68,785</td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td></td>
<td>103,967</td>
<td>25,439</td>
<td>0</td>
<td>64,946</td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
<td>86,512</td>
<td>30,770</td>
<td>0</td>
<td>63,645</td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td>70,557</td>
<td>36,260</td>
<td>0</td>
<td>63,072</td>
</tr>
</tbody>
</table>

Total: 5,040,160 2,365,443 157,824 6,096,852

**Internal Rate of Return (calculated annually):** 11.1%

**Notes:**
1. **Investor Capital** is discounted to a present value.
2. The **Fraction of Credit Available** is effectively proportionate to the average fraction of the property which is occupied by qualified tenants during the year.
3. The annual amount of tax credit allocable to the investor limited partners is 98.01% of the total amount calculated on Table 3-2.
4. The **Total Benefit** is equal to the amount of tax credit plus the amount of cash flow plus 38% of the amount of the tax deduction. The 38% figure represents an assumed combined effective Federal and state tax rate.
5. This table excludes the potential impact of the sale of the property.
Chapter 4

A Description of the Housing Tax Credit Industry

This chapter provides an overview of the housing tax credit industry. First, the industry as a whole is discussed. The overall industry is then further delineated into two sub-markets: the equity capital market, and the property market. The equity capital market is discussed in detail in Chapter 5. The property market is discussed in detail in Chapter 6. Chapter 7 then uses the material discussed in Chapters 4 through 6 as a basis for analyzing the housing tax credit industry, in particular the equity capital market.

Section 4.1 An Overview

Figure 4-1 provides an overview of the housing tax credit industry. The figure shows, in simplified form, the types of economic entities which participate in the industry. (For convenience, most of the industry participants will hereafter be called firms.) There are three major types of firms in the industry: investors, intermediaries, and developers. Investors and intermediaries often come together through distribution channels, although not always. Channels are a fourth type of firm that participates in the industry.

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1 Even though some industry participants are individuals or non-profit entities, and as such might not fully follow the behaviors associated with for-profit firms, for the purposes of this analysis there are sufficient similarities that the term is useful. For example, the industry’s non-profit participants exhibit revenue-maximizing behaviors in many respects. Furthermore, the focus of this analysis is the corporate investor, rather than the individual investor.
Figure 4-1
An Overview of The Housing Tax Credit Industry

Investors

Channels

Intermediaries

Developers
 Investors. There are two major types of investors: individuals, and corporations. Within these two general groups there are, of course, segments which have varying needs.

 Channels. Intermediaries use distribution channels to raise capital from investors. In general, individual investors are reached by using the larger broker-dealer firms, such as Wall Street firms (Merrill Lynch, Dean Witter), regional firms (Wheat First) or national networks of financial planners. On the other hand, there are a great variety of ways in which intermediaries reach corporations. The Wall Street and regional broker-dealers are used to some degree. More typical, though, are small brokers who specialize in this product. In addition, there are several other channels used, which are discussed further in Chapter 5. It is worth noting that some firms use no channel to reach corporate investors. In particular, the non-profit syndicators (Local Initiatives Support Corporation, The Enterprise Foundation) have historically not used a formal distribution channel.

 Intermediaries. There are a variety of intermediaries which participate in the housing tax credit industry. However, a substantial majority of the funds which are invested by investors flow through an intermediary of a type which fits a fairly general model. The intermediary forms an investment entity (typically a partnership), raises capital from a group of investors, and invests that partnership's capital into another form of asset. In this instance, the assets in which the partnership invests are in turn limited partnership interests in partnerships which own a property. (Partnerships and partnership structure are discussed further in Chapter 5.) Both the for-profit industry participants and the non-profit industry participants fit this model.
Developers. The industry participants discussed above are all involved in the portion of the industry which delivers equity capital to developers of qualifying affordable housing. The developers are involved in a wide range of activities in connection with the creation of that housing, including the following: feasibility analysis; site selection and acquisition; zoning and land use approvals; selection and supervision of the architect and the construction contractor; obtaining the mortgage financing; obtaining the reservation of tax credit; and, once the property is complete, managing the property or selecting a management agent.

As indicated by the solid and broken lines in Figure 4-1, to a substantial degree, the for-profit intermediaries invest with for-profit developers, although there is a significant amount of investment in properties developed by non-profit developers. Non-profit intermediaries appear to invest exclusively with non-profit developers. So to some degree the for-profit sector of both the property market and the equity capital market are not fully integrated and therefore operate somewhat independently of each other.

Section 4.2 The Property Market and the Equity Capital Market

While the discussion above provides an overview of the housing tax credit industry, few industry participants view it in that fashion or operate throughout the entire industry. For example, developers compete with one another for sites and tax credit reservations. Developers also communicate with one another, through personal contacts, trade associations, and industry publications. Obviously, developers and intermediaries communicate with each other. Intermediaries compete with each other for the opportunity to invest in developers' projects. On the other hand, developers
have little, if any, contact with investors and distribution channels, and investors and
distribution channels are not well understood by developers. (The reverse is also
true.) Therefore, there is a natural boundary to the activities in the industry among
the developers and intermediaries. Figure 4-2 delineates that as the *property market*.

Similarly, there is contact, communication, and competition among investors,
channels and intermediaries. The processes of this portion of the industry are largely
different and appear in some respects to be independent of what goes on in the
property market. Many industry participants see the scope of their own activities as
well-defined within the range of activities engaged in by investors, channels, and
intermediaries. That portion of the industry is referred to herein as the *equity capital
market*.

Chapter 5 further describes and discusses the equity capital market. Chapter 6
discusses the property market.
Figure 4-2
An Overview of The Housing Tax Credit Industry
Chapter 5

The Equity Capital Market

Chapter 4 outlined the concept of an equity capital market within the housing tax credit industry, as distinct from the property market. This chapter will examine the equity capital market. The chapter begins with a brief overview of real estate syndication, the general term for raising capital through intermediaries for investment in real estate, and some aspects of how it operates in conjunction with the low-income housing tax credit program. Then the chapter describes in some detail the actors in the equity capital market. The final section discusses market trends.

Section 5.1 Syndication of Tax Credit Investments

Syndication firms raise capital from investors, typically pool that capital in an investment entity, and invest that capital in other assets, such as real estate. Historically, many investors have preferred to invest through syndication firms in order to utilize the experience and skills of the syndication firm. In addition, investing through an intermediary can make available to the investor opportunities to invest in transactions which would otherwise be unavailable to them.

Developers will use syndication firms if they provide a source of capital which is superior to other alternatives available to them. Tax incentives for housing production virtually require the use of syndication firms in order to generate equity capital. The tax benefits must be utilized by an individual or a corporation in order to have value. As discussed in Chapter 3, the 1986 tax act generally limited the ability of individuals to use tax benefits, so the individuals involved in development

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cannot typically use the tax benefits. In addition, few development groups are large enough to use significant amounts of tax benefits. Even for those firms which can use tax credits, obtaining capital is viewed as far more important than obtaining tax savings. As a result, a developer will typically seek to allocate as much of the tax benefit as possible to investors in order to generate the maximum amount of capital.

**Real Estate Syndication in Recent Years**

In 1988 one observer noted that "the difficulty in the real estate markets, combined with the Tax Reform Act of 1986, has prompted major dislocation in the syndication business. A number of participants have been eliminated and new problems are evolving for those remaining."\(^1\) Although, in the several years since the 1986 tax act, most of the problems have now surfaced, with the perspective of hindsight the statement seems very accurate. Capital raised in the industry dropped dramatically when the 1986 act was adopted, and many of the firms active in the industry in the mid-1980s have gone bankrupt or otherwise ceased operating in the industry. The boom in syndication in the early 1980s was due to the passage of the Economic Recovery Tax Act of 1981 and the liberalization of securities laws, in particular the passage of Regulation D and the easing of licensing requirements.\(^2\)

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\(^2\) Jarchow, 1988, p. 4.
Legal Structure

Every tax credit investment is structured as a limited partnership (or legal entities which are taxed as limited partnerships for Federal income tax purposes). The limited partnership is the only entity which, for Federal income tax purposes, permits the pass-through of tax benefits to the owners. Because the housing tax credit is a creation of the Federal tax code, and the principal benefit is tax savings, this is obviously a paramount consideration.

Types of partners. Ordinarily, a limited partnership has two general classes of owners, limited partners and general partners. The limited partners typically provide substantially all of the capital required for the partnership. To maintain limited partnership status, and in particular to retain protection from the general liabilities of the partnership, the rights which the limited partners are given under the partnership agreement and the rights which they actually exercise must be restricted. These rights typically include the following, which normally can be exercised by a majority in interest of the limited partners: the right to replace the general partner, in some cases without cause and in some cases only for cause; the right to amend the partnership agreement; the right to approve the sale of all or substantially all of the assets of the partnership; and the right to dissolve the partnership.

The general partner exercises all other management rights, and as such is responsible for the operation of the partnership's business. Ordinarily the initial partnership agreement specifies the business the partnership will engage in, and lists certain limitations on the authority of the general partner.
Partnership agreement. A limited partnership is created and governed by a partnership agreement. This partnership agreement specifies all terms which govern the business of the partnership. Typically a partnership agreement will include provisions which discuss the following: the business to be undertaken by the partnership; the types of partners; the capital to be contributed by those partners; how profits, losses, and cash distributions will be allocated among the partners; the authority of the general partner, as well as restrictions on the authority of the general partner\(^3\); provisions for the addition or withdrawal of partners; transfers of partnership interests; and the voting rights of the limited partners.

Two-tier partnerships. Most capital raised in the tax credit industry is raised by so-called "funds." These funds are generally similar in concept to a mutual fund, in that an entity is formed to provide a pool of capital to invest in securities issued by other entities.\(^4\) Tax credit funds frequently utilize a "two-tier" partnership structure. Figure 5-1 illustrates the legal structure of a typical tax credit fund. An investment

\(^3\) In particular, often these restrictions focus on limiting the authority of the general partner to permit affiliates of the general partner to transact business with the partnership (sometimes referred to as "self-dealing"). These are intended to limit the possibility that a general partner will exploit the limited partners by entering into contracts and arrangements which benefit the general partner, but which are not competitive.

\(^4\) Partnerships which invest in low-income housing can apply for, and will generally receive, certain exemptions from the Investment Company Act of 1940. Ordinarily an entity which has 100 or more partners (such as most tax credit funds sold to individual investors), and which invested in the securities of other issuers in a manner which substantially limits the control of the fund (such as is the case with the limited partnership interests of the property partnerships) would be required to comply with the expensive reporting requirements of the Investment Company Act. The exemption make it possible to utilize the structure discussed herein, and illustrates another way in which low-income housing is afforded favorable treatment under Federal law.
Figure 5-1
Legal Structure of a Typical Tax Credit Fund

(1) Typically an affiliate of the intermediary.
(2) Typically an affiliate of the property developer.
partnership raises the capital from investors. The general partner of the investment partnership is typically an affiliate of the intermediary or syndicator. This investment partnership then invests, as a limited partner, in a number of other partnerships. (There may be as few as two or three property partnerships in a fund, or as many as fifty.) Typically each of these other partnerships owns one property. The general partner of each property partnership is ordinarily an affiliate of the developer of the respective property.

This structure offers a number of advantages. First, each property is owned by a separate partnership, which effectively insulates each property from the liabilities and operating problems of the other properties. Should a property encounter operating problems, or even face foreclosure, the other properties would be unaffected. (For this reason, most lenders, including state and Federal agencies, require that separate partnership be used for each property.) Second, because the fund is a limited partner of each property partnership, the fund is largely insulated from the obligations of the properties. As a limited partner, the fund is required to make its capital contribution but has no further obligation beyond that. Of course, this protection is also available to the investor limited partners. Third, the two-tier structure offers efficiency in the process of raising capital. Capital can be raised by the fund in large amounts and somewhat independently of the process of investing that capital in properties. A single set of disclosure and offering documents can be used for the entire fund. A developer need not become involved in or aware of the process of raising capital. These efficiencies lower time and transaction costs for all parties. The efficiencies can permit funds to raise capital for properties which would be too small, relative to the transaction costs, to otherwise allow investor capital to
be raised. Finally, the two-tier structure with many property investments provides diversification to the investors. Diversification has proven to be a very powerful method to create a highly predictable stream of tax benefits for the investors.

Section 5.2 The Actors in the Equity Capital Market

As discussed in Chapter 4, there are three major categories of actors in the equity capital market: investors, channels, and intermediaries. This section describes those actors in greater detail. Figure 5-2 illustrates the equity capital market and is referred to extensively in this section.

In particular, note that Figure 5-2 draws relationships between the actors in each group of investors, channels, and intermediaries. These relationships indicate where the majority of transactions between parties are made. As such, they illustrate important aspects of the structure of the equity capital market. These relationships are discussed below.

5.2.1 Investors

Investors can be divided into two broad categories, individuals and corporations. In general terms, investors can be understood by evaluating their objectives in making the investment and their tolerance for risk.

Individuals. Individual investors ordinarily invest to obtain a higher level of return than is available from alternative investments. They are willing to forego

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5 For individuals, an investment in a tax credit fund is often compared to a municipal bond as an alternative investment. Both investments provide a tax-free or after-tax return. The tax credit is, generally, a steady stream of benefits for several years, similar to the interest payments on the bond. Of course, for the tax credit investment, the return of the investor’s capital (continued...)
Figure 5-2
Housing Tax Credit Industry - Equity Capital Market

**Investors**
- **Type**
  - Corporation
- **Objectives**
  - 1. Safety
  - 2. Return
- **Risk Tolerance**
  - Low

**Channels**
- National Bank
- Specialty Broker
- Wall Street Firm
- Regional Firm
- Syndicator Affiliate
- Finder
- Property Investment

**Intermediaries**
- **Type**
  - Corporate Guarantor
  - For-Profit Syndicator
  - For-Profit Syndicator National Subsidized
  - Non-Profit Syndicator National Subsidized
  - Non-Profit State/Local Subsidized
- **Geography**
  - National
- **Property Type**
  - National
  - National Subsidized
  - National Subsidized
liquidity to obtain that higher return. Although they are willing to take on a greater level of risk than those alternative investments, in general individuals who invest in tax credit investments are still seeking safety of capital and predictability of return.

These investment objectives help to explain the investments individuals make and the channels they make them through. Individuals normally invest in tax credit funds which are registered with the Securities and Exchange Commission (SEC), which are referred to as "public funds." Public funds ordinarily raise substantial amounts of capital, typically from $20 to $100 million. This provides a diversified group of properties to the investor, because this large amount of capital is invested in numerous properties. In addition, because public funds require substantial costs to create and offer (with SEC and state securities registration being a substantial part of the cost), and because most securities firms subject the sponsors of the funds to review prior to selling a public fund, in general public funds are offered by the larger, more established syndication firms. This can provide a degree of safety to the investor.

For individuals, public funds can be contrasted with private placements. Private placements are not registered with the SEC. They are ordinarily offered to

5(...continued)
depends upon the sale of the properties, which would normally be expected to happen several years after the flow of tax credits ceases.

6 An investment in a tax credit fund is not liquid, in that there is no established market for the interest and there are significant restrictions on transfers of partnership interests required in order to maintain the desired tax treatment of the partnership and obtain the tax benefits. Investors are generally cautioned not to invest in a tax-credit fund if they require liquidity. However, there is a limited and somewhat effective secondary market for the interests available to investors should circumstances such as death, bankruptcy, or divorce require an investor to sell their interest.
a limited number of investors, and as such are exempt from SEC registration. It is worth noting the interaction of the limitations on the use of the credit, which were discussed in Chapter 3, with Federal securities law. To obtain the exemption from registration with the SEC, the number of investors must, as a practical matter, be limited. However, at the same time the amount of credit that any individual can use is strictly limited. The limit on the amount of credit one individual can use effectively places a limit on the amount one individual can invest. That limit on the amount invested, combined with the practical implications of the securities laws on the number of investors in a private placement, means that the amount which can be raised by using a private placement is limited. Most tax credit private placements for individuals raise between $1.5 and $3 million. Not surprisingly, a typical private placement will have fewer property investments than a public fund, and therefore may provide less diversification. The principal advantage which a private placement offers to individuals is the ability to make their capital contributions over several years. (SEC regulations sharply limit the ability of public funds to offer staged capital contributions.) By paying the capital contributions over several years, investors can effectively finance part or all of their investment from the stream of benefits flowing from the investment. In other words, each year for several years the investor is required to make a capital contribution. However, they are also receiving benefits from the investment. These tax savings from the investment can be applied to make

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7 A private placement can have an unlimited number of accredited investors, who have high incomes and/or high net worth, and up to 35 non-accredited investors. However, the limitation of 35 non-accredited investors often becomes the practical limitation because there are far more non-accredited individuals than accredited individuals.
some or all of the required capital contribution. This allows investors to purchase the investment without a large sum of capital.

To date, the activity in the private placement area for individuals has been quite small relative to the amount of capital raised in other parts of the industry. However, prior to the 1986 tax act, most of the large tax credit sponsors were active in private placements. In addition, some sponsors, such as The Arcand Company, have been able to enter the industry in recent years by starting with private placements to individuals, then later expanding into products for corporations.

*Corporations.* Corporations can be grouped into several broad categories, based upon their objectives for investing and their tolerance for risk. Figure 5-2 shows four general categories of corporate investor.

Much of the early investment in housing tax credit investments by corporations was with non-profit sponsors, such as the Local Initiatives Support Corporation (LISC) and The Enterprise Social Investment Corporation, an affiliate of The Enterprise Foundation. (These intermediaries are discussed further below.) Corporations began making these investments shortly after the program began in 1987. The corporations who invested were primarily interested in obtaining positive public relations and fulfilling their social responsibilities. Return on capital invested was a distinctly secondary consideration. These corporate investors were willing to invest without the expectation that their capital would be returned, and with some expectation that their return would be unpredictable and smaller than anticipated. In other words, their tolerance for risk is fairly high. This type of corporate investor is shown in Figure 5-2 in the box marked with the letter C.
A second distinct type of corporate investor is shown in Figure 5-2 in the box marked with the letter D. Throughout most of the life of the tax credit program, there have been some corporations which have invested more or less directly into properties. Often these corporations would use the services of individuals who would locate potential investments for them. These individuals are typically referred to as "finders." In addition, the corporations also used attorneys to assist them in negotiating the documents used to make their investments. However, neither finders nor attorneys typically offer strong skills at understanding and evaluating the feasibility of a particular property. Furthermore, neither the finder nor the attorney would typically be involved in the transaction after the corporation had made their investment. The corporations making these investments felt that they sufficiently understood the risks, and could deal with any problems that arose. In many cases, they drew on the talents of their corporate real estate department. In their view, the costs added by the channels and the intermediaries (typically, brokers and syndicators) outweighed both the value added from the underwriting and management skills of the syndicator and the advantages of a diversified portfolio of products. Investing directly provided them with the highest return, because none of their investment was used to pay fees to intermediaries.8 This type of investor is referred

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8 A discussion of how corporations measure return on tax credit investments could in itself constitute sufficient material for a lengthy article. It is worth noting that corporate management is primarily measured by the performance of the stock price of the corporation, which is largely driven by the earnings of the company. Not surprisingly, then, most investors measure their return on a tax credit investment by the effect the investment has on the corporation's earnings. (This is a significantly different calculation than merely calculating the after-tax internal rate of return based on the flows of tax benefits from the investment.) As noted in Chapter 3, much of the attraction of the housing tax (continued...)

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to as a "direct" investor. Two of the earliest direct investors were Chevron and the Federal National Mortgage Association, or Fannie Mae. Fannie Mae has committed to invest approximately $400 million in tax credit investments, some through funds and some directly. Broad, Inc. (later SunAmerica), Pacificorp, and Southern California Edison have also invested substantial sums in this manner. Recently, Transamerica Insurance and NationsBank have announced their intention to make substantial direct investments in housing tax credit properties.

The next type of corporate investor which became active can be categorized as primarily seeking return while, at the same time, the corporations were concerned that the level of risk which they were taking not be excessive. The individuals making the investments on behalf of the corporations needed to have a sufficient level of comfort that the returns would, in fact, be generated and that the investment would prove to be a reasonably good one for the corporation. Of course, the individuals recommending the investment were also concerned that they not put their own career at risk by having the corporation make an investment which later proved to be a poor investment. These corporations had only a moderate tolerance for risk. Relatively

8(continued)

...continued credit for corporate investors stems from a specific feature of the tax law. In particular, because the credits do not reduce an investor's tax basis, and therefore create no deferred tax liability, they generate the maximum impact on a corporate investor's earnings. In addition, many corporations also invest because reducing their tax liability reduces the corporation's effective tax rate. The effective tax rate is roughly equal to the amount of tax paid divided by the amount of net income for the corporation. Effective tax rate, like earnings, is a measure used to evaluate the effectiveness of a firm's management. Firm executives are therefore motivated to invest in order to reduce their taxes, so that their corporations will be judged to have performed better. For the purposes of this discussion, these considerations are all broadly considered aspects of the economic return to the corporation.
few corporations invested initially, and those that did invest limited their investments to diversified portfolios of properties sponsored by syndication firms with some track record in the industry or with other product features, such as operating subsidies, which provided a measure of safety. As a result of the dual objectives of return and safety, corporate investors of this type largely limited their investments to for-profit sponsors who invested in properties developed by for-profit developers. The corporations viewed those properties as more likely to be feasible over the fifteen year compliance period, as well as more likely to be sold for an amount which could return their capital when the compliance period was over. This type of corporate investor is shown in Figure 5-2 in the box marked with the letter B. This type of corporation began making small investments in 1989, but became most noticeably active in 1990 when The Boston Financial Group organized the first successful large-scale fund for corporate investors. This fund raised approximately $25 million in 1990 and had raised a total of $51 million when closed in 1991. This was far more than the sponsors or industry observers expected, and marked the beginning of the influx of corporate dollars into housing tax credits.

The fourth and final major type of investor emerged in 1990 and 1991, shortly after Boston Financial's initial success with a large corporate fund. Broad, Inc. had invested directly in a number of properties in the late 1980s. However, Broad found it could not utilize the tax benefits because the corporation was subject to the alternative minimum tax. Broad offered other corporations the opportunity to invest

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9 The alternative minimum tax (AMT) is an alternative tax calculation intended to ensure that every taxpayer is required to pay some tax. The housing tax credit cannot be used to reduce AMT liability, although unused tax credits can be carried forward or back to other years with tax liability.
in the tax credit producing properties. Most notably, however, they provided certain guarantees to these corporate investors. Broad guaranteed to fund all operating deficits of the properties, and agreed to provide a form of minimum return guarantee. For example, until 1993 most of the investments Broad offered were priced to deliver the investors approximately a 15% internal rate of return. Broad agreed to make payments to the investors if the returns fell below 10%, in an amount sufficient to provide a return of at least 10%. Recent developments are discussed further below in Section 5.3. By early 1994, investors were willing to accept an 8 to 9% return on their investment in products which were guaranteed in this fashion. Clearly this type of investor was willing to accept a lower return in exchange for the safety of the guarantees. This type of investor is shown in Figure 5-2 in the box marked with the letter A.

5.2.2 Intermediaries

Figure 5-2 also lists several types of intermediaries who operate in the housing tax credit industry. As the lines on Figure 5-2 indicate, each investor type has historically shown strong tendencies to transact their business with certain types of intermediaries. The types of intermediaries, and the types of investors who ordinarily invest through those intermediaries, are discussed below. Intermediaries are distinguished, in part, based upon whether they invest in properties across the nation or in a region; as well as upon whether they invest substantially all of the funds raised into properties which benefit from subsidies or whether they invest primarily in properties which do not receive subsidies, other than the tax credit.

Corporate Guarantors. This type of intermediary acquires the properties with its own capital. At a later date, typically when the properties have completed
construction and are generating tax credits, these firms offer corporate investors the opportunity to invest in the properties. To induce these corporate investors to accept a lower return, they offer certain guarantees, as discussed above. There are currently two firms operating as corporate guarantors: SunAmerica, an insurance and financial services company formerly known as Broad, and Mission First Financial, a subsidiary of Southern California Edison.

Not surprisingly, this type of intermediary corresponds closely with a particular type of investor. This investor is seeking safety and return. Corporate guarantors currently raise all of their funds from corporate investors. This eliminates the need for costly and time-consuming securities regulations associated with selling to individuals, as well as the high costs of brokers to distribute the investment to individuals.

Unlike the other intermediaries, the corporate guarantors initially acquire the properties with their own capital and later resell them to the investors. Obviously this requires large amounts of capital, and exposes that capital to risk. Their profit is the difference between the price they paid for the properties and the price at which they sell the properties to the investors.

*For-Profit Syndicators.* For-profit syndicators currently have the largest share of the market. Most for-profit syndicators invest in properties throughout the country, although many tend to concentrate in certain regions. Certain for-profit syndicators, such as The Richman Group and The Arcand Company, have historically invested almost exclusively in properties which have operating or financing subsidies, in addition to the subsidy provided by the tax credit. Some of the other for-profit syndicators invest substantially in properties which receive only the tax credit.
subsidy. Examples of this latter type of syndicator include The Boston Financial Group and National Partnership Investments Corporation (NAPICO). Finally, some syndication firms invest significant amounts in both types of properties. Boston Capital and Related Capital are examples of this type of sponsor.

Both corporations and individuals invest with for-profit syndicators. These corporations and individuals are investing primarily for return, and do not seek the safety of a guaranteed product. At the same time, they seek a level of safety by investing with sponsors who have experience selecting and managing properties, and who will assemble a diversified pool of properties for the investors.

For-profit syndicators ordinarily raise the investor capital prior to or concurrently with acquiring the properties. They generally do not use large amounts of their own capital to acquire properties, and ordinarily do not risk their capital for significant periods of time. The fees received by the syndicators are typically a fixed percentage of the capital, which is disclosed to the investors.

Non-profit syndicators. Non-profit syndicators are organizations which are themselves typically a non-profit entity. Furthermore, they typically invest in properties which are developed by non-profit developers. The primary examples of non-profit syndicators are LISC and Enterprise, which were mentioned above. In addition, affiliates of these two groups as well as non-affiliated entities also sponsor a variety of funds which focus their property investments upon a specific state or region. Typically the properties in which these intermediaries invest have substantial operating and financing subsidies.

For the most part, the corporations which invest with non-profit syndicators are a distinct group from the other investors. They are not principally motivated by
economic considerations, while all of the other types of investors are motivated primarily to seek a level of return and risk at which they are comfortable.

Non-profit syndicators are similar to for-profit syndicators in that they do not typically risk their own capital. In addition, fees and costs are generally fixed amounts.

Finally, note that corporations who invest directly into property partnerships do not use the services of intermediaries. Direct corporate investors are illustrated in Figure 5-2.

5.2.3 Channels

Intermediaries are brought together with investors through a variety of channels. Intermediaries who are seeking individual investors ordinarily use established broker/dealer firms who market a variety of investment products to individuals. These firms may include the recognized Wall Street firms (Dean Witter, Merrill Lynch, Smith Barney Shearson, and so on), as well as smaller national and regional firms, and financial planning organizations (such as IDS or Royal American). These firms are viewed as providing the only method of reaching the large number of individual investors necessary to raise substantial amounts of capital. However, the fees paid to the brokers for their services are typically high - 6 to 8% of the capital raised.

For-profit sponsors who are marketing to corporations also use, to a limited degree, regional and national broker-dealers. However, most of the capital is raised through brokers who specialize in marketing this investment to corporations. For most of these firms, their only activity is marketing tax credit products to
corporations. Recently, at least one sponsor (Boston Financial) has stopped using brokers to market to corporations.

The corporate guarantor intermediaries have either marketed the product on their own or, in the case of SunAmerica, with the services of a national bank, First Chicago. First Chicago has historically had a small group which marketed tax-oriented investments to corporations.

Section 5.3 Market Trends in the Equity Capital Market

The equity capital market has changed and evolved a great deal since the LIHC program became effective in 1987. Figure 5-3 graphs the annual amount of capital raised each year in the housing tax credit industry, showing the portion raised from individuals and the portion raised from corporations. Initially, relatively little capital was raised. Few investors, intermediaries, and developers were familiar with the program. Much of the tax credit available went unused. By 1988, however, individual investors had become aware of the tax credit and capital invested by individuals rose sharply. In 1988 and 1989, tax credits were a "hot product" for the Wall Street and regional brokers. Approximately $590 million was raised from individuals in 1989. At the same time, there was some investment by corporations,

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10 The figures for capital raised are based on a number of sources, including Boston Capital; Boston Financial; Local Initiatives Support Corporation Annual Report for 1992; The Stanger Report; and other sources. However, no definitive sources exist for much of the capital raised in the industry, since much of the capital is raised privately and is not subject to public reporting. Many of the numbers are approximate and/or estimated. Also, note that corporations often make their payments of capital over time. The amounts of capital raised for corporate investors have been adjusted to approximate a discounted, cash equivalent amount of capital, so that all figures will be roughly comparable.
Figure 5-3
Annual Capital Raised
From Corporations and Individuals
but it remained a small share of the market. Corporations invested approximately $240 million in 1989. Most of the capital invested by corporations in these years was either direct investment by a small number of corporations or capital invested with non-profit syndicators.

In 1990 and 1991, the amount of capital raised from individuals declined significantly, to $310 million in 1991, a level well below the 1988 highs. The decline in sales is not well understood. It has been attributed to a number of factors, including saturation of the market as those investors who were willing to invest in credits obtained all the credit they were allowed to use under the tax law; as well as frequent negative publicity about the problems with real estate partnerships which had been formed in the 1980s.

As investments by individuals declined in 1990 and 1991, however, capital raised from corporations increased. This was not coincidence, in that sponsors intentionally sought to replace the decline in investments by individuals with capital raised from corporations. Capital raised from corporations rose sharply in 1992, to about $670 million, and again in 1993, to about $1.41 billion, more than doubling the amount of capital raised in the entire industry. In 1993 total capital raised was approaching $2 billion. This dramatic increase in the amount of capital raised from corporations has had a number of effects on the industry, as will be illustrated below and discussed in Chapter 8.

Figure 5-4 again illustrates the annual capital raised, in this instance showing the relative share of non-profit firms and for-profit firms. (The for-profit amounts include amounts invested directly by corporations without the use of intermediaries.) The amount of capital raised by non-profits has grown steadily but slowly during the
Figure 5-4
Annual Capital Raised
By For-Profit and Non-Profit Sponsors
life of the tax credit program. An estimated $510 million was raised by non-profit intermediaries in 1993. However, the amount of funds raised by for-profits has increased sharply from 1991 to 1993, and represents most of the growth in the industry. For profit intermediaries raised an estimated $1.39 billion in 1993, of the total capital raised of $1.9 billion.

The capital raised by for-profit entities is graphed in Figure 5-5. Of course, it again illustrates the sharp rise in the amount of capital raised. In addition, it shows the growth in the number of significant intermediaries. Boston Capital, Boston Financial, and Related show regular, if varying, amounts of investment from 1988 through 1993. In 1988, those three firms held a sizeable share of the market. By 1993, seven firms had raised a significant level of capital. Figure 5-6 shows the share of the annual capital raised for each of the seven largest sponsors. This again illustrates the proliferation of sponsors.

If we focus solely on the capital raised each year from corporations, the point is illustrated more dramatically. Figure 5-7 shows the steep rise in sales, as well as the fragmentation of the market among numerous syndication firms as well as direct investors. Figure 5-8 shows the share of the capital raised from corporations by various for-profit sponsors. Most notable in this chart is the very high share represented by direct investment by corporations, in many years. Because the amount of capital invested directly by corporations did not rise as quickly as total investment, the share of the market taken by direct investment has fallen. However, it still represents a significant share.

The dramatic increase in the funds raised from corporations has had a tremendous impact on the equity capital market, as might have been expected. Figure
Figure 5-5
Annual Capital Raised by For-Profit Entities
Figure 5-6
Annual Capital Raised by For-Profit Entities
Figure 5-7
Annual Capital Raised by For-Profit Entities from Corporations

Equity Capital ($ millions)


Arcand
Boston Capital
Boston Financial
NAPICO
Related
Richman
Sun America
Direct
Other For-Profit
Figure 5-8
Annual Capital Raised by For-Profit Entities from Corporations

Equity Capital (share)

100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%


- Arcand
- Boston Capital
- Boston Financial
- NAPICO
- Related
- Richman
- Sun America
- Direct
- Other For-Profit
5-9 charts two sets of data: the amount of capital raised from corporations, and the price paid to developers for tax credit properties.\textsuperscript{11} The credit price paid to developers is expressed in the industry as the number of cents of equity capital provided for each dollar of tax credit generated. For example, if a property is expected to generate $200,000 of tax credit each year for ten years, it will generate a total of $2,000,000 of tax credit. If the market price for that tax credit property is 50 cents, the equity capital received by the property partnership is then $1,000,000. From late 1992 to early 1994, prices paid to developers increased by over 17%. This increase in prices corresponds to the increase in capital investment by corporations. In other words, the influx of corporate capital sharply increased the prices paid to developers for tax credits.

Of course, the amount paid for tax credits cannot rise without yields falling. Figure 5-10 shows that yields, as measured by the internal rate of return on the stream on tax benefits, fell sharply over the period from 1992 to 1994, as the amount of capital invested rose. In 1992, corporate investors in tax credit partnerships were

\textsuperscript{11} The developer's profit is typically equal to the difference between (a) the total capitalization of the property partnership, that is, the debt plus the equity capital, minus (b) the costs of developing the property. Therefore, in the short term increasing prices paid for tax credits increase developer profits. However, see Chapter 8 for a discussion of how, in the longer-term, this is not true. Also, note that although the credit price paid to developers, as well as the yields and fees discussed below, are based upon an analysis of the corporate tax credit programs of a single sponsor, The Boston Financial Group. This data should be representative of the industry. Boston Financial is a significant player in a competitive market, so their pricing should provide reasonably accurate data. Further, the data has the advantages of consistency and accuracy; it is not possible to obtain consistent and accurate data for the market as a whole.
Figure 5-9
As Corporations Invested More Capital, Prices to Developers Rose

Figure 5-10
As Corporations Invested More Capital, Yields and Fees Fell
enjoying yields over 17%; by 1994, effective yields had fallen to 12%. This reflects the effects of increasing amounts of capital competing for a fixed amount of tax credits available for investment.

While the developers who control the supply of tax credit properties have clearly had the most leverage in the market, the large corporate investors who supply the capital are, of course, not without influence. At the same time that developers were seeking the highest prices for the tax credits their projects were generating, investors were trying to obtain the highest investment yields possible. Figure 5-10 shows one way in which that was accomplished: reducing the spread between the amount invested by the corporation and the amount paid to the developer by reducing fees and expenses. These reductions principally represent reductions to the offering expenses, and the selling commissions paid to brokers. So the sharp rise in capital invested by corporations has, in the past two years, resulted in dramatic changes to the economics of the investment for developers, investors, and brokers. These changes will be discussed further in Chapter 8.

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12 The yield received by the investor depends upon whether they receive their capital back after the 15 year compliance period. Typically a number of scenarios are evaluated for distributions to the investors upon the sale of the property. For simplicity, the yield figures herein are based on an average of two yield numbers, the first assuming that no cash is distributed to the investors upon sale and the second assuming a cash distribution sufficient to return all investors their capital investment.
Chapter 6
The Property Market

In explaining the equity capital market, we have of necessity already touched on the key players in the property market: intermediaries and developers. Intermediaries turn to the property market to invest the funds which they have raised from investors. They negotiate with developers for the price and terms upon which an investment will be made in a property. In the current market environment, intermediaries compete with one another for the right to invest in tax credit properties. This section will further discuss the actors in the property market.

Section 6.1 Developers

The property market is diagrammed in Figure 6-1. Six types of developers are set forth. These six types of developers have been developed based upon the defining characteristics which tend to lead various developers to work with certain types of intermediaries. The three variables are the size of the developer; whether the development organization is for-profit or non-profit; and whether the properties they develop receive financing and/or operating subsidies.

For-profit developers might focus on properties which benefit only from the subsidy provided by the tax credit, or on properties which benefit from substantial operating or financing subsidies. The principal examples of properties which receive additional subsidies include the following: Farmers Home Administration properties, which receive mortgages for 97% of the cost of the property at an effective rate of 1% and, in many cases, operating subsidies as well; and properties with a wide variety
Figure 6-1
Housing Tax Credit Industry - Property Market

Intermediaries

Type
Geography
Property Type

Developers

Size
Type
Property Type

Corporations/Finders

Corporate Guarantor National
For-Profit Syndicator National
For-Profit Syndicator National Subsidized
Non-Profit Syndicator National Subsidized
Non-Profit State/Local Subsidized

Local/Self

Large For-Profit
Medium For-Profit
Small For-Profit
L/M/S For-Profit Subsidized
Medium Non-Profit Subsidized
Small Non-Profit Subsidized
of subsidies provided by state or local governments, which may include grants or below market mortgages.

The level of subsidy received by a property can be thought of as a point on a continuum: those properties with no subsidy other than the tax credit are on one end of the continuum, and properties with substantial financing and operating subsidies, such as Farmers Home properties, are on the other end of the continuum. There are properties at almost every point on the scale in between. For example, many state and local governments have programs to provide a so-called "soft second" mortgage for a property. Under these programs, a property obtains a conventional first mortgage. The state or local government provides a second mortgage with debt service payable at a below-market rate, and in some cases payable only if and when the property generates sufficient cash flow to pay the debt service on the second mortgage. However, the degree of subsidy depends upon the fraction of the total cost of the project which is financed using the soft second mortgage; how far below market the interest rate is; and how soft the soft second mortgage is, that is, whether payments of debt service are deferred if the property cannot pay them currently. It is in this sense, then, that there is a continuum of subsidy.

If there is no clear line determining the amount of subsidy a property benefits from then, of course, there is no clear line dividing the types of developers. However, the distinctions set forth in Figure 6-1 do provide a useful model for understanding developers in the context of the property market.

Note that Figure 6-1 does not include large non-profit developers as a type of developer. In general, non-profits tend not to do a substantial number of large properties on a regular basis.
Finally, it is worth noting that the development of housing tax credit properties, like all housing development, is a localized business. There are many development firms operating in the property market. Relatively few have a large organization or develop properties in more than one or two states. Few developers have a market share in excess of 1% of the national market.

Section 6.2 Intermediaries

Five types of intermediaries are set forth in Figure 6-1: corporate guarantors; for-profit syndicators; for-profit syndicators which focus on subsidized properties; non-profit national syndicators; and regionally-oriented non-profit sponsors. In addition, corporations which invest directly are included in the diagram because they participate in the property market and therefore can influence all of the other actors.

The five types of intermediaries were described in Chapter 5. Of particular interest, then, in describing the property market is understanding the typical relationships between developers and intermediaries.¹

Corporations which invest directly tend to focus on the largest properties or on the developers who generate the largest amounts of tax credits from a series of properties. Presumably this minimizes the transaction costs involved in identifying properties for investment, as well as in evaluating the feasibility of those properties and in closing a transaction.

¹ Of course, the intermediaries and their investors share similar investment preferences, either because the investors have specified their preferences to the intermediary before investing their capital or, as may be the case for the non-profit intermediaries, the intermediary has sought out investors whose preferences reflect the intermediary’s agenda.
Of course, for these same reasons the largest developers are also very attractive to corporate guarantors and for-profit syndicators. However, because these latter two types of intermediaries are more specialized, they are also able to actively pursue medium-sized properties and developers in a cost-effective manner.

Small for-profit developers generally do not have access to capital through intermediaries. The transaction costs are too large, relative to the amount of capital invested, for the intermediaries. In particular, the time needed to evaluate the abilities of the developer and the feasibility of the property for a small investment lead most intermediaries to avoid investing in small properties with for-profit developers. As a result, many of these properties are either syndicated, often locally, to a single corporation or a small group of individuals; or the developer retains the tax credits for its own use.

For-profit syndicators are also interested in medium to large developers where the properties benefit from subsidies. Again, for small developers and small properties the transaction costs are high enough to preclude investment by some for-profit syndicators.

Certain intermediaries have primarily focussed on small- to medium-sized for-profit developers, where subsidies are significant. For example, a number of intermediaries have historically focused on acquiring properties which benefit from Farmers Home subsidies. Examples include Arcand, Sterling and to a lesser degree Boston Capital. These properties are typically developed by fairly small development organizations. At least one intermediary, The Richman Group, has historically focused on subsidized properties of all sizes, including properties developed by both for-profit sponsors and non-profit sponsors.
Medium and small non-profit developers generally raise capital through national or regional non-profit syndicators. Although most for-profit syndicators have historically invested in some larger subsidized properties with the medium-sized developers, this has not been a consistent source of capital for non-profit developers.

Section 6.3 Typical Agreements Between Intermediaries and Developers

Intermediaries invest capital in a property partnership only after both parties have executed a set of agreements to govern the business relationship over the life of the investment. As discussed in Chapter 4, the principal document is a partnership agreement. The intermediary always invests as a limited partner, with strictly limited rights under the agreement. This provides the intermediary with protection from the liabilities of the property partnership.

In order to align the incentives of the developer with those of the intermediary and the equity capital investors, developers ordinarily agree to a set of guarantees and obligations regarding the development and operation of the property. To some degree, the types of guarantees are similar for various intermediaries, for three reasons. First, the early industry participants developed typical practices and standards which were widely imitated by later entrants. Second, a common set of legal and accounting experts provide advice to many of the intermediaries, which has tended to standardize their practices. Third, investors value certain provisions of the guarantees and therefore require intermediaries to agree, before the investor invests its capital, to include those provisions for all property investments. In general, these provisions are as follows.
**Construction completion.** The developer\(^2\) is obligated to fund all costs necessary to complete the property. In some cases, a payment and performance bond is required to guarantee construction completion.

**Operating deficit obligation.** Should property expenses exceed rental income, the developer is typically obligated to fund operating deficits for a period of time following the completion of the property. This obligation may run for a fixed period of time, or until a particular operating benchmark is reached, or some combination of those terms. Similarly, the amount of deficits may be limited to a specific amount or may be unlimited. For example, a typical for-profit intermediary might require the developer to fund all operating deficits, without limit, until the property generates enough income from operations to pay all operating expenses. (This is referred to as "breakeven.") For three to four years thereafter, the developer may be obligated to fund operating deficits up to some specified maximum amount. Some intermediaries require the developer to agree to fund some amount of operating deficits for the full fifteen year compliance period for the property.

**Credit adjusters.** Should the tax credits generated by the property be less than anticipated, typically the capital payable by the intermediary to the property partnership will be reduced. (If the capital has already been paid, the developer will be obligated to repay the appropriate amount.) These "adjuster provisions" are

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\(^2\) For the purposes of this discussion, to maintain consistency it is assumed that the developer is required to undertake the various obligations. In many cases, these obligations are in fact undertaken by the general partner of the property partnership. While this is important for legal and tax purposes, it is not necessary to make this distinction in order to understand the business terms. Therefore, because the property general partner is typically an affiliate of the developer, the distinction is ignored for the purposes of this discussion.
intended to generally maintain the tax credit return relative to the amount of capital invested in the property.

*Purchase obligation.* Frequently the developer will be obligated to buy the limited partner interest and repay the full amount of the capital invested to the intermediary should the property fail to achieve completion, permanent mortgage financing, or delivery of substantial amounts of tax credits. These purchase obligations appear to have a low level of enforceability, in that they are seldom if ever enforced in practice because the developers in such circumstances are typically unable or unwilling to fulfill this obligation. However, they do provide an incentive for the developer to perform its obligations.

*Representations and warranties.* Typically developers are obligated to make certain representations to the intermediary. For example, a developer may be required to represent that the property is owned by the partnership, that the property has obtained a reservation of tax credits, and so on. In addition, a developer is typically required to warrant that they will take certain actions, such as renting the property only to tenants who comply with the guidelines for the tax credit program. This provides the investing intermediary with a legal right to sue for damages or obtain specific performance, should the developer fail to make truthful representations or comply with the warranties.

*Conditional capital contributions.* Normally the capital contributions payable to the property partnership are payable only when certain conditions have been met. For example, the initial installment may be payable when construction commences, the construction loan closes, and a permanent financing commitment has been obtained. The second installment would typically be paid upon completion of the
construction of the property. The third installment would be paid when the permanent loan closing occurs, and when the property partnership's accountants have determined the estimated amount of the annual tax credit. A fourth installment would typically be paid when the property achieves breakeven operations. Depending on the perceived risk of the property and the standards of the intermediary, there may be additional installments of capital which are conditioned upon the performance of the property. For example, capital may be held until the property achieves a debt service coverage ratio of 1.10 or 1.15. (The debt service coverage ratio is equal to the net operating income of the property, after deducting operating expenses, divided by the required payments of debt service.)

Many industry participants hold the view that the most important protection for the intermediary and the investor, after careful selection of properties and developers, is the conditions on the capital contributions. Should a property experience problems, often the developer will be unable to fulfill their obligations. The capital which is still being withheld provides the intermediary with critical financial resources to work toward a resolution of the problems.

Of course, the standard set of obligations is often varied depending upon the specific nature of the investment to be made. Most often, the two most important variables are the financial strength of the development organization and the level of subsidy on the property. For example, with a financially strong development group, an intermediary may be more willing to rely upon the guarantees of the developer to protect against potential risks in the investment. On the other hand, with a less strong developer the intermediary might not value the guarantees of the developer, and may instead require bonding from third parties or escrows of capital to ensure

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that property risks are protected against. Similarly, a property with substantial subsidy and very low rents may be viewed as having little risk due to market fluctuations. Certain of the protections required of a property without subsidy may be eased or waived on a property which benefits from substantial subsidy.

Section 6.4 Relationships and Competition in the Property Market

The set of relationships between intermediaries and developers shown in Figure 6-1 and discussed above provides a guide to the level of competition among intermediaries for access to certain property types. At the simplest level, except for small for-profit developers, there are multiple intermediaries willing to compete for investments from every developer and for every property type. This, in itself, implies a certain level of rivalry for property investments.

Of course, the market is more complex than that. Figure 6-1 merely illustrates how many different types of intermediaries compete for investments generated by the various types of developers. For a more accurate understanding, one must consider how many alternative intermediaries are available to each developer type, and how much capital is being raised by those intermediaries. In the for-profit area, in recent

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3 Although many industry participants often assume that properties with substantial subsidy are less risky, it is more accurate to view them as having different risks than properties which do not benefit from subsidies. Properties with substantial subsidy are often highly regulated, which brings regulatory risk. For example, in recent years properties subject to regulation by the Department of Housing and Urban Development have experienced delays of several years in processing approvals. Furthermore, while subsidies may in some cases reduce the exposure of a property to competition for tenants, that only reduces the risks on the income side of the equation. There are also risks on the expense side. Many highly subsidized properties are experiencing unanticipated operating expenses and, as a result, are struggling to remain viable.
years for-profit syndicators have raised the largest amounts of capital, as was illustrated by the discussion in Chapter 5. Corporate guarantors and direct investors have also raised and invested substantial amounts. So there are several alternative types of intermediaries raising substantial capital. Furthermore, there are several such firms within each type of intermediary participating in the property market. This provides the developer with a variety of sources for capital. Not surprisingly, then, there is intense rivalry in the current market for properties developed by for-profit developers.

There are two principal areas in which the competition among intermediaries for the right to transact with developers manifests itself: price and terms. The results of the competition on price were illustrated in Figure 5-9. Competition on terms principally manifests itself in the negotiation of the guarantees and other obligations discussed in Section 6.3, as well as on a number of other obligations contained in the agreements between the parties. A developer will generally seek to minimize its obligations. It is very difficult to measure, in a meaningful and accurate way, the extent of the competition on terms. Obviously, these are private transactions and data is available for only a fraction of the actual investments made. However, although comprehensive data is not available, it is indisputably clear from discussions with industry participants that extensive competition on terms has taken place.

Of course, in many respects it is as difficult for investors to ascertain the extent of competition on terms as it is for industry observers. By their nature, intermediaries act as agents for the investors, and are responsible for utilizing their own judgement in negotiations with developers. For the most part, corporate investors have not imposed extensive or detailed requirements upon intermediaries.
To the extent that significant amounts of capital are raised by intermediaries from investors who are either not concerned with terms or who are not monitoring the terms of the investment, it creates significant pressures to compete on terms in the market.
Chapter 7
An Analysis of the Housing Tax Credit Industry

Chapters 4 through 6 provided a description of the housing tax credit industry. With that background, we can now analyze the industry. This analysis primarily focusses on the equity capital market, rather than the property market. However, some background on and discussion of the property market is necessary to understand the equity capital market. Furthermore, this analysis emphasizes the role of corporations as investors, and does not examine in depth the role of the individual investor. This analysis looks principally at two areas: the industry environment in which the firms operate, and some general characteristics of the firms which operate in the industry. Through segmentation and strategic mapping, a clearer and more coherent picture of the industry is developed.

This discussion is intended to describe and discuss the structure of the industry, rather than to develop or evaluate possible strategies which firms might follow. Therefore, much of the analysis contained in the classic works on competitive analysis, such as Porter’s *Competitive Strategy* and *Competitive Advantage*, is beyond the scope of this discussion.\(^1\) In particular, the discussion herein intentionally omits, for the most part, Porter’s well-known analyses of industry attractiveness, which is intended to help a firm decide whether to enter or exit an industry, and competitive position, which is intended to help a firm develop a position in the industry which

provides competitive advantage. Rather, the type of discussion in this work might serve as the initial basis for a firm wishing to go on to develop strategies. A firm doing strategic planning would want to take a detailed look at all of the firms in an industry, as well as thoroughly analyzing the firm's own competitive assets and liabilities. However, the fundamental aspects of Porter's works do provide an approach to understanding the housing tax credit industry which has relevance, particularly to the extent that they provide a clearer view by highlighting certain general patterns and they help to explain the behavior of firms within the industry.

Section 7.1 Segmentation

According to Porter, "An industry is a market in which similar or closely related products are sold to buyers." Figure 7-1 summarizes the key buyer and product dimensions which characterize the equity capital market in the housing tax credit industry. These fit well within Porter's definition - there are distinct buyer and product varieties, but as a group they are all closely related and are distinct from other markets. As such, they form an industry.

Industry segmentation requires an understanding of buyer needs and of product varieties. There are four broad categories which Porter suggests for variables to use in segmenting an industry: product, buyer type, channel, and geography. To the extent that one variable is closely correlated to another and is therefore a good proxy for that other variable, these can be combined. The labels along the edges of Figure 7-1 indicate the variables; closely correlated variables exist along both the

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Figure 7-1
Segmentation Matrix for the Housing Tax Credit Equity Capital Industry

<table>
<thead>
<tr>
<th>Buyer Type</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Individual Intermediary</td>
<td></td>
<td></td>
<td></td>
<td>(Null)</td>
<td>(Null)</td>
<td></td>
</tr>
<tr>
<td>B. Corporation Intermediary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(Null)</td>
</tr>
<tr>
<td>C. Corporation Direct</td>
<td>(Null)</td>
<td>(Null)</td>
<td>(Null)</td>
<td>(Null)</td>
<td>(Null)</td>
<td></td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Product Features</th>
<th>For-Profit</th>
<th>Non-Profit</th>
<th>None</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return Guarantees</td>
<td>Guaranteed</td>
<td>Not Guaranteed</td>
<td>Varies</td>
</tr>
<tr>
<td>Subsidy</td>
<td>Modest Subsidy</td>
<td>Substantial Subsidy</td>
<td>Varying Subsidy</td>
</tr>
<tr>
<td>Geography</td>
<td>National</td>
<td>State</td>
<td>Varying</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Buyer Objectives</th>
<th>Yield</th>
<th>Social Responsibility</th>
<th>Safety through:</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Low</td>
<td>Financial Guarantee</td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>Low</td>
<td>Sponsor Selection</td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>High</td>
<td>Subsidies</td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>High</td>
<td>Subsidies</td>
</tr>
<tr>
<td></td>
<td>Varies</td>
<td>Varies</td>
<td>Varies</td>
</tr>
<tr>
<td></td>
<td>High</td>
<td>High</td>
<td>Higher Risk</td>
</tr>
</tbody>
</table>

Notes:
1. Null cells represent segments for which there cannot be any firms operating or, in the case of Cell A5, where it is unlikely that any firms will ever operate (rather than segments in which there are currently no firms operating).
2. Moderate subsidy means tax credits; or, for some properties, tax credits combined with modest financing subsidy.
3. Substantial subsidy means tax credits combined with substantial financing or operating subsidy.
buyer variables and the product variables. The relationships between these variables were discussed in Chapters 5 and 6. In particular, the relationships in place between certain industry participants and the objectives of the buyers define the segmentation matrix.

Note the null cells in Figure 7-1. Porter cautions that it is important to identify as null cells only those segments which represent infeasible combinations of the segmentation variables, not merely cells where there are currently no firms operating. In fact, identifying feasible combinations where there is currently no firm active - that is, potential products and buyers - represent potential opportunities for a firm.

Having established the industry segments in Figure 7-1, Figure 7-2 provides a simplified version of the matrix, but with the names of firms operating in each segment listed in the appropriate cell. "Firms provide the link between products and buyers."\(^3\)

Obviously, some segments of the industry are crowded. This is particularly true of the for-profit intermediary, non-guaranteed, moderate subsidy segments which serve individuals and corporations. The for-profit intermediary, non-guaranteed, substantial subsidy segments have several firms operating in them as well. There is limited activity in the guaranteed segments, presumably because few firms currently have the capability to offer the guarantees. It is interesting to note the empty cells. Certain products are not being offered by firms to individuals: guaranteed products, and a non-profit intermediary product.

\(^3\) Porter 1985, p. 233.
Figure 7-2
Segmentation Matrix for the Housing Tax Credit Equity Capital Industry

<table>
<thead>
<tr>
<th>Buyer Type</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
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<td>Boston Financial</td>
<td>Other</td>
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<tr>
<td></td>
<td>Related</td>
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<td></td>
<td>Other</td>
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<td>Local Investors</td>
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**Product Features**

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<th>Non-Profit</th>
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</tbody>
</table>
Porter notes that segments of an industry have a structure just as industries do, and many of the approaches to analyzing an industry can be applied to a segment.\footnote{Porter 1985, p. 231.} For example, just as barriers to entry to an industry are a critical factor, barriers to entry to a segment determine behavior of firms within a segment. A related concept is the mobility of firms among segments. Figure 7-2 would be useful in evaluating the implications of firms already in the industry entering new segments.

Section 7.2 Understanding the Competitive Environment

7.2.1 Industry Life Cycle

Most industries show certain similar trends over time, a concept referred to as the industry life cycle.\footnote{Sharon M. Oster, Modern Competitive Analysis, New York, Oxford University Press, 1990, p. 8. The analytical approach underlying this chapter relies heavily upon Oster and Porter, 1985.}

The industry begins when a new product is introduced by a firm. Typically, the initial production capacity of the innovator is below what the market will support. Growth and profit opportunities in the new industry appear to be very attractive, and new entry occurs.\footnote{Oster, p. 9.}

Initially, then, for a successful product sales rise and so do the number of competitors in the industry. Often, in fact, too many competitors enter the industry, and there is more production capacity than an industry can support. Then the industry enters a shake-out or consolidation phase. The firms which can best meet the customers' needs, in terms of price and product performance, will survive the shake-out. Once the number of competitors and the industry capacity declines, the industry may enter
a period of stability. The character of the industry, and therefore the types of opportunities which are available to industry participants, change over time.

As should become more apparent in Chapter 8, the housing tax credit industry fits this description of the industry life cycle quite well, particularly if the focus is placed on corporate investors. For example, in late 1992 the demand for investment product by corporations began to exceed the industry's capacity to supply investments. Profit opportunities were high. Numerous firms entered the industry. Currently, it appears that the capacity of the industry to intermediate tax credit investments exceeds that necessary, given the limited amount of tax credits which are available. The tax credit industry appears to be entering the shake-out stage.

At the same time, there is also a product life-cycle at work. Over time, innovations and the development of substitute products can be expected to produce competitive products which better meet the needs of some or all of the industry's customers. Therefore, in the absence of growth in the underlying market of customers, sales of a product can be expected to decline over time.

7.2.2 Competitive Forces

Porter outlines five competitive forces which determine industry profitability by influencing the prices, costs, and required investments of firms in an industry. These forces are the threat of new entrants; the bargaining power of buyers; the threat of substitute products or services; the bargaining power of suppliers; and the rivalry among existing firms. "The strength of each of the five competitive forces is a function of industry structure, or the underlying economic and technical
characteristics of an industry." The discussion in this chapter focuses on a
discussion of the elements of industry structure. However, a limited discussion of the
effect of the structure of the tax credit industry on the five competitive forces will be
useful.

The threat of new entrants and rivalry are discussed in greater detail below. To turn to the other three forces, within the equity capital market, clearly the
bargaining power of buyers is significant. Corporations are a concentrated source of
demand. With $10 to $100 million they wish to invest, they can exercise significant
leverage over intermediaries. At the same time, though, intermediaries have shown
an ability to extract high profits due to their access to a supply of tax credit
properties. Thus, while buyers have an upper hand, the advantage is not
overwhelming.

Looking at the threat of substitutes yields some surprising results. Corporations, who presumably have a wide range of investment opportunities, in fact
have few substitutes for tax credit investments. No other investment product has the
favorable impacts of increasing earnings and reducing the corporation's effective tax
rate. To individuals, on the other hand, an after-tax return is an after-tax return.
There are many competing investments, many of which serve as adequate substitutes
for tax credit investments.

As to the bargaining power of suppliers, if developers are viewed as suppliers it becomes clear that they are a strong force in the industry. In the current market,
with the high level of demand by investors for a scarce commodity which developers

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7 Porter 1985, p. 5.
control, developers have substantial bargaining power. Developers have a much stronger threat of forward integration than intermediaries do of backward integration - that is, it is much easier for a developer to threaten to raise the capital on their own than it is for an intermediary to threaten to develop property on their own.

7.2.3 Entry

As discussed above, the industry life cycle is largely driven by the entry of competing firms. The actual progress of the industry life cycle is obviously highly dependent upon the rate and the magnitude of entry of new firms. How quickly will new firms enter, and how many new firms will enter? The more slowly entry occurs, the longer that the initial period of high profitability will last. "[T]he possibility of entry is fundamental to patterns of profitability in an industry."

The likelihood that firms will enter a market depends principally on whether they expect that entering the industry will be profitable, and upon the size of those profits. If there are industry characteristics which make it less likely that an entrant will be profitable, that industry has barriers to entry. The potential profitability of entry, and therefore the attractiveness of an industry to new entrants, is influenced by three important factors: the likely reactions of firms already in the industry to the new competitor; the advantages of existing industry participants; and the costs of failure or exit costs. Assuming that the chances of a new firm successfully entering the industry are less than 100%, there is some probability that a new entrant

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8 Oster, p. 20-21.
9 Oster, p. 32, 36.
10 Oster, p. 35.
will incur costs of failure, or exit costs. These exit costs are typically made up of the irreversible investment made in entering an industry, which cannot be applied to another industry.

**Reaction of Existing Participants to New Entrants**

There are three factors relating to the technology of an industry which influence the reaction that a new entrant can expect from the firms already participating in an industry.

*Specific Assets.* There is a set of tangible or intangible assets that is needed to compete in any market. "To the extent that an organization’s assets are specific to a market and thus primarily valuable only in that market, that organization is likely to fight harder to maintain its position in that market."\(^{11}\) Many of the assets used by the larger intermediary firms to compete are specific to the housing tax credit industry. For example, the ongoing monitoring and management of the properties is specialized, and the systems and experience applied do not easily transfer to other businesses. These represent a substantial investment specific to the affordable housing industry, and would tend to lead firms to react more strongly to new entrants.

*Economies of Scale.* In some industries, firms which produce larger volumes can significantly lower their per unit costs. Of particular importance is the *minimum efficient scale of production*, which is defined as the smallest volume for which unit costs reach a minimum.\(^{12}\) This is primarily of importance in that it determines the minimum size needed to enter a market, and therefore the share of the market needed

\(^{11}\) Oster, p. 39.

\(^{12}\) Oster, p. 40.
for entry. If the share of the market needed for entry is high, a firm can expect a more intense response from other firms already in the market, as well as a decrease in prices after they enter the market. (Note, however, that product differentiation can offset cost disadvantages by allowing a firm to charge a premium.)

There appear to be minor economies of scale in the housing tax credit industry. In fact, there may in some respects be diseconomies of scale. Clearly the minimum efficient scale of production is quite low; many small firms can participate effectively. The cost disadvantage of small firms is not that severe, and cost efficiency is not yet a key competitive issue in the industry.

However, there do appear to be some economies of scope in the housing tax credit industry. In particular, firms can and do serve multiple segments effectively because some portion of the processes by which they deliver value to the buyers are shared in different segments. The principal example of this is illustrated by firms’ activities in the property market. The process of acquiring a tax credit property for a group of individual investors may be nearly identical to the process of acquiring a property for a group of corporations. The economies of scope arise, then, from greater volume in processing property acquisitions and therefore reduced search and transactions costs, as a proportion of capital raised. Property acquisitions are obviously a central part of the process by which intermediaries create value for investors, and excelling in property acquisition is therefore an very good example of an area where a firm might lower costs or increase differentiation by providing superior performance in that portion of the value chain.¹³

¹³ Porter (1985) notes that costs of coordination, compromise and inflexibility in serving multiple segments with shared activities can offset the economies in part or in whole.
Excess Capacity. Some firms (and therefore their industries) have excess capacity, with fixed costs which must be borne regardless of how much the firm produces. Once a firm has committed to incur these fixed costs, it will be willing to produce and sell its product at a price equal to its marginal cost of production. If an industry has excess capacity, it makes price cutting more likely should a new firm enter the market. This will deter new entrants. However, because fixed assets are not a major part of the process of competing in the equity capital market, excess capacity does not appear to be a method which is used or usable to deter entry.

Advantages of Existing Industry Participants

A new entrant may be at a competitive disadvantage relative to firms already in a market for a number of reasons. Oster highlights four areas: (1) precommitment contracts; (2) licenses and patents; (3) learning-curve effects; and (4) a pioneering-brand advantage.¹⁴ These advantages are also referred to as first-mover advantages, because they make an industry more profitable for existing participants than for new entrants.

Precommitment Contracts. Firms often enter into contracts to buy or sell products over a period of time. In particular, firms may use contracts as an entry-deterring tool by obtaining exclusive access to either an essential input to their production process or to a critical distribution channel for their product. "[T]he value of these contracts depends heavily on the uniqueness of the contracted supply."¹⁵

¹⁴ Oster, p. 48.

¹⁵ Oster, p. 49. Note that, in order for the firm to benefit from exclusive access to a scarce resource, the firm must have better information about the scarcity (and therefore value) of that resource than the organization that controls the resource.
The resource in scarce supply, of course, is properties with tax credits. There are relatively few formal precommitment contracts in the property market. Although there is a tendency for developers to do a series of transactions with one intermediary, neither party is typically formally bound to that arrangement. Therefore, potential new entrants have access to developers.

In the equity capital market, there are some precommitment contracts in the distribution of investments to individuals. The major brokerage firms who serve as channels for distribution of tax credit investments to individuals generally distribute only one intermediary's product at a given time. Therefore, certain established intermediaries have an advantage over potential entrants. For example, Merrill Lynch and PaineWebber sell a public fund only for The Richman Group, and Dean Witter, Smith Barney Shearson, and Prudential sell only for The Boston Financial Group. Legally, these agreements generally in force only while a particular fund is being marketed. As a practical matter, though, these relationships have tended to change slowly. However, as sales of public fund products have declined, the importance of these precommitment contracts has declined.

There are relatively few examples of effective use of precommitment contracts in connection with raising capital from corporations. Access to product has been viewed as important by distribution channels, and some firms have therefore negotiated exclusive arrangements to distribute intermediaries' products. For example, Meridian, a specialty broker, currently serves as the sole channel for The Related Companies and for Arcand. They also served the same role, for a time, for SunAmerica. However, the intermediaries have not utilized contracts to tie up distribution channels in order to limit entry to their markets. For example, although
Boston Financial enjoyed virtually 100% market share in its segment for nearly two years from 1990 to 1992, it did not require its distribution channels to enter into contractual arrangements which would have deterred entry of competitors.

*Licenses and Patents.* If entry to an industry is controlled by the government or by law, clearly new entry can be deterred (though not always eliminated). Although there are certain securities regulations which must be complied with in order to operate in the equity capital market, in general there are no laws, licenses or patents which restrict entry to the equity capital market. For the most part, product innovations cannot be protected and are therefore widely imitated if they prove effective.

Of course, the process of credit allocation by the states, and the limits on the amount of credit which can be allocated, limit entry into the property market. However, the allocation of credit for a single property does not provide a developer with a continuing share of the market. Clearly there is strong competition for credit allocations among developers within most states. With each application round, all potential applicants compete again for the available allocation. Further, no single developer has a significant share of the market, and new entrants are unlikely to gain a significant share. Therefore, the regulation of credit allocations does not provide a barrier to entry for developers.

*Learning-Curve Effects.* Firms often experience falling unit costs as cumulative production increases. This is generally attributed to increasing labor productivity, as

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16 Of course, in many instances the legal limit on the size of the market will displace the market competition into the political process as developers use contacts to gain some advantage in the allocation process.
well as to improvements in distribution and the use of inputs. However, if the gains from learning cannot be limited to a single firm, no entry barrier is created.

In general, it appears that gains from learning are disseminated quickly and widely in the housing tax credit industry. Securities laws require disclosure of the terms of the proposed investment. This disclosure can be analyzed by competitors to determine many of the processes by which an intermediary adds value for its clients. Furthermore, because the process does not rely upon fixed plant and equipment, once a competitor has identified an innovation it can quickly be adopted. For example, the terms of a product offering can be amended by a written supplement to the disclosure documents. Because the industry is driven by tax and legal issues, it relies heavily on a relatively small group of advisors. Often these attorneys and accountants view it as their right, if not their obligation, to disclose the lessons learned by other industry participants. Finally, while there presumably is some competitive advantage in analyzing the feasibility of property investments which has been gained by firms with many years of industry experience, it is difficult for investors to evaluate this experience. As a result, whatever proprietary learning the more established intermediaries have obtained appears not to have presented an insurmountable barrier to recent entrants. In sum, then, learning-curve effects provide few barriers to entry in the housing tax credit industry.

**Pioneering Brand Advantages.** In some industries, customers prefer existing brands to new products. This seems principally motivated by risk. For *search goods*, products for which a reasonably accurate judgement can be made by inspecting the product, early entrants to a market will have little advantage. For *experience goods*, which must be purchased and used to determine quality, pioneering brands may have
a significant advantage. Customers who purchase a new brand of an experience good incur a risk by doing so. If the costs of making a mistake are high, it will deter consumers from purchase new products. Finally, if customers are satisfied with the existing product, it makes them less likely to try a new product. Price discounting, endorsements, and government certification may make customers more willing to try a new brand. Investments in tax credit funds would clearly appear to be an experience good. However, this has not in practice deterred many corporate investors from investing with a number of intermediaries.

Exit Costs

Firms who are considering entering an industry must consider the probability that they will not succeed, and evaluate the losses they will incur as a result of their failed attempt to enter the industry. Exit costs may be the principal determinant of entry to an industry.

Recent research maintains that in the absence of exit costs, excess profits will be very difficult to maintain. Should a profit-making opportunity appear, firms will enter quickly, earn temporary, but handsome profits, and then leave when the environment becomes less favorable. This has come to be known as hit-and-run entry, and in some industries it may hold down profits very effectively. It is only exit costs that discourage firms from plunging into what appear to be high-profit industries.¹⁷

Exit costs are high primarily when a firm must commit a large amount of capital to an industry and when that capital, once invested, cannot be recovered and used in another industry. Another way of stating this is to say that exit costs are high when large, irreversible commitments of capital must be made.

¹⁷ Oster, p. 57.
As discussed above, for the most part large fixed investments of capital are not necessary to compete in the equity capital market. Not surprisingly, the high level of entry described in the quote from Oster appears to fit the actual experience quite well.

In summary, then, the barriers to entry into the housing tax credit industry are currently low. In addition, the profits are so high that they have to fall a great deal before entry is deterred, that is, before entry appears unprofitable.

One might expect higher barriers to entry in the corporate investor segments than in the individual segments, due to the greater sophistication of corporate investors. However, it is again perhaps surprising to note that the barriers to entry in the individual investor segments are higher than in the corporate investor segments. In part, this is due to some first-mover advantages discussed above. However, the principal reason is because the management of the brokerage firms, which control access to the individual investor group, is generally more sophisticated and selective in their review of products and intermediaries than are most corporations. In addition, the costs of securities registration and printing are much higher on products for individuals, and this represents a substantial exit cost, due to the irreversible commitment of capital, which deters entry.

7.2.4 Rivalry Among Firms

While entry is typically the most important factor in evaluating an industry, rivalry among existing firms can also have a substantial impact. In discussing rivalry among firms, Oster notes that when the number of competitors in an industry is large, there is typically more competition in an industry, principally because having many
players makes it difficult for firms to coordinate market activities.\textsuperscript{18} In addition, if
the firms in an industry are similar in size, rivalry tends to be more intense. This
also appears as a result of the difficulty which numerous smaller firms have in
showing market leadership in such an industry.\textsuperscript{19}

The intense rivalry in the housing tax credit industry appears well explained
by these concepts. As shown in Chapter 5, there are many industry participants.
Furthermore, the share of the market which each intermediary enjoys is, broadly
speaking, comparable.

\textbf{Section 7.3 A Strategic Map of the Equity Capital Market}

Using the same variables as the segmentation matrix, Figure 7-3 provides a
strategic map of the housing tax credit equity capital market. The area of each circle
is proportionate to the capital raised by each of the firms shown.\textsuperscript{20} In some respects,
there is a diversity of types of firms represented, including for-profit and non-profit,
as well as firms which raise funds from corporations and individuals. However, there
is also clearly a significant cluster in the for-profit, non-guaranteed sponsor group.

Figure 7-4 shows how dramatically the industry has shifted since 1990. The
broken circles show where firms were located on the strategic map in 1990; the solid
circles show firms in 1993. Reflective of the overall growth in the industry, each of

\textsuperscript{18} Oster, p. 212.

\textsuperscript{19} Oster, p. 212-213.

\textsuperscript{20} To smooth out some of the arbitrary effects of using a calendar year, an average of
capital raised was used, with the weighting based 25\% on 1992 sales and 75\% on 1993 sales.

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Figure 7-3
Strategic Map of the Housing Tax Credit Equity Capital Market

Legend
- Corporate
- Individual

Product Features

<table>
<thead>
<tr>
<th>Intermediary</th>
<th>For-Profit</th>
<th>Non-Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return Guarantees</td>
<td>Guaranteed</td>
<td>Not Guaranteed</td>
</tr>
<tr>
<td>Subsidy</td>
<td>Moderate Subsidy</td>
<td>Substantial Subsidy</td>
</tr>
<tr>
<td>Geography</td>
<td>National</td>
<td></td>
</tr>
</tbody>
</table>
Figure 7-4
Strategic Map of the Housing Tax Credit Equity Capital Industry
Shifts from 1990 to 1993

<table>
<thead>
<tr>
<th>Product Features</th>
<th>For-Profit</th>
<th>Not Guaranteed</th>
<th>Non-Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermediary</td>
<td>Guaranteed</td>
<td></td>
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<tr>
<td>Return Guarantees</td>
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<tr>
<td>Subsidy</td>
<td>Moderate Subsidy</td>
<td>Substantial Subsidy</td>
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<tr>
<td>Geography</td>
<td>National</td>
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</tr>
</tbody>
</table>
these firms has increased the amount of capital raised, as reflected by the larger circles representing 1993.

The dramatic shift of firms from the individual market to the corporate market is also striking. Some firms have moved from one extreme, raising funds from individuals, to the other, raising most or all of their funds from corporations. This trend reflects the lower barriers to entry present in the corporate investor segments of the industry. Figure 7-4 illustrates how the influx of corporate capital has transformed the tax credit industry. As discussed in Chapter 8, it looks likely that the movement toward the corporate investor will continue and accelerate, as the corporate products begin to dominate the property market.

Section 7.4 Industry Groups

In some industries there are groups of firms with similar characteristics. To understand the industry, it can be useful to understand these groups. Industry groups operate at a level between the overall industry and the individual firm. "Strategic groups are clusters of firms within an industry that have common specific assets and thus follow common strategies in setting key decision variables."21 Of course, there may be characteristics common to all firms in an industry, so it is possible that most or all firms follow similar strategies at some times or in some respects.

Clearly different firms in the industry have developed in different ways. What causes firms to develop differently within industries? "In a new industry, considerable

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21 Oster, p. 61.
uncertainty faces early entrants. Consumer preferences are perhaps not even well understood by consumers themselves.²² Firms make investments into strategic assets based upon their estimation of consumer preferences. These early investments affect firms' position in the industry. Therefore, the history of an industry is important to understanding its current structure.

Different industry groups may respond very differently to changes in the environment, such as demand changes, regulatory changes, or technological changes. Barriers to entry may be different for different industry groups. We need to look at entry into the groups, as well as mobility between the groups.

The cells in Figure 7-2 present the strategic groups in one fashion, with detailed lists of the firms in each segment. Figure 7-3 illustrates the groups effectively. When viewed together with the trend shown in Figure 7-4, it becomes clear how large the for-profit sponsor group has become. (Keep in mind that Figures 7-3 and 7-4 omit many smaller firms.) In addition, many firms have crowded into the corporate area of the strategic map in recent years. This helps to explain the high level of rivalry in those strategic groups.

There are two other strategic groups as well: corporate guarantors, and non-profit syndicators. Two firms hold most of the market in each of the respective segments. Rivalry is low.

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²² Oster, p. 68.
Chapter 8
The Housing Tax Credit Industry as a System

We have reviewed the equity capital market in Chapter 5 and the property market in Chapter 6, and analyzed the industry in Chapter 7. This chapter now returns to the overview of the industry which was discussed briefly in Chapter 4.

Section 8.1 A Systems View

"Dynamic complexity arises when cause and effect are distant in time and space, and when the consequences over time of interventions are subtle and not obvious to many participants in the system."¹ The tax credit industry fits that description well. Figure 8-1 provides a detailed view of how the equity capital market and the property market combine to form the housing tax credit industry. (It may also be helpful to review Figure 4-2 to keep the overall perspective.) The equity capital market and the property market combine to form a larger, complex interrelated system. While this may seem apparent, particularly given the discussion up to this point, this overall view clearly has not been apparent to many industry participants until recently, if at all.

We have reviewed a number of changes which have occurred in the tax credit industry in the past twenty-four months. Capital investment by corporations has increased greatly, but yields to those investors are lower and fees to brokers are substantially lower. As will be discussed below, the primary forces behind the

Figure 8-1
The Housing Tax Credit Industry

**Investors**
- **Type**
- **Objectives**
- **Risk Tolerance**

**Channels**
- **Type**
- **Geography**
- **Property Type**

**Intermediaries**
- **Type**
- **Geography**
- **Property Type**

**Developers**
- **Size**
- **Type**
- **Property Type**
changes in the industry were the actions of the industry participants. In particular, the efforts by brokers to increase the number of firms investing in the industry and to increase the number of intermediaries which those investors invested with were major factors. The decision by corporations to invest with multiple intermediaries was a substantial factor as well. Inasmuch as investors and brokers were the most adversely affected by these changes, it is reasonable to conclude that they did not anticipate the changes which their actions would bring.

There are a number of reasons why industry participants have not had a wider understanding of their industry. First, the industry is, as has been discussed earlier, a relatively new industry. It has undergone steady change since the housing tax credit program commenced in 1987. So the industry itself has been evolving, and of course industry participants’ views have been evolving as well. Industry participants have not seen the entire industry system. Furthermore, industry participants have not of course had the benefit of hindsight. What appear in 1994 to have been inexorable trends were not so apparent in 1992.

Second, the asset which is generating the investment is affordable housing. For the most part, the industry was formed by firms who had background and experience in the affordable housing industry. However, the housing tax credit industry evolved in ways which were not necessarily well-suited to the strengths of many of those firms. For example, structuring and marketing financial products to corporations was something few firms had meaningful experience with. As a result, most firms learned new lessons as the industry evolved. Competitors and market forces emerged unexpectedly from areas which were beyond the edges of their mental map of the industry. The system came to include some participants with which they
were not familiar. For example, recently firms with financial resources and sophistication are increasing their influence, relative to firms which have a background in affordable housing. First Chicago used its experience in structuring and marketing tax-oriented investments in equipment leasing for corporations to significantly change the industry, as is discussed in Section 8.3 below. In addition, the firms with affordable housing experience, and the channels they used, were generally small firms without strong management or planning capabilities.

Finally, housing tax credit industry participants merely suffered from the same limitations we all tend to have. In particular, those shortcomings include a tendency to think "locally," to focus on our immediate environment without understanding the interconnections which tie that environment to more distant events and systems; and the tendency to have a short-term perspective, to measure results by what happens this week or this year without considering the longer-term effects. "[W]e tend to focus on snapshots of isolated parts of the system." 

8.1.1 The Importance of a Systems View

Viewing the housing tax credit industry as a system allows us to begin to understand the industry structure which causes the behavior of the industry. We can illuminate the distant and subtle interrelationships and understand the consequences of industry participants.

Richmond outlines several systems thinking skills: dynamic thinking, or seeing behavior patterns rather than focusing on particular events or attempting to predict

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the specific results that may occur; \textit{closed-loop thinking}, or understanding that the elements of a system interact such that neither is solely a cause or effect, but they mutually influence each other; \textit{generic thinking}, or understanding that the system, not necessarily the individuals or firms who are part of it, generate behavior; \textit{operational thinking}, or focusing on how the various elements of a system actually influence each other rather than noting that they tend to merely be correlated in some fashion; and \textit{continuum thinking}, which reminds us that the behavior and relationships in a part of the system do not remain constant, but that they may change depending upon the level of a certain variable. An example of this latter point is that, as water supplies are depleted, rationing may be implemented and water consumption patterns may change.\footnote{Another way to state this is, "It's the relationships, not the numbers, that deserve primary attention." High Performance Systems, \textit{Introduction to Systems Thinking and ithink}, Hanover, New Hampshire, 1994, p. 15.} The discussion in this chapter relies upon these concepts.

\textbf{8.1.2 The Limited Size of the Property Market}

A central feature of the tax credit industry, which has been discussed in various contexts elsewhere, is that the amount of tax credit is strictly limited by Federal law. As a result, the amount of activity in the property market is limited. Therefore, of course, so is the size of the equity capital market.

As noted in Chapter 3, states can allocate only $1.25 of tax credit per capital. If there are 255 million people in the United States, that permits a total of $319 million of annual tax credit to be allocated, or a ten-year amount totalling $3.19 billion. If equity prices are currently 53 to 55 cents per dollar of tax credit, that

implies capital invested in properties of $1.7-1.8$ billion per year. If the costs of raising capital, together with operating reserves, are $15-20\%$ of the capital raised, then the theoretical maximum size of the equity capital market is between $2.0$ and $2.2$ billion per year. Note that this assumes that every dollar of tax credit is utilized in the year in which it initially becomes available.

The limited size of the property market gives us a good example of the need for continuum thinking. Approximately $1.9$ billion was raised in the equity capital market in 1993. Given the substantial margin for error in the data on how much tax credit is actually used and how much capital was actually raised, it is reasonable to conclude that the industry is at or near its theoretical maximum size. Therefore, the trends discussed in Chapter 5 cannot continue in a linear fashion indefinitely - the behavior of the system will begin to change as we reach the limits of this part of the system. For example, it possible that as the system reaches this limits there will be a more drastic behavior, such as an even sharper rise in prices and a concurrent sharp drop in yields.

Note that rising prices for tax credits may allow the amount of capital raised to grow for a time, even though the amount of tax credits is fixed, until supply and demand reach equilibrium. Fundamentally, though, this does not change the limitations imposed on the industry by the limits on the amount of tax credit.

Section 8.2 The Rise of Corporate Investors

As discussed in Section 5.3, equity capital investment by corporate investors has risen sharply in recent years. Following the history of the industry over this period illustrates its behavior as a system.

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The tax credit program became effective in 1987. There were many features of the program which suggested that it would be an attractive investment for corporations. Unlike individuals, corporations could use unlimited amounts of tax credits, and could benefit from the tax losses as well. Nonetheless, initial efforts to raise capital met only limited success. As discussed in Chapter 5, non-profit intermediaries were able to raise capital in slowly increasing amounts over time. In addition, many banks invested in early partnerships in order to obtain credit toward their Community Reinvestment Act obligations. However, the complexities of the 1986 tax act which created the LIHC program also gave corporations a great many other issues to address before they could turn to learning about housing tax credits.

In addition, the collapse of the real estate sector of the economy deterred many investors. The related collapse of many banking institutions removed those corporate investors from the market as well. In addition, it may also be that the intermediaries' lack of experience with marketing to corporations prevented them from mounting an effective effort to raise capital from corporations.

In late 1989, in response to declining sales to individual investors, intermediaries began pursuing corporate investors more actively. In 1990, Boston Financial became the first for-profit intermediary to successful structure and market a large tax credit fund for individuals. Boston Financial raised approximately $25 million from corporate investors in 1990, which today looks like a small amount but at the time exceeded expectations. This was the beginning of the rise of the corporate investor in the housing tax credit industry.

Numerous other firms attempted to offer a similar product. Shortly thereafter, SunAmerica (then known as Broad) succeeded in raising capital from investors with
a product which provided certain guarantees to investors, a markedly different product. Boston Financial and Broad could, at that time, satisfy the entire demand of the market. Boston Financial was perceived at that time as offering the highest level of safety and quality. Similarly, the guarantee features of the Broad product addressed the concerns of early investors about risk. None of the other for-profit sponsors were successful in raising significant amounts of capital from corporations.

Over time, however, gradual processes were gradually changing the equity capital market. Corporations were increasingly becoming aware of the housing tax credit program. What had once been an unusual, risky investment became increasingly accepted. An officer of a corporation no longer had to worry that he was betting his career if he recommended the investment. In particular, corporations became increasing aware of how housing tax credits could increase the reported earnings of the corporation. As discussed earlier, the ability to increase earnings is the principal reason why corporations invest in housing tax credits. The level of awareness, acceptance and demand began to rise.5

Of course, a significant factor in this was the ongoing marketing efforts of the various channels and intermediaries in the equity capital market. In particular, a small group of brokers recognized the opportunity to make large sums of money by raising capital from corporations for intermediaries. At that time, the fees paid to these brokers were typically 4-5% of the capital raised. Brokers began to solicit increasing numbers of corporations.

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5 Perhaps this illustrates Senge's comment that "the primary threats to our survival ... come not from sudden events but from slow, gradual processes." Senge, 1990b, p. 22.
These brokers saw their first success, and the development of the corporate investor market took its next step, when corporations began investing in funds which invested principally in Farmers Home properties. Corporations perceived lower levels of risk in these properties, due to the large amounts of financing and operating subsidy typically provided to those properties. This lower risk from property operations was viewed as offsetting the relative inexperience and lack of resources of newer, smaller intermediaries. Firms such as Arcand were among the next to begin to have success raising capital from corporations.

As a result, the intense rivalry now present in the industry first appeared among intermediaries who invested in Farmers Home properties, and it is interesting to note that the pattern of behavior foreshadows the behavior of the larger industry system. Corporations began investing substantial sums of capital with a number of intermediaries. The result was numerous intermediaries with large amounts of capital pursuing a highly limited supply of suitable properties. Not surprisingly, this resulted in intense competition among intermediaries who were seeking the rights to invest in those properties. The sharp upward trend in prices shown in Figure 5-9 was preceded - and perhaps presaged - by the earlier upward trend in prices in the Farmers Home market.6

The pattern of behavior within the Farmers Home market was evocative of that generated by what Senge calls the "escalation" system archetype.

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6 It is expected that Federal appropriations for Farmers Home subsidies will be cut by 50%. As the effects of this reach the equity capital market, the behavior of the Farmers Home sector of the industry may provide some useful lessons to industry participants.
Two people or organizations each see their welfare as depending on a relative advantage over the other. Whenever one side gets ahead, the other is more threatened, leading it to act more aggressively to reestablish its advantage, which threatens the first, increasing its aggressiveness, and so on. Often each side sees its own aggressive behavior as a defensive response to the other's aggression; but each side acting "in defense" results in a buildup that goes far beyond either side's desires. 7

The intermediaries competing for the right to invest in Farmers Home properties sought advantage over their competitors by offering higher prices and less stringent terms. This, of course, elicited a competitive response which further escalated the price and softened the terms. Currently, the price escalation continues. Terms appear to have settled to the minimum level that corporate investors will accept, so to some degree that aspect of the competition has ended.

As corporations became more comfortable with the tax credit as an investment, they began to perceive less risk in other types of tax credit properties as well, and their interest in investing rose. In addition, brokers were anxious to maximize the volume of capital invested in order to maximize their own profits. Often, once corporations made the decision to invest, they wished to invest large sums of money so that they could have a material impact on their firm's earnings. Several firms had a target of $50 to $100 million each year. In late 1992 and early 1993, corporations began to invest substantial sums of capital. This coincides with the beginning of the sharp rise in investment by corporations, as well as the beginning of the rise in prices for properties, the decline in yields, and the decline in fees and costs. Corporate investment rose from approximately $340 million in 1991, to $670 million in 1992 and

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7 Senge, 1990b, p. 384.
$1.41 billion in 1993. A similar scenario to that which occurred in the Farmers Home sector was then repeated in the larger equity capital and property markets.

The total capital which corporations were trying to invest was testing the limits of the industry's ability to invest that capital. In late 1992, the equity capital market reached the point where corporations wanted to invest more capital with the established intermediaries than the intermediaries had the capacity to accept. The response of brokers and corporate investors to that situation has had a profound impact on the subsequent history of the industry: they turned to other intermediaries who would accept the funds and attempt to invest them. In late 1992 and early 1993, then, the number of intermediaries raising capital from corporations proliferated.

The objectives of brokers in taking this step seems clear. Their fees were a percentage of the capital invested. The larger the amount of capital invested, the greater their profits. The objectives of the corporations were to invest the sums they had targeted for investment, so that they could earn a return on that capital, and to reduce their risk by diversifying their investments beyond one or two intermediaries who might later face unexpected financial difficulties.

Diversification is, of course, part of the conventional wisdom of investing. If corporate investors had considered the limited capacity of the housing tax credit industry to accept investment, though, they might have questioned the conventional wisdom. It is unclear whether corporations achieved their objective of reducing risk through diversification. The risk of investing with a single intermediary which might later fail was presumably reduced by investing with several intermediaries. However, the competitive environment which the influx of capital created probably increased the risk of all intermediaries facing problems. Property diversification may only have
been achieved in part, in that in many cases intermediaries seeking to invest the same
investors' capital were competing against each other for the same properties.

Corporations achieved their objective of increasing the amount of capital which
they could invest. The total capital invested in the tax credit industry increased by
108% from 1990 to 1993. The competition among intermediaries inspired some
innovation to find ways to increase the industry's capacity to invest. However, part
of the progress which corporations made in investing large amounts resulted merely
because prices rose. For example, mathematically changing the yield on an
investment from 17% to 12% will increase the amount invested by 25%.

It is not clear whether, if corporations and brokers had anticipated the results,
they would have taken the actions which they did take. (This is discussed briefly in
Chapter 9.) The results which occurred may be an inevitable result of the structure
of the system, although the speed at which change has occurred could clearly have
been changed if different actions had been taken. However, it does seem clear that
the actions of brokers and investors clearly led, through the dynamics of the housing
tax credit industry, to substantial changes in the industry; that those changes had
some significant adverse effects for brokers and investors, as well as some other
industry participants; and those changes were not fully anticipated by industry
participants.

Two other factors have likely contributed to the pace of change. First, in
August, 1993 Federal legislation was enacted which made the tax credit program a
permanent feature of the tax code. This affected the industry in two ways. The
permanent extension gave corporations greater confidence that the program would be
in place for some time to come. This alleviated two concerns of corporate investors:
that they would invest time in understanding a program that would expire before they had the opportunity to invest significant amounts; and that, if they invested in tax credits, Congress would later eliminate their ability to use the credits in the same way it had eliminated the ability of individuals to use tax benefits in the 1986 tax act. In addition, the permanent extension meant that the housing tax credit industry would continue to exist for some time, which made the industry more attractive to new entrants.

The second factor which contributed to the pace of change was the recovery of the nation’s economy and the resulting increase in corporate profits and corporate tax bills. This obviously gave more corporations an interest in methods of reducing their taxes.

While, as noted, both the permanent extension and the economic recovery probably accelerated the pace of change, they does not have appeared to have affected the fundamental course of that change. Rather, the changes have been developing for some time and appear to flow from the structure of the industry rather than changes in environmental variables.

Section 8.3 Effects of Large Scale Investment by Corporate Investors

The large scale investment by corporate investors with multiple intermediaries in the housing tax credit industry since 1992 has had a number of important effects on the industry, beyond the price and yield effects. These effects include a declining role for the individual investor; substantial changes in products, distribution channels, and pricing; a convergence of the equity capital market and the property market;
increasing levels of sophistication; and changes in the economics and efficiency of the program. Each of these effects is discussed below.

8.3.1 The Decline of the Individual Investor

As noted above, increased capital investment by corporations has led to higher prices paid for tax credits and associated lower yields to investors. Of course, the effects of increased market prices for credits impact not only corporate investors, but individual investors as well. To date, investors have absorbed declines in yields. At the same time, intermediaries have reduced costs in order to offer both competitive yields to investors and competitive prices to developers.

However, the investment products offered to corporations are much better suited to adjustments to the new market conditions. As a result, individual investors have a decreasing role in the equity capital market and may soon disappear altogether.

Investor capital is not currently a scarce resource in the industry; feasible properties with a tax credit allocation are the scarce resource. So the long term viability of a tax credit investment product depends principally on whether that product generates a competitive offer to developers. As discussed in Chapter 5, price and terms are the two principal dimensions of an offer to a developer. Price is generally considered to be the most important. The price which a tax credit fund can pay to a developer is largely a function of two elements: the costs of raising the capital, and the yield required by the investors.

Costs. The costs involved in public funds appear to be much less susceptible to significant reduction than the costs for corporate investors. Public funds typically
use approximately 20-23% of the funds raised to pay the costs of raising the capital and fees to the channels and the intermediaries.\(^8\)

A significant portion of the front-end fees, typically 6-8%, are paid to the brokerage firms used to distribute the product. However, although the costs are high there appear to be few alternative means of distribution. In order to reach the large numbers of individual investors needed to raise substantial sums for this relatively unusual investment, it appears necessary to use brokerage firms.

In addition, the costs of registering the product with state and Federal securities regulators is substantial, as is the cost of preparing and distributing costly written marketing and disclosure material to thousands of brokers and potential investors. Registration, legal and printing expenses can easily amount to from several hundred thousand dollars to over a million dollars for a public fund. In summary, then, it appears difficult to reduce the costs of distributing a housing tax credit product to individual investors.

In contrast, adjusted to be comparable, at least one current corporate fund has front-end fees of under 10%, less than half the level of a typical public fund. The corporate funds are not subject to registration with the Securities and Exchange Commission, and are not typically reviewed by state regulators either. Printing costs can be much reduced, because the number of copies that must be distributed is much smaller and the materials typically include little if any elaborate color printing, as marketing materials for individual investors do. Effective distribution of a corporate product can be done very cost effectively by either a channel or by an affiliate of the

\(^8\) An addition 3-5% of the capital raised is used to fund a working capital reserve, in both public funds and corporate funds.
intermediary. With each firm often willing to invest from several million to twenty million dollars in a particular fund, it is not necessary to contact wide numbers of potential investors. Fees paid to channels for selling the product currently range from 0-4%, with the trend clearly downward. In addition, the other costs associated with raising capital through a corporate fund will likely continue to fall at least slightly as well.

It is also important to note that, because products for corporate investors are substantially exempt from securities registration, new products can be introduced rapidly. The terms can be adjusted, and yields and costs can quickly be changed. Public funds, which can take several months to complete the registration process, are at a distinct disadvantage in a rapidly changing market.

**Yield.** While costs are a significant factor in determining the relative market effectiveness of an individual investor product versus a corporate product, yields are obviously an important issue as well. In a mathematical sense, it is generally true that the yield on the investment is a function of (1) the amount paid to the developer for the tax credit property investments and (2) the costs associated with raising and investing the capital. Of course, it is ultimately the yield required by investors which sets the price paid to developers. A critical factor in determining investor yield requirements is risk. The risks of tax credit investments are discussed below.

As stated above, the scarce resource in the industry is tax credit properties. Investors for which the combination of yield requirements and costs associated with raising and investing their capital result in higher prices to developers will have a substantial advantage in competing for properties.
However, note that different investors may receive a different yield from the same investment. As discussed in Chapter 3, individual investors generally cannot use the tax losses generated by the properties, while corporations can use the tax losses. As a result, even if an individual investor and a corporate investor invested in the same property, they would each receive a different investment return.

The costs of raising capital from corporate investors have been lower all along. The first corporate fund introduced in 1990 had lower front-end costs than public funds. However, corporations required a higher yield than individual investors. As shown in Figure 5-10, the internal rate of return on early investments by corporations were approximately 17%. (This includes the benefits from both tax credits and tax losses.) This higher yield requirement offset the cost advantage of corporate funds, with the result that corporate products did not have a competitive advantage over public funds.

Since 1992, however, the yields to corporate investors have dropped sharply, as have costs. (See Figure 5-10.) Currently, corporate fund products are beginning to show a significant advantage in competing on price for property investments. As discussed above, the size of the equity capital market - the amount of investor capital needed by the industry - is limited. The current level of demand by corporations indicates that they are willing to invest all of the capital needed by the industry. With the possible exception of certain niches or certain property types, it appears likely that individual investors will quickly vanish from the equity capital market.

In addition to the influx of corporate capital, other industry trends are contributing to the decline of the individual investor. Public fund sales throughout the industry are down significantly. For example, Boston Capital, which raised the
largest amount of capital from individuals in 1993, reports that their 1994 sales pace is down by 50%. The continuing negative publicity about real estate limited partnerships formed in the 1980s is often cited as one factor. For example, unsuccessful real estate partnerships sold by Prudential Securities, and other sponsors, have regularly been topics in the business press. Of course, to the extent an investor has himself been disappointed by a partnership investment, he is less likely to invest. Other factors contributing to the decline in capital raised may include rising interest rates, which make competing investments more attractive; turbulent financial markets; and saturation of the market, as individual investors reach the legal limits of how much credit they can use.

One industry observer who was involved in the creation of the enabling legislation in 1986 has noted that Congress believed that corporations would be the principal investors in tax credits. While it has taken seven years for corporate investors to accept the product and assume the role of the primary source of capital, it appears the expectations of Congress are finally being met.

8.3.2 Changes in Products, Distribution Channels, and Pricing

Equity capital investment by corporations is fundamentally changing the equity capital market. As discussed above, corporate capital is displacing the individual investor. In addition, of course, yields to investors are sharply lower. There are other changes as well, particularly in the types of investment products, in the distribution of those investment products, and in the pricing of products.

*Products.* Since corporate investors began investing in housing tax credits, the products have changed significantly. The guaranteed products are the most striking example of this change. While it is possible that a guaranteed product for individuals
might have evolved, and may still evolve, the participation of corporate investors made it far more likely. The level of review and disclosure of the terms of a guaranteed product for individuals, in connection with securities registration, discourages the introduction of such a product. In addition, all of the cost considerations discussed above regarding individual investors would apply.

There have been other, more subtle, changes in corporate investments and the corporation's preferences for more customized products and terms have reduced the product standardization in the industry. There is a growing trend toward individual negotiations of terms for each investor.

In addition, some corporations have a much stronger geographic preference than individuals did. Many corporations prefer to invest near their headquarters or other facilities. In particular, banks can receive credit toward their Community Reinvestment Act obligations by investing in tax credit properties in the area they serve. This gives banks a strong geographic preference in the investments which they make.

Finally, corporations are markedly different from individuals in that some are willing to invest directly into properties, without using intermediaries. Some corporations have internal real estate groups or other expertise, and have decided that they are able to assess the risks of investments, select properties, and monitor them without the assistance of intermediaries. This is not entirely surprising, in that many corporations who are engaged principally in one business will, for various reasons, often have small groups who are engaged in substantially different businesses. Although there has been direct investment by corporations since the program began, the recent increase in investments by corporations has increased the interest of firms
in direct investments in properties. (In some ways, of course, increase in direct investment could be viewed as both a change in product type and a change in distribution.) In addition, the increase in direct investment likely reflects a reassessment of the risk of a tax credit investment. Corporations see housing tax credit properties as less risky than they did in the past.

**Distribution.** Corporate investment has also changed the distribution channels in the housing tax credit industry. If individual investors cease to be a significant source of capital, of course, the brokerage firms which serve as a channel for that investment will cease their participation in the industry as well.

In addition, the increase in corporate investment has changed the way the product is distributed to corporate investors as well. From 1990 until 1993, much of the capital raised from corporations was raised by a relatively small group of five or six specialty brokers whose primary or sole focus was marketing this type of product. In the past six to twelve months, though, that has changed significantly. SunAmerica ended its exclusive distribution arrangement with one such firm and engaged First Chicago, a national bank. The group within First Chicago which markets this product also markets tax-oriented leveraged equipment leasing products, such as equity in rail cars and airplanes, to corporations. In addition, Boston Financial recently stopped marketing its corporate tax credit funds through these specialty brokers and is distributing its current product without using a channel. The increasing capital raised has, as discussed, put pressure on yields and costs of raising capital, and some intermediaries have concluded that the value added by the former distribution channels is not commensurate with the costs, and have therefore ceased using those channels or have reduced the fees paid for distribution.

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**Pricing.** The most dramatic change which has resulted from the changing distribution channels, however, has been in the method by which tax credit product for corporations is priced by some intermediaries. Typically, an intermediary would organize a tax credit fund and offer it to investors with a schedule of benefit objectives and a fixed price, which together implied a certain target yield to the investor. Both Mission First Financial and SunAmerica have, in the past six months, utilized a request for proposals format in which investors submit a proposed price - in effect, a bid. If the amount of capital which investors propose to invest exceeds the amount sought by the intermediary, the intermediary will select the proposals which offer the highest amount of capital to the intermediary (and thus the lowest yield to the investor).

The results have been startling. Until 1993, for example, SunAmerica priced its investments to yield a 15% rate of return to the investors. In early 1994, using the request for proposals format, they were able to obtain investor capital at an estimated 8 to 9% yield. As a result, they were able to earn an enormous windfall profit due to the change in distribution and the change in the pricing method. Industry observers estimate that SunAmerica raised approximately $90 million for properties in which they had invested approximately $50 million. That obviously implies a $40 million profit, which is an enormous margin compared to industry norms. The full impact of this development has probably not yet fully unfolded. For example, SunAmerica could, rather than seek huge margins, choose to lower its margins somewhat and raise prices paid to developers. This could significantly affect the property and equity capital markets.

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8.3.3 Convergence of the Equity Capital Market and the Property Market

A third major change which has resulted from the rise of investment by corporations has been a move toward a partial convergence of the equity capital market and the property market. When individual investors dominated the for-profit equity capital market, the separation between the equity capital market and the property market was almost complete. Neither individuals nor developers understood each other well, and there was virtually no contact between the majority of individual investors and developers. Few individual investors would consider investing directly into properties, and few developers sought investment directly from individuals, in part because the costs were prohibitive, in terms of time, uncertainty and money.

Currently, however, corporations have increasing involvement and influence in the property market. The concentration of the sources of capital, with many corporations investing tens of millions of dollars each year, has of course been an important reason why this has occurred. In addition, a $30 to $50 million dollar investment by a corporation over a one year period can have a significant influence on the market.

Of course, the partial convergence of the two markets is best illustrated by direct transactions between corporations and developers. More corporations are

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9 For the purposes of this discussion, it is useful to think of the for-profit and non-profit intermediaries as operating somewhat separately; there is still relatively little overlap and competition between them, although the increasing competition for tax credit properties may change that. In addition, in the non-profit area, there is still considerable separation between the non-profit equity capital market and the non-profit property market.
making, or considering making, direct investments in properties. More developers are raising capital directly from corporations or through finders.

8.3.4 Increasing Sophistication

As noted above, the majority of industry participants to date (except for investors) became involved because of their background in affordable housing. In particular, the intermediaries have had the most significant role in shaping the industry. Intermediaries have operated in both the equity capital market and the property market, and have to some degree controlled the flows of capital, benefits, and information between the two markets.

However, the intermediary firms are typically not sophisticated in many respects, such as size, financial resources, and management. The largest intermediaries have fewer than 200 employees, if property management personnel in the field are excluded. Most intermediaries have less than 50, and some as few as 10-15, employees. In general, the financial resources of the firms, in terms of net worth and access to capital and credit, are quite limited. The net worth of most of the firms is under $15 million, and much of that is unavailable for use as capital to finance industry activities. Finally, the management of almost all of the firms is

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10 SunAmerica is the exception, in that its insurance and financial services activities employ several thousand employees. However, the housing tax credit is not a principal business of the firm, and reportedly fewer than ten people work in the area. Furthermore, although SunAmerica has played a significant role in shaping the industry, it has not been as aggressive or active a participant as it might have been.

11 For example, SunAmerica appears to be the only significantly active firm to date with access to relatively large amounts of capital. They have used that capital to operate in a significantly different manner than other industry participants. SunAmerica has acquired an inventory of tax credit properties, (continued...)
comprised of executives whose background is as a practitioner in finance or affordable housing. Few of the firms have senior executives who have a strong background in management and planning. Many of the firms appear to have weaknesses in internal controls and administration.

In part, the pace at which the industry has matured can be explained by the legislative history of the program. As noted above, the program had an initial term, and was extended three times before being made permanent in 1993. The uncertain future of the program appears to have deterred entry into the industry by larger, more sophisticated firms. This has effectively sheltered the smaller firms in the industry from competition with firms with greater resources.

However, the permanent extension of the tax credit program, together with the increasing levels of awareness and acceptance of housing tax credit investments among corporations, is clearly attracting new entrants to the industry. The increased competition by itself has spurred increasing levels of sophistication, as existing intermediaries strive to gain a competitive advantage and erect barriers to entry. In addition, there may be opportunities for firms with access to capital and other

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\(^{11}\text{(...continued)}\)

held the properties until construction is complete, and then raised capital from investors at that point, when the flow of tax benefits is ready to commence. This has allowed them to earn significant profits, both because the value of the assets increases over this holding period and because market prices for the credits have been steadily rising. Of course, there is also a risk that asset values could decline. However, their role as a principal which may gain or lose as asset values change is distinctly different from the way the other intermediaries function in this industry. In general, other firms receive a fee which is a fixed percentage of capital raised, and act as a pure intermediary in the sense that changes in asset values affect the developers and the investors, but generally do not affect the intermediary. This method of doing business has allowed these intermediaries to function without access to substantial capital resources.
resources. For example, should a guaranteed product become the dominant product in the industry, firms with access to greater resources would have a decisive advantage. In fact, such firms are rumored to be considering entry into the industry in some fashion. For example, reportedly Society Bank of Ohio is considering offering a product similar to that offered by SunAmerica. Of course, it may be that entry by such firms, or alliances of current intermediaries with such firms, will be necessary for the industry to evolve to the point where a resource-intensive product becomes the dominant product. In any case, levels of sophistication have increased and it appears likely that the trend will continue.

8.3.5 Economics and Efficiency of the Program

The fifth major set of changes which has resulted from the influx of corporate capital has been a modification of the economics of the industry. One consequence of this is an improvement in the efficiency of the program from a public policy point of view.

Although the amount of tax credit which can be allocated is limited, the rise in prices for tax credits provides more equity capital in total to build affordable housing. As discussed in Chapter 3, the state allocating agencies are required to allocate only enough tax credit to make the property feasible. Therefore, although one might initially conclude that rising tax credit prices create windfalls for developers, this is not true in the long term, and may not even be true in the short term.

The state allocating agencies use what is called the "equity gap" method to calculate the amount of tax credit to allocate to a property. The agencies evaluate the amount needed to develop the property, which includes a development fee for the developer. The difference between the development cost of the property and the
amount of mortgage financing available is referred to as the equity gap. The equity gap is the amount of equity capital needed to develop the property. The tax credit allocation can be determined by dividing the equity gap by the current price for tax credits. The higher the price for tax credits, the less tax credit is needed to fill the equity gap for a particular property. For example, if a property has an equity gap of $2,000,000 and the price for tax credits is 46.6 cents for each dollar of tax credit over the ten year credit period, that implies total tax credits of $2,000,000/.466 or $4,291,845 over ten years, which requires an annual allocation of $429,185. If tax credit prices rise to 54.8 cents, an annual allocation of $364,964 is sufficient to fill the equity gap. Clearly, this would allow the agency to meet the equity capital needs of more properties with the limited amount of total tax credit.

As long as state agencies remain abreast of changes in the price for tax credits, then, in the long run higher prices will result in less credit being allocated to a particular property, not a windfall profit to the property’s developer. This is a critical point for policymakers to understand. The proper administration of the program by the state agencies adds substantially to the effectiveness of the tax credit program.

Of course, given the long time frame for developing a property, it is possible that prices could rise between the date upon which the state agency determines the appropriate amount of the allocation. If the agency takes no action, this delay could in the short term result in greater than anticipated developer profits. However, the

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12 At any point in time prices for tax credits vary, based on a number of factors such as location, property quality, developer group, whether the property also benefits from historic tax credits, financing, the amount of tax deductions, and other factors. It is more accurate to use the current price for tax credits, for this property specifically or for a property of its type more generally.
state agency is empowered by law to review and adjust the amount of credit allocated to a property when it is placed in service, so even this unanticipated effect can be avoided.

In addition to allowing state agencies to produce more housing, the changes in the economics of the industry have improved the efficiency of the program. The term efficiency is used in the sense that the cost, to the Federal government, of achieving the objectives of the low income housing credit program are lower on a per unit basis. The prices used in the example above are approximately correct market prices for 1992 and 1994 - the price paid for tax credits rose from approximately 46.6 cents to approximately 54.8 cents. In other words, states are now able to generate 17.6% more equity capital from a dollar of tax credit that they were in 1992.

These changes in the economics of the program have substantially improved the efficiency of the low income housing credit program. Roughly speaking, it costs the United States Treasury 17.6% less, in terms of foregone revenue to the Treasury, to produce a unit of housing than it did in 1992.

Of course, that is a relative measure of efficiency, comparing the program at two points in time. That view offers clarity and accuracy, but does not answer the questions that have often been raised about the absolute efficiency of the program. For example, some observers have, in effect, compared the prices paid for credits to

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13 These price figures do not represent the average prices paid over the course of the respective year; no such data exists. Rather, these prices are the derived prices at a given point in time. In a rising market, it is reasonable to assume that property investments for which negotiations concluded earlier would have received a lower price and property investments negotiated later would receive a higher price. Also, as noted above prices vary depending upon certain characteristics of the property and the developer.
the cost of foregone taxes, in present value terms, to the Treasury. The alternative suggested is a direct cash subsidy, rather than a tax credit. It is beyond the scope of this work to construct a measure of the absolute efficiency of the program. Such a measure would have to incorporate a number of items, such as including the cost of the tax deductions allowed as well as the tax credits. Further, it is not clear that such a measure would resolve the efficiency debate, in that there are no successful alternative programs to compare with the LIHC program. In addition, it would likely to be quite difficult to get measures of efficiency that were both accurate, in that they included all costs of the programs, as well as objective, in that most of the discussion on this subject appears strongly influenced by the biases of the authors.¹⁴

The use of a tax credit clearly introduces costs into the program. For example, because developers must find investors in order to generate capital in return for the tax credits, the costs of raising capital incurred by using channels and intermediaries must be borne. However, at the same time there are a number of positive features which the tax credit program introduces. The presence of investors, who face penalties should the property not comply with the tenant income and rent guidelines, introduces a healthy tension with respect to the developer. Investors provide a balancing force to check developer excesses. There are a number of services which intermediaries provide in evaluating the feasibility of properties and in monitoring the health of the properties and the developers. These roles are typically overlooked;

¹⁴ For example, the General Accounting Office testimony on Low-Income Housing Tax Credit Utilization and Syndication dated April 27, 1990 reflects many of the difficulties encountered in evaluating the efficiency of the program. The lack of accurate and complete data leads to using theoretical constructions of questionable relevance. As a result, the analysis raises more questions than it answers.
intermediaries are simply viewed as costs of raising capital. While there are stories of success and failure on the part of both the public sector and the private sector for previous public housing programs, the private sector role in the LIHC program provides a focus on economic realities and a freedom from political pressures to ignore the economic realities. Both of these elements have been lacking in some housing programs managed by the public sector.

Certainly there have been important lessons learned from the operation of the housing tax credit program. As noted above, the oversight and corrective role of intermediaries and investors which the structure of the industry provides is useful. In addition, there appear to be many valuable lessons learned from the decentralized nature of the program, which is administered in many respects by state and local governments. State agencies have generally done an excellent job of tailoring the program to meet their own needs and policy priorities. These lessons should be applied to future housing programs.

Finally, on the subject of the efficiency of the program, it is interesting to speculate on the reaction of Congress and other policymakers to the success SunAmerica has had in pricing their tax credit product with the request for proposals format. Some in the industry have expressed concern that the enormous profits earned will undermine support for the program. It might be argued, however, that while the short term result was high profits for one firm, in the longer term it may significantly improve the efficiency of the program. Presumably developers will learn of the large profits and will use their leverage, in controlling the supply of scarce tax credit properties, to negotiate a piece of those profits in the form of higher prices. It also seems likely that other firms will develop a guaranteed product, and compete for
properties using some of the profits available. The price paid for tax credit properties will rise, further improving the efficiency of the low income housing credit program. Eventually, the extraordinary profits to SunAmerica will be eliminated, but the market-wide impact on the efficiency of the program will remain.

Section 8.4 The Status of the Tax Credit Industry

The discussion in this chapter so far focusses on how the industry has developed, particularly over the past two years. The final section of this chapter, below, discusses where the industry may go from here. Before moving on to a discussion of where the industry goes from here, it will be useful to discuss two aspects of the status of the industry: is the LIHC program is accomplishing its policy objectives; and what are the risks of an investment in tax credits?

8.4.1 Is the Tax Credit Program Achieving Its Objectives?

All indications are that the low income housing credit has achieved the objectives of the program - producing good quality affordable housing for a targeted population over a long period of time. In part, this success must be attributed to the lessons learned from earlier housing programs and incorporated into the program. For example, the LIHC program makes enormous strides in addressing the several problems from previous housing programs which were identified by Congress.

For the most part, the evidence of how well the program is working is anecdotal, in that a comprehensive review of how well the program is performing has not been undertaken. In fact, such a review would likely first require improved data collection about the program. One of the disadvantages of decentralizing the program...
to state and local governments has been that complete, centralized data about the program and the properties has not been available.

As noted in Chapter 3, the program has been extended four separate times by legislation. Each expiration of the program provided Congress with an opportunity to terminate the program, if it were not working. In connection with legislation, Congress has reviewed the program and held several hearings, with extensive testimony by a range of industry participants, state government officers, and policymakers. The conclusion to date has been that the program is working.

The 600,000 apartment units produced today make the LIHC program one of the largest Federal housing programs ever created. Clearly this also provides evidence that the property market and the developers have functioned effectively, under the program, in producing affordable housing. The recent changes in the equity capital market should improve the industry's ability to provide decent, safe housing for more Americans.

Of course, there is still room to improve the program. The National Realty Committee, a broad-based real estate industry organization, proposes the following:

Among the structural changes to the LIHTC program that policymakers should consider are proposals to raise to $25,000 the value of tax credits that an individual may apply against income taxes; to reduce the negative effect of the Alternative Minimum Tax on a taxpayer's ability to use these credits; and to allow the tax credit benefits to "flow" to the investor sooner than is currently allowed. ... Modifications such as these would dramatically increase the amount of capital raised under the LIHTC program and, thereby, increase the production of needed affordable housing.15

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In fact, the steady progress at improving the program through legislation as well as the increasing efficiency of the industry suggest that it is important to allow a housing program time to develop and become more workable. In fact, a more stable and consistent legislative environment might have allowed the industry to progress more quickly.

8.4.2 Risks of an Investment in Tax Credits

There are a number of risks involved with an investment in tax credits.

Real estate risks. As with any real estate based asset, there are risks around the development and operation of the property. Will construction be completed? Will the property succeed in leasing to qualified tenants at the required rents? Will the property remain viable over the investment holding period? Because most intermediaries require that tax credit properties charge below-market rents, these properties should be less exposed to market risks than a conventional property. Furthermore, as discussed in Chapter 6, the developer of the property makes certain guarantees which can mitigate some of the real estate risks. In addition, to the extent that some of the risks for a set of properties are not correlated with each other, these risks are diversifiable by investing in a pool of properties.

Although there is no comprehensive data available, the industry experience since 1987 appears to be that there have been very few foreclosures. (Of course, firms do not ordinarily publicize their failures.) There are properties in default of their mortgage obligations, which are undergoing workouts but may ultimately end up being foreclosed upon. However, so long as the property is not foreclosed upon, the delivery of tax benefits will continue. The tax credit is based upon the cost of the property, not the operations.
Tax risks. Because this is a tax-oriented investment, obviously there are risks associated with compliance with the tax law. Will the property generate the expected amount of credits, at the expected time? Will the property qualify initially for tax credits? Will the property maintain ongoing compliance? Will the investment structure permit the pass-through of credits to investors from the property investments?

The developer guarantees, particularly the adjustments to the price if credits are less than anticipated, provide some protection against these risks. In addition, all reputable intermediaries require an opinion from a qualified tax attorney prior to making a property investment. There appears to have been little or no industry losses from tax problems.

Management risks. Investors who entrust their capital to an intermediary and/or developer obviously take a risk that party will fail to perform. Successful development and operation of a tax credit property requires a certain level of management skill.

Investors must not underestimate the importance of property management in their strategic equations. Apartment complexes are management-intensive, with hundreds of leases rolling over annually and heavy wear and tear on units. Strong tenant relations are a must for stemming tenant turnover, which can lead to re-leasing costs averaging $1,000 to $1,500 per unit. Good management is also able to recognize subtle market changes and balance rent hikes with the need to maintain high occupancy. \(^{16}\)

In addition, there is the risk that the conflicts of interest between what is best for the investor and what is best for the developer or intermediary may not get resolved appropriately. Finally, there is always the risk of business failure or fraud on the part of the management group. Two Farmers Home syndication firms, The March Company and First American, have failed in the past several years. In addition, the president of another syndicator, Citi-Equities, was recently indicted on fraud charges. However, in the absence of fraud or bankruptcy, once again the anecdotal evidence suggests that a high percentage of properties operate successfully. Of course, the history of the program is not long enough to make this statement with any certainty, as problems may not yet have appeared.

**Investment risks.** There are risks related to the process of investing funds. Once the investor gives their capital to the intermediary, is the money put to work quickly? Will the property investments made achieve the desired returns? Will the property investments selected be consistent with the preferences of the investor?

A number of funds appear to have been adversely affected by the unexpected growth in the market in 1993 and the resulting changes in prices for properties. This resulted in those funds not achieving their yield objectives, by a significant amount. Actual experience, therefore, suggests that the investment risks are material. This may not be obvious to many investors, who naturally tend to focus on real estate and tax risks.

In addition, there are other risks. The investor itself is one source of risk. Will they have a continuing tax bill, so they can continue to use the credits and deductions? In addition, Congress demonstrated with the 1986 tax act that there is always an element of political risk in utilizing tax incentive programs. Finally, the
oversight and regulation of the program exposes it to regulatory risks, should government agencies make decisions which adversely affect the value or operation of an investor's properties.

In summary, industry experience suggests that, if structured carefully, an investment in tax credit properties has lower risk than many investors may initially have expected. The recent decline in yields clearly reflects, in part, a perception by investors that risk levels are fairly low. In effect, the decline in yields is eliminating a extraordinary yield premium as investors’ gain understanding of and experience with the program.

**Section 8.5 Possible Future Developments in the Industry**

Discussing the changes to date does, of course, beg us to ask what changes might be expected in the future. To some degree, understanding the structure of the industry, the interrelationships which form a system, and the dynamics of that system to date should form a useful basis for speculation as to how the industry might behave in the future.

It seems reasonable to project that the following may occur: yields to investors will fall further; at some point, this trend will stop; channels of distribution and products will continue to change; one or two dominant products will develop; firms will continue to enter the industry, and some firms will exit. The balance of this chapter will further discuss these possibilities.

*Lower yields.* Current evidence suggests that the equity capital market still has not found an equilibrium point which balances supply and demand. Despite the lower yields to investors, and despite higher market interest rates, intermediaries
report that the demand for their tax credit products continues to exceed the supply. Of course, this implies that the price is still too low - that is, the yield is more than the market requires. As noted above, the perception of lower risks is contributing to the decline in yields. In the absence of some countervailing force in the market, competitive forces will drive yields still lower. This will further improve the efficiency of the program.

Reaching equilibrium. Of course, eventually the equity capital market will find the balance of supply and demand. The increasing sophistication of industry participants suggests that the market will move to a balance point more quickly than it has in the past, as firms respond to competition more quickly. Of course, the economic environment is not guaranteed to stay constant. If interest rates rise, or corporate profitability drops, it will alter the price point at which supply and demand balance. However, those forces would not appear to change the underlying dynamics.

The process of reaching a balance of supply and demand may be a painful one, for three reasons. First, rapid market changes and increased competition add a level of stress for firms operating in the market. They must make decisions and develop products more quickly. It seems likely that some firms may not be up to the test, and some will miscalculate in their decisions. Firms who succeed will have strong market knowledge, an ability to learn quickly, and short product development times, as well as the ability to recognize market excesses.

Second, certain features of the tax credit industry could allow the equity capital and property markets to temporarily exceed their steady-state maximum size. As noted in Chapter 3, credits which are not allocated to properties can, to a limited degree, be carried forward and allocated in later years. To the extent that the
industry has accumulated tax credit allocating authority which has been carried forward from prior years, this might be allocated in a particular and generate a level of industry activity which is not sustainable. This appears to have happened in 1993, when $424 million of tax credit was allocated, well above the $319 million generated from the per capita allowance for that year.\textsuperscript{17} It appears that approximately $120 million of credit allocating authority will be carried over into 1994, allowing the industry to maintain its size or grow for at least another year. However, if all of the credit which has been carried forward is allocated in 1994, how will the industry behave in 1995? The process of adjusting the industry to a sustainable size could be difficult for industry participants. This is an interesting example of the dynamics of the system.

Third, for some time intermediaries have been operating in a market environment which has been behaving in a predictable, linear fashion. Demand has been rising, yields have been falling, and prices for tax credits have been rising for two years. When that changes, will firms react appropriately? For example, if some intermediary firms continue the escalation behavior described above past the point at which investors will support the reduced yields, it may temporarily result in a supply/demand imbalance which is the opposite of the current situation - prices will be too high, not too low. Theoretically, the flow of equity capital would then slow or stop until the market corrects. Similarly, developers have been operating in an environment which has been steadily more favorable to them, with prices rising and terms becoming more favorable. It is likely that downward price moves in the

\textsuperscript{17} "Tax Credit Allocations Surge Upward in 1993," \textit{The Multifamily Advisor}, National Housing & Rehabilitation Association, Spring 1994, p. 3.
property market will be sticky rather than smooth, as developers attempt to resist the operation of market forces unfavorable to them. This could also disrupt the functioning of the market for a time.

**Pressure on intermediaries.** Both investors and developers presently have a high level of power, relative to the channels and intermediaries. This power, together with the high level of rivalry among intermediaries, will put substantial pressure on intermediaries to operate effectively. Operating effectively has two dimension: responding with agility to changes in the market; and adding economic value commensurate to the cost of their services. The result will likely be continued changes in the channels of distribution and in the products offered in order to meet the demands of the market.

Changes here may illustrate the partial convergence of the equity capital market and the property market. Direct investment by corporations suggests that intermediaries will not be allowed to take their market position for granted. Market competition, from finders and other intermediaries, will require that their revenues reflect the value they add. At the same time, the brokers who were once paid 4-5% of the capital raised for finding corporate investors have now seen that merely finding investors has little value in a market awash with investor capital. An understanding of customer needs and knowledge of the market are the prerequisites to adding value today. Intermediaries are looking at new ways to accomplish those tasks, or are taking on those tasks themselves. Former channels of distribution are also looking at taking on roles intermediaries once served, blurring the lines between the equity capital market and the property market.
Dominant products. The firms which can construct a value chain of products and processes which makes the most attractive offer to developers will, of course, succeed best at obtaining tax credits. In discussing the product life cycle, Porter notes that in theory product innovation will ultimately reach a point where the optimal product configuration is reached; this will become the dominant product in the industry.\textsuperscript{18} The pattern of product evolution in an industry may result from changes in the scale of the industry, which permit new processes; learning about products; learning about buyers; and diminishing returns to product innovation, among other factors.\textsuperscript{19} Clearly the tax credit industry has seen product evolution, resulting in part from changes in scale as well as learning about products and learning about buyers.

However, the housing tax credit is different from many other industries in that tax credits are a limited commodity. The capital needs of the industry are relatively small, at $2 billion. Further, a portion of that capital is targeted to non-profit developers. Given the current availability of capital in the industry, it seems reasonable to envision a market in which all of the capital needs of the industry can be met by one or two of the groups of investors which were described in Chapter 5. If that is true, then it is likely that one or two dominant products will emerge. Again, the dominant products will be those which have the most to offer the developer.

\textsuperscript{18} Porter, 1985, p. 194. Porter cautions that different industries show different behavior; in some industries with undifferentiated products the dominant design appears quickly. In other industries, product innovation continues indefinitely.

\textsuperscript{19} Porter 1985, p. 195.
Changes in intermediaries and channels. Offering the dominant products and processes may require changes in the intermediaries and channels which presently exist in the market. For example, if capital-intensive products and processes are dominant, few of the intermediaries in the market today will be able to compete. It seems a safe forecast to say that new firms will enter the industry; firms currently in the market will need to change, some of them significantly; and that firms who do not change will exit the industry, either voluntarily or involuntarily.
Chapter 9

Conclusion

The housing tax credit is the nation’s principal program for producing affordable housing. Substantially all of the new affordable housing created in recent years has been financed, in part, with equity capital generated by the housing tax credit. In addition, the roughly 100,000 to 120,000 units of new and rehabilitated housing produced each year represent much of the current multifamily housing production of any type in the United States. Therefore, the program generates a significant amount of economic activity and impact as well. Housing Secretary Henry G. Cisneros has stated that the tax credit supports 67,000 jobs and $1.7 billion in wages each year.¹

The housing tax credit industry has undergone rapid change in the past twenty-four months, and that change continues. Industry participants continue to be surprised by changes which occur, so it seems more than safe to say that few if any of those industry participants anticipated the changes which have occurred. The major economic changes in the industry to date - lower yields to investors, higher prices for tax credits, and lower fees to brokers - have obviously affected different industry participants unevenly. Investors and brokers have suffered. Developers have benefitted. So have the state housing agencies and the public, because higher prices for tax credits allow more units to be created with the fixed amount of tax credit dollars which are available. To date, intermediaries have been less affected.

¹ "Revival of Tax Credit is Sought to Spur Low-Income Housing," The New York Times, April 18, 1993, p. 35.
However, it seems likely that at least some intermediaries will suffer loss of business and lower margins as the industry continues to change.

It is striking to note that the primary forces which started and promoted the changes in the industry were the actions of the industry participants who have been most adversely affected. The economic environment and the legislative change making the tax credit program permanent probably accelerated the pace of change, but do not appear to have changed its course. Rather, the efforts by brokers to increase the number of firms investing in the industry and to increase the number of intermediaries which those investors invested with were major factors. Of course, the decision by corporations to invest with multiple intermediaries was an associated and substantial factor.

If brokers and investors had more fully understood the structure of the housing tax credit industry, they might have anticipated that the actions which they took would not have achieved their intended goals. However, it may be equally possible that they would have taken the same actions, for two reasons. First, it might be argued that, given the structure of the industry, the industry was not at an equilibrium point, changes were inevitable, and the industry as it existed in 1992 was not going to continue regardless of their actions. Generic thinking, one of the systems thinking skills reviewed in Chapter 8, suggests that even if these particular participants had not taken the actions they did, other similar firms would have, with the same end results. However, because one of the principal goals of strategy is to maintain above-average profits and returns for as long as possible, it may have been possible for industry participants to attempt to coordinate industry efforts to sustain high profits and returns, rather than take individual actions which ensured that
profits and returns would be reduced. Second, it is likely that some of the brokers made larger short-term profits by increasing their business volume before margins began to fall. If the rate at which they were willing to trade away future longer-term profits for greater immediate profits was high enough, then brokers may have made the correct decision.

There are many instances discussed above in which the behavior of the industry closely matches the classic models of market behavior set forth in the literature of industry analysis. However, because the industry has not been carefully analyzed, these classic market behaviors surprised many industry participants.

In addition to the economic changes resulting from increased capital investment by corporations, five changes in the structure of the industry were noted: a declining role for the individual investor; substantial changes in products, distribution channels, and pricing; a convergence of the equity capital market and the property market; increasing levels of sophistication; and changes in the economics and efficiency of the program. These effects can be summarized by viewing the effects as a transformation of the equity capital market, which began in 1992 and is still continuing.

The two most important forces, besides the competitive forces unleashed by the actions of industry participants, have been the increasing sophistication of firms in the industry and the limitations on the size of the industry. These three forces together explain much of the transformation of the industry and the effects which resulted from it.

In the broadest sense, the changes as a whole may well be beneficial to the industry. The increased efficiency in delivering capital for affordable housing should
help sustain political support for the program. The increased sophistication of the industry should mean that at least some firms will be better positioned to respond to future changes that develop in the industry. Of course, what is good for the industry as a whole may not be good for individual firms. It seems likely that some will suffer significantly as the industry continues to change.

All indications are that the low income housing credit has achieved the objectives of the program - producing good quality affordable housing for a targeted population over a long period of time. The 600,000 apartment units produced today make the LIHC program one of the largest Federal housing programs ever created. In many ways, the lessons learned from earlier programs proved to be useful experience in developing the low income housing program. The subsidy is targeted to a selected tenant population, and is proportionate to the number of lower-income households served. The design of the program has been improved by subsequent legislation. The program has been effectively administered, at the Federal level, by the Department of the Treasury. However, the most important lesson may be the role of state governments.

States have succeeded in using the Low Income Housing Tax Credit (Tax Credit) to achieve the objectives Congress intended in creating the program in 1986 - to stimulate the development and preservation of affordable apartments for low income people throughout the country. ... Much of this success is due to the program's flexibility. States can customize the program to provide Tax Credits to the kinds of projects most needed in their communities, including projects designed for large families, smaller scattered-site projects to revitalize neighborhoods, and buildings with single-room occupancy (SRO) units for formerly homeless individuals.²

The importance of the role of the states to making the program work cannot be underemphasized. The states have a critical role in setting local housing priorities, evaluating properties to determine if they further the state’s housing goals, reviewing the viability of properties, and ensuring that the subsidy benefits low-income people. Developers, capital sources, and the state agencies have worked together to make the program work well to date.

The recent changes in the equity capital market should improve the industry’s ability to help provide decent, safe housing for more Americans. In some ways, it has taken some time for the equity finance portion of the industry to mature, inasmuch as the tax credit has existed since 1987. In part, this is due to the highly complex set of regulations used in the tax credit program. Further, it seems likely that the erratic pattern of enabling legislation slowed the maturing of the industry. The lapses of authorization and the last minute legislation required state agencies, developers, and intermediaries to operate in fits and starts. This suggests two lessons. First, successful housing programs will likely always be complex, if they are to achieve the many constraints of policy objectives, efficiency, and flexibility. Second, complex housing programs take time to become successful. They need to be steadily supported by Congress and given time to mature.

A note of caution is necessary. As discussed in Chapter 7, the industry is comprised of a large number of firms. No firm or small group of firms appears able to exercise significant leadership, because they do not represent a significant share of the market. With that industry structure, there are significant incentives for other firms to push the boundaries of accepted behavior. It is easy to envision the pattern of escalating competition resulting in excesses and poor business decisions. This, in
turn, could undermine the investor confidence and political support needed to allow
the program, and the industry, to survive.

This point illustrates a principal tenet of systems thinking. The primary forces
driving the industry, and the primary threats to the industry, do not stem from
outside causes, such as changes in the economy or in real estate markets. Rather, the
structure of the industry - the structure of the system - is the source of the greatest
threats to the housing tax credit industry and its participants.

Further Research

This work has also raised some questions which could be the subject of further
research. While this work has described the housing tax credit industry and
conceptually explored the dynamics of the industry when viewed as a system, a more
formal analysis would be useful test of the conclusions reached herein. For example,
a systems dynamics model of the industry might be constructed to test the behavior
of the industry. Also, it has been noted that the efficiency of the industry, from a
public policy point of view, has substantially improved. More accurate measures of
the efficiency of the program would be useful for formulating future policy. In
addition, there has been relatively little analysis of how well the program is
succeeding in delivering affordable housing to the target population and the extent to
which the rents paid by tenants are lower than market rents. It appears that the
program is performing well, but no thorough analysis has been performed. Accurate
and complete data remains a formidable obstacle to understanding the housing tax
credit industry, measuring the impact of the program, and formulating good policy
decisions. Both the National Council of State Housing Agencies and the Department
of Housing and Urban Development have proposed more comprehensive data
collection. Finally, the issue of understanding the impacts of production subsidies and demand subsidies remains. William Apgar states that, "It is relatively simple to show that the distributional effects of even small market price changes in nonentitlement housing assistance programs may easily overwhelm the direct effects of the subsidy for participants." How much benefit accrues to low-income tenants? What effects are there on the non-subsidized renter population? Do production programs lower rents for all renters? These difficult questions remain unanswered.

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3 William C. Apgar, Jr., "Which Housing Policy is Best?", Housing Policy Debate, Volume 1, Issue 1, 1990, p. 25.
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