REAL ESTATE DECISION MAKING – TAX CREDITS
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So a little bit of background about low-income housing tax credits. To be honest, when I started my job at Raymond James Tax Credit Funds three years ago, I hardly knew what a low-income housing tax credit was. I knew about real estate. But I didn't know a whole lot about it, and had to learn about it quickly to be successful over there.

But basically, it's a combination of private development and government funding. It's federally funded and state distributed. And the tax credits are very hard to get awarded, especially here in Florida.

So in Florida it's basically a lottery process. Every developer-- you find a site and you fill out your tax credit application for this property. Now, you have your plan. You know what you're going to do. And you have to reach a certain number of minimum points on the application.

Basically, you get points for, are you really close to a bus stop? Are you really close to a bank, a grocery store, things where people don't need a car to go towards? Are you really close to areas of employment? Are you serving those really low-income levels? All of those type of things get you more points on the application.

And basically, if you reach a minimum number of points, then your deal goes in the lottery system. And in Florida, it's basically one in five chances that your deal is going to get awarded. So there's five great deals out there that probably should get done. Only one out of every five of those gets done. So it's tough.

A lot of the bigger low-income housing tax credit developers, they'll put in 20 applications a year in hopes to get maybe four, five deals, sometimes only two or three if the cards don't fall their way. So they're finding five sites for every one deal they do, which is a lot of work. But they get pretty efficient at it. And how the tax credits actually work is each deal that gets awarded and funded gets 10 years of tax credits.

And I have a little example here. So this deal, The Portland, was a $17 and 1/2 million project. That's the total project cost that it needs to get done. And the amount of tax credits that we got to fund the project ended up being $14 million. So it funds a very significant chunk of the total development dollars.

So what you see here, is you get an allocation of $1.6 million per year in tax credits over 10 years. But the developer of the property doesn't want or need those tax credits over 10 years. What he's doing is he's selling that 10-year stream of tax credits for money now to develop his property.

So in this example, you see the exchange price I put is $0.85 on the dollar. So he sells that 1.6 times 10 years, $16.6 million. He sells those at $0.85 on the dollar to get $14.1 million now to trade the investor who's investing in these tax credits for their 10-year stream of $1.6 million.

And what these investors can do is-- a lot of the investors are big banks, Bank of America, Wells Fargo, big life insurance companies. So they pay an exorbitant amount of taxes each year. So this $1.6 million of tax credits for them just offsets their tax bill directly by that amount.

So they're paying $10 million in taxes a year, these big companies. Now they're paying $8.4 million a year in taxes. So it really is just directly increasing their profit, indirectly. I guess directly, indirectly, however much sense that makes. And it works for them because they're paying only $0.85 on the dollar, so they're getting the yield that they need off of the investment.

And there are all sorts of different investors of these things. So like I said, there's the banks, which typically-- sometimes the banks will even pay a dollar for dollar on the tax credits. Which means if you're paying a dollar for dollar, you're not getting much of a return on your investment per year, if you can imagine.

But what they also have is Community Reinvestment Act needs. So banks in Tampa have to invest a certain amount of dollars in Community Reinvestment activities each year, due to regulations and so forth. So these low-income housing tax credit deals are a way to fulfill that need. So if you find a bank that has a Community Reinvestment Act need in Tampa, you have a deal in Tampa, then you know that bank's willing to accept a much lower yield than an investor that is investing for profit.

So The Portland, like I said, it was just under a half acre in downtown St. Pete. It's an 11-story project, 68 units-- 14 ones, 36 twos, 18 threes. And how it works is the rents have to be a percentage of area median income.

So basically, the average income for this area are at the 60% level. So say average income was $100,000 in this area, which it's not. It's lower than that. But just for example purposes, 60% area median income is about $60,000 a year. 35% of area median income would be about $35,000 per year end-year income.

So these rents have to be based off of those incomes. So for example, most of our units were set aside at 60% of AMI, area median income. So the one-bedrooms, at $636 a month, are a lot cheaper than any other one-bedroom you'll find in downtown St. Petersburg. And that's the highest rent we're allowed to charge for these tax credit deals.

But also, a portion of our units are also required to be set aside at 35% of area median income, which is the very low level. So those one-bedrooms are $371 a month for one bedroom. Downtown St. Pete, that's ridiculously cheap. So the tax credit enables these low-income individuals, or these workforce housing individuals, to live in a nice property like this, close to where they work and live.

And the only way, really, the deal works out-- you could never make a deal like this work, financial feasibility wise, without the tax credits, because the government's basically feeding you money to build these projects in an indirect manner. Basically, we make x amount of developer fee on this deal. And that's how we as a developer fee get compensated for doing these low-income housing tax credit deals.

But we don't really make any money on the cash flow-- product doesn't cash flow. We're not selling this in a few years for more money. All of our money comes in when we get our developer fee after we construct the project and get it filled up. They pay us our developer fee.

So say our developer fee is $2 million for this deal, for example. And we have a shortfall of-- in this case, we had a shortfall of $549,000 to get the deal done. Our project costs were $17.5 million to get it done.

We only had sources of $16.9 to get it done. So how are we going to bridge that gap of funding? How are we going to find that additional $550,000 that we need to get that project done?

And how we do it is we sacrifice $550,000 of our developer fee. And so now, instead of $2 million, we're making $1 and 1/2 million. And they call it deferred developer fee, because potentially it could get paid back with the very limited amount of cash flow these properties make.

If you operate it very successfully, if you minimize operating expenses and so forth, then maybe you get a small chunk of cash flow on the project, and you get that deferred fee slowly paid back. But we're not counting on that deferred fee to make the project a win for us. So that's pretty much how that works. A lot of times, the deferred fees never get paid back, and it's almost like a grant from the developer to get the deal done. But sometimes in the cases that you're committed to minimizing expenses, you can get that fee paid back.

And the use is basically-- I don't know how much you guys have gone over all the costs that are associated in developing real estate. But obviously, you have the land acquisition. You pay for the land. You have the construction costs.

You have your soft costs, which are architecture fees, engineering fees, legal fees, accounting fees, all your consultant fees, all that type of stuff. Those can be pretty significant, anywhere between probably 10% of total development costs up to 35% of total development costs. So it can be a lot.

And then you have your contractor and developer fees, which-- unlike a typical real estate investment deal where you're banking on the profit and cash flow in the sale years down the road-- this one, you make your money on the developer fee. So those are baked into the costs, as well.

So back to 908 Development Group a little bit, this is how they got started. They successfully did this project. And we're going to be a low-income housing tax credit developer, go from one deal to maybe two deals a year, and expand that way.

But this deal actually got built pretty much during the real estate crisis. And we had an investor for it, but it was in such the wrong time that the investor pulled out. And really the only reason it got done is there was a tax credit exchange program, where the government stepped in on these deals that were already so far down the road.

We'd spent all this money in architecture costs and everything. And we were right up about to start this deal. We had our investor lined up. But things go the wrong way, investor pulls out.

So basically, the government stepped in and bought our tax credits. So we were lucky enough for that. So that was one thing that scared us.

Also, after the crash, Florida specifically-- because tax credits are awarded state by state-- Florida stopped awarding credits for a year. So how do you make your livelihood when you're at the mercy of the government awarding these credits? And they change up the way they do things a lot. So those are the challenges you have.

So we wanted to-- this was before I was at 908 Development Group-- 908 Development Group wanted to control their own destiny a little bit more. So they moved to student housing.

So some more of the upsides and downsides-- one thing, it helps you get started, helps you get your feet off the ground. Because you really have no capital invested for the deal on your end. Typically, a developer would have to put in 5% to 10%, even 20%, of their own money to get a real estate deal done. On these ones, you don't have to put in anything.

Yeah, you have to pay for the architects to design your product, and pay your engineers all the way up until the deal closes and start construction. But when it closes and starts construction, you get paid all of that back. You don't have to put any money into the investment.

So it helps people with not a ton of capital get into the development business. So the developer fees are really high on these deals, because you're not getting paid on the sale or the income. So those are the upsides.

Like I said, downsides-- highly competitive lottery award process. And also, you have to own the asset for 15 years. Even though all your compensation comes-- your developer fee-- right after you lease up the product, you own that thing for another 15 years, and have to operate it successfully before you're allowed to sell it to somebody else.

Basically, how the developer passes these tax credits on to the investor, so the developer is the general partner. General partner owns this project for 15 years. But the investor is the limited partner. So general partner's in control of it-- if the thing goes astray, is the one responsible for any faults of the deal.

The limited partner is the investor. So we just make it that we own 0.01% of that company, and the investor owns 99.99% of that company. So all the tax credits that the company is getting is basically being completely passed on to that investor who owns 99.9% of the company.

So that's how we own it. And we have control over it as a general partner. But all the financial incentives after the deal is constructed goes to that investor, limited partner, who owns 99.99% of the project.