Fixing Broken Deals

Crafting Workout Solutions for LIHTC Projects

By Allen Feliz, Tax Credit Asset Management, LLC

The vast majority of low-income housing tax credit properties perform well, and most are continuing to do so, despite the economic downturn. There are, however, pockets of deep distress.

In addition, in the absence of a speedy economic recovery, it is likely that we will see increasing stress on properties that have managed, so far, to weather the downturn. The current stresses in rental housing markets nationwide including mounting job losses, declining rents, and high vacancy rates, coupled with aggressive underwriting prior to the financial and economic downturn, have shaped the workouts of today's LIHTC market. As workouts continue to emerge, it is important to understand the major causes of distress and to have the expertise and strategies to turn around these troubled assets.

Workouts arise when properties face one or more issues that threaten the viability of the tax credit investment (and the underlying real estate asset). Requiring unusual levels of management, these properties suffer from one or more of the following problems: (1) significant operational stress; (2) material general partner violation of the property partnership agreement; (3) mortgage default; or (4) major tax credit and/or other regulatory compliance breach.

Causes of Problems

Prior to the recession, strong investor demand for housing tax credits coupled with a robust real estate lending environment led to the closing of many transactions with financial and legal structures that turned out to be vulnerable once the economy slowed. These transactions included highly leveraged tax-exempt bond deals with debt structures that, in weak rental markets, place huge burdens on property operations. The economic decline's impact on developer-sponsors has also contributed to distress. For example, developer-sponsors previously relied on cash from their portfolios of existing properties, and development fees on new transactions, as sources for funding operating deficits. Unfortunately, as many of these properties underperformed and any established reserves were depleted, the financial strength of developer-sponsors and their portfolios had also been diminished by a struggling economy and housing market. And the flow of new development fees has slowed to a trickle.

One of the major causes for distress in today's LIHTC market is the overall decline of rental housing markets nationwide. Cities such as Atlanta, Phoenix, and Las Vegas, and markets throughout Florida – including Jacksonville, Tampa, and Orlando – anticipated rapid economic growth prior to the recession but have instead witnessed staggering job losses and an over-supply of tax credit units. LIHTC properties in these markets have been hampered by declining market rents and home prices and high rental vacancies, which has put downward pressure on revenue – making it more difficult to pay for operational expenses and to service debt. These forces have also prevented some deals from reaching benchmarks necessary to convert to permanent mortgage financing. In some instances, projects have completed construction but seen their permanent loan commitments expire due to a failure to achieve the required occupancy and rent levels.

Strategies, Workout Plan

Despite the depth and complexity of the issues facing LIHTC workouts today, there are fundamental strategies that experts can employ to turn around these assets.

First, an initial assessment is necessary to identify the root causes of the problem(s), to identify potential issues that could emerge as bigger problems, and to develop a strategy for improving the asset. This phase involves collecting information on the property and borrower and on other factors that affect the exposure of the capital provider, and updating the original underwriting projections for the deal through analysis of market, operating, and sponsor conditions. This examination

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should conclude with a recommended course of action to resolve the problems.

The actual workout plan depends on the nature of the problems but may include identifying and securing new or additional sources to fill financing gaps caused by market conditions or by failures of any of the participants in the transaction. Sources can include new financing, revised financing terms, weatherization funds, tax abatements, new capital from new participants, or proceeds from the sale of tax benefits or physical assets. Other examples of workout resolutions include: bringing new, intensive property management; renegotiating payment in lieu of taxes (PILOT) agreements; preserving tax abatements; addressing physical or operating problems; negotiating settlements with participants; and, working with community groups and local service providers. Workouts are best solved through negotiation and compromise. However, foreclosure proceedings and/or litigation are sometimes necessary to move the parties towards resolution or, in rare cases, to address intransigence or fraud.

Affordable housing tax credit assets often entail layers of financing and regulatory requirements; public, private, and nonprofit stakeholders; and active local and residential community involvement. These complexities make workouts of LIHTC properties more difficult to address than other commercial real estate. However, the multiple participants and complex relationships can also be a source of strength in a workout. Many participants have goals beyond the purely financial, and, with deep roots in the community, can often bring new resources to the property from unconventional sources. With patience, expertise, and cooperation, much of the distress can be addressed, preserving the viability and affordability of the housing for residents and communities. TCA

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