EXCERPT

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# The GAP FINANCING Issue

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# Fannie Mae, Freddie Mac Make Great Sources of Gap Financing for OZ Projects While Preferred Equity Comes at a Cost

MARK O’MEARA, SENIOR COPY EDITOR, NOVOGRADAC

The opportunity zones (OZ) incentive is a powerful tool used to finance community development.

Qualified opportunity funds (QOFs) tracked by Novogradac have raised nearly $38 billion since the inception of the incentive in 2017. However, it is expected that actual OZ investment is greater than the Novogradac total by a figure of three or four times.

“I think the program is doing what it is supposed to do,” said Carl Anderson, president of Larkspur Capital, which acquires, develops and manages commercial real estate assets on behalf of institutional investors. “It’s a massive program with 8,000 zones. It’s hitting its objectives by drawing private capital to previously overlooked areas. Opportunity zones have drawn us to submarkets that we may have not looked at otherwise. While a project must stand on its own, the tax effected returns can tip the scale of an investment decision.”

But it takes more than equity raised by QOFs to finance an OZ project. Gap financing is needed to make OZ projects pencil out.

## About the OZ Incentive

The OZ incentive is a place-based community development tax incentive that became part of the Internal Revenue Code under tax reform legislation enacted in late 2017. The OZ incentive’s purpose is to unleash capital locked in highly appreciated capital assets and to invest it in distressed communities.

Taxpayers who invest in funds that invest in qualifying businesses and business property in those OZs are eligible for gain deferral and gain exclusion income tax benefits. The OZ incentive can be combined with other tax incentives, including the new markets tax credit, low-income housing tax credit, historic tax credit and renewable energy investment tax credit and production tax credit.

## An Array of Gap Financing Options

“In the past year, we have explored how best to provide gap money,” said Jason Ross, director of Cresset Real Estate Partners, a QOF manager. “We are looking at projects with construction loans from 2018 that are now coming up short with capital proceeds. How can we provide gap money to those projects?”

Ross said that Cresset often uses a three-to-five-year construction loan before refinancing with a permanent loan from Fannie Mae, Freddie Mac or funding from a life insurance company.

John Shaw, president of Alliant Strategic Development, and Anderson also may consider the use of permanent loans from Fannie and Freddie as gap financing for OZ projects.

"Fannie and Freddie are always an option," said Shaw. "We may use Fannie and Freddie loans as a takeout alternative. We lock in these loans when the construction loan needs to be taken off." Shaw said that Alliant Strategic Development is a multifamily housing developer that, "focuses on affordable and workforce housing and 'the missing middle.' The 'missing middle' is affordable, market-rate rents in the 80% to 120% of the area median income range."

Shaw added that in California, when developers build to certain sustainability standards, Fannie Mae and Freddie Mac offer more favorable loan terms including interest rates when the standards are met.

"Fannie and Freddie loans are out there and available," said Anderson. "They could go below 5% on interest rates. Or you can refinance into Fannie and Freddie. They still have good terms right now."

Financing from life insurance companies matches the demands of the OZ incentive. "Life insurance companies have long-term liabilities. So, they like long-term assets," said Shaw. "That meshes with opportunity zone's 10-year hold."

Anderson also uses the Property Assessed Clean Energy (PACE) program and tax-increment financing (TIF) as gap financing.

"It's tough because not many banks like PACE, as the bank's lien sits behind the PACE lien, but it's relatively inexpensive compared to preferred equity," said Anderson.

Anderson has also used TIF as gap financing. "In Texas, a TIF award is a grant and not a loan, so you don't have to pay it back," said Anderson. "Under the Tax Cuts and Jobs Act, TIF proceeds are now tax-exempt. … You can use TIF as equity in a project and the lender should give you credit for it. With increased construction and financing costs, this is a huge help to bridge budget constraints."

Shaw had one more recommendation. "We use recycled tax-exempt bonds with OZ equity," said Shaw. "It works well with OZ equity. It's long-term financing with favorable rates and requires inclusionary affordable housing, which is consistent with our lower risk strategy."

## A Closer Look at Preferred Equity

OZ developments can take on two types of equity: common equity and preferred equity. Common equity is the amount that all common shareholders have invested. Preferred equity, on the other hand, gets preferential treatment in the distribution of cash flow. In other words, preferred equity needs to be paid back before common equity.

"With common equity, the developer gets paid back at the same time as the investor," said Ross. "With preferred equity, money goes to the investor before it goes to the developer. … As an investor, we will charge preferred equity returns where it makes sense strategically for us as well as our partners and the project."

Preferred equity also costs more than common equity.

"Preferred equity is expensive," said Anderson. "When the preferred return start ticking, delays from a labor shortage or supply chain issues become costly. … Preferred equity can erode the common equity."

Shaw will carefully consider the potential use of preferred equity if needed.

"We may consider the use of preferred equity as appropriate. We always look at all alternatives," said Shaw. "[It's important to ask,] 'What is the cost of the equity or debt?' Preferred equity may be expensive."

However, Anderson acknowledged that there is certainly a place for preferred equity.

"Preferred equity is a great place in the capital stack to be for an investor. It solves a borrower's short-term

problems," said Anderson. "The investor gets equity-like returns with a better position in the capital stack. If the project doesn't perform, you take over the project and hollow out the common equity. It's great for investors, but for borrowers, it's a lot of leverage on a project."

## Outlook

"The underwriting is tough across the board. It's not easy to forecast the cost of debt," said Shaw. "Rates have gone up but are starting to come down more recently. Inflation has calmed down quite a bit."

Moving forward, Shaw's group is looking to reliable sources of gap financing as needed.

"For future financing options, we hear an awful lot," said Shaw. "It's important to have proven and reliable sources of funding." ❖

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