Using New Market Tax Credits to Leverage FQHC Capital Projects

By Tony Smith, Practice Leader and Executive Vice President, S. B. Friedman & Company

Still a relatively new federal community development financing tool, the New Market Tax Credit Program (NMTC) continues to evolve in its application. As a complex tax credit financing mechanism, the program can appear confusing at first glance. However, a growing number of organizations across the country have found that NMTCs can be an excellent tool for financing Federally Qualified Health Centers (FQHCs), and this trend is likely to continue.

What is the NMTC?

The NMTC is a federal tax credit benefit that is generated by the flow of capital through a U.S. Treasury-certified Community Development Entity (CDE). CDEs are a diverse array of private, mission-driven organizations created by banks, nonprofits and government entities that can apply for competitive allocations of NMTCs from The Treasury. Each CDE has a defined geographic service area—ranging from local to national—and a defined set of investment priorities. Many CDEs include the financing of community facilities, such as FQHCs, as a core part of their mission.

CDEs most typically serve as a conduit for capital. The amount of capital flowing through the CDE for a given transaction dictates how much federal NMTC benefit will be generated—the statutory formula is a federal tax credit equal to 39 percent of the total capital investment flowing through the CDE, spread over a 7-year investment period. CDEs in turn allocate this benefit to investors, in exchange for up-front cash invested in the CDE. Because the investor is purely buying a tax benefit, i.e., not seeking much if any cash return from the investment, the CDE is able to package this capital to provide very low-interest loans to Low-Income Community (LIC) borrowers, such as FQHCs.

Why NMTCs Can Be a Great Fit for FQHC Financing

The legislative intent of the NMTC program is to support flexible, borrower-friendly financing for businesses and non-residential development projects located in LIC Census tracts. The program places a high emphasis on projects that generate positive community impacts within LICs, including job creation/retention and expansion of available community services. Given the typical locations, patient base and community impacts of FQHCs, the NMTC program is a natural fit for these types of health care facilities.

How NMTC Transactions Can Work for FQHCs

NMTC deals can take a wide array of forms, but the best option for most FQHC transactions is likely to be the "leverage structure," whereby the NMTC benefit is used to create a layer of flexible, low-interest "gap financing" that supplements the other sources of capital available to the FQHC. CDE fees and investor pricing can vary widely, but in general, this financing structure can generate additional financing ranging from a 15-20 percent net increase in the capital available to the FQHC. This additional layer of capital generally is packaged as interest-only debt at a rate of about 1 percent. These loans can be used either to directly fund construction or provide "takeout" financing, i.e., a longer-term amortizing loan that replaces the construction loan after completion shortly after project completion. NMTC financing can also, in some cases, be used to provide more holistic business financing for the FQHC's operations. At the end of the 7-year NMTC compliance period, the deals frequently contain mechanisms whereby the FQHC can purchase this additional layer of debt for a nominal amount, effectively converting the low-interest loan into a permanent subsidy.

The main challenge in a typical NMTC leverage structure transaction is identifying sources of capital (generally equal to 75 percent or more of total project cost) that can be loaned to the NMTC investor up-front. These sources are typically referred to as the "Leverage Loan" in the NMTC structure. In turn, the investor packages the Leverage Loan proceeds with their NMTC equity and invests the combined amount into the CDE. Finally, the CDE lends these funds back to the NMTC borrower, passing on the benefits of increased capital and reduced interest cost. A chart is included on page eight to graphically show a sample of the leverage structure.

The PCC Community Wellness Center Example

PCC Community Wellness Center Austin Family Health Clinic—located in a low-income medically underserved area (MUA) on Chicago's west side— is one example of how FQHCs can use a NMTC. This facility, profiled in the January 2009 issue of *IPHCA Health Source*™, was completed in 2010.

The clinic is anticipated to serve about 10,000 predominantly low-income patients per year. In August 2010, PCC closed on a NMTC loan with Chicago Development Fund, a nonprofit CDE controlled by the city of Chicago that emphasizes community facility financing and has a highly borrower-friendly fee structure. This $6 million financing provided a permanent loan to PCC, which allowed the "takeout" of PCC's construction loan for the Austin facility, as well as recovery of funds PCC had advanced during construction. The NMTC benefit was purchased by JP Morgan Chase. Net of all transaction costs, fees, interest and compliance costs, the transaction provided a benefit of $1.25 million to PCC, or about 21 percent, of the facility's development costs. In turn, PCC has used this benefit to substantially reduce its long-term debt load for the facility, as well as to recover funds it had to advance during the construction process to address site environmental cleanup needs that were substantially greater than the organization had anticipated.

According to Bob Urso, PCC president and chief executive officer, "The NMTC transaction was complicated and challenging to understand. However, the team utilized by PCC to complete the transaction was outstanding. I would highly recommend other FQHC's look into NMTC transactions when completing major construction projects."

Combining NMTCs with HRSA Funding

A common goal among FQHCs is to maximize the use of their resources, including grants from the Health Resources and Services Administration (HRSA), to leverage additional NMTC

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funding. The benefit of this approach is clear: every $1 of financing that flows through the CDE in turn generates additional tax credits that increase the amount of NMTC subsidy that can be provided by the investor by roughly 25 to 30 cents.

On January 20, 2011, HRSA released a policy statement outlining specific requirements regarding use of HRSA grant proceeds in NMTC-financed projects. In general, HRSA's statement was supportive of FQHCs using NMTCs to increase their capital financing capacity, indicating that the agency "would consider the use of NMTC and/or HTC [Historic Tax Credits] project financing arrangements" on a case by case basis. HRSA went on to indicate that its grant funds may not be directly invested in the NMTC structure, but that certain bridge financing structures would be allowed.

Overall, the HRSA guidance appears to point to a prototypical structure where the FQHC would find a third party lender or an internal source of cash to temporarily advance the funds in an amount equal to the HRSA grant commitment. These bridge loan proceeds would be used as a Leverage Loan in the NMTC structure, and create a pool of NMTC-enhanced loan proceeds to pay for project development. This structure, including the Leverage Loan, would remain intact for the full 7-year NMTC period. During construction, the FQHC would submit reimbursement requests to HRSA for actual costs expended. In turn, the HRSA funds could be used to repay the temporary bridge.

The sample structure differs slightly from that used by PCC whose project included about $1.4 million of HRSA Facility Improvement Program (FIP) funding. Under the PCC structure, which also appears to fit within the new HRSA guidelines, the NMTC financing occurred shortly after project completion, by which time the HRSA funds had been fully disbursed. In turn, the NMTC loans repaid PCC's construction loans, and the previously spent PCC and HRSA funds

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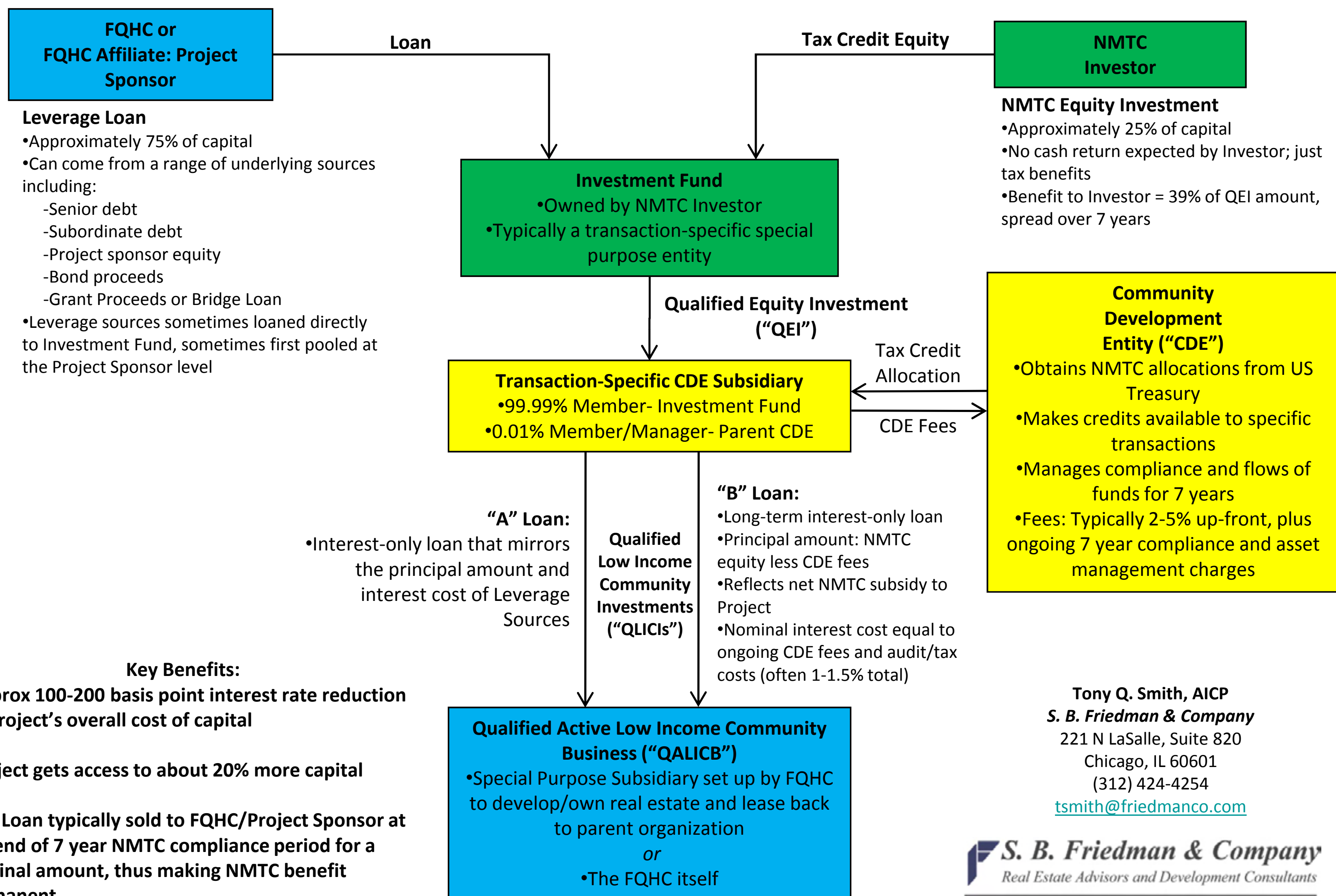
NMTC Leverage Structure: Prototy[ical Example for a FQHC Project



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The PCC Community Wellness Center Austin Family Health Clinic is one example of how the New Market Tax Credit (NMTC) program can be used to leverage construction costs of a Federally Qualified Health Center.

were able to be counted as leverage for the NMTC structure.

The January 20, 2011, HRSA guidance also states that FQHCs must request prior approval from HRSA before implementing a NMTC transaction involving HRSA funds. Such requests must include:

- Detailed descriptions of the nature and benefits of the proposed HRSA/NMTC structure
- Descriptions of any risks arising from the NMTC structure, and how they will be mitigated
- Confirmation of the likely drawdown schedule of HRSA funds and project timing
- Evidence of commitment from the CDE to participate in the transaction

While the above requirements are detailed and technical, it should not be difficult for a typical FQHC/NMTC project to meet them. The risks referenced in the HRSA guidance are primarily NMTC compliance-related and can be managed through careful deal structuring up-front. In general, HRSA capital grants should be able to work well with NMTCs for future FQHC development projects provided the organization:

- Finds a cooperative CDE partner that is willing and able to accommodate the HRSA approval process in its timing
- Seeks appropriate technical guidance from advisors early on to correctly structure the transaction
- Coordinates early and often with HRSA throughout the process

Outlook for NMTC Program

The NMTC program received a 2-year extension as part of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act passed by Congress and signed into law by President Barack Obama in December 2010. As a result, CDEs will find out in the first quarter of 2011 about the next round of NMTC allocations and will be given an additional opportunity to compete in 2011 for credits. The NMTC allocation is a finite resource, and is often quickly committed following an allocation round, so FQHCs are urged to contact CDEs early in their planning process to evaluate whether this financing option will work for their projects.

Resources

- Chicago Development Fund – www.chicagodevelopmentfund.org
- PCC Community Wellness Center– www.pccwellness.org
- CDFI Fund – www.cdfifund.gov

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