



First Southwest Company

Overview of

Public Private Partnership

Co-Investing

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 | **First Southwest Company**

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Introduction



The following presentation provides an overview of an innovative approach to the Public Private Partnership concept currently being considered by many state and local governments nationally



The concept outlined in the following pages differs from the more widely recognized approach because it uses “co-investing” in public projects through true “Partnerships”



Objective

- To achieve leverage of public funds while providing tax incentives/credits and attractive investment rates of return to “strategic” private sector partners
- The linchpin to this financing approach is the Federal New Market Tax Credit program

New Market Tax Credit Program

Program Summary

- Enacted on December 21, 2000 as part of the Community Renewal Tax Relief Act of 2000
- The New Market Tax Credit (“NMTTC”) program helps attract capital to businesses, real estate projects, and community facilities with beneficial impacts
- Administered by Community Development Financial Institutions Fund at Treasury
- The Program allows for investment capital to be deployed in the form of debt and/or equity in a project
- Provides a credit against Federal income taxes for investors that make Qualified Equity Investments (“QEI”) into Community Development Entities (“CDE”)
- Credits are designed to attract investment capital from corporate or individual taxpayers to low income communities

The NMTC Program

Program Summary

- \$15.0 billion in investments authorized
- \$12.1 billion in investments already allocated
- Allocated annually on a national competitive basis
- Applicant must be a Community Development Entity
- Through FY 2005 reporting period, a total of \$2,975,204,203 has been allocated to 686 different qualified business/projects

- The credit is taken over 7 years starting on the date when the equity investment is made in the Community Development Entity
- The credit rate is:
 - In each of the first three (3) years, 5% of the original investment amount
 - In each of the final four (4) years, 6% of the original investment amount
- Equals 39% of the QEI in the CDE
- Low Income Housing Tax Credit Investors get \$1.00 in credits for approximately \$0.80 investment; no expectation of economic return
- In non-leveraged financings, NMTC Investors receive \$0.39 in tax credits for each \$1.00 investment
- In “leveraged” NMTC transactions higher investment returns are expected

- The New Market Tax Credit Program is eligible for use in a designated Low Income Community (“LIC”)

Low-Income Communities are census tracts:

- With at least 20% poverty rate; or
- Where the median family income does not exceed 80% of the area median family income; or
- That have a population of less than 2,000, are contained within a Federally designated Empowerment Zone, and are contiguous to at least one other LIC; or
- Where the median family income does not exceed 85% of the area median family income, provided the census tract is located in a high migration rural county

- For an investment to be eligible to receive NMTC it must be delivered through a Community Development Entity (CDE), that has received an award of investment allocations from the U.S. Treasury Department

What is a Community Development Entity?

- A domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investments or financial counseling in Low-Income Communities
- CDE are required to demonstrate that they:
 - Have a primary mission of community development
 - Maintain accountability to residents of the Low Income Community that they serve through >20% representation on the governing board or advisory board
 - Be certified and receive allocations of credits by CDFI Fund

The Basics

Qualified Active Low Income Community Business (QALICB)

Any corporation or partnership (and LLC including non-profits) engaged in the active conduct of a qualified business that meets the following requirements:

- **Gross income**
 - At least 50% of total gross income is derived from the active conduct of a qualified business within an LIC
 - 50% test is met if entity can meet tangible property or services test (see below) using 50% of total gross income
- **Tangible property**
 - At least 40% of the use of the tangible property (owned or leased and on a cost basis) of the business is within any LIC
- **Services**
 - At least 40% of the services performed for the business by its employees is performed in any LIC
 - If a business does not have employees, it can meet the Gross Income and Services tests if it meets Tangible Property test at 85%
 - Portions of a larger business can be included separately

- Nonqualified financial property
 - Less than 5% of the average of the aggregate unadjusted basis of the property of the entity is attributable to nonqualified financial property
 - Includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property
 - Can not be an excluded business
 - Exception: reasonable amount of working capital held in cash or debt with a term less than 18 months
 - Safe harbor: if Qualified Low Income Community Investment (“QLICI”) proceeds will be expended within 12 months for construction, then treated as a reasonable amount of working capital

- Rental real estate
 - Cannot be IRC Section 168(e)(2)(A) “residential rental property” (building which derives 80% or more of gross rental income from dwelling units)
 - Substantial improvements must be located on property
 - Any lessee of the property must not be an excluded business:
 - A business which operates: a country club, golf course, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility or liquor store
 - Certain farming businesses

- An operating business located in a LIC
- A business that develops or rehabilitates commercial, industrial, retail and mixed-use real estate projects in a LIC
- A business that develops or rehabilitates community facilities, such as charter schools or healthcare centers, in a LIC
- A business that develops or rehabilitates for-sale housing units located in LIC

A Qualified Low-Income Community Investment is:

- Any capital or equity investment in, or loan to, any QALICB
- The purchase of qualifying loans from another CDE
- Financial counseling and other services to (e.g., advice regarding organization and operation) to businesses located in, and residents of, low income communities
- Any equity investment in, or loan to, another CDE (second CDE), to the extent the second CDE uses the proceeds as described in the first and third bullet points above

- NMTC are offered to investors for Qualified Equity Investments (QEI) in the CDE

A Qualified Equity Investment is:

- An equity investment in a CDE – an equity investment is stock in a corporation or any capital interest in a partnership
- The equity investment must be acquired by the investor at its original issue solely in exchange for cash
- The equity investment must meet the substantially – all requirement, 85% of QEI must be invested in QLICI and must remain invested in the project for the 7 year NMTC term
- CDE must designate the investment as a QEI and provide notification of designation to the investor and CDFI Fund
- QEI must remain invested in the CDE during a 7-year credit period – Investors claim credits beginning on the date a QEI is initially made

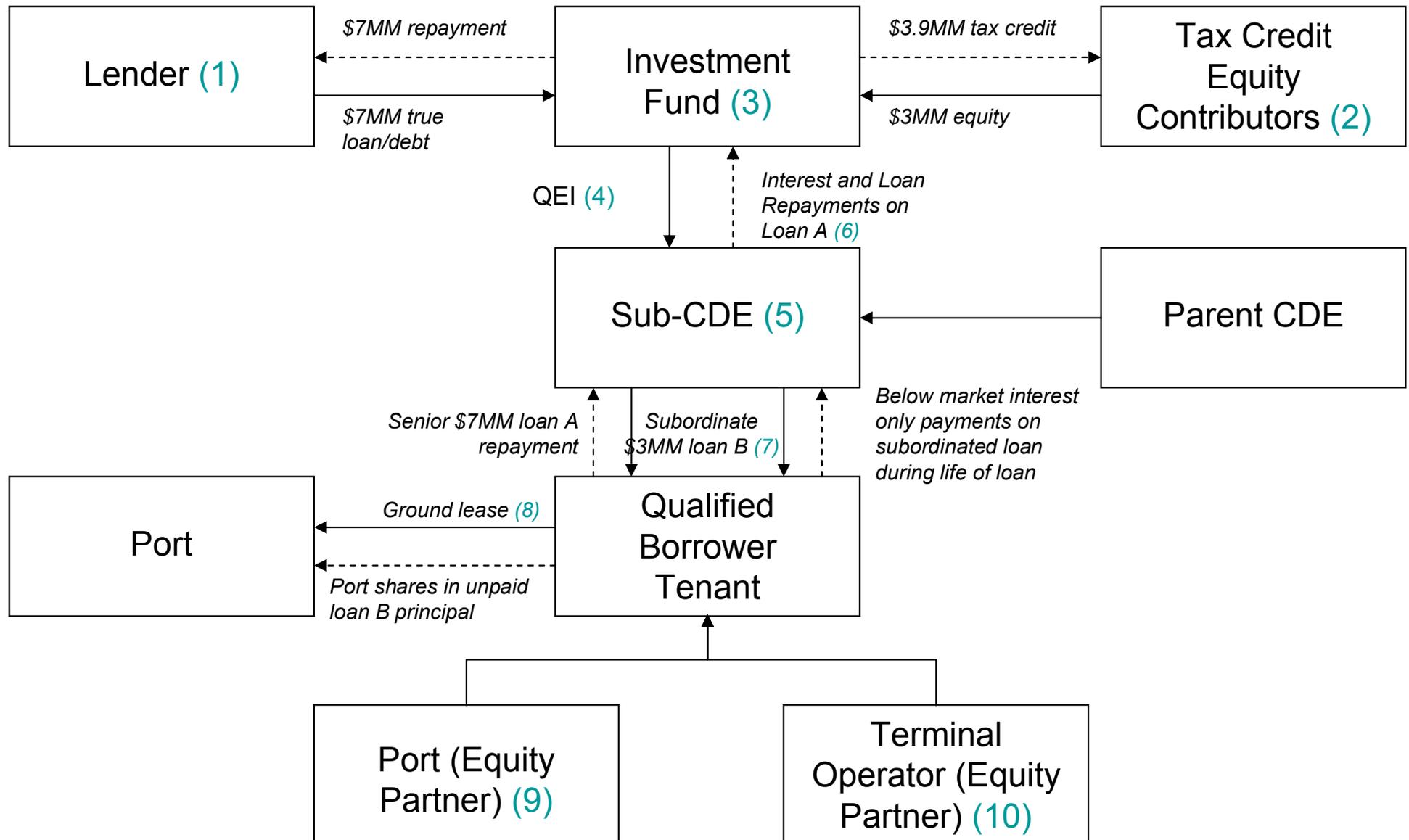


NMTC Deal Structure



\$10,000,000 NMTC Example

Leveraged Transaction



- 1) Lender: Can be a “traditional” provider of debt financing, ie. bank, insurance company, real estate or business lender or public entity – state, county, city or political subdivision. Public entity can provide funding from any legally available funds including bond proceeds, and grants
- 2) Tax Credit Equity Investor: Corporation or individual that can utilize 39% federal tax credit over 7 year life of NMTTC investment
- 3) Investment Fund: May be a for profit partnership or corporation and represents the combined investments of lender (debt) and tax credit equity contributors (equity). The investment fund will make a QEI in a sub-CDE
- 4) QEI: is the Qualified Equity Investment – see page (14)
- 5) Sub-CDE: is a sub-LLC formed by the parent CDE – see page (8). The parent owns a 0.01% ownership interest and the investment fund a 99.99% ownership interest in the sub-CDE

- 8) Qualified Borrower/QALICB: Any Corporation or partnership (and LLCs including non-profits) engaged in the active conduct of a qualified business that meets the requirements set forth on pages 9 - 14
- 9) 10) Partnership/LLC established between public sector entity (see flow chart (9)) and private sector business operator/owner (see flow chart (10)) for the purpose of owning and operating the Qualified Borrower/QALICB

\$10,000,000 NMTC Example

Leveraged Transaction

- 1) The Port could serve as a Lender, however, participation below the CDE level may be more economically beneficial to the Port.
- 2) Tax Credit Equity Contributors get a return of tax credits equal to \$3.9M (39% of the Qualified Equity Investment of \$10.0 M). Port tenants could participate as tax credit equity contributors. The tax credit arises at the Investment Fund level.
- 3) The Investment Fund may be a for profit partnership or corporation.
- 4) Assumes \$10.0 M of Qualified Equity Investment (QEI).
- 5) An LLC formed by the parent CDE (the Parent owns a .01% ownership interest and the Investment Fund a 99.99% ownership interest in the sub-CDE).
- 6) Interest and principal on a \$7.0 M Loan A. Interest only until maturity, typically after seven years, and then principal is due.
- 7) Below market interest rate loan. Low interest rate payments used to pay administration costs. Discounted principal repayment at maturity of Loan B (may be up to 98%). Qualified Borrower gets benefit of not repaying the full Loan B principal. Such upside benefit may flow back to the Port if it participates as a partner in the Qualified Borrower.
- 8) Ground lease term needs to exceed the economic life of the assets financed.
- 9) Port may participate as a partner in the Qualified Borrower entity.
- 10) Tenant may want to participate as an equity partner with the Port.

Steps in Setting up NMTC Structure

- Governmental Entity identifies potential project for co-investing
- Governmental Entity identifies potential strategic private sector partner
- Preliminary project cost and cash flows developed
- Preliminary co-investing cash flows including NMTC, other tax credits (if any) and internal rates of return developed
- Meeting of interested parties to discuss concept in greater detail and review preliminary cash flows
- Develop/draft partnership agreement between governmental entity and strategic partner
- Identify potential debt funding sources
- Identify potential CDE for funding
- Submit application to CDE to secure NMTC allocation
- Conference calls or meetings with CDE

Steps in Setting up NMTC Structure (cont.)

- Revise cash flows developed based on feedback/input from potential CDE
- Identify CDE that offers most attractive terms and conditions for investment of tax credits
- Begin discussions/negotiations with CDE that offers most advantageous terms for investment
- Draft investment agreement developed and circulated
- Detailed cash flows based on “preliminary” terms of agreement developed
- Negotiate terms of lenders’ investment. Draft lenders’ investment agreement circulated (if needed)
- Lender and tax credit investors make investment in “Investment Fund” based on terms and conditions set forth in their respective investment agreements

Steps in Setting up NMTC Structure (cont.)

- Investment Fund “loans” funds received from lenders and tax credit investors to sub-CDE by making a qualified equity investment in sub-CDE
- Sub-CDE makes loan to qualified borrower/tenant – Qualified Active Low Income Community Business (QALICB)
- QALICB uses funds from sub-CDE loan to develop project