Tax Increment Financing in Maryland

A crash course in TIF financing from two of the Nation's most experienced experts on the topic

<u>**LAI Baltimore Chapter – May, 2019**</u>

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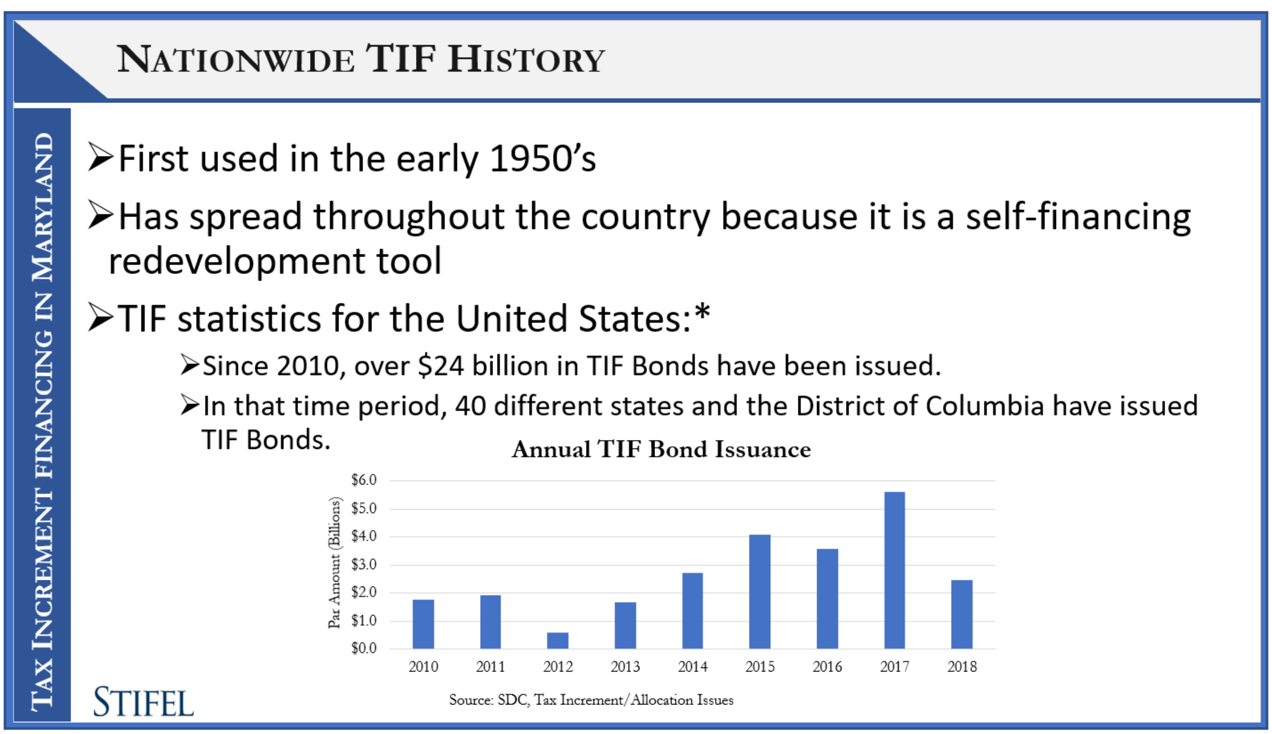
On May 15th, Nate Betnun of Stifel Nicolaus and Emily Metzler of MuniCap teamed up to provide the Baltimore LAI Chapter with a masterclass on Tax Increment Financing, or TIF's as they are commonly referred to. TIF financings have become an increasingly important tool for municipalities to finance large scale public infrastructure in conjunction with urban renewal efforts. Therefore, a working knowledge of this financing vehicle is a valuable tool for any real estate professional in today's world.

Mr. Betnun and Ms. Metzler are arguably among the most prominent professionals in the world of TIF's, having been key players in the majority of TIF's in Maryland and Stifel "almost a majority of TIF's on a nationwide basis". Their joint knowledge base of the subject matter is obviously quite deep, resulting in a presentation so packed with information that this summary will not be able to do it justice. A high-level overview will be all that is practical herein (a not-so-subtle reminder that there's really no substitute for attending these informative presentations in person!).

TIF's are a self-financing tool available to government entities to (i) redevelop urban renewal areas, (ii) rebuild public infrastructure, (iii) encourage economic development, and (iv) change the character of existing land uses in strategic locations. TIF's are "the largest program for infrastructure in the U.S.", making them a very timely topic given the "political focus on infrastructure" at present. The basic concept is fairly straightforward: a local government issues bonds that are to be repaid by the future taxes paid by tenants, landowners, and/or ultimate users of the new infrastructure. Beyond that basic concept the details quickly become intricate and nuanced.

Nate and Emily began with some history on TIF's, presenting this snapshot of their use nationwide:



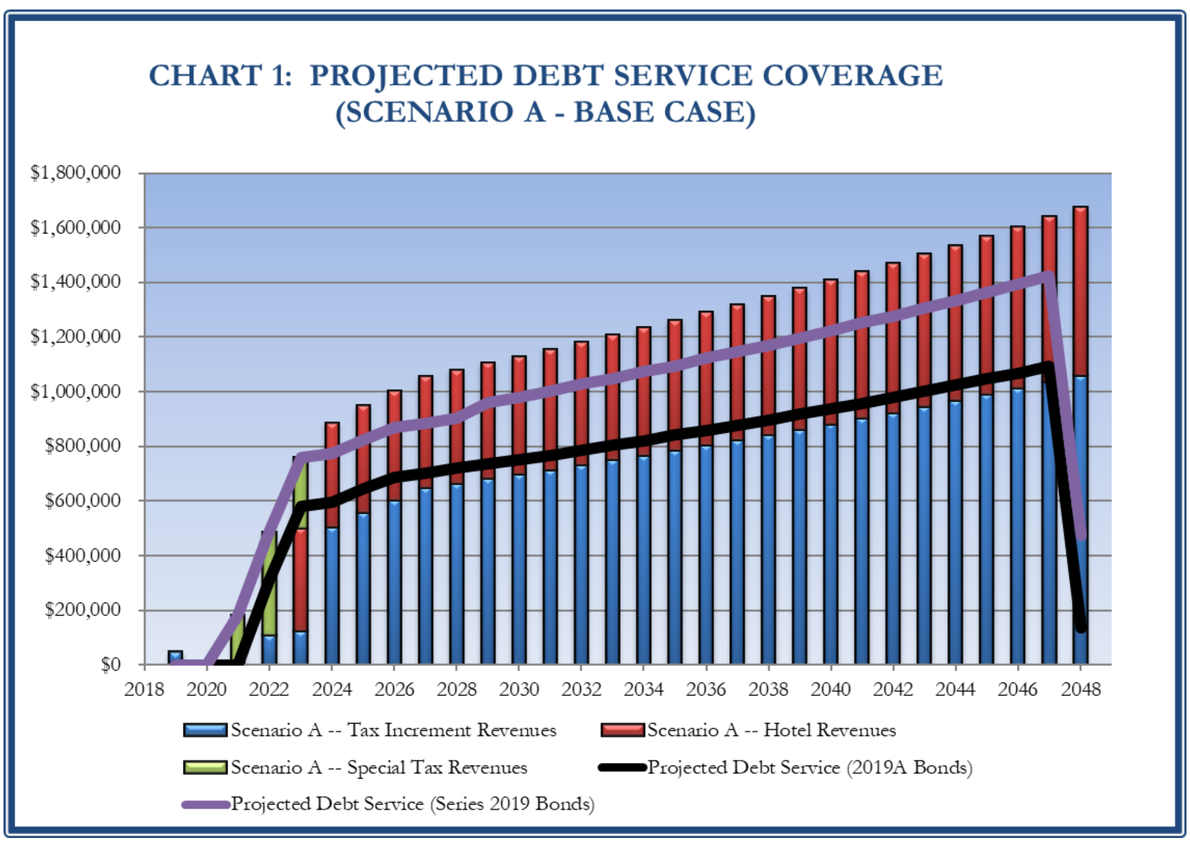
Within Maryland, approximately $768 million of TIF bonds have been issued (or approved but not yet issued) for such notable projects as Harbor Point, Port Covington, EBDI, and National Harbor. Nationwide the use of TIF's is growing, with approximately $24 billion issued since 2010. Emily opined that "Municipalities are getting smarter and use TIF's increasingly rather than general obligation funds" for infrastructure needs. TIF's generally comprise about 10-12% of the total capital stack necessary to fund a project. Maryland uses "best practices" when evaluating any TIF proposal, which means that there has to be a high level of scrutiny to ensure that: (i) a high proportion of private capital is invested relative to the TIF funding amount, (ii) the TIF is not a developer handout, (iii) the TIF does not put the municipality at risk, and (iv) the project won't go forward without the TIF ("But For" analysis -described below).

Emily advised that there are four major constraints to consider when sizing a TIF, as follows:

1) The Development Project – How much assistance does the project require to be feasible? How much up-front money will be required? Can the TIF funds be phased in over the life of the project, or is it all needed up front?
2) Legal Authority – What can be done within existing law? This relates to both the laws of the local jurisdiction and IRS rules. The IRS rules can limit what specific items the TIF funds can be spent on.
3) Financial Markets – What do the capital markets need? If the return requirements that the markets need are not provided, the project will not proceed.
4) Public Policy - What is the local jurisdiction getting as a quid pro quo for its participation? What social benefits will result, and are these sufficient to entice the political class to cooperate?

Most TIF's "get sized to the lesser of these four constraints".

Nate next stepped in to address what appears to be "the" big question with most TIF projects: How do we deal with the cashflow shortfall up front? Nate offered the following graphic depiction of a typical shortfall:



As can be seen above, a nascent project's cash flows are not going to cover debt service on the TIF bonds until a few years into construction. So, the developer typically agrees to fund a "Special Tax" backstop to cover the early years shortfall. In the above graphic for instance, the developer has agreed to a Special Tax during the project's first three years while the improvements are under construction and before those improvements begin to yield the projected tax revenue sufficient to pay the TIF bonds debt service.

Other structuring considerations which can help mitigate the cash flow risks early in a project's life are:

- Amortization – no principal is typically paid on the bonds in the TIF's early years, reducing the cash flow necessary to keeping the bonds current.
- Capitalized Interest – a construction period interest reserve is typically established to help cover the TIF bonds debt service.
- Reserve Fund – an amount which typically equals one year's debt service is placed in a reserve as an additional back up. Thus the project has both "belt and suspenders" to prevent its pants from falling down.

Nate held up a sample Offering Statement which was "over a thousand pages" and explained that these offerings include detailed descriptions of the project, the developer and its history, estimates of the proposed cash flows (MuniCap's specialty), appraisals & market studies, and ending with a long section on risks. Nate advised that the typical buyers of TIF bonds are tax exempt bond funds like those sponsored by T Rowe Price, Nuveen, and Fidelity. Although "a small percentage of bonds are bought by sophisticated individuals in $100k increments". So, if you're looking for a bit more yield in your 401K, these bonds typically yield 100 – 200 basis points more than triple A rated bonds of similar duration (that spread premium typically drops upon refinancing the bonds after the project's cash flows are well established).

Emily next stepped in to describe the "But For" test, which is "critical to best practices in issuing TIF's". This test is one important way to ensure that the project warrants the TIF. It is basically an exercise of stepping back and looking at the "big picture" and using good judgment to verify that "but for" the TIF proceeds, the project in question would not be able to proceed. Put another way, this is an exercise in answering the question of: "How much assistance is appropriate?" Emily went on to describe that almost all TIF's in Maryland now include a profit-sharing arrangement wherein, if the project's cash flows exceed proforma, the local jurisdiction shares in the excess cash flow. "Both the developer and the municipality must get a return – it must work from both sides".

Focusing further on the municipality, Emily provided this slide which addresses the considerations involved from the local government perspective:

Impact of TIFs on Local Governments

Tax Increment Financing in Maryland

- Successful tool for creating new tax revenue
  - Consider best practices for use
- Must be able to address key public policy issues (10 in total):
  - Is public assistance appropriate?
  - What is the sponsoring government agency receiving in return for the TIF? (TIF is both a financial and land use development tool.)
  - Will there be sufficient surplus tax revenues to cover costs of public services required for the project?
  - Is the proposed TIF economically efficient (i.e., more tax revenues or benefits than the No-TIF alternative)?
  - Will the public support the TIF?

Stifel

As our luncheon timeframe was approaching its limits, Nate and Emily provided some case studies of high profile, recent TIF's in Maryland, including Harbor Point, Port Covington (approved by not yet funded) and Downtown Columbia. Each had its unique challenges and quirks, but each eventually has been approved for a TIF District and the issuance of bonds (both Harbor Point and Columbia have issued bonds – Port Covington is currently working on its first issuance). Our LAI members now get to watch as these projects come to fruition with an improved understanding of the mechanics of, and the enormous effort entailed in, bringing TIF funds to worthy infrastructure projects.

The members thank Emily and Nate for a fascinating presentation!