Reprinted from the Commercial Real Estate Monthly section, July 30th, 2007

BANKER & TRADESMAN

THE REAL ESTATE, BANKING AND COMMERCIAL WEEKLY FOR MASSACHUSETTS *ESTABLISHED 1872*

Nonprofit Construction Projects: Getting Started on Financing

By Maria Krokidas & Samuel Nagler

For the nonprofit about to embark on a major construction or renovation project, it is not unusual for some lingering doubts to creep in after the initial exhilaration has worn off. The initial exhilaration generally occurs after the board, staff, supporters and hopefully some potential donors have concluded that the project will further the mission of the nonprofit; will result in expansion and/or efficiencies of operation; and will provide a better work environment for the staff and the recipients of services. The lingering doubts arise when the subject of financing is broached. Many questions appropriately begin to be asked: Are we sure we can afford this? What kind of consultants do we need? How do we select between the many debt and equity options available? How do we prepare staff and the board for the commitment of time and energy the financing process will entail? Those and many other questions really boil down to a single question: How do we get started on the financing?

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The Boston Health Care for Homeless Program is a nonprofit organization that has utilized various financing vehicles to complete a major renovation of a building it leases from the Boston Public Health Commission. This rendering shows the completed facility, which provides health care services to Boston's homeless population.

First, learn the basics of the options available to suit your project. There are a variety of equity and debt options available.

Equity options include:

- *Federal Rehabilitation Tax Credits.* Equity investor makes capital contributions and receives tax credits (either 10 percent or 20 percent of eligible project costs) claimed over a 5-year period;
- *Massachusetts Historic Rehabilitation Tax Credits.* Purchaser of credits provides funds to the nonprofit or the borrower entity created by the nonprofit in exchange for state tax credits in the amount of up to 20 percent of the eligible project costs; credits are competitively awarded by the Massachusetts Historical Commission;
- *Low-Income Housing Tax Credits.* Equity investor makes capital contributions and receives tax credits of either approximately 9 percent or 4 percent of the qualified costs every year for 10 years for low-income rental housing developments; and
- *New Market Tax Credits.* Equity investor makes capital contributions or low income loans in exchange for 39 percent credits claimed over a 7-year period. Available to qualified businesses in qualified low-income communities.

Financing options include:

- *Conventional Loans.* From banks seeking Community Reinvestment Act credits or insurance companies;
- *Public Lenders.* Loans from local, state or federal government or quasi-governmental agencies under loan programs established by those agencies; and
- *Tax-Exempt Bond Financing.* Bondholder receives tax credits or is exempt from paying income tax on the interest due to the nonprofit's 501(c)(3) status or a particular tax-exempt bond program (for example, housing, schools). Such financing sometimes may be combined with a small "taxable tail" to finance excess issuance costs.

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Many nonprofits mix and match between the various equity and financing sources, although some of the combinations are prohibited.

Building The Framework

A capital campaign is a time-consuming process and, for a nonprofit that has never done it, it may involve some thought and soul-searching as to the current mission of the nonprofit and how it may have evolved from its original mission; how the project promotes that mission; and how best to communicate all of this to the public or a discrete list of potential donors. A capital campaign can be critical, beyond the obvious reason that it provides the funding to fill any gaps in the financing. Lenders and equity providers like to see a strong capital campaign because it makes the overall financial puzzle fit and because it shows that the nonprofit has some "skin in the game."

Capital campaign funds do not all need to be paid up front; many lenders are willing to give bridge loans secured only by the pledges, usually in an amount equal to between 70 percent and 80 percent of the pledges. A prior capital campaign that perhaps was less than what was expected should not be a deterrent against trying again. Campaigns to raise funds for innovative programs, new staff or other legitimate needs simply do not attract the excitement that a capital campaign for a property acquisition or construction project does.

There is a bit of a chicken-and-egg problem with construction costs. A definitive price cannot really be known until a stipulated sum or guaranteed maximum price construction contract is signed (or, in the case of a construction management agreement, the guaranteed maximum price addendum is signed). However, the financing process, from preliminary interest to due diligence to closing, can be a lengthy one, and really needs to start before the construction costs are completely fixed. Experienced estimators, whether independent or in-house for the contractor (if one has been selected), can help. The inflation factor for construction material has been quite high lately, so the period of time from when the estimate is given to when construction can realistically expect to begin must be calculated.

It is important to select a financial consultant who has a deep familiarity with your particular niche in the nonprofit world. Financial consultants should know the workings of your industry in terms of methods of reimbursement, possible economic or legislative bumps in the road and, most importantly, sources of capital. Some financing programs are sufficiently complex that you would want to assure yourself of the consultant's experience with that type of financing. For example, you would generally not want your transaction to be your financial consultant's first New Market Tax Credit deal.

There are several reasons to involve an attorney at an early stage. First, an attorney can ensure that your corporate house is in order for the financing. Similarly, for nonprofits seeking tax-exempt bond financing, an attorney can investigate and hopefully assure that there are no potential issues with your 501(c)(3) status. Most problems are fixable but they cannot wait until the last minute. Your attorney may also help you avoid some particular pitfalls associated with certain financing programs. For example, something as innocuous as occupying a building prior to renovations could render a nonprofit ineligible for federal rehabilitation credits. There is no way to know such things intuitively, so an early discussion with your attorney as to your proposed game plan is important.

It is an overstatement to say that the simpler the structure, the higher the interest rate – but not much of an overstatement. There should be some frank discussions about your appetite for complexity and, to some degree, loss of control. For example, in larger projects, equity financing is generally the "cheapest money" but generally will involve the equity investor not just regulating you as a lender does, but being a co-owner of the property. Many equity programs also involve setting up one or more new entities, with the attendant requisite corporate housekeeping. The structures, especially when different forms of equity are combined, are complex and require a serious commitment of time, energy and fortitude. On the other hand, complex financing structures may be the only way to get your project built and there are many experts available to help you on your way.

Board members should be given as much information as possible about the potential for increases in costs of the project so there is no hesitation when the vote is needed to authorize the project. If it appears the financing will require the creation of new entities, board members should be solicited as early as possible to receive information about serving on the boards of new entities. There may be technical reasons for early board involvement, as well. Tax-exempt bond financing requires an "official intent resolution" to authorize costs that later will be reimbursed by bond financing.

Financing a major construction or renovation project presents many challenges and opportunities for a nonprofit. It is important not to run up the meter too much on soft costs until certain thresholds of assurances are achieved, but there is truth in the adage that an ounce of prevention is worth a pound of cure. ■