ADVANTAGE
CAPITAL
PARTNERS

February 6, 2012

Mr. Robert Ibanez
NMTC Program Manager
Community Development Financial Institutions Fund
U.S. Department of the Treasury
601 13th Street, N.W., Suite 200 South
Washington, DC 20005

Dear Bob:

On behalf of Advantage Capital Partners, we appreciate the opportunity to provide our feedback about the New Markets Tax Credit ("NMTC") program and our thoughts and suggestions about how the program can continue to be used for financing low-income community businesses that lack access to capital.

Advantage Capital Partners is an innovative group of venture capital and small business finance partnerships that has raised more than $1.6 billion in geographically-targeted capital. Founded in 1992, the firm has offices in Missouri, Louisiana, New York, Texas, California, Illinois, Florida, Mississippi and Washington, D.C., with affiliated offices in Alabama, Colorado, Connecticut and Wisconsin. During our twenty year history, Advantage Capital has raised private funds to invest in states and communities that are underserved by traditional sources of risk capital. The firm has built a strong and successful track record of public-private partnerships with state and federal economic development organizations, facilitating the flow of billions of dollars of investment capital into these communities. Advantage Capital provides equity and debt capital, along with value-added counsel and other support, to operating businesses that have the potential for excellent investor returns as well as significant community impact.

Advantage Capital has been an active participant in the NMTC program since the program's inception. Through our subsidiary, Advantage Capital Community Development Fund, LLC, we have received $444 million in allocation authority. Our NMTC strategy is unique in that we (i) focus exclusively on small and medium-sized operating companies where job growth is most dynamic, (ii) raise most of our capital through large, flexible funds, allowing us to meet smaller capital needs and recycle investments to help multiple businesses, and (iii) provide active, "hands-on" management to our portfolio companies, which, among other things,

NEW ORLEANS 909 Poydras Street, Suite 2230 • New Orleans, LA 70112 • (504) 522-4850 • (504) 522-4950 (fax)
SAINT LOUIS www.advantagecap.com
NEW YORK
TAMPA

helps them raise significant follow-on capital, thereby multiplying the amount of investment capital we bring to low-income communities across the country. While we are a member of the Novogradac Working Group and support many of the comments included in this letter, our perspective into the specific challenges involved in using the NMTC program to invest in small businesses, is unique, thus we wanted to provide more specific commentary in certain areas.

Our comments are set forth in the attached exhibit and are in the order that they were presented in the Federal Register, Volume 76, Number 215, on November 7th, 2011.

Thank you for considering these recommendations, and should you like to discuss further please do not hesitate to reach out to us.

Sincerely,

Michael Johnson
Managing Director, Advantage Capital Partners
Authorized Representative, Advantage Capital Community Development Fund, LLC

Advantage Capital Partners
Responses to Select Questions

2. Treatment of Certain Businesses

a. Should the CDFI Fund provide additional opportunities in the allocation award process for applicants to score more highly by committing to invest in certain business types over others (e.g., small business or rural investment, operating businesses vs. real estate projects, etc.)?

The CDFI Fund should encourage CDEs to provide additional financing to small businesses and operating businesses through scoring incentives in the NMTC application. Repeated studies have confirmed that the overwhelming majority of new jobs are created in our economy by small businesses. The U.S. Small Business Administration's Office of Advocacy estimates that 64% of net new jobs in our economy over the past 15 years were created by small business. Private research from institutions such as the Kauffman Foundation confirms this analysis (Where Will the Jobs Come From, Stangler & Litan, November 2009). It is clear that funding the creation and growth of small business is the key to job creation and economic development.

The NMTC program is a powerful tool for financing job growth. CDEs are permitted to finance almost any type of industry and customize the financial offerings to the needs of each business. It is possible to offer a range of loans and investments from venture capital to senior debt and loan amounts from $250,000 to tens of millions of dollars. In practice, however, very few CDEs fully embrace the financing flexibility that the program allows. As discussed elsewhere in this response, certain compliance risks and regulatory complexities often make financing small operating businesses more difficult than larger real estate projects. Since both options are equally permitted under the program, many CDEs naturally gravitate towards the larger, more straight-forward investments.

Because NMTC allocation continues to be a scarce resource, the CDFI Fund can encourage particular types of investment activities through the application process. This can take the form of either specific set-asides or variable scoring. In the case of a set-aside, the CDFI Fund has previously tailored the application to encourage more investments in non-metropolitan (rural) counties. We recommend that the CDFI Fund use the concept of a "Rural CDE" as a guide for formulating similar rules for "Business-Focused CDEs." In crafting such a definition, the CDFI Fund should consider breaking down the definition of "Non-Real Estate Investment" into smaller components such as "Owner-Occupied Investments" (i.e. capital projects for businesses) and "Operating

Business Investment" (growth capital). It could then define "Business-Focused CDE" as a CDE who has provided and will provide more than 50% of its loans/investments in the form of "Operating Business Investments." By creating such a set-aside, the CDFI Fund would encourage more CDEs to direct their financing activities to businesses that will use the financing to create or retain jobs. We do not recommend, however, that the CDFI Fund implement a variable scoring process to accomplish this result. If certain questions were to be scored more favorably if CDEs committed to operating business investments, this could push the industry too far in the direction of business financing to the detriment of CDEs who have expertise in real estate finance or owner-occupied investments, and potentially result in allocations to high-scoring applicants that may have great intentions but are lacking in the special skills needed to handle this type of investing. A set-aside, on the other hand, only ensures that a minimum percentage of allocation is made available for CDEs with a certain focus and expertise.

b. Are there specific administrative or regulatory changes that would facilitate the financing of specific types of businesses while preserving public policy objectives and safeguards?

We support the recommendations of the Novogradac NMTC Working Group regarding recapture regulations, the frequency and transitioning of updated census data, the definition of control, and the definition of a non-real estate QALICBs as mechanisms that would encourage additional investments in operating businesses. In addition, we propose the following administrative and regulatory changes that would increase the type and number of investors and other capital providers in the NMTC program, resulting in increased efficiency and more favorable financial terms for qualified businesses:

- A*llow credits to be specially or predictably allocated within an investment fund:* Today, a CDE can raise a QEI either from a single investor that has both business risk and tax credit appetite or from a combination of a tax credit investor and a leverage lender. Under current IRS rules, it is not possible for a non-tax credit investor to be an economic investor at the upper tier of the NMTC structure for fear that credits will get redirected. As a result, an entire class of investors (private equity/venture capital) who frequently invest in operating businesses is essentially excluded from using their vast source of capital as a source of leverage financing. Allowing credits to be predictably allocated within an investment fund would alleviate this issue, and open the program to important new participants. Similar allocation rules are permitted in a number of state credit programs. As an interim solution, we would encourage the IRS to clarify the kind of equity features (such as warrants, equity kickers, cash flow participation, etc.) a leverage lender might be permitted without risking a recharacterization of the leverage loan as equity.

- *Allow Alternative Minimum Tax (AMT) offset:* Allowing NMTCs to offset AMT is one of the most important steps to broadening the base of tax credit investors in the program, one that should bring investor yields down from 10-13% or more today to 7-10%, significantly increasing capital available to QALICBs. If NMTCs were able to offset AMT, this would give CDEs more opportunities to raise capital from a single investor in a non-leveraged transaction. Fewer sources of capital in the NMTC structure results in streamlined closings and reduced costs, further benefiting operating business investments. We realize such a change requires Congressional action and would encourage the CDFI Fund to support such a change.

- *Permit lenders to have security interests in QALICB assets*: Leverage lenders represent as much as 70% of the capital raised by each CDE. Outside of the NMTC environment, these lenders are accustomed to receiving security interests in the assets that support their loans. Very few commercial lenders are comfortable lending through the NMTC leverage structure which requires a complicated, multi-step process: the lender makes a loan to a NMTC investment fund which in turn makes an equity investment to a CDE which in turn makes a loan to the underlying business and assets. Without some type of security interest in the CDE's assets (perhaps to back up an obligation to redeem a QEI after 7 years), the leverage lender is exposed. The CDE's assets could be attached by another creditor of the CDE and not be available for distribution on the QEI because the investment fund's interest in the CDE is simply an equity security. If the leverage lending rules were modified to permit leverage lender to foreclose on the investment fund's security interest in the CDE and transfer the assets out of the CDE, the fundamentals of the NMTC structure would be preserved. Most notably, the recapture rules on redemptions would remain intact, so there is little danger in this type of security interest undermining the seven year nature of the program. It would, however, it would vastly increase lender comfort with the program. Permitting these interests would increase the number of lenders interested in the NMTC program.

We also encourage the CDFI Fund and IRS to consider ways to ease the costs and risks associated with compliance, particularly for investors and CDEs who invest in operating businesses. Investing in operating businesses is quite different from real estate investments: it attracts very different investors, and requires much greater agility as business conditions change. Whereas a new real estate development will typically undergo very few changes during the initial years after completion, operating businesses will often pursue additional capital raises, make acquisitions and divestments, hire new employees, and open or close locations, any of which could lead the business to cease (temporarily or permanently) to be a QALICB. Many business investors look for 3-5 year investment windows, thereby requiring "reinvestment" when using the NMTC program. The following would reduce compliance costs and risk of recapture:

- *Allow QALICB operating losses to be "added back" in operating income calculation:* In determining whether cash received by a CDE can be distributed to

the CDE's partners during the compliance period without causing a redemption, a CDE is permitted to use an "operating income" calculation to determine whether a proposed distribution is a return on capital (permissible) or a return of capital (impermissible). Broadly speaking, the operating income calculation considers the CDE's taxable income and allows certain flow-through tax items like amortization and depreciation to be "added back." We recommend that an additional "add back" of QALICB operating losses be permitted in the instance where a CDE makes an equity QLICI.

Consider a CDE that makes investments in a number of QALICBs. It makes $3 million of debt QLICIs in one or more operating businesses; the debt service generates $60,000 in annual interest payments. Meanwhile, the CDE makes a $1 million equity investment in a start-up QALICB, for which it acquired a 10% ownership stake. Under partnership tax rules, the CDE will share in the QALICB's taxable income and taxable losses. For instance, if the QALICB is spending money to develop and market a product before it begins generating revenue, it would likely generate significant taxable losses; in our example, if the QALICB has net losses of $700,000, the CDE will be allocated $70,000. For each dollar of operating losses that is allocated to the CDE, the CDE would have to reduce its taxable income and would have no corresponding "add back" when doing the operating income calculation (unless the losses are from depreciation or amortization which is rare for early stage companies). The allocation of losses on account of the equity QLICI would therefore eliminate the ability of the CDE to make any distributions from the $60,000 in interest income it earned from its debt QLICIs. As a result, the amount of cash a CDE could distribute to its partners or members (such as an investment fund) would be reduced by the same amount, thereby creating a mismatch on what the upper tier lender or investor is expecting in terms of current payments.

- *Limit recapture to QLICI rather than QEI*: Currently recapture is treated as all-or-nothing across an entire QEI throughout its 7-year compliance period. When choosing between a single real estate investment with only one QLICI to analyze through the 7-year period, and a revolving business investment fund that might contain 10 or more investments over the 7-year period (any one of which can cause a 100% credit recapture) investors will naturally favor real estate. A more limited recapture scheme, based only on the non-qualifying QLICI and on the compliance period remaining, would ease investor concerns about investing in multi-QLICI pools.

- *Confirm that "reasonable expectations" applies to investment workouts*: Under the NMTC regulations, the "reasonable expectations" safe harbor permits a CDE to treat a QALICB that falls out of compliance as if it still qualifies, so long as the CDE did not control the business and reasonably expected when the loan or investment was made that the business would continue to qualify during the term of the QLICI. While this safe harbor protects CDEs and investors from events outside of their control, some ambiguities remain. In particular, in the case of a

loan/investment default, CDEs may opt to modify the terms of the original loan or investment documents. Some investors have raised concerns that a modification equates to a "reissuance" of the financial instrument, as if the loan or investment were being newly made. This interpretation adds significant costs and delays to loan modifications. The cost of this process coupled with the risk the company no longer meets the QALICB test acts as an incentive to foreclose the investment entirely instead of modify the terms, eliminating any chance the business and jobs survive. With reasonable expectations intact, investors could pursue workouts more aggressively, giving QALICBs the best chance to regain success.

- *Adopt credit extension versus recapture in certain instances*: With low-income housing tax credits, certain compliance failures result not in recapture of credits but of delaying or extending when the investor can receive the credits. A similar approach with NMTCs would also give investors greater confidence that they will see some return on their investment even if mistakes are made, thus lowering the cost of investor capital and attracting more participants to the program. If extending the 7 year period is not an option, a partial recapture representing the duration in which the investment failed to qualify would also address this issue.

- *Modify "nonqualified financial property" definition*: Many businesses choose to own divisions of the company as separate legal entities, for liability or other reasons. Under the existing "nonqualified financial property" restrictions, shares of stock and membership or partnership interests are included in the definition. We recommend excluding these items from the definition where the entities are under common control.

Finally, we encourage the CDFI Fund to continue fostering a spirit of cooperation with other federal and state agencies that encourage similar investments to the NMTC program. For example, CDFI's efforts to work with the U.S. Department of Agriculture could be replicated with other agencies like the U.S. Small Business Administration.

3. Community Accountability

d. Should CDE activities be required to be coordinated with community stakeholders? If so, how should this coordination be conducted and demonstrated?

While it may make sense for CDE activities to be coordinated with community stakeholders in the context of large multi-tenant real estate development projects, such coordination efforts should not be required of CDEs who are financing operating businesses or businesses who are using the QLICI proceeds to finance the development of their own space. Such businesses rarely have community stakeholders who would offer relevant insight into the business's operations and need for capital. If the NMTC program required CDEs to establish community support or the buy-in of local stakeholders, this would be a particularly cumbersome and time-intensive process,

especially for CDEs who finance multiple small businesses in the course of a year. In those cases, a CDE should be allowed to exercise its own business judgment about whether it is an appropriate use of NMTC financing.

f. If a CDE has a Controlling Entity, should the CDFI Fund require that the Controlling Entity of the CDE also meets community accountability requirements? If so, what requirements should be applied?

Controlling Entities should not be required to meet community accountability standards. In many cases, Controlling Entities engage in multiple lines of business. Such diversification should be encouraged, not limited. Often the non-NMTC activities include experience raising and investing capital outside of low-income communities, providing additional tools and resources for CDEs to bring to bear in low-income community investing. To overlay NMTC requirements on these other lines of business could restrict private market activities that complement and supplement the CDE's specific activities. The CDFI Fund's accountability focus should be on the line of business that is dedicated to NMTC activities not unrelated matters.

4. Transaction Costs

a. Should there be greater disclosure of (and perhaps limitations on) the fees and other sources of compensation and profits that NMTC applicants propose and NMTC allocatees and their affiliates charge to (or receive from) their borrowers, investors or other parties involved in NMTC transactions? Should such information be made available by applicants and allocatees directly or through the CDFI Fund to the public or should it remain excluded from disclosure as proprietary business information?

In the allocation application, the CDFI Fund considers a CDE's overall business strategy (which includes fee structure and compensation plan) as part of its overall scoring determination. Because the program is so oversubscribed, CDEs have an incentive to modulate their fee and compensation structures to maintain a competitive advantage. We encourage the CDFI Fund to continue asking questions about how a CDE expects to achieve any and all economic benefits from their participation in the program. In the 2011 NMTC Application, applicants were required to complete Table F1, detailing particular types of fees or compensation, together with a companion narrative in Question 42. Because the Table requires CDEs to insert specific information in a particular form, it is possible that a CDE might not have to disclose information that falls "outside of the box Additionally, it excludes an analysis of the risk attached to different forms of compensation (i.e., escrowed back-end fees versus a profits interest that is only realized if the QALICB is successful). Further, because the narrative response in Question 42 is character limited to 5,000 characters, a CDE may have limited opportunities to describe its full compensation structure. To facilitate as much transparency as possible in the application process we propose that the CDFI Fund expand the character count in Question 42 to 25,000 characters, ask one or more open-ended questions designed to solicit a full and complete disclosure of the applicant's (and all affiliates') anticipated

economic benefit, and delete Table F1.

While we strongly support the CDFI Fund's application process encouraging as much transparency as possible, we do not believe that this information should be made available to the public. A CDE's methodology for structuring its financing products including how it funds its operations and earns a profit by means of the NMTC program is a core component of each CDE's business plan. Such information should not be made available to the public due to the likelihood of competitive harm as it could provide a "roadmap" for other CDEs to use in future application cycles.

b. Should the CDFI Fund provide an opportunity for CDEs that commit to limit fee and other forms of compensation to earn a higher score in the allocation award process? If so, please provide specific standards that could be used.

Because we believe that the competitive nature of the application process (aided by the increased disclosure on total compensation encouraged above) provides a natural curb against inappropriate fee and compensation structures for CDEs, we do not believe that the CDFI Fund should encourage CDEs to adopt a specific cap on compensation.

The CDFI Fund should continue to evaluate proposed fees and compensation as a component of a CDEs overall business strategy but should not single out questions related to fees and compensation as this single inquiry does not provide a full picture of a CDE's business strategy. For example, a CDE who provides higher risk capital for their QALICBs (e.g. venture capital investments or mezzanine capital or investments in earlier stage enterprises) may require a higher overall compensation amount to compensate for the higher level of risk involved in the investments. If the fee/compensation question were scored in isolation without corresponding point increases in other questions, such a CDE would be negatively impacted.

If the CDFI Fund were to implement or solicit a cap, however, we recommend that the cap be directed to risk-free compensation that a CDE obtains merely through participation in the program, such as up-front placement, syndication or origination fees.

c. Are there specific administrative or regulatory changes that would reduce transaction costs while preserving public policy objectives and safeguards?

As articulated in the NMTC Coalition's response to this question, clarification regarding the application of true debt analysis to NMTC investments would lower transaction costs across the NMTC industry. Because QLICIs made directly to QALICBs must be structured as either a loan or an equity investment for tax purposes (and not, for example, as a grant), investors routinely require that nationally recognized tax counsel provide an opinion that each loan or investment meets the applicable tax standard. Tax counsel, in turn, requires the borrower or CDE to procure a set of financial projections from an expert accounting firm in the NMTC industry; in many cases, the accountant will require additional third party appraisals or marketing studies to prove up the assumptions that underlie the financial model. In addition to the difficulties this can create for large real estate investments where appraisal values in very poor communities may stress the

analysis, the cost involved in procuring opinions (and financial projections and market studies) for small transactions can be prohibitively high.

One mechanism for reducing transaction costs that arise in connection with the true debt analysis would be for the IRS to issue guidance that a loan that fails to meet the tax requirements for indebtedness would be considered an equity investment.

6. Use of other federally subsidized financing in conjunction with NMTCs

c. Are there specific administrative or regulatory changes that could facilitate the coordination of other federally subsidized financing in conjunction with NMTCs while preserving public policy objectives and safeguards?

Combining NMTCs with other financing programs is a critical tool for raising capital in a NMTC transaction. This can be particularly true in the context of financing operating businesses where it is common to raise one or more pools of capital to use in multiple smaller QLICI transactions. Using a pool approach has a number of advantages: (1) up front and ongoing transaction costs are reduced because only a single CDE and single upper tier investment fund are involved; (2) the leverage lender has more economic protection with a cross-collateralized pool of lower tier investments; and (3) CDEs are able to make smaller loans.

Raising such pools is not without difficulty. As mentioned previously, the NMTC leverage rules prohibit an upper tier lender from having a direct collateral interest in the underlying QALICB's assets. Rather, the typical leverage loan structure requires seven-year, interest-only loans that are only secured by the upper tier investment fund's interest in the CDE and not assets of the business that is ultimately financed with the proceeds. The vast majority of conventional lenders, especially middle-market lenders who customarily provide business loans, are simply unwilling to make such a loan. One way to mitigate this concern is to provide credit enhancement on the QLICIs. For example, a CDE that has an SBA 7(a) or USDA license can directly originate loans that are 75-90% guaranteed by the full faith and credit of the U.S. government. Leverage lenders who typically shy away from the NMTC program are often willing to invest because of the underlying principal value of their loan is protected. The CDE is thus able to raise market rate leverage debt and combine it with low-cost tax credit equity to target its small business lending activity to businesses located in low-income areas. This is a "win/win" for both the NMTC and USDA or SBA programs. On the NMTC side, the CDE is able to tap additional sources of capital. On the guaranteed lending program side, the loan product is not just targeted to businesses in low-income areas but is also combined with even more capital than the guaranteed lending program itself can provide.

We encourage the CDFI Fund to continue working together with other governmental agencies to provide additional sources of financing for low-income community businesses that lack access to affordable capital.