Community and Economic Development in North Carolina and Beyond Blog: The Role of the NC Historic Rehabilitation Tax Credit in a Development Project

By CED Guest Author

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Last week, both the Senate and House of the North Carolina General Assembly included an extension of the state's Historic Rehabilitation Tax Credit (HTC) in their budget bills, allowing the credit to continue until January 1, 2024. The fact that both chambers included the extension in their budgets means it is highly likely that the extension will appear in the final budget to be approved by both chambers and delivered to the Governor for signature. This budget development was important enough that a national accounting firm included it in their news feed. Without the legislative extension, the tax credit would sunset on January 1, 2020—in other words, the state credit would be eliminated.

Why is the HTC's extension newsworthy? Why might some local governments care about the state HTC even though the credit can only be used by private taxpayers? One way to evaluate those questions is to look at a DFI project from 2014, which was the last time that the state HTC was allowed to sunset. The withdrawal of the credit that year, even temporarily, changed the fate of a historic building.

As background, the CED Blog contains multiple blog posts about the North Carolina HTC and the federal HTC (https://ced.sog.unc.edu/a-primer-on-applying-for-historic-tax-credits-and-the-national-historic-register/ and https://ced.sog.unc.edu/new-rules-on-historic-rehabilitation-tax-credits-and-where-credits-are-due/). These credits are critical tools to finance community economic development projects, but they also increase the complexity of development. HTCs can be leveraged with other tax credit programs including low-income housing tax credits and new markets tax credits.

The Prince Charles Hotel is centrally located in downtown Fayetteville, just across from City Hall. The hotel is over 100 years old and many people in the community have their own memories of staying at or attending an event inside this iconic building. The building is listed individually on the National Historic Registry and the City bestowed a local landmark designation on the building in the 1980s. Unfortunately, the hotel historically suffered from lack of investment and the City eventually closed the property October 2010 as it found the building unsafe. For obvious reasons, public perception of the hotel's condition and activity around it is important to the City.

<u>Loss of State HTC and Potential Investors Withdraw</u>

A few years after the hotel's closure, a group of local investors invested time and money into exploring whether the hotel could be adaptively re-used into apartments using North Carolina HTCs and federal HTCs. The proposed development plan—placing apartments into historic hotels—is common for historic structures and there are many examples across North Carolina including in Mount Airy and Monroe.

The City wanted to understand the likelihood that the investor group would be able to execute a redevelopment of the hotel, and it engaged the Development Finance Initiative (DFI) to look at the options for development. DFI conducted its typical research on the financial feasibility of redeveloping the hotel. Key lessons from DFI's research:

- *Historic renovations can be more expensive*. Retaining the historic elements of a building is expensive, so historic projects typically have higher construction costs on a dollar per square foot basis compared to new construction. These higher costs are typically associated with restoring historic components within projects such as windows, façade, and plaster work.
- *These projects can have lower program efficiency*. In a new building, a design team can ensure that leasable space is maximized in order to maximize revenue for the owner. In historic renovations, however, the design team is often constrained by historic components that are not leasable, such as wide corridors, public foyers, and auditoriums.

- *HTCs can offset some of the costs, and investors will invest in a historic building in order to receive historic tax credits*. Developers of historic buildings typically cannot use the North Carolina HTCs and federal HTCs generated by a historic rehabilitation project. Rather, a developer must find investors who want to use the credits. That is, the developer can syndicate ("sell") the tax credits to investors who can put the credits to use. When investors "buy" the credits, the developer can use the proceeds as equity for the project, offsetting some of the historic rehabilitation costs.
- *Market-rate apartments in downtown, historic renovations can generate higher rents*. Through simple market research, the investor group studied comparable projects. Market-rate apartments located in historic renovations in downtown communities, as compared to other high-quality apartments in that community, can earn higher rents because tenants prefer renovated historic buildings over other rental options.
- *Federal HTCs and North Carolina HTCs, together with higher rents, can make historic projects financially feasible for the private sector*. DFI's research demonstrated that tax credits could be used by investors to redevelop the hotel and retain the hotel's historic character. Returns for a private developer would be attractive enough that investors might be interested in the project.

However, the state budget enacted in summer 2014 contained a surprise for historic building developers. The budget allowed North Carolina's HTCs to sunset at the end of 2014. Federal HTCs were still available, but with state HTCs eliminated, there was significant uncertainty about the financial feasibility of redeveloping the hotel. In part due to this uncertainty, the original investor group withdrew its interest in the hotel. With no active interest from an investor group, the owner of the hotel decided to put the hotel up for auction. The owner hired an auction house to market the hotel and to conduct a public online auction in November 2014 with the actual sale occurring in early 2015.

This turn of events and short timeframe alarmed City officials. The City had no control over the owner or the auction, and City officials were concerned that a real estate speculator would acquire the property and sit on it. The hotel had already been vacant for years, and it was slowly deteriorating from inactivity. The City could not predict who might purchase the hotel, and the short timeframe for the auction would make it impossible for developers to perform due diligence, so the City was concerned that serious developers would not bid on the property. Would a new owner simply hold the property without investing in rehabilitation, allowing an important downtown building to deteriorate further? It was impossible to predict what a new owner might do.

DFI's 8-month contract ended in October 2014. DFI's work was complete, but the City nonetheless requested for DFI to notify potential developers and investors that the property was available. Through those efforts, a new investor group became interested in acquiring and redeveloping the hotel. However, the new investor group was not experienced with historic rehabilitation and the auction was approaching quickly. They asked DFI's director at the time (Michael Lemanski) to join their team as the developer due to his relevant prior experience as a private developer in downtown Durham, where he had completed similar renovation projects.

DFI is a charitable program that works for local governments—not private investors—so DFI could not assist the new investor group. The DFI director would need to join the development team in his personal capacity outside of DFI, which was possible because DFI's contract had ended and the City had no ownership of the hotel. However, if DFI's director agreed to work with the new investor group, it would mean that DFI could not assist the City with anything related to the hotel in the future because the director could not be on both sides of a transaction, assisting hotel owners on one side and assisting the City on the other. This was a difficult position for DFI. What was the best way for DFI to serve the City? Would it be better for DFI's director to assist the investor group in his private capacity outside of DFI, even though that would prevent DFI from assisting the City in the future with matters related to the hotel? DFI left the choice to the City: the City Manager was asked whether the City would prefer for DFI to remain available to the City, in which case the DFI Director would decline to work with the investor group.

DFI's contract had already ended, so there was no ongoing DFI work. The City therefore decided that it would prefer for the DFI director to work in his private capacity (outside of DFI) with the new investor group, with the understanding that DFI could not in the future assist the City with matters related to the hotel. The new investor group moved forward with acquiring the hotel from the owner—however, the investor group did not complete (or "close") its purchase of the hotel until after the City made its determination about DFI in writing.

New Investor Group Moves Forward without State HTCs

One unusual aspect of this project was the online auction format used by the private auction house. The new investor group entered the minimum bid set by the auction house ($200,000), and that amount turned out to be the winning bid. There were no other takers so the group won the auction and officially purchased the hotel in early February 2015. This online auction structure created even more uncertainty for the investor group as the auction prevented the investor group from completing significant due diligence prior to purchase.

Typically, developers of challenging and dilapidated historic structures would first seek to execute a Purchase and Sale Agreement (https://ced.sog.unc.edu/getting-it-under-control-acquiring-property-for-redevelopment-part-1/) with an extended due diligence period in order to fully underwrite the project. A developer would ordinarily hire architects to evaluate the efficiency of the building and propose ways to maximize leasable space. Engineers would be engaged to study the building condition and the soils. General contractors and cost estimators would evaluate construction costs and work with the architect on revision after revision of possible development plans to gain efficiencies and try to control costs. Those plans would be shared with lenders who would make their own determination about construction requirements and the amount of financing that would be available to the project (and if a lender could not be convinced to make a loan, the project would not proceed). A full development team would be assembled to iterate on the plans and conduct preconstruction activities. The cost of assembling that team would be “at risk” with no guarantee of success.

In this case, the investor group had even more risk because it had no time in advance to conduct some of the due diligence described above. In addition, State HTCs had officially expired, so the investors would need to figure out the project without that financing source.

State HTCs Return—Reduced—But Still Important Part of Capital Stack

One year later, North Carolina HTCs were restored by the General Assembly, but the benefits were reduced from earlier versions of the tax credit as described in this blog post. The investor group stuck with the hotel project. A parking solution had to be developed, and in June 2016, the City decided to locate a minor league baseball stadium adjacent to the hotel. Parking for the stadium could be leased by the hotel owners, solving the hotel’s parking issue. A lender for the project was finally identified in Fall 2017, and the hotel development broke ground in April 2018 with the following capital stack:

Project Sources	**Amount**	**Percent**
Equity	$2,500,000	16%
Loan	$9,300,000	58%
Federal Historic Tax Credit Equity	$2,600,000	16%
State Historic Tax Credit Equity	$1,800,000	11%
Total Sources	**$16,000,000**	**100%**

A critical source of the financing for this project was the North Carolina HTCs, which the investor group elected to syndicate for about 11% of the total project uses. Without the state and the federal historic tax credit programs, the investor group would not have proceeded with the project, as premium rents alone could not have overcome the higher costs for renovation and lower program efficiency of the historic building.

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