SECTION 3-7. FINANCIAL COMPONENT

3-7-1. POLICY.

a. General Financial Plan and Program. As a condition of eligibility for guarantee or interest loan assistance, a new community must be developed pursuant to a financial plan or program which must include provisions that will:

(1) Cover all anticipated project costs, including but not limited to, costs which will be met with funds to be borrowed under the obligations guaranteed;

(2) Demonstrate the manner by which, and the sources from which, these costs will be met including anticipated revenues from the project, financial resources of the developer, and borrowing;

(3) In the case of a private developer, provide assurances that the developer will have an adequate incentive, in terms of equity invested and expected return, for completing the approved project in an expeditious and efficient manner;

(4) In the case of a public developer, provide assurances that the difference between total revenues and costs over the development period will be sufficient to meet debt service and cover unforeseen contingencies;

(5) Set forth a procedure for periodic updating of the financial plan to take into consideration changes in costs, revenues, market conditions, and other relevant changes affecting the plan;

(6) Provide assurances that the project will not have an adverse long-term fiscal impact on the surrounding political jurisdiction;

(7) Indicate that the flow of revenues and costs are such that the project will reach the breakeven point or show positive cash flow after debt retirement within a reasonable period of time, and the supply of cash from
various sources will adequately meet the requirement each year;

(8) Demonstrate that the project will be financially feasible without Federal grants and provide an alternative cash flow statement which shows how project funds will be spent, or how lot sale prices will vary, to achieve the purposes of the Act, should federal assistance be provided;

(9) Show the financial impact of alternative assumptions with regard to costs, market demand, interest rates, and other factors.

b. Maximum Federal Assistance. The maximum outstanding indebtedness which may be guaranteed under the Act for any project shall be the following:

(1) In the case of a public developer not to exceed 100 percent of the sum of the NCDC's estimate of the value of the real property before development and its estimate of the actual cost of the land development, or

(2) In the case of a private developer, not to exceed the sum of 80 percent of the NCDC's estimate of the value of the real property before development and 90 percent of its estimate of the actual cost of the land development.

In no event shall the principal amount of the outstanding obligations guaranteed under the Act with respect to a single project exceed $50 million. The principal amount of interest loans outstanding under the Act at any time with respect to a single new community project shall not exceed $20 million. In the absence of a finding by the NCDC of exceptional need, interest loans and guarantees will not be available to assist the same project.

c. Security for Guarantee and Interest Loan Assistance. All obligations guaranteed under the Act or evidencing interest loans made under the Act must contain, or be issued subject to, such provisions relating to the security interest of the United States as may be required by the NCDC. These shall include
general provisions under which the United States shall acquire rights of subrogation on payment of a guarantee in addition to such special provisions relating to the security of the United States in the specific property, including real property being acquired and developed, or other property as may be appropriate. Unless otherwise required or approved by the NCDC, the security of the United States for guarantees will include a first lien on the real property of the developer (or such portion thereof as the NCDC may determine) owned or acquired in connection with the project.

3-7-2. DISCUSSION. Any new community project approved for guarantee or interest loan assistance must be found by the NCDC to represent "an acceptable financial risk to the United States" (Section 716 (a) of the Act). Such a finding is based on three tests. First, does the capital structure of the developer provide a sound basis for project development? Second, do reasonable projections of the results of operations indicate the project is viable? Third, do reasonable projections of the value of the government's security interest provide full coverage for potential liability or loss to the government?

a. Capital Structure.

(1) Ratio of Debt to Equity. Equity contributions to the developer - the legal entity issuing Title VII debt - serve two major purposes: they provide an incentive for effective project management and they "cushion" the risk of creditors, including the government as guarantor or direct lender under Title VII. No fixed equity requirement is imposed either by statute or regulation, but administrative standards are applied by the NCDC in determining whether a project represents "an acceptable financial risk" within the meaning of the Act.

(a) Basic Rule. In the absence of special considerations discussed below, the NCDC requires that, at the time a project agreement for guarantee or interest loan assistance is executed, equity must represent no less than 20% of the private developer's total capital structure and
debt no more than 80%. This ratio of 4 to 1 is drawn by analogy from the statutory requirement that at least 20% of the land value of private projects be financed from sources other than Title VII.

(b) Public Developers. In the case of public agency developers, the Act authorizes Title VII financing of 100% of land and improvements. Where general taxing powers are placed at the service of a publicly developed project, the NCDC will not impose a required ratio of debt to reserves, whether such powers are exercised directly by the public developer or support the project indirectly through a guarantee or other commitment of satisfactory scope by a unit of state or local government exercising such powers. In the absence of support from general taxing powers, however, the NCDC makes no distinction between public and private sponsorship in evaluating the adequacy of a reserve or equity cushion for debt.

(2) Composition of Equity. It is recognized that strict adherence to equity in a balance sheet sense might fail to reflect fair values of land available as a cushion for debt. Unrealized appreciation in value of the developer's land may therefore be considered as equity for purposes of the ratio of debt to equity, provided that short-term appreciation (in respect of land acquired less than three years prior to the date of filing a preapplication proposal) may account for no more than one-half the required equity (referred to as "soft" equity). Appreciation in land value above option price may be included as soft equity only if an escrow set-aside, letter of credit or other measure satisfactory to the NCDC provides assurance that the option will be exercised. As to the balance of at least one-half the required equity ("hard" equity), there must be a showing that tangible assets (which may include land at cost) are reflected in the developer's
balance sheet, with adjustments from book value in the sole discretion of the NCDC, or that cash expenditures for necessary predevelopment planning and other services have been made, in amounts totaling no less than 10% of total capitalization plus any percentage by which soft equity is less than 10% of total capitalization. The NCDC may exercise its discretion to disregard operating deficits incurred during the period of preapplication and application review in determining adequacy of the ratio of debt to equity. Under certain circumstances, subordinated debt may be treated as equity (see subparagraph (4) (e) below). But proceeds from a public offering of stock or subordinated debt may not be counted as equity for purposes of satisfying the initial ratio of debt to equity.

(3) Freestanding and Other Special Projects. To encourage projects of special difficulty and value, the NCDC may decide to assume increased risk through modification of the ratio of debt to equity. In the case of freestanding projects found to serve priority objectives of national growth policy, for example, there will ordinarily be little or no unrealized appreciation in land values, and the NCDC may determine to impose only the requirement for hard equity, thus permitting a debt to equity ratio of 9 to 1 rather than the usual 4 to 1. For projects of unusual merit in other respects, similar adjustments may be made which effectively increase the government's financial risk in order to achieve priority objectives of public policy.

(4) Composition of Debt.

(a) Maximum Guarantee Commitment. Commitment of guarantee assistance for a single project is limited in principal amount to the lesser of:

1. Funds demonstrated in cash flow projections acceptable to the NCDC to be required for Title VII

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purposes and not available from earnings or equity contributions (see subparagraph b. below);

2. The formula ceiling under the Act (in the case of private developers only) of 80% of estimated real property value plus 90% of estimated development costs (see paragraph 3-7-1. b); or

3. The flat ceiling under the Act of $50 million for any project.

In most cases, the first limitation listed above will govern. It is in the interest of both the developer and the government to reduce both financing costs and the use of guarantee authority by limiting the amount and term of Title VII financing to specific project needs. On the other hand, project needs must be realistically forecast and must include an adequate allowance for contingencies (of the order of 5% of total capitalization). Failure to assure adequate initial capital for the full development period is a difficult miscalculation to correct subsequently during a liquidity squeeze when additional equity may be costly or impossible to raise. While the terms of amortization of guaranteed obligations are not limited by statute or regulation, such terms will, like the principal amount of the guarantee commitment, be determined as a function of the developer's cash flow projections approved by the NCDC. For a full discussion of the terms of debt guaranteed under the Act, see paragraph 2-10-1. a (1).

(b) Maximum Interest Loan Commitment.
Commitment of interest loan assistance for a single project is limited in principal amount to the lesser of:

1. The NCDC's estimate, based on approved cash flow projections, of interest costs on indebtedness to finance
eligible Title VII activities (see paragraph 2-13-3 a (1)) during a period (not exceeding 15 years) estimated by the NCDC to be prior to substantial positive cash flow; and

2. The flat ceiling under the Act of $20 million for any project.

The timing of both principal repayment and interest payments on interest loans may be tailored to the cash flow requirements of the project, but principal repayment must commence no later than 15 years after the date of any disbursement. Disbursements will ordinarily be tied to payment dates for interest on the indebtedness in respect of which the interest loan is made, and under a pledge agreement may be made directly to a trustee or agent for the benefit of the holders of such indebtedness. See paragraph 2-10-1 a (3). Interest on the interest loan will be determined by negotiation at the time of initial disbursement but will not be less than a rate determined by the Secretary of the Treasury taking into consideration the current average market yield on outstanding marketable obligations of the United States with remaining periods to maturity comparable to the average maturities of the interest loan plus one-eighth of one percent. The NCDC, in negotiating the interest rate, will take account of the risk of default and the security against such risk.

(c) Combining Guarantee and Interest Loan Assistance. Because interest costs are eligible for financing from the proceeds of obligations guaranteed under the Act, interest loan authority will ordinarily be reserved to assist developers who do not seek guarantee assistance. The NCDC may determine to combine guarantee and interest loan assistance, however, based on a finding of exceptional need. Such a need might be found, for example,
due to the high costs of land acquisition and innovative features of a new-town-in-town serving priority objectives of growth policy but requiring debt capital in excess of the $50 million limit for guarantee assistance.

(d) Choosing between Guarantee and Interest Loan Assistance. Most public developers benefiting from tax-exempt interest rates will find the treasury-borrowing-rate-plus-1/8% statutory floor on rates for interest loans to offer no attraction. Guarantees will be attractive to such developers if supplemented with interest grants, since the grant will lower their effective cost of money below their tax-exempt rate to a hypothetical rate taking account of the federal guarantee as well as the tax-exempt status of interest (which the public developer must waive). Most private developers will also prefer guarantee assistance because it finances both principal and interest costs of land acquisition and development while the interest loan finances only interest costs and will have a negligible effect on the interest rates for financing of principal costs. The exception will be the large corporate developer with a financial position commanding a lower long-term interest rate in the market than the rates of obligations guaranteed under the Act after adjustment for program fees and charges. For such a developer, the interest rate on interest loans will usually be attractive though the cost of money for guaranteed obligations is not. As supplementary financing, the interest loan has the further advantages to a developer of permitting deferral of interest on the loan and of being exempt from escrow arrangements and cost certification procedures. In the case of a project well underway at the time Title VII assistance is sought, interest loans may be available though guarantee assistance is prohibited by administrative policy (see paragraph 3-1-8).
(e) **Other Long-Term Debt.** Included as debt in the debt to equity ratio are not only obligations guaranteed and interest loans advanced under the Act but all other forms of indebtedness issued or permitted under the project agreement to be issued by the developer and having a term of one or more years. Limited exceptions may be made for indebtedness conferring upon the lender no right of recourse against the general assets of the developer. Indebtedness which is fully subordinated to the satisfaction of the NCDC may be treated as equity rather than debt for purposes of the debt to equity ratio. The terms of subordination should ordinarily permit payments of both principal and interest to be made only to the extent that dividends and stock redemptions are permitted under covenants of the project agreement (see subparagraph (5)(a) below). If cash flow projections indicate a need for debt in excess of the $50 million guarantee limit under the Act, the developer must have firm commitments for such additional debt financing from sources satisfactory to the NCDC.

(f) **Standby Commitments.** The NCDC encourages payment at or prior to the first Title VII closing of all equity contributions necessary to support permitted debt (whether or not then issued). In appropriate circumstances, however, the NCDC will permit equity to be paid in as debt is issued, provided that both the required ratio of issued debt to equity and the same ratio of committed but unissued debt to equity are satisfied at all times. Committed but unissued equity must be supported by a letter of credit from an approved financial institution or other guarantee satisfactory to the NCDC which is issued to and paid for by the equity contributor, but which provides for payment on demand directly to the developer against issuance of evidences of equity participation.
Capital Restrictions During Development. Restrictions contained in the project agreement are designed to preserve the integrity of the developer's capital structure throughout the development period and to assure the application of needed capital resources for project purposes. These restrictions are applied to the combined resources of the developer and its subsidiaries subject to like restrictions as if they constituted a single entity. The restrictions govern (i) the flow of capital funds out of the combined entity, whether as return on or of capital or as new investments, (ii) the liabilities incurred as a function of the flow of capital funds into the combined entity and (iii) the general use of funds by the combined entity in current operations and the specific use of Title VII funds. Compliance with the restrictions is closely monitored through the financial and statistical reporting systems described in Section 2-13. Failure to comply is a financial default giving rise to the full range of remedies described in Section 2-15. The following subparagraphs provide a brief functional summary of the capital restrictions which are set forth in full in Article VI of Appendix 6.

(a) Capital Outflow. During the projected years of negative cash flow (usually about 5 years), a moratorium is imposed on all dividends and stock redemptions (except from the sale of new equity). Thereafter dividends and redemptions are limited to 50% of cumulative net earnings after taxes and after deduction of a lump-sum cushion of $1 million or (if greater) 5% of the initial capitalization (reflecting the provision for contingencies). Extensions of credit in excess of $150,000 are prohibited except in the ordinary course of business. Transactions with persons holding a 10% or greater interest in the developer require approval of the NCDC. Investments of the developer and restricted subsidiaries are limited to permitted investments of the trustee for escrowed funds (see