

Tax Lien Certificate Investing Summer 2024



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INTRODUCTION

The Tax Lien Certificate market is a \$5 billion niche subsector of the broader financial services industry that offers investors opportunities to capture significant returns through a low-loss, fully secured investment¹.

Tax Lien Certificates (“Certificates”) are issued by local governments and municipalities and sold at auction when property taxes on commercial and residential properties become delinquent. Certificates maintain a super-priority lien secured by the underlying property and relatively low Lien to Value (LTV) ratio. Investors that purchase Certificates gain the right to recoup the owed taxes plus interest, penalties, and fees when the property owner ultimately makes payment, otherwise known as a redemption. If the property owner fails to redeem within the allotted time, the investor may foreclose on the property and sell it for its market value (typically well in excess of the amount invested in delinquent taxes). Certificate investments are highly attractive due to the super-priority security, low LTVs, highly predictable repayment curves, and potential for outsized returns. Successful Certificate investors should expect to earn ~4% pretax ROAA and >20% ROAE. Unlevered yields average 10 – 15%; and cash on cash returns generally average >1.2x.

Investing in Certificates provides benefits to municipalities and homeowners. Municipalities generate cash flow that could otherwise be delayed for years to pay for schools, hospitals, emergency services and roads. Further, municipalities can outsource collection and legal burdens to the third-parties. Homeowners receive additional time to pay and stay in their homes while ultimately paying lower penalties and rates than if the municipality held the lien.

Over the past decade, the market has filled with mom-and-pop operators and individual investors due to the low cost of borrowing and strong trends in residential real estate. However, these investors have little staying power in today’s market. The institutionalized, long-term players are well positioned to capitalize, as inflation and higher interest rates increase supply of Certificates and decrease competition at auctions.

We see significant opportunity for investors over the next 24-36 months, as Certificate supply increases and the competitive bidding environment rationalizes. Tech-enabled players that span multiple geographies with adequate capital are poised to achieve outsized growth and returns.

¹Source: National Tax Lien Association

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1 INVESTMENT CHARACTERISTICS AND AUCTION PROCESS

Investors in Certificates earn returns through interest, fees and penalties charged by statute on unpaid taxes. If the taxes are ultimately paid by the property owner, the investor receives the tax amounts advanced plus interest, penalties, and fees. If not, the investor may foreclose on the property, acquiring it for well below market value, and then sell it, possibly for a gain. The investment's security is bolstered by the super-priority status of tax liens. Further, redemptions are highly predictable within local markets. Sophisticated investors can build large, granular portfolios of Certificates with unlevered yields of 10% - 15%. Meaningful leverage is available through bank facilities and an active securitization market to enhance returns. Asset class characteristics include:

	Typical Characteristic
Low Lien-to-Value ratios	<15%
Relatively small average transaction size; ability to build large, granular portfolio	\$10,000 for residential properties; commercial properties are larger
Highly predictable redemption curves	>95% in target markets
Short maturity	1 – 3 years
No fraud	All payments flow through the municipality
Secured lending	Super-priority lien status on the underlying property
Quality unlevered yields	10 – 15%
Highly financeable assets	90 – 95% advance rates
Significant cash-on-cash returns	>1.2x
Low losses	~20bps

SAMPLE CASH FLOW & UNIT ECONOMICS

Certificate investors generally acquire the initial Certificate and subsequent delinquent taxes (Subs) from the municipality. Interest, penalties and fees accrue during the term until redemption, at which point the total receivable is repaid.

All funds flow through the municipality. Investors fund and are paid by the municipality. Property owners redeem by paying the taxing authority. Investor funds never flow to the property owner.

The sample below outlines the cash flows an investor may expect in a typical Certificate investment.

IRR	15.0%
Cash on cash return	1.4x

CASH FLOWS

Quarter	Initial Certificate & Subs	Interest, Penalties, and Fees Accrued	Redemptions	Receivable Balance
	(\$10,000)	\$0	\$0	\$10,000
Y1 / Q1	(7,500)	600	0	18,100
Y1 / Q2	(2,500)	825	0	21,425
Y1 / Q3	(2,500)	938	0	24,863
Y1 / Q4	(2,500)	1,050	0	28,413
Y2 / Q1	(2,500)	1,125	0	32,038
Y2 / Q2	(2,500)	1,275	0	35,813
Y2 / Q3	(2,500)	1,388	0	39,700
Y2 / Q4	(2,500)	1,500	0	43,700
Y3 / Q1	(2,500)	1,575	0	47,775
Y3 / Q2	(2,500)	1,725	0	52,000
Y3 / Q3	0	1,800	0	53,800
Y3 / Q4	0	1,200	55,000	0

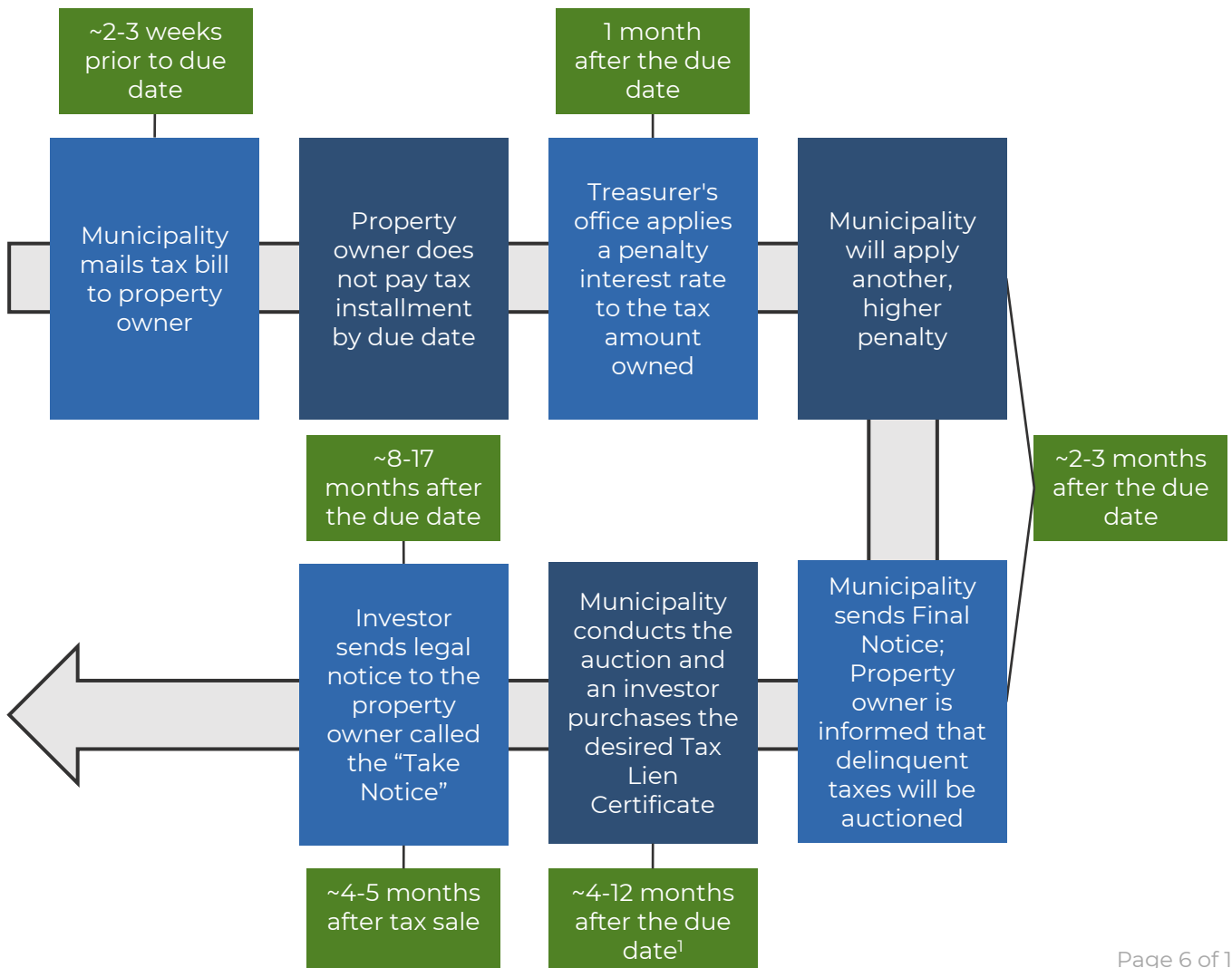
HIGH QUALITY ASSETS

<p>Attractive Yields</p>	<ul style="list-style-type: none"> ▪ Tax Lien Certificate portfolios generate yields that outperform other fixed income investments ▪ Auctions are competitive and may result in modest yields on the initial certificate; subsequent tax purchases result in significantly higher yields and enhance overall portfolio returns
<p>Minimal Credit Losses</p>	<ul style="list-style-type: none"> ▪ Super-priority lien ▪ Certificates are secured by the underlying property. If the Certificate is not redeemed, the property is foreclosed on, renovated (if needed), and sold ▪ Lien-to-value in the mid-teens
<p>Diversified Origination Strategy</p>	<ul style="list-style-type: none"> ▪ Certificate markets are hyper-local; supply, competition, and auction behavior can differ across municipalities ▪ Certificates can provide asset exposure to various geographies and property types
<p>High ROA and ROE</p>	<ul style="list-style-type: none"> ▪ High yields and low losses, coupled with a strong efficiency ratio and operating leverage, generate superior returns on assets and equity, well above other assets
<p>Opportunities to Securitize Portfolio</p>	<ul style="list-style-type: none"> ▪ Demonstrated ability to access the securitization market with investment grade ratings at scale ▪ Over \$500 million securitized in the last year across the industry

Certificates are sold via auctions held by the municipality. Auctions occur regularly (typically quarterly, semi-annually, or annually) and typically fall into the category of Bid Down (auction starts at a maximum rate, and investors bid lower rates, with the winner being the investor willing to charge the least) and Bid Up (Certificate earns a set rate, and investors bid a premium above the delinquent taxes that is paid directly to the county and does not accrue interest and fees).

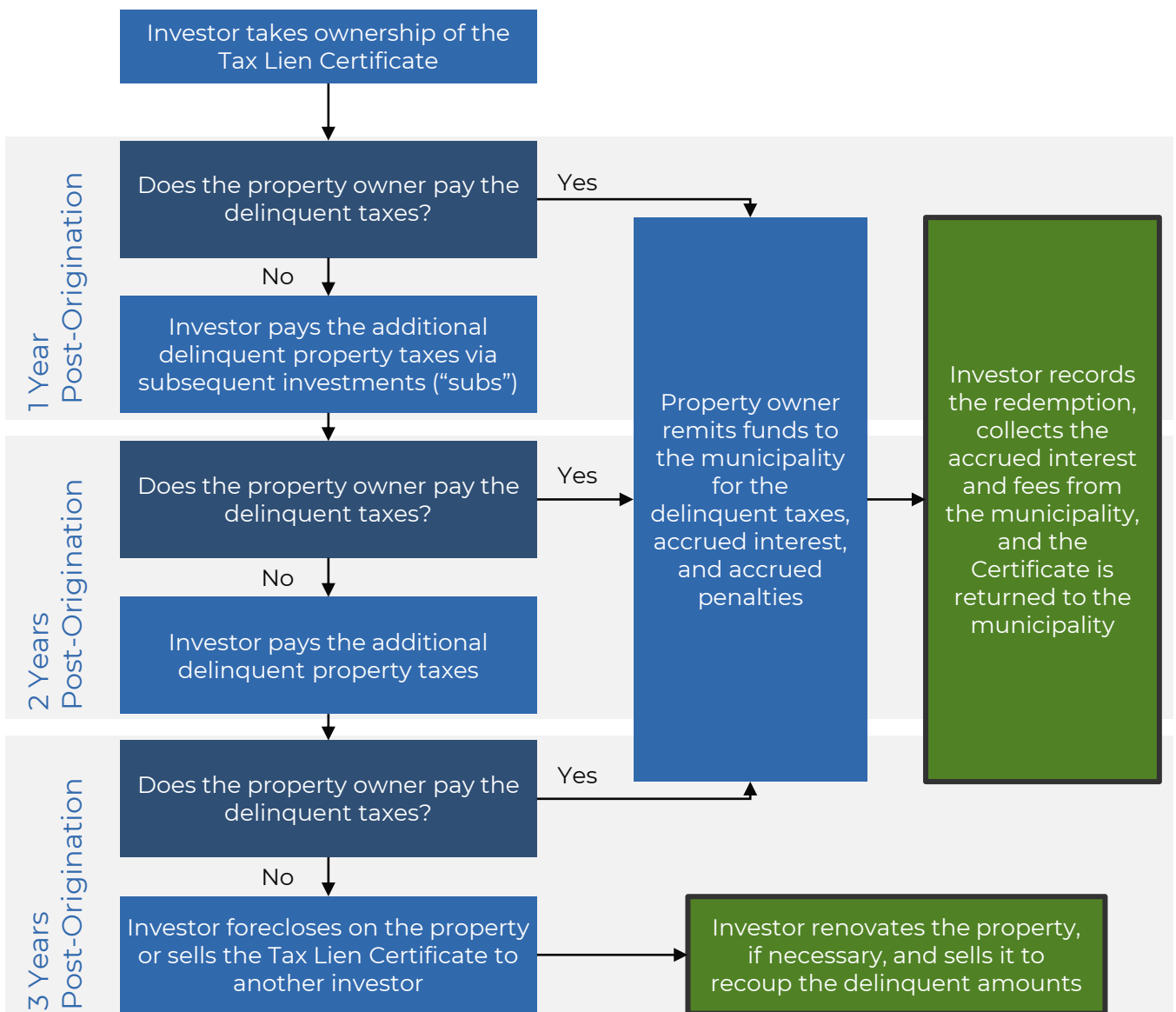
Auction processes and requirements differ widely by state, and even at the municipality level. Investors entering new markets must have a thorough understanding of all legal statutes surrounding the local auction processes. The complexity and nuance of the auction process are a major barrier to entry and a key reason why most investors focus on a single state or municipality.

CERTIFICATE ORIGATION TIMELINE



After an investor acquires the initial Certificate, the investor generally has the right to acquire any Subs. Purchasing Subs maintains the investor’s super-priority lien while also providing enhanced economics. Since Subs are not auctioned, the interest rate earned is typically well above the market rate of the initial Certificate and is often the primary driver of return to the investor. Successful investors in Certificates should expect to earn ~4% ROA and >20% ROE.

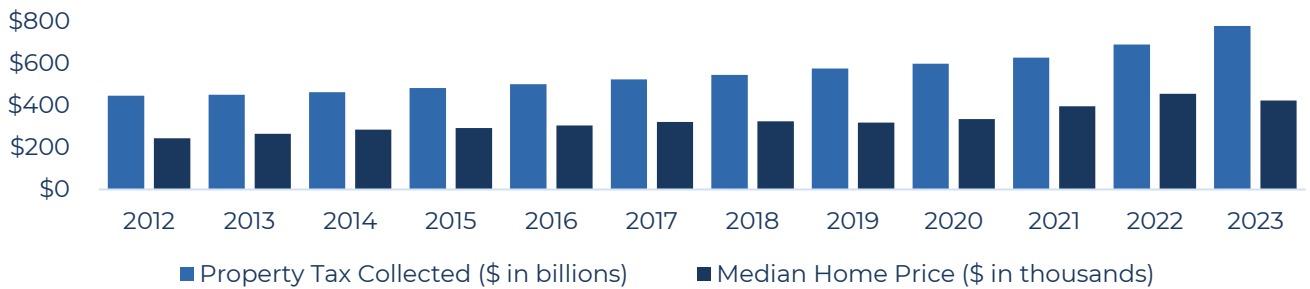
FROM AUCTION THROUGH REDEMPTION



2 EVOLVING MARKET DYNAMICS

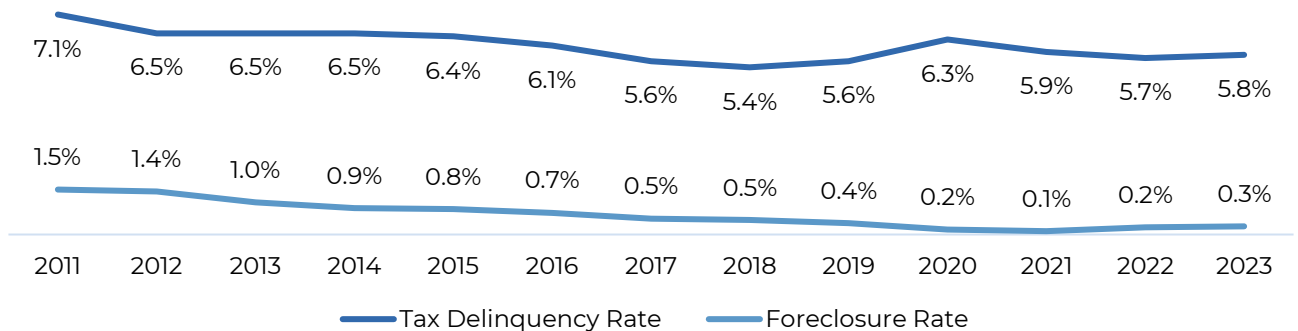
The national landscape for the Tax Lien Certificate industry is shaped by several key factors, including tax delinquency rates, home prices, and foreclosure rates. As of 2023, the U.S. has seen an increase in property tax delinquencies, driven in part by economic challenges such as inflation and rising interest rates. Median home prices have stabilized but remain high compared to historical levels, which has impacted homeowners' ability to pay property taxes on time.

RISING HOME PRICES DRIVE INCREASED CERTIFICATE SUPPLY



Foreclosure rates have also seen a moderate rise following the expiration of moratoriums related to COVID, with states like Florida, Illinois, and New Jersey experiencing notable increases in foreclosure activities. These trends underscore the importance of the Certificate market, providing a mechanism for local governments to recover owed taxes and for investors to earn meaningful returns.

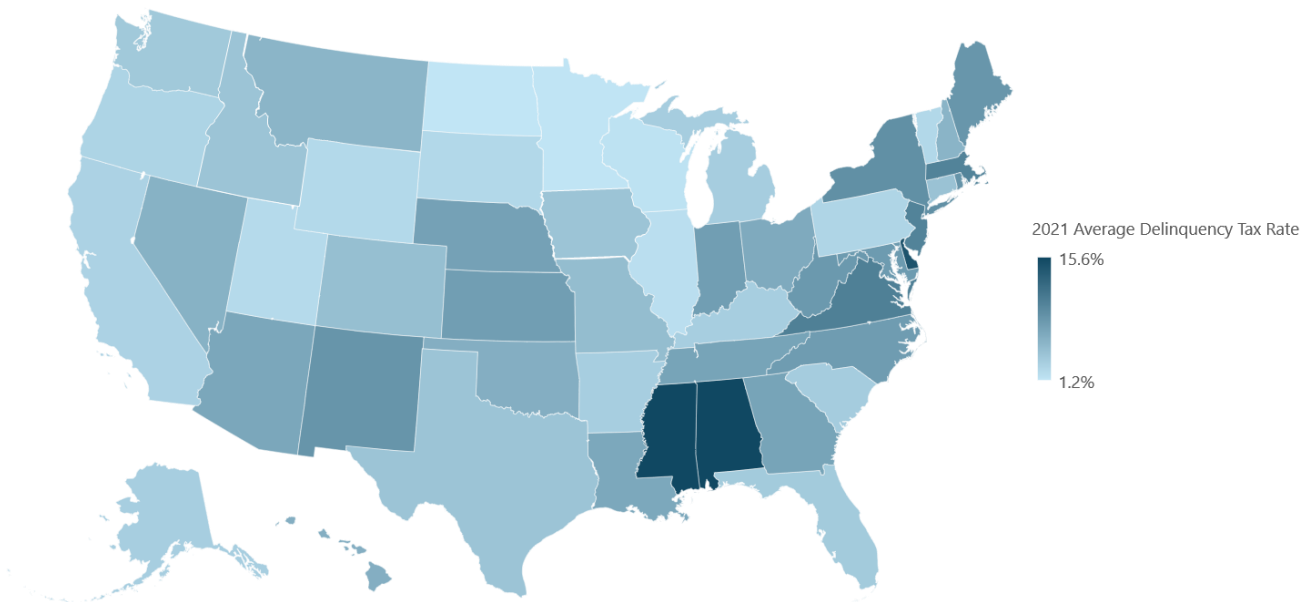
DELIQUENCY AND FORECLOSURE RATES ARE TRENDING UP IN 2023



Certificate supply generally lags delinquency by one to three years. It is expected that the impact of recent inflationary pressures and the 2022 and 2023 interest rate increases will result in increased Certificate supply in 2024 – 2026.

The same trends driving increased supply of Certificates are also impacting the investor universe. Buyers of Certificates that lack diversification and adequate capitalization are challenged to compete in current conditions, and there has already been an exodus of smaller participants from recent auctions compared to the prior years. For the market participants who can weather the storm, there is an opportunity to improve bid success rates at improved return profiles.

EVERY STATE HAS A MECHANISM FOR ADDRESSING DELIQUENCY



Delinquency rates vary regionally and by state, but each state has a mechanism for addressing delinquency and collecting revenue owed. The Certificate market spans 31 states in the U.S., each with varying rules. The largest markets in the U.S. for investors include New Jersey, Florida, and New York. Several states, such as Texas and Nevada, offer consumer loan products as an alternative mechanism to manage delinquent property taxes.

Each state, although impacted by similar macroeconomic factors, represents an independent sub-market, with its own microtrends and unique factors. Differentiating factors include the auction type (Bid Up vs Bid Down), deposit requirements, bid structure, and volume restrictions, etc. States also differ on the rates offered, the methodology of accruing interest, and timelines for foreclosure and redemption.

ROBUST SECURITIZATION MARKET

(\$ in millions)

Issuance Date	Series	Issuer	Kroll Rating	Type	Spread	Coupon	Size
May-24	2024-1	Alterna Tax Asset Group	Class A: AAA Class B: A	Fixed	Class A: 135 Class B: 225	Class A: 6.26% Class B: 7.14%	\$185
Feb-24	2024-1	RAM Financial Group LLC	Class A: AAA Class B: A	Fixed	Class A: 185 Class B: 300	Class A: 6.67% Class B: 7.79%	\$89
Sep-23	2023-2	PVOne Capital LLC	Class A: AAA Class B: A	Fixed	Class A: 250 Class B: -	Class A: 7.67% Class B: -	\$81
Jun-23	2023-1	PVOne Capital LLC	Class A: AAA Class B: A	Fixed	Class A: 250 Class B: -	Class A: 7.25% Class B: -	\$68
Apr-23	2023-1	First National Holdings	Class A: A	Fixed	-	Class A: 6.90%	\$141
Feb-22	2021-A	New York City Tax Dept.	Class A: AAA	Fixed	Class A: 55	Class A: 2.14%	\$89
Aug-21	2021-1	Home Tax Solutions LLC	Class A: A	Fixed	Class A: 110	Class A: 1.41%	\$105
Apr-21	2021-1	Finch Investment Group	Class A: AAA Class B: A	Fixed	Class A: 85 Class B: 125	Class A: 1.13% Class B: 1.53%	\$243

3 LEGAL AND REGULATORY ENVIRONMENT

Certificate investing is governed by state statutes for foreclosure and noticing and municipality statutes for servicing, noticing, and disposition. Otherwise, there is no regulatory or supervisory body.

Homestead laws and recent legal developments, such as the U.S. Supreme Court ruling in *Tyler v Hennepin County*, are affecting the way investors think about the industry. In *Tyler v Hennepin County*, the Supreme Court ruled municipalities are required to provide "just compensation" to property owners after foreclosure and has disrupted the market by ensuring excess proceeds are returned to owners and not collectible by the investor community or the municipality. This decision underscores the protection of property rights, ensuring that property owners can recover surplus equity. The ruling mandates that any proceeds exceeding the tax debt (inclusive interest, penalties, and fees) must be returned to the property owner, which aligns with historical property principles and the Takings Clause of the Fifth Amendment. This decision may influence future state legislation and impact how local governments handle tax foreclosures. This change is likely to force many real estate flipping-focused investors out of the market, clearing room for the more financial service-oriented investor to bid rates that result in stronger returns.

Homestead laws in states like Texas, Florida, and California also offer additional protections for homeowners, impacting the potential for property acquisition through tax liens. These laws protect a person's primary residence from foreclosure and forced sale, ultimately delaying returns, increasing the risk of loss of principal, and increasing the cost to exit.

4 CONCLUSION

The Tax Lien Certificate market offers a lucrative investment opportunity with diverse dynamics across various states. Understanding the specific auction processes and market conditions in each state is a critical yet overlooked aspect for new entrants. There are only a handful of national players within the industry, and as current market dynamics push out the less sophisticated players, the remainder stand to benefit from enhanced yields and outsized growth and improved returns.

We see significant opportunity for investors over the next 24-36 months, as Certificate supply increases and the competitive bidding environment rationalizes. Tech-enabled players that span multiple geographies with adequate capital are poised to achieve outsized growth and returns.

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