Opportunity Zones

SPECIAL REPORT

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By Mard Naman

Getting IN THE zone

Opportunity-zone tax breaks are great, but not nearly as important as the fundamentals of the investment.

Few new investment options have ignited as much interest, speculation, skepticism, hype and hope as qualified opportunity zones.

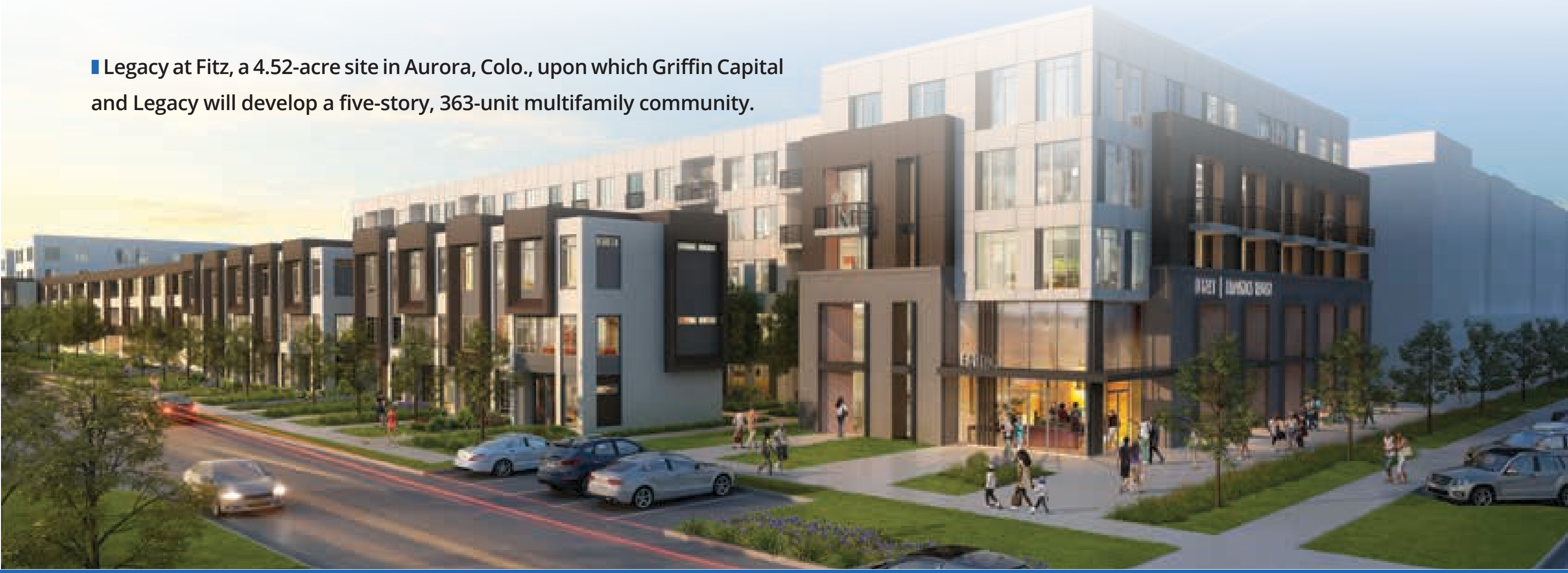
The opportunity-zone program was created in the Tax Cuts and Jobs Act of 2017 to incentivize investment in economically distressed areas throughout the United States and its territories, such as Puerto Rico. These zones are specifically in census tracts that meet the definition of "low-income community," and they are abundant — more than 8,700 of them.

Some zones are in areas already being revitalized and some are in thoroughly blighted areas, begging the questions: How good are the tax incentives, and how many enticing investment opportunities are there for real estate investors? (Answers: Very, very good, and nobody really knows yet.)

There is a lot to consider before deciding if you want to get in the zone or zone out.

First, the opportunity-zone program is structured to appeal to long-term investors: The longer investors keep their interests in the funds, the more tax breaks they receive. Investors can use money normally subject to capital gains tax from any source — not just real estate — to invest in opportunity funds.

Investors do not simply invest on their own. They must make all investments through a qualified opportunity fund (QOF), an investment vehicle organized as a corporation or partnership. An investor must invest the capital gains into a QOF within 180 days of the original asset sale.



Legacy at Fitz, a 4.52-acre site in Aurora, Colo., upon which Griffin Capital and Legacy will develop a five-story, 363-unit multifamily community.

Opportunity-zone investors get a deferment on the original capital gains tax until the earlier of December 31, 2026, or when they sell their interest in the opportunity fund. After five years, investors get the deferment plus pay no taxes on 10 percent of the original gains. After seven years, 15 percent of the original gains will not be taxed.

But the biggest benefit comes to those who hold for at least 10 years: They pay zero taxes on all capital gains from the opportunity fund investment. This is not a capital gains tax deferral or reduction; it is capital gains tax elimination. If, for example, an investor's $5 million investment in an opportunity fund doubles in value to $10 million after 10 years, the investor pays zero capital gain taxes on that additional $5 million upon exit.

"The benefits of the 10-year hold has brought the most excitement to the program," says Marla Miller, tax managing director with BDO's National Tax Office. And Jay Blaivas, partner in the federal tax group with law firm Morrison & Foerster in New York, says, "The tax breaks available under this program are essentially unprecedented."

By this he means they not only include the ability to completely avoid taxes on any gain realized after 10 years, but there are also virtually no restrictions or limitations on the amount of gain that can be excluded from taxation.

"The tax breaks are fantastic and arguably one of the largest tax incentives ever given by the federal government to investors," adds Clay Grubb, CEO of Grubb Properties, which develops multifamily and office in opportunity zones.

"If you match an investor with a long time horizon to a compelling investment opportunity, the potential there is strong," says Brad Alexander, senior adviser for McGuireWoods Consulting in Atlanta. "The question, of course, is how many really compelling investment opportunities will emerge from the program."

So many zones, but how many good ones?

Some early indications suggest there may not be as many compelling opportunities as investors would hope. A recent study claims that only a small fraction of the more than 8,700 opportunity zones are well positioned enough to produce the returns needed to justify the investment, even with the tax breaks. The *National Opportunity Zones Ranking Report* found only 2 percent of them could produce a "triple bottom line," meaning areas that would be profitable while having a positive impact on the community and the environment.

The study underscores the reality that when you designate that much raw land for special tax treatment, you are going to mostly have places that are unlikely to get projects in the program, Alexander says. "The best returns are going to come in areas that have factors that make them more compelling than just being in high-poverty census tracts," he says. "This includes development happening in adjacent tracts, access to infrastructure, and the willingness of government entities to partner on PPP deal structures in specific areas."

The majority of low-ranking opportunity zones in the report are within rural and suburban areas. But this does not necessarily mean investors should only stick to urban areas. It depends partly on the type of real estate. Alexander believes there will be more opportunities in rural and suburban areas for some project types. For example, distribution centers and advanced manufacturing can frequently locate outside urban nodes.

Do opportunity zones need to be near core real estate and, therefore, more conducive to redevelopment because of proximity to good infrastructure and highly valued assets? And how important are local demographics, such as median household income of the area, to make sure that the tenant base is solid or if there is expected rent and job growth in the market?

Again, Alexander argues it depends partly on the product type. Looking at median income is certainly important for higher-end residential projects, but many industrial projects can and do locate in areas with lower median incomes. PPP projects can also be less sensitive to local economics if the government is adding infrastructure in tandem with private development.

John Williams, president and CIO of Avanath Capital Management, says investors need to consider all the market fundamentals in order to get a complete picture of the asset's potential and make an informed decision. And some factors will outweigh others, such as how close the opportunity zone is to markets with strong growth industries and what the market drivers are.

Should investors take a long view on blighted areas they believe will turn around in 10 years? "The program really aims to incent investment in blighted areas, so the best returns are on projects that start with a low basis and offer massive gains as an area transitions," Alexander says. "Betting right on a blighted area turning around will offer the best returns. Unfortunately, betting wrong will not."

Institutional investors should definitely take a long-term view, says Phil Gross, tax expert and partner with Kleinberg Kaplan law firm in New York. If investors only want to take advantage of the deferral for a short amount of time, it is likely that many funds will not offer much liquidity, in order to meet the requirements of qualified-opportunity-zone funds for other investors.

There are many non-tax issues to consider as well, Gross says. How have opportunity-zone prices been affected in anticipation of the program's implementation? Have prices already increased so as to make the benefit not worthwhile? "You do not want to make a bad investment to save taxes," he says.

Location and fundamentals still key

Indeed, location is still paramount and investors must focus on the fundamentals of the deal for all opportunity-zone investments. "This is incredibly important," says Grubb. "The tax incentives will not make a bad deal good, but they can make a good deal great."

"While there appears to be a stampede to gain opportunity-zone tax benefits, it's good to remember that 'it's about the real estate project, stupid,'" adds Mark Edelstein, chair of Morrison & Foerster's global real estate group. Clearly, if the project is not sound and does not appreciate in value, there will be no tax benefits at all.

"Some people are looking for good real estate projects to invest in and consider the tax benefits the cherry on top of the ice cream sundae," Edelstein says. "This is a safer way to look at it." Investors should first make sure they are dealing

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Sound West OZ Fund I, LP - Marina Square

A Qualified Opportunity Fund

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MULTI-ASSET CLASS, INVESTOR CENTRIC, POSITIVE SOCIAL IMPACT

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PROJECT HIGHLIGHTS

- Marina Square will be a signature mixed-use, waterfront development at a "1st & Main" location, steps away to car and high-speed ferry service, transit center, and a yacht harbor, located just minutes from Seattle on Puget Sound. The 125-room Cambria Hotel tower (the premier brand of the Choice Hotel Group) will feature a waterfront restaurant, bar, fitness center, market, and conference center. The unique design will ensure every room has a view of the water, marina, and mountains.
- A separate high-end apartment tower will feature 145 urban-living apartment flats, all with views, and access to amenities which include: rooftop deck, fitness center, private clubhouse, business center and lounge.
- Both towers sit atop a subterranean, paid-parking garage for 382 stalls with distinct levels servicing the hotel, private residences, and marina.

KEY OFFERING DETAILS[1]

MAXIMUM OFFERING SIZE	LOAN AMOUNTS	TOTAL OFFERING COST	OFFERING LTC
$60,000,000	$71,790,150	$120,632,816	59.51%

MINIMUM INVESTMENT
$50,000

CURRENT CONSTRUCTION PROGRESS - 30-MONTH TIMELINE
APRIL 2019 - OCTOBER 2021
AS OF AUGUST 31, 2019 - 17.0% COMPLETE
(ON PHASE 2 OF 3)

PREFERRED ANNUALIZED RETURNS
SERIES A 12% (INCOME & GROWTH) | SERIES B 16% (GROWTH)

PREFERRED CASH FLOW AT STABILIZATION
5.00% (ACCRUED AND DISTRIBUTED) | N/A

[1]Based on current pro forma, policies and requirements outlined in the offering memorandum. There is no assurance preferred returns or cash flow will be achieved.

with reputable sponsors and developers and well-conceived, smartly underwritten projects, Edelstein emphasizes.

The property location, market demand for the property type, track record of the developer, comparable properties, and past projects in the area similar to the opportunity-zone project are all important to focus on, advises Derek Uldricks, president of Virtua Capital Management. Virtua develops primarily residential rental properties, as well as hospitality and commercial properties.

"Investing in blighted or otherwise low-income areas over the long term is inherently risky, and it's easy to imagine a lot of projects won't turn out as penciled," says Paul Fiorilla, associate director of research for Yardi Matrix.

Investors have to understand why a zone is low income to begin with, why demand for the area is low. Is the location too remote? Are there environmental or social factors? Investors need to understand such issues and answer why

Impact investing meets opportunity zones

Due to opportunity-zone investments, many low-income neighborhoods will see an uptick in investment, creating jobs, improving the housing stock and increasing property and sales-tax rolls, believes Mark Edelstein, chair of Morrison & Foerster's global real estate group. This means local governments will have more money to provide better services for schools, hospitals and roads. So, in theory, opportunity-zone investing should intersect nicely with impact investing.

Sean Burton, CEO of Cityview, also believes neighborhoods will be improved, but it is unclear whether the program will directly create more affordable or low-income housing. There is no requirement in the opportunity-zone legislation to build low-income or workforce housing. "Land, construction, labor and material costs are not any lower simply because you're developing in an opportunity zone, but the creation of opportunity zones may drive developers to locations that might otherwise have been overlooked, and help increase the overall housing stock," he points out. But, ultimately deals have to make sense financially.

That said, funds such as Grubb Properties, are focusing on affordable housing in opportunity zones. Clay Grubb, CEO of Grubb Properties, says young professionals struggle to find decent affordable housing near their work, and average rent for an apartment is beyond what 80 percent of millennials can afford. "Giving tax incentives to invest in development in emerging areas where class A properties will not succeed will force the development community to innovate to make housing more affordable," he claims.

Grubb notes one criticism of the program is it will increase displacement in many low-income communities the program is designed to help. Grubb's fund hopes to address this issue by working with community partners to make investments in opportunity zones. "We are working to commit a portion of our capital to community-focused projects in these areas, capping returns on projects and donating any excess back to the community, and not taking asset-management fees on the capital deployed in these areas," he says.

Marla Miller, tax managing director with BDO's National Tax Office, says high-net-worth individuals and institutions are increasingly looking for ways to diversify their investments in meaningful ways. The opportunity-zone provision is intended to bring new jobs and higher wages to underserved areas. "The opportunity-zone program provides a perfect vehicle to obtain potentially high returns on capital while also meeting the goal of social impact investing," she says.

The new tax incentive is a way to bring in new capital to build workforce housing in areas that otherwise would not have received the capital, says Dereck Uldricks, president of Virtua Capital Management. Virtua plans to build residential rental units in opportunity zones that address the need for workforce housing, and has partnered with local governments and community leaders to ensure their developments meet the needs of the communities involved.

Uldricks wants the positive impact to be long term. "We are not just looking to add temporary, minimum wage jobs," Uldricks says. For example, in communities where they develop hotels, Virtua has partnered with a management training program to provide opportunities for diverse job prospects, including executive management and other upwardly mobile jobs.

Avanath Capital Management has already been an impact investor in some of the markets that are now in opportunity zones. "It is consistent with our mission and capabilities to create a strategy for QOF investors," says John Williams, Avanath's president and CIO. "A main goal of our new initiative is to replenish and improve the stock of affordable and workforce housing in these economically challenged areas."

"Both opportunity zones and impact investing have the same goal — to improve economic conditions for underprivileged residents and neighborhoods," says Adam Hooper, co-founder and CEO of RealCrowd. Impact investing does this in a measurable way, and if economic and social improvements in markets with opportunity-zone investments can be quantified, Hooper believes there will be partnerships among the players in each camp. "In a best-case scenario, those partnerships would lead to more low-income and workforce housing development in the areas that need it most in this country," he says.

there will be demand for the new development, Fiorilla says.

Since opportunity zones are in low-income areas, Fiorilla says it helps for investors to be familiar with and prepared to take advantage of federal and state government support programs. "Tenants in apartments in low-income communities don't have the means to pay the higher rents that might be needed for a project to produce the kind of yield sought by developers," he cautions.

Manager selection crucial as new players rush in

Regulations on QOFs were purposefully streamlined and restrictions eliminated for ease of participation, BDO's Miller notes. "As such there is a risk that the QOFs may be operated by inexperienced professionals," she says. "It is very important for investors to perform their due diligence to mitigate these risks."

Indeed, many new players are rushing in, including hedge funds and investment banks. "There is a bit of a gold rush mentality going on right now, with everyone trying to stake a claim in some part of the opportunity fund food chain, in an effort to make money through the program," Edelstein says. "All sorts of advisers and managers seem to be popping up all over the place." This includes accountants and lawyers, too.

"Presumably, at some point things will settle down," Edelstein adds. "And undoubtedly, there will be charlatans and fraud, which could keep the government investigators, prosecutors and other enforcers busy."

So how can investors find the best fund managers? While the opportunity-zone program is new, people have actually been investing and developing real estate for a long time in many of the zones before they were designated as such — without the tax breaks.

"There are managers, sponsors and developers out there with a strong track record building in these locations, and that's exactly what investors should look for," says Sean Burton, CEO of Cityview, an investment management and development firm. Cityview focuses on developing multifamily and mixed-use projects in Western U.S. markets.

"There's no such thing as a good deal with a bad partner," Burton adds. He advises investors to be extremely diligent about whom they partner with because this will likely be a 10-year investment, at minimum. "You're going to be in business together a long time, so you want to find partners you can trust with experience and integrity," Burton says. A deal can look good on paper but without a strong partner, it's not going to be a good 10-year investment.

"There is a lot of hype surrounding opportunity zones and many inexperienced operators and managers are announcing large funds," Burton adds. "At this early stage, very few opportunity-zone fund transactions have actually closed." Ultimately, Burton believes the vast majority of sophisticated investors should and will end up selecting highly experienced managers who have done this before with a solid track record.

Grubb also emphasizes that a manager with a proven track record in opportunity-zone locations is especially valuable. Grubb Properties' opportunity-zone fund mostly targets the same markets they already have experience in, focusing on multifamily development along with value-add office where it brings synergy to their strategy.

"We can personally attest to the fact that investing in these regions is a good idea," says Avanath's Williams. Avanath has 14 assets in its portfolio in opportunity-zone regions. "Avanath has been active in these locations for more than 10 years without any tax advantages, so having those tax breaks will continue to enhance their value," he says.

To qualify for the tax breaks, investors must substantially redevelop an asset. Interestingly, only four of Avanath's 14 assets located in opportunity-zone regions warrant the extensive redevelopment required to qualify for the tax advantage.

As such, Williams says funds must evaluate opportunity-zone transactions using the same benchmarks they use for any other real estate investment. "They must determine if the market where the asset is located is fundamentally healthy, what its drivers are, the headwinds it faces, and how future events might impact it," Williams says. Investors must vet not only the property sector with those benchmarks, but also whether it is wise to invest a large amount of capital to redevelop the asset itself.

Avanath prefers multifamily because of its stability over the long haul. "Multifamily — particularly the workforce/affordable housing sector — is facing strong demand with limited supply, and will always be needed in both expensive and underserved markets," Williams says.

Investors should seek fund managers who have studied the tax code and can demonstrate a thorough knowledge of opportunity zones and what the benefits and rules are, says Adam Hooper, co-founder and CEO of RealCrowd. "These managers should have a track record of successful investments after tax-code changes and be able to explain to investors how they keep current on the rules and any changes that occur," Hooper says.

Effect on the broader real estate market

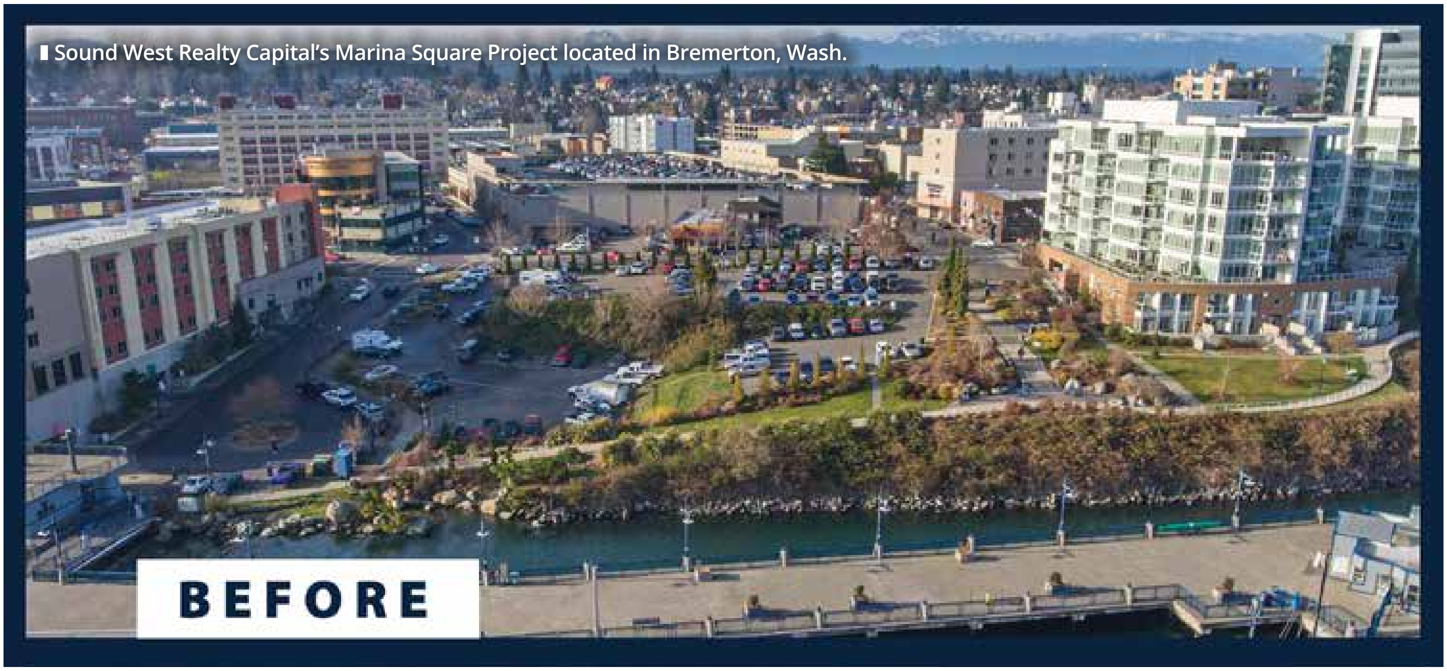
Grubb believes opportunity funds will not only bring a new influx of capital into the real estate market, but also a shift of focus and strategy to accommodate development in these areas. For example, he says about 75 percent of new multifamily construction since the great recession has been in class AA luxury development, which is really only affordable for residents making a significant amount more than an area's median income.

"This type of development does not suit most residents in an opportunity zone," he says. Grubb Properties strives to develop multifamily products that cater to resident making between 60 percent and 140 percent of an area's median income and deliver a high-quality product at a more affordable monthly rent. "This type of smart development is essential to success in opportunity zones," he says.

Williams believes the legislation will shine a light on the country's least fortunate areas and underscore the need for quality affordable housing in those areas. Once that housing is in place and other opportunity-zone investments begin to take hold, he says nearly every property sector will want to get involved, which will cause business to spread to the broader real estate market.

Property owners, developers, real estate funds and certain low-income markets all stand to benefit if the program takes off as intended, Edelstein believes. He says property owners in desirable opportunity zones are already seeing escalations in property values and many are selling at unexpected profits.

Hooper says property owners in opportunity zones will see revitalization of neighborhoods and surrounding assets, which should increase those assets' values. Developers will have a more streamlined path toward tax



Sound West Realty Capital's Marina Square Project located in Bremerton, Wash.

incentives and less red tape to contend with compared with other more complex incentive programs. Real estate funds will have fresh areas to invest and a new set of clients eager to improve underserved markets, and the markets themselves will certainly benefit economically and aesthetically.

All that said, Alexander from McGuireWoods believes developers are best poised to benefit from the program, mainly because he expects the supply of funds to exceed the number of compelling deals over the short term. "This puts developers who can put quality projects together in the most advantageous spot," Alexander says. "Bear in mind that opportunity zones are opportunity zones because they are hard to do projects in. So you need a strong local developer to turn theory into reality," he cautions.

Guidance delays slow fundraising

Many investors have remained on the sidelines, figuring out their approach to opportunity zones. A big reason is that the government has been slow to provide additional guidance about how the program works and finalize regulations.

BDO's Miller agrees this initial lack of guidance caused a delay in many investments and slowed fundraising. While the proposed regulations issued last October were generally taxpayer friendly, many important questions remained unanswered. This included the ability of a fund to churn investments, exit strategies, the definition of "substantially all" as used many times in the proposed regulations, and the criteria around 50 percent of the gross income of a qualified-opportunity-zone business (QOZB) needing to come from the conduct of a business inside the opportunity zone.

In April 2019, the U.S. Treasury Department and IRS issued a second set of proposed regulations that provided guidance on many of these issues. According to a Treasury Department press release, the guidance makes it easier for funds to ensure compliance with the requirement that a fund has 90 percent of its assets invested in opportunity zones and expands the working capital safe harbors.

A key part of the new guidance clarifies what is meant by the "substantially all" requirements for both the holding period and use of opportunity-zone properties. At least 70 percent of the property must be used in a QOF. The property must also be a qualified opportunity-zone business property for at least 90 percent of the QOF's holding period. And the partnership or corporation must be a qualified opportunity-zone business for at least 90 percent of the QOF's holding period.

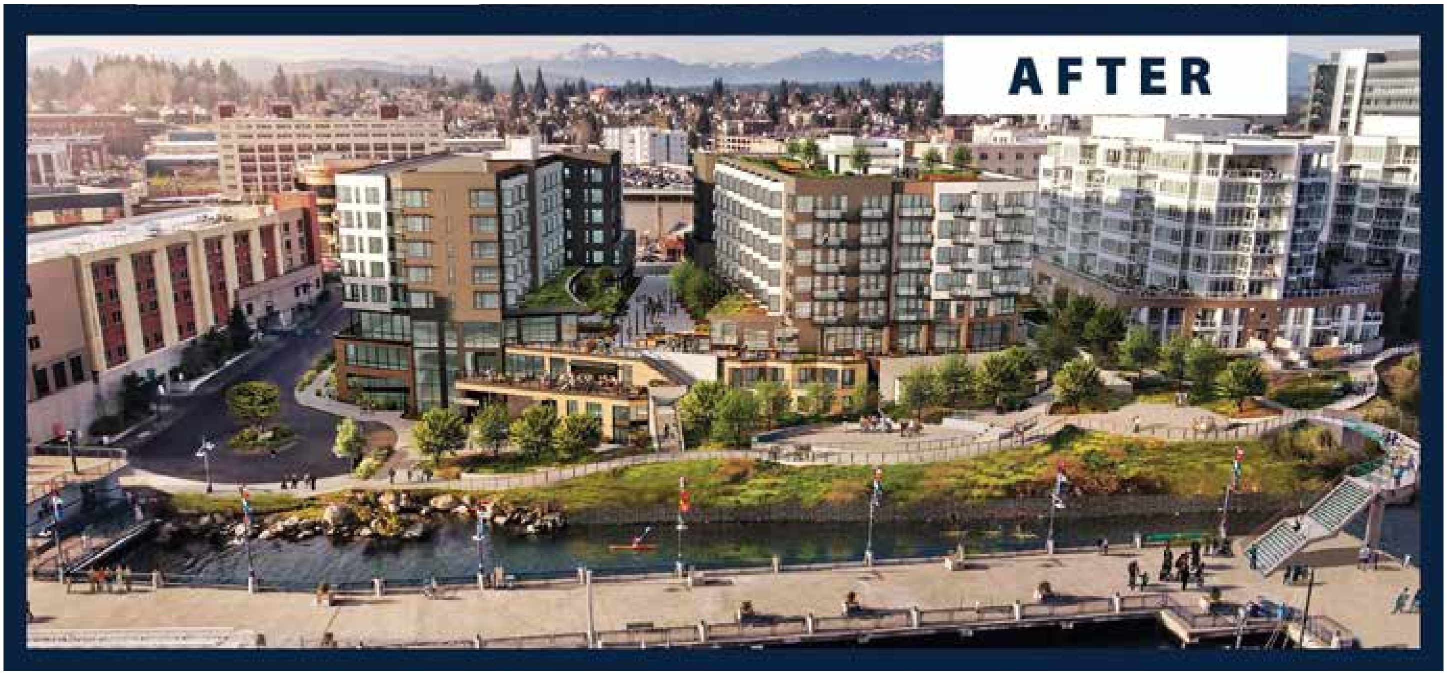
Also, the proposed regulations provided three safe harbors with respect to the requirement that 50 percent of a QOZB's gross income be derived from the active conduct of a trade or business in the QOZ. These favorable and flexible rules were welcome news for businesses.

"With this second tranche of guidance, Treasury and the IRS made substantial progress in providing a more robust regulatory framework for investors, communities and businesses," according to the Economic Innovation Group, a bipartisan public policy organization. A third and final round of regulations is anticipated later this year, and will focus on reporting requirements and anti-abuse policies.

A public hearing in July 2019 about the new set of proposed regulations showed that, while progress is being made, investors and developers still have many questions about the regulations, including the exit strategies for QOFs with multiple assets. Hopefully, all major issues will be clarified soon. "Once the additional guidance is released, we anticipate a spike in activity," Miller predicts.

Even with the delays, Miller says more than $20 billion is currently being raised for investments in opportunity zones and more than 100 qualified-opportunity-zone funds have already been created. Many more funds are building a pipeline of properties and investors, but are waiting until additional guidance is released before moving forward.

Most of these funds focus on multifamily, residential, hospitality and retail properties so far, she says. "As additional guidance is released, we anticipate seeing even more funds focused



Comparing opportunity zones to 1031 exchanges

"Opportunity-zone investments are like 1031 exchanges on steroids," says Sean Burton, CEO of Cityview, an investment management and development firm in the multifamily space. He believes opportunity zones offer many of the benefits of 1031 "like-kind" exchanges, but added tax incentives make them even more valuable. On the other hand, there are significant limitations to opportunity-zone investments and benefits that may make 1031 exchanges more appealing to certain investors.

Similarities and differences between the two include:

• 1031 exchanges defer taxes until a sale, while opportunity-zone investments allow for elimination of taxes (up to 15 percent on the contributed gain, and up to 100 percent of the gain on the new investment).

• 1031 exchanges allow you to invest only real assets, while opportunity-zone funds allow the investment of any capital asset.

• 1031 exchanges require that all proceeds, plus $1, be invested, while opportunity-zone funds require that only capital gains be invested.

• Both 1031 exchanges and opportunity-zone funds give investors 180 days to close on the investment.

• 1031 exchanges require an intermediary, while opportunity-zone funds do not.

• Both opportunity-zone funds and 1031 exchanges allow investors to offset operating income with depreciation from the asset. With 1031 exchanges, you have to pay taxes on the recapture of the depreciation at sale, whereas opportunity-zone funds do not pay taxes on depreciation recapture.

• With opportunity-zone funds, assets must be substantially improved to qualify, and 90 percent of the investment (or 70 percent if it is via a subsidiary entity) has to be in an opportunity zone.

• The only requirement for 1031 exchanges is that the investment must be a real asset. There is no improvement or geographic requirement.

• With 1031 exchanges, you do not need to hold the asset for at least 10 years, but with opportunity-zone funds, you do, in order to take full advantage of the tax breaks.

Additionally, there is no permanent deferral of the tax on the original opportunity-zone investment gain; however, much of that obligation may be reduced during the opportunity-zone holding period, according to Evan Hudson, partner with Stroock & Stroock & Lavan law firm in New York. "The investor must be ready to pay tax on that gain in 2026," Hudson says. "In a 1031 exchange, conversely, an investor may avoid gain recognition indefinitely."

And importantly, opportunity-zone investments are likely to be in riskier areas. Usually, if a region has been economically hot for years, with an educated workforce and highly paid jobs, it will not be in an opportunity zone. "A qualified opportunity-zone investment is, with few exceptions, automatically not core real estate — it is generally automatically opportunistic just by virtue of the market targeted," Hudson says. 1031 exchanges, on the other hand, have no such limitations and can be anywhere.

Lastly, opportunity zones are still new and much is unknown. "Regulatory guidance, best practices and market standards are still evolving," Hudson says. "1031s have been around a long time, and investors know the lay of the land with them."

on strategic businesses in opportunity zones," Miller says.

Grubb believes a primary issue with opportunity funds will be the ability to deploy capital raised, which is why Grubb Properties has targeted a $200 million raise. "I've seen projections that as much as $300 billion to $500 billion could come into the space over the next two years, and fund managers who aren't disciplined could find themselves going awry of regulations or making bad deals just to deploy the capital," Grubb cautions.

Best bets for investors

Miller says the primary property types being purchased in opportunity zones are undeveloped land, vacant buildings, and low-quality, class C commercial and multifamily properties. "These types of properties are best suited for the substantial improvement requirement in the regulations and potential for increase in appreciation," she says.

RealCrowd's Hooper believes assets in all sectors can make smart opportunity-zone investments, but the healthiest sectors and those with the best long-term potential are multifamily and industrial. Regions that have the ability to support growth and revitalization, such as Los Angeles, New York and the San Francisco Bay Area, will be less risky than zones in areas that may not yet have the infrastructure built up, Hooper says.

While gateway markets such as Boston, New York City, Washington, D.C., Chicago, San Francisco and Los Angeles are prime targets for opportunity-zone investments, Miller believes the program levels the playing field for non-gateway cities, and Philadelphia, Baltimore and Portland, Ore., have all had a lot of recent activity. Miller has also seen a spike of activity in Denver, Nashville, Seattle and Puerto Rico.

Importantly, some non-gateway cities have opportunity zones located directly in the downtown area, making the locations very attractive. "Successful cities are promoting the infrastructure, credits and grants available," Miller says. They are also often streamlining the zoning and permit process. As a result, investors should review state and local credits and incentives to see if they can "stack" benefits.

For example, there are 53 parcels in the city of Philadelphia that are in both the qualified opportunity zone and also in the

Pennsylvania keystone opportunity zone. "If you purchase one of these properties, you could participate in both programs," Miller advises.

Successful commercial real estate requires the demand to lease space that leads to increased cash flow, Fiorilla from Yardi Matrix notes. "If a company builds in a depressed area with an attitude of 'if I build it, they will come,' those kinds of deals are unlikely to produce great results," Fiorilla says.

Ultimately, Fiorilla believes opportunity zones may be most successful in areas that might be revitalized by larger forces, such as a new stadium, the relocation of a large employer, growth in an industry, or even housing connected to new or improved public transportation. "That's why investors must have hyper-local knowledge of projects," he says.

Cityview likes West Coast markets for opportunity-zone development and investment. Many urban, West Coast areas have strong demographic, job and income growth, a highly educated workforce, and lack of supply. "It's more about where these real estate fundamentals are strong than it is about opportunity zones," Cityview's Burton says.

Cityview is currently pursing multiple projects in opportunity zones in close proximity to major sources of employment, education, transportation, entertainment, shopping and dining. "We seek projects in thriving areas that continue to grow — the kind of locations we want to invest in regardless of the added tax breaks," Burton says.

Investors also need to consider barriers to entry in supply. In Dallas, for example, there are strong demand fundamentals, but local laws make it easier to build new products, Burton says, increasing the risk there may be a glut of new apartments. "This can create a challenging investment environment, especially over 10 years," Burton says. Even if the city continues to grow on the demand side, supply may not be constrained. "Once again, the opportunity-zone legislation is not as relevant as the fundamentals of the investment," Burton says.

But others like markets such as Dallas. Virtua, for example, is focusing its efforts on residential developments in high-growth. Sun Belt metro areas such as Phoenix, Austin, Dallas and Atlanta. "We view single-family rental properties as one of the best investment opportunities considering the emergence of the millennial workforce," Virtua's Uldricks says. As far as the supply/demand balance, Uldricks says, "We are targeting markets that are in need of supply; we would never want to build in an area where supply is outweighing demand."

Grubb believes anchors, infrastructure and demographics are critical to successful opportunity-zone investing, just as they are in all real estate investments. But as a multifamily developer, he defines "anchor" differently than a traditional retailer would. His favorite anchors are hospitals and colleges. Grubb Properties, for example, is currently building apartments in Winston-Salem, N.C., in a joint venture with Wake Forest University, next to its new medical school — a project located in an opportunity zone.

"Our focus as a company is on providing multifamily housing in urban areas where the highest concentration of jobs and infrastructure already exists," Grubb says. "What is missing in these locations is moderately priced rental housing."

Good opportunities in low-ranked areas?

The National Opportunity Zones Ranking Report found zones in Portland, San Francisco, Seattle, Philadelphia, Baltimore and New York/New Jersey scored highest for "smart growth potential." They scored highest for housing diversity, walkability, job density and proximity to CBDs. At the other end of the spectrum, Charlotte, San Antonio, Orlando and Dallas scored lowest for smart growth investment potential.

No one disputes the smart investment potential in top-ranking cities. "That doesn't mean markets ranked lower couldn't overcome those obstacles, but it would take a concerted effort between their governing bodies and the private sector to achieve that potential," Hooper says.

Avanath's Williams believes the rankings may not fully account for additional incentives, public/private partnerships and technological advances that could make these projects profitable, sustainable and impactful in a positive way. "Our industry is rather resourceful and once the light has been shown on the need for these projects, innovative ideas for making them pencil should surface," Williams adds.

Grubb believes the report is biased toward traditional tier 1 markets. Four out of Grubb Properties' last 10 multifamily projects have been in lower ranked opportunity zones, one of which is a seed asset for their opportunity fund. "All those projects were secured prior to the designation of the zones and are within our strategy in non-opportunity-zone funds," Grubb says.

The projects are in Virginia, North Carolina and South Carolina. "These are states that do not have a single opportunity zone within the top 10 percent of zones, according to the report." Grubb says. He is finding viable projects across the Southeast, mid-Atlantic states and Texas, and expects to continue exceeding investors' targeted returns in future deals in those same submarkets as they have prior to their designation as opportunity zones.

"I don't think the opportunities are scarce, and I think the report fails to appreciate the changes that will occur in many of these submarkets as a result of these new investments," Grubb says.

Charlotte, for example, is currently constructing a railed streetcar that will run through the center of its opportunity zone. This streetcar will link Charlotte's center city, the highest concentration of employment in the Carolinas, with a major health system and three significant colleges. "To think that won't result in smart growth is shortsighted," Grubb attests.

Avanath currently invests in a number of high-ranking markets, but does not discount other markets for their potential. For example, Avanath owns a property in North Carolina located in an opportunity zone that was constructed with very low density. "The new tax incentives may prompt us to increase density at the property by adding new workforce housing units — a strategy we would not have traditionally considered prior to this new legislation," Williams says. "That may be one way to encourage smart investment in some of the lower-ranking markets."

Oversupply risk

Clearly, not all opportunity zones have similar appeal. Some areas are already on their way to revitalization, while others will likely remain blighted for the next 10

Caliber Development's Double Tree by Hilton – Tucson Convention Center Hotel years to 15 years, regardless of investment. Since most investors will probably invest in areas already being revitalized, is there higher risk of supply exceeding demand in those regions, depressing price growth and negating the benefits of the tax break?

Burton thinks there is risk investors will invest in opportunity zones not because of fundamentals, but because of the tax breaks. This could result in some markets becoming oversupplied, which may cause long-term pressure on rents and occupancy. "This is why investors should focus on high-barrier-to-entry markets and work with firms that have experience building that product in that market," Burton says.

Hooper also acknowledges some oversupply risk, but says the likelihood is diminished because development underwriting has been much more controlled since the last recession. "As long as they continue to monitor market dynamics and the amount of development already planned for an area, supply and price growth should remain in check," Hooper says.

Investing through cycles

Since most believe we are at the tail end of a very long cycle, some opportunity zones may be hit hardest and be slowest to recover from a down market. If these investments suffer from lower valuations, increased vacancy rates, and flat or declining rents in the next few years, how much less appealing does that make opportunity-zone investment?

Hooper notes almost all investments tend to suffer during economic downturns, but since most investors will hold opportunity-zone investments for at least 10 years, it is likely any asset purchased as such will eventually ride out a downturn before the investor exits. "This will give the valuations, occupancy rates and rental rates in those markets time to recover," he says.

As an affordable housing investor, Williams adds that the asset class performs regardless of the economic cycle. "In fact, in economic down cycles, demand for affordable housing goes up," he says.

Grubb also points out that a multifamily investment strategy is demographically driven. Over the next 10 years, he says more young people will be entering prime apartment-renting age than ever before in our country's history. "We believe that combining our traditional strategy of developing value-based urban housing with the added incentives of the opportunity zones is actually a defensive strategy for the coming decade," he says.

Making it work

To make opportunity-zone investments work, it comes down to finding good locations in great markets and partnering with an experienced sponsor with whom you want to be in business for the next decade, Cityview's Burton concludes. "Good real estate and a good partner are the fundamentals of a strong opportunity-zone deal," Burton says. "On top of that, you get a tax break, but without the first two, that means nothing. You really need all three." ●

Mard Naman is a freelance writer based in Santa Cruz, Calif.

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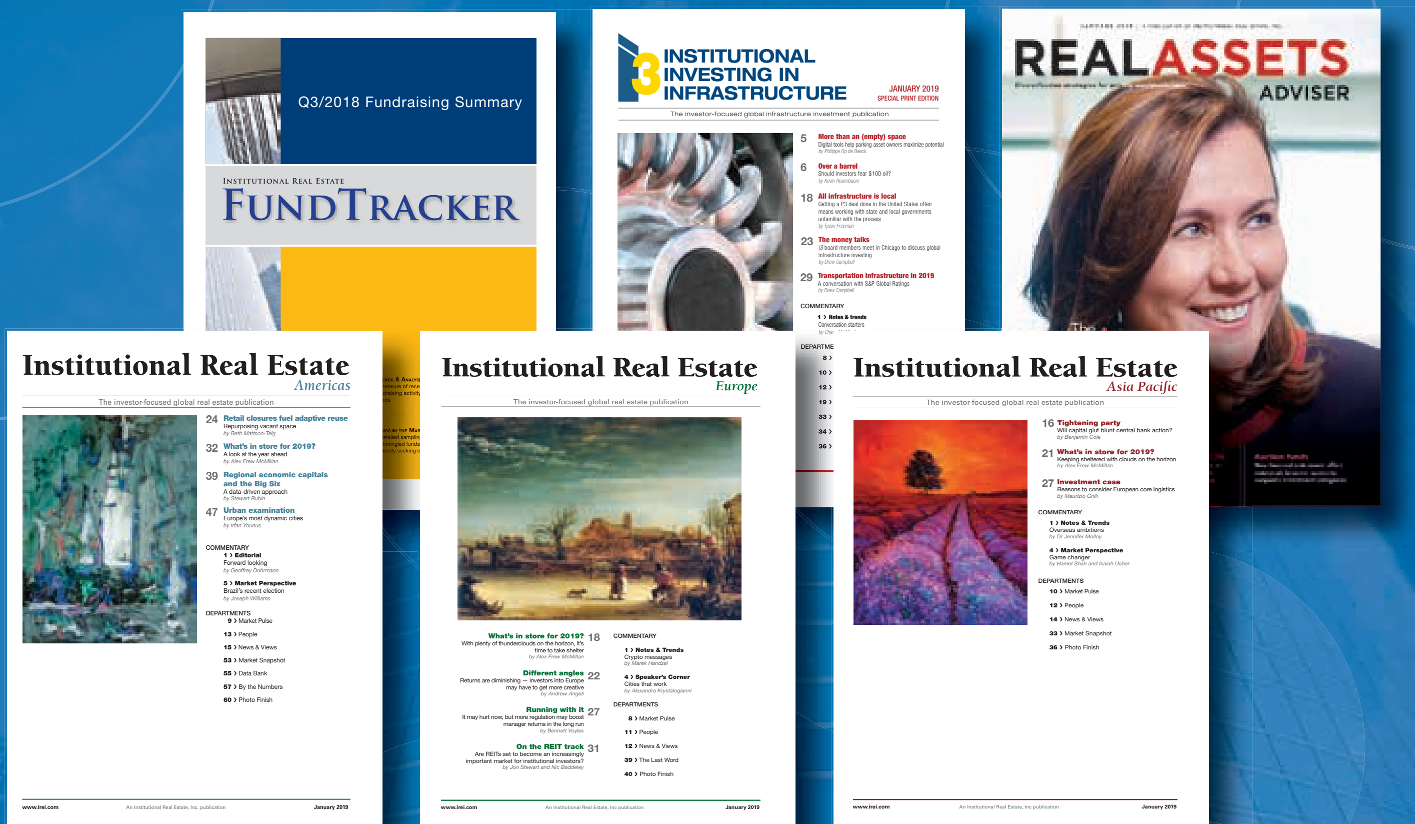

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QOZ Q&A

Answers from the experts

Qualified Opportunity Zone Funds are notably complex. From asset type, fund structure, impact and due diligence, there are a myriad of factors that need to be examined before deciding which investment is the right fit. We have asked these tough questions to leading experts in the field to help provide some guidance on the multitude of factors that go into Quality Opportunity Fund selection.

Chris Loeffler
CEO & co-founder, Caliber

QUESTION: As an investor, what are the key factors that go into an opportunity zone site selection?

We look for great markets as a starting point. The QOZ program has given us focus to find the best markets within the identified zones. Here are some significant factors we look for:

1. Friendly city and local governments — officials who want to advance development, speed up approvals, and give us good feedback on what their communities need.
2. Pre-packaged projects — markets where either the government or the private development community have pulled together projects that are ready to execute on will win. If we have to come in and imagine what could be built, it's a slower process and we may favor a different market or project.
3. Long term positive trends — job growth, population growth, education improvements, etc.
4. Markets with demand drivers — recently installed public transport, new schools and universities, art installations, airports, and good public infrastructure.
5. Markets with a story — the better you can tell your story, and make it compelling, of where you are and where you are going, the more attractive our investment will be.
6. Markets with a supportive community — if the community wants to grow, wants opportunities, and wants to see change, that is ideal.

Steve Meier
Partner, Seyfarth Shaw

QUESTION: What are the predominant risks associated with investing in a QOZ fund that investors may face?

QOZ funds are a brand-new creation of federal tax law, and as a result there are some meaningful legal risks faced by investors. Those risks include whether the QOZ fund will meet its various asset and operations tests, the possibility of adverse changes to the proposed regulations and tightening of reporting requirements and the uncertainty around state conformity for those states — such as California — that have not automatically adopted the federal QOZ rules. Among the legal risks that impact economic outcomes for investors is whether, in order to get the full benefit of investing in a QOZ fund, the investor needs to sell the interest in the QOZ fund rather than have the QOZ fund dispose of its assets. Under the proposed regulations as currently drafted, investors get the full benefit of the QOZ only on a disposition of an interest in a QOZ fund, which could lead to reduced sales prices at disposition.

Nevertheless, the most significant risks faced by QOZ fund investors are business risks. A QOZ fund must invest in businesses or real estate located in a low-income census tract, and the tax rules require the QOZ investor to remain in the investment for at least 10 years in order to obtain the full tax benefits. This combination — long term investment in a potentially unproven market — raises significant economic risks not faced by non-QOZ funds.

Jeffrey Shafer
CEO & co-founder, CommonGood Capital

QUESTION: How do QOZ's fit into the ESG/SRI investment bucket, and how do you respond when some say that those that fall within the ESG bucket will see lower performance metrics?

For clarity, ESG/SRI are more about screening and risk mitigation often associated with listed securities, whereas impact investing is about intentionality, measuring and reporting on both financial and impact goals. Collectively these concepts address how and what kind of impact an investment has on a broader set of stakeholders. These ideas completely align with the purpose of the QOZ program to produce real and positive impact for people and communities within the zones. Not all QOZ funds have this as a stated objective though.

Does one have to give up return in order to have a positive impact? QOZ funds are bringing this recurring question to the forefront again. Creative solutions and innovative capital sources with an eye toward a larger stakeholder group are at the heart of impact today. The QOZ program itself is a great example of this. While clearly there may be investments within opportunity zones that produce lower returns while providing significant impact, the two are not mutually exclusive. You can also find very competitive returns while greatly impacting the communities. The assumption that returns/impact come at a trade-off stems from a lack of awareness or a lack of creativity to solve problems for the common good.

Francisco Luis
Partner, Grant Thorton PR

QUESTION: Puerto Rico Governor Ricardo Rossello said he's seeking U.S. approval to put about $400 million of federal aid toward opportunity zone projects. What are the opportunities in the QOZ space in Puerto Rico?

On May 14, 2019, Puerto Rico approved its own opportunity zones legislation. The local act mirrors the federal opportunity zone legislation to provide local taxpayers with a parallel incentives scenario to the one afforded to federal taxpayers that invest in opportunity zones within Puerto Rico.

Therefore, federal and Puerto Rican capital gains that are timely re-invested in Puerto Rico opportunity zones will receive the immediate tax deferral. If such investment is held for five years, a 10 percent exemption is granted, which increases to 15 percent if held for at least seven years. The main benefit continues to be the permanent exclusion of the investment appreciation if it is maintained for 10 years or more.

However, the similarities end there — and not for the worst — as the Puerto Rico incentives go beyond its federal counterpart. If the Qualified Opportunity Fund in Puerto Rico is engaged in a trade or business that will contribute to the diversification, recovery, or social and economic transformation of the community in the eligible zone, additional incentives may be obtained. One of these is the concession of a flat income tax rate of 18.5 percent on the operating income of such activities and a minimum 5 percent investment tax credit that could climb to 25 percent of the cash invested.

Lastly, as an additional tool to encourage business development, the Puerto Rico government has negotiated with the U.S. Department of Housing and Urban Development to apportion approximately $400 million of the billions in Community Development Block Grant (CDBG) funds that will be allocated to the Island to setup a revolving fund with low interest that would assist in financing opportunity zones projects.

In summary, by marrying the federal tax incentives to the local legislation's attractive income tax rate, investment tax credits, as well as low-cost financing and fund matching from the CDBG, Puerto Rico opportunity zones projects present a unique investment and development opportunity not to be missed.

Kyla Ehrisman
MickLaw P.C.

QUESTION: Investors are looking at taking advantage of the tax benefits that come with investing in QOZ funds. What is the primary due diligence steps an investor can take to ensure they are investing in the right fund?

An investment in a QOZ fund requires all of the same due diligence processes as any other investment, as well as some additional queries based on the compliance requirements of QOZ funds. Investors should ask:

1. How experienced is the sponsor? QOZ funds have a minimum hold time of 10–12 years, so look for sponsors who have the 'staying power' to be around that long.

2. Has this sponsor ever terminated an offering before, rather than closing and deploying the invested capital? If an investor puts money in an offering that is later terminated, the investor may be out of time to invest that capital and defer capital gains taxes.

3. Does the fund intend to provide annual audited financial statements or otherwise report on the value of the investment? Investors need to know, at a minimum, the value of their investments as of December 31, 2026, when they are required to pay their deferred capital gains taxes.

4. For identified asset offerings, is there independent underwriting, and what projections is the independent underwriting making? The tax benefits of a QOZ fund should be the 'cherry on top,' so to speak — the investment should have solid underwriting before potential tax benefits are even considered.

Tony Barkan

CEO/Co-Managing Principal, Allagash Opportunity Zone Partners

QUESTION: How can a QOZ's ability or inability to sell assets impact the exit strategy and/or return for investors?

In order to receive the Opportunity Zone program's full tax benefits, investors must lock up their capital in a Qualified Opportunity Fund (QOF) for at least 10 years, a longer investment term than investors usually experience. At the end of this term, investors have every right to expect their capital be returned promptly and with the IRR that was initially projected. To avoid adverse outcomes, investors should seek out QOFs with a comprehensive exit strategy that has been fully developed even before the fund begins accepting capital. A QOF's choice of portfolio assets and the way those assets will be managed should be planned with exit strategy in mind. That exit strategy should be able to be communicated by the QOF manager from the start. For example, a portfolio of similar properties, developed or renovated in a similar manner, and managed to an institutional quality could be sold as a portfolio to a large institutional buyer or could be sold individually, or the QOF could be converted to a REIT and IPO'ed. Having a choice of exit strategies is a natural advantage of multi-property QOFs and should give investors the highest probability of achieving their investment goals.

Gregory Genovese

Principal & President, Sound West Realty Capital

QUESTION: How do managers decide whether to make a QOZ fund a single project or multi-project fund? What are the factors that are considered, and how does this impact the exit?

The majority of QOZ funds are blind-pool (multi-project) funds, but the tide has been turning steadily toward the single-project (project-specific) fund structure recently. While a multi-project fund can deliver an investor greater overall geographic diversification, they are usually limited in asset class diversification, and there are many more moving parts, from the fund investment and compliance perspective to the Treasury Dept. and SEC regulations over the life of the fund. Conversely, the single-project fund, may have less geographic diversification than a blind pool fund, but it can have better asset class diversification if the project incorporates multiple asset classes, making the projects demographics a paramount consideration to the investor. Yet, the single-project fund will undoubtedly have fewer moving parts and a higher likelihood of meeting compliance in order to maximize investors opportunity zone benefits. Moreover, single-project funds are able to apply for and obtain a legal tax opinion, which is highly recommended.

For managers hoping to attract capital from institutions or larger private equity, the blind-pool (multi-project) fund has been the structure of choice so far. Right now, most blind-pool funds range from equity investment raises of $100 million to as high as $5 billion, with equity being deployed into many different opportunity zone projects across the country or into specific regions. In most cases, these investments are focused into a single asset class with a limited exit strategy choice of targeting a portfolio sale of all of the fund's assets at the conclusion of the fund, which historically has had mixed results with regard to timing and profitability.

Conversely, the single-project QOZ fund model has proven to be the model of choice for high-net-worth investors, wealth advisers, and family offices, as they can evaluate each project on a stand-alone basis. Moreover, the single project fund model tends to have more manageable investment equity raises, ranging in most cases from $10 million to under $100 million per project (or fund), thus the funds ability to successfully execute their exit strategy to maximize investor returns can have a higher likelihood of success than the blind pool fund model. Although there are legitimate benefits to investing in both the blind-pool and the single-project fund structure, the best investment choice will usually come down to which model fits the type of investor — institutions and private equity tending to favor the pooled-funds model, while the individual investor and wealth advisors tending to favor the single-project fund model — coupled with the investor's expectations regarding surety of compliance, return expectations, and the timing of those returns. Regardless, it is clear that both blind-pool funds and single-project funds have their advantages and challenges.

Arthur Loyd
General Counsel & Vice President, Due Diligence, Buttonwood Due Diligence

QUESTION: Why is ongoing due diligence on QOZs more critical than ever?

The alternative investment industry trend over the past several years has been to focus on initial due diligence of sponsors and their funds, with less emphasis on ongoing due diligence in order to save time and resources. However, with QOZs, ongoing due diligence may be the most important piece for the investment community, as failure to meet certain ongoing regulatory requirements, like the 90 percent asset test, could risk the tax benefits of their investment.

Initial due diligence on QOZs includes verifying that underlying business documents satisfy established regulatory requirements, reviewing the written plan for the deployment of capital and evaluating the targeted investment economics as one might with any investment. The written plan should include a timeline for investment dollars to be placed into service for the acquisition and required improvements to the property, allowing the dollars to be considered business property for the purposes of the asset test for up to 31 months (longer if due to government delay or inaction). Due diligence on the ongoing efforts of a sponsor to comply with the regulatory requirements under the Code is key to ensuring that investors maintain their tax-protected outlay in an investment with such a long-term hold. This due diligence should be driven by the broker-dealer/RIA community demanding offering updates regularly.

Personnel

Denise DeChaine, Special Reports Editor, Project management, editing

Larry Gray, Editorial Director, Editing and proofreading

Maria Kozlova, Art Director, Design, layout and production

Susan Sharpe, Art Director, Design, layout and production

Jennifer Babcock, Copyeditor, Proofreading

Jennifer Dohrmann-Alpert, Managing Director, *Real Assets Adviser*

Cynthia Kudren, Senior Account Executive, Advertising Sales

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