Organizing Opportunity:

How to Drive Responsible Real Estate Investment in Opportunity Zones

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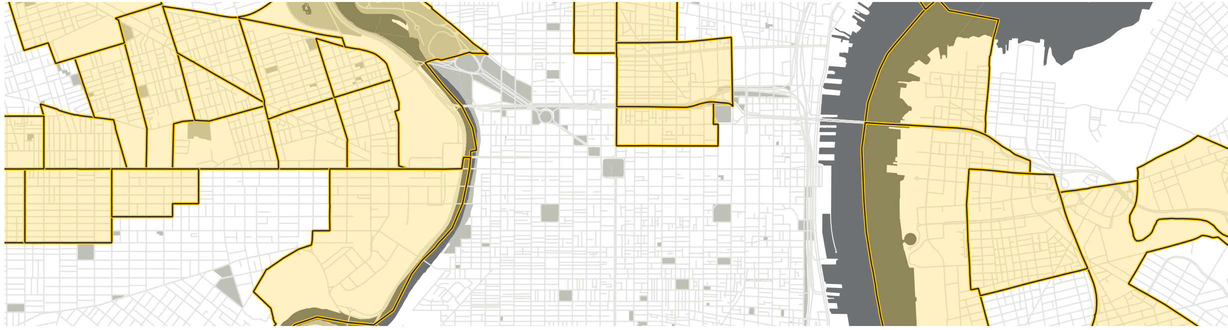

EXECUTIVE SUMMARY

Tax-advantaged real estate investment in Opportunity Zones has advanced from page 130 in the tax bill to the front page of the papers, and is now becoming a reality. In late 2018, fundraising announcements became commonplace and investors began diverting gains into qualified vehicles, and now construction is beginning on qualified projects. As much as we may be tempted to treat Opportunity Zones and the projects within them as a uniform asset class, in actuality the tool presents a diverse range of possibilities. The evolution of the market will bring wide variance across cities and their potential projects. With the fervor continuing to grow, we believe investors, economic development practitioners, elected officials, and others seeking to capitalize on the incentive need ordered thinking to understand and efficiently leverage a national landscape of over 8,700 tracts.

The Opportunity Zone tax incentive exists because current private capital markets solutions are failing to reach certain high-potential but historically underinvested parts of the country. Capital that is low on the risk-return spectrum tends to park in stabilized long-term assets in traditional geographies, often in entities driven as much by fee generation as value creation. Higher-cost capital rehabilitates or builds assets over short-term hold periods to generate elevated returns, or simply trades assets based on market timing. The markets do not provide a solution with the unique combination of risk appetite and patience to perform complex residential and commercial projects that accommodate underserved renters in evolving neighborhoods.

Whether focused on mixed-income units in housing-deficient gateway markets, knowledge sector office space in high-growth secondary markets, or catalytic downtown space in ex-industrial markets, Opportunity Zone incentives have the potential to enhance the private sector's economic value creation and social impact by filling this capital gap. The tool provides incentives to understand emerging neighborhoods as well as intricate public-private capital stacks. Its structure rewards long-term involvement, which will filter capital towards the highest quality, most locally engaged operators. Investors and their operating partners will make ten-year instead of four-year choices when it comes to quality of construction, community engagement, and overall neighborhood improvement. As with any federal subsidy, misuses and bad actors will emerge, but we believe the incentive's filter of complicated, nuanced projects should necessitate and reward responsible investors.

Cover: The MaKen South redevelopment in Philadelphia. The MaKen Studios are a project of Shift Capital, a real estate impact group dedicated to revitalizing urban neighborhoods through an inclusive and concentrated development model, who are currently leveraging OZs for future projects in their focus area. Photo credit: Shift Capital.

Above: Map of Opportunity Zones in Camden and Center City/West Philadelphia.

*To select the projects that will best achieve the incentive's intention of catalyzing underinvested communities, we must categorize the broad Opportunity Zone landscape of geographies, projects, investors, and additional stakeholder tools. The tracts themselves sort into **Opportunity Zone Types**, which capture the economic conditions of tracts and their surrounding geographies to assess potential organic growth. Across geographies, different **Project Types** classify the financial viability of potential real estate investments, with or without the subsidy. Preferences will emerge for Opportunity Zone and Project Types based on **Investor Expectations** and engagement with the tool, reflecting the intentions and motivations of capital aggregators in the space. Finally, **Non-Market Tools** contemplate the role of the public sector, institutions, philanthropy, and other non-investor parties in fostering inclusive growth.*

Opportunity Zone Types	Project Types	Investor Expectations	Non-Market Tools
Experiencing Growth	Incentive Agnostic	Upside Capture	Require
Path of Growth		Holistic	Catalyze
Cusp of Growth	Incentive Intended		
Deeply Distressed	Incentive Insufficient	Shortsighted	Request

Target deal set is highlighted in light blue.

OPPORTUNITY ZONE TYPES

The first top-down criteria to properly leveraging the incentive is a realistic understanding of the types of zones across the selected tracts, and their economic conditions. The law allowed state governments freedom to select their zones as a subset of qualifying low-income and contiguous census tracts. Most zones have relatively low incomes and high poverty, with the median family income of the median Opportunity Zone tract at $42K (compared to the country's $68K).[i] However, the census-driven approach does have limitations given eligibility was driven by 2011 – 2015 data[ii]; many geographies have truly transformed since then, and static data ignores whether communities are already growing organically.

We believe that analyzing additional data regarding the characteristics of the zones (and their surroundings) more fully, as well as qualitative evaluation by experienced practitioners, results in a spectrum of typologies to describe the current economic conditions and future organic growth prospects of these zones.

Census tracts **Experiencing Growth** have already benefited from significant economic growth and are already receiving or prepared for private investment, regardless of Opportunity Zone incentives or other public subsidies.

Census tracts in the **Path of Growth** represent neighborhoods that are in the early stages of organic growth, or are responding well to public investment that came in first to catalyze transformation. These neighborhoods are primed to see long-term economic transformation due to surrounding activity and the natural movement of economic prosperity.

Census tracts on the **Cusp of Growth** are well positioned for future growth, but due to historic stigma, infrastructural barriers, or recent economic challenges, still need to "prime the pump." Opportunity Zones and other targeted public investment could accelerate the transformation of these locations, which otherwise likely would have been years away from organic growth.

Deeply Distressed census tracts represent neighborhoods with entrenched poverty and structural challenges that require significant public investment before being ready for private investment. These areas will require deep public sector focus before being ready for Opportunity Zone or other private capital.

PROJECT TYPES

Across these Opportunity Zone types, investable projects range from eminently viable to rushed and mishandled. It is important to remember that the incentive's benefits enhance projects that work, and do not make bad projects good. The largest economic portion of the Opportunity Zone incentive is the elimination of long-term capital gains on new gains generated by a qualified project. This essential benefit only pays out if projects have inherent value and an achievable value-add underwriting regardless of Opportunity Zone qualification.

Incentive Agnostic projects are previously planned or achievable regardless of Opportunity Zone benefits. These projects' underwritten returns are simply enhanced by leveraging the tax benefits. The availability of Opportunity Zone incentives for these projects is catching negative headlines, but they should be viewed as a piece of a bigger pie. Additionally, many of these projects would otherwise be underwritten as short-term flips to maximize returns. Instead, owners and operators will be invested in the projects for at least ten years, resulting in more thoughtful and measured decision-making and business plans. This shift in the timing of incentives alone should have an incremental positive benefit on growing neighborhoods.

Incentive Intended projects are genuinely below the cutoff of being financially attractive, and become so by participating in Opportunity Zone benefits and potential additional involvement from non-market financing sources to fill gaps. These projects involve neighborhoods positioned for growth but whose fundamentals do not translate to the most competitive returns in the marketplace. In these cases, the implicit subsidy attracts capital which would otherwise have remained on the sidelines or been directed to already-thriving neighborhoods.

Incentive Insufficient projects do not yet have the economic profile to be viable or even to fully benefit from the tool, but are rushed to completion in order to accommodate the fervor around the legislation. Misaligned actors naturally seek to take advantage of the wide investor interest in participating in the incentive. In these cases, neighborhoods will suffer in practice and in reputation from irresponsible investment resulting in capital losses or low returns.

INVESTOR EXPECTATIONS

The interest in the space has resulted in practitioners from all corners of the real estate investment map emerging to participate: developers / operators, fund managers, passive investors, community organizations, and more. Across Project Types, an Opportunity Zone-qualified real estate deal could require a wide range of expertise including understanding of real estate equity risk, legal and tax, fiduciary experience, familiarity with transitioning neighborhoods, and public-private structuring. The investors emerging to capitalize Opportunity Zone projects have a mix of the tools and experience necessary to execute successfully.

Upside Capture investors are solely focused on enhanced returns for deals they would have pursued under their normal construct. These vehicles cull the Opportunity Zone set to the most traditional neighborhoods and deals, focusing on Incentive Agnostic projects in Experiencing Growth locations. These vehicles tend not to have a social impact or public sector mandate, and seek as much as possible to fit projects into structures with which they and their investors already have comfort.

Holistic investors are comprised of thoughtful, long-term focused groups that understand real estate equity risk and have public-private, emerging neighborhood experience. Holistic vehicles believe in the long-term potential of these neighborhoods, and are relieved that Opportunity Zones have provided them with a capital solution that is incentivized to understand the potential of challenged neighborhoods. These groups sometimes find capital that can invest more properly in Incentive Insufficient projects, mostly focus on Incentive Intended projects, and capitalize some Incentive Agnostic projects with an added community focus. This segment of the investment vehicle universe also attracts new, valuable types of expertise into neighborhoods where it has not existed to date.

Shortsighted investors seek to take what is a complicated equity product and make it appear standardized in order to scale and earn fees, ignoring long-term risks to investors. Groups attempting to represent real estate development equity risk as a product with consistent credit threaten to disrupt the marketplace with negative effects. These vehicles focus on less sophisticated, retail investors and irresponsibly channel their capital into Incentive Insufficient deals.

NON-MARKET TOOLS

The public sector, institutions, philanthropy, and other non-investor parties are distinctly interested in helping along the Opportunity Zone marketplace. These groups want to focus on inclusive growth in Opportunity Zones: catalyzing economic activity in communities that otherwise would not benefit, and directing benefits to people who would otherwise not benefit.[iii]

The Opportunity Zone incentive alone does not maximize these benefits, and these parties have to step up to help guide the tool towards positive outcomes. Opportunity Zone tax incentives are maximized for projects that are already economically viable, acting as enhancement rather than pure subsidy. The Opportunity Zone legislation is exclusively focused on geography and does not mandate or direct investment to connect with people in need.

As such, these parties need to pair additional tools with Opportunity Zones to achieve the desired benefits. Affordability requirements, mandates to work with community stakeholders, and aligned financing structures can help **Require** inclusion. Direct, tax-related, and tenant-facing subsidies, free or below-market land deals, and actual public sector or institutional tenancy can **Catalyze** growth. Finally, when these groups are powerless to actively impact project outcome, it never hurts to **Request** that projects align with their goals, as developers always seek to remain favorable in the eyes of key non-market stakeholders.

CONCLUSION

The Opportunity Zone legislation is imperfect, and lacks the required level of precision to ensure that tax benefits only flow to the exact neighborhoods, projects, and investment vehicles that will maximize social and economic benefits. However, the tool deliberately takes a directional approach and will undoubtedly dramatically transform the nation's lower-income communities overall.

Market-driven financial actors will naturally utilize the Opportunity Zone incentive for deals that do not need subsidy in order to maximize returns. In a small subset of Opportunity Zones, the rich will get richer as existing fund managers invest the gains of the ultra-wealthy into already-thriving neighborhoods. This organic market force will not be stopped, but at the very least, the tool will incentivize these investors to be long-term stakeholders rather than short-term flippers.

Shortsighted, reckless investment vehicles will lure retail investors into neighborhoods and projects that are not ready for market-rate equity capital. These projects will further damage distressed neighborhoods by taking the wrong approach to revitalization. Hopefully those of us invested in the long-term viability of the Opportunity Zone legislation will work to minimize those outcomes, and make sure distressed communities are aided by additional tools to take a thoughtful approach to growth.

This new market's sweet spot will be projects in neighborhoods in the path of or cusp of growth, where holistic investment vehicles paired with proper non-market financing tools will execute on the legislators' vision. Patient, community-focused investment in neighborhoods with untapped potential can catalyze and foster the economic dynamism this groundbreaking bipartisan legislation seeks.

ENDNOTES

i. "The State of Socioeconomic Need and Community Change in Opportunity Zones", Economic Innovation Group.

ii. Eligibility was determined by poverty rates or median family incomes from the U.S. Census Bureau's 2011 – 2015 American Community Survey.

iii. See, e.g., Bruce Katz and Evan Weiss, "From Transactions to Transformation: How Cities Can Maximize Opportunity Zones," (Nowak Metro Finance Lab, October 2018) https://drexel.edu/nowak-lab/publications/reports/opportunity-zones/

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