Opportunity Zones Introduction

December 2018

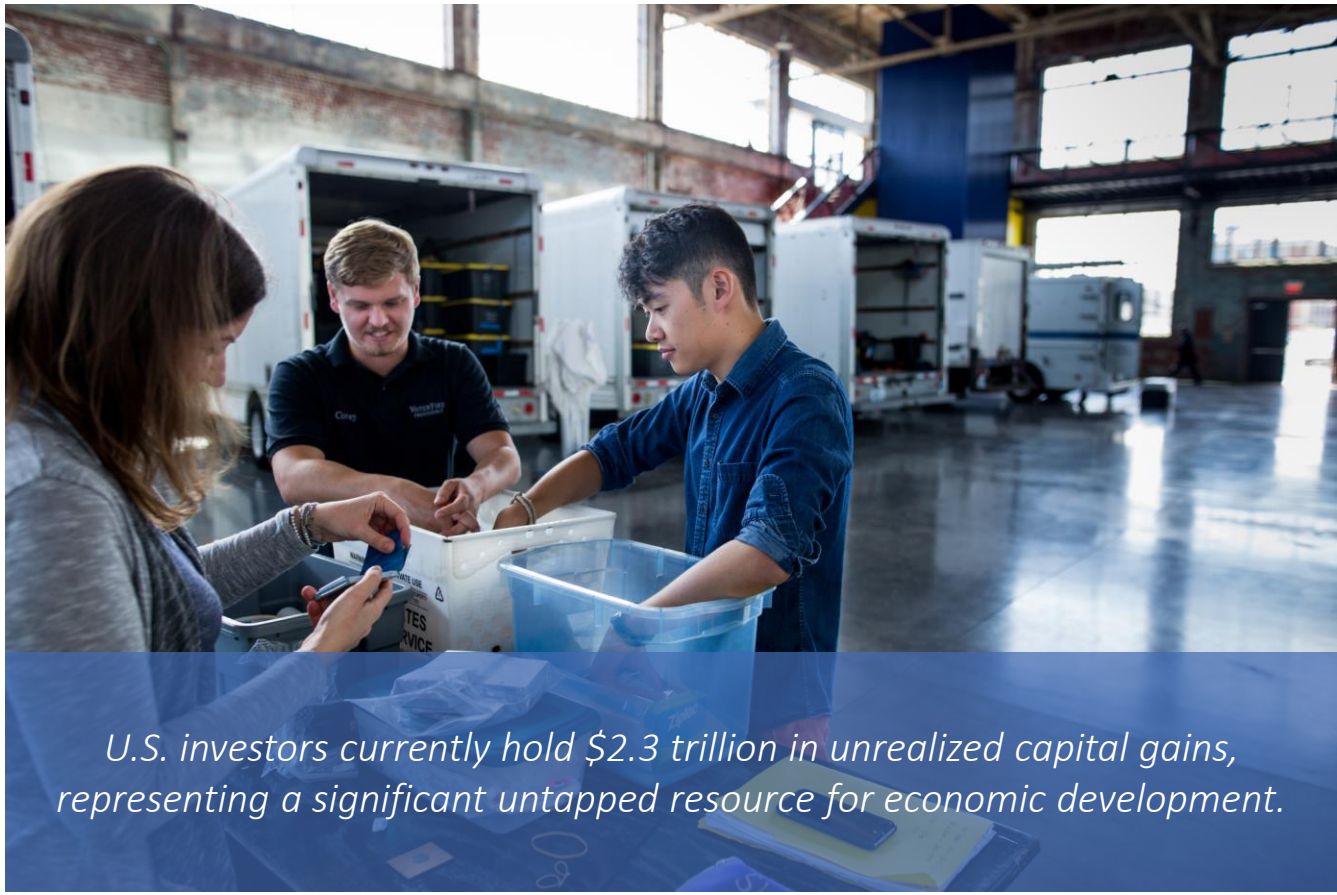
An affiliate of LISC
NMSC
New Markets Support Company

National Equity Fund INC
an affiliate of LISC

LISC
Helping neighbors build communities

What are Opportunity Zones?

The Opportunity Zone tax incentive is a bipartisan initiative to spur long-term private investment in low-income urban and rural communities, established by Congress in the 2017 **Investing in Opportunities Act**.



U.S. investors currently hold $2.3 trillion in unrealized capital gains, representing a significant untapped resource for economic development.

Why now?

Data from the Economic Innovation Group. Read more at eig.org/opportunityzones

More than half of America's most economically distressed communities contained both **fewer jobs and businesses in 2015 than they did in 2000.**

New business formation is near a record low. The average distressed community saw a **6 percent decline** in local businesses during the prime years of the national economic recovery.

The U.S. economy is increasingly dependent on a handful of places for growth. **Five metro areas** produced as many new businesses as the rest of the country combined from 2010 – 2014.

Now is the time to diversify.

What are Opportunity Zones?

Opportunity Zone: A low-income census tract **(LIC)**, as determined within New Markets Tax Credits legislation, is designated as an Opportunity Zone **(OZ)** by the governor of the of the state or territory in which it is located. Designations will stay in place for 10 years.

Up to 25% of LICs in a U.S. state or territory may be designated as OZs.

States or territories in which there are fewer than 100 LICs may designate up to 25 LICs as OZs.

Up to 5% of census tracts contiguous to LICs may be designated as OZs, if the median family income of the census tract does not exceed 125% of the median family income of the LIC to which the tract is contiguous.

Designated Opportunity Zones

All states and territories have officially designated their Opportunity Zones, as of June 14, 2018.

8,762

census tracts designated

24 million

current jobs in designated tracts

1.6 million

businesses in designated tracts

Rural census tracts	1,858
Average poverty rate	31%
Average unemployment rate	14.4%
Average family income in OZ census tracts relative to area median income (AMI)	60%

OPPORTUNITY ZONES

Investor **Incentives**

Deferral of taxes

On capital gains invested in Qualified Opportunity Zone Funds

Reduction of taxes

On investments held in Qualified Opportunity Zone Funds 5+ years

Cancellation of taxes

On new gains made through Qualified Opportunity Zone Fund investments held 10+ years

Ex. 10 Year Investment: **Fully Taxable vs. Opportunity Zone Fund**

Assumptions:

- 10% annual investment appreciation
- 24% capital gains tax (federal only)

Fully Taxed Investment		
Capital Gain		$100,000
- Tax payable (24%)		$24,000
Total Capital to Invest		$76,000
Sales Price after 10 years		$197,000
- Tax on Appreciation (24%)		$29,070
After Tax Funds Available		**$168,054**

Opportunity Zone Investment		
Capital Gain		$100,000
- Tax payable		$0
Total Capital to Invest		$100,000
Sales Price after 10 years		$259,374
- Tax on Appreciation		$0
Deferred Capital Gain Tax (24%) paid in 2026		$20,480
After Tax Funds Available		**$238,974**

Translation

Direct Effect

- More Equity Dollars
- Looking at projects in Opportunity Zones
- Willing to accept lower pre-tax returns on investment
- That need to hold their equity positions for 10 years
- And want to be able to sell the asset after 10 years
- Willing to take a bit more risk????

Indirect Effects

- More development in underserved areas
- Employment opportunities
- Contagion value effects or real estate (good/bad)
- More incentive to invest in businesses

Eligible **Investments**

Only equity investments are eligible for the Opportunity Zone tax incentive.

Business investments

1. can include investments in new stock issuance for corporations and ownership interests in partnerships and LLCs that own operating businesses.

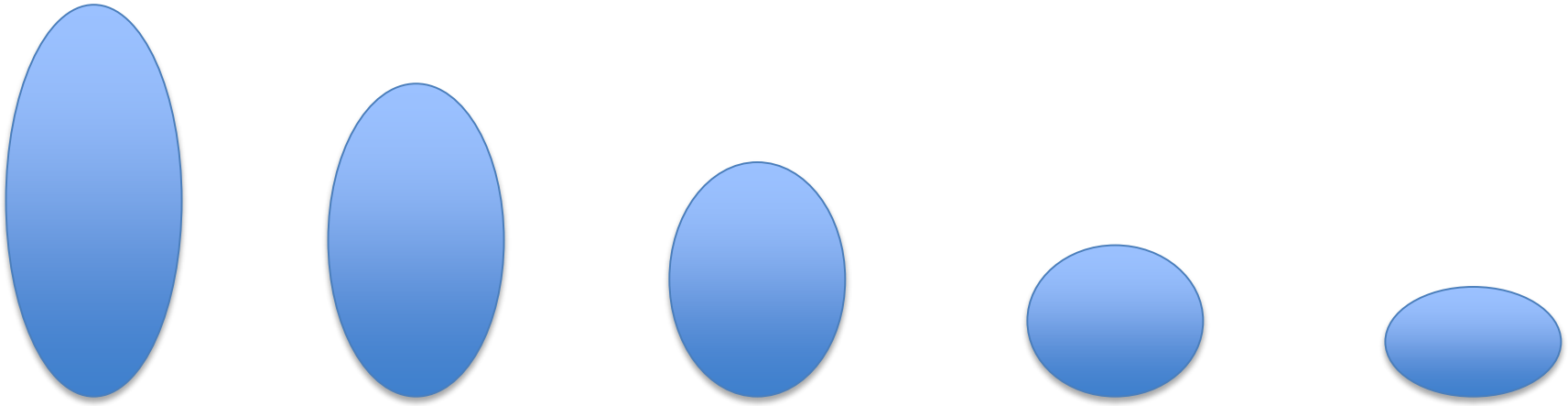
Investments in real estate

2. must include an ownership interest of new construction or assets that will be **"substantially improved"** within 30 months of acquisition by the Opportunity Fund. Can be include housing, hotels, health care centers, office buildings, restaurants.

New equipment and other assets

3. are also eligible investments.

So You have A Project in an OZ



Is the project in an OZ?

Is it a new build or a an existing building that will be substantially improved? (invest 100% of the building cost into the project)

Is there enough annual profit to cover the debt, pay the developer and then pay an equity investor?

Does the project meet LISC impact thresholds? What do we want to require after 10 years on the sale of the project?

IF there is already an interested investor – if the check size is >$10mln we can engage.

IF there is not an investor – we would want $25-50mln in pipeline in order to raise our own fund.

Example Workforce Housing Deal

- New Construction of 116 units for families with rents at 90-110% AMI
- Proven project in market (prior phases in non-Ozone locations)
- Expect this to be Single Asset Opportunity Fund with High Net Individuals as investors
- Capital Stack: Between 40 – 60% from ozone equity depending on return required by investor. Remainder of financing from non-recourse first mortgage.
- Investors to get preferred annual cash payments
- Exit scenario in year 10 - either sale or refinancing. Return of capital plus split of sales proceeds

Deal Economics (example only)

1

Project Development	
Land Acquisition	$4,000,000
Building Acquisition	$3,000,000
Total Acquisition Cost	$7,000,000
Project Improvements	$3,000,000
Total Capital Expenditure	$10,000,000

2

Initial Financing	
Acquisition Loan	$5,000,000
Developer Equity	$2,000,000
Initial Acquisition	$7.000.000
Construction Loan	$3,000,000
Total Sources	$10,000,000
Permanent Financing	
OZ Equity	$5,000,000
Permanent Debt	$3,500,000
Grant	$500,000
Tax Credit	$2,000,000
Total Sale Proceeds	$11,000,000
Developer Fee	$1,000,000

3

OZ Investor Returns	
OZ Dollars Invested	$5,000,000
OZ Annual Cash Return	$250,000 for 10 years
Net Proceeds on Sale	$1,000,000
OZ Pre-tax Return	6%
OZ Post-tax Return	8-9%

Investment Considerations

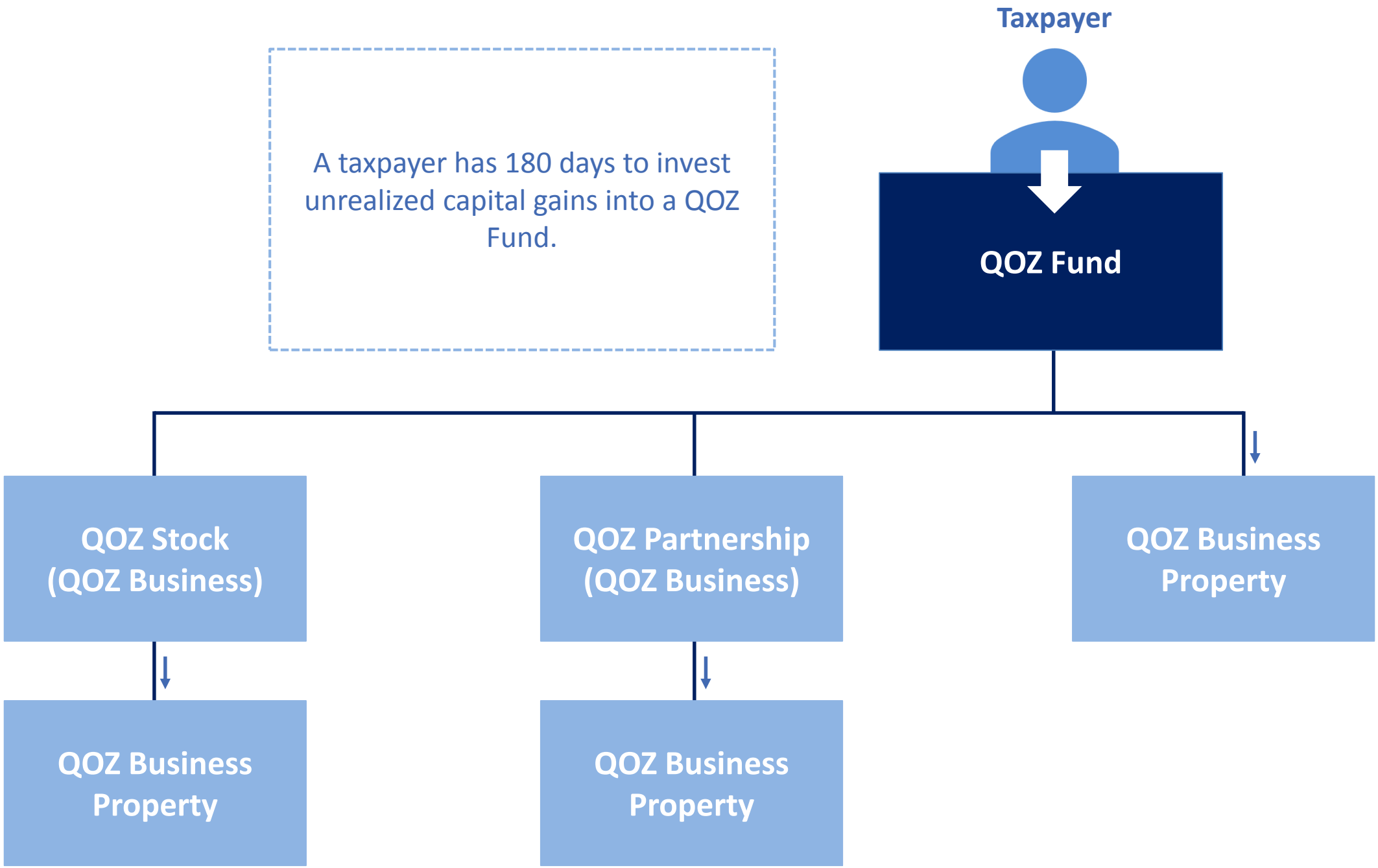
- **Capital Gains investors want to invest in strong real estate projects**
  - ✓ Will want annual preferred cash flow distributions - 90-100% of cashflow
  - ✓ Want a return of capital after year 10
  - ✓ Want a rate of return on their investment in year 10 - market rate or social impact returns

- **Capital gains investors have multiple investment options**.
  - ✓ Invest now through private equity markets
  - ✓ Will be looking at Opportunity Zone investments as compared to other investment options and how this matches to their overall investment goals

- **Things to consider**
  - ✓ Timing is important in these deals to ensure that Capital Gains investors get the tax benefits they anticipated.
  - ✓ These are market rate units, so investors want likely require a discount to market
  - ✓ Payment of developer fee - more over time and less upfront

Considerations for Opportunity Zone Investments

- **First – must be a strong real estate investment**
- **Substantial Improvement Requirement means that substantial rehab and new construction deals are what will work best. (construction costs must be at least $1 more than what it cost to acquire the building).**
- **Affordable Housing – Ability to provide lower rents (under 100% AMI) and meet investor returns may depend on ability to get tax abatement, permit fees reduced or assistance with the land costs.**
- **Commercial projects –additional requirements on % of business income generated from within the zone.**
- **Perm debt preferred to be structured as non-recourse to maximize investor benefits.**
- **Exit issues – plan for liquidity event in year 11 – either sale or refinancing. How can this be done to maximize investor return and yet retain some long term affordability?**


Taxpayer
A taxpayer has 180 days to invest unrealized capital gains into a QOZ Fund.
QOZ Fund
QOZ Stock (QOZ Business)
QOZ Partnership (QOZ Business)
QOZ Business Property
QOZ Business Property
QOZ Business Property

Strengths

Local	Flexible	New Investor Class	Potential	Straightforward
Designations are made by states and localities, rather than Federal agencies, ensuring more local buy in and coordination	The flexibility of the investment tool can support investments in any type of asset class	The incentive has the ability to attract high net worth individual investors to community development finance	The incentive could attract hundreds of billions of private sector capital into low-income communities	The tool is relatively straightforward from an investment and compliance standpoint, in comparison to LIHTC and NMTC

Concerns

Lack of Oversight

Lack of oversight from government entities could lead to program abuses

Lack of Impact Incentives

Incentives focus on back-end returns, rather than investments that will result in community impacts

Gentrification and Displacement

The tool might aid in the gentrification and displacement of residents and businesses in Opportunity Zone communities

Future of Other Tax Incentives

The new incentive might be used as an excuse to diminish or eliminate other community development tax incentives, such as the NMTC program

Investors in Opportunity Zones

The Opportunity Zones tool is structured to work with a wide range of potential investors, including:

- Banks and institutional investors that have previously invested in other tax credits
- Corporations with capital gains exposure – insurance companies, anchor institutions, others
- High net worth individuals
- Partnerships
- Social impact investors

Contact Information

George E. Ashton III
Managing Director, Strategic Investments
Local Initiatives Support Corporation (LISC)
1825 K Street NW, Suite 1100
Washington, DC 20006
(o) 202-739-9293
(c) 703-862-1905
Gashton@LISC.org

Karen Przypyszny
Senior Vice President, Equity Placement
National Equity Fund, Inc.
120 S. Riverside Plaza, 15th Floor
Chicago, IL 60606
312-697-6120
kprzypyszny@nefinc.org

Andres L. "Andy" Saavedra
Senior Program Officer
Rural LISC
1825 K Street NW, Suite 1100
Washington, DC 20006
318-434-1776
asaavedra@lisc.org
www.lisc.org/rural