Assessing Opportunity Zones

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Introduction

The Qualified Opportunity Zone ("QOZ") program has been a looming presence in commercial real estate since its passage within the Tax Cuts and Jobs Act in 2017, but recent clarifications from the IRS have brought it to the forefront of the sector's attention. Although it is one of the most sweeping tax incentive programs of its kind ever introduced, the program's implications for varying types of real estate investors are still being determined. Here Virtus assesses the scope, merits, and possible limits of the program, as well as how closely it fits the general expectations of Virtus' investor base. In summary, we believe QOZs will have a meaningful impact on a narrow group of investors with high appetites for risk and illiquidity, but many details of the program will pose a mismatch for more traditional investor expectations. Virtus has historically followed the principle that taking on increased risk should lead to fundamentally higher returns, rather than those driven by tax strategy. While the Opportunity Zone program is a uniquely generous incentive structure, Virtus nonetheless believes there are many risks or limitations not fully accounted for, and thus the firm is not pursuing an Opportunity Zone specific fund at this time.

The Program and its Intentions

The QOZ program encompasses 8,760 individual census tracts containing 31.3 million people within the United States (with additional sites in Puerto Rico and other territories). State governors were encouraged to nominate specific Low Income Communities ("LICs") that stood to benefit from increased investment: places underserved by existing private industry, but with clear growth potential. The final tracts approved federally have an average poverty rate of 31% compared to 15% nationally, and while the requirement for inclusion was a household income below 80% compared to median incomes, the combined QOZ tracts came in at 59%. Tract selection covers a wide variety of site types as well, from urban to rural. While the majority (76.8%) of all zones are in major Metropolitan Statistical Areas ("MSAs"), the Economic Innovation Group ("EIG"), an economic think tank focused on entrepreneurship, notes that low and medium density areas account for a combined 62% of all tracts. Finally, the average QOZ's housing stock has a median age of 50 years, which is more than ten years older than the overall U.S. median. In short, at a high level, the program seems to have made good on its purpose of selecting underperforming areas whose residents and infrastructure would benefit from investment. What is less obvious is how attractive they will now become to investors. This will vary significantly based on the individual site, but we offer a review of the common incentives available.

Investment Incentives and Demand

The US Joint Committee on Taxation has suggested the QOZ program will attract at least $86 billion in total investment, while some real estate industry sources estimate upwards of $250 billion in likely allocations. EIG has noted that the entire capital gains pool from which QOZ investments draw from totals roughly $6 trillion, so it is little wonder that new QOZ fund announcements have been a constant feature of the commercial real estate newswire. CoStar, one of the leading commercial real estate research firms, has tracked the status of fund formation and fundraising as of December 2018 and found 116 total funds

with a combined $18.2 billion in targeted raises. These funds range from highly targeted opportunities to nationally focused funds with broad mandates, with the median size fund at roughly $85 million and the largest thus far being SkyBridge Capital's $3 billion targeted fund. Given that much of the money deployed will be in private, single asset deals outside a fund structure, it is impossible to know just how much of a groundswell of outside capital will hit the real estate markets, but it stands to reason the impact may be disruptive in some submarkets. According to Real Capital Analytics, another real estate data analytics company, the Opportunity Zone program has already seen a roughly 60% year-over-year spike in land acquisition for development, starting speculatively as soon as the program began and accelerating to that level as of late 2018.

Investors have good reason for haste, as there is a short time window to invest. To receive full tax benefits, funds must deploy by the end of 2019, which suggests that most QOZ investors will be contending with the current landscape of high valuations found across all commercial real estate types. Also of note are the additional incentives that individual states are offering, such as in Ohio, which provides an additional 10% tax credit on investments over $250,000. According to CoStar, one-third of all states are actively considering additional incentives.

However, despite the short window for deployment, QOZ investors must have a long-term investment horizon and comfort with illiquidity, as achieving the maximum incentive of avoiding tax on capital gains requires that assets be held for ten years. While there are incentives for five- and seven-year holds, they are significantly less attractive and largely amount to tax deferral with only a slight discount. Additionally, the program requires that assets be "substantially improved" within 30 months, which is to say that total capital expenditures must be equal to or greater than acquisition cost. In short, investors must take long-term, high conviction positions in these markets in order to benefit from incentives. The dual requirement of the ten-year horizon coupled with taking a development or heavy value-add approach creates a backward incentive structure from traditional real estate strategies where development timelines are generally shorter and allow for maximum flexibility in disposition. The commercial real estate sector may be in a downturn or liquidity freeze at the ten-year horizon. A hypothetical investor who has rushed into an investment solely to pursue tax incentives may be in a significantly worse position than if they had kept their existing real estate investment strategy intact.

Possible Implications of QOZ Designation

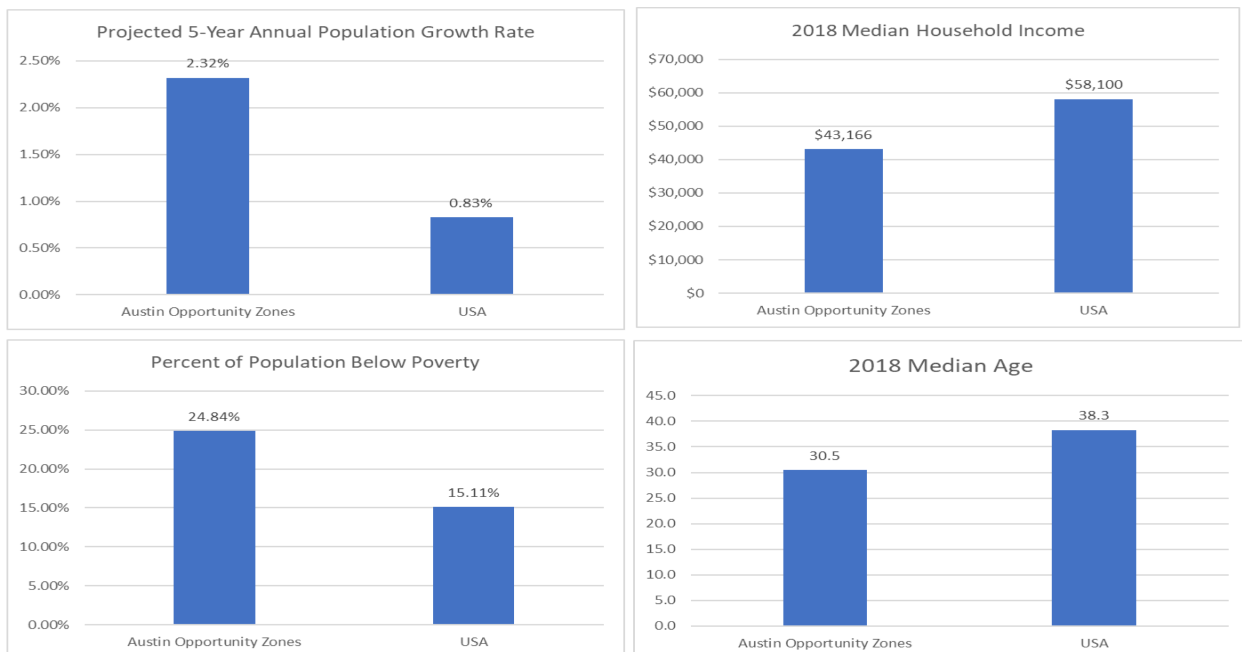
While the aggregate demographic profile of the QOZ program seems squarely within the stated goals of the legislation, many have noted that there is a surprisingly broad spectrum of communities covered by the program. In fact, organizations from local community groups to the Brookings Institution have voiced concern that the rules for QOZ tracts are too broad and include too many areas that do not actually need money. Some have concerns that the vast majority of investment will flow to major urban areas already gentrifying. Adding fuel to these concerns is the fact that QOZ tracts were designed around 2011-2015 vintage Census tract data, which is outdated in some areas that have seen rapid growth. Brookings also notes that many college towns or submarkets, which on the surface appear impoverished due to student incomes, have been added to QOZ lists despite being functionally affluent. Other reasonably affluent areas include gentrifying parts of downtown Los Angeles. Fundrise, a real estate investment platform, notes that four of their top ten QOZ opportunities are all located in urban California areas including Oakland, San Jose (where some of the most expensive housing in the country is located), and San Diego. Considering that the federal incentives are the same whether one invests in downtown Los Angeles or in a rural Opportunity Zone within a low growth, economically depressed region, it stands to reason that the rush of capital racing to deploy by 2019 will accumulate in many areas that are already highly invested,

potentially creating pockets of oversupply and further adding to the already unsustainable valuations in gateway areas.

Finally, since the program incentivizes investors via tax code benefits to capital gains, Brookings has noted it will be nearly impossible to know exactly how many individuals are investing, how much they are investing, which zones they are targeting, not to mention what the end cost will be to U.S. taxpayers. Brookings has suggested the IRS and the U.S. Department of Treasury require QOZs to report their activities in a more clear fashion than currently required by the IRS to increase transparency and accountability. In short, given that the program is still in a state of regulatory flux, it is quite possible that the heavy burden of administrative oversight may further evolve and grow as the program matures.

Case Study: Austin, TX

To better ascertain the local character of the program, Virtus assessed QOZs in its hometown of Austin, Texas, which has long been a real estate hotspot. While many of the 21 zones within Travis county are indeed within less affluent and developed parts of Southeast Austin, the designation also includes areas like Travis Heights and East Riverside—highly attractive and arguably overinvested areas with extremely strong population growth and high, rapidly rising incomes due to gentrification. When all QOZs within Austin are aggregated and compared to national demographics, it becomes quite clear that these are areas an astute investor might readily choose over any average site in America due to the dramatic population growth and only modestly lower incomes. For instance, Austin QOZs are projected to grow at nearly three times the national average over the next five years, and while they do have lower median income, the difference is a minor $43,166 versus $58,100. Finally, Austin's combined sites have a materially younger population than the national average, which further decreases the effective income difference. In other words, it is reasonable to assume that such sites will have the most intense focus for investment, perhaps limited only by existing enthusiasm without consideration for incentives. At this current point in the cycle, it is already difficult enough to secure deals in such submarkets with judicious underwriting that stays resilient under possible scenarios. If investors divorce their underwriting from fundamentals in such submarkets even further, it is possible the incentives will have negligible or even adverse impact on investor returns.



Source: Esri Site to do Business

Tax and Capital Implications for Investors

We have touched on the rough outline of the incentive program, which is admittedly still in flux and should see continual clarification and perhaps revisions. In October 2018, the IRS issued proposed regulations and a related revenue ruling addressing the treatment of QOZ investments. As it stands, the current incentives are as follows:

a) the ability to defer tax for up to eight years (deferral expires in 2026 regardless of actual sale date) on unrelated capital gains, such as gains from the sale of corporate stock, or gains from the sale of a business or real property interest not located in a QOZ, as long as those gains are invested in a QOZ within 180 days of the event giving rise to the gain;
b) the ability to avoid up to 15 percent of that deferred tax if the new investment is held for specified periods of time (15% avoidance occurs if the asset is held for seven years – only 10% avoidance would occur if the asset were held for five years); and
c) the ability to completely avoid tax on any gains realized on the new QOZ investment if it is held for at least ten years (i.e. basis of the property is stepped up to fair market value if held for at least ten years).

As a general matter, the QOZ program works well (or at least seems safe from a tax perspective) for simple single asset deals that are fully capitalized at the outset by money that is locked up for ten years (to achieve the maximum tax benefit). The QOZ rules in their current form do not translate very well for traditional real estate private equity funds, where capital is raised in multiple closings by different investors who seek liquidity before a ten-year horizon and want diversification of risks across multiple assets. Importantly, one of the requirements for a fund to qualify as a QOZ Fund is that the QOZ Fund must invest 90% of its assets in QOZ property acquired after December 31, 2017. This 90% requirement is tested twice a year, generally starting at the end of the first 6 months of the fund's existence. Because of this timing rule, it may be difficult or impossible for a Fund to hold gain funds while it searches for investment opportunities; if it does not find them in time, it will fail to qualify. In addition, investors must invest capital gains in a QOZ Fund within 180 days of the event giving rise to the capital gain. Because of this, a Fund that uses multiple closing must make sure that investors are informed of the investment early enough to realize capital gains and invest in the Fund within the investors' 180 day time horizon, but late enough so that investors do not run out of time on some gains.

The regulations released in October of this year still do not bring clarity to how the longstanding partnership rules regarding computation of outside versus inside basis and the use of depreciation deductions interplay with this program, which sets its own unique rules for basis in the investment. The regulations also fall short on addressing whether a QOZ fund can dispose of its QOZ asset and avoid triggering capital gain if the proceeds are reinvested in another QOZ property. Since the current rules require the disposition of the QOZ fund interest itself (rather than the underlying asset) to trigger tax incentives, they effectively require each QOZ partnership to hold a single asset for effective control. Also, one cannot sell the QOZ interest of a multi-asset fund without triggering capital gains on all the assets held by the fund. Said another way, the inability of a sponsor to manage the discreet timing of dispositions of a multi-asset portfolio held by a single QOZ Fund without compromising the status of the Fund and the overall deferral can leave the sponsor having to set up a separate QOZ Fund for each asset. This can create a large administrative burden from a legal, accounting, and tax perspective and could alter overall investor economics.

Overall, we believe the lack of clarity on these items is keeping many sponsors asking a lot of questions but not actually launching funds. As a fiduciary, we believe it can be too risky to promise the realization of these benefits on traditional deal terms without additional clarity from the IRS. We are monitoring the situation closely, as the QOZ program, if clarified in a manner more aligned with our typical deal terms, and would dovetail nicely with our strategy to provide affordable real estate to tenants.

Summary

At present, Virtus is not pursuing the launch of a discreet Opportunity Zone fund, largely out of concerns that it would not match the objective of our investor base as it relates to asset type, current income, market selection, and fund structure. That said, we are aware that the program has its merits and potential, even if we believe the benefits are likely to be priced into deals within the most highly attractive and in-demand areas covered by the program. We are mindful that either further clarifications from the IRS or a groundswell of investor appetite for a specific opportunity may cause our thinking to evolve. In the event that we find compelling reasons to shift our thinking beyond the current state, it will be in order to pursue deals that could only be feasible within the constraints of an Opportunity Zone investment, such as repositioning an obsolete product for better purposes or a form of affordable housing not currently achievable without such incentives. Such a change, of course, would require a satisfactory counterbalance to many of the existing contrary incentives and limitations of the existing program, such as the requirement to take on development risk while effectively being locked into a core type investment timelines, especially in low barrier submarkets ripe for further development. In addition, it is likely that other programs with different regulatory requirements may offer better results for sophisticated firms that value more control over assets. For instance, Virtus is currently reassessing the use of New Market Tax Credits as an alternative to the QOZ program. The firm may even find better returns acquiring distressed assets built hastily by unsophisticated investors because of the QOZ program, much like it historically found deals built with GO Zone incentives after Hurricane Katrina. In short, we are mindful that an astute firm should consider all means at its disposable to achieve the most accretive and defensible returns possible, including government incentives. However, it is only worth pursuing such incentives when they are in harmony with the fundamentals of a firm's business strategy, rather than in conflict with it. The current Opportunity Zone program includes too many requirements that conflict with core tenets of the Virtus investment philosophy that value control and flexibility over assets, and until that changes, the Firm will pursue other means of achieving outsize and resilient returns in commercial real estate.

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