the 9:05
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Is There Opportunity in Opportunity Zones?

Opportunity Zones (OZs) have been generating much debate and discussion lately. Created as part of the Tax Cuts and Jobs Act of 2017, OZs are federally-designated areas where real estate investors can get significant tax breaks by developing/re-developing properties. The Treasury Department issued interim guidelines in October, 2018 to help investors navigate the maze, but there are still many areas of uncertainty and a number of unanswered questions. The idea of providing incentives to accelerate investment into disadvantaged areas (approximately 8,700 designated census tracts) to create jobs is certainly laudable, but the over-arching question for Bailard and its clients is: "Is there opportunity in Opportunity Zone investment?" The simple answer is that it's still too early to tell.

The basics of the OZ program are straightforward. Investors who reinvest realized capital gains in a Qualified OZ Fund (QOF) can initially defer the tax burden on those gains and then, at five-year and seven-year milestones, reduce those capital gains. Ultimately, if the investment is held for more than ten years, investors can eliminate the tax liability on the OZ investment altogether (though 85% of the original capital gain an investor contributed into the QOF would still be taxable and payable in 2027).

If an investor picks the right QOF sponsor that makes astute investments, the OZ investment has the potential to be quite profitable above and beyond the tax benefits. As mentioned above, many of the OZs are distressed areas in desperate need of investment. So investors have an opportunity for a win-win-win: "doing well by doing good"... and doing so with tax advantages, to boot. Unfortunately, as with many tax-incentive programs, the devil is in the details.

Investments must be made through a QOF, which means that no existing fund vehicles may be used. This is unfortunate because there are already a multitude of private funds (closed-end and open-end partnerships and corporations) with tens of billions of dollars of investable capital whose investment strategies would potentially make them ideal investors into OZs.

A Flow of Dollars, along with Sponsors Chasing Them

However, there's no shortage of promoters interested in forming new vehicles to tap into the flow of capital eager to take advantage of the OZ program. In fact, CoStar Group recently tallied the number of announced funds aimed at the OZ opportunity and the results are stunning. In total, the list tops $18 billion in estimated fund-raising and includes 30+ funds targeting $50 to $99 million; 50+ funds targeting $100 to $500 million; and 10+ funds targeting at least $500 million (including a $3 billion fund sponsored by SkyBridge.) As expected, the pool of sponsors is a disparate group: some with track records, discernable real estate investment skills and solid reputations for fair dealing, integrity and transparency, along with some that exhibit, well, none of those qualities. Like many well-intentioned (and even well-designed) government programs, the opportunity for a quick buck attracts too many individuals and groups with questionable motivations.

> More than 100 funds seeking to raise **$18 billion**

The upshot is that there will be enormous amounts of new money (some of it disciplined and responsible, and some of it not) chasing a finite number of investment opportunities with real merit in a market already characterized by too much capital chasing too few really worthy deals. Interestingly, while most tracts designated as OZs are in secondary and tertiary markets yearning for investment, many of the OZ tracts are adjacent to Central Business Districts (CBDs), including San Francisco, Seattle, Portland, Denver, Los Angeles and Manhattan. For the past five to seven years, the latter had already been undergoing tremendous transformation because of their proximity to those hot and expensive CBDs. Investment capital was pouring into many previously blighted areas prior to the creation of the OZ program and some of those areas were already over-heating—not good for either the OZ program or QOF investors.

In an ironic twist on this same theme, the city council of Boulder, Colorado (yes, Boulder, one of the wealthiest enclaves in the United States) voted to put a moratorium on most new development in the city's opportunity zone. Apparently, there were concerns about the potential flood of new money into development projects that would amplify the gentrification and displacement of residents already occurring in the zone. Presenters at the public hearing in Boulder that preceded the city council's vote indicated that communities in Oregon and California were considering similar measures.

Equally concerning, as referenced above, there are still a number of details in the law and regulations surrounding the program that lack clarity. For example, it is not clear whether gains realized in OZ investments prior to the five, seven and ten-year milestones can be rolled into other OZ investments and preserve the original "clock," or does a new clock get tolled. Also, there is uncertainty about the role of land value in the equation used to determine the amount of capital that must be invested to improve an existing or develop a new property. Finally, the terms "original use" and "substantially improved"—the definitions of which are critically important for investors to know for certainty on time frames, quantum of investment, qualification and, ultimately, tax treatment—are still the subject of interpretation. Sophisticated investors will need answers to these and other opportunity-specific questions before they will feel comfortable making an investment. Conversely, some of the less disciplined and/or less experienced investors may jump-in imprudently and soil the program's reputation.

In Conclusion

The Opportunity Zone program emanating from the TCJA has the potential to funnel significant investment into many areas of the country that badly need it. Broadly speaking, it will provide incentives for taxable investors to make those investments in exchange for deferrals, breaks and even tax elimination in some cases. Unfortunately, in many ways, the program is not quite "ready for prime time" and suffers from some design flaws that may delay the salutary benefits it was envisioned to catalyze.

Beyond that, most institutional investors (including Bailard) would not make any investment purely based upon tax incentives. Bailard would not pursue any real estate investment unless there was an opportunity for significant income and capital appreciation, regardless of tax implications. Moreover, we all know that "What the government giveth, the government can taketh away." So best not to put too much faith in the benefits of a program that might not be around when the opportunity ultimately ripens. Finally, with the apparent flood of money into OZ funds, it would stand to reason that pricing on many OZ opportunities will likely increase, diminishing the attractiveness of those opportunities for investors seeking good relative value. Bailard is going to take a wait-and-see posture on the OZ opportunity for the foreseeable future. However, Bailard will continue to monitor the OZ program and keep its ear to the ground for any and all attractive investment opportunities whether they be in an OZ or not. And, if the landscape evolves such that creation of a QOF makes sense for Bailard's clients, Bailard will look to move quickly to diligently and prudently exploit the opportunity.

ABOUT *THE 9:05*

Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 meeting enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

DISCLOSURES

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