IN THE OPPORTUNITY ZONE:
JULY 2019
It’s rare for a policy program aimed at low-income areas across the country to garner a high level of attention and capital. But the opportunity zone program does just that. Program benefits: (1) increase capital inflows into the $8 trillion commercial real estate (CRE) market¹ by anywhere from $100 billion to over $6 trillion.²⁄³ (2) Boost after-tax IRRs for real estate projects by up to 150-300 basis points (bps) in the first 10 years. This is already affecting real estate prices in some areas. A recent MIT study⁴ found that opportunity zone designation resulted in a 14% price increase for redevelopment properties and a 20% price increase for vacant development sites.

We are currently tracking 138 large CRE funds targeting more than $44B in equity. Most of these funds have national mandates and intend to invest in multiple product types: 82% of capital in multifamily, 60% for office and 49% for retail. Industrial opportunities are thus far underappreciated.

Most deals are likely to get done in areas with strong CRE market fundamentals and/or where economic revival is beginning. Fast-growing markets in the Sunbelt, California and Mountain West, as well as Manhattan, offer attractive opportunities. Target markets in our database range widely—from Oakland, CA to the New York City boroughs to a number of Sunbelt markets.

Most funds (66%) and an even larger share of total equity (85%) intend to invest across multiple markets. Among single-market focus funds, New York City is the most preferred destination with over $1 billion in dedicated capital.

Timing is key! The clock starts ticking once capital gains are realized and funds should be invested 180 days afterward. The December 31, 2019 deadline to maximize tax benefits is fast approaching and the value of the tax break declines after that. However, investors can still contribute new capital to the program until the end of 2026 and avoid capital gains on the opportunity zone fund investment itself which can grow tax-free until 2047.

Eligible real estate investments comprise new (re)developments, capital-intensive renovations and, under the new guidelines, a wide range of operating businesses including those involved in managing and developing real estate. Investors can use debt on their projects and are permitted to execute cash-out refinancing after two years.

The inclusion of operating business in opportunity zones means that significant additional capital will be raised. Provided these investments lead to greater start-up activity and expansions of existing businesses in opportunity zones, leasing activity could accelerate.

Working capital can be held in cash and short-term debt securities for up to 31 months. Funds also have six months to identify projects for newly raised capital and 12 months to reinvest proceeds from asset sales. This will make it easier for opportunity zone funds to raise capital and function.

In addition, the 31-month and 12-month windows can be extended when a project is delayed while awaiting a government action. As a result, projects in highly regulated markets or ones that are not shovel-ready will be easier to do than previously thought.

This program is unlikely to make commercially unviable projects viable. The extent of the tax benefit depends on the success of the underlying investments, enhancing upside. Evaluation of individual deals should focus on the specifics of each investment.

DID YOU KNOW:
• 10-YR After-tax IRR up 150-300 bps
• OZ Prices Up 14% (redevelopment), 20% (land sites)
• $44B+ being raised
How It Works

The program allows for tax on any capital gains to be deferred provided those gains are invested in “qualified opportunity funds” (QOF) within 180 days. After reaching holding period requirements—at five and seven years—the basis for the original capital gain is adjusted upward, thereby deferring and reducing tax liability by up to 15%. The balance of the deferred gain will be recognized in 2026 or on disposal if earlier. If the opportunity zone investment is held for at least 10 years, there is no capital gains tax on the QOF investment itself.

Ninety percent of QOF assets must be invested in designated opportunity zones. Opportunity zone funds can either hold qualifying real estate directly or in equity investments in qualifying businesses. To qualify, a business must:

- Derive at least 50% of its gross income from an active trade or business located in one opportunity zone
- Have at least 70% of its tangible assets be qualifying opportunity zone property
- Have been established after December 31, 2017

In addition, the property investment needs to meet one of two tests:

1. Real estate needs to be put to “original use” with the QOF investment. I.e., the building was put into service for the first time for purposes of depreciation or amortization at the start of the QOF investment. The latest guidance provides an exception for buildings that have been vacant for at least five years prior to purchase.

2. The fund needs to “substantially improve” the property. I.e., QOF needs to more than double its basis in the property within 30 months of acquisition. These requirements apply only to the building and not to the land.

Development and capital-intensive repositioning projects are likely to qualify. Newly constructed property or projects currently under construction acquired prior to being placed in service (i.e. receiving a certificate of occupancy) also qualify and are likely the main path through which cash-flow-oriented investors could participate in the program.

For details on how this works reference page 3 of our November 2018 report.
The following investments in designated opportunity zones are likely to qualify:

<table>
<thead>
<tr>
<th>PURCHASE OF UNDEVELOPED LAND</th>
<th>INVEST IN BUSINESS THAT LEASES INDUSTRIAL SPACE IN AN OPPORTUNITY ZONE</th>
<th>PURCHASE AND REPURPOSE AN OFFICE COMPLEX</th>
<th>OWNED/OPERATED OFFICE BUILDING</th>
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<tr>
<td>Purchase of undeveloped land and building of affordable housing on the site. Low-Income Housing Tax Credits and debt financing may be used. Property is being put to original use with the investment. QOF has substantially improved the property by doubling its basis within the 30-month period. Land banking is prohibited.</td>
<td>An opportunity zone business can lease real estate in an opportunity zone and have it count towards the business’ 70% asset test. Any improvements the business makes to the leased property would also qualify as opportunity zone business property. <em>This provision will make locating in opportunity zones attractive to a wide range of tenants, supporting leasing demand.</em></td>
<td>Purchase of an office complex for $25 million (M). The QOF converts the property to residential rental. The purchase price is allocated as $10M to land and $15M to structure. Within 30 months of acquisition, the QOF has deployed an additional $15M (plus $1) into the property, thus more than doubling the fund’s basis in the building. This is an example of the property having been “substantially improved.”</td>
<td>An asset manager owns and operates an office building. The asset manager launches a QOF and uses the equity to launch a start-up accelerator located in the building. The QOF may also invest in the building’s other tenants provided that they meet the requirements. The QOF could also invest in any other OZBs.</td>
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The following investments in designated opportunity zones would likely not qualify:

<table>
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<tr>
<th>PURCHASE AND OPERATE EXISTING STRUCTURE</th>
<th>CONVERSION OF EXISTING STRUCTURE</th>
<th>INVEST IN BUSINESS THAT TRIPLE NET LEASES OUT PROPERTY</th>
<th>PURCHASE OF MULTIFAMILY PROPERTY TO RENOVATE</th>
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<td>Purchase of a strip center and continuing to operate the property. The property is not being put to original use, nor has it been substantially improved.</td>
<td>Purchase of a power center. The building cost is valued at $20M at the time of investment. The QOF spends $5 million converting the space to industrial but does not engage in a full tear-down and redevelopment. The property is not being put to original use because the structure had previously been in service, nor has it been substantially improved.</td>
<td>QOFs may choose to develop, own and operate their real estate projects through an OZB. Once a property has been developed or improved, should the OZB choose to operate the property by leasing it out to tenants, the lease cannot be a triple net lease because this is not considered “conduct of an active trade or business.” <em>Double net leases are permitted.</em></td>
<td>Purchase of multifamily property for $25M to renovate. The purchase price is allocated as $10M to land and $15M to structure. Thirty months after acquisition, the QOF has invested an additional $10 million in the building. The property is not being put to original use, and while the fund has increased its basis in the property, it does not fulfill the requirement for substantial improvement.</td>
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### Critical Questions Mostly Addressed
The guidance issued on April 18, 2019 clarifies most issues, of which the most critical areas are discussed below.

#### Opportunity Zone Businesses

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<tr>
<th>GUIDANCE</th>
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| A wide range of businesses can now qualify as OZBs, subject to different tests:  
• 50% of the hours worked by employees/contractors take place in an OZ  
• 50% of labor costs are from services performed by employees/contractors in an OZ  
• Property, management and/or operation functions in opportunity zone are required to generate 50% of gross income | • The labor costs test covers instances in which a firm’s engineering operations is in an OZ but its call center where most hours are worked is not in an OZ.  
• A landscaping business where the headquarters and management are in an OZ but services are performed elsewhere would qualify under the gross income test. This could also apply to consulting services firms.  
• A wide range of businesses qualify and even more could with minor restructuring.  
• Investments can only be made in businesses established or purchased from an unrelated party after December 31, 2017. | • This covers OZB investment in startups.  
• In addition, existing businesses can establish and capitalize new subsidiaries as OZBs. This should expand private equity investment into existing businesses.  
• Corporations may consider forming their own QOFs to invest in newly formed corporate subsidiaries that would qualify as OZBs. This would tend to be attractive only in cases where the corporation expects sizeable capital gains liabilities.  
• Leases and improvements made to leased property count towards the 70% OZ business property test. | • Leases are not subject to the same stringent, related party rules as asset sales.7  
• The program could have a material impact on leasing market fundamentals in certain opportunity zones.  
• The greatest impacts are likely to be on the office, retail and industrial markets; however, OZBs could also be formed to manage hospitality and multifamily assets as well.  
• The owner of a property in an opportunity zone could ground lease it to an OZB created by a QOF partly or wholly owned by the property owner. The OZB could then (re)develop or substantially improve the asset. |

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7 Requires only that the lease be market rate and that no prepayments more than 12 months are made.

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#### Working Capital

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| Working capital investments can be held in cash and short-term debt securities for up to 31 months without being counted against the 70% asset test.  
This provision applies to working capital held by a QOZB, not at the QOF level.  
The QOZB must have a written plan for how working capital will be deployed, and the fund must substantially comply with that plan.  
Extends 31-month window if the project is delayed awaiting governmental action. | QOFs will choose to invest in real estate primarily through QOZBs.  
This provision should facilitate real estate development and renovation projects as well as enable the function of a range of qualified opportunity zone businesses.  
The extension should encourage opportunity zone investment in highly regulated markets, such as California. Even in development-friendly jurisdictions, prospective investments no longer need to be entirely shovel-ready. |
Investment

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<td>• Investors can contribute assets as well as cash to QOFs.</td>
<td>• This will give rise to a mixed-investment where the existing basis in the contributed asset (e.g., land) would not be eligible for tax benefits while the embedded gain would be eligible.</td>
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<td>• After a QOF has formed, newly contributed capital will be exempted from the 90% asset test calculation for six months.</td>
<td>• This provides more flexibility in planning and investment.</td>
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<td>• Carried interests are not eligible for opportunity zone program tax benefits.</td>
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Reinvestment and Interim Gain

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<td>• If an investor disposes of his entire interest in a QOF on or before December 31, 2026, the investor may continue the original deferral and defer any additional capital gains by reinvesting the gain from such sale in another QOF within 180 days of such disposition. However, a new 10 year holding period clock for purposes of the deferred tax liability begins with the new QOF investment.</td>
<td>• Investors will be unlikely to exit their initial opportunity zone fund investments in the first 10 years of the program, unless the QOF investment seems unlikely to generate capital gains.</td>
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<td>• If the investor only disposes of a portion of his interest in a QOF, however, then there is no ability to continue the original deferral by making a new QOF investment, although the additional (new) gain could be deferred with a new QOF investment.</td>
<td>• This safe harbor is only for the purposes of the 90% asset test and not for holding-period-dependent tax benefits. Sale of an asset could generate taxable gain for the QOF itself or its investors if the QOF and/or the investors have not been invested for 10 years at the time of sale.</td>
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<td>• If a QOF sells an asset, the fund has 12 months to reinvest the proceeds from the sale for purposes of the 90% asset test.8 This 12-month period can be extended if the reinvestment is delayed in awaiting a governmental decision. Although reinvestment by the QOF will not result in the end of the deferral for the original deferred capital gains, any new gain recognized on the sale of the QOF’s assets will be allocated to the QOF’s members. If the gain is capital gain recognized on or before December 31, 2026, the QOF investor can defer such gains and otherwise get Opportunity Zone benefits by investing such gains into a QOF within the relevant 180-day timeframe. The original QOF investment will keep its original 10 year holding period clock, while the new investment will have a new 10 year holding clock.</td>
<td>• Any tax on interim gain could be deferred by either investing that gain in the same or another QOF (so long as such gain was recognized on or before December 31, 2026) or potentially via a 1031 exchange.</td>
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<td>• If a QOF sells an asset, the fund has 12 months to reinvest the proceeds from the sale for purposes of the 90% asset test.8 This 12-month period can be extended if the reinvestment is delayed in awaiting a governmental decision. Although reinvestment by the QOF will not result in the end of the deferral for the original deferred capital gains, any new gain recognized on the sale of the QOF’s assets will be allocated to the QOF’s members. If the gain is capital gain recognized on or before December 31, 2026, the QOF investor can defer such gains and otherwise get Opportunity Zone benefits by investing such gains into a QOF within the relevant 180-day timeframe. The original QOF investment will keep its original 10 year holding period clock, while the new investment will have a new 10 year holding clock.</td>
<td>• Interim gain taxation provisions currently prevent tax-free capital recycling in the first 10 years and are generally more favorable to pass-through structures. The provisions also create potential for conflicts of interest among investors that enter a QOF at different times (when the 10-year period has been reached for some but not all of the QOF investors).9 • Asset sales and reinvestment are more likely to take place within QOFs rather than via QOF investors exiting one QOF and reinvesting in another. In this case, there would still be potential taxes on interim gain prior to the 10-year holding period hurdle.</td>
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Debt

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<td>• Debt incurred by an opportunity zone fund is not considered a separate investment, ineligible for tax benefits.</td>
<td>• Absent this guidance, program benefits for leveraged investments would have been significantly reduced.</td>
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<td>• Investors can engage in debt recapitalizations after two year at the QOF and asset level—for example, when moving from construction bridge financing to permanent. This provides investors a means to increase near-term cash flow and could help investors pay their deferred tax liabilities.10</td>
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8 The proceeds are kept in cash or short-term debt securities.  
9 If the QOF is taxed as a corporation and the asset was held for less than 10 years, then the QOF would be assessed capital gain tax. If the QOF is taxed on a pass-through basis, then the tax impacts will vary for investors depending on how long they have been invested in the QOF. Gain passed through to an investor that has been invested for at least 10 years would be excluded even if the gain was generated by selling an asset that the QOF had held for less than 10 years. In contrast, a more recent investor in the QOF would be taxable. This same investor would be taxable even if the asset had been held for at least 10 years (and therefore prior to its investment in the fund). On the one hand, this clarification removes a key impediment to multi-asset funds. On the other, it creates potential for conflict among investors that enter the fund at different times. It also makes pass-through structures more attractive in general. Finally, it means that at least in the first 10 years of the QOF’s life, funds will not be able to recycle capital from one project to another without triggering tax consequences.  
10 There are provisions intended to prevent “disguised sales” that could cause certain debt proceed distributions to have tax consequences. In general, distributions from debt recapitalizations for investments that have been held for at least two years avoid this issue.
Areas for Further Clarification

• The original use and substantially improved requirements for business property of an OZB are applied on an asset-by-asset basis. This will cause reporting complexities and could raise issues in cases where there are multiple buildings within a facility but not all of them are either newly built or will be substantially improved. Further guidance is expected on this.

• It is currently unclear whether OZBs can reinvest the proceeds from sales of OZB property in the same manner as QOFs. The downstream tax consequences for QOF investors is similarly unclear. This is problematic because QOFs would tend to wish to own real property through an OZB.

To read about investing in a 1031 reference page 6 of our November 2018 report.

On your market, get set, go!

While headline figures suggest the opportunity to tap a potential $6T in unrealized capital gains through this program, the reality is that activity is likely to be more modest but still significant. Estimates range from $40B to $100B of equity over the next years. With leverage, the dollars put to work could be twice these estimates. For perspective, about $66B in product traded in the New York metro during 2018 according to Real Capital Analytics.

Cushman & Wakefield Research is currently tracking 138 funds, each targeting over $100 million in equity for a total of more than $44B in aggregate equity. The entire opportunity zone fund universe is significantly larger. For example, Costar Research has identified an additional 223 smaller funds, targeting $5.7B in aggregate equity.

Surveying the funds in the Cushman & Wakefield database leads to several observations:

• Geographic focus: Market targets range widely—from Oakland, CA to the New York City boroughs to a number of Sunbelt markets. Most funds (66%) and an even larger share of total equity (85%) in the Cushman & Wakefield database intend to invest across multiple markets. Among single-market focus funds, New York is the most common target with over $1 billion in dedicated capital.

• Product focus: Most funds plan to target multiple product types (52% of funds / 65% of equity). Among product types, multifamily investment is by far the most prominent focus, with 71% of funds representing 82% of targeted capital. Many of these funds will be investing in senior, student, affordable and/or workforce housing. Office is the next most common target followed by mixed-use. So far, fewer funds are targeting industrial assets. We expect this will change, however, as investors better appreciate the investment opportunity.

• Investment strategies: Most of the announced funds are focused on real estate investment. Still, a number seeks to combine real estate investments with support of local entrepreneurs. For example, Hypothesis Ventures plans to invest in opportunity zone startups via accelerator programs that would be operated out of co-working spaces it develops. The most recent guidance clarified which businesses would qualify for investment and did so in ways uniformly friendly to investors. We expect opportunity zone fund activity to expand beyond real estate going forward. OZB investments are likely to positively impact leasing market fundamentals in OZs.

• Investors: Only taxable investors with significant unrealized capital gains can benefit from this program. This means that investors will ultimately consist of high-net-worth individuals (and family offices thereof) and corporations. The opportunity zone program has visibility with high-net-worth investors, many of which have been driving greater interest in social impact funds and calls for “socially responsible investing.” Wealth management firms and private banking arms of various institutions will be critical to the fund distribution process. We expect these institutions to build platforms that offer their clients the ability to select from different QOFs. The development of this investment infrastructure appears to still be in its infancy, a result of which actual capital raised by QOFs is well short of announced targets. We expect aggressive movement by both QOF managers and intermediaries in the coming months ahead of the expiration of one of the program’s tax benefits at the end of this year.

• Fund managers: The entities launching funds are diverse; they include local developers, equity funds, social impact funds and large asset managers (e.g., Goldman Sachs, PNC Financial Services Group, Starwood and Brookfield). Municipalities and other non-profit groups across the country have been organizing to partner or otherwise assist QOFs in investing in their communities.

Promising Metros With Economic Momentum at a Tipping Point

Cushman & Wakefield evaluated 45 office and multifamily markets (containing 2,700 of the approximately 8,700 opportunity zones) across a range of factors indicative of economic momentum. These factors were divided into three categories: tax and regulatory including State Tax Confirmation Status (Wharton Land-Use Regulation Index), economic drivers (five-year forecasts for population growth, employment growth and household income) and CRE fundamentals (2019 office and multifamily inventory, vacancy and growth.)

Sunbelt markets lead the group, as growing populations support economic and CRE fundamental outlooks and the tax regulatory environments are generally favorable for development. Fast-growing markets in California and the Mountain West also appear, including the San Francisco Bay Area, Los Angeles, Portland (OR), Seattle and Manhattan. The full scorings and model detail are available in the appendix.


Economic Momentum Index
Composite Z-Score (mean = 100)

Source: Cushman & Wakefield Research

To access details on the metrics reference the appendix in our November 2018 report.

Though the opportunity zone program is still in its infancy, it has already begun to impact pricing in the designated areas. A recent MIT study found that redevelopment properties in opportunity zones are selling for 14% more than comparable properties outside the zones while vacant development site prices have increased 20%.12 Existing property prices, however, show little impact so far. Our metro ranking model suggests that price increases are likely to be even more significant in higher ranked areas. Moreover, these markets are the most likely to experience increased economic dynamism as a result, benefiting existing properties as well. This effect is liable to be further enhanced as opportunity zone investment extends to operating businesses and so impacting the leasing market.

CONTRIBUTORS

David Bitner
Vice President
Americas Head of Capital Market Research
david.bitner@cushwake.com
@Bitner_speaks

Revathi Greenwood
Americas Head of Research
revathi.greenwood@cushwake.com
@RevuGreenwood

FOR MORE INFORMATION

Sara Gougarty
Managing Director – Industry and Specialty Advisory Platform Lead, Americas
sara.gougarty@cushwake.com

About Cushman & Wakefield

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