Forming Opportunity Funds

Expecting startups by year-end

By Mark Fogarty

Funds seeking to take advantage of the new Opportunity Zones are actively forming now and may be deploying money for investments in economically distressed areas by the end of the year.

Meantime, implementation issues have the nascent Opportunity Funds looking to Treasury for additional guidance, which may come this summer.

Once formed, funds may start gathering money for investments later this summer, with implementation of investments in the fourth quarter of this year or the first quarter of 2019, according to John Gahan, a partner in the real estate department of Sullivan and Worcester, Boston. He said he knows of one fund that has registered as an Opportunity Fund in the state of Arizona and many others are in the organizational state.

But there are obstacles. Glenn Graff, attorney at Applegate & Thorne-Thomsen, Chicago, said, "There are very significant timing issues. We're looking for guidance from Treasury."

At issue is a tight window for turning projects around. The regulation now "requires you invest gain within 180 days of selling property," said Graff (with investors getting a tax deferral on the gain). "That may be either too early or too late for when a particular project needs money." Graff thinks a form of bridge financing may be the answer.

"Maybe a syndicator has funds it can loan to a project while it searches for investors. Or maybe a developer can borrow money and use that to get started up. Then when either a developer in a fund finds an investor or a syndicator finds an investor, when the money comes in they pay off that loan. We think that should work within the rules," he said.

Gahan noted great interest in the new funds and said, "We have lawyers from several departments working on it, both for existing clients and with an eye to target the affordable housing industry as well."

Graff said his firm is working on two funds, one from a syndicator and one from a developer, that are looking to develop mixed-use (residential/commercial) and workforce housing. Affordable housing is one (but not the only one) of the targets of the funds, which were authorized by last year's tax bill.

"Those are what I'm seeing so far," he said. "The possibilities are wide. There are hardly any limits."

The mixed-use fund "is talking to investors. They're just doing that now. They are just at the talking stage," said Graff.

Aaron Yowell, partner and chief innovation officer at Nixon Peabody, New York, also sees potential funds as not starting up right away.

"We are still in the very early stages of this. There are varying levels of progress, both on the fund side and on the deal side. That variance would be very little to a modest amount of progress," he said.

"The people who are the farthest along are the people who have identified gain that they can invest and have started to make investment funds."

New construction may be easier use

Yowell did not want to estimate what percentage of eventual program use might go towards housing.

"It's not a housing production program. You can use it to produce housing but there are other ways to use it," he said. He also felt new construction might be easier to work with than acquisition and rehab.

Gahan said while actual funds haven't launched yet "the ones creating the funds certainly have gotten to the stage where they have geographically mapped where they may use the funds they will create to help existing clients or new clients who own or who are buying property in Opportunity Zones.

"In the case of the fund in Arizona, I've seen the documents that have gone out to prospective investors to describe what the fund would do or how the fund would operate."

As of the beginning of June, 46 states and six territories/districts (Puerto Rico, Virgin Islands, Washington, DC, American Samoa, Guam and the Northern Mariana Islands) had submitted nearly 8,000 census tracts to be designated Opportunity Zones. In the case of Puerto Rico, every census tract on the island has been included in an effort to help the island recover from the damage

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done last year by Hurricane Maria.

At this early stage in their development, there is a lot of speculation (and few hard details) about how the funds will look and how they will benefit affordable housing. Graff thinks they will be organized mainly as partnerships, while Gahan thinks the LLC, which he said can be considered a partnership for tax purposes in certain cases, will see a lot of use.

"I practice in the real estate area," said Graff. "I know there's venture capitalists out there looking to try to use this. Some of the rules make it harder for venture capital. These rules that you can't have a lot of cash hanging around, if you wanted to do a tech startup and fund them with a lot of cash and burn through it over time, it becomes tricky to do it in an Opportunity Fund.

"Real estate is the easier sell. Investors can't afford to lose money. Real estate is a solid investment, something people will be comfortable with. I think real estate will be a prime area for this."

Gahan emphasized, "The key is to make investments in property that appreciates in value. Nobody who has gain is putting their gain money in the fund today to lose it. They'd rather pay their taxes today than lose their money. The people who are creating the fund and doing the investing have to pick winners."

Nonprofit perspective

How does the nonprofit sector view the new program?

Chris Herrmann, vice president of conventional equity at Enterprise Community Investment, New York, said, "Opportunity Zones and Opportunity Funds can be a powerful force for community revitalization. It's a tremendous opportunity to bring capital to distressed communities, to help invest in real estate in those communities, to grow small businesses and to ultimately improve residents' lives."

He said Enterprise was "uniquely well-positioned" to raise Opportunity Funds and deploy that capital in a socially responsible way.

"We certainly see Enterprise's role in this space being aggregating Opportunity Fund capital, investing in affordable housing and other community development endeavors, and we are actively seeking how we may be able to raise our own fund and deploy the capital."

There are challenges, however. "The industry is having a challenging time interpreting some of the technical aspects of the law in the absence of further guidance from Treasury," he said.

Another challenge is "who are the investors that have those gains?" Banks may not have much in the way of capital gains, for instance, while insurers may.

Enterprise will pursue funding both single-family and multifamily housing, Herrmann said, though its focus will be on multifamily. He thinks Opportunity Funds, including Enterprise's, should be ramping up in the fourth quarter of this year or the first part of next year.

Individuals "represent an interesting base of investors" and an opportunity for Enterprise to help them align their social goals with their investment goals, he said.

Individuals aren't the only other possible investors. Graff speculated that some companies that have a gain may structure their own funds. He used the example of Nabisco building an Oreo factory in Chicago in an Opportunity Zone.

"Opportunity Zones are a huge flexible tool. Nothing that says Nabisco can't do that. A very, very flexible tool. Those kinds of things can happen. I don't know if they will happen that often. I doubt it, but Amazon could choose to build its next headquarters in an O-Zone."

A non-housing project he could see succeeding would be a server farm.

"You buy a warehouse building in an Opportunity Zone area and you spend a bunch of money on computers and you let it rock," he said. TCA

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