

THOUGHT LEADERSHIP SERIES

OPPORTUNITY ZONES:

THEIR IMPACT ON THE MID-ATLANTIC
COMMERCIAL REAL ESTATE MARKET

MARCH 2019

OPPORTUNITY ZONES OVERVIEW

Created in the Tax Cuts and Jobs Act of 2017, Opportunity Zones are a new federal program designed to spur economic development and job creation in distressed communities. Opportunity Zones are low-income Census tracts in which tax incentives are offered to those who invest and hold their capital gains in Zone assets or property. The U.S. Treasury has approved 8,700 qualified Opportunity Zones that were designated by the governor of every U.S. territory and state as well as the mayor of the District of Columbia.

Investors can receive capital gains tax deferral, reduction in basis for long-term investments, and other tax incentives by placing capital in a Qualified Opportunity Fund. Invested capital gains are subject to two reductions in capital gains tax liability, a 10% reduction at the five-year hold mark, and a 15% reduction at the seven-year hold mark. Qualified Opportunity Zone investors

receive an exclusion from capital gains tax on Opportunity Zone investments if the investments are held for 10 years. Because investors may only claim the seven-year benefit if their holdings reach that threshold by the end of 2026, capital must be deployed by the end of 2019 to take full advantage of the incentives—meaning this year is a critical one for the new program. Of note, tax forgiveness applies only to the capital gains from the Opportunity Zone investment, not the capital gains placed with a Qualified Opportunity Fund. Please see the exhibit below for more details on the program's key tax benefit thresholds.

The U.S. Treasury estimates that at least \$1 trillion will be invested in Opportunity Zones over the next 10 years, reflecting their potential to reshape the future of commercial real estate investment. For a fuller examination of the national Opportunity Zone landscape, please see Newmark Knight Frank's study [*Opportunity Zones: Navigating a Path to Investment*](#).

TAX BENEFITS BY INVESTMENT TERM LENGTH

5 YEARS

Deferred payment of invested capital gains until the date the Opportunity Fund investment is sold or exchanged.

5 YEARS

Deferred payment of invested capital gains and liability is reduced by 10%.

7 YEARS

Deferred payment of invested capital gains and liability is reduced by 15%.

10 YEARS

In addition to deferred payment and 15% reduction in liability of invested capital gains, accrued capital gains generated from the Opportunity Fund investment are 100% tax-exempt.

CAPITAL IS AVAILABLE FOR INVESTMENT IN OPPORTUNITY ZONES

The current U.S. economic expansion has been the second-longest growth cycle post-World War II. If growth continues through mid-2019, the expansion will supplant the 10-year record set in the late 1990s by the technology boom. The United States commercial real estate investment market continues to experience near-record levels of activity, as investment volume in 2018 was higher than in any other year during the current cycle but 2015. An estimated \$6 trillion of unrealized capital gains remains on the sidelines from investments both within and outside of real estate, and some of that capital could be deployed in Opportunity Zones—though

because it is spread across so many households and corporations, not all of the capital is readily accessible.

From a public policy standpoint, there is some skepticism surrounding the Opportunity Zone program on the grounds that it may yield more tax benefits for investors than economic benefits for areas in need. However, the program thus far appears to be generating considerable investor interest, a necessary condition for achieving its policy objectives. Investors also have discovered that many local governments have been accommodating of permitting and zoning requests for Opportunity Zone projects, particularly for sites that the private sector would not develop under other circumstances. Importantly, not only real estate investors but also local businesses may benefit from the investments that will be made in the designated zones.



**MANY LOCAL GOVERNMENTS
HAVE BEEN ACCOMMODATING
OF PERMITTING AND ZONING
REQUESTS FOR OPPORTUNITY
ZONE PROJECTS.**

THE IMPACT OF OPPORTUNITY ZONES IN 2018

Interest in Opportunity Zone investment has been robust since shortly after the tax reform legislation was passed in December 2017, and major institutional investors are seeking to take advantage. In 2018, there were \$52.3 billion of commercial property sales within Opportunity Zones, a 12.4% increase compared with 2017 in those same jurisdictions. (To be clear, this investment volume includes all sales within those jurisdictions, not just Qualified Opportunity Fund transactions.) While Opportunity Zone sales represented a relatively robust 10% of total U.S. commercial real estate investment in 2018, data points to significant growth opportunity within these areas. In the current real estate market, large institutional investors often look to emerging markets to chase higher yields. In fact, some of the tracts selected as Opportunity Zones were already being targeted, particularly in the Mid-Atlantic region. According to a recent study by Real Capital Analytics, approximately 15% of all commercial development activity from 2015 to third-quarter 2018 was already occurring in Opportunity Zones.

One notable obstacle to Opportunity Zone investment has been the lack of detailed guidance from the Internal Revenue Service regarding the tax treatment of investments, and especially which categories of investment qualify for tax incentives. The partial government shutdown in late 2018 and early 2019 postponed expected guidance. Despite this information gap, motivated investors are moving forward with their plans, unwilling to miss out on potentially lucrative investments in the designated jurisdictions. Numerous funds have raised billions of dollars in a push to make suitable investments by the end of 2019 in order to capitalize on the program's tax benefits. For more information on early trends in Opportunity Zone investment, please see the [January issue](#) of Newmark Knight Frank's publication *Real Insight*.



THE MID-ATLANTIC REGION HAS FAVORABLE CONDITIONS FOR OPPORTUNITY ZONE INVESTMENT

Due to favorable economic conditions, support from state and local governments, and shovel-ready development in newly designated Opportunity Zones, the Mid-Atlantic's commercial real estate investment community is well positioned to capitalize on the Opportunity Zones program. See the chart on page 5 for a summary of the region's potential via comparative statistics.

By nature, Opportunity Zones are located in economically distressed neighborhoods, representing greater risk to potential investors. However, there are outliers within the program that exist in economically expanding neighborhoods, including 70 which a study produced by RCLCO labeled as "high-end neighborhoods." These are most densely concentrated in Mid-Atlantic and Rust Belt cities. These metro areas feature Opportunity Zones with an elevated median household income, a highly educated workforce, and an expanding tech workforce. In Washington, D.C., for example, there are three Opportunity Zones with median household incomes higher than \$90,000. While these zones give fodder to opponents of the program that it is not precisely designed to achieve its policy aims, they also represent intriguing real estate plays for investment capital.



MID-ATLANTIC OPPORTUNITY ZONES BY JURISDICTION

Jurisdiction	Number of Zones	Number of Contiguous Zones	Median Income of Zones	Median Income of Jurisdiction	Average Zone Poverty Rate	Jurisdiction Poverty Rate
District of Columbia	25	0	\$38,291	\$78,360	32.2%	19.1%
State of Maryland	149	4	\$47,504	\$80,607	22.6%	11.1%
Commonwealth of Virginia	212	8	\$42,944	\$74,308	22.5%	12.5%

Source: Urban Institute

A new report by Smart Growth America, a coalition of community advocacy organizations, ranked the nation's 8,700 Opportunity Zones for their potential to deliver on benefits for communities, the environment, and investors. The report ranked Baltimore in a tie for first in "smart growth potential" (along with Portland, San Francisco, Seattle, and Philadelphia), with Baltimore's Inner Harbor noted as the most promising market. Given the rapidly approaching deadline for investors to take advantage of the full tax benefits of the program, Opportunity Zone investment

likely will become focused on shovel-ready developments that already have the necessary entitlements. Opportunity Zones exist in Downtown Baltimore for areas already scheduled for major redevelopment, including Port Covington, Poppleton, and Perkins Homes in Southeast Baltimore. Port Covington, a 3-million-square-foot mixed-use development planned along South Baltimore's underdeveloped waterfront, is one of the nation's only shovel-ready, build-to-suit tracts of its size within an Opportunity Zone.

**BALTIMORE TIED FOR FIRST IN
SMART GROWTH POTENTIAL, WITH
BALTIMORE'S INNER HARBOR NOTED
AS THE MOST PROMISING MARKET.**



OPPORTUNITY ZONES IN OR NEAR GROWING NEIGHBORHOODS OF EXPANDING CITIES ARE WELL POSITIONED TO BENEFIT

Over the past two decades, the District of Columbia has undergone dramatic change, with an influx of commercial development transforming many of its more economically distressed neighborhoods into emerging economic epicenters for the city. Of note are the Capitol Riverfront and Southwest submarkets, two areas of the District that have experienced significant growth in the multifamily, office, and retail markets in just the past decade. Many developers are now looking across the river to Anacostia and nearby Prince George's County in Maryland, where largely underdeveloped neighborhoods are viewed as high-yield targets for Opportunity Zone investors. As of early 2019, local developer Redbrick LMD is setting up Opportunity Zone funds for several projects east of the Anacostia River, including its Columbia Quarter Development, a 2.3-million-square-foot mixed-use project that will include 1.6 million square feet of office space, 700 residential units, and ground floor retail.

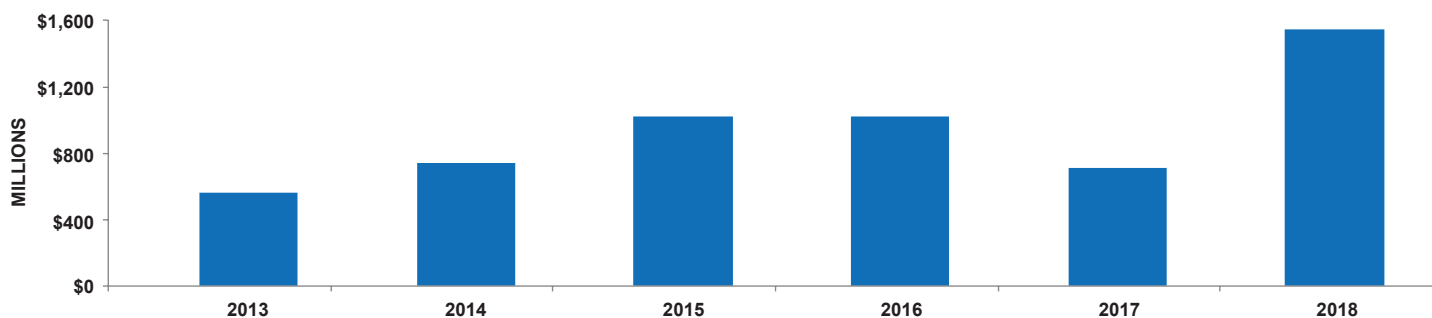
While the Washington metropolitan area has been developing rapidly over the past decade, investment sales data suggest that the Opportunity Zone legislation may have a more pronounced impact on the region than it has nationally. From 2013 to 2017, investment volume in Washington metro area properties located in the newly designated Opportunity Zones averaged approximately \$800 million per year, including \$714 million in 2017, as shown in the adjacent graph. In 2018, total volume in the newly designated jurisdictions reached \$1.5 billion, a 117% increase year-over-year. This compares with the United States' Opportunity Zone sales volume increase of 12%.



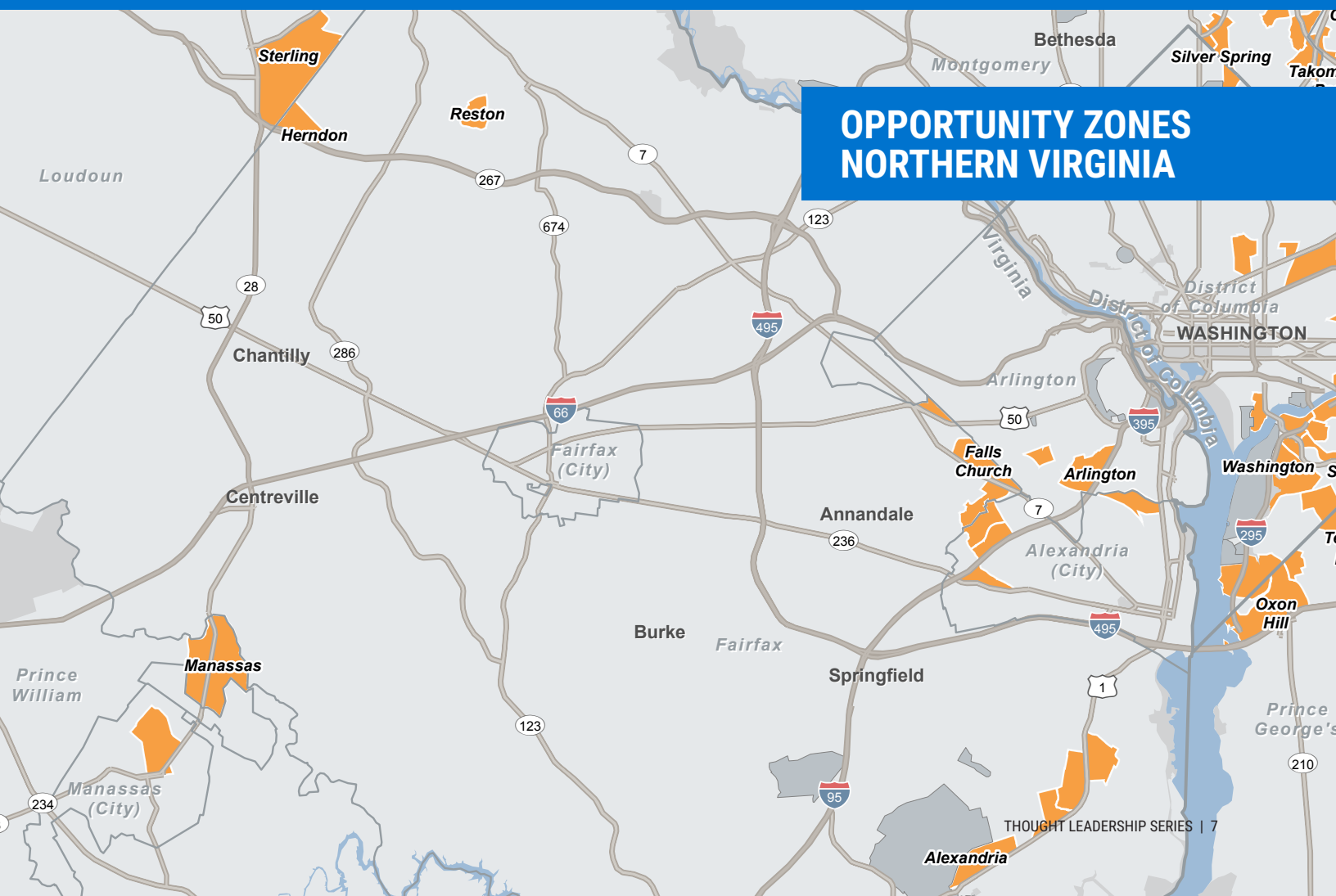
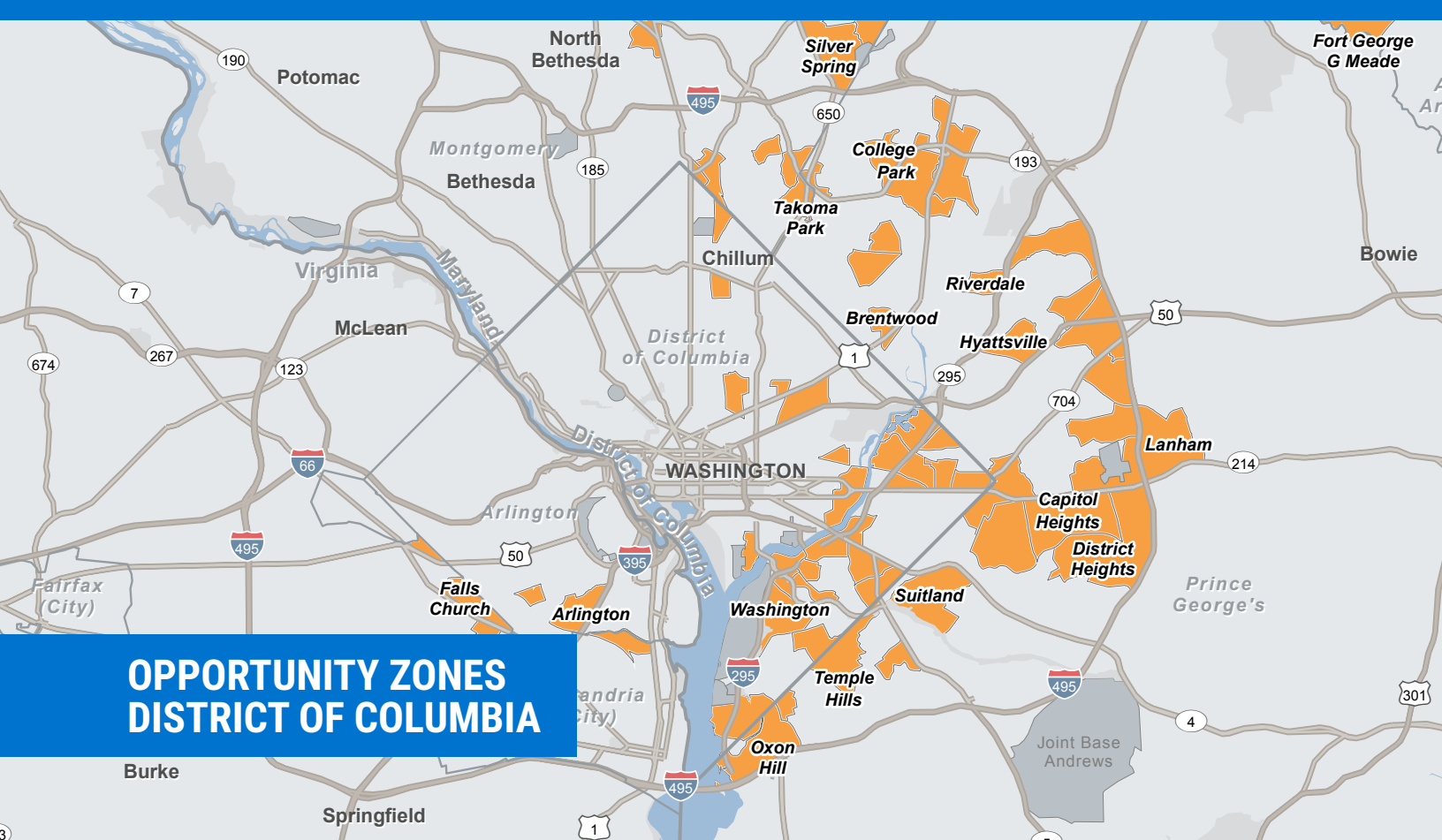
These figures are only roughly analogous, however. The sales data cited earlier includes stabilized product and Class B urban infill transactions, and these trades are not related to the program in a concrete way. The Opportunity Zone program is meant for undeveloped land, and Class C/tear-down commercial and multifamily properties. A Qualified Opportunity Fund must put as much money into development/renovation of an asset as the building is worth, excluding the value of the land (the substantial improvement provision). For most Class B assets and those even better, such an effort becomes cumbersome and expensive.

There are benefits of an Opportunity Zone designation, but they are weighted toward the intangible for now, related to the publicity surrounding the program (and the free marketing that properties within Opportunity Zones are given in the media) as well as the increased appeal to social impact investors of those assets located in the designated zones.

OPPORTUNITY ZONE SALES VOLUME WASHINGTON METRO AREA | ALL PROPERTY TYPES 2013 – 2018



Note: Sales from 2013–2017 are of properties within newly designated Opportunity Zone boundaries
Source: Data provided by Real Capital Analytics, analysis by NKF Research; January 2019



OPPORTUNITY ZONE FUNDS ALLOW MID-ATLANTIC DEVELOPERS TO RAISE CAPITAL FOR PROJECTS IN UNDERSERVED NEIGHBORHOODS

Because investments in low-income neighborhoods may pose greater risk than those in economically vibrant areas, investors in low-income tax credit projects are often institutions that do not have significant capital reserves. This has created a cycle in which securing financing for transformative commercial development in underserved neighborhoods has been more difficult. However, the significant tax benefits associated with the Opportunity Zone program have piqued the interest of large investors willing to assume greater risk.

One example is CityInterests' 3.1-million-square-foot Parkside development, located within the Mayfair Opportunity Zone, one of the District of Columbia's most economically distressed neighborhoods. Over the past decade, CityInterests has completed 700,000 square feet of development through traditional means like equity, bank financing, and tax credits. However, since the Opportunity Zone legislation was introduced just over a year ago, CityInterests has already teamed with several Opportunity Zone investors with a goal of raising \$40 million that will help fund the next three phases of the project.



OPPORTUNITY ZONES GARNER SUPPORT FROM STATE AND LOCAL GOVERNMENTS

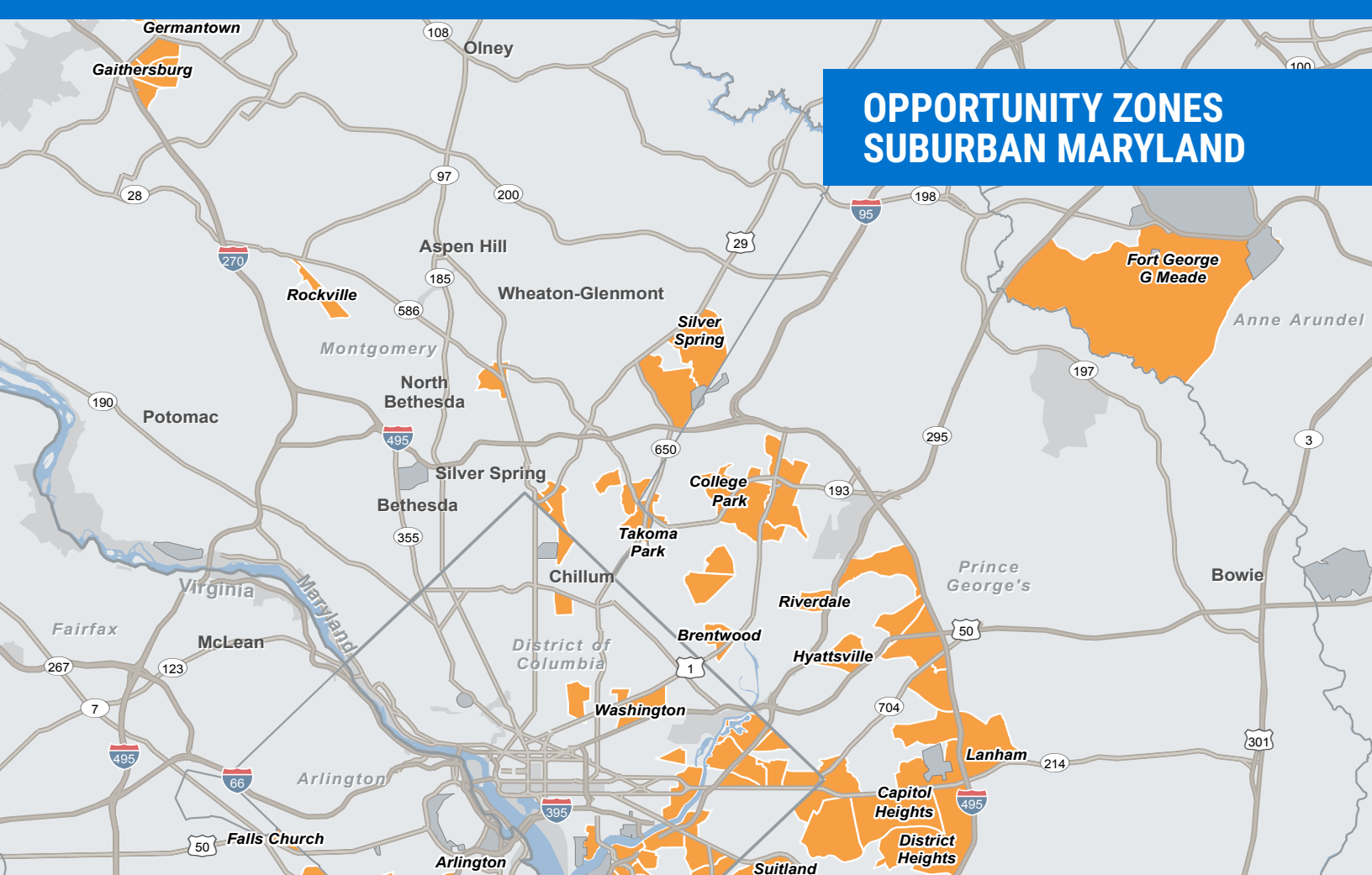
Although the Opportunity Zone program is part of a federal tax law, oversight of the program will largely be directed by state-level administrators. The relative success or failure of the program will depend on state and local governments implementing successful strategies and legislation to drive economic growth.

Notably, in Maryland, Governor Larry Hogan has dedicated significant funds toward a Maryland Opportunity Zone task force, which will oversee initiatives and legislation to take full advantage of the economic and social benefits the program can provide. Governor Hogan also announced that his administration will introduce the More Opportunities for Marylanders Act of 2019 to extend a 10-year tax credit for each new job created by a company that locates or expands in a Maryland Opportunity Zone. Baltimore stands to be a major beneficiary of this initiative, with 42 Census tracts currently designated as Opportunity Zones.

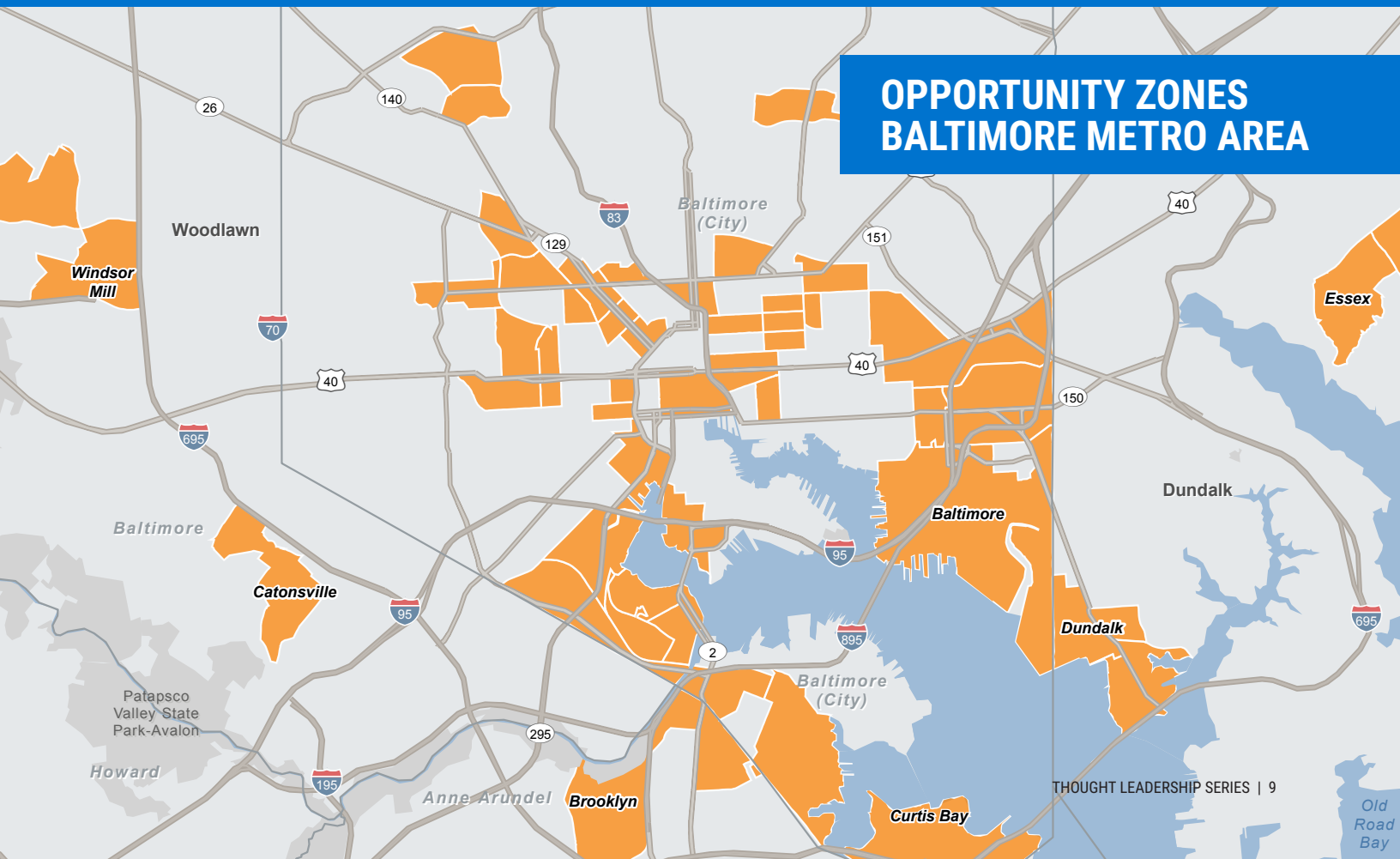
BALTIMORE STANDS TO BE A MAJOR BENEFICIARY OF THIS INITIATIVE, WITH 42 CENSUS TRACTS CURRENTLY DESIGNATED AS OPPORTUNITY ZONES.



OPPORTUNITY ZONES SUBURBAN MARYLAND



OPPORTUNITY ZONES BALTIMORE METRO AREA



MID-ATLANTIC OPPORTUNITY ZONES AND IMPLICATIONS FOR INVESTORS

The Opportunity Zone program has the potential to be an economic and development driver nationally, with increased investment in the commercial real estate market acting as an economic catalyst for distressed communities. Notably, the Mid-Atlantic commercial real estate market in particular stands to benefit due to favorable conditions for investment, interest from major institutional investors, and expressed support from state and local governments. Opportunity Zones are likely to attract a new and diverse set of investors willing to assume greater risk in previously underserved and underinvested emerging neighborhoods. Indeed, the substantial interest in the program has served as the impetus for the creation of new and wide-reaching avenues for investment. Recently, Connecticut-based real estate developer Belpointe announced the launch of Belpointe REIT, the first REIT targeting Opportunity Zone investments exclusively. The trust has set a minimum of only \$10,000 in capital for an investor to participate. By investing in a large number of Opportunity Zone assets across the country, the REIT says it will reduce risk for its investors while providing greater flexibility than a traditional private equity fund.

Notably, while fundraising is likely to come from a wider pool of investors than is typical, the sponsors of Opportunity Zone developments are likely to be the larger, institutional players who already have been active in these areas. At this point in the investment and development cycle, the skill of the sponsor is very important, because it is harder to turn a profit than it was earlier in the cycle. Investors are seeking to put their money with sponsors who have extensive development experience, particularly in emerging jurisdictions.

Investors who want to take advantage of these new opportunities will need to create or participate in a Qualified Opportunity Fund, find suitable investment opportunities that

meet pending IRS guidelines, and invest their capital gains before the end of 2019 in order to maximize tax benefits. The timeline is challenging, particularly given the still-incomplete guidance from Treasury. However, the returns to investors could prove substantial, and neighborhoods that have long sought more investment stand to benefit. Notably, the Opportunity Zone program might aid in the development of sites that previously would not have been of interest to the private sector. The benefits to after-tax IRR may offset the cost of environmental cleanups or other special situations that might have to be addressed in order to make a property functional.

SOURCES AND ACKNOWLEDGMENTS

- *BISNOW*
- *COSTAR*
- *ESRI*
- *FORBES*
- *FUNDRISE*
- *RCLCO REAL ESTATE ADVISORS*
- *REAL CAPITAL ANALYTICS*
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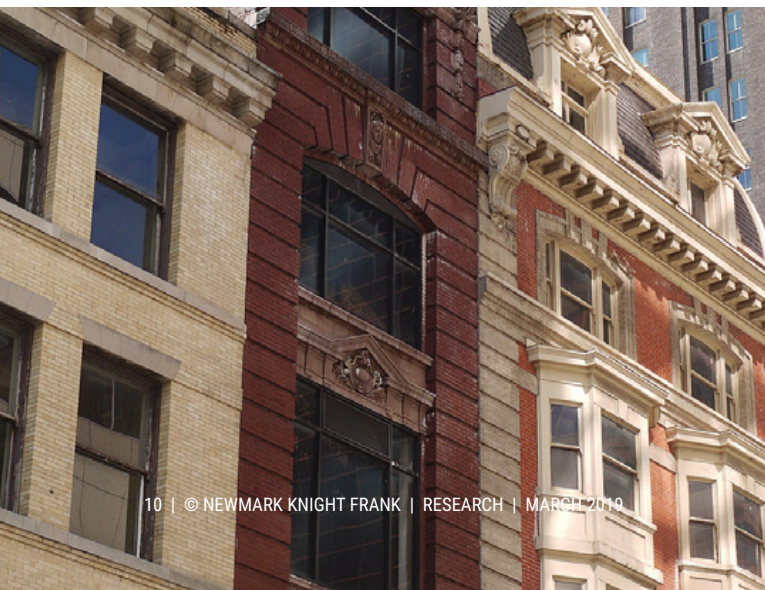
We offer a special thank you to our NKF research colleague, Daniel Littman, for his comments on this study.

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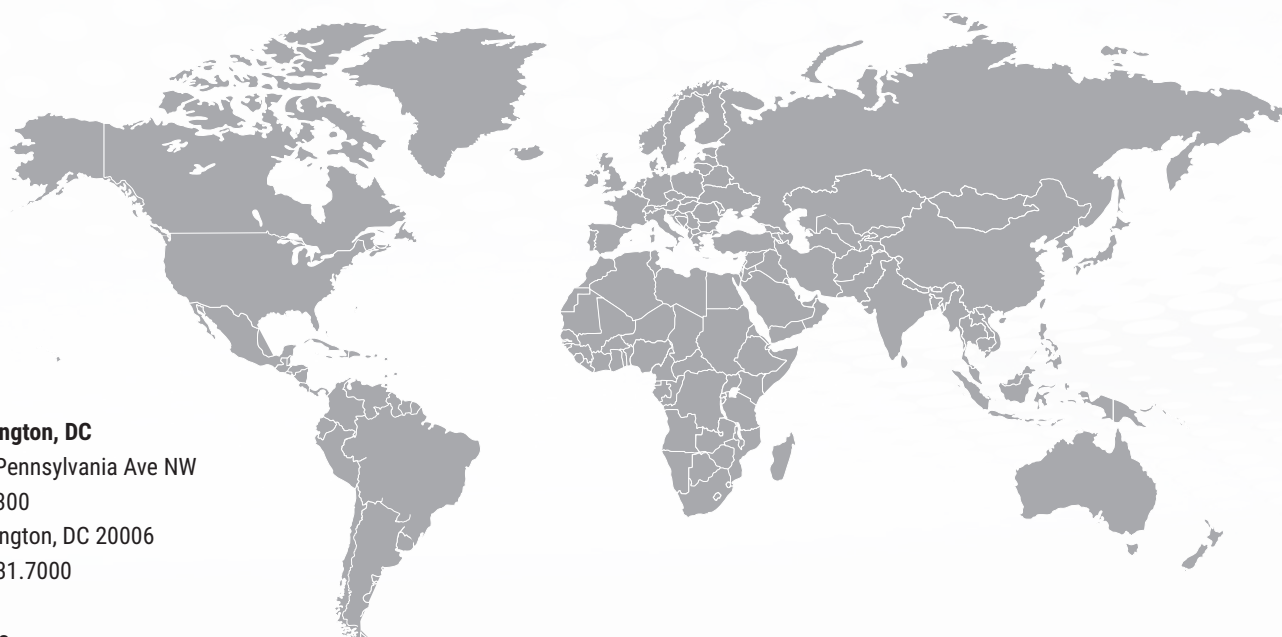
DESIGN: Dan Kidd, Senior Graphic Designer; Omar Bilal, Senior Graphic Designer

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PREVIOUSLY UNDERSERVED
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EMERGING NEIGHBORHOODS.**



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