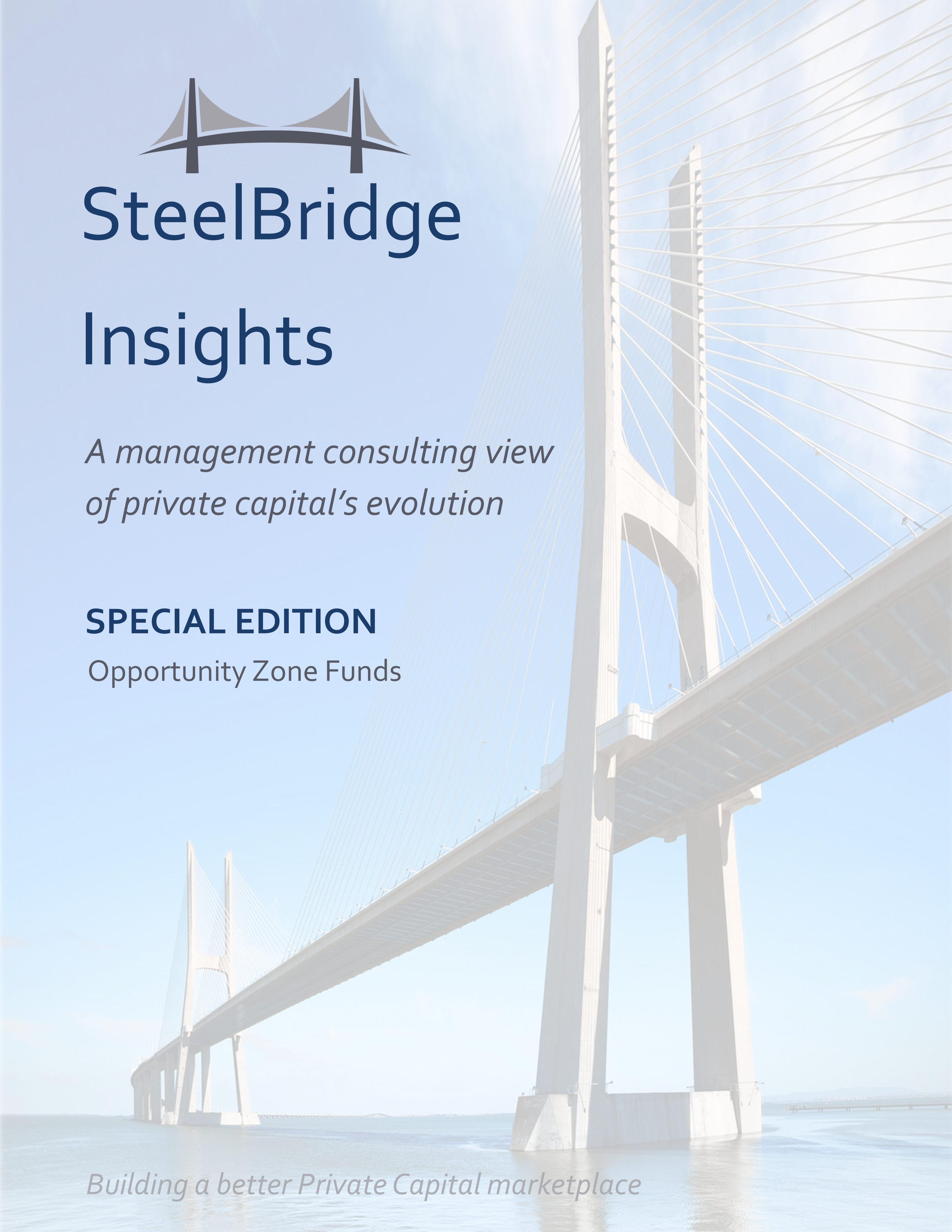

SteelBridge

Insights

A management consulting view of private capital's evolution

SPECIAL EDITION

Opportunity Zone Funds

Building a better Private Capital marketplace

Key Highlights:

- Opportunity Zones and Qualified Opportunity Funds (QOFs) present a unique opportunity to do well and do good
- With the creation of QOFs, managers and investors face new structural and reporting requirements for the government and investors
- Through careful structuring of funds and picking of investments, LPs and managers have the chance to make significant impacts on fund returns, struggling communities, and national policy
- Engaging third-party resources to navigate these new regulations and opportunities is critical to QOF manager success

Introduction

Occasionally in domestic policy there come opportunities to "do well and do good". These moments present those with the means to affect change to do so without sacrificing their ability to generate returns for the monies they manage on a daily basis. Recent history has seen many more of those opportunities – public-private partnerships, social enterprise and social entrepreneurship, and so on.

One such opportunity has arisen from the Tax Cuts and Jobs Act of 2017. Passed in December of 2017, the act authorized states to designate Opportunity Zones wherein dollars can be injected to improve communities in need of economic redevelopment. It further authorizes investors and fund managers to form funds specifically for the purposes of selecting and making such investments.

In this special edition of SteelBridge Insights, we explore the development of Qualified Opportunity Zones (QOZs) and Qualified Opportunity Funds (QOFs). Additionally, we provide some commentary on their potential impact in private capital and some ways to navigate these new waters.

It is important to note that the world of opportunity zones is a new one, one in which regulators, investors, and community members find themselves shaping policy as much they adhere to it. Our discussions with legal and accounting professionals as well as our own expertise has still yielded more questions for which there aren't answers. That said, we see this world as one in which sound operational decisions can help create that world where doing well also means doing good, and it's one in which we at SteelBridge can help fund managers create a sustainable program going forward.

What is a QO Fund?

Funds and Zones

Qualified Opportunity Funds (QOFs) are defined in H.R.1, popularly known as the Tax Cuts and Jobs Act of 2017. This legislation encourages long-term investments in designated low-income urban and rural communities nationwide. It does so by allowing investors to defer capital gains from other investments if they are invested in vehicles dedicated to putting capital to work in properties and businesses within Qualified Opportunity Zones (QOZs). For private capital, this portion of H.R.1 presents the unique opportunity to create QOFs almost exclusively dedicated to accredited investors' investment in QOZs.

A QOF is an investment vehicle – classified as a partnership or a corporation for federal tax purposes – that meets very specific structural and timing criteria. Given the limitations imposed by these criteria (detailed in Table 1 below), QOFs will likely be formed as single-asset entities with one real estate property per QOF. One significant point in structure is that the QOF is not permitted to hold working capital for any significant time period. Rather, a QOF must rely on a "subsidiary" or QOZ Business, also subject to very specific structural and timing criteria, to hold and deploy capital for the QOZ properties within the regulatory timeframes. Fund managers are often finding this model to be almost the inverse of a traditional "raise fund, deploy capital" structure and need to be very conscious of the unique requirements.

While the Treasury Department released an initial set of regulations in October 2018 for investing in Qualified Opportunity Funds, there are still a significant number of outstanding issues for which the Department has requested public comment. Given the complexity of the regulations, many investors are eagerly awaiting additional clarification from Treasury prior to finalizing and executing their fund structures. However, the enormity of the opportunity and the limited timeframe in which to realize the full benefit of the program has many investors ready to hit the ground running as soon as final guidance is provided.

The timeline on the following page represents a high-level overview of the critical dates which drive compliance and trigger the corresponding investment benefits.

Table 2 and Table 3 below indicate the status of the terminology used in the current regulations and whether further clarification is needed or anticipated in the next release.

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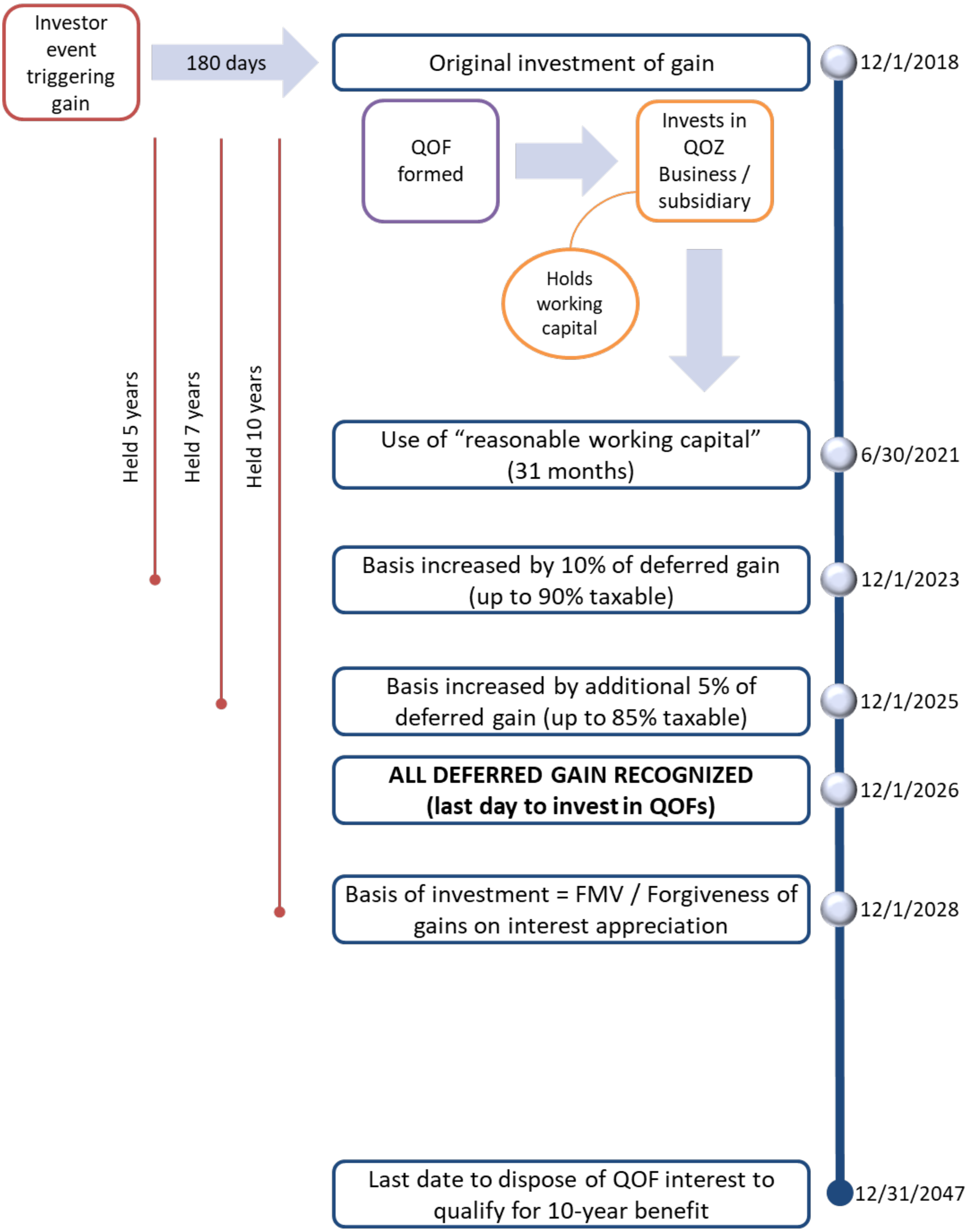
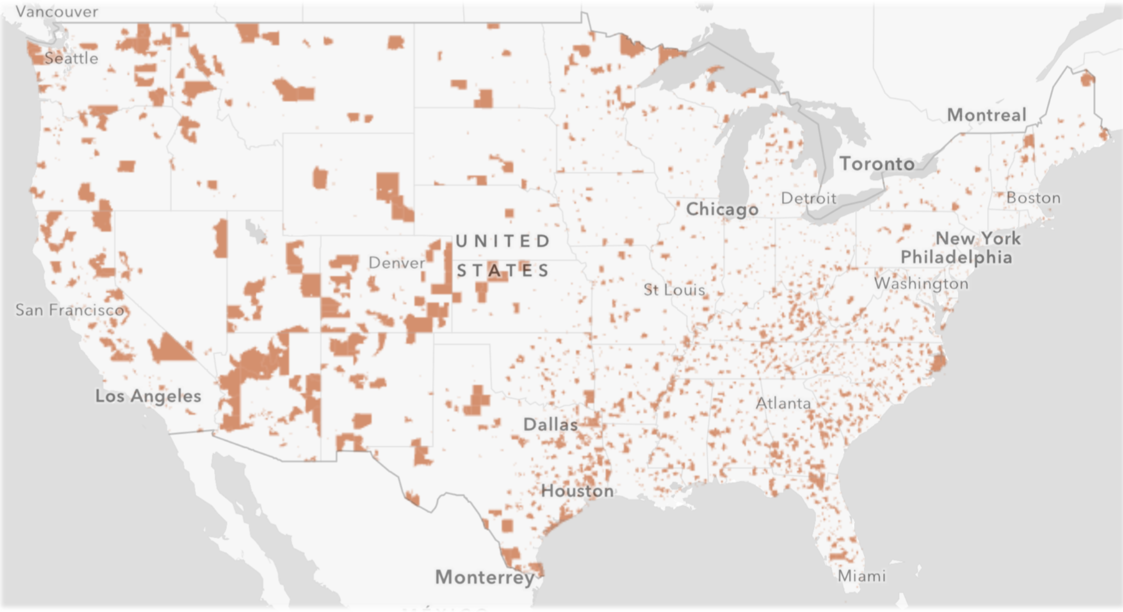


QO Funds are required to invest ninety percent (90%) of their capital in properties or businesses located within Qualified Opportunity Zones. Those zones were designated by state governments and then approved by the Treasury Department, establishing over 8,700 Qualified Opportunity Zones. The map below provides a high-level overview of the breadth and location of these zones nationwide.



Source: Economic Innovation Group, 2018.

In addition to the stipulation of investment in QOZs, becoming or starting a QO Fund requires the meeting of several thresholds and other criteria, both at the outset and ongoing. We break these criteria into three buckets – fund/fund manager, investment, and investor – and provide them here as a Fact Sheet, particularly for managers who are newly exploring the QOF world.

Table 1: Qualifying as a QOF

Metric	Description	Status
70%	Qualifying Asset Test – At least 70% of a QO Fund's assets must be invested in a QOZ	Defined in draft regulation, submitted for comment
30%	Non-Qualified Assets – A QOF cannot have more than 30% of its funds in non-qualifying assets (e.g. cash)	Defined in draft regulation, submitted for comment
5%	Repurchases – No more than 5% of capital can be used to repurchase stocks on existing investments	Defined in draft regulation, submitted for comment
Bi-annual Tests	QOFs will be subject to testing each of the requirements above every 6 months	Responsible parties (fund managers, agencies, etc.) and testing rubrics unknown

Table 2: Qualifying as a QOZ Business (Subsidiary)

Metric	Description	Status
70%	A QOZ Business must perform "substantially all", or 70%, of its operations in a QOZ	Defined in draft regulation, submitted for comment
50%	A QOZ Business must derive at least 50% of its income from QOZ activity and use a "substantial portion" of its property to do so	Percentage defined "Substantial portion" still undefined
5%	Less than 5% of a QOZ Business' property is Nonqualified Financial Property (e.g. securities)	Defined in draft regulation, submitted for comment
31 months	Safe Harbor – The QOZ Subsidiary has 31 months to hold "reasonable working capital" for use in the QOZ	Timeframe defined "Reasonable working capital" – definition unknown
30 months	During any 30-month period after acquisition of the QOF Property, the QOZ Business make "substantial improvement" in the QOF Property	Working definition is based on cost of improvements relative to property value (excluding land) at beginning of the 30-months
No Sins	A QOZ Business cannot be classified as a "sin business" (e.g. liquor store, casino, racetrack)	Defined in draft regulation, submitted for comment

Table 3: QOF Investors

Metric	Description	Status
180 days	Investors have 180 days from the last day of the QOF's tax year to invest realized capital gains	Defined in draft regulation, submitted for comment
5 years, 10%	If an investment remains in the QOF for 5 years, benefit basis increases by 10%, 90% taxable	Defined in draft regulation, submitted for comment
7 years, 5%	If an investment remains in the QOF for 7 years, benefit basis increases by another 5%, 85% taxable (must be invested by Dec 31, 2019 to realize benefit)	Defined in draft regulation, submitted for comment
10 years	Investors are encouraged, through the step-ups above, to remain invested for 10 years. They may also hold those investments for an additional 10 years, continuing to defer gains	Defined in draft regulation, submitted for comment

There are many resources the SteelBridge team has identified to learn more about the particulars of Opportunity Zones and the ability to create funds to invest accordingly. They include, but are not limited to:

H.R.1 - Tax Cuts and Jobs Act of 2017

IRS Proposed Regulations

IRS Draft Form 8996

Additional Reading & Interactive QOZ Map

What does it take to run a QO Fund?

"It's going to be difficult to administer. It's much more complicated than most real estate managers are used to. The constant testing to meet x percent and y threshold can be daunting."
Kimberly Carter, California Real Estate Attorney

As with any specialized fund, running a QO Fund takes special considerations. Fund managers and LPs should bear these considerations in mind when starting or managing a QOF. Below we present some of the questions being asked by fund managers and our perspectives on how to manage them through the phases of our Operational Roadmap. Again, the regulations around QO Funds are currently in a state of flux, so we recognize that answers below may change or that there may not yet be answers.

Fundraising

How do I court investors for a QO Fund?

- LPs interested in such funds not only will pay attention to the tax benefits inherent to them. They will undoubtedly also want to invest in QOZs that directly impact their communities. To avoid being geographically restricted when courting investors, fund managers could also focus on causes or initiatives within QOZs.

What type of investor is most likely to be interested?

- Our research indicates that QOFs will primarily attract HNW individuals and large family offices. Due to their existing tax-advantages, pensions, endowments, and similar "big check" investors appear to be waiting until clear guidance is released. Once those larger investors' commitments are made, we anticipate enthusiastic participation by HNWs and family offices.

Are there any stipulations or regulatory considerations to fundraising?

- Fundraising may require securities licenses. Much of this determination may be dependent on fund size limitations and whether working capital can move among QOFs.

How can SteelBridge help?

Our Capital Advisory practice regularly assists fund managers in sourcing and courting investors, both for "standard" and specialized private funds. As Opportunity Zone Funds develop, we are in discussions with LPs and HNW individuals to take their pulse on investing in these new funds.

Investor Prospecting

- Investor profiles and targeting
- Messaging and consistency
- LP and HNW Introductions

Document Prep

- Pitch deck drafting and design
- Presentation coaching
- PPM preparation and edits

Operations and Accounting

If QOFs are single-asset funds, how do I keep track of all the reporting requirements?

- Systems become a critical item to consider .if dealing with multiple properties (and therefiore QOFs). Due to the thresholds around which QOFs are designed, it is important to implement the right portfolio monitoring solution so a fund doesn't disqualify itself by accident or oversight.

Can one QOF invest in another QOF?

- No. Our discussions with legal experts have drawn the conclusion that QOF fund-of-funds will not be permitted. Based on our data collection and portfolio monitoring experience, the complexity of the reporting wouldn't be conducive to a QOF fund-of-funds regardless.

Can I hold multiple properties in a QOF?

- It is possible to structure QOFs in such a way that multiple properties do not run the risk of disqualifying the fund. We have identified multiple potential structures of a QOF, each of which carries benefits and drawbacks. Furthermore, we've received no guidance yet on whether funds can establish intermediaries, which would provide a method for singularly managing investments in multiple properties/QOFs. As QOFs are formed, we suggest an in-depth discussion with our team, legal counsel and, while we have the option, regulators in Washington.

Multiple teams interact with any given fund or subsidiary. How should that be handled?

- This partly becomes a matter of clear documentation and recordkeeping. Additionally, workflow tools should be established to ensure Finance, IR, senior leadership and all other teams are aware of the guidelines. Our team has extensive experience building workflow tools and documentation for complex organizational structures and can assist accordingly.

What if a fund is about to exit an asset before the deadlines are met?

- There is no clear guidance yet on the penalties for existing a QOF prematurely or for churning properties within a fund- replacing one property with another before a QOF closes. Our discussions with legal experts indicate this is a "wait and see" topic for the time being.

How can SteelBridge help?

We leverage multiple practices at SteelBridge in this area. At a high level, our Consulting Services group can act in independent COO or CFO functions while managers build out their teams to handle QO Funds. Due to the extensive accounting needs of QOFs, our Center of Excellence can support back- and middle-office teams as they collect accounting data for QOFs.

Managed Services

- Data collection
- Accounting books & records
- IR support

C-Level Services

- CFO functional support
- COO functional support
- Workflow monitoring & documentation

Testing and Reporting

How frequently will compliance testing occur, and how will it be monitored?

- Currently, QOFs will be required to conduct bi-annual self audits to demonstrate compliance with Treasury guidelines. In our experience, such self-audits often develop into full audits, so we recommend instituting at least quarterly self-audits and can assist in establishing the necessary rubric.

What reporting is required, and how will it be submitted?

- Presently, reporting to the Treasury Department will be conducted through the IRS, specifically Form 8996 (still in draft form). Populating and filing such forms can prove challenging, particularly on the scale of multiple QOFs, and can require data from multiple sources. SteelBridge has effectively constructed central data warehouses for similar scenarios.

Are there other regulatory bodies involved?

- No, not as of yet on the federal level. However, the SEC and FINRA have yet to weigh in on the regulation. We will likely see implications for fund managers not only in Form 8996 but in Forms ADV, PF, and others, through which we can provide guidance. Of course, there are also state and local tax laws and property development and zoning regulations that will apply.

Can existing zones be renewed?

- Unknown. The current QOZs expire in 2028, but the proposed regulations offer no barometers for whether or how a state could renew a QOZ's designation. However, the proposed regulations provide that QOF interests that continue to be held after that date will remain eligible for the 10-year step up, despite the designation's expiration.

How can SteelBridge help?

Our Technology Solutions team has extensive expertise in integrating software solutions and developing custom data collection and reporting platforms. Here, we partner them with regulatory specialists in our Consulting Services group to build a robust reporting architecture so fund managers can meet IRS filing and self-audit testing requirements.

Filings & Self-Audits

- Form 8996 preparation
- Portfolio testing procedures
- Agency monitoring & filings (e.g. SEC, FINRA)

Technology Solutions

- Portfolio /asset monitoring
- Workflow implementation
- Software vendor selection
- Custom development

Exit Strategies

When does exiting a QO Fund early make sense?

- This decision depends on the investor. Each will need to evaluate tax implications carefully. The proposed regulations do not currently provide guidance on the penalties for existing a QOF in advance of the 10-year hold period.

If a QOZ Business or QO property no longer qualifies, can the asset be sold and working capital deployed to a new investment?

- There is no clear guidance on how this "churning" scenario will be managed. We believe it would create a reporting nightmare for the QOF and IRS but are monitoring the commentary period in Washington.
- There may be penalties for an early exit like this. These have yet to be defined, however.

"Welcome to Washington"

Finally, managers should be aware that this entire environment is still in "living document" form.

"The regulations proposed by the Treasury Department are just that – proposed. They are, even as we speak, open for commentary by a litany of lobbyists, special interest groups, fund managers, and investors."
Brant Garda, SteelBridge Consultant

The meeting to finalize Opportunity Zone regulations is scheduled for 10 January 2019, meaning the final rules won't likely be released until March. Fortunately, all commentary will be available for public consumption in the interim, so we'll have a glimpse of where the market is trending.

We cannot emphasize enough the complexity of the environment in which QOZs and QOFs are being created. Their structuring runs counter to what a fund manager would traditionally anticipate. As such, other industry experts with whom we speak see many of the same open questions with no clear answers just yet. Even those questions that can be answered – like the testing requirements for QOFs and the use of subsidiaries for working capital – raise further questions for managers who would otherwise simply raise a fund and put the capital to work.

Summary

Tracking the ever-changing nature of these regulations and the processes and systems they entail, therefore, should not be an independent undertaking. Our experience has shown the importance of utilizing an objective third party when evaluating how to manage *any* form of private capital fund.

In the case of a QOF, where unique operational and regulatory criteria must be met, investors should be selected and courted strategically. Further, reports to regulators and investors, as well as the technologies used to generate them, should be reviewed and implemented from an agnostic perspective. That added layer of objectivity will allow managers to better run QOFs alongside their existing fund families.

Navigating the already-murky environment of Opportunity Zone investments presents a unique opportunity and an equally unique challenge. It will require significant attention to detail – from tax filing to regular portfolio monitoring and audits to clear, consistent reporting to regulators and investors. Through all this added work and uncertainty, it is important to partner with independent firms and vendors who know and follow the regulations to capture maximum benefits.

About SteelBridge

SteelBridge is a boutique advisory services firm with deep expertise in private capital. We have a passion for helping our clients identify and affect change to improve process and technology for more effective organizations. We help general partners, limited partners, third party administrators, software vendors, and portfolio companies. At SteelBridge, we hold ourselves to the highest standards by providing exemplary services for our clients.

To learn more call us at 646.737.7960 x1001, visit us at www.steelbridgeconsulting.com, or join us on our Facebook, LinkedIn, and Twitter pages for more information:

Let us show you why we are the leading boutique advisory services firm in the Private Capital space.

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