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OPPORTUNITY ZONE INVESTING EXAMINED

The 5 Greatest Perils of Opportunity Zone Investing

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Opportunity Zones have the potential to create unprecedented wealth...

But you MUST understand the potential risks

I have always believed that in order to create lasting wealth, it is necessary to get the highest returns available while at the same time seeking legitimate ways to protect that wealth from the erosive effects of taxation, inflation, and economic instability.

That's one of the main reasons that I was drawn to commercial real estate.   Overall, it has the best risk adjusted returns of all the major asset classes, outperforming stocks, bonds, and mutual funds.

Now with the advent of Opportunity Zone funds, there is even more upside to commercial real estate investing, plus the possibility of significantly reducing or even eliminating capital gains taxes.

Investors of all kinds are starting to catch on to the power of OZ's.

However, what few Opportunity Zone enthusiasts are mentioning are the traps waiting for those who don't do their homework when selecting projects in which to invest.

OPPORTUNITY ZONES

5 PERILS OF OPPORTUNITY ZONE INVESTING

AVOID THESE TO INCREASE
YOUR CHANCES OF SUCCESS
WITH OPPORTUNITY ZONES

Peril # 1: 80% of Opportunity Zones are in areas that may NEVER improve

While it is true that the Opportunity Zone Program could be the most important federal urban revitalization program in years, there is a dark cloud over that potential.

At the risk of sounding harsh or negative, my research leads me to believe that that no matter how well-intentioned the program is or how much money and effort is poured into it, the **vast majority of areas designated as opportunity zones will not improve.**

Some urban revitalization experts claim that as much as 80% of opportunity zones are unlikely to change class categories. This means that investors could put world class properties into zones which will never move from Class C area designation to a Class B area designation, much less reach class A status.   This fact means underperformance at best. At worst it could be a recipe for total failure.

Is there a way around this?
YES, there is! It's all in the data:

KNOW THE 5 CRUCIAL ...

DATA POINTS

WE USE BIG DATA TO DISCOVER THE TRUTH ABOUT:

- Population growth
- Median income growth
- Home price growth
- Crime reduction
- Job Growth

WE DIG DEEPER TO ANSWER THE QUESTION:

Does this AREA have a chance to change classes during a 10 year period?

For Example, Could a Class C Area Become a Class B Area In The Next 10 Years?

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Peril #2 Finding the Right Developer Won't Be Easy

It will be seriously challenging for the bigger funds to locate the right developer partners for opportunity zone projects.

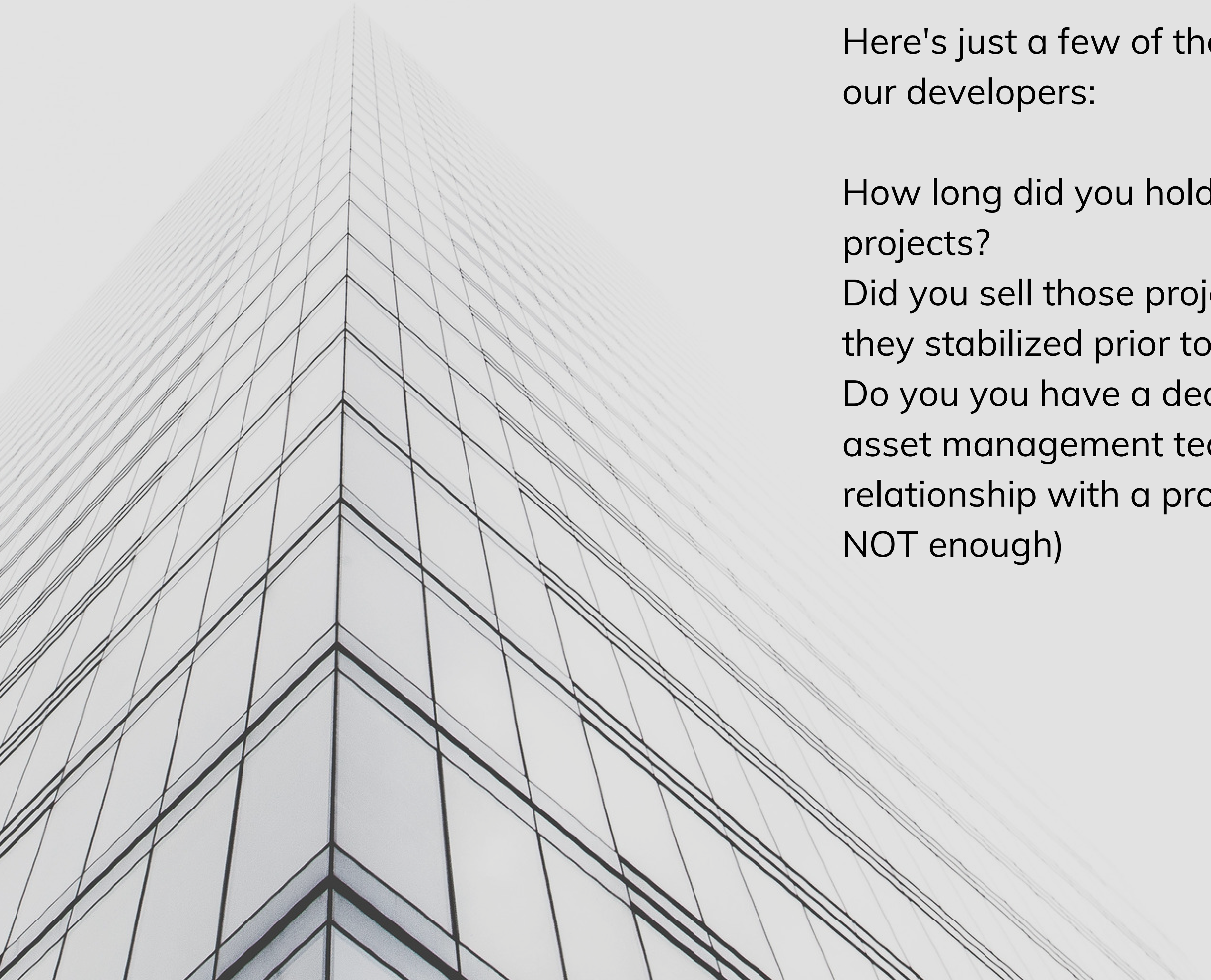
That's because, traditionally, developers don't hold properties for long periods of time. They follow the build-fill-sell model. It's generally not part of their business model to hold the assets for any length of time. This being the case, the typical developer usually lacks the protocols, procedures, and infrastructure necessary to successfully hold a project.

Managing a new Class A or Class B property in a Class C area is, by definition, a difficult task. To attempt it without experienced asset management staff and the accompanying systems could easily be a recipe for disaster.

This is particularly problematic for Opportunity Zones projects because promoters and developers in opportunity zones will need to have the competency to hold these assets for at least 10 years.

During those 10 years, we foresee at least two recessions. Higher end product in Class C areas tends to do poorly during recessions. That's where deep asset management experience can make a difference, and most developers simply don't have that talent in-house.

WE ARE PICKY ABOUT OUR DEVELOPERS



They must be patient.

Any developer who does not possess essential competencies and mindset will become impatient and wind up selling a project, perhaps even before the five year mark.

Due to the strict rules for Opportunity Zones, selling too soon will result in huge tax losses for investors (and potential lawsuits!).

They need the right answers to the right questions.

Here's just a few of the questions we ask our developers:

How long did you hold your last 5 projects?
Did you sell those projects vacant or were they stabilized prior to selling?
Do you you have a dedicated in-house asset management team? (a good relationship with a property manager is NOT enough)

CAVEAT

ASK QUESTIONS ABOUT THE PROJECT AND DON'T WORK WITH ANYONE WHO WON'T PROVE THEY USED ACCURATE DEMOGRAPHICS DATA TO TARGET THE RIGHT OPPORTUNITY ZONE.

Peril #3 No skin in the game

Developers could be involved only because of the fees.

New construction projects typically have very significant fees.

Commonly, that fee is 5% of the construction budget. While the fees, in themselves, are quite reasonable and appropriate, they can often create a conflict of interest.

Many developers have significant payroll and project management overheads, so they can feel pressured to bring in development fees to continue to fund their payroll.

This can lead to them executing sub-par projects, just so they can receive development fees.

The most logical way to avoid this pitfall is to work with developers that have very significant 'skin-in-the-game'. What that means is that a substantial portion of the equity (5 to 10% is common for large projects) is coming from the promoters themselves. This greatly reduces the likelihood that they will execute a project just for fees.

Also, specifically for OZ projects, you would want to check to make sure that this 'skin-in-the-game' money stays in for the entire 10 year run. In typical non-opportunity-zone projects, the developers tend to pull out their money once the building is built or stabilized.

While that is appropriate for a regular project, it is not appropriate for an opportunity zone project. An OZ project is much longer than a typical 3-year development project, so the development partners should stay financially engaged in the project throughout, not just in the construction phase.

Peril #4 Your project could get strangled by red tape

Many OZ projects are being announced in cities and counties that are notorious for zoning and entitlement delays. Given that a lot of these projects are already marginal due to low tenant median incomes, it is easy to envision scenarios where delays could lead to projects running out of money, or banks refusing to fund construction loans

Whenever possible, investors should only invest in projects that are already zoned and entitled. This reduces risk, and time to cash flow.

If that is not possible, investors should work with development teams that already own the land / project.

After all, they wouldn’t buy expensive land if they were not confident about the zoning / permitting challenges.

Peril #5: Beware of "Zombie" Projects

As soon as Opportunity Zones moved a little into the mainstream, we began to notice a proliferation of what we call “garbage” or “zombie” projects.

These were projects where the developer spent hundreds of thousands of dollars (or more) on the the initial land acquisition, zoning and permitting, only to discover that the project really didn’t pencil out, and investors were uninterested.

These projects have been sitting on a shelf ever since.

These projects are being “repackaged” as Opportunity Zones projects in the hopes that investors will not bother to look under the hood.

As demand grows, you can expect to see more and more of these garbage projects marketed, even though they have little to no hope of succeeding.

Viable Opportunity Zone projects are few and far between. If you are considering investing in one, we encourage you to talk with our data driven analytics teams first.

They can help you do an end run around the zombies and make decisions that will give you the best shot at success.

Lastly, look for projects where the city itself is asking for the project to be built (often called master planned developments).

Those projects tend to get faster approvals at every level. While no guarantee, this can reduce investor risk significantly.

Bottom Line

In Opportunity Zones, I see the potential for creating massive wealth for those investors who understand these and other pitfalls and challenges ahead.

Our team is dedicated to researching and reporting the pros and cons of Opportunity Zone investing.

In future posts and in webinars on our site www.grocapitus.com, we will address those problems and offer you the most complete set of solutions available.

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Interested in becoming an investor?

Find out about our investment opportunities, which include Opportunity Zone projects as well as traditional Value Add projects.

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