Cadence
CAPITAL PARTNERS

HOW TO DEVELOP AN OPPORTUNITY ZONE PROJECT AND MAKE MONEY TOO:

A PEEK BEHIND THE OZ COMPENSATION CURTAIN

Greetings all! The recent Opportunity Zone tax law changes are the current real estate flavor of the day. With the technical rules by and large answered,[1] investors and sponsors alike are now faced with the practical questions surrounding these investments. I will attempt to address some of these considerations and misconceptions in a series of articles based on my experience as a reformed tax attorney and my firm's front-line experience sourcing equity for direct Opportunity Zone projects (we have sourced three to date with several more near the finish line). This article addresses one of the most common question areas - sponsor compensation (fees and promotes) and how it differs from a non-OZ deal.

For quality deals - the short answer is not all that much. Taking a step back, this shouldn't surprise. The bulk of OZ investors are groups with real estate investment experience as either institutions (such as a PE Fund or Insurance Co) or the established real estate arm of a family office. These groups were real estate investors before the OZ rules and have not, overnight, altered their investment criteria. These investors expect the same returns and generally the same fee structure, regardless of OZ benefits. After all, if an investment ultimately results in a loss or slight gain after 10 years, there's little value to the OZ regime. A common mantra: the deal must pencil without the OZ benefits.[2] Nonetheless, everyone appreciates a sponsor's needs to earn a living.

FEES - GENERALLY DISLIKED - BUT SOME ACCEPTED

In a typical direct investment (10% Sponsor / 90% investor), certain fees are standard, some acceptable though not loved, and some frowned upon. A project will often always contain the following fees, as applicable (with some common ranges): (i) development fee (2 - 5% of hard costs); (ii) asset management fee (0.5% - 1% of committed capital);[3] and (iii) property management fee (market driven). While not beloved by investors, some sponsors charge an acquisition fee (0.5% - 1% of purchase price / land cost), which is often negotiated but ultimately accepted. The less frequently sought fees and much more often stricken: (i) refinance fees and (ii) disposition fees.

PROMOTE STRUCTURES - ADJUSTMENTS FOR A 10-YEAR HOLD

While every deal we see contains a promote, the structures vary wildly. For an institutional sized development deal, the typical promote structure is 20% to the sponsor after an 8-10% hurdle. For middle market deals, the first hurdle may be the same, but there may be one or two additional hurdles (for example, 14% and then again after 20%) with the sponsor receiving an increasing promote share (typically not exceeding a 50/50 promote split). In the OZ world, I believe investors are more amenable to a multi-tiered waterfall structure than a comparable non-OZ deal, representing one of the few economic advantages to a sponsor.

Given an OZ deal's 10-year hold requirement, the traditional hurdles outlined above would accrue relentlessly, often resulting in a smaller sponsor promote. To strike a balance, there are three primary alternatives utilized: (i) a reduced hurdle over the investment's life (6%, for ex.); (ii) an equity multiple based hurdle (1.5 or 2x equity returned before a promote, for ex.) or (iii) promote "crystallization." The first two are straightforward - substitute a lower or equity hurdle in a traditional promote (potentially tiered). Crystallization bears further exploration and, unavoidably, an example.

1 *For those holding out hope for further guidance - don't. There may be additional interpretation from time to time, but the rules are what they are at this point. I recommend any investor considering an OZ investor to hire their own tax lawyer/accountant and navigate outside the guidance with caution.*

2 *While not a substitute for an investor's underwriting, my firm created a proprietary analysis tool (in conjunction with 6 MBAs from the Ross School of Business's MAP Program) to choose which deals it takes to investors, focusing on the sponsor, market demographics and deal underwriting.*

3 *Where a fund invests as the direct partner, sometimes the Sponsor and investor will agree to split asset management fees rather than duplicate the fees at the fund level.*

Crystallization isn't a new concept - developers utilize these promotes in the build-to-core world where investor and developer agree to a long-term hold. The concept is fairly simple: (1) at stabilization the parties agree to a value for the completed project;[4] (2) treat the asset as sold by the JV in a hypothetical transaction for the agreed value; (3) reduce the sale proceeds by pre-enumerated transaction costs and construction debt; and (4) distribute the remaining proceeds pursuant to the waterfall. The relative ratio of the distributed cash becomes the new JV ownership percentages.

Let's use an example. Sponsor and investor agree to build an apartment building for $100 (funded 10% sponsor and 90% investor), using $65 of leverage and $35 of equity ($3.5 and $31.5, respectively). The JV provides for a 20% sponsor promote over a 10% hurdle, crystallized at stabilization. Assume stabilization occurs after 1 year, with an agreed $150 property value.

CRYSTALIZATION EXAMPLE			
	Agreed Value		$150.00
	Less Construction Debt		-$65.00
	Less Transactions Expenses (2%)		-$3.00
	Excess Proceeds		$82.00
	SPONSOR	INVESTOR	
Return of Capital	$3.50	$31.50	-$35.00
Hurdle Return (10%)	$0.35	$3.15	-$3.50
Profits Remaining Post-Hurdle			$43.50
Profits (promote reduced)	$3.48	$31.32	-$34.80
Sponsor Promote	$8.70		-$8.70
Total Proceeds	$16.03	$65.97	
New Ownership Percentages	**19.55%**	**80.45%**	

Following crystallization, sponsor will own 19.55% of the JV and investor 80.45% with respect to all future cash flows, including refinance and sale proceeds. Note no actual proceeds were distributed - crystallization acted solely as a mechanism to reset the ownership percentages. That is, unless the parties agree to a crystallization twist.

As stabilization often coincides with refinancing into permanent debt, the parties can also agree for the sponsor to receive all or a portion of its calculated promote out of refinance proceeds. Sponsors argue for this disproportionate distribution as the investor receives a tax benefit from a long-term hold while the developer now has to wait 10+ years to be paid. Let's go back to the example.

Now assume the partners agree to refinance the construction debt for $70 and to distribute sponsor 100% of the excess debt proceeds to the extent of its promote.

Here the sponsor was distributed $5, 100% of the excess proceeds, but since the proceeds did not exceed the sponsor's promote entitlement ($8.70), the sponsor's interest still increased from 10% to 13.45%. Of course, the parties could agree to a smaller disproportionate distribution (say 25% of the sponsor's promote) with the remaining proceeds paid pro rata at the new ownership percentages.

	SPONSOR	INVESTOR	
Total Proceeds (from above)	$16.03	$65.97	
New Debt			$70.00
Payoff Construction Debt			-$65.00
Distribute Excess Proceeds	-$5.00		-$5.00
New Capital Ownership	$11.03	$65.97	
New Ownership Percentages	**14.32%**	**85.68%**	

CADENCE CAPITAL PARTNERS

Cadence Capital Partners, a real estate investment bank, connects sponsors with joint venture partners and debt sources, including sponsors with Opportunity Zone projects. Focusing on capital groups outside the "usual suspects," Cadence has built an extensive investor database, including PE Funds, Insurance companies, debt funds and family offices. If interested in financing for your project or inclusion in our deal flow, please contact Jay Soave at jsoave@cadencerec.com.

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Jay is a Managing Principal and runs Cadence's Chicago office. Jay has been structuring, negotiating, and closing sophisticated transactions for 18 years, representing over $15 billion in gross value. Before Cadence, Jay was Managing Director Transactional Tax in Tishman Speyer's New York office. Before Tishman Speyer, Jay worked as an attorney in the Chicago offices of Skadden, Arps, Slate, Meagher & Flom, Kirkland & Ellis, and Baker & McKenzie. Jay received both his B.S. Engineering and J.D., magna cum laude, from the University of Michigan.

4 *Of course, determining a fair market value methodology is heavily negotiated in the JV agreement, but isn't uncharted territory. Often it involves the parties each engaging their own third party appraisers, comparing the results and, if some predetermined distance apart, engaging a third 'tiebreaker' appraiser.*