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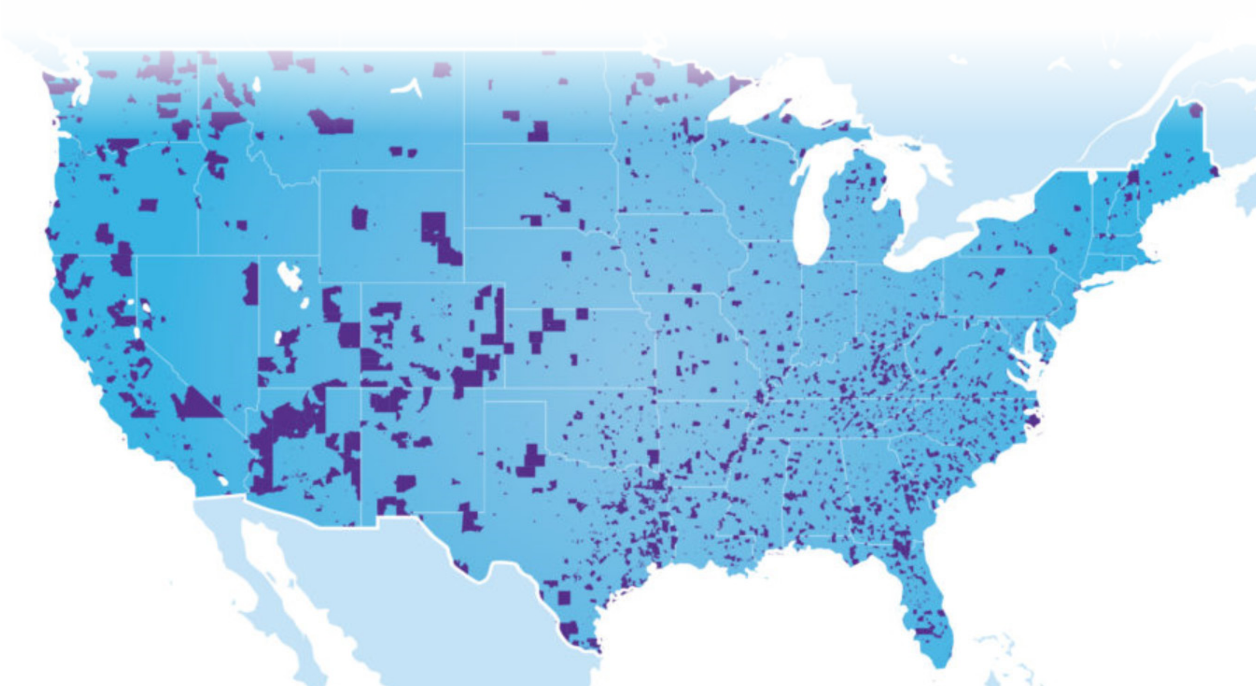
iCAPITAL OVERVIEW: QUALIFIED OPPORTUNITY ZONES ("QOZ")

The QOZ program is a new initiative that was created by the U.S. Congress as part of the Tax Cuts and Jobs Act of 2017. The program's overall mission is to stimulate economic activity in underdeveloped parts of the country, by providing tax benefits that encourage long-term capital investment into these designated low-income urban, suburban and rural areas. This is expected, in turn, to transform communities and boost the local economy. State governors designated over 8,700 census tracts across the country as QOZs, as shown in the map on the next page. Although many of these zones are indeed underdeveloped, there are also attractive areas that are already gentrifying or located near central business districts, such as certain parts of New York and Downtown LA.

Map of Qualified Opportunity Zones



Source: Economic Innovation Group

Investors who develop real estate or fund businesses in these Opportunity Zones are eligible for tax incentives – which has led to the advent of private investment vehicles known as Qualified Opportunity Funds (a "QOF" or "QOZ fund"). These funds provide several tax benefits to their investors, as detailed below. The key tax incentive is the complete elimination of tax on any capital gains generated by the QOZ fund (after 10 years) – this is the primary and most substantial draw of the QOZ program.

From a chronological perspective, firstly, QOFs allow investors to defer their existing or current capital gains taxes on appreciated assets until 2026, by selling and rolling their gains into a Qualified Opportunity Fund within 180 days of them being realized. Both return of principal and gains can be rolled into a QOF, however, only the "gain" portion is eligible for tax exemption on any future appreciation.

There is then a sliding scale of tax benefits that can be realized, which is primarily based upon the length of time that an investment is kept in a QOZ fund prior to being withdrawn.

Once an investment in a QOF is held for five years, an investor benefits from a 10% reduction in capital gains tax on their initial investment amount. After their investment is held for seven years, this reduction increases by an additional 5% to an overall 15% reduction in capital gains tax. There is also a timing element involved in being able to reap the full 15% reduction – with the full reduction occurring if QOZ investors commit prior to December 31, 2019, as deferred gains are taxable either when the QOZ investment is sold or exchanged or, if earlier, December 31, 2026.

The full tax benefit is only realized once the investment is held for 10 years. At that point, any new capital gain that has been generated by the investment in the QOZ fund is exempt from taxation.

The program's overall mission is to stimulate economic activity in underdeveloped parts of the country by providing tax benefits that encourage long-term capital investment.

As a hypothetical example, let's say an investor owns $1.1 million of Apple (NASDAQ: AAPL) stock, of which $100,000 represents the original cost basis and the remaining $1 million is unrealized capital gains. The investor sells their Apple position on June 1, 2019 and realizes $1 million in capital gains, which they invest into a QOF within 180 days of the sale – in this example, on June 30, 2019:

- After 5 years – on June 30, 2024 – the investor's basis in the QOF increases from $0 to $100,000 (thereby reducing their capital gain by 10%).

- After 7 years – on June 30, 2026 – the investor's basis in the QOF increases from $100,000 to $150,000 (thereby reducing their capital gain by a further 5% to an overall 15% reduction)

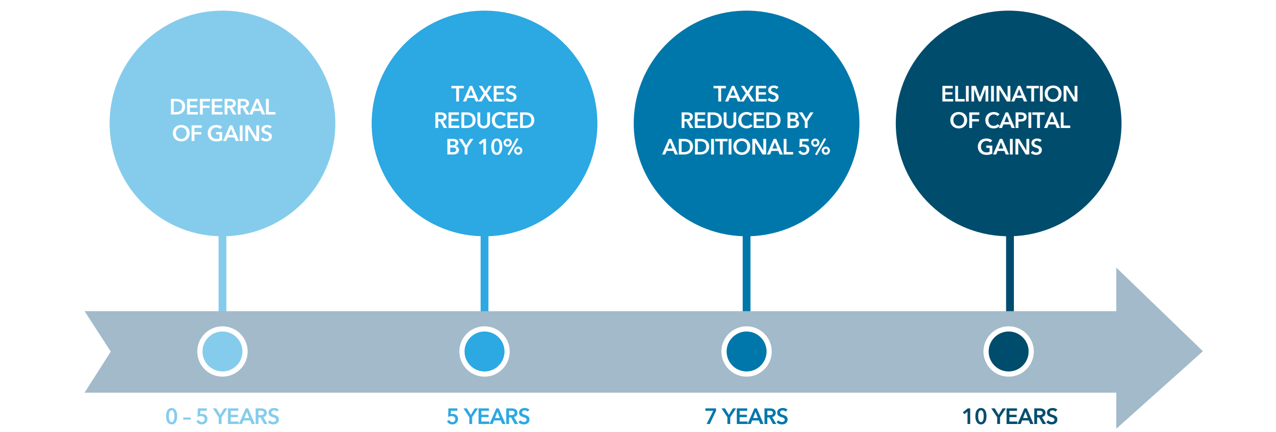
- On December 31, 2026, the investor's deferred gain is taxed. However, rather than applying to the full initial $1 million, the capital gains tax only applies to $850,000 (due to the $150,000 basis increase as described above).

- After 10 years – on June 30, 2029 – the investor is able to sell their interest in the QOF without losing any tax advantages. Assuming that the investor sells their interest for $2.7 million (representing a ~10% IRR), the $1.7 million of appreciation is sheltered from any capital gains tax.

However, it is not enough for a fund to simply declare themselves to be a QOF. In order for a vehicle to be designated as a QOZ fund, there is a specific set of requirements that must be followed. Firstly, a fund must invest into either properties or businesses that are located within a QOZ, with 90%+ of their portfolio held in QOZ assets – a threshold that will be tested annually. Businesses qualify by deriving at least 50% of their gross income from the active conduct of a trade or business in a QOZ, or by having a substantial portion of their intangible property used in the active conduct of a trade or business in a QOZ. Further, any company that operated as a "sin or sun business" is excluded, such as liquor stores, gambling facilities, suntan facilities, country clubs, and golf courses.

As for properties, they must either be newly built or, if investing into an existing building, be subject to "substantial improvement" (with more capital invested into the property than its original basis, excluding land) within the first 30 months. A development or redevelopment-oriented approach is, therefore, the most suitable real estate strategy for a QOF, as it's essential to meeting this former requirement.

Holding Period for Achieving Tax Benefits



Source: iCapital. For illustrative purposes only.

Although the appeal of the QOZ program is evident, with dozens of managers raising pools of capital to target this space, we would caution investors to take a measured approach. QOZ managers must be assessed on their ability to generate appealing real estate returns, independent of any tax relief benefits that may come into play. When conducting due diligence on managers to partner with, investors should hone in on those real estate firms with substantial vertically-integrated businesses. These firms benefit from an inherent competitive advantage when it comes to investment execution, as they can leverage the expertise of their in-house groups, such as capital markets, property management, asset management and/or leasing, among others. Vertical integration also allows real estate managers to have stronger oversight over the quality of their developments, as well as increased certainty over execution and speed. It is also important for managers to have a proven track record in developing and redeveloping their targeted property type (whether multi-family, office, retail, or other) within their targeted geography (whether the Sun Belt states or the Tri-State area, for example). If a manager's usual sweet spot is last-mile logistics in the Mid-West, there is little guarantee that their skills will translate well into multi-family ground-up development in New York.

A deep development arm and track record are usually also indicators of a manager who has not only the ability to source and underwrite attractive properties, but also strong local networks when it comes to construction, design, leasing, and overcoming the myriad regulatory and legislative hurdles that come hand-in-hand with real estate development. QOZ managers who have pre-identified a handful of potential assets for their fund are also attractive, as this not only somewhat mitigates blind pool risk, but also ensures that capital is put to work in a timely manner and within the constraints of the QOZ regulation.

Each investor must also decide for themselves if today is the right point in the real estate cycle to increase their exposure to the asset class, and balance that decision with any timing constraints surrounding the realization of their capital gains. This is critical, as real estate is widely considered to be at or close to its peak, with many assets priced to perfection. Investors are therefore taking a 10-year bet on a specific city's or region's long-term growth and economic prospects. Moreover, due to QOZ regulations requiring either ground-up development or significant redevelopment of assets, investors should be cognizant of the magnified risk-return profile compared to a core or core plus real estate fund investment.

Taking a cautious approach is particularly key as QOZ managers are still navigating legislation that is subject to change. Treasury has issued two rounds of guidance thus far – the latest round released on April 17th, 2019 provided affirmation for managers, but the laws are yet to be finalized. Moreover, the time horizon of a QOZ fund is ten years, if the full spectrum of tax benefits is to be achieved, and so investors are choosing a long-term steward of their capital, who will be ultimately responsible for ensuring that the portfolio is appropriately sold at the right time and in a way that maximizes final returns. It remains more important than ever to undertake deep due diligence and underwriting – the tax breaks are a real advantage but are meaningless if layered on top of a poor investment that doesn't generate significant gains to begin with.

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Overall, iCapital believes that QOZ Funds represent an interesting opportunity – both for local communities who set to benefit from the revitalization that this program encourages, as well as for those investors who can partner with some of the top-tier real estate names for whom QOZ investing is a natural extension of their current strategy.

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