The Potential Role for CDFIs in Opportunity Zones

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Foreword

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The Opportunity Zones legislation was designed to mobilize new levels of capital into low- and moderate-income (LMI) communities – areas that have historically been overlooked and underserved by mainstream capital markets. As longstanding financial partners to LMI communities, Community Development Financial Institutions (CDFIs), it would seem, are positioned to play a pivotal role in the Opportunity Zones ecosystem.

Yet the legislation presents a challenge on that front. As the law dictates, the mechanism through which Qualified Opportunity Zone Fund investments must be made are equity instruments, while CDFIs tend to operate more on the lending side. For this reason, the CDFI industry has struggled to determine exactly how it can harness the potential power of the Opportunity Zones tax incentive to advance their efforts to support LMI communities.

This report, then, is timely. As our partners at the University of New Hampshire's Center for Impact Finance show in the pages that follow, there is indeed a role for CDFIs in the emerging Opportunity Zones space – or, more accurately, several potential roles, both financial and non-financial alike.

Enterprise is proud to support this report and is grateful for its contribution to the field. It is now up to us, as CDFIs and mission-aligned partners, to convert the ideas held within this report into action. In so doing, we can help realize the original intent of the Opportunity Zones legislation: to responsibly direct significant capital into communities that have been financially marginalized for too long.

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Summary

Opportunity Zones ("Op-Zones") are likely to bring a material amount of capital investment into low-income communities. The intent is to encourage investment as much as it can. This encouragement is in the statutory structure and language as well as the propagated rules to date: The regulation is light, the penalties are modest and the barriers to entry are minimal.

The general view is that the structure, combined with its short turnaround time, will favor Qualified Opportunity Funds ("QOFs") involving single asset real estate investments at magnitudes of $50 million or more, where the operating risk is low, the potential for appreciation is high, and the exit strategy is clear. There will also be QOFs with multiple asset real estate investments involving commingled funds ("Co-Funds") that bring risk diversification and a wider range of size and asset class. These Co-Fund QOFs are likely to carry the same attributes as the single asset QOF, though further clarification of the rules is needed for enthusiastic adoption of this strategy. It is generally thought that the bulk of the market-based investors who engage in Op-Zone investments will minimize credit and term risk, by cashing out of the investment at the earliest point at which they can make the highest return. Thus the bulk of the activity is likely to occur outside of the higher risk, smaller, less profitable and more community oriented projects and investments that the CDFI sector has traditionally pursued.

In the context of these market inclinations, it will be difficult for most CDFIs to perform the role of the owner and manager of the Qualified Opportunity Zone Funds (QOFs). The five primary challenges are (1) the complexity; (2) the need for scale; (3) the difficulty of exit strategies; (4) the unfamiliarity of the investing public with CDFIs as counter-parties for equity risk; and (5) CDFI experience with market equity instrument.

However, there are still roles for CDFIs to play which will facilitate Opportunity Zone investment in their communities, and which could generate revenue for the organization. These roles include: (1) origination of suitable transactions; (2) facilitation of transactions with community leaders and officials; (3) due diligence; (4) provision of senior or subordinated debt to a transaction in order to fill a gap; and/or (5) syndication of the financing portion of the transaction together with provision of expertise in certain financial products. CDFIs should also be attentive to federal rule clarifications aimed at facilitating QOF investment in operating businesses and venture capital investments and the extent to which these can be "twinned" with guarantee and debenture programs at the SBA and USDA in particular.

Although there are impediments to the CDFI performance of the QOF role, and although managing an equity fund on behalf of investors falls outside of the traditional CDFI financial tool kit, there are several ways in which CDFIs can participate in raising and deploying capital

1. Strategic Partnerships:

    - Partnership with a large CDFI that already has equity investors of one kind or another in its projects—a role that experienced CDFIs with LIHTC and NMTC programs may be able to perform.
    - Partnership with an institutional investor that has an appetite for long-dated assets, has long-term capital gains obligations and is familiar with the community development sector.

2. Innovative Financing Structures and Instruments:

    - The CDFI creates a QOF that will be part of a commingled fund (Co-Fund)—i.e., a master partnership--led by an institution that is a known counter-party for equity risk—such as those noted above.
    - The CDFI uses one or more of four different kinds of Preferred stock or Preferred interest in order to tailor the cost of equity affordably to the cash flows of the asset—as outlined in Section X of this paper.
    - Perform the role of syndicator by (1) mastering the calculation or risk/return and the cost of funds; (2) injecting the most junior form of equity into the QOF; and (3) lining up the remaining funding streams to accommodate the cash flows of the asset.

CDFIs are in a better position than other participants in one particular respect: they can easily provide low cost long term funding to any part of the transaction, whether at the QOF level, the second tier entity ("2TE"0 level) or the direct property level. They can elevate the attractiveness of their participation by developing equity instruments that are tailored to the specific needs of their low-income community-based assets AND the needs of the short and long-term investor. How to go about that is a primary focus of this paper.

Given the limited timeframe of the Op-Zone tax treatment, it is incumbent on CDFIs to get involved in whatever roles they can, sooner rather than later, and aggressively rather than passively. At the very least they should begin assembling prospectus-quality summaries of the real estate projects they consider most important, as these are the most likely to attract investment in the shortest time. However, the main focus for the CDFI sector should be on long-term investors, like insurance companies, that also have capital gains and an implicit community reinvestment obligation, large CDFIs and banks that seek to use the Op-Zone investment in the context of their CRA obligations.

I. Design of the Op-Zone Tax Treatment

"Opportunity Zones, created by the 2017 Tax Cuts and Jobs Act, were designed to spur investment in distressed communities throughout the country through tax benefits."

The Economic Innovation Group, the principal designer of the Op-Zone tax treatment said: "Individuals are sitting on $3.8 trillion and U.S. corporations a further $2.3 trillion in unrealized capital gains at the end of December 2017 in stocks and funds alone…" If even a tiny percentage of that amount were moved into Opportunity Zones, it would have a dramatic positive impact on economic activity and real estate values.

The Capital Gains Tax

To understand why investors would want to take advantage of Op-Zones, let us take a look at the tax an investor faces when he or she makes a profit (gain) on the sale of an asset:

"A capital gain is the profit earned when an asset, such as an investment or property, is sold. Short-term capital gains, or profits on assets sold within one year of purchase, are taxed at a taxpayer's ordinary income tax rate. Long-term capital gains, or gains from assets held longer than a year, are taxed at either 0 percent, 15 percent, or 20 percent, based on a taxpayer's income. Individuals with income above $200,000 ($250,000 for married filers) are subject to an additional 3.8 percent tax on their net investment income."
Bond-Buyer Conference: Orick, Herrington, and Sutcliffe

Traditional Investment	
Original Investment:	$5,000,000
Sold for:	$15,000,000
Capital Gain:	$10,000,000
Capital Gain Tax Rate:	20%
Capital Gain Tax Due:	$2,000,000
Post-Tax Earnings:	$8,000,000

Assuming the investor's income triggers a 20 percent tax on this capital gain; their tax liability would be $2,000,000. This brings the investor's total post-tax earnings to $8,000,000.

Clearly, there is an attraction to deferring and or reducing this $2,000,000 tax liability. This is the reason that the market sentiment expects the use of the Op-Zone tax treatment to be large, and have a positive impact.

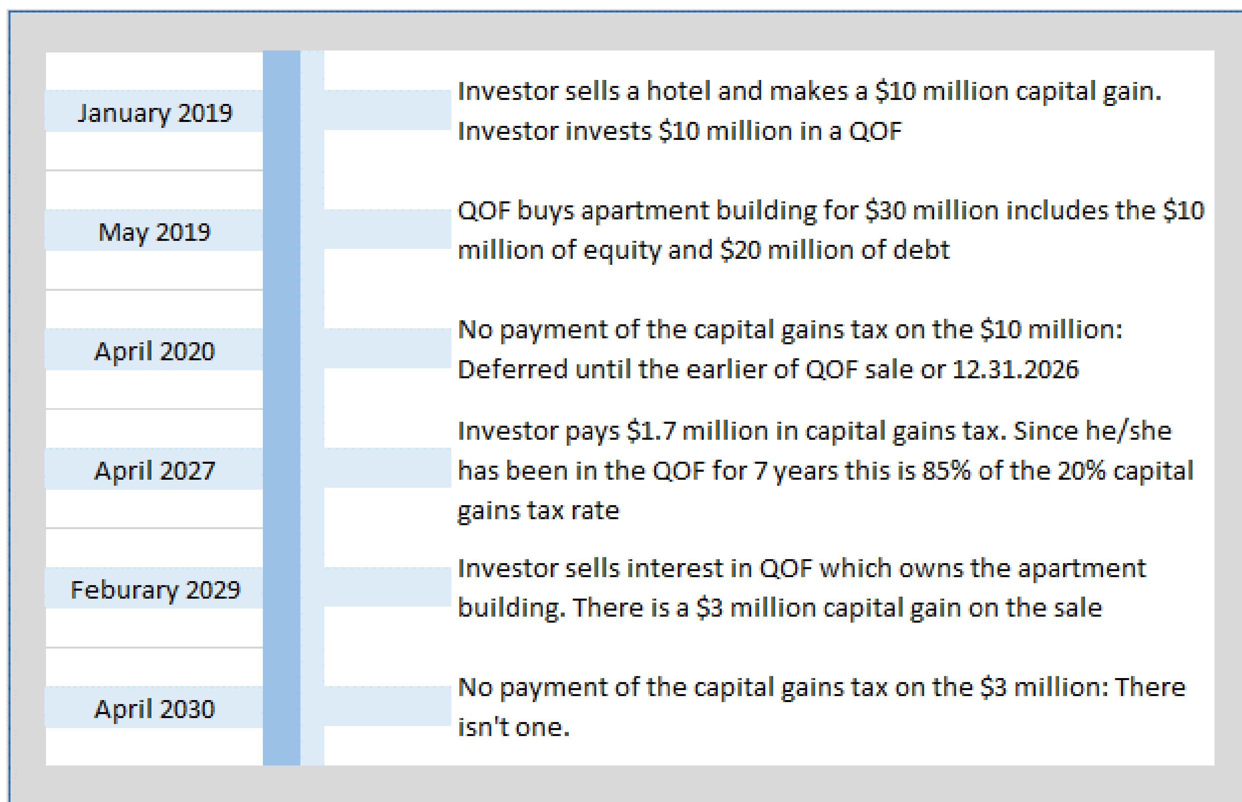
The Financial Benefits of the Op-Zone Investment

For the investor with capital gains facing a big capital gains tax, there are three primary financial benefits:

1. Deferral of the capital gains tax.
   An investor who reinvests his/her capital gain into a QOF (Qualified Opportunity Fund) within 180 days of the sale of his/her profitable investment can defer any tax on that capital gain. So in our example the payment of the $2,000,000 tax is deferred. The tax can be deferred until the earlier of (a) 12/31/2026 when the tax *must* be paid; or (b) he/she sells the new investment in the QOF. The time value of money makes this deferral very attractive in and of itself: the $2 million that is paid at 12/31/2026 is worth less than the $2 million that is paid today.

2. Reduction in the amount of the capital gains tax.
   The investor in the QOF can reduce the amount of the capital gain for tax purposes by 10% if he/she holds the QOF investment for 5 years. If they hold the QOF investment for 7 years, they can reduce the QOF investment by 15%. These 10% and 15% reductions reduce the amount of the tax by a like amount. So in addition to the reduction of true value in the $2,000,000 due to the time value of money, the actual amount of the tax is reduced by $200,000 if the QOF investment is held for 5 years and $300,000 if it is held for at least 7 years.

3. Exemption from a capital gains tax on any gains on the QOF whenever it is sold.
   The investor in the QOF can eliminate any capital gain they make on the sale of the QOF if he or she holds the investment for 10 years. The Op-Zone tax treatment accomplishes this by allowing the value of the QOF to be fair market value at the time it is sold—if it is held for 10 years. If, in our example, the QOF appreciated by $3 million in value over the space of 10 years to $13 million and then were sold, there would be no capital gains tax on the $3 million profit. This makes the long-term investment in a QOF highly attractive. However, there is a caveat: the tax savings becomes more attractive with assets that appreciate rapidly in value, and it is likely that most investors will want to channel investment into rapidly appreciating community assets at the expense of those that do not appreciate rapidly.



There are several key points in this chart:

- There is the 180-day period for the investor to commit the money to a QOF, between January 2019 and May of 2019.
- There is the deferral of the tax as of April 2020.
- There is the payment of the original capital gains tax, reduced by 15% at April 2027. It is critical to note that the QOF is not sold at this point. As a result, the $1.7mm in capital gains taxes on the original investment still has to be paid. Investors will likely want it to come from the QOF.
- The sale of the asset and closing of the QOF occurs in February 2029, almost 2 years after the capital gains tax is paid.
- There are no any capital gains taxes on the appreciation of the QOF asset when it is sold.

Capital Gains Tax Comparison for the Investor

Without Op-Zone		With Op-Zone	
Sold for:	$15,000,000	Sold for:	$15,000,000
Capital Gain:	$10,000,000	Capital Gain Transferred to QOF:	$10,000,000
Capital Gain Tax Rate:	20%	Increased Basis:	$1,500,000
Capital Gain Tax Due:	$2,000,000	New Calculated Gain:	$8,500,000
Post-Tax Earnings:	$8,000,000	Capital Gain Tax Rate:	20%
		Capital Gain Tax Due:	$1,700,000
		Post-Tax Earnings:	$10,000,000
		Tax Savings:	$300,000

This chart does not take into consideration the benefit of postponing the payment of the capital gains tax for 8 years. In a 3% interest rate environment, that $1,700,000 payment is worth about $1,400,000 today—so the value to the investor is double what the example above shows, effectively reducing the capital gains tax by 30%. In a higher rate environment the benefit would be greater. And that is before we account for the absence of any capital gains tax on the appreciated value of the QOF.

Time Frame

The clock is already ticking on Op-Zones. The legislation was passed in November 2017 and it took almost a year to propagate the rules needed to commercialize it. The key deadlines are as follows for deploying capital: The investor has up to 180 days following the profitable sale of an investment to invest the profit proceeds (capital gain) in a QOF

- 12/31/19: latest date to invest and receive a 15% reduction
- 12/31/21: Latest date to invest and receive a 10% reduction
- 13/31/28: Latest date to invest and receive a 100% elimination of capital gains tax on any gain from the sale of the QOF.
- The QOF must be sold by 12/31/47

Overview of key features of Op-Zone investing as of 12/31/18:

Some useful observations on this rapidly evolving opportunity:

- On October 19, 2018, the Treasury Department and the Internal Revenue Service issued proposed regulations and guidance that enabled potential investors and other participants to more precisely plan their QOF strategies. While many questions remain, the most important features and guidelines have been laid out. Of considerable importance is the demonstration of the government's clear commitment to help Op-Zone investing succeed by accommodating participant requests for ease, flexibility and efficiency.
- "Under a nomination process completed in June, 8,761 communities in all 50 states, the District of Columbia and five U.S. territories were designated as qualified Opportunity Zones. These Opportunity Zones retain their designation for 10 years." (US Treasury). Flexibility is built into these zones: properties, for example, that are contiguous to Op-Zones may be eligible for investment. The list of designated Qualified Opportunity Zones in which a Fund may invest to meet its investment requirements can be found at Notice 2018-48 or through Enterprise's Opportunity 360 tool.
- Though discussions continue, CDFIs are not eligible to restructure themselves as QOFs.
- Loans are not eligible forms of investment: for an investor's capital gain to be eligible for the Op-Zone benefits, the investment into the QOF must be in some form of equity.
- A major breakthrough for the CDFI sector is that Preferred Stock or Preferred Interest is an allowable form of equity. This is the possibly the best tool available to the CDFI sector for facilitating participation in the Op-Zone investing (See Section X).
- Investors can invest in 2nd Tier entities (2TEs) that provide funding to the QOFs.
- Commingled Funds, in which there are multiple QOFs and funding sources, are eligible. Certain processes and procedures, however, remain to be finalized (i.e., tax reporting).
- The QOF can be leveraged in every way. However, the tax benefits are tied only to the amount of capital gains from the original investment.
- A number of analysts, commentators and practitioners believe that most QOF deals will be in excess of $50 million, and that the Op-Zone tax treatment will succeed on Wall Street. One estimate is that a deal has to be at least $2.5 million in size to be economic.
- There is a sense of urgency in getting pipelines of deals lined up. There appears to be general agreement that "shovel ready" transactions will be at the forefront.
- As of 12/31/18, the single asset QOF was still viewed as the best structure to use with the Op-Zone tax treatment due to its ease, speed and cost. However, that militates against the smaller transactions (under $10 million).

II. Investment Guidelines

"A qualified Opportunity Fund is any investment vehicle organized as a corporation or partnership with the specific purpose of investing in eligible property or eligible business in an Opportunity Zone ("Op-Zone" assets).

In this section, all of the quotations derive from the FAQs issued by the Economic Innovations Group, the originator of the concept.

<u>The Qualified Opportunity Fund (QOF)</u>

Guidelines for establishing and managing a QOF include:

- The principal (in our case, the CDFI or CDC) creates a separate fund or separate partnership to house the Op-Zone capital, which will be invested in the Op-Zone asset or in a 2TE that owns the asset. This creates a tax paying entity called the Qualified Opportunity Fund ("QOF").
- "Anyone can start a fund, and funds can be closely held and have a single investor." They must only be separately organized corporations or partnerships formed for the specific purpose of investing in qualified Opportunity Zone property.
- Funds may also be set up with multiple investors and/or with multiple assets under management.
- There is no approval process for becoming a QOF. To become a QOF, an eligible taxpayer simply self-certifies: To self-certify, a "taxpayer merely completes a form …and attaches that form to the taxpayer's federal income tax return for the taxable year." Neither the Treasury nor the IRS are involved at the outset.
- This QOF will invest equity in the qualifying Op-Zone business or property asset either directly or through a 2nd Tier entity (2TE).
- The QOF receives the equity from investors who have generated a capital gain from the sale of a previous investment. The proceeds of that capital gain must be committed by the investors to the QOF *within 180 days of their sale of that previous investment*. They do not have to put all of their capital gain into one investment, but may put in a portion of it.
- There is a range of equity instruments that the QOF can use to invest in the stock, partnership interests or business properties of the Qualified Opportunity Zone ("QOZ") as long as these assets are acquired after 12.31.17.
- Whatever structure or equity instrument is employed, the QOF must hold at least 90% of its assets in the stock, partnership interest, or business property of a Qualified Opportunity Zone Business ("QOZBs").
- No more than 5% of the QOFs assets can be held in non-qualified financial instruments like loans.

- Although CDFIs will not generally qualify as for profit investors with capital gains tax liabilities, they can provide low cost long-term capital at any other part of the transaction to make it work. They can place funds at the asset level, the 2TE level or the QOF level—wherever the gap is, or wherever it can enhance the transaction most effectively.

Qualified Opportunity Zone Businesses (Businesses and Properties)

- Assets must be purchased after 12.31.17
- Substantially all of the use of the property is in the Opportunity Zone
- The QOF can make investments "in operating businesses, equipment, and real property. For example, [QOFs] can make equity investments in or purchase the stock of a company if substantially all of the company's tangible property is and remains located in an Opportunity Zone. [QOFs] can take interests in partnerships that meet the same criteria. Funds can also invest directly in qualifying property, such as real estate or infrastructure, if the property is used in the active conduct of a business and if either the original use of the property commences with the fund or the fund substantially improves the property."
- The substantial improvement test is met if, during the 30-month period after the date of acquisition, additions to basis of the QOZ property equal or exceed the adjusted basis of the property at the beginning of the 30-month period (often referred to as the "doubling down" requirement). This appears to allow the QOF to use depreciated basis when calculating the doubling down amount. The proposed regulations clarify that the basis of the land is not part of the reinvestment requirement. Because tangible property needs to be used in the active conduct of a business, a "buy and hold" model for land purchase is not permissible.
- Substantially all of a business's tangible business property must be in an opportunity zone to qualify for QOF funding. For this, substantially all means 70%.
- At least 50 percent of the gross income of a qualified opportunity zone business must derive "from the active conduct of a trade or business in the qualified opportunity zone." So long as substantially all of the business' real estate assets and capital equipment are located in the Opportunity Zone there is no requirement about the location of their customers.
- If a principal and/or investor in a QOF owns more than 20% of a property or asset, then it is deemed to be "related" and cannot be purchased by the QOF.
- The QOF must invest in a QOZB within 180 days of receiving the funds from the investor. If the QOF is investing in a Qualified Opportunity Zone Business Property, it is eligible for a 31-month safe harbor to apply funds and develop the qualified property per plan and schedule. This enables the QOF to keep cash assets on its books in excess of the 5% limit for the purposes of developing a property.

- A QOF may face the sale of a QOZB prior to the intended termination date of the QOF. This is a likely occurrence with commingled funds (Co-Funds). The question as to how the proceeds are reinvested within the QOZ and counted towards the 90% test are still under review at the Treasury Department.
- A QOF may face the potential of a QOZB relocating out of the QOZ. The Op-Zone tax treatment allows a 5-year "off-ramp" period for investors in the QOF to divest.
- Issues associated with the transfer of QOF interests to another QOF or to an affiliate are yet to be determined.
- No "vice" businesses, such as liquor stores, gambling venues, golf courses and the like are eligible.

Liabilities and Equity

- The equity contributed by the investors can only derive from the proceeds of capital gains realized within the prior six months if it is to get the beneficial tax treatment.
- The QOF can raise equity that comes from other sources as well, but that other equity does not qualify for the Op-Zone benefits. There is no restriction on the amount or type of equity from non-eligible sources. CDFIs may consider investing funds derived from grants.
- The QOF can also be leveraged with debt. There is no restriction on the amount of debt nor the type of debt.
- It is critical to note that investors are likely to expect the QOF to provide cash-out events to cover their tax bill at the earlier of 12/31/2026 or the sale of the QOF's QOZB. The CDFI or CDC will need to establish the terms and conditions of this cash outflow as part of the structuring of the investment.
- A critical part of the structuring of the investment is the exit strategy. There are equity instruments that can be used to facilitate the transfer of ownership of a QOZB without hardship to the CDFI and with credit support for the investor. [See Section X].

Portfolio Tests

In addition to assuring the 70% test for assets in the Op-Zone, the CDFI should perform the following tests every 6 months, including at tax year-end:

- The 90% test for the portfolio
- The 5% test for non-eligible financial assets. This test applies to those CDFIs that are developing a property or starting a business and who have provided a plan and a schedule that enables them to use the 31-month safe harbor option.

Penalties

If a Fund fails to maintain an eligible portfolio and is unable to demonstrate “reasonable cause”, the statute calls for a penalty at the IRS’s standard “underpayment rate.” The underpayment rate is the Fed “short term” rate plus 3%.

The penalty is calculated by subtracting from 90% the amount of the portfolio shortfall and multiplying it by the underpayment rate for the term of the shortage

Reporting

The statute had originally included provisions for annual data collection beginning five years after the bill passed, but those provisions were dropped in the final version. The only reporting requirement at present consists of data that confirm the eligibility of the Fund’s investment portfolio.

Potential Fund Structures

There are four QOF structures that appear relevant for CDFIs at this point:

1. Single Asset QOF.
   The CDFI would be the owner/developer for a specific property and would line up the financing including the equity.

   - The positives: there is a single asset with a single set of cash flows and exit strategy. The exit strategy is matched to the term of the QOF, and design and execution of the fund is quick.
   - The negatives: There are no economies of scale and no flexibility relative to the asset tests. The QOF is built around a single asset identified in advance of the transaction.

   Although there may be local investors and investors familiar with the community development sector who may have an interest, mainstream investors will be hard to reach. For CDFI’s, the best option is to take their QOZB and join up with a large Commingled Fund (see below) where the scale, the diversification and the experience/reputation of the manager brings access to the mainstream investor.

2. Single Asset owned through a 2 TE (2nd Tier Entity).
   This structure would function similarly to a CDE in the NMTC program. With this option, the CDFI may be a participant in a large QOF with multiple funders and multiple forms of equity for a large single asset.

- The positives: the positives are the same as for the single asset in #1 above. There may be additional flexibility in that the portfolio test can be calculated at the 2TE level. But the primary advantage is the possibility of doing larger transactions with more partners and sources of funding.
- The negatives: limited economies of scale, limited diversification, identification of the asset in advance of the transaction (no blind pool).

The potentially larger size of transaction with this structure, together with the increased number of participants, may expand the range of investors and the amount they are willing to commit. However, it is likely they will still be mostly local investors and investors familiar with the community development sector. As with the structure #1 above, the best option may be to join up with a large Commingled Fund (see below) where the mainstream investor can be more easily accessed.

3. Commingled Fund ("Co-Fund")

   In this structure, the fund manager invests through a 2TE --like a master limited partnership-- in a range real estate QOZBs. The CDFI would be participating in a pool of QOZBs that is large enough and diversified enough to attract a significant amount of mainstream investor equity.

   - The positives: the fund manager has market familiarity and all of the investing flexibility that a blind pool offers, together with the benefit of diversification by asset class, location and risk.
   - The negatives: There is still regulatory uncertainty as to the constraints on timing of investments and guidelines for reinvestment. There are questions about whether a single tax return can be produced or if a tax return must be created for each individual QOZB. It is also expensive to set up and to run.

   This is the optimal structure at present for gaining access to the mainstream investor, but the prospect of procedural questions and formation costs are impediments. There is also discussion of using this structure to create a "fund of funds" which in theory could be an ideal structure for the CDFI field, but the operational features as well as the eligibility have not been determined.

4. Real Estate Investment Trust (REIT)

   As with the Co-Fund structure, the REIT could involve economies of scale that are attractive to mainstream investors. The structure also could provide investors with additional financial benefits that reduce pressure on the target ROIs, the dividends and the cash flows of the CDFI QOZBs in the portfolio. If the REIT were managed by a reputable firm that was also knowledgeable of the CDFI sector, this could be a sector-changing structure going forward.

There are at least two community development REITs that can be models or even potential partners: HPET, an affordable housing preservation fund run by the Housing Partnership Network; and Community Development Trust, a REIT that has provided over $1.6 billion in both debt and equity to new and existing multifamily developments nationally. There is insufficient data at this writing to determine the near term attractiveness or operational viability of this structure in the context of Op-Zones.

III. Asset Classes

The intent of the Op-Zone tax treatment is to attract as much development to low income areas as possible—and make it as easy as possible. As a result, the range of asset classes is wide and the restrictions minimal. Again, the current thinking is that size will be a major factor in attracting investors and the general sense is that $50 million is where the interest

Land

The QOF can purchase land as part of a property that is actively used in a trade or a business. Buying land and holding it is not an eligible use. To be eligible, the land must be put to commercial use.

Residential

QOFs may invest in the development of any kind of residential housing whether owned or rented. There are no income restrictions.

Leaders in the CDFI field are already finding ways to put Op-Zone investments to use on LIHTC properties, and the Op-Zone investment is viewed as a welcome source of additional funds. There are four key benefits that come with "twinning" these two tax-advantaged investments: (1) the transactions can be of attractive size for investors; (2) there is a class of equity investor that already has familiarity with these kinds of transactions; (3) the combined reduction in cost occasioned by the LIHTC and Op-Zone tax treatment improves the sustainability of the project; and (4) there is reasonably good data on the credit performance and outcomes of this asset class.

Good data is essential to attracting new equity investors, and CDFIs should explore the ways in which other programs—like FHA, with its excellent data—can be put to good use on behalf of the QOFs they are promoting and negotiating.

Community Facilities

Community facilities are an eligible use. However, the owner or user will often be a government or a non-profit entity that is not able to use the tax benefits. As a result a CDFI that wants to use Op-Zone tax treatment for a project will likely need to focus on: (1) some form of leasing instrument; (2) an equity structure in which the investor clearly earns the tax benefits and can share the value of them by reducing the yield; and (3) some mechanism for transferring ownership back to the government or non-profit entity at the end of the investment period. With Preferred Stock as an eligible equity investment, the transfer at the end of the period can present

the investor with a less risky exit, and the community buyer with a more affordable purchase (See Section X).

Commercial Real Estate

It is likely that the greatest amount of Op-Zone activity will revolve around commercial real estate development. The size of each individual project, the data, and the potential for appreciation are all factors that make commercial real estate developments easier to promote with mainstream investors who have not previously exposed their portfolios to low income communities. Developments with well-known owners or tenants (i.e., Whole Foods, Walmart, Marriott) can leverage that familiarity into expanding the range of investors. The only restrictions on commercial real estate investment are: (1) they must be located in the Opportunity Zone to the extent required; and (2) there are to be no “vice” businesses such as liquor stores, casinos and golf courses.

Infrastructure

Infrastructure projects are likely to attract investor interest due to (1) the potential size and visibility; and (2) the availability of good data on credit performance of state and local entities. As with community facilities, the CDFI proposing to assist with one of these will focus on how to transfer the tax benefits that the government entities cannot use to the investors, and how to construct a lease structure that provides the least amount of risk.

Business

Large businesses with sizeable expansion plans in the Op-Zone represent an ideal use of the investment parameters. CDFIs should work with local authorities and the Chamber of Commerce to scout out opportunities to assist. Many CDFIs see the need for equity at the small business level. The Op-Zone investment parameters are not suited to small business equity finance except in the context of a large Co-Fund with multiple investments.

Investment in individual small businesses carries exceptional levels of risk: Successful lenders and investors provide debt and equity to the sector almost exclusively on a multi-asset portfolio basis in order to diversify risk and avoid volatility. This will hold true for the Op-Zone investment as well. Another reason this makes sense is that, due to the volatility, it is extremely difficult to assure investors that an individual small business will fit within the Op-Zone QOF tests.

There may be an exception to this; businesses that fit into the SBA 504 or the USDA B&I programs may have the size, the stability, the asset values, cash flow, the long maturities and credit data necessary to satisfy investors. Hence, to the extent a CDFI does wish to proceed with a single asset QOF for a small business, doing so in the context of these two programs would be recommended.

It is also possible that there are SBA 7a borrowers that could fit within the Op-Zone investment parameters on an individual basis, but they would have to be at the upper end of the allowable SBA size standards (as are the SBA 504 borrowers). Smaller SBA 7a borrowers could benefit from the Op-Zone investment if the CDFI puts together a Co-Fund, as suggested above. A rule of thumb would be that there should be more than 25 distinct borrowers—preferably more. The CDFI with this kind of portfolio would likely get the best (and most SBA-compatible) results by using one of the Preferred stock options rather than common equity, [See Section X].

In addition to diversification and flattening of cash flows, a multi-asset Co-Fund would provide the CDFI greater flexibility in managing portfolio tests like the 90% deployment rule, while insulating the investors from excessive small business equity risk. It is important to note that a multi-asset Co-Fund QOF for the SBA 504 and B&I borrower could also present investors with a much more attractive—and hence—less expensive Op-Zone investment opportunity than can be presented on an individual asset basis.

What holds true for the federal programs for residential development also holds true for business investment. The Op-Zone investor is going to need hard data on credit performance for the QOF asset class, and agencies like the FHA and SBA have exactly the data that investors will want to see. The data for these two asset classes may be more compelling and conclusive for the mainstream investor than the data for commercial real estate, most community facilities and infrastructure projects.

Venture Capital

Community Development Venture Capital (VC) Funds appear to be a good fit for common equity in that their investments generate strong returns relative to other community development investments. The Opportunity Zones investment makes those returns capital gains tax-free if the money is left in the fund for 10 years or longer. However, as the CDVCA has pointed out, there are problems with the QOF investing parameters:

- VC funds want to get capital commitments that they then call over a period that could be as long as 4-5 years. With QOFs however, investors need to shelter all of their capital gains within 180 days of incurring them. Funds cannot simply take in investment and sit on it, as the Op-Zone tax treatment requires 90% deployment. There may be ways to

address this barrier: (1) The VC call period qualifies under the 31 day safe harbor rule; (2) The VC call period qualifies as reasonable cause for missing the 90% deployment test; (3) The QOF can be used to fund a second or third round of financing of an existing entity; and (4) The typically high yields enable the QOF to economically absorb the Treasury underpayment rate.

- Many VC investments may be liquidated in less than 10 years. This then creates re-deployment risk within the Fund (if the Fund fails to find a new investment, its deployment ratio could fall below 90%, which could trigger financial penalties).

These issues could be avoided by setting up Funds just to do a single investment (or a series of single investments) in a business, where it was known that the time horizon for the investment would be at least 5-10 years. However, this would appear to push the investment parameters towards larger businesses with lower risks—which may exclude many of the businesses that community development VC funds try to target. Is there an optimal size of business or size of fund that would serve as the "control" for making these kinds of decisions?

IV. Investors

The following is a general outline of the mainstream investor and the community investor that CDFIs may wish to engage in their efforts to design and implement QOFS.

Governing laws

QOFs and QOF investors are subject to existing regulations for investing at the national and state levels. It is not anticipated that QOFs will have public solicitation, so the raising of the equity component of each transaction qualifies as a private placement. Hence the QOFs will have to comply with the following:

1. The Securities Act of 1933.
   Of particular importance: The "Reg D" private placement rules prohibit a general solicitation. They also establish and enforce strict disclosure requirements. Only Accredited Investors can be solicited: The term "accredited investor" is defined in Rule 501 of Regulation D of the U.S. Securities and Exchange Commission (SEC). They are investors who are financially sophisticated and have a reduced need for the protection provided by regulatory disclosure filings. Accredited investors include natural high net worth individuals, banks, insurance companies and similar entities. To qualify as an accredited investor, one must have a net worth of at least $1,000,000, excluding the value of one's primary residence, or have income at least $200,000 each year for the last two years (or $300,000 combined income if married) and have the expectation to make the same amount this year.

2. The Investment Company Act
   One of the relevant features of this set of regulations is that it limits the private placement to 100 accredited investors or qualified purchasers. A Qualified Purchaser under the Investment Company Act means:

   - A person with not less than $5 million in investments
   - A company with not less than $5 million in investments owned by close family members
   - A trust, not formed for the investment, with not less than $5 million in investments
   - An investment manager with not less than $25 million under management
   - A company with not less than $25 million of investments

3. The Investment Advisers Act, and state laws
   Depending on amount raised, the QOF may have to register with the SEC or the state. Registration is a difficult and time-consuming process for an entity that is not experienced in the marketplace.

The only way around these requirements is if the QOF equity is not syndicated. This would be the case, for example, if a single investor provided the equity and sponsored the QOF.

CDFIs should also be aware that not all states have incorporated the Op-Zone tax treatment into their tax codes or procedures, and that, therefore, the yield on a QOF may differ from one investor to the next depending on the state in which he or she resides.

Size of Transaction

Mainstream investors prefer large transactions for a variety of reasons: (1) the fixed costs of origination, design, due diligence, management, monitoring, workout and professional fees represent a lower percentage of revenue; (2) there is more and better credit performance data; (3) there is a greater range of exit strategies in the event of default; and (4) size attracts interest and buzz. Commentators have different views of what the average size of the Op-Zone transactions will be: one says the standard deal will be over $50 million, another says the deals will be in the $500 million range. CDFIs will be challenged to find the right instruments and structures to get to the appropriate scale, and the right level of duplicability.

Term of Transaction

Some commentators have suggested that the mainstream investor who is being introduced to the low-income community for the first time will attempt to get his/her money out as soon as practicable. Many of the investors who are cultivated and managed by institutional investors may mostly fall into this category—at least until such time as the markets become familiarized with community development generally and the Op-Zones specifically.

As part of the process of acquainting mainstream investors with Op-Zones, institutional investors are likely to promote large investments in certain kinds of prominent national enterprises, which may include retail chains, bank branches, fast-food franchises or convenience stores. Some of these may work with the long-term public service mission of the local CDFI, and others may work against. The CDFI will have to determine whether these kinds of assets are helpful and worth supporting on a case-by-case basis. CDFIs should not be discouraged by the possibility that much of the Op-Zone money will not, at first, be tailored to the kinds of projects that they normally develop and support. Instead, they should focus on those institutional investors and their clients who have a commitment to the community and to its long term interests.

Most CDFIs will want the business or the property to operate in alignment with the interests of the low-income community in which they are located over the long term. Many CDFIs will want to see ownership transferred to the community or to themselves at the end of the period in order

to assure this long-term outcome. Because of the recency of the Op-Zones and the speed with which they need to be rolled out, there is not time to develop the network of information necessary to develop an investor pipeline. As a result, CDFIs looking for the long-term community investors should engage and/or partner with those institutions that have the best bridges between community development and the capital markets. There are five basic groupings

- Local investors who know the community and the mission of the CDFI.
- Large CDFIs: such as LISC, Impact Community Capital, Enterprise Community Investment, Bridge Housing and HPN
- Socially Responsible Investors such as Calvert.
- Institutional Investors already involved in the community development sector through such programs as NMTC and LIHTC, FHA and SBA such as Goldman Sachs, Bank of America, Wells Fargo, and JP Morgan Chase.
- Insurance companies such as Prudential.

It is probably best for most CDFIs to enter the Op-Zone marketplace in partnership with one or more of these kinds of institutions or organizations. From their experience, they will know which investors are most suitable to the kinds of QOFs CDFIs will be assembling, and also how to approach them.

<u>Risk Parameters</u>

The first thing that mainstream investors (and their money managers) will want to see with the Op-Zone proposal is an analysis of the parameters of the investment:

1. Counterparty risk

   - Who is managing the QOF?
   - Do they have experience managing it?
   - Do they have the resources and sustainability to do what they are committing to over the life of the investment?

2. Exit strategy

   - If this is not a liquid investment and cannot be sold in the public market, how does one get one’s money back?
   - Since exit strategies are often negotiated at the outset of the investment, what metrics, terms and conditions will be used to encourage and track success?
   - In the event that the investment does not play out according to plan, what are the remedies? Under what circumstances can equity investors intercede?

3. Likelihood of success.

   - Are there data and metrics of similar assets that provide sound indications of how this proposed asset will perform—assuming the manager of the asset is capable?
   - In what ways are the risks diversified or mitigated?
   - Are there external mitigants (in the community or asset class) and are there internal mitigants (in the way the project is structured and financed)?
   - What amount of leverage is acceptable for the investment?
   - What sorts of terms and conditions should be associated with that leverage?

4. Likelihood of achieving the target return

   - Since the asset is in an unfamiliar (low-income) market that has not been served by mainstream lenders and investors, what is the right risk premium?
   - What is the right balance between dividends and appreciation?

The mainstream investor does not want to lose his or her capital gain. There will be little interest in exceptional risk. The problem is that for most of them, the notion of investing in a low-income community represents exactly that—exceptional risk. With the right partners engaged, CDFIs can mitigate the perception of exceptional risk. We will show how it may be done internally—within the deal structure-- below in Section X.

<u>Investor Pricing</u>

Institutions are appropriately reticent to broadcast the secret sauce of their equity strategies and pricing. The potential for mis-apprehending a set of calculations that are as changeable as they are complex, is great. Investors have different pricing expectations associated with different asset classes as well as with different financing structures and managements. Broadcasting the calculation of a risk premium associated with a new government initiative presents an even greater potential for misunderstanding. So, obtaining pricing parameters for prospective QOFs from institutional investors is possibly as meaningless as it is difficult. Having said that, there is one thing that virtually every institutional investor says: "We adhere to the 'prudent man theory' which means "we will not provide concessionary rates or take risks that put us out of line with the risk/return averages evident in the market."

So let us walk back from that and see what CDFIs may expect to see. First, let us understand that these rates are subject to daily changes as well as occasional monumental swings. ,Hence, they represent a moving target. But speaking very generally, we see investments in 10-year bonds in the 2.5-4% range, preferred securities in the 3-6% range and the total return on equities in the 7-8% range. This is a great place to start. These ranges, however, are for investments in

mainstream creditworthy companies, and the instruments are highly liquid and often actively traded.

This will not be the case with the assets being developed for Op-Zones. QOF assets will consist primarily of predevelopment property and small private businesses. The operations are new and untested, and the investments are illiquid. On an operating basis, they present higher risks than mainstream investors are used to. As a result, the target ROIs will be significantly higher. Again speaking very generally, and just for the purpose of providing an indication, we are assuming the following ranges for mainstream investor target returns at this point in time for Op-Zone investments:

10 year Bonds:	4% to 6%
Preferreds:	5% to 9%
Equities	12% to 17%

Note: These are indicators for the purposes of this paper only. There is no sensitivity to the key issues like counterparty, asset class, deal structure, term, valuation, leverage or coverages. These figures should not be used in the forecasting or negotiation of rates on live Op-zone transactions.

Note: for excellent data on market pricing of mainstream liabilities please see https://fred.stlouisfed.org/series/HQMCB10YR

V. The Challenge for CDFIs

Op-Zones open up community development to the mainstream equity investor, who is, for the most part, new to community development. The majority of the institutional investors who manage his or her money are new as well. For both, the mission, the metrics and operations of CDFI will not only be new, but will run contrary to the way they view the market and how they perform in it. The same holds true for CDFIs. CDFIs are familiar with the credit and investment parameters for banks, insurance companies, impact investors and a range of investors involved in programs like LIHTC, NMTC, and the SBA 7a secondary market. However, that mainstream investor and the institution that manages his or her money is new, and their expectations will present material challenges that CDFIs must address.

The mainstream equity investor is looking for a target yield that consists of either dividends or appreciation, most often a bit of both. Common equity is a financial instrument that does not fit easily into the world that CDFIs serve:

- Our asset is smaller.
- It is located in a community where economic activity, asset values, appreciation in asset values are all comparatively lower.
- We do not have a policy of maximizing value and/or “charging what the market will bear.”
- Our cost of funds must be in low single digits to keep things affordable.
- We are in the investment for the long term and our success is measured in achievement of economic and social objectives rather than ROI.

So on the face of it, a difficult match. The following is a discussion of those challenges with some recommendations on how CDFIs might address them

<u>Debt versus equity</u>

CDFIs are traditionally lenders rather than equity investors. In the big picture, the most notable difference is that debt carries a fixed rate of return, a fixed maturity and seniority in liquidation, while common equity has no contractual rate of return or maturity and comes at the bottom in liquidation. Equity is a much riskier and expensive form of financing. In order to mitigate this risk, the equity investor seeks greater control of the project or business than does the lender. There are also material differences between the two funding disciplines in terms of due diligence, underwriting, monitoring, reporting, remedies and pricing. There is a reason that, except in special situations—nobody ever provides both debt and equity to a project: The interests of the two are in opposition, operationally as well as in liquidation.

In order for CDFIs to bridge this gap, the best strategy is to explore the wider range of equity instruments. In addition to common equity there are a number of different kinds of preferred equity instruments. Preferred equity instruments are eligible in Op-Zone investing, and because they can have debt like attributes, will be more aligned with CDFI experience and mainstream investor risk tolerance. [See Section X].

<u>The cost of equity versus grants</u>

The financing gap that occurs when a community development project cannot get conventional financing derives either from the appraisal or the cash flow or both. In theory, the CDFI fills this financing gap through the use of grants. CDFIs sometimes view the grant as free money. It is not true, of course: in addition to carrying requirements that actually cause the CDFI to spend more, it often costs a lot of money to obtain the grant in the first place.

Nevertheless, when a CDFI sees the ROI target for common equity in a QOF (as shown in the previous chapter), the CDFI's response is likely to be that it is unaffordable for the QOF and/or the ultimate user of the underlying property or business. Part of the sticker shock derives from the dividends that must be paid, and the other part derives from the expected appreciation of the asset. Those are the two sources of the ROI for the equity investor. For the CDFI, the high dividends represent a cost that adds to the cash flow burden of the project, and appreciation is not always expected or achievable in a low-income community.

On the face of it, the CDFI may be right to back off from obtaining this apparently high cost form of financing. And, indeed, there will be projects and businesses for which it does not make sense. There is a distinction to be made, however: Where the CDFI is trying to fill an appraisal gap rather than a cash flow gap, the transaction may very well be feasible. By this we mean that the need for equity as part of the capitalization is more important than cheap funding. In low income—particularly rural—communities one can find examples where the appraisal or valuation is low even though the ongoing cash flow is adequate. In these situations, the addition of equity, even high cost equity, can be used to recapitalize the property or business with a view to reducing the cost of the debt, and perhaps even increasing the cash flow. [See Section X].

<u>Exit strategies</u>

Mainstream investors want to be sure there is an "exit strategy"—a way to get their money out of the investment. They particularly like the option to get their money out at any point. This is in direct conflict with the CDFI approach, which is to stay with the business or the property until it can stand on its own, and to be sure that it continues to fulfill the community development mission thereafter. This conflict in itself could cause some CDFIs to avoid the Op-Zone

initiative, but that would be a mistake. One of the breakthrough parts of the Op-Zone regulations is the inclusion of Preferred stock or interest as an eligible form of equity. With the proper use of Preferred stock, the CDFI can reduce the operating risk, improve the likelihood of an exit for the investor and retain community ownership and/or adherence to the mission. Again, this is discussed in detail in Section X.

Reporting and Valuations

In analyzing data for the purpose of establishing a risk profile, mainstream investors rely on established regulatory and accounting rules and procedures as well as benchmarks by asset class. The mission of a CDFI predisposes it to try to make its community projects succeed, and to take whatever time is necessary to achieve that result. This predisposition results in a more accommodative approach to accounting and valuation than that which predominates in the conventional sector. A good example of this is how delinquencies in small business loans are handled: it is not uncommon that a CDFI will modify a loan in order to assist a borrower in avoiding delinquency—as part of the mission—without adjusting the loan or loss reserves. In the mainstream, a modification would result in an adjustment of the value of the loan and/or the reserves reflecting the pressures that caused the modification. Both approaches are right in the context of their missions, but they are in direct conflict. This kind of conflict is less of an issue in real estate development than in lending, so it may not be as much of an impediment for the Op-Zone investment. However, in order to attract mainstream investors, CDFIs must be prepared to align their asset management, reporting and valuations with conventional protocols.

Meeting the Challenges.

Some CDFIs are already bridging the gap. For the most part, they have experience in the kinds of regulations, reporting requirements and investor relations that are required in the equity markets. They also have experience with different kinds of equity instruments. These CDFIs are large and have the resources and staff skillsets to manage an Op-Zone proposal and a QOF properly. Perhaps the most effective way to enable the broader field of CDFIs to participate in Op-Zones is for these CDFIs, together with the trade groups, to establish platforms that apprentice CDFIs in the creation and management of the QOFs. Successful apprenticeships could produce QOFs that are part of single asset partnerships with the large CDFIs or institutional investors familiar with the CDFI sector. Alternatively, perhaps even more impactful, the successful apprenticeships could be assembled in CDFI sector-based Co-Funds.

VI. Op-Zone Strategies for CDFIs: Definitions

In order to delineate the potential participants in an Opportunity Zone financing, we will use the following nomenclature:

Accelerated Dividend: This is the dividend that is paid out to cover the capital gains tax due at 12/31/2026, and may be used to buy-out the investor at the end.

Blended Cost of Funds: This is the overall cost of financing once the transaction has been completed. It includes both debt and equity and is expressed as a percentage to the total financing outstanding. The value of the calculation is that it enables the CDFI to determine how much of what kind of financing the property or business can afford.

CDFI: For the purposes of this paper, "CDFI" includes both CDFIs and CDCs.

Common Stock: For the purposes of this paper, common stock in a corporation also includes partnership interests in a partnership. Common stock represents a share of ownership in a corporation. It entitles the stockholder to own a portion of the company without actually being in possession. It allows the stockholder to vote on corporate issues, such as the board of directors and accepting takeover bids. Most of the time, stockholders receive one vote per share. Shareholders are compensated through the payment of dividends and the sale of the stock. Equity is the most junior form of financing in a corporation. In the event of liquidation, the shareholder will lose the investment if the lenders and other creditors are not paid out.

Investor: the person or entity (institution) that has the proceeds from a capital gain and wants to defer the capital gains tax.

Participation fee: The fee a senior or subordinate lender receives for participating in the transaction associated with the investment. Loan fees are typical in conventional lending, particularly in leveraged loan transactions. CDFIs should look for these when providing financing to QOFs.

Preferred stock: Preferred stock is the optimal instrument for CDFIs looking to invest in Op-Zone assets. It is a mainstream financial product and enables CDFIs and/or community interests to retain ownership of the properties while reducing the cost of dividends in the early years. For the purposes of this paper, preferred stock also includes preferred interests in a partnership. A preferred stock has the following attributes:

- A class of ownership that has a lower claim on assets in liquidation than bonds, but a higher claim on assets than common stock.

- It pays fixed dividends, and, like equity, has the potential to appreciate in price.
- Preferred shareholders have priority over common stockholders when it comes to dividends, which generally yield more than common stock and can be paid monthly or quarterly.
- Unlike common stock, preferred shares do not typically have voting rights.
- The Preferred holder may take control of the corporation under certain conditions, typically associated with non-payment of dividends or default.
- Most preferred issues have no maturity dates or very distant ones.
- If a company is struggling and has to suspend its dividend, preferred shareholders may have the right to receive payment in arrears before the dividend can be resumed for common shareholders. Shares that have this arrangement are known as **cumulative.**
- Preferred shareholders have a prior claim on a company's assets if it is liquidated, though they remain subordinate to bondholders.
- **Convertible Preferred**: a preferred dividend-paying instrument that enables the investor to convert to common stock typically at the end of 10 years. The purpose is to keep the dividend rate down in the early years and to compensate the investor by giving them the option to capture the benefits of appreciation in the later years. The conversion price is typically established at the outset.
- **Perpetual Preferred:** Some preferred stocks are deemed perpetual because they have no stated maturity

  Redeemable Preferred: Most preferred stocks are long term, typically with a maturity of between 30 and 50 years. Some preferred shares are "redeemable" which means that the issuing corporation has the right or the obligation (as the case may be) to purchase the shares back at a stated maturity date.

Sinking Fund: sinking funds are a method that issuers use to reduce the risk to the lender or investor, which in turn reduces the interest or dividend rate. When creating a sinking fund, the issuer sets up a custodial account and makes systematic payments into it. Payments might not begin until several years have passed. Amounts are typically fixed, although variable amounts may be allowed based on earnings levels or other criteria set by the fund's provisions. Sinking funds may be in preferred stock, cash or other bonds. Unless preferred stock is used with sinking funds, failure to make scheduled principal and interest payments results in defaulting on the loan.

Senior Debt: In order to obtain the lowest overall cost on financing, QOFs will likely be leveraged with senior debt. Senior debt has first claim on the QOF's assets in liquidation as well as first claim among financing sources on earnings. Banks, other depositories and CDFIs are the most likely sources of senior debt for the QOFs.

Subordinated Debt: In order to provide capital support to the senior debt, stabilize cash flow and keep reduce the need for expensive equity, QOFs should consider a tranche of debt that is subordinate to senior debt relative to claims on cash flow on assets. CDFIs, foundations and agencies may be the most likely sources.

Syndication: In banking, syndication has traditionally referred to the act of designing, negotiating, assembling a total financing package for a property or a business, and then distributing pieces of it among other financing sources. This action can be taken by a number of different parties. Typically the party with the equity has the most power in the negotiation, and deals are typically structured initially around the equity owner's needs. However, the negotiating power can change depending on the amount and type of financing needed for each tranche of the package. Because CDFIs know the range of financing sources in the community development sector, they are uniquely positioned to perform this role, once they understand the parameters of the Op-Zone investors. Equally important, because they can provide low cost long term money at any point of the balance sheet of the QOF, the 2TE and/or the underlying asset, they have the strategic advantage of being able to make transactions work, an advantage that few of the other participants will have.

Syndication fee: This is the compensation that the manager of the syndication (the syndicator) charges for the arrangement of the investment. The syndication fee varies in accordance with the size of the transaction, the number of participants, and the difficulty of implementation. The one-time fee is typically in a low single digit percentage.

Syndicator: the person or entity who structures the investment transaction and arranges the amounts, the terms and the conditions for each of the participants and potentially identifies/sells to the investor participants. Experienced CDFIs are ideally positioned to perform this function.

Transaction: The total financing package for the property or the business that the QOF is undertaking.

VII. Op-Zone Non-Financial Strategies for CDFIs

Not all CDFIs have the staff, resources or partnerships to participate in the financing of a QOF. But that does not mean that they cannot play a role, one that can generate fee income as well as investment in their communities. The fact that there is a tight time frame on the Op-Zone investing means that the value of the information that CDFIs have, and their relationships in the community are valuable. Likely CDFI non-financial activities that promote Op-Zone investment include:

Knowledge of the community

CDFIs hold a really valuable commodity: information. They know their communities, and they know the needs and the investment opportunities in them. They have relationships with the entrepreneurs, the city officials and the community leaders. That knowledge is likely to become a valuable commodity. Providing that kind of community information and providing introductions can save investors and syndicators considerable time. These services could be and should be provided on a fixed fee or retainer basis.

Prospectuses are already being developed by various municipalities to promote investment (Louisville, KY provides a good example). Based on the work that they have already developed in the context of fund-raising, CDFIs may be well equipped to assemble similar prospectuses that can be of assistance in investor presentations. CDFIs may wish to provide these for free as they are of a promotional nature.

Origination of suitable transactions.

Because they know the communities and market opportunities, CDFIs would be good originators of transactions. They have experience in structuring deals in the communities and they know who is doing what. Again, the quick turnaround time required by the Op-Zone investing schedule for the deferral of the capital gains makes speed a priority, and the development of a pipeline of potentially attractive QOF transactions is a priority for the investing public. CDFIs will have easy and quick access to the information on the properties and businesses that are eligible. Origination fees could be a fixed percentage of the overall transaction.

Facilitation of transactions with community leaders and officials.

Another role that CDFIs could perform is mediating investor plans with community needs. Large real estate transactions, for example, often encounter local citizen and community objections and associated delays. CDFIs are experienced with convening community leaders and public

officials for negotiating solutions with developers and/or project and business owners. This may or may not be a fee-generating activity due to the potential for conflicts of interest, but it does provide the CDFI with the opportunity to play a leadership role.

Due diligence and project monitoring.

One of the key characteristics that differentiate CDFIs from conventional lenders and investors is the experience with, and commitment to, due diligence and project monitoring. Both of these are costs which CDFIs are willing to bear, and which many of the typical participants in a private development deal are attempting to minimize or avoid. The fact that the CDFI is already in the target community is a significant cost-saver for both functions. This could be a fee-generating activity.

VIII. Op-Zone Debt and Tax Credit Strategies for CDFIs

CDFIs can play a critical financial role in the Op-Zone QOFs even if they are not involved in raising the equity or managing the QOF. The regulations enable the leveraging of a QOF, which can dramatically improve the ROI for the equity investor. The fact that a CDFI's contribution to the leveraging may involve longer-term lower cost financing means that the CDFI's participation provides an additional incentive to the equity investor. This opens up a wide range of possible debt and equity instruments and incentives in which CDFIs are already engaged.

Below market rate Senior Debt:
The CDFI can provide senior debt to the transaction. Since banks may also be looking to provide senior debt, the CDFI may be willing to provide the debt at or below prevailing market rates, or have a longer term of more liberal underwriting standards in order to participate in the mission. This is a benefit to all involved.

Subordinated Debt:
In order to fill in gaps around bank lending constraints, the CDFI may be willing to provide subordinated debt to the transaction. This does not have to be at a concessionary rate.

"Twinning" of tax credit equity investments.
Investors in tax credit equity programs are natural partners in Op-Zone QOFs. They could enhance their return on existing projects if the syndicator establishes a QOF to invest tax credit equity in qualified Opportunity Zone businesses or projects. CDFIs should explore how this layering of incentives could be achieved for each of the following tax credit programs:

- Low Income Housing Tax Credit
- Historic Tax Credit
- New Markets Tax Credit
- Solar Investment Tax Credit
- Historic Preservation Tax Credit

Federal Credit Agency Programs

The residential, community facility, infrastructure and small business programs at HUD, the SBA and the USDA all bring credit enhancement and essential metrics to the transaction, both of which are attractive to investors. To the extent a CDFI is actively engaged in one of these programs, it will be a welcome addition to any QOF financing.

IX. The Blended Cost of Funds

Because the cost of equity is so high—and so different from the grant funding that CDFIs traditionally use to close the capital gaps—CDFIs need a way of determining how to make it affordable.

The following is a chart that shows the amount of a QOF proposal and the amounts and rates of the various tranches of financing:

FINANCING TYPE	AMOUNT	RATE	EXPENSE
TOTAL ASSETS	$10,000,000		
SENIOR DEBT			
Short Term Debt A	$1,000,000	3.50%	$35,000.00
Short Term Debt B	$500,000	4.00%	$20,000.00
Short Term Debt C			$0.00
Short Term Debt D			$0.00
Long Term Debt A	$3,750,000	5.00%	$187,500.00
Long Term Debt B	$500,000	4.00%	$20,000.00
Long Term Debt C			$0.00
SUBORDINATED DEBT			
Long Term Sub Debt A	$1,000,000	7.00%	$70,000.00
Long Term Sub Debt B	$250,000	3.00%	$7,500.00
Long Term Sub Debt C			$0.00
PREFERRED STOCK		8.00%	$0.00
OTHER EQUITY SENIOR		0.00%	$0.00
COMMON EQUITY	$2,000,000	13.00%	$260,000.00
OTHER EQUITY JUNIOR	$1,000,000	0.00%	$0.00
AVERAGE COST OF DEBT	4.86%		$340,000.00
AVERAGE COST OF EQUITY	8.67%		$260,000.00
AVERAGE COST OF FUNDS	6.00%		$600,000.00
TOTAL DEBT	$7,000,000		
TOTAL EQUITY	$3,000,000		
TOTAL ASSETS	$10,000,000		
DEBT TO EQUITY	233.33%		
SENIOR DEBT TO EQUITY+SUB DEBT	135.29%		

This is essentially a “scratch sheet” to calculate the cost of the financing. The information is often used as the basis for pricing assets to ensure that a project will pay for itself. But it is also used by Syndicators to determine how much of which kind of financing is best for the success of the enterprise.

In this example, the CDFI is injecting $1,000,000 in “junior” equity. The reason is that the cost of the externally sourced equity (from Op-Zone investors) requires such a high ROI—as expressed here in the dividend yield of 13%--that the QOF can’t afford to have $3 million of it. At the same time, in order to keep the senior and subordinate lenders happy, there has to be at least $3,000,000 in equity overall. The CDFI is in a position to step up, and puts its non-dividend earning equity at the bottom where it will do the most good.

The result is an average cost of debt at 4.86%, an average cost of equity at 8.67% with an average cost of funds at 6.0%. The exercise shows how equity with a 13% yield can be raised and still fit within a more or less affordable capital structure.

There are, however, quite a few ways to drive those debt and equity costs down.

The Op-Zone investment parameters allow investors to buy Preferred stock, which, because of its fixed dividend, fixed maturity, and seniority to common stock, carries a significantly lower dividend. If we let the preferred investor share in the appreciation of the asset at maturity, we can drive the dividend down further.

If we lower the leverage, and hence the overall risk by raising the amount of preferred stock we are issuing and paying down debt, the dividend can go down even further.

If, at the same time, we can consolidate and renegotiate our senior debt to reflect the lower leverage and pay off any expensive debt—such as our 7% subordinate debt—then we can produce a truly affordable capital structure.

In the following example, we show how this set of alterations can lower the cost of debt to 3.71%, the cost of equity to 4.5% and the overall cost of funds to approximately 4.0%:

FINANCING TYPE	AMOUNT	RATE	EXPENSE
TOTAL ASSETS	$10,000,000		
SENIOR DEBT			
Short Term Debt A	$1,500,000	3.00%	$45,000.00
Short Term Debt B	$0	4.00%	$0.00
Short Term Debt C			$0.00
Short Term Debt D			$0.00
Long Term Debt A	$4,250,000	4.00%	$170,000.00
Long Term Debt B	$0	4.00%	$0.00
Long Term Debt C			$0.00
SUBORDINATED DEBT			
Long Term Sub Debt A	$0	7.00%	$0.00
Long Term Sub Debt B	$250,000	3.00%	$7,500.00
Long Term Sub Debt C			$0.00
PREFERRED STOCK	$3,000,000	6.00%	$180,000.00
OTHER EQUITY SENIOR			$0.00
COMMON EQUITY	$0	12.00%	$0.00
OTHER EQUITY JUNIOR	$1,000,000	0.00%	$0.00
AVERAGE COST OF DEBT	3.71%		$222,500.00
AVERAGE COST OF EQUITY	4.50%		$180,000.00
AVERAGE COST OF FUNDS	4.03%		$402,500.00
TOTAL DEBT	$6,000,000		
TOTAL EQUITY	$4,000,000		
TOTAL ASSETS	$10,000,000		
DEBT TO EQUITY	150.00%		
SENIOR DEBT TO EQUITY+SUB DEBT	135.29%		

This ability to put low cost long-term money anywhere into the transaction is one of the reasons that CDFIs are so well positioned to participate financially in Op-Zone transactions. This puts them potentially in the driver's seat for syndicating or helping syndicate the transaction. Hence, while they may not be able to directly access the mainstream investor, they can prove to be a vital—and compensated—part of the syndicating and management team for the QOF.

X. Innovative Equity Instruments and Strategies

Even with the benefit of the blended cost of funds and the CDFI's own capital injection, the cost of market equity may be viewed as too high for some of the eligible properties and businesses in a CDFI's neighborhood. The Preferred stock instrument, which is an allowed form equity under the Op-Zone investment parameters, is an optimal tool for tailoring the cost of that equity to the cash flows and asset valuation of the property or business that underlies the QOF.

- Because of the lower risk profile of preferred stock, the dividend payment is materially lower as is the expected ROI.
- This rate can be lowered further by way of a sinking fund.
- There is tremendous flexibility in the way that the dividend rate can be traded off against participation in cash flow and/or asset appreciation to keep the rates low.
- The CDFI can contribute equity that is subordinate to the preferred.
- The investor does not have voting control over the QOF, and may not have an interest in owning the underlying property.
- The structure enables easier transfer of the property at maturity.

In the following scenarios, we will show examples of how the different equity structures can be used to mediate the expectations of the investors with the cash flows from the assets and the mission of the CDFIs. The assets can be properties of any kind or businesses of any kind.

The key factors are as follows:

1. Value of the Asset: The value of the asset at the time the investment is made
2. Appreciation of the Asset: The average annual appreciation in value of the asset over the expected period of the investment
3. Cash available for Dividends & Other. This is the amount of annual cash flow that the asset should be producing minus all of the operating needs, debt service and taxes. It is the amount that is available before dividends or distributions and extraordinary costs.
4. Inflation of CAFD: how much the Cash Available will rise on an annual basis.
5. Amount of the Investment: The dollar amount of the investor's investment derived from capital gains.
6. Dividends on the Investment: The dividend yield on the investment. This yield percentage is inverse to the rate of appreciation of the asset: The higher the expected appreciation of the asset, the lower the dividend yield can be in order for the investor to hit his/her expected ROI target.
7. Discount rate for NPV: This calculation (or similar calculations) are used by the investor to determine todays' value of the future dividends (or distributions) plus the appreciated value of the building at the time of its sale or the redemption of the preferred shares at the targeted maturity. The discount rate is selected by the investor based on what he/she thinks about the risk of the financial instrument (bond vs preferred stock vs equity), the

term, the likelihood of achieving the cash flows over the term, the property or business value, the likelihood of appreciation of the property or business value and similar considerations. It is important to note that this discount rate is often the same as the expected ROI but that is entirely up to the investor.

The rate the investor chooses to discount the cash flows back to the present is typically based off of the rates in the marketplace for equivalent investments; bonds, preferred shares, or common equity. The investor will take these rates and raise them up or down based on differences in perceived risks between the Op-Zone investment and the alternate investment options in the marketplace.

The biggest distinctions between investment options in the marketplace and the Op-zone investment are:

- The Op-zone investments are illiquid. This is a critical issue which will raise the investor's ROI target.
- The Op-zone investments come with a material benefit in the context of reducing capital gains taxes. Whether the investor will count this benefit in the overall calculation of the discount rate is yet to be determined.

For the purposes of the following examples, we will assume that there is a higher ROI requirement on Op-zone investments due to the illiquidity of the instruments. However, we do NOT assume that the capital gains benefit is being included by the investor in his/her ROI calculation.

For each investment instrument there is a range of yields in the marketplace. These yields change daily and they can change dramatically. Speaking very generally, we see investments in 10 year bonds in the 2-4% range, preferred shares in the 3-5% range and the total return on equities in the 7-8% range. *These ranges, however, are for investments in mainstream creditworthy companies, and the instruments are highly liquid and often actively traded*.

Investments in predevelopment property and small businesses generally bear higher risk and are illiquid. As a result, the investor will require significantly higher ROIs. Again speaking very generally, and just for the purpose of the following examples, we are assuming the following ranges for the target ROIs by financing type. *These rates are for a predevelopment property or significant business expansion where there is a 70/30 debt to equity ratio*:

10 year Bonds:	5%
Preferred shares:	8%
Equities	15%

Note: These are indicators for the purposes of these examples only. These figures should not be used in the forecasting or negotiation of rates on live Op-zone capitalization transactions.

Because of the high cost of the equity instruments, the QOFs in the examples below are not capitalized in full by the common or the preferred equity. In the examples, we assume only $1

million dollars of Op-Zone equity in our $10 million transaction. Our example is 70% debt and 30% equity so it means that we have to put in $2 million in equity to bring full capitalization of $3 million. In the first two examples where the Op-Zone investor is providing common equity, we assume that our equity is in the form of preferred stock or junior common stock and that the dividend is zero. In the last four examples where the Op-Zone investor is investing in Preferred stock, our CDFI provides the $2 million in common equity, again for the sake of consistency, without a dividend. In both instances, our interest is in (1) filling the capital gap; (2) ensuring stabilization of the entity in the early years; and (3) obtaining control of the property at the end of the period.

There is one more item that must be considered, and it is reflected in the scenarios below: At some point within the first 10 years of an Op-Zone investment, the investor will need to pay the deferred capital gains tax on his/her original investment. CDFIs negotiating a QOF around an asset will, more than likely, have to arrange payouts from the operating cash flows to accommodate this requirement.

NOTE: The scenarios have been collapsed to fit onto the page, so years 2-6 are not shown.

Scenario I. Common Equity for a Low-Appreciating Asset

1) COMMON STOCK -Low Appreciation		THEY OWN THE BUILDING AND WE HAVE TO BUY IT AFTER 10 YEARS						
		Initial Investment	1	7	8	9	10	Sale in Year11
Value of the Asset	$10,000,000		$10,150,000	$11,098,449	$11,264,926	$11,433,900	$11,605,408	
Compound Appreciation Rate - Asset	1.50%							$11,605,408
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	-
Inflation of CAFD	2.00%							
CFAD Payout Ratio To QOF	90.00%		$108,000	$121,626	$124,058	$126,539	$129,070	-
(All passed through to QOF Investor)								
Sale Proceeds								$1,605,408
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%			($170,000)				
Net Cash Flow to QOF Investor		($1,000,000)	$108,000	($48,374)	$124,058	$126,539	$129,070	$1,605,408
Internal Rate of Return to QOF Investor	12.61%							

In this scenario, we have a $10,000,000 asset that is expected to appreciate at a 1.5% annual rate. We are presenting the opportunity to an investor who is looking to get the money back right after the 10 year target by selling the building at fair market value.

The investor is also looking for an ROI in the 15% range. The primary reasons: (1) the investment is illiquid; (2) the investor isn't sure it will generate revenue and positive cash flow as projected; (3) the investor isn't sure that the building will appreciate in value; (4) the investor isn't sure that we will be able to buy it; (5) the investor isn't sure that anyone else will be able to buy it.

Unfortunately, the ROI comes in at 12.61%. If we paid out 100% of the cash flow, it would not be much better—we would hit 13.71%. This deal would not work. However, if we lowered the investment from $1,000,000 to $800,000, and kept everything else the same, there would be an ROI of 16.5%--more than acceptable. We would have to put up an additional $200,000 of our own money.

There are two things to keep in mind here (1) the investment only represents 10% (or 8%) of the total funding, so the actual cost of funds for the project as a whole is a lot lower; and (2) if there's an unforeseen problem with cash flow we don't have to actually pay the dividend. It is equity after all, and that is often what happens with equity—which is one of the reasons the target ROI is so high.

<u>Scenario II. Common Equity for a More Rapidly Appreciating Asset</u>

2) COMMON STOCK -High Appreciation	**THEY OWN THE BUILDING AND WE HAVE TO BUY IT AFTER 10 YEARS**							
		Initial Investment	1	7	8	9	10	Sale in Year11
Value of the Asset	$10,000,000		$10,300,000	$12,298,739	$12,667,701	$13,047,732	$13,439,164	
Compound Appreciation Rate - Asset	3.00%							$13,439,164
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	-
Inflation of CAFD	2.00%							
CFAD Payout Ratio To QOF	90.00%		$108,000	$121,626	$124,058	$126,539	$129,070	-
(All passed through to QOF Investor)								
Sale Proceeds								$3,439,164
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%			($170,000)				
Net Cash Flow to QOF Investor		($1,000,000)	$108,000	($48,374)	$124,058	$126,539	$129,070	$3,439,164
Internal Rate of Return to QOF Investor	**18.32%**							

In Scenario II, our asset has a very strong prospect of appreciating at double the rate of Scenario I. In order to hit the 15% target ROI, the dividend is more than adequate.

This example shows us how the CDFI will be encouraged to look for rapidly appreciating assets in order to free up cash flow for reinvestment in the property or business and to reserve against unforeseen circumstances. It may be contrary to mission, but the lower appreciating asset in a more distressed area may have to carry a higher current dividend payment than a higher appreciating asset in an area with greater economic growth prospects.

One of the logical consequences of this is that CDFIs may introduce assets that are closer to market and more likely to gentrify or convert to market pricing than assets in distressed areas.

Scenario III. Perpetual Preferred for a Reasonably Appreciating Very Long Term Asset

3) PERPETUAL PREFERRED STOCK		WE OWN THE BUILDING WHEN THE SHARES ARE REDEEMED IN 30 YEARS							
		Initial Investment	1	7	8	9	10	11	30
Value of the Asset	$10,000,000		$10,200,000	$11,486,857	$11,716,594	$11,950,926	$12,189,944	$12,433,743	$18,113,616
Compound Appreciation Rate - Asset	2.00%								$1,000,000
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	$146,279	$213,101
Inflation of CAFD	2.00%								
Dividends on the Investment	9.00%		$90,000	$90,000	$90,000	$90,000	$90,000	$90,000	$90,000
Redemption of Preferred Stock in Year 30									$1,000,000
Amount of Capital Gains Invested	$1,000,000	($1,000,000)							
Capital Gains Tax Paid in Year 7	17.00%				($170,000)				
Net Cash Flow to QOF Investor		($1,000,000)	$90,000	$90,000	($80,000)	$90,000	$90,000	$90,000	$1,090,000
Internal Rate of Return to QOF Investor	8.18%								

An instrument that may better suit the CDFI asset needs is the Perpetual Preferred stock. First, the Preferred investor is targeting a lower ROI than on common equity. Here, instead of looking for 15% the investor is looking for an 8% ROI, which can be achieved by setting a dividend rate, in this case, of 9%.

Preferred stock has debt-like features in that the investor gets a set dividend rate—the 9.0%--which is paid prior to any common equity dividends. But it is also like equity in that it can be postponed if there is insufficient cash available for dividends. Most preferred stock dividends are "cumulative"—which means that if a dividend payment is missed, it must be paid before any common equity dividends are paid. Preferred stock is also like debt in another respect: the preferred investor does not own the asset, and is entitled only to the principal invested (plus dividends) over the life of the investment.

One of the great benefits of the preferred stock is the flexibility it provides to the CDFI relative to managing cash flows: If the CDFI needs to reduce the amount of the dividend in the early years, it can negotiate a larger payout to the investor at the end. This could be a percentage of the appreciation in the value of the asset, or a dividend formula that captures greater cash flows in the later years for payment to the investor. For example, in this Scenario III, if the CDFI shared 50% of the appreciation in value with the investor at the end of the 30 years, the dividend could be reduced to 6.5% and still generate an ROI in the 8%+ range.

This "Perpetual" Preferred stock can go on for as long as the investor wishes, though a 25 to 30 year term is generally targeted. In this example, the CDFI would redeem the preferred shares from the investor in the 30th year for the amount of the original investment. The CDFI can raise the funds to make the redemption from any source, including borrowing against the higher value of the asset at that time.

Investors who may be interested in this would be the traditional long-term investors like insurance companies. The one caveat: the only way the Preferred investor can end up owning the asset is through convertible preferred stock. If they don't want to own the asset, that is just fine

for our CDFI, but the investor will be giving up one of the prime benefits of the Op-Zone tax treatment: The elimination of capital gains taxes on the appreciated value of the QOF asset when it is sold.

Scenario IV. Redeemable Preferred for a Reasonably Appreciating Medium Term Asset

4) REDEEMABLE PREFERRED STOCK		WE OWN THE BUILDING WHEN THE SHARES ARE REDEEMED AFTER 10 YEARS						
		Initial Investment	1	7	8	9	10	Redemption - Yr 11
Value of the Asset	$10,000,000		$10,200,000	$11,486,857	$11,716,594	$11,950,926	$12,189,944	
Compound Appreciation Rate - Asset	2.00%							
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	
Inflation of CAFD	2.00%							
Dividends on the Investment	9.00%		$90,000	$90,000	$90,000	$90,000	$90,000	
Redemption of Preferred Stock in Year 11								$1,000,000
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%				($170,000)			
Net Cash Flow to QOF Investor		($1,000,000)	$90,000	$90,000	($80,000)	$90,000	$90,000	$1,000,000
Internal Rate of Return to QOF Investor	7.12%							

This is similar to the Perpetual Preferred in every respect except the term and the ROI. Here the investor might lower the ROI from 8 to 7% because of the likely shorter term of the instrument. But if not, we would simply restructure the transaction with a lower amount of investor equity and a higher amount of subordinate debt or other CDFI capital injection.

This structure may be the first stop in negotiation with investors who are looking for a shorter term investment for their capital gains, and who like having common equity below them and a fixed maturity and dividend, don't want to be involved in owning the asset. Although the dividend is relatively high—the same as the common stock dividend in Scenario I—this is due to the investor getting no asset appreciation. All the Preferred stock investor is getting in this Scenario at maturity is the principal back. Hence there is much less pressure on the CDFI to propose an asset with high appreciation potential.

Again, as with the Perpetual and Redeemable Preferred, the CDFI can own the building, and faces repayment of the original investment instead of the purchase of the whole asset at the end of the term.

However, if the investor would like to get the benefit of any asset appreciation and a tax-free capital gain when the shares are redeemed, they might want to get a look at the next Scenario—Convertible Preferred. Doing this could enable them to reduce the dividend rate significantly.

Scenario V. Convertible Preferred for a Reasonably Appreciating Asset

5) CONVERTIBLE PREFERRED STOCK	THEY OWN THE BUILDING AND WE HAVE TO BUY IT AFTER YEAR 10							
		Initial Investment	1	7	8	9	10	Conversion Yr 11
Value of the Asset	$10,000,000		$10,200,000	$11,486,857	$11,716,594	$11,950,926	$12,189,944	
Compound Appreciation Rate - Asset	2.00%							$12,189,944
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	-
Inflation of CAFD	2.00%							
Dividends on the Investment	2.50%		$25,000	$25,000	$25,000	$25,000	$25,000	
Conversion of Preferred Stock in Year 11								$2,189,944
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%				($170,000)			
Net Cash Flow to QOF Investor		($1,000,000)	$25,000	$25,000	($145,000)	$25,000	$25,000	$2,189,944
Internal Rate of Return to QOF Investor	8.16%							

Convertible Preferred is the "Hybrid's Hybrid." This could be set up like a Redeemable Preferred but with one big difference: it enables the investor to convert all or a portion of his/her investment from a debt-like instrument with a fixed dividend and maturity to an equity-like instrument that enables the investor to own all or a portion of the asset and to capture all or a portion of the appreciation in value at the end of the term. This option is important to the CDFI because it tends to reduce the dividend rate in the early years.

In the example, the dividend drops from 9% in Scenario IV to 2% here. In order to get to a targeted return in excess of 8% (8.16% in this example), the CDFI gives the investor sufficient ownership of the property—and the appreciation of it—to materially reduce the dividend.

The way this works is that the CDFI projects an asset value, and sets a price at which the investor can convert to equity ownership. The price is set at the origination of the transaction, and the investor makes the determination as to whether he/she wants to convert if and when the target value/price is hit.

This option increases opportunity for the investor while mitigating risk—a combination of attributes which will be attractive to many investors and which should lead to a lower ROI target and cost of funds on the transaction overall. The major shortcoming is that when the investor decides to sell the asset and capture the Op-Zone benefit that eliminates the tax on the capital gain, the CDFI has to buy the asset. Unless there are agreements at the outset as to the maximum price the CDFI would have to pay, this could produce a hardship for the CDFI. Nevertheless, this

structure can be very useful with those assets that have low initial cash flow, but show solid potential for appreciation.

Scenario VI. Sinking Fund Preferred for a Low-Appreciating Asset

6) PREFERRED STOCK WITH SINKING FUND	WE OWN THE BUILDING							
			1	7	8	9	10	Redemption - Yr 11
Value of the Asset	$10,000,000		$10,100,000	$10,721,354	$10,828,567	$10,936,853	$11,046,221	
Compound Appreciation Rate - Asset	1.00%							
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	
Inflation of CAFD	2.00%							Sinking Fund
Cumulative Sinking Fund			$45,000	$367,114	$429,956	$495,555	$563,967	56.40%
								of Redemption
Dividends on the Investment	7.50%		$75,000	$75,000	$75,000	$75,000	$75,000	
Redemption of Preferred Stock in Year 11								$1,000,000
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%				($170,000)			
Net Cash Flow to QOF Investor		($1,000,000)	$75,000	$75,000	($95,000)	$75,000	$75,000	$1,000,000
Internal Rate of Return to QOF Investor	5.62%							

This may be the most conservative and safest form of preferred stock. The reason is that the CDFI commits to paying a dividend as well as setting aside funds on a scheduled basis to redeem the Preferred shares at maturity. Each year, the investor receives a dividend while a cash sinking fund builds available cash to cover any shortfalls in dividends.

In this example, this enables the investor to lower the ROI target to the 5% range, because the risk of the transaction is now lower: At any point in the cycle there will be liquid collateral to support the investment.

In this example, the CDFI sets aside all of the cash flow after Preferred dividend payment in the escrowed sinking fund. The amount of cash in the cumulative sinking fund is shown in the gray row above and by the 10th year, it covers over 50% of the investor's principal. This materially reduces the investor's credit risk – as the lower 5.5% ROI indicates. There is a downside however: instead of reinvesting the cash available after Preferred dividend payment in the asset, it is put in the sinking fund. By taking all of the residual cash out of the asset and putting it in the sinking fund, the asset may not be getting all of the upkeep and reinvestment it needs. For this example, this diversion of cash is reflected in the lower rate of asset appreciation—1%.

The primary reason this structure should be of interest is that it helps the QOF maintain the 90% deployment test over the life of investment by capturing principal at the property level, while reducing the risk – and therefore the discount rate, the target ROI and the dividend rate.

The big negative here is that the asset must generate sufficient cash flow to cover both the dividend and the sinking fund. This may steer the CDFI away from assets that need the investment the most.

Note: for those CDFIs interested in assembling a qof using these corporate finance tools, please contact Michael Swack at the Center for Impact Finance at the Carsey School of Public Policy at the University of New Hampshire at michael.swack@unh.edu

There are three tools available:

1. Blended Cost of Funds ("BCF")
   This is the tool that is shown in Section IX

2. Equity Structuring Tool ("EST")
   This is the tool that is shown in Section X

3. Sustainable Mission System ("SMS")
   This system, originally created in 2004 in partnership with NeighborWorks America, enables CDFIs to forecast cash flows and balance sheets for the full range of loan and real estate types on a quarterly basis over a period of 7 years. It has been used by hundreds of CDCs and CDFIs in developing budgets as well as strategic plans. The results can be used to populate the BCF, and EST tools.

   There is a fourth tool under development, the "QST" that dramatically simplifies the calculations of the SMS and can populate both the BCF and EST:

4. The QST incorporates assumptions about the leverage of the QOF and the operating costs. It produces a more complex set of outcomes that show the impact on cash flow of the trade-offs among debt, equity and preferred shares.

APPENDIX - Sources of Information

:

We thank the following people who we interviewed as part of the data collection for this paper:

Monica Edwards at Bridge Housing Corporation

Kerwin Tesdell at the Community Development Venture Capital Association

Steve Joseph and Jonathan Kivell at Sandler O'Neil and Partners

Becky Regan at the Housing Partnership Network

Aaron Seybert at the Kresge Foundation

Jeff Brenner and Mike Loheimer at Impact Community Capital

Jessica Lowery at Veris Wealth Partners

Julia Shin at Enterprise Community Investment, Inc.

John Olsen and Mike Lohr at Goldman Sachs

Leslie Christian at NorthStar Asset Management

Beth Bafford at Calvert Impact Capital

The following comments were noted during a conference call sponsored by the National Development Council in December 2018:

<u>Cohn-Reznick</u>

- There is likely to be considerable Op-Zone activity in real estate. Also renewable energy.
- The tax benefit accrues to investors rather than the business, so the interests of the business are somewhat different than the interests of the investor.
- They are working through how to best allocate the financial benefits in the pricing: i.e., to what extent the tax benefits to the investor can bring down the ROI on the equity investment [a major issue for CDFIs!]
- The key to the success of the investment is the gross income of the underlying property or business in the QOF. It is THE existential issue.
- LIHTC: twinning with the 4% credit is very good. Boosting returns with the capital gains tax benefits will see attract additional investors. Ditto with the NMTC.
- CDFIs: mobilizing local capital is the key!!!!

Economic Innovation Group

- There are just three ways to create a QOF: own stock in a corporation, own interest in a partnership or own property.
- The key focus of the feds: ease of entry, ease of use.
- The light regulation is designed to encourage maximum participation.

PNC:

- PNC is doing deals off of its balance sheet.
- All deals must be CRA qualified.
- All Real Estate.
- They will put in up to 80% of the deal: 50% debt, 20% sub debt/equity, 10% developer "equity." This will leave a gap of 20% to be filled by Op-Zone equity. [Brilliant strategy!—question to be asked: does the PNC equity slice come in senior or subordinate to the Op-Zone equity—or can it be both?]
- Their 70% debt has covenants: Environmental, repayment, debt coverage.
- They will keep their equity slice as equity.
- Their loan has to be at the market rate. The full amount of their debt gets paid off at 10 years.
- PNC can control 80% of the deal, but because they don't own the QOF, they can get arms- length treatment.
- Problem: The appraisal is critical to the approval of the deal, and low income properties often have appraisal gaps.
- PNC can use –and actually needs--CDFI Sub Debt to help close the appraisal gaps where they appear.
- For PNC, a QOF has to be at least $2.5mm to be economic.

Dudley Ventures

- The party raising the money controls the property.
- In designing and negotiating the transaction identifying and sharing the benefits is key. What are the short term and what are the long term benefits—and how and when are they captured?
- It is important to make sure that you choose long term investors. This is not a build and flip type of investment.
- Most projects are likely to be $50mm plus.

NDC

- CDFIs should not feel that they have to create their own QOFs. Realistically, Op-Zone investing was not designed for cities, towns, nonprofits. It is really for big investors investing in big ticket items.
- Single asset equity investment in small business is not a winning strategy. At present the best way to assist this client base is through the provision of debt, especially in the context of SBA programs.
- There are lots of legal, accounting, and regulatory details. Investor eligibility will be a big issue, and so will fund or agency registration.
- CDFIs should focus on how to help guide the investment so that it does provides what their communities need.

The following were particularly helpful in getting data and ideas for this paper.

National Development Council

Enterprise Community Investment, Inc.

Economic Innovation Group

Bond-Buyer Conference: Richard Chiris and Quinn Moss of Orrick, Herrington & Sutcliffe, LLP

St. Louis Fed Note: for excellent data on market pricing of mainstream assets please see https://fred.stlouisfed.org/series/HQMCB10YR

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