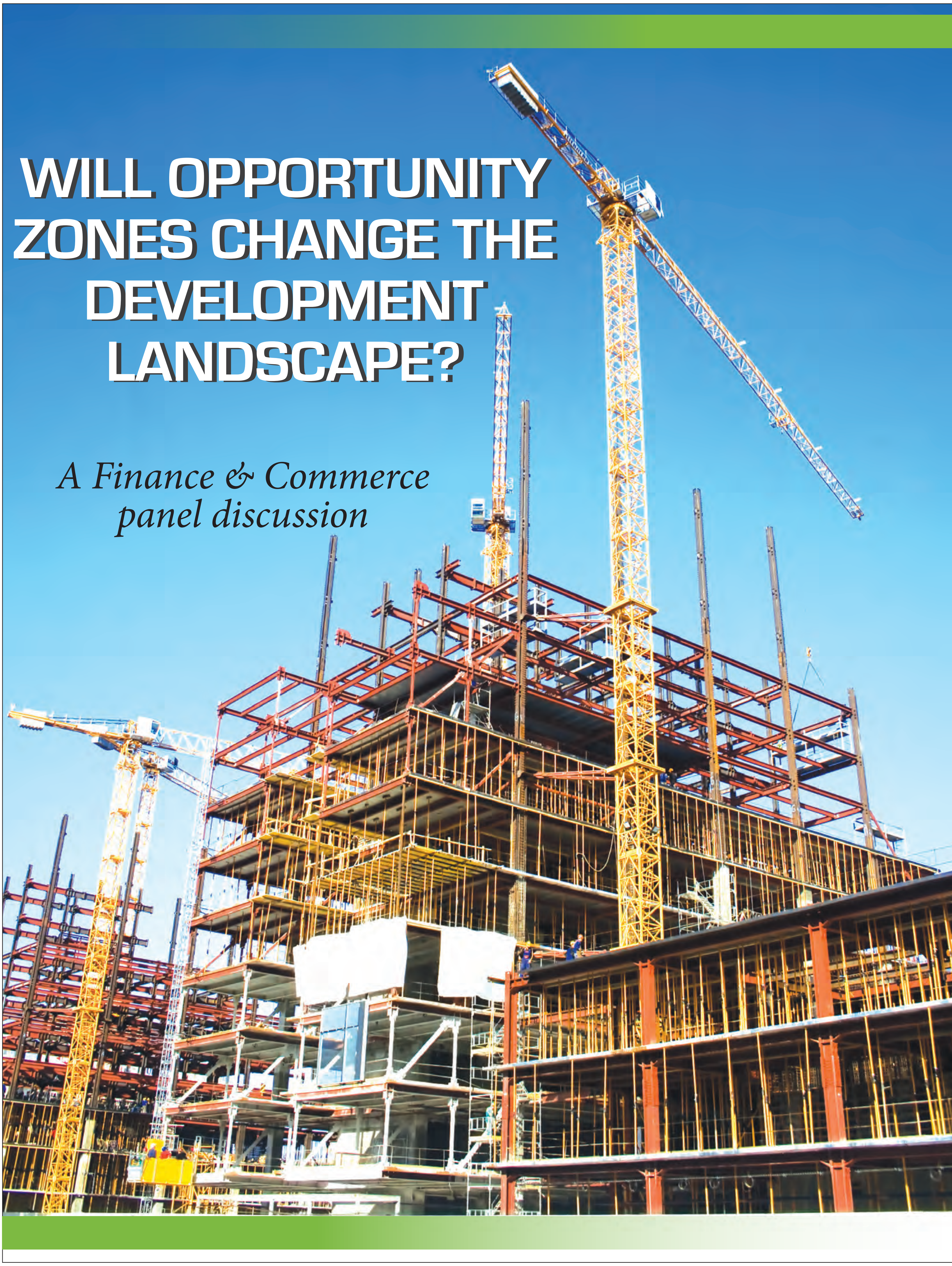
WILL OPPORTUNITY ZONES CHANGE THE DEVELOPMENT LANDSCAPE?

A Finance & Commerce panel discussion



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PANELISTS

JIM DUFFY
Shareholder, Briggs and Morgan P.A.

Jim Duffy is a shareholder of Briggs and Morgan. P.A. and practices principally in the area of taxation with an emphasis on tax credit financing and now on qualified opportunity zones. Duffy provides tax planning advice to LLCs, partnerships, corporations and individuals in connection with the formation of new companies, mergers and acquisitions, formation of joint ventures, new market tax credit financing, like-kind exchanges and general business operations. These clients are involved in a variety of industries, including banking, venture capital, real estate, construction, consulting and investing. Recently, Duffy has been assisting clients with opportunity zone transactions and is a frequent speaker on the subject.

DANNIELLE LEWIS
Senior manager, Wipfli

Dannielle Lewis is a senior manager in the tax practice, focused on serving clients in the construction and real estate industry. She advises clients on complex tax transactions involving partnership interest exchanges or business sales. Lewis stays up to date on the ever-changing tax laws and recognizes opportunities for new and potential clients to help save and structure their funds. She leverages her proactive planning and advising to ensure clients reach their goals and are successful. She has a B.S. in accounting from St. Cloud State University, and a B.A. in English and Master of Business Taxation degree from the University of Minnesota.

DUANE LUND
CEO, NAI Legacy

Duane Lund is the CEO of NAI Legacy. He is a 30-year veteran of the real estate industry and is also the president of Exchange Realty Inc., a private investment firm that was focused on the acquisition and ownership of commercial real estate assets. Exchange Realty holds positions in a diverse portfolio of real estate assets. Prior to Exchange Realty, Lund was involved in the formation of several private and public companies including The Geneva Organization, Stonehaven Realty Trust, First Industrial Realty Trust and RESoft Inc. Lund is the former president of the Wisconsin Real Estate Alumni Association, a current member of the University of Wisconsin Center for Real Estate, and a former board member of the National Association of Industrial and Office Properties. Lund earned a Bachelor of Business degree in accounting and a master's degree in real estate from the University of Wisconsin-Madison.

NICK WALTON
CEO, Reuter Walton Cos.

Nick Walton is the CEO of Reuter Walton Cos. With a comprehensive background in development, finance and construction, he is able to manage successful projects from concept to completion. Walton has developed more than 2.8 million square feet of projects valued at over $840 million in his young career. Reuter Walton is an award-winning real estate company that specializes in developing and constructing outstanding, community-driven projects in the multifamily, student housing, hospitality and commercial sectors. Reuter Walton prides itself on fostering a culture of collaboration whether it's developing its own projects or working for a third-party client. A successful project is a group effort, and the Reuter Walton team is equipped to facilitate every step from inception to completion.

JAMIE STOLPESTAD
Managing partner, Minnesota Opportunity Zone Advisors

Jamie Stolpestad is a founder and managing partner of Minnesota Opportunity Zone Advisors, a mission-driven real estate investment manager and sponsor of the MN-OZA DREAM Fund, a Minnesota-focused Qualified Opportunity Fund. Stolpestad is a real estate entrepreneur, adviser and educator with over 25 years and over $13 billion of real estate investment experience across the U.S. and abroad. His institutional real estate experience spans advisery, private equity, public and private REIT, and insurance companies, and across multiple property types, investment structures and project life cycles. He was the first employee and CEO of Allianz Real Estate of America, which grew to $8.6 billion of debt and equity investments across 45 U.S. markets during his tenure. Previously he held executive positions at GE Real Estate and The Mills Corporation. He earned his B.A. from Northwestern University, MBA from the Kellogg School and is an adjunct professor of finance at the NYU Stern School of Business.

Opportunity zones (OZs) are the result of the Tax Reform Act by which an investor can defer capital gains taxes on the sale of any asset by investing those gains within 180 days into a designated opportunity zone -- a specially designated census tract.

For a new idea, OZs are generating a lot of discussion. Are they worth pursuing? Where is Minnesota when it comes to creating OZ opportunities?

A panel put together recently by Finance & Commerce tried to tackle those and other questions.

The panelists included:

- **Jim Duffy,** shareholder with Briggs and Morgan;
- **Dannielle Lewis,** senior tax manager at Wipfli;
- **Duane Lund,** CEO of NAI Legacy;
- **Jamie Stolpestad,** a founder and managing partner of Minnesota Opportunity Zone Advisors;
- **Nick Walton,** CEO of Reuter Walton Cos.

The panel was moderated by Finance & Commerce reporter William Morris.

MORRIS: What is an opportunity zone? What are the benefits to investors, the developers, and the business operators of making investments they're in.

DUFFY: Qualified opportunity zones are basically low-income census tracts across the country. In Minnesota, we've got 128 that have been designated eligible for these investments.

The benefits of investing in them is that you can invest capital gains into a qualified opportunity zone investment, and defer the tax on those gains until Dec. 31, 2026. You also have the opportunity to reduce the amount of gain that's taxed if you hold the investment long enough. If it's held for five years, you reduce the amount of gain that's taxable to 90 percent. And if it's held for seven years, you reduce that to 85 percent.

If you hold the investment for 10 years, no further tax on any appreciation in value of that investment. So you pay tax one time on the deferred gain in 2026. If you get past the 10th anniversary, then you don't have to pay any additional tax.

STOLPESTAD: I'll just share that the intention of the legislation is to help those communities, and so there's an underlying hope that there will be certain kinds of investment that drive economic activity, that improve social conditions. They may even improve the environmental conditions of those communities. And that's an area of policy that has caused a lot of people to wonder how this will be implemented.

LUND: I agree with that comment. And it just turns out that the first round of guidance we received from the IRS last fall happened to be guidance for the real estate community candidly. It was favorable to real estate developers and owners, and that really began the whole process of opportunity zone conferences that we attended around the country. And this last round of guidance was certainly centered around the OZ businesses. This was meant to be a jobs creation program more than a building buildings program.

DUFFY: In talking with merchant real estate developers, the opportunity zones model doesn't really work for them. If they develop, rent and sell in like a three-year term, it doesn't have the tax benefit. So how's that going to be beneficial to them?

And thinking about that, one of the things that occurs to me is if you're building something more commercial, like an industrial warehouse, that may be an opportunity to attract job creators. If you build something they can come in, make their investments in equipment to outfit the building and business development. You may create jobs and also be eligible for qualified opportunity zone tax benefits.

LUND: My background's mostly owning industrial properties. I need a lot of land to do industrial deals. And a lot of the zones, at least here

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in the metro, don't fit that mold. And at the end of the day, if we can put up some buildings, and maybe the tenant is actually the beneficiary of the OZ treatment.

The deal we're doing in Robbinsdale, that was a site controlled by the Beard Development Group here in town. It was a site that was going to be built before they thought about opportunity zones. I think Nick (Walton) maybe has sites like that as well, but I don't want to say they got lucky, but all of a sudden you wake up, you realize you're in a zone, and that apartment complex we broke ground on last August before we really knew the guidance, it turned out it was in a zone. So we decided to recapitalize, put opportunities on capital.

WALTON: We're closing our fourth in August. The first one closed last July. It went July, December, May, and now this upcoming August. All four of those were put under contract, not knowing they were in opportunity zones.

DUFFY: After the effective date?

WALTON: Yeah. We found out one was an opportunity zone three weeks before closing. And that was when we started realizing that all of them were in zones. That's when we really opened our eyes to the map.

So for us, it's enhanced our four projects, versus us choosing to do any of these four projects, just because they were an opportunity zone and motivated by the taxes.

LUND: So, Nick (Walton), are the investors 100 percent OZ motivated or do you have some OZ investors that are with your traditional investors?

WALTON: Most recently, in our last closing, which was on May 7, was we were raising about $5.2 million, and a couple things that we discovered that were interesting.

One, we have a friends and family list that invest in a lot of our projects, and there wasn't a dollar that was placed, that wasn't gain. We also found that the list of people who invested was shorter than is typical for us. And what it was, obviously an unintended consequence, was that people who are used to investing in our typical market rate deals said, "I don't have gain and 10 years seems like a long time for me. So I'm just going to wait and I'll pass on this one, and I'll wait until the next one."

And that surprised us. Just because for such a long time, we've had people invest in every deal we put out.

I think it's interesting, opportunity zones definitely creates an interest. For those who had gain, they were really quick to invest and really excited about it. For those who didn't, it was a pretty quick pass. We didn't anticipate that.

LUND: That's similar to the Robbinsdale deal, where the capital date is just another source of capital when you really look at it. And if you're a merchant builder, it's not

Staff photo: Kelsey Broadwell

Dannielle Lewis makes a point during the discussion while Nick Walton listens.

attractive capital, because you're building to sell versus building to hold. The merchant builders here in town are looking at this, and this is just capital they have no interest in.

Then the question is: How can they, if they're in a zone, take advantage of it?

WALTON: That developer is looking just to get paid fees, maybe a promote on the takeout. They're not investing gain themselves, so they're not planning on being a 10-year hold?

LUND: On this particular year they're staying in for a portion of it. We kind of agreed on what we would value that property at once stabilized, and that's kind of set the benchmark. And what we did is, they're staying in, we wanted them to stay in, and then we're keeping Steven Scott on the management. So they're rolling some money right back into it.

WALTON: I invest pretty heavily in every one of our deals. We've sold quite a few projects in the last few years, which is a little bit of a merchant build model, though we don't consider ourselves a merchant builder. It just happened to be we had some exits.

Personally, I've had gain, so I like the opportunity zone tax treatment.

For us it's actually a nice balance in our portfolio; we know we're planning to hold our OZ deals. Now there's four of those. And if we end up deciding to sell one of our market-rate deals that's not an opportunity zone, we know which ones we keep and which ones consider selling.

STOLPESTAD: Out of curiosity, has the longer horizontal and expectation of that longer horizon changed the way you've programmed or built the buildings?

WALTON: No. Until about 40 months ago, I had never sold a building. Now, of our new builds we've sold nine, so we build everything assuming we're going to hold it. It really was just market demand that crept up on us in the last 40 months. And that has allowed us to have some pretty successful sales. But it's not changing anything.

MORRIS: Who is it, within the universe of people with capital gains, who's most interested in investing opportunity zones and what kind of questions are they asking you?

LEWIS: I think because of the first set of proposed regulations most people interested were people in real estate.

I think with the last set we have a private client wealth services group, and a lot of them have now jumped into it now that the kind of bigger sponsors like Merrill Lynch and Goldman Sachs have.

It kind of depends on the investment we're looking at. For people with more private client wealth, who just have straight capital gain, it's really: Can you explain what opportunity zones are? What are the benefits? Because they usually get this really, really low-level explanation of it.

And there's a lot of misinformation I would say, in the market. I have people coming to me all the time who rant about how I have to be wrong about something because they read an article. I have to show them what it really meant. What the hold period means. And that they really need to pay the first capital gain tax on their 2026 tax return.

We found a lot of people had already jumped into doing deals, or already signed all the agreements. And we're kind of like, this isn't qualified. Sometimes it doesn't qualify, but you're not going to get any of the benefits of this because you didn't get cap gains dollars.

I would say generally there's lots of misinformation out there, and so it's a lot of starting from ground zero when you meet with people.

MORRIS: What are the biggest misconceptions or the most persistent incorrect ideas that you hear from the clients?

LEWIS: That they don't have to pay the tax on the first capital gain. Highlight that a lot. And even every private placement memorandum has to highlight in bold saying, "You need this cash and we're not going to pay it out for you."

The following ones are probably just how the asset tests work and how the fund works itself. There are a lot of really weird nuances with the first set of proposed regulations that aren't easy to catch, necessarily. So it was kind of just correcting people and making sure their funds work with it.

Because a lot of people kind of think they can do the exact same deal they've always done, the exact same way, but a lot of times you can't.

WALTON: As developers, we never did the fund model. We identify a site, we decide what we can put on the site, we come up with a development, and we end up sending out an offering. If you have clients that are getting ready to put X dollars of gain into maybe a large fund, I think there would be all sorts of questions, like: Where is that fund going to invest? Where is the criteria to invest? What state am I going to be in?

Do you get questions like that? And if so, how do you answer those?

STOLPESTAD: A lot of the deals I've seen are more stained glass. They're really afraid of the exit strategy, so those ones were a lot more clear. I think in the next six months I'll probably get a lot more questions of people trying to figure out where their investment cash is.

LUND: I'm only doing single building, one deal, single investor. We're kind of doing the same model, where someone just has a building they can go touch and feel, and then I'm aligning myself with people like Nick (Walton). Nick doesn't need our group, but there are people that just don't want to be in the space of raising money and managing those relationships. So those are the developers we're talking to, if we decide to go to the next level with our program.

STOLPESTAD: We're seeing a pretty broad range of perspective investors and they're falling into, largely, two, maybe three camps.

The first camp are the traditional real estate investors who are more comfortable knowing exactly what project and what market, and are reasonably sophisticated about real estate vocabulary and metrics. They'll ask questions about return on cost. They'll ask questions about relative positioning and strategy of the asset.

Those investors, I think, have been the early adopters and probably come into those individual deals. And then there are others who, I anticipate will come into deals as and when timing works, you know, when they have a gain.

Then there's a huge, potentially gigantic, group of people who've never really invested in real estate other than through REITs.

And this group of investors really doesn't have a lot of knowledge about real estate vocabulary, real estate asset-specific metrics, and they ask questions which are somewhat unusual for real estate people. They ask questions which are more typical of consideration mutual funds. They ask about allocations and leverage

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levels and strategy, and assets under management, and fee structures, and other things which are typical of other alternative investments. And I think that group of investors has been slow to adapt.

But now that we've had some very large players -- the Merrill Lynches and the Goldman Sachs — come in, it's sort of validated the space, which had been perceived to be a little bit cowboy-ish for a while. And so I think it will be really interesting over the next six months or so, maybe through the end of the year, how broad a market emerges.

People anticipate there being a very large market, but it's too early to know. And the offerings that they're getting are now being funneled through the IRAs and it will be interesting to see how sort of sticky the Merrill-Brookfield relationship is, or do people want to seek out sort of the unique players in this space? Because there's, you know, there's 100 choices across the country. And do they really want to invest in affordable housing in Detroit, or do they want to invest in triple bottom line in Minnesota? Or do they want national big asset exposure? I'm not sure we know yet.

LUND: Brookfield, I think, announced a $1 billion fund. And, of course, they manage $300 billion, so they may just be moving assets from one side of the balance sheet to the other.

But will the half million-dollar investor go into a Brookfield billion dollar fund, or would they rather hook up with Nick (Walton)? Where they can go and touch and feel the building, and maybe even control the exit, which is one thing I've heard from a lot of the investors that have looked at. We get how we get into the deal, but how do we get out of the deal?

You've got a group of investors that have this 10-year expectation to hit the provisions of the OZ code, but life changes over 10 years, and maybe someone's going to want to get out. So if you give them 10 percent of a deal, how do you get out? The liquidity question has come up a ton on my particular deal.

MORRIS: How does one get out of a deal if, for whatever reason, you decide the 10-year hold period is not going to work? Are there issues with voting rights?

DUFFY: I don't know what you've seen, Dannielle (Lewis), but, you know, that up until the last regs came out, really the only way to take advantage of the tax benefits is to sell your interest in the company. Most of the ones that I'm seeing are one-investor or country club deals or something like that, where you don't just want to be partners with whoever happens comes in, so there's restrictions on your ability to transfer.

Now there's the ability under the proposed regs to sell assets and pass that through. I'm not sure that necessarily helps the transferability for one person who wants to get out.

Staff photo: Kelsey Broadwell

Jamie Stolpestad, a founder and managing partner of Minnesota Opportunity Zone Advisors, gestures during the panel discussion.

I think there's some open question and maybe there's more flexibility or will be more flexibility with larger funds, or REITs. I don't know if you've seen anything different.

LEWIS: The exit strategy was better with the last set of proposed regulations. The language they used was really bad. Qualified opportunity fund can sell its assets. So if the qualified opportunity-owned business is the one thing the assets, technically, those assets blowing up aren't going to be part of the exclusion to get this 10-year benefit.

Whether or not that was a misprint in the proposed regulations, we're not really sure, or whether or not they'll clarify them in the future. You still end up with a problem -- if the qualified opportunity zone fund owns a partnership interest, then the fund still has to sell the partnership interest somehow.

STOLPESTAD: I think the initial projects were set up as traditional private equity funds, which were typically closed funds. So the expectation is this illiquid long-term investment, and there would be an exit at the asset level at some point in the future, presumably after 10 years, that would give rise to liquidity but allow the redemption of people's interest.

As more funds have evolved and we have more individual investors, I think some people are hopeful that there will become a secondary market. But to my knowledge, none of the funds have been structured to allow redemption at the individual shareholder level. And there's, to my knowledge, not a ready secondary market. So there's a potential, if there's a lot of smaller investors, to create liquidity functions within the fund. And perhaps the very large Goldmans and Merrills and others will make available some degree of liquidity, but that's to be determined.

WALTON: How are you handling, when you talk to people, about timing? Because this came up quite a bit when we started talking with new investors: Are you committing to that sale for 10 years?

STOLPESTAD: We're saying it's not our intention to sell any assets. It's our intention to hold the assets for at least 10 years, and the fund is structured as a 10-year fund with three one-year extension options.

We're encouraging people to perceive this as a long-term investment that's illiquid. And so they should think about the overall economic benefits from the fund, as well as the tax benefits, based on their particular circumstance coming in, with the presumption that this is going to be a long-term tenure thing.

WALTON: But what if you had an offer that you thought made sense to sell the asset —

STOLPESTAD: There's not a prohibition from selling. Correct. So in practical terms, the fund manager has to be mindful of the potential consequences. From an economic perspective and then an after-tax perspective.

One of the benefits I would argue about that through ambiguity, in traditional private equity fund, investment managers tend to hold assets longer than they should. And they don't face the music on assets that didn't perform well, because they have sort of this perverse incentive.

I think that's flipped under opportunity zones. Because if you have an asset that has not performed well – and maybe you should sell it, but it wouldn't give rise to a gain -- you might as well sell it because it has no adverse consequence on your investors. So in a weird way, it promotes sort of appropriate pruning of a portfolio over a horizon. And I think that's actually a good alignment with investors.

DUFFY: Does your fund allow people to transfer their interest without consent or approval?

STOLPESTAD: We are softening our language. In the past it was a fairly traditional private equity structure, where there were various restrictions. Now we're softening that to ensure that they're accredited investors. We want to make sure that they have reviewed all the appropriate disclosures.

But otherwise, we don't want to overly handcuff people. Because one of the interesting things about the latest round of regulations is that they speak very deliberately about your ability to sell your interest and reinvest in another opportunity zone fund within 12 months. That feature has been picked up by some portion of the investment community as interesting. And we wanted to make it clearer that people had that ability.

DUFFY: Plus the proposed regs made clear that you could purchase somebody else's qualified operating fund, interest, and qualify for the tax benefit.

LUND: I thought that was interesting. In essence, you got a property, someone could come in that building in three or four years, it's wholly stabilized and they get the benefits. That's how I read it, too.

DUFFY: And then the seller can reinvest those in a different qualified opportunity fund, and roll those over.

LUND: If I sell the entire apartment building, let's say in year two, can the entire group then reinvest 12 months from now? Is that how you read it? Like can my entity reinvest and keep the whole group intact if we sell the asset? That's how I read it.

I'm looking at this thing, I think as soon as we have a good offer, we maybe take it because you make the right real estate decision at that moment in time.

And if there are these large funds, we'll have other ways we can go or I'll call Nick (Walton) up or maybe we'll swap into one of his deals. It's almost like a 1031 program within the OZ program. It's pretty compelling to me.

STOLPESTAD: So the latest regulations really opened up a lot of flexibility, especially as between the real estate investing and the business investing, it created a lot of opportunity for creativity in deal structuring.

One of the tensions about that provision is that for those investors who are very interested in knowing what they're investing in, they don't want you to have the ability to sell a bunch of assets and buy something that they don't know about.

I think it's incumbent upon the managers to be very clear about what their intentions are. Is this an investment that may be harvested and reinvested in other things over the course of 10 years? Or is this something that's really meant to be held with patient capital? And allowed to sort of appreciate?

DUFFY: Yeah, if the investor recognizes a gain -- because the funds sold the asset or it sold its interest -- it can elect to reinvest that gain within 180 days, subject to extension. And then everything starts over. That new qualified opportunity fund has basically six months to deploy that capital into a business and then 30-month safe harbor.

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LUND: And they can roll over their original gain, plus the new gain, is that how you read it as well? The depreciation.

STOLPESTAD: The original gain you still have to pay tax on in 2026. But the basis of your rollover, I think, is subject to that 10-year horizon.

LUND: If you put $1 million in the deal and you sell it, and you got $1.3 million, is both the 300 grand and the million deferred into the next deal? You make 300 grand on the investment?

LEWIS: You can only make that temporary election on that one capital gain once. They're not going to allow you like double-dip and get 15 percent twice.

LUND: I get it. But the 300 is also deferred.

LEWIS: Yes.

STOLPESTAD: There's a potential for a very interesting future market, I hear. And it's interesting -- very early on when this legislation was created, there were a few funds out of New York that said they were going to be the takeout for opportunity zones funds. And I thought that was unique to articulate an investment strategy on something that was intended to be 10 years from now. It's interesting that the regulations have now evolved where that takeout opportunity could actually be 30 months from now.

MORRIS: Going back a little bit to the conversation about the 1031s, how do the qualified opportunity zones stack up, and when is it better? When is it worse than a 1031 exchange?

DUFFY: I don't think one is better or worse. I think they have pros and cons, and a situation may dictate where one makes more sense than the other. I think the qualified opportunity fund rules are a lot more flexible than like-kind exchange; you can touch the money without blowing the deal. You got a longer redeployment horizon. By contrast, it's geographically limited. You don't have to use qualified intermediary.

It strikes me that the like-kind exchange is better -- you got a lot of built-in gain. And you want to roll that forward indefinitely, because it's a qualified opportunity zone, and you're going to have to recognize that in 2026.

LEWIS: I think it's pretty much all facts- and circumstances-based. The last set of proposed regulations did change the start date of when you can invest 1232 capital gains to treat as capital gain. So potentially you could end up where a 1031 was your only option to work because you need the property, depending on the timing.

LUND: But I think the biggest is exactly what Jim mentioned. A 1031 is potentially permanent deferral because you control it, whereas an OZ is a temporary deferral, you're going to pay taxes in 2026. And with a 1031 you can keep doing the swap, swap, swap and keep pushing that basis out until you get basis step up.

All this being equal, I think 1031 for most real estate people is better.

STOLPESTAD: For investors I think it's worth noting the different risk profile of different projects. A 1031 exchange will tend to be a lower-risk long-term investment, because you have an existing asset with an income stream.

One can debate the sort of relative value of swapping into that kind of investment. Whereas a qualified opportunity fund will tend to be a higher-risk, potentially higher-reward investment, because you're doing substantial rehab for new development. So it's very different kind of risk profile.

WALTON: We've also done 1031s on a build-to-suit, where you tend to go into it ground up. Less common, but available.

It's a lot more complicated to coordinate a ground-up development with multiple investors coming to a 1031 opportunity, doing tenant in common structure. It's so much easier for an investor to have $100,000 of gain, let's say, from the market, and they decide they'd like to try to invest it in real estate.

DUFFY: That's actually something I didn't think to mention — the flexibility. If you have partners in real estate and that real estate's going to be disposed of, and someone wants to harvest their gain, that gets pretty complicated with 1031. You've got to figure out a drop and swap, where you can just have the individual investors elect and they get a long runway to do it. They can wait six months until the end of the partnership year. So it's a lot longer than the like-kind exchange.

WALTON: Most of what we're building these days, we're doing them, not because they were opportunity zones. We were doing them anyway and the opportunity zone was the enhancement.

On any given project right now, about 85 percent of the units are smaller,

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but not typically micros. So we're doing a lot of the 550 square-foot one-bedroom, and we'll get down into some that are 450-, 475-square foot studios. So 85 percent of our unit mix is made up of that. The majority is still the ones versus studios and about 15 percent of our units are two bedrooms.

So if that's our project, here's the hallway, the shotgun units make all the sense in the world. Your outside corners mathematically are very difficult to turn into two units. They're just naturally set up to be a little bit larger, typically 900 square feet or more. So our outside corners are two bedrooms. And we're typically building six-story buildings, which is five stories of housing units.

Every time you see a two-bedroom, there is typically five of them. And so we often have five, 10, 15, depending on how many outside corners we have. But the rest of the project is really geared toward the smaller-unit format, with the majority of it landing right around $1,500 to $1,600 a month. So we're just really focused on a lowercase-A affordable chunk rent versus years ago, building units that were $3,000, $4,000, $5,000 a month. We're building as few of those as possible these days.

DUFFY: You built one, is that on Franklin and Lyndale?

WALTON: Those are micros. And that project did really well.

STOLPESTAD: I would argue that the migration of residential projects to smaller format units, fits many more communities because it provides a more accessible rent price point. It's very difficult to then flip it and say, "What's going to benefit the community?" Because each community is so different.

If you're looking in downtown St. Paul, where is the missing gap and where is the need? It probably overlaps with that kind of format. If you're looking in Owatonna, the need may be different because a lot of what we're seeing is seniors who are so-called "stuck" in their large homes, want to downsize, but they don't want to downsize to that level. They want to just get to the single-level apartment-style living. But they would like more comparable size to a house.

DUFFY: If you're building small units in the urban area, you're reducing the footprint and some of these are closer to transportation lines, things like that, so they're kind of green in that respect, maybe we're ringing the bell three times there.

STOLPESTAD: Well, I think it's a very appropriate strategy and presumably well-received in the communities. And even the political types like that format of housing choice in their community.

WALTON: We just started our 27th ground-up development, and 20 of them have been complete. Of those 20, one was out of market in Rochester, and so now down to 19, and one was a hotel, so now you're down to 18. Of those, every unit that we have that is a smaller unit is full right now. Like 99 to 100 percent full. The only vacancy that we have in any of our buildings are two bedrooms.

But that's urban core infill — Minneapolis, St. Paul. But I completely agree. You start getting into the suburban markets. That model's very different.

STOLPESTAD: There's 128 census tracts in Minnesota that are qualified opportunity zones. In 80 different municipalities, 40 of those have less than 5,000 people. So that subset of communities, I would argue, has a very different profile of housing stock, and a very different psychological profile of housing desires and needs.

Then you have this grouping larger than 5,000, but not quite metro markets -- Duluth and Rochester, St. Cloud, Mankato, and so forth. Many of those have universities or colleges, so there's some degree of kind of younger transitional residence. And then you got the metro region.

So one of the questions is: What is the appropriate product for this sort of in-between, and is there a viable product for the smaller communities? And I think the jury's out. There's certainly an excitement about attracting capital, and driving economic development. But I think it's too early to know what projects are going to be viable.

LEWIS: A lot of the ones in Minnesota outside the metro are more like greenhouses and couple multifamily.

STOLPESTAD: There's a really wide range of projects in the greater state, and it's fascinating to understand what manufacturing occurs, what other commercial activities occur, and what needs exist for unique structures.

LUND: Are you looking at any opportunity zones businesses versus real estate?

STOLPESTAD: No, we're only investing in real estate, but we're trying to be very sensitive to where the demand is, and where the user base is.

And based on this last set of regulations, there's more and more businesses that are intrigued about being in opportunity zones because they foresee the benefits for their business investors. And I think we're in early stages of seeing more of that.

DUFFY: Does that seem like a riskier investor profile, if you're kind of starting a new business as opposed to building real estate?

STOLPESTAD: Generally, yes. Real estate has lower risk profile or lower expected return than venture capital businesses. Having said that, there are some businesses, which are established businesses, that think that they can benefit from more attractive capital if they locate in opportunity zones. Some of them are businesses that are already in opportunity zones. They may be grow and they may need new facilities, but we're actually starting to see some of their outside opportunity zones that would like to be opportunity zones, in part of those tax benefits and part because of where some of these zones are.

In the Twin Cities, we happen to have a lot of zones that are in urban transit-oriented corridors. And so some people say, I would like to be in an urban transit-oriented environment, and if I have a choice between this one, which is an opportunity zone and this one which is not, I would rather be in the opportunity zone, because I have the potential of getting these other benefits.

MORRIS: That's like your Eric's Project in Bloomington, right?

STOLPESTAD: Right.

MORRIS: Talking a little bit about the range of communities in which you have opportunity zones, that was a whole lengthy selection process that the state went through. It's not just the 126 lowest-income census tracts, but there were other factors that you put in. Do you think that they made good picks, and do you think that there are opportunities that maybe left on the table?

STOLPESTAD: In Minnesota, from the evidence I've seen, the selection of zones was very authentic to the objectives of the programming. The communities that were selected truly did meet the need test. There are some other states around the country where the selection seems more puzzling, and one could argue they're not as needy, and that has some consequences for these large national funds who are seemingly gravitating to places outside of Minnesota that are less distressed.

I would then offer that folks who are interested in investing in Minnesota zones have a broad range of choices which are consistent with that intent, which makes it a little bit more challenging. These are not necessarily the easiest communities in which to do projects – as compared to going to Oakland or some other places around the country.

MORRIS: In some other states, they took a more pleasant approach to the selection, where they may be getting less of a desired social impact but also maybe making it more attractive to investors?

STOLPESTAD: That's the initial evidence.

LUND: I spoke at a conference down in Houston, because we're active down there with our 1031 program, and it was an opportunity zone conference. And Austin is an interesting example because it was based upon census tracts from 2010, the census tracts were then pushed to the governors, and each governor then could select 25 percent of their census tracts.

Well, Austin in 2010 is a lot different than Austin in 2018. And it's maybe one of the hottest markets, commercial markets in the country. And they're in an opportunity zone. There's a tremendous amount of capital that wants to be in Houston, and San Antonio and Austin, many of the main locations where buildings were going up anyway.

Denver's another one. There's some zones in Denver, so lot of outstate capitals are going to those markets.

In Minnesota, we're what's called a non-conforming state. Because as we sit here today, our tax code in Minnesota doesn't conform with the federal code. So the deferral of an OZ program, it works on your federal return, but not on your state return. And I think we're one of, maybe, 15 non-conforming states around the country?

MORRIS: This isn't the first program like this that's tried to spark projects in underserved areas. And, in fact, before we started, there was some conversation about another program the new market tax credit.

To the extent that we already had programs like the new market tax credit, what does the opportunity zone program bring to the table that these other programs didn't, and how do they fit together and work together?

STOLPESTAD: Prior programs tended to be more limited amounts of capital that had a greater degree of constraints on the eligibility projects. In contrast, the opportunity zone program is unconstrained in the amount of capital. We're seeing an experiment in progress. Many people in the business community feel that this program, because of its more limited constraints, will channel more capital to more places. But we're in early days, and it will be interesting to see.

Looking at projects within our pipeline that are eligible for new market tax credits or historical tax credits as compared to opportunity zones funds. It is clear that opportunity zones funds are a lot easier to do. They're faster, they're less complicated. They're less costly to implement. The other ones may sometimes bring pretty attractively priced capital, as compared to the private sector. But, boy, are they complicated.

DUFFY: I agree 100 percent. I mean, this last award, what was it? $3.5 billion or something like that?

And the federal government is the gatekeeper on those new market tax credits. They award them every year, and maybe it's $3.5 billion this year, and $2 billion or $3 billion next year, where there's no limit here. And that doesn't really drive equity or hasn't historically driven equity investments.

STOLPESTAD: That's another important distinction. Many of the historic programs introduce debt to projects. Opportunity zone capital is required to be invested as equity. So you have a very different risk profile. And I would argue that's more suited to enhancing low-income communities. In distressed communities, adding more leverage is an inherently risky proposition. As compared to deleveraging projects. I

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think structurally, this program has greater potential because it's essentially deleveraging.

MORRIS: Do you see projects where people are trying to mix and match their opportunity zones and new market tax credits and this, that and the other thing, and add it up all in a big Jenga tower of benefits?

LUND: Our deal in St. Paul on Griggs and University, it's really historic tax credits first, opportunity zone second. But what's driving that deal is the historic tax credit program. So, yeah, we're mixing and matching on that particular deal. And taking advantage of kind of both programs.

MORRIS: And do you find that opportunity zone plays nice with all these other programs?

LUND: On that particular deal it's an added benefit. It's a deal that I think we would be doing anyway, just for the tax credits. Now we can also defer some cap gains using the OZ.

And I think that's true of all the deals we're talking about here at this table that Jim's looking at and makes deals. These are all deals that were going to get done anyway.

We call it the "but for" tasks. We've been approached by a bunch of groups that want to build something. And I'll ask them, "But for OZ, would you build?"

If the answer's no, that's the end of the conversation. Because I do think you'll see some deals try to get pushed through the system, only because of the OZ, and that's a bad proposition right out of the box.

STOLPESTAD: I'm going to debate that a little bit. Because I think that's generally the case in urban markets, but I would disagree in a Greater Minnesota markets. I think that the designation of qualified opportunity zones across Minnesota is exposing communities to capital, that probably would never have gone there. We're seeing projects in Faribault, in Owatonna, in St. Cloud, Duluth, that many investors would never consider.

LUND: But are they deals that are only being built because of the opportunity zones treatment? I.e., it doesn't make any sense to build them but for that? Because I'd suggest a bad deal's a bad deal, no matter OZ treatment or not.

STOLPESTAD: It's hard to decipher, because I'm not sure we would ever be looking at deals in certain of those communities. If this incentive was not available in those geographies. It's hard to say, was there a capital? Were there deals that were viable?

LUND: It does open up the inventory; you see a deal, next thing you know you find a tenant or something. And that I don't disagree with. **STOLPESTAD:** Now, what we're starting to see is businesses, deliberately seeking zones. There are specific types of businesses looking for specific spots across the state to expand, and they want to be in a specific zone. I don't know if you're seeing that.

Staff photo: Kelsey Broadwell

Panel moderator, Finance & Commerce reporter William Morris, listens as Duane Lund talks.

LEWIS: There's been a lot in Denver and maybe more on the west coast where, because of the opportunity zones, they had these ideas to go there, build these greenhouses or other kind of development on the land that they wouldn't have done, absent this.

DUFFY: These greenhouses related to a new business industry that's springing up?

LEWIS: No. There definitely are some, but it's debatable whether or not it really qualifies for the opportunity zones.

LUND: I've read two articles now on the whole cannabis movement. There's one in California that is a cannabis-based opportunity zone, and they're suggesting it's not defined as a sin business -- there's a definition of OZ code of sin businesses.

Have you seen anything in that space?

LEWIS: Yeah, based on the fact it's not explicitly listed. I mean there are people moving forward with it and gambling.

MORRIS: You talked a little bit about businesses in different markets that are going out and looking for opportunity zones. Is most of the energy in opportunity zones coming from the top down or from the bottom up? Is it from investors wanting to throw money at people or people wanting money to be thrown at them?

LEWIS: I think a little of both. I know a lot of clients who have big capital gains that need something to do with it. So either have businesses that are haphazardly in an opportunity zone and somehow want to make that work; or the opposite, where people are starting a business and they want to figure out how to do it in an opportunity zone.

STOLPESTAD: It seems that way, which is really interesting. And I think that points to sort of the intent of the legislation, was to do certain things, and we're seeing that sort of bubbling up, occur.

A lot of communities are really excited about attracting capital and doing these kinds of things, and now they're looking for investors. And we'll see how many investors show up and where the investors want to put their money.

LUND: It's been some interesting conversations with these investors, because many of them are not coming out of a real estate deal. In fact, most of them aren't. They sold their business or they sold stock, but many of them sold businesses, and they sold it at a 10-times or a 20-times or 100-times profit.

And then we show them a real estate deal, that pays 5 percent to 6 percent, cash on cash, and maybe at the back end, the building sells for a 1.2 times or 1.4 times. But in real estate, you know, we build these things for $10 million, we don't sell them for $100 million later in life.

Steve Case, the guy who started AOL, now has Revolution, I think is the name of his company. It's a $250 million fund. He put in $10 million of it, and that entire fund is investing only in OZ businesses. And that one has a lot traction from what I'd call the Silicon Valley venture capital firms, because they want to find the next unicorn and if that unicorn's in a zone, pretty compelling because you get the tax rate at the back end.

It's more about the taxes rate after 10 years that's compelling to them, rather than the deferral for years.

MORRIS: I know that there's sort of the ecosystem popping up, of groups and entities trying to help, especially in Greater Minnesota, where smaller communities without the same specification are trying to, I guess, pitch their project or attract their investors.

Where do you see having the most success in waving a sign that brings opportunity zone investors to the table?

STOLPESTAD: Unfortunately, it seems to be occurring in other states. Alabama, Ohio, Indiana, apparently Colorado have more business-friendly economic development activities that promote specific locations, they present investor prospectuses on projects. They identify a fairly clear path from investment through completion and C of O, and that kind of activity makes it easier for investors to say yes. That kind of activity is emerging in Minnesota. We're certainly encouraging it. But Minnesota may have a little bit further to go to catch up to some of those other communities.

MORRIS: There's no way at the state level. It's tough when you're in a Willmar or little town like that, where you're not normally spending a lot of your day talking with investors at this level. So there is definitely a missing step there that people are trying to fill in.

STOLPESTAD: Some people have been critical of like things like the Amazon proposal and think that's illustrative of some shortcomings in our state's economic development activity. And some of those critics are probably fair in their commentary. So this creates an opportunity for some of those communities to use their new status as qualified opportunity funds to galvanize their community support, their civic resources, and others, and showcase that there are a lot of great communities, and there are viable projects.

So this could be a good outcome for the state. But it's going to take some of those communities a little bit more effort and kind of a change in attitude, in some cases. But there are some communities who are doing a great job. I was chatting with some folks in Faribault, and they have four housing projects that have evolved in the course of three months, because they took an aggressive stance toward opportunity funds. They hadn't had four housing projects in like the past 30 years. Incredible.

MORRIS: I want to ask about the single-asset fund versus the moving-asset fund issue, because we are seeing some developers create single asset funds. I know Dominium is doing that, McGough is doing that. Generally, I think either for projects that were already in the works or at least already like on the shelf, waiting to be dusted off.

For developers, what would be the pros and cons for going in loan versus going into a fund?

WALTON: Well, I'll go first because my answer's really simple. The way we're set up, we are just one asset at a time, whether it was an opportunity zone project or not. So we've chosen to not change our business model. We're continuing to just put out an offering for each individual project. Four of our 27 are in opportunity zones, so four were opportunity zone projects.

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MORRIS: So are you creating a qualified opportunity fund for each project?

WALTON: For each project, correct. And that's all we plan to do right now.

LUND: And I think from our side, we started our deal in 2018 and the guidance was such, that the single asset fund was also the way to go.

At that point based on what we knew within the code, it was a path of least resistance and then much like Nick (Walton), it was deal first, zone second. We just put it in a PPM as a single asset. Again, we only have two deals and it was just easier to do it as single asset.

Will we turn it into a fund? I did REITs for 15 years; maybe if we get enough traction I can see some benefits to what Jamie (Stolpestad) is doing and put it into a large portfolio. If that retail capital, that second group that Jim talked about earlier, if those checks come in, I wouldn't be surprised if those checks feel more comfortable in a REIT structure that happens to own multiple properties. So we may go there, but out of the box the path of least resistance is single-asset for us.

STOLPESTAD: I would agree, it's easier to do a single-asset fund, and many investors especially those who have historically invested in real estate, are more comfortable doing it that way. The potential new investors into our space historically have enjoyed having a diversified portfolio. And they seem uncomfortable putting all their eggs into one project, because they don't have the experience to judge a project. It'll be interesting to see, over time, what the balance of capital is.

One consequence of the single assets versus the multi-assets is the range of risk return projects that you can do. So historically, if you have a fund and you have 10 or 20 projects in the fund, not all of them are the absolute killer, winner, projects. You can take a couple risks, you can balance short term cash versus potential long-term appreciation.

I think the evolution for more multi-asset funds has the potential of expanding the universe of projects that will get done. And I think that will expand the geography of where these projects will occur. So some of the smaller communities in Minnesota will benefit by having more multi-asset funds looking at their projects, because it's more difficult to attract specific investors to Faribault, or what have you.

MORRIS: We talked I think mostly about the real estate side of opportunity zones, but we have these new rules that came out recently for the business investing. What were the topline takeaways as you look at those? Do you think that this is going to be the hot new thing for investors trying to turn over these gains?

LEWIS: I think some of the big takeaways are people didn't really understand how the gross receipt kind of tests were going to work. But they provided a lot of clarity, and made it pretty open. I think of people are now a lot more excited about it. We've seen a lot of traction with even university incubation groups, and once they're ready to kind of go out in the real world, they're looking for those startups to kind of go into opportunity zones because it's a cheap place for them to start, usually.

I think the gross receipt test and clarification how you can lease assets where assets can be leased were kind of huge takeaways for that. And then as well as expanding the working capital safe harbor to qualified opportunities like businesses, too. Before it was only clear that would work for real estate.

Before it would be pretty much do something with all your cash right away which would never work for a startup.

MORRIS: Are there business types or questions of scale that might make an opportunity zone more or less worthwhile? Do you find some businesses that are just too small to be worth of the bother, or is it nothing but gain all the way down?

LEWIS: This market is kind of new because these rules came out like April 17. So we haven't seen a lot of traction with the QOZBs looking to go forward that aren't really real estate motivated, other than the brand new startups, but I think the biggest hedge for people is the people in opportunity zones who have an existing business, how they can expand that in working the opportunity zones. So I don't think there's a cap of small versus big. Other than maybe the capital they're looking to get from other people. I think it's pretty wide open. In real estate I can definitely see trends, but I don't think with businesses we can really see it yet since those rules are so new.

LUND: I tend to agree, even though that tax act went through in September of 2017. The game is just really started for OZs because we didn't get that guidance until April 17 of this year.

In many ways, I feel like it's the first inning at best or maybe we're still warming up for the game. So we'll see. But I think at the end -- the intent of the program will be carried out. This was a program that had bipartisan support. And Washington, by the way of the guidance we received, seems to open it up saying, Jim, Duane, Nick, do this stuff.

It's pretty compelling how flexible in my opinion the guidance has been. They want to encourage participation in the program. They want people to set up funds. They want people to build buildings. And so I think long-term, it will be a great program and great tax incentive.