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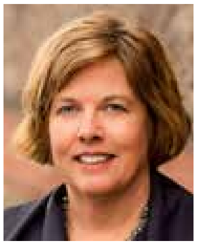
HISTORIC TAX CREDIT TOOL BOX

A Developer's Perspective on Combining OZs and HTCs



CINDY HAMILTON, HERITAGE CONSULTING GROUP

Since its creation under 2017 tax reform, the opportunity zones (OZ) incentive has incentivized reinvestment in economically distressed areas and is emerging as a powerful tool that can complement historic tax credit (HTC) developments.

HTC-based developments often target the same universe of real property investment that is attractive to qualified opportunity funds (QOFs). There are more than 8,700 OZs located in the 50 states, the District of Columbia, and five U.S. territories. Approximately 40 percent of OZs are located in rural census tracts, while 38 percent are in urban census tracts and 22 percent are in suburban census tracts. Often, these distressed areas include buildings that have the potential to become HTC developments.

Use of QOFs is expansive and not confined to real property investment or development (but is open to such investments), making QOFs a valuable equity source for HTC developments. An aspect of particular interest is that, similar to HTCs, QOFs incentivize long-term investment. The regulatory framework for QOFs incentivizes a "holding" position that aligns well within the five-year post-rehabilitation ownership requirement of HTCs.

Through a combination of thoughtful investment and careful rehabilitation, property developers can make significant gains on their property, while also providing a substantial economic boost for the community the project calls home.

Case Study: Poth Brewery in North Philadelphia

In this article, we interview real estate developer David Waxman of MM Partners for a developer's perspective on OZs, and how they can be combined with HTCs.

Throughout MM Partners' portfolio are projects that have successfully used federal and state tax credit incentives, including HTCs. While many of their developments are in OZs, Waxman and MM Partners have yet to complete a redevelopment project that combined equity from OZ funds and HTCs. This will change with the anticipated rehabilitation of the historic F.A. Poth Brewing

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Company building (Poth Brewery) in Philadelphia's Brewerytown neighborhood.

Brewerytown earned its name from the dozens of breweries that operated on the banks of the Schuylkill River. Multistory brick structures with good bones and brew houses were flanked by the elegant homes of brewery owners on one side, and modest two-story row houses of workers on the other.

"Brewerytown is an authentic neighborhood," said Waxman. "Prohibition put most of the breweries out of business, but some of the buildings remained intact. There is a mixture of housing stock, a high rate of home ownership, many families, senior citizens and ethnic diversity. For us, this neighborhood has been the perfect location to use HTCs and QOFs."

Image: Courtesy of Heritage Consulting
The Poth Brewery building is being rehabilitated and will become 132 loft apartments and 25,000 square feet of commercial space, thanks to equity from historic tax credits and qualified opportunity fund investment.

"People want to live in interesting places," said Waxman. "They don't want to live in cookie-cutter or spaceship-like buildings. They are naturally drawn to a building that has a story."

Poth Brewery was an investment opportunity that Waxman was unwilling to pass up. Marketed as "the beer without a peer," the Poth Brewery operated from 1871 to 1936, when the building was sold to other manufacturers. MM Partners bought the building for $4.1 million in January 2018. Upon completion in late 2021, the Poth Brewery rehabilitation project will create 132 loft apartments and 25,000 square feet of commercial space. The development has generated

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about $6.5 million in HTC equity and $10 million in QOF investment. Renovation and reconstruction will ultimately cost $37.6 million.

When considering adding HTCs and OZs to a development, Waxman suggests that developers who take the time to do their research and read the fine print will benefit greatly from their efforts. Waxman also recommends developers (especially newcomers) surround themselves with tax and historic preservation professionals.

"An accounting firm has to run the financial modeling for the tax credits and everything has to be cleared with the accountants and the state historic preservation office and the National Parks Service for a tax credit deal," Waxman said. "It's more cooks in the kitchen, but historic tax credits, opportunity zones and low interest financing can make a tough project worth the risk."

In addition to creating strong partnerships with developers, professional service providers and public agencies, the most successful projects are those that are transparent and have the support of the local community.

"We want the stakeholders to be with us from year zero, when the building is its most messed up, to the end, to see how the sausage is made," he said. "Adaptive reuse is not easy to do. The only way to build trust is to be completely transparent about the process from start to finish."

Waxman acknowledges that OZ investment is more than simply another means of procuring government incentives for a development project. Rather, the OZ investment is an incentive to invest in areas previously deemed uninvestable.

"The intent of the opportunity zone legislation was to de-risk transactions for developers to take on hard buildings," Waxman said. "With OZs, the question is how much does the new investor value the tax savings? Without OZs, a typical opportunistic investor would want to see a return of 18 to 20 percent on a project like Poth. Tax credits and the OZ benefits allow you to get more attractive financing, so that if it works out, the returns will reward you for taking the risk and bringing these amazing buildings back to life in a cost-efficient way."

"The key is, don't overpay for the real estate and don't overleverage the real estate," Waxman said. "If you can do those two things, you can hold on to it and you'll be successful over time."

Conclusion

OZs provide investors with an incentive to place capital in higher-risk adaptive reuse projects in economically distressed areas across the country. In many instances, OZs include dilapidated or abandoned historic buildings. These scenarios present an opportunity to use both HTCs and the OZ incentive to redevelop areas previously considered too risky to warrant substantial reinvestment.

While more parties are involved when combining HTCs and the OZs, the incentives make the challenges worth the risks, as is the case with the Poth Brewery redevelopment. A strong working relationship with investors, attorneys, accountants and the target community are critical in successfully executing a financially sustainable project that can serve as a catalyst for further investment in the area. ❖

Cindy Hamilton is vice president of Heritage Consulting Group. Hamilton heads the firm's Philadelphia office, where she develops strategies for owners to maximize rehabilitation incentives and represents clients in negotiations through all aspects of the historic tax credit process.

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David Waxman is the co-founder and managing partner of MM Partners, an entrepreneurial real estate development company. Waxman graduated from Boston University with a bachelor's degree in urban studies and public policy. MM Partners has specialized in adaptive reuse and urban infill projects since 2001, having secured more than $100 million of capital and invested in more than $300 million of real estate.

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