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Opportunities for HTCs in OZs

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In many of the more than 8,700 opportunity zones (OZs) in the United States–which include areas in five U.S. territories–historic buildings or buildings that are potentially eligible for historic designation, are ripe for redevelopment.

OZs are located in both rural and urban areas, so there are a variety of building types and styles that lend themselves for rehabilitation through the historic tax credit (HTC) incentive. On the surface, OZs present an optimal opportunity for developers to raise additional funds through the combination of the OZ incentive and HTCs. In fact, more and more rehabilitation projects in OZs are catching on to this trend.

A previous article described the developer's perspective on projects that combine the OZ incentive with HTCs. In the year since, developers have continued to rise to the challenge, taking on a steady stream of paired OZ and HTC projects. To better understand this trend, we reached out to three experts: Marc Cohen, managing director of tax credit investments at Fallbrook Financial Services Company; Heather Buethe, director of project management at the National Trust Community Investment Corporation (NTCIC), a subsidiary of the National Trust for Historic Preservation; and David Waxman, managing partner at MM Partners LLC, a Philadelphia-based real estate development firm.

Over the past few years, tax credit investors have begun to see OZ financing layered into HTC projects. Buethe indicated that in 2018, for example, "over 50% of Part 2 applications overlapped with opportunity zones." Although paired projects are not as common as standalone OZ and HTC transactions, both NTCIC and Fallbrook have undertaken several combined OZ/HTC projects in the past year and anticipate significant opportunities in the year ahead.

With increased understanding that the pairing of HTC and OZs is beneficial for developers, it is important to decipher who exactly is investing in them. Buethe noted that the projects NTCIC sees have typically involved a large institutional investor on the HTC side while the OZ investors have been more diverse, ranging from large financial institutions to members of the development team. It is a challenge to have the same investor in both incentives, due to differing risk profiles and structuring impediments such as the differing basis treatments. NTCIC remains hopeful that Congress will pass the HTC-GO Bill this year, eliminating the HTC basis adjustment and allowing HTCs to pair better with OZs.

For the large institutional investors, the other question of whether to take on an OZ investment comes down to risk. Since the payout of the OZ incentive is a 10-year process, the return on investment requires patience, and by nature, a more extended period of risk that the investment does not succeed. According to Cohen, the ultimate goal of institutional investors is to identify credits for a particular year. As such, they are more likely to partake in HTCs, as opposed to OZs.

With institutional investors more likely to invest on the HTC side of the combined project, who is the ideal investor for the OZ side of this scenario? Both Buethe and Cohen agree that it is often easier to

find an individual investor to take on the elongated risk associated with OZs and that it is unlikely that projects will use the same investor for both the HTC and OZ.

Additionally, both Fallbrook and NTCIC have seen other emerging patterns of development regarding paired HTC/OZ projects. In terms of geography, Buethe said that, while many projects are on the East Coast due to the region's large inventory of HTC-eligible buildings, she has seen similar transactions become more prevalent in the Midwest and southern states. NTCIC recently financed two southern HTC/OZ projects, the revitalization of a USPS distribution center and the redevelopment of a former tobacco manufacturing factory.

Similarly, the type of redevelopment project appears to be consistent across the board, particularly amid the pandemic. Cohen noted that the vast majority of transactions Fallbrook is engaged in are residential, whereas, before the pandemic, a significant percentage of its investments were hospitality-based. Cohen explained, "Then COVID hit, which halted the hospitality sector." However, Cohen remains optimistic that commercial, hotel and food service redevelopment projects will return to the market as vaccination continues across the country.

Image: Courtesy of Nick Kraus
The West Philadelphia Passenger Railway Company Carhouse will be redeveloped using the opportunity zones incentive and historic tax credits.

Case Study: West Philadelphia Passenger Railway Carhouse

Last year, we interviewed David Waxman, a Philadelphia-based developer for MM Partners LLC (MMP), highlighting his redevelopment project at the Poth Brewery in Philadelphia's Brewerytown neighborhood. The Poth Brewery was MMP's first project in which HTCs and OZs were paired. As the redevelopment of the historic brewery comes to a close this year, Waxman's team has undertaken additional paired HTC/OZ projects, including the West Philadelphia Passenger Railway Carhouse (WPPRC) in the West Philadelphia neighborhood of the city.

The historic streetcar car house was built in 1876, during the city's centennial celebration and played an integral role in West Philadelphia's growth as a streetcar suburb. MMP's redevelopment of the building will result in a mixed-use property with leasable retail space on the first floor and residential units on the second floor. The successful financing of Poth Brewery directly led Waxman to duplicate the model in his WPPRC rehab, MMP's fourth OZ project.

According to Waxman, MMP feels "very comfortable leveraging the [OZ and HTC] programs to allow us to undertake difficult historic renovation projects in emerging neighborhoods." Waxman also noted that completing projects under this financial model affords developers such as MMP the opportunity to take on historic rehabilitations, "rather than taking the easy way out to tear down great old buildings and replace them with new construction."

The WPPRC rehabilitation serves as an excellent example of increased awareness in opportunities to use OZs with the HTC. As more and more developers like Waxman begin to incorporate the two incentives into their financing models, there is likely to be a significant increase in viable buildings for redevelopment.

Conclusion

Through Buethe, Cohen and Waxman's experience with projects that pair HTCs with OZs, it is evident that the two incentives work well together to accomplish their shared goal of economic development in distressed areas. The number of historic, or potentially historic buildings within OZs presents developers an opportunity to plug holes in funding gaps that might otherwise deter redevelopment efforts. Furthermore, the preservation-focused investment guidelines in the HTC, or the community development-focused guidelines in the new markets tax credit, help ensure and strengthen the overall community benefits OZ-financed projects were intended to achieve.

The key, however, to the maximization of these opportunities will be the potential extension of the OZ incentive, which currently sunset at the end of 2026. As of this article's writing, legislation has been introduced in the House of Representatives that would extend the OZ incentive through the end of 2028. The rehabilitation of the WPPRC accurately illustrates the growing trend of projects pairing HTCs and OZs. As more and more developers and investors look to this financial model to fund these rehabilitations, the potential to expand the impact of OZs and historic preservation within underserved communities also rises. ❖

Cindy Hamilton is president of Heritage Consulting Group.

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