Community Best Practices

how to successfully leverage opportunity zones

Part 2: Bringing an OZ Project to Market

THE GOVERNANCE PROJECT

COLORADO

Office of Economic Development & International Trade

Bringing projects to market – finding the "win-win"

Framing the Day

Model Approach to Opportunity Zones

Today's Focus

1. Orient Community around vision for the Zones - develop prospectus
2. Identify Zone-Specific Community Needs
3. Identify Community Resources that Can Be Leveraged
4. Prioritize Projects from the Intersection of Needs and Resources
5. Advance Priority Projects through Pro Forma Development & RFP Process

Day 2 Agenda

- 9:30 – 9:45: Intros and Framing
- 9:45 - 10:30: Overview of New Regulations
- 10:30 - 11:00: Private Equity Overview
- 11:00- 11:15: Break
- 11:15- 12:30: How Investors Evaluate Projects
- 12:30–1:15: Lunch - Prospectus and Project Feedback
- 1:15 - 1:25: Stockman Kast Ryan + Company
- 1:25 - 2:15: Building a Financial Model and a Proforma
- 2:15 - 2:30: Break
- 2:30 – 3:00: Bringing It All Together

What is allowed? And what is not?

Overview of Policy & Regulations

How investors think

Private Equity Overview

How (Most) Investors think about OZ Investment

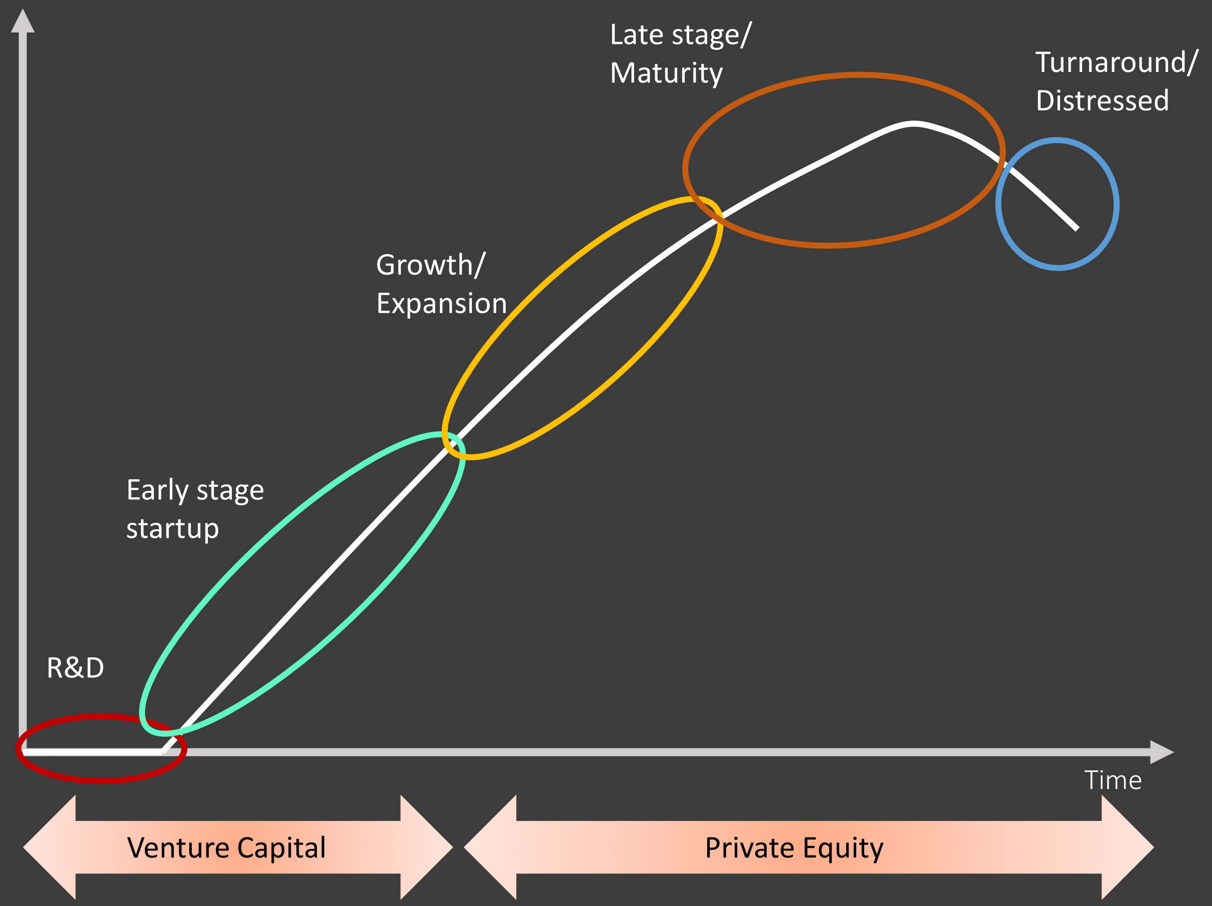
- Excellent tax incentives to invest, but still seeking risk-adjusted market-rate returns (12% - 15%)
- Will attract long-term equity investments within portfolios, patient capital
- Mainly focus project-by-project, but new rules make multi-asset funds more possible
- For investors approaching new places, it’s not always clear how to find viable projects
- Business investment recently became more clear, but implications still unknown

Debt vs. Equity

Basis for comparison	DEBT	EQUITY
Meaning	Borrowing a fixed sum from a lender which is paid back with interest	Selling a percentage of the business to an investor in return for capital
Creates	An obligation	Ownership
Term	Usually a fixed, comparatively short term	No fixed term
Types	Bank loans, credit cards, bonds, convertible notes, etc	Shares, preferred shares
Return	Fixed and regular	Variable and irregular
Nature of Returns	Interest + repayment of principal	Dividends + proceeds from sale
Collateral	Secured against the assets of the business	Unsecured

Courtesy of Yossarian Capital Partners

5 Types of Private Equity Investors

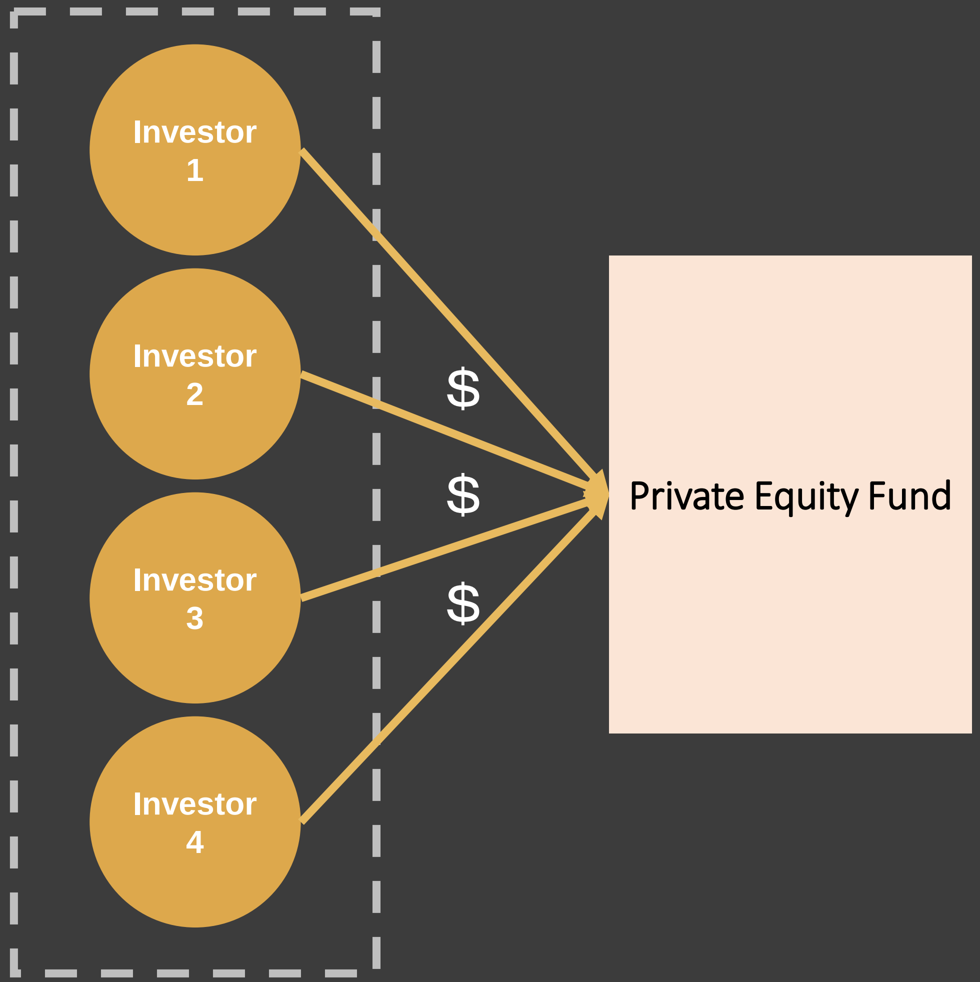


- **Bootstrap/Family & friends/Incubators/Angels:** Initial concept, R&D, and MVP/beta development
- **Seed Stage:** Product launch, initial marketing, team expansion, product market fit
- **Series A to Growth Capital:** Expansion of business with some track record of traction, with good customer and revenue growth
- **Late Stage:** Sustained growth of an established business, potential acquisition funding
- **Turnaround:** Re-establish a business that has encountered difficulties: poor trading, over levered, bankruptcy, etc

Courtesy of Yossarian Capital Partners

How Private Equity Firms are Structured

- A group of investors pool their capital together to make investments
  - Typically high net worth individuals, family offices, or institutional investors
- Pooled capital is invested in a Fund, which is managed by the PE firm
- PE firm invests in accordance with their advertised investment strategy
- Aim to return a healthy profit back to their investors



Courtesy of Yossarian Capital Partners

What Firms are Looking For

- ❖ The PE Firm is <u>ultimately answerable to the Limited Partners</u>
  - o Seeking highest risk-adjusted returns relative to investment strategy/industry vertical
  - o Will help them raise their next Fund if Limited Partners are happy

- ❖ They're constantly searching for attractive investment opportunities that fit their investment criteria
  - o Over time seek exit opportunities to lock in return on investment

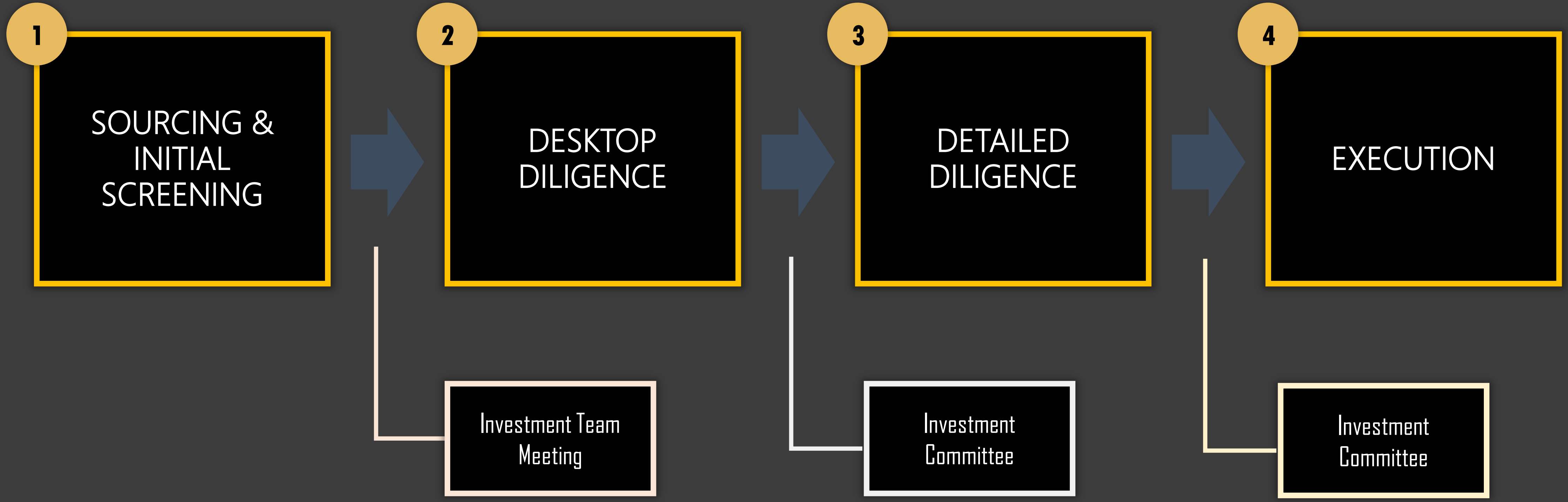
- ❖ Opportunity Zones *can* provide a nice performance kicker for PE Firms investing in certain opportunities

Courtesy of Yossarian Capital Partners

Taking the fund perspective

Activity: How Investors Evaluate Projects

The investment process involves multiple steps to qualify, diligence, and execute on an opportunity



Courtesy of Yossarian Capital Partners

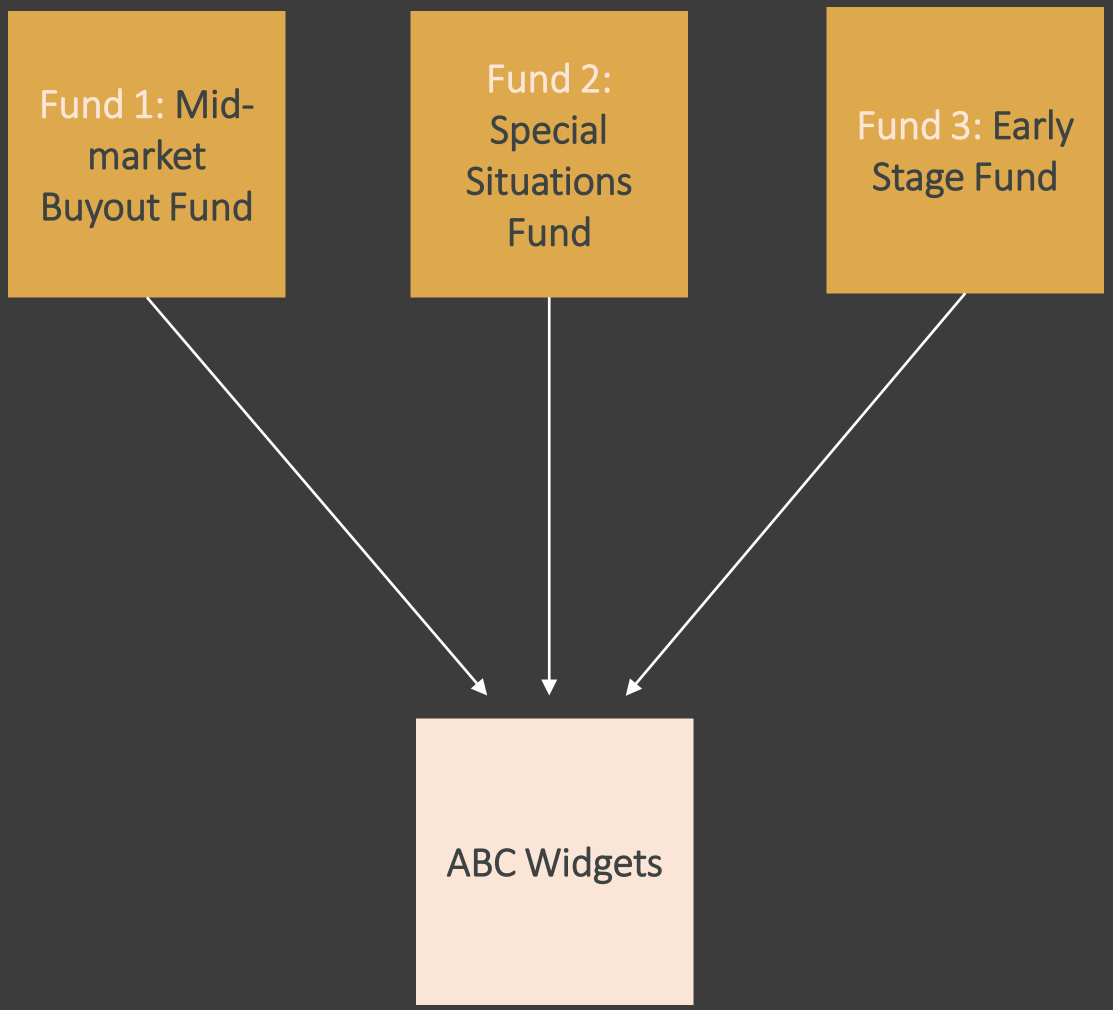
Investment Strategy Criteria:

- Geography Allocation
- Industry Vertical
- Stage of Business
- Business Size or Financial Profile
- Ownership Style (minority vs. control)

- A Fund's investment strategy can be as broad or as niche as the fund manager wants it to be, but has to be clearly defined
    - Fund Manager has a fiduciary duty to its Limited Partners, so there need to be clear rules and guidelines as to how the Fund's money will be deployed

- Establishes the framework the Fund uses to source, analyze, and invest in opportunities

See Handout: How Investors Evaluate Projects



- Would you invest?
  How much?
  Why/why not?

- What additional information would you like to see?

Courtesy of Yossarian Capital Partners

Case Study: Email

Hi, I'm the CEO at ABC Widgets, located in an opportunity zone Alamosa, CO. ABC Widgets is the largest producer of widgets in the Rocky Mountain and Southwest region of the US, with annual revenue of $10m and approximately 25% market share in Denver, Albuquerque, and Salt Lake City. We're currently looking to raise $10M of growth capital to upgrade and expand our current 10,000 sqft production facility and capitalize on favorable industry thematics to solidify our position as the dominant producer in the Rocky Mountain and Southwest corridor.

Below are the key investment highlights:

- Favorable market thematics: $600MM+ industry growing at ~2.5% p.a. with a declining number of widget manufacturers
- Production predominantly out of PA and CA, presenting a great opportunity for ABC Widgets to own the Rocky Mountain and Southwest corridor
- Highly experienced management team
- Been growing revenue at approximately 25% yoy since beginning operations in 2014
- Capital injection intended to triple annual production capacity and allow the business to take advantage of inherent operating leverage to realize margin expansion
- Strong customer base
- Indicative IRR in 30%+ based on preliminary internal analysis

If you're interested to learn more, please let me know a convenient time for an intro call.

Desktop Diligence: Do you proceed to detailed?

	Mid-Market		Special Situations		Early Stage	
Geographic Focus	North America	✓	Greater Midwest	✓	North America	✓
Business Type	Established operating businesses	✓	Distressed or going through turnaround/restructuring	✓	Early stage businesses	✓
Financial criteria	\$5m - \$10m EBITDA Cashflow positive	✗	\$1m - \$5m EBITDA Pathway to cashflow breakeven	✓	\$2m - \$10m ARR Pathway to cashflow breakeven	✓
Investment/ Management Type	75% - 100% ownership Strong control/Hands-on	✗	<40% minority position Hands-on	✓	<25% minority position Passive	✓
Leverage?	Yes	?	No	✓	No	✓
Target Returns	25%+ 5 - 7 year hold period	?	20%+ 7– 10 year hold period	✓?	25%+ 7 year hold period	✓?
Target Industry	Manufacturing	✓	All	✓	Widgets	✓
Investment Size	\$40m - \$100m	✗	Up to \$10m	✓	\$2m - \$5m	✓?

Detailed Diligence: Do you invest?

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Lunch: Peer Feedback

Sponsor Presentation: Stockman Kast Ryan + Company

Project finance 101

Building a Financial Model and a Proforma

What does it mean for a project to pencil?

Breaking down elements of the return

What are the key elements that make a project “pencil”

Net Cash Flow

		Timing
-	**Upfront Expenses** ❖ the costs of getting business or development up and running ❖ This includes costs of: land, construction & equipment (hard costs), architecture , legal fees, engineering (soft costs), developer fees	Paid by investors & property owners all up front to finance project
+	**Total Gross Operating Income** ❖ Rental income or sales income ❖ Annual subsidy ❖ Minus vacancy, concessions, and loss to lease	Comes in to property owner annually over lifetime of project
-	**Total Operating Expenses** ❖ All the costs of managing a property year to year or costs of production, including: ❖ Payroll, rent, insurance, payment of debt obligations, management fees, capital costs, maintenance, supply costs	Paid by property owner annually over lifetime of project
+	**Distribution & Fees** ❖ Amount that goes to the General Partner remainder that goes to the limited partners ❖ Cash on cash: the ratio of any single year’s distributions to the initial amount of equity provided (should be increasing until the point of sale)	Comes back to investors at the project s completion

Example

Upfront Expenses for mixed use development: $28.5 M

Uses		Commercial		Housing
Land				-
Site Work		$ -		$ 2,000,000
Construction		$ 8,465,226.05		$ 11,203,975.65
Professional Fees		$ 500,000.00		$ 1,000,000
Construction Interim Costs		$ 761,870.34		$ 1,008,358
Permanent Financing Fees		$ 200,000.00		$ 185,000
Soft Costs		$ 846,522.60		$ 1,120,398
Developer Fees		$ 969,625.71		$ 1,486,596
Project Reserves		$ 400,000.00		$ 600,000
Total Uses		$ 12,143,244.71		$ 16,363,532
Sum Commercial + housing:				$ 28,506,776.40
Sources				
First Mortgage				$ 18,529,405
Subordinate Debt				-
Concessionary Capital (Cap on Return)				-
Concessionary Capital (return of Capital)				-
Concessionary Capital (Grant)				$ 2,240,795
Market Rate Equity				9,977,371.74
Total Sources				$ 28,506,776

Year 1 Cash Flow

Income - PSF	1.80
Gross Potential Income	$ 1,762,348
Vacancy	(114,219)
Concessions & Other	-
Loss to Lease	-
Total Gross Potential Income	$ 1,648,129
Other Income	-
Total Gross Income	**$ 1,648,129**
Operating Expenses	
Payroll	$ 20,007
G & A	$ 24,009
Mgt Fee	$ 96,223
Leasing	$ 6,002
Maintenance	$ 16,006
Redecoration	$ 4,001
Utilities	$ 32,011
Non Routine Maintenance	$ 7,843
Non Controllable (Taxes & Ins.)	$ 108,038
Cap Ex	$ 20,020
Total Operating Expenses	$ 334,160
NET OPERATING INCOME	**$ 1,313,969**
Debt Service - P & I	**$ 729,219**
NET CASH FLOW	**$ 584,750**

Investor view

Equity	Up Front	Year 1	Year 2	Year 3.	Year 10
Total Cash Available for Distribution	$ -	$ 584,750	$ 611,029	$ 637,834	$ 841,095
Preferred Return	-	46,780	48,882	51,027	67,288
Cash Available for GP/LP Distribution	$ -	$ 537,970	$ 562,147	$ 586,807	$ 773,808
Limited Partner Distribution	$ -	430,376	449,717	469,446	619,046
Limited Preferred Return		46,780	48,882	51,027	67,288
Total Cash Flow to Limited Partners	$ -	477,156	498,600	520,473	841,095
Sales Distribution					6,905,312
Return of Equity	$ -	-	-	-	5,503,044
Total Distributions to Limited Partners	(5,503,044)	584,750	611,029	637,834	13,249,452
IRR	15.31%				
Cash on Cash Returns		10.63%	11.10%	11.59%	

* Most of OZ return gets accounted for in post-tax return after sale

Key Assumptions Impacting Projections

The basics of a model are simple arithmetic, the assumptions are the tricky part

Market Cap Rate at sale: In real estate this is how “hot” the market is. The lower the rate, the higher returns will be. Nationally it is low right now, hard to predict on a 10 year timeframe.

Upfront cost contingencies: Land costs can vary as can construction material costs and labor costs.

AMI, Market rate costs, vacancy: Real estate version of, what’s the income of the target population? What’s the price-point (how much can one reasonably charge)? And what’s the rate at which you expect your product not to sell? Getting this assumption right is data-intensive.

Capital stack composition: How much debt can you reasonably assume the project will use? Market rate equity? Impact equity? Public subsidy? Tax credits? Grant funding?

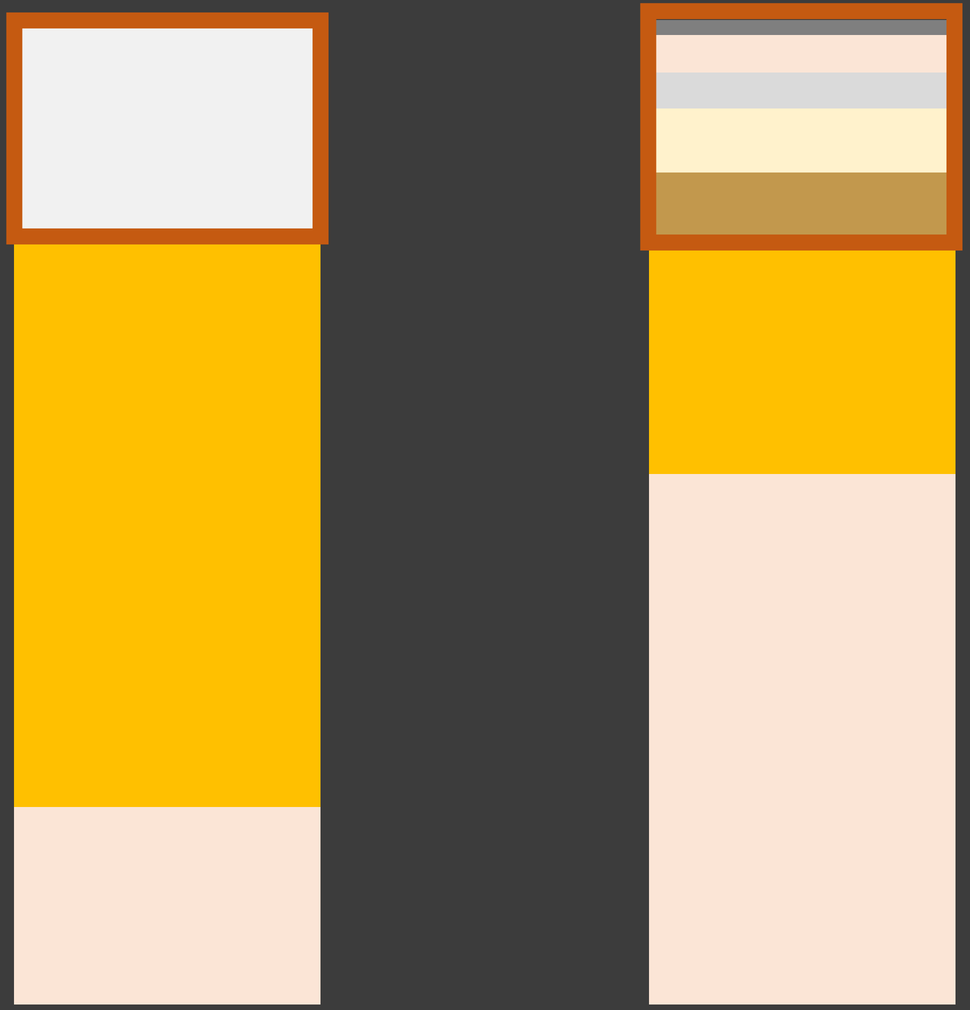
Building the Capital Stack

What are the key gap fillers & the constraints they impose

GAP: Costs not covered by debt + equity funding

Construction costs: labor & capital

Land costs



Hypothetical Cost Drivers

Hypothetical Funding Sources

Opp. Zone tax benefit: long term payoff

Tax credit: can be time consuming, but is a direct subsidy (LIHTC, New Markets)

Public Subsidy: comes with pub sector requests (TIF, land support, etc.)

Philanthropic grant: hard to get requires mission focus

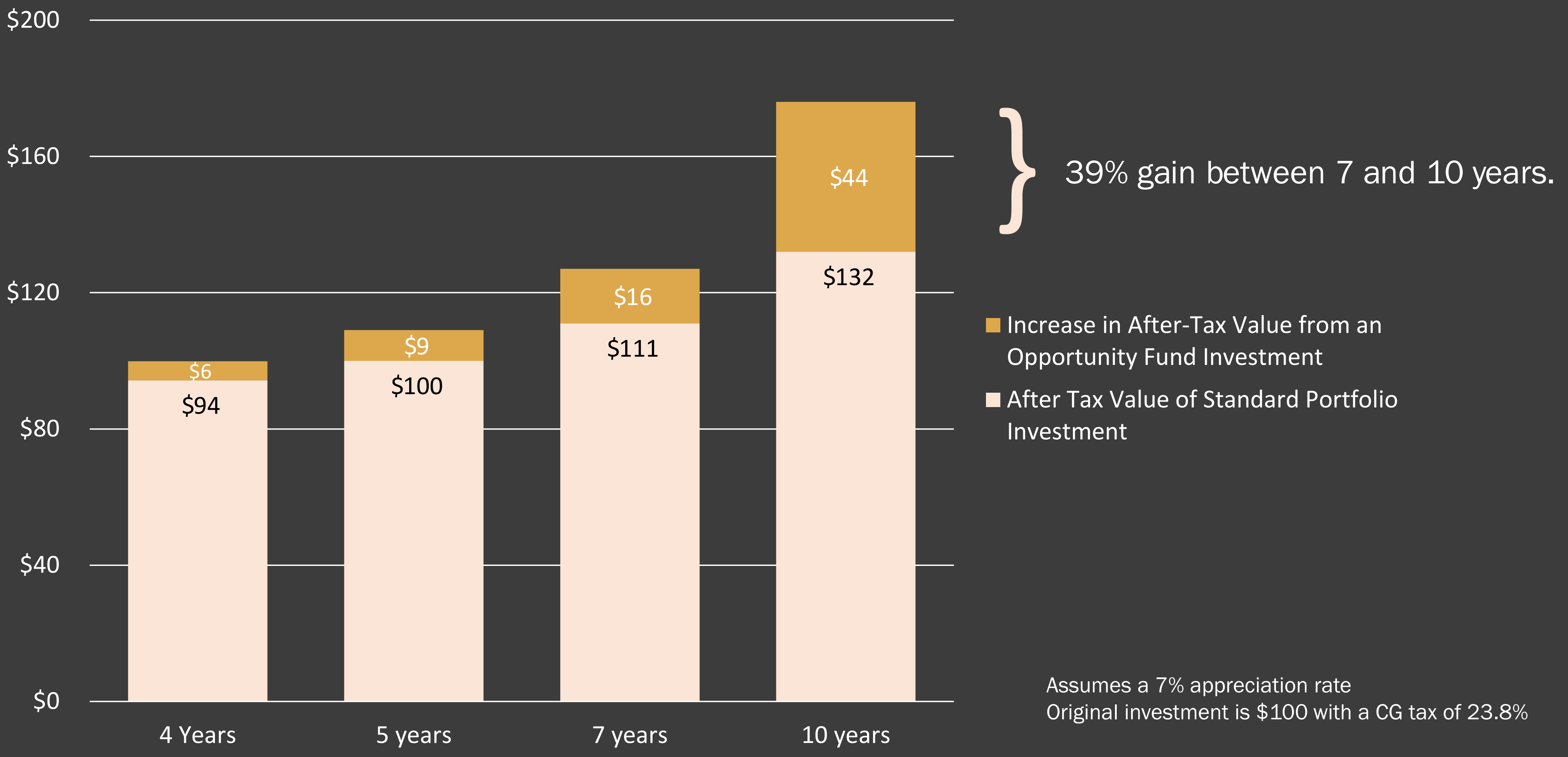
Impact equity: smaller capital pool, seeking lower returns (less expensive, but less common).

Market rate equity: expensive since it's a direct cut of profits, equity investors are discerning and looking for certain returns.

Debt: less expensive, but banks will not give out loans above a certain coverage ratio (usually between 75% and 80%). HUD gives out lower interest rate loans, but with timing constraints.

What makes the OZ incentive an attractive proposition to investors?

And why is it not enough to move projects on its own?



Assumes a 7% appreciation rate
Original investment is $100 with a CG tax of 23.8%

The Role of City Hall & Project Sponsors in OZ Project Finance

Now that you know all this, what should you do?

1. Understanding how investors & developers think helps act strategically: distributing incentives & outreach to maximize impact. Helps to refine strategic priorities to what makes projects pencil
2. Figuring out ways to lower input costs in OZ (land, labor, capital) in exchange for outcome provision – often up-front subsidy is most important
3. Convene, encourage, and support, actors to fill gaps on community-focused projects (philanthropy, landowners, CDFIs).
4. Include key financial metrics in prospectuses
5. Model out projects to make sure you’re not being taken advantage of
6. Develop term sheets for specific OZ deals you’re involved in

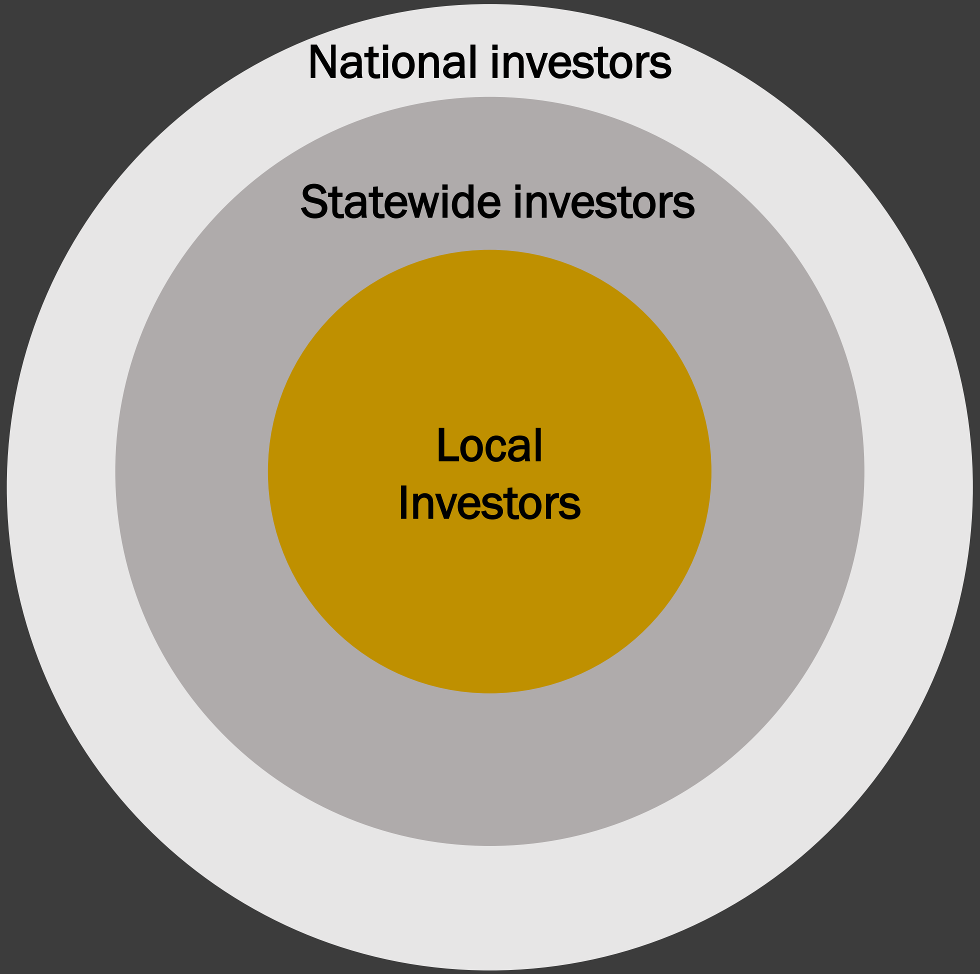
Developing an action plan

Bringing it all together

Next Steps

- ❑Finish financial modeling and proforma development
- ❑Identify assets and financing that can make the deal attractive to market rate capital
- ❑Identify appropriate investors
- ❑Refine "the ask" – understand key considerations for the investor
    - ❑ Risk, return, mission alignment, headline risk, & level of involvement desired
- ❑Develop term sheets + contracts
- ❑ Agree upon a mutually understood reporting process
- ❑Close the deal!

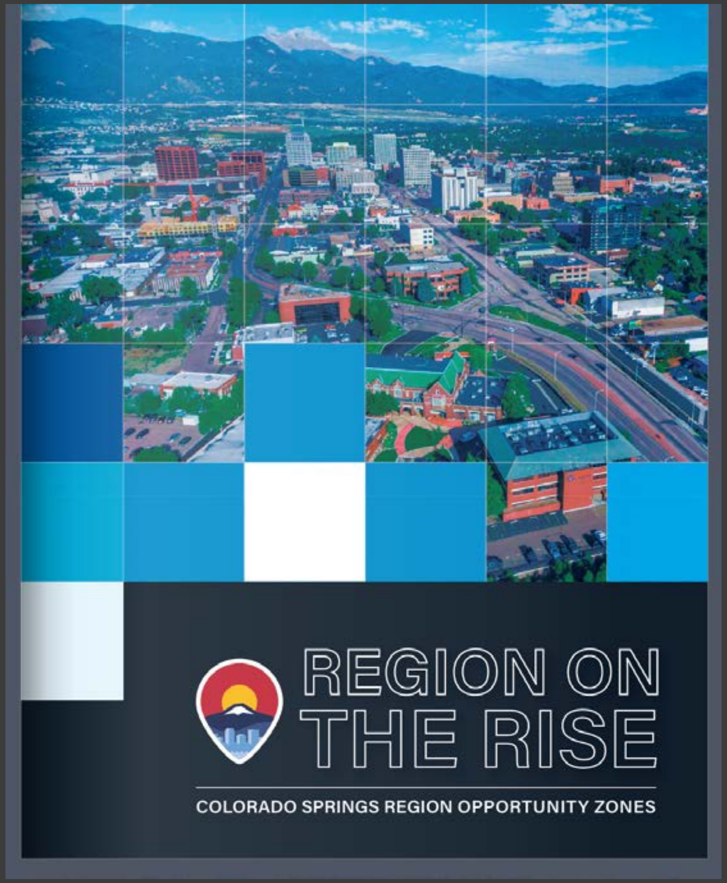
Identify Investors – Understanding the considerations and tradeoffs



<u>Key Resources</u>

- Co-Invest: www.co-invest.co
- Curated lists (i.e. Novogradac, EIG)
- Wealth managers/financial service providers
- Networking at local events
- Pitch events

Making it real – Colorado Springs Region



State Resources

Co-Invest

- Please share your zone + regional prospectuses/projects!

Fall 2019 Pitch Events – stay tuned!

- www.choosecolorado.com/oz

Technical Support Grants (DOLA/OEDIT)

- www.choosecolorado.com/oz

Closing

Please reach out if we can help!

THANK YOU
questions and comments welcome

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