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Opportunity Zones and Affordable Housing: Perfect Together?

Two of the most topical subjects in commercial real estate are the dire need for affordable housing, and the prospects for investing in opportunity zones. Can the solution for the two issues be intertwined, like the old candy commercial where chocolate meets peanut butter?

The picture on affordable housing is dire, one that grows worse by the year. As apartment rents increase faster than income, the number of households that pay a substantial portion of income on housing is rising. Meanwhile, supply of affordable units is constrained by rising land and construction costs and stringent restrictions on building in many metros.

Opportunity zones were created by the 2017 tax law to encourage development in areas with low household incomes. Investors may defer taxes on capital gains and to avoid paying taxes on profits for investments in qualified zones that are held for the long term. A law designed for development of real estate in low-income areas should help solve the demand for affordable housing. Although off to a slow start while capital was being raised and regulations are being clarified, the number of opportunity zone funds and projects started has begun to gain momentum. There's little doubt that opportunity funds will contribute to the effort on housing affordability.

However, because of the complicated nature of affordable housing, the nuances of the opportunity zone program and the demands of investing in real estate risky submarkets, it will take several years to get a full picture of the impact on the affordable housing puzzle.

Properties in Opportunity Zones: National Overview

	In-Place + UC	Planned + Prospective	Total
Mutlifamily OZ Units	1.9 Mil	455K	2.3 Mil
% of Total MF Units	13.1%	19.3%	14.0%

Source: Yardi Matrix (as of August 2019)

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Affordable Housing in Short Supply

The need for affordable housing in the U.S. is well-documented. Some 47.4 percent of U.S. renter households are cost-burdened, meaning they pay 30-50 percent of income on housing, while 10.8 million renter households are considered severely burdened because they pay more than 50 percent of income on housing, according to a 2019 report by the Joint Center for Housing Studies at Harvard University. Most households with annual income of less than $35,000 are cost-burdened, and the percentage of burdened renters is higher in metros with high rents.

The affordability issue is exacerbated by the lack of new affordable housing. The Harvard study estimates that the country should be building 1.5 million housing units per year based on household formation and other factors, but in 2018 the number delivered was short by 260,000. Furthermore, new housing construction is concentrated on the luxury segment, while demand is highest for units affordable to mid- and lower-income households.

Opportunity zones should incentivize at least some housing development. As of mid-year 2019, more than 300 funds were raising upwards of $50 billion of capital to invest. The Treasury Department estimates that $100 billion will be invested in OZs within the next few years. A study by brokerage firm Cushman & Wakefield found that housing was being targeted by 82 percent of opportunity zone funds, more than any other asset type.

Most development within opportunity zones is likely to target low- and middle-income households, since the zones have weaker economic profiles than the nation as a whole. A study by the Economic Innovation Group found that opportunity zones had almost twice as many households living in poverty (29% versus 15% for the U.S.), median income was lower ($44,700 versus

Most In-Place & UC MF Units in OZs

Market	Units	% of Market Total
Washington DC	55,453	17.5%
Phoenix	54,467	17.2%
Brooklyn	49,080	32.5%
Manhattan	47,329	14.6%
Richmond–Tidewater	45,250	20.5%
Detroit	43,045	20.1%
West Houston	42,655	9.4%
Metro Los Angeles	40,299	20.8%
East Houston	39,017	20.1%
Portland	36,408	22.9%
Boston	35,816	14.9%
Cleveland–Akron	34,952	21.7%
San Fernando Valley	31,373	20.7%
Urban Atlanta	31,099	12.7%
Baltimore	30,726	13.7%
Inland Empire	30,034	19.4%
Northern New Jersey	29,791	12.9%
Northern Virginia	28,634	12.6%
Bridgeport–New Haven	27,853	20.7%
Indianapolis	27,765	15.9%

Source: Yardi Matrix (as of August 2019)

Least In-Place & UC MF Units in OZs

Market	Units	% of Market Total
Fort Worth	1,996	1.0%
San Francisco–Peninsula	5,005	4.0%
West Palm Beach	6,137	9.1%
Suburban Twin Cities	6,236	7.4%
Tacoma	6,876	10.1%
Bay Area–South Bay	7,133	5.3%
Jacksonville	8,898	8.6%
Suburban Atlanta	9,860	4.8%
Orange County	9,921	4.8%
North Dallas	10,117	2.8%

Source: Yardi Matrix (as of August 2019)

$70,900 for the U.S.) and had higher housing vacancy (13% versus 8% for the U.S.) All told, there are more than 8,700 opportunity zones in the U.S., encompassing roughly 10% of the U.S. population and 12% of the land.

Potential Multifamily Development

The potential to build multifamily units in opportunity zones is enormous. As of year-end 2018 there were 1.9 million apartment units in properties with 50 or more units in opportunity zones, and another 455,000 multifamily units that are in pre-development stages, which could add 24.2% to stock, according to Yardi Matrix's database.

Potential for development varies by metro. Because states had to make decisions about which zones to choose for the program, there is only a loose correlation between metro size and the amount of potential opportunity zone housing supply. Some states decided to focus on more developed areas in which there are shovel-ready projects, while others are trying to encourage development in more rural areas or far-flung suburbs.

For example, about 60% of the opportunity zones in New York are in the boroughs of New York City, and roughly one-quarter of Arizona's opportunity zones are in the Phoenix. Texas concentrated 96 opportunity zone tracts in Houston, about 13% of the zones in the entire state, while designating only 23 zones in San Antonio, 19 in Austin, and fewer than 10 in Dallas. Only 11 of California's 879 zones are situated in San Francisco, where NIMBY-ism and red tape prevent the construction of badly needed new housing stock. Miami, Los Angeles and Washington D.C. have the most planned units in opportunity zones, while Chicago and Dallas have among the least.

Rents are also weakly correlated. In markets such as Chicago, San Francisco and Southern Florida,

Most Planned/Prospective MF Units in OZs

Market	Units	% of Market Total
Miami	27,341	29.8%
Metro Los Angeles	25,426	35.4%
Washington DC	24,492	24.8%
Northern New Jersey	20,520	26.1%
Bay Area–East Bay	14,256	33.3%
Phoenix	12,023	30.2%
Brooklyn	11,925	40.7%
Boston	10,586	20.6%
Seattle	9,339	14.7%
Eastern Los Angeles	9,195	40.3%
Bridgeport–New Haven	8,553	32.6%
Tampa–St Pete	8,356	24.0%
Detroit	7,898	56.9%
Baltimore	7,835	26.7%
Cleveland–Akron	7,265	69.9%
Urban Atlanta	7,212	21.1%
Denver	7,100	12.5%
Nashville	6,949	23.8%
Richmond–Tidewater	6,843	30.6%
Portland	6,663	31.1%

Source: Yardi Matrix (as of August 2019)

Least Planned/Prospective MF Units in OZs

Market	Units	% of Market Total
Suburban Chicago	50	0.3%
Pittsburgh	406	4.6%
Fort Worth	602	3.3%
North Dallas	723	1.3%
Suburban Philadelphia	743	3.9%
Suburban Twin Cities	1,025	7.2%
West Palm Beach	1,151	4.5%
Inland Empire	1,298	8.5%
Tacoma	1,694	20.5%
East Houston	1,734	15.8%

Source: Yardi Matrix (as of August 2019)

Multifamily: Highest Rent Spread Between OZs and the Metro Average

Market	Spread	% Spread	Avg. Rent Inside OZs	Avg. Rents Outside Ozs	2018 Rent Growth Inside OZs	2018 Rent Growth Out-side OZs
Urban Chicago	$869	86.9%	$1,000	$1,869	8.5%	4.2%
San Francisco–Peninsula	$792	34.2%	$2,315	$3,107	1.5%	5.3%
West Palm Beach	$522	44.6%	$1,171	$1,693	4.2%	3.5%
Ft Lauderdale	$387	30.4%	$1,274	$1,661	4.0%	3.6%
Urban Atlanta	$362	36.1%	$1,003	$1,365	8.0%	5.3%
Northern New Jersey	$360	22.7%	$1,587	$1,947	2.2%	2.4%
Metro Los Angeles	$358	16.2%	$2,205	$2,563	4.9%	5.3%
Manhattan	$354	9.2%	$3,868	$4,222	3.9%	3.9%
Orange County	$351	20.2%	$1,735	$2,086	4.5%	2.7%
Suburban Chicago	$349	39.6%	$881	$1,230	2.2%	2.7%
Northern Virginia	$294	18.9%	$1,553	$1,847	3.9%	2.4%
Seattle	$294	19.0%	$1,550	$1,844	2.2%	4.4%
Pittsburgh	$283	33.5%	$846	$1,129	1.3%	5.8%
San Fernando Valley	$269	15.6%	$1,724	$1,993	5.1%	5.0%
Orlando	$268	25.0%	$1,071	$1,339	5.8%	5.0%
San Diego	$265	15.7%	$1,687	$1,952	7.1%	5.3%
Las Vegas	$251	29.9%	$839	$1,090	8.1%	7.7%
Miami	$247	17.1%	$1,446	$1,693	6.6%	3.0%
Charlotte	$230	25.3%	$909	$1,139	3.2%	3.7%
Inland Empire	$221	16.8%	$1,317	$1,538	7.7%	5.3%

Source: Yardi Matrix (as of August 2019)

Multifamily: Lowest Rent Spread Between OZs and Metro Average

Market	Spread	% Spread	Avg. Rent Inside OZs	Avg. Rents Outside Ozs	2018 Rent Growth Inside OZs	2018 Rent Growth Out-side OZs
Urban Philadelphia	$(410)	-22.5%	$1,820	$1,410	4.7%	3.3%
Brooklyn	$(344)	-11.3%	$3,032	$2,688	-0.6%	4.0%
Bridgeport–New Haven	$(340)	-19.4%	$1,749	$1,409	1.9%	1.7%
Eastern Los Angeles	$(257)	-12.4%	$2,069	$1,812	2.8%	5.1%
Indianapolis	$(221)	-20.4%	$1,084	$863	1.7%	3.7%
Cleveland–Akron	$(150)	-14.4%	$1,040	$890	5.5%	2.9%
Central New Jersey	$(79)	-4.9%	$1,624	$1,545	1.1%	1.6%
Bay Area–South Bay	$(77)	-2.6%	$2,934	$2,857	3.4%	5.5%
Bay Area–East Bay	$(69)	-3.0%	$2,315	$2,246	3.1%	2.7%
Portland	$(60)	-4.2%	$1,438	$1,378	3.0%	3.7%

Source: Yardi Matrix (as of August 2019)

multifamily rents in opportunity zones trail the metro average, but in some metros that include urban Philadelphia, Brooklyn and Eastern Los Angeles, average multifamily rents of properties in opportunity zones are higher than the metro average. Again, the discrepancy has to do with the way the states drew the lines for the zones and the nature of urban neighborhoods in which neighborhoods with expensive real estate can be adjacent to less-toney areas.

Poor Match for Subsidized Housing

The solutions devised by municipalities to combat the affordability crisis range from fully subsidized housing, to relaxing zoning standards, or granting developers increased density in exchange for making a portion of units available as affordable for low- to medium- affordable residents. Opportunity zone developments can help to create more housing, but they are unlikely to produce much fully subsidized housing.

For one thing, subsidized housing already has tax advantages for developers and investors, which reduces the allure of the opportunity zone tax subsidies. Another reason is the way the law was drawn. To qualify for the opportunity zone tax break for an existing property, a buyer must double the basis in the property. For example, if an apartment building is purchased for $5 million (broken down as $4 million for the building and $1 million for the land), an opportunity zone fund must spend least $4 million of improvements into the property. That rules out most existing subsidized housing, because few need that kind of immediate capital improvement.

Yet another complication is time. Subsidized housing complexes typically involve extended negotiations between developers and state, local and federal officials, while the opportunity zone program has relatively strict time limits. Investors must put capital into qualified funds within six months of the capital gain, and the fund must have investments targeted within another six months. Then the fund has 30 months to spend the capital. Such strict time limits don't mesh well with new construction timetables, even more for projects that are negotiated with multiple government entities.

Sparking Rehabilitation Projects

Opportunity zones are more likely to produce market-rate or partially affordable housing, particularly as part of a larger development. Because the opportunity zones were selected by state governments to coincide with areas where rehabilitation is needed, and because many are in areas that wouldn't attract capital absent tax incentives, many projects could have a public-private element.

Many governments envision the program as a way to inject capital in blighted areas and to create modern live-work-play developments with a wide range of asset types, including office, retail, entertainment, lodging and housing. Municipal officials want to emulate the success of holistic developments in metro areas that attract businesses and cater to the lifestyle of the younger generations. For cities, that means redeveloping infill locations in areas that have abandoned industrial or office buildings. Smaller markets envision resurrecting downtowns that have eroded as factories and other businesses have shuttered on Main Streets.

The public-private nature of opportunity zone projects in areas being rehabilitated means that developers may have to layer incentives to get the full benefit. One such example is the redevelopment of the former Brooks Air Force Base in San Antonio. To attract capital, city and state officials have designated the 1,300-acre site as a Tax Increment Reinvestment Zone (TIRZ), a Smart San Antonio Innovation Zone, and a San Antonio Tomorrow Regional Center.

Public sector participation is likely to be a key in many projects, such as the redevelopment of Port Covington, an abandoned and contaminated industrial area in South Baltimore. The site is targeted for an ambitious redevelopment led by Under Armour CEO Kevin Plank's Sagamore Development Group and Goldman Sachs Urban Investment Group. The $5.5 billion project is slated to encompass a wide range of uses that include office, retail, a food court, hotel and residential. The first phase, recently started, includes 1.4 million square feet of office, 337,000 square feet of retail and nearly 1 million square feet of apartments.

The project has attracted controversy because the port did not originally qualify to be in an opportunity zone until the state revamped its list. Objections aside, state and city officials dream the project will attract capital and create another trendy section of Baltimore that rivals the Inner Harbor. The goal is to create jobs and a desperately needed economic jolt for the area. The developers in 2016 entered into an agreement with the state that would redirect $100 million of profits into the local community.

In Philadelphia, opportunity zones are spurring a number of redevelopment projects that will produce housing, including: the conversion of an abandoned brewery into 128 multifamily units and a separate 108-unit apartment property in the Brewerytown section; the conversion of a former medical supply factory in Germantown into a mixed-use property with 39 multifamily units and commercial space; the conversion of a defunct 1920s-vintage power plant in Fishtown into a mixed-use complex that will include hundreds of apartments, coworking offices and an event venue; and the rehabilitation of a former nurses dormitory in Francisville into a 22-unit apartment building.

Can OZs Unlock Potential?

The need for affordable housing is too big to be fixed by one tax incentive. The shortage of housing affordable to low- and middle-income households is in the hundreds of thousands nationally, and even under optimistic scenarios opportunity zones won't produce nearly that many units.

However, the fact that housing is being built in low-income areas (and blighted properties are being redeveloped) are steps in the right direction. The sharp drop-off in new housing supply after the last recession was a major contributor to the affordability problem. Rents skyrocketed in part because household formation exceeded new supply for several years after the Great Recession. Increasing total supply and lowering occupancy rates is arguably the best way to stem the rate of rent increases.

That said, potential remains the key word for opportunity zones. There is great potential to raise money, to make deals, to get projects financed and completed, and to attract tenants. Potential, though, encompasses the possibility that everything won't work, either because of an external cause (such as an economic downturn) or because the projects are not able to draw the demand needed to produce the hoped-for returns.

Given the amount of capital looking for an investment, the success that many developers have had in mixed-use projects that are breathing life into formerly low-performance areas, and the demand for housing in proximity to jobs and amenities, it's a good bet that opportunity zone developments will proliferate for the next few years and will become a critical tool to alleviate the affordability problem.

—**Paul Fiorilla,** *Director of Research*

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