# The Four Perils of Opportunity Zones that all investors MUST know about, and how to avoid them

By Neal Bawa, CEO, Grocapitus

Opportunity Zones are slowly entering the mainstream consciousness and are being mentioned on financial websites and podcasts all over the internet. For the most part, we think that's a good thing.

Many people seeking decent returns on their investments and/or a buffer against capital gains taxes stand to benefit from Opportunity Zone investment. They are unique vehicles with numerous upsides, about which every wealthy business owner or investor should have at least a basic understanding.

Unfortunately, while there is a lot of positive buzz being generated by Opportunity Zones, there hasn't been enough said at all about the potential risks faced by investors.

Lately, our team at Grocapitus has been researching issues which could spell trouble for Opportunity Zone Funds unless they become more pro-active and savvy in the way they design and manage such funds.

Here are just a few of the dangers of Opportunity Zones we discovered during our research:

**Peril 1: Finding the Right Developer Won't Be Easy**

Right off the bat, we ran across an issue that may prove a difficult problem to solve. Namely, it will be seriously challenging for the bigger funds to locate the right developer partners for opportunity zone projects.

Traditionally, developers don't hold properties for long periods of time. They follow the build-fill-sell model. It's generally not part of their business model to hold the assets for any length of time. This being the case, the typical developer usually lacks the protocols, procedures, and infrastructure necessary to successfully hold a project. Managing a new Class A or Class B property in a Class C area is, by definition, a difficult task. To attempt it without experienced asset management staff and the accompanying systems could easily be a recipe for disaster.

This is particularly problematic for Opportunity Zones projects because promoters and developers in opportunity zones will need to have the competency to hold these assets for **at least 10 years.** During those 10 years, we foresee at least two recessions. Higher end product in Class C areas tends to do poorly during recessions. That's where deep asset management experience can make a difference, and most developers simply don't have that talent in-house.

It is easy to imagine that a developer who does not possess essential competencies and mindset will become impatient and wind up selling a project, perhaps even before the five year mark.  This will result in huge tax losses for investors (and potential lawsuits).

Working with the right developers, then, is paramount to success when it comes to OZ Funds.  Finding those developers, on the other hand, is easier said than done.

Some questions that savvy investors should ask the development partners – How long did they hold their past five projects? Did they sell those projects vacant or did they stabilize them before selling? Do they have dedicated in-house asset management team (a good relationship with a property manager is definitely not enough).

**Peril 2: It's the 80/20 Rule All Over Again**

While the Opportunity Zone Program could be the most important federal urban revitalization program in years, its' potential as a way for conscientious investors to help breathe life into underperforming neighborhoods is clouded by a grim reality.  That reality is simply that no matter how well-intentioned the program is or how much money and effort is poured into it, the vast majority of areas designated as opportunity zones will not improve. Harsh words, but true.

Some urban revitalization experts claim that as much as 80% of opportunity zones are unlikely to change class categories.  This means that investors could put world class properties into zones which will never even move from a Class C area to a Class B area, much less reach class A status.   This means, of course, that such projects are likely to ultimately fail or underperform.

You might be wondering: is there a way around this problem?  Is it possible to locate and maximize the valuable 10-20% of projects that have the possibility of success? Can an investor stack the deck in his or her favor and avoid throwing good investment dollars into projects that are doomed to fail or underperform?

The answer is yes, there is a way to mitigate the risk of project failure.  We have found a demographics driven methodology that involves the use of technology and Big Data to research and gather the data required in order to ferret out the best choices. We start with demographics data such as Population growth, job growth, median household income growth, home price growth and crime reduction. We then overlay this data with incoming supply to predict if an opportunity zone has a chance to undergo a Class change during the 10-year hold.

With 8,700 opportunity zones, and dozens of demographics metrics to choose from, this is not an easy thing to do, and we are betting that most Opportunity Funds will take their chances rather than do the extra work it takes to increase the odds of success.

As an investor, you should work with Opportunity Funds willing to show you proof of the use of demographics data to target the right opportunity zones. Don't hesitate to ask for this information upfront, before you make your investing decision.

**Peril 3: Beware the "Zombies"**

As soon as Opportunity Zones moved a little into the mainstream, we began to notice a proliferation of what we call "garbage" or "zombie" projects. Many of these are from developers eager to get failed projects off the books. These were projects where the developer spent hundreds of thousands of dollars (or more) on the the initial land acquisition, zoning and permitting, only to discover that the project really didn't pencil out, and investors were uninterested. These projects have been sitting on a shelf every since.

Now, these projects are being "repackaged" as Opportunity Zones projects in the hopes that investors will not bother to look under the hood.

As demand grows, we expect to see more and more of these garbage projects marketed, even though they have little to no hope of succeeding. Viable Opportunity Zone projects are few and far between. If you are considering investing in one, we encourage you to talk with data driven analytics teams first. They can help you do an end run around the zombies and make decisions that will give you the best shot at success.

**Peril 4: Construction projects can get stuck in zoning and entitlement phases**

Many OZ projects are being announced in cities and counties that are notorious for zoning and entitlement delays. Given that many of these projects are already marginal due to low tenant median incomes, it is easy to envision scenarios where delays could lead to projects running out of money, or banks refusing to fund construction loans.

Whenever possible, investors should only invest in projects that are already zoned and entitled. This reduces risk, and time to cash flow. If that is not possible, investors should work with development teams that already own the land / project. They wouldn't buy expensive land if they were not confident about the zoning / permitting challenges.

Lastly, look for projects where the city itself is asking for the project to be built (often called master planned developments). Those projects tend to get faster approvals at every level. While no guarantee, this can reduce investor risk significantly.

Bottom line - there are other pitfalls and challenges ahead for investors wanting to take on Opportunity Zones. In future posts and in webinars on our site www.grocapitus.com, we will address those problems and offer you the most complete set of solutions available.

To your investing success!

Neal Bawa,
Founder and CEO, Grocapitus

## About Neal Bawa and Grocapitus

Neal Bawa is a technologist and entrepreneur in love with the power of numbers to create profit for his real estate investors. He is CEO / Founder at Grocapitus, a commercial real estate investment company. Neal acquires Commercial properties across the U.S., for over 800+ investors. Current portfolio over 1800 units/beds, over $150 Million value. The portfolio includes Multifamily and student housing properties in 9 U.S. states.

Neal also serves as CEO at MultifamilyU, an apartment investing education company. He is a top-rated speaker at conferences & events across the country. Nearly 5,000 students attend his multifamily seminar series each year and many hundreds attend his Magic of Multifamily boot camps each year. Many tens of thousands hear his podcast appearances and he has been featured in nearly 40 podcasts and radio shows. Neal's management techniques and revenue optimization techniques for Multifamily are considered unique in the industry.

Neal and his team of five analysts are now identifying and underwriting Opportunity Zones (OZ) projects throughout the U.S. Currently, a total of 13 projects in 6 states with a total value of over $300 Million are in consideration. Our pool of 800+ equity investors have indicated a very high level of enthusiasm for OZ projects.