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The Deepening Convergence Between Promote Crystallization and Qualified Opportunity Zones

How QOZ Developers, Sponsors and Investors Can Use Crystallized Promote To Accomplish Competing Objectives

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OPPORTUNITY ZONES, EXPLAINED

In 2017, the US Federal Government launched the Qualified Opportunity Zone ("QOZ") Program to encourage financial investment and commercial real estate development in economically distressed areas of the country. Initially, the program's benefits included several generous tax breaks, including an immediate partial deferral of taxes on capital gains that are re-invested in Opportunity Zones and a complete waiver of capital gains taxes the QOZ fund generates by holding the investment for 10 or more years.

Additionally, the QOZ Program offered the opportunity to earn stable long-term returns on real estate investments while bringing new and affordable housing, retail, office and industrial space to underprivileged areas. This unique and compelling combination of financial and social incentives enticed many commercial real estate investors and developers to break ground on a wide range of projects in designated Opportunity Zone areas across the country.

Interest In Qualified Opportunity Zones Remains Strong

Although several of the Qualified Opportunity Zone program's initial benefits have expired, the program still offers many enticing tax breaks:

- **Deferment of taxes on prior capital gains reinvested into Qualified Opportunity Zone projects or Qualified Opportunity Zone Funds (QOFs). The deferral lasts until the date the investment is sold or exchanged or December 31, 2026, whichever comes first.**

- **If the QOZ/QOF investment is held for at least five years, 10% of the deferred gain is exempt from taxes.**

- **If the investment is held for at least seven years, that increases to 15%.**

- **In addition, if an investor holds the QOZ/QOF investment for at least 10 years, when the investment is sold or exchanged, any appreciation of the investment is exempt from taxes.**

As a result– and understandably– interest in Qualified Opportunity Zones and Qualified Opportunity Zone Funds remains high from investors looking to reduce their tax liability.

THE GROWING ALLURE OF PROMOTE CRYSTALLIZATION

At Realogic, we've worked on a steady stream of creative and promising Opportunity Zone projects since the program's inception in 2017. And, as we've seen interest in Opportunity Zones and Qualified Opportunity Zone Funds increase steadily over time, we've simultaneously seen a noticeable increase in the use of promote crystallization—also known as crystallized carry or carried interest crystallization--in QOZ fund valuations, pitches and negotiations.

Why the steady increase in the use of promote crystallization? Mainly because it can help Opportunity Zone developers, investors and funds accomplish multiple objectives that are key to the financial and operational success of their QOZ projects.

PROMOTE CRYSTALLIZATION IN COMMERCIAL REAL ESTATE, EXPLAINED

First, before we discuss the myriad benefits, potential drawbacks and various considerations of promote crystallization, we should define the concept. To anyone who's worked in real estate, investments or finance for any length of time, the concept of crystallized carried interest is probably familiar. In case it's not, in commercial real estate, promote crystallization works like this:

HOW CRYSTALLIZED PROMOTE WORKS

STEP 1 — **Determine** the property's fair market value

STEP 2 — **Subtract** all closing costs to calculate a theoretical net sales price

STEP 3 — **Run** the net sales price through the original equity waterfall model

STEP 4 — **Adjust** all parties' payout percentages so sponsor receives their promote early through an increased share of cash flows

Fair Market Valuation of the Opportunity Zone Property

The partnership that owns the Opportunity Zone property determines the property's fair market value, as if it were being sold at the time of crystallization. This is usually done one of two ways: through a professional appraisal, including a detailed valuation model, or through a Broker Opinion of Value, or BOV, from a qualified commercial real estate broker.

Once the property's fair market value has been determined and agreed upon by all parties, it becomes the hypothetical gross sales price for the property. Closing costs are estimated and deducted from the gross sales price, leaving a net sales price.

Commercial Real Estate Equity Waterfall Models

The QOZ's net sales price is then run through the partnership's original equity waterfall model. This calculates what the payouts to all parties would be if the commercial property were sold at the time of crystallization, including the return of original capital and hurdle returns to investors and the promote the project sponsor would receive.

Ownership Share Adjustments

Everyone's payout percentages are then adjusted accordingly so the sponsor receives their promote early through an increased share of cash flows from the property, rather than having to wait until a future capital event like a sale or refinancing to occur.

The term "crystallization" refers to the value of the sponsor's or developer's promote being established at that point in time rather than in the future when the building is sold or refinanced.

AN EXAMPLE OF CRYSTALLIZED PROMOTE FOR AN OPPORTUNITY ZONE PROJECT

Here's an example of how promote crystallization works in commercial real estate and with Opportunity Zones in particular:

- A developer and group of investors have partnered on a multi-family building in a Qualified Opportunity Zone.
- The developer delivers and stabilizes the building and wants the benefits of their promote early instead of having to wait until the building sells in 10 years. The investors prefer to hold the building for 10 years to receive all the tax benefits from the QOZ program.
- The partnership agrees to use carried interest crystallization to reward the developer now without having to sell or refinance the building.
- The parties agree that the hypothetical fair market value of the building is $100,100,000. Under the original equity waterfall model, the investors receive 80% of the building's revenue, while the sponsor receives 20%, plus a promote when the building sells.
- Closing costs are estimated at $100,000. They are deducted from the property's fair market value, resulting in a net sales price of $100,000,000.
- After running the $100,000,000 net sales price through the equity waterfall model, the sponsor's promote at that sale price is determined to be a hypothetical $5,000,000.
- In order to pay the sponsor their promote sooner, the sponsor's share of revenue is increased to 30% while the investors' share is reduced to 70%. The sponsor eventually collects their full $5,000,000 promote through their increased ownership share of the building.
- When the building does sell, the sponsor does not receive an additional promote, regardless of the building's actual selling price, because they already received their promote through their increased share of the building's cash flow.

THE BENEFITS OF CRYSTALLIZED PROMOTE TO OPPORTUNITY ZONE DEVELOPERS AND INVESTORS

The most obvious benefit of crystallized promote is to QOZ developers-- that the developer receives its promote sooner than if it had to wait for the building to be sold or another capital event, like a refinancing. By returning its capital sooner, the developer can pursue new projects earlier, whether in a Qualified Opportunity Zone or elsewhere.

In the current uncertain economic environment, capital markets are tight and are expected to remain so for the foreseeable future, so access to affordable working capital has become even more critical to commercial real estate developers.

Another benefit of promote crystallization for the developer is the developer doesn't have to wait until everyone else in the capital stack receives their payout to receive its promote. The longer the wait and the more investors to pay out, the greater the chances the building's value decreases or the developer's financial obligations increase, reducing the developer's net promote.

Qualified Opportunity Zone investors can benefit from carried interest crystallization too. Because the partnership fulfills its financial obligation to the developer, but still holds the property for the full required 10-year term, the project's investors receive all the tax benefits they're entitled to, the reduction or deferment of capital gains taxes likely being the main reason they invested in the project.

DEVELOPER RECEIVES PROMOTE SOONER

Frees up capital for new projects

Reduces chances developer's promote decreases

BUILDING CAN BE HELD FOR 10 YEARS

Investors receive full QOZ tax benefits

IF INCLUDED IN INITIAL MODELS/TERM SHEETS:

Potential investors have more transparency into projects

QOZ projects can be assessed more thoroughly

HELPS QOFS ATTRACT THE RIGHT PARTNERS/INVESTORS

MITIGATES PROJECTS' LONG-TERM RISKS DUE TO COVID

THE BENEFITS OF CRYSTALLIZED PROMOTE TO OPPORTUNITY ZONE FUNDS

For many Qualified Opportunity Zone Funds, or QOFs, crystallized carried interest is now a standard component of many fund deal structures. Crystallized promote scenarios are often included in QOZ property models and in term sheets shown to prospective developers and investors. This communicates upfront that the sponsor intends to crystallize the promoted interest at some point in the project's lifecycle and shows the financial impact on the project's short and long-term returns.

Prospective developers and investors, in turn, can assess a project upfront and more comprehensively and make more informed decisions about which QOZ projects to participate in. QOFs, in turn, can attract the right partners and save themselves the time and trouble of having to recalibrate the deal later to include carried interest crystallization, and deal with potential fallout from investors who were not expecting a crystallized promote scenario. Qualified Opportunity Zone Funds also can use crystallized promote to attract and bargain with new developers and investors as the fund grows and new deals are added.

BUILDING PROMOTE CRYSTALLIZATION INTO REAL ESTATE FINANCIAL MODELS

Take, for instance, one of Realogic's current and most successful QOF clients. When we built their initial Excel development and fund models, we included promote crystallization functionality. They assess each deal individually and decide whether to include crystallized carried interest, depending on the nature and objectives of the deal, as well as the parties they are pitching and the parties' objectives.

If they decide crystallized promote is warranted, the functionality is already built into their models so all they have to do is plug in the numbers and make adjustments as needed. This saves them a considerable amount of work and time because they don't have to start over with each model or build in crystallized promote functionality each time they are considering it.

Plus, because the models are tested and proven, our client has complete confidence in the accuracy of their numbers, as do the developers and investors they work with regularly.

CRYSTALLIZED PROMOTE, OPPORTUNITY ZONES AND THE IMPACT OF COVID

Another valuable benefit of crystallized promote for Qualified Opportunity Zone developers that arose during the Covid-19 pandemic but is just as relevant today is that crystallized promote helps mitigate the long-term financial risks inherent in any QOZ project, especially in a turbulent and uncertain economy.

Although the pandemic has waned, its onset triggered a level of uncertainty around nearly every sector and aspect of commercial real estate, including future rents, occupancy rates, valuations and previously projected returns– especially for office buildings– that continues today.

As a result, many QOZ sponsors and developers are looking to earn their promote in the short term rather than wait the full 10-year hold and gamble that the property's value will appreciate according to the original equity waterfall model.

THE POTENTIAL DOWNSIDES OF CRYSTALLIZED PROMOTE

As with any complex financial transaction involving multiple parties, promote crystallization has some potential downsides for QOZ developers, investors and funds as well, the biggest being coming up with a valuation for the property that all parties can agree upon.

Even when a property is modeled by an experienced and neutral third-party, like a commercial real estate consultant, or appraised by a reputable and neutral commercial real estate appraiser, disputes over the hypothetical sales price used to calculate the promote can still arise and, depending on how strongly everyone disagrees, could lead to a forced sale of the property and dissolution of the partnership before everyone's investment goals are met, negating the benefits of the project.

Bound To The Commercial Real Estate Partnership

Unless specified in the terms of the partnership agreement, once the carried interest is crystallized, the developer or sponsor may not be able to initiate an exit from the partnership later, essentially locking them into the project until the building is sold or refinanced. Depending upon how long the partnership intends to hold the building, that might not occur for years, which may not be the sponsor's plan.

Increased Share of A Commercial Property's Expenses

As the developer's/sponsor's share of ownership and revenue increase, so may their share of the property's expenses and other financial obligations. This could present a whole new set of challenges, depending upon the sponsor's financial situation and ongoing access to working capital.

Increased Tax Liability

Then, there are the potential tax issues. When a promote crystallization event occurs, all the partners' ownership shares and share of profits will likely shift, which could have a significant impact on their individual tax liabilities, for the Qualified Opportunity Zone project and, if the project is part of a larger investment strategy, their taxes overall. For this reason, it's wise to consult an accountant or tax attorney specializing in commercial real estate—Opportunity Zones in particular—before moving ahead with a crystallized promote scenario.

COMMERCIAL REAL ESTATE FINANCIAL MODELING AND CRYSTALLIZED PROMOTE

One of the keys to making crystallized promote work for an Opportunity Zone project or fund is skilled financial modeling. Financial modeling comes into play throughout the property's lifecycle and repeatedly during the carried interest crystallization process, so it's essential that all modeling is accurate and thorough and the data generated is reliable and trustworthy.

First, as with any process, it's essential to start with a strong and stable foundation. For Opportunity Zone projects, this means the original development model must be well constructed, because if there are problems with the development model, they will impact the entire project downstream, including the promote crystallization calculations.

Best Practices For Financial Modeling For Commercial Real Estate

Based on our over 30 years of experience modeling commercial real estate development projects, the model's formulas should be transparent so it's plain to see how numbers were calculated. All components, from the rent roll and debt and timing elements to debt and equity waterfall calculations, should be meticulously audited to check for errors or missing data, which can have a domino effect and completely throw off the outcomes. Cost curves should be confirmed, especially if they're customized. Assumptions should be based on the best available data, then sensitized to show an array of possible outcomes.

BEST PRACTICES

- Make formulas transparent
- Audit every component
- Confirm cost curves
- Base assumptions on best data available
- Always sensitize assumptions

Equity Waterfall Models For Commercial Real Estate

Then, the underlying equity waterfall model for the partnership must be modeled well. The initial model should accurately reflect the project's projected returns so partners are not misled and the investment opportunity is not misrepresented.

In addition, when it comes time to calculate the crystallized promote, the building's estimated fair market value will be run through the same model again. So, if there are problems with the model's structure or the data in it, the numbers for the promote and ownership share adjustment might be skewed, unfairly shorting at least one of the partners.

The sponsor's, developer's and each investor's hurdles and projected returns should be triple checked. If the sponsor is even remotely considering carried interest crystallization, it should be included in the initial waterfall model. Or waterfall calculations can be modeled two ways initially, with crystallized promote and without, to show potential partners both potential outcomes upfront.

If no one on your team has ever modeled crystallized promote before or audited models that include it, it's best to get expert help from an experienced commercial real estate consultant or contractor.

Commercial Real Estate Valuation Model

Then, there's the valuation model that might be used to determine the fair market value of the opportunity zone property at the point the promoted interest is crystallized.

When crystallized promote is utilized, and the agreed upon valuation of the building is run through the original equity waterfall model, the results should be thoroughly audited because the promote

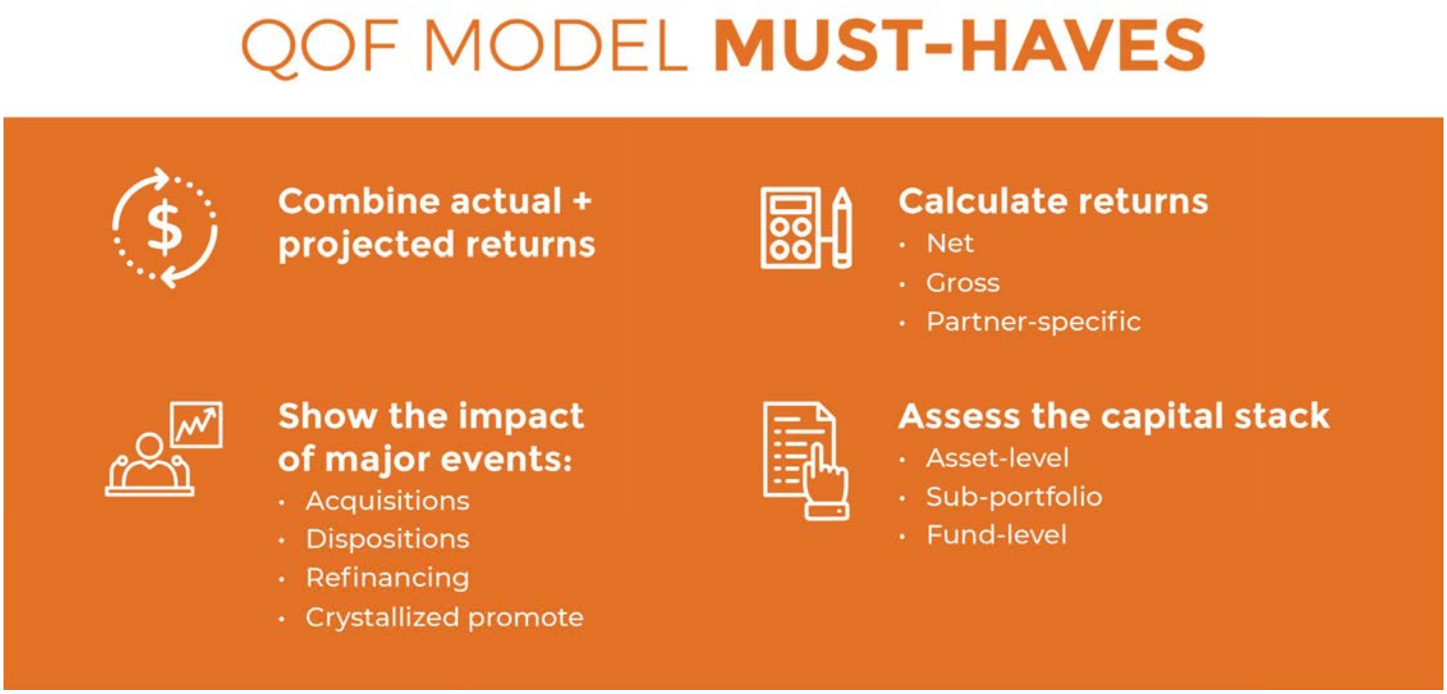
will be calculated based upon those numbers and everyone's share of the building's revenue and expenses will be adjusted accordingly. If there were any errors in the original model or supporting data, this is the last best chance to catch them. Otherwise, the errors will manifest themselves in the updated waterfall model and the promote numbers.
One of the best ways to catch errors in real estate financial models is by auditing them against the multitude of detailed reports that Excel and the leading DCF software platforms can generate.

Financial Modeling and Qualified Opportunity Zone Funds

Finally, sound financial modeling is essential at the fund level too. A good QOF model should have the flexiblity to combine actual and projected returns, and show the impact on the fund of individual property acquisitions and dispositions and major events like promote crystallization and refinancing.

A good QOF model also should have the functionality to calculate Net, Gross and partner-specific returns from the fund, as well as to assess the capital stack at the asset, sub-portfolio and fund level. Having access to that level of detail will help fund and asset managers maximize the returns on the assets they manage, and will give investors greater visibility into the fund, boosting their confidence in the fund and potentially spurring additional investment.

Anything less from your fund models, and you should consider updating or even completely rebuilding them. Or, to completely eliminate the work and guesswork, you can outsource the fund component of your modeling to a commercial real estate consultant that has extensive experience with Opportunity Zones and financial modeling, or use a pre-built Excel model created by an expert in real estate financial modeling.



A WIN-WIN-WIN

In sum, based on Realogic's extensive and ongoing work with Qualified Opportunity Zone projects, we're seeing Opportunity Zones and promote crystallization increasingly intertwined. Given the requirement that a property in a QOZ must be held for a minimum of 10 years in order for the owner or owners to receive the full tax breaks from the federal program, promote crystallization is a sensible way to bridge competing objectives of QOZ project sponsors, developers and investors.

Developers can receive their reward for delivering and stabilizing the building without having to wait the full 10 years or for a capital event and can move on to their next project. At the same time, the partnership retains ownership of the property for the full term, so investors who invested in the Opportunity Zone project primarily for the capital gains tax breaks receive the benefits they sought.

Because there are so many details involved in crystallized promote, and often many parties participating in the partnership or fund, it's wise to lay out the terms for the entire crystallized promote process in detail in the partnership agreement to avoid disagreements when the time comes to execute.

In addition, Opportunity Zone property valuations, equity waterfall models and opportunity term sheets should include scenarios where crystallized promote is used, so everyone involved in the project knows it will be considered and understands the financial impact upfront.

Done right, crystallized promote can be a win-win for Opportunity Zone developers, investors and funds. And, by eliminating or reducing potential barriers to investment and development in Opportunity Zones, those who live or work in Opportunity Zones benefit too. A commercial real estate deal where everyone involved benefits. *How can you not like that?*

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About The Author

Multiple members of Realogic's commercial real estate consulting and marketing teams collaborated on this eBook, each contributing their unique perspective, knowledge and insights. We welcome your comments, questions and feedback. You can reach us at **info@realogicinc.com**

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ABOUT REALOGIC

Realogic is a best-in-class commercial real estate consulting firm based in downtown Chicago. Our company was founded in 1992 and in the over 30 years since has developed a well-earned reputation for our unmatched commercial real estate knowledge, experience, skills and expertise, as well as for the unrivaled quality, integrity and accuracy of our work.

We offer a wide range of services, support and insights to help commercial real estate organizations of any type or size maximize the returns on their investments, including due diligence, underwriting, lease abstraction, lease administration, financial modeling, loan abstraction, closing support and commercial real estate training.

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