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Want to Invest in Opportunity Zones? Think P3.

Public-private partnerships may just be the secret to maximizing the enhanced benefits of this program for investors and local governments.

By now, everyone in commercial real estate have been deluged with notices from lawyers, accountants and consultants explaining the significant benefits of raising funds to invest in opportunity zones under the new tax law. And these notices are quite accurate. The tax benefits are significant, especially for investors with large capital gains or investors with long-time horizons (which basically describes everyone who invests in real estate).

However, many may wonder, after reading all these, how to put together a commercial real estate deal that will appeal to investors and leverage the opportunity zone tax benefits to enhance returns. The answer to this question is complicated and represents the biggest reason why—at least initially—the supply of dollars to invest in opportunity zones will exceed the number of available deals.

Why is this? Simply put, state governments chose opportunity zones for location in areas with chronically low employment rates and incomes. These areas are not traditionally appealing for investment. The basic idea of the major deferrals, reductions and eliminations of capital gains taxes in the new provisions is to get investors to build and create jobs in those zones. However, the practical side of finding real estate deals that can locate well in economically depressed areas remains significant.

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This is where public-private partnerships or "P3" arrangements can help facilitate deals. In the U.S., a large number of state and local governments have updated their laws to facilitate P3 deals. At their core, P3 real estate deals combine public and private assets into real estate facilities that serve public and private uses. The kinds of buildings in the P3 space right now include workforce housing, K-12 schools, higher education teaching and research facilities, government office buildings, sports facilities, public safety buildings and even speculative commercial office buildings that aim to attract private tenants in areas where governments want to see economic growth. Additionally, there is robust deal flow into heavy civil facilities, such as roads, bridges, ports and tolled highway lanes.

In trying to cobble together an economically viable real estate deal in tough geography, partnering with the public sector can be of significant benefit. First, it can ease—and in some cases subsidize—the cost of basic infrastructure that catalyzes growth, such as roads, transit, water/sewer, education and public safety.

Second, public sector users often can locate facilities in areas outside of class-A commercial zones. For example, having a new charter school, 50,000 feet of government office space or a new police precinct on a long-term lease provides a credit tenant that eases the burden of raising capital and attracting private sector users to an area. For more "commercial" government uses—such as research buildings, hotels, convention centers and sports arenas—the advantages are even more significant.

Finally, the opportunity zone law itself provides tax advantages that make private capital more willing to accept lower returns on a long-term lease or build to suit for a government use. Put differently, one of the big obstacles to P3 deal formation using private capital is the higher return it seeks, relative to public revenue or general obligation debt. In this scenario, the opportunity zone tax advantages enhance the return on capital, making rates compare more favorably to the cost of funds from other public sources.

The state and local governments that figure this out first, and put P3 deals on the table in opportunity zones, will be the ones that capture the early advantages from the new law. On the private-sector side, consider public-private partnerships an essential tool to help create an availability of real estate deals that will satisfy the coming demand from investors seeking to benefit from the new law.

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