



By Adam Bernstein

The o-zone imbalance

The overlooked opportunity in opportunity zones

When they introduced the Investing in Opportunity Act in 2017, Sens. Cory Booker (D-NJ) and Tim Scott (R-SC) described their opportunity zones program as “a new approach to connecting struggling communities with the private investment they need to thrive.” They indicated they hoped qualified opportunity funds formed to invest in OZs would prioritize investment in “local infrastructure projects” as well as businesses and real estate.

To date, the OZ program has not delivered on the senators’ aspirations for its ability to mobilize capital to meet the infrastructure challenges of our communities-of-greatest-need. According to recent data from Novogradac, 580 opportunity zone funds have raised about \$12 billion for investment in OZs through Sept. 1, 2020. Nearly all of this capital appears destined for real estate investments, with only \$320 million targeted for investments in infrastructure.

This isn’t for a lack of need. In 2017, the American Society of Civil Engineers gave the United States a nearly failing grade (D+) in its *2017 Infrastructure Report Card*. At the time, the organization estimated the country would need to invest \$4.6 trillion by 2025 simply to improve to a B grade of “adequate for now.”

Given these needs, why hasn’t more opportunity fund capital been earmarked for infrastructure? One reason is how differently the real estate and infrastructure investment management industries have responded to the OZ program. While many national real estate investment firms have formed large OZ funds, no infrastructure firms of a similar profile have so far attempted to do so.

At first glance, this may seem surprising. The OZ program provides private investors with certain capital gains tax benefits to incentivize long-term, location-specific investments, and OZ regulations provide clear guidelines for how investments in physical assets can comply. Therefore, the OZ program should be well aligned with the infrastructure asset class, which is defined by long-term, location-specific investments in physical assets that

deliver essential services to municipal, utility and business customers. However, many infrastructure managers have been skeptical of the program for several reasons:

- **Audience:** OZ funds generally require investors have a U.S. tax profile, while most infrastructure managers primarily serve the needs of large pension funds and other institutional investors seeking long-term, liability-matching investments. As tax-exempt entities, pension funds typically cannot easily benefit from the OZ program’s tax incentives.

- **Asset profile:** Regulations make it difficult for OZ funds to invest in the stable operating assets preferred by core infrastructure buyers; rather, the program is best suited to investing new construction projects or existing assets requiring substantial improvement through large capital expenditures. Plus, the idiosyncratic contours of the OZ map, dictated by federal census tracts and various state economic development policy objectives, does not easily lend itself to large-cap infrastructure investments, particularly in popular sectors such as communications, midstream energy or transportation, where assets can frequently span large geographic footprints.

- **Scalability:** The above factors have led many infrastructure firms to be skeptical an OZ strategy could absorb \$1 billion or more of asset growth, and are hesitant to expend the upfront structuring costs and allocate internal resources to raise dedicated OZ funds.

However, an infrastructure-focused opportunity zone strategy can make sense provided it is targeted to U.S. taxable investors with realized capital gains looking to avail themselves of the OZ tax benefit — and that it emphasizes smaller greenfield projects, particularly in power, waste, water or other asset types where smaller project footprints may fit more easily within the boundaries of specific OZs.

THE CASE FOR WASTE

One area of opportunity for OZ infrastructure investors is environmental infrastructure. In 2017, the American Society of Civil Engineers gave poor grades to America’s



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waste, wastewater and water infrastructure, identifying a \$108 billion funding shortfall through 2025. Much of this investment is needed to repair or replace outdated infrastructure built in the mid-20th century.

Since then, population growth and internal migrations have transformed U.S. demography and the country's municipal infrastructure needs. For example, significant investment in municipal wastewater treatment facilities followed the passage of the Clean Water Act in 1972, but at the time the U.S. urban population had been stagnant for more than a decade and this factored into capacity planning decisions. Since the 1980s, migration back into cities has dramatically boosted U.S. urban population and the EPA forecasts another 56 million new users will tap into U.S. wastewater systems over the next 20 years.

These and other demographic trends are straining aging and/or capacity-constrained municipal infrastructure at a time when the United States has been “chronically under-investing” in these systems, and “lagging” federal support has placed added pressure on budget-constrained state and municipal governments.

According to the EPA, wastewater treatment is a leading source of methane emissions, accounting for 2 percent of the U.S. total between 1990 and 2017; but this pales in comparison to the methane produced by agricultural waste (36 percent) and landfills (17 percent).

Agricultural waste includes biomass, inedible crop waste and livestock manure, which can produce myriad environmental issues, including methane emissions, if not dealt with responsibly. Landfills receive 50 percent of America's nearly 300 million tons of municipal solid waste each year and more than half of what ends up in landfills is food waste. Like agricultural waste, food waste is a leading source of methane when it degrades. Methane represented about 10 percent of total U.S. greenhouse gas emissions in 2017, but the EPA notes the compar-

ative impact of methane is “25 times greater than CO₂,” underscoring the need to address these emissions.

An increasing number of state and local governments are now moving to tighten waste regulation amid growing awareness and concern about landfill capacity and methane production. Such state and municipal waste mandates, as well as corporate sustainability goals, are driving the need for new infrastructure that harnesses agricultural, landfill and liquid waste to produce renewable fuels, clean power and recycled materials.

For example, waste methane from agriculture, landfills and wastewater can be captured and processed into renewable natural gas or utilized to produce electricity; yet, fewer than 1,000 of America's nearly 14,000 active and legacy landfills have gas-capture facilities today, and less than a quarter of America's municipal solid waste is diverted to power generation facilities.

Many landfills sit within opportunity zones, and while the historical factors contributing to this are coming under increasing scrutiny, responsible investment activity can be aimed at improving these sites, remediating environmental threats, and adding to the local tax and employment base.

CONCLUSION

The United States needs significant capital investment in its infrastructure to remain globally competitive. Much of this infrastructure is required to serve local needs for essential services and solve major challenges. Small project sizes require middle-market solutions and the opportunity zones program is a compelling financing tool available to project developers and their municipal, utility and business customers. ■

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