DelCam Holdings, LLC

OPPORTUNITY ZONE OPERATING BUSINESSES:
PRIVATE EQUITY RETURNS WITHOUT THE TAX BILL

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INTRODUCTION

By now, we assume that most financial professionals have at least heard about Opportunity Zones and have a basic understanding of the tax benefits of investing in a Qualified Opportunity Zone Fund (QOF). As a result, this white paper is intended to provide a brief overview of Opportunity Zone basics as a refresher, and to get in to more advanced Opportunity Zone related topics around investing in Opportunity Zone businesses to keep the conversation moving forward as this innovative Federal program gains momentum.

As of this writing in August 2019, based on information tracked by Novogradac's Opportunity Zone Resource Center, only 7% of QOFs are focused on operating businesses. In order to achieve the full spectrum of economic and social benefits of the Opportunity Zone program, we believe developing operating businesses is the critical success factor for permanent improvement of undercapitalized communities and the best way for investors to achieve superior returns.

WHAT IS A QUALIFIED OPPORTUNITY ZONE FUND (QOF)?

A QOF is an investment vehicle that is set up as either a partnership or corporation for investing in eligible property or businesses located within Qualified Opportunity Zones. If you don't know what Opportunity Zones are by now, your clients will thank you for learning about them as there are significant tax benefits associated with the investment. There are 8,764 Opportunity Zones across the country that are ripe with investment potential for real estate property and operating businesses and there are hundreds of QOFs available for private investment.

A QOF can invest directly in qualified Opportunity Zone property or it can invest in subsidiaries that invest directly into qualified Opportunity Zone property. The investments made in a QOF can be any type of equity investment, however, in order to achieve the full tax benefits of investing in an Opportunity Zone, the investor should allocate capital gains that have been realized within the past 180 days.

HOW DOES OPPORTUNITY ZONE INVESTING WORK?

DEFER
Capital gains tax liability until the earlier of investment exit or Dec 31, 2026.

REDUCE
The tax you owe by up to 15% after 7 years.

EXCLUDE
Tax on gains earned from the Opportunity Fund.

THE TAX BENEFITS OF INVESTING IN OPPORTUNITY ZONES

The Opportunity Zones program offers three tax benefits to stimulate investments into low-income communities through a qualified Opportunity Fund.

1. A temporary deferral of inclusion in taxable income for recently realized capital gains reinvested in an Opportunity Fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026.

2. A step-up in basis for capital gains reinvested in an Opportunity Fund. The basis is increased by 10% if the investment in the Opportunity Fund is held by the taxpayer for at least 5 years and by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation.

3. A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Fund if the investment is held for at least 10 years. This exclusion only applies to gains on holdings in an Opportunity Fund.

The graphic below demonstrates the capital gains tax benefits of investing in a QOF for 10 years versus a traditional investment yielding the same annual rate of return.

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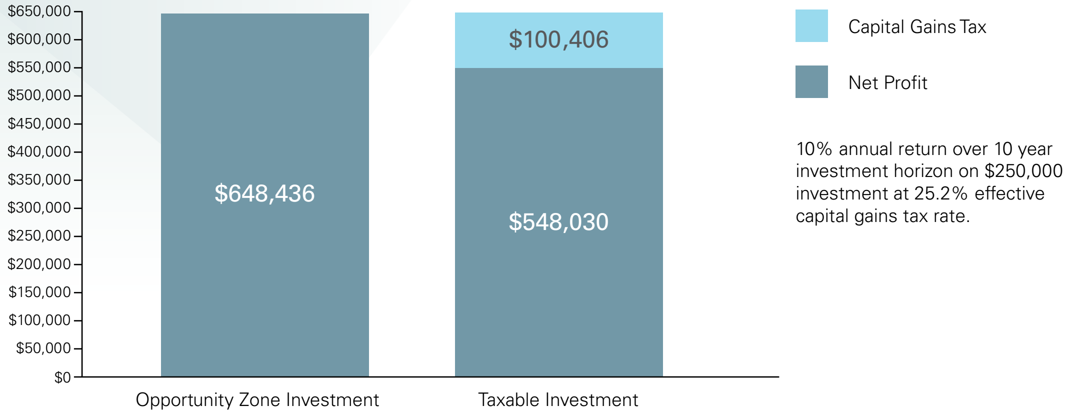
OPPORTUNITY ZONE CAPITAL GAINS TAX BENEFITS



BENEFITS OF INVESTING IN AN OPPORTUNITY ZONE BUSINESSES VS. REAL ESTATE

In contrast to most Real Estate Opportunity Zone funds, we believe there is a more attractive return and social profile by investing in QOFs that focus on operating businesses. Currently, based on information tracked by Novogradac's Opportunity Zone Resource Center, 93% of QOFs invest in Real Estate. This imbalance underscores the need to drive more investment toward QOFs focused on operating businesses in order to realize the full potential of the Opportunity Zone program.

Real estate transactions will undoubtedly create jobs in the short term during the construction phase and potentially some ongoing jobs related to property management and maintenance. However, operating businesses will create long term and permanent jobs at a rate significantly higher than a stand-alone real estate project. This is one of the key differentiators from a social perspective.

Moreover, the return profile of an operating business can be quite lucrative compared to a real estate investment with no ceiling on the growth potential of a business. Whereas an individual piece of real estate is limited to the finite improvements that can be made to a physical and confined property. Lastly, the possibility of market saturation with real estate investments in Opportunity Zones is real. A concentrated supply of real estate will hit the market after the 10-year Opportunity Fund hold period that could lower investor returns, subsequently making property a riskier investment than an operating business which likely will not have competitors in close proximity.

OPPORTUNITY ZONE OPERATING BUSINESSES OFFER MORE FLEXIBILITY THAN REAL ESTATE

Although the substantial improvement of a Qualified Opportunity Zone Business (QOZB) presents a greater challenge than the substantial improvement of real estate, we believe operating businesses allow for more flexibility as an investment for three key reasons:

1) As long as the majority of the QOZB (at least 50%) occurs within the Opportunity Zone an operator could have a business with multiple locations inside and outside of an Opportunity Zone. 50%+ of the gross receipts of a qualified Opportunity Zone business (QOZB) must be attributable to income from an active business within an Opportunity Zone. Additionally, hours worked, and employee compensation must be at least 50% inside the Opportunity Zone. What this means is that 49.9% of the business can happen outside of the Opportunity Zone while still meeting the program's qualifying criteria. A portion of a contiguous parcel of real estate can be outside of an Opportunity Zone border as long the

majority of the land area is within a zone. The important difference is that a contiguous real estate parcel is physically demarcated according to boundaries, whereas 49.9% of a business can be de-coupled and operated anywhere in the country. This flexibility opens up interesting possibilities for investors to acquire minority businesses outside of Opportunity Zones while maintaining QOZB status.

2) An operator can move a business that is currently located outside an Opportunity Zone into an Opportunity Zone, which increases the number of businesses available to an investor. This is more likely to work with smaller businesses, as a small business may be more mobile. This effectively deems that any business in the country could become a QOZB. The point being that mobility is not an option for land parcels, while businesses can be relocated.

3) A QOZB is not required to own the real estate where it operates its business, which can eliminate the need to "substantially improve" the real estate and thereby allow the Fund to conserve capital that it would otherwise be required to invest to improve the physical property. Substantially improving businesses with relatively low tangible assets becomes more economically feasible when the business is measured exclusive of the value of the property it occupies.

HOW PERTINENT OZ RULES WOULD BE APPLIED TO AN OPERATING BUSINESS DEAL

As mentioned previously, the structuring of a QOZB deal can be slightly more complex than structuring a real estate transaction as the rules and testing are easier to define with a simple real estate acquisition. As a result, we have seen a lack of willingness on the part of managers to pursue QOZB deals. However, with the right accounting team and ongoing oversight and compliance, managers can ensure they are playing by the Opportunity Zone rules and maximize returns for LPs.

In the below hypothetical example (see diagram):

1) A manager starts a $10M Qualified Opportunity Zone Fund and purchases two businesses, the "Subsidiaries".

2) The QOF must invest 90% of the funds in to the subsidiaries, which subsequently must invest 70% of the funds from the QOF into the operating business.

3) The QOF retains 10% ($1M) for working capital and cash reserves.

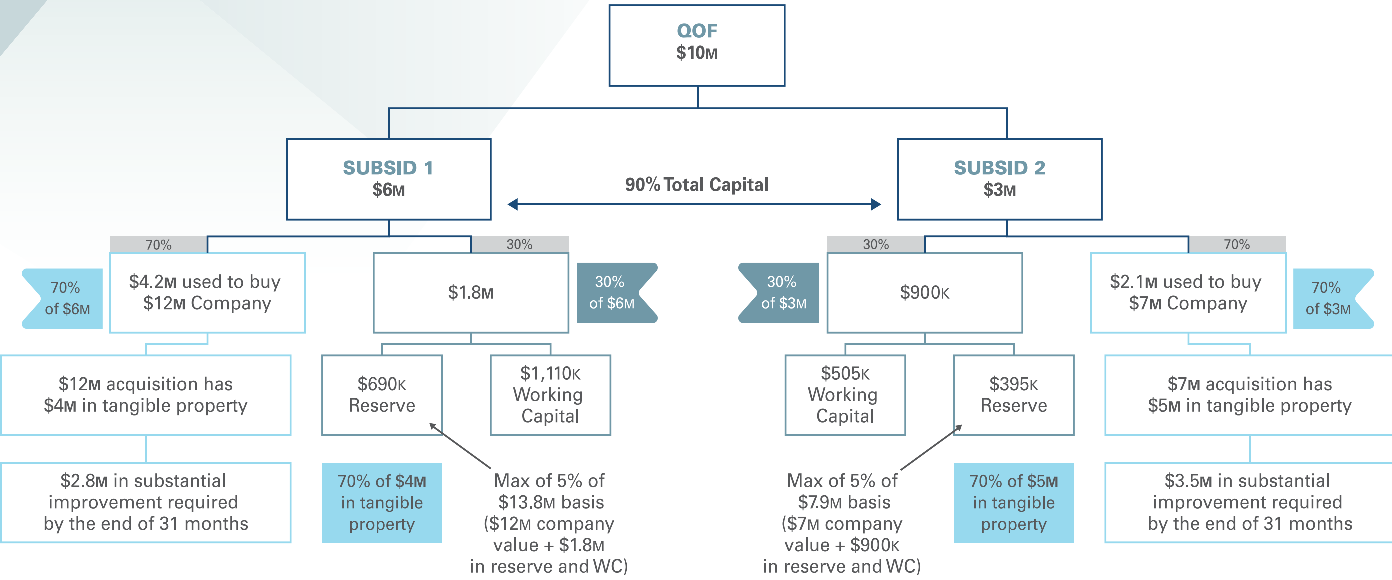
4) The QOF deploys $6M of its $10M in capital to one investment ("Subsid 1" in this example).

5) The QOF purchases a $12M operating business with 65% leverage, utilizing $4.2M (70%) of the $6M in capital deployed to Subsid 1.

6) The remaining $1.8M (Original $6M, less the equity investment of $4.2M) can be used for working capital, including up to 5% of the basis ($13.8M) or $690k can be held in cash reserves.

7) Subsid 1 has $4M in tangible assets. As a result, in order to comply with Opportunity Zone rules, the manager must improve 70% of the tangible assets, or in this case $2.8M. Although the current Opportunity Zone guidance suggests each specific tangible asset needs to be improved by 70%, we believe this will move toward an aggregate method of accounting for the improvements resulting in the need to add $2.8M in improvements at the total tangible asset level. This level of investment can happen quite quickly in an industry like manufacturing where advanced manufacturing equipment can cost upwards of $1M for a single machine.

8) See "Subsidiary 2" for a similar example with different capital levels.



MAKING A SOCIAL IMPACT ABSENT THE REQUIREMENT TO EVALUATE DEALS ON AN ESG BASIS

Inherent in an QOZB investment is an impact or social component, as the substantial improvement requirement dictates that the owner must invest additional capital into the business post-acquisition. Economically speaking, this investment in infrastructure will improve productivity resulting in revenue growth and stimulating job creation. Increasing employment in a community has well documented positive effects on quality of life, crime statistics and property values.

Often screening of public companies according to ESG factors can eliminate a significant portion of an investment universe. This narrowing of the field can prevent managers from selecting an optimally performing portfolio. Further, passive managers have no control over the way the business they own is run. Fortunately, Opportunity Zone investments are not subjected to this screening paradox. Active owner/operators can exert complete control over the business decisions of the portfolio companies and have the unique ability to instill ESG values as part of the company culture. In summary, an impact investment is made simply by investing in a QOF focused on operating businesses, this reality is enhanced when managers have active control to make triple bottom line business decisions.

HOW TO SOURCE DEALS IN OPPORTUNITY ZONES

Sourcing deals in Opportunity Zones can take several forms depending on the investment strategy. Sophisticated managers have developed their own proprietary processes for identifying potential deals across real estate and operating businesses.

Real estate investors either buy existing properties with the intention of improving them for residential or commercial purposes or purchase undeveloped land and build to suit. Irrespective of the decision to rehab or start from scratch the investor must locate available properties physically located within the boundaries of designated Opportunity Zones. The investor can rely on brokers to present potential properties, search online databases, or physically prospect by exploring designated tracts in person. Demographic and zoning considerations must be taken into account and depending on the final purpose of the property other factors must be considered like ground and water contamination, proximity to schools, traffic and highway access, and moreover a qualitative analysis must be made regarding the speed at which the rest of the Opportunity Zone will be improved.

For investors acquiring operating businesses the process shares some of the aforementioned factors, but adds layers of complexity with respect to executing comprehensive due diligence research of the prospective acquisition. An important variant is that operating businesses can be relocated into Opportunity Zones. An investor who identifies an attractive business that is situated outside of a designated Opportunity Zone may acquire the business and relocate it to within an Opportunity Zone's boundaries and fully comply with the guidelines of the program. There are risks involved in this strategy, primarily revolving around the potential loss of human capital if the move covers a substantial distance.

As with real estate deals, the investor may rely on business brokers or investment bankers to identify and propose opportunities. In addition, investors will likely categorically screen online business listings by sector, revenue and profitability metrics, size of the workforce, whether the employees are unionized, and other important variables that affect the most significant determinant of value; the acquisition price.

Whether the investor decides to go the real estate or the operating company route, Qualified Opportunity Zone funds have the potential to acquire multiple assets creating a diversified portfolio or a single asset resulting in a concentrated portfolio. The benefits of diversification as a means of risk mitigation are well documented.

CONCLUSION: JUST LIKE TRADITIONAL PRIVATE EQUITY WITH THE ABILITY TO EXPLOIT SIGNIFICANT TAX BENEFITS

Funds that acquire operating businesses are required to make "substantial improvements" to the asset. As stated, the dollar value of the improvements must be at least equal to 70% of the tangible value of the acquisition. While substantial improvements are required to comply with the Opportunity Zone regulations, the objective of any private equity manager is to create value around the acquired asset. Consequently, the expected return profile of Opportunity Zone Funds and traditional private equity funds should be comparable; with the distinct exception being the significant tax advantages uniquely available to Opportunity Zone Funds.

Further, there is ample evidence to suggest that smaller private equity funds outperform their larger peers for both systematic and idiosyncratic reasons. The larger the asset base of the fund the more difficult it is for the manager to allocate the fund's capital because there are fewer companies able to absorb sizable investments. Moreover, larger target companies often carry higher valuation multiples leaving a shorter runway for future profits.

In addition to the larger menu of potential targets available to smaller funds, there is relatively less competition among smaller funds for acquisitions, so the values of the targets avoid being bid up in price. From an institutional perspective, there is considerable evidence supporting the thesis that first-time managers outperform their larger and more established peers. Reasons for this relative outperformance are that emerging managers are extremely focused on establishing a strong track record of profits and a successful first fund. On the other hand, larger funds tend to lose sight of their initial vision, becoming complacent and distracted by asset gathering, lining up the next fund, and other external forces that move the managers' attention away from managing the fund and the portfolio companies.

According to NAICS there are approximately 14.6 million small businesses in the United States with less than $10 million in revenue. Our conservative estimates project there are at least 500,000 small businesses located in Opportunity Zones that are ripe for investment. There exists an interesting opportunity in that the competition to acquire many of these businesses, even successful ones, is not intense. Sub-ten million revenue companies fly below the radar of larger financial sponsor groups. Additionally, the number of small private equity investors pales in comparison to the number of small businesses available for sale.

We believe that these dynamics present an extremely compelling investment landscape for intrepid investors who execute a focused and disciplined Opportunity Zone strategy.

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