APPLETON PARTNERS, INC.

OPPORTUNITY ZONES: AN IMPETUS FOR MUNICIPAL CREDIT ENHANCEMENT

TARGETING UNTAPPED OPPORTUNITY

An economic development incentive from 2017's federal tax reform has received increased media and investor attention in recent months. Opportunity Zones, created to attract private capital to areas that otherwise might not have been as economically viable, have the potential to help revive communities that commercial and residential development have long largely bypassed. Although not part of the public finance market, investors in municipal bonds may still indirectly benefit, as increased private investment has the potential to spark economic activity, attract businesses and residents, and bolster an issuer's tax base and credit quality. Below we discuss what qualifies as an Opportunity Zone, outline guidelines for investing, and highlight where we see the greatest potential portfolio impact.

WHAT IS AN OPPORTUNITY ZONE?

Opportunity Zones were created by the 2017 Tax Cuts and Jobs Act to promote private capital investment and economic growth in distressed communities. According to an October 19, 2018 article in the Wall Street Journal, "the program has bipartisan roots and Congress deliberately created an open-ended program with few restrictions, with the idea of relying on market forces and the new tax incentive to guide development." Governors of all 50 states and five territories were tasked to identify communities that would benefit from designation as an Opportunity Zone.

On June 14, 2018 the IRS released a list of qualified Opportunity Zones, identified by their census tract number. The list encompassed 8,700 tracts covering 12% of the U.S. land mass. Concentration varies among states based on size and socioeconomics. As examples, nearly all of Puerto Rico (861 tracts) was designated as an Opportunity Zone, whereas the County of Los Angeles had 274 distinct qualifying tracts.

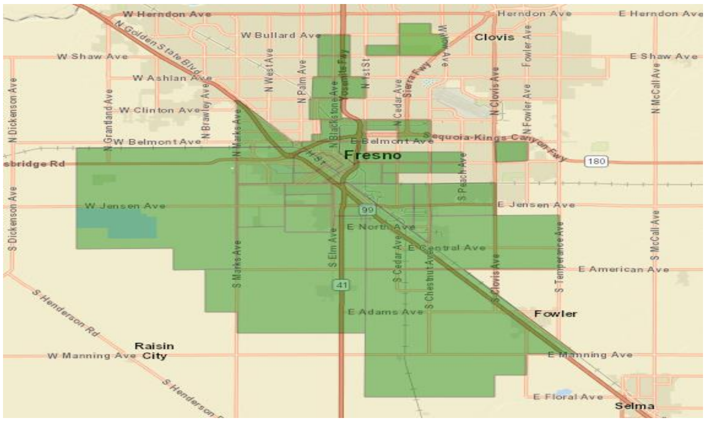
Opportunity Zones are in both rural and urban settings, and there is at least one in each major city. Although rates of poverty and unemployment are materially above average, the nomination process also allowed for 5% of tracts to be non-Low-Income Communities so long as the tract was adjacent or contiguous to a Low-Income Community.

Largest Urban Opportunity Zone Concentration

Location	Opportunity Zones	Census Tracts	Concentration Level
Macon, GA	15	36	42%
Albany, GA	10	25	40%
San Bernardino, CA	17	56	30%
Columbus, GA	16	53	30%
Baton Rouge, LA	20	67	30%
Fresno, CA	36	126	29%
Dayton, OH	18	64	28%
Augusta-Richmond, GA	13	47	28%

Source: U.S Department of the Treasury

Fresno Offers a Multitude of Opportunity Zones



Source: California Department of Finance

INVESTMENT GUIDELINES

To qualify for favorable tax treatment, an investment in an Opportunity Zone must be made by a Qualified Opportunity Fund in the form of purchase of property or an equity investment in a business. The property must receive additional investment to "substantially improve", while a qualified business must have at least 70% of its tangible property in the Opportunity Zone.

Any person or entity (corporation, REIT, trust, etc.) that is a U.S. taxpayer is eligible to make an investment in a Qualified Opportunity Fund. However, per the U.S. Treasury and IRS, only proceeds from the sale of an asset subject to capital gains are permitted to be invested in these Funds.

The principal financial incentive for investors is that capital gains taxes on Qualified Opportunity Fund investments can be deferred for up to eight years (through December 31, 2026) and the basis reduced by up to 15% if invested for more than seven years. In addition, if the investment is maintained for up to 10 years, any appreciation of the Qualified Opportunity Zone investment can avoid capital gains taxes.

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POTENTIAL IMPACT ON MUNICIPAL ISSUERS

It's important to emphasize that Opportunity Zone investments are not municipal securities, and the success or failure of Opportunity Zone Funds will likely take years to manifest. The IRS will not even begin reporting on these special purpose fund operations until 2022, given the potentially long construction and investment timetables associated with major redevelopments.

However, the ability of municipal securities investors to "tag-along" with these investments is already present. As capital flows into Opportunity Zones, we are actively looking for localities with the best prospects for new business development, upward pressure on property values, and growth in population and wealth. Should this occur, tax-exempt investors could benefit from future credit quality enhancement by owning the General Obligation bonds of the "parent" municipality in which targeted Opportunity Zones are located, be they city, town, county, school district, or other issuers.

OUR SEARCH FOR VALUE

As always, careful credit selection is imperative. At Appleton, we are active, research-driven managers, characteristics that can be of considerable value in a $3.8 trillion municipal market featuring more than 50,000 distinct issuers and approximately 1 million outstanding bond issues.[1]

We believe the most attractive Opportunity Zone investments are likely to involve property rather than new business ventures and favor urban centers with a greater ability to cluster investments. Although these designated areas typically exhibit below average incomes and elevated unemployment levels, many are located within diverse and economically stable cities. We are less optimistic about smaller, more rural markets.

Our outlook for Opportunity Zone development aligns well with a longstanding investment preference for large, well-established local governments. Weeding through Opportunity Zone tracts early in their evolution offers our research team an ability to identify municipal issuers with overlooked future credit prospects, thereby planting the seeds for potential attractive risk-adjusted returns.

1. Municipal Securities Rulemaking Board, March 2019

A LOOK AT PHILADELPHIA

Despite being home to some of the nation's most prestigious educational and healthcare institutions, Philadelphia's per capita income is only 79.6% of the US average, and its poverty rate of 25.8% remains stubbornly high[2]. In our view, Opportunity Zone development holds significant promise for several reasons.

82 Census Tracks within the City have been designated as qualified Opportunity Zones, many of which are clustered closely together, thereby creating more favorable conditions for economic development. Through the non-profit Philadelphia Industrial Development Corporation, the City has put in place the administrative infrastructure needed to encourage and guide Opportunity Zone capital investment.

Furthermore, Philadelphia's credit currently trades at a discount to many peer cities, in part due to volatile and sometimes underperforming tax revenues. A stronger tax base and revenue generation would create a healthier financial foundation, potentially leading to credit rating upgrades and spread tightening.

2. U.S. Census Bureau

**This commentary does not serve as an advertisement or recommendation to invest in Opportunity Zones. In addition, the tax implications described are only hypothetical and questions regarding specific tax implications should be directed to a qualified tax expert.*

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