NEIGHBORHOOD ALLIES

A Brief on Community Development Finance

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Community development finance is a complex, legacy investment system that has evolved over the past several decades to support projects in low- and moderate-income (LMI) communities that would otherwise have difficulty accessing capital due to various financial limitations. Small businesses, commercial revitalization in low-income communities, affordable housing, and community facilities all benefit from the current system. However, significant limitations remain, and projects frequently face long delays in securing all their necessary capital or stall entirely.

This brief focuses on the current dynamics of the community development finance system with a particular focus on how projects attract and structure equity and debt, in service to LMI communities. It begins with an overview of conventional real estate finance. It then contrasts the conventional system with community development finance, and details the various financial solutions and workarounds that are in place. It ends with a brief discussion of emerging trends and solutions.

Conventional Real Estate Finance

Developers typically begin the financing process by organizing and securing the equity necessary to make the project work. Development projects often have multiple investors that are offered common conditions and returns. Smaller developers will turn to families, friends, and others in their personal networks to find investors, while larger ones may access institutions and capital markets, such as real estate investment trust (REITs), family offices, or private equity firms.[1]

Equity investors receive returns on their investments in two ways. First, net operating income from the property is a source of periodic, steady cash flow that is distributed to investors. Second, property appreciation, through the value-add of development and/or the longer term increase in real estate value, grows an investors' equity position. This second return is realized at property sale, or if the project's initial debt can be refinanced and increased to convert equity into cash.[2]

Developers also use their own, personal resources as a source of project equity. These funds are particularly useful at the very earliest, due diligence stage to ensure a project is feasible before approaching investors. However, unlike outside investors, a conventional developer often receives their most significant return through the one-time development fee, as well as the so-called "sponsor promote." A sponsor promote is a disproportionate share of profits that are paid to the developer (usually after the equity investors have received some baseline level of return) that serves as an incentive to maximize asset performance.[3]

When equity is properly structured, experienced developers with sound projects can attract debt financing relatively easily. The commercial real estate financing market is robust, with banks competing to win business. Because interest rates are lower than the returns demanded by investors, developers are incentivized to maximize project debt. The typical real estate project loan is 75-80% of the as-completed, appraised value of the property. The appraised value will almost always be at least as much as the total cost of the project.

Both equity investors and banks are, of course, more likely to invest in projects led by developers with a track record of performance. Real estate financing is often relationship-driven and reputation-based. As a result, the development industry can be difficult to break into and diversify: 75 percent of real estate executives are White men.[4]

Differences and Challenges in Community Development Finance

The dynamics of community development finance are similar to those in conventional real estate finance, but they produce entirely different results due to the entities, locations, and history involved. Community development is typically led by community-based nonprofit organizations or neighborhood residents. They are, inherently, not profit motivated, and they lack the resources and relationships necessary to build project equity. Property values in low-income neighborhoods are depressed, and any future appreciation is uncertain. Perhaps most importantly, the legacies of property seizure, redlining, and systemic racism (in communities of color) and the erosion of manufacturing and similar employment (in low-income communities writ-large) have not been sufficiently remedied.

Community development projects have difficulty attracting and supporting debt. In weaker markets, rental income is inherently lower while operating expenses are comparable. Less net operating income means periodic debt service payments must also be lower.

Lower property values also negatively impact financing prospects in community development. As noted above, banks will typically lend no more than 80 percent of a project's appraised value. However, unlike conventional real estate projects, community development projects total costs often *exceed* the final appraised value. As a result, community developers must not only raise equity for the 20-percent share required by banks, they must find sources to cover the portion of project costs that exceed its appraised value.

Community developers are left with no choice but to tightly manage projects costs. Projects rarely meet the same design standards or material and finish upgrades as conventional projects. More perniciously, community developers also often cut necessary costs that affect a project's overall strength. Projects rarely receive enough funding to capitalize appropriate reserves. Energy efficiency upgrades that require up-front investment but result in long-term savings are rare. Developers commonly sacrifice all or a portion of their developer fee, whether as a cost-saving measure or at the demand of a funder. As a result, community development is more difficult but less financially rewarding than conventional real estate development.

The Importance of Appraisals

The appraisal industry is a critical player in real estate finance. Appraisals are a key driver of bank decision-making and, in turn, affect the amount of equity required to complete a project's budget. In strong markets, appraisals are a generally reliable measure of property value, as appraisers will have numerous comparable properties of similar size, use, and building age to examine.

However, in community development finance, the appraisal process is fraught. Appraisers may have too few comparable properties from which to choose, especially when the subject property is attempting to become a catalyst for additional neighborhood development, as is often the case. Appraisals can be particularly unreliable in communities of color, where there is ample evidence of bias that unfairly depresses property value.[12]

Existing Solutions in Community Development Finance

The financial challenges facing community developers are not new. For decades, policy makers, the philanthropic community, and institutional and civic leaders have developed tools that have improved access to capital, either directly or by incentivizing the private market.

Perhaps the most significant policy intervention is the Community Reinvestment Act (CRA). The CRA was passed in 1977 to address banks' historic practice of redlining – refusing to extend credit in certain neighborhoods based on race or ethnicity. Under the CRA, federal regulators assess banks on whether and how their products benefit LMI communities. Qualifying activities can include mortgage, consumer, and business lending, community investments, and low-cost financial services.[5]

The CRA spawned an entire new and innovative sector of community development financing. In addition to bank departments that are focused on meeting the law's requirements, Community Development Financial

Institutions (CDFIs) emerged as a solution to support banks, organize capital, and build trust and make an impact in LMI communities. Banks can earn credit under the CRA for making investments into CDFIs. CDFIs then invest (typically in the form of loans) in communities, with a variety of purposes including home mortgages, small business loans, affordable housing and commercial real estate finance, charter schools, health care centers, and many others.

Current Sources of Community Development Finance Capital: Strengths and Limitations		
	Strengths	**Limitations**
Bank CRA Programs and CDFIs	Can support large projects; market-oriented and responsive	Debt needs to perform almost immediately; dependent on project cash flow and LTV
Tax Credit Programs	Designed to replace project equity at scale	Highly complex and only workable >$5 million; highly competitive
Government Programs	Often comes in the form of grants; often targeted at communities most in need of investment	Highly competitive; typically funded on a reimbursement basis; often "last dollar in"; may require political connectedness
Philanthropy	Typically comes in the form of grants; strongly aligned with community goals	Limited amounts and competitive; difficult to structure for for-profit entities

While the CRA, in theory, levels the playing field moving forward, LMI communities still experience funding challenges stemming from decades of blight, disinvestment, and population and job loss. In the late 20th century, tax credit programs evolved as a direct way to address equity shortfalls for community development projects. Most notably, the Low Income Housing Tax Credit, which supports the construction and preservation of affordable housing, and the New Markets Tax Credit, which supports primarily commercial development activity in LMI areas, allow banks and other institutions to invest equity into projects in return for a reduction in their federal tax liability. For community development projects, NMTCs can result in an equity contribution up to about 30 percent of projects costs, and LIHTCs about 50 percent.[6]

Even projects that successfully layer debt and tax credits are often still reliant on grants to close funding gaps. State and local governments have numerous grant and low-cost loan programs that support capital projects, and they have become essential players in community development financing. Similarly, foundations and, in some cases, corporate donations are often important sources in for community development projects. Foundations in particular can be a vital source of early or acquisition capital.

Emerging Solutions and Trends

Despite the numerous sources of flexible debt, tax credit equity, and grant funds available, community development projects still struggle to reach completion. Community development practitioners are creating new and innovative solutions that directly address the biggest remaining financial challenge: accessing early stage, equity or equity-like capital that can accelerate projects, attract debt, and ensure the project starts on sound financial footing.

Guarantees – whereby a third-party co-signs the debt of a borrower in order to strengthen a project's financials and induce a lender to offer credit – are increasingly being used as an innovative community development finance tool. The Community Investment Guarantee Pool began as a $33 million fund managed by LOCUS Impact Investing that guarantees loans in affordable housing, small business, or development that addresses climate change.[7] Projects the pool has supported have leveraged up to 10 times the guarantee amount.[8] In Pennsylvania, the state housing finance agency has set aside $10 million for a Developer Opportunity Fund that will provide guarantees to women- and minority-led development firms that are trying to access the LIHTC program for the first time. Details of the fund are still under development, but advocates expect the fund to support $175 million in new affordable housing development.

Mission-driven investors are also experimenting with direct equity investments into a project. Enterprise Community Partners, a national CDFI, is a leader in this space. They offer unsecured lines of credit to minority-led development firms unrelated to any specific projects in order to give them the flexibility and capacity to explore and start new projects.[9] They also offer direct investment into certain affordable housing projects, taking an equity stake in joint partnerships of up to $20 million.[10]

Finally, industry leaders are increasingly recognizing the need for and value of cross-sector collaboration for the purpose of building a stronger, more equitable community investment systems. For example, the Center for Community Investment (CCI) organizes members of the nonprofit, philanthropic, and institutional communities with the goal of aligning projects to regional priorities and unlocking new sources of capital. CCI emphasizes their Capital Absorption Framework, which centers on cultivating a pipeline of quality, investable projects. They have been a national leader in driving health care systems to invest in community development activity that affects health, including affordable housing.[11]

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[2] *Ibid.*

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[10] "Preservation Equity," Enterprise Community Partners, available at: enterprisecommunity.org/capabilities/preservation-equity

[11] "Accelerating Investments for Healthy Communities," Center for Community investment, available at: https://centerforcommunityinvestment.org/our-work/initiatives/accelerating-investments-for-healthy-communities/

12 "Get Informed," PAVE Interagency Task Force on Property Appraisal and Valuation Equity, available at: pave.hud.gov/getinformed