Policy Brief: Closing the Capital Gap for Emerging Small-Scale BIPOC Developers

By Ahmad Abu-Khalaf

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Enterprise

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About the Author

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Enterprise

About Enterprise Community Partners

Enterprise is a national nonprofit that exists to make a good home possible for the millions of families without one. We support community development organizations on the ground, aggregate and invest capital for impact, advance housing policy at every level of government, and build and manage communities ourselves. Since 1982, we have invested $54 billion and created 873,000 homes across all 50 states – all to make home and community places of pride, power and belonging. Join us at enterprisecommunity.org.

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Enterprise's Policy Development & Research team provides thought leadership and data-backed recommendations to influence housing and community development policy, addressing both emerging policy issues and long-term needs. Read reports and policy briefs by the team (https://www.enterprisecommunity.org/capabilities/policy) and follow us on Twitter @E_HousingPolicy.

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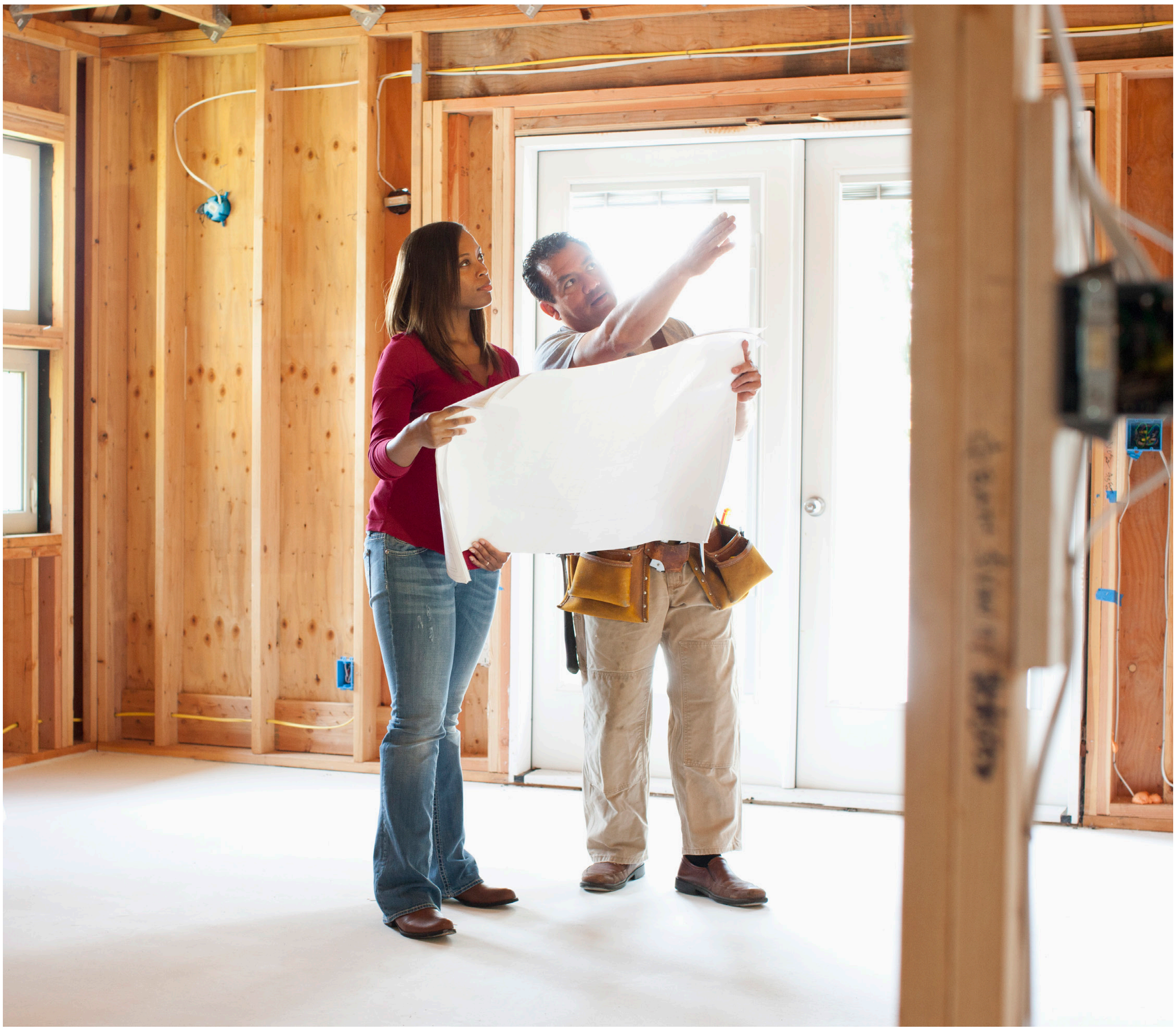
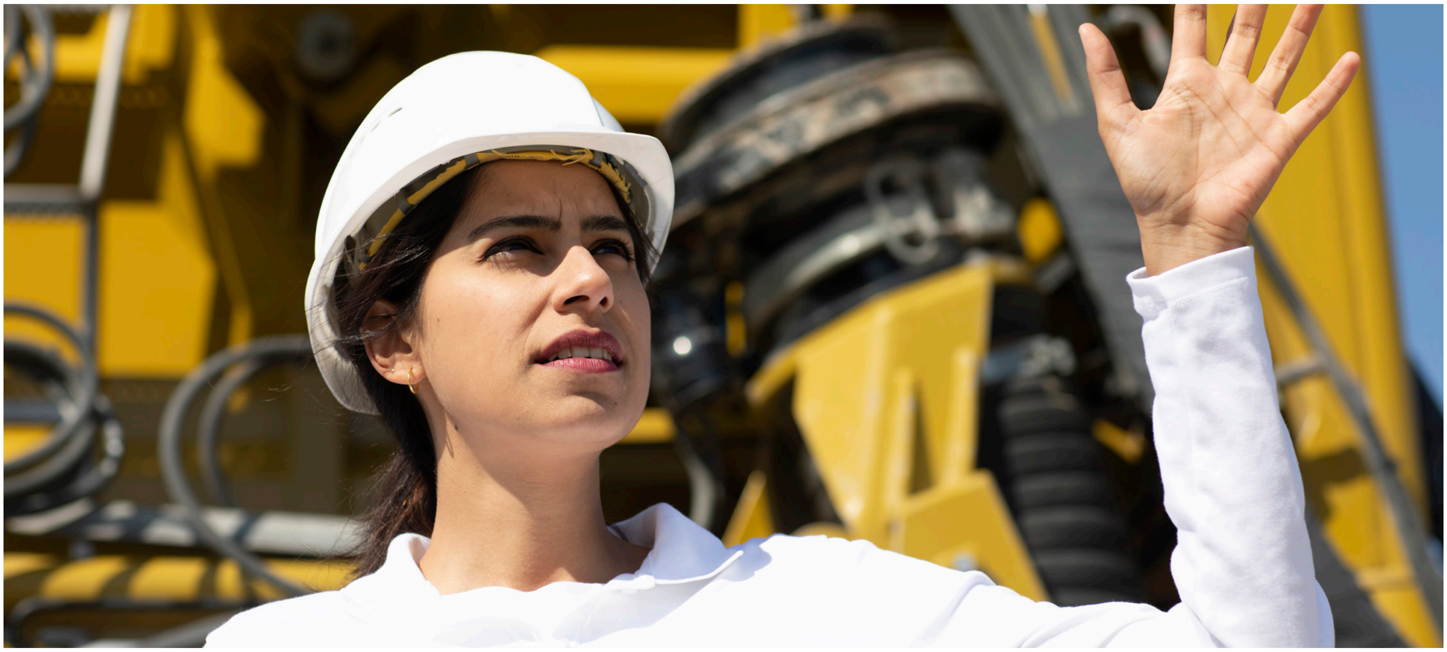




Background

Accessing capital is widely acknowledged to be the most significant hurdle facing small-scale residential developers, especially emerging small-scale developers who identify as Black, Indigenous and other people of color (BIPOC).[1] This policy brief defines emerging small-scale BIPOC developers as real estate developers who have taken on smaller-scale multifamily developments (either new construction or acquisition-rehabilitation projects), but experience systemic challenges in accessing capital necessary to work on larger-scale, new-construction and/or acquisition-rehabilitation multifamily developments, as well as to scale up their business operations.

The definition of small-scale development[2] varies across state and local housing markets, depending on the market's development density context. Accordingly, the definition of small-scale developers will vary from one housing market to another based on the local density context. For example, while a New York City real estate developer who primarily works on residential developments with up to 50 units could be considered a small-scale developer, a real estate developer who primarily works on residential developments with up six units in Minneapolis could also be identified as a small-scale developer.

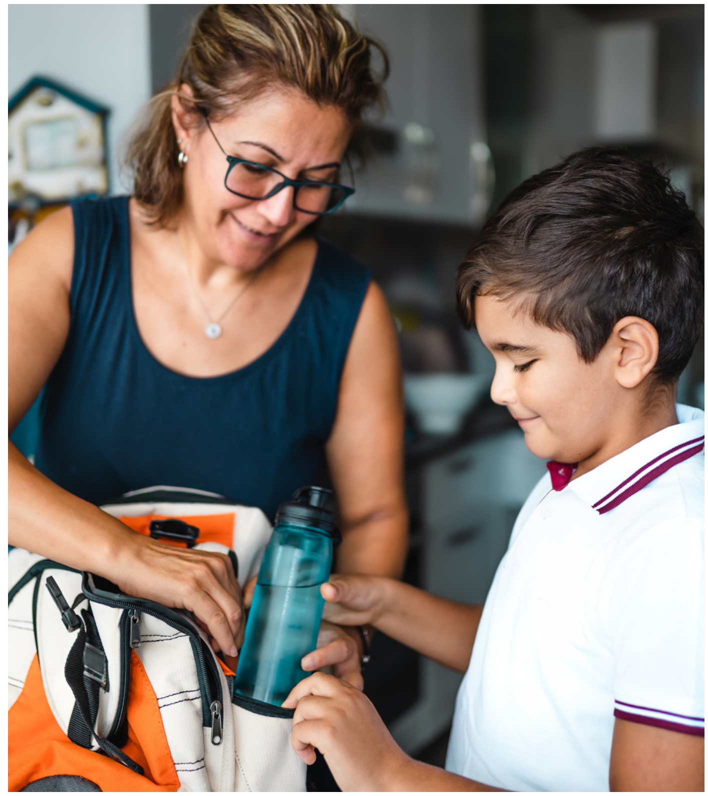
While each real estate project has a unique financing structure, typically referred to as a capital stack, most housing developers finance their developments through a blend of equity capital provided by investors and debt capital offered by lenders. These lenders and investors use a range of requirements[3] to examine the developer's capacity and ability to successfully develop and operate the proposed development, which would enable the developer to pay back the borrowed debt capital and deliver the expected financial return on equity investments.

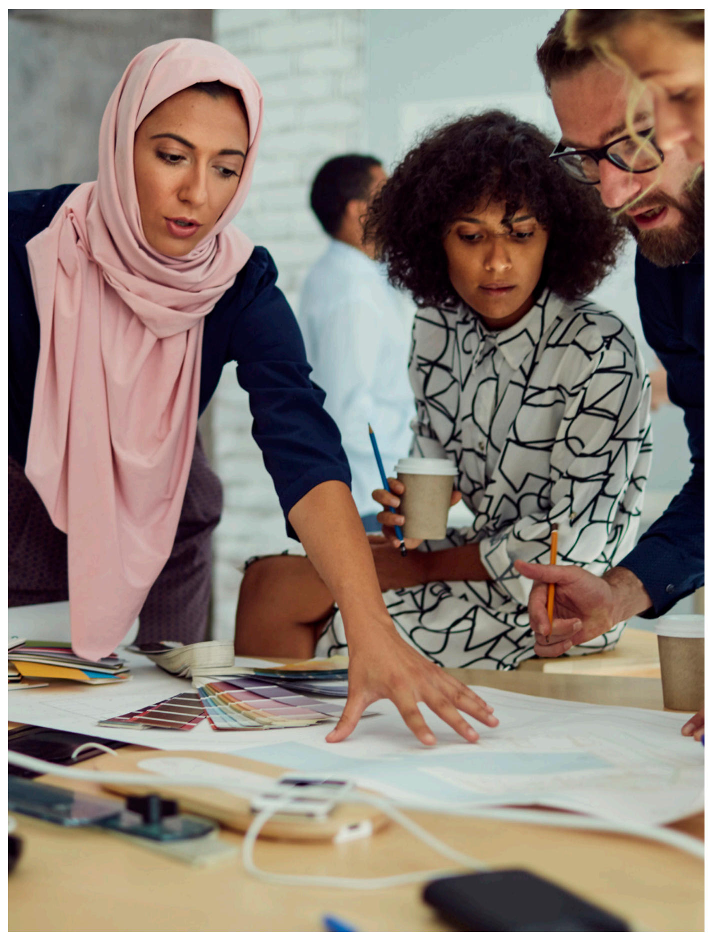
Prominent investor and lender requirements, such as specific liquidity and net worth levels, do not explicitly exclude emerging small-scale BIPOC developers from accessing capital. Instead, they have a systemically disparate impact on these developers due to the deeply-rooted legacy of racism in land ownership, housing and community development, including government-sanctioned discrimination like redlining, race-based federal mortgage programs, racially-and ethnically-restrictive deed covenants, and discriminatory lending.

Decades-old racist policies and practices have created multigenerational racial disparities in homeownership and the wealth that serves as seed capital for many small businesses, including developers. Housing developers and experts agree that disparities in access to equity capital from individuals in a developer's family, friends and business networks is another persistent systemic challenge for emerging small-scale BIPOC-led development companies.

On top of limitations in accessing equity capital from their networks, emerging small-scale BIPOC developers often experience common barriers to accessing capital stemming from perceived risk in real estate lending and investments. Generally, emerging small-scale BIPOC developers face a catch-22: They need to work on larger-scale residential developments to grow their real estate portfolio and build their balance sheets to meet prominent investor and/or lender requirements, but it is nearly impossible to accomplish that without accessing sufficient capital in the first place.[4] As a result, only 2% of real estate development companies are Black-led, and just 1.5% of real estate assets under management are controlled by BIPOC-owned firms. Even among community development corporations, only 16% are BIPOC-led.[5]

This policy brief examines some of the most significant systemic barriers to financing experienced by emerging small-scale BIPOC-led developers throughout the various stages of real estate development. Additionally, the policy brief discusses innovative solutions designed and implemented by mission-driven housing and community development stakeholders to help address barriers to financing among these developers. In challenging underlying risk assumptions, this brief shows how emerging small-scale BIPOC-led developers can successfully sustain growth of their operations and real estate portfolios when they are provided with access to sufficient capital.





Barriers to Financing the Planning and Predevelopment Processes

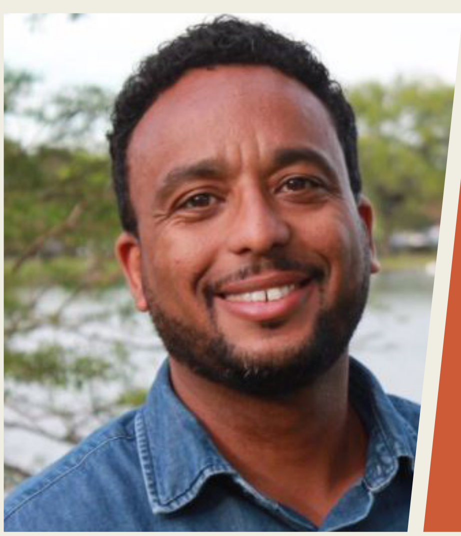
Planning and predevelopment processes typically include analyses designed to identify any site-specific factors that can have legal, financial or design/physical planning implications for a proposed residential development. This includes conducting a real estate market analysis to determine the existing and projected levels of demand for the proposed development, as well as a financial feasibility study for the proposed development. These phases also include conducting analyses on the site's environmental conditions, topography and soil, zoning restrictions and other physical conditions. The predevelopment process also includes developing architectural renderings and may require community engagement.

Small-scale developers typically cover the costs of the planning and predevelopment processes from their own funds. This is mainly due to the lack of an asset (either a vacant site or a site with any improvements) that can be used as collateral, or because the developer is deemed risky by lenders and investors. Since the preliminary analyses might ultimately lead to a "no go" decision, predevelopment capital is very much at risk and therefore hard to come by. Emerging small-scale BIPOC developers also face racial wealth disparities that prevent them from accessing equity capital, making it particularly challenging for them to cover the costly planning and predevelopment activities required for larger-multifamily developments.

Community development financial institutions (CDFIs) have been playing a significant role in providing capital that could be used by emerging small-scale BIPOC developers to finance planning and predevelopment processes. CDFIs are certified, mission-driven lenders that provide fair and responsible financing to underserved communities. Through the Capital Magnet Fund, Financial Assistance awards, and other initiatives, the federal CDFI Fund provides competitive grants to CDFIs to create financing tools, such as loan loss reserves, revolving loan funds, risk-sharing loans and loan guarantees, which can be used to finance affordable housing activities, including predevelopment activities.

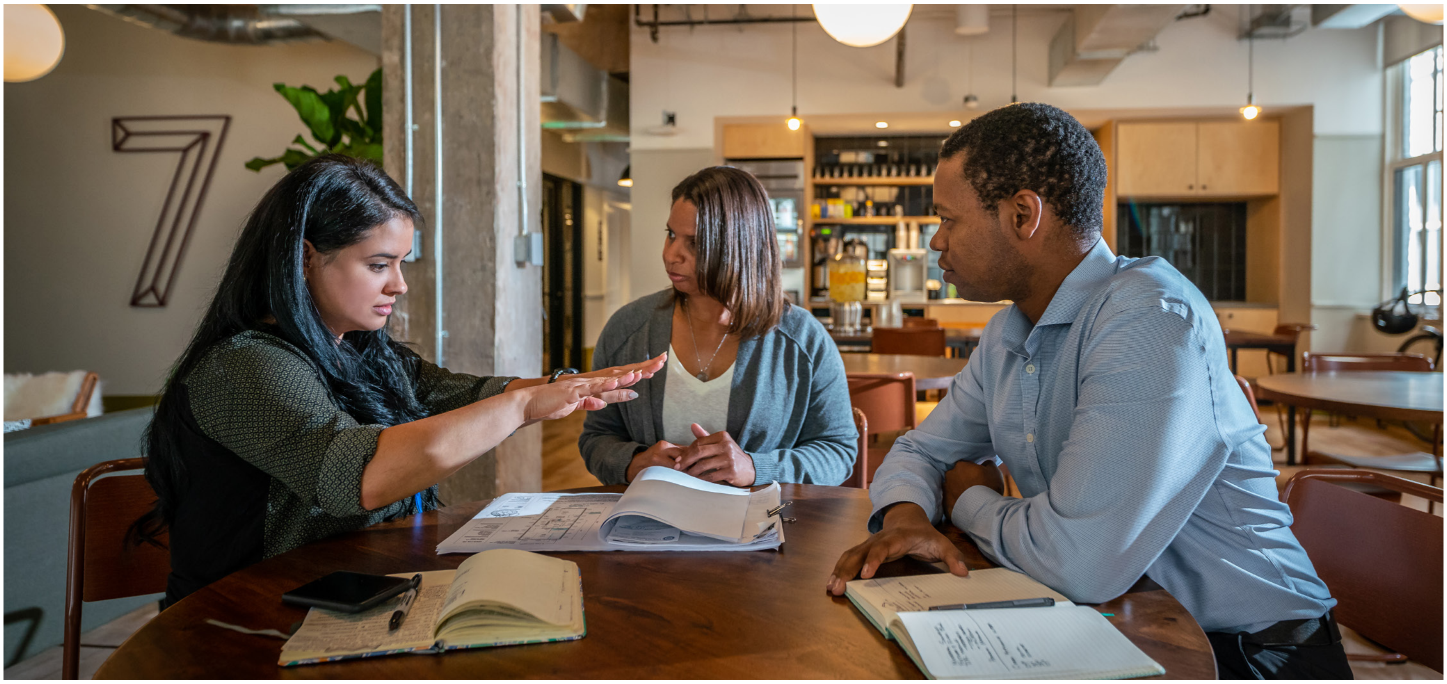
There are a number of efforts designed to help emerging small-scale BIPOC developers overcome size, capacity and balance sheet constraints that make it difficult for them to access CDFI capital. Enterprise's Equitable Path Forward (EPF) initiative[6] offers access to credit enhancements including unsecured lines of credit, which are among the hardest-to-come-by capital resources, to help these developers secure funding to engage in larger-scale developments and grow their operations. LIIF's Black Developer Capital Initiative's Line of Credit[7] provides eligible developers with early-stage capital to move multiple projects forward and support their business growth. Additionally, LISC's Black Economic Development Fund[8] provides eligible developers with access to early-stage capital in the form of short-term predevelopment loans and lending products offered by a predevelopment credit facility.

In addition to early-stage capital challenges that prevent finance planning and predevelopment activities, emerging small-scale BIPOC developers typically have difficulty accessing capital to finance land acquisition. These barriers are largely due to not being able to meet set capacity and track record requirements. Under certain circumstances, emerging small-scale BIPOC developers may pursue an option contract[9] in land acquisition. In this uniquely designed agreement, a seller offers an option to the buyer to purchase property at a fixed price within a limited time frame. Such options can lead to higher land acquisition costs.



"A century of policies has prevented too many from building wealth. We need more creative access to capital for people who have been excluded from the game,"

CURTIS DOUCETTE JR.
CEO
Iris Development Company

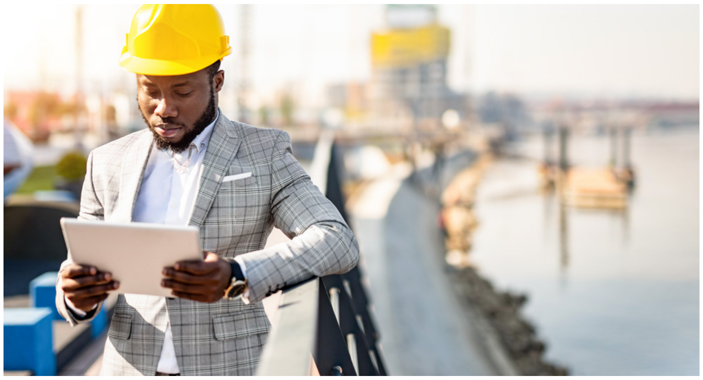


Barriers to Qualifying for Equity and Debt Capital

Moving to later development stages, such as the construction phase, emerging small-scale BIPOC developers often face barriers to accessing capital that stem from a range of capacity-related requirements. For example, they are often unable to meet lender and investor requirements for receiving debt and equity capital. These requirements are typically used by both lenders and investors to examine the developer's capacity and ability to successfully develop and operate the proposed development, as well as their ability to successfully pay back the borrowed debt and provide investors a return on equity investments.

One of the most prominent developer capacity requirements that limits emerging small-scale BIPOC developers' access to capital is balance sheet requirements. A developer seeking debt and equity capital to finance a proposed real estate investment is often required to have a minimum of $1 million in liquidity and $5 million in net worth. These thresholds serve as systemic barriers to accessing capital, which inhibit emerging small-scale BIPOC developers from accessing the debt and equity capital required to undertake larger-scale real estate deals, grow their business operations and expand their real estate portfolios.

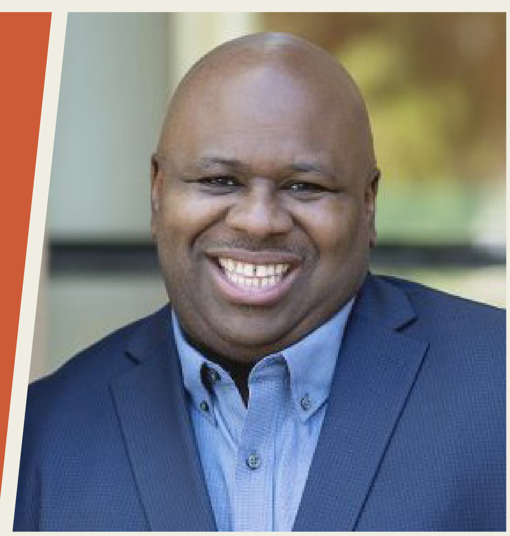
There have been efforts to move away from examining a developer's capacity risk based on personal wealth and instead focus on a developer's experience and demonstrated industry success. As part of Enterprise's EPF initiative, the Enterprise Community Loan Fund revised its internal lending guidelines to address these barriers. LIIF pursued similar action through its Black Developer Capital Initiative with minimum thresholds for developer liquidity and net worth. Adopting this change more broadly can increase emerging small-scale BIPOC developers' access to capital by addressing the negative impacts of limited liquidity and net worth on this group of developers.



When emerging small-scale BIPOC developers aren't able to meet developer capacity thresholds, lenders may require that these developers secure guarantor(s). Through this legally binding agreement, guarantors promise to secure part or all of the developers' debt obligations in the event of development default. Such a requirement adds another barrier to accessing financing by requiring developers to identify and secure guarantor(s). Moreover, this requirement typically leads to partnerships with larger-scale developers, who then receive the largest share of the developer fee (a negotiable amount awarded to the developer to cover operational and overhead costs during the development process). These conditions inhibit emerging small-scale BIPOC developers' ability to grow their balance sheets and their business operations. Instead, they are permanently relegated to participating as junior partners in every deal.

In order to create new resources for BIPOC developers whose balance sheets don't meet traditional capacity requirements, Enterprise's EPF initiative launched the Standby Guaranty Facility. The Standby Guaranty Facility is a first-of-its-kind credit enhancement tool that allows developers to avoid third-party co-guarantor requirements. Through this tool, EPF aims to enable BIPOC developers to compete for institutional capital on a level playing field, while allowing them to hold onto more of their profits and growth potential.

> **"In today's world, you can have all the cash you want and still effectuate a bad idea. But if you have a great idea and don't have any cash, it's harder to get that done. That puts people who have generationally not had access to cash at a disadvantage,"**
>
> **AMIN IRVING**
> **President and CEO**
> **Ginosko Development Company**

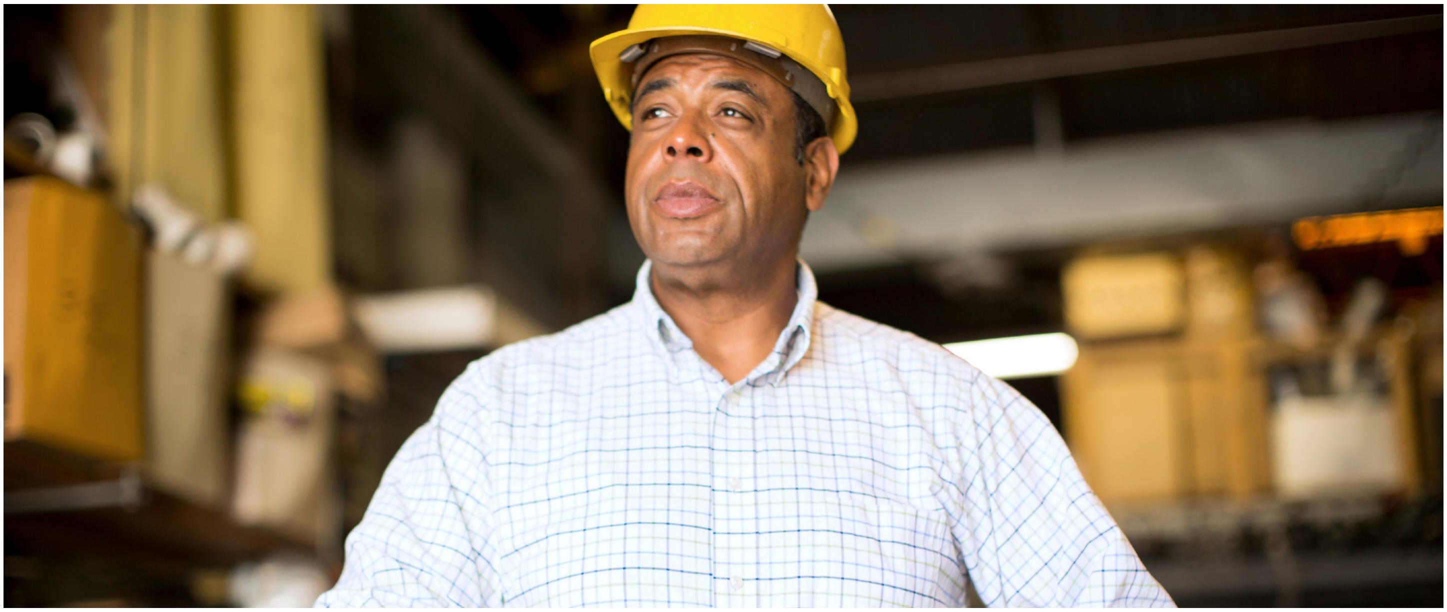


Barriers to Securing Equity Financing

Even when emerging small-scale BIPOC developers qualify for debt capital, they often face barriers to securing equity capital. Conventional lending products frequently cover up to 80-85% of the total development's appraised market-rate value through debt capital, requiring a developer to cover the remaining cost through personal equity or equity debt from investors. However, as mentioned previously, these developers often do not have access to equity capital of their own or from individuals in their networks due to systemic racial wealth disparities. Under these circumstances, even if developers secure 85-90% of the total development's appraised market-rate value through debt capital, they will be unable to secure the remaining 10-15% of the total development cost.

In addition, emerging small-scale BIPOC developers often fail to meet equity investors' capacity or risk thresholds, resulting in a lower loan-to-value, or LTV (LTV is the ratio of debt capital to the appraised market-rate value of the proposed development). Furthermore, predominantly BIPOC communities often receive undervalued appraised market-rate value for the proposed development, which is based on the appraised value of similar developments in the same area. This limits the amount of debt capital a lender would finance, as the offered debt capital is based on the appraisal. Undervalued appraisals can also impact LTV calculations. In both cases, the developer must cover a larger share of the total development cost through equity capital.

Mission-driven housing and community development stakeholders are exploring opportunities to provide emerging small-scale BIPOC-led developers higher LTV and loan-to-cost, or LTC, ratios (LTC is the ratio between the total loan amount and total cost of the project). This would help reduce the equity capital burden commonly experienced by these developers. For example, the Community Preservation Corporation's Flex Small Loan Program[10] offers eligible developers 24-month standard construction loans with up to a 90% LTC, requiring an equity stake of 10%. Similarly, the Enterprise Community Loan Fund offers higher LTV and LTC for eligible projects to enable emerging small-scale BIPOC developers to access capital necessary to scale up their operations and expand their portfolios. These lending standards would help address challenges facing emerging small-scale BIPOC developers in securing equity capital, which is necessary to scale up their business operations and take on larger-scale developments.



Key Takeaways

Efforts to address barriers to capital among small-scale BIPOC developers:

- Accessing capital is widely acknowledged to be the most significant hurdle facing emerging small-scale BIPOC developers, which can be explained by a range of factors, including racial wealth gaps and the disparate impact of some investor and lender requirements on these developers.
- A number of mission-driven housing and community development stakeholders, including Enterprise, have recently launched innovative solutions to help address barriers to financing among emerging small-scale BIPOC developers. These efforts are designed to help emerging small-scale BIPOC developers grow their balance sheets, real estate portfolio and business operations.
- While it is not yet possible to examine the long-term impacts and extent of these recent efforts, they are promising approaches that will help ease barriers to financing among small-scale BIPOC developers over time.

Strategies to scale up efforts to address barriers to capital among small-scale BIPOC developers:

- Targeted innovative solutions have been designed to help address barriers to financing among emerging small-scale BIPOC developers. However, larger-scale government lending reforms and public-private partnerships are needed to close these systemic capital gaps among emerging small-scale BIPOC developers and address the disparate impact some lender and investor requirements have on these developers.
- Systemic changes can mitigate racial disparities, which are the byproduct of legacy of racism in real estate development, and provide greater access to debt and equity capital for real estate development:
    - Federal finance agencies could explore launching federally-backed lending products that would provide emerging small-scale BIPOC developers with access to predevelopment line of credits and higher LTV/LTC.
    - Private financial institutions (in partnership with their regulators) and the real estate industry could explore revising debt and equity capital requirements and standards that tend to have a disparate impact on these developers, including balance sheet and track record thresholds.

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