Back in the Game: CDFIs Help 1- to 4-Unit Rental Housing Rebound in Chicago

After the housing crash, Chicago's 1- to 4-unit rentals weren't bouncing back in many neighborhoods. Three CDFIs came together to make it happen.

By **Stacie Young** - November 28, 2017

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The home before it was rehabbed. Photo by Gordon Whalek

A tenant stands in front of her new residence, with, from left, Andre Collins, who acquired the home for the Chicago collaborative; Scott Allbright, who bought the home from the collaborative and rehabilitated it; and Steve Schaffer, coordinator of the Neighborhood Stabilization Initiative program through which the collaborative purchased the home after foreclosure. Photo by Gordon Whalek

Michael Altheimer, a responsible developer committed to working in difficult markets on the south side of Chicago, had always focused his work on multifamily buildings. After the housing crash, there was an increased demand for rental housing, and he saw opportunities in the many vacant 1- to 4-unit buildings. And yet, he was hesitant to move into the 1–4 market. "One to fours can be more difficult than larger properties," he explains. "The time it takes to acquire a small building and a large building isn't that different, making it much more difficult to get to scale [with a smaller building]. Add that many of these buildings were stuck in foreclosure, and how hard it was to find financing … I would have never bothered with these buildings."

DePaul University's Institute for Housing Studies confirms what Altheimer saw on the ground: 31 percent of all rental units in 2- to 4-unit properties in Chicago and Cook County's low- and moderate-income communities were directly affected by a foreclosure filing between 2007 and 2010. Most of these properties had been formerly owned by owner-occupants but potential new homebuyers avoided struggling neighborhoods still reeling from the crash.

As prices plummeted, private market developers recognized this new investment opportunity. These types of investors can be agile and quickly improve properties, but, as Altheimer observed, it is difficult to slog through individual acquisitions, let alone when foreclosure is involved. Plus financing was barely available—and expensive when it was.

Serving New Borrowers

Partners in a joint effort in the Chicago area to preserve affordable rental housing called The Preservation Compact had already come together to explore distressed 1- to 4-unit buildings. We knew from our analysis that rehabbing 1- to 4-unit buildings for reuse as rental housing would meet local demand for affordable rental housing and jumpstart revitalization—both things that would serve our preservation mission, and the missions of some of our most key partners—Chicago's community development financial institutions (CDFIs). Yet while some CDFIs had provided services to owner-occupants of 1–4s, until the crash hit, none had worked with private market investor-owners to finance this segment of the housing stock.

This confluence of opportunity and challenge drove three CDFI nonprofit lender partners together to form the Chicago CDFI Collaborative. The collaborative coordinated three different lending products to leverage the capabilities of responsible private market developers and remaining owner-occupants to tackle distressed 1- to 4-unit residential properties in low- and moderate-income (LMI) neighborhoods.

Over three years, the partnership has reached scale, improving conditions of nearly 600 deteriorated 1- to 4-unit buildings in distressed neighborhoods that have struggled to recover from the Great Recession.

Chicago's Housing Market

While Chicago boasts a vibrant downtown and a number of strong neighborhood markets that have made a comeback since the 2008 housing crash, many LMI communities in the Chicago area have continued to struggle with stagnant incomes, foreclosure, abandonment, and disinvestment. A major component of this struggle is the challenge of the city's 1- to 4-unit residential housing stock, which composes nearly half of Chicago's total rental housing and a significant proportion of the naturally occurring affordable housing in LMI neighborhoods.

Traditionally, most of Chicago's 1- to 4-unit buildings had been owner-occupied. Foreclosures in the 1- to 4-unit residential housing stock, however, led to widespread vacancy, deteriorating building conditions, and a significant loss of affordable housing—both owner-occupied and rental. Limited demand from owner-occupants to purchase properties in these markets compounded and sustained those difficulties.

For those properties that did remain owner-occupied during the crisis, homeowners seeking to improve their properties faced numerous challenges. Low property values increased the lenders' risk on for small home improvement loans, and given the economic uncertainty, homeowners were unable or unwilling to invest in needed home repairs, even when they were not at imminent risk of foreclosure. According to 2012 HMDA data, hardly any home improvement lending activity was occurring in the Chicago region, and home equity lines of credit were not available in many neighborhood markets due to depressed values. From 2000 to 2012, there was a 74 percent drop in financing for home improvement lending in Cook County.

The Chicago Collaborative members recognized that rehabilitating 1- to 4-unit buildings into affordable rental properties could remove the negative effects of vacant property, alleviate communities' affordable housing shortage, repopulate distressed areas, and improve local municipal finances by bringing abandoned properties back onto the tax rolls.

Yet the housing crash had choked off the flow of credit. The significant reduction in property values resulted in low appraisals, further complicating access to financing. Small- to mid-sized responsible investors were stymied in acquisition attempts by a confusing disarray of property owners and legal ownership structures. Although a number of large national REITs and private equity funds were actively repositioning significant portfolios of foreclosed single-family properties in suburban markets with a high potential for upside, they were generally not active in the city's LMI markets. With so many buildings for which access to sufficient capital was lacking, the communities had few avenues to stabilization and revitalization.

A Collaborative Strategy

The Chicago Collaborative is a partnership of three established, locally-focused Community Development Financial Institutions (CDFIs): Community Investment Corporation (CIC) (where I work, and home to The Preservation Compact), Chicago Community Loan Fund (CCLF), and Neighborhood Lending Services (NLS), a subsidiary of Neighborhood Housing Services of Chicago. Each partner used $1.5 million from a JPMorgan Chase PRO Neighborhoods Program grant to launch or expand a relevant financial program that would address the challenge of distressed 1- to 4-unit properties. The programs of the partners naturally complement one another, and the CDFIs coordinated implementation to match borrowers with the right product and appropriate technical assistance for their project.

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CIC created a flexible acquisition pool to acquire and assemble vacant and distressed 1- to 4-unit properties in strategic areas, and then transfer the properties to interested developers. CIC's expertise in acquiring troubled properties took the complex acquisition/assembly process out of the equation for developers, making it much easier for them work with this type of building. CIC has been able to acquire 268 units, which have been subsequently sold to responsible owners/ developers.

Historically, CIC's primary lending program had financed only multifamily properties (buildings with 5 units and up). After the market crash, however, CIC recognized the critical role of 1- to 4-unit properties as rental and expanded its financing efforts to include that asset class. CIC had just developed a new take-out financing pool for 1–4s when the Chicago CDFI Collaborative was launched, allowing it to add the acquisition pool as well.

CCLF offered a loan pool targeted to small investors to acquire and rehab individual vacant 1- to 4-unit buildings on the market. CCLF's experience working with a variety of projects helped it tackle transactions with different types of financing structures, from direct loans to lines of credit. In some cases, investors used CCLF loans to finance the purchase and rehab of a building that CIC had acquired. (In other cases CIC's pre-existing takeout financing product paired well with CCLF construction loans.) CCLF leveraged acquisition and rehab of 94 units with its financing.

Existing owner-occupants of 1- to 4-unit properties were able to access resources from NLS, which extended the reach of the collaborative by providing financing to homeowners to rehab their own properties. NLS financing through the Collaborative helped homeowners rehab 231 units.

The partners targeted these products to small neighborhood areas identified by the City of Chicago's Micro Market Recovery Program (MMRP). MMRP is an effort to attract programming and resources to 13 small Chicago submarkets. The Collaborative deployed financing in many areas, but they especially focused activities in MMRP geographies to magnify redevelopment impact.

Building the capacity of borrowers—owners and developers—has been an important ancillary benefit of the collaboration, creating a durable infrastructure for long-term community development.

A Market-Based Approach to Redevelopment

Adopting a market-based strategy to address the issue of distressed 1- to 4-unit properties was an unusual take on the traditional CDFI role of targeting gaps in the market. Post-crash, LMI neighborhoods badly needed speed and efficiency, something that the collaborative members determined could be achieved by working with small, responsible developers.

The collaborative was very intentional about working within the realities of weak real estate markets and distressed building types. It focused on distressed properties with low acquisition costs where the total cost of acquisition plus rehab would be supported by neighborhood rents. The collaborative did not take on buildings so deteriorated that total costs exceeded neighborhood rents and would, therefore, require additional subsidy.

Similarly, as the collaborative partners created acquisition and financing tools to nurture economic activity in these tough markets, it did not make sense to require affordability restrictions as a condition of financing. While such restrictions may be appropriate in gentrifying neighborhoods, markets desperate to attract resources need to make investment decisions appealing and easy.

Because they are tough markets, the low values in these areas make the buildings naturally affordable. In the Chicago market and in other areas across the country with disinvested and distressed communities, the idea of "naturally occurring affordable housing" is not a cloaked term for low quality. Certainly, there are some irresponsible owners who are conspicuous in their mismanagement, sucking cash flow from their buildings and failing to reinvest in long-term maintenance and improvements. These owners are best addressed through aggressive local code enforcement. For the most part, however, most naturally occurring affordable housing in Chicago neighborhoods is well maintained by responsible developers. These developers know their neighborhood markets, and that informs their financial feasibility analysis. They buy at a price where the cost of acquisition plus rehab is supported by rents affordable to households with modest incomes. This enables owners to keep buildings in good shape in order to secure maintain high occupancies.

Involvement of experienced, mission-driven CDFIs like those in the Chicago Collaborative also helps ensure high-quality rehab. CDFIs that have a local presence and on-the-ground experience are often better able than traditional lenders to vet prospective investors and mandate high standards of rehabilitation work, while at the same time remaining flexible and agile.

Engaging Small-Scale Investors

Small- and mid-scale investors are an enormous resource of untapped potential in the fight to preserve affordable housing and redevelop neighborhoods. Members of the Chicago Collaborative recognized that responsible investors could open the door to private investment capital for LMI neighborhoods. Private sector operators already own or manage a large amount of naturally-occurring affordable housing in LMI communities, and they are extremely nimble and efficient with private capital. In addition to restoring significantly deteriorated buildings and providing hundreds of homes to LMI households, these investors and owner-occupants, with the help of the collaborative, poured over $41 million worth of renovations into 1- to 4-unit buildings in disinvested areas.

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Collaborative partners sought to identify and activate the best of these investors. By selectively supporting private investors with strong track records, the partners helped to crowd out more speculative, low-quality developers. (It should be noted that nonprofit developers also took advantage of collaborative resources and contributed to the program's impact.)

For small- to mid-sized market-rate developers like Altheimer, expediency is key to the success of a project. When Altheimer learned of the Chicago CDFI Collaborative's 1–4 program, he was motivated to begin acquiring and redeveloping 1- to 4-unit properties. "The speed of transactions and the pipeline of properties offered by collaborative partners made it attractive to look at 1- to 4-unit properties. Now I can make it worthwhile," Altheimer says.

Realistic Collaboration

Although the concepts of "collaboration" and "partnership" remain popular buzzwords in an era of declining resources, the truth is that meaningful collaboration can often be difficult to get right.

In Chicago's case, the recipe for success was creating and maintaining realistic expectations for coordination, and approaching properties from an opportunistic perspective. The three organizational partners had already worked closely together on different initiatives, and so had strong relationships and lines of communication. For this collaborative, the partners identified opportunities to work together, but did not spin their wheels trying to create perfectly coordinated transactions where more than one organization had a role in a deal. While some early projects were structured to have equal involvement of all three Chicago Collaborative members, it quickly became clear that ad hoc coordination and regular communication were more efficient ways to ensure volume and achieve goals. Collaborative partners realized that working together to create geographic impact and scale were more laudable goals than the orchestration of each individual deal.

Through regular discussions, we pursued investments in small, city designated geographic areas where 1- to 4-unit project redevelopment efforts could be paired with city-funded financing products, targeted code enforcement efforts, foreclosure prevention outreach programs, and incentives to encourage new investment. These concentrated efforts served as important building blocks toward overall stabilization and revitalization.

Community Development Impact

The community development impact of the CDFI Collaborative has been significant. Over the course of three years, $5 million in grant funding has leveraged $41 million in private capital, to support the redevelopment and improvement of nearly 600 housing units—and that leverage goes to over $40 million when developer rehab investments are included.

In addition to bringing affordable housing units back, our partners have all seen the physical building improvements spill over into local attitudes regarding investment. Great rehab work next door or around the corner has inspired neighbors on surrounding blocks, contributing to even more meaningful community development.

Most importantly, the collaborative has helped speed recovery in historically disinvested neighborhoods of color with primarily low-income populations, which were struggling even before the market crash. “The Chicago case study illustrates what CDFIs can accomplish,” says Daniel Sprehe, managing director for corporate responsibility at JPMorgan Chase, “and the potential unleashed when they deploy their resources collectively.”

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