



CDFA Impact Investing White Paper Series

URBAN REVITALIZATION & IMPACT INVESTING

*Unlocking the Potential for an Impact Investing & Development
Finance Agency Urban Revitalization Collaboration*

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Unlocking the Potential for an Impact Investing & Development Finance Agency Urban Revitalization Collaboration

Henry Cisneros, the former HUD Secretary and Mayor of San Antonio, calls urban revitalization, “the new urban reality...and urban renaissance.” Urban areas have seen a significant increase in investment for both residential and commercial development in the past 15 years. This is due in part to demographic changes such as the population getting younger, more diverse, better educated, and more mobile, as well as costs of suburban development increasing and renewed interest in downtown and dense urban areas on the part of business, universities and health care.

Many, if not most, central city or neighborhood urban areas are seeing an increased interest in revitalization. Office buildings are being converted to condos or rental units. Companies are relocating from suburban campuses to denser downtown areas. Older factories and Class C office buildings are being upgraded or converted to residential and tech spaces. Retail, restaurants, grocery and hardware stores, and other commercial businesses are looking at downtowns as the place to be. Yet, despite all of this economic activity, major metropolitan areas still struggle with disinvestment, poor or insufficient infrastructure, and declining housing stock. Targeted and specialized financing through public private partnerships is required to see a true urban renaissance occur.

The purpose of this Urban Revitalization & Impact Investing White Paper is to document the potential of a collaboration between impact investors and high performing Development Finance Agencies (DFAs) to fill the capital gaps facing cities and neighborhoods working to support urban revitalization and to accelerate DFAs as a major source of capital to grow, create jobs and spur economic and community development.

With the increasing interest in more urban living, neighborhoods that have experienced deterioration and disinvestment over the years are becoming more popular because of their proximity to job centers. This migration and shift of resources is presenting unique challenges to the planning and economic development sectors. It also presents a vast opportunity to align impact investing and urban revitalization efforts like never before.

The primary financing challenge to today’s urban revitalization is that the capital markets have not kept up with the capital needed to invest in older areas. Most conventional financing sources, along with the national capital markets, are still entrenched in older traditional models of investment: safe, risk averse, suburban, strong credit quality, and safer markets.

Urban revitalization is a broad-based term, representing efforts to build stronger neighborhoods, downtowns, business districts and anchor institutions. Specific investments can include:

- Basic infrastructure investments including water, sewer, streets, bridges, parks, community centers, libraries, schools, broadband, transit, parking and sidewalks.
- Real estate redevelopments, including residential, commercial and retail as well as mixed-use, mixed-income, historic rehabilitation and adaptive reuse projects.
- Cultural facilities including theaters, museums, arts spaces, cultural centers and magnet schools.
- Large scale infrastructure including ports, highways, subway, bus-rapid transit, clean energy facilities, wind farms, solar facilities, docks and wharves.
- Anchor institutions, including colleges and universities, dormitories, hospitals, clinics, wellness centers and research parks.

Cisneros identifies 15 key activities for urban revitalization, most important of which are building for sustainability, harnessing advanced industries and anchor institutions, modernizing urban infrastructure, increasing walkability

and transit options, cementing public/private partnerships and financing urban real estate. These efforts encompass a wide range of projects:

- Large master planned mixed use developments, under the direction of a limited number of developers, in an effort to revitalize an entire block or neighborhood. Examples include transformative developments like the Chinatown Gallery Place revitalization in Washington, DC and the redevelopment of the East Bank Flats in Cleveland, OH.
- Single office buildings or retail centers within an urban area. These types of projects can include a single housing rehab or new construction, the rehab of a historic residential property, or a mixed-use, mixed-income redevelopment within an established, but struggling, neighborhood.
- Redevelopment and infill lot development in neighborhoods, along with rehab of existing housing units to increase their sustainability. For example, the Redevelopment Authority of the City of Milwaukee or Invest Atlanta routinely use tax increment financing to address infill and revitalization in this manner.
- Adaptive reuse of existing structures of significance such as hospitals, warehouses, schools, military barracks and abandoned skyscrapers. Several projects in the urban core of the City of Newark, NJ have converted abandoned warehouses and factories into hotels, residences, and corporate offices.
- Environmental remediation of brownfields, abandoned gas stations, dilapidated parks, crumbling industrial parks and other necessary green initiatives. The Denver Urban Renewal Authority harnessed their financing power to invest in several downtown neighborhoods blighted by brownfields sites.

WHAT IS A DEVELOPMENT FINANCE AGENCY?

Development finance agencies (DFAs) can be either public or quasi-public/private authorities that provide or otherwise support economic development through various direct and indirect financing programs. DFAs may issue tax-exempt and taxable bonds, provide credit enhancement programs, and offer direct lending, equity investments, or a broad range of access to capital financing mechanisms. DFAs can be formed at the state, county, township, borough or municipal level and often times have the authority to provide development finance programs across multi-jurisdictional boundaries.

Examples of development finance agencies include:

- Industrial development authorities, boards or corporations
- Economic development authorities, corporations or councils
- Special purpose authorities (port, transportation, parking, development, energy, air, water, infrastructure, cultural, arts, tourism, special assessment, education, parks, healthcare, facility, etc.)
- Local and community development authorities, corporations or institutions
- Departments of development or commerce and finance authorities, divisions, or departments within state and local government
- Business development corporations, centers or districts
- Development and redevelopment authorities, commissions or districts

Learn more about DFAs online at www.cdfa.net.

Risk Assessment & Urban Revitalization

It's critical to understand that risk in the context of urban revitalization is not the same as risk of an individual entrepreneur, developer, business or product. An essential tenet of urban revitalization is that there are project risks that go above and beyond the market for any one particular product or service.

These risks are based upon the existence of prior conditions that force the developer, business, lender and investor to bring more money to the table, without any increase in return. Each prior condition works together to significantly increase capital costs, extend development time and thus increase the risk in urban revitalization

efforts to bring projects to spec. Mitigating prior conditions to bring projects to spec is an expensive but essential component of urban revitalization and sustainable urban development. Rural or suburban greenfield projects do not face the same challenges, and are, as a result, often more enticing options for developers.

Aging and Obsolete Buildings

Old buildings are not, by definition, unusable. But when a building has deteriorating walls, ceilings, HVAC, or generally suffers from lack of investment, the building is unsuitable for a new use. In addition, changes in building preferences and standards such as fire protection, ceiling and loading dock heights, floor capacity, and “clear span” construction all require that additional investment be made in the facility.

Aging Infrastructure

Most urban areas have sewer, water, utilities and roadways that have existed for many decades, with limited upgrades and maintenance. This is true for both public and private infrastructure.

Contaminated Sites and Buildings

Beyond aging infrastructure, many existing sites and buildings are contaminated with lead, asbestos and other pollutants. This requires that the buildings be cleaned up before they can be put to new use. In some circumstances the contamination from soils and/or groundwater on one site can “leach” to a neighboring site and have greater impact.

Increased Building Standards from Change of Use

In many communities, former factories and office buildings are being converted to residential use. The Uniform Building Code requires better and different fire protection than would be required in a lower density facility. This causes increased costs for fire suppression, such as sprinklers, fire escapes, air ventilation and bearing walls.

Land Cost

As urban areas become more popular for business location, the cost of land tends to go up, adding to the overall cost increases for development.

Development is easier in suburban and rural areas when there are no existing infrastructure or aging facilities to rehabilitate. In addition, most development in these areas is greenfield and stand-alone and is being built by communities in good financial condition. With hundreds of projects like these in development every year, it is easy for the traditional capital markets to gravitate towards them.

Further, the recent recession has put fiscal stress on local governments as reduced property values have lowered tax revenues and decreased state and federal revenue sharing. As such, many communities have decreased capacity to fund needed public infrastructure while at the same time facing increased demand for urban revitalization.

All of these revitalization issues must be mitigated prior to development, including deteriorated infrastructure, contaminated industrial sites, little maneuvering room between building, major freeways that divide up neighborhoods, while also making significant changes to site or building use. These obstacles must be addressed before a property can be considered ready for private sector development. In suburban areas, most development sites are “site ready” meaning that new investment increases property value from the start. In urban areas, because of the previously noted problems, property can actually carry a negative value. In other words, all of the environmental remediation needed for a brownfield site simply brings the property up to a developable standard. Thus, leveling the urban revitalization playing field.

These issues combine to cause extremely daunting financing challenges for urban revitalization:

Significant additional capital cost without a commensurate increase in cash flow or market value: Private investors tend to look at “return on investment” as a guideline. Whenever there is investment without any increase in the return, they will look elsewhere to place their capital. Remediation activities – repairing

infrastructure, cleaning up contaminated sites, replacing outdated utilities, etc. – all add significant cost but do not increase the market value or cash flow of a property. They tend to simply bring a property up to being developable. All of the rest of the investment still needs to be made.

Significantly longer development timeline: The time needed to restore a site or building prior to development can add up to two years to a development timetable. This can lengthen the time for a project to “go vertical” with income producing revenue.

Depressed market values in distressed or even transitioning neighborhoods: Banks and market-based investors lend on cash flow and value. When values are depressed because the neighborhood is “transitioning” or there are no comparable sites, lenders will perceive increased risk. This tends to lower bank loans, increase interest rates, and decrease loan terms. Each of these places additional pressure on cash flow and makes lenders reluctant to invest.

In summary, the cost and time of urban revitalization makes lenders reluctant to loan enough to make a project work in market conditions, which in turn makes typical investors look for higher ROIs or go elsewhere for investment.

The Role of DFAs in Addressing Urban Revitalization

Because they are experienced in complex transactions and knowledgeable in the use of public financing programs, many DFAs have played a central role in urban redevelopment. These roles have included:

Transformation through Real Estate Acquisition, Development and Management

DFAs have a track record of serving as broad-scale set of real estate developers. This is accomplished, for example, by obtaining site control of a strategically located property in an urban neighborhood, and working with developers to bring desired projects to the site. This controlling role helps to spread out the risk of any one use in a development project, which frees up unencumbered capital that can be utilized for high risk investments. In some cases, the DFA continues to own and manage the property as a way of maintaining site control over the long term. A good example of a DFA serving as a catalytic real estate developer is the Toledo-Lucas County Port Authority that acquired and demolished a former auto plant and redeveloped it as a suppliers park. Many DFAs serve as land banks, which enable the acquisition and holding of strategic property for potential redevelopment.

Bond Financing

To the extent a project or business is eligible, DFAs will use traditional bond financing, which generally consists of long term, fixed rate financing for anywhere between 75% and 90% of a project. Bond financing can either be taxable or tax-exempt, depending on how the bond proceeds are used. Bond financing is very applicable for larger size real estate or industrial projects occurring as part of an urban revitalization effort. In addition, many DFAs operate bond reserve funds or pooled bond programs that raise capital for smaller real estate projects. Bond interest rates are market-based and based on borrower credit analysis, so they remain highly competitive among investors.

Enhanced Conduit (Revenue) Bonds

DFAs are also active in obtaining some type of credit enhancement to increase the risk profile for conduit bonds. Enhancement can come from a variety of sources, including insurance, reserve accounts or bank letters of credit. Each of these tools provide additional support to investors that serve to increase the likelihood that the bond can be sold, reduce the interest rate on the bond, or overcome some structural issue with a project. DFAs in some states and communities utilize a “common bond fund” to increase the risk profile of their projects. Common bond funds pool resources that serve as payment guarantees. In the case of each form of enhancement, there are additional fees, a tendency to prefer larger projects, and are generally utilized to get access to the longer term, fixed rate financing from the markets.

Tax Increment Financing

DFAs frequently finance project infrastructure through the redirection of specific tax revenue to support public purpose needs such as roadways, sewer and water, connectivity, and power and much more. This process, called Tax Increment Finance (TIF), is the most popular form of targeted area finance nationwide. TIF is by far the most utilized form of financing for large scale, real estate projects in the urban core. Forty-nine states and the District of Columbia have some form of TIF enabling legislation that allows for this form of financing to be directed for urban revitalization, blight removal, or investment in redevelopment efforts

Direct Lending

DFAs are frequently direct lenders that operate myriad loan programs. Typically, a DFA will participate at 40% to 60% of a total project cost, often subordinated to conventional bank financing of a like amount. Direct loans can have interest rates ranging from significantly below market to market. This transaction is typical for DFAs that are SBA 504 Certified Development Companies, Community Development Financial Institutions, Rural Intermediary Lenders, etc. In addition, DFA direct lending is extremely diverse. For instance, thousands of revolving loan funds exist to address undeserved markets such as minority and woman owned businesses and geographically disadvantaged communities. The variations within the DFA direct lending space are unlimited but strained by fund capitalization options.

New Markets and Low Income Housing Tax Credits

Many DFAs serve in multiple roles to increase the use of federal redevelopment tools in local urban revitalization projects. The two most active programs that support large-scale urban revitalization have been the New Markets Tax Credits (NMTC) and Low Income Housing Tax Credits (LIHTC). NMTC and LIHTC are federally issued tax credits that are sold to investors with a guaranteed return on investment. Investors have typically been banks and community motivated private investment funds. In both cases, projects are burdened with very high fees, long approval and disbursement times, and as such work best with very high project size. In addition, the need for funding through these programs far exceed the available capital.

Brownfield Remediation Programs

Many DFAs are experienced in working with contaminated urban industrial sites that need remediation before they can be redeveloped. DFAs most often obtain funds from state brownfield programs and from the U.S. Environmental Protection Agency for projects of this nature.

Revolving Loan Funds, SBA and other Public Sector Programs

DFAs utilize locally funded revolving loan funds, tax abatement programs, and SBA lending programs to support urban revitalization. RLFs are primarily focused on smaller size, individual small business projects. Most financing from the Small Business Administration requires conventional bank support, and can only be loaned to operating small businesses, rather than independent real estate developers, which forms the basis for much urban revitalization. To be clear, SBA programs are important for urban revitalization in a variety of ways by increasing access to capital for business located within urban revitalization projects or districts.

Impact Investing, DFAs & Urban Revitalization

While DFAs are experienced in working with both large and small scale urban revitalization projects, the funding that is available through primarily market based financing tools has a fairly narrow view of risk. To date, most responses to the urban revitalization opportunity have taken the form of government funded or enhanced programs that work alongside, but not with, market based financing options.

The opportunity to forge a truly public/private/philanthropic partnership through impact investment can significantly increase the amount of capital available. The primary focus of impact investment with DFAs should be on bridging the inherent risks of urban redevelopment and the gaps that exist in urban redevelopment. Each of the following concepts are being done now in various forms, and are sustainable solutions over time:

Credit Enhancement – Reserve Accounts for Infrastructure Investment

A reserve account, or some other form of credit enhancement, can help to bring in capital for infrastructure

projects at an earlier time in the development process. This will improve return on investment, ensure early months' payments, and leverage private capital by providing the lender with a senior lien position. In addition, reserve accounts can relieve bond holder risk concerns in the early years of debt service payments.

Subsidy for Targeted Brownfield Remediation

Through direct investment or loan guarantees, impact investments in the remediation of specific project constraints can bring that property/project to market in a manner than would otherwise not occur.

Direct Purchase of Notes

Impact investors have the potential to directly purchase bonds or notes for specific projects that drive urban revitalization. Through the use of TIF and other financing mechanisms, the bond issued on these deals can be directly purchased by the impact investor. These bonds are typically non-investment grade which limits the market for affordable financing. Through an impact investment direct purchase, the project can move forward with much needed capital and a financial partner in hand.

Short Term Financing for Site Acquisition

A DFA can speed up a project by completing site acquisition through short term impact investment capital, being repaid as the project is completed. This direct lending source provides project liquidity and allows for the developer to plan accordingly.

Conclusions & Next Steps

There are significant opportunities for impact investors and high performing Development Finance Agencies (DFAs) to collaborate on filling the capital gaps facing cities and neighborhoods working to support urban revitalization. Through DFAs, impact investors can become a major source of capital to grow, create jobs and spur economic and community development in urban areas.

This paper only begins to understand the potential for this transformative collaboration. DFAs are experienced in working with primarily market based, long term financing tools, doing catalytic real estate development, and developing community based approaches to urban neighborhoods. The strategic (and limited risk) enhancement of their financing tools to solve the challenges of urban redevelopment can leverage significant additional capital.

Further review and pilot programs are needed to fully understand and engage philanthropy and traditional development finance. Foundations and impact investors looking to support urban revitalization should consider partnering with their local DFA to unlock transformative development.



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Council of Development Finance Agencies | www.cdfa.net

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