Real Estate's Small Problem

How barriers to small-scale real estate development deals stymie growth and wealth building

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The United States faces a catastrophic housing shortage, with a need to create as many as seven million new residential units to meet demand. Despite the postpandemic commercial vacancy crisis in large-city downtowns, there is also evidence of an urgent need for commercial space in many communities. Yet one of the most sensible paths to providing this space — repurposing smaller vacant or underutilized existing buildings or creating infill development on vacant lots — is often nearly impossible in America at the current time.

Developers today face extraordinary difficulty in acquiring financing for small-scale real estate development projects, specifically projects with costs under $5 million. Communities also very often lack the local capacity — skilled and willing developers with robust personal balance sheets — to complete this work. This is especially true in communities of color and rural areas, often the very places most in need of high-quality housing and commercial space.

In addition to meeting the demand for more space, small-scale development offers an important path to help achieve carbon-reduction targets and revitalize communities that have long suffered from disinvestment. The inability to create such space prolongs the housing crisis, suppresses new business creation and business expansion, and eliminates the ability of people — especially in traditionally marginalized communities — to leverage the income-producing and wealth-building benefits of commercial real estate ownership.

Building Small: Why It Matters

Outside of major central business districts or their large suburban satellites, smaller buildings make up the fabric of most places in the United States. Communities' inability to invest and reinvest in these kinds of places is, at its core, an impediment to healthy communities. Our organization, Main Street America (MSA), finds this challenge evident in many of our 2,000 participating communities, including rural areas, big-city neighborhoods, and places in between. A fall 2022 survey of our members, the majority of whom are located in downtowns or districts in low- or moderate-income census tracts, found that 70 percent of communities report a lack of built-out space to meet local demand. This, in turn, impedes economic development in their communities.

West Valley Junction New Construction

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Beyond hampering the interrelated goals of community economic development and housing creation, the inability to build new small buildings or reposition existing ones suppresses economic mobility. Although real estate ownership presents one of the best pathways for building personal and generational wealth, racial disparities persist in commercial real estate ownership, with nearly three times as many white households owning income-producing properties as do African-American households.

As with home ownership, a path to commercial real estate ownership tends to start small, since few people outside of the wealthiest can purchase and redevelop larger buildings — the buildings that can most readily attain conventional financing. Thus, a failure to offer ways to finance small deals hinders opportunity for long-term wealth creation.

In addition to the economic development and economic mobility benefits of small-scale development, reinvesting in our existing buildings and infill development (which tends to skew small) offers an immediate path to decarbonization in the built environment. The adaptive reuse of existing buildings — particularly when paired with efficiency upgrades, electrification, and renewables — offers substantial carbon-reduction benefits over the construction of new buildings. For example, research from the Carbon Leadership Forum estimates that, on average, **reusing existing buildings will save 50–75 percent of the emissions that would be emitted by the construction of a new building.**

Small-scale adaptive reuse and new infill construction in compact, connected, walkable, and mixed-use neighborhoods also benefit the environment by reducing the carbon-intensive infrastructure needed to serve buildings and reducing Vehicle Miles Traveled, a key driver of greenhouse gas emissions.

The Problems of Building (or Rebuilding) Small

Weak Economic Fundamentals and Poor Capital Access

Building owners and developers who seek financing to reposition small-scale buildings often face extraordinary barriers. This is especially true for buildings under $5 million in total project value and for projects in disinvested communities — including communities of color and rural places. The convergence of several factors makes financing small projects uniquely difficult.

For instance, in many disinvested neighborhoods, economic fundamentals for projects are weak, which translates into higher risk for lenders. Building valuations are often low, thereby limiting the amount that can be borrowed. In addition, there is often a lack of local comparable projects through which reliable rent or sale prices can be established. And, of course, even when such "comps" can be established, rents and sale prices in economically marginalized places are often insufficient to cover construction costs. Higher interest rates and material and labor costs only compound the problem.

The Wall Street Journal reported on exactly this challenge in the summer of 2023, profiling a small grain-milling operation in Skowhegan, Maine. Looking to expand her business, the

Biddeford, Maine

Czech Village Mixed Use

small-business owner wanted to construct a new building next door but encountered the fundamental problem that stymies growth in so many places. Constructing a new building would cost $4.7 million, though it would only be worth $2.4 million once completed, given low land valuations. As of this writing, the project has not moved forward.

Developers wishing to reposition existing buildings encounter the same problem. For example, Wetumpka, Alabama, located about 30 minutes north of Montgomery, faces a significant housing shortage. Although a few recently created downtown residential units have been snapped up quickly, and despite high demand, willing building owners, and plenty of vacant upper stories along Main Street in Wetumpka, the economics of converting this space to housing do not work. Cash flow associated with converted space simply does not cover rehabilitation expenses. And down the road in Enterprise, Alabama, in a market that also desperately needs housing units, new small-scale mixed-use projects only look to be feasible when residential units are converted to short-term rentals. While Enterprise faces significant demand for these rentals, which will benefit the community, it's noteworthy and troubling that developers are unable to generate housing units downtown that are economically viable.

Even where proposed projects might generate a conventional rate of return, changes in the lending landscape hinder small-scale development. Most Main Street professionals will likely tell you that historically the banks most likely to invest in their downtowns have been smaller community or regional banks. But with a seemingly **continuous wave of bank consolidations in recent years,** fewer of these banks remain, leaving fewer lenders who will even consider Main Street–scale deals.

Typically, national banks have little interest in smaller projects; the underwriting on a small building requires virtually the same amount of work as a larger deal, and a big project will yield far more profit to the lender. Furthermore, big banks are looking to deploy massive amounts of capital, which is most efficiently done at scale on large projects. As one seasoned commercial real estate professional put it, today in America, it's far easier to secure a $100 million investment for a real estate development project than it is to secure $1 million.

These challenges are only amplified among communities of color. The **struggles to access capital in communities of color** are well documented and take many forms, including the **devaluation of entire Black neighborhoods** (thereby making it impossible to secure funding that will cover rehabilitation costs) **and general struggles to access credit among people of color.** Moreover, as has been documented by the Aspen Institute, difficulties obtaining financing in rural places are increasingly evident.

While Community Development Financial Institutions (CDFIs) can offer a pathway for funding small-scale projects, CDFI coverage in many parts of the country is inconsistent, and many rural areas do not have local or regional CDFIs to turn to for financing. Even where communities are fortunate to have access to these nonprofit financial service providers, only nine percent of CDFI capital is deployed as loans or equity investments in commercial

real estate projects. CDFI loan conditions (balance sheet requirements, etc.) often mirror those of conventional lenders **or are only marginally more flexible,** and thus make debt inaccessible to those newer to real estate development, including women and/or BIPOC (Black, Indigenous, and people of color) developers.

Finally, while federal and state Historic Tax Credits and New Markets Tax Credits would seem to offer help, these programs are typically ill-suited to small projects. The transactional costs associated with these tax credits and **excessively restrictive requirements on the use of space within these buildings** make them very difficult to use on small deals. While there are some exceptions in states with robust historic state tax credits, most small-scale developers find these credits of little utility.

Inexperienced Developers

According to MSA's research, about 40 percent of communities lack the developers needed to take on rehabilitation or infill projects. Specifically, there are often few experienced local real estate developers — particularly among women and people of color — within communities.

Aspiring developers often must navigate a fragmented and complex ecosystem, grappling with challenges ranging from property acquisition and local entitlement processes to securing financing and managing construction. Numerous interviewees observed that even when communities are fortunate to have local developers, these individuals tend to progress to larger projects with the promise of higher returns. This underscores the necessity for ongoing capacity building within communities to cultivate a pool of developers who are ready to gain experience through small-scale projects.

More than half of developers highlight the difficulty of securing predevelopment funding in the development process, particularly for smaller-scale, community-focused projects. Predevelopment expenses typically encompass architectural, engineering, and legal fees, as well as preliminary financial applications incurred during the initial stages of project development. MSA's research reveals that predevelopment funds often come from sources that may be scarce for first-time or inexperienced developers, such as personal balance sheets, support from friends and family, and investment clubs. As a result, any effort to support a healthy small-scale development ecosystem must cultivate alternative sources of predevelopment funding, specifically for individuals who traditionally face barriers to accessing such resources.

The Path Ahead: Investing Big in Small Deals

While we can hope for a future in which federal action helps to support small-scale development — through fixing federal tax credits and requiring national lenders to invest in small deals as a way of adhering to Community Reinvestment Act requirements — these solutions may be slow in coming or simply never materialize. Like many problems facing cities today, finding solutions to support small-scale deals will require creative action by local government professionals and elected officials. Specifically, unleashing capital and capacity-building resources is very likely to require partnership with a constellation of partners, including Main Street programs, Business Improvement Districts, the CDFI community and other community leaders, and philanthropy.

Consider Direct Investment

Across the country, many examples exist in which local government takes a direct role in repositioning small-scale projects. For example, two key buildings in Marion, Virginia, were damaged by a fire in 2021, subsequently becoming major eyesores in the community's downtown. Recognizing that the economics

Austin Avenue Sunset, Georgetown, Texas

of rehabbing these buildings were a nonstarter for a private developer, the town of Marion stepped in to play a direct role in rebuilding.

After competing for and receiving a $500,000 grant from the commonwealth of Virginia's Mixed Use on Main Street program, the Marion Economic Development Association (EDA) purchased the badly damaged buildings and created a plan to renovate the structures into 12 units of housing and three new retail storefronts. Once hazard abatement was completed, the EDA took action to identify a private developer to complete the redevelopment. Marion will deploy a portion of the $500,000 grant as low-cost debt to the developer; as this loan is repaid, it will create a revolving fund that the town will invest in other Main Street rehabilitation projects.

Engage Your Community Foundation or Other Regional Foundations

Many philanthropic foundations and other community-minded nonprofits are making incremental movements to align their investments with their charitable purposes, including deploying program-related investments (PRIs) or PRI-like investments. PRIs are mission or social investments that private foundations make to achieve their philanthropic goals. These investments are often not part of the 5 percent distribution that foundations are required to make by the Internal Revenue Service and are often deployed as investments with the expectation of a below-market financial return.

The Van Wert County Foundation in Van Wert, Ohio, is one such example, having recently invested significantly in Van Wert Forward. This multiphased initiative brings together multiple community partners and invests more than $100 million in a project that will focus on restoring buildings in Van Wert. This work reflects the movement of some foundation's investment goal to reduce their investments in Wall Street and redirect funds to local income-producing investments. Altogether, Van Wert Forward targets an impressive 50-plus parcels for redevelopment in Van Wert's Historic downtown, with a focus on modernizing structures to provide high-quality commercial and residential space. It's expected that most buildings will be held as income-producing assets that support the Van Wert County Foundation's charitable purpose for the foreseeable future.

The Danville Region Foundation (DRF) in Danville, Virginia, offers another example of a creative approach to supporting small-scale development (and larger rehabilitation projects, too.) While severely blighted and suffering from disinvestment, in the mid-2000s the DRF and other community partners began to realize the untapped potential of Danville's downtown and committed to supporting its revitalization. With the support of the DRF, the community created a downtown master plan, which has served as the playbook for downtowns' reactivation. DRF also located its headquarters downtown, and stepped in to purchase a large motor lodge and ready a key site for development, recognizing that private developers would not step up until demolition had been completed.

Connect with Your Local or Regional CDFI

While CDFI coverage across the country is inconsistent, where available these nonprofit lenders can be useful in providing financing to small-scale projects, particularly in disinvested places. The Opportunity Finance Network offers a **CDFI finder tool** on its website.

Find a Lender Offering Greenhouse Gas Reduction Funds

Many CDFIs and other nonprofit lenders, including credit unions, will soon receive funding through the federal Greenhouse Gas Reduction Fund (GGRF). Most of these dollars will be deployed by lenders as low-cost debt and to support decarbonization in the built environment. Adaptive reuse projects and downtown infill projects are **explicitly included as eligible activities** under this program, given the carbon benefits of reusing existing buildings and locating businesses and housing in walkable areas. The GGRF program rollout is expected to begin toward the end of 2024.

Consider CDBG Funding

The Community Development Block Grant (CDBG) program is available to communities as an entitlement or through state competition. CDBG funds can be used to support predevelopment and construction costs for projects that meet program eligibility requirements. In October 2023, the US Department of Housing and Urban Development released an updated **Community Planning and Development (CPD) Notice for CDBG grantees,** which offers in-depth guidance on how CDGB can be used to support affordable housing creation, including through adaptive reuse. The notice also offers details on how to use the CDBG Section 108 Loan Guarantee Program to support projects by leveraging an annual grant allocation to access low-cost financing for housing creation.

Technical Assistance Resources

Several technical assistance providers have emerged in recent years to support small-scale development.

The **Incremental Development Alliance** supports new developers through training and mentorship. They also support civic leaders in creating ecosystems that support small-scale development.

Building Small, led by architect and small-scale developer Jim Heid, connects small-scale developers to each other for peer learning and coaching.

Reimagine Development Partners offers the Community Real Estate Academy, a cohort-based training program that equips "local developers and community leaders with the skills, knowledge, and unwavering support needed to develop their own real estate projects."

Grow America is a national CDFI that offers an extensive range of training programs, including those useful for small-scale development.