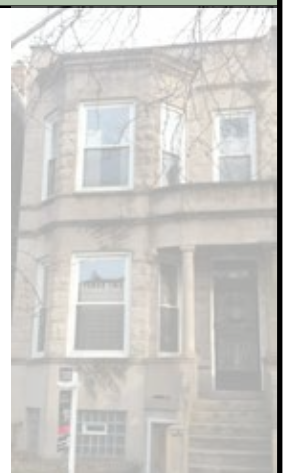
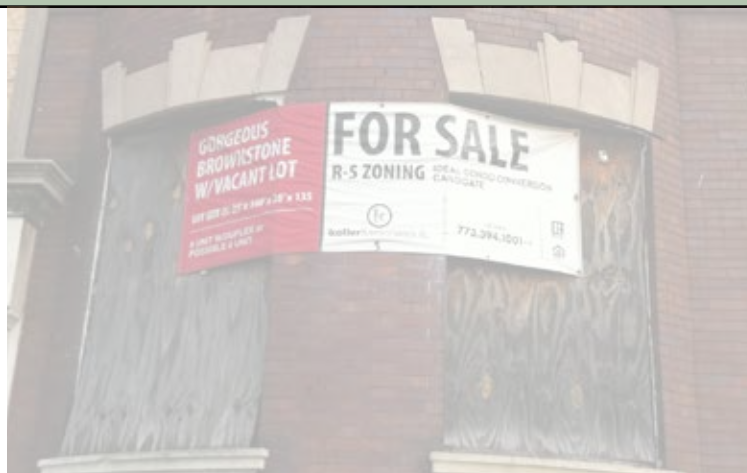


# The Social Ecosystem for Revitalizing Two- to Four-Unit Buildings in Woodlawn

A Case Study and Strategic Plan  
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## Chapter 2 Development Process



## **Chapter 2: Development Process**

### **Introduction**

This chapter is the first component of a three-part presentation of the results of a qualitative case study of the market for two- to four-unit buildings in Woodlawn, including both the numerous vacant buildings as well as the occupied buildings. Here I focus on the development process stretching from acquisition, renovation to leasing & sale of two- to four-unit buildings (or parts within), and also including the availability of financing and other forms of capital. The next two chapters present the social ecosystem surrounding the development process inspired by the work of Bloom and Dees (2008) who demonstrated how community development financial institution Self-Help Credit Union effectively cultivated its social ecosystem in re-shaping the home mortgage market. Chapter 2 focuses on the web interrelated individuals and organizations that are involved in the two- to four- market, including the resource providers, partners, alternative providers of housing, customers, problem makers and bystanders. Chapter 3 focuses on the environmental conditions that shape what players can do and their relationship with each other, including the economy, laws & regulations, demographics, culture and geography.

### **Framework**

The first chapter, in presenting the findings associated with the real estate development process, serves as the setting for the remaining presentation of the case study that forms a social ecosystem around the development of two- to four-unit buildings.

As it applies to this chapter, the process of real estate development of existing two- to four-unit buildings involves acquisition of the assets, renovation, sale or leasing to another, property management and financing. The sections of this chapter are organized into these process elements. The first section presents the collection of findings concerning the acquisition of two- to four-unit buildings in the neighborhood. The second section presents the collection of findings about the rehabilitation of buildings in Woodlawn, particularly the properties that have lay vacant for a significant period of time. The third section organizes the findings concerning the sale, leasing and ongoing property management of the entire property or individual units. The final section addresses the availability of capital, a critical part of the entire process.

### **Acquisition**

This section presents observations concerning the acquisition of two- to four-unit buildings in Woodlawn. There are a significant number of vacant properties, especially two- to four-unit buildings. Relevant to all efforts to alleviate building vacancies, there are particular idiosyncrasies in a one's ability to legally obtain smaller buildings and doing so is often cost prohibitive.

In the neighborhood, vacant one- to four-unit buildings are estimated at 200-300.<sup>1</sup> Vacant units in a study of Chicago neighborhoods similar to and including Woodlawn are overwhelmingly located in two- to four-unit buildings, reportedly as high as 95%.<sup>2</sup>

Despite the quantity, actual availability of the buildings depends on the ability to purchase them. The process for acquiring small buildings is considered to be particularly laborious.<sup>3</sup> Many properties are in “foreclosure limbo status,” such that the home may be vacant but because the foreclosure process has started the home could not be purchased through the city’s Neighborhood Stabilization Program (NSP) efforts. Homes could be tracked for several months, but it would still be uncertain as to when they might become available for purchase.<sup>4</sup>

In addition, information on available REO properties is often neither available publicly nor through the common databases of property listings. There is a tendency for REO properties to be listed on proprietary databases, not the Mortgage Listing Service that is the industry standard for realtors.<sup>5</sup>

Many buildings become difficult to acquire because of the amount of research required to determine official ownership of the property as well as potentially special legal action to needed to resolve these complexities. This is an issue with REO properties where ownership is complicated by the secondary market and derivatives.<sup>6</sup>

From a financial standpoint, unpaid property taxes and payments for municipal services pose another significant barrier to the purchase of smaller buildings for potential developers. They must be settled or removed (the latter is rare) before they can be sold or else they transfer to the new owner. One six-unit apartment building, for example, had \$130,000 worth of back-taxes.<sup>7</sup>

## Renovation

This section presents observations about the rehabilitation of buildings in Woodlawn, which is particularly relevant for properties that lay vacant for a significant period of time. Faced with the existing building conditions and the market demand, developers face several renovation options and limitations in Woodlawn.

### Current Building Conditions and Renovation Costs

There is significant variation in the building conditions and associated construction costs for vacant smaller buildings in Woodlawn. Some have more neglect, deterioration and expensive roof repairs that need to be addressed; others have attracted squatters who have created additional damage.<sup>8</sup> The nature of these repairs (plumbing, roof repairs and seepage) requires a significant amount of

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<sup>1</sup> Interview with Informant #17, 1/25/2013

<sup>2</sup> Interview with Informant #8, 1/22/2013

<sup>3</sup> Interview with Informant #2, 1/10/2013

<sup>4</sup> Interview with Informant #14, 1/24/2013

<sup>5</sup> Interview with Informant #15, 1/25/2013

<sup>6</sup> Interview with Informant #14, 1/24/2013; Interview with Informant #15, 1/25/2013

<sup>7</sup> Interview with Informant #15, 1/25/2013

<sup>8</sup> Interview with Informant #13, 1/23/2013

construction expertise that is generally greater than that of typical homeowners who might buy and upgrade their future home.<sup>9</sup>

Many two- to four- properties require \$100,000 to \$150,000 to renovate excluding the cost of paying back taxes and water bills.<sup>10</sup> For a homeowner, there are additional costs (and risk) associated with managing a contracting process and waiting for the project to be completed before move-in.<sup>11</sup> Not only is there imperfect information in assessing the renovation costs, but these overall cost outlays are also comparable to the cost of completed homes in other communities (Greenline Development, Inc., 2011).

An additional cost factor is labor, with a split between development with union labor and/or prevailing wages and development with lower costs.<sup>12</sup> The requirement of prevailing wages effectively eliminates the possibility of renovating smaller buildings without excessive financial cost.<sup>13</sup> This shapes the strategies with which developers consider the use of public subsidies that may invoke this requirement.<sup>14</sup>

### **Renovation Options**

Developers may consider a range of renovation approaches for two- to four- properties. These do not represent the extent of renovation schemes, but the distinctions speak to a number of implied business strategies outlined below.

#### *Subpar Renovations*

Before and after the onset of the financial crisis, inadequate renovations had already taken place in two- to four-unit buildings. Investors in Woodlawn and surrounding communities often completed minor renovations very quickly without permits and with little concern for quality in order to meet the market demand (for condominiums mainly).<sup>15</sup> When such homes went into foreclosure and banks realized how insufficient the renovations were, sometimes they just tore the buildings down.<sup>16</sup> This practice did not stop with the recession, as landlords still may take shortcuts in renovation or deliberately under-renovate properties with a rental strategy in mind.<sup>17</sup>

#### *Upscale Finish*

On the other side of the spectrum, many rental housing developers consistently pursue high-quality renovations with finishes that are marketed as “condo-quality” given their resemblance to the

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<sup>9</sup> Interview with Informant #15, 1/25/2013

<sup>10</sup> Interview with Informant #15, 1/25/2013; Interview with Informant #13, 1/23/2013

<sup>11</sup> Interview with Informant #15, 1/25/2013

<sup>12</sup> Prevailing wages are minimum wages that are set by local regulatory agencies, in this case the Illinois Department of Labor, that seek to prevent public expenditures from going to contractors that pay less than mandated. They may become attached to a development project with the provision of public funds, and are often highly consistent with the wages paid to a unionized workforce.

<sup>13</sup> Interview with Informant #7, 1/22/2013

<sup>14</sup> Interview with Informant #2, 1/10/2013

<sup>15</sup> Interview with Informant #1, 1/9/2013

<sup>16</sup> Interview with Informant #3, 1/16/2013

<sup>17</sup> Interview with Informant #3, 1/16/2013; Interview with Informant #13, 1/23/2013

amenities and level of finish found in condominiums. In addition to a general high-quality of construction, this scheme includes a consistent set of architectural features and amenities: hardwood floors; nicer cabinets, windows that provide more sunlight, expanded unit footprints, in-unit washer and dryer, granite or natural stone kitchen counters, kitchens overlooking larger dining/common rooms with bedrooms in back of the unit, higher-quality light fixtures, more expensive bathroom finishes, enforced HVAC controlled within unit and other utilities that are also controlled by tenants.<sup>18</sup> This was put in contrast to units that have one-color paint, carpeted, have less cabinet space and (subsequently) cost less.<sup>19</sup>

Though much of the so-called “condo-style” approach focuses on amenities, it also emphasizes construction quality. In addition, there is an apparent middle ground that foregoes marble countertops, premium bathrooms, but still emphasizes a commitment to quality that appeals to more selective tenants.

### *Conversion to/from Single-Family Housing*

Conversion between one- to four-unit and two- to four- properties has a long history in Woodlawn. Subdividing single-family units began in 1930s, which was considered a significant downgrade in the quality of the housing stock. The Chicago Fact Book Consortium (1984) notes that this “began an era of substandard housing in in Woodlawn.” Buildings that were originally constructed as single-family homes were converted to multifamily buildings after their wealthier inhabitants moved out and numerous, less wealthy inhabitants replaced them. Chicago saw “thousands of illegal conversions of dwelling units” during post-WWII era (ASPO, 1949). As a potential reversal of trend, planners have considered the viability of converting two-unit buildings into larger single-family homes.<sup>20</sup>

### **Professional and Building Services**

While many developers are vertically integrated and have the necessary construction experience, smaller-scale investors and homeowners generally do not. They must rely on various forms of professional and building services in dealing with renovation of buildings.

### *Construction Contractors*

When dealing with general contractors, it is important to appropriately structure incentives given the appearance of a principal-agent problem. Providing all the funds to contractors upfront is not advised as the contractor will “get lazy with it” and presumably complete the work in more time and with less precision leading to a greater probability of cost overruns.<sup>21</sup> However, smaller contractors will often not have the working capital to pre-pay the cost of labor and materials and are, thus, unable to get the job done without upfront payment.<sup>22</sup> Thus, the ability of smaller entrepreneurs to compete for construction contracts depends on finding this balance.

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<sup>18</sup> Interview with Informant #6, 1/18/2013

<sup>19</sup> Interview with Informant #6, 1/18/2013

<sup>20</sup> Interview with Informant #6, 1/18/2013

<sup>21</sup> Interview with Informant #16, 1/25/2013

<sup>22</sup> Interview with Informant #16, 1/25/2013

### *Design Services*

Architectural services are necessary because the homebuyers and smaller investors generally do not have the capacity to draft work scopes that general contractors will follow without an architect or the benefit of interior designers. These services have presented an acute need for smaller buildings that contractors have responded to.<sup>23</sup>

### *Local Economic Development*

In several respects, small building development was described as an opportunity to promote local economic development. If contracting is put out for bid, local developers have the opportunity to compete.<sup>24</sup> Small building redevelopment could serve as an opportunity to hire young, unemployed and under-employed workers who, consequently, are the same group associated with the neighborhood's public safety challenges.<sup>25</sup> In the eyes of sum, this would represent an improvement on the on-going Grove Parc redevelopment where there is a perception that few residents (of both the neighborhood and the development) have been involved in this work.<sup>26</sup>

### **Role of Scale in Renovation**

Issues of scale for the multifamily building with two to four units are significant when compared to the 5+ unit building. Larger projects are considered a more impactful use of resources, both in the case of public resources such as the design of NSP and also with developers who are deploying institutional capital.<sup>27</sup> The process of renovating both is similar, but depending on the mix of fixed costs (wiring, roofing) and variable costs (labor, other basic materials), the buildings may cost very similar despite how much more revenue larger buildings will generate.<sup>28</sup> For investors, larger buildings spread fix costs across more units.<sup>29</sup> To complicate the matter further, properties with a third and fourth unit (because they translate to additional floors), can add extensive construction costs when compared to a two-flat and were described as less desirable unless acquired at a considerably below-market price.<sup>30</sup>

### **Sale, Leasing and Management**

This section offers observations concerning both the disposition of properties and units through sale and leasing and their ongoing property management. Properties may be sold prior to (or without) renovation, they may be sold as finished buildings, and they may be sold individually as condominium units. Property management is required for both investor properties and for owner-occupied homes with one to three additional rental units.

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<sup>23</sup> Interview with Informant #1, 1/9/2013

<sup>24</sup> Interview with Informant #17, 1/25/2013

<sup>25</sup> Interview with Informant #12, 1/23/2013

<sup>26</sup> Interview with Informant #12, 1/23/2013

<sup>27</sup> Interview with Informant #13, 1/23/2013

<sup>28</sup> Interview with Informant #6, 1/18/2013

<sup>29</sup> Interview with Informant #13, 1/23/2013

<sup>30</sup> Interview with Informant #6, 1/18/2013

### Rental Properties

The combination of families who have exited foreclosure and cannot obtain bank financing has been causally associated with a generally stronger rental market.<sup>31</sup> There is some precedent for professionally managed rental housing in two- to four-unit buildings, with one property management provider describing a conscious effort to increase such buildings in their portfolio.<sup>32</sup> Portfolios of scattered site properties are associated with higher maintenance costs given the challenge of geography, but also the diversity of building types of fixtures.<sup>33</sup> Condos are also rented out with professional management, either as a cash flow strategy while an entire portfolio is being sold in a difficult market, or while a private owner holds on to a unit and waits for property values to increase.<sup>34</sup>

In spite of the challenges, there are two- to four-unit buildings maintained as rental properties, they are just not considered ideal candidates for this type of investment. The margins are low when compared to buildings with 6 or more units. Moreover, owner-occupants generally depend on self-management and subsidized mortgages.<sup>35</sup>

### Tenant Selection

Methods of tenant selection further uncover varying philosophies and business strategies with different implications for neighborhood considerations, which I will address in later chapters. Many successful, mid-range, developers rely on active property management and the previously detailed high-quality amenities in order to maintain a desired tenant base. Both the reputation of a landlord and the intangible, outward signals of property management style were important in tenant selection.<sup>36</sup> For those interviewed, wanting “good” tenants did not imply being dubious about Housing Choice Voucher recipients and discriminating against poor people, but recognizing that having clear and consistent expectations that apply to all tenants would deter the subset of tenants who move often, are relatively destructive to the property and consistently disruptive.<sup>37</sup>

Both the quality of property management and physical renovation were instruments of a value-driven business strategy. Informants believed getting a “better tenant make-up” was valuable for maintaining (and increasing) the value of the real estate asset.<sup>38</sup> Performing management internally was also important for quality management.<sup>39</sup> These strategies (combining the amenities with particular property management philosophies) were associated with mid-range or larger investors and not as common among the smaller “mom and pop” operators of housing.<sup>40</sup>

Though other developers consider Woodlawn unable to compete off the basis of amenities, local developers are confident that property management is the key to doing just that: “If you've got a

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<sup>31</sup> Interview with Informant #13, 1/23/2013; Interview with Informant #6, 1/18/2013

<sup>32</sup> Interview with Informant #1, 1/9/2013

<sup>33</sup> Interview with Informant #1, 1/9/2013

<sup>34</sup> Interview with Informant #1, 1/9/2013

<sup>35</sup> Interview with Informant #17, 1/25/2013

<sup>36</sup> Interview with Informant #6, 1/18/2013

<sup>37</sup> Interview with Informant #6, 1/18/2013

<sup>38</sup> Interview with Informant #6, 1/18/2013

<sup>39</sup> Interview with Informant #13, 1/23/2013

<sup>40</sup> Interview with Informant #13, 1/23/2013

quality rental unit that people find attractive, meaning the construction is well done, the finishes are very nice and you are priced competitively then I think you're going to be ok," one informant noted.<sup>41</sup>

### *Management of Housing Choice Voucher Recipients*

The Housing Choice Voucher (HCV) program is a demand-side subsidy for low-income persons, who can use them to secure housing in the private market. As part of the program, CHA enters a contract with the landlord and serves an intermediary between the landlord and tenant. While there are greater maintenance costs associated with HCV tenants, the underlying factors for this phenomenon appeared to be disproportionate representation of families with children, incentives for utility usage and the troubling effects of social networks (chosen and not).<sup>42</sup> In particular, instability was not a uniform characteristic of all participants in the program.<sup>43</sup>

Some are doubtful that pursuing voucher holders is a prevalent business strategy given the perception of higher management costs and hassles associated with the program; however, landlords do charge housing choice voucher tenants higher rents than those they could collect from the average market-rent tenants.<sup>44</sup> Additionally, the Metropolitan Planning Council (2013) describes how HCV recipients factor into the rental strategy for one- to four-unit buildings, with an emphasis on their ability to counteract high neighborhood vacancies:

Single-family rental owner-operators are using housing vouchers to achieve adequate cash flow on properties where rental vacancies may be higher. Many CDCs, such as nationally recognized Beyond Housing in St. Louis, rely on HCV payments to effectively manage their single-family rental home portfolio. (p. 12)

This strategy seems to be most applicable to West Woodlawn. Building landlords on the other side of the neighborhood are especially un-interested in voucher holders, showing a preference for young professionals who are looking for higher amenity buildings that subsequently cost more.<sup>45</sup>

### **For Sale Properties**

Entire two- to four-unit buildings were sold primarily to homeowners, but also occasionally to investors. Identifying potential buyers includes reaching through existing organizational infrastructures because these connections demonstrate an existing investment in the neighborhood.<sup>46</sup> When found, it was likely that buyers would need technical assistance on the construction process (in the case of buying homes in need of renovation) and also homeownership counseling.<sup>47</sup> The particular case for two- to four-unit properties for homeowners is their supplemental income that can make homeownership possible at the margin or support a more

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<sup>41</sup> Interview with Informant #13, 1/23/2013

<sup>42</sup> Interview with Informant #7, 1/22/2013; Interview with Informant #6, 1/18/2013

<sup>43</sup> Interview with Informant #6, 1/18/2013

<sup>44</sup> Interview with Informant #4, 1/17/2013; Interview with Informant #6, 1/18/2013

<sup>45</sup> Interview with Informant #6, 1/18/2013

<sup>46</sup> Interview with Informant #2, 1/10/2013

<sup>47</sup> Interview with Informant #2, 1/10/2013

expensive home; that is, assuming that the added responsibilities of being a landlord are not overly burdensome.<sup>48</sup>

Buildings are not only sold to homeowners. Two- to four-unit properties may also be developed and sold to other landlords looking to maintain the property as rental housing.<sup>49</sup> Portions of Woodlawn have had an active market for condominiums in smaller buildings. Yet, selling condominiums in two- to four-unit buildings pose unique challenges because of the smaller number of owners involved in a fundamentally collaborative venture. The stability of condominiums in two- to four-unit buildings is jeopardized once a single unit becomes vacant due to foreclosure. The chain effect of vacant condo units in smaller buildings has proven to be a critical challenge citywide. As described by one informant, “When half the units are vacant, then it's a real mess. Hard to sustain a condo when nobody is paying the bills.”<sup>50</sup> One or two foreclosures would leave a large portion of the condominium fees, such as insurance, unpaid. This can and has often led to foreclosure for remaining payments as well.<sup>51</sup>

Furthermore, the legal structure of a foreclosed building consisting of condominiums cannot be sold to a single homeowner or another entity without costly legal work to re-assemble the property. The City of Chicago has had to develop a special program to do so, as part of the Troubled Building Initiative that will be described in later chapter.

### **Financing Two-to-Four Unit Buildings**

This section describes the general structure and availability of capital for various parts of the development and management of two- to four-unit buildings. The use of permanent financing, if sought, is split unevenly between owner-occupants and investors. There are also financing needs for rehabilitation, which are typically different in the commercial real estate world. Capital availability has decreased as a result of the appraisal process and the reaction of banks to the large-scale fraud during the height of the housing boom.

To consider the availability of financing for two- to four-unit buildings, one must consider the prevalence of cash purchases. There were 76 recorded sales of two- to four-unit buildings in Woodlawn in 2011, approximately 63.2% of which were purchased with cash, slightly higher than the citywide average of 56.5%. Just less than half of the buildings were purchased out of REO status (IHS, 2012a). Cash buyers have an easier time acquiring properties compared to those investors who must gather financing.<sup>52</sup> They also have a much easier time participating in business strategies that are not in the best interests of the neighborhood's revitalization.

### **Investment Properties**

Investor financing for two- to four-unit buildings is rare and difficult to achieve, but not entirely impossible. There is a growing consensus among community and policy leaders that inadequate funding exists for investor owners of smaller buildings. Even in the case of someone wanting to purchase more than a single two-flat on the same block, developers have great difficulty obtaining

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<sup>48</sup> Interview with Informant #3, 1/16/2013

<sup>49</sup> Interview with Informant #6, 1/18/2013

<sup>50</sup> Interview with Informant #2, 1/10/2013

<sup>51</sup> Interview with Informant #2, 1/10/2013

<sup>52</sup> Interview with Informant #2, 1/10/2013

loans from the banks that purportedly engage in this type of lending.<sup>53</sup> Those developers who successfully obtain this type of financing have consciously cultivated a relationship with a bank that understands their business model, have self-financed much of their earlier projects and seek mortgages on portfolios of at least 6 or more properties.<sup>54</sup> Barriers for developers include the requirement for personal guarantees for loans or the 25% down payment, general tightening of lending by banks for new developers, and bank failures (such as Shore Bank who was once a major lender in this niche).<sup>55</sup>

Recent changes in the lending environment include the discontinuation of more lenient down payment requirements and loans to ordinary working professionals for up to 110% loan-to-value of the property.<sup>56</sup> Appraised values were much higher prior to the recession, which raises the possibility that terms are similar and that appraised values are the primary reason for differences in the availability of capital.

Another prominent reason for difficulty in financing individual two- to four-unit rental properties is the volatility of the associated revenue stream. Banks find it difficult to “justify” lending \$100,000 for a two-flat, given how much of a percentage of the monthly revenue is lost with just a single vacancy. The same bank would be much more apt to loan \$110,000 for a six-unit apartment building.<sup>57</sup>

One alternative source of financing for two- to four-unit buildings is the working capital loan. These business loans may need to be settled every 6 months and also require personal guarantees, but can be easier to obtain from banks than permanent financing. They allow the ease of purchasing properties with cash, paying for construction and also building a fruitful business relationship with a lender.<sup>58</sup>

There is also the possibility of raising equity for portfolios of smaller buildings, specifically diversified portfolios of both two- to four-unit and larger properties. In one example, investors do not have guaranteed returns, get back the majority of their investment during the construction and lease-up phase, and then share ongoing revenues.<sup>59</sup>

### **Owner-Occupants**

Although financing for homeowners is so limited in low to moderate-income communities like Woodlawn, it remains the predominant type of financing available for two- to four- properties. The former is attributed to skepticism on the part of banks given concerns about the future of home

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<sup>53</sup> Interview with Informant #15, 1/25/2013

<sup>54</sup> Interview with Informant #1, 1/9/2013

<sup>55</sup> Interview with Informant #6, 1/18/2013; Interview with Informant #1, 1/9/2013; Interview with Informant #13, 1/23/2013

<sup>56</sup> Interview with Informant #13, 1/23/2013

<sup>57</sup> Interview with Informant #6, 1/18/2013

<sup>58</sup> Interview with Informant #6, 1/18/2013

<sup>59</sup> Interview with Informant #6, 1/18/2013

values.<sup>60</sup> The prospect of falling home values, presumably, raises the specter of additional foreclosures.

Informants provided countless examples of the difficulties prospective homeowners experience in obtaining home mortgages. One particular NSP property saw a slew of potential buyers get denied for a loan.<sup>61</sup> After the housing crisis, someone earning as high as 80% AMI is generally unable to qualify for a loan.<sup>62</sup>

Federal Housing Administration-insured loans have the primary advantage of allowing a homeowner to put less money down (as low as 3.5%), and they are more flexible on credit scoring. There was at least one example of a homeowner of a two- to four-unit building who put down 20% to buy his property.<sup>63</sup>

One lender acknowledged that his industry had utilized the discretion offered in FHA-guidelines to be more restrictive. The guidelines have not changed dramatically, such as qualifying ratios that compare income and debt. The FHA still allows a homeowner to have weaker credit and put less money down. However, while banks were previously allowed to exceed the guidelines, now they have been given authority to exceed the guidelines even further.<sup>64</sup>

Sharing anecdotes about difficulties that consumers have, lenders will readily point out that every loan is different, from the credit score, qualifying income to the actual home for sale. They may also point to the steps they take to expand homeownership opportunities, including allowing future homeowners to receive gifts that can go towards reducing their down payment. For three- to four-unit buildings they require the homeowner to directly fund a 3-month reserve for payments, interest, taxes and insurance, as well as mortgage interest premium.<sup>65</sup>

### **Acquisition and Rehabilitation Financing**

Distinguished from the traditional home purchase loans, acquisition and rehabilitation financing allows an investor or a homeowner to apply for permanent financing that incorporates yet-to-be-completed renovations to the property. Once approved for the loan, a portion of the funds are disbursed in a similar manner as a construction loan to be used for the same purpose.

Standard construction loans are also available for the purchase of two- to four-unit buildings, but they can be more difficult to access. Organizations like Neighborhood Housing Services of Chicago are known to work with buyers to draw out the scope of work and manage the construction process.<sup>66</sup> They also provide acquisition and rehabilitation loans through their lending arm. These type of loans are much more difficult for investors to obtain.<sup>67</sup>

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<sup>60</sup> Interview with Informant #13, 1/23/2013

<sup>61</sup> Interview with Informant #14, 1/24/2013

<sup>62</sup> Interview with Informant #4, 1/17/2013

<sup>63</sup> Interview with Informant #3, 1/16/2013

<sup>64</sup> Interview with Informant #16, 1/25/2013

<sup>65</sup> Interview with Informant #16, 1/25/2013

<sup>66</sup> Interview with Informant #2, 1/10/2013

<sup>67</sup> Interview with Informant #16, 1/25/2013

For homeowners, the most advantageous opportunity for obtaining an acquisition and rehabilitation loan is through HUD's 203(k) program. This FHA-backed loan lends on the post-renovated property. It allows a purchaser to submit construction plans to an appraiser, and take out financing on the property for the after-improved value. The program allows a bank to increase the loan value up to 110% of the appraised property value, which could give special consideration to neighborhoods where property values are low. However, not all banks exercise this option.<sup>68</sup>

### Appraisal Processes

Appraisals are central to the process for obtaining financing. Professional appraisers conduct a review of the comparable sales in a 1-mile radius over the past 12 months to determine a home's appraised value. Banks use these appraised values rather strictly as the upper limit on the value of a loan.<sup>69</sup>

Appraised values are considered by many to limit the availability of mortgage financing. As real estate declines, so will the amount of mortgage a bank will provide.<sup>70</sup> In addition, sales of distressed properties that are foreclosed or sold through short sales are included in appraisals. Banks use this practice, justifying it with arguments that such properties (of comparable condition) represent available properties on the market.<sup>71</sup>

Many banks do not appear to be visibly proactive in their lending in low to moderate-income communities, but they do make some effort towards improving capital access. Unfortunately for Woodlawn, they do not take into consideration ongoing public investment that has yet to be observed in property values.<sup>72</sup> However, on occasion a loan officer may react to an appraisal that is perceived as unfairly low and proactively fight for a higher value.<sup>73</sup> As mentioned, the HUD 203(k) loan program allows banks to loan at up to 110% of the appraised value for acquisition and rehab loans.<sup>74</sup>

### Chapter Summary

While there are a sizeable number of vacant two- to four-unit buildings that appear to be on the market, it is also difficult for developers to obtain access to them because of a combination of factors: the cost of information, foreclosure status, title issues and back taxes, and utility services that would have to be paid as well.

The renovation of two- to four-unit buildings presents a scenario in Woodlawn, where the building condition is a significant unknown that must be assessed on a case-by-case basis. Renovation often requires assistance of a professional and can cost well over \$100k. Labor costs are a major cost driver for renovations, one that can make or break a project. Beyond labor costs, developers can choose to pursue a more luxurious finish that helps in attracting higher-income tenants or pursue a less luxurious finish or even a subpar renovation. The market appears to tolerate lower quality

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<sup>68</sup> Interview with Informant #16, 1/25/2013

<sup>69</sup> Interview with Informant #16, 1/25/2013

<sup>70</sup> Interview with Informant #13, 1/23/2013; Interview with Informant #2, 1/10/2013

<sup>71</sup> Interview with Informant #16, 1/25/2013

<sup>72</sup> Interview with Informant #16, 1/25/2013

<sup>73</sup> Interview with Informant #16, 1/25/2013

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renovations. The history of the building stock reflects that two- to four-unit properties are often converted to single-family homes, and re-conversion presents a possible option in today's climate. Renovating two- to four-unit buildings are difficult for investors because the fixed costs are considerable and are only spread across a few units. Ideally, the renovation activity presents a source of economic development for the neighborhood's residents.

As simple as it may be to name different steps in the real estate process, in reality they are interlinked from the perspective of its application to buildings. The sale and leasing of two- to four-unit buildings requires property management that both investors and homeowners alike (unless they purchased a condominium) must perform this task. Property management is, in many respects, the key to interventions in the two- to four-unit market, as there is much variation in approaches and business strategies with important implications for the market. There are both landlords providing high-quality rental units with impressive management standards (the "high-road") as well as landlords that pursue a strategy of cost cutting (the "low-road"). Voucher holders can present an attractive strategy for bolstering revenues for all landlords and it would appear on the face of it to apply equally to "low-road" landlords as it does to "high-road" landlords, though landlords in East Woodlawn seek to avoid many such tenants altogether.

Scattered site rental is accompanied by greater maintenance and renovation costs, however aggregating portfolios presents an opportunity for successfully vying for investor financing. Other factors limiting the availability of capital include low property appraisals (for homeowners and investors alike), the requirement of 20-25% equity for investor financing and the difficulty of establishing relationships amid the transition and tightening of the financial industry. As with the entire single-family market, homeowners have a distinct advantage over investors with FHA loans that allow smaller down payments and easier access to acquisition and rehabilitation financing, yet other factors make it difficult to apply these lessons to Woodlawn.

### **Conclusion**

The real estate process around two- to four-unit buildings raises important questions about the relationship between real estate and the larger social ecosystem. Whether it is the unique circumstances of financing renovation for two- to four-unit buildings, the capital availability for homeownership, or the challenges of acquiring ready-to-develop properties, it is easy to begin to see how the environmental conditions in Woodlawn contribute to perpetuating vacancy in the neighborhood. In addition, one can also see how the transactions, decisions and relationships undertaken by various players in the real estate process, such as the tenant selection strategy, the renovation strategy, prior relationship with lenders, and others, all have implications for the well-functioning of the two- to four-unit building market that would potential welcome additional housing stock in the form of renovated buildings. In the two chapters that follow, I turn to the discussion of the social ecosystem and its effects on the development process.