White Paper

Building a Supportive Capital Market for Underinvested Neighborhoods

Investing in Chicago's South and West Sides

Brianne Ziegler, Hans Montgomery, Ryan Curley, Cassandra Di Prizio, Kedra Newsom Reeves

In Chicago and across the wider United States, there is a consistent challenge in attracting stable, long-term investment into disadvantaged communities. However, investors in Chicago have been working to reverse this trend. To create financial and social benefits, this paper, funded by BCG's Center for Illinois' Future, recommends an approach focused on building project pipelines, simplifying transactions, and increasing the flow of capital.

Flexible, low-cost financing is often unavailable to entrepreneurs and developers of color in underinvested communities across the US, especially for catalytic investments of $5-10M and above. In Chicago, around 80% of Black and LatinX entrepreneurs are unable to get access to sufficient equity capital for their ideas, compared with 46% of their White counterparts. The result is an estimated $146 million equity capital gap.[1] When there are challenges raising equity capital, entrepreneurs and developers in underinvested neighborhoods often turn to debt — an option that is both expensive and inflexible. Even then, debt is harder to secure than for White entrepreneurs and developers: between 2015 and 2017, majority non-white census tracts in Chicago were home to 25% of the city's businesses but received just 16.5% of loan funding.[2] This state of affairs is reflected nationally. Across the US, Black-owned high-turnover businesses in 2017 were allocated only half of loans allocated to White-owned businesses, and those that were offered tended to be more expensive.[3]

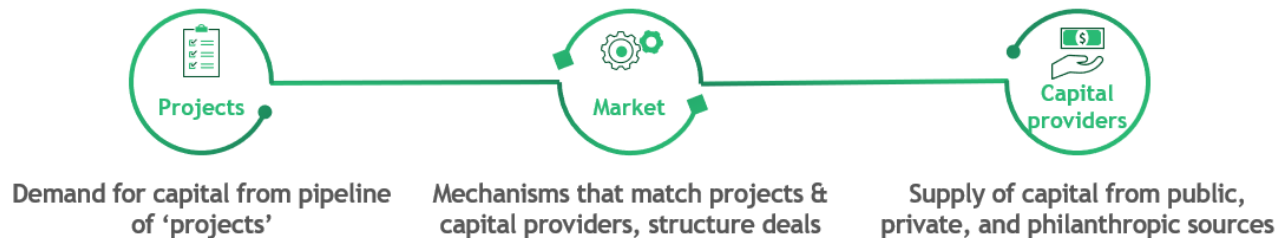
The financing shortfall in underinvested neighborhoods is the result of generations of discriminatory housing policies, combined with the departure or decline of industries that once sustained urban economies. These events followed by lack of investment contributed to an environment in which potential projects score low on traditional financial metrics. In addition, for projects within underinvested neighborhoods, there are often few existing examples to benchmark the investment case and index potential returns. As a result, the supply of capital — especially patient, flexible capital — is limited, particularly at projects' early stages. These conditions undermine pipeline development and starve neighborhoods of new investment.

To break the circle of underinvestment, under-employment, and depopulation, bold actions are required. These should aim to bring together projects, market mechanisms to match projects and capital providers, and capital (Figure 1). One recent success was the case of E.G. Woode, a social enterprise based on the South Side of Chicago that provides turnkey retail space and business support to Black and Latinx project generators (e.g. entrepreneurs). E.G. Woode secured a City of Chicago retail grant but required additional financing. It teamed up with The Community Desk Chicago, which unlocks capital for transformative real estate development in historically underserved Black and Latinx communities, and the University of Chicago, to develop a business model primed to attract capital. These efforts led to funding from sources that included a CDFI (Community

[1] The Equity Capital Gap (June 2020), Next Street
[2] Patterns of Disparity: Small Busines Lending in Illinois (August 2019)
[3] Bloomberg, Minority Business Development Agency (2017) (link)

Development Financial Institution) loan and private capital. Today, E.G. Woode supports six project generators on the South Side.

Figure 1: Three key success factors: Projects, market, and capital



The progress made by the E.G Woode initiative reflects a wider cause for optimism around social impact investing. The COVID-19 pandemic, which has disproportionately impacted people of color and small businesses, and the growing focus on racial justice have sparked renewed urgency among corporations, philanthropies, and individual investors to make a difference. The vast majority of Chicago's private and philanthropic investors interviewed for this paper say they want to be more involved in directing capital to South and West Side businesses and real estate development. In addition, local Chicago-based initiatives, including Chicago Mayor Lori Lightfoot's INVEST South/West effort and the Chicagoland Opportunity Zones Consortium, have picked up momentum.

Despite these positive trends, however, significant barriers to investment remain. Beyond individual projects, a supportive market structure needs to be put in place, first discussed in the BCG and JPMorgan Chase Foundation paper "Amplifying Investment in Chicago's Disinvested Neighborhoods".

Stakeholders we interviewed for this current paper affirmed the power of many of these amplifiers, including community collaboration, asset-based planning, and concentrated investment. Our work leverages interviews with more than 45 individuals, representing traditional investors (banks, asset managers, private equity), mission-aligned impact investors (family offices, CDFIs, foundations), and mission-aligned organizations to understand barriers to investment and identify remediation strategies. It sets out key elements of a supportive capital market ecosystem and describes how stakeholders across Chicago can coalesce to amplify impact in three areas:

1. **Enhancing the project pipeline:** Build the capacity of project generators to deliver investment-ready projects.
2. **Optimizing market mechanics:** Reduce transaction costs (search, processing, etc.) and increase speed to execution to match capital providers more efficiently with suitable projects.
3. **Increasing the flow of patient, flexible capital:** Attract more first-loss and equity capital to unlock access to traditional capital sources.

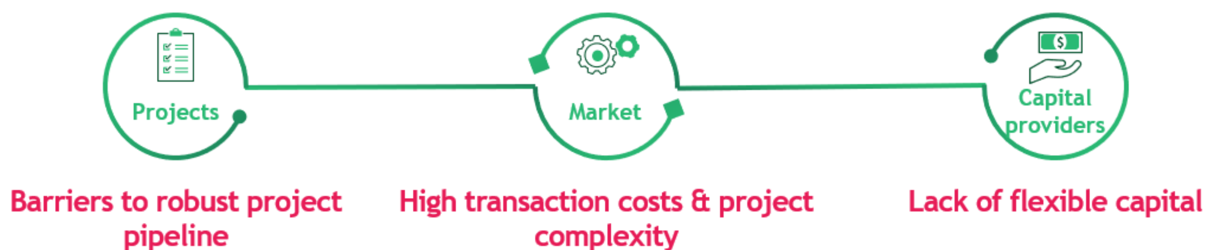
COMMUNITY DESK CHICAGO

The Community Desk Chicago was launched in 2019 as an initiative of The Chicago Community Trust, following a six-month joint effort between BCG's Center for Illinois' Future and JPMorgan Chase Foundation. It aims to explore how to drive more impactful community-oriented investment in Chicago's South and West sides. The Desk works to close funding gaps in real estate projects involving underserved Black and Latinx communities. Specifically, the Desk leverages private market expertise and knowledge of financial markets to put community projects in a position to attract capital.

Why the Traditional Market Often Fails

There are barriers to investment in all of the key market components in underinvested communities — projects, the market, and capital provider (Figure 2). First, project generators and investors often struggle to align on project returns and impact potential. Market mechanics, meanwhile, are challenged by high project search costs and project complexity. These serve to drive up transaction costs for both project generators and capital providers. The supply of capital is thus limited, especially at critical points such as in the pre-development phase.

Figure 2: Capital market structure & barriers



A PROBLEM GENERATIONS IN THE MAKING

Systemic economic and racial segregation has plagued many Chicago neighborhoods over the past century. Discriminatory housing policies such as "red lining" have exacerbated racial segregation and created isolated communities that were subsequently neglected. In parallel, industries that once sustained urban economies have declined. One example is the closure of the US Steel complex in South Chicago, which devastated the once prosperous community. While initiatives such as INVEST South/West aim to attract new investment, South and West Chicago neighborhoods continue to face disproportionately high rates of poverty and unemployment.

Project pipeline

A significant challenge on the South and West sides is population loss[4], which makes it more difficult to start or grow a business or development opportunity. Commercial real estate projects in the South and West sides tend to deliver mid-single digit returns[5], compared to 10-15%+ returns from the same projects in other neighborhoods. Capital needs vary depending on the stage of development a project has reached—from idea to research to implementation. Projects also frequently take more than seven years to deliver returns, which is too long for many investors[6].

Beyond pure financials, projects are often unable to meet investment criteria. These tend to be opaque and specific to the investor (e.g., impact sought or preferred industry focus). Project generators often do not have networks that can help them navigate these issues.

Pressure-testing business plans and pro formas, constructing the capital stack, and perfecting investment pitches are all necessary elements of successful financing. However, they require experience and expertise. Sometimes additional knowledge is required to facilitate community ownership. While some capital providers work directly with project generators to address these areas, these capital providers often lack the bandwidth to provide coaching, so more resources are required.

Market

The capital market for underinvested neighborhoods is too shallow and slow-moving. Project generators not only incur higher costs of capital but also spend significant resources and time identifying opportunities and constructing capital stacks. Stacks for commercial real estate projects are particularly complex, often comprising concessionary capital, tax credits, and multiple sources of market-rate funding. This drives up costs and extends the timeline to execution.

Capital providers also incur high per-project costs to find projects that meet their investment criteria, even if they are impact driven. Capital markets for underinvested neighborhoods often lack transparency; there are limited platforms to communicate funding opportunities, and public incentives can be unclear. Many capital providers may be unfamiliar with underinvested neighborhoods and must reach outside their immediate networks to identify deals. Because they have no track record in these neighborhoods, investors cannot leverage comparable properties to judge risk. Other risk evaluation tools, such as property appraisals, have been shown to perpetuate racial biases by systematically undervaluing Black-owned properties and "grandfathering in" the impact of racist policies.[7] If an investor does identify

[4] Downtown Chicago Grows While The South And West Sides Lose Population, NPR (2019) (link)

[5] Bridging the Gap: Impact investment supply and demand in the Chicago Region (2017); BCG-conducted investor interviews

[6] Bridging the Gap: Impact investment supply and demand in the Chicago Region (2017); BCG-conducted investor interviews

[7] IFF, Bloomberg

a promising deal, they must then pursue bespoke negotiation and due diligence processes. While deals that are $5-10M are large for these communities, deals that size are relatively small for large capital providers (e.g., national banks, asset managers) and can be highly illiquid, which disqualifies them from many institutional mandates. After investment – unlike more well-resourced neighborhoods – the need for a double line and concerns of a tenuous financial return arises. These impacts are frequently tracked ineffectively, or not at all. From end-to-end, the process is often more time and resource-intensive than in traditional projects.

Capital Providers

Access to patient, flexible capital remains a major issue. Commercial real estate projects typically need 20-40% equity financing[8] in their capital stacks to satisfy the requirements of other capital providers, but investors are often unwilling to provide equity for project generators in underinvested neighborhoods. In 2017, the MacArthur Foundation estimated that there would be between $100 and $400 million in unmet flexible impact capital needs by 2022[9]. Many of those interviewed for this report agreed with this assessment.

One major challenge to obtaining financing is pre-development costs that are driven up by factors including complex land acquisition, zoning and permitting, and environmental conditions.[10] For that reason, bridge financing is important, reflecting the fact that timelines from plan to revenue generation are long. However, the capital available to fund those costs is often cost-prohibitive or not allocated given the perceived risk of the project.

While there are sources of philanthropic or first-loss capital to supplement capital stacks, many philanthropists are inexperienced in deploying capital as program-related investments (PRIs) or mission-related investments (MRIs).[11] While some philanthropies are working to develop those skills, they are unlikely to be able to address the lack of patient, flexible capital alone. The public sphere has stepped up, too: Chicago Mayor Lori Lightfoot's INVEST South/West is attracting private sector investment by concentrating city funding in visible developments in specific corridors in 10 neighborhoods. While it has mobilized $250M in city funding and $500M+ in private and philanthropy commitments, more investment is needed to achieve the vision.

CDFIs are a vital conduit to funnel capital to businesses and development projects. However, they are restricted in their impact because they typically only offer debt financing. CDFIs are also generally tied to risk metrics that allow them to maintain and attract capital sources, and have limited ability to provide equity or invest in "riskier" projects. Further, the COVID-19 pandemic has increased demand for CDFI services and strained financial and human resources.[12]

[8] BCG-conducted investor interviews
[9] Bridging the Gap (2017), MacArthur Foundation and the Chicago Community Trust
[10] Collaborative Capital Investing (Philly webinar)
[11] https://nextbillion.net/in-search-of-innovation-flexible-capital/
[12] https://www.minneapolisfed.org/article/2020/covid-19-connecting-small-businesses-to-pandemic-relief-is-a-struggle-cdfis-say

A Supportive Market: What it is and What it Needs

Given that the traditional market has failed to channel sufficient capital to underinvested neighborhoods, there is a need for a supportive capital market that leverages funding from private, philanthropic, and public sources. A supportive market maximizes community impact to: (i) enhance the project pipeline; (ii) optimize market mechanisms to efficiently direct capital to projects at scale; and (iii) increase the supply of patient, flexible capital. The foundations for these are in place, but more work is required to bring them to maturity.

1. *Enhance the project pipeline*

A supportive market nurtures projects and effectively communicates economic and social value to investors. Today, most stakeholders familiar with commercial markets in Chicago's South and West sides assert that there is a strong pipeline of projects[13], but say that more effort is required to make the pipeline investor-ready. This may require support to fine-tune and strengthen the underlying business case or enhance the story behind the pitch. There are several organizations dedicated to building project pipelines (see detail: Capacity Building Organizations), but more resources are required to achieve an optimal flow of projects. These should focus on:

- Community plans: Continue to build and refresh neighborhood plans, and center community development efforts on these priorities.
- Technical support: Provide resources for developers, Community Development Corporations (CDCs), and project generators to improve business plans and deal making; including polishing pitches to ensure projects are viable and investor-ready.
- Communities of practice: Create forums where CDCs and others involved in development work can share best practices and coordinate investment efforts.
- Emerging developer programs: Upgrade capacity-building programs for new and diverse developers to build networks and share best practice.

CAPACITY BUILDING ORGANIZATIONS

With increased focus on neighborhood revitalization, there are several organizations dedicated to enhancing the project pipeline, as well as tailoring the pipeline to traditional, impact, and philanthropic investors. One example is CEMDI, a centralized resource for community-focused real estate developers. CEMDI aims to expand developers' experience of large-scale commercial real estate projects and improve access to funding.

2. *Efficient, scaled market mechanisms that direct capital to projects*

Mechanisms are required to efficiently aggregate and deploy capital to suitable projects at scale. These will reduce transaction costs and abate liquidity concerns:

[13] BCG-conducted investor interviews

- Data platform: Assemble a repository of neighborhood-specific data that project generators and capital providers can leverage to better articulate and understand project fundamentals (cash flows, foot traffic, unit profitability) and risk profiles. Some of this exists but scaling up could drive significant impact.
- Network directory: Create a directory of funds, CDCs, and local developers to improve marketplace transparency and access to information.
- Scaled horizontal services: Centralize key horizontal services (investment assessment, capital stack construction, business plan pressure testing, background checks) in one entity, which will be particularly useful to smaller capital providers.
- 'Pre-certification' agreements: Facilitate partnerships (potentially through an intermediary) between capital providers and project collectives (e.g., CDCs) to elevate vetted projects and fast track investment.

A fund structure or asset management entity that aggregates capital from a broad range of capital providers and allocates across portfolios of projects would optimize market mechanics and increase the flow of patient, flexible capital. It would enable investors to diversify risk, increase liquidity, and scale search and evaluation functions. There are a set of exciting fund structures operating in Chicago today, as well as focused asset managers emerging outside of Chicago, but there is room to pull more capital into this ecosystem with new and unique characteristics.

CAPITAL AGGREGATION STRUCTURES
Several recent capital aggregation structures have emerged in Chicago to drive funding to underinvested neighborhoods. These funds often provide capital targeted at a specific funding stage (seed, growth, etc.). A good example focused on the real estate sector is the **Pre-Development Fund**, a $1.5M fund launched by The Chicago Community Trust. The fund awards non-renewable grants of up to $100,000 to Black and LatinX developers for pre-development activities.

3. *Increase the volume of patient, flexible capital*

Driving funding to underinvested communities has become an increasingly mainstream use of philanthropic capital, both via large initiatives and smaller, more centralized efforts from mission-driven capital providers and family offices. Philanthropic advisors report a growing donor focus on community development[14]. To fully capitalize on the increasing volume of funding directed at community development, public, private, and philanthropic investors must concentrate on the most in-demand forms of investment: first-loss capital and equity. These forms of capital unlock funding from traditional investors who might otherwise not have invested in these projects. Organizations in this area can:

[14] BCG-conducted investor interviews

- Build the case for patient, flexible capital: Make the case for the amplifying effect of first-loss capital and patient, flexible equity in community development efforts.
- Increase access for individual donors: Make it easier for individual donors, who often operate through donor-advised funds, to provide capital (e.g., as grants) to impact funds or other non-profits engaging in community development through new partnerships.
- Leverage existing community development channels: Direct funding from capital providers who cannot manage direct investments (i.e., foundations without investment functions) to existing community development channels such as impact funds and CDFIs (assuming these channels extend existing underwriting standards and increase their risk-tolerance).
- Develop relationships between capital providers: Patient, flexible capital providers should seek ways to partner with traditional capital sources to amplify the impact of their capital (e.g., leverage grant capital as a credit enhancement and pair with traditional debt funding).

Looking Ahead: Priorities for Decision Makers

Capital providers interviewed for this report expressed a desire to create and participate in a supportive market that deploys capital to underinvested neighborhoods. When searching for solutions, many interviewees highlighted the need for improvements in the project pipeline, market mechanics, and the supply of capital. To supercharge the flow of capital, however, comprehensive solutions that touch on all three aspects will be required. We have identified three solutions that would move the needle significantly, each of which is grounded in one dimension of the ecosystem but has the ability to influence all three.

Build a world class accelerator for Chicago neighborhood investment

Capacity and skill building for developers on the South and West side would help support a project pipeline. Initiatives including Yield Chicago with LISC and ULI Chicago and Chicago Emerging Minority Developer Initiative (CEMDI) have stepped up to serve this need for real estate developers, but there are few resources to enable scaling by non-profit developers, such as neighborhood CDCs, which often engage in real estate development in their communities. An accelerator would offer programming for non-profits across the city to help them establish relationships with developers (e.g., evaluating partnerships) and behave like developers themselves (e.g., leveraging data to identify opportunities, negotiating contracts, pitching to investors), as well as creating networking opportunities. The accelerator could address the limited supply of capital and solve for clunky market mechanics by facilitating closer relationships with capital providers and offering a platform for non-profits and prospective investors to connect. It could develop data assets or tools to find and assess opportunities. These could also support project generators in enriching their pitches to capital providers (e.g., database of community assets, promising trends).

Launch a Community Investment Intermediary
Lack of scale is a significant barrier to investment in underinvested neighborhoods — smaller capital providers, such as family offices and foundations, often cannot afford the specific expertise for this type of investment, and larger capital providers find it difficult to source sufficient numbers of deals. A Community Investment Intermediary would centralize many of these functions, lowering costs and barriers for capital providers, while allowing project generators to expand their networks. The organization would have two main functions. First, it would act as a clearing house for capital providers, curating a vetted list of projects following light-touch due diligence. It would also match capital providers and project generators and advise project generators on how to shape pitches. Second, the Intermediary would provide deal advisory services targeted at capital providers such as family offices and foundations, setting expectations around market conditions and return profiles. It could also help structure supportive investments with suitable vehicles (e.g., convertible bonds, revenue-based financing) and deal terms. This should pull more capital into the ecosystem, lowering barriers to entry.

Aggregate capital into a scaled, diversified fund or asset manager
A key element of the supportive capital market is the ability to pull in more traditional capital by pairing investment with patient, flexible capital (which may also be first-loss capital) and creating a multiplier effect. This typically happens on a deal-by-deal basis, forcing project generators to seek out various forms of capital and develop appropriate terms for each deal. If this pairing were to happen at a fund level, aggregating different types of capital (e.g., grants, recoverable grants, market-rate seeking capital), it may be possible to attract capital more efficiently. The specific structure and terms of the fund would differ based on the mix of capital.

An illustrative example: A fund raises capital in the form of grants, recoverable grants, and market rate-seeking-equity from foundations, family offices, DAFs, corporations, and others. The capital providers commit to a ten-year term, during which the fund invests in a portfolio of projects to generate the target return for the fund (which is far below market rate, given the blended structure of the fund). The fund is likely larger than a purely philanthropic fund, given its ability to source capital from a deeper pool of providers. This allows it to make bigger investments in each project. Larger investments drive down the effort for a project generator to complete the capital stack, speeding up the process and reducing transaction costs. The fund could expand beyond making its own investments and take the Community Investment Intermediary's functions, building relationships with capital providers & project generators to offer a curated pipeline and deal advice, thereby multiplying the capital it draws into the ecosystem.

These ideas represent potential routes to achieving a supportive capital market and making the most of the growing desire to provide more capital to underinvested neighborhoods. By creating the right conditions for a supportive market, the ideas of local developers, project generators, and non-profits can become a reality, catalyzing further development and economic activity in our communities.

The authors would like to thank Ja'Net Defell of The Community Desk Chicago, Michael Davidson of The Chicago Community Trust, Charlie Corrigan and Mambu Sherman of the JPMorgan Chase Foundation, and Cindy Moelis and Andy Beideman of the Pritzker Traubert Foundation for their contributions to this paper. BCG's Betsy Morgan and Sabrina Daar also contributed greatly to this effort.

About the Authors

Brianne Ziegler is a Partner in the Chicago office of The Boston Consulting Group. Hans Montgomery is a Managing Director and Partner in the firm's Chicago office. Ryan Curley is a Managing Director and Partner in BCG's Chicago office. Cassandra Di Prizio leads the Center for Illinois' Future in BCG's Chicago office. Kedra Newsom Reeves is a Managing Director and Partner in the firm's Chicago office.

You may contact the authors by email at:

Ziegler.Brianne@bcg.com
Montgomery.Hans@bcg.com
Curley.Ryan@bcg.com
DiPrizio.Cassandra@bcg.com
Newsom.Kedra@bcg.com

About BCG's Center for Illinois' Future

BCG's Center for Illinois' Future works to equitably and inclusively advance wellbeing in Illinois by investing BCG's teams and resources in collaboration with organizations that share our passion for driving breakthrough change in our community. We invest over $10 million annually to place pro bono and low bono consulting teams with social impact and public sector leaders to drive change in their organizations and our community. Together we unlock transformative solutions to our city and state's biggest challenges and help improve education, accelerate inclusive economic development, and restore neighborhood vitality. We dig deep to understand the underlying causes of complex societal challenges, develop innovative, sustainable solutions, and roll up our sleeves to translate recommendations into impact. Our work in catalytic investments in Chicago's communities of color includes advancing new approaches with multiple foundations and supporting the launch of a city-led community development initiative designed to attract private investment into several historically disinvested neighborhoods in Chicago. Across our diverse portfolio, CIF teams have helped to design an equitable state school funding formula; improve educational outcomes; create innovative programs to reduce youth violence; promote new approaches to inclusive economic development; develop strategies for high impact institutions; and incubate transformative social impact organizations.

About BCG

Boston Consulting Group partners with leaders in business and society to tackle their most important challenges and capture their greatest opportunities. BCG was the pioneer in business strategy when it was founded in 1963. Today, we help clients with total transformation—inspiring complex change, enabling organizations to grow, building competitive advantage, and driving bottom-line impact.

To succeed, organizations must blend digital and human capabilities. Our diverse, global teams bring deep industry and functional expertise and a range of perspectives to spark change. BCG delivers solutions through leading-edge management consulting along with technology and design, corporate and digital ventures—and business purpose. We work in a uniquely collaborative model across the firm and throughout all levels of the client organization, generating results that allow our clients to thrive.