

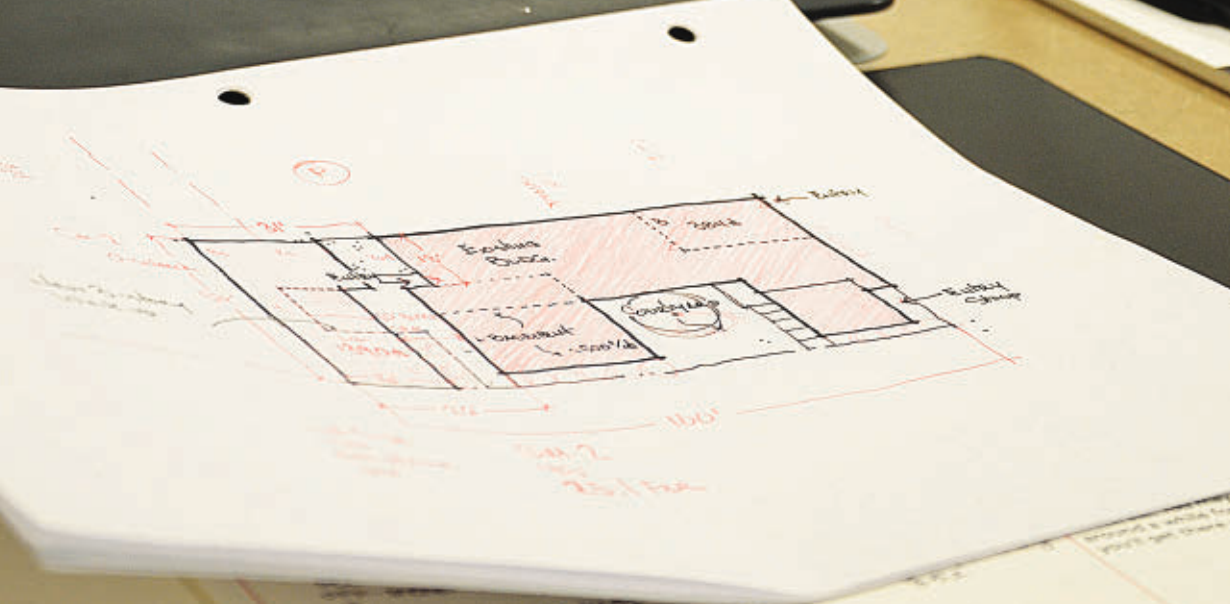
Your Pathway

Have you heard of the “missing middle”? It’s where opportunities abound for small-scale developers to turn languishing spaces into community assets. Here’s how to get a project off the ground. **BY MEG WHITE**

Imagine you’re heading to your favorite coffee shop. It’s a familiar walk, and every time your shoes crunch the loose gravel that’s escaped from the deserted parking lot next door, you think to yourself, “Why is this patch of land still unused? It has so much potential.”

That’s what R. John Anderson likes to call a “somebody oughta moment.” Anderson, principal at Anderson Kim Architecture & Urban Design based in Portland, Ore., and New York, says it’s a common first stop on the journey to becoming a small-scale developer. As a real estate professional, you may well have tripped—literally—over an opportunity with potential benefits for both your community and your business portfolio.

Anderson is a cofounding member of the nonprofit Incremental Development Alliance, created in 2015 to train people to leverage underused spaces to boost their local economies and their own bottom lines. While the IDA works with a wide variety of professionals, Anderson says real estate professionals are particularly well suited to this task thanks to their knowledge of the local economy, business relationships, and understanding of how transactions work. “They typically know who makes a good property manager or does whatever they don’t specialize in,” he says, adding that they also have their fingers on the pulse of the market. “The more thoughtful real estate professionals are following larger trends.”



KICKSTARTERS Two-day boot camps like the ones run by the Incremental Development Alliance in Memphis teach participants the fundamentals of transforming underused spaces into high-impact properties.

to a New Niche

Why Small Is Good

One trend fueling Anderson's optimism about small-scale development is pent-up demand for an often overlooked housing subset. Daniel Parolek, founding principal at Opticos Design Inc. in Berkeley, Calif., describes the segment as the "missing middle," including duplexes, pocket neighborhoods, and live-work arrangements. "The real estate industry is heavily weighted to delivering single-family homes or bigger urban buildings," Parolek says, adding that demand for the missing middle far outpaces supply, an assertion backed up by studies from Urban Land Institute, strategic real estate advisor group RCLCO, and others. "When developers are delivering these types, the market is responding really strongly."

Michael Ward, an agent at High Street Real Estate in Springdale, Ark., who recently established his own development company called Escala Group, agrees. "Almost every town in the United States has a need for that missing middle housing," he says. "That's the low-hanging fruit, especially for real estate professionals."

This unmet demand dovetails with a vital piece of advice for new developers: Start small. If you're a residential agent who's never invested in real estate outside your own house, consider buying and renovating a duplex. That first project will help you build a baseline knowledge and establish contacts to move you toward more complex and creative mixed-use developments.

Finally, it's easier to get community buy-in on projects with lower stakes. "If the scale gets too big, people are typically not happy with the results," Anderson says, adding that small projects can lead to big positive changes. "If you look at the type of places we really like, they were all built in small increments."

Define the Need

When hunting for the right opportunity, developer Nathan Mitchell, CRS, with Crye-Leike in Memphis, Tenn., suggests keeping to your real estate farming area. He takes a "fishing net"

approach—checking foreclosure and tax records, contacting current building owners, communicating regularly with other real estate professionals who work nearby, and simply driving and walking the streets of his community.

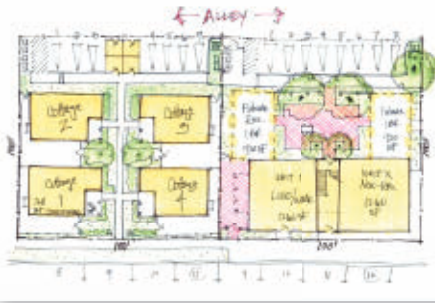
Monte Anderson, a developer and broker-owner of Options Real Estate in Duncanville, Texas, who worked with R. John Anderson (no relation) and others to cofound the IDA, advises being present in your target neighborhoods, regularly attending community events and meetings. "Every day your mind is recording, and it's going to give you the instinct you need to find the right tenants," he says. "Stand on a street corner and turn around in a circle. Ask yourself what's missing."

This is where your local market knowledge takes center stage. Your town's main street might feature an empty unit above a popular storefront that could be converted to condos with a 96 percent "walk score." Or perhaps you know a small-business owner looking for a better fit. Many communities suffer from a missing middle in their commercial space, too. R. John Anderson says small-business owners are often stuck with more backroom storage space than they need in buildings designed before paperless offices, work-from-home lifestyles, and on-demand shipping existed. He says most business owners want more exposure to potential customers than the typical strip mall floor plan can provide. If developers configure buildings to better match the needs of today's small businesses, they can generally fit more tenants in one building, translating to more affordable rents and more profitable investments.

Visualize It

Once you have a location and idea of the area's needs, it's time to sketch the project out. Learn the current zoning designation and applicable regulations. Determine the minimum and maximum sizes for the lot area and the





building's allowable height. Are parking and storm water management space part of these figures? Speaking of parking, how much do you have

to provide, and must it all be off-street? The research can be daunting, but it's important to know the rules, even if you need to meet with your city's zoning department. If your plans require a new land survey, entitlement, or zoning changes, you can make that a condition of the sale. That way you have control of the property, but you haven't purchased it before knowing it's going to work.

This isn't just for new construction, either. Older buildings often don't comply with newer rules and codes. If you don't plan to make substantial changes, your development may be grandfathered in. But if you're planning major construction, you could be subject to current codes. If your city, county, or state subscribes to the International Code Council's International Existing Building Code, you might have an easier time. Beth Tubbs, senior staff engineer at the ICC, says the code was created to "facilitate the reuse of buildings, rather than tearing down and building new," but its application often depends on how much you're changing the structure. If you're tearing down walls, your municipality may expect electrical and plumbing that meet today's standards. "The more work you're doing, the more you're taking the building apart, and it's easier to do those updates."

Once you know the rules that govern your space, draw a site plan—a scale model of the development including the parameters that define what you're allowed to build (setbacks and parking, say). If you have a variety of ideas, create multiple drawings. They'll be useful later when you go in search of partners, investors, and financing.

The Pro Forma

Armed with a visual aid, it's time to figure out if your project will make money. R. John Anderson estimates every \$1 in rent (per square foot) supports around \$100 in total project costs. Of course, estimating rent is easier for seasoned real estate pros than figuring out hard development costs. Anderson suggests consulting the National Association of Home Builders for estimates of residential costs, and partnering with contractors well-versed in the type of development you're considering.

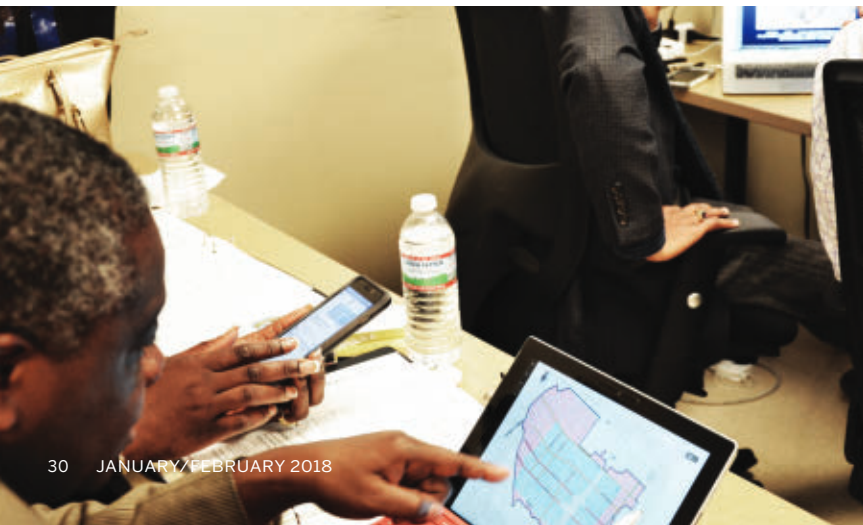
A pro forma—a spreadsheet balancing a project's expected income against its costs, recurring expenses, and financial risks—will help. Jim Kumon, a Minneapolis-based developer and executive director of the IDA, says this living document begins with estimates and assumptions that are revised and specified as the project progresses. Download the IDA's sample pro formas, project ideas, and site plan examples at realtorm.ag/small-developer.

Anderson underscores the importance of this step. "Do not get a 'numbers person.' Do it yourself," he says. "That's one you can't farm out." Ward agrees: "You have to understand how to use Excel and model a project." He admits that estimating construction costs is always a challenge, especially for new developers. When building single-family homes in his area of Arkansas, Ward starts at \$100 per square foot, adding soft costs, such as design and permitting fees, later. "Ultimately you have to start getting bids from contractors, and that's where it gets real."

When crunching numbers, Mitchell suggests incorporating contingencies and exit strategies. If you're planning to rehab a building and sell it, make sure that you can keep it and rent it out if the market turns. For those hoping to secure tenants and rent out space: If you needed to, could you sell it for a profit?

Assemble Your Team

The size and skills of your team will depend both on the scope of your project and on the knowledge and time you can devote to it. Rehabbing a duplex is much less likely to warrant the hiring of an



architect than a mixed-use, new-construction project, for example. Mitchell's background in carpentry and economics—along with the fact that he's gradually curtailed his work as an agent from 30 or 40 transactions annually to roughly 10—means he can manage projects more or less on his own.

If you want to keep your regular real estate business rolling, or if you lack the basics in architecture, building, finance, or property management, find partners. Concentrate on finding professionals work on a small scale, because they can tailor their offerings to your budget. Look for local chapters of the Congress for New Urbanism, Urban Land Institute, or Main Street America programs.

Find the Money

With site plans and a pro forma under your belt, you're ready to finance the project. Banks will be particularly interested in your debt service coverage ratio, estimating how easily you can pay off the loan. Anderson says lenders like to see it at about 1.25, meaning you have 25 percent more money than is needed to service the debt. "The bank is not a partner," he says. "They want to know that it's not too thin a deal for them to get paid."

Anderson notes most residential developments of four units or less can be financed with a simple 30-year mortgage, and many can include commercial space. If one of the units is your primary residence, HUD's 203(b) mortgage offers low down payment options for residential or mixed-use buildings under five units. However, you may need a separate construction loan. While Fannie Mae and Freddie Mac both have small commercial loan programs, Anderson says it may make more sense to re-configure a six-unit building into four units to qualify for simpler lending terms, as long as market rents support it. "Form follows finance," he says. "It's not how much it costs you; it's how much the building is going to make you at the end of the day."

Lenders will expect you to have skin in the game in the form of a down payment. Besides savings and money from investors, you can also consider throwing your real estate commission into

the deal as part of your equity.

The Benefits of Owning It

Small-scale development can boost your real estate business, too. Mitchell says clients often trust him more after they learn about his other work. "Your credibility jumps forward immensely," he says, noting it also demonstrates buy-in to the idea of real estate as a smart investment. "I don't know any financial advisers who don't own stock."

And Anderson says investing in small-scale property brings intangible yet boundless benefits to your portfolio and neighborhood. Infill developments are usually walkable and near other businesses that appeal to tenants, both free luxuries that are often more alluring than landscaping or other costly amenities: "Urban civilization—for people to live in real neighborhoods—is something that defies the laws of supply and demand. The more we build of this, the better the neighborhood gets, the more demand there is for it. That's the kind of business I want to be in."

Resources for Small Developers

The **Incremental Development Alliance** will be offering workshops and intensive boot camps all around the country in 2018 (incrementaldevelopment.org/events). **CCIM's Development Specialty classes** are open to all students: ccim.com/education/development-track/. CCIM offers development tools at its Site to do Business (stdb.com). Users can generate reports on development opportunities using powerful demographics, economic data, and Esri mapping products. The site also offers prospecting capabilities for finding potential tenants and investors. The tools are free for CCIM designees, and most features are available for purchase for \$1,295 a year. And don't forget **REALTORS Property Resource®** (narrpr.com), an NAR member benefit.

