Construction Lending 101

Working with developers and lenders requires collaboration and risk management

By Joel C. Solomon

Commercial construction loans are unique because these loans are for properties that will exist in the future. Developers seeking these loans are typically in the midst of a long process that may have begun years before with assembling the parcel, getting legal entitlements, developing concepts and gauging the market for the envisioned project. When a developer seeks financing, several critical-path processes may occur simultaneously — from locating major tenants or reservations to negotiating key contracts.

Commercial mortgage professionals should understand the unique characteristics of construction lending to capitalize on this niche. Their ability to envision the moving parts of this process as well as the roles of various parties is essential to closing construction deals more efficiently.

Mortgage brokers and lenders work on a loan in parallel with the property development. First, they must negotiate big-picture loan terms with the developer, including the interest rate, the percentage of the project that the lender will finance and the repayment schedule. When the process moves forward, they must visit the site, review the feasibility study and underwrite the ultimate project and its economic value.

By closing, the lender and the developer have typically finalized certain critical-path items, like property insurance and the construction contract. The loan agreement should require post-closing lender approvals for anything not final at closing. Notwithstanding a loan agreement's funding hurdles — like orderly draw requests with lien waivers and architect's sign-offs — a lender is contractually obligated to fund the loan provided the borrower is in compliance with the terms. The lender cannot change its mind or enforce the terms of the loan agreement unfairly or in bad faith.

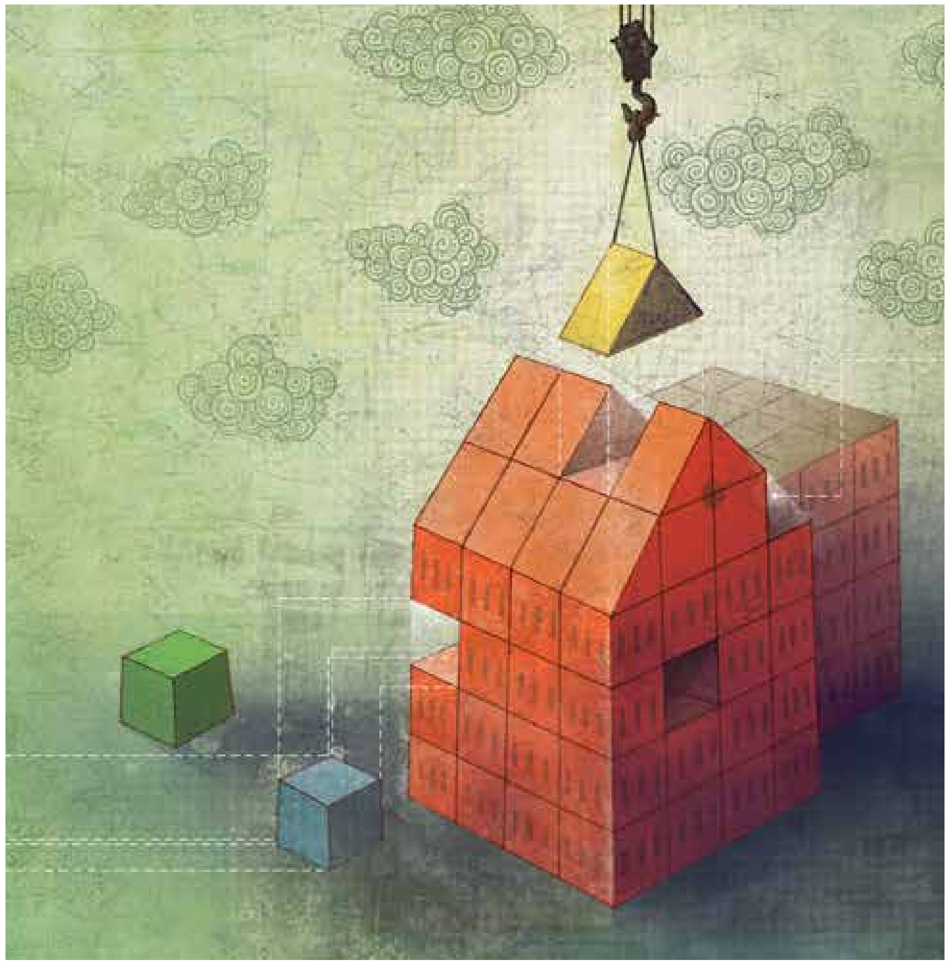

Illustration by Dennis Wunsch

The lender only recoups its investment if the borrower can draw the loan proceeds and successfully complete the project. After more than a small amount of the loan is funded, there is no turning back. The liquidation value of a partially complete project is a fraction of the value once the certificate of occupancy has been obtained. Therefore, although the developer-bank relationship is that of debtor-creditor, it is akin to a partnership with aligned interests.

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Fundamental concepts

Loan recitals should contain a detailed physical description of the proposed construction project. The lender and its counsel should know exactly what the loan is funding. The physical description should specify a clear site location, the number of stories, ceiling heights, amenities, parking and signage rights. Because saleable or leasable square footage is an important factor in determining the economic value of the finished product, there should be a detailed description of the total square footage, the square footage of individual units and the retail square footage.

The loan agreement must incorporate plans and specifications, which range from mechanical plans for plumbing, electric and ventilation to floor plans and finish standards. A construction loan is a work in progress, so the lender must approve the plans and specifications before or after closing.

Although an initial loan disbursement may be made to reimburse the borrower for excess equity invested in land or predevelopment work, the main construction disbursements may occur after plans and specifications are fully approved later in the process. These specifications include exterior and interior finish standards, from landscaping and the exterior facade finish to appliances and lighting fixtures.

Change orders

Change orders are part of the construction process, especially on larger projects, and they occur for many reasons. A general contractor using a more limited scope of work could bid low to win the contract and cause a change order when the project progresses and requires work outside the contract's scope. Change orders also result from inefficiencies in design-build projects, material cost increases, allowances (estimates of costs) that prove to be wrong, and developer or end user-requested changes.

Change orders usually mean increased costs and the risk of the project going over budget. Less often, change orders reduce costs by reducing the project costs (value engineering) with either seen or unseen changes to the building.

Loan-in-balance provision

Comprehensive loan agreements anticipate change- order problems with the budget, reallocations and contingencies. The ultimate protection for a lender, however, is the requirement that the loan remain in balance, meaning that the unfunded loan is sufficient to complete the project.

The budget expresses the project's cost. It accounts for everything required to transition from concept to finished project, including leasing costs and operating deficits for multifamily projects; marketing costs for condominium projects; costs of tenant improvements and leasing commissions for office projects; and furniture, fixtures and equipment costs for hotel developments.

A well-drafted loan agreement addresses the general budget and specifies the equity investment and junior debt which, in addition to the loan itself, will fund the project. A detailed line-item budget should be attached as an exhibit and individually describes acquisition costs, the general construction contract, work outside that contract, hard and soft costs, and contingencies — amounts set aside in anticipation of budgetary changes. The lender must underwrite and approve every component, so before the first change order arrives, the parties must agree on and approve a budget.

When change orders increase the overall cost, reallocating savings from other line items or contingencies provides flexibility. Reallocations should be tied to the percentage of construction completed to avoid depleting contingencies halfway through the project. Hard-cost contingencies may only be reallocated to increases in hard-cost line items. Hard-cost contingencies are distinct from the general contractor's contingencies, which are part of and governed by the terms of the general contract.

This leaves soft-cost contingencies available for overruns of soft costs. Aside from professional fees for architects and engineers, building-permit fees, utility- access fees, real estate taxes, leasing commissions, and sales and marketing costs, this includes the interest reserve. Construction-loan budgets have a set-aside to get through loan payoff. In reality, the bank is essentially paying itself and therefore capitalizing the interest into loan principal.

From the lender's perspective, there should be no reallocations to the agreed-to interest reserve. A prudent lender should insist that the borrower or another developer party/sponsor support the loan if actual interest costs exceed the interest reserve. Because of the moving parts of change orders, budget reallocations and contingency reallocations, a time could come when the lender no longer believes that the undisbursed loan proceeds will be sufficient to complete the project and pay the borrower's obligations through the payoff of the loan.

If that occurs, the lender has the right to declare a loan out of balance. In effect, the lender can declare default based on the conclusion that certain line items in the budget are insufficient. The line-item distinction is important to prevent a borrower from lumping everything together and claiming the gross amount will be sufficient.

An ideal loan-in-balance provision provides that the loan shall be in balance only when the available source of funds equals or exceeds the lender's estimate of remaining cost (a global budget analysis) and each budget line item is sufficient to pay the costs the line item was established to pay (a line-item analysis).

Because the lender relies on firm and defensible criteria before asserting that a loan is out of balance, the available source of funds should incorporate the remaining unfunded loan, the contingency (to the extent available), upgrade deposits, tax deposits and any other sources of income. The definition of lender's estimate of remaining costs should set forth objective criteria that the parties have agreed a reasonable lender may rely on to determine what remains unpaid. These may include pending and expected change orders,

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contractor or supplier claims for additional amounts, and general contractor claims for additional amounts.

A declaration of an out-of-balance default for a loan has significant consequences. The lender may institute default-rate interest, stop funding and even shut down the project. The significant costs of demobilizing and remobilizing a project make these doomsday scenarios for a borrower/developer. Declaring a loan out of balance is a drastic step: Lenders want to avoid a shutdown and must be in a fully defensible position if they declare an out-of-balance default.

The balance provisions in a loan agreement therefore must be carefully crafted to give a lender objective support if it seeks to declare default. Similarly, the borrower should maximize flexibility in the use of contingencies and reallocations, and ensure that the facts support the lender's cost estimates.

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Developers possess a rare combination of nerve, creativity and the ability to actualize a vision into a project. Whether the development is a simple building or a tower with cutting-edge architecture, success is not guaranteed and successful completion is no small accomplishment.

For mortgage professionals, the challenge is to mitigate the lender's risks through a detailed loan agreement. They have powerful tools to enforce the loan agreement by exercising their consent rights. Lenders learned in the Great Recession that when loans are foreclosed, they become the developer, and no details are unimportant when realization on the collateral is the exit strategy. ■