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Defensive construction lending — what a lender needs to know before making a construction loan

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Construction lending can be risky for various reasons in the best of economic times, and even more so with the backdrop of a weak or down-turning economy. Projects may struggle to become successful, particularly in a sluggish economy, potentially resulting in a failure to complete the project or retain its viability. Such failures can adversely impact the associated borrower's ability to repay their loan. It is important, therefore, that construction lenders identify the market and other risks associated with potential construction loans and adopt a course of conduct aimed at achieving timely payment thereof based on the particular project, the borrowing entities and the economy. To offset potentially heightened market risks, a construction lender should make every effort to limit the non-market risks inherent in construction loans, setting up the borrower and the project for successful repayment of the loan, regardless of the state of the economy.

Few construction lenders have the opportunity to consistently make construction loans to high credit entities or on commercial and industrial properties fully leased to lessees with high credit ratings. Construction lenders can, however, engage in a variety of strategies to ensure a project's attractiveness and success such as:

- intimately knowing their borrower and guarantor/s
- pursuing cautious and diligent pre-commitment investigation
- drafting and reviewing their term sheets with great care, including consideration of any potential requirements under the loan and attentive administration of the loan

This article discusses each strategy in turn.

The borrower and the guarantor

The construction lender must first be satisfied that the borrower, its sponsor, the guarantor/s and their related parties have sufficient experience and knowledge to complete the contemplated project at its estimated cost and in accordance with the terms of the finance documents. Otherwise, the parties should not proceed, even to the term sheet stage. Conversely, a borrower with a tremendously strong reputation and history may have the capability of outweighing evidence of high market risks. For example, the borrower or owner of a particular project may have such a substantial investment in the project that the construction lender could safely conclude that such personal investment sufficiently protects against possible losses due to poor market conditions resulting in disappointing project performance. Further, situations may arise where the borrower or owner has such an excellent track record with prior projects and/or are so well and favorably known to the construction lender that the construction lender may decide to make the loan regardless of apparent weaknesses of the project or the economy at that time.

The borrower and its sponsor

Of primary importance to any construction loan is the identity of the borrower and its controlling entities (as borrowers typically establish special purpose entities vehicles for each separate project). The party's character, as well as its professional and financial capacity to accomplish the project and the repayment of the construction loan, must completely satisfy the construction lender. In this regard, the construction lender should, to the extent possible and practical, investigate the party's reputation, competence and prior track record by obtaining references from builders, professional advisers, major tenants and investors who have dealt with the applicable party in the past. Additionally, the construction lender should obtain from the borrower a list of all prior projects in which it has been involved, as well as disclosure of the results, all of which the construction lender should independently verify (ie, pre-sales history for other projects, whether any project was sold prior to completion, foreclosed upon, given to a lender in lieu of foreclosure, successfully completed, currently under construction, etc). The construction lender should inspect these prior projects, including the success and current maintenance of these projects in respect of commercial premises, particularly those projects similar in size or use to the one under consideration. During the investigation, the construction lender should keep in mind that most borrowers are a pleasure to do business with during the "good times", but that "good borrowers" are those who live up to their obligations during the bad times as well. Therefore, the construction lender should always determine and consider the reliability of the borrower in bad times.

As part of the construction lender's analysis of the borrower, the construction lender should review the borrower's and its controlling entities' financial condition by examining relevant financial statements, (including monthly, quarterly and annual financial statements). These statements should be examined both from the viewpoint of real net worth, contingent liabilities and net income, which should calculate the income from the borrower's sponsor's other projects that may contribute to the contemplated project. These other project commitments could cause such sponsor to divert its resources and/or attention from the proposed project, particularly any commitment in which such sponsor has a minority interest. Minority interests may appear as minor investments in such sponsor's overall portfolio, but they may contain large potential liabilities and obligations of such sponsor.

Notably, the construction lender should have enough meetings with the principals of the borrower to determine their integrity and professional ethics. These intangible qualities may prove to be of paramount importance in the long-term relationship.

All of the information supplied by the borrower to the construction lender in connection with its review of the borrower should be deemed a part of the borrower's application for the construction loan. Additionally, the construction loan term sheet should recite that the construction lender issued the term sheet in reliance upon such representations.

The guarantor

Repayment of its loans, rather than completion of the underlying projects, is the ultimate concern of the construction lender. If the construction lender makes the loan to a responsible, solvent entity who has no issue repaying the loan, then the construction lender is quite fortunate (and unique). More typically, however, as mentioned above, the borrower's sponsor/s form entities for the specific purpose of constructing the project without any additional assets. Therefore, the construction lender must obtain satisfactory assurances of payment elsewhere. Accordingly, the construction lender should make every construction loan with a firm source of repayment — a guarantee.

Most guarantors with the financial wherewithal to respond to a guarantee of payment on a major construction loan have already given similar guarantees to one or more other lenders. Many of these guarantees exist concurrently. Calling upon the guarantor to respond to its obligations under a guarantee can have the effect of triggering a default under all of its other guarantees and the guarantor quickly becomes unable to respond to any of them. Therefore, prudence mandates a financial study of each guarantor and its other obligations.

To the extent that someone other than the borrower or a principal of the borrower guarantees payment of the construction loan or completion of the project, the construction lender should also conduct the borrower review described above with respect to each proposed guarantor. The construction lender must keep in mind that any guarantee is only worth the value of the guarantor giving it. Regardless, the construction lender should still obtain a guarantee of payment. Even if such guarantees are not iron-clad, at a minimum, they create a psychological effect of obligation upon the guarantor, enabling the construction lender to obtain and keep the guarantor's attention and, at the very least, add an interested party or parties to any possible workout negotiation. A guarantee is, of course, stronger when backed by some form of collateral, such as a grant of a general security agreement, specific security agreement (over shares or units in a trust or in respect of amounts placed on deposit as security). A construction lender should determine whether to request such collateral prior to issuing the construction loan term sheet. In all cases, the construction lender's financial review of the guarantor's financial condition must conclude that the guarantor has the liquidity and overall net worth to fund any obligations the guarantor undertakes.

Pre-term sheet investigation

In order to minimise the risks generally inherent in construction loans, a construction lender should pursue cautious and diligent pre-term sheet investigation by adhering to certain practices, procedures and principles during its underwriting and due diligence process. Although this article cannot discuss every conceivable problem or legal or business consideration that the construction lender should address before making a construction loan (ie, methods of credit investigation and the details of construction loan documents), this article will, however, attempt to set forth the most basic considerations, all of which apply whether the construction lender directly makes the construction loan or the lender acts as a co-lender or participant in a construction loan made by another lender.

The construction lender should not hesitate to engage its own independent experts, such as a quantity surveyor or engineer, to review the proposed project at the earliest possible date.

Before the construction lender expends any money on experts, it should enter into a term sheet with the borrower. The term sheet will account for the costs of the construction lender's due diligence.

The project

The construction lender should also review the viability of the contemplated project itself. During this review, the construction lender should ask the following questions:

- Is the project well-conceived and likely to be successful?
- Does the project make economic sense?
- What is the value of existing pre-sales? (relevant for apartment and subdivision developments)
- At the time of completion, will the economy support this particular type of project?

In this regard, the construction lender ought to obtain an independent feasibility study and a cash flow projection in order to determine the economic viability and the total possible cost of the project. Additionally, the construction lender's loan personnel and quantity surveyor or engineer should visit the site in order to fully understand the project.

The construction lender should carefully and critically analyse the project's budget, including all construction costs (soft and hard), potential operating deficits and amounts set aside for tenant improvements (as relevant). If there is the slightest chance that final costs will exceed the proposed construction budget, including contingencies, the borrower must identify and provide a source for those funds. Otherwise, the risk exists that in order to complete the project, the construction lender will need to fund the excess to obtain the full realisation of its collateral.

Generally, the construction lender should avoid making loans on specialty projects not readily adaptable to an alternate use in the event that the intended purpose of the specialty project is not economically viable by the time of the maturity of the construction loan.

The valuation

The valuation is not just something for the construction lender's file pursuant to credit and risk requirements. Instead, if done correctly, it greatly facilitates the decision as to whether or not the contemplated project has economic viability and assists the construction lender in determining specific loan terms. Although the valuation contains important information for the construction lender, also keep in mind that at this stage of the project, the valuer generates the valuation somewhat in a vacuum since work on the project has not even commenced. Notwithstanding this fact, the construction lender should require delivery of a valuation done by a reputable valuer acceptable to the construction lender and the valuation either be addressed to the construction lender, or the valuer formally provides written confirmation that the valuation can be relied upon by the construction lender. Additionally, the valuation will assist the construction lender in determining the necessary loan-to-value ratio. Prudent practice generally dictates, a loan-to-value ratio of no more than 65% to 75% for loans secured by improved real estate and of no more than 55% to 70% for loans secured by vacant land.

Valuers utilise various valuation methods — replacement value, market value, income, etc. Construction loans most commonly use the "as-is" value of the land and an "as if complete" value of the land. In no event should the valuer use residual method for unimproved land valuation because the residual method is based upon a valuation of the land as improved by its highest and best use. A method considering the highest and best use can only be justified with a completely constructed successful project.

Builder and construction contract

Unless the borrower's or a guarantor's net worth alone assures the repayment of the construction loan, the construction lender should insist upon the construction contract containing a guaranteed maximum price from a financially responsible builder, notwithstanding the extra cost involved in obtaining such a guaranteed maximum price. Even if the construction contract does reflect a guaranteed maximum price, the construction lender's quantity surveyor or engineer should perform an independent cost-out of the construction of the project and an in-depth investigation of the builder's financial ability to complete construction to determine the accuracy of the proposed construction budget. The quantity surveyor or engineer should also review the completeness of the construction contract as well as the track record and bondability of the builder. This review ideally should include a determination of whether the builder has built any comparable projects, how such projects fared over time and whether the builder completed the projects within the cost of the proposed budget.

Quantity surveyor or engineer

Before providing any construction funding, the construction lender's inspecting quantity surveyor or engineer should review many elements of the transaction. They should begin with the plans and specifications of the project to determine their completeness and the soundness, engineering and feasibility of the design. Additionally, they should conduct an independent cost analysis of the proposed site work and construction, especially if the construction contract does not set forth a guaranteed price by the builder including in respect of provisional sums. Finally, they should independently review the construction schedule and the draw schedule. Borrowers often attempt to front-load the draw schedule and reduce the estimate of the amount of funds needed for finish work, landscaping and the like. Additionally, if the builder grossly underestimates the timeframe of construction, the project will likely exceed budget. Both situations can result in the borrower requesting increases in the construction loan as the loan approaches the maturity date. An independent review of both the construction schedule and the draw schedule can decrease the likelihood of these eleventh-hour loan increase requests.

Other due diligence investigations

The borrower and the construction lender often procrastinate assessing the characteristics of the land upon which the project will be built until the very end of the transaction. However, these characteristics embody a critical aspect of the project, and any problems which result can create a huge risk for the construction lender. The review must analyse the following:

- compliance with laws (eg, the local zoning and building codes, heritage overlays and aboriginal culture heritage issues)
- any environmental issues (eg, subsoil conditions, whether boring tests should be conducted, the presence of rock or peat or water which could cause construction problems)
- water matters (water resources, sewer allocation, storm water runoff, any nearby wetlands)
- potential traffic restrictions (eg, any planned roading works)
- adequacy of utilities and use restrictions

Analysis of these items will uncover most hidden construction problems which could result in increased construction costs.

As part of its due diligence, the construction lender should also require an environmental audit report of the proposed project. The borrower may try to downplay this important investigation, especially when utilising vacant land. However, the construction lender must keep in mind that sites can become contaminated from a polluted site several miles away.

Term sheets

Regardless of the construction lender's relationship with the borrower and the assurance the construction lender feels based on the oral understanding they have reached, the construction lender should ensure the term sheet is drafted with great care and includes any potential future requirements under the loan. Depending on the complexity of the project, the construction lender may engage lawyers who fully understand the terms of the transaction and of any special conditions, the task of preparing the term sheet. The construction lender should use caution with the preparation of the term sheet because it can create a binding obligation on the construction lender. The obligation is created either because the term sheet itself creates the obligation through its text and intent or, if not, because the construction lender is reluctant to dishonour the term sheet because the construction lender wants to maintain its reputation with potential borrowers. The term sheet must explicitly contain the specific business terms of the transaction (eg, the loan-to-value ratio, the loan-to-cost ratio, equity requirements and the specific terms of any mezzanine financing), including any terms both the construction lender and the borrower consider oral understandings. Otherwise, the construction lender will have difficulty incorporating such terms in the ultimate loan documents.

A term sheet should also set forth the following additional items, each of them subject to the construction lender's approval, as requirements before any funding of the construction loan:

- the parties:
  - — identify as many specific parties as possible, the borrower (or the borrower's controlling entity), the guarantor, the builder, any developer or development manager etc
  - — the financial statements described above for the borrower, its controlling entities, each guarantor and any major tenants
  - — current financial statements for the builder
- general terms:
  - — identify the project and general proposed improvements
  - — provide maximum loan amounts, the loan term and any extension options, and the applicable interest rate
  - — outline any required cash management structure and required reserves
  - — clarify the equity requirement
- fees:
  - — require an establishment fee and line fee and any other fees the construction lender may feel appropriate (including for example minimum earn or early repayment fees)
  - — include provisions for the payment of the construction lender's expenses, including the

fees of construction lender's counsel, inspecting quantity surveyor or engineer and closing costs by the borrower

- loan documents:
  - provide for the general documents essential to the transaction (eg, loan agreement, guarantee (either incorporated into the loan agreement or a stand-alone), first ranking mortgage, first ranking general security agreement, specific security agreement (for example over shares, units in a trust, deposit amounts)
  - provide for any relevant side deeds, including builder side deed, developer side deeds and tenant side deeds, to ensure that the construction lender can step in to relevant contracts in the case of insolvency or repudiation of a contract by the borrower
  - opinion, usually from lender counsel, that addresses enforceability of finance documents, capacity, due authorisation and due execution of entities and security interests
- covenants:
  - clarify the maximum loan-to-value ratio
  - spell-out any relevant borrower or guarantor financial covenants (including minimum liquidity or minimum net worth) including covenant maintenance requirements throughout the term of the loan
  - set forth a specific time period for initial draw of the funding (to ensure that the construction lender has certainty of its obligations vis-à-vis credit and fund allocation) and project completion (typically timed to be 3–6 months before date for practical completion under the construction contract)
  - subordination of shareholder or related party loans
  - subordination of any amounts payable to joint venturers, developer or development manager (typically a related party of the borrower or guarantor)
- project requirements:
  - require a valuation, environmental audit report, quantity surveyor's report and/or structural engineer's report and the like
  - mutually agree on a budget
  - plans and specifications for improvements and evidence that they comply with all applicable laws and regulations
  - evidence of satisfactory zoning issuance of all planning and building permits
  - qualifying pre-sale requirements
  - minimum pre-sale (typically 100% of the construction facility limit) or pre-leasing requirements
  - performance guarantee/bonding requirements
  - qualifying surveyor reports to be provided before monthly draws
  - statutory declarations to be provided by the builder in respect of cost claims
- insurance:
  - evidence of property insurance, contract works insurance, public liability insurance, professional indemnity insurance and workers' compensation insurance. The property insurance and contract works insurance should specifically name the construction lender as a loss payee
- miscellaneous:
  - whether or not the construction lender will allow mezzanine financing and if permitted, the terms of such mezzanine financing and whether the construction lender will require an intercreditor agreement
  - whether or not the construction lender maintains the right to syndicate the loan, and if the construction lender so chooses, require the borrower to reasonably assist with the syndication process
  - a warranty that all the borrower's representations to the construction lender made to obtain the loan continue to be accurate and that lender is relying on such representations to make the loan
  - time periods specifying when the construction loan terms must be accepted by the borrower and the construction loan closed
  - the right for the construction lender to require additional information or vary the loan terms as the transaction progresses
  - the borrower's signature to the term sheet

As stated previously, each transaction will have its own special conditions, but the foregoing provides the basic provisions that the construction loan term sheet should address.

Attentively administer the loan

Throughout the loan term, the construction lender can best protect its investment by diligently keeping informed of the project and reviewing on-going materials provided to it. The following processes are recommended in order for the construction lender to ensure completion of the project and protection of its collateral:

- Ensure receipt of mandatory monthly/quarterly (as relevant) and annual financial statements and review such statements for compliance with the required minimum liquidity, minimum net worth and contingent liabilities.
- Actively monitor the borrower's budget and contingency level and ensure conformity with the required figures prior to any advances.
- Obtain and review any contracts the borrower promises to acquire post-closing and obtain assignments running to the construction lender of such contracts.
- Obtain a performance guarantee or bond from a lender or insurer acceptable to the construction lender.
- Prior to advancing under the construction loan, conduct a careful inventory of stored materials. The construction lender should not make advances for materials stored on or off-site, unless the construction lender has a valid security interest in such materials. Also, the borrower and/or the builder must always properly protect all on-site material from theft or vandalism.

Conclusion

In sum, a construction lender which conducts business only with the borrowers and guarantors in whom it has the utmost confidence, undertakes cautious and thorough pre-term sheet investigation, considers term sheets as very serious and binding documents and actively administers the loan will be more likely to have a successful and fully repaid construction loan, regardless of the economy.

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