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A New Paradigm For Distressed Construction Assets

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In the past decade, construction lending has been a metaphoric study of the lending industry as a whole. It was a perfect storm, where experience and best practices became subordinate to production.

In many ways, risk mitigation in construction lending followed the same fate as risk mitigation in residential lending. The fact that a construction loan was underwritten based upon future value that could only be realized if the asset was completed became lost in the hysteria of origination's heyday.

Now, after the crash, our diminished ranks are left to clean up the mess, with partially completed construction projects being the most challenging. Often because of the high degree of complexity involved with these projects, lenders are leaving these assets until last to try to sort out.

However, such an approach is the exact opposite of what lenders must do with stalled construction projects, if they wish to recover part or all of their investment.

The typical distressed project

The traditional and practical solution set for lenders with distressed assets is to obtain title to the secured asset, minimize the potential loss by investing as little additional money as possible, and discount and dispose of the asset through sale.

What is required of partially completed construction assets is often the polar opposite. Without a studied, proactive response to partially completed construction projects, the traditional approach will often result in a larger, if not total, loss of the lender's investment.

While seemingly counterintuitive, aggressive enforcement of the asset-protection clauses of the construction-loan agreement (which might include taking control of the asset prior to foreclosure) and additional investment may be the only way to avoid a total loss.

The best way to illustrate the foregoing is to describe a typical distressed commercial construction project.

The lender makes a 12-month, $12 million construction loan with an interest reserve component on a single-purpose entity owned by the developer but with limited recourse to the developer. Upon closing, the lender funds a $3 million land and soft-cost draw. The construction loan is used to construct a mid-rise, infill, 20-unit luxury condominium project with ground-floor commercial retail.

The zero-lot line project sits between two existing structures and requires extensive excavation for three levels of underground parking. The excavation and contiguous properties must be shored up during excavation, and the water table is shallow. The above-ground vertical improvements are a combination of steel and wood framing.

Immediately, the project runs into setbacks. The developer says the city is responsible for permit delays and new conditions that will result in costly improvements not accounted for in the budget. The permits are finally issued, and the construction, which begins two months before the 12-month loan commitment matures, progresses at a snail's pace.

Throughout the next three years, the developer proffers myriad reasons for cost overruns, change orders and various mechanics' liens. The lender, in a good-faith effort to complete the project and cooperate with the developer, makes loan extensions and modifications, including advancing an additional $1.5 million in loan funds.

After three years, the project is only 85% complete. The market demand for luxury condominiums and commercial retail space deteriorates. The interest reserve is exhausted; the developer makes no out-of-pocket interest payments and defaults. Construction comes to a halt.

After protracted additional stalling negotiations by the developer, which add another 12 months to the process, the lender moves to foreclose four years from the first origination. The developer, in order to avoid personal liability from a limited personal guarantee, contests the foreclosure action with lender-liability counterclaims. The contested foreclosure could conceivably add another 18 to 24 months to what already adds up to four years.

The partially completed improvements are exposed to the elements and subject to deterioration or theft. The building permits expire, and the city cites the asset for violations. The underground parking structure has standing water. Exposed lumber is rotting and the interiors have evidence of mold. Exposed steel beams are rusting. The site is poorly secured, dangerous and subject to vandalism. There are aging tax liens against the property that have priority over the loan.

What should the lender do?

A new paradigm

Time is of the essence. If a lender is not proactive, the potential losses associated with partially completed construction assets will compound, as will the associated liabilities.

First and foremost, in order to make logical determinations, the lender must take inventory, figuring out where the project currently stands.

A construction project needs to be reviewed as an integrated whole. In other words, the sum of all parts will provide a clear asset solution assessment of the risks, liabilities, action items and financial exposure.

Liens, permits, entitlements, legal costs, foreclosure time, insurance, loan agreement rights and responsibilities, and other considerations can be associated with both risk and cost. Like an algorithm, each element plays a part in the financial analysis that will determine the best course of action.

The information, once compiled, should be assembled into one report. If the lender has the requisite in-house expertise to analyze the individual elements, as well as the sum total, it can perform the review internally. Alternatively, the review could be assigned to an independent third party with construction-asset expertise.

Stage one: forensic review

The following is an inclusive list of the key information necessary to perform an analysis of a partially completed construction project:

- Construction loan agreement. Obtain a copy of the loan agreement, all addendums, attachments, security instruments and any other lender-specific construction loan information.
- Original appraisal. A review establishes what was intended to be built and provides key asset detail. It also provides critical information for the inspector in determining if changes to the asset have been made.
- Plans and specifications. If available, the project's plans and specs will facilitate the preparation of a cost-to-complete budget and thorough inspection analysis.
- Entitlement review. The status of the building permits, entitlements and any code violations is imperative. In some jurisdictions, if the permits expire, the city can require the project be resubmitted for approval as if it were a new project. Moreover, if the building codes, zoning or permissible land uses have changed, they may determine the project must be modified, scaled back or even torn down. It should be established what is the minimum necessary in order to obtain a certificate of occupancy.
- Title report. Obtain a title date-down report to determine if impermissible transfers, property tax, improvement tax districts and mechanics' liens encumber the property. Tax liens are superior to the lender's security interest. Some jurisdictions have relatively short periods of time for the taxing authorities to foreclose against the property. In some states, special improvement tax districts established by the developer can unilaterally subordinate the lender's loan priority.
- Forensic inspection. Obtain a comprehensive forensic on-site inspection of the asset. The inspection, among other things, must detail the asset on both a macro and micro level. It should quantify what is complete, incomplete and partially complete. The inspection should note hazardous conditions, unprotected improvements and any other construction anomalies. It should inventory improvements that have or will be compromised by exposure to the elements.
- New appraisal. Order a new appraisal of the asset, and provide the appraiser with the original appraisal and plans.
- Broker price opinion (BPO). A BPO from a local expert can be as valuable as an appraisal in establishing the true value of the asset.
- Cost-to-complete budget estimate. A comprehensive budget estimate should look at completion in two ways, determining what is necessary in order to obtain a certificate of occupancy, as well as what is necessary to finish the property as originally planned. For a proper financial analysis, the asset must be reviewed as-is, as-complete with a certificate of occupancy, and as-complete per plan.
- Insurance review. A review of the property and liability coverages should be made. The lender may not receive notices of cancellation, and the asset may be uninsured.

Stage two: determinations

Once the foregoing information is reviewed, it should provide a clear understanding of the issues surrounding the project and attendant action items. It will also provide the requisite information to prepare a financial analysis in order to establish the best course for the lender's disposition of the asset.

The following is a sample financial analysis. It has been simplified for the purposes of this article. Lenders often ask to customize the formula to add specific costs, including interest, legal fees, time estimates, investor return on investment (ROI) and more.

In this example, there were two loan commitments, the first of which was the $12 million construction loan and the second of which was the $1.5 million advance in loan funds. With $500,000 not yet disbursed, the loans' outstanding balance totals $13 million. The estimated value as-is is $8 million, while the estimated value upon completion is $11.5 million.

Analysis of the project determines the cost to complete the project is $1.4 million (which would use up the $500,000 in undisbursed funds and require an additional $900,000 not included in the original budget). Selling the project as-is nets a $5 million loss, while selling the project upon completion results in only a $2.9 million loss.

In turn, an investment of $1.4 million yields a 150% ROI and reduces the lender's overall loss by $2.1 million.

As detailed above, a systematic and comprehensive forensic assessment is the only way to objectively analyze the assets and liabilities. Moreover, the report serves to objectively substantiate further investment in the asset.

Lenders are also advised to throw out the old dogma of passivity in order to avoid liability and aggressively exercise their rights under the default provisions of the construction loan agreement. In our example, the elements were quickly compromising the existing improvements: mold was developing, the site was not secured, and the property was dangerous and subject to vandalism.

In fact, lenders have far less risk if they act diligently and document their decisions, rather than let the asset fall to ruin. Virtually all construction loan agreements provide that the lender may enter the property in order to protect the asset in the event of default. For loan defaults on partially completed construction assets, determined action is the only way for lenders to truly protect their security.

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