LOAN-TO-COST RATIO

The loan-to-cost ratio is defined as the ratio of the construction loan to the total cost of a construction project.

$$\text{Loan-to-cost ratio} = \frac{\text{Construction Loan}}{\text{Land Costs+Hard Costs+Soft Costs+Reserve}}$$

$$= \frac{\text{Construction Loan}}{\text{Total Project Costs}}$$

A loan-to-cost ratio means that the developer has a lot of his own money into the project. A higher loan-to-cost ratio means that the developer has very little of his own money into the project.

Traditionally, this ratio is not allowed to exceed 85%.

The cost of a project should always be *at least* 15% less than the appraised value of the property upon completion, and preferably the total project cost should be 20% to 25% less. This means that the developer stands to earn a profit of at least 15% to 25% of the total cost of the project.

Watch out for deals where the finished value of the project is not significantly higher than its cost. Otherwise, the developer has little incentive to complete the project if costs end up totaling more than originally expected. Otherwise, the developer is likely to say, "Adios!" to the project and to the construction lender halfway through the project.

It is possible to have a well-conceived construction project where the loan-to-value ratio is only 65%, but because the developer is trying to put very little of his own money into the deal, the loan-to-cost ratio is 95%. It is important to make sure the developer has a vested interest to stay in the project so if it doesn't go as planned, the developer will stay in the deal.