THE CONSTRUCTION LOAN PROCESS

Over 50% of all construction loans are made by commercial banks. A commercial bank is the best prepared lending institution because construction loans have short maturities, they are usually tied to the lender's prime rate which allows the commercial bank to match it's yield with its cost of funds, they require a knowledge of the local market, and because commercial banks have the capability to easily monitor and control loan disbursements. The remaining construction loans are made by mortgage bankers, real estate investment trusts (REIT's), life companies and pension funds.

<u>The construction lender is most always a local lender.</u> The reason is two-fold. First of all, construction loans are disbursed in stages. After each disbursement, an appraiser from the construction lender inspects the site to insure that the work for that stage has been completed according to the plans and specifications. Secondly, most commercial "takeout commitments" require a certain percentage of the project be leased at or above the pro forma rate in order to fund.

If the new commercial property does *not* lease at the pro forma rate, then the takeout loan will not fund, and the construction lender will be forced to either foreclose on the property or convert their loan to a permanent. Since construction lenders are usually only short term lenders, they do not want to be stuck for 5 years in one project when they could be rolling over their funds every 12-18 months and earning more loan fees. Therefore construction loans are usually made by local lenders who know there is a demand for that type of space and that it can be leased at the pro forma rate.

The construction loan process starts with the construction lender. It is the construction lender who analyzes the request and determines whether or not there is a demand for the space at the pro forma rent or higher. If the lender likes the project, the next question the construction lender will ask is how the developer plans to pay off the construction loan at maturity.

A "forward commitment" is a commitment by a lender or an institution to either deliver a permanent loan or purchase the property at some specific date in the future. In order for a forward commitment to be acceptable, it must be "bankable." In other words, it must be issued by a large, dependable institution. A forward commitment issued by a small mom and pop mortgage company would probably *not* be bankable. There are three types of forward commitments: a takeout loan, a standby *loan,* and a forward equity purchase commitment.

The Construction Loan Process

A “takeout commitment” is a promise to deliver a permanent loan at a specific date in the future that will be used to pay off a construction loan. A "permanent loan" is a first trust deed loan, usually amortizing, with a term of 5 years or more, that is secured by a "standing property." A "standing property" is *one* that has been completed. Unlike "standby loans", which we will discuss in more detail below, takeout loans have desirable interest rates and terms and are likely to actually fund. Takeout commitments are issued by long-term lenders, such as Banks and life insurance companies and usually cost the borrower 1 point at the time of issuance. Takeout lenders are becoming more and more reluctant to issue fixed rate forward commitments because when rates drop, developers usually refinance their construction loans through other lenders. Therefore many takeouts are now tied to 5 year Treasury Bonds, AAA corporate bond rates or the Federal Home Loan Bank cost of funds index.

A "standby commitment" is also a promise to deliver a permanent loan at a specific date in the future, except that the terms are generally very expensive and the loan is not expected to fund. Standby commitments are issued primarily to satisfy the construction lender that a source of funds exists to repay his loan. Standby commitments are expensive and not used very often.

A "forward equity purchase commitment" is a promise by an institution to buy the property upon completion. They are usually issued by larger institutions in unique situations on properties of $10 million and above.

Most all construction lenders will not require a forward commitment. Takeout commitments of less than $1 million are often difficult to obtain, and when banks are flush with cash, they do not want to lose a good loan to a bank down the street by requiring a developer to pay for a standby. When a construction loan is made without a takeout commitment, it is known as being "open-ended" or "uncovered." Some construction lenders were hurt during the last recession when their loans matured and rates were so *high* that the developers could not qualify for takeouts. Rather than force the developer into bankruptcy, most construction lenders "worked out" extensions until rates settled down.

Many lenders, most of whom are Banks, will provide the developer with a construction/takeout combination. The construction loan terms will be the same as an open-ended construction loan: the interest rate will float .5% - 1.50% over Prime, with a 1.0 -2.0 point loan fee, a maturity date of 1-2 years, and possibly 1 or 2, 6-month options to extend at 1/2 point each. The takeout loan is generally fixed for 5 years or adjustable for 10-30 years.

The Construction Loan Process

The takeout commitment usually costs the developer 1 point at the closing of the construction loan and another 1 point if the takeout actually funds. If the developer can find a better permanent on his own to pay off the construction loan at maturity, *he* usually does not have to accept the construction lender's takeout.

A popular form of construction/takeout combinations is the construction and "mini-perm" combination. These loans are most often arranged by Banks and major credit companies. A "mini-perm" is generally a 3 year takeout loan used to allow the developer time to establish an operating history on the project so he can qualify for a traditional permanent from a long-term lender. Mini-perms might be used for hotels or other business properties. Another use is when rents are expected to increase.

In summary, the developer goes first to a local construction lender, who analyzes his cost projections and the demand for the proposed space in the area. If the construction lender requires a takeout and is not prepared to offer one of his own, the developer next goes to a long-term lender for a takeout commitment. The takeout lender analyzes the pro forma cash flow statement to determine if the project will generate enough income to support a permanent loan large enough to pay off the construction loan completely and at the same time have a debt service coverage ratio satisfactory to the permanent lender. If so, the takeout lender will issue a commitment subject to the property being built according to the plans and specifications and subject to the project leasing out at the pro forma rent or higher. The developer then takes his forward commitment to the construction lender, usually a local bank who is confident that the projected lease rates can be reached, who then funds the construction loan.

CONSTRUCTION COST BREAKDOWN

LAND

Balance Owing/To Clear Title	$ ________		
Developer's Downpayment/Equity	________		
	Cost/Market Value/Appraised Value of Land:	$ ________	

DIRECT (HARD) COSTS

Demolition	$ ________	
Excavation and Grading	________	
Foundations	________	
Masonry	________	
Steel	________	
Drywall	________	
Heating & Ventilation	________	
Plumbing	________	
Electrical	________	
Parking	________	
Landscaping	________	
Tenant Improvements	________	
	Total Direct Costs:	0

INDIRECT (SOFT) COSTS

Architectural Fees	$ ________	
Civil Engineering Fees	________	
Soils Engineering Fees	________	
Appraisal & Market Research	________	
Legal & Accounting	________	
Real Estate Taxes	________	
Insurance & Bonds	________	
Fees & Permits	________	
Overhead	________	
Loan Fees	________	
Construction Period Interest	________	
Marketing & Leasing	________	
Escrow & Closing Costs	________	
	Total Indirect Costs:	0

CONTINGENCY RESERVE	0% (of direct and indirect costs)	0
TOTAL COSTS		$ 0
LESS CONSTRUCTION LOAN		________
DEVELOPERS CONTRIBUTION		$ 0