JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

- I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing
  - 6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance
    - k. "Construction Loan Process", no date

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Construction Loan Process

I. Construction loan has been considered as a self liquidating commercial bank loan, similar to loans for financing goods in process:

A. Basic elements of construction lending program:

1. Reliable construction budget estimate
2. Cash front money by borrower
3. Valid permanent loan take-out commitment to pay off construction lender
4. Controlled payout to avoid mechanics liens or misapplication of funds or cash out of contractor-developer prior to completion
5. Certification of completion

B. Preservation of legal control is combined with maintenance of accounting control plus attitude control by intimidation requires unique management talent.

II. Until recently construction loans commanded a premium interest rate of 4-6% above commercial bank rates. Real estate trusts and instability of commercial paper market introduce use of the floating rate - a fixed loading over a base such as prime rate, commercial paper rate or some other index.

A. Liquidity of construction loan depends on permanent take-out commitment which is usually conditioned on:

1. Substantial completion to meet specs
2. Freedom from all prior liens
3. Achievement of specified occupancy or operational levels
4. Loan ratio maximum as percentage of certified costs or appraised value, whichever is less
5. Expiration date of commitment

B. Construction lender therefore has to have confidence that:

1. Project is feasibile and can achieve occupancy and appraised value necessary to support permanent financing
2. Developer has adequate funds to complete project and pay all bills to remove rights of lien. Hence need for detailed project budget.
3. Completion according to specs and achievement of all conditions prior to expiration date of commitment

C. Construction lenders tend to become careless by assuming take-out commitments by big name lenders means sophisticated analysts think the project will work; big name lenders feel the conditions in the letter of commitment will protect them from projects which don't live up to their assumptions so they may also give only a shallow review of the proposal.

III. Assuming the construction lender is satisfied as to the viability of the project and the sincerity of the permanent commitment, then it is necessary to assure adequacy of funds and completion free of liens through the construction draw process.

A. All funds disbursed by lender on order of draws authorized by both owner and architect.

1. Required equity cash deposited with lender and disbursed by lender
2. Balance of cash needs disbursed from open construction loan balance with interest computed on daily balance outstanding
3. Standby funds for overruns disbursed last

B. Standby funds for cost overruns must be guaranteed by:

1. Payment & performance bond
2. Letters of credit
3. Escrow accounts of cash, near cash investments, or properties
4. Gap loans designed to finance $'s of overrun or time period between maturity of construction loan and achieving of conditions for permanent take-out
5. Cash resources of borrower

C. A draw request as developed by AIA general conditions procedure might look something like this:

Original contract sum------------------------	$2,960,918.00
Net change by change orders--------------	0,000,000.00
Contract sum to date-------------------------	$2,960,918.00

Total completed & stored to date-------------	$2,583,167.00
Retention-10%--------------------------------	258,316.70
Total earned less Retainage-------------	$2,324,850.30
Less previous certificates for payment-------	2,320,588.00
Current payment due-------------------------	$ 4,262.30

D. Most important line is "Total completed and stored to date" and yet is extremely vague and soft because:

1. Only materials stored on job site has detailed invoice audit trail
2. First draw may include allowance for land value and soft costs rather than cash cost to borrower
3. Percentage of work complete is simply a guestimate by supervising architects or by subcontractor applying for payment
4. Weak controls to prevent removal of property from site

E. Construction loan theory is that balance of funds still available under construction loan should always be sufficient to complete project if original borrower-developer fails. To do this require agonizing accounting detail summary reports such as the following example: