

COMMERCIAL LOANS: CONSTRUCTION AND LAND LOANS

CHAPTER 11

KEY TERMS AND PHRASES

Audited statement

Balance sheet

Certified Public Accountant (CPA)

Commercial loan

Construction loan

Feasibility study

Land development loans

Land loan

Net operating income

Office of Interstate Land Sales

Operating statement

Pro forma statement

Profit and loss statement

Release clause

Takeout commitment

LEARNING OBJECTIVES

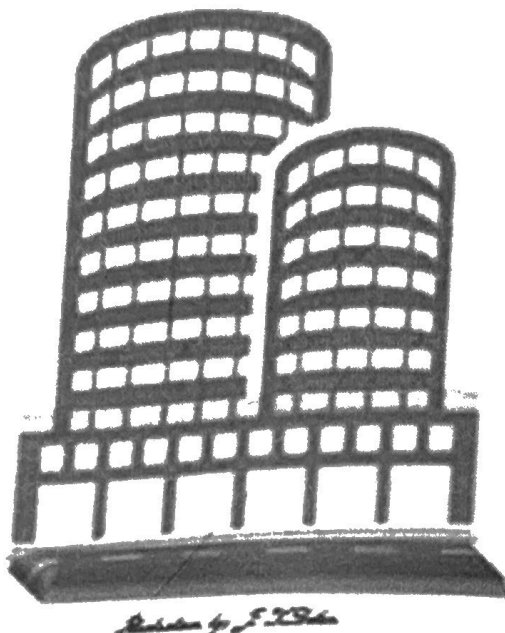
At the conclusion of this chapter, the students will be able to:

- Understand key aspects of commercial real estate finance analysis
- Describe the commercial real estate loan application process and documentation requirements
- Understand how the property evaluation process relies on more than the appraised value of the property, and how the type of commercial loan will affect the approach to valuation and maximum loan considerations
- Explain the draw or disbursement process for commercial construction real estate loans
- Describe the approach used for considering commercial loans for residential properties versus other types of commercial real estate loans

INTRODUCTION

In mortgage financing, the term **commercial loan** has a broad and ill-defined meaning. One major discrepancy in the standard accepted definition is that an





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apartment loan is considered a commercial type of loan. Yet for tax purposes, such as calculating depreciation, an apartment is classed as residential property. Perhaps the best definition of a commercial loan would be simply “those loans that are not classed as residential.” Generally, loans on one- to four-family residential units are not considered commercial, while any housing unit that has five or more units is considered commercial. It is a broad category with considerable variety in the handling of each major class of property.

A practical distinction between residential and commercial loans can be drawn from the anticipated source of loan repayment. A residential loan is expected to be repaid from the personal income of the borrower—that is, income unrelated to the property offered as collateral. The commercial loan is a business loan and in most instances repayment is expected from income generated by the property pledged as collateral. The individual involved with seeking a commercial loan is certainly important, but not crucially so as with a residential loan. Some very large commercial loans may not have any personal liability for the principals as individuals, since the property securing the commercial real estate provides both the loan collateral and the anticipated source of loan repayment. Most community banks and smaller local lenders still make a practice of obtaining the personal guarantee of the principals on smaller commercial real estate projects. Many of the risks of investing in commercial real estate still must be addressed by the owner and lender. The following are some of the more common of these risks:

- **Business risk.** This is a form of risk due to fluctuations in economic activity/economic conditions, including changes in interest rates.
- **Financial risk.** This is the use of debt or leverage, which can magnify business risk.
- **Liquidity risk.** Many believe this risk has to do with the lack of ability to sell rapidly or into a distressed market. However, it also includes the risk that a business will have inadequate cash flow and/or working capital to satisfy ongoing expenses, pay creditors and lenders, and maintain capital facilities in proper working order, and the possibility that tenants will relocate when their leases expire.
- **Management risk.** Poor management of a commercial property or development project can cause unnecessary delays or tenant dissatisfaction; poor record keeping can cause rating agency, investor, or debt covenant problems.
- **Risk management.** Includes identifying material sources of risk; measuring and monitoring those risks; and devising approaches to control, mitigate, or hedge those risks (e.g., purchase of liability insurance, completion bonds, hazard insurance, and building security).

Commercial loan evaluation focuses first on the property, then on the business applicant who expects to own the property. The following section discusses the type of information needed for commercial loan analysis and several of the tools that are used to make such an analysis.

INFORMATION SOURCES

The underwriter of a commercial loan has more sources of information than are normally found with home loans. The home loan evaluation is based primarily on an applicant's personal income and a market appraisal of the property offered as collateral. Proper underwriting of a commercial loan usually involves a business operation and property expected to produce sufficient income to repay the loan. So, to evaluate a commercial loan, the underwriter examines the financial statements offered by the business (or individual) applicant, studies the income-producing capability of the property offered as collateral, and conducts an investigation of the local market for that property's particular product or service. In addition, analysis of a commercial loan application can include extensive interviews with the principals involved in the business operation, who

should have provided resumes or background documentation covering their relevant commercial operations experience prior to this interview. Finally, it includes a thorough inspection of the property itself. Other underwriting requests might include an inspection of the rent rolls, tenant lease agreements, and credit quality of the tenants.

THE LOAN APPLICATION

All loans commence with an application. However, unlike residential loans, a commercial loan application is not a standardized form. It is designed by lenders to suit their own specific requirements. Often, the application has specialty sections that focus on different classes of properties—for example, the distinctive information needed for a hotel loan, which differs from that needed to evaluate an apartment loan application. Knowing what questions to ask about specific kinds of properties is one reason commercial lenders tend to specialize in their lending practices.

Depending on market conditions, it is normal for the lender to charge a reasonable fee in order to pay for the appraisal, the environmental report, the engineering report, and the title commitment. This fee defrays the cost of studying an extensive, and usually “one of a kind,” body of information that supports sound applications. It also discourages frivolous applications. Some mortgage brokers charge an application fee, typically less than \$1,000, which can be considered reasonable due to the time and effort the broker must invest in order to see if the loan is marketable. Some lenders will only charge an application fee if the loan is made, while in some market conditions, lenders may not charge a fee.

Information Required for a Commercial Loan Application

There are few standards and little regulation guiding how financial information is presented. The design of the principal kinds of statements comes closest to being standardized, but even this information can vary considerably. Regulations that apply to this type of information are directed almost entirely at those real estate companies that offer securities to the general public. At the end of the chapter, there are several links to different commercial real estate loan applications from a sampling of existing lenders. Next, we will examine the specific information most likely to be required in a real estate loan application.

Operating Statements of Property

If the property has been operating, statements for the past two or three years are required. These include annual balance sheets and profit and loss statements. A third statement—an operating statement—reports on an individual property and does not show income tax or depreciation figures. While tax and depreciation figures are very important, they are not considered as operating expenses, but rather, as costs that vary with the owner's personal situation. More detail on the three principal financial statements follows.

Balance Sheet

The **balance sheet** is the most standardized of all the financial statements. It is a listing of a company's (or individual's) assets in a column at the left of the page, and a listing of the liabilities plus the net worth in a column at the right of the page. The difference between the assets (what is owned) and the liabilities (what is owed) amounts to the net worth of the company. This makes the sum of liabilities and net worth on one side of the sheet equal in amount to the assets listed on the other side—thus, a “balance” sheet.

The figures that are of most concern to an analyst as regards the balance sheet are the valuation of assets. This is particularly important when major assets consist of real estate. A distortion in value can easily present an erroneous picture of true worth. The careful underwriter will need to know how asset values, particularly land and buildings, are derived. Therefore the underwriter is faced with the following questions:

- Is it a book value representing the original cost of the property?
- Is it based on a professional appraisal?
- Might the value be an owner's concept of market value?

Most other figures found in a balance sheet are more easily verified with simple auditing procedures.

Profit and Loss Statement

The **profit and loss statement** (P&L) is a statement of income and expense; it has nothing to do with assets and liabilities. An underwriter or a buyer doing due diligence must be aware that a set of audited financial statements prepared by a Certified Public Accountant (CPA) will be titled either the “Income Statement” or the “Statement of Operations,” which are the terms professional accountants use and which constitute a different basis of presentation from the profit and loss statement. These differences

will be discussed later in the chapter. The basic format is simple. Start with the revenues (usually rental income), then deduct expenses, and the bottom line shows a profit or loss for the time period covered. The figures may be presented in excruciating detail, covering several pages, or may be reduced to three lines: one for gross revenues (all items of income), one for total expenses, and the third representing the difference between the two, which is the profit (or loss). Most statements fall between the extremes.

Normally, the P&L statement gives some detail as to what items comprise the operation's income, as several sources are often involved. The same is true of expenses that provide information on where the money has been spent. The result of subtracting the operating expenses from income is commonly called **net operating income**, not to be confused with a term by the same name in the more formal CPA-audited Income Statement. Using the P&L statement, operating expenses are those costs necessary for the day-to-day operation of the business. Operating expenses in the P&L do not include such important deductions as debt service, depreciation, and reserves for payment of income taxes, as would the more formal audited Income Statement. This is why net operating income best reflects the true operation of a property.

To explain further, the other costs mentioned (debt service, depreciation, and tax reserves) are determined by the owner's decisions and have little to do with the efficiency of day-to-day management of operations (fixed costs are not really considered controllable). Debt service is the cost of financing and has nothing to do with operations. To put it another way, if the property is overloaded with debt, firing the manager is not a solution. As identified on a P&L statement, debt service is the payment of principal and interest only. It does not include insurance premiums and property taxes (these are deducted as expenses), as is customary with home loans. (Home loans identify this cost as a *mortgage payment* that includes principal, interest, taxes, and insurance—or PITI.)

The choice of depreciation procedures allows an owner some flexibility and reflects tax decisions rather than operations. After the 1986 tax reform, income tax policy settled on straight-line depreciation methods (which imply an increasing rate of depreciation for older buildings), with the depreciation rate based on 27.5 years for apartments and 31 years (subsequently increased to 39) for non-residential commercial buildings.¹

¹ Bokhari, Sheharyar, and Geltner, David. "Characteristics of Depreciation in Commercial and Multi-Family Property: An Investment Perspective." *Social Science Research Network*, Nov. 30, 2014. Available at <http://ssrn.com/abstract=2464164> or <http://dx.doi.org/10.2139/ssrn.2464164>

And in today's world of income taxes, there is no standard that can be applied to any particular income. Such taxes, particularly when real estate is involved, must reflect all sources of income. Therefore, identical dollar amount of income no longer results in identical taxation.

Because of the questions just raised, a profit and loss statement should deduct debt service, depreciation, and tax reserves from the net operating income after that figure has been determined. This gives an important "bottom line" for an owner or analyst to make informed decisions on future property rehabilitation, expansion, possible disposition, and tax matters. This information is often considered proprietary and not readily available to potential buyers of the property. Instead, for potential buyers a shortened form of the P&L is commonly used, which is better known as an *operating statement*.

Operating Statement

Because it is similar in format, an **operating statement** is often confused with a profit and loss statement. As a shortened P&L, it limits information to income and expenses. It does not include debt service, depreciation, or income taxes. Furthermore, both income and expenses should be presented in sufficient detail to give a reader good knowledge of the property's operation.

An operating statement contains the kind of information most commonly found in real estate transactions. It gives some detail on the income that can be made (the potential gross income), reduced by vacancy and credit losses. Operating expenses are then listed as a deduction from income. The expenses are given in considerable detail and include property taxes and insurance premiums. As explained earlier, these items are not included in debt service when considering commercial loans. The information, subject to verification, can be used as part of an offering package for prospective buyers.

A helpful addition found on some operating statements is a percentage column that gives the ratio of an expense to the property's gross operating income. For example, to use round figures for simplicity, a property that shows a gross operating income of \$100,000 where the cost of electricity is \$8,000 would represent an 8% (8,000 divided by 100,000 equals .08) measure.

Key expenses should be shown in a percentage column for two reasons: (1) for comparison of operating expenses between potential acquisitions, and (2) to single out those expense items that appear inordinately

high compared with local norms. Percentages are a more accurate reflection for comparing costs than dollar amounts because of variation in size of properties. They help to show whether or not expenses may be increasing because of increased revenue or for some other reason.

Pro Forma Cash Flow Statements

A **pro forma statement** is a projection of both income and expenses. It is not a record of what has happened, but of what might be expected. Pro forma statements are most frequently used as an analysis for new developments. They may be found in a prospectus for an offering of a real estate security. Because the figures are all projections, a pro forma statement should be very clearly labeled. In the hands of a professional analyst, the pro forma can provide very helpful information on a proposed investment project. In the hands of a sales enthusiast, however, it can be misleading. New technologies are available for forecasting and pro forma statement preparations, including software tools such as ARGUS Valuation-DCF™, ARGUS Developer™ and ARGUS Property Budget™, which we will discuss further in Chapter 14. Cash flow projections like the one that follows can often be developed and supported with ARGUS Valuation-DCF software that documents and projects assumptions while supporting the resulting financial conclusions with its standard reporting of all input data, property and portfolio-level summary reports, and detailed tenant-by-tenant supporting schedules.

Where Are We Now?

Cash Flow Projections

PROPERTY: CITY LIGHTS SHOPPING CENTER
YEAR END DATE: mm/dd/yyyy

INCOME AND EXPENSE ITEMS:

Gross Scheduled Income	\$1,240,000
Miscellaneous Income	\$ 83,500
Gross Possible Income	\$1,323,500
Less: Vacancy and Credit Loss	\$ 62,000
Adjusted Gross Income	\$1,261,500

OPERATING EXPENSES:**NET OPERATING INCOME:****LESS DEBT SERVICE****NET CASH FLOW**

\$ 300,000

\$ 961,500

\$ 758,302

\$ 203,198

Business Financial Statements

If the real estate borrower has a business, or is a business, lenders will require two or three years' worth of signed and dated statements. Audited statements are usually preferred; however, depending on the loan amount, the lender may accept compiled or reviewed statements.

Personal Financial Statements

The principals involved are expected to furnish personal financial statements for at least the past year. Many lenders want these statements to have been updated within the past 60 days.

Business and Personal Income Tax Returns

A complete loan package will include two or three years' worth of tax returns for both a business and the principals involved. A typical lender will ask for any extensions of tax filings that are outstanding and the expected disposition of each.

Current Rent Roll

The rent roll is a list of the space available for rent and, if available, should include current tenants, vacancies, current rent (gross and effective rate per square foot per year), escalation clauses, maturity of rent contracts, options for renewal, type of rent (single tenant net lease, double net lease, or triple net lease), rent concessions and their timing, and square footage currently under lease. Copies of all leases are normally required. Creditworthiness of current tenants is reviewed, and the lender may require an assignment of leases and rental agreements as additional collateral.

Accounts Receivable and Accounts Payable Aging Reports

Some lenders may require this information to help analyze the overall financial health of the business.

Purchase Contract or Warranty Deed

If the property is to be purchased, the lender will require a copy of the purchase contract and all addendums. If the property is already owned, the lender will want a copy of the recorded warranty deed.

Insurance

Lenders require that the property have hazard and general liability insurance. Depending on the location of the property, other types of insurance (such as flood insurance) may be required.

Current Real Estate Appraisal

Lenders usually order the appraisal because they have their own list of acceptable appraisers. A narrative-type appraisal is normally required, giving cost, market, and income approaches to value. Depository lending institutions will not use appraisals prepared by the borrower or the appraiser selected by the mortgage broker. They select an appraiser using their own list, which has been approved by their board of directors.

Survey

Lenders require a current survey of the land, made by a registered surveyor.

Property Tax Bill

Some lenders require a copy of the tax bill to verify the legal description, the owners, and the tax assessment on the land and any buildings.

Resumes of Principals

The borrower should supply a lender with a brief resume of all principals' work history. Also, if a business is involved, a brief history is helpful.

Articles of Incorporation

If the borrower is a corporation, the lender will require a copy of the articles of incorporation and a corporate borrowing resolution.

Authorization to Release Information

A commercial loan package should contain an authorization for the lender to request credit information on all principals and the business if one is involved.

Environmental Audit

All commercial loans require an environmental site assessment. The audit should be made by a professional acceptable to the lender.

Permits Obtained or Zoning Requirements Met

It is important for the applicants for any development loan to have completed their due diligence on any permits that are needed or to have obtained zoning variances or have researched zoning restrictions to ensure that no violations will be committed based on planned use. A completed file on this type of information will typically be required by a commercial real estate development underwriter. For existing buildings or land that will be purchased for alternative uses, the loan can be allowed to go to closing with the permits or zoning requirements being a closing condition rather than a precondition of underwriting.

PREPARATION OF FINANCIAL STATEMENTS

The most important assurance of receiving complete and accurate information on a financial statement is the caliber of the person preparing the statement. The highest professional designation in this field is **Certified Public Accountant (CPA)**, a qualification that may be granted by each state. Some states offer lesser designations, such as "public accountant" for those meeting certain requirements, usually preparatory to reaching the CPA level. The requirements vary somewhat among the states, but all demand completion of educational courses, some experience in the field working for another CPA, and the passing of exhaustive qualification tests.

In practice, only a CPA may prepare an **audited statement**. This means that the information contained therein has been prepared in accordance with accepted accounting practices and that the numbers used have been verified by the preparer. The preparer then certifies that the statement accurately represents the financial condition of the subject. CPAs can also prepare statements without audit that do not offer the substantiation of data provided with an audit. For larger commercial loans, lenders may insist on audited statements.

The initial presentation of most commercial property investments as found in sales brochures often offers financial information that has not been compiled by professional accountants. If the preparer is an owner or a sales broker, the information given may be suspect because of the vested

interest of the preparer. Nevertheless, such information can be verified to some degree by an interested investor and does provide a point of beginning. A major problem with these statements is that they lack consistency, do not have uniform account identification, can reach conclusions that defy easy comparison, and are not always accurate.

Prudent investors normally take the financial information supplied, verify essential details, and then restate all of the figures onto a standard form. A standard form is used to shift income and expense items into uniform accounts that allow easier comparison. The standard statement procedure also reveals accounting information that may be lacking, such as how replacement costs are handled. By restating information onto a standard form, an investor or analyst can make a better comparison between properties offering investment opportunities.

PROPERTY EVALUATION

In commercial loan analysis, the evaluation of property offered as collateral involves more than determining its present value. In most instances, it is the income produced by that property that is expected to repay the loan, so the study involves its potential for producing sufficient income to handle timely repayment. Each kind of property presents a different set of circumstances that affects its cash flows. Because of this, many lenders simply limit their participation in commercial lending to the types of properties they know best. Experience is a valuable teacher.

We will discuss the specialized problems of the major classes of income properties in the next chapter. More generalized information can be obtained from an appraisal and a feasibility study, as explained next.

Appraisal

Unlike residential loans, there are no standardized forms and few regulations that apply to how an appraisal must be prepared for a commercial loan. The most common practice is for a lender to require a narrative-type appraisal prepared by a recognized professional. If the loan is destined for handling by any federally-related lender, such as a multifamily housing loan, a state-certified or HUD/FHA-approved appraiser must be used. It is most important that the appraiser be acceptable to the lender. Or the lender requirement might be given as a minimum level of appraiser designation, such as an "MAI appraiser or the equivalent with state certification."

For a lender, an appraisal represents several things. It is used to confirm an applicant's opinion of value. It provides a professional opinion of what the property actually comprises in land and buildings. And it gives regulated lenders an acceptable basis for meeting maximum limits on loan-to-value ratios. An appraisal should be recognized as an estimate of value at approximately the time of loan origination, and not an assurance that value will remain unchanged over the life of the loan. Nevertheless, the appraisal industry has come under increasing scrutiny by regulatory authorities (see Chapter 10).

Feasibility Study

A **feasibility study** is a variation of the more standardized appraisal techniques in that it places much greater emphasis on a market study of the products and services offered by the subject property. Furthermore, while appraisers are professionally recognized with designations offered by various peer groups and state certifications, those who prepare feasibility reports are not. Even so, feasibility studies are usually prepared by various professionals such as appraisers, property managers, real estate brokers, and market analysts.

As its name implies, a feasibility study attempts to determine whether or not a proposed investment is likely to be successful. It estimates the cost of the project, whether new construction or rehabilitation. Potential income is measured with a market analysis of competing properties in the area. This involves a study of occupancy, amenities offered by the competition, and rental rates. Based on the proven experience of similar properties, the analysis will include a pro forma statement of the expected income and expense of the operation. It should also include a variance analysis that contains some adjustments to deal with the risk of ownership—in particular, the financial risk or leverage risk. Use and overuse of financial leverage occurs cyclically and in differing economic conditions. The over-leverage in commercial real estate that took place in the late 1980s and early 1990s caused by, among other factors, easy access to low-cost debt, helped fuel the risk taking that eventually took property investment markets into unsustainable territory. While commercial real estate was not the direct cause of the problems that surfaced in 2007, the end result has turned out to be nearly the same as in the late 1980s, and potentially more destructive given the widespread nature of the ramifications of the financial credit crisis and resulting international recession. The build-up in easy credit was caused in part by the international market's excessive financial

assets needing a place to be put to work. People have tended to forget the fact that real estate prices can go down, and there are various forms of liquidity risks inherent to commercial real estate investment and lending. Multifamily and commercial mortgage debt surged over the past 20 years from just over \$1 trillion in 1997 (as the sector finally emerged from the early 1990s downturn) to \$3.4 trillion in the third quarter of 2008, and was \$3.3 trillion in the third quarter of 2014,² with a shift of \$200 billion of that total to multifamily debt. The net effect of this surge was the growth of the mortgage market from about 14% in 2007 to 25% by the end of 2008, exceeding the 1980s peak of 20% of the nation's gross domestic product.³

Feasibility studies should also consider problems associated with environmental questions as they relate to the subject of property. In its conclusion (which is often presented at the beginning of the report), the study attempts to answer the practical question of whether or not the project will be successful. Obviously, the knowledge and ability of the preparer is critical in reaching reasonably accurate conclusions. Most feasibility studies consist of the following five broad topics: 1) market analysis, 2) location analysis, 3) analysis of usage concept, 4) competition analysis, and 5) risk analysis. Several good examples can be found at the following web links:

- <http://graziadiovoice.pepperdine.edu/a-feasibility-study-for-developing-new-real-estate/>
- http://www.rainmakermarketing.com/financial_feasibility_studies/

Where Are We Now?

Comparison of Debt Coverage Ratio (DCR) and Loan-to-Value (LTV) Methods

Consider the City Lights Shopping Center, which has been appraised at \$12,000,000 and is expected to have a pro forma statement as shown in the earlier example. The loan constant (K) for this type of loan is 8.275 percent and the Net Operating Income (NOI) is \$961,500.

²Federal Reserve Bank (2014). "Mortgage Debt Outstanding." Federal Reserve Bank Report Release Dec. 14, 2014. Accessed Jan. 31, 2015 at <http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm>

³Garner, C. Allen. "Is Commercial Real Estate Reliving the 1980s and Early 1990s?" Federal Reserve Bank of Kansas City Research Study released October 2009. Accessed May 31, 2011 at <http://www.kansascityfed.org/PUBLICAT/ECONREV/PDF/3q08Garner.pdf>

Debt Coverage Ratio Method:

Lender's DCR for this type of property is 1.2

The maximum debt service (DS) allowed by the lender:

$$\text{NOI/DCR} = 961,500/1.2 = 801,250$$

The maximum loan amount is;

$$\text{DS/K} = 801,250/.08275 = \$9,682,500 \text{ (rounded)}$$

Loan-to-Value Method:

The lender will lend 75 percent of value:

$$12,000,000 \times .75 = 9,000,000$$

The debt service will be:

$$\text{DS} = \text{Loan} \times \text{K} = 9,000,000 \times .08275 = \$744,750$$

LAND PURCHASE LOANS

Considered as a class, raw land acquisition loans are probably the most difficult of all mortgage loans to obtain. Undeveloped land offers no income that might be used to repay the loan. There is further concern in the need for additional cash each year to pay property taxes, possibly insurance, and various "standby" charges. A hindsight view of the serious decline of real estate values and the collapse of many savings institutions in the late 1980s point a heavy finger at raw land as the most serious real estate problem. As a result, not many lenders will even entertain an application for a **land loan**.

Lenders who do make this kind of loan are likely to restrict approval to those with (1) a good track record of repayment of other land purchase loans, (2) substantial other assets available, or (3) an assurance with some written commitment of a future resale of the land. Effective in March 1993, new loan-to-value limits were placed on regulated lenders at 65% for raw land loans. However, lenders can, and do, apply even lower limits as prudent policy. (This limit has not changed and updates dating from February 2011 can be found at FDIC Law, Regulations, Related Acts, under Section 2000, Rules and Regulations, PART 365—REAL ESTATE LENDING STANDARDS, Sec. 365.1 Purpose and scope; 365.2 Real estate lending standards; Appendix A to Part 365—Interagency Guidelines for Real Estate Lending Policies.)⁴

⁴Federal Deposit Insurance Corporation (2014). FDIC Law, Regulations, Related Acts: Appendix A to Subpart A of part 365, last update April 20, 2014. Accessed Jan. 31, 2014 at <https://www.fdic.gov/regulations/laws/rules/2000-8700.html#fdic2000appendixatosubapart365>

Any mortgage loan that is expected to be repaid through the sale of its collateral carries a higher risk for the lender. A future sale is not always an assured condition. In certain situations, a future sale or use of the land might be known when the land is acquired, yet final disposition is not immediate. For instance, the land may be purchased for a housing development, or perhaps a shopping center, requiring time to complete plans and secure permanent financing. If such conditions exist, the attraction for a lender to assist in the immediate purchase of raw land is the potential to make the construction and permanent loans.

Sometimes a land broker or developer will locate a tract of land highly suitable for a particular purchaser. It could be a small tract for a service station or a larger parcel on which to erect a retail store outlet. But at the time the property becomes available, the ultimate user may not be in a position to consummate the land purchase. In such a circumstance, a binding letter of intent by a creditworthy buyer issued to a real estate broker or developer would greatly facilitate a raw land loan to acquire the chosen site. The land broker will present the lender with a reasonably sure sale for the land within a specified time period, with the land itself as collateral.

LAND DEVELOPMENT LOANS

The next logical step after purchase of raw land is its development. Land development for loan purposes means the building of streets and utilities to prepare lots for resale as home sites. In contrast, the land development work associated with the construction of an apartment or office building project is in the category of site development, or land preparation, and is an integral part of the project's construction costs.

For such projects, separate **land development loans** are not needed. Since the work called for in land development plans can easily identify the project for residential purposes, such a loan is much more acceptable to an insured deposit-taking financial institution or other lender than the land purchase itself. The reason is that the development loan classifies as "residential," which for regulatory and tax purposes may receive more favorable treatment for the lender than strictly commercial loans.

A development loan is limited for regulated lenders to a maximum of 75% of the property value. The property value normally used for this measure is the appraised value of the finished lots. This is one of several types of loans that generate what might be called a certain distortion in values due to the fact that the very development being financed greatly

enhances the value of raw land. Normally, the appraised value of completed lots based on an existing market would be substantially greater than the development costs. In such a case, a 75% loan could permit the developer to borrow an amount in excess of the actual costs. In lending jargon, the amount of a loan that exceeds a borrower's actual costs is called *walking money*—that is, money the borrower can walk away with upon completion. The prudent lender is reluctant to permit a borrower to obtain cash “profit” from a development loan, since this has a tendency to lessen the incentive to sell the property as intended.

Release Clause

An integral part of a land development loan agreement is the **release clause**. This is the clause that spells out when, how, and at what price any lot or lots may be released from the mortgage pledge of the initial tract of land. The release terms may call for an order of priorities by which the land can be developed and will state in what manner lots may be released. The purpose of this kind of mandate is to assure overall development in a manner that realizes the most efficient utilization of the entire tract that is pledged.

Another important clause specifies the amount of money from each lot sale that must be paid to the lender to release that lot. The release itself is a specific release of the mortgage lien on the lot or lots being sold and is intended to permit delivery of a clear title to the lot purchaser—usually the home builder. The amount of money required to release a lot may be a percentage of the sales price of the lot, such as 75%, stating a minimum sales price. In this procedure, any increase in sales price over the minimum would increase the payment to the lender and amortize the loan more rapidly.

Another method is to set a flat sum on each lot for release and let the developer sell it at whatever price he or she can. The flat sum per lot is usually calculated to repay the development loan with interest in full when somewhere between 60% and 75% of the lots have been sold. Lenders are not interested in waiting for the last, perhaps least desirable, lots to be sold in order to recover the loan.

Office of Interstate Land Sales

Since 1968, the Department of Housing and Urban Development (HUD) has had an **Office of Interstate Land Sales** charged by Congress with the responsibility of establishing guidelines and procedures for land

developers in an effort to minimize deceptive practices and outright frauds. Sales of lots—developed and undeveloped—and certain types of time-sharing condominiums have grown substantially in this country and have brought out some unscrupulous operators. Basically, the rules require a full disclosure of the essential facts for the land buyer and serve as protection for both buyer and seller. As one explanation goes, a developer can sell a lot that is completely under water but must state in writing that it is physically under water. The rules apply to any development with over 25 lots for sale. However, certain Statutory Exemptions from both *Anti-Fraud Provisions* and *Registration Requirements with HUD* are allowed. For example, If a seller wants to live dangerously, he or she can claim an exemption from the Registration Requirements, but only if the development has 99 or fewer lots for sale, or if each lot contains at least 20 acres each, and on which no construction is required. Failure to comply with HUD regulations can lead to fines and imprisonment for the lender, the developer, and the sales agents. Legal decisions handed down since 2007 have held that condominium purchase contracts on a lot on which a condominium will be built are only exempt if the completed unit is built and inhabited by the purchaser within a two-year period from the date of contract; otherwise, the developer must be in compliance with the Interstate Land Sales Full Disclosure Act (ILSFDA).

The Dodd-Frank Act placed enforcement under the Consumer Financial Protection Bureau and, due to the financial crisis, more enforcement actions were set into process as purchasers of lots and condominiums tried to get out of transactions using the ILSFDA non-compliance as their cause of action. One interesting action, as evidence of the breadth of the act's definition of "developer," in *Aaron v. The Trump Organization, Inc.*, 2011 WL 2784151 (M.D.Fla., July 15, 2011), the court found that The Trump Organization was liable under the act as a "developer" because it had licensed the Trump name to the condominium project, including using the name on various sales and marketing materials. The Trump Organization had the authority to review various plans and specifications for the project.⁵

In a rare bipartisan action, the initial bill to remove condominiums from the act passed with a 410-0 vote in the U.S. House of Representatives. This was part of a bill to amend the ILSFDA to exempt condominiums

⁵Lubinski, Joseph. "Interstate Land Sales Full Disclosure Act: 2012 Update." *American Bar Association Journal*, 2012, February issue.

from the act and was signed into law in September of 2014.⁶ Therefore, condominiums developers are relieved, but consumers will need to become more aware that the ILSFDA no longer provides them the same amount of protection as before.

CONSTRUCTION LOANS

The construction industry is a major employer in this country and it depends heavily on the availability of lendable funds. However, several large segments of the construction business are not so dependent on the regular commercial loan market. These are mostly government projects such as streets, highways, dams, and public buildings, which can be paid for from tax revenues. To finance these projects, various types of bonds can be sold that are often collateralized with a pledge of tax revenues. Another large segment of the construction market is the building of industrial plants and utility systems by large corporations. These projects are often financed from their own revenues, or perhaps through the sale of corporate securities, including mortgage bonds.

The type of construction lending discussed in this section concerns a building loan—that is, a loan of the money needed to construct a house, an office building, or a shopping center. While these loans vary substantially in size, there is a similarity in the risks involved. All are secured by a mortgage on the land and the building to be constructed, all are funded only after each stage of construction has been completed, and almost all require a permanent loan commitment or takeout of some kind to assure repayment of the construction loan immediately upon completion of the project. So where is the big risk?

The risk to the construction lender lies in whether or not the building can be completed with the available money and whether it meets all required specifications. Many factors that are difficult to foresee can hamper the successful completion of a building. Some of these problems include the weather, labor difficulties and strikes, delays in the delivery of materials, and changes in the plans or specifications. A more recent requirement involves meeting sometimes difficult-to-define environmental

⁶GovTrac (2015). H.R. 2600 (113th): To amend the Interstate Land Sales Full Disclosure Act to clarify how the Act applies to condominiums. Accessed Jan. 31, 2015 at <https://www.govtrack.us/congress/bills/113/hr2600>

stipulations. These can result in time-consuming meetings, additional paperwork, and even litigation.

Definition

The definition of a **construction loan** focuses on the special requirements for this type of financing. A construction loan is initially a loan commitment that provides for the money to be disbursed at intervals during construction in a manner that ensures payment of all construction costs and finance charges. It requires completion of the building in accordance with the plans and specifications so as to deliver a valid first mortgage upon completion. Further explanation of each part of this definition follows.

Disbursement during Construction

Unlike other types of loans, a construction loan is not funded when the borrower signs the note. All the borrower has at the beginning is a commitment that funds will be released as construction progresses. There are two basic ways that progress payments are released: (1) on a time-interval basis, and (2) on a by-work-completed basis.

With the time-interval method (usually monthly), the building progress is inspected at specified intervals and the amount of work completed is duly noted. The lender then releases that portion of the loan that has been allocated to the work accomplished. Under the by-work-completed plan, the lender and borrower agree at the outset on about five stages of progress that, when reached, will release that amount of the loan proceeds. An example of a first stage might be the completion of all underground work and the pouring of the foundation.

Assurance of Payment of Costs

While it is the borrower's prime responsibility to use the loan proceeds for the payment of charges on the construction, the lender has an important stake in making sure that all labor and materials are paid as the money is released. Every so often, a builder, accidentally or by design, may mix the records and use the proceeds from one construction loan to pay charges accruing from another project. The result can be labor liens and material suppliers' liens filed on the property for loan funds that have already been released to cover those claimants.

Lenders can minimize the risk of improper disbursement in several ways. One is for the lender to handle the payments to contractors and subcontractors. Another is to require proof of payment for costs incurred by the borrower before any funds are released from the loan. Another is to require a waiver-of-lien form, signed by each contractor involved, with every progress payment. Many lenders have a real estate attorney do a lien search of the subject property prior to any disbursement. This search will reveal if there have been any mechanic's liens on the property due to non-payment by the owner or contractor. Perhaps the most important protection for the lender in this regard is to know the borrower's reputation for handling building projects, then to make close inspection a standard procedure.

Completion in Accordance with Plans

Again, it is the borrower who is primarily concerned that the building be constructed according to the plans and specifications. But the lender also has a real interest in this question, as failure to meet the plans can be a cause for refusal by the permanent lender to release the loan for payoff of the construction loan. The problems are mostly technical, such as the size of pipes and wiring, the grade and thickness of concrete, the amount of reinforcing used, and the compaction of foundation and parking areas.

On small projects, the lender may rely on its regular staff for inspection approvals. On large projects, it is more common to employ an independent firm or professional to serve as the inspector. Architects and engineers are both used for this purpose, and the decision of the professional is usually accepted by both the borrower and lender as final determination of the acceptability of the project as it is built.

Delivering a Valid First Mortgage

Insofar as the lender is concerned, the goal of a successful construction loan is to complete the project within the money allocated, with all bills paid and no liens filed. The construction loan can then be repaid through funding of a permanent loan or the sale of the property.

Additional Comments

It is customary in a construction loan for the lender to withhold 10% from each progress payment until final completion. The purpose is to provide a reserve against unexpected claims. Some lenders will hold this reserve

until the statutory lien period has expired (after construction completion) before releasing it to the borrower. If an unexpected cost is encountered that was not allowed for in the loan amount committed, the lender will ask, or demand, that the borrower make such payment. The same procedure is used if the borrower decides to make some changes in the plans after the loan has been committed. Such changes must be approved by the lender, and if they should cause an increase in the anticipated cost, the borrower will be expected to use his or her own funds for payment. The lender does not want to have a building only partially completed with all loan funds exhausted.

Personal endorsement by the borrower/owner is almost always required on a construction loan. The same lender may agree to make a long-term permanent loan with no personal endorsement required, but will refuse to do so on the construction loan for the same project. The reason is not just the added security given by another endorsement; it is to place personal responsibility on the borrower/owner, who is in a controlling position during construction to insist on changes in the plans or create costly problems that can upset orderly construction work. The lender just wants to make certain that the borrower/owner carries a full share of responsibility.

The principal sources for construction money are commercial banks with specialized construction loan departments, savings associations, mortgage companies or commercial mortgage brokers that represent life insurance companies, and other funding lenders such as sovereign funds. The commercial banks' interest is in the higher yield and short terms represented in construction lending; savings associations, sovereign funds, and mortgage companies prefer the higher yields, but also are usually in a position to pick up permanent loans at a minimum of expense to themselves.

Construction Loans for Residential Properties

Single-family detached houses and some townhouse projects are financed by builders on both a contract basis and a speculative basis.

Contract Basis

A house built for an owner under contract represents a reduced risk to the construction lender. The normal sales contract to the home buyer is a firm commitment by the purchaser and includes a permanent loan

commitment for closing. Often, the permanent commitment is made to a home buyer by the same lender handling the construction financing as a sort of package deal, which minimizes paperwork. On such a loan, the risk to the construction lender is primarily in the builder's ability to complete the house within contract terms. The builder's track record must be known to the lender.

In smaller communities and rural areas, houses are often constructed under contract by a local builder, who may also operate a lumberyard or other supply facility, with the builder providing the construction financing from personal resources. A nearby savings association will have already agreed to make the permanent loan when the house is completed.

Speculative Basis

Many builders, mostly in growing suburban areas, build houses with the expectation of selling them by the time they are completed. Added to the risk of being able to complete the house within the projected cost figure is the risk of selling the house at a profit upon completion. A lender must look at the strength and capability of a speculative builder before accepting such a loan. As a builder proves satisfactory ability to the lender, the construction line of credit can be expanded.

When the housing market fluctuates downward, the speculative builder is the first to be hurt. He or she can be caught with many unsold houses on which the high interest of a construction loan can continue to eat at any profits. More and more, construction lenders are seeking to protect themselves against a soft market by demanding a takeout commitment before they will agree to the construction loan. This has created a whole new industry of placement firms selling the end (permanent) loan to specialty real estate investment trusts and hedge fund managers, who then place the permanent or takeout loan into the portfolio of the REIT or managed fund accounts of the hedge fund's clients.

Takeout Commitment

A **takeout commitment**, sometimes called a *standby commitment*, is a promise to the home builder by an acceptable mortgage lender to make a permanent home loan directly to the builder in the event that the subject house is not sold within a certain time limit—commonly, one year. The commitment is usually in the form of a simple letter agreement and costs the builder at least one point payable upon delivery of the letter

agreement. The amount of the commitment would be the same as the construction loan—normally, 80% of the sales value of the house.

However, the commitment is not really expected to be used. It serves more as an insurance policy to protect the construction lender's loan. To encourage the builder to sell the house rather than rely on the takeout commitment, the rate of interest on the takeout is set at one to three percentage points over the going rate, and the term much shorter (probably 10 years) than if the loan had been made to the intended occupant/buyer. The builder still has the problem of selling the house, but has a little breathing room because he or she is facing a monthly amortization payment rather than full repayment of the construction loan, while the construction lender is clear with all money repaid.

Construction Loans for Income Properties

Apartments, office buildings, shopping centers, and warehouses all use construction financing, sometimes termed *interim financing*, to accomplish the building of the project. As noted earlier, only the strongest builder/developers are capable of commanding construction financing for any income property without a permanent loan commitment to pay off the construction loan at completion. The terms of the permanent loan influence the manner in which the construction money can be handled. Special requirements for funding the permanent loan, such as an 80% lease-up before release of the loan proceeds, place the construction lender in a far riskier position. If a permanent lender is currently unavailable, the developer may resort to a takeout commitment within the same framework as described earlier for a home builder. The construction lender must have a closing date for the takeout within a reasonable period (one to three years) for proper recovery of the construction loan.

Construction lending calls for highly experienced personnel who can work with builders and who understand construction progress and procedures, so as to make timely releases of the loan proceeds. Most lenders will not release a progress draw without physically inspecting the project or having an independent architect inspector submit an estimate of work accomplished. The trick is to be able to complete the project within the money available and still have 10% of the loan amount retained at completion to protect the lender against any unforeseen contingencies.

When the lender is satisfied that all bills are paid and that no valid liens can be filed, this 10% retainer/holdback can be released. Commercial construction loan draws are somewhat more complex and can have many additional requirements if they are from a community or state development agency. Common mistakes made for draw requests can include any or all of the following:

- Missing invoices and/or proper support documentation
- Invoices lacking sufficient information (e.g., type of work performed, periods covered)
- Charging previous balances or accounts receivable balances (most lenders and state community development agencies will only approve “invoiced amounts”)
- Failure to properly carry forward approved work-in-place on the Mortgagor’s Draw Requisition
- Development budget/sources on Mortgagor’s Draw Requisition not agreeing with the approved development budget
- Support documentation not properly organized or identified on the Mortgagor’s Draw Requisition
- Payment request and attachments not signed
- Request for soft/hard costs not preapproved
- Failure to provide any required supporting documentation
- Lack of coordination between multiple lenders

Loan Syndications or Participations

Many large commercial mortgage loans have been placed in commercial mortgage-backed securities (CMBS) over the past 20 years. This replaced the more common consortium of banks or other investors that put together loan syndications and/or large commercial banks or savings and loans selling 75% to 90% of a commercial mortgage loan to another investor such as a large insurance company. With the negative impact of the recent financial crisis on the CMBS market, more lenders have returned to the syndication market, and some private commercial mortgage bankers have started working with savings and loans and sovereign wealth funds in selling commercial loan participation on a more active basis.