

Construction Lending Today

If your lender doesn't have a good risk-management plan, your client may not have a good loan

By **Penny Roach**, executive vice president of business development, Granite Loan Management

FOR THE PAST SEVERAL YEARS, MOST construction lenders did not focus on risk management but rather on market share. When the market begins to cycle, however, lenders that follow prudent risk-management procedures end up surviving.

In fact, most lenders can ensure profitability by implementing some simple-yet-concrete risk-mitigation policies into their programs. These simple changes in process will not only appease internal due-diligence committees, but they will also offer additional sales and marketing spin to almost any program. Moreover, they'll help mortgage brokers' clients realize profitable, well-managed projects.

That said, when you're looking for the right construction lender for your developer clients, it's wise to choose one that has a solid risk-management plan in place.

What constitutes success?

To understand the risks that often slay the average construction lender, first you need to understand the types of construction lending programs that succeed.

Smaller local and regional lenders know their builders, borrowers and investors directly. They are successful because they handle each project review face-to-face and are available to walk the property at any given time or to stop issues as they arise.

National lenders can make it work by taking the personal process of the regional or community lender and updating it to fit their transcontinental needs. They may add additional checks to the process or outsource to risk-mitigation firms. These steps help offer a personalized product to clients across the country. Typically, the lenders

have a pre-loan and post-loan mitigation process in place.

Measuring contractors

Once you've decided on a local or national construction lender, the next thing to anticipate is the lender's desire to review the contractor. The lender will want to know how the project may progress and will achieve such knowledge by reviewing its most crucial component — the contractor. After all, if the contractor isn't qualified to build the project from the onset, then it likely won't matter how effectively the lender manages construction.

The contractor has the most direct influence on how a project is handled, from managing and paying subcontractors and suppliers to monitoring the construction budget. Some items the lender will evaluate during this review typically include the following:

- Authorization to release information
- Contractor's insurance and workers compensation
- Contractor's license and positive identification
- Gross sales or audited financial statements
- Personal or business credit report
- References

Many of these items will give the lender a truer picture of whether the contractor is financially stable enough to meet all payables throughout the life of the project.

Reviewing the project

An initial project review and budget review are also crucial steps in the mitigation process.

Handled during the pre-loan evaluation, these reviews essentially educate the lender on the potential success or failure of the project.

Because the lender will approve the loan based on collateral that doesn't yet exist, it seeks a detailed understanding of the project scope and associated costs to make that decision effectively. To determine project feasibility and identify project-related risks prior to the loan closing, the lender will often ask the following questions:

- Does the budget total correctly and match the contract amount?
- Is it feasible from a cost perspective?
- Does the disbursement schedule follow the project's construction progress?
- Does the square-footage on the plans match that of the appraisal?
- Does the project detailed in the plans match the contract?
- Are there unusual components that could significantly impact cost?
- What is the overall cost per square foot?
- Is the cost per square foot adequate to build the asset?

The initial project review immediately highlights cost deficiencies and special provisions that could hamper the project down the road.

Disbursing funds

Because quality and timeliness are always a concern during the construction-funds-draw process, many lenders often think that once the contractor and project have been reviewed, their job is complete. This, however, isn't the case. Many times, a lender will fund a project that has yet to be completed in its entirety only to find out that the funds were used for another component or for another project entirely.

Successful construction lenders adhere firmly to funding on a "work-in-place" mandate that enables them to ensure each phase is completed before funds are released. They take the

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time to establish a funding module to evaluate and measure a project during various stages of construction.

An effective funds-control system will ensure that the project progresses in a timely fashion, that the bills are paid and that the project works within the approved budget. The lender will monitor the project's progress through a comprehensive construction inspection. In addition, a crucial piece of this process is setting up the approved budget and confirming that the contractor adheres to this budget throughout the disbursement phase.



So what should your construction lender's risk-management plan offer? Assurances that the contractor is qualified to oversee the project, that the project is feasible from a cost perspective and that all bills will be paid during the construction phase. Look for those things, and the result for your clients should be a profitable, well-managed construction project. 