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Main Street Monday — Lenders Demand Developers Minimize Risk in Construction Lending
Will immigration restrictions affect the construction industry? Will changes to bank regulations make it easier to finance construction projects? Will the Keystone Pipeline compound the industry's issue of a shortage of qualified labor? Those are just some of the questions that attendees at the recent Construction Lenders Risk Management Round table asked about how the new administration will change the construction market. Of course, we can't predict how these changes will affect development and construction, but round table attendees had a chance to hear from industry leaders and compare notes with their peers on where the construction lending market is headed.

Looking at the US Market: Strong but Cautious
The US economy is hitting on all cylinders now. Continued improvements in unemployment, consumer confidence, and spending are expected to extend the current real estate cycle. In 2016, construction was in high gear in and around gateway cities like Los Angeles, Seattle, San Francisco, Phoenix, Denver, Chicago, Washington D.C., New York and Boston. In search of higher returns investors also increased consideration of secondary metropolitan markets. This trend is expected to extend into 2017, but investors and lenders are concerned that the real estate cycle is at or near a peak. Lessons from the past have led to a general sense of caution in the industry. Key considerations on the direction of the US construction market include:

1. Upcoming Construction Activity
The Architectural Billings Index (ABI) is a useful indicator of future construction activity. Increased billings indicated an improvement in the construction market 8 – 10 months later, after those design projects get underway. With a few exceptions, the index has indicated increased billings throughout 2016, which bodes well for 2017. A deeper dive into the data shows the majority of increases to result from commercial, industrial and institutional projects. Geographically; however, recent indexes show flat to decreasing billings in the western states.

2. Availability of Skilled Labor
The shortage of skilled labor continues to drive up construction costs, especially in the busiest markets. On the other hand, depressed energy and commodity costs have benefitted most markets. Limitations on skilled labor are expected to contribute an overall increase in construction costs during 2017 in the range of 5%, though some markets will continue to see higher increases. The cost of construction materials is also expected to go up, though by a more moderate 2% -3%. Gypsum wall board is one exception to this, with an expected increase of more than 5%. CLRMR attendees reported increased fees for quality subs to prevent them from being poached, which may not be reflected in market price data but dramatically increases the risk of contractors being unable to keep up with project costs and cash flow.

3. Interest Rates
With the improving economy comes the prospect of increased interest rates. So far, increases have been slight, and the FED appears to be moving cautiously to avoid unnecessarily slowing the recovery. As a result, though increases are expected, interest rate changes are not expected to significantly impact construction in 2017.

The Regulatory State of Play
The past few years have seen increased oversight of regulated banks, with extension of High Volatility Commercial Real Estate (HVCRE) construction lending rules to additional lenders and close monitoring of real estate and construction lending concentrations. As a result of studies conducted during the recent recession, regulators have also paid close attention to significant increases in the concentration of commercial real estate and construction

loans, since a short term increase in concentrations was highly correlated with bank failures. Banking regulators have been relatively silent in new revisions to construction lending policies. The potential for changes in regulatory requirements cannot be discounted. Regulators are expected to remain cautious for the foreseeable future. Attendees at the roundtable reported there is still confusion surrounding the application of the HVCRE regulations, with many banks likely reporting the classification incorrectly. Reportedly, some lenders are over-allocating loans as HVCRE in an effort to play it safe, while others may be interpreting the terms loosely so as to include fewer loans in the HVCRE classification.

Risk Management Considerations

With lessons from past bank failures fresh in the mind, many current risk managers are wary when taking on new construction projects. As a means of spreading risks, the participation or syndication of construction loans has been expanded to include smaller transactions lenders would previously have kept to themselves. Many lenders have also adapted their approach to the management of risks during construction, requiring enhanced monitoring of construction, accounting, liens, leasing, etc. In the face of projected increased construction and reduced availability of funds from regulated lenders, additional activity by non-bank lenders has increased.

Attendees discussed that in today’s environment, lenders are willing to pay a premium for risk management tools that keep a project moving. The risk of losing subs to other projects means it is particularly important to address issues as they arise to prevent a project stalling.

Technological Advances in 2017

Improvements to construction technologies are continuing, but these are not expected to have a revolutionary impact on the industry yet because many companies don’t have (or don’t want to commit) the resources to implement them. However, because developments in robotics such as drones and 3D printing and management systems such as intelligent machine control and or software solutions have the potential to greatly improve the efficiency and profitability of construction projects, they are expected to continue to gain traction in the year ahead.

Making Decisions Amid Uncertainty

Attendees at this year’s roundtable agreed that in this time of change, it is critical to minimize uncertainty in your deals and projects. Operating from a position of knowledge by performing a thorough due diligence process into the asset, borrower and market will help prevent surprises and allow you to better assess all risks involved. Challenges faced by lenders in today’s market such as increased competitive and regulatory pressure, and increasing costs means the industry must invest in efforts that improve efficiencies and transparency to best manage their risks and remain profitable.