COMMERCIAL

Risk Management Strategies for Bridge Loans That Include Construction

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In commercial real estate, a bridge loan (also referred to as bridge financing) is short-term financing that is intended to bridge a financial gap between current circumstances and future, more permanent lending. This often takes the form of hard money. One of the common purposes of a commercial bridge loan is for value-add investment opportunities. For example, you might own a property that needs to improve performance, occupancy rate or attract business, but needs extensive rehabilitation before the property can be repositioned and stabilized. Using a bridge loan can finance tenant improvements and refurbishing efforts, after which a longer-term financing solution can be obtained. Therefore, projects funded by bridge loans often have a construction component. These loans are short term (usually 6-18 months) and involve fixed hard money, however more and more, regional and local banks, those with $10 to $100B in assets, are a fast-growing sector of alternative lending as they prioritize CRE financing. Commercial and multifamily mortgage portfolios increased by more than $88B in 2017, three-quarters of which came from regional and local banks. Overall, bridge loans demand a high interest rate, lower LTVs, and often involve collateral based on future transactions. Therefore, there is some inherent risk in acquiring these loans, particularly with a construction component.

Currently, the construction landscape in California is robust and will be for the foreseeable future. New construction is comingling with value-add opportunities on existing structures to take advantage of high demand and low vacancy rates. With so many fresh players and diverse opportunities entering the bridge lending space recently, mitigating default risk becomes more critical than ever for all stakeholders. A loan default can cause project delays, cost overruns, or worse – contractor default, stalling construction indefinitely. On the other hand, asking for due diligence the client doesn't necessarily feel they need, especially for small or straight forward renovations or upgrades, can increase costs and slow down the process unnecessarily.

For stakeholders considering taking on or giving a bridge loan, one of the most important considerations is properly quantifying and underwriting the risks associated with the construction component of the loan. What risk management protocols do you have in place? Are they enough, or are they too much? Below are the most crucial considerations to keep in mind.

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Do you have internal technical expertise in construction?

Construction can be complicated and inherently risky. If you don't have an in-house construction risk management professional, or simply don't have the manpower to commit to overseeing the project, a third-party consultant is your best bet to mitigate risk and protect your investment. Many local and regional banks, who are getting into this space, are already understaffed and need third-party support. But if you do have in house technical expertise, be clear about what specific components you want to handle in house and what tasks you expect the consultant to handle.

How big is the construction budget and how big is your risk appetite?

What is the hard-cost construction budget? What percentage of the loan proceeds are earmarked for the construction component? What level of risk are you comfortable assuming? These factors will help determine your level of necessary due diligence. Historically, about 75% of bridge loans only need a one-time upfront budget review (as the construction costs are not a large percent of the loan and construction time-tables are relatively quick), and about 25% require ongoing construction progress monitoring. For larger construction projects, you may want to go more in depth by getting additional details on the subcontractors or engaging in ongoing construction progress monitoring.

How will you verify percentage complete and what are the triggers for release of funds?

Approximately 80% of construction defaults occur due to lack of oversight in the payment process. Having qualified inspection services to verify percentage complete, progress according to schedule, as well as continuing to balance the requests in-line with the budget, helps protect against budget-related defaults. This is especially important for projects where the construction hard costs are high enough to warrant greater risk management.

Are the budget and schedule of the rehab/renovation/completion realistic?

To evaluate this for bridge loans, it is prudent to conduct a Budget Review in conjunction with a Property Condition Assessment (PCA). For some projects, a more thorough Document & Cost Review can be done and for others a high-level budget opinion can be incorporated into the PCA. At a minimum you should have these four documents to better evaluate the project (and to provide to your consultant, if you are outsourcing this part):

- Complete budget
- Final schedule
- Final contract (not to be changed before executed)
- Stamped/Signed drawing, plans, & specs

Other documents that may be requested/reviewed by your consultant (if available) include:

- Construction subcontracts and/or purchase orders
- ALTA Survey
- Affidavit of compliance
- Zoning approvals
- Environmental reports
- Geotechnical report
- Permits
- Utility letters
- Insurance certificates and bonds

What is your comfort level with the contractors?

A Contractor Evaluation – where the contractor's experience and capability as it relates to the project at hand is evaluated – is not always necessary for bridge loans. You may consider getting one if you don't know the expertise of your local contractor, or if there is an indication of inexperience – for example, bids come in well below market expected or with a schedule that may not seem reasonable.

Is there a potential takeout and how much is it?

This may be the most critical consideration involving bridge loans. At the end of the bridge loan, how is the lender going to get paid back (sale of condo units, permanent financing, etc.)? Repayment of short-term bridge loans can be risky if you don't make contingencies ahead of time. Make sure your level of due diligence is commensurate with the level of due diligence that will be required to make you whole when

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the loan term is up. For example, if the permanent financing will be from Freddie Mac or Fannie Mae, they might need to have an affidavit of compliance that the plans comply with agency specific requirements.

Implementing the above recommendations mostly involves good communication with your third-party consultant. Every project and every client is different, as are the risks associated with them. It is our job to ask the right questions and help guide you to the level of oversight appropriate for your institution and the particular transaction at hand.

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to continue as banks fight for clients and as the loosening of the HVCRE rules filter through the system and it becomes easier and more profitable for banks to underwrite construction loans.

- Banks Keep Protecting Their Books: Banks have gotten increasingly aggressive on maintaining and growing existing relationships. Not only are banks getting aggressive on economic loan terms for client relationships, but they also are getting more creative and flexible on transactions that typically would not be a fit. They do this to further strengthen and protect the relationship and keep as much of their business in-house. This trend will continue as banks focus on continued sustainable growth.
- Banks Continue to Offer Longer Duration Loans: More California banks are regularly offering seven- and 10-year loans for commercial assets. Swapped loans continue be the preference, because banks can book the entire swap profit at close. But some banks are just fixing rates internally. Banks have done this before 2018, but more banks are competing for this business at spreads considerably lower than in previous years.
- Floating Rate Spreads to Stay Low: As the FED has increased its target rate, LIBOR has increased, and banks are making more interest on their loan books. This has enabled spreads to come in and we anticipate this continuing into next year.
- Bigger Push for Deposits: We've seen a notable push from bank originators to bring in deposit relationships. Luckily banks are offering better pricing and proceeds to lure borrowers for their operating and deposit accounts. Being able to pull this lever is a big competitive advantage as it seems banks can transact at pricing levels not achievable by their competition for the right relationship. We don't see this push for deposits changing going forward.
- Underwriting Rates Are Going Up: As a result of the recent rise in interest rates, notably the 10-year UST rose more than 30 basis points in the past three months, banks have reacted by increasing their stressed underwriting rates to provide more of a cushion between their actual rate and the rate that they are using to size their loans. Unfortunately, this move has reduced the amount of leverage that can be achieved in what has already been a DSCR constrained borrowing market.

Based on recent discussions California banks will have larger allocations for 2019 and some new tools to win business. Continued pressure from other lender sources will force our banks to remain competitive on economic terms, so I'm hopeful the market will remain very strong for borrowers.