The Journal 2019
Construction Lender Risk Management

CLRM
LEARN. SHARE. BUILD.
Welcome to our first edition of the CLRM Journal! The Construction Lender Risk Management Roundtable was formed in 2013 to provide a forum for construction investors and lenders to talk over common problems and share ideas and solutions. Though construction investments and finance have taken place for hundreds of years, there is no recognized way to oversee and manage related risks. By providing a place to get to know your peers and exchange ideas the Roundtable aims to help build prudent and consistent construction risk management practices.

Over the last 6 years we’ve continually expanded the space for the CLRM community – in person via our national and regional meetings, online via webinars and a LinkedIn forum, and now in print via this Journal.

Managing risk effectively really matters not just to the success of each member’s portfolios, but to the U.S. economy at large. The commercial real estate industry plays a significant role in the U.S. economy. Private construction totaled over $1T in 2018, most of which was funded by investors and lenders.

Construction investment and lending can provide significant returns when done right, but the risks of failure are high. Studies following the great recession showed that many lenders failed to adequately manage risks associated with construction portfolios - sometimes becoming too heavily invested in a region or developer, and sometimes simply failing to maintain controls consistent with the volume, speculative nature, and complexity of projects or misjudging their allocation of risk-based capital. On page 15 you’ll find more insights on the connection between construction lending and bank failure during the recession.

In the journal, we’ve collected insights from the CLRM community concerning the market, construction costs, regulatory updates, risk management and other hot topics. Thank you to all the contributors for sharing your expertise and perspectives!

By helping each other, we can contribute to a stronger economy and help to minimize risks in the next downturn.
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**LEARN**  **SHARE**  **BUILD**
CLRM’s Mission & Purpose

Many years ago, a small group of construction risk managers from various banks got together and said, ‘we need a space to have real conversations about our most pressing issues.’ There was no forum for them or their peers to share experiences, perspectives, war stories and best practices. The lift to organize such a forum eventually proved too heavy and the idea, like many great ideas do, fell victim to day to day pressures. Then 6 years ago the spark reignited when I had the chance to connect with Bob Biggs and David Drummond. At that point I realized my company could provide a lot of the heavy lifting to turn the idea into a reality, and we were humbled to be entrusted with the opportunity to do so. And so was born the CLRM organization.

Over the last 6 years, my colleague Bill Tryon, a former Wells Fargo construction risk manager, has worked tirelessly alongside our lender and investor advisors to ensure the CLRM agenda is driven by what matters most to financial stakeholders. Today, CLRM has grown to include over 50 different financial institutions from around the country and many opportunities to gather for open and frank conversations. Members have told me ‘I’m in a silo at my organization, it’s so refreshing to finally connect with like-minded professionals.’

If you haven’t already, I hope you’ll take advantage of this forum to stay current with construction trends, develop relationships with peers and experts, and facilitate career learning.”

– Joe Derhake, PE, CEO of Partner

In Person Meetings 2019

National Roundtable: San Antonio, TX
March 11-13, 2019
St. Anthony Hotel on the Riverwalk
300 E Travis St, San Antonio, TX 78205
Registration is complementary on the CLRM website

Regional Forums: Schedule TBD
• Atlanta, GA
• Cincinnati, OH
• Las Vegas, NV
• NYC, NY
• Chicago, IL
• Denver, CO
• Dallas, TX
• San Francisco, CA
• Newport, CA
• Other locations pending
Who Typically Comes
Seasoned construction risk managers as well as the next generation of professionals from national, regional and local lending institutions and equity providers. This includes senior vice presidents, asset managers, directors of construction risk and similar titles.

Typical Agenda Topics
Discussions include: regulatory environment, market trends, recurring problems in construction projects and how to address them, management of workflow and vendors, risk management approaches and scopes of work, data and technology, emerging issues, and so much more.

Monthly Calls
This is great way to plug in from afar, or invite your team. Visit our website to register.

LinkedIn
Join us on linked in. Search Construction Lender Risk Management Group and request to join. Or, you can click the link: https://www.linkedin.com/groups/6635200/

We Want Your Insights
If you are interested in submitting a topic for a call, event, or future editions of this publication, please reach out to us.

What Do I Have to Do to Become a Member
Participate! Join a call, come to an event, bring your perspective to the table.
As the new year gets underway, recession chatter is growing. Notwithstanding the ongoing federal shutdown at press time, virtually every economic barometer is painting a picture of healthy market conditions. In fact, 2018 shaped up to be more robust than many analysts had predicted at this time last year. Below is a list of five trends to watch in the new year.

(1) The rate of growth in commercial property deals is decelerating.

After two years of consecutive quarterly declines in U.S. commercial property transactions, preliminary data for 2018 signals a return to growth. Fueling the commercial real estate engines were the strongest GDP growth rates the U.S. economy has seen since 2015, coupled with a record-high streak of monthly job creation. Add to that the federal stimulus and tax relief that the new Administration threw on an already-thriving economy. Unknowns surrounding the federal tax plan presented an obstacle to property investment that characterized much of 2017, fostering a “wait and see” attitude on the part of many investors. After the tax plan was finalized late in the year, the market gained momentum in the first and second quarters as deals that had been stalled were put back into motion. The likelihood of further interest rate increases also encouraged developers and investors to secure financing and close deals while borrowing costs were still relatively low. Also worth noting is that the 2018 data indicate that development site sales, which had cooled in 2016 in response to HVCRE regulations, changed course and rose by 9 percent last year.

Yet despite the market's strong performance in 2018, forecasters at the Urban Land Institute are forecasting declines from the historic highs of 2015 and 2018 to a
more sustainable path of transaction activity. The projected slowdown is largely due to the anticipated impact of rising interest rates and the fading stimulus from the federal tax reform package. Smaller deals in smaller metros as investors expand their focus will also likely put downward pressure on the dollar volume of transactions over the near term. And despite the forecast declines, annual volume is still expected to end the next two years well above the 13-year average of $313 billion.

(2) **Headwinds are balancing out tailwinds for the first time in this recovery.**

Slowing growth over the near-term is due in part to a trend that characterized 2018. It was a year of transition as the winds in the sails of the market were balanced out by the strength of a number of headwinds (see table). Until 2018, the forces impacting commercial real estate were largely positive, such as the strength of property fundamentals, rising corporate profits, and abundant debt and equity targeting commercial properties. Growing strength in the market, and the ensuing optimism, combined to pull commercial real estate out of the depths of the financial crisis. The longevity of this economic expansion is nothing short of remarkable, having passed the tenth anniversary of the Great Financial Crisis last September.

Now, not only are rising interest rates increasing the cost of borrowing for construction projects and property investment, but property values in many metros across the U.S. are no longer appreciating like they were earlier in the recovery. This means that assets will not necessarily be showing higher yields to accommodate those higher costs. Construction costs are also rising, and labor is in short supply, making it more challenging to pencil in new development and increasing the costs of upgrading older buildings.

While capital is still plentiful, there are more lenders and buyers than there are good deals to finance so competition is fierce. On the political scene, the trade situation is tense and myriad geopolitical concerns risk upsetting confidence in the market. The impact of tariffs thus far remains limited, but that could also change. Last, there is a growing unease about the extended shutdown and the timing of the next cyclical downturn, factors that are making construction lenders more cautious.

(3) **Smaller banks are stealing back market share in construction lending.**

Back in the early days of this recovery, banks were essentially the only ones lending, and any developers that did not already have a solid relationship with a bank were likely out of luck. Fast forward to today where the universe of lenders extending capital for construction projects has increased significantly—along with the competition. Banks are no longer so dominant that they’re shouldering all of the risk of funding construction projects. Today risk is distributed...
among banks, insurance companies, government agencies, private equity firms and alternative lenders.

In terms of share of the overall construction lending pie, the regional/local banks have been on a roll. Back in 2015, regional and community banks accounted for 23% of the total, rising to 33% in the first half of 2018 and 37% for 2017 as a whole. Some institutions are new to lending on construction projects, while others are looking to grow beyond their traditional, local footprint. Likewise, the share accounted for by non-bank financing companies, mortgage Real Estate Investment Funds (REITs) and institutional debt funds expanded to 21% of construction lending in 2018, up from just 10% in 2015. Over this same time period, large national institutions pulled back on construction lending, accounting for only 22% of the total in 2018 compared to nearly 40% just three years ago.

### Top 5 MULTIFAMILY Metros by Completions

<table>
<thead>
<tr>
<th>METRO</th>
<th>Units</th>
<th>YOY Growth (4Q18)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dallas</td>
<td>4,734</td>
<td>3.7%</td>
</tr>
<tr>
<td>Atlanta</td>
<td>3,309</td>
<td>2.3%</td>
</tr>
<tr>
<td>Denver</td>
<td>2,884</td>
<td>5.4%</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>2,322</td>
<td>2.2%</td>
</tr>
<tr>
<td>Seattle</td>
<td>2,311</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

**SOURCE: Reis Construction First Glance, 4Q2018.**

### Top 5 RETAIL Metros by Completions

<table>
<thead>
<tr>
<th>METRO</th>
<th>SF Additions</th>
<th>YOY Growth (4Q18)</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>327,000</td>
<td>1.1%</td>
</tr>
<tr>
<td>San Francisco</td>
<td>252,000</td>
<td>0.3%</td>
</tr>
<tr>
<td>Austin</td>
<td>215,000</td>
<td>0.7%</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>176,000</td>
<td>0.4%</td>
</tr>
<tr>
<td>Raleigh-Durham</td>
<td>161,000</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

**SOURCE: Reis Construction First Glance, 4Q2018.**

### Top 5 OFFICE Metros by Completions

<table>
<thead>
<tr>
<th>METRO</th>
<th>SF Additions</th>
<th>YOY Growth (4Q18)</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>1,537,000</td>
<td>1.4%</td>
</tr>
<tr>
<td>San Francisco</td>
<td>1,358,000</td>
<td>4.7%</td>
</tr>
<tr>
<td>Austin</td>
<td>878,000</td>
<td>3.7%</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>867,000</td>
<td>0.7%</td>
</tr>
<tr>
<td>Raleigh-Durham</td>
<td>721,000</td>
<td>3.2%</td>
</tr>
</tbody>
</table>

**SOURCE: Reis Construction First Glance, 4Q2018.**

(4) Industrial knocks multifamily out of the top seat.

Multifamily had been, until this year, the darling of this recovery. By anyone’s measure, industrial is now in the lead. There is a very deep pool of investors and developers looking to get into industrial, and lenders are favoring loans underwriting industrial projects. Last-mile distribution space is critical to e-commerce, and warehouse space, particularly outside of urban centers, is in short supply. Old, obsolete industrial buildings are getting new life as online retailers strive to be closer to consumers. The good news is that the industrial sector is only just now hitting its stride. In 2018, warehouse construction was up 18 percent, and accelerated growth is expected into mid-2020. In contrast, despite recent growth in multifamily, construction starts will decline in the near term and into mid-2020.

(5) Caution, cycle-awareness is starting to take root at this late stage of the cycle.

While it’s hard to imagine healthier market conditions, warning bells are sounding that the next cyclical downturn could arrive by 2020. Value-add projects are more attractive as developers and investors search for yield in smaller metros. A sense of urgency is also taking hold as investors and developers look to close deals and secure funding before a market transition or higher interest rates.

These good times won’t last forever so while we are all enjoying a busy start to the new year, it is important to plan for a softening in the market. The strong factors boosting today’s market can mask the risks, and encourage lenders and developers to overreach at this late stage of the cycle. Rigorous due diligence is critical, especially for projects or loans that span a long time-frame.
What Is the Beige Book?

The Beige Book provides an overall summary of economic conditions based on interviews and other research conducted by each of the twelve Federal Reserve Banks just before each Federal Open Market Committee (FOMC). It summarizes existing economic conditions and identifies emerging trends across the country that may not be apparent in wholesale economic data. Each Federal Reserve Bank gathers information through anecdotal methodology, including reports from Bank and branch directors, in person and phone interviews and questionnaires completed by community contacts, economists, market experts and other sources. The information is then supplemented with data and analysis used by Federal Reserve economists to assess widespread economic conditions in each of the twelve Federal Reserve Districts (see chart below).

Overall Economic Summary

Economic activity largely expanded across the United States, with 8 of 12 Federal Districts reporting moderate or modest growth in all metrics. Lending volumes grew modestly, with a few Districts noting slowed growth. Commercial real estate markets were largely unchanged since November, while residential markets experienced ongoing price increases and mixed sales results, and local shortages of housing inventory eased in some markets. Labor markets were reportedly tight in all districts. Many firms reported struggling to find workers at any skill level, and construction firms in Minneapolis have turned down business because they could not find workers. Though fuel prices fell across the board, overall prices continued to grow at a moderate pace across all Districts.

Manufacturers reported raising the price of finished goods due to the rising cost of raw materials such as metals, which they attributed to tariffs. Retailers also reported raising prices due to increased costs in transportation and tariffs. Manufacturing, one of the most important sectors tied to the economy, reported overall moderate expansion with tempered forward-looking potential. As a result of increases in materials and shipping costs, trade and tariff concerns, rising interest rates, and persistent labor shortages many Districts reported a less optimistic outlook.

Credit standards generally held steady, though the Atlanta District reported increased delinquencies and loosening of underwriting standards on “select portfolios” as a result of slowing demand for credit and increased competition.

Commercial and residential real estate results were mixed, with most districts reporting generally stable conditions, while the Cleveland and Philadelphia Districts reported solid conditions and the San Francisco District reported solid expansion but a slowing growth rate.

Federal Reserve District Highlights

Overall, a plurality of Federal Reserve Districts reported moderate growth across all economic metrics, with some mixed growth in manufacturing and consumer spending, and certain Districts (such as Dallas and Atlanta) leveling off to more modest growth since the last report. New York, Philadelphia, and Kansas City reported flat or downward overall growth. San Francisco reported robust growth across the entire West Coast in commercial and residential real estate and employment.

The below chart summarizes major economic indicators for each of the twelve Districts of the Federal Reserve.
Today’s technology has transformed how appraisers and assessors perform their day-to-day tasks. Technology gives us the power to obtain accurate information within seconds. When it comes to real property cost data, using automation to generate cost reports saves time and ensures greater accuracy for calculations. Although technology and automation has been a major improvement for many, others struggle with the fact that they are unable to explain how the costs are assembled or explain what the automated program is doing behind the scenes, leading to the “Black Box Myth”. Dispelling this “myth” is easier than some may realize.

To begin, we examine how cost data was presented in the past using print form. According to the procedures outlined in the Marshall & Swift® Valuation Service, a distribution warehouse occupancy could be costed following a few simple steps.

**STEP 1:** Determine the occupancy to be used.

**Warehouses** are designed primarily for storage. An amount of office space commensurate with the quality of the building is included in the costs. Typically, this is between 3% – 12% of the total area. **Distribution warehouses** will have larger areas, between 15% – 30% for office/sales and/or other subdivisions designed to accommodate breakdown and transshipment of small lots, as well as increased plumbing, lighting, and compartmentalization to accommodate a larger personnel load. **Mega warehouses** are the large storage-distribution facilities, typically over 200,000 sq. ft., where interior build-out is only 1% – 5%. Narrow the cost to a more specific type of construction and select the quality that best represents the budget required to replace the building new today.

### DISTRIBUTION WAREHOUSES (407)

<table>
<thead>
<tr>
<th>CLASS</th>
<th>TYPE</th>
<th>EXTERIOR WALLS</th>
<th>INTERIOR FINISH</th>
<th>LIGHTING, PLUMBING AND MECHANICAL</th>
<th>HEAT</th>
<th>SQ. M.</th>
<th>COST</th>
<th>Cu. Ft.</th>
<th>Sq. Ft.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Good</td>
<td>Ornamental concrete, brick, or metal, glass panels, office front</td>
<td>Plaster, drywall, partitions, distribution areas, fin. ceilings, vaults</td>
<td><em>Good lighting, plumbing, restrooms for personnel</em></td>
<td>Hot water</td>
<td>1151.74</td>
<td>7.64</td>
<td>107.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>Brick on block or tile, concrete panels, good fenestration</td>
<td>Painted walls, offices, and distribution areas</td>
<td><em>Reading-level lighting and adequate plumbing</em></td>
<td>Space heaters</td>
<td>871.88</td>
<td>5.78</td>
<td>81.00</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>Good</td>
<td>Ornamental concrete, brick, or metal, glass panels, office front</td>
<td>Plaster, drywall, partitions, distribution areas, fin. ceilings, vaults</td>
<td><em>Good lighting, plumbing, adequate restrooms</em></td>
<td>Hot water</td>
<td>1097.92</td>
<td>7.28</td>
<td>102.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>Brick on block or tile, concrete panels, good fenestration</td>
<td>Painted walls, offices and distribution areas</td>
<td><em>Reading-level lighting, adequate plumbing</em></td>
<td>Space heaters</td>
<td>828.82</td>
<td>5.50</td>
<td>77.00</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>Excellent</td>
<td>Brick, metal, glass, ornamental facades and fenestration</td>
<td>Completely finished, drugs, food, or bonded storage, large offices</td>
<td>High-level lighting and good plumbing</td>
<td>Package A.C.</td>
<td>1162.50</td>
<td>7.71</td>
<td>108.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Good</td>
<td>Steel frame, good brick, block, or tilt-up, tapered girders</td>
<td>Plaster or drywall, some masonry partitions, good offices</td>
<td>Reading-level lighting, adequate fixtures</td>
<td>Forced air</td>
<td>801.91</td>
<td>5.32</td>
<td>74.50</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>Steel or wood frame or bearing walls, brick, block, or tilt-up</td>
<td>Painted walls, finished offices and distribution areas, hardened slab</td>
<td>Good lighting, adequate plumbing</td>
<td>Space heaters</td>
<td>548.96</td>
<td>3.64</td>
<td>51.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Low cost</td>
<td>Block, tilt-up, very plain, light construction</td>
<td>Unfinished, shell type, adequate offices, partitioned areas</td>
<td>Adequate lighting, plumbing fixtures</td>
<td>Space heaters</td>
<td>392.88</td>
<td>2.61</td>
<td>36.50</td>
<td></td>
</tr>
</tbody>
</table>

**STEP 2:** Refine the costs for size and shape, different types of HVAC, various climates, elevators, location, etc.
STEP 3: The end result is an opinion of value for the distribution warehouse.

We frequently hear, “I can point to the page and show you the base cost per square foot used.” Using automation to generate cost reports streamlines the manual process required to generate the reports but still requires that the user select the correct occupancy, residence type, quality, condition, etc. With this in mind, the “Black Box Myth” stems from the lack of understanding around the tool’s intelligence. The fact that the Marshall & Swift Valuation Service shows you a cost per square foot along with definitions does not mean that the final report is correct. The onus is on the valuator to select the occupancy and quality; and then, they must be able to apply their benchmarking experience to ensure they are identifying all the correct aspects of the structure. The same thought process is used with the automated Marshall & Swift cost services. The user is guided through a series of data entry screens which culminates into a final calculation. The automated Marshall & Swift cost services are derivatives of the print manual; however, as with the print manual, the onus is on the user to select the correct occupancy, quality, etc.

Here are a few tips to help gain greater insight to explaining the values generated by software:

- Download program and occupancy reference manuals and become familiar with their content.
- Look for page level help that defines the entry being made
- Print out getting started reference material
- Define occupancies before selecting them
- Use data entry reports to show the steps used to generate the final reports
- Take advantage of video tutorials and free technical support
- Run the reports at various quality levels to see the impact
- Interpolate between qualities and or occupancies
- Run reports using various occupancies

By knowing how to explain the tools used to generate cost reports, the “Black Box Myth” can be a thing of the past. With online technology and smart phone apps becoming the new standard of communication, it is imperative that we understand the underlying data behind these tools. The responsibility of relying on any automated cost tool lies with the user. Knowledge is power and the more we know and understand about automated tools the more they will be accepted as credible sources of data. ■
Tariffs on steel (25%) and aluminum (10%) imports were the first round in tariff wars between the U.S. and China. Subsequent tariffs on both sides have rattled financial markets and sparked concerns about global trade. Related materials costs have eased recently, but increases resulting from the tariffs have taken a toll on U.S. construction projects and manufacturers. Many new development and infrastructure projects have reportedly stalled as a result of higher prices. Manufacturers have also been affected. The largest U.S. manufacturer of nails, for example, recently closed one plant and decreased staff by 40% after a 19% effective increase in costs resulted in a 50% reduction in sales vs. foreign manufacturers. Manufacturers of heavy equipment anticipate a dent in fiscal 2019 earnings by 6-9%, and have implemented significant price increases for 2019.

Initial Impact Mostly on Costs

Increases in the cost of material goods have been the biggest and most acute impact on construction. Cost increases have stretched project budgets, decreased the profitability of existing contracts, and contributed to increased contractor bankruptcies. Construction across all sectors (energy, transportation, and water infrastructure; commercial and residential) accounted for 43% of all steel shipments in 2017. However, steel only accounts for a small fraction of the overall project cost. If further price surges occur suddenly, and domestic product cannot meet demand, impacts on construction timelines will increase. For newer projects, many contractors have shifted uncertainty to developers by including price increases and other risks from tariffs. The price of U.S. hot-rolled coil steel, a central product of the construction industry, is up about 20% since tariffs were announced due to a combination of tariffs and strong economic demand. Meanwhile, within a month of imposition of a 10% tariff on U.S. plywood exported into Canada, U.S.-produced plywood crossing the border has slowed to a trickle.

In addition to cost increases, spiraling tariffs impact the feasibility and profitability of new development, reduce construction employment, and dampen economic expansion. For projects already underway, developers and contractors can mitigate the impact of tariffs by purchasing materials at the outset of the project, including price increase provisions.
into contracts ahead of time, and providing a range of engineering and project contingency mechanisms.

**Steady, Cautious Approach Towards Construction Deals**

Forecasts for 2019 generally indicate a continued growth of construction, but at a slower pace. Aside from tariffs and price increases of material goods (that were already steadily rising), certain single and multifamily construction has slowed, while the development of industrial sites continues to increase. Cost increases fueled by tariffs on steel and aluminum imports are expected to continue to slow growth as new construction becomes increasingly less feasible.

In regional meetings in New York, Chicago, Atlanta and elsewhere, CLRM members reported a great deal of uncertainty about the long-term impact tariffs will have on commercial real estate development. For the time being, most members are continuing a cautious approach to evaluating and managing risk, though opportunities are still there for high-quality deals through continued careful scrutiny of construction loans. Evaluation of plans, budgets, and contractors, as well as geotechnical, environmental, seismic, property condition, and specialty risk assessments such as flood risk mapping can help everyone involved to understand and better control uncertainties. And careful construction risk management and funds control have become even more critical to reducing risk of default and making sure projects meet budgets on schedule.
Even when construction is slow, overall construction costs seem to go up year after year, and 2019 will likely be no exception to this ongoing trend. Increases in recent decades have ranged from as little as ~1.2% in 1998 to nearly 7% in 2005, with an average annual increase of about 3% since 1990. With constant pressure for more development, shortages of skilled labor, record high lumber costs (followed by a record decline), spiraling diesel fuel costs, and geopolitical concerns over the impact of trade agreements, cost increases in 2018 were on the high side with national increases in the range of 4.5% and double that in the hottest markets. According to Turner Construction, the fear of tariffs and widespread shortage of skilled labor continue to be the major sources of uncertainty among contractors.

Lumber prices, after increasing to record highs in the first five months of the year, had fallen nearly 45% by November, with plywood faring only a little better. At the same time, tariffs on aluminum resulted in a 10% spike in pricing before settling back while higher prices for steel have been more persistent. According to Engineering News Record, year over year increases in aluminum sheet pricing have moderated to +1.2% vs. approximately +5% for wide flange steel and 8% for rebar.

Though residential and multifamily construction growth has recently slowed, the Architectural Billing Index and Dodge Momentum Index, considered to be 10-12-month leading indicators of construction volume, indicate continued growth albeit at a slower pace. Not surprisingly, the Associated Builders and Contractors Construction Backlog Index has finally eased below historic highs in most areas of the country.

Construction Analytics forecasts a modest 1.5% increase in overall construction for 2019, but forecasts non-residential construction cost increases in the range of 4.25% to 5.5% barring significant impacts from trade wars or the government shutdown. Nonetheless, uncertainties are higher than normal so locking prices early in the construction process and careful monitoring of trends and fluctuations in material costs will help avoid construction failures.
OCC Asks CLRM for Feedback on Handbook

OCC (the Office of the Comptroller of the Currency) publishes guidance for examiners in their Comptroller’s Handbook A–CRE. The booklet addresses the risks inherent in CRE lending and specific lending activities and property types. It also describes supervisory expectations and regulatory requirements for commercial real estate as well as construction lending.

In 2017, OCC requested comments from CLRM on their next release of the handbook. CLRM submitted suggested refinements such as the independence of loan origination and administration functions, and other considerations during the underwriting and servicing of loans and examination of banks. CLRM’s suggestions were well received, though it is difficult to predict when the next revisions will be issued.
Economic development programs in financially distressed areas are not a new phenomenon; however, the 2017 Tax Cuts and Jobs Act (“TCJA”) introduces new tax incentives that may interest real estate developers and the construction industry. These incentives provide for the deferral and reduction of tax to be paid on realized gain and the elimination of taxes on future capital gains from investments made in designated Opportunity Zones (“O-zones”).

A. Overview of Opportunity Zone Legislation

The purpose of the O-zone program is to spur long-term private investment in rural and low-income urban communities meeting certain requirements.

To realize the tax benefits, a taxpayer must reinvest all or a portion of the gain derived from a sale (or exchange) of property that occurred after December 31, 2017 into a Qualified Opportunity Fund (“Opportunity Fund” or “Fund”) within 180 days after the gain is realized. An Opportunity Fund is an investment vehicle, established as a partnership or a corporation, which holds at least 90% of its assets in eligible real property or businesses, known as qualified opportunity zone property (“QOZP”). While an Opportunity Fund may include both capital gains and other funds, only the monies from gains are eligible for O-zone tax benefits.

Taxpayers who invest in a Qualified Opportunity Fund may receive three distinct tax benefits. First, tax on the gain invested in the Fund is deferred until the date the taxpayer sells its interest in the Fund or December 31, 2026, whichever is earlier. Second, if a taxpayer holds its ownership interest in the Fund for five or seven years, 10% or 15%, respectively, of the original capital gain invested in the Fund is excluded from the tax owed upon the sale of the interest or December 31, 2026, whichever is earlier. Thirdly, if the taxpayer holds its interest in the Opportunity Fund for at least ten years, all
appreciation earned on the investment is tax-free upon the taxpayer’s sale of its interest in the Fund.

B. Potential Benefits to the Development and Construction Industries

O-zone investments may be particularly advantageous to the real estate development and construction industries. The monies in Opportunity Funds must be deployed in O-zone businesses or properties in which (1) the original use of the property began with the qualified opportunity zone business, or (2) the property is “substantially improved.” There is a 30 month time period within which to complete the improvements, and the test for “substantial” is tied to an increase in the property’s basis. As an example, if an Opportunity Fund purchases the QOZP for $1 million (the original basis), then the improvements must cost at least one million and one dollar. Quite obviously, this scenario will create a heightened demand for development and construction services to meet the statutory criteria.

Opportunity Funds provide a source of capital that may prove to be different from other sources which finance initial development and construction. Unlike construction lenders who require debt service payments or equity investors who seek annual returns, Opportunity Fund investors are expected to focus on a longer term return on equity. Arguably, these Funds may be available without requirements of periodic payments and/or annual cash flow distributions.

The O-zone legislation has been hailed as a “win-win” proposition for developers, construction companies, investors, and those residing and/or operating businesses in O-zones. However, potential investors must be mindful of the current lack of regulatory guidance. The legislation explains the function of Opportunity Funds and the tax benefits that may be enjoyed, but fails to “fill the gaps” on compliant implementation. Congress provided the Department of Treasury and Internal Revenue Service with broad authority to craft rules and guidance and such guidance is expected to be issued in the next few months.

Opportunity Zone investment can benefit economically distressed communities and provide generous tax benefits for investors, which, in turn, may generate new opportunities for the real estate and construction industries. However, taxpayers with gain who are considering investing in an Opportunity Fund or those seeking financing from a Fund for investment in an O-zone business or project would be wise to seek professional advice to guide transactions in what are still uncharted waters.
Construction lending played a major role in the failure of hundreds of banks during what is now being called the Great Recession. According to studies conducted by the OCC, FED, and FDIC, 80% of FDIC insurance funds went to banks with construction loan to risk-based-capital ratios of more than 100%. 13% of those banks failed and an additional 60% were found to be in poor condition. Nonetheless, some banks with high concentrations of construction loans suffered minimal impacts during the recession. Studies found that failures frequently resulted from:

**Aggressive Growth and Poor Strategic Decision-Making** – Many failures resulted from strategic decisions to increase the bank’s risk profile by expanding into new activities or market areas; introducing new product; continuing loan growth following initial signs of a market downturn; and pursuing growth opportunities through mergers, acquisitions, or loan pool purchases without conducting sufficient due diligence.

**Asset Concentrations in CLD Loans Correlated to Likelihood of Failure** – Asset concentrations contributed to every failure studied by the Federal Reserve. Though the vast majority of the failed institutions had high CRE concentrations, more in-depth review found that failure more often correlated with construction lending as a component of CRE.

**Ineffective Internal Controls and Poor Risk Management** – Significant risk management and internal control weaknesses were found at 80% of banks studied. Most often, these banks did not assure that risk management capabilities and internal controls maintained pace with rapid growth and increasingly complex operations.

**Reliance on Certain Specific Funding Sources** – Non-core sources of funding contributed to failure in 50% of banks studied by the FED as a result of higher capital costs, lack of liquidity and continued availability during the downturn.

**Compensation Incentives/Inappropriate Risk Taking** – A smaller proportion of failures (~15%) was attributed to incentive programs which led to risky decisions by lenders and senior management in the interest of short term compensation.

These results provide a road map for lenders to minimize the impact of future economic downturns. It seems clear that maintaining strong construction risk management criteria can go a long way toward surviving future economic woes. At the same time, regulators can help to control risks through increased regulatory oversight to carefully monitor portfolio concentrations, particularly when a significant increase in construction lending is observed; improved examination guidance; and earlier supervisory action to address significant risk management and internal control weaknesses, even during stable economic times.

Done well, construction lending can provide significant yield to lenders, but without careful management the results can be disastrous. Lenders and investors have little to no control over external market conditions, but regulators have consistently found that those with strong leadership and controls fare best in economic hard times.
As digital innovations continue to inundate the financial space, construction lending has remained one of the most under served areas in financial technology. This lack of digitization exposes bank and non-bank lenders to unnecessary risks, costs shareholders money, and negatively impacts the client experience for borrowers, builders, and inspection vendors and consultants. For an asset class that is finally gaining steam after punishing many lenders during the Great Recession, this is an area that can’t remain lacking in digital innovation.

When a construction loan closes, rather than receiving funds in a lump sum, it’s booked into a loan servicing system. In order to ensure that the loan is serviced properly, lenders, borrowers, builders, project monitoring staff, and title companies often rely on folders, files, spreadsheets, and an endless string of phone calls and emails throughout the construction period for project monitoring. This coordination between parties is critical to ensuring that every dollar is being allocated properly, but often leaves gaps in terms of risk mitigation and administrative efficiency. This reactive, rather than proactive, process can be slow and costly, often preventing even the most sophisticated internal systems from providing lenders with real-time visibility into the status of the project, much less their clients and vendors.

Only recently has the concept of applying financial technology to proactively reduce risk, increase transparency, eliminate friction, improve the customer experience, and drive cost savings made its way into construction lending.

**Technology Can Help**

**Risk:** Construction loans are often perceived as the riskiest loans within a bank’s portfolio. As such, they garner significant attention from regulatory agencies in order to ensure that risk is being properly managed. By applying cloud-based technology to construction lending, key information and documentation becomes transparent and accessible in real-time to all parties involved in the project. The digitization of manual processes, reporting, and documentation significantly reduces the opportunity for human error, ensures loans aren’t being overfunded, helps the lender maintain a first lien position throughout the life of a construction project, and unlocks powerful analytics that were impossible to access using antiquated processes and systems - analytics that can now be used to help lenders make better decisions about the loans they make as well as proactively manage risk in their active portfolio. Proactive notifications, for instance, can alert appropriate lender personnel when a construction project has gone stale or that a borrower has materially changed their behavior based on historical data.

**Efficiency:** Construction loans require more post-closing support and ongoing servicing effort than any other type of lending. By bringing collaboration and automation into the loan administration process, lenders can connect with their borrowers, builders, draw inspectors, and other key parties in real-time, allowing each party to push things forward while knowing where (and with whom) things stand in the process. This eliminates countless steps and saves everyone significant time. Not only does this improve a lender’s efficiency, but it also gets borrowers their money safer and faster – creating happier builders and allowing lenders to accrue more interest.

**Customer Experience:** The typical disbursement processes can make it difficult for borrowers and contractors to confirm the adequacy of information provided or status of requested payments. Communication across unsecure channels, such as phone or email, is often the only outlet to receive information on the status of their project, which can trigger a domino effect of delays that disrupt the lender’s workflow. Technological solutions can make this process more transparent and user friendly, resulting in greater efficiency for the lender and satisfaction for the borrower.
Appraisal Issues in Construction Lending
by William E. Jones, MAI
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While a good appraisal should comply with current regulations, it can also help construction lenders with issues that arise in loan underwriting. The OCC, FDIC and Federal Reserve minimum appraisal standards include requirements for appraisals made for construction lending. Appraisals made for construction loans should be carefully reviewed to ensure their compliance with these requirements.

For construction lending, an understanding of “as-is” and “as-complete” or prospective values is critical. The “as-is” value reflects the current market value, and “should consider the real property’s actual physical condition, use, and zoning as of the effective date of the appraiser’s opinion of value.” The “as complete” value, however, assumes completion of proposed construction.

Because the “as complete” value assumes some development of the property, a good construction appraisal will consider the feasibility. Is it feasible to build the proposed improvements given market conditions? The appraisal should consider not only current supply in forecasting supply/demand conditions, but the supply of competing properties which are under construction and likely to be built. Market conditions may be ideal for construction at present, but a glut of competing properties coming on the market at completion may affect feasibility.

A good appraiser will also consider two other important areas that affect value and feasibility - construction costs and construction timing.

Some appraisers rely on a borrower’s cost pro-forma, but a good construction appraisal scrutinizes the cost figures to see if they are realistic. The cost of proposed improvements can be evaluated through publications such as Marshall & Swift and RS Means that track construction costs. Analysis by a construction cost consultant can also be enormously helpful in enhancing the reliability of an appraisal.

Construction time is also important in forecasting when a completed property will “hit the market”, which can be important for some property types. For example, newly built homes should be ready to market in spring and early summer, prime home buying seasons. It may be harder to market homes that are ready for delivery in late fall or winter, especially in some parts of the country. In addition to construction cost information, Marshall & Swift Valuation Service provides information showing estimated construction times for various projects depending on the type and size of the project. Or, as above, a construction cost consultant can provide a more project-specific evaluation.

Finally, be sure that the person reviewing the appraisal has experience in reviewing appraisals prepared for construction loans. A reviewer with experience in a particular property type can help to spot assumptions and inadequacies in the appraisal, and can help guide the underwriter in identifying risks.

The above considerations are not meant to be exhaustive. However, a lender who considers these key factors is on the way to developing a good understanding of the pitfalls of appraisals ordered for construction lending.

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Inherently, construction can be a risky business. Mistakes can happen, critical dates can be missed, and general contractors can become overloaded or over-extended. When a general contractor fails to perform, schedule delays, lost personnel, deterioration of existing improvements, as well as increased interest and carrying costs can add up quickly.

Performance bonds have historically been used to mitigate this risk, but the claims and resolution process can take months, or even years. While the work and excess costs might eventually be covered by the bonding company, mounting interest and carrying costs can eat into profits, while delays in going to market can cost developers millions.

A proactive approach to project evaluation, monitoring, and disbursement management can be a much more effective process to mitigate these risks. At about half the cost of a typical bond, the Construction Completion Commitment (CCC) combines three critical elements to proactively manage risks: 1) a pre-construction review of plans, schedules, budgets, in addition to an evaluation of contractor capabilities and abilities to do the project; 2) construction progress monitoring, disbursement controls, and lien waiver tracking throughout the life of the project in order to provide early warning of potential contractor failures, and to help assure the adequacy of remaining loan funds; and 3) a commitment of professional services to course correct if needed, despite the previous measures.

The CCC is more like a fire department than fire insurance - these professional services are critical to keeping subcontractors on the job and preventing waste in the construction project. Bonds are called into play only when a contractor fails to perform and subsequently defaults, but the key value of the CCC, and accompanying control measures, is the ability to step into action to help avoid default in the first place! On the rare occasion that the GC is unable to perform despite these preventative measures, the CCC consultant helps to quickly replace the GC, and then coordinates with the developer, subcontractors and suppliers, and other pertinent parties to assist the project to seamlessly move forward.

Case Study: Construction Completion Commitment Saves Hotel Construction
How does CCC work under real circumstances? In a recent example, a CCC was engaged for a hotel renovation project. In this particular case, the GC initially attempted to convince the developer to fund all of the improvements up front, claiming that he was using his own crew for most of the work; however, this was prevented by the terms of the CCC. Despite the control measures in place, the contractor was eventually terminated as a result of repeated failures to maintain the schedule, spiraling costs resulting from delays in contracting suppliers and subcontractors, and poor workmanship. The CCC consultant stepped in, met with the project team, worked with the owner to bring in a new GC, and monitored the engagement of new subcontractors and the appropriate buyouts, in addition to providing assistance for the revised project schedules and budgets, etc. Construction resumed with minimal downtime, with continued construction progress monitoring and funds control, and, as a result, the project was ultimately completed. Though it was over budget and behind schedule, it wasn’t over by much and was only behind by weeks (not years), and the lender was paid in full.

For any lender or developer, undertaking a major construction project constitutes significant financial risk. By providing ongoing oversight, monitoring and evaluation of construction and funding, as well as assistance to coordinate completion of the work if needed, the CCC improves the chance of a successful project, even after failure of the GC.
Lots of Steps, Lots of Risk
Expediting Construction Disbursements

by William Mitchell, CEO / Co-Founder
Contract Simply

Conventional construction disbursement processes cost the industry billions through inefficiencies, reduced interest payments, contractor capacity, carrying costs and hundreds of other indirect expenses. Productivity throughout the world has more than doubled for most industries in the last 25 years, while construction productivity has not only flatlined, but started to decline.

With the exception of digital submittals, modern disbursement processes have changed little in recent decades. Suppliers send invoices to subs and contractors, who complete work on projects, create their own invoices, and request payment from general contractors, who then coordinate with developers. After completing their own review, the information is compiled and submitted to lenders, who generally perform yet another review, obtain additional information, evaluate invoices and improvements, and make payments that eventually make their way back to subs and suppliers. Though submittals are digital, the vast majority of information is electronically inaccessible, so it must be manually reviewed or entered into an administrative system - throttling many of the benefits electronic systems could provide.

- Electronically dead information provided to lenders frequently requires manual evaluation and re-entry, resulting in higher risks of error.
- Inadequate and missing documents can increase inefficiencies, delay funding and restrict interest income.
- Closed communications between parties lacks transparency and can require long chains of communications, decreasing efficiency throughout the process.

Even with everyone’s best intentions and desire to expedite the process, it is difficult. This slow payment processing costs the industry billions. Administrative, accounting, financing charges, and other expenses cause real physical impacts on the industry. The cash flow impact on small construction businesses restricts their ability to take on additional work and to invest in technology and other capital expenditure projects that would improve efficiencies. In a world in which productivity has doubled in most industries over the last 25 years, construction productivity can and should increase as well. Standardized, consistent and transparent electronic processes can result in faster payments, reduced risk, and increased efficiency and interest income. •
Construction Schedule: A Lender’s Guide

Bob Scales, Managing Director
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The construction schedule is a project’s road map from beginning to end. It tells the team when events are to occur and in what sequence. Schedules used by contractors in the field can be very complex with resource allocations, dependencies, and a depiction of the critical path to completion. Schedules for lenders need not be as complex and instead should provide a measurable time frame to verify progress and ensure available funds are being allocated at the expected pace.

From a lender’s perspective, there are only a few key elements to monitor to ensure successful lending. They are a commencement date (start date), a series of key milestone events, and a completion date. The commencement date is the date which initiates the construction progress and should be consistent with the loan commitment. The milestone event dates are a series of completion dates associated with critical events in the life cycle of the construction process. And finally, the completion date is when the project is finished. Each of these dates, however may have differing definitions from one job to the next.

Although the commencement date may seem straightforward, its definition from a contractual perspective can have a significant impact on the project. Many times, the contractual commencement date is tied to the receipt of permits or approvals. Often construction can begin before satisfaction of the contractual commencement requirements. This creates risks associated with permit approvals and can lead to a project duration which exceeds the loan commitment.

Milestone events from a lender’s perspective should include a short list of key activities with their projected start dates and completion dates. For example, the placement of the slab should be one such milestone. If it has not started as anticipated or is not completed as anticipated, chances are the project is delayed. Other milestone events may include framing, the placement of the roof, hanging of drywall, etc.

Defining completion is also essential to understanding the projected cash flow associated with the project. A completion date is not always synonymous with occupancy. Completion may mean the project is available for the next contractor to commence their work or it may mean substantially complete but may not have a Certificate of Occupancy.

Why is the schedule important to the quality of the loan? There are several direct and indirect impacts. Directly, the duration of a project influences the amount of interest which will be necessary to carry the loan. If the project is delayed, the interest reserve may become insufficient. A delay may also result in additional costs from contractors which again will impact the available funds. Indirectly, slow projects can become a public image problem. Being associated with a delayed project and becoming entangled with budget shortfalls due to delays can have an adverse reaction with your clients.

Mitigating risks associated with the construction schedule is a simple process. Understand the start and completion dates and their relationship with the loan. Monitor progress against the milestone dates. Procrastinating on a schedule delay only intensifies the impact. It’s important to coordinate with the borrower to understand how delays will be addressed to avoid increased costs, missed deadlines and other impacts to the project.

Technology provides tools which eliminate the manual effort associated with tracking multiple schedules across multiple projects. A comprehensive construction lending platform will alert you to delays so you can react accordingly and maintain your relationships and peace of mind.
Construction Funding in Nevada: Disbursement Control Benefits and Regulatory Requirements

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Construction projects can quickly go underwater when funding isn’t monitored carefully. In fact, close to 80% of construction loan defaults occur due to funds-related reasons. Lenders commonly use risk management tools such as construction progress monitoring and funds control to make sure that improvements are consistent with the proposed collateral, the construction is on-schedule, and remaining loan funds are adequate to complete construction.

Practically speaking, funds control services act as the eyes and ears of the client, whether they are a lender, developer, contractor, subcontractor or a credit union. In the beginning, funds control ensures that projects are reasonably budgeted according to needs and that the work is done on schedule. Over the course of the project, funds disbursement assures that all subcontractors and suppliers are properly paid and that projects are completed lien-free.

For Nevada, a roaring economy and the fastest-growing employment in the country has resulted in a statewide construction boom. Las Vegas, which was heavily hit during the economic devastation of the Great Recession, is investing billions in continued recovery and growth. Prominent projects include the $4 billion-dollar World Resorts Las Vegas, estimated to open in 2020, and the new $1.8 billion-dollar stadium for the Raiders, also set to open in 2020. Now under construction are the Las Vegas Convention & Visitors Authority Expansion, estimated at $900 million dollars and the MSG Sphere, a $633 million-dollar project. With a footprint of more than 1.9 million square feet, the Reno-based Tesla Gigafactory, which houses more that 4.9 million square feet of operational space across several floors, has been under construction since 2014. Once completed, the Gigafactory is anticipated to be the biggest building in the world!
With such a heavy volume of construction and development comes the increased risk of project default. But in addition, in Nevada, special construction control requirements may apply. For example, under two special circumstances, Nevada law mandates third-party funds control. In some cases, hard money lenders, as many alternative lenders are, may be required by Nevada law to engage third-party funds control.

In the second circumstance, if a landlord or owner files a notice of non-responsibility on a tenant improvement(s), Nevada law mandates the tenant must record a Notice of Posted Security on the property by either a) securing a surety bond 1 1/2X the value of the tenant improvement or b) depositing 100% of the tenant improvement value with a third-party construction control company. The statute outlines in detail the consequences to the Owner and to the Tenant if they are not in compliant with the law.

If a third-party funds control company (a “construction control company”) is engaged for services, Nevada law stipulates that it must be a licensed and bonded escrow agency and any person(s) managing construction funds must be a licensed escrow agent by passing a test of fifteen (15) specifically required CEU’s, passing a background check, and completing a licensee application. In addition, they must renew their license annually by passing a test of ten (10) CEU’s and updating and re-submitting their personal documentation. The escrow agency must also renew their license annually by submitting specific updated company, financial, and personnel information.

I refer to any disruptions or defaults in construction projects as having to “unscramble the egg”. If your construction control company (issuing funds control disbursements) is not licensed and they are issued with a Cease and Desist Order, you will need to unscramble the egg! If lack of funds or misappropriation of construction budgets causes a default, you will need to unscramble the egg! In the long run, developers will experience construction delays, confusion, possible loss of contractors, construction disbursements will stop, and the State will step in. It will create a high risk for mechanic liens to be recorded on the property and put the construction loan itself at risk. To best protect your investment and ensure a smooth, compliant construction process that is on time and on budget, engage the funds control services of an experienced construction control company with specific expertise in Nevada law. You can verify that the construction control company is appropriately licensed by going to the State of Nevada/Division of Mortgage Lending website.
Borrowers are frustrated, the third-party monitoring groups won’t return your call, the general contractors are about to walk the job, and you are just trying to figure out what is what. You want to get payments completed (done right, of course) so that you don’t have to see it for another month. Oh! Welcome to a day in the life of a monthly payment application approval! You ask yourself: isn’t there a better way to do this without some loss of my sanity, time and effort?

We live in an increasingly fast paced world. The speed of information, money, goods and services has been accelerated in the digital age and, as participants in this age of increased transactional velocity, we naturally expect things to happen fast - really fast! Compare that need for speed with the world of construction and loan administration and you find very different expectations.

Construction loan administrators must weigh the need for payment accuracy and proper documentation against the cost of processing time and the fact that the best way to keep a project moving is to keep the money flowing to the contractors. As a construction lender, LCM has found that the best way to balance these conflicting needs is to take a white glove approach and monitor projects actively on a weekly basis. Hmm! Could more be less?

The main component of this process is a weekly call or touch with all the project stakeholders (Lenders, Borrower, GC and Construction Monitor). This call can be as quick as 10 minutes or up to an hour in some cases where there are complex issues to discuss. The typical agenda discusses job site progress over the past week, the two-week job look ahead, any changes to the budget or schedule, the status of the pay application and any other issues that pertain to the project. This seems simple, and often the best practices are, but we have found it can have a profound impact on minimizing time and risk.

This routine of touching base weekly allows lenders to keep a finger on the project pulse and identify potential issues early. How many times have you opened a monthly pay application to find a surprise change order or a slide in the completion schedule? Then think about how much time you spend tracking down the answers to your questions. Could 10 minutes a week limit those surprises and lag time? If lenders wait until a pay app is in hand to ask questions, borrowers and contractors can feel like they are being stonewalled or delayed which can lead to project slowdowns and hard feelings amongst the stakeholders. No one wants that!

There is no magic bullet when it comes to construction management and funding. There is still no substitute for interpersonal communication and regularly touching base with the primary stakeholders. We all live in a digital, fast paced world, but some things still require the personal touch and more could be less.
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