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CONSTRUCTION LOANS – DEBT, DEBT AND MORE DEBT!
Part I of II

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With condominium developments sprouting up on, what seems like, every block in New York City, with construction costs escalating on a daily basis, with new "developers" being born every other day and with interest rates climbing, why are lender's willing to lend 85 percent, 90 percent or sometimes more of total project costs and why are developers taking the money?

Traditionally, a developer would seek construction financing from banks and finance companies, the lender would lend 65 percent to 75 percent, and the borrower would come up with the balance in equity. In today's market, banks and finance companies have been pushed further than they have been in years in order to stay competitive in the construction lending market. In a recent construction loan that our office closed for a developer, 90 percent of the total project costs were financed, non-recourse to the individuals with an interest rate of LIBOR plus 3.25 percent. Another loan that we recently closed for a lender was for 85 percent of the total project costs, 15 percent recourse to the individuals with an interest rate of LIBOR plus 2.75 percent. When we saw the terms of each of these loans, we were surprised how far the institution was willing to go in order to capture this business and how much debt the developer was willing to leverage itself. These loans looked more like financing for a stabilized apartment building rather than construction loans.

As a result of construction loans like the foregoing examples, lenders have had no choice but to become more aggressive if they wish to keep up with the competition. With the 1980's as a back drop and the most recent lesson of why not to over extend yourself, why are lenders pushing the envelope so hard to stay competitive in the construction lending market and why are the developers willing to take this money? There is no one answer to these questions and it can only be explained by a number of facts and circumstances.

With respect to the lender's willingness to make the loans, there are several factors that are driving the market: Over the last few years, the lending market has seen a rise in competition, the interest rate spreads and profits on conventional loans have decreased and there has been an influx of many new projects on the market. Retaining the customer base has also always been a primary focus of all banks.

Next week Cohen & Perfetto will continue to explore this slippery slope and take a closer look at why developers are willing to take out these type of loans.