ctinnovations.com



What's next starts here.

**What to Expect When Seeking Financing for a Commercial Construction Project**

You have an idea for what you'd like to build but need to find an appropriate site. Or, perhaps you have a specific site in mind and must determine what type of commercial project that location would most likely support. You know that once those pieces are in place, you'll have to develop detailed plans and submit them to various municipal committees or entities – such as the inlands wetlands commission, the planning and zoning commission, and the health district – for their approval.

You'll also have to start thinking about financing for your project. Once you've scoped out some ballpark project cost figures and have some basic project information assembled, you'll be ready to begin discussing financing with potential lenders.

Here is what you can expect when seeking financing.

**Step 1: Approach a Local Bank/Lender**

Approaching a bank or lender in your vicinity is the first step in the project financing process. Seeking out a local lender, rather than one that's quite a distance from you or in another state, is important. From a lender's point of view, new construction loans carry a higher degree of risk. Unlike a regular commercial mortgage, there is no operating history to rely on. As a result, commercial construction loans are typically entertained by local or regional lenders intimately familiar with their local markets. If a lender does not understand its local real estate and business markets, it would be extremely risky for that institution to take on both the construction loan and lease-up risks.

A “construction loan” is, by definition, a short-term loan. Its purpose is to fund the costs associated with the construction of a building and to fund the interest on the loan during the construction period and initial lease-up.

Upon completion of the construction and the lease-up of the property, long-term or “permanent financing” is used to retire or pay out the short-term construction loan. Permanent financing is usually not available until the property has stabilized. A property is considered to be stabilized when the occupancy rate approximates the average occupancy rate in the market for that property type.

Sometimes both types of financing are committed to by the lender in combination. This is called a “mini-perm” or “construction-permanent” mortgage. In this case, the lender is committing to fund the project from construction to market stabilization. There are built-in mechanisms in this type of loan structure for the loan to term out or start amortizing on a monthly basis after the construction/stabilization period, which is usually between 18 and 24 months. The construction permanent mortgage will often amortize on a 20- or 25-year schedule with a balloon payment or maturity 10 to 15 years after it converts to a permanent mortgage.

**Step 2: Lender Review and Underwriting Processes**

In the initial stages of your financing request, a bank will often need only general details of the project. Borrowers are not typically expected to provide detailed financial statements, personal tax returns and detailed project plans. At this preliminary review stage, the lender is usually focused on reviewing a basic outline of the project, the project cost, summary projections and underlying assumptions, and the background of the project developers.

It is not unusual for a lender to reject a project after a preliminary review. There are many reasons a lender might not move forward on a project, regardless of its viability. A lender might currently have several ongoing construction projects in its portfolio and not be in the market for another, or the project may be too big or too small for the particular lender.

If a lender intends to move forward with the project, a nonbinding term sheet will be provided. The term sheet outlines the various terms and conditions the lender is proposing. There is often some give and take at this stage, where you, as the developer, might ask for certain changes that the bank may or may not agree to. Once you and the bank agree to the proposed terms, the loan request will move into the underwriting stage.

The underwriting stage begins the lender's process of compiling detailed information about the project and the principals behind the project. In general, you can expect the lender to request detailed building plans; general contractors' bids; cost projections; the construction timetable; copies of all local, state and federal approvals; pre-leasing information; and a three-year financial history for all companies and principals involved in the project, including, but not limited to, company and personal tax returns. You can expect the bank to order a detailed financial evaluation/appraisal analysis (including a feasibility analysis), site-environmental testing and other project-specific professional reviews, at your expense.

The underwriting process is arguably where the heavy lifting in the decision-making process is done. It will be critical that the independent appraisal and market feasibility study validate the value of the finished project and the underlying assumptions supporting the project plan. For example, will lease-up take longer than originally expected, or will it be "on plan"? A longer lease-up period would increase the carrying costs of the construction loan and, hence, the total cost of the project. Will the market support your projected rent levels? Any of these factors and others could impact the overall cost of the project or the project's ability to make its debt payments and perhaps put the bank approval in question.

As a potential borrower, it is important to obtain an understanding of the time frame your lender typically requires for loan approval. Timing details should be discussed early in the process. The best way to begin a discussion with your lender is to ask, "How long will it take you to issue a commitment letter from the time you have all the information you need from me?" You'll want to key in on the steps to loan approval and how long each step usually takes. Those steps are: loan/credit analysis, supervisory approval, loan committee(s) approval, the issuance of a commitment letter and the closing of the loan.

**Step 3: Attorney Involvement**

Construction loans are complicated transactions that will require representation by experienced legal counsel. It is critical that you have a reputable attorney proficient in commercial transactions representing your interests in this transaction. Your attorney may or may not be the same individual that provided legal counsel during the municipal approval process or during the negotiation of construction agreements with your contractor(s) during the earlier stages of the project. Whoever it may be, the attorney that you will be using in the loan transaction should be consulted, at the latest, at the time of your lender's issuance of the commitment letter. Your attorney can provide valuable insight into whether any of the loan requirements set forth in the commitment letter merit further discussion with the lender. Most banks are receptive to revision requests provided they are commercially reasonable and within the parameters of their internal approvals. As the bank's counsel will draft loan documents from the outline provided in the commitment letter, it is important for you to raise any issues prior to execution of the commitment letter.

**Step 4: Loan Agreement and Closing**

Once the commitment letter is executed, the bank's attorney will provide a closing checklist outlining the due diligence documents that you and your attorney must provide prior to closing. Typically, these include a title search of the mortgaged property, a Uniform Commercial Code (UCC) filing, judgment lien and bankruptcy search of the borrower and any guarantors, evidence of insurance covering the mortgaged property (including builder's risk coverage during the construction period), and entity information for any borrower or guarantor such as bylaws or operating agreements, certificates of legal existence, articles of organization and authorizing resolutions. Your attorney will work with you to compile all required information.

As the closing date approaches, the bank's counsel will circulate draft loan documents and afford your attorney the opportunity to review and revise them after consultation with you. In addition to those loan documents that are commonplace in a commercial real estate mortgage setting (i.e., promissory note, mortgage deed, collateral assignment of leases and rents, security agreement), your lender is going to require some additional documents due to the construction financing component of the transaction. Chief among those is the construction loan agreement.

The loan agreement will set forth the conditions that must be satisfied prior to the lender advancing the needed construction funds in stages over the course of the construction. There will be conditions that must be met prior to the initial advance of funds, such as evidence of municipal approvals, including a building permit, and lender approvals of plans and specifications, a construction budget, schedule and contractor. Many of these conditions will have been satisfied prior to the closing.

There will be additional conditions on advances over the course of the construction term. These controls on advances are part of an effort by the lender to devise and enforce safeguards against risks that are inherent to construction loans, such as increased construction costs, weather delays, and unscrupulous or substandard contractors. For instance, the lender will typically require inspections by either the loan officer or another of the lender's agents of all construction work in place prior to approving each advance. The construction loan agreement will also restrict the frequency of advances (i.e., no more than monthly) and set forth the percentage of the cost of the completed work that the lender will be willing to advance. As such, it is important that the criteria for advances dovetails with the corresponding provisions set forth in the contract with your general contractor.

At the closing, your attorney will issue, at your expense, a mortgagee title insurance policy to your lender ensuring that such lender has a first priority lien position in the mortgaged property. With each advance request, your lender will want to know that it remains in first position and that no contractors or others have placed liens on the property subsequent to the date of the issuance of the initial title policy. To that end, your lender will likely require that you provide waivers or subordination of lien instruments covering all work on the project through the date of the particular advance. The lender may also require your attorney to provide interim title policy endorsements ensuring the lender's priority position at the time of each advance.

Prior to any final disbursement of the balance of the loan proceeds, the lender will require a certificate of completion from the architect, a copy of the certificate of occupancy issued by the municipal building official, and an "as built" survey showing the constructed improvements upon the land.

From a lender's perspective, the value of the collateral granted as security in a construction loan depends on both the successful completion of the construction and the realization of the projected economic value of the completed project. The lender, through the structure and administration of its advance program, is attempting to protect itself from difficulties that may arise during construction, such as unsatisfactory work, delays in construction, violation of building codes, failure to administer subcontracts properly, and diversion of funds for other purposes. While the advance conditions imposed by the lender are reasonable in light of the risks undertaken, they do result in additional burdens on you, the borrower. However, having an organized approach with the assistance of capable professionals, such as your loan officer, your attorney, your contractor and your architect, the construction financing process can be very manageable and contribute to the successful completion of your project.

**About the Authors**

Dave Barry is a partner with the law firm Jacobs, Walker, Rice & Barry LLC of Manchester, Connecticut. You can contact him at DBarry@jwrb.com.

Jay McGuinness is vice president, loan officer, with Connecticut Innovations. You can contact him at Jay.McGuinness@ctinnovations.com.