FINANCING YOUR CONSTRUCTION PROJECT

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OVERVIEW

At The Korte Company, we've built for some of our nation's greatest visionaries. Innovators with ideas that needed a place to call home. In our experience, securing smarter construction financing has been one of the primary challenges they've faced. This white paper will give you key knowledge to help overcome this challenge so your big ideas can keep moving.

We've written this guide primarily for owners in the private sector who are unfamiliar with construction finance and need to secure funding. In it, we cover five primary topics:

- The basics of construction finance
- How to get financing and prepare documentation for lenders
- The kinds of financing available and strategies for securing funds
- The advantages and disadvantages of different financing strategies
- Specialty financing sources for the biggest projects

PART 1:
THE BASICS OF CONSTRUCTION FINANCE

THE BASICS OF CONSTRUCTION FINANCE

In this section, we cover the way construction loans work, project costs and the key numbers that lenders evaluate.

HOW CONSTRUCTION FINANCING WORKS

The first thing to know about construction finance is you actually need to fund two different loan periods, each with different risk levels. Most owners secure two loans, one for each period. The first is the period during construction, funded with a construction loan. The second is the period after construction, funded with a permanent loan, AKA a takeout loan.

Typically, owners structure financing through a real estate holding company, which holds the construction property and the loans to limit risk for owners and their businesses.

CONSTRUCTION LOANS

A construction loan pays for up-front project costs. In most cases, you'll make interest-only payments during construction, meaning once construction is complete, you'll still have to pay the full principal amount of the loan plus interest. The faster you complete construction, the less interest you'll have to pay, or the lower your cost of capital.

STABILIZATION

Once construction is complete, you need your facility to reach what's called stabilization, which happens when your facility is worth more than the initial cost of construction. Lenders consider your finished property quality collateral, so lending to you is less risky. Depending on the type of property you build, it may not achieve stabilization until it's reached a specified level of occupancy or rental income.

STABILIZATION

property value **>** initial cost of construction

PERMANENT LOANS

Once your property has achieved stabilization, you'll get a permanent loan with a lower interest rate to pay off the construction loan. Then, you'll pay back the permanent loan, which typically has a set repayment structure and schedule.

In some cases, you can take out a combination loan, which covers both the construction period and the post-construction period. In combination loans, conditions for stabilization are defined up-front, and a pre-negotiated interest rate and payment plan kick in once stabilization is achieved.

The most favorable option would usually be a low-interest balloon loan, in which owners make low monthly payments (possibly interest-only) for a specified time period and make a large final payment. But because of today's tight financial markets, balloon loans are difficult to attain.

FINANCING BASICS: RISK, COLLATERAL AND VALUE

Lending money for construction, particularly new construction, is riskier than many other types of lending. For starters, construction is a complex undertaking with many potential pitfalls. It requires a strong ownership group with a defined plan for finished facilities. And it demands a skilled project team to deliver your build on-time, on-budget and to high quality standards. Lenders want to know your project will succeed, so they'll take measures to evaluate your project's viability and their risk.

PASSING THE PROFIT TEST TO GET A CONSTRUCTION LOAN

When evaluating potential borrowers for a construction loan, lenders start with the profit test, which determines whether or not your finished facility will be worth more than cost of your project — particularly if you plan to use your facility as loan collateral.

Lenders will evaluate how much relevant experience your ownership group has and the experience of your project team. And they'll consider how invested you are in your project using two measures:

1. The loan-to-value ratio
2. The loan-to-cost ratio

LOAN-TO-VALUE RATIO

=

amount of money borrowed

vs.

estimated value of facility

LOAN-TO-COST RATIO

=

amount of money borrowed

vs.

cost of project

Today, most lenders don't usually finance more than 75 percent of a project's value. Depending on the job, the threshold may be lower than 75 percent. The lower the loan-to-value and loan-to-cost ratios, the less risk your lender is taking and the less need you have for additional collateral or personal guarantees.

COLLATERAL AND GUARANTEES

In almost every construction loan, owners use their facility as collateral. If owners default on the loan, the lender gets the facility. Collateral may also be land. Depending on the project, land may be a bigger portion of collateral. The reason? Some properties are easier for a lender to sell or lease than others — e.g. an office space can be rented to many tenants, while a gas station has limited use.

Almost always — particularly given today's tight credit environment — lenders will require your ownership group to provide personal guarantees, wherein your investors agree to personally pay back the loan if the project fails. Lenders will evaluate the net worth of your ownership group and want to see that it's at least equal to the amount of the loan. The official term for this is the "loan-size ratio."

Today, borrowers usually must show ALL of their assets and liabilities, providing an annual update to lenders. Personal guarantees can be joint and several. And they can be capped at a certain amount.

DEFINING STABILIZATION: HOW LENDERS VALUE YOUR PROPERTY

To get a permanent loan, you'll need a valuable facility that's achieved stabilization and a venture that's making more money than you owe. Lenders measure this primarily using your debt service coverage ratio, or DSCR (see sidebar for definition).

Any DSCR number greater than 1.0 means the property is generating enough income to cover its debt (NOI is greater than debt service). And that's what lenders require. In fact, many lenders want to see a DSCR of 1.25 or better. A ratio greater than 1.25 can help you get not only a permanent loan, but also secure a more favorable interest rate.

Lenders will usually also require your business to have a positive cash flow. This means having a net income greater than all expenses, including tax write-offs, depreciation and interest.

Lenders want to see that your property achieves a value greater than the cost of construction. While several measures are used to value a property (location, value of similar properties, cost for repairs, etc.) lenders primarily define value as the amount of income you earn divided by your rate of return in operating your facility.

Though these formulas may appear daunting, just remember they're all tools for testing one thing: whether or not your project will be profitable.

DEBT SERVICE COVERAGE RATIO (DSCR)

=

$$\frac{\text{net operating income (NOI)}}{\text{total debt service}}$$

NOI

=

annual operating income from your property **-** the cost of operations (not including tax write-offs, depreciation and interest).

DEBT SERVICE

=

total money owed from construction loan (principal plus interest)

PROPERTY VALUE

=

$$\frac{\text{NOI}}{\text{Capitalization (Cap) rate}}$$

CAPITALIZATION [CAP] RATE

=

rate of return on an investment property

BASICS OF INTEREST RATES

Construction loan interest rates fluctuate along with market interest rates, which are largely determined by the Prime rate and the LIBOR rates. A fair construction loan interest rate is typically the Prime rate plus one or two percent.

THE FOUR MAJOR TYPES OF PROJECT COSTS

When planning your project and asking for loans, you'll need to account for four different types of costs:

1. **Hard costs**
   a. Your direct construction labor and materials costs
2. **Land costs**
   a. The cost of acquiring land and property— sometimes, land costs are considered soft costs
3. **Soft costs — all the costs you don't see**
   a. Permitting
   b. Architectural design
   c. Engineering
   d. Taxes
   e. Insurance (liability, builder's risk, title policy and contingency policy, among others)
   f. Construction bonding, testing and inspections
   g. Developer's fee or broker's commission
   h. Appraisal and legal fees
   i. Interest on construction payments
4. **Contingency reserve**
   a. You must keep a reserve fund at all times to make interest payments and keep your project solvent
   b. Lenders may require you to keep a certain reserve level, typically 5 percent of soft costs

Consider all of these costs before you ask for a loan. If you fail to account for all of them, it'll be a challenge to secure funding or even complete your project.

PART II:
SECURING FINANCING

SECURING FINANCING

Now that we've addressed what lenders want to see from you, let's dive into what you can do to ensure you secure construction financing. These are the aspects of the process you can control.

COME PREPARED

Both private and public lenders require you to show your books. And for a construction project, it takes time to secure financing. Start getting documents in order early — many months or even years before you want to build.

Anticipate constant communication. You must have a clear project plan and keep prospective lenders in the loop as your project develops. Lenders will want to see an operating pro forma for the project that shows the anticipated income and expenses for the first ten years. This must include a realistic estimate of the lease-up period — i.e. the time it'll take for your property to achieve stabilization.

BUILD THE RIGHT TEAM

Lenders perceive less risk when the right team is involved. Lenders are all about the warm and fuzzy feeling that the project will succeed. Your lender likely has to sell this project to his loan committee, so it's a much easier sell if he knows all of the parties involved are experienced and professional. And it'll put lenders at ease if your investor group has a high net worth.

LINE UP TENANTS

It's always easier to get a loan for an owner-occupied, single-tenant building than for a non-owner occupied facility. Why? Because there's a clear plan for how your property will be used and who will pay the bills. For multi-tenant facilities, having tenants lined up makes it easier to procure financing. Lenders on multi-tenant retail projects may require pre-leasing to one or more anchor tenants before providing financing. Banks may not make this type of loan at all until a specific percentage (60 percent, for example) of the property is leased to reputable, good-credit tenants.

PART III:
TYPES OF FINANCING AVAILABLE

TYPES OF FINANCING AVAILABLE

Depending on your project, you may have many financing options available, including:

- Private financing sources
- Public sources of financing
- Federal programs for specialized projects
- State-by-state opportunities

PRIVATE FINANCING SOURCES

For most projects, private financing is the easiest to attain. We'll cover the most popular private funding sources.

BANK LOANS

Bank loans are far and away the most common source for construction financing. They're highly attractive to owners because local banks know local areas and can evaluate projects in their region. Though used most often for smaller projects (less than $5 million), local bank loans may be available for big ones as well. In these instances, you'll work directly with your bank lender, who will lead financing and raise funding from partner banks.

CONSTRUCTION LENDING BANKS

Construction lending banks specialize in financing construction projects. These specialty companies possess great construction knowledge and can serve as useful advisors. But they usually charge more than local banks do — in either interest or fees.

LENDING EXCHANGES

Lending exchanges, such as C-Loans, are a vehicle to place your project in front of a variety of lenders. You provide the exchange with information about your project. And the exchange identifies, from its database of commercial lenders, those likely to have interest in it. This approach works because lenders are trying to fill a financial portfolio with profitable investments. At any given time, any one lender may or may not have capacity or desire to fund your specific type of project, regardless of how attractive it is, because it may not fit his or her portfolio. Lending exchanges help you reach more lenders at once, particularly those actively looking to invest in your type of project.

LOCAL GOVERNMENT SOURCES OF FINANCING FOR PRIVATE PROJECTS

Government entities have made affordable financing available for a wide variety of projects.

SMALL BUSINESS ASSOCIATION (SBA) LOANS

The SBA offers its 504 Loan program (commercial construction loan) to for-profit businesses that occupy their own properties. It's available to small and mid-sized businesses for projects of up to $20 million.

The SBA Loan allows you to preserve capital, maximize tax deductions and control overhead, as you only need to put 10 percent down and may potentially use land as equity. It offers a long-term amortization (25 years for first loan, 20 years for second).

The way you use your space is limited though. You can only lease up to 40 percent of a newly constructed space to another business and up to 49 percent of an existing building you upgrade.

TAX INCREMENT FINANCING

Throughout the U.S., run-down, vacant areas and facilities reduce property values. Communities aim to raise property values and generate sales tax revenue by attracting strategic investments in their area. One tool they use is Tax Increment Financing (TIF), a

TAX INCREMENT
=
property tax value after development - property tax value before development

long-term tax incentive offered by a municipality (rural or urban). TIF has been used in 49 states (not Arizona) and has been around since the 1950s. Through TIF programs, owners pay the up-front costs of a project, but as the property value of the facility and the surrounding TIF area rise, the increases in property tax value are actually paid to the owner in the form of tax increments. A tax increment is the difference between the property tax value of a property before and after development.

Each year for a set term (usually not more than 15 years), you'll a receive tax increment payment. The more you raise the property value, the more money you get back.

HOW TO GET A TIF

To get a TIF, you need to work with a Community Redevelopment Authority (CRA) and show that your project increases the value, not only of your development, but also of the surrounding properties within the TIF area. And you need to show that your project will spur additional investment in the community. A TIF has to pass the "but for" rule, which states "development wouldn't happen but for public help." It's a mechanism to make impossible projects financially feasible. To get a TIF, you'll likely need a specialty consultant and must meet a range of requirements.

DRAWBACKS OF TIF

Securing TIFs is a difficult and long process involving public reviews of your project. Your property must be located in a designated TIF district, so your site options are limited. And the municipality can use TIF money for specific purposes only (depending on the type of TIF district). This usually involves some type of infrastructure improvements, such as clearing land, installing storm water retention, extending utilities and services or a similar project. While a TIF may reduce the cost of construction, the payoff may not come for a period of time. There is some risk involved, as your property must achieve a higher value. As you must pay for the project up-front, you may still need to secure initial project financing.

HISTORIC TAX CREDITS

One well-known program is the Federal Historic Preservation Tax Incentives Program. Similar to TIF, this program reimburses owners for much of the cost of construction over time in the form of tax incentives. The program is in place to encourage rehabilitation of historic buildings and landmarks. To procure this funding, you'll need to have your property designated as a historic landmark and go through a rigorous application program.

INDUSTRIAL REVENUE BONDS

The industrial revenue bond (IRB) is a loan issued by state or local governments to finance the construction or acquisition of manufacturing facilities or equipment. The interest is tax-exempt for the lender (government entities), which reduces your interest rate. And payback schedules can be 20 – 30 years — much longer than payback schedules required by private banks. The drawback is that as a government-issued funding source, it can be a meticulous, challenging process to secure financing. Any individual IRB can't exceed $10 million, and you can't use an IRB for a project exceeding $20 million. Right now, the IRB may also be difficult to attain due to a tight credit environment.

FEDERAL PROGRAMS FOR SPECIALIZED PROJECTS

The federal government has created a range of loan and grant programs for specific project types. You can find more information on these programs at govloans.gov.

DRAWBACKS OF FEDERAL FUNDING

Federal programs are dependent on annual funding. Projects have to compete for this funding, so it isn't guaranteed. Also, timing becomes critical. If you miss the funding round, you may have to wait up to a year, potentially jeopardizing your project timeline. Most federal funding programs are so specialized you'll need to hire expert consultants to attain them. These consultants come with their own fees, adding soft costs to your project.

STATE-BY-STATE OPPORTUNITIES

Each state offers its own funding programs. Depending on where you build, you may be able to secure funding, so it's worth researching what's available at the state level.

PART IV:
FUNDING THE BIGGEST PROJECTS

FUNDING THE BIGGEST PROJECTS

Many of the biggest projects involve a high level of personal finance from a group of investors. But if you're looking to complete a particularly large project worth many tens or hundreds of millions of dollars, you may also need to consider some unique funding sources.

TAKING A SECOND LOAN

If your project is large enough, most primary lenders won't be able or willing to take on the full risk of funding it. You'll likely need a second loan, called a mezzanine loan.

In a mezzanine loan, the collateral is usually the stock of the corporation that owns the property. This is one of the biggest reasons why you'll want to use a real estate holding company, which will own the property. Typically, mezzanine loans share the same term as the first loan you procure, but they come at far higher interest rates — usually 11 to 12 percent. Most of the largest projects use mezzanine financing, with mezzanine loans typically totaling at least $5 million.

EB-5 FINANCING

Due to today's credit and regulatory environment, EB-5 Financing is the most popular and often the best option for financing the biggest projects. EB-5 is a federal program designed to bring foreign investment into the U.S. and create jobs. In EB-5, foreign investors each contribute up to $545,000 into a project and earn U.S. citizenship. To secure EB-5 financing, you'll go to a licensed, regional EB-5 organization that will evaluate your project. If it meets their criteria, they'll have their contacts abroad pitch it to international investors. EB-5 financing is often structured as a mezzanine loan.

PREFERRED EQUITY

Preferred equity isn't technically a loan; it's actually when a financial firm provides part of the down payment on a project. It's used if a lender is unwilling to loan you the money to close the gap between your down payment and your project cost. When your project achieves ROI, the preferred equity investor receives reimbursement of their principal first, but you'll be paid your principal before they take interest. Usually, preferred equity investors charge a high interest rate, about 15 percent, but sometimes they're the only option available.

MORE ABOUT THE KORTE COMPANY

In 1958, we started building with little more than three people, a truck and a saw. Today, we're a nationally recognized leader in construction and one of the 400 largest contractors nationwide. We've completed more than 3,000 projects from coast to coast for some of our nation's biggest (and smallest) companies. Our specialty is Design-Build, an innovative process that streamlines design and construction to save time, reduce costs and eliminate headaches. We have our own in-house architectural team, Korte Design, but we also partner with specialty architectural firms on more than 70 percent of our Design-Builds. We form the right team to get the job done — safely, on-budget and on-time. Every time.

To start your project and give your big idea a place to call home, give us a call at 618-654-8611 or contact us here.

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