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Reins Easing on New York Construction Loans

By JULIE SATOW

Construction in New York slowed to a trickle in the recession, but there are finally signs that the construction loan market is coming back to life.

While lending for multifamily rental buildings, with its steady income flow, has been popular for the last 12 to 18 months, a growing number of lenders are now looking at condominium projects, hotel developments and certain office and retail buildings.

"There is plenty of debt capital available and as we bid on transactions there is a lot more competition than there was 12 months ago, and certainly more than 24 months ago," said Bill Cotter, the northeast division manager at Wells Fargo Commercial Real Estate.

As the real estate market continues its slow recovery, land prices have been rising, enabling borrowers to pay back their construction loans or refinance. That has pushed down the default rate and spurred more lenders to make new loans. In the third quarter of 2012, the most recent number available, the default rate on construction loans was 9.5 percent, the lowest it has been since the end of 2008, according to Chandan Economics, a research firm.

Construction loan commitments are trending up, the firm found. Because developers draw on construction loans as building progresses, they are not recorded until the funds are deployed, so the increase in commitments is anecdotal. "We know they're up, but we can't say exactly how much," said Sam Chandan, president and chief economist of Chandan Economics.

With default rates declining and the market improving, competition among lenders to make construction loans is intensifying. In New York City, more projects are being financed, and for the strongest borrowers, the equity requirements and other terms are softening. Helping to drive the trend is the limited amount of construction in recent years, which has led lenders to believe there is sufficient demand for more building. Construction loans also offer more yield than other loan types and so are appealing in a low-interest-rate environment.

Lenders generally see construction loans as riskier than other loan types, in large part because if a project falls apart, the lender is left with a partly finished building that does not generate revenue. To make up for some of this risk, lenders typically charge borrowers higher rates.

"Interest rates are generally so low that lenders are focused on how they can improve yields, and construction lending usually has higher yields, so it is a way to improve their return on funds deployed," said Andrew A. Lance, a partner at the law firm Gibson, Dunn & Crutcher.

With more lenders looking to make construction loans, the types of properties they are willing to finance have expanded. Hotel development, for example, is typically considered a riskier property type but is nonetheless being financed at a fast clip.

Abraham Hidary, the president of Hidrock Realty, for example, is negotiating with lenders for loans to build a 317-room hotel at 133 Greenwich Street and a 200-room hotel near Rockefeller Center. The banks are offering to finance 60 to 65 percent of the cost of the projects, and are requiring that he personally guarantee 15 to 20 percent of the loan, he said, with interest rates that range from 3.25 to 3.75 percent.

In late 2010 and 2011, Mr. Hidary was negotiating the loans for two other hotels that he is developing — a 173-room Springhill Suites and a 168-room Courtyard by Marriott, both in Midtown South. At that time, banks were willing to lend only 55 percent of the cost of the projects and were requiring that he personally guarantee as much as 30 percent of the loans. The interest rates then ranged from 3.75 to 4.5 percent, he said.

"It has definitely helped us that there is more competition among lenders," Mr. Hidary said.

In recent months, banks have also begun looking at financing condominium developments. That is partly because many of the projects that are looking for financing are new, rather than precrash developments that have been dusted off and repurposed. "Pre-2008 we were doing a lot of condos, and land prices were elevated and the cost of construction to build them was high," said Abraham Bergman, a managing partner and co-founder at Eastern Union Funding, a mortgage broker. "But when you look at a new project today, the land has been recently purchased and it is being viewed in today's dollars so it makes a lot more sense."

Experienced developers with large balance sheets who can offer to personally guarantee at least part of the loan can borrow as much as 70 to 75 percent of the cost of a condominium project, said Alan P. Miller, an executive managing director and a principal at broker Eastern Consolidated. The rate on these loans, he said, is roughly 5 percent. In comparison, during the market peak, some developers were able to finance as much as 90 percent of the project at rates as low as 3 percent.

Lenders are also looking at financing more retail and office development, "although one of the themes of 2013 is strong preleasing," said Mr. Cotter. "There won't be much spec construction; you won't see any empty office buildings."

While banks are more open to lending for different projects and are easing some terms, their underwriting standards remain conservative. The most important aspect for most lenders is "borrower first, real estate second," said Mark Fisher, a senior vice president in the capital markets group at CBRE. "Who is the borrower, what is his liquidity, can he get us out of trouble? In every case, those are the No. 1 issues."

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Abraham Hidary, president of Hidrock Realty, said banks would now finance 60 to 65 percent of his hotel construction costs at lower interest rates.

Most construction loans now also require a completion guarantee, where the borrower promises construction will be completed within a specific time frame. They also include a maximum price contract, where the borrower obtains an agreement from the contractor that the price of construction will not exceed a certain number.

Since the downturn, lenders are also pushing more borrowers to agree to carry-cost guarantees, where the borrower assumes expenses like taxes and insurance until construction is completed and the property is generating sufficient rent to cover the costs, Mr. Lance said.

To further disperse risk, banks are also participating in so-called club deals where several banks lend on a single construction loan. Gary Rosenberg, a partner at Rosenberg & Estis, said he was working now on two construction loans. Over the last few years, he said, banks were unwilling to lend more than $50 million to $75 million. But "now, for the right borrower, we are finding that they are easily offering between $100 million and $200 million," he said.

Because banks remain conservative in their underwriting, alternative lenders like opportunity funds are stepping in to fill the void. "There is a need for those borrowers who don't want to put in so much equity," said Peter D'Arcy, regional president for New York City at M&T Bank, which will typically lend 55 to 65 percent of the cost of a project, he said. "These funds will take on more risk in return for a higher yield and do what an aggressive bank would have done back in 2007."

And it may be that as competition continues to increase, some lenders will begin shedding their conservative skin. "We are currently lending just 50 percent or less of the cost of a project, but before the crisis we were in the 65 percent range," said Mr. Cotter. "As the economy improves, that number is going to go back up."