**Tally-Whoa! Sizing Up the Risks of Construction Lending in the COVID-19 Era**

**BY**[**CATHY CUNNINGHAM**](https://commercialobserver.com/author/cathy-cunningham/)**SEPTEMBER 11, 2020 11:41 AM**



**IMAGE: MATTHEW BAEK/ FOR COMMERCIAL OBSERVER**

Construction lending isn’t easy at the best of times and didn’t earn its market “niche” categorization without financiers suffering some battle scars over the years. Savvy souls sign up to finance a complex, multifaceted process that’s often plagued with delays and cost overruns, among other issues — for a decent return, of course.

In making a construction loan, lenders are also betting on that property’s success when it’s completed two to three years down the line. But add the complexity of a global pandemic with an uncertain timeline, and you now need a crystal ball in addition to a calculator when assessing a potential deal.

While everyone agreed that our elongated market recovery from the global financial crisis couldn’t last forever, nobody thought a highly contagious virus would be the black swan event to bring it to a screeching halt. And *nobody* thought the next downturn would render us all fearful of public places and close quarters, forcing us to reevaluate our perspectives of where we work, live, play and travel.

“The world changes quickly and, as a lender, you have to reassess and pivot,” Jonathan Roth, co-founder of 3650 REIT, said. “We’ve seen this show before. It’s not the same show this time round, but there are always periods in the world of real estate where the music stops and you have to regroup.”

**It’s a Lender’s World (Again)**

Pre-pandemic, commercial real estate was indisputably a borrower’s market as lenders jostled for space in an overly crowded playing field. While some construction lenders stepped back when competition drove yield too low to compensate for the risk involved, borrowers’ cups for the most part overflowed with financing offers. Post-COVID, the power balance has shifted and lenders are once again calling the shots.

“More [lenders] are willing to consider deals compared with three months ago, and pricing is a little more expensive in response to the market uncertainty,” Shaunak Tanna, head of structured investments at Basis Investment Group, said.

“Everybody’s being a lot more careful today,” Roth said. “I think the projects that you’ll see coming out of this period of time will be really thoughtful projects, because, while there’s a lot of capital out there, it’s being very selective. We’re certainly not seeing dumb things get done.”

Morris Betesh, a senior managing director at Meridian Capital Group, said that lenders are taking a “pretty simple” approach to construction lending today. “They are absolutely willing to do construction loans, but they are focused on asset classes that have proved to be resilient during COVID-19.”

Betesh said the strongest performer in terms of those resilient asset classes has been multifamily rentals, but he’s also seeing lender appetite for office buildings in the suburbs or with strong credit tenants and — unsurprisingly — industrial properties.

“Anything else is challenging,” he said. “In theory you’re not delivering [the property] for two to three years, but lenders are not paid enough to make the bet that the world is going to be materially different years from now, so they prefer to take risk on assets that have proven to be resilient.”

Hotels and retail, both casualties of COVID-19, are therefore “super challenging,” when it comes to construction financing, Betesh said, as is any property that’s being built on spec.

Despite a new scrutiny being placed on the viability of office properties, Betesh closed a significant construction loan for a Philadelphia asset in early August: a $187 million financing for the development of Parkway Corporation’s 2222 Market Street. The built-to-suit trophy office comprises 305,000 square feet and is pre-leased to law firm Morgan, Lewis & Bockius. The capital stack included a senior loan from Citizens Bank and Santander as well as a mezzanine loan and preferred equity investment from ACORE Capital.

The deal was signed up pre-COVID, but “I would do that deal again in a heartbeat,” Warren de Haan, a co-founder of ACORE Capital, said. “Even though it’s an office property, it’s fully leased to a credit that we like, that we underwrote, and that we’re comfortable with.”

Generally speaking, though, ACORE is also focused on multifamily and industrial properties as less risky bets while the pandemic plays out.

“We’ve had success in signing up some very high-quality multifamily developments,” de Haan said. “Our belief is that you can’t really bet against the Fed’s pocketbook, plus, shelter is high on Maslow’s hierarchy of needs.” (De Haan was referring to Abraham Maslow’s paper about what motivates people psychologically.) “Notwithstanding the fact that we will likely have a high unemployment level for at least for a period of time, we still strongly believe that the government is going to continue to provide stimulus, and as that happens we should still see success in the apartment sector.”

But even financing the development of multifamily properties — the quintessential “safe haven” bet both pre- and post-COVID— isn’t necessarily easy to navigate through the pandemic’s murky veil.

“How do you underwrite rents?” Tanna said. “Do you keep them at the same level as today? Do you do trend growth, as per the long-term averages? Those are all those questions all lenders are struggling with. What we’re trying to do [at Basis] is underwrite conservatively and not include trending growth in rents — meaning underwriting to today’s levels and leaving room for error.”

An added complexity is that some markets have been disproportionately impacted by COVID-19. In New York City, rents have dipped as interest in suburban housing picks up.  As such, the two deals Basis has done post-COVID are in suburban Chicago and suburban Long Island. “That’s where our focus has shifted,” Tanna said. “As opposed to trying to develop in Brooklyn or Long Island City, our focus has shifted to where people want to live right now.”

While some view New York’s density as a con post-COVID, properties with the luxury of extra space continue to land significant financings. Case in point, in late July, Cape Advisors and The Pioneer Group closed $280 million in debt and joint venture equity for the development of 30-77 Vernon Boulevard, a three-building rental property on Astoria’s waterfront with plenty of surrounding outdoor space. Square Mile Capital Management provided the debt.

COVID has accelerated some trends that were already firmly in play pre-pandemic, including the red-hot attractiveness of the industrial sector, as e-commerce skyrockets and in-person retail declines even further.

As such, construction loans on industrial properties continued to close during COVID — a recent example being J.P. Morgan and Square Mile’s $155 million loan for DH Property Holdings and Goldman Sachs Asset Management’s planned project at 640 Columbia Street in Red Hook, Brooklyn — and are perhaps more competitively bid than ever, sources said.

“We are doing a couple of large construction loans right now, and we would continue to do more of that type of lending on both a speculative basis as well as a lease basis,” de Haan said. “[Multifamily and industrial] are making up the majority of what we are doing right now in the construction sector.”

Conversely, hospitality — like retail — has become the second red-headed stepchild of the COVID fallout.

“We think that there’s still a lot to learn about any potential behavioral changes in the office and in hospitality sectors,” de Haan said. “ So, for example, how confident are you that demand is going to return in the hospitality sector? And how would you effectively underwrite that? There’s also a lot of science being done around the additional costs associated with cleaning and other COVID-related activities that are going to be needed in hotels. And what is the impact going to be on the P&L? It’s just too early to know. Hospitality is not a place that we feel is a good use of our capital right now.”

**Equity Equation**

Of course, it’s not just lenders who are taking risks in development deals today.

“Developers deserve to be rewarded with great riches,” Roth said. “They have to conceive of a project, acquire the underlying land, and then they have to develop it. That process can take years and years, and the world changes, it doesn’t stand still. Construction is fraught with risk, and that’s why the reward should be what it is. From a construction standpoint, we as lenders protect our downside by identifying each node of risk; we quantify that risk, and then we find an appropriate downside mitigant for that. And that translates into proceeds, pricing and structure.”

Pre-COVID, the market was awash with capital, and, while there’s still plenty out there, lenders are being far more cautious now in how much leverage they offer. Before the pandemic, senior construction lenders were in the 60 to 65 percent loan-to-cost range, while today they’re at around 50 to 55 percent, Tanna said, referring to non-recourse construction loans specifically: “We are typically filling the gap from that level up to about 75 percent. So, overall, leverage has come down by anywhere from 5 to 10 percent on development, and equity is plugging the gap.”

The industry thankfully had a head-start on this conservative approach as pre-COVID leverage was much more muted in comparison to leverage prior to the global financial crisis, when it was common for CMBS loans to reach 80 percent loan-to-value, and for mezz pieces to bring that level up to 90 percent. “From that perspective — and this is across all loan types, not just construction — I think the industry has done a good job, generally speaking, of maintaining discipline,” Tanna said.

But, he added, less leverage means more equity from sponsors, and that has led to a natural selection of strong sponsors in the post-COVID environment — because not everybody can come up with the additional equity needed. “In that sense, we like the development space right now because the quality of sponsor and deals is such that only the best sponsors in the best locations are getting execution,” Tanna said.

De Haan said that the quality of the borrower base is also improving. “Because construction financing is harder to get right now, the quality of our borrowers continues to improve as we’re financing borrowers that otherwise were only taking bank debt at very cheap levels and are now willing to pay the freight with a debt fund or a group like us. So, we’re seeing very high-quality clientele because construction financing is not as readily available. Borrowers used to get financed at Libor plus 250, non-recourse. Now they’re willing to borrow money at Libor plus 500.”

**COVID Clauses**

In general, construction loans have a lot of protection built into them in the form of carry guarantees and completion guarantees, but those CO spoke with said they haven’t seen any additional pandemic-related language written into loan documents — yet. There is, however, additional structuring in place to protect against elongated construction or lease-up periods.

“There’s an evolving set of structural changes, which include greater reserves for operating shortfalls,” Roth said. “We’re doing this on our stable cash flow product as well; building in larger reserves to facilitate longer ramp-up periods or periods of uncertainty where you might have — if it’s a multifamily property — a portion of your tenants who are unable to pay rent.”

Seattle-based Broadmark Realty Capital has been actively providing multifamily construction loans through the pandemic. “If we as lenders keep our underwriting criteria in front of us and know that what might have been a 24-month loan can end up being a 30-month loan we can plan for that,” Jeff Pyatt, CEO of Broadmark, said. “We do stress testing, so cap rates might not be at 5 percent, they might be at 7 percent. And vacancy rates might not be at 5 percent, they might be double that at 10 percent. And so what’s that going to do to our model? What we do is look at the deal and say, ‘Okay, we can do it given the structure,’ or we’ll say, ‘We can’t, you need to bring in an extra 5 percent equity,’ or whatever the number is.”

The calculation isn’t easy, though.

“There’s so much complexity being thrown in the lending community today, because of the disparate laws, whether it’s through executive order or black letter law in any particular jurisdiction,” Roth continued. “It’s sometimes hard to know which direction to turn, because the government is throwing in a lot of protections for tenants in both commercial and residential properties, but they’re not throwing in the same protection to the owners, and those owners still have their responsibility and obligations to their lenders.

“What we do when we’re making a new credit decision today is bake in all that uncertainty,” he added. “We’re very mindful of coming up with a structure that protects our downside, because, as a lender, our best day is when we make a loan and it gets repaid. So, we have to be very conservative in our view of the world.”

And part of that conservative approach trickles down to language in post-COVID leases.

“There’s going to be language in new leases — which are basically the credit documents that support our loans — and properties are going to have to live up to certain standards for tenants,” de Haan said. “I do expect that we will see some tightening or some of the loan covenants and requirements, but we are going to be a backstop to what’s in the leases.”

**Lend of Opportunity**

One thing for sure is there’s plenty of opportunity in today’s market.

“Lenders are able to extract terms that are super profitable relative to what their cost of funds are,” Betesh said. “So it’s a better time than ever to be a construction lender.”

Additionally, several lenders walked away from construction deals during the pandemic or retraded borrowers, allowing other firms the chance to step in.

Tanna said he’s seen deals where equity partners have exited or senior lenders have reduced proceeds and there is a new need for mezzanine financing: “We’re seeing situations where somebody was committed to a transaction or close to coming into a transaction, pre-COVID, then COVID hit and they reworked the numbers or walked away so the developer needs more equity.”

At the start of COVID, Roth said 3650 REIT closed seven loans where borrowers were left at the altar by other lenders.

“In every case that I can think of, loan documents were being negotiated,” Roth said. “Then the borrower got the phone call that the lender could no longer honor their commitment. It wasn’t shocking to us at 3650 REIT because we have been doing this for a very long time and lived through a lot of cycles where when some exogamous event occurs, the capital markets shut down. Those lenders that relied upon the capital markets, for leverage or other sources of capital, oftentimes cannot fulfill their obligations and the borrower ends up suffering.”

Pyatt said Broadmark has also seen several opportunities to step into loans where other lenders have walked away, but that some of those lenders are now back in the game, with new funding.

“I think we will see fewer opportunities as time goes because lenders are coming back,” he said. “I’m told there are new entities coming in to fund some of our competitors, that they’re getting their lines of credit from one life insurance company or another. I never know quite what to believe. All I know is that we have a great pipeline, and we’re holding our pricing, we’re taking good care of our borrowers, and we’re comfortable with our collateral. The rest of this stuff becomes noise because there’s always another competitor; there’s always somebody trying to undercut you. All we can do is do what we do, and do it really well.”