CONSTRUCTION LENDING

If You Build It, They Will Come*  
(*Subject to Approved Financing)
Your Presenters

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Construction Lending
The Players

- Lender
- Borrower/Sponsor
- Equity Funders
- General Contractor
- Subcontractors
- Design professionals
The Lender
The Lender

• Principal Concerns
  • Project built on time and within budget
  • Collateral value increases with loan balance
  • Borrower/Guarantor(s) can financially support project
  • Maintain lien priority
  • Ability to step in and complete if necessary
The Borrower/Sponsor
The Borrower/Sponsor

• Principal Concerns
  • Risks vs. Rewards
  • Accessibility of loan proceeds
  • Ability to comply with Lender requirements
  • Retain control of the Project
The Equity Funders
The Equity Funders

• Principal Concerns
  • Risk to investment
  • Implications on returns
  • Equity requirements
  • Preservation of remedies
GC, Subs, & Design Professionals
GC, Subs, & Design Professionals

- Principal Concerns
  - Prompt Payment
  - Preservation of lien rights
  - Remedies/obligations in the event of foreclosure by Lender
  - Certifications, warranties and representations required by Lender
  - Approval requirements, i.e. change orders/amendments, modifications to plans and specs
Types of Lenders

• National Banks
• Regional Banks
• Preferred Equity Investors, or “Hard Money” Lenders
• Joint venture
Financing Options
Types of Financing

• Construction-to-Permanent
• Mini-perm
• Second-Lien Financing
• Mezzanine Financing
• Preferred Equity Investors
• Joint Venture Arrangements
Construction-to-Permanent

• Closest to “classic” approach
• Initial short-term financing for construction to lease
  • Usually higher interest and interest accrued during construction
• Followed by long-term financing after “stabilization” to “take out” the construction loan
Mini-Perm

• Solves challenge of limited stabilized revenue
• Financing that “takes out” construction loan, but shorter than permanent financing
• Provides operating history prior to refinancing in permanent market
Mezzanine Financing

• Hybrid of debt and equity financing
• Gives lender right to convert to equity if default
• Permanent lenders may hesitate without inter-creditor agreements
Preferred Equity Investor

• Similar to mezzanine financing
• Builds financing into entity’s operating agreement
• Generally get preferred rate of return and accelerated repayment on maturity date
• Can be used for more complicated structures, such as “waterfalls”
• Lack foreclosure rights, but have contract remedies set forth in operating agreement
Joint Venture Arrangements

• Temporary agreement to create a subsidiary that has access to the resources of each venture partner
• Spreads risk and rewards among members in proportion to member’s interests
• Enables bids on otherwise-unavailable projects
• Financing built into JV operating agreement
Role of Counsel
Internal Counsel

• Business terms and representations and warranties
• Due Diligence
• Loan obligations and administration
• Compliance with internal policies
• Efficient coordination with outside counsel
External Counsel

• Advise with the transaction as a whole in mind
  • Understand the client’s operations, organization and needs
  • Understand the current state of the Project
• Ensure conformity of loan documents
• Provide insight on what is market in the industry and locality
• Leverage relationship with lender counsel
Getting the loan
Challenges in Construction Lending

• No operating history
  • Special purpose entities
  • Link separate projects by common development manager experience
• Collateral is incomplete
  • Development team and GC are key
• Loan-to-Value ratio is a moving target
  • Keeping loan in balance
  • Continual monitoring of progress
• Stage of Development
  • Construction may have started
  • Prior mortgages/deeds of trust and collateral assignments
‘Vertical’ Development

• Value in pre-leasing
• Municipal permitting issues
• Property management
• Core construction vs. finish-out construction
‘Horizontal’ Development

• Commitment for purchase of permit-ready lots
• Utility Availability
• Accessibility of the Project
• Obligations to dedicate improvements
Due Diligence

• Feasibility of Project
  • Project plans
  • Utilities
  • Environmental

• Credit of Borrower and Guarantors
  • Financial statements, tax returns, other liabilities
  • Equity and sources

• Cost and Completion
  • Budget
  • Project schedule
  • Experience

• Legitimacy of Borrower
  • Evidence of formation and organization
  • Verification of authorization for the transaction
Underwriting

• Net Operating Income
  • Pre-leasing requirements
• Loan-to-Value ratio
  • Challenge: constantly moving target
• Loan-to-Cost ratio
  • Can borrower or guarantor(s) meet shortfall
• Debt Service Coverage Ratio
  • Improper pricing can jeopardize Lender’s return
Maximizing Negotiating Leverage and Flexibility

• Borrower’s leverage is typically limited
  • Solicit financing options from competing lenders
  • Potential for future projects and repeat business
• Recourse vs. non-recourse
• Guaranty of equity members of borrower
• Clear conveyance of borrower’s requests and reasons for them
Loan Documentation

• Promissory Note
• Construction Loan Agreement
• Deed of Trust or Mortgage
• Guaranties
• Assignment of Construction Contract and Design Documents
• Environmental Indemnity Agreement
Key Provisions

“We have an agreement in principle. The question is, do we all have the same principles?”
Key Provision 1: Budget

Lender reserves the right to make Advances which are allocated to any of the designated items in the Approved Budget for such other purposes or in such different proportions as Lender may, in its sole discretion, deem necessary or advisable. Borrower may not reallocate items of cost or change the Approved Budget without the prior written consent of Lender. Advances against the contingency line item on the Approved Budget shall be made only for such purposes as Lender may hereafter approve.
Key Provision 2: Change Orders

Borrower shall deliver to Lender revised, sworn statements of estimated costs of the Project, showing any requested changes in or variations from the original Approved Budget, as soon as such need for any such changes is known to the Borrower. Any such changes shall be subject to the approval of Lender, in Lender’s sole discretion and Borrower shall not consent or agree to any change in the Plans, the Construction Contract, or the Project without the prior written consent of Lender.
Key Provision 3: Insurance (1 of 2)

Each of Borrower and Parent shall keep its insurable properties adequately insured at all times by financially sound and reputable insurers; maintain such other insurance, to such extent and against such risks, including fire and other risks insured against by extended coverage, as is customary with companies in the same or similar businesses operating in the same or similar locations, including public liability insurance against claims for personal injury or death or property damage occurring upon, in, about or in connection with the use of any properties owned, occupied or controlled by it; and maintain such other insurance as may be required by law. Each of Borrower and Parent shall cause all such policies to be endorsed or otherwise amended to include a "standard" lender's loss payable endorsement, in form and substance reasonably satisfactory to Lender, which endorsement shall provide that, from and after the Closing Date, if the insurance carrier shall have received written notice from Lender of the occurrence of an Event of Default, the insurance carrier shall pay all proceeds otherwise payable to any Loan Party under such policies directly to Lender; cause all such policies to provide that neither any Loan Party, Lender, nor any other party shall be a coinsurer thereunder and to contain a "Replacement Cost Endorsement" without any deduction for depreciation, and such other provisions as Lender may require from time to time to protect its interest; . . .
Key Provision 3: Insurance (2 of 2)

... deliver original or certified copies (or certificates evidencing the same) of all such policies to Lender; cause each such policy to provide that it shall not be canceled, modified or not renewed (a) by reason of nonpayment of premium upon less than 10 days' prior written notice thereof by the insurer to Lender giving Lender the right to cure defaults in the payment of premiums, or (b) for any other reason upon less than 30 days' prior written notice thereof by the insurer to Lender; deliver to Lender, prior to the cancellation, modification or nonrenewal of any such policy of insurance, a copy of a renewal or replacement policy (or other evidence of renewal of a policy previously delivered to Lender). Further, Borrower shall cause the General Contractor to maintain such insurance to such extent and against such risks as is customary with companies in the same or similar businesses operating in the same or similar locations, including public liability insurance against claims for personal injury or death or property damage occurring upon, in, about or in connection with the Project, as may be required by Lender, and to furnish evidence of same to Lender.
Key Provision 4: Retainage

With respect to the portion of each Advance that is to be used to pay costs of development or of construction of the Improvements, Lender may, at its election, retain (a) all amounts permitted to be retained by owner under the terms of the Construction Contract less amounts to be funded by the Development Incentives, plus (b) the amount or amounts necessary to pay any claims of persons who may have sent notices thereof to Borrower in accordance with [Sections 53.056, 53.057 or 53.058 of the Texas Property Code], as amended (collectively referred to herein as “Retainage”).
Key Provision 5: Timing of Payments (1 of 2)

Whenever Borrower desires to obtain an Advance of Loan proceeds for the portion of the Approved Budget allocated to the Construction Contract, Borrower shall submit to the Inspecting Architect (unless and until Lender notifies Borrower otherwise) and/to Lender such documentation as Inspecting Architect shall request with respect to such Advance, at least ten (10) days prior to the date on which the requested Advance is to be made ("Advance Date").
Key Provision 5: Timing of Payments (2 of 2)

The provisions of this Agreement requiring submission of the documentation described in above and the required retainage specified by this Agreement shall not apply with respect to Loan proceeds to be disbursed for the items listed below, which may be disbursed in full upon submission of a Disbursement Request listing such items signed by Borrower or, upon default, by Lender, and/or the following special documentation, if any:

<table>
<thead>
<tr>
<th>Item</th>
<th>Special Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender charges (interest, fees, etc.)</td>
<td>Lender invoice</td>
</tr>
<tr>
<td>Attorneys’ fees (including Lender’s counsel)</td>
<td>Copy of statement</td>
</tr>
<tr>
<td>Inspecting Architect’s fees</td>
<td></td>
</tr>
<tr>
<td>Real estate taxes on the Project and Land</td>
<td>Copy of bill</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>Copy of statement</td>
</tr>
<tr>
<td>Soft Costs and other indirect (non-construction) items</td>
<td>Copies of invoices or as specified by Lender</td>
</tr>
<tr>
<td>FF&amp;E</td>
<td>Copies of invoices</td>
</tr>
</tbody>
</table>
Key Provision 6: Conditions of Advance

The Lender shall not be obligated to make the initial advance or any subsequent advance under this Agreement or the other Credit Documents unless:

a) Borrower has delivered current Subordination Agreements executed by each Contractor under each Construction Contract then existing and each subcontractor and materialman who has supplied or will supply labor or materials to the Project;

b) Borrower has delivered copies of all contracts then in existence with each Subcontractor

c) Borrower has delivered a current Survey
Key Provision 7: Lender’s Control (1 of 2)

**Negative Pledge.** Borrower shall not grant, suffer or permit any contractual or noncontractual lien on or security interest in the Project, or any of its other assets, its assets, except for Permitted Liens. Parent shall not grant, suffer or permit any contractual or noncontractual lien on or security interest in any of its assets, except for Permitted Liens.

**Merger, Etc.** Neither Borrower nor Parent shall enter into any merger or consolidation.

**Extensions of Credit.** Neither Borrower nor Parent shall make any loan or advance to any individual, partnership, corporation or other entity without consent of Lender, except (a) loans and intercompany adjustments between Parent and Borrower and their respective subsidiaries occurring in the ordinary course of business, and (b) advances made to employees of Borrower and Parent for the payment by them of items for which an expense report or voucher will be filed and which items will constitute ordinary and necessary business expenses of Borrower and Parent.

**Borrowings.** Neither Borrower nor Parent shall not create, incur, assume or become liable in any manner for any indebtedness (for borrowed money, deferred payment for the purchase of assets, lease payments, as surety or guarantor for the debt for another, or otherwise) other than to Lender, except for (a) normal trade debts incurred in the ordinary course of their respective business; (b) existing indebtedness disclosed to Lender in writing and acknowledged by Lender prior to the date of this Agreement; (c) leases of personal property which are not "capital leases" under GAAP and for which the lessor's remedy for a breach by the lessee thereunder is limited to recovery of the item leased; (d) net liabilities under Swap Agreements permitted hereunder (valued at the termination value thereof, computed in accordance with the method agreed to by the parties in the applicable Swap Agreement); and (e) indebtedness secured by purchase money security interests permitted by this Agreement which is included in the Budget.
Transfer of Assets. Neither Borrower nor Parent shall convey, assign, transfer, sell, lease or otherwise dispose of, in one transaction or a series of transactions (or agree to do any of the foregoing at any future time), all or substantially all or a substantial part of its properties or assets (whether now owned or hereafter acquired) or any part of such properties or assets which are essential to the conduct of its business substantially as now conducted.

Change of Control. Borrower and Parent shall not permit the change of control of Borrower or of Parent. "Change of control" means (a) as to Borrower, Parent ceases to own 100% of the Equity Interests of Borrower, and (b) as to Parent, [enter name of Parent’s general partner] ceases to be the general partner of Parent.

Change in Management. Borrower shall not permit [name of current President/CEO] to cease being the President and Chief Executive Officer of Borrower. Parent shall not permit [name of current President/CEO] to cease being the President and Chief Executive Officer of the general partner of Parent.

Change in Nature of Business. Neither Borrower nor Parent shall conduct any business other than, or make any material change in the nature of, its business as carried on as of the date hereof.

Subsidiaries. Neither Borrower nor Parent shall form or acquire any subsidiaries.

Restricted Payments. The Borrower shall not declare or make any dividend payment or other distribution of assets, properties, cash, rights, obligations or securities (whether as a return of capital or as a loan repayment) to any partner, member or other equity holder, except that while no Event of Default exists, Borrower may make distributions of assets to the owners of Borrower only for the purposes of paying taxes incurred as a result of the income earned by Borrower (any such payment a "Restricted Payment").
Key Provision 8: Notice and Cure (1 of 2)

Borrower shall default in the payment of principal due according to the terms hereof or of the Note and such default shall not have been cured within ten (10) days after Borrower has been provided with written notice thereof. Additionally, Borrower shall default in the payment of interest on Advances made by Lender or in the payment of fees or other amounts payable to Lender hereunder or under any one or more of the Loan Documents and such default shall not have been cured within five (5) days after Borrower has been provided with written notice thereof.
Key Provision 8: Notice and Cure (2 of 2)

Borrower shall default in the performance or observance of any other agreements, covenants or conditions required to be performed or observed by Borrower under the terms of this Agreement or any of the Loan Documents and such default shall not have been cured within thirty (30) days of written notice thereof from Lender to Borrower, except if Borrower cannot reasonably cure such default within such thirty (30) day period, Borrower shall have a reasonable time to cure the default provided Borrower commences to cure the default within such thirty (30) day period and diligently prosecutes such cure to completion.
Key Provision 9: Borrower’s Reps & Warranties (1 of 2)

No Litigation or Defaults. There are no actions, suits, or proceedings pending or, to the knowledge of Borrower, threatened against or affecting Borrower, any of Borrower’s members, or any Guarantor or the Project or involving the validity or enforceability of the Loan Documents or the priority of the lien thereof, except as revealed in writing, at law or in equity, and neither Borrower, any of Borrower’s members, nor any Guarantor is in default under any order, writ, injunction, decree, or demand of any court or any administrative body having jurisdiction over Borrower.
Financial Information. The financial statements of Borrower, Borrower’s members, and Guarantors previously or hereafter delivered to Lender fairly and accurately present or will fairly and accurately present the financial condition of Borrower, Borrower’s members, and Guarantors as of the dates of such statements, and neither this Agreement nor any document, financial statement, credit information, certificate or statement referred to herein or furnished to Lender by Borrower, Borrower’s members, and Guarantors contain or will contain any untrue statement of a material fact or omit or will omit a material fact or is or will be misleading in any material respect.

There has been no material adverse change in the financial condition of the Borrower, any of Borrower’s members or any Guarantor since the latest financial statements given to Lender. At Lender’s request, any certified financial statement submitted by Borrower, a member in Borrower, or a Guarantor to Lender shall contain an acknowledgement that it has been prepared in accordance with cash basis accounting principles and that it is being submitted to induce Lender to make the Loan or continue to make additional Advances on the Loan.
Key Provision 10: Interest Rate

%
Key Provision 11: Events of Default

- failure of the Borrower or any Contractor to perform, observe or comply with any of the terms, covenants, conditions or provisions of any of the applicable Construction Contracts;
- failure of any Purchaser or any Development-Related Entity to perform, observe or comply with any of the terms, covenants, conditions or provisions of any Development Agreement or Sales Contract;
- Any party under any Development Agreement or Sales Contract shall repudiate or attempt to repudiate its obligations under the Assurances;
- create or suffer to be created any lien, encumbrance, easement, use or charge affecting any of the Premises other than liens securing the Debt;
- modify or amend the Development Plan in any respect
- Lender shall reasonably deem itself to be insecure.
Key Provision 12: Call for Funds

If the Lender reasonably determines at any time that the unadvanced Loan proceeds will be insufficient to pay for (a) Completion of the Improvements in accordance with the Plans and Specifications and all Legal Requirements and (b) all other items set forth in the Approved Budget, including but not limited to, interest which the Lender estimates may accrue on the Debt prior to its maturity, the Borrower shall make arrangements satisfactory to the Lender to provide sufficient funds to complete the Improvements in accordance with the Plans and Specifications and all Legal Requirements and to pay for all other items set forth in the Approved Budget.
Loan Administration

- Balance between control and being too cumbersome
- Active versus passive administration
- Draw requests
- Change orders
- Lien waivers
- Dispute resolution
Questions?
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