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A tale of three construction loans gone awry in Manhattan: A review to builders and brokers

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Recently, my company, Wawona Worldwide Capital, LLC was contacted to arrange financing for three construction deals in Manhattan. One project was a $4 million project on the West Side, and two others for $36 million and $16 million were on the Upper East Side. Remarkably none of them has received financing. A quick review is instructive to builders and brokers alike.

The project on the West Side was a rehabilitation of two-three apartments in a mixed-use six-unit (five apartments / one retail space ground floor) building. I found the developer in the newspaper, met him with a colleague and we quickly put an offer together for him from a local bank in one to two days. A few days later the developer decided not to take our bank's offer even after signing our fee agreement. The developer had had a change of heart and began demanding a non-recourse loan because one of the larger brokerage houses promised to get it for him. Weeks later I found the developer in the paper again searching for the same loan. It seems he would not listen to us even when we explained to him that even substantial developers like Harry Macklowe were required to put up substantial personal guarantees to get financing today.

The same developer has a project on the Upper East Side that has gone through similar machinations. Back in April we brought his loan to a well know construction lender in Manhattan. They were in the middle of producing a nice offer, when the developer began to advertise for a loan in the newspaper again. Before our offer could be released, two other brokers showed up at our lender representing the same project. Of course the bank was furious and pulled its offer. Now the sponsor has $0 financing. And given what has happened, he is back in the newspaper looking for JV partners because his liquidity has dried up and would be found to be inadequate today to sponsor any project. In the end had he taken our lenders' offers, the developer would have had two projects well underway. At best, now he will have to sell some of his holdings to be able to complete some of the others.

Sometimes, however, not even hefty personal guarantees and liquidity help. As to the other project on the Upper East Side, the sponsors had a) substantial equity in their deal, b) substantial liquidity, c) a construction loan in hand but, d) only very expensive mezzanine to round out the deal. The developer's management was not comfortable with the expensive mezzanine, so it asked our firm to arrange to have the whole financing done by one hedge fund. While the hedge fund was willing, the hedge fund stumbled because they could not get satisfied since the project had $0 presales. (A presale is defined as a signed purchase and sale agreement that has a non-refundable deposit in place of at least 20-30% of the purchase price.)

Recent articles in the Wall Street Journal point out the problem. Nearly one in three banks that the FDIC has recently analyzed has construction loan portfolios that exceed 100% of their total risk based capital. Even more alarming, 73 of those banks had construction loan delinquency rates of more than 25%. Over the next few quarters, banks are expected to begin recording much larger write-offs. For example, in the first quarter of 2008 U.S. banks wrote down just 0.7% of their residential construction and land assets as bad debt, according to Zelman & Associates. Over the next five years that figure could rise to 10-26% which would mean that about $65 billion - $165 billion will be written off. In short, developers have to have: a) uniform story with one broker representative; b) strong liquidity; c) substantial net worths to provide meaningful recourse; and, d) substantial pre-sales to succeed in obtaining construction loans in this market.

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