

Building Momentum

Construction and Risk in a Post-Recession Era



Foreword



“Solving the puzzle of uncertainties – changing real estate conditions, construction trends, financial markets and other variables – continues to present developers with a fascinating, and profitable, challenge.”

— **Ken Sisk, PE**
National Client
Manager, Consulting &
Engineering Services
Partner Engineering and
Science, Inc.

Decision-making in any business is complex, but so many variables can affect a commercial real estate development that deeper insights into all facets of risk are needed.

To better understand how the industry copes with construction risks, Partner Engineering and Science, Inc. and GlobeSt.com continue efforts to identify and evaluate the concerns of industry participants with this latest in-depth survey, focusing on current market trends and risk management policies and practices in the commercial real estate industry. In this survey, we asked two key groups, lenders and developers/investors, to evaluate the current state of construction risk management practices and how those practices affect the current business environment. We also wanted to learn more about survey respondents’ experience with failed construction loans and projects, and the factors contributing to the failures.

The responses suggest that while the industry’s prospects appear to be improving over the near term, the financial crisis of 2007-2008—and its lessons about prudent underwriting and deal selection—is still very much in the minds of market participants as they evaluate credit and construction risk of their deals.

—**Steve Lubetkin**
Custom Content Editor
GlobeSt.com



Executive Summary

Despite broad agreement among survey respondents that markets are poised for growth across almost all sectors, the financial market collapse of 2007-2008 cast a long shadow over how market participants have worked during the past five to six years, and continues to affect how they are likely to approach the anticipated resurgence of construction and development going forward.

The failures experienced during the recession have led to increased regulatory oversight, and greater management scrutiny through tighter underwriting/risk management.

“A single failure can wipe out the profits from a dozen loans. It’s important for lenders to stay abreast of market risks in order to protect assets and maximize profits,” notes Brian Ward, Technical Director of Construction Risk Management for Partner.

Indeed, regulatory concerns dominate among survey participants who were lenders (one-third of the respondents). Most reported being regulated by some federal or state agency. Of these, some 37% said regulations and bank audits were the primary driver of risk management policy in their organizations. Policy dictated by stakeholders in the project; preventing loss, whether from lawsuits, engineering or non-engineering causes; and the anticipation of future variables such as market trends, subcontractor defaults and labor shortages all weighed to a lesser degree on lenders’ decisions.

“Bank regulation is a substantial force in the industry that affects regulated institutions and could even create opportunity for non-

regulated institutions in areas like construction lending,” says Joe Derhake, PE, President of Partner.

While lenders may seem more focused on construction risk management than before the financial crisis, it’s clear that construction risk management is handled differently among various institutions. Asked which department creates construction risk policies for lenders, there is no clear consensus among respondents though 31% reported that Executive Management is involved. 44% of developers reported using a mix of in house staff and 3rd party firms for due diligence, while others use only in-house staff or only 3rd parties.

“People’s roles within their institutions really affect how they see the deal, the risks involved, and how they approach risk management,” observes Bill Tryon, Director of Strategic Development at Partner.

Respondents also said due diligence had become a more important factor in evaluating projects, including the use of feasibility assessments, property condition assessments, and document

and cost reviews.

Says Partner’s Ken Sisk: “Feasibility reports require an understanding of market-based ambitions along with engineering and entitlement constraints.”

Among the issues that seem to be keeping lenders awake at night is the need to balance risk management with remaining competitive, while also responding to regulatory pressures. Developers are mainly

KEY FINDINGS

Primary drivers of construction risk management:

- Regulations and bank audits
- Policy dictated by other stakeholders
- Preventing loss (from lawsuits, engineering problems, non-engineering problems)
- Anticipating variables (like market trends, subcontractor defaults, labor shortages)

concerned with being able to anticipate market demand, labor availability, and subcontractor performance.

On a brighter note, there was widespread agreement that markets were poised for strong growth over the next year in at least six of the ten sectors—single family, hospital/healthcare, multifamily, mixed-use, retail, and distribution/warehouse. Regionally speaking, respondents reported an expectation of higher construction costs in all areas, but especially in the West.

“The west is hot, but challenging as inflation in construction costs are more pronounced in California and Washington,” notes Sandy MacLean, Technical Director of Construction Risk Management for Partner.

Respondents also indicated they have little concern about current labor shortages, regardless of the geographic region.

Ultimately, if the financial crisis has made lenders more aware of the risks they need to monitor, keeping a close eye on their risk management policies is going to be a positive development for the commercial real estate markets. But as Bill Tryon notes, “Banks should not let regulators drive their policy. Banks profit by taking risks. The most successful lenders take steps to understand and mitigate risks in order to maximize profitability. Policy must balance competitiveness with risk management.”

In the final analysis, robust advance planning, coupled with solid risk management policies and open lines of communication are the best defense.

As Ken Sisk notes, “Short of predicting the future, the best way to limit risk is to do thorough due diligence, plan ahead, put a lot of contingencies in place, have great communication between all parties, and work with a team you really trust.”



“Entering new markets presents new risks and unknowns for institutions, so risk management policy should be a living and flexible thing that evolves as the business evolves.”

— **Bill Tryon**
Director of Strategic Development
Partner Engineering and Science, Inc.

Methodology

Thought Leader Partner **Engineering and Science, Inc.**, and **ALM Real Estate Media Group's GlobeSt.com** conducted this online survey to better understand the current construction trends and risk management policies and practices of commercial real estate professionals.

Respondents were asked for their assessment of the business environment both now and in the next 12 months, what current policies and procedures are in place for construction risk management, how changes to these policies are prompted and the levels of failed projects or loans their institutions have been exposed to in the past, among other topics.

The study was conducted between August and September 2014 and pulled from over 200 respondents.

Note: For many of these questions, respondents were asked to include their top two or three answers, so results will not be equal to 100%.

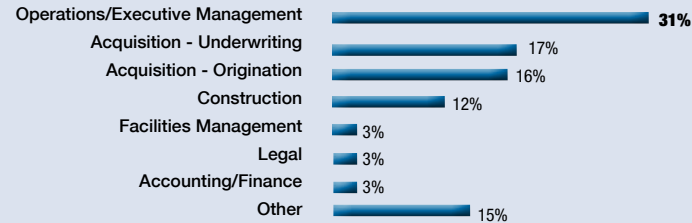
RESPONDENT PROFILE

Owner/Investor/
Developer

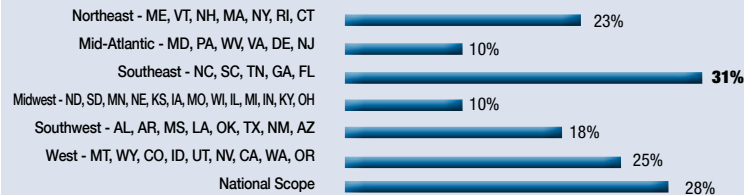
63%

Developer.....35%
Investor.....23%
REIT.....5%

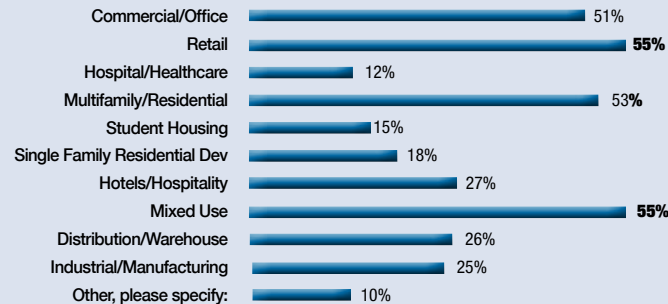
JOB FUNCTION



REGION OF OPERATION



PROPERTY TYPE



C&D PORTFOLIO

\$25.8M **37%** of deals/loans have a construction/development component.
average size of institution's deals that involve a construction/development component.

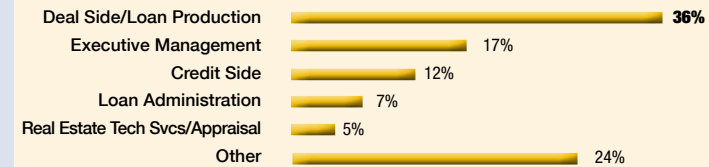
DEVELOPERS

LENDERS

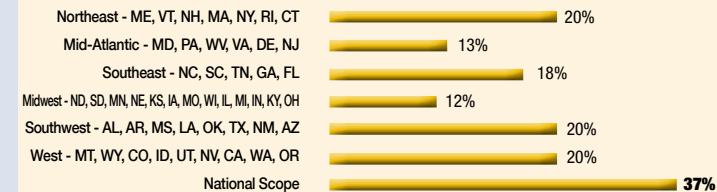
What is your institution's primary function?

Lender 37%
Lender.....31%
Attorney Representing Lender.....6%

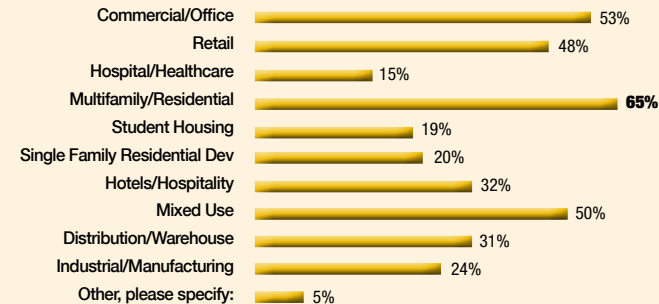
What category most closely represents your primary job function or discipline?



In which U.S. region(s) does your business primarily focus?



In which sectors is your institution an active participant?





Construction Trends Expected Over the Next 12 Months

Developed in conjunction with:

PARTNER
Engineering and Science, Inc.

In the next 12 months, what kind of changes in construction activity do you anticipate for...

SINGLE FAMILY/ RESIDENTIAL



↑ 71%

■ 20%
 ↓ 4%
 ? 4%

HOSPITAL/ HEALTHCARE



↑ 67%

■ 29%
 ↓ 0%
 ? 5%

MULTIFAMILY/ RESIDENTIAL



↑ 56%

■ 33%
 ↓ 7%
 ? 4%

MIXED USE



↑ 56%

■ 39%
 ↓ 1%
 ? 4%

RETAIL



↑ 51%

■ 36%
 ↓ 5%
 ? 7%

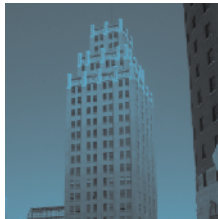
DISTRIBUTION/ WAREHOUSE



↑ 50%

■ 33%
 ↓ 6%
 ? 12%

COMMERCIAL/ OFFICE



↑ 47%

■ 36%
 ↓ 11%
 ? 6%

HOTELS/ HOSPITALITY



↑ 44%

■ 42%
 ↓ 12%
 ? 2%

INDUSTRIAL/ MANUFACTURING



↑ 39%

■ 45%
 ↓ 9%
 ? 7%

STUDENT HOUSING



↑ 29%

■ 46%
 ↓ 21%
 ? 4%



“This data reflects an overall improving economy, but also trends driven by demographics like a new generation of home buyers, a demand to live, work and play in urban areas, aging baby boomers, and other things like the continued growth of e-commerce.”

— Joe Derhake, PE
 President
 Partner Engineering
 and Science, Inc.

KEY:

↑	Increase
■	Flat
↓	Decrease
?	Don't know

Note: Only respondents who are active in a sector were able to answer for that sector.

In the next 12 months, what kind of changes do you expect in construction activity and costs?

“The west is hot but challenging as inflation in construction costs are more pronounced in California and Washington.”

— **Sandy MacLean**
 Technical Director,
 Construction Risk Management
 Partner Engineering and Science, Inc.



“As the recovery progresses, costs are expected to continue to increase as suppliers and workers re-tool for renewed growth. Careful review of projected budgets can minimize the impact to new developments.”

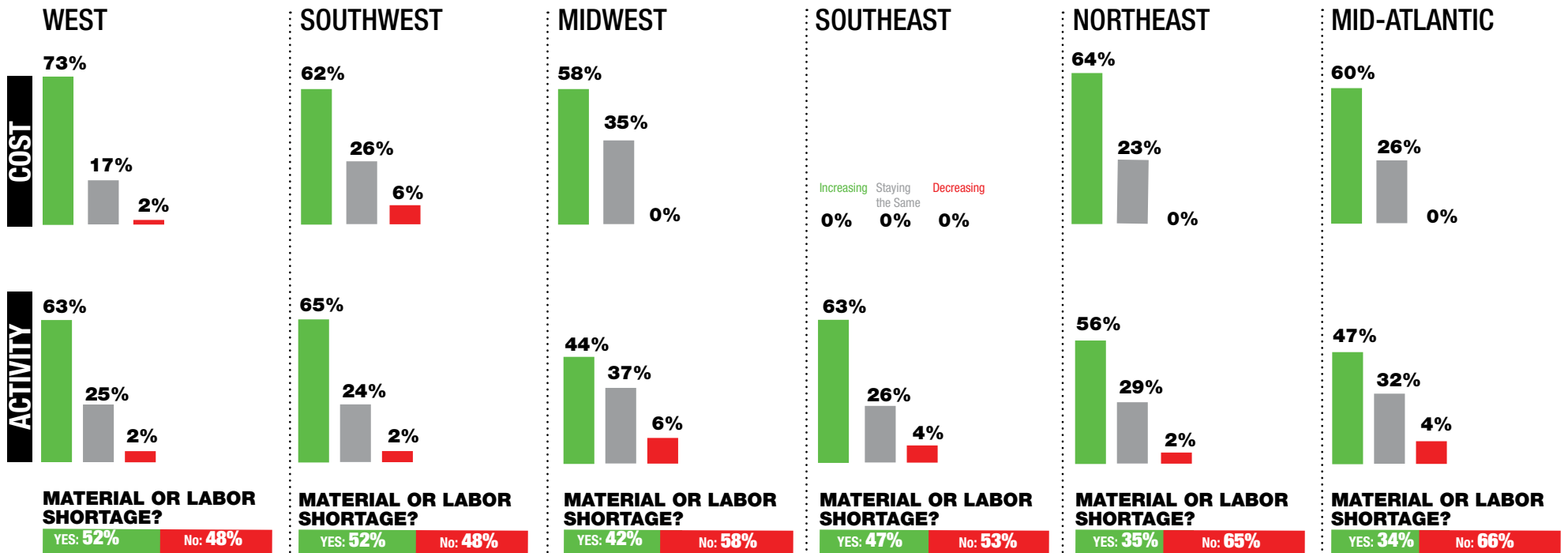
— **Joey Bonin**
 National Client Manager,
 Construction Risk Management
 Partner Engineering and Science, Inc.

KEY:

Increasing

Staying the Same

Decreasing





Risk Management and Policy Outlook

Developed in conjunction with:

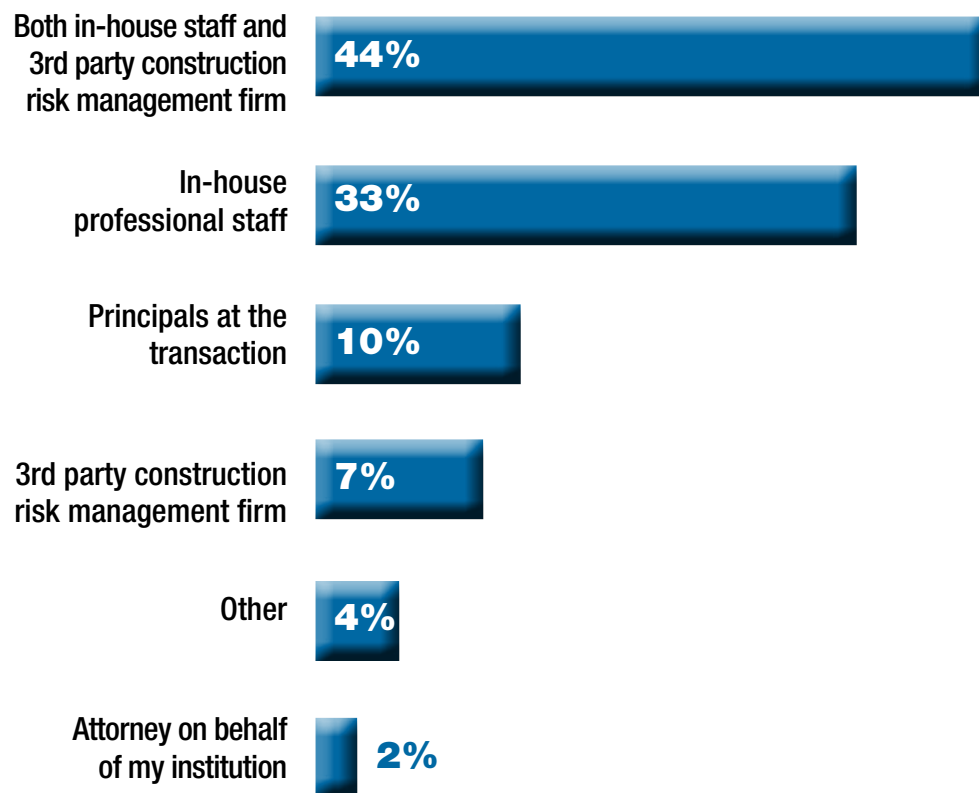
PARTNER
Engineering and Science, Inc.

RESPONSIBILITIES

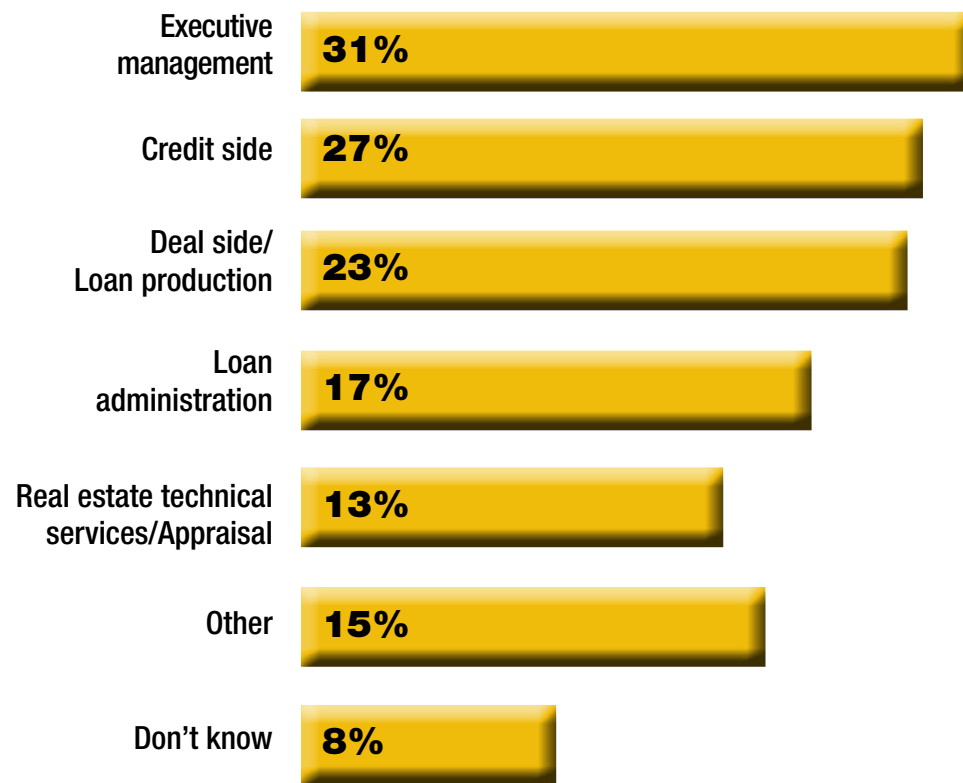
DEVELOPERS

LENDERS

Who conducts due diligence for your construction projects?



What department in your organization is responsible for crafting construction risk policies?



“People’s roles within their institutions really affect how they see the deal, the risks involved, and how they approach risk management.”

— Bill Tryon

What factors most drive your institution's construction risk management policy?



“Factors that tend to drive risk tolerance down (regulations / bank audits, legal considerations, and potential loss) are outweighing factors that tend to drive risk tolerance up (pressure to remain competitive, aggressively pursuing business).”

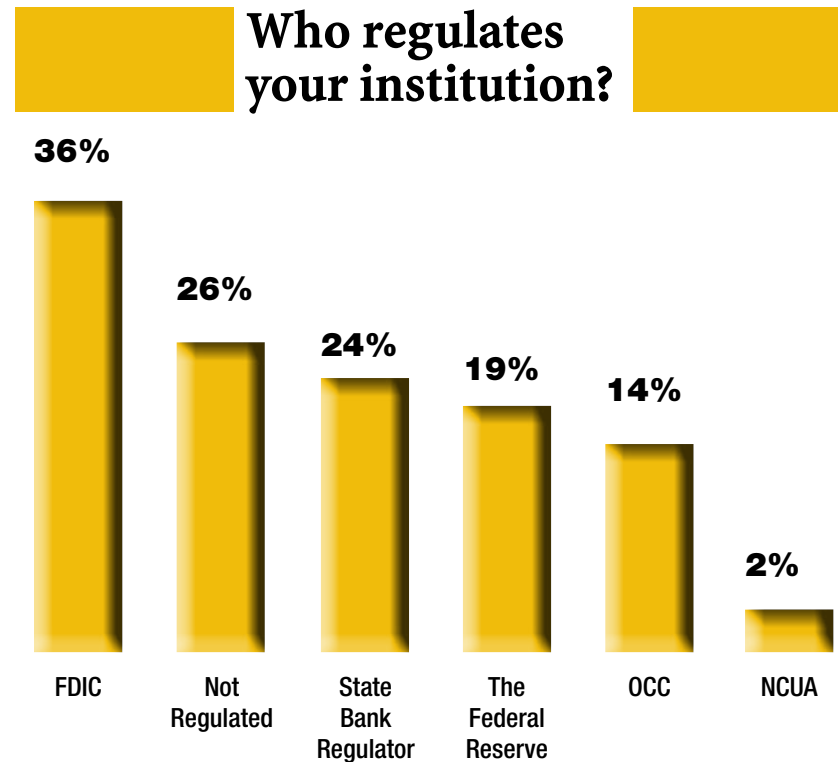
— Bill Tryon



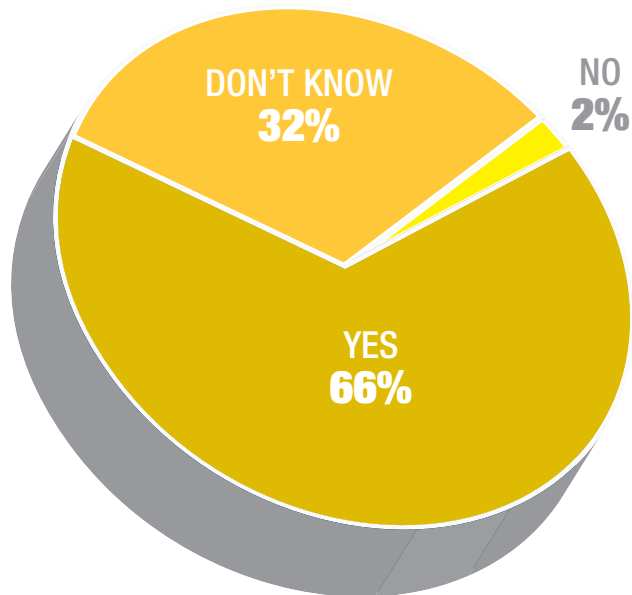
“Bank regulation is a substantial force in the market that affects regulated institutions and could even create opportunity for non-regulated institutions in areas like construction lending.”

— Joe Derhake, PE

Who regulates your institution?



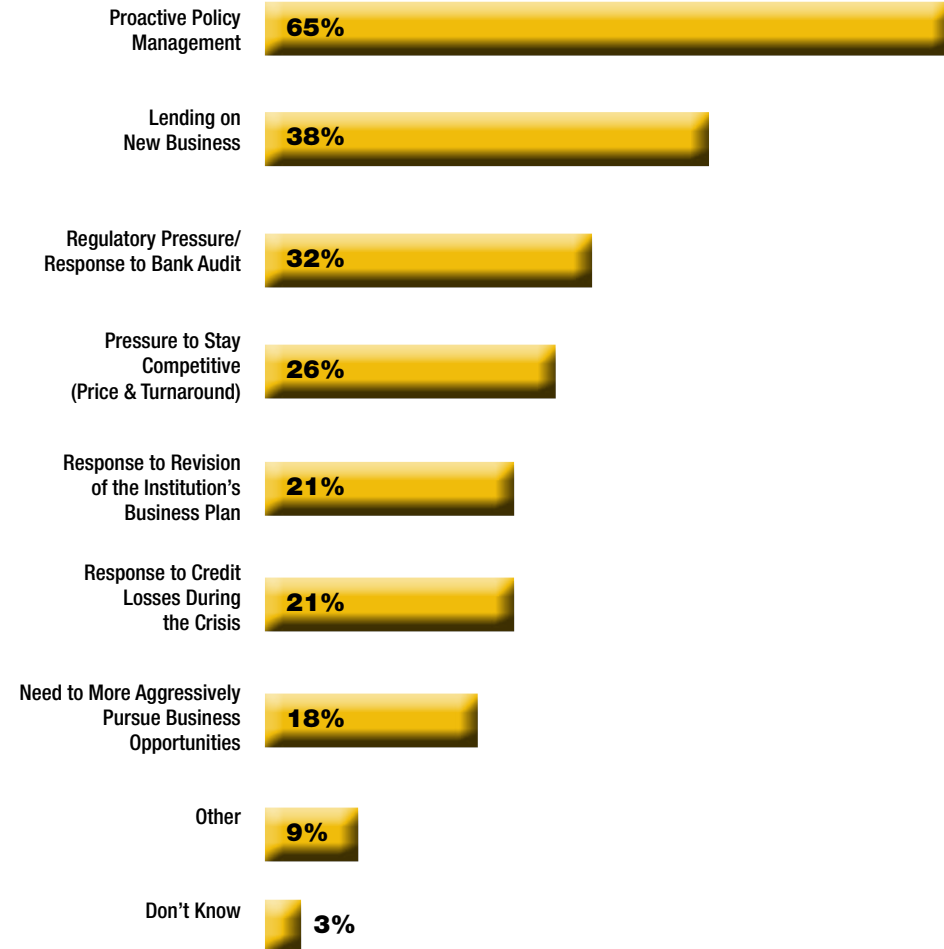
Have your construction risk management policies been updated in the last 5 years?



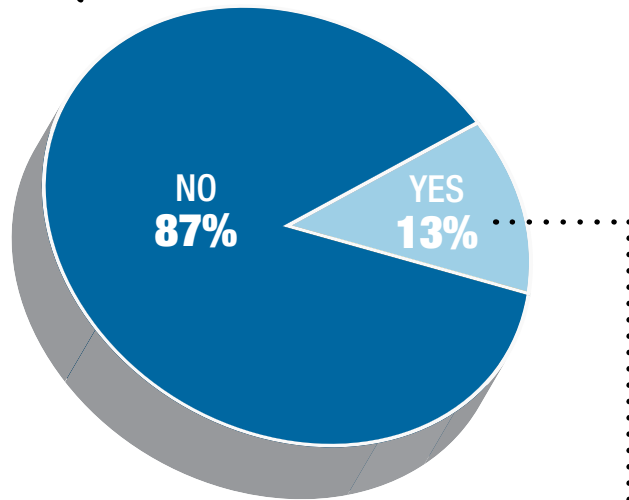
“Lenders aren’t just revisiting their risk management policies because they are told to, but because it’s good business practice. Entering new markets presents new risks and unknowns for institutions, so risk management policy should be a living and flexible thing that evolves as the business evolves and external factors arise.”

— Bill Tryon

What was the impetus for the change in your institution’s risk management policies?



Has your institution had a **construction project** fail in the last 5 years?



CONTRIBUTING FACTORS

Market demand for the product collapsed	50%
Construction project went significantly over budget.....	21%
Delays	21%
Contractor, subcontractor or supplier failed to perform	14%
Partner in the deal had financial trouble	14%
Investment funds dried up	7%
Partner in the deal had operational issues and/or behaved badly	7%
Loan funds dried up	7%



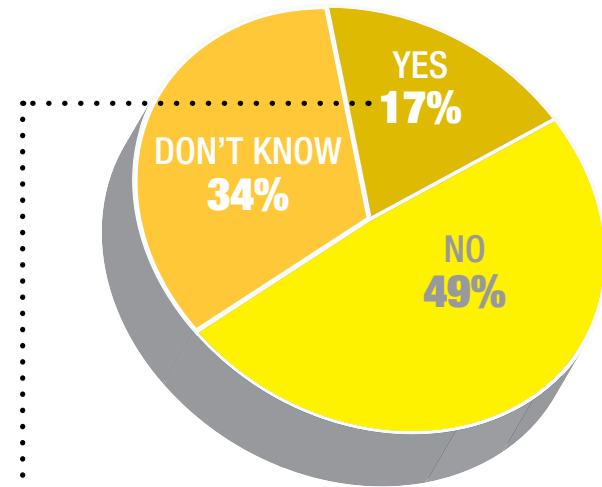
“Half of these failures were non-market issues that theoretically could be caught during underwriting.”

— Joe Derhake, PE

PROJECT FAILURES



Has your institution had a **construction loan** fail in the last 5 years?



CONTRIBUTING FACTORS

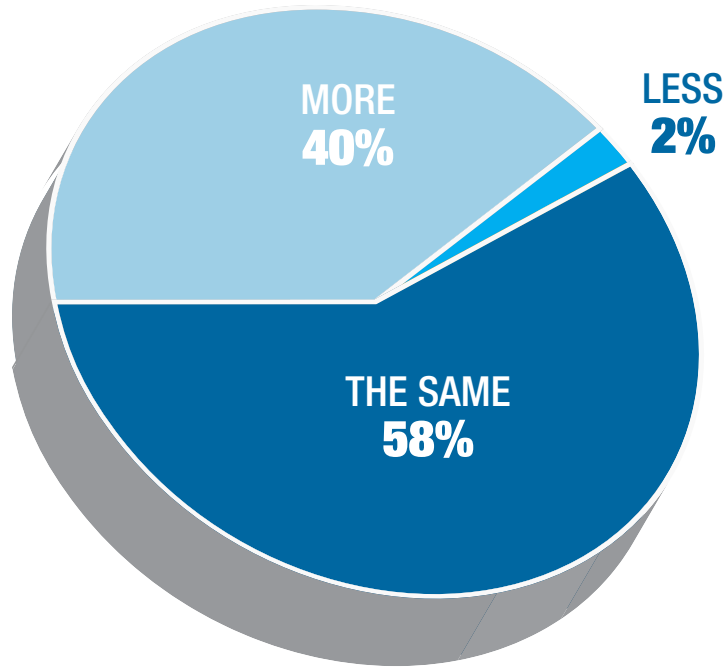
Demand for the product collapsed.....	64%
Developer / sponsor had financial trouble.....	44%
Delays	33%
Contractor, subcontractor or supplier failed to perform	11%
Developer / sponsor had operational issues and / or behaved badly.....	11%
Construction project went significantly over budget.....	0%



“A single failure can wipe out the profits from a dozen loans. It’s important for lenders to stay abreast of market risks in order to protect assets and maximize profits.”

— Brian Ward
 Technical Director, Construction Risk Management
 Partner Engineering and Science, Inc.

In the last 12 months, has risk management due diligence become more or less a priority?



“With the resurgence of new construction, developers are tightening up protocols in order to maximize returns and attract investors.”

— Ken Sisk, PE

SPECIAL RESOURCE:

Last year **GlobeSt.com** and **Partner** presented a webinar on Development Due Diligence – visit <http://www.partneresi.com/partner-webinar-archive.php> to watch the archived version.

This webinar presents the lowdown on essential due diligence tools, including:

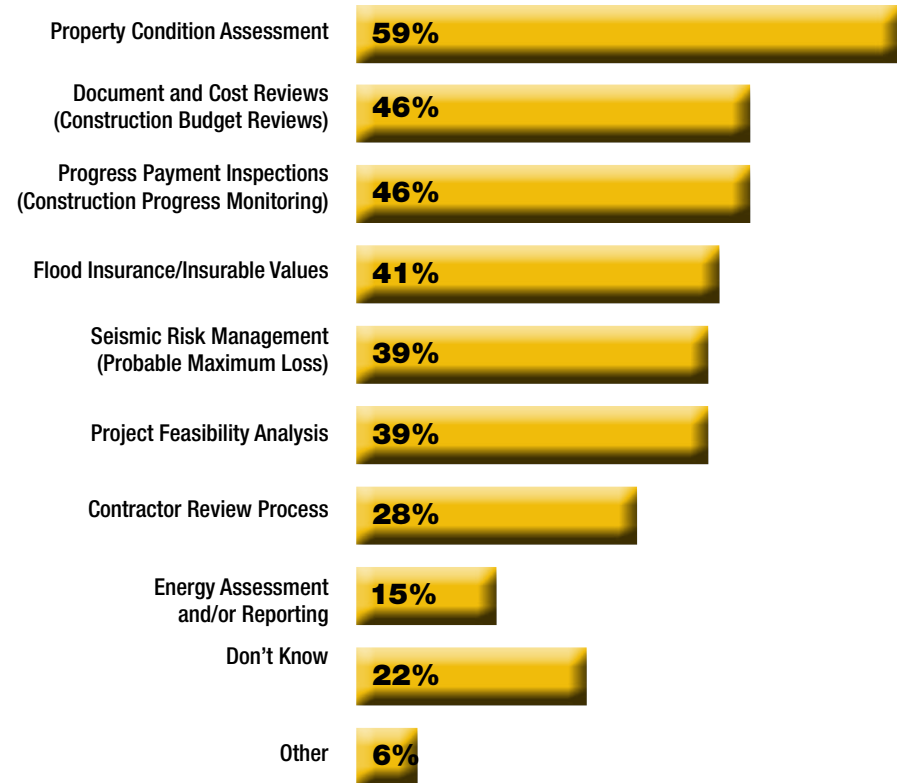
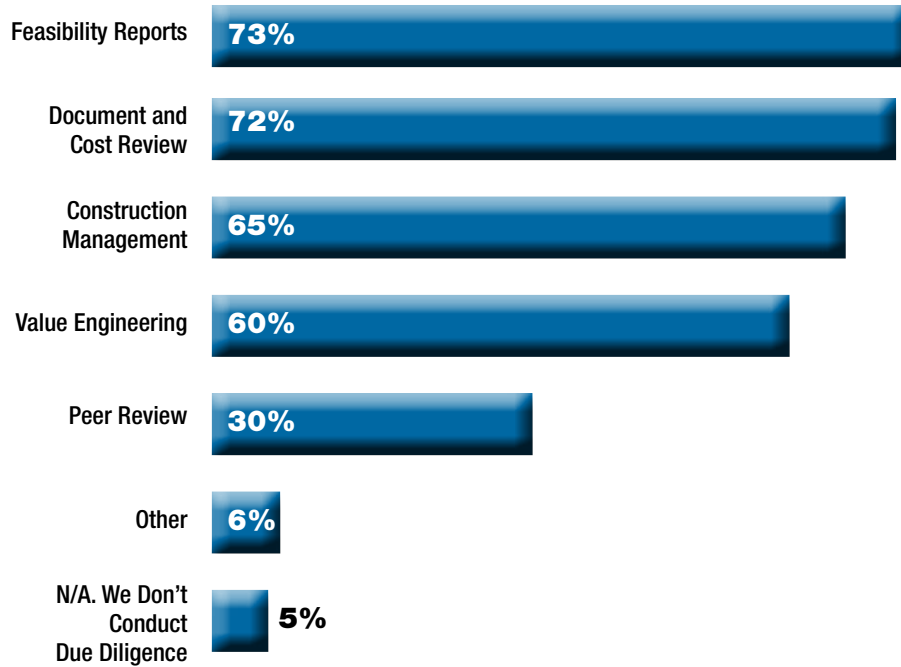
- Zoning
- Geotech
- Traffic
- Environmental
- Surveys
- Utilities
- Impact fees
- Adaptive reuse
- Energy & sustainability

DUE DILIGENCE TOOLS

What items does your institution address in your **due diligence** process?

DEVELOPERS LENDERS

Which of the following **construction/engineering** risk management procedures are explicitly addressed in your institution's policy?



“Feasibility reports require an understanding of market-based ambitions along with engineering and entitlement constraints.”

— Ken Sisk, PE



“In connection with changes in the OCC’s CRE lending handbook published in 2013, guidance for lenders with assets over \$50 billion is expected to lead to additional standardization in the industry.”

— Bill Tryon

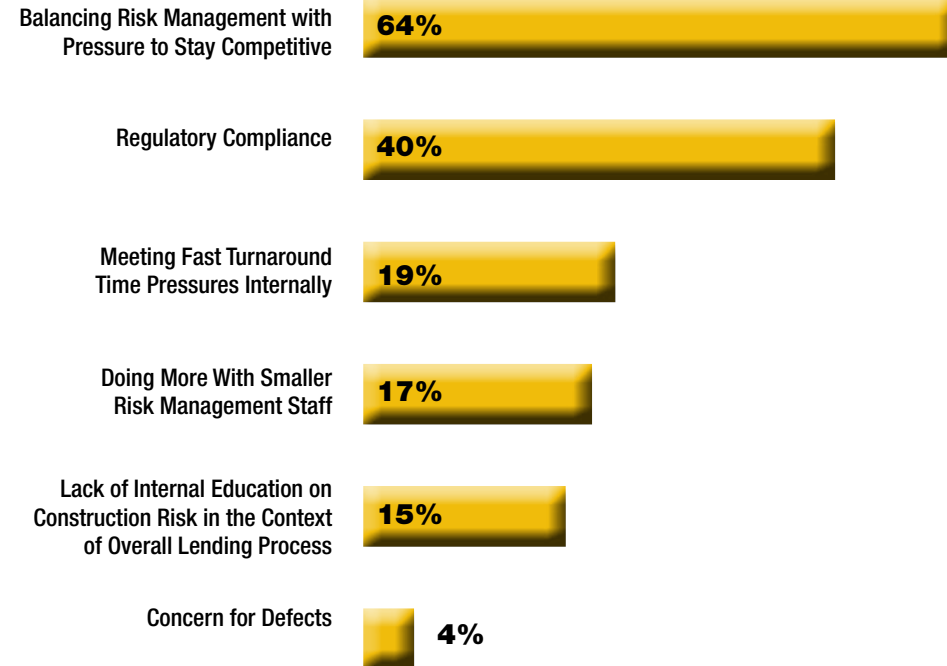
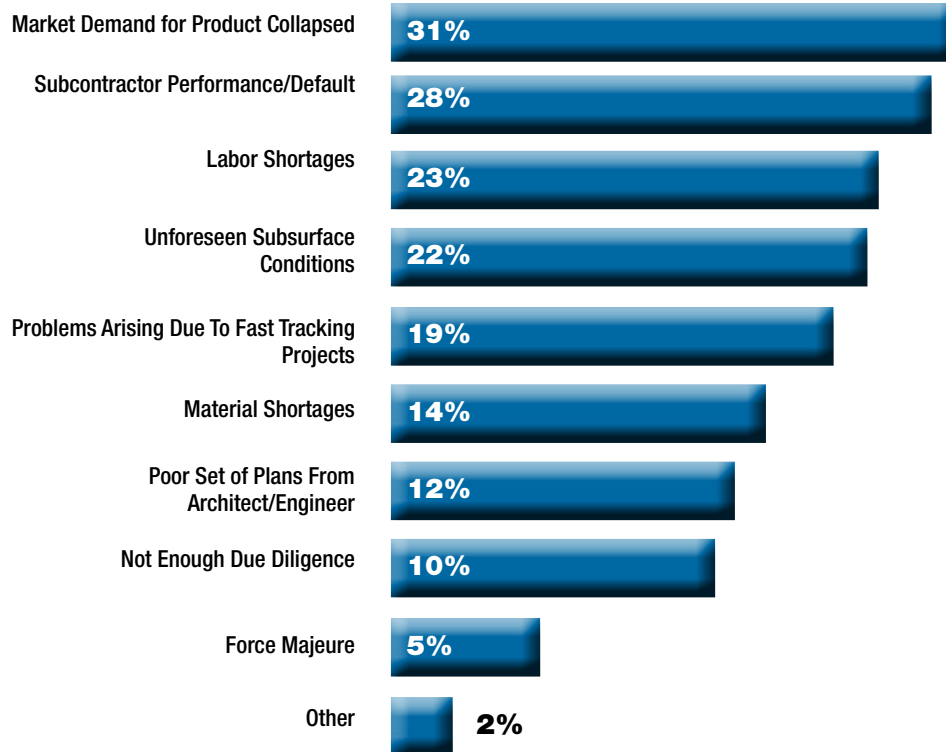
RISK MANAGEMENT CHALLENGES

What are the biggest risk management challenges as they relate to your institution?

DEVELOPERS

LENDERS

Which are the biggest challenges to implementing risk management policy at your institution?



“Construction and development is just downright complicated. Solving the puzzle of uncertainties - changing real estate conditions, construction trends, financial markets and other variables - continues to present developers with a fascinating, and profitable, challenge. The best way to limit risk is to do thorough due diligence, plan ahead, put a lot of contingencies in place, have great communication between all parties, and work with a team you really trust.”

— Ken Sisk, PE



“Banks should not let regulators drive their policy. Banks profit by taking risks. The most successful lenders take steps to understand and mitigate risks in order to maximize profitability. Policy must balance competitiveness with risk management.”

— Bill Tryon



COMPANY PROFILE

PARTNER ENGINEERING AND SCIENCE, INC.

Partner Engineering and Science, Inc. (Partner) is a full-service engineering, environmental and energy consulting firm completing projects nationwide. Partner specializes in services to support real estate transactions, development, ownership and management. This includes Environmental Due Diligence; Subsurface Investigations and Remediation; Industrial Hygiene; Health, Safety & Compliance; Building Sciences; Energy & Sustainability Consulting; Site Civil Engineering; Construction Services; Land Surveying; and Zoning Reports. At Partner, we understand the impact of our services on our clients' business and bottom line. Our clients rely on us not only to provide trusted, objective services but also to provide solutions.

Because of this, we are your Partner.

In addition, Partner is the official Engineering Thought Leader for GlobeSt.com. Through informative webinars, educational blogs, and insightful video interviews, Partner's expert environmental consultants and building engineers regularly tackle a variety of CRE related topics including environmental and engineering due diligence.



To View The Science of Real Estate Blog, visit:
GlobeSt.com/blogs/buildingsciences

REFERENCE LINKS:

Webinar: Under Pressure – Lender Compliance in the New Regulatory Landscape

http://www.globest.com/events/industry_event/national/Under-Pressure-Lender-Compliance-In-The-New-Regulatory-Landscape-350791.html

Webinar: Development is Back! Mitigate Risk with Due Diligence

<http://www.partneresi.com/partner-webinar-archive.php>

Article: Building a Platform for Construction Risk

<http://www.partneresi.com/resources/platform-for-construction-risk-july-2014-ward.pdf>

Article: Construction Lending Risk - Management that Knows No Bonds

<http://www.partneresi.com/resources/construction-lending-risk-june-2014-rma-bonin.pdf>

Blog: What the Experts are Saying about Construction Spending

www.globest.com/experts

Blog: What is the Key to Successful Brownfield Development?

<http://www.globest.com/blogs/buildingsciences/engineering/Multi-disciplinary-approach-to-Brownfield-development-350056.html>

About ALM's Real Estate Media Group

Real Estate
Forum

RealShare
CONFERENCE SERIES

GlobeSt.com™

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