Construction Financing
The Speculative New Build Market

Have you heard these? "Get rich quick in real estate by using other people's money!" or "Make $100,000 per deal with no risk and without using any of your own money!". Fortunately, these once ubiquitous infomercials have gone off of the air, yet we still have potential real estate investors and even investors with some experience who believe these mantras. Like a carnival pitch, they are not outright lies but they are not exactly the truth either.

Yes, it is possible to invest in real estate, the spec construction market, or otherwise with borrowed money and yes, you can make a lot of money per deal. What the hucksters, the motivational speakers and the "investing gurus" almost never tell you is that every deal is different and every deal to some degree or another will require seed money. You're going to need some cash to get your project off the ground and to keep it moving smoothly, at least in the beginning.

Ways to Fund Your Project

There are several ways to fund a project, so many that we will not attempt to cover them all here. The most common methods are: all cash, by using a HELOC (home equity line of credit), hard money, and the most common, getting a construction loan from a bank.

The all cash method is exactly what it sounds like. You have all of the cash up front and simply pay as you go. While this is by far the best way to keep a project humming along, it is also the least common. Most people just don't have $400,000 to $1,000,0000 in extra cash, and if you did, would you really want to put it all on the line?

Using a HELOC is a fairly common practice, particularly for new investors. You can leverage the equity in either your personal home or rental properties by acquiring a home equity line of credit to fund your project. Assuming that it is enough to cover the entire project cost, this kind of line of credit can eliminate the need for an investor to have cash on hand to get a project started. However, it can be a risky choice as it puts real assets on the hook. In the event things went horribly awry and a project failed, the bank would have recourse against your personal home and/or rental properties.

According to Wikipedia, a hard money loan is a specific type of asset-based loan financing through which a borrower receives funds secured by real property, typically issued by private investors or companies. In our experience, hard money financing is almost never a good idea. The interest rates are very high and the terms are much less favorable to the borrower. While there are a few instances where hard money may be an appropriate short term solution, we advise against this method of financing.

Construction Loans

The fourth and most common method of financing is a construction loan. Construction loans are obtained from accredited financial institutions and usually have reasonable interest rates. They can be set up as construction financing only or as a loan that automatically switches from construction loan to a permanent mortgage when the project is complete. The quality of the product can vary greatly from bank to bank so it is important to select your lending institution carefully. After all, you will be dealing with them frequently throughout the execution of your project. It is often easier to obtain a favorable construction loan if you already own the lot, and you will need seed money to cover the time between closing your loan and submitting your first draw request for funds. While some banks will provide a first draw at the time of closing the loan, in most instances that is not the case.

Construction Loan Timing

It is important to choose the right bank for so many reasons but the most important is timing. How long will it take to get from first contact with the bank to a closed construction loan that is ready to start funding draws? And how long will each draw take to go from submitted to inspected and funded? Answering these two questions is crucial.

Some banks can go from pre-approval to the closing table in four to six weeks, while other banks may take several months. When shopping for a construction loan it is essential to find a bank (and accompanying loan officer) that does a fair number of construction loans regularly. Construction loans are unique in ways that can cause inexperienced loan officers to get bogged down. Some banks offer construction loans, but don't produce them often enough to have a streamlined system in place. The time and level of hassle it takes for a bank to close on a loan can indicate what the draw process will be like once the project gets rolling.

Construction Loan Compliance

Some banks require a lot of documentation to accompany a draw request, like sub contractor agreements, lien waivers, COI's* for every sub, etc. It is important for both the investor and the builder to have a clear understanding of the bank's compliance requirements before the project starts.

At Ballast, we have created an internal compliance process that is streamlined and mostly automated, making it relatively easy to collect documentation and submit it to the bank as needed. We collect all of these things as a general practice but many builders do not. Unorganized builders will find it very difficult to produce the assorted documentation on demand and many banks will NOT issue a draw without it. When this type of bank finds itself dealing with a disorganized builder, delays can be frequent and long. Make sure your builder is both capable of and actively collecting all compliance documentation, not just for the bank, but for your own peace of mind. These documents are also invaluable if a dispute over payment or craftsmanship ever arises.

Generally speaking, smaller banks and Credit Unions are good places to look for construction financing. At smaller institutions, you are more likely to form a personal relationship with the loan officer. This is important because you want to be able to pick up the phone and talk to your loan officer if there is an issue with funding.

Construction Loan Funds and Seed Money

Once a construction loan has been closed with a lender, the funds to be loaned are placed in an escrow account from which they are disbursed after work has been completed and paid for. When a draw request is submitted to the bank, the bank sends out an inspector to verify the work has been completed, the builder submits documentation showing the work has been paid for (usually in the form of lien waivers) and then the bank funds the portion of the project they deem completed. The important point to note is that the bank will not release funds until you have paid, out of pocket, for the work being completed on site. This requires seed money.

While some investors will attempt to place the burden of seed money on the builder, this is a terrible way of doing business and can easily bring your project to a stand-still. Typically, builders are working with multiple investors on several projects and though a solid builder should be able to seed a job or two, once the number of active projects increases, builder seeding is no longer feasible. When this happens, projects get prioritized. The ones at the top of the list (i.e., the ones closest to their next bank draw) will keep moving while the ones at the bottom stay idle. The best way to avoid this is to have a predetermined amount of seed money on hand to keep wheels turning between draws. Even though the investor and the builder work together, they have two very different jobs. The builder's job is to move the project forward and bring it to completion in a timely manner. The investor's job is to bring the money to make this possible. Be sure to have a solid understanding of how much seed money you will need before a project starts. This is a discussion you should have with your builder during the due diligence period and again before closing the construction loan.

Quality construction financing is critical to the process of building and selling houses. A good bank will be an asset to you, a great bank will be more like a partner. And remember that aside from weather and municipal bureaucracy, the gear in the machine that can keep a project moving or bring it to a stand-still is seed money. Ask your builder if they have a preferred lender as a starting point, then do your homework and choose wisely.

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