

The complexities of construction financing

By Dan Mikes

Construction financing is much more involved than financing for an acquisition or a refinance of existing debt. Acquisitions and refinances are accomplished with term loans, or mortgages, and are generally offered with a fixed interest rate, a set amortization period, and a regular monthly payment comprised of both principal and interest.

A lender will typically require a deed of trust and title insurance, as well as environmental reports on the property and perhaps an appraisal. Once the loan has been documented the only ongoing obligations are to make the monthly payments and submit required financial information (or other information as specified in the loan agreement).

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In contrast, construction loans are generally structured as non-revolving lines of credit and monthly interest-only payments are required, based on the outstanding loan balance. As construction progress, requests for payment to the subcontractors are made and, if approved, the funds are “disbursed” from the loan. The loan balance will thus increase as the project progresses and monthly interest-only payments will be made on the outstanding balance of the loan.

There is much more work to do before closing on a construction loan. In addition to the title insurance, environmental work and appraisal mentioned above, the lender will review the plans and the construction budget, assess the financial strength of the contractor and perhaps involve a construction management company to do site inspections and sign off on construction draws.

The construction period is a risky time. For example, if a contractor, subcontractor, or any one of their employees or material suppliers’ claims they have not been paid they may file a lien against the church’s property. The parties filing such “mechanics” or “materialmens” liens, if not satisfied, may ultimately initiate a foreclosure action against the church. In such a scenario the title insurance company protects the lenders’ interests up to the dollar amount of construction funds disbursed to date. Disbursement must stop until the dispute is resolved.

Taking precautions

It is common for the liens to be settled either by the church obtaining a bond for the disputed payment amount or to put its own cash in escrow pending resolution of the dispute. Resolution may take some time, during which the project is stalled. There can be a snowball effect if the church does not have the liquid funds to pay other project payables. As such, it’s wise for both the church and the lender to take certain precautions before proceeding with a construction loan.

Start with a comprehensive construction budget. Your contractor will be responsible for what are commonly called “hard” construction costs — the cost of erecting the building (concrete, steel, lumber, doors, etc.). Don’t overlook the “soft” costs — architectural fees, landscaping or off-site costs such as adding a turning lane, water or sewer connection, etc. Lenders will want to be sure there are adequate loan funds or liquid cash to cover all of these costs as the city may not issue a certificate of occupancy until all of these project elements are completed.

The lender will also want the facility to be functional. Therefore there will need to be an adequate allowance for furniture, fixtures and equipment. If the new auditorium has a sloped floor your budget will need to include permanent seating. If the floor is flat you may be able to utilize existing seating.

Make sure that all the funds necessary to complete the project are on hand prior to commencement of construction. You may need a loan that will bridge capital campaign receipts. Neither you, the contractor, nor the lender may be comfortable with relying upon uncertain future events as a means of funding

a significant portion of the project. You may need a larger financing commitment than originally planned, but you can always use your own funds rather than draw on the loan. The additional cost will be minimal, and well worth your peace of mind.

Once construction is underway, the contractor will require periodic payments for work completed to date. The contractor will submit an "application for payment" and the church will review it and forward it to the lender. The lender may require an on-site inspection to verify that the work being paid for has been completed. The lender will also contact the title insurance company to verify no liens have been filed since the prior payment request. Assuming no liens were filed and the work was completed, the lender will disburse funds to the church, to be forwarded to the contractor and the subcontractors.

Be prepared for changes

In virtually all construction projects, there are unanticipated changes to the project budget that result in "change orders." For example, the original project budget may call for linoleum flooring in the narthex. The church may decide ceramic tile would be much more attractive and durable. The upgrade from linoleum to tile is considered a change order, and the incremental cost will need to be paid for in cash by the church unless

there are savings in other areas of the budget. Most lenders require that all change orders in excess of a minimum amount (such as \$5,000) be approved in writing by the bank prior to execution and the incurrence of the additional cost.

Navigating your way through a construction project is much easier when you have an experienced financial partner beside you. Look for a lender that has handled numerous projects comparable in size. Highly qualified lenders will have a depth of experience and a professional in-house team that will be able to process construction draws promptly and efficiently. They will also evaluate the strength of your contractor and may determine that a costly construction bond and inspections are not required. A lender that specializes in working with churches can provide you adequate checks and balances through the construction process without layering on unnecessary costs.

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