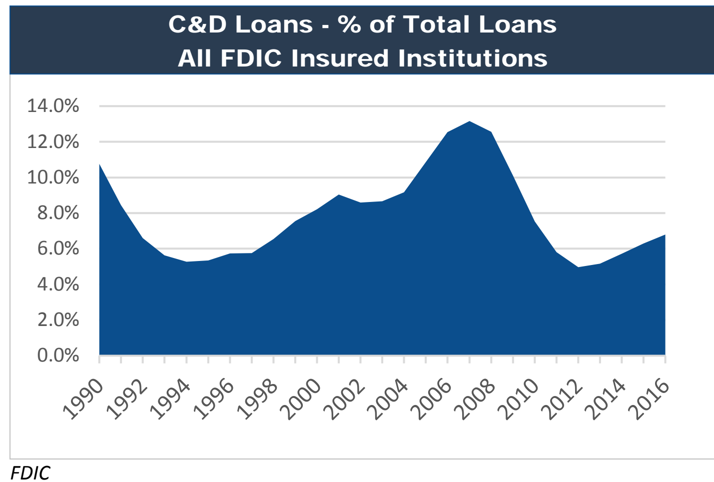
# PCCP Market Commentary
## Construction Loans Are Hard to Get!
## Second Quarter 2017

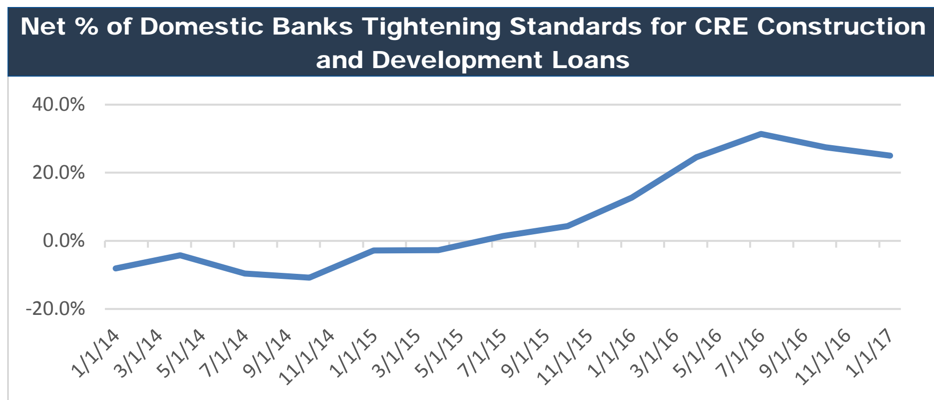
In the U.S., there seems to be a lot of development underway. Cranes are everywhere and multifamily construction is at or near record highs, but construction loans are increasingly hard to come by. This quarter we take a deeper look at why traditional bank construction lending is constricting and what it might mean for unregulated lenders.

The highest growth loan category for U.S. banks in 2016 was construction and development (C&D). Construction loan dollars outstanding have increased from 2012 through 2016, but today, while growing, C&D Loans represent significantly less of banks' balance sheets than in prior years: currently less than 10% of total bank real estate exposure.




*FDIC*

In fact, bank exposure to C&D Loans today is far lower than annual exposures from 1999 through 2010. As of year-end 2016, C&D Loans were a modest 6.8% of total real estate loans compared to a peak of 13.2% in 2007. And in terms of dollars, C&D Loans outstanding are roughly half of the previous peak, with loans outstanding at $313.2 billion today vs. $629.5 billion in 2007. This reduction has occurred even though total US bank real estate loans outstanding as of year-end 2016 reached 96.3% of the 2007 peak of $4.8 trillion.




*Board of Governors of the Federal Reserve System (US)*

So, while the construction loan market is growing, overall development exposure by traditional bank lenders is considerably more conservative than in the previous cycle. Moreover, in each of the past four quarters, the Federal Reserve Board has recorded a significant percentage of banks reporting a tightening of lending standards on construction loans. On the surface, this survey is at odds with the FDIC data demonstrating increased C&D Loan volume. However, the key distinction is the lending practices behind the new loans.

Banks are still originating C&D Loans, but consistent with the message illustrated by the Federal Reserve Board survey, terms are more stringent with lower advance rates, tighter covenants, higher guaranty requirements and higher pricing.

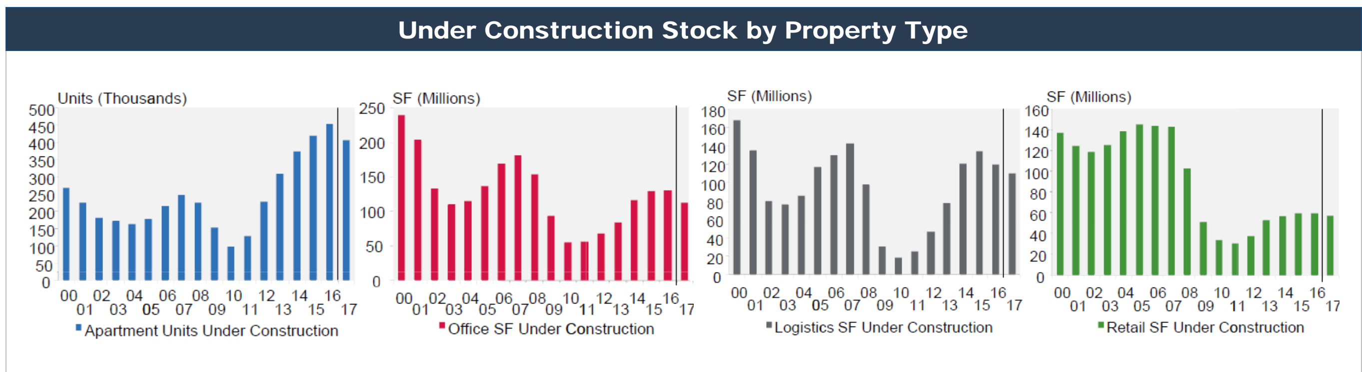
Based on our discussions with banks, we believe that the tightening of lending standards on construction and development loans is a result of several specific factors:

- ***Regulation*:** Under Dodd-Frank and Basel III, banks are required to set aside additional reserves for construction lending causing construction loans to be considerably more expensive to make today than pre-GFC.

- ***Past Experiences***: Supply at the height of the last cycle was met with weak demand; the institutional knowledge of past losses affects the risk perception of future projects.
- ***Current Exposure:*** Banks simply have a decreased appetite for the riskier end of the new lending spectrum after making significant early cycle bets.

Looking ahead, based on our discussions with banks, we believe the regulatory environment for lending will not materially change over the next few years. Banks have adapted to this environment, and don't appear too eager to overhaul their systems anew.

While supply this cycle has picked up across all product types, CoStar Group reports that 2016 was the peak year for new construction this cycle and they think we are at an inflection point: the pull back on bank C&D Loans should correlate with a cut back on construction starts. New construction starts in the office and retail sectors have already slowed from a level of activity that was well below past expansionary periods. Apartment construction activity has already surpassed prior cyclical highs and industrial is right at those cyclical highs. We believe we will see a pull-back in 2017 despite supply and demand generally remaining in balance throughout the domestic market. Ultimately, the relative cut back in lending compared to last cycle should correlate with a supply decrease and lead to more balanced fundamentals across markets, with select high-supply outliers.




*CoStar Group*

These market conditions have left borrowers with limited choices for construction: either a bank demanding increased pricing, higher guaranty requirements (recourse or not) and lower advance rates; or specialty lenders offering much the same, albeit with even higher spreads on pricing, offset by the possibility of slightly higher advance rates.

Said another way, while there has always been opportunity for real estate high-yield debt funds to participate in construction lending, this time it will be on better terms to the lender. As long as more stringent bank lending practices prevail, there will be a dramatic widening in the pricing and availability of debt for development vs. cash flowing assets. Thus, specialty lenders will be able to command premium yields in a balanced market and encroach on a formerly bank-dominated construction market. We expect to see debt funds originating more construction loans to top tier borrowers with best in market locations.

*SOURCES: FDIC, Federal Reserve Board, CoStar Group*

| **William R. Lindsay** | **Greg Eberhardt** | **Steve Chase** | **K.C. Kriegel** |
|---|---|---|---|
| wlindsay@pccpllc.com | geberhardt@pccpllc.com | schase@pccpllc.com | kkriegel@pccpllc.com |
| (310) 414-7868 | (310) 414-2004 | (646) 308-2101 | (646) 308-2102 |

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