

GUEST COLUMN

Preparing a Cost-to-Complete Study for Workout Purposes

By Carl de Stefanis, P.E.

Should a partially completed construction project be a candidate for a loan workout or become an REO, a cost-to-complete study is routinely prepared. The lender, however, should consider the study as a process to learn about both the asset and the borrower. To realize the most benefit, the study should be viewed as a collaborative effort amongst the lender, its consultant and the borrower.

A cost-to-complete study serves many functions. It may help to do the following:

- Evaluate the borrower's capabilities so as to assist in determining whether he can competently complete the project.
- Evaluate the adequacy and thoroughness of the borrower's submitted cost-to-complete study.
- Provide answers as to what caused the budget deficiency.
- Provide insight as to whether additional capital requirements would impact the borrower's motivation level to complete the project.
- Be used as a negotiation tool with the borrower should the loan be re-structured or with the other parties that would like to purchase the note or the deed.
- Be used to support a lender's position that the borrower no longer has any equity in the project should the lender move to take possession. This is an argument that may be necessary in order to lift a stay to the foreclosure proceedings, should the borrowing entity be placed into bankruptcy.

Preparing an accurate cost-to-complete study is usually a challenge and sufficient time to do it is usually not available. Stressed projects are often complemented with stressed

development teams, paperwork management that is incomplete or in disarray, unresolved and pending change orders and mechanics' liens. Rarely is the cost-to-complete preparer privy to all of a project's pertinent cost data either by conscious omission on the part of the borrower or by incomplete or missing information. Thus, a cost-to-complete study is usually

an ongoing process of soliciting, vetting, and incorporating information.

It is prudent to commence the study in the early phase of the workout process while the parties are still communicating, the development team is intact, site access is available and the borrower is still amenable to submitting cost information and requested documents. If negotiations break down, communication and information transfer may take place

only through respective attorneys.

A comprehensive cost-to-complete study should include an analysis of both direct and indirect costs. Conclusions should not be derived by simply totaling the difference between the monies paid to date and the subcontractors' agreements' full contract amounts. Nor should a lender or purchaser of the note or deed rely solely on the cost-to-complete amount identified in a construction consultant's monthly project status report.

A cost-to-complete will assist the lender in determining which disposition scheme will maximize the return on the loan by helping to provide answers to the following questions:

- Is a workout is feasible?
- Should the note be sold and for how much?
- Should the deed be sold if the lender gains possession?
- If the lender gains possession and sells the asset, should he fund the acquisition and construction balance through a purchase money mortgage?

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- Should the project be completed by the lender?
- Should the project be mothballed and waited out?

Depending upon the project's scope, cost-to-completes are often prepared to reflect different completion scenarios involving variables such as changes in the development team, the construction delivery method, type of general contractor (GC) and construction manager (CM) agreement, proposed project scope changes, and timing issues.

Time is often referred to as the lender's enemy. Should a workout prove unfeasible, the objective is usually to quickly gain control. Thus, a lender should approach a cost-to-complete study methodically, and within parameters established by counsel to mitigate lender liability claims, to take into consideration the following issues:

- 1) Understand the depth and history of the borrower/GC/CM relationship.
- 2) Determine whether the existing GC/CM should complete the project.
- 3) Determine if there are any local nuances with respect to construction delivery practices.
- 4) Obtain the lender's original project budget, which will disclose the loan commitment's direct and indirect budgets.
- 5) Obtain a complete set of the lender-approved drawings.
- 6) Determine if the project should be re-positioned for a different use or market segment.
- 7) Understand the capital structure.
- 8) Review the borrower's submitted cost-to-complete study.
- 9) Determine if the subcontractors are still around.
- 10) Schedule a site visit. It will probably be the first of many.
- 11) Document all existing conditions by using both still and video photography to serve as an aid in developing the cost-to-complete.
- 12) Review a schedule of all contracts and agreements.
- 13) Obtain all of the construction loan monitoring reports and the construction consultant's front-end or construction risk assessment report.
- 14) Review the subcontractors' trade payment breakdowns, payment requisitions, and subcontracts.
- 15) Review all approved and pending change orders.
- 16) Survey the building for any defective work that requires replacement.
- 17) Review the mechanic liens.
- 18) Determine if any payments were made for work or materials not yet incorporated into the building.
- 19) Interview local authorities to determine if any borrower obligations exist such as off-site wetland mitigation or infrastructure improvements.
- 20) Take into consideration subcontractors' re-mobilization costs, if the same subcontractors were to be authorized

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to complete their work.

- 21) Determine the impact of a revised construction schedule.
- 22) Re-examine the general conditions and GC/CM fee budgets.
- 23) Review the bonds, if any, to make sure that they identify the lender as an additional obligee.
- 24) Acknowledge foreclosure tradeoffs.
- 25) Develop a contingency budget. This amount, which is usually a percentage of the subcontractual cost-to-complete plus general conditions and fees, is subjective and depends on many factors.

As to indirect costs, the following should be considered:

- 1) Assess the role of the architect-of-record.
- 2) Contact the local building department.
- 3) Construction financing and associated fees are usually the largest indirect cost line item. Have the interest reserves/projections been adjusted to reflect the extended construction period lease-up/sales period and the revised direct cost-to-complete amount? Even though LIBOR is very low and most existing construction projects have interest rates that float over LIBOR, it is necessary to determine if this line item will need to be funded.
- 4) If a project is to be re-positioned, it will impact its marketing. Have there been any marketing contracts let to date? Do marketing materials need to be revised? Have the leasing and sales commissions been revised to reflect the lower rental or sales income? Will the marketing team need to be changed?
- 5) Developer municipal contributions are not unusual when seeking entitlements. Are there any unfulfilled proffers, agreements between developers and municipalities requiring either monetary contributions or developer constructed improvements to mitigate the impact of the project on governmental resources? Have municipal fees such as sewer connections, water service connections, and municipal contributions been paid? Will the project lose any tax abatements or entitlements that would impact the budget?
- 6) Legal fees are usually substantial, whether a lender pursues a workout, forecloses, or accepts the deed in lieu. Depending upon the scheme selected, disposition legal fees need to be considered. Then, there is always the risk of a lender liability claim, whether with cause or frivolous, which could substantially add to the legal fees.

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