Many Risks Influence Construction Lending

STATE COLLEGE (Centre) — "It doesn't take a whole lot to go wrong before you can have an unhappy customer or a financial loss on the job. And those are two critical results you do not want to realize," said Gregory E. Diehl, senior vice president with Keystone Agricultural Credit Association. "Anyone in business knows that too many unhappy customers damage your professtional reputation, which will eventually put you out of business. Financial losses only help you go out of business faster."

Diehl presented the concerns lenders faced when administering construction loans to attendees at the Eighth Annual Farm Builders Conference earlier this month. "My objective is to give you some insight that I think will help you anticipate and confront those many challenges that cause you frustration, dissatisfied customers, and lost money," he explained.

To understand construction loans, according to Diehl, builders should know that risk is the chance of loss, construction loans pose a higher-than-normal risk to banks, and there is only one construction loan program, however loan controls vary widely according to the risk perceived.

Construction loans are risky for several reasons. One is the financial position of the mutual customer. "Customers with marginal equity make more controls necessary. If the building is going to generate the income needed to repay the construction loan, expect strict controls," said Diehl. "In cases where the bank's collateral is dependent upon the building being completed as porposed, you will see loan controls."

Those people with strong equity and buildings that don't generate direct income or contribute collateral values, such as a machine shed, require few loan controls, according to Diehl.

"While you probably don't know your customer's financial situation, the degree of loan controls will give you some indication," he added. "As a builder, you need to know that loan controls are a function of risk the bank perceives."

Construction loans also are considered risky because there are risks inherent to the construction project itself. A basic building such as a machine shed could be considered low risk. Machine sheds don't normally produce direct income and don't add a lot of value to the farm operation. "There are things that could still go wrong with the project, but even if they do, the bank would have very little concern," said Diehl.

A high risk project would be something like a layer house. Not only is the project highly specialized, but the customer would normally require a large loan. According to Diehl, customers would usually take on a $500,000 debt to build and equip a layer house. In addition, during construction, interest is accruing on any loan proceeds that have already been disbursed.

Subcontractors and materials suppliers can add to the project's risk. "They are third parties for which the customer and banker have no control," stated Diehl.

Another risk is possible cost overruns. Many things can increase the project's cost including delays or added expense in excavating caused by rock or storm-water control requirements, additional expenses involved in locating an adequate water supply, inadequate insurance protection, and weather.

"I have experienced situations where cost overruns resulting from problems like those I just mentioned are so great... that there wasn't sufficient income to service debt, provide for living and adversity, nor adequately recapitalize their business," related Diehl. "Those are the kind of lessons experience teaches bankers that risk must be thoroughly evaluated and controlled in a prudent manner."

There are also Pennsylvania state laws that can affect the project's risk factor. The most critical law is the the Mechanics' Lien Law, according to Diehl. This law allows those who do work or supply material for the construciton of buildings to file real estate liens if they are not paid.

"If a lender ignores this law and fails to control loan proceeds, he could find himself in a junior lien position or, what's worse, the customer ends up with more debt than expected, which could cause the forced sale of the property in order to satisfy a builder's claim," Diehl noted.

Another important law deals with multiple advances made against a real estate mortgage. Normally when a mortgage is closed, all of the loan proceeds are disbursed at the same time. In construction lending though, the disbursements could be made over a period of six months or longer, and in Pennsylvania any mortgage used to secure a construction loan must state so and often the disbursement schedule..

"Bankers aren't just conservative, they're normal people who like you, hate to lose money. In order to lessen the chance for loss, they make every reasonable attempt to manage or control the various risks just covered," said Diehl.

He concluded with several suggestions that will help contractors keep farmers happy and profits coming in.

1. Get accustomed to using good documentation. That includes contracts, building plans, and specifications. In the long run, they will save time and money.

2. If you leave any part of the project to the customer, assure yourself they have the wherewithal to do it and document it.

3. Find out how the customer intends to pay for the project. Get some references if bank financing is not to be used.

4. If no one else requires it, insist on a joint meeting between you, the customer, and the banker. Do this after loan approval in order to review contracts and bank controls on advancing loan proceeds.

5. Make sure you understand the terms of the bank's construction loan agreement.

6. Establish regular progress meetings involving your customer and the bank. regular communication in such a manner is one of your best ways to insure against disagreements.

7. Remember that good controls work in everyone's favor. From proper insurance policies to construction loan agreements, they help manage risks to everyone involved.

U.S. Regaining Share Of World Corn Markets

NASHVILLE, TN — Producers will have to be better marketers of their crops in the years ahead, said Frank Beurskens, president of Advance Trading Inc. of Bloomington, Ill.

And, Buerskens advised the audience at the Sunrise Marketing Seminar at the NCGA Corn Classic, "There will be greater volatility in the markets ahead and marketing will be extremely important." Beurskens recommended that farmers learn all they can about the world economy and the marketing system. "The world economy influences everything we do," he said.

Beurskens touched on the positive and negative factors affecting corn and soybean prices. The positive factors for corn include:

* There's been a big turnaround in corn demand and the U.S. is regaining its market share of the world grain trade.

* Soviet demand for grain is increasing.

Negative factors include:

* U.S. government stock liquidation.

* The increase in South Africa's corn planting will make up for the decrease in Argentina's corn crop this year.

* Mild winter weather cut livestock feed demand.

"Overall, the world corn situation is not that negative," Beurskens concluded.

The soybean price picture is more negative, he said. Although soybean usage and demand have increased steadily since 1973, U.S. soybean acreage has declined since 1979. The substituting of soybean plantings on corn base acres is coming two years too late, he said.

Other soybean market influences include:

* The Soviets are buying corn, not protein crops like beans.

* The European Community's soybean consumption is going down as they are substituting other commodities for protein sources.

* High prices from the drought have cut demand.

Beurskens said that South American economics, particularly in Brazil and Argentina, will not improve much in the years ahead because of high inflation and other economic problems. "If the economic situation does not improve in Brazil and Argentina, we might see acreage return to the U.S.," he said.

Beurskens also advised the audience to watch the growing concentration in agribusinesses that buy from farmers. As the larger companies snap up their smaller competitors, he said, the amount of competition is cut and prices farmers receive could drop.

"That's your biggest fear in the next decade," he said.