

Is Your Construction Lending Team Ready for an Economic Downturn?



**FUTURE-PROOF
YOUR CONSTRUCTION
LENDING PROGRAM**

EXECUTIVE SUMMARY

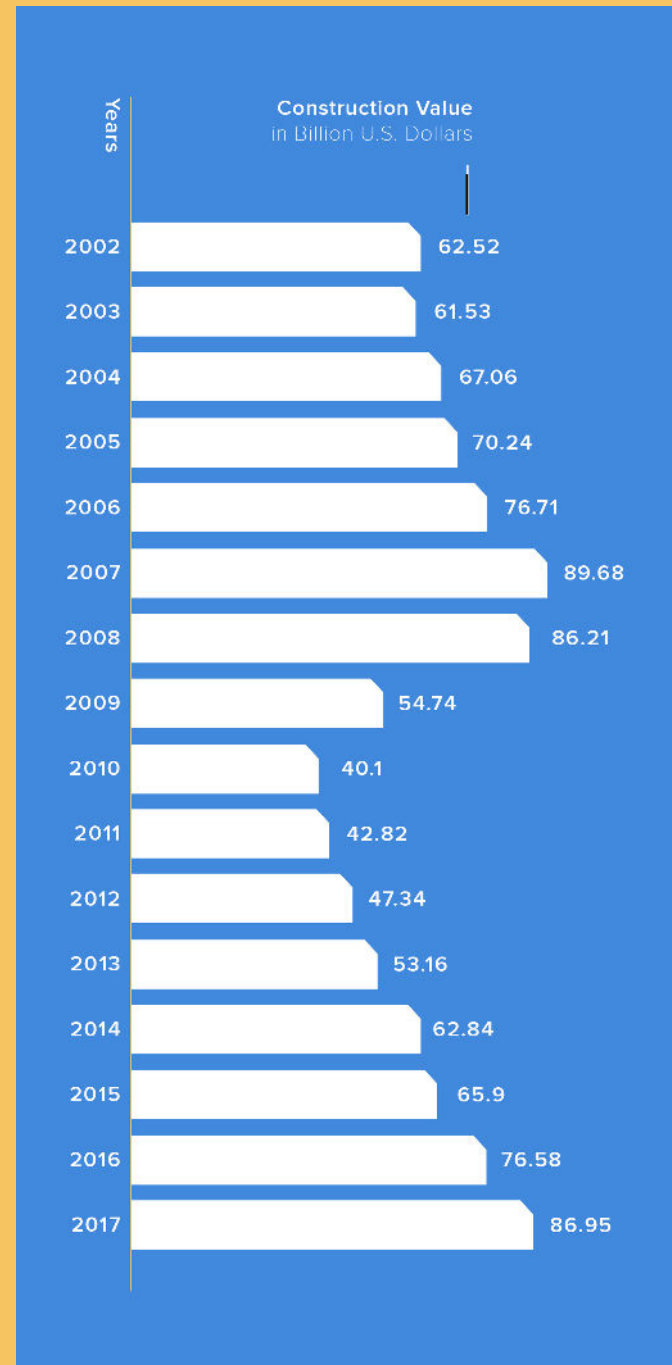
The United States is experiencing one of the most prolonged economic growth cycles on record. This cycle has led to an expansion of the commercial construction industry with growth expected through 2020. However, in addition to the “what goes up must come down” history of recessions, signs of a potential downturn are peeking their heads up from behind the cinder block. We’re beginning to see subtle signs of a slowdown, like the upward inching of interest rates and inflation, and not so subtle signs, like skyrocketing costs for materials and trade wars.

The anticipation of tomorrow’s competitive landscape and the dynamics of technological advances are forcing banks to assess their ways of doing business from an economic, process, and regulatory standpoint. In the face of these uncertainties, it is vital for banks to understand and seek opportunities to improve efficiencies and profitability.

This report provides insights into the market conditions that may lead to an economic downturn and how lenders can begin to prepare their construction lending programs today to thrive under any market conditions. It will shed more light on how best you can achieve a high level of profitability in your construction loan portfolio by leveraging new technologies to take care of manual and administrative tasks.

Some say, rightly so, that it is the best of times. The recommendations in this report help lenders plan and thrive now and in the worst of times.

Value of Commercial Building Over Time



Source:
<https://www.statista.com/statistics/245029/value-of-us-commercial-construction/>

THE U.S. ECONOMY HAS NEVER BEEN STRONGER, RIGHT?

The U.S. economy is back from the days of financial crisis. Major stock market indices are hitting all-time highs while GDP and consumer sentiment is upward trending. Moreover, the Gross Domestic Product (GDP) increased at an annual rate of 4.1 percent in the second quarter of 2018, according to the “advance” estimate released by the Bureau of Economic Analysis.¹ This estimate compares to a 2.2 percent real GDP increase in the first quarter of 2018.

The U.S. commercial and residential construction market has benefited too and has been expanding since 2010. For example, the New York Building Congress reports that the volume of construction spending anticipated through 2019 represents the city’s most significant building boom of the 21st century.²

And, the Urban Land Institute’s Real Estate Consensus Forecast projects commercial real estate transaction to continue to exceed the 17-year average through 2020.³

BUT, WHAT ABOUT TOMORROW?



In spite of today’s positive indicators, an economic downturn is a regular and cyclical phenomenon. Many anticipate a decline after 2020 for valid reasons. While the Trump administrations’ tax cuts show a near-term upside potential (e.g., Q2 2018 GDP), there is less certainty of the long-term impact. Also, tax cuts and industry bailouts due to trade wars are indications of a potential economic slowdown in the U.S. as they will likely lead to increased costs and debt. For example,

tariffs on steel from China, Mexico, and Canada will raise domestic prices. These tariffs not only impact the cost to import and produce items in the U.S, but they will hurt U.S. industry as countries retaliate with their own tariffs. This tit for tat may lead to industry bailouts for farmers, manufacturers, and builders leading to even more debt. Moreover, even slight increases in interest rates will further put pressure on the economy.

In the construction industry, land, materials, and labor costs are upward trending in every market. These expenses are creating a differential where developers and investors must reconsider their project locations or redevelopment opportunities. This type of hesitation may be another indication of potential construction spending slow-down. According to Engineering News-Record's second-quarter Construction Industry Confidence Survey⁴, 86.4 percent of construction executives said that materials price pressure is something that they are experiencing, more than a 12 percent increase from the first quarter, with steel prices now a significant concern for most in the wake of U.S. tariffs.

WHAT A SLOWDOWN MEANS FOR YOU

As you read this piece, you may wonder how a future recession will impact you. If you've lived through one or experienced the impact recessions have had on your family, you'll quickly recognize some of the outcomes listed below.

Hiring Freezes and Downsizing

A recession means hiring freezes or, worse yet, layoffs. Your remaining team will be left to take on a more significant workload. You'll need to do more with fewer people, or you may be next to receive a pink slip.

Paying More Attention to Risk Than Ever Before

Lenders will take on additional risks due to rising construction costs and less certainty

about future demand. To manage this risk, you will be held accountable for assessing a project's feasibility, geographic and asset class risk, the likelihood of on-time completion, budget projection accuracy, and demand-driven pricing.

Lien and Cash Management

Lenders will need to carefully monitor project momentum to ensure costs align with the budget and timeline to mitigate risk. Hypervigilant attention will be necessary when reviewing draw requests, the equity contributions and requirements per loan over time, retainage, and interest reserves. Construction loan administrators will need to also look closely for suspicious line items, change orders, duplicate invoices, and other accidental or fraudulent mistakes. Moreover, slow payments by general contractors to their subs is a leading cause of liens that can delay a project. Closely auditing lien activity and other lien management best practices will be required to improve the likelihood of on-time project completion.

Getting Creative and Identifying New Opportunities

Lenders will need to be more patient for the right deal to fund, as the capital will still be available to deploy. However, saturation in luxury markets and rising interest rates will add risk. Developers may present new projects that involve value added repurposing of well-located buildings. For example, we'll see more and more retail, housing, and office repurposing of buildings from malls to adult-style dormitories.

To prepare today for an inevitable downturn, lenders must identify opportunities to improve efficiencies, mitigate risk, and cut costs. But how do you do more with less, monitor risk, and manage draw disbursements when faced with many of the challenges in today's construction lending economy, not to mention those brought on by an economic slowdown?

We can start by looking at what's wrong with today's process to manage and administer construction loans.

PROBLEMS WITH THE CURRENT STATE OF CONSTRUCTION LOAN ADMINISTRATION



The use of manual processes in managing construction loan draws and disbursements is not only inefficient, but it's also prone to unnecessary risk. The primary challenges include a risk-prone environment, unstructured data, and outdated modes of communication.

Draws take up to 10 days to process because the current way we manage them is cumbersome. Moreover, it's hard to know how to act on much of the data created throughout the process because it can be idiosyncratic, unstructured, and from many sources.

Other challenges that hurt the current construction loan management process include complicated and changing regulations and the fact that 83 percent of contractors file project-stalling liens due to slow payments from general contractor.⁵

Vulnerable to Human Error

While fraud and hacks will always be a threat to outdated systems, a more significant risk is their susceptibility to human error. For example, manipulations in company Excel files have resulted in billion-dollar losses.

“The error occurred when the accountant omitted the minus sign on a net capital loss of \$1.3 billion and incorrectly treated it as a net capital gain on this separate spreadsheet. This meant that the dividend estimate spreadsheet was off by \$2.6 billion...”

Fidelity's Magellan 1995 fund estimating error from the Risks Digest

The main underlying reason behind this type of vulnerability is the inherent lack of controls, which makes it so easy to alter formulas or values, accidentally or otherwise. Even trivial mistakes can lead to significant consequences. Missed negative signs and misaligned rows may sound harmless but, when they cause a considerable loss of opportunity amounting to millions of dollars, it is time to move on to better alternatives.

Unstructured Data

The manual collection of unstructured data and documents in a variety of formats from a range of stakeholders feels like a process from another era. With the variety of materials required to package each month's draw submission, it is not surprising when lien waivers, invoices, and other documentation fall through the cracks. Besides, it's tough to track the data and troubleshoot discrepancies. For example, it's not uncommon to have required documents and interrelated spreadsheet data scattered across different folders, workstations, offices, or even geographical locations.

Tracking down a piece of data or a particular record can be daunting. Worse, even if you can pinpoint the whereabouts of every related file, tracing the logic of formulas from one associated cell to another in a spreadsheet can take a ridiculous amount of time. Good luck with troubleshooting any questionable data.

A Process Unfit for Agile Business Practices and Collaborative Work

We live in an age when technological changes are shaping and reshaping the business landscape. If your business isn't agile enough to adapt to such changes, it could quickly be left behind or even face extinction. Manual document collection and use of spreadsheets for tracking go against the idea of agility.

Spreadsheets are generally created by individuals who have no or little knowledge regarding software documentation and, in the end, these files become highly personalized user-developed applications. The problem with this is that planning, forecasting, budgeting, and reporting are all collaborative activities that typically require information from various individuals belonging to different departments. Additionally, the final documents are a result of multiple exchanges of data, ideas, and files usually shared through email. This method of transfer is susceptible to duplicate and even erroneous data.



HOW TO PREPARE TODAY FOR TOMORROW'S DOWNCYCLE

Recessions are a regular part of operating a business. While many companies did not survive the great recession, many came out leaner, more focused and prepared to thrive during the prosperous years that followed. Now is the time to plan ahead and prepare to tackle risks from multiple fronts.

Start with Loan Origination

Lenders may want to pay closer attention to their title insurance policies. This type of insurance protects against problems with the title to a property like if someone sues to say they have a claim against the property. It's critical to spend more time reviewing and identifying vulnerabilities or deletions for things like unrecorded mechanics' liens, assessments, encumbrances, encroachments, easements, water rights, mining claims, patent reservations, conflicts of boundary lines, and shortages in area access to and from the land and other visible matter.

Lenders must also spend more time evaluating contractors to identify any negative history or overcommitments on their part. According to the FDIC, documentation files should include background information concerning reputation, work and credit experience, and financial statements. This extra level of due diligence will reinforce that the developer, contractor, and subcontractors have the experience and capacity to complete the project successfully.⁶

Automate document, budget, and cost reviews

Simple process actions today will ensure healthy efficiency ratios and more sophisticated and future-proof practice tomorrow.

An area in lending overlooked by technology until recently is the use of process automation for back-office administration. New machine learning and intelligent automation capabilities present lenders with a safe, affordable, and game-changing opportunity to improve the loan management process and maintain a competitive advantage.

Lenders can now capitalize on unstructured data to identify errors and make intelligent decisions. For example, the Bank of New York Mellon Corp experienced an 88 percent improvement in processing time thanks to over 220 AI digital robots that automated tasks like data requests from external auditors and fund transfer bots. The bots help correct formatting and data mistakes in requests for dollar funds transfers. Automating this type of work that previously required humans to sift through mounds of data manually has allowed them to cut down response time to 24 hours from 6 to 10 business days.⁷

In another example, J.P. Morgan Chase discovered that nearly 80 percent of loan servicing errors were due to contract interpretation issues. They tested machine learning algorithms to automate document analysis and to extract essential data points and clauses. Like the Bank of New York Mellon, J.P. Morgan Chase cut what used to require

thousands of hours of manual document review down to a few seconds.⁷

Third-party inspections

More than ever, you will need to rely on your 3rd-party inspectors to help evaluate and monitor project progress and identify potential issues before they become problems. This is most important for residential projects.⁸

Focus on payment disbursement to reduce the risk of liens

Improving draw review and disbursement efficiencies not only reduces administrative time, but also expedites draw processing time to disburse funds faster in turn reducing the likelihood of a lien due to slow payment. Faster time to disburse also increases portfolio interest revenue.

The OCC also recommends that lenders pay subcontractors directly. Too often a lien is filed because a general contractor is slow to pay. This scenario becomes more common during a recession.⁹



HOW CONSTRUCTION LOAN MANAGEMENT SOFTWARE HELPS

Construction loan software enables lenders to efficiently manage and automate construction loan administration. It is scalable, flexible, and will allow you to handle any size portfolio of construction loans with existing or reduced headcount. With the right software, your construction loan administrators will be able to do their jobs more efficiently and to a higher standard of quality.

Let's take a closer look at some of the benefits of construction loan software.

Intelligent Process Automation

Simply put: the problems that would take human being hours to solve, or questions that would take days to answer, can all be resolved and responded to seconds by applying machine learning to the construction loan process.

Construction loan software and digital draw management allow lenders to aggregate all of the information from those countless emails and PDFs, automate various processes like budget reconciliation and approval workflows, identify errors, provide actionable recommendations, and ensure your projects move quickly towards lien-free completion.

No longer will you need to rack your brain trying to figure out which invoice belongs to which part of the project, or if an invoice is a duplicate from a previous draw, or if there's an outstanding conditional lien after the release of a draw disbursement.

Consolidate Tools

Construction loan software is a single platform that connects the lender, borrower, builder and any other parties involved in the process by providing a secure alternative to risky communication through other channels like email. This type of software also reduces dependency on spreadsheets to manage the entire process. Construction Loan Software can help you:

- Keep all of your construction files and documents in one place, organized, shareable and downloadable.

- Create unique workflows to accommodate all types of construction loan products and multiple lines of business.
- Configure draw workflows to ensure proper approvals and compliance.
- Use digital draw schedules and project budgets that are automatically reconciled in place of the old methods like spreadsheets.
- Access the information you need quickly and easily.

Improve Efficiency and Quality of Service

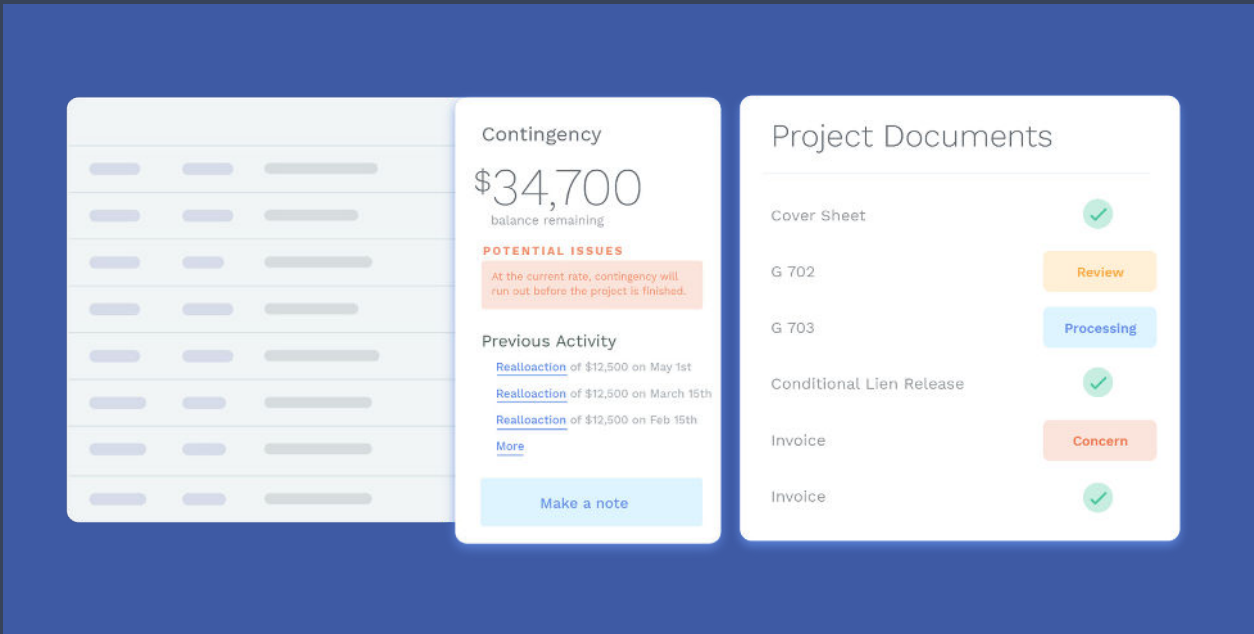
What differentiates one construction lender from another in this competitive industry is ease of access and the quality of customer service that a lender can offer. Construction loan software can help you become more efficient and provide better service by making processes easier for you and your borrowers.

It increases efficiency by:

- Managing loan budgets and controls with ease.
- Providing an easy-to-use tool to borrowers that allows them to have insight into what's going on with the project 24/7.
- Significantly reducing manual processes, including elimination of data entry, document collection, and payments processing.

Reduce Risk

Construction loans require more post-closing support and ongoing administrative effort to be properly serviced than any other type of lending. By eliminating a lot of manual processes, loan automation software helps lenders avoid risks and allows them to focus on what they do best (i.e. building relationships and growing business.)



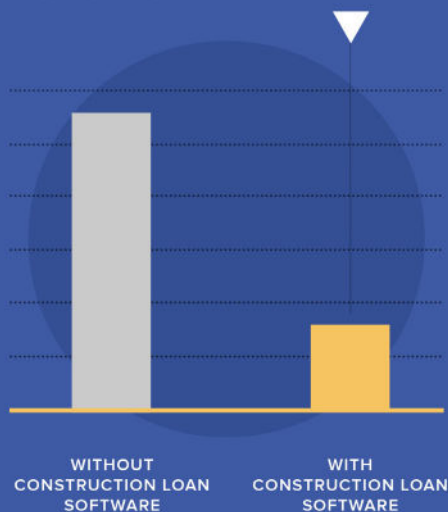
Without a digital and automated processes, lenders rely on paper files, spreadsheets and numerous phone calls, emails, faxes, and meetings with borrowers and builders to manage their construction portfolios. With construction loan software, lenders can avoid the risks of fraud and human error with:

- Real time connectivity between all parties (lenders, borrowers and builders).
- Administrative efficiency through simplified compliance and automated budget tracking, giving your team the ability to manage more loans in less time and reduce your underwriting risk.
- Streamlined processes which result in more interest income for you and quicker draw turnaround times for builders.

Increase Profitability

Institutions are now competing less on price and more on ease of doing business and the overall experience they provide to borrowers. Competing for business based on rates alone is quickly becoming ineffective. However, the ability to provide a digital platform that can ensure a faster, more efficient draw process and provides complete transparency for every action is a valuable asset that builds trust with borrowers and builders, ultimately resulting in increased business through referrals.

80% FASTER



CONCLUSION

We're fortunate to be living and working during a prosperous time and healthy economy. Not only are we near full employment levels, but we're also earning record profits. Regardless of the economy, good construction loan management practices improve efficiencies, reduce risk, and drive profits. Some of the most competitive lenders in the world are embracing the advances in technology and intelligent process automation tools today.

With best practices in place today, construction lenders are more likely to comply with regulations and mitigate risk now and in the future. Lower levels of risk allow lenders to differentiate themselves with competitive interest rates and capture a larger share of the market with 2-10 percent more profitable loans.

On a high level, construction loan documentation and payments have historically been a logistical nightmare with documentation coming in various forms and formats. Process automation platforms and smartphone adoption have now advanced to a point where technology can be used to streamline the process.

With the right software, you can grow profitability and save money by:

- Increasing administrative efficiency
- Reducing draw turnaround time
- Growing loan portfolio without increasing its administrative headcount
- Reducing risk
- Simplifying compliance

ABOUT RABBET

Rabbit is bringing efficiency, accuracy and transparency to the complex connected construction economy. The intelligent construction finance platform uses machine learning to parse documents and connect information for reduced administrative burden, verifiable compliance, and faster decision-making for real estate lenders and developers. Based in Austin, Texas, Rabbit is venture-backed by QED Investors, Camber Creek and Goldman Sachs.

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