"The man who views the world at 50 the same as he did at 20 has wasted 30 years of his life."
Muhammad Ali

LePatner Report

CONSTRUCTION COST CERTAINTY

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A Sharp Slow Down in NYC Construction

What it Means for the Rest of the Country and How Congress Might Still Make Matters Worse

By Barry B. LePatner , Esq.

A recent report on construction activity in New York City revealed that new construction project starts had fallen to the lowest level in four years sending a shock wave through the city's real estate, design and construction communities. According to a report by the New York Building Congress, only $6.4 billion worth of construction projects started during the first six months of 2011, representing an astounding 40% drop from the first half of 2010, when construction starts reached $10.6 billion. These numbers have taken a huge plunge from 2007's $35 billion high.

In a massive understatement, New York Building Congress President Richard T. Anderson stated, "Construction activity in the first half of 2011 was extremely disappointing. The more than $20 billion in construction starts recorded for the year in 2010, amid signs of a slowly strengthening economy, offered hope that the building industry was turning the corner," he added. "The initial data for 2011, however, tells a story of relative weakness in each sector."

Other distressing signs in New York City construction were registered by a drop in massively large projects from the private and quasi-public sector. First-half construction starts in the non-residential sector—which had been buoyed in 2010 by the start of the World Trade Center Transit Hub, Barclays Arena in Brooklyn and the renovation of Madison Square Garden—fell 40% to $4.6 billion. Thanks to the $1.2 billion expansion of Terminal 4 at John F. Kennedy International Airport, the $4.6 billion marked an improvement over the $3.8 billion in starts in the first half of 2009 and $3.7 billion in 2008.

Of course these signs of trouble are not limited to New York. We currently face nationwide problems for the construction industry. The residential sector, which had been progressing better than most other sectors, dropped to $840 million in the first half of 2011, compared to $1.3 billion in the first half of 2010, and $3.6 billion ▶

Protecting Construction Lenders Against Defaults

By Ronald B. Feingold, Esq.

When U.S. economic activity begins to accelerate and construction lending resumes, lenders will take a more guarded approach. They will likely choose to fund borrowers who can demonstrate a strategy to avoid the ever-present and industry-pervasive cost overruns and project delays, which invariably impact construction loan repayment.

Many owners defaulted on their construction loans during the most recent recession, causing bank write-offs and even bank failures. Nonperforming commercial real estate (CRE) loans dominated the portfolios of banks that were shut down, according to the February 2011 U.S. Bank Failure Report, issued by Trepp LLC. According to Trepp, construction loans made up over 50% of the bad CRE loans. Trepp expects bank failures to continue at least into 2012.

According to Foresight Analytics LLC, total delinquencies for construction loans rose during 3Q2010, to an estimated 19.5%. Still impacting the construction and lending market are major valuation declines and the unavailability of financing. Some new loans are being initiated, but not enough to outpace the tightening construction market.

Another sign that construction recovery has a ways to go is that builders began work on fewer offices, hotels, shopping centers and other commercial projects in January, 2011, pushing construction spending down to near a decade low, according to the Commerce Department's March 2011 report. Unsurprisingly, the construction unemployment rate jumped to 22.5 percent in January 2011 according to an analysis of new federal employment data released in February 2011 by the Associated General Contractors.

The construction industry is desperate for work. Contractors are forced to hold the line on bid pricing. Bidding low adds hope that the Contractor could be awarded the project.

However, as in the past, once hired and contracted for the project, the Contractor often has nonstop opportunities to increase its profit through (i) change orders, (ii) errors and omissions, and

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A Sharp Slow Down in NYC Construction

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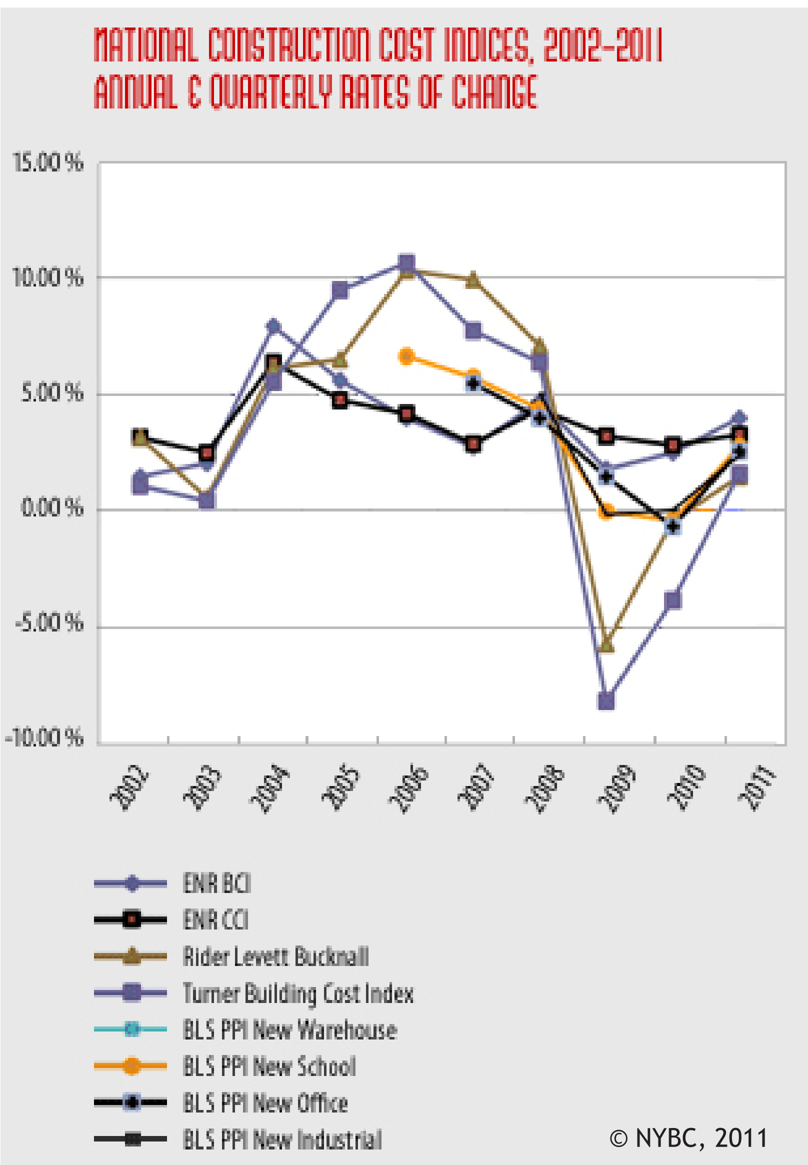
during the same period in 2008. Infrastructure projects, such as bridges, highways and mass transit fell 38% to $1.7 billion from the corresponding period in 2010.

Not only has the total value of construction in the nation fallen by $400 billion over the past three years, but the federal deficit on our funding for corrective work needed by our ailing infrastructure exceeds, according to the American Society of Civil Engineers, $2 trillion! But judging by the rumblings in Washington, the worst is yet to come. On September 30, 2011, the federal gas tax, which largely funds the nation's road and bridge construction, will expire. If Congress doesn't extend it, the consequence will be a halt to billions of dollars of work. In New York State, impact on funding transportation projects would be felt on road and bridge projects around the state, and funding the $10 - $16 billion to replace the failing Tappan Zee Bridge will become a near impossibility.

Without a gas tax extension, no responsible transportation administrator or civil engineer can deny that more bridges, dams and levees will fail, jeopardizing the lives of our citizens. After all, structures such as the I-35W Bridge in Minneapolis, which collapsed killing 13 and injuring 145, have already failed. New York City is not safe from similar tragedies.



Restoring fiscal stability to the Highway Trust Fund is essential to maintaining the viability of our nation's transportation system. In 2010, HTF revenue was $35 billion, but Congress authorized $50 billion in spending. Over the past three years, Congress has transferred approximately $35 billion from the General Fund into the HTF to keep it solvent. A delay in extending the gas tax would cost the federal government billions of dollars over time. Multi-billion dollar corporations, such as Exxon Mobil which has vast fleets of trucks on the road, would save as much as $78 million a month. That money is desperately needed for the critical task of maintaining our nation's roads and bridges.

In addition, halting existing road and bridge and other ongoing projects will add greatly to the number of unemployed construction industry workers. By March of this year, 2.2 million construction workers were unemployed. This represented an unemployment rate in the industry of 21.8%, nearly twice the national average. The latest news on the drop in New York City construction will certainly reflect more unemployment for workers in the city who, were hopeful the trend was turning up for improved vitality for public and private work. Since the end of 2008, when construction employment was at its peak -- employing 136,000 construction workers -- the industry has lost 25 percent of it's work force, falling to 101,200 last quarter. The last time things were this bad was the second quarter of 1998, when only 99,000 people were working in construction.

Bringing new infrastructure and other construction investment to a virtual halt will prove to be one of the most significant mistakes this nation has ever made. It will impact our economy today and affect our long-term commercial vitality, reduce our competitive edge internationally and threaten the public welfare until we act boldly and courageously—something our leadership in Washington has failed at for too long.

As real estate prices in the city, or at least in Manhattan, approach pre-Lehman levels, and the wider economy teeters back from the brink, the guys who built the apartments are still suffering. The credit markets are still tight, making it hard for developers to find financing for new construction. This is why the one sector that has seen growth over the past three years is heavy construction and civil engineering, due to the expansion of publicly funded infrastructure projects. (Who says the stimulus was a bust!)

Leaders in New York City have an opportunity to set an example for the nation and our Federal government by showing the job creating ability of construction projects—public and private—and the greater safety and economic benefits of increasing construction work on infrastructure repair projects. Will they answer the call? ■

Replacing the Tappan Zee Bridge,
New York's Ultimate Infrastructure Challenge

From a presentation by Barry LePatner at The Manhattan Institute's Infrastructure Forum, June 22, 2011

Librado Romero/The New York Times

In his definitive blow-by-blow account of the 2008 Wall Street meltdown that triggered the financial crisis, Andrew Ross Sorkin quoted Richard Fuld, the head of soon-to-be-bankrupt Lehman Brothers. Fuld acknowledged the myriad of short-term profitable but long-term investment mistakes he had allowed to go on that eventually led to his firm's demise. According to Sorkin, Fuld said, "It's paving the road with cheap tar. When the weather changes, the potholes that were there will be deeper and deeper." "Now," wrote Sorkin, "here they were, potholes as far as the eye could see, and Fuld had to admit, it was worse than he'd ever expected."

The attitude of our national and state leadership on infrastructure issues for decades has been about its failing akin to paving our rotting roads and bridges with cheap tar as the solution for both the short and long term.

As Nicole Gelinas's excellent article on the Tappan Zee shows in the Spring 2011 *City Journal*, there is a huge price to pay for mere "stopgap" efforts when it comes to remediating our roads, bridges and tunnels. New York State has publically acknowledged that it will spend $150 million a year to keep the bridge operational. Looking to a minimum 10 years before a replacement could conceivably be designed, financed and built, NYS taxpayers are facing an additional cost to maintain a bridge that is capable of collapsing at any time of over $1.5 billion!

There is a clear lack of political will in both Washington and state capitals for dealing with the overwhelming challenge of addressing our failing infrastructure. Decades of ignoring the obvious need for ongoing maintenance – in effect, states starving our built infrastructure assets while taking funding from Washington and using billions for new projects while ignoring our existing roads and bridges – has left a price tag of over $2 trillion for bringing our infrastructure up to minimal standards.

A reluctance to raise the federal gas tax that once funded the entire construction of the interstate highway system – while politically expedient -- is economically unsupportable. President Ronald Reagan raised the tax in 1982 when he realized that without doing so would make the cost of replacement even greater over time. President Bill Clinton was the last president to raise the gas tax in 1993. Today, a "per gallon" gas tax is unsustainable. The depressed economy has caused a major decline in miles driven. Ironically, hybrids and more fuel efficient cars have also cost the highway fund dearly. The gas tax must be recast so that those who are major users get taxed on how many miles they drive. Those who do not use our roads should no longer be subsidizing roads that are falling apart.

We can and we will begin to rebuild our infrastructure to meet the needs of a population that is projected to total over 400 million by 2050. Repairing bridge inventory like the Tappan Zee that has exceeded its intended 50-year lifespan, must occur before gravity wins, and we are forced to acknowledge our infrastructure shortcomings under tragic circumstances - again.

But make no mistake about the need for controlling the cost of our new and rebuilding efforts. We cannot afford to delay these projects with arguments that uncontrollable construction cost overruns leave our state and federal budgets at risk. Controlling construction costs with true fixed-price agreements, negotiating with contractors all identifiable contingencies, and requiring contractors to assume the risk of completing projects on time and on budget are within our control. Any politician who argues otherwise is ignoring the defined mechanisms that are available to secure a complete price for these projects and ignoring the benefits of returning tens of thousands of unemployed contractors to work. Different studies show that for every $1 billion of infrastructure work, 11,000 to 30,000 jobs are generated!

Finally, it is important to recognize that our infrastructure future will ultimately entail turning to an increased role for public/private partnerships and state and federal infrastructure banks to stimulate investment. Private investment funds totaling hundreds of billions of dollars await a workable financial model that can be adapted to allow remediation of bridges and tunnels and construction of new infrastructure across the nation. But private investors are concerned about the lack of leadership and the haphazard politics of moving these projects forward. New P3 models will not only provide fresh funding for building these needed assets but make provisions for maintenance and enhancements over the term of a long term lease so that the governmental "owner" receives a quality facility back at the end of the concession.

We need fresh thinking without question. But most of all we need leadership in this vitally important policy area. ■

Construction Loan Defaults... *continued from p1*

(iii) delay claims. Incomplete designs, guaranteed maximum price (GMP) contracts, and "fast-track" project delivery make it easier for the builder to profit on change orders and delay claims. This reality jeopardizes borrowers who bear the unexpected additional costs of carrying these loans for extended periods of time or finding additional capital.

Lenders are at risk when borrowers are distressed by unexpected costs and cash flow problems. In an August 2010 *USA Today* article, Paul Wiseman reported that construction loans surged more than 150% between the first quarters of 2003 and 2008, when they peaked at $631.8 billion. (Overall loans rose just 55% during the same period.) Wiseman quoted Bill Bartmann, who owns a debt advisory firm, as follows: "Most construction loans are so unique, so different, so non-homogenous, that you can't securitize them…They were kept on the books of the banks that originated them." Troubled construction projects are a nightmare for banks. "If a bank forecloses on a house, it's a house. Everybody knows what to do with it," Bartmann says. "But if you're dealing with a half-constructed hotel or a strip mall, not only does no one want it, you now have to maintain it." Writes Wisemann, "Many bankers have chosen to wait it out, extending the terms of loans to troubled developers to keep from foreclosing and taking possession of a half-built headache. Which leaves bad loans and troubled property in limbo."

Using common standard industry agreements, which encourage "fast track" and GMP contracts, owners have little chance of steering clear of unanticipated cost overruns. There is an essential need for design and construction contracts to establish a structure that ensures that the owner pays a true fixed-price.

Owners needing design and construction contracts are often faced with many challenges including:

- How to structure a true fixed-price contract if the C.M. insists that the project proceed "fast track" based on construction drawings that are only 60-70% complete?
- How to secure reliable, independent construction cost pricing in order to conduct meaningful negotiations with the C.M. on contract price?
- How to know that the construction team will assume the risks for achieving the construction schedule and contract pricing without delay or cost overruns?
- How to protect against contractors' below-cost low-bids, which to make a profit on the job, trigger contractor change orders and claims for design errors and omissions and delays?

There are solutions. Construction cost certainty is achievable. Owners can avoid problems with GMP and "fast-track" projects by retaining a reliable owner's intermediary to manage the project. Secondly, a true fixed-price contract is crucial. It should (i) require fully completed and coordinated construction documents; (ii) eliminate typical C.M. bidding abuses; (iii) coordinate the efforts of the entire project team from the outset of the project; (iv) identify and price potential risks and conditions that may arise; and (v) equitably allocate those risks to team members.

Our firm developed **LePatner C³™** {Construction Cost Certainty} for Owners, a proven complete-price approach to designing and building capital projects. Using LePatner C³, contractors bid on fully complete and coordinated drawings as opposed to bid documents that are typically 85% or less complete. Contractors bid confidently on these complete and coordinated construction documents and feel more comfortable in waiving their right to assert claims based on incomplete scope documents. Implementing LePatner C³ reduces lenders' construction loan risk while reducing borrowers' exposure to unanticipated cost overruns.

Lenders and borrowers alike will see that a LePatner C³ TruFixedPrice™ Agreement incorporates critical protections in designer and contractor agreements that fairly shifts certain risks to the contractors in order to mitigate or eliminate delays and unnecessary cost overruns.

Going forward, construction lenders will likely demand greater levels of assurance from borrowers that their projects will be completed on-time and on-budget. Lenders and their borrowers no longer need to face the uncertainties of an inefficient construction industry. As the new economic cycle takes hold and construction begins moving forward, owners and their lenders will, for the first time, have a real choice. Either they can continue to utilize a practice that benefits contractors, which enables them to hold a project captive to improper claims and delays. Or, borrowers and their lenders can choose to utilize a methodology that ensures completion of a project within a fixed budget, and without delays. ■

This article was edited first published in *Real Estate Finance & Investment,* June 20, 2011

FIRM NEWS

Barry LePatner is receiving some nice exposure on CNBC. In late July, he was interviewed at the George Washington Bridge by Michelle Caruso Cabrera, an award winning reporter for the network, who wanted to hear from the author of **Too Big to Fall** for her upcoming special program on infrastructure. The first question she asked was: "How would you describe the state of the nation's infrastructure?" LePatner answered: "I would state to our national and state government leaders that the state of the country's infrastructure assets is perilous and getting worse with each passing year. More tragedies, like the I-35W in Minneapolis, are not a question of if, but when." The program will air this Fall. Sign up for our Blog to get our latest updates for showtimes.

Barry LePatner wrote a guest column for Bloomberg Economics Brief July 1 titled "Housing Renaissance May Lie in Construction Productivity" in which he argued that a more efficient construction industry could spur demand for new projects and mitigate the 20%+ unemployment in the industry.

LePatner was a live guest on Dylan Ratigan's talk show on MSNBC Friday September 16 to discuss the major issues confronting our nation's infrastructure. As Ratigan started the broadcast, he noted that last year the word "infrastructure" was a wonk word or "channel changer" but today it is deserving as a most crucial topic of discussion. You can watch the entire interview **here**.

Barry LePatner was the keynote speaker at the ASCE's Metropolitan Section Forensic Engineering Forum on September 20 and presented "Public Safety and the Role of the Engineering Professionin Addressing Our Nation's Infrastructure Failures." On October 20, he will present a similar address to civil engineers at the ACEC's 2011 Fall Conference in Las Vegas.

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