National Association of Home Builders

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Residential AD&C Financing: The Basics

Normal View

AD&C stands for residential land acquisition, development and construction, the financing required to purchase land; develop home lots through clearing and grading; install infrastructure such as streets, curbs, sidewalks, lighting, and sewer and utility connections; and build homes on the improved lots. AD&C loans are extended in a series of "draws" tied to stages of completion, and the balance of the loan increases with each draw. Interest is paid periodically (usually monthly) while the loan is outstanding, and principal is repaid when a completed home is sold. For residential construction, "completion" means that the house has received a certificate of occupancy. A loan can be for the production of one home, several homes or an entire subdivision of homes. Loan maturities generally range from 6 to 18 months, depending on the complexity of the project, the local approval process and weather conditions.

Most AD&C loans have floating rates that are tied to the commercial bank prime rate, and the rate of interest is applied to the outstanding portion of the loan commitment. Borrowing costs also include origination, processing and inspection fees that are applied to the full amount of the loan commitment regardless of the amount drawn and outstanding.

Banks also will charge up-front fees, or points, on the loan. A point is one percent of the loan commitment amount. Points are paid when the commitment is funded. Points typically represent a significant portion of the cost of borrowing on a residential construction loan because the contract interest rate is applied to funds actually drawn, while the points are applied to the full commitment amount. Since AD&C loans are drawn in stages as construction progresses, the lender receives interest on the full commitment amount only briefly, if at all.

Loan Limits

Regulations limit the amount that financial institutions can lend in various loan categories. These limits are usually expressed in terms of a "loan to value" ratio. For example, the maximum amount a financial institution can lend for a loan to build a single-family home is 85 percent of the appraised value of the completed property.

There are also limits on the amount that financial institutions can lend to one borrower. For example, a financial institution is generally prohibited from lending more than 30 percent of its capital to one borrower for residential development purposes.

Financial institution regulators have recently taken steps to increase scrutiny of commercial real estate loans (including residential AD&C loans), and NAHB is working with the regulators to exclude residential AD&C loans from the commercial real estate category. The banking regulators issued guidance on commercial real estate lending activity on December 6, 2006.

Underwriting Guidelines

Financial institutions are also required to establish written procedures for approving and administering loans. In addition to the regulatory loan limits, financial institutions also incorporate the following criteria into their loan underwriting guidelines:

- **Pre-sold units** – A loan is more likely to be approved if the project has a large number of pre-sold units under contract relative to speculative units.
- **Amount of cash equity or other collateral provided by the borrower** – A loan is more likely to be approved if the builder puts some cash equity into the project or posts a significant amount of collateral.This ensures that the builder has a vested interest in the project's success and protects the lender against losses.
- **Financial strength of the builder and guarantors** – The lender will closely examine the overall financial strength and track record of the builder and the guarantors to determine whether the project will be a success.
- **Construction period of the project** – Lenders generally want to be repaid sooner rather than later, so they usually favor projects with shorter construction terms as opposed to longer ones.

Loan Disbursement/Funding

The builder receives the proceeds of the loan in a series of disbursements commonly referred to as a "draw schedule." The builder and the lender establish a draw schedule based on stages of construction, and interest is charged on the amount of money disbursed to date. The draw schedule details the amount available to be disbursed and the requirements that must be met throughout the construction process. Generally, there are about six draws. Loan proceeds, or draws, are disbursed to the borrower after the agreed-upon work has been completed for that stage of construction. Usually, the lender first inspects the property to verify the work has been completed prior to disbursing the draw. A loan is almost never funded in excess of the amount of completed construction.

This is an example of a formula for calculating construction loan draws/disbursements:

- **First Draw** (Slab/Foundation - 15%) This draw will be used to purchase land if the builder does not already own it. The draw is released at closing. Any builder "soft costs" such as permits are added to this advance. Septic and any site work are also included. The loan fees, attorney's fees, title insurance, etc. are paid at closing.
- **Second Draw** (Framing/Rough Carpentry - 10%) This draw is released when the foundation is poured. It covers building the first floor walls, putting the sub-flooring in place and sheathing the exterior walls.
- **Third Draw** (Roof/Mechanicals - 20%) This draw occurs after the second floor sub-flooring and walls, roof framing, rough plumbing, electrical, HVAC, and any miscellaneous items like garages and pools are in place.
- **Fourth Draw** (Exterior/Interior Finishes - 20%) This draw occurs after doors, windows and drywall are installed, and the exterior siding or painting is complete
- **Fifth Draw** (Trim-out - 20%) This draw occurs when all interior trim, cabinets, paint, final plumbing, HVAC, and electrical are complete.
- **Final Draw** (Project Closeout - 15%) This draw occurs when all decks and patios, house cleaning, appliances, and landscaping are complete, the final inspection has occurred, and occupancy permits have been issued.

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