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Stalled Construction Projects and Financing

THE AMERICAN INSTITUTE OF ARCHITECTS
Stalled Construction Projects and Financing Problems

An Agenda to Keep Contraction of America’s Buildings and Infrastructure Going

THE AMERICAN INSTITUTE
OF ARCHITECTS

Economics and Market Research,
and Government and Community
Relations

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Introduction

The construction industry is one of the most volatile sectors in the U.S. economy, and as such benefits greatly from economic expansions and suffers greatly in economic downturns. The most recent economic cycle has been particularly devastating for the construction industry. Since the end of 2008, construction spending in the U.S. has declined by more than a quarter, or by almost $300 billion, with the loss in this sector alone accounting for a 2% decline in the size of the U.S. economy.

Even this significant decline underestimates the total impact of this loss on the economy, however. Analysis by Dr. Stephen Fuller of George Mason University concluded that $1 spending on the construction of buildings added an additional $2.35 in indirect benefits to the national economy. With residential structures and nonresidential buildings accounting for about two-thirds of total construction activity at present, the losses in home and building construction could have generated another $470 billion in indirect losses to our economy, even if we ignore the indirect benefits from public works construction.

The downturn has been much more serious for private construction activity. While overall construction spending has declined by 27% since the end of 2008, private projects have fallen by more than a third, while public construction has declined less than 10%. Some of this differential has to do with funding initiatives for public projects under the American Recovery and Reinvestment Act of 2009. However, lack of construction financing opportunities has also been a significant factor holding back a private construction recovery.

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It does not appear that a recovery in the construction industry is imminent. The Architecture Billings Index, a monthly indicator of design activity in the U.S. that is compiled by the American Institute of Architects (AIA), has yet to point to a full recovery in design activity at architecture firms. Signs of an upturn in late 2010 and early 2011 evaporated during the second quarter of this year. Recent positive signs of a rebound in design activity hopefully will be sustained over the coming months. However, research undertaken by the AIA indicates that architectural design activity leads construction spending by 9 to 12 months, so even an immediate turnaround in this indicator would not point to growth in construction activity until around mid-year 2012.

Even Continued Gains in the Architecture Billings Index Unlikely to Result in Construction Upturn Until Mid-2012
Lending Restrictions at the Core

A recovery in construction activity will have difficulty gaining traction without greater access to financing. Regular surveys of senior bank lending officers on lending practices conducted by the Federal Reserve Board document the dramatic tightening of commercial real estate loans from mid-2007 through the end of 2009. During 2008 and early 2009 in particular, the overwhelming majority of respondents were reporting an ongoing tightening in standards for these loans. Beginning in 2011, lending standards for these loans began moving back toward neutral, as the share reporting tightening in lending standards was almost evenly offset by the share reporting easing. Still, even though lending standards are probably not getting more restrictive, they remain very tight by historical standards.

When lending standards were tightening during the heart of the recession, demand was extremely weak. So, the dramatic tightening in commercial real estate loans in 2008 and 2009 coincided with extremely weak demand for these loans. With limited interest in investing in real estate or building new facilities during this time, the tighter lending standards were minimally disruptive. However, beginning in 2011, demand for commercial real estate loans began to increase faster than lending standards have been easing according to this survey, creating the current credit crunch for many sectors in the nonresidential construction sector.
In fact, the volume of outstanding construction and development loans held by financial institutions has fallen sharply in recent years. Levels at midyear 2011 were just under $275 billion according to FDIC figures for institutions that they insure, down almost 15% from December 2010 levels, and less than half of their December 2008 volume.

U.S. architecture firms have been reporting increased financing problems for construction projects for most of 2011. A July, 2011 AIA survey of a nationally representative panel of architecture firms discovered that almost 70% of firms had one or more projects at that time where work was currently stalled. There were a variety of reasons why these projects were not moving forward at that point, including general client nervousness about the viability of the project, a generally weak economy, and an insufficient budget for the project as currently conceived. However, financing problems topped the list. Over 60% of architecture firms with stalled projects indicated that at least one of their stalled projects was having problems with financing.

Difficulties in securing financing are widespread across most building construction categories. Architecture firms report that residential, commercial and institutional construction projects all are subject to serious financing problems. And it is not only large, complex projects that are at risk. To the contrary, architecture firms recently reported that projects with estimated construction costs of under $5 million account for almost half of all projects stalled due to lack of financing, even in the commercial and institutional categories. In fact, only 15% of stalled projects have estimated construction costs in excess of $25 million.
Nor are all projects with difficulties in obtaining financing new construction projects. During recessions, renovations and retrofits of existing facilities often are seen as more cost effective projects. In the current downturn, architecture firms report that over a third of projects stalled due to financing problems are additions to, or renovations of, existing facilities. Indeed, in spite of growing interest in energy efficiency and sustainable construction, not even green certified projects are immune from financing issues. Over a quarter of projects reported as stalled due to financing by architecture firms could be expected to receive LEED, Green Globes, or other green certification status.

A High Proportion of Stalled Design Projects are Smaller, Focused on Existing Facilities, and Expect Green Certification

![](chart)

**Share of Projects in Jeopardy Has Doubled**

With available financing for real estate projects declining faster than demand for projects in recent years, financing has become a more common cause of stalled projects. The extensive construction project databases maintained by McGraw-Hill Construction and Reed Construction Data indicate that there are thousands of stalled projects. The potential construction value of these stalled projects is approaching a full year’s worth of construction activity.

For a variety of reasons, many of these projects will never be constructed. Many, however, hopefully will have their problems resolved and move forward. A recent analysis of the McGraw-Hill Construction project database determined that of stalled projects since 2008 that have seen some resolution, over 40% have moved ahead toward planning, design, or construction, while the remainder was abandoned.
Regardless, problems with financing have clearly emerged as the primary factors stalling commercial real estate construction. At present, financing is the principal reason for more than one in five projects being stalled. This share has essentially doubled since 2008 when lending standards began to tighten. Additionally, financing issues are no doubt a secondary reason for project delays for many other stalled projects.

![The Share of Projects Stalled Due to Financing Problems Has Almost Doubled Since 2008](image)

Some types of projects are much more vulnerable to financing problems than others. While about one in five stalled projects at present is directly the result of financing problems, the share varies considerably by construction category. Two sectors in particular have had an unusually difficult time securing private financing recently. A third of private education projects that are stalled at present have financing problems as the central issue, with financing accounting for a higher share of stalled projects in the South than in other regions.
For multifamily housing – both designed as for-sale and for-rent – over one in five stalled projects is the result of financing problems. Construction sectors with stalled projects where financing is a less common reason for these projects being stalled include manufacturing facilities, private healthcare, and retail facilities (stores and restaurants). Even public construction projects – such as schools, public recreational facilities, as well as transportation facilities – which generally don’t rely on private financial institutions for construction financing, are increasingly facing financing challenges.

Financing Problems Account for a Higher Share of Stalled Projects in the Education and Multifamily Sectors

Clearly, the economic recession and a weak recovery have generated less demand for commercial and institutional space. Equally clearly, though, difficulties in obtaining financing currently are delaying many otherwise viable projects and therefore holding back a recovery in these construction sectors. Until more credit is extended, the potential of nonresidential building construction to promote greater levels of economic growth will not be realized.