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FINANCE

Gasping Bank System Puts Credit in Doubt

Everything from project finance to acquisitions and retirements may have to be postponed

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By Richard Korman, Debra K. Rubin, Tom Ichniowski and Steven W. Setzer

The swift deterioration of the U.S. banking system is threatening to restrict funds needed at every step of the construction industry's life cycle, with participants putting the brakes on everything from casino jobs and privatized bridge-repair projects to company buyouts and executive retirements.

The impact is uneven. Many buyout and investment deals went forward but some smaller ones were put on hold. Some banks had already temporarily bowed out of financing commercial construction projects, but what unfolded recently at industry stalwart American International Group in New York City put the credit market in greater trouble. Even the reliability of insurance policies underwritten by AIG, which was taken over by the federal government, seemed in doubt for a while.

At ENR press deadline, President Bush and administration officials were urging Congress to move swiftly on legislation to let their proposed rescue plan for financial institutions go forward. Under the administration's plan, the federal government would buy some of the bad mortgages and related assets weighing on banks and other lenders.

Members of Congress are holding out for changes in the plan put forward by Bush and Treasury Secretary Henry M. Paulson Jr. Some lawmakers want relief for those facing foreclosure, an equity stake in companies selling the housing-related assets to the government and tougher oversight of Treasury Dept. actions. In addition, leading Democrats want to add limits on compensation for executives at companies whose assets are taken over. The AFL-CIO's Building and Construction Trades Dept. also opposes the administration's plan.

The House point man on the legislation, Financial Services Committee Chairman Barney Frank (D-Mass.), told reporters on Sept. 22, "We accept, reluctantly as everybody does...the fact that bad decisions in the private sector, unconstrained by

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appropriate regulation, have brought us to the point where we have to do this." He added, "So we have to do it. We have to use the federal government's power here."

For an industry accustomed to risks and dangers, few in construction had seen anything so ominous. The real trouble won't show up until late next year, sources say.

The initial blow to commercial construction may be the heaviest, but other projects will suffer because most construction loans are made by state and regional banks. Unless a project appears near-perfect, it probably won't get financed, says James Nelson, director of credit risk for the Risk Management Association, whose members are mostly banks. The secondary market for construction loans and mortgages on commercial properties has almost completely dried up, he says. Gone is the "book-to- distribute" approach, where banks booked a loan, then sold it on the secondary, or commercial mortgage-backed securities, market. Any loans "must be squeaky clean," says Nelson.

What had been a tough "market will likely remain difficult for some time," adds Michael P. Niemira, chief economist of the International Council of Shopping Centers.

At least one public-private infrastructure finance project felt the pain. The Missouri Dept. of Transportation announced on Sept. 18 that it would discontinue talks with Missouri Bridge Partners, an industry venture headed by San Antonio-based Zachry American Infrastructure, to fast-track a major bridge- rebuilding program because of tighter credit and added cost. "We believe our efforts over the past two years culminated in an innovative proposal that provided the maximum scope of work for the lowest cost possible," says Zachry Senior Project Manager Dwight Munk. The state is opting instead to fund the bridge project by issuing \$700 million of state bonds.

On another front, architectural and engineering principals may delay retirement as new investors become harder to find, says Mick Morrissey, a partner in consultant and investment banker Morrissey Goodale. "The last recession caught owners of firms off-guard," he says. "They anticipated they could retire at the beginning of decade but because of the slowdown in mergers and acquisitions weren't able to. Then they did well and anticipated they could pull off a sale this year or next."

On bigger deals involving private equity firms, debt or debt requiring syndication is now impossible. But some private equity funds will continue investing in construction companies in 100% stock deals without borrowed funds, says Hugh Rice, chairman of FMI, Denver. Strategic acquisitions financed from cash flow and existing bank lines that require no outside financing are going forward, he adds.

"There is just a higher level of anxiety and uncertainty than even what we saw earlier this year, and more boards are doing a 'gut check' operationally," says Steve Gido, merger specialist with consultant Zweig White, Natick, Mass.

Before the government bailout of AIG to counter its investment losses, the company's teetering posture and construction links through its surety, liability, environmental and other coverage, sent shivers down the backs of clients. "Everyone was nervous; they have businesses on the line," says one broker executive, noting concern about how an underwriter in bankruptcy protection might honor claims.

"AIG is the biggest underwriter for the construction industry, and firms did not want to be in default" of contract terms requiring coverage by an A-rated insurer, says Michael Culnen, president of Totowa, N.J.-based broker C&H Agency.

Construction insurance sources say clients are watching how well AIG protects the strength of its remaining profitable assets. "AIG has been excellent at what they do, and we will look for every way possible to stay with them, but they will need to be able to quantify the risk ahead," says Culnen.

Any continuing fallout could accelerate as the end-of-year policy-renewal season begins. "There are thousands of brokers out there worrying about how to make renewal decisions," says Culnen. "All the other insurance firms we deal with have asked us to give them a shout if something happens."


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