

A Different Exit Ramp For Lenders To Partly Built Projects

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If a construction loan goes bad, the lender could sell the loan or the project, or perhaps with some help see it through to completion.

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Construction lenders have recently had to deal with a growing volume of partially constructed developments—often called “stalled assets”—where the original developers can’t finish the job. Traditionally in those cases, lenders first try to sell their loans at par—or more likely at a steep discount—to someone else. The lender hopes that the loan purchaser knows how to handle the situation while the lender reduces its risk and goes on to the next deal.

As a second choice option, the construction lender will sometimes foreclose. This is usually done with great hesitation. Typically the last thing any construction lender, except the occasional “loan to own” lender, wants is to actually own their real estate collateral. Therefore, once the construction lender forecloses, it then tries to quickly sell whatever is left of the failed project. Again, any such sale will almost certainly be made at a painful discount.

Neither a sale of the loan nor a sale of the foreclosed collateral will typically make the construction lender whole. To the contrary, after either of those sales the lender will typically take a substantial loss. On the other hand, a quick exit allows the lender to move on and not spend a lot of time, effort, and attention overseeing an asset that rarely improves with age.

Current market conditions have pushed lenders away from the traditional practice of “extend and pretend,” by which lenders would traditionally not do too much about problem loans and hope that the problems will go away with time. That worked reasonably well in the Great Financial Crisis. Today’s market conditions are very different. Interest rates have fundamentally shifted, returning to their historical levels, leaving much less room for tolerance and patience. Lenders are less inclined to keep existing borrowers in place, and more inclined to try to recover as much of their investment as they can, as quickly and efficiently as possible.

Against that backdrop, a New York City developer, Eric Brody, offers a third path for construction lenders whose projects are in distress: rather than sell off the loan or the project, the lender can take title as quickly as possible and then hire a firm like Brody’s to see the project through to completion. With the right plan and budget for completion, the lender can avoid a fire sale. The rest of this article is based on conversations with Brody, without separately attributing each of his statements to him.

Brody’s company, ANAX Real Estate Partners, has developed many projects of its own and rescued many others. When ANAX steps in to finish a project started by another developer, that doesn’t always mean completing it as originally planned. Instead, Brody first reevaluates the project with a focus on current market conditions, which can differ significantly from the state of the real estate world when the project broke ground.

He will propose adjustments that typically do not add many months to the schedule or substantially increase costs. In one recent rental apartment project, for example, Brody repurposed part of the lobby, changed the furniture package, added more technology (universal wi-fi, intelligent locks, etc.), and turned some common spaces into shared work areas, a newly popular amenity.

He brought in new designers for parts of the project, especially common areas, recognizing that today’s rental apartment tenants place more emphasis on how things look and feel than they did even half a decade ago. Rental tenants want an experience, starting with curb appeal and continuing with their arrival into the building and going onward into the lobby, elevators, and hallways.

Even before Brody stepped in and rethought that particular project, it never would have worked in the hands of the original developer, because the developer’s basis--total investment--was too high to make the project ever work given changes in the market. The

lender, on the other hand, came into its ownership of the project with a much lower basis. This made it possible to rework the project, inject modest additional capital, and come out the other end without great pain.

Beyond overseeing successful completion of the project, ANAX also sourced and delivered some new capital needed for the recapitalization, allowing the project to move forward as a financial matter and not just as a construction matter. A completed and stabilized project can be sold much more favorably than a defaulted loan or an incomplete project acquired through foreclosure.

In taking over other unfinished projects, Brody has focused on rooftops, converting them from mechanical space or unused space into another increasingly popular amenity that today's renters value. That requires installing new decks above the regular roof (which typically can't deal with all the foot traffic), furniture, and limited kitchen equipment. Sometimes he'll focus on the unit interior themselves, specifying different finishes and hardware rather than redesigning anything wholesale.

His turnaround projects typically take two to six months, depending on scope, complexity, and condition of the job when he takes it over. Sometimes he'll recommend converting a rental project into a condominium or vice versa, which can take longer and cost more because it will often involve an overall upgrade (or downgrade) of style and quality.

By enlisting a third party like Brody to finish an unfinished project, the construction lender can perhaps avoid taking the hit that would otherwise result from the bad condition of the project and the fact that not too many buyers have the appetite to clean up such messes. The same structure can also help buyers of distressed notes get comfortable with their exit strategy and perhaps bid more than they otherwise might.

Brody said he sometimes gets paid with a fixed fee, other times a percentage of some formulaic amount tied to the success of the turnaround project, and sometimes a combination of the two. It sounds like a good business to be in these days.

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