



Deconstructing the risks of construction lending

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, spoke in December with **Robert Schwartz** and **Joshua Crane**, about the implications of the current market conditions for investment in demographically driven property sectors. Following is an excerpt of that conversation.

Many investors seek out credit strategies for their ability to protect capital and generate current income. How does construction lending fit into that equation?

Joshua Crane: Construction lending is the first of three different kinds of loans used to turn undeveloped land into income-producing real estate. We provide the initial capital for the construction phase, typically covering the first 24 to 30 months until a project reaches a certificate of occupancy. Then, a cheaper bridge-to-permanent loan will refinance the construction lender while the building is in lease up. Finally, a senior lender steps in with a permanent loan once stabilized.

Robert Schwartz: Most real estate credit strategies focus on bridge lending, but to generate the returns that investors seek from private credit, bridge lenders today must go deep into the capital stack and use significant back leverage. Additionally, once a bridge loan closes, all (or nearly all) the money is out, and lenders have little ability to affect the outcome. Construction has a reputation for being riskier, but we believe that with the right structure and active oversight, it has the potential to deliver better risk-adjusted returns than loans on existing assets.

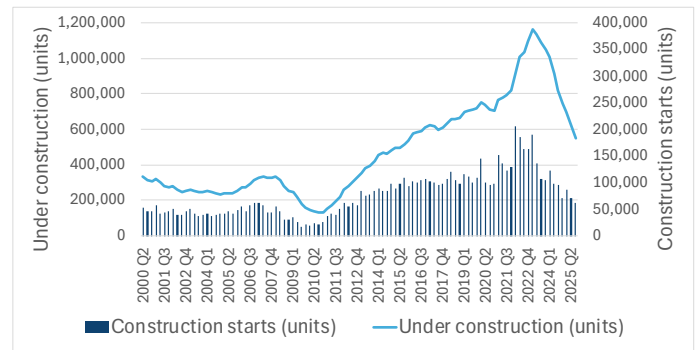
Joshua Crane: Absolutely. Another advantage is we can look at construction starts today to get a clear picture of the environment our borrowers will be delivering into. For example, the recent nationwide decline in multifamily construction starts should mean less competition for our sponsors, which can benefit our strategy.

How has the landscape of construction lending evolved over time?

Robert Schwartz: The construction lending landscape has shifted dramatically in recent years. Regional banks, which used to account for 70 to 80 percent of construction loans nationwide, have significantly reduced their activity due to regulatory changes and capital reserve requirements. Historically, we were competing against regional banks with mezzanine funds coming behind them. Today, those same banks are partnering with us as A-notes, which is treated as lender finance and subject to more favorable capital treatment.

Joshua Crane: This retrenchment by regional banks has created a substantial gap in the market, which specialized private lenders like S3 are well positioned to fill. By leveraging our real estate development expertise and in-house construction team, we aim to support development in markets that need it most.

Figure 1. Annual Unit Starts and Units Under Construction



Source: CoStar, Q3 2025

What do you see as the core risks in construction lending, and what are the ways that S3 Capital seeks to mitigate those risks?

Joshua Crane: We like construction because we can affect outcomes. We don't take entitlement risk. We stay at a relatively low leverage basis to ensure that we don't get too high in the stack. Our borrowers typically have all their equity invested before we contribute our first dollar, so there's a lot of truth serum from the equity. We get personal guarantees that they will complete the building per the specs they gave us and that they'll pay all carry costs during the loan term.

Robert Schwartz: We also require our borrowers to retain meaningful liquid net worth during the life of the loan so if something does go awry, they have the means to fix it. And operationally, our in-house construction team reviews every subcontract and contract, pursuing transparency and control over project costs and execution. Real-time, boots-on-the-ground monitoring is at the heart of our approach, and we have observed this is something most lenders simply don't have the infrastructure to support. Over the past 12 years, we've built a well-oiled machine that allows us to spot potential issues early. That's the model, and it works.

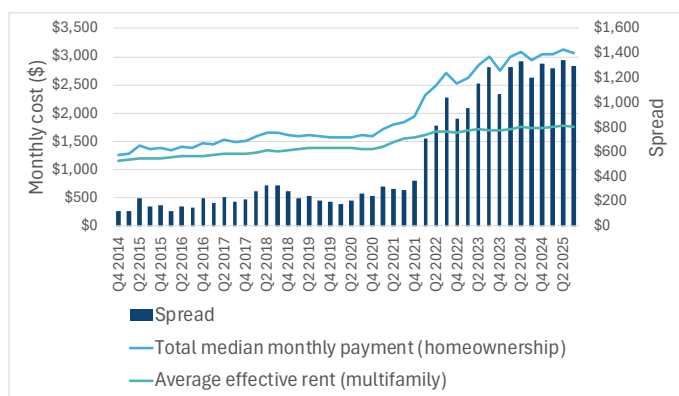
Joshua Crane: I always like to say that what we do is simple, not easy. One of the interesting things about construction lending versus other forms of private credit is that we're building real assets. You can go to all our credits and see the progress. We're the first lien and the only lien. That's a big distinction. The amount of value we create by taking a plot of land and turning it into a building is meaningful. We are consistently repaid at substantial premiums to our loans. And from a risk perspective, what matters most is having the operational capacity and expertise to step in and exert influence when problems arise, even taking over if necessary.

Tell us more about how your portfolio has performed during periods of macroeconomic uncertainty.

Robert Schwartz: Since our loans' values have such big safety margins (typically representing debt yields that are 300 to 350 bps over the prevailing cap rate), and we are funding up over time as construction progresses, we have the opportunity to affect outcomes as Joshua mentioned. This means events like interest rate or rent fluctuations don't generally affect our performance. We have been tested over the years by a variety of challenges. This includes COVID, unfriendly rent regulations, and a period of rapidly rising interest rates when LIBOR went from almost zero to over 5 percent during the 2022 rate hike cycle. Rising rates hurt a lot of bridge lenders, but our portfolio avoided losses.

Joshua Crane: Exactly. I'm proud of the fact that even during COVID, our team managed to collect all outstanding interest and principal, and everything got built. For about 120 days, we didn't originate. We just did a lot of asset management. We worked with our borrowers and allowed them to catch up on interest payments over a longer period. Times like those test the mettle of an organization, and we succeeded because of our hands-on approach to asset management and our ability to leverage our development expertise to craft bespoke solutions for our borrowers.

Figure 2. Cost of Homeownership Compared to Renting



Source: Atlanta Federal Reserve, Zillow (data as of Q3 2025)

Where are you finding pockets of opportunity right now in this market? And how has that evolved over the last few years?

Joshua Crane: There's been a tremendous shift in rental demographics that's going to keep fueling multifamily development for years to come. The median age of first-time homebuyers continues to rise, and a new class of "renters-for-longer" has emerged, in large part due to affordability challenges – renting is significantly less expensive than buying. We like financing Class A affordable luxury developments that target these larger cohorts. From a location perspective, we still like tier one markets with strong population growth and a highly educated workforce. We've always had a big toehold in New York, Florida, and other select markets. But our focus on operational oversight means that we prefer to have deep expertise rather than

broad exposure. We take a neighborhood-by-neighborhood approach, and we excel at identifying up-and-coming sub-markets because of our deep familiarity with the areas and local participants.

Robert Schwartz: And we have likely financed the project next door or down the street, which provides us with proprietary data that we use in our underwriting. Each loan informs the next. Repeat relationships are a natural driver for future deal flow. Even the ones who haven't transacted with us are within one degree of separation. We very much take a partnership approach with our borrowers, and that yields more successful and consistent outcomes.

CONTRIBUTORS



Joshua Crane

Co-founder and Principal

Joshua Crane is Co-Founder and Principal of S3 Capital. Prior to founding S3, Joshua worked at Irongate, where he developed the Trump International Hotel and Tower at Waikiki Beach Walk. He also worked at Stellar Management, where he was involved in the acquisition of Independence Plaza, a 1,330-unit rental building in New York City's Tribeca neighborhood, and 2,000 units in Washington, D.C. Joshua began his career at Salomon Brothers in its M&A group and earned a degree from the Wharton School at the University of Pennsylvania.



Robert Schwartz

Co-founder and Principal

Robert Schwartz is Co-Founder and Principal of S3 Capital. Prior to founding S3, Robert helped run a successful family business where he established the family's real estate investment program. He began his career in investment banking at Donaldson, Lufkin & Jenrette and UBS in the Financial Institution Coverage groups. Robert graduated from the Wharton School at the University of Pennsylvania and serves on the Executive Board.

COMPANY OVERVIEW

S3 Capital is a vertically integrated real estate credit specialist focused on protecting investor capital while generating high current income. S3's founders spent decades as New York City real estate developers before identifying the opportunity to provide institutional-quality financing to smaller and mid-sized developers. Since 2013, S3 Capital has originated more than 820 individual loans totaling over \$8.2 billion and today is recognized as one of the largest non-bank multifamily construction lenders in the United States. Armed with a deep understanding of all aspects of development, S3 Capital utilizes an established approach steeped in risk management to serve its global investor base.

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