INDUSTRY INSIGHTS

By Costa Nicodemou and Brett Lennane

Federal Budget 2017: How proposed changes will impact developer cash flow and lender security

The Budget included a controversial plan to shift the responsibility of remitting GST on new residential sales from property developers to purchasers. Under the proposal, purchasers settling sales after 1 July 2018 will be liable to pay the GST on the sale directly to the Australian Taxation Office (ATO). The exact process, and implications for existing pre-sales contracts, is unclear.

There is no doubt the change will have a negative impact on developers' cash flows. BRI Ferrier believes that the cash flow impact will be felt for up to 50-days depending on the date of settlement.

Lenders may face a significant change

Here is how it works now:

- Developers claim GST refunds on expenses during the course of a development.
- They then pay GST on sales settled, applying either the Ordinary Method or the Margin Scheme (the latter is the common method used for residential projects because it minimises GST expense).
- The onus to remit the GST is on the entity that completes the sale.
- Where a secured lender enforces its security on default as mortgagee in possession or through a Receiver, it incurs the liability for GST payable on sales.

In the past, when developers had financial difficulties, lenders would often prefer to maintain a watching brief. This left the developer to settle as many sales as possible while the lender insisted on full net proceeds of sales in reduction of the secured debt. Payment of the GST liability was deferred and a secured lender would reduce the loan to value ratio (LVR) to the full extent possible.

If the secured lender was repaid, the distressed developer would still have an incentive to defer the payment of GST on sales preferring other unsecured creditors. For example, the directors of the development entity may have personal guarantees to some creditors or they may prioritise repayments on related party loans, or pay builders and consultants rather than the ATO.

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If a developer then suffered an external appointment, the ATO would rank equally with other unsecured creditors, for the developer's GST liability. Any 'preferred' creditors (i.e. those that received payment ahead of the ATO) may be exposed to a preference recovery action by a subsequently appointed liquidator.

The changes announced in the Budget will prevent this, giving the ATO a superpriority above all other creditors, even those lenders that have security over the development.

What is the impact on residential property developers and secured lenders?

These changes will hurt developers' cash flow. They will place more pressure on struggling developers to enter into external administration.

In our 4-part series on Risk Mitigation in the Residential Development Industry, we explained that sponsor risk is a key risk in pre-sales. Where pre-sales issues do arise, other issues are often also apparent, and unreported, by sponsors.

The incentive for a secured lender to adopt a watching brief over a struggling developer will disappear. As sponsor risk is such a key risk in property development, lenders may choose to "appoint" earlier in the workout phase to avoid further risk.

How might property developers and secured lenders respond?

We would always encourage developers to work closely with their secured lenders and resolve any questions of ongoing viability in a transparent manner.

We expect that secured lenders will:

- review credit policies and standard covenants for pre-sales, and possibly facility LVRs;
- review facilities where development pre-sales will settle after 1 July 2018;
- tighten scrutiny on sponsors;
- reduce their willingness to finance cost overruns that occur late in developments; and
- move quicker to "appoint" to distressed developers after completion of construction to avoid the risk of funds leakage.

About BRI Ferrier

BRI Ferrier is a unique affiliation of expert business recovery, insolvency, forensic accounting and advisory firms. We provide practical, innovative services that help financially distressed businesses to recover or at least minimise the negative impacts of insolvency.

As well as traditional insolvency services, our specialist Real Estate team provides services to all participants in the property industry.

Our advisory services include:

- funding origination;
- borrower, contractor and sub-contractor reviews;
- pre-sale due diligence and management services; and
- financial tools.

Our broad experience and industry resources equips us to assist in the most complex situations. Please contact Costa Nicodemou and Brett Lennane to find out how we can support you.

Authors

Costa Nicodemou
Principal
BRI Ferrier, Sydney

E: cnicodemou@brifnsw.com.au

Brett Lennane
Consultant
BRI Ferrier, Sydney

E: blennane@brifnsw.com.au