BRI Ferrier

INDUSTRY INSIGHTS

By Costa Nicodemou and Brett Lennane

Our take on residential pre-sales

This is the first in a 4-part series of articles on pre-sales in the residential property development sector in Australia.

The members of our specialist real estate team have dealt with residential property pre-sales for three decades. Over this time, we have gained a broad perspective through our experience:

- as lenders, imposing prudent loan conditions specifying the required amount and terms of pre-sales;
- as lenders and advisors, reviewing, qualifying and monitoring pre-sales;
- as insolvency professionals enforcing pre-sales for developers and lenders; and
- as expert witnesses on litigated matters concerning property developments where pre-sales featured.

A brief background to pre-sales

When the members of our team first became involved in lending for property development, pre-sales were uncommon. Most residential developments were small in comparison to the current property market cycle. 'Large' projects were often staged to mitigate sales risk. At that time, a project with 50 units was considered large.

In the run-up to the Global Financial Crisis (GFC), pre-sales had become commonplace. Typically, lenders would require 30% of the stock in a development to be pre-sold. This would provide pre-sales cover of 50% or so of a lender's debt, where borrowings amounted to approximately 80% of the total development cost.

A 'large' development would comprise around 100 units. To achieve the required 30% pre-sales, might take a couple of months. The analysis undertaken by lenders was straightforward and manageable due to the size of the developments and generally the local domicile of buyers.

Today, developments often contain 200 or more lots and lenders ask for pre-sale coverage of 100% of the debt. This means around 130 pre-sold units are required to activate construction finance.

Since 2013, the Australian east coast property market has boomed, and developers have achieved these pre-sales at an unprecedented rate. In some cases, developers have even sold out entire projects in a single weekend.

Lenders need to undertake a more thorough analysis of each project, which can be complicated and time consuming.

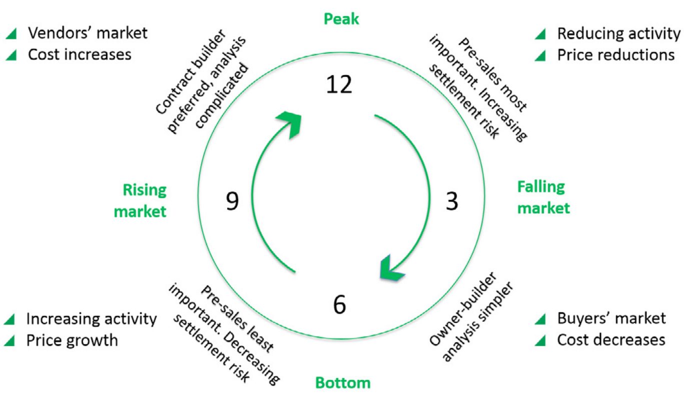
Our take on residential pre-sales

Pre-sales are a big deal

The reasons pre-sales appeal to both the lender and the developer are clear. To begin with, pre-sales 'prove-up' a development, establishing that buyers actually want the product on offer. Pre-sales support the developer's applications for finance, and is now a requirement for almost all bank development loan approvals. Pre-sales reduce the risk for both the lender and the developer, provided they remain in place. The pre-sales form part of the lender's security (even though borrowers may sometimes think otherwise).

They are particularly important in a flat or declining market.

Where are we in the residential property cycle?



Property development pre-sales risk mitigation – post-GFC

During the GFC pre-sale settlement rates in metropolitan Sydney continued to be strong. In areas outside Sydney, settlement rates were much weaker. Other areas, such as coastal NSW, saw very poor settlement rates.

In Sydney, industry feedback suggests that over the long-term, presale default rates have been low. Our experience has shown that in a rising market, all sins are forgiven. Often issues don't come to the surface because high settlement rates mean the lender is quickly repaid. The developer deals with any issues behind the scenes, without the need for a lender's intervention. However, in a declining market, developers under pressure may consider 'questionable' practices to obtain and manage pre-sales.

Examples of such **practices, at various stages** in the development cycle, include the following:

Prior to activation of construction finance

- Offering undisclosed incentives (such as contract cash or goods rebates) to achieve the required pre-sales. This would maintain 'headline' prices and support bank security valuations. However, this distorts market values and potentially the balance of the bank's unsold stock.
- Contracting related-party sales (such as sales to family and friends), which are cancelled before settlement in the hope that they will be replaced with arms-length sales.

During construction

- Convincing purchasers to release deposits (for cashflow).
- Failing to extend sunset clauses or rescinding sales to capitalise on market price rises. Recent changes in NSW and other states consumer laws seek to offer additional protection against this practise.

At project completion

- Off-set arrangements with development sub-contractors and suppliers, which hides the true value of the construction cost and potentially minimises or defers state and federal taxes.
- Deferring stock revaluation (in a declining market).

Provided below is a table summarising common pre-sales risks that have arisen in distressed development matters we have dealt with:

Case studies – Summary of Presales issues Experienced

Development	Type	Lot No.	Deposits released	Conditional sales	Related parties	Foreign sales	Sunset date	Rebates / Side agreements	Trade dollars	Can't locate	Below Valuation	Design changes	Misreps
Scot's Church, Sydney CBD	Res	100			✓								
Clarence St, Sydney CBD	Res	24			✓					✓		✓	
Rockdale	Res	106				✓	✓			✓	✓		
Rockdale	Res	100						✓			✓	✓	
Western Sydney	Ind	20			✓								
Northern NSW subdivision	Res						✓						
Northern NSW resort	Com	40		✓					✓			✓	✓
Western Sydney site	Res		✓		✓								
Project M (Interstate)	Res	300			✓	✓							
Sylvania	Res	18			✓		✓						
Camperdown	Res	132	✓				✓				✓		
Epping	Seniors	24					✓					✓	✓

Our take on residential pre-sales

We've seen it all

In this series of articles, we provide some timely insights into pre-sales:

Part 2, 'The pitfalls and risks of pre-sales in residential property development', provides a discussion of some of the pitfalls and risks inherent in pre-sales and suggests some steps that lenders can take to mitigate risk.

Part 3, 'Risks grow as property developments grow', details the process lenders undertake, or at least should always undertake, to analyse and manage the risks of pre-sales.

Part 4, 'Residential property development – where to from here?', conveys our perspective and opinions on the outlook for the residential real estate industry.

Our broad experience and industry resources equips us to assist in the most complex situations. Please contact Costa Nicodemou or 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

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.

With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

BRI Ferrier's team has the expertise and resources to meet any client challenge. By combining our skills and enthusiasm, we achieve the best possible outcomes in all cases where a business experiences financial distress.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

Important notice. The information contained in this Industry Insight is by way of general comment only and is not intended as a substitute for specific advice that addresses your particular circumstances. You should seek specific advice before acting. The information contained in this Industry Insight remains the exclusive intellectual property of BRI Ferrier and any reproduction, publication, communication or adaptation of this information, without the prior written consent of BRI Ferrier, will constitute an infringement of The Copyright Act 1968.

For positive solutions to financial difficulties please contact us.
The initial consultation to your client is free, strictly confidential and without obligation.

Sydney
T: 02 8263 2300
info@brifnsw.com.au

Melbourne
T: 03 9622 1800
info@brifvic.com.au

Adelaide
T: 08 8233 9900
info@brifsa.com.au

Perth
T: 08 6316 2600
info@brifwa.com.au

Brisbane
T: 07 3220 0994
info@brifsq.com.au

Cairns
T: 07 4037 7000
info@brifnq.com.au

Townsville
T: 07 4755 3300
info@brifnq.com.au

Mackay
T: 07 4953 7900
info@brifnq.com.au