BRI Ferrier

INDUSTRY INSIGHTS

By Costa Nicodemou and Brett Lennane

Pre-sales analysis – where to from here?

This is the final article in our series on pre-sales risk mitigation in the residential property development sector. We share our observations and outlook and offer our key takeaway: market conditions in the short to medium term will be challenging for developers, financiers and valuers.

Exact data is difficult to obtain. Unlike settled sales that are registered on a land titles database and publicly accessible, pre-sales data is fragmented, private, and generally only seen by project marketers, valuers, developers and their financiers.

The analysis outlined in this paper is therefore derived from our industry network and is anecdotal.

Increased supervision by APRA and ASIC is changing the finance landscape for developers and pre-sale purchasers

APRA has placed commercial real estate lending growth restrictions on banks. The effects started being felt by residential developers from mid-2015. Bank-credit contracted further in 2016 and remains 'tight'.

For prime customers with viable developments, bank funding will still be available, albeit at a higher cost and with more hurdles. Yet bank funding options for many customers are limited. Increased regulatory supervision diverts the focus of banks, which will further slow approvals.

APRA has also identified that some banks leave something to be desired when it comes to pre-sale analysis. Banks are responding in a couple of ways:

- imposing more restrictive pre-sales covenants on new facilities, up from 100% pre-sales cover to as high as 120% of the proposed loan amount; and
- improving pre-sale due diligence.

Typically, banks' lawyers qualify pre-sales (which focuses on contract enforceability). But banks are shifting their focus to commercial pre-sales due diligence, which provides valuable insights into pre-sales risk. This will be critical as we move into a more difficult real estate market.

Commercial pre-sales due diligence can give banks more comfort on the arm's length nature of the sales. It can also offer information on market acceptance of the development and the capacity of purchasers to settle.

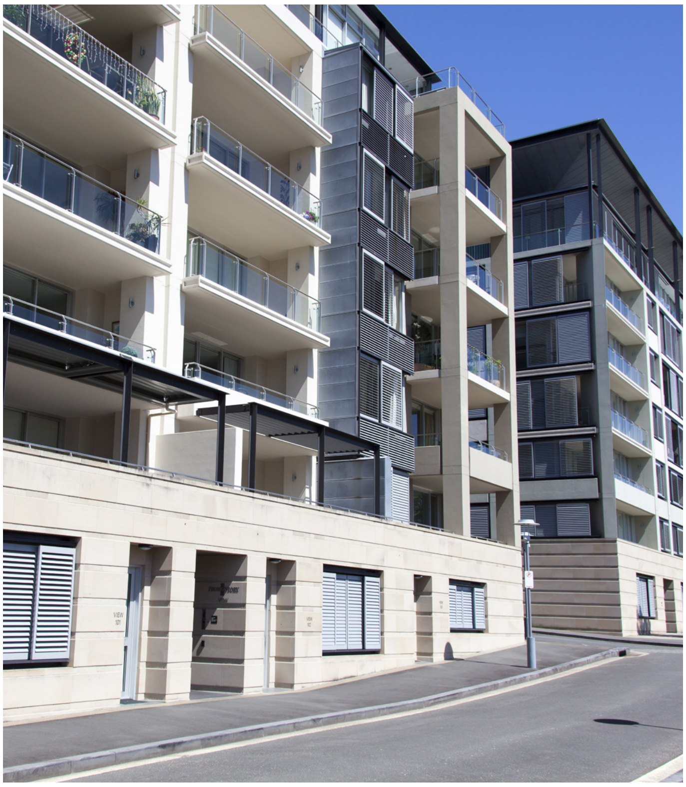
Non-bank lenders, such as hedge funds and private groups, are seeking to exploit the commercial market lending opportunities the banks have left behind. Lower bank competition gives them the opportunity to write "bank-risk" development loans at historical mezzanine loan pricing (15%+ pa). But, they are being overwhelmed by deal flow and developers will often face delays and finance uncertainty.

Though returns are attractive for non-bank lenders, pricing at this level is unsustainable for developers beyond the short-term, unless land prices fall significantly.

On the retail side, the regulatory pressure imposed on the banks, such as ASIC's focus on responsible lending to retail customers, has resulted in the following bank responses:

- reluctant and slow to approve interest-only loans. Unfortunately, they are popular with property investors, many of whom buy off the plan;
- repricing investor loans; and
- refusal to finance foreign pre-sale purchasers.

Pre-sale investors in the current cycle would have been confident in getting finance at settlement when they made their purchases. In this new environment, many will experience difficulties and delays in obtaining finance when they need it. This will lead to a broadening of settlement delays across the industry, and higher fall-over rates generally.



Legislative changes must also be considered. Developers no longer have the right to simply terminate pre-sales when sunset dates pass. Purchasers, or the Supreme Court NSW, now need to agree before pre-sale contracts can be terminated.

Past performance should not be the guide for the future: a Sydney perspective

There's a strong belief in the industry that price gains in recent years have underwritten many of the property cycle's current batch of pre-sales.

In the last quarter of 2015 there was a noticeable decline in pre-sales rates of sale and price growth. We understand that for some projects, particularly those aimed at foreign buyers, enquiries are down by as much as 75%. Foreign purchaser numbers have primarily reduced due to the following factors:

- tightening of foreign exchange controls by the Chinese Government;
- local banks refusing to provide funding; and
- extra duties levied on foreign purchasers (4% surcharge in NSW).

Whilst pre-sales have continued to weaken through 2016 and into 2017, the broader residential market has continued to enjoy strong price growth with high auction clearance rates of late also strong at around 80%. According to Corelogic, year on year price growth for Sydney for the year to 31 March 2017 was 19%.

Pre-sales risk is high, but can be mitigated

Pre-sales exchanged in late 2015 and early 2016, will generally be "in the money". That is, the pre-sales contract prices will be below the current market value of the underlying real estate. Many of these pre-sales are due to settle in 2017.

Notional profits provide a real incentive for purchasers to settle. But, if finance is unavailable, even the best-intentioned purchasers will have difficulty locking in these gains. We are aware of a couple of instances where fall-over rates of "in the money" foreign purchaser pre-sales have increased substantially, albeit from a low base.

Pre-sales analysis – where to from here?

In the short term, higher fall-over rates will be a relief to some developers. They will be able to re-sell rescinded stock at higher than contract prices. But, at some point, pre-sale contract fall-overs will become costly for developers.

We believe that the tightening of retail bank-credit will exacerbate pre-sales fall-over rates and any decline in market values. A decrease in market values will "unlock" a variety of pre-sales risks that lenders haven't had to deal with since the GFC.

In the current environment, developers already committed to site purchases will be under increasing pressure for three reasons: scarcity of finance; more restrictive pre-sales covenants and a softening in the pre-sales market. Once finance is approved, it will take longer to activate construction drawdowns. The result: ongoing holding costs whilst sites sit idle.

Increased pressure to secure pre-sales under strict finance conditions will encourage some developers to manipulate pre-sales data, or enter into pre-sales contracts that aren't bona fide. Examples of such practices include:

- arranging related party sales (to relatives and associates), that can later be rescinded;
- offering rebates, cash or otherwise, that distort market values;
- making misrepresentations that provide opportunities for purchasers to rescind contracts;
- obtaining the release of deposits;
- offering inflated sales commissions when using third party sales channels (such as financial planners);
- making trade deals and offset arrangements with subcontractors;
- selling the best stock in the development, whilst the worst is unsold; and
- understating foreign sales.

These practices would impact a bank's assessment of the underlying security.

And finally…

It's more important than ever for lenders to analyse pre-sales data thoroughly, to identify pre-sales risks and consider them in the context of the loan facility.

We hope you enjoyed reading this series on pre-sales risk mitigation in the residential property development sector.

In addition to 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.

Pre-sales analysis – where to from here?

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.

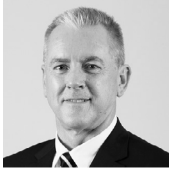
Authors

Costa Nicodemou
Principal
BRI Ferrier, Sydney

E: cnicodemou@brifnsw.com.au

Brett Lennane
Consultant
BRI Ferrier, Sydney

E: blennane@brifnsw.com.au



Access earlier articles in this series; part one, part two and part three. To receive future articles from BRI Ferrier register your interest here.

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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.

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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

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