INDUSTRY INSIGHTS

By Costa Nicodemou and Brett Lennane

The perils of contagion risk: Can the failure of a Large Builder Developer Property Group be isolated?

This is the first article in a three-part series of articles on Large Builder Developer Property Group (LBDPG) risks.

PART 1: Setting the Scene

What is a Large Builder Developer Property Group (LBDPG)?

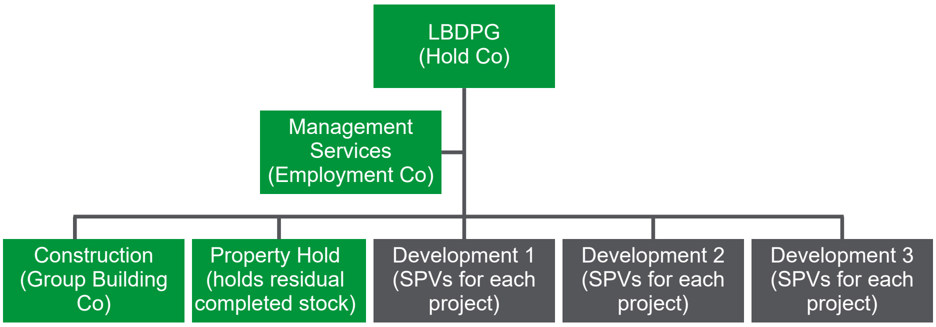
We deem a LBDPG to have the following characteristics:

- Consolidated turnover over $250m per annum;
- More than 400 dwellings completed per year;
- Funding lines in excess of $250m, often from multiple tier-one banks and second tier financiers; and
- Multiple active projects with over 100 units.

Furthermore, the following operational characteristics are indicative of a higher LBDPG risk:

- Fragmented ownership of developments;
- Non-consolidated and or unaudited financials;
- Large number of financiers, particularly, second-tier and private financiers;
- Large land bank portfolios, particularly development sites under option or contract that require finance to settle;
- Developments located in recently re-zoned or growth areas that are not traditional high density markets and more vulnerable to over supply;
- High density, multi-staged developments that have long dated programs that run longer than the property market cycle and expose the development to price fluctuations; and
- High density developments and complicated integrated or mixed use developments where the risk of defect claims post completion increases.

How are LBDPGs structured?



The flowchart above illustrates a generic LBDPG structure. The benefits of such a structure are as follows:

- Construction and development (asset holding) entities are segregated to minimise the impact of insolvency of one entity on the broader group and quarantine assets from liabilities. For example, warranty claims against the building entity are quarantined from the land or asset holding entities;
- For the same reason as above, each development is held in a Special Purchase Vehicle (SPV). Further financiers prefer this so as to 'ring-fence' their borrowing entities from other group activities;
- The LBDPG will most likely be 'grouped' for income tax and GST purposes, allowing the offset of losses and profits; and
- Any residual stock held, is generally transferred to a 'Hold Co' entity to quarantine it.

How have LBDPGs grown so quickly?

The current residential property cycle has seen unprecedented growth and concentration of LBDPGs. They have benefited from consistent increases in property prices and access to finance from the banks and non-bank lenders operating in Australia, and abroad through hedge funds. Anecdotally, many recent projects have been underwritten by an influx of predominantly Chinese investors with an insatiable appetite for property and a willingness to commit to presale contracts. Aside, from the well documented market issues, we consider the following to directly relate to the growth and concentration of LBDPGs:

1. Low Barriers of Entry to Construction Industry

   The NSW construction industry has enabled rapid growth of LBDPGs to occur with few financial barriers to entry. Any licensed building entity can undertake a project regardless of the size of its balance sheet (i.e. no financial test for capacity). Licensing can be obtained relatively easily, as long as a nominated individual within the company holds a building license.

2. Non-cash Equity Leveraging

   Development generally requires substantial capital investment (equity). LBDPGs can mitigate or manage their equity commitment by purchasing sites under delayed terms. For example, they may negotiate terms of up to 12 to 18 months on a relatively low capital outlay with option fees of around 2%. A general timeline for a LBDPG securing a development site, is as follows:

   - Site option (12 to 18 months). During this period, the LBDPG will seek planning approval (6-12 months) and commence pre-sales marketing (until recently 1 to 2 months depending on size and location of development);
   - Independent site valuation. Valuers will generally use a Discounted Cash flow Method (DCM) to value the site, with the variables being the planning approval obtained, pre-sales prices and number achieved and the LBDPG's construction budget, which is generally below third party prices and rarely includes a profit margin;
   - Secure finance based on a combination of bank and 'mezzanine' or preferred

equity finance (sourced from a hedge fund, for example); and
- Construction (18 to 24 months).

In circumstances where the project receives a favourable planning approval (i.e. additional unit density), market prices escalate and a high level of pre-sales are achieved, the valuation of the development site will often be significantly higher than the sale price agreed under the option. The LBDPG will endeavour to use this 'uplift value' as part equity combined with senior and mezzanine loans to finance completion of the development. This minimises the LBDPG's cash equity contribution allowing it to spread its equity over a number of developments.

With limited cash equity and assuming a viable development site has been bought at the right time and for the right price, LBDPGs have been able to substantially expand their development capacity and balance sheets, and exponentially grow their turnover in a short timeframe.

3. **Tax Planning**[1]

This is complicated, depending on the circumstances of the LBDPG and the development, but generally takes two forms:

- **Growing year on year:** When the size and or number of developments undertaken increases year on year, generally, turnover and overheads of the business will also increase. Given the time lag on profits realised on a completed development (say 18 to 24 months from development site purchase), these profits can be partly absorbed in the profit and loss by increasing overheads of the larger business (rents, staff, systems, processes, etc.). Overheads are increased in the same year that the profits are made, but for the purposes of facilitating a larger business when profits will be realised in the next year. This has the effect of partly deferring profits (and income tax) until the LPDPG ceases to grow; and
- **Holding Completed Stock:** For a mature LBDPG, tax payable can be managed by holding some completed stock and leveraging it to defer taxable profit.

The benefits to the LBDPG are:

- Defers tax whilst still accessing equity in the stock through borrowing, generally lending loan to value ratios (LVRs) for mortgage purposes don't factor in the tax liabilities of the completed stock;
- LBDPGs can leverage any residual stock held (e.g. 80% LVR) and use the funds to buy new development sites;
- In a growing market (over the last 4-years), LBDPGs have benefited from significant increases in the value of completed stock held; and
- LBDPGs can control the release and supply of stock in a development to influence values.

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.

1 BRI Ferrier are not tax advisors. These comments are provided for general information purposes only and should not be construed as legal, tax or investment advice to any particular holder. We would recommend seeking specific advice for your individual set of circumstances.

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.

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The initial consultation to your client is free, strictly confidential and without obligation.

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