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

Part 2: Does this Model Create a House of Cards?

What are the risks faced in the Short-term?

Subject to individual circumstances, such as the level of gearing and access to capital, LBDPGs concentrate risk in the following areas:

- **Finance risk:** LBDPGs are often highly geared, with short-term development specific funding from a large range of banks, financiers and private funders. We believe heavy reliance on private funders is a greater risk than reliance on banks and large finance groups. This is because private funders, often:
  - Are small illiquid funds;
  - Have limited ability to meet cost overruns and loss provisions where new investor funds are not obtained or recycled; and
  - Have thin balance sheets, unlike a traditional bank.

  If a financier declines to recycle funding lines, cash flow issues may cause problems for a growing LBDPG that is continually purchasing new development sites. Also, finance facilities are often cross-collateralised, with cross-default conditions with each financier. One default can cause a default, or at least a review event, across every facility and financier. For example, one financier failing to meet a progress claim could indirectly cause a default across all financiers, affecting all facilities and impacting the value of stock holdings;

- **Cost overruns and subcontractor failure risk:** LBDPGs assume full delivery and construction risk, unlike the transfer of risk that occurs between an independent developer and a contract builder. Should a key subcontractor fail, the LBDPG absorbs the cost within the development. They must find the extra funds needed to meet any cost overrun. If a key subcontractor fails, chances are they're involved in the construction of a number of other developments for the LBDPG. This could impact multiple financiers across a number of developments;

- **Market risk:** The degree of market risk is subject to market movements. This is multiplied within highly leveraged balance sheets that are generally not diversified by property class and location. In the current cycle, the focus has been on metropolitan, high-density residential development in areas where zoning has changed; and
- **Tax risk:** It is difficult to maintain the growth necessary to defer tax long-term. Leveraging residual stock leaves minimal cash flow to meet GST and income tax when these liabilities fall due. For LBDPGs the amounts payable can be substantial, and can cause immediate difficulties.

Failure of a LBDPG... is it contagious?

The fallout from the failure of a LBDPG could be catastrophic for stakeholders and the residential property market in general;

- Financiers:
  - Banks: due to the large-scale funding of LBDPGs, banks could incur large losses. This might send shock waves through the banking community, and could result in a significant credit squeeze until banks digest the outcome;
  - Private financiers and funds: small funds may not have the capital base to absorb a substantial loss. This could result in the collapse of the fund, or loss of investor confidence. Furthermore, where the fund has other active borrowers and developments, such a loss may affect these otherwise unrelated projects;
- **Bond or security providers:** often provide bonding facilities on larger developments. The default of a LBDPG could undermine the provider’s confidence in issuing new bonds;
- **Other financially stable LBDPGs:** The collapse of a competitor could impact similar structured LBDPGs in a number of ways:
  - Loss of market confidence and access to finance, where they have similar banking relationships;
  - Collapse of common subcontractors;
  - Reduction in site values and gross realisations of stock, where the assets of the insolvent LBDPG are put to the market for sale by financiers and insolvency practitioners;
- **Subcontractors:** This was previously mentioned as a risk to a LBDPG, but conversely the failure of a LBDPG can trigger the collapse of a subcontractor. LBDPGs have grown exponentially over a short time-frame. They have in turn required their subcontractors to grow with them, by size, complexity and in the number of developments undertaken. From the subcontractor’s point of view, this is positive. They have a growing source of work and an established relationship. This relationship allows them to grow their business to match their customer's needs. Often these subcontractors have also grown over a short time-frame. They may lack the management expertise and capital to successfully operate a business of a larger scale. Also, they rarely analyse the risk associated with generating much of their revenue from one customer. They overlook the impact on their business should this customer either reduce its demand or fail due to insolvency. If these subcontractors also work for other LBDPGs, their failure can consequently flow-on to their developments.
- **Consumers (purchasers of residential stock):** The effects on consumers include delays and the risk of contract cancellation, securing and returning pre-sales deposits and potential defect claims on completion; and
- **Reputation:** A LBDPG collapse not only impacts consumer confidence, it can also harm the reputation of the financiers involved.

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.

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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