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Property & Construction: Balancing on the balustrade in a softening market

The old adage – “those that fail to plan are planning to fail” – is particularly relevant in our current property market. With conditions tightening across the country – and with inexperienced developers continuing to make fundamental mistakes – it is likely we will see a continued increase in the number of property and construction related defaults over the next 18-24 months.

The boom conditions of the last few years have attracted many new players into the property and development market. As conditions have softened, it is the less experienced that feel the most pressure as market forces close in on those that are unprepared. For the past two years, Ferrier Hodgson has witnessed a steady increase in the number of developers and financiers experiencing financial losses resulting from a failure to undertake the most basic planning. In this article we examine six simple steps that will help manage the risks in a softening market.



Plan ahead

In 2005, Ferrier Hodgson acted as court-appointed Receivers of the oldest heritage-listed fibro cottage near the waterfront on Sydney's Northern Beaches. It was a highly sensitive family dispute, with various parties arguing over the future of the site, which was due to be auctioned. But on the morning of the auction, arsonists set the cottage on fire and it was completely destroyed.

In the process of extinguishing the fire, high winds and the fire brigade's high-pressure hose blasted asbestos onto nine adjoining properties. Now, it is not widely known that virtually all residential property insurance policies include asbestos exclusion clauses or that under the Environment Protection Act, any person in control of land can be held liable for environmental damage and clean-up costs. The local council deemed it was up to the Receivers to remove the soil and subsoil of each contaminated property – at a total cost of \$1.5 million.

While Ferrier Hodgson successfully managed rectification of the site and negotiated agreements with the neighbours, local council and the NSW

Heritage Office, for most small-scale residential developers and private property owners, this disaster could have spelled financial ruin. There is a lesson here for financiers and stakeholders with exposure to latent and potentially contaminated sites. But it also highlights the need for developers to plan ahead for almost every contingency – no matter how remote it appears at the time.

Construction Costs

The financial viability of projects will continue to be challenged by the increasing cost of residential construction. Construction costs increased by a minimum of four per cent from 2005 to 2006, with similar increases forecast for 2007 driven by labour shortages and a strong economy.

Tripartite agreement

A well-drafted tripartite agreement ('TA') between the financier, developer and builder establishes 'step-in rights' allowing parties to facilitate completion of a project in the event the developer or builder defaults. If, for example, the builder fails, the developer may be entitled to take over the sub-contracts negotiated by the builder and go ahead and complete the project in order to protect the value of the investment.

Recently we have seen a number of circumstances where the TA has been non-existent or poorly drafted, resulting in a magnification of the project's risk profile.

Consultants

Consultants such as architects, town planners and engineers frequently claim a lien on project documentation when there are unpaid costs. In a recent matter, Ferrier Hodgson acted as agent for the mortgagee. Despite the fact the financier held a Deed executed between the architect, developer and builder, the architect claimed to be owed outstanding fees and refused to have his plans offered for sale with the development site.

In this circumstance, the architect was an associate of the builder and his claim was used to frustrate the sale of the site. Whilst the issues attached to the architectural drawings were eventually resolved and the site was sold, the Deed was deficient because it did not provide the financier with the right to grant a license to a purchaser in the event of default.

Financiers should ensure project documentation is drafted to avoid risk in the event of default. Financiers should use their leverage to request additional rights from a developer – particularly in circumstances where the developer, builder and consultants are related parties – to ensure that no one party can frustrate or delay any subsequent sale process.

Medium Quality

| Construction Type | 2004 | % change | 2005 | % change | 2006 |
|--|---------|----------|---------|----------|---------|
| 3br, 2-level brick veneer townhouse | \$1,200 | 4% | \$1,248 | 4% | \$1,302 |
| 3-level walk-up unit complex, concrete structure, ground floor parking | \$1,400 | 4% | \$1,458 | 4% | \$1,521 |
| Multi-level apartment building, basement car parking | \$1,600 | 9% | \$1,739 | 4% | \$1,814 |

Source: Maverick, BMT & Associates

When costing projects, developers need to factor in the constantly increasing costs of labour and materials – particularly when construction will take place over an extended period. Something as simple as a delay in obtaining approval from the regulatory authorities can be enough to push a project into time and cost overruns that have not been budgeted for.

As an example, the following table demonstrates the increasing residential construction costs (per square metre) for the Sydney market since 2004.

Other hidden costs

Financiers should also be mindful of project feasibilities that do not include a builder's margin (usually six per cent of the construction cost) which may be paid by the developer to the builder. From a financier's perspective, this situation requires a higher level of supervision in relation to funding draw-downs.

In the event the builder defaults in completing the project, the costs for a third party to complete it are usually significantly higher than the notional costs of completion under the existing building contract. This can have a significant impact on the value of the financier's security. In these circumstances, it may be appropriate for the project being offered for sale to include incentives in relation to deferred terms and funding arrangements. Alternatively, the vendor could consider targeting smaller builder/developers who do not include a construction margin in their project feasibility.

Home Owners Warranty Insurance ('HOWI')

The building legislation in all states impose an obligation on builders to rectify building defects for periods of up to six years. If the builder fails to do the work, the homeowners are supported by Home Owners Warranty Insurance ('HOWI'), a form of indemnity insurance covering limited rectification work.

Due to its indemnity nature, HOWI represents a contingent liability to any receiver completing the construction works – and, therefore, the financier through the receivers' indemnity.

In the event of a project default requiring replacement of the builder, it is commonly impossible to find a new builder prepared to accept the risks associated with the earlier builder's work through HOWI. From a project financier's perspective, the cost of obtaining a new policy can be prohibitive enough to impact the project's feasibility. In dealing with this issue, it should

Did you know...

The market

- The residential market remains resilient in Western Australia thanks primarily to the resources boom, but a recent downturn in market conditions on the Eastern Seaboard, particularly Sydney, has resulted in numerous property and construction defaults.
- Statistics for 2005, 2006 and 2007 suggest a decreasing trend in residential building commencements in New South Wales, Victoria, South Australia and Queensland. This decline is partly attributable to increasing interest rates, although the latest rental vacancy rates (circa 1.5 per cent) suggest an improvement in rental yields during 2007, which may help reverse this trend.

Ferrier Hodgson's Property & Construction Team

- There are 20 people in Ferrier Hodgson's Property & Construction team headed by Brian Silvia, an industry specialist who has been part of this sector for almost 30 years. We also draw on a pool of people with specialist knowledge in this sector. Our specialist contact base includes project managers, quantity surveyors, architects, surveyors, builders and specialist property lawyers. We are able to draw on their specialised knowledge and slot them into temporary roles where necessary.
- Ferrier Hodgson's specialist teams have handled diverse property and development briefs, ranging from the divestment of the massive Pyramid and Custom Credit property portfolios to the remediation of Pasmenco's Cockle Creek smelter.
- Amongst the high-profile projects we have handled, are:
 - Pyramid
 - Custom Credit
 - KB Hutcherson
 - Stuart Brothers
 - Parkes Development Group
 - Rennat Constructions
 - Westpoint – Scots Church
 - North Sydney Finance

be remembered that it is an offence to construct residences without a HOWI policy where required. However, it can be possible in certain circumstances to sidestep these difficulties.

For example, a Mortgagee in Possession can sell residential properties without a HOWI policy (or the obligation to rectify defects on larger projects), although it may result in the reduction of the sale price.

Looking ahead

There are many challenges ahead for developers and financiers at this point in the economic cycle – the boom conditions have attracted numerous inexperienced developers and as conditions tighten, there will be casualties.

The key to avoiding some of the simplest traps is to plan for them: take steps to deal with each issue during the initial documentation phase – long before there is a chance for the issue to develop into a problem.

Devoting some time to addressing these issues during the drafting of loan documentation, whilst managing the project and approving funding draw downs is insurance against financial disaster. By identifying and dealing with the issues up front, financiers will be maximising their prospects of success if there is ever a need for a workout.

There is no doubt experienced developers will recall the key lesson learnt from the 1990s – that while property always increases in value over the long term, short term fluctuations can be disastrous for the unprepared. In the current market, there are many players who may go through the unpleasant process of learning these lessons for themselves.



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