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FINSights: Emerging trends in FS

Headwinds in residential development create new opportunity

A perfect storm of volatile market conditions, regulatory change and stricter lending requirements presents serious challenges for residential developers. These include settlement risk where portfolio concentration is in high-risk areas and funding issues for new projects (or expansions). At the same time, they present opportunity for non-traditional lenders such as domestic and offshore funds and international private banks. Tougher lending criteria from the large banks, and the corresponding expansion of non-bank lenders is spurring the development of innovative funding strategies and structures. Investors and development/construction companies now need to consider alternative sources of funding.

CHALLENGES

Tightened bank lending protocols restrict access to funding

Big 4 banks and most recently foreign banks applying increasingly restrictive lending covenants and conditions have contributed to a fall in appetite for project funding and investor loans including:

- changing risk profiles
- capital costs and tighter APRA/ASIC policies restricting lending growth. This has resulted in: re-pricing transactions; tighter loan to cost and/or value criteria; higher pre-sale requirements (tighter limits on % foreign purchasers, tighter deposit or initial equity requirements).

Foreign investment constraints

Lending freeze or increased restrictions for overseas retail buyers means developers with significant exposure may face difficulties in accessing capital. Foreign-sourced loans attract higher capital weighting under Basel IV while new FIRB rules have reduced overseas demand.

Changes to state and federal tax regimes include:

- state tax on foreign purchasers of residential property from 3% to 7% from 1 July 2016
- surcharge on absentee landholders from 0.5% to 1.5% from 2017 land tax year
- CGT withholding tax on foreign vendors.

Settlement risk

- Tightening senior credit conditions pose financing challenges for new projects and possibly create issues for settlements on existing projects.
- Portfolio concentration in high-risk areas has banks reassessing loan books.
- Purchasers unable to complete due to funding issues from higher LVRs and lower valuations. For some overseas buyers there maybe tighter restrictions on capital flows in home jurisdictions post exchange putting pressure on ability to complete.

MinterEllison

SOLUTIONS

Expansion of non-bank lenders and other trends

Alternative lenders are establishing or expanding platforms in Australia to provide capital for property related transactions including:

- capital partners
- unitranche and stretch senior loans
- preferred equity, subordinated debt and mezzanine funding to plug gap funding given lower LVR
- countercycle plays: hedge funds and distressed debt trading opportunities; M&A rationalisation / consolidation opportunities.

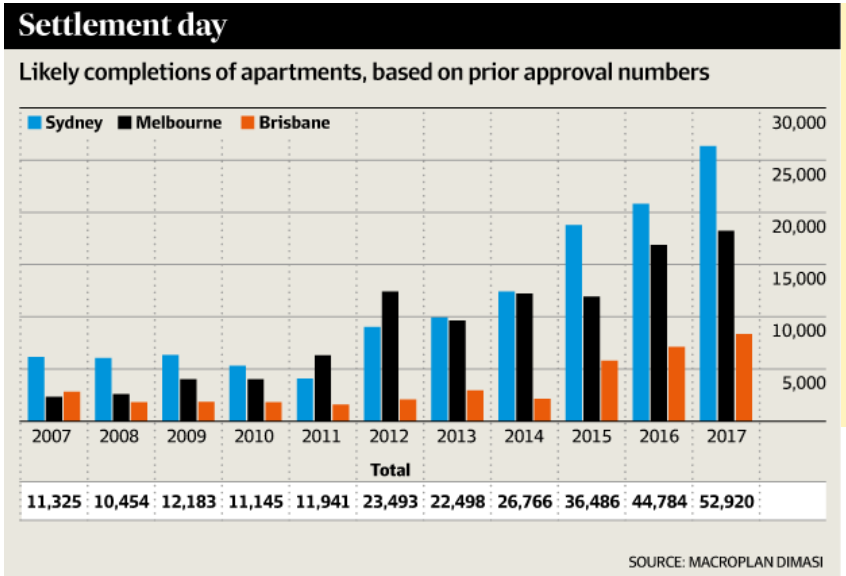
Innovative funding strategies and structures

Debt/equity structuring (eg structural subordination, redeemable preference shares) meet bank criteria and provide tax and capital protection. Innovative capital structures are being considered to ensure projects proceed.

- internal funding capability
- changed business model (eg serviced apartments and leasing in lieu of sales)
- residual stock facilities
- securitising pre-sales.

Watertight contracts

- Stark contrast between the value of pre-sale contracts and ability to enforce them, beyond forfeiting a 10% deposit (if 10% made).
- Issues of due diligence on new and just completed projects – where purchasers may seek to rescind contracts, eg. relying on new unfair contract provisions in the Australian Consumer Law, expiration of sunset dates, marketing misrepresentations or product variations.



- 44,784 apartments are due for completion and settlement this calendar year (2016) across Sydney, Melbourne and Brisbane, up almost a quarter on last year's 36,486 (2015)
- In 2017, expected settlements will be 52,920 (and increase of 18% on prior year)
- The surge in settlements this year alone will see 4x as many apartments settle compared to 2010

Foreign buyers account for:

18% of *new* apartment sales

53% of *all* apartment sales

New apartments **set for completion**

92,000 by May 2017

230,000 by May 2018

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