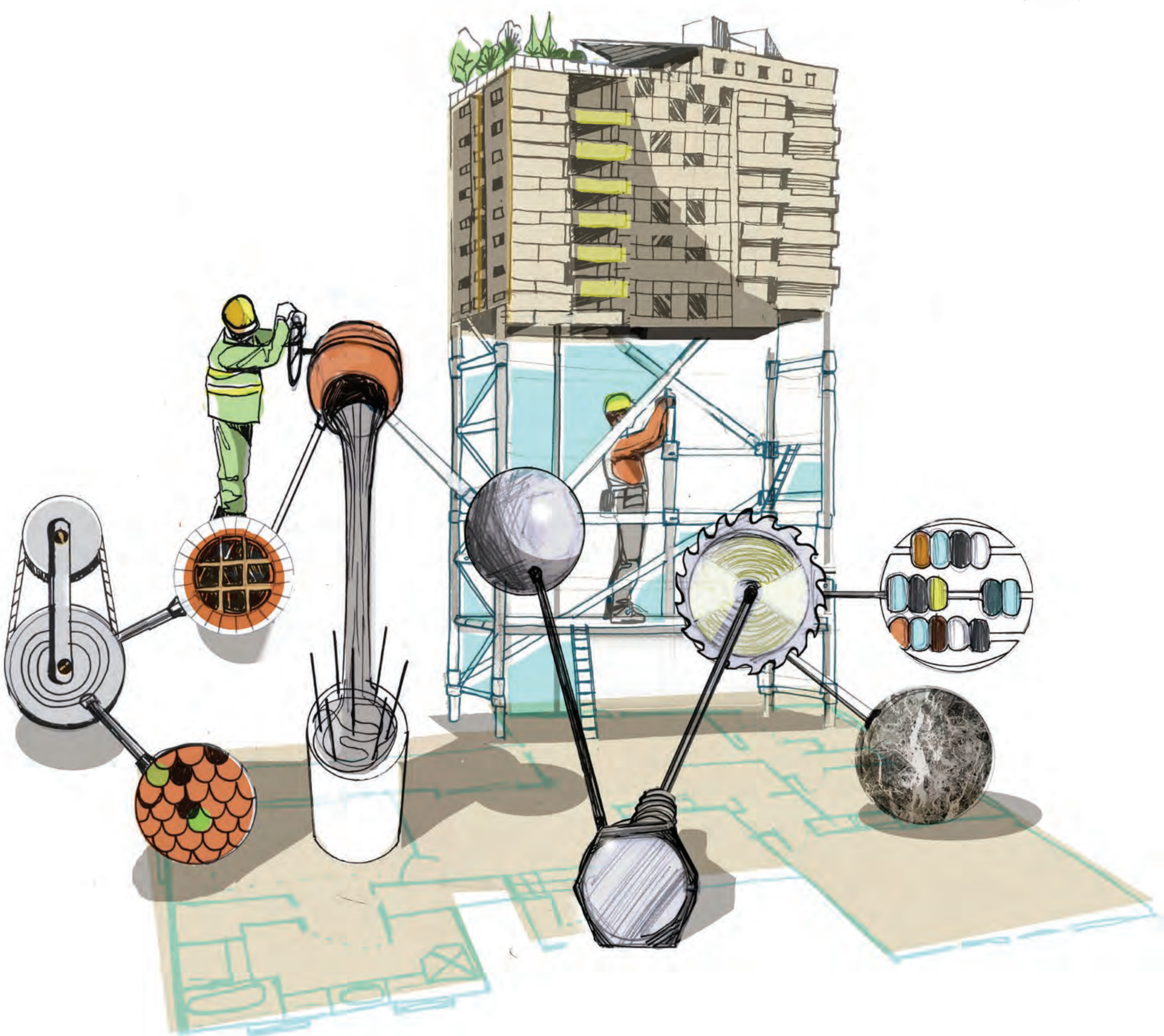
OCTOBER 2012

# Real Estate & Construction

## Industry Insights - Funding Developments



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# Welcome

## It's been a prolonged period of downturn for the Australian Real Estate & Construction (RE&C) industry. While some regions and sectors have fared better than others, many have struggled to weather the storm. For those organisations, the ability to manage existing facilities or source alternative funding has proven key to survival.

In the current capital climate, gaining access to funds for development projects is particularly challenging. With financiers stuck with only a limited pool of capital to allocate to property assets, they've had to be particularly diligent in ensuring their risk criteria is met.

There is no doubting the importance of the RE&C industry to the Australian economy and the contribution it makes to GDP, tax revenues and employment. For these reasons, Grant Thornton felt it was important to highlight the issues currently faced by the industry given the follow-on impact of the downturn on the broader community.

In producing the Grant Thornton Industry Insights Report, we undertook in-depth interviews nationally with key industry participants and financiers at executive level, to gain a better understanding of their challenges and strategies to overcome these. We also sought to identify gaps between the expectations of industry participants and their financiers, and gain insight into how they are approaching development funding.

From the conversations we had with both public corporations and privately owned groups, we established that there are currently a large number of development projects planned and ready, but are being held up due to limited or prohibitively costly funding options.

In the Grant Thornton Industry Insights Report, we share a snapshot of the common themes revealed by these interviews and provide some ideas for consideration when looking at funding developments.

I sincerely thank those who gave up their time to participate in the interviews and candidly shared their challenges and solutions, along with their insights.

**Sian Sinclair**
**National Head of Real Estate & Construction**

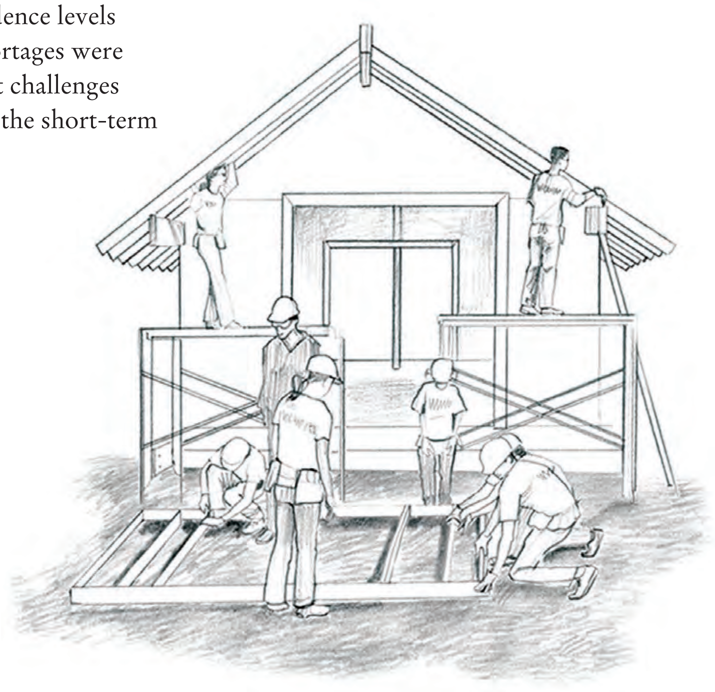
# Industry insights at a glance

This Grant Thornton Industry Insights Report highlights the challenges that the Australian RE&C industry is facing in sourcing development funding. Our conversations indicated that this issue is widespread, impacting both public and private organisations, big and small and is having a serious impact on development activity throughout the country.

Interestingly, developers do have an appreciation that financiers are under funding pressure. Despite the caution around funding, 95% of those surveyed agreed their bankers had been and were continuing to be supportive in the post-GFC environment.

Some key findings:

- 68% of all participants, (including more than half of the public companies we spoke to) stated that they had experienced issues with securing finance for developments in the past 18 months. In many cases, 'hurdle rates' such as pre-sales and loan-to-value ratio (LVR) levels were considered unachievable or unacceptable
- 84% of respondents said that they had an appetite for additional debt in the next 12 to 18 months
- 79% of participants had seen developers pulling out of particular regions or sectors due to banks being unable to support projects in that area
- More than 89% of respondents agreed that development financing impacts the structure of projects and 55% believed it is the key factor
- Joint ventures were considered a popular option to share risk and the funding burden, as well as enabling projects of greater size to be taken on
- Limited access to capital, red tape, consumer confidence levels and skilled labour shortages were considered the biggest challenges facing the industry in the short-term



# Key findings

## Limited access to capital

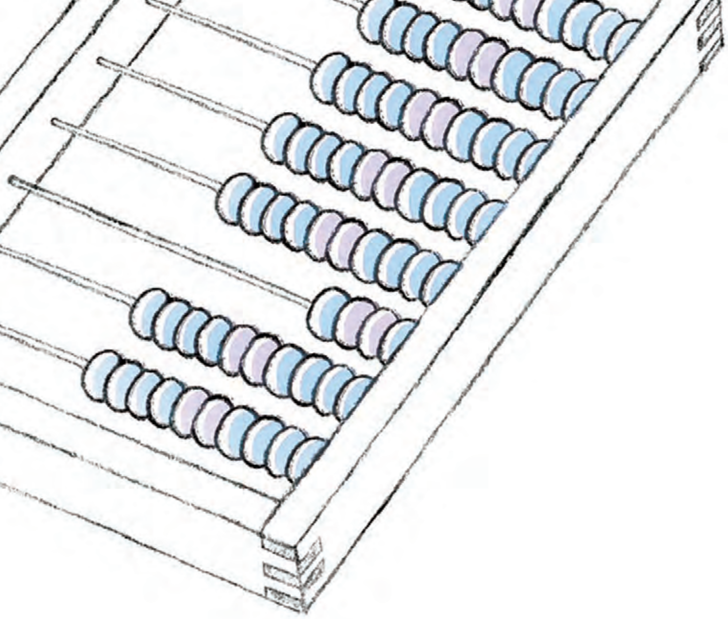
**Confidence on the rise but still weak**

A recurring theme in our conversations was that the majority of industry participants have an appetite to take on more debt to finance new projects (84%). For many developers, it is not simply planned expansion activities they wish to fund, but more critically the maintenance of their project pipeline and replacement of maturing projects.

The largest survey of the Australian small and medium enterprises (SME's) sector, the Sensis Business Index, showed a slight rise (2%) in business confidence in the Australian building and construction sector in the September 2012 release. However, Grant Thornton Senior Economic Advisor, Steven Shepherd cautions:

> "The latest confidence figures for the sector are only marginally ahead of total business confidence across the entire economy, but more importantly, they are noticeably lower than what they were just six months ago."

Developers have expressed their concerns around projects that they want to bring to market, many of which are being stifled by their inability to access reasonably priced capital. Despite this, rental vacancy rates and continued population increases demonstrate there is a need for new product and if this cannot be brought to the market to keep up with demand, affordability will continue to be a long term issue. With State Governments providing incentives to stimulate housing activity, pressure on lenders to provide more flexibility when it comes to assessing new development projects will continue to grow.

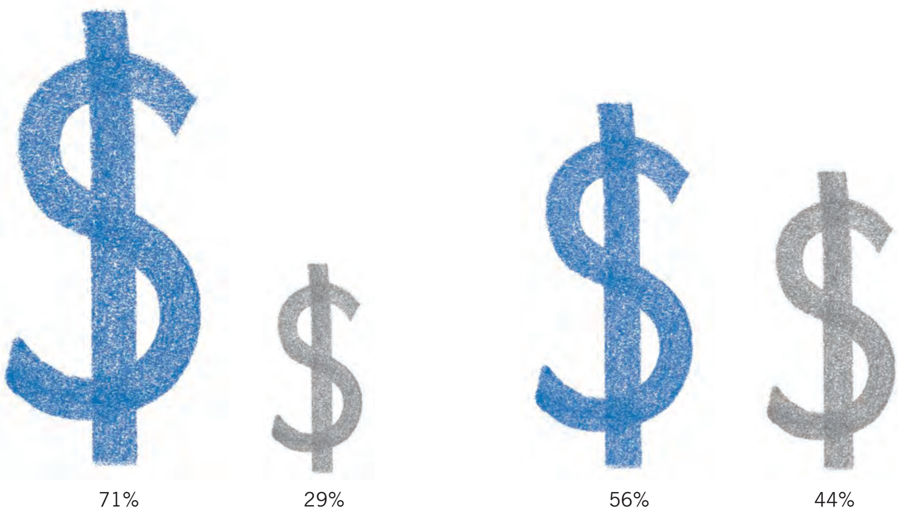


**The expectation gap**

While financiers are saying that they are ‘open for business’ when it comes to property lending, industry participants are telling us they are finding it harder than ever to source funding; there appears to be an ‘expectation gap’ in the market between borrowers and lenders. The majority of those we spoke with (68%), had experienced some degree of difficulty in securing new project finance or refinancing existing debt facilities. Unsurprisingly, a much greater proportion of private developers had experienced problems than public companies.

**Securing finance - private companies**

**Securing finance - public companies**

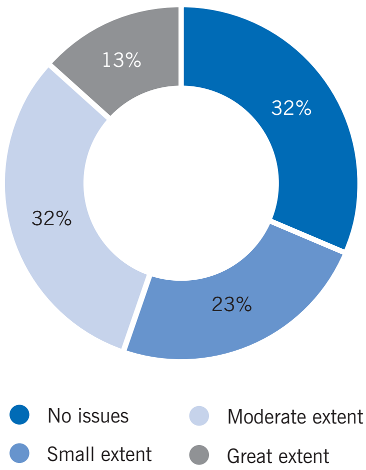



Had issues securing finance

Did not have issues securing finance

> The banks have plenty of money for ‘vanilla’ deals but to the valuer, nothing is vanilla. After they have applied their levels of conservatism to the project, the end result is that significant levels of cash equity are needed to access the debt facilities on offer. For many developers, the cash equity is not available so sound projects are not proceeding.
>
> **Bob Sharpless**
> Managing Director,
> Springfield Land
> Corporation

**Extent of difficulties securing finance in past 18 months**




Common financing issues raised by those experiencing difficulties included:

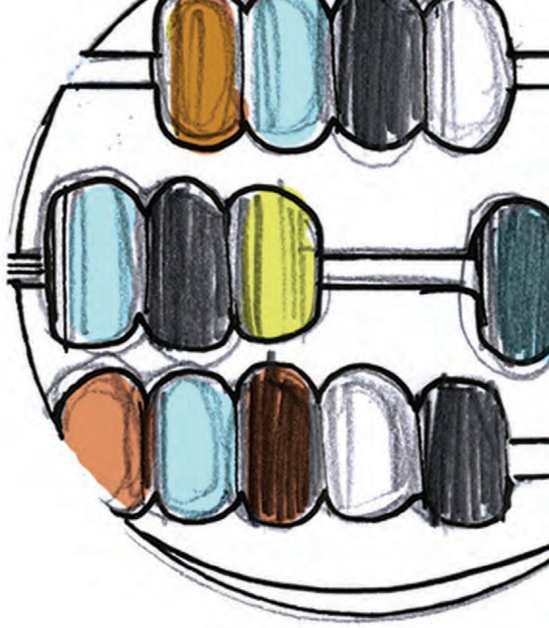
- Increasing pre-sale quota requirements
- Loan covenants becoming more onerous
- Lower LVR's requiring more capital up-front
- Unrealistic valuations
- Approval times increasing due to more stringent risk assessments
- Banks looking for security from income producing projects over asset values and thus being reluctant to lend on land-only developments

Clearly, there is an increasing gap between the minimum lending criteria set by financiers and what the industry perceives to be a reasonable assessment of development risk.

One suggestion to alleviate issues with pre-sale quotas was made by Matt Lawrence - State Director for Queensland and Northern Territory, Institutional Property Group at ANZ. Mr Lawrence proposed a change to the restrictions on developers taking deposits of over 10% from foreign buyers as a way to de-risk projects for developers and make them more fundable:

"By allowing developers to take a larger deposit, between say 20% and 30% - banks would be able to consider increasing the proportion of foreign sales that would qualify as a pre-sale. This would make projects more fundable and able to commence. It would also reduce settlement risk. Given Asian buyers progressively pay the purchase price to fund their own unit developments, it is unlikely an increased deposit would affect sales."

The financiers we spoke with all confirm that they are happy to lend for property development, but stressed that projects must stand up to their risk assessment criteria. The message is that assessment criteria hasn't changed over time, but is perhaps being more stringently applied in this tight capital market. Key factors noted by financiers when assessing loan applications were the level of debt-to-equity ratio, pre-sales and the reputation and standing of the sponsors behind the particular project.



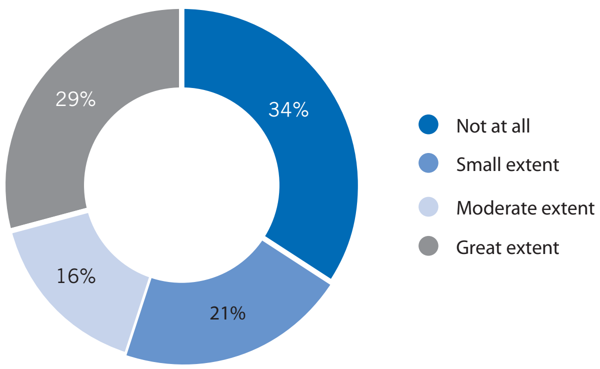
### Reporting – has the GFC increased the burden?

Around two thirds of participants agreed that since the GFC, they were facing additional reporting requirements to comply with debt covenants. However, most accepted that this was primarily a return to standard practice that had been relaxed in the years prior to the GFC. Interestingly, a similar portion of financiers agreed that there had been an increase in reporting requirements in recent years.

Even among industry participants who believed the level of reporting detail required had not changed, there was still consensus that the information they were supplying was being more closely scrutinised than in the past and perhaps requested more frequently. This was explained by financiers as simply part of their responsibility to understand what was happening within the businesses of their borrowers.

Despite any perceived increase in reporting obligations, 95% of respondents agreed that their bankers had been supportive both during and since the GFC, which is a great report card for the banks in these difficult times.

**Industry participants view of additional reporting**




> The extent of risk aversion by financiers is reinforced by the noticeable rise in the gearing ratios for RE&C sector companies in the last few years.
>
> **Steven Shepherd**
> Senior Economic Advisor,
> Grant Thornton Australia Limited

> What's important to a potential financier is that, ultimately, the loan they make will be repaid. While there is never any guarantee of this (there is no such thing as risk free lending) a financier will want to know that the person they are lending to has the appropriate experience to deliver the project and has the appropriate financial capacity and resources to deal with any adversity during the life of the project and beyond.
>
> **David Kelly**
> Head of Property Finance Queensland
> Westpac Institutional Bank

## Looking more attractive to lenders

Our conversations highlighted a number of key strategies for RE&C sector companies seeking finance. In order to put your business or project in the best position for bank funding, consider the 'Four Cs':

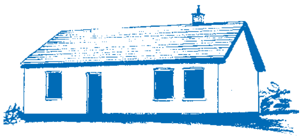
**Character**

- The strength of your relationship with current or prospective lender
- Ensure historical compliance obligations are all up-to-date
- Focus on the industry reputation and experience of your team. Even if you're new to the industry, look at the people you have involved or advising on the project and use their expertise to sell the opportunity
- Know what your credit history looks like
- If you are partnering with another party, consider what reputation and financial solidity they bring to the arrangement
- Consider your ability to offer good quality internal reporting on a timely and regular basis

**Capacity**


- Demonstrate you can manage the payback period even if set-backs occur - has adequate financial modelling with sensitivity analysis been completed?
- Allow for contingencies in the loan servicing plan
- Consider whether the project deliverables match lenders' timeframes
- Ask what other projects or income producing activities are available to service the loan through tighter periods

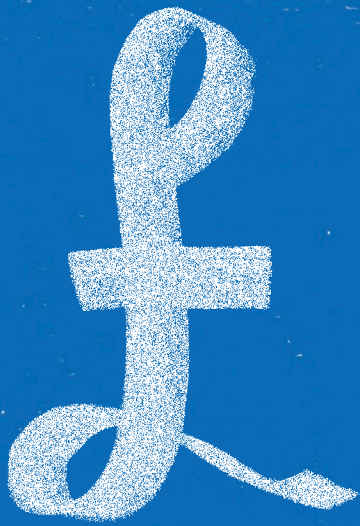
**Capital**



- Be prepared to have some 'skin in the game' and have those arrangements in place first
- Don't be caught by surprise when the bank valuation comes in - have an independent idea of what the asset you are developing is worth so you are prepared when negotiating LVRs
- Get in early enough to allow adequate time for the bank to do their assessment

**Collateral**


- Be prepared to think about what the bank might be left with by way of assets if things don't work out. For example, will there be an income producing asset or vacant land to resell? While it may seem negative to ask these hard questions at the start, you can be sure the bank will be asking the same questions
- Consider your capacity to offer additional security and ask, what is the saleability of this asset?



## Exploring funding alternatives

Due to the difficulties many SMEs  in the RE&C industry are experiencing in accessing finance, more and more are choosing to explore alternate sources of funding, with 82% confirming that they have considered alternatives to traditional bank debt.

Some of the alternatives being considered by both SME and larger public and private companies include:

**Overseas funding**

Since the GFC, Australian listed companies have been increasingly interested in accessing non-traditional financing solutions from overseas sources such as convertible notes, high-yield debt or private placement debt. While these avenues are easily available to larger public entities with Treasury divisions, SME developers seeking to explore foreign markets for funding are not so fortunate – for these entities, there is no market for generic overseas debt.

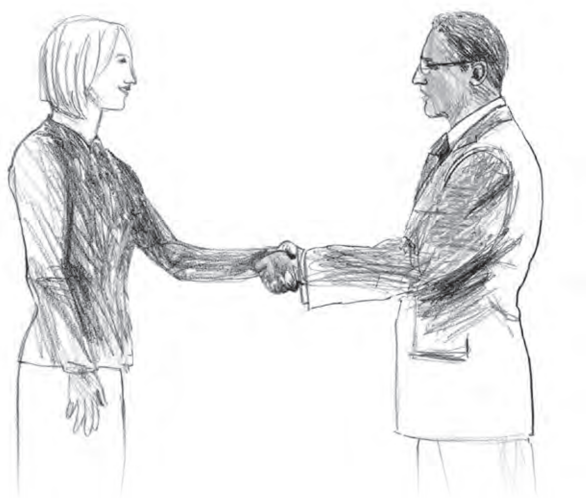
From our conversations, the simplest way for SME developers to access overseas funding is through a commercial finance broker who has an existing book of lenders with development finance products. It's worth noting that over the last 12 months, there has been a significant inflow of investment capital from the Asian market and an increased level of interest in Australian property from the Indian market in particular.

**Private Equity**

While many developers are willing to consider Private Equity (PE) injections into their projects, they commonly struggle to source this type of investor. Those that do utilise PE are usually looking at offers made to known 'friendly' investor groups with sophisticated industry knowledge and with whom they have previously done business.

Our conversations highlighted that the costs involved in putting together a proposal that contained sufficient information to satisfy potential PE investors were generally prohibitive and the returns sought on funds invested were enough to seriously impact potential profits. With access to PE dollars getting more competitive, investors are spoiled for choice and can demand quality information to assess their investments. However, given the limited capital available at the current time, more developers are considering this option.

While not all PE organisations that operate in Australia invest in property, some have returned to property investment in projects that meet their individual investment criteria. Grant Thornton can assist in identifying and making introductions to PE firms that operate in the property space.



## Joint ventures

Throughout our industry conversations, Joint Ventures (JV) proved a popular option to help capitalise projects. Common advantages raised included:

- Enabling risk sharing
- In some instances, the ability to keep debt off the corporate balance sheet
- Assisting to win projects in new markets by partnering with someone with local knowledge or expertise in that sector
- May help to overcome funding hurdles for a project or ability to take on larger projects if the JV partner has strong financial or reputational standing with financiers.

JVs are used widely in the RE&C industry for collaboration on projects. While use of the term 'joint venture' in the industry covers far more than the legal (or taxation) definition, a true JV involves a contractual arrangement between two parties contributing to an end result and sharing in the outputs of the venture.

Often, the venture involves development of a product that is sold to an external party, or pooled expertise and resources to deliver a construction outcome for a third party.

In the past, JV's were often used as a method of keeping debt off the partner entities' balance sheets, thereby not impacting existing banking covenants. However, the introduction of new IFRS rules will mean this method of accounting is not always available.

With JV's being a common structure for developments, both participants need to ensure they are protected if the actual substance of the arrangement is such that it may leave them exposed to joint liability. The taxation and GST implications of JV arrangements can also be complex, so the responsible reporting parties need to ensure compliance requirements are met.

Despite this, JV's are a popular vehicle for undertaking developments where there is benefit from having the input of another party's expertise or capital to deliver the outcome.

> Locating a landholder with limited gearing who is willing to participate in development profits as lots sell, rather than sell to a developer for a fixed profit, can significantly reduce the financing burden on the project as there is no lump sum outlay to acquire the land up-front.
>
> **Sian Sinclair**
> National Head of Real Estate & Construction, Grant Thornton Australia Limited

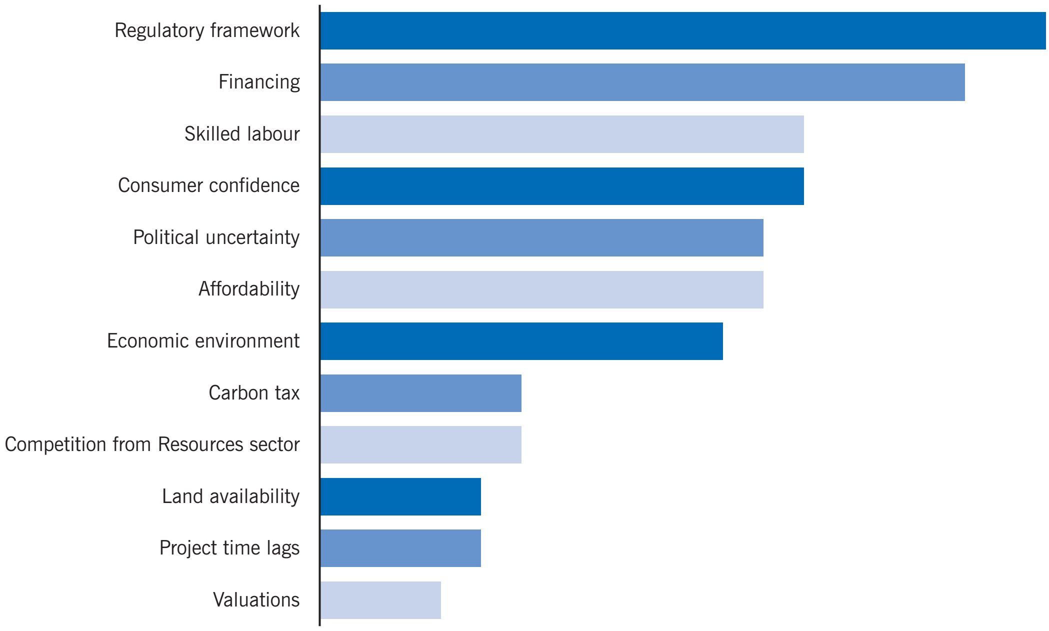
# The RE&C industry outlook

During our conversations, participants felt that overall, RE&C industry growth would continue to be flat over the next 18 months to two years, but did predict an upswing in the years following. Given the difficult economic conditions, many shared the strategies they were employing to remain competitive. Common responses included:

- Specialisation of product in the residential sector
- Diversifying by moving into more active sectors (eg. resources)
- Managing costs (especially supplier costs, overheads and operating costs)
- Improving the timeliness and quality of management reporting to assess performance more frequently
- Getting closer to banks
- Offering lower priced product and rebates to keep sales ticking over
- Altering the product mix to address affordability and keeping in touch with market needs

## Industry challenges

We also asked both industry participants and financiers to identify what they saw as key challenges for the industry over the next 12 months:




From our discussions, the most frequently identified industry challenges were the current Australian regulatory framework, financing, consumer confidence and the shortage of skilled labour.

### Regulatory framework – still a minefield

There is still a lot of uncertainty around the regulatory framework at both Federal and State levels. The current amount of red tape is certainly considered to be unacceptable and was identified as the biggest industry challenge over the next 12 months. The introduction of the Carbon Tax and other environmental policies have also added to the burden by delaying projects and adding to project costs. Given the bumpy ride the Federal Government has experienced in this current term, uncertainty about what the regulatory landscape may look like after the Federal election in late 2013 is also sapping confidence.

It is interesting to note that regulatory framework for the real estate and construction sector, appears to be a bigger concern than for other sectors across the economy. For example, the Sensis Business Index, showed that only 6% of all SME's across Australia believe that the bureaucratic and paperwork burden is currently a business concern.

It does appear however, from regulatory issues currently being discussed by various governments across Australia, when coupled with existing regulations, that the real estate and construction sector will be disproportionately impacted by red tape.

> Fixing planning is a powerful lever that governments at all levels could trigger to boost productivity and increase housing affordability. It's critical that we overhaul our planning and development assessment systems to achieve time and cost efficiencies if we are to increase construction activity and investment.
>
> **Kathy MacDermott**
> Executive Director,
> Property Council of Australia
> (QLD Division)

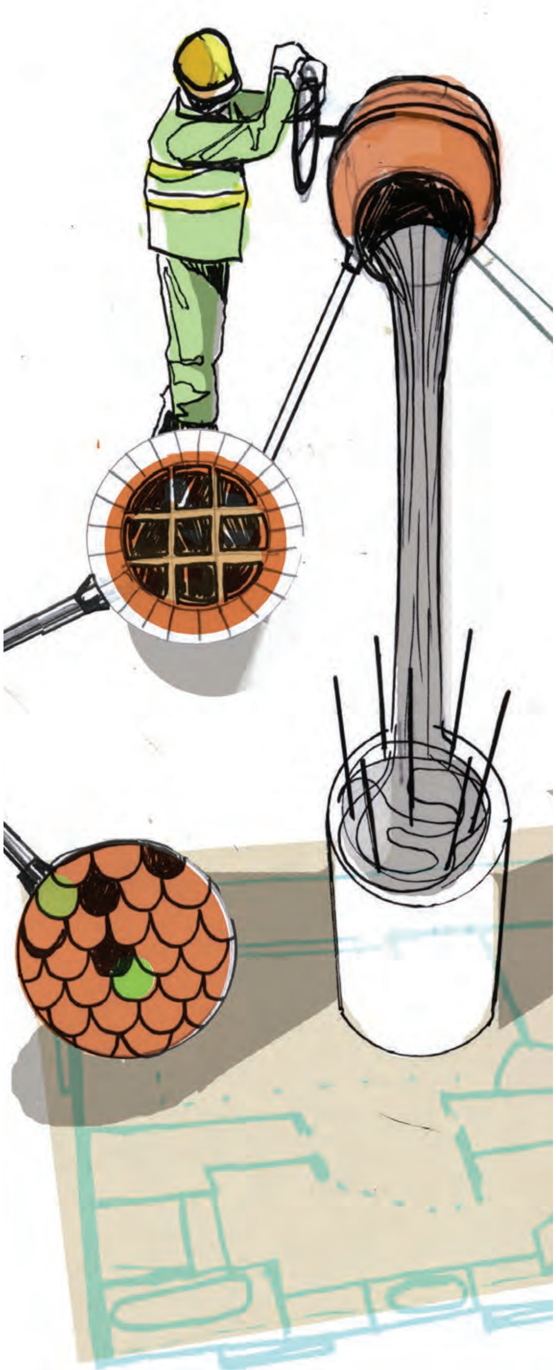
**Financing remains a priority**

While Australia's economy remains relatively strong when compared with many European economies, global economic turmoil is still having an impact on access to capital. With 84% of developers saying they would like to take on additional debt for projects, it's concerning that a large proportion of participants believe that access to funding is going to get more restrictive before the situation improves, with an increasing gap between what they wish to borrow and what financiers are willing to lend.

**Consumer confidence and skilled labour are both scarce**

Consumers have been 'battening down the hatches' with increases to their cost of living, uncertainty around interest rates, falls in property valuations and the European economic crisis just some of the issues impacting their willingness to spend and driving debt reduction behaviour. While savings rates for households have reached the highest levels in many years, the key to moving the industry forward will be unlocking the equity consumers have been building up during this consolidation period.

In terms of finding and keeping staff and the whole issue of access to skilled labour, recent business surveys show while this is an issue, it's not as acute as it has been in recent years. Moreover, the continuation of relatively low unemployment means it will be something that businesses continue to confront for some time yet.



# Interview participants

Grant Thornton would like to express our appreciation to those individuals who participated in these conversations and provided their insights in support of the industry.

The following participants agreed to be disclosed for the purposes of our report:

- AJ Chappell Pty Ltd
- ANZ
- Atcon Constructions
- Ausbuild Group
- Bankwest
- BMD Group
- Brisbane Housing Company
- C2 Property Group Pty Ltd
- Dale Alcock Developments
- Devine Limited
- Dorado Property
- Excel Property Group
- Finance Company Australia Pty Ltd
- Imperial Builders
- Leighton Properties
- Lester Group
- McNab Constructions
- Mirvac Developments
- Mitie Developments Pty Ltd
- PHI Property
- Pindan
- QM Properties
- Robina Land Corporation
- Springfield Group
- Sunland Group
- Surat Basin Property Group
- Terranovis Pty Ltd
- Villa World Limited
- Wiley Constructions
- Westpac

# About the Grant Thornton Industry Insights Report

Grant Thornton is committed to providing the RE&C industry in Australia and overseas, with real insights into the issues and challenges facing the sector. As part of this commitment, we have put together this Report, focusing on issues with development funding. We have drawn on interviews with a range of industry participants and their financiers, to gain their first-hand perspectives.

Our findings are based on these interview discussions. We have collated the responses to questions raised and highlighted common themes that arose in the interviews.

**Methodology**

Our National Real Estate & Construction industry team met directly with executives from both public and private organisations including:

- Developers and owners of commercial and residential property
- Builders and civil contractors
- Industry financiers

In depth, interview-style conversations were held to gain an independent perspective on a range of topics but primarily, on funding issues.

Some key questions discussed included:

- What limitations are you experiencing when it comes to accessing funding?
- What is your appetite for additional debt?
- How would you rate your relationship with your bank?
- What funding alternatives beyond traditional bank finance are you exploring?
- How would you describe RE&C industry sentiment?

The responses to these questions and others, along with general points raised in the discussions have been collated and key themes identified.

# About Grant Thornton

## Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms.

We help dynamic organisations unlock their potential for growth by providing specialist services, business advice and growth solutions. In Australia, we have more than 1,300 people across seven offices in Adelaide, Brisbane, Melbourne, Perth and Sydney. We combine service breadth, depth of expertise and industry insight with an approachable "client first" mindset and a broad commercial perspective.

We are a member of Grant Thornton International which comprises firms operating in more than 100 countries worldwide. Through this membership, we access global resources and methodologies which enable us to deliver consistently high quality outcomes for our clients.

### Our services to the Real Estate & Construction industry

Grant Thornton assists with challenges faced by companies across the industry.

**Attracting and retaining staff**

- Employee share schemes
- Ex-pat tax services
- HR advisory (including remuneration strategies, policies)

**Fundraisings**

- Fund raising assistance (eg pre-IPO raisings)
- Capital markets – advice on selection of appropriate market and assistance with the listing process
- Independent Accountant for IPOs (ASX and other markets such as AIM)
- Nominated Advisor services for AIM listings
- Independent Expert Reports

**Transactions**

- Valuations
- Independent Expert Reports
- Project acquisitions and divestments
- Sourcing joint venture partners
- Financial modelling
- Due diligence

**Meeting regulatory requirements**

- External audit
- Corporate governance reviews
- Corporate and private tax
- Transfer pricing reviews
- Indirect tax advice (GST, payroll tax, R&D tax incentive, etc)

**Corporate structuring**

- Tax effective structuring advice
- Corporate simplification (winding up of dormant/defunct subsidiaries)
- Insolvency

**Systems and outsourcing**

- Systems and controls review
- Technical advice and financial reporting assistance
- Technical training (IFRS, accounting, auditing and legislation changes, etc)
- Financial statement preparation
- Payroll outsourcing/interim payroll
- Internal IT audit
- Forensic Investigation Services

# Real Estate and Construction contacts


**Adelaide**
**Dale Ryan**
**Partner**
T +61 8 8372 6535
E dale.ryan@au.gt.com

**Brisbane**
**Sian Sinclair**
**National Head of Real Estate and Construction**
T +61 7 3222 0330
E sian.sinclair@au.gt.com

**Melbourne**
**Andrew Hewitt (Institutions)**
**Partner**
T +61 3 8663 6003
E andrew.hewitt@au.gt.com

**Dean Schultz**
**Partner**
T +61 3 8663 6261
E dean.schultz@au.gt.com

**Perth**
**Craig Simon**
**Partner**
T+61 8 9480 2030
E craig.simon@au.gt.com

**Sydney**
**Don O'Brien**
**Partner**
T +61 2 9286 5735
E don.o'brien@au.gt.com