THE ULTIMATE SHORT GUIDE TO PROPERTY AND DEVELOPMENT FINANCE IN AUSTRALIA

There is much more to it than just numbers

Understand the fine print in finance documents and become a smarter borrower. Avoid costly mistakes and exceed your expectations

By Peter Faludi

The ultimate short guide to property and development finance in Australia.

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FOREWORD

WHAT THE EXPERTS THINK

THE ULTIMATE SHORT GUIDE TO PROPERTY AND DEVELOPMENT FINANCE IN AUSTRALIA – THERE IS MUCH MORE TO IT THAN JUST NUMBERS

I have been in the commercial and development property finance sector for over 15 years, as a banker at the Australian & New Zealand Banking Group (ANZ) and, more recently, as a Director of CBRE Capital Markets Debt & Structured Finance.

Throughout my career, I have seen issues many borrowers create for themselves as a result of not fully understanding the terms of the agreements they enter into with their financiers. For example, they often:

- don't understand the process required to be undertaken by financiers in approving a loan;
- are unaware of the extensive list of conditions precedent that need to be satisfied before the funds under the loan facility are available to be drawn;
- are surprised at the broad scope of the restrictions imposed on them under the finance documents which can adversely affect their control of the project (for which the finance was provided) or indeed their business generally;
- don't realise the broad nature of the rights financiers have to potentially change the terms of the deal: and/or
- underestimate the time and cost involved in trying to renegotiate the terms they agreed to when signing the letter of offer issued by the financier.

I have known Peter Faludi for over 7 years, having been involved in matters where ANZ was the financier on projects undertaken by clients represented by Peter. As I expected, given his significant experience in property finance matters, Peter proved to be not only knowledgeable, commercial in his approach and a good negotiator on behalf of his clients, he was also very focussed in ensuring his clients understood the relevant issues and made informed decisions when determining whether to accept or reject the financier's position on important matters.

When Peter mentioned to me that he was going to write a simple guidebook on development finance for the purpose of helping developers and commercial property investors understand issues relating to financing that they often, mistakenly, regard as boiler plate or "just" fine print, I thought:

> *"finally, there will be a book that will be an invaluable resource for developers and commercial property investors that will not only help them understand issues which arise in financing documentation but, more importantly, will improve their financing outcomes".*

After having read this book, I can confirm that it is easy to read and understand and its clear approach will help readers identify ways in which to improve their position in financing arrangements relative to their past (and often unhappy) experiences.

By reading this book, property developers and investors in commercial property will improve their knowledge of issues common to most financing arrangements. As a result, they will be able to more effectively choose and work with their advisers in improving the terms of these arrangements.

I commend this book to you.

Steven Bougoukas | Senior Director
CBRE | Capital Markets
Debt & Structured Finance

WHY ARE "NON-MONETARY" TERMS IN PROPERTY FINANCE DOCUMENTS IMPORTANT?

The Answer: Because they can have significant adverse financial and commercial consequences

In the current difficult market for development and other property finance, financiers will be scrutinising their documents to ensure that they provide themselves with the strongest possible rights and best outcomes in circumstances where a project they have financed suffers difficulties.

In such a climate it is the "non-monetary terms" of finance documents that are increasingly important.

IMPORTANT COMMERCIAL AND FINANCIAL CONSEQUENCES THAT CAN FLOW FROM "NON-MONETARY" CLAUSES INCLUDE:

- Your ownership structure may be an impediment to getting finance on acceptable terms.
- Your financier may have the right to change the terms of the loan at any time prior to repayment.
- A problem with the builder on a project is likely to allow your financier to call a default under your facility.
- Your pre-sales may not count in satisfying your financier's requirements
- There may be little or no equity left for you in a project if default interest becomes payable for an extended period of time.

Read on if you would like to minimise these and other potential adverse consequences arising from "non-monetary" terms.

INTRODUCTION

After more than 35 years as a lawyer practising in real estate financing in Australia, I have seen most mistakes made by first time, inexperienced or foreign property developers, investors and their advisers when arranging financing for their first or even subsequent real estate projects in Australia.

Time and time again, I have seen developers and investors faced with the choice of either having to accept terms which they would prefer not to assume or having to pay the price, either in terms of money or time, in order to have the other parties to the transaction agree to changes requested by the developer or investor.

I have also seen the frustration of financiers and other parties to a transaction, arising from unnecessary delays due to developers, investors and/or their advisers not understanding the terms of documents or not acting in a timely manner.

Unfortunately, these scenarios have not diminished over time due to:

- The increased appetite of foreign investors to undertake projects in Australia, and their unfamiliarity with Australian law, documentation, investment structures and differences between lawyers, and
- The attractiveness of Australian property as an investment, encouraging investors to get involved in property development for the first time.

Why This Book?

It has become clear to me that there is little in the way of a simple guide for newcomers or inexperienced property developers (or even developers and investors undertaking larger more complex projects) and their advisers to help them understand and avoid some of the most common mistakes made when negotiating property finance documentation.

There is much more to it than just numbers

Most developer and investor borrowers, whether inexperienced or not, will tend to read a term sheet regarding a loan, focusing solely on numbers, such as the amount of the loan, the period of the loan, the fees payable and the interest to be charged. If these are in accordance with their understanding of the transaction, they will sign the term sheet without considering the impact other provisions of the term sheet may have on their rights or interests. **In the current difficult market, these 'non-monetary terms' of finance documents are of primary importance. It will be these terms that determine whether a project continues and on what terms or is taken over by the financier or sold.**

For example, non-monetary provisions may give the financier the right to change other terms, including interest rates and fees, during the course of the loan. Presumably if the borrower were aware of this, it would generally not agree to such rights or would at least want them qualified.

As you will see below, the initial term sheet or letter of offer provided by a financier will often not contain much detail, and without proper advice a borrower may not be aware of such terms merely by reading the term sheet. As they say, the devil is in the detail.

The purpose of this book is to highlight these 'non-monetary provisions' and other matters which can have a serious adverse impact on a borrower who is unaware of the consequences of such provisions.

By having the guide inside this book, developers and investors will benefit by:

- Better understanding the main issues which come up in most property financing transactions,
- Being better equipped to negotiate the terms of such finance arrangements before committing to them, and
- Being able to determine whether the adviser they wish to appoint is appropriate, given the nature of the transaction.

This book is the guide you have been waiting for.

In this guide we:

- highlight issues that are specific to newcomers and inexperienced developers or investors in the Australian market (and developers and investors undertaking larger more complex projects), and
- Provide examples and case studies which demonstrate matters to be aware of when considering financing documentation to ensure you avoid unnecessary heartache.

Having read this book, you will realise that it is not difficult to achieve better outcomes and avoid repeating mistakes in relation to property financing arrangements. All it takes is a better understanding of these matters.

This book is easy to understand and, if you apply your new level of knowledge to future property financing transactions, better outcomes should be achieved.

Please feel free to contact me to discuss any transactions you are thinking of entering into so we can work together to achieve the results you want.

If you are a foreign developer or investor, please see my upcoming publication on this topic, which focuses on issues specific to foreign investors.

Peter Faludi
Director
Peter Faludi Consulting

EXECUTIVE SUMMARY

TIPS TO IMPROVE YOUR TRANSACTION OUTCOMES

SO YOU THINK YOU ARE A PROPERTY DEVELOPER?

Tip 1

Look into working with more experienced investors or developers before undertaking your own project

If you have not undertaken a project like the one you are proposing to embark on, it may be worth considering the possibility of entering into a joint venture with an experienced developer or investor in the Australian market rather than undertaking it on your own.

By working with a seasoned developer or property investor, an inexperienced investor can become familiar with the structures, documents and other issues associated with particular types of projects, which are likely to be relevant to you in the future.

For more detail on this Tip please see page 25

Tip 2

Become familiar with terminology

You will not fully comprehend your position and be able to protect your interests unless you understand the terminology used in finance documents. There are many standard terms which can create difficulties for a developer or investor who does not understand their meaning before committing to proceed with a proposed financing. When the real meaning of a term is not understood by investors before making a decision, it can cost them dearly.

For more detail on this Tip please see page 26

Tip 3

Seek and listen to advice

It is essential to obtain advice in relation to the documentation to be entered into in respect of a project's financing or the project generally. You cannot protect your interests unless you are aware of the relevant issues, as well as the terminology and concepts used in the documentation.

For more detail on this Tip please see page 26

Tip 4

Engaging builders and consultants with a recognised excellent Australian track record can make the difference between success and failure in getting finance

It is essential that you engage builders and consultants who have an excellent proven Australian track record as this will be seen positively by prospective financiers and substantially improve the likelihood of you obtaining construction finance.

For more detail on this Tip please see page 27

Tip 5

Know your project

It is very important to document all aspects of a proposed project properly. The ability to provide complete, well thought out and accurate details (including project feasibility and budget) on a timely basis to a prospective financier will be viewed by the financier as indicative of the professionalism and quality of the developer/borrower.

For more detail on this Tip please see page 27

Tip 6

Make sure your lawyers and advisers will help, not hinder, you

Financiers and their lawyers prefer to deal with borrowers' lawyers who are familiar with finance documents and therefore do not require explanations regarding normal market concepts/terms, can turn documents around efficiently and have the resources to be able complete the transaction in the proposed timeframes. It is therefore important to choose your lawyers carefully.

For more detail on this Tip please see page 28

Tip 7

Check out your proposed financier to make sure they can fund the project as required

When dealing with non-bank lenders, you, as borrower, need to be comfortable that the funds will be available when required, that the lender will adopt a reasonable and commercial approach where there are difficulties with the project and will not immediately seek to enforce its securities if a problem arises. You should do due diligence on the proposed non-bank lender to ascertain this.

For more detail on this Tip please see page 28

Tip 8

Consider the ownership structure to be used

Different ownership structures can have different tax and liability consequences. This is one of the first matters on which you should seek advice.

For more detail on this Tip please see page 31

Tip 9

Financiers (both bank and non-bank) generally prefer to lend to familiar and simple structures.

For more detail on this Tip please see page 31

Tip 10

Special Purpose Vehicles (SPVs) – what are they?

The use of an SPV to acquire the property has, subject to the particular terms of any financing involved (such as whether personal guarantees are also required), the benefit of shielding other businesses or assets of the the developer and other investors from liability associated with the project. It is also preferred by financiers.

For more detail on this Tip please see page 31

Tip 11

Types of SPVs
Unit trusts

The unit trust structure is commonly used where more than one investor is involved in a project. A unit trust is not a legal entity. It is a 'flow-through' vehicle, meaning income and profits are not taxed in the trust but rather in the hands of the unitholders. The trust does not itself pay tax, provided that all income and profits are distributed to the unitholders.

For more detail on this Tip please see page 33

Tip 12

Document your relationship

The relationship between the unitholders who are investors in the project should be set out in a unitholders agreement as well as in the trust deed establishing the trust.

For more detail on this Tip please see page 34

Tip 13

Benefits to unitholders

A unit trust structure can provide substantial benefits to certain types of offshore investors, and is commonly used when offshore investors are involved in a project.

For more detail on this Tip please see page 34

Tip 14

Joint ventures

A joint venture is an arrangement where two or more parties agree that they will work together to implement a project,

each contributing different assets and/or skills. The individual contributions of investors and the developer, as well as their rights and obligations and their entitlements to proceeds from the project, should be set out in a joint venture agreement.

For more detail on this Tip please see page 35

Tip 15

There are differences between a unit trust and an unincorporated joint venture.

For more detail on this Tip please see page 35

Tip 16

If an unincorporated joint venture is used, other parties involved in the project may not fully understand the ownership structure and the obligations or rights of the joint venture parties.

For more detail on this Tip please see page 36

Tip 17

Companies

If a company is used to acquire a property, a shareholders' agreement should be put in place between the investors setting out their rights and obligations in relation to the company.

For more detail on this Tip please see page 36

Tip 18

A company is itself taxed, and as such does not provide the 'flow through' structure mentioned above in relation to unit trusts or for taxation to be solely at the joint venturer/investor level, as is the case in an unincorporated joint venture.

For more detail on this Tip please see page 36

Tip 19

Timing of investment

It is preferable for the parties to first agree the level of their individual investment in the project and their roles and then establish the appropriate vehicle, with its ownership interests in the agreed proportions, to acquire the relevant site. Failure to do this may have significant adverse stamp duty consequences.

For more detail on this Tip please see page 37

FINANCE STRUCTURES

Timing of investment

A diagram showing a typical structure used in construction/ development financing can be found in Schedule 2

THE FINANCE DOCUMENTATION PROCESS

Tip 20

Beware of indicative or initial term sheets or letters of offer

If the financier's initial term sheet (Initial Term Sheet) states it is indicative only, that means the loan has not yet been approved and there is no commitment on the part of the financier to actually provide the loan.

For more detail on this Tip please see page 43

Tip 21

Due to the lack of detail in Initial Term Sheets, failing to seek further detail on a number of issues before accepting the document is generally a mistake which can lead to potentially serious adverse consequences. This will only become apparent once the detail is provided.

Unless you and your advisers are familiar with the normal clauses found in formal finance documentation (which can have adverse consequences to the borrower), it is easy to merely accept a term sheet or facility offer without any understanding of the issues which will subsequently come to light and, no doubt, be unacceptable to you.

For more detail on this Tip please see page 44

Tip 22

Impact of credit approval

It is often difficult to seek changes to the terms agreed by a financier after credit approval has been provided as any changes requested may need to go back to the relevant committee for approval. This may delay settlement of the transaction.

For more detail on this Tip please see page 44

Tip 23

It is very important that you ensure that the main issues of concern to you in relation to the financing are included in the Initial Term Sheet before it goes to the investment or credit committee for approval.

For more detail on this Tip please see page 45

Tip 24

Formal documents

Due to the complexity of some of the terms of finance documents and the consequences of those terms, it is essential for you to understand the main issues arising from those terms before signing any document.

For more detail on this Tip please see page 45

Tip 25

Tripartite deeds

You should also ascertain whether any third parties, such as the builder or a major tenant, are willing to sign the documents required by the financier.

For more detail on this Tip please see page 46

ALTERNATIVE SOURCES OF FINANCE

Tip 26

Where can developers get finance other than from banks?

In the current market, banks are very selective about providing development finance.

Developers or investors who do not have longstanding, successful relationships with their bank need to consider funding alternatives, such as non-bank lenders. Debt advisers can assist in identifying potential financiers.

For more detail on this Tip please see page 49

Tip 27

Risks associated with non-bank lenders

Due to the diversity of participants in the non-bank lending market, you should do due diligence on any proposed non-bank lender to be sure the funds will be available when drawdowns are required and that they are able to process drawdown requests in a timely manner.

For more detail on this Tip please see page 50

Tip 28

Your equity must go into the project ahead of the debt finance

In development funding, the senior financier will generally require you to fund certain project costs prior to your accessing funds under the senior debt facility.

For more detail on this Tip please see page 50

Tip 29

Mezzanine finance

Where you do not have sufficient equity to fund the above-mentioned project costs, it may be possible for you to obtain a second layer of finance (known as mezzanine finance or preferred equity). Such finance ranks behind the senior debt.

For more detail on this Tip please see page 50

HOW TO DODGE THE PITFALLS – DON'T TAKE THINGS FOR GRANTED

Tip 30

Traps to avoid

In addition to the financial arrangements agreed with a financier (such as the amount and term of the loan, interest rates and fees payable), there are other provisions in finance documents which are essential to understand in order to avoid unacceptable risks and/or onerous provisions.

For more detail on this Tip please see page 53

Tip 31

Financier review rights

Where a financier has the right to review the terms of the loan, such rights should be limited as to when such a review may occur and the circumstances in which it may be used to amend the terms of the loan.

For more detail on this Tip please see page 53

Tip 32

Events of Default – Did you know that if your builder is in trouble you can be in default with your financier?

All financing documents will contain events of default. If an event of default is triggered, the financier has a number of options including demanding repayment of the outstanding loan, enforcing its security by way of the appointment of a receiver or effecting a mortgagee sale.

It is important from your perspective to minimise the circumstances which can trigger an event of default. This is generally done by including materiality thresholds in various events of default and/or having the right to remedy the potential default or circumstance before it becomes an event of default. It is also important to try to limit events of default occurring as a result of issues associated with third parties, for example your builder.

For more detail on this Tip please see page 54

Tip 33

Default interest

In development lending, it is not uncommon for default interest to start accruing if a non-monetary default occurs, although there may be scope to limit the non-monetary defaults to which such consequence applies. Ideally, default interest should only accrue in relation to unpaid amounts.

For more detail on this Tip please see page 55

Tip 34

Minimum interest requirements

Non-bank lenders generally require a minimum interest amount to be earned by the financier notwithstanding early repayment of the facility. You must ensure you are satisfied with such requirements.

For more detail on this Tip please see page 56

Tip 35

Conditions precedent

It is important to ensure the conditions precedent that must be satisfied to access funding during the course of the facility are achievable in a timely manner. Particular care should be taken in relation to the terms of the pre-sale contracts.

For more detail on this Tip please see page 56

Tip 36

Avoid the pre-sales trap

It is critical to ensure pre-sales contracts are on terms that satisfy the requirements of the financier, otherwise funding will not be provided. Your lawyer should be familiar with the pre-sale requirements of the financier before agreeing to negotiate any changes to standard pre-sale contracts.

For more detail on this Tip please see page 57

Tip 37

Builders and building contracts

Financiers must be satisfied with both the builder and the terms of the building contract. To minimise issues relating to this, you should confirm with your potential financiers that the proposed builder and terms of the building contract will be acceptable prior to engaging the builder.

For more detail on this Tip please see page 58

Tip 38

Financial covenants

In property lending documents you are obliged to comply with various financial covenants. These include loan to value ratios and loan to total development cost ratios. You must ensure that you understand the meaning of these ratios and that the relevant ratios can be satisfied during the course of the project.

For more detail on this Tip please see page 58

Tip 39

Tripartite/Side deeds

As the need for a builder to enter into a side deed with a financier is generally not negotiable, it is important that the terms of such document are agreed between the parties (including the builder) as early as possible.

For more detail on this Tip please see page 59

Tip 40

As the need for a major tenant to enter into a tenant's side deed with a financier may not be negotiable, it is important that the terms of such document are agreed between the parties (including the tenant) as early as possible.

For more detail on this Tip please see page 60

SOUND ADVICE

Tip 41

Not all lawyers are created equal

Lawyers who have traditionally been involved in conveyancing or non development transactions will not necessarily be familiar with each of the issues that need to be considered and dealt with in relation to development financing.

For more detail on this Tip please see page 63

Tip 42

It is important that you are aware of the experience and skills of the lawyers you are proposing to engage, and are satisfied that they have the track record and resources to protect your interests and act in a timely manner to facilitate the completion of documentation.

For more detail on this Tip please see page 63

NOTES

THE FINE PRINT
SO YOU THINK YOU ARE A PROPERTY DEVELOPER?

1. LOOK INTO WORKING WITH MORE EXPERIENCED INVESTORS OR DEVELOPERS BEFORE UNDERTAKING YOUR OWN PROJECT

Tip 1: If you have not undertaken a project like the one you are proposing to embark on, it may be worth considering the possibility of entering into a joint venture with an experienced developer or investor in the Australian property market rather than undertaking it on your own.

By working with a seasoned developer or property investor, an inexperienced investor can become familiar with the structures, documents and other issues associated with particular types of projects, which are likely to be relevant in the future.

It may be that the Australian developer or investor is not comfortable having an inexperienced developer or investor participate in their project. In such a case, you may wish to be a passive investor with no rights in the management of the project. This way you will not interfere with the carriage of the project by the experienced developer or investor, but will be kept informed of all stages and requirements and be able to participate in meetings to discuss such matters.

It is important that, if you do participate in such a project, your rights are nonetheless protected, even if you are participating in a purely passive capacity.

2. BECOME FAMILIAR WITH TERMINOLOGY

In order to fully understand the documentation to be entered into for financing a project or in relation to investment in it, it is important to understand the terminology used in such documents. We suggest that you seek advice from experts in the types of projects in which you wish to invest as to the meaning of such terms.

Tip 2: You will not fully comprehend your position and be able to protect your interests unless you understand the terminology used in finance documents. There are many standard terms which can create difficulties for a developer or investor who does not understand their meaning before committing to proceed with a proposed financing. When the real meaning of a term is not understood by investors before making a decision, it can cost them dearly.

3. SEEK AND LISTEN TO ADVICE

It is not possible to properly protect your interests in relation to a property financing or a property project generally unless you are aware of concepts, terminology and issues that are normally found in the documentation to be entered into in respect of such transaction.

By executing documents without first obtaining advice and understanding such matters, problems are likely to occur during the course of the transaction which will not necessarily be able to be remedied to your satisfaction. Indeed, it may not be possible to correct the particular issue, resulting in potentially significant losses to you.

I have seen this time and time again, where people sign documents they don't really understand thinking that because they ticked off the main financial/commercial points the rest of the document was not important. This is a big mistake. Non-financial/monetary terms often have significant financial consequences.

Tip 3: It is essential to obtain advice in relation to documentation to be entered into in respect of a project's financing or the project generally. You cannot protect your interests unless you are aware of the relevant issues as well as the terminology and concepts contained in the documentation.

4. ENGAGING BUILDERS AND CONSULTANTS WITH A RECOGNISED EXCELLENT AUSTRALIAN TRACK RECORD CAN MAKE THE DIFFERENCE BETWEEN SUCCESS AND FAILURE IN GETTING FINANCE

In the current market, it is virtually impossible to obtain property finance for a development or (to a lesser extent) even an investment in an income producing property if the developer or investor has no proven track record in Australia for similar projects. For foreign investors the problem is even more acute as they may not have any experience in the Australian market.

For a financier to provide a loan, the developer or investor must have well-known, good, experienced advisers, consultants and builders involved in the project. It is the track record and quality of these advisers, consultants and builders that will impress the financier and reassure them that any issues associated with the project will be minimised.

Tip 4: It is essential that you engage builders and consultants who have an excellent proven Australian track record as this will be seen positively by prospective financiers and substantially improve the likelihood of you obtaining construction finance.

5. KNOW YOUR PROJECT

It is important in seeking development finance that the prospective lender feels confident that you are aware of all details associated with the project. In order to demonstrate such competence, it is essential that all relevant reports be prepared and available to the lender and that a detailed project feasibility/project budget be prepared incorporating reasonable projections and assumptions.

Tip 5: It is very important to document all aspects of a proposed project properly. The ability to provide complete, well thought out and accurate details (including project feasibility and budget) on a timely basis to a prospective financier will be viewed by the financier as indicative of the professionalism and quality of the developer/borrower.

6. MAKE SURE YOUR LAWYERS AND ADVISERS WILL HELP NOT HINDER YOU

If inexperienced lawyers and advisers are involved in a project, the financier and their lawyers will fear that its implementation will take longer. Inexperienced lawyers and advisers will not necessarily approach negotiations consistently with market practice or be able to respond to queries in a complete and timely manner. This works against you in obtaining the finance you require.

Tip 6: Financiers and their lawyers prefer to deal with lawyers who are familiar with documents and do not require explanations regarding normal market concepts/terms, can turn documents around efficiently and have the resources to complete the transaction in the proposed timeframes. It is therefore important to choose your lawyers carefully.

7. CHECK OUT YOUR PROPOSED FINANCIER TO MAKE SURE THEY CAN FUND THE PROJECT AS REQUIRED

As mentioned above, it is important to understand the risks associated with any project, and the terms of documents that you will be entering into in relation to property financing or any project generally.

In order to ensure that you carry out adequate due diligence, the use of the advisors and consultants referred to in point 4 above is vital. In addition, to the extent that you will be seeking finance from a non-bank lender, it is important to ensure that the non-bank lender has the funds available to be able to fund drawdowns during the project. This requires an understanding of the track record of the financier and its senior management in relation to other Australian projects, the source from which the funds are to be provided as well as their attitude to enforcement in a default scenario.

Tip 7: When dealing with non-bank lenders, you (as borrower) should be comfortable that the funds to be provided by the lender will be available when required, that the lender will adopt a reasonable and commercial approach should there be difficulties with the project and that it will not immediately seek to enforce its securities if a problem arises. You should do due diligence on the proposed non-bank lender to ascertain this.

GET YOUR AFFAIRS IN ORDER

8. CONSIDER THE OWNERSHIP STRUCTURE TO BE USED

An often overlooked critical issue

When considering a new development project, it is critical to determine the appropriate ownership structure to be used by the developer and/or investors.

> **Tip 8:** Different ownership structures can have different tax and liability consequences. This is one of the first matters on which you should seek advice.

Although the above may seem obvious, what is not so obvious is that the structure used is also important in relation to the financing of the project. Financiers are used to dealing with particular ownership structures, and therefore the use of a structure which financiers understand and which 'ticks the box' from the financier's perspective can assist in obtaining credit approval.

> **Tip 9:** Financiers (both bank and non-bank) generally prefer to lend to familiar and simple structures.

The use of such structures can also save on the time and costs associated with implementing the transaction.

Special Purposes Vehicles (SPVs) - what are they?

In the context of development transactions, the ownership entity used is generally established specifically for the purpose of carrying out the particular development, hence the name Special Purpose Vehicle or **SPV**.

Tip 10: The use of an SPV to acquire a property has, subject to the particular terms of any financing involved (such as whether personal guarantees are also required), the benefit of shielding other businesses or assets of the developer and other investors from liability associated with the project. It is also preferred by financiers.

Example: As an SPV borrower will be primarily liable to a financier for a loan, it is possible for the individual owners of the SPV (be they unitholders in a unit trust or shareholders in a company) not to have any personal liability for the obligations under the financing. This will depend on whether or not the financier requires personal guarantees or security directly from the owners. By not having such personal liability, the assets of the owners of the SPV (other than those associated with the particular project) will not be at risk.

SPVs also provide greater flexibility to the investors in terms of bringing in other investors, selling their interest in the project, and achieving different tax outcomes to those associated with their core business.

The use of SPVs is well understood and accepted by financiers in relation to development funding.

The most common types of ownership structures for real estate development projects in Australia are:

- A unit trust
- A joint venture (incorporated or unincorporated)
- A company.

Each may be used as an SPV for a project. They are particularly relevant where multiple investors are involved in the project.

Types of SPV

Unit trusts

A unit trust is a trust where the entitlements of the beneficiaries/unitholders (being the investors in the project) are fixed by reference to the units they own in the trust. The trustee of the trust (which is normally a company) is the owner of the property and the party which executes the project and financing documents.

The benefits of a unit trust are that it enables investors who have different tax profiles to participate in a project without compromising their existing tax profile.

Tip 11: A unit trust is not a legal entity. It is a 'flow-through' vehicle (meaning income and profits are not taxed in the trust, but in the hands of the unitholders) and does not itself pay tax provided that all income and profits are distributed to the unitholders.

The unitholders then pay tax at their individual rates (which can be different as between the unit holders).

Example: If a trust earns income or makes a profit from a project, the trustee will distribute such amounts to the unitholders without deducting any tax. The trust itself is not taxed and the gross amounts are distributed to the owners. The owners must then account for the gross amount paid to them in their own tax return, and such amounts will be taxed at their individual rates. Where particular owners have losses they can carry forward, or are subject to lower tax rates than would apply to a company, the use of a unit trust can provide financial benefits to the owners.

Document your relationship

Tip 12: The relationship between the unitholders (who are the investors in the project) should be set out in a unitholders' agreement as well as in the trust deed establishing the trust.

Benefits to unitholders

Tip 13: The unit trust structure can provide substantial benefits to certain types of offshore investors and is commonly used when offshore investors are involved in a project.

Example: To the extent that a unit trust satisfies the requirements of Australian taxation law necessary to be considered a managed investment trust for tax purposes then, depending upon the activities of the trust in relation to the project, the nature of any foreign investors in the trust and the jurisdiction in which they reside, it may be possible for distributions received by such investors to be taxed at 15 per cent rather than the higher rate that would apply if the investment were through a company.

Foreign investors should seek tax advice in relation to this for each project in which they are involved as the taxation laws associated with trusts are complex, currently under review and likely to change.

As unit trusts are the most popular ownership structure used for property development and other commercial property matters, financiers are very familiar and comfortable with this structure.

Joint ventures

Joint ventures can be incorporated or unincorporated.

Unincorporated joint venture

Tip 14: The individual contributions of investors and the developer to the project, as well as their rights and obligations and their entitlements to proceeds from the project, should be set out in a joint venture agreement.

An unincorporated joint venture is created when two or more parties enter into an investment or joint venture agreement where the individual parties agree that they will work together for the purposes of implementing the project.

For administrative/practical reasons it is common for the parties to appoint a nominee or manager (generally a company) to act and execute documents on behalf of the joint venture parties.

Financiers would usually also request that the joint venture parties execute the finance documents and grant security over their assets as the nominee or manager will have no assets. To the extent a joint venture party has other assets not related to the project, this requirement would generally not be acceptable.

An unincorporated joint venture is not a legal entity and so income and capital gains earned from the project are distributed to each joint venture party in accordance with its entitlements under the joint venture agreement and taxed in their hands.

Tip 15: There are differences between a unit trust and an unincorporated joint venture.

For example, unitholders are generally not liable to third parties, such as a financier, unless they execute a guarantee or similar document. Where an unincorporated joint venture is used, as the nominee or manager is the agent of the joint venture parties, these parties may be liable to third parties without having to execute a guarantee or other document.

Tip 16: If an unincorporated joint venture is used, other parties involved in the project may not fully understand the ownership structure and the obligations or rights of the joint venture parties.

Having said that, it is not an impediment to a financier although there may be more complexities involved in terms of the security to be taken, potentially resulting in delays in getting credit approval and finalising the loan and security documents.

Incorporated joint ventures

An incorporated joint venture would normally be established through a company owned by the various investors.

Tip 17: A shareholders' agreement should be put in place between the investors, setting out their rights and obligations in relation to the company.

As companies are legal entities, the shareholders would not generally be liable to third parties in the absence of a specific agreement imposing such liability.

Companies

Although there are a number of different types of companies in Australia, the most common one used for development transactions is a proprietary company limited by shares. As mentioned above, a company can act as the trustee of a unit trust (if that is the preferred structure), it can be the entity used for an incorporated joint venture or it can be involved in the project in its personal capacity (if that is preferred).

Tip 18: A company is itself taxed and as such does not provide the 'flow through' structure mentioned above in relation to unit trusts or for taxation to be solely at the joint venturer/investor level, as is the case in an unincorporated joint venture.

Example: The tax rate for a company in Australia depends on the amount of its revenue. For companies with revenues of less than $50 million, recent tax changes will result in the income of such companies being taxed at between 25 and 27.5 per cent, depending upon the year in which the income is earned. To the extent that a shareholder would have a lower tax rate than that, it may be preferable for the investment to be structured as a unit trust (with the benefits mentioned above – see Tip 11). Although franking credits are available in respect of tax paid by the company, the usefulness of these franking credits to the shareholders is currently uncertain due to potential changes in policy. Investors should seek advice in relation to any proposed investment in a company to determine their tax position.

9. TIMING OF INVESTMENT

The importance of getting it right

Adverse stamp duty consequences may arise if an investor or developer gets involved in a project where the development site has already been acquired by one of the other parties involved in the project. If an investor or the developer already owns the site and then invites other investors to participate in the project, depending upon the percentage to be acquired by the other investors in the entity which owns the site, such other investors may be subject to transfer duty. To minimise this impact, complex structuring may be required, which may not be ideal from a financing perspective.

Tip 19: It is preferable for the parties to first agree the level of their individual investments in the project and their roles and then establish the appropriate vehicle (with its ownership interests in the agreed proportions) to acquire the relevant site (see above for the various ownership structures commonly used). Failure to do this may have significant adverse stamp duty consequences.

Case Study: A company established by an Australian developer had exchanged contracts to acquire property valued at over $5 million, which was to be used to develop residential apartments. The developer then sought external investors for the project. A Chinese investor agreed to contribute 75 per cent of the development costs, but required a 75 per cent interest in the entity which had exchanged contracts. As the entity had already exchanged contracts, it was regarded as land rich for stamp duty purposes. This would have resulted in the foreign investor having to pay stamp duty as if it had acquired a 75 per cent interest in the property. This stamp duty would be in addition to the stamp duty paid by the developer entity on the contract to purchase the property.

If the entity which was to undertake the project had first obtained the investment of the foreign investor, prior to exchanging contracts, this adverse outcome would not apply and only one lot of stamp duty would have been payable in relation to the acquisition of the property.

NOTES

FINANCE STRUCTURES

A diagram showing a typical structure used for construction/ development financing can be found in Schedule 2

THE FINANCE DOCUMENTATION PROCESS

Beware of indicative or initial term sheets or letters of offer

The financing of commercial property, including development funding, generally starts with the issue of an Initial or Indicative Term Sheet or facility offer by the financier (Initial Term Sheet).

Tip 20: If the financier's Initial Term Sheet states it is indicative only, that means the loan has not yet been approved and there is no commitment on the part of the financier to actually provide the loan.

The Initial Term Sheet usually focuses on the main commercial terms agreed, such as:

- The amount and term of the loan
- The interest and fees payable
- The security to be provided as well as who is to guarantee the loan
- A high-level summary of the conditions precedent that need to be satisfied by the borrower in order to be able to drawdown on the loan.

It is not intended to cover all matters and will often refer to the financier's standard terms and conditions (which will be in a different document, often not provided to the borrower with the Initial Term Sheet).

It will also refer to representations, undertakings and events of default which will apply to the loan but may only make reference to them at a very high level, and contain statements such as clauses dealing with these matters will be those usually found in these types of transactions.

Tip 21: Due to the lack of detail in Initial Term Sheets, failing to seek further detail on a number of issues before accepting the document is generally a mistake which can lead to potentially serious adverse consequences. This will only become apparent once the detail is provided - (see section below dealing with How to dodge the Pitfalls – Don't Take Things for Granted).

Unless you and your advisers are familiar with the normal clauses found in formal finance documentation (which can have adverse consequences to the borrower), it is easy to merely accept a term sheet or facility offer without any understanding of the issues which will subsequently come to light and, no doubt, be unacceptable to you.

Case study: A development company with a track record with its existing bank financiers executed an Initial Term Sheet which did not specifically refer to the review rights of the bank. In previous arrangements with the bank, the bank did not have the right to review the facility. Having received further details as to the terms applicable to the new loan, the borrower indentified that the bank wished to have very broad review rights (see Tip 31 below). Despite the existing relationship between the developer and its bank, the bank refused to amend the terms of the new facility and remove the review rights. Accordingly, the developer had to proceed with the loan subject to very broad review rights being provided to the bank.

Had this term been identified prior to the Initial Term Sheet being executed, it might have been possible to negotiate this matter.

Impact of credit approval

Once the borrower accepts the Initial Term Sheet, it will then be used to seek credit approval for the transaction from the investment or credit committee of the financier. Once such approval is given, a credit approved term sheet will be issued and form the basis on which the formal documents are to be prepared.

Tip 22: It is often difficult to seek changes to the terms agreed by a financier after credit approval has been provided as any changes requested may need to go back to the relevant committee for approval. This can delay settlement of the transaction.

Case study: A foreign investor sought to obtain bank finance to repatriate equity funds it had previously contributed towards the acquisition of a commercial office building in Sydney. The Indicative Term Sheet was signed by the investor prior to obtaining advice.

The term sheet provided that the entity which was to borrow the funds could not acquire any other property or borrow any other money without obtaining the bank's approval. Once the investor understood this, it decided that it was not acceptable. As the bank had already obtained credit approval for the term sheet with this restriction in it, and despite negotiations, the investor remained subject to the restriction.

The investor was not prepared to accept this restriction and the loan was not made.

Tip 23: It is very important to ensure that the main issues of concern to you in relation to the financing are included in the Initial Term Sheet before it goes to the investment or credit committee for approval.

Formal documents

Once credit approval is obtained and the borrower pays the initial application fee, the financier will instruct its lawyers to prepare the formal documentation.

The documents will normally consist of:

- A loan or facility agreement,
- A mortgage over the site,

- A general security deed over all the assets of the borrower. Sometimes the guarantors will also be required to provide such security,
- In certain cases, financiers will require specific security deeds over the ownership interests in the borrowing entity (such as units in a unit trust and shares in a company),
- A tripartite or builders side deed between the borrower, the financier and the builder,
- A subordination deed between the directors and shareholders/unitholders of the borrowing entity and the financier under which such directors, shareholders and unitholders agree that any funds that they provide to the borrower for the project are not to be repaid until the financier is repaid in full,
- A tripartite deed between the developer/borrower, the financier and any major tenant (which has signed an agreement for lease)
- A guarantee from the directors and/or owners of the borrower may also be required.

Tip 24: Due to the complexity of some of the terms of finance documents and the consequences of those terms, it is essential for you to understand the main issues arising from those terms before signing any document.

Tip 25: You should also ascertain whether any third parties, such as the builder or a major tenant, are willing to sign the documents required by the financier (see section below dealing with Tripartite/Builder's Side Deeds).

NOTES

ALTERNATIVE SOURCES OF FINANCE

Where can developers get finance other than from banks?

In the Australian market, the main financiers in relation to property development have traditionally been the four major banks. These lenders have drastically pulled back on providing such finance in the last 18 - 24 months and are limiting the provision of such finance to established clients with successful track records.

Tip 26: In the current market, banks are very selective about providing development finance. Developers or investors who do not have longstanding, successful relationships with their bank need to consider funding alternatives, such as non-bank lenders. Debt advisers can assist in identifying potential financiers.

In response to the reduced appetite of the banks for development finance, the non-bank lending market has grown dramatically with a large number of participants now involved in that market. The main difference between borrowing from a bank as opposed to a non-bank lender is that finance from non-bank lenders is generally more expensive. In addition, some of the non-bank lenders' covenants may be more onerous than those found in bank documents.

Having said that, bank documents often contain onerous provisions.

For a more detailed summary of the non-bank lending market, please see our October 2017 Newsletter on our website at www.peterfaludiconsulting.com.au. as well as my article in the March 2018 Edition of the Australia & New Zealand Property Journal published by the Australian Property Institute.

Tip 27: Due to the diversity of participants in the non-bank lending market, you should do due diligence on any proposed non-bank lender to be sure the funds will be available when drawdowns are required and that they are able to process drawdown requests in a timely manner.

Due to the nature of our network, we can introduce developers to potential financiers and are happy to do so.

The difference between senior and mezzanine debt

Senior debt

Property finance normally involves senior debt with the senior financier obtaining the securities and requiring the documents mentioned above. Senior debt is first ranking secured debt.

Your equity must go into the project ahead of the debt finance

Tip 28: In development funding, the senior financier will generally require you to fund certain project costs prior to accessing funds under the senior debt facility.

Mezzanine Finance

Mezzanine finance is second (or possibly third) ranking debt, which may be secured or unsecured.

Tip 29: Where you do not have sufficient equity to fund the abovementioned project costs, it may be possible for you to obtain a second layer of finance (known as mezzanine finance or preferred equity) to fund such costs. Such finance ranks behind the senior debt.

The interest rates for such finance are generally in excess of 18 per cent per annum.

Mezzanine financiers are not seen favourably by many senior financiers and it is therefore important to understand whether any potential senior financier would be willing to allow a mezzanine financier to participate in the project. If they do not wish such finance to be involved, it will be difficult for a developer to access mezzanine debt.

If a senior financier is willing to allow a mezzanine financier to be involved in a project, the mezzanine financier will need to sign an inter-creditor deed with the senior financier, which places severe restrictions on the mezzanine financier’s ability to enforce its security or be paid any interest. Such documents will prevent the mezzanine financier from being repaid until the senior financier has been repaid in full.

The use of two levels of debt is not as common as it used to be as the non-bank lending market can often provide a blended facility, which is partially senior debt and partially mezzanine debt.

In addition to mezzanine debt, some financiers are prepared to provide ‘preferred equity’, which is generally the same as mezzanine debt, but may not be secured.

HOW TO DODGE THE PITFALLS – DON'T TAKE THINGS FOR GRANTED

Traps to avoid

Tip 30: In addition to the financial arrangements agreed with a financier (such as the amount and term of the loan, interest rates and fees payable), there are other provisions in finance documents which are essential to understand in order to avoid being subject to unacceptable risks and/or onerous provisions.

These other provisions are often contained in a financier's standard terms and conditions (if a bank) or in the formal loan documentation which lawyers would read when negotiating the full terms of the loan facility.

This section is intended to highlight some of the more common non-monetary provisions, which can have unacceptable or onerous consequences and which are often overlooked by a developer/borrower and its advisers before the borrower becoming bound to the finance documentation.

Financier review rights

Bank documents often have provisions which allow the bank to amend the terms of the facility at any time on notice. These provisions are clearly unacceptable from a borrower's perspective as most borrowers do not expect the terms of a two or three year loan to change during that time, particularly if they are not in default.

It is important to note that the above clauses are often not qualified at all, thereby exposing the developer/borrower to the risk of having the terms of their loan changed at any time and from time to time.

Tip 31: Where a financier has the right to review the terms of the loan, such rights should be limited as to when such a review may occur and the circumstances in which it may be used to amend the terms of the loan.

If a borrower and/or their advisers are unaware of these clauses or do not understand them, the terms of the loan could change at any time through the facility (which would be unacceptable).

Non-bank lenders may also include review rights in their documents which will need to be considered for the above-mentioned reasons.

Events of Default – Did you know that if your builder is in trouble you can be in default with your financier?

Tip 32: All financing documents will contain events of default. If an event of default is triggered, the financier has a number of options including demanding repayment of the outstanding loan, enforcing its security by the appointment of a receiver or effecting a mortgagee sale.

It is important from your perspective to minimise the circumstances which can trigger an event of default. This is generally done by including materiality thresholds in various events of default and/or giving you a right to remedy the potential default or circumstance before it becomes an event of default. It is also important to try to limit events of default occurring as a result of issues associated with third parties, for example your builder.

Example: Financing documents often regard the insolvency of a builder as being an event of default by the borrower. The insolvency of a builder is not a matter within the control of a borrower. It is therefore inappropriate that such circumstance should be regarded as an event of default. Borrowers should negotiate that such circumstance does not trigger an event of default if the borrower can arrange to replace the builder within an agreed timeframe.

Default interest

In relation to default interest, it is important to understand whether it accrues merely on the occurrence of a monetary default or whether it will accrue on the occurrence of any default (even if there is no monetary default).

Default interest will accrue on the loan at a rate which will normally be about 3 per cent per annum in addition to the normal interest rate, although it can sometimes be higher especially for non-bank lenders.

In development deals, as interest will be capitalised and not actually payable until the end of the project, financiers may be less inclined to limit the imposition of default interest to monetary default. In such transactions, default interest is more likely to be charged where a non-monetary default occurs including where a delay occurs in construction or there are issues associated with the builder.

Tip 33: In development lending, it is not uncommon for default interest to start accruing if a non-monetary default occurs, although there may be scope to limit the non-monetary defaults to which such consequence applies. Ideally, default interest should only accrue in relation to unpaid amounts.

Minimum interest requirements

Non-bank lenders are often funded by a number of investors. If the non-bank lender has committed to provide such investors with a minimum amount of interest in consideration of their participation in the loan, it may be necessary for them to ensure that such interest is earned irrespective of whether the borrower repays the loan early.

It is usual for non-bank lenders to require the borrower to pay a minimum amount of interest in respect of a loan facility notwithstanding the facility may be repaid prior to expiry of the minimum period for which interest is payable. This is generally between six and 12 months.

Such minimum interest will be payable in addition to any other moneys owing by the borrower to the financier if the loan is repaid early.

Tip 34: Non-bank lenders generally require a minimum interest amount to be earned by the financier notwithstanding early repayment of the facility. You must ensure you are satisfied with such requirements.

Conditions precedent

All finance facilities contain conditions precedent, which must be satisfied before the financier becomes obliged to provide any funding. In development loans, such conditions precedent include:

- Quantity surveyor sign-offs and the provision of various statutory declarations or certificates associated with the project to verify that the project is proceeding on schedule without any cost overruns and that all contractors have been paid,
- The provision of both 'as is' and 'as if complete' valuations of the site and the project, prepared by valuers on the financier's panel, or otherwise acceptable to the financier,
- Presale contracts meeting certain criteria, and
- The financier being satisfied with the builder (and the terms of the building contract) and other key consultants engaged in the project.

If a condition precedent is not met, the financier is not required to provide any funding. This will clearly have significant adverse consequences to the developer and the project as it would either require the developer to fund the amounts due to the builder and subcontractors or go into default under the building contract as a result of not being able to fund such payments.

Tip 35: It is important to ensure that conditions precedent that must be satisfied to access funding during the course of the facility are achievable in a timely manner. Particular care should be taken in relation to the terms of the pre-sale contracts.

Avoid the pre-sales trap

In the case of pre-sale contracts, developers/borrowers will often agree to vary the terms of their master sale contract so that potential purchasers may exchange contracts. Unfortunately, such variations may lead to particular contracts not satisfying the financier's pre-sale contract requirements and so will not be regarded as complying or qualifying pre-sales. Similar consequences apply in relation to a failure to meet other financier requirements relating to pre-sales such as limits on the number of foreign buyers and the sunset dates included in the contract.

Generally, unless the developer/borrower has entered into sufficient complying or qualifying pre-sale contracts as required by the financier, the financier will not agree to provide any construction funding or, potentially, any funding at all.

Case study: A developer entered into a number of presale contracts in order to satisfy the requirements of their financier. In order to attract purchasers, the developer was willing to negotiate amendments to the standard presale contract. On reading the amended presale contracts, the financier

determined that they did not satisfy the criteria necessary for such pre-sales to be regarded as complying for the purposes of getting the finance. As a result, the facility was not provided until the exchanged sale contracts could be amended to make them comply. This proved to be difficult, with the result that the financier decided not to provide the facility.

Tip 36: It is critical to ensure pre-sales contracts are on terms that satisfy the requirements of the financier, otherwise funding will not be provided. Your lawyer should be familiar with the pre-sale requirements of the financier before agreeing to negotiate any changes to standard pre-sale contracts.

Builders and building contracts

As the track record of the bullder and the terms of the building contract are fundamental to the success of a development project, financiers need to be satisfied with both. If the builder is engaged prior to the proposed financier having an opportunity to consider their identity, track record and the terms of the building contract, you risk not getting finance approval or, alternatively, having to terminate the builder's engagement, renegotiate the building contract or both,

Tip 37: Financiers must be satisfied with both the builder and the terms of the building contract. To minimise issues relating to this, you should confirm with your potential financiers that the proposed builder and terms of the building contract will be acceptable prior to engaging the builder.

Financial covenants

In order for a financier to ensure that the amount of its loan remains within the limits it has approved, it would generally require a borrower to demonstrate satisfaction of a number of financial ratios during the course of the loan. The most common ratios are:

- Loan to value ratio - the ratio of the outstanding amount of the loan (including capitalised interest) relative to the value of the property from time to time,
- Loan to total development costs ratio - the ratio of the outstanding amount of the loan, including capitalised interest, relative to the total development costs to be spent on completing the project,
- Interest cover ratio - the ratio of the income to be earned from a project over a particular period relative to the interest payable on the loan during that period. This covenant generally does not apply in relation to development financing.

Tip 38: In property lending documents you will be obliged to comply with various financial covenants. These include loan to value ratios and loan to total development cost ratios. Interest cover ratios do not apply to construction or development financing. You must ensure that you understand the meaning of these ratios and that the relevant ratios can be satisfied during the course of the project.

Tripartite Deeds/Builder's Side Deeds - What are they?

Builder's Side Deeds

It is standard practice in development loans that the above type of deed be executed by the builder, the developer/borrower and the financier.

The purpose of this document is to provide the financier with an opportunity to remedy any default by the principal under the building contract (which generally relates to non-payment), which would entitle the builder to terminate the contract. If the financier agrees to remedy the default the construction works will continue. It is generally not in the financier's interests for the construction work to stop, although they will not be obliged to remedy the default or provide any such funding in that circumstance.

Tip 39: As the need for a builder to enter into a side deed with a financier is generally not negotiable, it is important that the terms of such a document are agreed between the parties (including the builder) as early as possible.

Tenant Tripartite Deeds

Where the development is being carried out for the purposes of a major tenant who has signed an agreement to lease the building or the majority of it once construction is complete, a financier may also require the tenant to sign a similar document. The purpose of this document is to provide the financier with an opportunity to rectify any default by the landlord under the agreement for lease so as prevent the tenant from exercising its rights to terminate that agreement.

As is the case in these types of transactions, the end value of the project is dependent on the tenant taking up the premises. It is generally not in the financier's interests for the agreement for lease to be terminated, although the financier will not be obliged to remedy the default or provide any such funding in that circumstance.

Example: Major retailers and other large organisations are often not willing to execute tenant side deeds with a developer's financier. A tenant's side deed will normally restrict a tenant from terminating an agreement for lease because of difficulty with the developer unless the financier does not remedy the problem. Although this can operate to the benefit of a tenant, large retailers and other organisations do not like to restrict their rights. Accordingly, it is important to ensure that a tenant from whom a financier requires a tenant side deed is in fact willing to sign such a document. If not, this needs to be identified quickly and the requirement removed from the financing terms.

Tip 40: As the need for a major tenant to enter into a side deed with the financier may not be negotiable, it is important that the terms of such a document be agreed between the parties, including the tenant, as soon as possible.

NOTES

SOUND ADVICE

Not all lawyers are created equal

Inexperienced developers and investors entering the Australian market for the first time or becoming involved in a more complex transaction than they are used to will not necessarily know which lawyers have the requisite experience to ensure that the finance documentation being entered into protects their interests. Lack of familiarity with these documents can lead to delay causing frustration to all parties and increasing the total costs incurred in setting up the facility.

Tip 41: Lawyers who have traditionally been involved in conveyancing or non development transactions will not necessarily be familiar with each of the issues that need to be considered and dealt with in relation to development financing.

Tip 42: It is important that you are aware of the experience and skills of the lawyers you are proposing to engage and are comfortable that they have the track record and resources to protect your interests and act in a timely manner to facilitate completion of documentation.

Lawyers who have previously been involved in non-development property work or smaller and simpler developments can, if so required by the developer, continue to be involved in the transaction dealing with the property specific issues, however a lawyer with experience in documenting development finance should also be involved to maximise the protection of the developer's interests.

SUCCESS

There is more to it than you think

Success in a development project relies on many factors: the right project, the right price or cost, the right location, the right builder and the right marketing/sales agent all contribute to success in any development project.

In addition (but not as commonly focused on), understanding the issues that must be addressed to maximise the likelihood of obtaining development funding and putting such funding in place in a timely manner and on terms that protect the developer's interests are equally important.

The main potential problems for any development are time delays and cost blowouts. These can arise not only from commercial and building issues, but also from delays in funding or incurring additional costs to deal with issues that should have previously been resolved in finance documents.

For this reason, developers should consider success in a broader manner than they have traditionally by:

- Considering and understanding the matters referred to above, and
- Engaging advisers with the right expertise and experience to help negotiate the documents involved.

In doing so, developers will avoid common mistakes, which can be expensive from both a time and cost perspective, and be seen as more knowledgeable and savvy counterparties by others involved in the transaction.

CONCLUSION

When times are good, parties often do not study the legal documents relating to their project or relationship with other parties, including their financiers. The purpose of legal documents is generally to guide parties in circumstances where there is uncertainty or a dispute.

It is in those circumstances that parties to a transaction open the bottom drawer (or file on their laptop), pull out the legal document that relates to the project or relationship and hope that the document deals with the relevant issues in a manner that is in their best interests.

In financing arrangements, most documents are prepared by the financier and, as you would expect, are drafted to protect their interests. As a borrower, you cannot hope that the document will also protect your interests. It is therefore essential that you understand the consequences of the terms in finance documents and endeavour to negotiate them so as to provide reasonable commercial outcomes when there is uncertainty or a problem.

By doing so you will achieve a better financing outcome than might otherwise be the case.

I trust that in reading this book you have identified matters that will help you obtain a better financing result than you have had in the past.

I wish you well in your future projects and would be delighted to help you achieve even better outcomes in the future.

Peter Faludi Consulting
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May 2019

NOTES

SCHEDULE 1

SUMMARY OF CASE STUDIES AND EXAMPLES

CASE STUDIES

Case study A:

(Failure to understand the tax consequences of a transaction can lead to significant adverse outcomes)

A company established by an Australian developer had exchanged contracts to acquire property valued over $5 million, which was to be used to develop residential apartments. The developer then sought external investors for the project. A Chinese investor agreed to contribute 75 per cent of the development costs, but required a 75 per cent interest in the entity which had exchanged contracts. As the entity had already exchanged contracts, it was regarded as land rich for stamp duty purposes. This would have resulted in the foreign investor having to pay stamp duty as if it had acquired a 75 per cent interest in the property. This stamp duty would be in addition to the stamp duty paid by the developer entity on the contract to purchase the property.

If the entity which was to undertake the project had first obtained the investment of the foreign investor, prior to exchanging contracts, this adverse outcome would not apply and only one lot of stamp duty would have been payable in relation to the acquisition of the property.

Case study B:

(Review of the Initial Term Sheet before signing is necessary to understand major terms and identify hidden traps)

A development company with a track record with its existing bank financiers executed an initial term sheet, which did not specifically refer to the review rights of the bank. In previous arrangements with the bank, the bank did not have rights to review the facility. On receiving further detail as to the terms applicable to the new loan, the borrower identified that the bank wished to have very broad review rights (see Tip 31 above). Despite the existing relationship between the developer and their bank, the bank refused to amend the terms of the new facility and remove the review rights. Accordingly, the developer had to proceed with the loan subject to very broad review rights being provided to the bank.

Had this term been identified prior to the initial term sheet being executed, it might have been possible to negotiate this matter.

Case study C:

(Failure to understand concepts and terms used in finance documents before signing can make or break a transaction)

A foreign investor sought to obtain bank finance to repatriate equity funds they had previously contributed towards the acquisition of a commercial office building in Sydney. The Indicative Term Sheet was signed by the investor prior to obtaining advice.

The term sheet provided that the entity which was to borrow the funds could not acquire any other property or borrow any other money without first obtaining the bank's approval. Once the investor understood this, it decided that it was not acceptable. As the bank had already obtained credit approval for the term sheet with this restriction in it, and despite negotiations, the investor remained subject to the restriction.

The investor was not prepared to accept this restriction and the loan was not made.

Case study D:

(Terms of pre-sale contracts are a key factor in obtaining development financing)

A developer entered into a number of presale contracts in order to satisfy the requirements of its financier. In order to attract purchasers, the developer was willing to negotiate amendments to the standard presale contract. On reading the amended presale contracts, the financier determined that they did not satisfy the criteria necessary for such pre-sales to be regarded as complying for the purposes of getting the finance. As a result, the facility was not provided until the exchanged sale contracts could be amended to make them comply. This proved to be difficult, with the result that the financier decided not to provide the facility.

EXAMPLES

Example A:

(The use of Special Purpose Vehicles (SPVs) can provide significant asset protection benefits to developers/borrowers)

As an SPV borrower will be primarily liable to a financier for a loan, it is possible for the individual owners of the SPV (be they unitholders in a unit trust or shareholders in a company) not to have any personal liability for the obligations under the financing. This will depend on whether or not the financier requires personal guarantees or security directly from the owners. By not having such personal liability, the assets of the owners of the SPV other than those associated with the particular project will not be at risk.

Example B:

(Unit trusts can provide financial benefits to borrowers and their investors)

If a trust earns income or makes a profit from a project, the trustee will distribute such amounts to the unitholders without deducting any tax. The trust itself is not taxed and the gross amounts are

distributed to the owners. The owners must then account for the gross amount paid to them in their own tax return, and such amounts will be taxed at their individual rates rather than at the rate which would be applicable to, for example, a company. Where particular owners have losses they can carry forward, or are subject to lower tax rates than would apply to a company, the use of a unit trust may provide financial benefits to the owners.

Example C:

(Unit trusts are commonly used when foreign investors are involved in a project)

To the extent that a unit trust satisfies the requirements of the Australian taxation laws necessary to be considered a managed investment trust for tax purposes then, depending upon the role of the trust in relation to the project, the nature of any foreign investors in the trust and the jurisdiction in which they reside, it may be possible for distributions received by such investors to be taxed at 15 per cent rather than the higher rate that would apply if the investment were through a company.

Example D:

(Check the tax consequences to the borrower and their investors of using different types of SPV before deciding how to proceed)

The tax rate for a company in Australia depends on the amount of its revenue. For companies with revenues of less than $50 million, recent tax changes will result in the income of such companies being taxed at between 25 and 27.5 per cent, depending upon the year in which the income is earned. To the extent that a shareholder would have a lower tax rate than that, it may be preferable for the investment to be structured as a unit trust (with the benefits mentioned above – see Tip 11). Although franking credits are available in respect of tax paid by the company, the usefulness of these franking credits to the shareholders is currently uncertain due to potential changes in policy. Investors should seek advice in relation to any proposed investment in a company to determine their tax position.

Example E:

(Builder default should not immediately trigger an event of default)

Financing documents often regard the insolvency of a builder as being an event of default by the borrower. The insolvency of a builder is not a matter within the control of a borrower. It is therefore inappropriate that such circumstance should be regarded as an event of default. Borrowers should negotiate that such circumstance does not trigger an event of default if the borrower can arrange to replace the builder within an agreed timeframe.

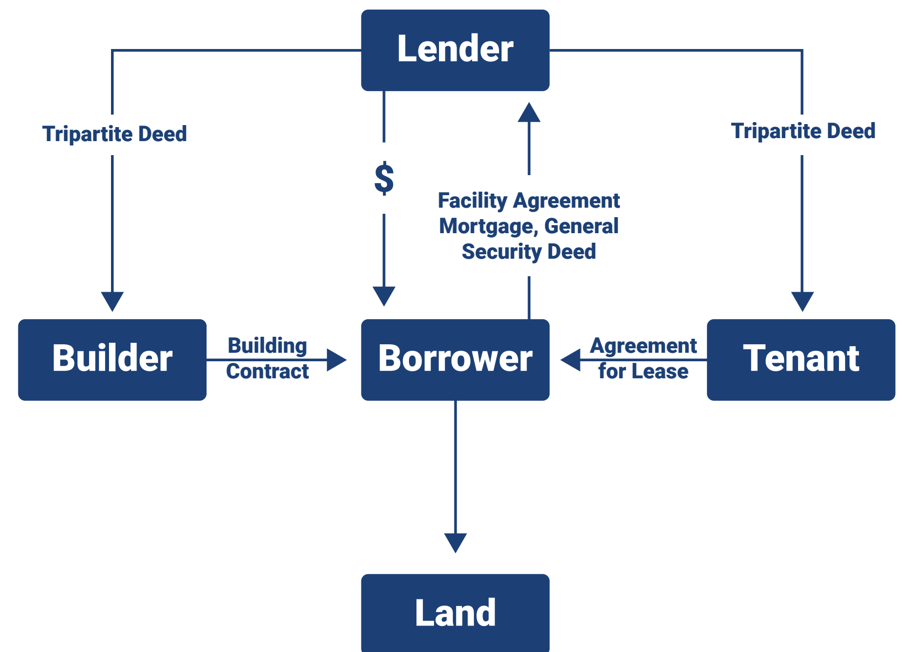
Example F:

(Make sure relevant third parties understand and accept the financier's requirements)

Major retailers and other large organisations are often unwilling to execute tenant side deeds with a developer's financier. A tenant's side deed will normally restrict a tenant from terminating an agreement for lease because of difficulty with the developer unless the financier does not remedy the problem. Although this can operate to the benefit of a tenant, large retailers and other organisations do not like to restrict their rights. Accordingly, it is important to ensure that a tenant from whom a financier requires a tenant side deed is in fact willing to sign such a document. If not, this needs to be identified quickly and the requirement removed from the financing terms.

SCHEDULE 2

TYPICAL CONSTRUCTION FINANCING STRUCTURE



ACKNOWLEDGEMENTS

This book is a culmination of decades of experience gained in negotiating thousands of finance documents for property developers and investors in relation to their financing arrangements.

I would like to thank all my clients over those years, and my colleagues at the various law firms where I have worked, for involving me in their transactions and allowing me to help them improve their position relative to that which was initially offered to them by their lenders. It has been an interesting (and often difficult) journey but one which has provided me with great satisfaction knowing that, despite the often long and stressful hours, I have been able to add value to, and improve the outcomes for, clients in relation to their various projects.

It is the satisfaction I feel when achieving these results which continues to drive me and is the reason why I decided to write this book.

I would particularly like to acknowledge the contributions to this book by:

- Steven Bougoukas of CBRE Capital Markets Debt & Structured Finance (for agreeing to provide the Foreword),
- Frank Shien and Brent Mulligan (for their kind words appearing on the back cover and for allowing me to assist them in matters over the years), and
- Jaqui Lane, The Book Adviser (for giving me the expert guidance I needed to make this book a reality) and her team of consultants without whom this book would not be the quality publication that it is.

And, of course, I could not let this opportunity pass without thanking my wonderful wife, Odile, for her patience, words of encouragement and willingness to help me throughout my career and in the writing of this book. I could not have done it without you.

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ISBN-13: 978-0-6482866-8-4

ABN 61 747 410 514

Email: jaqui@globalstories.com.au
Website: www.globalstories.com.au

Publisher and Editor: Jaqui Lane
Designer: Rasika UM www.shashika.info
Proof reader: Clare Wadsworth

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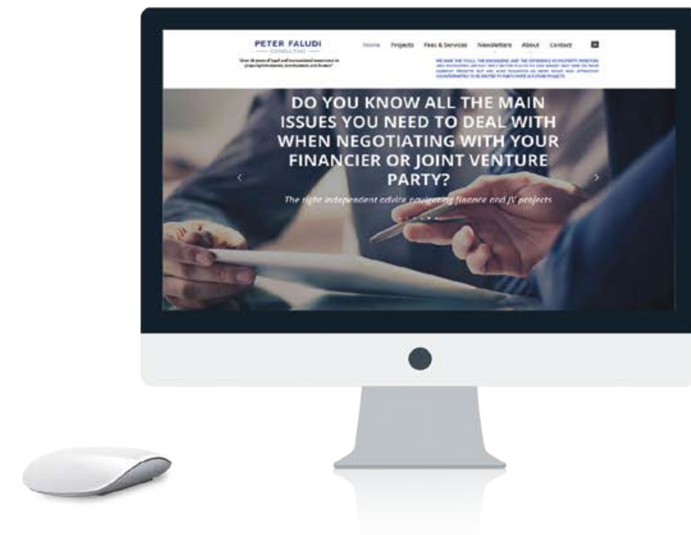

I trust you have enjoyed reading this book and have gained a number of useful ideas which you can immediately adopt to improve your position in relation to your future property development or investment financing arrangements.

If you would like to order more copies of the book please go to **www.peterfaludiconsulting.com.au** and follow the prompts.

As this book deals with matters at a high level, should you wish to discuss any of the issues mentioned in the book in more detail or get a better understanding how they apply to any current or future projects you are involved with, please contact me by email

peter@peterfaludiconsulting.com.au or

call on 0401 500 528 so we can discuss further.

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Peter has assisted me in relation to property financing, joint venture and co-ownership arrangements and other commercial matters relating to property transactions for over 10 years. As a property investor and developer, I have found his expertise and commercial approach invaluable in guiding me (and my investors) through complex transactions and making sure our interests were properly looked after.

His experience and strategic approach has helped me understand complex legal concepts and documents thereby enabling me to negotiate better results with the other parties to the transaction. As a result I regard him as a trusted adviser who I can speak to about legal and commercial issues associated with property investment and financing matters whenever I want help to make sure I am approaching the matter properly and protecting my interests.

Frank Shien, Property developer and former CEO of a listed public company

Kingsmede has trusted Peter to represent them across a number of varied and complex real estate, development and financing transactions over the past five years. His commercial approach and in depth understanding of real estate markets and financing has ensured we always achieved the desired outcome and completed the transaction. Peter is a trusted adviser who we seek counsel on in relation to both legal and commercial issues relevant to property investment and financing matters.

Brent Mulligan, General Manager – Kingsmede

Benefit from Peter's 35 years of legal experience in property finance and learn over 40 simple ways to improve your Australian property finance outcomes.

Having acted in 100's of successfully negotiated property construction and investment finance transactions for large and small developers and investors (in each case having improved the outcomes for the borrower), Peter is passionate about helping newcomer, inexperienced and foreign property developers and investors achieve better, smarter and more profitable property finance arrangements.

Peter brings knowledge from the big-end of the commercial and property development market and makes it available to all developers and investors in a cost-effective way.

Peter Faludi

ISBN 978-0-6482866-8-4