National Australia Bank

Institutional Markets & Services

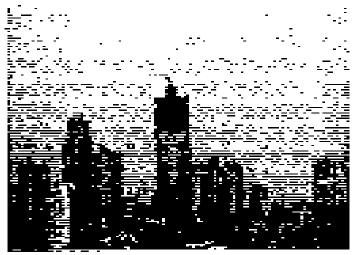
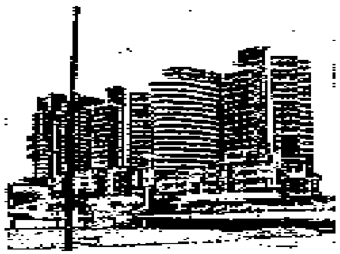
August 2005

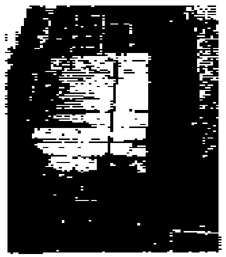
Construction Finance

BFSLA Conference

Presented by
Martin Green
Joint Head of Property Finance





The aim of this presentation

- Provide an insight of the Banks experiences in the arranging major construction transactions
- Give an impartial view of the key risks in documenting construction transactions
- Provide participants with some behind the scenes deal making that has been at the heart of the construction industry
- Give a perspective on what may emerge as the key trends going forward
- What factors will impact on how financiers manage construction risks going forward

A thought.......

The landscape is changing.....developers are in house building, builders are developing and fund managers are developing.

What does this mean for a financier and at what point will a financier see the risks as too high for the returns on offer for any given development.

Is the construction industry changing?

The Current Dilemma

- Construction cost escalation and completion delays
  - Immediate pressure on margins
    - Leading to losses in current building cycle
      - Builders profitability erroded
        - Construction contracts at risk

What does this mean for the way a builder will think and manage their contract risks and negotiations with financiers and developers

Construction Risk – How do Banks think?

Developer Capability

Performance Security

Construction Contract

Complexity and Documentation

Builders Liquidity

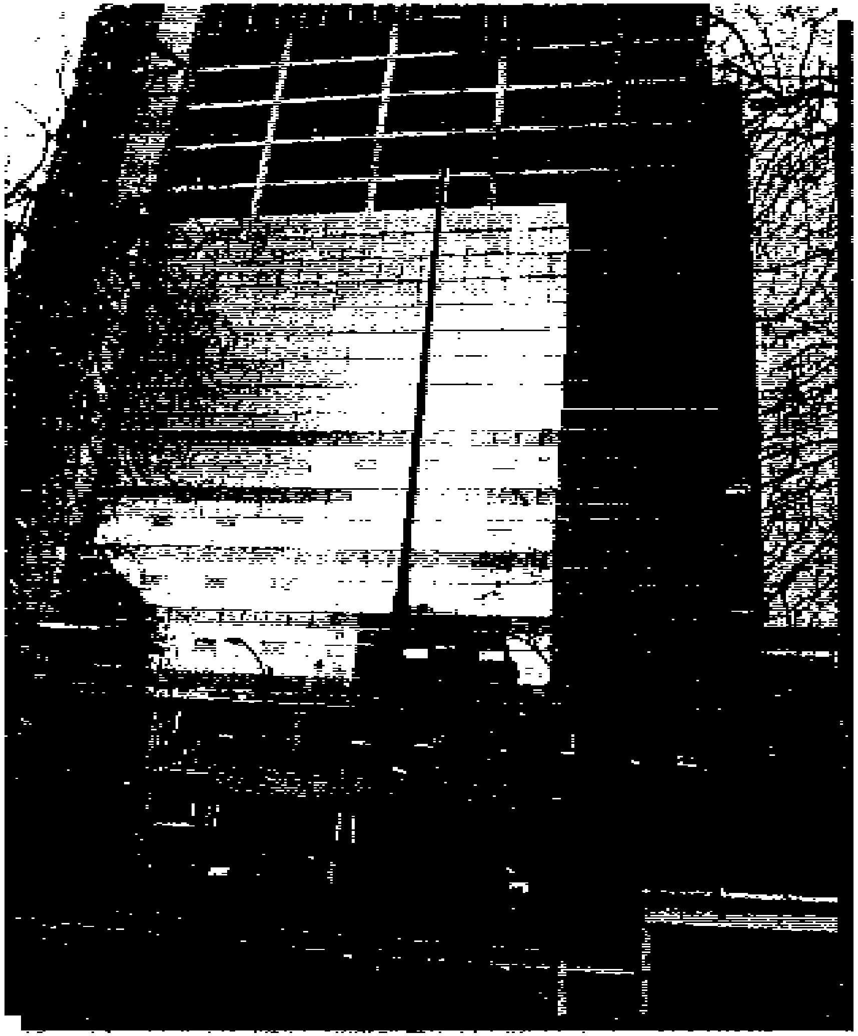
Performance Benchmarks

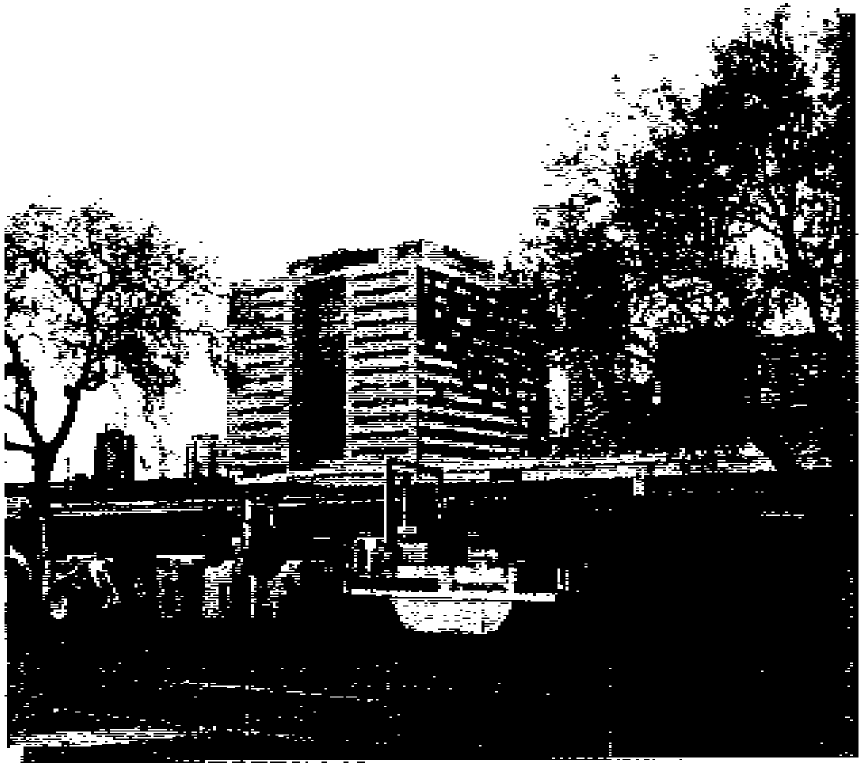
Banks and Construction Risk – What's happening?

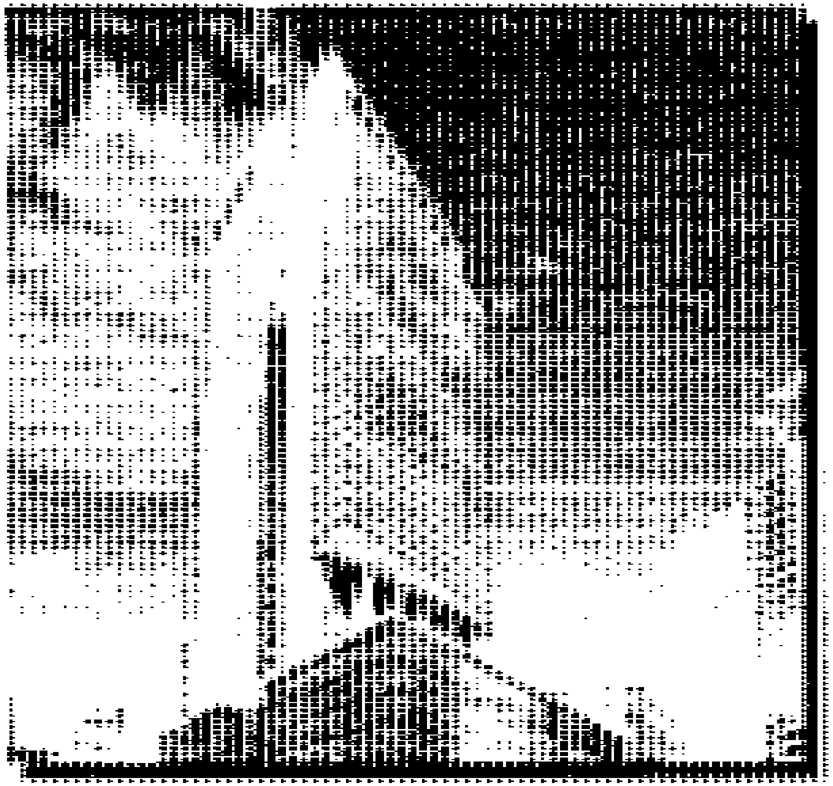
- Developers expecting Banks to take greater risk (always ring fenced)
  - LVR's / Market / Interest Cover / Funding Term
- Structuring of the opportunity is critical to the risk mitigation
- Moving up the risk curve (mezz and equity bolt on)
- Banks showing signs of being more focussed on end outcome than the risks of delivery (will change)
- Banks need to be proactive and involved early in builder negotiation understanding what is the delivery risk profile of the project

Builder Negotiations – *Changing World*

- Process is changing
  - Some builders want to know what Banks think… *big change*
  - Trying to bring Banks into the negotiation
  - Seeking protection from the financier
  - Seeking Developers to carry overrun risk
  - Major projects unfixed (onsite and offsite) materials problematic
  - Understanding SPV risks of the developer
- Tripartite Negotiations changing
  - Pushing back for pre notice protection for financing doc'n breaches (no link)
  - Variation consents seeking wider protection powers







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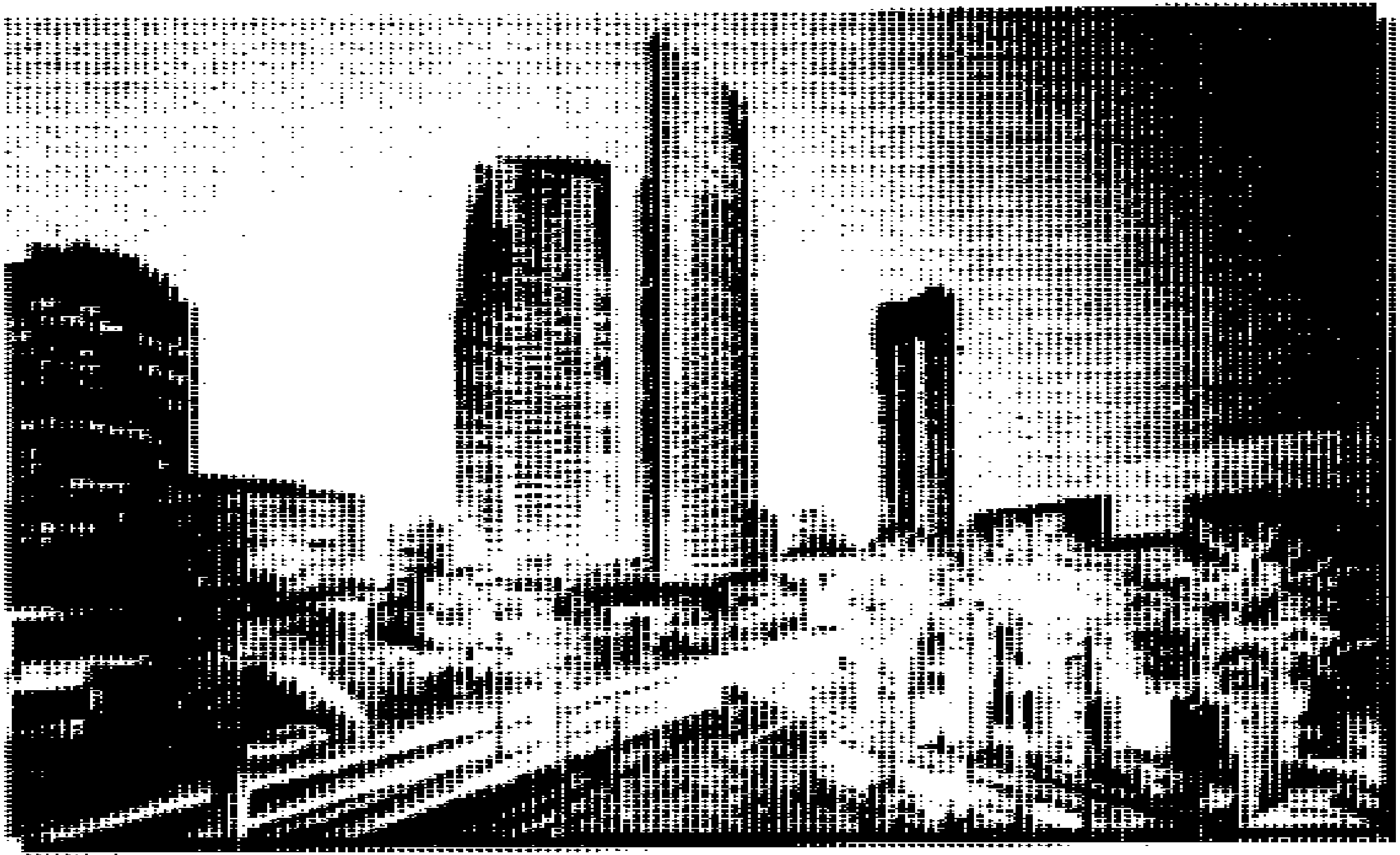
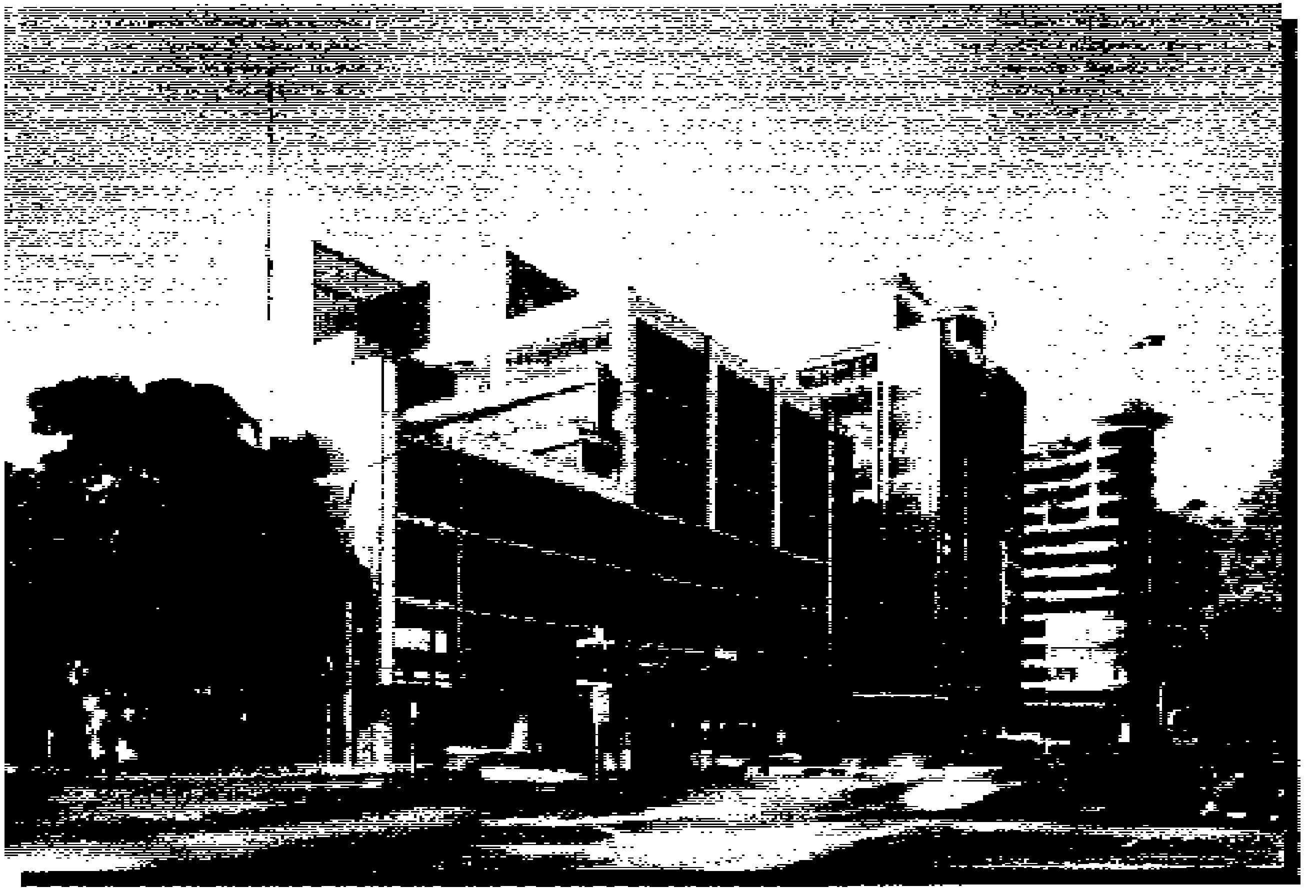
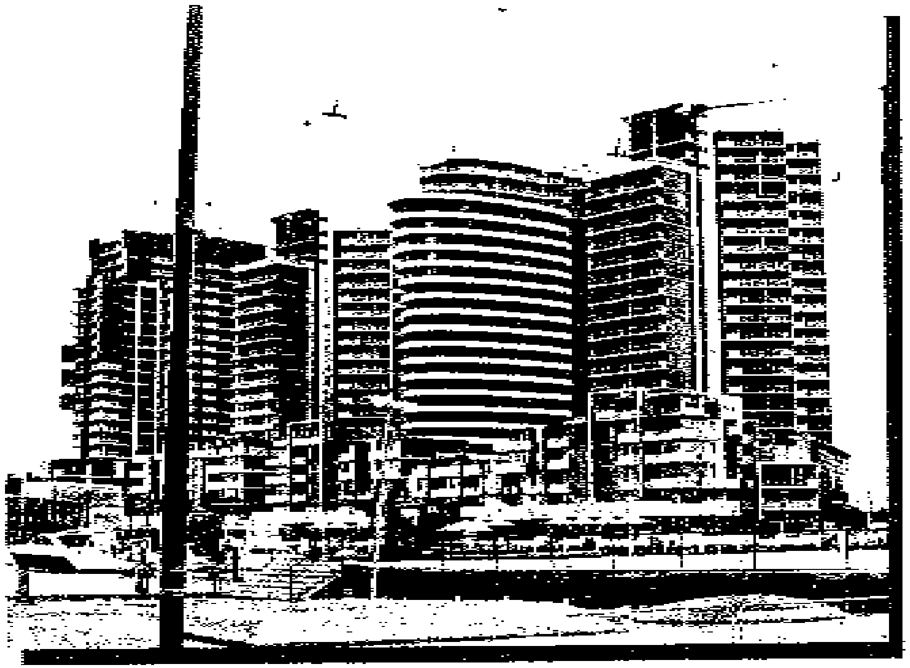
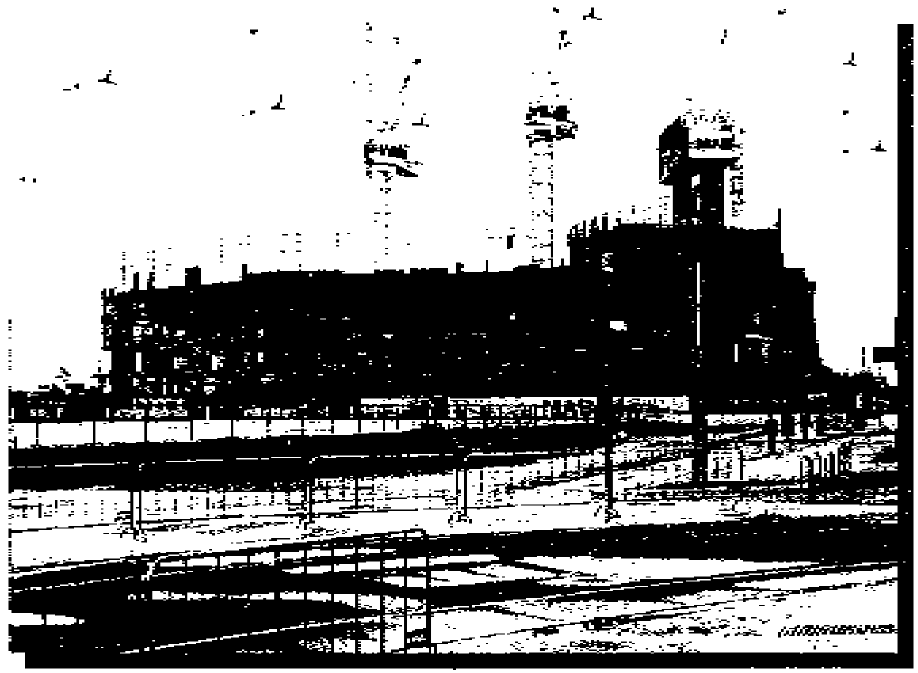
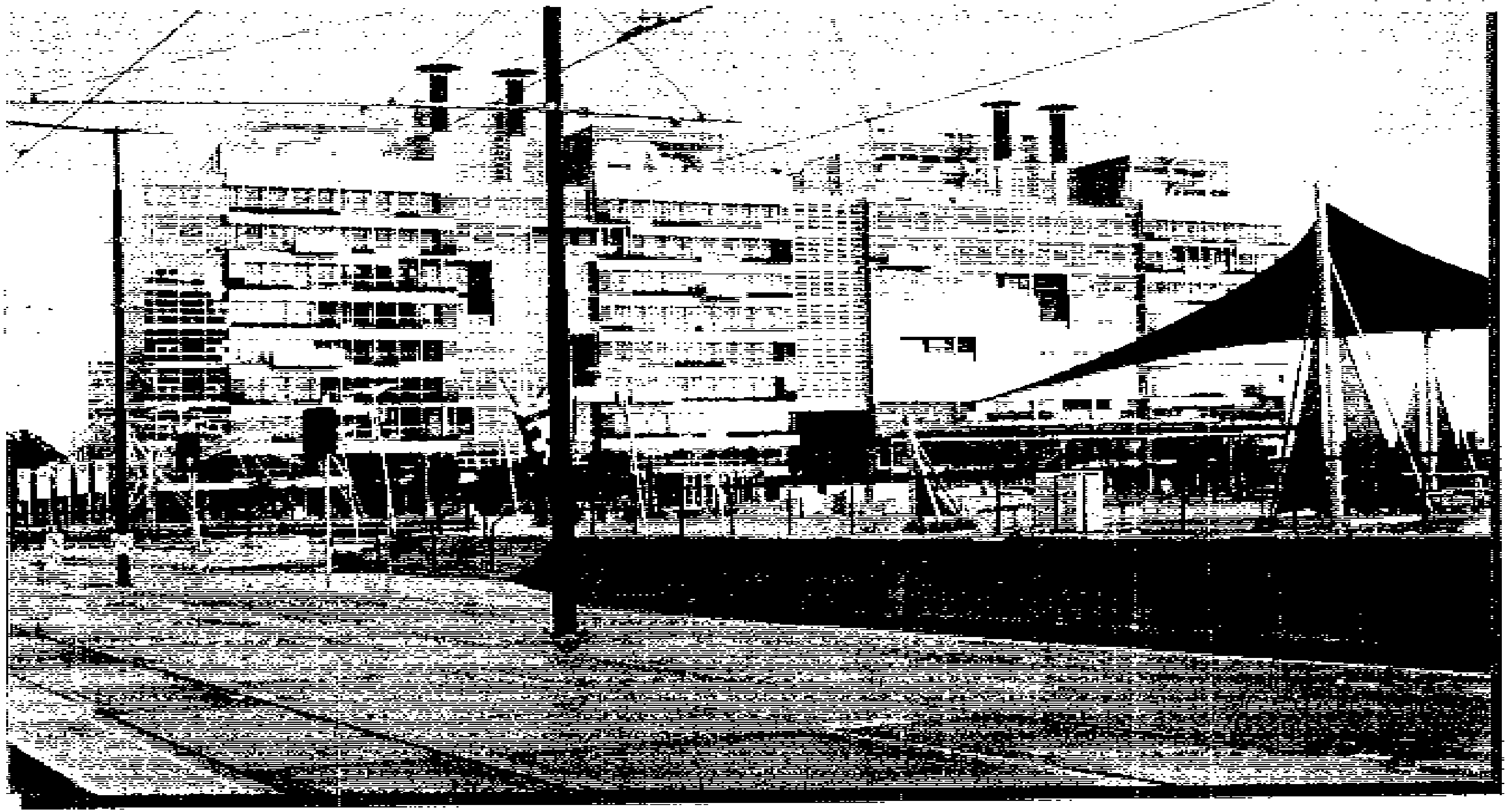










Does the builder make a difference?

- Capabilities of the builder is key some are strong with structure and on site skills others are better administrators
- Current flurry of major project work has created serious shortages in trade protection
- Programming competency
- Cost Control systems and experience
- Contract letting experience and relationships
- Level of activity in regional location (ie state or city)
- *Bulk of head contractors are not builders, they are project managers which must always be carefully considered by financiers in determining the most appropriate forms of protection in the documentation.*

Financing Construction – Risks and Mitigants

Risks

- Late completion
- Cost Escalation
- Builder default / liquidity
- IR – productivity
- Builder fraud (non pay't)
- Developer and Builder fall out
- Quality of product

Mitigants

Understanding the builders strengths

Understanding the builders cost management framework for the project

Managing programming risk

Structuring flexibility and protection into the documentation

Maintaining adequate performance bonding

Receiving quality advice (QS / Engineering/ prog.)

Structure Risk

- Protecting for the build complexity in the finance structure
  - Builder Performance Milestones
  - Latent Risk
  - Subcontract Milestone Risks
  - Staged Project Delivery
- Major Towers Vs Low Rise complexes
  - Each has risk however very different impacts if builder defaults
  - Compensation margin contraction
  - Why would a Bank take the risk?

Transaction Negotiation

Themes

- Key outcome is to ensure builder delivery is managed
- Ensure clear alignment of financier requirements are reflected in contractual drafting
- Ensure appropriate processes are inbedded in documents to protect for transparency between builder and developer to the financier
- Ensure the builder's obligations are reinforced in the documentation (via S/Dec payment regime)

What are the contentious issues?

- Builders searching for payment protection pass through to financier. (Bypass the developer)
- Alternative means of bonding performance obligations (insurance bonding etc)
- Limiting Liquidated damages liability (20 % cap not uncommon)
- Builders are trying to marginalise the role and power of the financiers QS advice and role.
- Builders are looking to remove cost escalation risk from tendering and moving to a landscape of negotiated construction margin

What's happening in the market?

Deutsche ... to Walter workers' hall

INFRASTRUCTURE

Flood of mo... ...blic-private deals

Multiplex, Westfield link in $8.5bn brawl

What's happening to builders?

Cause

- Builders are under pricing regularly……*many examples available*
- Builders are not managing programs well
- Builders are exposing themselves to trade costs escalation

Effect

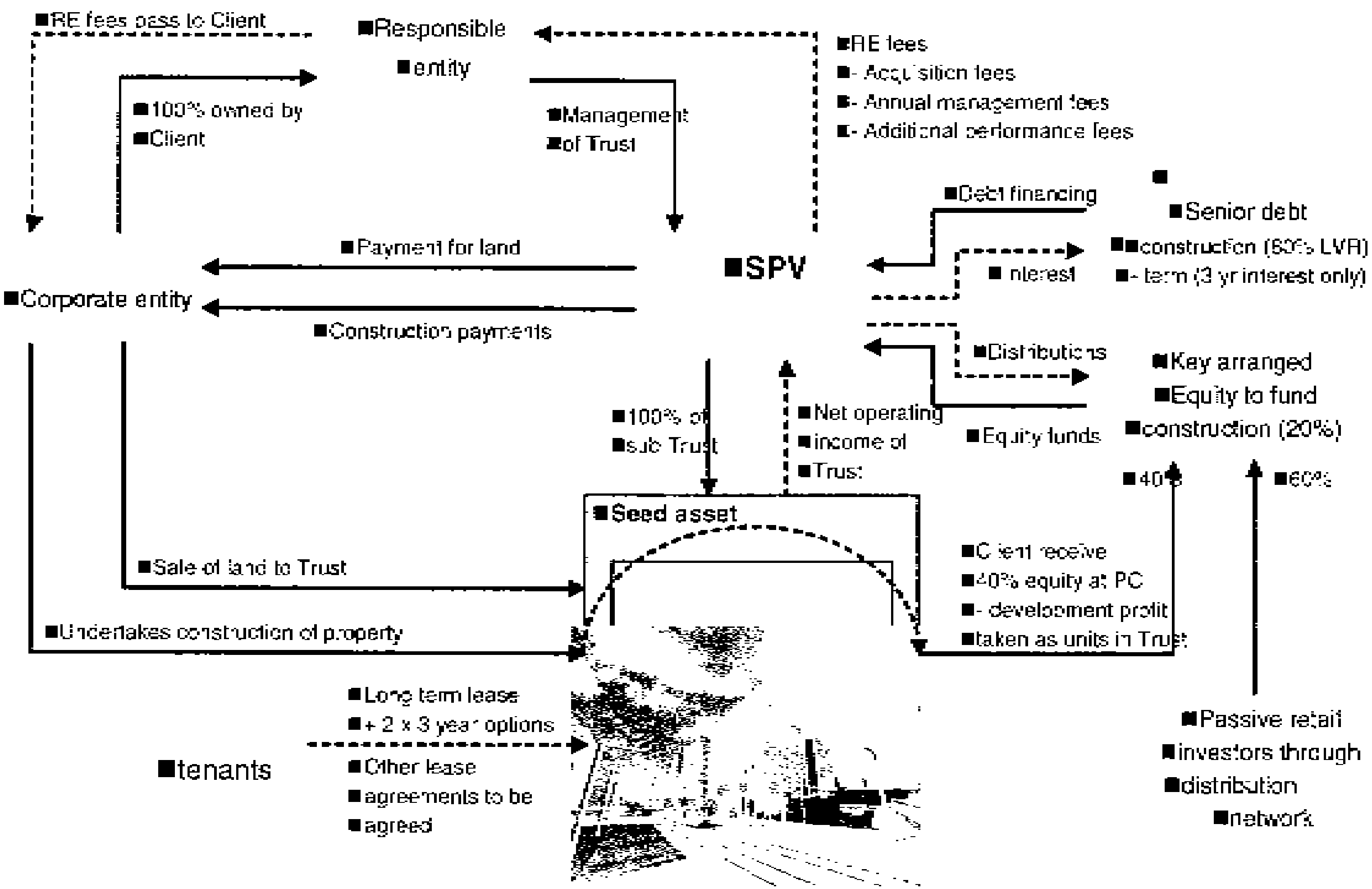
- Serious balance sheet (profit / margin) pressure
- Equity markets impacted for development entities
- Banks tighten availability of capital (capital allocation)

Result

- Developers impacted (carry the effect) as far as Banks can manage

Complications "*smoke screen*"

- Deal Confusion Phenomenon
  - Complexity of the transaction masks (equity driven) the real risks of construction (next slide) (who drives the deal)
- Deal Fever "greed" Phenomenon
  - A strong margin is offered to mask the construction risks in Tight Markets
- New Age "Product" Phenomenon
  - Securitisation / Credit Enhancements / credit derivatives


RE fees pass to Client
Responsible
entity
100% owned by
Client
Management
of Trust
RE fees
- Acquisition fees
- Annual management fees
- Additional performance fees
Debt financing
Senior debt
construction (60% LVR)
- term (3 yr interest only)
Interest
Payment for land
SPV
Corporate entity
Construction payments
Distributions
Key arranged
Equity to fund
construction (20%)
100% of
sub Trust
Net operating
income of
Trust
Equity funds
40%
60%
Seed asset
Client receive
40% equity at PC
- development profit
taken as units in Trust
Sale of land to Trust
Undertakes construction of property
Long term lease
+ 2 x 3 year options
Other lease
agreements to be
agreed
tenants
Passive retail
investors through
distribution
network

What is occupying the Banks?

- Lack of deal flow – cycle positioning
- Managing late project deliveries
- Winding back builder performance facilities
- Good transactions are keenly sought
- Enhancing fundamentally weaker transactions
- Building resources to track the markets (Qld etc)
- Name of the game is "product penetration"

<u>POSITIONING</u>

- Relationships, quality skilled teams and credit delivery are key drivers for Banks in the micro property development markets going forward.

A Final Thought.......

Via the financing structures required do the Banks drive the development and therefore construction markets in Australia?