Financing residential development in Australia

MEDIUM AND SMALL RESIDENTIAL DEVELOPERS CAN OVERCOME FINANCIAL RISK BARRIERS BY PURSUING JOINT VENTURES WITH THE PUBLIC SECTOR—BUT OPPORTUNITIES TO SECURE FINANCE FOR AFFORDABLE HOUSING ARE LIMITED.

KEY POINTS

- Property finance for a developer is crucial, no matter what sector they operate within. In the post-Global Financial Crisis (GFC) context, large developers are still able to finance their developments. However, many small and medium-sized developers borrowing on a project-specific basis find it difficult to access finance.

- Competition in the sector has diminished due to the exit of alternative lending institutions, while the banks have tightened their loan conditions. This has led to restricting project level debt finance for smaller and medium-sized developers.

- Successful development has been reliant on developers communicating a successful track record, increasing pre-sales, accessing retained earnings or other equity finance, or sharing development risk with contractors and other joint venture partners.

- Larger developers can undertake new developments because they can access corporate (rather than project level) finance, and because they often have a balanced portfolio of assets which mitigate risks associated with individual developments.

- The strategies used to access finance have differed across the greenfield, medium density infill, high density and affordable segments of the market depending on land holding costs associated with the cost of land and length of time to market.

- The leverage opportunities available for the not-for-profit sector are reasonably modest, largely because lending...
institutions treat the loans as cash flow loans, rather than loans against assets. Transfers of public housing stock to the community housing sector would allow it to leverage finance and increase the social housing stock.

**CONTEXT**

The financing of residential developments is an important step in developing properties to supply the demand for housing, including affordable supply. This research examined how property finance decisions are made and how they affect housing supply, including in the affordable housing sector.

**RESEARCH METHOD**

This study undertook a literature review and 21 interviews with property developers and financiers operating across three states (Western Australia, New South Wales and Victoria) in high density development, medium-density infill development, greenfield development and the affordable housing sectors. Formal face-to-face interviews were supplemented with informal discussions with key industry players and industry groups. Financial modelling also examined the impact of finance on development feasibility.

**KEY FINDINGS**

*Development finance adversely impacted by the GFC*

The GFC (2007–08) caused serious instability in the Australian financial market and a loss of confidence in the wider economy. The Reserve Bank of Australia stated the availability of finance was constrained because there was a withdrawal of regional banks and a 'retreat of foreign banks' from lending. Residential lending is now dominated by the 'big four' banks, which account for around 80 per cent of residential development lending, leading to a substantial reduction in competition in the sector.

Post-GFC, financiers focused on minimising risk on new debt by:

- Reducing the proportion of debt finance available to any one project and reducing debt-to-value ratio from a maximum of 100 per cent down to 70 per cent.
- Only lending to developers with an existing relationship with the financier.
- Lending into 'safe' development and tenure types with a proven sales record (smaller apartment products continue to be problematic for lenders).
- Mandating a minimum number of pre-sales or imposing tighter loan conditions to reduce the risk for the financier, some of whom required developers to get pre-sales equal to 100–110 per cent of the debt.

The risk has also been priced into the cost of debt (expressed as the margin over the bank bill swap rate). In addition, the length of debt facilities has shortened, requiring developers to re-finance, which can prove expensive.

Developers also noted how the GFC has created more regulation by financiers, requiring more reporting and formalisation of processes such as roll-overs of loans.

*Struggle to obtain project-based debt finance*

Post-GFC, small and medium-sized developers borrowing on a project-specific basis have found it very difficult to access finance, particularly in the areas dominated by smaller-scale developers such as infill development. Banks either refused to lend or tightened their lending criteria, creating loan conditions that were impossible for smaller developers to meet.

There were also particular issues for developers in the requirements for pre-sales. Some purchasers could only finance approvals for a period less than the time it might take for the development to occur, requiring refinancing which was often unavailable so that many pre-sales fell through. This arrangement suited large apartment developments where overseas investors could make a big dent in the required level of pre-sales, but was less viable for unproven developers taking on considerable risk and up-front costs.

Developers noticed they were no longer able to get decisions made with local senior bank
managers. Instead, decisions were made about developments elsewhere in central offices, sometimes far away from the local market. They also noticed that financiers were reticent to consider some local (especially regional) markets for investment because of bad experiences of financial losses, overexposure, and the need to clear previous bad debts.

**Attracting finance by minimising development risks**

Successful smaller developers sought to mitigate risks (e.g. interest rate fluctuations, project overruns, withdrawal of support from lenders, and incorrect forecasting of project values or cash flows) by using a range of methods including:

- Using strong contractual terms shifting liabilities for delays onto contractors.
- Greater use of equity funding, syndication or joint ventures with land owners in relation to land purchase. All of these potentially minimised the need for developers to use debt to purchase land thereby minimising debt exposure making funding more attractive to banks.

**Accessing corporate finance, retaining earnings or private equity**

Larger developers can access other forms of corporate finance for new projects which offer flexibility. This means they do not need to negotiate finance for individual projects. Strategies included:

- Publicly-listed *Australian Real Estate Investment Trusts (A-REITs)*, such as Mirvac and Stockland. These were favoured because banks saw their large balance sheet including many passive income producing property investments as a source of stability. Even so, A-REITs reduced their debt to equity ratios after the GFC.
- *Non-A-REIT listed companies*, such as Peet, were not required to distribute earnings and so were more likely to have retained earnings. They were able to raise finance if they had low levels of debt on the balance sheet, regular stable cash flow and good levels of retained earnings. Companies with stable lower end payout ratios have also been able to raise additional equity from existing shareholders.
- *Unlisted private developers* have an advantage as they are not exposed to the scrutiny of the public listing process and are able to access international funds.

Large developers also found that banks wanted to reduce their exposure, so they used joint finance from a number of banks.

**Financing arrangements differ by segment**

The strategies used to adapt to the post-GFC conditions differed across different segments of the market (e.g. greenfield, medium density, high density).

- *Greenfield developments* usually occur over a long time scale so the developers are typically major companies (often REIT or non-REIT) with a significant track record in land development. They often draw equity capital from major institutional investors (e.g. super funds) with similar long time horizons and often rely on land syndication to purchase land. Pre-sales were important but not as important as the lender's own financial circumstances. Joint ventures with land owners became increasingly common in order to spread risk.
- *Medium density in-fill developments* involve redevelopment of land within an urban boundary and can involve medium to high-density apartment buildings through to medium-density house and land packages. Most are large and medium-sized developers, but smaller companies can play a major role in piecemeal development, under 50 units for example. While land costs are typically higher and there are costs associated with removal of structures or remediation, the holding costs are lower as the development has a much shorter timeframe than greenfield therefore debt is a more common form of finance.
- *High density development* typically involves apartments that are capital intensive and take considerable time to complete. Project finance is a vital component of the development and
Limited financing opportunities for the not-for-profit sector

The affordable housing sector (including private sector developers operating at the low cost end of the house and land market) faced barriers getting developments off the ground, such as obtaining pre-sales when financiers require low-income purchasers to provide a deposit of at least 10 per cent. The opportunities available for the not-for-profit sector to leverage finance were reasonably modest, largely because lending institutions treat the loans as loans against future cash flow, rather than loans against assets.

Continued growth in the sector will make it easier for community housing organisations to access finance and expand the social housing stock. Institutional funding of the sector at scale would accelerate such growth. At present, there are relatively limited opportunities to generate significant cash flows from affordable housing projects because of the modest incomes of tenants. Subsidy programs, such as the National Rental Affordability Scheme (NRAS) reduced concerns for lenders, although the time required for the lenders to understand new schemes can be significant.

POLICY IMPLICATIONS

If policy-makers want to stimulate housing supply in a particular segment of the housing sector (greenfield, infill or high density), they need to be aware of the type of developer operating in that space. With a need to increase supply and affordability, governments could improve financing opportunities for smaller developers and those focused on affordable housing development. Suggestions include:

- **Reduce uncertainties** in the development approvals process, avoid delays and ensure equitable infrastructure charging, as well as flexibilities around design features (e.g. parking requirements that can render developments unprofitable).
- **Help de-risk projects** by creating joint ventures, including using government land, government guarantees to purchase unsold units, pre-sales to government and direct profit sharing partnerships.
- **Transfer public housing assets to the community housing sector**, thereby building the affordable housing sector’s capacity to leverage those assets for further finance and investment.

FURTHER INFORMATION

This bulletin is based on AHURI project 81009, *The financing of residential development in Australia*.

Reports from this project can be found on the AHURI website: www.ahuri.edu.au or by contacting AHURI Limited on +61 3 9660 2300.