Counterparty risk splits townhouses

KordaMentha real estate

Split contracts create an issue for financiers of medium density townhouse developments

Overview

The property industry has seen a rise in medium density townhouse developments sold on 'split contracts'.

The term 'split contract' refers to the sale of a property 'off the plan' whereby the land is sold and settled under a contract of sale of real estate and is subject to the purchaser entering into a building contract for construction of the dwelling with a designated builder.

Although the land is subdivided, its use is tied to the planning approval allowing construction in accordance with a specific design.

Split contracts are common for traditional single dwelling homes, however, the implementation of split contracts for townhouse developments is a departure from the typical off-the-plan '10/90' contract where a purchaser pays a 10% deposit and the balance on completion of the development.

Despite the use of split contracts, essentially the product remains the same. The purchaser is buying a completed dwelling and not vacant land, its just being done in two steps. The land and building are intrinsically linked – one relies entirely on the other, which now creates a financing issue.

In recent times, split contracts have been used by townhouse developers, as a way of improving cash flow through settlement of the land and the passing on of construction funding requirements to the individual purchasers. Whilst beneficial to the developer, split contracts pass to the purchaser and subsequently their lender, the inherit construction completion risk.

Although previously accepted amongst all stakeholders, recent issues highlighted within the Australia Property Institute's ('API') Member Alert dated 13 June 2013 and subsequent Member Alert dated 8 October 2013 to provide clarification and reinforce concerns of both lenders and lenders mortgage insurers ('LMI's) in respect of this product offering.

The issue

Medium density townhouse developments typically have shared or common property including party walls, driveways, landscaping, shared services, etc. Typically developers of medium density projects take responsibility for co-ordination and completion of all the shared services and common property in their role as the developer, prior to settling the individual saleable properties.

The introduction of split contracts to medium density projects with common property and shared services introduces a level of counter-party risk which in turn places additional risk on financiers and LMIs. Reliance is placed on all stakeholders fulfilling their obligations, in particular purchasers making their construction progress payments through the construction period.

If a purchaser defaults, construction may cease, and the following issues would arise:

- A secondary market for the land does not exist as its use is tied to the development scheme and an incoming purchaser and therefore the land on its own cannot be sold on the open market.
- The lender would be holding security at a value which bears no resemblance to market value as it has been calculated by arithmetic rather than market assessments i.e. on completion townhouse value less construction cost.

The implications

Split contract arrangements for medium density developments are already in use, however now present various implications for stakeholders.

Valuers

- Further to the API's recent technical briefing, valuers will no longer provide a land value where a split contract exists for medium density developments. Valuers are required to provide a single 'as if complete' market value reflecting market value of the completed townhouse.
- Valuers consider the land to be encumbered by the development scheme and therefore a secondary market does not exist.

Lenders and LMI's

- Coupled with a valuer's inability to provide valuation support for the product, many lenders and LMI's now view this development type as not suitable mortgage security given the unacceptable risk profile.
- Consequently many lenders deem this type of contract to be unacceptable for a standard construction loan with progress payments creating a funding issue for purchasers.

Developers

- With restricted finance options available for split contracts on medium density townhouse projects, developers will be required to look for alternative funding solutions or deliver projects on standard 10/90 off-the-plan contracts.
- These changes could have the potential to cause cash flow issues for developers of medium density townhouse stock. It remains to be seen how financiers will deal with those already under construction.

Builders

- This issue has the potential to cause delays to current work and consequently have knock-on cash flow impacts.
- Volume builders often participate as developer/builders, which may require redistribution of funds to complete the product.

Purchasers

- Purchasers of medium density townhouses may find it difficult to obtain finance under a standard construction loan causing completion problems.

Where to from here?

Many industry participants are steadfast that medium density product sold under a split contract no longer represents suitable mortgage security.

The simple solution is to revert to the traditional method of sale under 10/90 off-the-plan contracts where developers take responsibility for completion and fund the construction and purchasers simply buy a product off-the-plan. However, this creates additional cash flow and funding issues for the developer.

With opposing stakeholders at loggerheads, it remains to be seen if the ever resilient property industry can overcome this issue and appropriately account for all stakeholders.

Will we see creative insurers implement new products to provide financiers with adequate risk coverage, the emergence of additional funding products that appropriately weight and price the counter-party risk, developers/builders providing performance guarantees or step-in rights where one party defaults or will it be a case of once bitten twice shy for lenders, LMI's and valuers?

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