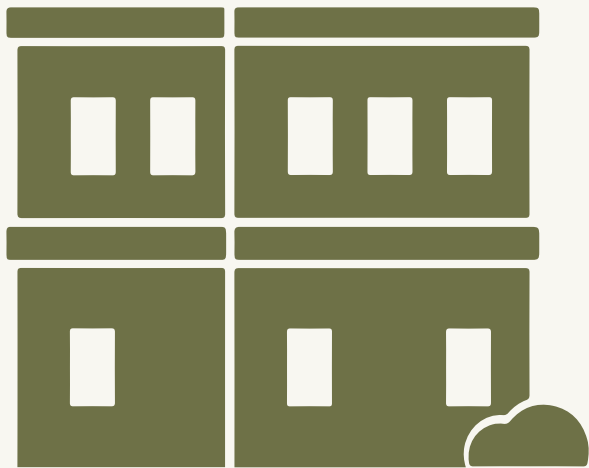


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Development contracts – all you need to know.



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The 5 key contracts for a successful development

For this document, we partnered with Andrew Newlands from Omni Development Partners. Omni Development Partners provide advice and guidance across all scales of property development, whether you're a seasoned professional or making your first moves. Andrew breaks a development down into 5 key contracts for his clients. His belief is that if you can ensure you manage your risk across those contracts, the development should track to plan.

Those contracts comprise:

- 1) the purchase of the land,**
- 2) the authority to develop (RC,BC etc),**
- 3) the sale (or lease) of the end assets,**
- 4) the build contract and**
- 5) the loan contract.**

These 5 contracts are crucial to any development and can provide success or heartache.

Any questions along the way?

Call your Lateral Partners adviser or adviser support person and we can help you out or point you in the right direction.

1

The Sale and Purchase Agreement for acquisition of land

This is usually the first contract for any development, the acquisition of the development site. At this stage of the development you carry the maximum amount of uncertainty, and therefore it is vital to ensure you manage that properly.

Choosing a site needs to reflect the intended end use. You need to have a concept of what you want to develop, who the end user might be and how much they might be worth. We often see people paying what is effectively market rates for land, only to find out during the feasibility process that a sales value required to support a realistic margin is out of step with what an end user is willing to pay, hence you have over capitalised the site. In simple terms, working backwards from an end sales point of view can help inform you what a realistic land price should be. It is usually less than what the seller wants, but this is a logical point to leverage during negotiations.

It is important to ensure you have adequate time to perform your due diligence on the property. You want to make sure you can iron out as many issues as possible before being unconditional in the contract. This includes a detailed feasibility study, bulk and location, understanding of project risks (sloping site, services connections etc.) and finance, amongst other items.

It is crucial to acquire land at the right price, but you may also negotiate this relative to the terms that are on offer. A longer Due Diligence period for example, may allow you to take things further, removing more risk. We have seen properties contracted conditional on consent being issued, removing an enormous amount of risk in the project cycle, this is not often, however. Deferred settlement is another common ask from property developers saving on capital outlay (as not being required to settle) and allowing better cash flow during the consenting process.

2

Authority to Develop

This is a suite of agreements with consultants that ultimately culminate with award of a resource consent and/or building consent with associated approvals. Vanilla in some ways, a function of process and time, this crystallises what you are going to build. Emphasis should focus on the somewhat discretionary aspects of the resource consent, whether it might get notified and what the decision maker needs to consider.

The Resource Consent controls what you can do with the property and is a determining factor to the outcome of the development. An additional unit on a site may be the difference between a project being a profitable venture or not, or your conditions may make a project prohibitive.

Furthermore, the cost of time needs to be considered. Paying interest on a piece of land adds up over a 6–12-month timeframe, which is typically how long consents take from start to finish. Stacking the process and running design, RC and BC at the same time can help, but you take on additional risk of redesign should one of them hit a stumbling block that requires changes.

3

The Pre-sale or Pre-lease Contracts

These are the contracts that determine how you are going to make money from the development. There are many items to be wary of when negotiating these contracts, as they have a direct impact on your ability to fund a project.

These should at the very least be conceptualised and thought about at the outset. What is a likely sale price? What is the demand for this product? How easy will it be to sell? These should all be questions that can be answered with relative confidence prior to land acquisition.

A common example of things to look out for is the sunset dates in either a sale or lease contract. Funders will require the sunset dates to be 12+ months from the expected completion date – not to be confused with practical completion of the physical works, which in itself is normally 12 – 15 months from start of construction. We often end up working with clients on extending these out as they fall too soon and impact on their ability to acquire funding.

Other important clauses include the deposit amount (10%+), ability to substitute materials and the ability to remove caveats on the title. It is important that you negotiate and understand these contracts at the outset so you don't tie yourself in knots when it comes time to get funding in place.

4

Build Contract

This is perhaps the most spoken about contract but often underestimated. There are many different types of build contracts you can enter into, but perhaps the most common 3 for developers are the standard Master Builders contract, the NZS3910 and the NZS3915 contracts.

The Master Builders contract is great, but much better suited to independent or small builds. It often weights the payments and terms in favour of the builder and doesn't provide for sufficient protection for lenders. It is less commercially viable. We would expect to see amendments to this document for it to be in a commercially acceptable form for a funder.

The 3910 and 3915 contracts are very similar, the key difference being the requirement for an engineer to the contract (3910). These contracts, however, include 3 clauses that are important to lenders, particularly at the moment. These include Liquidated Damages, Retentions and the requirement for a Performance Bond.

Liquidated Damages (LD's).

LD's is a clause in a contract that stipulates an amount of money payable for a breach or loss suffered under the contract. This often is a result from time overruns due to poor performance from the contractor and is therefore vital when you are borrowing a significant amount of money for a development (you don't want those interest costs ticking up as time ticks on). With interest rates the way they are, it is often easy to demonstrate an estimate of LD's much higher than a builder will accept on a commercial basis. Navigating these issues is important.

Retentions

Retentions are simply a portion of a payment that is withheld under a construction contract, to act as a form of security or assurance that a project will be completed and any defects remedied. These normally amount to 3-5% depending on the contract.

Performance Bond

A performance bond is a guarantee provided, normally by the head contractors bank, to the developer. It is enforceable in the event of default by the contractor and the underwriter must irrevocably pay the sum provided for by the bond. It is put in place to ensure that if a contractor tips up during the build there are funds provided to offset the cost of securing another party to complete the development. A performance bond is often required by a lender and normally amounts to 5% of the contract value.

A successful build contract is usually a reflection of the relationship between the parties and what preparation is done prior to execution. Getting the right price, a fair allocation of risk as well as a time for completion are key aspects. This is usually heavily predicated on the quality of the design (read: Detail). Having a builder price from a Resource Consent set of drawings is undoubtedly going to have more issues than if they priced off the Construction set. However the time advantage of having a price/builder/contract early and ready to go may have advantages that you are willing to consider in exchange for the added risk.

5

Funding Contract

Often the final contract you will enter into for a development, it is an important one to get right. The first thing to consider is that this contract can often hinge on those before it, any issues with the land purchase, resource consent, pre-sales or build contract can make securing finance difficult.

Beyond that, understanding your finance contract in itself is vital. In exchange for the finance you normally pay significant costs but also give away rights in the event of a default. Understanding the terms of your agreement, the events of default and the lender you are working with are extremely important to a successful outcome to your project.

In terms of the costs, these typically consist of an up-front fee, a line fee and an interest cost on borrowed funds. Regarding the rights, quite often as part of the security structure you will assign control over the key contracts in a development to the lender in the event of a default.

Time

These contracts rarely exist in isolation. They are dynamic and rely on outcomes from each other. All the while time is moving forward and the lost opportunity is growing. Think about how to bring these items closer together and what additional increases in risk may occur and weigh these against the time it will take.

If you want to do multiple developments, getting a development completed once per year (but for a lower margin – because you paid for more risk) may be better than only doing one every two years but for a higher margin. For example, earning \$800,000.00 over 1 year versus \$1,200,000.00 over 2 years represents a better return relative to time (\$800,000.00 per year vs \$600,000.00 per year)

Ideally first a presale contract performable only by the vendor, followed by land acquisition (now you know the sale value you can buy at the right price) with a long settlement (as close to finance date as possible) would mean you are only having to fund the design process – now ask yourself – how fast can this be done?

The above is desirable but not always realistic. The point is when strategizing these contracts, think about their interactions and the time each will take.

Get in touch



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Ben has over 10 years' experience in the finance industry spending 9 years with ASB Bank as a Commercial Manager as well as 2 years running the commercial and development division of Squirrel Mortgages. As Director of Lateral Partners, Ben specialises in working with developers, businesses and large investors to provide financial advice, lending, equity and transactional solutions.

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Andrew has over 10 years' experience in project delivery. He has actively participated in the delivery of large infrastructure projects throughout Australasia with both Fletcher Construction and Lendlease. More recently, he has held senior positions providing cost advice and property finance due diligence to facilitate a variety of developments around New Zealand — with a total delivery portfolio at any one time of some \$750m. After leading the construction management team at Stellar Projects, Andrew started Omni Development Partners to provide an advisory service that can scale to all levels of property development. His engineering background provides a more pragmatic approach, paired with a personal desire to provide a more people-centric approach to development advisory.

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