Briefing

Development Finance

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Managing ‘Construction Risk’

The market for development finance has improved dramatically since the recession with recent reports indicating that lenders are once again lending furiously. However, the majority of banks are maintaining their discipline in relation to loan to value and the security they seek from their customers. During the recession some lenders took the opportunity to reflect on how they were managing key risks and ‘construction risk’ in particular. This led to a number of them developing more rigorous procedures to mitigate this risk. This article explores what lenders mean by ‘construction risk’, their related security requirements and how developers can save time and cost in meeting those requirements.

Construction Risk

So what is meant by ‘construction risk’? In broad terms, ‘construction risk’ refers to the risk of events arising that increase costs, delay completion or disrupt the occupiers of a development and could result in a developer defaulting under a loan.

To mitigate against this risk lenders will require certain rights against those providing the design and other services as well as the main contractor and, on larger schemes, key subcontractors. They include a right to step into the key contracts to allow the development to be built out and the value of the development to be realised, as well as rights to recover the cost of rectifying defects that could reduce the capital value or impact the revenue stream of a development. Those rights are usually captured in ‘collateral warranties’ and their value to the lender will be influenced by the underlying appointments and building contracts between the developer and the consultant or contractor. Lenders will look at the complete package - not just the collateral warranty.

When does the Lender need to be happy?

Typically the lenders’ rights must be secured to the lender’s satisfaction before the developer may drawdown any monies for the development under the loan. It is therefore important for the developer to understand what the lender wants and to ensure the contracts it agrees with its supply chain include those requirements. In simple terms, the better the contracts, the sooner they will be approved and the developer will be able to use the loan, and the smaller the lender’s adviser’s bill will be, a bill the developer typically picks up.

For a developer new to development finance by far the most cost effective way of managing this lender requirement is to engage specialist advisers to develop a suite of contracts that address the specific matters lenders look for when carrying out their due diligence. This allows the developer to start negotiations with its supply chain on the right footing.

Unfortunately, many developers do not take this step and find themselves incurring considerable unnecessary costs arising from the need to ‘reverse engineer’ lender requirements into poorly drafted contracts. This becomes even more difficult if the developer has already entered into binding agreements with consultants, contractors, occupiers and investors who are understandably reluctant to agree any changes to what they perceive to be a great deal. In this scenario unnecessary delay and cost are added to a project as developers look to retro fit documents to meet a lender’s requirements. .

The key message for developers new to development finance is therefore to invest in specialist advice to future proof your contracts – a stitch in time saves nine. Those experienced in development finance know what lenders are looking for and can draft your contracts accordingly so you don’t waste money, or unnecessarily damage your relationship with your lender, and are able to use your development loan at the earliest opportunity.

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