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Service: Leasing, Project Finance, Projects & Construction, Property & Development, Property Development, Property Transactions, Strata & Community Title
Sector: Real Estate

The art of the Fund Through – critical considerations for a beneficial venture

In a market where credit is tightening and banks are reducing their allocation to development loans due to global macro economic trends there are obvious benefits to developers intent on pursuing a "fund through" structure. Developers have the opportunity to benefit from the security of capital under such a structure which might not otherwise be available from traditional lenders of development finance.

Fund through structures also benefit investors in providing investors with access to high-quality brand new product underpinned by secure and long WALEs.

The fund through is not specific to a particular asset class but are becoming more prevalent with commercial office, childcare, large format retail and hotel developments underwritten by quality lease covenants.

What is a fund through structure?

A fund through structure involves a developer and investor. The developer may own the land to be developed and divested (or has otherwise secured the rights to acquire and develop). Typically, the investor provides construction finance to a developer for the construction of improvements in consideration for the transfer of land, a development agreement for the delivery of the completed building and a regular coupon payment on all monies drawn-down during construction including the land purchase price. The fund through structure (where the investor purchases the land and funds the construction payments to the developer) gives the investor an immediate return on their investment.

It may be that the transfer of land occurs after completion of the development in which case it will be imperative for the investor to take appropriate precautions to secure its funding including by mortgaging the developer's interest in the freehold.

The fund through is predicated on a lease commitment being in place in the form of an agreement to lease (with it being prudent for the developer's construction deliverables to be aligned with the deliverables in the agreement to lease).

Where an investor is funding the construction, it is critical for these payments to be secured and a fund through structure usually involves a number of agreements involving third parties – in that regard:

1. there is usually a building contract (commonly for a guaranteed maximum price) between the developer and a builder for the construction of improvements pursuant to the agreement to lease – it is not uncommon for the investor to have some influence over the form and substance of the building contract to ensure a proper alignment with the requirements of the agreement to lease with regards to design, construction deliverables, timing for completion and extension of time claims;
2. tripartite deed between the developer, investor and builder providing the investor with step-in rights under the building contract in the event of a default on the part of the developer;
3. independent certifier deed between the investor, developer and independent certifier governing the appointment of the independent certifier to make critical decisions under the development agreement as between the investor and developer including the certification of work carried out and completed, payment claims, extension of time claims and practical completion;

4. security documentation in the form of a corporate guarantee/personal guarantees from related entities of the developer or a general security deed over the assets of the developer in favour of the investor; and
5. a bank guarantee (or other security) proffered by the developer for the benefit of the investor.

The fund through structure is markedly different to a “take out” which requires the investor to pay a deposit on execution of the land sale contract/option agreement with settlement usually linked to the date of completion of the construction works and commencement of the lease pursuant to the agreement to lease.

Investor Considerations

The price offered to investors under a fund through structure is usually lower than the price that would be offered under a “take out” on the basis that the developer is not required to seek debt funding – the lower price is also driven by the additional risk taken on by the investor in funding construction.

If the fund through is predicated on the investor taking title of the property on completion of the development then the investor will not be in a position to leverage the property for debt funding purposes. For that reason, the investor must ensure it has the capital available to fund the progress payments to the developer. Even where the property is able to be leveraged, this may not be sufficient to generate the required levels of finance so the fund through structure is therefore more appropriate for investors with sufficient capital capable of being allocated to the project (with little or no reliance on debt funding).

The following protection mechanisms are usually embedded in the structure for the benefit of the investor (which provide the investor with considerable control over the project):

1. the developer usually provides security in the forms mentioned above which would likely include a general security deed over the assets of the developer, a mortgage over the property (if title has not passed to the investor) and a bank guarantee;
2. the appointment of an independent certifier to certify the payments to be made to the developer and to also certify completion of the building works provides the investor with supervisory power to ensure construction deliverables are being met – it is prudent to ensure that the relevant payment milestones in the development agreement (as between investor and developer) align with the requirements of the building contract to eliminate any gap risk;
3. insulation from cost overruns by applying a maximum cap on construction and development costs with the developer;
4. step-in-rights permitting the investor to replace the builder and/or developer (on account of any event of default) to facilitate the completion of the project;
5. the deferral of the investor’s obligation to pay the development margin to the developer on completion of the project and lease commencement;
6. the implementation of milestone targets with regards to construction deliverables and timeframes for delivery of the project – this provides time certainty for the investor and is also essential to ensure the delivery of the project will meet the required time stipulations under the agreement to lease; and
7. compulsory buy-back mechanisms compelling the developer to purchase the property back from the investor where the agreement to lease terminates or the project is not delivered on time.

Fund through structures may be extremely tax effective for investors where stamp duty is paid on the land price as opposed to the land which is transferred on an “as complete” and improved basis.

Developer Considerations

The fund through structure operates as a “pre-sale” for the developer and benefits the developer’s liquidity position as the developer’s costs are funded by the investor. However, there are limits, and the developer usually bears the risk associated with cost overruns so it would be prudent for the developer to pass such risk to the builder (to the fullest extent possible in the circumstances).

The issue with the developer being privy to the building contract is that the developer will assume the burden of payment obligations which will ultimately be passed through to the investor. If the payment obligations are not met by the investor then the developer will be exposed to credit risk. With an investor default of this nature, it is common for the developer to have the benefit of a call option to acquire the title to the property from the investor (where it is transferred prior to completion). This may leave the developer in an unenviable position as it may be forced to assume control of a project which it may not have the financial appetite to assume control over by virtue of the buy-back mechanism. Ways to mitigate risk include ensuring a sound level of security for performance by the investor under the development agreement, taking steps to preserve the enforceability of the buy-back regime and contracting with an entity of substance/strong financial standing.

The developer is also exposed to a builder default. An example of this is where the builder does not complete and facilitate handover on time. This is a scenario which should be contemplated when negotiating a development agreement noting that it is not uncommon for a default by the builder to enliven the investor’s step in rights to replace the builder and/or developer. Mitigation strategies against such risk include appointing a reputable and reliable builder and ensuring that there is sufficient time contingency built into critical time stipulations in the development agreement when compared with the time stipulations in the building contract.

Mutual Considerations

The establishment of a clear vision with regards to the project brief, design, construction deliverables and timing is imperative for the success of a fund through. This involves detailed prescriptions with respect to the project brief so that there is a clear course of action as the project progresses which will assist with mitigating the scope for disputes to arise.

To the extent design is not agreed and available at the outset then it is critical for processes to be enacted which appropriately integrate the requirements of the tenant, developer and investor for the project particularly with respect to cost and timing.

Concluding Remarks

Fund through structures are complex and bespoke. Ventures of this nature require considerable deliberation to be given to each element of the transaction which should be supported by competent and sophisticated legal counsel.

The tightening of credit and lending practices from banks and traditional lenders of development finance may result in fund through structures increasing in popularity particularly in view of the limited supply of quality assets being brought to market which will likely increase the risk appetite for some investors.