

Financial risk management for funding agencies on major construction projects

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Abstract

This paper examines in detail a now proven methodology for managing the interests of lenders on major construction projects. By way of a case study approach we detail the means by which lenders' financial controls are successfully instituted and monitored on major construction projects within New Zealand. The requirements of lenders on major projects has been undergoing a redefinition and this paper demonstrates the increasing demands being placed on the quantity surveyor or cost engineer to provide the fiscal safeguards which these clients require.

Keywords: funding, certification, due, diligence, risk, mitigation

Introduction

Project Audits and Cost to Complete Certification are not new to quantity surveyors. Most practices in New Zealand would have experience of providing monthly reports to funders as a double check that their exposure is manageable.

The requirements of funders on major high-risk projects are now taking on totally new dimensions. Their requirements are becoming increasingly more attainable as quantity surveyors and cost engineers gain experience in funding certification and the banking industry and can translate that experience into appropriate products and services. In part this is driven through researching clients' requirements and tailoring a service to meet and exceed those

requirements and consequently enable the funders to increase their level of funding or to fund at risk levels not normally envisaged.

The client relationship

Collectively, as Quantity Surveyors and Cost Engineers, our clients for Funding Certification on major construction projects are the Lenders. We are their trusted advisers who provide expert advice on the property and construction industry processes. We are their eyes and ears and as such have to be able to speak their language, that of the banking industry, as well as that of property and construction procurement.

In the client's eyes we are engaging in a process of applied risk identification and mitigation. A client bank or institution funding a major project primarily sees itself as being the potential owner of the development being funded. If the developer defaults on the loan the funding institution usually holds as its ultimate form of redress, the right to title on the property or a guaranteed process by which the project can be completed to enable realisation of the debt.

The majority of such funding institutions would not see themselves as property owning businesses; consequently their interests would lie in disposing of the property at a price sufficient to recover their outlay.

The service that they require is one which best protects all of these interests.

Scope of Services

Due Diligence Audit

The first part of any funding certification is the due diligence or initial audit which is carried out to provide the funders with assurance that the project is indeed viable and that in the event of the developer's demise, the funders have a saleable asset against which to recover their funds. It is also the benchmark against which ensuing financial performance is measured.

The scope of works offered to funders includes:

- Detailed examination of the development cost especially:

- Δ Review estimates of construction costs against the contractors tendered or negotiated cost

- Δ Reasonableness of the level and timing of preliminaries

- Δ Review of contingent provisions. This is done through Quantifiable Risk Analysis (QRA) techniques.

- Δ Review all other costs within the development budget

- Δ Comprehensive QRA to determine probable outcomes of all costs.

- Resources and Building Consents

Critically review all Resource and Building consent documents and conditions to ensure they can be met and identify any potential risks.

- Conditions of Contract

Extensively review the total contract documentation including all transaction and project documentation and briefs to highlight any potential risk to the Developer and Lenders.

- Ensure that all requirements pertaining to the development have been satisfied within the contract documentation and obtain a sign-off on the project brief and other documents.

- Review and report on the adequacy of services and technical innovation to ensure that market expectations are met.

- Review and report on the tender and ascertain reasonableness of proposal for the scope of work to enable cost to complete mechanism to operate correctly

- Review and report on proposed project reporting methods and procedures.

- Review and report on any alterations to drawings subsequent to Sale and Purchase agreements becoming operative.

- Review and comment on the construction and development programme.

- Peruse all documentation relating to the development to satisfy ourselves on the lenders

behalf that the amount of the loans and the programme allowed are sufficient to undertake the development in accordance with the plans and specifications.

- Review and report on the Management procedures and personnel involved in the project including all consultants.

- Review and report on the capability of the contractor to fulfil the obligations of the contract.

This is an extremely detailed and in-depth audit of the project. It often involves many man-weeks of senior time to fully evaluate the development. This may also involve working with real estate people, valuers, solicitors and other specialist consultants where necessary to satisfy all requirements of the due diligence. This initial due diligence certification will be structured to meet the varying requirements of individual funders.

Invariably the quantity surveyor's internal knowledge of the industry as a whole and personnel involved can be of valuable assistance to funders at an early stage when they are carrying out a preliminary review of funding prior to credit papers being presented. We can often prevent funders wasting unnecessary time considering funding for a project that will not be viable.

The end product of this research is a Certificate to the lenders that unequivocally states our opinion as to the risks faced by the lenders and the ability to mitigate those risks or a report of recommendations that should be incorporated into the project requirements to satisfy our requirements to sign off the project.

Monthly Certification

The prime concern of the lenders during the construction process is ensuring that the money available is at all times sufficient to complete even if the developer or the contractor was to fail during the course of the project. At no stage may the current cost to complete the project, including all variations and changes to project requirements, exceed the funding available. This is monitored on a category by category basis, reporting against the feasibility approved for funding. If any category cost to complete exceeds funding available for that category then expenditure against contingency has to be approved and monitored monthly. The funder must approve all expenditure additional to the original feasibility.

The key indicator, which the lenders rely on,

is the estimated cost to complete. We certify that the estimated cost to complete the development, as at the date of the certificate, will not exceed the amount of the loans that will remain available for drawing.

The monthly certification report becomes a sizeable document that can include:

- The cost to complete certificate
- Our certification that there has not been material change to the development either carried out or authorised without the consent of the lenders.
- A review of all relevant correspondence in respect of cost and time overruns and submit to lenders for approval.
- Certification that the development is being carried out in accordance with the approved plans and specifications.
- Certifications from separate building consultants (architects and engineers) that the construction of each part of the development has been carried out to a proper and workmanlike standard and manner.
- Certification that the estimated date of completion of the development and the construction timetable is achievable.
- A detailed commentary on progress against programme, notification of delays and extension of time claims.
- Review the building owner's Monthly Report prepared by their project manager and comment on the administration of the Contract by the parties.

The monthly Certification report is accompanied by a signed drawdown advice which sets out the full financial details of the drawdown, cost to complete and a range of associated key indicators. In addition a wide range of processes that cover the confirmation of payments to subcontractors and suppliers are implemented.

The process of continuity guarantees requires the subcontractor to complete the project directly for the funders should the main contractor default on the contract. The process of ensuring all monies drawn down from the funder have been applied to satisfy all the project debts on a month by month basis ensures that a main contractor cannot use funds from this project to support other projects.

A major requirement of Project Audits is to ensure that the building as designed and approved for funding is in fact completed to the level of appointment to satisfy all lease and sale agreements thus enabling the funders to satisfy their debts. It is also necessary to satisfy the funders that no element of developers profit is paid out until all funder's requirements have been satisfied.

Completion Stages

In the lead up to practical completion and during the completion phase the following is carried out:

- Review and report on Practical Completion plans and risks and performance of the Borrower in achieving Practical Completion as scheduled.
- Check and assess the completed parts of the building for compliance with the Master Agreement and Sales Contracts to ensure operation and settlement can be effected.
- Provide a Certificate of Practical Completion to the lenders
- Assist with arranging for as-built records and project accounting data to be provided to the lenders.
- Review defects lists and monitor completion of work as necessary to satisfy Sales Contracts, Master Agreements and Building Contract.
- Assist with the settlement process and documentation as required to satisfy the obligations of the Borrower under the Transaction Document.

Throughout the project we have an overriding obligation to notify the Lenders immediately if we become aware of anything that:

- Makes any previous certificate / statement incorrect
- Will delay practical completion
- Will result in a variation
- Will increase the cost to complete over budget
- We consider in the context of the development to be of material interest to the Lenders
- May involve a breach of any transaction documents.

Project relationships

In providing the service to the Lenders, our contractual relationship is entirely with them. However in order to access and validate the information required to provide this service it is necessary that we have a contractual relationship with much of the construction team.

Generally this is not a problem — it is obviously in the interests of the developer and his agent — possibly a project manager — to ensure that we are included within the information loop and the respective appointments and contracts can reflect this.

The project consultants - including architect, engineers, and quantity surveyors - have often been appointed well in advance of our arrival on the scene. We are reliant to a certain degree on the reports that they produce. However these consultants have no contractual link to the Lenders or to us as the lenders representative.

We have introduced Deeds of Covenant that create a duty of care between any consultants, whose advice we have to rely upon, and ourselves.

The keys to this document are the following Clauses:

In the performance of their obligations Maltbys will be relying on reports, information and material provided to Maltbys by the Consultant produced by the Consultant in the discharge of its obligations to the owner and the contractor.

Maltbys wish to have the Consultant acknowledge and agree that the Consultant owes Maltbys a duty of care and other obligations in relation to the reports, information and material provided to Maltbys and relied upon by Maltbys.

The full Deed of Covenant provides security to the Lenders that they, through us, are able to rely on the advice of the Consultants as professional advice. It also provides them with an ability to seek legal remedies from the Consultant and their Professional Indemnity insurers as if the Consultants were providing professional advice directly to the Lenders. This redress would be available through common law but is faster and more effective when incorporated into a contract.

Fees and charges

The fees for funding certification are generally negotiated directly with the lenders, although in the final analysis the borrower or developer will pay them for

To be successful in offering such a service it advisable to use very senior personnel who can relate directly to the banking fraternity and who have the experience and confidence to be able to make judgement calls.

As can be seen from the scope of work above, the lender can require a very extensive service and it is not unusual for the funding quantity surveyor's fee to exceed that of the project quantity surveyor (excluding BQ production).

Conclusions

In New Zealand increased globalisation has resulted in funders, developers and contractors from overseas playing a major role in the market. This applies now to most countries in the world.

The net effect is that funders in particular are operating in markets in which they have little hands on experience. In order to identify and manage their risk they need professional advice that is tailored to suit their particular requirement.

What the lender's quantity surveyor can bring to the table is that professional service and downstream benefits that include:

- Greater surety of outcome
- An over-riding discipline to the total development process
- A rigour that is often not present in development projects — eg checking of the sale and purchase agreements
- Additional assurance to the end owner that he will get what he has commissioned.

Financial Risk Management for Funding Agencies on Major Construction Projects has international applications on a wide range of project types including:

- Private development projects
- Public development projects
- BOOT and privately funded infrastructure works

It is a further tool for the quantity surveyor and cost engineer in project risk management and mitigation. 