Risk Management for Construction Loans

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Outline of Presentation

- Introduction
- Understanding of Risks
- Risk-Return Expectations of Capital Providers
- Risks that Providers of Finance Consider
- Risks Managements/Mitigation Tools
- Shelter Afrique Experience
- Conclusion

Introduction

- Projects must however meet requirements of technical feasibility and financial viability. They must yield the required rate of return and other non-financial benefits;

- The nature of housing and construction projects require the involvement of many parties;

- Architects, Engineers, Quantity Surveyors are well aware of the importance of a well-prepared and implemented project;

- Once a good project has been identified and prepared the next step will be how to finance it.

Introduction……….

- Finance is one of the most important inputs in project development;
- Many financiers, especially banks shy away from construction financing/loans because of their perceived risks;
- A typical construction project involves many actors, authorities, services providers, technologies and time
- Lenders are concerned about how these actors and variables interplay and time implications;
- Evidence shows that most capital projects are funded through a combination of equity and debt;

Understanding of Risks

- Risks broadly defined relate to the probability that the expected outcome would not be realized for whatever reasons;

- The interests of the different stakeholders (developers, lenders, managers, services providers) in the value generated in a firm or project could lead to different understanding of risks;

- Construction and housing projects and in fact all investment activities are inherently risky undertakings;

- Most capital providers are risk averse and would prefer to avoid risks, hedge them or be adequately compensated for whatever risks they assume;

Risk-Return Expectations of Capital Providers

- The characteristics of providers of debt and equity are the same: they seek returns commensurate with the risks they assume;
- Debt providers worry about downside risks: they lose if the borrower defaults or goes bankrupt. They are therefore not worried about 'up side' potential since they do not partake in it;
- Equity providers or owners of the company want to maximize their returns. Interested in 'up side' potential at the expense of 'down side' risk. In the event of default or bankruptcy they invoke their limited liability protection;
- Both debt and equity providers therefore have different perceptions of risks. They also seek different security for their investments;

Risk-Return Expectations of Capital Providers..........

- Debt providers depending on whether their funds are secured or enjoy seniority status have first claim on borrower’s assets;
- Most major debt providers operate in regulated environment and are expected to meet certain prudential and risk management guidelines;
- Loans being financial assets are priced based on *risk free interest rate + inflation premium + risk premium;*

Construction Loans Risks

- While equity signifies the promoter's confidence in the particular project, it is never sufficient to completely fund construction projects.

- In most projects therefore debt is needed (in multiples of equity) to complete the financing of a construction project;

- Outsourcing is used in many construction projects thereby increasing the risk of non performance.

Construction Loans Risks

- The type of organization, ownership structure, business areas and availability of projects with positive net present value, amongst other factors determine the capital structure of the firm.
- A firm is a complex contractual system of agents (managers) and principals (shareholders) with diverse and at times conflicting interests or objectives which more often than not generate serious agency problems;
- debt creation is one of the ways of reducing agency problems and conflicts since managers are literally forced to generate sufficient free cash flows to pay creditors. The cost of not acting in the interest of the firm is bankruptcy which could jeopardize the interests of both the agents and principals;

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Construction Loans Risks

- **Land acquisition and titling risks**: Land is the bedrock of most construction and housing projects and where its ownership is in doubt and transfer tedious, owners of capital could be discouraged from investing or demand higher premium;

- **Performance risks** (by statutory and approving authorities, service providers, contractors, developers and buyers) ;

- **Funding risks** mainly due to the tenure and pricing of funds available in the market due to inflation and asset/liability mismatch;

- **Marketing risks** arising from the inability of the investment to generate adequate cash flows to service the loan due to rising prices, cost and time overruns, lack of demand, etc.

- **Quality and safety performance risks**: many projects do not meet basic quality and safety standards when subjected to use.

Risks Managements Tools

- Most lenders consider characteristics such as capacity, credibility and collateral of borrowers before giving out loans.
- These are the bedrock of credit underwriting and risk management: capacity to conceive and implement the project; credible to produce reliable data and honour obligations; quality collateral to deter non compliance;
- Thorough understanding of construction projects, cost, management of the procurement system and use of competent service providers;
- Land free of any encumbrances: developers to fund this as part of its contribution. Value to be real not speculative. Title verifiable

Risks Managements Tools

- Better use of building insurance performance bond, professional indemnity, defects insurance,
- Cash flow management to ensure that loan proceeds are correctly applied and that proceeds from projects are captured and retained for loan servicing.
- Complete financing plan before project commencement including large equity component of not less than 30%;
- Quality control and independent monitoring of implementation process;
- Availability of take-out finance.

Risks Managements Tools

- Proper loan documentation and clear understanding of the covenants and provisions of the agreement. May be better to keep the agreement simple;
- Collateral and third party guarantees that could be enforced with minimal difficulties;
- Syndication or diversification and spreading the risk amongst many lenders especially in large scale construction projects;
- Diversification is important. to avoid large loan concentration or exposure to few borrowers

Shelter Afrique Experience

- Shelter Afrique provides construction finance for housing projects in over 25 countries;
- It works with mainly small and medium-sized developers mainly family-owned businesses, some first time developers;
- Average loan amount per project is about US$1 million. Performance has been generally good with zero loan loss since inception.
- Foreclosures where necessary have resulted in full recoveries indication of good collateral value.
- Good legal system help to minimize construction loan risks.

Conclusion

- Risks are never a deterrent to capital providers if the rewards are commensurate;
- However dominant institutions with capital have other potentially good areas to put their funds;
- Some promoters of housing construction projects have not done themselves much good in the way they package their projects;
- Services providers such as contractors and professionals are critical in managing construction risks.

THANK YOU

- Everything that is worthwhile in life is scary. Choosing a school, choosing a career, getting married, having kids, *even choosing any a project for funding* (emphasis mine)--all those things are scary. If it is not fearful, it is not worthwhile.

  -Paul Tornier

Address

Shelter-Afrique

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