Property development

Summary of the Operation Performance Evaluation Review

THE PROJECT

The project scope was to complete a half constructed Class A office building for commercial letting in a prestigious area in a major city of the target country. The construction of the project building was first commenced in the mid 1990s by one of the country's leading financial institutions aiming to build its headquarters. A leading foreign developer (the contractor) was hired to carry out construction works. However, the financial institution became insolvent and merged with another financial institution in the mid 1990s under the banking reforms, thereby creating one of the largest financial institutions in the country.

In 1999, the merged financial institution (the FI) and the contractor who also acted as the other sponsor, agreed to carry on the construction in a project finance structure (the project). They jointly established a limited liability partnership (the borrower). The European Bank for Reconstruction and Development (EBRD) joined the project by providing a senior loan with an equity kicker that could increase the EBRD's return on investment according to the property value. The construction of the half built project building resumed in 1999 after being moribund for several years. The construction was significantly delayed against the schedule. The FI occupied 30 per cent of the project building in 2001 after a seven month delay.

Tenant pick up was very slow for various reasons. In 2002, a major foreign organisation moved into the project building occupying 25 per cent of it. The rent stream has since stabilised and the occupancy rate has increased. The project completion was, however, delayed because of disagreement between the EBRD and the sponsors on certain issues. The EBRD notified the borrower of the project's completion in October 2004.

PROJECT RATIONALE

The project had a strong rationale for the sponsors. In 1998-99 the country's economy experienced a downturn. The FI tried to dispose of the project building, but failed at auction three times. The contractor needed to recover the construction receivables, which remained unpaid. Neither party had enough cash to complete the project building. General market practices prevented international financial institutions such as commercial and investment banks from helping the sponsors with a partly completed property on technical and liability grounds. The EBRD's involvement was considered indispensable in order for the sponsors to turn an unviable piece of property into a viable investment.

The project was justified by the EBRD mainly from the viewpoint of transition impact. However, a sceptical view about the market assumptions and potential transition impact was noted by the EBRD during the appraisal. Another rationale underlying the project was an attractive return to the EBRD. An additional investment to complete the building was expected to make a full cash flow available. The sponsors agreed to an equity kicker in addition to a high margin on the loan.

ACHIEVEMENT OF OBJECTIVES

The objectives of the investment were to achieve:

1. profitability for the borrower
2. a satisfactory occupancy rate and reasonable rent
3. long-term demonstration effects from the construction of the project building.

The Evaluation Department considered the achievement of the objectives was *Good*.

Despite a slow pick-up, the occupancy rate of the project building rose significantly, first from 16 per cent to 24 per cent, then from 48 per cent to 79 per cent between 2001 and 2002. In 2003, the occupancy rate remained at 76 per cent. In the first half of 2004, 21 tenants occupied 81 per cent of the project building, which was close to the market average of 88 per cent.

The current market per tenant average is US$ 27 to US$ 35 per square metre, with the target rent a Class A building owner can offer a potential tenant is US$ 35 per square metre. The project building's per tenant rent ranges between US$ 7 and US$ 39 per square metre. The average is US$ 27 and the median is US$ 30. These figures have kept abreast with the market level.

It is difficult to argue that the project building's long-term demonstration effect facilitated property development in the city. Given the strong economic outlook, many foreign companies have started searching for more space. The Class A office market is currently full of optimism and favourable market conditions are likely to be linked to other factors for the next few years. It appears clear that development activity has not been intensified by the project building's demonstration effect. This objective was, therefore, not achieved by the project.

OVERALL ASSESSMENT

The Evaluation Department considered the project to be *Successful* according to the EBRD's Operations Performance Rating System.

The current occupancy rate is more than satisfactory to the EBRD. Although the project building did not stimulate construction activity of other similar buildings, the achievement of the project's objectives was *Good.*

The project has delivered *Some* environmental change, but the major environmental impact has been adequately mitigated in accordance with the EBRD's policy and guidelines. Therefore, the rating for the environmental performance of the project and the sponsors was *Satisfactory*.

With the Class A building and facility management services up to international standards, the project has generated *Satisfactory* transition impact with low risks to transition potential. The EBRD's additionality in financing the project was *Verified in all respects* given the conditions of the financial markets at appraisal time.

The Evaluation Department assigned a *Good* rating for the financial performance of the Company and the project. A few concerns were identified about how the operation team handled the project, in particular during project preparation. Therefore, bank handling received a *Marginal* rating.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The Evaluation Department gave the project's transition impact a *Satisfactory* rating. The risks to transition were considered *Low* as most of the impact has already emerged and the Class A office market is receptive to new technology, international practices and business conduct. The transition impact for the industry and the economy at large was assessed as *Good,* particularly in terms of private ownership and increased competition.

The following special features of the project building have had a positive impact on the domestic property market: (i) anti-seismic design and construction: The project building was one of the few anti-seismic Class A buildings in the country, a design feature now considered standard in the local property market; (ii) National Fire Protection Association, US standard fire life work: Sprinklers are a unique feature in the project building among all Class A buildings in the country; (iii) insurance coverage for terrorism; (iv) tight security; and (v) quality leases. The transition impact with respect to the introduction of new standards was *Good.*

ENVIRONMENTAL IMPACT

The project, which involved significant construction work, was classified as B0. No contamination or other significant potential liabilities were found during the environmental analysis. The environmental risks were adequately screened at appraisal. The environmental issues which emerged during project implementation included: (i) anti-seismic design and construction; (ii) waste-water treatment and legionella control; (iii) sprinkler installation; (iv) heating, ventilating and air-conditioning; (v) workers health and safety measures; and (vi) an access road. These issues were dealt with satisfactorily by the EBRD and the lender's supervisor. On this basis, the Evaluation Department rated the environmental performance of the project and the borrower as *Satisfactory.*

COMPANY FINANCIAL PERFORMANCE

Even though uncertainties have arisen due to the expected relocation of a major tenant in 2006, the Evaluation Department considered that the financial performance of the project and the borrower continues to be *Good* for the duration of the loan. Based on current assumptions, EBRD's investment return is estimated at 9.5 per cent against 8.6 per cent at appraisal, and at 11.9 per cent if it exercises the equity kicker.

BANK HANDLING

The Evaluation Department assessed bank handling as *Marginal* based on the following major findings.

Project preparation and due diligence. As the project building was half built at the beginning of the EBRD's involvement, the prior to the project construction costs should be reasonably consistent, from a technical viewpoint, with the physical works delivered, so that any unpaid job from the prior to the project construction period would not be charged on the EBRD's financing. However, such a technical substantiation was omitted at the project preparation stage. This technical substantiation should have taken place since the turnkey contractor was the same as for the prior to the project construction. Further, technical and financial liability for any engineering fault caused during the prior to the project construction period should have been made clear prior to the EBRD committing to financing. However, engineering due diligence only occurred after appraisal.

Consultant's recruitment. A consultant who acts as a lender's supervisor must be contracted by the EBRD and not by the sponsor or the borrower. The consultant should work under the direction and for the primary benefit of the EBRD so that conflicts of interest can be avoided. In this project, however, the lender's supervisor was not hired by the EBRD, but by the borrower. Potential conflicts of interest arose during construction management supervision, particularly with respect to the lender supervisor's endorsement of construction works against the EBRD's disbursements.

Cash shortfall and delayed debt servicing. The Evaluation Department and the sponsors had an optimistic view of the physical completion of the half built building due partly to the lack of engineering due diligence during appraisal. The agreed cash contribution from the sponsors was only US$ 2.2 million against the EBRD's commitment of about US$ 10 million. This financing structure was vulnerable to any unanticipated event such as a completion delay, which actually occurred. The borrower fell into a serious cash shortfall and failed to service the debt in a timely manner during the first five consecutive interest periods. During the same time, the EBRD continued disbursing by waiving the event of default and offsetting the unpaid amount against the drawdown.

Project design. The project was designed as a finance project. In substance, however, the lending conditions for the construction phase were more like ones for corporate finance to the contractor/sponsor. No physical completion date was set out in the agreement, while risks were all put under the umbrella of the contractor/sponsor's completion guarantee. The avoidance of defined construction milestones allowed the contractor to exert too much discretion during construction management and, thereby, avoid the lender's intervention in the construction progress as well as the project cost variations, which are normally required in a project finance structure. The mechanism of the project finance did not work properly due partly to the FI's low level of interest in controlling the project because the FI's only objective was to complete the part finished building. The EBRD could have structured the project to ensure more transparency in the construction management.

Clearance of the condition precedent to disbursements. The agreement stipulated a condition precedent to the first disbursement, which required a minimum debt service coverage ratio. The EBRD overestimated the projected cash flow despite there being no rental income due to the completion delay. The EBRD executed the first disbursement based on this overestimation in order to make cash available to the borrower.

Design and handling of the mandate related covenants. The quality lease covenants, including EBRD's standard lease agreement, are the EBRD's intervention tool to realise the transition impact. If breached, waived or eased, there could be a lesser degree of transition impact than expected. There have been a series of breaches of the required leasing parameters which have resulted in waivers of the quality lease covenants in order to proceed with further disbursements. These suggest that the quality lease covenants did not fully achieve their objectives and were finally waived.

With regard to covenant administration, the Evaluation Department noted the lack of transparency and accountability in the process of compliance monitoring, particularly for waiving mandate related conditionality. Major covenant breaches, even if they are waived, should be appropriately recorded in the monitoring reports.

MAIN OPER ISSUES AND LESSONS LEARNED

The importance of technical due diligence for partly completed property and infrastructure

Lack of technical due diligence during the project design stage resulted in an overly optimistic construction schedule and contractor driven project implementation.

Lesson Learned

The absence of appropriate technical due diligence can result in inadequate project design for a partly completed property. Technical due diligence, which provides critical information for financial parties such as the EBRD, must form one of the core elements of a comprehensive project design, in particular for a project involving construction works. Although the technical due diligence in this case was for a partly completed property, investigations during project preparation should have been carried out with the same rigour as for a new construction project and this pivotal information should have been reflected in the project document for Board considerations and incorporated in the agreements.

Potential conflicts of interest in construction management supervision

The EBRD's rules required a lender's supervisor to be hired by the EBRD. However, the lender's supervisor, based on the Property and Tourism Team's request, was employed by the sponsor and later by the borrower. This action undermined the EBRD's principles in its operations for sound practices.

Lesson Learned

Securing the independence and integrity of a lender's supervisor is a prerequisite. The EBRD's projects should foster transaction integrity whereby the main focus is transparency and accountability. The EBRD's policy and rules to prevent potential conflicts of interest should be strictly observed in order for the EBRD to receive full, fair and unbiased advice, which would secure transaction integrity. Accordingly, the independence of the lender's supervisor was crucial for the sound execution of the project.

Cooperation between headquarters (the operation team) and the resident office

Some external parties involved with the project gained the impression of a slow response and weak accountability for the project on the part of EBRD staff. The

Evaluation Department is of the view that the fragmented and undefined delegation of responsibilities produced only marginal effects on the project implementation. The Property and Tourism Team at headquarters could have taken more initiative with respect to implementation.

Lesson Learned

Enhancing cooperation between headquarters and the resident office can improve project quality. Taking into account the volatile nature of the property market in some of the EBRD's countries of operations, it is essential that continuous updates on market conditions and changes in risk profile are provided. They are a vital input to the EBRD's monitoring regime. In this case, the resident office could have played a key role in monitoring the fast changing local property market. The Property and Tourism Team may wish to ensure the continuity of support monitoring mechanisms with the assistance of one of the resident office staff members.