

Risk Review – Bulgarra Apartments

City of Karratha



McLEODS

Lawyers

Stirling Law Chambers | 220 Stirling Highway | CLAREMONT WA 6010

Tel: (08) 9383 3133 | Fax: (08) 9383 4935

Email: mcleods@mcleods.com.au

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Background

- (1) The City proposes to lease three sites (Lot 636 Nairn St, Lot 1926 Ridley St, and Lot 751 Gregory Way) to Karratha Development Pty Ltd (**Developer**) for the construction and operation of 116 modular dwellings.
- (2) The City will provide a \$56 million loan facility, secured by a General Security Agreement (GSA) and a charge over the dwellings, with ownership of the assets reverting to the City at lease end, as more particularly set out in the Business Plan prepared for the proposed transaction.
- (3) The City has instructed us to assess the structural and contractual risks during the operational period of the Bulgarra Apartments proposal, specifically focusing on the risk allocation, enforceability, and sustainability of the City of Karratha's investment framework.

Contractual and structural risk assessment

1. Risk allocation

- (1) The financial structure and contractual arrangements between the City and the Developer involve a complex allocation of risk that requires careful management. While the documentation — including the Development Agreement, Loan Agreement, and Lease — generally assigns responsibilities to the party best positioned to manage those risks, there remain significant exposures for the City, particularly in the event of default or underperformance by the Developer.
- (2) The City's principal risk lies in its financial exposure under the \$56 million construction loan facility. If the Developer fails to deliver the project or defaults on its repayment obligations, the City may be required to step in to complete construction or service the debt. In such a scenario, the City would also inherit ongoing obligations associated with the maintenance and operation of the asset.
- (3) On the Developer's side, the key risks relate to project delivery and operational performance. The Developer is contractually responsible for ensuring the project is completed on time and within budget, for bearing the risk of cost overruns, and for achieving sufficient tenancy and cash flow to meet loan repayments. These obligations are fundamental to the financial viability of the development and the repayment of the loan.
- (4) While the contractual framework attempts to align risks appropriately, the City remains materially exposed in downside scenarios. It is therefore essential that strong governance mechanisms are in place, particularly in relation to the administration of loan drawdowns and the certification of construction milestones. This includes ensuring that all payments under the loan are tied to verified progress — ideally certified by an independent quantity surveyor — and that any default triggers are clearly defined and enforceable. These measures are necessary to safeguard the City's financial interests and ensure that risk is actively monitored and managed throughout the life of the project.

2. Triggers and remedies in default scenarios

- (1) The contractual framework outlines several key events that would constitute a default by the Developer. These include failure to commence construction within the agreed timeframe, failure to meet loan repayment obligations, and failure to operate the development in accordance with the agreed terms. Each of these events poses a material risk to the viability of the project and to the City's financial position.

- (2) In the event of a default, the City is entitled to exercise a range of remedies. These include the right to assume ownership of the dwellings developed under the project and the ability to enforce its security interests under both the registered charge and the General Security Agreement (GSA). These enforcement mechanisms provide the City with a legal pathway to recover value or assume control of the project if necessary.
- (3) While these remedies appear adequate in principle, their effectiveness will depend on the clarity and strength of the underlying provisions. To ensure enforceability and practical application, it is essential that the agreements incorporate:
 - (a) **Clear and unambiguous step-in rights**, allowing the City to intervene promptly where the Developer fails to meet its obligations;
 - (b) **Defined performance benchmarks**, so that underperformance can be measured objectively and linked to contractual consequences; and
 - (c) **Precise definitions of default events and associated cure periods**, to reduce ambiguity and avoid potential disputes regarding when enforcement action may be taken.
- (4) In summary, while the default and enforcement framework provide a solid legal foundation for protecting the City's interests, the practical value will depend on their clarity, enforceability, and the City's readiness to act decisively in the event of non-performance.

3. Long-Term Sustainability of the Operating Model

- (1) The financial model underpinning the project indicates a projected Internal Rate of Return (IRR) of 8.19% to the Developer, reflecting a commercially viable outcome based on current assumptions. For the City, the model forecasts a net cash outflow of approximately \$9.1 million over a 20-year period. However, this is partially offset by the projected residual asset value of approximately \$46.6 million at the end of the term, representing a significant long-term benefit to the City.
- (2) The model could be susceptible to several key risks that could affect its financial sustainability. These include potential downturns in the rental market, unexpected cost inflation (particularly in relation to maintenance or capital works), and prolonged periods of high vacancy, all of which could materially impact cash flows and project viability.
- (3) A further area of concern relates to the assumed refurbishment cycles scheduled for years 10, 13, 16, and 19. These capital works are integral to maintaining asset performance and tenant attractiveness over the long term. While the model assumes these refurbishments will occur, it is important that the requirements are imposed within the Lease, to ensure that the City is provided with a quality long-term asset quality at the end of the Lease term.
- (4) Additionally, to ensure the long-term sustainability of the model, ongoing oversight will be required, including regular performance reviews, market testing of assumptions, and clear contractual obligations around capital reinvestment throughout the lease term.

4. Insurance requirements

- (1) To protect the City's financial and operational interests throughout the Bulgarra Apartments project, it is essential that comprehensive insurance provisions are embedded across the Development Agreement, Loan Agreement, and Lease. These insurances play a vital role in mitigating key risks during construction, financing, and ongoing operation.
- (2) During the construction phase, the Developer should be required to maintain Contract Works Insurance to cover damage to the works caused by events such as fire, vandalism, or extreme weather. The City should be named as an interested party on this policy to ensure its interests are

protected. In addition, Public Liability Insurance should be maintained at a minimum coverage of \$20 million to protect against third-party injury or property damage occurring on the site. Where the project involves professional services such as design or engineering, Professional Indemnity Insurance is also recommended to cover errors or omissions. Workers' Compensation Insurance must be held in accordance with statutory requirements to cover all contractors and subcontractors involved in the project.

- (3) Once construction is complete and the loan is drawn, the Loan Agreement should require the Developer to maintain full Property Insurance on the completed dwellings. This policy should provide coverage for events such as fire, flood, or cyclone, with the City noted as mortgagee or lender. To safeguard rental income streams that support loan repayments, the Developer should also maintain Business Interruption or Loss of Rent Insurance.
- (4) During the operational phase, the Lease should require the Developer or lessee to maintain ongoing Public Liability Insurance, again with a recommended minimum of \$20 million. This protects the City from liability arising from injury or damage involving tenants or visitors. Building and Contents Insurance should also be maintained at full replacement value to protect the asset and any City-retained infrastructure. The City should be named as an interested party on all relevant policies. As an additional safeguard, the Lease may also include a requirement for a performance bond or bank guarantee to cover potential default or early termination scenarios.
- (5) Across all agreements, it is important to include clear and enforceable insurance clauses. These should specify the required types and levels of coverage, the responsible party for maintaining each policy, and the City's rights to receive certificates of currency annually. Each agreement should also include a mechanism allowing the City to step in and maintain insurance coverage at the Developer's cost in the event of non-compliance. Further, the City should reserve the right to audit the Developer's insurance arrangements periodically and require prompt notification of any claims, cancellations, or material changes to coverage.
- (6) These insurance provisions, if implemented correctly, will provide critical protection for the City and ensure that the financial and asset risks associated with the Bulgarra Apartments project are properly managed throughout its lifecycle.

Key structural risks

5. Developer default

5.1 Risk level - high

The risk of developer default, whether during the construction or operational period, is assessed as high. If the developer fails to meet its obligations, the City is exposed to a significant repayment risk on the \$56 million loan.

5.2 Mitigation Strategies

- (1) This risk can be partially mitigated by the City:
 - (a) including within the loan agreement the obligation for the Developer (and the related lessee entities) to enter into a general security agreement and mortgage of each lease to strengthen the City's rights as lender. (By way of background, a general security document is a legal document used in Australia (under the Personal Property Securities Act 2009 (Cth), or PPSA) that gives a lender or creditor a security interest over all or most of a borrower's present and future personal property as collateral for a loan or obligation);
 - (b) by ownership of the asset reverting to the City in the event of default;

- (c) defining step-in rights to ensure that the City can step in the shoes of the Developer in the event of the Developer's default; and
 - (d) the Development Agreement also functioning as a quasi "Agreement to Lease," whereby the formal grant of the leases is deferred until the development has been completed to the required standard. This approach ensures that the City retains greater control during the construction phase and avoids premature vesting of leasehold interests before key delivery obligations are met. By tying the commencement of the lease term to the achievement of practical completion, the City can better safeguard its position, reduce exposure in the event of default or delay, and maintain a stronger enforcement position until the Developer's obligations under the Development Agreement are fulfilled; and
 - (e) implementing operational control measures during construction, such as the City approving the builder and building contract and linking drawdowns to verified construction progress.
- (2) While these measures are contractually sound, their effectiveness depends on the City's ability to enforce its rights, actively monitor project delivery, and exercise step-in provisions swiftly and effectively to safeguard its financial and asset interests.

6. Insufficient rental revenue

6.1 Risk level - moderate

One of the moderate risks identified in the financial model is the potential for insufficient rental revenue over the life of the project. While the current projections are based on conservative rental assumptions, the model also includes a downward adjustment to anticipated rental income after Year 5 to reflect possible softening in the market or reduced demand over time.

6.2 Mitigation strategies

- (1) One recommended risk mitigation measure is to require, as a condition precedent to the commencement of construction, that a sufficient number of pre-sale rental agreements be secured. This would help demonstrate market demand and ensure a baseline level of tenancy upon project completion, thereby reducing the risk of early-stage revenue shortfalls and enhancing overall financial viability. By tying construction commencement to evidence of tenant commitment, the City can gain greater assurance over the project's commercial sustainability from the outset.
- (2) Additionally to further mitigate this risk, the City may consider incorporating minimum rental **levels** into the lease structure. This would establish a baseline income threshold and provide greater certainty around revenue flows. Additionally, the inclusion of structured rent review **mechanisms**, such as CPI-linked increases or periodic market rent reassessments, would help ensure rental levels remain aligned with market conditions and inflationary pressures over time.
- (3) However, it is important to note that the Developer is commercially incentivised to maximise rental income as part of its return model. As such, the need for prescriptive rental provisions may be reduced, particularly if the City is satisfied that the Developer's interests are aligned with maintaining the asset's income-generating performance. The inclusion of such mechanisms should therefore be balanced against the potential for overregulation and the administrative complexity of enforcing minimum rent covenants.

7. Inadequate maintenance and refurbishment

7.1 Risk level - moderate

The long-term success of the project is partially dependent on the ongoing maintenance and periodic refurbishment of the asset. This risk has been assessed as moderate, as while the financial model includes assumptions around refurbishment costs—particularly in years 10, 13,

16, and 19—there is no contractual guarantee that these works will be carried out. Without adequate reinvestment, the asset may deteriorate over time, potentially reducing rental income, increasing vacancy rates, and eroding the long-term value of the asset.

7.2 Mitigation strategies

- (1) To mitigate this risk, the City may consider including within the terms of the Leases:
 - (a) the contractual obligation to refurbishment in years 10, 13, 16 and 19;
 - (b) a clearly defined capital works schedule, setting out expected maintenance and refurbishment milestones during the lease term; and
 - (c) establishment by the lessee of a dedicated reserve account to fund these required works to ensure that adequate resources are set aside in advance, reducing reliance on uncertain future cash flows or discretionary decision-making by the Developer.
- (2) These above measures would support the long-term sustainability and performance of the assets and help preserve the City's financial return.

8. Enforceability of step-in rights

8.1 Risk level - high

- (1) The enforceability of the City's step-in rights is assessed as a high-risk area within the project's legal and operational framework. These rights are critical to protecting the City's interests in the event of a Developer default or failure to perform. If the City is unable to assume control of the project without legal challenge or delay, it may face significant financial and reputational exposure, particularly where urgent intervention is required to maintain continuity of delivery or protect public assets.
- (2) The effectiveness of these rights depends on the clarity and legal robustness of the underlying contractual provisions. Any ambiguity, inconsistency, or drafting gaps could significantly limit the City's ability to act decisively when required. Step-in rights must not only be clearly articulated in the legal agreements but also enforceable.

8.2 Mitigation strategies

- (1) To mitigate this risk, the Development Agreement, Loan Agreement, and associated Leases will require clear and enforceable explicit step-in provisions.
- (2) The City will also need to maintain a close level of oversight throughout the life of the project, enabling early detection of performance issues and facilitating a timely response where required.

9. Cost overruns or construction delays

9.1 Risk level –moderate

Cost overruns and construction delays pose a moderate risk to the project. Although the Developer is responsible for delivery and a 17.5% contingency is included in the financial model, site-specific risks such as ground conditions or weather may still cause cost increases. Modular construction provides some pricing certainty, but delays could result in increased capitalised interest for the City.

9.2 Mitigation strategies

Ongoing monitoring and strict cost control measures will be essential to managing this risk effectively. It is recommended that loan drawdowns be strictly linked to verified construction progress. The appointment of an independent certifier to assess milestone completion may also provide an additional layer of assurance and help ensure that funds are released only in line with actual progress on site.

10. Residual value risk

10.1 Risk level – moderate

The residual value of the asset at the end of the operating period is a moderate risk for the City. While the financial model forecasts a residual value of approximately \$46.6 million, this figure is subject to market conditions at the time of handover. As the City will ultimately bear the value risk, any deterioration in market value could significantly affect the overall return on investment.

10.2 Mitigation strategies

While there are no fixed mechanisms in place to guarantee the forecasted value, the City retains flexibility at the end of the term to manage this risk. Options may include selling the lots, pursuing strata subdivision to realise individual asset value, or continuing to operate the development under the existing leasing model. This optionality provides some degree of mitigation by allowing the City to respond to prevailing market conditions and optimise its financial position.

11. Operational risk

11.1 Risk level – moderate

Under the current structure, the City has limited oversight of day-to-day operations unless a default event occurs. This presents potential exposure to poor maintenance, ineffective tenant management, or declining asset performance over time—all of which could affect long-term financial returns and community outcomes.

11.2 Mitigation strategies

To mitigate this risk, it is recommended that the agreements include defined performance standards and reporting obligations during the operational phase, even in the absence of default. Regular performance audits or compliance checks could also be introduced to monitor operational performance. Additionally, clear enforcement pathways should be included to allow the City to intervene if standards fall below acceptable levels, without needing to rely solely on default triggers.

Recommendations

12. Conclusion and recommendations

12.1 Conclusion

- (1) The Bulgarra Apartments proposal includes substantial safeguards but also exposes the City to significant structural and financial risks, particularly in the event of default. While the \$56 million loan is secured, the effectiveness of the City's protections depends on rigorous enforcement, clear contractual terms, and active governance throughout the lease period.

- (2) A number of the identified risks can be mitigated through clear and enforceable obligations within the transaction documents. In that regard, implementing the recommendations below will materially enhance the City's ability to manage these risks and maximise long-term public benefit.

12.2 Recommendations

The City can strengthen its position by:

- (a) requiring as part of the loan arrangements the requirement for the Developer (and related entities) to enter into a Loan Agreement, a General Security Agreement and a mortgage of each lease to protect and strengthen the City's rights as lender;
- (b) requiring that the Development Agreement be structured as a quasi "Agreement to Lease," such that the formal grant of the leases occurs only upon completion of the development to the City's satisfaction. This will ensure that leasehold interests do not vest prematurely and will enhance the City's control and enforcement position during the construction phase;
- (c) ensuring step-in rights are clearly and enforceably drafted in the Development Agreement, Loan Agreement and Leases;
- (d) implementing operational control measures during construction, including approval of the builder and building contract and linking loan drawdowns to independently verified construction progress;
- (e) ensuring the City has the capacity and readiness to actively monitor delivery and enforce rights promptly in the event of default;
- (f) ensuring the Development Agreement, Loan Agreement, and Lease each include comprehensive and enforceable insurance requirements, including but not limited to Contract Works Insurance, Public Liability Insurance, Professional Indemnity Insurance, Property and Contents Insurance, and Business Interruption Insurance. The City should be named as an interested party on all relevant policies, and the agreements should require regular provision of certificates of currency, include rights for the City to step in and arrange insurance at the Developer's cost in the event of non-compliance, and allow periodic audit of the Developer's insurance coverage;
- (g) assessing whether the Developer's commercial incentives align sufficiently with income performance to potentially reduce the need for prescriptive rent controls; and
- (h) ensuring the Lease includes:
 - (i) contractual obligations for refurbishment in years 10, 13, 16, and 19;
 - (ii) a capital works schedule outlining key maintenance milestones;
 - (iii) a dedicated reserve account funded by the lessee to ensure availability of refurbishment capital;
 - (iv) defined performance standards and reporting obligations; and
 - (v) regular audits and compliance checks to monitor tenant and asset performance.