BUILDERS GUIDE TO ELIGIBLITY

Insurance Under the HBCF

This reference guide contains information extracted from the Home Building Compensation Fund's Underwriting Guidelines. The Guidelines are a comprehensive document explaining the underwriting process and are available at www.hbcf.nsw.gov.au

Purpose

The purpose of this reference guide is to enable builders to quickly understand those aspects of their business operation which are taken into account by the Home Building Compensation Fund (HBCF) in order to determine whether the builder presents an acceptable or unacceptable risk to the Fund and homeowners.

Where the overall assessment results in an outcome which is considered to present an unacceptable risk the eligibility application/review may be declined or conditions imposed on the builder's eligibility to purchase cover in order to reduce the level of risk.

Why assess risk?

The HBCF has a duty to all builders, sub-contractors, suppliers, homeowners and the community to ensure that only those builders assessed as being able to support the level of turnover applied for and complete projects for which they intend contracting are granted eligibility.

Builders running their business in a prudent manner should not have to compete against builders whose business practices are likely to result in insolvency.

Builder insolvency can have a major adverse impact on the businesses of sub-contractors and suppliers. The level of claims directly impacts on premiums levied on the industry as a whole. If premium income is not sufficient to meet claims costs the Government may have to meet the shortfall.

The HBCF compensates homeowners for losses in having unfinished work completed and defective work rectified. Nevertheless, homeowners can incur losses outside the coverage of the Fund and experience delays, inconvenience and anxiety as a result of the failure of the builder they have engaged to build their home.

Assessment and risk categories

The following tables set out the characteristics of a builder's business and the financial and other factors examined by the HBCF and the level of risk presented by those characteristics and factors.

Risk Characteristics

Builder Characteristics	Limited Risk	Medium Risk		Highest Risk
Trading Structure	Sole Traders and Partnerships between Individuals	Company		Trusts & Partnerships between corporate entities
Continuous Trading in structure	Over 6 Years	Between 2 - 6 years		Less than 2 years
Management	Rates high in Integrity, depth, excellent track record	Heavy reliance on a few key people in the business		Lacks experience or has past history of building business failure
Building Qualifications	Meets all educational requirements and keeps updating CPD points			Nil
Management Information Systems	Fully developed and installed easy to access	Partially developed and installed, some key information access lacking	Initial stages of development & implementation	Non –Existent “Shoebox mentality”
Business Planning	Detailed and comprehensive and integrated with operations			Non- Existent
Risk preference	**Risk Averse:** analyses Risk with risk minimised as much as possible	**Conservative:** Accepts risk on conservative basis	**Optimistic:** Accepts risk on optimistic basis	**Risk positive:** accepts all risks little analysis
Track record (Past Objectives)	High success rate			Consistently fails to achieve
Track Record (Character – Moral Risk)	Clean History	**Nominal Client/ supplier disputes** - always takes action to resolve before legal action	**Frequent Client/ supplier disputes** -lets it get to legal action stage	Prior failures and poor history in dealing professionally with clients and suppliers

Builder Characteristics	Limited Risk	Medium Risk		Highest Risk
Financial Characteristics -Trading Position	In all industry conditions demonstrates favourable results Performs above industry average benchmarks	In most conditions favourable results. Has satisfactory explanation for any poor performance below industry averages	Unfavourable results and trends performs below industry average benchmarks	Consistent poor/ negative performance with heavy losses
Financial Characteristics -Financial Position	Strong position with sound net asset position	Safe position with satisfactory net asset position	Marginal position with heavy external debt load	Distressed position and likely to fail under minimal stress
Financial Information	Audited, stable accounting policies, adheres to planning and budgeting processes	Audited relatively stable accounting policies	Not audited, relatively stable accounting polices	Not audited, constantly changing policies, no planning or budgeting
Shareholder/ Owner relationship	Stable, supports management, willing to inject further funds	Stable, supports management, may be able to inject further funds	Unstable, partially supports management, unwilling to inject further funds	Unstable, lack of financial and management support, will not inject further funds

Financial Risk Factors (Small and Medium Builders)

Ratio	Low Risk	Medium Risk	High Risk
Gross Profit margin (Gross profit as a percentage of Cost of Goods sold)	> 20%	12%-19%	<12%
Net profit margin before tax	>8%	4-7%	<4%
Adjusted Net Tangible Assets ANTA/ turnover	> 10-15%	5% - 10%	< 3%
Working Capital (Current Assets/Current Liabilities)	>1.8	1.2-1.4%	<1.0
Creditor days - Average Accounts Payable/ Average Cost of Goods Sold per day	<30 days	30-60 days	>60days *
Debtor days - Average Accounts Receivable/ Average Sales per day	<15 days	15-30 days	>30 days
Turnover Change from average of past years	<50%	50-100%	>100%
Overhead expense (days coverage out of working capital)	>40 days	21-30 days	< 14 days
Capital and retained earnings to turnover	>2%	1.5-2%	<1.5%

** Unless negotiated with suppliers and profitability is sound*

Other Factors: Characteristics and Assessed Risk

Characteristic	Assessed Risk
1. Trading Structure	Trust = High Company = Modest Sole Trader = Low Partnership = Low
2. Continuous years trading in this structure experience	Nil to 1 year = Very High 1-3 years = High 3-5 years = Acceptable 5-10 years = Modest > 10 years = Low
3. Principals' residential building business experience	Nil to 1 year = Very High 1-3 years = High 3-5 years = Acceptable 5-10 years = Modest > 10 years = Low
4. Signs of adverse history	Very serious recent pattern of incidents = Very High Serious but isolated incidents = High Minor or older incidents >5 years ago = Acceptable Clean history = Low
5. Trade Credit history	Poor/Adverse = high Marginal = Acceptable Clean history = Low
6. Directors'/Principals'/Key Managers' history	Poor/Adverse = high Marginal = Acceptable Clean history = Low
7. Past insolvencies / insurance claims (including key managers)	Severe and unmitigated = Very High Moderately severe and partially mitigated = High Recent but appears to be fully rehabilitated = Acceptable No previous business closures = Low

Assessment of risks

The cause and potential impact of certain risks identified during the assessment will be attempted to be established. Consideration will also be given to whether there are reasons which can be taken into account in determining the significance of the risk. For example:

Current Ratio < 1.0

- What is driving this poor working capital?
- Is there an underlying margin issue connected with poor job estimation processes and/or margin erosion during the construction period?

- Is there an issue of asset management which is not providing enough liquidity?
- Is it an issue of progress payment scheduling?
- Are debtor and creditor day listings and controls appropriate?

Net Profit Negative Within Last Three (3) Years

- Was it a material loss or just a paper loss?
- Is the timing of reporting relevant?
- Is this an issue that is inherent in the business or a one-off extraordinary loss?
- Has the business since recovered?

Debtors > 30 days

- Has there been a deterioration in debtors, or are these consistent over the last three (3) years?
- Is an up to date aged debtors listing available to confirm that the value of debtors is realistic and that there are not any delinquent accounts?
- Are there reasons for the delay in relation to major debtors owing over 30 days?

Creditors > 60 days

- Has there been a material deterioration in creditors, or are these consistent over the last three (3) years?
- Is an up to date aged creditor listing available?
- If a long established business, are the payments within supplier credit terms?
- Is the builder having difficulty meeting obligations as they fall due?

Gross Margins Low

- Is the business still able to generate positive net profits? If so, then the business has successfully maximised efficiency in order to be sustainable in a competitive market.
- Is the underlying margin issue connected with a franchise or a marketing relationship?
- Is the applicant producing a detailed costing breakdown?
- Is there poor supervision and site management with margin erosion during the construction period?

Assessment Outcome

The outcome of the assessment is the combined consideration of all of the aforementioned characteristics and factors via a system of scoring and weighting relative to the significance of each characteristic and factor. There may also be additional factors identified during the assessment process that affect the risk and require assessment.

The completion of the risk assessment process will result in the eligibility application/review being placed in one of the following assessed risk rating categories:

Category W

- The building entity has been assessed as being strong in its own right, with no adverse features.

Category X

- The building entity has been assessed as being fair to strong in its own right with few adverse features. Approved turnover is not to exceed 20 times adjusted net tangible assets.

Category Y

- The building entity has been assessed as a conditional acceptable risk – that is, with conditions to be applied beyond the standard profile conditions. The financial status of the entity has been assessed as not optimum and/or there are some other adverse features.

Category Z

- The building entity has been assessed as an unacceptable risk. The granting of eligibility will only be considered subject to conditions which will enable the builder to remedy the weaknesses identified by the assessment.

Category D – Decline

- The building entity has been assessed as an unacceptable risk and it is not considered that the imposition of conditions would enable the builder to remedy the weaknesses identified by the assessment.

Where conditions are offered, they may include one or more of the following:

a) Capital injection

   Injecting further new capital and/or financial capability into the business could address working capital deficiencies. Converting related party liability loans to share capital will strengthen deficiencies in adjusted net tangible assets.

b) Provision of security by way of a deed of indemnity (refer section 11 of Underwriting Guidelines)

c) Increased reporting frequency if the issue is management experience or adverse financial trends.

d) The Building Contract Review Program (BCRP) for contracts of $50,000 and over (refer section ~~16~~ 12 of Underwriting Guidelines).

Some applications may require a combination of conditions, to address different weaknesses identified during the assessment process. For example:

‘Gross Margins’ may require the help of the building contract review program, to assist in costing projects appropriately.

‘Negative working capital’ will require a capital injection and a monitoring of cash flow through more frequent reporting.

‘Fatal’ characteristics/factors

Some factors are considered ‘fatal’ to the Eligibility assessment and will have an overriding impact irrespective of other strengths. These factors are:

- insufficient adjusted net tangible assets available for security;
- recent insolvencies due to mismanagement of the building entity by the directors/ partners;
- recent insurance claims particularly where due to defective building work deemed to be the responsibility of the builder;
- current adverse history.

Such factors will generally result in the application being declined.

Increasing Approved Turnover Limit

Turnover Growth

The HBCF takes a balanced score card approach to the risk presented by turnover growth.

The below table sets out the general, in principle, acceptable increases in turnover (based on actual business turnover NOT eligibility turnover) provided the adjusted net tangible assets of the builder and the assessment outcome meet the proposed turnover limits.

1. Guideline for thresholds for consideration of turnover growth approvals

Turnover Approved	Increase (Rating 'W' & 'X')	Increase (Rating 'Y')
Up to $1.5 Million	50%	30%
$1.5 to $3 Million	30%	25%
$3 to $5 Million	30%	20%
$5 to $10 Million	30%	20%

1. The % level of growth sought is calculated by comparing the requested turnover against actual business turnover, which is obtained from the "turnover" or "sales" figure on the last financials (**not the approved Eligibility turnover**).
2. An increase in construction values driving the turnover increase is more about technical competence. An increase in the volume of work is about the strength of the business management and financial capacity, as well as the way in which these sales are generated and costed.
3. Where growth sought is in excess of the above thresholds this does not mean that the request will be automatically declined. There may still be a valid case to approve the requested growth however, this will require additional investigation. Refer to below comments.

Turnover growth is a significant cause of builder insolvency. Growth requires **capital** until increased cash flow and profits cover the increased overheads associated with the growth. Increased growth increases overhead cost (staff, systems, plant and machinery, vehicles, offices). Until the extra projects generate sufficient profit to fund the additional costs, these additional costs must be funded placing pressures on working capital.

If builders seek to fund these additional costs initially through cash flow payments on the extra jobs, the builder can be more susceptible to failure to meet overhead costs as progress payments may be delayed, disputed or defaulted.

Funding growth from retained earnings assists to mitigate this risk. Progress payments can continue to be used for their main purposes of funding costs and generating margin. In time the extra profit can be used to assist covering additional overheads costs.

Assessment of risks

In order to establish the potential impact of risks associated with turnover growth in excess of the acceptable thresholds consideration will be given as to whether there are reasons which can be taken into account in determining the significance of the risk.

- Is the builder sufficiently capitalised to fund the requested level of growth?
- Does the builder have the management experience to manage the requested level of growth? Including,
- managing a greater spread of projects geographically and of varying complexity
- managing a higher number of project managers, as with a higher number of projects, day to management of each project becomes increasingly devolved
- sourcing and managing a higher number of subcontractors
- co-ordinating the cash flow in relation to a higher number of jobs at different stages.
- What is the source of the increased sales projections and is it likely to adversely impact on the profitability of the business?
- For instance, if growth is being driven by a relationship with a marketing entity,
  - What is the fee structure to the marketing agent – how will it affect builder margins?
  - To what extent can the builder control job scheduling. Is there a risk that the builder will not be able to effectively control the level of concurrent jobs?
- Is there a heightened risk that the growth request is symptomatic of the builder seeking to address cash flow shortages, through deposit collection or through front end loading a disproportionate number of contracts in early stages? A review of the work in progress (including a check that there is a suitable mix across work stages) and a financial assessment may assist in assessing risk.

Some concerns regarding the risk presented by turnover growth in excess of the thresholds may be addressed by placing a condition on the builder's eligibility requiring an increase in the frequency of management reporting.

References in this guide to builders and building work include and apply to trade contractors and other building contractors (e.g. electricians, plumbers, carpenters, swimming pool builders etc.) and to trade and other residential building work (e.g. electrical wiring, plumbing, carpentry, swimming pool construction/installation etc.).