Property investment and finance

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PROPERTY investment may be a straightforward home purchase instead of leasing. In the business field, a company has the choice of purchasing a property for occupation for its business or alternatively renting, so that capital may be invested elsewhere.

If it was decided to purchase property in future the company may decide to realise capital tied in property by means of a lease-back or mortgage transaction. In this article property is viewed and compared with other forms of investment.

The choice between different forms of investment available such as the basic bank account, stocks and shares, like insurance, property, etc., depends on: a) the security and regularity of the income; b) the security of the capital; c) the liquidity of the capital; d) the costs of transfer, i.e. the costs of putting in the capital in the first instance and taking it out subsequently.

If one obtains good lease agreements and secure tenants, condition (a) for property compares well with other secure investments.

Condition (b) is a plus for property as this is considered as a hedge against inflation, generally not subject to the erosion effect of the capital value.

Property investments suffer from conditons (c) and (d). The sale of property, from placing on the market to the final contract, could take nine months. The transfer costs in stamp duty amount to 3.5%, being high compared to ½% or nil for other investments.

The problem of illiquidity is overcome by securitisation of property investment and property companies, where the conversion of assets into tradeable paper securities occur.

Property company portfolios are often divided into three main categories – office, retail and industrial in the proportion of 50%, 20% and 30% respectively. The initial yields expected for such property are:

SHOPS

Prime sites occupied by national retail organisations......................4.5%
District centres..................6.5%
Small parades....................8.0%

OFFICES

In financial centres.............5.5%
Other main provincial.........8.0%

FACTORIES

Single storey.....................8.0%
Multi-storey.....................10.0%
Depressed areas...............15.0%

From the above values it is noted that the more secure the lease agreement and the tenant, the lower is the initial yield. The riskier the lease agreement, the higher the yield.

Factories are considered a risk investment, because if a company closes down it might not be so easy to negotiate a new lease, as different companies have different requirements, so one factory might not be suitable for the prospective new tenant.

On the other hand, it would not be a problem to find a new tenant for vacated shop premises in a prime much sought-after business area.

To understand the growth that has occurred in institutional property investment over the past 30 years from under 9% on their total assets to over 25%, one must compare the different investment yields for varying investments, as influenced by inflation world-wide over the years.

Year	Ordinary shares	Bank rate	Retail price inflation	Prime shops	Prime office	Prime industrial
1950	5.5	2.0	2.4	5.5	6.5	n/a
1955	6.25	4.0	6.2	5.5	7.0	n/a
1960	5.00	6.0	1.8	5.5	7.0	10
1965	5.25	6.5	4.6	6.0	6.5	9
1970	5.00	7.5	7.9	7.5	7.5	9
1975	6.74	10.5	24.9	6.5	6.5	9
1980	6.45	15.0	15.1	4.5	5.5	7.5
1985	4.75	10.0	5.3	4.5	5.5	8.0

From the above table it is noted that yields from property investments, similarly the equity market, do not vary so much with the effect of inflation, due to the capital growth potential characteristic.

Prior to the inflation market property was leased on terms of 99 years. With the advent of inflation, properties started to be leased on 22-year terms, then seven-year terms and now the norm is for two or three yearly rent reviews with growth rates varying from 3% to 15% p.a. So a property besides having a capital growth potential is subjected to rental growth reviews.

If prime offices are leased with an initial yield of 5.5% with three yearly rents reviews of 10% p.a. its equated yield works out at 15%. If provincial offices are leased with an initial yield of 8% with three yearly rent reviews of 5% p.a. its equated yield works out at 12.50%.

If one is after a long-term investment, the equated yield is to be considered not the initial yield, when comparing with other investments.

In simple arithmetic the return summed to infinity, on an investment with a growing income stream may be approximated to the initial yield plus the growth rate at which it is compounding.

Thus the previous 15% equated yield may be approximated to an initial 5.5% yield on the value of the property compounded indefinitely at the 10% rate. Likewise the 12.5% equated yield may be approximated to an 8% initial yield compounded indefinitely at the 5% rate.

The credit risk from leases is to be taken at 1½% p.a. over secure investments. It costs more to manage property than bond portfolios and rent-review intervals cause rent receipts to lag behind inflation.

To cover these two points a further 1¾% p.a. is necessary, meaning that an additional 3¼% is required from property over a secure investment. If one considers a secure investment in Malta averaging 9%, then an equated yield for property may be taken at 12¼%.

Rents like wages track inflation quite closely. Rent is an overhead which businesses afford to let rise roughly as fast as their wage bills. If the long term rental growth is taken at 5%, with an inflation of 3%, this means that rental growth exceeds inflation by 2%. If inflation rises to 8%, the rental growth would need to increase to 10%.

Typical rental values for investment property are:

	Malta	Overseas
Offices......................	Lm2/ft²	Lm40/ft²-Lm6/ft²
Retail.......................	Lm20-Lm5/ft²	Lm50/ft²-Lm10/ft²
Industrial..................	Lm1/ft²	Lm8/ft²-Lm2/ft²

Note that as office and industrial leases are dependent on the wage structure, while retail leases depend on turnover, the differences in rent patterns are more marked for office/industrial premises than retail premises.

Cost of properties suitable for investment purposes run into the six- or seven-figure category. The funding of these projects is very important. This is usually provided by debt or equity finance or a combination of both.

If a property is to be funded wholly by debt finance at a fixed rate of 8%, while the initial yield of this premises is expected at 7%, then over the initial years the company is to be running at a deficit.

If the banks want to contribute more towards property investment, variable interest rates during the period of a loan should be introduced. As an example during the early stages the rate could be fixed at 6% increasing to 10% during the later stages so that the investor is always left with a balance.

As property investment is subject to risk and uncertainty, the developer may be relieved of this by so-called limited recourse lending. This is designed to limit the recourse of the bank to the project itself.

The bank bears the risk of a shortfall in the repayment of the principal from the sales proceed of the property. The bank here absorbs some of the equity risk of the development in return for a slightly higher interest margin.

Banks can take comfort that land is in short supply and historically, values and rents have increased reasonably consistently, despite the occasional economic crisis.

Due to the low initial yields from property investments, equity finance could be a major source of finance. This is generally provided by long-term savings institutions, such as insurance companies. During the 1950s and 1960s, these companies provided finance through fixed interest rate mortgages. However as inflation accelerated by the mid-1970s, property investment and development has become a significant market in its own right.

Property companies' activities are financed partly by equity via their share capital and reserves, drawn from investors and partly by the debt market, borrowing over short and long-terms as the market permits.

In the property market the actual returns may vary from the expected returns, thus creating a difficulty between deciding on debt or equity finance. The most potent tool for

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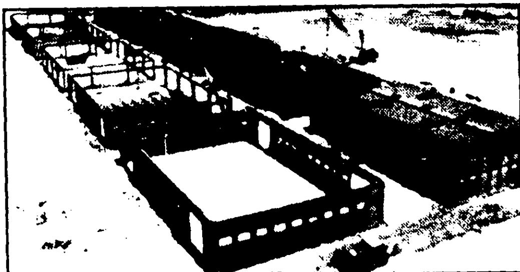

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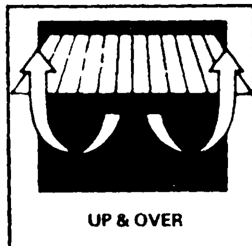

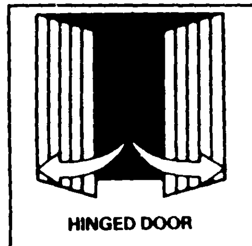

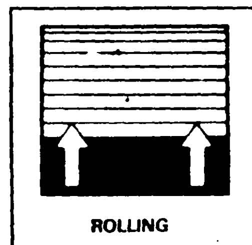

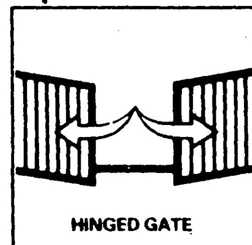

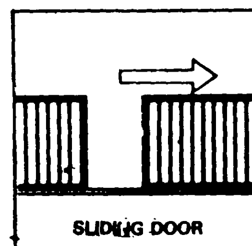

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LAND in Malta being in such short supply, property values and rents have increased reasonably consistently.

enhancing risk and return is gearing, the borrowing of money on fixed interest rates in order to finance an equity investment.

As an example consider:

Cost of venture	Lm100	expected at	10% = Lm10	Actual return	Lm20
Borrowing	Lm 70	interest at	8% = Lm 5.6		Lm 5.6
Profit			Lm 4.4		Lm14.40

With the return from the venture rising 100%, the equity income has risen by 227%. Thus are fortunes built! The wealth created in private hands by means of a mortgage on a private house is an excellent example. But the obverse is also true, and thus are bankrupts made.

It is not surprising that long-term savings institutions are unwilling to gear their portfolios, but live happily with gearing in the hands of companies whose shares they hold because those shares are reasonably liquid.

Securitisation

The latest novelty is securitisation of property investment. Its introduction confirms a significant change in traditional attitudes to property investment. It opens up the world of commercial property investment to the general public. It overcomes many of the intrinsic shortcomings of property as a price-efficient investment medium.

Securitisation overcomes the liquidity problem; property, as mentioned earlier, is converted into an easily tradeable paper security. In this way one may easily assemble a reasonably diversified property portfolio, which at a practical level amounts to 20. This would have been unachievable, except over a period of many years.

Creating both debt and equity securities from the same property provides the investor a choice of investment return. Investors can choose between securities which yield largely income return and those which yield largely capital growth.

For developers, securitisation provides a new source of long-term equity finance for the larger scheme. It enables developers to tap the capital markets directly for both longer-term equity and debt funding, providing an alternative to outright sale of the entire development to a single purchaser, should one be available at a discounted price.

By floating the completed property on the Stock Exchange, the developer avoids dependence upon a single purchaser and has the opportunity to return a stake for the future in a marketable form.

The property market is subject to booms and slumps. The investment to be made should be envisaged as long term. However, one has to survive the short term in order to enjoy the long term. This boils down to the question of cash-flow being the whole crux of property development.

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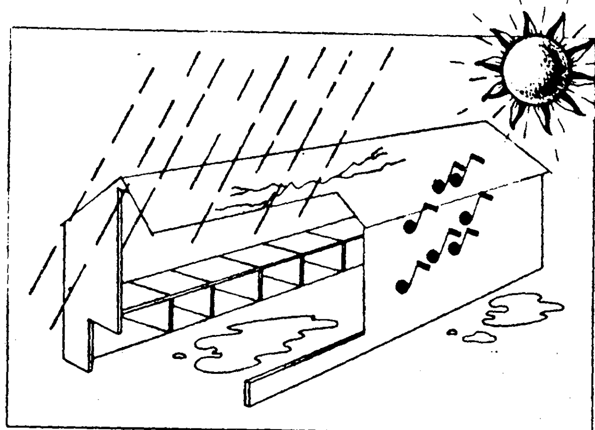

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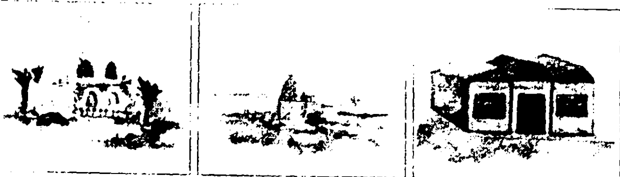

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