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REAL ESTATE:
A case for Malta's economic growth

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MALTA'S economic growth as a percentage of GDP has recently been sliding, totalling 1.5 per cent. Inflation for the same period stands at 2.9 per cent. On the other hand global economic growth for 2004 averaged 3.9 per cent.

It is felt that with the present taxation measures being resorted to, to reduce the national deficit, a national growth mentality is lacking. The functioning of the property market shall be briefly considered to understand how growth is stimulated in this sector, with a possible carry over effect to the national economy.

Debt vs equity in property investment

The most potent tool for enhancing risk and return in an investment is being considered first. This is known as "gearing" i.e. the ratio of debt to equity (shareholder's) money.

As an example consider:

Cost of venture Lm100; expected return @ 10% = Lm10; actual return Lm20;

Borrowing Lm70; interest @ 8% = Lm5.60

Profit Lm4.40 (Lm10-Lm5.60); and actual return is Lm14.40 (Lm20-Lm5.60).

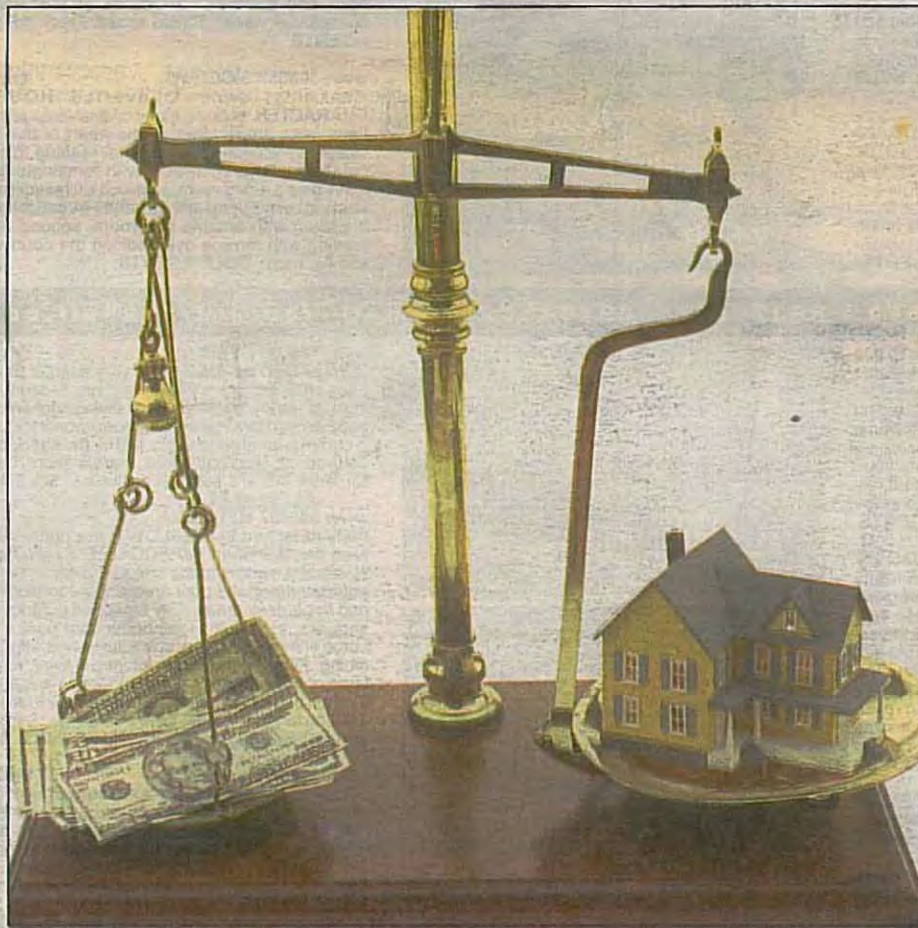
With the return from the venture doubling, the profit (equity portion) has risen by 227 per cent. Thus are fortunes built! The wealth created in private hands by means of a mortgage in a private house is an excellent example. But the obverse is also true and thus are bankrupts made.

The above illustrates how an investment's underlying growth can be supplemented by gearing, the amount of borrowing and how gearing increases risk.

Debt has a variety of advantages over equity for a company wishing to raise capital, as it is cheaper, with interest being paid from earnings before tax, while dividends are paid out of after-tax earnings.

However, debt capital has a prior claim over the equity shareholder's capital; thus the higher the rate of gearing, i.e. the borrowed portion, the greater the risk. At corporate level company gearing averages 25 per cent (debt: total capital), with it rarely exceeding 50 per cent.

This optimal level will vary according to the company's activities. Food retailers face a relatively stable demand and can afford high gearing, while for property developers operating in a cyclical market, high gearing is risky.



House borrowings

For most people owning their own home is their most important investment. This is carried out by taking out a bank loan (mortgage) with a very high gearing ratio, possibly from 70 to 100 per cent, thus (from section above) considered very risky, with no other investments obtaining such high gearing ratios.

Most frequently, the efficiency of a mortgage is questioned. The most common complaint being that, over a 40-year repayment period, payment totals more than double the cost of the present property being purchased.

The first thing to be considered is that almost 75 per cent of Maltese households are property owners, so they do not appear to have all taken a wrong investment decision, with the majority being more than satisfied.

The Central Bank has noted that over the past 25-year period house lending has increased at a rate of 17 per cent per annum, with further property lending in the early Eighties accounting to 22 per cent of all lending bank facilities, increasing to 43 per cent by 2004.

Further, if the growth rate of all property types over the past 25 years is considered, from the Central Bank's property database the growth rate averages out at seven per cent pa. Rental earnings average out to three to four cent of the property's value, while maintenance and depreciation is catered for at 0.5 per cent pa.

Thus total return from owning a residence equates to: 7% + 3.5% - 0.5% = 10% pa.

This is less than mortgage expenses, which currently at an interest rate of 4.75 per cent over a 40-year period equates to 5.65 per cent pa, when the capital repayment is taken into consideration.

By taking out an 80 per cent mortgage on the value of the purchased property, the householder's return on his equity portion increases to 31 per cent from 10 per cent, while for a 90 per cent and a 95 per cent loan the respective equity return increases to 57 per cent and 106 per cent respectively, however followed with an increase in risk.

To be noted that as long as the property's growth is higher than the mortgage rate, with the current mortgage rate standing at 4.75 per cent and property return at 10 per cent pa, equity growths increase in value and fall in value in times of high mortgage rates and low property growth rates.

Additionally at a seven per cent growth rate, property doubles in values over a 10-year period, so over the 40-year repayment period it should conservatively be 12 times its present value, by far well off from the double mortgage repayment amount.

Now that Malta has joined the ERM II, mortgage rates over the immediate future should converge to the EU average mortgage rate currently at 3.5 per cent, for the local based banks not to lose out to foreign banking. It is indeed strange how the Central Bank, two weeks prior to Malta joining ERM II, raised the basic bank rate by 25 points.

Although the property market as noted has been subjected to a sustainable growth rate at seven per cent pa over the past 25 years, the past couple of years have seen double figure growth rates averaged out at 17 per cent pa. According to the NSO the first quarter of this year was also subject to a three per cent increase in property prices.

In the EU, countries which experienced double figure growths over the past two years include France, Spain, Ireland and the UK. France had the highest growth close to 18 per cent, followed by Spain. Countries with growths hovering around 7.5 per cent were Belgium, Sweden, Finland, Portugal, Italy and Denmark. The Netherlands, Switzerland, Germany, Austria and Greece have seen house price rises at zero or a very low rate.

The Netherlands' housing market remains slow after the country had one of the highest rates of house price inflation in Europe in the second half of the Nineties. The increases ground to a halt in 2000, although the housing market had not experienced a collapse as expected. This experience gives some hope of a soft landing to the other EU housing markets, including Malta, which have witnessed substantial price rises in recent years.

This augurs that, if the housing bubble were to burst in Malta, this could possibly only be temporary, not tempering with the feasibility of a long-term investment. Unlike other investments, the Maltese housing market has been less volatile over a prolonged period, thus considered a risk minimised investment.

Prospective homebuyers should, however, learn the new low inflation housing market

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Malta can develop into the First World in under 20 years

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game by moderating their borrowings and house price bids, together with taking the longer time horizon associated risks into account.

What happens if and when interest rates rise again? Furthermore, with the present low inflation climate, the monthly paybacks are going to erode far slower than previously in the high inflation era, with a consequent lowering of the household quality of life.

The BICC State of the Construction Industry Report 2004 states that rental increases from 1999 to 2003 for affordable property was minimal, with the rental increases noted in the upmarket villa developments. This indicates that it may currently be cheaper to rent out an affordable property, as the rental payments could be substantially less than the mortgage payments. This possibly reinforced with the much awaited amendments to the present archaic rental system could witness a renaissance of the rental property market.

Commercial investment properties

Considering the above residential gains, it still appears that the institutional investor is more interested in the prime office, retail and industrial/warehousing sector. The gain in a residence's value is to the gain of the shareholder, in this case the owner.

It is possibly due to a high global home ownership rate in the advanced economies that the crash of the Stock Markets at the dawn of the new millennium, did not cause the depression experienced in the Thirties.

Unlike the residential sector, which as previously noted is currently experiencing unsustainable double figure growth rates, the commercial sector over the same three-year period is experiencing growth stagnation, if not decline in capital value. This due to a present oversupply of commercial properties, together with a number held up by the banks due to foreclosure, further compounded with a slowdown in the economy. In a slowdown, rents are an overhead that companies restructure by relocating.

In an article published in *The Architect*, reference was made to the development of the Opera House site, with the players being Government as the supplier of the land and provider of design services, whereby with the private investor being presented with an approved MEPA scheme the viability planning risk thus being eliminated, the private sector then partakes in the construction profits and the general public partaking in the annual normally revisable upwards rental earnings, as a partner with the government who had offered a large proportion of the asset in the form of land value.

It was however, stated that for this property securitisation to be successful, Malta needed to be branded as the Capital of the Mediterranean. However one asks how this branding is to be achieved if the present road development upgrading is tackling the outlying roads, while the Airport road leading to Castille is in a deprecated condition? Surely funds should be used to yield the greatest benefits.

Considering the current large land, which is sending hoteliers out of business, as the land value is substantially higher than the going concern of the hotel trade, why has land reclamation not been attended to?

Land over the past 25 years has been appreciating at 16 per cent pa, i.e. a doubling in value every five years, so a larger land area for Malta dedicated to the leisure industry, could possibly save our tourism industry which is a provider of approximately a third of our GDP. Another recent characteristic of land value: as from last year, the land values are mirroring the development value of property in the coming year.

To get prime developments in place in time not to lose out to other destinations requires a concentrated effort involving the Government, the private sector and the private small/medium investor. This all points to public, private partnership (PPP) schemes which have been undergoing studies since 2000.

In such cases, leverage ratios are common, and typical ratios would vary between 1:8 and 1:10, i.e. for every Lm1 spent by government, an equivalent of Lm8 to Lm10 investment generated by the private sector would be expected for a project to be considered as successful.

This also means that whereas if government had to do such projects alone it would have finished with, for example, Lm10 million value of investment, now, with the same Lm10 million, it would have generated an Lm80 to Lm100 million equivalent investment.

Now that the Valletta Waterfront project is nearing completion, why not tackle Fort St Elmo on the PPP principle, where the creation of a boutique hotel among other uses would help revitalise further the lower part of Valletta.

The Victoria Lines escarpment is also calling out for redeveloping the existing British heritage forts linked by well laid out footpaths creating a heritage trail. A recent seminar – "PPP: Getting Down to Business" – attended by the Lord Mayor of London sets one thinking: we're still at the very beginning; five years of studies considered wasted. Further lost time means losing out to other destinations.

Target returns

The hurdle property return is perceived differently from an institutional investor and a corporate company. In the case of institutional investors, money they invested does not have a direct cost, as it is not raised in the capital markets, but is received as regular payments from insurance premiums, and life or pension plans.

The required return is normally added on as a premium to a safe bond yield, such as a 15-year Government Bond. This premium varies from 2.75 per cent for prime high street shops and offices up to nine per cent for leisure properties. Thus a hotel's earnings profit is to be discounted at around 14 per cent, while a prime office location is to have its net rental earnings discounted at around 7.75 per cent, reflecting the lower risk of office investment, explaining the reason for not including leisure properties in an institutional investor's portfolio.

In the case of the corporate company, it is based on the after-tax weighted average of capital. Capital consisting of debt and equity thus depends on the optimal gearing ratio and the company's cost of equity. In the case of a project that is typical of the company's activities and of similar risk, then the rate is similar.

Adjustments have to be made if a project to be undertaken is considered more or less risky than a company's activities. None of the above may be quantified precisely as real estate companies undertake development (high risk) and investment (low risk), but according to Barclays Capital 2000, the extra return earned by equity shares over the return from gilts averaged 4.7 per cent pa in the 20th century, while the excess return over Treasury bills averaged 4.1 per cent pa. This information helps to provide a guide for a company's equity cost.

In the case of projects, as distinct from existing portfolio investments, the required return includes a return for enterprise. A simple rule of thumb to assess development required return is to double the cost of capital. If bridging finance to complete project works out at eight per cent pa, then target return to be 16 per cent pa, thus giving an additional markup of five to 10 per cent pa, not seen to be exceptional.

Alternatively property developers are more confident in assessing required return as a capital profit calculated at 15 per cent of the project's total cost. Inland Revenue here take note in applying the right profit mark-up for calculating capital gains, as the uncertainty created in the collection of these taxes is one of the reasons for the present double figure hike in property prices.

This scenario considers that if the philosophy of growth is undertaken in lieu of the present concept of debt servicing, Malta in under a period of 20 years should develop into a First World country, as has been successfully delivered by other nations.

To deliver this national growth, which has to be coupled with the branding of Malta as the capital of the Mediterranean, the private sector needs to combine with government entities to deliver projects in business-like ventures.

As land presently commands a substantial asset value, this is to be taken advantage of by the government for the benefit of all the citizens, as outlined in a previous article relating to the securitisation of the Opera House site. Increasing Malta's land area by reclamation would further enhance this asset value.

The present system whereby the taxpayer is being asked to contribute to a bottomless deficit pit is just helping reduce the quality of life of the Maltese citizen, together with the risk of sending a greater proportion of households to living below the poverty line.

People's savings together with repatriated moneys currently have few worthwhile investment opportunities. Government bond issues, although issuing returns to investors are however being eroded, as national growth with fixed rate bond issues is not being created.

Thus a total rethink on wealth creation by undergoing national securitisation projects on a partnership basis, whereby the smallest investor may participate alongside the big investors, will help restore the good-will feeling of the Maltese Islands.

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