Book Summary: An Introduction to Commercial Property Finance, Development and Investment (Unisa Press) by Tony Collins & Valmond Ghyoot

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Note: This is a very concise paraphrased summary. Please support the author and buy the book.

An Introduction to Commercial Properties & Investments

- **Commercial property is property purchased with the intention of producing profits**, rather than to be developed for artistic merit or mere utility.
- Commercial Property Finance (CPF) prefers to be involved with:
    - shops
    - shopping centres
    - offices
    - office complexes
    - factories
    - warehouses
    - residential developments for sale including eco and golf estates
    - township developments for sale
- **Residential Property**
    - Residential property is defined as property that is suitable for people to live in as a home.
    - The following categories are common:
        - **Vacant Land**
            - Such land is specifically zoned for residential development (that is, not for general public use, such as parks) and registered in the deeds registry as an erf, lot, plot, or stand, or as any portion thereof.
        - **Dwellings**
            - A dwelling is a freestanding, permanent building on a single identifiable piece of land that is zoned for residential use and that should be used exclusively as a home.
        - **Cluster Housing**
            - Cluster housing can be described as high density group housing where:
                - each house is built on a separate sub-division of a tract of land.
                - both the house and the land are owned by the same person(s).
                - the owner has separate title for the property.
        - **Sectional Title**
            - Sectional title complexes are also high density housing schemes where a property complex is divided into different sections (portions or units) and the different sections of the same property may be owned individually by different owners.
            - Some of the property may, however, offer exclusive rights (right of use only to the unit owner) and other portions may offer common rights.
            - The land on which the building is erected, as well as common areas such as staircases, corridors, washing areas and recreational areas, are owned jointly by the owners of the units within the complex.
        - **Share block**
            - A share block property complex is owned or leased by a company and shares are sold that grant the owner of such shares the right to occupy a specific part or unit within the building.
            - The company that operates such a share block scheme is called a "share block company".
            - Shares in a share block company are not recognised as immovable property but these shares grant the holder of the shares the right to occupy a portion of the property.
            - The shareholder does not become the owner of the unit but merely has the right to occupy it.
        - **Time share**
            - This type of ownership occurs where a number of people have the right to occupy a portion of a property such as an apartment, over successive recurring short periods of time (1 to 4 weeks, say, per year).
            - Time share is used mainly for holiday accommodation, assuring the owner of such shares the right to occupy the property for a set time period each year.

        - Time share is not immovable property and thus cannot be mortgaged.

- **Commercial Property**
    - Commercial property is defined as property that is suitable
    - The following categories are common:
        - **Vacant Commercial Land**
            - Such land is specifically zoned for commercial development (that is, not for general public use, such as parks) and registered in the deeds registry as an erf, lot, plot, or stand, or as any portion thereof. The land is classified as vacant because there are no buildings or improvements upon it.
        - **Commercial Buildings and developments**
- **Industrial Property**
    - Industrial property is defined as property that is suitable for warehousing or manufacturing purposes or for the purposes of operating a factory.
    - The following categories are common:
        - **Vacant industrial land**
        - **Industrial buildings and industrial developments**
        - **Industrial parks**
            - Industrial parks refer to clusters of adjacent industrial erven, lots, plots, or stands zoned for commercial or industrial use, and which are often fenced off in a security area.
- **Specialised Property**
    - Specialised property include properties that are designed for to serve a single purpose and which are difficult or expensive to convert to any other use.
    - Examples of such property include refrigerated storage facilities, churches, sport stadiums, hospitals and schools.
- **Agricultural Property**
    - Agricultural property refers strictly to land used for agricultural purposes and falls outside the scope of commercial property finance.
- **Property can be categorised according to the following characteristics:**
    - **Function:** The purpose for which it can be used.
    - **Size:** The extent of the property and its divisibility into investment portions.
    - **Investment risk:** includes its cash flow, inflation hedge, operating risk and liquidity risk potential
    - **Finance risk:** its potential to be used as collateral to raise finance and its ability service such cash flow from its cash flow streams.
    - **Ownership:** The nature of its owner(s) and the extent of equity committed by the owner(s).
    - **Management:** The degree of management expertise required to control the property.
    - **Usage:** This is distinct from its function. Usage refers to the manner in which it can be used.
    - **Tenure:** The life span of economic use.
    - **Supply & Demand:** The availability of capital, general economic conditions, the business cycle and building resources availability.
    - **Government Control:** land use controls, environmental impact, traffic controls, restrictive building and marketing practices and property taxes.
    - **Location:** Attraction in terms of surrounding facilities, positioning in relation to infrastructural services, population groups, soil and land conditions, residential/commercial/industrial nodes, availability of micro-economic resources (such as water), scenic benefits and recreational offerings.

Ownership

- In theory one owns everything above the ground surface and everything below the surface of the property you purchase. In practice, however, these rights are limited by public and private legal circumscription.
- **Public legal circumscription**
    - Taxes
    - Expropriation
    - Control measures include planning regulations that control subdivision, zoning and the erection of buildings.
- **Private legal circumscription**
    - Neighbour law
        - Attempts to achieve harmony between neighbouring owners, exercise control as regards to nuisance, provide lateral support and prevent interference with the natural flow of water.
    - Independent legal rules
        - Rules that fall outside the scope of neighbour law which helps to regulate the relationship between persons and property.
    - Limited real rights

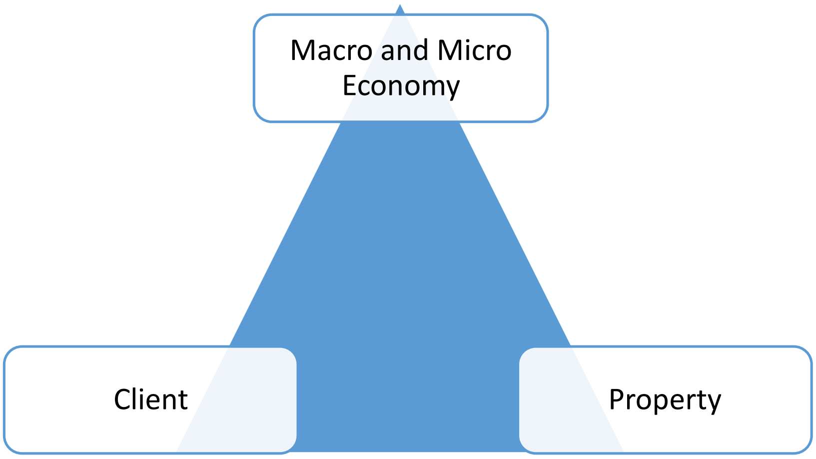
    - Limited real rights restrict the rights of ownership by decreasing the productivity of the land and reducing the uses in the following ways:
        - they limit the ownership of one's property in favor of someone else
        - they can be classified according to extensiveness
        - extensive right to enjoyment (lease, leasehold, usufruct)
        - limited right of enjoyment (praedial servitudes)
        - rights of security (mortgage bond) for debt
        - limited real rights can be so extensive as to create bare ownership (bare dominium)
    - **Dominant tenement:** Land in favor of which an easement or other servitude exists over another's land.
    - **A personal servitude gives the owner the right to do something on a servient erf – drive over or graze cattle. A negative servitude compels the owner of the servient tenement to refrain from specific acts, e.g. building above a certain height.**

- **Leases**
    - Short leases are not registered and do not exceed 10 years.
    - Long leases exceed 10 years and have to be registered at the deeds office.
        - Where not registered the lessee is protected for 10 years only.
- **Benefits of commercial property as an investment**
    - regular cash flows
    - profit from capital gains
    - tax shielding benefits
    - cash inflow from refinancing
    - combinations of these income streams
    - capital security

An Introduction to Commercial Property Finance and Risk Assessment

- **Value added CPF service**
    - Portfolio Asset Management
    - Risk Evaluation and Reduction Advice
    - Specialist impost to Improve Feasibility
    - Administrative Assistance
    - Legal, Tax, Property Economics & Other Specialist Services
    - Trust/Investment Management
    - Equity Partnerships – Value Added Involvement
    - Valuation Service
    - Specialised Property Finance
- **Two basic phases of financing a development**
    - **The first phase is the short term phase during the construction of the development** where the maximum risk occurs because the developer has to find tenants and carry the costs of interest and construction expenses without any cash inflow from the project.
    - **The second stage of financing is the long term loan secured on completion of construction** and proof that the building has been satisfactorily let.
- **Banks**
    - **Banks typically borrow money at a rate 2% to 4% below the lending rate.**
    - They buy at the Repo rate from the Reserve Bank, or use money market instruments such as Banker's Acceptances (BAs) or Negotiable Certificates of Deposits (NCDs) when they are available.
    - The net margin made after deducting other costs, taxes and revenue stamps can therefore be very low.
- **Loan to value**
    - When evaluating the project a higher interest rate may be used as a "test rate" (2% above the quoted rate) to ensure that the cash flow is still sufficient if interest rates rise in the near future.
- **Defining client risk form the bank's point of view**
    - Is the client an investor, speculator or developer?
    - What is the client's debt exposure in terms of commitments to other liabilities and loans?
    - How do the client's financials and net after tax cash flow projection look?
    - What security can the client offer as comfort to the bank in terms of sureties, other properties or assets as collateral and partners with equity inputs?
    - Are the property managers a risk in terms of qualifications and experience?
    - Is the property owner-occupied, depending on income from the business run by the client?
    - Will there be expected shortfalls in the income stream, and if so, how will they be met?
    - Are the property managers a risk in terms of qualifications and experience?
    - What does the reputation and integrity of the client look like, based on past projects?

- <u>Typical commercial property finance clients</u>
    - investors who hold the assets
    - owner occupiers
    - private landlords
    - institutional shareholders and investment vehicles
    - developers and construction companies
    - **land-bankers (Investors in vacant land)**
    - speculators who on-sell
    - refurbishes and renovators of existing properties
    - asset managers and administrators
- **CPF is a long-term commitment (normally 10 to 15 years)**
- **In many banks' CPF divisions, classic security-based lending procedures have been replaced by informed, sophisticated and well-managed and monitored cash flow-based lending.**
- <u>Repo rate</u>
    - **The Repo rate is the key interest rate that determines SA bank's lending rates to the public.**
    - The repo rate is determined as follows:
        - The Reserve Bank conducts a daily estimate of liquidity needs at 09h00 GMT.
        - Once the Repo tender amount is signalled by the Reserve Bank to all the banks in the market, the individual banks submit bids for the tendered money by 10h15 GMT each day.
        - At 10h30 GMT the Reserve Bank announces the results of the auction and publishes the Repo rate for the day, with the amount of the money available, thereby allowing the banks to purchase the available money.
- <u>Liquidity and Gearing</u>
    - Liquidity refers to the ease with which an investment can be converted into money.
    - Gearing is also known as "leverage" in American Books.
    - **Gearing:** A ratio of the loan to own equity
    - **Leverage:** Loan is expressed in relation to the value of the property; also referred to as the "loan to value ratio" (LTV)
- <u>Risk Factors to Consider for Investment Decisions</u>
    - **Location Risk**
    - **Purchasing Power Risk**
        - For a specific property to keep pace with inflation:
            - it must have a good location
            - rental must be adjusted periodically
            - the property must not be subject to sharp increase in operating costs
    - **Institutional Risk**
    - **Interest rate fluctuation risk**
    - **Financial Risk**
        - Where no borrowed capital is used by the investor to finance the purchase of property, the ratio of operating income to operating expenses is most important.
- <u>Considerations of the credit department</u>



- **The client**
  - Who are the developers or investors and how wealthy are they?
  - What does their "business family tree" look like and are there signed, audited financial statements available to assess?
  - Are there signed securities, cession of shares, pledges, etc. and does the client have collateral to offer the bank as security in terms of property or other assets they own?
  - Is there an equity partnership with other partners or with a bank?
- **The property**
  - What is the property in terms of retail/commercial/industrial/residential and what are the related risks involved?
  - What is the location risk?
  - Does the property have the ability to sustain value into the future?
  - Is the property capable of generating a market-related cash flow for the length of the loan, which is large enough after expenses and vacancies to service the loan?
- **The economy**
  - What is the length of the construction period and how will sales/letting be affected by the property economic cycles for the country and the region?
  - Has a proper market analysis been conducted and are the demographics for the area correct for the type and size of the property to be financed?
  - What is the current and projected state of the national and regional economies with regards to supply and demand in the market place?
  - What is the government policy on fiscal and monetary policy in the property market?
- **Importance of client equity contribution**
  - A core criterion when lending is the input of own cash/equity into the project before the bank will lend money to the investor/developer.
  - **The forced sale value of a property is considered to be 70% to 80% of open market value and has been experienced to be as low as 50%** in the case of a high risk project or where a poor economy affects demand.
  - This is why the **30 to 35% equity input** and **65% to 80% pre-sales/letting** is required before lending takes place.
  - A bank usually only makes 3.5% to 4% on their money when lending out prime, therefore they will also charge fees.
    - A short-term development loan would normally carry higher fees than the long-term mortgage type loan as the interest made is gained over a shorter period.
- **Property cash-flow**
  - Operating statement

	Amount per annum
Potential Gross Income (PGI) from a fully let property (PGI is based on rental)	R1 000 000
Less income lost through vacant space (vacancies)	R50 000
Plus other income generated (e.g. from advertising on the property)	R60 000
Equals **effective gross income (EGI)**	R1 010 000
Less operating expenses	R200 000
Equals **net operating income (NOI)**	R810 000

- <u>**Sureties, Covenants and Cessions to Back Finance Arrangements**</u>
  - **Sureties**
    - Personal Security by way of a surety is normally required in addition to the equity injection as a backdoor if all else fails.
    - **Difference between Guarantees and sureties:** the creditor must first attempt to collect the debt from the principal debtor/obligor before demanding performance from the guarantor.
  - There are however, exceptions to the rules: the guidelines above are not applied rigidly. **Banks will be more flexible when the following situations arise:**
    - A client's overall financial position is sound
    - Another property is ceded as security
    - Collateral security is provided or shares (blue chip) are ceded
    - Cash flow of the property is sound
    - Equity partner transactions were the bank is involved or another bank is an equity partner in the deal.
    - Banks are often prepared to give certain high net worth individuals 100% loans regardless of the cash flows produced by the property to be financed.
  - **Quality collateral security**

        - other property
        - cash deposits
        - debentures
        - endowment policies, although these are currently less acceptable
        - JSE listed shares (only good quality shares and only a part of their value will be taken into account by the bank, due to the risk of volatility)
        - other financial assets such as government stocks
    - **Covenants**
        - Covenants are special conditions set by the bank and agreed with the client that commit the client to perform certain obligations, such as:
            - maintaining a certain level of interest cover
            - ensuring that all proceeds from sales (after tax) will be paid into the loan first until the loan is repaid
            - requiring that the loan will not be repaid within a certain time period, otherwise there will be a penalty to pay (usually in the form of penalty interest or a commitment fee)
            - obligating the client to not take up any further loans on the same property through another institution
            - ensuring that the property is adequately insured to the satisfaction of the bank for the full period of the loan
            - requiring the building to be adequately maintained during the loan period
        - **The objective of covenants is to allow the bank specific rights, should the customer not adhere to the set covenants** to:
            - withdraw from its finance commitment
            - renegotiate the terms and conditions of finance
    - **Cessions, pledges and undertakings**
        - **Cessions** are used to transfer rights to an asset and involve the transfer of the asset or a document laying claim to the asset into the hands of the bank.
        - **Pledges** may involve only the promise to transfer the rights to an asset.
        - **Waiver of builder's liens:** Commonly used where an erf is being developed and a waiver of rights to the materials is demanded from the building contractors. This means that the building contractors waive their rights in favor of the bank to any claim over the site in the event of default by the developer (bank's client).
- <u>Cash Flow</u>
    - Two instances when cash flow can influence the banker to exceed the parameters of the risk related to the property:
        - For owner-occupiers, the mortgage is serviced by the cash flow from the business, therefore, the business needs to have a long and trouble-free track record to prove a reliable surplus cash flow over the long-term.
        - The investor requires a property with a lease profile that is strong enough to override the need to adhere to property risk principles. The tenant has a long lease and is a blue chip corporate tenant.
- <u>Leaseback Agreement</u>
    - **With a sale and leaseback the property owner sells immovable property, subject to a long-term lease in its favor.**
    - **This releases the capital tied up in the immovable property and/or any improvements thereto by the seller/lessee, allowing rental to be written off for tax purposes. Leaseback Facilities facilitates the release of operating capital for the expansion of activities and the provision of services.**
    - As an example, oil companies are often not interested in holding expensive properties such as office blocks as these are not their core businesses.
    - **Net leases:** The lessee pays a proportionate share of the cost of maintaining common areas and direct costs, such as water and electricity.
    - **Net-net and triple-net leases require the tenant to pay for most, or all, of the property owner's operating expenses, i.e. property taxes, insurance, maintenance, security, etc.**
    - The triple-net lease may additionally include mortgage repayments.
    - Often the leaseback is a head lease in that a company like BP would rent all 20 floors through they only require 10 floors themselves. They will then sub-let the other 10 floors using commercial brokers.

<u>Financing Methods</u>

- <u>Four types of finance</u>
    - **Short term bridging finance** through an overdraft to secure the purchase of the land

- **Short term development loan** for the payment of the land and the building construction costs over, say, 12 months.
- **Short term VAT Facility/overdrafts** for the duration of the building period plus for two months after the building period.
- **Long term investment finance loans** over 10 years to repay the loans.

- <u>Commercial Loans</u>
  - Commercial loans include **development loans** over short periods to finance the development of property and long term **investment loans or term loans.**
  - **Investment loans** are loans that finance or re-finance the acquisition of property.
  - **Development loans** are sometime referred to as project finance (through in corporate banking terms project finance generally specialises in infrastructural finance, but both may involve medium and long-term finance of developments).
  - **At the end of the construction period the development loan is either paid-off from the sale of erven, houses or apartments or it is converted to a commercial loan** that is to be paid off by the income generated from the rental returns obtained from letting the property.
- <u>VAT Financing Facilities</u>
  - Since development loans focus on assisting with the finance of building construction alone, such loans do not, generally, allow for the direct finance of working capital was well and thus do not provide finance for VAT.
  - **Development loans work on the basis that the developers will be required to put their own funds into the development of the project first and then claim "reimbursement" finance from the bank based upon the value already in the project as well as the forecast cost to complete the project.**
  - The finance can be structured as an overdraft facility.
  - **The overdraft limit is calculated according to the peak of the expected cash flow deficit.**
  - It is preferable to open a secondary bond account for VAT withdrawals where the developer and SARS guarantee to pay all VAT returns into this account again.
  - **The developer, after paying VAT to suppliers, can claim the VAT due for the construction work back from SARS. At specified two-month intervals SARS repays the VAT into the secondary bond account.**
  - Caution needs to be exercised with such facilities as SARS will not recognize any third party claims to VAT refunds and, hence, the bank must be prudent in ensuring that such facilities are only offered to experience developers of very good credit rating.
- <u>Bridging loans and overdraft facilities</u>
  - **A bridging loan is a short –term finance facility, normally at higher interest rates that compensate for the additional risk.**
  - Being of a short-nature, an overdraft facility is best suited for use here.
    - An overdraft facility is supported by daily exception reporting mechanisms and facilitates more regular review, thus applying more reliable governance mechanisms to contain the risk.
  - Used in cases were the loan approval process is expected to be lengthy.
  - Such facilities normally place the bank at a higher risk because the securities and conditions of the loan are not fully in place.
- <u>Flexi-reserve facilities</u>
  - Long-term commercial loans can provide flexibility to a customer allowing the utility of drawing repayments paid in advance of the contracted repayment schedule.
  - **In other words, a client may be allowed to withdraw any amounts paid into the loan that the bank does not require them to repay at that stage.**
  - The facility will not allow the tenure of the finance to be extended, nor will the client be allowed to draw against normal contractual repayments already made.
- <u>Loan repayment structures</u>
  - **The plain (vanilla) amortization loan**
  - **Interest only structures**
    - The loan amount stays constant and the client pays interest according to the applicable current interest rate.
  - **Future dated repayments**
    - With this method interest only can be repaid, except that at certain agreed future dates, balloon payments of capital must also be made.
  - **Stepped repayment structure**
    - With stepped repayment structures the payments are started lower and increased as the lease escalates the income.
  - **Fixed equity capital repayments with reducing interest**

    - **Stepped capital repayments with reducing interest**
    - **Balloon payments**
        - Give the investor a five year term with a balloon payment in year six, whereby the investor pays off the loan for five years and then has a choice of selling the property or rolling the loan over for a further five years from year six.
    - **When calculating a loan repayment structure, consideration should first be given to the projected cash flows of the investment, because it is upon these cash flows that the repayment structure should be based.**
- <u>Interest Rate Charges and Other Pricing Mechanisms</u>
    - The methods banks use to earn money from loans and cover costs include:
        - **Charging (administrative) fees** that cover overhead costs
            - Banks often charge **initial fees** that may be deducted from the loan on registration (the USA term is "discount points").
            - **Charging a higher interest rate is a better income earner than, for example, increasing the initial fee.**
        - **Charging interest on loans** that protects against the risk being taken.
            - Variable interest is also known as the **floating rate** where the interest rates moves up and down with the prime rate and the South African Reserve Bank's Repo Rate.
            - **Interest can also be fixed** for periods of 1 to 10 years on commercial property and these rates may be substantially different from the ruling prime rate.
            - **Hedging interest rate risk**
                - Fixed rate mortgage contracts are not to be confused with swaps.
                - **Swap options** give the holder the right to enter into an interest rate swap, through the holder is under no obligation to necessarily do so.
                    - **Caps, floors and collars, are also swap options, as are FRA.**
                - **FRAs** are forward rate agreements that allow you to enter into a swap for a 1- to 10-year period beginning a specific date in the future, thus, making it possible to confirm the effective interest cost.
                - **Caps** place an upper limit on the applicable interest rate's movement. **Floors** place a lower limit on the applicable interest rate's movement. **Collars** provide a cap and a floor to the applicable interest rate.
        - **Claiming professional fees** recouped from the use of professionals
        - **Sharing in the profits being made** from an investment or equity stake
        - **Charging management, structuring or consultancy fees for intellectual capital benefits provided.**
        - **Factors Affecting Loan Pricing:**
            - Where does the bank obtain the funds for on-lending as loans?
                - The Reserve Bank
                - The Money Market
                - The bank's own investment attracted from retail clients
                - The bank's own equity reserves
                - Direct inter-bank funding
            - At what price is this funding bought?
                - At the Repo rate
                - At the BA rate
                - At the NCD rate
                - At the JIBAR rate
                - At specifically negotiated rates
            - What costs are involved?
                - Registration of loan costs
                - Government stamp and tax costs
                - Liquidity and capital adequacy requirements
                - Administration costs
                - Professional service costs
            - What are the risks influencing the deal, such as the client, the economy, etc.
- <u>Bare dominium properties</u>
    - **A bare dominium property is a property where the rights or the fruits of the property, which is normally cash flow or usage, have been removed from the ownership and given or sold to a third party.**
    - The leases are normally triple net leases and are sold off during structured finance deals. The leases are sold to a third party, removing the income from the property and leaving the bare dominium.

    - **The owner of the property can also then sell the bare dominium to a company specialising in buying bare dominium properties at a discounted price, or after 10 years when the lease lapses, he can get the full ownership of his building back.**
- **Lease discounting**
    - The lease may be used as the bank's security for a loan if:
        - the lease is at least 10 years long, to cover the loan
        - the tenant is a blue chip company that is financially strong enough and stable.
    - When the lease is better than the market value, this lease can be **top-sliced** to calculate the extra value created by the better-than-market-value of the lease.

Sources of Finance

- The most important sources of finance for the purchase of fixed property:
    - **Commercial Banks**
        - **A maximum loan of 70% to 80% of the bank valuation of a property used to be the rule of thumb.**
        - However, each client and the subject property is now assessed as to the risks and the security offered before finance in one or other format, as well as the amount of finance, is decided on.
    - **Participation Bond Schemes**
        - Participation bond schemes are often used for the financing of office blocks, shopping centres, blocks of flats and industrial properties.
        - Colloquially, these funds are often referred to as "part bonds."
        - The funds are regulated under the Collective Investment Schemes Control Act, the same Act that regulates unit trusts and property unit trusts.
    - **Insurance Companies & Pension Funds**
        - They now play a far less important role than other sources of finance.
        - They usually only become involved when large sums of money are involved and the interest rates are high enough to ensure a good return on their money.
        - Furthermore, insurance companies and pension funds are actively involved in the case of sale and leaseback as a form of finance.
- **Equity Finance and Joint Ventures**
    - **Joint Ventures (JV)** represent a product where the bank joins the developer as a partner by contributing equity and taking a share of the profits.
    - **Typically banks supply equity for a project in exchange for a return on equity of 35%.** In this case a bank may contribute 26% to 50% equity for a project. This would equate to between R5m minimum and, say, R75 maximum that can be loaned out by the bank's equity department on one project. All banks have different parameters.
    - Before a bank becomes an equity partner in a project, it will have to be satisfied that the joint venture partner is a developer with a track record and relevant experience in the type of project that is being developed.
    - **The exit strategy is normally a short term period of up to three years,** since this is not core business but extra profit being made, over and above interest earned and bank fees charged on the loan to the developer.
    - Bank's JV divisions are usually involved in the listed and the non-listed sector of the property markets. Supplying JV capital to the listed sector is more complicated than supplying JV capital to individual developers.
- **Property Syndications**
    - Property syndications seem to have become largely redundant and there are few property syndications left.
    - Being a normal company, unlike a property loan stock company, the directors could control the dividend payout and decide to give low returns even where the properties may have performed well. Abuse occurred.
- **The Listed Sector**
    - The listed property sector companies comprises Property Unit Trusts (PUTs), Property Loan Stock Companies (PLS) and REITS.
        - These companies are structured for tax efficiency with interest income being taxed 9n the hands of the investor.
    - **The main difference between listed and unlisted companies is that listed property companies can raise capital (cash) by issuing shares to the public.**
    - **Property unit trust companies**
        - **Investors buy units in these companies** in the same way they buy shares in ordinary companies.
        - They are structured as investment trusts that hold the total issued share capital and loan accounts of the underlying property owning companies.

        - Their distributions come from operating income generated from the underlying income generated from the underlying property portfolio and are **treated as interest for tax purposes**. Income is thus taxable in the hands of the unit holders, according to their own tax status.
        - **A hundred percent of income is distributed.**
        - They are regulated vehicles and governed by the Collective Investment Schemes Control Act of 2002 (CIS Act).
        - They have characteristics of the normal share company with limited liability as well as those of a unit trust company.
        - **A property trust may use only a limited percentage of financial leverage or borrowed capital for financing purposes, expansion or in an attempt to increase the return on investment.**
    - **Property loan stock companies**
        - Property loan stock companies (PLSs) were established in response to the numerous limitations placed on property trust companies.
          Have a linked unit equity structure.
        - **Each linked unit** includes a share and a subordinated **unsecured debenture, the debenture comprising the vast majority of the value.**
        - Distribute operating income from the property portfolio to unit-holders as interest on the debentures, with a small dividend portion.
        - PLSs fall under the South African Companies Act and have less regulatory restrictions than PUTs with regard to gearing and investment choices.
        - May loan as much as they wish in theory.
        - Have an average gearing of only 30%.
        - Banks prefer to see no more than 50% to 60% gearing on direct property.
    - **REITs**
        - REITs are the preferred investment vehicle worldwide.
        - REITs have some differences with South African PUTs.
        - PLSs and PUTs structures are "REIT-like" in their tax transparency.
- **Lending to listed property companies**
    - Excess interest coverage (ICR) is expected by the banks, typically ICR > 1.5:1 (BEE 1.1:1). Normally interest cover is equal to 1.2, meaning that net income should cover 1.2 times more than the interest.
    - Due to the large amounts involved, listed companies expect low interest rates which means the bank has very tight interest margins.
- **Portfolio Evaluation**
    - The following ratios assist in analysing the portfolio:
        - **Gross income multiplier** (market value/effective gross income)
        - **Net income multiplier** (market value/net income)
        - **Operating ratio** (operating expenses/effective gross income)
        - **Operating ratio including the loan** – the property breakeven ratio
- **Securitization**
    - **Securitization is a process of packaging individual loans and other debt instruments.**
    - The portfolio of mortgages should be:
        - Low risk in terms of the individual lenders
        - **Have a good spread of locations that are low in risk**
        - The improvements should be desirable enough to liquidate them quickly in the event of defaults by the original investors.
        - The **individual loan documents should also be standardized** for easy administration of individual loans.

Property Economics

- **Property is market driven because it is an economic good.**
- Some of the basic input and output factors in the economy that affect property markets and properties.
    - Business Cycles
    - Inflation
    - Government spending and taxes
    - The balance of payments and foreign exchange rates
    - Monetary and fiscal policy including interest rates
    - Supply and demand
    - Marci and micro economics
    - Location attributes
- **Banker's acceptances(BAs)**

- BA is a money market instrument that offers companies an alternative method of financing debt.
- Where short term credit is required a bill of exchange can be drawn on a bank. The bank accepts this bill by signing accepted across the face of the bill.
- The bank therefore agrees to pay the borrower a specific sum of money after a certain time period, which is usually 90 days. Since the company normally requires the money immediately, they can now sell the BA at a discounted rate in the market to a discount house which could also be a bank. s
- BAs are usually only purchased from companies with sound financial standing and they are only available when the money supply in the market has good reserves.

- <u>Property Cycles</u>
    - **Forecasting the property cycle is important when planning large scale developments.**
    - **Demand and supply of property moves in cycles.**
    - Residential property usually reacts first, followed by retail, industrial and commercial property. The danger of being in long term projects such as large housing estates therefore carries the most risk.
    - **Because real estate supply is fixed in the short and medium term, price changes will be governed by demand.**
- <u>Various Stages of land use</u>
    - **Developable bare or unimproved land**
        - **Rezoning affects the supply side of the market.**
    - **Serviced Land**
        - When the land has already been serviced with roads, sewerage and storm water pipes, electrical substations and water reticulation, the value of the land should be significantly enhanced and the bank's security enhanced.
    - **Improved Land**
        - Improving the land means adding value to the land by adding roads, servicing with electrical, water and storm water reticulation and by adding buildings and landscaping.
- **Location is probably the most important factor contributing to value as it is the sum of all the typographical, transport and other influences on land use that characterise a particular neighbourhood.**
    - **It is therefore imperative to look out for signals that indicate a changing neighbourhood.**
    - **Changes in land patterns need to be observed.**

<u>Financial Statement Analysis</u>

- The broad objective of financial statement analysis is to examine the financial position of a business with a view to forecasting the future prospects of the business.
- **Loans from shareholders do not form part of shareholder's equity** as a shareholder has the right to claim repayment of this loan as desired or as contractually arranged.
- <u>Approaches to financial statement analysis</u>
    - **Comparative financial statement analysis**
    - **Trend analysis**
    - **Index analysis**
        - A base year is chosen and all values for that year are expressed as 100%.

	2010	2009	2008
Fixed assets	118%	117%	100%
Investments	100%	97%	100%
Current assets	166%	135%	100%
Stock	166%	149%	100%
Accounts Receivable	159%	152%	100%
Cash and bank	170%	89%	100%

    - **Common-size analysis**
- <u>Ratio analysis of Financial Statements</u>
    - Debt Management Ratios
    - Asset Management Ratios
    - Liquidity Ratios
    - Profitability Ratios
    - Market Value Ratios

Property Tax

- **Capital or revenue nature**
  - **Whenever a property is sold by a taxpayer, it is essential to determine whether the proceeds on a sale are of a capital nature (and therefore not subject to income tax) or of a revenue nature (and therefore taxable).**
  - This determinates whether the taxpayer is seen as developer or an investor by the South African Revenue Service.
  - Capital gains are taxed at a lower effective rate of tax in comparison to ordinary revenue income.
- **Tests to apply**
  - **Was the property sold in the course of carrying on an observable trade or business?**
    - If the answer to this question is "yes" the proceeds will be of a revenue nature.
  - **Was the sale merely a realisation of a capital asset to the best advantage?**
    - An affirmative answer leads to the conclusion that the proceeds are capital.
  - **Intention**
    - Tax law does not recognize inflation and the real value concept of money over time.
    - **The current (2009) rule of thumb applied by SARS is that holding a property for three years or longer usually qualifies as an investment.**
      - However, this rule of thumb, may never be applied din isolation.
    - **Note that the taxpayer's stated intention must be supported by documentary evidence as well as by his subsequent activities.**
      - The documentary evidence could be in the form of minutes, correspondence or other notes made at the time and should include feasibility studies, financing arrangements, architect's plans, etc.
- **Purchase of property**
  - **Trusts are frequently used as property ownership and development vehicles because their procedural and financial reporting requirements are less onerous than companies.**
  - **Partnerships** have certain disadvantages as vehicles for property ownership:
    - In the event of membership of a partnership changing, such change require re-registration of the partnership at the deeds office.
    - This will frequently lead to transfer duty being payable on the value taken by a retiring partner and paid by an incoming partner.
    - Quite apart from that, legal costs on re-registration become repetitive and onerous.
    - For this reason, partnerships frequently own fixed property through companies, whose shares are registered in the name of the partnership, thereby removing the need for any registration of transfer or any duty of any kind.
  - A word of caution: the effects and implications of capital gains tax differ between each vehicle.
- **Cash-out Refinancing**
  - A company raises a loan against security of the property and in turn lends the funds interest free to the shareholders.
  - If the rental earned by the company is sufficient to cover the interest rate cost, most property owners assume that it will be deductible against the rental.
  - **Unfortunately, the borrowing has not been raised in order to produce further income for the company but to make an interest free loan to the shareholders.**
    - The only effective way around this is to establish a new company in order to do so. The old company will then be liquidated and the proceeds distributed to its shareholders. Note that loans to shareholders could be treated as deemed dividends and subject to STC.
- **Termination of leases**
  - When a lease is uneconomic and the landlord wishes to have a tenant vacate to enable the landlord to re-let a higher rental, a lump sum paid to the tenant as a "sweetener" for early termination is usually deductible.
- **Value Added Tax**
  - Commercial rentals are subject to VAT.
  - VAT is charged on each separate rental payment and must be included in the VAT return for the period in which it is due, even if not paid.
  - Collection admission and related fees are also subject to VAT.
  - **Where a sale is subject to VAT at 14% or zero rated, no transfer duty will be payable. If the sale is not a VATable transaction, transfer duty will be payable by the purchaser.**
- **Disposals**

- **CGT events** would include, inter alia, disposals by way of:
  - sale
  - donation
  - conversion
  - exchange
  - expropriation
  - scrapping
  - destruction
  - vesting
  - decrease in value as a result of value shifting arrangements
- **Base Cost** comprises the sum of:
  - initial cost of acquisition
  - cost of improvements
  - moving and installation costs
  - costs associated with acquisition such as stamp duty and transfer duty
  - costs associated with sale such as agent's commission

Laws relating to Sectional Title and Share Block Companies

- Sectional Ownership
  - **A unit is defined as a section (of a building) together with an undivided share in common property which is allotted to the section according to the participation quota.**
  - **Formal requirements for establishing a sectional title scheme**
    - **Draft Sectional Plan**. Must:
      - delineate the boundaries of the land and the location of the relevant buildings on the land according to the diagram or general plan.
      - state the name of the building(s).
      - include a scale plan of every floor in the building(s).
      - define the boundaries of every section and distinguish it by a number.
      - state the floor area measured up to the centre of the outer walls of every section, and the total floor area of all the sections together.
      - delineate every exclusive area in the prescribed manner.
      - state the participation quota of every section
    - **Application to local authority**
    - **Approval of sectional plan**
    - **Opening of sectional title register**
      - With the opening of the sectional title register, the property is withdrawn from the land register. The developer must submit, the following documents:
        - the sectional plan (two copies)
        - annexures indicating all servitudes and title conditions, certified by a conveyancer
        - the title deed of the land
        - existing mortgage bonds and consent for their cancellation
        - a certificate by a conveyancer with regard to the rules applicable to the scheme
        - a certificate of registered sectional title for every unit in the scheme
  - **Body corporate and rules**
    - Once a sectional title register is opened and the sectional title scheme established the developer can alienate units.
    - As soon as the first unit is transferred to a person other than the developer a legal person (the body corporate) of which all the sectional owners are members is created, and the management powers with regard to the sectional title scheme are exercised by this body, subject to the rules of the scheme.
    - **The body corporate is responsible for the enforcement of the rules of the scheme in terms of section 35 and for the control, management and administration of the common property in the interests of all the sectional owners.**
- Share Block Schemes
  - Unlike with sectional ownership the shareholder acquires ownership of a share in the share block company and not ownership of a unit.
  - Ownership of the share provides the shareholder with the right of use.
  - **The most serious risk for a shareholder in a share block company is that he may lose his shareholding and right of use if the company is liquidated. In such a case the shareholder has nothing more than a concurrent claim against the liquidated estate of the share block company. It**

is therefore of the utmost importance to prevent the shatter block company from entering into hazardous business transactions.

    - A share block scheme may be used when it is impossible to establish a sectional title scheme. This may be the case where the developer is not the owner of the property.
    - The formalities for the erection of a share block scheme are fewer than is the case with a sectional title scheme. The establishment of a share block scheme is, for instance, not subject to the approval of the local authority or the registrar of deeds, apart from the approval of building plans. It is therefore cheaper and quicker to establish a share block scheme than is the case with a sectional title scheme.
    - Financing the purchase of a share block is problematic. Due to the lack of a real right, shareholders have difficulty in obtaining financing from financial institutions.

- Procedures related to property
    - A property cannot be transferred from one person to another while the seller has a mortgage bond registered over the property to be transferred.
    - Before a property situated within the area of a local authority may be transferred, all municipal rates and taxes must be paid. Proof payment in the form of a clearance certificate must be obtained from the local authority.
    - The conveyancer is an attorney who has taken an additional examination specialising in all aspects of property law and who has been admitted to practice as a conveyancer by the High Court. It is only a conveyancer who may be given a power of attorney by the owner of a land to execute deeds before the registrar on the owner's behalf.
        - Notwithstanding the fact that the conveyancer is nominated by the lender a diligent conveyancer will do all he can to assist the borrower with any queries he may have with regard to the loan.
- Forms of property investment vehicles
    - **Limited liability companies**
        - A limited liability company will generally be the most suitable investment vehicle, since it allows great flexibility and can be used for joint ventures.
        - Two types of limited liability companies are possible in South Africa: public companies and private companies.
            - An auditor must be appointed.
            - There is no requirement that there be any local shareholders or directors.
            - Separate legal personality.
    - **Branches**
        - A foreign company not wishing to incorporate a subsidiary in South Africa may instead set up a branch office.
        - The foreign company must register as an "external company" within 21 days of establishing a place of business in South Africa.
        - External companies must comply with the Companies Act by appointing a South African auditor and by submitting statutory returns and filing annual financial statements.
        - There is no need to appoint a local board of directors but simply one person residing in South Africa to accept service of any process and notices.
        - Branches are taxable entities but are taxed at a higher rate than domestic companies, namely, 35%.
    - **Property loan stock companies**
    - **Partnerships**
        - Because of their flexibility, partnerships are frequently used to create a joint venture between corporate entities.
        - They may be constituted by contract or by implication from the conduct of the partners. They are not regulated by statute.
        - The partnership must keep proper books and records and submit a copy of the partnership balance sheet and income statements in support of each individual's annual tax return.
    - **Business/trading trusts**
    - **Joint ventures**
        - Joint ventures may be conducted through any of the vehicles discussed above and be constituted between any two such vehicles.

The Fundamentals of Property Market Valuations

- The value indicated by recent sales of comparable properties in the market (sales comparison approach).

- The value of a property's earnings power based on a capitalisation of first year income (**income capitalisation approach**).
    - Although direct capitalisation is conceptually simple, it incorporates many assumptions. The most important assumption is that the first year's net operating income and the cap rate that is used will remain the same during the investment cycle.
    - **The international investment community regards direct capitalisation as inadequate and prefers to use discounted cash flow analysis for valuation purposes, because that approach makes most assumptions visible.**
- The value of a property's earnings power based on projected future income (**discounted cash flow analysis**).
- The current cost of reproducing or replacing the improvements, less loss in value from depreciation, plus the value of the land (**The cost approach**).
- **Valuation Report Format**
    - **Part one: introduction**
        - Title page
        - Table of contents
        - Certification of value
        - Qualifying and limiting conditions including general underlying assumptions
        - Summary of important conclusions
        - Purpose of the valuation
        - Definition of value and date of value estimate
        - Property rights valued
    - **Part two: factual description**
        - Identification with photographs
        - Area, city, neighbourhood and location data
        - Zoning and taxes
        - Site data
        - Description of improvements
        - History
    - **Part three: Analysis of data and opinions by the valuer**
        - Highest and best use of land as though vacant
        - Highest and best use of property as improved
        - Land value
        - One or more of the sales comparison approach, the income capitalisation approach or the cost approach (in North America all three are used for every valuation).
    - **Part four: Addenda**
        - Detailed legal description if not covered in Part two
        - detailed statistical data
        - leases or lease summaries
        - qualifications of the valuer

The Property Development Process

- The Participants in the Development Process:
- **The developer**
    - **The developer is the entrepreneur who initiates the production process and as such is the key player usually referred to as the client by the consultants.**
- **The consultants**
    - **Professional project manager**
        - The professional project manager is normally only financially justifiable on a large complex contract or on fast-track contracts where the architect's span of control or his management expertise would be insufficient due to the complexity of the project.
    - **Quantity Surveyor**
        - The major duties of the quantity surveyor as the construction cost manager in the building industry include feasibility studies, cost estimates, preparation of tender documents, evaluation of tenders, cost planning and control, preparation of cash flows, cost reports, interim valuations and the final account of building cost.
    - **Architect**
        - On contracts where there is no project manager, the architect is the principal agent of the client and the leader of the consultant team.
    - **Engineers**

        - The structural engineer will advise the architect on the design of the structural components of the building.
        - Electrical and mechanical engineers design and control the installation of the electrical installation.
    - **Other consultants**
        - Land surveyors
        - Property Valuers
        - Market analysts and researchers
        - Economists
        - Landscape architects
        - Town and urban planners
        - Interior decorators
        - Selling and letting agents
        - Advertising and public relations agencies
        - Accountants and tax consultants
        - Financiers
        - Attorneys
        - Computer, communication and security experts
- **The contractors**
    - **Civil contractors**: Responsible for the township infrastructure, such as construction of roads, storm water, water supply, sewer reticulation. They also do specialist ground works such as bulk excavations, dewatering of sites, ground improvements and piling operations on individual building sites.
    - **Building contractors:** Responsible for the erection of the building/s to the required quality, according to the drawings and specifications, within the specified contract period. **They are also responsible for control of subcontractors.**
    - Subcontractors consist of:
        - **Non-nominated/domestic subcontractors**
            - Plumbers
            - Plasterers
            - Painters
            - Joiners
            - Roofers
        - **Nominated subcontractors**
            - Specialist service contractors who specialise in the fields of electrical installations, lifts, etc.
            - Nominated by the client.
        - **Selected subcontractors**
            - Perform the same specialist work as nominated subcontractors
            - The difference is that the building contractor has more say over their appointment and the control of their performance.

Key stages in the Development Process

- **Stage 1: Initial planning stage of the project**
    - Phase 1: Formulating the developer's objectives
    - Phase 2: Conducting market analysis
    - Phase 3: Preparing financial feasibility study
    - Phase 4: Taking a decision on whether to continue with the project, shelve it until a later date, or abort it completely.
- **Stage 2: Acquiring the land**
- **Stage 3: Developing the land**
- **Stage 4: Constructing the building/s**
- **Stage 5: Marketing and leasing space and/or units**
- **Stage 6: Setting up property management and maintenance system**

The Property Investment Process

- **Property investment can be defined as the purchase of a property that generates capital gains and/or future expected income inflows for the owner.**
- **Property investors may be classified into active and passive investors:**
    - Passive investors are those who invest in property investment trusts, property loan stock companies or invest equity in a property as a sleeping partner.

    - Active investor son the other hand will acquire ownership of the property and will ensure that the property is well managed internally or they will outsource a specialist property management enterprise.
- **Due diligence is the investor's and not the bank's responsibility.**

Feasibility Analysis

- **A real estate project is feasible when the real estate analyst determines that there is a reasonable likelihood of satisfying explicit objectives.**
- **Components to be included in the framework for total feasibility analysis:**
    - **1. Objectives of the enterprise for whom the feasibility should be performed**
        - Strategic objectives and priorities
        - Tactical alternatives acceptable to the enterprise
        - Decision rules or policies to ultimately make a selection from alternatives.
    - **2. Market trends to identify opportunities areas consistent with objectives:**
        - Aggregate data on population, employment, income, for the appropriate area.
        - National economic and political factors affecting priorities, incentive, timing, etc.
        - Significant trends in public attitudes
        - Economic Innovation relevant to the client
    - **3. Market segmentation for merchandising targets**
    - **4. Legal political constraints**
    - **5. Aesthetic-ethical constraints**
    - **6. Physical-technical constraints and alternatives**
    - **7. Financial synthesis of proposed enterprise form**

Residential, Large Scale and Specialised developments

- **Sub-division of land is done by the land surveyor and is registered at the Surveyor General Office.**
- **Take an option and pay interest or a fee if required, instead of committing to a development that has hidden problems.**
- **In the case of renting, proof of pre-letting is important to the bank, while in the case of selling the units, proof of presales becomes important to the bank.**
- **Timeline**
    - A factor to consider is that you may not want to sell all the erven and the phases in the first sex months.
    - Prices may be escalating so that it is better to keep stock to sell later at higher prices, if the developer can afford to do so.

Development ideas

- Acquire old C-grade offices in the cities that generally have large vacancies and convert the building into residential units and possibly parking garages. Retain the office space at street level and convert the upper levels to sectional title apartments.
- Purchase a single residential property and apply to the local authority for a more intense residential use of the site by building flats on the property.

Shopping Centres

- **Types of shopping centres**
    - Convenience and neighbourhood
    - Community
    - Regional and Super Regional
    - Retail warehouses and access parks
- **Rental determination**
    - **Anchor tenants up so much space at low rentals, the rest of the tenants pay higher prices per square meter.**
        - The anchor tenants are the main draw cards and they end up paying the lowest rentals, but often also pay a percentage of their turnover per month.
        - Turnover could be anything from 0.8% to 2% and usually starts at a certain threshold figure.
        - They key tenant should be prepared to pay a fair share of the upkeep of common areas, centre promotion and advertising.
    - **Generally the larger the space, the less the rental per square meter.**

- <u>Types of tenants</u>
    - **Anchor tenants**
    - **Nationals**
    - **Magnets** are the other draw cards and would include chain restaurants, chain computer shops, etc.
    - **Line shops** includes everyone else.
- **One of the important areas to check is whether the national name on the tenant business such as Pick 'n Pay is actually Pick 'n Pay or a franchise operator who does not have the same financial strength. However, sometimes the franchisor could stand surety for the franchisee. This would give the bank more comfort.**

Fundamentals of the Property Management Function

- **A property poorly managed will cause expenses to rise and reduce the net operating income.**
- <u>The Management Plan</u>
    - **The management plan is an important document because it outlines the property's physical and financial management during the process of achieving the goals and objective set by the owners of the property.**
- <u>Marketing and Leasing</u>
    - Signage on the site.
    - Newspaper advertisements through leaflets and large advertisements.
    - Classified advertising in the classifieds sections of newspapers.
    - Billboard advertising along high density traffic routes.
    - Radio broadcasting advertisements
    - Television advertisements – for the very large developments to reach a national market.
    - Direct mail with pamphlets in post boxes or handed out at traffic lights.
- <u>Renting techniques</u>
    - **One way to induce renters into signing a long contract is to give them a few months rent free, and in the case of commercial properties to assist with paying the installation costs of the tenant.**
    - This is tax deductible to the building owner.
    - When calculated over the term of a typical lease, it may be better to give three months free rent and then start the tenant on R65 per square meter than to start them on R6- per square meter without a rent free period.
- <u>Checking the leases</u>
    - Since the lease is the document which "guarantees" the cash flow of the property **it is important that the bank checks all the original lease documents and not photocopies.**
    - There are dishonest Tippex operators in the market.
- <u>Rental collection</u>
    - **Dealing with non-paying tenants**
        - The tenant needs to be given a monthly rent invoice before the due date as a reminder of their obligations.
        - A second copy with a reminder to pay should be handed to them at closing of business on the second or third of the month where their payment is late.
    - **Eviction of tenants**
        - The eviction notice is the request to the tenant who has not paid in five days to immediately pay or vacate the premises by a given date.
        - They will lose their deposit, which should be calculated at more than one month's payment to allow for escalation and costs.
- <u>Functional obsolescence</u>
    - Each property is designed for a purpose/function and over time these functions alter because business processes and technologies change.
    - **Rule of thumb**: If you leave an A-grade building for 10 years without upgrading/modernising it you will have a B-grade building and 10 years later you will be in possession of a C-grade building.

The property financing process

- **The initial client meeting.**
    - **Discussing the CPF compliance requirements with the client.**
- **Collecting relevant data the bank requires for registration and compliance of the loan.**
- **Conducting the valuation/feasibility for development.**
- **Writing the application for credit with consultants estimated desktop valuation.**
- **Submitting the application to credit for loan approval.**
- **On approval, sign a formal contract for a loan.**
- **Submit the legal documentation for registration of the loan to the attorneys.**

- **Discuss the CFP compliance requirements with the client again, specifically with respect to documents outstanding for registration and disbursement.**
- **Disbursement on a monthly basis controlled against construction progress,**
- **Conversion of the development loan to a term loan on completion of construction.**
- **On payment of income from sales back into the loan account as per agreement.**
- **Finalisation of payment back into the VAT overdraft facility.**

The property financing process

- **Both the valuation and the application for loan approval have to be completed using the standard bank CPF templates.**
    - In this way, the bank ensures that all applications are uniform and the risk consultants can evaluate the loan applications without wasting time.