Global Management Review
Vol 13, Issue 2, July - December 2019
Doi:10.34155/GMR.19.1302.05

CASE STUDY - FUTURISTIC FUNDING FOR COMMERCIAL REAL ESTATE

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Real estate broadly comprises of residential and commercial. Real estate properties built for the purposes of offices, commercial services, trade purposes, Information Technology Parks, shops, entertainment centres, educational institutions, hospitals, hotels, etc are categorized as commercial real estate properties. Development and construction of these properties are projects involving huge capital. The developer of the project requires commitment of huge funds without which the projects cannot be completed.

Being capital intensive, even with a debt equity ratio of 70:30, the requirement of equity money for any project would be so high and developers have been finding it very difficult to fund their projects.

The residential projects usually have running sales and hence the equity requirement would be relatively lower due to receipt of intermediate cash flows. However, the case is different for commercial projects since usually commercial projects would not have any intermediate sales and therefore the equity requirement would be relatively much higher.

Developers mobilize debt for their projects from banks in forms including project finance, term loans, asset finance, working capital funding, etc. Still, since commercial projects do not have intermediate cash flows and require higher equity margin, the developers should be capable of infusing more equity funds to execute commercial projects. Since own funds are scarce for the developers, they find it very difficult to infuse sufficient equity to take up projects. This difficulty is causing developers to overleverage by borrowing for their equity portion from private sources, unsecured loans, and from indigenous bankers. Such funding is associated with high costs and reduces the profitability of the project. Further, any delays in execution, sales, or realization can overturn the profit margin from positive to negative. Loss in one major project can inflict other projects of the same developer and such incidents cause panic in the economy.

If projects have to be taken up only by a mix of debt and pure equity rather than envelope borrowing for the equity, then significantly fewer projects will only be taken up and only financial strong and big companies will be able to take up projects. Such a phenomenon also could be harmful to the competitive spirit of the market. Further, even the big companies also can take up very limited number of projects and the market needs may not be met with such a subdued and restrained pace of developments.

Developers do have commercial aspirations and have been exploring possibilities of mobilizing funds from alternate possible sources.

The outcome of the endeavors of the construction sector players or the investors have not been futile. There have been few major financial innovations which have given birth to new modes of fund mobilization such as Construction Finance cum Lease Rental Discounting from Banks or Non-Banking Finance Companies (NBFCs), issue of units in capital market through Real Estate Investment Trusts (REITs), issuing equity or preference shares to private equity investors through crowd funding (regulatory authorities apprehend this as a circumvention), issue of rupee denominated Masala Bonds outside India, etc. A brief discussion on the aforesaid innovative financial sources / modes is presented below.

CONSTRUCTION FINANCE CUM LEASE RENTAL DISCOUNTING

While construction finance (CF) and lease rental discounting (LRD) as separate funding options have been in existence for quite a long time, it is a recent phenomenon that CF and LRD are bundled as one product and are being made available to the companies that are in to developing and owning of commercial properties. The lender assesses the debt requirement of the commercial real estate project and sanctions CF for the development. Once the construction is completed, the property is expected to have a tenant occupying and would have rental income flowing in. Therefore, the CF will be converted (rather will stand converted) in to an LRD upon completion of the construction.

Since the rental income is more stable and consistent with LRD mechanism, the rental income will be escrowed in favour of the lender towards the loan servicing. The quantum of CF will be equivalent to the amount arrived at as per the discounted cash flow (DCF) method by discounting the future lease rents. Therefore, the repayment of the loan is tied-up with LRD and the CF is secured by the LRD. The CF part of the loan usually carries a higher rate of interest than that of the LRD. This is because LRD is a mere discounting of the future lease rentals with much less risk whereas CF is a loan advanced to create the property which will be the underlying asset for generating the regular rental income.

Of late, CF & LRD has been considered as a mutually beneficial mode of funding for lender and developer. But the company needs to maintain its debt equity ratio or total outsiders' liability to tangible net worth etc., parameters to be eligible to avail of funding through this source / mode.

Further, being the typical bank lending product, CF & LRD do carry relatively higher interest rates and may strain the profitability of the project. Therefore, although CF & LRD does exist widely, it has its own limitations and it cannot meet all the funding requirements of even commercial projects developers.

REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts (REITs) is an organization specifically formed for the purpose of owning income producing real estate properties. In most of the cases, REITs also operate the properties on their own. REITs mobilize funds through public offers and are listed on stock exchanges. REITs are similar to mutual funds except that while mutual funds invest in equity stocks and debt instruments, etc., REITs invest only in physical real estate properties meant for income generation for onward distribution to its investors. The periodical rental income and the capital receipts from the sale of properties will be distributed to the investors. SEBI has announced the regulations of Real Estate Investment Trusts (REITs) in 2014 to facilitate investments in real estate sector and more particularly in an organized manner. Dividend distribution tax is exempted for REITs considering REITs as a pure pass-through so that double taxation effect will not dissuade investors.

There are many investors who intend to take part in investment in realty assets but are not willing to take the risks involved in holding such realty assets physically. For such investors, REITs are the better alternative. Investors can buy and sell the units in REITs as frequently as they can do in case of equity stocks and therefore enjoy huge liquidity along with periodical income, capital appreciation, etc.

However, the stamp duty and capital gains involved in the process of moving the realty assets by the issuers intending to come out with REITs need exemption from capital gains tax and stamp duty levy so that the domiciling of the existing income generating assets in to REITs can be expeditiously done for the real success of REITs.

As on today, only one REIT is listed viz., Embassy Office Parks REIT. This REIT is sponsored by Embassy Group and Blackstone which is presently India' s largest office space owner. This REIT has been doing very well but not every developer can look at REIT option since it requires Rs. 500 crores value of assets to form a REIT. Also, since REITs are required to have income earning realty assets only, this source / mode is not directly available for launching and developing new projects.

MASALA BONDS & LOANS

Masala bonds are debt instruments denominated in Indian rupees but issued in countries other than India. These could be subscribed by non-resident Indians living in those other countries or locals of those countries (i.e., foreigners to India). These are more like external commercial borrowing (ECB) bonds except that Masala bonds are denominated in Indian rupees while ECB bonds are denominated in the local currency of that host foreign country in which the ECB bonds are sold from India by Indian companies.

There have been a good number of Masala Bond issues that were made and have been success. However, now that Masala Bonds are considered as External Commercial Borrowings (ECBs), the ECB related regulations and limitations are applicable for Masala Bonds as well and making them not conducive for all the developers.

UNMET NEED OF FUNDING

Although the traditional sources of funding and the new sources such as CF & LRD, Masala Bonds, REITs etc are existing, the complete funding requirements of developers are not met. Correspondingly, not many new investment instruments are engineered for attracting investors to provide funding to the commercial real estate sector.

The commercial real estate properties yield returns by way of rents from the commercial establishments occupying the buildings on lease basis. The rental yield from commercial properties range from 5% to 9% depending upon several variable factors including location, nature of property, specifications of the property, lessee, lease tenure, etc.

The capital investment on the commercial real estate properties usually get locked-up and the payback period is quite longer. For a developer to have early payback the only option is to sell of the complete commercial property. It would not be easy to find single buyers who could purchase complete commercial properties which would have high capital values. Due to this, the liquidity for exiting from such commercial projects will be lower and due to lack of sufficient liquidity, demand would be lower and therefore the profitability on such sales also would be lower for the developer. Again, if the profitability is lower, the developer will not have sufficient commercial motivation to develop commercial real estate projects and the commercial space needs of the businesses will not be met. Further, if commercial office spaces are not sufficiently available for leasing, the entrepreneur initiatives will be much lower since start-ups and MSMEs cannot afford to invest on their own office space.

Due to these limitations, majority of the capital could remain locked-up in the commercial real estate projects executed by the developers and newer source or mode of funding has been an imminent need for the developers.

STRATA SALE

This dire need of the hour impelled the developers to explore yet another new source to mobilize funds for their commercial real estate projects. The result is forward sale or part ownership sale of the commercial building to multiple owners such that the rent receipts also can be divided in the proportion of their ownership.

Under this Strata Sale model, the investors purchase a part of the commercial property and this amounts to a collective ownership of the property by all the part owners put together. The sole objective of purchasing (investing in) the commercial property by the said investors is to earn periodical revenue and long term capital appreciation, but not to occupy the part property owned by them. The commercial property developer usually undertakes the responsibility of finding a tenant for a relatively longer period of say 10 to 15 years with an upfront lease agreement execution.

Usually, the developer reserves the right and takes the responsibility of managing the property including the maintenance, insurance, routine repairs, security, power, etc., and will be entitled for a fee ranging between 5% to 15% depending upon the terms of the agreement.

The attraction of Strata Sale is that the developer can enter in to an agreement for sale with all the prospective buyers of the part property and can practically mobilize full or a part of the equity funding for developing the property. Depending upon the milestone based payment schedule as structured and agreed between the developer and the property buyers, developer may mobilize debt funding from banks or may even be able to manage just with the receipts of milestone based amounts from the property buyers.

Strata Sale is an innovative model which has evolved out of financial innovation by the developers to address the limitations of higher scale, size, issue costs, and compliance costs in funding through REITs.

It is understood that there have been quite a number of Strata Sale deals in various parts of the World and in India as well. Most of the Strata Sale deals are made within close circles and in an informal manner.

Since Strata Sale is not a shelf product like CF & LRD or a sale of a shop etc., the terms and conditions between the developer and the investor are mostly driven by the broad terms of a pure realty sale transaction. However, there are few established groups which have chosen to launch Strata Sale as a scheme for their investors / customers either with an objective of mobilizing funds or with an objective of convenient sales of their commercial space or with an objective of upfront receipt of funds, etc.

The overall return will comprise of annual yield and also the capital appreciation of the asset. It is not disputed that the yield is real and the capital appreciation is more notional unless the asset is sold.

Capital appreciation is not a contracted aspect to reckon in affirmation. It is more a projection or an expectation unless and until actually realized the extent and timing of which is not certain. Even then, since as per the past experience capital appreciation is certain if not its percentage, the historical average capital appreciation can be safely considered to estimate the overall return.

Historically, it is observed that value of a newly developed commercial property doubles in 48 to 60 months and thereafter appreciates at 4% to 8% per annum depending upon its nature. In any case, it can be safely presumed that the property value will double at least after 8 years.

MERITS OF STRATA SALE

Under this model of investment for investors and funding for developers, developer will sell small space of say 500 sft or 1000 sft units each, or multiples of such small units to investors who intend to invest in commercial realty for income purposes. All the investors (unit holders) will be the owners of their purchased units but are obligated to sign an irrevocable lease agreement through developer. The lease rentals will be distributed to the unit owners as per their space of square feet owned but after deducting the property management fee, insurance, property tax, etc.

Developer will take the onus of organizing the execution of lease deed, maintenance agreements, and rendering related administrative support along with the property management responsibility, all for a fee as per the agreed terms with the investors.

With this structure, the investor will promptly get its periodical return in to its bank account. Property management is taken care of. Property can be used as collateral security for any borrowings by the investor. Property appreciates progressively. Although both in terms of periodical income and capital appreciation, the commercial properties yield almost double or triple returns than those from residential properties, most of the intending investors are deprived of investing in commercial properties for major reason being huge investment which would be mostly beyond the capability of individual investors.

Under Strata Sale, individual investors can own a part of commercial property and can enjoy the financial benefits without any dilution in terms of proportion regardless of owning only a part of the commercial property. Further, the challenge of regular attention involved in case of real assets is also taken off with the developer itself undertaking the responsibility of property management and to remit net rental income to the investor-property owner.

The developer also benefits because it can minimize its equity margin in to the project, may avoid or minimize debt funding, can complete sales before launch itself, and may also have scope of achieving table profit before commencement of the project itself. As most of the investors may not be able to purchase the whole of the commercial property, it will not be easy for even the developer to easily find a single purchaser-investor for the whole of the commercial property. Therefore, it will be very convenient for the developer to fragment a big valued property into small property units and sell them to multiple investor-purchasers. This also facilitates the developer to realize a better price since the transaction will be done in a sellers' market rather than in a buyers' market.

CONCLUSION

Of the leading real estate players in the Country, several organizations including Puravankara, Prestige, Brigade, Artha, etc have been implementing projects funded through Strata Sale. There are numerous small developers who are mobilizing funds through this route and thereby been able to execute commercial real estate projects successfully.

Strata Sale deals do have their own limitations such as scope for disputes related to ownership sharing and maintenance of property being collectively owned, multiple tax deductions at source, costs involved in maintaining the rental distributing escrow system, etc.

However, as of now, for developers Strata Sale appears to be an additional and attractive funding source in addition to the long exiting funding sources.

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CASE QUESTIONS

1. How important are commercial real estate projects for the economic development and employment creation of a country?
2. What are the traditionally available funding sources for the developers of commercial real estate?
3. What are the limitations involved with conventional sources of funding for commercial real estate developers?
4. If sufficient funding is made available, would there be more number of commercial real estate properties and would that alone mean that additional employment opportunities will be generated and economic development will be facilitated?
5. What are the modern sources of fund raising that big developers are able to tap?
6. Why are the small and medium level developers not able to tap the modern sources of fund raising?
7. What is Strata Sale and how can that be explored by the developers to raise funding for their commercial real estate properties?

8. What regulation or systems should be expected so that the financial discipline, regulatory compliances, and transparency will be ensured while developers mobilize funding from Strata Sale source?

TEACHING NOTES

1. Importance of commercial real estate

Importance of commercial real estate cannot be overstated since there has to be a balance among residential and commercial real estate without which either of them can have growth prospects. Without real estate, economy cannot develop since construction sector contributes about 13% and real estate development denotes the quality of living and housing availability for the people of the country.

Without commercial real estate, office spaces cannot be created and employment opportunities will not be facilitated. Without employment opportunities, income earning power will not increase and the tax contribution will not be achieved, and thereby the virtuous cycle cannot be effectively achieved.

2. Traditionally available funding sources

The traditionally available funding sources include cash credit, over draft, term loan, construction loans, etc. Cash credit is virtually a perennial source since the credit is available against future inflow of cash flows. The interest is charged only on the actual utilized levels of limits although of late bankers are charging a commitment fee on non-utilized funds. Over draft is of similar nature of cash credit except that in case of overdraft the limits are of temporary in nature and that the drawing power is increased for the temporary purposes. Term loans are more of asset loans or equipment loans or construction loans granted for a fixed period of time. These need to be repaid over a period of time as per the sanction terms.

3. Limitations of conventional sources of funding

Conventional sources of funding such as overdraft, cash credit, asset finance, short term working capital loans, etc., come at a higher interest rates and also the banks' lending these credit facilities require huge collateral securities. Not every developer will be able to provide high level of collateral securities to the lenders.

However, the traditional funding sources have established patterns and it would be relatively easier to mobilize if the developer is capable of meeting the requirements of the lender including furnishing the required higher level of collateral securities.

4. Employment opportunities

It is interesting to note that firstly construction activity itself generates employment opportunities. Further the commercial office spaces created gets occupied by organizations which deploy manpower in their offices for carrying on their business activities. Thus the commercial real estate facilitates employment creation.

However, commercial real estate on its own will not be able to create sustainable employment opportunities unless the office spaces are needed by businesses and unless the business would be capable of paying the rents for the commercial office spaces.

5. Modern sources of funds, the bastion of big players:

By theory, the modern funding options such as Masala Bonds, REITs, etc are available for all the developers. However the costs, regulatory compliances, procedures, minimum volume requirements, etc practically limit the scope of availing funding from such modern sources only to the big players who can afford to comply with the requirements and can take advantage of the economies of scale.

6. Small and medium players not able to tap modern funding sources:

These funding sources such as Masala Bonds, REITs have huge regulatory compliances. These compliances come with huge cost and procedure. Great level of professionalism and sophistication is required for the borrowers to mobilize funding from these sources.

Such sophistication and professionalism will be difficult at small and medium size players. The level of funding required for them will not be able to absorb or afford the costs and manpower required to meet the compliances.

7. Strata Sale

Strata Sale is a sale method where parts of the commercial real estate property is sold to multiple owners either at the beginning or midway or upon completion of the commercial property. The investors invest in this mode since each of them will not be able to own the complete property and at the same time they do not want to miss out on taking advantage of the returns from the commercial real estate.

The established players or players with goodwill will be able to find investors within their own customer base or known circles and will be able to sell parts of the property such that the funding is generated for the developer and the investors get to own commercial real estate property in parts. This will be a win-win situation to both the developer and the investor.

8. Regulations / systems required

Any funding method needs to be regulated in a country like India since the financial literacy levels are relatively much lower. Further, in the absence of sufficient regulation, certain rogue developers may exploit the gullible investors and may harm the entire industry. Government will then have to put a mechanism and manpower in nabbing the culprits and also need to devise strategies and regulations to bring them to law. Instead having a proper system and regulatory mechanism in advance will be prospective and fruitful for all the stakeholders including developers, investors, lessees, tax authorities, Government and general public at large.

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