Chapter II

PROPERTY FINANCE

2.1 Introduction

A property or building can be owner-occupied or rented i.e. an investment property. Property finance is money raised for the purpose of expenditure on properties. Whether the property is owner-occupied or an investment property may alter the criteria for the raising and application of the funds, but the fundamental concepts may well be the same.¹ For instance, funds could be raised internally or externally by an organisation but the criteria for the internal loan or transfer of funds may well need to match those in the market.

The investment market for property cannot be seen in isolation from other investment markets. The application of funds to property has to face competition from other forms of investment. The decision to invest in a particular area will be a comparison of return and security. The nature of the lender and the property to which finance is applied is also important.

At its simplest it is an individual purchasing a single property with a single loan. However much finance is also raised by corporate entities, such as property companies, lending on the back of existing property and other assets for the purchase of a portfolio of assets, which may also include property assets.

Property and finance are also significant to the economy. The importance can be shown in three different ways: as a factor of production, as a corporate asset and as an investment. As a factor of production, property is the space in which economic activity will take place, the efficiency and costs of such space will affect the cost of goods and services produced. As a corporate asset, it forms the major asset value in the balance sheet and the majority of corporate debt is secured against it. As an investment it is one of the major types of investments held by the financial institutions on which pensions and assure benefits depend.\(^2\)

2.1.1 The Structure of the Investment Market

There are three major areas of traditional investment opportunity: these are fixed interest securities, company stocks and shares and real property. The stock exchange provides a market for listed shares and certain fixed interest securities such as those issued by the Government, local authorities and public bodies.

The market in real property contrasts with that of company shares and other securities. The property market is fragmented and dispersed while that of shares and other securities is highly centralised. The centralisation of markets assists the transferability of investments, as does the fact that stock and shares can be funded in small units, thereby assisting transferability.

Compared to other traditional investment opportunities real property investment has the distinguishing features of being heterogeneous and indivisible and having inherent problems of management. These problems of management may include collecting rents and dealing with repairs and lease renewal and thus may lead to real property being an unattractive proposition for the small investor. A decentralised market will tend to have high costs of transfer of investments and also there will be an imperfect knowledge of transactions.

Thus the nature of the real property market makes property difficult to value. There is no centralised market price to rely on, as the price may be too difficult to ascertain unless a transaction has recently taken place. Many of the problems of valuation relate to difficulties of trying to relate comparable transactions to properties being valued or even trying to assess what transactions could be considered comparable. Because of the nature of real estate

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market, individual investors have tended to withdraw from the market. This is also due to the channeling of savings into collective organisations, such as pension funds and insurance companies rather than individuals using their savings for direct investment.4

2.2 Financial Structures

Property finance is important in the property investment market. The costs and availability of finance will affect the cost of the provision of new investment property and therefore its supply. It is through finance that the structure of the investment interest in property may be created, so finance has effect on the form of the interest. While costs and availability of funding are obvious in the case of the funding of development property, it is critical to the investment market also. There are basic principles of the financial structure, which have been identified among others.5

- A company must maintain a balance between equity and debt capital. Traditionally property companies are highly geared; this means that these companies carry a high level of debt capital relative to equity or total capital. The security of property and the growth in rental values and capital value have provided an appropriate environment for increasing debt

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capital. Apart from the balance of equity and debt, the nature and composition of equity and debt in themselves are also important.

- There should be a balance of maturity dates of the debt with the majority being long-term. Redemptions should be spread evenly to avoid the risk of a major refinancing operation occurring at a time of adverse financial conditions. The proportion of the money should be flexible so that it can be repaid without cost or penalty at any time during the duration of the term.

- A company should match short-term assets with short-term liabilities and long-term assets with long-term liabilities. If long-term property investment is funded through short-term borrowing e.g. overdraft or short-term debt, then there could be major problems for refinancing, as an appropriate stock of new capital may not be available at the crucial time of refinancing. This may mean that the property asset would have to be disposed of at an inappropriate time, leading to a collapse in its value.

- Companies should maintain a balance between fixed interest money and variable interest money. Fixed interest rates protect the company in a period of rising interest rates but obviously are expensive if rates fall. Variable rates need to be available if interest rates fall so that the benefits of the
reduced cost of money can be obtained. Fixed interest money with exorbitant interest rate could have a disastrous effect on a property company in a period of low inflation.

- Debt should be structured so that interest repayments are spread over the year so as to even out the cash flow for the company.

- To avoid foreign currency risk, companies with operations overseas should reduce their exposure to this risk by matching overseas assets and debts in the same currency.

- The financial structure should aim to maximize the tax shield i.e., the avoidance of tax payment to maximise the after-tax cash flow.

- The arranging costs should also be minimised. The price of capital includes not just the interest rates, but commitment and arrangement fees, penalties for early repayment and is based on the frequency and how interest is calculated on the outstanding amount.

2.3 The Finance Function

Management and finance theory suggest that in a well-organised business each section of the business should arrange its activities to contribute to the attainment of corporate goals. Central to this function in a corporate entity is the maximisation of
shareholders' wealth. The generation and management of cash basically do this. This is the fundamental concern of finance. Pike and Neale\(^6\) suggest a simple cash flow diagram.

![Cash Flow Diagram](image.png)

**Figure II.1   Cash Flow**

### 2.3.1 Types of Funds

There are two major sources of funds for financing any investment. Investors can contribute their own capital or they may use the capital of others. The combination of owner and creditor capital tends, under the proper conditions to increase the owner's overall return on an investment compared to all equity financing.

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2.3.2 Equity Funds

Under normal circumstances when owners wish to finance a property, they will have the title. This leaves the lenders with the need for some protection of their interests. The equity supplied by the owner provides a cushion of value for the lender so that if the property needs to be sold to settle the debt, any loss in value will be absorbed first by the owner.\(^7\)

There are several sources of equity funds for prospective owners. They may use their own savings, a major source of such funds. Investors may also liquidate some of their non-cash assets such as securities or personal property to obtain equity funds. Borrowing may also raise equity. Often an investor may be able to borrow from relatives and friends without security. Even though this is not true equity, it is a viable substitute.

Another substitute for equity is leasing. If investors lease a property they need from the owner, they generally do not have to supply any equity at all. An investor who does not have sufficient equity may sell shares to other investors known as syndication. Syndicates may be limited partnerships, corporations, trusts or other miscellaneous joint ventures.

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2.3.3 Creditor Capital

The leverage that an investor can obtain for financing property comes from borrowing and leasing. Borrowed funds can be obtained from institutions or individuals. Many borrowed funds obtained from individuals are secured from the seller of the property in the form of purchase money mortgages, land contract arrangements or leases. Most institutional borrowings are in the form of mortgage loans or leases.

2.3.4 Mortgage Loans

A mortgage loan is a loan secured by land or improved property. With this arrangement, the lender can cause the sale of the property to settle the debt if the borrower defaults on the loan.8

When a property owner borrows money using a real estate mortgage loan, the owner is committed in two ways. First, the borrower signs a note with the lender, which is evidence of the debt incurred. This note specifies the amount of money, which is owed, the rate of interest to be charged and other terms of the debt. The borrower also makes a mortgage with the lender, which offers specific real property as security for the debt.

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2.3.5 Mortgage Varieties

The most common form of the mortgage loan is the first mortgage or senior mortgage. First mortgages are typical while second mortgages are used only occasionally. There are many other types of mortgage loans that may be used in special situations.

2.3.6 Blanket Mortgage

An investor in the process of developing and selling a large tract of homes may find it economical to obtain a blanket mortgage on the entire group of homes. As each unit or lot is sold, the borrower will settle with the lender to release the unit from the blanket mortgage.

2.3.7 Package Mortgage

A mortgage in its pure form is an instrument secured by real property. When a developer is building and selling homes, it may be desirable to include personal property under the mortgage. Stoves, dishwashers or even furniture may be sold in the home and covered by a package mortgage loan.

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2.3.8 Transactions Involving Mortgaged Property

When a property is sold with a mortgage lien against it, there are at least three ways of handling the situation. The buyer may allow the seller to discharge the loan by refinancing the property with a new mortgage. The proceeds of the new loan will be used to pay off the old one. The old lien will thus be removed and a new one put on.

The second solution is for the buyer to assume the seller's existing loan. In this situation, the buyer will make the payments on the loan. This process often allows that buyer to lower the cost of the transaction by avoiding the cost of refinancing. However the seller remains secondarily liable for the loan if the buyer fails to pay the payments properly.

A property with an existing loan may also be sold subject to that loan. The buyer makes the payments but the original borrower remains primarily liable in case of default.

2.4 Other Financing Forms

The mortgage loan is an important form of long-term financing. There are two other important long-term forms and

several short-term sources of funds, which are used in property financing.

2.4.1 Land Contracts

This form of financing is given by the seller to the buyer. The buyer executes a contract with the seller in which the buyer promises to pay for the property at a certain rate. However the seller retains title to the property until the contract terms are fulfilled. The buyer gets possession and the responsibility for the property, but not the deed.

A land contract is similar in form to any other type of contract. It contains a property description and the basic terms under which the deed will be transferred. Land contracts have been popular in transfers of farms and raw predevelopment land. The use of a contract permits sellers to prorate any capital gain they have over the life of the contract. The buyers alternatively do not have the same sort of commitment with a land contract than they would have with a mortgage. If contract buyers find themselves unable to fulfil their contract especially early in its life, they can walk away and the seller retakes possession.

2.4.2 Leases

A lease is a contract between the current owner of the rights to possession and use (the lessor) and the party to whom these will
be transferred (lessee). Most forms of lease arrangements are for reasonably long periods or at least more than a year or so. Rent can be fixed for the life of the lease or it may vary according to some schedule.

2.4.3 Net Leases

A lease contract is basically a form of financing an interest in property. A net lease is one which fails to provide one or more of the standard services or one in which the lessee pays expenses such as taxes or insurance.\(^{11}\)

2.4.4 Long-Term Leases

If improvements on the land are to be financed, the lease must generally be for a period at least one year longer than the period of the loan. For this reason, the owners of the prospective leasehold are forced to seek a long-term lease in order to set up the financing required for the improvements.

2.4.5 Sale and Leaseback

In a sale and leaseback the developer sells a completed project to an investor and simultaneously takes back a long lease

of the development at an agreed rent calculated on the basis of an appropriate rate of return applied to the purchase. The developer then sublets the project to occupying tenants and enjoys by way of a profit the difference between the rent paid to the investor and that received from the tenants.12

2.4.6 Leases as Collateral

Both the lessor and the lessee may use their interest in leased premises as security for other financing. The owner of the property has a contract, which guarantees a stream of benefits in the form of rent. Even though the lessor does not possess the property, he or she has a valuable interest. This interest may serve as valuable security for a loan.

Similarly the rights of the lessee are also valuable. With a suitable ground-lease, a lessee may make improvements which can be financed.

2.4.7 Short-Term Financing

Often real estate purchasers need money only for a short time. Usually these sources are only interim loans required to bridge the gap between purchase and the final long-term financing.

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2.4.8 Construction Loans

When an investor is in the process of building a new improvement to a property, funds may be needed for the construction period. Construction funds may be given to the builder on a percent completion basis or they may be paid directly to subcontractors presenting bills for work completed. This choice will depend on the credit-worthiness of the builder.

2.4.9 Gap Financing

Often when an individual is moving from one house to another, the closings of the two transactions do not coincide. If an individual must use the equity from the home being sold as a down payment for the house being purchased, there may be a gap to fill in between the transactions. Banks and other lenders are utilized here for short-term loans to cover the needed equity for closing the purchase transaction.

2.5 Term Loans

Often coupled with the development of a commercial property, there will be a requirement to purchase equipment or provide working capital. Even though these needs are not strictly required for the purchase of the real property, they may be necessary to enable the owner to use the property in its intended purpose. As part of the total financing package, the borrower may
arrange a term loan at a bank for a period of three to five years to help defray business start-up costs. As the venture becomes profitable, the loan can be converted to equity by paying for it with the profits retained in the business.

2.6 The Flow of Funds

2.6.1 The Role of Personal Savings

The primary source of funds for all new investment in the economy is personal savings.\(^{13}\) When an individual receives income, there are two choices for its disposal: consumption and savings. If an individual has more disposable income than is needed, then this surplus will be saved for a future period.

Individual savers have many outlets for their savings. If investment is chosen, the savers have a number of possible choices. The funds can be used to purchase securities, commodities, or direct interests in business and real estate ventures. In these cases, the individual saver is making the placement decision and assessing the risks and returns. Savers may also deposit their funds with a financial intermediary who makes the investment decisions for them.


Thus the funds for lending come from three sources: individual savings, corporate profits and indirectly from money creation. These funds flow into direct investments in business capital and deposits in financial institutions. These institutions then complete the process of investment by using the savings to make loans and finance the equity in new ventures.

2.6.2 Sources of Property Finance

The main lenders in the market are:

1. **Savings and Loan Associations**

   The largest source of mortgage money for single-family residences in developed countries is savings and loan associations. Savers open various types of time deposit accounts at these institutions, and the savings and loan associations use the money almost exclusively for mortgage loans.

2. **Insurance companies**

   The insurance companies are providers of property finance. Life insurance companies especially the larger ones have a great deal of cash to invest annually. Because of the long-term nature of a life insurance contract, the insurance company prefers long-lived stable investments such as bonds, real estate mortgages and leases to more volatile investments.\(^\text{14}\)

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3. **Private sector**

In most developing countries like India, the private sector plays a dominant role in property finance. However the lion’s share of this investment is for the growing needs of the urban population. The builders, who are motivated by profit, show a great deal of initiative and enterprise and take risk in house building activities that are useful only to a small section of the community living in urban areas. A major part of the finance comes from the buyers of these houses who pay this in instalments.\(^{15}\)

4. **Commercial Banks**

Finance provided by banks for property especially in developing countries like India includes loans to individuals and institutions like central and state Government undertakings, housing boards and local development authorities etc which are engaged in house-building activity as a primary or subsidiary function.\(^{16}\)

5. **Real Estate Investment Trusts**

A real estate investment trust is an institution, which is organised much like a mutual fund or security investment trust.

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Shares are sold and money is borrowed to invest in real estate. Real Estate Investment Trusts may lend money or invest directly in real estate and distribute the proceeds to the investors.

6. Lending Criteria

The cost and availability of lending is a function of the value of any particular project and the amount of cost to be financed. The nature of the development is also important: the design, mix, location and likely demand. The letting conditions are important, as are whether or not the investment is pre-let or speculative. The qualities of the tenant, who will be providing the cash flow to the investment, are also important. Other important criteria are the track record of the developer and the strength of security. Finally the duration of the loan will be important as well as the details of repayment, for example, the anticipated regularity of repayments and the size and amount of repayments prior to redemption.\(^{17}\)

Most lenders look for the same aspects of a lending proposal, which are:

- Character
- Cashstake
- Capability
- Collateral

**Character**

This relates to the trading history or development experience of a borrower. In respect of a property developer or an investment company, the lender will want to know whether the borrower has the experience to complete the development, manage the investment or run the business. The lender will also be interested in whether the client is respectable and trustworthy.

**Cashstake**

This relates to how much equity (the borrower's own money) is going into the transaction. In addition the bank will want to know where the equity has come from.

**Capability**

Capability relates to whether the borrower is capable enough to service the loan - that is to pay the interest when it arises and the capital as and when repayment is required.

**Collateral**

The lender will want to know what security will be offered for the loan, its value and its saleability. The lender would also want to know who valued the security and on what basis.
**General Criteria**

Lenders want the borrower to be a successful, well-respected individual or company who can comfortably afford to repay the proposed borrowing.

### 2.7 Property Companies

Property business is defined as extraction of value from land and buildings such that the landlord takes a creditor's view rather than an equity holder's view of the occupiers.\(^{18}\) The main features of a property company to be considered by an investor are:

1. The quality of assets in the portfolio, the age, location and tenure of individual properties and their relative importance in the portfolio.

2. The perceived quality of management in the company, which is very subjective and is often about single individuals in the company.

3. The sources of income of the company. These will vary between well-established property investment companies relying on rents and property development companies whose income arises from selling of completed developments.

4. The capital structure and gearing of the company. A highly geared financial structure is more appropriate for established

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companies deriving a large proportion of revenue from rental income than for development companies dependent on less secure trading profits.

2.7.1 Funding of property development by property companies

There are a number of indirect routes into investment in property. The main ones are: property company shares, property unit linked life assurance schemes, exempt unit trusts and managed funds, mortgages and debentures. Shares are generally available to a wide range of investors whereas bonds are an investment medium for an individual. Exempt trusts and managed funds often provide an indirect investment vehicle for pension funds and charities. The value of the shares of the Property Company bears some relationship to the value of the property it owns and the income it derives from property operations.