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PROPERTY DEVELOPMENT

LUMPS, BUMPS, AND SLUMPS

By Alan Lok, CFA, Eunice Chu, and Guruprasad Jambunathan

In a complex and fast-moving financial world, it's comforting to know that some sectors remain relatively easy to understand. A case in point is property development. The property developer acquires land and an architect then designs the building and obtains planning approval before passing the baton to the construction team.

At this stage, the developer could choose to undertake marketing and sales before construction is complete or wait until the last brick falls into place. Either way, you can then calculate the gross development value (GDV) of a project or profit from the project, of which the sum of GDV, excluding the developer's liabilities, will yield the value of the development.

FUNDAMENTAL #1: LUMPY REVENUE GENERATION

So far, so simple. There are, however, a few variations to this straightforward business model that you should note. We shall begin with the lumpy nature of revenue generation.

It can take years to complete a project, and if the developer only has only one development, then the profit-and-loss account will not record any revenue during the planning and construction phase – something that can stretch for many financial reporting quarters. Upon completion, and the subsequent sale of residential or commercial units, revenue will spike before declining when all the units are sold. Investors and analysts are somewhat uneasy with this supposedly erratic performance.

That said, revenue volatility is not a pertinent issue for big developers, as they usually have multiple projects running concurrently with different completion dates.

For companies that do not fall into this category, the need to smooth out their income stream is far stronger. The following steps may stabilise the variations in a firm's financial statements:

- Develop the land in phases. The first tranche is completed and sold, often at a lower entry price to generate interest in the project. When word gets out that the initial stage was well-received, work will start on phase two. By adopting this approach, the smaller developer's revenue will appear more fluid.
- For developers that lack the financial resources to take on multiple enterprises, there is the option of running numerous projects through joint ventures. The landowner supplies the land while the property developer does the rest, which evens out revenue-reporting numbers and reduces risk exposure to a project.
- Generate money from property investment. Developers may hold onto units for rental purposes, forming a revenue base and providing earnings stability. Alternatively, they may spin-off the property investment portfolio to a real estate investment trust (REIT), where dividends are declared on a quarterly or half-yearly basis.

It is also important to point out that any assessment of a property developer should consider the geographical distribution of its revenue sources – diversification reduces the risks associated with revenue concentration. Nevertheless, embodied in the points above are the all-important reputation and track record of the company. Purchasing real estate is not the same as buying fast-moving goods and services. We can choose not to patronise a restaurant due to poor service, but being saddled with a troubled property is painful, and the discomfort can be long lasting. Buyers and investors certainly place reputation and track record at a definite premium.

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FUNDAMENTAL #2: THE DIFFERENT DEMAND FACTORS FOR PROPERTY DEVELOPERS

For residential property developers, key statistics include demographics: population, age, and net migration, as well as movement from the countryside to the city. Changes in income statistics should also be observed. Other areas to investigate include issues relating to single-occupancy city-centre apartments and suburban family houses. It also pays to understand the culture of each market – is home ownership seen as a measure of success or is perpetual renting accepted as the norm?

In the wake of near-zero interest rates, property prices have accelerated in many countries, including those in Asia Pacific where the price-to-income ratio (a measure of affordability) has soared. It is indeed a concern and you will likely solicit an angry response if the respondent has yet to own a residential unit. Governments may therefore offer subsidies to first-time home buyers, which can bode well for developers in the lower-end residential property space.

When examining the more cyclical commercial property developers, begin by looking at economic data. Stronger growth and expansionary monetary policies usually suggest an increase in business activity. Therefore, warehouses, factories, and retail assets will be highly sought after. The expansion in the service industry will also propel demand for office space.

After that, drill down and explore the factors unique to each industry and the location of the property. For example, when researching hotels, you should examine the growth in tourist arrivals. Another significant factor is the expansion of e-commerce, with demand for retail space suffering in favour of high-tech warehousing space in Asia-Pacific.

FUNDAMENTAL #3: LAND – THE CRUCIAL RAW MATERIAL IN PROPERTY DEVELOPMENT

Most developers possess a land bank, but this is an asset that can be depleted if not replenished promptly. Companies do participate in public auctions of land released by governments and can also choose to buy land from private owners. The key to land parcels is location, location, and location – but not at any cost. Overly optimistic offer prices at the peak of an economic cycle will hit the bottom line, more so in highly developed territories where the land cost forms the overwhelming proportion of total development costs.

Alternatively, developers may acquire old buildings. Although this can be less expensive than participating in auctions, such activity raises questions about the time and cost-effectiveness of renovating or converting an existing asset. In some areas, developers may also "land bank" through the conversion of one use of land to another, subject to the jurisdiction of the local authority.

FUNDAMENTAL #4: COMPANY ANALYSIS – DEVELOPERS AREN'T HOMOGENOUS

Several key performance metrics can be employed in the study of developers. Sell-through rates for recently launched projects can be a direct indication of company performance and an indication of track record and reputation. Observe changes in overall transaction volume, also known as transaction velocity, as there is a strong correlation between share prices and property transaction prices (as measured by property price index) and volume.

Changes in unsold inventory can indicate cyclical upswings and downswings. As a value measure, share price to revalued net asset value (RNAV, which is the book value of development property plus revaluation surplus) is a useful metric. During an up cycle, this ratio may range from around 0.9 to 1.5. On the other hand, in a bear market can this ratio may range from approximately 0.3 to 0.6.

Studying how a developer manages its working capital (WC) requirement is helpful. Such an assessment should begin by analysing how the developer raises WC and the implications for the cost of capital and risk. At the same time, find out if the developer requires a higher level of WC in different areas of its operations, such as projects in other countries. Investors also need to note the developer's capital-allocation strategy in apportioning money to acquiring land parcels, developing properties, and other competing uses.

Another variation on the straightforward business model is the outsourcing of construction to contractors, as well as subcontractors. A developer's essential competency rests on having a keen eye for acquiring reasonably priced land parcels and developing these into coveted real estate trophies. While doing this, its management may decide to focus on what generates value for the business and outsource the construction segment. When extracting value from construction, the core competency differs – in this case, execution and cost control form the recipe for success. If this is the variation, then capital and WC requirements will be lower.

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FUNDAMENTAL #5: SOURCES OF CAPITAL

Funding is critical for property development projects. External sources of money may come from bank loans, bond financing, share-rights issuance, or some other form of equity financing. Where a property developer has obtained funding, take the time to understand the funding structure because this can impact returns, especially if the company is highly geared.

FUNDAMENTAL #6: RISKS - ANALYSE THESE UNDER A MICROSCOPE

A developer may successfully bid for land during a boom only to experience a subsequent market correction. Alternatively, it may bid overzealously and pay too much for individual land plots. As land forms a sizeable portion of total production, this cost misstep will hurt.

There may also be a supply shock with too many projects being completed all at once. This oversupply can be exacerbated by macroeconomic downturns, depressing both prices and take-up rates. Highly leveraged developers are acutely exposed when there is a double whammy of falling prices and risk-averse buyers.

Government intervention in the market is a further source of risk. Developers may experience the adverse consequence arising from regulatory policy changes designed to curb a perceived bubble.

For research points that look at the sector in more detail, please refer to the respective sections of our guide.

About the Authors
Alan Lok, CFA, is Director of Society Advocacy Engagement, CFA Institute. He researches and writes on investor protection issues and capital-market structure. He recently co-authored a CFA Institute position paper on capital-market integrity, "*Portfolio Pumping in Singapore: Myth or Reality.*" Mr. Lok has more than 10 years of equity research experience, spanning various industries and sectors.

Eunice Chu is an ACCA-qualified finance professional. She was a regional finance director of a Fortune 500 multinational corporation and at present heads the policy function of ACCA Hong Kong.

Guruprasad Jambunathan, FRM, is Director for Financial Research at CRISIL, a global research and analytics company. He has more than 12 years of experience in equity research and works closely with a broad clientele of buy-side and sell-side firms, as well as with academic think tanks across various continents.

Sector Analysis: A Framework for Investors

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The business model of property developers face related, yet different, operational dynamics as those faced by the asset owner (REITs)

01 REVENUE SOURCES
Balancing Stable vs. Lumpy (Uneven) Revenue

- Property investment business – Rent collection
- Property development
- Strategic investments – depending on specific asset class nature

02 Structural Influencers

- Tiers of city – economic development
- Regulatory restraints (in relation to jurisdiction)
- Population
  - Demographics
  - Migration friendliness
  - Urbanisation
- Government housing subsidy
- Culture – asset owning vs rental

03 TYPE OF PROPERTY ASSET CLASS

- Residential
- Commercial
- Industrial
- Hospitality

04 SOURCES OF LAND BANK

- Legacy sources
- Redevelopment of existing property
- Public auctions/ land tenders
- Conversion of land-use nature

05 SOURCES OF FUNDING

- Committed banking facilities
- Bond financing
- Rights issue
- Equity financing

06 RISK

- Mismatch of market timing during property development
- Supply shock
- Unexpected macro shock
- Over leveraged gearing ratio
- Market interest rate change
- Average tenor of loan too short
- Expectation mismatch (between type of units developed versus end-consumer needs)
- Regulatory policy
- Increase in vacancy

07 OTHERS

- ESG
- Other KPIs
  - Sell-through rates
  - Unsold inventory
  - Price to RNAV
  - Price-to-income ratio

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Property Developers

1. **What are the details of the project profile of the company?**
   a. Does the company cater to both residential and non-residential consumer categories?
   b. How is the residential category classified in geographies where the company operates? Are there additional segments beyond affordable or budget housing, mid-size, luxury housing and retirement homes? Which of these segments does the company operates in?
   c. What are the types of properties the company develops for the non-residential category? Does it cover segments beyond offices, retail space, shopping malls, hotels and recreational facilities?

2. **What are the drivers of demand for properties in the key markets?**
   a. How does the demand versus supply situation look in different consumer categories and segments across the company's key markets?
   b. Is there oversupply or undersupply in any specific segments, consumer categories or locations?
   c. How much relative importance do consumers attach to factors such as location, quality, and reputation of developer, pricing, total property cost, availability of finance and payment terms while making purchase decisions? Are there any other critical factors considered important by consumers across categories or segments in different regions?
   d. To what extent does the company customize properties to suit customer needs?
   e. What is the trade-off between the level of customisation and overruns in cost and time?
   f. What is the extent of cyclicality and seasonality of demand for the company's properties?

3. **What are the drivers of demand for properties in the residential category?**
   a. What is the level of unsold home inventories in different segments and regions?
   b. Which segment is the company's primary focus? Does this vary by region?
   c. How do house prices compare with income levels in key markets?
   d. How do the dynamics of home ownership vs rental accommodation compare in the key markets of the company?
   e. How favourable is the regulatory environment for growth of the housing finance market?
   f. How prevalent is housing finance and how easy is it to obtain home loans?
   g. How stringent are the down payment requirements and credit assessment norms?
   h. What are the recent trends in building permit issuances, housing starts and unsold inventories?
   i. How correlated are consumer confidence and employment conditions with new home sales, building permit issuances, housing starts and unsold inventories?

4. **What are the drivers of demand for properties in the non-residential market?**
   a. What are the trends in discretionary corporate spending on buildings and other infrastructural facilities?
   b. Which are the industries driving demand for office and other non-residential properties?
   c. What are the office vacancy rates, unsold inventory levels and trends in commercial property prices?
   d. How correlated are business confidence indicators with occupancy rates?
   e. How easily and quickly can properties be reconfigured for different uses? For example, can a property built for a traditional, large office space designed for a large bank be converted into multiple smaller workspaces to accommodate start-up companies?

5. **What are the factors driving property prices in the key markets?**
   a. How do location, type and quality of property and availability of amenities affect prices?
   b. What is the share of properties that are self-funded by the buyer versus those funded by borrowings?
   c. What is the size and liquidity of resale property market?
   d. How does the availability of housing finance and ease of payment terms influence prices?
   e. What is the effect of liquidity and credit conditions on prices?
   f. How does the perception of property as an investment vehicle compare with that of other asset classes in the key markets?
   g. Is cyclicality observed in house prices? How does the company manage the impact of cyclicality?
   h. How does the company manage the trade-off between waiting for the best bidder (highest price) and maintaining a light inventory of properties to sell?

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6. What is the mix of revenue and profits by consumer categories, segments and geographies?

a. What is the mix of revenues and profits by consumer categories, segments and regions?
b. How do the margins vary by consumer categories, segments and regions?

7. What are the long-term drivers for the business?

a. What is the growth rate, median age and dependency ratio of the population in the key markets?
b. What are the home ownership rates in the key markets?
c. What is the average household size and household formation rate in the key markets?
d. What are the urbanisation and immigration rates in the key markets?

8. What are the investment-driven factors that are expected to influence structural demand?

a. What is the proportion of properties bought for own use versus those held for investment?
b. What are the private sector and household debt levels? What proportion of this is from residential and non-residential mortgages?

9. What are the consumption-driven factors that are expected to influence structural demand?

a. What are the various social, cultural and economic factors that influence home and property ownership in the key markets?

10. What are the regulation-driven factors that are expected to influence structural demand?

a. What are the existing, upcoming or expected legislative and regulatory mandates on housing and affordable housing?
b. Are there any tax benefits to investors, builders and funders of housing and property development?
c. Which are the segments likely to benefit from these drivers?

11. What is the market concentration level and are there barriers to entry of newer players?

a. What is the share of top 3 and top 5 developers by consumer categories, segments and regions?
b. What are the factors facilitating or impeding entry of new players?
c. What are the approvals and licences required to operate as a property developer? What is the ease and cost of getting these clearances?
d. How easy and expensive is it to get skilled management team, engineering and technical staff, with experience of successfully executing projects in the specific markets where the company operates?
e. Do any existing or proposed labour or immigration regulations affect the company's ability to execute projects in specific geographies?

12. What are the various market and regulatory factors affecting the availability of new properties in the key markets?

a. What is the estimated size of land available for development? Are sufficient land parcels in desired sizes available in preferred locations?
b. How concentrated or fragmented are land holdings across locations where development is planned?
c. How clear, reliable, transparent and accessible is the information on land titles?
d. How prevalent and restrictive are zoning regulations? How do they affect development costs and time?
e. How easy is it to obtain necessary approvals and permits? What is the typical time taken?
f. What is the typical transaction cost (registration charges, stamp duty, professional fees, statutory levies, etc.) as a percentage of property value?

13. What are the details of the size and profile of the company's land bank?

a. Across key markets, how are company's land banks distributed?
b. How close to civil, social and economic infrastructures are the land parcels located?
c. How does the profile (location, proximity, market premium etc.) of the company's land bank compare with that of competitors?

14. How mature is the market for property financing?

a. What are the various avenues available for investor participation in the key markets: real estate investment trusts (REITs), real estate exchange traded funds (ETFs), commingled real estate funds (CREFs) and infrastructure funds?
b. What is the extent of participation of various classes of investors (retail, high net worth individuals, institutions, retirement funds etc.) in the property market?

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15. How conducive is government policy on property development?

a. Is the policy stance of governments on, and engagement with, property development active or passive in the key markets?
b. What are the major objectives driving the policy stance and level of activity of the government?
c. How clear, consistent and reliable is the policy stance, pronouncements, prescriptions and enforcement?
d. Are there components of the government policy which influence demand, distort market activity or affect property prices?

16. How has the company performed on operational measures? How do these compare with peers? How are these expected to evolve?

a. What has been the growth rate of the size of the company's property portfolio sold in terms of gross floor area and value?
b. What has been trend in average selling price per square foot?
c. How fast do the expectations of property buyers change?
d. How does the company track and manage the changing preferences of buyers?

17. What are the major components of the company's cost structure?

a. What is the cost of building material and supplies as a proportion of selling price and total cost?
b. How does the material and supply cost vary by consumer categories, segments and regions? Are there any bottlenecks on this front?
c. How well has the company been able to control various components of its costs? What are the objective measures used by the company to track performance on this front?
d. What has been the track record of timeliness in completing projects and delivering properties to clients?
e. What has been the extent of time overruns across projects? What has been the financial and other implications of the overruns?

18. How are working capital requirements managed?

a. What is the preferred mode of raising working capital (WC)?
b. What is the currency mix of the WC?
c. What has been the weighted average cost of the WC?
d. How are the currency mix and cost of the WC expected to evolve?
e. What is the sensitivity of interest rate and forex volatility on the cost of WC?
f. Do the company's operations in specific projects, consumer categories, segments or geographies require higher levels of working capital than others?

19. How efficiently has the company utilised capital?

a. What is the capital allocation strategy between acquiring land banks and developing properties?
b. What is the target financial leverage level maintained by the company? Has the company been successful in maintaining its leverage within this range? How often have there been exceptions?
c. What has been the asset turnover by consumer categories, segments and regions?
d. How long is the development cycle in different consumer categories, segments and regions?

20. How has the company performed on financial measures? How do these compare with peers? How are these expected to evolve?

a. What has been the average selling price and revenue growth by volume (floor space, number of units) for different consumer categories, segments and geographies?
b. How are incoming cash flows structured? Are they tied to an agreed schedule based on time or project milestones?
c. What has been the gross, operating and net profit margins?
d. What is the sensitivity of margins to interest rates and forex volatility?

21. What has been the company's track record in managing labour relations?

a. What is the proportion of unionised workforce?
b. What are the key market and regulatory challenges in relation to labour affairs?
c. Have there been instances of labour unrest in the past? How were those situations managed?

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Environmental, Social and Governance

22. What are the details of the company's ESG principles, practice and track record?

a. What is the company's strategy, practices and track record in reducing the energy intensity, water intensity, emissions intensity, material consumption, waste generation and overall environmental and ecological footprint during execution of projects?

b. How does the energy consumption, emission, water use and waste generation intensity of the properties developed by the company, during their normal functioning, compare with industry benchmarks? What are the initiatives taken to reduce these?

c. Has the company received, or has plans to receive, certifications such as the Leadership in Energy and Environmental Design (LEED) rating devised by the United States Green Building Council (USGBC)?

d. What proportion of properties are equipped with smart metering applications to monitor consumption of energy, water and other utilities?

e. When the projects entail demolition of built structures, how much of the material is typically recovered? What is the procedure for handling recoveries and debris arising from the demolition?

f. Where possible, are features suited to the local climate incorporated in projects?

g. How much recycled, eco-friendly and locally sourced material are used in constructing buildings?

h. How has been the company's track record regarding the safety and fair treatment of labourers involved in its projects? What is the total number of fatalities, days lost and injuries in relation to total number of personnel employed?

i. What is the proportion of total work sub-contracted or outsourced?

j. What is the proportion of the local population in the workforce?

k. How much is the typical spend on maintenance and safety at the company's offices and project sites?

l. What is the size and proportion of the company's sold, owned, managed and under development portfolio that is covered by ESG principles?

m. Has the company faced accusations of corruption, bribery or offering inappropriate inducements to obtain land use permissions, development permits or construction approvals?

n. Has the company ever been accused of, investigated or penalized for not obtaining prior approvals or violating approved plans?

o. Does the company have a documented policy on ESG and sustainability principles that govern the property development agenda?

p. What is the company's policy and track record relating to political donations?