

REAL ESTATE DEVELOPERS – Finding Ways Out of the Financial Crisis through Tax and Innovation Strategies

Globally, commercial real estate transactions which are considered a key indicator of economic activity have started to show signs of recovery. Data shows that the last quarter of 2009 witnessed month-on-month growth, ranging from between 2.3% and 6% in terms of property deals across Europe and other developed markets. While a recovery is still a while away, it is almost certain that the downturn has been arrested as property prices show signs of holding on.

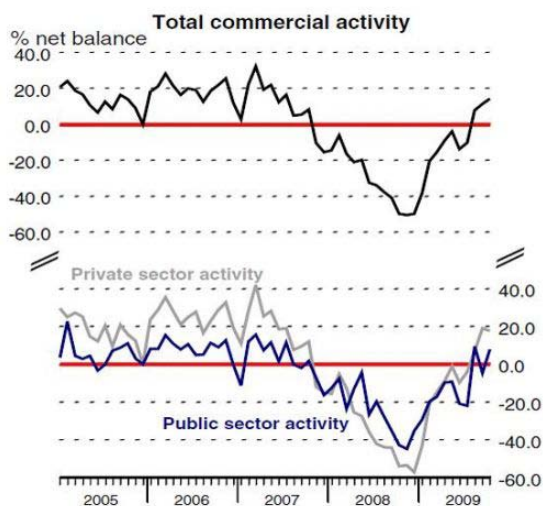


Fig.1 – Total Real Estate Commercial Activity in the UK – Markit Economics

In Nigeria, with limited transaction data available for review, it appears that although the free fall of values may not be as drastic as the latter part of 2009; the bottom has not been reached. We expect to see a further 5 - 15%¹ drop in values (depending on location) in the residential market, alongside increasing numbers of forced sales before the end of Q2.

Most industry players (developers, contractors, manufacturers, designers, advisers and other service providers) now agree that when calm returns, it can no longer be business as usual. In the reshaped real estate market, new approaches will be essential to success. This edition of Real Estate Insight reviews how **tax** and **innovation** strategies can enhance the viability and competitiveness of the developer, in an environment that is certain to be more demanding in terms of environmental issues, quality, affordability and timeliness of product delivery.

WHAT DOES A DEVELOPER DO IN UNCERTAIN TIMES? – With a dearth of credit, rising construction costs and fewer buyers demanding more for their cash, developers find themselves holding the short end of the stick – an unfamiliar place to be after decades of dictating to the market. Increasing numbers of unfinished/abandoned projects and unoccupied units now forces developers to look at the options available to get themselves out of this situation and begin to chart a course towards recovery.

Tax and Accounting Strategies

With a relatively undeveloped tax regime (in addition to a general lack of understanding of applicable tax regulations), most developers may not seek to exploit the “rescue packages” inherent in tax laws, or creative accounting practices which often help to minimize losses.

When selling is difficult: While a real estate investor holds property with the expectation of future appreciation, a developer generally profits from activities that enhance the property. The developer capitalizes all direct and indirect costs associated with enhancing the property, taxes and interest. Real estate is not inventoried for tax purposes (unlike other industries); therefore the developer cannot “write down” the value of the property to its lower of cost or market. As a result, property held by a developer usually cannot be deducted for tax purposes until the property is disposed of.



Aside construction costs; one of the most significant costs incurred by a developer is interest costs. Like other costs attributable to the development, interest on the property loans must be capitalized, (during the construction period) and is deducted without regard to the sale of the property.

When a project is abandoned: In the current situation, many developers have reconsidered some of their planned projects. When circumstances dictate that a project is no longer viable, the developer does not appear to be able to deduct certain costs associated with an abandoned project. In developed markets, when applicable, abandonment costs are fully deductible provided that it can be proved that the project has stalled.

Juggling debt: In the few years prior to 2009, many developers took on substantial debt to finance projects that are now stalled. Several have been left either overextended, unable to meet their debt obligations or stuck with properties that are worth less than the debt securing them. In most cases, the property is transferred to the lender in lieu of the debt; the transfer is generally treated as a sale of the property for tax purposes. In developed markets, most lenders do not take the rights to the property as a precondition in negotiations on outstanding liabilities.

Between Investment and Development Property: Developers are known to take advantage of the difference in tax treatment between “investment” and “development” property. When a property is held as an investment, most costs associated with the property are deductible when incurred unlike development property which is subject to capitalisation. In several economies, there is also a preferential tax rate of gains on the sale of investment property in addition to providing the developer more options for disposing of the property. Unlike development property, investment property can be sold on an installment basis, allowing the gain to be recognised as the payments are collected. This differentiator is not recognised in Nigeria’s tax laws.

INNOVATION IN THE REAL ESTATE DEVELOPMENT INDUSTRYⁱⁱ

“Innovation” is now one of the most discussed topics in the real estate development industry. For an industry often perceived as an innovation laggard because it is closely associated with construction, this is a first and is doubtless driven by the recent crisis.

Product Innovation: This is the most obvious innovation because it is the most noticeable. In real estate development, product innovations include changing exterior designs, layouts or building functions and adding special features, providing “exclusive” services, introduction of green technologies, etc. These easily noticeable changes can be simply copied by competitors. Nigerian developers have in the past limited innovation to architectural styles and spatial functions.

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Process Innovation: Besides building the end-product, real estate developers must now also conduct other processes that impact their overall business performance. In the past, this has been ignored as there have always been willing buyers at any price point. Process innovations cover finance, methodology, management, procurement and marketing. To create competitive advantage, real estate companies must review and develop optimum processes. Key business process innovations in construction, finance and marketing are most significant and often create tremendous competitive advantages for real estate developers.

Innovative construction methods can greatly impact project costs, time, and quality. Prefabricated construction, just-in-time construction and top-down construction are a few examples of innovative construction methods. Innovative financing processes include real estate investment trusts (REIT), property funds, alternative mortgages and securitization. Innovative marketing includes digital marketing; offering bespoke management services, show flat experiences, etc

Although process innovations are often more difficult to implement, they normally impact a company's performance significantly and are difficult to imitate.



Fig 2 – “Green” Townhouses, Australia (Designer – Brett Blacklow) implementing sustainable energy efficient standards and extensive use of recycled materials

Materials Innovation: Materials are a major real estate development industry input. In developed markets, construction materials suppliers are often also major housing industry innovators. Nigeria unfortunately does not belong to this category. The built landscape is largely a combination of a concrete jungle and shanties, and technology advancement in this area is non-existent. Major material innovations include the use of autoclaved aerated concrete (to reduce building weight, therefore cost), fiber reinforced concrete (for insulation and acoustic quality enhancement), geo-textiles, polymer products and the use of synthetic wood for construction. The primary purposes of materials innovation include achieving environmental objectives, durability, aesthetics and in most cases, short or long term cost reductions.

Information and Communication Technology (ICT) Innovation: ICT advancements particularly in the personal computer and internet eras have played key roles in the real estate industry's development. ICT technology has played a major part in collecting and analyzing marketing data, tracking construction information or real estate transactions. Technology harnessing ICT technologies can create competitive advantages and enhance a developer's overall strategy if properly implemented. The real estate sector suffers a dearth of data, developers of the future must seek to bridge this gap, and in the process create a valuable tool through which a competitive edge is established.

Value Innovation: Value innovation redefines the attributes, experiences or values that consumers receive from products or services that already exist in the market and does not necessarily require high technology. However, what it requires is a deep understanding of the customer.

CONCLUSIONS

Nigerian tax and accounting laws and regulations need a good dose of innovation as it affects the real estate development sector, particularly with regards to financing real estate projects and the tax treatment of the developer entity. Tax regulations need to provide a combination of incentives which help the developer (and the investor) in good and bad times. Developers have not felt the pressure to be innovative. However, highly successful industries thrive on innovation. Globally, the industry is said to be on the cusp of a fundamental structural change in many waysⁱⁱⁱ. Although a highly fragmented industry, developers are best placed to set the pace and champion innovation, even if out of necessity.

ⁱ Alitheia market research Jan 2010

ⁱⁱ Culled from Real Estate Development Industry Innovations – Influencing Factors, GH Bank Housing Journal, T.Tharachai

ⁱⁱⁱ Competitive Strategy and Real Estate Development – Prof. M. Porter