UNIVERSITY OF JOHANNESBURG

Department of Finance and Investment Management

Advanced Property Finance and Investment

(PFI8X01)

FINAL ASSESSMENT OPPORTUNITY

JUNE 2016

Time: 3 hours **Marks: 150**

Assessors: Mr M Booyens

Moderators: Miss J De Beer

INSTRUCTIONS:

- This paper consists of **7** pages.
- Answer ALL questions.
- Start each question on a new page.
- Silent, non-programmable calculators may be used, unless otherwise instructed.
- Show all calculations clearly.
- Round all calculations to TWO decimal places, unless otherwise instructed.
- Answers with tippex and in pencil will not be marked.
- Scratch out open spaces and empty pages, **or else NO REMARK will be considered.**
- **HAND IN YOUR QUESTION PAPER.**

Question	Topic	Marks	Time
1	Short questions	30	36 minutes
2	Alienation of land Act	40	48 minutes
3	Investment decision	20	24 minutes
4	Property performance and portfolio	30	36 minutes
5	Leverage	30	36 minutes
		150	**180 minutes**

QUESTION 1 [30 marks]

Answer the following independent questions.

A property has a McDonalds restaurant on it, which can earn R50 000 per year. In any other use (including another brand of restaurant), the most it can earn is R40 000 per year.

REQUIRED:

1.1 Assuming a discount rate of 10% and constant cash flow in perpetuity determine the "investment value" of this property to McDonalds, as well as its "market value". **(6)**

Consider an 8.5% loan amortising at a 25-year rate with monthly payments.

REQUIRED:

1.2 Determine the maximum amount that can be loaned on a property whose net operating income (NOI) is R500 000 per year, if the underwriting criteria specify a debt service coverage ratio (DCR) no less than 125%. **(5)**

1.3 For the same property as above, suppose the underwriting criteria is a maximum loan/value ratio (LTV) of 75%, and we estimate property value by direct capitalization using a rate of 11% on the stated NOI. By this criterion calculate the maximum loan amount. **(5)**

Consider the investment evaluation of a real estate development in which the property to be built is projected to reach stabilised occupancy at the end of Year 2 (two years from the time the investment decision must be made and construction will begin). The project is speculative in that there are no leases signed as of Time Zero (the present, when the investment decision must be made). The property level opportunity cost of capital is considered to be 9% for stabilised investments, and 10% for assets not yet stabilised (lease-up investments).

1.4 Which of the following is true?

A Property level before-tax cash flows beyond Year 2 should be discounted back to the end of Year 2 at 9%, and the projected stabilised asset value as of the end of Year 2 should be discounted two years to Time Zero at 10%.

B Property level before-tax cash flows beyond Year 2 should be discounted back to the end of Year 2 at 10%, and the projected stabilised asset value as of the end of Year 2 should be discounted two years to Time Zero at 9%.

C Property level before-tax cash flows beyond Year 2 should be discounted all the way back to Time Zero at the 10% rate.

D Property level before-tax cash flows beyond Year 2 should be discounted all the way back to Time Zero at the 9% rate. **(2)**

1.5 Discuss your choice for the above question (1.4). **(4)**

The Donald Grump Corporation, a publicly-traded REIT, has expected total return to equity of 13%, average interest rate on their debt of 7.5%, and a Debt/Total Asset Value ratio of 40%.

1.6 Calculate Grump's average cost of capital. **(4)**

1.7 Discuss why the weighted average cost of capital is such an important tool in making property investment decsions. **(4)**

QUESTION 2 [40 marks]

In summary the Alienation of Land Act 68 of 1981 provides:

1. That contracts for the sale of immovable property or rights in immovable property must be in writing and signed by the parties or their duly authorised representatives in order to be enforceable. The Act therefore is the source of the law in South Africa that verbal agreements for the sale of immovable property are unenforceable.

2. That the material terms applicable to a sale of immovable property must be in writing, namely the description of the land sold, the identity of the parties to the contract and the purchase price. If any one of these material terms are not specifically provided for in a written document which is signed by the contracting parties or persons who are authorised by such contracting parties in writing the contract is void and unenforceable.

3. For the sale of land on instalments defining such a contract as one where land is sold against payment by the purchaser to the seller of an amount of money in more than two instalments over a period exceeding one year. The provisions which govern the sale of land on instalments are intended to cover land used or intended to be used mainly for residential purposes and, inter alia, exclude agricultural land as defined in Section I of the sub-division of Agricultural Land Act 1970.

4. Extensive rules which dictate the contents of a contract for the sale of \and on instalments and the omission of certain clauses and/or information from a deed of alienation can in certain circumstances render the contract unenforceable.

5. In Section 6 and in precise terms the provisions which have to be included in a contract and which are compulsory and no estate agent should attempt to negotiate the conclusion of a contract for the sale of land on instalments without being fully appraised of the legal requirements or being satisfied that the standard contract form being used is in fact a form which complies fully with the provisions of the Act as the consequences of non-compliance can be serious.

6. For special protection to a purchaser under a deed of alienation (a sale of land on instalments) and in summary that protection incorporates:

- 6.1 The right of a purchaser to take transfer of the land where the seller is rendered insolvent or defaults in terms of any mortgage bond which the seller may have registered over the land. In essence provided the purchaser is in a position to secure payment of the balance of the purchase price which is unpaid there is no risk of loss of the property as would normally be the case in insolvency.

- 6.2 At any time during the life of the contract the purchaser can demand that the land be transferred to him or her against the registration of a mortgage bond which provides for terms of repayment and interest no more onerous than as are provided for in the deed of alienation.

- 6.3 Powerful restrictions on the right of a seller to cancel a sale and take back the land. These restrictions are embodied in provisions against cancellation prior to a 30 day written notice of breach delivered in a prescribed manner. In other words the normal common law provisions relating to breach and cancellation of contracts and the standard 7 day notice clause as provided in most deeds of sale or offers to purchase are excluded and purchasers are given serious protection on default.

- 6.4 The requirement that deeds of alienation are to be recorded in the deeds registry by the seller, or in certain circumstances by the purchaser, and such recordal has the effect of endorsing the title deed of the property and thereby properly protecting a purchaser. The nature of the recordal is similar to that of an interdict which precludes the transfer of the property by the registered owner to any one other than the bona fide purchaser under the deed of alienation and in such a manner gives substance to the protection of the purchaser for which the Act is deisgned.

http://www.iprotect.co.za/articles-alienation.php

REQUIRED:

Contrast the option of using the ALA as a form of financing to the traditional debt financing model. You may include calculations to aid your discussion. **(40)**

QUESTION 3 [20 marks]

Suppose a property can be bought for R1 000 000 and it will provide R100 000/year net cash flow forever, and you can borrow a perpetual interest-only mortgage secured by that property at an 8% interest rate, up to an amount of R 750 000.

REQUIRED:

3.1 Does this present "positive" or "negative leverage". **(1)**

3.2 Discuss your decision above (3.1) **(5)**

3.3 Will the expected return to the levered equity be less than 8%, exactly 8%, between 8% and 10%, exactly 10%, or greater than 10%? Explain your decision. **(6)**

3.4 Do you think that the use of leverage in this case will increase the NPV of the investment for the equity investor in the property. Explain your answer. **(8)**

QUESTION 4 [30 marks]

When investing in property there are many vehicles through which the investment can be made. Three of these possible vehicles are the partnership, the joint venture and the syndicate.

4.1 It is difficult to ascertain a vehicle which is a clear superior manner to invest through. But in some cases there is a more suitable method. Consider the article below and discuss why a syndication is the best vehicle for the property discussed. **(10)**

> Whilst the idea of owning a home in a great location is attractive, the high costs and hassles that go with it negate the possible benefits, hence the **growing popularity of Syndication (also called fractional ownership).**
>
> A Syndication investment at Castleburn will meet your needs. It is a cost effective holiday ownership investment. If you are looking to spend more quality time with your family in a relaxed and peaceful environment look no further. This is your second home away from home.
> In a Castleburn syndication unit, the ownership is divided amongst 13 owners each owner having use of 4 weeks a year in a serviced maintained home in a luxury resort location. The four-week module is extremely popular as it provides sufficient holiday time to be able to get away with your family on a regular basis. A One-week timeshare is not enough and 52 weeks a year is just too many.
>
> As a syndication owner you need not worry about the high cost of mortgage bonds, homeowners insurance, home security whilst you are not occupying, and the arduous repairs and maintenance tasks that you face when you get to enjoy your second home. No mowing the lawn, cleaning the gutters and painting the house. All these tasks are attended to by the onsite management team on your behalf.
>
> Daily housekeeping services are also available on request should you wish to be pampered like a hotel guest.
> A further major benefit of investing in a syndication unit is that owners are able to exchange their units via RCI into any one of their resorts situated in Southern Africa or internationally.
>
> *Source: http://www.castleburnresort.co.za/castleburn-syndication.php*

4.2 Briefly discuss the difference between the IRR preference and the IRR lookback methods of distributing the remainder of cash flows from property sales in a Joint venture. Include a short calculation to illustrate the differences. **(12)**

4.3 Discuss the importance of the (1) initial and (2) additional contributions made by the partners when establishing a partnership for investing in property. **(8)**

QUESTION 5 (30 Marks)

When financing a property an investor has the option to use debt or equity financing or a combination of the two sources. It is widely said that there are certain benefits relating to the use of debt.

REQUIRED:

Discuss the statement above. Your answer should address as a minimum these benefits mentioned, the concepts of leveraging, positive and negative gearing and the before and after tax Internal rate of returns (BTIRR and ATIRR). **(30)**

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