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CONSIDER SECURITIZATION TO IMPROVE LIQUIDITY IN THE SOUTH AFRICAN PROPERTY MARKET

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The article focuses on the methods of applying securitization on property holdings and property investments in order to improve liquidity attached to such property holdings and property investment forms.

The 1980's and early parts of 1990's saw attractive returns being generated by property holdings. Life companies and pension funds largely created this tendency. They were known as the "big players" in commercial properties to the extent that shopping centers sprung up, CBD's and suburbs were created through high rising offices which were thought of as corner stones in developing local economies. The reason, life and pension inflows needed a "house" of which the returns were relatively safe and outperformed inflation. Since then, investment portfolio allocations declined from levels of 10% to 15%¹ to current levels of 8%. This decline was driven by similar declines internationally due to greater movability of capital across borders, declining inflation, creation of derivative driven investments, which has higher liquidity than investing in property.

Factors that drove the local decline are due to a decline and greater stability in inflation, introduction of taxation on retirement funds, relaxation of foreign controls, which created higher yielding investment opportunity due a depreciating exchange rate. Declining returns were somewhat alleviated with the establishment of Property Loan-Stock Companies and Property Unit Trusts, which to some degree, through the pooling of properties reduced risks and improved trading liquidity, through the units, but without substantially allowing for improved returns from property holdings.

Property investors have five property investment mechanisms to allocate investment funds to - Direct Property Investment, Equity investment in Property Companies, Linked Unit investments in Property Loan

Stock Companies, investment in properties through Property Unit Trusts and Participation Bonds. In addition thereto businesses also invest in their operating premises.

The distinguishing difference between the application of securitization on property holdings and investment, compared with the above mentioned property investment forms is derived from the unchain effect attached to securitization which has a positive impact on the returns being generated by existing property investment types and the subsequent return profiles in re-aligning asset allocations away from property into other investment vehicles. Such differences is noticeable in comparing returns being generated by Asset-Backed Securities that facilitate the securitization of property holdings and investments, with earning yields and dividend yields being generated by existing property investment forms.

The difference in return profiles further emanate from creating divisibility, through securitization, between a property's income stream, income generating potential and the property it self. An extension of the divisibility effect emanating from securitization hinges on the application of securitization on the natural capital appreciation of the property. This divisibility suggests that existing property valuation models have become outdated.

Traditionally, the value of a property has been perceived as being of increasing nature directly tied in with the income being derived from the property. General volatility in investment markets, coupled with the movability of investment capital, the illiquid status of direct property holdings the effect and magnitude of e-commerce together with corporate strategies assigning operational preference to flexibility as apposed to owning operating premises, raises the question as to whether direct property holdings are still of capital appreciating nature.

Risk management through the use of derivatives and risk pricing methodologies in general, away from net income assessments, focusing on cashflow assessment, also contributes to traditional property valuation

¹ Property has hedging rivals, Business Day, March 30, 2000



techniques to be outdated. The very nature of securitization is risk and cashflow focused as opposed to net income focused which makes it an important tool to consider in assessing capital and income returns being generated by property holdings.

Securitization is therefore aimed at putting cashflow back into the hands of property owners and simultaneously allows institutional investors to trade out of property investment holdings into a more liquid investment form being created through securitization and at higher rates of return attached to the Asset-Backed Securities.

A recent study conducted on the UK market² suggests that securitization affords investors the opportunity to attain a higher after tax return, through securitization, in comparison with after tax returns being generated by equity related property investment.

Applying Securitization as an acquisition tool in acquiring properties

In comparison to bank funding, securitization affords the acquirer the opportunity to maximize the acquisition funding that can be raised. The use of securitization in this manner addresses a certain "property gap". This gap emanate from institutional investors whiling to sell [being driven by the scaling down of direct property investment] a buyer whiling to buy through the use of bank funding. However the credit vetting processes of banks looks at the collateral value and forced sale scenarios hence advancing between 60%-75% [75% being the exception to the rule] of the value of the building. The acquirer still has to inject own equity to the tune of 40%. Knowing that institutional investors, given a general property reduction strategy, are not whiling to further increase their exposure to properties, the acquirer finds it difficult to raise the required selling price and hence promote a further round of illiquidity attached to property investments. By securitizing the future income stream attached to the property, provided that the tenants are of rated investment quality, the acquirer can raise funding, on an after tax basis, representing 78% to 89% of the value of the building [not implying that the securitization should be tax aggressively structured]. The securitization of a portion of the modeled growth attached to the property, which depend on the demographics of the property, can provide funding for the remaining balance. Hence close on 100% of the value of a property can be raised through securitization.

Securitization affords the acquirer the opportunity to obtain funding on an off-balance sheet basis, subject to the transaction conforming to securitization legislation.

Securitization legislation promotes the conduct of the securitization on an arms-length clean break basis.

The seller of the property, provided it is an institutional investor in property holdings, may be afforded the opportunity to participate as an investor in the Asset-Backed Securities [provided the Asset-Backed Securities are of at least investment grade rating and can be listed on The Bond Exchange of South Africa]. The result is, trading out of property holdings into an instrument that generate cashflow returns that is higher than the returns attached to existing property investment forms, because, securitization is cashflow rather than income driven. [traditional ratio and income return analyses simply do not work in securitization and will portray an incorrect profile of returns being derived from Asset-Backed Securities. For all practical purposes, such analysis can be termed obsolete].

Applying Securitization as a portfolio optimization and value unleashing tool

Unlocking value for re-investment in alternative investment allocations, or creating portfolio shifts within the same type of property asset-class [due to similar properties having better return profiles attached to them compared to the properties currently invested in] is possible through the use of securitization.

Due to different property investment mechanisms, mentioned earlier in this article, each securitization transaction will be different due to the differing nature attached to each investment mechanism. The application of securitization within each of these investment mechanisms is discussed below.

Direct Property Investment and investment in Property Companies

The investor or owner of the property can apply securitization on the property's existing income profile, the income producing capabilities of the property or the growth in capital appreciation. Each transaction will depend on the ratibility of at least investment grade of the tenant supporting the income profile of the property and the geographic aspects attached to the property itself with regard to capital appreciation. Distinction for purposes of securitization origination should also be made at a higher level with regard to the facilitation structure of ownership of the property [Partnership, Trust or Company]. The securitization profile will also differ given the sub-classification of the types and groupings of properties, such as multi-tenanted, single tenanted properties and offices, retail or industrial properties.

A property investment company can apply securitization to raise funding off-balance sheet at arms length and use the proceeds to address specific imbalances in its existing property portfolio holdings

² Property Market: Tax wish-list for investors: Two Studies support the creation of tax efficient vehicles for investment; Financial Times, March 17, 2000



[using the income and growth profile attached to lower yielding properties to diversify and shift a portion of its portfolio into higher yielding properties]. The re-shifting within the portfolio will have a positive impact on the net earnings of the company, thereby contributing to after tax investment returns for equity investors in the property investment company. Alternatively securitization can be applied on existing property holdings in order to raise funding for a new development with the same intrinsic benefits, and in addition thereto, avoid the need to issue more shares to existing shareholders in raising funding for growth.

Fund managers and institutional investors can apply securitization to address imbalances within investment portfolio allocations between property investments and other investments such as equity and bonds. An added advantage lies herein. Ownership of the property vests with the institution originating the securitization, which may allow for deriving capital appreciation, not tied into a securitization, accruing and belonging to the owner, should the owner for instance want to dispose of the property in the future.

Linked Unit investments in Property Loan Stock Companies

Applying securitization directly on the property holdings of such an entity follows the same thinking and rationale given under the preceding section.

A more advanced form of securitization can be applied on the loan-stock portion of a linked unit, since the loan stock portion represents and resembles the cashflow profile attached to fixed income and/or floating income securities. The linked-unit holder, securitizing a portion or the whole of its investment in the loan stock, originates this form of securitization, belonging to Collateralised Loan Obligations. The proceeds of such a securitization can be used by the investor to improve the return on his entire portfolio through investing in similar loan-stock investments being issued by another Property Loan-Stock Company, or other investments that offer a better return.

The benefit to the investor lies in that securitization allows him to create divisibility between the loan-stock and equity portions of his original investment in the Property Loan Stock Company, effectively retaining the equity portion. This enhances portfolio diversification through the manner in which securitization proceeds are allocated to new investments in Property Loan Stock Companies or other investment vehicles.

Investment in properties through Property Unit Trusts

Property Unit Trusts function on the basis that a unit trust invests directly in property as supposed to equity. The assets are represented through the sale of units to

investors. All income in the unit trust is disbursed to unit holders. The income consists of both realization of capital appreciation, when a property is disposed off, and rental income being produced by the properties³. The dividends are therefore more predictable than dividends of other companies. Securitization can be applied on these future dividend flows in such a manner that the unit holder securitizes the income portion attached to the dividend and retaining the capital appreciation being realized on properties sold by the Property Unit Trust. This affords the investor to remain exposed to any capital appreciation attached to the properties within the Property Unit Trust. The investor uses securitization to enhance total portfolio returns through reallocating the proceeds from the securitization into higher yielding Property Unit Trusts or investments other than an investment in Property Unit Trusts.

Applying securitization directly on the property holdings of such an entity follows the same thinking and rationale explained under the application of securitization on direct property investments and investment in property companies.

Participation Bonds

These property investments are attractive long-term investments which are being facilitated and catered for by a bank. It takes on the form of back-to-back funding. More than one investor places investment funds with the bank through the bank's participation bond scheme. The bank in turn on-lends the funds to a client seeking to develop a property. A first mortgage bond over the property secures the loan so granted and the bank administers the collection and pass-through to the investor participants in the scheme for which the bank earns fee income according to a predetermined scale.

Given that the cashflows are predictable, and coupled with the long investment horizon attached to participation bonds, an investor may apply securitization on either the capital portion or the interest portion attached to the pass-through within the participation bond, allowing it to unlock value in addressing the maturity profile attached his portfolio. Securitization further affords the investor the opportunity to create divisibility between the interest and capital of the investment. The proceeds from the securitization can be used to invest in further participation schemes given the investor's preference of interest rate risk, or diversify its portfolio into other investments apart from participation bonds.

The predictability attached to the cashflows affords the bank in turn the opportunity to apply securitization on the fee income structure.

³ Lyons Financial Solutions Holdings Ltd



Investment in operating premises

Business has in the past opted for owning operating premises as apposed to renting them, emanating from the traditional believe that it is better to own a property as apposed to renting operating premises. The changing world is rapidly changing this believe. In a modern society operational flexibility weighs more.⁴ Property can be seen as "dead" capital, which does not contribute to earnings growth.

Through the use of securitization such businesses, provided they themselves are of ratable investment grade, can dispose of the property into a dedicated arms-length property holding company [shareholding not to be controlled by the business disposing of the property] that originates the securitization through securitizing the existing or income producing capabilities of the property in isolation or in combination with the securitization of a fraction of the capital appreciation of such property. This allows the business to introduce flexibility in operating premises that better supports earnings growth.

The taxation aspects attached to each investment form will affect the diverse application of securitization explained herein. The recent announcement of the introduction of Capital Gains Tax on April 1, 2001 as well as the introduction of the taxation of Unit Trusts will further have an impact on the future returns associated with the mentioned investment mechanisms as well as returns that are being derived from investing in Asset-Backed Securities. A separate article looking into the affects of proposed taxation changes is to be published by the author in due course.

Sotta Securitisation International Ltd has been successful in establishing two securitization special purpose vehicles [SPV's] that will cater for the securitization of existing property income, the income producing capabilities of properties and the securitization of capital appreciation attached to properties.

The two SPV's have been designed according to the known international variations of securitization structures conforming to bankruptcy remoteness aspects. Each securitization being facilitated by these SPV's have to conform to applicable Securitization legislation. As a minimum requirement the assets or income streams being securitised must further conform to applicable rating criteria and pool constituents are subject to a ratable status of at least investment grade.

The issuing of Asset-Backed Securities is conducted pursuant to Commercial Paper legislation that governs the issuing of corporate bonds and debentures. It is therefore also applicable on the issuing of Asset-

Backed Securities. The Asset-Backed Securities itself have to have a ratable investment grade rating as the minimum. Credit enhancement is dealt with according to the logistics and parameters attached to each securitization.

Summary

Further developments of securitization and the customized application thereof aimed at the different property investment forms will contribute towards creating and improving liquidity attached to such property investments. Securitization allows for diversification of investment portfolios, investment optimization in different property investment alternatives measured against the fact that, securitization allows for earnings growth [from a securitization originator's point of view], offers investors indirect exposure to property investments in the form of higher yielding arrangements [returns being derived from Asset-Backed Securities¹] as apposed to direct exposure to either the property itself, or through different property investment mechanisms.

Further diversification within property investment is created through securitization on a level where different institutions are investing in one another's property activities on an indirect basis.

After all, securitization deals with the repackaging of cashflows into tradable debt paper arrangements of which such cashflows need to be identifiable and predictable. It is these intrinsic requirements embodied within securitization that make property investments more liquid through the use and application of securitization.

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¹ Returns being derived from Asset-Backed Securities are functions of: Type of asset or income flow being securitised; Different taxation aspects attached to securitizable assets and income flows; Credit enhancement form and type used; The manner in which the Asset-Backed Securities are assembled; The form or type of securitization being used; Pricing mechanisms in the free marketplace that determine interest rate expectations.

⁴ No more excuses, Fife Ian, Financial Mail, March 30, 2000