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Decisions by Listed Residential Property Developers on Entering the Market Segment of Commercial Real Estate

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Abstract

The subject matter of this article are the decisions of listed residential developers to expand their operations into the segment of commercial real estate. The subject is presented both in terms of quantity (the number of entrances, dynamics) and in the context of motivation (the reasons for diversification of the commercial segment). The aim of this article is to verify the hypothesis concerning the domination of financial and profitability motivations (marketwise) in this process. The research conducted on a sample of 118 annual reports (for the years 2010–2015), published by listed companies of the WIG-DEVELOPERS segment, became the basis for the formulation of the conclusions.

Keywords: commercial property, investment property, residential property, International Accounting Standards, International Financial Reporting Standards

JEL: G39, M41, R39

Introduction

As a part of development activities, the segments of residential and commercial real estate are usually separated. These segments overlap to a large extent, which partly is a result of the provisions of local zoning plans, but primarily the result of a conscious expansion of business profiles. The aim of this article is to verify the hypothesis concerning the domination of financial and profitability motivations (marketwise) in this process. The research was conducted on a sample of 118 annual reports (for the years 2010–2015), published by the companies with particular emphasis on the information disclosed pursuant to the provisions of International Financial Reporting Standards (IFRS) 8 Operating Segments.

1 Commercial real estate as a business segment

The literature does not provide a uniform definition of commercial real estate, which is largely due to the fact that within Polish law there is no such category as "investment property" and the Civil Code provides only a definition of property. There seems to be, however, insufficient justification for the lack of a universally accepted definition, since 21 April 2013, which is until the entry into force of the Act on the Protection of the rights of the buyer of a dwelling or a detached house; in any legal act the term "developer" has not been defined, however there would be no doubt as to how you define the developer.[1] Marcinek indicates two proposals for the definition of commercial real estate:

1. Here it should be noted that naming of the entrepreneur by the term "developer" suggests two sectors: real estate sector (where it is the official name), and the IT industry, where according to a jargon a developer is an entity that provides programming services (a term derived from the position of software developer).

- following Lipiński — property generating periodic income derived from the use or ownership in the form of flowing time streams of capital, and
- following Nalepka — real estate acquired for investment purposes, bringing the owners periodic rent revenue resulting from putting the estate in the use of others.

Additionally, citing Brueggeman and Fisher, commercial real estate may include office buildings, shopping centers and hotels/motels (Marcinek 2009, 13–14). The specified directory brings no doubt, like that proposed by Lipinski, but the proposal of Labels introduces an unnecessary subjective tightening. Nalepka indicates the fact that it is an acquired property, which in the light of his proposed definition, subjectively excludes developers (who buy construction work rather than property), and leaves development entities out of this definition.[2]

Jońska defines commercial property as follows: property, from which the owner can reap a profit. Commercial buildings are designed for business. They generate profit on the basis of lease agreements. As a catalog of commercial real estate Jońska points out:

- office buildings
- office parks
- buildings held for rental
- shopping malls
- logistics centers
- warehouse centers and warehouses
- residential property for sale or rent
- other — hotels, cinemas, entertainment and sports centers, spa&wellness, parking lots, maneuvering spots, etc. (Jońska 2014, 13–14)

The above definition by Jońska should be considered too broad. In this definition, unjustifiably are included residential properties within the segment of commercial real estate. What should be emphasized is that there are significant differences between the residential and the commercial segments. The detailed scope of differences is indicated in table 1.

Commercial real estate should meet the definition of investment property (IAS 40 Investment Property)[3], but without having recourse to the criterion of dissimilarity of core operating activities, which is postulated in the real estate investment term by Greuning et al. (Greuning, Scott, and Terblanche 2011, 158). Therefore, commercial real estate is: the property of retail and service purpose, office or warehouse, having the capacity to generate regular income from rent for renting it in whole or in part, or to generate sales revenue from the sale of the whole, or a part.

Tab. 1. The differences between residential and commercial segments

Specification	Residential segment	Commercial segment
A means of revenue generation over a specified period of time	One-time (with the option to break the income into several tranches)	One-time (sales) or at regular intervals (for rent)
The dominant recipient	Natural person	Enterprises
Price weighted (in terms of cost) effectively incurred by the purchaser	Gross price	Net price
Price weighted (in terms of cash flow) effectively incurred by the purchaser	Gross price	Gross price
VAT rate	8% as a dominant rate	23% as the only rate, provided the transaction is subject to VAT
The possibility of taxation other than VAT (sales of the company)	No	Yes
The possibility of IAS 40 appliance	Occasionally practiced and methodologically questionable	Yes

2. For example: Skanska S.A., Interbud-Lublin S.A.
3. IAS — International Accounting Standards.

In light of the above presented differences in the area of possible channels to generate revenue, taxation method, destination area, the type of customer and perception of the category of the purchase price by the recipient, commercial estate segment (the so-called commercial segment, colloquially also known as "commerce") should be considered a separate segment of the real estate market, including the terms of real estate development.

2 Developers' decisions to extend the activities of the commercial segment

Among housing developers listed in the period 2010–2015 with an 83,33% share,[4] entities operating in the commercial segment in a sustainable manner and significantly in value, increased in number. This is due to the fact that the basis for the analysis of financial results obtained from the operating segment is called reporting by segments (IFRS 8 Operating Segments), which is obligatory when revenues/profits/losses/assets of the segment constitute at least 10% of the revenues/profits/losses/total assets, or when the results of the segment are regularly the subject of the analysis of the management.[5] During the same period, the number of housing developers listed on the Warsaw Stock Exchange (WSE) increased by 22,22%. In the initial period, the annual growth of entrances to the commercial segment was significantly higher than the growth of net entrances[6] of housing developers to the WSE, so that at the end of the analyzed period it conformed to the dynamics of the net input. In nominal terms, the largest IPOs in the commercial segment were in 2012, which means that decisions about entering this segment were taken in 2010–2011.[7] This is consistent with the general trend of increase in the value of transactions in commercial real estate, which took place after 2009, however, at the same time, the majority of companies such as CEF([8]) of the real estate market went down in value.

In real terms: on the Warsaw market transaction prices of real estate offices were rising, while in other cities there was a mild downward trend, and regardless of the geographical analysis: the average prices and hedonic price of commercial real estate there were several years of sideways movements. At the same time, we witnessed a quite dynamically growing supply of office space, warehouse and shopping. Vacancy rates fell only in selected location office space, and rents for most locations were sideways with small amplitude fluctuations.[9] In view of such a system of market

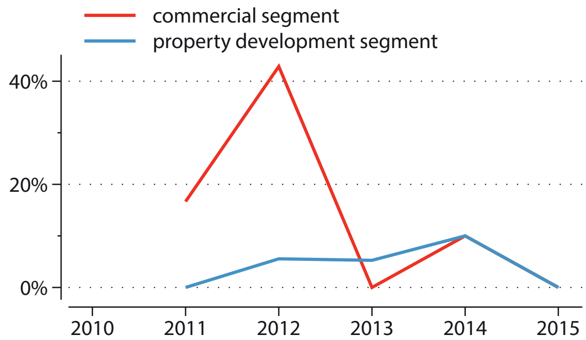

Fig. 1. The dynamics of changes in the number of listed developers of housing and residential developers listed that were present in the commercial segment

4. [In the journal European practice of number notation is followed — for example, 36 333,33 (European style) = 36 333.33 (Canadian style) = 36,333.33 (US and British style). — Ed.]

5. This is not a complete catalogue of the obligation to segment reporting under MSSF8 Operating Segments. See: Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council. Official Journal of the European Union, L 320, 29 November 2008.

6. IPOs adjusted for the exclusion from the market-maker quotes of declining entities.

7. The estimated period of a decision already taking into account the possible process of acquiring the land, the design process, obtaining building permits and construction. Finding tenants is realized simultaneously in principle (it is possible to implement this step, even before getting the final building permit), so there is no need to adopt a separate interval at this stage.

8. [Closed End Funds — Ed.].

9. See: Report on the Situation in the Polish Residential and Commercial Real Estate Market in 2012. Narodowy Bank Polski, Warsaw, August 2013, pages 23–26, [@:] http://www.nbp.pl/en/publikacje/inne/annual_report_2012.pdf.

conditions, the market situation and possible forecasts for the segment cannot be considered as a sufficient incentive to take the decision to start operations in the segment of commercial real estate. It is therefore necessary to examine other potential factors in the business segment of the commercial prospects of listed residential developers. Other potential factors determining the entrance to the commercial segment can be divided into three basic groups: legislative factors, finance and accounting factors, and other managerial and organizational factors.

Legislative factors are local zoning plans or resolution of the municipal council, adopted under Article 14 of the Act on the planning of spatial development. They are bound to define the ways of developing and building sites.[10] From the perspective of the developer, it may mean the need to consider the specific development project in addition to the surface area of commercial residential (commercial and service), if the local zoning plan defines the minimum proportion of commercial space for new buildings. Due to the generally proportional distribution of residential and commercial space, or dominance in the overall balance of living space, the legislative factor cannot be considered as a factor determining by itself the permanent entrance in the commercial segment.

Another group of factors are factors of financial and accounting services, which could include data on the profitability of the segments and opportunities offered by the IAS 40 Investment Property. Information about the profitability of the segments were available for developers listed, although not directly. It was possible to enlist them with the notes to the financial reports, if the entity was obliged to segment reporting under IFRS 8. Thus, Apartment Management developers had the opportunity to analyze the results of the stock market competition, which decided to enter the commercial segment. The analysis yields a view of the commercial segment (calculated based on average values) against the profitability of development activities throughout the period 2010–2015, which shows the considerable attractiveness of the commercial segment. Its value ranges from 40,73% to 60,15%, while return on total development activities in the sample ranges from 12,31% to 32,66%. After the biggest wave of entrances to the commercial segment (in year 2012), the profitability of the segment was growing rapidly, which is due to the use of the opportunities to generate revenue based on the IAS 40 by the entities which extended their business profiles. It is not possible to generate the profitability of real estate on the lease of the commercial market at the level of 50%–60% per annum, because the market conditions of the lease and the typical cost of maintenance, especially as the annual rate of return on investment in commercial property at 10%, is considered high.

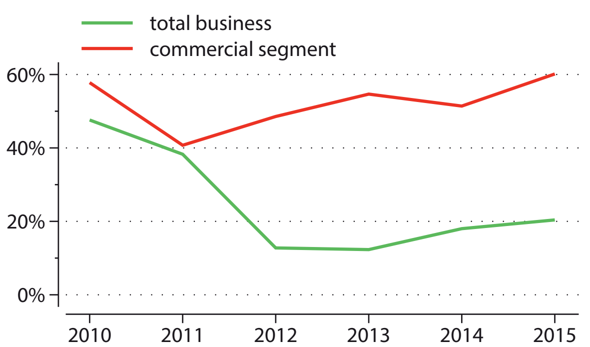

Fig. 2. The comparison of the profitability (based on an arithmetic averages) of the commercial segment and the total business of listed residential developers in 2010–2015

In favor of such opinion is the further analysis of the profitability of the segments and the overall profitability, calculated upon the median. Significant and abrupt fluctuations in the profitability indicate that:

- In 2012 a number of commercial real estate parcels were put to use (which is consistent with the inputs in the commercial segment), and the sharp rise in yields suggests that the basis for the creation of profitability was not the primary operating activities (rental income) and other operating activities (one-time revaluation to fair value).

10. See: Ustawa z dnia 27 marca 2003 r. o planowaniu i zagospodarowaniu przestrzennym. DzU z 2003 r. nr 80 poz. 717.

- In 2013 there was a significant decrease in profitability, which should be combined with the slowdown in the property market, which included also the commercial segment and caused a reduction in the fair value of the property, and thus the need to write-down the value of such property in negative terms.

During the period 2014–2015 the profitability of the segment was significantly higher than the profitability of the total business and comes at the end of 2015, reaching almost 80%. This is the effect of the next big wave in plus-side revaluations (revaluation in negative terms are incidental, because of the short period of operation of new commercial real estate and discounted in the previous periods of adverse changes in the value of older properties).

While comparing the segment profitability with total profitability I conducted analysis covering descriptive statistics. Table 2 presents some of them. To test whether segment profitability is different than total profitability, at the very beginning I applied the Shapiro-Wilk test of normality. The null-hypothesis of this test is that the population is normally distributed. Where the p-value for both groups of data is less than 0,001, I rejected the null hypothesis. The results of the normality test mean that there is evidence that the data tested are not from a normally distributed population. In other words, the data are not normal. It means that differences should be tested with a nonparametric test.

In the next stage, I applied the nonparametric U Mann-Whitney test. The null-hypothesis of this test is that the distribution of the segment and total profitability is similar. Where the U Mann-Whithey test equals $-4{,}332$, and the p-value of U Mann-Whitney is less than 0,001, then the null hypothesis is rejected and there is evidence that the data tested are not similar. This proves that segment profitability is higher than total profitability.

The second factor of a group of financial and accounting factors is the possibility of application of IAS 40 by the entities with the assets of commercial real estate.[11] The indicated IAS enables the demonstration of real estate (meeting the definition requirements of commercial real estate) at fair value, as well as a reference to the difference between the fair value and acquisition cost/production cost to other operating income. This treatment allows a significant increase in disposable income and the financial result, thereby improving the profitability of the business and demonstrating high profitability ratios for the commercial segment. It also affects the balance sheet in total — it shall be increased by the demonstration of real estate at fair value, which in turn creates the impression of stronger foundation assets of the entity than in reality. In addition, the structure of assets is stiffening, which is desirable for commercial activities.

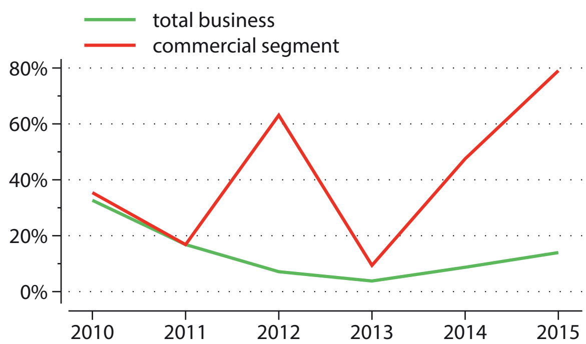

Fig. 3. The comparison of profitability (based on median) of the commercial segment and the total business of listed residential developers in 2010–2015

Tab. 2. The descriptive statistics of profitability (in percentage) for analyzed companies

	Median	Stand. dev.	Min	Max	Skewness	Kurtosis
Commercial segment	63,2	1,18	−360,51	600,43	1,297	10,178
Total	11,04	2,97	−687,48	2 618,46	6,264	50,668

11. IAS 40 Investment property can be used in the case of real estate rents, real estate held for resale, and property without a clear destination.

As the last group of factors determining the entrance to the commercial property segment, managerial and organizational factors were indicated. It should be noted that the development activity in the residential segment is characterized by a significant degree of seasonality of the production process, and in the case of adoption of the company's financing model of the customer in the area of financial management, seasonality also applies to the revenue side. If the company does not attempt to actively neutralize seasonal fluctuations, and even tries to use these in their activity with the natural cycle of seasonal fluctuations, to implement the strategy it flows with the tide as a seasonality management strategy. This strategy should be considered a starting point for the housing developers. However, not all entities evaluate this strategy as the most beneficial, and some may seek to neutralize the effect of seasonality (river control strategy) and apply this to diversify the activities of the segment that is insensitive to seasonal fluctuations (Wójcik 2016, 42–44). The commercial segment meets the requirement of insensitivity to seasonal fluctuations (rental of commercial space shows no cyclical fluctuations during the year). Therefore the inclusion of development of commercial activities within the business profile (rental services in particular) allows an entity to mitigate the interim fluctuations in key financial categories, resulting in an increase in the stability of the enterprise. The real strength of the stability growth is difficult to assess, but it is seen as a strong stabilizer from the perspective of investors, analyzing developers' quarterly periodic reports.

3 Threats to the expansion into the commercial segment

A large number of diverse reasons made housing developers relatively willing to expand the profile of their activities in the commercial segment over the past few years. As part of the activities in the commercial segment, three basic patterns of conduct are used by the developers:

- purchase/construction of real estate and maintaining it in a portfolio of a company's assets in order to reap the benefits of rents
- purchase/construction of commercial real estate, acquisition of real estate tenants, and sale of the property with the active leases
- acquisition/construction of commercial property and reselling it without entering into a lease agreement (the solution practiced mainly for commercial premises construction in residential and commercial)[12]

The solution indicated second, which is disposal of real estate, together with active leases in accordance with the latest position of the tax authorities, creates a significant risk to the developer. So far, transactions of that kind are treated as a regular supply of goods and subjected to 23% VAT rate, even if the sale of any such property was by the SPV. In the light presented in November 2016 by revenue authorities, with tax classification of the transaction as a supply of goods was repeatedly wrong, and where the property was disposed by a special purpose company or the company for which the property was a key asset and a key source of revenue, the transaction had a charter of disposal of an organized part of the company, not as a supply of goods. This raises significant tax consequences, because in a situation of an organized part of the company transactions—type, the right tax is a civil law at a rate of 2% of the property and 1% from other property rights (Zalewski 2016). Consequently, an additional risk factor in commercial activities in the form of incorrect VAT payments, both on the purchaser and the seller, is the tax liability arising from irreclaimable civil tax and penalty interest on arrears of that (on the purchaser). In view of the number of historical transactions difficult to estimate, which will question the correctness of tax settlements, one cannot predict the scale of the real impact of these changes on the segment of commercial real estate and housing developers' willingness to enter into a new segment of commerce. However, the rational direction of changes in this situation, is to opt out of the vehicle's SPV for the execution of transactions involving construction, then renting, and finally the sale of leased commercial real estate.

12. Concerning the situation of the share of commercial space in the newly developed space (in the light of the provisions of local zoning plan).

Summary

In the past few years, one can observe a clear trend of expansion by developers of residential property development into the business segment of commercial real estate. This phenomenon was analyzed on a sample of listed companies from the segment of housing developers, which were listed on the Warsaw Stock Exchange in the period 2010–2015, taking into account entities that were listed for at least one year in the specified time interval. As research material 118 annual reports (ESPI), published by the companies were examined, and the basis for the recognition of the company's entering the commercial segment on an ongoing basis significant in terms of value, to meet the company's requirements of IFRS 8 Operating Segments on the obligation to draw up reporting of operating segments, including the commercial segment.

The aim of the study was to determine whether the profitability motives (in terms of the market) can be regarded as a dominant theme of housing developers for the expansion into the commercial segment. Preliminary analysis showed that the dynamics of solid and substantial in value entrances to the commercial real estate segment in the analyzed period was higher than the net entrances to the WSE by housing developers, which reflects the highly attractive commercial segment from the perspective of housing developers. Most entrances (disclosures of commercial segment as a separate segment) in nominal terms took place in 2012, which proves that the decisions to enter into the segment of commercial real estate were made by these companies in 2010–2011.

The years of 2010–2011 are difficult to assess unequivocally on the commercial real estate market. At the same time, there was a large supply of all types of commercial properties, rents were sideways, and vacancy levels fell only in selected locations. It cannot therefore be considered that the situation of the industry and its prospects for the moment were sufficient incentive to start a business in the commercial segment. It is therefore necessary to analyze the motives of housing developers in a broader context. As other motives to start a business in the commercial segment by housing developers were legislative factors, financial and accounting factors and other managerial and organizational factors were indicated.

In the light of the statistics on the real estate market for the period 2010–2011, the extent of use of IAS 40 Investment properties, as well as disagreements between the level of profitability of the segment (often built on the basis of revaluation) and the profitability of the business in general, it is clear that the profitability motives (in terms of market) cannot be assigned a leading role in the decision-making process of developers (the same hypothesis tested negative). This conclusion is particularly important in light of the new type of tax risks which first occurred in November 2016, and is associated with a potential questioning by the tax authorities, of selling the properties with the commercial real estate VAT instead of the civil tax. As this will enrich the catalogue of financial and accounting factors which have so far constituted an important theme in the context of the decision-making process of developers, concerning operations in the segment of commercial real estate.

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