Çetin Ali Dönmez

An innovative capital markets instrument: Real Estate Certificates

Think about an instrument that directly links capital markets and real estate projects, an instrument which allows investors to buy and sell their claims or their shares on certain real estate projects in organized exchanges. These certificates will further allow investors to become the owner of a residential or commercial property using the certificates they own. Real estate certificates or real estate shares exactly serve this purpose. This instrument is intended to bring liquidity of organized exchanges to real estate market while benefiting the dynamism of real estate projects to attract a new investor base to capital markets.

Turkey was and still is the leading country in promoting real estate certificates. Rather than the historical background and an analysis of globally known real estate based capital markets instruments, I prefer to directly go into details of how these instruments can be structured, traded and converted to actual residential and/or commercial properties.

Assume that you have developed a project on a piece of land. The classical way to sell the real estate is to start marketing campaign and sell the residential and/or commercial units on a desktop small scale model. In general, the developer of the real estate project calculates the costs and determines the sales prices of individual units. The sales price may change depending on the form of payment (cash or periodic installments or delayed payments etc.), it may also change whether the buyer buys one or more units from the project. In conventional sales of real estate units, developers usually start with very attractive low prices and then they increase the sales prices step by step to help the early-comers gain money, so that they will have a loyal customer base for later projects. If there is enough investor interest to purchase the real estate units, the developer will get pre-financing from actual buyers and do not need bank credit. However, In this case, banks will still be in the game since mostly buyers of real estate, rather than the developer will need bank credits. If there is not much demand at initial launch of the real estate project then the developer needs financing. This can either be in the form of the developers' own money or mostly in the form of bank credit. In short, this system of real estate sales seems to favor banks and lenders.

In this article, I will dwell on a brand new financing and investment alternative. The so called real estate certificates might be a serious remedy to this vicious cycle of mostly interest rate based bank financing. It works as follows: The value of whole real estate project and the value of each individual unit is calculated first. The valuation is very important and should be very attractive in terms of pricing. After this step there are two ways to securitise the project.

First way is to find out total area to be sold and divide this into square meters or square decimeters . By doing so, you calculate the sales value of a square meter or a square decimeter . Second way is to divide the total sales of value of the project into a number, to find a nominal value and indicate that unit in terms of currency such as 1 USD or 1 TL. After division of the project into to smaller units, you can make an initial public offering and offer your certificates to investors. In either case, rather than sticking to a specific value, it is much better to determine an interval for the values of these smaller units. As the developer or the seller of the property, you will get the market valuation during the IPO phase. By doing so you offer your real estate projects to broader investor base, since you give opportunity to people who can not afford to buy any individual unit to buy some part of it, you also attract some investors who have not yet decided to actually purchase a real estate, or even some other investors who do not intend to buy the property ,but wish to benefit from the upward trend in real estate market. At the very start of the IPO, the seller will have to declare the amount of certificates needed to actually purchase each individual residential or commercial unit. This way you convert your certificates to actual property. The certificate holders may purchase a specific residential or commercial unit by presenting the certificates they have. They get the title deed and in return their certificates are redeemed. Investors may also prefer to sell the certificates, some investors may further purchase more certificates to actually own enough number of certificates to get the title deed. This way the developer of the real estate projects sells all the project to many number of people, gets the finance and does not have to bother about selling the individual units. All he/she has to do is to show the units available for sale to certificate holders. On the other hand, the amount of money collected from the IPO is not transferred totally to the developer, in order to preserve the rights of certificate holder in case of the default of the real estate developer. The money collected is gradually given to the developer depending on the progress of the project. The progress rates are to be controlled and checked by independent entities.

The real estate certificates will traded in an organized exchange after the IPO just like any other security, till a specified time in which the real estate project is supposed to finish. At this terminal time, the picture is as follows: Some individual units have been purchased by certificate holders and some units have not actually been purchased by anyone, certificates representing those units are floating in the market. At this stage the regulator in Turkey stipulates that the remaining unsold units will be sold to anyone by publicly announcing the sale and then proceedings of the sales are to distributed to certificate holder and finally all the floating certificates will be redeemed. Alternatively though, you can think of transferring these floating certificates to an SPV and converting them to Sukuk. In either case we are talking about an equity-like instrument with a maturity and although it has a maturity it does not bear any interest on it. Then comes our efforts to promote Islamic financial instruments. I strongly believe that this instrument may serve the needs of investors with interest and/or usury concerns. In order for the reader to understand the basics of how this instrument works the following table shows the process.

You have three types of residential property. Type 1 is the cheapest in terms of value of each square meter, namely 1000 USD/sqm. Type 2 residence has 10 % betterment, i.e. each square meter of type 2 is 1100 USD. Type 3 has the highest betterment (the residences with sea view for example), namely 1200 USD/sqm.

Total value of your project is calculated to be 54,400,000 USD. Benchmark the cheapest type of residence determine the price of one square meter to be 1000 USD which means that you will issue 54,400 certificates to public. However you should be mindful of the fact that, if you make an IPO, it may turn out that your pricing is above market valuation and you may have to accept a price of 900 USD per certificate, or it may well be a positive surprise to you and you may sell the certificates at a higher price, say 1050 USD.

The above table tells us that if an investor has 100 certificates he/she can buy type1 residence, for type 2 residence however 110 certificate is not enough, since it has a betterment of 10 %. Thus the investor has to present 132 certificates to buy a 120 square meter size type 2 flat. Any investor wishing to purchase type 3 flat has to give 156 certificates since this type has the highest betterment. Hoping that the example is explanatory enough, I should point out that this instrument is really very promising and can open up new frontiers for reaching out much larger investor base especially those with Islamic sensitivities.