Off-Plan Property Sales as an Innovative Financing Option in Real Estate Development

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Abstract

Real estate development is fraught with many uncertainties leading to serious shortages particularly of affordable housing for the majority of urban population. As a consequence, development developed a fairly innovative financing strategy – off plan sales. The strategy has emerged as an alternative source of finance, presenting developers with a chance to obtain funds from would-be buyers of the units in their proposed development. In spite of the huge significance of off-plan property sales and its growing popularity in the global platform, there is limited knowledge in this strategy as a financing option. The paper aims at sought to determining the challenges and constraints of off-plan property sales, as a financing strategy to the developers and as an investment to the property buyers and recommending appropriate mechanisms of enhancing it. Data was collected through a combination of different tools including questionnaires and key informant interviews. The study established that off-plan sales is an effective mode of financing real estate development since it generates significant savings on the cost of development, mainly through savings on interest to the tune of between 4% - 8.5% of the total cost of development. In the end, it emerged that the success of financing through off plan sales requires among others: establishment of an optimal mix in financing options; careful planning; early and vigorous marketing of the development; pre-qualification of potential off-plan buyers; the need for due diligence by buyers prior to purchase of the off-plan units; and the need for legal framework regulating off-plan sales.

Keywords

off- plan, finance, real estate, investors, and buyers

JEL Classification

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Introduction

Real estate in the form of commercial, residential or industrial developments play a major role in the socio-economic advancement of a country. For instance, it plays the role of providing space and facilities for people to carry out their economic and social activities as well as being a basis for expectation of return on investment for property owners or investors. Financing real estate development became even more difficult after the financial crisis of 2007 – 2008 (Squires, G. et al; 2015). In Africa the rapid population growth despite increased demand for housing and launching of ambitious projects by private developers the supply is still unable to meet the demand. This is partly due to significant delays to complete the projects due to financing problems as well as restrictive property development policies.

Similarly, despite attempts by the government and the private sector to meet the housing demand and needs, these remain elusive. This is attributed to pressures emanating from population growth, increased numbers of single family households, inward migration and the growing student and elderly populations (GoK; 2016). This has prompted developers to carry out residential real estate development, especially apartments/flats, terraced maisonettes and stand-alone houses in various urban centres in Kenya. The housing supply deficit is partly attributed to the high cost of development compared to capital available to developers as well as the challenge of high interest rates, thereby pushing developers to find innovative ways of financing their developments.

This partly explains the driving force behind the desire for more innovative approaches to financing real estate development globally. This is because as Okal, R. (2011) observes developing real estate is a high risk activity which requires commitment of large sums of capital. She Yet real estate development and returns are affected by the prevailing economic situation making the business fairly risky. Yet most investors and developers do not have access to large capital outlays needed and are thus forced to borrow or have a combination of equity and debt to finance their real estate investments.

Evidence from literature further reveal that about 50 per cent of real estate development is largely from banks, while other options or channels finance only a small proportion (Wu, T.T. (2019). In addition, Wu, T.T. (2019) adds that stringent regulations by central banks that followed after 2007/8 collapse of the financial sector make the situation even worse. In addition, Bartke, S. (2013) contends that the situation is further complicated by prevailing difficult economic situation coupled with the increasing competition for financial resources and investor caution amidst increasing demand for real estate demand (e.g. residential housing, retail, commercial and industrial space among others) due to population increase especially in urban areas driven by migration and natural population growth (Van Nieuwerburgh, S; Buelens, F. and Cuyvers, L. (2006), Obala, 2011 and 2014). It is this type of situation that calls for innovative financing options to deal with the complex financing issues and facilitate spreading of risks, provide greater flexibility and innovation (Carter, A. 2006). However, Squires, G. et al (2015) argue that this desire is hardly ever achieved.

Off-plan property sales as a financing option has been used by real estate developers in Kenya over the past two decades therefore comes in as an alternative source of finance to developers presenting them a chance to obtain funds from would-be buyers of the units in their proposed development. This paper main objective is to deepen our understanding of the role of off-plan sales as a financing option. In this process it highlights the challenges and constraints of off-plan as a financing strategy and/or option.

Real estate financing options

Traditionally real estate development and purchase has been financed through banks that provided loans to both individuals and institutional developers; and cooperative approach that entailed partnership with land owners (Wu, T.T; 2019 and Mwathi, J. and Karanja, D.J.M; 2017). However, the financial crisis of 2007 – 2008 as well increased uncertainty following the increasing climate change dilemma has rendered these sources unsustainable. At the same time, rapid urban population increase especially in the global south is further increasing need for more housing. Existing financial systems are unable to provide adequate resources thus the search for innovative and flexible financing options. Squires, G. et al (2015) identified a six point criteria for evaluation of innovative financing as: i) establishing if the option is responsive to underlying economic rationale; ii) determining whether the options allows for a financial mix; iii) whether it fits within plans and governance; iv) how risks and returns to the parties are shared; v) whether it encourages partnerships between the parties; and vi) need to policy drivers for the option.

According to Isthmus Partners, (2010) off-plan property is a property before a structure has been constructed upon it. Pre-constructions are usually marketed to real estate developers and to early adopters as developments so that the purchaser can secure much better finance terms from their lenders Isthmus Partners, (2010). Department of Mines Industry and Safety of Government of Western Australia (2014) notes that buying “off-the-plan” can mean many things but generally involves signing a contract with a developer to buy a property before the developer has obtained final approval to subdivide land that is being purchased or, in the case of a building, before building has commenced or been completed.

In off-plan sales contracts or agreements, a developer promises to deliver a parcel of land, a house and land package or a strata property to a buyer at an agreed price at a future date, subject to the developer obtaining all necessary approvals in respect of the development from the relevant authorities and satisfying any conditions necessary to finalise the development. In the case of land subdivisions, for example, this would include the construction of roads, and connection to services such as power, water and sewerage.

Department of Mines Industry and Safety of Government of Western Australia (2014) notes that this kind of arrangement has become popular because home owners are looking for an arrangement where they can get a cheaper deal than other similar units by the time the construction is complete Department of Mines Industry and Safety of Government of Western Australia (2014). The grace period allowed to arrange for financing is also key to popularization of this mode of property acquisition as investors and home buyers seek to get a smooth experience to property ownership. Developers in this form of arrangement also get the opportunity to avoid using their own internal financing or debt financing from lending institutions. For a world driven towards maximization on returns, in this case for the developer and the buyer, it's clear that off plan buying and selling of property is geared to be used as a risk management tool.

Off-plan sales has been used by developers in Kenya to finance projects in the past such as Loresho Ridge in Loresho Area; Ramata Greens in Baba Dogo Area; Kings Millennium Development in Imara Daima; Muthaiga Valley Apartments in Parklands Area; and Pearl Heights in Kileleshwa among others all located in Nairobi City. It is ideal due to minimal risks involved, but not necessarily the easiest to achieve. Funds raised through off-plan sales form part of the developers' equity hence the developer avoids paying high interest to the financiers, which has an effect of increasing returns on investment.

On the other hand, it is not uncommon to find many real estate development projects in Nairobi, being sold off-plan and the developers are not willing to break ground until they reach a certain percentage of sales or target in terms of off-plan sales. This is also important when borrowing as it demonstrates to the banks the viability of the projects.

In spite of the huge significance of off-plan property sales and its growing popularity in the global platform, there is limited knowledge regarding this strategy as a financing option. This is largely because most studies on financing of property development have concentrated on conventional financing options such as pooling of funds or construction loans.

Research on the use of off-plan sales in financing real estate development has therefore been long overdue. This study aimed at extending the existing knowledge and literature on off-plan property sales. It sought to provide an in-depth assessment of the off-plan property sales in Kenya, specifically analysing its effectiveness to developers as a source of finance for property development as well as its effectiveness to the buyers as an investment avenue. The study also investigated the challenges facing developers and buyers in off-plan sales and proposes appropriate recommendations on how the sector can be enhanced in the country.

Research method

A descriptive cross-sectional study design was adopted. Data collection involved the use of a mixed method to carry out an in-depth investigation into the phenomenon. The respondents were purposively selected from real estate developers and property agents within the Nairobi city. Data was obtained using interviews and questionnaires. Interviews were carried out intensively on key-informants in the study areas to get comprehensive information from them. This method is important as it enables the collection of first-hand data from those who understand exactly what goes around off-plan property sales and its efficiency in financing real estate development.

Data was obtained through the use of questionnaires that were administered to the property developers and estate agents. The estate agents were treated as representatives of property buyers and sellers. Information sought from them was mainly on their opinions on various aspects of off plan sales and particularly its effectiveness, both as a financing strategy to the developer and as an investment to the buyer as well as its challenges.

In addition, more information was obtained through direct interviews with developers and involved projects that had adopted off-plan sales as a strategy to finance real estate development. The direct interviews provided an opportunity for explanations and clarifications and were supplemented by the information that had been collected through questionnaires to various developers and estate agents outside the case study areas.

Field Observation involved visiting the case study areas, making observations on the nature, size and quality of the real estate developments. Photography, which is an indirect mode of data collection, was also used to capture the state of developments in the study areas.

Secondary data was obtained through library research, reviewing existing and available literature from text books, dissertations, Acts of Parliament, journals, newspapers and other documents.

Results

The results of the study revealed that the use of off-plan sales presents both opportunities and challenges to the developer and the buyer. For instance, from the case study, it is evident that developers are able to raise between 30% and 40% of the total project development costs through off-plan sales. But it is also clear that achieving set target also depends on the type of development (flats, apartments, villas, maisonettes and bungalows). For instance the project cases that included; Ramata Greens in Baba Dogo Area, Muthaiga Valley Apartments in Parklands Area and Pearl Heights in Kileleshwa all achieved their off plan sales target of 30%, 35% and 30% respectively by actually getting 31%, 41% and 32% of the total construction costs through off-plan sales respectively. On the other hand; Loresho Ridge in Loresho Area and Kings Millennium Development in Imara Daima each fell short of their 40% target and actually achieved 28% and 24% respectively.

The study further established that the type of development had influence on success of achieving the set target, for instance; projects that focused on the development of apartments had success in achieving their target off-plan sales as opposed to those which incorporated villas and town houses. The estate agents in the case study areas who participated in the off-plan sales attributed this to the lower selling price of the apartments relative to the villas and town houses. This reveals that there is need for market study to appreciate what the consume tastes, preferences as well as income levels to be able to housing units that appropriate for the market.

It further emerged that projects failed to achieve their financing plans due to the failure by off-plan property buyers to complete payment of the purchase price. This is partly attributed to the structure of the agreements that provided for; a) payment of deposit; b) then payment of residue over a specified period to ensure financial flow to the project as the development progressed as per budget. However, the results revealed that many failed to make further payments in time, while others failed to make payments beyond the deposit. In the end, the developers are forced to find alternative sources of finance and incur extra expenses by paying extra legal fees to have the contract enforced.

On the other hand, the results revealed that in the event of delay in completion by developers is the payment of interest on the purchase price. The study findings reveal that the delays may occur from various construction risks beyond the developers' control such as environmental or political factors, leading to payment of interest to the off-plan property buyers. This appears to put undue pressure on the developers. This coupled with the fact that the contracts between developers and off-plan property buyers clearly outline the obligations of the developers with regard to specifications of the units under development and timelines for completion of the development, would on the face of it appear to favour the off-plan buyer, in reality the buyer is often in a more uncertain situation given the number of off-plan projects that have failed due to developers actions in the recent past (see Mugendi, G.N. , 2012; East African standard newspaper, 14th April, 2017; and Daily Nation Newspaper15th June, 2019).

The study also revealed that the prices of the off-plan units in the case study developments were lower relative to sale prices of the units upon completion of development. It was revealed that a comparison between these prices creates the notion that developers stand to gain more profit by avoiding the use of off-plan sales as a financing strategy, therefore discouraging them from using it in their subsequent developments. However, a careful analysis of the financing options indicates that off-plan sales lead to savings on interest payments for the developer that eat into their profits.

Overall, discussions with other stakeholders revealed that achieving the target financing through off-plan sales is difficult due to scepticism and uncertainty by potential property buyers consequently, unwillingness to commit their funds without seeing actual developed units. However, developers in reality stand a better chance if they carefully craft an optimal mix of equity; off-plan sales and debt financing that would lead to lower cost of financing.

In the case of buyers, the study revealed that though the offer for off-plan is attractive there is always fear of potential loss of funds due to fraud by unscrupulous developers. This fear is made worse by cases that are often reported in the newspapers (see East African standard newspaper, 14th April, 2017 and Daily Nation Newspaper15th June, 2019). Furthermore, potential buyers are sceptical of purchasing off-plan as they are deemed to be 'buying into a concept'. For one to 'buy into the concept' and accept to purchase the off-plan units, the purchaser must trust the developer to keep his word and deliver the project.

The study also revealed that most potential buyers of the off-plan properties lack confidence that the developers will complete the developments as marketed off-plan. This idea is backed up by examples of unscrupulous developers who have collected funds for off-plan sales and stalled the construction due to misuse of funds or failed to commence construction and disappeared with the money altogether. A background check on the developer is essential for the buyer when carrying out due diligence before committing funds in off-plan purchase.

Study findings revealed that most sale agreements for off-plan property units provide for payment of the purchase price in instalments. The buyer is required to pay a deposit of about 15% of the purchase price upon signing of the sale agreement and the residue payable within a certain stipulated time. It was further revealed that some property buyers only pay the deposit and later fail to pay subsequent instalments to complete the purchase price. A compromised investor in this situation often resorts to selling on the contract for little or no profit to other investors.

The study further established that marketing for off-plan units is usually done using very attractive brochures, billboards, newspaper advertisements or television footages with beautiful artistic impressions of the real estate development that is anticipated upon completion. However, the final product delivered in many instances are substandard and below the expectations of the buyers. Thus buyers may not get value for money as opposed to buying a complete unit where one visits and inspects the property then negotiates the purchase price based on the condition of the building.

The findings also established that developers are often faced with serious uncertainty due to unpredictable market conditions which may lead to low returns on their investments. Such changes in the market may include changes in demand and supply dynamics in the market or changes in government policy. In such an instance, it would be seen that the developer over-promised the expected returns such as rental yields and capital appreciation yet the buyer achieves lower returns on completion of the development. Besides, it also revealed that it is not uncommon for developers to fail to complete the projects within the planned period. This leads disruption of buyers' financial plans

On financing, the study established that developers use a combination of various modes of finance to facilitate real estate development. This is to spread risks and to leverage on cost of finance from the sources. As such the use of different sources is further driven by the need to find an optimal mix. Although equity and debt have always been the traditional modes of finance, the high cost of debt in the local financial institutions as well as unavailability of equity funds necessitated the incorporation of other innovative ways of financing real estate development. This includes real estate investment trusts, crowd funding and off-plan sales. It was established that off-plan sales is currently gaining popularity among real estate developers and is mostly included as one of the target sources of financing real estate development.

It emerged from the study that main sources of finance for developers include: internal company equity; bank loans, joint-venture arrangements (especially between a land owner and a developer - whereby the land owner offers the land for the real estate development while the developer sources for funds and carries out the real estate development and both parties agree on a formula for sharing the developed units); and off-plan sales. They targeted to have off-plan sales financing between 30% and 40% of the total cost of construction in the real estate developments and managed to achieve between 24% and 41%. The research also established from the case study areas that real estate developments which only focused in the development of apartments had success in achieving their target percentage of off-plan sales as opposed to those which incorporated villas and town houses.

On the general prevalence and use of off-plan sales by developers in general and estate agents. It emerged that a majority of developers had used off-plan sales as a strategy of financing real estate development, but fell short of achieving their target financing through this strategy. Most developers in the case study real estate developments targeted to achieve between 30% and 40% of the total cost of development through off-plan sales of the units to be developed or under development but only managed to finance between 20% and 30. On participation of estate agents in sales/purchase of off-plan property units, findings revealed a majority of them have participated.

In determining the effectiveness of off-plan property sales, as a financing strategy to the developers, it emerged that off-plan sales is a cheaper mode of finance relative to debt financing. It generates significant savings on the cost of development mainly through savings on interest since the alternative would be to take a construction loan of the same amount (amount raised through off-plan sales) which would be repaid with interest.

However, it was noted that the selling price for off-plan properties was significantly lower compared to prices of these properties upon completion of the construction meaning the developer would generate higher returns in selling the properties upon completion of construction as opposed to off-plan.

To determine whether the sale of off-plan property units to finance real estate development leads to net savings on interest, a comparison (for each of the case study developments) of the cost of borrowing the funds raised through off-plan sales (assuming the developer was to take a construction loan) versus the amount that would have been realized from the units sold off-plan, had they been sold at the prevailing prices upon completion of the development. In the end, it emerged that the developers of the five case study real estate developments saved between 4% - 8.5% of the total cost of development by using off-plan sales as a financing strategy. The savings were: 6.21% for Loresho Ridge – Loresho Area; 8.48% for Ramata Greens – Baba Dogo Area; 4.90% for Kings Millenium development – Imara Daima Area; 4.06% for Muthaiga Valley – Parklands Area; and 6.98% for Pearl Heights – Kileleshwa Area.

The study results revealed that off-plan sales leads to an effective marketing strategy. Marketing the property as “percentage sold-off” reduces the time taken to sell the remaining units since property buyers are encouraged to purchase properties when they know others have already purchased ahead of them. In the case of off-plan sales, a section of the development would have already been sold by the time of completing the construction. Also, off-plan sales is effective to the property developer since successful completion and delivery of the development as per the plans and specifications boosts the reputation of a developer. Therefore, when the developer offers a subsequent proposed development for off-plan sales, the uptake would be great due to reference of the previous work done by the developer.

On effectiveness of off-plan properties as an investment to the property buyers. It established that the off-plan purchase price is usually lower and buyers expect increase in property value upon completion of development. Analysis of the data from the case study developments, whereby a comparison was done between the off-plan prices and prices upon completion of development, indicated that the prices appreciated by 32% - 42%. As such off-plan properties are effective investments since construction risks are transferred to the developer, including technical risks, logistical risks, environmental risks, management related risks, financial risks and socio-political risks.

It was also established that most residential property buyers prefer a gated community set up whereby they can have neighbors and a community. Most residential real estate developments sold off-plan comprise of multiple units and may include including apartment blocks, multiple units of villas, maisonettes, townhouses or bungalows with a common entrance gate and various shared facilities. Therefore the property owners are assured of having neighbors as opposed to living a solitary life. In some cases, the developer may give buyers the discretion to select the fittings and finishes for their units thereby ensuring their tastes and preference are met captured satisfactorily.

The study also attempted to find out the challenges and constraints of off-plan property sales in Kenya. The challenges faced by developers in using off-plan sales as a strategy of financing real estate development include: difficulty in achieving the target amount through off plan sales; penalties to developers (as per the off-plan property sale contract) in the event of project delays; failure by off-plan property buyers to complete payment of the purchase price; and lower prices of the off-plan sales relative to sale prices of the units upon completion of the developments. Challenges faced by buyers of off-plan property include: potential loss of funds due to fraud by unscrupulous developers; probability of distressed sale due to inability to complete purchase price;

poor quality of construction; lower returns on the development upon completion than anticipated; and delays on project delivery.

Conclusions and recommendations

In conclusion, it is clear from the study results that property development requires huge capital outlay which most developers are not able to raise without relying on borrowing or partnership. And that although equity and debt have always been the traditional modes of finance, the high cost of debt in the local financial institutions as well as unavailability of equity funds necessitated the incorporation of other innovative ways of financing real estate development. Off-plan sales comes up as an effective strategy which would supplement debt and equity hence its increased popularity among real estate developers.

The study also concluded that Off-plan sales as a financing strategy is widely used by real estate developers in Kenya because of its effectiveness as a strategy of financing real estate development. Indeed the case study results revealed that real estate developers saved between 4% - 8.5% of project cost when they used off plan approach – the savings contribute to increase in developer's profit.

In addition, the adoption of off plan approach provides an effective marketing strategy as a significant "percentage sold off" before completion of the structures thereby reducing the time taken to sell the developed units upon completion. Thus contributes boosting the developer's reputation and reduction in interest payment for the amount borrowed. The off-plan property buyer also benefits through property price appreciation over the construction period, transfer of construction risks to the developer and enjoying the benefits of a gated community set up.

However, off-plan property sales comes with several challenges to the developer and to the buyer. The developer may fall short of achieving the target amount of finance through off plan sales as evidenced in some of the case study real estate developments, pay penalties to the property buyers in case of project delays and face inconveniences when off-plan property buyers fail to complete payment of the purchase price. The off-plan property buyers may purchase properties from unscrupulous developers who may disappear with their funds or fail to complete the development. The buyers would also need to plan and budget for the payment of purchase price installments to avoid distressed sale of their property units due to inability to complete the payment.

It is clear that off-plan sales is made an attractive due to poor planning, lack of adherence to set timings, adherence to quality for completed structures and lack of trust in developers. It is thus our recommendation that given the potentials of off-plan sales to enable the buyers access housing through a fairly flexible payment plan and the developers to access finance at reasonable costs. The various stakeholders should urge the government to facilitate enactment of appropriate laws to govern off-plan sales and buying as well as ensure that developers obtain licenses to use the mechanism as well as enforce compliance by developers with conditions of the license.

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