Financing developers and contractors' activities in theory and practice in Poland

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Abstract

The paper deals with financing of activities conducted by companies in Poland, with the focus on developers and contractors. The theoretical deliberations are supported by the examples of solutions used in business practice by the companies surveyed. Due to the complex character of the issues, which are the subject matter of the deliberations, the paper focuses on the selected sources of financing for investment activities carried out by companies and, in particular, the role of corporate bonds issued by the selected developers in Poland.

Key words

Sources of financing, corporate bonds, developers, contractors, Poland

JEL Classification: G12, G21, L74, L85

Introduction

An investment and construction process usually involves a number of entities. In a developer's process, in particular, the most important participant is a developer, who carries out development projects and has to ensure financial resources for such investments. This is a very significant issue, especially now, i.e. in the times of a global economic crisis, when a lot of bankruptcies have hit the development industry all over the world, e.g. in such countries as Spain or Portugal. (The crisis in Poland, however (...) has not been as turbulent and severe as in other European countries, such as e.g. Greece, Hungary [1]. It should be underlined here that some of the reasons for the present crisis can be traced down to the real estate market; this is about so-called *subprime* credits, used to finance real estate investments in the United States). Such difficulties affect other participants of an investment and construction (development) process as well contractors, in particular. Recently, in Poland there have been some bankruptcies of developers and entities cooperating with developers.

In business practice worldwide, one of the most crucial issues that need to be tackled by entities operating on the investment and construction market, together with the housing sector, is to ensure adequate resources to finance activities, including investment activities. At present, participants of this market in Poland may use a variety of sources. According to the classic division, sources of financing can be divided into one's own sources and external ones. Therefore, the financing of investment and construction (development) activities may be analysed in terms of certain models, which investment processes follow and which take into

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account the relations among the participants, i.e. an investor, a developer and a contractor, with reference to market conditions that provide the framework for such activities. An issue which also has some impact on the analysis of sources of capital is the size of an entity which carries out an investment project, as well as their experience in such projects, reputation and relations with financial institutions, such as banks or investment funds, which increasingly tend to act as developers' business partners. It should be underlined here that in addition to credit, which has long been regarded as a basic source of capital for investors, due to the stricter investment financing policies recently implemented by banks, e.g. on the real-estate market in Poland (which is an immediate consequence of the credit crunch), non-bank financing instruments, such as corporate bonds, are also becoming more and more important.

These issues are in focus of the paper, which mainly aims to discuss the problems of financing activities carried out by developers and contractors in Poland. The authors present the problems in this area in a synthetic way. Therefore, the basic aim of the paper is to analyse the sources of finance in Poland, especially corporate bonds. Due to the complex character of the issues outlined in the paper, the authors, using the general theoretical deliberations as the background, have attempted to describe how the selected listed companies, belonging to the WIG Stock Exchange index and its developers' industry sector WIG-Developers (published by the Warsaw Stock Exchange), raise capital in their business practice. Currently, the industry index of WIG-Developers comprises 25 listed companies and the market value of this portfolio, as of 23 August 2011, amounts to PLN 5,119,395,490. Furthermore, some companies which aren't included in the WIG-Developers index have been analysed. The issues are presented mainly from the perspective of developers-contractors, which are unique entities that have appeared in business practice on the Polish market. Such entities combine the features of a typical investor and a contractor. The paper is mainly theory-cognitive in its character. The authors have drawn on the knowledge and experience they have gained from their long-term research into this field. The methods used in the deliberations include, first of all, deduction, induction and synthesis.

1. Developers and contractors as participants of the investment and construction market in Poland

In business practice, the number of entities involved in an investment project varies, according to the size and type of a project. As emphasized in the introduction, in the case of a typical 'development' project, we have, first of all, an owner of capital, i.e. an investment project. Another important entity participating in an investment and construction (development) project is a contractor, who often also acts as a developer in business practice in Poland. Both here and in the other European countries, development activities are frequently carried out by construction companies, which have construction capacity and become developers-constructors [2]. In fact, it's quite difficult, at times, to distinguish the scope of tasks which are typical for developers from the scope of tasks assigned to a contractor only, as numerous construction and assembly companies register development business as one of their statutory activities. As a result, these contractors carry out development projects on the real estate market. („A 'development' project is an activity, which involves the cooperation of many entities, organised in time and space, intending to affect this space by making new goods, i.e. real estates, or converting the existing ones, with the aim of increasing the value of capital invested and creating certain intangible values reflected by fulfilled social needs"[2],[3]). „(...) It should always be kept in mind, however, that true creators of this market are investors who, as capital owners (decision-makers) (...) bear a lot of risk, which is sometimes higher than the one incurred by contractors themselves"[4]. A significant part of big development companies have their own investment land holdings which they administer, among their assets and, consequently, such entities may be classed as developers-investors.

The scientific literature uses such terms as „(...) a so-called 'pure developer', whose role is limited to the organisation of a development process under the most favourable conditions (...), a developer-contractor, whose strategic goal is to create such investment projects, in which they act both as a general contractor and as a construction manager"[5]. When looking at activities carried out by a typical developer, however, it should be emphasized that in day-to-day business the developer performs the role of a project coordinator, represents the interests of investors, as a substitute investor, is responsible for the technological cycle, as a general contractor and, in addition, often acts as an investor as well. The term investor is defined in the Polish Construction Law and in official public statistics issued by the Central Statistical Office (Główny Urząd Statystyczny - GUS). „(...) An investor is an entity for which an investment project is executed. (...) This entity has to organise a construction process in a strictly specified way under the legal regulations. Such entities may be individuals, churches and religious denominations, housing cooperatives, workplaces, communes, building societies, developer companies"[6]. Based on authorization, a developer, as a substitute investor, replaces an investor, carrying out specific activities entrusted to them which, in an investment and construction process, are the responsibility of the investor. The substitute investor is an organisational entity which operates on behalf of the client, for a payment, and is responsible to the client for the organisation and coordination of activities carried out by all the parties which participate in the investment project, performing a specified scope of work, based on an agreement for investor substitution [7]. „(...) Using the substitute investor is a convenient way of performing the investment project, especially in situations when the investor doesn't have appropriate expertise or experience required to handle the practical or formal aspects of the investment and construction process. (...) It should be kept in mind, however, that the investor carries the risk for any activities performed by the substitute investor appointed by this investor. (...) It means that the investor still remains the main party in the investment and construction project and is accountable for all its obligations in this respect"[7].

As mentioned above, a developer-constructor is a unique economic entity. A developer, as a general contractor, with the support of subcontractors cooperating with them, undertakes to perform all construction works, which are needed to complete the agreed objects within a given investment project. The term of general contractor is defined in official public statistics published by GUS. A general contractor is a corporate entity, an organisational entity without legal personality or an individual conducting economic activities under an agreement with the investor, having their own production forces or a limited capacity to perform a specific type of works (e.g. specialised ones), which employs, with the investor's approval, subcontractors on the construction site; in most cases the entity which carries out construction activities [6]. This entity is fully responsible to the investor for meeting all the conditions specified in the construction agreement [6]. The general contractor's duties include also an obligation to conclude direct agreements with subcontractors which are to perform specific types of construction works, coordinate activities carried out by subcontractors during the construction project and ensure that all the works are performed by subcontractors, with high quality, in a complete, timely and due manner [6]. Under the Civil Code regulations in Poland, a general contractor is obliged to obtain a permission for engaging a specific subcontractor and agree with an investor on terms and conditions of such engagement [8]. Irrespective of this permission, however, the principle that remains valid is that the general contractor, at the moment they sign an agreement with an investor, incurs an obligation to perform the entire investment using their own efforts and, as a consequence, the general contractor is responsible to the investor for themselves and for their subcontractors [8]. There is no doubt that entrusting the general contractor with the performance of the investment brings a lot of benefits for the investor. This applies, first of all, to big investments which require technical expertise, in the area of construction, an ability to organise and coordinate a complex investment process and appropriate experience in working with subcontractors. As the term general contractor doesn't have any statutory definition, there are still no legal regulations to apply directly to the terms and conditions of cooperation established between an investor and a general contractor.

2. Financing models and capital structure of developers and contractors – theoretical and practical approach

As emphasised in the introduction, participants of an investment and construction process may tap into a number of sources to finance their activities. „(...) An entity's status, its stage of development and, in particular, a specific character of a real estate project to be performed determine the right choice"[9]. In theory, internal sources of financing which are available to developers and contractors in Poland include, first of all, share issue (to increase equity) and retained earnings. Also, private equity or venture capital funds may be used. In Poland construction and assembly companies which want more financial support for their business often decide to increase their equity by issuing new shares. This is a very comfortable way of financing their companies' activities and offers many benefits. Such solutions are governed by the provisions of the Commercial Companies Code. External sources, in turn, include bank credit and loans, bond issues, leasing, factoring, forfaiting, securitisation or e.g. issue of short-term debt securities (commercial papers). In this context, the table 1 provides more insight by presenting three types of strategies designed to finance companies' activities, i.e. moderate, defensive and offensive strategies.

Specification	Diversification of sources of finance (moderate strategy)	Priority given to internal capital (defensive strategy)	Priority given to external capital (offensive strategy)
1	2	3	4
Model features	- close connection between the capital structure and the asset structure - optimisation of the debt level - flexible approach to the capital structure, depending on changes in internal and external conditions of a company's operation	- full use of internal sources of finance - priority for conservative methods of finance management - spare borrowing capacity - stabilisation of sources of finance	- employing borrowed capital, to the limits of liquidity - priority for aggressive methods of finance management - day-by-day control of due dates and capital engagement

Use requirements	- access to market information and acceptance of its costs - high ability to adapt to the changing environment - a possibility to diversify the company's operations - the company's maturity	- owners' acceptance of a risk that return on equity may decrease - easy access to equity	- acceptance of high financial risk - sound creditworthiness - a low level of operational risk - stable cash inflows from operating activities - day-by-day evaluation of changes in interest rates - asset structure with most tangible assets, which can be easily converted to cash
Opportunities	- flexible use of financial leverage - optimisation of weighted average cost of capital - limitation of insolvency risk	- keeping spare borrowing capacity - higher security for creditors and owners - ensuring long-term financial liquidity - better position on the financial market - low risk of financial difficulties and related costs	- full use of financial leverage in given market conditions - minimisation of weighted average cost of capital
Threats	-change in the company's market position, limiting the ability to adapt to the changing environment - unexpected directions of changes in market parameters - a rise in operational and financial risks	- a fall in return on equity - no possibility to satisfy commitments to creditors (expected rate of return) - decision not to use financial leverage and use of tax shield - dispersion of decision-making centres, minority shareholders' interests at risk - a rise in agency costs	- worse borrowing capacity - operating cash flows give no security for commitments to creditors - high risk of financial difficulties - a risk that the market value may fall

Table 1: Capital structure models for companies

Source: [10].

Table 1 shows the basic division of strategies. The criterion applied to distinguish these strategies is the dominant role of internal or external capital in the overall structure of financing a company's operations. It also takes into account risks (threats) resulting from the use of various sources of capital. „(...) Risks connected with various sources from which capital is collected to finance investment projects vary"[11]. In a way, this is the basis for creating some kind of universal models of financing companies. The solutions presented in Tab. 1 have a practical value for typical development or construction and assembly activities. In particular, the analysis of the Polish business practice allows us to distinguish the sources of finance, which play an important part in financing of developers' investment projects, for instance. Another division, which may be applied, is the one into dominant sources of capital and less important sources of capital, i.e. the ones which are regarded as supplementary. Based on the analysis of the sources of finance for investment projects on the real estate market, the dominant sources of finance are: bank credit, i.e. long-term mortgage-secured credit taken out by investors and investment credit facilities taken out by contractors, equity from a share issue; borrowed capital from corporate bond issue. Sources of supplementary capital, in turn, are equity, bank credit and loans, borrowed short-term capital from an issue of commercial papers, which can be used by their issuer to finance medium- or even long-term investment projects by means of rollover, real estate lease. This is illustrated in the table 2.

Models of financing	Dominant capital			Supplementary capital			
	Equity Share issue	Borrowed capital Bank credit	Borrowed capital Corporate bond issue	Equity	Borrowed capital Credit facilities and loans	Commercial papers	Real estate lease
Model of financing with the dominant role of bank credit, with mortgage security		✓		✓	▪	▪	▪
Model of financing with the dominant role of equity from a share issue	✓			▪	✓	▪	▪
Model of financing with the dominant role of borrowed capital from a corporate bond issue			✓	✓	▪	▪	▪
Legend	✓ Probable selection of dominant capital			✓ Probable selection of supplementary capital ▪ Less probable selection of supplementary capital			

Table 2: Models of financing developers' commercial projects

Source: Elaborated based on: [12].

As shown in Tab. 1, the leading model among so-called models of financing development projects is the model, in which credit facilities are the dominant source of capital, with participation of equity. The available studies for 2009 show that less than half of the investment projects started in that year were financed using bank credit, which may lead to a conclusion that non-bank sources of financing played quite an important role (flats without credit: 42% (with credit: 58%); investments without credit: 53% (with credit: 47%) [13], including the projects following the models in which equity, derived from a share issue, and borrowed capital raised by issuing developers‘ corporate bonds were the dominant sources of capital. When looking at the general structure of financing developers‘ activities in Poland credit facilities and loans were indicated as a source of both the dominant and the supplementary types of capital. Financing from banking sources is based on a universal banking system (financing based on financial resources from bank deposits) and a mortgage banking system (where credit refinancing is based, by assumption, on financial resources acquired from an issue of mortgage bonds), although the dominant source of credit refinancing in Poland are deposits and mortgage bonds are just a supplement in the real estate financing system [14]. It should be underlined that an issue of mortgage bonds in Poland to refinance mortgage portfolios isn't a significant solution. According to the estimated data for 2010, the nominal value of such instruments in circulation, with reference to the portfolio of credits financing housing and commercial real estates, accounted for 1.2%, while in other EU countries, such instruments are a significant long-term source of financing mortgages. Mortgage bonds may be issued in Poland by mortgage banks, under the Act on Mortgage Bonds and Mortgage Banks of 29 August 1997, as amended. *T*he attractiveness of mortgage bonds is translated into high interest in such bonds, shown by institutional and individual investors, which is confirmed by successful public and non-public issues conducted in Poland. The issuers of mortgage bonds in Poland, according to the data for 2010, included: BRE Bank Hipoteczny S.A. with 68%; Pekao Bank Hipoteczny S.A. with 31% and Śląski Bank Hipoteczny S.A. with 1%. For example, the structure of purchasers of Polish mortgage bonds in the HPA10 series, issued by BRE Bank Hipoteczny, was as follows: 50% for investment funds, 33% for open pension funds and 17% for banks. The index which describes the relation between the value of mortgage bonds issued and the value of mortgages in the selected EU countries is less than 17%, with 45.6% for France, 14.5% for Spain, 63.5% for Portugal [15]. Mortgage banks, due to the fact that their offer for financing real estate is less competitive than the offer of universal banks, do not hold any significant share in the mortgage sector; they finance small commercial real estates and housing developers, i.e. their share in this segment is estimated to amount to approx. 12% [15]. In the group of universal banks, the leaders are the following ones: PKO BP, Bank Millennium SA, Pekao SA and BRE Bank, which were included in '2010 Ranking of Banks Crediting Developers' Housing Projects'. It should be added that the evaluation concerned twenty financial institutions and was carried out by development companies that are members of the Polish Association of Development Firms, which initiated this study. The comparative analysis for 2009 and 2010, based on an evaluation of lenders under the criteria, which show the relation between banks and developers, allows us to draw the conclusions that banks are increasingly interested in crediting developers' investments and the relation between banks and developers has been improving. In all the areas, developers gave better marks to banks, which led to a higher overall mark for the banking system of financing developers in Poland.

3. Corporate bond issue as a source of capital: a case of developers' sector in Poland – a brief synthesis

As mentioned above, the financial crisis which has forced banks that finance the real estate sector to introduce stricter prudential standards, has had a direct impact on market participants who need to look for alternative forms of financing, in addition to credit. Corporate bonds have become an attractive source of external capital as they are a more flexible financial instrument and, as experience shows, offer a lot of advantages, which make this source of finance much more favourable, in many respects, than traditional credit. In 2010 developers issued their bonds worth PLN 840 million in total. Currently, we can see a rise in corporate bonds issued by developers. The scale of corporate bond issues is shown by the figures given in Tab. 3. These figures cover securities traded in the Catalyst bond market, which is a public market on transaction platforms within the Warsaw Stock Exchange and BondSpot.

Developer	Value of issue [in PLN million]	Interest rate [%]	Type of interest rate Fixed/Variable
Gant Development SA	15 10 28.85 26 1.1 25 1.25	7.10 10.79 11.19 8.41 8.95 8.75 10.66	F V V V V V V
LC Corp SA	100 35.35	8.47 8.41	V V
Ronson Europe N.V.	51.34 36.16	8.75 9.45	V V
Robyg SA	60 20 22.75	8.90 8.35 8.90	F F F
Warimpex Finanz & Beteiligungs AG	66.25	8.50	F
Total/Average bond interest rate	Total: 499.05	9.04	In most cases: variable

Table 3: Corporate bond market GPW Catalyst: companies included in WIG-Developers portfolio, as of 22.07.2011

Source: Elaborated based on: [16].

Bonds make an attractive investment since they yield much higher interest than treasury debt securities, they are well secured by mortgages on real estates included in the issuer's portfolio, their market prices exceed the value of the entire issue, they ensure high liquidity due to the issuer's reliability as a company listed on the Warsaw Stock Exchange and they are quoted on the Catalyst GPW market. Therefore, developers are expected to become more and more attracted by this form of financing. The examples of developers' bonds issued in 2010 (companies not included in WIG-Developers portfolio) are given in Tab. 4.

Developer	Value of issue [in PLN million]	Maturity [years]	Interest rate [%]	Coupon payment	Type of security
Archicom	30	3	10.10	quarterly	mortgage
Green House Development	1,8	1	17.00	quarterly	none
Marvipol	20	3	9.45	quarterly	company's shares
Nickel	15	3	10.34	quarterly	mortgage

Table 4: Corporate bond market: companies not included in WIG-Developers portfolio

Source: [17].

Market analysts believe that bonds are now a more easily accessible and just slightly more expensive source of capital for developers than bank credit. For the sake of comparison, developers who collect capital from bank credit incur the cost of 8-8.5%, and when they issue bonds secured by mortgages on real estates, especially land, they bear the cost of 9-13%. We should also take into account commissions for the organization and placement of issues which are paid to companies that organise issues, i.e. issue agents. It's estimated that the costs of corporate bond issues in Poland should decrease to reach the level of 8-9%[18].

Conclusions

The growth of the financial market results in a larger variety of modern financing techniques on offer, as alternatives to traditional credit facilities. Investors in the real estate market, including developers, cooperate in financing real estate projects of different scales, in the structures of entities of various organisational and legal forms. The availability of modern financing techniques facilities the decisions to start investment projects of a bigger scale and complexity, giving entities more freedom in capital allocation. In some specific cases, certain organisational solutions lead to a better borrowing capacity and, as a consequence, investment capacity of an entity which initiates a project. With regard to commercial (private) projects, as well as private-public projects executed in the developer's system, project finance is a technique that offers a specific type of financing for investment projects which are non-standard and require considerable expenditure.

As real estate investment projects are very capital intensive they require the financing models mentioned before. They are based on the dominant source of strategic capital, which has the biggest role in financing of a project, and so-called supplementary capital, with a much less significant share in the total financing structure. When financing big-scale projects, careful selection of strategic capital and diversification of sources of finance which supply the supplementary capital reduce the financial risk that a developer has to bear. It seems that credit facilities are still the main source of finance and the dominant capital when financing the majority of projects in Poland. Currently, the main source of finance for typical construction and assembly companies is bank credit, with the special role of operating credit. The noticeable integration of the real estate market and the financial market, however, and the relation between the real estate market and the capital market, allow for the use of financial instruments available on the Polish capital market and connected with the real estate market and, as a consequence, provide an opportunity for economic entities to raise capital from non-banking sources.

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