The era of equity

By Shahram Safai

The economic meltdown is a global phenomenon which has had a knock-on effect on the Dubai property market. This article will consider how external equity investment can be a viable source of finance for property developers as an alternative to bank debt financing and in the absence of unit purchaser payments.

The global recession has resulted in reluctance by unit purchasers to make timely payments to developers. It has also resulted in reluctance by banks to make available debt financing to developers. As an alternative, equity financing provides investment funds to a developer in exchange for a share of the development company. Equity financing is attractive for developers because no interest expense is incurred on funds invested and investor influence over the business can be curtailed. Generally, an investor obtains returns on an equity investment through dividends which are payments made out of the company's profits. However, in this way, a developer also gains access to much needed capital from the investor with no immediate commitment to provide returns until the company is profitable. But an investor also gains in such scenario as the investor has made an equity investment in the development company at a rock bottom valuation given the economic cycle: he stands to benefit from significant capital gains as the economy improves and the valuation of the development company increases.

Technically, there are a variety of ways that developers can raise equity capital, each having its disadvantages and advantages.

Developers may issue ordinary shares to investors in return for invested equity funds. Dividends are distributed only if the company is profitable and when the directors so choose. A potential pitfall of this approach is caused by a shareholders' right to participate in voting. An investor who purchases more than 50 per cent of the shares of the development company will generally be able to control dividend declaration, allotment of shares, and appointment and removal of directors, (and thus control of the board). In such scenario, if developers issue ordinary shares they should strive to retain more than 50 per cent of the shares in order to retain control.

To avoid some of the drawbacks associated with issuing ordinary shares, developers may consider issuing non-voting shares with the contractual right to a dividend of a fixed percentage in priority over other shareholders. Since the shares carry non-voting rights, investors cannot influence the running of the company. However, developers could issue such preference shares with the right to appoint board members thus granting a certain level of minority board control to such investors.

Another option that a developer may consider is convertible debt, which is a compromise between debt and equity financing. An investor's loan to a developer may be structured such that at the discretion of the investor or at the occurrence of a predetermined event, such loan is convertible into shares.

The rights and obligations of the investor and the developer, as well as the rights and restrictions attaching to shares issued, as discussed above, are generally agreed and specified in the memorandum and articles of the development company and in a shareholders agreement. A shareholders agreement is a contract governing the relationship between the shareholders including the financial relationship, process of decision making and mechanism for transferring and selling shares. Such an agreement is a private agreement between the shareholders and is generally expressly agreed to take precedence over the memorandum and articles of association of the company.

It is important to bear in mind that approval from relevant governmental organisations such as Dubai's Real Estate Regulatory Agency and the Land Department are required for the introduction of such investors. Additionally the master developer of the project in question must be notified as most plot purchase agreements require approval for change of control or sale of shares in a development company.

Given the low valuations of property development companies that have resulted from the global recession, equity financing can provide a viable solution to the dilemma of the lack of financing for property development companies in these difficult times.

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