Changes in housing construction industry in the RF: securities as an alternative to Shared construction participation agreement

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Abstract. Changes in housing construction entail a corresponding reaction of the real estate market especially with regard to residential real estate since developers have lost "free" funds of shareholders-natural persons. As a result of transition to project financing volume of housing construction has decreased by 14.8% in the Russian Federation over a recent year. Housing construction is characterized by zero and negative profitability in half of entities of the Russian Federation due to low solvency of its population, according to Expert RA Agency [1]. Banks do not provide developers with financial resources in such situation. To achieve success construction companies have to raise additional capital which can be obtained from the public debt market. Improvement of transparency and reliability in the construction industry under the ongoing reform, structurization of developers groups, formation of credit-rating dossier should attract investors' attention to builders' securities and reduce the size of risk premium which developers-issuers have to pay today. According to the authors, entering the securities market of 20-30 huge developers in the next 2-3 years will guarantee attraction of investment flows in housing construction in an amount of up to 40 billion rubles.

1. Introduction

According to the reform carried out in the field of housing construction, all new projects from 1 July 2019 must be implemented under project financing scheme with banks' participation. Until that moment, most of developers have used the mechanism of SCP Agreement (Shared construction participation agreement) and therefore they have no experience with a bank loan today. Volume of current construction in the industry has decreased by 17.18 million square meters or 14.8% in the year since innovative activity has been initiated [2]. Falling-off in demand for housing adds extra pressure on volume of real estate market. Since the third quarter of 2019, a share of officially registered SCP Agreement has been decreasing compared to the same period in 2018.

However, decline in demand will not compel developers to reduce prices since their level is supported by a number of factors: firstly, competition in the market is decreasing as some companies are not able to adapt to changes in the industry; secondly, the program of concessional mortgage lending has been implemented since May 2020.
Profitability of housing construction in regions of the Russian Federation is at low level. Real disposable income of population has been falling over the past five years [3]. As a result, developers have lost opportunity to raise prices, especially in regions. Such situation significantly worsens their economic situation. According to the Union of Estimating Engineers, about half of regions in the country are currently characterized by near-zero or negative net profitability of housing construction, and in another quarter of regions it does not exceed 5%. In most cases, in order to obtain project financing from a bank project's margin should be at least 15%. [4].

Securities will probably turn into an important tool for attracting financing by developers in a new environment. Having lost access to “free” shareholders' funds, the construction industry will most likely not be able to obtain comparable volume of project financing in the short term. Therefore, entering the public debt market is practically the only alternative in terms of financing for many participants of the market. To issue successfully securities, developers will have to do a lot - to form construction holdings, increase transparency of companies and organize systematic cooperation with investors, banks and stock exchanges. At the same time, one should be ready for the fact that investors evaluate the construction sector as high-risk [4,5,6]. Initial placement of securities will require additional risk premiums to be paid even by reliable issuers.

2. Research
In connection with the ongoing reform, the volume of current housing construction will decline, but not prices. Housing construction industry is being reformed. The first stage of the industry reform consisted of amendments to legislative base, which came into force on 1 July 2018. The changes were mainly focused on strengthening requirements for developers, increasing bank control over them, and also generated impulse to voluntary application of escrow accounts (a special bank account that opens for settlements between a buyer of residential premises in a building under construction and a developer). As a result of this stage, developers have received a record number of building permits in the first half of 2018. It is means that in order to produce construction based on former and understandable rules market participants tried to stock up on land plots as much as possible. Such policy would allow them to maintain volume of current construction at a fairly high level in the following years. At the moment, land plots that can be still sold under the former rules for "free" funds of shareholders are already being completed [8,9].

The second stage of the construction industry reform has begun in early 2019. All projects that have not reached the required percentage of construction readiness and sales, as well as new projects, must be implemented through the project financing mechanism with participation of banks from 1 July 2019.

One should understand what the project finance mechanism means. A source for servicing debt obligations is cash flow generated by a project. The nature of this type of investment means that assessment of costs and revenues is carried out taking into account distribution of risks between project participants [10]. The process begins when shareholders open an escrow account in a bank. Further, funds of shareholders are transferred to escrow accounts and used for funding a loan. Then a bank starts financing the costs defined under agreed budget of a project minus its own funds [11]. Finally, the process is completed when a bank transfers funds from escrow accounts to a developer after a building will be put into operation [12].

Developers applying escrow accounts to pay under SCP Agreement can get sufficient credit to put a building into operation. However, before introduction of the project financing mechanism, many developers do not have ever deal with banks. Banks also have found themselves in a difficult situation, because they need to strengthen significantly their competencies in construction in a short time, as well as develop and offer a new product to the market. Currently, the housing construction market is responding rather painfully to the reform. So, volume of current construction in the industry has decreased by 17.18 million square meters or 14.8% in the year since project financing has been introduced [2]. Approximately a third of residential real estate under construction is sold through project financing as at 1 July 2020. It is means that in the situation of insufficient replacement of funds received
through SCP Agreement with project financing, decrease of construction volume may become even more significant.

In addition to the fact that developers are forced to overcome objective difficulties caused by the reform, they also, due to fall in demand for housing, began to proceed cautiously when launching new projects. Let's analyze the changes in a number of indicators over the past year, presented in Table 1.

| Mechanism for attracting natural persons’ funds | Developers, the number of organizations | Living area, thousand m² | Apartments, thousand units |
|--------------------------------------------------|-----------------------------------------|--------------------------|---------------------------|
| All mechanisms                                   | October 2019: 3 772, October 2020: 3 346 | October 2019: 118 162, October 2020: 98 549 | October 2019: 2 326, October 2020: 1 967 |
| Through escrow accounts                         | October 2019: 931, October 2020: 1 705 | October 2019: 19 203, October 2020: 41 968 | October 2019: 447, October 2020: 831 |
| Through payment of contributions to the compensation Fund | October 2019: 2 577, October 2020: 1 715 | October 2019: 75 901, October 2020: 49 630 | October 2019: 1 526, October 2020: 998 |
| Without attracting natural persons’ funds       | October 2019: 867, October 2020: 316 | October 2019: 23 058, October 2020: 6 951 | October 2019: 353, October 2020: 138 |

As table shows the total number of developers decreased by 11.3%, but the number of those who used escrow accounts increased by 83.1%. The total housing area decreased by 16.5%, while the housing area built through escrow accounts increased by 118.5%. The total number of purchased apartments decreased by 15.4%, while the number of apartments purchased through escrow accounts increased by 85.9%.

As reflected in Figure 1, the volume of housing construction has been declining over the past year, however, a share through escrow accounts in the total volume of construction has been constantly increasing: on 01.10.2019 - 16.3%, on 01.01.2020 - 24.5%, on 01.04.2020 - 30.7%, on 01.07.2020 - 36.8%, on 01.10.2020 - 42.6% [2].
Figure 1. Amount of housing construction.

Volume of home sales varies throughout a year. There is a clear tendency of increasing the number of transactions from quarter to quarter. However, since the third quarter of 2019, when mandatory transition to project financing began, the number of registered SCP Agreement has been decreasing every quarter compared to the same period of last year. In Q3 2019 the number of registered SCP Agreement decreased by 16% compared to Q3 2018, in Q4 2019 the number of registered SCP Agreement decreased by 53% compared to Q4 2018 and in Q1 2020 decrease in the number of SCP Agreement was 26% compared to Q1 2019 and 7% compared to Q1 2018 (Figure 2). At the same time, many developers at the end of the first quarter of 2020 noted an extra "protective" demand for apartments associated with the devaluation of the ruble. Even a reduced mortgage rate and an increase in the volume of issued mortgage loans traditionally serving as a key driver of home sales could not support demand [1].

As already noted, decline in demand for residential real estate will not force developers to cut prices. History of housing construction shows that even in the crisis year 2015, when volume of SCP Agreement greatly fell after a rush of demand at the end of 2014, developers practically did not correct prices excepting point actions within individual projects. The concessional mortgage launched in May 2020 is a powerful driver of home sales and at the same time helps to maintain prices. Figure 3 shows dynamics of mortgage lending volume over the last 3 years. The data shows that this volume has been increasing all year [13]. The tendency was broken in 2020.
The price level offered by developers is maintained by reducing competition in the market. The largest and medium-sized players having a margin of safety to prevent dumping become beneficiaries of such pricing policy. The number of such companies has decreased by 426 units from 01.10.19 to 01.10.20 (table 1). Projects implemented through a SCP Agreement mechanism are already in a high degree of readiness and, as a rule, have a significant share of housing sold, therefore, companies implementing the projects do not need to force sales by reducing prices [14,15]. And new projects implemented through project financing, in principle, do not need shareholders' funds and are able to withstand temporary decline in demand without slowing down the pace of construction [16,17].

The reform carried out in housing construction industry provides that companies will start to organize business applying project financing, so influence of banks which will decide on financing or denial of financing for a project, will undoubtedly increase. One of the main indicators assessed by banks when deciding on the approval of project financing for a construction project is LLCR (Loan life coverage ratio - the ratio of debt coverage by cash flows; calculated by dividing the net present value of money (NPV) available for debt repayment in the amount of outstanding debt). If LLCR exceeds 15%, a project will probably receive funding from a bank. However, according to the data of the Union of Estimating Engineers, gross profit per 1 sq. m of housing exceeds 10% only in 40% of constituent entities of the Russian Federation. If one also takes into account commercial costs amounting to about 3% of a project cost, and costs of project financing with an effective interest rate of 5% (Figure 4), it turns out that approximately half of constituent entities of the Russian Federation at the moment will be characterized by near-zero or negative net profitability of housing construction [4]. When developers discontinue to implement construction projects through SCP Agreement mechanism, the volume of current construction is expected to decrease.

Real disposable income of the population has been declining over the past five years. As a result, developers are deprived of an opportunity to raise prices and are striving to implement construction projects in places with a high solvency of individuals - first of all, in cities with federal status - Moscow, St. Petersburg, as well as in the largest cities of Russia. According to an analytical center "DOM.RF", about 60% of the projects currently implemented through escrow accounts, in terms of the volume of housing under construction, falls on the projects carried out only in 10 constituent entities of Russia. [2].

Figure 3. Amount of issued mortgage loans secured by the right of claim under SCP Agreement.
The value of the coefficient LLCR for the constituent entities of the Russian Federation.

Figure 4. The value of the coefficient LLCR for the constituent entities of the Russian Federation.

The housing construction industry aims to increase a construction volume up to 120 million square meters by 2024. To achieve the goal, they should cover the constituent entities of the Russian Federation demonstrating a lower purchasing power. However, in conditions when developers in most regions cannot obtain banks consent to begin project financing of construction, they loose motivation to increase construction volumes.

3. Conclusion

The changes taking place in connection with the housing construction reform imply the transition of the industry to bank control through the mechanism of project financing with application of escrow accounts. The volume of housing construction has been decreasing over the past year, but the share based on application of escrow accounts in the total volume of construction has been constantly increasing (Figure 1). If all developers address banks within the next month, obviously that banks will not be able to satisfy the need for financing by 100%. Banks have concluded loan agreements using escrow accounts of developers to 1,800 billion rubles (Figure 5) as at 1 September 2020. It is means that banks should provide about 2,500 billion rubles more, given that only 42.6% of developers have switched so far to project financing. Banks simply do not have such the volume of funds.
Investors traditionally associate the construction industry with increased risk [18]. Until recently, the industry was characterized by absolute non-transparency. Before creation of the analytical center "DOM.RF", organized by Ministry of Construction Industry, Housing and Utilities Sector of the Russian Federation, there was no official database on developers in open access. At the same time, more than 100 companies go bankrupt in the construction sector every year. In the situation characterized by presence of "free" financing flows given by shareholders from one hand and by absence of legal requirements to disclose financial information from another hand, developers have not ever published in the open access, with rare exceptions, any significant data on their activities. Investors did not have a database that could be used to compare developers among themselves, and, as a result, they had no a more complete understanding of the construction market. One is not able to make a comparison with foreign databases of developers in order to perform a high-quality peer analysis due to differences in legal regulations existing in different countries. The resonance bankruptcies of such major players as SU-155 and Urban Group have stroked a powerful blow to the image of the industry.

As a result, the situation is such that even the best companies in the industry have to offer investors additional return compared to companies from other industries with similar creditworthiness. It is despite the fact that rating agencies already include in their assessment the risk of the industry associated with its cyclical nature and capital intensity.

The authors believe that consolidation of construction companies, additional bank control over their activities, increasing of overall transparency of the sector and expansion of rating coverage will reduce the industry risk premium. Market leaders who are already beneficiaries of changes should be the first to feel this trend. Small and medium-sized companies will need more time to gain investor confidence.

Developers need additional sources to raise capital. In the conditions of almost complete lack of own funds, the only option which developers can follow is entering the securities market, since it is an alternative way for developers to attract additional capital. In the authors’ opinion, securities in the form of shares, as well as, and even primarily, in the form of obligation should be used to raise capital.

On the one hand, when developers issue bonds, they have more freedom to dispose the funds received as a result of the issue compared to targeted bank loans, on the other hand, the issue of bonds forms a credit history under open access that can have a positive effect on further conditions for attracting project financing. However, developers will have to make serious effort to successfully enter the bond market.

Figure 5. Amount of loan agreements through application of escrow accounts.
First of all, they should reorganize a construction company or a group of companies. A parent company of a construction holding should be a company unencumbered by construction projects, which will later issue bonds or act as a surety for a financial SPV (Special purpose vehicle). All legal entities-developers should already be concentrated under a parent structure. If one does not organize all projects and assets under one structure issuing securities or acting as a surety, the rating of securities will be lower than creditworthiness of a developer. In this case, when issuing bonds, a company will have to pay an additional risk premium what may be evaluated by some investors as a negative factor.

Also, in order to issue bonds, developers will have to increase significantly information transparency, establish the practice of regular disclosing of financial and operational indicators, and organize systemic interaction with investors (Investor Relations or IR), stock exchanges and rating agencies. Given that most participants of the construction market have almost zero experience in the field, in order to introduce a full-fledged IR companies should enclose significant budget and time efforts, so it is advisable for medium and small companies to transfer IR to outsourcing to enter the public debt market more efficiently and quickly.

Largest players have been on the bond market for a long time, having placed securities worth more than 200 billion rubles. At the same time, medium and small companies, whose activity has increased over the past two years also has attracted more than 10 billion rubles from the market. According to the authors’ forecast, in the medium term, developers will continue to attract investment through the issue of bonds. By the end of 2021, the number of developers - bond issuers may exceed 45 companies, while new players will borrow up to 30 billion rubles on the market. Subsidy costs program for organizing, rating, and placing of initial bond issues implemented by government institutions could speed up the process, increase transparency and reliability of the industry, and ultimately support the pace of housing construction in the Russian Federation.

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