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Professional Practice Program

WORKSHOP 4: BUSINESS MANAGEMENT- ARCHITECT AS DEVELOPER

Introduction

Our skills and training as an Architect can create other opportunities for income beyond that of earning fees in private practice. We are endowed with a wide range of abilities that enables us to find and take advantage of opportunities in the extremely complex and intimidating industries of property, construction and development.

For virtually every single person, buying a fixed property will most likely be the most money they will ever spend in a single event in their lives. It is a daunting undertaking, and the majority of people find the task intimidating. What if they get it wrong? What if they have paid too much? What if the building is unsound? What if the area is declining?

For Architects, such considerations are the currency of our trade. We arrive with an intimate understanding of such issues as:

- Building costs
- Contractors and building contract agreements
- Structural integrity
- Property values
- Property potential
- Construction regulations
- Town planning regulations and opportunities
- Lease agreements
- Tenant requirements
- Building finance
- And many more…

All these being issues with which we deal on a daily basis. Clearly there is a vast amount of scope to exploit these skills to procure other sources of income in the field in which we are already qualified professionals.

I do want to make one point inescapably clear – the purpose of this workshop, and the singular goal of the 'Architect as Developer', is to go about creating a long-term investment in property improvement and ownership. There is no intention to sell these properties, the intention is to create a self-sustaining passive income.

'Flipping Properties' is an entirely different enterprise, and one that *Jason Lee* in "Making Money Out of Property in South Africa" drily observes, is never done well by Architects and Contractors, who both tend to over-invest in the project, and not do what is necessary to create a quick profit.

THE PREMISES

Ownership of business premises provides an astonishing opportunity to leverage all of our professional skills, as outlined above, to our best advantage. As Architects, we are well placed to bring significant additional value that we can also achieve at significantly better prices than the man in the street. A building we have designed says something about us as an architect, it is not a generic chunk of rented meterage in an office tower. Our own building can make a profound statement.

1. Should we invest in property: Property stability and investment reliability

When I first built my own home and office in 1997, I was exposed to a very simple yet fundamental principal of financing – the banks have calculated over the granting of innumerable home-loans that your home is always 30 % of your living costs, and therefore they will lend you the amount that 30 % of your combined income can effectively service.

I reverse-engineered the banks' logic and drew my own conclusion; if you own outright the home you live in, and additionally two further properties of similar value that are leased, you can create a sustainable retirement. In reality the arithmetic is not quite so clean due to agents fees and maintenance costs, so make if 4 properties to be safe!

But as my disappointing Institute breakfast survey discouragingly revealed, not everybody has the appetite or faith in the industry to create a retirement in this manner. Fundamentally, it becomes clear to ask, is property a good place to invest in order to create our wealth?

This is my own opinion on the matter, one based on a long view and not the daily headlines.

- I back my own horse. Having chosen Architecture as a career, it seems appropriate.
- I have faith that the building industry in a developing country like South Africa will remain vibrant.
- The banks are happier to finance property over all other asset classes, making capital far more accessible.
- I back bricks and mortar over paper – I play to my strengths and skills. Furthermore, to quote South African property investment guru Jason Lee; "It allows the investor the added benefit of being able to control the investment decision, as well as the process and outcome."
- Bricks and mortar are more difficult to liquidate into thin air. The value of the materials and labour is intrinsically attached to its physical substance, and in a very negative market, one may have to absorb a 30 % drop in value in a fire-sale. But it is a game where we have skills and competence.
- Property prices in South Africa are exceptionally compared to other countries in respect to the buying power of their respective currencies.

- Over the last five years the Rand has stabilized substantially against foreign currencies and the prime interest rate is being carefully managed.
- As the South African middle class grows and diversifies, which it is doing at a healthy rate, it is creating a huge housing shortage.
- Furthermore, as this emerging middle class grows and invests, the security of land tenure stabilizes. No ruling political party will (sensibly) nationalize private property when such a high percentage of our population is now invested in land ownership and has so much to lose.
- Our industry is fickle, and it behoves us to investigate and pursue all methods to secure our income stream as is possible. It makes sense that we should fall back on our own professional skills and competencies to achieve this and find different ways to exploit them to our benefit.

2. <u>How to get started: The Investment Power of Your Own Lease</u>

Within three years of starting my own practice, I bought a piece of land in Fourways and designed and built myself a home for my young family. It included a separate office from which I ran my practice for a further five years. Building my own home and office presented the following advantages:

- My professional fees cost me almost next to nothing.
- I used a builder with whom I had worked for years and negotiated a good price.
- I made calls to all the product reps to offer them an opportunity.
- I salvaged several large building components from demolition sites.
- I built many of my own fittings and accessories and learnt something of my ‘trade’.

Once completed, working from my own property had several advantages:

- It provided an enormous cost and time saving in commuting.
- My business rental paid a large part of my bond and had tax benefits.
- My own home served as a fullscale model and advert for my architectural tastes and abilities.
- I got to spend an inordinate amount of time with my infant children.
- I still own the property and it continues to pay me an income twenty-five years later.

This exercise revealed the power of my own lease as an investment in my own wealth. Many years later when I formed a partnership, my business partner and I pursued the same logic.

We ended up paying off this property within the first ten years. It is worth mentioning that a true developer rolls their bonds and never aims to settle. A short while later the National Credit Act would show us the error of our ways, suddenly it became very hard to borrow money and existing bonds became very useful.

Advantages to holding your own lease:

- The lease can be internally renegotiated during lean times, thus taking pressure off cash flow, or adjusted upwards in good times, as a pension plan in a very real sense
- The bond can be used as a cash-flow buffer for the practice when the need arises.
- The bond can be used as a bank – loaning money from your bond provides better rates than normal personal, business and vehicle loans. An access bond can provide easy and quick access to cash at much cheaper rates. Personal and business loans are notoriously difficult to secure.
- The bond can be used to raise further finance, should you wish to expand your business – banks do not like financing small businesses, but will happily lend against the equity in your property. This provides a far better interest rate than business loans as a benefit.
- If the practice vacates the premises, it can be let and will still offer an escalating monthly income, all the while increasing in value due to inflation.
- If the practice is forced to close, the asset remains that can either be sold or leased for income.

3. <u>How to go about developing: Some technical points</u>

Considerations When Purchasing and Developing a Business Property:
When making the decision to purchase and develop one's own business premises, the following considerations need to be investigated:

When purchasing:

- Create a new company to be the owner of the premises, and always take transfer directly into that company. This offers a way to 'bank' wealth that is out of the reach of claimants or creditors should the practice run into trouble and reduces risk exposure.
- Buying a property in the name of separate company allows us to change or even to close a practice without having to make an expensive transfer to a new company later on. Speak to your accountant about this.
- Non-architect partners can be included in the deal, a Property Investment Club can be created for the purpose of extending reach into the market. Additional members can even be clients undertaking their own projects.
- Use a lawyer to set up proper partnership agreements, these agreements need to concretize issues such as company structure, shareholding, members responsibilities, liabilities, capital obligations and shareholder exit mechanisms.
- The value of any investment property is directly related to the value of the lease. The banks consider this value when lending money. A business lease becomes valuable collateral when trying to raise a bond – the project is no longer 'speculative'.
- Make allowance for the opportunity to grow – as growth will always be the steepest in the first 24 months of a new practice. Make sure this opportunity is available so it does not become necessary to have to relocate for at least five years.
- Location can provide exceptional awareness for the brand.
- The rest of the location debate extends into the sphere of the estate agent, and all their arguments will be equally valid.

4. Maximizing value: How to leverage your skills and knowledge

Rezone or Consent Use to Add Value to Your Investment:

One of the greatest opportunities to add value and capitalize on our own freely available skills is to acquire a property with the potential to improve rights. We deal with the municipalities and with Town Planners on a regular basis in the course of our working day, so we have the opportunity and resources to thoroughly investigate the development opportunities of properties that may take our fancy. Once purchased, a property can be rented until new rights have been secured, or a practice can run quietly from the premises during the application process.

Making Deals:

We have the ability to make structural and aesthetic improvements that tailor the building to our specific needs. In both of our developments, we made deals with our developer / contractor clients.

- Offset outstanding fees to secure labour and materials for construction.
- Negotiate beneficial rates with Contractors and suppliers.
- Take advantage of purchasing power.
- Every rand not bonded is a rand regenerated as equity in your development. It is a rand not tied up in 20 years of compounding interest.
- As the developer / contractor is not having to pay fees on work we are doing for him, it offers him the opportunity to reduce his costs and cash flow pressure using these deals.
- It benefits your developer / contractor in exactly the same manner as it assists us – he can trade value that is not costing him full market rates.
- Be aware that all offset deals have to go through the books at proper value. The Receiver becomes very interested when assets start improving dramatically in value for which there is no corresponding expenditure.

Without doubt it is hard and frustrating work doing it this way, but it maximizes every advantage that being in the industry offers. At some point, we can use our own professional time more profitably doing this kind of work than practicing as an Architect. Ask any developer !

5. Maximizing opportunity: Using your own developer clients to build a portfolio

A few years ago, when we were insanely busy, we found an opportunity to become investors with some of our developer clients. This offered huge benefits to both parties and helped us build a humble portfolio to create some income from a source other than our practice.

Rolling Cash Flow Cycles With Developers

A phenomenon that will be familiar to those who do a lot of work with developers is that of the rolling cash-flow cycles.

Being able to synchronize with a developer's cash-flow cycle makes us very attractive to them. Typically, all acquisition and start-up costs for a developer create a gigantic cash-flow burden for them. If we are able to delay our payment cycle until they can access their funding, normally about the time they break ground, then we make ourselves very developer friendly.

Once the project moves into the payment cycle, all is good. However, it can create a strange financial space; we find ourselves receiving payments for work that we are not presently undertaking, and its value is unrelated to our present workload.

Investing in Our Client's Stock
We can assist ourselves and our developer clients by buying into their stock. This creates the following advantages:

- Slows our spending and redirects cash into solid investments.
- Leverages our industry status to provide best advantage for deals.
- Avoid transfer costs.
- Avoid agent's fees.
- Seek the best pick of the stock.
- Negotiate the purchase price.
- Endear yourselves to your developers by becoming one of their investor clients.
- Being an investor cements a professional relationship with our developer clients.
- The mysterious effect of the multiplier phenomenon. For tax reasons and fiscal disclosure, the above units had to be placed in the name of our architectural practice. Although it was not ideal, it did create a strange financial harmony – the income generated paid the full salary of one of our technicians, every month. That technician generated income to about 2,4 times their salary (generally more) for the office. The whole deal turned out to be very sweet and profitable – in a sustainable, long-term fashion.

The developer gains the following advantages:

- Reduced early cash-flow burden.
- Secure firm sales up front, helping him achieve his 70 % pre-sales quota to release his development bond as several of the professional team members jumped on the wagon.
- They can offer value in return that comes at a discount to themselves, selling on to you at market price, not their cost price.

A win-win situation that helped us better deploy our income and gave our practice the opportunity to create 'wealth' as opposed to 'money'. The previous argument about every rand not bonded is a rand redeployed as equity applies here, and when we start using our money in this way.

Spreading Income Streams and Investment Risk
A simple way to diversify risk is to try and invest in different sectors of the property market. It is uncanny how different sectors will take turns to perform well.

Becoming a Developer
We have done two developments off our own bat. In both cases we used our own lease to secure the deal and minimize the risk. Doing such work on the open market would not have been so easy or guaranteed to succeed. I think that it will fall to your own financial stability and appetite for risk that would open this route to you.

As Henk Boogertman observes, developers are just born, and have a drive and imperviousness to risk that exceeds even us tenacious Architects by a margin. If that is you, then you are well placed to take advantage of that character trait.