INFORMATION FOR CLIENTS ON THE CHARACTERISTICS OF PROPERTY INVESTMENTS AND THE RISKS INVOLVED (INCLUDING THROUGH SHARES, UNITS AND INVESTOR LOANS)

Every property project involves various risk factors, which the investor needs to assess before subscribing. In this document, investing in a property project primarily means the investment of capital through shares or units, but providing investor loans, with security as a priority one mortgagee, is also included.

General points about property investments

Property investments normally provide returns in the form of periodic distributions or profit on the sale of the property. The underlying value of the investment may also increase or decrease in relation to the price paid when the investment was made. The total return is the sum of the distributions and profit on sale, or alternatively the change in the price of the investment.

The investor is naturally looking for a total return that is positive, i.e. it results in a profit. But there is also a risk that the total return will be negative, i.e. the investment results in a loss. The risk of loss varies between different investments. Usually, the chance of a profit on an investment is linked to the risk of a loss. The longer the time perspective for the investment, the greater the chance of profit or loss. To reduce the risk, there are various ways of investing in property. It is usually better to invest in several different property projects than in a single one or just a few. These investments should then have characteristics that involve a spread of risk, rather than being concentrated so that they may be triggered simultaneously. A currency risk also arises when trading in foreign property investments.

Investing in property carries a financial risk, which will be described in more detail below. The client is personally responsible for this risk and must therefore learn about the conditions, prospectuses etc. that apply when subscribing for such property projects and about the special risks and characteristics of the investments. The client must also monitor the investments on an ongoing basis. This applies even if the client has received individual advice about the investment. Clients may monitor the performance of their own investments via the mass media, for example newspapers, the Internet and TV text services. In some cases, information may be available from the securities firm itself. If necessary, clients should react quickly in their own interests, for example by disposing of investments showing negative trends, or by providing further security for investments financed by loans and where the value of the security is declining.

Categorisation of risk

Property values are normally determined by dividing the relevant rental income by a ***yield*** (direct return), a percentage rate that is established primarily on the basis of three main factors: the financial strength of the tenant; property-specific risk, and the applicable level of interest rates/requirement for returns. The property's yield indicates the expected "infinite" real return from the property purchase.

Each assessment of the risk factors in an unlisted property project can therefore be split into three sub-groups of risk: tenant risk, property risk and macro risk. An investor should also assess exit value, including the risk of being able to realise the investment. These four sub-groups are explained below. Please note that this explanation is not exhaustive, and is simply meant to exemplify the risks within the groups.

Tenant risk

Before making an investment the property's tenant(s) must be assessed. One of the risk factors for the property is the financial strength of the tenant. As the whole of the income from the investment usually comes from the tenants, evaluating the security of this income stream will be crucial. The assessments that need to be done include the tenants' financial strength in accounting terms, future prospects for the tenants' industry and their competitive conditions.

If the tenant profile is diversified it may be sufficient to make an overall assessment of most of the tenants, while for single occupancy buildings a thorough review will be particularly necessary.

As far as vacant periods during the investment period are concerned, a property with a single tenant and a long lease will probably not fall vacant during the investment period. By contrast, a diversified tenant profile with both short and long leases will probably lead to some vacant periods being experienced during the duration of the investment. On the other hand, a property with only one tenant will suffer a significant drop in value and risk of bankruptcy if the tenant can no longer service the lease.

Moreover, the tenant does not necessarily have to become insolvent for the property to suffer a drop in value as a result of trends in the tenant's business. An increase in the tenant's credit risk will give the market an indication of increased cashflow-related risk, reflected in a subsequent rise in the yield on the property. Likewise, if the tenant has payment difficulties and tries to solve this by reducing rent payments etc., the landlord may be forced to renegotiate before the lease period expires.

Property investments are also exposed to risk on renewal of an existing lease, both as regards leasing market prices at the time of renewal and the risk of termination by the tenant. Ordinary leases normally provide for future renewal at market rates, which may be difficult to estimate several years into the future. If no agreement is reached about future rental payments and the tenant then moves out, significant costs can accrue in connection with obtaining a new tenant. There will probably also be a period without any rental income.

At the time of investment, the tenant's willingness to relocate its business also needs to be evaluated. Depending on their industry and ownership, certain types of tenant relocate more frequently than others, necessitating an assessment of the rental rates for alternative tenants.

Property risk

In addition to the tenant, there are several local risk factors associated with the property itself. These are related to future use, leasing potential and the level of operating costs. The property's potential will vary, for example, depending on the zoning of the property and its neighbouring properties, as well as the extent to which the local authorities may be open to any change of use. A property zoned for office purposes, in an area that is becoming increasingly residential, will be at increased risk of a drop in value if conversion to residential purposes is unrealistic or change of use would not be permitted.

Changes in the local area in terms of the tenant profile of other properties, and the development of public infrastructure and communications, will be risk factors that affect potential financial performance. This means that there is a political risk attached to every property investment. Independently of the work put in to developing the value of a property, the value may be reduced because of decisions made at a local political level.

The value potential of the property will also be affected by local demand and thus by expectations related to the local market. Even if the general price trends in the property market are largely governed by macro factors such as interest charges (see below), particular local expectations can also affect the price. This applies, for example, to the number of new ventures in the area. An increase in the amount of land on offer in an area may also affect the market positively (where new high-quality sites increase the area's attractiveness) or negatively (if there is too much empty space).

As property investments are largely based on a net rental amount divided by a yield, it is necessary to consider the risk associated with the property's recurring operating costs and future maintenance requirements. Even if most property investments require ordinary operating costs to be invoiced on to the tenant as shared costs, it is the tenant's total rental cost (rental cost, plus shared costs) which is relevant. Consequently, the investor should assess whether the level of operating costs for the property falls within a normal range, before making a property investment.

Among what are normally defined as ownership costs, it is cost items such as maintenance, replacement and tenant adaptations that need to be assessed. The risk applies both to the level of ownership costs and when they accrue. Even though a technical inspection of the property is normal prior to investment, technical due diligence will not reveal all future maintenance requirements. The life of technical installations varies and this makes it difficult to predict when replacement will be needed. Introduction of property tax, or any increase to existing property tax, is also a risk that has to be assessed for all Norwegian and foreign property investments.

Macro risk

Any investment in property is exposed to a risk of changes in macro-economic factors. As explained above, property yield performance depends on factors such as the market interest rate. As both long-term and short-term interest rates are set on the basis of wider national and international economic developments, it follows that most macro-economic factors (for example unemployment, economic growth, productivity and population trends) will affect the property market.

As the interest element in the yield will represent the whole financing cost, trends in the lenders' marginal rates and the expectations of return on capital invested will also affect the value of property. In other words, in a period when the banks' willingness to lend is low (for example because of high margins and low lending rates) increased yields may be expected. The refinancing risk will also increase during such a period.

Because the interest rates/rates of return used for calculating the yield are largely dictated by macro-economic conditions, predicting the yield will not be easy.

The political risk, described above at the local level, also exists at the macro level. Changes to tax and duty policies in a country can affect the financial performance of property as an asset class. For example, in Norway, changes in capital taxes, taxable value assessment calculations and the introduction of property tax will be factors that affect the financial performance of property.

All the above factors also affect the psychology of the market, which in turn may either reinforce or reduce their influence.

Terminal value risk

Property investments are generally presented as an investment case, with a rolling forecast of results over a given period, terminating in a sale. As this period is often ten years or more, the terminal value assumption carries considerable risk. Investors must therefore evaluate for themselves whether the terminal value is realistic and whether a reduction in terminal value will mean that the investment is no longer attractive.

Property investments are a class of assets that can be illiquid and difficult to realise. This applies especially to syndicated property investments, where gaining access to the underlying value often requires the whole property to be sold. Because the market for second-hand sale of shares and units in such property companies is not very efficient, it must be anticipated that a sale of such shares/units without the whole property being sold will result in a loss, compared with the property's market value. The risk of a liquidity rebate of this nature is usual in most property investments.