

Commercial Mortgage Loan in the system of private ownership

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Keywords

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Abstract

One of the problems of small business today is the necessity for the production sphere entrepreneurs to buy real estate premises. Commercial premises are very expensive and the deficit of immediately available funds causes an objective necessity in commercial mortgage. That is why there is a keen interest towards this topic. One of the strategic goals of the institutional modernization of modern Russian economy is to create an effective mechanism of the development of the commercial mortgage institution. As a result there appear institutional models that reveal institutional character and unique features of contractual relationships (leasing, mortgage, rent) as an alternative to purchase and sale. Revealed specific inner problems allow to work out the ways to solve them.

1. Introduction

In the developed countries small business is viewed as an “engine” of economics as it quickly adapts to changes and thus is very flexible in nature. This flexibility allows small business to find and occupy free niches in the market. Moreover, small and middle businesses offer working places and provide employment for the majority of population. A thorough study of the works of national and foreign scientists in the area of small business development (V.A. Rube [9], D.V. Kolpakidi [5], N.V. Gagarinova [4], A. Ayansola Olatunji [13], K. Gundolf, O. Meier, A. Missioner [14], R. R. Sharma, V. Lindsay, N. Everton [15], etc.) let the author to single out main tendencies in all the researches and they may be summarized as the following: the necessity of government support is evident.

After the events in 2014, which were followed by sanctions and then countersanctions, Russian authorities again paid their attention to small and middle businesses (hereinafter SMB) and once again set the task to create comfortable conditions for their development. It seems necessary to mention here that in the modern history of our country one can distinguish relatively three periods which show difference in development tendencies of small businesses. According to the Federal Statistics figures which are reflected in Figure 1 [6], the period between 1991 and 1993 is characterized by the explosion of the amount of small businesses, as well as in the span from 2007 to 2013. But the period between these two “splashes” is rather stable.

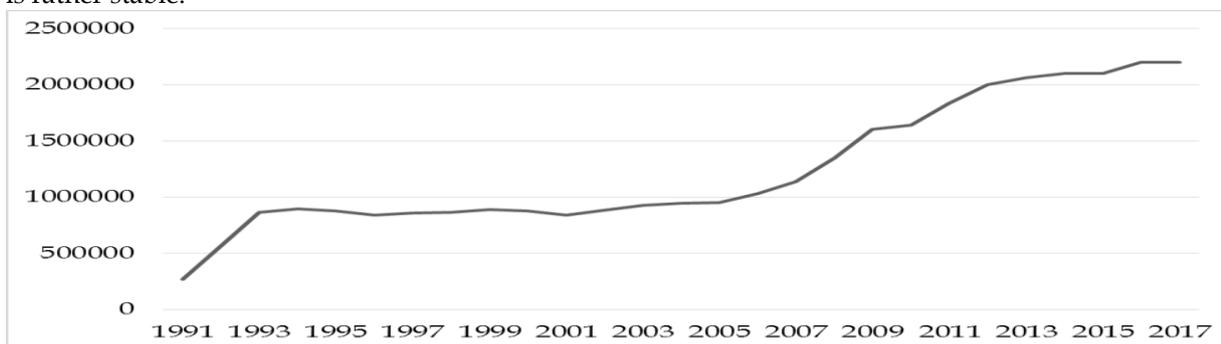


Figure 1. Dynamics of small businesses growth in Russia as of the end of the year, ea.
The source: compiled by the author according to the Rosstat data.

Besides general growth of small businesses and their dynamics, author's attention in this article is concentrated on the industrial structure of these businesses. This structure is shown in Figure 2 and can be viewed as an indirect evidence of SMB industrial focus in Russia.

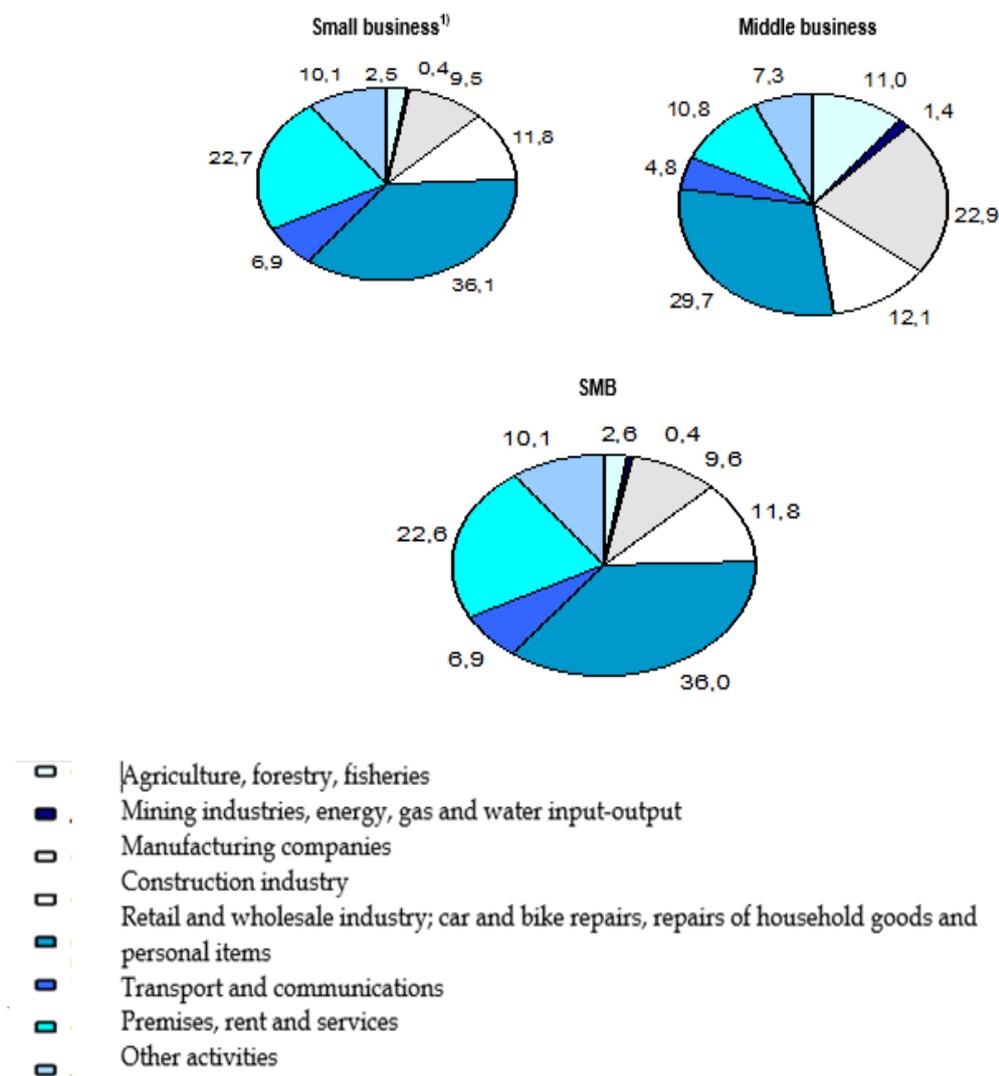


Figure 2. Amount of businesses according to their economic activities in 2017 (by the end of the year; in %)
The source: compiled by the author according to the Rosstat data.

From the data given above we can conclude that the majority of small businesses are aimed at distributive sector but not at industrial sector or innovations sector. Thus one may notice the discrepancy between the desire of the Russian authorities to involve small business into the sphere of import phase-out and innovative technologies, and extremely low interest of the SMB to perform in the material sphere. The author of this article believes that the way out of this controversial situation is the change of status quo in the system of private ownership where special attention should be given to the premises used in industrial processes.

2. Understanding the term “property” and the role of property in business

Premises can be subdivided into residential property, nonresidential property and land. Under the category “residential property” fall all types of premises (buildings) which are used for permanent housing with mandatory public registration. All other types of premises shall be deemed to be nonresidential and can be used in industrial sphere to gain profit. In this article we are not going to speak about land as it is not the object of our study here.

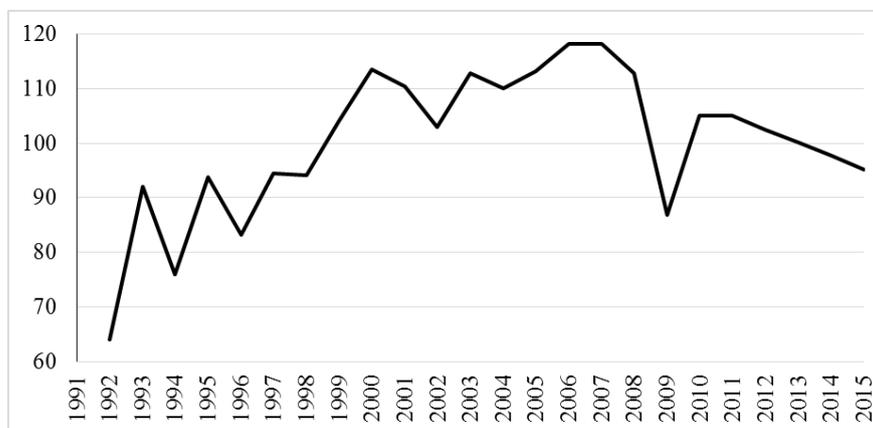
Following the statistics of the construction industry (the industry that creates premises), one can notice that different changes to buildings, constructions and objects of residential or cultural premises are registered with the aim of statistical service. With accordance to "All-Russian Classifier of Fixed Assets" all nonresidential buildings can be divided into industrial, agrarian, commercial, administrative, educational, health care buildings, etc. Surfing the sites of constructors, developers, real estate agents or even banks one may say that commercial premises, office buildings, industrial constructions or storage premises are offered for sale or rent. Thus, we can claim that for one and the same type of nonresidential premises used in the process of creating amenities or rendering services there can be used a great number of terms or labels. Strange as it may seem, but more often than not these terms do not coincide with the nomenclature of Civil Code that regulates commerce. The contradictions in the state policy and business practices as well as theoretical understanding of SMB development in Russia require "refinement" of the terms mentioned above. It is also necessary to make research into dynamics, conditions and tendencies of such premises usage.

Any material industry should have "a place to live". Non-residential premises are an absolute necessity for any enterprise in the production sphere. The majority of those who provide services also are in need for industrial premises. So, any property used for industrial needs, for storage purposes, for offices, hotels or agrarian needs fulfills the function of "habitation" for a company and is used to gain economic benefits. All these, according to the civil Code, should be qualified as entrepreneurship [1]. It's a clear fact that for conducting any form of a business one should establish a legal entity, in other words should establish an organization. Organizations can be commercial (for-profit enterprise) and nonprofit groups. To the first group we refer organizations which "... are aimed at gaining profit as a result of their performance" [2]. It gives grounds to claim that from theoretical point of view it is more correct to use the term "commercial property" under which we understand premises or production areas used in the production of goods or services.

Following the definition given in the Civil Code of Russian Federation [2, part 1, chapter 130] commercial property is viewed as an object of a material world used for gaining profit. It is tightly bound to land (it's impossible to remove or replace an object without any substantial damage) and is subject to legal registration. Theoretical aspects of commercial property use and purchase by SMB are not thoroughly studied yet. Some aspects of commercial property usage are discussed in the works of E.A. Savelyeva [10], where the author pays special attention to the property administrating and to some aspects of investments into the property assets. In the works of I.N. Shestak we find systematic and political-economic approach to the property as to economic category. Works by V.R. Starkov [11] are devoted to a new scheme of private investing into commercial property. V.I. Belousov and A.A. Polyakov make research into the financial operations with property, into methods of property appraisal, professional property management. Here, it's worth mentioning that all these authors study commercial property statically; their works lack in description of objective changes that are well under way.

The development of the commercial property market in modern Russia depends on several factors. From one side, it's dynamics of the construction activity and gross output – and they can be viewed as supply and demand for square and cubic meters. From the other hand, institutional terms of commercial property use and legal ownership. Let us mention here that big business is not involved in market as they usually use commercial property (construction and putting into commission) as an object for investment. The management of the company initiates, organizes and realizes the process, i.e. the company is a customer as well as a consumer of all the production areas. At the same time, SMB doesn't have such financial and organizational capabilities. And this, in its turn, leads to the situation when small and middle businesses create a demand for already constructed commercial property.

Let us have a closer look into the dynamics of supply and demand at the commercial property market. Liberalization and structural reconstruction of Russian economy at the beginning of the 90s of the previous century led to legislative changes and legalization of entrepreneurship. There appeared the possibility to purchase and sell the property or to exchange rights to it. Rapid growth of small businesses in the sphere of retailment and services led to the explosion in the demand for commercial property. But the offer (construction of new property objects) was constantly decreasing at that time. This claim is supported by the statistical data [16] presented in Figure 3.



The amount of work done in the field "Construction Industry" in %

Figure 3. The index of the amount of work completed in the construction sphere in Russian Federation.

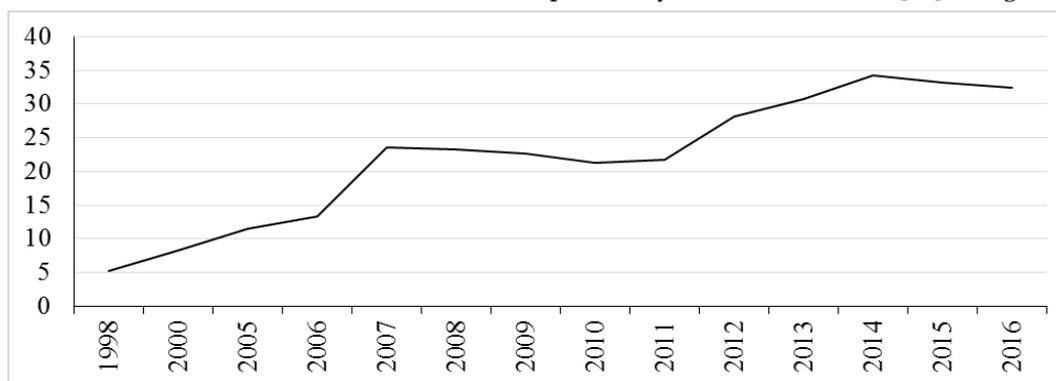
The source: compiled by the author according to the Rosstat data

Thus, we may come to a conclusion that up to the middle of the noughties the commercial property market could have been characterized as a "seller market". The lack in production areas and commercial facilities gave rise to two main tendencies that were very common in the 90s:

- * purchasing of the apartments on the ground floors (with the possibility to construct a separate entrance and a shop window) and converting them into non-residential property. This led to street retail development in the sphere of retailing and services;
- * rapid growth of open-air markets, stalls and other unsteady forms of business which potentially are interested in housing themselves in "steady" premises.

3. Commercial property market in Russia today: shifting from "seller market" to "buyers market"

The demand for commercial property gave an impulse to the construction of non-residential premises which businesses could rent and this can be proved by the statistical data [17] in Figure 4.



Total space of non-residential property put into operation, (million m2)

Figure 4. Commercial property put into operation. (million m2)

The source: compiled by the author according to the Rosstat data

As a result of the processes described above commercial property market gradually was changing from "seller market" to "purchasing market". Empty areas that have appeared in the office centers and shopping centers in the last years can be considered an indirect proof to it. In particular, according to Russian Business Channel [8] the amount of empty areas in business and shopping centers in Moscow should have reached 10-15.5% by the end of 2016. The experts of Knight Frank [16] are sure that the explanation lies in a big amount of new construction activities. Almost 70% of empty areas can be found in shopping centers that were open in 2014. Similar trend is observed in many other cities of Russia. Structural changes that occur in the industrial sector of SMB can be explained by several factors. Form one hand, it is excessive amount of commercial property, which is sometimes quite expensive, and certain

requirements of lessors (property owners) to lessees (renters). On the other hand, it is the decrease of consumer demand in retailing sector and in the sector of everyday services. The shift from agency business towards production activities require certain conditions which allow to draw into economic circulation not only office areas or shopping premises but industrial and storage premises as well. In retail business the most effective way to draw the property into economic circulation is renting, in contrast to that, the best way for manufacturing business is the ownership.

4. Institutional conditions for drawing the property into business activities

At this point let us consider some institutional conditions which accompany the process of industrial premises use or ownership. In the most general sense the procedure of the ownership transfer (creation and termination of the ownership over property) looks as following:

1. So, there is a need for property (economic interest) – need to purchase (sell, etc.) the property
2. Expression of will (either to buy or to sell the property): one-way, two-way agreements, etc.
3. Exchange of ownership and signing of a contract

From the legal point of view the right for ownership (right to thing) is the right that gives legal power over a thing. There are certain kinds of the right to thing:

- ownership;
- special property.

The way of business behavior allows two ways of drawing property into business circulation: either ownership or renting. It is known that the right for property in Romano – Germanic law system “reads into the contract” three powers (an owner triad): ownership, use and administration. Any company gets this right in case of purchase/sale of property. It can be done instantaneously or by installments (by means of loans: leasing or mortgage). Renting gives the right to use the property (on a fee basis) but not to dispose it. Thus, it is an “incomplete” form: the owner retains the right to dispose the property and the right of ownership and use is transferred to the renter. The choice of the way of drawing commercial property into economic circulation has its positive and negative sides. If you need stability and foreseeability then the most preferable variant is the ownership. At the same time renting is an advantage if you don’t want to invest instantaneously huge sums of money into the property. In this case renting allows saving time and money. Owners of the property also have to maintain their premises and keep them in a proper condition. One may say that it can be viewed as a disadvantage. But at the same time, the owners have the right to use their property a security to promote investment. Table 1 shows a systematized approach to the assessment of the way of drawing property into business activities.

Type of Deal	Purpose of use	Initial Installment	The right of ownership	The Owner Triad (O - ownership U - Use A - administration)	Term	Type of contract	The moment of accrual of the right
Rent	Any	No	No	O, A	1 day - 50 years	Rent contract	No
Purchase	Any	Yes	Yes	O, U, A	Unlimited	Contract of purchase	Immediately
Leasing	financial	No	Yes	O, U, A	Up to 3 years	Lease agreement+ purchase and sale agreement	After full pay out of the lease
	operating	No	No	O, U	Up to 3 years	Lease agreement	No
Mortgage	Any	Yes (15-30%) of the cost	Yes	O, U, A	5-15 years	Mortgage agreement+ purchase and sale agreement	Immediately but the borrower is bound to pay out the loan

Table 1. Comparative characteristic of the variants of the drawing commercial property in business activities

Let us have a closer look at renting as it is the easiest way to draw the property into business activities. In comparison to purchasing, leasing and mortgage it is the relatively cheap. In economic practice it is very widely used, but it doesn't invoke change of ownership and thus it will never let the renter to change their status into the owner. Many start-ups use renting and never purchase any property in their future business activities. Here, one of the positive moments is the ability to change the location of a company without any essential expenses, just by renting another property. But, from the other point of view, all the money spent on paying rent with time will become equivalent to the real cost of the same property.

Now we'll pass over to purchasing, leasing and mortgage. In this case one should be sure that they have enough money to buy a unit of property. If financial abilities of the entrepreneur allow buying some property then the most preferable variant is to sign a purchase and sale agreement. If a business faces the lack of personal finances then it's possible to benefit from leasing or mortgage. In this case it is necessary to sign two agreements simultaneously: lease agreement (or mortgage) and purchase and sale agreement. In both cases the buyer will become eventually the owner of the property. In case of purchasing or mortgage the estate of freehold is passed to the buyer immediately; in case with leasing – only after a full pay-out. Thus, both cases are characterized by positive as well as negative effects. In accordance with purchase and sale agreement a vendor of property agrees to transfer the property into the ownership of purchaser, whereas the purchaser agrees to take it and pay for it a certain sum of money. Such practice is characterized by two main features:

- 1) The right of ownership is transferred from the vendor to the purchaser immediately after official state registration;
- 2) The purchaser should pay the vendor of the property a certain sum of money determined by the agreement.

It should be mentioned as well that the vendor of the property has the right to sell it with one-time payment, by installments, on a deferred basis (at the moment of signing the contract, sometime after the thing was given to the buyer). The time limit of a full pay out is not regulated by the current law [7]. The main advantage of purchasing the commercial property is the fact that it enables the buyer to use and dispose the unit of property according to their own choice. However, purchasing the property always leads to the increase of a company tax base; moreover, the money spent on purchasing is the money that could have been used as operating assets, which, in its turn, may lead to the necessity of commodity loans or other kinds of loans. So, the decision whether to purchase a unit of property or not is dictated by financial stability of the company.

Theoretically, property can be purchased on terms of leasing. Leasing is possible only in the entrepreneurial sector. The object of lease – commercial property in our case – is recognized by the lessor and only after the expiration of a lease period the right of ownership is transferred to a leaseholder. The benefit of leasing is the absence of a big downpayment. In case of leasing, the leaseholder may choose a convenient scheme of payment and lease companies seem to be more secure borrowers for banks than individual entrepreneurs. But property leasing is not very popular in Russia as it requires complicated legal procedures and is characterized by high risks.

Mortgage is known to be a certain kind of loan that allows purchasing of any kind of property. It is important to mention that any kind of property for an entrepreneur is not just the object of disposal but an asset and a source of profit. Besides the aspects mentioned in the table above (Table 1), mortgage loans differ from leasing in risks: an entrepreneur doesn't depend on the risks of the leasing company, in case of bankruptcy the property will remain with the leaseholder, the loan-period is essentially longer and the interest rates are lower. As the experts say, it is possible to choose between mortgage and leasing if we know the current position of the company and the exact object for leasing. Anyway, it is absolutely impossible to work out a general scheme, as well as it seems hard to foresee and estimate which of the variants is more profitable when financial position of the company, its credit history, the condition of the unit for leasing or mortgage are unknown.

Coming to conclusion, it is possible to claim that there exists several ways to draw commercial property into business activities, but the ways SMB use them are different.

5. Statistical data analysis of the survey (a questionnaire for entrepreneurs compiled by the author)

The tendencies that exist in the commercial property market can be understood only if there is real statistics of the amount and types of bargains made. As it is really impossible to obtain official statistics the author of the article conducted a survey. The entrepreneurs of Tula Region (Central Russia) were questioned within the span of 2015-2016 to find out real ways of using property items in business activities. The amount of respondents is 400; the method used is "random choice". The participants of the survey: commercial property owners (33%) and commercial property tenants (67%). All of them were distributed within 9 groups according to the type of business activity in agreement with Russian National Classifier of Types of Economic Activity (hereinafter CTEA).

The survey contained different questions about SMB business activities and problems connected with them. In this article our interest is concentrated on the part of the questionnaire where the ways of drawing the property into business activities are discussed. The results obtained were processed with the help of the statistical package STADIA. As the data show, 60% of owners and 32% of the tenants are interested in the development of their business and are ready to use different loans for that purpose. The mentioned above respondents according to their investment behavior are divided into clusters which can be clearly seen from the dendrogramm (Figure 5). X-axis: groups of entrepreneurs according to CTEA; Y-axis: span of clusters.

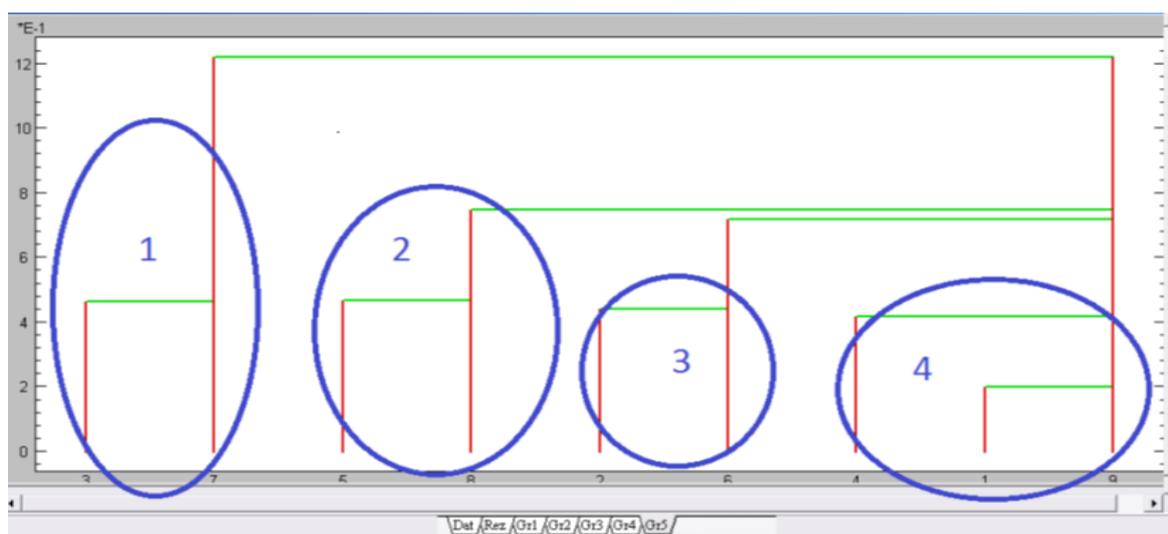


Figure 5. Dendrogramm (Euclid's Metrics + Ward Method)

The source: compiled by the author

As it can be seen from Figure 5, Ward method distinctively allocates 4 clusters. The answers to the questionnaires of the survey give the ground to interpret such results in the following way:

- The first cluster includes such business activities as freight activity and realtors. These businesses feel quite confident in the present day economic situation and show no interest in purchasing permanent property but are in need of capital widening and operating assets increase;
- The second cluster comprises wholesale business and different construction businesses. Purchasing of storage premises was the main aim of investment for the respondents of this cluster;
- The third cluster includes hotel business and manufacturing businesses. The entrepreneurs working in these businesses usually deal with industrial areas (buildings) which they own. They show a real interest in commercial mortgage loans and are not interested in financial leasing at all;
- The fourth cluster: services, catering and retail business. These businesses are the most "mobile" in terms of housing and their need in financial resources is determined by their sales.

6. Conclusion

So, we can claim that almost all representatives of SMB show the need of financial resources but only members of the second and the third clusters are in real need of long-time investment.

In conclusion, we would like to note that it is necessary to create favorable institutional conditions to draw commercial property into business activities as Russian government is interested in the development of manufacturing industries and in the involvement of a small business into this sphere. The use of commercial property mortgage loans may become one of the supportive mechanisms in this development.

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