Liquidity Risks In Direct Investment

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Liquidity Risk and the Financial Constraints of Direct Investment

Liquidity risk refers to risks that a firm may not be able to meet its short-term financial needs. This is bound to occur when firms are unable to convert security or hard assets without incurring a loss in capital. The liquidity risk is characterized by long-term funding risks and short-term funding risks (Pástor & Stambaugh, 2003, P. 680). The long-term risks are incurred when loans are not available when the company requires them or when the loans are not available at an affordable cost. These are risks connected to any investment, and therefore, all companies need to manage liquidity risks to ensure that they can meet their current financial needs. In indirect property investment, investment firms manage the liquidity of their clients. Direct property investment refers to investing in real estate in a foreign country apart from the investor's country. This aims at the acquisition of controlling interest in the foreign market and committing capital to the real estate sectors to gain returns.

Real estate trusts in the UK act as intermediaries in the transactions of buying and selling direct property investments since the country lacks a central trading exchange for major transactions. In the UK, although building depreciates and loses value over time, land retains and appreciates its value every day since it is limited in supply (Bond, Lin & Vandell, 2007). Real Estate Trusts and Property Unit Trusts in the UK provides platforms through direct property transaction are based. However, some investors consider not to use intermediaries. Real estate trust in the UK acts similarly to mutual funds by owning operating income-producing real estate-related assets.

Property in the UK is classified as a tangible asset, which compares land and buildings. The objective of a real estate investment trust is to provide investors with dividend income, especially from rental income and generation of financial leverage from real estate assets (Baum & Schofield, 1991). Real estate trusts and property unit trusts enable their investors to be exempted from high taxation, paying pension funds as well as charities. They relieve the investors from the burden of day-to-day property management. REITs specialize in a single real estate through the acquisition and development of real estate property initially as an investment portfolio.

Property Trusts, Rental Income, and Access to Real Estate Returns

Real Estate Trusts and Property Unit Trusts allow the investor to have an insight into the property income earned from property investments. It is a benefit attributed to owning property. Investors in real estate are provided with the opportunity to buy or develop the property with the aim of earning higher profits through either renting or appreciation of price and selling at higher profit margin levels. Investors in this sector have flexibility in choosing what kind of investment to commit their capital to and how to manage the investment. Real estate allows investors to determine how much to charge for their property, either based on market values or the valuation of their property. Also, investors have the potential to appreciate a highly leveraged asset to secure income from lenders or purchase a property using debtor money to own a highly leveraged investment.

Every investment decision in every sector, whether in property or any other industry, comes with its inherent risks. It's, therefore, up to the investors to mitigate these risks to be able to earn anticipated returns. Investors in the direct property investment sector experience liquidity market risks by committing their capital to Real Estate investments. In the UK, property as an asset class level has raised illiquidity premium which ranges from 2 percent to 4 percent, and this depends on the locality and cost of the investment. Each asset is subjected to asset-level analysis through which the expected return is assessed in compensating the direct property investors for the illiquidity of the assets to which the investor commits capital. This ensures that investors can mitigate liquidity risks incurred by direct investment.

Different areas of the workplace can trigger liquidity risks. These areas of risk include an unplanned reduction in revenue and inadequate cash flow. Also, insufficient financial facilities, an unanticipated decrease in income, seasonal fluctuations, continuous reduction in profits, breach of loan covenants, incompetent management of capital and mismatch of the maturity period of debts- just to mention a few. Surprisingly, risks can be mitigated, for instance, by concentrating on well-situated and high-value properties having low returns and low income from hard assets. Equating these factors will add up to more liquidity after making sales.

Financial Crisis and the Recognition of Property Liquidity Threats

The global financial crisis reinvented the idea of promoting the understanding of liquidity threats facing direct property investment (Chossudovsky, 1997, p. 2295). Although the lending firms take charge of these risks, the investor can be directly affected in the future. Liquidity risks are, in other words, termed consequential risks as they lead to the rise of other financial risks.

Funding liquidity risks refer to the capability to meet demands and liabilities immediately when due. Therefore, funding liquidity risks are driven by the possibility that, with time, a business may be unable to fulfill its obligation when due. Funding liquidity risks reflect the magnitude of risks by taking on many infinite values. Proposed funding liquidity risk measures in property development consider information on the cost of liquidity and the amount of liquidity obtained. This is carried out to maintain consistency in different sizes of auctions. Funding liquidity risks take many aspects to analyze the magnitude of the risks involved in direct property investment. Converting property into cash requires long processes due to its complexities both in legality and valuation terms.

Funding liquidity risk leads to the rise of leverage risk, which is perhaps the most common risk attributed to every type of investment in the Real Estate sector in the UK. Since the property is a tangible asset and classified as an asset class, it definitely attracts being used as leverage in debt securing (Baxter, 1967, p. 400). Real estate provides a somehow anticipated income stream, and hence leverage risks brought by more debt pose a negative implication towards the valuation of the assets. Increased debt connected to assets results in a diminishing equity value of the overall investment. Additionally, there are risks associated with when the business has utilized all its leverage and hence lacks the sufficient leverage needed in a strong market and rough market conditions. In mitigating leverage risks, investors in Real Estate trusts in the UK manage the type of debts in which the investment will provide leverage to cope with market conditions with strong leverage successfully.

Market Liquidity, Fair Pricing, and Transaction Risk

Commonalities in liquidity risks characterize risks involved in property investment. These risks regard the inability of the investors to transact at a fair price. Market liquidity risks arise when the investors can transact business based on fair market price with the aim of appreciating of price to gain returns. Also, trading at reasonable prices leads to the emergence of tenant risk, which is influenced by market liquidity. The primary source of funds in the direct property investment is rental income. Almost every investment in the real estate sector earns rental income either directly or indirectly.

Rental income provides this sector with steady cash flow throughout the year, and thus, tenant risks have to be analyzed and mitigated properly for the investment to yield the investors' anticipated returns. Rent is charged based on market prices in the UK, which incorporates trading profits to cater to the investor's balance sheet reserves. Since the sector basically relies on rental income, the real estate assets should be strategically placed in a marketable locality and in good condition. Although there is a rising demand for housing in the UK, the locality of the rental property affects the percentage of residents of the property. Also, investors face the risk attributed to the tenant's ability to pay the rent on a timely basis and changes attributed to the market value of the property and rental expenses.

Many types of research and studies have been conducted to define the panacea of a single risk

measure to no avail. Currently, it is becoming a trend for many firm clients as they appear to be taking the view that there is an independent or personalized allocation to real estate as well as other private class assets (Lintner, 1975). By understanding, there is bound to be a diverse return stream. This diverse return flow is in a bid to attract asset class. Perhaps the primary critical threat attributed to private commercial investment and direct investment is the illiquidity risk of which most of them are not aware. However, liquid investment has the advantage to the clients in that there is a cost in which one can trade with certainty when uncertainty issues strike; there is also a wide range in the market in the form of buyers as well as investors (Dietrich et al. 2000, p. 130). This cost can be, in turn, used in the valuation process

Dynamic Risk Management and Preparation for Unexpected Conditions

Liquidity risk is dynamic, and therefore, businesses need to take charge of unexpected conditions. This will aid in ensuring that liquidity covers all areas. The potential risks in liquidity include but are not limited to insolvency, breach of legal requirements, lack of capacity to meet legal requirements, non-payment of risks as well as inability to meet payment terms (Girma, Greenaway & Wakelin, 2001). A property leasing firm is exposed to fewer risks in meeting its obligations, hence securing its investors from losses and generating a lot of profits and interest income on their behalf. Due to the flexibility of the real estate trusts and new negotiation terms with customers and suppliers, they have been able to generate new and wide opportunities for their investors.

The property unit trusts measure the degree of liquidity risks to determine their exposure and effects on the investors (Brunnermeier & Pedersen, 2008, p. 2230). Through these certain measures are undertaken by the firm without involving their clients. These measures of effectiveness include forecasting the cash flows, which involves analysis of the long-term cash flow as well as short-term cash flows. Cash flow forecasts provide insights into the financial details of the company for proposed lenders. Short-term liquidity analysis is also carried out with the aim of monitoring the market conditions favorable for investments. It also highlights short-term business problems and provides ideas on how to solve them (Kim & Verrecchia, 1994, p. 47). Through financial ratio analysis, the business can determine areas that are exposed to liquidity risk. The ratios of liquidity identify the perfect timing for cash flow and investors' return in the Real estate sector. It also indicates how current liabilities can be settled out of liquid assets.

Real estate trusts can opt for leverage in their move to avoid exposing the investors to liquidity risks which lead to insolvency. Through leverage, the business's vulnerability to downturns, especially in cash flow, is reduced. Factors such as consistency, quality, and reliability are factors that should be put into consideration while gearing to success (Saunders & Cornett, 2003). Funding facilities can also be assessed to determine the extent to which the firm relies on financial facilities, the extent to which it depends on one lender, the availability of funds in uncertainties, the maturity profile of the facilities

and the strength of the relationship with lenders. The financial facilities available for the firm should be analyzed to determine the volume of assets needed to acquire them (Banks, 2014, p. 77). This would help in preventing inconveniences to the investors. The cost at which the capital is to be acquired should be identified to determine whether it is acceptable or not.

Leases, Rent, and the Structure of UK Property Income

In the UK, income from property investment is sourced mainly from rent and leasing, by which the tenants of the property commit to the terms of the lease. Real estate funds are either income-oriented or growth in investors anticipate gaining both dividends and returns on capital gains. The income from direct property investment, mostly from commercial lease contracts, provides a long-term source of rental income. Property income from the UK is majorly determined by the prevailing market condition, which determines the rent charges and contract terms. Most of the funds earned from the sector by investors are sourced from the selling of appreciated properties within the market prices.

Direct property investments ensure that investors secure property in areas that have demonstrated evidence of capital growth both currently and in the future (McAllister, 2000, p. 50). This involves areas that have less land supply, less skilled labor, increased population and average wages, as this puts forward pressure on property value. Investors manage through the diversification of portfolios across multiple markets and locations. Reduced exposure to the single market in the UK stabilizes overall growth and provides long-term plans for generating returns. Investors generate returns through investment in localities with high rental yields and maintaining an income generation portfolio for increased cash flow.

Real estate funds tend to be more volatile as compared to other direct investments. Funds from the real estate investments are distributed within a range of defined timeframes which anticipate the amount in which the investors own (Hartzell, Hekman & Miles, 1986). Real Estate Trusts and Property Unit Trusts act as risk managers where they protect the investor’s wealth and ensure that their portfolio survives and grows for the long-term. It is conducted through the implementation of risk management strategies, which ensures that the investors will not incur losses and, hence, high returns.

Property Design, Tenant Demand, and the Attraction of Investment

Because various parts of the UK structure properties with artistic skills, the UK has been able to attract new tenants to occupy rental apartments, both local and international. This has led to

increases in overall demand for rental houses, which has, in turn, led to high returns due to increases in rental income (Ibbotson & Siegel, 1984, p. 220). In the UK, market prices set the price at which the property will be sold and the rent to be charged, and since market prices are influenced by demand, market conditions will increase the prices to cater to high demand and limited supply.

Overall, direct property investment provides higher returns since it provides opportunities and the development of productive capacity, which is integrated with the domestic economy of the UK with the global economy. This exposes them to a wider market share through which they constantly generate revenue. Since the UK embraces free market economies, it has increased the cash flows of direct property investment by bridging the gap between domestic savings and globalization (Brueggeman & Thibodeau, 1984). As compared to other direct investments, direct property investment also serves the long-term financial interests and the growth of the host country.

The UK offers a competitive locality for property investment due to its large population and limited supply of land, which has created an unbalanced equilibrium. Investments in the real estate sector yield higher returns as compared to other competitive locations and hence offer attractive incentive packages for foreign investors.

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