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Analysis of the Income Gap and Divergence of Purchase Prices of Investment Units in a Condo System on the Basis of Selected Properties - a Case Atudy

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ABSTRACT

Purpose – The main intention of the analysis was an attempt at defining the income gap and identifying the return from condo units in Poland.

Design/methodology/approach – The article presents the subject of condo properties. Two main types of condo properties have been distinguished: condo apartments and condo hotel rooms. The fundamental differences are presented. The research uses case study approach.

Findings – The research suggest that rent calculation mechanism is the decisive factor for the occurrence of an income gap in investments in condo property. This is affected by three aspects: The requirement to buy furniture/equipment and no rent charged for the invested capital. The requirement to buy a parking place, which is not included by the operator in the determination of yearly rent on the invested capital. The investor exercising their right to become a resident owner of the condo unit on the applicable terms.

Research limitations: The analysis covers condo units in towns with significant tourism potential, and in Warsaw. The sample includes selected operator contracts examined for six condo properties in Poland.

Research implications: The paper answers two vital questions that may be interesting to property investors, both institutional and individual: Which factors explain the annual retur from cond properties in Poland? What are the annual returns under specific contract terms in the circumstances of the Polish condo property segment?

Keywords:	condo apartment, condo hotel, ROI, income gap, investment efficiency, condo unit price
JEL codes:	M21, R33, Z30, Z33
Article type:	case study
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INTRODUCTION

The market in commercial and tourist properties is highly diversified. It distinguishes between hotel properties and flat properties. In the tourist real estate market, looking for a fair profit (Frehse, 2007), there are often investors investing in flats or hotel rooms in the condo system (O'Neill & Ouyang, 2020). When considering investments in the tourist real estate market, including condominiums, a group of variables and economic indicators should be taken into account (O'Neill & Ouyang, 2020). Institutional investors often invest in the hotel real estate market, encouraged by favourable growth forecasts for hotel services. Investors in the condo market are similarly motivated (DeFranco et al., 2021). There are various models of operation of tourist properties around the world.In the USA there has been research into how much and whether there are better rates of hotels with condo units, and what influences such a state of affairs (Kim & Tang, 2020). There has been research into the relationship between the developer and the purchaser (investor), where the experience of the purchaser of the property is of key importance to the profits made by that property.

In response to ubiquitous advertising, encouraging investors to invest in the condo property market, and the incentive of 'guaranteed' yearly profits at 6-8% of the value of investment, it has become necessary to investigate the actual incomes and the divergence between the advertised, or even contractual incomes and the actual market incomes, followed up with identification of the factors with an essential effect on the differences.

In the course of analyzing the contents of secure 'guaranteed annual profit' investment advertisements, which are compared to contractual terms, certain inconsistencies were discovered in the values of yearly incomes (*Zarabiaj* …, 2021).

While reviewing operator contracts, it has been observed that the operators pay out the gains (yearly rent) not on the basis of the full price of a condo unit but only the net price, excluding furniture or other components necessary for closing a contract, which is also noted in the communication by the Office for Competition and Consumer Protection (*Inwestycje w*…, 2019) and the Polish Financial Supervision Authority (*Komunikat* …, 2019)

Typically, in order to close a deal with an operator, certain additional components of a condo unit need to be purchased, such as:

a. a parking place,
b. furniture and equipment as per the operator's standards,

In Poland, the lack of legal regulation concerning condominiums also causes certain abnormalities and all related consequences.

Moreover, certain differences have been observed in the prices of condo units, payable by the buyer to the property developer. Considering the property components which are necessary for a contract, the price of a condo unit can be +10% up to +25% higher than presented in the advertising brochure. It has also been observed that condo properties generate different amounts of income. Depending on the management model, investments are more or less profitable. In Poland, other problems have been observed in the area of condominium management. The problem of the lack of legal background for condominiums in legal acts can be observed worldwide. This results in a number of imprecise legal interpretations and consequent problems.

Taking the above aspects into consideration, it has become necessary to identify the factors and their weights that have a significant effect on the returns generated by condo units typical of that segment.

Literature studies and empirical studies (Markowitz, 1959; Markowitz, 1987) were focused on the following key questions: Which factors are relevant to the amount of yearly earnings?; How much does a investor John Doe actually earn per year under specific contract terms in the circumstances of the Polish condo property segment? Further research into the subject of condo properties is therefore necessary. It should be noted that research in the field of investing in condo propertiesis becomingindispensable.

ANALYSIS AND EVALUATION OF THE COSTS OF PURCHASE OF A CONDO UNIT AND OTHER PREREQUISITES FOR CLOSING A CONTRACT WITH AN OPERATOR – A CASE STUDY

For the purpose of analyzing the purchase price discrepancy for condo units for rent to an operator, investment projects at specific locations were selected to represent the average of that location in terms of prices, sizes and conditions for tourists. The analysis covers condo units in towns with significant tourism potential, and in Warsaw.

Operator contracts were examined for the following condo properties:

a. Hotel Aries Residence & SPA, Szczyrk.
b. Horizon Hotel & Resort Szklarska Poręba.
c. Condohotel Mercure Warszawa Ursus Station.
d. ECO Masuria Frombork.
e. Radisson Resort Kołobrzeg.

f. Baltin Hotel & SPA Mielenko.

Table 1 presents the prices per unit and the additional amenities required for closing a contract with the operator.

Table 1. Prices of condo units and specific amenities necessary for closing a rental contract with the operator

Location	Price of condo unit (PLN)	Price of parking place (PLN)	Price of furniture and equipment (PLN)	Total price (PLN)	VAT (PLN)	Gross value (PLN)	Base amount for rent determina tion by operator (PLN)	Net amount (VAT exclusive) invested in the property, not working towards the investor's earnings (PLN)
Szczyrk	656 888	40 000	83 690	780 578	179 532.94	**960 110.94**	696 888	83 690
Szklarska Poręba	407 385	40 000	54 318	501 703	115 391.69	**617 094.69**	407 385	94 318
Warsaw	532 301	0	57 757	590 058	135 713.34	**725 771.34**	590 058	0
Frombork	300 000	0	0	300 000	69 000.00	**369 000.00**	300 000	0
Kołobrzeg	409 780	29 900	49 900	489 580	112 603.40	**602 183.40**	439 680	49 900
Mielenko	349 000	10 000	30 000	389 000	89 470.00	**478 470.00**	349 000	40 000

Source: author's own research.

It can be noted on the basis of the data in Table 1 that the price of a condo unit (whether a condo apartment or a condo hotel room) increases significantly, which is a prerequisite for signing a contract with the operator. The price of a unit is increased by the necessary purchases of furniture and equipment as per the operator's standards, as well as a parking place. The purchase of such additional components leads to an unavoidable increase of funds to be assigned to the investment. The values of such necessary additional investment finance are presented in Table 1.

This higher amount of money for investment leads to a consequence which should not be disregarded. Namely, the entire investment is split into two parts:

a. The value of the investment on the basis of which the operator calculates the yearly rent,

b. Non-working funds, capital that needs to be invested in purchases of furniture/equipment and a parking place, not considered by the operator in annual rent payoff.

VAT is also charged on the property purchase, which is recoverable. An individual not running a sole proprietor's business(Dz. U. 2004 Nr 54 poz. 535) can also apply to the Tax Officefor a refund of surplus VAT. Considering the subject-matter of this paper, the VAT aspect will not be discussed here.

The components necessary for the calculation of yearly rent and the values of non-working funds are presented in Figure 1.

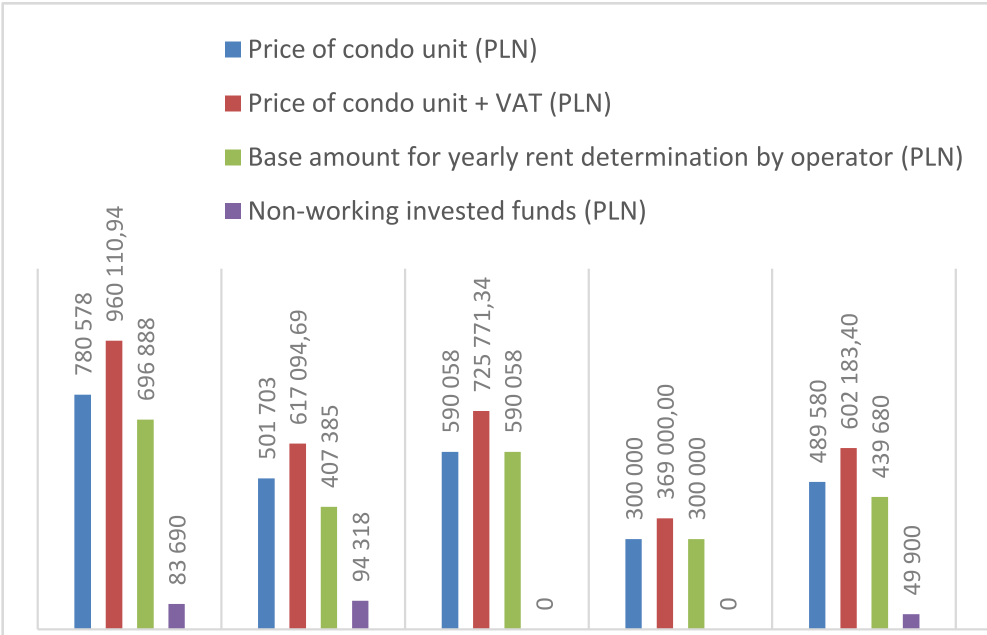


Figure 1. Comparison of prices, rent base, and invested funds not working towards the investor's profit

Source: author's own research

It has been observed in the course of analyzing the prices of specific condo properties and the components required for closing a contract with an operator that a significant portion of the property is not working towards the investor's earnings. A comparison of working and non-working funds invested in a condo property by an investor is shown in Figure 2.

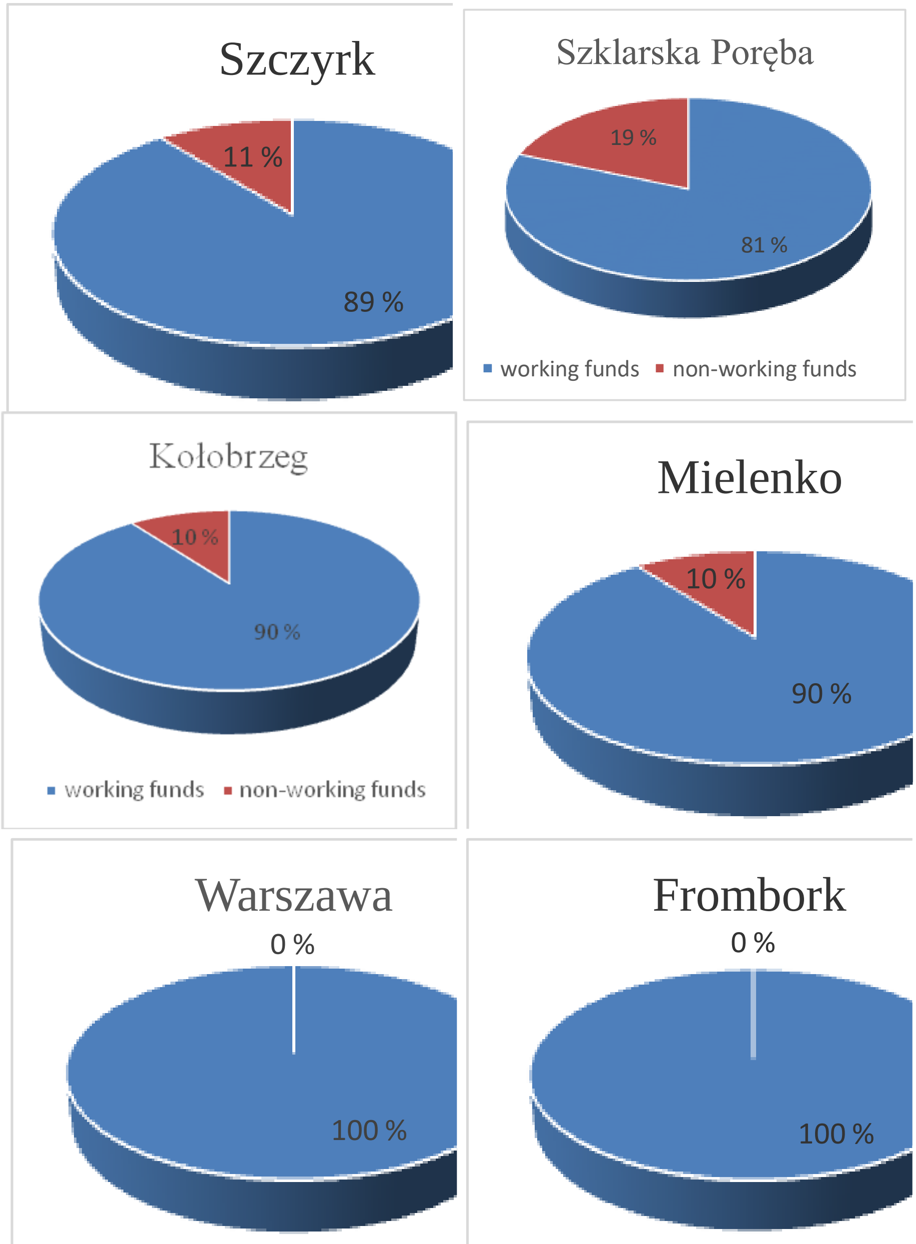


Figure 2. Proportion of working funds invested in a condo property to non-working funds invested in a condo property (not generating profit for the investor)
Source: author's own research.

With the exception of the Warsaw and Frombork projects, the non-working funds component for the remaining properties ranges from 10% of investment value in Kołobrzeg and Mielenko to 11% in Szczyrk and 19% in Szklarska Poręba.

It should be noted that the non-working funds, necessary for closing a contract with the condo operator, lower the yearly rental incomes, which will be discussed further in the paper.

ANALYSIS AND EVALUATION OF THE INCOME GAP DURING ONE YEAR AND 15 YEARS OF CONTRACT – A CASE STUDY

The profitability analysis covers 6 condo properties located in various regions of Poland, identical to those used for the analysis of condo unit prices. In order to assess the actual yearly incomes, the calculation includes the market prices of condo units and the values of the units being the basis for the operator to charge the yearly rent. The yearly rent values were also determined for resident owners. Resident owners were not accepted only in the case of the Warsaw project - this option was not included in the operator contract. The Warsaw project, where the income gap is absent, is presented as an alternative option for the settlement of accounts between the operator and the owner of a condo unit. Here, the parties settle their mutual accounts according to their proportional shares in profits generated by the entire condo.

An income gap is the difference between the amount of yearly rent charged by the contract operator and the rent determined on the basis of the full value of investment (condo unit + parking place + furnishing the unit as per the operator's standards).

By reviewing the operator contracts, the rent base amounts were identified as well as the actual amounts per unit, yearly rent amounts and reduced yearly rent amounts for resident owners; the results are presented in Table 2.

Table 2. Prices of condo properties and amounts of yearly rent payoff

Location	Net price of condo unit on the basis of which rent is charged (PLN)	Actual condo unit price (PLN)	Yearly rent amount (PLN)	Yearly rent amount, including resident owner option (PLN)
Szczyrk	696 888	780 578	48 782.16	41 813.28
Szklarska Poręba	407 385	501 703	32 590.80	31 090.80
Warsaw	590 058	590 058	35 403.48	51 335.04 (*)
Frombork	300 000	300 000	21 000.00	21 000.00
Kołobrzeg	439 680	489 580	24 182.40	21 544.32
Mielenko	349 000	389 000	29 665.00	26 175.00

*Resident owner option not included in the contract, and the rent determination mechanism is presented in the paper

Source: author's own research.

The measure of investment efficiency and generated earnings is the return on investment, a basic measure that presents the value investment ratio. It is determined as the proportion of annual earnings from invested capital to the amount of capital invested across a specific accounting period (Rogowski & Kasiewicz, 2006).

$$ROI = \frac{Yearlyincome}{Investmentexpenditure} \times 100\ \% \qquad (1)$$

The result is the present value of money to be received by the owner in consecutive years, not including the change of the value of money in time.

$$\text{YIG} = \text{YCRAEROO} - \text{YARAEROO} \qquad (2)$$

where:

YIG - Yearly income gap,
YCRAEROO - Yearly contract rent amount, excluding resident owner option,
YARAEROO - Yearly actual rent amount, excluding resident owner option.

$$\text{YIGRO} = \text{YCRAIROO} - \text{YARAIROO} \qquad (3)$$

where:

YIGRO - Yearly income gap - resident owner,
YCRAIROO - Yearly contract rent amount, including resident owner option,
YARAIROO - Yearly actual rent amount, including resident owner option.

Based on the above formula and the data presented in Table 2, a calculation was made of the actual rent amounts and income gaps, which were then compared to the contract rent values paid out by operators for specific condos (cf. Table 3).

Table 3. Summary of rent amounts and income gaps

Project	Yearly income gap (%)	**Yearly income gap - resident owner (%)**	Yearly contract rent amount, excluding resident owner option (%)	Yearly contract rent amount, including resident owner option (%)	Yearly actual rent amount, excluding resident owner option (%)	Yearly actual rent amount, including resident owner option (%)
Szczyrk	0.75	0.64	7.00	6.00	6.25	5.36
Szklarska Poręba	1.50	1.43	8.00	7.63	6.50	6.20
Warsaw (*)	-2.70	-	6.00	-	8.70	-

Frombork	0	0	7.00	7.00	7.00	7.00
Kołobrzeg	0.56	0.50	5.50	4.90	4.94	4.40
Mielenko	0.88	0.77	8.50	7.50	7.62	6.73

*Resident owner option not included in the contract, and the rent determination mechanism is presented in the paper

Source: author's own research.

The conclusion that should be drawn from the results presented in Table 3 is that the values of the ultimate income gap are high. With a gap of annual incomes at 0.75 of a percentage point, compared to the actual value of the condo property in Szczyrk, the annual loss is at PLN 5 854 each year. Only the Warsaw project, based on a different method of settlement of accounts between the parties, offers an opportunity for higher earnings. The Warsaw project is the only one in which the 'guaranteed' rent is at 6%, whereas the 2.7% rate is the anticipated share in profit. Therefore, we cannot refer to this case in terms of an income gap; rather, there is a surplus here. It is the effect of a higher business risk (Willet, 1951) for the investor (Sinkey, 1992). Nevertheless, we should pay attention to the fact that the 2.7% of the amount of capital invested in the condo property generates an additional PLN 15 931 each year beyond the 6% guaranteed returns.

Table 4. Total income gap for specific periods

Location	Income gaps for specific periods (%)		
	5 years	10 years	15 years
Szczyrk	3.75	7.5	11.25
Szklarska Poręba	7.5	15	22.5
Warsaw (*)	- 13.5	- 27	- 40.5
Frombork	0	0	0
Kołobrzeg	2.8	5.6	8.4
Mielenko	4.4	8.8	13.2

*Resident owner option not included in the contract, and the rent determination mechanism is presented in the paper

Source: author's own research

The income gap values for specific periods are presented in Table 4. Whereas the contracts are typically concluded for a 15-year term, the loss of income during that period for the Szklarska Poręba project is 22.5%, i.e. PLN 112 883, based on the actual price (the actual value of capital invested in the condo property). Attention should be drawn to the Warsaw project, which generated a 40.5% surplus over the guaranteed 6% return.

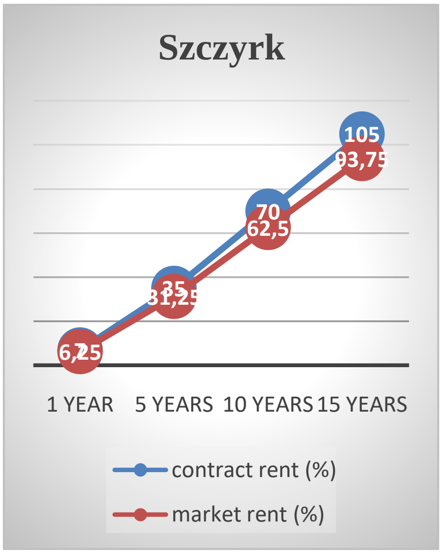
Table 5. Total income gap for specific periods where the resident owner option is exercised

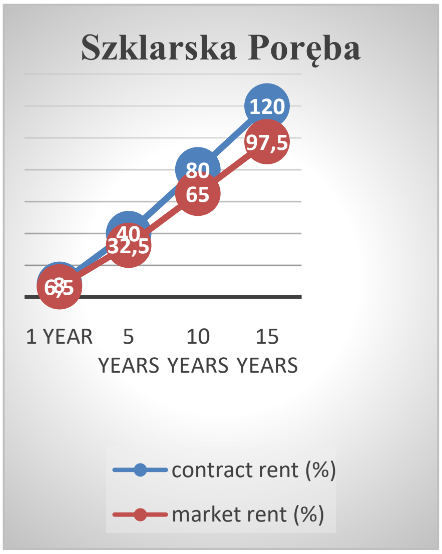
Location	Income gaps for specific periods (%)		
	5 years	10 years	15 years
Szczyrk	3.20	6.40	9.60
Szklarska Poręba	7.15	14.30	21.45
Warsaw (*)	-	-	-
Frombork	0	0	0
Kołobrzeg	2.50	5.00	7.50
Mielenko	3.85	7.70	11.55

*Resident owner option not included in the contract, and the rent determination mechanism is presented in the paper

Source: author's own research.

Table 5 presents the income gaps for the same projects with the resident owner option. Here, the income gap turns out to be slightly more advantageous, yet lower rent amounts should be taken into consideration as well. In simple terms, using a condo property as a resident owner extends the time for the return of invested capital.





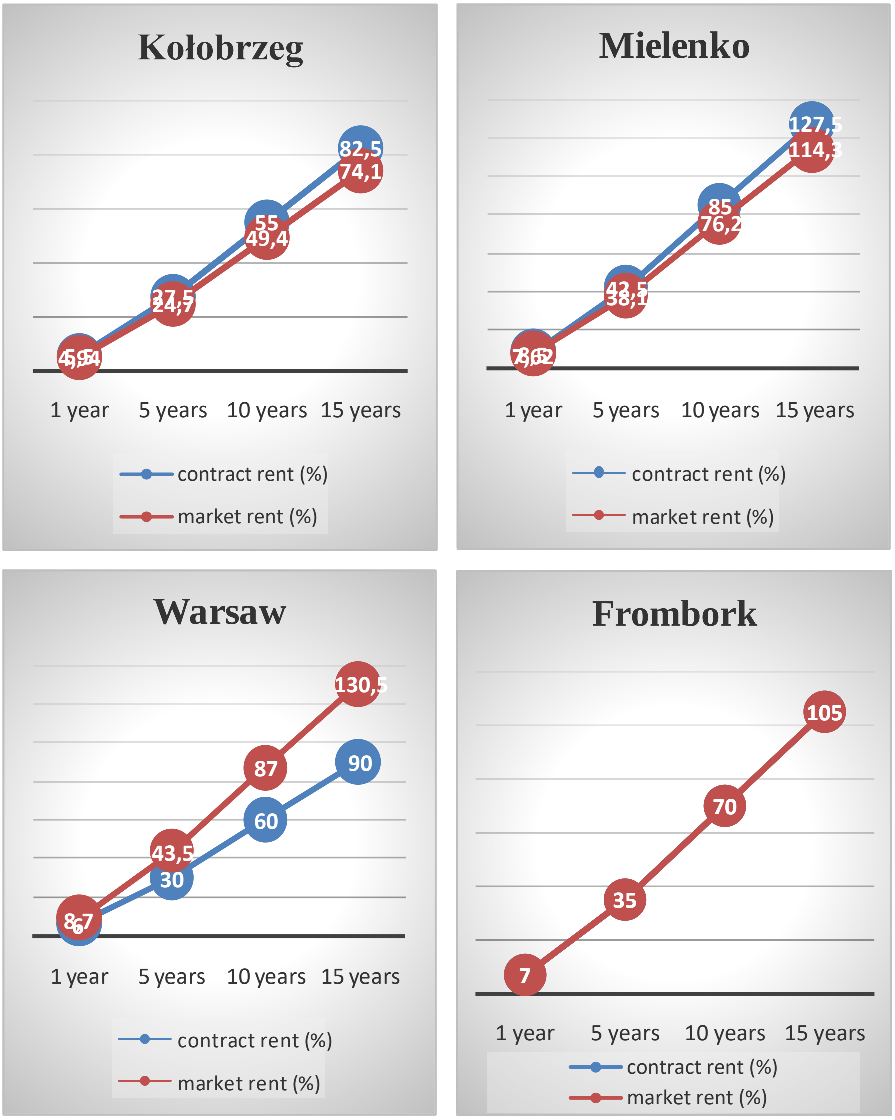


Figure 3. Comparison of contract rent and market rent amounts for selected projects

Source: author's own research.

The income gap is particularly well illustrated in Figure 3. Even though the values for a single year are not unacceptable, they become significant across longer periods of time. In the case of investments in condo properties, a 15-year term is the time necessary for generating a return on invested capital, and an income gap at +10% or even 20% presents a significant loss in incomes from invested capital.

Figure 4 presents a comparison of income gap for all the projects across a 15-year time span. Income gap is present in four out of six projects. It was not determined for the Frombork project, whereas the Warsaw project shows an income surplus. Whether such a surplus actually exists has not been verified, nor the value of such surplus, if any. However, the operator presumes the surplus at 2.7% of the value of invested capital.

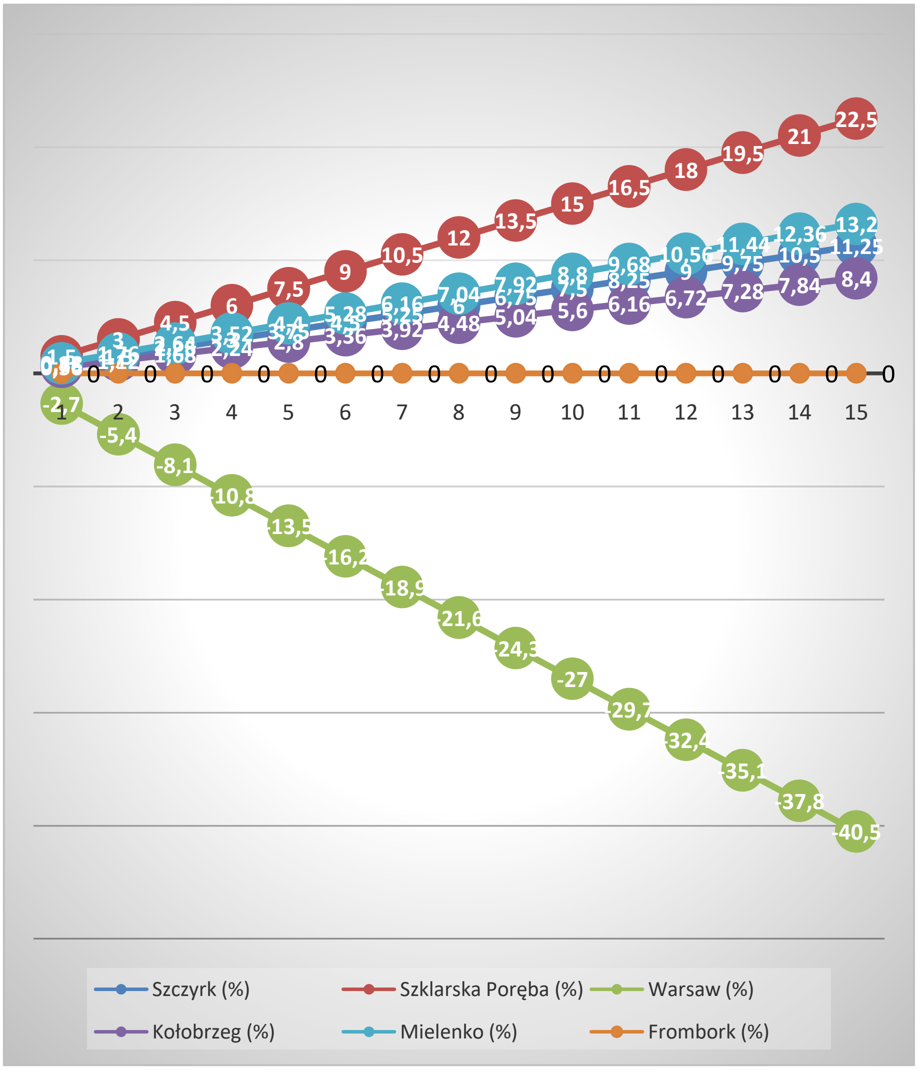


Figure 4. Change of income gap across a selected period
Source: author's own research.

CONCLUSION

The condo property sector is a new sector of the property market, which has emerged in Poland relatively recently. Uniquely high growth rates in this area have been observed in those territories of Poland where tourism flows exhibit a significant potential. Pomorze Zachodnie (West Pomerania), with its popular holiday resorts existing for years, is the region characterized with the highest volume of condo properties, followed by Pomorskie province and southern Poland territories, i.e. mountain ranges with winter holiday resorts.

A new trend can be observed in the development of hotel properties which are being built as condos in large towns. Here, investors do not buy apartments developed in new buildings but rooms in a hotel, where the operator runs a hotel business.

Different annual rent accounting schemes have been identified across the territory of Poland. There is a fixed rate of return, a combined rate composed of a fixed part and an additional profit-based portion, divided pro rata according to the size of the purchased condo unit, and based on actually generated earnings only.

This paper only covers two accounting schemes, i.e. the fixed 'guaranteed' rate of return, and the combined rate, supported by the Warsaw example.

The analysis covered the purchase prices of condo units, and an observation was made in the course of examining the prices at 6 locations that in order to close a rent contract with the operator, investors had to buy a parking place and furniture/equipment for the unit.

The purchase of a parking place was not required in only two cases, i.e. in Warsaw and in Frombork. Moreover, furnishings did not have to be purchased in Frombork only. In the remaining 5 projects, furnishings had to be purchased extra, and within this group of 5, only in the Warsaw project was the value of such furnishings included as an investment on the basis of which rent payoff was calculated for the condo unit owner.

Four operators would not include the amount paid by the investor for buying the furniture and equipment as per the operator's standards in the calculation of the yearly rent.

It has to be mentioned here that the amounts invested by investors in the purchases of furniture and equipment ranged from PLN 40 000 up to PLN 94 318, representing 10% to 19% of the entire value of investment. It should also be noted that the invested amounts were not working towards the investor's earnings - this amount represented as much as 19% of the overall investment value in the case of Szklarska Poręba.

The price of a condo unit and the yearly payoff received from the operator is the starting point for the analysis of returns on investment. In the course of analyzing the operator contracts, income gaps were noticed in four cases; in one case (Frombork), the value of yearly rent was consistent with the contract; and in one case there was a surplus of rent earnings over the contractual amount.

Based on the analysis of the operator contracts and the yearly rent amounts stipulated therein, we should conclude that the yearly rates of return declared in the contracts are different from the actual ones. This is due to the fact that the operators determine the yearly rent rates not on the basis of the whole capital investment but rather on the basis of the net value of the respective condo unit. Hence, it should be presumed that when a condo unit buyer enters into a contract with the operator, the buyer offers the furniture/equipment to the operator for use without any compensation. This is an extremely disadvantageous position for the investor. Income gaps emerge as a consequence of the thus designed rent calculation mechanism. In the cases under consideration, the yearly gaps ranged from 0.56% to 1.5% per annum. Whereas hotel operator contracts are typically concluded for the most common 15-year term, as a consequence of the income gap, an investor buying a condo unit will lose 8.4% to 22.5% of their income, determined on the basis of the invested capital, in the cases under consideration.

In other words, in the case of the resident owner option, the rent calculation method is more beneficial. Even though the annual earnings are lower, the income gap is also lower annually, in accordance with the contract, ranging from 7.5% to 21.45% in the same time period as stated above. It should be noted here that owners can reside in their units only during less popular seasons, excluding holidays.

The Warsaw project is different from the other projects under consideration. With the combined return calculation mechanism, the annual 'guaranteed' rent rate is lower, as well as the anticipated share in the profits generated by the whole condo. This model imposes a risk burden upon the investor, i.e. the risk of failure to generate the anticipated earnings by the entire condo.

Table 4 in this article presents the investor's losses across a 15-year time span if the income gap is present, together with the benefits they could have accomplished had the income gap been eliminated. This is a comparison of two alternative methods of yearly rent calculation.

Thus, only the yearly rent calculation mechanism is the decisive factor for the occurrence of an income gap in investments in condo property. This is affected by three aspects: The requirement to buy furniture/equipment and no rent charged for the invested capital. The requirement to buy a parking place, which is not included by the operator in the determination of yearly rent on the invested capital. The investor exercising their right to become a resident owner of the condo unit on the applicable terms.

Considering the diverse provisions in condo unit purchase contracts and rental contracts, investors should be particularly sensitive when making their investing decisions. The target should be to avoid the income gap as presented in this article, or to have it reduced to a minimum.

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