Construction of Real Estate with the Involvement of Individual Funds: The Ukrainian Experience

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Abstract

In the modern world, construction plays an important role, as the cities are developing leading to an increase in demand for housing and the construction of new real estate. The construction of residential real estate depends largely on attracting individuals' funds to real estate construction. One of the important issues is raising funds from enterprises, organizations, and the state budget to develop various spheres of public life, including real estate. In this context, this paper examines the Ukrainian experience of real estate construction with the use of individuals' funds. It analyses the features of various models used in financing real estate construction in general to identify the mechanisms for raising funds from individuals for the construction of real estate in Ukraine. It intends to identify the risks arising during the construction of real estate with the financial participation of individuals.

The research employs a blend of qualitative and quantitative methodologies. Grounded primarily in documentary research, the study extensively scrutinized various primary and secondary sources, including regulatory documents, government publications, and market analyses. This ensured an in-depth grasp of both the historical evolution and present-day nuances of individual financing in the Ukrainian real estate sector.

The findings reveal the regulations of raising funds from individuals for the construction of real estate.

The paper concludes that individual funding for real estate in Ukraine offers significant potential for addressing housing needs and stimulating economic growth, yet is marked by legislative inconsistencies and investor vulnerabilities. Drawing from best practices, such as developer liability insurance, can bolster trust and efficacy in this financing mechanism. A refinement of legislative structures and enhanced protections for individual investors is essential for optimizing its potential.

Keywords: Equity participation, Property rights, Real estate, Housing, Ukraine.

Introduction

In the modern world, construction plays an important role, as the world's population is growing every year. Cities are developing, which in turn leads to an increase in demand for housing and the construction of new real estate (Borysova *et al*., 2019). Therefore, the construction sector, especially the construction of residential real estate is important. One of the issues to be addressed during the transition to a market economy is the issue of raising funds from enterprises, organizations, the state budget or the population with a view to develop various spheres of public life, including real estate construction (Tashian *et al*., 2021). In fact, the issue of attracting individuals' funds to real estate construction is thus important too.

An integral element of economic growth of any country is the existence of legal mechanisms to ensure the conditions for the proper functioning of civil society (Lutsiv, 2018). A pre-requisite and one of the factors for this is the creation of effective investment activities, part of which is the attraction of funds from individuals aimed at the construction of real estate. Unfortunately, the current state of raising funds for the construction of real estate by the state of Ukraine has led to a significant decrease in funding, and therefore the practice of raising funds from individuals is increasing (Rym, 2021).

Construction sector is one of the most important areas of the national economy. It contributes to the efficiency of the economic sector. Ukraine thus depends on this sector like most other countries. In fact, by attracting funds from individuals, the development and improvement of this sector contributes to the creation of new jobs in Ukraine (Shut, 2016).

However, construction is an industry that requires large-scale and long-term investments. Most of the existing construction companies in Ukraine lack the capacity to implement construction projects on their own and therefore need to raise funds (Baringolz, 2021). Currently, there is a shortage of funds, which is the main problem of construction financing. Therefore, to overcome this problem, it is necessary to raise funds, including from individuals (Krysovatyy, 2019).

According to Lutsiv (2017), the importance of real estate developments in economic growth of Ukraine are related to:

- Residential buildings and their development.
- Construction and expansion of the housing stock that contributes to the development of related sectors, which in turn contributes to the employment of the people in these sectors.

Ukraine can reach the standards of other countries in the field of real estate construction if it improves and modernizes the institutes and resolves the issues of attracting funds from individuals to finance the construction of real estate. During the past several years, a number of different conferences and roundtables have been held, and many studies have been conducted on the real estate construction market, including residential real estate construction in order to address this problem. Therefore, it would be appropriate to focus on the issue of raising funds from individuals to be used for the construction of real estate. In this context, this research aims to reveal the experience of real estate construction in Ukraine in utilizing individuals funds (Vapniarchuk *et al*., 2019).

The objectives of this study are:

- To identify the regulations of raising funds from the individuals
- To identify the risks that arise when raising funds from individuals for the construction of real estate and developing the ways to overcome them.

Theoretical Framework

The conceptual foundation of this study hinges upon the intricate interplay between funding, financing, and real estate, particularly in the context of the Ukrainian real estate sector. This theoretical framework strives to dissect and elucidate these constructs to provide a grounded understanding that would further inform our empirical exploration.

Funding, as a construct, relates fundamentally to the provision of necessary resources to support or operationalize a certain initiative or project. This typically takes the form of monetary allocation but transcends mere capital provision to encompass the underlying dynamics of resource allocation and capital accumulation. Central to the notion of funding is the decision-making calculus, underpinned by the risk-reward paradigm. Within this framework, the decision to allocate resources is not merely transactional but deeply strategic, with individuals or entities gauging potential returns against assumed risks.

Delving into financing, this construct moves beyond the realm of resource provision to the modalities of obtaining said resources, especially for investment purposes. In essence, financing provides a more granular perspective on how resources, particularly capital, are sourced. At its core, the theory of financing oscillates between equity and debt. Equity financing encompasses the sale of a business share, while debt financing manifests as borrowed capital, typically loans. For real estate construction, the dynamics of financing evolve further, shaped by myriad factors including market conditions, interest rates, and loan durations. Notably, within this financing spectrum, the role of leverage emerges as pivotal, where borrowed capital is deployed to enhance potential returns, with the inherent acceptance of potential amplified losses.

The third pillar, real estate, is expansive, encapsulating land and tangible enhancements therein. This could manifest as structures, buildings, or even natural features. The theoretical foundation of real estate integrates principles from diverse fields including economics, urban planning, and legal studies. Fundamental to real estate theory is the principle of 'highest and best use,' suggesting that a piece of real estate realizes its maximum value when optimally utilized to garner the highest potential income. Additionally, the immutability of real estate, given its permanent nature, introduces unique market dynamics, particularly in the context of funding and financing, where it often transitions into a pivotal asset or collateral.

In synthesizing these constructs, especially within the Ukrainian milieu, the study acknowledges Ukraine's distinct socio-economic and regulatory environment. Post-Soviet economic shifts have catapulted the role of individual funds, reshaping the contours of how real estate endeavors are conceptualized, funded, and realized. By interweaving the theories of funding, financing, and real estate, this framework aims to provide a robust theoretical lens to critically examine and understand the nuances of real estate construction through individual funds in Ukraine.

Review of Literature

The real estate sector, especially in the context of individual funding, has been a subject of extensive research in recent years. Scholars and practitioners have explored various facets of this sector, aiming to understand its dynamics, challenges, and prospects. This critical review endeavors to encapsulate the significant research on this topic, highlighting the contributions made, especially in the Ukrainian context, and identifying the gaps in the current body of knowledge.

Zhang, Li, and Roca (2023) conducted an intriguing study on the moments and momentum in the returns of securitized real estate, focusing on real estate investment trusts (REITs) before and during the COVID-19 pandemic. Their cross-country analysis provides insights into the risk factors driving these trusts, revealing the inherent vulnerabilities and opportunities in real estate investments during turbulent times. In a different avenue, McKellar (2023) elucidates the increasing role of private investment capital in infrastructure. While the book predominantly focuses on infrastructure, the principles highlighted therein are relevant to the real estate sector, emphasizing the convergence of public infrastructure and private capital. Frame and Steiner (2022) dove deep into the impact of quantitative easing on the investment and financing choices of mortgage REITs. Their findings underscore the intricate relationship between broader economic policies and the nuances of real estate financing, a theme that resonates well with the individual funding of the real estate sector.

Selim, Rabbani, and Bashar (2022) proposed an innovative cooperative model for home financing based on Qard Hasan. The implications of such a model on home ownership and real estate development are profound, suggesting alternative pathways for individual funding mechanisms. Higgins (2022) postulated the concept of a sovereign public sector property fund, aiming to build a robust conceptual framework around it. The idea further emphasizes the intersection of public and private sectors in real estate financing, shedding light on the potential evolution of property funds in the coming years. From a developmental perspective, Kogan (2021) explored the evolution of civil engineering financing forms and their subsequent impact on economic development. The dynamics of financing in civil engineering, as highlighted by Kogan, provide a foundational understanding of how individual funding mechanisms can shape the real estate landscape.

Shahrokhi and Parhizgari's (2020) treatise on crowdfunding in real estate presents a disruptive avenue for funding. They posit that crowdfunding, as an evolutionary mechanism, can redefine the contours of real estate financing, marking a shift from traditional mechanisms. Abdallah, Al-Tamimi, and Duqi (2020) undertook a qualitative exploration into the behavior of real estate investors. Their findings illuminate the motivations, challenges, and strategies of investors, offering a micro-level understanding of the dynamics of individual funding.

Turning to the Ukrainian context, Baringolz (2021) highlighted the rights of citizens buying housing in new constructions and delineated strategies for their protection. Chizhevskaya and Timofeeva (2017) mapped the routes of financing the construction industry in residential real estate, focusing specifically on Ukraine. Their study is complemented by Krysovatyy (2019) who delved into the nuances of investing and financing real estate objects. Lutsiv (2017; 2018) critically examined the legal forms of attracting investors in housing construction and elucidated the methods of protection of property rights of these investors, specifically within the Ukrainian landscape.

The funding mechanisms for the real estate sector, especially with individual investments, are multifaceted. While global studies provide a broad overview of trends and challenges, the Ukrainian context presents unique opportunities and barriers. The studies underscore the need for a balanced integration of global best practices with local contextual understanding.

Research Methodology

In constructing a detailed investigation into the Ukrainian experience of real estate construction using individual funds, a multi-faceted approach to data collection was pursued. This strategy was anchored on both qualitative and quantitative methods to foster a comprehensive understanding of the issue.

The foundation of our research methodology was rooted in documentary research. This approach entailed a rigorous examination of various primary and secondary sources relevant to the topic in the Ukrainian context. By delving into regulatory documents, government publications, real estate market reports, and scholarly articles, the research mapped out the existing legislative and normative framework that underscores the mobilization of individual funds in real estate construction. This intensive study of documents was vital in providing a foundational understanding of the historical and contemporary aspects of real estate financing, thereby setting the scene for further inquiry.

Findings and the Discussion

Financing in General: Principles and Practices.

Funding is a complex activity. According to Aronovich and Nepomiashcha, (2021) financing of the construction sector can be divided into three types as follows.

- Public financing, which involves the attraction of budgetary and extra-budgetary funds,
- Market financing, which involves raising funds from enterprises, organizations and individuals;
- Mixed financing, the main purpose of which is to combine the above two types of financing.

In a broad context, the concept of "financing" can be comprehended as the process of attracting and allocating essential financial resources to diverse enterprises and organizations, with the aim of utilizing them for commercial objectives. The term "financing" should be defined in two ways. First, it means the funds that are derived from any source, the main purpose of which is to accommodate expenditure. Second, it means capital that is borrowed or lent through financial markets or institutions, primarily for investment (Code "Money for construction", 2021). Thus, construction financing should be understood as a process aimed at generating the necessary financial resources, which in turn are used for design and survey work and construction of real estate.

The high-risk nature of investing in the construction of real estate in the early stages is directly correlated with a decrease in the cost per square meter of real estate, which in turn leads to high demand among the population for such an investment mechanism. It is economically more profitable to invest in the process of real estate construction than to purchase a ready-made object (Davydenko, 2017). There are various methods and ways to attract funds from individuals to the construction of residential real estate. The concepts of "attraction and financing of construction" should be understood as the investment of funds by individuals in the process of real estate construction.

The peculiarity and reason for attracting funds from individuals to real estate is that in some countries of the world, companies that build residential real estate do not have their own funds sufficient for construction. Therefore, it is necessary to raise funds. As a rule, funds are raised from the state, various funds, companies or individuals (Higgins, 2022).

In the vast majority of residential real estate, equity participation in the construction of real estate is one of the most common global models of raising funds from individuals for the construction of real estate. Although this type of fundraising in the construction sector is new compared to other types, it has become rapidly adopted worldwide. Argentina was the first country to introduce equity construction in the 1980s (Kushnir, 2017). The creation of this type of participation and its essence was primarily stemmed from the fact that the 1980s were marked for Argentina as the years of depreciation of the national currency in the country and the cessation of lending by banks, which resulted in a decrease in the level of housing. The essence and purpose of this equity participation was that developers were able to borrow money from the population, and in return provided individuals, from whom they borrowed money, with shares that could be exchanged for housing in the future in accordance with the amount they provided.

Equity participation in the construction of real estate has rapidly gained popularity around the world. For example, this type of financing has been used in almost all Latin American countries and has gained both positive and negative experiences. Subsequently, this model of raising funds in the construction process was used by English developers who built real estate, mostly residential real estate in Kuwait, Egypt, the UAE. In turn, in the former USSR countries, this model of raising funds from individuals in the construction process gained popularity in the 1990s, which led to both positive and negative results. The positive outcomes encompass a reduction in inflation and the construction and acquisition of housing during inflationary circumstances. Conversely, the negative outcomes entail primarily the occurrence of numerous fraudulent activities, resulting in financial losses for individuals who invested their funds in the construction process. Even though raising funds of individuals in the process of real estate construction through equity participation has become widespread in the world and has received many positive features, along with the positive features there are also negative ones, including fraudulent activities, loss of money by individuals.

Another type of raising funds from individuals for the construction of real estate is a contract for the sale and purchase of property rights to real estate. The purpose of this agreement is not to purchase the real estate itself, but to acquire property rights to the relevant real estate, mainly residential real estate (Resolution of the Supreme…, 2019). The above agreement must specify the following:

- the emergence and subsequent registration of property rights to the real estate object;
- detailed information about the future real estate object;
- terms of commissioning of the future object and registration of ownership of its part (flat, office, parking space);price;
- terms of unilateral withdrawal and legal consequences and settlements between the parties.

In France, for example, a future real estate purchase and sale agreement is used to finance the construction of real estate by individuals. According to this agreement, the developer uses the funds of individuals for construction, but in turn undertakes to provide financial guarantees to complete the construction of the real estate object in case the developer is declared bankrupt, liquidated or otherwise unable to complete the construction of the real estate object (World experience of construction financing, 2020). In accordance with Poland's experience in financing the construction of residential real estate, it can be noted that Poland has a practice whereby a separate account is opened for each construction project, where funds of individuals are stored and accumulated, which allows the funds to be used in accordance with their intended purpose. In addition, part of the funds contributed by them for the construction of real estate is frozen, which in turn allows individuals to refuse to invest in the housing or to change the housing in question.

Another type of financing for the construction of real estate is participation in a housing cooperative. Participation in a housing cooperative provides members of the cooperative with the opportunity to obtain ownership of housing. At the expense of the share contributions paid by the members of the cooperative, the housing cooperative builds a residential building, in which the ownership of the flat is transferred to the members of the cooperative after paying the entire share. The size of the share is determined by the size of the flat. In addition, the share itself is an object of property rights, and if there is no prohibition on its alienation in the cooperative's constituent documents, a member of the cooperative has the opportunity to sell, donate or inherit it. The relatedness of the cooperative form with the structure of the contract for equity participation in the construction of housing is manifested directly in the fact that the basis for the emergence of ownership of the residential premises in a cooperative building is not so much participation in a legal entity that is a cooperative as payment of the share contribution by a member of the cooperative in full (Mayboroda, 2007).

Financing in Ukraine: Laws and Practices

The fundamental difference between participation in a housing cooperative and a share participation agreement in the construction of housing is that the latter is a classic contractual form that lies in the plane of binding (contractual) legal relations between legally equal and independent participants in civil relations, while participation in the activities of housing cooperatives is covered only by internal relations of the legal entity (cooperative) and its members. In European countries, the issue of raising funds from individuals for the construction of real estate, including residential real estate, does not cause as many problems as in Ukraine. It is established that everyone should be provided with housing at their own expense. In

European countries, financing of real estate construction by individual's accounts for about 90% of the total volume in the construction market, for example, in Germany, while in Ukraine, this figure amounts to about 60% (Housing financing in Germany, 2020). In developed countries, such as Europe or the United States, the risk of losing the funds invested in the construction process is minimal or even non-existent. The absence of risks when individuals finance their own funds in the construction process can be explained primarily by the protection provided by the state to its citizens, acting as the main guarantor of their rights and freedoms. This experience of protecting rights and guaranteeing them in foreign countries was appropriate for Ukraine to adopt.

In Ukraine, the provisions that enshrine and regulate the rights of individuals to invest in real estate are contained in many regulations, primarily the Constitution of Ukraine, the Civil Code of Ukraine. Thus, the Law of Ukraine No. 1560-XII "On investment activity" (1991) stipulates that investment and financing of housing construction using non-state funds raised from individuals and legal entities, including management, may be carried out exclusively through construction financing funds, real estate funds, joint investment institutions, as well as by issuing targeted corporate bonds, the fulfilment of obligations under which is carried out by transferring an object (part of an object) of housing construction. Other methods of financing the construction of such facilities are determined exclusively by law (Law of Ukraine No. 1560-XII..., 1991). However, the schemes for raising funds from the public for the construction of residential real estate based on the use of construction financing funds, real estate funds, joint investment institutions and the issuance of targeted bonds have not proved to be effective in the Ukrainian context and resulted in high-profile bankruptcies of developers and a large amount of unfinished construction. After the bankruptcy of Ukrbud, one of the largest construction companies in Ukraine, the issue of proper legislative regulation and guaranteeing the rights and interests of persons investing in future real estate under construction has become even more urgent. The situation has been exacerbated by the war and the enormous destruction of entire cities, towns, and neighbourhoods in Ukraine.

The most recent special regulation aimed at regulating the civil turnover of unfinished construction and future real estate objects and guaranteeing property rights to such objects is the Law of Ukraine No. 2518-IX "On guaranteeing property rights to real estate objects that will be built in the future" (2022). This law introduced a number of legal constructs that are inconsistent with the Civil Code of Ukraine (2003). For convenience, they will be set out in a certain order that reflects the logic of the legislator:

- Future real estate object – a special property right to a future real estate object
- Indivisible object of unfinished construction – a special property right to an indivisible object of unfinished construction;
- Divisible object of unfinished construction – a special property right to a divisible object of unfinished construction;
- Unfinished construction – a special property right to an object of unfinished construction, a future real estate object.

Along with the great confusion and complexity of the objects of civil rights that are new to civil legislation, there is a certain inconsistency of the categories and constructions used by it with the provisions of the Civil Code of Ukraine (2003). Along with the undoubted achievement, which is reflected in the creation of relevant registers of property rights aimed at identification, recognition and, consequently, protection of property rights of participants in the equity construction of real estate objects, the problem of identifying an object of unfinished construction with materials and equipment used in the process of construction that has not been completed and commissioned has not yet been resolved at the legislative level.

The attraction of funds from individuals for the construction of real estate will contribute to the development of the economy in Ukraine, as well as to the approximation of Ukraine to international standards and Ukraine's entry into the international market (Law of Ukraine No. 1087-IV..., 2004). The legislative framework regulating investment in real estate construction is still in its infancy and is based on investment regulations and special regulations governing this area. This, in turn, leads to a substantial quantity of regulations containing contradictions and inconsistencies in certain provisions, which significantly affect the regulation of real estate construction. The construction of real estate at the expense of individuals provides a real opportunity to provide such individuals with housing and, accordingly, reduce the cost of residential real estate at the construction stage (Law of Ukraine No. 978-IV…, 2003).

The Practices

The purpose of raising funds for the construction of real estate is to create fixed assets, and for the construction of residential real estate is to obtain housing in the future. The difference between financing of real estate construction and financing of other spheres of public life is the special object of such financing. Such objects include residential buildings, social facilities, buildings and separate structures. In this regard, the investment process in real estate construction is long-term (Rym, 2021). The models and types of raising funds from individuals in the real estate process include equity participation, a contract for equity participation in the construction of housing, a contract for the sale of property rights, an investment contract, and investment in securities.

One of the forms of raising funds from individuals for the construction of residential real estate and obtaining housing in the future is equity participation in the construction of the relevant real estate. An equity participation agreement should be understood as the instruments used to raise funds from individuals and legal entities for the construction of real estate with the subsequent transfer of the constructed property is proportionate to the respective contributions made by the shareholders (Code "Money for construction", 2021). In other words, under this agreement, individuals can invest their own funds in construction, and in return, in the future, receive the real estate object, distributing it according to the shares of funds contributed by each of the shareholders.

Sometimes the role of the state in regulating and guaranteeing the rights and interests of participants in the construction of real estate is seen in the creation of licensing requirements for the developer. For example, Chizhevskaya and Timofeeva (2017) proposed the introduction of a ban on unlicensed attraction of funds of individuals in the construction of real estate. According to the author, licensing has the following advantages:

1. Replenishment of the state budget of Ukraine;
2. Licensing of all companies that raise funds for construction, which in turn allows the state to exercise its controlling function;
3. Obtaining reliable information on the use of illegal ways and methods of raising funds from individuals in the process of real estate construction. This method is noteworthy, but with some clarifications.

The latter should be based on a correct understanding of the essence of the relations arising in the process of financing housing construction at the expense of the population and understanding the status of the developer. The developer actually receives funds for use for a rather long period of time (the average construction period is 3–4 years) from the public without paying interest for the use (unlike a bank loan agreement) with the obligation to build a real estate object in the future. In fact, the developer, to some extent, by accumulating funds from the public and directing them to the construction of real estate, performs financial functions. Consequently, the requirements for the developer should align with those imposed on institutions such as banks or insurers, while considering the distinctive characteristics of construction activities.

The risks of attracting several competing investors to finance one real estate object can be minimized by creating a register of property rights to the future real estate object. It is property rights because, in essence, the claims of a participant in share construction to the developer are of a binding property nature, since the real estate itself does not legally exist at the time of the contract and before the information is entered into the Unified State Register of Real Estate Rights. In Italy, a number of protection mechanisms are used to protect the rights of persons whose funds are used for the construction of real estate. One of these mechanisms is that the developer must obtain guarantees for the performance of its obligations aimed at the construction of real estate. The developer receives the relevant guarantees from an insurance company or bank (World experience of construction financing, 2020). In fact, this is insurance of the developer's liability to the participants of share construction, and it is indeed an effective way to protect the interests of participants in the construction of real estate, and needs to be implemented in the national legislation of Ukraine.

Conclusions

The construction industry in Ukraine, particularly in the real estate sector, is at the forefront of addressing the pressing housing needs of its citizens, bolstering economic growth, and generating new employment opportunities. The intricacies of individual funding mechanisms for real estate ventures in Ukraine offer a unique perspective, especially when compared to European nations. Key terms, such as "financing" and "equity participation," play pivotal roles in shaping the landscape of real estate financing. In Ukraine, these concepts carry nuanced differences, especially when applied to real estate endeavors. This underscores the distinct nature of the Ukrainian experience in this domain.

Individual funding, when examined through the lens of the Ukrainian context, presents both opportunities and challenges. Notable methodologies such as equity participation contracts in housing construction, property rights sale contracts, housing cooperatives, and voluntary contributions offer insights into the diverse financing avenues available. However, they also reveal certain vulnerabilities tied to the legislative framework and practices in Ukraine. While Europe, and other developed regions, witness fewer complications in individual real estate financing due to robust state-backed guarantees, Ukraine grapples with legislative inconsistencies and the challenges of unfinished constructions. This points to a unique juxtaposition where individual funding offers a significant potential for economic upliftment, yet is riddled with challenges that need robust legislative and practical solutions.

Moreover, the state's role in safeguarding individual investors and the experiences from nations like Italy provide pathways for enhancing the protection mechanisms in Ukraine. Drawing from best practices, such as developer liability insurance, can serve as a potent tool in fortifying the trust and efficacy of the individual financing mechanism. In summation, while individual funding for real estate in Ukraine holds promise for addressing housing shortages and boosting the economy, there's an inherent need for refining legislative structures, borrowing best practices, and ensuring robust protections for individual investors to truly harness its potential.

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