

THE 13TH NATIONAL HOUSING AND PROPERTY SUMMIT

“Gearing Up For Sustainable Growth During The 10th Malaysia Plan Period”

29 & 30 July 2010 * Sunway Resort Hotel & Spa

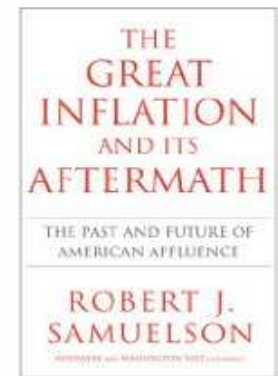


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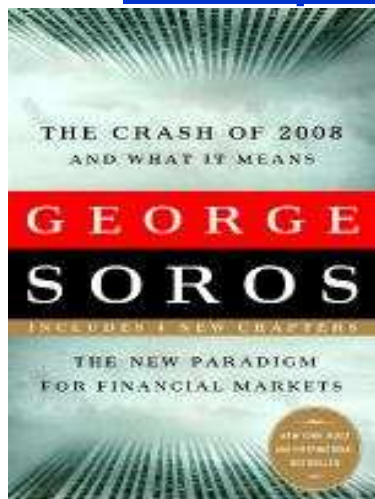
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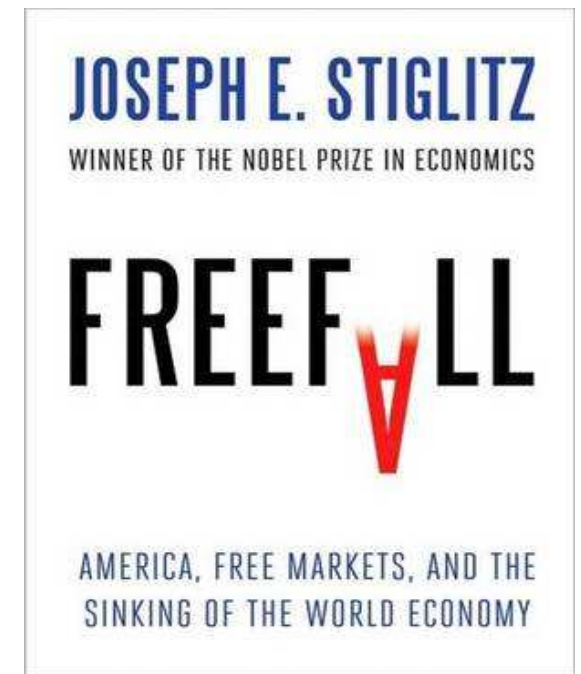
1. "The Great Inflation and its Aftermath" by Robert Samuelson who traces the rise and fall of inflation in the lead economy of the world, the U.S economy as the principal background setting for the crisis. The central message of the book was: thinking the world less risky, people took actions that made it more risky. The pleasures of prosperity backfired and the book concludes with some suggestions but on the note that if the lessons of the past are not properly learnt, the sequel will be even more devastating.



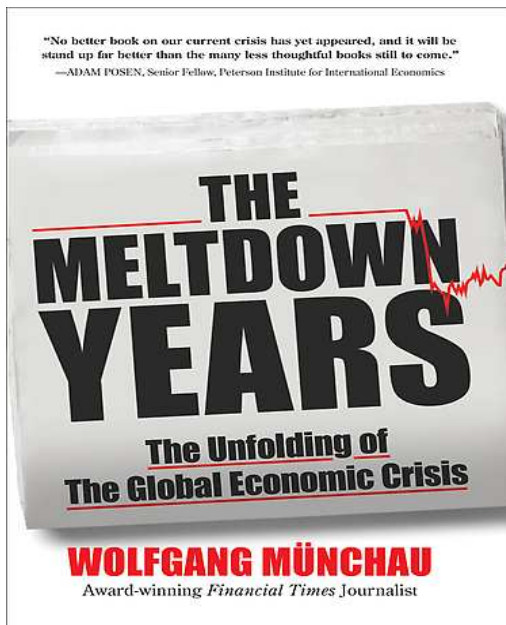
2. George Soros in his recent book "The Crash of 2008 and what it means", that "The bursting of the U.S housing bubble served as a detonator that set off a much larger explosion: the bursting of a super-bubble that has been growing since the 1980s..."



3. Joseph Stiglitz, winner of the 2001 Nobel Prize in Economics says in "Freefall" that "Among the long list of those to blame for the crisis, I would include the economics profession, for it provided the special interests with arguments about efficient and self-regulating markets." He then goes on to say that "A deregulated market awash in liquidity and low interest rates, a global real estate bubble, and skyrocketing subprime lending were a toxic combination. Add in the U.S. fiscal and trade deficit and the corresponding accumulation in China of huge reserves of dollars - an unbalanced global economy - and it was clear that things were horribly awry."



4. In "The Meltdown Years" by Wolfgang Munchau, he also takes the broad view and refers to Martin Feldstein's six "American" reasons for the crisis, namely that (a) U.S. interest rates had been too low; (b) financial regulation had been insufficiently focussed; (c) bad housing policies had set wrong incentives; (d) rating agencies had misled investors; (e) the banking system had failed to account for risk properly; and (f) borrowers had taken on too much debt.



He goes on to say that that analysis is superficial because the questions that ought to be asked are **why was there regulatory failure**, **why did people take on so much of debt**, etc. He says that in search for answers, one invariably encounters the global economy, the global monetary system, and the global financial system.

ANDREW ROSS SORKIN

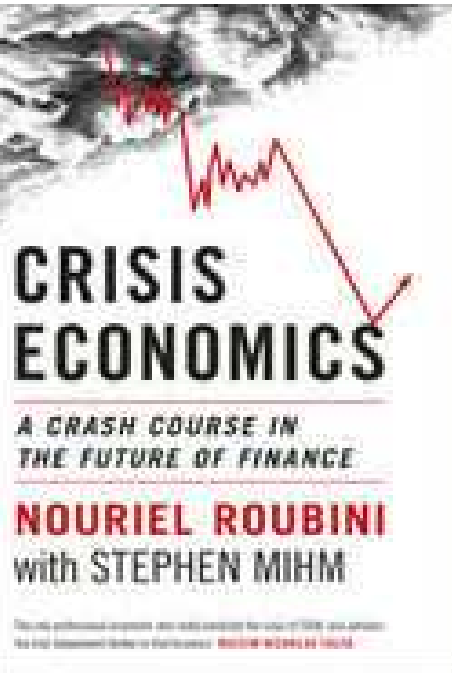
TOO BIG TO FAIL

INSIDE THE BATTLE
TO SAVE WALL STREET



5. It was only through a massive dose of capital injections and stimuli that the world was saved. To start the ball rolling, according to Andrew Ross Sorkin's Bestseller "Too Big To Fail", "Paulson told Bush in no uncertain terms that the financial system was collapsing.

' If we don't act boldly, Mr. President,' he said, 'we could be in a depression deeper than the Great Depression,' an assessment with which Bernanke concurred." Indeed the U.S. and the whole world did act boldly as they, in a coordinated manner, pumped billions of dollars into the world economy.



7. A takeaway from a more recent publication: *Crisis Economics* by Nouriel Roubini and Stephen Mihm is the contrasting remedies for severe economic downturns by Keynesian "pump-priming" on the one hand and Joseph Schumpeter's "creative destruction" on the other hand. The authors accept both ideas and say that whilst Keynesian pump-priming is essential for the short term, aspects of "winnowing" or painful but positive adjustments are needed in the medium to long term so that survivors will create a new economic order.

8. In a recent article in the Financial Times, July 12, 2010, By Nouriel Roubini and Ian Bremmer think that the **"global economy is heading for a serious slowdown this year.**

- a) Emergency austerity programmes in some countries will put a drag on growth.
- b) Inventory adjustments will run their course.
- c) The effects of tax policies that steal demand from the future – such as the US “cash for clunkers” scheme, tax credits for home buyers or cash for green appliances – will fizzle out.
- d) Labour market conditions will remain weak.
- e) The slow and painful deleveraging of balance sheets and income-challenged households, financial institutions and governments will continue.
- f) The result is governments and consumers that spent too much and now need to deleverage – in the US, Britain, Spain, Greece and elsewhere – will spend, consume and import less.



9. But those governments and consumers that saved too much – in China, emerging Asia, Germany and Japan – are not spending more. In a world of excess supply, the recovery of global aggregate demand will be weak, pushing global growth much lower. **The most realistic scenario for global growth is painful, even if we avoid a double dip. In the US, 1.5 per cent growth in the second half of this year and into 2011 will feel like a recession, given a probable further rise in unemployment, larger budget deficits, a further fall in home prices, larger losses by banks on mortgages and loans, and the risk that a protectionist surge will further damage relations with China."**

1. A table on the Klang Valley office market is presented. It is developed from property information releases from the National Property Information Centre or NAPIC. The figures in the blue column shows the existing supply, the occupied space and the future supply ("incoming" generally meaning under construction and "planned" meaning approved but not commenced as yet), as at the end of March 2005. The figures exclude Government buildings.
2. The figures in the pink column sets out the same information but it is as at March 2010.
3. The **"existing" office space grew** from 76.14 million square feet in March 2005 to 90.57 million square feet by March 2010, i.e. adding on 14.43 million square feet or **2.89 million square feet a year on average between the intervening five year period**. The compounded annual growth was 3.5% per annum, during what can now be considered as mostly "boom" years. **Occupied space** on the other hand increased from 60.24 million square feet to 71.47 million square feet, i.e. adding on 11.23 million square feet or **2.25 million square feet a year on average**. The compounded annual growth rate was 3.48% per annum.
4. Vacant space, calculated by deducting occupied space from existing space, as at March 2010, was 19.1 million square feet.
5. Incoming supply as at March 2010 was 9.61 million square feet and there is another 10.84 million square feet of "planned" supply and this does not of course include all the proposed office space in the newly announced commercial developments within the many mega projects.

PHYSICAL PROPERTY



OPTIONS FOR CREATING A MALAYSIAN PROPERTY HUB

1. Many countries vie for creating a 2nd Home market focussed at attracting the well-heeled foreigners to come and reside in the country and which **usually is beneficial** to the country.
2. However, it would be clear at the outset that there is some **limitations** as to the number of foreigners who can be attracted in this manner.
- 3.
4. The **more incentives** that are given to attract foreigners (especially retirees) **reduces the benefits** that will accrue to the country.
5. Usually, the foreigners select specific locations and in Malaysia the two locations that stand out are **Penang and Kota Kinabalu**.
6. **Nonetheless, all attempts should be made to attract as many foreign well-heeled retirees as possible, notwithstanding the limitations.**

1. Commercial real estate – which are **big ticket items** – when sold to foreign investors are also beneficial.
2. However, in most countries and cities where commercial real estate becomes highly attractive are cities **where the risk/returns ratios on investment are high** and where there is **high liquidity** in those specific markets.
3. In cities where there is insufficient risk/return attractiveness, there is usually less attraction and **no amount of marketing can usually surmount the natural investment appeal.**

- 4. In Malaysia and in Kuala Lumpur, to take an example, the office market looked fairly attractive prior to the global financial crisis but during the global financial crisis the market did shake up. It shook up because there was clearly apparent weakness. While values were on the uptrend and scaling above RM1,000 per square feet for prime office space, post the crisis this has come down about 20 percent and the drag down was due to the "gravitational" pull by the primary fundamental in the office market, rents. (Rents in turn are fixed largely derived from business profits but that is another matter.) Real estate markets may overextend during booms but get corrected by fundamentals during busts.**

- 5. At rentals of about RM7 to RM8 per square feet per month gross, the current value would work out to about a yield of seven percent which is a historical norm for Kuala Lumpur, a equilibrium of sorts to which the market always returns to when supply and demand move back towards a balance. Most of the time however the market gets pulled to either side of this equilibrium point and such a movement to the upside did occur during the recent high in the market when "easy money" drove markets worldwide. This pull away from equilibrium was termed "yield compression" when the yield drifted to below seven percent for prime space, but as expected, perhaps not so clearly then, there has been a quick "mean reversion" as they say in economics.**

- 6. Given Malaysia's smaller population base, ownership of local physical property, especially by foreigners, has limitations. Wrenching attractive yields from local properties ultimately depend on sustainable demand by end-users and in this connection the supply demand balance at any one point in time is a constant challenge.**

- 7. Another significant point to note is that at current value levels, the value is not that much above the replacement cost, land value and the higher "green" replacement cost of the building included, with all costs divided by the nett lettable area. For more iconic buildings the cost could be as much as twice that which also means that one would require gross rents to about double to provide the same returns.**

- 8. The announced mega projects must consider the points raised in this article to ensure that a bubble is not created in the office market. When undue reliance is placed in these mega projects, simultaneously, and by entities not driven by short term profits (who would readily adjust to the market as it evolves for its profit maximisation motive), real estate may not withstand the expected contribution towards underlying viability.**

- 9. As seen in most financial crises in the past, real estate is heavily complicit in the crises, especially due to its boom and bust tendency and policy makers around the world are seriously awakening to this and attempting to unravel this core issue, as to how to tame the extremes in the property cycle, going forward. Recently, many lead articles in the global financial press have alluded to this need: to tame the real estate cycle extremes as a means of taming the recurrences of crises.**

SECURITISATION

- 1. The alternative to physical ownership of property is the indirect ownership of local and foreign commercial property through securitisation, through REITs. A vibrant REIT industry may also spawn a property derivatives market which many have described as "property unlimited".**
- 2. Although the word "derivative" may not be a popular word in today's climate, property derivatives should be distinguished from other financial derivatives because of the solidity of the underlying asset. To create a thriving REIT industry and then to build upon it a robust property derivatives industry ought to be a game plan for Malaysian property, before other regional peers beat us to it with first mover pickings.**

SECURITISATION

3. The REIT industry in Malaysia holds much promise for deepening and broadening the investment market for large cornerstone investors, property funds including insurance companies and for small investors, local and foreign. On the flip side it is also attractive for housing developers who aspire to go on to the next level in property development which is to hold commercial investment property apart from their housing development activities.
4. The three legs of the stool in a successful REIT industry is :-
 - a) to have a **good regulatory framework** that is continuously fine-tuned and with the end objective of creating a vibrant industry,
 - b) **a tax regime that is also constantly fine-tuned** to not only make this nascent but potentially a major hub-creating industry attractive but one that also makes the industry competitive in terms of regional peers.
 - c) The third leg which is possibly the most important, given that we have already made substantial strides in the first two, is **for REIT Managers to display needed corporate and property skills of a high order**, consistent with the trust placed on the industry by virtue of the special tax benefits given by the government and the extraordinary regulatory assistance and profile provided to the industry.

SECURITISATION

- 5. Given that there are still substantial investable funds in Malaysia, including those held in fixed deposits, REIT managers can focus their skills at tapping such funds. The key would seem to be a new and high level of transparency that convinces these big and more particularly the small retail players as to how secure their savings are in a REIT vehicle. REIT managers must clearly show the link between their dividend payout possibilities and underlying income streams that are possible. The income streams can be known to the retail investor only if more information is publicly made available about the rents, the quality of the tenants, the rent review possibilities and the terms and conditions of the leases. The certainty of the future cash is what drives values. Tell them and they will invest.**
- 6. REITs are collective investment schemes and thus are not required by law to have Annual General Meetings with their unitholders and this fly in the ointment should be studied by the regulators. In fact it is being done so by other regional regulators. But notwithstanding this, REITs can themselves have yearly or half-yearly meetings with their unitholders in the interest of high levels of transparency which is a key for a vibrant REIT industry.**

SECURITISATION

- 7. Malaysian REITs, although growing in size are still considered not big enough in terms of market capitalisation for the high level of liquidity that is required by REIT investors. Acknowledging this the regulatory framework has been changed to allow REITs to grow, not only from acquisitions of local properties but also foreign properties. If there are limitations in terms of initial yields in the purchase of local properties then REIT Managers are obliged to also seek foreign purchases and the higher country and currency risks in going overseas should not be a constraint given that sometimes the better yields and potential for accretive growth more than offset such risks.**

BEYOND REITS (i.e. PROPERTY SECURITISATION)

Property Derivatives which offers Malaysians an opportunity to take advantage of its good legal and real estate infrastructure to leap-frog into becoming a property hub.

BUT

To do that you need to put in place a robust system for

- (a) **Forward looking, reliable valuations**
- (b) **Indices for different property types**

BEYOND REITS (i.e. PROPERTY SECURITISATION)

Paul Volcker - Chairman of the Board of Governors of the Federal Reserve, USA and a Chairman the Board of Trustees of the International Accounting Standards Board wrote in a forward to an actuarial text that:-

“derivatives by their nature do not introduce risks of a fundamentally different kind or of a greater scale than those already present in the financial markets. Hence, systemic risks are not appreciably aggravated and supervisory concerns can be addressed within present regulatory structures and approaches”.

In general terms a **derivatives transaction** is a **contract** whose **value** depends on (or “derives” from) the value of an **underlying asset, reference rate, or index**. Over-the-counter or OTC contracts are privately negotiated whilst standardised contracts (such as futures) are sold on exchanges – the main OTC derivatives include swaps, forwards, and options, based upon interest rates, currencies, equities, and commodities. Through derivatives, the complex risks that are bound together in traditional instruments can be teased apart and managed independently and often more efficiently. **Derivatives** help to **manage risk in new ways**, an important economic attribute.

CONCLUSIONS

1. The Malaysian property market **must be anchored by fundamentals**. In the **housing** market, the two fundamentals are **household income** and **rental returns**. From time to time, the market may advance on speculative binges. However, in the longer term, the market returns to the gravitational pull of the fundamentals. Different fundamentals apply for the commercial market – rental returns backed by factors such as **company profitability** or **consumer spending** or **corporate activity and tourism** for **offices**, **retail** and **hotels** respectively.
2. To make Malaysia into a property hub, the better road to take is to **strengthen the securitisation industry** which can then lead to a possible derivatives market which in fact is **“property unlimited”**. To hitch our wagon to the sale of physical property to foreigners may not be substantially fruitful. Foreigners will automatically buy property when there is sufficient long-term investment strength in the local market and in which case no selling is required. They will and they ought to come to you as a matter of investment choice. The smart money does not need to be told about investment opportunities in property. Smart money knows how to find it.



ELVIN FERNANDEZ, FISM, FRICS
REGISTERED VALUER,
CHARTERED SURVEYOR
MANAGING DIRECTOR
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KL HQ

57-1 Jalan Telawi Tiga
Bangsar Baru
59100 Kuala Lumpur
Tel : +6 03 2282 9699
Fax : +6 03 2282 9799
H/P : +6 012 2184542
www.khongjaafar.com.my
Email : khongja@po.jaring.my

PENANG BRANCH

89A, Lebuhr Farquhar
10200 Penang
Tel : 604 – 2614 184 / 2163 501
Fax : 604 – 262 1075
Email: khongjaa@tm.net.my

IPOH BRANCH

8, Jalan Sultan Idris Shah
30000 Ipoh
Perak Darul Ridzuan
Tel : 605 – 2411 322 / 1924
Fax : 605 – 255 2828
Email: kjipoh@po.jaring.my

KHONG & JAAFAR PROPERTY CONSULTANCY

(INDIA) PVT LTD
Bangalore – 560043, Karnataka State, INDIA
Tel No : + 91-9880477461
Email : kevinrajesh@rediffmail.com