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PAPER: “THE CONDOMINIUM MARKET – WILL HIGH PRICES BE SUSTAINED?”

1.0 INTRODUCTION

The aim of this paper is to assess the current high-end condominium Market in Kuala Lumpur (show introductory chart).

The paper and presentation materials will be focussed on the high end condominium submarket at two specific locations in Kuala Lumpur, namely the KLCC area and the Mont Kiara area.

The high-end condominium sub-market is broadly defined as the market for condominiums in the price range of RM500 per square foot and above. This categorisation however will only be applied on a broad basis, to aid the discussion. By this categorisation, the affordable sector or otherwise known as the mass market sector of the condominium market is excluded.

2.0 THE GLOBAL ECONOMY

The Global Financial Crisis (GFC) that started in August 2007 and which became fully blown in August 2008, was seemingly tamed, until recently, in August 2011, when it has resurfaced with a vengeance. There is now uncertainty, confusion and volatility in global financial markets and regulators around the world are faced with coming up with fresh responses but with diminished firepower in their arsenal of policy tools.

The big question for us at this Session is, how this second deflationary wave will affect the property market and the high-end condominium sector in Kuala Lumpur (show GDP chart). During the GFC whilst the consensus of opinion was that the GFC did not unduly affect or shake the Malaysian property market, there were at least two sub-markets that were adversely affected, the office market and the high-end condominium market in Kuala Lumpur. Both submarkets descended by about 25

percent in terms of prices and rents and were affected on the demand and supply sides. With this in mind it cannot be contended that all submarkets in the Property Market in Malaysia are impervious to external shocks, domestic or foreign, and thus we ought to keep an open mind to possible effects to the high-end condominium market given the renewed downturn in the global economy arising from the Europe's widening sovereign debt crisis and the slowing 15 trillion US economy due to a more long term structural adjustment.

Financial commentators are grappling with the question of whether the underlying economic forces are deflationary or whether in response to anti-deflationary policy measures a resultant may be an inflationary spurt. Thus it is said that investors who lean towards the former are in a rush to safe assets such as US treasuries, from time to time, and investors who lean toward expectations of inflationary are in a headlong rush to a hard asset like gold. Where does property stand? In the US where the economic forces are in full play and display, there is no rush to property on the notion that property is a good hedge against inflation, which makes me wonder as to the general belief that it is a good hedge against inflation. Perhaps in certain circumstances it is and in other circumstances it is not. In India which is experiencing high rates of inflation, there is no rush to property, although demand is still there notwithstanding the high mortgage rates which is due to the general increase in interest rates to combat inflation.

3.0 THE PROPERTY MARKET IN MALAYSIA

The property market in Malaysia has performed generally well in the last five years. There are sufficient degrees of optimism on the demand side, support from the government as it looks to the sector to enhance economic growth, support from banks and financial institutions and innovative product and financial offerings from developers. Fundamentally it is a free market, with relatively less restrictions on the supply side (as it should be) and it thrives on the current sell off the plan approach to housing delivery, which in turn ensures the lowest possible price levels in the long term as risks are well distributed between developer, financier and purchaser.

The high-end condominium and the office submarkets were noticeably affected by the GFC and can be said to have stabilised at slightly lower levels. The weaknesses that were inherent and which caused the market to correct in the face of the external shock still resides in the market, to a degree, but ameliorated as well to a large extent by the correction. If there are more shocks, then the correction will continue as I believe that especially for the high-end condominium sector there is still corrections to fundamentals ahead if and when there are severe external shocks whether generated from domestic or foreign sources.

However, on account of the said correction in the high-end condominium market, demand, especially speculative demand has shifted down to the net high level submarket in the residential universe - that of the landed, good class terrace houses and these properties have seen run ups in values that are high in the selected areas that they exist in. Whilst the traditional fundamentals that have tied this submarket at 4 to 5 times household income and plus 3 percent net returns, both fundamentals are now in excess of these in the "hot spots". The belief that the coming economic environment is inflationary is one factor that is driving demand and speculative demand to these submarkets. Other factors include the low interest rates regime, developer's special incentives, and lack of alternative investments.

The landed, good class terrace houses, having spearheaded demand and prices, are now spreading values down the line in the residential market and the entire residential market is slowly being shifted slightly away from its traditional fundamentals and this is a new risk that ought to be watched. Some of the speculative fervour is also spilling onto the latest craze - small sized, and more affordable, commercial cum residential accommodation known as SoHo's and some financial products built on real estate - i.e. condominiums, serviced apartments and retail units in shopping malls with high rental guarantees and other extraordinary incentives. All these need regulatory oversight. (show 5 tables on household income, rents, values)

That values for the high-end condominium Market in Kuala Lumpur came down about 25 percent during the GFC is a significant fact. There has been no bounce back and there are now high numbers of condominiums looking for tenants and rents at the highest levels are not much above RM15,000 a month and at lower levels in the region of RM5,000 to RM10,000 a month. At these rental rates the net yields at the top end are about 3 per cent net and higher at 5 to 6% on the lower end. Ideally the returns should be at least 5 to 6% net given risk and reward specifics.

The fundamental link to household income is not as relevant as the link to rental returns in this sub-market.

4.0 MECHANICS OF VALUE

If the Gross Development Value (GDV) is based on RM1,200 per square foot, the supportable land value is RM2,000 per square foot which is basically the existing rate. The size of the typical condominium as envisaged in this example is 3,500 square feet.

Return on GDV is 25% and pre-tax IRR is 36% - both reasonably and comparatively good returns.

The RM1,200 per square foot capital value is enabled by a gross rental of RM3.80 per square foot per month and at a net yield of 3% per annum

At RM3.80 per square foot the gross rent is RM13,000 a month. This is the main constraining factor for the upward advance of the high-end condominium market.

If the rent can be RM20,000 (in the future, with ETP) i.e. RM5.70 per square foot and if at a better return of 3%, the GDV value in the model will be RM2,000 per square foot and supportable land value will be RM6,500 per square foot.

But this is not tenable as 3% per annum return on a condominium unit is too low for long-term rate of return – it should be 5% which will bring back the GDV to RM1,200 per square foot and support a land value of RM2,500 per square foot.

All of this shows, in simplified form the closely knit relationship of rents, and values for the completed condominiums and land values. One affects the other and an understanding of their interrelationship, existing and potential, is required for a better understanding of the condominium and/or property market. (TO BE EXPLAINED WITH THE AID OF AN EXCEL MODEL).

5.0 PROSPECTS, GOING FORWARD

We can "kick the can down the road" and in the medium to long term to shore up fundamentals.

The roll out of the ETP with its recognition of the need to focus on making Kuala Lumpur a livable city in the context of the identification that in the future it will come to city versus city rather than country versus country when it comes to urban living choices. The Prime Minister announced on 8 September that 84% of the 87 initiatives announced under the ETP since October last year are being implemented with 23 operational, 50 commenced and 14 in progress. Added to this focus on making Kuala Lumpur a world class city is the move by the same ETP programmes to attract world class corporations and talent and this, upon its realisation, offer much of the hope for the high-end condominium market in Kuala Lumpur. As the ETP delivers on its promises the high end condominium sub sector can be expected to rebalance itself better on firmer fundamentals, mainly by having stronger and higher rental support. Rents shall drive the market.

In the meanwhile there are other policy measures to watch out for and they include Bank Negara's policy trajectory in increasing interest rates to fight inflation, directives to banks to lend not on gross incomes but net income, mainly to reduce the over borrowing, further tweaking of Loan to value ratios to dampen excessive demand and the likelihood of the recalibration of RPGT to cut out excessive speculative activity.

The long term interests of the property market as a contributing pillar for the economy is for the market to be tied as closely as possible to its fundamentals and in this respect the more that is known of the fundamentals the better and the consensus on the fundamentals from policy makers downwards as to their specifics and the extent to which they drive the market the better.

Had the US policy makers placed greater emphasis on property fundamentals, knowing that property plays an inordinate role in financial crises, they would not have permitted the property bubble to get oversized and cause the entire world to be tossed into the current continuing state of volatility and uncertainty.

Malaysia, like many East Asian governments, must, through policy measures, keep the property markets closely tied to fundamentals, to ensure financial and social stability.

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