CHAPTER 3 - PROPERTY SECTOR IN MALAYSIA

3.0 Introduction

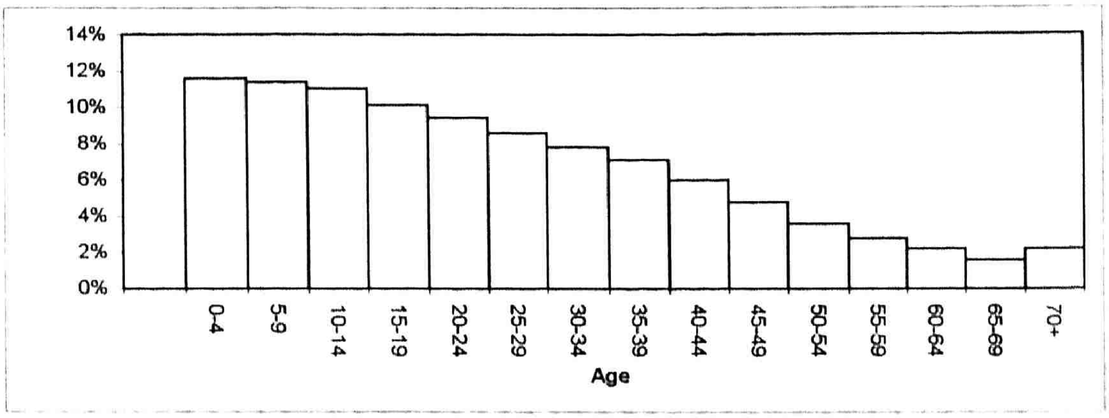
This chapter analyses the property sector in Malaysia to give a better understanding of the factors that lead to a firm's failure. Commencing with details of the industry structure, the next segment will entail a brief history of the Malaysian property industry, followed by factors that lead to the 1997 property bubble, resulting in widespread corporate failure.

3.1 Industry Structure

The property industry in Malaysia is fragmented and dominated by large players as it is capital intensive. Up to December 2002, there were 865 companies listed on the KLSE and out of which, 82 or 9.4 percent are listed under the property industry classification. The residential property segment has been the mainstay of the property market in Malaysia over the last four decades due to favourable demographics and the government's effort to promote infrastructure development and home ownership. Malaysia has a strong population base of 23 million with an annual growth rate of 2.6 percent per year, or about 0.6 million new people every year.

A closer look at the age profile reveals that Malaysia has a very young population and about 2.3 million people are moving into the 25-29 years age group per year from the period 1991 to 2010, where household formation and propensity to buy houses are stronger. The Eighth Malaysia Plan also showed that Malaysians will require 782,300 new houses between 2001-2005, a slight decline of 800,000 units targeted in 7th MP.

Figure 3.1 – Age profile of Malaysian population



Source: Department of Statistics Malaysia

The single most important factor that determines the success of a development project is location. Locations adjacent to established developments and those with good accessibility and adequate amenities are the favourite picks for most buyers. The Klang Valley offers the highest growth potential to all property developers as demographics in the Klang Valley are the most favourable due to migration to the city for better education and job opportunities. People living in the Klang Valley also have higher disposable income compared to the other states.

Property developers are hardly competing on equal footing as the success of a project is dependent on location and size of landbank owned. Land is considered a scarce asset and that explained why developers were rushing to gear up heavily to acquire landbank (sometimes at the wrong locations) prior to the burst of the property bubble in 1997. The two largest developers listed on the KLSE in terms of market capitalization and sales values are Sime UEP Properties Berhad and IOI Properties Berhad. These two companies have been focusing on residential developments and they are blessed with abundant landbank in choice locations in the Klang Valley due to conversion of plantation estates from their respective parent companies, i.e. Sime Darby Group Berhad and IOI Corporation Berhad, the two largest oil palm producers in the country.

Growth of other companies are far slower than Sime UEP Properties Berhad and IOI Properties Berhad due to cashflow constraints as they are required to complete an existing development before they are able to generate enough cashflow to pay for the infrastructure costs of new projects. A greenfield project that are located away from amenities will be costly to the developers as they are required to fork out huge capital outlays to provide linkages to major roads or highways. However, the developers may have no choice but to develop a greenfield project given the limited undeveloped land in the Klang Valley. The higher infrastructure costs often lead to profit margins erosion for the developers. In addition, these secondary locations pose higher risks of poor sales as consumers prefer choice locations. As a result, property developers compete for choice locations and they are willing to pay a higher price just to ensure saleability. The rush to acquire land while borrowing heavily leads to poorer financial health.

3.2 A Brief History (1957 – 1997)

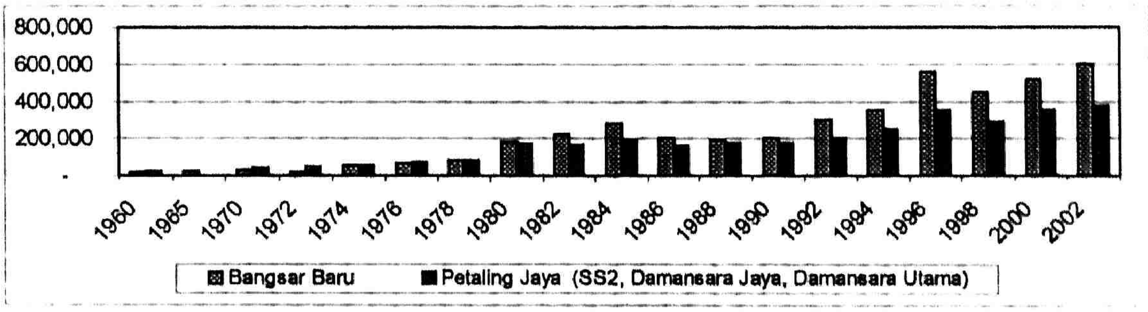
The property sector in Malaysia went through a period of rapid growth since independence in 1957. A brief look back at history reveals that the Merdeka Stadium was the only established building in 1957 and the 150-room Federal Hotel that costs RM6 million then was the only hotel. Despite improving social welfare and stability, there were still no shopping malls and office blocks in the 1960s. The ground floor shops and places like Globe Silk Store, the prestigious Robinson along Jalan Mountbatten (Jalan Tun Razak) and The Weld were the most popular shopping destinations.

The property market went through a trying time in the early 1970s due to the May 13 riot, coupled with the country's worst flood in 1971 that led to negative consumer and business sentiment. However, the dull outlook took a turn with the government's decision to discontinue subsidized housing for civil servants, replacing it with a housing loan scheme at an interest rate of 4.0 percent. This lead to a flood of potential property buyers that sparked a mild boom, fuelled further by "hot money" from overseas in 1972 and 1973. Many terrace houses were built in new locations such as Petaling Jaya and Bangsar. The 1970s also saw the mushrooming of shopping centers such as Ampang Park, Campbell and Sungai Wang Plaza in 1978.

The property sector was riding the uptrend until 1985 when the economy was badly hit by the commodity crisis. Prices for residential properties in Bangsar and commercial spaces at the heart of Kuala Lumpur contracted by more than half. In response, the government introduced measures such as cutting the Real Property Gains Tax and relaxing foreign ownership, and this helped to create new buying interest that slowly pushed up prices. After the slowdown of the property sector in the mid-to-late 80s, the property industry in Malaysia experienced a surge in demand in the 1990s following rapid economic development and strong consumer confidence which peaked in 1993 as a result of the stock market bull-run.

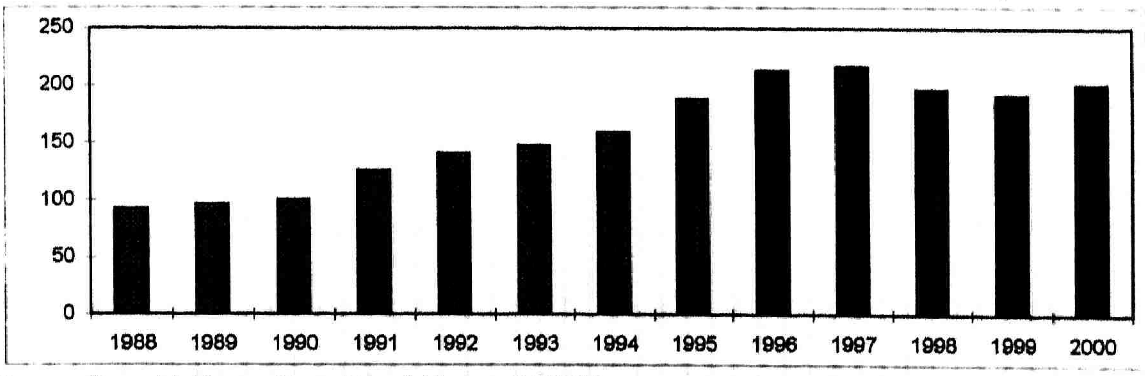
The boom in the property sector continued till early 1997. During the property boom, almost everyone was into property. These include the bankers with their easy credit policies, the authorities (politicians and administrators) with their indulgent land conversions and approvals, home buyers with their panic-price chasing, and investors with their complete faith in property price resilience. Developers were also facing intense competition from large corporations and conglomerates that jumped into the bandwagon of property development. Apart from that, companies involved in plantation and construction were also active in property development due to their abundant landbank (for plantation companies) and synergy from construction activities (for construction companies). Figure 3.2 shows the escalating property prices in the Klang Valley over the last three decades and Figure 3.3 indicates the rising House Price Index, especially from 1993-1997.

Figure 3.2 - Price movement of 2-storey terrace houses in the Klang Valley from 1960-2002



Source: Pusat Maklumat Harta Tanah Negara (NAPIC)

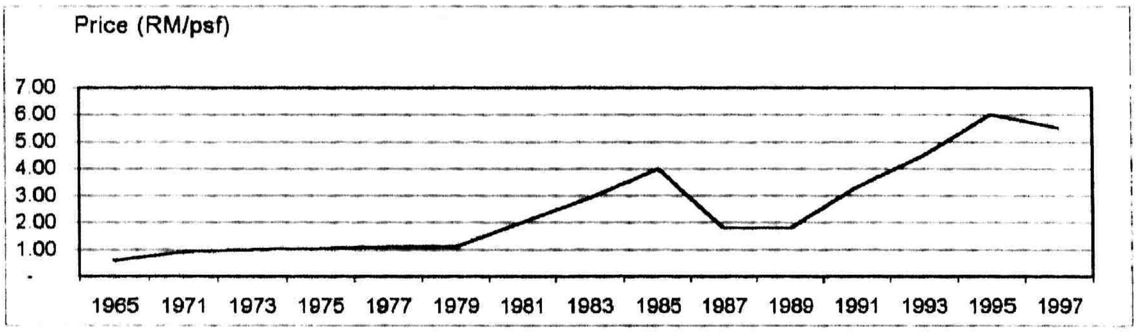
Figure 3.3 – Malaysia House Price Index 1988-2000 (based on 1990 price)



Source: Pusat Maklumat Harta Tanah Negara (NAPIC)

With the benefit of hindsight, it all seemed like madness or "irrational exuberance". But, while the party was in full swing, there appeared to be justification for the optimism in the property industry in the 1990s. The economy was growing at better than 8.0 percent per annum and consumer demand was growing strongly and household income were growing rapidly at 11 percent per annum (from 1991-1997) – particularly among the younger population. In addition, average office rental in Kuala Lumpur rose from RM1.80 per square feet (psf) in 1987 to RM3.20psf in 1990 to RM4.50psf in 1993, and was touching RM6.00psf in 1995/96 (please refer to Figure 3.4), justifying the increase in capital values and reinforcing the faith that Kuala Lumpur will see a massive step up in property valuation. Incidentally, not only was Kuala Lumpur's commercial real estate in 1995 merely a fraction of Singapore's valuation, it was lagging behind Bangkok, Manila and Jakarta. In addition, interest rates appeared benign.

Figure 3.4 - Average Rental of office space in Kuala Lumpur (1965 – 1999)



Source: Pusat Maklumat Harta Tanah Negara (NAPIC)

3.3 Property Bubble Burst in 1997

However, when the financial crisis hit in 1997, things took a sharp turn as take-up rates for new launches were slow due to lackluster job prospects and high mortgage rates. As a result, sales and property prices both plunged. The excesses over the years had resulted in a property oversupply of RM39 billion as at 31 December 1998, which was equivalent to 14 percent of the Gross National Product during the same period. Data from the National Property Information Centre indicated that the value of residential property transactions fell by 36 percent to RM13.9 billion (1997: +15.2%). The number of residential transactions fell by 30 percent to 122,881 units. The significant decline in sales reflected both the smaller amount transacted as well as the domination of lower valued property during the period as property developers shifted away from higher end launches that suffered weaker demand and focused on development of affordable housing.

In 1998, construction starts slowed, new sales and advertising permits for Peninsular Malaysia declined by 28.3 percent. The construction sector also contracted by 24.5 percent, compared to a rise of 9.5 percent in 1997. The sharp decline in demand, especially for high-end units resulted in an oversupply situation. The situation was aggravated by the supply of high-end condominium (above RM250,000) coming on-stream in 1998, which increased significantly by 87.9 percent to 14,151 units. There was a glut in residential properties of 43,595 units with total value of RM7.6 billion as well as 12,743 units of non-residential properties with a total of RM7.7 billion. Table 3.1 shows the property overhang situation in Malaysia, which persists until today.

Table 3.1 – Property overhang by sector

	Jul-Dec 2000		Jan- Jun 2001		Jul-Dec 2001		Jan- Jun 2002	
	Units	Value (RM'm)	Units	Value (RM'm)	Units	Value (RM'm)	Units	Value (RM'm)
Residential	51,348	6,609.4	35,203	4,860.2	40,977	5,529.1	43,541	5,719.6
Industrial	3,196	1,111.6	3,295	1,344.4	2,686	987.0	2,453	865.4
Retail Shop	7,507	2,114.2	7,817	2,235.8	7,601	2,010.5	7,999	2,251.8
Shopping Complex ('000 sqm)	1,462	10,202.6	1,448	9,286.1	1,411	8,537.7	1,395	8,448.4
Purpose-built office ('000 sqm)	2,459	8,354.2	2,528	8,842.7	2,701	10,015.5	2,720	10,084.7

Source: Pusat Maklumat Harta Tanah Negara (NAPIC)

The initial tight monetary and fiscal policy stance also aggravated the situation. Bank Negara Malaysia (BNM) directed all banks to stop funding new projects and they started withdrawing Overdraft lines to developers. BNM only allowed lending to houses costing below RM150,000 but this segment is only about 20 percent of the total housing and property industry. As such, both developers and house buyers were unable to obtain financing. Developers also could not convert assets into cash because there are few purchasers. Developers were in a position where they had no income, but yet had to service loans and overheads.

The plunge in property prices and the inability to service bank borrowings forced many property companies to seek creditor protection under Section 176. A list of Section 176 companies dated 15 October 1998 indicated that 11 out of the 33 companies were involved in property development activities. The aim of Section 176 is to provide companies with some time to turnaround and resume operations. However, only a handful of these companies were able to turnaround and most of the companies were subsequently classified under "Practice Note 4" of KLSE ruling due to their weak financial health and negative shareholders' funds. Some of these companies have become targets of reverse-takeover and new businesses have been injected to resume the listing status on the KLSE.

What went wrong? Disregarding economic fundamentals, significant over-building- often in the wrong locations, heavy reliance on speculators rather than end-users, and easy access to financing are the major factors that caused the property bubble. Property development projects are very capital intensive and borrowings are required, especially for greenfield projects. This is because waiting for budget allocation to provide essential utilities is a lengthy process in Malaysia and property developers are required to fork out infrastructure costs to draw utilities from the nearest power, water and telecommunication sources. Easy credit especially in foreign funds was also to blame since there is a mismatch in cashflow. Most of the short-term loans taken before 1997 were denominated in US Dollars while revenue from property projects were denominated in Ringgit that requires long gestation period to breakeven.

In short, the preliminary reasons for the failure of property companies are over borrowings, rapid accumulation of landbank at high cost leading to margin erosion, short-term borrowings in foreign currency and over exposure to the commercial property segment that resulted in oversupply. Most often than not, the non-property developers are those that suffered from financial failure. The "real" property developers (the companies with their principal activities involved in property development) are mostly spared due to their in-depth knowledge of the property market and better-diversified plan.

In order to ease the situation, the Government established the national asset management unit, Danaharta, in 1998 to acquire the non-performing loans (NPLs) from the banking sector that are secured by property. The practice of Danaharta, which set a minimum price to all tendered properties, has helped to stabilise property prices. Danaharta has acquired NPL totalling RM29 billion from banking institutions. Of the NPLs acquired, land forms nearly half, with industrial, residential and office space accounting for 37 percent. Although property demand as well as property prices began to trend upwards since year 2000, they are limited to well-located and affordable residential properties. The commercial and retail property segments have still not recovered due to the oversupply situation. Most of the property developers that were adversely affected by the 1997 financial crises are still mired in poor financial health as they are unable to proceed with new launches due to limited cashflow and lack of strategically located landbank.