

Ascertaining disposal price of commercial properties with guidance from the property market

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Abstract

The right timing of disposing commercial properties is important particularly to investors, as this will have an impact on the disposal price. This paper demonstrates that the disposal price of properties differs excessively during the different points of the property market cycle. Monitoring the property market changes and understanding property market cycles may provides some guidance for investors and fund managers to make beneficial decisions in determining disposal and acquisitions time. Although the practice of monitoring property market has not been widely accepted in Malaysia, studies on the variations of occupancy rates and office rents in prime commercial area in Kuala Lumpur revealed the existence of the property market cycle and that it provides guidance for disposing and acquiring properties. During the period of market depression owners are forced to dispose of properties at extremely low prices in view of the increasing numbers of NPL. However if disposal can be delayed, there are chances that properties can fetch higher prices. Analysis on disposal price when the property market cycle was its lowest point during depression period has deprive the owner of a potential gain of about 70% if they were to hold on and dispose a year later when the property market was at its recovery period. This finding suggest that the commercial property market need to be analysed monitored and kept up to date to enabled it to be utilised for any decision-making. This has important implication on the utilisation of property analyst to investors holding property assets.

Keywords:

Disposal price, property cycles, non-performing loans, occupancy rates, rents, commercial properties

Introduction

When to acquire, dispose or to hold on to properties? These are some of the important decision that owners, investors, financial institutions and others having interest in properties have to make. Indeed this decision can be extremely difficult particularly when there is market uncertainty. Disposal of properties during this time will amount to loss in capital value in consequence to the drop in the overall market value of properties. The recent market depression of 1998 saw this situation where some prime commercial properties were forced to dispose at extremely low prices in consequence with rising non-performing loans referred to as NPL. The Bank Negara reported that property collateralised NPL accounts for 30-40% of the total loan portfolio in the lending financial institutions (BNM, 1999).

In the event of payment default, after exhausting all avenues and arrangement to normalise account, the bank will exercise the right granted in the loan agreement to foreclose the pledged property to recover the loan (Brueggerman & Fisher, 2001) by disposing the property through private treaty or public auction. Public auction sale is an effective method of loan recovery and preferred over private treaty since it refutes the allegation of unfair practice due to subjective nature of the disposal price.

The Bank Negara Guideline requires the appointment of an independent valuer to value and advice on the reserve price prior to the disposal of the property. The state of the economy or the phase of the property cycles are the critical factors in determining the reserve price and the quantum of disposal price of the property. The reserve price for auction under section 257 and 253 of the National Land Code 1965 is equivalent to market value of the property. It is common knowledge that the reserve price will be depressed during the economic turbulence and the likelihood of getting high value as compared to the loan is slim.

The auction success rate of auction sales was low at 2-20% during the episode of economic turbulence of 1987-1988(Antoni, 1987) and repeated during 1997-1999

financial crises. Poor demand for properties under auction caused the disposal price to decline (Khong, 2nd February 1998). This triggers banks to pursue bankruptcy proceedings so much so that the bankruptcy rate peaked to 12,268 cases in 2002(BNM, 2003). On the contrary, the bankruptcy rate declined by about 2.2 % each year(BNM, 2003) and the success rate of auction in terms of disposal and disposal price was better during improved economy(Antoni, 1987). Sale success of properties under auction is influenced by the cyclical and this suggest that a relationship between the timing of auction sale and the disposal price.

In this paper, it is argued that property owners can benefit if decision to dispose properties can be delayed to a suitable time when the market has slightly recovered. This may be realised, as there appears to be a positive but lagged relationship between economic cycles and property cycles. A careful analysis of the property market cycle and trends on disposal prices is vital to guide owners to make beneficial decision. Cost incurred in delaying the disposal of properties will have to be considered.

This paper is covered in five sections. Section two will describe the nature of property cycle and reviews the impact of different cycles. Section three examines the Malaysian property cycle and the length of each cycle. Section Four analysis the variations of disposal price following the different points of the cycle. This is analysed from the sale of a prime property in Kuala Lumpur. Finally section five summarises the findings and highlights the implications of the findings.

Review of the property market cycle.

Cycle is a sequence of events that repeat (Miller, 1997) and the property market is cyclical in nature. Brown (1984) validated this by studying house sales during 1968 to 1983. Later attempts to understand the property cycle documented property cycles as recurrent but irregular fluctuations as illustrated in the rate of all total property return which are also apparent in many other indicators of property activity but with varying

leads and lags against all property cycle (RICS, 1994). Mueller and Laposa (1994) describes the real estate cycle into four phases of recession, recovery, expansion and contraction. Phase 2 and 3 are characterised by falling vacancy rates while phases 4 and 1 are periods of rising vacancy rates. The equilibrium level is at the inflection point that differentiates positioning and direction for markets.

According to CCH Asia (1997), the trough of the cycle is characterised by excess supply, low prices, low confidence in future economy, reluctant to long term investment and higher incidence of foreclosures. Recovery phase is characterised by improving economic conditions, incentives to built because of increase demand, lower cost, lower interest rate, lower unemployment, rising wages, increase volume of transaction and property values. Peak is characterised by demand exceeds supply, acute labour and material shortage leading to increase in prices and costs. Inflation is felt and cost of borrowing increases due to high demand for loans. Contraction is characterised by supply exceeds demand, property become overvalued, banks start to restrict loans for property purchases, tightening of credit and rising cost will eventually decline in activity.

Studies on behaviours of property cycles varies according to its local conditions and the length also varies 3 to 5 years for short cycles and 18 to 50 years long wave cycles which are oriented to rapid growth. Hekman (1985) showed that there is a correlation between office market and local national economic conditions and that rent levels are affected by vacancy rates and this is similar to that of Wheaton (1987) and Pritchett (1984). Studies on the Canadian property market showed that property values are driven by returns rather than expected future net property income. Similarly cycles are driven by changes in the market forces of demand and supply and this have frequently been addressed in many research.

Malaysian property market cycles

The above section suggests that property cycles can vary according to nations and regions. The understanding on the pattern of the Malaysian property market cycle will shed some lights to the forces that lead to the cycle and the extent of the effect of cycle on property investment. For the purpose of assessing the property market cycle, the trends in office rent and the occupancy rate(OR) will be analysed for the period of 18 years from 1984-2002. Rent alone as indicator to measure cycles has its weakness since it is not always matching with the more frequent macro economic fluctuations (Kling & McCue, 1987; Wheaton 1987; Grenadier, 1985). Wheaton and Torto (1988) suggested to use rent as variables in synthesising the commercial property cycle. Hence, for this reason, OR and rent will be used to develop the chart for commercial property cycle. GDP is another variable that is relevant to produce economic cycle.

The pattern of the economic cycle and property cycles is compared to determine its peak and trough. This will enable analysis on the disposal price during different points of the cycle. The pattern of the property market and economic cycle showed that GDP lead OR by about one year. Any movement in the GDP will have the same effect on OR and rent of office buildings in Kuala Lumpur Golden Triangle. Observation in movement of the economic cycle revealed that it has gone through two troughs in 1985 and 1998 and the peaks being in the years 1984, 1990, 1997 and 2000. The property market cycle follows a similar pattern although it lagged by one to two years.

The commercial property was caught in a down cycle from year 1986 to 1989 when OR contracted from 88% in 1985 to bottom at 75.3%. It however improved by about 15% in 1989 to record to 87.2%. Rent fell by about 40% from RM2.51psf in 1985 to record at RM1.50 psf in 1988 and then improved to the level of RM2.50psf in 1989. Hence 1986-1987 is termed as recession and 1988-1989 is recovery phase as the OR was below the equilibrium of 86.4%. This is termed as the contraction phase or trough of the market cycles.

The commercial property market recovered from the contraction phase where expansion began in 1990 and continued right through to 1992. The market subsequently went through a slight contraction in 1993, the same year when stock market had a bull run with KLCI hitting a high of 1,275.32 points. In the following year it improved and continued until 1997(OR 97.72) when there was sign of contraction with the onset of Asian financial crisis in mid 1997. Consequently the market value fell by 16% in the year 1998 with OR touching a low of 82.1%. At the same time the rent dropped significantly by about 37% from RM6 psf in 1997 to RM3.80 psf. It deteriorated further until 2001 and 2002 with OR OF 75.3% and 76.3% respectively. Since 1999 the rent has been hovering around RM4.50 psf and in line with OR which fell below equilibrium to maintain at about 76%.

The effect of cycles on the disposal price

The effect of cycle on disposal price can be illustrated by analysing the disposal price of a major commercial building which is on the verge of being foreclosed via public auction and determining the difference in disposal price assuming the said property was to be disposed later when the market has recovered from recession. This will determine whether there is a gain in disposal price after considering all foreclosure costs and the cost of capital of holding the property.

Case Study: Wisma Supreme

a. Sale of Wisma Supreme during the 1988 recession

The building is a 20-storey class B office building located at the junction of Jalan P.Ramlee and Jalan Puncak, Kuala Lumpur. It has a net lettable area (NLA) of about 95,953 sq.ft. and was provided with 160 car parking bays. The freehold rectangular shaped commercial land measure about 35,500 sq.ft. The building was under pressure by foreclosure and became the first major building to be sold during the recession in 1988. It was sold at a price of RM15,000,000 which was analysed to be about RM160.00 psf.

b. Valuation of Wisma Supreme in 1989

A hypothetical valuation of the buildings was carried out a year later when the market started to recover. A year later a few other buildings 17 major properties was sold of which 4 were of class B office buildings. By comparing the sale of other properties, the value for Wisma Supreme are as follows:

Sales comparison:

- | | | |
|----|--|-----------|
| 1. | Plaza Atrium
Jalan Puncak, Off Jalan P Ramlee | RM284 psf |
| 2. | Menara Kewangan
Jalan Sultan Ismail | RM241 psf |
| 3. | Bangunan Peremba
Jalan Tun Razak | RM295 psf |
| 4. | Bena Tower
Jalan Ampang | RM273 psf |

The most comparable building sales is Plaza Atrium which is located 3 lots away from the subject property along the same street. The buildings are about the same age and thus need no adjustment as they about the same age. Hence, the valuation of Wisma Supreme are:

Hypothetical disposal price in 1989 (DP2) = 95,953sq.ft @ RM284psf
=RM27,250,652.

C. Foreclosure costs

The main elements to the foreclosure cost are as follows:

- i) The legal fess RM 5,000

The market rate for legal fees stipulated is RM5,000 regardless of the value and has not varied much over the years

- ii) Auctioneer fees

The maximum scale fees impose for high court matter is 1% of the disposal price. Though, the high court impose a maximum rate of RM2,000.00 regardless of the amount of the disposal price, 1% scale fees is adopted for this analysis. The lump sum fee is negligible compared to the fees which is based on successful disposal of the property (Tancorp,2003)

- iii) Valuation fees

This is based on the valuation fees for properties to be foreclosed .

- iv) Interest Charges

The banks practice is to impose the maximum ceiling rate of BLR + 3.5% on the amount outstanding for every account classified as NPL

Calculation of foreclosure cost:

Foreclosure cost in 1988(FC1)

This will be legal fees + auctioneer fees + valuation fees + interest charges I1

$$\begin{aligned}\text{FC1} &= \text{RM5,000} + (1\% \times \text{RM15,000,000}) + \text{rm22,393} + \text{RM393,750} \\ &= \text{RM571,133}\end{aligned}$$

Foreclosure cost in 1989(FC2)

$$\begin{aligned}\text{FC2} &= \text{RM5,000} + (1\% \times \text{RM27,250,652}) + \text{RM34,633} + \text{RM1,181,250} \\ &= \text{RM1,493,390}\end{aligned}$$

Analysis on difference of disposal price

Disposal price in 1988, (DP1) RM15,000,000

Less foreclosure costs

- i) Legal fees RM5,000
- ii) Auctioneer fees RM150,000
- iii) Valuation fees RM22,3983
- iv) Interest charges RM393,750

RM571,133

Net disposal price 1988, NDP1 RM14,428,867

Disposal price in 1989, (DP2) RM27,250,652

Less foreclosure costs

- i) Legal fees RM5,000
- ii) Auctioneer fees RM272,507
- iii) Valuation fees RM34,633
- iv) Interest charges RM1,181,250

RM1,493,390

Cost of capital(7%NDP1) RM1,010,021

Quit rent and assessment RM211,518

Net disposal price 1989(NDP2) RM 24,535,723

Difference in disposal price RM 10,106,856

Percentage gain (DF/NDP1 X100%) 70%

From this analysis, it appears that if the decision to dispose the property is delayed by one year, there is a possibility that the foreclosing chargee will gain a margin of 70% which is about RM10.1 million.

Conclusion

It has been observed that for every down cycle, there will be a next cycle. Careful consideration of the timing of the cycle and taking advantage of the upswing cycle can help to reap a potential gain in disposal price.

The study on property market cycle is important as it can assist property decision makers to make better decision based on the information of changes in market trends. The timing of disposing property can help in getting a better price if disposed at the right time

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