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Estimating the Rental Adjustment Process

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Abstract

Rental adjustment equations have been estimated for a quarter century. In the U.S., models have used the deviation of the actual vacancy rate from the natural rate as the main explanatory variable, while in the UK, drivers of the demand for space have dominated the estimation. The recent papers of Hendershott (1996) and Hendershott, Lizieri and Matysiak (HLM, 1999) fall into the former category. We re-estimate these equations using alternative formulations but can do little to improve them overall. However, we identify econometric concerns with the specifications.

We then derive a model incorporating both supply and demand factors within an Error Correction framework, and show how the U.S. and UK traditions are special cases of this more general formulation. We next estimate this equation using data from the City of London office market. Our initial specification of this more generalized model is greatly superior to the vacancy rate model. Finally, we estimate a two-equation variant with a separate vacancy rate equation; this model also performs much better than that of HLM. Importantly, our model passes standard modern econometric requirements for unit roots and co-integration. We find little evidence of special or temporal variation in natural vacancy rates.

Keywords : rent change, vacancy, office markets, London, Sydney

Introduction

Rental adjustment equations have been estimated for a quarter century. The primary focus in U.S. research has been adjustments to deviations of the vacancy rate from the natural or equilibrium rate. Not surprisingly given this focus, significant emphasis has been directed towards how or whether the natural rate varies spatially or temporally. Given the greater tendency of office markets toward overbuilding and thus to wider swings in office than in retail, industrial or residential vacancy rates, it is also not surprising that most research has been directed to this property type.

Over time, U.S. researchers have begun to realise that the simple vacancy rate model is inadequate and that more structure is needed. The current state of the art was illustrated recently in the Hendershott, Lizieri and Matysiak (1999) - hereafter HLM - study of the London office market. U.K. researchers, on the other hand, have estimated reduced form demand-supply equations, finding drivers of the demand for space, in particular, to be important determinants of real rents. While this gives added structure, it seems inappropriate to give up the obvious explanatory power of the vacancy rate.

In section 2, we review the key literature on rental adjustment models based on the vacancy rate. In section 3, we consider the addition of the deviation of actual rent from equilibrium rent term in earlier studies of the London and Sydney markets, and in section 4, we test alternative specifications to improve the HLM model. We derive an Error Correction Model (ECM) for rental adjustment in section 5. This model requires estimating a long run rent equation from the underlying supply and demand for space and a difference equation including the error from the long run equation as a regressor. In section 6, we estimate this model using the HLM London data. While the vacancy rate (and the supply of occupied space) is a key component of the equation, financial and

business services employment is even more important. Further, the explanatory power of this equation is far greater than that of the HLM equation, reducing the unexplained variance by 30 per cent.

Estimation of Vacancy Rate Models

Rental adjustment equations, linking change in real rents to deviations in the vacancy rate from the equilibrium or natural vacancy rate, are a well-established part of the modelling of property markets.¹ This approach has its origins in labor economics, where real wage inflation has been related to deviations of the employment rate from the natural or full employment rate. Possible application to the rental housing market was first noted by Blank and Winnick (1953).

The basic relationship may be written as:

$$\% \Delta R_t = \lambda (v^* - v_{t-1}) \quad (1)$$

where:

$\% \Delta R$ is the percentage change in real rents;

v^* is the natural vacancy rate;

v_{t-1} is the lagged vacancy rate; and

λ is the adjustment factor.

In the estimation v^* is calculated from the constant in the regression. Smith (1974) was the first to provide empirical support for the vacancy rate model. Using data from five Canadian cities, he regressed the rate of change in rents on the vacancy rate, lagged vacancy rate, and the current and lagged rate of change in property taxes. The vacancy rate and its lagged value were usually significant but the impact of tax changes was less clear.

Eubank and Sirmans (1979) added $\Delta OE_t / OE_{t-1}$ the rate of change in operating expenses, to the model to capture cross-section variation in these. They consider four U.S. cities and four apartment building types in each city. Overall, the vacancy rate variables worked poorly and

the operating expenses worked well. The authors use nominal data but state in a footnote that estimations using real data produce 'substantially unchanged' results. In contrast, Rosen and Smith (1983), also using nominal data, find vacancy rates, and not operating expenses, to be the important explanatory variable. They then estimate a pooled model for their 17 U.S. cities with fixed city effects. In the pooled estimation, all three variables were significant. Their estimates of natural vacancy rates by city vary from six to over 23 per cent, certainly an implausible range. Using real housing rents, Gabriel and Nothaft (1988), investigating 16 cities over the shorter 1981-1985 time frame, obtain a more reasonable natural vacancy rate range of four to ten per cent.²

Shilling, Sirmans and Corgel (1987) consider office markets and also employ the pooled approach for 17 U.S. cities. They use *real* values for current rental change and current change in operating expenses and estimate the city natural vacancy rates. The expenses variable is significant in only four cities and the vacancy rate is in 11 (at the 10 per cent significance level). Here, too, the variation in natural vacancy rates is implausible, ranging from one to 21 per cent.

The natural vacancy rate can vary across time as well as space. Wheaton and Torto (1988) use real rents and estimate the basic model (with the current vacancy rate but without operating expenses) for the US office market over the period 1968-1986. They introduce a linear trend to accommodate a hypothesised rise in the natural rate, and estimate a six percentage point rise, which they attribute to the spatial expansion of office centres, the broader base of tenants, increases in tenant turnover and a shortening of the average length of lease. Although this formulation results in a better fit, the six point rise is implausibly large and is clearly period specific; their data cover a cycle and a half, with the vacancy rate starting at four per cent and ending at 18 per cent. The linear trend increase arguably reflects the overbuilding associated

with government mismanagement of the 'saving and loan' problem (Hendershott and Kane, 1992), rather than the factors Wheaton and Torto suggest.

Grenadier (1995), building on Voith and Crone (1988), analyses office vacancy rates directly, using semiannual data for 20 cities over the period 1960-91. Variances in individual city vacancy rates are decomposed into a common time-varying component and city-specific fixed effects. City-specific persistence terms are also included to allow for lagged adjustment toward equilibrium.

Grenadier estimates a statistically significant common time varying component, but the magnitude is minor, a rise from the mid 1970s of less than a full percentage point. This is the magnitude of increase that the factors Wheaton and Torto identify would reasonably explain. Grenadier also estimates a wide variance in city natural vacancy rates. Excluding Houston and Dallas, whose high rates are almost certainly attributable to the saving and loan problem, the rates vary from two to twelve per cent. This ten point variation, while still surprisingly large, is more plausible than a twenty point variation.

Equilibrium Rents

The basic vacancy rate model is fundamentally deficient for two reasons. First, equilibrium real rents are unspecified and can, in fact, end up anywhere depending only on the pattern of past shocks. Second, there is no role for shocks during the current period; only those reflected in the beginning period vacancy rate matter.

Consider a market starting in full equilibrium being hit with a supply shock that raises the vacancy rate above the natural rate. Over time, demand for space grows, returning the vacancy rate to the natural rate. During the period that the vacancy rate is above the natural rate, the model suggests a monotonic decline in real rents. Thus, when the vacancy

rate returns to the natural rate, real rents will be far below their initial, presumably unchanged, equilibrium value. The only way the model can get real rents back to equilibrium is for the vacancy rate to overshoot the natural rate, and there is no obvious mechanism for this.

In full equilibrium, the vacancy rate will equal the natural rate, real rent will be at its equilibrium level, capital values will equal replacement costs and little development will take place. If vacancies fall below the natural rate, real rents will rise above their equilibrium level and induce development that will continue until vacancies *and* real rents return to equilibrium. Similarly, if the vacancy rate rises above the natural rate, rents will fall below their equilibrium level and development will stop until demand and rents increase and the vacancy rate falls.

Hendershott (1996) proposed and estimated a model for Sydney that both allows a more general rental adjustment path and constrains rents to return to their equilibrium level:

$$\% \Delta R_t = \lambda(v^* - v_{t-1}) + \beta(R_t^* - R_{t-1}) \quad (2)$$

where $\% \Delta R_t$ is the percentage change in real effective rents and R_t^* is the time varying equilibrium (natural) real rent. HLM (1999) estimate the same equation for London.³ The equilibrium rent in equation (3), R_t^* , is the user cost of capital - the product of replacement cost and the sum of the real interest rate (from the capital market), the depreciation rate (δ) and the operating expense rate (θ). Thus, the identity is:

$$R_t^* = (r_t + RP + \delta + \theta)RC \quad (3)$$

where r_t is the real risk-free interest rate, RP is the risk premium and RC is the replacement cost. In practice, the equilibrium rent varies only with the long-term real default-free rate; RP , δ , θ and RC are taken to be constant.⁴ For Sydney, Hendershott used 3 per cent for RP , 2.5 per cent for δ , and 5 per cent for θ . For London, HLM set these parameters at 2 per cent, 2 per cent, and 1.5

per cent, respectively. The large difference in the operating expense ratio is due to the fact that tenants pay many of these expenses directly in the UK (the full insuring and repairing lease) but not in Australia.

In both studies the nominal default-free rate was taken to be a long-term Treasury rate and the expected inflation rate was calculated as a simple average of the rate of change in the GDP deflator in the current and two previous years. Unfortunately, this led to substantially negative estimates of the real default-free Treasury rate during the middle 1970s. In the later London study, the negative real default-free interest rates were truncated - this real rate being set at the maximum of the calculated rate and one per cent - whereas in the Sydney study they were not. The source of the negative rates was clearly the OPEC oil shock. In the UK, inflation leapt from 8 per cent in 1973 to 19 per cent in 1974 and 26 per cent in 1975, before receding to 9 per cent in 1976. To build this surge in inflation into long-term expected inflation estimates requires one to presume that investors believed that oil prices were going to continue *rising* at the 1974-75 rate over the next decade. Because this is implausible, the London truncation seems quite reasonable.

Setting RC is more difficult. In both studies, the authors determine RC by selecting a year in which actual and equilibrium rents are likely to have been equal (1986 and 1983, respectively, in Sydney and London), substituting actual rent for equilibrium rent in equation (3), and solving. The real value of RC is assumed to be constant over time. Given that replacement cost must include real land costs, this assumption is rather strong.⁵

A Closer Look at the Estimation

The results for Sydney and London are reproduced in Table 1. The coefficients have the expected signs and are significant. The implied natural vacancy rates for the two markets are 6.4 and 7.1 per cent, respectively, i.e., there is trivial difference. To make the

estimates more comparable, the Sydney equations are re-estimated with the real interest rate set at the maximum of the calculated rate and one per cent, as was done in the London study. This adjustment improves the fit, raising the adjusted R^2 above that of the London model and producing a natural vacancy rate of 5.1 per cent (see Table 1, Sydney equation (a)).

The HLM formulation resembles an Error Correction Model (ECM) in that rents are specified as adjusting to the difference between long run and actual rents. But, rather than estimating a long-run relationship, they define it as equation (3). As an alternative, we relate actual rents to the primary driver of equilibrium rents, their estimate of the real default-free Treasury rate, and a constant to reflect the risk, depreciation and expense parameters. Unfortunately, the equation has zero explanatory power. Of course this may be partially due to our short estimation period and lags in the relationship.

This raises the possibility that the explanatory power of the rent gap variable comes entirely from the lagged rental rate. To test this, we break the $R_{t-1}^* - R_{t-1}$ variable into its two components. Table 1 presents the results for Sydney (using the original data - equation (b) - and the recalculated equilibrium rent-equation (c) and London. In all cases, both components are statistically significant with their expected signs and are not significantly different in absolute value. Real rents do seem to be reverting towards a level driven by the real default-free interest rate (Because rents are an index, the magnitudes of the coefficients do not indicate the speed of reversion). Nonetheless, the fact that no statistical relationship exists between actual rents and the estimate of equilibrium rents is disturbing.

There is a further concern with this specification. The dependent variable is integrated of order zero ($I(0)$) while both explanatory variables are $I(1)$ (see Table A1). Moreover, the evidence for a co-integrating

relationship is weak and the single vector that can be determined has incorrectly signed coefficients (using the Johansen cointegration test within *Eviews*, a cointegrating relationship cannot be detected with a one period lag on the first difference in the VAR but appears with two lags). Refer Table 1: London and Sydney rental adjustment equation.

An Expanded Formulation

As an alternative to the rental adjustment models discussed above, we derive an estimation equation from the occupied space market. Market clearing directly gives us a long run relationship between real rent and the underlying supply and demand for space. The short-run relationship is a difference equation of the long run, including the lagged error from the long run equation as a regressor.

Let the demand for space be a function of rent (R) and employment (E):

$$D = \lambda_0 R^{\lambda_1} E^{\lambda_2} \quad (4)$$

where the λ_i are constants (the 'price' elasticity being negative and the 'income' elasticity being positive). The market clearing rent for a given level of vacancy is that which solves

$$D(R, E) = (1-v)SU \quad (5)$$

where SU is supply and v is the vacancy rate. Substituting equation (4) in (5) and solving for R

$$R = \gamma_0 E^{\gamma_1} [(1-v)SU]^{\gamma_2} \quad (6)$$

The underlying elasticities are obtained as $\lambda_1 = 1/\gamma_2$ and $\lambda_2 = -\gamma_1/\gamma_2$. Taking logs of both sides of equation (6) gives:

$$\ln R = \ln \gamma_0 + \gamma_1 \ln E + \gamma_2 \ln(1-v) + \gamma_2 \ln SU \quad (7)$$

The coefficients on the vacancy rate and supply variables should not differ.

This type of equation, without the vacancy rate, has been estimated mainly by UK researchers. Demand drivers used in the literature include retail sales, consumer expenditure, financial and business services output and employment, manufacturing output and employment and GDP, depending on the property type under consideration. These variables are typically highly significant. In contrast, decent quality supply and vacancy data are rarely available. Some studies use construction orders (a flow variable) rather than a stock, some use proxy variables and some omit supply altogether. Most studies that test supply proxies find them to be insignificant. Vacancy rate data are even more difficult to obtain in Europe, and we know of no estimation of a variant of equation (8) that uses vacancy rates.

The residual in the estimation of equation (7) is:

$$u_t = \ln R_t - \beta_0 - \gamma_1 \ln E_t - \gamma_2 \ln[(1-v_t) + SU_t] \quad (8)$$

the difference between the observed and the estimated long run value. If the levels variables are integrated of order one (I(1)) and are co-integrated, this error is stationary and its lagged value can be used in a short run dynamic model as an adjustment process⁶.

The short run model is a difference equation with an Error Correction term, namely the lagged error described by equation (9):

$$\Delta \ln R_t = \alpha_0 + \alpha_1 \Delta \ln E_t + \alpha_2 \Delta \ln[(1-v_t) + SU_t] + \alpha_3 u_{t-1} \quad (9)$$

Thus, rent adjusts to short run changes in the causal variables and also to lagged market imbalances, measured by deviations from the long run equilibrium. In the estimations, it is expected that α_0 will be approximately zero, α_1 will be positive, and α_2 and α_3 will be negative. An α_3 value of -1 means complete or full adjustment.

A problem with this structure is that the vacancy rate is an endogenous variable; both it and rent operate to 'clear' the space market [equation (5)].⁷ In effect, we have a two-

equation model. To explain the vacancy rate, we first tested an analogue to equation (3), using the gaps between the natural and lagged vacancy rate and equilibrium and lagged rents. While tracking the general directional movement in the vacancy rate, this was very poor at estimating the magnitudes of changes to the vacancy rate. Regressions of the vacancy rate on lagged values were then estimated in the spirit of Grenadier (1995), with much greater success. The best fitting relationship is

$$v_t = 0.95 + 1.84v_{t-1} - 1.38v_{t-2} + 0.42v_{t-3}$$

The adjusted R^2 is 0.90, and the equation standard error is 1.62. This AR(3) process allows for both persistence and time variation in the natural vacancy rate. We use the predicted rate from this equation in explanations of real rental changes.

Estimations of the New Model

The series used are all I(1), and for all the equations estimated there exists a co-integrating vector with correctly signed coefficients (see the Appendix). Table 2 presents the results of our estimations.

There are four basic models: two using the actual vacancy rate and two using our predicted rate. In each case there are versions with supply and vacancy rate separate and with them combined as a single variable. The upper part of the table presents the results of the long run models and the lower part presents the short run models.

For the long run models, all coefficients are correctly signed and significantly different from zero. When the vacancy rate and supply variables are entered separately, their coefficients are not statistically different from each other. The explanatory powers are high, and no explanatory power is lost by replacing the actual vacancy rate change with the predicted change. The implied "price" elasticities of the demand for space (for models 2 and 4, respectively) are -0.19 and -0.24, and the "income" elasticities are 0.67 and 0.92.

In the short-run models, all coefficients are correctly signed and significant except for the stock variable when the predicted vacancy rate is employed. In this case, the coefficient is not significantly different from zero. This variable is dropped in Model 5.

The demand coefficients are close to those in the long run models, but the supply coefficients are significantly lower. In all cases, the constant term is not significantly different from zero, and the ECM coefficient is not significantly different from negative unity, implying full adjustment in one year to the gap between long run and actual rents. The explanatory power is high, but, not surprisingly, is lower for the models using the predicted vacancy rate than those using the actual rate.

For a proper comparison of our model with HLM, both need to be estimated over a common period. This requires re-estimation of the HLM (1999) model. These results are shown in the HLM column in Table 2. Our model 5 reduces the unexplained variance of the HLM model by 30 per cent. Figures 1 and 2 plot the actual percentage change in effective rents and the predicted values from the two models.

Figure 1: Actual and Fitted Values, Model 5

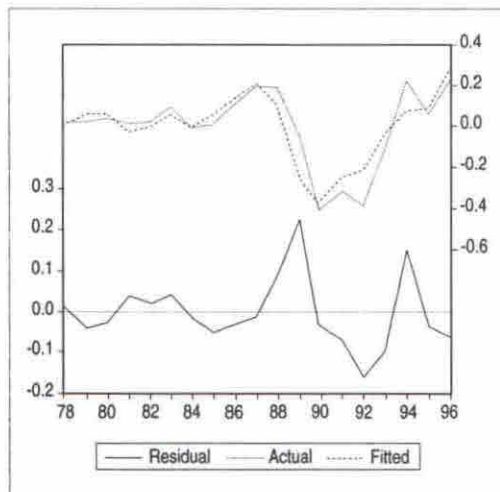
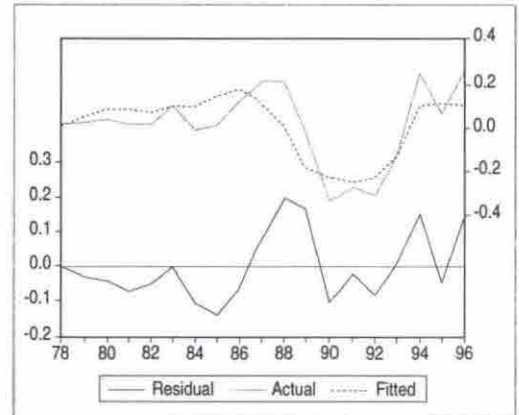


Figure 2: Actual and Fitted Values, HLM



Conclusions

In this paper, we discussed the development of the vacancy rate model in the U.S. and the latest extension and estimation of it by Hendershott *et al* (1999). This estimation introduces the deviation from a time-varying equilibrium rent as a variable and in doing so creates a link between the capital and space markets. Estimates of the model using London and Sydney office market data show the equilibrium rent variable to be significant and have similar coefficients.

We then derived a more general model based on the supply and demand for occupied space. Using the same London data, we estimated both a long-run equation and a short-run Error Correction Model.

In the short-run model, the rate of change in real rents was related to rates of change in the supply and demand variables and the vacancy rate and to the difference between the actual and fitted long-run rent values. This equation was shown to be greatly superior to the HLM estimates.

The ECM model has a number of clear advantages over the vacancy gap models. It is based on a structural model of the space market, and the coefficients have useful economic interpretations. Moreover, it is based on sound econometrics. However, it requires both stock and vacancy rate data, and these are not available in many markets.

In contrast, the basic vacancy rate model is conceptually much simpler and does not require stock data. However, its theoretical underpinnings are weak. The introduction of the deviation of actual real rent from equilibrium rent is conceptually elegant but creates measurement difficulties in the absence of a market-based real, default-free

interest rate and data on risk premia and land costs. Further, from our evidence, this model produces poorer estimates and may have problems of levels of integration and co-integration. Thus, where data permit, the ECM space market approach appears to be far superior.

Endnotes:

¹ For full reviews of the early literature, see Eubank and Sirmans (1979), Rosen and Smith (1983) and Shilling *et al* (1987).

² Gabriel and Nothaft have a second estimation in which the natural vacancy rate is treated as endogenous, being related to such factors as the growth in rental units and population and the level and dispersion of rents in the city. Here the range in average natural vacancy rates is 7 to 12 percent.

³ Both Hendershott (1996) and HML adjust headline rents to take account of letting incentives and use the GDP deflator to convert to real rents. The HLM model has equations for completions, net absorption and rental adjustment. Here we concentrate solely on the rental adjustment equation.

⁴ The depreciation rate is likely to vary with the building cycle, older buildings being discarded at a more rapid rate when property is overbuilt, and the risk premium is also likely to be time-varying, with the premium growing when property markets are weak. Measuring these variations empirically is a non-trivial task.

⁵ In U.S. cities, with relatively available land supply and possible long-term rental growth in land values of zero, this may not be a problem. In contrast, in a constrained market with strong planning controls, there may be an upward trend in land costs that should be in the cost of capital (equ 3).

⁶ Formally:

A series with no deterministic trend and which has a stationary and invertible autoregressive moving average (ARMA) representation after differencing d times, but which is not stationary after differencing $d-1$ times, is said to be integrated of order d .

The components of a vector x , are said to be co-integrated of order d , b , if x is $I(d)$ and there exists a non zero vector a such that $a'x$ is $I(d-b)$, $d > b > 0$. The vector a is called the co-integrating vector.

In our models, we are looking for co-integrating relationships among variables that are individually integrated of order one, so the deviation from the equilibrium relationship is integrated of order zero, that is, it is stationary. (Banerjee *et al.*, 1993)

⁷ It can also be argued that the vacancy rate is partly determined by exogenous variables. Several studies have developed cross sectional models linking the natural vacancy rate to exogenous variables [see, for example, Rosen and Smith (1983) for housing and Shilling *et al.* (1987) for offices]. Arnott and Igarashi (2000) consider the demand for vacant space in the context of search models.

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Table 1: London and Sydney Rental Adjustment Equation

Original	Sydney				London	
	Original model	Re-estimated model (a)	Re-estimated model (b)	Re-estimated model (c)	Original model	Re-estimated model
Constant	0.112 (0.033)	0.139 (0.029)	0.409 (0.097)	0.282 (0.12)	0.201 (0.046)	0.0945 (0.16)
V t-1	-1.76 (0.46)	-2.71 (0.42)	-2.53 (0.49)	-2.89 (0.44)	-2.83 (0.54)	-2.87 (0.55)
$R_t^* - R_{t-1}$	2.57 (0.61)	3.85 (0.71)			3.72 (0.57)	
R_t^*			1.86 (0.78)	2.86 (0.17)		4.68 (1.47)
R_{t-1}			-3.64 (0.72)	-3.76 (0.70)		-3.45 (0.69)
Adj-R ²	61%	71%	70%	71%	69%	68%
DW	1.87	1.92	2.04	2.09	1.61	1.69
v*	6.4%	5.1%	16.1%	9.8%	7.1%	3.3%

Notes: standard errors are in brackets; DW is the Durbin-Watson statistic; original models were re-estimated and validated from original data sets and rescaled for comparison; Sydney models (a) and (c) are based on a lower bound of 1% for the default free real rate

Table 2: The Error Correction Models

Variables	Model 1 1975-96	Model 2 1975-96	Model 3 1977-96	Model 4 1977-96	Model 5 1977-96	HLM 1977-96
<i>Long run</i>						
Constant	18.55 (2.11)	17.75 (1.74)	16.07 (2.22)	15.90 (1.73)	15.90 (1.73)	
Employment	3.74 (0.52)	3.58 (0.45)	3.84 (0.58)	3.80 (0.47)	3.80 (0.47)	
Stock	-5.69 (0.90)		-4.21 (0.91)			
(1 - v)	-6.18 (1.40)					
Stock *(1 - v)		-5.37 (0.76)				
(1 - predicted v)			-4.31 (1.50)			
Stock* (1 - predicted v)				-4.14 (0.75)	-4.14 (0.75)	
Adjusted R ² DW	80% 1.46	80% 1.34	79% 1.09	80% 1.06	80% 1.06	
<i>Short run</i>	1976-96	1976-96	1978-96	1978-96	1978-96	1978-96
Constant	-0.046 (0.029)	-0.023 (0.023)	-0.047 (0.034)	-0.005 (0.026)	-0.028 (0.024)	0.201 (0.046)
Employment	3.75 (0.80)	2.59 (0.54)	3.37 (0.96)	2.09 (0.68)	2.80 (0.71)	
Stock	-2.07 (2.29)		1.70 (2.25)			
(1 - v)	-4.26 (1.44)					
Stock *(1 - v)		-3.91 (1.37)				
(1 - predicted v)			-2.00 (0.98)		-2.16 (0.90)	
Stock* (1 - predicted v)				-1.72 (1.01)		
ECM	-0.95 (0.17)	-0.95 (0.17)	-0.87 (0.23)	-0.72 (0.23)	-0.83 (0.22)	
v_{t-1}						-2.77 (0.55)
$R_t^* - R_{t-1}$						3.58 (0.84)
Adjusted R ² DW	79% 1.90	79% 1.51	72% 1.79	69% 1.39	73% 1.62	61% 1.37 v*=7.3%

Notes: standard errors are in brackets; DW is the Durbin-Watson statistic

Table A1: Unit Root Tests

	Augmented Dickey Fuller test	Phillips - Perron Test
Effective rents	Accept 5%	Accept 10%
D(Effective rents)	Reject 1%	Reject 5%
Employment	Reject 5% Accept 1%	Accept 10%
D(Employment)	Reject 1%	Reject 5%
Stock	Reject 5%	Accept 10%
D(Stock)	Accept 1% Reject 5%	Reject 5%
$1 - v$	Reject 5% Accept 1%	Accept 10%
D($1 - v$)	Reject 1%	Reject 5%
Stock*($1 - v$)	Accept 10%	Accept 10%
D(Stock*($1 - v$))	Reject 1%	Reject 1%
$1 - \text{predicted } v$	Accept 5%	Accept 10%
D($1 - \text{predicted } v$)	Reject 1%	Reject 1%
Stock*($1 - \text{predicted } v$)	Reject 5% Accept 1%	Accept 10%
D(Stock*($1 - \text{predicted } v$))	Reject 1%	Reject 1%
v_{t-1}	Reject 5%	Accept 10%
D(v_{t-1})	Reject 1%	Reject 5% Accept 1%
$(R_t^* - R_{t-1})$	Accept 10%	Accept 10%
D($R_t^* - R_{t-1}$)	Reject 1%	Reject 1%

Notes : all series can be assumed I(0); all variables in logs; D is the first difference; result with null hypothesis of unit root (non stationary); all levels tests with a trend and constant; differences tests with neither.

Table A2: Co-integration Tests

Variables	Null hypothesis and result
Rent, Employment, Stock (1 - v)	None: reject at 1% At most 1: reject at 5% At most 2: accept One vector correctly signed
Rent, Employment Stock*(1 - v)	None: reject at 5% At most 1: accept One vector correctly signed
Rent, Employment, Stock (1 - predicted v)	None: reject at 1% At most 1: reject at 5% At most 2: accept One vector correctly signed
Rent, Employment Stock*(1 - predicted v)	None: reject at 5% At most 1: accept One vector correctly signed
Percentage rental growth, lagged v, (current equilibrium rent - lagged rent (*))	None: reject at 1% At most 1: accept One vector incorrectly signed

Notes : in all cases Johansen test used with constant and assumption of linear deterministic trend in the data; one lag of first difference, except (*) where two lags had to be used to obtain a cointegrating relationship.

An Analysis Of Office Investment Depreciation - Hedonic Modelling Of Its Sources

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Abstract

This paper is an extension of a previous paper published in The Journal of Valuation and Property Services, Volume 2, 1999. It attempts to develop a systematic statistical methodology for the analysis of office depreciation. An appropriate functional form, which avoids potential bias as well as links depreciation to physical deterioration, building and site obsolescence, is selected. A hedonic model for the City of Kuala Lumpur offices rental depreciation aims to explain rather than to predict the phenomenon as the cross-section analysis of rental market in 1996 was undertaken. The perceived importance of variables in causing depreciation is identified and explained in detail. The result indicates that depreciation of offices in the city of Kuala Lumpur is largely dominated by physical deterioration and building obsolescence compared to site obsolescence.

Keywords: impact of depreciation, physical deterioration, obsolescence and hedonic modelling

Introduction

Depreciation and its impact on property investment have been a focus of many studies in the early 1980s. In the United Kingdom, the analysis of property depreciation concerns the growing awareness of property mispriced as a result of implicit analysis of its impact. This issue has raised the need for better approach to quantify the impact as well as one capable of considering other depreciation variables apart from 'age'. The approaches to estimate depreciation have developed significantly since the last decade especially in economic (see Hulten and Wykoff, 1996) and accounting. The methods progressed from a simple measurement to more complicated methods (bivariate to multiple depreciation causal) with increased incorporation of statistical tools aimed to appropriately quantify and explain property investment depreciation.

This paper aims to construct a hedonic model for office depreciation considering all possible causes of depreciation. This empirical model expands upon the previous research (Md Yusof, 1999 and 1999a) into the relationship between rental depreciation and its three major causes (physical deterioration, building obsolescence and site obsolescence) using the hedonic price technique. Within the context of a hedonic price model, the contribution of included variables explains the impact of depreciation. This offers an alternative to a version of an *age* to explain depreciation as in Sykes (1984), Salway (1986), Barras and Clark (1996) and Clapp and Giaccotto (1998). In this paper, depreciation factors, which are represented by original and an orthogonal combination of depreciation variables, are used. The hedonic price for each factor is calculated and used to explain the perceived importance of each factor in office investment depreciation.

To develop the model, related literature is reviewed in the next section of the paper. This literature review is followed by the

specification of the model. Data used in developing the model is presented. Problems associated with data efficiency and bias in the construction of the hedonic model are discussed. The empirical results are reported and the research is summarised and concluded in the final section.

Literature Review

In property investment, depreciation rate (especially of housing) is commonly estimated by examining price data on units of various ages (Barras and Clark, 1996 and Clapp and Giaccotto, 1998). The rate of change of observed property prices with respect to *age* is interpreted as a depreciation rate. Works, such as by Sykes (1984), Salway (1986), and Barras and Clark (1996) also quantified the rate of depreciation as property ages. The age-life method of estimating depreciation is one method that incorporates the above information and is often used by practising appraisers (Cannaday and Sunderman, 1984). The difficulty of using *age* is attributed to the fact that 'Age' is strongly correlated to other variables (Epley, 1990); therefore the effect of other depreciation variables, such as design factors, is incapable of being separated.

Md Yusof (1999 and 1999a) proposed three main sources of depreciation: physical deterioration, building obsolescence and site obsolescence (fuller discussion on sources of depreciation can be found in Md Yusof, 1999 and 1999a). Physical deterioration indicates the situation of declining utility due to physical usage and the passage of time. Physical deterioration emanates from 'use' and 'action of elements', which require the passage of time, as both 'use' and 'action of elements' occur progressively through time. Obsolescence is a decline in property utility or usefulness, which is not directly related to physical deterioration (Salway, 1986 and Baum, 1989). The property becomes obsolete as it falls in comparative status due to factors such as technology or design of a new property. Obsolescence can be classified as building obsolescence and site obsolescence.

Building obsolescence refers to a degree of mismatch between a building and its use. Building obsolescence may arise from deficiencies in design, building systems, services and other factors. Site obsolescence indicates a decline in usefulness of a site (Md Yusof, 1999 and 1999a). Factors that may cause obsolescence of a particular site or location include accessibility, site-specific factors (such as size, location, etc), planning and the environment.

Attempts to incorporate different sources into the analysis of depreciation had resulted in the application of statistical tools. In Baum (1989), Hulten and Wykoff (1996), Khalid (1992) and Md Yusof (1999), multiple regression analysis and its extension hedonic price model has been used to explain rather than predic the impact of depreciation on property investment especially when the data is analysed cross-sectionally, i.e., at one particular time. The main concern in this part is to review the material to support the need to consider multiple causes of depreciator using the hedonic price technique. The technique has been used as a better alternative to explain different sectors in property investment analysis. The hedonic price technique has been used in determining rental and house price and the impact of the countryside characteristics on house values (for example, Garrod and Willis, 1991 and 1993). In addressing the impact of depreciation, numerous studies such as Palmquist (1979), Linneman (1980) and Chinloy (1980) have measured house depreciation by the coefficient on age in the hedonic regression. The most recent is a rational expectation framework for interpreting the coefficient on age in a standard hedonic model developed by Clapp and Giacotto (1998) for residential sector.

In office investment, the models used to measure office performance can be linked to the analysis of depreciation as depreciation is largely related to property performance. Bough and Kratz (1983) and Vandell and Lane (1989), for example, consider the price of good architecture in rental determination

of offices by hedonic price technique, which can be linked to depreciation in terms of the method and variables used. Dunse and Jones (1998) include factors such as physical characteristics, tenure and location to determine value of offices in the United Kingdom, which are also appropriate to the analysis of depreciation.

What is hedonic regression? Hedonic regression is an extension of MRA, which can be applied to a series of property values, together with their associated characteristics to identify and quantify the significant determinants of value and, consequently depreciation. Hedonic multivariate regression is a technique for measuring price while controlling for the quality of the heterogeneous commodities. Hedonic price is the implicit price of each attribute possessed by those goods. Each attribute contributes to the value of the good as the model specified that the good *per se*, does not affect the level of their utility to a consumer. It is the attributes possessed by the good that increase or decrease the utility (Rosen, 1974). The interpretation suggests that the price paid for a particular good is the sum of the implicit prices of the associated attributes as the hedonic price equation is a reduced-form equation reflecting both the demand and supply influences (Halvorsen and Pollakowski cited by Edmond, 1984).

In this study, the hedonic model is based on the assumptions that an office's utility is a general function of a dimensional vector of characteristics which encompass locational and physical characteristics where the market prices are known for any offices and each user maximises utility, subject to a budget constraint. As in Dunse and Jones (1998), the office unit, Z , is composed of n attributes $z_1, z_2, \dots, z_n$ and vector of n attributes for which rent depends upon the quantities of the various attributes associated with Z . The rent function can be expressed as

$$R(Z) = f(z_1, z_2, \dots, z_n).$$

The hedonic equation is estimated using regression analysis to obtain a price measure, $R(Z_k)$, the corresponding rent being for the k^{th} property. This equation can be as follows:

$$R(Z_k) = \beta_0 + \sum_{i=1}^n \beta_i Z_{ik} + \varepsilon_i \quad 1.0$$

The hedonic price function may increase, decrease or remain constant depending on the functional form of $R(Z)$. Despite various advantages of hedonic analysis, some issues require careful consideration. Caution must be taken to ensure that the included characteristics must be restricted to those which pertain to the good itself. A proper set of characteristics of demander and supplier should be carefully examined. Other issue is related to the underlying factors that cause depreciation to vary and whether the importance of these factors will vary cross-sectionally. This is also a subject of interest that requires accurate measures of prices on a standardised bundle of office services for each locality considered. More importantly, the appropriate functional form for a hedonic price equation cannot in general be specified on theoretical grounds and the lack of a firm basis for the choice of functional form is unfortunate. This, nonetheless, does not prevent the application of hedonic price model in other studies as well as in this study.

Methodology and Research Design

This research is designed to model or explain the impact of depreciation on rental for offices in the City of Kuala Lumpur. The modelling process involves the identification of data for analysis, construction of a hedonic model, model specification and an assimilation of the whole process to explain the impact of depreciation. Previous works have been used to justify the selection of the data used in the analysis. Appropriate statistical tests such as correlation analysis and ANOVA test are further employed to ensure that significant and relevant variables are included in the model. The development of models follows an order of variables

selection, model specification and validation. In selecting variables, stepwise selection in regression analysis is used since the method refines and combines both forward and backward selection. In stepwise method, the variables are assessed and reassessed at every stage for their significance in the model whereas in the forward or backward procedures variables remain in the equation once they are entered.

As mentioned earlier, the model developed aimed to show the perceived importance of each variable in depreciation by regressing dependent variables (rental depreciation) with two sets of independent variables: non-transformed and transformed variables. Non-transformed variables consist of original variables, which are significantly associated with rental depreciation as observed in correlation matrices.

Data: Data for this study is derived from information on forty nine offices in the city of Kuala Lumpur. The average rental for these offices ranged from RM3.10 to RM5.80 per square foot in 1996. The offices are located in three traditional commercial areas: Golden Triangle Area (GTA), Central Business District (CBD) and Decentralised Area (DCA). The GTA is the most prime location in the city followed by the Central Business District and Decentralised Area. Rental depreciation as dependent variable is denoted as the percentage difference between subject (which is under investigation) and prime offices. The 'prime' is used to indicate the highest rental achieved in the market based on the consumer theory: a good is paid the highest price for the highest utility offered (Lancaster, 1966). The selection of property characteristics or attributes is guided by the analysis of sources of depreciation as well as statistical significance. Variables selected are linked to physical deterioration, building obsolescence and site obsolescence. A total of 53 variables were collected. Nonetheless, not all variables are significantly associated with rental depreciation, hence insignificant

variable are eliminated from further analysis. The list of all variables is shown in Exhibit 1.0. The specific information on broad categories compiled for each property is summarised under the category of Location, Age of the offices, Physical characteristics, Services available in the building, Building systems and Building Design according to the City of Kuala Lumpur's, 'Guideline on Office Classification' (DBKL).

As mentioned earlier, in addition to the original variables, eight components or factors are also used to explain the impact of depreciation based on three sources of depreciation: physical deterioration, building obsolescence and site obsolescence. The components, which were extracted with the Principal Component Analysis, represent the underlying constructs of thirty-seven office characteristics collected (please refer Md Yusof, 1999 and 1999a). Principal Component Analysis is performed on 31 variables (which are strongly correlated with rental depreciation), aimed at summarising and reducing the number of independent variables. The use of large number of independent variables can create a number of problems such as multicollinearity. Principal Component Analysis eliminates multicollinearity problem, which can easily be observed when variables are strongly linked to each other. The problem of multicollinearity may cause difficulty in determining causal variables in the model, as the independent variables are closely associated among themselves. Eight orthogonal factors derived in the Principal Component Analysis performed are:

- 1) The quality of the building (BldQty),
- 2) Size and Efficiency (SizeEff),
- 3) Design and Lay-out (DesLay),
- 4) Location (Locat),
- 5) Appearance (Appear),
- 6) Complementary (Compl),
- 7) Facilities (Facil),
- 8) Parking services (Park),

As the variables have been identified, the next step is specifying the model. This is discussed in the following sub-section.

The Specification of the Model

The model specification includes selection of the dependent and independent variables and determining the overall functional form of the model. As mentioned earlier, two forms of hedonic model are developed in this paper: non-transformed and transformed. The highest rental achieved in the market is selected as a benchmark. In 1996, the prime rent was RM5.80. The rate of depreciation is arrived as follows:

$$\text{Rental Depreciation (\%)} = \frac{[\text{Prime Rent} - \text{Office Rental}] \times 100}{[\text{Prime Rent}]} \quad 2.0$$

Dependent variable, rental depreciation ($DepR_{it}$), is the difference in rental between the equivalent new, modern and prime and the subject property (property in the study). The use of this as an indicator for rental depreciation is consistent with other studies (Baum, 1989, Khalid, 1992 and Barras and Clark, 1996). Selection of independent variables for the model is attempted to incorporate all the physical deterioration, building obsolescence and site obsolescence variables that would be required to minimise specification bias. Therefore, the selection of variables is guided by the results of previous studies and the availability of data.

A testable form of equation related to depreciation begins with a standard cross-sectional hedonic model (Rosen, 1974):

$$DepR_{it} = f(\text{Physical deterioration, Building obsolescence and Site obsolescence}) \quad 3.0$$

Depreciation for offices is a function of physical deterioration, building obsolescence and site obsolescence. This equation can be rewritten as Equation 4.0 and Equation 5.0

$$Y = a + b_1x_1 + b_2x_2 + \dots + b_nx_n \quad \text{or} \quad 4.0$$

$$Y_i = a + b_1x_{1i} + \dots + b_nx_{ni} + \varepsilon_i \quad 4.0$$

$$DepR_{it} = a_0 + b_1x_{1t} + b_2x_{2t} + b_3x_{3t} + \dots + b_nx_{nt} + e_{it} \quad 5.0$$

where

- $DepR_{it}$ = Rental depreciation of office i during period t
- a_0 = Constant represents that portion of rental depreciation for each office that may be attributed to the overall level of depreciation
- e_{it} = Random errors for the rental of property i during period t
- $b_{1...n}$ = The coefficients for the quantitative or qualitative variable i for period t
- $x_{1...i}$ = The observed value of the quantitative or qualitative depreciation variable j for office i in period t

The intercept 'a', the coefficients on 'b₁ to 'b_n, are allowed to change over time. Any unexplained variation is captured by the random error e .

Based on the above equations, two models have been developed and are discussed below.

i) Model with original variables

In the model, rental depreciation is a function of a set of original variables.

$$DepR_{it} = a + b_1(Variable\ 1) + b_2(Variable\ 2) + b_3(Variable\ 3) + b_4(Variable\ 4) + \dots + b_n(Variable\ N) + e_{it} \quad 6.0$$

ii) Model with transformed factors

$$DepR_{it} = Constant + \beta_1(Fac1) + \beta_2(Fac2) + \beta_3(Fac3) + \beta_4(Fac4) + \beta_5(Fac5) + \beta_6(Fac6) + \beta_7(Fac7) + \beta_8(Fac8) + e \quad 7.0$$

$$DepR_{it} = b_0 + Fac_1 x_{1t} + Fac_2 x_{2t} + Fac_3 x_{3t} + \dots + Fac_n x_{nt} + e_{it}$$

Any violation of the model is carefully observed. Problems of multicollinearity (strong correlations amongst independent variables), normality error, linearity or heteroscedasticity are analysed through appropriate statistics. Tolerance level, for example, shows the proportion of variability,

which cannot be explained by other variables and the smaller the tolerance, the larger the standard errors of the coefficient. Large standard error of coefficients causes computational problems and is always associated with multicollinearity. The determination of the importance of variables in the equation can be difficult if the model is affected by multicollinearity.

Findings

The first stage of the analysis involved performing different methods of selecting variables. As discussed earlier, stepwise selection provides extra advantages over forward selection and backward elimination. The included independent variables were reassessed at every step of the model development, ensuring the significant variables remain in the model. The capability of explaining rental depreciation is determined by the high value of R^2 , which refers to explanatory power of the model. Hence the higher the R^2 , the better the model. However, this is subject to some limitations. In most cases, adjusted R^2 will be observed as the adjusting process takes place. Two models with different sets of independent variables are presented as follows:

(i) Model with original variables

Only variables that are statistically significantly associated with rental depreciation are selected for further analysis. Thirty-seven variables are regressed with rental depreciation. These variables are selected based on their significant association with dependent variable. Eight variables included in the model are 'Age'(age of the building), 'Bay_rate'(parking bay relative to floor area), 'Ex_fin'(external finishes), 'Fl_fin'(floor finishes), 'Plrat'(plot ratio of particular site), 'S_chrg'(service charges), 'Stry'(number of storey) and 'Ty_con'(type of construction). The model is developed using eight variables (selected from a range of variables listed from Exhibit 1.0), which

explains 82.9 per cent of variation in $DepR$. The R^2 of the model is adjusted to 79.3 per cent. Equation 6.0 can be rewritten as follows to indicate rental depreciation in 1996:

$$DepR_{96} = 49.27 + 0.34 (Age) - 2.02 (Bay_rate) - 1.02 (Exfin) - 2.535 (Fl_fin) - 0.557 (Plrat) - 21.492 (S_chrg) - 0.161 (Stry) + 2.72 (Ty_con)$$

There is no site-related factor included in the equation, which means that the aim to consider the site obsolescence may not be achieved. Further statistical tests are carried out and relevant statistics are observed. The associated F-test shows that there is significant relationship between the dependent and the entire set of independent variables. With eight variables, the model explains 82.9 per cent of variation in rental depreciation. Adjusted R^2 is used to compare equation fitted not only to a specific set of data and two or more entirely different sets of data. In this case, adjusted R^2 fall to 79.3 per cent, which indicates that the ability of model is decreasing. A summary of the model is shown in Exhibit 2.0.

The equation can be read as, for example, one unit of 'age' contributes 0.34 per cent to rental depreciation. The largest variation in rental depreciation is attributed to 'S_chrg', the negative sign means that as service charge increase, depreciation decreases. The main concern here is 'service charges' neither represents nor indicates any depreciation factors. Furthermore, although most variables indicate correct signs of coefficient (the better quality of variables minimise depreciation), 'Ty_con' displays contradictory association. An error is suspected in the model. No site related variable is included and therefore there is no scope to consider the impact of site obsolescence. In addition, Exhibit 2.0A, shows that the equation is seriously affected by multicollinearity. Low level of tolerance level indicates this problem. As a result, the model with original factors/variables is not favourable to model

the impact of depreciation on offices in the City of Kuala Lumpur.

(ii) *Model with orthogonal or transformed factors*

The rental depreciation model for 1996 is developed with seven orthogonal factors.

$$DepR_{96} = 15.61 - 5.203(BldgQty) - 3.438(EffSize) - 1.557(DesLay) - 3.143(Locat) - 1.947(Compl) - 1.587(Facil) - 1.515(Parking)$$

In order to link the factors to the classification of sources identified earlier, the discussion in this section begins with factor classification.

Classification: In the earlier discussion, the sources of depreciation can be classified into physical deterioration, site obsolescence and building obsolescence. In Md Yusof (1999 and 1999a), it is suggested that physical deterioration is related to the normal wear and tear of mechanical and electrical systems. The rate of deterioration depends on the level of use and the quality of the materials used. In the analysis, the components 'BldgQty' and 'SizeEff' can be classified as physical deterioration-related factors. 'Deslay, Facil and Parking' can be building obsolescence factors. Nonetheless, it is important to realise that this is not an ultimate classification, as 'SizeEff' and 'BldgQty' may also indicate building obsolescence and vice-versa. The only possible difference between them is that physical deterioration is concerned with wear and tear but obsolescence is more related to qualities correspondent to changes in demand. In the study, site obsolescence is described by 'Compl' and 'Locat'. These factors can be used to show the relative impact of site obsolescence.

b) Variables inclusion

The model incorporates multiple variables which are different from Sykes (1984), Harker (1985) and Salway, (1986). In these studies, 'Age' is the only explanatory

variable. The first factor entered into the equation is 'Building Qly'. With a statistical significance of 0.000, the 'BldgQty' explains 32.2 per cent of variation in rental depreciation for the selected offices in the City of Kuala Lumpur in 1996. This further shows that rental depreciation was reduced by 5.2 per cent with an increase in one unit of 'BldgQty', as shown in the rental depreciation model.

A 15.2 per cent of variation in DepR is caused or explained by 'SizeEff'. Here, the size of the space and the level of efficiency offered by the property influence more than 15 per cent of office rental depreciation. In other words, high-rise buildings with efficient services are preferred and, therefore, a higher rental could be expected (hence low rental depreciation). In the model, an increase in one unit of 'SizeEff' decreases rental depreciation by 3.4 per cent.

Additional variables such as 'Locat' and 'Compl' explain further variation in rental depreciation. Although the contribution of each component is still considered to be significant, it is obvious that as more variables entered equation, the marginal contribution of each factor decreased steadily. The role of each factor in minimising depreciation becomes less. Exhibit 2.0B summarises the contribution of factors in the model.

The above discussion shows that with seven factors or components, 73.8 per cent (adjusted to 69.1 per cent) of variation in rental depreciation in 1996 is explained. The remaining 26.2 per cent (30.9 per cent as adjusted) is due to factors which were collected but are not in the equation or were not collected or observed during the proforma survey. This includes micro aspect of location, which could explain further variations in rental and consequently, depreciation.

c) Violations checking

The model is checked for any violation that may result in any inconsistent findings. The following have been undertaken:

Heterogeneous Variance: It is always assumed that errors of variance of regression models are homogeneous. The assumption of a homogenous error of variance, as suggested by Myers (1989) is often violated in practical situations. This occurs because as the number of either dependent or independent variables increases, variation around the trend of fitted models becomes larger. To investigate if the error variance is homogenous, One-Way ANOVA was performed and is discussed. With the one-way test of equality of variance, the hypothesis is that all residuals from which the random samples are taken must not only be normal but must also have the same variance. Here, if the significance levels are relatively large, the hypothesis that the populations have the same variance cannot be rejected. In case of rental depreciation, the result of the test indicates a significance level of 0.2022. This means the hypothesis that variances are the same cannot be rejected. Thus, for the model there was no danger of violation in terms of equality of variance.

Non-normal error: In regression analysis, the error is assumed to be normally distributed. Kolmogorov-Smirnov and Shaphiro-Wilks tests check the normality assumption. Again, although it is possible to test normality using a histogram of standardised residual to visualise the error distribution, it has poor resolution in the tails or wherever data are sparse.

The Kolmogorov-Smirnov test is used to test how well a random sample of data fits a particular distribution (Uniform, Normal and Poisson). It is based on the comparison of the sample cumulative distribution function to the hypothesised cumulative distribution function. If the D statistic is significant, then the hypothesis that the respective distribution is normal should be rejected. The result of the test indicated high significance levels, D -statistics for rental depreciation model (0.9379) suggesting that error terms for the models are normally distributed. The normality error distribution was further

justified by a high significance value of Shapiro-Wilks as another test of normal distribution. The Wilks statistics are 0.5327 for rental depreciation and the result of the test proved that the error for the model is normally distributed.

Outliers: Outliers are problems of individual data points that do not fit the trend set by the rest of the data. The model violations may produce a suspicious data point on two occasions: (i) there is a breakdown in the model at the i^{th} point, producing a location shift, $E(e_i) = D_i \neq 0$, which is known as the mean shift outlier model, and (ii) there is a breakdown in the model at the i^{th} point and $\text{Var}(e_i)$ exceeds the error variance at the other data locations. In the statistical package, the outliers cases are those with residual of greater than ± 3 . However, in this study, a standard deviation of ± 2.5 has been used as well as ± 3 . There were no outliers for DepR in both, ± 2.5 and ± 3 , standard deviations used.

Appropriate statistical tests have been performed to detect any violation in the model. There is no evidence to suggest that violation exist in the model thus it is robust to explain depreciation based on the information collected.

Conclusion

The analysis of rental depreciation indicates that for the selected Kuala Lumpur offices, the level of depreciation ranged from 1.2 per cent to 33.6 per cent in 1996. The study shows that the level of risk associated with the city's offices is a function of changes in demand for and supply of better quality offices. The study of decline or loss in value, in terms of rental was undertaken in 1996, aimed to explain the impact of depreciation based on three sources of depreciation; physical deterioration, building obsolescence and site obsolescence. Although the attempt to model each factor separately has not been successfully undertaken, the hedonic price

model shows that physical deterioration and building obsolescence have been the major causes of depreciation for offices in the City of Kuala Lumpur. This, nonetheless, does not negate the importance of site obsolescence in the city's office depreciation. When the offices are considered based on location, the analysis shows less systematic influence of the site factor but there is scope for cancelling the severe impact of building obsolescence and deterioration for offices in the Golden Triangle Area only, as the impact of site obsolescence was low.

The study indicated that Kuala Lumpur office depreciation is greatly influenced by differential in building characteristics. The differences are attributed to variations in construction technology to respond to changes in working styles. The requirements of office occupiers changed over the 1980s where demand for modern offices became significant. The finding of this study is similar to some tenant's survey (for example, Valuation and Property Services Department, 1992) where the building components were rated above location or site-related variables. This indicates that the role of site becomes less dominant as evident from hedonic pricing for site related factors, which are less significant, compared to those related to building. It was found that good location might not necessarily lower the level of depreciation. However, the combination of good location and good buildings may reduce the impact of rental depreciation.

The study has been repeated using data on performance in 1998. Surprisingly, based on information in 1998, building characteristics have been identified as factors that explained large variations in rental depreciation. Despite weak market in 1998, the trend to occupy better offices (termed as intelligent offices) is still significant. In conclusion, this preliminary study requires more rigorous information on property-specific characteristics and its performance.

EXHIBIT 1.0**A LIST OF VARIABLES IN THE STUDY**

Labels	Description
1. Ac_sys	Air-conditioning system in the building. The variable is measured by score with higher values for better and modern systems
2. Ac_fl	The variable indicates whether the air-conditioning system is equipped with the latest feature of system: Variable Air Volume. The score is indicated by Yes or No
3. Access	The variable used to describe the accessibility of the property from the main road and public transport
4. Age	Age of the building
5. DepR	Annual Depreciation on Rent.
6. DepY	Annual depreciation on Yield
7. Bas	Explain the state of the Building Automation System of the building. Modern or best system denoted by higher scores.
8. Bay	Number of parking spaces provided in the building.
9. Bay_rate	Indicates percentage provision of parking spaces based on floor area and space ratio.
10. Bi_spac	The biggest space occupied by single tenant in the building
11. Bigs_ten	Number of bigger tenants occupying space of 5,000 square feet and above
12. Ce_high	Measured floor to ceiling height, more or less than 10 feet
13. Comm	Telecommunication system in the building
14. Cm_ref	Shows whether facility of Common Refreshment area is available in the building
15. Conf	Conference hall or room in the building
16. Cr_fin	The state of architectural finishes of lift car
17. Dine	Dining facility
18. Ex_fin	External finishes of the building
19. Fn_com	Tenant Profile - Finance Companies
20. Fire	Fire Prevention System of the building
21. Fl_area	Gross floor area of the building, denoted by several categories.
22. Fl_fin	Building floor finishes
23. Gen-com	Type of the ownership - general commercial
24. Govtagen	Tenant Profile - Government Agency
25. Gym	Gymnasium facility
26. Int_car	Car interval movement
27. Lascap	The state of landscape in the building
28. Ld_area	Land area of the property
29. Lif_car	Number of lift cars
30. Lif_con	The control system for the lift
31. Locat	Location of the property - Three commercial areas in Kuala Lumpur used
32. Mj_Inst	Type of ownership - Major institution
33. Numten	Number of tenants in the building

34.	Occrate	Occupancy rate of the building
35.	Owrel	Relationship to owner
36.	Plratio	Plot ratio of the property
37.	Profser	Tenant Profile- professional service
38.	Prox	Proximity to other uses such as retail
39.	Rd_fr	Is the property is situated on road frontage
40.	Re_count	The state of Reception counter in the building
41.	Refur	Any refurbishment undertaken
42.	Rnt_rev	Rent review interval
43.	Schrg	Service charge, measured as fraction of gross rent
44.	Security	Security system of the building
45.	Sp_utl	The space utilisation (Column free, etc.)
46.	Spd_car	The speed of the lift cars
47.	Stck-br	Tenant Profile -Stock broker
48.	Stry	Number of storeys
49.	Trdagen	Tenant Profile - Trade agent
50.	Ty_bay	Type of bay provided in the building
51.	Ty_con	Type of construction - Modern, Transitional or Traditional
52.	Use_lev	The intensive use, based on type of business and number of tenants
53.	Wait_car	The average waiting time during peak hours

EXHIBIT 2.0**A SUMMARY OF STEPWISE SELECTION**

DEPENDENT VARIABLE: DepR

Multiple R 0.91026

R Square 0.82858

Adjusted R Square 0.79249

Standard Error 4.08027

Variable	B	SE B	Beta	Tolerance	VIF	T	Sig T
Age	0.3404	0.138	0.245	0.457	2.189	2.465	0.0183
Bay-Rate	-2.0231	0.862	-0.187	0.789	1.267	-2.477	0.0178
Ex_fin	-1.0167	0.587	-0.172	0.457	2.184	-1.732	0.093
Fl_Fin	-2.535	0.571	-0.332	0.855	1.169	-4.437	0.0001
Pl_Rat	-0.557	0.252	-0.171	0.754	1.329	-2.215	0.0328
S_Chrg	-21.492	4.06	-0.452	0.617	1.621	-5.289	0.0000
Stry	-0.161	0.078	-0.184	0.573	1.744	-2.073	0.0450
Ty_con	2.717	1.052	0.260	0.443	2.253	2.582	0.0138
Constant	49.273	5.116	-	-	-	9.631	0.0000

Notes:

- 1) B is registered coefficient - the relative importance of variables
- 2) SE B is Standard Error of Coefficient
- 3) Beta is the standardised regression coefficient
- 4) Tolerance - Variance of Estimators
- 5) VIF - Variance Inflation factor
- 6) T - statistic
- 7) Sig T - observed significance level

EXHIBIT 2.0B

A SUMMARY OF MULTIPLE COMPONENT REGRESSION ANALYSIS

DEPENDENT VARIABLE: DepR

Multiple R 0.85893

R Square 0.73776

Adjusted R Sq 0.69069

Standard Error 4.98157

Analysis of Variance

DF Sum of Squares Mean Squares

Regression 7 2722.80374 388.97196

Residual 39 967.82435 24.81601

F = 15.67424 Signif F = .0000

Variable	B	SE B	Beta	Tolerance	VIF
(Fac1-BldgQty)	-5.203	0.741	-.576	-.7.016	.0000
(Fac2-FffSize)	-3.438	0.729	-.387	-.4.718	.0000
(Fac3-DesLay)	-1.557	0.720	-.177	-.2.164	.0366
(Fac4-Locat)	-3.143	0.727	-.355	-.4.323	.0001
(Fac6-Compl)	-1.947	0.728	-.219	-.2.674	.0109
(Fac7-Facil)	-1.587	0.733	-.178	-.2.167	.0364
(Fac8-Parking)	-1.515	0.720	-.172	-.2.014	.0419
Constant	15.614	0.728		21.452	.0000

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Strategies to Revitalise the Securitised Property Industry in Malaysia*

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Abstract

Malaysia is the first Asian country to develop listed property trusts in 1989. However despite an eleven year lead in the industry, the development of the listed property trust industry has been slow. Currently only four property trusts are listed on the Kuala Lumpur Stock Exchange. Three of the property trusts are listed since 1989 with the fourth listed in 1997. Despite regulatory changes by the authorities that allow greater investment flexibility, property investment portfolios of existing trusts have not expanded in a significant manner.

The purpose of this paper is to examine the development of listed property trusts in Malaysia and discuss the problems faced by the listed property trust industry. Suggestions to improve the industry encompass measures to enhance supply and demand for listed property trust units from investors. In addition, recommendations to make listed property trusts a more attractive investment option are also suggested.

Keywords: listed property trust, unit holding analysis, demand and supply

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Introduction

Efforts to start a property trust began way back in 1984, when the Association of Merchant Banks Malaysia submitted a comprehensive paper to the relevant authorities on the feasibility of setting up property trusts in Malaysia. The Malaysian authorities were receptive to the new investment concept as property trusts are able to mobilise the investment of surplus funds in order to develop, diversify and deepen the capital market. A regulatory framework that allows property trusts to be set up and operate was subsequently set in place (Kang 1989 and Gumley 1989).

However the poor state of the property market in 1984/5 had hindered the introduction of property trusts to the capital market. The economic recovery in 1986/7 and a steady economic growth in 1988 paved the way for the launching of property trusts in 1989. At that time five financial institutions including two merchant banks had been given approvals in principle to establish property trusts in Malaysia.

Amanah Hartanah PNB (AHP) was the first property trust launched in Malaysia as an unlisted property trust when it made an offer for sale of its units on 21 March 1989. The successful launch of AHP was followed by the first listed property trust i.e. the Arab Malaysian First Property Trust with its listing debut on the Kuala Lumpur Stock Exchange (KLSE) on 23 November 1989 with an initial fund size of 135 million units and a market capitalisation of RM180.9 million as at 31 December 1989.

Development of the Malaysian Listed Property Trust Industry

The development of the Malaysian listed property trust industry has been lethargic. The number of listed property trust funds has remained the same from 1989 to 1996 i.e. Amanah Hartanah PNB (AHP), Arab-

Malaysian First Property Trust (AMFPT) and First Malaysian Property Trust (FMPT). The fourth listed property trust fund, Mayban Property Trust Fund One (MPT) was listed in 1997.

Today the listed property trust industry constitutes less than 0.1% of the KLSE market capitalisation.

Property trust managers had commented that the property trust industry is over regulated by the *Guidelines on Property Trust Funds* 1991 issued by the Capital Issues Committee, Ministry of Finance (Azim 1992, 1993). The restrictions imposed by the Guidelines are related to property acquisition, disposal, development and borrowing limit. The restrictive provisions of the Guidelines relating to property acquisition had prevented property trust funds from expanding their investment portfolios through new property acquisitions. Subsequently promoters and managers of trust funds had sought major reviews of the Guidelines from the regulatory authorities particularly the Securities Commission.

A revised *Guidelines on Property Trust Funds* were issued by the Securities Commission on 26 June 1995 incorporating amendments relating to property acquisition, property disposal, property development and borrowing limits. The revised guidelines were well received by the property trust managers (Azim 1995).

The amendments have enabled property trust funds to acquire properties more easily by providing more options and flexibility in property acquisitions. In particular, property trusts can now acquire property interests such as:-

- (a) strata properties;
- (b) equities of real estate companies;
- (c) properties in foreign countries; and
- (d) properties such as office buildings which are not fully tenanted but having the potential of achieving full occupancy.

The wider property acquisition options were supported by corresponding changes in financing and borrowing methods.

Despite the 1995 revisions to the *Guidelines on Property Trust Funds* 1991, the industry has remained stagnant. The greater flexibility allowed under the *Guidelines on Property Trust Funds* 1995 on property acquisition and financing have not spurred listed property trusts (LPTs) to be more active in the local property investment scene. Property investment portfolios of existing LPTs have not expanded in a significant way.

In the case of FMPT, the property acquisitions from 1994 - 1997 were reinvestments of the proceeds from the sale of its flagship property investment, Plaza MBF in 1994. FMPT took advantage of the relaxation in the Guidelines and made a foreign property purchase in 1996 of a warehouse-cum-showroom in Victoria, Australia.

The ten property acquisitions by AHP from 1995 - 2000 were small properties comprising nine 3 to 4 storey shop-office premises and one office building.

The property acquired by Mayban Property Trust in 1996 was a medium size 9¹/₂ storey office-building owned by the Malayan Banking Group.

In short, the revised Guidelines 1995 have not made a positive impact on the property trust industry and there are impediments that prevent property trust managers from taking full advantage of the provisions under the Guidelines (Ting et al, 1998).

Tharmalingam (1999) commented on the long time period to obtain approvals for the purchase of property from the regulatory authorities. Tharmalingam also noted that local investors perceive LPTs as unexciting investments with limited or no growth potential compared to shares.

An opinion survey was conducted in 1998 on CEO Property Managers of LPTs. The findings showed that the constrained expansion of existing property portfolios was due to the following factors (Ting 2000):-

- Lengthy capital market requirements in raising capital for property acquisition. The acquisition bid from a property trust is conditional on approval by the Securities Commission. The acquisition may take more time to complete compared to another buyer.

The vendor may also face uncertainty in the selling price as the price may be adjusted downwards by the Securities Commission.

- Restrictions in bank borrowings to a maximum of 10% of the gross assets of the fund by the Securities Commission's *Guidelines on Property Trust Funds* 1991 and 1995.
- Poor investor perceptions of property trust investments.
- The lack of interests from institutional investors.
- Properties available for acquisitions are providing low yields.

Feedback from the CEO Property Managers indicated that the following factors had hindered the launching of more property trust funds in Malaysia (ibid):-

- Competing investment alternatives (e.g. initial public offerings (IPOs) and unit trust funds). In the past, IPOs on the KLSE have achieved high premiums upon listing resulting in high capital gains by stags. Property trusts which have a trust structure are not allowed to speculate and are viewed as defensive stocks offering stable returns and prices;
- poor investor perceptions on property trust investments;

- restrictive Securities Commission's *Guidelines on Property Trust Funds*;
- the lack of demand from institutional investors; and
- too few institutional investors.

Characteristics of Malaysian Listed Property Trusts

The currency crisis which began in July 1997 has revealed LPTs as a viable investment option that is able to provide a steady stream of dividend distributions despite the currency turmoil and the subsequent economic and property downturn. The LPTs have survived the 1998 stock market crash as none has faced corporate failures. Prior to the currency crisis, the income distributions and net tangible assets of LPTs have been growing steadily (Ting 1999).

Table 1: Income Distribution of Listed Property Trust in Malaysia (%)

YEAR	AHP	AMFPT	FMPT	MPT
1989	5.50	4.99		
1990	6.50	5.75	4.54	
1991	7.20	7.70	5.68	6.09
1992	8.24	10.00	6.82	5.80
1993	12.00	11.00	7.18	6.30
1994	12.25	10.58	6.72	6.30
1995	12.25	11.10	6.24	7.07
1996	12.50	11.50	6.92	7.58
1997	7.00	11.50	6.67	7.50
1998	6.00	8.00	5.11	7.00
1999	6.50	8.00	0.50	4.43
2000	6.00	7.00	0.00	4.32
Mean	8.5	8.9	5.1	6.2
Std deviation	2.86	2.31	2.55	1.15

Source: Annual Report of LPTs (1989 - 2000)

The income distributions of LPTs have reduced after the currency crisis and downturn in the commercial property market. However, the post crisis average gross yields from December 1998 to December 2000 for three of the LPTs are 6.3 per cent to 9.6 per cent which are above the savings and fixed deposit rates. The average dividends declared for the same period range from 5.3 per cent to 7.7 per cent.

Table 2 shows the portfolio characteristics of the LPTs.

Table 2: Characteristics of Malaysian Listed Property Trusts (December 2000)

Property Trust	KLSE Listing	Total assets (RM-Ringgit)**	Level of Property	Number of Properties	Property Portfolio composition (by property type and location)
Arab Malaysian First Property Trust	Sept 1989	RM188m	95%	2	Office (100%) Kuala Lumpur (100%)
First Malaysian Property Trust	Nov 1989	RM96m	59%	6	Office (43%) Industrial (44%) Retail (7%) Hotel (6%) Kuala Lumpur (41%) Australia (25%) Others (34%)
Amanah Harta Tanah PNB	Dec 1990	RM155m	81%	12	Office (93%) Retail (7%) Kuala Lumpur (93%) East Malaysia (3%) Others (4%)
Mayban Property Trust Fund One	March 1997*	RM121m	76%	5	Office (100%) Kuala Lumpur (40%) Others (60%)

* - previously an unlisted property trust from August 1990 - February 1997

** US\$1 = 3.8 Malaysian Ringgit (December 2000)

Dynamics of investments in Malaysian Listed Property Trusts: Unit holders and unit holding analysis

The major unit holders of the LPTs are bank/financial groups and fund management companies (Table 3).

Table 3: Major Unit Holders of LPTs in Malaysia (December 2000)

Listed Property Trust	Major Unit holder	Unit holding (31.12.2000)
AHP	PNB	42.98%
AMFPT	AMMB Holding	43.49%
FMPT	Sistem Televisyen Malaysia Bhd	70.70%
MPT	Malayan Banking Group	

Source: Annual Report of LPTs

Overall, the number of large unit holders has not changed significantly. However, there is a noticeable fluctuation on the number of small unitholders of the 1 -5,000 unit category (Fig.1) which varies with the investment climate. The figure shows a steady increase in the number of small unitholders since the 1993 stock market bull. However the number

of investors started to decline when the currency crisis and the subsequent economic recession caused an increase in vacancy rates and drop in rental and capital values in the commercial property market. This has resulted in a decrease of unitholdings of small unit holders.

Fig.2 shows that the unitholdings of large unitholders (more than 10,000 unit category) have increased slightly since the currency crisis. This showed that large investors were attempting to move into investments which could provide steady income. The increase in unitholdings of large investors comes from the decrease in unitholdings of small unitholders.

However, the increase in unitholdings of large unitholders is not from institutional investors as their holdings were constant over the period (Fig.3). The increase in unitholdings of large unitholders were attributable to the high net-worth individuals.

The unitholders analyses further confirm the lack of participation of institutional investors in property trust investments.

Institutional Investors and Property Investments

Institutional investors in Malaysia comprise statutory and private provident funds, pension funds, insurance companies and unit trust funds. The major institutional investors in Malaysia i.e. EPF, PNB, LUTH, SOCSO and LTAT, collectively own about RM250 billion in assets. These top five institutional investors have invested in equities totalling an estimated RM73.6 billion in KLSE accounting for about 17 per cent of the KLSE market capitalisation of RM444 billion.

Pension funds and insurance companies have not played a significant role in the development of the listed property trust market. Statutory requirements have prevented them from being significant institutional investors in the LPT market and direct property market.

Table 4: Total Asset of Major Institutional Investors in Malaysia (June 2000)

Institutional Investors	Estimated Total Assets (RM billion)	Estimated investment in KLSE (RM billion)
EPF	172.5	50.5
PNB	58.0	15.5
LUTH	8.6	2.5
SOCSSO	8.3	1.4
LTAT	4.8	3.7

Note : EPF - Employees Provident Fund
 PNB - Permodalan Nasional Berhad
 LUTH - Pilgrims Fund Board
 SOCSO - Social Security Organisation
 LTAT - Armed Forces Fund Board

Source: Malaysian Business 1st December 2000

Property investments of these institutional investors are made mostly via shareholdings in listed property companies on the KLSE. Property development is the main activity of most of these listed property companies.

The majority of the investments of provident and pension funds are invested in corporate securities, government securities, cash and bank deposits.

Table 5: Composition of Assets of Provident and Pension Fund in Malaysia

Investment	1988 (%)	1998 (%)
Corporate securities	6	32
Government securities	81	27
Cash & bank deposits	4	26
Debentures & loans	4	13
Others assets	5	2
TOTAL	100	100

Source: Bank Negara Malaysia (2000) *The Central Bank and the Financial System in Malaysia - A Decade of Change* Bank Negara Malaysia Publication

EPF is the largest provident fund in Malaysia with its members accounting for 96 per cent of the total workforce in the country. The low level of property investment is due to its asset allocation policy whereby EPF can invest only up to 5 per cent of its fund in the property sector. Currently EPF's investment in the direct property sector is about RM860 million. EPF's property investments comprise mainly commercial properties functioning as branch offices for EPF in various states.

**Table 6: EPF Asset Allocation for 1997 - 2000
(at cost)**

Investment	1997	1998	1999	2000
Malaysian Government Securities	29.4	31.3	31.6	34.1
Loans & Bonds	25.9	26.1	24.6	20.8
Money Market instrument	25.0	23.9	24.4	22.9
Shares	4	26		
Property	19.3	18.3	19.0	21.8
Property	0.4	0.4	0.4	0.5
TOTAL	100.0	100.0	100.0	100.0

Source: Nanyang Siang Pau 7 March 2001

Compulsory investments in public pension/provident funds have crowded out private investments in other insurance and pension schemes and have hindered the development of a private pension fund industry. To a certain extent, public pension/provident funds through voluntary and forced savings have also crowded out potential individual investments in the LPT market. The majority of the pension funds accumulated captive investments as they are invested in government securities.

There are a total of 127 approved unit trust funds with a total size of 90.351 billion units and a net asset value of the funds totalled RM43.3 billion which stands at 9.74 per cent of the KLSE market capitalisation of RM444.5 billion at the end of year 2000. There are 34 unit trust management companies currently operating in Malaysia.

Although the unit trust industry has grown significantly since 1990, unit trust investments in LPTs are negligible (as shown in Fig. 3).

Table 7: Market Capitalisation of Property Trust and Unit Trust Sector versus KLSE 1996 - 2000 (RM billion)

Investment	1996	1997	1998	1999	2000
KLSE	806.7	375.8	374.5	537.0	444.5
Listed Property Trust	0.54	0.26	0.34	0.38	0.27
Percentage of listed property trust to KLSE market capitalisation (%)	0.067	0.069	0.091	0.071	0.061
Unit Trust	60.0	33.6	38.7	43.0	43.3
Percentage of unit trust to KLSE market capitalisation (%)	7.44	8.94	10.33	8	9.74

Market Potential for Further Expansion of Property Trusts

There is no shortage of investment grade properties in the Kuala Lumpur property market. The active construction and property market have built a large number of office, retail, hotel and industrial properties in the Kuala Lumpur conurbation. Investment quality properties are available for further expansion and establishment of more property trust funds (refer Table 8).

However, despite the availability of investment grade properties, LPTs are unable to make property acquisitions due to weak stock market sentiment, weak rental and oversupply of commercial properties (refer Table 9 and 10).

Table 8: Office Buildings by Floor Size in Kuala Lumpur

Net Floor Area	%
Less than 20,000	73
20,000 to 50,000	25
More than 50,000	2
Total	100

Source: Kuala Lumpur City Hall (DBKL)

Table 9: Existing Supply and Occupancy Rate of Purpose-Built Office Buildings in Kuala Lumpur (Q2 2000)

Area in Kuala Lumpur	No of Buildings	Total Space (sm)	Occupancy rate (%)
Golden Triangle	43	882,409	73
Jalan Ampang	25	1,032,210	75
Central Business District	87	1,109,324	86
Within city centre	111	1,392,503	76
Suburban	73	1,266,505	73
TOTAL	339	5,682,951	77(mean)

Source: Kuala Lumpur City Hall (DBKL)

Table 10: Incoming Supply of Office Space in Kuala Lumpur (Q2 2000)

Area in Kuala Lumpur	Completion Incoming supply (sm)			
	No. of building	Total Space (sm)	No. of building	Total Space (sm)
Golden Triangle	1	38,090	4	62,995
Jalan Ampang	1	19,044	4	81,839
Central Business District	0	0	7	315,868
Within city centre	2	48,797	13	320,952
Suburban	9	175,678	20	948,070
TOTAL	13	281,609	48	1,729,724

Source: National Property Information Centre (NAPIC)

Prospects for the Listed Property Trust Industry

The listed property trust industry is expected to benefit from the following market developments:-

a. The Capital Market Master Plan

In its recently released Capital Market Master Plan in February 2001, the Securities Commission (SC) will introduce a framework for the issuance of asset-backed securities to offer a financing alternative for companies with good assets. To facilitate asset securitisation, the following areas will be looked into:-

- (i) to further clarify and make transparent the tax position surrounding securitisation structures to ensure consistency of treatment; and
- (ii) to administratively rationalise the application of other regulatory requirements imposed by various regulatory bodies.

The existing taxation framework, the stamp duty and real property gains tax on transactions relating to the issuance of asset-backed securities will be removed to encourage asset securitisation.

b. The growth of the unit trust industry

The unit trust industry has grown considerably over the same period compared with the LPT market. The proliferation of unit trusts will contribute towards the greater demand for LPT units particularly from income unit trust funds which are interested in investing on investments providing a steady stream of dividend income.

c. The consolidation and mergers of banking groups

Banks in Malaysia have undergone mergers to form ten major banking groups. Property assets owned by the banking groups could be securitised as LPTs on the KLSE.

- d. The development of the financial planning industry will facilitate demand for LPT units to meet the investment objectives of investors.

Future Directions

The potential of the Malaysian property trust industry has yet to be fully realised. It is pertinent that interests in the listed property trust industry are revived and given a new lease of life as property securitisation in the form of listed property trusts provides a key solution to the current oversupply of commercial properties. The large supply overhang needs to be cleared to lessen the drag on the recovery of the Malaysian economy.

The failure of the secondary market to take off comes down to two major issues - demand and supply. The low trading volumes of listed property trust units on the KLSE reflect the lack of demand from institutional investors. Institutional investors who are keen to invest in LPT are few.

The lack of demand has impeded the formation of new LPTs and issuance of more LPT units by existing LPTs. This vicious cycle has existed despite the revisions to the LPT Guidelines.

The following suggestions are made to improve the supply and demand of listed property trusts as an attractive, viable and profitable indirect property investment vehicle in Malaysia:-

• Increase the supply of listed property trusts units

- a. Review on regulatory structures and policies on the setting up of new property trusts.

The successful creation of a property trust market requires the establishment of infrastructure and policy framework which are conducive to the setting-up of more property trust funds, secondary market trading and market development.

The regulatory framework should be facilitative and efficient. Under the existing Guidelines, sponsors of LPT must be financial institutions. This requirement should be reviewed to allow more opportunities for other Malaysian entrepreneurs to set up more property trusts. This would also allow developers and listed companies which have quality property portfolios to be launched as LPTs e.g. Tan & Tan, Country Height and YTL Group etc. This could provide the needed push to the industry as property trusts with quality portfolios are introduced into the market.

b. Danaharta

Danaharta, the Malaysian national asset management company, was set up to help solve the problems of non-performing loans (NPLs) in the banking system. Due to its roles, Danaharta will be one of the largest direct property owners in Malaysia. One exit strategy that can be adopted by Danaharta is through asset/property securitisation.

Danaharta could float more than one property trusts or launch sector specific property trust funds. By launching the new trust funds during property market trough and with appropriate timing of listing on the capital market, it would attract investors interests as there will be potential for high yields and capital appreciation in the longer term. Coupled with well diversified property portfolios, Danaharta would help to revive interests in the listed property trust industry.

c. Setting up Benchmark Performance Measures

Property performance benchmarks are lacking in Malaysia. For direct property, the only performance

measure available is the Malaysian House Price Index for the residential sector prepared by the National Property Information Centre (NAPIC).

Table 11: Property Performance Measures in Malaysia

Property Investment	Performance	Notes
Direct property	Malaysian House Price Index	Capital return only
Indirect property	Property Sector Index (KLSE)	Capital return only
	Hotel Sector Index (KLSE)	Capital return only
	Plantation Sector Index (KLSE)	Capital return Capital return

It is noted that NAPIC is currently in the process of coming out with more indices, in particular office performance indices.

No index is currently available for LPTs listed on the KLSE. The creation of a new listed property trust index by the KLSE would greatly enhance the level of visibility and comparability of LPT with other sectors of the KLSE.

The absence of LPT index has deprived investors of the opportunity to compare risk and return of LPT with other investment options.

Total return indices including KLSE indices are not available in Malaysia. A total return LPT index could be easily created to allow comparisons of LPTs with shares and Government bonds.

d. Creating sector specific LPTs

By relaxing regulations on LPT promoters, corporate groups with sector specific properties (e.g. retail, office, leisure/tourism) can seek listing as LPT. This process will create sector specific LPT. Investors would then

have the opportunity to invest in buoyant property sectors and to benefit from property managers who have specialised management skills in managing such properties.

Once such LPTs are created, it would provide attractive property investment opportunities. As such property portfolios are unlikely to be duplicated. And the only way to own such properties or a portfolio of properties is to buy into the LPT concerned.

- **Increase the demand for listed property trust units**

- a. To allow EPF contributors to invest in LPT

EPF contributors have been allowed to invest in approved unit trusts. Designating LPTs as allowable investments by EPF would greatly increase the demand for LPT units as investments.

- b. Foreign investors

Restrictive regulations on foreign investors in the past e.g. Foreign Investment Committee (FIC) requirements, unfavorable Real Property Gains Tax and inconsistencies in regulations/policies on property have reduced the attractiveness and competitiveness of property investment in Malaysia.

This has exacerbated the lack of demand from foreign investors who could provide the support and stability to the Malaysian property investment market.

Allowing foreign investors to own up to 49 per cent of the total unit holdings of a property trust fund would create greater demand for LPT.

- c. Educate the investors

The investing public should be educated on the roles of property trusts in investment strategy and portfolio allocation.

The investors should understand what drives the market prices of listed property trusts and how the performance is related to the property market, stock market, bonds and interest rates. A high yield LPT would serve as an alternative to savings and fixed deposits.

A campaign can be carried out to educate the public on the use of LPT as an alternative investment vehicle to property investment.

- d. More institutional investors

As more unit trusts are formed the investing institutions would create greater demand for more LPT units. LPTs offer liquidity and this would allow unit trusts to rebalance their investment portfolios according to their investment needs.

- **Making listed property trust investments more attractive**

- a. Tax-exempt status

One major factor contributing to the growth of property trusts in Australia and USA is the tax-exempt status of the property trusts. Property trusts in the United States, Australia, Canada and Switzerland (Pietra 1991) distribute all income and capital gains annually to the unit holders in order to benefit from the tax-exempt status as provided by the laws. A similar tax-exempt status would put property trusts in Malaysia on a similar footing with the international counterparts where income to unit holders is taxed in their hands.

Currently, LPTs in Malaysia do not enjoy any tax advantage. The LPT is taxed at the corporate tax rate (26 per cent) before payment is made to unit holders. Tax-exempt distributions would avoid the current double taxation of distributions and it would attract investor interests as income in the investors hands will be higher. In this regard co-operations from the Inland Revenue Department and other regulatory authorities are necessary to make this tax-exempt status possible for listed property trusts.

- b. New framework and guidelines from the Securities Commission (SC)

It is unfortunate that the LPT sector is left untouched by SC in the Capital Market Masterplan. SC should come out with a new framework and guidelines that could facilitate the development of the LPT industry.

- c. Renaming of listed property trusts to real estate investment trusts (REITs)

To remove the stigma of the existing property trusts, upon the granting of tax-exempt status, listed property trusts should be re-launched as REITs so as to be identified as comparable to the REITs in the USA.

- d. Attractive high dividend yield

Current dividend distributions of the LPTs have provided a reasonable yield compared to savings and fixed deposit rates. Given the current low savings and fixed deposit rates environment, an attractive high dividend yield of 8 - 10 per cent from the listed property trusts and further supported by tax exemption on earnings would be a compelling reason for investors to invest in listed property trusts.

- e. Finite-life property trusts

Under its Deed of Trust, AHP was initially a fixed term property trust to operate for a maximum period of 10 years commencing from 21 March 1989. AHP has shown the viability of the property

trust concept as its net tangible assets has increased from RM1.00 since inception in 1989 to RM1.68 on 31 December 1998. However due to the currency crisis, AHP was not able to terminate and liquidate the trust during the 1997-1998 economic downturn. Instead, the term of the trust has been extended to an indefinite period (AHP Annual Report, 1998).

A finite-life property trust would be more attractive to investors as the trust could devise appropriate exit strategies so that the trust can be terminated and the proceeds could be distributed to the unit holders thereby allowing them to enjoy the capital appreciation of the trust fund's property portfolio and other investments.

- f. Improving liquidity in the secondary market

The LPT market is characterised by low trading volumes and low institutional investors shareholding in LPT. The lack of liquidity in the secondary market is due to a lack of a diverse and active group of institutional investors with incentives to maximise returns on their portfolio.

In this respect the unit trust industry and fund management which is consistently promoted by the Securities Commission will benefit the property trust industry.

In addition insurance companies, pension funds, investing corporations, charitable organisations and other fund managers should be allowed to make a larger portion of the investment assets in real estate to diversify investment risks.

In this regard, tax-exempt dividend distributions will be most welcome by some of these institutional investors.

- g. Information and financial disclosure

A greater level of information disclosure and reporting system on the leases/tenancies profiles, rent

reviews, rental levels and equity investments will provide the greater transparency needed for decision making by investors.

Such information will allow investment analysts to make projections on the future earning potentials of the LPTs.

h. Security/Investment analysis

More analyses and information on LPT should be carried out and disseminated. More security analysts following the LPT sector would further boost the level of confidence of the investing community.

On-going research and a supply of information will stimulate and maintain investor interests.

i. Property acquisitions

LPTs need to expand through property acquisitions to achieve bigger market capitalisations to provide greater liquidity. Large capitalised LPTs is more favoured by institutional investors as small market capitalisations and low trading volumes make trading of the LPT units difficult. Upon reaching a sizable market capitalisation, institutional investors can buy and sell LPT units without affecting its market price.

AHP in particular should continue its portfolio expansion strategy to become the biggest property trust in Malaysia. It should acquire more prime properties (not small secondary properties) to increase its market capitalisation so that no investors could afford not to invest in the property trust.

Conclusions

The Australian LPT market took some 25 years to grow to its current size and the USA REITs market took about 40 years to reach today's market capitalisation. The Malaysian LPT market which has a history of 12 years is a relatively young market. It is interesting to note that Japan and Singapore have set up property trust funds in recent years and other Asian countries such as Korea, India and Thailand are also keen to set up property trust.

The future directions of the Malaysian listed property trust industry rely on changes to regulatory, legal, tax, accounting and funding structures. It is envisaged that these changes will bring forth an increase in the demand and supply for property trusts. More support from the regulatory authorities are required to provide the impetus to the growth and development of the Malaysian LPT industry.

With the implementation and the realisation of the Capital Market Masterplan, the Malaysian LPT industry will be able to benefit from the implementation of its various measures.

Institutional investors could play a more important role in assisting the development of the listed property trust industry. Institutional investors should look into the roles of direct and indirect property in their investment portfolios.

There exist a sufficient number of commercial investment properties in the Kuala Lumpur property market to enable more property trusts to be introduced and existing trusts to expand their property investment portfolios.

With improvements in the supply and demand for LPTs, it is envisaged that LPTs will continue to provide Malaysian investors an investment option which could provide a stable and attractive yield plus long term capital growth.

Fig. 1 : Number of Unitholders in Malaysian Listed Property Trusts (AHP, AMFPT, FMPT, MPT)

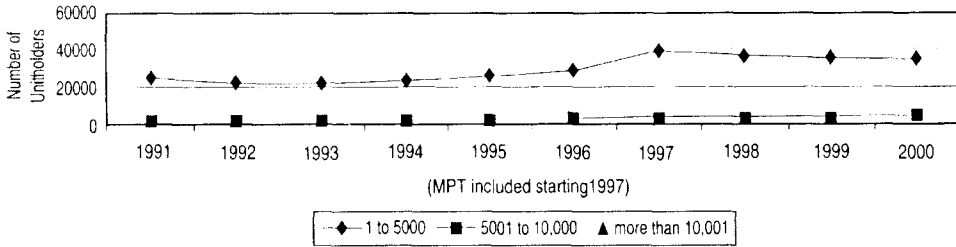


Fig. 2 : Number of Unitholdings by Size of Holdings in Malaysian Listed Property Trust (AHP, AMFPT, FMPT & MPT)

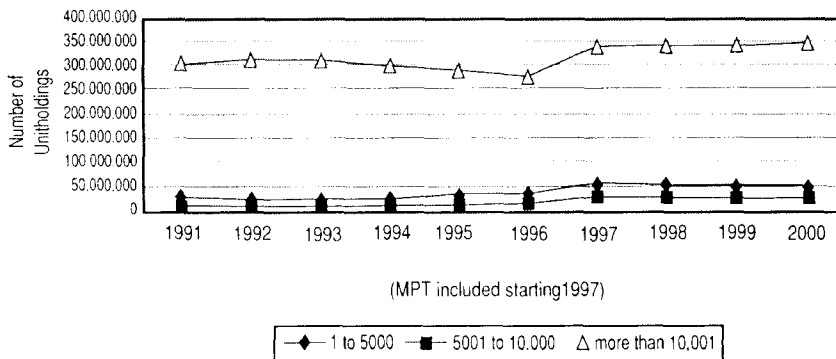
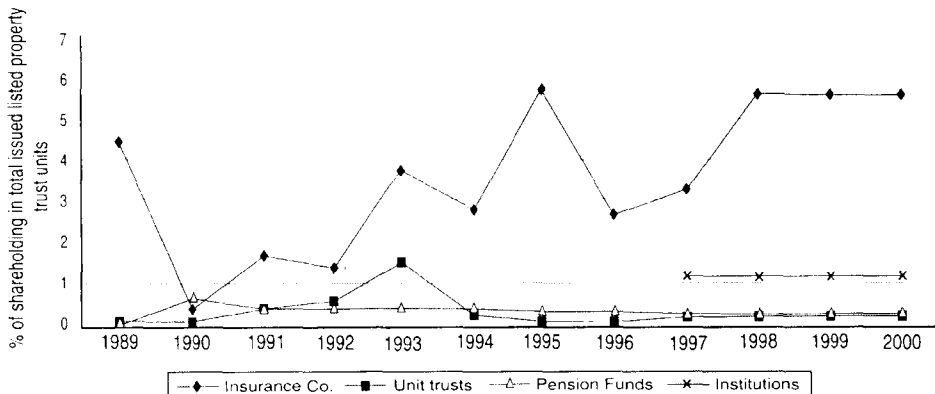


Fig. 3 : Percentage of Unitholding in Listed Property Trusts by Institutional Investors (Dec. 1989 - Dec. 2000)



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The Future of Hong Kong's Residential Market: Polarisation and Segmentation

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Abstract

The objective of this paper is to analyse the possible future changes in Hong Kong's private residential property market. We begin by introducing some background information of Hong Kong's residential market. We then go on to present two possible structural changes in the private residential property market. First, the price differentials between luxury and mass residential properties are anticipated to widen. Second, the price differentials between new and old residential properties are also expected to be more segmented, as the speed of building obsolescence will accelerate due to technological advancement and modification of building control regulations.

Keywords: residential property market, price differentials

Introduction

Hong Kong is a densely populated city, a large number of very similar high-density developments located in a very small urban area. It is a common belief that the performances of the all-private residential properties are very similar, irrespective of their physical characteristics and locations. This might have been the case in the past. However, recently, there seems to be evidence that the residential markets are becoming more segmented (Chau and Lam, 1997). This paper analyses the potential diverging trends in Hong Kong's residential market and examines the implications of such diverging trends.

The local residential units have been officially categorised as five classes according to the size of the units (Rating and Valuation Department, 2001). Table 1 shows the classification of housing units in the private housing sector. Class A units are often referred to as small or mass residential units. They constitute approximately 35 percent of the total number of private residential properties in 2000 (Figure 1). Demand for Class A unit is mainly from end-users who are first-time homebuyers or from the lower income groups. There is very little investment demand for small units, resulting in a relatively inactive rental market. Investors are less willing to purchase small units for four reasons. First, the rentals of small residential units were subjected to rent control until recently (Chau, 1997). Second, leasing smaller units entails a higher risk as tenants of such units are usually individuals from the lower income group and the default risk is relatively higher. On the other hand, tenants of larger units are usually institutions or large company. The default risk of these tenants is comparatively lower. Third, larger units are often located in traditional prestigious residential areas with a pleasant environment that is very much favoured by the higher income expatriate working in Hong Kong. The rental demand for larger units is therefore higher making them a more attractive investment than

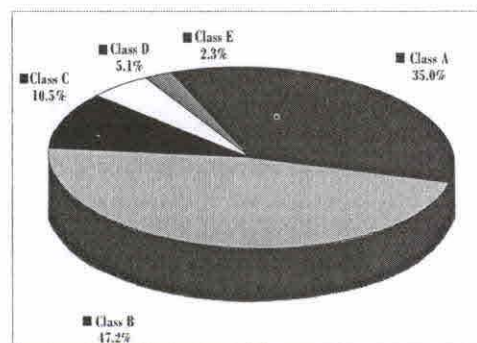
small units. Fourth, the search costs (such as the costs of inspection of unit and collecting information on the nearby environment) for small and large units are similar in absolute terms; therefore the search costs of a small unit relative to its value are higher.

Table 1. Classification of Private Residential Properties by Size (usable floor area)

Housing Class	Size
Class A	<40m ²
Class B	40-69.9m ²
Class C	70-99.9m ²
Class D	100-159.9m ²
Class E	≥160m ²

Source: Rating and Valuation Department. Property Review. Government of the Hong Kong Special Administrative Region, various issues.

Figure 1: Distribution of Private Housing Stock as at the end of 2000



Note: Total number of units 1,026,125

Class D and E units are often referred to as large or luxury units in Hong Kong. They are limited in supply and constitute only approximately 7.4 per cent of the total stock of housing units. Demand for large units is from both the investors and owner-occupiers. Compared with the small units, the proportion of owner-occupier is much smaller for large units. Official figures reveal that the average proportions of newly completed rental-occupied units for Class D and E are 41 and 70 per cent respectively, which are significantly higher than that of Class A units (21 per cent) during the period 1990 - 2000 (see Table 2).

The rental market for large units is much more active than for small units since most employees cannot afford to purchase larger units. Even after the crash in the stock and property market in 1997, the price of a large unit in good location by the mid-1998 was still higher than US\$1,000 per square foot, which was beyond the reach of an average household in Hong Kong.

Compared with the small units, the price appreciation is higher for large units but this sub-sector of the market is more volatile (see Table 3). This is, however, not unique to Hong Kong. Carson and Kiel (1990) have shown that there are significant differences in price appreciation between cities, physical characteristics and even owners' characteristics. In particular, their study suggests that larger houses experience

higher rates of appreciation than smaller ones. In a related study, Smith and Tesarek (1993) have found that during a long boom period in Houston (1970-1985), the real average unit price increased by 27 per cent for high quality houses while the rise in prices for low quality units was only 14 per cent. During the downturn (1985 - 1987), the decline was larger for the higher quality units.

Due to the domination of owner-occupiers, the small unit sub-sector is also characterised by lower vacancy rates. The higher vacancy rates for large units are also a result of higher proportion of short-term investment and speculative activities in this sub-sector. Table 4 shows the vacancy rates of the mass and large units for the period 1990-2000. The vacancy rate of small units was consistently lower than that of large units.

Table 2. Mode of Occupation for New Domestic Units after Completion (% of total)

Year	Small Units		Large Units	
	Class A	Class D	Class E	
	Owner occupied	Renter occupied	Owner occupied	Renter occupied
1990	78.5%	21.5%	52.0%	47.9%
1991	84.4%	15.5%	52.2%	47.8%
1992	83.0%	17.0%	51.8%	48.0%
1993	78.5%	21.5%	59.3%	40.7%
1994	74.9%	25.0%	52.3%	47.7%
1995	74.5%	25.4%	49.9%	50.1%
1996	72.4%	27.6%	69.5%	30.5%
1997	80.2%	19.8%	68.4%	31.6%
1998	83.3%	16.7%	54.9%	45.1%
1999	74.9%	25.1%	67.9%	32.1%
2000	86.0%	14.0%	74.9%	25.1%
Average	79.1%	20.8%	59.4%	40.6%
				30.1%
				69.9%

Source: Rating and Valuation Department, Property Review, Government of Hong Kong Special Administrative Region, various issues

Table 3. Average Price Appreciation and Risks 1980:Q1 - 1997:Q4

	Small Units (Class A)	Large Units (Class D/E)
Capital Return (p.a)	11.5%	12.7%
Price Volatility (Std dev)	15.8%	23.9%

Source: Figures compiled from the price indices constructed by the Rating and Valuation Department, Government of the Hong Kong Special Administrative Region.

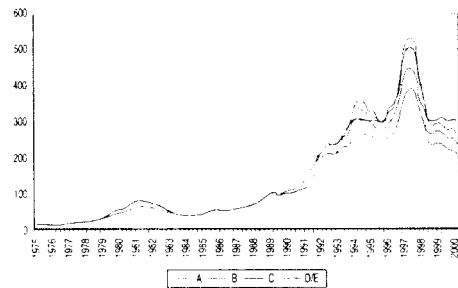
Table 4. Vacancy Rates of the Mass and Luxury Residential Units (% of total)

Year	Small Units		Large Units
	Class A	Class D	Class E
1990	2.0%	6.0%	6.5%
1991	1.9%	4.8%	8.0%
1992	2.8%	4.5%	4.5%
1993	2.6%	3.2%	5.3%
1994	3.0%	6.4%	2.5%
1995	2.4%	6.3%	3.3%
1996	2.4%	5.1%	4.2%
1997	2.4%	4.8%	4.9%
1998	2.4%	7.2%	8.4%
1999	4.2%	6.0%	6.1%
2000	3.8%	8.1%	6.1%

Source: Rating and Valuation Department, *Property Review*, Government of Hong Kong Special Administrative Region, various issues

Market Conditions

Figure 2 exhibits the price trends of the five categories of the private residential properties in Hong Kong for the period 1975:Q1 -2000:Q2. The prices first peaked in 1980, bottomed out in 1984, and have been rising since then, except for brief corrections in 1989, 1993, 1995 and severe downturns in 1997 and 1998. Despite the anti-speculative measures adopted by the government in the mid-1994, property prices have been generally on the upward trend until the second half of 1997². With rampant speculation, prices of residential properties skyrocketed to new highs in the mid-1997, more than 30 per cent over the fourth quarter of 1996. Demand for residential property remained strong. Some 115,700 housing units were transacted. New residential developments were over-subscribed. On the other hand, rental levels only rose marginally, resulting in a fall in residential yield from 3.5 - 4.5 per cent to 2 - 3 per cent (Chesterton Petty, 1999). Housing affordability therefore deteriorated significantly and price escalations posed the threat of creating an overheated economy.

Figure 2. Price Index of the Residential Market Sub sector

On 8 October 1997, the Chief Executive announced three targets to stabilise the “property market: (i) increasing housing production to at least 85,000 units by 1999/2000; (ii) achieving home-ownership rate of 70 percent by 2007; and (iii) reducing average waiting time of being offered a public housing unit to 3.5 years by 2004. Meanwhile, starting 1 July 1997, the restriction on new land supply of 50 hectares imposed under the Annex III of the Sino-British Joint Declaration was lifted. The government therefore planned to increase land supply significantly to speed up housing production. Although the public did not expect the new administration to adopt restrictive measures to regulate the property market, the extent of further escalation in property prices was limited. Indeed, the immediate effect of the announcement was a reduction in transaction volume, from 22,700 units in June 1997 to 15,300 units in July 1997. However, the decline in property prices was mild, and recovery took place towards the end of the third quarter.

Following the Asian financial turmoil in mid-1997, Hong Kong property market, as a whole, witnessed a slump. Interest rates were high and the lending policy of the retail banking sector was tight. As for the luxury residential property sector, investors/speculators actively participated in the stock market. Due to the losses on the stock market, together with the tight credit constraint, many had to liquidate their property holdings.

During the first three quarters of 1998, the residential property market was sluggish, especially for the second hand market, due to the economic depression and volatile external environment. Some 80,000 transactions were recorded in 1998, a decline of 47 per cent over 1997. With respect to capital depreciation, capital values for luxury residential property dropped by 40 per cent. The economic downturn also led many sellers to the leasing market as a way of retaining some form of cash flow until there was a signal of market improvement. Generally, the residential property price index dropped from 433 in the third quarter of 1997 to 253 in the fourth quarter of 1998, with an accumulated decline of 41.6 per cent. At the end of 1998, prices of large flats in popular developments in urban areas were 37.3 per cent lower than they were a year earlier. Prices of small to medium-sized units in urban areas fell 36.1 per cent during the same period. In popular developments in the New Territories, prices of large flats fell 35.3 per cent during the year while those of small to medium-sized flats fell by 35.1 per cent (SCMP, March 10, 1999).

To speed up sale, competition for buyers urged local developers to offer new flats at close to cost or even below prices in the secondary market during 1998/1999. As housing supply (including the unsold units in 1998) amounted to 40,000 units in 1999, together with 25,000-30,000 new completions offered to the market at the second half of 2000, it has been a general belief that the excess supply of residential property would depress any rise in prices in 2000. Compounding the situation was that there were 60,000 vacant units of residential properties. Indeed, buyers are not likely to enter the property market until there are some indications that the market has reached its trough. The situation suggests that after the Asian financial crisis, property has no longer been viewed as an investment hedging against inflation. This would effectively reduce speculative demand and transaction volumes for residential property.

Competition among banks for mortgage business intensified recently. Banks in Hong Kong have never offered mortgages to buyers of new private developments at rates below costs. On 2 April 1999, at the sale of Cheung Kong (Holdings) Laguna Verde flats in Hunghom, some banks offered mortgages at costs significantly below the prime rate. Chekiang First Bank offered buyers a mortgage rate as low as 7.75 per cent for the first six months of the mortgage loan, which was 1 per cent below the best lending rate of 8.75 per cent. Loan war among banks continued in the second half of 1999. The price war in the home loan market flared again in August 1999, with one of the leading banks - Hang Seng Bank Ltd. raising the level of cash-rebate incentives for new mortgage borrowers to 0.75 per cent of the loan from the previous 0.5 per cent (SCMP, August 28, 1999).

In the first half of the new millennium, economic conditions slightly improved. Real GDP growth reached a rate of 14.3 per cent in the first quarter. Pressure on deflation alleviated as the composite Consumer Price Index (CPI) declined by 4.5 per cent in June when compared to a 6.1 percent drop in September 1999. The employment rate also decreased from 6.2 per cent in October 1999 to 5 per cent in June 2000. In mid-February 2000, average prices of small-to-medium sized residential properties rose 4 per cent over the fourth quarter of 1999 (at \$3,950 per square foot).

In April 2000, the Rating and Valuation Department announced that the completion of private residential property exceeded the annual target of 35,000 private units set by the Chief Executive in October 1997. Overall vacancy rate was 5.4 per cent in 1999. Annual completion is estimated to be 25,790, 27,756 and 29,653 units for the fiscal years 2000-2002. These negative sentiments, together with the volatility of the US Nasdaq Index before the end of the first quarter, and a poor government land auction of a mass residential

site in West Kowloon Reclamation area sold at 30 per cent below market price expectation in April, caused property prices to fall by 6-8 per cent to between HK\$3,360 and HK\$4,370 in the second quarter of 2000 (Vigers GVA Worldwide, 2000a). On the other hand, luxury property prices were not seriously affected by the poor sentiment in the mass residential market. Average prices for luxury residential property rose by more than 3 per cent to HK\$8,000 per square foot in the first six months. The rise in prices was a result of limited supply, which was comprised of less than 10 per cent of the total annual residential property supply.

On 30 June 2000, the Chief Executive of the Hong Kong SAR Government announced the suspension of the annual target of 85,000 residential units with a view to stimulating the property market. The Home Ownership Scheme (HOS)¹ projects originally scheduled for disposal for the remaining of 2000 were also suspended. Moreover, the supply of HOS units will be cut by 16,000 units in the next four years. Meanwhile, economic conditions slightly improved, with the unemployment rate falling from 6 per cent a year ago to 4.5 per cent in December 2000. Market sentiment heated up immediately after these announcements and major developers resumed to raise the selling prices of residential developments. During the second half of 2000, average prices of small-to-medium sized residential properties rose by 3 per cent to between HK\$3,260 per square foot to HK\$4,270 per square foot. Demand for luxury residential properties from end-users and investors were also increased. At the sale of a major luxury residential project "The Leighton Hill", all 544 units were sold within weeks, with some sold for prices as high as HK\$14,000 per square foot. By the end of 2000, average luxury residential property prices rose to HK\$8,200 per square foot (Vigers GVA Worldwide, 2000b).

In the first quarter of 2001, average prices of small-to-medium sized residential properties did not change much relative to the end of

2000. As local interest rates were cut three times, bringing the best lending rate and mortgage rate down to 8 per cent and 5.75 per cent, homes were more affordable. In February, the Government issued a package of measures with a view to reviving the private residential market. First, the monthly income ceiling for families applying to purchase HOS units was lowered from HK\$31,000 to HK\$25,000, with the objective of driving more families back to the private property market. Second, the Government limited future residential property supply by restricting land supply for residential development. As a result, only 10 lots of land, with the total site area of 5.13 hectares and the capacity of providing 1,000 units will be put for auction in 2001/2002. Third, all anti-speculative measures were lifted for a 6-month trial period.

The immediate effect was the improved market sentiment, as the general public believed that the Government was trying to revive the private residential market. Mass residential property prices in prime areas rose slightly by less than 10 per cent in February 2001 as buyers were still cautious. However, when the sentiment cooled down, the prices actually fell by 3 per cent between HK\$3,160 and HK\$4,170 per square foot at the end of the first quarter, when compared with the end of 2000 (Vigers GVA Worldwide, 2001). The positive effect of government intervention was a 130 per cent surge in transaction volume to 11,412 cases recorded in March when compared with the previous month. On the other hand, despite the fact that investment for luxury residential properties was active during the first quarter of 2001, its capital value remained more or less unchanged when compared with the end of 2000, at an average of HK\$8,200 per square foot (Vigers OVA Worldwide, 2001).

Future Trends in the Housing Market

Given the current market conditions and governmental housing policies, we anticipate that two phenomena will emerge in the private

residential property market in the future. First, the price (\$/floor area) differentials between luxury and mass residential properties will widen in the future. Second, the prices of new and old residential properties will also diverge, as the speed of obsolescence of buildings will accelerate due to technological advancement and future change in building control regulations.

a. Increasing price difference between small and large units

- *Polarisation of Income Distribution*

Income distribution will continue to polarise due to the continuing restructuring of the economy resulting from the economic reform in Mainland China. Since the early 1990s, the manufacturing industry in Hong Kong has been contracting in terms of labour employment and income generation. The labour force of the manufacturing sector grew from 591,659 persons in the first quarter of 1975 to 942,819 persons in the second quarter of 1981 and thereafter fell to 245,457 persons in the fourth quarter of 1998. During the same period, the income share of the manufacturing sector as a percentage of GDP reached its peak at 28.3 per cent in 1979 and then dropped to only 8 per cent in 1998 (Census and Statistics Department, 2000). These two indicators suggest that given the rising production costs and the "Open Door Policy" of China, many local industrialists have relocated their routine production lines to the Southern part of Mainland China so as to take the advantages of cheap labour and factory premises.

Recently, negotiations have been carried out to determine whether China is allowed to join the World Trade Organisation (WTO). For China, one of the benefits of joining the WTO is the

entitlement to Most-Favored-Nation (MFN) treatment by other WTO members. This will reduce uncertainties in trading such as those arising from the annual renewal of China's normal trading right status with the US. According to the agreement between China and US, US has agreed to phase out the quota on Chinese exports of textiles and garments during the next 5 -6 years. In other words, China will be treated like other signatories to the Agreement of Textiles and Garment (which is a multi-lateral agreement to phase out the Multi-Fiber Agreement by 2005).

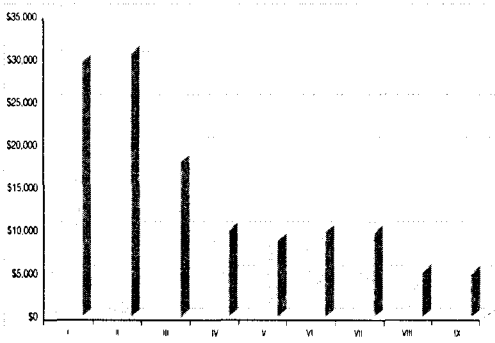
Local industrialists who relocated their production lines to China have benefited from the open door policy of Mainland China. With China joining WTO, many of them will find that their products are even more accessible to international markets. On the other hand, the lower income group in Hong Kong, whose productive skills can be easily replaced by cheap labour in the Mainland, will have difficulty in adjusting to the economic transformation.

The current economic reform and development in China, which require a lot of specialists and financing, will create numerous job opportunities for local professionals in legal, financial and information technology fields, such as lawyers, accountants, and computer engineers. In order to compete with other Asian countries, Hong Kong, as an international financial centre, is anticipated to transform into a knowledge-based economy with high demand for specialised skills and knowledge, especially if China joins the WTO.

This restructuring of Hong Kong's economy is likely to continue in the future. The result is that the income growth for the lower income group will be slower compared with that of

the higher income groups. Figure 2 reveals the income distribution by occupation in the first quarter of 2001. The monthly earning of a professional is 5.6 times that of a worker in elementary occupations category, and 6.2 times that of a worker in other categories. In the future, it is expected that such income spreads between professionals and ordinary workers will continue to widen.

Figure 2. Median Monthly Earnings by Occupation (HK\$)



Notes: I: Managers and Administrators; II: Professionals; III: Associate Professionals; IV: Clerks; V: Service Workers and Shop Sales Workers; VI: Crafts and Related Workers; VII: Plant and Machine Operators and Assemblers; VIII: Elementary Occupations; IX: Others

- *Limited Supply of Luxury Units*

The supply of luxury units is relatively fixed (at least in the short run) due to the limited supply of “prestigious locations”. Luxury units are not simply large residential units in any location. They have to be located in expensive prestigious residential area in order to meet market demand. Therefore, large units tend to concentrate in prestigious areas. The formation of prestigious location is a rather complicated issue that involves sorting of different income groups and evolves slowly over time. This slow process makes the supply of luxury unit much more inelastic than that of mass residential unit. Official

figures suggest that the average annual completion of Class A unit is 4 times of Class D unit, and 12.6 times of Class E unit during the period 1991-2000. Furthermore, as shown in Figure 1, the total housing stock of Class A unit is approximately 7 times of that of Class D unit and 15 times of that of Class E units, which suggests that the supply of large units has increased (relative to small unit) recently.

- *Change in land supply policy*

The supply of residential units as a whole is becoming more elastic due to a change in the land supply policy after the mid-1997. Before the return of the sovereign of Hong Kong to China, the new land supply was constrained by the Annex III of the Sino-British Joint Declaration. Under the agreement, the maximum bound of new land sale by the Hong Kong Government was restricted to 50 hectares of land in a single year during the transition period between 27 May 1985 - 30 June 1997. This had contributed to rapid escalation of property prices before mid-1997 and resulted in serious housing problems and Hong Kong losing its competitiveness in the region.

After the hand over on 1 July 1997, the land supply constraint was removed and we expect that the government will increase new land supply to stabilise the property market in the long run. The relaxation of this constraint will make supply of mass residential units more elastic since supply of land for luxury residential development cannot be easily increased. On the other hand, it is relatively easier for the government to increase the supply of land for mass residential development by increasing plot ratios of land lots or invest to

increase the amount of developable land in the rural New Territories. Wong et al. (1998) point out that for the period 1975 - 1985, the average plot ratio was 3.35 while the figure was 4.27 for the period between 1985-1994. There was a 27 per cent increase in average plot ratio after the Sino - British Joint Declaration. The significant increase in plot ratio was likely an attempt to offset the impact of restrictive land sale imposed by the Joint Declaration, since the development densities of the 50 hectares of new land supplied to the private sector were not specified.

The increased supply of land and future economic growth imply that there will be increasing pressure of upgrading the living standards, including increase in living space per person. This filtering up process involves selling of smaller units and buying of larger units. The demand for larger units relative to that of smaller units will increase.

- *Privatisation of Public Housing*

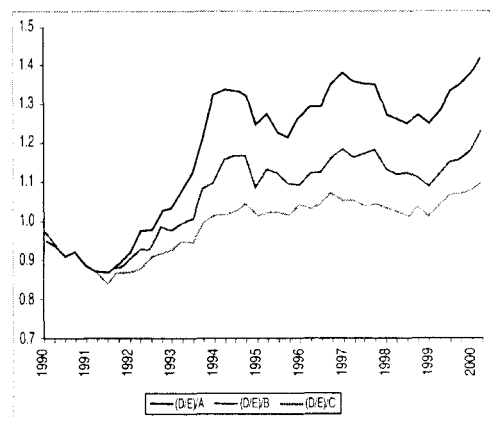
Besides the private sector, the public sector also plays an important role in providing housing accommodation to Hong Kong people. At present, more than 40 per cent of Hong Kong's population are living in public housing rental units and subsidised housing units which are sold to eligible household at a substantial discount (45 - 55 per cent of market prices). Public housing units, which are provided to the lower income groups, are generally smaller and have lower quality. Through the provision of small residential units, the government is competing with the private sector in the mass residential market. On 8 December 1997, the Hong Kong Housing Authority proposed a Tenants Purchase Scheme (TPS) to sell public housing units to sitting tenants. The

first batch of public rental estates which included Cheung On Estate, Heng On Estate, Kin Seng Estate, Wan Tau Tong Estate (in the New Territories), Fung Tak Estate (in Kowloon) and Wah Kwai Estate (in Hong Kong Island), was sold in early 1998. A total of 19,807 public rental units were sold by March 1999 (Hong Kong Housing Authority, 1999). Until now, this TPS is still in practice. The policy of privatising public housing will result in an increased supply of small units in the market place, thereby curbing the growth of the price of small housing units.

- *Implications*

The above analysis suggests that the price differentials (unit price measured in terms of HK\$/GFA) between luxury residential unit (large units in expensive locations) and mass housing (small units) are anticipated to widen in the future. This trend can be crudely measured by the ratio of price index of Class D/E (>100m²) unit to Class A (<40m²) unit. Figure 4 exhibits the price of luxury residential property as a ratio of the price of mass residential property for the period 1975:Q1 - 2000:Q2.

Figure 4. Price of Class D/E units as ratio of Price of other Class units



The figure shows that there has been an increasing trend in the ratio of price of large to small unit in recent years. The trend is more obvious for Class D and E units to that of Class A units. This trend is likely to continue in the future.

For investors, this means that the investment return on large units will outperform the market. Unfortunately, it is not possible to sell property short in the residential market, otherwise short selling small units and holding large units at the same time will be a perfect arbitrage strategy. A close substitute to this strategy is to hold stocks of the listed property companies that are known to concentrate on developing luxury residential units and short-sell the stocks of the listed property companies that are known to concentrate on developing mass residential development. However, the obvious risk of this strategy is that developers may change the focus of their business.

As the price of luxury residential property is expected to rise more rapidly than that of mass residential units, developers are advised to increase the portion of large units in their development strategy. Moreover, as “prestigious locations” for residential development are very scarce in Hong Kong, developers should try to “create” prestigious locations by adopting various marketing techniques.

b. Shorter economic life of residential property

Although economic development has grown substantially for the past 30 years, the current building regulations have not

changed much since the 1960's. Development control regulations need to be revised and amended in order to keep up with the ever-changing environmental management policy and business environment. In recent years, there is an increasing demand for more environmental friendly “green buildings”. Furthermore, the high land price in Hong Kong together with the undated development density control result in developers' maximisation of gross floor area and minimisation of circulation space. The result is that building designs are similar for different developments.

The government is now reviewing the building and development control regulations. We anticipate that there will be relaxation of various design constraints imposed by building and development controls. With the current pace of technological advancement and the changes in building and development control regulations, developers will be able to produce housing units with more innovative designs, which are more environmental friendly and more habitable in the future. Older units with design subject to old regulations and constraints will become less popular and their values will decline relative to newer units.

In the future, shorter economic life of product is anticipated due to rapid technological progress and change in taste and preferences. Older products become obsolete when new models of products are put to the market. Excellent examples are personal computers and mobile phones. Although this process is more noticeable for hi-tech products, it is equally applicable to residential units. Despite the fact that this process evolves very slowly in the housing market, we can still observe at least two examples of housing attributes that become obsolete over time. First, pre-war residential building units without flushing toilet and

lift are disappearing over the past twenty years. Second, large estate-type development has been popular since the 1980's. Nowadays, "standalone" residential buildings in Hong Kong are much less popular and are often sold at a discount to comparable units in large estate-type developments. In the future, it is expected that the speed of obsolescence of older residential buildings will increase, thus enlarging the price gap between older and newer units.

- *Implications*

Given that the economic life of properties is decreasing in the future, property investors should take this into account in the cash flow projection of property investment. The risk of investing in older units will also increase. For the developers, development is no longer just a timing problem. Product design, which is very much ignored by developers, is also an important element in the future. We expect that more resources

will be invested in the design of housing units. In the future, housing units will be less "homogeneous".

Conclusions

While speculating into the distant future is difficult, there are often hints and evidence that allow us to make bold assumptions and predict future changes. We have predicted that two phenomena will emerge in the private residential property market in the coming future. First, the price differentials between luxury and mass residential properties will widen. This is due to polarisation of economic growth with uneven income distribution, limited supply of prestigious locations, increased land supply, and privatisation of public housing. Second, due to the technological progress and the modification of building and development control regulations, the economic life of housing units will decrease. The result is that the price gap between new and old residential properties will enlarge in the future. Both predictions have important implication for property investors and developers.

Notes

1. A Task Force on Land and Property Prices was set up to control the rapidly rising property prices in the mid-1994, with the result of collectively achieving the immediate objectives of curbing rampant housing speculation and depressing property prices. During the second half of 1994, average property prices around the territory dropped by 6.8 per cent, with the greatest falls experienced in Kowloon (9.4 per cent), followed by the New Territories (6.3 per cent) and Hong Kong Island (3.3 per cent). For a description of the anti-speculative measures, please see Ho (2000).
2. For a detailed description of the Hong Kong real estate market for the period 1980 to the mid-1997, please see Chau and Ho (2000).
3. In April 1954, the Hong Kong Housing Authority (HKHA) was set up by the government to provide

cheap and low-quality rental units for those incapable of housing themselves. Since then, Hong Kong has experienced dynamic socio-economic and demographic changes. Growing economic affluence has led to aspiration for home ownership. The Home Ownership Scheme (HOS) was drawn up by the government in 1976, and was the first plan featuring public sector apartment for sale. It is the government's intention to sell apartments to better-off tenants of public rental housing and low-middle class of the general public whose household income is too low to afford a housing unit in the private sector.

4. Due to the linked exchange rate system adopted by the Hong Kong Government on October 17, 1983, the Hong Kong dollar was pegged to US dollar (US\$1=HK\$7.8). In order to keep this system operative, an increase in US interest rates is usually met by an increase in local rates. Otherwise, investors/speculators will excessively sell Hong Kong dollar and buy US dollar so that US dollar will relatively appreciate.

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Administrative Law Issues in Challenging Land Acquisitions

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Introduction

Compulsory land acquisitions of alienated land by State Authorities had, in the past, been challenged on several grounds. A few have ended well for the dispossessed landowners, especially where the challenges have been grounded on inadequacy of compensation, failure or neglect to comply with procedures, and inordinate delay by the Land Administrator in completing the proceeding, but the great majority of these challenges have ended in dismal failure.

Case law to date shows that challenging land acquisitions on the ground of *mala fide* (bad faith) had, for the most part, ended badly for the landowners. The courts have consistently held that mere suspicion of bad faith on the part of the State Authority is not sufficient. There must be cogent proof of such bad faith, which under the circumstances, can be very difficult for the owners to adduce in court.

This short commentary is focussed on some of these leading cases, explaining why they did not end well for the landowners. It then considers whether the conclusion of these same cases would have been any different if the lawyers acting for the landowners had resorted to certain basic principles of administrative law in their quest for justice.

Before going into that, however, a brief introductory background into the law is necessary.

Constitutional Safeguards

What every Land Administrator ought to

remember is that there are fundamental safeguards for every registered landowner in this country. These take the form of Article 13 of the Federal Constitution which states that "No person shall be deprived of property save in accordance with law" (Clause (I) and "No law shall provide for the compulsory acquisition or use of property without adequate compensation" (Clause (2).

That "law" (mentioned in Clause (I)) is of course the Land Acquisition Act 1960, in force since October 13, 1960. Over the last four decades, this law had changed in shape and size, substantially eroding whatever limited rights the landowner had enjoyed at the inception of that law. In this context, the term "law" refers not only to the "substantive" provisions of the law (which set out the rights and duties of each party) but equally (if not more important) to those procedural safeguards built into that law.

With regard to the "adequacy of compensation" as provided in Clause (2) of that Article, reference must be made to the First Schedule of the Act, which sets out in detail the acquired land's "market value" which the State Authority must pay to the dispossessed landowner. The First Schedule, too, had gone through several amendments, as a result of which the dispossessed landowner now will get less than what he would have received when the law first came into force on October 13, 1960.

To be fair to the legislators, not all the amendments had a negative impact on the landowners. As a result of numerous complaints against several past incidents of abuse, amendments were made to tighten up

existing procedures where land is to be acquired from X to be ultimately given to Y via the privatisation process, under section 68A of the Act. These amendments (introduced in 1966) had produced a positive result in putting an end to these abuses. More on this point later.

What should be emphasised at this juncture is that the paramount law regarding compulsory land acquisition is Article 13 of the Federal Constitution, not the Land Acquisition Act. The latter is merely the enabling statute under which the State Authority is empowered to acquire alienated land, but that power is constitutionally circumscribed and limited, not absolute in nature.

Purpose of Acquisition

Under section 3(1) of the Act (as it stands today), the State Authority can acquire any land which is needed -

- a. for any public purpose;
- b. by any person or corporation for the purpose which in the opinion of the State Authority is beneficial to the economic development of Malaysia or any part thereof; or
- c. for the purpose of mining, residential, agricultural, commercial, industrial, recreational purposes or any combination of such purposes.

Section 3(1) itself had a chequered history. It began in 1960 as simply section 3. The original paragraph (b) states "by any person or corporation undertaking a work which in the opinion of the State Authority is of public utility", before it was amended by the Land Acquisition (Amendment) Act 1991 (Act A804), in force since September 13, 1991, resulting in its present form.

Likewise, paragraph (c) originally states "for the purpose of mining, residential and industrial purposes" before it was enlarged in an amendment exercise in 1984 to include

agricultural and commercial purposes as well. Finally, under Amendment Act A999, paragraph (c) was enlarged again to attain its present form.

Thus, whilst the draftsman or author of the 1960 Act was contemplating compulsory land acquisition merely for three basic purposes (i.e. "public purpose", public utility, and the trinity of mining, residential and industrial purposes), under the present umbrella of the law, compulsory acquisition can be carried out for virtually any purpose dreamt up by the State Authority. Under the expanded law as it stands today, alienated land can be taken for any purpose, including commercial or recreational purposes, or for any economic purpose considered "beneficial" - even if to only part or a section of the public (and even though it may give rise to adverse effects to some other sections of the public).

Only paragraph (a) has retained its original form, but even here problems of interpretation have surfaced from time to time, as discussed below.

Scope and Meaning of "Public Purpose"

The term "public purpose" in paragraph (a) has eluded clarity and precision of meaning ever since the law came into force. One would have thought that since the Act has chosen not to give it any specific or precise statutory definition, the courts would judicially define or interpret it, thereby resolving any uncertainty as to its scope and meaning. Unfortunately, the local courts had consistently declined to do so, probably following suit the judicial trend in other jurisdictions, particularly India. In *S. Kulasingam & Anor vs. Commissioner of Lands, Federal Territory & Ors.* [1982] 1 MLJ 204, Hashim Yeop A Sani lamented that the "*The expression 'public purpose' is incapable of a precise definition ...*" but nevertheless declined to define or interpret it as the contesting parties in that case had

hoped for. He did say, however, that in determining the meaning of that phrase, "*it is best to employ a simple common test, that is, to see whether the purpose serves the general interest of the community.*"

Judicial reluctance amongst the local judiciary, as apparent in *Kulasingham* (above), reflected a similar judicial trend in India in the 50s. Consider, for example, the reluctance of the Indian court in *Bhagwat Dayal vs. Union of India*, AIR 1959 Punj. 544, as cited by O.P. Aggarwala in his authoritative work, "Commentary on the Land Acquisition Act - Compulsory Acquisition of Land in India", (1995) 7th edition, at page 101.

What the local judiciary might not have overlooked is that in 1984, the Indian statute in question (Land Acquisition Act 1894) had been amended. Any past uncertainty as to the meaning of "public purpose" in that country had been put to rest when the term (found in section 3(f) of the Indian Act) was defined to include -

- a. the provision of village sites, or the extension, planned development or improvement of existing village sites;
- b. the provision of land for town or rural planning;
- c. the provision of land for planned development of land from public funds in pursuance of any scheme or policy of Government and subsequent disposal thereof in whole or in part of lease, assignment or outright sale worth the object of securing further development;
- d. the provision of land for a Corporation owned or controlled by the state;
- e. the provision of land for residential purposes to the poor or landless or to persons residing in areas affected by natural calamities, or to persons displaced or affected by reason of the implementation of any scheme undertaken by Government, any local Corporation

owned or controlled by the state;

- f. the provision of land for carrying out any educational, housing, health or slum clearance scheme sponsored by Government;
- g. the provision of land for any other scheme of development, sponsored by Government or with the prior approval of the appropriate Government, by a local authority;
- h. the provision of any premises or building for locating a public office.

In the light of the legislative development in India, what should have been done over here is that either the Parliament amends the 1960 Act to have the term "public purpose" defined in the light of local conditions and the prevailing circumstances, or failing that, the local judiciary should discontinue its past reluctance and start giving the term a clear and concise judicial interpretation.

It is strange that when Parliament considered it necessary, under the Amendment Act A999 (in force in 1996), to give a precise definition for "*public utility*", it declined to do so for "*public purpose*". Understandably, this state of affairs leads only to unhealthy and unwarranted speculation as to the reasons behind this continued legislative reluctance.

Procedure

Since challenges to land acquisition can be grounded on the Land Administrator's failure to comply with the procedures laid down under the 1960 Act, a brief explanation of the procedure involved is necessary.

A compulsory acquisition proceeding begins when a preliminary notice of intended acquisition under section 3 (in Form A) is published in the Gazette - see section 4. This notification of intended acquisition lapses if the Land Administrator fails to take the next step (making a section 8 declaration in Form

D) within 12 months. Pending that declaration under section 8, the State Director of Lands and Mines can authorise any officer or person, under written authority in Form B, to enter upon any land to do such work as may be specified - section 5. If any damage is caused by such entry, compensation must be paid to the landowner - section 6.

The Land Administrator is then required to prepare and submit to the State Authority a plan of the area of the land to be acquired and a list of such affected lands - section 7.

Where a declaration under section 8 has been made (in Form D), and subsequently published in the Gazette, that declaration becomes "conclusive evidence" that the scheduled land referred to therein "is needed for the purpose specified therein".

What should be remembered then is that time begins to run. An award under section 14 of the Act must be made within 2 years of this declaration. Failure to do so will render the entire acquisition proceeding null and void.

For the purposes of assessing the amount of compensation to be paid to the landowner, the Land Administrator is required to obtain information from the State Director of Town and Country Planning (who will in turn get the information from the local planning authority) as to whether the acquired land is within a local planning authority area, whether it is subject to any development plan, etc. Information so requested must be given within 2 weeks by the local planning authority to the aforesaid State Director, who will in turn pass it on to the Land Administrator. Failure to comply with this time-schedule, however, will not invalidate the land acquisition, as the information sought is only intended to assist the Land Administrator in determining the compensation.

Thereafter the Land Administrator is to commence proceedings for the acquisition of the land, by serving a notice (in Form E) and informing all interested parties regarding the enquiry which is to be held under section 12

of the Act.

At the end of that enquiry (during which the Land Administrator can summon and hear witnesses), the Land Administrator must make his award under section 14. This award must be in writing, in Form G. The award shall then be served on the relevant parties under section 16 (Form H). As said earlier, this award must be made not later than 2 years after the section 8 declaration has been published in the Gazette. When compensation has been paid, the Land Administrator can take possession of the land. Formal possession is taken by the Land Administrator serving a notice in Form K.

A landowner, whose land has been acquired under the Act, may choose to accept it, reject it, or accept it under protest (section 30). If the owner does not wish to accept it, the Land Administrator can make payment into court. If the compensation is accepted under protest by the landowner (who intends to refer the award to the High Court), the Land Administrator is required to release 75 per cent of the amount of the award, withholding the remainder until the final disposition of the case by the High Court - section 29A.

Time of Payment of Compensation

Section 29 of the Act states that after notice of the award in Form H has been served on the landowner, payment must be made "as soon as may be". In the past, the vagueness and lack of clarity of this phrase had led to several abuses where compensation was paid out to the dispossessed landowners after several years.

Under section 32 (revamped under Amendment Act A999), it is provided that if compensation is not paid to the landowners "on or before the due date", late payment charges at the rate of 8 per cent per annum must be paid. The expression "due date" has been defined to mean "the date of taking possession of the land" or a date three months after the service of the award under section 16 (Form H).

Whilst the law is now quite clear, we still

come across newspaper reports of landowners having to wait for a long time before the compensation was actually paid to them.

Challenging The Award/The Acquisition

For the dispossessed landowner, the most obvious ground or reason for challenging the land acquisition proceeding is that the compensation paid to him is not "adequate" in the context of Article 13 of the Federal Constitution, read together with the First Schedule of the 1960 Act. This challenge turns on the quantum of the award, and this will depend whether the High Court (which hears the case) is satisfied that the Land Administrator has taken into consideration all the factors in making up his award.

Apart from that, however, there are other grounds upon which the challenge can be made, and these will focus not on the quantum of the award but on the validity of the entire acquisition proceeding.

Going by case-law, the following grounds have been put forward by the dispossessed landowners to challenge the validity of the acquisition, with varying degrees of success

a. *Ultra vires* the Federal Constitution

In *Kulasingam vs. Commissioner of Federal Capital* [1982] 1 MLJ 204, the landowner challenged the validity of the acquisition proceeding on the ground that he was not given any pre-acquisition hearing. Abdooldader J held that unlike the position in India (which provides for such a procedure), the 1960 Act does not provide for such a hearing. On the question of whether such a denial of pre-acquisition hearing amounts to an infringement of the right to property as enshrined in Article 13 of the Federal Constitution, the Judge held that the legislature "can by clear words" exclude the principles of natural justice in the absence of specific constitution guarantees. The Judge noted that there is

"express provision in the Act for an inquiry and hearing in respect of the quantum of compensation payable but none with regard to the acquisition itself." In the circumstances, the challenge was dismissed.

b. Contrary to Article 13

In *Goh Seng Peow & Sons Realty Sdn Bhd vs. Collector of Land Revenue Wilayah Persekutuan* [1986] 2 MLJ 395, the applicant company became the registered owners of the acquired land on March 3, 1977. In September 1984, whilst in the process of developing the land into a housing estate, they were informed that their land had been compulsorily acquired. Their solicitors immediately wrote to the respondent for further information. The respondent subsequently forwarded to the solicitors copies of Forms E, F, G and H. All these forms named Goh Seng Chong and Goh Seng Peow as the registered proprietors instead of the applicant company.

The applicant company contended that the acquisition proceeding was illegal, null and void because as the registered owners of the land, they had no notice whatsoever of the purported acquisition proceeding and that the necessary notices and documents had not been duly served on them as required by law. The company argued that the acquisition proceeding not only contravened Article 13 of the Constitution but was also in breach of the rules of natural justice. L.C. Vohrah J held that the acquisition proceeding "had taken place contrary to the provisions of the Act and in breach of the fundamental rules of natural justice." Consequently, the acquisition proceeding was held to be null and void.

c. Breach of natural justice

Not all cases where the landowners alleged breach of natural justice ended

favourably for them. In some cases, such as *Ee Kim Kin vs. Collector of Land Revenue Alor Gajah* [1967] 2 MLJ 89, on the facts the challenge was dismissed. However, the challenge succeeded in *Lau Cher Hian vs. Collector of Land Revenue Muar* [1971] 1 MLJ 96, where Ong CJ (Malaya) said that “those in authority should have more tender regard for the fundamentals of fair procedure”.

d. Non-compliance with section 9(1) of the Act

In *Kulasingam vs. Commissioner of Federal Capital* [1982] 1 MLJ 204 (referred to earlier), the landowner also argued, in the alternative, that failure to comply with section 9(1) of the Act (which requires the Land Administrator to mark out the land and to make a note of the intended acquisition on the register document of title) vitiated the entire acquisition proceeding. Unfortunately for the landowner, both the trial judge and the Federal Court held that section 9(1) is only directory and not mandatory. In any case, the court found that the omission was subsequently rectified and the necessary notation was subsequently made on the register document of title. Consequently, the challenge on this ground was also rejected.

e. Mala fide

In *Syed Omar bin Abdullah Rahman Taha Alsagoff and Anor vs. Government of Johore* [1979] 1 MLJ 49, the respondent had acquired some 5,700 acres of land belonging to the appellant, for which only 2,000 acres were actually needed by the respondent for its Pasir Gudang port project. The remaining portion of the land was marked somewhat vaguely as being required for some “special purposes”. The appellant challenged the validity of the acquisition,

alleging that the land was in fact acquired for purposes other than those permitted under the Act. At the Privy Council, Viscount Dilhorne said that “in the absence of bad faith” (which had not been proved in the courts below), section 8(3) of the Act makes it “not possible” to challenge the validity of the acquisition merely by asserting that some of the land was not needed for the purposes stated in the section 9 declaration.

In *Yeap Seok Pen vs. Govt of Kelantan* [1986] 1 MLJ 449, another case which went up on appeal as far as the Privy Council, the appellant’s father ran a goldsmith’s business for 45 years in a rented shophouse in Kota Bahru. In 1979 the shophouse owner sold it to the appellant. In March 1980, when the instrument of transfer was presented for registration, the appellant was informed that there was some delay as the authorities were in the process of determining whether the appellant was a native of Kelantan. In July 1980, the transfer was registered. Three months later, in October, the Kelantan Government published a section 8 declaration in the Gazette stating that the shophouse was needed for the purposes of office and commercial space for the Kelantan Foundation. The appellant challenged the acquisition on several grounds, including mala fide.

In the proceedings before the Federal Court, Suffian LP considered the submission by the appellant that the real reason of the acquisition was not that the property was needed by the Kelantan Foundation, but that it was to prevent the property from falling into the hands of a non-Malay purchaser, even though the appellant is a native of Kelantan. Expressing sympathy for the appellant, and agreeing with her that the Kelantan Foundation “could easily build on the land alienated to it or buy or rent one of

the properties to be built by the State Economic Development Corporation”, the Federal Court nevertheless held that “the fact that other properties were available is not enough to prove that the State Government had acted mala fide when it acquired this property.”

On further appeal to the Privy Council, Lord Griffiths held (rejecting the appeal) that “bad faith is an exceedingly serious allegation to make and she who makes it has a heavy burden to discharge the onus of proving it”. Mere suspicion is not enough.

f. Unconscionable and unmeritorious conduct

In *Stamford Holdings Sdn Bhd vs. Kerajaan Negeri Johor & 4 Ors* [1998] 2 AMR 997, the appellant company owned some 8,500 acres of agricultural land in Johor. In 1984, the appellant applied to the first respondent for approval to develop part of the land (1,788 acres) but failed to obtain the necessary approval, even after waiting for 4 years. The appellant then approached the third and fourth respondents for their assistance, as the latter had indicated to the appellant that they could procure the necessary approvals from the first respondent. They also alleged that they had direct links with the second respondent, who was in control of the first respondent. After a series of meetings and negotiations between the appellant and the third and fourth respondents, the necessary approvals were granted by the first respondent to the appellant.

The third and fourth respondents thereafter approached the appellant to jointly develop the remaining 6,600 acres. A series of meetings and negotiations took place, but the parties failed to reach agreement on crucial issues such as shareholding and the sale price of the 6,600 acres. According to

the appellant, if the parties cannot agree on the terms put forward by the third and fourth respondents, the appellant’s land would be compulsorily acquired. In December 1992, a notification of intended acquisition under section 4 was issued. However, it lapsed on December 31, 1993.

The parties thereafter resumed negotiations, but when these talks failed, compulsory acquisition commenced for the second time. The appellant then filed proceedings in court, contending in their statement of claim that the whole acquisition proceedings were an act of bad faith, namely, that they were an act of vengeance against the appellant for not submitting to the second, third and fourth respondents, and that therefore the acquisition was void and inoperative.

The respondents countered by filing their application to strike out the appellant’s writ and statement of claim on the ground that there was a failure to disclose a reasonable cause of action. In the meanwhile, none of the respondents had filed their defence to the appellant’s claim.

On April 14, 1995, the Johor Bahru High Court struck out the appellant’s claim against all the respondents on the ground that it did not disclose any reasonable cause of action. The appellant then appealed to the Court of Appeal. On January 6, 1998 the Court of Appeal allowed the appellant’s appeal and ordered the case to go to full trial.

In its judgment, the Court of Appeal said that “acquisition proceedings may be challenged on the ground of mala fide or bad faith.” The court added that “So long as the statement of claim discloses some ground of action the mere fact that the plaintiff is not likely to succeed on it at the trial is no ground for it to be struck out.”

The court also noted that the facts “as stated in the statement of claim ... clearly

show the unconscionable or unmeritorious conduct of the respondents. At least these facts are, in the absence of any defence filed, assumed true, stand un rebutted and would constitute a good cause of action against the respondents.”

Administrative Law Issues

All administrative actions and quasi-judicial decisions can be challenged by means of judicial review on anyone or more of the following grounds

- a. Denial or breach of natural justice;
- b. Ultra vires.

There are two separate elements of natural justice - one, the right to be heard (which means the right to be informed and to make representations before any decision is made as affecting one's interest) and two, the rule against bias. The decision of L.C. Vohrah J in *Goh Seng Peow & Sons Realty Sdn Bhd vs. Collector of Land Revenue Wilayah Persekutuan* [1986] 2 MLJ 395 (mentioned above) is an example of land acquisition being successfully challenged on the ground of breach of natural justice.

With regard to ultra vires, recent development in the realm of administrative law has expanded this doctrine to include the following aspects -

- a. ultra vires includes both substantive as well as procedural ultra vires;
- b. abuse of discretionary powers, such as actions done in bad faith (*mala fide*), taking into consideration extraneous factors or failing to take into consideration relevant factors, improper motive, unreasonable or irrational (referred to as “Wednesbury unreasonableness”), procedural unfairness, inordinate or unreasonable delay.

In *Kulasingam* (above), the Federal Court held that failure to comply with section 9(1) of the Act does not result in vitiating the land acquisition proceeding because the court considered that provision to be merely directory and not mandatory. With respect, it is submitted if administrative law principles have been fully considered by the court (procedural ultra vires), such failure to comply with an important provision of the Act should make the acquisition proceeding null and void.

With regard to *Syed Omar* (above), it is submitted that if principles of administrative law have been fully considered, the court might reach a different conclusion. In *Sydney Municipal Council v. Campbell* [1925] AC 338 PC, the council had statutory power to acquire land compulsorily for purposes of road widening, road improvements and carrying out any “improvements” or “remodelling” of any part of the city. The council decided to acquire a piece of land for purposes of road widening and another (larger) area for purposes of carrying out improvements to the city. It was later discovered that the primary objective of the council was to acquire as much land as possible for future capital appreciation, with a view to bringing more income to the city rather than for the statutory purposes of carrying out improvements or remodelling. In the circumstances, the Privy Council held that its action was in breach of its discretionary powers and should be restrained by the courts from carrying it out.

In *Syed Omar*, it is conceivable that the 3,700 acres (not immediately identifiable as part of the Johor Port project and marked vaguely for some “special purposes”) was acquired by the State Authority for future capital appreciation. If the decision in *Sydney* had been fully considered, it is possible that the court might have allowed the challenge by the landowner.

FDI And Foreign Ownership of Properties In Malaysia

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Preamble

The 1997 regional economic crisis was a wake-up call for the Asean region, which suffered a drop in foreign direct investment (FDI). The ensuing economic downturn in the United States has left Malaysia, with its export-driven economy, feeling the pinch, as FDI is crucial to the prosperity of Malaysia. The UNCTAD World Investment Report 1998 observed that FDI inflows into the region, including Malaysia, could decelerate in the short term resulting from the decline in intra-regional investment, the loss of asset values and reduced earnings for multinational corporations (MNCs).

To promote FDI, the Malaysian Government liberalized the equity policy for the manufacturing sector. It also relaxed the 30 per cent limit imposed on foreign ownership for several domestically oriented activities such as telecommunications, shipping and forwarding, insurance, hotel and tourism as well as approved activities in the Multimedia Super Corridor (MSC).

With all the incentives offered by the Government to attract FDI, the last decade was an opportune time for foreign investors to buy into the Malaysian property sector. Property prices are rock bottom compared to those offered by Malaysia's competitors. However, the country's position is that FDI are welcomed so long as they are consistent with the National Development Policy. Accordingly, any proposed acquisition of property assets must be examined in the light of the objectives of the National Development Policy (NDP).

*Against this background, a 1998 UNCTAD survey of the 500 largest MNCs in the world

notes that Malaysia continues to remain attractive to foreign investors. Among the reasons given are its relatively more liberal approach to FDI and its lower property prices arising from the currency depreciation. Foreign investment guidelines were also relatively liberal compared to its neighbors to allow foreigners greater opportunities for property ownership. This statement is supported by a comparison of the restrictions on foreign ownership imposed by the governments of Malaysia, Australia and Singapore (see Appendix B and C).

In Malaysia, the purchase of any property by foreign concerns requires the prior approval of the Foreign Investment Committee (FIC) pursuant to Section 433A of the National Land Code 1965, irrespective of the amount of the purchase price. Foreign concerns are defined as foreign citizens, companies incorporated overseas or companies incorporated in Malaysia but with more than 50 per cent owned by the previous two categories.

The FIC was established in 1974 to ensure a fairer distribution of economic opportunities among the ethnic communities in Malaysia. It is thus part of the NDP or its precursor, the New Economic Policy (NEP) initiatives, with its restructuring objectives very much a central concern of the FIC. Thus in its efforts to facilitate foreign investment inflows, the policies of the FIC cannot relinquish the country's national aspirations and strategic priorities (see Appendix A).

The FIC resides within the Economic Planning Unit (EPU) of the Prime Minister's Department. Members of the FIC are high-powered and their job is to protect the national interests, especially in strategic industries such

as utilities, communications, broadcasting and lately, property. The functions of FIC are four, without any direct mention of property. The reason for the FIC guidelines not being enacted as law is anyone's guess, but the impact of the guidelines remains far-reaching.

Introduction

The local property industry is long recognized as one of the country's main economic drivers. Property has strong linkages to 142-odd industries such as brick- kilns, sawmills, distributive trades, construction, manufacturing, etc. It is estimated that the real estate sector currently provides employment to some 1.4 million people in Malaysia. Total direct bank lending to the broad property sector continues to hover around the 30 per cent level.

Despite recent financial difficulties, effective demand and interest in landed property has remained strong. Foreigners also enjoyed our 40 per cent devaluation earlier, and property prices also have never really dropped. So real estate remains an attractive option for foreigners.

The interest in the FIC property guidelines arises out of the special characteristics of property investment. Although there is a huge property oversupply (the glut of unsold apartments, offices and retail space collectively valued at 10 per cent of GDP, *circa* 2000), there is no stock clearance as would have happened in the manufacturing sector. There were few real bargains about. Generally, prices have remained relatively inelastic since no one was forced to sell and what transpired was just a dearth of transactions. With a prolonged oversupply in most of the real estate sub sectors, property developers were looking at a relaxation of the FIC regulations, as a way of attracting FDI and boosting the contribution of the real estate sector to the Gross Domestic Product.

FIC duly relaxed the conditions for the acquisition of properties by foreign interests

through the introduction of Special Guidelines, effective from 22 April 1998 as well as under the Home Ownership Campaign for the period from 12 December 1998 to 12 January 1999. The FIC guidelines are regularly updated once the economic conditions improve or consolidate. However, any new conditions will not be imposed retrospectively to any purchases that have been approved under these guidelines.

The FIC Guidelines On Property Investment

Summaries of the latest FIC Guidelines relating to property acquisitions are tabled in Appendix D1, D2 and E.

Guidelines relating to property first appeared on 17 December 1992, with amendments on 23 June 1995, 22 April 1998 (property overhang) and on May 2001. These guidelines are to clarify the rules and regulations on the acquisition of properties by foreign interests, which were imposed at the Federal and State levels as announced by the Deputy Prime Minister on 23rd June 1995. A complete set of guidelines was later released in November 1995 to clarify the initial announcement.

The 1998 Guidelines were also to address the problems confronting the property market during the Asian economic crisis of mid-1997. This relaxation was made pursuant to the recommendations made by the National Economic Action Council (NEAC), after discussions with various parties involved in the property sector. The latest guidelines expedite and simplify the FIC procedure for acquisition of properties by local citizens and foreigners:

17th December 1992 FIC Guidelines on the acquisition of residential units by foreign interests-applies only to completed residential units.

Sales of office space-relaxation only for sales of office space in the hands of developers-not office buildings.

Acquisition of companies exceeding a value of RM5 million also required FIC approval.

24th June 1995	RM250,000 rule introduced.
22nd April 1998	Foreigners were allowed to purchase all types of completed buildings and newly launched projects, if the price is greater than RM250,000 per unit, without the need to incorporate local equity participation, but all such acquisitions must be made from a developer.
25th April 2001	New guidelines on the acquisition of property by locals and foreigners. Relaxation of equity conditions on almost all types of properties.

- a. All purchases of landed property by foreign nationals, regardless of value, require FIC approval.
- b. Foreign parties are not permitted to acquire all types of properties priced at below RM250,000 per unit or less.
- c. Properties bought by foreign nationals cannot be resold within less than three years from the date of FIC approval.
- d. Certain categories of properties cannot be acquired at all, including low and medium cost residential properties, Malay Reserve Land, agricultural land etc.

Under the 22 April 1998 Special Guidelines and Home Ownership Campaign (HOC), the limits on the number of residential or commercial properties that can be bought by a foreigner is removed. The equity conditions imposed previously were also removed. Other conditions that came with the Special Guidelines and the HOC, viz the project must be newly completed or at least 50 per cent in progress, and the financing must be from offshore funds, were also later removed. The only condition remaining is that the prices of the properties must be above RM250,000 per unit.

The HOC was a series of marketing events, organized by the Real Estate and Housing Developers Association (REHDA) in the form of a national road show as their response to the property overhang. The relaxation of the FIC Guidelines under the HOC was a one-off, and only applicable to those who signed their Sales and Purchase Agreement between 12 December 1998 and 12 January 1999, provided they submitted a copy of the Special Certificate endorsed by the developer and REHDA, stating that the property was purchased during the HOC.

Policy Analysis

The FIC Guidelines are based on four basic rules, and deviations from these rules are exceptions or relaxations to these four basic rules:

Residential Property

A foreign national may purchase a terraced house of more than 2 storeys if it costs more than RM250,000 per unit and the total number of units sold to the foreign nationals do not exceed 10 per cent of the total number of units for a particular type in a residential project. Foreign nationals may also purchase land for bungalow and semi-detached houses subject to the same conditions. Similarly, foreign nationals may also purchase condominiums or apartments priced at more than RM250,000 per unit, provided that foreign interests acquire not more than 50 per cent of the total number of units in each block.

Individual foreigners are allowed to purchase two residential units of which one unit must be a condominium. Any additional units will be considered as an investment and the acquisitions must be made through a company that has 70 per cent Malaysian equity, including at least 30 per cent Bumiputera equity. Foreign manufacturing companies or companies promoted by the Government are allowed to purchase more than two residential units for use of its employees.

The RM250,000 per unit upper limit is not a hard and fast rule as there are several exceptions. Apartments costing RM80,000 and above can be bought by manufacturing

companies for use by their employees, in companies promoted by the Government. Similarly, permanent residents may buy properties costing RM60,000 and above, provided the spouse is a Malaysian citizen.

The government has also introduced a Silver-Haired Programme, where foreign nationals are allowed to own residential units costing RM150,000 per unit and above, if such units are within the areas identified by the Ministry of Culture, Arts and Tourism for that purpose. Foreign companies may also purchase more than one residential unit to be used as company resort homes.

Commercial Properties

For many years, the Government has a policy of encouraging foreign companies incorporated in this country to locate their regional office or headquarters here. In this regard, foreign companies may acquire without limit, any number of offices or amount of office space including branch offices costing more than RM250,000 per unit, without any equity conditions. Thus, there is no restriction on the purchase of office space for use as the headquarters of foreign companies, but the Ministry of Finance must be informed. The previous policy was that sales of office space require FIC approval, except for sales of office space in the hands of developers - not completed office buildings.

Foreign nationals who are not building their headquarters here may also purchase commercial complexes or office space, provided that not more than 20 per cent of the particular type of property in each project is acquired by foreign interests and the acquisition is made through a Malaysian incorporated company with at least 49 per cent Malaysian equity, including 30 per cent Bumiputra share interest.

Foreign nationals may purchase shophouses of three storeys or more, with prices exceeding RM250,000, provided that foreign interests

acquire a total of not more than 50 per cent of the total number of units in each block.

Agricultural Properties

The basic rule is that foreign nationals are not permitted to purchase agricultural property perhaps because they are seen as strategic assets. Acquisition for the purpose of pursuing traditional agricultural activity, such as rubber or oil palm plantation is thus not permitted.

There are a few notable exceptions. The first are cases where the acquisition is for an agricultural venture where high or advanced technology will be utilized, provided that the acquisition is made through a Malaysian incorporated company with at least 49 per cent Malaysian equity, including 30 per cent Bumiputra share interest.

Secondly, the purchase of agricultural property is likewise permitted if the purpose is to undertake an agricultural-based industry or a tourism project. Thirdly, foreign interests are permitted to purchase agricultural land, for the purpose of providing goods for export, as outlined by the Ministry of International Trade and Industry (MITI). The equity structure of the foreign interest is to be in accordance with the guidelines determined by MITI.

Industrial Property

Foreign nationals are permitted to purchase industrial properties for the purpose of a company's operational purposes, provided that the foreign interest possesses a Manufacturer's License from the Ministry of Trade and Industry. For those without the License, the foreign interest must obtain prior FIC approval on the foreign-owned equity.

Foreign interests that are operating manufacturing activities which are exempted from obtaining manufacturing licenses from the Ministry of Trade and Industry (MITI) are permitted to purchase industrial lots and

factories for manufacturing activities only but equity conditions are imposed if they are letting the properties out. This step is to facilitate the acquisition of industrial properties by foreign nationals since it does not impose any equity requirements; however, as stated above, this exemption only applies to manufacturing activities by foreign nationals if they are not going to rent out the properties.

This means that foreign nationals may purchase industrial land if there is a license from the Ministry of Trade and Industry (MITI). If they are exempted from taking a license from MITI, they may acquire the properties but they cannot rent them out without equity conditions being imposed on them.

Development Property

For development properties, foreign nationals may acquire landed property for the purpose of development as a housing project, business (commercial) property, or industrial area, provided that the acquisition is made through a Malaysian incorporated company, with at least 70 per cent Malaysian equity, including 30 per cent Bumiputra share interest.

Summary of the Latest Position

Acquisition of property by local citizens costing below RM10 million does not require the approval of FIC. This is an increase of RM5 million compared to the earlier guideline. This new amendment is to expedite and facilitate real estate transactions costing below RM10 million, by enabling them to be settled at State Authority level.

Bureaucratic red tape and uncertainty is also reduced further. Acquisition of properties by locals costing more than RM10 million but below RM20 million need not be approved by FIC but only needs to be reported to FIC Secretariat for record purposes before the transaction is done if it involves the following special cases:

- a. Bumiputera to Bumiputera
- b. Non-Bumiputera to Bumiputera
- c. Non-Bumiputera to non-Bumiputera and
- d. Foreign interests to Malaysians

Approvals are given on a case-by-case basis. Thus, acquisition of properties by a Bumiputera to Bumiputera does not require FIC approval if it is below RM10 million.

The Asean countries has forged an understanding in many political and business areas. It should also be noted that under the AIA (Asean Investment Area) agreement, head of states of the Asean countries agreed that any Asean national can get equivalent reciprocal treatment in any Asean country, equivalent to locals. Thus, a 100 equity can be held by an Asean national in a company incorporated in Malaysia.

In this context, foreign companies incorporated within Asean countries which wishes to set up a joint-venture, a co-operative company or carry out trade and business activities in this country are allowed to own office or commercial space costing above RM250,000 per unit, without domestic equity conditions. Hotel properties and other tourism projects, due to their special nature, may be majority owned or 51 per cent owned by foreigners, with the equity going up to 100 per cent after five years.

Foreign nationals are permitted to acquire all types of residential, shophouses, office and commercial space, whether old units or newly launched ones, provided they cost more than RM250,000 per unit, without the need to form a company with the participation of local equity. The previous relaxation applied only to projects that were newly completed or where construction was at least 50 per cent completed. These acquisitions can also now be financed from local sources, such as domestic banks, whereas previously, such acquisitions had to be financed from overseas funds.

Similarly, we can summarise the landed properties which are still "out of bounds" to foreigners, as follows:

- a. All landed properties below RM250,000 per unit.
- b. Properties built on Malay Reserve Land or reserved for Bumiputras.
- c. Acquisition of three or more units of residential properties (for individuals, including spouses) .
- d. Agricultural land without technological input on Malay Reserve Land.
- e. Historical or gazetted buildings.

Reviewing The FIC Guidelines

The main sentiments against the FIC guidelines can be summarised thus:

- a. The FIC Guidelines are rather micro.
- b. Since the foreign nationals cannot take the property away even if they owned it, there is no need for undue worry.
- c. It causes delay.
- d. Thresholds are too low compared to other countries.
- e. It changes frequently.

To put things in perspective, a lot of the reasons for the dissatisfaction with the FIC are creatures of the recession. Likewise, solutions should embrace measures to foster greater economic growth. The FIC guidelines are not the main reason for the ills of the property market in this country, since FIC policies are only one of many factors why investors choose to invest in this country. Other factors include political stability, expected returns, risk analysis, etc. Ultimately, Malaysia's efforts to lure foreigners to buy surplus properties depend on the state of the national and regional economy.

In this context, the Malaysian government in recent years has taken several steps impacting on the property sector as part of the financial measures to promote economic recovery: On 7 September 1998, lending for the construction or purchase of residential properties costing

RM250,000 and below were exempted from the 20 per cent limit on lending to the broad property sector. On 5 October 1998, the 60 per cent maximum margin for financing the purchase of non-owner occupied residential properties costing RM150,000 and above, shophouses costing RM300,000 and above, and the purchase of land lots was abolished. The National Housing Company Berhad also offered bridging finance to developers for the construction of houses costing RM150,000 and below.

Solutions also cannot be patterned solely on those of other countries, as the national aspirations and strategic priorities are different. Proponents of liberalisation have put on cogent arguments, but it is ultimately a question of getting the right balance between the aspirations of the country's economic policies and that of the business imperatives. Words like AFTA, globalisation, free trade, etc, should not be excuses to throw caution to the wind, by totally liberalising the acquisition of property assets by foreign nationals. Even developed countries like Australia have not gone down this path. A similar body to the FIC, the Australian Foreign Investment Review Board (FIRB) also has similar regulations to the FIC. See Appendix A. Thus, even for a developed country like Australia, purchases of its properties by foreign nationals are controlled.

The frequent relaxation of the FIC Guidelines relating to property acquisitions is not only to clarify and simplify the FIC procedures for the acquisition of property by local and foreign interests but also to be proactive in responding to urgent issues of the day. However, a common grouse of foreign property investors in the past is that the government has a tendency for flip-flopping on regulations relating to foreign property ownership. The retroactive 100,000 ringgit (\$26,315) sales tax introduced temporarily in 1995, is still fresh in the mind of some foreign investors, making them nervous about future policy about-turns relating to property

purchases by foreigners. Investors who got their fingers burnt will not return easily. Thus, whilst responsiveness to public feedback is good, the FIC policies relating to property needs the balm of permanency, as real estate is a long-term investment. The foreign investors need assurance that these policies are here to stay.

Another area of uncertainty is whether the Malaysian Ringgit (RM), which is pegged to the US dollar, will be revised downwards in the medium term, as Malaysia is forced to devalue its currency. As landed properties are long-term investments, the value of Malaysian equity or properties held by a foreign investor would diminish in such an event. This concern has already resulted in various Singapore-based financial institutions, such as the Government of Singapore Investment Corporation Pte Ltd (GIC), reducing its exposure to Malaysian assets recently.

The RM10 million threshold may be too low; perhaps a higher threshold of RM30 million might be more appropriate, if the Australian experience is anything to go by. Certainly the FIC should find an appropriate threshold to plant the goalposts and keep them there, come recession or otherwise so that investors would be reassured of the continuity, long term nature and stability of our national policies. This calls for a deep discussion among all relevant parties on what an appropriate threshold is, and how we want to go forward. In this context, FIC should be applauded for taking the initiative to provide various briefings and holding various dialogues with all the relevant parties before coming out with the new guidelines.

With regard to delays, as a federal government, policies are sometimes administered concurrently through different Ministries as the transactions involves different areas such as companies, properties, services, labour laws, approval and operating permits and so on. This can be perplexing to some investors and may be regarded as red

tape, especially if this process takes longer than expected. To be fair, the FIC has vastly improved their act. They receive about 80 applications a month, and on average, a single application takes about two months to process. This does not include delays caused by insufficient information being provided by the applicant.

Nevertheless, it is important that the various government agencies try to work in unison as much as they can, to avoid confusion among investors. For example, FIC and the Ministry of Trade and Industry (MITI) must not contradict each other. FIC should also work towards processing applications simultaneously with all the other relevant departments, instead of asking applicants to apply serially. Even better, automatic approval should be given within a certain frame if the conditions set out are met.

It is estimated that business transactions can be slowed down by RMS to RM10 million if FIC takes too long to process the applications due to too many applications in the pipeline. A typical application would take 6-8 weeks, putting off many potential buyers. If FIC is inundated with applications, this delay is bad for business. Against the backdrop of most of the available foreign investment previously due to countries within the Asean region going to China, there is a need to review the FIC guidelines. The basis for the argument is that the FIC Guidelines should support the efforts of the businessman to fight for a share of a shrinking FDI. Further, since all shares on the Kuala Lumpur Stock Exchange (KLSE) are freely traded, companies listed on the KLSE find waiting for the FIC approvals rather difficult, as they need quick decisions to buy or sell.

The merits and demerits of FIC guidelines may always be subject to different perspectives of the different interested parties. Objective discussions on the policies of the FIC can be difficult, as there is not much reliable data on application and

approvals forthcoming, since land, is a state matter whilst FIC is a federal body. Analysts estimate that foreigners make up less than 2 per cent of the property market, so how much impact the previous regulations had on putting off Singaporean investors cannot be measured except to say anecdotally that the public perception is negative. The need for more data is imperative, so that the impact of FIC policies on the country can be more closely gauged and monitored by researchers.

Concern has also been expressed that the current rules provide a relaxation only to developers, whereas other landed property owners also suffer from property overhang. This is believed to be because most purchasers are direct from the developer, not sub-sales. On this point, it is up to the aggrieved parties to put their grievances across clearly to the authorities, in the same way as the developers had done. Overhang figures should also be correctly interpreted, as a small overhang would not be a totally bad thing. As with other sectors of the economy, such as employment, a small amount of excess capacity is needed to ensure flexibility in economic response.

Conclusion

By all accounts, the policies of the FIC have attracted a lot of Press. Depending on their perspective, it is perceived as a boon or a bane to FDI. It has been variously described as a perpetrator of dead end policies, or the savior of the country's strategic long-term interests. That some sort of guidelines on foreign

investment is needed is common ground. Much of the more rational comments are due to the different expectations of the various parties relating to threshold levels and how the policies of the FIC should be implemented.

It should also be noted that since land is a state matter, the FIC has no direct control over the land transaction process in the respective states. However, through the National Land Council, which is chaired by the Deputy Prime Minister, and where all the states are represented, the cooperation of the various states are sought to ensure administrative facilitation by the states to implement the FIC Guidelines. This step also shows the FIC's role vis-a-vis the state in liberalizing property transactions. If this role is not effective, then even if any new measures send a strong signal to the market, foreigners may not be coming in droves to take advantage of the new rules yet.

When the NEP was first introduced, the Bumiputra equity in Malaysia was about 2 per cent, whereas the foreign equity was about 70 per cent. Now in 2002, the foreign equity is about 30 per cent, while the Bumiputra equity is about 20 per cent. There is still a need to continue with the policies of the FIC to address this continuing imbalance. The equity conditions imposed under the FIC Guidelines are in line with the objectives of the NEP. Since the intention is to make Malaysia a country which is always united, peaceful and prosperous, all companies which are affected by the policies should endeavor earnestly to comply with the conditions.

List of Appendices

- Appendix A Main functions of the FIC
- Appendix B Purchase of Property In Singapore By Foreigners
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- Appendix D1 Summary of Guidelines For Residential Property From 1992-2001
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- Appendix E Summary of Guidelines For Agricultural Land

Appendix A

Main Functions Of The FIC

The main functions of the FIC are to:

- Plan policy guidelines on foreign investment in all sectors of the economy (including the property industry)-
- Administer and advise Ministries and Governmental Agencies on foreign investment matters.
- Assist foreign investors in their business activities in Malaysia and recommend suitable investment policies.
- Organise and control the acquisition of assets or any interests, mergers and take-over of companies and businesses in Malaysia.
- Monitor and evaluate the form, extent and conduct of foreign investment in the country and to maintain comprehensive information on foreign investment matters.

The FIC guidelines apply to the following:

- Foreign investors proposing an acquisition of any large fixed assets in Malaysia.
- Any proposed acquisition, merger or take-over of companies and businesses in Malaysia that will result in ownership or control passing to foreign parties.
- Any proposed acquisition of 15% or more of the voting power by anyone of the foreign interests or associated groups or by foreign interests in the aggregate of 30% or more of the voting power of a Malaysian company or business.
- Control of Malaysian companies and businesses through any form of joint venture agreement, management agreement and technical assistance agreement or other arrangements.
- Any merger or take-over of any company or business in Malaysia whether by Malaysians or foreign parties.
- Any acquisition of assets (including properties) or interests exceeding the sum of RM5 million, whether by Malaysian or foreign parties.

Appendix B

Purchase of Property In Singapore By Foreigners

Under the Residential Property Act 1976 (RPA), all Singapore citizens and companies can freely buy any type of residential property in Singapore. However, foreigners wishing to buy a property are not permitted to acquire “landed” properties. Landed properties are properties that have their own land title, for example, detached, semi-detached or terraced houses, non-strata-titled property; vacant land zoned for residential use and apartment units in buildings below six storeys in height without condominium status.

However, they can purchase a flat comprised in any building containing six or more storeys, or property that bears the title ‘condominium’ in any approved documents, or any non-residential, commercial or industrial property.

Any foreign person who wishes to purchase any of the above restricted residential property for owner-occupation may apply to the Controller of Residential Property for his written approval. Once approval is given, the successful applicant is required to sign an undertaking to the government that the property will be used for occupation as opposed to investment.

The application process takes about three months and the applicant will be evaluated on a case-by-case basis. Foreigners eligible to apply are permanent residents of Singapore; those who are of “economic benefit” to Singapore or are able to make economic contributions to Singapore; and foreigners who possess professional or other qualifications or expertise which are of value or benefit or are advantageous to Singapore. Foreigners who have been granted approval to purchase landed property in Singapore cannot later transfer this approval to another foreigner .

In terms of financing, since May 1996, foreigners cannot obtain Singapore Dollar loans to purchase residential properties. Foreign currency loans e.g. HKD, USD, GBP, are available to foreigners and Singapore permanent residents from most commercial banks.

Appendix C

Purchase of Property In Australia By Foreigners

Acquisitions of developed residential real estate by foreign interests in Australia are not normally approved except for the following two categories:

- i. Foreign companies, with an established substantial business in Australia, buying for named senior executives continuously resident in Australia for periods longer than 12 months, provided the dwelling is sold when no longer required for this purpose. Whether a company is eligible, and the number of properties it may acquire under this category, will depend upon the scope of the foreign company's operations and assets in Australia. Unless there are special circumstances, foreign companies normally will not be permitted to buy more than two dwellings under this category.
 - Foreign companies would not be eligible under this category where the property would represent a significant proportion of its Australian assets.
- ii. Foreign nationals temporarily resident in Australia, holding a current temporary resident visa which permits continuous residence in Australia for a minimum further period of more than 12 months from the time of application, purchasing a dwelling for use as their principal place of residence (and not for rental purposes), subject to the immediate sale of that property if their visa expires, or if they no longer occupy the property or when they cease to reside in Australia. This latter category includes long-stay retirees, and students 18 years of age and over studying courses of more than twelve months duration at recognised tertiary institutions. A general limit of \$300,000 applies to the value of properties acquired by students temporarily resident in Australia.
 - Persons who only hold visitor or bridging visas are not eligible for approval under this category.
- iii. Acquisitions of residential real estate (including vacant building allotments and house and land packages where construction has not commenced) for development by foreign interests' are normally approved subject to a specific condition requiring continuous construction to commence within 12 months.

Foreign interests may apply to acquire home units, town houses, house/land packages (where construction has commenced), strata titled hotel/motel units etc in a new development, either 'off-the-plan', during the construction phase or when the dwelling is newly completed, provided that it has never been occupied or sold and provided no more than 50 per cent of the dwellings in anyone development are sold to foreign interests. This category includes dwellings that are part of extensively redeveloped buildings where the building's use has undergone a change from non-residential (eg office, warehouse) to residential and the cost of redevelopment is at least 50 per cent of the total acquisition cost based on purchase price or market value of the property, whichever is the greater .

- This category does not include developed residential real estate that has been refurbished.

Integrated Tourism Resorts

Acquisitions of residential real estate within a resort which has been designated by the Government as an Integrated Tourism Resort (ITR) prior to September 1999 are exempt from the normal foreign investment restrictions applying to foreign acquisitions of residential property and do not require further foreign investment approval. For resorts designated as ITRs from September 1999, the exemption only applies to developed residential property which is subject to a long term (10 years or more) lease to the resort/hotel operator, making it available for tourist accommodation when not occupied by the owner .

Commercial Real Estate

Commercial real estate means developed property (such as offices, retail and industrial complexes), but **not** (i) vacant land (ii) accommodation facilities (iii) residential properties (i.e. houses, flats, units, 'hobby farms' and 'rural residential' blocks) and (iv) land which is integral to a farming business.

Who Should Apply?

Acquisitions of commercial real estate by foreign interests should be submitted to the Government through the Foreign Investment Review Board for approval prior to purchase unless the acquisition is exempt (see below).

Exempt Commercial Real Estate Acquisitions

Acquisitions of commercial real estate by Australian citizens resident abroad or Australian incorporated companies or Australian based trusts owned by Australian citizens resident abroad do not require approval. Acquisitions of commercial real estate where the total value of the property being acquired is less than \$50 million do not require notification or approval unless:

- i the land is vacant;
- ii the whole or part of the land comprises an accommodation facility;
- iii. the property is being acquired by a foreign government or its agent.
- iv. the property is valued at more than \$5 million and is subject to heritage listing. 35.

Acquisitions of developed commercial real estate which are to be used immediately for industrial or commercial purposes which are incidental to an existing or proposed business (other than a business of dealing in land or operating an accommodation facility) do not require notification or approval.

The United States remained the largest source of proposed foreign investment in Australia during 2000-01 accounting for around 45 per cent of the total. The other major source was the United Kingdom, its proposed investment in Australia increased to \$22.7 billion in 2000-01 or 21 per cent of the total. This represents a 97 per cent increase from \$11.5 billion in 1999-2000. The next largest contributors of proposed foreign investment were Germany, Canada and Hong Kong with proposed investments valued at \$4.7 billion, \$3.6 billion and \$3.1 billion, respectively.

Appendix D1: Summary of Guideline For Residential Property From 1992 - 2001

Issued Date	17 December 1992	1 November 1995	22 May 1998	18 May 1998	2 May 2001
Effective Date	17 December 1992	23 June 1995	16 October 1997	22 April 1998	25 April 2001
Price	RM80,000 and above	RM250,000 and above	RM250,000 and above	RM250,000 and above	RM250,000 and above RM150,000 for Silver Haired Programme
Source of Funding	*	*	*	offshore	within Malaysia
Restricted Purchases		a. 1 & 2 storey terraced house b. low and medium cost c. houses on Malay Reserve land d. Bumiputra quota	a. 1 & 2 storey terraced house b. low and medium cost c. houses on Malay Reserve land d. Bumiputra quota		
Restricted Sales	a. For own use, cannot be resold within 3 years b. For rent, cannot be sold within 5 years	Cannot be sold within 3 years	Cannot be sold within 3 years		
Restricted Purchases and Sales According To Price Categories	Terraced Houses	a. RM80,000 to RM200,000 for own use only b. RM200,000 and above, for own use or for rent			
	Condominium	a. RM80,000 to less than RM300,000, for own use or rent b. RM300,000 and above no restriction			
	Bungalows	a. RM80,000 to less than RM500,000, for own use only b. RM500,000 and above, for own use or rent			
Additional Condition For Purchases of Bungalows and Semi-detached Units	If land is developed for investment, the owner has to transfer the title to a local company, with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	If land is redeveloped for investment, the owner has to transfer the title to a local company, with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	**	**	**

* No statement concerning sources of finance is mentioned in the above Guideline but approval is given to applications that has obtained offshore financing.

** No statement concerning development but every approval for purchase of bungalow units includes the condition that "every redevelopment must obtain prior approval of FIC"

Appendix D2: Summary of Guideline For Residential Property From 1992 - 2001 -cont

Issued Date		17 December 1992	1 November 1995	22 May 1998	18 May 1998	2 May 2001
Effective Date		17 December 1992	23 June 1995	16 October 1997	22 April 1998	25 April 2001
Number of Units Permitted		Only one - extra units have to be purchased through a local company, with 30% foreign equity and 70% local equity(including 30% Bumiputra share)	Only one - extra units have to be purchased through a local company, with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	2 condo units or 1 landed and 1 condo unit, extra unit have to be purchased through local company, with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	No restriction	No restriction
Purchased By Foreign Companies as resort/holiday homes		a. One unit is permitted for company staff b. Extra units must be purchased through a local company, with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	For staff use, purchase of more than one unit may be considered			
Purchase By Local Manufacturing companies		a. For staff use, may purchase more than one unit, provided less than RM80,000 per unit b. For investment, units must be purchased through a local company, with 30% foreign equity and 70% local equity (including 30% Bumiputra share)		For staff use, purchases of more than two units are permitted, but they must cost less than RM60,000 each		
Developer Sales Quota	Terraced Houses	30 per cent	30 per cent	50 per cent		
	Condominium	30 per cent	10 per cent (more than two storeys)	10 per cent (more than two storeys)		
	Bungalows/ bungalow lots/ semi-detached	30 per cent	10 per cent	10 per cent		
Relaxation For Permanent Resident				May purchase property costing more than RM60,000 each if husband or wife Malaysian citizen Or buyer qualifies for permanent resident status and has applies for it		
Purchase under "time sharing Schemes"		No restriction				

Appendix E: Summary of Guideline For Commercial Property, Industrial Land and Factories, and Development Land From 1992 - 2001

Commercial Properties

Issued Date	17 December 1992	1 November 1995	18 May 1998	22 May 1998	2 May 2001
Effective Date	17 December 1992	23 June 1995	16 October 1997	22 April 1998	25 April 2001
Price		More than RM250,000	More than RM250,000	More than RM250,000	More than RM250,000
Restriction on Purchase		a. Two-storey shops and lower b. Low cost shops c. Stalls d. Service workshops e. Business premises on Malay Reserve Land		1. Subsales only (not from developers) 2. If from developers, projects must be less than 50 per cent completed	Subsales only (not from developer)
Source of Financing				Offshore	Within the country
Equity Condition	For shop-house only, a local company with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	1. For own use: A company that is incorporated in Malaysia with 30% foreign equity and 70% local equity (including 30% Bumiputra share) 2. For Renting out: A company that is incorporated in Malaysia with 30% foreign equity and 49% local equity (including 30% Bumiputra share)			
Sales Quota (Developer)		Less than 20 per cent of such units within a project			

* Shop-house, Office and Retail Lots

** Only the conditions for the purchase of residential units are mentioned

Industrial Land and Factories

Issued Date	1 November 1995	18 May 1998	2 May 2001
Effective Date	23 June 1995	16 October 1997	25 April 2001
Condition	1. With a manufacturing license from MITI - no equity conditions imposed 2. Without a manufacturing license from MITI - A company that is incorporated in Malaysia with 30% foreign equity and 70% local equity (including 30% Bumiputra share)		1. With a manufacturing license from MITI - no equity conditions imposed 2. Without a manufacturing license from MITI - no equity conditions imposed but only for manufacturing activities
Purpose of Purchase	For own use only	For own use only	For own use and for rent

* Only the conditions for the purchase of residential units are amended

Land For Development

Issued Date	1 November 1995	18 May 1998*
Effective Date	23 June 1995	16 October 1997
Price	More than RM250,000	More than RM250,000
Equity Condition	A company that is incorporated in Malaysia with 30% foreign equity and 70% local equity (including 30% Bumiputra share)	

* Only the conditions for the purchase of residential units are amended

Strata Titles Act 1985 -Legal Needs, Implications and Impacts of the Recent Amendments: Part I

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Abstract

One of the present trends of the construction industry is on the construction of high-rise buildings which is to accommodate the growth in demand for property within the cities where land is a scarce resource. The requirement of ownership especially in the residential and commercial sub-sectors requires the sub-divisions of buildings which will give rise to demands for strata titles. In comparison to properties issued with land titles, properties issued with strata titles have three main stages instead of one. There are the pre-issuance, the issuance and post issuance stages. During the pre-issuance stage there are issues on meeting the requirements of the law for application of titles and the issues on building management by the developers. During the issuance stage there are issues of owners who pass away and companies that have wound up or are declared bankrupt and at the post-issuance stage, there are issues again on building management, this time under the management corporations. These issues have given rise to problems over the implementation of the Act and hence the Act was recently amended to meet the needs. One of the major amendments under the Act is the establishment of the Strata Titles Board. These amendments are not conclusive and are subject to further amendments in future.

Keywords: strata titles, sub-divided buildings, management corporations, strata titles board

Introduction

A present trend in the construction industry is that it is moving towards the construction of high rise buildings especially in the residential and commercial sub-sectors and, to a lesser extent, the light industrial sub-sector of property development. From the demand and supply perspective, rapid urbanisation, high population growth, increase in investment opportunities as well as increasing job opportunities in the cities are making land a scarce resource. The logical response is to maximise land use by building upwards.

Given that such is the case with land development, it follows that this will give rise to a compelling demand for strata titles to the individual units in the high-rise buildings. Undoubtedly, strata title is paramount to purchasers as proof of ownership on property. As evidence, 6,135 strata title applications involving 329,401 parcels have been received by 31 December 2000, of which 169,651 strata titles have been registered.

A comparison of the number of applications received and the number that have been processed shows the occurrence of some delay. On top of this, some developers of completed high-rise buildings have yet to apply for strata titles.

In contrast with landed properties such as houses where buildings sit on individual parcels of land, the development process on high-rise buildings does not end with the issuance of strata titles to the individual units. Other components in the process involve the management and maintenance of the buildings both before and after the issuance of strata titles. In other words, when buildings are subdivided for the issuance of strata titles, there is the pre-issuance phase, the issuance phase and the post-issuance phase.

The presence of these different components peculiar to multi-storey buildings requiring

strata titles, requires an effective legal framework. This framework is provided for by the various provisions under the Strata Titles Act 1985 that regulate the requirements for issuance of strata titles and other related matters. Nevertheless, there are also legal implications over its application. Hence, it is best to look at the requirements for the issuance of strata titles and other related issues. The discussions should be followed by looking at the implications of implementing the Act.

Basic Requirements For Issuance of Strata Titles

- Strata titles can only be registered and issued when the following basic requirements are met.:
 - a. There is a completed building on the land;
 - b. The building has two or more storeys, whether above or below the surface of the land;
 - c. The land is held under one lot;
 - d. The land is alienated land; and
 - e. The land is held under final title.

Application for Strata Titles

- The time taken for issuance of strata titles very much depends on whether the developers' submissions meet the requirements of the Strata Titles Act 1985. It is therefore necessary for developers to keep a check-list of the procedures and the requirements to be followed in their application for strata titles. A check-list that can be used as a guide for applying strata titles is as follows:

a. Application Form

The application for strata titles is to be made by using Form 1 under the First Schedule to the Strata Titles Act 1985. The form has to be signed by the proprietor/owner of the land.

b. Submission Requirements

- (i) the application fee as prescribed in the State's Strata Titles Rules;
 - (ii) 3 copies of approved building plan;
 - (iii) 3 copies of proposed strata plan which consists of the location plan, and the storey plan of the building which has been certified by a land surveyor;
 - (iv) permit to use air space, if applicable;
 - (v) certification by the architect, if applicable;
 - (vi) where applicable, the written consents of the chargee, lessee or lien-holder of the land, or chargee and lien-holder of the lease;
 - (vii) the issue document of title to the land;
 - (viii) 3 copies of the certified plan of the lot which has been approved by the Director of Survey, if the land is held under qualified title; and
 - (ix) where phased development is involved, 3 copies of the approved building plans of the provisional blocks, the location plan and 3 copies of the storey plan of the provisional blocks, and the proposed quantum of share units.
- In making the application, one of the most important factors to consider is the allocation of share units to each of the parcels to be issued with strata titles. There are a number of factors which may be taken into account in allocating share units to individual parcels. These include the sales price, floor area, or location, and whether there is any accessory attached to it,

e.g. a car parking bay. Generally, the floor area factor is usually adopted. However, if the development is a mix of commercial complex and condominium developments, then it may be based on the sales price. It may also be based on the floor area x a factor of 1 for condominium unit and a factor of 1.5 for a commercial unit. This is to distinguish the values between the two properties.

- With all the necessary requirements, the developer/proprietor then submits the application to the Land Office. In practice, the licensed land surveyor is usually engaged to prepare the application. This is the first of a 12-step process for strata titles. It should be pointed out that the Strata Titles Act 1985 was amended for the second time in 1996 to provide some leeway in enabling the developers to submit their applications very much earlier. Firstly, developers are now allowed to apply for strata titles although the land is still held under qualified title, but provided that a certified plan has been approved by the Director of Survey. However, the approval can only be granted when the final title is available. Secondly, developers are also allowed to apply for strata titles although the completed building has yet to be issued with a certificate of fitness.

These amendments are aimed at shortening the processing time for strata titles. The time frame set for the issuance of strata titles is 12 months, provided that the applications are complete and fulfill the requirement of, and the conditions for approval under, the Strata Titles Act 1985.

- Developers are also reminded of their legal duty to apply for strata title. Section 8 of the Strata Titles Act 1985 makes it mandatory for developers

who have sold or agreed to sell any of the parcels, to apply for strata titles within the specified time period. Generally, it is 6 months from the date of the issuance of the certificate of fitness. The penalty for failing to do so is a fine not exceeding RM5,000.00 and a further fine not exceeding RM1,000.00 for each day the offence continues to be committed. It has been observed that the penalty is too light to enforce conformance on the part of the developers. In the light of this, a higher amount was substituted in the recent amendment of the Strata Title Act 1985. The details of the amendments will be discussed later in the paper.

Management Of Buildings Upon Issuance of Strata Titles

- The issuance of strata titles constitutes only one part of the subdivision of buildings. The other part, management of building, represents a permanent duty that has to be shouldered as long as the strata titles exist. The management aspect is regulated in the Strata Titles Act 1985 because strata title ownership does not merely involve the individual ownership of the property, but also common ownership of areas outside the individual property which is known as common property. It is for this reason that the Strata Titles Act 1985 provides that the management of the building is to be undertaken collectively through a body known as the Management Corporation.
- Under the Strata Titles Act 1985, A Management Corporation is a body corporate to be established upon the registration of strata titles. As a collective body, the Management Corporation comprises all strata title owners. The Strata Titles Act lays down

a comprehensive code of regulations governing the management of buildings by the Management Corporation. It includes the duties and powers of the Council elected to carry out the duties and powers of the Management Corporation, the convening of meetings, the rights and obligations of parcel proprietors, and record-keeping.

Despite the several amendments made to the Strata Titles Act 1985, for the first time in 1990 and again in 1996, the Act is still seen as ineffective in meeting the needs of the affected public. Developers were still slow when it comes to submitting their applications, or worse, failed to submit their applications at all. Another outcome is that the Act lacks adequate provisions to handle particular issues and, as a result, there is an increasingly high number of complaints and reports on disputes occurring between the parcel owners themselves or between the parcel owners and the Management Corporations received by the Ministry of Land and Cooperative Development as well as the State Authorities. At present, excluding the state authorities, the Ministry has received 185 complaints on the management of multi-storey buildings. More than 80 per cent of the complaints come from the Federal Territory of Kuala Lumpur, Penang and Selangor. Among the complaints are poor keeping of account books and the minutes of the annual general meetings or subsequent meetings by the Management Corporations; the non-audit of Management Corporations' management funds; failure to conduct council meetings and annual general meetings by the Management Corporations; parcel owners' refusal to contribute towards the management funds under the Management Corporations; inadequate funds to manage the buildings; disputes between the parcel owners themselves and disputes between the parcel owners and the Management Corporations. The Management Corporations have to take their own initiative to resolve the disputes but when faced with complex situations, the corporations are not able to handle them.

Under such circumstances, the interference of the State Director of Lands and Mines is necessary but act more in an advisory capacity. As a last recourse, the matters have to be brought before the courts.

Obtaining remedy through the courts is costly and time-consuming. It is therefore very necessary to create mechanisms for handling disputes speedily. In view of such needs, the Act was further amended in early 2001.

The Recent Amendments of The Strata Titles Act 1985

The Strata Titles Act 1985 was again amended in 2001 to help address inadequacies in the Act. The amendments to the Act were intended to resolve disputes with regard to the running of the Management Corporations; overcoming delays in the application of strata titles; simplifying applications for strata titles; and above all, to promote conduciveness for harmonious living among parcel owners in this fairly new concept of community living under one roof and with common facilities to share. The most outstanding feature under this new amendment concerns the formation of the Strata Titles Board, which comes under Sections 67A to 67X of the new amendments. The Board's functions are similar to the one under the Australian and Singaporean acts on strata titles. With the establishment of the Board, all disputes be resolved without going to the courts and this greatly reduces the courts' burden. The provisions regarding the Strata Titles Board are discussed in detail later.

Apart from providing for the establishment of the Strata Titles Board, other provisions deemed necessary have been included in the amendments.

- **Amendment of Section 8 - Penalty for non-compliance**

Before the amendment, when an application for strata title is not made within the period specified, the

proprietor shall be subjected upon conviction to a fine of not exceeding RM5,000.00 and a further fine of not exceeding RM1,000.00 for each day the offence continues to be committed. In order to force developers to submit their applications for issuance of strata titles, the new amendment raised the fine to not less than RM10,000.00 but not more than RM100,000.00, and to a further fine of not less than RM100.00 but not more than RM1,000.00 for each day the offence continues to be committed.

- **Amendment of Section 15 - Registration of Caveats**

Caveats are registered in the master title of the main land lot of the subdivided buildings. This form of registration causes delay in the registration of strata titles as the caveats have to be endorsed on all the strata titles of the unit parcels in the building. At the same time, it creates inconvenience for the parcel owners to carry out dealings on their unit parcels. Under the new amendments, in order to simplify the registration of caveats, the Registrar shall, in the case of private caveats appearing on the register document of title to the lot, if satisfied that such caveats affect only particular parcels created on the subdivision, endorse such caveats on the register documents of title to the parcels in question. When the Registrar is unable to ascertain the caveats which affect the particular parcels, he may endorse a statement in Form 3 to the effect that the lot is so subject to the caveats entered on the register document of title to the lot. This is with the condition that if the Registrar may at any time thereafter that it can be ascertained that such caveats relate to particular parcels, endorse such caveats on the register documents of title to the parcels in question.

- **Amendment of Section 25 - Amalgamation of Parcels**

The amendment allows for amalgamation of parcel units even though it results in the creation of new common property areas. In this case, a parcel proprietor may, with the approval of the Director of Lands and Mines (DLM), divide his parcel into two or more new parcels, each to be held by him under a separate strata title; or where he holds two or more contiguous parcels, amalgamate them to form one parcel to be held by him under a single strata title. Under the new amendment, where the division of a parcel or the amalgamation of two or more parcels results in the creation of any additional or new common property, the proprietor shall obtain the written consent of the management corporation before making the application under section 28 for the approval of the Director of Lands and Mines.

- **New Section 33A - Common Property**

In relation to Section 25, upon registration of the strata title or titles to the new parcel or parcels and upon the division or amalgamation, the parts of any parcel which are created as common property shall be deemed to form part of the common property in relation to all the parcels comprised within the sub-divided building.

- **Amendment of Section 41- Distribution of Management Fund**

Under subsection (5), the first annual general meeting includes the following matters under its agenda:

- a. To decide whether to confirm, vary or extend insurances effected by the management corporation;

- b. To decide whether to confirm or vary any amounts determine as contributions to the management fund;

- c. To determine the number of members of the council and to elect the council where there are more than three proprietors; and

- d. To decide whether to amend, add or repeal the by-laws in force immediately before the holding of the meeting.

The agenda does not include a matter on the apportionment of the Management Fund for the Special Account. Therefore, the new amendment inserts sub-section (ba) under (b) with provision, 'To determine the portion of contribution to the management fund to be paid into the special account to be maintained under Section 46'.

- **New Section 41A - Contribution to Management Fund**

This new section was inserted to protect the interest of parcel owners who are a minority where the first annual general meeting of a management corporation in respect of a subdivided building has not been convened. The proprietor of each of the parcels or provisional blocks, if any, in the sub-divided building shall, commencing from the opening of the book of the strata register in respect of the sub-divided building, pay to the management corporation any such sum which has been approved by the Director as the amount payable for the maintenance of the sub-divided building and the common property and such sum shall be deemed to be the amount determined by the management corporation as the contributions payable by the proprietors to the management fund of the management corporation.

- **Substitution of section 50 - The Appointment of Managing Agents by the Director of Lands and Mines**

The original section 50 is being substituted by the new section 50 whereby the Director of Lands and Mines has the authority to appoint Managing Agents. In the substitution, the Director may, upon complaints by a proprietor or any other person or body having a registered interest in a parcel that the management corporation has not functioned satisfactorily, if satisfied that it is in the interest of the parcel proprietors in the subdivided building concerned, appoint a managing agent to exercise the powers and discharge the duties and functions of the management corporation.

Where the Director makes the appointment under subsection (1), he may also specify that the managing agent shall have and may exercise and discharge -

All the powers, duties and functions of the management corporation for the subdivided building to which the appointment relates or of the council of the management corporation;

Anyone or more of those powers, duties and functions except those specified in the appointment.

The expenses incurred by the managing agent shall be charged on the management fund of the management corporation.

- **Amendment of section 53A - Recovery of sums by attachment of movable property**

a. Apart from obtaining a court order to obtain payment for non-payments and arrears over the

contributions to the Management Fund under the Management Corporation, a Management Corporation can request the Land Administrator to issue a warrant of attachment on the movable property to recover the payments. In this instance the Land Administrator may issue a warrant of attachment in Form 7A authorising the attachment of any movable property belonging to the defaulting proprietor. The warrant shall be executed by a member of the Council of the management corporation or by a person specially employed by the council to execute such warrants.

- b. Under the new insertion of subsection 2A, if the management corporation encounters difficulties in executing the warrant, it may seek the assistance of the Director and the Director may request for the assistance of a police officer not below the rank of Inspector.
- c. A person executing the warrant may in the day time effect forcible entry and shall make an inventory of the property attached under the warrant and serve a notice in Form 7B on the person in possession of the property.
- d. With the new insertion in subsection 3A, any tenant, sub-tenant, or occupier who, in order to avoid the attachment or sale of the movable property for non-payment of any sum due to the management corporation by the parcel proprietor, pays such sum may thereafter, in the absence of any written agreement to the contrary, deduct the amount so paid by him from the rent due or to become due by him to the parcel proprietor, and may retain

possession until such amount has been fully reimbursed to him whether by deduction from the rent or otherwise. In the new insertion in Sub-Section 3B, the receipt issued by the management corporation for any amount so paid by any such tenant, sub-tenant or occupier shall be deemed an acquittance in full for the like amount of rent.

- **New Section 55A - Failure To Pay Contributions**

Where any proprietor has failed to pay the contribution demanded by the management corporation in the manner set out in section 53, the proprietor shall be guilty of an offence and shall be liable on conviction to pay a fine of not more than RM5,000.00 and an additional fine of not more than RM50.00 for each day the offence continues to be committed.

- **Amendment of Section 64A - Order to Establish a Management Corporation**

In the management of low cost multi-storey buildings, there are cases where the parcel owners refuse to accept ownership of their unit parcels from the developers. The developers were not able to transfer ownership at 100 per cent and therefore could not impose upon the parcel owners to set up their own Management

Corporation which can relieve the developers of the responsibility for managing the buildings. Now with the new amendments the proprietors, other than the original proprietors, of parcels having share units totalling more than half of the total share units of all the parcels may apply to the Director for an order that a management corporation be established. At the same time with the new insertion in subsection 1A, where the original proprietor has transferred parcels having more than half of the total share units of all the parcels, he may also apply to the Director under subsection (1) for an order that a management corporation be established.

Furthermore, in the substitution for Sub-Section 2, upon receiving the application, the Director

- a. in the case of an application by proprietors other than the original proprietor, if satisfied that the original proprietor has failed to discharge his duties or exercise his powers satisfactorily; or
- b. in the case of an application by the original proprietor, if satisfied that good grounds exist in support thereof,

may order that a management corporation be established.

to be continued.....

Announcement

Do You Have A Paper You Would Like To Share With Other Real Estate Professionals?

The Journal of Valuation and Property Services (JVPS) is a major publication by the Valuation and Property Services Department, Ministry of Finance Malaysia. JVPS is an international journal that provides a forum for critical appraisals of fundamental issues affecting the real estate industry. It is specially intended for real estate professionals to keep abreast with developments in the real estate industry as well as in the real estate profession.

The Publication Board of this journal invites original papers from real estate professionals on any of the following areas:

- areas of major interest and practical relevance to the real estate profession;
- new techniques, applications, theories as well as related concepts relevant to the real estate profession;
- policy issues and regulations and their impact on the real estate market.

The journal focuses on Asia, with particular emphasis on Malaysia, but papers that promote cross-national learning on the real estate industry worldwide are welcome. Each issue will also present practice notes relevant to the practice of valuation and property services written by senior professionals.

Further details on the journal are available from:

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Notes to Contributors

1. Submission

Contributors can submit their papers to:

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43000 Kajang

Computer disc copies (IBM compatible 3.5") are encouraged. In preparing the disk, please use the Microsoft Word or Rich Text format.

A prospective contributor may submit a summary of a proposed paper to the Editor for preliminary consideration as to its suitability for publication in the journal. The receipt of each paper submitted will be acknowledged. The Editor reserves the right to accept, modify or decline any article.

2. Reviewing Process

All contributions will be reviewed by one or more referees. Contributors will be informed about the acceptance (or otherwise) of their papers after the comments of referees have been received. The entire reviewing process will be conducted in complete confidentiality. For this purpose, the name, address and affiliation of the contributor should not appear on the first page of the paper, but only on the accompanying letter.

3. Style

Papers should be the original, unpublished work of the contributors. They should not be under consideration for publication elsewhere. Submissions must be in English. Papers should be written in a clear and simple style, and should have a carefully considered

structure. Contributors are encouraged to adopt the most effective way of communicating their information to the reader.

Illustrations may be used to elucidate the issues raised. All illustrations are to be presented at the end of the text.

4. Contents

Papers should preferably be in the range of 4,000 to 6,000 words, excluding illustrations. A brief (max. 60 words) profile of the contributor should accompany each article.

In the case of Practice Notes, a minimum of 1,000 words is required.

All manuscripts for publishing are to be typed in double-spacing on one side of A4 sized paper with 1.5 inch margin on the left-hand side. The pages should be numbered consecutively.

(a) First Page

The full title of the paper must be shown on the first page of the manuscript. Also to be included on the first page are an abstract of not more than 200 words and up to five keywords to facilitate indexing. The abstract should summarise the objectives, main findings and conclusions of the paper.

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For books: surname, initials, (year) title, publisher, place of publication.

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Example

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Book

Lim, K. K. (1990), *Valuation Methods*, Pelandok, Kuala Lumpur.

Journal

Zahuruddin A. (1994), "The New Economic Policy and the Integrated Housing Model", *Ilmu Alam*, Vol. 2 No.7, pp 23-35.

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Illustrations such as diagrams, tables, graphs and similar materials should not be part of the text but should be submitted separately with the text. Table of values used to generate graphs must be included to ensure accurate representation. All illustrations should be identified correctly in the order in which they are referred to in the text, e.g. "Figure or Table 1., etc". The exact places where illustrations are to be inserted in the text should be clearly shown in the manuscript. Photographs should be black and white glossy prints. The contributor's name, figure number, caption, and an indication of which is the top, should be written lightly on the back of each photograph.

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- b. Comment
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The Editor reserves the right to edit/format the manuscript to maintain a consistent style.

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