"AN EMPIRICAL EXAMINATION ON THE USE OF ASSET-BACKED SECURITIES AS AN ALTERNATIVE DEBT FINANCING: A CASE STUDY OF SUNWAY CITY BERHAD"

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ABSTRACT

The objectives of the study are to evaluate the mechanism of Asset-Backed Securities (ABS) in Malaysia and examine the use of ABS by Sunway City Berhad as an alternative debt financing. The study examines only Sunway City Berhad as a case study because it is the first ABS in Malaysian capital market, and the launching of mortgage-backed securities since 1986 to asset-backed-securities in 2001. The study covers a period of financial years of Sunway City Berhad from 1999 as a pre-ABS to 2003 as post-ABS. The results of the study show that the use of ABS helps Sunway City to improve its financial performance gradually with the declining of its long term debt obligations and its ability to reduce its debt exposure as an effective risk management tool.

Keywords: Asset-Backed Securities, financial performance, financial years, debt obligations, risk management

1. INTRODUCTION

Securitisation began in the United States in the 1970s with the initiation of government funding programmes for residential mortgages, followed by private financings for mortgages and credit cards. Interestingly, since the beginning of the 1980s, it has become a global financing tool. As one of the fastest growing forms of finance, securitisation is now a feature of most financial markets, including Malaysia.

In the case of Malaysian market, the origin of securitisation can be traced back to 1986 when the government set up its national mortgage agency, Perbadanan Cagaran Malaysia (Cagamas) Bhd. Cagamas was formed on the model of Fannie Mae and Freddie Mae of USA. Accordingly, Cagamas functions as a Special Purpose Vehicles (SPV) between the house mortgage lenders and investors of long-term funds. Cagamas is by far the most important issuer of securitised instruments in Malaysia. Since 1986, the securities issued by Cagamas have acquired the name "Cagamas Bond" in Malaysian debt market.

Since asset-backed securities (ABS) were first introduced to the domestic market in 2001, much has been said about the potential for securitisation in Malaysia and the fresh impetus it brings to the capital market. Though three ABS deals followed quickly on the heels of the regulatory guidelines in 2001, the market has since little activity of a similar nature. This scenario is justified as the past year only saw two securitisation transactions coming into the market whilst another two deals that had long been in the pipeline eventually failed to make a debut for various reasons. With transactions worth RM 2.37 billion to date, ABS only forms a miniscule fraction of the growing RM 113 billion debt market in Malaysia.

With the inconsistence market for asset-backed securities and development of bond market, this study attempts to examine on the use of ABS with reference to real estate as alternative debt financing in Malaysia since 2001.

2. SIGNIFICANCE OF THE STUDY

According to Rating Agency Malaysia (RAM) in their report on March 2005, asset-backed securities or securitization are increasingly getting popular in Malaysia. With sizeable transactions originated in the residential mortgage segment, securitization is poised for steep growth by 2010, as part of Securities Commission's 2001-10 Capital Market Master Plan to develop a viable bond market in Malaysia.

In view of the vast developments that have occurred in financial markets since the introduction of the asset securitisation in 1986, it recognizes the importance of developing a comprehensive capital framework for asset securitization, including both traditional forms and synthetic forms of securitisation. However, like many modern and sophisticated financial instruments, in the wrong hands or with the wrong strategies, many organisations may be on the path to destroy rather than enhance the rewards of asset securitisation.

Thus, this research is attempted to examine the use of asset-backed securities and their complimentary roles towards the development of active bond market in Malaysia by 2010 with reference to Sunway City as its pioneer.

3. RESEARCH OBJECTIVES

The objectives of the study are to overview of the Malaysian ABS market, examine mechanics of its securitisation and measure its viability as alternative debt financing in Malaysian capital markets.

4. RESEARCH SCOPE

The study will examine Sunway City Berhad because it was the first Malaysian Asset-Backed Securities (ABS) as alternative debt financing in Malaysian capital market. This study is timely and justifiable as Malaysia has introduced securitisation of housing government loans since 1987 as mortgage backed-securities as opposed to asset-backed-securities in 2001.

5. RESEARCH METHODOLOGY

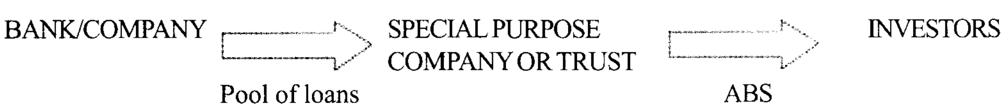
The monthly data will be collected from the annual reports of Sunway City Berhad from 1999 to 2003. The year 1999 was chosen in order to reflect its financial before issuing ABS, and 2003 as its post-ABS. The data will be analysed using the descriptive statistical tool to measure the mechanism and viability of ABS in the Malaysian financial markets.

6. LITERATURE REVIEW

In finance literature, Asset-Backed Securitisation (ABS) is defined as a creative way of raising funds through the issuance of marketable securities backed by future cash flows from revenue-producing assets. By trading procedure, securitisation is the transformation of an illiquid asset into a security that is issued and more importantly it can be traded in a capital market. Assets that have been transformed in this manner include residential mortgages, auto loans, credit card receivables, leases and utility payments. The term asset-backed security (ABS) is generally applied to issues backed by non-mortgage assets (Ming, 2005). These asset securitisation techniques are being embraced by a number of Asian countries seeking to promote home ownership, to finance infrastructure growth, and to develop their domestic markets, including Malaysia.

Asset securitisation differs from collateralized debt or traditional asset-based lending in that the loans or other financial claims are assigned or sold to a third party, typically a special-purpose company or trust. This special-purpose vehicle (SPV) is in turn issues one or more debt instruments (the asset-backed securities) whose interest and principal payments are dependent on the cash flows coming from the underlying assets. This process is outlined in Figure 1.

FIGURE 1: PROCESS OF ASSET-BACKED SECURITISATION



The technique of asset securitisation involves the separation of good assets from a company or financial institution and the use of those assets as backing for high-quality securities that will appeal investors. The assets, financial claims or contract securing future revenue flows, are typically sold to a special-purpose entity that is independent of the originator's credit (Tan and Ting, 2004).

ABS process is a more complex transaction compared to the traditional funding approaches provided by the financial intermediaries. Unlike the traditional collateralized loans, ABS is a more sophisticated financial innovation that involves off-balance sheet transfer of assets into a Special Purpose Vehicle (SPV), which in turn issues marketable securities to fund the purchase of assets. This situation is understood as asset-backed differs from collateralized debt or sold traditional asset-backed lending in that the loans or other financial claims are assigned or sold to a third party, typically a special-purpose company or trust. Furthermore, the securitisation process begins when a lender (usually a bank or finance company) creates a special-purpose entity such as a corporation, a limited liability corporation, or a business trust, and transfers to it the ownership a portfolio of loans that are similar in type (mortgage, auto loan, and credit card), maturity, interest rate and their likelihood of default. As such, asset securitisation is a highly adaptable and versatile technique for mobilizing capital, notably debt financing.

The regulated Malaysian ABS with the guidelines of Securities Commission is timely for debt market as securitisation is already providing to an important option for governments seeking to promote private-sector growth and employment and to access funding for infrastructure development, as contained in the Ninth Malaysian Plan. Interestingly, Malaysia was the first country in the region, probably one of the earliest among the developing countries to establish a secondary mortgage market with the launching of Cagamas bonds in 1987, referred as mortgage-back securities.

As noted earlier, the process of asset securitisation is a new and innovative financing method used for funding and risk management purposes. Evolved over the last few decades, securitisation represents a substantial and established part of US and global capital markets, including Malaysia. Therefore, Kuala Lumpur sets to transform mortgage-backed to asset-backed securities as contained in strategic planning of Securities Commission, 2001-2010.

Over the past 25 years, financial innovation has produced revolutionary changes in financial instruments and processes, notably assets securitisation. Therefore, a process of asset securitisation has now being regarded as a notable example of such innovation by global investors. Therefore, by trading procedure, securitisation can be viewed as the process by which pools of illiquid and relatively homogenous financial assets are converted into a tradable security in a secondary market.

Securitisation first came to prominence in the early 70's in the USA and has developed at a rapid rate with around 60% of all new residential lending currently funded through this techniques. In recent years, adoption of securitisation has become widespread in many other parts of the world including Europe and Australia. Past empirical studies attribute the growth in securitisation to its central role in enabling financial firms to dissect their core functions as asset origination, servicing and funding. As such, securitisation allows loan originators to specialise in bearing only those risks in which they have a comparative advantage, while shifting other risks to banks and investors better able to absorb them. In other words, it recognises that the growth of firms specialising in origination of assets such as residential mortgages has enabled the development of securitisation markets, including Malaysian property market.

Literally, asset securitisation is the segregation of a particular set of cash flows from corporation's other assets and the issuance of the securities based only on these cash flows. The types of financial assets involved in asset securitisation transactions are frequently receivables. The practice of securitisation originated with the sale of securities backed by residential mortgages, but a wide variety of assets have been securitised including lease, auto loans and credit cards receivables, commercial mortgages, equipment leases, franchise fees, state lottery winnings and litigation settlement payments. Due to its dynamic innovations, it is expected that more unconventional assets have been the subjects of securitisations.

Securitisation has enjoyed high growth over the last two decades. Annual issues are over $500 billion, current outstandings are $2.5 trillion and $5 trillion have been issued since the market's inception. In 2004, to highlight its significance, about one-half of mortgages and one-forth of consumer credit are securitised in USA. Securitisation generally gives an opportunity to financial institutions to sell off large fixed income portfolios, thereby obtaining financing potentially less expensive than through direct borrowing and also possibly improving risk sharing. As a result of this, securitisation has the potential to alter the wealth and the risk of the securitising corporation, and hence, ABS is seen to provide a hedging tool as in the cases of derivatives.

Over the past two decades, ABS has developed remarkably worldwide and has grown into an alternative, attractive and importance source of funds in the capital markets. However, as mentioned before, the asset backed securities process involves much more complicated transaction arrangements than the traditional funding approaches provided by financial intermediaries, and in particular more complicated regulatory problems and relevant arrangements which in fact to a large extent determine whether or not successful asset backed securitization transaction can be carried out, notably the new ABS markets.

The asset backed securitisation process involves a number of important third party that provides various commitment and services to an asset backed securitisation transaction such as credit support provider, underwriter, paying agent, custodians, and rating agency. As such, they can affect the structural and procedures feature of asset backed securitisation transactions by means of different ways. While the basic transaction of asset backed securitisation is the swap of securitised asset and funding proceeds between the originator and the SPV, the specific structure of asset backed securitised transactions are often complicated due to the involvement of the different types of third party, notably the degree of default by the issuers, as in the cases of bond market.

As mentioned before, securitisation involves packaging financial promises and transforming their cash flows into a form whereby they can be freely traded among investors. The market for asset backed securitisation (ABS) that includes home equity loans, credit cards, automobile loans and equipment leases, increased from $316 billion in 1996 to $1.69 trillion in 2003. Securitisation has been very popular in USA with commercial banks, lending subsidiaries of industrial companies (such as General Motors Acceptance Corporation) and other specialised lending institution such as The Money Store with approximately 60% of the residential mortgages and a similar fraction of revolving consumer credit (credit cards) securitised.

7. PROFILE OF SUNWAY CITY

7.1 Corporate Structure

Sunway City Berhad (Suncity) was incorporated as a private limited company under the Company Act, 1965 on 13 July 1982 as Sri Jasa Sdn Bhd and subsequently changed its name to Sri Jasa Development Corporation Sdn Bhd on 1st December 1986 and Bandar Sunway Sdn Bhd on 25th July 1987. It was converted to a public limited on 24 July 1995 and assumed its present name as Sunway City Berhad on 2 April 1996. Sunway City Berhad (Suncity) is a member of The Sunway Group, one of the largest Malaysian conglomerates.

The company was officially listed on the main board of Bursa Malaysia Securities in 1986 (formerly known Kuala Lumpur Stock Exchange). Sunway City Berhad (Suncity) is one of the country's fastest growing property development and property investment companies. It has 21 sub sidiaries in various sectors namely entertainment, hospitality, healthcare, industrial and residential properties.

The principal project of Suncity was the development of the 494-acre Sunway City into an integrated township. Through subsequent land acquisition, the township development finally spanned over 800 acres. The success of Sunway City spurred on the developer to take on various developments around the country, most notably the 1,309-acre Sunway City Ipoh, a joint-venture development with Perbadanan Kemajuan Negeri Perak in 1996.

The company has received various great achievements since it was commenced. First and foremost, Suncity has received four recognitions from World FIABCI Award. The first reward was won by Sunway Lagoon Theme Park as its "Best Resort / Leisure Development" in 1993, "The Best Shopping Centre" award went to Sunway Pyramid in 2000, "The Best Hotel Development Award" was won by Sunway Lagoon Resort Hotel in 2001 and Sunway Lagoon Resort has won the prestigious "FIABCI d' Excellent Award" in the Leisure Category.

7.2 Reasons For Asset Securitisation

Suncity had undertaken the securitisation exercise for the following reasons:

I. To enable the company to obtain a fair sale price for the properties owned
II. To enable the company to continue to enjoy productive use of the properties by a sale and leaseback option

III. To reduce gearing of the company, enhance earnings per share and other performance ratios of the company
IV. To raise funds for working capital and expansion of the company's property development business at a lower cost.

Sunway City Berhad ABS exercise in 2001 is a landmark property deal as it involves the largest property and asset sale by a single corporation in Malaysia. In fact, Suncity was the first ABS that is backed mainly by property assets. The company has securitised the portfolio of properties and asset of seven Suncity's subsidiaries commencing at 30 October 2002. The portfolio comprises Suncity's corporate headoffice building (Menara Sunway), three hotel buildings (Sunway Lagoon Resort Hotel, Sunway Hotel Penang, Sunway Hotel Seberang Jaya), college buildings (Sunway college), Sunway Lagoon Theme Park & Surf Pool and Sunway Pyramid Preference Shares.

FIGURE 2: THE TERM OF ABS NOTES BY SUNWAY CITY BERHAD

Terms	Sunway City Bhd
SPV/Issuer	ABS Real Estate Bhd (AREB)
Arranger/Lead manager	Deutsche Bank (Malaysia) Bhd
Mode of issue	Private placement
Date announcement	16 May 2002
Primary subscriber	Deutshe Bank (Malaysia) Bhd
Facility description	ABS notes issued via an asset backed securitization comprise: a) Senior Notes Class A, B, C1 and C2 b) Subordinated Class D Notes
Issue size	**Senior Notes** Class A RM 120 million Class B RM 75 million Class C1 RM 45 million Class C2 RM 210 milion **Subordinated Notes** Class D RM 466.20 million
Legal maturity date	6 years from the date of issue of the ABS notes

Coupon rate	**Senior Notes** Class A 5.25% Class B 5.75% Class C1 8.00% Class C2 7.875% **Subordinated Notes** Class D 20.00%
Coupon frequency	Semi-annual based on actual / 365 days
Redemption	**Senior ABS Notes** Mandatory redemption on legal maturity date. Early redemption possible by Suncity. Subordinated Notes It can only redeemed after all outstanding principal and interests have been fully repaid.
Status of the ABS Notes	Secured against properties, shares, lease payments on the properties and redemption and dividends of the redeemable preference share.

FIGURE 3: THE FINANCIAL PERFORMANCE FOR FINANCIAL YEAR (FY) 1999 - 2003 ON SELECTED FINANCIAL RATIOS

RATIO	FY 1999 (RM'000)	FY 2000 (RM'000)	FY 2001 (RM'000)	FY 2002 (RM'000)	FY 2003 (RM'000)
a) ROA	$\frac{13626}{2060319}$	$\frac{(280)}{2077288}$	$\frac{6282}{2134442}$	$\frac{118440}{2083844}$	$\frac{25480}{2277724}$
	=0.66%	=-0.013%	=0.29%	=5.68%	=1.1.9%
b) ROE	$\frac{13626}{429039}$	$\frac{(280)}{600671}$	$\frac{6282}{603607}$	$\frac{118440}{735009}$	$\frac{25480}{762858}$
	=3.18%	=0.047%	=1.04%	=16.11%	=3.34%
c) DTA	$\frac{1472917}{2060319}$	$\frac{1130052}{2077288}$	$\frac{1188682}{2134442}$	$\frac{1095622}{2083844}$	$\frac{1225476}{2277724}$
	=0.715 X	=0.544 X	=0.557 X	=0.526 X	=0.538 X
d) DTE	$\frac{1472917}{429039}$	$\frac{1130052}{600671}$	$\frac{1188682}{603607}$	$\frac{1095622}{735009}$	$\frac{1225476}{762858}$
	=3.43 X	=1.88 X	=1.97 X	=1.49 X	1.61 X
e) NTA (Per Share)	RM 1.43	RM 1.42	RM 1.43	RM 1.77	RM 1.87

Key:

ROA = Return On Assets (Measure the ability of a firm to make net income for every ringgit invested in assets)

ROE = Return On Equity (Measure the ability of a firm to make net income for every ringgit provided by shareholders)

DTA = Total Debt to Total Assets (Measure the portion of capital funded by debt on its assets)

DTE = Total Debt to Total Equity (Measure the relationships between debt and equity capital)

NTA = Net Tangible Asset (Measure the net value of a firm per share basis)

8. Results and Discussion

Sunway City Berhad is the Malaysia first property backed securitisation. Suncity entered the asset-backed securitisation (ABS) as one of the sources of long term debt financing. The purpose is to manage their debts and to focus on its core business, property development. This company which represents as an originator in ABS transaction, has sold their assets and shares to the special-purpose vehicle (SPV), namely, ABS Real Estate Berhad (AREB) worth RM 892 million.

The portfolio of property and assets being securitised show very good performance in the Malaysian market. It consists of Sunway College building and land, Sunway Lagoon Resort Hotel building and land, Sunway Hotel Penang building and land, Sunway Hotel Seberang Jaya building and land, Menara Sunway Office building and land, plant and equipment in Sunway Lagoon Theme Park and Redeemable preference shares (PRS) in Sunway Pyramid Sdn Bhd. Suncity raises RM 450 million from the ABS issues by AREB.

Upon completion of its ABS in FY 2001, Sunway City has recorded a better financial performance since 2001 as demonstrated by FIGURE 3. The return on asset and equity indicating its ability to make better profits, have been improving, Likewise, its debt obligations have been declining, indicating its efficiency managing its debts. The net tangible asset per share also increases to RM 1.81 per share indicating the added value of its shareholders' fund. More importantly, Sunway City expects to repay approximately RM 348 million in bank borrowing hence reduce its gearing from 1.34 times to 0.78 times, as a result of ABS transactions.

As measured by financial ratios, Suncity demonstrates its ability to make its ABS as a new and innovative financing and risk management purposes. In other words, its' ABS can be viewed as the process by which pools of illiquid and relatively homogenous financial assets are converted into a tradable security in a secondary debt market.

From risk management perspective, Suncity ABS allows its loan originators to specialize in bearing only those risks in which they have a comparative advantage, while shifting other risks to third party. As such, Suncity has valuable time to focus its property developments as a core business, without fearing on the volatility of domestic interest rates and inflationary pressure.

In addition, with ABS, Suncity gives the opportunity to banks to sell off large fixed income portfolios and subsequently obtaining inexpensive financing as opposed to direct borrowings. As such, Suncity has an ability to improve its risk sharing and the potential to create the value of the firm, and hence, wealth of shareholders.

With the success stories of its first ABS, Sunway Group securitised further its quality assets. In mid-August 2003, its two subsidiaries, Sunway Holdings and Sunway Construction have undertaken another real estate backed securitisations. The securitisation will involve the disposal of properties and companies owned by Sunway Holdings and Sunway Construction worth RM 185 million and RM 55 million, respectively.

9. Concluding Remarks

Through the analysis that have been done, it can be said that despite securitisation being slow to take off in 2002, the

Malaysian market should brace itself for more exciting times ahead, to come, buoyed by strong investor-appetite for highly rated papers and growing confidence in heavily structured instrument. In the means time, the major challenges for the market will revolve around accounting and regulatory issues, concerns over which may have somewhat dampened activity to date. Though guidelines on issuing ABS are available, much of the market processes remain untested as they are still in the early stages of development. Transparency, long and lengthened approval process, and unclear standards of application are some of the more common issues in ABS transactions.

Further, the legal and tax implications for the various transaction parties in an asset securitisation arrangement still represent a grey area to the market participants. Asset securitisation is still a relatively new financing concept and it will take time for it to be fully developed in Malaysian market. Overall, it can be said that securitisation activities have increased significantly in several Asian countries that include Korea (1997) and Singapore (1998). In Malaysia, the trend for securitisation has been growing since 2001 with the introduction of the 2001-2010 Capital Market Masterplan by Securities Commission.

The fact that Islamic institutions have a growing participation in the global securitisation business is an affirmation of the success they have achieved during the last three decades. Interning Malaysia as a hub of Global Islamic Capital market, Malaysia also engaged in Islamic Securitisation in which the first issuance of the Islamic ABS is in year 2003.

With the ABS framework in place, the ABS provides significant benefits to the parties involved in this securitisation exercise. From an originator's perspective, securitisation provides a vehicle for transforming relatively illiquid financial assets into liquid and tradable capital market instruments. Besides, cash strapped companies with weak credit ratings but having good cash flow generating assets will have access to a wider scope of corporate financing options and at cheaper funding costs.

Likewise, the variety and flexibility of credit, maturity and payment terms made possible through securitisation structures provide investors a much broader selection of fixed income products in the Malaysian market.

The establishment of liquid and efficient secondary securitisation markets would also have the effect of increasing the availability of financing options and also reduce the cost of financing in primary markets. It will encourage the efficient allocation of capital by subjecting credit-granting activities to the pricing and valuation discipline of the capital markets. As such it is in like with the aspiration of Malaysia to develop an active bond market.

Of equal importance is the fact that securitisation can serve as an effective risk management tool for corporate, particularly financial institutions, to minimize their interest rate and maturity mismatches. By securitising their loans and receivables, financial institutions would be able to offer long-term fixed-rate financing to their customers without significant exposure to the risk of interest rate and maturity mismatches. Hence, securitisation offers an ideal mechanism by which financial institutions can shift their concentrated credit, interest rate and market risks associated with their portfolio activities to the more diverse capital market, thereby reducing risks of individual institutions and systemic risks within the financial system.

There are three biggest assets types of ABS transaction in Malaysia, which are Government Housing Loan, Infrastructure and Property Receivables, amounting 28%, 12%, and 11% respectively. Nevertheless, ABS in Malaysia seem to exhibit a great potential in securitisation of pool of SME loans, toll receivables, commodities receivables and future rights to entertainment royalty payments.

Therefore, it is expected that with the efforts put in to remove the tax and accounting impediments, more efficient and facilitative framework will be created to facilitate the development of securitisation in Malaysia. Given time, asset securitisation will emerge as a viable and significant source of competitive financing for the corporate sector in Malaysia. As such, private sector is set to increase their investments via cost-effective ABS financing as a creative way and strategic tool to meet a new-launched of Ninth Malaysian Plan.

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