

Landlease (asia) property limited (II) essay sample

[Finance](#), [Investment](#)



LandLease (Asia) Property Limited (LL) wants to infiltrate the Hong Kong real estate sector. Louisa Martin and her senior advisor Marco Li have two main possibilities to achieve this goal, direct and/or indirect investment. By investigating the different investment possibilities they want to understand the merits and demerits, including risk and return of the possible investments. Bearing these outcomes in mind, they can form a new strategy for the company. We will discuss 4 different subjects as stated in the assignment: * The merits and demerits of direct real estate investing are highlighted; * The potential benefits for LL of allocating its assets to indirect real estate; * The opportunity of assembling real estate property assets for listing as a REIT; * Propose a strategy for LL, taking into account the fundamental issues and opportunities available to LL. 2. Direct Real Estate investments, merits and demerits

As is known, LL operates mainly in direct commercial investments back in Australia, where a lot of benefits are earned in this way of investing. Geltner and Miller (2007) give a definition of direct real estate investments: direct ownership of the underlying asset. Two possibilities of direct investments in Hong Kong arise in the LL case: ownership can be required or one should engage in direct development of assets to include in the portfolio. High returns are generated when investing directly in real estate; this is generated by cash flows from lease contracts. They can use more debt financing which can favour their tax situation. Another merit is the possible increase in NPV. By owning the title directly, the company can use their own expertise and knowledge to change the negative NPV of a project to a positive NPV. Also by investing in direct real estate the company is able to

choose their investment sector. Again they can use their own expertise and knowledge, which can reflect in high returns. The drawbacks and demerits of investing in direct real estate in Hong Kong are also discussed in the LL case.

Direct investment requires abundant time, professional expertise and large amount of capital. Since LL does not have the expertise in the Hong Kong real estate market yet, developing quite good and solid relationships with local banks for future financing probabilities is of great importance. Joined venture or co-investing may be a good alternative to diversify and mitigate risks with local (HONG KONG) property companies. These firms are more professional and familiar with local knowledge and practise and will reduce the investment risk and increase the return.

One of the merits discussed is the entry barrier due to high land bids and dominant Asian property companies. Also formal differences (taxes) and informal business differences (cultural) should be taken into account as disadvantages. Some other risk possibilities should be taken into consideration, for example managerial issue, ownership, and currency risk, policy and culture difference. These are the factors that influence the return of direct investments significantly. The cyclical concerns that Louisa has will have to be taken into account as well. The Hong Kong market is highly dependent on trades with the rest of the world. Due to a decrease in growth in world economy the real estate sector was dampening. Declining transaction volume resulted in lower liquidity and therefore allocation become more difficult, thus risk increases.

3. Indirect Real Estate Investments, merits and demerits

One of the major downsides of direct investment in real estate is the high entry barrier. Both the direct acquirement of assets as well as the development of assets would involve substantial capital requirements. Indirect investment in real estate lacks these high entry barriers, which forms it into an attractive alternative for direct investment. Originally the Hong Kong real estate sector provided two mechanisms that supported indirect real estate investment, investing in shares of listed real estate companies and investment in Real Estate Investment Trusts (REITs). The Hong Kong real estate sector has ten listed major property companies that basically form the market. Graphical analyses can be found in the appendix. The 3 largest companies, based on market capitalisation, are Sun Hung Kai Properties, Cheung Kong (Holdings) and Henderson Land Development. Due to a consolidation in the property sector these key players increased their share of new residential sales from 30% to 50%. Since both REITs as share in real estate properties are traded on the (supposedly transparent) Hong Kong Stock Exchange, they are considered to be relatively liquid. This has risk merits since no long investment is required and allocation is relatively quickly possible.

The investors does not need special local knowledge since all locations and properties are already chosen. No extra capital need to be spent on property management and maintenance. Investors also do not have to worry about the tenants since the property companies of REIT managers do this for them. Indirect investing can contribute to international diversification of the portfolio, which happens to be in arm length with the LL strategy. One of the downsides of indirect investment is that as a minority shareholder the firm

would lack certain control rights regarding management of the underlying assets. Furthermore, a number of the major listed property companies were involved in non-property investments and in sectors as Hotels. Since LL is originally not interested in these types of investments this would limit the indirect investment opportunities. Since REITs and shares are traded on the stock market, this could make them more volatile to market fundamentals. Sensitivity to interest, dividends pay out, management skills all become risk factors.

4. Opportunities for listing as a REIT on Hong Kong stock exchange

LL also has the possibility to start its own REIT listed on the Hong Kong Stock Exchange. Setting up their own investment fund has some possibilities and merits compared to the other investment opportunities.

Of course this investment vehicle also has the necessary disadvantages. One of the problems that occurred in investing in direct real estate was the large amount of capital needed. When listing as a REIT on the Hong Kong Stock Exchange, this is not necessary. This leads to lower barriers to enter the market. By participating in an IPO, large institutional but also smaller investors are able to invest in your REIT. This makes it easier and probably also cheaper to gain equity for investments. This is an important component for REITs. When new capital is needed for investments in properties in the portfolio (refurbishment), the manager will not have to sell other properties but he can simply raise equity. One of the important aspects in creating your own REIT is that investments become more liquid compared to direct investing. This is important for the strategy of LL, when listed as a REIT they can still choose the properties and allocations included in the portfolio.

However, since there are already REITs listed on the Hong Kong Stock Exchange, some properties may not be available anymore.

As a REIT, LL would want to focus on Grade A properties, but chances are that these properties are already in other REITs' portfolios. Lower grade properties might be available, but might not fit the strategy of LL, and acquiring the A Grade buildings may be very expensive and not all companies are willing to sell properties to REITs. This can be reflected in a poorly performing IPO. Other demerits are closely related to the direct investment strategies. It requires a large amount of capital to invest in properties and this depends on the availability of equity on the market and on trust in the fund. When setting up a listed REIT, a lot of market information and expertise is needed to avoid big risks and to actively manage the portfolio. As discussed above, LL does not have this knowledge yet. Gaining this knowledge might take a lot of time or money. The positive side is that when LL acquires this information and the fund is successful they can ask for managing fees. This can lead to a structure where LL earns money on fees, but the REIT, and thus its investors, will carry most of the risk.

5. A proposition for a new LL strategy

The purpose for Louisa Martin, Chairman of LandLease (Asia) Property Limited (LL), is to explore commercial real estate investment opportunities for the group. Specific preferences regarding the risk and return profile of LL are not specified in advance. Focusing on the Hong Kong case, the question for direct and indirect real estate investments is to formulate a diversification strategy for the group following fundamental market analysis.

Hong Kong suffers from economic decline at the moment LL wants to invest in the market. Since the beginning of 1999 there is deflation (exhibit 2B). The uncertainty because of a sharp increase or decrease in prices (inflation/deflation) cause uncertainty in the market and harm the economy. Pricestability is a necessary condition for a healthy economy (De Bruine, 2009). An investor always aspires positive real rents. Inflation is an important aspect for each investor. When LL decides to invest in this uncertain market at this moment, the investment has to offer LL a hedge. LL has to diversify their investment to be able to hedge this inflation. Still, due to the high correlation between the inflation rate and real estate assets, a delaying investment strategy is advisable.

Although direct (development) investment is the strength of LL company, this strategy requires knowledge of the market. LL lacks expertise in the Hong Kong real estate market. There is a possibility to outsource the management, but this will decline the total returns on investment sufficiently. To develop it will require a large capital investment to bid for development land while other large property development companies like Sun Hung Kai Properties and Cheung Kong Holdings are already active players in Hong Kong. Furthermore exhibit 3A reveals there is vacancy in the market while there is (almost) no take up for the last two years. The strategy to overcome the problem of lack of knowledge about local fiscal regulations, operational differences and intensive management concerns, direct investment by starting a joint venture with a local player who has sufficient expertise on the local market while LL keeps partly in control over the strategy. Reasonably large cultural differences between the board of both

companies can cause problems in this direct investment strategy. => Not to invest directly in real estate

Indirect real estate investment is possible in three possible strategies: 1) Invest in REITs; 2) Develop a REIT fund and; 3) The purchase of shares of listed companies. Investing in REITs Buy REITs (disadvantage, less influence in strategy). As property securitisation vehicles, REITs thus offered property investors or companies a channel for converting fixed property assets into tradeable securities, thereby reducing the risk of illiquidity and the management risks associated with direct ownership. Purchasing shares of listed companies - (table 5a and 5b): Negative average returns (except for Henderson Land, Sun....) Due to consumer confidence - stagnation and deflation of the economy since 1997 + companies have high reciprocal correlation coefficients.

Individual returns show cyclical pattern - buy low, sell high strategy. Returns on real estate investment very attractive relative to alternative investment assets such as exchange fund bills (Jo) - why, it is dependent on the goals of LL. Advise (jo): invest in REITs, importance to diversify because economy in state of deflation (sectoral and geographical diversification). REITs more liquid in passing its net earnings on to their shareholders without having a long-term financial commitment and with the possibility of easily transferring ownership by reacting quickly to changing market conditions. Jo: With investing in REITs LL will stay close to their core business without a big exposure to risk. It gives the opportunity to invest in the Hong-Kong real

estate market without having the costs of outsourcing or external management.

Source:

Bruine, M. A. de (2009), Vastgoed&inflatie; Een analyse van de inflatiehedgekwaliteiten van Nederlands en international onroerendgoed, ASRE augustus 2009, Master of Studies in Real Estate, Amsterdam