Zeppelin's Real Estate Tech

4Q 2012: A Real Estate Newsletter by Zeppelin Real Estate Analysis Limited
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QE3 arrives, EU is still in the doldrums, the US is mired in presidential debates with one candidate reportedly implying only 53% of his countrymen are hard-working, and Japan, well, nothing really new here except the islands squabble with China. In this issue:

- **Mitt's Illogicality**
- **Hong Kong CBD Office Rents Top Asia and the Investment Implication**
- **Conservative Real Estate Investors Should Embrace Down Markets**

Quarterly Quote: "Real estate prices tend to go up, well yes, sometimes in flames"

We would also like to hear from prospective readers / writers who wish to share their real estate experience with us.

This quarterly (generally published in January, April, July and October) newsletter is circulated freely via email to over thousands of readers comprising real estate developers, investors, fund managers, financiers, owners, users, top executives, senior managers, prominent academics and related professionals from Hong Kong and abroad. Our content is / has also been published in newspapers and web portals such as the **South China Morning Post, China Daily**, **Hong Kong Economic Journal**, **21st Century Business Herald**, **Apple Daily**, **Sing Tao**, **Quamnet Magazine**, **The Standard**, **MITCRE Alumni Newsletter**, **Surveying Newsletter**, **Reidin.com, Centanet.com, Netvigator.com, Hongkong.com, E-finet.com, Red-dots.com, PacificProperties.net**, **Soufun.com** and **House18.com**. We had also been quoted in the **Asian Wall Street Journal** and interviewed by **USA Today**, **i-Money**, **Ming Pao, Radio Hong Kong**, and **Commercial Radio**. We also publish monthly articles and analyses in the months in between. This newsletter is now into its **17th year** and **65th** issue.

We also operate a website www.real-estate-tech.com through which we intend to share some of our real estate knowledge and ideas with interested parties. There are close to 1,000 content items, in English or Chinese, including analyses, articles, charts, and tables, plus spreadsheets, tutorials, e-books, and the like, the majority of which is free with some requiring a token fee. The website is regularly visited by thousands from all over the world and focuses on China / Hong Kong real estate markets.

Zeppelin Real Estate Analysis Limited is involved in real estate development, investment, and management with a focus on **independent real estate analysis**. Together with Zeppelin Property Development Consultants Limited, we offer services related to real estate asset management [analysis, investment strategy, and portfolio allocation], project management [architectural design, cost control, and contract administration], and facility management [facility utility assessment, facility strategy, and building maintenance]. We are part of the Zeppelin Group headquartered in Hong Kong with office operations in Mainland China and we also have access to networks covering Asia, North America, and Europe.

About the Author(s)

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Stephen is an independent real estate analyst and chartered surveyor and has been involved in real estate development, investment, and management in Hong Kong / China / Asia and North America.

Stephen provides relevant real estate market insights and macro-micro assessments to real estate developers, investors, owners, financiers, funds, and civic organizations, and possesses many years of experience in building economics, project management, facility strategy, marketing, and research.

Stephen is also a real estate writer and his articles have been published in both English and Chinese media including the following:

- China Daily
- Hong Kong Economic Journal
- South China Morning Post
- Apple Daily
- Quamnet Magazine
- Real estate and finance websites such as Soufun.com, Finet.com etc
- Journals of professional institutes such as the Hong Kong Institute of Surveyors

Stephen is also an honorary adjunct professor with the University of Hong Kong and the City University of Hong Kong and has been invited to speak to audiences from:

- Universities: such as the University of Hong Kong, City University of Hong Kong, York University
- Professional Institutes: such as the Hong Kong Institute of Surveyors, Canadian Institute of Quantity Surveyors, Royal Institute of Chartered Surveyors
- Business Associations: such as the Rotary Clubs

Stephen has to date compiled 2 books; one online and one in hard copy format. Both are published in Chinese (with the titles translated into English below):

Online book = Easy Real Estate Lectures
http://www.real-estate-tech.com/eBook/zeppelin_ebook.htm

Hard Copy = Real Estate Investment Know-How above 101
http://www.edpress.com.hk/Product.asp?id=6282

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Mitt's Illogicality

Real Estate Tech, 4Q 2012

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Which bolts and which nuts are more vital than the others?

USA Republican presidential candidate Mitt Romney was reportedly to have said that 47% of Americans pay no (income) taxes, depend on government handouts, and contribute very little, if any, to society, sort of implying such people are lazy, during a fund raising event to a crowd of sponsors and supporters. Mitt subsequently claimed that was not what he meant.

Your humble author knows little about American politics and who will eventually win the presidential election entices him not. It is rather the logic, or the lack of it, behind such utterance which is intriguing:

1) Statistically, the distribution of income tax payers and non-income tax payers is highly unlikely to match exactly the distribution of hard working and lazy people = especially when one is talking in terms of hundreds of million people.

When only 2 persons are involved, and if a <u>relative</u> comparison has to be made, then yes, 1 of the 2 persons is likely to be more hard-working than the other. In absolute terms though, both persons may be hard-working or lazy.

Yet when the sample size involves many people, then the distribution is unlikely to be as discreet. Assuming a normal distribution, there will be the extremely hard working, very hard working, hard-working, via the sometimes hard working and sometimes not, lazy, very lazy, and all the way to the extremely lazy. Usually, the extremes are few and far between and the bulk of the people would fall between hard-working and lazy.

To complicate matters further, on the individual level, a person's diligence (or laziness) may depend on circumstances such as his age, stage of his life, health condition, subject matter of the task in hand, background environment, and the like.

For instance, a young and low ranking soldier in the US Army today is likely to be busy these days (i.e. needs to work hard) yet the pay is unlikely to be high enough requiring him or her to pay (significant) income taxes. On the contrary, a real estate owner with 100 rental income producing properties may pay lots of income taxes but needs to work little (as most of the property management functions can be outsourced).

In short, drawing a line between the hard-working and lazy is not as easy as it sounds.

2) Coupling a relatively easy to measure aspect (e.g. the number and identification of income tax payers, either you are or are not) to a difficult to objectively measure aspect (e.g. a hard working aptitude) generally spells bias = just like saying that with age (an easy to measure aspect) comes wisdom (a difficult to define, let alone measure, aspect) smacks of bias. A casual observation of older people – make sure the sample size is large enough - around you is generally sufficient to dispel the myth. Not that there is absolutely no truth in the saying, just that it does not apply to each and every aging / aged individual.

Likewise, it is more likely that there are both hard-working and lazy income tax payers AND both hard-working and lazy non-income tax payers as well.

3) Continuous application of the 53 / 47 distribution ultimately boils down to 1 person = say we start with 100 people and based on the 53 / 47 split, we rid ourselves of the 47 laggards; now the degree of diligence of the remaining 53 will rise and again, we can get rid of the new 47% laggards i.e. 25 of the 53 will be banished leaving 28 behind; the average degree of diligence will rise again and so another lazy 47% is eliminated leaving 15 behind; and so the sieving goes on and on until only 1 person remains. Naturally this is hypothetical.

There is no denial that being hard working increases the chance of having more earnings and thus paying larger income taxes, just that it is not the only phenomenon, nor is there evidence that hard work alone must lead to more earnings and larger tax payments.

As such, based on the hypothetical example above, whether the 47% are really lazy or not is beside the point (so is whether the 53% are hard working or not), at some stage close to having just 1 person remaining, there will likely be disorder ranging from the remaining 99 people giving up and simply walking away from the game all the way to revolting when and if their livelihood (survival) appears threatened.

A view on taxes

No one really enjoys paying taxes although many would deem them essential as governments and public administrations do require capital and cash flow to provide and run the various services, such as roads, police, fire fighting, libraries, the armed forces, and so on. Furthermore, no one in their right mind objects to spending such taxes as efficiently and effectively as practically possible via checks and balances on governments and administrations.

However, to think that simply by lowering taxes the economy will get back to its feet could be overly simplistic. Sometimes this will be sufficient on its own but in other times this alone will not work. Current times may well be such other times, and one reason is demographics.

There is one more angle: think of taxes as payments, especially when well spent, made to ensure the system which enables one to thrive (and thus being able to pay taxes) can be sustained, and to enable those less thriving to consent to sustaining the system.

Hong Kong CBD Office Rents Top Asia and the Investment Implication

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Spit, shiny, and sparkling office towers, no?

According to a Jones Lang LaSalle August 2012 real estate report, the Hong Kong CBD grade A office rents top all Asia, exceeding the 1st runner up Tokyo by around 50% despite experiencing a bit of downward pressure.

As such, there is some truth to the view that the grade A office sector is undersupplied, core areas in particular. While future supply from newly planned office clusters such as the district in and around the old Kai Tai Airport may provide some relief, these are a few years too far away to meet current demand.

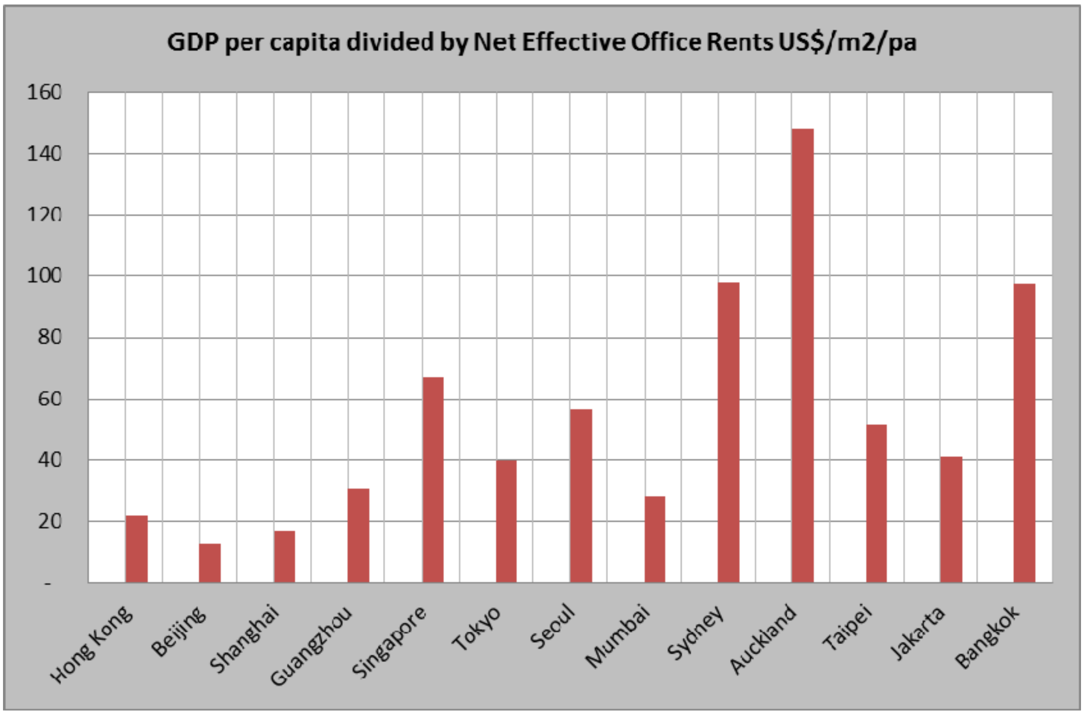
In any event, for occupants needing to be in Central CBD, supply in the sub-cores may mean little. Here is a summarized table on the office rents in various Asian cities:

Cities:	Net effective rent US$ / m2 / year
Hong Kong	1,544
Beijing	977
Shanghai	758
Guangzhou	417
Singapore	735
Tokyo	1,059
Seoul	468
Mumbai	595
Sydney	463
Auckland	266
Taipei	478
Jakarta	225
Bangkok	174

Simply by looking at the rents, it is difficult if not impossible to tell which markets have better office investment potentials, other than to speculate that markets with higher rents are likely to have one or more of the following: better economy, higher productivity, tighter supply, or increasing white collar employment.

As to CBD grade A offices, these generally rely on the demand from the financial multinationals ranging from traditional investment banks via hedge funds to private equities (and their accompanying lawyers and accountants), which collectively in turn benefit from and depend on the increased global liquidity seen in the last couple of decades and in the last 5 years in particular.

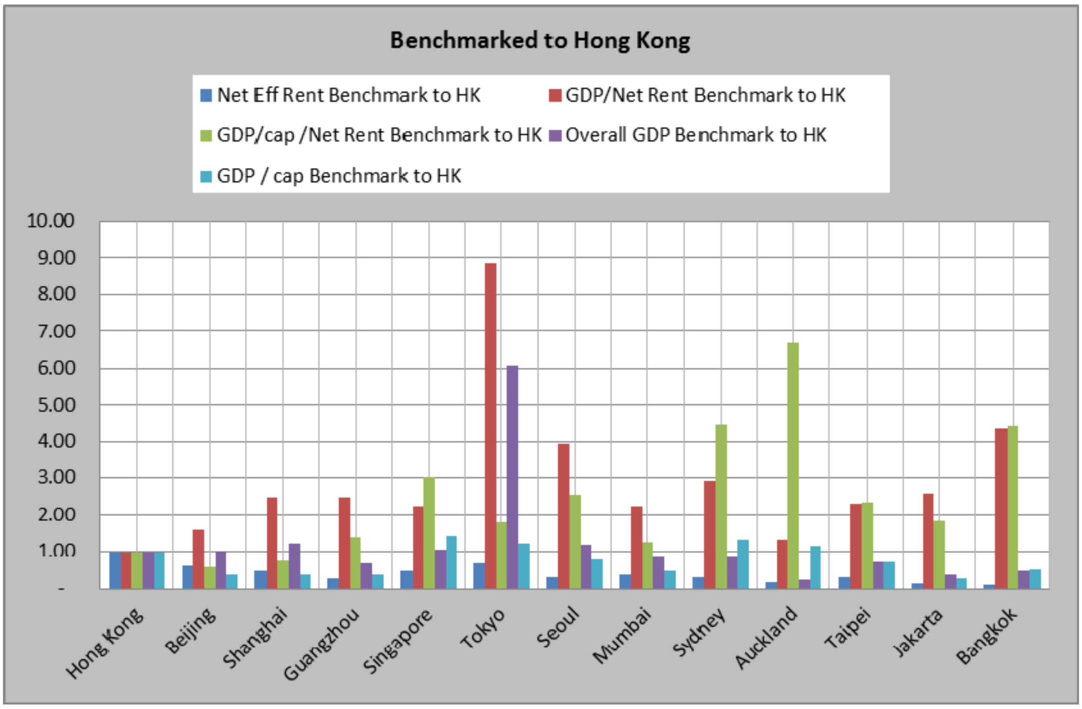
Nonetheless, a quick and dirty (though not very meticulous) way to preliminarily assess the markets is to measure the ratio of office rents to some income data such as GDP per capita. This will give a rough picture of how much GDP (economic) support there is for 1 unit of office floor space and while the figure for any 1 city is not very meaningful, having a figure for a group of cities could be:



Technically, the chart gives the number of years the GDP per capita can pay for the relevant office rent. For instance, Hong Kong has around 20 years, and only Beijing and Shanghai have lower numbers. The middle ones are Seoul, Singapore, Taipei, and the like, while Auckland has a ratio of around 150.

On a superficial level, a high ratio implies the rents may be quite affordable although the market in question may also be having a lackluster economy, higher unemployment, oversupply, and the like. On the contrary, a low ratio may mean office rents eat up quite a chunk of the resources yet may signal a more vibrant economy, insufficient supply, and so on.

Perhaps the trick is to seek markets with similar GDP levels and go for the ones with higher ratios, assuming their office sectors are only experiencing cyclical i.e. non-structural problems.



Conservative Real Estate Investors Should Embrace Down Markets

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Wouldn't call this conservative

Let's define what is conservative in terms of real estate investing.

It implies: a) the leverage is low e.g. if a real estate portfolio is worth US$10M, then no more than 30% of that is borrowed i.e. financing, and yes, despite current historically low mortgage rates; b) the investment is made for cash in the form of rental income as much as for potential price appreciation i.e. the investment timeframe is longer and the investment motive less speculative.

Why down markets are favorable to conservative real estate investors? Because they offer the conservative investors advantages and enable them to show their true colors. We use the following illustration:

1) There are 2 investors, investor A and investor B = investor A holds a real estate portfolio of US$10M and no leverage is used while investor B owns US$20M of real estate of which 50% is leveraged i.e. his equity is also US$10M.

2) Market goes up 50% = investor A now has a US$15M portfolio while investor B has a US$30M portfolio, and after deducting his US$10M financing, investor B now has an equity of US$20M. Better than investor A.

3) Market goes down 50% from point (2) above = investor A now holds a US$7.50M portfolio while investor B now owns a US$15M portfolio, and after deducting his US$10M financing, B now has only US$5M in equity. Both A and B suffer losses but now A has more than B in terms of net equity in the portfolio.

4) Financing for investor A = assuming all factors being equal, investor A has better capacity to raise financing and very likely a positive rental cash flow, while bankers may be wary of investor B whose portfolio is now 66% leveraged, not to mention the bulk of his rentals needs to be used to cover his debt payment thus leaving little or no cash to capture investment opportunities now arising.

5) Say investor A now goes for around 25% leverage, borrowing US$2.50M based on his US$7.50M portfolio = thus acquiring US$2.50M more real estate [with no money down] and bringing his total portfolio value to US$10M. Given the leverage is only 25%, banks have little problem with lending to him and very likely he would still see a positive rental income flow.

6) Market bounces back 50% from point (3) = investor A would have a portfolio worth US$15M and after deducting for financing, his net equity is US$12.50M, whereas investor B would now have a US$22.50M portfolio and after deduction of the US$10M financing, his equity would also be US$12.50M. Investor A ties it with B in terms of equity instead of trailing behind B as he did during the last up market.

Note we have already adopted very conservative assumptions for investor A e.g. he remains conservative even when he could have borrowed more. If A were to turn more aggressive, he could have beaten investor B at point (6).

Many people think real estate owners and investors ALWAYS (as if ONLY) like to see their asset prices go up. Generally this may be true but then again probably not with all investors, and certainly for whom NOT ALL the time.

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