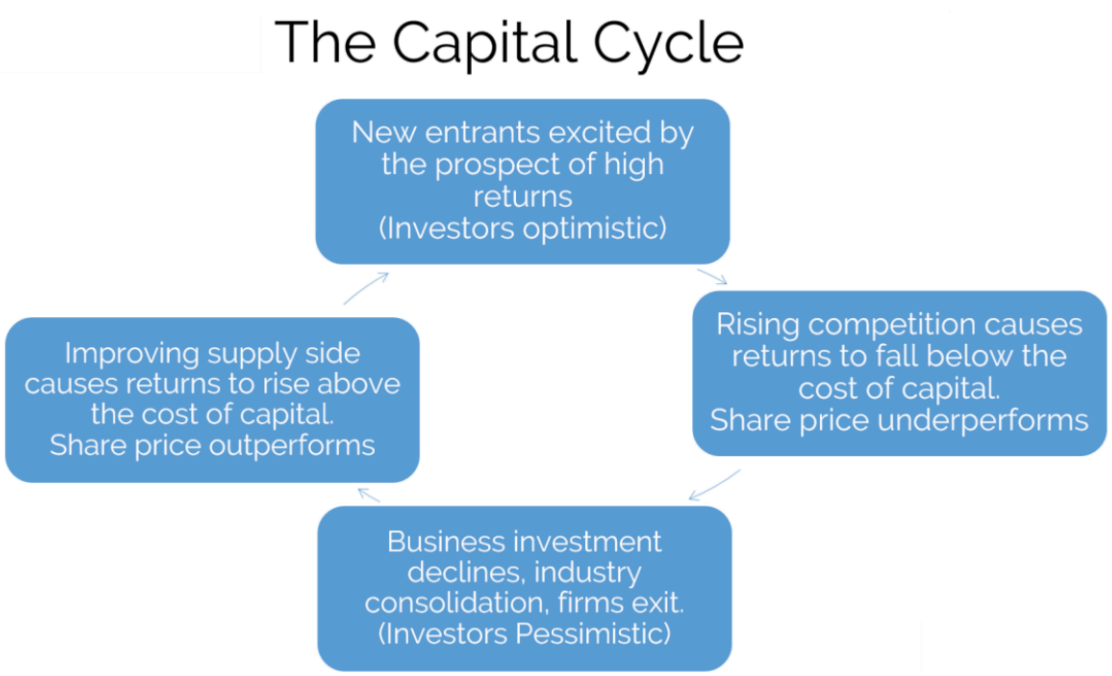
Up and Down Again — The Story of Singapore's Property Market

For many people in Singapore, their first property often represents their first significant investment. Most people generally have positive experiences over the long run – leading them to buy more investment properties as they grow older.

Even in the stock market, property and construction firms make up a significant section of the market, as does a significant portion of the local banks' (DBS, UOB & OCBC) domestic loan portfolio.

Given the dominance of real estate and the industries that support it, it is crucial to understand the dynamics that drive the property cycle over the long run.



Source: Capital Returns: Investing Through the Capital Cycle

One of the central pillars of our investment framework is the capital cycle.

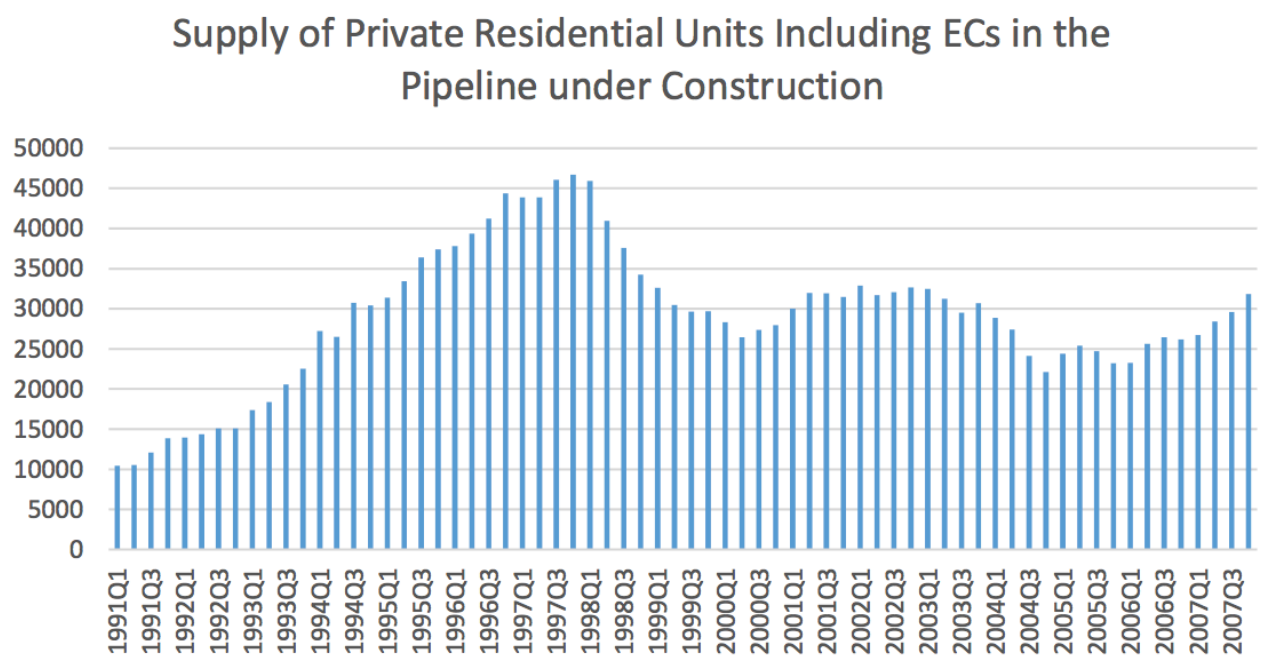
Simply put, it states that capital (i.e. investors) will be attracted to industries where there exist the prospects of high returns. Conversely, when investors are faced with the prospect of low or even negative returns, capital leaves the industry.

Few things move in a straight line, and most things will prove to be cyclical.

We at the Heritage Global Capital Fund believe that investors who have a clear understanding of this and are disciplined and patient will be able to profit immensely when people forget this.

The Capital Cycle in Practice – The Singapore Property Market

Many of the woes that confront investors of property in Singapore now can be understood within the context of the capital cycle.



Source: URA

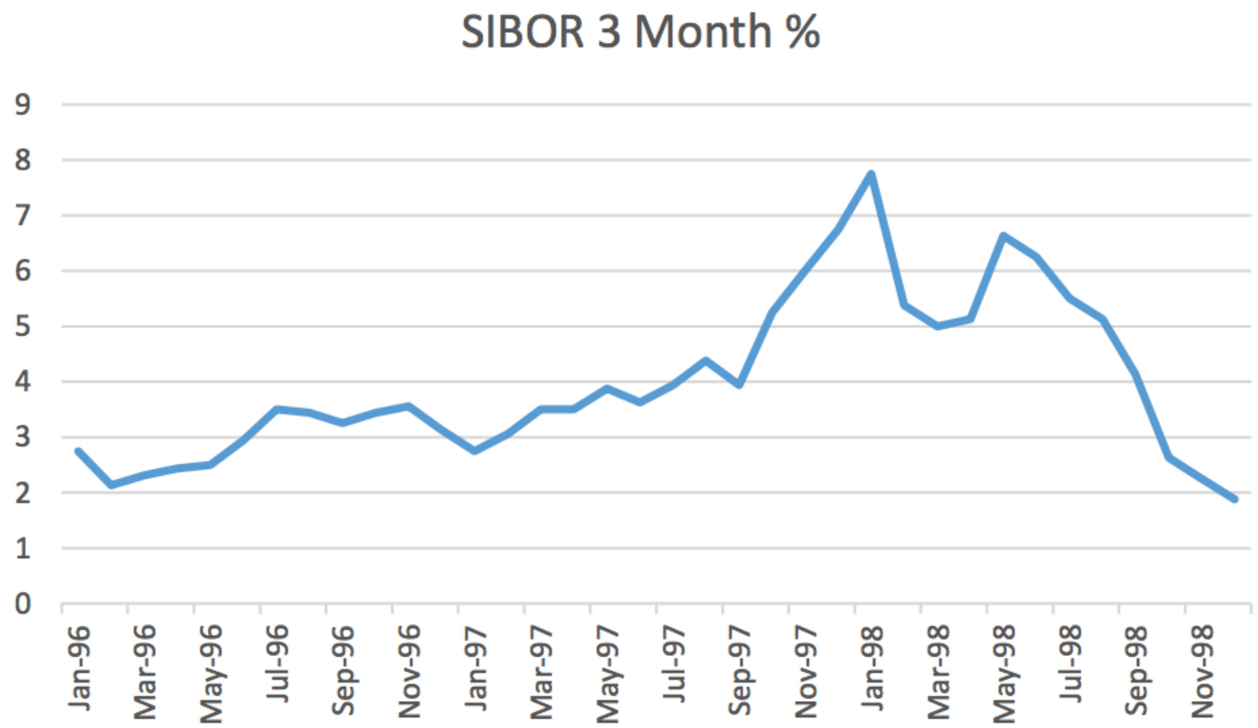
The early 1990s proved to be a golden period for Asia and Singapore. The regional economies boomed, and business sentiment was overwhelmingly positive.

From bottom to peak, property prices in Singapore rose more than 100% in just three years. Investors were bullish and hungry for more. Developers were happy to meet their demand. Buoyed by easy credit and strong profits from previous years, developers invested heavily in new projects.

The number of private residential units under construction surged dramatically from just 12,000 units in 1991 to 35,000 units in 1995.

The government responded to this situation by introducing its first cooling measures in 1996.

What was not expected was the severity and the swiftness of the Asian Financial Crisis in 1997. Sentiment was crushed and demand evaporated from this double whammy. The government unwound the cooling measures quickly in 1997 but the damage was done

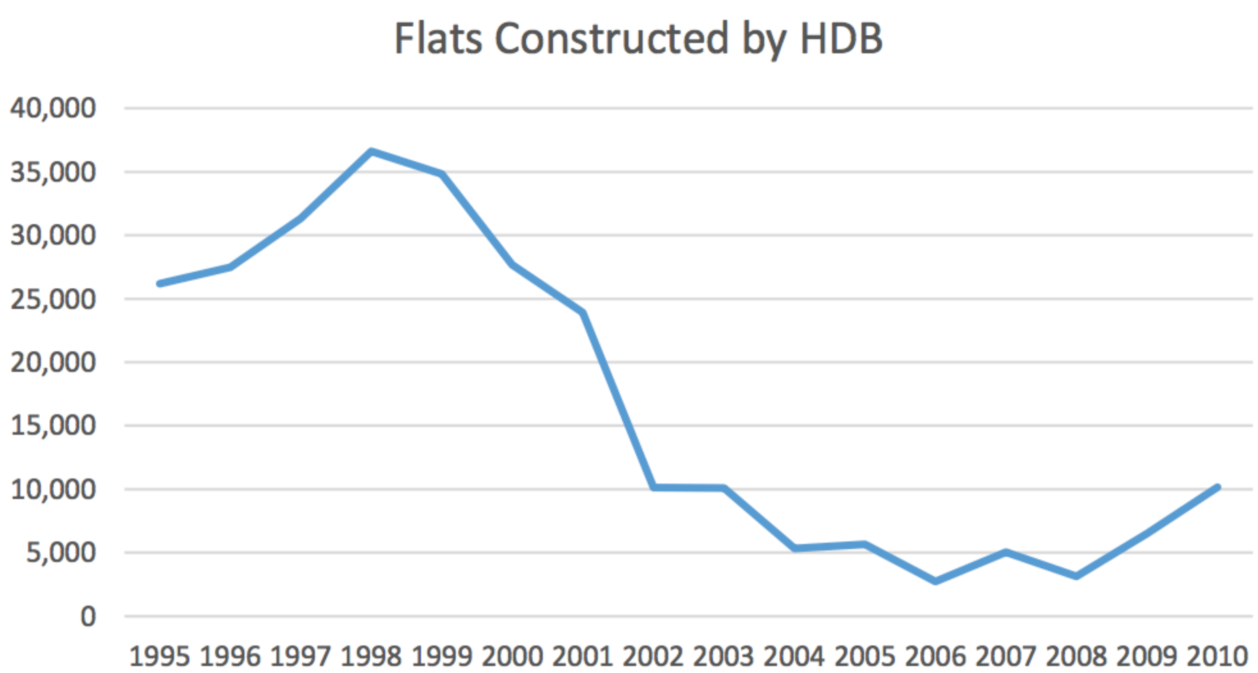


Worst, the cost of borrowing dramatically surged, leading to a liquidity crisis for many over-leveraged investors. Non-performing loans at local banks rose significantly in the subsequent years as the economy deteriorated and unemployment levels rose.

Despite the cooling measures and the poor ensuing economic conditions, supply of new units continued to be strong for several years as previous developments were already underway.

It's worth highlighting that investors often overlook the time lag between the commencement of new projects which can take several years, and the actual delivery of that supply into the market.

The supply glut of housing in Singapore made it a buyer's market from 2001 to 2006. By then, the government had already instituted a slew of property relief measures to boost demand. However, the oncoming tsunami of supply built during the boom years had yet to be worked off.



To deal with the oversupply, then Minister for National Development Mah Bow Tan dramatically curtailed the construction of public housing. The number of public flats constructed by HDB fell from an average of 30,000 units from 1995-2000 to just 5,500 units from 2005- 2010.

2007-2012: This period marks the start of the upward leg of the current cycle. In an effort to sustain economic growth, the government embarked on a dramatic pro-immigration policy, leading to a surge in demand.

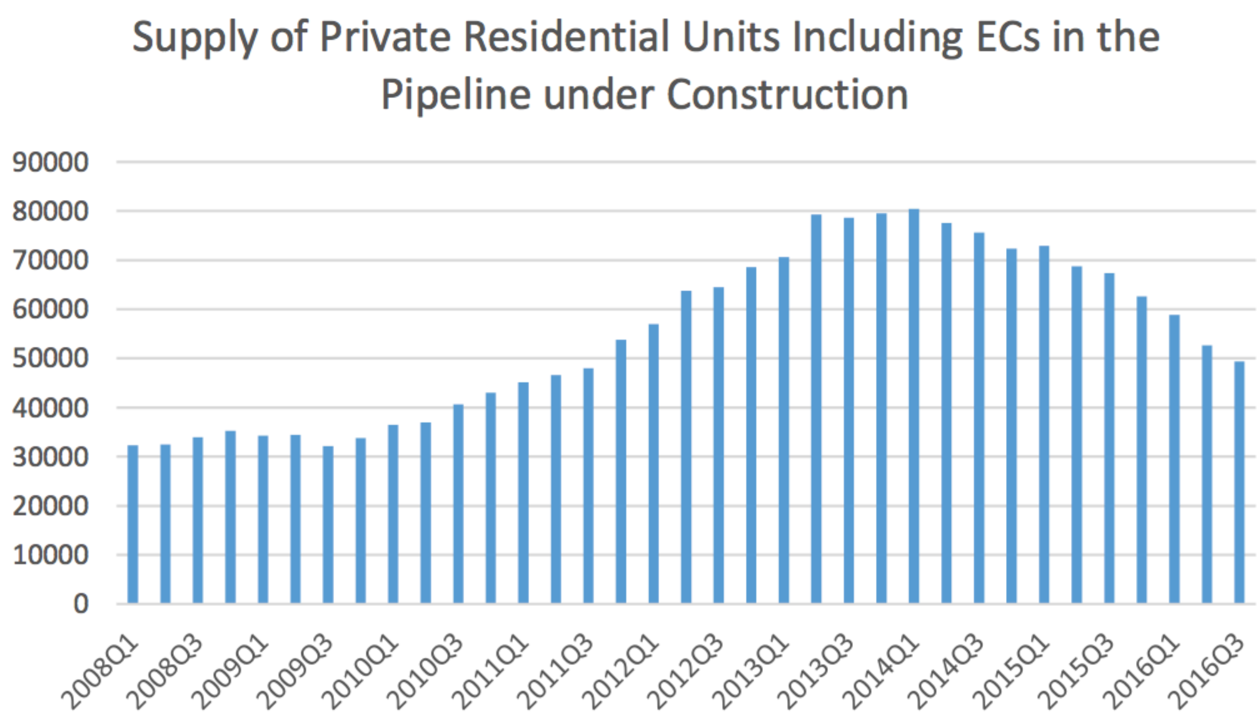
Considering that many of these people were new entrants into Singapore, without an existing home, demand rose correspondingly. The surge in demand helped to work off the pre-existing glut in the system.

Somewhere along the line in 2009-2011, this equilibrium moved out of balance as it became apparent that policy planners were unprepared for the influx of migrants.

Public transportation was running at near maximum capacity, inflation was running high and public discontent was palpable. Things got to a head in 2011, with the PAP posting the worst results since its formation in the General Election that year.

Minister Mah Bow Tan resigns, and Khaw Boon Wan takes his position with a pledge to supply enough new housing to meet public demand.

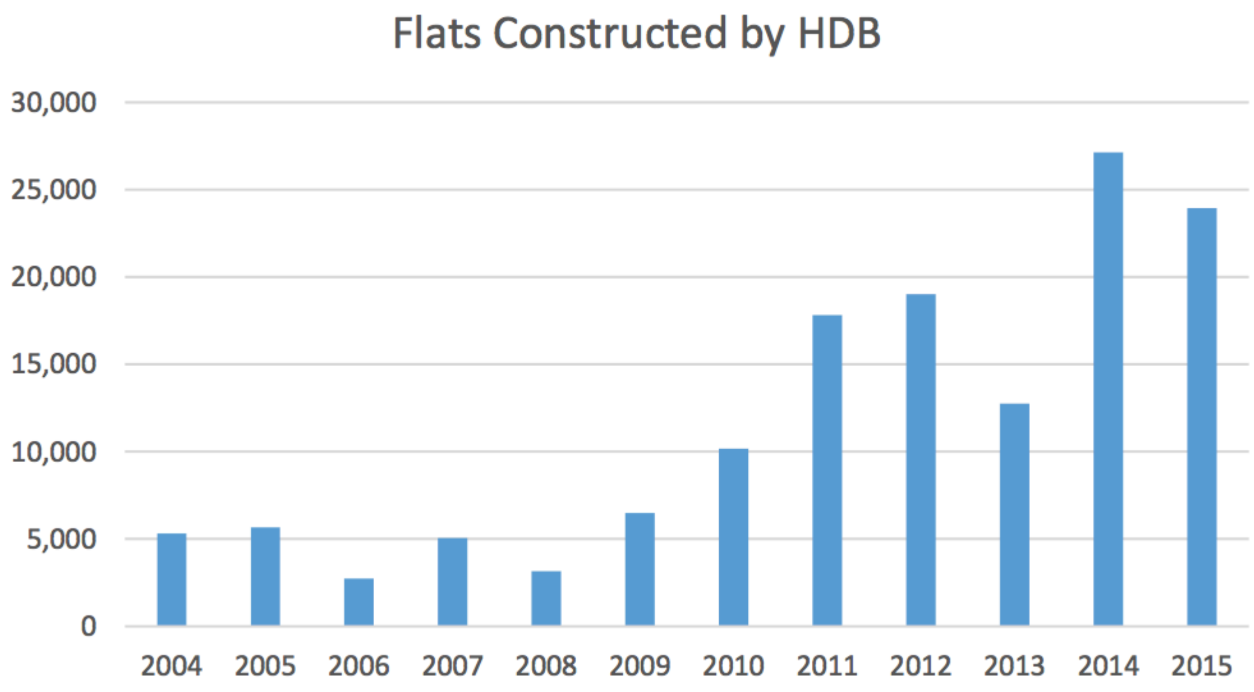
2012-2016: At this point, the tail end of the cycle had begun with a seismic shift in government policy.



Source: URA

On the supply end on the equation, capital attracted into the industry surged dramatically, and even non-Singaporean developers and businesses traditionally not involved in property development got into the game.

The availability of easy credit and record low interest rates exacerbated the situation. The number of private residential flats including ECs surged from just 40,000 units in 2010 to over 77,000 units consecutively in 2013 and 2014.



Source: Housing & Development Board

Reeling from the poor election results, the government responded in force. The Housing Development Board went from constructing an average of 5,500 units in 2005-2010 to an average of 20,000 units annually from 2011-2015.

Eventually, much of this supply under construction started coming online and the equilibrium of the housing market tilted towards oversupply. Vacancies trended upwards and rental yields fell reflecting this new reality

The Time Lag in The Capital Cycle

We want to highlight the most important point of the capital cycle – the time lag of supply coming online. Despite the change in policy planning, prices only eased after 2013 – **because there was <u>no immediate availability</u> of new supply.**

Property development takes years from conception to delivery. Any potential increase in existing housing stock from a major policy shift could only be met 2-3 years later. Potential end users who needed a place to stay were faced with 2 options – buying or renting at elevated levels. As such, prices continued to rise, helped in no small part by record low borrowing costs.

Investors were happy as rents continued to be buoyant, fuelled by the temporary undersupply.

Cycles correct themselves eventually as the excess glut of housing supply is cleared from existing demand – unless a permanent structural change occurs (permanent decline in population from war, disease). In the case of the current property cycle in Singapore, two forces were at play.

On the demand side of the equation, a change in the immigration policy in the late 2000s led to a sudden surge in the population. Policy makers, fighting the last war from the last property boom, were caught off-guard, leading to a chronic undersupply of housing for the growing population.

This realisation led to a sharp U-Turn in policy in 2011.

The boom enjoyed by construction companies and property developers from 2010 to 2013 was unfortunately unsustainable – especially if understood within the context of the capital cycle.

A sustained effort by both the government and the private sector led to a dramatic increase in the overall housing stock, and without a corresponding increase in demand from population growth coupled with the government's property market cooling measures, this has led to a situation of mild oversupply starting from 2015 as projects were completed.

The Perils of Over-Expansion – Tat Hong Holdings

Companies that did not pay heed to the cycle were caught off-guard as demand cratered, especially those that had expanded heavily during boom times. The case of Singapore listed Tat Hong Holdings, a supplier of cranes & heavy equipment, is reflective of the perils of investing at the wrong end of the capital cycle.

Year	2016	2015	2014	2013	2012	2011	2010
Capital Expenditures (Addition to Fixed Assets) / mil	-$29	-$78	-$141	-$103	-$126	-$79	-$80
Total Assets / mil	$1,362	$1,491	$1,569	$1,541	$1,377	$1,148	$1,036
CAPEX / Total Assets	-2.1%	-5.2%	**-9.0%**	**-6.7%**	**-9.1%**	**-6.9%**	**-7.7%**

Year	2009	2008	2007	2006	2005	2004	2003
Capital Expenditures (Addition to Fixed Assets) / mil	-$29	-$39	-$9	-$17	-$14	-$1	-$5
Total Assets / mil	$883	$839	$627	$479	$418	$315	$252
CAPEX / Total Assets	-3.3%	-4.6%	-1.4%	-3.6%	-3.5%	-0.2%	-2.1%

In the aftermath of the Great Financial Crisis of 2008, the construction industry prospered from the fiscal stimulus by governments around the world. Buoyed by strong profits, Tat Hong expanded aggressively.

Capital expenditures on equipment such as cranes rose dramatically, funded from a mixture of cash from existing operations and debt.

Year	2016	2015	2014	2013	2012
Loans & Borrowings / mil	$545	$557	$578	$514	$456
Shareholder Equity / mil	$630	$701	$727	$740	$598
Debt / Equity	**87%**	**79%**	**80%**	**69%**	**76%**

Year	2011	2010	2009	2008	2007
Loans & Borrowings / mil	$409	$245	$218	$148	$145
Shareholder Equity / mil	$572	$593	$462	$449	$303
Debt / Equity	72%	41%	47%	33%	48%

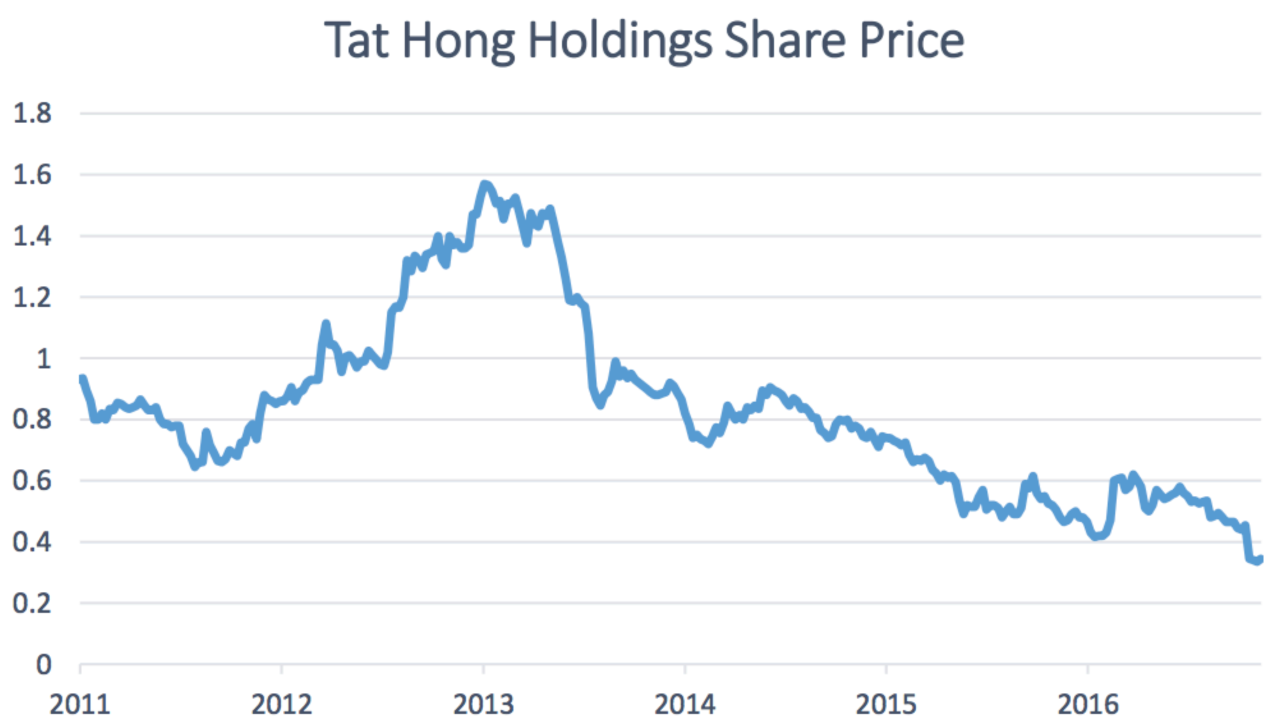
Around 2014, the boom started to taper off and its core markets of Singapore and Australia were affected. Worst off, an influx of excess equipment into its markets (from other firms riding the same boom) increased competition and led to lower profit margins.

Their highly geared balance sheet left little room for error.

In 2015, the company wisely reversed its plan, dramatically curtailing its expansion. Aware of their increasing precarious financial position, they started divesting non-core assets and right sizing its fleet (i.e. selling of its equipment). However, their efforts proved insufficient as the market awoke to the dire straits the company was in.

From peak to bottom, Tat Hong's share price fell more than 75%.

In November 2016, the company announced a dilutive rights offering at less than 50% of its latest book value to raise $41 million. The market promptly reacted with a decline in share price to all time low of 34 cents, breaching its previous all-time low of 43 cents in 2008.



You Can't Predict, But You Can Prepare

Cycles are inevitable, and most pronounced in property cycles because of their length, and the inability of most market participants to recognise the warning signs. They are self-correcting, with each boom setting the stage for the next bust.

The parallels between the woes facing the industry now, the sub-prime crisis of 2008 and the current slowdown in China are clear for those willing to connect the dots. While history may not repeat itself, they often rhyme.

A thorough understanding of where we are in the cycle is crucial in the fund's investment process. It helps us avoid "value-traps" in industries which may appear superficially cheap – but are prone to more significant distress as write-downs and impairments continue from the overhang of the last boom.