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Assessing Management Implications from Ownership Change in Public Real Estate

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Key words: Privatization, divestment, government assets, customer satisfaction, social effects, service quality.

SUMMARY

This study is mainly concerned with assessing critically the policy, processes and implications of a local government's privatization and divestment of government assets. A private organization (TLM is a nickname adopted to serve protection) obtains the management rights of majority commercial retail properties originally owned by government. TLM has to manage these properties under the direction of government and related regulations initially. A year later, TLM goes for an Initial Public Offer (IPO) and acquires these properties to become the largest single owner of retail properties (affects most residents lodging in public rental housing estates) in local market. This paper aims to study the changes of management services from that offered previously by government to that by TLM and its impacts in terms of customer satisfaction, implications to residents' life, social effects, overall service quality etc. Qualitative research such as interviewing with major stakeholders, with a well-designed questionnaire, will be adopted. It is expected to cast some insights for better services improvements offered by TLM in the coming future.

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1. INTRODUCTION

Divestiture did not feature much before the establishment of Hong Kong Special Administration Region (HKSAR) in 1997. Prager (1994) contends that contracting out has been adopted as a flexible way of incorporating private sector involvement, and it can be done through the following:

- *Service contracts* (e.g. cleaning or security management contracts) and other types of outsourcing;
- *Management contracts* (e.g. granting concession to a private company to management car parks); and
- *Build-own-operate* (BOO) or *build-own-operate-transfer* (BOOT) schemes (e.g. granting concession to a private company to build, finance and operate, or subsequent transfer to government, a new infrastructure project such as a bridge or tunnel).

The HK 1999-2000 Budget identified the 'privatization of public corporations' and 'rethinking the mode of delivering public services, with more private sector involvement and contracting-out' as some of the major reform initiatives. The first divestment of public assets started with the Mass Transit Railway Corporation (MTRC) in late 2000. The listing of the TLM Real Estate Investment Trust (REIT) was another major divestment of government assets. In any method of privatization/divestment, the government assets concerned must be first vested in a company of divisible shareholding. Unless the assets prior to privatization are already held in the form of a government-owned company, organizational restructuring is a must (Sznajder, 2010).

In July 2002, Housing Authority (HA) appointed a consultant to assess the feasibility of the divestment, recommend the divestment strategy and formulate an implementation proposal (Lego, 2003). The Chief Executive in Council (CEC) ordered that HA's agreement be sought to divest its retail and carpark (RC) facilities, and that the net proceeds from the divestment should entirely go to HA. HA plans to sell both the management and ownership rights of the facilities to a new private company which will in turn make an initial public offering on the HK Stock Exchange. TLM, a private organization, intends to accomplish its objective for sustainable long-term growth through optimizing the performance and overall quality of a geographically diversified portfolio of commercial properties owned originally by HK government for implementing various investment and business strategies. With the understanding of privatization and later Initial Public Offer (IPO), this study aims to explore the implications of public consultation, political support, stakeholder consensus and consumer interest regarding TLM's Real Estate Investment Trust (REIT) listing.

In July 2003, HA agreed in principle to divest its RC facilities as follows (Lego, 2003):

- A REIT structure would be established to hold HA's RC facilities to be divested;
- Initially, HA would assign the cash flow of the RC facilities to TLM and sign a sale and purchase agreement. On this basis, TLM would make an IPO on The Stock Exchange of Hong Kong (SEHK) which, tentatively, was set in 2004-05;
- TLM would pay to HA for the sale of the RC facilities by two installments: a major proportion of the sale amount would be paid immediately after the IPO and the balance would be paid upon the completion of transfer of legal titles.

2. LITERATURE REVIEW

Historically, REITs were first introduced in 1960 in the United States of America (US). More than two-thirds of the registered REITs are traded on the major US national stock exchanges (Chang, Chou and Fung, 2012). It can deduct the dividends paid to the shareholders for the corporate tax bill, which implies only one level of taxation for investors. In 2001, Japan became the first Asian country to offer REITs. Currently, there are six REITs being traded in Japan, two in Singapore, and three in Korea. Other places studying the possibility of introducing REITs include Taiwan, India and HK. In 2003, SFC released a draft code stating the general principles and rules that would govern REITs in HK.

The potential tensions are higher in the case of divestment resulting in mixed government-private ownership (Savas, 1992). As a consequence, in many international cases, privatized enterprises (in particular public utilities) are often put under additional public laws and regulatory controls. Moreover, securitization is a form of government lending and does not transfer the government ownership of assets. It merely refers to the financing arrangements designed to translate the expected future stream of revenues into government loans in the form of securities, notes or bonds, which can be issued through public offering or other means. It also requires some organizational structuring such as setting up a company as a new vehicle to hold the assets and for other necessary financial arrangements. Theoretically, these services can still be managed along either commercial or non-commercial lines, as the case may be, although the latter would mean a higher cost of government lending and is thus less preferred.

Such organizational restructuring bears important implications on the process of privatization and post-privatization governance (Filatotchev et al., 1996). This is because the privatized body may need:

- to completely change the management of the services concerned and become profit-seeking;
- to comply with a different set of market laws and regulations, possibly including regulations applying to international financial markets; and
- to automatically become autonomous or independent from the government's direct control, unless new laws are enacted.

- Primarily, REITs possess the following characteristics:
- Equity REITs which own and operate income-producing real estate such as the listing of the Link-REIT in HK.
- One major distinction between REITs and other real estate companies is that a REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than to resell them once they are developed.
- Today mortgage REITs generally extend mortgage credit only on existing properties.
- Mortgage REITs which lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage-backed securities.
- Hybrid REITs which both own properties and make loans to real estate owners and operators.

A REIT is a collective investment scheme constituted as a trust that invests primarily in real estate with the aim to provide returns to holders derived from the rental income of the real estate (Dubreuille, Cherif and Bellalah, 2016). Furthermore, a REIT is a company that owns, and in most cases, operates income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses. It is a collective investment scheme constituted as a unit trust that invest primarily in income-producing real estate assets and uses the income to provide returns to its unit holders. In addition, REITs that authorized by SFC should have the following features:

- invest in real estate in HK only;
- provide regular detailed reports regarding its performance to investors;
- limit the level of borrowing to 35% of the gross asset value;
- require an independent trustee to provide a layer of oversight over the operation of the scheme; and

- pay at least 90% of its after-tax income to investors in the form of dividends at regular intervals.

In this regard, a trustee responsible for overseeing the operation of the REIT and protecting the rights and interests of unit holders should be appointed. The management company of the REIT should be licensed under the Securities and Futures Ordinance (Cap. 571) and approved by SFC. That company should also maintain satisfactory internal controls and written compliance procedures which address all regulatory requirements. The names of persons holding 10% or more of the outstanding units of the REIT and their relationship with the REIT should be disclosed. Mandatory rotation of the property valuer is required once every three years. Practically, the HK Exchanges and Clearing Limited is responsible for listing-related matters of REITs, including vetting the listing documents, supervising the conduct of the listing process, and monitoring the continuous compliance with the Listing Rules. However, SFC also stresses that the total return on REITs is subject to the performance of the property market, interest rate cycles, economic prospects and political outlook. Dividends may not be paid if the REIT reports an operating loss.

In reality, one day before the closing of the public offering period, two public rental housing estate (PRHE) tenants filed an application for judicial review of HA's statutory power to divest its asset. One of the two tenants then filed an appeal to the Court of Appeal of the High Court which upheld CFI's ruling. The tenant later filed an appeal to the Court of Final Appeal (CFA) and refused to accept HA's proposal to expedite the court procedure. This decision had given rise to grave public concern. Concerns were raised on the possible tangible and intangible economic losses, such as the toll on the international status and reputation of HK, the impact on the offering price if the listing was relaunched in future. The abortion of IPO had aroused concern on the existing listing regime. Yet, the public housing program might be affected should the divestment exercise were eventually called off. It was opined that divestment was not the only means to tackle HA's financial hardship. The government was also urged to conduct consultation on the divestment again (Lego, 2004).

In April 2005, CFA granted leave for the PRHE tenant regarding her appeal for HA to divest itself of its RC facilities under the Housing Ordinance (Cap. 283) (Lego, 2005). CFA heard the appeal and unanimously dismissed it in July 2005. HA later decided in September 2005 to re-launch the global offering of units in a REIT to implement its decision to divest its RC facilities. In fact, HA holds approximately one million square metres of retail facilities and 100000 car-parking spaces, amounting to some 11% and 16% of the market respectively. Divestment of HA's RC facilities was first mooted in 2000, with the following objectives:

- First, it would enable HA to focus its resources on its core functions as a provider of subsidized public housing;
- Second, with the cessation of production and sale of Home Ownership Scheme (HOS) flats indefinitely, HA lacks a recurrent source of income. Proceeds from the divestment, expected to be in the region of $30 billion will definitely help to meet HA's funding requirements in the short term.

The first argument is weak. There is no reason why HA could not competently engage in housing-related business as private property developers do. The second reason seems a more genuine motive, as part of the government's fiscal strategy to divest public assets to raise funds to ease the deficit situation, as in the case of the sale and securitization of toll roads and bridges, the partial privatization of MTRC and the proposal to partially privatize the Airport Authority and the future merged railway corporation. If so, HA should not list the REIT, unless there is a deliberate policy decision to let the general public, as owners of government assets, to share the fruits of good investment by way of IPO. In other words, the listing should not be a short-sighted relief measure to a cash-stricken HA, but a bolder attempt to return benefits to ordinary citizens.

As a public sector, the role and overall policies for commercial properties of HA mainly focus on assuring residents of adequate services to the public housing residential tenants. The scale of the HA's contribution to residential development is such that ancillary facilities are also required to assure residents of adequate services. These facilities, encompassing retail, carparking, welfare and educational are termed "commercial". Broadly speaking, premises are let at market rent on terms comparable to those in the private sector. The above role and policies of HA are lack of the elements towards customer services. The HA's properties have historically been managed on public sector practices, there is considerable scope for the removal of historical operational constraints and for the implementation of private sector market practices to drive net rental income and profitability over time after the listing.

In addition, the REIT's Manager intends to accomplish these objectives through optimising the performance and enhancing the overall quality of a large and geographically diversified portfolio of assets in HK through implementing various investment and business strategies. According to the Offering Circular of TLM, the Operational Enhancements are mainly used as a set of key business strategies. Such measures on pro-actively managing and leasing properties include:

(a) Delivery of High Quality Services to Tenants and Shoppers

The Manager intends to be responsive to letting enquiries form prospective new tenants and to maintain strong relationships with existing tenants through providing the decision-making authority to manage the facilities, and making them accountable for the performance of the assets. Thus, the Manager will set high standards, for the property management services provided to the retail facilities. To this end it will regularly evaluate the performance of the external property managers based on key performance standards.

(b) Disciplined and Efficient Asset Management and Cost Control

The Manager has set up a comprehensive asset management platform to facilitate a disciplined and efficient approach in the overall management of the assets, so as to maximize the REIT's market position and portfolio strengths.

(c) Pro-active Retail Leasing

The Manager will endeavour to achieve this by pro-actively managing lease renewals, securing new tenants and minimizing void periods arising from non-renewals and early terminations of Leases. The additional flexibility under the Manager's leasing strategy in dealing with existing and potential future vacancies as well as ongoing Lease renewals will assist the Manager in achieving its objective of maximizing the occupancy of the retail facilities.

(d) Continual Improvement in Tenant Mix and Facility Layout

Therefore, the Manager intends to monitor actively and research relevant market factors and formulate detailed and responsive retail plans to ensure that the tenant profile and trade mix within each centre are optimised on an on going basis. This will assist the centres to maintain their relevance to the shopper base and remain competitive in terms of attracting shopper traffic and maximizing tenants' sales.

(e) Improvement in Operational Efficiency and Reduction in Operating Costs

For the remaining retail facilities, the Manager will also explore the progressive re-modelling of the form of Property Management Agent (PMA) Contracts to remove the supervision headcount given that the Manager's centre management staff will perform the role of supervising the staff under the PMA Contracts going forward.

(f) Enhancement of Carpark Operations and Profitability

The Manager intends to adjust carpark rates and allocate carpark spaces between hourly and monthly parking according to market conditions and demand that will have a positive impact on future carpark demand and revenue.

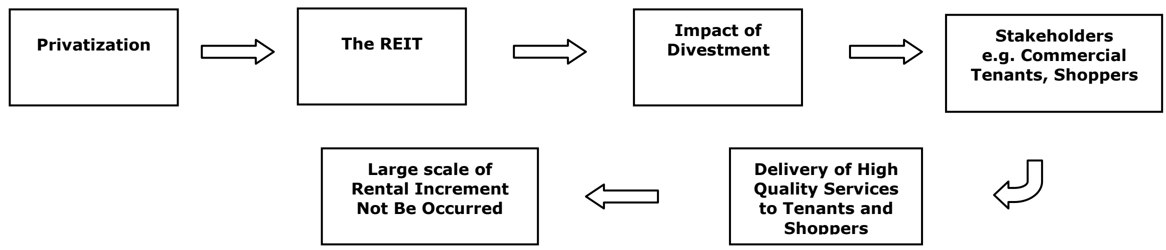
(g) Active Marketing and Promotion

The Manager will look to enhance the marketing and promotion of the retail facilities and develop marketing plans for the portfolio and also for the individual larger retail centres, taking into account factors such as trade mix, customer base, market characteristics and operational conditions of the individual properties. These plans will address the retail facilities' needs with regards to maximizing shopper traffic and tenant sales.

(h) Pursuit of Additional Revenue Opportunities

The Manager also believes that marketing and promotional events by tenants can be an important source of income, such as through the leasing of atrium spaces for sales and promotions of products and services and sponsorships, and will actively pursue such opportunities.

From the above implementation of private sector market practices, there is considerable scope for the removal on of operational constraints historical public sector practices to drive net rental income and profitability over time after the listing. Yet, one should not jump to conclusions at the other extreme by assuming that must necessarily harm the interests of public housing residential and commercial tenants. Actually, the usual economic argument for privatizing a public sector operation is that this helps to rationalize the cost structure and reduce costs. The REIT should actually be able to lower rental levels should less costly private sector employees instead of civil servants as under HA be used, with a more streamlined and cost-effective staffing structure after reengineering. After the IPO, a large scale rental increment is not the main business strategy. The Rationale is interpreted as follows:



3. RESEARCH METHODOLOGY

Qualitative research, via structured interview and a properly designed questionnaire is adopted, for dispatch to major stakeholder e.g. government officials, commercial tenants, PRHE tenants, staff of TLM/HA/PMA and contractors. The principal methods of administration are personal or face-to-face interviews, telephone interviews, and self-administered questionnaires by mail or hand delivery. The questionnaire is designed to focus on the reasons of divestment, research rationale and standard of management in order to examine the probable different services standard offered by HA and TLM. Initial data will be gathered via target projects like OT Shopping Centre, located at the New Terriorities of HK. The surrounding area is predominated by public and private residential housing estates. The property is located within OT PRHE with close proximity to amenities and educational institutes. The questionnaire will cover:

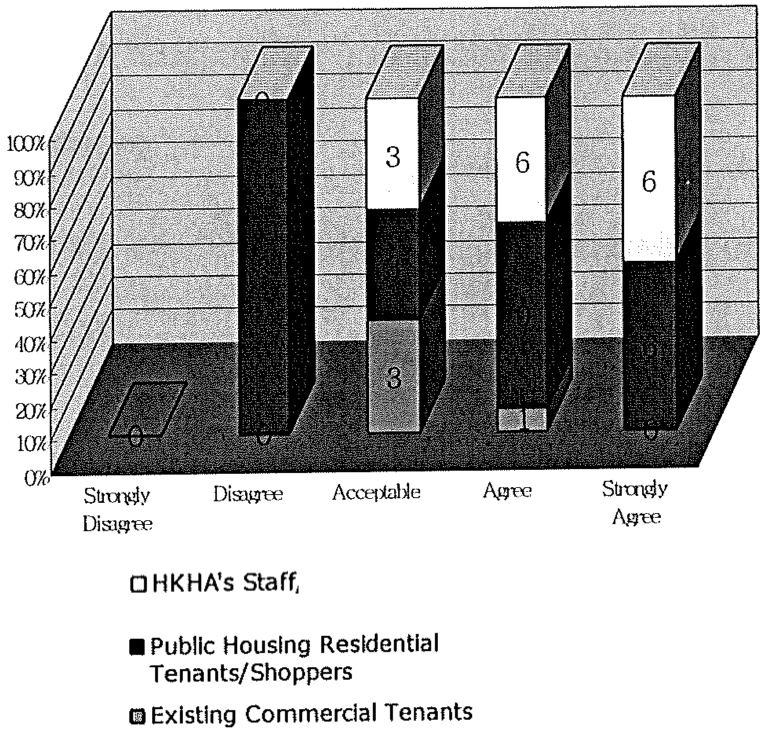
(i) Questions (A)1 to (A)4 are focused on the reasons of divestment. Firstly, it would enable HA to focus its resources on its core functions as a provider of subsidized public housing; and secondly, with the cessation of production and sale of Home Ownership Scheme (HOS) flats indefinitely, HA lacks a recurrent source of income. Proceeds from the divestment, expected to be in the region of US$3.85 billion will definitely help to meet HA's funding requirements in the short term.

(ii) Question (B)1 to (B)7 concentrate on the rationale, to compare the changes on the management services after divestment between HA and TLM.

4. RESULTS AND ANALYSIS

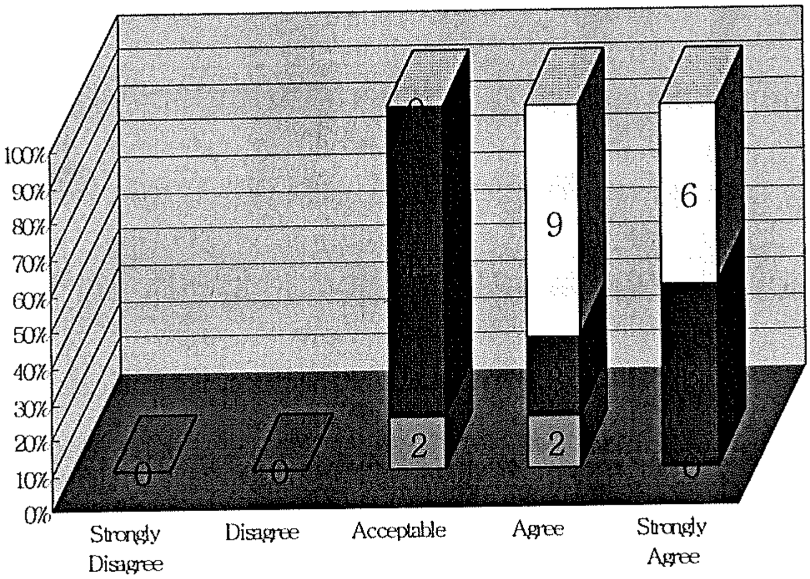
There are 25 respondents from PRHE tenants/shoppers, 15 respondents from staff of HA/TLM, whilst none from contractors. In order to focus on whether the rationale is established or not, Feedback of Part (ii) questionnaire is mainly adopted for detail analysis, as revealed below.

From Q(B)1, About 70% respondents opine that TLM is more concerned with the quality of customer services, while 22% consider this neutral/acceptable.



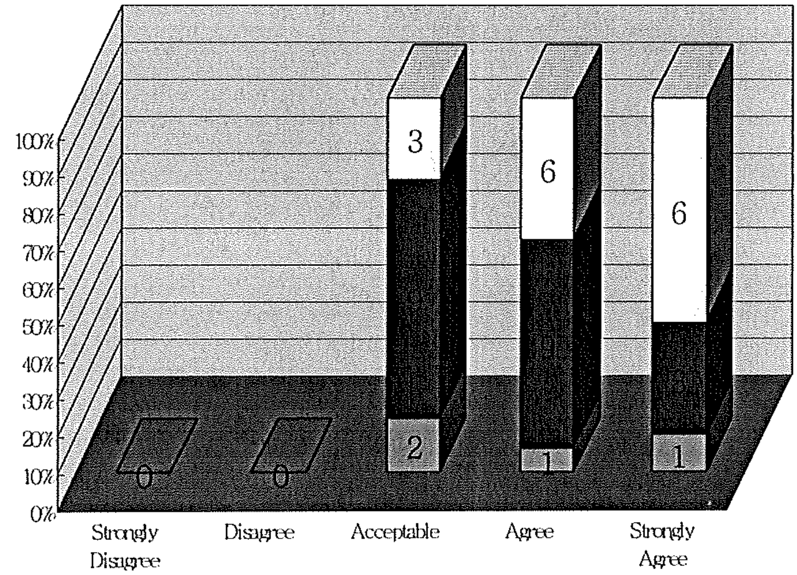
Question B1. TLM is more concerned with customer services quality

From Q(B)2, About 65% respondents contend that TLM can handle repair and maintenance more efficiently for the shopping centres, whilst 35% consider this as neutral/acceptable .



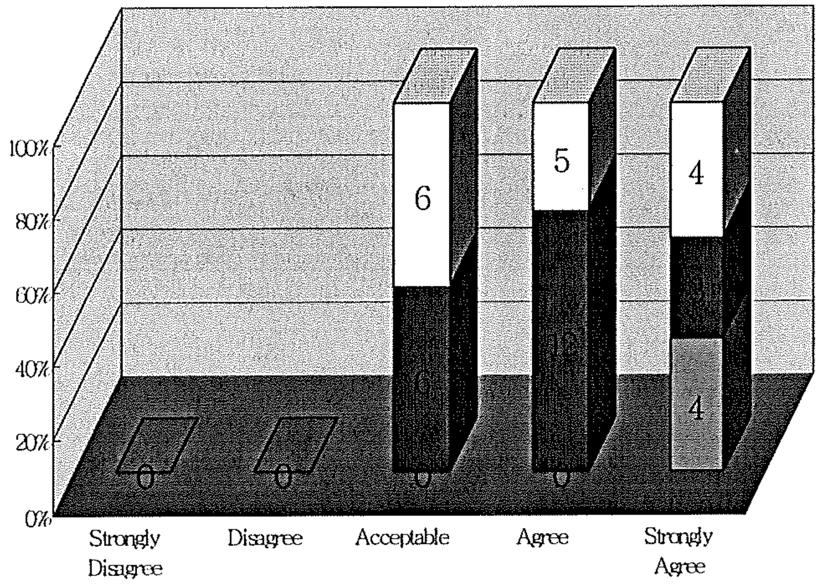
Question B2. TLM can handle repair/maintenance more efficiently

From Q(B)3, About 65% respondents opine that TLM handles complaints more efficiently than HA, while 35% consider this as neutral/acceptable.



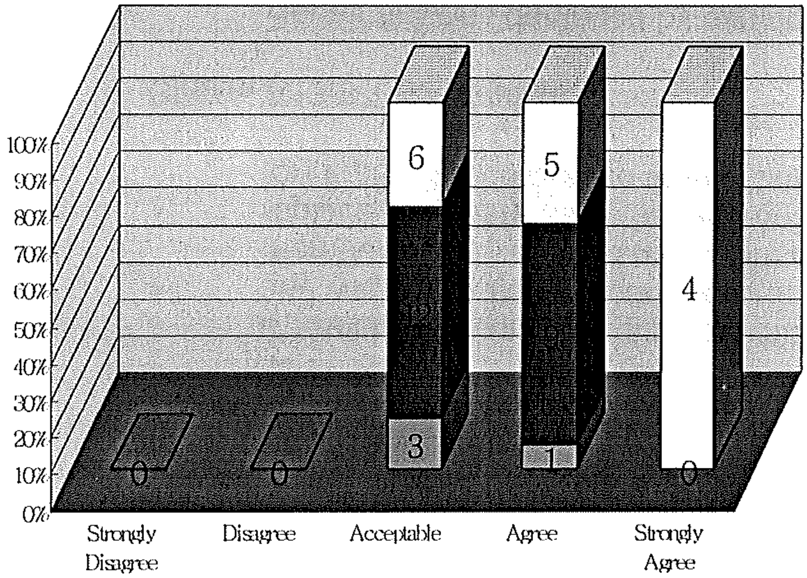
Question B3. TLM can handle complaints more efficiently

From Q(B)4, About 70% respondents contend that TLM's leasing strategy is more commercialized and market-oriented, whilst 30% consider this as neutral/acceptable.



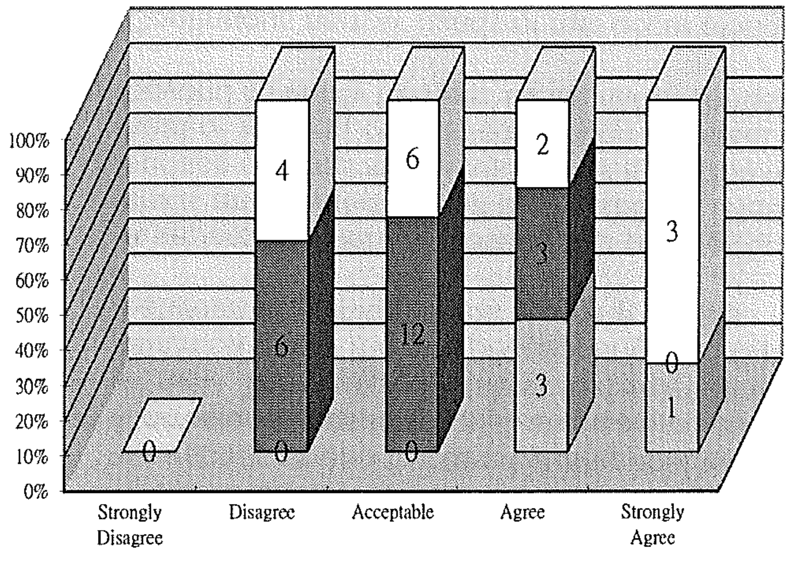
Question B4. TLM's leasing strategy is more commercialized/market-oriented

From Q(B)5, About 48% respondents reckon that TLM is to positively improve overall shopping atmosphere and increase visitor flow, whilst 52% consider this as neutral/acceptable. This can be done by (i) strengthen trade mix, (ii) increase physical attractiveness with value-adding asset enhancement work, and (iii) organize a variety of publicity and promotional activities. From so doing, the commercial centres will have a greater and positive change to meet customers' needs than before.



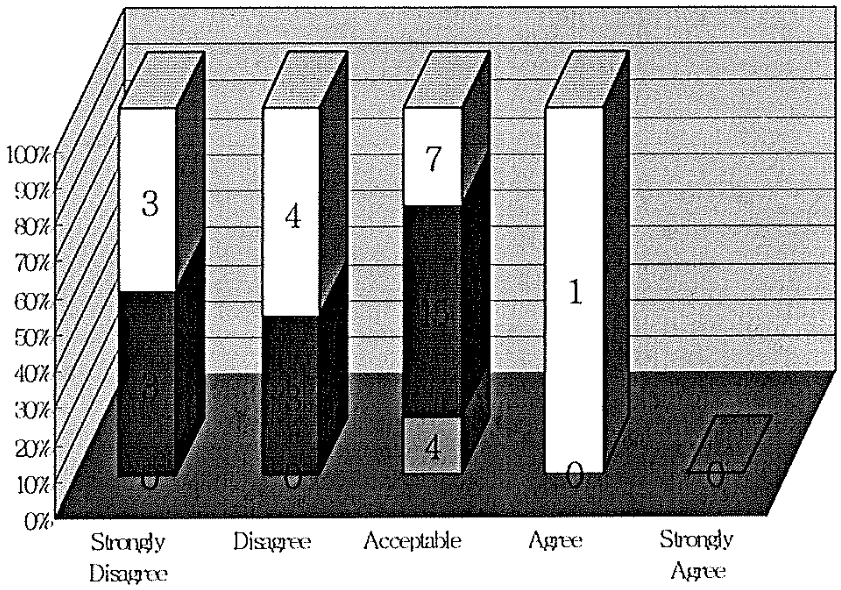
Question B5. TLM's leasing strategy is more commercialized/market-oriented

From Q(B)6, About 30% respondents believe that TLM will not have a negative impact after divestment over the PRHE tenants, e.g. consumer goods may cost more in the commercial centres; while 45% consider this as neutral/acceptable; and 25% disagree.



Question B6. TLM will not have a negative impact after divestment

From Q(B)7, About 3% respondents agree that TLM may not bring in brand goods outlets and supermarket chains to drive out small shops/business, whilst 65% consider this as neutral/acceptable, with 32% disagree.



Question B7. TLM may not bring in brand goods outlets & supermarket chains

Besides, two interviews were conducted with the existing Managers in YL and TM Districts, whom have over 30 years' property management experience. They have experience over 20 nos. of properties such as flagship centres including CF Shopping Centre, LK Shopping Centre, which are highly ranked shopping centres in TLM. They contend that rental increment is not their main business strategy. Since 2005, TLM has undertaken the management of HA commercial properties, under the direction of HA and in line with HA's existing policies/practices of the Housing Ordinance. Therefore, TLM has not been able to execute its own strategy until the acquisition of these properties by REIT through using the proceeds from Global Offering in November 2006.

Other than profit seeking strategy, they mainly concern about the delivery of high quality services that previously neglected. They intend to accomplish the objectives to provide unit holders with stable distributions through optimising the performance and overall quality of the diversified portfolio of assets with private enterprise management concepts. The rental increment is in line with the market rent, though may be perceived as higher than before (partly because the previous rental is lower than the market at the time). Also, taking into account the unique characteristics of individual retail facilities, they will gradually roll out the measures to raise the quality of customer services, and improve the overall shopping atmosphere by organizing various promotional activities. These measures will benefit shoppers, tenants and unit holders. Therefore, the leasing strategy is modified basing on the schedule of improvement works done.

5. CONCLUSION

The majority respondents believe that TLM is more concerned with the quality of customer services, handles repair and maintenance more efficiently for the shopping centres, handles complaints more efficiently than HA, with a more commercialized and market-oriented leasing strategy. TLM can positively improve overall shopping atmosphere and increase visitor flow by (i) strengthen trade mix, (ii) increase physical attractiveness with value-adding asset enhancement work, and (iii) organize a variety of publicity and promotional activities. From so doing, the commercial centres will have a greater and positive change to meet customers' needs than before. About 3% respondents agree that TLM may not bring in brand goods outlets and supermarket chains to drive out small shops/business, whilst 65% consider this as neutral/acceptable, with 32% disagree. Yet, about 30% respondents believe that TLM will not have a negative impact after divestment over the PRHE tenants, e.g. consumer goods may cost more in the commercial centres; while 45% consider as neutral/acceptable; and 25% disagree.

TLM will be operated fully on a commercial basis, demanding for higher quality services will result in higher rental income that in turn, deployed in overall upgrading/renovation to the less trendy commercial properties. Consequently, the customers will be prepared to pay higher costs for improved overall services in line with the market. Besides, the privatization and IPO must be demonstrated to achieve the required efficiency to benefit the public housing tenants and community as a whole. TLM should commit to a transitional agreement to ensure continuity of existing HA tenancy policy as status quo of tenancy to ease the minds of present commercial tenants. The political consensus with major stakeholders should be properly secured; and TLM should accompany HA to consider amending the relevant provisions of Housing Ordinance, to remove any legal doubts regarding HA powers/influences.

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