Asian Tigers and Lion Kings

BY HOWARD C. GELBTUCH, CRE®, FRICS

China's high-speed rail system is an apt metaphor for the country's hurtling economy over the past decade: a colossal investment project, born of the state… built for maximum velocity, and imposed… on a public that is at once amazed and skeptical. The rail system has married foreign technology with national ambition in a network billed as the biggest and most advanced in the world, in a country whose per capita income ranks below that of Jamaica.[1]

Across the Middle East and North Africa, superficial political calm has been shattered by convulsions of rage. Idealistic young protestors have toppled some of the most ruthless and well-resourced political strongmen on the planet. In sub-Saharan Africa, many are asking: Will the Arab Spring spread south?[2]

WOULD YOU LIKE TO GO VALUE A PROPERTY IN CHINA OR Africa? If your answer is "No," you would be missing the fastest-growing areas of the globe. And if you haven't done it before, you should know that valuing a property overseas is not as hard as it sounds. The principles of valuation are the same everywhere in the world: Value is a function of a property's income-generating ability, replacement cost or the recent sale of similar properties. Additionally, English is the universal language of business, global real estate is often priced in U.S. dollars, and if you exercise a reasonable degree of caution and common sense, you should be safe.

On the other hand, data is generally not as readily available or reliable as it is in the U.S.; corruption is far more common overseas, especially in emerging markets; and at the end of the day you probably won't be as confident in your estimate of value as you are in the U.S. But why work overseas? Consider a few observations about the growth overseas, particularly in light of the recessionary environment we have at home in the U.S.

There's no doubt that China is on its way towards becoming the world's largest economy. The only question is when. Just ask HSBC (2050), Deutsche Bank (2040), the World Bank (2030) or Goldman Sachs (2020). And in case you've missed it, we've gone from "made in China" to "sold in China." China's economic model has shifted from export to domestic consumption. As the country's populace becomes more urbanized and affluent, demand for goods and retail stores has increased dramatically. For example, in 2002, 2.5 million cars were sold in China.

About the Author

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This year, 18 million cars are expected to be sold there. In contrast, we bought 11 million cars in the U.S. last year.

The potential for growth in China is almost unfathomable. Consider that Apple has about 229 retail stores in the U.S., roughly one for every 1.4 million people. It currently has four in China (two each in Shanghai and Beijing), or one for every 350 million people, the equivalent of having a single store in the U.S. Starbucks, with 450 stores in mainland China (many of which are *not* open early in the morning), expects to have 1,000 stores there by 2015. And McDonald's, which opened its first China store in 1990, has since grown there to 1,300 currently, with a target of 2,000 stores by 2013.

As reported in the Jan. 6, 2011 edition of *The Economist*, in percentage terms, China was the second fastest-growing economy in the world between 2001 and 2010 (trailing only tiny Angola), and is forecast to be the world's fastest-growing economy over the next five years.

Interestingly, while many African nations are expected to dominate the list of fastest-growing countries over the next half decade, both the Chinese and African economies are closely intertwined. As reported in *The Economist*:

> *In 1980 Africans had an average income per head almost four times greater than the Chinese. Today the Chinese are more than three times richer.*
>
> *Africa's changing fortunes have largely been driven by China's surging demand for raw materials and higher commodity prices. Africa has benefitted from big inflows of foreign direct investment, especially from China.*

Indeed, China now has six of the world's ten busiest ports, and Brazil's Acu Superport, a $2.7 billion project scheduled for completion in 2012, part of an industrial complex that will be twice the size of Manhattan,[3] has been dubbed "the highway to China."

Although the anticipated growth of China has been widely reported, less recognized is the rapid development of Africa. While much has been written about the rise of the BRICs (Brazil, Russia, India and China), and the shift in economic power towards Asia, the analysis by *The Economist* found that from 2001 until 2010, six of the world's ten fastest-growing economies were in sub-Saharan Africa.[4] This trend is expected to become even more pronounced through 2015, as illustrated below (Figure 1).

So now you're convinced that you ought to consider working overseas. Perhaps even confident of your abilities. You already know that in many emerging markets, one has the right to *use* land, rather than having outright ownership. Not so fast. There are lots of hazards along the way. The devil is in the details, and if you're not careful, it's easy to make costly mistakes by assuming things are done the same way overseas as they are in the U.S. Consider the following examples, based on the recently published *Real Estate Valuation in Global Markets* textbook:[5]

Figure 1

World's Ten Fastest-Growing Economies as Measured by Average Annual GDP Growth

Rank	2001-2010	Avg. Annual GDP Growth	2011-2015	Avg. Annual GDP Growth
1.	Angola	11.1%	China	9.5%
2.	China	10.5%	India	8.2%
3.	Myanmar	10.3%	Ethiopia	8.1%
4.	Nigeria	8.9%	Mozambique	7.7%
5.	Ethiopia	8.4%	Tanzania	7.2%
6.	Kazakhstan	8.2%	Vietnam	7.2%
7.	Chad	7.9%	Congo	7.0%
8.	Mozambique	7.9%	Ghana	7.0%
9.	Cambodia	7.7%	Zambia	6.9%
10.	Rwanda	7.6%	Nigeria	6.8%

Source: The Economist, *Jan. 6, 2011.*

- In Bulgaria, a property may not be sold for less than its official "tax appraisal."
- In Colombia, there is no uniform Market Value definition, and appraisal fees are capped at 20 times the monthly minimum wage. Appraisers must rely upon "market observation," while use of the Income or Cost approaches is optional.
- In the Czech Republic, if no term is specified in a lease agreement, it is assumed to be for an indefinite period. Appraisals are presented as a bound workbook including a sewing cord attached to the last page with the expert's professional seal attached. Sale prices are not required to be reported to the government.
- In Denmark, leases generally don't expire unless terminated by either party or violated by the tenant. The denominator used to calculate a capitalization rate (usually called a "yield rate" in Europe), includes both transaction fees and security deposits.
- In Guam, zoning changes made by politicians do not always appear on zoning maps. For example, although the zoning code includes both the "P" and "LC" designations, there are no parcels zoned accordingly.
- In Ireland, sale prices may not be disclosed without the consent of the buyer and seller. One need not belong to a professional association to hold oneself out as a valuer.
- In Italy, the recession has forced some families to sell their long-owned homes to strangers at a discount on the condition that they can retain a life estate. These transactions are called "naked sales" or "nude sales" because owners are stripped of ownership while retaining use of the property until they die.
- In Japan, there is a separate registry for land and buildings, but no title system. Boundaries are established by having each adjoining property owner sign a document similar to a site plan. Due to the high percentage of land value, a property's income was rarely considered in appraisals until the late 1990s. However, nationwide (overall) land values have declined every quarter for the last 20 years from March 1992 through March 2011.
- In Qatar, annual rent is paid in advance with a series of 12 postdated checks. Penalties for a bounced check are "severe."
- In Romania, appraisers applying the Income Approach use an "un-occupancy rate" rather than a vacancy allowance.
- In Taiwan, leases may not exceed 20 years; a lease having a longer term is automatically reduced to 20 years. The appraiser licensing exam lasts three full days, and while only a 60 percent grade is required to pass, the pass rate is about five percent.
- In the Ukraine, there is no recognition of precedent in the legal system. As a result, identical cases are often decided differently by the courts. Construction costs are often quoted per cubic meter.
- In Venezuela, the physical existence of a building on a site is considered proof that it adds value to the land.

Following are some specific examples of valuation techniques.

CHINA

From the textbook cited above, Figure 2 is an example of the valuation of an office building in China. This is a 30,000 square meter (about 323,000-square-foot) building; measurements refer to net usable floor area, not net rentable area. The first part, deriving Net Operating Income, should look familiar to any reader of this publication. The renminbi (RMB) is China's currency.[6]

Figure 2

POTENTIAL GROSS INCOME	RMB	US$/PSF
30,000 square meters @ RMB 30 per month	10,800,000	$5.35
At Average Occupancy of 90% (10% Vacancy Loss)	–1,080,000	
Effective Gross Income	9,720,000	$4.82
Less: Operating Expenses of RMB 100,000 per Month X 12	1,200,000	
Property taxes @ 10% of EGI	972,000	
Other taxes @ 5% of EGI	486,000	
Total Expenses	2,658,000	$1.32
Net Operating Income (65%)	7,062,000	$3.50

Source: Real Estate Valuation in Global Markets, 2010

Then, as is common in many parts of the world, rather than capitalize the estimated Net Operating Income into an estimate of value as we do in the U.S., future income is instead discounted to present value based upon the expected remaining economic life of the building and the amount of time remaining on the right to use the land (although direct capitalization *is* sometimes used). In this instance, the valuer used 45 years, and a 10 percent discount rate.

- Present Value of 7,062,000 RMB per year for 45 years of remaining life @10% equals 69,651,200 Yuan ($11,145,000)
- US$11,145,000 Value / 322,917 Square Feet = $34.50 per Square Foot Value
- 7,062,000 RMB NOI / 69,651,200 Value = 10.1% Cap Rate
- 69,651,200 Value / 10,800,000 Gross Income = 6.45X Gross Rent Multiplier

If you can value a complex office building, surely you can value a simple parcel of land, right? Not so fast. Have a look:

Land is often valued in China using the Cost Approach to Land, and is calculated as:

Expense of Land Acquisition
+ Expense of Land Development
+ Interest Cost on the Investment
+ Appreciation
= Land Value

See Figure 3 below:

Figure 3

ITEM	DERIVATION	RMB per sq. meter
1.	**Acquisition** Land Compensation, Resettlement Subsidy, Compensation for Green Crops on Land	155.61
2.	**Development** Amortized Costs of Access, Power Supply, Water, Drainage, Sewer, Grading	90.00
3.	**Interest on Investment** 2 years, 7.47% Interest Rate on Fixed Assets Set by the Bank of China	12.57
4.	**Profit on Investment** (155.61 Acquisition Cost + 90/00 Development Cost) at 8.0%)	19.60
5.	**Appreciation of Land** Total Cost (155.61+90.00+12.57+19.60) X 30%	83.33
	Land Value (or US$5.37 PSF)	361.11

Source: *Real Estate Valuation in Global Markets*, 2010

Land valuation is important in China. Feeding China's 1.4 billion people has become a real problem for the Chinese, hence their expansion into African farmlands. During a recent trip to Hunan province, federal and local government officials proudly showed me how they are relocating homes to enable the consolidation of agricultural land into adjoining areas to make farming more efficient.

AFRICA

It's been said that Africa is as undeveloped today as China and India were 15 years ago. Indeed, ARA Asset Management, a $15 billion property fund manager, recently placed plans on hold for a contemplated real estate investment trust that would have focused on the Middle East and North Africa, but is proceeding with a fund investing in Asia for which it expects to raise $1 billion by the first quarter of 2012.

Despite the recent turmoil in North Africa and the Middle East, the long-term prospects for this continent are outstanding. Consider the following recent excerpts from various articles that recently appeared in *The Wall Street Journal*:

- *Africa is attractive for Western brands because its resource-rich countries are adding infrastructure while increasingly urbanized areas are creating opportunities for retail development.*
- *Approximately 40 percent of Africans live in urban areas now, and the number of households with discretionary income is projected to increase by 50 percent to 128 million over the next decade, according to a recent study by the McKinsey Global Institute.*
- *After spending two decades introducing fried chicken and pizza to Chinese consumers, Yum Brands now sees Africa as its next international jewel. By 2014, the company expects to double its number of KFC outlets in Africa to 1,200. In the next four years, it aims to more than double its revenue on the continent to $2 billion. "Africa wasn't even on our radar screen 10 years ago, but now we see it exploding with opportunity."*
- *Walmart recently offered to buy 51 percent of South African retail giant Massmart Holdings Ltd. (for a reported $2.5 billion).*

Other recent articles focused on the numbers:

- 220 million. Number of Africans who are able to meet only basic needs but will become consumers by 2015.

- $1.6 trillion. Africa's collective GDP in 2008, roughly equal to that of Brazil.
- 20. Number of African companies with at least $3 billion in revenue last year.
- 40 percent. Revenue growth in African telecom industry at compounded annual rate over the last five years.
- $72 billion. Foreign direct investment in Africa in 2008—almost as large as the flow into China relative to GDP.

The Chinese have been particularly active in Africa, buying up agricultural land to help feed their 1.4 billion people, and even constructing some of the new government buildings in the Ugandan capital of Kampala; on time and under budget, I was told!

One important difference between China and Africa is the distribution of wealth. The total number of poor people around the world has declined from about 1.3 billion in 2005 to less than 900 million in 2010,[7] with most of that attributable to improvements in China. While still far from being evenly distributed there (on a recent trip to Hunan Province, I stayed at a first-class hotel, then observed people washing clothes by hand in the Yangtze River), the prosperity in the urban areas is clearly evident in the modern age and design of many office buildings and shopping centers, along with state-of-the-art airports and highways.

In contrast, not only is poverty still widespread throughout Africa, but it's far more prevalent than wealth. The Serena hotels in Nairobi, Kampala and Kigali are at least as good as any I have frequented around the world, but walk a few blocks and be prepared for unpaved streets, broken sidewalks and panhandlers. While the continent's middle class has unquestionably expanded in recent years, its members remain politically and economically beholden to whoever holds political power. More than three-quarters of Kenya's population is under the age of 34, and growing by about a million people annually. With the onset of the Internet, Facebook and Twitter, this generation, many of whom have not participated in their country's growth because of a lack of education, is acutely aware that the Kenyan president's son drives an expensive Ferrari, and the Rwandan government operates a highly visible fleet of upscale, black Mercedes-Benz G-Class SUVs. "Inequality and perceptions of inequality have now replaced poverty as the number one development challenge facing the world."[8]

It's difficult to generalize about Africa since it's made up of 54 different countries; its latest addition, South Sudan, was born on July 9, 2011. Based on my personal experiences in Kenya, Uganda and Rwanda, the lack of available appraisal data in many places is simply a function of local valuers not knowing which questions to ask. Asking a local valuer about Gross Rent Multipliers in these markets is likely to result in a blank stare. Yet one can easily go into the countryside, visit a residential project under construction, and determine both sale prices and rental values. The demand for U.S.-based instructors in many emerging markets is strong. The Africans I've met there are uniformly industrious and intelligent—but they have not had the advantage of more than 200 years of capitalism we've had in the U.S., and are desperately trying to catch up.

While South Africa is a bit different in that real estate investor surveys are available from as many as half a dozen different sources, one common problem remains: the lack of accurate, verifiable data for sales of commercial properties. It would be highly unusual for almost anyone in an emerging market to report the correct sale price to the government and pay the full amount of taxes due on the transaction. (Government officials in Rwanda recently devised a clever way of dealing with this problem in their efforts to obtain more accurate information: charging a tax that is not based on the sale price.)

Further complicating the issue is corruption. In Kenya for example, it's not unusual for someone to "sell" a property that he or she doesn't own to an unsuspecting (or even experienced) buyer. And stories abound of an actual owner selling the same property to more than one purchaser. Many local real estate professionals there distrust title companies since fraud is so widespread.

That said, the principles of valuing property in Africa are surprisingly similar to those of the U.S., although again fraught with local idiosyncrasies. With inflation of about 13 percent and an emerging market, use of the Discounted Cash Flow (DCF) technique in Nigeria[9] is rare. In fact, use of the Income Approach is relatively uncommon, especially since it's difficult to get actual rental data. When the direct capitalization technique of the Income Approach is used, income is usually multiplied by a factor, rather than divided by a capitalization rate, although the result is the same.

Use of the Sales Comparison Approach there is hampered by the need to obtain a consent fee from the governor before a property can be sold. The fee is a function of the sale price, and a lower reported value equates to payment of a lower consent fee. Furthermore, most purchasers of property do not want their identities disclosed, and a culture of sharing data among local professionals doesn't exist. That leaves the Cost Approach, which serves as a reliability check on the conclusions derived from the other two approaches. It's often said that one can "value" properties overseas, but "appraise" them in the U.S. and a few other fully developed markets.

Additional items to keep in mind in Nigeria are that residential rents for one- and two-year leases are often paid in advance; and the cost of legal fees to prepare a lease for an industrial property is paid for by the tenant, not the landlord.

In South Africa, despite bouts of inflation, the DCF technique is used to value income-producing properties, albeit often with a five-year holding period as opposed to the more common ten-year projection found in the U.S. In addition to investor surveys, one commonly followed approach calls for use of a discount rate derived by adding the appropriate capitalization rate (say 10 percent) to the market rent growth rate (say 5 percent).

Use of the Sales Comparison Approach is limited by the lack of good, verifiable data, and as with the U.S., the Cost Approach is generally reserved for specialized properties such as abattoirs (slaughterhouses).

The impact of inflation on valuing overseas properties can't be overestimated. In late 2008, inflation in Zimbabwe was about 98 percent per day, and the government issued a $100 trillion dollar bill, the largest ever. You can buy one today on eBay for under US$5.

OUTLOOK AND CONCLUSIONS

In case you think you're too late for the BRICs or Africa, fear not. In late 2005, investment bank Goldman Sachs launched its N-11 Fund. According to the fund's prospectus:

> *The "N-11 countries" are countries that have been identified by the Goldman Sachs Global Economics, Commodities, and Strategy Research Team as the "Next Eleven" emerging countries (i.e., after Brazil, Russia, India and China) that share the potential to experience high economic growth and be important contributors to global gross domestic product (GDP) in the future.*[10]

Figure 4

	GOLDMAN SACHS NEXT 11 (N-11)
1.	BANGLADESH
2.	INDONESIA
3.	EGYPT
4.	IRAN
5.	KOREA
6.	MEXICO
7.	NIGERIA
8.	PAKISTAN
9.	PHILIPPINES
10.	TURKEY
11.	VIETNAM

Source: Goldman Sachs

Should you be called upon to value an N-11 property, be aware that:

- In Indonesia, you may have to deal with the right to exploitation (hak guna usaha): Unlike its American connotation, this refers to the right to use state-owned land for agricultural, fishery or husbandry (breeding and raising livestock) purposes.
- In Egypt, the number of years of appraisal experience needed to become licensed is a function of your education. With a high school diploma, it's 20 years; a college degree requires 15 years; a master's degree, 10 years; and a PH.D., five years.
- In South Korea, land is valued in accordance with prices set by the government, rather than comparable sales.
- In Mexico, foreigners may not own land within 100 kilometers (about 62 miles) of the country's land border, or 50 kilometers (31 miles) of its shoreline.
- In Turkey, land acquired by a municipality for public use can be taken without compensation.

Returning to the aforementioned *The New York Times* editorial:[11]

> *Steady economic growth and urbanization, combined with high levels of youth unemployment and conspicuous consumption… create a situation in which growth*

> *exacerbates political volatility instead of quelling it. China, with its highly centralized system of economic management and… efficient security machine, has been able to keep a lid on the contradictions thus far.*
>
> *But as African countries grow, despite the unevenly shared benefits of that growth, the expectation of the poor and aspiring middle class will continue to advance—aided by social media—and both groups will become only more angry and predisposed to protest as they perceive the stark inequalities around them.*

In terms of valuation, it's hoped that with greater risk comes greater reward. And should you choose to undertake a valuation in one of these markets, remember that the principles of valuation are the same. It's the customs and technicalities that one needs to avoid getting hung up on.

Riding a bicycle to work in a place like Portland, Oregon, or the New York City boroughs of Brooklyn or Manhattan might be considered the sign of a young, urbane, environmentally-conscious, upscale professional. In China or Africa, where people are more likely to ride bikes because they can't afford a car or traffic is too congested, the bicyclist is probably a member of a lower socio-economic class.

In the U.S., "It's the squeaky wheel that gets the grease;" but in Japan, "The nail that sticks out gets hammered down;" and in China "The loudest duck gets shot." ■

ENDNOTES

1. Dean, Jason and Jeremy Page, "Trouble on the China Express," *The Wall Street Journal*, Saturday/Sunday July 30-31, 2011.
2. Githongo, John, "When Wealth Breeds Rage," *The New York Times*, July 23, 2011.
3. Rendell, Ed and Scott Smith, "Transportation Spending Is the Right Stimulus," *The Wall Street Journal*, Aug. 11, 2011.
4. As opposed to the seven primarily Arab countries that comprise Northern Africa: Algeria, Egypt, Libya, Morocco, Sudan, Tunisia and Western Sahara.
5. Gelbtuch, Howard C. with Eunice H. Park, *Real Estate Valuation in Global Markets*, Appraisal Institute, Chicago, 2010.
6. The distinction between the yuan and renminbi (RMB) is analogous to the difference between the English pound and sterling; the pound (yuan) is the unit of account while sterling (renminbi) is the actual currency.
7. "Poverty in Numbers, The Changing State of Global Poverty from 2005 to 2015," The Brookings Institution, January 2011.
8. Githongo, op. cit.
9. With 155 million people, Nigeria is the eighth most populous country in the world, ahead of Russia, Japan and Mexico, and nearly twice the population of Germany.
10. Goldman Sachs Fundamental Emerging Markets Equity Funds Prospectus, Feb. 16, 2011, p. 3.
11. Githongo, op. cit.