

IPS Closed-Door Discussion: The Costs and Benefits of Landlord Institutionalisation

By Chang Zhi Yang
IPS Research Intern

Introduction

Just a week before the release of Budget 2014, the Institute of Policy Studies (IPS) held a Closed-Door Discussion to examine the costs and benefits of landlord institutionalisation. This discussion took place against the backdrop of local businesses feeling the increased pressure from the economic restructuring that was initiated in 2010.

The session was chaired by Mr Manu Bhaskaran, IPS Adjunct Senior Research Fellow, with insights from Mr Kurt Wee, President of the Association of Small and Medium Enterprises (ASME) and Mr Tham Kuo Wei, CEO of Mapletree Industrial Trust Management. Associate Professor Sing Tien Foo from the Department of Real Estate at the National University of Singapore helped facilitate the discussion.

The recent trend of rising rental rates set against the pattern of increasing landlord institutionalisation raises the issue of asymmetric bargaining power that organised landlords have over their tenants. Singapore's real-estate investment trusts (REITs), as flag bearers of institutional landlords, have borne the brunt of public's scrutiny. Moreover, SMEs are increasingly squeezed on profit margins, which have led to the general business predilection for greater governmental intervention in the commercial property market.

Is the Property Sector an Oligopoly?

Under normal circumstances where there is a competitive market, governmental intervention is usually unnecessary as demand and supply are expected to autonomously adjust to a competitive equilibrium. However, the common perception of most business tenant representatives at the discussion was that the property sector is an oligopoly that is dominated by a few institutional landlords. Companies in an oligopoly tend to have greater bargaining power.

Such a strong bargaining chip would give landlords the ability to charge higher prices and to craft terms and conditions to their benefit. To highlight the situations some of their business peers face, participants anecdotally shared that every few years several local businesses would experience rental hikes of up to 300%. In addition, they also highlighted certain rent contract features that put tenants at the losing end. Some examples of unhealthy practices

cited are clauses that prohibit tenants from opening shops in other competitors' malls and the short tenancy termination notice period from the landlords.

In particular, the use of gross turnover (GTO) information to determine rent was put under the spotlight. In principle, the inclusion of GTO is expected to align tenant and landlord business interests as it creates the incentive for landlords to help tenants drive higher sales in return for higher rent proceeds. However, many tenants feel that this does not happen in practice. Instead, the use of GTO information seems to unilaterally benefit landlords and creates a situation whereby each instance of business vibrancy would result in rent being raised, which in turn inhibits the growth of business vibrancy. The idea of reciprocal transparency from landlords to publish effective rentals and not contracted rentals was mooted. This would help tenants to make more informed decisions and not be misled by low basic rents.

Landlord representatives and a number of participants responded to the prevailing view on market structure by explaining that a significant share of the property market is held by end-users and public agencies. This is at least true for the industrial space where end-users and public agencies collectively own about 73% of the market. They therefore feel that the market is unlikely an oligopoly. They generally think that rent increases are mainly driven by tight demand and supply conditions. With a large supply of property space in the pipeline, occupancy rates are expected to decline over the next two years, and prices should soften.

When evaluating rent increases, one also needs to take into consideration the extra value that institutional landlords add to their properties through investments and initiatives. These range from infrastructure upgrades to tenant assistance like media exposure and in-house advice. These activities would translate to higher rent prices but they are justifiable because the expected business returns of the tenants would have increased as well.

Another key factor determining sustainability of rent price growth is whether the price growth outpaces GDP growth. To that, statistics gathered from the Urban Redevelopment Authority and the Department of Statistics show that the rent price growth is not above GDP growth. The point that this group of participants were trying to make is that rent price is a function of many factors, and yet the general attitude seems to only focus on market structure and discounts other equally important factors. They suggested there is really no convincing evidence pointing to an oligopoly market structure.

A participant argued that the main problem that tenants face may not be large rent increases but in actual fact, the lack of market demand for their goods. Businesses that are more productive and generate greater sales would be able to deal with higher rent prices. With regard to unfavourable terms and conditions, the participant felt that businesses that do not have a strong business case or brand would rely heavily on the landlord's ability to drive foot traffic to the location. In this case, their bargaining power would be weaker and hence they would be subject to the conditions set by landlords. These arguments serve to remind us that the clamour over rent price increase may be obscuring the true issue that is business profitability.

Government's Involvement to Support Business Vibrancy

Although there is a clear split in views on whether institutional landlords are culpable for “unjustifiable” rent price increases, most participants agreed that governmental involvement is required to support business vibrancy. One participant said that if local businesses continue to experience margin compression, they would eventually be forced to raise the prices of their goods. This would lead to a higher cost of living, which is detrimental to society. Besides, local businesses act as a shock absorber to the economy; while a free market is always touted as imperative to attracting MNCs to Singapore, in economic downturns, MNCs may not be able to provide the type of social stability as SMEs. Hence, in order not to “kill” this layer of diversity in the economy, there is a need for some regulation to make small businesses more sustainable.

Some participants proposed the idea of implementing a market cap on price increase but others felt that this measure would disrupt future developments in the industry as investors would shun away due to lack of ample returns. It also puts a lot of burden on the government to administer the right market cap.

The suggestion that the government should extend its support directly to the group of businesses that needs help instead of intervening through price mechanism regulation was made. This would reduce the distortion of resource allocation to the factors of production. Some landlord participants even added that they are willing to help businesses improve their cost structure so that they are more competitive as this aligns with their business model of taking a longer investment horizon that seeks to provide their investors stable long-term returns.

Lastly, there is concern among the participants over the macroeconomic trend of capital flowing from value-creating activities into the property sector. They questioned if this trend would create a long-term problem as people are incentivised to choose rent-seeking activities over activities that create real value. However, a participant countered that this trend is just part of market forces at work. As returns in the property sector normalise, the flow of capital would change direction.

Conclusion

There were three main points from this discussion. First, more work has to be done in this area. This is important because the property market is intrinsically related to the economy. Academic researchers need to be given much more granular data by the government so that they can answer the question of whether there is indeed oligopolistic pricing in the commercial and industrial real estate markets. Second, although participants disagree on the form governmental intervention should take, there is a general consensus on the importance of subsidising certain business activities undertaken by SMEs to foster vibrancy and stability in the economy. Finally, more attention should be given to the current structure of the economy to prevent the forming of a “rentier” class that pursues rent-seeking activities over real-value activities.

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