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Investment Newsletter – December 2005

Real Estate in Thailand Part III – Risk Analysis

Last month's newsletter detailed the reasons for expecting high returns from investing in development in certain areas of Thailand. Of course no analysis of an investment is complete without a good hard look at the risks. This month I'll complete the picture by analyzing the true risks (as opposed to perceived risks) of investing in Thai real estate development. I truly believe that it's worth serious investors' time to evaluate the risks and returns of this very foreign market.

I realize many of my clients perceive offshore investing as very risky. I could write an entire newsletter (and I probably will) on the psychological aspects of risk, but for now I will simply attempt to bring my reality to you through sharing of knowledge and hope that I gain some measure of your trust in the process. The act of educating yourself about any market, while costly, reduces risks tremendously by systematically decreasing the number of unknowns you must deal with. My goal here is to enable my clients to more accurately assess this market's risks for themselves, and, to show you that I have the knowledge necessary to adequately assess the true risks in the market for you. Although educating yourself is time consuming, this newsletter should help reduce the time requirement and convince you that the potential returns are worth the effort it takes to understand the market.

Before we can understand and analyze risks, you need some background on the legal framework in Thailand.

Land Ownership by Foreigners in Thailand

Although Thai Law technically requires majority Thai ownership of most property, there are well accepted methods for complying with the letter of the law while still maintaining full control of the land for the foreign investor. A Thai limited liability company (LLC) is formed to hold the land title. Thai citizens should own 61% of the shares and the investor would own the rest. The standard practices to insure control of the land by the foreign investor contains several layers of legal safeguards:

- The foreign investor is designated as the sole director and owns a superior class of shares that provide a majority of the voting rights of the LLC.
- The Thai shareholders sign an agreement transferring their shares to a new shareholder to be named later by the foreign investor. Thus the investor can change the Thai shareholders at will if they get greedy.
- The land is leased from the LLC to the foreign investor for 30 years with two 30-year renewal options. The lease is registered at the land office. You could also include an option to purchase contingent on a change in ownership laws.

If additional assurance were required, a callable loan, secured by the shares would provide another way to maintain indirect control of the shares. The investor can then call for repayment of the loan anytime and has the right to "sell" the shares if the Thai shareholders don't repay the loan. These methods provide a sound legal structure for owning property in Thailand.

Treaty of Amity and Economic Relations between Thailand and the U.S.

This document has been in force since 1968 but is expected to be replaced by a free trade agreement in 2006.[1] Subject to seven exceptions, Americans are granted the same rights that Thai nationals have to own and operate businesses in Thailand. Exploitation of land is one of the seven exceptions – hence the legal mechanisms explained above. The relevant point here is that the treaty obligates Thailand to enforce the legal contracts used in the ownership structure described previously. As a result of these safeguards, U.S. companies have invested over $20 billion in Thailand. Disregard of treaty provisions would subject Thailand to costly retaliation. After all, the U.S. is Thailand's number one trading partner.

Political/Legal Risks

This is really what everyone is thinking of when they say investing overseas is risky. It is the risk of not knowing what the rules are or that the local government may change the rules to hurt foreign investors. Thai politicians realized long ago the benefits of foreign investment for their citizens.[2] As a result Thailand has historically encouraged foreign investment and avoided actions that would hurt foreign investors.

The government has accepted the use of the legal methods described previously for complying with the technical requirements of the law while providing for actual control of land titles by foreigners. Any change in such a long standing practice would doubtless bring both international criticism and

[1] Both countries commitments to the World Trade Organization require that this treaty be terminated or replaced.
[2] In fact, the Prime Minister is a business tycoon who knows very well that foreign investment = prosperity.

reprisals from Thailand's trading partners. This is a risk the *Thais* cannot afford to take.

Thailand is pretty good with regard to securing property rights and enforceability of contracts. The World Bank publishes ratings for 155 countries on various measures of the business environment. The two primary measures of concern to us are the ease of registering property and the enforceability of contracts. Such measures are best understood in comparison to other countries. The following table compares Thailand to selected countries on the ease of securing property rights.

Ease of Registering Property		Indicators used in Ranking		
Country/Territory	Ranking	Procedures	Time in days	Cost as % of value
United States	12	4	12	0.5
Thailand	22	2	2	6.3
United Kingdom	23	2	21	4.1
Canada	27	6	10	1.7
Costa Rica	38	6	21	3.6
Puerto Rico	46	8	15	1.6
Italy	48	8	27	0.9
Mexico	74	5	74	5.3
OECD[3] Average		4.7	32.2	4.8

With regard to enforceability of contracts, Thailand is slow but does OK – especially when compared to Italy. This measure is based on the number of steps required, the time it takes to get a case through the courts, and the ultimate cost of doing so as a percentage of the amount owed. The following table shows how Thailand compares with the selected countries.

Enforceability of Contracts		Indicators used in Ranking		
Country/Territory	Ranking	Procedures	Time in days	Cost as % of value
United States	10	17	250	7.5
United Kingdom	13	14	288	17.2
Canada	34	17	346	12.0
Thailand	49	26	390	13.4
Italy	76	18	1,390	17.6
Puerto Rico	77	43	270	21.0
Mexico	100	37	421	20.0
Costa Rica	141	34	550	41.2
OECD Average		19.5	225.7	10.6

[3] Organization for Economic Cooperation and Development: 30 developed countries.

In both tables Thailand rates significantly better than Puerto Rico which is a territory of the U.S.!

Currency Risk

In July 1997, the government was forced to devalue the currency (and let it float) thanks to massive speculation against the Thai Baht by a group of international hedge funds. Of course this hurt the Thais as much or more than the foreign investors. In the long run it actually benefited foreign investors in export production facilities because it effectively cut their wage bills without affecting the value of output[4]. Real estate investors were not so lucky. The resulting credit crunch and recession caused a severe downturn in real estate values.

Today the market determines the value of the currency; there is no fixed rate for the hedge funds to speculate against. The Thai economy is much stronger and more resilient than it was in 1997. Furthermore, the demand for the properties I recommend is coming from hard currency investors from outside Thailand. Therefore I expect the dollar value of these properties to hold up even if there were a drastic depreciation of the Thai Baht. In fact, devaluation would lower other costs in Thailand and further enhance the attractiveness of living or vacationing there.

Market Risk

When investing in development projects, market risk is usually the biggest risk. Once you have bought the land and signed the construction contract, your costs are committed but your sales prices could turn out to be lower than expected. While this risk cannot be totally eliminated, it can be minimized by selling the units before they are built. By selling units before they are built the developer gives up (to the buyers) the price appreciation over the construction period, but this is justified by the reduction in market risk.

In order for prices to drop in any real estate market, either demand must decline or supply must increase so that prices decline to bring the two back into balance. As I argued in my previous newsletter, supply of western standard condos is currently constrained by insufficient management and capital in the development sector. Unless there is a sudden surge of big developers and capital into Thailand, we are unlikely to see oversupply relative to current demand levels. On the demand side, I don't see any purely economic factors that could seriously reduce demand from overseas investors. Of course there may be location specific events that could potentially reduce demand for specific areas – at least temporarily. I will discuss these risks in the following paragraphs.

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[4] Exporter profits depend on hard currency prices and local costs translated into hard currency. Devaluation of the Thai Baht versus the dollar thus reduced wage bills in terms of dollars without affecting dollar revenues.

Tsunami Risk

The 9.0 earthquake that caused the tsunami to hit Phuket in December 2004 was the largest in the world over the last 40 years. The probability of this happening again in the next 3 years is very low. While tragic, such an event would actually *increase* business for Koh Samui and Pattaya. I say this because the Eastern side of Thailand is not exposed to tsunamis coming from earthquakes along the continental plate in the Indian Ocean. Therefore people who would have gone to the West coast will tend to switch to these East coast destinations.

Terrorism Risk

Thailand is a predominantly Buddhist country but there is a substantial Muslim population in the southern provinces. For many years the Muslims have complained of unfair treatment by the majority. There have been occasional acts of violence directed against the government and Buddhist monks in the South. So far the conflict is localized and the government is actively working to suppress violence and address grievances. Still the conflict could conceivably lead to an attack on a tourist area.

If such an attack occurred it would most likely cause a drop in tourist arrivals. So long as the government is seen taking action to boost security, I think tourists would eventually return. I expect that things would be back to normal within 6 months unless there were continuing incidents. After all, attacks can happen anywhere so why stop taking vacations? This situation probably would slow unit sales and therefore hurt the profitability of a development project but would not cause losses unless the project was abandoned.

Flu Epidemic Risk

A flu epidemic is similar to terrorism in that it would reduce tourism and decrease demand for units temporarily. Judging by the SARs epidemic, the effect would probably be to delay the project by 12 months. We will take prudent measures to manage our financial risk so that we can ride out any flu epidemic and complete the project later. This means maintaining sufficient liquidity and including provisions in contracts to deal with this possibility. While the holding costs for this period will reduce profitability, the project would still go forward eventually and generate substantial returns.

Conclusion

All investments have risks. Our job is to understand what those risks are so that we can minimize them and properly assess whether the potential returns justify the risks taken. Lack of knowledge causes us to naturally assign higher risk to the unknown. In order to find the great opportunities out there, we must take the time to understand the risks and/or hire an advisor to do so for us. This newsletter has identified the risks of Thailand development investing so that you can more accurately assess the true risks rather than dismissing the market as too risky simply because it is an unknown. Ignorance is bliss, but knowledge is profitable! Please contact us if you are interested in participating in this market.

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