Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

Licensed by the California Department of Corporations as an Investment Advisor

Investment Newsletter – November 2005

Real Estate in Thailand Part II – The Investment Thesis

Last month's newsletter gave a brief introduction to the Thai real estate market and highlighted the fast growing resort areas in Pattaya and Koh Samui. This month I'll lay out the details of my investment thesis for investing in new development in Thailand and explain some innovations that can further enhance the returns versus risks in developing property there. I'll also provide some numbers showing what is possible for actual property now available in Thailand. Next month I will provide the information needed to accurately assess the risks of such investment.

The Case for Investing in Development in Thailand

Most of my argument here will apply to Thailand real estate investments in general, but I will also discuss my own plans for insuring success there. My thesis consists of four main points:

1. Demand is increasing faster than supply
2. Supply is constrained by local factors
3. Development margins are high
4. Innovative financing and distribution can provide a competitive advantage

If you have experience in the California[1] or Hawaii markets you'll recognize that the first three points have historically applied to those markets and the results have been spectacular. I expect a similar result in Thailand over the next few years.

Demand is Growing Faster than Supply

As I've explained in several recent newsletters, the large baby boomer generation is now retiring, or at least arranging their affairs to prepare for retirement. This is true not just in the U.S. but also in Europe and Japan. In fact the proportion of retirees in Japan is much higher than the U.S. and will grow faster. Keep in mind that Japan is a country with huge savings and very limited domestic investment opportunities. Japanese invests huge sums in foreign

[1] I would argue that California is, or soon will be, lacking on points 1 and 3. But that would be a whole newsletter in itself.

investments. Because of the distance and lack of familiarity, I don't expect any huge move by Americans to buy in Thailand. Rather, my point is that the same forces driving Americans to buy homes in the Southwest, Hawaii, Mexico and Costa Rica, are working in other countries to pull them into Thailand. Besides the Europeans and Japanese, people from Hong Kong, Singapore, and Australia are all finding Thai real estate a compelling opportunity for buying vacation and retirement properties. Even when they don't buy there, they will still spend significant time renting resort properties there just as we do in Hawaii. These demand factors will only increase in the years to come.

Although not currently a factor, I expect a huge increase in demand for Thai real estate to come from mainland China once the government allows the general population to invest money outside the country. This will likely happen after they've solved the bad loan problems in their banking system sometime in the next 5-10 years. It could happen much sooner given the government's huge buildup in foreign currency reserves.

You wouldn't know it from anything you read in the U.S., but Thailand real estate has already been discovered by the mainstream - especially in Europe. The British and Germans have invaded the beach resort areas in mass. If you visit Pattaya or Koh Samui, you will find western real estate agents along with glossy real estate magazines and brochures (in English) in abundance just as if you were in California or Hawaii. According to two of the long time local brokers I met with, the number of western real estate agents catering to foreign buyers has increased by fourfold since 2002. Do a Google search for Thailand Real Estate and you'll see the extent of the foreign involvement in the local market. These people would not be there if not for a constant stream of foreign buyers coming into the market (Thai people use Thai agents).

While I wasn't specifically looking for Japanese speaking brokers, I got the sense that there were few, if any, on the ground in Thailand. I expect this to eventually change but I also see it as an opportunity for Berkeley Investment Advisors thanks to our established marketing presence in Japan.

As explained in the last newsletter, Thailand has become popular because it has an unbeatable combination of scenic beauty, good weather, pleasant lifestyle, safety, and low living costs.[2] For example a fulltime maid to do all the cooking, washing, and cleaning, will cost you all of $100 per month. Tasty Thai food at the average restaurant on the beach in Koh Samui will set you back a whopping $5 per person. There really is no other place like it on Earth. Well, I've only been to 43 countries so I could have missed something.

[2] Costa Rica is the closest comparison in my mind but I give the nod to Thailand.

Supply is Constrained

In talking to local real estate people it became very clear that virtually all the upscale development going on at the beaches is being done by foreigners. As of yet, Thai builders have not figured out how to build to the quality standards demanded by westerners. The builders I spoke with all complained about how much time they had to spend training their Thai workers. There were countless stories of the follies of inexperienced workers. In order to build to western standards, you need western management on the ground in Thailand; most local Thai builders simply don't bother to build to our standards. Not only that, but they seem even more handicapped by a lack of understanding of how to market their product to westerners. They build the wrong thing, in the wrong place, and set prices too high for the features and quality offered.

Thus it is left to western immigrants to produce the housing and resorts to meet the needs of the increasing numbers of foreigners coming to Thailand. While Thailand has attracted a fair number of foreign developers, my sense is that there is simply not enough management talent in the country to increase the rate of production. Developers in western countries, as in the U.S., have done very well the last few years and therefore have had little incentive to make the move to Thailand. Most have strong roots in their home countries and so the Thai market has been left to those westerners who came there to live and decided to get into the local development game to take advantage of the opportunities they saw. Consequently there are not enough of them to take advantage of all the opportunities. The other issue constraining these developers is capital.

There are several indicators of the scarcity of capital in the hands of the developers in Thailand. First is the fact that they cannot afford to buy up all the prime pieces of land as they come on the market. Given the development margins available with the current land prices (see below and Appendix A) the developers should be buying and banking every bit of ocean front land that comes on the market. The fact that they are not means that they do not have access to enough funds - regardless of the profit potential. Part of the reason is that banks in Thailand will not provide financing for foreign developers without a guarantee from a Thai citizen with the assets to back up the guarantee. As a result the foreign developers fund their projects primarily with equity capital. Another capital scarcity indicator is the practice of funding development with buyer deposits. It is standard practice in Thailand to use buyers' money as a significant source of construction financing. A few years back developers were selling units purely based on plans and collecting deposits before they even built models. Accumulated profits from the past three years have provided some breathing room and it is now standard for buyers to see model homes before buying.

Result: Development Margins are High

First let me define what I mean by Development Margin. This is the profit of a development project as a percentage of the total costs before taking into account financing costs. For example, if land costs you $20 per square foot (of building), construction costs are $80 per square foot, and the sales value, net of commissions, is $140 per square foot, then your development margin is 40%[3]. Based on my analysis of the top nine properties I saw, development margins fall mostly in the 30-40% range – though apparently there are some opportunities with margins in excess of 50%. These margins are based on current land values and current prices of houses and condos. See Appendix A for my financial analysis of the best parcels I saw. If we were to capture some portion of the likely rise in condo prices during the build out, margins would be even higher.

In fact, the appreciation of land prices alone is likely to make any project profitable once land is acquired – even if you did not build anything. Essentially we would get paid for providing the capital necessary to bank the land for the eventual development. Provided we have sufficient cash reserves, delays don't really hurt us in such an environment - unless we've already locked in sales prices, or there is a huge change in demand. These built-in profit escalations work in developers favor both by increasing profit directly and by giving buyers an incentive to buy sooner rather than later.

Innovation Provides a Competitive Advantage

As mentioned earlier, debt financing is difficult to obtain for developers in Thailand. Equity capital is scarce and therefore expensive. Holding land takes capital but is inherently much less risky than spending money to develop the land. Therefore, there is an opportunity to segregate these two pools of capital according to risk and thereby add value for investors. We can accomplish this by setting up two investment entities: one to fund the development and one to own the land. The investors in the land company are guaranteed a fixed return by the investors in the development company and this promise is secured by the land and improvements thereon. Thus can we create a class of investment for those who prefer a safer fixed income return. Effectively the development company is doing a secured borrowing from the land company investors and this vastly increases the developers' returns on equity. Meanwhile the land company investors earn a relatively high return while taking minimal risk. They are, in effect, taking advantage of the fact that the banking system in Thailand lacks the sophistication to provide this financing.

---

[3] Calculated as $\frac{140-(80+20)}{80+20}$

Another way we can add value compared to existing players in this market is by utilizing a much wider international distribution system. By this I mean we can market the product through agents in Europe, Japan, Hong Kong, and Singapore, rather than just the brokers in Thailand. By expanding our reach into these additional investor markets we can effectively reduce price competition versus the other local producers. By making our product known to people who otherwise would not find these opportunities, everyone wins.

Another innovation that will increase the appeal of our product, and therefore its value to investors, is a guaranteed return for buyers via a leaseback to an operating company. By building a resort property at the beach we can operate the property at high rental yields and pass on a very nice net return to the unit owners. A guaranteed annual cash return of 6-7% on the purchase price will set this product apart from the rest and provide support for premium pricing.

Financial Analysis

The financial analysis at appendix A shows the development profit potential of selected parcels of land that I visited on my trip to Thailand in October. The assumptions underlying this analysis are conservative in the sense that I've used:

- <u>Historical</u> selling prices of condo units that would have some disadvantages compared to what would actually be built.
- The highest construction costs quoted by anyone - for premium building.
- Land asking prices.
- Density of buildings well below what is allowable under current regulations.

While all of these look profitable, my favorites are Samui #7 and Pattaya #7.

Conclusion

Fundamental demand and supply factors are pushing up housing prices rapidly in Pattaya and Koh Samui Thailand. The shortage of both capital and development management talent has pushed returns on these factors of production to very high levels. This opportunity looks likely to persist for several years at least. Berkeley Investment Advisors is assembling a development team to enable our investors to profit from the situation. Contact us if you wish to participate.

Notes on a Hatchet Job

Bloomberg magazine has published two articles accusing SFBC International Inc. (SFBC) of improprieties in its conduct of drug trials for its pharmaceutical company clients. The second article accuses officers of SFBC of threatening patients who were quoted in the first article. The market reacted by pushing the stock down 40% - from $40 to $24. On December 1st the stock plunged another 26% on reports its headquarters requires structural work. This plunge seems to be based on the view that this news indicates more "dirty laundry" to come.

The company has vigorously denied all allegations and has hired outside counsel to investigate itself. It also said that the work needed to fix its headquarters would not have a material impact on the firm. So far, clients are sticking by the firm. The only way this firm has lost this much value is if this leads to losses of clients. That won't happen unless the allegations are true AND there are alternative vendors without these issues, AND SFBC cannot fix the problems fast enough to placate its clients.

My gut tells me this is a hit job inspired by some short sellers and that it will blow over in six months. Every now and then, such a price decline is justified by subsequent events; still, betting the other way will, on average, pay very well.

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280 Tokyo phone: (080) 3122-9601		Single Family Home Investment: RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332

Berkeley Investment Advisors

Investment Newsletter -November 2005

Appendix A

Economic Analysis of Development of Selected Land Parcels

Location:	Samui #1	Samui #5	**Samui #7**	Samui #8	Samui #10	Samui #2	**Pattaya #7**	Pattaya #6	Pattaya #4
Statitics in $1,000's									
Total Land Cost	10,625	3,375	**1,999**	2,375	3,400	7,650	**2,625**	5,000	5,025
Total Costs excluding capital	36,636	11,736	10,775	9,384	12,538	32,424	15,882	23,711	27,259
Total Net Revenue	45,408	14,839	13,970	12,319	16,390	44,712	24,069	32,379	38,471
Total Project Profit	8,772	3,103	3,196	2,935	3,853	12,289	8,188	8,668	11,212
Net Profit % of Costs	26%	33%	**37%**	39%	37%	40%	**57%**	40%	44%
Other Metrics									
Avg. Gross Sales price/s.f.	124.27	132.38	118.33	132.89	132.99	128.61	131.99	124.23	123.62
Land cost per sq. foot.	29.08	30.11	16.93	25.62	27.59	22.00	14.39	19.18	16.15
Construction cost per sq. ft.	69.68	69.68	69.68	69.68	69.68	69.68	69.68	69.68	69.68
Approximate Acres of land	9.9	2.6	4.2	2.4	3.2	7.1	3.8	5.5	6.6
Approximate Total Bldg. sq. ft.	365,413	112,095	118,059	92,699	123,247	347,653	182,362	260,637	311,206
Avg Unit size in square feet	834	709	944	820	816	922	860	1,014	1,027
Number of Units	438	158	125	114	152	377	212	257	303
Avg. Density - Bldg/Land Area	85%	100%	64%	90%	89%	112%	111%	108%	108%
Profit per s.f.	24	28	27	32	31	35	45	33	36