

RESEARCH REPORT

PROTECTION OF SHAREHOLDERS' INTEREST IN LISTED PROPERTY FUNDS IN SOUTH AFRICA

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ABSTRACT

Recognising that governance is the key to South Africa's future as a global player in the property market, this study explores the protection of shareholders' interests in listed property funds in South Africa. The views of property managers, asset managers and analysts involved in the listed property sector were obtained through in-depth, semi-structured interviews. The main themes highlighted in the data are transparency and disclosure which are a major factor in corporate governance being successful.

DECLARATION

I, Gillian Ann Boorsma, declare that this research report is my own, unaided work. It is submitted in partial requirements for the degree of Masters of Business Administration at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

Gillian Ann Boorsma

15 December 2006

DEDICATION

To my parents, Pieter and Jeannette Boorsma, without your love and support this research would never have been possible.

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1. CHAPTER ONE: BACKGROUND TO RESEARCH

1.1 THE CONTEXT OF THE STUDY

After decades of apartheid and discrimination on the basis of race, democratic elections were held in South Africa for the first time in April 1994. While the start of democracy was a time of uncertainty (Bush, 2005: pg 58-62), by the start of 1998, the mood in the South African economy had improved to one of cautious optimism – interest rates had begun to fall in October of the previous year, another drop in lending rates was anticipated within the first quarter and all seemed set to accelerate the GDP growth, which had been slowing throughout 1997. The interest rate was cut in March, and further cuts were anticipated. Inflation dropped to a new 25-year low, with consumer price index inflation at 5% (Bush, 2005: pg 58-62).

This economic development was translated and reflected in the Johannesburg Stock Exchange (JSE), which showed some important strides in technology, security and auditing during this period (Bush, 2005: pg 58-62). The listed securities grew dramatically, with most of the growth taking place in the listed property portfolios.

Five years ago, the JSE property sector was very different (Bush, 2005: pg 58-62). It was largely seen as the domain of stodgy, unadventurous investors determined to chase yields rather than follow the excitement of ‘sexy’ equities. Since early 2004, the sector index has risen by 50%, and the market capitalisation has soared by 80% to R74 billion. This exceptional growth warrants a critical evaluation of the listed property portfolio and the mechanisms that govern it (Bush, 2005: pg 58-62).

1.2 THE PURPOSE OF THE RESEARCH

As there are potential conflicts between fund managers, shareholders and managers pursuing activities that enhance their interests rather than those of the shareholders, this research seeks to determine whether the governance mechanisms of the listed property funds in South Africa are sufficient to ensure that the shareholders are adequately protected. A relevant question is how shareholders can protect their interest and ensure

that their managers do not siphon funds or make poor investments that are to the shareholder's detriment.

1.3 THE PROBLEM DEFINITION

The problem definition is to determine the potential conflict of interest in listed property funds and to determine if the governance mechanism is sufficient to protect shareholders' interests.

The sub-problems:

- To research the listed property funds governance mechanisms to determine if they protect the shareholders' interests.
- To research the potential conflicts of interests between the various stakeholders who manage the funds on behalf of the shareholders.

1.4 THE DELIMITATIONS

This research addresses the facets of the listed property industry of both the Property Unit Trusts (PUT) and the Property Loan Stocks (PLS).

PUTs are listed under the Real Estate sector of the JSE Limited, together with PLSs. Comprising a portfolio of investment grade properties, each PUT generates value for the investor through a combination of a share in the rental income (yields) of the property portfolio and through the appreciation over time of the underlying property assets. Not only are PUTs managed by experienced and reputable management companies which are responsible for the day-to-day operation of the properties, including lease management, and for the investment strategy of the trust, but they are also subject to stringent regulatory requirements. They are governed by the Collective Investment Schemes Control Act, under the auspices of the Registrar of Collective Investment Schemes, a function of the Financial Services Board (FSB). In addition, the affairs of the management companies which administer the PUTs are regulated by a Trust Deed drawn

up between the management company and a trustee. PUTs are also subject to all the regulatory requirements imposed by the JSE for a securities exchange listing (Barnard, Jacobs and Mellet, 2006: pg 1-25).

OWNERSHIP	MANAGEMENT	REGULATION
Unit holders have effective direct ownership of the fund and its underlying property assets.	Professional asset and property managers manage the fund and the underlying properties.	<ul style="list-style-type: none"> - Registrar of Collective Investment Schemes - JSE Limited - Financial Services Board - Auditors - Trustees
PROPERTY UNIT TRUST Underlying properties		

Property Loan Stock (PLSs) companies invest solely in property. As with all other listed companies, they are subjected to the Companies Act and JSE regulations and are governed by the memoranda, articles of association and debenture trust deeds.

The main difference between PLS companies and others is how their owners fund the investment. The owner of a PLS company needs to buy a linked unit which consists of a share and a debenture (loan). The debenture portion earns interest, which comes from the net income (income less expenses) that the PLS company decides on from the properties in which the company invests. A PLS company's income is taxed in the hands of the investors (Barnard, Jacobs and Mellet, 2006: pg 1-25).

The delimitations of the research are to investigate the potential conflict of interest and

governance mechanisms in the total JSE listed property portfolio funds. As the value of the listed funds on the JSE has increased dramatically over the past few years, the corporate governance and 'agency theory' is researched.

1.5 CONCLUSION

With the South African economy slowly maturing, corporate governance is becoming a critical part of business practice. This is equally true for the property sector which is known for its lack of transparency. Today's investor is also more educated, which impacts on the choice of investment vehicles and what is expected of them.

2. CHAPTER TWO: LITERATURE REVIEW

This chapter outlines the literature that was covered to derive the propositions against which the research was conducted. It starts with an introduction into property and asset management, managerial opportunism and property securitisation. It then covers the definition of corporate governance, the mechanisms and agency theory. It concludes with a summary of the argument thus far. The review forms a solid foundation for an investigation into the potential conflicts of interests between key players involved in listed property funds and to investigate the governance mechanisms to protect shareholders interests.

2.1 INTRODUCTION

The future of the asset management industry remains secure (Adendorff and Nkadu, 1996). Many fund managers feel fairly confident about their future in the industry and about the opportunities for new entrants and niche players to enter the market. The main drivers that influence the future of fund management include the rapidly changing demographic profile across most developed countries, the trend towards privatisation of social welfare provision and the emergence of intergenerational transfer of wealth (Adendorff and Nkadu, 1996: pg 134-148). The combination of these factors will have a profound effect on the way we do business. As increasing numbers of people accumulate wealth, live longer and have a higher expectation of living standards, investment managers face the challenge of providing accessible, uncomplicated and relevant products for their expanding number of customers. In emerging countries such as South Africa, there is even a move towards creating state pension fund schemes (Morrell, 1994: pg 8-21).

Much of what is deemed the “new economy” is in fact consumers and businesses having greater convenience, choice and efficiency in fulfilling their needs, rather than a fundamental change in these needs. It is generally a process of ongoing development rather than a radical change (Morrell, 1994: pg 8-21). However, despite these rapid changes, the essence of the fund management industry is not expected to change greatly.

Institutional asset management will continue to rely on good relations between managers and trustees, engendered by good performance, accurate assessment of clients' needs and timely reporting of performance. In retail fund management, branding remains of paramount importance for the fund manager, as investors have an ever-widening array of funds and providers to choose from (Morrell, 1994: pg 8-21).

While there is an increasing demand for transparency, it is virtually impossible for lay investors to detect weaknesses in a company's financial statistics. Investors effectively lend their life savings with the hope of securing a certain level of return, but they are never made fully aware of the high level of risk inherent in their decision (Morrell, 1994: pg 8-21).

One of the main drivers in determining the future of asset management is the role of government. The introduction of the Pension Fund Act 1995, for example, had a significant impact on the industry (Morrell, 1994: pg 8-21). Changes such as pension funds trustees appointing specialist asset managers rather than balanced managers, the creation of customised benchmarks and a shift away from peer-group benchmarks altered the sector significantly (Morrell, 1994: pg 8-21). Therefore, when considering the future of fund management, one should bear in mind the influence of legislation and regulation (Morrell, 1994: pg 8-21).

Most investments in direct property in South Africa continue to be held by Life Offices and Pension Funds, despite reduced investments in this sector in recent years (Hunting, 1999: pg 60-65). These investments are illiquid assets that are expensive to manage and cannot always be realized in times of need of liquidity risk (Hunting, 1999: pg 60-65).

There has been a trend in the past decade for local institutions to outsource their property management function. This has resulted in established, independent property consultancies being contracted as service providers to assume the role of landlord's intermediary. However, this trend has moved in cycles, with a shift back to internal management from time to time. It appears that when the market is active, the business is

outsourced, but when it is slower, owners try to derive income from self management.

A property manager's primary objective is to safeguard the interest of the property investor and to ensure that the return on the investment is maximised at all times. This must be achieved without compromising the quality of the investment or its potential for future income and capital growth, which means ensuring expected cash flows are met. This suggests that separating the roles of the property manager and the asset manager is well-founded (Hunting, 1999: pg 60-65).

The asset manager benefits from the increased use of the professional skills and expertise of established property consultants that have property management and broking divisions, such as the following:

- The provision of market intelligence, and hence strategic investment data, gleaned from specialist activities in relation to decisions on disposals, acquisitions and lease terms.
- The preparation of independent market-related property valuations.
- Timeous research and investigation of individual property investments to either exploit the potential for latent value or recommend early warning strategies in problem cases.
- The role of the asset manager is to assist the owner in decisions regarding the acquisition and disposal of assets.

2.2 SECURITISATION OF PROPERTY INDUSTRY

Generally, investors limit service providers to day-to-day property management. Strategic investment decisions that affect portfolio performance are generally excluded from the contractual mandate (Goobey, 1990: pg 28-35). Thus, a firm line is drawn between the property manager and the property asset manager, with the investors dictating and controlling decisions concerning the performance of directly-held individual properties and portfolios as a whole (Goobey, 1990: pg 28-35).

It follows that the independent property consultancies that provide a property management service have not been able to make meaningful inroads into property asset management (Goobey, 1990: pg 28-35). The notable exceptions are those consultancies that are contracted to management companies of listed or other formal property investment vehicles. However, there does appear to be a shift in mood towards property as an investment and as there is a possible lack of expertise in this field, employing such expertise in-house would be costly (Goobey, 1990: pg 28-35).

Major investors are now focusing their attention on trading stock and the potential benefits of securitisation, which presents the opportunity for holders of direct property to dilute investments and increase liquidity (Newell and Fife, 1995: pg 8-19). Securitisation is the conversion of directly held property into tradable securities which are more easily transferred between investors, such as property trusts. The trusts are thus the actual investors, such as trusts of trusts. The tradability issue is critical and accordingly the securities tend to be listed on a recognised stock exchange. Internationally, securitisation has taken off and property investment trusts in South Africa, have followed suit (Newell and Fife, 1995: pg 8-19). Securitisation has become the accepted practice whereby the major local institutions have restructured their property assets. The traditional models of capital structure are based on the premise that corporate managers always act in the best interest of the owners and that the primary aim of managers is to increase shareholders wealth. However, some researches have argued that managers do not always do so (Newell and Fife, 1995 pg 8-19). Instead, they pursue actions that serve to perpetuate their own agenda, which may be in conflict with the owners' interests. Managers are also prone to spending available funds in "empire-building" projects that enhance their own power and public reputation (Newell and Fife, 1995: pg 8-19).

Newell and Fife (1995) argue that illiquidity, indivisibility and lack of flexibility are the traditional criticisms of direct property investment, compared to equities and gilts. In recent years, this has been accentuated in most property markets with a decreased demand for property investment and an increase in the completion value of property projects.

In recent years, these concerns have been the catalyst for the development of a range of property investment vehicles in many countries (Newell and Fife, 1995: pg 8-19). Property securitisation or the ability to divide a single property asset effectively into smaller, more readily tradable interests has been the focus of these liquid developments. Property securitisation is expected to offer a number of attractive property investments benefits, including:

- Improved tradability and liquidity.
- Ability to invest in high assets of a value that would otherwise be beyond normal prudent investment criteria.
- Ability for investors to achieve better investment mix by diversifying risk in terms of geographic spread and property type.
- Greater investment flexibility, with ability to react more quickly to changes in market conditions.
- Partial disposal of an asset while retaining significant management benefits.
- Ability for investment managers to reduce costs through economies of scale and specialization.
- Enabling investors to develop strategic links with other institutional property investors.
- Enabling institutions to re-weight property sector exposure, while retaining management control.
- Prestige of investing in “trophy” property assets.
- Possible reduction in differentiation between fund managers on basis of quantum funds.
- Redirection of investment performance.

Potential disadvantages of property securitisation include thin trading markets, price volatility and lack of directional control over management of the property asset (Newell and Fife, 1995: pg 8-19). While the specific applicable property securitisation investment vehicle is clearly dependent on the different prevailing legal structures, tax regimes and economic circumstances, the emergence of improved exit options has seen property

securitisation receive considerable attention in the financial sector as a viable option for both large and small investors. The expectation is for growth in the range of new and innovative financial instruments relating to property.

The factors that are likely to cause an increase in the use of securitised property vehicles in the next few years include:

- Fund managers showing greater caution towards direct property.
- Property management difficulties with major landmark buildings.
- Emergence of smaller specialist fund managers and specialised investment funds.
- Growth in the indexed funds and need for responsive portfolio re-weightings.
- Diversification difficulties concerning premium property.

These developments will clearly have a significant sustained impact on both direct and indirect property investment levels among institutional investors (Newell and Fife, 1995: pg 8-19).

According to respondents of this study, the most significant advantages of property securitization are:

- Access to higher value assets.
- Investment spread.
- Liquidity of investment.
- Management cost efficiencies.

The most significant disadvantages are:

- Lack of directional control.
- Potential illiquidity.
- Higher cost/lower return.

2.3 MANAGERIAL OPPORTUNISM

Ooi, (2000) highlights managerial opportunism as especially relevant in the corporate governance of property companies where managers have numerous opportunities to exercise their discretion in property matters. Due to the longer horizon associated with property investment, managers are usually subjected to less pressure to provide immediate results compared to their counterparts in other sectors (Ooi, 2000: pg 316-331). Since the 'irrelevance theorem' of Modigliani and Miller, (1958), there has been a consensus in the corporate finance literature that financial structure irrelevant in the valuation of a firm. Hence, one of the most important financial decisions corporate managers face is deciding on the amount of debt and equity in a firm's capital structure.. In the presence of managerial opportunism, Jensen and Meckling, (1976) propose that an important role of debt is to pre-commit the firm to pay out its free cash flows. Accordingly, debt acts as a disciplining device that constrains the amount of funds available for managerial opportunism (Ooi, 2000: pg 316-331).

The financial reports showed the ownership levels of companies and investors holding 5% or more equity shares in the companies (Ooi, 2000: pg 316-331). Using the measurement adopted by Agrawal and Mandelker, (1990) and Martin (1996), they defined management shareholdings as the percentage of shares owned and controlled (both directly and indirectly) by all the company's officers and directors. The definition also includes property company shares that are held in trusts that are not directly controlled by the directors but are nevertheless benefiting them (Ooi, 2000: pg 316-331).

Outside block shareholders include all investors with shareholdings of at least 5% that are either not affiliated to the management or have no representation on the board of directors (Ooi, 2000: pg 316-331). Such outside block shareholders are usually institutional investors, such as insurance companies that chose to leave the day-to-day running of the property company to the management team, even though they hold a substantial interest in the firm (Ooi, 2000: pg 316-331). Ooi, (2000) considers this category of investors as most likely to monitor managers closely and have the muscle, if necessary, to oppose management's decisions.

Inside and outside ownership are, as expected, inversely related. This means that companies with low management ownership are usually those with large outside block ownership and vice versa. Professionally managed firms also tend to strive for faster growth rate than owner-managed firms. This is hardly surprising considering that remuneration and power base are often linked to the size of the portfolio under a manager's charge (Ooi 2000: pg 316-331), and hence, the manager's inclination towards empire building and managerial entrenchment activities.

There is a lot of scope for managerial opportunism in the corporate governance of property companies, which consequently has important implications on real estate practice and research. To attract investors and raise funds, managers of property companies need to assure outside investors that they would get a fair return on their investment.

2.4 CORPORATE GOVERNANCE IN LISTED FUNDS

Corporate governance, according to Bonnafous-Boucher (2005), is part of an interdependent bundle of governances. In this respect, it occupies an important position in governance and its principles are consolidating. Its objective is essentially to perfect the principles of governance applied in what Chandler terms "big business". The essential meaning of all governance is to reveal the transformation taking place in power mechanisms and the wavering of the idea of sovereignty and to expose the precarious equilibrium between principles of sovereignty and legitimacy based on shareholder value that is open to question by stakeholders (Bonnafous-Boucher, 2005: pg 34-47).

Governance designates the entire raft of rules and practices – those that are in gestation and those that are being put through their paces – which are the object of incessant compromise within an organisation, whether its juridical status is private or public. Governance, unlike government, is characterised by this compromise, which must always be renewed between the various actors who produce the rules, as if the stability of the principles of governance were not only historical, but also uncertain (Bonnafous-Boucher, 2005: pg 34-47).

In the context of corporate governance, the producers of rules are the shareholders and the stakeholders. Both influence corporate governance and are affected by it, but the first govern with the increase in the value of their shares and thus of their representation on governing bodies in mind. The other are, to some degree, governed by the power of shareholders since they relativise that power by appealing to values that are, if not alternative, at least complimentary. Yet certain forms of governance are more successful than others (Bonnafeous-Boucher, 2005: pg 34-47).

Governance, thus defined, is in search of its legitimacy beyond its member states, but which invites a more direct relationship with a civil society composed of stakeholders (Bonnafeous-Boucher, 2005: pg 34-47). Corporate governance is rarely considered from the point of view of compromise and the instability of rules except, insofar as the interests of stakeholders and shareholders are concerned. Furthermore, there is a hierarchical difference between stakeholders with direct and indirect rights. Typologies are drawn up that trace a line between a share value and a partnership value of a firm, and also between organisational performance and the search for stakeholder legitimacy. How these interests are taken into account depends on the definition of a “stakeholder”.

Many theorists establish a hierarchy between direct and indirect stakeholders (Bonnafeous-Boucher, 2005: pg 34-47). However, corporate governance is generally regarded as the body of principles and rules that guide and limit the actions of directors. This clear yet restrictive approach is established on the basis of 'agency theory' where the firm is a nexus of contracts, and governance is a way of controlling managers via shareholder-creditors. Governance is thus focused on the balance between management and shareholders (Bonnafeous-Boucher, 2005: pg 34-47). The profits generated on the financial markets are thus indicators of efficiency and governance is the technical result of a process of financial optimisation, the cost of the agency versus the profits generated.

The life of companies, according to Bonnafeous-Boucher (2005), is governed by the whole body of operational and control rules in a given historical framework. Corporate governance is that which covers all the mechanisms whose effect is to limit powers and

influence decisions, or, in other words, which governs the behaviour of companies and define discretionary boundaries. Bonnafous-Boucher describes the coherent ensemble of institutional frameworks of the firm and the types of behaviour that enable it to function, emphasising that governance stands in contrast to management.

The most popular approach to governance studies is ways of increasing the efficiency of its mechanisms. The major variants are found in contexts that are more or less propitious to the development of corporate governance (Bonnafous-Boucher, 2005: pg 34-47). The relationship, by posing questions about the nature of duality of the political and the economic – their sacrosanct separateness – also calls into question recent compromise-based models in that the bottom line in corporate governance is that, after all, effective decision-making powers fall to those who hold capital. Corporate governance is assimilated to the principles that govern relations between shareholders and stakeholders (Bonnafous-Boucher, 2005: pg 34-47).

Corporate governance is based on two interpretations of the Lockean liberal logic (Bonnafous-Boucher, 2005: pg 34-47). When this logic is used to address the strict separation of powers between shareholders and managers, its interest is confined to existing shareholders, even when they represent institutional investors represented by pension funds. Thus a functionalist approach to corporate governance is justified for two reasons. First, because there is permanent state of conflict between the various actors of the firm around how generated wealth should be shared, and second, because it is impossible to predict every conflict that is likely to arise in the future and to propose *ex ante* solutions (Bonnafous-Boucher, 2005: pg 34-47).

2.5 CORPORATE GOVERNANCE MECHANISMS

Shleifer and Vishny, (1997) formally define corporate governance as the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. It is a set of mechanisms designed to protect investors against expropriation by insiders and management. Some of these mechanisms include large block investors,

board independence and composition, legal protections and external market control via debt issuance (Fan, Sing, Ong and Sirmans, 2004: pg 414-434). The potential problems in governance structures in many modern corporations are the agency problems that arise from separating the ownership, the management and the suppliers of finance (Shleifer and Vishny, 1997: pg 737-783). Information symmetry between the three parties could be mitigated by optimal designs.

2.5.1 Large Block Investors

The ability of individual investors to exert significant influence on corporation management via his/her voting rights is limited when investment shareholdings are dispersed (Fan, Sing, Ong and Sirmans, 2004: pg 414-434). By concentrating shareholdings in a small number of investors, large block investors have been found to be effective in solving governance problems in the modern corporations (Shleifer and Vishny, 1997). Large investors, usually represented by institutional investors, possess professional knowledge and asset management skills, are more able to carry out effective monitoring and control of the managers' activities.

2.5.2 Legal Protection

Minority shareholders and creditors are well protected by the law against expropriation by controlling the shareholders or managers (Fan, Sing, Ong and Sirmans 2004: pg 414-434). If managers act in their own interest, minority investors have the legal right to extract their investment returns from the managers (Fan, Sing, Ong and Sirmans 2004: pg 414-434). Creditors, who possess legal liens on the firm's assets, have the power to repossess and dispose of the mortgage assets in the case of default. Shareholders can also exercise their voting rights to replace an inefficient board of directors (Porta, 1998).

2.5.3. Board Composition

The board of directors is an important organizational mechanism for monitoring and disciplining the management's activities (Fama and Jensen, 1983). The board of a public firm is usually composed of independent outside directors and executive or

inside directors. The number of outside directors on the board is an indication of the board's independence (Fan, Sing, Ong and Sirmans, 2004: pg 414-434). The outside directors play an important role in resolving agency problems between the management and the shareholders, and to ensure that minority shareholders' interests are fairly represented in the firm (Fama, 1980; Fama and Jensen, 1983; Zahra and Pearce, 1989)

2.5.4. Debt issuance and external market control

Debt is an effective mean of disciplining managers and reducing agency costs (Jensen and Meckling, 1976: pg 305-360). Debt issuance creates an effective external control to discipline managers' action by cutting down on free cash flows that they can spend at their discretion (Fan, Sing, Ong and Sirmans, 2004: pg 414-434). The threat of liquidation also forces the managers to generate sufficient cash flows to meet the periodic debt repayment needs (Aghion and Bolton, 1992; Gale and Hellwig, 1985; Hart, 1995; Hart and Moore, 1989). The managers' reputations will be at stake if they fail to meet the debt repayment obligation of the firm (Diamond, 1989: pg 393-414).

Real estate assets differ due to their unique locations and architectural characteristics. Sirmans, (1999) has identified three major features of real estate transactions that are the main causes of governance problems – the non-standardisation of the product, information asymmetry and the potential for generating quasi-rents that must be distributed *ex post*. The management's action (hidden action) is not observable. It is difficult for the investors to force the fund managers to pick a pareto-optimal managerial action. Investors can only set appropriate incentive structures that will condition the management's utility to the observable variables, and thus eliminate the moral hazard problem (Fan, Sing, Ong and Sirmans, 2004: pg 414-434).

A professional management company (servicer) was normally appointed by the fund managers to perform the day-to-day operations of the underlying properties, the collection of rental incomes or the provision of services to property tenants (Fan, Sing, Ong and Sirmans, 2004: pg 414-434). Other than these routine functions, the fund

managers are also required to carry out cash flow management, property tenant services, monitoring underlying property conditions and reporting duties. It must also ensure that rental revenue collections are distributed as coupon payments to the investors. Embedded options, if not fairly executed, could be the roots of potential managerial conflicts and governance problems.

Other factors that can cause potential governance problems are:

- Rental guarantees which provide a form of credit enhancement for bond investors, which not only mitigates the financial uncertainty but also helps to protect the investor from expropriation. Such lease-back arrangements remove the uncertainty associated with the management of the leases and transfer the risk, which will have to ensure that the property is competitively leased at market rate and is well maintained.
- Board independence and composition.
- Managerial relationships between fund managers and the property manager.
- Compensating property managers on gross rather than net income.

The incentive contract is widely used in publicly-held companies to control corporate governance problems. It aims to align managerial behaviour with the interest of shareholders by strengthening the link between managers' interest and corporate performance (Fan, Sing, Ong and Sirmans, 2004: pg 414-434). It can adopt various forms such as basic salary, cash bonuses, stock options, and performance-based dismissal threat. Basic salaries are determined by firm-external salary levels, which are independent of the firm's performance, whereas, cash bonuses are usually linked to the current firm accounting earnings and/or stock market returns, and are used to reward managers for a firm's short-term performance. Stock options are effective long-term financial incentives to align managers' interests with those of shareholders (Ezzamel and Watson, 1997). Murphy (1985) shows that without the stock options, the effect of managerial remuneration on corporate performance is quite limited (Barro and Barro, 1990). The focus in property seems to have been on income generation, not always NOI, and hence the cost side of the equation.

The institutional arrangements to control managerial behaviour in corporations in Western countries is either the Anglo-American (or “outsider”) model of corporate governance or the German-Japanese (or “insider”) model (Stephen and Backhaus2003) In Germany and Japan the stock market does not operate as a market for corporate control.

The major German financial institutions, which control around 60% of the country's market equity (Stephen and Backhaus, 2003: pg 389-468), perform the supervisory function associated with the stock in the Anglo-American system. The banks themselves only own around 10% of the equity but control a significant proportion of other shares by holding shares of their own depositors. However, there is evidence that the performance of German companies is a function of the size of the shareholding owned by the banks rather than those controlled by them (Stephen and Backhaus, 2003: pg 389-468). There are also a significant number held by companies. It is usually argued that a small number of shareholders with significant shareholdings is more active in monitoring managerial performance than a large number of small shareholders. The latter group generates a free riding problem: as individual shareholders only make small gains relative to the costs of active monitoring, they are better off free-riding on the monitoring efforts of others (Stephen and Backhaus, 2003: pg 389-468). Where shareholdings are concentrated, the gains to the shareholder are greater and active monitoring is more likely to occur. As argued above, the generally low level of individual shareholder's stake limits the possibility of a take-over (Jackson, 1994). However, collusion between insiders (managers) can produce a bias towards the status quo and resistance to change, which can increase the wealth of small shareholders (Stephen and Backhaus, 2003: pg 389-468).

According to some economists (like Prodhon, 1993), the two-tiered board system partly explains Germany's post-war prosperity. By clearly separating the duties of the managing board of the senior management and the supervisory board, which represents the stakeholders' interests, the company can ensure a clear division in roles with respect to its day-to-day management and long-term planning (Stephen and Backhaus, 2003: pg

389-468). However, the system has recently come under criticism because key supervisory board members are increasingly seen to be members of a number of such boards and are alleged only maintain their own interests (Prodhan, 1993; Kaplan, 1994). It has also been argued that with the banks' greater access to information, this system reduces transaction costs and increases efficiency (Stephen and Backhaus, 2003: pg 389-468).

2.6 LOCAL CORPORATE GOVERNANCE MECHANISMS

In 1994, the King Committee on Corporate Governance, headed by former High Court judge, Mervyn King S.C., published the *King Report on Corporate Governance* (hereafter referred to as King 1) which incorporated a Code of Corporate Practices and Conduct. This was the first of its kind in the country and was aimed at promoting the highest standards of corporate governance in South Africa. Over and above the financial and regulatory aspects of corporate governance, King 1 advocated an integrated approach to good governance in the interests of a wide range of stakeholders. Although groundbreaking at the time, the evolving global economic environment, together with recent legislative developments, necessitated an updated report. In 2002, the committee developed the *King Report on Corporate Governance for South Africa, 2002*, referred to as King 2.

King 2 acknowledges that there is a move away from the single bottom line, that is, profit for shareholders, to a triple bottom line, which embraces the economic, environmental and social aspects of a company's activities. In the words of the King Committee:

“...successful governance in the world in the 21st century requires companies to adopt an inclusive and not exclusive approach. The company must be open to institutional activism and there must be greater emphasis on the sustainable or non-financial aspects of its performance. Boards must apply the test of fairness, accountability, responsibility and transparency to all acts or omissions and be accountable to the company but also responsive and responsible towards companies identified stakeholders. The correct balance between conformance with governance principles and performance in an

entrepreneurial market economy must be found, but this will be specific to each company.”

King 2 guides the following aspects of corporate governance in South Africa:

- Directors and their Responsibilities
- Risk Management
- The Internal Audit Function
- Integrated Sustainability Reporting
- Accounting and Auditing
- Compliance and Enforcement

To prevent the Code from becoming too burdensome, and because it is largely non-prescriptive, compliance is for the most part treated as a matter between boards and company stakeholders. The Code encourages greater activism by shareholders, business and the financial press and relies heavily on disclosure as a regulatory mechanism. The legal mechanisms for enforcement King 2 and the Code of Corporate Practices and Conduct are:

- Existing legal remedies, principally under the Companies Act (such as section 424, which deals with the liability of directors and others for the fraudulent or reckless conduct of a company’s business) and the common law.
- The provisions of the amended listing requirements of the JSE.

In this regard, it is important to note that King 2 recommends a number of changes and developments to existing legislation and enforcement processes to ensure that role-players do not merely pay lip service to the Code and the provisions of King 2. Boards should implement effective measures to achieve compliance with the Code and the provisions of King 2 and should closely monitor corporate governance issues in order to ensure that they are not caught unawares by changes and developments.

The findings contained in KPMG’s 1997/98 corporate governance survey, its third and

the second since JSE-listed companies were required to state their level of compliance with King's recommendations, found that despite complying with the King Report on Corporate Governance, companies in South Africa continue to lag behind their international counterparts in embracing the spirit of best business practice.

The survey findings show a similar trend to the previous two, with gradual improvements in the level of disclosure, according to KPMG partner Sergio de Castro, (1998). In essence, while South African companies are willing to adhere to the King Report's minimum standards of compliance, they are making little headway in revealing the finer details of the more sensitive and important business issues. One of the key reasons for this is the lack of shareholder activism in South Africa compared with other countries (De Castro, 1998).

South Africa should pre-empt an increase in shareholder activism by implementing and formalizing corporate governance practices that go beyond the minimum level required by the King Code and meet the latest international standards. For instance, South African institutions are not major proxy voters at company meetings, but there is a move internationally to make voting obligatory and such trends are likely to seep through into South Africa's increasing globalised economy. The areas where disclosure is still lagging include policies, terms and conditions of directors' appointment and retirement, assessment of board performance, the manner in which directors' salaries are determined, disclosure of directors' emoluments, training of new directors, the approach to risk management and implementation of a code of ethics.

The assessment of board performance is an area not covered by the King report but is increasingly being insisted upon by international institutional investors. De Castro (1998) argues that much of the lack of qualitative compliance can be attributed to a lack of guidance from the King report and other international corporate governance codes. Globalisation will also play a role as South African companies look for foreign listings and find themselves forced to comply with such requirements.

The great strides that have been made in corporate governance internationally have still to be made locally. Parastatals, companies and government departments that shy away from such issues may soon have nowhere to turn, given increasing peer group pressure, shareholder activism and the potential for fresh legislation.

2.7 AGENCY THEORY

Agency theory, according to Doherty and Quinn, (1999), is based on the principal-agent relationship, where the 'principal' is an individual or group of individuals who control a set of economic functions or assets in some form of ownership of property rights. The 'agent' is delegated by the 'principal' to control these assets and functions and operate them on their behalf (Jensen and Meckling, 1976: pg 305-360). In the standard theory of control, shareholders are the principals in the relationship and management are the agents (Doherty and Quinn, 1999: pg 224-236).

Agency theory, derived from the work of Jensen and Meckling, (1976), and Fama and Jensen, (1983), is another approach to corporate governance (Adams, 1994: pg 8-12). Jensen (1983), distinguishes it from the more general and abstract mechanism which is concerned with deriving constraints to apply to an optimising problem to ensure that agents maximize the principles utility. In contrast, agency theory seeks to explain observed institutional structures as attempts to control the behaviour of agents (Adams, 1994: pg 8-12). It focuses on the individual economic agent as a utility maximiser. Organisations are composed of different agents, each seeking to maximize their own utility, subject to constraints (Adams, 1994: pg 8-12). Managers in a shareholder-owned corporation will make different decisions from those of the owner-manager in a classical capitalist firm. However, the managers will bring skills and knowledge to the firm, which the owners do not. The divorce between ownership and control is seen as an aspect of specialization or the division of labour: owners specialize in the supply of capital; managers specialize in the supply of management skills (Adams, 1994: pg 8-12). The cost of this specialization is the agency problem: as utility maximisers, managers will not necessarily operate a company in the interest of the shareholders.

The positive literature on agency theory is concerned with exploring the extent to which different forms of organization constrain such managerial behaviour. With corporations, the constraints come from the stock market, in its role as the market for corporate control and the market for managers themselves (Adams, 1994: pg 8-12). An essential feature of this approach is the assumption that the stock market will discount a company's value because of the risk of managers diverting resources to maximize their utility rather than that of the shareholders. However, managers do incur bonding costs to signal to shareholders that they are operating in the shareholders' interest (Jensen and Meckling, 1976; Fama and Jensen, 1983).

Agency theory postulates that the firm consists of contracts between the owners of economic resources (the principles) and managers (the agents) who are charged with using and controlling those resources. Furthermore, it is based on the premise that agents have more information than principals which adversely affects the principals' ability to monitor effectively whether their interests are being well served by agents. It also assumes that principals and agents act rationally and that they will use the contracting process to maximize their wealth. Thus because agents have self-seeking motives, they are likely to take the opportunity to act against the interests of the owners of the firm (Adams, 1994: pg 8-12). This occurs when the principal or owner does not have access to all available information at the time a manager makes a decision and thus cannot determine whether the manager's actions are in the best interest of the firm.

Scapens argues that a state of efficiency, or "pareto-optimality", exists in the contracting process, where both principals and agents incur contracting costs. For instance, to minimise the risk of shirking by agents, principals will monitor expenditures, for example the costs of subjecting financial statements to external audit scrutiny (Adams, 1994: 8-12). Agents, on the other hand, incur bonding costs, for example the cost of an internal audit, in order to signal to the principal or owner that they are acting responsibly and in a manner consistent with their contract of employment. Such action also helps managers to secure their positions in the firm and to protect their salary levels. Wallace argues that the principal's expenditures for monitoring services, like internal auditing, reduce the risk of

principals making adverse adjustments to executive compensation.

For Pass (2003), executive incentive schemes are aimed at rewarding the executive directors of the company for improving the financial performance of the company's shareholders. Both practitioners and academics regard incentive schemes as powerful reward mechanisms for "reconciling the "principal-agent" issue. The shareholders or principals as owners of the company hire salaried professional executive directors as agents to manage the affairs of the company on their behalf. Executive incentive schemes can thus foster maximum goal congruence to the mutual benefit of both groups (Greenbury, 1995; Hempel, 1998; Jensen and Meckling, 1976).

A long-term executive incentive scheme is a "motivator" for the company's executive directors (as appointed "agents") to focus on improving the financial performance of the company and by doing so, to align their interests more closely with those of the shareholders ("principals") –(Pass, 2003: pg 299-304). By linking a substantial amount of the executives' own remuneration to an improvement in corporate performance brings about a greater commitment to the creation of shareholder wealth (Pass, 2003: pg 299-304).

Since the release of the Greenbury Report in 1995, the use of conditional incentive pay schemes has become widely accepted as constituting part of a wider system of corporate governance "best practice" (as recommended by the Cadbury Report (1992) and Hempel Report (1998)). The Greenbury Report specifically recommends the adoption of conditional executive incentive pay systems as "best practice".

Jensen and Meckling, (1976) suggest that separating ownership and management creates a potential conflict of interest between the two parties. Certain mechanisms perform much needed monitoring functions to ensure that firm management behaves in a manner consistent with maximizing shareholder wealth.

Consequently, agency theory contributes to the problem of corporate governance, which

different organisational forms will evolve to deal with the agency problems which arise from the attenuation of property rights.

2.8 REAL ESTATE INVESTMENT TRUSTS (REITs)

Real estate investment trusts (REITs) are a special form of corporation created in the USA in 1960 to encourage liquidity and to improve efficiency of capital allocation in the real estate sector (Campbell and Sirmans, 2002). REITs are not required to pay taxes on net income as long as they are distributed to shareholders, where of course they are taxed at the shareholder level (Campbell and Sirmans, 2002: pg 388-405). Thus REITs allow individuals and institutions to make equity investments in real estate without incurring the high transaction costs related to direct investment. At the same time, they avoid the burden of double taxation. The tax advantage comes at a considerable cost to REITs, since it requires the acceptance of a restrictive institutional structure designed to limit unfair competition with taxable corporations (Campbell and Sirmans, 2002: pg 388-405).

According to Campbell and Sirmans, (2002) the three key elements that are of essential importance in the structure of REITs are:

- Their assets and revenues are closely restricted to real estate, plus a limited portfolio of securities.
- Although they are usually public companies, they can avoid paying corporate taxes, so that their owners are not subjected to the double taxation normally associated with public corporations.
- They are required to distribute essentially all their accounting earnings, so that they become taxable at the investor level.

Regarding the first element, a US REIT must derive at least 75% of its gross income from real estate, and at least 90% from the combination of real estate and its securities portfolio. Further limitations are imposed upon the securities portfolio itself (Campbell and Sirman, 2002: pg 388-405). The REIT may not hold more than 10 % of the

outstanding voting securities of any one issuer, and no more than 5% of its total assets may consist of the securities of any one issuer, unless that issuer is another REIT (Campbell and Sirman, 2002: pg 388-405).

Other important restrictions are imposed even when income is derived from real estate. The tax rules specify that the REIT may not obtain more than 30% of its income from the sum total of securities held for less than one year, and property held for less than four years (Campbell and Sirman, 2002: pg 388-405). This is to restrict the REIT's ability to compete with developers and brokers by building or acquiring properties for sale, to prevent brokers from building or acquiring properties for sale and to prevent the REIT from engaging heavily in securities trading,

Regarding the matter of corporate taxation, REITs are able to avoid corporate taxes because they are authorized to claim an income tax deduction for dividends paid. First, taxable income is computed in the usual manner using generally accepted accounting principles (GAAP earnings) (Campbell and Sirman, 2002: pg 388-405). Dividends paid to shareholders are then deducted from taxable earnings, up to a maximum of 100%. Dividends paid in excess of earnings cannot be carried forward. (Campbell and Sirman, 2002: pg 388-405).

Regarding the matter of income distribution, to assure that personal income taxes are assessed at the investor level, the tax rules require REITs to pay out at least 90% of earnings. In order to achieve full deduction, however, most REITs pay out at least 100% GAAP earnings (Campbell and Sirman, 2002: pg 388-405). REITs usually elect to pay out more than 100% of accounting earnings, obtaining the extra cash flow that is exuded from earnings because of the depreciated tax shelter.

In addition to these three elements, , US REITs are subject to a prolific set of restrictions on their structure, their financing and their operations, to reduce unfair competition with taxable entities (Campbell and Sirman, 2002: pg 388-405).

Campbell and Sirman, (2002) suggest the advantages and disadvantages of adopting the REIT structure are:

Potential Advantages:

- It provides greater liquidity in domestic real estate markets, which leads to a more efficient allocation of capital.
- It provides greater price stability in local real estate markets, since REITs have access to alternative sources of financing through times of institutional credit rationing.
- It provides an opportunity for pension funds and other investors to achieve portfolio diversification benefits from real estate, without accepting the burden of double taxation, or paying large transactions costs associated with direct property ownership.
- It provides a potentially useful vehicle for privatizing the ownership of government property.
- It provides an enhanced ability of domestic firms to compete with tax-advantaged foreign real estate companies for control of local real estate.

Potential disadvantages:

- It provides reduced revenues from corporate taxes, resulting in reallocation of tax burden to other firms, or to individuals.
- Taxable firms may find it difficult to compete with REITs because of their tax advantage, even though the taxable firms may have more operational flexibility.
- It provides reduced efficiency in the real estate business, since institutional limitations placed on REITs reduce their ability to adjust to market conditions.

According to Campbell and Sirman, (2002) one of the main issues related to the structure of a REIT is whether REITS should be permitted to manage the properties of others. . In the USA, the level of activity permitted to REIT managers has undergone a clear evolution. When REITs were first authorized, equity managers were not permitted to operate the properties the REIT owned, and had to engage the services of external

management services. This was to prevent REITS from competing unfairly with taxable real estate operating companies.

Since 2001, not only can US REITs manage their own properties, but they can also sell management services to others through taxable subsidiaries relative to the size of the REIT. However, this is severely limited to assure that the sale of management services does not become a REIT's primary activity. The new rule gives the REIT more operating flexibility, and diversifies its potential sources of income. At the same time, it creates a regulatory challenge for the Internal Revenue Service, which must now scrutinize the activities of these subsidiaries to try to prevent the inappropriate transfer of revenues out of the management subsidiary and into tax-advantaged REIT.

Campbell and Sirman, (2002) also question whether REITs should be subjected to special disclosure requirements. One of the motivations for creating REITs is to develop an appropriate vehicle for individual investors to participate in the real estate market, allowing them to benefit from property value increases in ways other than through home ownership. It is important to these investors that REITs minimize information problems, and become as transparent as possible. It is not clear that market forces alone will result in optimal levels of disclosure. To the contrary, US REITs have created complex and controversial organisational structures in many cases, including privately held subsidiaries (Ling and Ryngaert, 1997: pg 433-56) and large joint ventures, many of them in Europe (Campbell and White-Huckins, 2001: pg 388-405). The degree of disclosure requirements include marking property values to market, identifying all preferred claims on cash flows and specifying accounting standards for joint ventures.

REITs are survivors, having been resilient from their creation in 1960, their abuse in the 1970's tax laws changes, the reduction in real estate prices of the 1980's and 1990's through to the volatile capital markets of the 2000's (Scherrer, 2004: pg 78-82). REITs are typified by a small but growing market. Those that have survived have acquired other REITS and grown. Their structure provides some safety for investors that they cannot obtain in direct real estate investments (Scherrer, 2004: pg 78-82).

Poor management is not eliminated simply by choosing a REIT structure. In effect, a REIT election is merely a tax tool and high leverage and poor market selection can result in disaster. Since loans to REITS are generally unsecured, investors and lenders need to be very concerned with cash flow and the REIT's ability to access long term capital (Scherrer, 2004: pg 78-82).

The value of a REIT is the sum of the value of its underlying real estate assets with some bonus for excellent management. The investor's /and/or the lending risk is related to real estate and thus more market specific than the risk associated with a non-real estate company (Scherrer, 2004: pg 78-82). The investment or lending considerations must include specific market analysis and a determination of the REIT's ability to remain viable during conditions of market instability (Scherrer, 2004: pg 78-82).

Scherrer (2004) argues that corporate governance in the REIT sector has been a topical issue with the institutional customer base. REITs carry the stigma of having the worst corporate governance relative to other public companies. In a recent report, Scherrer (2004) defines the “Weapons of Mass Entrenchment (WME)” which can hurt shareholders and entrench management. By reviewing structural issues such as staggered elections, the independence and alignment of interests of such board members, and the reputation and past practices of each board, he concludes that REITS have more WME than other companies. He measured three broadly grouped categories, the quality of the board being the most important. The second category was board power and the extent to which power is vested in directors, via WME, rather than in shareholders, where the power should be vested. The third category was the potential conflicts between key insiders and shareholders. He concluded that none of the companies scored an A and that the majority scored an F. This helped him confirm that poor governance is widespread across REITs.

2.9 CONCLUSION / PROPOSITIONS

The propositions that have been made obvious from the literature review are that the governance mechanisms of the South African listed property sector: as follows:

- Are reflective of international standards
- Are reflective of local standards. .
- Protect shareholders interests

CHAPTER THREE: METHODOLOGY

3.1 INTRODUCTION

While research is important in both business and academic activities, there is no consensus in the literature on how it should be defined (Amaratunga, Baldry, Sarshar and Rita; 2002). One explanation for this is that research means different things to different people. However, from the many different definitions offered, there is agreement that research:

- Is a process of enquiry and investigation.
- Is systematic and methodical.
- Increases knowledge.

There have been no research studies on governance mechanisms in listed property portfolio funds in South Africa. A definition of a research strategy is a fundamental and necessary requirement for a sound empirical study in such a field. Qualitative research involves the use of qualitative data, such as interviews, documents, and participation observation, to understand and explain social phenomena.

3.2 QUALITATIVE RESEARCH PARADIGM

This study investigates the potential conflict of interest in listed portfolio funds and the governance mechanism to protect shareholders interest. The proposed research paradigm for the study is qualitative in nature.

Critics of empirical research (for example Blalock, 1991; Willer and Willer, 1973) focused on the deductive nature of the quantitative process, and the preoccupation which researchers supporting quantitative process have with statistical analysis to the detriment of quality data production. They claim that this narrow approach forces researchers to work within theory, rather than challenge or extend it. Qualitative research is often cast in the role of the junior partner in the research enterprise, and many of its exponents feel it should have more clout and more credit (Dey, 1993).

Supporters of qualitative research designs (for example, 1993; Piore, 1983; Stainback and Stainback, 1988; Strauss, 1987; Strauss and Corbin, 1990; Van Maanen, 1983) stress its potential for theory and development through rigorous coding and interpretive procedures. For Strauss and Corbin, (1990), the tasks of qualitative research are to uncover and understand what lies behind a little-known phenomenon or to gain a new or fresh perspective about a known one. They also claim that qualitative methods can provide intricate details of phenomena that are difficult to convey with quantitative methods.. Those who support the qualitative approach claim that a deductive methodology constrains researchers within current theory, whereas an inductive method encourages theory development or theory extension (Jarratt, 1996: pg 6-15).

3.3 QUALITATIVE RESEARCH DESIGN

The design of the research is qualitative and, more specifically, interpretative. The motivation for conducting qualitative research is that it helps researches understand people and the social and cultural contexts within which they live. Kaplan and Maxwell (1994) argue that the goal of understanding a phenomenon from the point of view of the participants and its particular social and institutional context is largely lost when textual data are quantified.

Qualitative research is not synonymous with interpretative research – qualitative research may or may not be interpretive, depending on the researcher's underlying philosophical assumptions. Interpretive research, philosophically based in hermeneutics and phenomenology (Boland, 1985), assumes that reality (given or socially-constructed) is only accessible through social constructions such as language, consciousness and shared meanings. Interpretive studies generally attempt to understand phenomena through the meanings that people assign to them and interpretive methods of research. Interpretive research does not predefine dependent and independent variables, but focuses on the complexity of human senses as the situation emerges (Kaplan and Maxwell, 1994).

3.4 POPULATION AND SAMPLE

This study's research population is the group of expert professionals in property field that

have an interest in the outcome of the governance mechanisms in the listed property portfolios. The sample includes consultants, chief executive officers, fund managers, portfolio managers and legislation that govern the securities exchange and corporate organisations. For the purpose of triangulation, the above stakeholder groupings are considered to be sufficient.

Data triangulation, described by Jick (1983) as combined methodologies to study a specific phenomenon, can be either “between method” (providing cross-validation of outcomes) or “within method” (using a variety of techniques within a stated method to gather information about an aspect of the research that will confirm the outcome). Triangulation in its extreme can “capture a more complete, holistic, and contextual portrayal of the units under study” (Jick, 1983). Jick provides a practical example of how to implement the concept of triangulation. The effectiveness of all triangulation designs rests on the premise that the weakness of one method is compensated by the strength of another (Jick, 1983). The research method described by Jick, (1983) combined multiple viewpoints and approaches, gathered through direct and indirect reports, observation, surveys and semi-structured, probing, interviews.

Simon, (1994) presents a generative strategy, incorporating the concept of triangulation and arguing the case for combining content analysis, in-depth interviews, participant observation and a review of the literature with open-ended, non-standardised schedule interviews. His ideal research method is supplementing an analysis of information gathered from secondary data and literature reviews with a variety of in-depth interviews. He also recommends including two phases of qualitative research using in-depth interviews followed by structured, open-ended qualitative interviews to “flesh out” themes produced through initial unstructured interviews.

The research was conducted using twenty respondents. The sample size is drawn from experts in the industry and is relatively small due to the limited number of listed property industry players.

STUDY RESPONDENTS

No.	ORGANISATION	SECTOR	NAME	DESIGNATION
1	Broll Property Group	Property Services	Arnold Meyer	CEO
2	Redefine	Listed Fund	Grant Abrahams	Asset Manager
3	Apexhi	Listed Fund	Gerald Leissner	CEO
4	Grayprop	Listed Fund	John Rainier	CEO
5	RMB Properties	Property	Warren Schultz	CEO
6	EMIRA	Listed Fund	James Templeton	CEO
7	Catalyst Securities	Fund Managers	Andre Stadler	CEO
8	Ambit	Listed Fund	Kelly Clinton	
9	Investec Properties: Provest	Listed Fund	Angelique de Rauville	Chief Executive
10	Pangbourne Properties	Property Management	Johan Groenwald	Company Secretary
11	Madison Asset Managers	Fund Managers	Wolfe Cesman	
12	Standard Bank Properties	Property	Stuart Shaw-Taylor	Managing Director
13	Brait	Financial (Investments)	Mervyn King	Senior Chairman
14	Spearhead	Listed Fund	Mike Flax	CEO
15	Resilient Properties	Listed Fund	Des de Beer	CEO
16	Old Mutual Properties	Listed Fund	Colin Young	Asset Manager
17	Hyprop	Listed Fund	Pieter Prinsloo	CEO

18	Standard Bank	Economics	Elna Moolman	Economic Analyst
19	FNB	Economics	John Loos	Economic Analyst
20	Financial Mail	Media	Ian Fife	Property Writer

3.5 DATA COLLECTION

The interviewee was contacted initially by telephone to inform them of the purpose of the study, subjects to be covered and the research process, including the expected duration of the interview. The interviewee was then invited to participate in the study and an interview was set-up. Each interviewee was offered a copy of the research proposal, as an incentive to participate in the study. Importantly, interviewees were guaranteed that their responses would be held confidential and remain anonymous.

To put the interviewees at ease in talking to the researcher, the interviews took place at the most convenient place for the interviewees. Each interview was audio-taped and transcribed thereafter. In addition, notes were taken in case of equipment failure.

In-depth interviews, being one approach to qualitative research, can be either non-directive or semi-structured (Sampson, 1972). In non-directive interviews, a relaxed and sympathetic relationship must be developed between the interviewer and the interviewee, and probing should not cause bias in responses. When the interviewee digresses or exploration of a particular area becomes fruitless, the interviewer must guide the session back to the relevant topic.

In semi-structured interviews, the researcher can cover a specific list of topic areas, leaving the time allocated to each topic area to the interviewer's discretion. The open structure ensures that unexpected facts or attitudes can be more easily explored (Sampson, 1972: pg 7-27).

By selecting a non-threatening environment, the interviewer can encourage the,

interviewee to look within themselves for the underlying motivations behind their perceptions (Jarratt, 1996: pg 6-15). Furthermore, with no right or wrong answers, the interviewee is positioned as “the expert”.

The researcher must refrain from using judgmental statements or questions that might be interpreted as threatening and evaluative (Jarratt, 1996: pg 6-15) and the interviewer must maintain control of the interview, instilling confidence in the interviewee so that opinions expressed are perceived as simply being recorded rather than judged (Reynolds and Gutman, 1988). This approach ensures that emerging issues, as well as those suggested through previous research, are included in the research, develop an in-depth understanding of key dimensions and provide the researcher with valuable information for interpreting quantitative data (Jarratt, 1996: pg 6-15).

3.6 DATA ANALYSIS

The data analysis of this study was cyclical. It first involved collecting and analysing the data and then referred back to the literature. While quantitative research usually involves a clear distinction between data gathering and data analysis, this is problematic with qualitative research (Myers, 1997). For example, from a hermeneutic perspective, it is assumed that the researcher’s presuppositions affect the gathering of data – that the questions informants are asked largely determine the outcome. The analysis affects the data, which in turn affects the analysis in significant ways. Consequently, in qualitative research, it is perhaps more accurate to speak of “modes of analysis” or different approaches to gathering data, analyzing and interpreting qualitative data - than to speak of “data analysis” (Myers, 1997). The common thread is that all qualitative modes of analysis are concerned primarily with textual analysis, whether verbal or written.

Hermeneutics can be treated as both an underlying philosophy and specific mode of analysis (Bleicher, 1980). As a philosophical approach to human understanding, it provides the philosophical grounding for interpretivism. As a mode of analysis, it suggests a way of understanding textual data. The idea of a hermeneutic circle refers to the dialectic between the understanding of the text as a whole and the interpretation of its

parts, in which descriptions are guided by anticipated explanations (Gadamer, 1976). It follows that we expect meaning from the context of what has gone before. As Gadamer (1976) explains, “It is a circular relationship....The anticipation of meaning in which the whole, themselves also determine this whole.” Ricoeur (1974) suggests that “Interpretation ... is the work of thought, which consists in deciphering the hidden meaning in the apparent meaning, in unfolding the levels of meaning implied in the literal meaning.” Different stakeholders in an industry can have confused, incomplete and contradictory views on many issues. The aim of the hermeneutic analysis is to make sense of the whole and the relationship between the different stakeholders. In addition, the data is coded and tabulated, depicting the various opinions throughout the sector. No statistical analysis is performed.

3.7 VALIDITY AND RELIABILITY

As qualitative research methods are more intrusive and less structured than quantitative ones, they are more appropriate when the research is exploratory in nature, when the researcher is unfamiliar with the area for examination and when the research is clinical. In all these situations the interviewer must gain insight into a specific topic area.

As judgments have to be made during the data collection phase, the researcher must understand the theoretical issues (Yin 1989) A review and knowledge of the literature is an integral part of the exploratory phase of data collection (Simon, 1994) and is an important source for gaining “theoretical sensitivity” (Strauss and Cobin, 1990)

The accuracy of verbal reports depends on the procedures used to elicit them and the relation between the requested information and the information provided (Ericsson and Simon, 1984). Invalid reports can be due to lack of access to thoughts (their claim), inadequate procedures for eliciting verbal reports or requesting information that can not be provided, even when thoughts are accessible. When subjects are asked to recall instances, investigators find the retrieval information to be valid (Ericsson and Simon, 1984). Thus, qualitative interviews should encourage the respondent to describe the phenomenon under investigation.

3.8 CONCLUSION

With the inherent risk of data being distorted by the introduction of bias, added to the practicality of data collection, it is imperative that the most appropriate and effective research design is carefully selected.

4. CHAPTER FOUR: EVALUATION AND DISCUSSION OF RESULTS

4.1 INTRODUCTION

The objective of this chapter is to evaluate and discuss the results of the in-depth, semi-structured interviews conducted with the respondents. Representatives of half of the 40 funds currently listed on the Johannesburg Stock Exchange were interviewed. All are senior managers - CEOs and Managing Directors - and all are well-respected in the industry, which supports and validates the data.

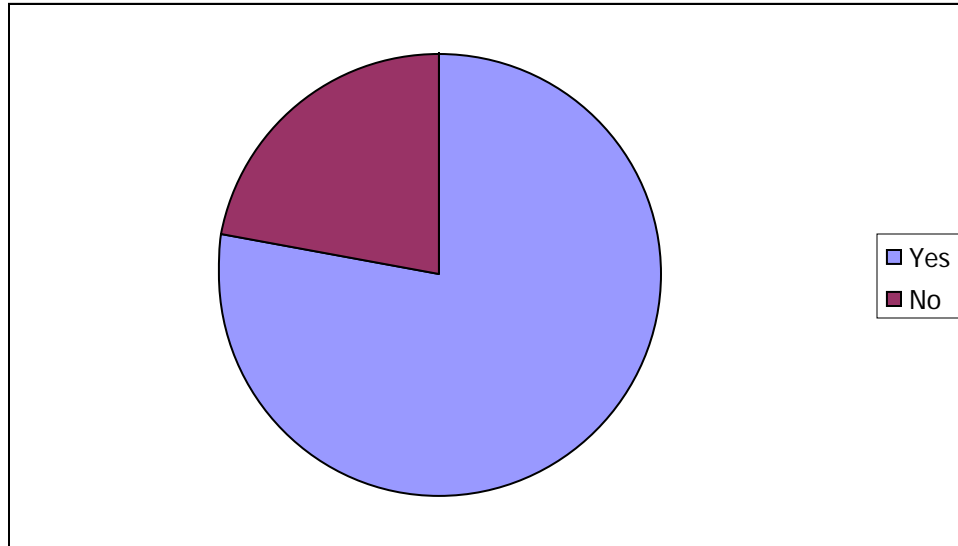
The interviews were successful and the interviewees were enthusiastic in their responses, provided their identity would remain anonymous. The interviewees felt comfortable, and were forthcoming and candid in providing information. The data drawn from the interviews and their analysis are discussed below. Comments from the transcribed interviews are used to provide additional insight into each of the factor associated with the protection of shareholders' interests in the listed property sector.

The chapter begins by exploring the research results on corporate governance and the board framework, the factors that protect shareholders' interests. –This is followed by the results relating the listed property's different business practices - the asset management structures, promoters' fees and directors' dealings. The chapter concludes by identifying other factors not associated with the main findings.

4.2 CORPORATE GOVERNANCE

Does good corporate governance pay?

“...Who do you look to protect? Is it the tenants, we or the shareholders? I would definitely say that the shareholders are what we are here for.”



The majority of the respondents agreed that good corporate governance and management ethics pays.

They recalled that about 20 years ago, the property industry was in the hands of a few institutions and a few listed funds. Those who thought they could make a quick profit saw an opportunity of promoting these listings. . The yields were high, there were arbitrage opportunities and funds were listed. The industry then crashed. As disgruntled vendors sold their properties and got their equity as cash, the equities of the properties devalued by half, leaving a great number of dissatisfied investors. This tainted the entire property sector market, and investors lost confidence in it. Then new players with integrity came into the market and, in financial terms, brought sophistication to the property industry, which restored investors' faith in the industry. Perceptive investors with clever ideas about cash flows brought new ideas and fresh thinking to the industry and considered property a solid asset. Soon after, new property companies and other established funds came into the market, bringing with them funds from other countries and a whole new outlook to the property industry. This resulted in a major change in property asset management. Then a new system evolved which most companies now prescribe to - a more open manner of dealing with valuations and the establishment of the Investment Property Databank (IPD). Prior to this, none of the institutions would disclose the extent of their portfolios and no-one knew the true value of these investments. It was more a

mentality of secrecy and keeping the value of the investments artificial.

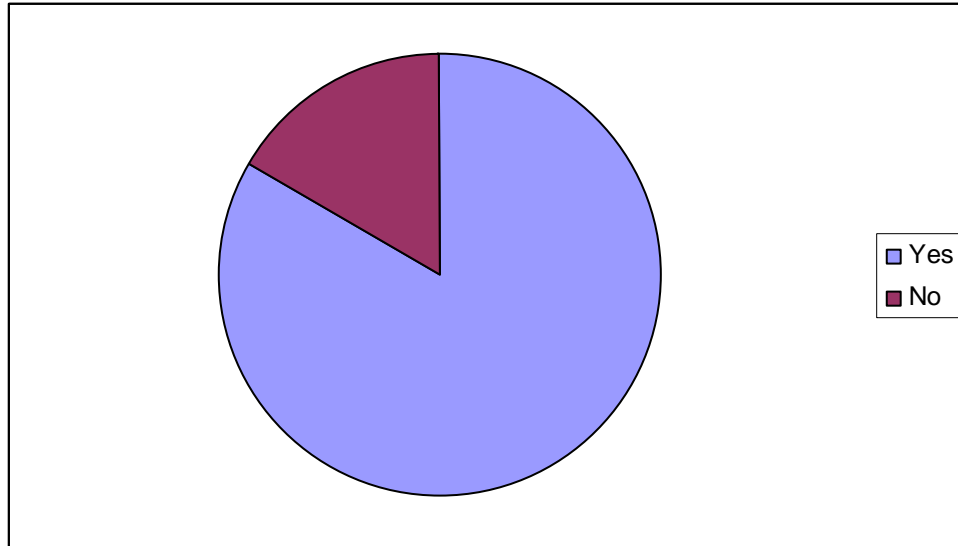
Respondents argued that corporate governance is the defining issue of the 21st century, yet it is not the foremost issue for South African investors. In South Africa, the market has been driven by results, whereas internationally, investors are extremely vigilant about corporate governance. Today, corporate governance is reflected in the markets and good corporate governance reflects on the share price, which attracts more investors. The property market is also more sophisticated with many controls in place, particularly in the financial markets. Corporate governance is a combination of the reputation of the directors and the executive team, which adds value together with the governance mechanisms.

For most of the respondents, the focus on corporate governance has been slightly overdone. They argue that the quality and ethics of management is of greater importance. One can have effective corporate governance, but if the management is unethical, there can be no positive results. However, with less corporate governance but with ethical management, some positive results can be achieved.

Various governance processes and policies have emanated, mainly from the United States which has cost businesses huge amounts of time and money. While respondents are generally positive about the move to corporate governance as generally, they feel many areas are overdone. With ethical management, these processes are redundant. Putting corporate governance regulations in place can still result in unethical management.

Are shareholders able to influence the way the industry is governed?

“Shareholder apathy is a huge problem in South Africa.”



While the majority of the respondents felt that block shareholders do influence the way the industry is governed, they are apathetic about governance regulations. Some felt this would change in time, with the smaller shareholders becoming more involved and exerting more influence.

Shares are primarily held by institutions and are therefore in the control of asset managers who work on blanket decision-making within their organisations. Property is difficult to analyse, as simply examining financial reports is insufficient to determine whether properties are being managed in accordance with investors' expectations. The analysis needs to go beyond this and requires an in-depth knowledge of properties, such as how well they are being maintained, whether the parking meters are in working order and how effective the security is. This type of hands-on analysis provides insight to the underlying aspects of an individual building, which a financial report alone cannot provide. To provide an effective analysis, a manager must study the leases, build models, and determine what companies are likely to achieve from their earnings in future. They also need to know that the properties are being managed on a day to day basis in accordance with expectations.

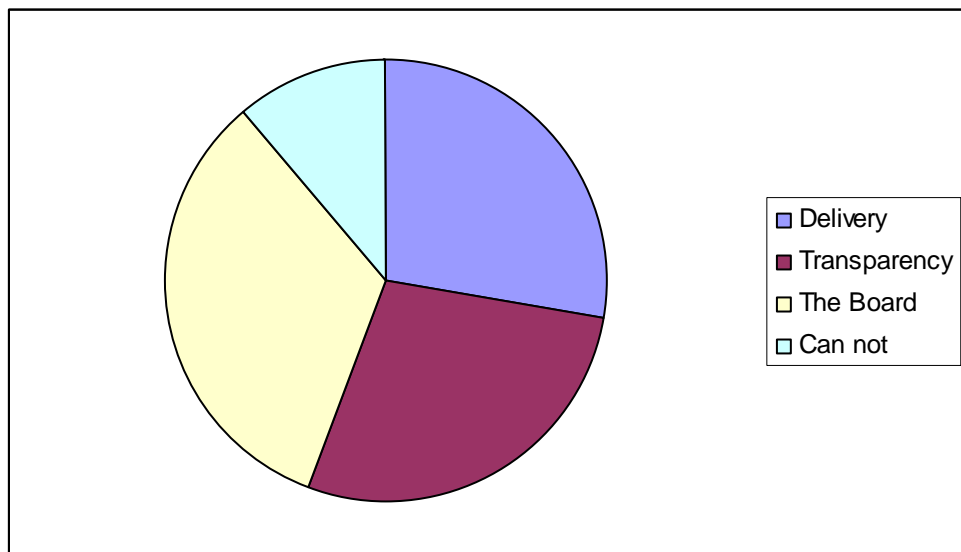
Respondents were of the opinion that companies such Old Mutual, Marriott, Stanlib, as major shareholders in a number of funds, should exert more influence in the sector. Most

of the major block shareholders seem to have a passive approach to issues such as the fees. If they are not content with them, they simply sell their shares. Respondents argued that the major shareholders should exert more influence since in many ways; they are equally responsible to the management or board of directors in determining how the sector should operate. These are the players that can influence companies, either by changing the board or forcing the management to act responsibly.

According to the respondents, shareholder activism in South Africa is becoming increasingly apparent and it is only a question of time before shareholders attending AGMs or meetings will start asking the pertinent questions. Legislation of these regulations will have to be introduced as South Africa is now falling behind the international markets. Shareholder activism will be a major factor in keeping companies and funds in line.

How can managers assure outside investors that their interests are being looked after?

“We can communicate with them until the cows come home but if we get no feedback, we don’t know what their thinking is, or whether their interests are being taken care of.”



The respondents were unanimous that managers can assure investors that their interests

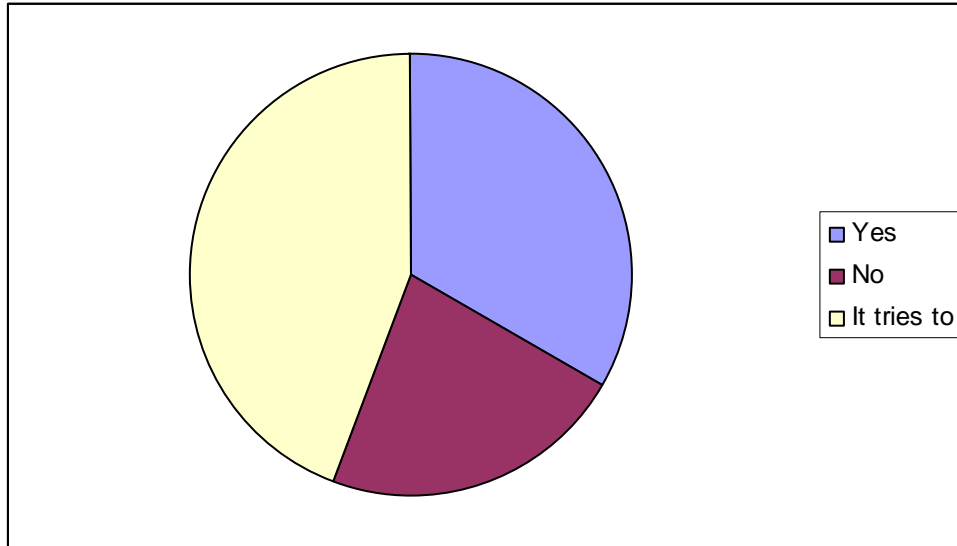
are being looked after by being transparent, communicating often, meeting one-on-one and making sure that they have a good track record. Through the board mechanism, managers can primarily communicate with their shareholders through the annual reports. Through the governance structures, i.e. the correct non-executives, the right investment committee processes and credibility on past transactions, they can communicate that these transactions have performed as they predicted. In this way, the shareholders can be more confident that their interests were being looked after. This is also achieved by having performance targets and by managing in accordance with Key Performance Indicators.

Respondents generally felt that the share price is more important than corporate governance since investors tend to care more about the share price than about corporate governance. They also felt that transparency in fees paid and the disclosure of promoters fees and all fees payable to the related bodies, is vital,

Respondents also added that investors would be reassured that their interests were being looked after if funds could prove that they comply with the major points of the King 2 report, which is designed specifically to protect shareholders and make sure companies run on a basis to ensure that protection.

Is governance adhered to and does it deal with conflicts adequately?

“I think it is, but here again too, is a set of rules and one can’t always stick to every rule.”



The respondents stated that while their companies and/or funds are extremely serious about corporate governance, its success rate is not always measurable. While they make every effort to meet all the guidelines, they are not always successful. In general, it creates certainty amongst investors. Most of the respondents stated that governance is over emphasised and in fact detracts companies from focussing on their core business.

As the King 2 report is merely a guideline, there are varying degrees of compliance with it. An examination of various properties in a report highlights the different items that are complied with within a reasonably broad band of parameters. However, many funds don't pay sufficient attention to this.

The respondents stated that the King 2 report exposes what the Companies Act says in one paragraph; the JSE regulations are exactly the same. From this perspective, the respondents find it useful but feel it has been over-emphasised and is generating a lot of income for some. How they succeed in that is not always measurable. What they strive to do, what they can afford to do and what they actually achieve, are not necessarily what they want. They are still striving to do better.

The respondents felt that by comparison, the regulations in accounting standards were relatively lax, but that after Enron and other related scandals, these became too stringent

It is felt that regulations are generally cyclical. Corporate governance improves in the long-term but at one point, it is overdone and a backlash occurs which eases it up somewhat. It then becomes too lax, at which point a new cycle begins. While corporate governance was extremely important several years ago, people are now less focused on it because the market is performing well. In time, it will be fashionable again, and corporate governance will continue to improve. The respondents felt that much of business and life works according to such cycles.

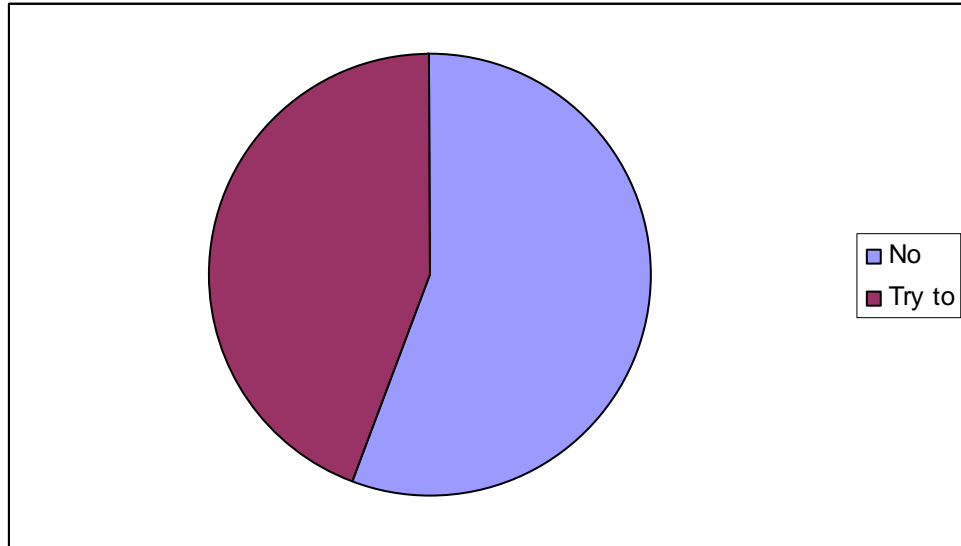
The respondents stated that a general opinion shared throughout the business community is that the introduction of accounting statements and standards has confused rather than enlightened investors. They have created information that is less meaningful for investors as they are difficult to interpret and are often illogical. Furthermore, a huge amount of effort is spent on complying with the standards.

There are governance processes and policies emanating mainly from the US which has resulted in huge amounts of time and costs for businesses. The move to more governance is generally good but there are many areas that are overdone it is felt that if you have good ethical management all these processes are unnecessary as you can put all these regulations in place and still have unethical management.

Do companies disclose all information?

“I don’t think that disclosure is going to affect any practice and I am not sure that disclosure is going to add any value to anybody.”

“This disclosure over disclosure over auditor over policeman!, Where do you stop?”



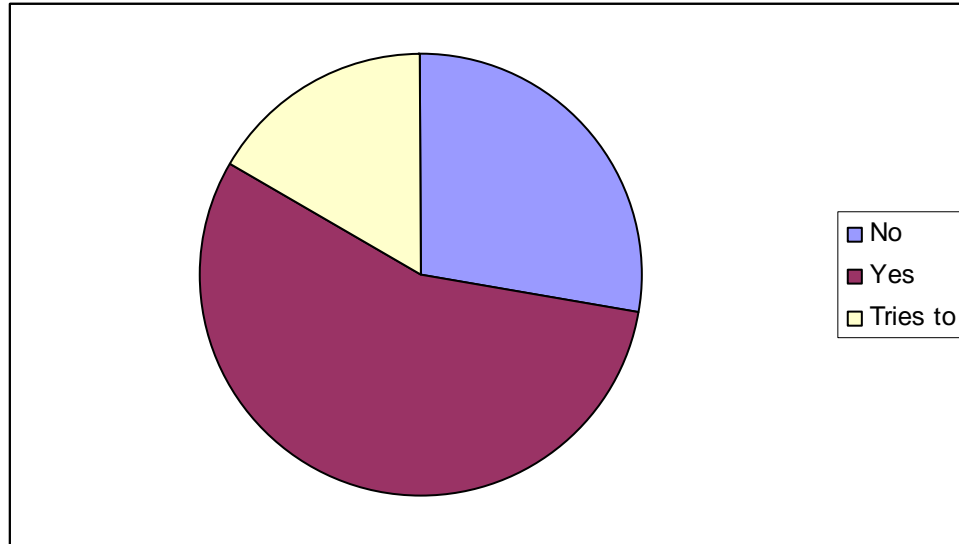
A few respondents felt that transparency, which provided information to one's competitors, is counterproductive to competitiveness. They argued that what is significant is not the information one has but how that information is used. With the directors, the auditors, and the JSE on the one hand, and the executives, non-executives and the independent directors on the other, it is questionable why independent directors can not ensure that the management adheres to good practice. Further disclosure should not be necessary as in an ideal world; all transactions within a company are vetted by an independent board of directors.

Respondents felt this was similar to Black Economic Empowerment (BEE) schemes, which now require agencies to be rated. It was unclear to them who approve the ratings. It was felt that they are creating a whole new mechanism of 'checking on' people and a whole new industry, which adds further unproductive costs to companies. Furthermore, they argue that all the checking mechanisms are in fact making people more dishonest and dishonest people will eventually be caught.

They concluded that, by definition, if something is 'material' it can influence an investor's decision; if it is not material, it can't. Thus only material transactions should be disclosed. Any other disclosure is irrelevant to decision-making and simply uses up resources.

Do you think good governance adds value to the shareholder?

“It’s a hygiene factor. it doesn’t add value but it detracts from value if not in place.”

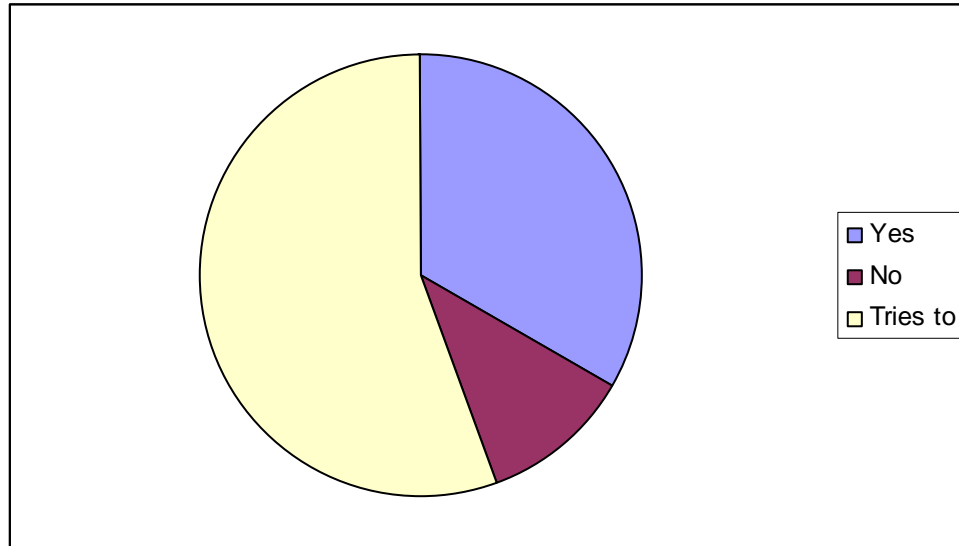


The majority of the respondents felt that good governance adds value, but that in the immediate future, it will create confusion and inconvenience and will not add much value to investors. Examples include Sarbo and Oxley and the new IFRS in the JSE listings requirements. Governance will serve to impede investors' understanding and will distract managers from their core task in the immediate future. The increase in compliance requirements has been positive in that it has focused attention on previous bad practices. It has weeded out management companies and individuals that act in their self-interest at the expense of shareholders. There were many examples of these in the past, but probably because of the increase in governance, there are less today.

4.3 THE BOARD FRAMEWORK

Do board members enforce effective measures to achieve compliance and corporate governance in SA?

“Good boards do, bad boards don’t. It depends entirely on the integrity of the board members.”



The majority of respondents stated that boards try to enforce effective measures to achieve compliance.

They felt that there are pros and cons for people to be on multiple boards, but that there should be a ceiling. Directors and non-executive directors cannot be dictated to about the number of boards they can serve on, as this depends on the board and the level of involvement. It is useful for independent directors to be on several boards as they should have the necessary gumption to keep them in line. Furthermore, they can attract business from one company to another. This is networking and directors should not be penalised for this.

Certain respondents felt that board structures undermine the basic principles of business. They feel that the principle of ‘he, who pays the piper, calls the tune’ is being overlooked. They also feel that it is incorrect to say that the board is responsible for the company strategy. Some argued that the CEO runs the company and is directly involved in the business, and that without adopting his or her company strategy, one cannot have a committed or passionate leader. As a consequence, people are unlikely to invest in the

business. A company is unlikely to succeed if it is run by an administrator who is executing someone else's ideas.

Another issue raised was that of finding appropriate board members. The responsibility of sitting on a listed company board is very time consuming and onerous. The board member is as culpable as the directors and there is great risk if they do not keep up to date with the activities of the company. Being a valuable non-executive board member is a difficult task.

According to the respondents, it again comes back to the individual. There are sufficient rules and regulations to ensure that people behave properly and, as stated previously, can draw from the expertise of non-executives, which is a shallow pool in the property industry. There are other synergistic and negative reasons, but provided the conflicts are managed, that expertise can be drawn upon.

Conflict does not necessarily detract from benefiting a fund. A person's resignation from one board because of a conflict can result in longer-term negatives for that vehicle. The erosion of certain synergies can then benefit a fund.

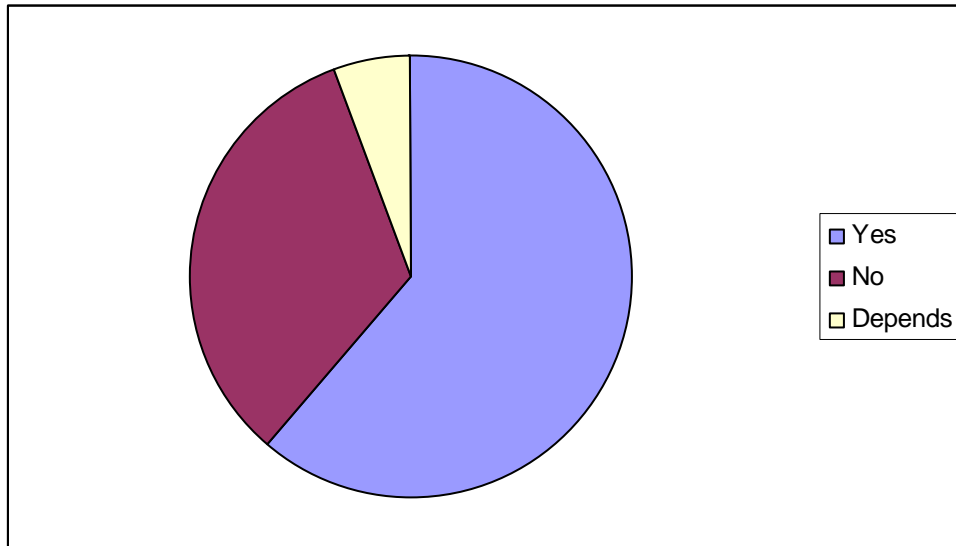
The respondents felt that there are certain clear rules concerning good and bad governance. Strictly speaking, having a board member on a board of companies that is in competition with one another company is not good governance. However, some of these companies are among the best run property companies, and their shareholders are very pleased with them.

All in all, the respondents felt that long-run, corporate governance is the defining issue of the 21st century.

4.4 ASSET MANAGEMENT STRUCTURES

Do external management companies (Mancos) create a potential conflict of interest?

“The mancos are being put first. A lot of companies do this and it is a flagrant violation of corporate governance.”



The majority of respondents felt that external Mancos create a definite potential for conflict of interest.

The crux of business and the definition of an asset manager is the preservation or the growth in shareholders value and investment. Rather than protect the tenants, the directors or the shareholders, the asset manager should protect the shareholders who rely on them to get them the maximum investment to equal or better the average return they can expect in the current economic market environment.

There are clearly influences on return such as interest rates, the stock market and the listed bond markets, that the asset managers have no control over in the macro-economic environment. The aspects that asset managers can control such as the level of rental returns, vacancies and bad debts can be managed to ensure that they are better than their competitors. Ensuring that investors are getting the best value for returns means sustainable returns that are not based on six-month or one-year horizons but on five-year

horizons.¹

It is a trend and a perception that the management in an internally managed company is more committed to the company and has a greater vested interest in it than the management in an externally managed one, where the company is just one of many.

Respondents felt there is too much overlap between asset and property management. They should be kept separate as there is a conflict of interest between them.

Conflicts occur when property and financial management is out-sourced and administration is done in-house. . With the asset managers being paid a fee on the market capitalisation, there is a risk that the asset manager bulks up the size of the company, and if he predicts incorrectly, devalues the share price thus the risk in asset management is that the fees earned in buying and selling properties can be driven by self-interest.

Analyses of property income ratios on properties that have internal and external Mancos are regularly done. These show that there are various clear advantages and disadvantages to having external Mancos. Most show that properties are more profitable with external managers. This is interesting as properties with external Mancos generally do not involve large sums of money and remunerations are generally fair.

On the other hand, properties with internal Mancos generally have very high property income ratios and have a reluctant approach to managing their operational expenses. Several years ago when corporate governance was less prominent, there were situations where the salary of a non-executive chairman's secretary or speeding fines were paid by the listed company. Some executives lived very lavishly on their expenditures, such as enjoying holidays in six-star game lodges.

Respondents questioned why there are so many highly-paid executives in listed

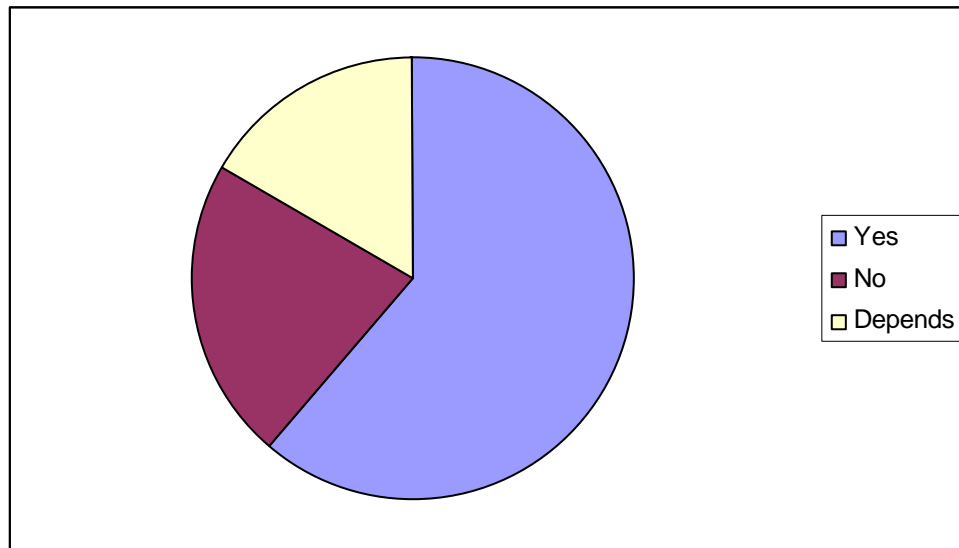
¹ Five years appear to be a long time frame but in South Africa it is prudent that asset managers look at each five year period whereas in the UK they are looking at 10, 15 to 20 year horizons because they operate in different economic climates.

companies that have no external Mancos. They felt that a listed property can be run simply with a CEO, an accountant, a secretary and a few assistants.

Respondents felt that having internal or external management structure was largely dictated by trends.

Does the in-house management structure benefit the shareholder better than the out-sourced management structure?

“South Africa has historically had situations where managers act for self enrichment, putting properties together, listing them and then, for instance, sailing to Australia for three months.”



The respondents agreed that an in-house management structure benefits the shareholder but they had mixed responses regarding in-house verse out-sourced management structures. They agreed that there are some advantages to an internal management structure but that the way some of the listed property companies are currently conducting themselves is not stacking up favourably against those listed properties that have external management structures. It is the lesser of two evils.

Analysts cannot pick up transparency and disclosure issues as they don't have access to some of the details. It is only over several years that people hear about mismanagement within such companies. With an external Manco, it is easy to calculate the accuracy of fees on the last day of every month in comparison to what other companies are paying their executives.

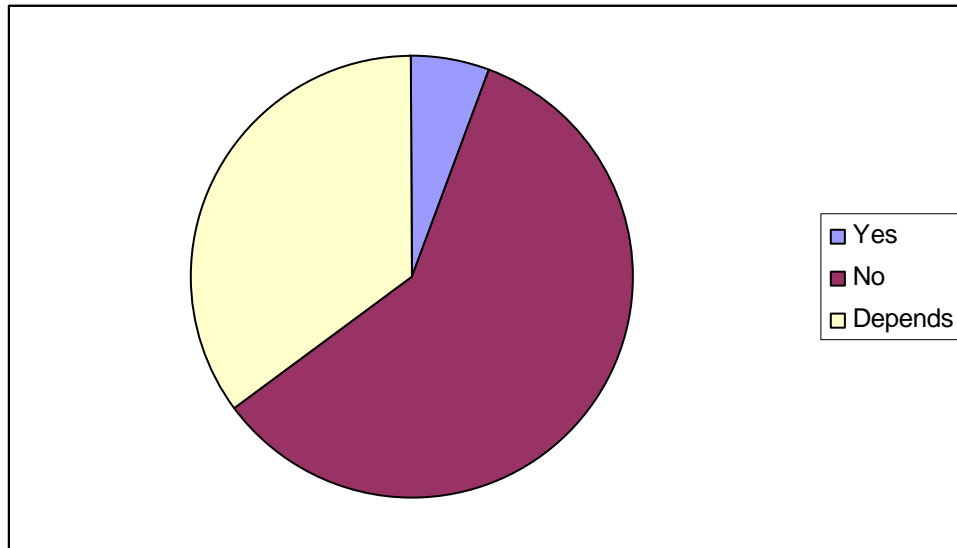
Respondents added that South Africa has historically had situations where managers act for self enrichment, putting properties together, listing them and then, for instance, sailing to Australia for three months.

Respondents felt that listed property sector now has some credibility and that CEOs have better ethics and have their shareholders interests at heart. Five years ago, shareholders were not invited to company presentations and taken on tours of properties. Today, CEOs are willing to educate their investors. By having their shareholders interests at heart, companies ultimately see their share prices grow and their cost of funding decrease. Asset managers recognise that they need to have their shareholders interests at heart to grow their business.

4.5 PROMOTORS' FEES

Does the current promoters' fees structure align the interest of both the shareholder and investor?

“If there are promoters' fees, then there is a tendency to churn.”



The majority of the respondents said that promoters' fees in general were not acceptable.

It was generally felt that promoters grew the industry from what it was 10 years ago. While still not an enormous industry, they felt that it is at least being noticed, as seen by the coverage of analysts and asset. As little as five years ago, there were only two independent property analysts in South Africa. Today, the picture is very different. Promoters have brought a new energy to the market, given investors something new to invest in and are forming new companies. Taking into account the risks they took, they have been fairly remunerated for their effort in the last few years, and their remuneration was fair.

Many of the respondents felt that there should be no promoters' fees as it is the promoters' job to look after the shareholders and their fee should come out of a better asset management fee. Most companies work on the basis that they receive a bonus from doing their job well. The bonus comes out of the asset management fee which reflects the promoters' performance.

Respondents felt that promoters' fees create a tendency to churn. Straight asset management fees are acceptable if they add value. An examination of IPD results shows that companies that churn their results have better returns than those that don't. Churning

is considered as positive, as long as it isn't done on the back of promoters' fees. If it is just the asset management fee which is a function of the share value, with churning to add value, then the share price should rise. The asset management fee should rise, but not for promoters' fees.

In some companies, directors deal on behalf of the company in the interests of the company, buying and selling assets, listing in funds and raising new capital. As they don't pay handling or consultancy fees, nor commissions, all the benefit contribute to the bottom line and go straight to the shareholders. These directors work for a salary and incentives based on performance, and all the benefits are for the shareholders.

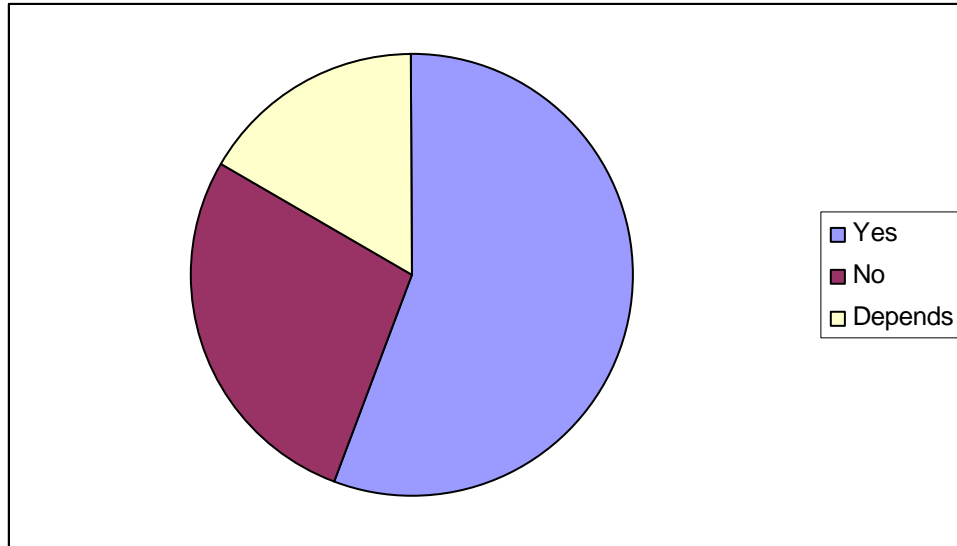
The general perception is that while promoter's fees are acceptable, how they are paid is not. Respondents feel that promoters are only interested in obtaining new investors, taking their profit and then withdrawing. Respondents argue that ideally, promoters' fees should be inequity or shares in the fund, that promoter should be locked in for a specific period and that the fee should be based on the performance of the fund.

The respondents felt that promoters' fees should be based on whatever works best for the company as there is a common pricing in the market; if the pricing is broken down between the different funds, you get to a similar answer. For instance, a charge 0.5% of enterprise value and enterprise value being the market cap + the net, other companies might charge 0,25% but then they charge a transaction fee or a capital movement fee. Many companies charge the same amount as there are very small differences in the industry.

4.6 DIRECTORS' DEALINGS

Should individuals be allowed to hold numerous directorships?

“You cannot legislate on human behaviour as people are either inherently honest or dishonest.”

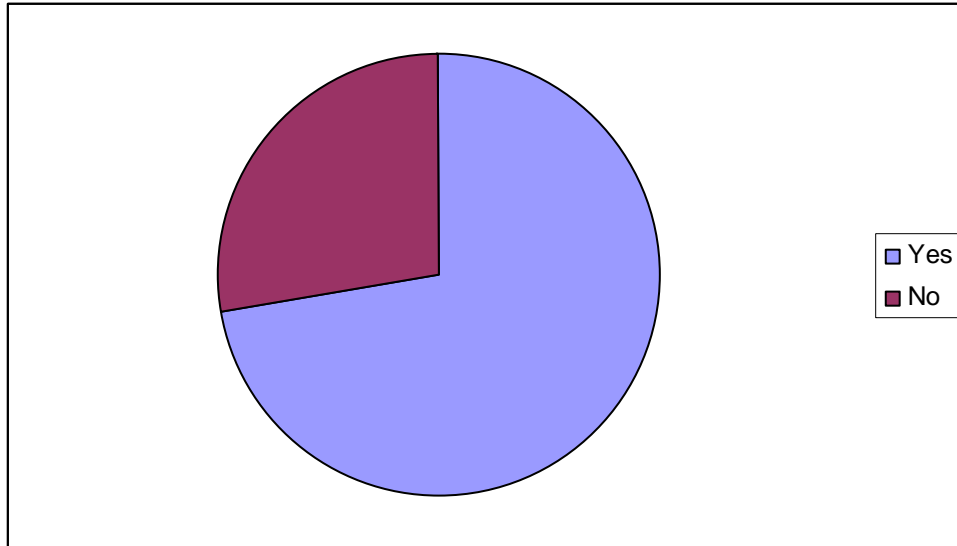


The majority of the respondents felt that due to the skills shortage in South Africa, directors should be able to sit on multiple boards. The issue that was raised was that a person's behaviour stems from an individual's integrity, how they conduct themselves on the numerous boards and how they manage the conflicts.

If directors act responsibly and are accountable for their actions, King 2 would not be necessary. One can stipulate that these are the director's responsibilities and what directors are accountable for. It is not necessary to legislate on human behaviour since how directors interpret a code of conduct is based on how they personally perceive honesty or dishonesty.

Should comprehensive disclosure of direct and indirect transacting with directors be provided?

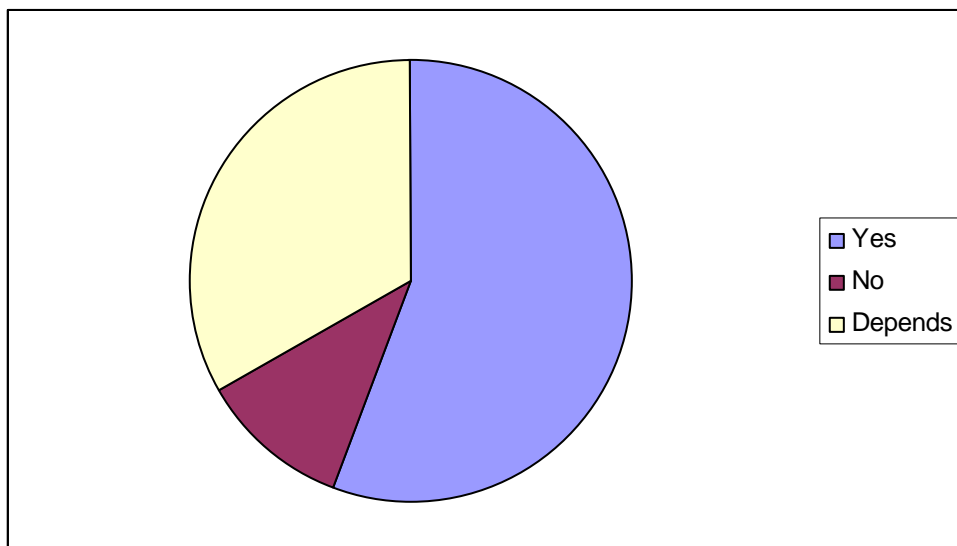
“There should be comprehensive disclosure of any transactions however small or big.”



The majority of the respondents said that all transactions should be disclosed but there was an outlying view that it should not be enforced as the investors are not interested and that it is an onerous task. Enforcing disclosure can become exceptionally cumbersome.

Do incentive schemes align managerial behaviour with the interests of shareholders?

“Those funds where management has a big stake in the funds definitely have a greater incentive to perform well.”



The majority of respondents agreed that incentive schemes would align managerial behaviour with that of the shareholders.

There is a huge debate amongst listed companies whether incentive programmes or share options are more effective. Both options can work but have to be aligned in the interests of the company. Aligning short-term interests with longer term incentives can also lead to abuse, if the focus is to chase the incentive. Like any share scheme, there is a risk attached to it.

It was felt that since all income received in the property industry is paid to shareholders; there is a closer relationship between income and price. However, this can create problems, as happened several months ago when the industry in South Africa was knocked down by 25%. Such problems can occur in the short term when there is a disparity between price and income, but in the long-term, there is a very close relationship between the two.

One school of thought is that management should be given shares, which puts them in exactly the same shoes as an investor. However, the down side to this approach is that share movements are not always related to management performance; they can also be simply due to the market. Another approach is recognising that investing is a long-term process, and since managers are employees by definition, they cannot be expected to go without income for several years in the hope that, in time, the share price will increase and they will then be rewarded.

It is difficult to map the two concepts as incentive schemes are seen as remuneration. A manager or director is paid slightly less than would otherwise be the case and an incentive scheme makes up for the shortfall. If the incentive scheme only performs in four or five years, the individual has been underpaid for the first two years until that incentive provides value.

Short-term incentives provide short-term results, not necessarily long-term ones.

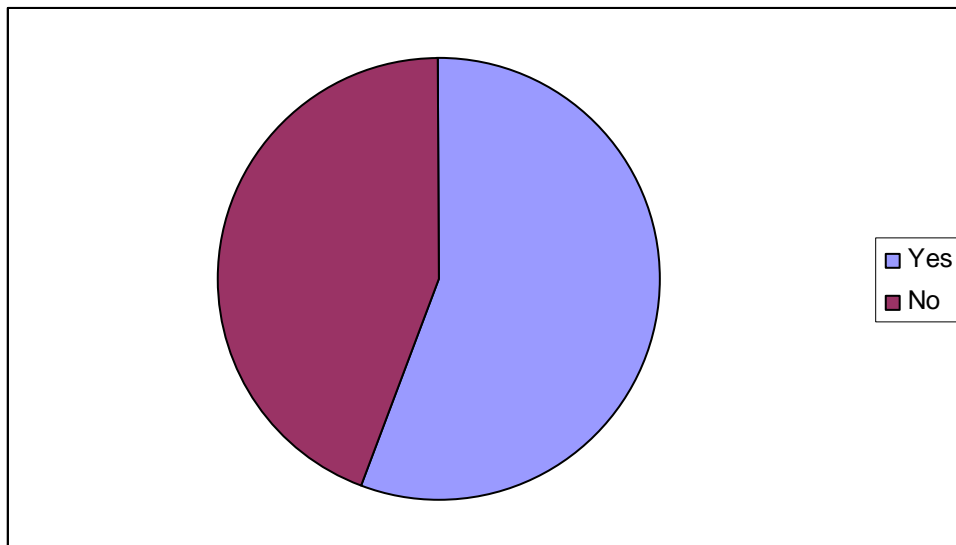
However, markets have dictated that incentives don't affect results. In a large company, it is virtually impossible for management to influence the share price. Respondents felt that all that would happen is that management would stay with the company; feeling happier because they were making more money.

The respondents felt that incentive schemes should apply to managers, rather than directors, as managers are employed to do a job and are paid a fee to do it. There are intermittent share incentive schemes for fund managers which are linked to the share price of the fund. This price can fluctuate, irrespective of whether the manager is performing well or not. The fluctuations of interest rates cannot be legislated on. Essentially, respondents felt that incentive schemes are effective. When management has a large stake in the funds, it has a greater incentive to perform well. Internal boards managing the interests of the company receive a bonus from the net profit of the company.

4.7 VALUATIONS

Are valuers being pressurised into meeting management's expectations?

“The estimated amount for which a property should be exchanged on the date of valuation between a willing buyer and a willing seller is an arm's-length transaction after proper marketing, wherein the parties had each acted knowledgeably, prudently, and without compulsion.”



Valuation is a critically important issue that goes to the heart of good corporate governance and financial asset management. In the listed property sectors, it is widely recognized that a consistent approach to valuation is needed to ensure a credible South African Property Index. This is depicted in the data collection. Investors, now more than ever, are comparing property investments with competing asset classes such as cash, bonds and equities.

In line with the JSE regulations, it is recommended that where properties are externally valued at least once every three years, the listed property sector should regularly instruct and consult with independent valuers. Adhering to this ensures ongoing unbiased and consistent reporting of valuations. In accordance with the International Valuation Standards Committee, the listed property sector should determine the market value of every property,

Respondents stated that valuers have recently come under pressure, and there are instances where the cash flow rate exceeds the value. CEOs have then contacted independent valuers to question this. It should be noted that in reality, when a property is put on the market, quotes from three brokers can be 20, 30 or 40% more than the value being placed on it.

In the past, institutions that conducted valuations for investments were not held accountable and were pressurized into giving false information. This caused many investors to burn their fingers, which caused a furore. The industry was eventually forced to deal more openly and governance was put into place to avoid future miscalculation. In the UK and US, valuers can be sued for over or devaluing assets.

Today, property values are well audited and no one benefits from dramatically increasing the value of the investments to impress their shareholder and board of directors. Most funds prefer to have half the portfolio valued externally for transparency and compliance with corporate governance. Audits are done externally to give credibility to the investors that the company is not improving their results artificially.

Respondents felt that by creating transparency and giving cognizance to investors, the listed property sector is now an interesting investment. It is now a bond with a potential for growth. What analysts are looking for today is market growth, annual reports and long leases. They can now put a price to a portfolio, which is redefining the sector's strategy on transparency.

Today, everyone in the property industry believes that valuations over the past few years have been too conservative, which explains the premium. The board works with the valuer in a valuation committee to discuss values, however, in the end; it is the valuer who makes the final valuation. The committee can only explain why it wants a property valued for a certain amount.

Respondents stated that the issue again boils down to managers, and how they are checked upon. The property market generally increases by 8%, so if a property is re-valued at 30%, the market does not take the market seriously.

Another respondent's view was that management should be allowed to value their own properties as valuer adds no value. *"I don't have to have valuers tell me what my assets are worth," said one respondent. "The markets tell me what my assets are worth every single day"*.

A respondent stated that valuers value a property differently depending on the circumstances. A valuer will come up for a different figure for a property if it is owned by a company that has no gearing than if it is owned by a company that is heavily geared. This is associated with the greater risk of being sued by the company that is heavily geared.

Respondents argued that valuations should be performed by external valuers and that new valuers should be selected every three years. This does not increase the cost in any way and ensures that expenditure is well spent.

Furthermore, the market has to go through the cycle. In a bull market it will be undervalued and in a bear market, over valued. This is because in their valuations, valuers do not always adjust the inputs as often as the markets changes. For example, a valuer might use an older 20% risk pre rate, when in fact it has now dropped to 7%. To be useful, the valuations need to be market related.

4.8 CONCLUSION

This chapter has provided insight into the protection of shareholders interests in the listed property funds in South Africa. The conclusions linked to the evaluation and discussion of results and the testing of the three research propositions are discussed in Chapter 5.

5. CHAPTER FIVE: CONCLUSION

5.1 INTRODUCTION

In this final chapter, the three broad propositions formulated at the start of the research are tested against the findings in Chapter 4. The chapter concludes with areas of further research.

5.2 STRENGTH OF SUPPORT FOR RESEARCH PROPOSITION 1

The South African listed property sector governance mechanism is reflective of international standards. (International market)

From the results presented in Chapter 4, it was clear that, broadly, the governance mechanisms in the South African listed property sector are not reflective of international standards. This is due to a number of factors.

International investors are more vigilant about corporate governance than local ones, especially after scandals such as Enron. However, it is unfair to say that the South African listed property sector is not reflective of international standards when, on paper, Enron was compliant.

The literature defines corporate governance as a process that reveals the transformation that take place in power mechanisms. Corporate governance, as a whole, is part of a bundle of governance mechanisms that are still being finalized in South Africa. Internationally, the governance mechanisms are in place, yet certain forms of governance appear to be more successful than others. Locally and internationally, governance is the object of incessant compromise within an organization, which must always be renewed.

The only factor that respondents felt were reflective of international standards was that of directors' dealings. The evaluation and discussion of results in Chapter 4 made it clear that human behaviour could not be legislated. The Enron scandal was a perfect example

of a company that adhered to all corporate governance regulations but where the ethics and integrity of the directors was totally lacking. This could happen anywhere in the world. While corporate governance is broadly defined as the body of principles and rules that guide and limit the actions of directors, it cannot stop a dishonest director from ignoring corporate governance rules.

The findings also suggest that the board framework doesn't reflect international standards in that the international market has the breadth of skills to ensure that its framework is consistent with corporate governance best practice.

The study suggests that the South African listed property sector's local structure, of both PUTs and the PLSs, is also not reflective of international standards. It is difficult for shareholders to have confidence in the local market because it is not transparent. However, the literature suggests that corporate governance in REITs is not necessarily any better.

The study also concludes that the local valuation of the South African listed property sector does not reflect international standards. International standards are more advanced due to the industry following one standard.

5.3 STRENGTH OF SUPPORT FOR RESEARCH PROPOSITION 2

The South African listed property sector governance mechanisms protect shareholders interests. (Shareholders interests.)

From the results presented in Chapter 4, it was made clear that, broadly, the governance mechanisms in the South African listed property sector do not protect shareholders interests.

The literature states that corporate governance consists of a set of mechanisms designed to protect investors against expropriation by insiders and management. South African

listed sector governance mechanisms protect shareholders interests in certain areas. At the moment, the industry tries to adhere to the rules and regulations but most companies find it difficult to do.

The findings also make clear that governance stands in contrast to management. The majority of respondents said that the corporate governance mechanisms were becoming extremely onerous and were hindering companies from focusing on their core business. Another outcome of the research was that all effective decision-making powers fall to those who have capital. However, corporate governance is justified for two reasons:

- There exists a permanent state of conflict between the various stakeholders and shareholders in the firm due to the decision of how wealth should be shared.
- It is impossible to predict every conflict that will arise.

The board framework is important in ensuring that the governance mechanisms protect shareholders. The literature states that the board of directors is an important organisation mechanism in monitoring and disciplining the management's activities. The number of outside directors on the board is an indication of the board's independence. The outside directors play an important role in resolving agency problems between management and shareholders.

The local structure of the listed property sector of both the PUTs and the PLSs are made to adhere to certain governance mechanisms that protect shareholders. The current structure is not transparent which makes it difficult for the governance mechanisms to protect shareholders interests.

Another issue that was raised in Chapter four was the incentive structures that could assist in aligning management with the shareholders. It is difficult for investors to force fund managers to pick a suitable managerial action. Investors can only set appropriate incentive structures that will condition the management's utility to the observable

variables, and thus eliminate the moral hazard. Incentive contracts are a widely used strategy to control corporate governance problems. Incentive contracts aim to align managerial behaviour with the interests of shareholders through strengthening the link between managers' interests and corporate performance.

The areas where the South African listed property sector has potential governance problems in protecting shareholders' interests are:

- Board independence and composition
- Managerial relationships between fund managers and the property manager
- Property managers are compensated on the gross income – not net income.

5.4 STRENGTH OF SUPPORT FOR RESEARCH PROPOSITION 3

The South African listed property sector governance mechanisms are reflective of local standards. (Local market.)

The results presented in Chapter 4 suggest that on a broad level, the governance mechanisms in the South African listed property sector are reflective of local standards. This is due to a number of factors.

Corporate governance mechanisms have improved dramatically in the listed sector. Existing legal remedies, such as the Companies Act, the JSE listing requirements, are forcing companies to comply. The King 2 Report on Corporate Governance, moved to a triple bottom line, which embraces the economic, environmental and social aspects of a company's activities. The South African listed property sector governance mechanisms are partially reflective of local standards as they partly legal and mainly guidelines that companies can comply with if they choose. From the results presented in Chapter 4, it was clear that on a broad level, companies try to adhere to all the guidelines but sometimes fall short. The problems arise when South African companies comply with the minimum standards but make little headway in revealing the finer details of the more sensitive and important business issues. One of the key reasons for this is the lack of

shareholder activism in South Africa compared with other countries.

The literature states that the separation of duties between the managing board of the senior management and the supervisory board representing the interests of the stakeholders in the company ensures a clear cut division in roles with respect to day-to-day management and long run planning. But locally, this has come under a lot of criticism, as key supervisory board members are increasingly seen to be members of a number of such boards and are alleged to maintain only their own interests. However, it has been argued that this system, where banks have greater access to information, reduces transaction costs and increases efficiency.

From the results presented in Chapter 4, it was clear that the South African listed property sector does not have the expertise to have different outside directors sitting on the boards. It was noted that this situation was not adhering to governance standards but it was mentioned that the integrity of the individuals were able to manage the conflicts and that the shareholders interests were protected.

The local structure of the listed property sector of both the PUTs and the PLS's are under scrutiny from the local and international sector and discussions are underway to change the existing REITs structure. One of the reasons for this is to encourage outside investment as international investors do not understand South Africa's existing structures. The question was raised whether a REIT structure would improve South African listed properties corporate governance. The literature states that poor management is not eliminated by adopting a REIT structure. Corporate governance in the REIT sector internationally has been a topical issue. The US REITs have had a stigma of having the worst corporate governance relative to other public companies.

5.5 CONCLUSION

Corporate governance can be regulated and legislated, but what validates and makes it a success is the integrity of individuals whose power it is to enforce it. Human behaviour

and values unfortunately can be. Corporate governance is more about the ethics of the management than regulatory bodies. For corporate governance to be more successful, shareholders need to be more active and exert more power. The board has a major part to play in governance as it has direct influence. The issue of directors having multiple directorships can only be rectified over time as the industry grows, with which will come a larger resource base of qualified experts. The main themes highlighted in the data are transparency and disclosure, which also, could improve corporate governance.

5.6 AREAS FOR FURTHER RESEARCH

The research presented in this report offers a broad view of the protection shareholders interests in listed property funds in South Africa. From this, a number of areas for future research have been identified.

- The valuation mechanisms of the listed property funds in South Africa.
- The protection of shareholders in the South African REITs structure.

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ANNEXURES

Appendix A: Draft Interview Protocol

The proposed interviewee candidates, as listed in the table in Chapter 3, will be contacted and invited to participate in the research. If the candidates are willing to participate, the initial meeting will be set-up at the convenience of the interviewee. Once the research has been completed, the participant will be given a copy of the final document.

Proposed key research questions

Question 1: Does good corporate governance pay?

(Global institutional investors pay a premium for shares of a well-governed company. Is this true of South African investors?)

Question 2: Please give me an understanding of how the structure in your organization is set out, with regards to the board, the asset managers, the property managers and the fund managers.

Question 3: Do you think external Manco's create the potential conflicts of interest by obscuring the disclosure of management remuneration?

Question 4: When it comes to securitisation, traditional models of capital structure are based on the premise that corporate managers always act in the interest of the owners and the primary aim of managers is to increase shareholders wealth. Is this true of South African listed property?

Question 5: Do you think individuals should be allowed to hold numerous directorships?

Question 6: Do you think that debt can be used as a disciplining device that constrains the amount of funds available for managerial opportunisms?

Question 7: What ownership levels are given to the management shareholding as the percentage of shares owned and controlled by the office and directors of the company?

Question 8: Are the shareholders able to influence the way the industry is governed and assist with ensuring the equilibrium of power is equal between shareholders and managers?

Question 9: Do you think the current promoters' fees payment structure aligns the interests of both the promoter and the investor?

Question 10: How can managers assure outside investors that their interests are being looked after and that they will be receiving a fair return on their investment?

Question 11: Do you think that governance in South Africa is adhered to and that it deals with conflicts of interest adequately?

Question 12: Do you think comprehensive disclosure of both direct and indirect transacting with directors should be provided regardless of transaction size?

Question 13: Are valuer's being pressurized into meeting management's expectations?

Question 14: Do asset management fees create an outright conflict of interest by tempting management to "churn" a portfolio for their benefit instead of the fund?

Question 15: Do you find rental collection, board composition and independency, the relationship between fund managers and property managers and property management compensation to be areas of potential conflict?

Question 16: Do you think incentive scheme contracts will help align managerial behaviour with the interests of shareholders by linking managerial decisions with

corporate performance?

Question 17: The two-tiered board system, devised as a corporate governance mechanism, was aborted due to board members sitting on multiple boards of the same industry. Is this not true of South African listed property boards?

Question 18: Is it acceptable for directors and mancos to share in brokers' commissions?

Question 19: King 2 relies heavily on disclosure. Do companies disclose all information?

Question 20: Do board members enforce effective measures to achieve compliance and corporate governance in SA?

Question 21: Do you think that the in-house management structure should benefit the shareholder better than the out-sourced structure?

Question 22: Do you think good governance adds value to the shareholder?

Question 23: Does the existing PLS and PUT structure, which allows for external management companies, obscure transparency?

Question 24: Non-executive directors are often shareholders or representatives of mancos.. Are the interests of the property company or those of the manco being put first?

Question 25: Can shareholders be assured that decision-making regarding the payment of management fees is being made in their best interests?

Question 26: Where directors of the fund are also directors of the property management company, do they objectively assess performance and what role do they play in the negotiations of the property management fee?

Question 27: Are companies making independent decisions with regard to funding when executive directors of banking institutions are on the board?

Question 28: Where are promoters' fees deemed acceptable?

Question 29: Where do you think the future lies for the SA listed funds? Do you think that South Africa will follow the REIT structure?