INTERNATIONAL REAL ESTATE INVESTING

by

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March, 2001

Working Paper #371

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As a freshman college football player, I was impressed when I read in a press guide that I possessed "great potential." In my naivete I thought that this meant I would be a top-notch college player. However, as I read the press guide more closely I realized that the word “potential” did not appear in the descriptions of the really talented players. “Potential” was just the press guide’s way of saying, “He doesn’t really have enough talent to play but we’re too polite to tell him.” This memory comes back to me as I consider the "great potential" of investing in international real estate.

The attractions of international real estate investing are both obvious and alluring. Perhaps as much as 60 percent of investment-quality real estate lies outside the U.S. This real estate is occupied by a rapidly globalizing tenant base, and is financed by capital sources that are increasingly international and integrated. In addition, the prevalence of large, passive owners such as banks, insurance companies, corporate real estate users, and government entities outside the U.S. makes these markets appear ripe--U.S.-style-- for entrepreneurial real estate investors and operators.

In spite of these attractions, most efforts to create truly global property investment portfolios have fallen short. Notable disasters include JMB’s acquisition of Ranstad (U.K.), Mitsubishi Estate’s acquisition of Rockefeller Center, and the expansion of Rodamco. In analyzing why such disasters have occurred, a number of problems with international real estate investment become apparent.

A major problem is that most foreign property markets are not markets in any meaningful sense of the word. Properties rarely if ever trade; information is scarce, distorted and self-serving; many properties are overtly manipulated by (often corrupt) governments; there are only a limited number of capital sources; and, the rules of the game frequently change, often in mid-play. The result is markets with a high degree of uncertainty and inefficiency.

At first blush these inefficiencies appear attractive to “smart” operators, who see an opportunity to realize abnormal returns. On closer inspection, however, these inefficiencies reduce property values and severely limit exit options. When market inefficiencies create excessively high property values, it is hard to harvest one’s profits as exit is difficult due to market illiquidity. In fact, many markets are so inefficient that no reliable exit options exist. The inability of investors to short the market in order to to pressure property values downward when property values are excessively high means that markets can remain out of balance for prolonged periods. Even entering inefficient markets opportunistically during periods when property values are below economic levels is risky as property values may remain depressed for prolonged periods of time. These risks are particularly severe for outsiders entering markets that possess little in the way of legitimate legal infrastructure.

THE CAPITAL SHORTAGE MYTH

It is commonly believed that foreign real estate markets generally experience shortages of capital. In fact, major foreign markets such as London, Paris, Frankfurt, Madrid, Milan, Zurich, and Amsterdam are no different from New York City, Chicago, and Los Angeles: there is too little capital available 1-2 years out of every 10 years, too much capital 2-3 years out of every 10 years, and the majority of the time the supply and demand for real estate capital are roughly in balance. This is hardly surprising, as all major markets

possess substantial financial institutions and participants with a relatively high level of financial sophistication.

The fact that major foreign markets in developed countries are generally in capital supply balance presents a severe problem for outsiders looking to enter, who must possess either a significant value-added operating ability, or access to “hidden” deals, in order to realize above-average returns. Unfortunately, an outsider rarely has access to “hidden” deals, which are generally parceled out to favored insiders with longstanding relations to the country’s major financial institutions. In addition, it is difficult for new entrants to add substantial economic value to a property in ways that are not also available to top-quality domestic operators. A notable exception is when a major U.S.-based tenant expands into a foreign market and the operator’s established relationship with this tenant provides significant value-added ability.

When there is too much capital in major markets, outsiders are welcomed to buy--even in many relatively closed markets. The best evidence of this phenomenon is the inflated price that has been paid over the past twenty years in numerous markets by oil money, thieving third world potentates laundering money, and hapless Japanese investors. Frequently, the smartest locals have sold their prized assets to such outsiders, often repurchasing these assets when the overpaying buyers are squeezed during periods of capital shortages.

Well-developed local infrastructure and information networks are essential to exploit opportunities created by capital shortages. In periods when there is too little capital in real estate markets, it is usually the smart locals--not outsiders--who are the first to spot the best opportunities. Generally, only as a long-depressed market exhibits some upward momentum do outsiders enter, frequently too late to realize the best investment opportunities. A notable exception is when some U.S. opportunity funds have successfully utilized their networks to invest in major markets experiencing temporary capital market shortages. Their experiences in England, France, and Sweden suggest that often these smaller markets experience briefer capital shortage periods than is the case in the U.S.

THE LAND OF THE RISING SUN

The problem of supporting the overhead associated with maintaining an operational and investment infrastructure during times when the markets are not experiencing capital market shortages is paramount. This is why opportunity fund investments have been done primarily through local partners Only in the largest and most liquid markets can internal organizations be justifiably supported. In this regard, Japan presents a major challenge. The cost of establishing a Tokyo office is very high while the transaction velocity remains very slow. Japan, particularly Tokyo, is a unique situation where real estate has been overvalued for almost two decades. As a result, just as only Japanese investors are willing to invest in Japanese government bonds that pay effectively zero interest rates, only Japanese capital sources have been willing to invest in Japanese properties.

Although Japan is a wealthy, high-income country with a large and diverse property pool, the economic outlook remains murky, and a great deal of structural realignment is necessary before its economic vibrancy will be achieved. Real estate returns available in Japan generally are still too low to justify substantial investments

given the lack of transparency, illiquidity, the stagnancy of the economy, and continued low yields. Even though property prices in Japan have fallen by 50-90 percent from their peaks, yields remain in the 5-8 percent range, and even a billion dollars of investment does not go very far in terms of creating a substantial operating base. The main investment opportunities in Japan remain the purchase of distressed loans. These investments are less real estate plays than an exercise in the restructuring of bank debt, where knowing which investors are capable of buying back their notes at restructured terms is more important than the ability to add value to the real estate via operations.

Although Japan is a large, well-developed economy, it will be a long time before there is substantial foreign ownership of real estate. Japan remains insular, with a strong bias against outsiders and deep-rooted socialist tendencies. While it is slowly changing, other parts of the globe will attract foreign real estate investment more quickly.

A RISKY WORLD

Real estate capital is almost always scarce in places where there is high political risk, high economic risk, and an absence of markets with meaningful exit opportunities. Extreme examples are Iraq, Sierra Leone, and Zimbabwe. More relevant examples to investors include South Korea, Thailand, the Philippines, central and eastern Europe, and most of Latin America. While each of these areas offers high returns, each also poses serious risks. For example, although South Korea has experienced a strong rebound from its economic collapse, considerable risk remains in its real estate markets due to the need for substantial structural reforms. These include the elimination of many of the weak subsidiaries of the major *chaebols*. Many of the *chaebols* have attempted to sell some of their secondary properties at 12-15 percent cap rates on 5-year sale-leaseback terms. The buildings being offered are generally new but located in secondary locations, and are occupied by the weakest subsidiaries of the *chaebols*. Even at these yields the pricing for these deals remains unattractive. If South Korea continues its rebound and the subsidiary tenant survives, the buyer will only realize a 12-15 percent return (before taking into account currency risk) as the tenants execute their repurchase option in year 5. If the economy flounders and the weak subsidiary fails, the property (and many others) will remain vacant for some time. In this case, the cash flow will disappear, the repurchase option will not be exercised, and the owner will be stuck with a building in a secondary location with no obvious tenants. Since many of the weakest subsidiaries are in businesses that should never have existed in South Korea, the odds of numerous subsidiary failures are substantial. It is not worth the risk of purchasing these properties merely to receive a 12-15 percent return on an illiquid, low credit-quality “debt” instrument if all goes well, and having to manage a disastrous investment in a foreign country if the subsidiary fails. As in Japan, a substantial loan workout opportunity exists in South Korea in purchasing and restructuring distressed loans. Again, this is a loan restructuring business rather than a real estate business.

In a similar vein, Thailand, Indonesia, and Malaysia are all experiencing shortages of real estate capital. However, these shortages are caused by the multitude of risks presented by these economies. Thailand is the strongest of these economies, but also has experienced the greatest real estate excesses prior to the recent collapse. As a result, a vast quantity of empty (often partially completed) speculative properties remain to be

absorbed. Even when they are occupied these properties will not generate sufficient cash flows to justify their construction costs for many years to come. Further, many of these properties are so poorly conceived, located, and executed that they will never be finished, much less occupied. In addition, the business climate remains non-transparent. While the legal infrastructure has improved, it will be a long time before Thailand achieves an effective functioning real estate market.

Indonesia and Malaysia also experienced enormous real estate excesses prior to their collapse. In fact, to a large extent these excesses were a major cause of their economic collapse. In addition, these weak economies have effectively cut themselves off from the mainstream of global capital flows. Add to this the ethnic conflicts and political discontent that bubble beneath the surface in both countries, and it is clear that substantial real estate investments--at almost any price--can only be justified in the most extraordinary situations.

THE OLD SOVIET EMPIRE

The former Soviet Union offers a number of intriguing opportunities for global real estate investors. Unfortunately, the heart of the former Soviet Union, Russia, remains an undesirable location for real estate investors. It is a country where people believe that the road the riches lies in stealing from others--particularly the government and one’s partners--rather than by adding value. As a result, newly arrived foreign investors are viewed as prime opportunities for exploitation via fraudulent contracts, self-dealings, and other nefarious acts rather than as partners for value-added operations. The near-term prospects for the Russian economy remain, at best, uncertain while the Russian political and judicial systems show only the faintest signs of evolving into those of a modern liberal democracy. As a result, Russia remains an investment target only for those who are both politically connected and have deep pockets--and strong stomachs.

In contrast, Poland, the Czech Republic, Hungary, and the Baltic states all have undergone considerable economic reforms. They are all rapidly evolving into modern liberal democracies, have turned their backs on Russia, and are showing strong commitment to joining the European community. These countries will continue to integrate into mainstream Europe over the next 10-15 years. However, these countries present two clear difficulties for most global real estate investors. First, with the exception of Poland, they are relatively small. As a result, it is difficult to establish the critical mass of local operations necessary to justify the costs associated with researching the markets, mastering legal and tax structures, etc. Nevertheless, global tenants are rapidly expanding into these countries and demanding global quality space, presenting the opportunity for U.S. real estate operators to leverage their relationships with these tenants.

A second major difficulty faced by foreign real estate investors in Eastern Europe is that for almost a half century the location of commercial, industrial, and retail nodes was arbitrarily fixed by the Soviet planning system. Only over the past decade have market forces been gradually establishing where these activities will occur. However, the transportation and residential infrastructure established by the Soviet system will remain major constraints on the evolution of these markets for many years. As a result, in most cities the ultimate location of the prime residential, commercial, industrial, and retail

nodes remains unclear. This substantially raises the risks associated with real estate investments in these markets. In addition, these markets possess few--if any--high quality properties, even a decade after the end of the Soviet empire. Thus, foreign entrants into these markets must assume risks associated not only with real estate, tenant quality, politics, and economics, but also with development. Development risks are compounded by the fact that the political infrastructure required to deal with development is in its infancy. Further, the depth of demand in these markets is uncertain. This phenomenon is often ignored by investors and is vividly displayed in Warsaw, where in the mid-1990s developers were attracted by the very high rents being paid by a very small number of international tenants. These developers calculated that at these rents they could build to western European standards and achieve substantial returns. Unfortunately, as these properties have come on-line developers have discovered that there are few tenants who are willing to pay the required rents. Stated differently, developers developed Mercedes quality properties for a market of Chevy consumers.

The integrating economies of eastern Europe offer the attractive investment bet that over the next decade,although rents may fall over time as new construction continues to bring quality space on the market, the economic integration of these markets into western Europe will result in notably lower cap rates. The bet is that cap rates will fall by more than rents fall over the decade, yielding attractive returns, particularly where leverage is available. If these countries successfully become part of an integrated European economy, Warsaw, Prague, and Budapest, will price at cap rates similar to those found in secondary western European cities, such as Barcelona, Dublin, and Lyon. This would mean that cap rates would fall to roughly 7 percent from their current 10-12 percent levels.

SOUTH OF THE BORDER

Latin America is a very fragmented region, under the shadow of inflation and the return of military dictators. The fear of inflation is analagous to the fear of the Great Depression held by the generation of currently retired Americans, that is, real estate is viewed as a unique asset which provides substantial protection against inflation. In Latin America, this attitude generates real estate prices higher than justified simply on the basis of supply and demand, as many wealthy local investors are willing to pay a premium for the inflation protection offered by real estate. For example, frequently local investors purchase condominium interests in commercial properties or fund new development at returns well below those demanded by foreign investors.

In Argentina, Brazil, and Chile, there are properties yielding 12-15 percent U.S. equivalent returns on investments. But it is difficult to generate returns on equity above these levels due to the absence of long-term debt that is the outgrowth of the political and economic uncertainty of these economies combined with their history of runaway inflation. As a result, most U.S. real estate operators find the risks too high relative to the returns on equity which are available elsewhere, while opportunity funds cannot access sufficient debt to leverage their returns into the range required by their investors.

The most robust investment opportunities in Latin America are in Mexico, where the strong U.S. economy powers the industrial sector. In addition, the recent election of a central-right opposition candidate as President underscores the emerging political

stability of the country. In many ways the industrial zones of the Mexican border and the southeastern U.S. are becoming a single economic region.

THE UNITED STATES OF EUROPE

Most cities in western Europe have an excess supply of real estate capital. This is the result of the low returns on equity that remain acceptable to European--particularly French, German, and Italian--banks and insurance companies. These low returns on equity, and the willingness of German open-end fund investors to accept 4-5 percent returns, have fed capital into European real estate as a favored investment class with low yields. This is reflected by the homogeneity of returns in major urban property markets, where high quality properties trade at 5-6 percent cap rates even though the lease structures, the growth prospects, asset liquidity, and tenant quality are very different. Perhaps the most interesting example of this phenomena is Paris, where top-quality office properties trade at 5-6 percent cap rates in spite of the fact that standard leases are 9-years, indexed to the CPI for construction cost, can be broken by the tenants every third year, and give the tenant an absolute right of occupancy at the end of year 9. This lease structure means that if market rents fall, tenants will break their leases every third year, producing returns less than 5-6 percent. Alternatively, if rents rise substantially over the term of the lease, tenants will remain in place and rents will rise only 1-2 percent annually. Active investors in Paris tell themselves that they will receive big rent bumps at the end of the lease, however, this seems to be somewhat wishful thinking, as France remains a fundamentally socialist country. These socialist tendencies make it doubtful that, if market rents tripled over the term of the lease, rents would be allowed to triple at the expiration of the lease.

Observers of western Europe are excited by the unification of European currencies, as well as the integration of economic and regulatory activities. They see the potential for enormous growth driven by integration and the collapse of local protectionism, increased competition, reduced regulations, privatization, and reduced taxes. However, they ignore the flip side of the Euro. Perhaps the most difficult question facing real estate investment in western Europe is how the “local hero” problem will be resolved. For many years, each European country protected its banks, telecommunication companies, automobile companies, airlines, power companies, etc. in order to safeguard jobs from competition--and gain votes. This means that every country houses the headquarters of a carmaker, electronics firm, major telecom, bank, etc.--the local hero--in its major cities. However, as these countries (including portions of the former Soviet Union) continue to integrate, not every country will be able to have a major telecom company, a major electronics company, a major automobile company, etc. In fact, many of these local heroes will be completely eliminated by global competition, while others will be forced to consolidate. As a result, while some cities will see enormous demand growth for headquarters offices, much of the space currently occupied by these noncompetitive local heroes in almost every major European city will be vacated. A similar phenomenon took place in the U.S., when the banking industry, the telecommunications business, electrical supply companies, etc. moved, shrank, or disappeared from many cities, while rapidly expanding in others.

The local hero problem will be exacerbated by political pressures to stop "globalization" since Europeans are generally reluctant to move within their own country, much less across countries. It is difficult enough to move from Cleveland to Dallas, but many times more difficult to move from Copenhagen to Madrid, which involves a change in language, business cultures, governmental structures, tax systems, and legal protections. Western European real estate investments should carry a risk premium for this local hero risk as it remains unclear which cities will winners or losers in this competitive process. Instead, we see premium pricing for real estate cash flows driven by the availability of capital at local hero banks and insurance companies which are allowed to remain in business by protective governments and corporate governance structures in spite of noncompetitive returns on equity. When these financial institutions are required to achieve higher returns on equity, the adverse reverberations on property prices will be felt throughout European property markets.

FOREIGNERS ARE NOT DUMB

It is often assumed that foreigners are not as smart as U.S. real estate operators. While in many countries local real estate operators are not as adept at sophisticated financial analysis and at the slicing, dicing, and reslicing of real estate cash flows, this is more than offset by the fact that they are intelligent, well-educated, and more importantly, know the rules by which real estate markets operate in their country. And the knowledge of how these local markets work is much more important than in the U.S., as the rules of the game and of transactions are much less predictable and transparent. Not unlike the "old days" in the U.S., local operators generally have a cozy relationship with a friendly local financial institution. In fact, in many cases these operators are the major local banks and insurance companies acting directly as real estate investors. They may not be as nimble or as customer-friendly as the more entrepreneurial U.S. real estate operators, however, tenants in most foreign countries are dominated by large, governmentally influenced institutions, making it more difficult for entrepreneurial U.S. real estate operators to achieve the necessary prestige and clout.

LOCAL PARTNERS

One of the most difficult questions faced when deciding to enter a local real estate market is whether to use a local partner. Local partners bring a wealth of knowledge and expertise. In addition, they know the rules of the game and the major players, as well as which properties have historically been duds (and why). However, these partners generally operate within a different institutional framework than major U.S. real estate operators. They have generally been more reliant on governmental and institutional contacts and inside deals, and less reliant on detailed financial analysis and carefully conceived exit strategies than their U.S. partners.

Particularly in less developed markets a strong local partner is attractive because of extensive contacts and their ability to "make it happen." But this ability often rebounds on the foreign investor when the local partners turn their attention to "making it happen." All too often foreign investors find that their local partners use their powers to restrike their partnership, and that there is little that can be done to stop them. In many markets,

particularly less developed economies, the strength of local partners can change very quickly. Perhaps the best example is that for years the Suharto family was the ultimate local partner in Indonesia. Yet overnight they became a liability. Even in more developed and stable economies, this problem exists due to the greater role played by governments.

The alternative to a local partner is to purchase or build a deep local infrastructure. This allows the foreign investor to control his culture and incentive structures, but requires a much greater commitment of capital and managerial effort. Few real estate investment companies can afford to put in place the necessary infrastructure before they have a business. As a result, most global real estate investors choose to use a local partner initially, building their own infrastructure as they generate a sufficient level of business.

CURRENCY RISK

An important issue facing every international real estate investor is currency risk. It is possible that even if the real estate investment performs superbly in terms of local currency, a sufficiently large adverse currency movement can destroy the investment's dollar performance. This risk is not unique to real estate investments, and has been addressed by global corporations for many years. There are several ways that such corporations have historically dealt with currency risks. First, they usually hedge the risks, at least in major currencies, associated with the investment transactions. That is, once a transaction is entered a currency hedge is used to protect against adverse currency movements prior to closing. Such hedges are usually of short duration, and hence relatively cheap. However, in countries with thin currency markets this risk cannot be efficiently hedged, and currency swings between signing and closing are often a contingency for which they may break a deal.

Hedging cash flows associated with the ongoing operation of the properties and the residual value of the asset is much more difficult. This is because even in relatively thick currency markets it is difficult and expensive to hedge long-term currency exposures. Some companies use dynamic hedging models that combine a rolling series of short-term hedges. These models provide adequate hedging coverage on short-term investments but for longer periods their hedging capability greatly diminishes and the expense rises substantially.

An alternative is to underwrite currency erosions that are expected to occur during the investment lifetime process. In the long run, expected changes in currency rates are equal to the difference between expected inflation rates between the two countries. For example, the dollar could be expected to strengthen to the extent that the U.S. expected inflation rate is less than that of the target country. Investors may use the difference in long-term bond rates, adjusted for differences in credit quality, payment mechanics, and liquidity to proxy the differential inflation rates expected by the market. This simple model, while theoretically sound, performs well only in the long run. Even then it is undermined by the fact that inflationary expectations will deviate from actual outcomes. A number of developing countries often quote rents, either legally or de facto, in U.S. dollars in order to offset the volatility and illiquidity of their currency, which greatly reduces the currency risk. However, it does not completely eliminate it because the residual value and the rent renewal cash flows are not in dollars.

The use of local currency debt to partially match the currency exposures of assets and liabilities, thus notably reducing cash flow volatility, is another common risk management technique. Further, to the extent that real estate investors intend to keep their money at work in the country to grow their business, the currency risk is greatly reduced because the returns are made and reinvested in local currency. Thus, even if the currency falls versus the dollar, it still purchases the same amount of new assets and services in the target country. This is the reason why many international corporations do little other than hedge their transactions, leaving their cash flows unhedged, while leveraging in local currency. For most long-term real estate investors this is probably the most efficient long-term strategy.

All of these currency risk management approaches for long-term cash flows are seriously limited. Therefore, the committed international real estate investor must simply accept that currency risks are a part of the risks they accept in order to achieve the performance and diversification advantages of international investing. Currency risks are yet another reason for opportunistically entering foreign markets.

GREAT POTENTIAL?

Will a successful large-scale global real estate investment company ultimately evolve? Despite the perils, the answer is "yes," for the simple reasons that both the tenant base and capital markets are globalizing. It makes sense that banks, automobile companies, electronic companies, accounting firms, and law firms will turn to global space providers. In addition, global capital sources will gravitate to the most efficient real estate firms pulling them into new markets. Further, just as the demise of local banks in the U.S. radically changed the nature of the U.S. real estate market, the demise of local hero banks and life insurance companies will create a demand for global real estate operators who can best service customers and yield the highest returns. As the home of the globalization process, U.S. real estate companies should be among the leaders of this process, and the best opportunistic American firms will ultimately demonstrate that globalized real estate investment is more than just an idea with potential.

[Endnote: This research was supported by a research grant from the National Association of Realtors.]