The Expanding World of Cross-Border Real Estate

The perils and profits of global real estate investing.

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INTERNATIONAL REAL ESTATE investing is moving into the mainstream. By comparison to other financial markets—stocks, bonds, and commodities—real estate capital is just beginning to flow cross-border on a regular basis. The origin and destination of investment capital aimed at real estate now includes a greater number of countries than ever before. The volume of capital seeking cross-border investments is also growing rapidly. Finally, the number of different vehicles that offer access to international real estate has expanded greatly in just the last five years. Although transaction costs are often higher than domestic-to-domestic transactions and international benchmarks can be elusive, the trend toward greater cross-

border movement of real estate capital is as unmistakable as the growing volume of world trade.

Why is real estate capital going cross-border now? What are the principal drivers? How should investors approach the world of cross-border real estate? What frameworks are useful for analyzing real estate opportunities in other countries? This brief essay cannot do full justice to all these important questions, but it can attempt to shed light on some of the answers and de-mystify some of the common misconceptions about cross-border real estate.

LOST IN TRANSLATION

First, it is useful to clear up some common misconceptions. There is little that is "global" about the "world" of international real estate. This is not a "world" that treats all 197 countries tracked by economists at the United Nations, the World Bank, the OECD, and the IMF as equally eligible investment targets. In fact, in terms of the number of countries involved, cross-border capital flows are dominated by a relatively small subset. In recent years, most of the capital willing to move across borders into real estate comes from eight to ten countries and is directed toward 20 to 25 countries. According to Jones Lang LaSalle research, the principal "origin" countries in 2002-2004 were Australia, Canada, Germany, Middle-Eastern countries (including Israel and the principal oil-exporting Arab states), the Netherlands, Singapore, the United Kingdom, and the United States. In terms of global GDP, however, the major target countries represent close to 80 percent of the world's productive capacity. Lack of transparency and secure property rights exclude many of the world's emerging markets from consideration by institutional investors.

Local real estate practices show relatively few signs of convergence, despite the pressures of "globalization." In fact, our research shows that these practices still vary greatly among the 36 highest-ranked countries in the most recent Real Estate Transparency Index produced by Jones Lang LaSalle. Lease contracts, mortgage instruments, and regulatory and tax regimes remain deeply rooted in country-specific traditions and institutions, notwithstanding the growing trend of cross-border investing and the advent of multi-country trade blocks like the Euro-zone, ASEAN and NAFTA. Transparency regarding the nature of these differences is rising, but country-specific real estate practices remain closely tied to long-held institutional frameworks such as: the Civil Law versus Common Law approach to property rights; tenant versus landlord-friendly approaches to lease contracts; and local standards applied to zoning/building regulations.

Tenants (occupiers) have more far-flung international real estate portfolios than investors. For decades, facilities leased and owned by MNCs (multinational corporations) have pushed far ahead of dedicated real estate investment capital flows into emerging markets. Even today, relatively few cross-border investors have international real estate exposures that exceed 10 percent of their portfolios (by value or square footage), whereas many MNCs do. The exception to this would, of course, be investors from Middle Eastern countries, the Netherlands and Singapore where domestic choices are limited.

Unlike the world of stocks and corporate bonds, and more like the world of government bonds and asset-backed securities, cross-border real estate is still very much about "pure-plays" in specific countries. Listed real estate companies have experimented with global real estate portfolios in the past (Rodamco) and the present (Westfield), but by far the most common approach to stock-exchange listed real estate companies and investment trusts is to focus on a single country. A handful of opportunity funds and core/value-add investment managers do have the skills needed to assemble cross-border portfolios, but each asset held in these portfolios is still largely a pure-play in a specific country. Tenants may be international, but the rental income streams are dictated by highly localized market conditions. By contrast, investments in the earnings streams (stocks or bonds) of larger consumer goods, financial services, technology, or transportation companies are inherently international, and give investors easier access to international markets, but also less control over international exposures.

WHY INTERNATIONAL?

The motivations and objectives of cross-border real estate investors vary greatly. They basically can be put into one of two categories: Return Enhancers (seeking premiums to a domestic market); or Risk Minimizers (seeking diversification away from limited or inefficiently priced domestic markets).

At present, the interest in cross-border real estate is growing most rapidly from the Return Enhancer crowd. Record flows of capital aimed at real estate in Australia, North America, and Western Europe have pushed up prices and pushed down yields to levels not seen for decades. As a result, investors have struggled with falling point-forward estimates of domestic real estate returns and so are seeking ways to invest in parts of the world that may offer more attractive risk-return combinations. The notion that all cross-border real estate must deliver opportunistic-style returns

is also giving way to a more sophisticated approach that acknowledges the very different risk-return profiles to be found in the real estate markets of London, Paris, Sydney, or Tokyo, by contrast to, say, Bangkok, Beijing, Mexico City, or Moscow.

The other major reason that more investors are considering international real estate for the first time is that more tools are now available to implement a cross-border program and more investment managers now offer international capabilities. Higher transparency makes it easier to determine required risk premia in far-flung markets. The rapid adoption of dividend-paying Investment Trust vehicles in Japan, Hong Kong, Korea, Singapore, and the U.K. opens up new options in these countries.

After 20 to 30 years of relatively successful forays into international stocks and bonds, asset allocators are now much more open to an international approach to private equity asset classes, such as real estate. Compared to highly efficient securities markets, the relative market inefficiency of real estate pricing in general, and especially of cross-border real estate, gives credence to the claim that it should be possible to find persistent Alpha managers in international real estate. More sophisticated approaches to tax, legal and currency advice make the job of going cross-border somewhat easier than five years ago.

The question, "Why not international?" remains relevant to many conservative investors. Significant obstacles remain. Investors from countries with large domestic real estate markets (like the U.S.) who expect real estate to act primarily as a risk reducer and as a source of steady, contractual income, will be frustrated by the higher volatility brought on by currency swings and the potential for higher transaction costs and a persistent tax drag. The absence of private equity benchmarks with long time series—only five countries have them: Australia, Canada, the Netherlands, the United Kingdom, and the United States—can be unsettling. The recent introduction of private equity benchmarks in many other developed countries does not give some investors the long-term analytical perspective they typically seek.

Cross-border real estate is not for every investor and those with short time horizons will find the currency swings very annoying. The natural hedging ability of a multi-country portfolio held over time or the ability to keep track of international real estate exposures as part of a currency overlay program may be beyond the patience of individual investors, or those who measure their success quarter by quar-

ter, rather than over multi-year periods.

THE KIMCHI MATTERS

Marvin Zonis, a professor of international political economy at the University of Chicago, coined this term to describe the important role that local culture, political regimes and institutions play in determining the success of international investments and cross-border business practices. Taking their cue from the work of "transaction cost or institutional economics," Zonis and the co-authors of *The Kimchi Matters*, describe how important it is to understand the "rules of the game" when investing in other countries. Kimchi, a pickled cabbage salad favored by Koreans, is a metaphor for the cultural differences that persist between countries, even as capital and goods move across borders more freely than before. Those unwilling or unable to take the time to figure out these "rules," and the stability (or lack thereof) of the institutions that enforce these rules, face huge risks.

In recent years, the most rewarding aspect of real estate investing has come from riding the yield compression (or multiple expansion) that accompanies the move of real estate from a marginal to a mainstream asset class in various countries. However, to do this with confidence requires taking the time to gauge the pace of change (from low to high transparency) and the stability of the local legal/political/economic framework that governs real estate.

The imposition of distinctly Anglo-American practices around the world is unrealistic and not necessarily desirable. The transparency and stability of the institutional framework surrounding real estate markets, however, is of the utmost importance to the cross-border investor. A thorough understanding of these institutions and their pace of change holds the key to successful investment programs in less transparent markets. This knowledge is also the key to getting paid appropriately for assuming the risks inherent during periods of upheaval or when property rights are insecure. But the determination of an appropriate risk premium is also useful for stable G-7 countries such as Japan, France, and Italy as much as in the so-called BRIC (Brazil, Russia, India, and China.) and other emerging markets that are expected to dominate incremental global economic growth over the next 50 years.

Whether an investor puts return enhancement or risk reduction as the primary goal of their cross-border real estate program, the principle of setting an appropriate risk premium creates an important investment discipline. This discipline helps

ensure that investors are compensated for transparency and structural risks (alongside market and asset-specific risks) as they move into unfamiliar markets.