The Paradox of Commercial Real Estate Debt

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Executive Summary

With the economic crisis devouring the US financial landscape, debt, specifically real estate debt, emerges as a culprit in the debacle. Reliance on debt financing for real estate has been the lynchpin of the property market for decades. Furthermore, US investors have looked to replicate debt financing as a foundation for real estate transactions when investing in other countries. But true, first lien mortgage debt is not at the heart of the US financial crisis. Rather, the effects of structured finance and derivative securitizations far removed from "plain vanilla" mortgage financing are the contributing forces to the calamity. An aspect of the securitized market that is not involved in the crisis is the equity-like investments in commercial transactions that offer credit support to the debt market-a crucial difference between the residential mortgage market and the commercial mortgage market. This paper examines these offshoots of the commercial securitized market that shares more economic characteristics with equity than with debt. The question presented is whether emerging markets can circumvent the traditional debt route and rely more on these equity-like forms of investment. Pardoxically this equity investment may provide a requisite risk cushion for investors while at the same time avoid the limitations imposed by reliance on debt financing.

One of the many lessons offered fromn the current economic crisis in the US, is that a well functioning real estate market is built upon a robust debt market. Just as access to real estate capital serves as a lubricant to development, lack of capital forestalls entry to integrated real estate markets. In the evolving world economy the marketing of domestic debt products to international investors (and the eventual development of mortgage backed securities investments) is predicated on an established domestic debt market.[2] More likely than not, real

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[2] Kenneth G. Lore, Cameron L. Cowan , Chapter 2. The Public and Private Sectors in an Expanding Secondary Mortgage Market V. New Directions in the Private Sector Mortgage-Backed Securities § 2:24

estate investors in countries with a mature real estate market demand debt financing in a developing country as a perquisite to investment. The irony of this resolute insistence on debt is that in developed countries as the debt market has become interlocked with the secondary mortgage market "hard debt" levels have restrained.[3] The advent of the secondary market for commercial real estate debt has spawned the growth of what I call "disguised equity" financing in several forms including a type of lending commonly referred to as "mezzanine lending".[4] In terms of secured lending mezzanine financing is more risky that mortgage lending but less risky that straight equity contributions. The loan in these types of investments is not secured by the real estate. Rather, it is secured by the owners stake in the real estate firm. Default on the loan allows the lenders to take over the owners equity position in the firm Lenders and borrowers in the United States have entered this mezzanine market when, for example, debt leverage ratios have been constained and availability of mortgage debt is limited. It is interesting that investors will, on the one hand, eschew equity financing and demand that a developing real estate market make available debt financing. Conversely in a highly developed sophisticated market these same investors will participate in a system where quasi-equity financing (in the form of mezzanine lending) provides crucial and significant credit support for securitized debt financing.

As developing economies attempt to position themselves as participants in the international real estate markets, debt financing (or the lack thereof) continues to divide the players from the spectators. In this paper I will first give a brief explanation of the importance of secured debt in real estate financing using the market in the United States as an example. Next I will discuss the foundational requirements for a functioning debt market (legal, economic and

[3] Indeed, one possible saving grace of the commercial real estate market versus the residential market in the US is the limitation on Loan-to-Value ratios. As LTVs continue to erode one questions whether the commercial market will become mired in confusion as has the residential market.

[4] Georgette Chapman Poindexter, Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing, 2 BBLJ 233, 240-1 (2005).

political). The next step in this comparative analysis includes countries that have successfully transitioned out of an equity based market and are now participants in the international sphere (focusing on Poland). The next section provides a comparative analysis focusing on Latin America (specifically Brazil, Mexico and Argentina). Completing the circle (and highlighting the paradox) mezzanine lending will be explained highlighting its equity-like attributes. The final, perhaps not yet answerable, question to be posed is whether a market can "leap frog" the debt market and jump from equity financing straight to mezzanine financing.

A. Importance of Commercial Debt Financing

Financial leverage is the ratio of long term debt to total capital invested.[5] Increasing leverage intensifies an owner's gain or loss through use of borrowed funds. It likewise intensifies risk because net operating income services the debt payment. However, from an investor's perspective debt financing not only allows an owner to diversify a portfolio by investing in several projects but also produces a more attractive cash yield (assuming positive leverage).[6] This is especially true with non-recourse financing which limits the extent of borrower loss to the equity investment.

Debt financing in real estate is almost universally secured by a mortgage. If the borrower defaults the lender has the right to sell the property (foreclosure) and use the proceeds to repay the loan. Securing the loan lowers the cost of transaction by simultaneously increasing the lender's enforcement rights in the event of non-payment and restraining future borrowing that

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[5] Richard A. Brealey & Stewart C. Myers, Principals of Corporate Finance 237 824 (7th ed. 2003)

[6] Developers stretch their borrowing power by using the least amount of their own money in a purchase. See, Jeanne Calderon, MEZZANINE FINANCING AND LAND BANKS: TWO UNCONVENTIONAL METHODS OF FINANCING RESIDENTIAL REAL ESTATE PROJECTS IN THE 21ST CENTURY, 29 Real Est. L.J. 283 (2001) By using borrowed money to fnance the property and investor gets a larger cash yield on equity infusion. For example, assuming a $10 million property with a $1,500,000 net operating income if it is an all cash purchase the cash yield would be 15%. However, if the investor borrows $9 million at 8% interest the cash yield is 67.2% ($672,000 [cash flow after debt service]/$1,000,000 [cash payment]).

may lessen the likelihood of repayment.[7] In essence the real estate fundamentals of a transaction become more predictable thus decreasing the overall risk. Obviously the ability to recoup the collateral is crucial in structured financing.[8] As will be discussed later in this paper this reliance on debt financing is constrained in developing markets for many reasons including past financial crises and economic/political instability.[9]

a. Origins of the US Mortgage Debt Market

While mortgage law in the United States certainly has its roots in British jurisprudence, significant differences emerged during the infancy of the US law.[10] Generally speaking, American mortgage law is anchored on the notion of the granting of a security interest in the land rather than a conveyance of title and thus limits the lender's right to pre-judgment possession.[11] As one commentator has noted, a borrower's equity right of redemption illustrates the US courts' reluctance to transform the essential debt relationship into a fee interest.[12]

Prior to the 1930s the mortgage lending was relatively constricted. High loan to value requirements and short amortization periods limited borrowers' access to capital.[13] Central government market intervention, however, changed the landscape. In 1934 the Federal Housing Authority was created to spur the residential market. In 1938 the Federal government created the Federal Housing Administration to insure mortgage loan repayment and thus reduce risk of

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[7] Explaining Pattern of Secured Credit, 110 Harv. L. Rev. 625, 683 (1997)

[8] Rating agencies enhance the rating of a security that is collateralized. Petrina R. Dawson, RATINGS GAMES WITH CONTINGENT TRANSFER: A STRUCTURED FINANCE ILLUSION 8 Duke J. Comp. & Int'l L. 381, 382-3 (1998)

[9] Malcolm Knight, Developing and Transitional Countries Confront Financial Globalization, http://www.imf.org/external/pubs/ft/fandd/1999/06/knight.htm (last visited April 22, 2008)

[10] Ann M. Burkhard, LENDERS AND LAND, 64 Mo. L. Rev. 249, 257 (1999).

[11] Ann M. Burkhard, LENDERS AND LAND, 64 Mo. L. Rev. 249, 257 (1999) *citing* various statutes and case law

[12] Andrew R. Berman, "ONCE A MORTGAGE, ALWAYS A MORTGAGE"-THE USE (AND MISUSE OF) MEZZANINE LOANS AND PREFERRED EQUITY INVESTMENTS, 11 Stan. J.L. Bus. & Fin. 76, 86-88 (2005).

[13] LTV generally were 50-60% on first mortgages. Dan Immergluck & M.E. Sharpe, CREDIT TO THE COMMUNITY, 2004 p. 36.

default for the originating lenders.[14] This reduced risk led to banks requiring a smaller down payment and permitting a longer loan repayment period.[15] Capital flowed quickly into the residential market. In 2007 the residential mortgage market stood at US$2.39 trillion.[16]

Likewise there has been astounding growth in the commercial real estate market. From approximately US$147 billion in 1970 the market grew to US$402 billion in 1980 and in 2007 grew to US$3.2 trillion.[17] Growth in the commercial market, like the residential market, was fueled from central government intervention. In 1990 most of the US$1.1 trillion mortgages were held by financial institutions. In response to the debt crisis the US government created the Resolution Trust Corporation that securitized commercial mortgages owned by traditional lenders. Between 1991 and 1995 the RTC securitized US$18 billion in loans (US$14 billion in the first two years). This restructuring of the loan income flow opened the doors of Wall Street finance to local real estate markets. Private investment companies entered the market further fueling it growth.[18] In 2007 28% of the $3.2 trillion mortgage market was held in CMBS and other pools.[19]

Currently, the repercussions of a seizing residential mortgage market ripple through the economic crisis that continues to grip US and international financial markets. These economic

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[14] Michael H. Schill, THE IMPACT OF CAPITAL MARKETS ON REAL ESTATE LAW AND PRACTICE, 32 J. Marshall L. Rev. 269, 270 (1999).
[15] Ann M. Burkhard, LENDERS AND LAND, 64 Mo. L. Rev. 249, 272-273 (1999).
[16] MBA Research Monograph Series, "The Residential Mortgage Market and Its Economic Context I 2007, available online at http://www.mortgagebankers.org
[17] CMSA Compendium of Statistics, Updated 2/15/08 available on line at: http://www.cmbs.org/IndustryResources.aspx?id=5640&ekmensel=c580fa7b_70_72_5640_4

[18] Georgette C. Poindexter, SUBORDINATED ROLLING EQUITY: ANALYZING REAL ESTATE LOAN DEFAULTS IN THE ERA OF SECURITIZATION, 50 Emory Law Journal 519, 528 (2001).
[19] Federal Reserve Board Flow of Funds cited in: The Role of Commercial Mortgage Backed Securities and Commercial Real Estate Collateralized Debt Obligations in the US Real Estate Finance Market, available at http://www.cmbs.org/IndustryResources.aspx?id=11036&ekmensel=c580fa7b_70_72_11036_5

problems, however, are not condemnations of mortgage securitization as a system but rather cautionary tales of straying far afield from the primary business of sound mortgage lending and accurate risk assessment. Mortgage underwriting criteria that disregard the borrower's ability to repay (so called NINJA loans[20]) portend disaster when these loans are the basis for rating the payment flow to bond holders. The other issue in the current crisis are the dizzying array of derivitives that spun off of the securitization framework each, like a bad photocopy, carrying less and less of the original but still maintaining the fiction of comparable value.[21] It is important to note that throughout all of this crisis, the artifacts surrounding the market that have crumbled (asset backed paper that supported warehousing, spinning off the tranches into CDOs). The fundamental soundness of the underlying mortgage structure is not in question. Securitization of these mortgages awaits originations of solid quality loan product.

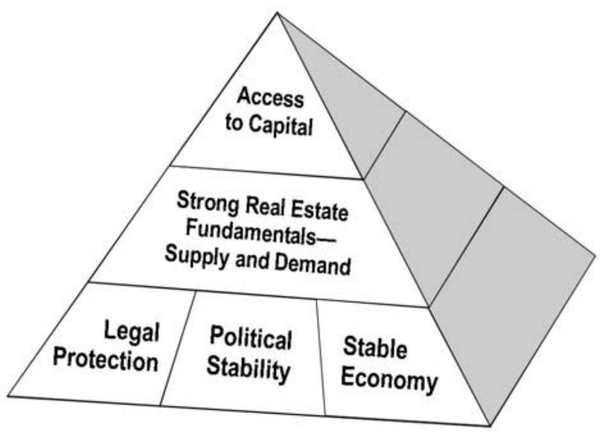
In contrast to the dubious lending scenarios of the residential market, in the commercial loan arena the lasting influence of the securitized market on commercial lending is that the rating agencies pushed down the acceptable loan to value ratio. Whereas the imposition of the secondary market served to raise the residential LTV above the historical 60-70%, this same market pushed down the commercial LTV levels from 80-90% to 65%.[22] Borrowers, due to their unquenchable thirst for leverage (as illustrated above), sought out what has come to be known as mezzanine debt. Mezzanine debt is not secured by the real estate asset. Rather it is secured by the interest in the borrowing entity. Upon default on this debt the mezzanine lender does not foreclose on the asset. Rather the lender "forecloses" on the equity interest of the borrower and takes over the ownership interest—i.e. the equity. This sets up notion of equity as a substitute for

[20] No Income No Job or Assets
[21] For example, Commercial Debt Obligations
[22] Georgette C. Phillips, DEQUITY: CAPITAL STRUCTURE IN SECURITIZED REAL ESTATE FINANCING 2 Berkeley Business Law Journal 233, 235 (2005)

debt. We will return to this idea when discussing the project capitalization pressures faced in developing countries.

B. Foundations of a Functioning Debt Market

A strong market is constructed upon three foundational stones—legal protections, political stability and economic stability.[23] Once this footing is in place market fundamentals can be addressed. Strong real estate essentials of supply and demand will clearly determine the robustness of the market. Translating this market strength into access to capital remains the goal.



a. Legal protections

As one commentator has noted, while economic deficiencies in a particular market may pose transactions costs, legal deficiencies can serve as a complete transactional bar.[24] The ideal legal environment should promote and assure transparency of legal process to achieve stated economic goals thus assuring that the investor receives the benefit of the bargain. Sometimes the

[23] Bertrand Renaud, World Bank Policy Research Paper no. 1565 (1995). See also, Michael Lea, PREREQUISITES FOR SUCCESSFUL SECONDARY MORTGAGE MARKET: THE ROLE OF THE PRIMARY MORTGAGE MARKET, 15 Housing Finance International 2, (December 2000).
[24] Yuliya A. Dvorak, TRANSPLANTING ASSET SECURITIZATION: IS THE GRASS GREEN ENOUGH ON THE OTHER SIDE?, 38 Houston Law Rev. 541, 575 (2001)

underlying legal system itself may pose problems. Civil law jurisdictions rely on formal legal codes more than on equitable principles.[25] In crafting the legal parameters of a new debt market the scarcity and/or uncertainty of precedent may introduce novel challenges. Leaving aside the potential primary limitations of a given legal environment, a functioning mortgage market relies on transparency of rights in several fundamental spheres, namely: title, landlord/tenant and foreclosure.[26]

Title registration identifies the mortgaged property and assures ownership. An owner cannot pledge an asset where title is up for conjecture. Title problems are fatal flaws as the ownership of the property must be unassailable in order for the risk to be correctly underwritten. Countries with historically bad land title records (whether through political regime, such as communism, or through sheer inadequacy or corruption) struggle to construct an effective mortgage market.[27]

Likewise predictable landlord tenant laws bolster the mortgage market. In a commercial loan the lender underwrites on the basis of future and in place Net Operating Income (NOI). This NOI is generated through rents and leases in the property. Fluctuations and uncertainty in the

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[25] Petrina R. Dawson, RATINGS GAMES WITH CONTINGENT TRANSFER: A STRUCTURED FINANCE ILLUSION 8 Duke J. Comp. & Int'l L. 381, 384 (1998). For this reason civil law countries are less successful at implementing asset securitization than common law countries. *See*, Lina Aleknaitë, WHY THE FRUITS OF CAPITAL MARKETS ARE LESS ACCESSIBLE IN CIVIL LAW JURISDICTIONS, 5 DePaul Bus. & Com. L.J. 191, 194 (2007) a*ccord*, Chiquier, Hassler and Lea, MORTGAGE SECURITIES IN EMERGING MARKETS, The World Bank (2004) p. 33., ("The development of a satisfactory legal framework for mortgage securities is often complex and time consuming (often requiring further amendments) notably in civil code legislative environments where the concept of a trust may be missing as a convenient, flexible and bankruptcy remote special vehicle to issue mortgage backed securities.")

[26] Naturally other areas such as tax law, bankruptcy law and securities law are important but these areas operate above the basic requirements noted here. For the importance of these other areas see, Transplanting Asset Securitization at 552.

[27] Hernando de Soto, Law and Property Outside the West: A Few New Ideas about Fighting Poverty, NUPI 349-61, December 2002 (Arguing the lack of property recording systems results in undervalued capital assets and hinders finance; discussing Peru, Indonesia, Haiti, Argentina & Russia); Dwight Jaffee & Bertrand Renaud, Strategies to Develop Mortgage Markets in Transition Economies 4 (World Bank Policy Research, Working Paper No. 1697, 1996)(Discussing post communist countries in Eastern Europe and noting " land property boundaries were not drawn up and recorded at the time of construction under the state system.." therefore, " loans secured by real estate lending suffer especially from the legacy of poor land titling." p. 8

NOI stream threaten the stability of the loan. Therefore, leases must guard against such fluctuations by binding the tenant to payment and limiting tenants' rights to terminate. In entering the mortgage market, countries with very pro-tenant environments labor under the weight of this legal impediment.[28]

Foreclosure laws are possibly the single most important body of jurisprudence to affect the mortgage market. At its core the market depends on the ability of the lender to expeditiously realize the value of its investment by first taking possession of the property and then sell the property to pay back the loan. If the legal infrastructure is weak investors will avoid the market due to risk aversion.[29] If that is the case, then the loans would not be underwritten as secured debt and the market would grind to a halt.[30] Several Latin American countries have recently streamlined and updated their mortgage foreclosure laws. Reforms to the Argentinean law include allowing non- judicial foreclosure and use of summary judgment (when utilizing judicial foreclosure).[31] Changes in the Mexican law have allowed lenders to speed up the foreclosure process (from 5 years to 6 months) thus preserving value in the asset.[32] The Brazilian process is

[28] Jerome A. Cohen & John E. Lange, THE CHINESE LEGAL SYSTEM: A PRIMER FOR INVESTORS, 17 N.Y.L. SCH. J. INT'L & COMP. L. 345, 3361-62 (1997) discussed in Dvorak, TRANSPLANTING ASSET SECURITIZATION: IS THE GRASS GREEN ENOUGH ON THE OTHER SIDE? 38 Hous. L. Rev. 541 at f.n. 93.

[29] Neftali Garro, INSURANCE PRIVATIZATION IN COSTA RICA: LESSONS FROM LATIN AMERICA WITH SPECIAL REFERENCE TO URUGUAY, 7 Conn. Ins. L.J. 359, 377 (2000)

[30] Securitization of debt requires underwriting discipline to reassure investors. "Underlying the entire transaction is the income stream produced by the mortgages in the pool. Income stream is critical to the success of the securitization. The overwhelming importance of the income stream reduces the real estate to a fungible commodity. It is not the real estate that is being securitized, it is the cash-flow." Georgette C. Poindexter, SUBORDINATED ROLLING EQUITY: ANALYZING REAL ESTATE LOAN DEFAULTS IN THE ERA OF SECURITIZATION, 50 Emory Law Journal 519, 528-9 (2001)

[31] Georgette Chapman Poindexter and Wendy Vargas-Cartaya, EN RUTA HACIA EL DESARROLLO: THE EMERGING SECONDARY MORTGAGE MARKET IN LATIN AMERICA, 34 Geo. Wash. Int'l. L. Rev. 257, 271 (2002) .

[32] Georgette Chapman Poindexter and Wendy Vargas-Cartaya, EN RUTA HACIA EL DESARROLLO: THE EMERGING SECONDARY MORTGAGE MARKET IN LATIN AMERICA, 34 Geo. Wash. Int'l. L. Rev. 257, 272 (2002) ; see also Larry B. Pascal, REFORMS MODERNIZE MEXICO'S FINANCIAL SERVICES SECTOR, 67 Texas Bar Journal International 46-47 (2003); Michelle Scatigna and Cimailo E. Tovar, SECURITISATION IN LATIN AMERICA, BIS Quarterly Review September 71, 79 (2007) ("In the case of Mexico, the development of securitization remained limited for a long time owing to a ban on trusts issuing debt, as well as to overly long foreclosure proceedings. For such reasons, securitization only became possible after important legal amendments

now more efficient because the property can be held in the name of an independent trustee (instead of the borrower). The lender can use non-judicial foreclosure shortening the timeframe from sometimes 7 years to a much more manageable 6-12 months.[33]

b. Economic Foundation

Major economic threats to a robust mortgage market rest on the pressure of inflation and interest rate risk. This is true in any market but is especially worrisome in countries experiencing economic volatility. Volatility in inflation makes it very difficult to determine the true interest rate. While a floating interest rate may ameliorate the problem, without appropriate caps and reset limitations this solution is certainly less than ideal in a commercial real estate setting. The operating income that provides the cash flow to service the debt is produced by rents paid by tenants. When the rents are fixed through the lease agreements the cash flow is likewise limited setting up a disastrous situation in the event of an interest rate reset.

One answer may be to peg the local currency to a more stable external currency. However, as the experience in Argentina (2002), Brazil (1999) and Mexico (1994) demonstrates when the target country's economy is performing less strongly than the country to which the currency is fixed either the peg must be adjusted or the target currency will become overvalued. This type of lending masks the real cost of funds which sets the stage for catastrophe when the local currency is eventually unpegged and devalued (as happened in each of the above referenced countries). As one commentator has noted: "currency risk does not go away merely because one's domestic currency is pegged to the foreign currency."[34] Concealing the true cost of

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were introduced. In 1996, laws were passed allowing for more expedient foreclosure proceedings and an easier transfer of mortgages.")

[33] Georgette Chapman Poindexter and Wendy Vargas-Cartaya, EN RUTA HACIA EL DESARROLLO: THE EMERGING SECONDARY MORTGAGE MARKET IN LATIN AMERICA, 34 Geo. Wash. Int'l. L. Rev. 257, 273 (2002).

[34] Ross P. Buckley, A TALE OF TWO CRISES: THE SEARCH FOR THE ENDURING REFORMS OF THE INTERNATIONAL FINANCIAL SYSTEM, 6 UCLA J. Int'l L. & Foreign Aff. 1, 35 (2001)

borrowing in this way encourage excessive indebtedness by lenders and borrowers alike.[35] Even worse, problems in banking unsoundness tend to show up suddenly, with little warning, in developing economies.[36] Lack of investor confidence quickly leads to disastrous "runs" on banks.

c. Political Risk

The most obvious political risks are political changes that may inhibit the enforceability of the mortgage contract. Unstable political environments undermine long term investor confidence that is crucial to mortgage financing. Sovereign risk includes direct risk such as moratorium on payment of certain types of debt or indirect risk such as changes in monetary policy that affect inflation and interest rates.[37] This political risk likewise extends to acts of violence and terrorism that inhibit confidence in the market. Insurance against political and sovereign risk is available.[38] However, like any other type of insurance the cost may effectively proscribe the transaction as too costly.

A more subtle, but nonetheless important, political risk is bureaucracy. Like legal considerations, bureaucracy snafus inhibit the transparency needed for a functioning mortgage market. With bribery at one end of the spectrum and inefficiency at the other end, dealing with governmental agencies for permitting, zoning, title registry, etc. is an important development aspect. Corruption, for example, implies instability and poor quality investment potential to

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[35] See, Buckley at 39.

[36] IMF Website, Banking Failures and Impact on Real Estate, http://www.imf.org/external/pubs/ft/fandd/1999/06/knight.htm

[37] Georgette Chapman Poindexter and Wendy Vargas-Cartaya, EN RUTA HACIA EL DESARROLLO: THE EMERGING SECONDARY MORTGAGE MARKET IN LATIN AMERICA, 34 Geo. Wash. Int'l. L. Rev. 257, 282 (2002)

[38] Report by the Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, NEW DEVELOPMENTS IN STRUCTURED FINANCE, 56 Bus. Law. 95, 137 (2000)

investors, thereby impeding the likelihood of doing business there.[39] The cumulative effects of bureaucracy can be dire for business. For example, jumbled bureaucracy meant that it can take sometimes up to five years to foreclose on a commercial mortgage in Argentina.[40]

C. Transitional economies' access to international real estate investors

Of course laying the foundation of legal, economic and political framework signals only the beginning of a local market's push into the international scene. Strong real estate fundamentals-supply of product and sufficient demand for product—constitute the driving force. Before discussing the specific cases of Latin American countries and their push onto the international market, it may be useful to contrast a country that evolved from a non-existent market to a robust and somewhat stable international player: Poland. Post-communist Poland has undergone financial crises, changes in political regimes and frequent economic instability. It was difficult for owners to leverage properties with debt. Transaction volume was minimal. However, the recent Polish market looks very different. Ownership can be financed with mortgage debt and even the beginnings of a secondary mortgage market. Foreign investors are locating offices in Poland (e.g. GE Commercial Real Estate).[41]

During the 1980s Warsaw was filled with empty lots and underutilized office space. However, attempts to attract foreign capital to develop this property were compared with "promoting property on the moon."[42] Although theoretically possible, mortgage financing was economically unfeasible as interest rate hover around 52%.[43] From a political perspective there

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[39] Andrea Kennedy King, THE LINK BETWEEN FOREIGN DIRECT INVESTMENT AND CORRUPT IN TRANSITIONAL ECONOMIES (2003) p. 8

[40] Brink Lindsey, "How Argentina got into This Mess", Wall Street Journal, 2002, available online at **www.cato.org/pub_display.php?pub_id=6617**.

[41] For a journalistic account of the growth of the Polish market see Steve LeVine and Christine Haughney Wall Street Journal (Eastern Edition) New York, NY Feb. 27 2006, p. A1

[42] LeVine & Haughney, Wall Street Journal (Eastern Edition) New York, NY Feb. 27 2006, p. A

[43] Gary Goodman, & Beata Jostmeier, ATTRACTIVE REAL ESTATE INVESTMENT OPPORTUNITIES IN POLAND, Real Estate Review, Winter 1993 Vol. 22 Issue 4, pp 70-76.

were questions of title as property was still often under control of local governments.[44] This governmental entanglement exacerbated an already complex bureaucratic interaction.[45] Furthermore there were no standard underwriting procedures guiding loan to value ratios and debt service guidelines.[46]

Conditions began to change during the mid 1990's. Just as in the United States, governmental and quasi-governmental entities stepped into the initial formation of the Polish market. The World Bank, US Agency for International Development, European Bank for Reconstruction and Development and other international funding agencies prepared programs totaling $2.6 billion aimed at creating a Polish mortgage market.[47] Although there are still hurdles (for example, there is a long lag time for title registration—sometimes up to 6 months), transformative systemic changes were implemented.

The first steps were stabilizing the economy and reforming institutions. Economic stabilization required restraining inflation and attaining market equilibrium.[48] Institutional reform involved liberalizing foreign trade, introducing a market economy, introducing institutions and privatisation.[49] Creating a mortgage market initially involved defining private

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[44] Poland re-established local governments in 1990 and transferred most urban land and housing stock to them under the Act on Local Autonomy and implementing regulations. State and local governments were then permitted to sell the land pursuant to the amendments to the Land Use and Expropriation Act of 1990. Cheryl W. Gray et al., THE LEGAL FRAMEWORK FOR PRIVATE SECTOR DEVELOPMENT IN A TRANSITIONAL ECONOMY: THE CASE OF POLAND (Country Economics Dept., The World Bank, Policy Research Working Papers No. WPS 800, Nov. 1991). P.4

[45] The land registration system was incomplete and in disarray, hindering mortgage financing. Moreover, with notaries in short supply, land transaction documents were difficult to notarize. Cheryl W. Gray et al., THE LEGAL FRAMEWORK FOR PRIVATE SECTOR DEVELOPMENT IN A TRANSITIONAL ECONOMY: THE CASE OF POLAND (Country Economics Dept., The World Bank, Policy Research Working Papers No. WPS 800, Nov. 1991). at p. 6

[46] Michael Lea et. al., The Urban Institute, 1997 at p. 40, available online at www.polandhousingfinance.org

[47] Gary Goodman, Beata Jostmeier, ATTRACTIVE REAL ESTATE INVESTMENT OPPORTUNITIES IN POLAND, Real Estate Review, Winter 1993 Vol. 22 Issue 4, pp 70-76.

[48] David Gordon, PRIVATISATION IN EASTERN EUROPE: THE POLISH EXPERIENCE, 25 Law & Pol'y Int'l Bus. 517, 525 (1994).

[49] David Gordon, PRIVATISATION IN EASTERN EUROPE: THE POLISH EXPERIENCE, 25 Law & Pol'y Int'l Bus. 517, 525 (1994).

property rights in the Polish constitution, reprivatising property, creating a functioning land registration system, updating the notary system, and deregulating land use laws regarding planning, building standards, and rent control.[50] One commentator has written that, in hindsight, the decisive changes included "rapid commercialization of the banking sector and intense competition; participation of foreign institutions; poor interest of the authorities in the mortgage loan system and, as a consequence, avoidance of failure of experiments and subsidies; and perceptible, progressing stabilization and consumer optimism in the largest cities".[51] From 2004 to 2006 foreign investment in Polish proper doubled to approximately $3.5 billion.[52] As the nation stabilizes and modernizes it becomes a safer place for foreign investment in Polish real estate.

Latin American economies are as varied as their distinctive local cuisine, geography and languages. To a certain degree, though, most of these developing countries have encouraged capital market liberalization, financial regulation and discouraged distorting fiscal policies and disadvantageous tax schemes.[53] In fact financial markets have begun to grow in this region. In 2003 the total amount of mortgage and asset backed securitization rose to $5.6B (up from $3.9B the previous year).[54] Nonetheless, the region lags behind other real estate markets in access to

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[50] Cheryl W. Gray et al., THE LEGAL FRAMEWORK FOR PRIVATE SECTOR DEVELOPMENT IN A TRANSITIONAL ECONOMY: THE CASE OF POLAND (Country Economics Dept., The World Bank, Policy Research Working Papers No. WPS 800, Nov. 1991). P.4-7.

[51] Jacek Laszek, DEVELOPMENT OF HOUSING FINANCE SYSTEM IN POLAND-LESSONS LEARNED, Economic Annals no. 169, April 2006-June 2006, p. 69

[52] LeVine & Haughney, Wall Street Journal (Eastern Edition) New York, NY Feb. 27 2006, p. A

[53] The factors have been noted as real estate drivers is Latin America. See, Betrand Renaud, The 1985 to 1994 GLOBAL REAL ESTATE CYCLE: AN OVERVIEW, 5 Journal of Real Estate Literature 13-44 (1997).

[54] Kenneth G. Lore, Cameron L. Cowan , Chapter 2. The Public and Private Sectors in an Expanding Secondary Mortgage Market V. New Directions in the Private Sector Mortgage-Backed Securities § 2:24

sophistical global capital.[55] To better understand the range of development it will be helpful to contrast Mexico, Brazil and Argentina.

a. Mexico

Mexico has the world's eleventh largest population and is currently the fourteenth largest economy.[56] In 1994, when Mexico's peso devaluation decimated the economy, the possibility of U.S. investors re-entering that market seemed remote. Since then, "interest rates that once were almost 100 percent have declined precipitously, inflation is at about 4 percent, and there's been a flood of activity by U.S. companies." [57] Since this crisis, numerous economic policies allowed the economy to rebound and opened the markets to foreign investors. Mexican Central Bankers instituted mandates to increase transparency of the government's monetary policy decisions stabilize the currency, and lower inflation, which were successful and resulted in export led growth, driving foreign direct investment up.

Mexico's economy "has been transformed since the 1980's as a result of economic liberalization and joining the North American Free-Trade Agreement (NAFTA)."[58] This agreement allowed preferential market access for the U.S. and the geographic proximity to the U.S., allowed Mexico to become closely integrated in the production and distribution system of U.S. industry, raising property values. This proximity distinguishes Mexico from other Latin American economies and provides the real estate market in Mexico with significantly more

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[55] As an example, less than 6 % of CMBS securitized offerings were in property outside the United States and Europe,see, CMBS Issuance by Country, Compendium of Statistics, last update June 6, 2008, available online at http://www.cmbs.org/IndustryResources.aspx?id=5640&ekmensel=c580fa7b_70_72_5640_4

[56] Mexico's population in 2006 was 104.2 million according to the World Bank see http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?&CF=&REPORT_ID=9147&REQUEST_TYPE=VIEWADVANCED&HF=N/CPProfile.asp&WSP=N; and see http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf

[57] Field, Anne. "Commercial Development South of the Border." Retail Traffic. August 2007.

[58] "Investment Case for Mexico." Jones Lang LaSalle. February 2007.

investor interest for commercial properties and new real estate development. Mexico is far from most large Latin American economies, and this distance keeps the country insulated from the volatility of countries undergoing crisis.[59] Thus, although not fully separate from currency crises in Brazil, Argentina and Chile, Mexico becomes the safer haven for investors. But as the capital markets integrate and become global, this distance will become insignificant. In the present market, Mexico's open economy is attractive to investors and business environment rankings score Mexico strongly on a number of measures, including the political and institutional environment, macroeconomic stability, market opportunities, private enterprise and foreign investment policies, the foreign trade and exchange regime, tax system, financing, labor market and infrastructure." [60] Along with real estate fundamentals, real estate investors scrutinize these country-wide criteria before deciding on entering a foreign market and accounting for risk.

Economic fundamentals are strong with low unemployment of 3.2%, GDP forecasts predict a modest 3.2% growth for 2007, and inflation is at a low 4.1%. This economic strength carries over to the real estate market and attracts investors who are placing a bet on the macroeconomic and local growth.[61] Also, a decrease in interest rates have contributed to the favorable macroeconomic variables and helped maintain stability in the market.[62]

Given the proximity and standardization of the Mexican real estate market, properties in Mexico are often included in U.S. CMBS securitizations, as underwriting standards make pooling across borders easier. The advent of a public securitization market lowers the cost of capital for commercial development in Mexico as it has in the United States by increasing

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[59] See generally, A Real Estate Boomlet in Latin America, Knowledge @Wharton, published September 22, 2004, available online at http://knowledge.wharton.upenn.edu/

[60] "Mexico: Country Risk Summary." The Economic Intelligence Unit Limited." EIU Economy –County Risk Rating. 28 November 2007.

[61] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br.

[62] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br.

standardization and efficiency in underwriting. This indicates that the Mexican real estate market has matured significantly and increased the liquidity of real estate while lowering debt prices.

Mexican real estate was the 7th largest destination of inter-regional capital in 2005 indicating the increasing prevalence of foreign investors. [63] Furthermore, as the "financial markets have stabilized and matured, the Mexican real estate market has become increasingly sophisticated. Mexican banks increased their mortgage lending by 50% in 2005, and mortgage backed securities issuance tripled. In 2005 the Mexican congress approved a REIT-type vehicle known as 'FIBRAS'—the first vehicle of this type in Latin America"[64] The real estate market has experienced rental growth recovery and many international real estate players have capitalized on this strengthening of fundamentals and continued yield compression. Low vacancy rates and high demand for new products has driven rents up 15 to 20% in the past two years.[65] The vacancy rate for Mexico City Class A office is about 8.15% and the current trend in commercial real estate is developing mixed-use projects.[66] Also, many domestic and international companies have been purchasing office space in the Mexico for corporate image and because of the infrastructure available.[67]

However, there are still challenges in this market that will need to be improved for increased transparency and efficiency. "In Mexico, winding your way through the government bureaucracy and getting the necessary approvals is an especially laborious process" and there are also difficulties in purchasing land, thanks to communal property laws dating back to 1917." [68]

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[63] "Investment Case for Mexico." Jones Land LaSalle. February 2007.
[64] "Investment Case for Mexico." Jones Land LaSalle. February 2007.
[65] Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br.
[66] Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br.
[67] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br.
[68] Field, Anne. "Commercial Development South of the Border." Retail Traffic. August 2007.

Because of these inefficiencies, most international real estate investors form a joint venture with a local developer who can more easily navigate the bureaucratic hurdles. Currently, sixteen U.S. funds are investing in JV partnerships in Mexico worth $6.5 billion. [69]

Mexico's economic policy and proximity to the United States provides economic stability that attracts foreign real estate investment and notably reduces international risk premium. The sovereign risk for the country is stable and "tight fiscal policies and good access to financing ensure that the risk of debt-servicing difficulties is low." [70] Overall, the real estate market in Mexico is the most advanced relative to Latin American neighbors, with sophisticated international real estate developers and financiers involved in the market. The government's economic policy initiative was successful in helping the economy rebound after the crisis and open-market policies with the U.S. boosted investor confidence and interest in Mexico.

b. Brazil

Brazil is the largest country in South America and controls about half of the GDP of the continent.[71] "Economists anticipate that Brazil will grow to be the world's 8th largest economy by 2020 and the 5th largest by 2050. This growth is largely due to favorable demographic trends. In particular, as more young adults enter the workforce, this younger working population is anticipated to increase the country's productivity and drive economic growth." [72] From a real estate perspective, this creates inexhaustible demand for real property from businesses catering to the population.

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[69] Field, Anne. "Commercial Development South of the Border." Retail Traffic. August 2007.
[70] "Mexico: Country Risk Summary." The Economic Intelligence Unit Limited." EIU Economy –County Risk Rating. 28 November 2007.
[71] Field, Anne. "Commercial Development South of the Border." Retail Traffic. 9/10/07 *citing* report by Prudential Real Estate Investors.
[72] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br.

Brazil's economy fell into a deep recession with inflation an all time high of 2,938% in 1990. The 1994 Real Plan created conditions for a more stable domestic economy. It introduced a new currency, tightened monetary policy while loosening fiscal policy and created incentives to attract foreign investment."[73] The plan was widely successful, but a growing deficit, overvaluation of the real, stock market losses and rising interest rates followed a few years later.[74] In the aftermath of the Asian Financial crisis of 1997, Brazil's currency collapsed and the Central Bank devalued the currency in 1999, allowed the Real to float and tightened monetary control. After this devaluation there was an IMF bail out.[75] The economy improved until 2002 when inflation suddenly increased fivefold**.**[76] However, fiscal responsibility and macroeconomic stability together with continued interest in the country by the financial community helped improve economic fundamentals.[77] One important impetus driving economic growth and stability was the sound macroeconomic policy framework that supported a sustainable decline in country risk.[78]

Since the Brazilian currency crisis the economy recovered, and growth combined with low inflation and strong economic policy helped attract investors and foreign direct investment.[79] Inflation in 2006 in Brazil was about 3.4%, compared with 10% in Argentina, indicating a stark

[73] Jorge M. Guira, PREVENTING AND CONTAINING INTERNATIONAL FINANCIAL CRISIS: THE CASE OF BRAZIL, 71 LBUSRAM 481, 488(2001)
[74] Jorge M. Guira, PREVENTING AND CONTAINING INTERNATIONAL FINANCIAL CRISIS: THE CASE OF BRAZIL, 71 LBUSRAM 481, 488(2001)
[75] Ednei Roza, THE IMF AND THE EFFECTS OF STRUCTURAL CONDITIONALITIES IN BRAZIL: WHAT IS ABOUT TO HAPPEN?, 14 L. & Bus. Rev. Am. 347, 354 (2008)

[76] Ednei Roza, THE IMF AND THE EFFECTS OF STRUCTURAL CONDITIONALITIES IN BRAZIL: WHAT IS ABOUT TO HAPPEN?, 14 L. & Bus. Rev. Am. 347, 355 (2008)
[77] Ednei Roza, THE IMF AND THE EFFECTS OF STRUCTURAL CONDITIONALITIES IN BRAZIL: WHAT IS ABOUT TO HAPPEN?, 14 L. & Bus. Rev. Am. 347, 355 (2008)
[78] Scatigna & Tovar, SECURITISATION IN LATIN AMERICA, BIS Quarterly Review, September 2007, p. 71 at 75
[79] Dan Shirai, Chasing Brazil's Yields, The Institutional Investor, Jan. 2007 p. 1-10
Dan Shirai 2008. Brazil Land Grab Heats Up. *LatinFinance*, April 1, 10-13. http://www.proquest.com/ (accessed June 10, 2008)

difference in the state of the underlying economic condition and the control of the Central Bank.[80] The Brazilian government has set the maximum inflation target at 4.5% and inflation has been below this target since 2005. Brazil's strong external accounts have resulted in a strong currency, allowing for disinflation, lowering interest rates, which lowers the opportunity cost of capital and raises demand for money by households and foreign investors.[81] Unemployment is high at 12.8%, but can be a reflection of the sheer size of the population and the inefficiencies of emerging economies.

Drivers for domestic demand remain positive and GDP growth forecast has risen steadily throughout the year to 4.9% for 2007 and 4.3% for 2008.[82] A Brazilian risk assessment states that the currency risk is stable, and "there remains the risk of volatility in the event of global financial market turbulence, but a prolonged overshooting is unlikely, given the confidence in policy framework, high real interest rates, a large cushion of reserves and strong external accounts."[83] Given the improved macroeconomic environment, Brazil's country risk has been at record lows in the past year, reducing the overall risk for real estate investing.

This strengthening of economic fundamentals has been accompanied by progress in the real estate investment market. Improvements in the structure and enforceability of lease contracts are enabling the securitization of lease receivables providing new financing options for institutional investors and introducing a new source of capital for real estate investment. The structured finance market has recently improved.[84] The general legal framework for Brazil's

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[80] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br
[81] Dan Shirai 2008. Brazil Land Grab Heats Up. *LatinFinance*, April 1, 10-13. http://www.proquest.com/ (accessed June 10, 2008).
[82] Marketbeat Latin America 2007." Cushman & Wakefield. p. 3 www.cushwake.com.br
[83] "Brazil: Country Risk Assessment." The Economist Intelligence Unit. EIU Economy –Country Risk Rating. 19 November 2007.
[84] Dan Shirai, "Digging up Real Assets", LatinFinance, May 2007 p. 1 ("Real estate is another emerging asset class with enormous potential for deal flow. Last year MBS accounted for (…) 8% (of securitizations) in Brazil

structured finance market provides for two SPVs: Fundos de Investimento em Direitos Creditórios (FIDCs, asset-backed investment funds) and Certificados de Recebíveis Imobiliários (CRIs, real estate backed certificates). "FIDCs act as bankruptcy-remote entities separate from the originators of the assets that protect against an originator's creditors. CRIs provide for the isolation of assets and protection against seller/originator creditors, but not against fiscal and labor related claims of the securitization agent." [85] These long-term asset backed debt alternatives are beginning to emerge providing further alternatives for investing. In 1997 the Real Estate Financing System introduced the fiduciary lien on real estate loans, representing an alternative to traditional mortgages that are costly and difficult to recover in the event of default. This law also expedited the foreclosure on real estate, increasing the recovery value of entering foreclosure and established a fiduciary regime for receivables collateralizing a specific debt issue.[86] These important regulations improve the real estate market conditions for investors by increasing the security for mortgage lenders and landlords.

Brazil's economic size and growth attracts aggressive real estate investors to the area because of the high potential returns. Prudential Real Estate Investors estimates the size of the high-grade commercial real estate market in Brazil at $497 billion, which makes it the largest in South America.[87] However, the debt market is not well-established, so high equity investments lower the yields of the properties. "Most investors believe Brazil is about two or three years behind Mexico. Debt is increasingly available, and yields are will have considerable room to rise

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according to Standard Bank. (…) Volume is expected to multiply several times through the use of CMBS and RMBS."

[85] "Latin America Quarterly." Fitch Ratings. November 7 2007.; see also Scatigna & Tovar, Securitisation in Latin America, BIS Quarterly Review, September 2007 p. 71 at 75.

[86] "Latin America Quarterly." Fitch Ratings Report. Fitch Ratings November 7 2007.

[87] Morilha, Deborah. "Brazil." Spotlight on South America. NAREIT. December 2005.

as those leases roll over."[88] Challenges in the Brazilian real estate market include debt accessibility, but recently, the debt market has shown growth. As in Mexico, developers face the challenge of navigating the bureaucratic laws of Brazil. Brazil also has "a complex system of federal, state, and municipal taxes, as well as tough environmental rules" [89] In recent months, developers have seen a change in the credit conditions in Brazil and most expect the availability of debt financing to increase further going further, along with falling interest rates.

Given the low availability of debt financing in Brazil's history, the markets in the major areas of São Paulo and Rio de Janeiro have been characterized by owner-occupied real estate. Organic growth of the market, driven by companies looking for new, larger and better located properties has resulted in many sale-leaseback opportunities. Brazilian pension funds have historically been major investors and owners of corporate real estate, but recent legislation limiting pension fund allocation of assets to real estate has made these large investors sell properties.[90] Overall vacancy for São Paulo is 12.5% and the lack of quality space is forcing many companies to move out of the central business districts. Demand is very strong in the market, but there is a lack of buying opportunities.[91]

The demographic characteristics and size of the country make potential growth of the economy very attractive to investors, who bet on the demand side of the real estate market. As

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[88] Freed, Dan. "U.S. Institutions Eye Brazilian Real Estate." Investment Management Weekly. April 24, 2006.

[89] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br

[90] Paulo Andre Gomes, BRAZILIAN PENSION FUNDS: REAL ESTATE INVESTMENTS, Thesis (S.M.)--Massachusetts Institute of Technology, Dept. of Urban Studies and Planning, 2000 available online at http://hdl.handle.net/1721.1/32203; see generally, James Attwood and Alexander Ragir, Bloomberg.com, May 30, 2007; http://www.bloomberg.com/apps/news?pid=20601086&sid=awZg5JGhsBOA&refer=latin_america("In Brazil, stock rose after regulators eased investment rules for pension funds to invest in stocks. The National Monetary Council, the government body in charge of setting inflation target and some regulation for financial markets, said pension funds such as Caixa de Previdencia dos Funcionarios do Banco do Brasil SA can invest in riskier assets to boost returns. The regulator will also allow pension funds to increase holdings of asset-backed securities and double the amount of time they have to reduce equity holdings to within limits.")

[91] Vacancy rates in Sao Paulo, which had reached 24% in 2004, fell to13.3% in 2006, see Thierry Ogier, "Sao Paulo: Strong Real Estate Demand", Latin Business Chronicle, May 7, 2007.

seen in recent real estate transactions, multinational real estate developers have created joint ventures to explore the opportunities in Brazil. While the price of the property may be diminished to compensate for market risk, investors are able to earn the return they want even without the leveraging capability. Credit markets are improving and transaction volume increases as investment funds come into the market for short and long term opportunity.

c. Argentina

Argentina has the third largest economy behind Mexico and Brazil with a population of 38.64 million.[92] The country has not only undergone more prolonged and recent economic crises that slow progress of the real estate market but also has been infected by the crises in neighboring Latin American countries. From 1998 to 2002, Argentina's economy was mired in recession and the country's reliance on foreign investment combined with a fixed exchange rate system that limited the Government's ability to stimulate the economy. In 1999, the devaluation of the Brazilian Real created a major blow to Argentina's exports as well as "the incomes of Argentine real estate companies with Brazilian interest, such as IRSA (Inversiones y Representaciones Sociedad Anónima)."[93] The economy grew unstable and fell into recession with a growing budget deficit, and the Argentine government defaulted on to sovereign debt. In 2001, the government devalued the Argentine peso as capital flight from the country continued and in 2002 further devaluation continued as the government eliminated the fixed peg of Peso to the US Dollar.[94] This lower value of the Peso eventually led to recovery by expanding exports and boosting demand for domestic products. The country rebounded to a limited extent, with

[92] International Monetary Fund, World Economic Outlook Database, April 2008, available online at http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx
[93] Deal, Morgan. "Foreign Investment in Latin American Real Estate: A comparison of Argentina, Brazil and Mexico." MIT. 2001 September.
[94] "Argentina." South America Country Reviews. Morgan Stanley. October 3, 2007.

GDP growing approximately 9% since 2002. However, this growth is expected to slow in the near future.

After an initial recovery, the Argentine economy is not faring as well as its Latin American counterparts after their economic crises. The Argentine economy is still showing “positive growth and expansion although at a slower pace than previous years. The lack of investment makes this growth unsustainable over the long term.” [95] GDP growth in 2006 was a strong 8%, but expected growth for 2007 declined and is at 6.5%.[96] Furthermore, despite the government’s effort to lower inflation, the sharp increases in price level continue to be one of the most challenging issues facing the economy for future years. Inflation in 2006 was in the double-digits and does not show signs of decline, and many economists believe this inflation data was understated. This high inflation is one of the risks that deter investors from the commercial real estate market in Argentina and it eliminates the possibility of a sensible debt market to leverage properties.

The real estate market remained inactive after the crisis until 2004. In 2005 companies that “improved their productivity (rebound effect), locally and regionally, (aided by external factors that further encourages the process) started to pay close attention the office market,” but this did not result in investment.[97] The current real estate market can be characterized by low vacancy rates and an increase in recycling of Class B/C buildings, creating a continued shortage of space in the market due to a lack of investment. Class A vacancy rates continue to remain below 5% and it “is expected that with the introduction of new developments it will slightly increase to normal level around 10-15%.” In Buenos Aires “[m]ost of the investment is a

[95] “Marketbeat Latin America 2007.” Cushman & Wakefield. www.cushwake.com.br
[96] Michael Mussa, Global Economic Prospects 2007/2008, Slowing to Sustainable Growth, Table 1 Real GDP Growth Projections as of April 4, 2007, p. 18 available online at http://www.peterson-institute.org/publications/papers/mussa0407.pdf.
[97] “Argentina.” Colliers Argentina. 2006-2007.

speculative undertaking because the volatile economy and tenant friendly laws do not form an office market with ideal conditions for investment into income producing assets." [98] Also, Argentina (like other Latin American countries) is known for laws providing the tenant with more benefits than the landlord. The tenant has early termination rights (the standard being a six month notice with no penalties), which continues to "pose a risk for investors." [99] Furthermore, the leases have short three year terms and need to be renegotiated as the currency depreciates, are indexed to inflation, or are denominated in U.S. dollars. This short term contract requires frequent tenant searches and increases this risk for the property owner, who has to re-lease and may be burdened with unoccupied space for long periods of time. Even more problems are presented by the frequent options to purchase or rights of first refusal held by many tenants.

The industrial and retail markets experience a similar lack of investment and quality space. Vacancy rates in these property sectors continue to decline and there is high demand for space. In the retail market, "the most important shopping malls have tenant waiting lists and landlords choose their next tenant based on probable sales." [100] Thus, although there is significant shortage in supply, the risks of the market are too high for foreign investors to pour money in to create new developments and they tend to propose build-to-suit projects to eliminate tenant risk.

This situation is exacerbated by the lack of a debt market in Argentina. Real estate capitalization rates need to be high enough to warrant a full equity investment because the developers will not be able to reap the yields with leverage. The only debt available is from the government, and this debt is unsecure and offered at prohibitively high interest rates. It is not accretive to borrow against the property, and most investors pay with full equity. The real estate

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[98] "Buenos Aires Office Investment Market." Market Outlook CBRE. August 2007.
[99] "Buenos Aires Office Investment Market." Market Outlook CBRE. August 2007.
[100] "Marketbeat Latin America 2007." Cushman & Wakefield. www.cushwake.com.br

market also is fairly illiquid with low transaction volume due to the risks of the market. This low liquidity makes it difficult for owners to sell properties and for developers to have reliable exit strategies. This makes market prices very difficult to predict because very few properties are marked-to-market by going onto the seller's block.

D. Paradoxical Financing

In these emerging economies (and especially in countries less integrated into the global capital market such as Argentina), predicating investment on the creation of a debt market continues to hinder further growth. Even if legal mechanisms such as an unassailable mortgage can be developed their use is limited by the economic realities of uncertainty. [101] To compensate for the lack of debt, many structures have evolved to simulate debt using equity and have allowed real estate investment to continue, although at a slow pace. Hence the paradox: in the absence of leverage, these markets are too risky for low risk investos but the returns on the unleveraged market are not high enough for high risk investors.

Attracted by the strong fundamentals of the commercial real estate market in Argentina, local and regional investors purchase commercial property in Argentina using creative investment financing structures to bypass the inaccessible debt market and maximize risk-adjusted returns. However, many foreign players are left discouraged from the multiple risks of the Argentine market. The high interest rates for long-term commercial loans in Argentina range between sixteen to twenty percent, and this high cost of capital is prohibitive for investors, who then choose to invest with equity and often attempt to replicate debt using equity.

[101] In fact Argentina has just such a security device (the Spanish word for these mortgage like instruments is "hipoteca." US lawyers would immediately recognized the similarity). See, Guillermo A. Moglia Claps, Julian B. McDonnell. SECURED CREDIT AND INSOLVENCY LAW IN ARGENTINA AND THE U.S.: GAINING INSIGHT FROM A COMPARATIVE PERSPECTIVE, 30 Ga. J. Int'l & Comp. L. 393, 403 (2002)

In Argentina, and often in Brazil, long-term debt financing is not a viable option for owners of commercial property. In these countries, the most commonly used structure for investing in real estate is direct ownership through full equity investment using a condominium structure for office buildings. Under this self-financing structure, “the buyer of an apartment or office floor will often pay a down payment around 5% and approximately 50% of the purchase price in monthly installments during construction, with the balance due at completion.” [102] This compensates for the lack of debt, and provides the developer with construction financing to reduce his own equity investment. With this structure, the developer invests in the property once about 20% of the pre-sales are complete, and will then draw from the equity owners as construction progresses. This scheme mimics a construction loan with individual “lenders” providing a pool of equity to draw from as needed. Once the office floor or unit is sold, the owner owns the real estate and has the right to rent and improve it. He has the full rights of the owner, creating office buildings with ownership divided by floor, unit, and wing. Investors with equity to spare can invest in the countries without debt financing, but smaller players are unable to become active players, reducing potential market growth. This investment structure offers an alternative to long-term financing and short-term construction loans, but also lowers the overall return for developers. Nevertheless, these sell-out schemes are profitable compared to leveraging a property with high-interest financing.

The paradox alluded to earlier arises when foreign investors shy away from this type of equity financing as not producing a high enough return and while at the same time shunning the market as being too risky for for traditional debt leverage. In the present US market there is a large and robust mezzanine loan market that depends on the same principles of equity

[102] Deal, Morgan. “Foreign Investment in Latin American Real Estate: A comparison of Argentina, Brazil and Mexico.” MIT. 2001 September.

financing.[103] Obligors on the note are the equity holders of the borrower—not the mortgage borrower itself.[104] As such in the event of default the mezzanine lender "forecloses" on the equity in the borrower and would assume ownership and control of the property. Whereas the mortgage borrower owns the underlying real estate asset the mezzanine borrower only owns the equity component in the mortgage borrower.[105]

To pose the question: can these developing markets "leap frog" the debt stage and go straight to mezzanine financing?[106] From an economic perspective (Modigliani and Miller) capital structure should not affect value.[107] Value should be independent of debt versus equity capitalization decisions. However, in reality target debt levels are most likely influenced by the probability of financial distress. Companies with higher risk (economic, political, legal) should be expected to use less debt (and, logically, more equity). This is exactly the position of real estate firms in these developing economies. Mezzanine financing cuts the middle path in opening up markets to third parties while acknowledging that the risk profile of the firm will not support debt.

The mezzanine lending market grew in the US in response to the limitation on debt financing in many securitized transactions. Just as the growth of this type of lending proceeded from limitations on the debt financing in the US, the introduction of this type of systemized

[103] In 2006 issuances of mezzanine debt in CDO's was approximately $3.22 billiion, see US CMBS and CRE CDO, Moody's Approach to Rating Commercial Real Estate Mezzanine Loans, Moody's Investor Services, Structured Finance, March 29, 2007.

[104] In other words credit is extended to the partners or members of the borrower—not to the borrower itself. Jeanne Calderon, MEZZANINE FINANCING AND LAND BANKS: TWO UNCONVENTIONAL METHODS OF FINANCING RESIDENTIAL REAL ESTATE PROJECTS IN THE 21ST CENTURY, 29 Real Est. L.J. 283, 288 (2001)

[105] Andrew R. Berman, RISKS AND REALITIES OF MEZZANINE LOANS, 72 Mo. L. Rev. 993, 999 (2007).

[106] This presupposes that any legal limitations on foreign ownership of firms do not impede foreclosure. Many Latin American governments now impose fewer limits on foreign ownership of business. See, Ernest R. Larkins, BUSINESS TAXATION IN LATIN AMERICA: SIMILARITIES, TRENDS, AND STRATEGIES, 11 J. Int'l Tax'n 22, 24 (2000)

[107] Franco Modigliani & Merton H. Miller, THE COST OF CAPITAL, CORPORATION FINANCE AND THE THEORY OF INVESTMENT, 48 Am. Econ. Rev. 261, 267-270 (1958). As this relates to real estate firms see, Poindexter, DEQUITY at 243.

equity financing can begin to replace the reliance on debt in other countries. In fact some have commented that equity investment is preferable to debt for recipient nations owing to the risk and loss sharing mechanisms.[108] Mezzanine financing is closer to equity because the value of the "collateral" derives solely from ownership in the mortgage borrower.[109]

The choice between equity (current financing schemes) and debt (straight mortgage) is not dichotomous. There is a range of financing alternatives that exist between these poles. Mezzanine financing is one such choice. Unlike other commentators, I am not contending that mezzanine financing is a mortgage substitute.[110] Rather it offers an alternative to debt that will, nonetheless, allow investors in developing economies access to foreign investment. Clearly the pricing must reflect the increased risk; foreclosing on an equity interest is not the economic equivalent of foreclosing on a real estate asset.[111] Indeed, the value of this investment can be analogized to "reverse strike" price in a convertible security. Whereas normally the price of a convertible security would reflect the likelihood of an *increase* in value, value here is the likelihood that the value will not *decrease*.

The fact remains that despite the legal changes that have been implemented in several developing economies the economic realities still preclude the growth of a robust mortgage market. Countries such as Argentina (and, with fewer exigencies, Brazil and Mexico) should consider implementing legal groundwork that would smooth the path for this type of financing. As a fundamental issue restrictions on foreign ownership must be eradicated. The value of this financing is contingent upon the ability to foreclose on the on equity interest. Next legal and

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[108] See, Ross P. Buckley, A TALE OF TWO CRISES: THE SEARCH FOR THE ENDURING REFORMS OF THE INTERNATIONAL FINANCIAL SYSTEM, 6 UCLA J. Int'l L. & Foreign Aff. 1, 41 (2001)
[109] See, Andrew R. Berman, RISKS AND REALITIES OF MEZZANINE LOANS, 72 Mo. L. Rev. 993, 995 (2007)
[110] See, Andrew R. Berman, "ONCE A MORTGAGE, ALWAYS A MORTGAGE"-THE USE (AND MISUSE OF) MEZZANINE LOANS AND PREFERRED EQUITY INVESTMENTS, 11 Stan. J.L. Bus. & Fin. 76, 113 (2005)
[111] A point very well made by Andrew Berman, see, ONCE A MORTGAGE at 108.

regulatory changes must occur to solidify the lien of the mezzanine lender on the equity interest. The foundational document in the United States is the UCC-1 Financing Statement. This document is filed in the appropriate state recording office and insures that the lenders lien is effective and superior to third party claims.[112] Adoption and enforcement of such filings should be implemented. In this way markets that are closed to traditional debt financing still have the opportunity to access global capital.

E. Conclusion

Foreign investment will facilitate the real estate economies of developing nations in becoming competitive in the global marketplace. The market fundamentals, demand, and infrastructure are in place to set the stage for a real estate boom. The evolving global economy hungers for the marketing of domestic financing products to international investors.[113] Debt is not the only path to access to international capital. While legal, political and economic stability remain as crucial building blocks, strong real estate fundamentals should prod the market towards exploring alternative methods of finance. As in the US when debt is not an alternative the power of structured equity financing cannot and should not be dismissed.

[112] See, Berman, Once A Mortgage at 107.
[113] See, Kenneth G. Lore, Cameron L. Cowan , Chapter 2. The Public and Private Sectors in an Expanding Secondary Mortgage Market V. New Directions in the Private Sector Mortgage-Backed Securities § 2:24