

Think Intelligently, Act Globally

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Global real estate capital markets — which I define as the flow of money between nations for the purpose of investing in real estate — are not new. However, today's global real estate activities represent a significant departure from recent historical precedent.

Historically, select private individuals and companies made investments throughout the world. Growing numbers of multinational corporations acquired or developed facilities. Foreign real estate holdings in the U.S. grew in the early 1980s, and stayed relatively constant in the \$30 billion to \$35 billion range except for a brief period of Japanese investment in the late 1980s and early 1990s that pushed holdings up over \$45 billion.

Today, with \$10 billion to \$15 billion already raised for global real estate investment (Institutional Real Estate, Inc.), and more money on the way, international real estate markets are for the first time seeing a large influx of U.S. private institutional investment. Furthermore, the level of international economic integration has moved to unprecedented levels and is showing no signs of slowing down.

A key question that needs addressing is whether such an unprecedented flow of U.S. real estate capital out of the country is sensible, or is it an overreaction to the lack of “opportunistic” real estate investments available in the United States.

The “overreactive” transfer of real

estate capital was a critical theme that drove U.S. real estate recessions. The significant real estate collapse in Texas in the mid-1980s started a transfer and flow of money into the Southwest, then to the Northeast, to the mid-Atlantic states, and finally to California, contributing to the real estate market collapses in each region. Similarly, while office buildings were the first to have problems, capital flowed out of that sector into the hospitality sector, apartments, and finally retail, creating a domino effect that hurt property performance throughout the U.S.

Fortunately, global real estate investing today has a strong foundation beyond the lack of “higher-return” opportunities available in the U.S. The world economy has become much more integrated in the last fifteen years, and integration is accelerating. One measure of this is the volume of exports and imports as a percentage of gross domestic product (GDP). This figure remained remarkably constant between 8% and 10% for the forty years between 1930 and 1970. By 1985, exports and imports as a percentage of GDP had grown to 17%, and by 1997 exports and imports reached 25% of U.S. GDP.

Another indicator of integration is the growth of multinationals. As of 1995, the top 100 multinationals had foreign sales of over \$2 trillion, 6 million foreign employees, and foreign assets of \$1.7 trillion. GATT and NAFTA trade agreements have also lowered national boundaries and many U.S. real

estate development, finance, and service firms have gone multinational, providing the experience and familiarity that many U.S. institutional investors need to begin substantial international investing.

So, on balance, the significant and quite sudden interest by institutional investors in foreign real estate markets is strongly supported by longer-term market trends. Furthermore, most major institutional investors got on the international bandwagon years ago, with some investors having 20% or more of their portfolios in foreign equities. With this substantial exposure, the relatively small investments in foreign real estate are logically consistent with existing portfolio allocation strategies.

The rest of this article provides an overview of global and domestic trends in the real estate property and capital markets to provide further context for making investment decisions today.

GLOBAL MARKET TRENDS

Global real estate markets are quite diverse. Average annual returns between 1989 and 1998 varied from negative 24% in Italy to positive 30% in Hong Kong. When the volatility of returns is considered, investors are able to select from a wide range of higher-risk/higher-return, and lower risk/lower return, options, even among the thirteen countries we analyze.

Investors that have a high-risk/high-return orientation could invest in Hong Kong or Spain, while investors with a lower risk tolerance could invest in Australia, Germany, or France. The key point is that because there are many different types of opportunities globally, it is critical to establish specific risk and return objectives before determining which countries and metropolitan areas to invest in (The Muldavin Company, Salomon Smith Barney World Property Index, January 1999).

Torto Wheaton's take on global real estate investing is put more simply: "Europe is for investors, Asia is for cowboys." In Torto Wheaton's Spring 1999 analysis of the overseas market, they find instability in many of Asia's major markets. Markets in the Far East continued to be adversely affected by weakened economies and, in some instances, political instability.

Interestingly, Asian hotel transactions have also lagged other markets. According to statistics published by Jones Lang LaSalle's Singapore office, only eight hotel transactions took place last year, representing far less than 1% of the entire Asian hotel market. By contrast, more than 15% of the U.S. hotel market changed hands last year.

This fact alone indicates the need for increasing liquidity and reflects on the potential opportunities for investors with significant capital and local market expertise (Global Villagers, *Feeling at Home in a Foreign Land*, Jim Miara, Institutional Real Estate Securities, September 1999).

Some interesting differences between U.S. and non-U.S. investors and property markets were highlighted at a recent conference focusing on international investment. Pension funds outside the U.S. tend to make their own investments and take the long-term investment approach. This contrasts with U.S. investors, who typically think of real estate as an investment that must compete with other investment vehicles for capital. U.S. investors are also seen as "traders," with a much greater emphasis on total return than on cash flow. Consequently, shorter time frames and predefined exit strategies are important to U.S. investors, but less so to non-U.S. investors.

A key difference in the real estate markets is the extent to which land is available for development. Land in many parts of the world is scarce and strictly regulated, while in many parts of the United States land is relatively cheap and available. Accordingly, from an investment perspective, land abroad typically represents a substantially larger percentage of property value than in the U.S. Thus, for international investments, initial yields and cap rates are typically lower than in the United States, and more of the return results from residual value.

Another key difference in international markets is the lack of information and "transparency." The lack of historical data and strong comparative information within countries makes local market expertise that much more important. The good news is that imperfect flow of information creates investment opportunity (It's a Local Local World — Don't Be a Foreigner, Prudential Real Estate Investors, June 1999).

Corporate expansion activity in Europe was strong in 1998 and is continuing today. Over 2,300 new and expanded corporate facilities were recorded in 34 different countries across Europe last year. The United Kingdom continued to capture the most business investment, with 647 new or expanded corporate facilities. This strong investment activity quelled fears that investment would be adversely affected in the short term by the country's decision not to participate in the European Monetary Union (Site Selection, July 1999).

While the United Kingdom saw the strongest growth of corporate facilities in 1998, a recent survey of 500 senior managers and board members of 500 industrial, trading, and service companies found that Frankfurt, Ger-

many is the city most likely to become the future financial capital of Europe. Frankfurt is home to the new European Central Bank and is an integral part of European financial markets. Its central location, telecommunication infrastructure, and internal transportation systems are other key factors in the city's favor (Land Use Digest: Europe, July 1999).

Asia appears to have started to recover from last year's ills, and more opportunistic investors are looking for high returns in Asia. Total returns from Asian real estate securities markets have also rebounded, with the returns near 15% through the end of May, compared to negative returns of 16% and 25% in 1998 and 1997, respectively (Market Watch, LaSalle Investment Management, 2nd Quarter, 1999).

While most market observers feel Asia's economic outlook is improving, the region still has significant underlying economic concerns. Japan and some of the other countries in the region have not addressed some of their systemic problems including inadequate supervision of financial and government institutions, lack of standard underwriting procedures, the unwillingness of banks to follow mark-to-market accounting, government support for insolvent financial institutions, weak or non-existent bankruptcy laws, and very high levels of government debt (Kick Starting Asia, Jack Rodman, 1999 Deal Makers Guide, Urban Land Institute, Mid-1999).

Substantial problems in Japanese markets, where property values declined about 15% annually for the past six years, has left Japanese banks holding hundreds of billions of dollars of problem real estate loans. While U.S. investors had alone spent more than \$800 million to buy twenty portfolios of non-performing Japanese real estate loans by the end of the first quarter of 1999, the pressure on Japanese institutions to increase sales is growing. Some of the major U.S. and European based investors who are actively participating in the Japanese market include Morgan Stanley, Bankers Trust, Secured Capital Corp, Salomon Smith Barney, Deutsche Morgan Grenfell, Goldman Sachs, Lehman Brothers and J.P. Morgan (Ernst & Young Press Release, May 1999).

U.S. investors are also becoming more active in the South Korean property market that many feel resembles the U.S. real estate market in the early 1990s — relatively low property prices that are beginning to climb. Key to this renewed interest is South Korea opening its real estate market to foreign ownership in June 1998 and their establishment of the Korean Real Estate Information Service to supply investors with information.

Foreigners spent approximately \$1.4 billion acquiring 4,200 acres in Korea in the second quarter of this year, which is triple the amount bought in the first quarter. Hewlett Packard Korea Ltd. is planning to acquire a large office building for \$85 million and many real estate finance and service companies are opening full service offices in South Korea (Institutional Real Estate Newslines, September 6, 1999).

In another interesting move, GMAC Commercial Mortgage recently agreed to buy a Tokyo mortgage firm. GMAC purchased Nippon Leasing, which originates commercial mortgages and credit tenant loans, to get its Japanese operation off the ground. Japan is a huge market for real estate loans, but to date there has been little business between U.S. lenders and Japanese borrowers (Commercial Mortgage Alert, August 23, 1999).

Latin America, like much of the rest of the world, is seeing significant increases and interest from multinational companies, creating opportunities for U.S. and other international real estate companies. Many brokerage, property management, appraisal, environmental, and other real estate service firms have opened offices in Latin America to provide the higher level of service required by multi-national corporations.

Corporations and service providers are faced with an obsolete business infrastructure in Latin America. U.S. businesses with high expectations are challenged in markets where there is a lack of long-term financing, little or no zoning, and little record keeping.

The good news is that for those companies that can meet the challenge, there is significant opportunity. Over 9,000 companies currently operate in Mexico backed fully or in part by U.S. capital. Brazil with the tenth largest economy in the world, and Argentina, Chile, Costa Rica, and other countries with strong attributes of their own, make Latin America's real estate investment prospects positive going forward (Commercial Property News, August 16, 1999).

MERGERS, ACQUISITIONS, AND JOINT VENTURES

The dynamic real estate markets continue to spur changes in real estate companies. In perhaps the largest recent deal, Lend Lease Real Estate Investments, who has been absorbing Equitable Real Estate Investment Management's business from their acquisition a few years ago, plans to acquire the Boston Financial Group, one of the nation's largest investment managers. Following the

merger, Lend Lease would have more than \$30 billion in real estate assets under management.

In a related move, Lend Lease has entered into an exclusive dealing arrangement with AMERESCO to purchase the company's asset management, commercial mortgage banking, servicing, and structured finance business platforms.

In another service company acquisition, Grubb & Ellis Company has acquired certain assets of Landauer Associates, the real estate consulting subsidiary of Aegon USA Realty Advisors (Investment Property and Real Estate Capital Markets Report, September 1999; PR Newswire, September 23, 1999).

Other large deals include a \$4 billion merger transaction between Hilton's Hotel Corporation and Promus Hotel Corp. Hilton owns and operates hotels around the world while Promus manages and franchises hotel brands. The combined company will have about 1,700 hotels including such world known brand names Hilton, Embassy Suites, Hampton Inn, and Doubletree.

In another interesting deal, CB Richard Ellis and Prudential Insurance Company of America have formed a strategic alliance under which CB Richard Ellis will be the lead broker of Prudential's corporate real estate portfolio. As part of the deal, CB Richard Ellis will place about \$50 million annually in residential and commercial referrals through Prudential Real Estate affiliates, while CB Richard Ellis is expected to have access to between 300 and 500 corporate real estate portfolio transactions in the year 2000 (Inman Real Estate News, September 8 and 10, 1999).

In the debt markets, IndyMac Mortgage Holdings decided to change its status from a REIT to a taxable growth oriented company by becoming a savings and loan institution. A desire to retain earnings and avoid the dependence on regular access to capital markets pushed IndyMac to make the change. The firm plans on becoming one of the largest California-based institutions with branch offices throughout the state and Internet connections to markets outside the state (Institutional Real Estate Securities, July 1999).

In other debt news, Provident Bank recently acquired Capstone Realty Advisors in a move to expand their commercial mortgage business. With the acquisition of Capstone, Provident will round out its menu of commercial mortgage offerings that already includes construction loans, mini-perm loans and permanent loans financed through securitization. Capstone, a premier Ohio company in the placement of debt and equity investments

has annual loan production volume in excess of \$400 million, primarily funded by various life insurance companies. The move by Provident compliments a move earlier this year when it created Provident Capital Funding, a new division that specializes in the origination and securitization of commercial real estate loans nationwide (PR News Wire, September 23, 1999).

Joint venture developments with institutional equity sources have become an important financing mechanism for private developers. The trend has been particularly strong with private apartment developers including such firms as Legacy Partners, Lincoln Property, and Trammel Crow Residential. Additionally, REITs like BRE Properties and AMLI Residential are also actively seeking joint ventures with pension fund capital.

Unlike the 1980's, development typically requires equity contributions by both partners. Typical terms for a developer would be equity investment of 5% to 10% of initial equity, ultimately securing 40% to 50% of the finished project's equity as compensation for overseeing the development process (Apartment Finance Today, July/August 1999; Crittenden's REIT Bulletin, August 16, 1999).

TRENDS IN THE REIT INDUSTRY

REIT fundamentals remain solid, but the benefits from the rally in the Spring have disappeared during the last ninety days as REIT total returns dropped 8.4%, bringing year-to-date performance for the industry as a whole through early September to a negative 2.4%.

Year-to-date, only apartments have shown positive returns at 9.5%. Healthcare with a return of negative 20% and retail mall REITs at negative 8.7% have been the biggest losers.

There continues to be substantial performance variation within sectors. For example, in the office/industrial REIT sector, Boston Properties and Spieker Properties both had positive returns over 10% year-to-date, while Crescent Real Estate and Reckson and Associates Realty had total year-to-date returns of near negative 10%. This type of variation can be found in all properties sectors (Merrill Lynch Comparative Valuation REIT Weekly, September 17, 1999).

Declining REIT returns are clearly reflected in REIT pricing relative to net asset values. During the heydays a few years ago, the REIT sector overall had net asset value premiums of over 20% and many office and hotel REITs had pricing premiums of 30% over net asset value. As of September 16, net asset value discounts for the indus-

try as a whole were 15% and the average office/industrial company now trades at a 20% discount to net asset value. None of the seventeen office/industrial companies covered traded at a premium (REIT NAV Handbook, Merrill Lynch In Depth Report, September 16, 1999).

So, the question today is which direction are REITs heading, and how fast are they going to get there? There is some consensus by analysts that for patient longer-term investors, REIT prices today represent a reasonably attractive entry point. However, because today's REIT prices reflect cyclically high occupancy levels, solid rental growth, strong earnings performance, a powerful economic expansion, and dynamic stock market — in other words, fundamentals that don't get much better — the possibility for REIT performance declines as property markets soften is possible. Another perspective on this is that REITs' significant declines in 1998 occurred against a backdrop in which the companies increased their average earnings by more than 14% (REIT's: Where is Darwin When You Need Him?, Salomon Smith Barney, September 15, 1999; Everen Securities, Equity Research, September 15, 1999).

To survive and prosper, a REIT needs a business model that is consistent with expectations of public market investors. Some of the business models that are well suited to public markets include 1) the focused/high volume developer; 2) the opportunistic investor; and 3) the REIT "utility" or large, diversified management company. Companies that don't pursue one of these business models, or create a business model that differentiates them from competitors and provides them with a sustainable competitive advantage are likely to languish or be taken out (REIT's: Where is Darwin When You Need Him?, Salomon Smith Barney, September 15, 1999).

THINGS TO THINK ABOUT

In what may be the first use of the Internet to attract real estate equity on a broad basis, EquityCity.com has successfully matched up equity seeking members with equity capital partners. So far in September it has successfully matched over \$28 million worth of equity to investments. They report real estate deals they qualify and list are finding interested equity investors in as little as ten days. EquityCity.com does not act as a broker, dealer or agent and charges a maximum fee of \$1,200 to list investment opportunities on its site (PR News Wire, September 23, 1999).

UCBH Holdings, the holding company of United

Commercial Bank, is the most recent candidate to announce its establishment of an on-line commercial real estate lending process. Rather than develop its own internal systems, the company has established a licensing agreement with Financingsources.com, formally [Datamerge, Inc.](http://Datamerge.com) (Inman News Features, Mortgage Bankers Association of America, September 15, 1999).

On the residential side, American Home Mortgage Holdings, Inc., a small mortgage banker with an active Internet lending site, plans to raise \$22.5 million an initial public offering, part of which will be used to finance the expansion of its Internet business. With an IPO target price to earnings ratio of 23.4, the deal appears rich compared to the established mortgage companies such as Countrywide Credit Industries with a PE ratios of around nine, and Resource Mortgage Bankshares Group with a PE ratio of a little over three. However, the proposed valuation is much lower than younger mortgage companies such as E-Loan, Inc. which was trading at a PE ratio of over 98, and Rock Financial Corp which was trading at a PE ratio over 30. With most companies in America promoting Internet strategies as they expand today, investors must pay careful attention to the true long-term competitive advantages of the Internet component of a company's business in determining the appropriate price to pay for a company (Small Lender With Web Focus Plans \$23 Million Public Offering, American Banker On-line, September 17, 1999).

Demand for senior housing remains strong, especially among low income households based on a study released by the National Investment Center for the Seniors Housing and Care Industry. While it is no great secret that senior housing demand is strong and will get stronger, the report reinforces the importance of the demand for senior housing by moderate-to-lower income people. The study found that as income goes up, so does health and ability level, lowering the need for senior housing. Consequently nearly 75% of households living in senior housing that provides support service have incomes at or below \$25,000. Investors and developers that learn how to tap in and serve this market will be the true winners moving into the new millennium (Institutional Real Estate Newslines, August 2, 1999).

The rapid expansion of Dot com companies has been challenging for landlords. While landlords are interested in having "Dot coms" in their projects if they put up substantial security, there are concerns about the lack of track records and growth history for many Dot com companies. Dot com companies need to use all their assets

in demonstrating security for their leases, and landlords need to have flexibility. Substantial venture capital partners, major contracts, reduced TI budgets, and larger security deposits are some of the tactics used by both tenants and landlords with rapidly growing high technology companies (PikeNet Dispatch, September 21, 1999).

CONCLUSION

Keeping track of trends in the real estate property and capital markets is changing with the industry. While traditional debt and equity sources remain critically important to real estate finance, the new trends will continue to be reported in this column. It is important to monitor the changes in overall real estate capital markets caused by changes in globalization, securitization, and technology. As discussed above, there are many changes underway, and those changes not only provide investment opportunities, but change the context of more traditional investment opportunities.