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Privcap/ Report

The Globalization of Real Estate

An executive summary of the Privcap thought-leadership series on the opportunities and challenges created by increasing global capital flows

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Key Takeaways

1. U.S. real estate is attracting strong interest from international investors
2. The profile of the global real estate investor is changing
3. Fund managers who take foreign investment face a series of challenges
4. The outlook for global investment is positive
5. The regulatory climate should continue unchanged

The Experts

Sean Bannon
Managing Director,
Zurich Alternative Asset Management

Aureon Herron-Hinds
Senior Manager,
RSM US LLP

Peter Merrigan
CEO,
Taurus Investment Holdings

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1. U.S. real estate is attracting strong interest from international investors

Investors around the world are searching intensively for yield, and this is driving interest in real estate, U.S. real estate in particular. International investors see the U.S. as, if not a safe haven, certainly a very desirable place to put capital.

In the U.S., "there is strong rule of law, a relatively stable government—despite what's going on these days—and strong growth prospects," said Peter Merrigan, CEO of Taurus Investment Holdings. "So people all over the world are interested in investing here, on a comparative basis, rather than in other alternatives."

They see the U.S. as an efficient, risk-adjusted, return-friendly place to put their money. "Foreign capital went from something like $46 billion in 2014 to about $90 billion in 2015, down a little bit in '16, but the numbers have been very, very strong," said Sean Bannon, managing director of Zurich Alternative Asset Management.

Other factors influencing the appeal of the U.S. market include the recession of 2008, when a lot of investors were badly hurt in emerging markets, as well as the uncertainty in Europe surrounding the future of the euro.

And, perhaps surprisingly, tightening regulation of the real estate market has not dented interest among global investors. "Irrespective of anticipated tax reform and other potential concerns, we're still seeing just as much activity," said Aureon Herron-Hinds, senior manager at RSM. "From a regulatory perspective, there have been increases, and there's an anticipation that there is more reform on the horizon, but I haven't seen the impact in terms of what clients are [interested in] doing. It's still onward and upward."

2. The profile of the global real estate investor is changing

Changes in the world economy over the past 10 years have changed the profile of the typical international investor in U.S. real estate. As nations in Asia have emerged as financial tigers, investment from Asia has roared ahead.

"By far the largest net increase in terms of the share of foreign investment in the United States has been Asia—that's Singapore, China, and a number of different countries," Bannon said. "It's now somewhere in the vicinity of 43 percent, up from probably 4 percent from around 2007. In terms of folks that have shrunk in their share, Australia is down from around 18 percent in '07 to about 1 percent now. And the Middle East has given up about 10 points."

Foreign investors are also now better informed and more strategic, another factor increasing the draw of U.S. real estate. They think more about risks and returns and less about the cachet of any particular market.

Negative drivers are also attracting investment from markets abroad. Merrigan said that, at Taurus, he's seen an uptick in money from the Gulf, where trouble of all types is on the rise. He's also receiving more calls from South America.

Bridging the Cultural Divide
Peter Merrigan
Taurus Investment Holdings

The culture gap is one of the biggest challenges faced by fund managers with a large pool of foreign capital.

When you have investors coming from many parts of the world, their cultural expectations are very different. These investors are accustomed to operating a certain way in their own country, which is likely quite different from the way they'll be operating in the U.S.

"That's something we spend a lot of time working through," said Merrigan. "For example, a German investor may look at the world differently than a Saudi Arabian investor or a Turkish investor. We do have to try to be cognizant of that if they're in the same projects together."

So how can a firm go about gaining the necessary cultural insights? "A lot of it is education and knowing your client, knowing your investor," Merrigan said. "We spend a lot of time really trying to understand what their strategy is and what they're trying to accomplish, and then putting them in the appropriate vehicles and investments relative to that."

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"I wouldn't necessarily call it flight capital," he said, "but I would say that they're seeing a lack of alternatives and instability at home. So they're attracted to the stability and the yield available in the United States."

3. Fund managers who take foreign investment face a series of challenges

For fund managers, it's not simply a matter of throwing out the welcome mat to foreign investors. Funds that accept investment from foreign sources face an imposing thicket of regulations.

That means funds need to pause and think. "What's going to be required if I accept this investment? Am I going to have to disclose information about my underlying investors or controlling persons?" asked Herron-Hinds. "If I do make those disclosures, what will it mean for the fund and for the investor? Will there be a withholding component, and now is the U.S. government or another country going to have information about them that I don't necessarily want them to have?"

Herron-Hinds pointed to things like the Foreign Account Tax Compliance Act (FATCA), which requires funds to disclose certain information about their investors. "In some instances, funds will be required to withhold on certain types of U.S.-sourced income that's generated from those investments," she said.

It is not only the Foreign Account Tax Compliance Act that fund managers must consider, though FATCA should certainly be near the top of their list. Other major regulatory regimes include the OECD's Common Reporting Standard and U.S. nonresident alien reporting and withholding requirements set forth under Chapter 3 of the U.S. Internal Revenue Code.

"FATCA requires disclosure and reporting of information about certain investors to the U.S. government," Herron-Hinds said. "And it requires withholding on certain payments in the event that it's determined that the fund or the investor is not compliant with FATCA—meaning that they either have not entered into an agreement with the U.S. government to report information or the investor hasn't provided documentation to the fund to establish that they're compliant."

This could subject them to 30 percent tax on certain income derived from sources in the U.S. U.S.-sourced interest, for example, may generate a FATCA withholding component. "It is therefore important for funds to develop systems, policies, and procedures to manage risk associated with these requirements and to pay attention to new global reporting obligations," Herron-Hinds added. "We've seen increased enforcement of these requirements, higher penalties, and more exams by the U.S. government recently in this area."

A Taxing Situation

Aureon Herron-Hinds
RSM US LLP

When it comes to tax reform, the only thing that's certain is uncertainty itself.

"As the U.S. administration unfolds its tax plan, we're anxiously awaiting something that we can really wrap our arms around," Herron-Hinds said. "But the reality is that there may be decreases in certain tax rates or changes with respect to the treatment and deductibility of interest, so funds and investors will need to consider what that means for them.

"I keep going back to reporting and withholding requirements," she said. "You could potentially have exposure for reporting in jurisdictions and for withholding on things that you weren't previously reporting or withhold on and don't have systems or processes in place yet to start doing so now."

The reality, she said, is that increased regulations will not keep foreign investors out of the U.S., but they will require that funds themselves be prepared to respond to and comply with a number of new requirements.

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4. The outlook for global investment is positive

The macro picture for the U.S. real estate market over the next 12 to 18 months remains positive in most sectors. “We’re spending a lot of time investing in multifamily and industrial, which a lot of other people are doing as well, but there is still good demand and dynamics there,” Merrigan said.

Deep Dive

Sean Bannon
Zurich Alternative Asset Management

There are several strategic reasons why real estate funds are looking to attract foreign capital. Foreign investors help diversify a firm’s capital base, and they comprise a deep pool of resources from which to draw.

“Some of the foreign investors are remarkably large,” Bannon said. “So I think, from an efficiency standpoint, from an execution standpoint, and from an opportunity standpoint, there are tremendous benefits to having that kind of capital at your disposal.”

Another benefit, he said, is that foreign investors can help create a fund that not only has various sources of capital but also has subfunds that can tailor exposures to different types of opportunities and different markets at different times.

“Oftentimes, the risk profiles may be slightly different,” he said. “So as you think about the opportunities in the United States, with its different property types, deal sizes, and markets, you can create optimal portfolios. You don’t necessarily have to limit your portfolio construction to a certain balance sheet.”

He outlined the decision-making process on the investor end this way. They’ll start out looking at the opportunities at home, and if they’re in a market where they’re making money, the U.S. becomes less attractive—and vice versa.

“I don’t think we’re going to see a significant spike in interest rates in the U.S.,” he added. “I think it’s going to be stable in near term. But with that 2 percent or 2.5 percent Treasury rate, there are still positive investment dynamics for foreign capital. It’s a good yield, relative to what they’re seeing in Germany, for example, where you have negative interest rates.”

Supply-and-demand fundamentals are also good. “Very, very good,” Bannon said. “And on the capital side, it’s difficult to look at the pricing today and take issue with it. There’s no question it’s expensive, but if you look at yield expectations from equity sources and what continues to look like very responsible debt being originated, we don’t have the same kind of interest rate environment or underwriting standards that we had during the last cycle. You can draw a lot of comfort from that.”

5. The regulatory climate should continue unchanged

Given the turmoil in Washington and the resulting legislative stasis, rules regulating real estate investment should continue or even improve. Whatever unfolds over the next year, the government will certainly maintain its pro-business stance.

“I think it’s certain there will be tax reform,” Herron-Hinds said, “but there’s still uncertainty as to what it will be. I think we all agree there is not much expectation that there will be a tremendous impact with respect to investors in the real estate market and funds themselves.”

She added that, with increased investment from abroad, she does expect stronger enforcement of the existing regulations requiring the automatic exchange of information, but she doesn’t think this will discourage foreign investors. “Eventually they’ll provide the information” she said. ■

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