

International Capital Invasion

Concern over
fiscal cliffs aside,
foreign investors
still see attractive
relative returns
in the US

By Jennifer LeClaire

Safe haven. That's the phrase many global investors are using to describe core US markets as uncertainty continues to rattle many parts of the world. Indeed, with fundamentals improving in cities like New York, Miami, Atlanta and Houston, global investors are looking for opportunities stateside.

According to Colliers' 2013 Global Investor Sentiment Report, the most attractive region to invest in immediately is the US, followed by Asia and Western Europe. And that investment may soon move beyond US core markets to non-gateway cities as supply shrinks and prices rise.

"There is ample capital from foreign sources looking for a home in the US," says Jahn Brodwin, senior managing director in the FTI Real Estate Solutions practice in New York. "However, the equity is very patient and disciplined. Reminders of yesterday are still in everyone's memory. There is great reluctance to give US funds a blank check. The foreign money wants more control and better alignment of interests."

Apparently, foreign money is satisfied enough with that control and alignment, at least compared to other options. Dan Fasulo, managing director for Real Capital Analytics in New York City, reports that capital from foreign capital flows into the US is at or near all-time highs. He shares, "The US is acknowledged as having good risk-adjusted returns versus other countries."

So who are these investors and what's driving their decisions? How will global capital flows into the US change in 2013? And what, if anything, could derail the renaissance? Although no one claims to have a crystal ball, the uncertainty is giving way to clarity and answers are easier to come by.

According to Colliers International's Year-End 2012 Foreign Capital Trends Report, Canada continues to dominate the foreign capital buying market in the US for all com-

mercial property types, accounting for 34% of the total foreign investor sales. Investors from Germany, Israel and the United Kingdom make up the second-largest group, accounting for 23% of all foreign capital transactions in the US over the past 36 months. Fasulo says even North Korea and China are looking at the US. But our neighbor to the north is likely to remain the most aggressive in 2013.

"Against a global backdrop of financial uncertainty stemming from continuing issues with stability in Europe, a potential slowdown in China, the debt ceiling and new fiscal cliffs in the US and potential plateauing in Canada, North American real estate markets still appear to be the most stable—with a healthy balance of risk and opportunity," says Mark Rose, CEO of Avison Young.

The strong Canadian dollar is a problem for the domestic economy, though positive for Canadian institutions going global—a trend Avison Young expects to increase in 2013. Rose says Canadian investors are questioning whether Canada is "at the top" while early signs of a housing recovery in the US are triggering the question, "Is the US at the bottom?"

"The lack of development is providing confidence for investors making value-add acquisitions, and core class A product is expensive everywhere," Rose says. "Canada appears to have reached a short-term top in pricing, whereas the US is just beginning to get its sea legs."

But Canada could see more competition from foreign investors in 2013. Expect a cornucopia of global capital investment. Despite the debt crisis, European investors are still inking plenty of deals stateside. Jordan Ray, managing director of the debt & equity finance group at Mission Capital Advisors in New York, is seeing plenty of activity. His firm closed a \$45-million condo construction loan at the end of the year with

a German bank and a \$27-million hotel balance sheet loan with a French bank.

"In general, European lenders are still very tight but the smart money is lending again to grow their balance sheets, reduce substandard asset ratios and work toward profitability," Ray says. "Asian capital has increased its presence but only for top tier assets in gateway markets."

Ray Cirz, CEO and Chairman at Integra Realty Resources in Miami, says he continues to see interest from his foreign clients, primarily for equity and investments—and, more recently, for debt.

"Institutional Canadian investors have maintained their appetite for retail and office properties and more recently, multi-family projects," Cirz says. "They are convinced that conditions in the US are favorable both politically and economically. European, Japanese and Australian investors still favor New York, Boston, Chicago, San Francisco and Los Angeles. However, Washington, DC has been put on the watch list as a decrease in government spending and potential overbuilding in the multifamily sector are new concerns."

As Mission Capital's Ray sees it, the world gravitates to US real estate because our lending, contractual, legal and workout infrastructure is the best in the world for lenders and investors. He predicts this continuous interest in US investments will hold rates down for the foreseeable future, driving even more global investment from around the world. "People sometimes incorrectly believe that the Fed's quantitative easing is what keeps rates so low," he says. "It's actually in large part due to foreign investment in the US, fixed-income products, treasuries, real estate and the like."

Global capital may be exploring the US, but the overall deal flow has dipped dramatically. According to a March 2013 report from McKinsey & Co., cross-border capital flows have collapsed, falling from \$11.8 trillion in 2007 to an estimated \$4.6 trillion in 2012. Western Europe accounts for some

70% of this drop, as the continent's financial integration has gone into reverse, the firm reports.

How does that impact the US? Brodwin says foreign equity today wants much more say in what is bought, how deals are structured, and how fees and promotes get paid. He reports some foreign equity investors are making deals with emerging managers where they fund start-ups and get a piece of the platform in exchange for coming in early and big—a new variation on "most favored nation" status.

"The problem with foreign money is it tends to want the class A properties in class A neighborhoods. The price is very high and it is difficult to make the numbers work," Brodwin says. "Foreign money wants properties that provide liquidity. They want to be able to exit when they want to exit."

Of course, that's not always possible, especially in non-gateway markets. That's why there's more effort to educate capital sources about secondary markets. Ray's firm was recently involved in a "bus tour" of Williamsburg, Brooklyn sponsored by an association of financial and real estate journalists from Germany. The goal was to educate German fund investors about the growth in New York's outer boroughs.

Challenges are one thing. The unknown is quite another. Consider the following scenarios: Are North and South Korea going to start dropping nukes on each other? Is Iran going to dismantle its nuclear plant or will the US go in to dismantle it? What about the fiscal cliffs? The European debt crisis? War in the Middle East? The what-ifs are many, but US and European financial issues are at the top of the heap.

"We need to get our national debt under control. We can't continue to spend more than we make year after year, and to the extent we are spending," Brodwin says. "This will have a long-term negative effect on our economy, slow real growth and put downward pressure on rents and occupancies."

Ray sees Europe as the X factor. From his perspective, once European financial institutions commit to selling substandard credits and lending at a grassroots level, the region's recovery will accelerate. "You cannot sell loans for high prices in markets where no lenders exist. It's a Catch-22," he says. "The US recovery is three to four years ahead of Europe. The good news is that once Europe recovers, this rising tide will raise all boats globally."

In a word, the outlook for 2013 and 2014 is bright. Although the Foreign Investment in Real Property Tax Act remains a challenge, all signs point to continued healthy investment from foreign buyers into US commercial real estate. RCA's Fasulo predicts double digit increases in transaction activity and solid property value increases, especially in secondary markets and for choice transitional assets.

Dwindling distressed assets are one reason for the bright outlook. RCA reports that 58% of the \$394 billion of mortgages that have fallen into trouble since the 2007 peak have now been resolved. Another \$168 billion still needs to be worked out. Brodwin says prices have already risen enough to make working out maturing debt feasible. Although it will require fresh equity, he is betting the equity will be there to get the deals done. Meanwhile, artificially low interest rates are preventing new bankruptcies and are giving the market a respite while real estate companies rebalance their balance sheets.

"Many properties are still overleveraged but not as much as they were a couple of years ago. Things are not nearly as under water as they were. There has been very little panic in the commercial real estate markets," Brodwin says. "The spread between the properties' value and the debt has narrowed to a point where deals can be done. Owners are raising fresh capital and using it to renegotiate debt." ♦

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