CAPITAL FLOWS Markets are late-stage and the economic-political backdrop risky. **Thomas Wiegelmann** and **Nikodem Szumilo** look at why cross-border investment continues unabated

Investors leave the tap running

Investment in many mature real estate markets is booming, a trend now in its seventh year. In light of this long-lasting upturn, market participants are becoming sceptical about the potential for further growth. Their concern is driven by more than just market cyclicality – economic and political factors could also affect financial and real estate markets.

This network of mutually influential factors is made more complex by the importance of international capital. Real estate has become a more prominent asset class than ever before, but the trend appears to be closely related to the increased significance of cross-border transactions.

Even before the UK voted to leave the EU, investors were faced with rising uncertainty, but cross-border investment continued to be strong. In fact, one of the key points made in the biannual investor survey by Union Investment was that European real estate investors were not adopting any additional safeguards despite rising uncertainty and the market appearing to be at an advanced stage of the cycle.

The report also suggested that the search for yield remained the primary motivation behind investment decisions and it reported no signs of changes in this trend.

This led to yield compression in most regions and sectors and 2016 appears to be the sixth year of sharp price increases and sustained investor demand. Despite initial yields remaining low in many markets, real estate prices appear not to be drifting far from their fundamental values and are priced fairly in comparison with stocks or bonds. High demand is driven primarily by international, cross-border investors. We expect the global transaction volume to amount to US$1trn (€952bn) by 2020, with about half of this invested by international investors.

Where does the capital come from? Global institutional investors tend to follow the traditional 40-40-20 asset allocation strategy, investing 40% in stocks, 40% in bonds and 20% in alternatives. The last category typically includes real estate, which now accounts for almost half of it and continues to grow.

In recent years China, Taiwan, Singapore, Norway, Africa and Latin America have become active cross-border investors. Nevertheless North America, Asia, and the Middle East dominate as sources of capital, accounting for 70% of all international transactions.

Europe is a main target, with about 65% of investment here coming from non-European investors. One of the strongest capital flows in recent years has been from North America to Europe. Thanks to their easy access to capital, North American investors feel drawn to the rich supply of high-quality real estate all over Europe, especially in light of the exchange rate between the euro and the US dollar.

The capital comes primarily from insurers, pension funds and sovereign funds – institutions with very similar investment goals and needs. Their investments accounted for about 20% of capital invested in commercial real estate around the world in 2015 (about $35bn). In the past six years, cross-border flows have grown at twice the rate of intra-regional investment in the Americas, EMEA, and Asia Pacific. It is possible that they could grow further to $500bn (50% of global transaction volume) by 2020.

Exogenous threats, transparency

However, the rate of the increase is likely to be determined by political and macroeconomic conditions. In times of crisis, capital flows have a tendency to reverse very quickly and return to regions, countries and cities of origin. If exogenous risks in destination countries are viewed as being too great, international investors act quickly to protect their assets.

At the moment, political conditions appear to be changing fast. International terrorism, growing tension between East and West, and religious conflicts are increasing economic uncertainty and creating obstacles not just to global trade, but to real estate transactions. Consequently, there is a clear connection between investments and the prevailing local and regional conditions.

> “The real estate market is certainly entering an interesting phase. While the mature markets have little room for growth due to already low yields, investment capital continues to flow internationally”

Access to local market information and attractive investment opportunities, liquidity, transparency of regulations and low barriers to entry are just a few of the factors that are important to global institutional investors. As a result, despite all of the dynamic growth in the emerging markets, the majority of capital continues to flow to the world’s established metropolitan areas. About half of global transaction volumes is accounted for by 30 cities, with just four of them (New York, London, Paris, and Tokyo) accounting for approximately 20%. It appears that transparency is the main determinant of international attractiveness of real estate markets.

According to JLL and LaSalle Investment Management’s 2016 Global Real Estate Transparency Index (GRETI), which analysed 109 global markets, two-thirds of real estate markets have shown progress in levels of transparency over the past two years. The 10 countries identified as “highly transparent” by GRETI account for 75% of global investment in commercial real estate. This shows the extent to which transparency drives real estate investment decisions. In this context it is interesting to analyse what is behind changes in transparency.

The GRETI 2016 report shows the progress that the real estate industry is making worldwide. Several factors were reported to have contributed to improvements in market transparency. Interestingly, some, like initiatives to deepen the availability and quality of market data and performance benchmarking, were not necessarily driven by local governments but the industry itself; others, like new legislation, higher ethical standards and wider adoption of ‘green building’ regulations and tools, were an outcome of collaborations between the two.

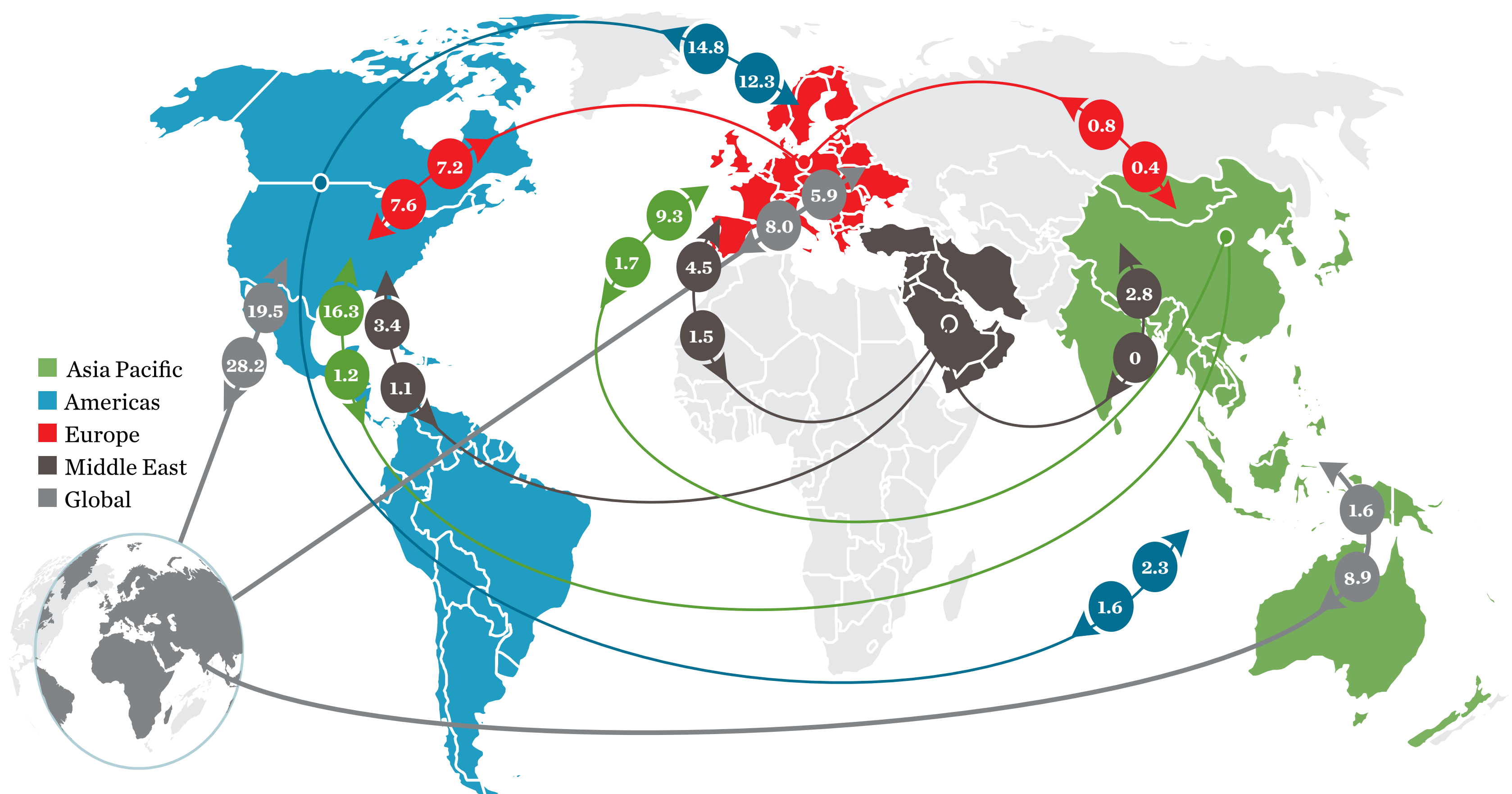
The amount of investment capital allocated to real estate is growing. JLL forecasts that within the next decade more than $1trn will be invested in the sector. This is a significant increase over the current US$700bn. Since real estate will be viewed as an alternative to other investments, investors will demand further improvements in real estate transparency, expecting standards to be on a par with other asset classes. Consequently, markets with highest transparency may be more attractive internationally than high-growth markets.

Improvements in transparency are generally accompanied by increases in foreign direct investments and user activity. International investors and businesses have helped to spur transparency reforms in many countries. National governments are starting to realise that low transparency affects foreign investments and long-term growth prospects – which also has consequences for local quality of life. This is a very interesting effect, as it appears that increased transparency of real estate markets also has a considerable domestic impact.

There is a growing recognition that transparent real estate practice plays a significant role in municipal finance and provides a platform for regional development. This effect is largely attributable to security of property rights and an honest and professional estate-agent industry. Technological progress is also an important factor in improving real estate transparency. It allows both digitisation of real estate data and its dissemination. Further improvements in data collection techniques allow more detailed and quicker assessment of real estate markets.

Those who have already invested in real estate are likely to benefit from further value increases as yields compress, but they could also receive higher rents if the economy continues to perform better than expected. However, those looking to increase the share of their investment portfolio allocated to real estate at this point generally find themselves competing with numerous other potential investors for properties that are in short supply, so they have to pay higher prices. Real estate is still relatively attractive compared with other forms of investment, such as bonds, but there are few real bargains left in the market.

Global sources of funds in $bn, 2016 YTD



Source: JLL

Living in interest-rate times

In the short-to-medium term there is no end in sight to the upward trend in pricing, which could last until the European Central Bank signals an end to its 'zero-interest' policy. The Brexit vote, however, has created conditions that have once again indefinitely postponed the ending of loose monetary policy.

This, combined with the attendant uncertainty, is driving investors into safe-havens such as real estate, especially core offices. The powerful compression of yields has a profound impact on capital values.

Fears of markets overheating, as was seen at the start of the global financial crisis in 2007 and 2008, are rising largely because of the upward pressure on prices across almost all real estate markets. It appears appropriate to consider the current real estate market situation in the context of the events surrounding the global financial market crisis and the period leading up to it.

Ever since the start of the of real estate transaction market recovery in the wake of the financial crisis, some experts have regularly held that future income streams are limited. This is due to the deeper and more detailed analysis required for purchases and financing, as well as investors having more realistic expectations. In addition, based on the experiences gleaned from the crisis, experts argue that risk can be more accurately identified and managed.

On the whole, there are signs of surplus demand in the investment market. This is due to delayed adjustment effects in the real estate market compared with other areas of the capital market and – in very general terms – securitisation challenges of real estate investments. Development activity has also returned to a clear upward trend in recent years as prices have risen. These projects are now successively entering the leasing and sales stages.

Today, conscious handling of the interest-rate risk is a key aspect of any sustainable approach to investment management. A large increase in long-term interest rates would have a negative impact on the entire real estate industry. Market players are increasingly favouring deals with longer periods of fixed interest rates. Alongside long-term fixed interest, lenders are now offering a broad range of possible interest-rate-hedging instruments, depending on the investor's individual assessment of where interest rates will go, the level of risk appetite, and preferred financing terms. These include caps (optional interest-rate hedge), payer swaptions (optional fixed-rate hedge), payer swaps (fixed-rate hedge), and futures or options. As always, however, investors need to choose their strategies according to need to manage the interest-rate risk appropriately.

The real estate market is certainly entering an interesting phase. While the mature markets have little room for growth due to already low yields, investment capital continues to flow internationally. Since it appears that the destination of capital is directed predominantly by an ability to identify and control risk, transparency appears to play a key role in attracting it.

One of the best ways to enter an unfamiliar market without taking on unnecessary risk is to partner with a local expert whose knowledge of the market and established networks can help understand its characteristics and provide access to attractive (off-market) investment opportunities. This makes international collaboration a fast developing area and vitally important to global investors, especially given the importance of local support for real estate projects. In this context, cross-cultural negotiations are also starting to emerge as a vastly under-appreciated part of many transactions.

The challenge of international partnerships is magnified by vast differences in local practices and the growing shortage of people who can put them in a global context. The real estate industry used to focus on domestic markets due to high barriers to entry in others. As those barriers come down, training and education on how to take advantage of this fact may be critical to success.

However, even the best local partners cannot provide the level of institutional assurance required by large international investors in areas such as ownership rights or economic policy stability. Fortunately, in addition to attracting international capital, improvements in those areas offer considerable domestic benefits and therefore are very attractive to local and national governments.

Consequently, it appears that the future of global real estate markets will be defined by international capital flows to countries that can offer the greatest improvements in their investment transparency.

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