

"SEEING OURSELVES AS OTHERS SEE US"

THE INTERNATIONAL INVESTOR IN THE U.S. REAL ESTATE MARKET

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How easy it is to fall prey to limited perspectives! In the ordinary routine of daily business, we tend to keep our noses to the grindstone and attend to the immediate tasks at hand. Crises need to be managed, and in short order. Business plans need to be executed; progress on performance benchmarks measured and reported. Deals need to be evaluated, priced, and negotiated. Rarely do we have the time to step back and look at the big picture. Yet taking the time to get that larger perspective is essential to making sense of all the immediate, urgent tasks that occupy the working day.

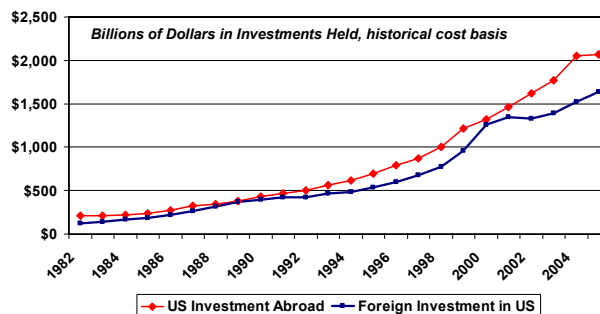
Occasionally, it helps to get beyond the horizons that define the internal operations of our businesses, or even the competitive evaluation of our direct peer group. While it is always important to look in the mirror – the ancient advice to “Know Thyself” has perennial value – it is equally worthwhile to get an “outsider’s view.” For institutional investors in U.S. real estate, considerations of asset allocation, returns, pricing, and relative performance can benefit from an attempt to get beyond the standard NCREIF numbers (as good as they are, and improving in utility each year). Let’s take a look at how others see us: international investors, as they deploy significant capital into American commercial real estate and indeed help to shape our markets at the upper end.

Capital volume for U.S. investment has soared and Foreign Direct Investment (FDI) has been growing as the complement to our trade deficit. While much of the public’s attention has focused on the purchase of U.S. Treasury securities by foreign central banks, much of our export/import imbalance has generated a huge, largely dollar-

denominated, pool of surplus funds in the hands of offshore corporations and wealthy individuals. For much of this money, the most obvious investment strategy includes recycling the funds in the U.S., the world’s largest market for assets of all kinds.

Figure 1

Globalization Has Massively Increased Cross-Border Direct Investment



Source: U.S. Bureau of Economic Analysis

Data from the Organization for Economic Cooperation and Development (OECD) shows that inward investment to its member nations grew 30.7% between 2003 and 2005, to \$583.5 billion. The U.S. share of all OECD inward investment grew from 15% in 2003, to 21.9% in 2004, to 22.0% in 2005. But other OECD member nations are growing as well; Canada, the United Kingdom, and Germany have recently found themselves attracting significantly higher volumes of international purchases of assets. Outflows from OECD members show significant growth amongst several European nations (Germany, France, Spain, and Italy) and continuing strong flows from Japan.

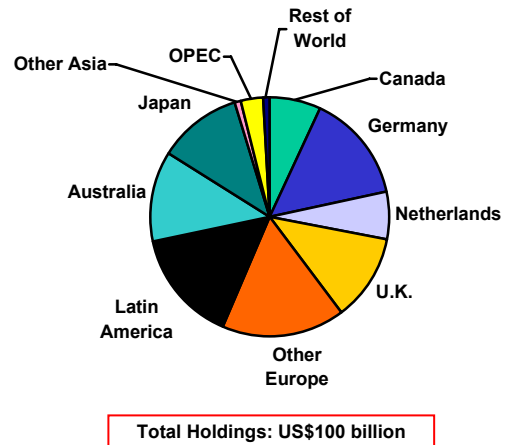
Of course, the OECD gives us only part of the picture since its membership is drawn from North America and Europe, with only Japan, Korea, Australia, and New Zealand from the fast-burgeoning Pacific economies. The U. S. Bureau of Economic Analysis (BEA) provides a more comprehensive profile of investment flows in its annual review published in the *Survey of Current Business* each July. The BEA’s data shows dramatically how globalization is affecting cross-border capital flows, as both U.S. Direct Investment Abroad (USDIA) and foreign investment into the United State have increased ten-fold since 1984 (see Figure 1). As of year-end 2005, American holdings abroad were just over \$2 trillion while Foreign Direct Investment in the US (FDIUS) tallied \$1.6 trillion. These figures, as large as they are, actually understate the value of the investments, since they are computed on a “historical cost basis.” Measured by current market value, USDIA is estimated to be \$3.5 trillion and FDIUS \$2.8 trillion.

With the total pool of capital expanding so rapidly (roughly 11.5% compounded over the past twenty years), it is no wonder that asset values have been increasing so sharply. As the Pacific Rim economies come charging into the modern age, it is also no wonder that they are becoming larger forces on both sides of the equation – as sources of capital for U.S. assets, and as targets for investment that compete with the U.S. for funds.

Real estate is part of that overall story. The amount of FDIUS directed to real estate is modest and the major international holders of U.S. real estate assets are (in order of dollar volume): Germany, Australia, the United Kingdom, Japan, the Netherlands, and Canada. (There is another “hot spot” of inward investment in real estate from the tax-havens of Caribbean Islands, but the ultimate source of that capital is deliberately obscure.) As we will see a bit later in this essay, recent flows into the U.S. are altering the historical distribution of offshore investment, and we can expect even more change in the not-too-distant future.

Figure 2

Shares of U.S. Direct Real Estate Holdings by Source of Capital



Source: U.S. Bureau of Economic Analysis, July 2006 (data reflects 2005 holdings); Torto Wheaton

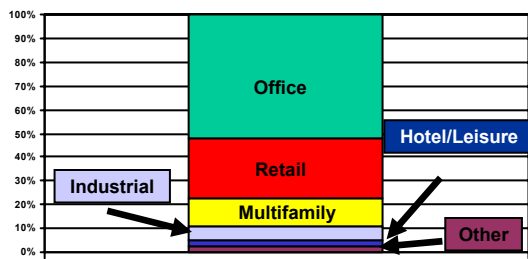
Meanwhile, the opportunity to channel cross-border real estate investment to other markets is rapidly expanding. Many of the largest real estate developments occurring in the world are outside U.S. borders. China’s building boom is drawing architects, developers, and capital from around the world. Shanghai alone is said to be increasing its skyline by 20% in the next year or two. China’s consumption of building materials has already spurred double-digit construction cost increases in the U.S. Dubai, in the United Arab Emirates, is a boom-town with an entry in the “world’s tallest building” sweepstakes, and is reported to be using 25% of the world’s tower cranes, according to *ENR* (the *Engineering News-Record*). Meanwhile, on a 1,400 acre site near Inchon, S. Korea’s airport, a new “intelligent city” is being developed at a cost of \$20 billion – including 50 million square feet of offices, 10 million square feet of retail, as well as residential and hotel space to comparable scales.

All of this means that the U.S. share of total real estate investment is under downward pressure. The most recent survey of Association of Foreign Investors in Real Estate (AFIRE) members,

released early in 2006, indicates that global allocations of new real estate investment for North American assets dropped below 50% of total capital for the first time in 2005, to 44.8%. Still, that is far and away the greatest share of any world region, leading Western Europe’s 34.9% and dwarfing all other markets around the globe.

Figure 3

Foreign Investment Portfolios in U.S. by Type of Property



Source: AFIRE

The motivations behind the U.S. allocation dominance tell of the world’s evaluation of American commercial property prospects. An astounding 73.5% of AFIRE’s respondents ranked the U.S. first in the world as having the safest and most secure real estate investments. The U.K. ranked second, with 8.8%. America also placed first as the national real estate market with the greatest potential for capital appreciation, so identified by 39.4% of the responses with China coming in second at 12.1%. In all, 64.6% of the AFIRE survey respondents indicated that their appetite for U.S. real estate investment going into 2006 was “stronger” or “much stronger” than in previous years. This appears to have translated into actual market activity during the year, as Real Capital Analytics measures office investment from foreign sources up 40% from 2005 levels. Investors with higher risk capital can certainly find opportunities within the U.S. as well as abroad: turnaround assets, second and third-tier markets, and speculative development. Even in the past several years, the double-digit returns from real estate can be attributed (partly at least) to investors who were willing to commit capital

to markets with comparatively high vacancy and soft rents.

The AFIRE results simply tell us that investors feel that the level of systematic risk in U.S. real estate markets is lower than the systematic risk elsewhere. In every investment, there is also the idiosyncratic risk associated with the particular property and its local market – the risk that can be diversified away, according to Modern Portfolio Theory. International investors use the safety characteristics of U.S. real estate markets (and the U.S. economy generally) – justifying our low cap rates – and then manage the higher-risk individual investments worldwide in their portfolios by carefully considering the risk opportunities in their own markets and diversifying appropriately.

The composition of capital sources is changing from Europe, to the Middle East (especially Dubai) and Asia (Hong Kong and Japan, most recently). Petrodollars are being recycled, and so are the Asian trade surpluses. Through the end of the Third Quarter 2006, the top international buyers of U.S. office properties have been the Hudson Waterfront investment group, a conduit for Hong Kong capital, the Dubai investor Istithmar, and the Hines-Sumisay Fund, which invests Japanese capital, according to Real Capital Analytics. Thus far, we have not seen much in the way of mainland Chinese direct investment, but that appears inevitable given the exceptional trade imbalance favoring the Chinese. Furthermore, J-REITs (the Japanese trusts) do not have sufficient domestic opportunity and have been thus far generating disappointing returns at home. We can expect additional funds targeting the U.S. as the pool of J-REIT capital seeks competitive yields for their public market investors – probably partnering at first with experienced U.S. investors to avoid repeating mistakes made in the Eighties by the first wave of Japanese investment.

Retail investment is also popular, although it has been dropping in the AFIRE rankings of preferred property types. The sources of funds targeted to shopping centers are more widespread, including Australian, UK, and German money

favoring larger malls. It is not just a single investor from each country either. The Australian purchases this year, for instance, have included buys by Macquarie Bank, Centro Properties’ acquisition of the Heritage REIT, and investments by Galileo Shopping Trust America. From across the Atlantic, 2006 has seen retail property acquisitions by the Grosvenor Estate, Oxford Properties, and the Anglo-Irish Bank.

Foreign investment in industrials is focusing more on flex assets, indicating belief in a technology rebound and a growth play as office markets tighten. Few warehouses have been purchased by international investors, who ranked this property type last on their shopping list in 2004, and next-to-last in 2005, according to AFIRE. Real Capital Analytics placed foreign investment in the industrial sector at just 5% of total for flex space, and about 2.5% of total for warehouses.

By and large, the U.S. is seen as the largest and most stable of the real estate investment markets. International investors, like institutional investors here in the States, have learned the virtues of diversification. This is positive for the market, as U.S. real estate represents a substantial asset class on the world scene. However, it also means that investors will be diversifying around the globe more than before, sharpening the competition that U.S. assets face for this capital. This is a two-edged sword. From the perspective of the international investors, the U.S. is a tough market in which to find assets – nothing seems “undervalued” at the moment at the property level. No one thinks it is easy to acquire attractive properties today, and 94% of the AFIRE respondents characterize current conditions as “difficult” or “very difficult,” with U.S. pension funds and other institutional investors their prime competition in the search for good deals.

One sign of the broadening of the international sector is the growth in AFIRE’s membership. AFIRE began as an almost “club-like” organization in the late 1980s, but now is comprised of over 150 members from 17 nations, and has had to take steps limiting attendance at its

meeting to preserve the high level of interaction and participation its members have come to expect. International investors are increasingly sophisticated and knowledgeable about the workings of U.S. markets, and there is a very level playing field at present as far as the expertise they bring to the table as compared with U.S. institutions.

Significant partnering opportunities nonetheless are arising for institutional investors, as international capital seeks to ally itself with experienced domestic funds, and offshore funds are, in many cases, actively seeking joint-venture opportunities. In an attempt to bolster yields, some are migrating from a core asset strategy and embracing more “value-added” acquisitions in the U.S. This can range from investment in second-tier markets and non-traditional assets to ground-up development opportunities. While there is still a strong propensity to focus on just the top-tier cities, some funds are showing greater willingness to put capital into Sunbelt markets where they are beginning to perceive a combination of better pricing and faster demand growth.

Top Cities for Real Estate Investment

U.S. Markets

Washington, DC
New York City
Los Angeles
San Francisco
San Diego
Boston
Seattle

Non-U.S. Markets

London
Paris
Tokyo
Shanghai
Toronto
Seoul
Berlin

Source: AFIRE

In many ways, the perspective of the large international investors should validate the positive outlook many U.S. institutional investors have for commercial property. One of the great strengths of the American economy is its transparency and the ease of entry of capital from abroad. This helps buoy asset values by expanding the overall capital pool. It also exerts discipline on the markets, as more and more investors “vote” on prices and returns.

What of “dollar concerns” as the recent and well-publicized fall in the U.S. Dollar in the currency markets influences international buyers? This is another example of how anticipation helps shape the news. For the past several years, it has been clear that the twin deficits – a Federal budget, with hundreds of billions in red ink deep into an economic recovery, and a Balance of Trade running negative to the tune of about 6% of GDP – has led to a downward adjustment in the exchange rate. Thus, when the Euro strengthened to 1.30 over the U.S. dollar, the "Aha! Gang" was out in force, saying, "I told you so." (Never mind that the Euro was priced at 1.34 to the dollar at the end of 2004... the story is all about the weak dollar.)

Inevitably, discussion has arisen about what the shift in the dollar means for real estate investment – as if real estate were in any way an appropriate vehicle for currency speculation. Experienced investors realize that floating currencies have their own cycles and that playing that cycle is best left to arbitrageurs in the high-risk/high-cost businesses of FX trading and hedge funds. Commercial property investment looks to much more fundamental economic factors.

One area where the impacts of the weakening dollar might have a noticeable effect is in the potential reaction of the Fed. Some have assumed that the rhetoric in Washington about our commitment to a “strong dollar” would lead to the Fed pushing interest rates up. Believe it or not, sometimes what they say in Washington is not the unvarnished truth! The Fed is much more likely to let the dollar weaken and to smile while it is doing so. If our trade imbalance is a serious concern to anyone, more expensive imports and more affordable exports are part of the cure. The Fed, unlike some Fed-watchers, also has a sense of history. Previous lows in the Fed’s Major Currency Index (in July 1980 and in July 1995) have preceded periods of solid U.S. economic growth, a situation both the Bush Treasury and the Bernanke Fed would like to see repeated.

So, rather than putting upward pressure on cap rates, any Fed action (or deliberate inaction) is likely to favor commercial real estate investment performance. Furthermore, on the income side, the Fed’s propensity to extend the expansionary GDP cycle should help the demand side of the real estate equation by keeping job generation around two million per year. Finally, on the cost side, the higher import prices will continue to keep replacement cost for new construction elevated, since so much of our building materials inventory comes from abroad.

Given that real estate investment in any country is a long-term commitment, we see the fundamentals behind these factors driving decision-making, while traders might fret over short-term fluctuations in the dollar and rates.

It has been the case that offshore investors have often led the market upward, nimbly seeing opportunities where more conservative domestic investors moved to the sidelines. Sometimes, as in the late Eighties, the offshore capital was too aggressive and paid a heavy price. However, in this cycle, it seems that international buyers correctly saw the recessionary trough as an acquisition signal that could provide properties with income potential as vacancies diminished and rents recovered. The “foolish” prices they paid three years ago look pretty savvy right now.