FOREIGN INVESTMENT IN U.S. REAL ESTATE

Investment in U.S. real estate by foreign institutions and individuals may slow down in the 1990s, but it will continue to be a major influence on the real estate market in this country.

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Foreign investment in the United States can be put into historical perspective with just one phrase that tells it all: the United States was built by foreign capital. It is a long and honored tradition in America and an absolute requirement of economic development in a massive continental nation such as ours to have foreign investment. This fact often is lost on members of Congress and others.

Historical Perspective

In American history, there have been basic foreign investment themes. In prerevolutionary days, there was tremendous land speculation in America primarily handled through syndications sold into European markets, particularly England's. One of the major facts that led to the American Revolution was the Crown's effort to suppress these activities.

After the Revolution, land syndicates involving major foreign participation were a major force in moving the population beyond the Appalachians and to the old Northwest.

Between 1850 and 1880, U.S. railroads were given land by Congress in order to extend their route systems into the far West. Railroads sold massive amounts of securities backed by land in European investor markets.

Between 1880 and 1920, there was an inflow of capital from England, Scotland and Ireland into U.S. farm land investment. Major cattle ranches and farming combines were put together based on European capital. Interestingly, this is the time when most of the statutes restricting foreign investment and ownership of agricultural land came into being at the state level.

After World War II, the English backed Zeckendorf and other U.S. investors. The English also were active in some of their own investments. The Pan Am building, for example, was syndicated in England. In the 1960s, off-shore real estate mutual funds sold shares to small investors in Europe. These were unsuccessful as they were marginal properties that were poorly structured and often involved fee rip-offs. Today, many individual European investors remember this period and are very careful about making investments in the United States.

The 1970s saw major increases in oil prices. With this came the need to recycle funds. Middle Eastern capital started coming into the United States for the first time, as well as Latin American flight capital. This period also witnessed the move of major Canadian developers into the United States. With few exceptions, ventures financed by these investors were not successful.

In the 1980s, the Japanese, who had been investing only marginally in U.S. joint ventures, really

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started to hit their stride. Important new sources of investors from Hong Kong, Singapore, Taiwan and other areas also developed at this time. As we enter the 1990s, we can look back on a long historical experience with foreign investment that has come from virtually all over the world.

Current Trends

How big is foreign participation in the U.S. real estate market? At the end of 1988, the value of the commercial real estate market in the United States was $3.5 trillion. Foreigners held less than 1% of that market or about $32 billion; pension funds about 2%; securitized real estate about 2.7%; financial institutions about 20%; and U.S. corporations, which are by far the largest holders of U.S. investment real estate, about 74.4%. If you do not consider holdings by corporations and financial institutions, foreign investment represented 16.3% of this market in 1988 vs 22.2% in 1982. So, in terms of market share, foreign investment has actually declined.[1]

How fast is it growing? Looking at the period from 1982 to 1988, foreign investment in real estate has grown about 25% a year. This compares to a growth rate for securitized assets of about 45% and a growth rate for pension fund assets of about 43%. Foreign investment has not been growing as fast as other forms of domestically generated investment, which explains its decline in market share.

Where does it come from? By the end of 1988, Europe slightly dominated U.S. foreign real estate investment with 33% of the investment assets. Japan had 31% of U.S. investment assets with by far the fastest rate of increase. Latin America was third with 16%; Canada fourth with 13%. All others had about 7%.[2]

What are some of the factors driving investment in U.S. real estate? From the institutional point of view, yields are the basic driving force. In the 1970s and early 1980s, yields were higher in U.S. real estate than they were in real estate in other countries. So the fundamental driving force for this investment and flow of capital remained what institutions always try to achieve: improvement in their returns on assets.

In some cases, this quest for yields has been short-term in nature. Major syndicators in Japan, as an example, have bought U.S. assets, resyndicated these assets back into the Japanese market and taken a spread on arbitrage of yields. There also has been a move among institutional investors for country diversification. The weakness of the U.S. dollar also has been an attractive factor, as has the higher transaction volume of the U.S. market, making it possible to build a portfolio more quickly in this country than in others.

For individual investors, the fact is that a good part of foreign capital flows involves the diversification of flight capital in order to reduce the risk a particular family faces in its own country. Investors from these countries are looking for a safe haven. We have established legal institutions to facilitate investment. Our market has free entry. We have financing sources that are not common to other countries.

Where are investors buying? One of the traditional theories is the "port of entry" concept. That is, foreign investors invest in those areas of the country where their nationals most commonly arrived at some point in time: San Francisco has been the magnet for investment from the Chinese community; Los Angeles has been the site of investment from the Japanese; Chicago, New York and other areas in the East have been targets of European investment. The Japanese, as an example, put 40% of their money in 1988 into three markets: Los Angeles, New York and Honolulu.[3]

This port of entry theory is breaking down to some extent today as foreign investors become more sophisticated and, frankly, run out of opportunities in the markets where they first began their investment activities. Other markets, such as Atlanta, Boston, Washington, D.C. and Seattle, are emerging as new targets for foreign investors.

What products are they buying? Let's look at the Japanese since they are by far the most active of today's foreign investors. In 1989, 23% of Japan's investments in the United States went into office buildings, 28% into resorts and hotels, 15% into mixed uses, 15% into residential developments, 2% into retail, 2% into industrial uses and 9% into land.[4]

Japan's investment transactions are getting smaller, but they are still very large. The average transaction in 1989 was $50.8 million. That was down from $78 million in 1988.[5] It is pretty clear that, as Japanese investors diversify into secondary markets and buy other types of products, they will reduce the size of their transactions.

Who is Buying? Let's look again at the Japanese experience. In 1989, 49% of Japan's investments in U.S. real estate came from firms involved in either construction or development, 6% from life insurance companies, about 17% from business firms and 21% from individuals. Individual Japanese investors are a new force in the market, becoming active only in the last few years. Pension funds are important as a result of a change in policy made by the Ministry of Finance which allows these funds to invest up to 20% of their assets abroad (it had only been 3% before).

In terms of a risk profile, 56% of the Japanese investment in 1989 went into existing properties and 44% was in new development. This was a substantial increase in development activity over the previous three to four years. In terms of deal structures, the Japanese continue to prefer joint ventures. About 54% of these investments were in joint ventures and about 46% were in fee ownership.[6]

Major Issues

I want to address three major issues. The first is the risk-return relationship that exists in U.S. real estate today. As I indicated, most of the foreign investment is made by institutional funds, and it is

yield driven. Today, cash returns in U.S. real estate range between 6.5% and 10%, depending on the market. These returns are higher than the returns in Europe, which range from 5% to 6%, and they are dramatically higher than the returns in Japan, which are about 2%.

It is in the total return area that the U.S. real estate market is developing some problems. For the first time in the last five years, we find total returns in overseas markets exceeding those in the U.S. markets. This is due to several factors, the most important of which is the much stronger role of government in the development process abroad. This tends to limit supply and prevents the overbuilding that has been experienced in the United States.

An examination of U.S. returns over the last five years shows that for the first time since World War II, real estate trails bonds. This, of course, is forcing institutional investors to reconsider the asset allocation issue. As a result, British investors pulled out of U.S. investments last year, feeling they could get higher returns in European real estate. The Japanese also are increasing their investments in Europe.

It is pretty clear that if risk-return relationships do not improve, the United States will see a lower share of the real estate market held by foreigners as foreign investment activity slows down.

A second major issue I want to talk about is vertical integration. I refer to an excellent paper by Larry Bacow from the Massachusetts Institute of Technology.[7] *(For complete text of Bacow's paper, see pages 1–8.)*

Clearly, there is an underlying fear in the U.S. real estate community that if foreign firms integrate in this country as they have in their own countries, they can establish a monopoly position and force out U.S. firms or dilute the market share of U.S. firms. In a period of a possible recession and soft markets, having to share this diminishing return with foreign nationals is not a good prospect. This fear is experienced by individuals and firms who otherwise are very favorably disposed towards foreign real estate investment.

Bacow's paper concludes that vertical integration will not be successful in the United States. Let me review some of his reasons. First, vertical integration of U.S. real estate has not worked for U.S. or Canadian firms that have tried it in the past. There is no reason to believe that it would work better for other foreign firms. U.S. markets are too dispersed in terms of multimarket activity. They certainly are not homogeneous.

A third major issue is regulation. It is the position of some people that foreign investment in the United States should be absolutely prohibited. This type of thinking is reflected in 27 state laws, many of which were introduced in the late 1800s, that deny ownership to foreign investors, although most of these laws are directed at the ownership of farm land and not at the ownership of investment properties.

The next level of regulation is the registration of foreign ownership, which is generally proposed at the federal level. This type of regulation often is introduced as a tracking device. In most cases, it ends up being a harrassment device. Today, legislation (FIRPTA) requires more disclosure on the part of foreign national investors than it does from American investors.

The third area of regulation is taxation. If there are treaty provisions, foreigners can be treated better than U.S. investors. Here, there is a move toward achieving equality between U.S. and foreign investors. In future years, no doubt several attempts will be made to pass measures that will limit foreign investment unless there is "reciprocity" from other countries.

Prospects For The Future

In terms of the future, there will be continued foreign investment in the United States, and foreigners will continue to be major players in the U.S. real estate market. Because of the yield problem, there will likely be a slowdown in the rate of foreign investment and a shift in the movement of assets to other nations. There will likely be limited vertical integration, except in certain homogeneous markets.

Foreign investors will influence one aspect of the real estate market that is not healthy for U.S. real estate firms: there will be fewer transactions. Most foreign investors will not be recycling properties for some period of time. There will be less volatility because of the longer term investment perspective of many foreign investors.

There is clear evidence of globalization of real estate. This follows the globalization of the securities market over the last ten years. Finally, there is an increased level of institutionalization of U.S. real estate partially because most foreign investors are institutions.

Generally speaking, the 1990s will be very challenging in terms of the changing structure of the real estate industry. By the end of this decade, foreign investment will not be discussed in the same sense that it is today. There will be acceptance of the fact that there is a worldwide investment market. Some investment goes out; some comes in. Dealing with a global market will be just a part of the day-to-day life of the real estate professional.

NOTES

1. Roulac Group of Deloitte & Touche: *Real Estate Capital Flows 1989*. San Francisco, p. 4.
2. U.S. Department of Commerce, Bureau of Economic Analysis. *Survey of Current Business*, Aug, 1989. p. 52.
3. Kenneth Leventhal and Company: 1989, *Japanese Investment in United States Real Estate*, Los Angeles, p. 15.
4. Ibid. p. 7.
5. Ibid. p. 8.
6. Ibid. p. 25.
7. Bacow, Lawrence. *Foreign Investment, Vertical Integration and the Structure of the U.S. Real Estate Industry*, Massachusetts Institute of Technology Center for Real Estate Development, Working Paper No. 25, Jan, 1990.