FOCUS ON LEGAL ISSUES

REFLECTIONS IN AN INTERNATIONAL EYE

by Edwin "Brick" Howe, Jr., CRE

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Just how is foreign investment in U.S. real estate doing these days, especially when compared to, say, 25 years ago?

Not all that well, I'd guess (or to look at it from another standpoint, not all that badly, since such investment is far from the fad it was some years ago). My point of view may be a little different from yours. As a real estate lawyer for 35 years, I've had to know a bit about real estate, just, as an international lawyer, I've had to know a bit about differences among cultures and bridging them. But I've seldom had the opportunity to occupy a forward position on the substantive real estate lines and therefore hope that I can regard matters like this in a more detached fashion than many CREs.

I start by asking a question that has been rattling around the back of my skull for many years: Why should a foreign institutional investor be interested in U.S. real estate? I'd ask the same question about *any* foreign investor. Or any domestic institutional investor.

As for non-institutional domestic investors, I'd ask the same question and say the answer is obvious: That is the way the Helmsleys, Silversteins, Greens, et al., of this world make their living—or lose their shirts—by being primarily in the real estate and related businesses and "knowing their respective territories," as a less folksy *Music Man* might have put it. If anyone is going to succeed, one would expect that it is this group of investors.

But why the others? Here is a small, and clearly non-exhaustive, sample of the answers I've heard over the years:

- "It's a hedge against inflation." Not true; real estate is as subject to inflation as any other part of the economy and actually is less well equipped than most other sectors to respond to inflationary conditions because leases, at more-or-less fixed rental rates, will remain in effect for some time to come. In fact, real estate can be a hedge against very *short-term* recession, though there must be very few real estate portfolios having a core strategy of capitalizing on short-term recession. Shorting stocks would seem a much more efficient way of implementing such a strategy.

- "It's a hedge against volatility." Yes, sometimes, especially when stock or other securities markets are behaving in a fashion that appears irrational to us mere humans. But think, for example, about the sudden 35% upturn in non-primary-market shopping center capitalization rates experienced over some six months during 2001. Think about what happened to real estate during the Asian financial crisis a few years back. That is very big-league volatility and positive turn-arounds in the real estate market are something like reversing the course of the Queen Mary, as compared to the experience of a rebounding securities market.

- "It's *real* estate, after all, assets I can touch, not just pieces of paper." Please. I will not put further ink into this one, except to note that, at least in the languages other than English with which I'm familiar, the word we translate as "real" is "immovable," a distinction that speaks for itself.

- "Maybe trends in real estate will, over time, counterbalance trends in other investments." Yes, maybe they will. The key word there is "maybe." To base portfolio management on this principle, I'd want a two-line graph, one line marked "Real Estate" and the other marked "Other," going back 100 years at least and adjusted for panics, droughts, wars, Great Fires, earthquakes, plagues, irrational exuberance, and insatiable greed. If those two lines didn't complement each other reasonably well, I'd drop this as a theory of portfolio management.

- "If managed with a careful eye to costs and with a creative leasing strategy, net cash flow can grow very substantially and capital value can grow geometrically." This one makes sense, subject to a carload of qualifications, and is something of a springboard into my own view of the matter, which differs from the viewpoint just stated not in concept but in the approach to the endeavor to be adopted by the spider at the center of the investment web.

My view, simply stated, is that the potential virtue of institutional investment in real estate is that a real-estate project is a *business* that is small enough for an institution to manage on its own free-standing basis, employing its own management and portfolio policies and exercising its own business judgment as to the timing of acquisition, financing and sale of the asset in question. Note that I say its *own* judgment, not that of Jack Welch, Hank Greenberg, Bernie Ebbers, Dennis Koslowski, or Martha Stewart (to mix the apparently OK with the apparently non-OK). As such, a real estate investment can be an appropriate counterweight to investments in assets, management and perhaps unsavory motives belonging to someone else.

The individual foreign investor can look upon U.S. real estate investment similarly, but the temptation to delegate the efforts on his part normally necessary to run the business properly to persons not worthy of his trust all too often is overwhelming, in consequence of which I can count on the thumbs of both hands the foreign individual investors whose U.S. real-estate programs I have witnessed succeed.

As for the institutional investors, it would seem that, if they are smart and prudent enough to run standard securities portfolios, they should be smart and prudent enough to add to the mix a few investments that can take direct advantage of their own business acumen. This is not to say, of course, that institutional investors who do not take such advantage are inadequate, but merely to suggest that putting together such a mix should not, in and of itself, be regarded as a negative so long as the institutional managers really do possess the necessary business judgment.

But, if a particular institutional investor or its manager cannot lay claim to that kind of ability, then the investor probably should stick to the program of "passive" investments that have traditionally been the concentration of such investors. If there's one thing that direct investment in real estate is, it's not passive—or, as an old colleague of mine once put it, "Real estate is *PROBLEMS!*" (Emphasis in original.) And, in particular, such investors should not look to REITs as "indirect" investment in real estate. REITs do invest in real estate and some of them very successfully, but over the years they have performed far more like stock than real estate and the movements of REIT shares are about as responsive as any other stock to the unknowable fashions, whims, misunderstandings and corruptions of Wall Street "analysts."

A rather benign example of how resistant Wall Street is to a true understanding of real estate occurred when a client of mine some years ago explored a public offering of its shares. A very distinguished Wall Street investment bank was engaged for the exercise, and my client was accorded the services of one of the bank's most skillful executives. At the first meeting with him (at which the lawyers were present for some long-forgotten reason), the executive said to the client, "Well, now, how do you manage your assets—for income or for growth?" The client quickly realized that some educational work would be necessary and the plan to market a new share issue did not long survive that incident. I do not accuse Wall Street of maintaining that antediluvian mind-set, but I do think many Wall Streeters haven't made it much beyond the Napoleonic Wars in their view of real estate.

So just how well have the foreign institutional investors done in U.S. real estate over the last two and a half decades or so? As with so many things, it's a mixed bag and one that I have to approach anecdotally, largely on the basis of my own knowledge of the records of some of my firm's clients, which number (though not exclusively) some of the larger and more distinguished foreign institutions, and of similar clients represented by other professionals whom I have known over the years:

- Most such investors should have kept entirely clear of U.S. real estate. (I concede, of course, that this statement is a lot easier for me to make today than it would have been fifteen years ago, when I earned much of my living that way, and I hasten to add that many of my current judgments are made only via 20-20 hindsight.) The lessons learned from these investments were by and large far greater than the profits they produced. One of those lessons is that one has to operate a real estate investment like a small business. Not many of the investors in questions did so, and I'd venture that not all of *them* did so competently.

- Having said the foregoing, I need to set the record straight: Many of these investors were lured into U.S. real estate investment in the mid-1970s and even the early 1980s because of U.S. tax policies in place at the time. If you think back to the early years of the Kennedy Administration, you will remember a weak U.S. dollar and an inability of this country to attract as much foreign investment, including both portfolio and direct investment, as it should have. This was in part the result of a tangle of archaic fiscal rules which the U.S. had applied to foreign investors (among others) with increasing vigor since the early days of the New Deal. The Foreign Investors Tax Act of 1966, a piece of legislation beautifully crafted by some of our most illustrious fiscal minds, was intended to do away with all that and in fact did do away with much of it. Indeed, as the "tax industry" moved into the 1970s, it was possible for any foreign investor who adopted the right tax planning to invest in U.S. real estate on a virtually tax-free basis. With such a fiscal background, the watchword became, "How can we afford *not* to invest in U.S. real estate?"

- Then, as time passed, as a certain xenophobia developed in the U.S., and as our legislators realized that foreign investors vote only with their feet, the fiscal screws on foreign investors were tightened again and again until their position was in some cases actually worse than their tax-paying domestic counterparts. But this is a message that somehow just didn't get through to foreign institutional investors. They needed to see some real, even abundant, losses in terms of actual greenbacks to break themselves of the habit.

- In retrospect, investment by foreign investors in U.S. real estate was very much a herd phenomenon, and typically those who were first in (say, 1975-77) and also first out were the winners, while many of the others were losers.

- When FIRPTA was enacted at the end of 1980, this legislation for the first time made it vastly more difficult, frequently impossible, for foreign investors in U.S. real estate to do so tax-free, and as a consequence the relevant market became stone-cold for about three and a half years. But there was a pent-up demand for U.S. real estate on the part of foreign institutional investors which evidenced itself in a second, utterly irrepressible wave of investment activity beginning about the middle of 1984—ironically, just at the moment when the U.S. dollar was approaching its highest level vs. virtually all foreign currencies in decades. Far too many of these investments were big losers in terms of U.S. dollars and far greater losers when expressed in terms of home currencies, some of which had grown 2½ times stronger vs. the dollar by the time of sale (or foreclosure).

- To be fair, when the first wave of such investment began in the mid-1970s and exchange rates were more like they are today, I observed to several foreign clients that they would probably end up making a fair profit, on repatriation, in terms of their home currencies. Invariably the reply was that this was in no way a currency play; a certain part of the portfolio had been allocated to dollar-denominated investments and a portion of that had targeted real estate. I never pursued this point, as I had no reason to doubt any client's candor. In retrospect, my best guess is that they foresaw selling U.S. Property 1 and investing the (tax-free) proceeds in U.S. Property 2 and so on.

■ And one must not forget the security factor. For decades, investors have put some of their money in the U.S. because they found the physical environment here more favorable than at home. We have to bear it in mind that the Berlin Wall did not come down until 1989, when a great many of the investments in question had already been made. Today, of course, the reputation of the U.S. as a safe haven for real estate investment may no longer be what it once was.

■ The investors whose programs (even if they were losers, and for sure not all of them were) outpaced the others invariably did their investing the "right" way, as did some but not all of the less successful investors. All of those who did it the "wrong" way, to the best of my knowledge, were in the "less successful" class.

■ The "right" way in my judgment was *(1)* to rely on independent investment advisers, fee-driven as little as possible, and *(2)* not to think in terms of "having to get $X invested in U.S. real estate this year." On one occasion, when an investment offered a client turned out to be essentially fraudulent, the client actually said to me, "We are coming back to make more investments in two months and, Brick, *next time we must not fail!*" (Emphasis in original; and, by the way, that client's approach was manifestly the "wrong" way.) Many of the investors who did it the "right" way set up elaborate monitoring systems to track operations and some even set up representative offices in the U.S. All of this turned out to be pretty expensive of course, particularly when compared to investment in portfolio securities.

■ While there are many other ways that didn't work out, one of the "wronger" ways was *(1)* to adopt a "house broker" or two, some of whom offered "guarantees" of cash flow for a few years, and *(2)* to visit this country two or three times a year, always with advance notice to the broker, who was by now acting as managing and leasing agent. With such diluted attention from abroad, it all too often happened that a shiny new office building, say, was built 250 yards away, to come on line just as the larger leases in the client's building were beginning to roll. This presented what the "house broker" normally referred to as "a fabulous leasing opportunity" from the client's viewpoint.

■ The investors who went "wrongest" of all are those who made decisions, at their highest levels, to dispose of the entire U.S. real estate portfolio by X date. Invariably, the pressure on their operatives to sell was well known, and they got out at prices most of which were heart-breakingly low.

■ And one final point: Much of the allure of foreign institutional investment in U.S. real estate probably had to do with the related perks, the trips to the U.S. to kick the tires and enjoy the Kansas City strip steaks. In that respect, those enjoying the perks were clearly no more venal than the author of this article. My only saving grace is that it was not my own attraction to perks that led investors into programs of investment that at first appeared very attractive but, certainly from 1982 onwards, did not stand much of a chance. Of course, as we have seen from recent revelations in certain divorce papers, even the most highly regarded among us have their little venalities.

To sum up, it appears that the vast majority of foreign investments in real estate were made on the basis of noble, and certainly not ignoble, motivations. That is true especially if you consider it noble for the real-estate manager of, say, a foreign pension fund to go looking in the U.S. after his boss has said, "*ABC* and *XYZ* are going into U.S. real estate in a big way; why aren't we?" Moreover, the fact is that there were—and are—a number of foreign-owned U.S. real estate portfolios that have been successful. To the best of my knowledge, they were all acquired in the "right" way and then managed, including in terms of timing of refinancing and sale, as businesses, some in recent times with innovative tax planning of the sort I have written about in a previous issue of this publication. The pity is that more of them haven't been handled that way.

ABOUT THE AUTHOR

Edwin "Brick" Howe, Jr., CRE, *is a lawyer specializing in international, real estate and tax law and the management of dispute resolution, a real estate broker and a marketing consultant based in Ticonderoga, NY, where he is President of The Roseville Company LLC. He is also Senior Counsel to Howe & Addington LLP, the law firm he founded in New York City in 1970.* [redacted]