

REAL ESTATE ISSUES®

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INSIDERS' PERSPECTIVES

Global Property Outlook and Role
of Real Estate in the European Financial Crisis

Investing in Emerging Markets:
China, India and Brazil

Go South, Young Men (and Women...)
Key Investment Considerations in Latin America

Seller Beware: The Impact and Consequences
to Date of Asian Investment in Metro
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Turkey: Modernizing through
Mall Development

Asian Tigers and Lion Kings

Public-Private Partnerships:
Lessons From Military Housing

RESOURCE REVIEW

*When the Boomers Bail:
A Community Economic Survival Guide*



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Global Property Outlook and Role of Real Estate in the European Financial Crisis

Robert Peto MA, FRICS

This article traces the relationship between real estate and the global financial crisis (GFC), and the failure of financial regulators and central bankers to understand the dangers of asset price bubbles. A sceptical note is introduced about the ability of Basel III on its own to reduce the likelihood of future financial crises. GFC Round One in Europe exposed the excessive lending to the commercial real estate sector which has not yet been properly provisioned. Some 80 percent of real estate debt is "secured" against poor quality assets, a problem the banks have not really addressed. This unresolved problem has made GFC Round Two much worse as the European banks are also heavily exposed to poor quality sovereign debt. Default could lead to another banking crisis requiring another round of recapitalisation. This uncertainty, coupled with the risks of a breakup in whole or in part of the euro zone, make cross-border investing risky and is adversely impacting business and consumer confidence with knock on effects on occupational markets. Exceptionally low interest rate structures are currently holding the show together, but there is no confidence that European commercial real estate values have any further significant upside in the next few years.

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Investing in Emerging Markets: China, India and Brazil

David J. Lynn, Ph.D., CRE; Tim Wang, Ph.D.; and Cassandra Meblum

Real estate in emerging markets, in general, can be characterized as "embryonic and growth oriented." China, India and Brazil exhibit such characteristics as accelerating market growth, industry potential that substantially exceeds its current volume and a rapidly growing number of relatively unsophisticated real estate players. Entry into these markets tends to be easy but exiting the market can be more difficult with a weaker legal structure and fewer market players than developed countries. The article addresses both the opportunities and risks of investing in these markets, all of which have seen significant property appreciation, and benefit from large national economies and demand based on solid growth fundamentals.

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Go South, Young Men (and Women...)

Key Investment Considerations in Latin America

James M. Whittington, CRE, FRICS

As the demand for international real estate development and investment continues to accelerate, Latin America is rapidly becoming an attractive alternative to more traditionally popular international markets such as China, India and Eastern Europe. Strong economic fundamentals and a rapidly growing middle class are driving demand for all types of real estate. In this article, the author takes a look not only at why Latin America is more than Brazil and Mexico, and countries such as Colombia, Chile and Peru are markets worthy of strong consideration, but which countries should be avoided and which are too small to matter.

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Seller Beware: The Impact and Consequences to Date of Asian Investment in Metro Vancouver's Real Estate Market

William P.J. McCarthy, CRE

No city on Earth's residential real estate market has been more affected by a targeted and concentrated Asian investment, particularly that from China, than Vancouver, British Columbia. While only the perspective of time will define the consequences of this growing control over large segments of the region's housing markets, its impact on affordability and the region's overall economy is not positive. In this article, the author offers lessons learned for other regions seeking the quick fix of offshore investment, in particular those learned from the Vancouver experience. The circumstances that have made Vancouver the epicenter for Asian investment cannot be readily duplicated, and evidence increasingly signifies that they should not be.

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Turkey: Modernizing through Mall Development

Marc Louargand, Ph.D., CRE, FRICS

Turkey is a nation that has—both literally and figuratively—one foot in Europe and the other in Asia. More specifically, Turkey straddles the boundary between Europe and the Middle East. The contrasts between Turkey and Europe in terms of lifestyle, education and affluence are growing dimmer while their respective economies converge. Turkey is an emerging economy that has arrived. A key element in the transition is the shopping mall and modern retail systems. This article describes the current state of retailing in Turkey, the forces at work transforming Turkish society and their integral relationship.

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Asian Tigers and Lion Kings

Howard C. Gelbtuch, CRE, FRICS

Would you like to value property in China or Africa? If you answer “no,” you’ll miss the fastest-growing areas of the globe. Although the growth of China has been widely reported, less recognized is the rapid development of Africa. Both the Chinese and African economies are closely intertwined, and many African nations are expected to dominate the list of fastest-growing countries over the next half decade. This article addresses the economic emergence of both China and Africa, and describes differences in valuation techniques around the world.

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Public-Private Partnerships: Lessons From Military Housing

Mablon (Sandy) Apgar, IV, CRE, FRICS

This column, by author Sandy Apgar, IV, CRE, was originally published in the *Baltimore Sun* in August 2011 under the title ‘How the Army Saved Big Bucks.’ In it he praises a U.S. Army program called Residential Communities Initiative (RCI), an initiative that develops military “cities” that combine housing, jobs, shops and recreation at a 20 percent lower cost than previous government projects and at higher maintenance levels. In this op-ed column, Apgar takes the reader through the various lessons developers can learn from the success of RCI projects.

RESOURCE REVIEW

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When the Boomers Bail: A Community Economic Survival Guide Mary C. Bujold, CRE

The book is about baby boomers and much, much more. It is about the fundamental economics of our communities and how we are going to prepare for the Inverted Labor Market Curve. Lautman's premise is, says reviewer Mary Bujold, CRE, that if a community is not growing its economy faster than its population, it will soon find itself in a situation where it cannot support the service-burden that is increasing more rapidly than the revenues it is taking in. This book, says Bujold, is a “must-read” for anyone remotely concerned with or involved in economic development.

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Editor's Note

BY PETER C. BURLEY, CRE



“As man draws nearer to the stars, why should he not also draw nearer to his neighbor?”

—LYNDON B. JOHNSON

IN THE LATE 1960S, IN THE MIDDLE OF THE COLD WAR, I WAS fortunate to join a small group of about a dozen high school students from The Bay Area, New York and Chicago on a summer tour of the Soviet Union and Eastern Europe which, to most Americans at the time, lay behind a dark, impervious and forbidding “Iron Curtain.” My mother was terrified. I was exhilarated. It was a remarkable experience during a remarkable period in history. In those days very few westerners traveled to what Ronald Reagan would later dub the “Evil Empire” to meet—even talk to—people who lived there, to see the expanse of the Russian steppe, marvel at the architecture of the Kremlin, to view the collections in the Hermitage, to look across the wide Volga River toward the even greater unknown that was Central Asia. We toured most of Eastern Europe as well during the latter, turbulent days of the Prague Spring (including a couple of days milling about with the defiant crowds in Wenceslas Square) before returning to the U.S. just hours before it all came to a sad, disconsolate end.

Some 40-odd years later, I am amazed at how so many of the political, ideological, cultural and economic barriers that kept so much of the world apart from itself have largely dissolved. Not that we don't have our differences; in many cases, we just don't get along very well. But, today we talk to, visit, trade with, and invest in more of the world—and the world in us—than we could ever have imagined in 1968. Today, we have a U.S.-Russia Business Council (USRBC) that has been meeting annually for the past 19 years. An article in the Oct. 26, 2011, edition of *Russia Now*, a weekly supplement to the *Washington Post*, entitled “A Warm Climate for Investors” promoted foreign investment in the Chelyabinsk Region in the Southern

Urals in Russia. The article points to the doubling of foreign direct investment in the region since 2006 by Switzerland, France, Finland, the U.S., the U.K., Germany, Italy, the Czech Republic and Kazakhstan. In the first half of 2011, foreign trade in the region has increased by 38 percent with China, by 22 percent with Germany and 18 percent with Italy.

New technologies, free trade, financial deregulation have changed the landscape in which we do business. We are, in 2011, a highly integrated, interconnected, *interdependent*, global economic community.

Real estate is a huge part of our now global cultural, economic and financial lives. In fact, as Robert Peto points out in his article herein, the World Bank has estimated that real estate represents some 70 percent of global wealth.

We transact our business around the globe daily. Firms that a few years ago concentrated most, if not all, of their investment activity only in the U.S. (or just small parts of the U.S.) now transact business in Europe, Latin America and Asia, even Africa. Real Capital Analytics reports that over the past twelve months, the top ten markets for real estate transactions were New York and London, to be sure, but also Beijing, Shanghai, Tokyo, Singapore, Hong Kong, Paris, Metropolitan Washington and Seoul, with the largest real estate players being firms from the U.S. and Canada, China, Singapore and Korea. The more we learn about the rest of the world, and the world about us, the more interaction and opportunity become apparent. Keen eyes are turning to the BRICS (Brazil, Russia, India and China) and to the CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) and scouring the PIIGS

(European nations with dangerously large sovereign debt burdens, Portugal, Italy, Ireland, Greece and Spain) for opportunity. According to the Association of Foreign Investors in Real Estate (AFIRE) countries that offered the best opportunity for capital appreciation in 2010 were the U.S., China, the U.K., and Brazil, in that order. A lot of the rest of the world invests in the U.S. too, with about \$400 billion of more than \$630 billion in planned cross-border equity investment likely to be placed in the U.S. this year. AFIRE, by the way, which was founded in 1988 (20 years after I went to Eastern Europe) to preserve and promote cross-border investment in real estate, currently has more than 180 member institutions representing 21 countries.

To interpret, untangle and chart a course in this new global activity, one can ask any number of brokers, advisors or investment managers for direction. There are few major participants in the business today who do not have an international—global—presence. Among The Counselors of Real Estate®, we now boast more than 50 members from outside the U.S., hailing from 19 countries including Austria, Canada, Brazil, the Czech Republic, France, Germany, Greece, Hong Kong, Italy, Japan, Korea, Lebanon, Netherlands, Portugal, Serbia, Switzerland, Taiwan, Turkey, and the U.K. This past March, The Counselors hosted a high-level education session at MIPIM, in Cannes, the world's largest global real estate conference. Noted CREs were participants in several other MIPIM sessions as well. Counselors are strongly represented among the ranks of the Royal Institution of Chartered Surveyors (RICS).

We are all a part of the global economic community now and have comingled our lives 'over there' with our lives 'over here.' Today, events and circumstances that present themselves in one corner of the world can have profound—often propitious and, sometimes, quite harsh—implications in another. In this issue of *Real Estate Issues*, we are pleased to present some views of our new global real estate economy, its opportunities and its pitfalls.

The Global Financial Crisis affected all of us. In a detailed and impenitent look at the crisis, its causes and its ramifications for real estate and the banking sectors, **Robert Peto**, 2010 Global President of RICS, tells us in his article “**Global Property Outlook and Role of Real Estate in the European Financial Crisis**,” that in the “West we are in a perfect storm. (The crisis) was caused by financial engineering and excess, partly based on real

estate.” Many European banks, Peto tells us, “will struggle to withstand the double whammy of unresolved and under-provisioned real estate loan issues at the same time as suffering from heavy exposure to sovereign debt risk.” Both continue to be at play as I write this, with an unresolved, heavily indebted and newly austere EU facing an uncertain course. Further, current uncertainties “created by the financial and political turmoil and the impact of austerity measures...are affecting business investment decisions and consumer confidence with the consequence that GDP growth in western economies has stalled...” with the “danger of a vicious downward spiral.” Peto suggests that we may have “at least 10 years of hard work in front of us to rebalance our economies and put our national and personal balance sheets in order.” Included in that effort will likely be a “very significant haircut on sovereign debt to Greece and probably other countries...and ... many banks will need to be significantly recapitalized.”

Brazil, China and India represent some of the largest and fastest-growing emerging markets in the global community, according to **David Lynn, CRE, Tim Wang, Ph.D., and Cassondra Mehlum** in their article “**Investing in Emerging Markets: China, India and Brazil**,” some of the most compelling opportunities for real estate investment. With rapidly growing middle class populations, expected to hit 800 million people in the next decade, and a concomitant rise in demand for goods—and real estate—the authors suggest that these markets present significant return potential. Not without risks, certainly, including political as well as economic risk, but as Lynn, et al., point out “there has been significant property appreciation, which we expect will continue in the near term.” The authors discuss each country in turn with respect to specific economic and political considerations one might make in approaching investment. China appears to be ready to develop a consumer market as it transitions away from an export-driven economy to a domestic consumption economy. India is in a rapid urbanization phase with the likely result that this century will likely see a majority of the population living in urban areas for the first time. Brazil, which is resource rich and has a substantial labor pool, is one of the fastest-growing economies in the world.

Brazil may indeed be among those countries offering the greatest potential for capital appreciation by cross-border investors. Small wonder, since as **James Whittington, CRE**, points out in his “**Go South, Young Men (and**

Women...),” Brazil has been a significant success story in recent years. It is the seventh-largest global economy and projected to become the fifth-largest in the next few years. But, Whittington tells us that there is more to the rest of Latin America than might meet one’s eye, and to ignore opportunities *beyond* Brazil (and Mexico) would be “short-sighted.” Chile, Colombia and Peru present important opportunities. Whittington details some of the plusses and minuses in approaching investment in these countries. He points to Latin American economies that may best be avoided as well, including Argentina, Venezuela and Bolivia, and others that are probably too small to consider (Uruguay, Paraguay, Ecuador, Costa Rica, Panama). As Whittington puts it, “Just as the western frontier of the U.S. provided unlimited economic opportunity in the latter half of the 19th century, the fundamental building blocks are in place in Latin America to offer the same to real estate investors, developers and practitioners alike.”

There can be drawbacks to the increasing flow of capital across borders and across oceans. Outsized waves of targeted offshore investment can artificially distort local and regional property markets, inflate demand and pricing, undermine affordability and have an untoward effect on the broader economy. **William McCarthy, CRE**, describes the experience of Asian investment, particularly from China, in Vancouver, British Columbia, in his article “**Seller Beware: The Impact and Consequences to Date of Asian Investment in Metro Vancouver’s Real Estate Market.**”

Vancouver, which is one of the most livable (and incredibly beautiful) cities on the planet has experienced an enormous wave of Chinese investment which, according to McCarthy, has pushed pricing to unaffordable levels for local residents, likely causing businesses to relocate to less expensive locales (or to limit expansion plans) and put the region at risk of a significant correction. Additionally, he says, the local economy has been structurally changed from a resource-based economy to one that depends on speculative real estate for revenues and growth. He notes, “...if other jurisdictions are contemplating similar means to salvage or grow their real estate markets, they should consider the timeless words of the preamble to the REALTOR® Code of Ethics and Standards of Business Practice: ‘Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization.’”

At history’s crossroads between Europe and Asia lies Turkey, a nation that has evolved in the past hundred years from the feudal society of the Ottoman Empire into a thriving modern state. In his article, “**Turkey: Modernizing through**

Mall Development,” **Marc Louargand, CRE**, reviews for us some of the transitional elements in that country’s economy, its demographics and, specifically, the retail environment as it evolves from bazaar and bakkal to the modern grocery and hypermall. Of those countries ranked by the International Monetary Fund, Turkey is now the 17th largest—and growing. The nation’s gross domestic product grew by 8.7 percent in 2010 and is expected to rise another 6.7 percent per year between 2011 and 2017. As Turkey transitions from an agrarian and nomadic economy into a mixed urban economy, evidence of the global marketplace is becoming clear. Retailers from around the world now hawk their wares in Turkish malls, with upscale goods from Europe, North America and Asia. And, while growth in the retail sector has been rapid, there appears to be plenty of room for continued expansion going forward as Turkey continues to grow and to modernize. As Louargand concludes, “the nascent level of the shopping mall promises significant market penetration opportunities for retailers and retail developers.”

Considerable ink and bandwidth have been devoted to China in recent years, and with good reason. **Howie Gelbtuch, CRE**, elaborates in his article “**Asian Tigers and Lion Kings**” that “there’s no doubt that China is on its way towards becoming the world’s largest economy. The only question is when.” Gelbtuch describes the recent shift in China’s economy from rural and agrarian to urban and affluent, and the shift from an export economy to a consumer economy. And, in many ways, he suggests, much of the rest of the world is growing in concert with China’s almost nonstop global economic expansion. But, while much attention has been directed toward China and the other BRICs, it is interesting to note that six of the fastest-growing economies over the past decade have been in sub-Saharan Africa. In fact, Gelbtuch refers to an analysis by *The Economist* that shows Angola, Nigeria, Ethiopia, Chad, Mozambique and Rwanda with growth rates between 2001 and 2010 that would put the developed world economies to shame. The Chinese have been particularly active in Africa, buying up African agricultural land and trading in other raw materials. “The devil is in the details” when considering approaching property markets overseas, Gelbtuch says, and he offers his considerable personal experience and wisdom in describing some of the local quirks and peculiarities in approaching overseas property markets. Still, “in case you think you’re too late for the BRICS or Africa,” he says, “fear not.”

Global trade and cross-border investment aside, here in the U.S. we still face some significant issues at home, namely,

the effort to reduce taxpayer costs and whittle back our budget deficits. **Sandy Apgar, CRE**, offers an example of how the U.S. military has managed to find bipartisan support for a large national program that has successfully reduced taxpayer costs. His article, “**Public-Private Partnerships: Lessons from Military Housing**,” describes the Residential Communities Initiative, or RCI, that enlists

“I am amazed at how so many of the political, ideological, cultural and economic barriers that kept so much of the world apart from itself have largely dissolved.”

private participation in a program that neither Congress nor the Defense budget could cover. To date, Apgar reports, the RCI program has cleared a \$7 billion maintenance backlog, and its partners are building or renovating more than 85,000 homes and community facilities. RCI projects include Fort Meade and Aberdeen Proving Ground, here in Maryland, as well as other projects in 22 other states. Apgar offers a rundown of lessons and practices that might prove useful in meeting public need, in the face of rising budgetary imbalances, through public-private partnerships.

When a community fails to grow its economy faster than its population, it will soon find itself unable to support the service burden that will increase more rapidly than the revenues it requires. Such is the basic premise of *When Boomers Bail: A Community Economic Survival Guide* by Mark Lautman, reviewed by REI Associate Editor **Mary Bujold, CRE**. “Many of the scenarios presented in the book are happening right now,” Bujold says, “and not just in the United States, but in other parts of the world as well.” And, she says, “the U.S. is starting to seem like “Loserville” when some others, like China, Brazil and India are starting to look like “Winnersville.” As an economic development primer, Bujold suggests, the book “bears serious consideration by all of us.”

Some 40-odd years ago, when I was traveling across Eastern Europe, I could not imagine the global economy as it exists today. I doubt if anyone could have imagined it. I have not had the opportunity to travel back to most of the places I visited when the world was divided into political-economic blocs. I am most curious to do so. It is a new world now. And, despite its problems, all the better. ■



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Global Property Outlook and Role of Real Estate in the European Financial Crisis

BY ROBERT PETO, MA, FRICS

I HAD THE PRIVILEGE OF SPEAKING AT THE COUNSELORS OF Real Estate® Midyear Meetings in San Diego in May this year on global real estate trends, but in truth, part of my speech was devoted to the relationship between real estate and the health, wealth and happiness of our respective peoples. My belief is that those who do not understand that real estate is one of the four factors of production (land, labour, capital and entrepreneurship) and that there is a looped connection between politics, macroeconomics, human psychology, finance and real estate, are not likely to make good decisions. Sadly, it would seem that politicians, regulators and central bankers have been ill-educated on this or have chosen to ignore the loop.

Consider the World Bank calculation that some 70 percent of global wealth is in real estate. If the dynamics of real estate prices become too volatile and out of balance in relation to affordability, then the destabilising effect on economies can be enormous. One of the major issues for the U.S. financial authorities was the failure of the Federal Reserve to believe that asset price bubbles were damaging and that they could be left to subside or crash without knock-on effects. How wrong they were as the residential bubble in the U.S. created \$7 trillion of mythical value (value above long-term sustainable trends linked to affordability) which was used to enhance consumer spending. When this subsequently evaporated the consequences were horrendous.

It was William McChesney Martin Jr., one of the greatest Federal Reserve chairmen, (who was in office for 19 years from 1951 to 1970, serving five presidents from Harry

Truman through to Richard Nixon), who once said that the job of central bankers is “to take away the punch bowl just as the party is getting started.” In the past 15 years or so this sound advice appears to have been completely ignored. Greenspan kept interest rates too low for too long, encouraged by successive U.S. administrations not prepared to face up to the need for adjustment in the short term.

Both the Asian financial crisis of 1998 and the current global financial crisis (GFC), with their subsequent economic and political crises, were, in the final analysis, triggered by the bursting of real estate price bubbles, linked in both cases to fraudulent activities. This of itself

About the Author



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would not have been catastrophic had property not been abused through unwise leadership and the application of game theory to risk management, leading to the creation of an inverse pyramid of debt and insurance products which Warren Buffet so eloquently described as “weapons of financial mass destruction.”

As John Kay said in one of his *Financial Times* columns in the summer of 2009: “The explosion of derivative markets and the application of sophisticated mathematics to risk modelling is a tribute to how theories can readily be given practical application if the rewards are sufficiently large.” He went on to say: “The risks that the financial sector has devised techniques to manage are not the everyday risks of an uncertain world—they are risks almost entirely created within the financial sector itself. The benefits to the non-financial economy are slight, if they exist at all.” This is what Adair Turner, the chairman of the U.K. Financial Services Authority, had in mind in querying the social value of modern financial developments. Paul Volcker’s jaundiced answer, that the only useful recent financial innovation had been the ATM, is very much to the point.

Sadly, I would also make the comment that the American approach to financial regulation which is rule/tick-box based, rather than principle based, led to some very questionable financial practices and organisational structures. These were not confined to U.S. shores as Lady Thatcher, advised by Alan Walters and Patrick Minford, her two main macroeconomic gurus, who in turn were very much influenced by the American monetarist free market economist, Milton Friedman, deregulated the City of London in 1986, thus leading to “The Big Bang” and the effective sale of the City to more powerful U.S. financial institutions from 1987 onwards.

I do not believe that any lessons have been learnt so far, as the financial institutions that were part of the problem have not been overhauled or broken up. In the U.S. it would seem that most of the poachers remain in post and some of them are actually in the administration, and have not turned into gamekeepers yet.

In the U.K., on the 16 June 2010, the Chancellor of the Exchequer announced the creation of the Independent Commission on Banking (ICB), chaired by Sir John Vickers. The Commission was asked to consider structural and related non-structural reforms to the U.K. banking sector to promote financial stability and competition and to make recommendations to the

government by the end of September 2011. The Commission released its final report on 12 September. This confirmed the thrust of its interim report that suggested that the final recommendations would stop short of seeking a separation of retail (Main Street) banking from investment (casino) banking as occurred under the Glass-Steagall Act of 1933 in the U.S. Many experts believe that the repeal of this Act in November 1999 by the Gramm–Leach–Bliley Act during Clinton’s presidential reign directly contributed to the severity of the GFC by allowing Wall Street investment banking firms to gamble with their depositors’ money that was held in commercial banks owned or created by the investment firms.

The final ICB report recommended ring fencing of the two parts of the banking spectrum in such a way as to protect the retail bank from failure in the event that the investment banking arm makes the wrong speculative calls, without asking for their full separation. The Chancellor has indicated his support for this approach but the devil will be in the detail.

Needless to say, there has been, and continues to be, intense lobbying from the banking sector against this recommendation, and also from the Confederation of British Industry, both of which are concerned that immediate implementation would disrupt the supply of funds to industry at a critical stage in the cycle. In any event, the implementation of the recommendations is not expected to be completed until 2018, which gives plenty of time for the situation to change. Personally I believe that the outcome will be a fudge.

Having said this, it should be recognized that, in response to the financial crisis of 2008, the Basel Committee on Banking Supervision and its oversight body, the Group of Governors and Heads of Supervision, have developed a reform programme to address the lessons of the crisis, which delivers on the mandates for banking sector reforms established by the G20 at their 2009 Pittsburgh summit. Collectively, the new global standards to address both firm-specific and broader, systemic risks have been referred to as “Basel III.”

As one might expect, there is a degree of cynicism as to whether enhanced capital adequacy requirements will prevent future crises. Andrew Haldane, executive director of Financial Stability at the Bank of England, has written an interesting paper based on a speech he gave at the

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American Economic Association, Denver, 9 January 2011. He reminds us that:

these international capital standards are supported by three pillars. Pillar I defines the regulatory rules, Pillar II provides scope for supervisory discretion, while Pillar III seeks to foster market discipline through disclosure. In countering systemic shocks, three supporting pillars have understandably been felt to be better than one. But the success of international capital standards in forestalling banking distress has been mixed. Basel I regulatory rules were arbitrated due to their risk insensitivity. This gave rise to Basel II with its greater focus on risk calibration. But Basel II buckled under the weight of the recent crisis. Repairs have since been applied through Basel III. Historical experience suggests this is unlikely to be the end of road.

He refers to an experiment carried out by the U.K. Financial Services Authority (FSA) in 2009 to establish how different banks value essentially identical exposures. For U.K. banks' wholesale credit portfolios, a hypothetical portfolio was constructed based on 64 externally rated corporate, bank and sovereign exposures. Banks were then asked to use their models to generate "probability of defaults" (PDs) and capital for this hypothetical portfolio, which could then be compared across banks. As Andrew Haldane said:

The range of reported capital requirements held against this common portfolio was striking. For wholesale exposures to banks, capital requirements differed by a factor of over 100. For corporate exposures, they differed by a factor of around 150. And for sovereign exposures, they differed by a factor of up to 280. Those differences could equate to a confidence interval around reported capital ratios of 2 percentage points or more.

A final means of gauging potential model error is to consider past evidence. During the crisis, model error was largest and most egregious in the trading book. Losses were up to six times greater than pre-crisis trading book capital. And capital ratios would have needed to be up to 2.5 percentage points higher to accommodate this model risk. A fundamental review of the trading book is underway to address this problem.

This evidence only provides a glimpse at the potential model error problem viewed from three different angles. Yet it suggests that model error-based confidence intervals around reported capital ratios might run to several percentage points. For a bank, that is the difference between life and death. The shift to advanced models for

calibrating economic capital has not arrested this trend. More likely, it has intensified it. The quest for precision may have come at the expense of robustness.

[Friedrich] Hayek titled his 1974 Nobel address "The Pretence of Knowledge." In it, he highlighted the pitfalls of seeking precisely measurable answers to questions about the dynamics of complex systems. Subsequent research on complex systems has confirmed Hayek's hunch. Policy predicated on over-precision risks catastrophic error. Complexity in risk models may have perpetuated Hayek's pretence in the minds of risk managers and regulators.

Haldane went on to suggest that market-based metrics of bank solvency could be a better predictive guide to central bankers as to financial stress. He refers to three possible alternative bank solvency ratios based on market rather than accounting measures of capital:

- *Market-based capital ratio: the ratio of a bank's market capitalisation to its total assets;*
- *Market-based leverage ratio: the ratio of a bank's market capitalisation to its total debt; and*
- *Tobin's Q: the ratio of the market value of a bank's equity to its book value.*

He comments on these as follows:

The first two are essentially market-based variants of regulatory capital measures, the third a well-known corporate valuation metric. How do they fare against the first principles of complex, adaptive systems?

They clearly offer the advantage of simplicity and transparency. 200 million separate calculations would condense to a simple, single sum. The clerk would make a glorious return and displace the quant. Market-based measures could be observed and verified in real-time by regulators and market participants. That could help in enhancing both supervisory discretion and market discipline. Market-based capital ratios could support all three Pillars, helping to rebalance the Basel scales.

Market-based solvency metrics offer two further advantages. First, they are not reliant on myriad, mis-specified models. They are largely model-free, if not error-free. They are robust to model error and ignorance. Second, history suggests that, at least in the latest crisis, they would have given far timelier signals of impending stress, and so a better guide to prompt corrective action, ahead

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of the crisis cliff-edge being reached.

Certainly, as I sit in London writing this article (in the aftermath of some of the most serious post-war rioting in the U.K.'s major cities) the collapse in many bank shares could be a harbinger of further serious bank distress around the sovereign debt crisis in Europe.

ROLE OF REAL ESTATE IN THE EUROPEAN FINANCIAL CRISIS

The bursting of the real estate bubble in Europe has had both immediate and consequential effects on the European financial crisis. The immediate effects were initially those of catalyst for the collapse in banking confidence, which led to the evaporation of interbank lending and the wholesale debt/bond markets, leading to the collapse of Lehman Brothers, and resulting in banks at the door of bankruptcy with seriously impaired real estate loan portfolios. The consequential effects are that European banks are too weakened by their real estate exposures to take any serious hits on European sovereign debt as well. I will comment on each of these effects in turn.

GFC ROUND ONE— REAL ESTATE DEBT AND THE BANKS

The collapse of real estate values in much of the western world has brought our banking system to its knees, and led to the requirement to recapitalise, and in some cases nationalise, in part or in whole, our banks. Banks were regularly lending in excess of 90 percent LTVs at the height of the market and there was a feeding frenzy by banks to lend to real estate, and to use commercial mortgage-backed securities (CMBS) conduits to lay off risk, thus allowing more balance sheet lending. This fuelled rises in values, which led to an upward spiral in prices supported by refinancing.

Europe is much more vulnerable to the real estate problem than North America where the sources of loans are more diverse. In North America 21 percent of commercial real estate debt is provided by insurance companies and other institutions and 22 percent by CMBS, with 55 percent coming from the banks. In Europe 75 percent of commercial real estate debt is provided by banks.

The deleveraging process in relation to the banks' real estate books has hardly started, with DTZ Research (DTZ Global Debt Funding Gap – May 2011) estimating that total outstanding real estate debt in Europe of just over \$2 trillion has reduced by only five percent between 2009 and 2010. In addition the refinancing time bomb is

increasing as banks have been, and are, extending loans where this is necessary.

Many of the loans against core prime properties have been worked out or are deemed to be sound, but this leaves banks with a substantial debt exposure to secondary real estate. The responses to DTZ Research's annual "Money into Property" survey undertaken earlier this year shows that 15 percent of lenders claimed they had already finished dealing with distressed debt secured against prime property, 65 percent were well underway and 25 percent had not yet started. Contrast this with the responses to distressed debt restructurings in non-prime markets where only five percent considered they had finished, 42 percent were well underway and 53 percent had not even started.

It would seem that the easy problems are well on the way to being solved, helped by a significant bounce back in values and transaction volumes in the prime property sector, but it is believed that more than 80 percent of commercial property bank debt is secured against non-prime assets, and it has been calculated that in Europe about €520 billion of real estate debt is maturing in the next three years. DTZ Research estimates that there is an European debt funding gap of about \$118 billion. (The debt funding gap is defined as the difference between the total bank debt/loans outstanding to the real estate sector—excluding mortgage debt to the private residential sector—and the amount that would now be lent assuming loans would not be at greater than 70 percent LTV against today's market values.)

To counter this, DTZ estimates that there is about \$114 billion of equity available to invest in European commercial real estate over the next three years, either by acquiring assets directly or indirectly through the purchase of loan portfolios from the banks. The problem is there is a mismatch between the type of assets and returns sought by this capital and the type of property that is likely to come to the market if additional equity is not forthcoming from the existing borrowers at the time of loan maturity.

In addition, much of this equity will need debt to achieve desired returns and this is in scarce supply as European banks suffer from write-offs, and seek to reduce their real estate exposure due to increased capital requirements flowing from Basel III, which is being introduced progressively over the next eight years to 2019.

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One example of the lack of finance for new property loans is the case of Eurohypo, a subsidiary of Commerzbank. It has slashed its commercial property lending by 43.5 percent in the first half of 2011 to €1.3 billion from €2.3 billion for the same period in 2010. It has cut its loan portfolio in the six months to end June 2011 from €72 billion to €67 billion with a stated intention to further reduce this to €60 billion by the end of 2012. In the U.K. the major banks are all pursuing similar strategies.

The CMBS market is also struggling. According to Moody's the number of securitised loans in special servicing has climbed 55 percent to 104 since October 2010. The maturity profiles for the CMBS sector will lead to some challenging refinancing issues over the next five years, and there is no sign that the market for new issues will recover in any meaningful way for some years.

There is some hope that the availability of senior debt will increase from the insurance sector, encouraged by what has become known as "Solvency II." But this would have to "explode" in size if it is to fill the financing shortfall in any meaningful way.

Until this problem is resolved European banks will continue to struggle to provide sufficient loans to normal commercial businesses to allow for investment and to oil the wheels of commerce generally. This has looped negative effects for real estate as it will slow recovery in the general economy and therefore dampen, if not weaken, the occupier demand for real estate, with consequent effects on rental income security.

What is interesting is that there has not been a flood of distressed real estate coming onto the market in most of

Europe as the banks are trying to take a longer-term view of managing problems over time. They are seeking partnerships with property companies and private equity funds that can inject not just asset management expertise but also capital to reposition assets or complete projects.

The worry is, however, that many European banks will struggle to withstand the double whammy of unresolved and under provisioned real estate loan issues at the same time as suffering from heavy exposure to sovereign debt risk.

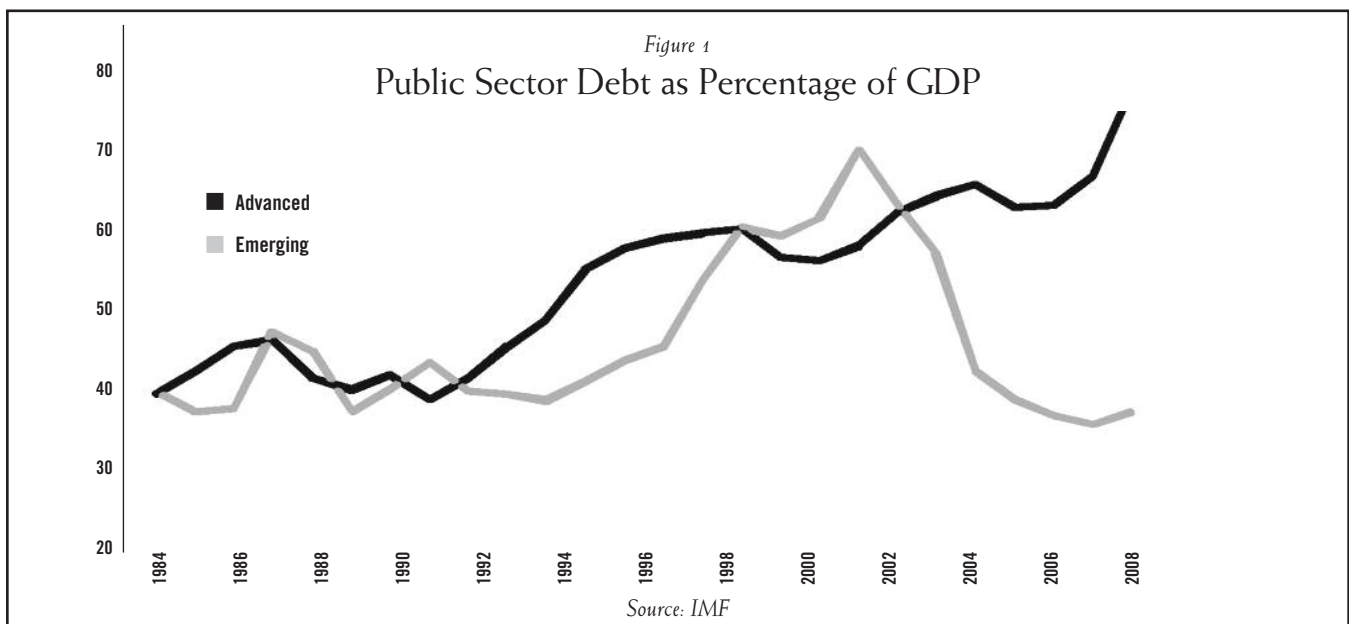
GFC ROUND TWO— SOVEREIGN DEBT AND THE BANKS

My elder brother many years ago provided me with an insightful comment about humanity. He said "the corpus of knowledge is expanding exponentially but the corpus of wisdom is static." How right he was. Just consider the following exhortation:

The budget should be balanced, the treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands curtailed. People must again learn to work, instead of living on public assistance.

No, not words from a 2011 political speech, but of Cicero in relation to Rome in 55 B.C. So what have we learnt in the last 2066 years? Some might say not a great deal.

The sheer scale of indebtedness in the western world has reached alarming proportions, both in sovereign and personal sectors. In relation to sovereign debt in Figure 1 is self explanatory and gives credence to the statement that a picture is worth a thousand words.



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The West has permitted China to join the World Trade Organisation without insisting on a floating currency and, in the drive for short-term profits (quarterly reporting), we have allowed, if not encouraged, the transfer of considerable swathes of our manufacturing to China. In return China has indulged in the world's largest vendor financing scheme ever, by recycling her huge trade surplus into buying dollars and U.S. treasuries, thus allowing the U.S. government to run huge budget deficits. At some point the music had to stop.

Whilst reading recently a global strategy commentary by Albert Edwards of Société Générale ("Believe the Doom Merchants: Ice Age Part 3 begins") I came across a reference to a comment by the mayor of London, the colourful Boris Johnson:

My friends, as I have discovered myself, there are no disasters, only opportunities. And, indeed, opportunities for fresh disasters.

Mr. Edwards commented that Ben Bernanke is living the Boris dream, but I think he could have made the same comment about the politicians on Capitol Hill, the European Central Bank and the political leaders of the EU core countries in trying to deal with the European sovereign debt crisis.

In the West we are in the perfect storm. GFC Mark 1 was caused by financial engineering and excess, partly based on real estate. In 2010 we were in the relative calm at the eye of the storm and now GFC Mark 2 has arrived, and we do not have the fiscal or monetary wiggle room to cope with this easily.

The numbers are difficult to establish but there is no doubt that if the Greek, Portuguese and Irish governments were to default on their sovereign loans it could require significant recapitalisation of many European banks to cope with the write-offs, given their exposure to these bonds. The position would be exacerbated enormously if Spain followed suit. The current bout of volatility in stock markets, especially in bank shares, reflects the uncertainty.

The situation is complicated in Europe by the political overlay of the perceived need to prevent the breakup of the Euro.

The result is that the decision currently has been taken to support the three weakest members of the euro zone, by providing additional funding through the International

Monetary Fund in conjunction with the European Financial Stability Facility. This is a special purpose vehicle agreed to by the 27 member states of the EU on 9 May 2010, aiming at preserving financial stability in Europe by providing financial assistance to euro zone states in economic difficulty. In addition, the European Central Bank has been forced into buying over €20 billion of Italian and Spanish bonds to calm markets.

The view of many experienced economic commentators is that the level of funds available to support the euro zone countries is insufficient and that the true crisis is being delayed, resulting in greater difficulties when the day of final reckoning arrives. There are arguments saying those countries with debt positions that are very unlikely to be repaid should be allowed to default, and money now used to support the euro would be better spent recapitalizing the banks, allowing them to write off defaulting sovereign debt. At the present moment the politicians are pursuing the idea of enforcing closer financial and fiscal integration, which would be another step along the road to the creation of the United States of Europe. This includes the possibility of issuing euro zone bonds backed by all euro zone countries.

The uncertainties created by the financial and political turmoil and the impact of austerity measures, whether actual or psychosomatic, are now affecting business investment decisions and consumer confidence with the consequence that GDP growth in the major western economies has stalled, with the risk of a double dip recession. There is now the danger of a vicious downward spiral. This is not helped by the current ferocious debate as to whether the present problems are better dealt with by the Hayek or Keynesian economic approaches.

Whether or not this occurs, I feel confident in saying that we have at least 10 years of hard work in front of us to rebalance our economies and put our national and personal balance sheets in order.

REAL ESTATE TRENDS AND OUTLOOK

One of the remarkable features of the GFC is the extraordinarily rapid bounce back in prime commercial property values. This has been driven by a mixture of factors: uncertainty in the performance of other investment asset classes; the search for yield; and in some cases the belief that real estate is a safe haven, as even if the tenant goes bust there is always the opportunity to re-let or sell.

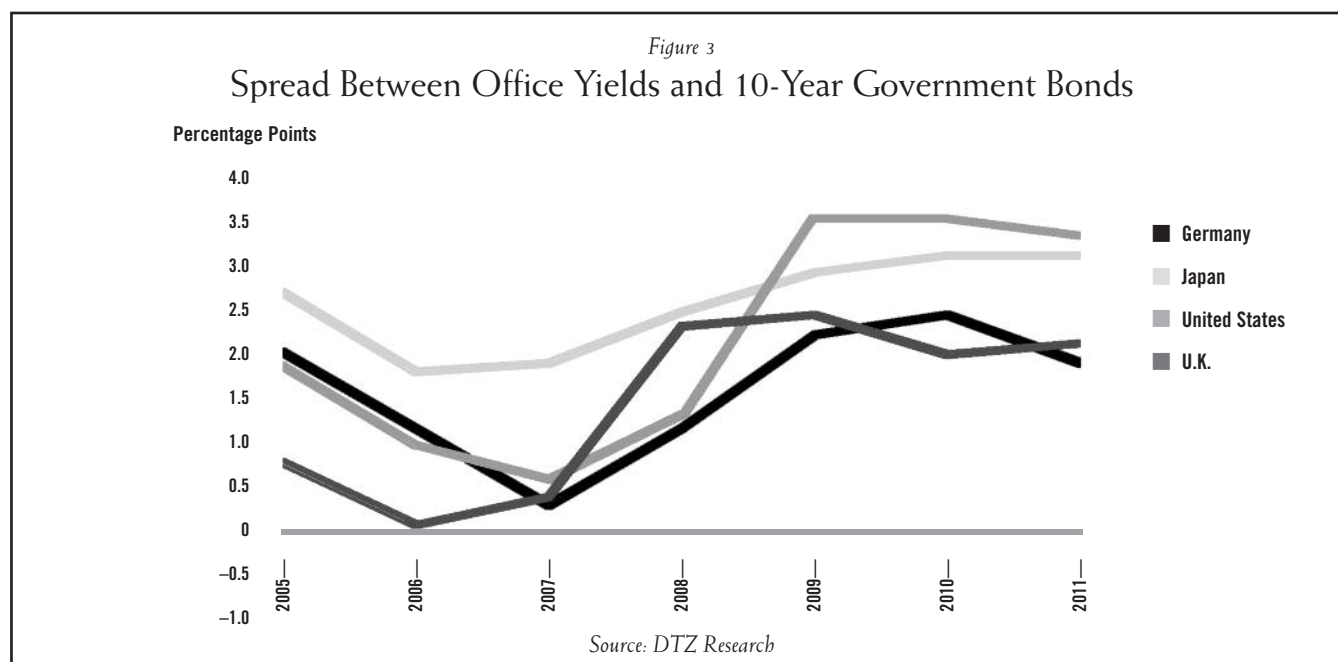
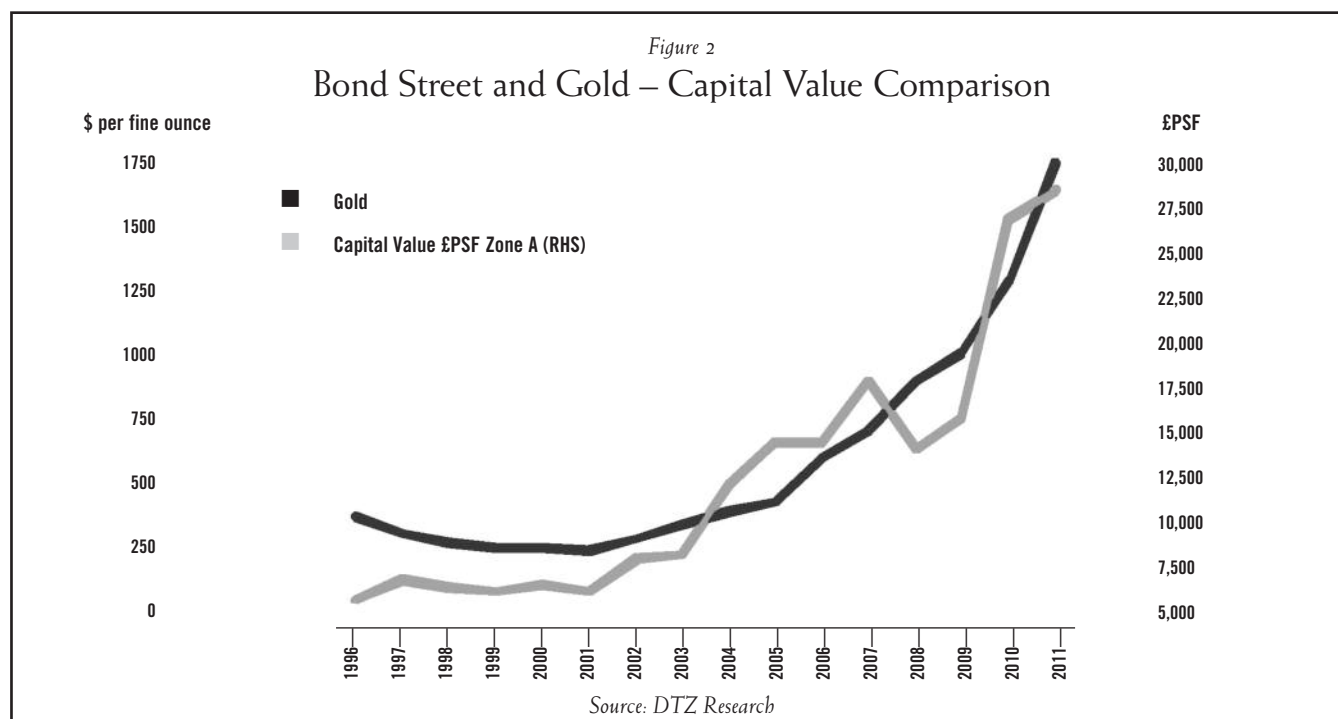
DTZ Research recently undertook an interesting but slightly unscientific exercise in comparing the value of

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retail real estate in prime Bond Street in London with the value of gold over the last 15 years. The results can be seen in Figure 2. They seem to be highly correlated. This rather extreme example highlights the fact that in some special cases internationally footloose capital will look at super prime property as a gold substitute.

However one of the main driving forces in the rapid

recovery in prime real estate values in the advanced countries has been the yield issue. Figure 3 plots the difference in 10-year benchmark sovereign bond yields and property yields over the last six years for various countries. The gap is significant and is encouraging institutions and sovereign wealth funds to divert significant amounts of capital into the real estate markets.



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Of course the comparison between bond yields and property yields is really relevant only to institutional type investors. Those requiring leverage will find their cost of debt linked to swap rates. These are also favourable against property yields although the growing margins demanded by banks with scarce funds available to lend to real estate are making the situation more challenging.

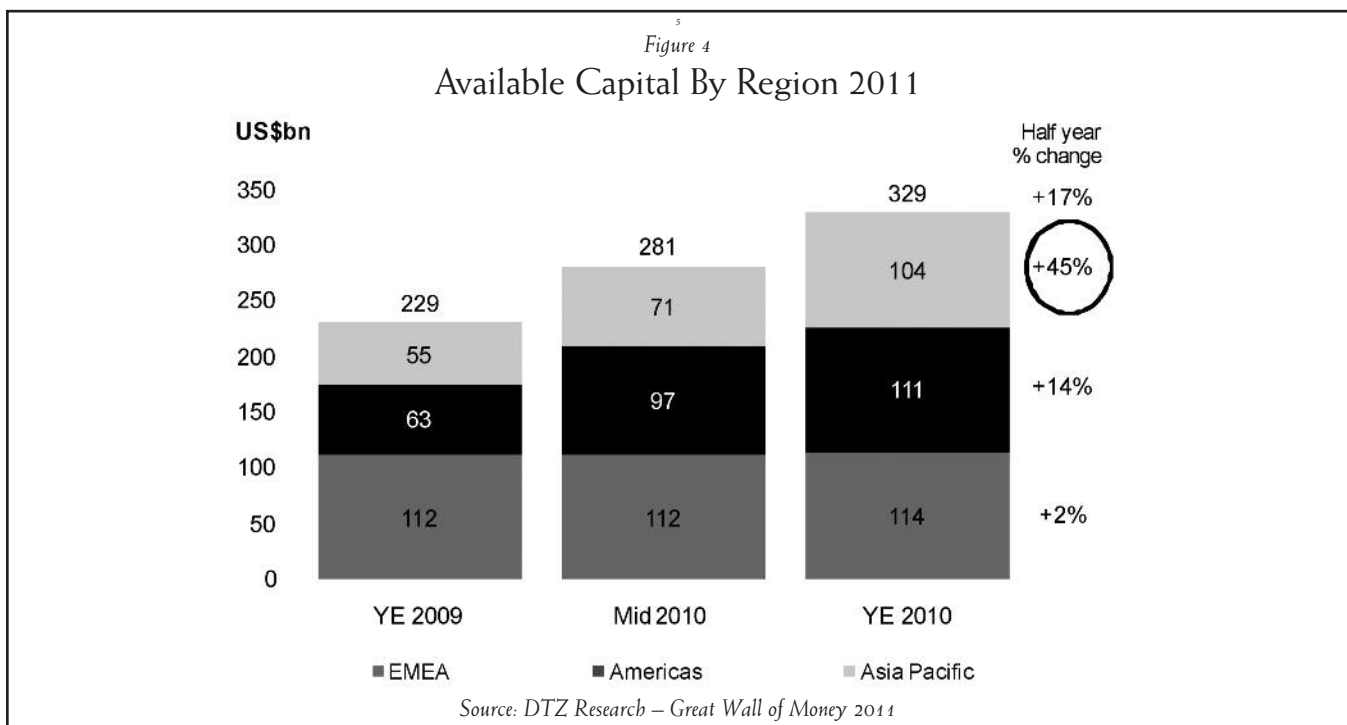
The bounce back in certain cases is also underpinned by actual or perceived rental growth. This has been the case in CBD London and Paris, but in some Asian countries the driving force has been the scale of general economic growth and the belief that this will drive rental growth.

Figure 4 indicates the increasing level of capital available for investment in real estate worldwide. During 2010 the amount allocated increased from \$229 to \$329 billion, but most of this increase is focused in Asia.

Investor debate is now beginning to focus on whether the recovery in values of good quality assets has come to an end.

FAIR VALUE?

DTZ Research has produced over the last few years a model for assessing "Fair Value" in a number of markets and sectors around the globe. This model relates anticipated income and capital receipts over a five-year hold, discounted at a risk-adjusted rate having particular regard to risk-free government bond yields in the relevant country as well as the particular characteristics of the property use type. It therefore takes into account both anticipated rental growth and yield changes and the country specific bond yield rates to produce an index of attractiveness. Any reading above 50 would indicate that current pricing is below the risk-adjusted required rate of return and vice versa.



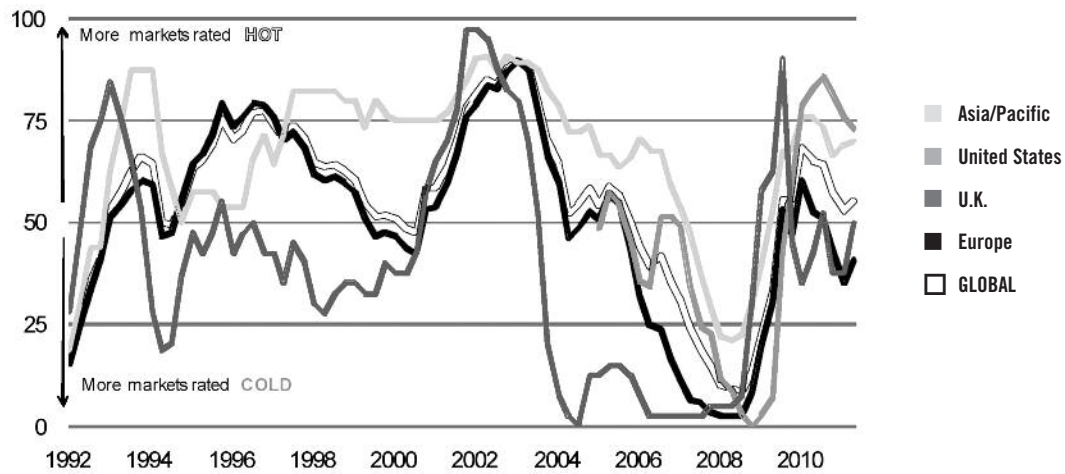
In Europe the amount of capital available has remained relatively stable and the amount of investment transactions has risen from a low of €10 billion in Q1 2009 to between €20 billion and €25 billion per quarter in the first half of 2011. One of the constraining factors has been the availability of the right product, largely in the prime sector. Existing owners are happy to keep their investments and there has not been a flood of good quality assets coming to the market as a result of debt distress.

In Figure 5 DTZ has plotted the Fair Value Index score for the major global regional markets. With the exception of the U.S., the model runs from 1992 through the present time. It is interesting to note that the pricing of U.K. commercial real estate became expensive in relation to estimates of Fair Value as far back as 2004.

The graph clearly indicates the bounce back in 2009/10 for all regions of the world, largely as a result of significant reductions in interest rates. The speed of this recovery and

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Figure 5
Fair Value Index Score



Source: DTZ Research

the momentum that it built up led to an overswing, and it will be noted that, in the U.K. at least, real estate could have been deemed to have been at about or more than Fair Value in the last 18 months. This is reflected in the Investment Property Databank statistics for U.K. institutional commercial real estate where capital values have virtually now stagnated.

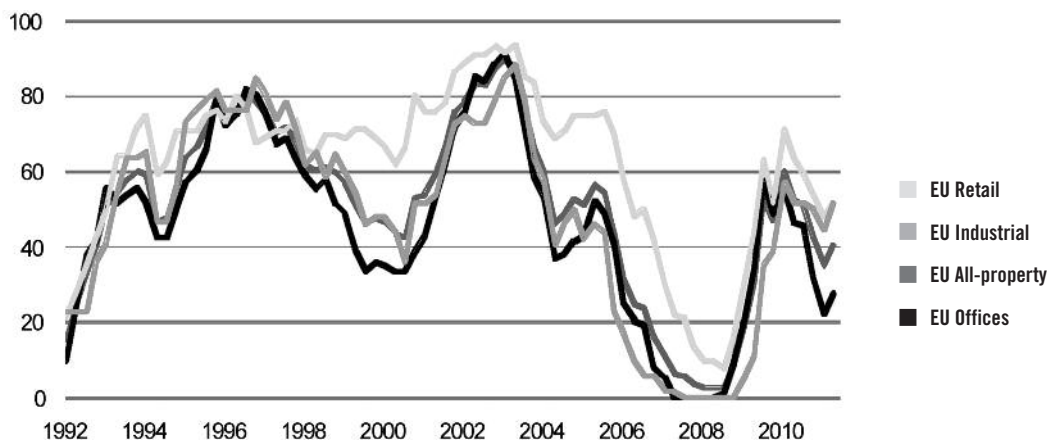
At a general level the same can be said of continental Europe.

In Figure 6, DTZ has analysed the use sectors in Europe which indicates that the office sector is the most vulner-

able to potential value correction if a rational viewpoint is taken.

It is important to remind readers that these Fair Value graphs relate specifically to the prime end of the market. The secondary end continues to suffer and may well be seeing further reductions in values for two reasons. One cause is occupational markets' weakness outside the core retail and office locations and rental values' being static at best, and falling in many cases. The second cause is the absence of debt funding for this type of property to go with rising bank margins where debt is available.

Figure 6
Fair Value Index Score



Source: DTZ Research

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It is also interesting to note that at the peak of the market in 2007, nearly 70 percent of all commercial property transactions in Europe involved foreign capital. This has now reversed and, whilst there is still global capital available, most of the transactions are domestic. This trend towards domestic investment is being exacerbated by the problems of currency risk given the uncertain future of the euro.

The outlook for commercial real estate in Europe is one of considerable uncertainty with weak occupational demand compounded by political and economic dysfunction. The political and financial authorities are moving reluctantly to the conclusion that there will have to be a very significant haircut on sovereign debt to Greece and probably other European countries and that therefore many European banks will need to be significantly recapitalised to withstand the writedowns. In some cases this will mean nationalisation as the private sector will not have the means or the inclination to find the €500 billion which is probably necessary.

If this is not done and done rapidly, we are all in for a very bumpy ride, which will see a significant shrinkage in debt availability for normal banking business, which is to oil the wheels of commerce. The consequences for property would be a double whammy as tenant stress will increase and debt funding will probably dry up all together.

Even if sanity prevails and there is a wholesale switch away from propping up delinquent countries to propping up the banks through recapitalisation, the best one can hope for is that prime properties are likely to hold value if bond rates remain low (a view which I would support), but secondary property in many locations is likely to see further falls in value to compensate for tenant and income risk and lack of debt financing. The one hope for the future is that, at the prime end of the market, the near absence of new development will in due course lead to a spike in rents as grade A space is slowly taken up.

I wish I had a clearer crystal ball. ■

Editor's Note: The views expressed in this article belong to Robert Peto and do not reflect the collective house view of either the RICS or DTZ.

Investing in Emerging Markets: China, India and Brazil

BY DAVID J. LYNN, PH.D., CRE®; TIM WANG, PH.D.; AND CASSONDRA MEHLUM

INTRODUCTION

China, India and Brazil are expected to be among the world's largest economies by the year 2050.¹ These countries encompass a significant percentage of the world's land coverage, 30 percent of the world's population and amount to a combined gross domestic product (purchasing power parity) of US\$16.3 trillion dollars. They are among the biggest and fastest-growing emerging markets with significant long-term growth potential.

Combined, they have an expanding middle class which will double in number within three years and reach 800 million people within a decade. This massive rise in the size of the middle class in these nations will create demand for a wide range of economic goods, including real estate. It is reasonable to assume that a huge increase in demand will not be restricted to basic goods but result in greater demand for all consumer segments. High economic growth combined with the enormous populations of these nations will translate into a large aggregation of wealth, creating ever more attractive world markets.

INVESTING IN INTERNATIONAL REAL ESTATE

Increasing global economic integration makes the opportunities in international real estate investment more compelling than ever before—especially given slower growth in the domestic real estate markets of most developed economies. While traditional international capital flows were largely directed toward U.S. and Western European opportunities, substantial interest has developed for markets in Asia, and more recently, a growing interest in Latin America.

About the Authors



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Although most capital currently going into international real estate has an “opportunistic” risk/reward structure, we expect that, over the next few years, “value-added” and “core” strategies will follow as comfort with international real estate grows and reduction in portfolio risk becomes more attainable.

The same logic drives investment in international real estate as in domestic real estate: higher returns, portfolio diversification and the ability to hedge inflation. The international dimension also provides two additional factors: potential to invest in an expanded universe of real estate investments and the need to match international asset holdings to the increased international liability exposure of multinational corporate pension funds.

While real estate investing is not without risk, international investing includes two additional risk factors: political and economic. Political risk is concerned with government structure, policy, leadership and stability, conflicts, tensions and war, political parties, and bureaucracy. Economic risk is concerned with the stability of exchange rates and the performance of the economy. The measurement of economic risk is more quantitative, and insight can be obtained from factors such as output growth, inflation, debt, current account balances and exchange rates.

CHARACTERIZING EMERGING MARKET REAL ESTATE

Real estate in emerging markets, in general, can be characterized as “embryonic and growth oriented.” China, India and Brazil exhibit such characteristics as accelerating market growth, industry potential that substantially exceeds its current volume, and a rapidly growing number of relatively unsophisticated real estate players. Entry into these markets tends to be easy but exiting the market can be more difficult with a weaker legal structure and fewer market players than developed countries. These are young and growing markets. There has been significant property appreciation, which we expect will continue in the near term. All three markets benefit from large national economies and demand based on solid growth fundamentals. There is ample opportunity to innovate and to build market share. The inherent returns in many strategies can be very high.

CHINA

China's growth has been breathtaking, with an average annual real GDP growth rate of more than nine percent from 1978 to 2010, faster than that achieved by any East Asian economy during their fastest-growing periods.

China reported a total population of 1.3 billion and GDP of US\$5.89 trillion in 2010. The country's per capita GDP reached US\$4,400 that year (nominal term). Per capita GDP is as high as US\$9,000 in first-tier cities: that is, Beijing, Shanghai and Guangzhou. However, Chinese economic development has been uneven among regions. The western regions of the country remain relatively undeveloped while the eastern regions tend to be much more industrialized.

While China has a huge population, it is also one of the fastest-aging populations due to the one-child policy and increasing longevity of the elderly. Despite the slowing labor force growth, there will be an ongoing increase in human capital accumulation. Advances in human capital investment and educational attainment of the general population have boomed.

We believe that one of the keys to sustaining long-term growth will be the gradual shift of the Chinese economy away from exports and towards more domestic, demand-driven growth. To facilitate this, China will gradually let its currency appreciate, thereby making imports more affordable for Chinese consumers. It will also likely develop its consumer market as well as its consumer financial services sector to facilitate a wider range of consumer credit products available to average Chinese households. The expanded use of credit cards would likely spur retail demand and imports, while long-term affordable mortgages will boost housing demand and the concomitant accoutrements associated with home ownership.

China represents a significant opportunity in real estate investment. All of the main drivers of real estate demand are strong—economic growth, demographics, urbanization, rising per capita and household incomes, domestic investment as well as foreign direct investment (FDI). China is moving along a path of (albeit sometimes uneven) economic development, liberalization and privatization. Opportunities abound in both the primary markets and increasingly the secondary markets.

There are dangers of speculative excess. Additionally, some developers operate largely on a cash basis, declaring little profit for the tax authorities. Another risk is that the legal and institutional framework is vague and seemingly arbitrary in terms of real estate rights, title, and investment regulations. Perhaps the biggest risk currently involves laws governing real estate, particularly real estate FDI. The changes to real estate FDI in July 2006 radically altered the rules of the game for investment by foreigners.

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This was done with virtually no warning. This kind of unforeseen, rapid-fire changing of the rules has the potential to wreak havoc on investment. Working with established in-country partners and trusted consultants is fundamental to helping mitigate these risks.

In the coming years, growth is expected to be driven less by fixed-asset investment and more through consumer spending. Real estate investment is expected to become more dispersed around the country. Urbanization will be a key driver of real estate. Estimates on urban population growth reach 200 million new urban residents by 2015, when 60 percent of the population is predicted to reside in urban areas.² This growth would fuel demand for housing, consumer goods and infrastructure. The consumer class is expected to grow prodigiously with higher wages and a declining savings rate.

The lack of sufficient investment-grade properties is one of the main barriers to investing in China. There is the greatest potential in the second-tier cities, but much of this will have to be through development as there are few investment-grade properties to be purchased. The tax regime including lack of predictability, differing tax structures (local, regional, provincial, national), and high capital gains often forces investors to buy out the shares of an existing property holder so as not to affect the transfer of the property itself. This practice exposes the buyer to additional risk and due diligence requirements. Finding a domestic Chinese real estate partner is a key challenge, given potential nonalignment of competencies, interests and reputation. However, Chinese development partners are continually improving in skills and sophistication. This means that much investment will be value-add or new development—moving investment up the risk curve from simply core investment. Repatriation of profits has become easier and less risky over the past years with the implementation of State Administration of Foreign Exchange (SAFE) regulations; however, SAFE registration has slowed the acquisition process, which has made pursuit of prime properties (given shorter acquisition periods) more difficult.

China's real estate sector is highly fragmented—even the largest developer does not command a market share of more than 10 percent in any given city. Most local developers come from non-real estate backgrounds such as manufacturing or heavy industry. This is a result of those companies' accessibility to land and financing. Due to the rapid rate of urbanization, many highly labor-inten-

sive factories and plants are located in prime locations. The closure, relocation and redevelopment of these locations represent one of the major themes in Chinese real estate over the last 10 years.

It is likely that investment capital will continue to flow into the real estate sector unless performance of the equities market dramatically improves. Over the past decade, about 80 percent of all real estate investment in China has been directed into the residential sector. Since 2001, however, commercial and other types of real estate have gained investment share—a trend that is expected to continue. Policies encouraging home ownership and liberal lending enabled investment in the residential sector to increase more than six times from 2000 to 2008, while over that same period investment in commercial real estate increased about four times.

Concerns about overheated real estate markets and speculative bubbles have prompted the Chinese government to take measures since the end of the recession to cool down the real estate markets. The government has increased the interest rate and enabled the renminbi, China's currency, to appreciate against foreign currencies to cool inflation pressures.

INDIA

Since 2003 India has been one of the fastest-growing major economies in the world, leading to rapid increases in per capita income, increasing demand and integration with the world economy. India has made structural reforms that have led to its growing prowess in certain sectors of the service economy as well. Should the government maintain a growth orientation with respect to economic policy, trade and globalization, India's GDP in dollar terms could surpass that of the United States by 2050, making it the world's second-largest economy.

The increase in service and manufacturing productivity has been a large component of India's surging GDP. The gradual opening up of the economy introduced competition that forced the private sector to restructure, emerging leaner and more competitive. Leading this change have been international trade, financial sector growth, and the spread and adoption of information technology.

The 21st century will likely see a majority of India's population living in urban areas for the first time in history. India has 10 of the 30 fastest-growing cities in the world and is witnessing rapid urbanization. This is

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happening not only in the larger cities, but in small and mid-size cities as well. We believe India's rapid urbanization has implications for demand in housing, urban infrastructure, and location of offices, retail and hotels. The increasing expenditures in infrastructure will likely drive growth in the transportation sector, spur demand for vehicles, contribute to increasing real estate values along road corridors, and boost suburban growth—the natural next phase of urbanization.

The Indian property market differs significantly from many other markets in the world, and investment strategy and decisions must be adjusted accordingly. The Indian market is extremely large, diverse, complex, fragmented, and experiencing rapid growth. It is also rather undeveloped at this time. The economy is growing, and demand for many types of real estate is strong around the country, albeit concentrated in a handful of cities.

The playing field appears open for a variety of investment and development strategies. There are relatively few major foreign players in the office space, retail (shopping centers/malls), hospitality (hotels/serviced apartments), IT/business parks, and industrial/logistics/warehousing sectors, and limited foreign presence in for-sale residential.

The fundamental growth factors that drive real estate are strong. GDP growth, exports (current account), foreign direct investment, urban growth, population growth, income growth (particularly the middle class), increasing disposable incomes—all portend greater real estate demand and increasing market segmentation. Moreover, the market has been rather artificially constrained because the many regulatory barriers that have been erected for so long greatly limited foreign competition. These have only recently been reduced or removed or are in the process of being scaled back. There is pent-up, unfulfilled demand in several sectors that the domestic real estate market alone has not been able to fulfill.

With the change in FDI regulation, the continuing strength of the Indian economy, and the ongoing improvements to infrastructure, India could be entering a phase of even stronger, deeper and more diversified growth in the real estate industry. In fact the real estate sector is booming, growing at a rate of about 30 percent per year.

The sectors with the greatest opportunity currently seem to be residential, hotel/hospitality and office/R&D. In all

three sectors foreign investors would enjoy advantages in expertise, development standards and capital strength. According to industry players, the housing sector makes up 4.5 percent of GDP, with urban housing accounting for 3.1 percent.

Real estate markets continue to gather momentum in all major areas of the country. Mumbai, Delhi, Bangalore, Chennai, and Hyderabad continue to attract interest from IT and high-tech (domestic and multinational) companies that are either establishing a base in these places or are looking for expansion. Driven by the IT/ITES/BPO³ demand, the suburban locations are witnessing the most development: the suburban business districts of Mumbai, Delhi, Bangalore and Chennai are all seeing brisk development activity due to easier availability of land, construction of larger floor plates, and offers of build-to-suit facilities.

India lags far behind other developing countries in terms of the contribution from real estate (development and construction) to its GDP. Very low labor productivity in the residential sector reflects low capital investment and a marginalized sector with little international competition. In proportion to the size of its economy, its record of strong economic growth, domestic and international demand, the real estate sector appears to have significant potential for growth. In fact, more than half the FDI inflows into China are in the real estate sector compared to less than one-tenth of one percent for India.

BRAZIL

Brazil is forecast to be among the world's fastest-growing economies for the next several decades. By 2050, Brazil is predicted to be the world's fifth-largest economy. The country possesses vast natural resources, sizable pools of labor, growing productivity and high investment rates. Unlike most other Latin American economies, its debt position has improved, having moved from the world's largest emerging market debtor to a net foreign creditor by 2008. Since the early 2000s, Brazil has made great progress towards putting into place the foundations for growth, with particular emphasis on achieving macroeconomic stability. Brazil's growth rate has lagged behind that of China and of India in part because of the stabilization measures, which have acted as a drag on the economy, but nevertheless should serve as a strong foundation for future growth.

The economy still remains relatively less open to trade compared with other fast-growing emerging market

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countries. Brazil has gradually been opening up its markets and lifted barriers to trade. While still primarily a domestically-focused economy, a boom in the global demand for raw materials and increased openness pushed the share of imports and exports to a quarter of GDP in 2007. Going forward, a combination of capital accumulation, population growth, and total factor productivity should continue to boost growth. In terms of productivity, increased human capital associated with a growing middle class should be a significant driver of economic expansion. We believe this should help move Brazil rapidly up the value chain in terms of its commodity and raw materials sector and further expand its manufacturing base.

Brazil benefits from a large and expanding economy, a growing urban population and youthful demographic profile, expanding real estate market capitalization, lessened levels of systemic market risk, and proven political and financial stability. Furthermore, strong capital appreciation and high rental growth rates were recorded in real estate markets of the country during its economic recovery from 2004 through the middle of 2008. Following Brazil's quick recovery from the global recession, rental growth has returned and we believe that this strong performance will likely continue.

Brazil can be characterized as a growth-oriented market. There is ample opportunity to innovate and to build market share. The inherent returns in many strategies can be very high. The country represents an enormous opportunity; however, there are many risks having to do with market strategy, location and timing. Investment has been largely focused in the primary markets of Rio de Janeiro and São Paulo; however, secondary markets also offer compelling growth dynamics.

The for-sale residential industry has boomed in recent years and should enjoy healthy fundamentals as demand outstrips supply. Mass housing development in the for-sale category should continue to do well as Brazilians have little propensity to participate in the rental market. We believe that home builders targeting developments in well-located submarkets of first- and second-tier cities should continue to do well in the coming years.⁴

The industrial sector is dominated by owner-occupiers. Build-to-suit and sale-leaseback are potential opportunities, especially when credit-worthy tenants present opportunities to outsource the management of their buildings. New infrastructure—ports, airports and ring roads—is

being developed/planned throughout Brazil on a massive scale. The development of distribution facilities at strategic locations relative to this new infrastructure will likely be necessary. Despite the short-term slump in foreign trade caused by the global economic downturn, exports and imports are expected to continue growing at a very fast pace once the downturn is over. Given the increasing volume of imports expected (partly due to a wealthier population and rising consumption levels), logistics facilities near the main centers of population and located on key infrastructure should respond well to demand. Average asking rents grew by 15.6 percent in 2010 in Rio de Janeiro according to Cushman & Wakefield, and prime A rents in industrial parks in São Paulo increased by nine percent, according to CB Richard Ellis Group (CBRE). Supply will likely increase but robust demand and the scarce international standard supply will likely continue to push rents up and cap rates down.

For the office sector, strong rent growth and capital appreciation characterized the main markets over the period 2006 to 2008. Rents were resilient in both Rio de Janeiro and São Paulo during the downturn. According to Cushman & Wakefield, rents increased by 25 percent in 2010 in both markets. This was led by a jump of more than 40 percent in average rents in Rio de Janeiro. Although the specific figure varies by broker, 2010 was a strong year for office rents in Brazil, especially for Rio de Janeiro, which represents a more local demand and a very constrained market. In the first half of 2011 rents grew by 13.5 percent compared to 1H 2010, ending the quarter at an average R\$68.6/square meter/month (US\$47/square foot/year).⁵

Supply and demand fundamentals vary widely by office submarket and must be considered closely. Currently, vacancy rates are at relatively low levels in Rio de Janeiro and São Paulo. Vacancy rates are traditionally lower in Rio de Janeiro, which is a smaller market and is constricted geographically. The vacancy rate in São Paulo fell to 3.8 percent in 1Q 2011 (CBRE), the lowest on record, and was at three percent in Rio de Janeiro (slightly up from year-end levels due to new deliveries). Prime properties with credit-worthy tenants are likely to perform well in the medium and long terms. Retrofitted buildings, especially in the highly constrained markets with out-of-date supply, may provide good opportunities. The market could be entered through co-development and retrofit strategies. For European or North American multinational tenants (where environmental considera-

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tions may matter in home jurisdictions), there may be a premium to be paid for a “greener” building in Brazil, as there are very few of these currently.

Retail confidence and sales continue to be much more robust in Brazil than in other major markets. Brazil still has an overall shopping center penetration ratio (gross lettable area per capita) that is quite low considering the average purchasing power of its consumers. Those municipalities and states that have low current shopping center penetration relative to their size and wealth have been identified for development through joint venture “JV” with local partners. Additionally, the middle class is growing and becoming wealthier, which will likely expand the consumer base of shopping centers. Smaller malls, anchored with grocery chains or department stores, could do well in smaller, second-tier cities, which are currently underserved. We believe the continued expansion of the middle class and the home-building boom suggests that shopping centers located near areas of high population growth, and with the appropriate tenant mix serving new household formation, might do well. ■

Editor's Note: This article is based on the book Emerging Market Real Estate Investment: Investing in China, India, and Brazil (John Wiley & Sons, Inc.) written by David J. Lynn, Ph.D., CRE; and Tim Wang, Ph.D.

ENDNOTES

1. Goldman Sachs, *Dreaming with the BRICs: The Path to 2050*, Global Economic Paper No. 99. 2003.
2. World Bank, Urban Development and China, <http://go.worldbank.org/LHTNOP9GU0>.
3. IT/ITES/BPO stands for information technology, information technology enabled service, and business process outsourcing.
4. Especially given the very favorable political and financial environments, which are highly supportive of homeownership.
5. Cushman & Wakefield, *MarketBeat* 2Q11, Brazil Offices.

Go South, Young Men (and Women...)

Key Investment Considerations in Latin America

BY JAMES M. WHITTINGTON, CRE®, FRICS

“GO WEST, YOUNG MAN” WAS WISE ADVICE from Horace Greeley in the mid-1800s and, in today’s world, “Go South, young men” (and, of course, women), may be equally wise advice for real estate investors seeking attractive opportunities around the globe. While most investment capital remains focused on the United States, with sizeable amounts also allocated to Asia and Europe, many countries in Latin America offer attractive, and possibly less risky and more fundamentally sound, investment alternatives. The following article presents a brief synopsis of the key factors that investors should consider as they evaluate the potential opportunities that Latin America offers.

WHY LATIN AMERICA?

As most real estate professionals know, hundreds of billions of dollars have been raised to take advantage of the distressed environment that exists in the U.S. as a result of the recent global financial crisis. However, the reality is that most of the anticipated “opportunities” have never materialized, primarily due to the “pretend and extend” strategy adopted by the U.S. government and major financial institutions. Moreover, the reality is that as long as there is no meaningful private sector job growth, any “value-added” investments that require significant lease-up in order to produce appropriate risk-adjusted returns are likely to fail by not fulfilling the underwriting assumptions upon which they are based.

About the Author



James M. Whittington, CRE®, FRICS, co-founder, Nove International LLC, Chicago, specializes in investment and development opportunities in various markets outside of the United States. Whittington's career in commercial real estate investment and development has focused on capital market transactions. Since 1975, he has closed more than \$3 billion of sales, acquisitions and financings, working with both domestic and international investors. He is personally involved with all of the company's investments, developments and clients, and currently is working on projects in Chile, Colombia, Peru, Argentina, and the United States.

Prior to founding Nove International, Whittington was an executive vice president and managing director of Finance and Investments for U.S. Equities Realty, a full-service commercial real estate firm headquartered in Chicago. During his 15-year tenure there, he completed a number of major transactions including the negotiation of a development joint venture between the Chicago Sun-Times and Donald Trump, resulting in the Trump Tower Chicago, and a series of debt and equity financings totaling approximately \$1 billion for Grand Plaza, a 1.4 million-square-foot mixed-use development located in Chicago.

Whittington graduated magna cum laude from the University of Notre Dame, and was elected to Beta Gamma Sigma (the National Honorary Business Fraternity) and to Beta Alpha Psi (the National Honorary Accounting Fraternity). He is a certified public accountant and a licensed real estate broker.

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Furthermore, other global investment targets such as China, India and Europe face significant threats to their economic stability because of high sovereign debt and/or other underlying factors. Alternatively, many countries in Latin America are supported by healthy fundamentals that will help grow and stabilize their economies over the next decade. These fundamentals include:

- 1) Growing middle classes fueling strong demand and job growth;
- 2) Abundant and largely undeveloped natural resources;
- 3) Financially strong national banking systems and institutions;
- 4) Positive foreign trade surpluses;
- 5) Inflation that is generally under control;
- 6) Generally stable (if not appreciating) currencies.

With Latin America as a major source of food, oil and minerals to the rest of the world, billions of dollars of capital continue to flow into this region, and the corresponding need for development of infrastructure and real estate will be fueled by these strong underlying fundamentals.

As investors consider Latin America as a possible investment target, it is important to understand that potential financial returns will be *relatively* attractive in comparison to the U.S. and other regions of the world. Any return expectations should be evaluated in the context of the relative risks and underlying fundamentals that each region and/or country presents in relation to alternative targets. Therefore, an investor should not expect a risk "premium" over what one might expect to achieve in the U.S. or elsewhere. Rather, the real "risk" is to continue to allocate investment capital to regions that historically have produced acceptable risk-adjusted returns, but may now be fundamentally unsound. On the other hand, no one should invest in Latin America because they expect higher returns by taking higher risks, but because the relative returns they might achieve will be more likely due to the stronger underlying fundamentals that exist there.

Investors from the U.S. and Europe also may discover that Latin America is an easier place to do business than more far-reaching countries such as China and India. While China and India collectively contain 2.5 billion people (more than 36 percent of the total global population), which naturally presents untold real estate development opportunities, the cultural differences and travel distances make realizing such opportunities extremely challenging. In contrast, most Latin American people share the same

Western European heritage as U.S. and European investors, offering cultural similarities. Travel to the southern hemisphere does not require crossing as many time zones, and travel costs are dramatically lower. Furthermore, while speaking Spanish or Portuguese is desirable, it is not mandatory in order to conduct business, as a large majority of business people in Latin America speak English. Even so, since both are Romance languages, they are inherently easier to learn than Mandarin or Hindi.

BRAZIL? MEXICO? WHAT ABOUT THE REST OF LATIN AMERICA?

When the subject of Latin American real estate investment is raised, investors invariably respond: "Tell us about the deals we can find in Brazil and Mexico." While any prudent Latin American investment strategy should always begin with a consideration of these two major countries, ignoring the rest of Latin America would be shortsighted. Although Brazil has rightfully been one of the dominant success stories in recent years (it is currently the seventh largest global economy¹ and is projected to be the fifth largest within the next few years, surpassing both the United Kingdom and France), the stampeding investment "herd" has not only picked over the low-hanging fruit, but also gobbled up the best local partners that are essential to doing business in that country. Despite this, given the size of the country and its enormous growth potential, many attractive investment opportunities remain. But investors must be very cautious. The amount of red tape one encounters can be frustrating. Just forming a company and bringing in capital takes a great deal of perseverance by the investor.

In the case of Mexico, with its proximity to the U.S., the investment community has operated in that country for decades. However, proximity to the U.S. is a double-edged sword. On one hand, the easy travel distance and many cultural similarities provide significant benefits, but on the other hand, because of its dependency on the U.S. consumer market, Mexico is more directly affected by downturns in the U.S. economy. Unfortunately, the highly publicized drug war and border incidents have dramatically raised red flags in both the U.S. business and tourist communities, leading many investors to think twice about investing there at the present time.

COUNTRIES OFFERING THE BEST POTENTIAL

Of all the remaining countries in Latin America, Colombia, Chile and Peru offer the best potential for

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Figure 1
Regional Country Facts

Country	Population (Global Rank)	Largest City (Population)	Other Cities with Pop. > 500,000	Main Exports	Per Capita Income (Global Rank)	Key Factors
Brazil	203M 5	São Paulo 19.6M	40	Cotton, sugar, gold, aluminum	\$10,900 104	Projected to become world's 5th largest economy
Mexico	113M 11	Mexico City 19.3M	37	Manufactured goods, petroleum, silver, fruits, vegetables, coffee, cotton	\$13,800 85	Issues with crime and drug trade
Colombia	45M 28	Bogotá 8.2M	8	Petroleum, coffee, coal, nickel, emeralds, apparel, bananas, cut flowers	\$9,800 112	Rapidly growing middle class with need for new housing stock and retail supplies
Argentina	42M 31	Buenos Aires 12.9M	9	Soybeans, petroleum, vehicles, corn, wheat	\$14,700 76	Political and legal system challenges
Peru	29M 41	Lima 8.7M	3	Copper, gold, zinc, tin, iron ore, molybdenum, petroleum products, natural gas, coffee, vegetables, fruit, textiles	\$9,200 115	Latin America's fastest growing economy
Venezuela	28M 42	Caracas 3M	6	Petroleum, minerals, chemi- cals, agricultural products	\$12,600 92	Political challenges – “the Chavez factor”
Chile	17M 60	Santiago 5.4M	2	Copper, fruit, fish products, paper and pulp, chemicals, wine	\$15,500 72	More evolved financial market – closer to U.S. model than other Latin American countries
Ecuador	15M 68	Guayaquil 2.6M	1	Petroleum, bananas, shrimp, cacao, coffee, hemp, wood, fish	\$8,000 123	Termination of bilateral investment treaties in 2009 has generated economic uncertainty and discour- aged investment
Bolivia	10M 80	La Paz 1.6M	3	Natural gas, soybeans and soy products, crude petroleum, zinc ore, tin	\$4,800 150	Political challenges (similar Marxist/socialist government as in Venezuela)
Paraguay	6M 105	Asunción 1.9M	0	Soybeans, feed, cotton, meat, edible oils, electricity, wood, leather	\$4,900 149	High unemployment forcing immigration to neighboring countries
Costa Rica	5M 120	San José 1.4M	0	Bananas, pineapples, coffee, melons, ornamental plants, sugar, beef, seafood, electronic components, medical equipment	\$11,400 84	Alternative resort/vacation home destination to Mexico and Caribbean
Panama	3M 133	Panama City 1.3M	0	Bananas, shrimp, sugar, coffee, clothing	\$12,700 91	No currency exchange issues (balboa/dollar are used interchangeably)
Uruguay	3M 134	Montevideo 1.6M	0	Beef, soybeans, cellulose, rice, wheat, wood, dairy products, wool	\$14,300 82	The “Switzerland” of Latin America – advantageous international banking laws

Source: The World Fact Book, CIA, Nove International

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strong economic growth and investment opportunities. Many well-known experts agree, as indicated by the following quotes:

[Sam] Zell thinks the Latin American real estate boom is in its early stages.... [He believes that] the middle class will continue to create growing demand ... His ... private investment firm has put about \$1.5 billion into international markets, including Brazil, Mexico, Colombia, Peru, Chile.

Forbes, February 14, 2011

Investors see political stability in countries like Chile, Brazil, Mexico, Colombia and Peru, strong domestic demand and expanding credit. We are seeing unprecedented interest in the region.

The Wall Street Journal, March 21, 2011

We are also optimistic on growth in Latin America and are prepared to increase our investment there... Brazil is fast growing, but Chile, Colombia are also providing interesting opportunities for private equity investors.

Jin Liqueun, chairman of the China Investment Corp., March 30, 2011

Colombia

Not long ago the mere mention of Colombia would conjure up visions of drug trafficking, bombs and terrorist kidnappings. However, after eight years of stable governance by the Alvaro Uribe administration, 2002–2010, Colombia has been dramatically transformed. In many respects, it is a much safer place to visit than many other favored investment markets (three of its largest cities—Bogota, Medellin and Cartagena—have lower homicide rates than Washington, D.C.²). No wonder tourism is booming along with the rest of its economy.

As the third-largest country in Latin America with a population of almost 45 million (only Brazil and Mexico are larger), Colombia possesses a highly educated workforce and a rapidly growing middle class, providing great opportunities for retail and residential development. Rich in fertile farmland with a temperate 12-month growing season, it is the second-largest producer of coffee and fresh flowers in the world. With largely untapped natural resources (including a recent major petroleum discovery), 37 international mining companies established operations in Colombia in 2010 alone.

Colombia is strategically located in the center of the Americas. Situated directly south of the Panama Canal, with major coastlines on both the Atlantic and Pacific, it

is ideally placed to serve as a major logistics/distribution point for South America. Colombia also enjoys being in a hurricane-free zone, and is rapidly becoming a major shipping and cruise line destination. Flying north or south is also easier, as most destinations are no more than about six hours in either direction.

With nine cities having more than 500,000 residents, its population is spread over the entire country, offering development opportunities across several markets. Given all of its positives, it is not surprising that Colombia recently has been awarded investment grade status by Moody's, Standard & Poor's and Fitch. Colombia was also recently named by *The Economist* as one of the strongest emerging markets in the world (it is the "C" in CIVETS, a new group of emerging countries expected to soon rival the BRICs. The former group is composed of Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa; the latter is Brazil, Russia, India and China.) Now that the free trade agreement with the U.S. has been executed, Colombia will no longer be the best-kept secret in Latin America.

Chile

For the past two decades Chile has been a favored market of the international investment community. Chile maintains the lowest country risk in Latin America because of its economic stability, monetary discipline and a balanced political and fiscal environment. Its capital markets are highly sophisticated and are more similar to the U.S. than any other country in Latin America. As a result, it ranks 11th on the Global Economic Freedom Index, 19th on the Business Environment Index, and 31st on the Competitiveness Index. Its people are hard working, highly efficient, and known for their honesty (it ranks 21st on the Corruption Perception Index). The sources for these global index rankings have been compiled by several different respected global organizations, including The World Bank³, World Economic Forum⁴ and The Heritage Foundation.⁵

With a climate and terrain much like California, its fertile agricultural lands make it a major source of food for the entire world (avocados, fruit and wine are just some of its major exports). Chile also is a top exporter of fish (e.g., salmon and sea bass) and minerals (copper among them).

With all of its positive factors, Chile's main challenge is its size. With fewer than 17 million people, and only three cities with more than 500,000 residents—Santiago, Valparaíso and Concepción—investors just can't find enough projects to invest in.

Go South, Young Men (and Women...) Key Investment Considerations in Latin America

Peru

Like Colombia, Peru is another country that has enjoyed dramatic positive economic development in recent years. In fact, its economy has grown more than any other Latin American country over the past ten years (more than 144 percent from 2000–2009, and an estimated nine percent in 2010⁶). Over the same time span, it has also benefited from the lowest inflation rate, averaging only 2.2 percent annually.⁷ Peru is an open trading partner, with recent free trade agreements with the U.S. and the EU, along with long-standing agreements with China, Canada, Korea and Singapore. It continues to encourage direct foreign investment by offering attractive tax incentives and tax stability agreements.

Peru is the second-largest fishing exporter in the entire world and the third-largest mining country. China has been a major investor, pouring billions into the country to purchase gold, copper and other minerals, and this capital has helped fuel Peru's growth. It is also a major food supplier to the world, as it also enjoys a temperate climate and 12-month growing season. In addition, a soon-to-be-completed water tunnel through the Andes will connect the Amazon River Basin with a vast tract of semi-arid land in the northern region, which will substantially increase the country's agricultural capacity.

Peru has the same investment grade ratings as Brazil, so its economic prospects should remain high for decades to come. However, after many years of stable democratic government, a socialist regime recently took office. As a result, many investors are taking a wait-and-see attitude before undertaking any major new projects.

COUNTRIES WITH CHALLENGES

Argentina

Of all the countries in Latin America, Argentina is the most frustrating. Blessed with rich natural resources, vast agricultural lands and a highly educated and sophisticated work force, it sadly is its own worst enemy. At one point in the early 1900s, it actually had one of the largest economies in the world, and rivaled the U.S. in many respects. However, its well-known political instability in the latter half of the 20th century, which has continued up to the present time, has held it back from reaching its full potential. This instability is highlighted by its government actions during its financial crisis in 2001, when it refused to enforce international contractual laws, resulting in billions of dollars of losses suffered by foreign investors. While foreign tourists still enjoy the beauty and cultural

richness of Buenos Aires (the "Paris of Latin America"), most foreign investors remain wary of making any meaningful financial commitments to Argentina. Although it is currently experiencing strong economic growth (9.3 percent in 2010 and an estimated 8 percent for 2011⁸), long-term prospects remain challenging due to political issues facing foreign investors.

Venezuela

The investment prospects in Venezuela can be summarized in three words: "the Chavez factor." As one of the largest petroleum exporters over the past 50 years, Venezuela still has a higher per capita income than most other Latin American countries. However, the leftist socialist Chavez government has dramatically curtailed its economic prospects, and many large multi-national companies have left the country. Although companies can continue to operate profitably there, it is extremely difficult to get capital out of the country. This dire situation is most clearly illustrated by two recent World Bank⁹ rankings of Venezuela—out of 183 countries in the world, it is currently ranked 172 in Business Friendliness and 179 in Investor Protection.

Bolivia

Like Venezuela, Bolivia is controlled by a leftist socialist government that severely restricts the economic activities of the private sector. Like many other Latin American countries, it is rich in undeveloped natural resources, especially natural gas. However, the government has not enforced international contractual laws, most recently reflected in its failure to fulfill international natural gas contracts. Of all the countries discussed herein, Bolivia is one of the poorest.

THE SMALLER COUNTRIES

Uruguay

With its proximity to Argentina (Montevideo is only a short boat ride across the Rio de la Plata from Buenos Aires), Uruguay is culturally very similar to Argentina. Known as the "Switzerland of Latin America" because of its attractive banking laws, it has also encouraged foreign investment by enacting many free trade zones. Punta del Este, an oceanfront resort destination, has become an international playground of sorts. However, with a population of only 3.3 million residents, half of which live in Montevideo, the country's size limits any meaningful investment opportunities.

Paraguay

Paraguay has twice the population of Uruguay, but is a

Go South, Young Men (and Women...) Key Investment Considerations in Latin America

very poor country with per capita income of only \$4,900. While its economy grew 15.3 percent last year, the highest growth rate in all of Latin America, that figure is off of a very low base.¹⁰ Despite agricultural exports like soybeans and cotton, its main export is its people, who migrate to other countries seeking work because of high unemployment and lack of economic opportunities there.

Ecuador

Ecuador, with a population of more than 15 million, is substantially dependent on its petroleum resources. Other major exports include bananas, shrimp and cacao, but the country terminated 13 bilateral investment treaties in 2009, generating economic uncertainty and discouraging private investment. On a positive note, Quito is currently ranked as one of the top retirement destinations in the world, primarily because of its low cost of living and temperate climate.

Costa Rica

Over the past 10 years Costa Rica has become an attractive alternative to Mexico and the Caribbean for vacation homes and retirement. The short travel distance and good weather have helped foster this, and medical tourism has also spurred some economic activity. But besides typical agricultural exports like fruit and coffee, there is no real industry to generate significant investment opportunities.

Panama

Panama also has become an attractive retirement home destination for U.S. expatriates because of its good weather, low cost of living and use of the U.S. dollar as its daily currency, as opposed to the balboa, the official currency. It also will benefit from the widening of the canal, which is scheduled for completion in 2014. However, it is currently hampered by overbuilding in the residential and hotel sectors.

OTHER COUNTRIES

There are many more countries in both Central and South America, such as Guatemala, Nicaragua, Belize, Honduras, etc., but they all are essentially non-factors from an institutional investment standpoint.

CONCLUSION

Latin America is a region of the world that has been ignored for too long. With its abundant natural resources and burgeoning middle class, it will continue to grow as a formidable economic force. With its vast agricultural capacity, it is poised to become the bread basket for the world. Just as the western frontier of the U.S. provided unlimited economic opportunity in the latter half of the 19th century, the fundamental building blocks are in place in Latin America to offer the same to real estate investors, developers and practitioners alike. As they say in Spanish, "Hombres y mujeres jóvenes, su futuro les espera en el Sur!" (Young men and women, your future awaits in the South!) ■

ENDNOTES

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Seller Beware:

The Impact and Consequences to Date of Asian Investment in Metro Vancouver's Real Estate Market

BY WILLIAM MCCARTHY, CRE®

INTRODUCTION

NO CITY ON EARTH'S RESIDENTIAL REAL ESTATE MARKET HAS been more affected by a targeted and concentrated Asian investment, particularly that from China, than Vancouver, British Columbia. While only the perspective of time will define the consequences of this growing control over large segments of the region's housing markets, its impact on affordability and the region's overall economy is not positive. What are the lessons for other regions seeking the quick fix of offshore investment, in particular those learned from the Vancouver experience? The circumstances that have made Vancouver the epicenter for Asian investment cannot be readily duplicated, and evidence increasingly indicates that they should not be.

This rapid and unplanned rise of Asian investment in Metro Vancouver has led to, contributed to, and greatly accelerated the following:

- A virtual destruction of traditional housing affordability models. By the second quarter of 2011 the average price of a detached home in Vancouver was \$843,300 (which would currently purchase only a modest residence). To fund this average residence now requires an impossible 95.5 percent of household income. Canada's largest bank now raises the possibility that in Vancouver "home ownership is becoming a far-fetched dream."¹
- A corresponding rise in overall local household debt to unsustainable levels;
- A severe shortage in affordable rental stock;
- A speculative real estate economy superseding much of

the traditional mixed-use and balanced economy as a taxation driver;

- Provincial and local governments that increasingly involve themselves in the real estate market, dependent on the taxation and fees, and in the process distorting the risk/reward property development matrix;
- Wordy, expensive and unproven green initiatives being used to partially justify land use policies and high housing costs;
- Evidence that foreign investors may have no permanent commitment to local communities other than their financial involvement, nor an interest to assimilate.

On June 15, 2011, Mark Carney, the governor of the Bank of Canada (the equivalent of the chairman of the U.S. Federal Reserve), spoke before the Vancouver Board of Trade to once again warn Canadians about the bank's growing concern over this country's overheated housing market and unprecedented levels of personal and household debt. With the average Canadian spending 147 percent of annual income (on par with the U.S. and the



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worst of Europe),² and most of this debt tied to housing costs, the governor has consistently warned Canadians not to rely on ever-escalating housing prices to keep them solvent.

That Carney chose to speak in Vancouver was no coincidence. It was a deliberate attempt to warn Canadians and, in particular, Metro Vancouver residents, that their debt was unsustainable and that with interest rates eventually rising and continued global economic challenges, the vulnerability of this region of Canada was particularly troublesome:

While Canadians have seen the value of their real estate holdings rocket upwards some 250 percent in the last twenty years, vastly outpacing increases in consumer prices and incomes, it hasn't necessarily left the country better off. Some people in this room may have been enriched by recent developments, their children and neighbors may have been relatively impoverished.³

While Carney acknowledged that Vancouver has always been Canada's most expensive housing market, even with its heavy Asian investment, the housing fundamentals and trend lines were negative. Furthermore, the Bank of Canada would not provide future stimulus or policy to extradite this or any other Canadian market should Canada experience the bursting (or leaking) of its real estate bubble. "We cannot manage monetary policy for a specific housing market or specific region."⁴

The rise of China's economy has been monumental, as has been its global home buying spree. Much of this capital went to Australia, the United Kingdom and Vancouver—a continent, a country and a city. Currently, only Vancouver has not enacted legal and tax deterrents to prevent, or at least curtail, foreign speculation and multiple purchases in its housing markets, something even China has been forced to do.

Has the Asian influence on Metro Vancouver and Canada's housing markets prevented this country from experiencing the bursting of a housing bubble such as has occurred through the U.S. and much of the world since 2008, or has it priced locals out of their own market and undermined the western gateway to Canada, its economy and future? If an objective cost/benefit analysis were to be performed, the Asian impact on Vancouver's real estate markets, what would the outcomes be? Currently, much of the analysis available is overly subjective, self-serving, largely anecdotal, and immature, such as when local

realtors tell the international press that Vancouver real estate is a "sport, and realtors are rock stars," or that Vancouver's pricing is so high because we have become a "resort city."⁵

This is particularly pertinent as China continues its global expansion in light of its own difficulties back home. While Chinese investment in Vancouver's markets currently shows no sign of slowing, China is also spreading its funds and risks around the world. This includes the U.S., where year-to-date March 2010–2011, the percent of foreign purchases by Chinese in the U.S. grew from five to nine percent, with their investments focused in California's Silicon Valley, Hawaii, Las Vegas and New York.⁶ While nine percent is considerably less than the 23 percent of foreign purchases made by Canadians in the American market, the Chinese are now the second-largest foreign investors in American real estate.⁷

GREATER VANCOUVER: THE SETTING

Greater Vancouver is one of the most naturally beautiful and cosmopolitan cities in the world. Situated in the Pacific Northwest in a natural rain forest setting, Greater Vancouver, now known as Metro Vancouver, is 50 kilometers (30 miles) from the American border and 220 kilometers north of Seattle, a city with a similar physical setting and climate. Both are major port cities.

Figure 1

British Columbia



Source: Davenport Maps

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There are increasingly two Vancouvers—the downtown peninsula with its ongoing transformation from a commercial centre to one dominated by high-rise condominium towers, and the rest of the city.

Vancouver is a young city, having been incorporated in 1886. Named after British explorer George Vancouver (1757–1798), the city and British Columbia reflected this British heritage, culture and demographics for most of its first century. Despite its international reputation, it is also a relatively small city with a population hovering around 600,000, making it the 580th largest urban city on Earth.⁸ Approximately 2.1 million of British Columbia's total population of 4.5 million reside in the 21 cities that comprise the administrative entity known as Metro Vancouver.⁹

Figure 2

Metro Vancouver



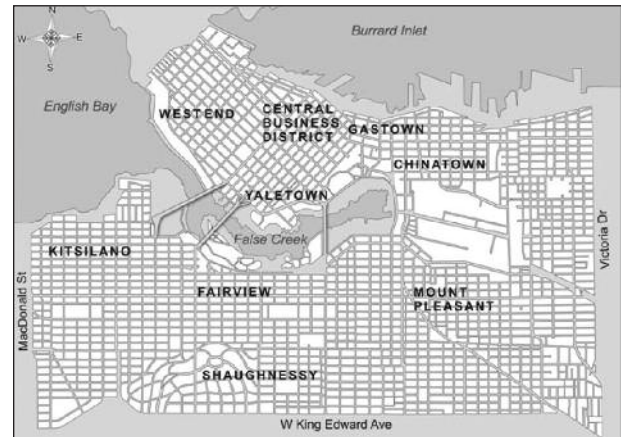
Source: Metro Vancouver

The City of Vancouver itself is relatively small in both population and geography. Its most stunning and beloved feature is Stanley Park, the 1,000-acre northern isthmus which is connected via the Lion's Gate Bridge to the North Shore mountains. As an active port city with a mountain backdrop, the city, especially the downtown corridor, is visually stunning. It is this prime section of real estate, formerly known as the Downtown Business Core, that has been transformed from the economic and cultural hub of the province into the epicenter of Metro Vancouver's real estate frenzy. (The downtown core was profiled both during the 2010 Winter Olympics and the recent Stanley Cup riots.)

There are increasingly two Vancouvers—the downtown peninsula with its ongoing transformation from a commercial centre to one dominated by high-rise condominium towers, and the rest of the city. The downtown core is the home of the urban planning and architectural style known as “Vancouverism,” which refers to slim high-rise office and residential towers situated in a dense urban setting which successive planners have been trying to make increasingly less dependent on automobile traffic.

Figure 3

Central and Downtown Vancouver



Source: City of Vancouver

When most people see images of Vancouver, they are of the northern peninsula, formerly known as the central business district, with Stanley Park to the northwest and the stunning view of the North Shore mountains across Burrard Inlet to the north. What was formerly the commercial centre of the province is now the centre of Vancouver's condominium boom and the urban planning and architectural style known as Vancouverism.

Urbanists and city planners who share notes are enamored by Vancouver, or at least by its small but increasingly transformed downtown core. It is often cited as an example of world-class innovative urban planning. Several former civic officials, planners, architects and developers actively try to export Vancouverism to other jurisdictions. In order to keep this franchise alive, there must be ongoing development and investment into the city core. And as Vancouver has ceased being a head office city, with a declining business base, it has been the residential market that has fueled development, and this has largely been condominium projects, many funded by and increasingly owned by, offshore investors.

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Harvard University Professor Edward Glaeser's *Triumph of the City* is one of the more provocative of a recent series of books that promote the rise of the city state, especially through intensive densification and "sustainability." For Glaeser and his fellow urbanists, the city is "both humanity's greatest invention and our best hope for the future."¹⁰

In order to sustain this thesis, Glaeser has to provide some examples of cities that meet his definition. In chapter nine of his text, entitled "How Do Cities Succeed," he provides nine examples from around the globe including Vancouver. These brief civic profiles include Tokyo ("the Imperial city"); Singapore and Gabrone ("the Well Managed city"); Boston, Minneapolis and Milan (the "Smart city"); Chicago and Atlanta (the "Growing city"); and Vancouver, which he proclaims to be the "Consumer city."¹¹

All of these vignettes are brief, with few facts or figures to complicate his general thrust. With regard to Vancouver, Glaeser chooses to spend much of the three pages reviewing the past works of controversial Vancouver architect, Arthur Erickson (whose most noted work occurred 30–40 years ago), and to highlight the role and importance of Canada's open immigration policies, specifically with regard to the Asia Pacific:

Good urban planning, along with Canada's eminently sensible immigration policy, has helped Vancouver attract human capital. A full 40 percent of the city's population is foreign-born, and a quarter of its citizens were born in Asia. More than half of the people who came to the country in 2006 have a college degree, making them far better educated than native Canadians. Also, nearly half of the Canadians with a Ph.D. were born somewhere else. . . . Those immigrants have helped make the city culturally interesting and economically vital . . . from restaurants to skyscrapers to investment houses, Vancouver immigrants have helped turn a picturesque logging town into a global city.¹²

Glaeser's superficial and dated overview of Vancouver can be increasingly challenged by data on both the livability and affordability of the city, as well as the actual impact on and commitment to the city and region that recent immigrants have shown. (Only about 10 percent of recent Chinese purchasers speak English, according to anecdotal

reports by Chinese-Canadian realtors who facilitate their purchases.)¹³

VANCOUVER: THE MOST LIVABLE CITY ON EARTH; OR THE 29TH "BEST PLACE" TO LIVE IN CANADA

According to the annual ranking compiled by The Economist Intelligence Unit, for most of the past decade, Vancouver was "the most livable city in the world." This and similar subjective rankings are always presented as evidence that Vancouver is not only a world-class city, but one on which other cities should model their urban planning. (The city's pride and self promotion were set back this year when Vancouver unexpectedly fell to third place in *The Economist's* rankings.)

The Economist ranking of 140 cities is based upon 30 factors spread across five areas: stability, healthcare, culture and environment, education and infrastructures. The 2011 livability ranking and each city's score out of 100 points is as follows:¹⁴

Figure 4

***The Economist's 2011 Ranking of the
Most Livable Cities in the World***

Melbourne	97.5
Vienna	97.4
Vancouver	97.3
Toronto	97.2
Calgary	96.6
Sydney	96.1
Helsinki	96.0
Perth	95.9
Auckland	95.7
Source: The Economist, Aug. 31, 2011	

Conversely, in a different ranking by *Money Sense* magazine, for the same year, Vancouver ranked as only the 29th best city in which to live in Canada, among 180 cities or towns with a population greater than 10,000. In this ranking, which placed considerable emphasis on the cost of living, housing affordability, crime and climate, Vancouver scored considerably lower than several Canadian metropolitan areas.¹⁵ Whereas the *Economist* survey of most livable cities focused on image and subjective analysis, the *Money Sense* ranking zeroed in on the

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costs and more mundane aspects of living in a city or town, and how these affected livability.

SOME CHARACTERISTICS OF METRO VANCOUVER'S HOUSING MARKET

Metro Vancouver, and specifically the City of Vancouver, has long been, by a significant margin (historically by a factor of two times), the most expensive housing market in Canada and one of the most expensive in North America. There has traditionally been a premium placed on housing in this region because of Vancouver's beautiful natural setting, lifestyle and its emergence as a young global city.

Real estate has always played an active role in the region's economy. Canada's first real estate board was established in the city at the time of its incorporation. (In Canada, real estate regulation is a provincial jurisdiction). The province and local real estate boards are extremely well organized and administered, and provide excellent services and education programs for their large membership.

However, in recent years the cost of housing and the affordability gap in Metro Vancouver has entered an irrational phase. Low interest rates, foreign investment, and restrictive land use and transportation policies promoted and favoured by some politicians and planners all combine to encourage high density residential towers and attempts to limit the use of the automobile. Metro Vancouver has become one of the top three most expensive housing markets in the world.

The condominium market has fueled much of Vancouver's recent real estate activity as these are very basic developments and Vancouver is one of the premier pre-sale markets in the world. It has been the norm for condominium projects to "sell out" within hours or days of being offered on the marketplace, something actively hyped and promoted by the local media as further examples of the region's "red hot" real estate market. But the "purchases" are essentially assignable options to purchase. Many of these condominium projects were bought on speculation by both novice and sophisticated investors trying to profit from a flip or, if necessary, a rental unit. With units being

purchased for as little as five percent down, low interest rates and extraordinary long amortization periods (at one point 40-year amortizations were available), the risk element was minimized in the eyes of many, as pre-sales typically are done two to three years before the building is even constructed or ready for occupancy.

One negative consequence of this condominium boom has been what is referred to as "Vancouver's Leaky Condo Crisis," which has resulted in numerous reports including a provincial enquiry. Because of changes in applicable building codes, poor design, poor workmanship and Vancouver's often rainy and inclement weather, many condominium projects have faced ongoing repairs and upgrades, with property owners

The condominium market has fueled much of Vancouver's recent real estate activity as these are very basic developments and Vancouver is one of the premier pre-sale markets in the world.

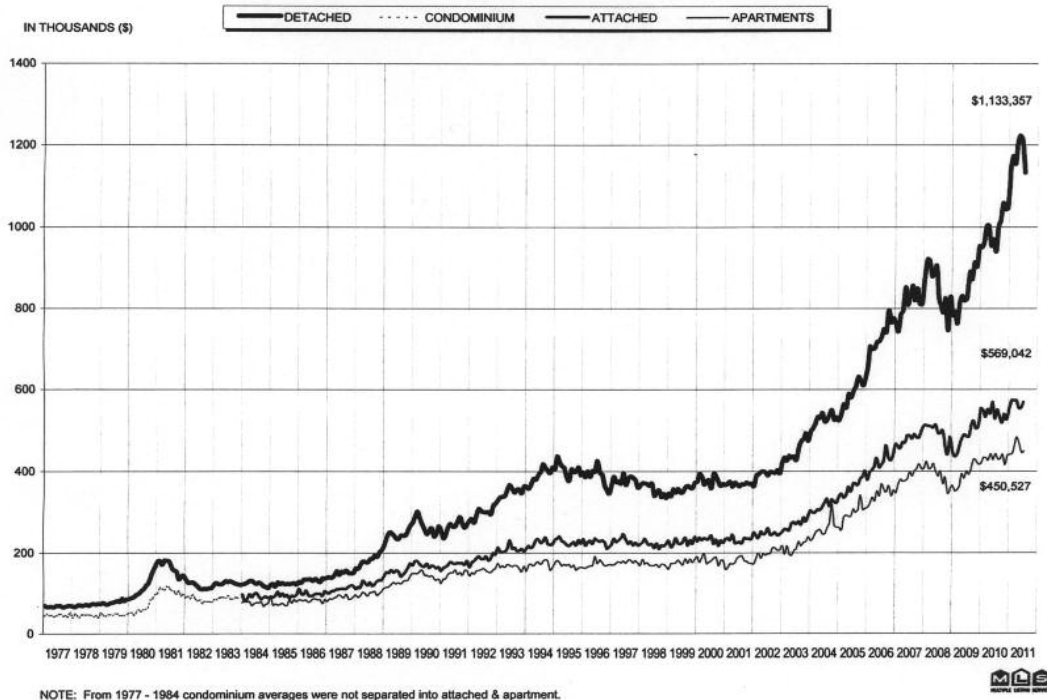
receiving special assessments for their proportionate shares of remediation. It has been a multi-billion dollar crisis in the province and specifically Metro Vancouver. With so many condominium sales being of the pre-sale variety, a purchase can be risky.

With condominiums and townhouses now accounting for approximately 60 percent of residential sales in Metro Vancouver,¹⁶ one might assume the dense vertical construction and increasingly small size (400 to 1,200 square feet is common) would cause housing costs to stabilize, or at least to not escalate. The opposite has occurred. The following are residential average sale prices, as reported by the Real Estate Board of Greater Vancouver, from January 1977 to July 2011. As of this article's writing, the average detached home in this market is \$1,133,357, with townhouses averaging \$569,042 and condominiums at \$450,527.¹⁷

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Figure 5

Vancouver Residential Sales 1977-2011



Source: Real Estate Board of Greater Vancouver

How do people in Metro Vancouver afford their homes, especially first-time purchasers? This is the key question that has not been answered fully to date, and will determine if Vancouver's housing bubble bursts spectacularly, leaks slowly, or continues to defy logic and remain one of the most expensive and unique housing markets on Earth.

The ultimate determinants will be affordability and basic housing fundamentals. In contrast with the U.S., Figure 6 shows data from the National Association of REALTORS®.¹⁸

Figure 6

National Association of REALTORS Median Priced Single-Family Home United States Housing Affordability Index, June 2011

REGION	MEDIAN PRICE	MEDIAN FAMILY INCOME	QUALIFYING INCOME	PAYMENT AS A % OF INCOME
National	\$184,600	\$61,537	\$36,960	15%
Northeast	\$260,600	\$70,830	\$52,128	18.4%
Midwest	\$148,800	\$60,951	\$29,760	12.2%
South	\$161,500	\$56,184	\$32,208	14.3%
West	\$245,800	\$64,885	\$49,632	19.1%

Source: National Association of REALTORS®

The wide gap between these American and the following Canadian prices is dramatic. (It should be noted that mortgage interest deductibility is not permitted in Canada, as it currently is in the U.S. Also note that the American statistics are median prices whereas the Canadian prices

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are averages.) The housing affordability measure used in the Canadian examples is the percentage of disposable income required to fund the applicable mortgage payments, property taxes and utilities.¹⁹

Figure 7

Standard Canadian Two-Storey Detached Home Average Price Second Quarter 2011

REGION	AVERAGE PRICE	QUALIFYING INCOME	HOUSING AFFORDABILITY MEASURE
Canada	\$393,000	\$ 87,900	49.3%
British Columbia	\$664,000	\$131,400	76.6%
Vancouver	\$843,300	\$163,100	95.5%

Source: Royal Bank of Canada Economic Research, June 2011

Figure 8

Standard Canadian Condominium Average Price Second Quarter 2011

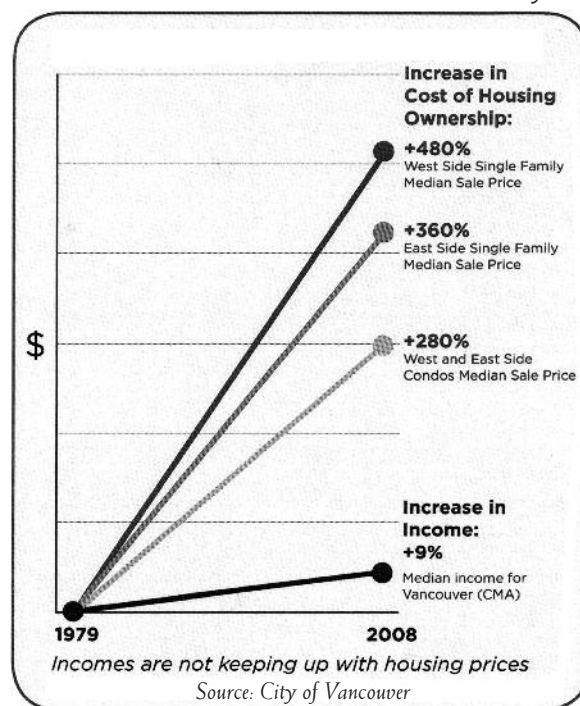
REGION	AVERAGE PRICE	QUALIFYING INCOME	HOUSING AFFORDABILITY MEASURE
Canada	\$230,000	\$ 52,000	29.2%
British Columbia	\$312,300	\$63,200	36.8%
Vancouver	\$410,800	\$80,500	47.1%

Source: Royal Bank of Canada Economic Research, June 2011

The two Canadian tables show that even with some distortion based upon the most expensive Metro Vancouver sub-markets, and despite the advantage of record low interest rates, reduced down payments and extended amortization schedules, the local household incomes cannot afford these units. Therefore, the influence of foreign investment is perhaps far greater than currently understood or reported. Figure 9, produced by the City of Vancouver, shows the growing and irrational disconnect between housing prices throughout Vancouver and local household incomes, which essentially have remained stagnant with some inflationary increase over thirty years.²⁰

Figure 9

Vancouver's Income and Affordability Gap



While Vancouver's housing market continues to rise, most analysts project an eventual "price correction" in the 15–20 percent range, with some more bearish forecasters stating the correction could be up to 40 percent. Any significant deflation could be catastrophic, as many Canadians are relying on household debt to be neutralized by ever-increasing housing values.²¹ (By contrast, Seattle, which shares many characteristics with Vancouver, currently has an estimated one-third of all its region's homes "under water," with the home values less than their current mortgage).²²

Perhaps somewhat late in the game, financial institutions themselves are now joining the Bank of Canada in warning Canadians about their "torrid love affair with credit, seduced by easy access to low borrowing rates . . . Canadian housing valuations are raising eyebrows."²³ This is especially true with regard to Metro Vancouver, a single market which can, and does, impact the entire national housing cost averages.

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Vancouver home prices have risen by a frightening 23 percent over the past year, merely the continuation of a highly caffeinated trend. Unsurprisingly, affordability has suffered. ... Projecting affordability once interest rates have normalized is even grimmer: Vancouver home prices will be 40 percent too high for fixed-rate borrowers, and 38 percent too high for variable rate borrowers. Clearly, Vancouver is an extraordinarily pricey market. Arguably, some premium is warranted due to its physical beauty, attractive climate, limited land mass and Asian investment. . . . There remains a significant and growing affordability gap in the city, and it should be viewed as the canary in the coal mine for the rest. Whatever happens to the country, Vancouver should lead the way.²⁴

The only reprieve this and similar reports give with regard to the affordability gap is the possibility that if one excludes the top 20 percent of the market, where most of the recent Asian investment has been, then housing prices and the affordability gap are lessened enough to limit the size of a future pricing correction and its impact on homeowners. Regardless, as with any pricing model, it is the top end that always pushes the prices up across the board. This is what has occurred in Vancouver, in large part due to foreign investment and a shift in control of much of the local real estate markets.

CANADA: A LAND OF IMMIGRANTS OR A NATION OF EMIGRANTS?

Canada has an enviable and well established reputation as a very accommodating and welcoming country with regard to immigrants. Unquestionably, Canada will require a steady stream of skilled immigrants to fuel its economy because of its current low birth rate and the sheer geographic size of the country.

The Chinese in particular have been a long-term presence in Greater Vancouver and British Columbia. Thousands of Chinese laborers were brought to Canada in the 1880s to work (and die) during the construction of the Canadian Pacific Railway. Subsequent immigration from China and the Asia Pacific was slow but consistent during the last century. Many of these immigrants showed a tremendous entrepreneurial zeal and quest for education, often in the face of prejudice, and in turn, became well integrated and successful members of the multi-ethnic society that predominates Greater Vancouver. With Communist control of China after 1949, Chinese immigration increased steadily and included many who migrated from

Taiwan. As Hong Kong was a British territory and, like Canada, part of the British Commonwealth, access to and from Canada was relatively easy. And after the Tiananmen Square uprising of 1989, leading up to China's reclamation of Hong Kong in 1997, many Chinese became what is known as satellite investors and residents, purchasing homes and businesses in Greater Vancouver as a hedge against the political and economic uncertainties of China, while remaining residents of China or both.

According to Statistics Canada, as of 2006, Metro Vancouver's 2.1 million residents consisted of 42 percent visible minorities, with 18.2 percent of Vancouver's total population Chinese. (By contrast, Greater Toronto's population, which is approximately three times that of Metro Vancouver, has an estimated Chinese population of 9.6 percent).²⁵ Approximately 70 percent of visible minorities in Vancouver were born outside Canada, with two-thirds of these coming to Vancouver in the last fifteen years. Almost 75 percent of the Chinese in Vancouver were born outside Canada.²⁶ To see the rise and scope of recent immigration throughout the entire Vancouver region, click on an interactive map adapted from Statistics Canada at <http://www.vancouver.sun.com/news/vanmap/5241636/story.html>.)

The impact of this huge demographic and cultural shift on a relatively small region is yet to be fully understood or quantified. Perhaps the biggest question to be answered is how deep and lasting are these recent immigrants' commitments to Canada and Metro Vancouver? If there are assimilation and firm roots planted, as was the case in generations past, then this foreign capital and population will transform Metro Vancouver significantly. However, if this relationship is one of convenience, then the consequences may be detrimental, including a decline in housing affordability, a rise in foreign control over the region's economy, and a lessened sense of community and cohesiveness.

Recent evidence indicates that we are simultaneously a nation of both immigrants and emigrants. An astonishing 2.8 million Canadians, fully nine percent of our country's population, live abroad while retaining the rights of Canadian citizenship. According to the Asia Pacific Foundation of Canada (formed to facilitate Asian-Canadian relations), proportionally, about five times as many Canadians as Americans are likely to be living abroad.²⁷ "The demographic shift towards significant emigration will

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eventually force Canada to confront a long established ambivalence to citizens living beyond its borders.”²⁸

The percentage of Canadians living abroad is extremely high as a proportion of the country's population. At 8.8 percent, only the United Kingdom at 9 percent is higher. By contrast 4.3 percent of Australians, 3.3 percent of French, 2.6 percent of Chinese and 1.7 percent of Americans live abroad.²⁹

The Canadian diaspora is widespread, with Canadians residing in virtually every country on earth. Not surprisingly, the majority of foreign-based Canadians are in the U. S., followed by the Asia Pacific. The following are the major countries of choice for the Canadian diaspora, of which 58 percent are Canadian born:

<p><i>Figure 10</i></p> <p>Where Canadian Citizens Live Abroad</p>	
United States	1,062,640
Hong Kong	300,000
United Kingdom	73,000
Lebanon	45,000
Australia	27,289
China	19,990
South Korea	14,210
Japan	11,106
<i>Source: Asia Pacific Foundation, June 2011</i>	

WHAT HAVE BEEN THE COSTS AND BENEFITS OF RECENT FOREIGN INVESTMENT?

A recent Asia Pacific Foundation of Canada reported that “Canadian government policy discourages attachment to Canada among its diaspora,” (who will) be a growing threat to Canada's free public healthcare system and heavily subsidized educational system—while at the same time their taxes are paid and their expenditures are made in foreign countries.”³⁰

To encourage immigration of high net worth and entrepreneurial-focused immigrants, Canada has established various programs to encourage immigration by what are referred to as investor-class immigrants who currently must have a net worth of at least \$1.6 million Canadian. Approximately 55 percent of this class of immigrants came to British Columbia, specifically Metro Vancouver.³¹ While the net worth requirement has steadily increased,

the impact these new immigrants have had on local economies, other than their real estate markets, is hard to measure. Indeed, any discussion about Canada's immigration policy, which tries to balance family reunifications, refugees and work force requirements, is sensitive in this country. Cost and benefit analyses of Canada's immigration policies are even more controversial. Recent studies by the conservative think tank The Fraser Institute, indicate that currently, new immigrants to Canada cost the federal government between \$16.3 and \$23.6 billion in various social services and other costs, and that it may take up to ten years of support before immigrants become revenue generators.³²

The Province of British Columbia, like most jurisdictions, has undergone significant pressures on its budget expenses, while its revenue streams, especially its traditional resource taxation, have declined. The province currently runs a deficit on its 2011 budget of \$41.8 billion, of which \$18.166 billion is by way of direct taxation including income and corporate taxes. Fully 13 percent of this taxation revenue comes from one of the world's few carbon taxes (\$740 million), and the traditional “sin” taxes: tobacco (\$730 million) and liquor (\$897 million).³³

Showing just how important an active real estate market has become for the provincial budget, British Columbia currently generates \$1.891 billion of its taxation revenue from property taxes and a further \$850 million by way of its property purchase tax. (In 1987 the province implemented a property purchase transfer tax on property sales. This tax is based upon an assessment of one percent on the first \$200,000 and two percent on the balance of the purchase price).

With 15 percent of the province's taxation revenue coming from property taxes, and the provincial debt currently sitting at \$47.757 billion, up 30 percent³⁴ in just the past four years, it is obvious why the province itself is reluctant to curtail either foreign investment or hyperactive real estate markets.

(An interesting contrast is presented by another tax source. British Columbia has long been known as a resource rich jurisdiction, especially with regard to its softwood lumber, the finest in the world. Currently, because of world market conditions, the taxes derived from forestry sales amount to only \$422 million, half of the province's property purchase tax, and a fraction of the

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\$1.071 billion the province receives from its new growth industry, casinos and lotteries.)³⁵

Canada and British Columbia are extremely generous with regard to social services, healthcare and education. In British Columbia, 49 percent of the direct taxation revenue goes to the healthcare budget, while 28 percent goes toward education.³⁶ There is generally universal access to these public health and education systems. It is also a relatively straightforward process to become a Canadian citizen. The current guidelines include living in Canada for at least three of the past four years, knowing one of Canada's two official languages (English or French) and "learning about Canada."³⁷

Therefore, owning Canadian real estate, regardless of its cost, and especially holding Canadian citizenship, provides extremely favourable access to the Canadian social safety net. These benefits, as well as the natural beauty of Canada, its political and societal stability, diverse ethnic and cultural makeup, educational systems, and the ease of access into its markets are most often cited as the prime motives for those immigrants looking to invest in Canada.

WHY CITY GOVERNMENTS WANT ACTIVE REAL ESTATE MARKETS

Not surprisingly, politicians, planners and bureaucrats as well as the local real estate and development communities focus hard on promoting the image of Vancouver as the most livable city in the world. This allows them some defense of high housing costs and property taxes. This image is also used to justify land use and zoning policies and restrictions, and political objectives. The current City of Vancouver now has as its cornerstone to eliminate homelessness by 2015³⁸ and make the City of Vancouver the "greenest" city on Earth.³⁹

Despite the well-founded skepticism within the real estate and development community as a whole and the public at large about the twin goals of eliminating homelessness and transforming a former resource-based city into a green economy, considerable energy and resources from the City of Vancouver and Metro Vancouver are being

directed at these two targets. To fund them requires an increasingly active residential real estate market, as the commercial and industrial markets continue to stagnate. The City of Vancouver also requires a high property tax base and ongoing development fees simply to meet its growing payroll. For every 100 people who work in Vancouver, three are municipal employees.⁴⁰

British Columbia and the City of Vancouver have an ad valorem property tax system whereby the local government sets a mill rate that is charged against the provincially assessed value of the property. By statute, local governments in this province cannot run deficit budgets, so they simply adjust the property mill rate and raise taxes to meet their expense needs. It is therefore in their best interest from a taxation standpoint to have high property values from which the taxable property base can be extracted from. The tax rate gap between residential and commercial property owners is significant, with business owners paying on average about six times the rate of residential owners, and without a vote in municipal elections. This tax system works very well for local politicians and growing bureaucracies. Of the City of Vancouver's 2010 operating budget of \$961 million, 63 percent came from property taxes, with 18 percent from user fees and other charges (including development cost charges), and the balance of 18 percent from utility fees.⁴¹

In addition to their property tax control, local governments also generate significant revenue from development cost charges and "amenity surcharges." In recent years Metro Vancouver has seen considerable trade-off with regard to zoning and density issues. Developers seek bonus densities and favourable rezoning while local governments in turn extract higher development cost charges and permit fees, and quite often amenities such as the developer's providing some "non-market and affordable housing" within their projects, community space or other charges or conditions. It is now not uncommon for those within the real estate industry to contribute to the political campaigns of several parties, often simultaneously, regardless of ideological concerns. The develop-

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ment industry together with the municipal employee unions are the largest financial contributors in civic elections.

In such an active market, developers have quickly acquiesced to these impositions, as the prices are simply incorporated into the project and ultimately paid by the consumer. It is not uncommon for development projects to carry soft costs of more than 25 percent of the project's overall budget. Soft costs now incorporate a wider range of expenses and also are a significant profit and overhead component of a development. Foreign purchasers pay little attention to these realities. More time is devoted both by local realtors and Asian investors into the feng shui of a particular property. (For example, home addresses with the numeral "8" are particularly desirable, as this numeral signifies to the Chinese wealth, prosperity, happiness and health. Canada Post is regularly inundated with requests for address changes to incorporate the numeral 8.)

For some perspective on how much the Canadian consumer pays in taxes and fees, the Canada Mortgage and Housing Corporation (the Canadian equivalent of Fannie Mae and Freddie Mac), analyzed these costs nationally and concluded that Canadian buyers of a new \$567,000 home paid approximately \$108,000 in taxes, fees, levies, and other imbedded charges imposed by the federal, provincial and municipal governments.⁴² To put this in some further perspective, \$567,000 would not provide the consumer with very much purchasing power in Metro Vancouver. But the \$108,000 in taxes and fees embedded in new Canadian homes equates to fully 59 percent of the median U.S. detached home price of \$184,000 as of June 2011.⁴³

HOUSING AFFORDABILITY: THE KEY VARIABLE

In order to better understand local, national and international housing markets, Demographia International began its International Housing Affordability Survey, which currently analyzes 325 markets in seven countries and quantifies the relationship between median household incomes and median home prices.⁴⁴ Based upon its analysis, Demographia International states that if median home values exceed three times median incomes, then the cost of housing is unaffordable.

Figure 11

Demographia Housing Affordability Rating Categories

Median Income Multiple required
for Median Home Value

RATING	MEDIAN MULTIPLE
Severely Unaffordable	5.1 & Over
Seriously Unaffordable	4.1 to 5.0
Moderately Unaffordable	3.1 to 4.0
Affordable	3.0 or less

Source: Demographia International 2011

Of the six countries and one region (China/Hong Kong) analyzed, the only country close to having a national affordability index close to affordable was the United States. (This result follows the 2008 collapse of the American housing bubble.)

Figure 12

Housing Affordability National Medians by Major Markets

(Over one million population)

NATION	NATIONAL MEDIA
China	11.4
Australia	7.1
New Zealand	6.4
United Kingdom	5.1
Ireland	4.8
Canada	4.6
United States	3.3

Source: Demographia International 2011

With a national median index of 4.6, Canada's housing market is considered seriously unaffordable, according to this survey's methodology. With a 9.5 median multiple, Vancouver is the third most expensive housing market in the world. The following is the median multiple for some of the 82 cities profiled with a metro population more than one million.

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Figure 13

Housing Affordability: Major Metropolitan Markets

(Rank out of 82: Metropolitan Market Median Multiple)

RANK	METROPOLITAN MARKET	MEDIAN MULTIPLE
1	Atlanta, GA, USA	2.3
10	Dallas, TX, USA	2.7
33	Chicago, IL, USA	3.6
36	Washington, DC, USA	3.8
43	Calgary, AB, Canada	4.0
47	Portland, OR, USA	4.4
50	Dublin, Ireland	4.8
55	Boston, MA, USA	5.0
55	Seattle, WA, USA	5.0
59	Toronto, ON, Canada	5.1
66	Los Angeles, CA, USA	5.9
68	New York, NY, USA	5.9
76	London, UK	7.2
76	San Francisco/Oakland, CA	7.2
80	Vancouver, BC, Canada	9.5
81	Sydney, Australia	9.6
82	Hong Kong, China	11.4

Source: Demographia International 2011

For the Metro Vancouver calculations, Demographia used a median house price of \$602,000 and median income of \$63,100. If only Vancouver city and not its metropolitan area were used, the price-to-income ratio would be 11.7 to 1.

While Metro Vancouverites pay a high premium for their residential real estate, this does not necessarily translate into either premium quality or value. The age, size and quality of materials and finishes varies significantly from project to project (both detached and condominium). Housing sizes are decreasing, and condominiums with more than 1,000 square feet of living space are now considered to be larger units. Curb appeal of residences varies greatly. (The infamous “Crack Shack or Mansion” Web site, which was created by local residents out of frustration about the high cost of housing in Vancouver, literally asks the viewer to pick between a Vancouver “crack shack or mansion.” The Web site can be viewed at <http://www.crackshackormansion.com>).

Now, perhaps too late in the game, housing affordability is the new mantra of governments, developers and realtors. But what denotes housing affordability in such an extreme market like Metro Vancouver? Two current affordability initiatives highlight not only creative planning, but costly and limited-use alternatives. The City of Vancouver has recently launched two programs that highlight the extraordinary cost of any form of housing in the region. These include laneway housing and “basements in the sky.”

The laneway housing initiative calls for structures to be built literally in the back alley of existing detached homes. The structures are meant to provide shelter for immediate family members and cannot be part of a separate property title. However, the estimated cost of constructing a 750-square-foot laneway house is \$160,000 to \$220,000—far more than the cost of an average detached home in the U.S.⁴⁵

Similarly, the “basement in the sky” bylaws are meant to be sustainable alternative rental units to assist condominium owners with their mortgages. To qualify, a condominium owner needs a unit “large enough” to be subdivided to provide 205–280 square feet of space that must have its own separate entrance, and its own bathroom and kitchen.⁴⁶ Where once realtors had to disclose illegal secondary suites, now they are being actively promoted by cities themselves, stating that such housing initiatives are common in other parts of the world, including Hong Kong.

The prime example of convoluted planning and overall incompetence was the conception and development of Vancouver's 2010 Olympic Village. What was proclaimed as one of the world's greatest mixed-use and green initiative developments—a new urban model where owners of multi-million dollar units would live beside heavily subsidized social housing occupants—has proved to be a massive failure. The multi-building project, which housed the Olympic athletes for two weeks in advance of being placed on the market, was initially offered at per-square-foot sale prices in excess of Manhattan's. It has turned out to be the most costly misadventure in city history, and is currently in receivership. The city, which is now the creditor of the property, will lose hundreds of millions of tax dollars.

A final point on affordability concerns the rental market. Another consequence of the speculative nature of foreign investment in the local market has been the severe

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decline of both new commercial developments and rental apartments. With condominiums becoming increasingly dominant in the local real estate markets, many existing commercial and apartment buildings were converted to condominiums, with virtually no new projects replacing them. The newest crisis facing Metro Vancouver is now the lack of affordable apartments. Currently it is estimated that upwards of 65,000 apartment units are needed annually because of the lack of affordability of the housing stock. Fewer than 600 units are built per annum.⁴⁷

LESSONS TO BE LEARNED TO DATE

Metro Vancouver is a city that either remains on the rise or is heading for a fall. To what extent either of these outcomes could occur is still unknown. Vancouver's current real estate market continues to defy expectations and global realities. Foreign investment continues unabated and shows no sign of slowing—yet. Is this because foreign funds, especially from China, are invested in British Columbia in order to create a permanent connection with this city? Or are investors still hedging their bets on China's own housing markets and its political and economic stability? If China's growth were based upon Western consumerism and debt, as well as its own cheap labour and artificially devalued currency, how can its model be sustained in light of the world's current economic decline?

While the circumstances that have led to the current Vancouver real estate experiment cannot be easily transferred to another jurisdiction, there are still some points to be noted:

1. Housing affordability remains the key variable.

When a city or region loses its housing affordability, its economy is hamstrung and the workforce and entrepreneurial base lost. Existing businesses will relocate to less expensive locales, or simply limit their own expansion and growth plans. The impact on a society with a denied or restricted home ownership dream is currently unknown.

2. The principal, interest, tax (PIT) calculation is the key housing fundamental.

For generations, the traditional housing market was built upon a simple PIT calculation. Previously, to buy a house one needed roughly one-third of the purchase price available for down payment, and the combined PIT could not

or should not exceed about one-third of the family's gross income. The housing bubble was exacerbated when higher-risk loans reduced down payments and people began using their homes as a source for cash withdrawals. As a result, debt too often exceeds home equity. Local residents, not foreign investors, bear this responsibility.

3. Debt is debt.

Both sovereign nations and their citizens have assumed greater debt than perhaps is possible to repay. In Metro Vancouver, it is increasingly the escalating home prices that owners look to, to keep them solvent. But how much equity is really available in these assets and how liquid are they if the market turns? This in turn has led to an overdependence on foreign purchasers to buy out local owners.

4. You cannot build a sustainable economy on a speculative real estate market.

As shown in this article, all levels of government are indebted to the hyperactive real estate market in British Columbia and in particular Metro Vancouver. Without the taxes and fees generated by real estate, local and provincial budgets are literally sunk. Strong and vibrant economies with global influence do not rely on their local real estate markets and ever-expanding gambling cultures to fund their operations. This was highlighted when the Business Council of British Columbia commented on the latest Metro Vancouver Regional Growth Plan, which tries to project thirty years into the future:

*The current version of the Regional growth strategy seems to be more of a 'preservationist' plan than a true growth plan. If the past two decades have taught us anything, it is that steady population growth, high levels of immigration, and a changing global economy are sure to have a major impact on Metro Vancouver in the coming decades, and in ways that cannot be fully anticipated in 2010 . . . The regional growth strategy has five primary goals, but only one even references the economy, stating simply that the regional growth plan's second goal is to support a 'sustainable economy.'*⁴⁸

British Columbia has not had measureable productivity gains within its economic models in more than a generation and has lost much of its resource-based industries, something further addressed in the Business Council's critique:

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The Greater Vancouver region does not score particularly well on a number of key indicators of economic success. Relative to size of population and GDP, regional exports are lower than elsewhere in the country and clusters of traded industries tend to be weak. Labour productivity and employment incomes are lower than in most other large Canadian cities. The region also stands out for its very poor record in maintaining, let alone growing head office employment.⁴⁹

5. Planners do not necessarily plan well.

While all cities and regions require skilled and competent urbanists and city planners, Metro Vancouver might not be the model other jurisdictions want to follow—despite its current reputation as a leading-edge region. For forty years the governing mantra of Metro Vancouver has been the twin pillars of “livability and sustainability.” While short on specifics, facts and figures, the general wording of successive planning documents was to provide both livability and sustainability in tandem. There now has been a subtle move towards promoting sustainability and green initiatives and downplaying livability (affordability).⁵⁰

6. Politicians will be politicians.

Politicians, especially career ones, tend to act out of expediency and with an immediate and short-term perspective. This is not beneficial in real estate—which is a long-term proposition. There is perhaps too close a relationship between politicians, the real estate and development industries and the civic bureaucracy and planners—and this does not necessarily lead to good decision making. What is the point of having detailed official community plans and zoning bylaws if these can be traded on or amended as easily as they have been in recent years? Another outcome is mega-projects or legacy projects that politicians always want to be part of—yet may not be suited to comprehend or manage. Vancouver's Olympic Village is the best example of this.

7. Sustainability and green initiatives will be used to defend policy decisions and rising costs.

While sustainability and green initiatives are here to stay, they should not be imposed unless the technologies and benefits are proven. Higher densities, fewer transportation options and higher taxes to combat perceived or actual threats to the environment are not necessarily practical and should not be used to justify higher real

estate prices and taxes. Individual green initiatives should always be encouraged and promoted.

8. Real estate risk should be borne by the developer and purchaser – not transferred to the taxpayer.

Traditionally real estate development required control and/or leverage over four variables: land, capital, tenants/purchasers and knowledge. Those who develop and market real estate should be doing so with their own capital and not benefit from public assets or influence. Risk assessment and management—the possibility of success or failure based upon one's efforts and resources—is a great deterrent for bad projects, as ultimately the market will decide.

9. While some foreign investment in real estate can be positive, excessive amounts will negatively alter the traditional housing market.

The rapid escalation of foreign capital into Metro Vancouver's residential housing market is unprecedented. High-end prices increase all housing prices and this has certainly been the case in Metro Vancouver. As goes the housing market, so goes the commercial real estate markets and the economy as a whole. Furthermore, without some objective cost/benefit analysis of such concentration of foreign money in one's region, and the overall impact on various government budgets and services, it cannot be stated with any degree of accuracy what the actual cost and benefits are of this investment. While the short-term gains may appear advantageous, the ultimate returns may not justify the transformation.

Unless recent immigrants fully integrate with this region's communities and economies, and Canada's extremely large emigrant population reintegrates with Canadian society and fully pays taxes here, this whole process is flawed.

10. It is not rude to ask who is investing in your real estate markets and where their money comes from. It is called due diligence.

There is growing unease within Metro Vancouver about the rapid rise of the Asian real estate influence over the region. Who are the purchasers and where does this money come from and how was it earned? What is their commitment to the region and Canada? Will they integrate or be satellite investors and residents?

It is now becoming clearer that locals are being priced out of their own real estate markets—and that home ownership for their children is a fading dream. If proper due

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diligence is not part of the equation at this point, then perhaps tax and legal deterrents that address speculation should be considered and implemented.

Those of us who are fortunate enough to call Metro Vancouver our home, and work within its real estate industry, consider ourselves very fortunate indeed. This is why many watch with growing trepidation what is currently occurring in our real estate markets and consider what might be the long-term and lasting impact of our Asian investment experiment. Accordingly, if other jurisdictions are contemplating similar means to salvage or grow their real estate markets, they should carefully consider the timeless words of the preamble to the REALTOR® Code of Ethics and Standards of Business Practice:

*Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization.*⁵¹

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Rennie Marketing Systems and Realty is headed by realtor Bob Rennie, proclaimed by the Vancouver media as the region's "Condo King." He is the single most influential and controversial marketer of condominium projects in the region. He is also the frequent keynote speaker at the region's annual gathering of the Urban Development Institute, where his presentation and predictions are as interesting as they are bizarre and disjointed. Readers who visit the firm's website (<http://www.rennie.com>), can view Rennie's 2011 UDI speech, entitled "Vancouver, The Best Place to Live or the Least Affordable – You Decide." Prior to speaking, largely on the Asian influence on our housing markets, Rennie enters to the 1970s disco song "Kung Fu Fighting" followed by a brief remark about his sex life. In his presentation, Rennie will try to mitigate the Chinese impact on Metro Vancouver's real estate markets by stating if the top 20 percent of the market are excluded (almost exclusively Chinese), then the region's housing market affordability is not as drastic as reported.(It is).
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Turkey: Modernizing through Mall Development

BY MARC LOUARGAND, PH.D., CRE®, FRICS

TURKEY IS A NATION THAT—BOTH LITERALLY AND FIGURATIVELY—has one foot in Europe and the other in Asia. More specifically, Turkey straddles the boundary between Europe and the Middle East. The contrasts between Turkey and Europe in terms of lifestyle, education and affluence are growing dimmer while their respective economies converge. Turkey is an emerging economy that has arrived. A nation of more than 70 million, it has a diversified economy and a young workforce unburdened by a large dependent populace, unlike many European countries. Yet Turkey also represents the ancient ways of the nomad, the souk and the bazaar. In the past five decades Turkey's population has shifted from 40 percent in provincial centers and sub-centers to 76 percent, a pace of urbanization matched only by China. During that period the economy has grown at a rapid pace and diversified dramatically. How does the culture evolve to keep up with such rapid change? A key element in the transition is the shopping mall and modern retail systems. This article describes the current state of retailing in Turkey, the forces at work transforming Turkish society and their integral relationship.

TURKISH ECONOMY

While the Ottoman Empire had been in decline for nearly a century of its 700-year history, its dissolution at the end of World War I marked an end to a religious and feudal state. In less than a century, the modern state envisioned by Mustapha Kemal Atatürk has emerged as a modern and thriving economy. Turkey's gross domestic product of €536 billion places it as the 17th-largest economy in the world out of 181 nations ranked by the International Monetary Fund. As a full member of the European Union (EU) it would represent about five percent of European output today and be tied with the Netherlands as the

sixth-largest member economy. The Organization for Economic Cooperation and Development (OECD) reports that Turkey's real GDP grew by 8.7 percent in 2010 and is forecast to grow by 6.7 percent per year on average from 2011 to 2017. It is expected to be the fastest-growing economy in the 34 OECD member countries. In "The World in 2050," PricewaterhouseCoopers forecast that the Turkish economy will grow at an average rate of 5.1 percent in U.S. dollar terms for an extended period.

About the Author



Marc A. Louargand, Ph.D., CRE®, FRICS, is an internationally known economist and investment expert and has been active in real estate and institutional investment for more than forty years. He is a principal at Saltash Partners LLC, a private equity investment firm he founded in 2007. Louargand was a co-founder of Cornerstone Real Estate Advisers where he was chief investment strategist until his retirement in 2007. In addition he was a professor of finance and economics at California State University at Northridge, University of Massachusetts and Massachusetts Institute of Technology. He has been editor or editorial board member of the Journal of Real Estate Portfolio Management, Journal of Real Estate Research, Journal of Real Estate Literature, Journal of Corporate Real Estate, Real Estate Issues and Briefings in Real Estate Finance (UK). Louargand is the past president of the American Real Estate Society and one of its Distinguished Fellows. He is also a Fellow of the Homer Hoyt Institute and the Royal Institution of Chartered Surveyors. He is a board or advisory board member of The Counselors of Real Estate®, The Counselors of Real Estate Foundation, the American Real Estate Society, the James R. Webb Foundation of ARES, the Angel Investor Forum of Connecticut, Doran Capital Partners (Korea) and Sustainable Real Estate Solutions, Inc. Louargand holds a master's degree in business administration and a doctorate degree from UCLA's Anderson School, and a bachelor of arts degree from the University of California at Santa Barbara.

Turkey: Modernizing through Mall Development

The Turkish economy is one of the most successful of the 20th century. While retaining part of its labor force in traditional agricultural roles, exports from the automotive and electronic industries now surpass Turkey's traditional textile exports. Full accession to the EU is still in question but may occur at some time in the coming years. Accession to the euro zone would likely increase tourism and trade significantly.

HALLMARKS OF A GROWING MODERN ECONOMY

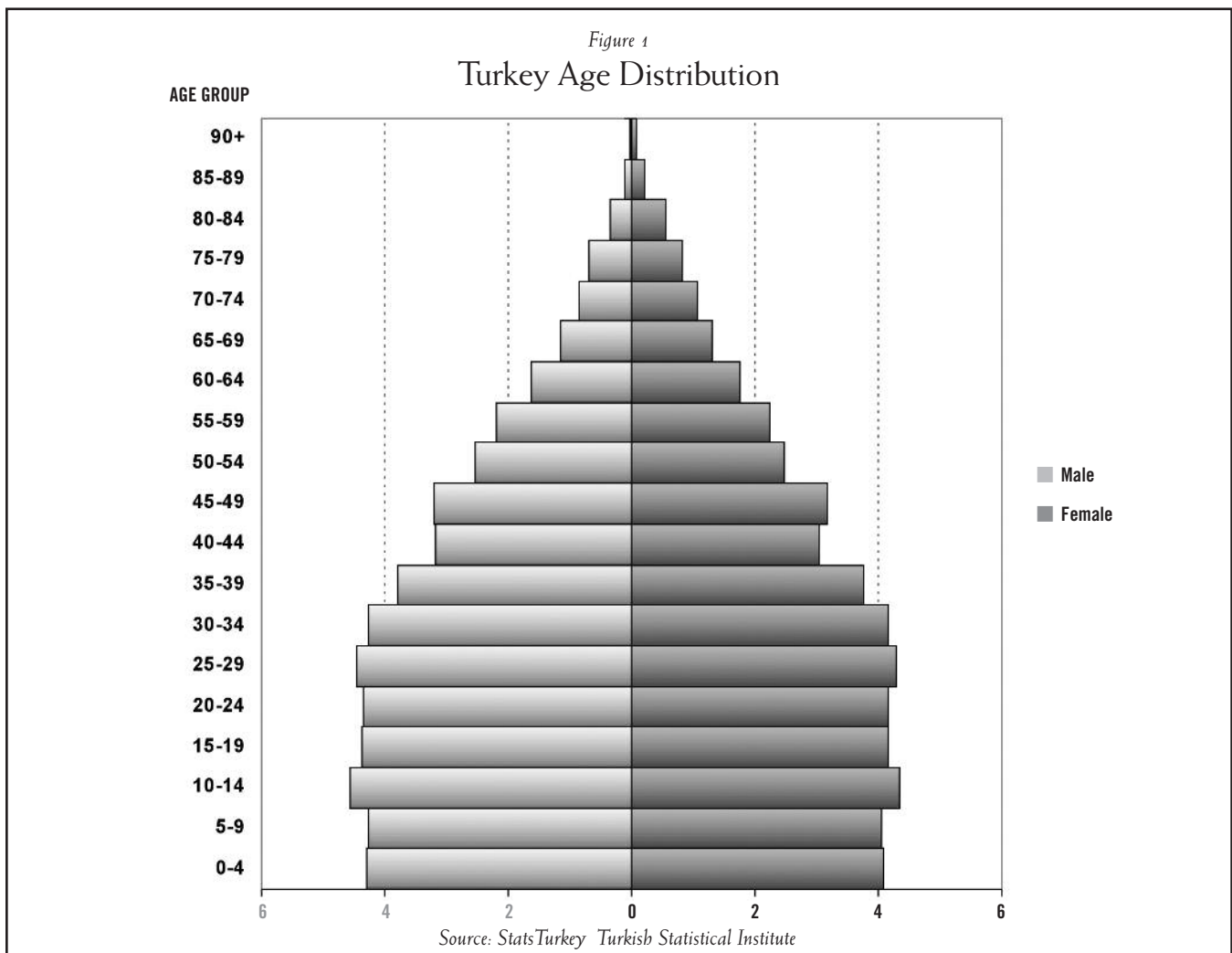
Rapid growth brings cultural and social change as well as economic. The rise of the mall in Turkey is both a function and a result of those changes. Changes include urbanization and suburbanization, female labor force entry, increased income, globalization of attitudes and tastes, homogenization of taste through television and Internet access, and shifting socialization to leisure time from the traditional workplace. The modern mall is a key element in these changes.

Suburbanization

Turkey has become an urbanized country much like the rest of the developed world. In 2010 the government estimated that more than 76 percent of the population lived in an urban setting (district and province centers). Urbanization has been rapid, as it was estimated at 40 percent in 1960. This urbanization has created cities with substantial suburban surrounds. Suburbanization led to increased automobile use and provided fertile ground for the development of the modern shopping mall.

Demographics

Turkey's population is young. Sixty-seven percent of the population is between 15 and 64 years of age and the median age is 29. More than 25 percent are below the age of 14 (see Figure 1).

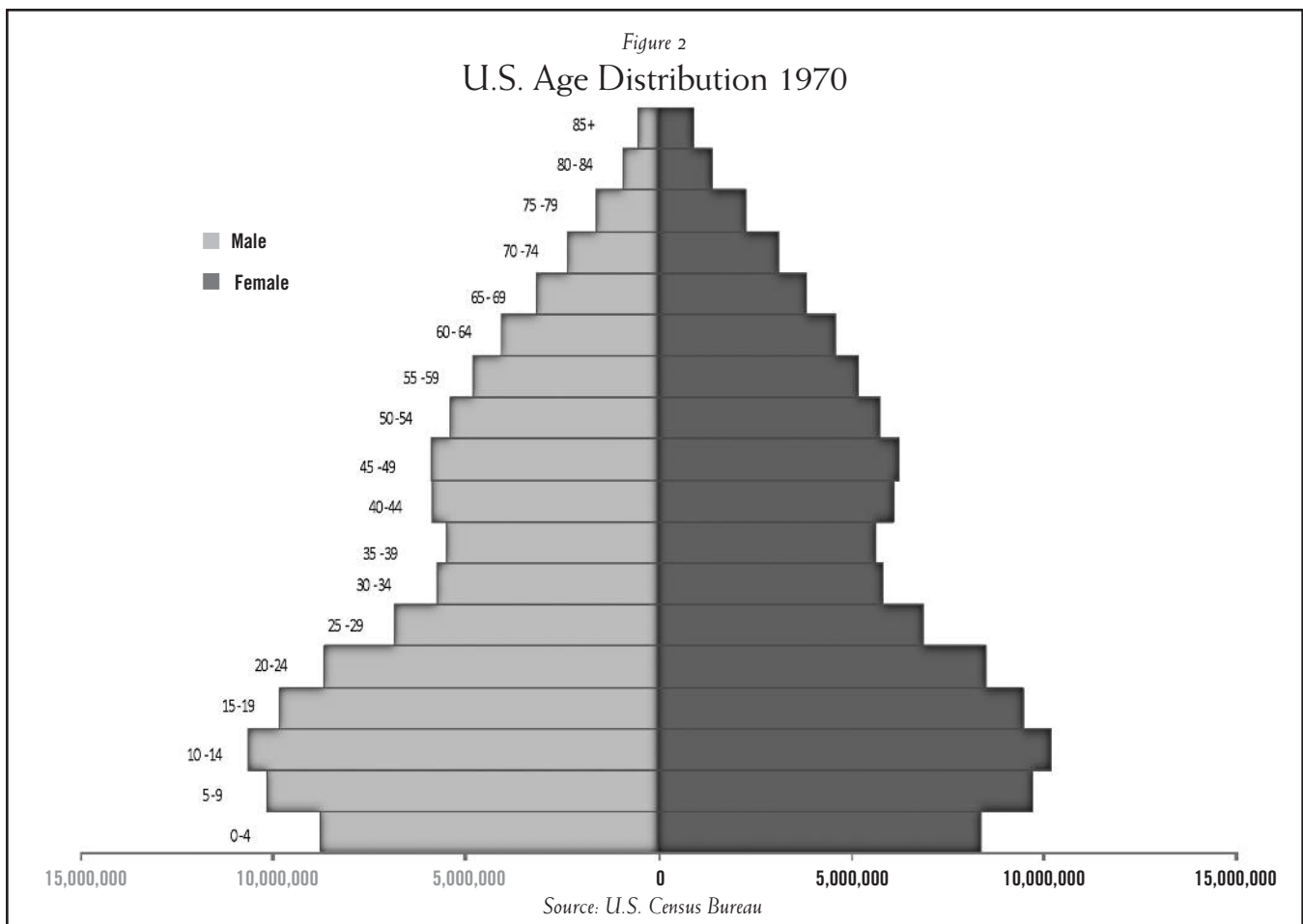


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Perhaps the best way to grasp the impact of the age distribution is to contemplate Figure 2, which shows the U.S. age distribution in 1970 when the bulk of the baby boomers were in their teens and twenties. One benefit of Turkey's youth is that it will have the world's second-fastest labor force growth rate in the next few decades, trailing only India. Additionally, the small ranks of the elderly means that Turkish workers will not have a large dependent population to support, so rising earnings will likely translate into rising retail sales. A third benefit of a youth-centric population is openness to change and new ideas, which will hasten the transition from traditional Middle Eastern retail models to modern western ones.

education have participation rates of 85 percent male and 72 percent female. This bodes well for labor force growth, considering the country's large youth cohort, growing population and increasing female education. Under these circumstances the labor force can grow significantly faster than the population, creating growth in prosperity. A food and beverage industry report by Deloitte for the prime ministry of Turkey observes:

Through the widespread presence of modern MGR [mass grocery retail] outlets and rising disposable incomes, consumption patterns have been shifting to packaged and processed foods, such as ready-to-eat meals and frozen foods. Additionally, the increases in the number of females in full-time employment have supported the



Female Labor Force Entry

Turkey's labor force comprises a wide range of skills and education. Those in the labor force who have less than a high school education have participation rates of 69 percent male and 23 percent female. Those with higher

trend towards packaged, frozen and ready food. Therefore, considering that Turkey still has the lowest per capita consumption of packaged food in Europe, there is considerable potential in the aforementioned sub-sectors.

Turkey: Modernizing through Mall Development

Conditions in the Bazaar

The traditional bazaar, while colorful, does not suit the modern lifestyle evolving in Turkey. Increasing independence of women is particularly at odds with tradition. The bazaar may be less attractive to women shoppers on grounds of efficiency, safety, cost and convenience in comparison to a modern enclosed mall. While the bazaar is an ancient and enduring tradition, modern retail is new to Turkey and appears to be gaining ground quickly in terms of shoppers' preference.

Efficiency of Traditional Retail

Retail in Turkey has traditionally been the province of the bazaar and the bakkal. Bakkal are generally small shops, often specializing in one or more products. In some respects they continue to serve some of the needs that a convenience store serves in the U.S. They may be open late and may be an integral part of a neighborhood. But like much traditional retail, they are not efficient and are unable to drive price and volume in the manner of modern retail. There are conflicting views in Turkey about the viability of the bazaar and the bakkal. It is likely that they will endure but retain an ever-smaller share of retail volume as more modern retail is developed and the population becomes more affluent. (Even in Singapore, which has the third-highest GDP per capita, there remain traditional retail venues despite the presence of massive amounts of modern retail.) Traditional retail outlets are often staffed only by family members. They typically buy in relatively small quantities and the pace of business may not be the equivalent of the modern shopping mall.

Modern Food Retailing

The grocery store and hypermarket were the first evidences of modern retail in Turkey and comprise about half of the stock of anchor tenants in malls. Major firms include domestic operators, joint ventures between Turkish and offshore firms, and foreign retailers who have acquired Turkish operators. The French retail giant Carrefour entered into a joint venture with Sabanci in 1996 creating Carrefour SA. In 2003, British retailer Tesco

acquired local firm Kipa to form Tesco Kipa. The largest operator is a Turkish firm established in the 1950s—Migros. Thus the grocery landscape is evolving into a pattern much like that of the U.S. with domestic and offshore ownership and with a bias toward traditional domestic branding.

The McKinsey Global Institute published a study in 2003 that analyzed the barriers to modernization and productivity in Turkey's economy. The analysis included a focus on what are classified as fast-moving consumer goods (usually defined as consumer nondurables and semi-durables, i.e., the goods found in a hypermarket).

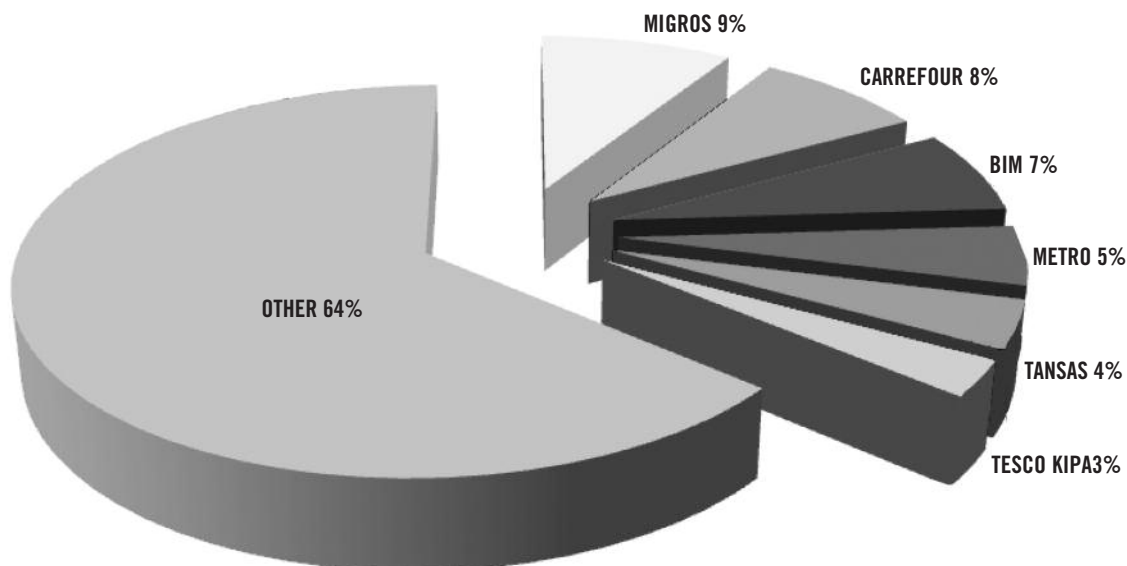
McKinsey's focus on retail included the opinion that: "When Turkish policymakers address the barriers to productivity central to the fast-moving consumer goods (FMCG) retail sector, they will be tackling the two most important factors affecting productivity in the economy overall and, potentially, they will be stimulating a ripple effect that should catalyze improvements in a broader slice of GDP. FMCG retail is a large and rapidly growing sector, with a pivotal role as the final link in a long value chain going back to agriculture."

In the eight years since, modern retail has taken a substantial leap forward. Food sales are generally estimated at 50 percent of total retail. The modern retail component of that has risen from 20 to 60 percent of sales since the 2003 McKinsey report. While growth has been rapid, there is still a substantial opportunity for extended growth from both market penetration and increasing affluence. Taken together, the major chain grocery retailers had a bit less than 40 percent market share at last measure. Migros, the largest, had a nine percent share in 2008 and others trailed that. Sixty-four percent of the mass grocery retail market is potentially available to modern tenants. During 2009, MGR consumption fell back a bit in response to the financial crisis, so these shares are probably close to the current status of the market, which rebounded in 2010 to previous levels, with substantial growth expected in 2011 and beyond.

Turkey: Modernizing through Mall Development

Figure 3

Mass Grocery Retail Market Share 2008



Source: Business Monitor International; Deloitte

Figure 4

Beymen Department Store Brands
(Sample)

Alexander Wang	Halston
Armani Collezioni	Jil Sander
Balenciaga	Jimmy Choo
Balmain	Marc Jacobs
Bottega Veneta	Michael Kors
Brooks Brothers	New Balance
Canali	Nike
Church's	Nina Ricci
Diane VonFurstenberg	Prada
Dior	Red Wing
Dolce & Gabbana	Stella McCartney
D-Squared	Timex
Ermenegildo Zegna	Tom Ford
Givenchy	Tory Burch
Gucci	Valentino

Source: Beymen Stores

Global Brand Awareness

While Turkey has successful homegrown retailers, global brands are a major factor in the marketplace. While a combination of some sort is a major theme in the food market, soft and hard goods with familiar names are widely seen. Figure 4 lists a sample of brands carried by Beymen Department Stores, a Turkish retailer of long

standing. The brands represent designers and manufacturers from Europe, North America and Asia. Turkey is estimated to have 25 million Internet users, a critical mass of eyes on the world that will serve to spread brand awareness and demand to its residents.

Changing Household Composition

The transition from an agricultural and nomadic economy in the past hundred years has changed the nature of the family in Turkey as it has in many societies. In an agricultural setting, children have positive economic value as they can work the fields. In an urban mixed economy, they are cost centers, requiring education, food, clothing and shelter. As educational levels rise they require these things for even longer periods of time. Throughout the world, economic emergence is accompanied by lower fertility rates and smaller household sizes. One beneficial result is that rising incomes are more available for discretionary consumption than would be the case with large families. Between 1978 and 1998, Turkish households changed dramatically. The extended family household shrank from 20 percent of households to 10 percent while nuclear family households rose from 62 percent to 72 percent, and single adult households rose from three to five percent of total households.

Turkey's urbanization is recent and modern, including modern-sized, multi-family residential units that also

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encourage smaller households. Since 1990, the divorce rate has tripled and since 2000, the rate of divorce in marriages of long duration has quadrupled according to Statistics Turkey. This appears to indicate that Turkish household characteristics are rapidly assuming western form, another sign that rising affluence is fueling the growth of smaller households. Despite these changes, Turkey still has relatively large household size compared to other emerged economies, and especially so relative to euro zone nations. Thus, it is reasonable to expect the Turkish household size to continue to shrink, creating increasing demand for retail services as the ratio of households to population rises.

Increased Educational Attainment

Turkey's youth are attending college in greater numbers. Recent estimates are that 13 percent of high school graduates attend college, on a par with Sweden, Norway, Mexico and Austria. These data do not include those who enroll in college some years later. By contrast, the U.S. enrolls 41 percent of its high school graduates in college. Greece has the highest attainment at 68 percent. Again, these disparities indicate that the in-place trend is likely to continue with ever-increasing numbers of young people attending college and expecting growing affluence in their adulthood.

Increasing Affluence

As industry and services have replaced agriculture as the dominant forces in the economy, incomes have grown substantially. At the same time, the level of sophistication in industry has risen, creating more affluence for a portion of the population. As GDP per capita has reached double digits (approximately €10,250 on a purchasing power parity basis) the potential consumption mix has changed beyond subsistence goods to include western style goods. Turkey's GDP per capita has doubled in the past decade, growing at an average rate of 7.6 percent per year according to the CIA's *The World Factbook*. The Economist Intelligence Unit forecasts private consumption to grow at more than five percent per year through 2015. Consider that there is likely to be a continuing shift away from traditional retail during that time so that the growth in mall spending could be significantly higher than five percent per year.

New Patterns of Socializing

A big part of the mall's attraction is its use as a venue for socialization by the young. In "the rise of the shopping mall in Turkey: the use and appeal of a mall in Ankara,"

Professor Feyzan Erkip of Bilkent University in Ankara sampled shoppers over time at the Bilkent mall. The responses broke into patterns that would be very consistent with a similar study at a U.S. mall. Young people often came to the mall without shopping as did a smaller share of more mature people. The young saw crowded conditions as positive, indicating that they were there for socializing. Women felt more comfortable in the mall setting. Erkip writes: "Turkish people are looking for a new modernity in these global spaces through consumption and leisure patterns provided by a more 'civilized' space than the existing urban center and the street." A motivational survey had several overwhelmingly positive responses, including: "Shopping is convenient;" "It's a beautiful place;" "Like activities other than shopping;" "Came here for browsing;" "This place is secure;" and "Feel comfortable here." These responses reinforce the attractiveness of the mall relative to the traditional bazaar.

Density and Spread of Malls

PricewaterhouseCoopers (PwC) released "Glimmering Star – Impact of Retail Sector on Turkish Economy" in September 2010, estimating that the retail sector will grow to 304 malls totaling eight million square meters by the end of 2011. While the sector has shown very rapid growth, it has barely penetrated the market, especially outside of Istanbul. PwC's estimate translates to approximately 115 square meters of modern retail per 1,000 persons. The current density estimates range from between 200 square meters per 1,000 in the Istanbul market to less than 100 square meters per thousand in other parts of the country, according to Jones Lang LaSalle. By contrast, the International Council of Shopping Centers estimates that there are in excess of 660 million square meters of shopping centers in the U.S. which represent 47 percent of total retail space. That translates to approximately 2,100 square meters of shopping center space and 4,500 square meters of all retail per 1,000 people in the U.S. While one might argue that the U.S. has more than enough retail and that these data include a significant amount of obsolescent or redundant retail, it seems clear that Turkey's rapidly growing and modernizing populations can support substantially more than the current stock of modern retail space.

Mall Investment

Transactions data from Real Capital Analytics show that Turkey is developing as an investment market as well. Retail mall transactions since 2005 have included buyers Merrill Lynch JV Krea Real Estate, VastNed Retail NV

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(Netherlands), Citi Property Investors, Corio NV (Netherlands), LaSalle, and Commerz Grundbesitz Investmentgesellschaft (Germany), as well as entities domiciled in Turkey. Other property type purchasers have included Apollo and Blackstone. A sample of those properties most consistent with modern mall characteristics shows sale prices averaging €1,973 per square meter. These transactions were reported to have cap rates averaging 8.2 percent in a tight range from 7.8 to 9.0 percent. While not as deep as markets in the euro zone, the institutional property market in Turkey appears to be well on its way to robust development. Turkey has enjoyed foreign direct investment in excess of €60 billion in the past five years according to the United Nations. Both Goldman Sachs and Jones Lang LaSalle have published reports in 2010 indicating that they expect Turkey to be upgraded from its current rating of BB+ (Fitch) to BBB, which would make it investment grade and significantly increase its attractiveness for foreign direct investment. Should that occur, Turkish real estate would very likely be a focus of foreign investors.

CONCLUSION

At a time when the U.S. property market is facing a tough two or three years of recovery, Turkish retail may offer an attractive diversification opportunity for portfolios of high net worth and institutional investors. Turkey is forecast to have stronger economic growth, faster labor

force growth, shrinking household size, greater affluence and increasingly western tastes. The nascent level of the shopping mall promises significant market penetration opportunities for retailers and retail developers, with much less intense competition than what might be found in the U.S. or other venues. ■

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Asian Tigers and Lion Kings

BY HOWARD C. GELBTUCH, CRE®, FRICS

China's high-speed rail system is an apt metaphor for the country's hurtling economy over the past decade: a colossal investment project, born of the state... built for maximum velocity, and imposed... on a public that is at once amazed and skeptical. The rail system has married foreign technology with national ambition in a network billed as the biggest and most advanced in the world, in a country whose per capita income ranks below that of Jamaica.¹

Across the Middle East and North Africa, superficial political calm has been shattered by convulsions of rage. Idealistic young protestors have toppled some of the most ruthless and well-resourced political strongmen on the planet. In sub-Saharan Africa, many are asking: Will the Arab Spring spread south?²

WOULD YOU LIKE TO GO VALUE A PROPERTY IN CHINA OR Africa? If your answer is “No,” you would be missing the fastest-growing areas of the globe. And if you haven’t done it before, you should know that valuing a property overseas is not as hard as it sounds. The principles of valuation are the same everywhere in the world: Value is a function of a property’s income-generating ability, replacement cost or the recent sale of similar properties. Additionally, English is the universal language of business, global real estate is often priced in U.S. dollars, and if you exercise a reasonable degree of caution and common sense, you should be safe.

On the other hand, data is generally not as readily available or reliable as it is in the U.S.; corruption is far more common overseas, especially in emerging markets; and at the end of the day you probably won’t be as confident in

your estimate of value as you are in the U.S. But why work overseas? Consider a few observations about the growth overseas, particularly in light of the recessionary environment we have at home in the U.S.

There’s no doubt that China is on its way towards becoming the world’s largest economy. The only question is when. Just ask HSBC (2050), Deutsche Bank (2040), the World Bank (2030) or Goldman Sachs (2020). And in case you’ve missed it, we’ve gone from “made in China” to “sold in China.” China’s economic model has shifted from export to domestic consumption. As the country’s populace becomes more urbanized and affluent, demand for goods and retail stores has increased dramatically. For example, in 2002, 2.5 million cars were sold in China.



About the Author

Howard C. Gelbtuch, CRE®, FRICS, MAI, is a principal with Greenwich Realty Advisors Incorporated, New York City, an internationally oriented valuation and consulting firm. Gelbtuch has 37 years of real estate experience. Prior to founding Greenwich in 1994, he was a senior vice president at Landauer Associates; director of research for Morgan Stanley Realty; and oversaw the real estate valuation practice for North and South America at Jones Lang LaSalle, among other work experiences. He has worked or taught real estate courses throughout the Americas, Eastern and Western Europe, Asia, the Middle East, Russia, and Africa. A prolific author, Gelbtuch supervised the writing of the tenth edition of the Appraisal Institute’s textbook *The Appraisal of Real Estate*, and authored two textbooks on global valuation techniques. Gelbtuch chaired *The Counselors’ Consulting Corps* for many years, and will serve as 2012 first vice chair of *The Counselors of Real Estate®*.

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This year, 18 million cars are expected to be sold there. In contrast, we bought 11 million cars in the U.S. last year.

The potential for growth in China is almost unfathomable. Consider that Apple has about 229 retail stores in the U.S., roughly one for every 1.4 million people. It currently has four in China (two each in Shanghai and Beijing), or one for every 350 million people, the equivalent of having a single store in the U.S. Starbucks, with 450 stores in mainland China (many of which are *not* open early in the morning), expects to have 1,000 stores there by 2015. And McDonald's, which opened its first China store in 1990, has since grown there to 1,300 currently, with a target of 2,000 stores by 2013.

As reported in the Jan. 6, 2011 edition of *The Economist*, in percentage terms, China was the second fastest-growing economy in the world between 2001 and 2010 (trailing only tiny Angola), and is forecast to be the world's fastest-growing economy over the next five years.

Interestingly, while many African nations are expected to dominate the list of fastest-growing countries over the next half decade, both the Chinese and African economies are closely intertwined. As reported in *The Economist*:

In 1980 Africans had an average income per head almost four times greater than the Chinese. Today the Chinese are more than three times richer.

Africa's changing fortunes have largely been driven by China's surging demand for raw materials and higher

commodity prices. Africa has benefitted from big inflows of foreign direct investment, especially from China.

Indeed, China now has six of the world's ten busiest ports, and Brazil's Acu Superport, a \$2.7 billion project scheduled for completion in 2012, part of an industrial complex that will be twice the size of Manhattan,³ has been dubbed "the highway to China."

Although the anticipated growth of China has been widely reported, less recognized is the rapid development of Africa. While much has been written about the rise of the BRICs (Brazil, Russia, India and China), and the shift in economic power towards Asia, the analysis by *The Economist* found that from 2001 until 2010, six of the world's ten fastest-growing economies were in sub-Saharan Africa.⁴ This trend is expected to become even more pronounced through 2015, as illustrated below (Figure 1).

So now you're convinced that you ought to consider working overseas. Perhaps even confident of your abilities. You already know that in many emerging markets, one has the right to *use* land, rather than having outright ownership. Not so fast. There are lots of hazards along the way. The devil is in the details, and if you're not careful, it's easy to make costly mistakes by assuming things are done the same way overseas as they are in the U.S. Consider the following examples, based on the recently published *Real Estate Valuation in Global Markets* textbook:⁵

Figure 1

World's Ten Fastest-Growing Economies as Measured by Average Annual GDP Growth

Rank	2001-2010	Avg. Annual GDP Growth	2011-2015	Avg. Annual GDP Growth
1.	Angola	11.1%	China	9.5%
2.	China	10.5%	India	8.2%
3.	Myanmar	10.3%	Ethiopia	8.1%
4.	Nigeria	8.9%	Mozambique	7.7%
5.	Ethiopia	8.4%	Tanzania	7.2%
6.	Kazakhstan	8.2%	Vietnam	7.2%
7.	Chad	7.9%	Congo	7.0%
8.	Mozambique	7.9%	Ghana	7.0%
9.	Cambodia	7.7%	Zambia	6.9%
10.	Rwanda	7.6%	Nigeria	6.8%

Source: The Economist, Jan. 6, 2011.

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- In Bulgaria, a property may not be sold for less than its official “tax appraisal.”
- In Colombia, there is no uniform Market Value definition, and appraisal fees are capped at 20 times the monthly minimum wage. Appraisers must rely upon “market observation,” while use of the Income or Cost approaches is optional.
- In the Czech Republic, if no term is specified in a lease agreement, it is assumed to be for an indefinite period. Appraisals are presented as a bound workbook including a sewing cord attached to the last page with the expert’s professional seal attached. Sale prices are not required to be reported to the government.
- In Denmark, leases generally don’t expire unless terminated by either party or violated by the tenant. The denominator used to calculate a capitalization rate (usually called a “yield rate” in Europe), includes both transaction fees and security deposits.
- In Guam, zoning changes made by politicians do not always appear on zoning maps. For example, although the zoning code includes both the “P” and “LC” designations, there are no parcels zoned accordingly.
- In Ireland, sale prices may not be disclosed without the consent of the buyer and seller. One need not belong to a professional association to hold oneself out as a valuer.
- In Italy, the recession has forced some families to sell their long-owned homes to strangers at a discount on the condition that they can retain a life estate. These transactions are called “naked sales” or “nude sales” because owners are stripped of ownership while retaining use of the property until they die.
- In Japan, there is a separate registry for land and buildings, but no title system. Boundaries are established by having each adjoining property owner sign a document similar to a site plan. Due to the high percentage of land value, a property’s income was rarely considered in appraisals until the late 1990s. However, nationwide (overall) land values have declined every quarter for the last 20 years from March 1992 through March 2011.
- In Qatar, annual rent is paid in advance with a series of 12 postdated checks. Penalties for a bounced check are “severe.”

- In Romania, appraisers applying the Income Approach use an “un-occupancy rate” rather than a vacancy allowance.
- In Taiwan, leases may not exceed 20 years; a lease having a longer term is automatically reduced to 20 years. The appraiser licensing exam lasts three full days, and while only a 60 percent grade is required to pass, the pass rate is about five percent.
- In the Ukraine, there is no recognition of precedent in the legal system. As a result, identical cases are often decided differently by the courts. Construction costs are often quoted per cubic meter.
- In Venezuela, the physical existence of a building on a site is considered proof that it adds value to the land.

Following are some specific examples of valuation techniques.

CHINA

From the textbook cited above, Figure 2 is an example of the valuation of an office building in China. This is a 30,000 square meter (about 323,000-square-foot) building; measurements refer to net usable floor area, not net rentable area. The first part, deriving Net Operating Income, should look familiar to any reader of this publication. The renminbi (RMB) is China’s currency.⁶

Figure 2		
POTENTIAL GROSS INCOME	RMB	US\$/PSF
30,000 square meters @ RMB 30 per month	10,800,000	\$5.35
At Average Occupancy of 90% (10% Vacancy Loss)	-1,080,000	
Effective Gross Income	9,720,000	\$4.82
Less: Operating Expenses of RMB 100,000 per Month X 12	1,200,000	
Property taxes @ 10% of EGI	972,000	
Other taxes @ 5% of EGI	486,000	
Total Expenses	2,658,000	\$1.32
Net Operating Income (65%)	7,062,000	\$3.50
Source: <i>Real Estate Valuation in Global Markets</i> , 2010		

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Then, as is common in many parts of the world, rather than capitalize the estimated Net Operating Income into an estimate of value as we do in the U.S., future income is instead discounted to present value based upon the expected remaining economic life of the building and the amount of time remaining on the right to use the land (although direct capitalization *is* sometimes used). In this instance, the valuer used 45 years, and a 10 percent discount rate.

- Present Value of 7,062,000 RMB per year for 45 years of remaining life @10% equals 69,651,200 Yuan (\$11,145,000)
- US\$11,145,000 Value / 322,917 Square Feet = \$34.50 per Square Foot Value
- 7,062,000 RMB NOI / 69,651,200 Value = 10.1% Cap Rate
- 69,651,200 Value / 10,800,000 Gross Income = 6.45X Gross Rent Multiplier

If you can value a complex office building, surely you can value a simple parcel of land, right? Not so fast. Have a look:

Land is often valued in China using the Cost Approach to Land, and is calculated as:

Expense of Land Acquisition
+ Expense of Land Development
+ Interest Cost on the Investment
+ Appreciation
= Land Value

See Figure 3 below:

Figure 3		
ITEM	DERIVATION	RMB per sq. meter
1.	Acquisition Land Compensation, Resettlement Subsidy, Compensation for Green Crops on Land	155.61
2.	Development Amortized Costs of Access, Power Supply, Water, Drainage, Sewer, Grading	90.00
3.	Interest on Investment 2 years, 7.47% Interest Rate on Fixed Assets Set by the Bank of China	12.57
4.	Profit on Investment (155.61 Acquisition Cost + 90/00 Development Cost) at 8.0%	19.60
5.	Appreciation of Land Total Cost (155.61+90.00+12.57+19.60) X 30%	83.33
	Land Value (or US\$5.37 PSF)	361.11
Source: <i>Real Estate Valuation in Global Markets</i> , 2010		

Land valuation is important in China. Feeding China's 1.4 billion people has become a real problem for the Chinese, hence their expansion into African farmlands. During a recent trip to Hunan province, federal and local government officials proudly showed me how they are relocating homes to enable the consolidation of agricultural land into adjoining areas to make farming more efficient.

AFRICA

It's been said that Africa is as undeveloped today as China and India were 15 years ago. Indeed, ARA Asset Management, a \$15 billion property fund manager, recently placed plans on hold for a contemplated real estate investment trust that would have focused on the Middle East and North Africa, but is proceeding with a fund investing in Asia for which it expects to raise \$1 billion by the first quarter of 2012.

Despite the recent turmoil in North Africa and the Middle East, the long-term prospects for this continent are outstanding. Consider the following recent excerpts from various articles that recently appeared in *The Wall Street Journal*:

- *Africa is attractive for Western brands because its resource-rich countries are adding infrastructure while increasingly urbanized areas are creating opportunities for retail development.*
- *Approximately 40 percent of Africans live in urban areas now, and the number of households with discretionary income is projected to increase by 50 percent to 128 million over the next decade, according to a recent study by the McKinsey Global Institute.*
- *After spending two decades introducing fried chicken and pizza to Chinese consumers, Yum Brands now sees Africa as its next international jewel. By 2014, the company expects to double its number of KFC outlets in Africa to 1,200. In the next four years, it aims to more than double its revenue on the continent to \$2 billion. "Africa wasn't even on our radar screen 10 years ago, but now we see it exploding with opportunity."*
- *Walmart recently offered to buy 51 percent of South African retail giant Massmart Holdings Ltd. (for a reported \$2.5 billion).*

Other recent articles focused on the numbers:

- 220 million. Number of Africans who are able to meet only basic needs but will become consumers by 2015.

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- \$1.6 trillion. Africa's collective GDP in 2008, roughly equal to that of Brazil.
- 20. Number of African companies with at least \$3 billion in revenue last year.
- 40 percent. Revenue growth in African telecom industry at compounded annual rate over the last five years.
- \$72 billion. Foreign direct investment in Africa in 2008—almost as large as the flow into China relative to GDP.

The Chinese have been particularly active in Africa, buying up agricultural land to help feed their 1.4 billion people, and even constructing some of the new government buildings in the Ugandan capital of Kampala; on time and under budget, I was told!

One important difference between China and Africa is the distribution of wealth. The total number of poor people around the world has declined from about 1.3 billion in 2005 to less than 900 million in 2010,⁷ with most of that attributable to improvements in China. While still far from being evenly distributed there (on a recent trip to Hunan Province, I stayed at a first-class hotel, then observed people washing clothes by hand in the Yangtze River), the prosperity in the urban areas is clearly evident in the modern age and design of many office buildings and shopping centers, along with state-of-the-art airports and highways.

In contrast, not only is poverty still widespread throughout Africa, but it's far more prevalent than wealth. The Serena hotels in Nairobi, Kampala and Kigali are at least as good as any I have frequented around the world, but walk a few blocks and be prepared for unpaved streets, broken sidewalks and panhandlers. While the continent's middle class has unquestionably expanded in recent years, its members remain politically and economically beholden to whoever holds political power. More than three-quarters of Kenya's population is under the age of 34, and growing by about a million people annually. With the onset of the Internet, Facebook and Twitter, this generation, many of whom have not participated in their country's growth because of a lack of education, is acutely aware that the Kenyan president's son drives an expensive Ferrari, and the Rwandan government operates a highly visible fleet of upscale, black Mercedes-Benz G-Class SUVs. "Inequality and perceptions of inequality have now

replaced poverty as the number one development challenge facing the world."⁸

It's difficult to generalize about Africa since it's made up of 54 different countries; its latest addition, South Sudan, was born on July 9, 2011. Based on my personal experiences in Kenya, Uganda and Rwanda, the lack of available appraisal data in many places is simply a function of local valuers not knowing which questions to ask. Asking a local valuer about Gross Rent Multipliers in these markets is likely to result in a blank stare. Yet one can easily go into the countryside, visit a residential project under construction, and determine both sale prices and rental values. The demand for U.S.-based instructors in many emerging markets is strong. The Africans I've met there are uniformly industrious and intelligent—but they have not had the advantage of more than 200 years of capitalism we've had in the U.S., and are desperately trying to catch up.

While South Africa is a bit different in that real estate investor surveys are available from as many as half a dozen different sources, one common problem remains: the lack of accurate, verifiable data for sales of commercial properties. It would be highly unusual for almost anyone in an emerging market to report the correct sale price to the government and pay the full amount of taxes due on the transaction. (Government officials in Rwanda recently devised a clever way of dealing with this problem in their efforts to obtain more accurate information: charging a tax that is not based on the sale price.)

Further complicating the issue is corruption. In Kenya for example, it's not unusual for someone to "sell" a property that he or she doesn't own to an unsuspecting (or even experienced) buyer. And stories abound of an actual owner selling the same property to more than one purchaser. Many local real estate professionals there distrust title companies since fraud is so widespread.

That said, the principles of valuing property in Africa are surprisingly similar to those of the U.S., although again fraught with local idiosyncrasies. With inflation of about 13 percent and an emerging market, use of the Discounted Cash Flow (DCF) technique in Nigeria⁹ is rare. In fact, use of the Income Approach is relatively uncommon, especially since it's difficult to get actual rental data. When the direct capitalization technique of the Income Approach is used, income is usually multiplied by a factor, rather than divided by a capitalization rate, although the result is the same.

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Use of the Sales Comparison Approach there is hampered by the need to obtain a consent fee from the governor before a property can be sold. The fee is a function of the sale price, and a lower reported value equates to payment of a lower consent fee. Furthermore, most purchasers of property do not want their identities disclosed, and a culture of sharing data among local professionals doesn't exist. That leaves the Cost Approach, which serves as a reliability check on the conclusions derived from the other two approaches. It's often said that one can "value" properties overseas, but "appraise" them in the U.S. and a few other fully developed markets.

Additional items to keep in mind in Nigeria are that residential rents for one- and two-year leases are often paid in advance; and the cost of legal fees to prepare a lease for an industrial property is paid for by the tenant, not the landlord.

In South Africa, despite bouts of inflation, the DCF technique is used to value income-producing properties, albeit often with a five-year holding period as opposed to the more common ten-year projection found in the U.S. In addition to investor surveys, one commonly followed approach calls for use of a discount rate derived by adding the appropriate capitalization rate (say 10 percent) to the market rent growth rate (say 5 percent).

Use of the Sales Comparison Approach is limited by the lack of good, verifiable data, and as with the U.S., the Cost Approach is generally reserved for specialized properties such as abattoirs (slaughterhouses).

The impact of inflation on valuing overseas properties can't be overestimated. In late 2008, inflation in Zimbabwe was about 98 percent per day, and the government issued a \$100 trillion dollar bill, the largest ever. You can buy one today on eBay for under US\$5.

OUTLOOK AND CONCLUSIONS

In case you think you're too late for the BRICs or Africa, fear not. In late 2005, investment bank Goldman Sachs launched its N-11 Fund. According to the fund's prospectus:

The "N-11 countries" are countries that have been identified by the Goldman Sachs Global Economics, Commodities, and Strategy Research Team as the "Next Eleven" emerging countries (i.e., after Brazil, Russia, India and China) that share the potential to experience high economic growth and be important contributors to global gross domestic product (GDP) in the future.¹⁰

Figure 4	
GOLDMAN SACHS NEXT 11 (N-11)	
1.	BANGLADESH
2.	INDONESIA
3.	EGYPT
4.	IRAN
5.	KOREA
6.	MEXICO
7.	NIGERIA
8.	PAKISTAN
9.	PHILIPPINES
10.	TURKEY
11.	VIETNAM
Source: Goldman Sachs	

Should you be called upon to value an N-11 property, be aware that:

- In Indonesia, you may have to deal with the right to exploitation (hak guna usaha): Unlike its American connotation, this refers to the right to use state-owned land for agricultural, fishery or husbandry (breeding and raising livestock) purposes.
- In Egypt, the number of years of appraisal experience needed to become licensed is a function of your education. With a high school diploma, it's 20 years; a college degree requires 15 years; a master's degree, 10 years; and a PH.D., five years.
- In South Korea, land is valued in accordance with prices set by the government, rather than comparable sales.
- In Mexico, foreigners may not own land within 100 kilometers (about 62 miles) of the country's land border, or 50 kilometers (31 miles) of its shoreline.
- In Turkey, land acquired by a municipality for public use can be taken without compensation.

Returning to the aforementioned *The New York Times* editorial:¹¹

Steady economic growth and urbanization, combined with high levels of youth unemployment and conspicuous consumption... create a situation in which growth

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exacerbates political volatility instead of quelling it. China, with its highly centralized system of economic management and... efficient security machine, has been able to keep a lid on the contradictions thus far.

But as African countries grow, despite the unevenly shared benefits of that growth, the expectation of the poor and aspiring middle class will continue to advance—aided by social media—and both groups will become only more angry and predisposed to protest as they perceive the stark inequalities around them.

In terms of valuation, it's hoped that with greater risk comes greater reward. And should you choose to undertake a valuation in one of these markets, remember that the principles of valuation are the same. It's the customs and technicalities that one needs to avoid getting hung up on.

Riding a bicycle to work in a place like Portland, Oregon, or the New York City boroughs of Brooklyn or Manhattan might be considered the sign of a young, urbane, environmentally-conscious, upscale professional. In China or Africa, where people are more likely to ride bikes because they can't afford a car or traffic is too congested, the bicyclist is probably a member of a lower socio-economic class.

In the U.S., "It's the squeaky wheel that gets the grease;" but in Japan, "The nail that sticks out gets hammered down;" and in China "The loudest duck gets shot." ■

ENDNOTES

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3. Rendell, Ed and Scott Smith, "Transportation Spending Is the Right Stimulus," *The Wall Street Journal*, Aug. 11, 2011.
4. As opposed to the seven primarily Arab countries that comprise Northern Africa: Algeria, Egypt, Libya, Morocco, Sudan, Tunisia and Western Sahara.
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6. The distinction between the yuan and renminbi (RMB) is analogous to the difference between the English pound and sterling; the pound (yuan) is the unit of account while sterling (renminbi) is the actual currency.
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Public-Private Partnerships: Lessons From Military Housing

BY MAHLON (SANDY) APGAR, IV, CRE®, FRICS

Editor's Note: this column was originally published in the Baltimore Sun in August 2011 under the title 'How the Army Saved Big Bucks.'

THE RANCOROUS DEBATE OVER THE FEDERAL BUDGET has obscured a central fact: The U.S. military has accomplished the near-impossible feat of reducing taxpayers' costs with bipartisan support in a large, complex, national program that nearly everyone admires.

The program, named Residential Communities Initiative (RCI), is modeled on Columbia, Jim Rouse's pioneering city that combines housing, jobs, shops and recreation. One of the first RCI projects, in Fort Meade, is now home to 2,600 military families. They live in walkable neighborhoods with community centers and other amenities. One of the latest RCI projects has begun at Aberdeen Proving Ground. Similar projects abound in 22 other states.

The Army, soldiers and outside experts attest to RCI's success. It cleared a backlog of \$7 billion in unfunded maintenance costs that neither Congress nor the Defense budget would cover. Its partners are building more than 85,000 new and renovated houses and community facilities at about 20 percent lower cost than previous government projects and operating them to a higher standard. For every taxpayer dollar, the private sector has contributed \$6. More than \$12 billion in development value and 22,000 jobs have been created. The first "green" buildings are occupied, energy costs are lower, and sustainable management practices are installed. Both the program and individual projects have won numerous awards. Most important, the quality of life for soldiers and their families has vastly improved. As one sergeant said, "I reenlisted because I like my buddies and my wife loves our home."

How were these outcomes achieved? And what do RCI's practices tell policymakers about meeting public needs?

- First, reframe the problem. Budget myopia and siloed organizations still drive government, despite efforts to incorporate business practices. The military had approached housing in small, one-off projects with separate budgets and incremental funding for capital and operations. Such piecemealing was costly, did not engage private capital or creativity, and led to poor

About the Author



Mahlon (Sandy) Apgar, IV, CRE®, FRICS, counsels senior executives and boards on real estate. Through professional practice, public service, research, teaching and writing, he has positioned real estate and facilities as strategic assets, corporate resources and catalysts for organizational transformation.

Apgar has advised more than 150 organizations in 12 countries. He established The Boston Consulting Group's real estate practice and was a partner of McKinsey where he developed an international practice and led Middle East operations. He was assistant secretary of the Army during the Clinton administration, responsible for global real estate and facilities, and led its Residential Communities Initiative program.

Apgar has pioneered real estate management innovations including a patented evaluation method. He has edited two books and authored more than 60 articles including a series in the Harvard Business Review. He received the CRE's Felt Award for Creative Counseling (2002) and Ballard Award (2003). He also is a ULI Foundation Governor and former chairman of two ULI Councils.

Apgar received a bachelor's of arts degree from Dartmouth and a master's degree in business administration from Harvard. He taught the first MBA Real Estate course at the University of Oxford, and has taught real estate and entrepreneurship at Harvard, Princeton and Yale.

Public-Private Partnerships: Lessons From Military Housing

long-term results. Officials reframed the problem by analyzing the entire installations portfolio with a strategic 50-year view, and resetting priorities based on future property values as well as current costs. RCI was scaled up to revitalize military communities across a range of markets, combining government and business resources without exposing taxpayers to undue risk.

- Second, engage business. Industry leaders were invited to help design RCI with the intent that many would execute it. U.S. real estate and homebuilding companies led the world in efficiency and effectiveness, but they did not participate in the military market. From dozens of industry forums and individual discussions, we learned which incentives would attract them and which hurdles would deter them. We assured them that government's role was to create the market, not manage it, and enlisted them to provide their best products and services. Cooperation infused the program; compromise protected it when naysayers tried to kill it.
- Third, introduce a "budget multiplier." While leaders focus on cutting the budget, the tougher challenge is multiplying it—making tax dollars work harder and go further by attracting private capital to enlarge public investment. In business, this is leverage: the ratio of debt to equity. Prudently employed, leverage fuels growth and impact. In government, the budget multiplier is the ratio of private capital to taxpayer commitments. The multiplier enables government to do more with less. Before the recession, RCI achieved a multiplier of 11 private dollars for each public dollar committed. Even today, when the banks' funding capacity has sharply declined, the multiplier is 6:1.
- Fourth, secure bipartisan support. RCI was launched in the Clinton era, grew during the Bush era, and is being completed in the Obama era. At the start, Republicans held the majority in Congress. Because RCI engaged business, we thought they would be enthusiastic and the Democrats resistant. But perversely, we confronted strong Republican opposition and gained critical

Democratic support. The solution lay in using the budget multiplier and the promise of cheaper, better housing to justify multi-year budget commitments and radical changes in business practices. After a fractious process, with persistent, behind-the-scenes congressional leadership, the program was approved. Since then, both sides have supported it and, deservedly, claimed credit for it.

- Fifth, reform the system. Every organization has costly, cumbersome, even wasteful systems and procedures. One of the worst is federal contracting. Industry leaders told us they would consider RCI only if procurement was fixed. We reformed the system, within the law, by shifting from the traditional proposal-and-bid system to qualifications-based selection. This cut procurement time by half, shaved expenses by one-third, and encouraged private partners to contribute their experience and expertise in jointly planned RCI projects. It opened the defense housing market to first-class firms with proven track records and long-term outlooks that shared the risks as well as rewards. Simultaneously, we transformed the military mindset from adversarial "them-us" contractor relationships to cooperative "we"-driven partnerships. The recession could have broken the partners' spirit; instead, as they strove together to survive, their mutual respect deepened.

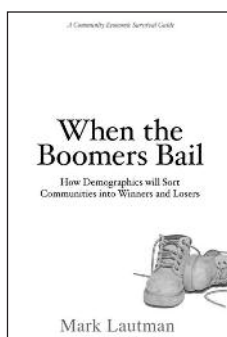
Federal policymakers face staggering challenges. More than 40 percent of the defense budget—\$220 billion—is spent on military infrastructure. This must be cut. The nation's infrastructure deficit is more than \$2 trillion. This must be recapitalized. RCI, now the largest public-private partnership in the federal government, offers a proven model—not fiscal magic—for enlisting private capital and ingenuity in addressing these needs. It should be extended, both within the Defense Department and to other departments, such as Housing and Urban Development, Transportation, and Veterans Affairs. Despite the current crisis, there are billions of private investment dollars waiting for well-conceived public projects. Let's capture them, as RCI has done. ■

RECOMMENDED READING

When the Boomers Bail: A Community Economic Survival Guide

by Mark Lautman (©2010 by Mark Lautman)

REVIEWED BY MARY C. BUJOLD, CRE



I AM A RELATIVELY POSITIVE PERSON and somewhat of a skeptic. Also a little bit of a data geek. Okay, so perhaps more than just a little. That is why when the book *When the Boomers Bail: A Community Economic Survival Guide* by Mark Lautman came across my desk, I thought, “Here is another one of those somewhat shallow pop

culture treatises on our generation.” Well, Mark Lautman proved me wrong.

The book is about baby boomers, when we all retire, or think that we will all be able to retire, but it is much, much more than that. It is about the fundamental economics of our communities and how we are going to prepare for the Inverted Labor Market Curve, where there will be fewer workers and more jobs. Let’s face it, boomers as a generation did not replace themselves. We were too busy self-actualizing to make the next generation larger than we are. We can hope that by working longer, perhaps dying earlier and increasing our investment in technology we will stave off the doomsday that is to come when communities find their populations increasing faster than their economies, or P>E instead of E>P.

Lautman’s premise is that if a community is not growing its economy faster than its population, it will soon find itself in a situation where it cannot support the service-

burden that is increasing more rapidly than the revenues it is taking in.

The eerie thing is that many of the scenarios presented in the book are happening right now and not just in the United States, but in other parts of the world as well. Comparatively, the U.S. is beginning to seem like “Loserville” when some others like China, Brazil and India are starting to look like “Winnersville” in the economic scheme of things.

But since we are in a global economy, the reverberations are being felt right now on many Main streets, and soon, in larger communities, if we don’t wake up and smell the coffee.

About the Reviewer



Mary C. Bujold, CRE, president, Maxfield Research Inc., Minneapolis, Minnesota, is considered a market expert in the field of residential real estate and in market analysis for financial institutions. As well as providing strategic, direction for the firm, Bujold heads project assignments for large-scale land use and redevelopment studies, including downtown revitalization for private developers and municipalities in the Twin Cities and in the Upper Midwest. Her work spans public and private sector clients, including institutional clients. Bujold also regularly testifies as an expert witness for eminent domain, tax appeal and other types of real estate litigation. She holds a bachelor’s degree in business administration from Marquette University and a master’s degree in business administration from the University of Minnesota.

When the Boomers Bail: A Community Economic Survival Guide

Lautman's answer to the crisis of mediocre communities is that we must innovate and creatively plan and implement our way out of this mess. That is, if we are willing to admit that we have a mess.

Lautman's 12-step process reads like a rehab treatment center, but that might be what it will take for more of us (the communities) to dig in and cure ourselves of the addiction that thinking that tomorrow will be better. What if it isn't better?

Some of the scenarios in the book are frightening to think about, but that is what kept me reading and turning each page—wondering what solutions are possible and which ones will actually work. Is it like Japan, offering couples \$80,000 on the birth of their fourth child? Or Russia, which has official worker "sex" breaks to try and add to its future workforce? How are we going to address the inevitable demographic reality that none of us is getting any younger?

Lautman provides a starting point at the end of the book, a community quality report card. It is quite long and involved, but for anyone remotely concerned with or involved in economic development, it is a must-read and must-do.

For those of us in the private sector with real estate investments across the country, it will be important to identify the future winners and losers in this game.

When Boomers Bail is not just a catchy phrase; it is an economic development primer that bears some serious consideration by all of us at all levels of our economy and our governments.

Perhaps my greatest fear is that Lautman is right and that we will be too late to the ball game to win this one. If you care about your future and that of your children and grandchildren, I urge you to read this book and influence your community now rather than later. ■

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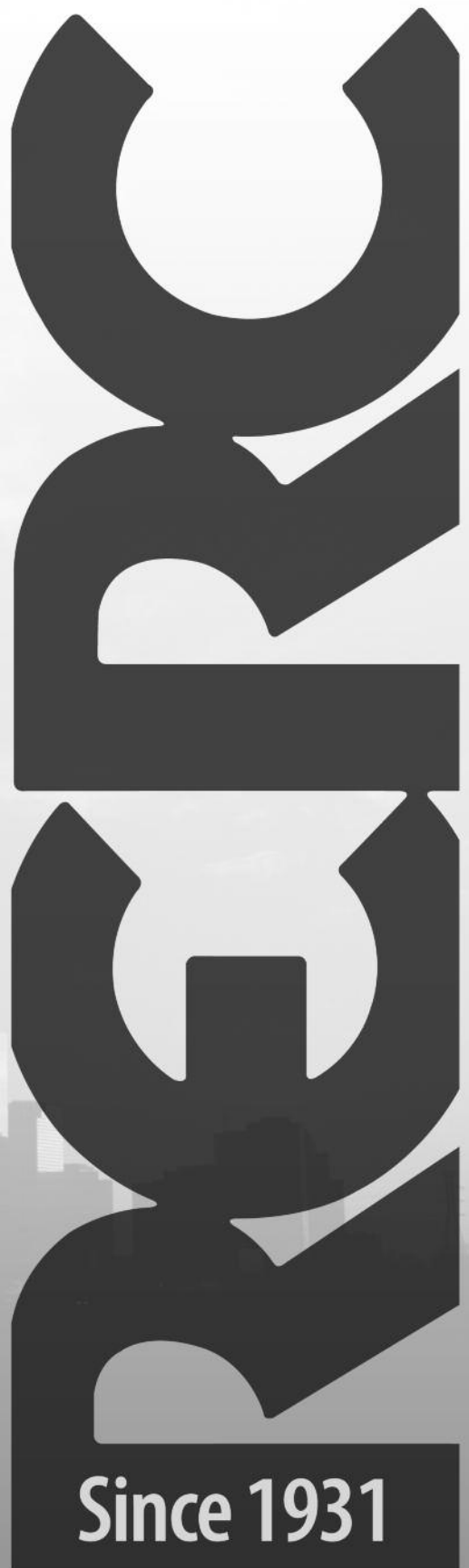
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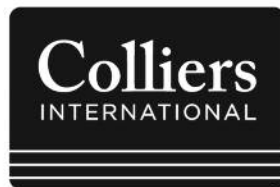
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