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FOCUS ON COMMERCIAL REAL ESTATE

GLOBALIZATION IS KEY TO REAL ESTATE INDUSTRY GROWTH

By Dale Anne Reiss

Put "global" in front of some words and the connection makes sense: global economy, global capital markets, global entertainment, or global sports. As for a global real estate market, it hasn't arrived—yet. What exists is mostly a patchwork of national real estate markets, some similar, but most strikingly different. The first guiding principle for real estate owners, investors and users is: "there is no global real estate market per se."

If a seamless, integrated global real estate market does not yet exist, it is not due to a lack of interest on the part of corporations, businesses, and other users of space, nor indifference on the part of real estate investors and owners. Companies see globalization as a means to find new markets, move closer to customers, and reduce manufacturing and other costs. Investors, too, are looking beyond their own borders, in part because some home markets are too small or too competitive and do not offer many investment opportunities. Investors are trying to realize higher returns by taking advantage of inefficiencies or unique opportunities in local markets, while owners are seeking to expand their existing portfolios of assets and build on the success of their domestic businesses.

Globalization offers these parties increased exposure to markets, more investment choices, access to global capital markets, and additional opportunities to increase deal flow to achieve greater geographic diversification, reduce dependence on a single market, and smooth or increase portfolio returns. For the host country, global investment means increased domestic employment, greater access to international capital to finance growth and compete internationally, access to global technologies, and other benefits.

In the global environment, the key to success for owners, investors and users of real estate is to really understand local real estate markets. Whether they're investing billions around the planet, or millions in a few countries, owners, investors and users should have a thorough knowledge of the markets in which they choose to invest or operate. They should know these markets as well as their home markets.

Even sophisticated real estate professionals can make the mistake of taking their knowledge of their home real estate markets and trying to apply it to other markets. But what's true in one market is not necessarily true in another. International best practices are developing but are not universally accepted and almost always have national twists. Often, these best practices are adapted to local traditions, cultures, and politics. As a result, every market has a unique set of obstacles or barriers to entry that, depending on one's viewpoint, can be pitfalls or opportunities; for example, laws favoring tenant rights may be an obstacle to investors and owners but an opportunity for multinational companies and businesses. The key is to recognize these obstacles or opportunities, consider the options for dealing with them, and develop strategies to mitigate or exploit them. To deal with barriers to entry and other issues, owners, investors, and users often utilize impartial, reputable local real estate resources, including accounting and tax advisors, attorneys, consultants, brokers, and capital partners.

Despite international efforts to reduce barriers to foreign investment, foreign ownership of real estate in many countries is often subject to specific domestic restrictions and prohibitions, and global investors often utilize specially tailored ownership structures to mitigate such restrictions. In Mexico, for example, direct ownership of real estate by a foreign individual or entity is prohibited within 100 kilometers of the border and within 50 kilometers of the coastline. A foreign-owned Mexican company, however, may acquire trust rights to real estate through the creation of a trust with a Mexican bank as trustee.

Real estate markets slowly but surely are moving toward globalization by removing barriers to entry, adopting global real estate standards, and developing the legal and professional infrastructure needed to attract companies, businesses and investment capital. Global investors, owners, and users are helping to drive this process by generally taking a consistent approach and using the same methodologies, valuation techniques, tax analysis, limited liability structures, metrics, and models to invest in or acquire properties or do business from market to market. The key to successful offshore investing is to make the right contacts with reputable local partners and local accounting, tax, legal, and other service providers, and to carefully develop the most efficient structures that limit investor liability and minimize foreign taxes and withholding obligations.

The Czech Republic is an example of a country that has made structural changes in its economy, including development of a private real estate market, to attract businesses and real estate investors from all over the world. Depending upon their risk, tax, and capitalization requirements, global investors in the Czech Republic can choose from a variety of ownership vehicles, including limited partnerships, limited liability companies, and joint stock companies. Lease provisions are fully negotiable and enforceable and real estate mortgages are common.

Countries differ considerably in their approaches to lease law and tenant rights. Many have established leasing guidelines that favor the tenant's rights over the landlord's. Although many countries limit such rights to residential real estate, a number have extended similar rights to commercial properties. Furthermore, tenant rights often vary by product type within a country.

In Brazil, early lease termination and automatic renewal rights are common in commercial leases. Leases are for a minimum term of 36 months, but tenants have the right to terminate a lease with one month's notice regardless of the contractual expiration date. Once a tenant has occupied the premises for more than five years, that tenant has the right to continue to occupy the space for a minimum of one month per year of occupancy. For multinational companies and other global users, tenant rights can be an advantage; however, for real estate owners and investors, tenant rights present a number of risks, the most important being the disruption of cash flows. There may be ways for owners to at least partly mitigate these risks, such as requiring tenants to pay higher security deposits.

One of the most common ways in which countries are lowering investment barriers is through international tax treaties, which are being changed to reduce foreign investor withholding taxes or double taxation of income or to achieve other tax-reduction measures. The structure adopted for the acquisition of direct or indirect interests in real estate outside the investor's country of residence almost always controls the extent of taxability of the profits, and the use of tax losses and deductions, from the investment. Depending on the countries involved, the use of tax haven entities can be beneficial or a disaster. The ownership and tax structure planning process must take into account the particular circumstances of the investor (for example, the investor's resident jurisdiction, whether the investor includes tax-exempt or pass-through entities or real estate investment trusts (REITs), and the investor's individual tax attributes).

Even with tax treaties in place, the issue of local taxation is a constant vexation for owners and investors. Property, income, and capital gains tax vary widely from country to country and sales and transfer taxes such as Value Added Tax (VAT) further complicate both the structural and fiscal position of offshore investments. In the area of taxation, as in so many other areas concerning overseas investment, there is no substitute for local knowledge.

The issue of how and where to finance real estate is also problematic for owners, investors and users. Most real estate markets provide some form of leveraged real estate financing. First, mortgages are the most established form. Also common are varying forms of second mortgage or mezzanine financing. In these countries, international real estate capital providers such as pension and opportunity funds are often the primary sources of mezzanine capital. In countries without an existing market for mezzanine financing, the legal infrastructure is usually sufficient to support such financing. Complex equity structures are also common. Large-scale real estate developments and trophy property acquisitions often lead the market with sophisticated deal structures that are designed to meet the respective needs of their investors. In some countries, complex equity structures are tailored to address market-specific issues.

In Argentina, for example, most commercial real estate transactions are made on a 100% equity basis. While commercial mortgages exist, Argentine investors generally favor increasing their equity stakes or utilizing preferred equity partners to borrowing from Argentine banks. When such partners are used, preferred, and subordinated equity structures in Argentina simulate conventional first mortgage financing and offer leveraged returns to subordinated equity holders.

CONCLUSION

In an era when virtually everything we come into contact with on a daily basis is either manufactured, assembled or produced outside the United States, it is clear that the era of globalization is here and here to stay. However, globalization moves at a differing pace depending on the demands of the economy and of the willingness of each industry to re-tool for global expansion. Real estate is, and always will be, essentially a local industry. Yet, the lure of globalization and the pressure placed on the real estate industry by its core clientele—Corporate (read *Global*) America—and also by an increasingly international clientele that is itself looking to globalize by expanding into new markets, including North America—is forcing new ideas, innovations, and best practices that will lead to a greater appreciation of the global market among owners, users and investors in the real estate industry. The global real estate market is likely to become reality sooner than we all might think.

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