REAL ESTATE SERVICES AND A GLOBALIZED ASSET CLASS

By Maureen Ehrenberg CRE, and Steve Mallen

"It was the best of times, it was the worst of times"
(Charles Dickens, *A Tale of Two Cities*, 1859)

The last 20 years of the 20th Century will go down as a period when the international real estate market achieved two things: maturity and global spread. Like a wayward teenager, real estate learned from its mistakes, went to college and became better educated and then demonstrated more prudence and caution than previously. At the same time, with international commerce, trade liberalization, and globalized capital came a passport and escalating air miles.

In the early years of the new century, real estate, on a risk-adjusted basis, looks like a preferred investment asset class throughout much of the world. Cycles come and go, but supply and demand are, for the most part, relatively well balanced in historic terms in most countries. Prices are shifting incrementally rather than dramatically and the volume and profile of capital and debt entering the sector is far better regulated and subject to far more due diligence than before. With an aging global demographic and volatility in other asset classes, real estate has become a target for both venture capital and annuity, bond-style investors seeking retirement profile income. "How are we going to fund our retirement?" is

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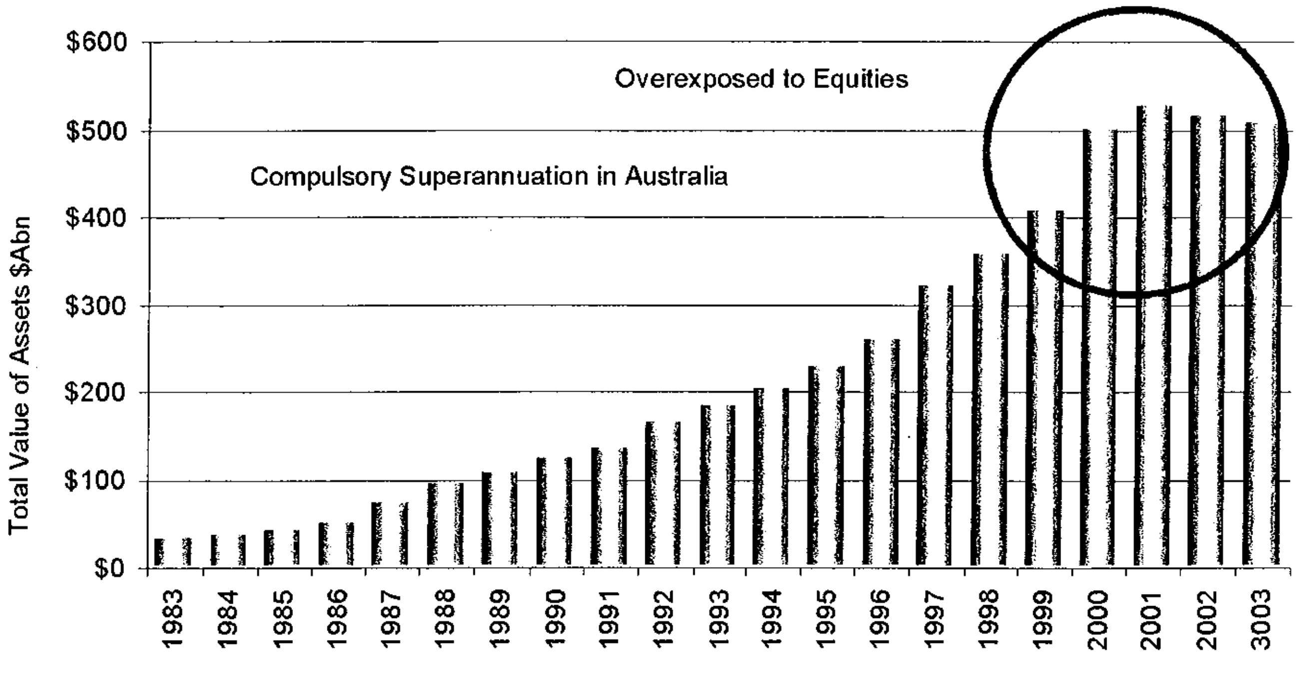
Exhibit 1

Growth in Superannuation Funds in Australia



Source: APRA

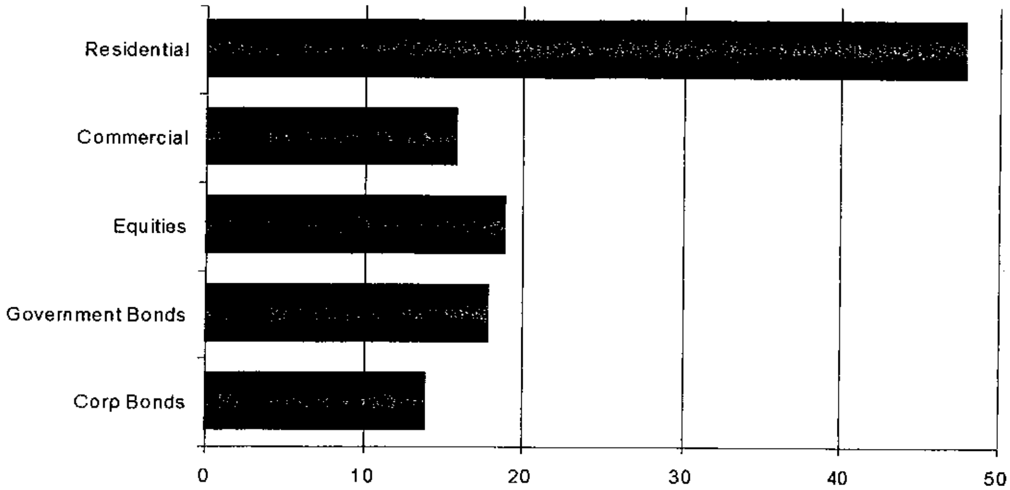
Item One on the sociopolitical agenda in the Western world with real estate right there alongside in the action column. Expectations are high.

By way of illustration, the Australian Government has introduced compulsory pension contributions for all employees in defense against a poverty-stricken retired population in the medium to long term. The net inflow of capital into Australian superannuation (pension) funds has increased at an unprecedented rate in consequence and, by volume, is set to overtake the value of the nation's entire fixed asset base. Asset and geographical diversification are now not only a certainty but mission-critical from a risk perspective. Real estate will figure prominently as a result of its ability to offer stabilized, annuity style returns over time, thereby matching policy liabilities against capital and fund liquidity requirements. It is only a matter of time before the other developed nations of the world follow the same route. Global capital flows in real estate will escalate dramatically in the next 20 years. The public and private REITS in the United States currently represent dramatically different options for investors and yet both have thrived in recent years with high expectation for both.

Capital alone however, does not a market make. The intensity with which qualifying investment opportunities are being bid up by investors anxious to place capital or take advantage of a cost of finance to income arbitrage environment that has not been seen in more than a generation, means that cap rates are being driven down while the underlying demand for the commodity, in this case real estate, is weakening. This is an imperfect market in any textbook. There is perhaps still more maturity required for this very new market type predicament, which has created a fundamental disconnect in many real estate markets around the world.

The stakes are high. The combined value of the developed economies' residential and commercial property markets is greater than the combined value of all the international equity and bond markets added together. In many countries, imperfections in the real estate sector are actually directly impacting upon that country's largest fixed asset base. Real estate really is big business. Indeed, its fixed capital position and its investment expectation

Exhibit 2 Asset Values – Developed Economies



Source: Economist / Knight Frank Research $ Trillion

profile arguably make it the biggest business of all moving forward. It is also worth noting that around 30% of the developed world's commercial real estate by value (some $4.7 trillion) is located in the United States.

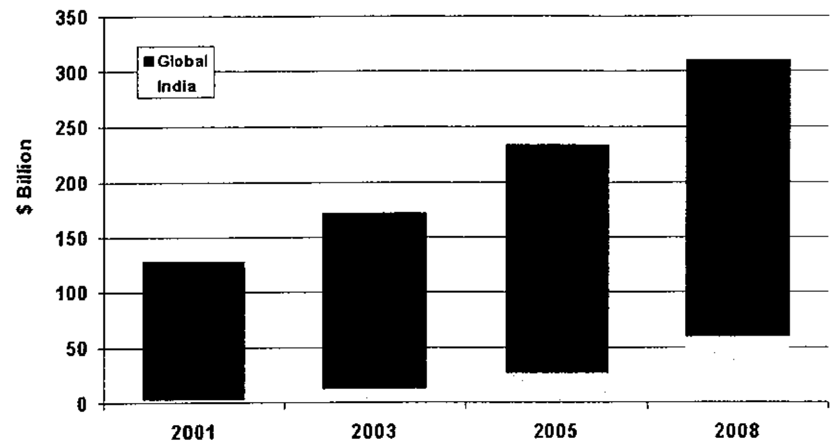
So, what of demand? The equity markets are inching back upwards on the back of gradually improving corporate profitability and all economic forecasts point towards better economic performance throughout the world in the middle years of the decade. At the same time though, reserve real estate capacity is high, head-counts are being closely scrutinized and the emphasis on cost control and reduction has arguably never been greater. There will be no bounce-back in demand and it will be some years before a more positive corporate climate puts real estate rents and prices back in the sunshine.

Moreover, global capitalism continues to evolve. To what extent will future growth in the West actually be articulated in the real estate markets of the East? The compelling cost advantages of India, China, and Eastern Europe have become impossible to ignore and this issue is rising rapidly up the political agenda. Protectionist rhetoric and trade union opposition is mounting, but, in a post-Enron world where transparency and shareholder return are everything, international decisions that see dramatic cost reductions in two key factors of production, labor, and real estate, can not be overlooked. One could go further: any Multinational Corporation (MNC) that has not at least considered offshoring or outsourcing could now be considered negligent in the eyes of its shareholders. The globalization of real estate has become a structural certainty.

Current forecasts vary, but consensus suggests that the U.S. will lose perhaps upwards of 3 million jobs to offshore markets by 2015, comprising both migrated posts and new growth transferred elsewhere. Even in an economy the size of the U.S., this is a big number. In real estate, it is a very big number, perhaps equating to a loss of stock approaching 500 million sq ft (nearly twice the office stock of metropolitan Washington, D.C.). Since the 2000 presidential election, the U.S. has lost 1 in 6 of its manufacturing jobs (some 2.8 million positions) via contraction and, increasingly offshoring. This is one of the reasons why the current "recovery" is "jobless." There is of course the fact that offshore operations will generate revenues back to the home country and thereby continue to bolster domestic economic performance. However, where is the real estate? Where is this key factor of production and where is its value accounted for and traded? It is increasingly no longer just around the corner and may not even be on the same continent. Therefore, how does a global economy relate to local real estate investors and their respective returns?

Exhibit 3

Business Process Outsourcing



Source : Credit Lyonnais

Observers will say that this is not new, remembering the 1970s and 1980s shifts in manufacturing to Mexico, Latin, and South America. Worries of becoming a nation of "CEOs and burger-flippers" proved unfounded as the economy grew and developed new services and industries, not least of which was the ICT (Information and Communications Technology) phenomenon. This time however, the pace of outsourcing and offshoring is more rapid, the fiscal arguments more compelling and the ability of the domestic economy to innovate and realign more questionable.

Moreover, the current shift is not restricted to "low value, low order" functions, but has moved up the service sector food-chain into IT development and maintenance, business analysis, and corporate accounting. It is no accident that in the UK the government has announced a new initiative to relocate public sector jobs away from the expensive South of England to the cheaper, more disadvantaged North of the country. While this will partially placate concerns about ballooning public debt and mounting costs, it will also offset some of the inevitable economic contraction and employment reduction which will undoubtedly occur in the regional cities (Cardiff, Leeds, Glasgow etc).

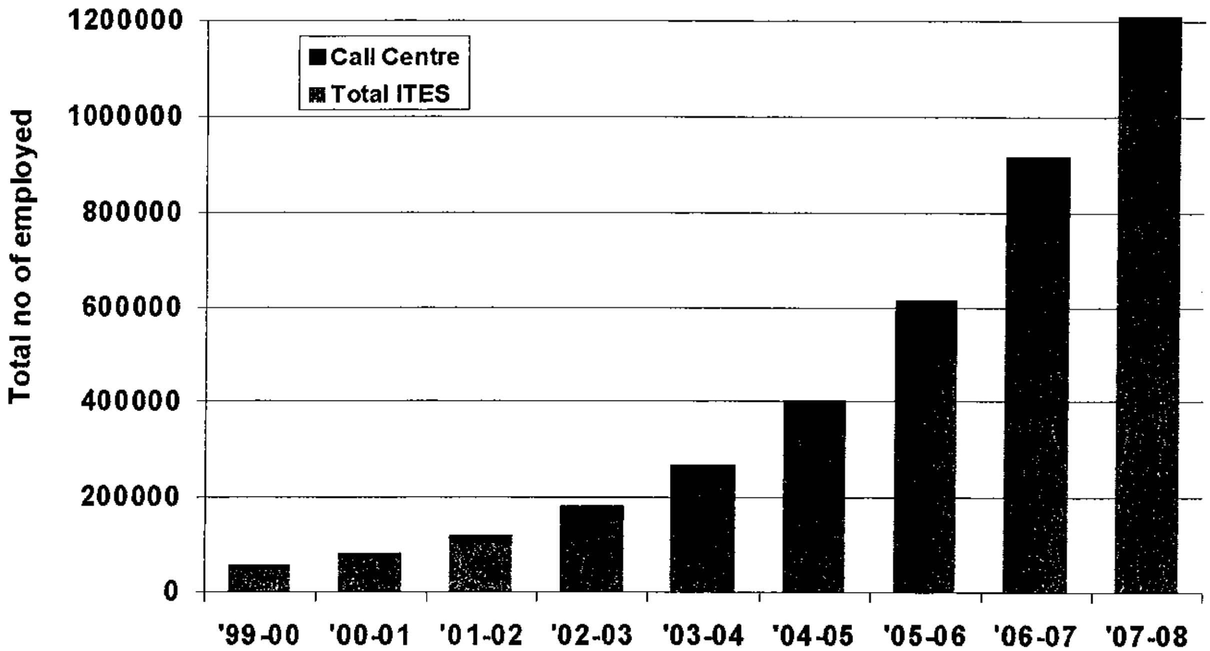
Detailed and highly credible research recently issued by Goldman Sachs suggests that the size of the Chinese economy will overtake France next year, the UK the year after that, Germany in 2007 and Japan in 2016. In 2041, America will finally cede its throne to China. From a lower economic base, India will become the world's third largest economy within 30 years behind the U.S. and China. Within Europe, projected foreign investment flows into the Eastern nations that are shortly to accede to EU membership are substantial. In the case of Poland, Russia, and the Czech Republic, annual foreign investment over the period 2001-2005 will exceed that of the UK, which is the fourth largest economy in the world and already long since integrated into the world order of commerce.

In real estate there has always been a pronounced tendency towards "short-termism": when will that transaction close? Who is best qualified to provide security services at my building? Will my performance as a fund manager provide the bonus I need for that second home? And so on. Real estate is not especially unique in this regard, but in an advisory environment where the greatest compensation flows are from transactions and where remuneration to individuals in most countries is commission oriented, our industry often finds it very difficult to see beyond and plan for much more than the next two or three quarters. If the real estate advisory community is to survive and prosper, it is the contention of the authors that we have to embrace and understand the multiple profound and structural changes in the economic and business landscape which will shape our clients' needs in the future. Failure to plan now will lead to a mismatch between client expectation and service delivery capability.

Simmering in the background for at least a decade, the challenge this presents to the real estate advisory and service provider community has now come

Exhibit 4

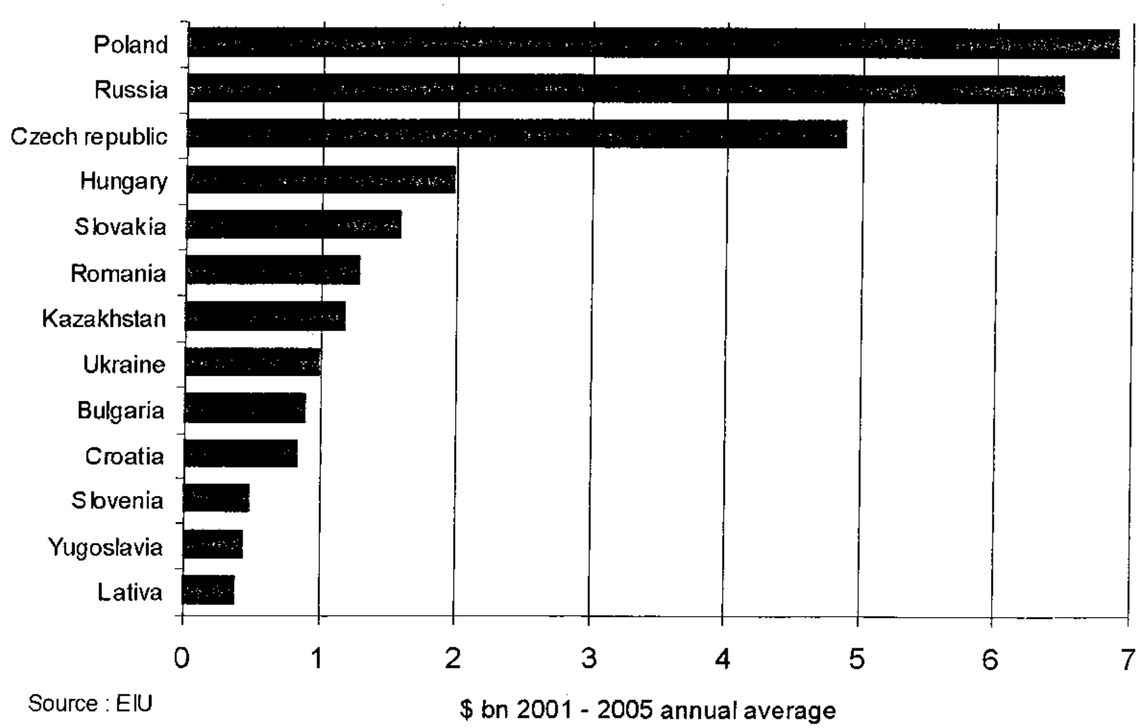
IT Sector Employment Generation (India)



Source : NASSCOM – McKinsey

Exhibit 5

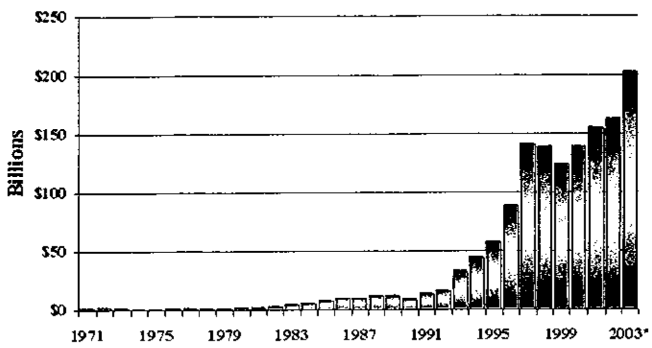
Foreign Investment in Eastern Europe Forecast (2001-5)



Source : EIU

Exhibit 6

US REIT Market Capitalization



* As of September 30th

Source: NAREIT

to a boil. Real estate has become a global commodity with preferred status throughout much of the investment community. However, real estate is essentially, and some would say irrevocably, a parochial construct that can only be fully understood, transacted, and managed at a local level. This is embodied in the "think globally, act locally" mantra, and its infinite variations, which have passed into mainstream parlance throughout the industry in recent years.

The corporate community, naturally and quite rightly, expects a service delivery platform which embraces all markets and skillsets. However, in a world where real estate legislation and codes of practice have almost infinite variety between countries and indeed, between sectors, this is a difficult expectation to meet. The capital cost of recruiting, training, and retaining the thousands of personnel that collectively encompass the local expertise and technical skills necessary to administer real estate around the globe is enormous. Add to this the challenge of global technological infrastructure, the need to enmesh multiple cultures and languages and the requirement for an administrative and management framework to oil the entire machine and the task becomes near daunting. And this is to say nothing of regulated professional standards, best practice conformity and the pernicious curse of indemnity protection in an increasingly litigious world.

In response, the service delivery community is polarizing. Large firms have coalesced into quasi-corporations and gone to the capital markets for expansion finance and operational debt facilities. Smaller firms have realized their strengths, limited their aspirations, and carved out niches in the market whether these be geographical, sectoral, or skill based. Middle league players are at a crossroads: return to the comfort zone of niche services or gear for growth and new market penetration. With turnover in the occupational market slowed by the economic climate and with the direct investment sector frustrated by access to qualifying stock around which to base transactions, the revenue flows from the market are not as high as they might be. This makes leverage and risk in the service provider community a brave and challenging proposition.

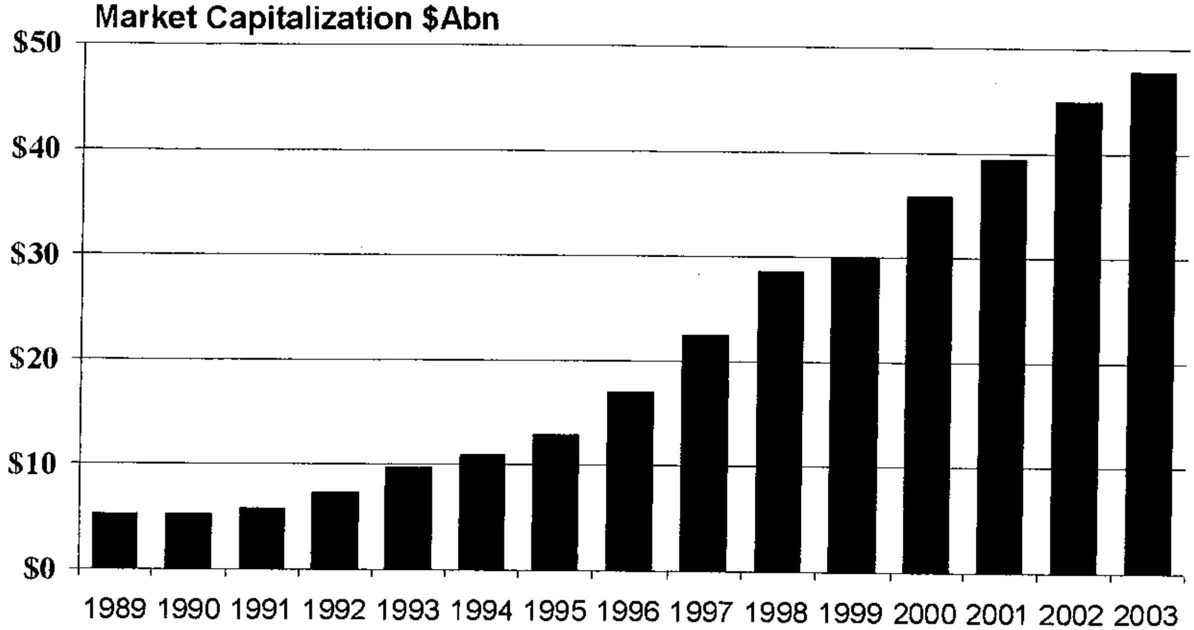
To further confuse the picture, it is becoming abundantly clear that no one service delivery model can actually deliver the full range of consulting, accounting, legal, tax, transactional, management, and technical skills necessary to service the corporate real estate user and owner. The plethora of accountancy, legal, brokerage, banking, and FM providers required to run and generate value from an MNC portfolio on an international scale has presented the corporate real estate director with a bewildering array of service options. Moreover, accountants are entering the transaction market, bankers are creating marriage value where it previously did not exist, brokers are becoming consultants, and everyone purports to be able to value and manage the assets. What you see is no longer necessarily what you get and advisors have become chameleon-like in their service offering, subject to the nature and identity of the people on the other side of the RFP table.

So what's next? What will the real estate services community look like two decades from now? What should we be doing today in order to be better placed as organizations and in order to better serve our industry tomorrow? Not surprisingly, the answers to these questions are far from straightforward.

In adding clarity to the position, a clear distinction between the supply and demand sides of the property equation is perhaps beneficial. From a development and investment perspective, the very diversity, complexity, inefficiency, and opaqueness of the global real estate market is what gives it lifeblood. Knowledgeable investors, who have taken time and deployed capital to understand new markets and forge appropriate local relationships, are well placed to take advantage of differential market

Exhibit 7

Growth in Australian Listed Property Trusts



Source: Property Investment Research

cycles, varied tax structures, government assistance, planning loopholes, leasehold reform, currency plays, debt arbitrage positions, new demand sectors, imported construction techniques—the variables are infinite.

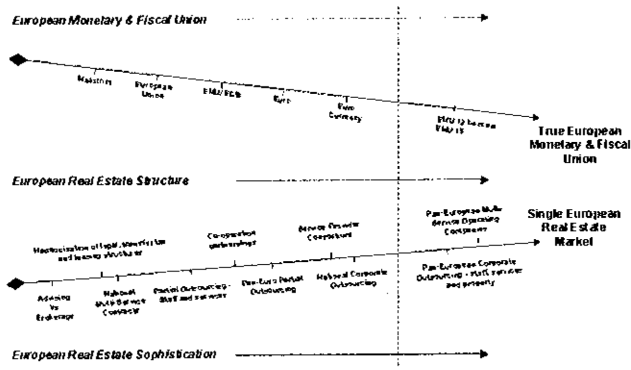
The very inefficiency of real estate as an asset class encourages international capital flow, facilitating healthy profit or mistake level losses, subject to the preparation and judgement (and sometimes luck) of the investor. If real estate were a transparent commodity, the drivers behind international investment would be no different from those of the equity market—geographical and sectoral spread over a unified, largely transparent investment landscape. This would clearly still produce substantial capital flow as investors spread risk and seek returns. However, in real estate, market complexity and diversity is a more powerful force. Shifting economics and local market dynamics make it possible, for example, for U.S. private equity to interface with the markets of Eastern Europe and generate internal rates of return in excess of 25%. Here, preparation is lengthy and risk is high, but the returns are seductive. Real estate is one of only a handful of capital plays in which this is possible. Moreover, in the low inflation, low growth, and lackluster domestic return environment that now persists in most developed markets, the drive towards seeking enhanced returns becomes more pronounced. Global capital flows will accelerate in consequence in the years ahead.

The perspective from the demand side of the market is however, fundamentally different and indeed, contradictory. The sheer complexity of the international market is the very thing which frustrates the corporate occupier. Market inefficiency, local complexity, and overall illiquidity makes real estate a capital and risk item which bedevils the corporate real estate director and the CFO. It is little wonder that moving real estate off the corporate balance sheet is likely to be one of the most powerful drivers in the real estate sector in the next decade and beyond. It is also entirely logical that corporate occupiers are perpetually seeking new ways of improving transparency, developing multinational management systems, and aligning real estate flexibility with the shifting demands of business. This becomes a second fundamental driver in international real estate for this decade and beyond.

It is important to note that, for both the investment and corporate occupier sides of the equation, the complexity and inefficiency of the market is a key

Exhibit 8

European Economic & Real Estate Convergence



support to the international advisory community. Whether for supply or demand protagonists, international service providers derive substantial revenue from educating or representing clients in new markets and sectors. Market complexity is thus a prime support for such a large real estate advisory industry. Without that complexity, the advisory sector need not and will not be so large.

There is however, a dialectic position here. In the next two decades, the apparently contradictory positions of supply and demand are likely to converge into a more integrated paradigm.

The investment market will increasingly be driven by securitization and the development of secondary trading in financial products. This is already apparent in the global drive towards the construction of REIT style markets and the ongoing development of an international CMBS sector. REIT legislation now exists in at least the U.S., Japan, France, Singapore, Australia, South Africa, and Belgium. The UK and Hong Kong lead the list of additional countries close behind. There are obviously several fundamental drivers to real estate securitization. In the future, the combined forces of investment market liquidity, spreading of risk and return and the need to provide better exposure to the real estate sector for retail level investors (who are increasingly worried about their pensions), will be crucial.

The phenomenal growth of the REIT market in the U.S. over the past 15 years and the exceptional returns being delivered by the Listed Property Trust (LPT) market in Australia—the only major market where real estate stocks consistently trade at a positive net Asset Value (NAV) level—illustrate the demand for this type of investment and the returns that are available. In the CMBS sector, most of the major U.S. investment banks are developing products in Europe and beyond, leveraging their U.S. expertise and experience. This market will balloon too over the next decade as investors seek what to many have become the twin holy grails of real estate investment: syndicated risk and liquidity.

Ongoing securitization and real estate listing will fundamentally enhance market transparency, improve capital flows and broaden investment appeal. Real estate investment will thus move towards a more perfect commodity model and away from the dense parochialism by which it is currently characterized. Retail investors, together with institutional and private capital, will be able to gain liquid, multi-market and multi-sector exposure with comparative ease on a global scale. It will be more possible to construct portfolios more closely aligned with the efficient frontiers of portfolio theory.

The other half of the dialectic response comes with the occupational market. MNC occupiers—that after all, are what actually drive the entire asset class—will demand structures of leasing, owning, and managing property which iron out market parochialism, conform to international templates and benchmarks, provide operational flexibility and offer a financially efficient and acceptable profile. In theoretical terms, there is no reason why, for example, an international corporation could not access a standard leasehold and property management package on a global scale, making location largely inconsequential whether it be Dallas, Dubai, or Dar es Salaam.

There are two barriers to synthetic leasing. Firstly, market dogma and parochialism, sometimes supported by local legislation and secondly, an insufficiently developed international capital market to underwrite risk, securitize the income stream, and provide the deep capital context to develop and run such a model. This is where the marriage occurs and the dialectic is resolved: the capital markets will catch up with the occupier markets to create value and service factor of production requirements.

As an aside, local legislation merits brief attention. In India, by way of example, tens of millions of square feet of world class real estate leased to MNC, blue-chip covenants and build to suits have and will be developed. However, foreign ownership of

Indian real estate is not permitted. These laws will be reformed—they will have to be if India truly wants to realize its dream of mainstream capitalism. If this occurs suddenly in say, ten years time, one of the largest real estate markets in the world will open up overnight. A sophisticated capital market model will facilitate this.

In Europe, EU legislation has touched virtually all forms of commercial activity and social life. The notable exception is real estate. This is adjudged so complex and so vested with history that even the bureaucrats in Brussels balk at the challenge. The corporate occupier community however, is demanding standardization. How long before there is a standard lease enshrined in legislation across the 20+ countries that will make up the EU? If legislation does not assist, the market will find a way through code of practice and client insistence. Here again, the necessary precursor is a sophisticated capital market.

Lastly, South Africa. Here, exchange controls prevent capital rich and highly sophisticated domestic institutions and developers operating offshore in any substantial fashion. These controls will be lifted to permit the nation to join the free trade world. The capital outflow from South Africa into the capital and real estate markets will be substantial. This will provide further impetus to capital market development, secondary trading, and overall liquidity.

There are many triggers and valves around the world that will be released over the next decade, which will add further impetus to the global real estate capital market. The migration of corporate real estate assets and liabilities off the balance sheet, together with more standard models of occupancy and management will provide much of the fuel to the capital market fire.

The above hints at utopianism. Pragmatically, there are still significant barriers, on the occupier side of this debate. The world's MNCs are, in reality, at very different stages in the evolution of their real estate methods and models. Some have developed highly efficient, multimarket systems that perpetually monitor cost, measure performance, and respond to business need. Others, even today, struggle to even provide an inventory of their freehold and leasehold exposure beyond a national level. Very few have made any real transition to an off-balance sheet model. The diagram below was constructed in a European context, but its central precept is global.

The differential progress of corporate occupiers will retard the process of globalization and the alignment of stock with the capital markets. The challenge for real estate consultants and advisors is to really listen to the corporate occupiers and truly hear how they describe their changing business and real estate requirements. Sound real estate advice is critical, but it appears that the time has come to turn the adage of "think globally and act locally" on its ear. Standardization of processes amongst occupiers, offshoring, benchmarking, emerging market opportunities, acquisitions, and so on has also created a need for real estate service firms to work with their clients to think locally and act globally, which is not nearly as easily executed as the converse. The value that real estate service firms can provide to MNCs is enormous, however, the measure against which value is perceived is changing. We must be able to innovate, test our paradigms from which we typically offer solutions, act locally effectively, and to participate and execute more globally in a very changing world of business, politics, economics and, yes, real estate.

The U.S. occupies center stage in this unfolding drama. Not only is the U.S. market by far the largest in the world, it is also the most transparent, the best researched and, most importantly of all, the most sophisticated in terms of its asset management models and capital market development. U.S. market practitioners lead the field in many aspects of real estate advice, finance, innovation, and management. However, and here is the real challenge, if the past 50 years have taught us anything it is perhaps that American cultural and commercial principles overlaid upon a complex world without proper recourse and deference to local practice, custom and culture is at best misplaced and, at worst, downright dangerous. The challenge for the next 50 years thus rests on the ability of the U.S. to export its experience and models in a manner which is highly sensitized to the importing local environment. The future success of the global real estate market depends on this. Travelling more and seeing the market through the eyes of others is not just tourism, but essential to the prosperity of one of the world's most important asset classes. In these often troubled and turbulent times, the subtext here, that extends well beyond real estate, is, we hope, obvious.