Global Real Estate Investment and Risk:
An Interview with David J. Lynn, Ph.D., CRE

Interviewer:

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Interviewee:

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INTRODUCTION

One of the subjects on The Counselors of Real Estate's "Top Ten Issues Affecting Real Estate 2013" list is global real estate investing and risk. Foreign investors have been investing in real estate in the U.S. for many years, although recently, there seems to have been an increase in their activity. Investing in foreign markets has its rewards, but it also tends to come with a higher risk profile than investing in U. S. commercial markets. While foreign investors continue to invest in their own domestic markets, they may also seek to diversify their portfolios and spread risk by investing in other countries that could offer opportunities. The U.S. is one of those markets. **David J. Lynn, Ph.D., CRE,** chief investment strategist with Cole Real Estate Investments, and author of the book *Emerging Market Real Estate Investment: Investing in China, India and Brazil,* spoke with *Real Estate Issues*' Editor in Chief **Mary C. Bujold, CRE**, about global real estate investment and its risks.

BUJOLD: ***How would you characterize current commercial real estate markets in the U.S.?***

LYNN: The U.S. is one of the most attractive real estate markets globally. The economy is improving

About the Interviewer

Mary C. Bujold, CRE, *president, Maxfield Research Inc., Minneapolis, Minnesota, and Real Estate Issues® editor in chief, 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.*

About the Interviewee

David J. Lynn, Ph.D., CRE, *is executive vice president, chief investment strategist and a head of portfolio management at Cole Real Estate Investments, Phoenix. In this role, he is responsible for leading Cole's real estate investment strategy, and serving as the firm's economist. Lynn also serves as executive vice president and chief investment strategist of Cole Capital Advisors, Cole Capital Partners, CCPT I Advisors, CCPT II Advisors, CCPT III Advisors, CCI Advisors, and CCPT IV Advisors. Lynn previously was a partner and managing director at Clarion Partners, a commercial real estate investment firm. Prior to joining Clarion Partners, he was managing director, global head of strategy and portfolio manager with AIG Global Real Estate; senior director, investment and development with Avalonbay, Inc., a REIT; and vice president of GE Capital Real Estate/Bidcom.com JV, a real estate technology firm. Lynn earned doctoral and master's of science degrees from the London School of Economics, with a specialization in financial economics; a master's degree in business administration from the MIT Sloan School of Business; a master of arts degree in City and Regional Planning and Real Estate from Cornell University; and a bachelor of arts degree from the University of California at Berkeley.*

gradually, overall debt is decreasing, and households and corporations decreased debt during the recession. Improved real estate fundamentals, a low cost of debt, very low levels of new supply and positive returns during the past three years have all led to a strong domestic commercial real estate market in most sectors. Emerging markets notwithstanding, investors view the U.S. real estate market as one of the best in the world.

BUJOLD: ***Can you elaborate on that?***

LYNN: Since the economic slowdown, households and corporations have reduced their debt. Corporations significantly reduced payrolls and other business costs, and increased their use of technology in order to achieve higher levels of productivity. This resulted in corporations stockpiling cash—approximately two trillion dollars on the books—whereby their recovery phase was shortened, spurring production. Right now, manufacturing is making a comeback for the first time in many years, exports are up, agriculture is strong, energy development is very robust, medical is solid, as is education, although we still have an issue with student debt and some resistant unemployment. Higher unemployment rates are likely to stay with us for a while as we transition to the digital age where technology continues to play a larger role in worker productivity and production. We are feeling our way through this transition, but it is difficult to predict at this point how we will bring our workforce to a level where it has the skills necessary to implement new technologies. We are not doing enough to steer young people into the science, technology, engineering and mathematics disciplines to support our long-term business growth so that the U.S. can increase its competitiveness globally. Mexico currently graduates more engineers than does the U.S. We have acknowledged that there is a shortage in the U.S. of highly trained technical people, and companies are already lobbying to try to bring those workers into the U.S. The gap between skilled and unskilled labor is expected to widen before it gets better, and that is likely to have some long-term implications on the economy and real estate markets. Employment needs are shifting in the U.S. and elsewhere. In the book, *Race Against the Machine,* Erik Brynjolfsson and Andrew McAfee from MIT present a strong case for how the digital revolution is accelerating innovation, driving productivity and transforming employment and our economy. The U.S. business markets are relatively solid and gaining momentum. This spills over into real estate, potentially making our market even more attractive to foreign investors. In addition, the significant write-downs that occurred in the real estate market in the early part of the recession resulted in a much lower basis whereby when the market turned around, the ramp-up was more extreme, significantly improving fundamentals, which made real estate more attractive to investors over other types of investments.

Long term, as technology becomes more integrated into our economy, there may be some challenges as to how many workers we need, what types of positions are available, the education required for those positions and how that impacts office development in the future. Already there is discussion of declining space needs for office users moving forward.

BUJOLD: ***Which markets are seeing the highest levels of investment and why?***

LYNN: Of course, the global gateway markets have experienced the greatest inflows of capital (both domestic and foreign) over the past several years. This is primarily because these markets are considered to be "safer"—more liquid and with larger, more diversified economies underlying the real estate. Core markets are also easier to access and are more attractive to a wider array of buyers, including institutions. Risk aversion is typically greatest during a recession, making core gateway markets even more popular. As the recovery matures, investment capital, seeking higher returns, could migrate to secondary and tertiary markets. This is happening now to some degree. This trend is bolstered by the fact that many non-coastal states are seeing strong economic growth.

BUJOLD: ***Are investment-grade inventories in these major markets limited and are investors, in general, bidding up the price of commercial real estate?***

LYNN: Yes, there is, in general, a finite supply of high-quality properties in the global gateway markets, particularly Class A properties. These markets are generally more supply-constrained and are difficult to supply, accentuating the relative shortage and causing cap rates to fall, in some cases, below their 2007 lows. This has also been helped by a very low cost of capital.

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BUJOLD: ***What market conditions are prompting foreign investors to look to the U.S. for real estate?***

LYNN: There are a few very different reasons. First, the total and income returns for U.S. real estate have been very attractive. Second, prospects for future growth in many mature industrialized markets (Europe and Japan) are dismal. Capital is also coming into the U.S. from the Middle Eastern energy countries that have benefitted enormously from higher prices over the past five years, as well as high-growth emerging market countries that have amassed wealth (and real estate holdings) to the point where diversification makes sense. Many emerging market investors are also attracted to the transparency, liquidity and the rule of law found in the U.S.

In the U.S., we tend to take a lot of things for granted regarding our real estate markets that are not present in most other countries in the world such as strong private property rights and rules, enforceable contracts, a much higher level of transparency, and a very large and diverse economy. Also, we have a very stable government. Investors in other parts of the world may want to diversify into the U.S. not only for wealth building, but also as a protection for their own personal safety or that of their family in countries that are not as open and free as the U.S.

BUJOLD: ***In your opinion, do you believe that foreign investors are more likely to consider investment in U.S. markets than other population markets globally? If so, why? And which other foreign markets would tend to compete effectively again the U.S***?

LYNN: It is not an either/or proposition—foreign investors will continue to invest in their own countries, the U.S. and other foreign countries, both in mature and in emerging markets. Cross-border investment is becoming easier each year and is prudent from a portfolio diversification standpoint, as well as returns. Moreover, in certain countries such as China, India and Brazil, there is fear that the boom might turn into a bubble, and so investors are inclined to take some chips off the table and put money into more stable, liquid and mature markets such as the U.S.

BUJOLD: ***What types of fundamentals does the U.S. real estate market typically have that may not be present in other foreign markets?***

LYNN: We have a strong multifamily market that is virtually unknown outside of the U.S. Industrial is another sector which is not usually investable in many countries. The U.S. also has fairly developed niche markets in storage, student housing, seniors housing, digital storage and others, enabling more choice and diversification. In almost every case, the main and niche sectors in the U.S. are much larger and deeper than in most other countries.

BUJOLD: ***Are U.S. investors increasingly looking at opportunities overseas because they cannot get suitable returns here in the U.S., or is that not the case?***

LYNN: I believe that, if anything, there has been slightly less interest on the part of domestic investors to consider foreign markets because U.S. real estate returns and fundamentals have been so good. Also, emerging markets have been more volatile and have experienced some slowdown in recent years, so they are not quite as attractive as they appeared to be earlier. Also, during periods of economic difficulty, capital tends to be more conservative and investors are less eager to venture out on the risk curve. Some markets are highly opportunistic such as Brazil and India, but the risks are very high.

The U.S. has a very strong income-producing real estate sector which is very attractive to foreign investors and is generally limited in many other countries.

BUJOLD: ***In what ways do foreign investors approach buying real estate in the U.S. that would be different than U.S. investors?***

LYNN: They tend to use consultants and local partners to a greater degree. As mentioned earlier, they tend to stick to larger coastal markets and they usually, though not always, prefer larger, Class A assets. Examples of these coastal markets are Boston, Washington, D.C., Miami, Houston, Los Angeles, San Francisco, New York and Seattle.

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BUJOLD: ***Are foreign investors in China, Brazil and India investing just as heavily in their own markets as they might be in the U.S?***

LYNN: Yes, they certainly are. There have been great opportunities in these countries—high growth and strong returns, but they have been primarily in the form of opportunistic investment. As investors grow their portfolios, they want to diversify to different segments (core and income become more important) and not simply put all of their eggs in one basket, even if it has been a high-growth basket. There is also more concern among foreign investors' domestic markets of a greater potential for boom and bust. One way to hedge against that is to invest into a more stable and diverse real estate market such as the U.S.

BUJOLD: ***In the area of global risk, can you provide a risk ranking of the top five real estate markets in the world as related to their current level of risk in investing in commercial real estate?***

LYNN: Least risky markets:

1) U.S.
2) UK
3) Canada
4) Australia
5) Singapore

BUJOLD: ***How much do currency fluctuations or currency hedging play a role in commercial real estate investments here in the U.S. and abroad?***

LYNN: Currency fluctuations can affect returns dramatically and both positively and negatively. This has discouraged investment in places such as Argentina where rapid and dramatic currency devaluations happen regularly. Some countries in the past have tried to inflate their way out of their debt. Now, it is not that easy to do anymore. Carmen Reinhardt and Kenneth Rogoff, authors of *This Time is Different,* have written an excellent treatise on financial crises in history and how countries have produced financial crises that have devastated their economies.

One reason why emerging market countries have been investing in the U.S. is that their currencies, in general, have been appreciating against the U.S. dollar over the long-term. This has been true of the RMB (China), the Real (Brazil) and the Rupee (India), again, over the long term. Hedging is very expensive in real estate investment, and for that reason, is rarely done. The best way to hedge against currency fluctuations may be to receive rental and capital income in the form of dollars—if a U.S. investor.

Geopolitical stability is also more of a factor now with the rise in global investing. We are much more connected globally than ever before. There is a spillover and an interlinkage of events that can affect returns. Consider political disruptions in Egypt and Syria and how these affect the Suez Canal.

Also, the U.S. has one of the highest corporate tax rates in the world. This issue is likely to continue to be controversial as more companies take advantage of global opportunities. ■

David Lynn, Ph.D., CRE, *serves as executive vice president and chief investment strategist at Cole Real Estate Investments, Inc. The views and opinions expressed in this commentary are those of the contributor as of the date of publication and are subject to change, and do not necessarily reflect the views of Cole Real Estate Investments and/or its affiliates.*