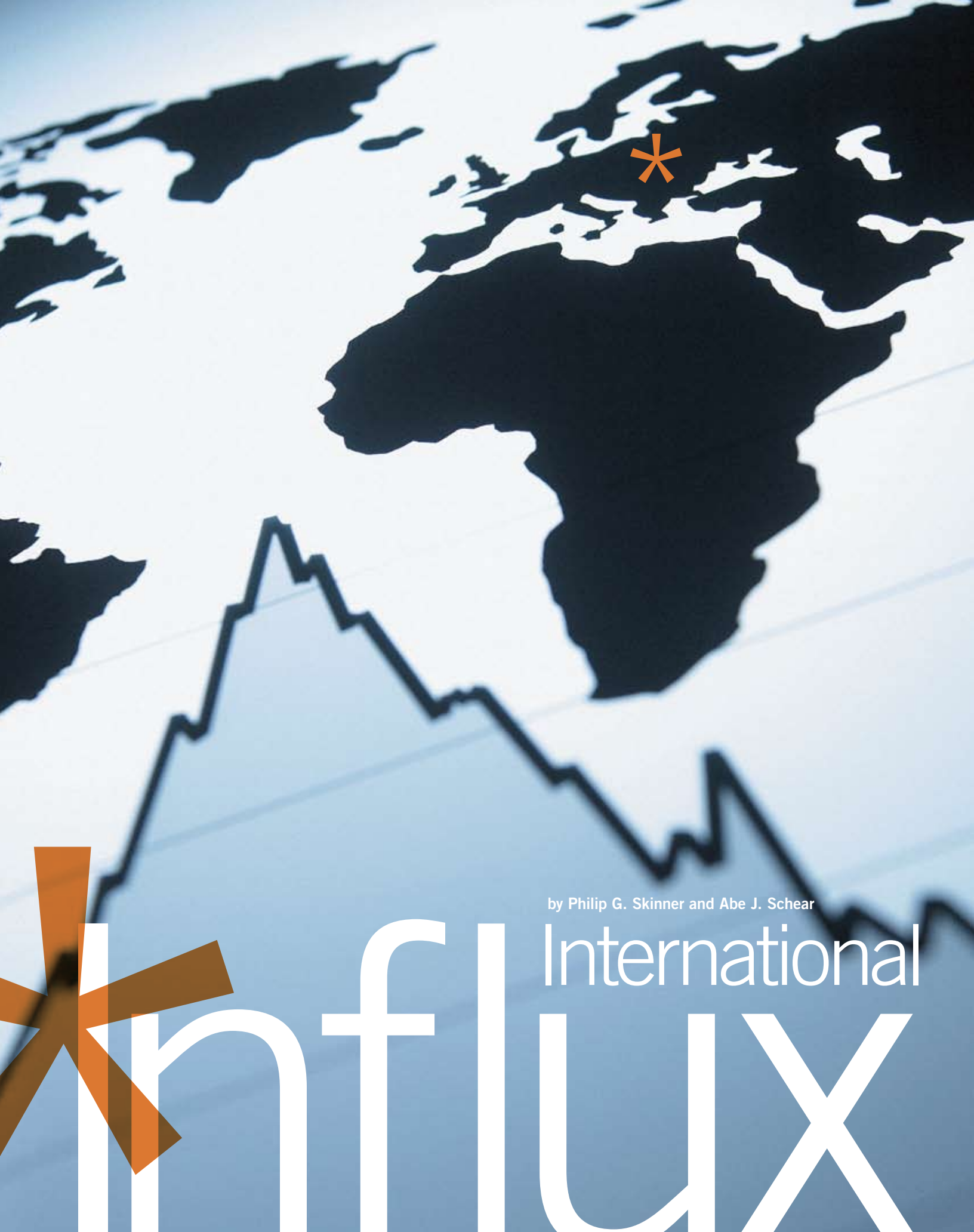




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by Philip G. Skinner and Abe J. Schear

International

**influx**

A rising tide of foreign real estate investment may help to lift all U.S. markets.

The role of foreign investors in the U.S. real estate market ebbs and flows with a host of factors. Though not quite as predictable as the tide, its movement often is in tandem with the market's fundamental drivers. Currently two factors — the decline in commercial real estate prices and the constraints on available capital to finance or refinance — align to make this a very favorable time for foreign investors with sources of equity or debt to acquire U.S. real property.

When these aspects of the U.S. market are coupled with global factors such as favorable currency exchange rates, instability of various kinds in other countries, and the desire to achieve both product and geographic diversification on a worldwide scale, the time appears to be ripe for foreign investment capital to come to the U.S.

The answers to certain key questions about the prospects for foreign investment in U.S. real estate in the next year or two will help stateside commercial real estate professionals understand the current trend and perhaps profit from it.

Is the current market climate likely to attract more attention from foreign investors?

Foreign investors looking to the U.S. now likely are experienced investors who have invested in a number of countries around the world. These savvy investors believe that they can take advantage of the problems that the U.S. commercial real estate industry currently is facing. They believe that the U.S. offers the best global opportunity for capital appreciation at this time, while also being the safest

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FOREIGN INVESTMENT PREFERENCES

Top U.S. Cities

Washington, D.C.
New York
San Francisco
Boston
Los Angeles

Top Property Types

Multifamily
Office
Industrial
Retail
Hotel

Association of Foreign Investors
in Real Estate, January 2010
survey

country in which to invest. They can be aggressive and effective negotiators and can wield their foreignness as both a sword and a shield in negotiations. They know how to make a deal but also are willing to walk away if the deal doesn't suit them.

U.S. market dynamics clearly give any investor who has capital or access to ready capital the opportunity to make investments in good properties at a greatly reduced cost basis, and often well below replacement cost. We should expect that many foreign investors will take advantage of this opportunity in the next two to three years. This wave of investment will have the beneficial effect of helping depressed

U.S. real estate markets find and define the bottom of the current cycle and help lead to an eventual recovery.

What types of properties interest foreign investors?

Discussions with Israeli and European investors over the course of the last year indicate a wide variety of U.S. real estate investment interest. Core central business district office properties in major markets, multifamily/residential in locations with projected long-term positive demographics, and retail, including both grocery-anchored neighborhood retail as well as major mall properties, came up most frequently. Industrial, hospitality, and mixed-use projects came up far less frequently.

Regardless of property type, foreign investors uniformly are interested in taking advantage of depressed U.S. prices, as well as a scarcity of financing, to drive good deals in the next year or two. They believe that in many cases property valuations are the lowest they have been in 15 or even 20 years, notwithstanding the fact that many properties have ongoing solid cash flow and stable rental income in place.

Foreign investors also prefer off-market opportunities or properties that are being quietly marketed, rather than those where they have to bid competitively in the open market. Foreign investors are not afraid to use discounted debt acquisitions as an indirect vehicle that ultimately will lead either to acquisition of the underlying assets or favorable loan repayment terms.

What deal structures work best?

Many of the larger foreign investors with sufficient capital are interested in direct investments or co-investments with U.S. strategic partners. Regardless of the type of joint venture vehicle used, the foreign investor typically wants to be the majority partner with control over major decisions, allowing its U.S.

A DONE DEAL

In 2009, Profimex, an Israeli private equity firm that has co-invested in an estimated \$26 billion worth of properties worldwide, raised half of the \$6 million purchase price for Northwoods Business Center in Atlanta. With an additional \$700,000 of equity from U.S. investors, the newly formed partnership's 60 percent equity secured a commercial loan on acceptable terms for the remaining 40 percent of the purchase price. Because of the low leverage, existing rents, net operating income, and positive cash flow from the property, the investors are realizing an annualized 8 percent return. The property and transaction characteristics made the deal attractive to the foreign investors: The investment could immediately yield a solid return, while it had upside potential because the property was not 100 percent leased.

Like any investor, Profimex had to approve the deal from several different perspectives: The purchase price, operating budget, lease risk, internal rate of return, and exit assumptions all had to be acceptable. The property type and location had to fit the investors' appetite, as did the existing leases, current vacancies, and lease-up assumptions. The investors had to have full confidence in the proposed joint venture structure and the U.S. strategic partner, who would run and manage the property on a day-to-day basis.

Both U.S. principals made multiple trips to Israel to meet with Profimex to establish mutual trust and confidence. Building such strategic alliances to develop a commonality of interest and mutual goals helps ensure trust and confidence. Foreign investors in particular rely on their U.S. attorneys, brokers, property managers, and other experts and consultants to be their eyes, ears, and active representatives. Those that do a good job are awarded with repeat business, which is the best recommendation that can be given to a service provider.



strategic partner to have day-to-day operational control and responsibility, including the right to earn arm's-length fees for necessary services including property management and leasing services. For cash-strapped U.S. property owners that may be faced with looming debt maturities, cutting a 90/10 or a similar deal with a foreign investor that will allow the U.S. partner to retain some ownership, earn leasing and management fees, and also have a profit participation based upon a typical waterfall distribution can literally save the day. Of course, many foreign investors might look to negotiate with lenders on such deals to acquire the debt, based on a loan-to-own strategy.

What are the biggest challenges in putting together a foreign investment deal?

Challenges often relate to the learning curve: helping foreign investors understand the market, submarket, and property conditions that characterize a particular investment and dictate the time to make the deal; familiarizing them with the relevant U.S. deal process, including the use of non-binding letters of intent followed by full contract negotiations, a due diligence period, and a closing period; helping them select, engage, and work with brokers, surveyors, environmental consultants, and title insurance agents and companies, among others, all of whom may play different roles than in the investors' home countries and may cost more than they anticipate; and structuring the joint venture relationship between a foreign investor and its proposed U.S. strategic partner. All take time, patience, and expertise to help coordinate the foreign investor's path through what may be an unfamiliar and uncomfortable landscape.

What geographic markets interest foreign investors?

Generally foreign investors who don't have strong strategic alliances with U.S.-based partners are interested in major U.S. markets and core CBD areas that they already are familiar with, such as New York City, Boston, Washington, D.C., San Francisco, and Los Angeles. These are areas they believe will rebound well in the next five to seven years, if not sooner.

A strong alliance with a U.S. partner can widen the focus to include a variety of products in a greater array of market areas, with the foreign investor relying upon its U.S. partner to identify appropriate markets and properties.

What foreign investors are looking at U.S. properties?

Traditionally, investors from around the world have looked to the U.S. as a safe haven for commercial real estate investment. Investors from Germany, Holland, Israel and other Middle Eastern countries, Canada, Japan, and China have been historically active. Currently investors from many of these locales who are in strong financial shape are looking at the U.S. based on the belief that the timing is again right for them to invest.

Largest Global Real Estate Markets

COUNTRY	GLOBAL INVESTMENT VOLUME (IN \$ MILLIONS)		ANNUAL CHANGE (%)
	2008	2009	
China	64,392	156,195	142.6
United Kingdom	41,380	38,802	-6.2
United States	106,028	38,354	-63.8

Source: Cushman & Wakefield



Some of these investors held off investing in the U.S. from 2004 to 2007, as commercial real estate here became more overheated. During this time some foreign investors felt that other areas of the world offered greater upside potential and less downside risk than the U.S., including areas that were considered to be emerging markets in Eastern Europe, India, China, and Brazil. Now the tide has turned: Many emerging-market economies have been shaken by the worldwide financial crisis, and U.S. prices have come down to what some investors view as historic levels, creating capital appreciation opportunities that only come around once in a generation.

What skills are needed to succeed with foreign investment deals?

The skills are the same as those used when dealing with U.S. investors. But such skills have to be packaged in a manner that is at the same time clear, convincing, informative, articulate, direct, helpful, patient, and deal-oriented. Also, one must be aware of the differences in the level of involvement of various professionals. For example, in a number of other countries lawyers play a greater or lesser role than they typically play in U.S. transactions. Civil law systems often use civil law notaries, who play a much greater transaction role than U.S. notaries. Title insurance, which is universally desired or required here in the U.S., may be an unfamiliar deal requirement and an unanticipated deal cost for some foreign investors. Good communication and sensitivity to cultural differences can help to minimize or avoid misunderstandings and manage expectations of the foreign investor.

What kinds of connections facilitate foreign investment deals?

Developing a plan that will introduce you to foreign investors and their brokers, attorneys, or other professionals locally or overseas is the best way to create a favorable environment for working with foreign investors. Trade associations, foreign chambers of commerce, consulate offices, and other groups exist in which these kinds of interaction can occur over time. The time to work on these relationships is now, before a deal is at hand. By doing so, you and your foreign investor partner or client can be poised to strike when the time is right, rather than having to complete negotiations with each other first.

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