ASIAN INVESTMENTS IN US REAL ESTATE AMID AN UNCERTAIN WORLD

DISCOVER:

- What is spurring this appetite for US real estate
- What Singapore investors are looking out for in US real estate
- How you can protect your investment interest in the US

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Asian investments continue to flow into US real estate and the West maintains its appeal as an asset-rich environment primed for growth.

The concept of home country or home bias in the context of investing has been well documented. Investors — even savvy institutions with truly diverse portfolios — tend to invest more heavily in local markets than abroad. The decision to do so can stem from a number of factors ranging from familiarity and perceived risk to currency headwinds and the added complexities of cross-border transactions.

That said, Asian institutional investors have been anything but averse to global investing, especially in the robust, liquid markets of the United States. For example, Japanese insurance companies, Singapore-based property investors and other sovereign wealth funds, and Asian public pensions are all well-established participants in global markets, with a particular fondness for prime assets (especially office properties). But, more recently, the likes of South Korean-based capital, Chinese insurers and other Hong Kong family offices have also shown an increased appetite for US real estate. Unsurprisingly, the destinations for much of such capital have been top-tier gateway cities. However, given current pricing and competition for assets, even second-tier US locations are attracting interest these days.

WHAT'S SPURRING THIS APPETITE FOR US REAL ESTATE?

There are many reasons, but perhaps none as obvious as the negative yields offered by some sovereign bonds, forcing some investors to look for alternatives overseas. No matter how expensive pricing seems at face value, it is critical to keep it in the proper context. The reality is that there is still a seemingly attractive spread between US real estate and 10-year government bonds in many large and liquid global markets where Asian investors participate heavily. As long as this spread remains, it is likely that there will be an Asian institutional "bid" for quality US real estate.

WHAT EXACTLY DOES "QUALITY" MEAN?

By and large, the more conservative Asian institutional investors have been keen to focus on vibrant, coastal US markets, such as New York, Boston, Washington, DC, San Francisco and Los Angeles, along with interior cities such as Chicago, Minneapolis, Denver and Dallas. Given that investors are taking on greater complexities with cross-border transactions, they tend to prefer Class A office assets in central business district (CBD) locations, with limited lease rollovers or, at the very least, staggered expirations. For these types of top-tier assets, investors are willing to pay up and accept low cap rates.

In a low-yield environment, Class A assets that offer predictable and consistent income streams hold obvious appeal for investors trying to diversify assets or even match their liabilities. In 2016 for example, Japanese investors purchased Miami Tower, a 47-storey landmark office tower, for a reported US$220 million. The property was more than 90% leased at the time of sale and is well located in the resurgent Miami CBD.

DIVERSITY IN THE ASIAN INVESTMENT APPETITE

One should not generalise on investment preferences and risk appetite, particularly with a capital base as broad and diverse as Asian institutional money. It would therefore be wrong to assume that all transaction activities involve conservative capital chasing conservative investments. Since there are limits to what even aggressive bidders will pay for top-tier assets, some investors are showing a willingness to step a bit further out on the risk spectrum, either by looking at a new location or perhaps assuming some leasing or capital improvement risks. Increasingly, moving out on the risk spectrum involves looking far beyond the typical CBD office properties.

Take, for example, China's Anbang Insurance Group, which purchased New York's Waldorf Astoria hotel last year for almost US$2 billion, and then reportedly followed up last year with an acquisition of Strategic Hotels & Resorts from Blackstone for US$6.5 billion. These notable transactions are just two examples of Chinese capital pouring into US hospitality assets, which presumably carry a higher risk profile than the typical prime office acquisition.

Earlier in 2016, Singapore sovereign wealth fund GIC reportedly purchased a majority interest in Yes! Communities, a Denver, Colorado-based owner/operator of manufactured housing in the US, for US$2 billion. This came on the heels of GIC's 2014 acquisition of the IndCor industrial portfolio for US$8.1 billion and its US$1 billion acquisition of the Hillwood Properties logistics portfolio. The notion of global capital chasing mobile homes in Middle America is not absurd in today's context. The willingness of foreign investors to invest in such a niche asset type in a faraway land demonstrates how global capital has been able to adapt and assess risks.

WHAT SINGAPORE INVESTORS ARE LOOKING OUT FOR IN US REAL ESTATE

While the volume of Singapore investments into US assets continues to rise, this trend and the nature of assets involve mainly hospitality and housing projects.

Between 2007 and 2016, Singapore's outbound investments to the US witnessed a compound annual growth rate (CAGR) of 90%. There was a stark contrast in the years prior to and after 2012; the former saw a mere US$200.9 million worth of transactions, while the latter registered a total transaction value of US$10.8 billion. There was an evident lack of activity particularly in 2008 and 2009 as they bore the brunt of the subprime turmoil, which was triggered by the collapse of Lehman Brothers and eventually evolved into a full-fledged global financial crisis. The market saw some recovery by 2012 and took another leap to deliver US$2.5 billion worth of deals in 2013. The years 2014 and 2015 saw slower activity, in the range of US$2.0 billion to US$2.1billion. Thereafter, a record US$3.2 billion worth of outbound investments to the US were recorded in 2016, approximately half of which was the result of acquisition by GIC, the Singapore government's fund manager, in the US manufactured housing business[1].

Throughout the years, the sovereign wealth fund (SWF) and a variety of Joint Venture efforts formed the bulk of Singapore investments into the US (Exhibit 1). Over a period of 10 years, GIC contributed US$4.5 billion or 40.6% of total investment value, while JVs contributed US$3.8 billion or 34.9% of the total investment value. That said, one should delve into the nature of these JVs and note that the SWF was also involved in two of the top three deals inked. GIC and Abu Dhabi Investment Authority (ADIA) jointly purchased Time Warner Center (New York, US) at US$1.3 billion in 2014. The other notable acquisition took place in 2012, where GIC, together with Hong Kong Monetary Authority (HKMA), purchased a majority interest in 101 California (California, US) at US$837.2 million. The US has traditionally dominated the world in terms of GDP[2], despite having fallen behind China since 2014. It is believed that the US will continue to be an economic powerhouse[3] and its potential for long term returns is an attractive attribute for sovereign wealth funds.

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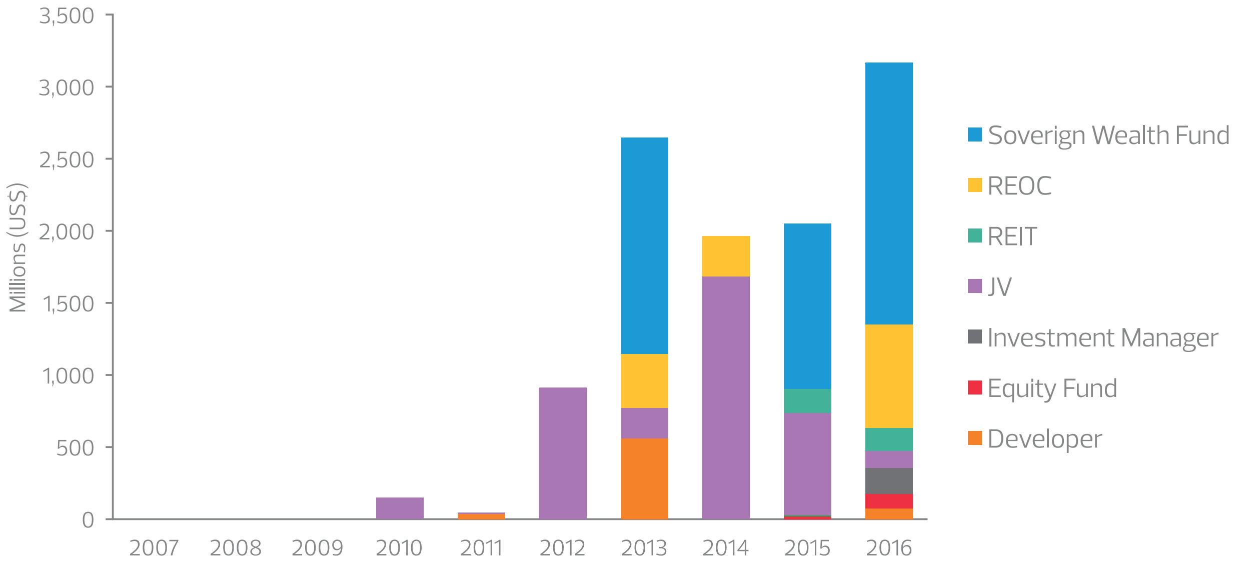
[1] Manufactured housing is a type of prefabricated housing that is largely assembled in a factory and then transported to sites of use. The requirement to have a wheeled chassis permanently attached sets "manufactured housing" apart from other types of prefabricated homes. (Source: Wikipedia)

[2] Gross domestic product based on purchasing-power-party (PPP) valuation of country GDP (Source: IMF)

[3] According to IMF's forecast, the US will continue to be ranked second worldwide in terms of gross domestic product based on purchasing power parity (PPP) valuation of country GDP from 2016 to 2021, while unemployment is projected to stabilise in the range of 4.77% to 5.06% over the same period.

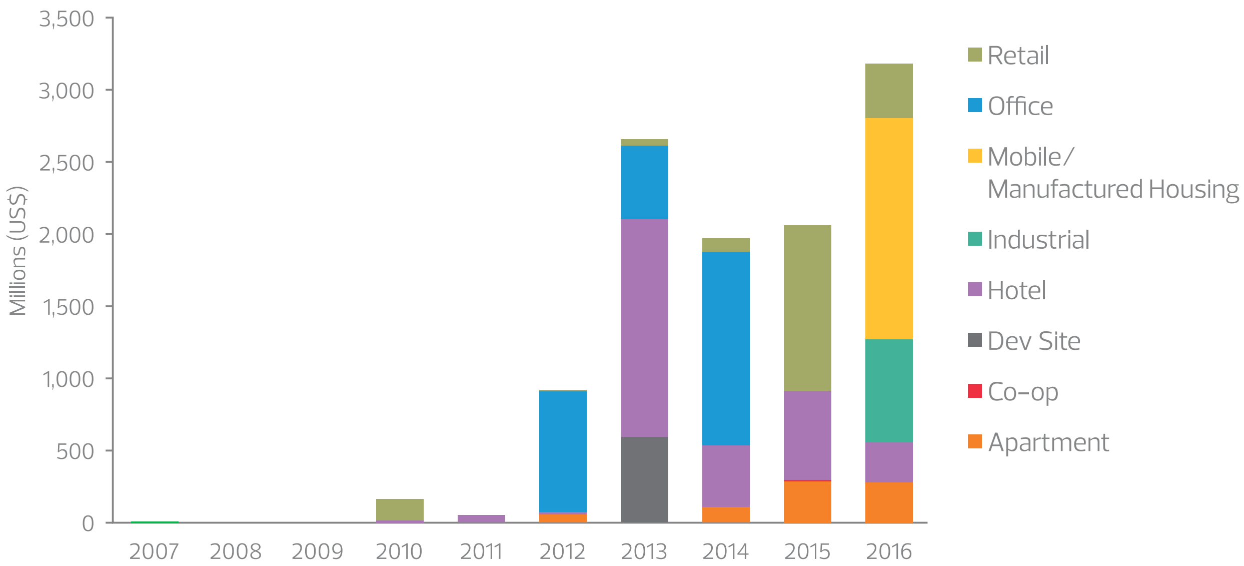
Exhibit 1: Singapore outbound investments to the US, by types of investor



Source: Real Capital Analytics, Knight Frank Singapore Research

Singapore investors' preference for asset types has changed over time as seen in Exhibit 2, with trends often led by the hunt for safe returns in prominent global cities in US states that offer quality assets. The office sector dominated the market in 2012 and 2014, with prominent transactions like 101 California and Time Warner Center respectively. The shift to hotels in 2013 can be attributed to GIC's US$1.5 billion worth of investments in hotels. Subsequently in 2015, the retail sector became the focus of attention with investments totalling US$1.1 billion when GIC purchased shopping centres located across California, Texas, Arizona and Oregon. The SWF then set its sights on the manufactured housing business in 2016 and closed the year with a deal worth US$1.5 billion in the sector.

Exhibit 2: Singapore outbound investments to the US, by types of asset



Source: Real Capital Analytics, Knight Frank Singapore Research

Appetite for US real estate continues to increase among many Singaporean and other Asian investors despite high prices, fierce competition, and even cap rate compression. In response, investors are stepping back to target new types of investments and locations. First, they were prime offices in fabulous CBD locations and industrial portfolios nationwide. Then, we witnessed a willingness to consider second-tier cities or more complex deals, such as roll-ups of logistics assets. Now, global capital is venturing even further into niche asset classes. What is obvious is that despite home country bias, the world is becoming smaller and global investors are growing more bold and comfortable with every passing year and every transaction.

EASING OF US TAX REGULATIONS HAS OPENED MORE DOORS FOR FOREIGN INVESTORS

US tax regulations can be confusing to many outsiders and the easing of tax requirements for foreign investors is certainly a relief to many Singapore and other Asian investors alike. While non-resident alien individuals and foreign corporations are still taxed on US-source income and income effectively connected with a trade or business conducted within the US, recent changes in the Foreign Investment in Real Property Tax Act (FIRPTA) have given foreign investors the much-needed push to take a leap of faith into US real estate.

FIRPTA

Under the FIRPTA, foreign and US investors pay US tax on the disposition of US real estate at the same rates; for foreign investors, tax is paid based on their effectively connected income for US real estate. Effectively, this puts foreign and local investments in the US on an equal footing.

In a sale of US real property interest, the purchaser or recipient (i.e. the transferee) is now required to withhold a tax of 15% (previously 10%) of the amount realised by the foreign seller. Nonetheless, according to amendments to the FIRPTA effective since 18 December 2015, gains realised in the disposition of real estate interests in Real Estate Investment Trusts (REITs) or public stock by foreign taxpayers are exempt from US tax under the FIRPTA if they do not exceed the ownership threshold of 10%. Definitely, the easing of US tax regulations has boosted Asian investors' confidence to invest in US real estate.

HOW CAN YOU PROTECT YOUR INVESTMENT INTEREST IN THE US?

In an uncertain economy, it is important for middle market businesses to acknowledge that the future of their assets and market focus depends on conscious strategies developed and risks assessed. Conscious awareness and application of good risk mitigation techniques will limit domestic risk and maximise return potential.

With favourable tailwinds in the US market and the position taken by the new Trump administration, global capital will continue to be drawn to US real estate. For companies and investors seeking to exploit this lucrative market, it is critical to consider the internal and external factors that affect investment (see Exhibit 3 below).

In Exhibit 3, we have also provided useful guidelines categorised based on "VUCA" — a common acronym used to describe Volatility, Uncertainty, Complexity and Ambiguity. Arguably, VUCA aptly describes the political, regulatory and economic landscape for 2017 to which businesses have to become accustomed.

Industries, economies and governments are not immune from a VUCA world and the unpredictability it brings. As this trend is expected to continue, evaluating investment risk alongside the contributors to VUCA will bring relevance to the current investment mindset.

Exhibit 3: Investment assessment framework

VUCA

Volatility

Being exposed to multiple points of risk and changes when investing in overseas real estate

Internal Constraints	
CONCERNS	**SOLUTIONS**
Lacking the right skills and capabilities *"My company does not have the right talent well versed in real estate management."*	· Form a strong core team to steer the foreign venture for the company. · Woo the right partner who can provide complementary skills for a successful venture. · As intensive labour is needed in real estate and construction, incorporate strategies and technological enhancements to increase manpower productivity.

External Constraints	
CONCERNS	**SOLUTIONS**
Restrictions of foreign jurisdiction *"I do not know how to safeguard my business interests in a foreign land."*	· Protectionist laws that favour local companies over foreign ones can be unwelcoming to foreign investors. Exercise your rights in a foreign land and safeguard your interest by working with local professionals with a track record for successfully helping foreign investors. · Appoint experienced legal personnel well versed in both home and foreign laws to conduct thorough legal due diligence and to advise on possible legal constraints in overseas operations.
Getting on the wrong cycle of real estate	· Time your entry as real estate is a cyclical industry. Investors should be cautious of overall sector trends and forecasts by monitoring indicators such as vacancy rates and rental yields in comparable asset classes or locations when investing in foreign real estate.

Exhibit 3: Investment assessment framework

VUCA

Uncertainty

Being unable to foresee how real estate investment could perform in the future

Internal Constraints

CONCERNS	SOLUTIONS
Unable to meet financing needs *"Slow collections and higher borrowing cost will affect my financial position and cash flows."*	· Regular assessments of financial position and forecasts allow understanding of the capacity to make interest payments on loans and debts. · Use instruments such as structured notes to ensure stability of cash flows. · Prepare contingency plans and buffers through gearing ratios or treasury reserves to tide you over unforeseen periods of weaker performance.

External Constraints

CONCERNS	SOLUTIONS
Uncertain macroeconomic environment *"Uncertainty is the only certainty in our current world."*	· Stay ahead of the game by reducing bureaucracy and red tape in the decision-making process, but have robust governance and accountability structures to facilitate proper business decision making. · Foster a culture which balances risk aversion and opportunity management in the organisation to be equipped to deal with a volatile macroeconomic climate. · Define clear investment strategies and goals, set distinct and measurable targets; and establish robust investment criteria to catalyse the investment making process.

Exhibit 3: Investment assessment framework

VUCA

Complexity

Being confused by various options available for overseas real estate investment

Internal Constraints

CONCERNS	SOLUTIONS
Weighing the investment approach *"My company does not know which approach is suitable."*	Direct investments — Purchase of real estate, construction and management of property Indirect investments — Taking a stake through Real Estate Investment Trusts (REITs) or securities of real estate companies

Metrics	Direct Investments	Indirect Investments
Return	Asset value appreciation	Correlates with equity market performance and industry movements
Liquidity of asset	Less liquid as sale of physical asset/ property development may be time-consuming	Publicly traded securities are market quoted and inherently liquid
Transpar-ency of investment	Limited market information available for investment decision	Investment information is publicly available

CONCERNS	SOLUTIONS
Lack of tools to evaluate investment decisions *"The viability of the investment may be myopic if it is not analysed using proper assumptions."*	· Select a suitable risk and return benchmark based on your risk appetite and tolerance. · Use a scenario and sensitive analysis to model a dynamic investment environment. · Conduct sufficient due diligence on foreign investments.

Exhibit 3: Investment assessment framework

VUCA

Complexity

Being confused by various options available for overseas real estate investment

External Constraints

CONCERNS	SOLUTIONS
Complicated tax regulations and entity structures *"The investor is required to comply with both domestic and foreign corporate and tax laws for investments."*	· Foreign tax regulations can get complex; it is wise to appoint a tax advisor who can assist you in the investment. Proper tax due diligence should be undertaken to obtain a more holistic perspective of tax costs. · Understand the different incorporation structures for overseas operations. · Consider implications on transfer pricing and profit repatriation with the given or selected corporate structure.
Mismanagement of joint venture *"What assurance does my company have that our economic interests will be protected in a joint venture?"*	· Consider how the joint venture will be structured and controlled by the respective parties. · Thorough due diligence on the joint venture partner should be performed on areas such as financial health, quality of assets, credibility of management team, legal commitments and existence and history of claims. · Incorporate considerations for dispute resolution in the agreement and understand your rights in the joint venture. · Put in place a mechanism for joint decision making at the board or subcommittee level. · Develop and build an environment of trust with your business partners.

Exhibit 3: Investment assessment framework

VUCA

Ambiguity

Being unsure and having doubt as to the viability of the real estate investment

Internal Constraints

CONCERNS	SOLUTIONS
Difficulty in aligning investment with strategy and growth *"I want to align a possible US real estate portfolio with my business investment direction."*	· Impact on profitability and growth — Provide more sources of revenue and establish brand or corporate presence in international markets. · Impact on diversification agenda — Investments in foreign real estate can diversify current business portfolios geographically and in terms of entity types. · Impact on synergy — Explore areas of cooperation between foreign real estate and current business operations. · Impact on succession plans — Building a strong business model with diversified sources of revenue creates a strong company that lasts for succeeding generations. Pioneering and managing overseas operations can also serve as good training grounds for the incoming successor. · Impact on stakeholders – Engage the board and senior management in investment decisions by objectively evaluating the proposed strategies and corporate actions against the overall strategic goals.

External Constraints

CONCERNS	SOLUTIONS
Increased competition *"Efforts to deregulate the US business environment may lead to greater competition."*	· Develop and sharpen your competitive advantage to ensure that your investment portfolio remains sustainable. · Explore cost-reduction strategies. · Continually innovate and explore new enablers through technology that can re-energise your value proposition.

CONCLUSION

Global investment in US real estate looks set to continue, despite unpredictability of the new political administration. In some circles, there have been concerns that the anti-globalisation campaign rhetoric might undermine fund flows and cross-border transactions. However, it seems to be in the best interest of international investors to see funds flowing freely and unabated to the most liquid and transparent US real estate markets. Foreign investments are expected to continue their focus on US real estate, albeit in a cautiously optimistic manner. For example, if Beijing makes good on its promise to restrict capital flows exiting China, it might impede a very active acquirer in US commercial real estate markets. But, as ever, global capital and free markets will continue to remain efficient and investments will naturally migrate to the best opportunities. It would be interesting to see which investor groups step in to fill any potential void.

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