Foreign Investment Capital – U.S. Outlook for 2016

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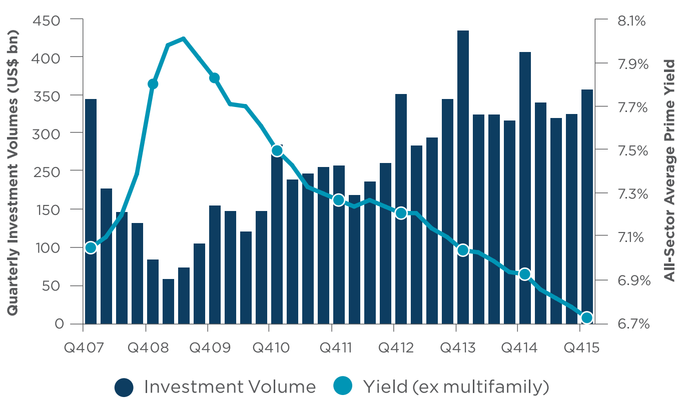
As we finish the first quarter of 2016, it's a good time to evaluate what's ahead for U.S.-bound real estate investment capital. To understand the broad trends, and the outlook for 2016 and beyond, we can use cross-border commercial property transactions data, recent surveys from important industry organizations, and opinions expressed by industry experts.

According to Cushman & Wakefield's Atlas Outlook 2016, global property trading activity fell in 2015 (for the first time in six years) by 2.4% to $1.29 trillion, although, excluding land, global volume rose 8.2%. "Insurance and pension funds increased their activity by 23% with a focus on North America and Europe, but the strongest growth was among private equity and sovereign growth funds." The report also concluded that the fastest growing source of global capital was the Middle East with an 81% increase in cross-border investments.

Exhibit 1
Global Property Investment Volumes – 2007–2015 Quarters



Source: *Atlas Outlook 2016*. Cushman & Wakefield Capital Markets Research Publication

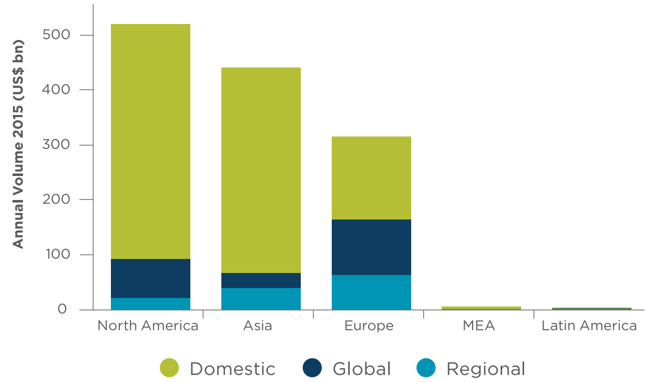
In a similar vein, CBRE's *2016 Global Real Estate Market Outlook* indicates that "global commercial real estate activity will remain robust (in 2016), but the pace of growth will slow after [past] six years of recovery and expansion…" as indicated by the global investment turnover in H1 2015 which was nearly five times above the H1 2009. The report attributes this growth to excess global savings, low bond yields and under allocation of real estate in Asia. Furthermore, JLL's *Global Market Perspective, Q1 2016* indicates that the market has recovered as U.S. 2015 transaction volume at $765 billion surpassed the pre-recession peak of $758 billion in 2007.

U.S. Capital Inflows

If we focus on the U.S. property market, historically, 80% of the cross-border capital inflow emanates from Europe, Canada and Japan. However, in recent years, and particularly after the growth of investment from oil-exporting countries, the makeup of cross-border investor groups has changed, with increasing participation by sovereign wealth funds and countries with surplus savings, such as China, Singapore and UAE.

The largest source of global capital inflows during the past five years, in decreasing order of importance, comes from Canada, China, Singapore and Norway, while the largest drop in investment is from Australia, Germany and UAE.

Exhibit 2
Targets of Global Capital – 2015



Source: Atlas Outlook 2016. Cushman & Wakefield Capital Markets Research Publication

According to Real Capital Analytics (RCA), a commercial property data and analytics firm, the cross-border investment in the U.S. real estate market totaled $78.4 billion in 2015, or a little over 16% of the total $483 billion invested. Canada remained the number one buyer, followed by Norway. Nearly 20% of volume was in six major U.S. gateway cities, 13% in secondary markets (Dallas, Atlanta and Seattle) and 10% in tertiary markets.

Investment Rationale and Top Global Investors

According to *Atlas Outlook 2016*, investment flow into the U.S. may be better in 2016 due to low global interest rates and the relative strength of the U.S. economy, currency and property markets. Canadian and global funds doubled cross-border spending in the U.S. and took a 28% market share of transactions in 2015 (*Atlas Outlook 2016*), a 70% increase in cross-border investment from 2014. This increase was largely due to investments from China, Singapore, Norway, Canada, Switzerland and Germany. As a result, the market share of the overseas investors increased from 10% to 18.1% by 2015 (the highest on record).

The Counselors of Real Estate's online magazine in a recent article titled "The CRE 2015-16 Top Ten Issues Affecting Real Estate" states, "Funds continue to flow from outside the U.S. to purchase U.S. real estate. The supply is driven by economies that have high savings rates, a shortage of mature financial markets and few safe assets." Also, according to *Urban Land*, the magazine of the Urban Land Institute, "Global economic and political uncertainty continues to drive capital to a "safe haven" in the United States. The U.S. property market is the most stable and transparent in the world, making it an easy investment choice."

This sentiment is further supported by the Association of Foreign Investors in Real Estate (AFIRE), whose survey shows that multifamily and industrial are the preferred property types. Investment in retail, office and hotel properties are other sectors of interest, in order of preference.

Based on data provided by RCA, the following Tables summarize total investments in millions of dollars in the U.S. commercial property market in the past 5-year and 10-year periods, respectively, beginning in Q1 2006 and ending in Q4 2015, for transactions of $5.0 million and above, by individuals, portfolio investors and pension fund entities.

Exhibit 3
Top Countries of Origin

Country	Total Props	Total Volume
Canada	3,055	$73,919.1
China	341	$22,173.3
Singapore	911	$20,283.1
Germany	272	$16,257.4
Norway	323	$14,804.6
Switzerland	280	$12,302.3
South Korea	96	$8,719.1
Israel	288	$8,262.3
Japan	166	$8,068.3
Other	1,891	$59,602.5
Total	7,623	$244,391.8

Source: RCA

In the most recent 5-year period (Table above), China, Singapore and Norway have increased their U.S. real estate holdings tremendously (from an aggregate of $2.1 billion in the 2006-2010 period to $57.3 billion), followed by Canada, Switzerland and Germany (from an aggregate of $41.9 billion in the 2006-2010 period to $102.5 billion). Also, Japan and South Korea have replaced Australia and UAE as two of the prominent global investors in the U.S. from the previous five years (Table below).

Exhibit 4
Top Countries of Origin

Country	Total Props	Total Volume
Canada	4,093	$101,377.2
Australia	1,434	$27,336.1
Germany	470	$26,169.2
China	377	$23,113.7
Singapore	936	$21,008.0
UAE	413	$20,067.0
Switzerland	401	$17,156.5
Norway	336	$15,190.3
Israel	409	$14,543.6
Other	2,670	$95,978.8
Total	11,539	$361,940.4

Source: RCA

It is noted that the average value per transaction has remained similar over both 5-year spans ($32.66 million) and ($31.37 million).

Favorite Sectors for U.S. Real Estate Investment

From 2005 to 2014, industrial and multifamily were the favorite sectors among global investors, followed by hospitality, retail and office (RCA).

Yet from Q1-2011 to Q4-2015, the new favorites are office, $88.24 billion; multifamily, $41.55 billion; industrial, $36.59 billion; hospitality, $31.13 billion; and retail, $27.82 billion. During the past five years, the favorite destination for these investments were Manhattan, Los Angeles, Boston, Chicago, Dallas, D.C., San Francisco, Houston and Seattle. This is largely true for the previous five year period beginning Q1-2006 and ending in Q4-2011, though Seattle has replaced Atlanta.

Total investment in the industrial sector in the past ten years was $42.11 billion, of which $36.59 billion is attributable to the most recent five years. This indicates that the growth in this sector was one of the fastest and perhaps more strategic with high demand for logistics space, as retailers and distributors adjust to the continued customer demand for more rapid delivery. The compound annual growth rate (CAGR) in this sector was 45.98%.

The multifamily sector is one of the most popular among foreign investors. The investment in this sector was $41.55 billion from 2006 to 2011, and $53.89 billion in the past ten years which translates into a CAGR of 27.46% in the past five years.

The hotel sector also has been quite popular among foreign investors. The total investment in this sector from 2006 to 2015 is $42.38 billion. The investment just in the last five years alone has been $31.13 billion indicating that the investment in this sector grew from a mere $11.25 billion at the end of 2010, at a CAGR of 22.58%. This is particularly noted in the context of more or less stagnant Chinese investment in the sector in the past five years at around $10.5 billion, which is likely to change in 2016 due to increased and seemingly large scale inflows into this sector from Chinese investors.

Online shopping has been gaining ground and retail store sizes are shrinking. Since January 2011, foreigners have invested $27.82 billion in this sector. The total investment over the past ten years is $53.19 billion, representing a CAGR of 13.84% during the recent 5-year period.

A total of $143.25 billion has been invested by global investors in office properties since 2006 of which $88.24 billion took place just in the last five years, at a CAGR of 9.91%.

Search for Better Returns

The Fed pushed up the federal funds rate by a quarter point in December 2015 while acknowledging the fact that U.S. economic growth was stable and in the right direction towards lower unemployment rate (below 5.0% as of Feb. 2016) and inflation was much under the target level of 2.00 percent. U.S. capital markets seem to have absorbed the interest rate hike of .25% during the anticipatory period and should do the same with additional slow increases in the coming years. In contrast, with the negative interest rate scenarios in Japan and the Eurozone, one can expect foreign investors to do their math and consider increased cross-border investing in the U.S. market.

Challenging Influences

There are many factors that continue to influence and affect cross-border investing and the flow of capital into the U.S. market in 2016 and beyond. A select few are stated below:

- Low commodity prices are expected to continue creating a drag on surplus investable capital from many countries dependent on such exports. However, according to CBRE Research, "the world economy will still have a very substantial "glut" of savings, and the oil producers only account for around 40% of this."

- Monetary policies, reform agendas, political developments and election outcomes in a number of countries will affect the investment atmosphere in the coming months.

- Bold economic measures in some countries, including QE as market support in Eurozone, may actually free up capital for cross-border investment in the U.S.

- Lending in the U.S. is contracting as banks are getting more cautious by applying tighter underwriting standards. Market and price contraction is already being noticed at the high end of the residential market which also seems to have an excess supply.

Mixed Environment

Overall, global investment flow into the U.S. market is expected to remain fairly stable, mainly attracted by the U.S. real estate market fundamentals, which are expected to stay solid.

There are mixed opinions about the yields due to uncertainty about the Fed's decision on short-term interest rates. Increase in interest rates will put upward pressure on 10-year US Treasuries and required yields in commercial real estate; however, competition from investors for quality assets is expected to keep the yields mostly in the range they have been in the past few quarters.

Atlas Outlook 2016 argues that persisting lower oil prices will bring changes in the investment policies of some of the Middle Eastern buyers, which may include lesser demand and divestment of existing asset. This is borne out by other industry leaders: CBRE points out that the depressed commodity prices has created a low cash flow into these countries and consequently there will be a low level of recycled capital outflows in 2016.

China's economic slowdown is considered positive for global investing as smart capital moves out of the country looking for long-term stability, better returns and just parking for the short-term. Chinese buyers spent $8.6 billion in U.S. commercial real estate in 2015, more than four times the amount spent in 2014. China is expected to further liberalize its capital account, thus giving additional impetus to outflow of capital from China. Additionally, with their negative interest rate environments, Japanese and European investors are likely to increase their overseas investments to diversify and boost investment yields. A substantial chunk of all this money is likely to go into real estate acquisitions in the U.S.

The growth of global investments in the U.S. in 2016 is also expected to be boosted by the reforms to FIRPTA (Foreign Investment in Real Estate Property Act of 1980), which allows foreign pension funds to invest through any structure and exempts them from the 35% withholding tax on proceeds of real estate dispositions, thus providing incentives to buy as much as 10 percent of a U.S. publicly-traded real estate investment trust, up from the previously set position of 5 percent.

2016 and Beyond

2016 and beyond cannot be looked at in isolation from the past or the recent capital market trends. "The Big Picture, Overview Across All Property Types", published in March 2016 by RCA, states that as real estate financing terms have been changing in the past few months due to various factors, the year-over-year deal volume in the U.S. fell 46% in February, 2016 on sales of $25.5 billion; further, year-over-year single asset sales were down 26% on sales of $18.8 billion with strongest year-over-year decline seen in the industrial (78%) and hotel (73%) sectors.

Going by these indicators, it is debatable whether the U.S. real estate market is on the verge of a severe downturn or ripe for a correction. However, it is likely that the market is absorbing various global market pressures of the past few months, including commodity prices and monetary and regulatory policy measures, leading to a periodic review of investment portfolios by market players.

"In the increasingly unstable global eco-political atmosphere, foreign investors will seek more certainty on returns and reallocate saving surpluses to seek U.S. growth opportunities."

We have to keep in mind the positives of the U.S. economy: 2.7 million non-farm jobs were created in the U.S. last year; the cumulative increase in employment since the trough of early 2010 is more than 13 million jobs; and the unemployment rate has dropped to 4.9% in February 2016.

CBRE Research indicates that we should expect the real estate environment to remain positive in 2016, with a moderate yield compression as investors do have a large amount of capital to deploy. *Atlas Outlook 2016* concludes that there would be a 4.2% rise in real estate trading volumes in the U.S. as global uncertainty will boost demand from some quarters coupled with strong supply of debt in the U.S. capital market.

It's also helpful to keep in mind that while all investments involve a risk-return trade-off, cross-border investments have additional risk-return dimensions such as fluctuations in currency exchange rates, significant and often uncertain socio-economic and political situations, and unattractive tax environments. Real estate investments are less liquid than traditional investments and investors would be wise to consider longer investment horizons beyond 2016.

The 2016 international investment outlook for the U.S. market is aptly summarized by James A. Fetgatter, CEO of AFIRE: "The investment opportunity is the United States itself. The real estate fundamentals are sound; the economy remains strong; there are opportunities across all sectors of the real estate spectrum and in both gateway and secondary cities. The recent legislation bringing welcome relief from certain FIRPTA taxes should provide additional incentives for foreign investment into the US. In an environment that is regarded both as the safest and most secure in the world, with a strong currency and the best opportunity for capital appreciation, the US is the safest harbor."

In the increasingly unstable global eco-political atmosphere, foreign investors will seek more certainty on returns and reallocate saving surpluses to seek U.S. growth opportunities. ■

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