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## HOT TOPICS—

ANSWERS TO CURRENT BUSINESS ISSUES

**GLOBAL CAPITAL FLOWS:  
HOW THEY AFFECT YOUR BUSINESS**

COMMERCIAL  
Real Estate



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## GLOBAL CAPITAL FLOWS: HOW THEY AFFECT YOUR BUSINESS

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Global capital loves real estate. According to Jones Lang LaSalle, there are \$5 of investment capital for every \$1 of commercial real estate product. While improving supply and demand fundamentals have increased commercial property cash flows in many markets, it's been the enormous amounts of equity capital and affordable debt that have enabled eager investors to snap up properties worldwide at seemingly ever-rising prices.

While the heady movement of capital from Dubai to Frankfurt may seem far removed from the day-to-day concerns of the commercial broker or manager, more money available means better interest rates for borrowers and higher commissions for commercial brokers. The globalization of capital markets and real estate's growing role as a global asset class have altered where the money you and your investment clients borrow comes from and how much it costs.

### **What factors have contributed to the current high level of global capital?**

In a recent study, *Global Real Estate Capital: Moving Further and Faster*, Jones Lang LaSalle research determined that global direct investment in real estate (excluding multifamily) reached \$682 billion in 2006, an increase of 38 percent over 2005. Globalization of real estate continued apace with 42 percent of investment value involving a cross-border transaction. With residential and entity-level deals included, total worldwide real estate investment volume reached \$900 billion, according to JLL. U.S. cities that have benefited most from the international capital flows include Manhattan, Washington, and Chicago. Only Los Angeles saw a decline in 2006 activity.

A variety of factors have given rise to this phenomenon. Commercial real estate's consistently strong and steady performance since the beginning of the decade has attracted investors put off by the volatility of the stock market, says Steve Collins, managing director, International Capital Group, Jones Lang LaSalle. "Stocks go up and down, while commercial real estate has seen just a steady tick, tick, tick up," he says. The added transparency of real estate markets as a result of securitization has given both

public and private investors at every level more confidence and has also been a contributing factor to rising capital flows, he says. A new wave of syndications—often in the form of tenant-in-common interest funds and private pools for high-net-worth investors are also adding their share to the flood of capital. Capital also comes from hedge funds placing money for both pension funds and high-net-worth individuals, notes Ed Wlodarczyk, senior vice president at Transwestern in Chicago. "Many fund managers are seeing real estate allocations from many of their clients increase by 15 to 20 percent," he adds.

Demographic factors, such as aging Boomers trying to save or invest their inheritances and pension funds and insurance companies trying to grow the funds they'll need to float Boomer retirements are also adding to the worldwide river of capital, says Jon Southard, senior vice president and director of debt management and valuation at Torto Wheaton Research, owned by CB Richard Ellis. The steady income from real estate—especially as fundamentals are improving—combined with the possibility of an upside makes real estate a perfect match for those needs. "Real estate is in the right place at the right time," says Southard.

Global investors' need for diversification is the No. 1 reason commercial real estate is currently so attractive to many global investors, says Dennis Yeskey, national director of real estate capital markets at Deloitte. Stability of earnings and relative yields are also parts of the attraction, but "diversification is key. Why else would investors buy in London at a two cap rate?" he asks.

### **Where has all this global capital buying commercial real estate come from?**

In part, more capital for commercial real estate is simply a byproduct of a global capital glut. The creation of the euro has simplified currency exchange concerns in Western Europe and contributed to the expansion of corporate bond issuances in the zone, says Dr. Jay Bryson, global economist for Wachovia Economic Group. Participation in the global capital arena by India and other Pacific Rim countries with current account surpluses has also opened up previously untapped capital sources for

worldwide investment. Savers from other countries, such as Australia, often look abroad to find a sufficient scale for investment. Japanese investors, who sat on the sidelines for a decade, are once again beginning to seek global investment options, suggests Dr. Ron Donohue, CRE, director of research for Hoyt Advisors.

“Even if global funds are invested in Treasuries or commercial mortgage-backed securities instead of directly in real estate, commercial real estate benefits,” Bryson says. Strong demand for these other types of securities can—and has—pushed yields down, making real estate a more attractive alternative for investors, he adds.

The falling U.S. dollar will also provide an opportunity for offshore investors to purchase in the U.S., notes Dr. Steve Laposa, director of global real estate research for PricewaterhouseCoopers. He notes, however, that while currency fluctuations and differences in country interest rates have an impact, they can’t explain all the flows of capital from one part of the world to another.

The increased securitization of real estate has been another major factor in the tremendous amount of money available for real estate investment, both in the U.S. and abroad. Issuances remain strong worldwide, growing 28 percent in the U.S. and 22 percent abroad in the first-quarter of 2007 over the same period the previous year, according to *Commercial Mortgage Alert*.

The newest twist in the commercial real estate debt arena that’s adding funds to the fire is the collateralized debt obligation, says Southard. These instruments, which can combine a variety of debt income streams from CMBS, REIT debt, and some types of direct loans, offer more flexibility than traditional CMBS. Unlike CMBS, CDOs sometimes permit investors to reinvest capital that is paid back. This shorter time horizon for recovering monies makes CDO a potentially new capital source for construction and value-added investment, says Southard.

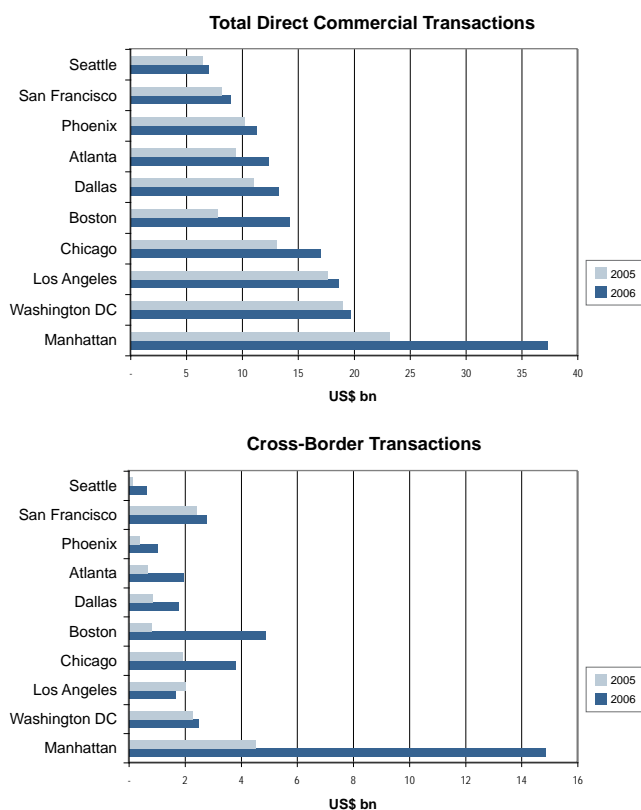
REITs, both in the U.S. and now increasingly in other countries such as Australia, Japan, the United Kingdom, and France, have also contributed to real estate’s attractiveness to capital at both the institutional and the individual investor levels. In March 2007, the average

Figure 1: Global flows to commercial real estate (in billions)

	2005	2006
<b>Total transactions</b>	\$495	\$682
<b>Cross-border (%)</b>	\$166 (34%)	\$288 (42%)
<b>Interregional (%)</b>	\$115 (23%)	\$201 (29%)

Source: Jones Lang LaSalle (from sources including Property Data (UK), KTI (Finland), and Real Capital Analytics (USA))

Figure 2: U.S. Cross-border and interregional capital flows



Source: Jones Lang LaSalle

daily dollar trading volume for U.S. REITs was \$4.2 billion, according to the FTSE NAREIT All REIT Index, while global REIT market caps reached \$932 billion.

### How are investments in non-U.S. commercial real estate faring?

While foreign investors have been purchasing real estate in the U.S. for decades and U.S. buyers have been looking abroad for similar periods, the volume of transactions

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has grown significantly in the last few years. According to a recent report from Jones, Lang, LaSalle, Germany has been particularly active because of a high number of willing sellers in the country. And like the U.S., Europe and parts of Asia are experiencing a seemingly endless flow of investment capital looking for commercial real estate.

In addition, investors who a decade ago limited their purchases primarily to Western Europe and the United States are now looking farther afield to Russia, Latin America, India, and Eastern Europe. On the buy side, Middle Eastern investors have joined Australians and U.S. funds as big global real estate buyers in the last year. While the flows of capital to some of these riskier, higher return locations are small compared to investments in stabilized large cities, the growth of emerging market investments clearly demonstrates the ongoing globalization of real estate, says Yeskey. Investment in China may be cooling somewhat, he adds, as concerns surface about the lack of a legal system to protect investment.

According to *Emerging Trends in Real Estate® Europe 2007*, published by PricewaterhouseCoopers and the Urban Land Institute, most European investors believe that they have neared the peak of the investment cycle and expect relatively calm markets in '07 with capital flows dropping slightly to \$6.29 billion. The same survey found investors anticipating only single-digit returns this year, despite a projected 4.2 percent GDP growth in Western Europe.

### **How has this capital availability affected the price of real estate in the U.S and elsewhere?**

Cap rate compression, fueled by strong investor appetite and widely available capital for investment, has dropped U.S. cap rates to long-time lows for many property types. Writing in a Feb. 2006 issue of *Urban Land*, Bowen McCoy, CRE, noted that an estimated 75 percent of the value increases in core properties since the beginning of the decade could be attributed to cap rate compression rather than NOI. The risk, said McCoy, is that if interest rates do rise, returns on real estate could turn negative and most capital would evaporate.

In *Further, Faster*, Jones Lang LaSalle noted that as much as 50 percent of the 38 percent growth in global

commercial real estate transactions between 2005 and 2006 was the result of cap rate compression. The report estimates that cap rates fell 50 basis points in North America, 65 basis points in Europe, and almost 100 basis points in the Asia/Pacific area over the period.

Global capital factors are also contributing to rate compression. Cap rates for real estate are increasingly influenced by yields on other types of investments, both in the U.S. and abroad, says Yeskey. "We truly have a new paradigm in which the returns on all assets are blending."

Cross-border cap rates are beginning to flatten out, with even higher risk countries such as Russia experiencing cap rate compression, notes Laposa. Brazil, which has an educated workforce and has taken a hit from currency devaluation, could become the next hot market, he says. Other attractive fund options include Russia and Argentina. Dubai's emergence as a financial center is also prompting significant commercial development.

Still, if lower cap rates are becoming more of an accepted norm, some have been dipping dangerously close to what Yeskey calls "the red zone," within 150 basis points of 10-year Treasuries. At those levels, the risk-adjusted returns may no longer attract investors, he says.

Cap rates have begun to flatten in many markets and may even see some increases in multifamily and retail, says Wlodarczyk. Within a couple of years, you may see price slippage in tired Class A and Class B space unless properties are renovated and effectively managed, he says. And like Yeskey, he's concerned about returned falling too low for investors' appetites.

Marginal increases in value have slowed down overall, however, and owners are not likely to get the same price increases they've seen recently, agrees Laposa. At the same time, he notes, fundamentals both in terms of rents and occupancies are improving in most markets.

"People are still a little nervous, but most properties are fairly priced today, as opposed to being underpriced as it was in the 1990s," says Robert Bach, senior vice president, Grubb & Ellis.

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For now, owners who bought at high prices may face some real challenges in increasing future value says Wlodarczyk. In order to raise rents significantly enough to justify purchase costs, owners will need real estate practitioners able to find effective ways to increase value. Yet, it remains to be seen whether such standard practices as improving finishes will be enough to justify the rate hikes, he says.

Reducing expenses will also become a bigger part of the equation to re-fabricate value, says Wlodarczyk. For example, he notes, some property owners are reassessing a higher portion of common area space as rental square footage. “Most tenants do not take the time to measure their space and may not notice the difference.”

The search for yields has also paid dividends for brokers and owners in smaller markets, as both foreign and larger domestic investors looked beyond first-tier cities and trophy properties in search of returns, says Collins.

### **How have lending practices for commercial real estate affected capital availability and costs?**

Because much of the emphasis on current capital availabilities has focused on equity, the impact of widely available, affordable debt on the expansion in commercial real estate investment has been overlooked to a great degree, says Yeskey. Mortgage rates remain low—around 6 percent for five-year fixed loans on most commercial property types—continuing to make debt affordable.

But both debt service coverage ratios and underwriting quality have begun to deteriorate, according to Deloitte’s *2006 Real Estate Capital Markets Industry Fall Update*. “We’ve been tracking the decline for three years and while the change is not ringing alarm bells, it is a cause for concern,” says Yeskey. He notes that debt service ratios, which typically range in the 1.4 to 1.3 range are inching down to 1.25. The expansion of CMBS, CDOs, and other derivatives is also edging up real estate’s debt load. In early 2006, McCoy predicted that interest rates in the 6 percent range would also pose a threat for loans with negative amortization unless property cash flows strengthened.

Lenders are already becoming a little more cautious because they fear that the commercial real estate market

is overheated, says Chris Cole, regulatory counsel for the Independent Community Bankers of America.

“Clearly there’s a growing concern amount rating agencies over underwriting, in CMBS, particularly in conduits, says David Farrell, CRE, senior vice president and managing director, NorthMarq Capital Inc. He cites a March 2007 announcement by rating agency Moody’s that increased the suborigination levels for conduits. This move will squeeze profits for securities lenders, which will probably increase spreads to offset these losses, he predicts. CMBS spreads have been widening at all risk levels, according to *Commercial Mortgage Alert*.

Yeskey also points to the privatization of REITs as another source of commercial real estate’s growing debt burden. “What’s the first thing a private buyer does when it purchases a REIT portfolio? Leverage it up,” he says. Since REITs are generally restrained by rating agency pressures to carry no more than 40 percent to 45 percent debt, leveraging privatized portfolios to a more standard 70 percent to 80 percent leverage brings more capital into play.

### **How could proposed Federal Commerce Commission commercial lending regulations and the new Basel Accords affect the availability of global capital for real estate?**

Because banks are a highly regulated industry, changes in federal regulations can significantly impact capital availabilities. The Federal Reserve and other federal bank regulators are currently proposing some changes to banking requirements that could adversely affect lending to commercial real estate.

One such set of standards is those proposed by the Basel Committee on Banking Supervision. This group, which consists of representatives from central banks and regulatory authorities of major European and North American economies, makes recommendations on how much capital financial institutions should retain to protect themselves from losses.

Currently, the Federal Reserve is reviewing two new Basel standards. The mandatory Basel II standard, which would apply to only the 10 to 20 largest banks, attempts

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to align bank capital to risk through the application of complex formulas and each bank's historical data on loan performance and losses. The other standard, called Basel I-A, proposes a new, optional capital standard for the rest of the banking industry.

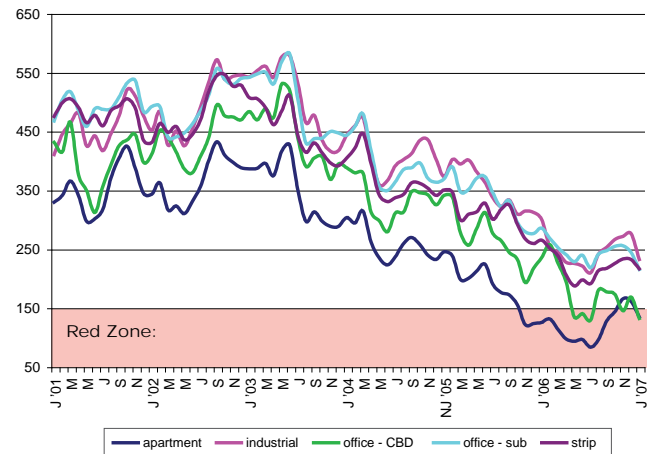
Basel I-A is optional, but will probably be adopted by banks that compete in markets with the largest lenders, says Cole. Banks in other markets may be less likely to use the standard, he says. Under Basel I-A, unless a commercial exposure has a credit rating (for example, a rated bond), almost all commercial loans are given the same risk rating.

NAR's comment letters on Basel I-A point out that real estate loans on all types of real estate property have varying risk profiles and those with lower risk should receive more favorable capital treatment.

While most banks want some type of standardized approach to capital reserves, U.S. banks are concerned that the version of Basel supported by the Federal Reserve will put them at a competitive disadvantage internationally, says Cole.

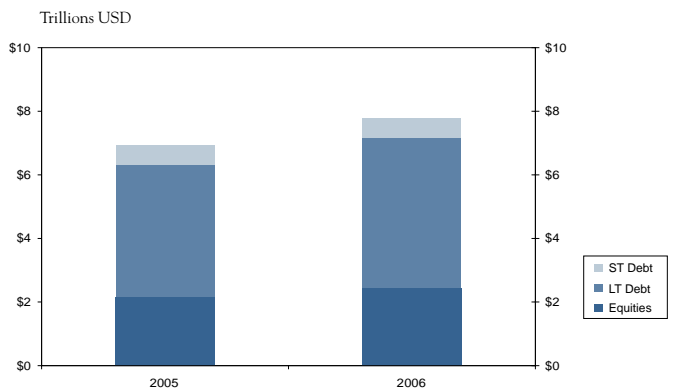
A second potential hurdle for commercial borrowers is a set of new nonbinding commercial lending guidelines from the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, released on December 6, 2006. As initially proposed, these guidelines would have required banks making loans on commercial real estate to hold a higher level of capital reserves than would be necessary for many other types of commercial loans. Thanks to efforts by NAR and other trade groups, a revised proposal would not require most lenders to raise their capital reserves for loans on commercial real estate, a key issue, says Cole. However, the final guidelines include a new section to give banks guidance on assessing risk. While the agencies are explicit that the guidelines do not set limits on bank commercial lending activity, the guidelines do include concentration thresholds to aid examiners in assessing potential risk. This may have a cooling effect on lending to commercial real estate, says Cole.

Figure 3: Average Cap Rates—Spreads to Treasury



Source: Deloitte, based on data from Real Capital Analytics

Figure 4: Foreign Holdings of U.S. Securities



Source U.S. Department of the Treasury and Wachovia Corporation

Reductions in debt capital may seem less important when equity capital is plentiful, but could have a more pronounced impact as money flows ebb. According to *Emerging Trends in Real Estate® 2007*, public and private debt capital accounts for approximately 75 percent—or \$3,200 billion—of all capital funding U.S. commercial real estate. Banks remain the principal private source of debt, accounting for approximately \$1,793 billion in 2006.

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At the same time, says Yeskey, regulators have an obligation to look at underwriting and debt coverage to ensure that the strong real estate market remains healthy. Although securitization and abundant capital have kept commercial real estate loan foreclosures low, no one wants another repeat of the late 1980s.

### **What impact would any changes in capital flows have on U.S. commercial real estate?**

Net investment in U.S. real estate has already slowed, according to “Expectations and Global Realities in Real Estate 2007,” a report from Torto Wheaton Research, Real Estate Research Corp., and Principal Real Estate Investors.

While U.S. interest rates seem steady for now, central banks in Europe and Japan are already tightening rates, says Bryson. These higher interest rates may attract some investors away from U.S. securities—reducing overall available capital. Net investment in U.S. securities, bonds, and equities fell slightly between late 2005 and 2006 and could also slow general economic growth, affecting demand for commercial real estate.

Europe will also benefit from strong economic growth and rising rental rates, predicts the Jones Lang LaSalle report. The report also predicts that the Asia/Pacific market, after growing investments by 42 percent between 2005 and 2006 will continue strong.

When U.S. interest rates rise, as most experts expect eventually, it could reduce the amount of money available to real estate, but interest rates would need to move “substantially” before U.S. commercial real estate would suffer any real ill effects, says Collins. Problems in the subprime residential market may also cool commercial lending even though there’s no direct relationship.

The rollover of many 10-year commercial loans in the next year or two will also increase demands for capital, as owners seek to refinance, says Farrell. He also expects to see more aggressive lending in the affordable housing and low-income-tax-credit areas.

Capital flows to U.S. commercial real estate could be disrupted by that most basic of problems, an imbalance

between supply and demand, says Donohue. If job growth declines or if commercial real estate gets significantly overbuilt, some capital could take these signs of weakness as a reason to invest elsewhere, he says.

“When you start seeing free rent and concessions as a part of lease underwriting for purchasing an asset, trouble is on the way,” concurs Collins. Anything that disrupts cash flows could trickle down to hurt overall capital availability, he says.

The intrinsically cyclical nature of commercial real estate and capital availability may also lessen monies available for commercial real estate. Such a shift, last seen in the mid-1990s, could lead some of the recently privatized companies and REITs to turn once again to the public capital markets. Portions of recent REIT privatizations have already been sold off to other REITs and returned to the public markets, notes Laposa.

All told, there’s every expectation that commercial real estate will continue to see strong flows of capital for years to come. Any slacking in leveraged buyers if interest rates rise will be picked up by pension funds and global investors, predicts “Emerging Trends.” Approximately 40 percent of investors surveyed by Grubb & Ellis in fall 2006 anticipate between one and three more years for good commercial real estate prices.

What will be different is the increasing difficulty of getting a deal done, says Wlodarczyk. Buyers are becoming more selective and are focusing more on off-market deals to avoid bidding wars. This shift places a greater emphasis on cultivating relationships and keeping a keen eye on the market on a constant basis. “Strategic client relationships and robust communication are keys to success,” he says.

### **Learn More**

Listen for more on global capital markets in the third-quarter *T&I Briefing*, when RCA interviews Dr. Glen Mueller, a noted researcher on this topic. The T&I Briefing CD will be mailed with the Summer 2007 RCA Report.

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