GLOBAL PROPERTY INVESTMENT

STRATEGIES, STRUCTURES, DECISIONS

ANDREW BAUM
AND DAVID HARTZELL
Global Property Investment
To our wives and children

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- PowerPoint slides to accompany chapters and case studies
- Spreadsheet materials to help to better understand text examples
- Selected papers on relevant topics
- Additional case studies with spreadsheet solutions
Global Property Investment
Strategies, Structures, Decisions

Andrew Baum
Professor of Land Management
University of Reading

and

David Hartzell
Professor of Finance and Real Estate
Director, Center for Real Estate Development
University of North Carolina – Chapel Hill
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A book about global property investment is rare, and a good one is, frankly, difficult to write. Which countries should be referred to? Can we extrapolate from the small number of markets we are familiar with? If so, how much generalization is reasonable, fair or justified? How big is the language barrier? Are the same concepts familiar to real estate investors in all markets, even though they may have different labels?

You may have guessed that by writing this book the authors believe that these difficulties can be overcome and the questions answered in the positive, to some extent at least. Happily, increasing globalization allows some generalization from a limited base knowledge of global markets. We would ideally have shared the load with a third author from Asia, but given one US author with a keen interest in other markets, and one from the UK with a professional focus on international investing, we feel fortunately qualified.

First, we have been lucky to have worked together enough to know how to jump over or run through the language barrier. Second, we work in the most liquid and transparent markets: the most widely accepted real estate transparency index (Jones Lang LaSalle, 2010) ranks, largely on the grounds of information availability, the UK and the US in the top group of all global markets. Third, the longest, most detailed and heavily analysed datasets describing real estate performance in the modern era exist in the UK and the US. The book is the result of the authors’ varied experience of applied property research, property fund management, international property investment and academic research in these two leading markets but also their work elsewhere, including the Asian, Australian, European and developing markets.

The subject matter can be described broadly as institutional investment in real estate, and the foundation is an international and capital markets context viewed from the perspective of property investment and finance.
professionals. The objective of this book is to provide insights that will help global real estate investors of all types make more informed decisions.

Investors in real estate can take many different forms. At one end of the investor spectrum are individual investors hoping to increase their wealth by buying and holding investment property. By holding direct investments in buildings, they hope to earn income from rents and from selling the asset at the end of a holding period for more than they paid for it.

At the other end of the spectrum are institutional investors like sovereign-wealth funds, life insurance companies and pension funds that may hold large portfolios of individual properties, or shares in partnerships or funds, or publicly-traded securities secured on real estate.

At either end of the spectrum, or anywhere in between, investors should be aware of four different aspects of real estate investment, which represent the four parts of this book.

**Part One: Real estate as an investment: an introduction**

First, there is a context and a history for real estate investing around the globe. How does real estate compare to other asset classes, and how has it performed over time? What basic economics and finance theories help us to understand this context?

Real estate, usually seen as an excellent but illiquid diversifier (see Chapter 1), has been a part of investor portfolios for most of the twentieth and twenty-first centuries. Since the 1970s, real estate has become more accessible for a broader cross-section of the investing universe. Through vehicles such as Real Estate Investment Trusts (REITs), individual investors have greater access to real estate investments. In addition, the development of real estate partnerships and other ownership forms has also led to more availability for investors. Further, regulations have also created an incentive for institutional investors to expand the amount of money that they invest in real estate; pension funds, life insurance companies and high net worth individuals have all increased their allocations to real estate. Since the 1970s, these investors have both made and lost a great deal of wealth depending upon when they placed their money into the real estate asset class and where that money was invested. Understanding their motivation for investing in real estate is critical to developing an investor mindset.

An important aspect of real estate markets, and investment in them, is cyclical (see Chapter 2). In the US since the 1970s, three complete cycles have run their course. Similar cycles have been demonstrated around the world in the UK, Europe and in Asia Pacific. Generally, prices of real estate assets reach high levels due to strong interest by investors; prices paid as the cycle takes an upswing are unrelated to the underlying supply and demand for space in the local market where tenants lease space; and when
the underlying demand and supply fundamentals deteriorate in the local market, prices must adjust downward.

The US real estate market has experienced three distinct cycles since the 1960s, and each was caused by similar occurrences. Some subsets of investors or lenders miscalculated the risk of owning real estate, and bought property for prices that in retrospect were too high. Once the market corrected to more accurately reflect the risk, prices fell dramatically and large amounts of individual and institutional wealth were destroyed. This happened in the US in the 1970s, again in the 1980s and early 1990s, and most recently in the latter part of the first decade of the twenty-first century. Similar cyclicality was experienced at different times and for slightly different reasons around the world. To deal with the inevitable cyclicality in future real estate markets, we need to understand the economics of rent (see Chapter 3) and the finance-based theories of asset pricing (see Chapter 4). We have to be able to answer this question: what is a fair price for real estate?

Part Two: Making investment decisions at the property level

Few, if any, of the investors who bought property as a wealth enhancing asset during the upside of the last cycle anticipated that their assets would lose value and that they would suffer a loss in wealth due to the investment. It is more likely that they expected to earn income and to have the value of the property appreciate during their holding period. However, due to a misunderstanding of the characteristics of real estate investment, some of these investors were sorely disappointed in their experience.

There are numerous techniques used to evaluate real estate investments, ranging from simple back-of-the-envelope heuristics to complex and dynamic valuation models using discounted cash flow analysis and real options. What has clearly changed in the real estate industry is the level of sophistication among real estate investors and the amount of time and analytical power they devote to analysing potential real estate investments. This has occurred partly due to the increasing professionalization of the industry, and also to the large amounts of money that are being invested in the real estate asset class.

As with any investment, determining investment value and how much to pay for a real estate asset requires making some judgement regarding the future cash flows expected to be earned by the property. Generally, income from a real estate asset comes in the form of income produced by renting the property to tenants and from value appreciation during the period over which the asset is held. Since these cash flows must be forecast into the future, and the future is impossible to predict, the difference between realized cash flows earned and expected cash flows can be substantial.
Risk can be defined as uncertainty of future outcomes. For those investments that exhibit greater uncertainty, the risk will be greater as well. Generally, investors in real estate have valued assets too highly because they do not fully appreciate the risk, or uncertainty, that an investment exhibits. This mis-estimation causes them to pay prices that are too high relative to the property’s fair value.

The ability to model cash flows using discounted cash flow analysis is essential to understanding how to value assets (see Chapter 5). Developing expertise in generating expectations of cash flows, and adjusting valuations for the risk involved in the investment, help to ensure that an investor does not overpay for a real estate investment. We also need to understand the impact of leases (see Chapter 6) and be able to build an income statement (see Chapter 7). We have to understand the common forms of debt finance, especially mortgages (see Chapter 8), and model the impact of leverage and taxes (see Chapter 9). Finally, it is essential that we understand how carried interest structures work in joint ventures and simple co-investment funds (see Chapter 10), and to consider how this may influence incentives and decision making.

However, while we believe that spreadsheets are wonderful (and that they should be pushed hard to explore the various option pricing and simulation techniques that we do not have space to deal with properly in this book), many investors have made the mistake of letting their spreadsheet analysis make their investment decisions for them. It is important to recognize that techniques for valuation are merely tools to be used in making decisions, and are only a small part of the overall appraisal or underwriting process.

Part Three: Real estate investment structures

The nature of real estate as an asset class brings with it two key problems. It is expensive to buy, leading to ‘lumpy’ portfolios, low levels of diversification and high levels of asset-specific risk; and it is illiquid. Various investment structures have been developed to cope with these issues, with such success that these structures now dominate the global investment strategies of most new entrants to the market.

Diversification and specific risk reduction have been the motivation for managers to take the joint venture model introduced in Chapter 10 to a higher form of private equity, or unlisted, real estate fund (see Chapter 11). The same driver, plus an attempt to add liquidity, is a feature of REITs and other public equity real estate formats (see Chapter 12), and liquid exposure to what should be low-risk property-based debt income is the goal of the structured finance market described in Chapter 13. To gain an index exposure without incurring the risk and trouble of buying buildings is one of the key goals of the nascent property derivatives market (see Chapter 14).