

# Global real estate funds – trends and issues

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**Emergence, evolution and energy – three words that best describe current global real estate markets and capital flows. There is clearly an emergence of the growth and number of international real estate funds, global real estate fund of funds, and diverse opportunities in the private and public capital markets for domestic investors to participate in foreign real estate markets. It is truly exponential over the last several years. In addition, growth of public equity real estate markets has yet to emerge in countries such as India, China and South Korea. If the forecasted growth in Asia Pacific public equity markets reaches a comparable benchmark level as real estate investment trusts (REITs) in the US, then there is a reasonable probability that the Asia Pacific public real estate equity markets will surpass the US REIT in terms of market capitalisations over the next five years based on recent trends.**

There is an *evolution* occurring in many international real estate markets, especially for cities in Brazil, Russia, India and China (BRICs), Central and Eastern Europe and even the Middle East. Real estate markets are moving from immature status to maturity via various economic, political, financial and real estate factors. An economic factor that moves cities towards maturity is the impact of multinational firms that locate goods-producing and service-producing activities throughout the world, such that a host of international real estate service providers and foreign real estate investors soon follow. Real estate investments in Sao Paulo, Mumbai, Prague, Beijing, or Moscow are now generally discussed in conjunction with Paris, London, New York and Tokyo as prudent diversification strategies.

The evolution of real estate markets in these geographies naturally occurs with increased foreign owners and investors and the maturity of domestic real estate firms and capital markets. As real estate markets mature, so too the increase in transparency, consistent production and quality of real estate market information, and the expansion of the breadth and depth of the market. The continued growth of global real estate funds is supported by the increase number of international real estate markets moving toward maturity.

There is an *energy* surrounding global real estate markets concurrent with the exponential growth of international real estate capital flows. Recent economic growth rates and trends in many emerging markets such as China, India and Singapore have ranged from the high single digits to the low double digits. Whether or not such economic growth rates are sustainable, growth nevertheless creates significant demand for residential and commercial

property types alike. According to the World Bank, world gross domestic product (GDP) is expected to continue at 3.5% per year in 2007 and 2008, with developing and emerging countries averaging in the 6% to 7% range.

The capital accumulation within developing economies through international trade in goods or services, or based on internal economic growth, has implications for global real estate capital flows. Domestic and foreign real estate investors gravitate towards countries, regions and cities experiencing growth. For example, Asia Pacific investors and firms can redeploy capital within their respective countries, within their region or invest internationally outside the Asia Pacific region. Over 2005, Middle East petroleum dollars have invested within their region in locations such as Dubai, or outside their region such as the US, where Middle East investors now rank second behind Australia in foreign real estate capital flows into the US in 2006.

The emergence, evolution and energy surrounding global real estate markets and capital flows raise several questions. Why now, why the emergence of global real estate funds? How can one explain or model where money is coming from, and where money is going? Is it possible that real estate as an asset class has reached international acceptance with investors, and if so, are recent trends in global real estate capital flows simply following an evolutionary path similar to international equity capital flows?

Tracking global real estate capital flows is not an easy task; transparency across countries is not equal to the same standards of reporting transactions or quality of information available. However, using

various private and public real estate information sources, it is possible to provide a reasonable estimate of capital flows from one region to another. According to a heroic effort by Jones Lang LaSalle, there was approximately US\$475bn in global real estate direct investments completed in 2005, an increase of 21% from a total of US\$393bn in 2004.

Figure 1 illustrates originations of capital and destinations of capital of inter-regional real estate investments for 2005. For example, Europeans invested US\$5.9bn into the US, and US investors accounted for US\$6.5bn into Europe. The chart also shows a relatively new source of real estate capital titled 'Global Source of Funds'. Global sources of funds invested US\$5.3bn into the Asia Pacific region, while only receiving US\$0.9bn from Asia Pacific investors. The exhibit confirms that Europe was a favourite origination and destination of global source of funds. The chart prepared by Jones Lang LaSalle essentially provides a road map of which regions are net exporters of foreign real estate capital flows, and which regions are net importers of foreign real estate capital flows.

As real estate funds become more global, investment strategy, valuation, accounting and tax issues are becoming increasingly complex for investment advisors, accountants and investors alike. What follows is a brief overview of a few of the more significant issues associated with these topics.

### Investment strategy

Every investment prospectus tells a story beneath all the tables, graphs, models and texts. The story boils down to 'why invest with us', and 'why to invest based on this strategy'. International real estate funds

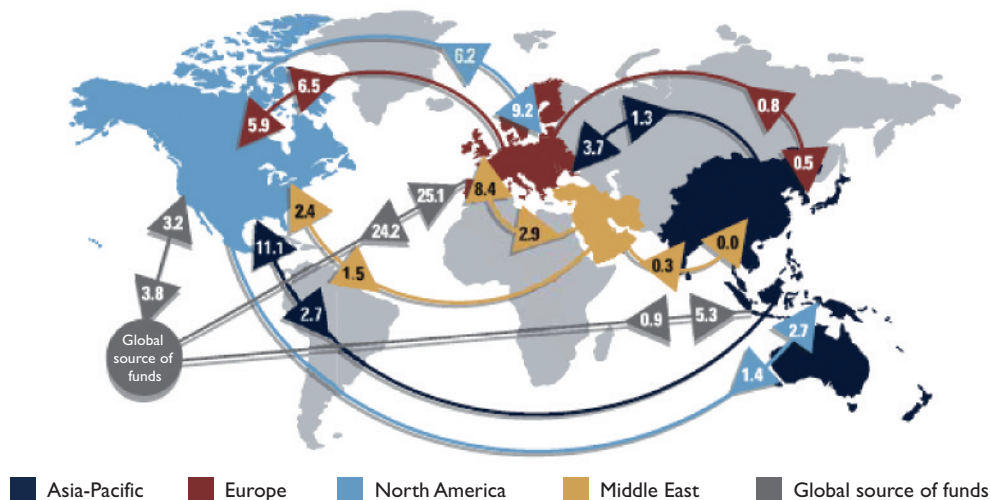
targeting a specific region as central Europe or Latin America tell a story, whereas a global real estate fund of fund tells another story. For example, demographic-based investment strategies in the Asia Pacific region targeting residential developments, retail, mixed-use or retirement properties may appear just as reasonable as an international fund focusing on office properties in cities with a significant presence and demand from multinational firms. Both examples tell a story of an investment strategy, but which strategy has better odds of attracting international investors?

If international real estate funds and global real estate fund of funds continue to gain acceptance and momentum with investors, then international advisors and sponsors of such funds need to accept the challenges of delivering timely, research-supported and creative investment strategies. There is a healthy debate on whether or not international equity markets are more correlated today than a decade ago. If one stock market index such as the FTSE 100 moves, there is a strong likelihood that the NYSE, CAC 40, Nikkei and the DAX will also move in the same direction. Is this phenomenon also occurring with international real estate equity markets, or even with commercial real estate values? According to Global Property Research<sup>2</sup>, correlations between Europe, America and Asia listed property markets indicate mixed trends since 2001, and also between global property returns compared to global stocks and bonds.

### Valuation issues

A large number of investments are made by funds that follow the accounting and reporting requirements for Investment Companies that are required to report their investments at estimated fair value. A key issue is

**Figure 1: Inter-regional investment – purchases and sales, 2005**



Source: Jones Lang LaSalle, *Global Real Estate Capital, More Markets, More Competition*, March 2006 (used with permission)

determining a reasonable estimate of fair value. In the US, information on metrics used to determine fair value is readily available and such information can be utilised to estimate the value of other similar investments. Additionally, there are defined valuation and appraisal standards that are understood and generally applied on a consistent basis. However, in some foreign jurisdictions funds are not required to report using fair value, fair value may be defined differently, and information needed to estimate fair value may not be readily available and even more difficult to substantiate. Accordingly, a key issue from an audit perspective is understanding the markets in which the assets are located so as to understand the valuation methodology employed and appropriately challenge management's value estimates.

### **Accounting standards**

US based real estate funds, which follow the Investment Companies Guide (the Guide), could be seeing substantial changes to its reporting in the near future. The Guide is being modified to more clearly define to whom the Guide applies, as well as to more clearly define how a fund that follows the Guide will record investment earnings. Currently, there is significant diversity in practice in terms of the recognition of investment earnings. Funds record investment earnings in a variety of ways including: upon cash receipt, consolidation, equity method of accounting and variations of each of these methods. If adopted, the Guide will mandate that all entities that follow the Guide will record investment earnings under the dividend method. Under this method, earnings will only be recorded to the extent that cash distributions are made by the investment and only to the extent the underlying investment has generated taxable earnings and profits. To the extent the investment has no tax basis earnings and profits, all distributions will be considered a return of capital. For global funds, determining taxable income within 30, 60 or 90 days following a Fund's year-end could prove challenging.

Finally, the regulatory bodies are diligently working towards one set of international accounting standards; however, they are several years away from reaching such international convergence. Until such time as international convergence is reached, funds' management and accountants will have to deal with local accounting standards, International Financial Reporting Standards (IFRS) and US GAAP, and the differences between those standards.

### **Tax issues**

Real estate private equity funds have become structurally complex. Structural complexity is caused primarily by the tax and legal issues encountered when funds expand their geographic footprint, and the diversity of the investor mix is increased. Taxes and tax

related treatments play a key role in an investment advisors ability to generate attractive returns; a fund's structure drives the tax efficiency and ultimately the returns generated for the investors. From an accounting and auditing perspective, gaining an understanding of the structure, working with tax advisors to understand whether the structure is aggressive or conservative, and how fund advisors manage tax risks are all complex and key considerations that need to be fully understood and updated on a periodic basis.

Additionally, in July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB No. 109 ("FIN No. 48"). Although FIN No. 48 was just recently issued and there are many complexities associated with FIN No. 48, the effective date is for fiscal years beginning after December 15, 2006. At first glance, one might conclude that since most Funds are established as Limited Partnerships, Limited Liability Companies or other "flow-through" type entities, FIN No. 48 would not apply. However, since distributions are made to investors under the assumption taxes are not due in a particular jurisdiction, this most likely is an uncertain tax position which may require consideration of the implications of FIN No. 48 at either the investment level, the Fund level, the investor level or all three levels.

In comparison with the investor mix found in traditional sector specific funds, investor target lists for global funds are generally not limited to two or three investor types. In addition to domestic high net worth individuals and pension funds, global fund investor rosters now commonly include complex investors such as foundations and endowments, global funds of funds, foreign governments, and various other global individual and institutional investors. Each investor profile represents separate and distinct tax challenges.

The impact of taxes puts substantial pressure on investment returns, and represents a major challenge for fund sponsors in achieving financial rewards. Global investing significantly increases exposure to the myriad of local country tax regimes applicable to real estate investments. As a result, tax minimisation made possible by creative structuring and planning, is a necessity rather than a luxury.

Navigating through the various tax laws, and recommending strategies to minimise taxes, becomes the task of tax and legal advisors. The starting point is choosing the appropriate investment entity type required to avoid unnecessary entity level taxes. Next, implementing

the appropriate capital structure to reduce the local income tax base and to mitigate onerous franchise or capital based taxes. Taking the structural analysis a step further, a properly capitalised investment may also provide a tax efficient cash repatriation mechanism over the term of an investment. Finally, an advisor must consider the planned exit strategy for the investment. The recommended tax structure should anticipate the exit strategy, and attempt to achieve several tax minimisation objectives including, minimising local income tax on gains, ensuring preferential income characterisation (i.e. capital versus active treatment), or allowing the flow through of losses.

In addition to the optimal *investment structure*, the fund sponsor must also consider the *optimal fund structure*. Global fund structures commonly offer investors more than one equity funding alternative. These funding alternatives are normally referred to as “parallel funds” or “alternative investment vehicles - (AIV's)”.

The investor can generally choose which funding alternative provides the best after tax returns. The relative tax efficiency of the various funding alternatives is normally analysed by considering the nature of the investment instrument offered by the fund, the character of income that will be generated by the underlying investments, the aggregate taxes imposed at the fund level and in the hands of the investor, the availability of local tax credits, and the ability to reduce withholding taxes through the application of tax treaties.

The goal of the tax and legal advisors is to present structures that solve cross border tax issues contemporaneously, for a diverse mix of investors. The challenges for the fund sponsor are determining what level of structuring will be necessary to attract targeted investor profiles, forecasting the investors' risk tolerance, and weighing the costs associated with implementing and administering tax structures against the economic and tax benefits achieved.

The above topics are a few of the more complex issues being considered today by global real estate funds. In addition, other items which require careful consideration include: (i) maintaining an effective control environment to appropriately manage fraud considerations in multiple geographies, (ii) retaining qualified operating partners in foreign jurisdictions to safeguard the assets, (iii) managing the foreign currency exposures, (iv) monitoring investment and

fund level returns as returns are not consistently calculated across geographies and (e) understanding the political and social uncertainty in foreign jurisdictions.

## Conclusion

Globalisation is not entirely a new concept. Throughout history there have been times of emergence, evolution and energy surrounding international investments. Beginning with the early 1600s, British and Dutch trading companies essentially forged new foreign territories with international trade between Europe and India; in the late 19th century complex entities called free standing companies scattered throughout the world seeking investments and control over foreign assets.

The existence of global real estate funds is a natural extension of the evolution of real estate in many countries and in many cities. As the world economy continues to expand over the next decade, the development, construction and operation of commercial real estate assets will likely become more global, thus creating new, interactive and interdependent networks of local, regional and global sources of financing and ownership structures.

## Notes:

<sup>1</sup> As of July 2006, the Asia Pacific market capitalisation was only US\$60bn less than the US REIT market.

<sup>2</sup> <http://www.propertyshares.com/> (September 6, 2006)

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