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Views from abroad

Inbound and outbound opportunities in real estate

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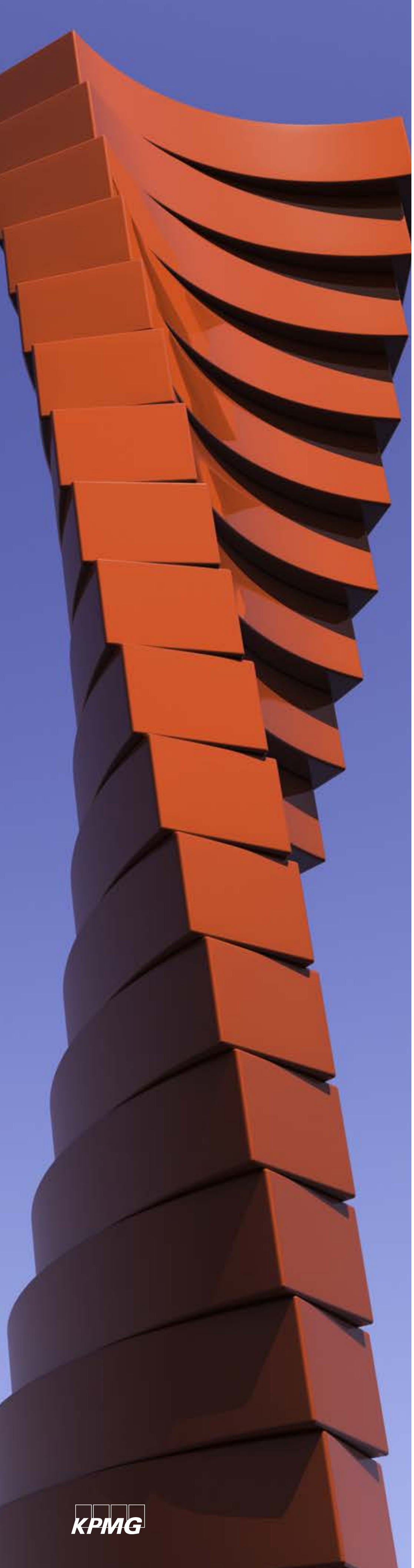


A real estate cycle of unprecedented length. A low interest rate environment. Tax and regulatory reform uncertainty. Geopolitical uncertainties, including Brexit in the European Union, North Korea aggression, and the Trump Administration's position on free trade and immigration in the United States (U.S.).

Across the world, it is a challenging time to be a real estate investor. To navigate turbulent waters, investors must keep constantly abreast of emerging issues and be nimble and strategic in how they respond.

A recent program brought together real estate leaders from KPMG's global network of member firms to examine inbound and outbound investing in seven major global real estate markets: Japan, China, the United Kingdom (U.K.), Germany, Canada, Mexico, and the U.S.

This paper summarizes our speakers' viewpoints and perspectives on the major opportunities and challenges in real estate investing in the countries where they operate.

By the numbers*

— Real estate investors say North Korea's nuclear program poses the greatest global economic threat (71%)

— The greatest challenges in investing in foreign real estate markets are complying with local tax laws/financial reporting/regulations and selecting investment markets based on return potential/risk alignment (both 40%).

— Real estate investors think the issue the Trump Administration and Congress are most likely to find common ground on is tax reform (47%).

— Supply of equity (48%) will have the biggest impact on demand for new development in the U.S.

*Data was gathered through an informal poll of real estate investors at KPMG's Global Real Estate Program on September 7, 2017 in New York City

Japan

As the nation continues to enjoy an economic recovery, global real estate investors have been quite active in Japan, with a heavy emphasis on assets in its capital city, Tokyo.

The Tokyo market is liquid, and competition for deals is deep. Buyers are encountering rising prices for properties, often leading to lower returns.

Residential property remains a stable investment, as default rates in Japan are quite low and banks will offer good financing options. Investors are also looking ahead to 2020, when Tokyo will host the Summer Olympics. Given the shortage of 3-, 4- and 5-star accommodations in the area, investors see an opportunity in developing hotel assets to host the expected influx of tourists during the Games.

To get yield, some investors are pursuing riskier deals or alternative asset classes. Foreign investors, especially, may need to think creatively to compete. Non-Japanese investors usually enter the market with a higher cost of capital than their domestic competitors, putting them at a further disadvantage.

Looking at the outbound market, Japanese investors, on the other hand, are keen on investing outside of Japan, and U.S. gateway cities—led by New York City—are the first place they look. However, the complex regulatory and tax environment in the U.S. are a challenge. In Japan, transacting in real estate is quite simple, and investors are used to a high level of detail, transparency and clarity about their deals. Running into regulatory roadblocks for U.S. investments, such as the Foreign Investment in Real Property Tax Act (FIRPTA), may spark some concern.

But most Japanese investors are not deterred from deals in the U.S. Their structure of choice is to set up corporations overseas and repatriate dividends back to Japan, where, if structured correctly, the money is substantially tax-exempt. Recent court rulings in Japan created uncertainty with investments through U.S. limited partnerships, but the Japanese tax authorities were quick to seek to dampen the effect of the court judgment and as yet no action has been taken by the U.S. Internal Revenue Service.

“In Japan, inbound real estate investors usually enter the market with a higher cost of capital than their Japanese domestic competitors, putting them at a disadvantage. Foreign investors have had to think creatively to be competitive.”

— David Lewis, Real Estate Tax Partner, KPMG in Japan

China

> **The brakes have been put on capital outflow from China. But China is growing and its capital has to be invested and the domestic market has limits. The long-term view is likely to lift as the specific application of the restrictions is resolved.**
>
> — Chris Abbiss, Global Head of Real Estate Tax, KPMG in China

Chinese government policy and the continued reform of the Chinese economy are changing real estate investment both within the country and by Chinese investors overseas.

Recent currency depreciation and a high debt load has driven action by the Chinese government to de-risk the Chinese economy which has slowed capital flows out of China. Recent legislation has sought to restrict foreign investment by Chinese enterprises in certain assets, including foreign real estate which now requires approval before an investment is made.

As a result, outbound investment from China is down and will likely continue to slow in the immediate future. We expect companies that have a genuine need to invest more oversees to be able to transact in foreign real estate, but many businesses are currently curbing their global real estate investment activities.

For the local markets, the slowdown in overseas investment means liquidity is available to domestic investment instead, leading to a high level of local competition and institutional activity. In fact, growth in China shows no sign of abating, with projects in infrastructure and real estate supporting China's "One Belt One Road" initiative.

With Chinese banks being asked to carefully consider their risk positions, finance rates have crept up. However, they are still at a stage where the ability to get authorization for borrowing is more of a deterrent than the rates themselves. As a result, non-performing loan management has been undertaken by China's banks as part of de-risking and international funds are starting to show interest in investing in non-performing loan portfolios. Niche lending markets have sprouted up to give investors other options.

United Kingdom

It's one year post-Brexit, and the U.K. real estate market is still buoyant. While transaction activity declined in the immediate aftermath of the historic vote, many in-progress deals for U.K. assets were just put on hold temporarily, and then came back to life throughout late 2016 and into 2017.

Interestingly, more domestic investors are pulling out of the market than foreign ones. The slower pace of growth has also made development funding harder to come by as U.K. lenders focus in on more stable assets, such as completed office and, in particular, student accommodations. Still, U.K. pension funds remain largely domestically focused and relatively quiet in foreign investment.

And the falling value of the pound is actually a strong incentive to keep overseas investors focused on the U.K. While some North American and European investors have shied away in light of the Brexit vote, the U.K. is still largely seen as a stable business jurisdiction by Asian investors. In fact, U.K. real estate has seen an influx of Asian capital, with a heavy concentration within London.

Long-term, Brexit is a significant risk to the U.K. economy, and therefore its real estate market. But the immediate future will probably bring continued stability. It will take the next two years for the nation to complete the difficult and uncertain process of negotiating its exit from the European Union (E.U.). And it is always possible that a transitional arrangement will be reached that extends the exit even further. As we look ahead, there is also a burgeoning progressive socialist political movement challenging the conservative leadership, which could potentially reshape the economic landscape in the U.K. once again.

"Leaving the European Union will be damaging to the economy and that will impact the real estate market, but so far we haven't seen much of an impact."

— Peter Beckett, Real Estate Tax Partner, KPMG in the United Kingdom

Germany

> In today's strong German real estate market, sellers have the power, which allows them to sometimes take a 'take it or leave it' approach. Deals may go through without proper due diligence or with complicated, risky or poorly managed tax structures.

— Marco Müth, Real Estate Tax Partner, KPMG in Germany

Relative to other global powers, Germany is enjoying a period of stability in its business environment, and that is reflected in the strength of its domestic real estate market.

Since Brexit, Germany has overtaken the U.K. to become the leading economy in the E.U. Overall property development from overseas is on an uptick across the country. Some big European banks have moved their E.U. headquarters out of the U.K. and into Frankfurt, improving both the office and housing markets there. Other European companies are moving their back office functions to Berlin, where office space is more affordable. There are also real estate investments coming in from Asia and the U.S.

While investors are facing a lack of investment alternatives, the German lending market is proving to be a challenge. There is so much financing available and such high competition for deals that funds are struggling to deploy their money—and when they do, margins are small. Some portfolio and trophy transactions even see bidders in the double digits.

Despite both regulatory and tax reform uncertainty, German individuals and companies are also actively investing in U.S. real estate. Closed-end funds have been a success story for years. Open-end funds seeking regional risk diversification tend to focus on office properties in core gateway cities. Meanwhile, German insurance companies and pension funds pursue deals for office, residential and industrial space all across the U.S. There has also been a recent rise in German investment in U.S. debt.

In addition, investment tax reform in Germany, which goes into effect in January 2018, introduces a new investment vehicle which should help German companies invest all across the globe.

Canada

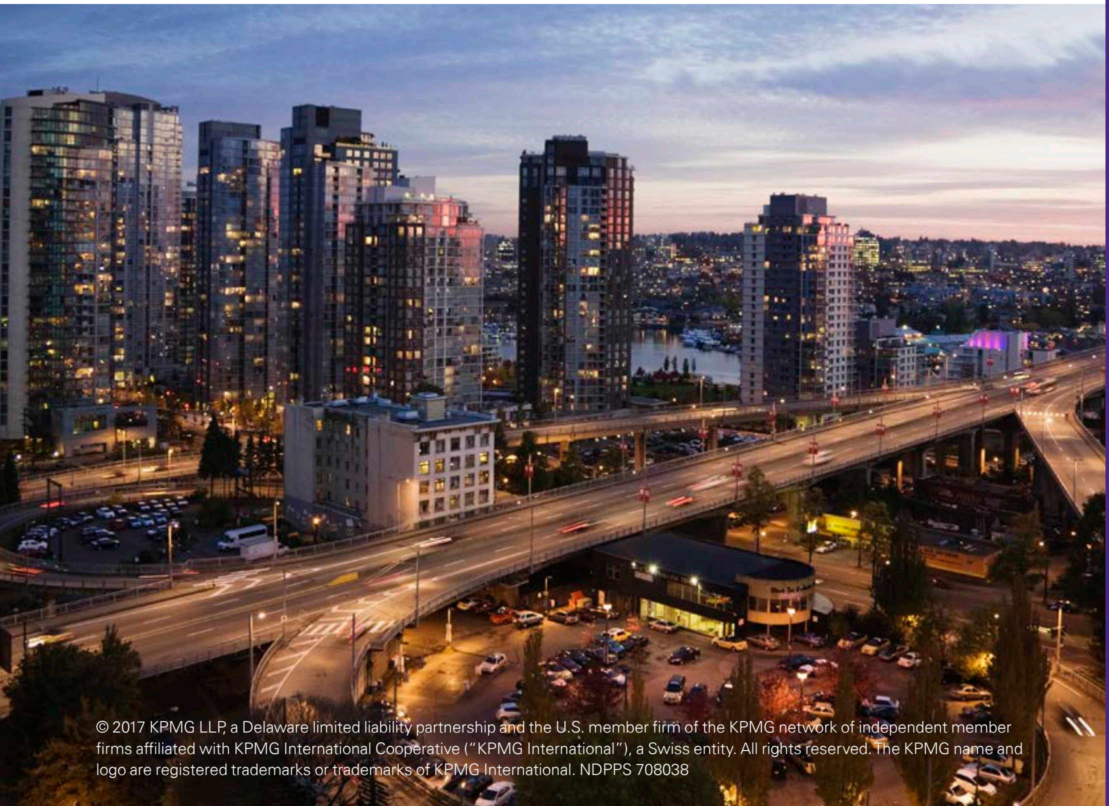
While Canadian funds are closely following the Trump Administration and how its actions might impact investment opportunities, Canada is again the biggest foreign investor in U.S. real estate.

Canadian outbound real estate investors haven't been deterred by the delay of activity on U.S. tax reform, nor the Administration's positions on climate change and other social and political causes. That's despite the fact the Canadian funds often have very socially conscious stakeholders and tend to try to invest responsibly to avoid reputational risk.

Activity by Canadian investors in the U.S. is highest for office space in primary markets, such as New York City and Chicago, as well as urban and suburban residential properties. Faced with an aging Canadian population, pension funds are also investing more in debt in the U.S. in order to deliver the cash flow they need. Retail allocation, however, is on the decline due to the dominance of Amazon.com and other online retail options across the U.S.

"Even given the unpredictability of the current Administration in the White House, Canadian investors still view the U.S. as a very strong real estate market."

— Wesley Riley, Director, Taxation, Ivanhoé Cambridge (Canada)



Mexico

> “The value of Mexican currency was negatively impacted between President Trump’s election in November 2016 and inauguration in 2017, but now it has stabilized and regained certain value. NAFTA discussions aren’t causing the same fluctuation.”
>
> — Jorge Caballero, Real Estate Tax Partner, KPMG in Mexico

With U.S. relations strained over the Trump Administration’s desire to build a border wall and curb illegal immigration, and to renegotiate the North American Free Trade Agreement (NAFTA), there has been a devaluing of the Mexican peso and slowdown in Mexican real estate activity.

However, while many projects stopped in the last quarter of 2016 many then resumed in the first two quarters of 2017. Now, interest rates are rising and asset classes are stabilizing.

Industrial development was most negatively impacted in the wake of Trump’s election, since he campaigned on moving U.S. manufacturing and automotive jobs back to the U.S. Yet, major international automakers such as Toyota and KIA are still developing their factories, and related real estate properties remain relevant.

Housing is also a big opportunity in Mexican real estate. Mexico City is one of the most crowded cities in the world, and multifamily apartment properties are now drawing a lot of foreign institutional investment. In addition, overseas investors are pursuing deals for hotels in popular tourist hotspots such as Cancun, Playa del Carmen, Los Cabos, and Punta Mita.

Although Mexico leads Latin America in terms of regulations, relatively immature regulatory rules for funds investing into Mexico is a challenge. For that reason, most overseas companies work with local partners and developers. Joint investment helps them enter the market with less risk.

As a result of the earthquake suffered on September 19, 2017, new regulations involving construction and infrastructure are expected. Also, the office and residential market may foresee some adjustments in pricing, specifically in Mexico City.

United States

If you're an investor, foreign or domestic, looking for consistent returns, the U.S. is still perceived as one of the safest markets for real estate investment—if you can afford it. In fact, there is so much competition that only the biggest bidders have a chance to close prime real estate deals, such as large office buildings in the core gateway cities.

As a result, many investors into U.S. real estate are seeking new types of investment focus, such as student housing and long-term healthcare, as well as new ways to enter the real estate markets, such as investing in mortgage funds or debt.

With tight margins and yield, many foreign investors into U.S. real estate face pressure to reduce tax leakage. But the regulatory environment doesn't help. Some investors were hopeful the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), which allows qualified foreign pension funds to avoid FIRPTA tax, would lead to further FIRPTA reform, but that hasn't happened. However, proposed tax legislation has targeted a significant reduction in the corporate tax rate which may lead to a sizable reduction in the FIRPTA withholding rate on gains for foreign investors taxed as corporations.

Also uncertain is how the Trump Administration's policies and rhetoric will impact offshore investment in the U.S. real estate market. So far, it hasn't. Despite global apprehension about the U.S. political climate, foreign investors recognize that the Trump presidency is, by definition, time-limited, and they haven't changed their investment strategies. They still view the U.S. as one of the best places to invest in real estate.

"Although foreign investors are concerned about U.S. politics, they still view the U.S. as one of the best places to invest in real estate."

— Candice Turner, Principal, M&A Tax, KPMG in the U.S.

About the authors

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KPMG LLP advises owners, managers, developers, lenders, intermediaries, construction and engineering firms, and investors in effectively executing complex transactions ranging from acquisitions and dispositions to securitization of real estate properties and portfolios to entity-level mergers and acquisitions. We believe that our experience and knowledge can help you successfully address today's challenges while preparing for tomorrow's opportunities.


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