Views from abroad

Inbound and outbound opportunities in real estate

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We live in a global business environment, and real estate investing is no exception. Seeking to diversify their portfolios and to take advantage of higher-yielding opportunities, many investors are looking to overseas real estate markets. Inbound capital into U.S. properties already represents 53 percent of total investment in 2018.[1] And with the global real estate market in the midst of a lengthy expansion period, foreign investing shows few signs of slowing down, though pressure is building in the currency markets with U.S. government policies pushing the dollar up.

To compete on U.S. soil and tap into the opportunities in overseas real estate, investors must have a strong grasp of current market conditions in their target geographies. At the same time, sellers and managers of U.S. properties need a deep understanding of foreign investor appetites for U.S. real estate assets.

KPMG LLP (KPMG) recently brought together six of our KPMG real estate leaders from across the world to share insights on the local real estate markets in their countries. This paper summarizes their country-by-country viewpoints on the state of inbound and outbound capital investments in real estate, including perspectives on the impact of emerging issues such as tax reform in various jurisdictions, trade and treaty negotiations, geopolitical uncertainty, and economic volatility.

[1] *Global Capital Trends (Real Capital Analytics, Q2 2018)*

United Kingdom

Stability today. Uncertainty tomorrow and beyond.

Perhaps surprisingly, Brexit's impact on inbound real estate investing has so far been limited.

While leaving the European Union (EU) is certainly a risk to the U.K. economy and will undoubtedly reshape the economic landscape in the future—the value of the pound has plummeted 10 percent against the dollar since the vote[2]—uncertainty has not yet led to instability, nor caused overseas investors to shy away. Some financial services firms have moved jobs out of London, but despite concerns about trade access on London-based exchanges post-Brexit, the city remains a central hub of the international finance world and there is no sign of a mass exit coming.[3]

And while transaction volume is slightly lower than last year, there was still a tremendous amount of global capital coming into the U.K. real estate market. Foreign investors are focusing on higher-end properties, with London's trophy assets particularly in high demand.

Inbound investments are increasingly concentrated in the logistics, hotel sectors and student housing. Only a small percent of U.K. students live in purpose-built accommodations, so demand is high, and the asset class continues to deliver consistent alpha.

U.K. companies typically concentrate their real estate investments domestically due to the strength of the London market. When looking to expand their asset base overseas, other EU countries are usually the destination of choice. However, the tax rate reduction in the United States may start to encourage more U.K. investments across the pond in the coming years.

Big tax changes are also simmering within the United Kingdom, which may have some effect on foreign direct investment. The exemption from capital gains tax for nonresidents will soon be abolished both for direct property disposals and indirect disposals of shares in property owning companies. Note that these changes are designed to be prospective in nature with a grandfathering of pre-2019 appreciation in commercial property.[4]

"The general view among real estate investors and the larger business community is that it won't be possible to accurately assess Brexit's effect on the U.K. market until a final deal is reached, likely no sooner than 2021."

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

[2] *Brexit puts London house prices in danger of first fall since 2009 (Evening Standard, June 6, 2018)*

[3] *Brexit and the City: Tracking the fortunes of London's financial districts (Reuters, March 28, 2018)*

[4] *Capital Gains Tax and Corporation Tax on gains for non-residents on UK property (Gov.UK, July 6, 2018)*

Germany

Better in comparison: Tumult elsewhere supports real estate upswing.

> "German companies looking to diversify their portfolios often look at investments in U.S. real estate, as currently, there appear to be limited alternatives within the EU."
>
> — Stefan Kunze, Real Estate Tax Partner, KPMG in Germany

When compared to its neighbors, German real estate is now an even more attractive market for global capital than it has been in the past.

Italy and Spain are both in the midst of impending political change in the wake of historic elections in both countries.[5] The economic uncertainty surrounding Brexit is shifting some U.K. investments over to Germany. German tax rules are already very strict, so the base erosion and profit shifting (BEPS) initiative does not appear to be having as significant of an impact on Germany as on other EU countries.

In the highly competitive German market, characterized by record transaction volumes, low interest rates, high prices, yet steady returns on investment,[6] foreign investors are still investing in core assets but are more and more seeking opportunistic investments due to the lack of available investment opportunities. Many choose to enter the market in a joint venture with a construction firm or development company which has the necessary local base of knowledge to gain access and capitalize on opportunities.

From an asset class perspective, the latest trends in investing into Germany are logistics and, as a niche, student housing. The residential sector is saturated, especially in Berlin, and it is hard to find high-yield opportunities. Shopping centers were hot five years ago, but less so today.

German investors have traditionally focused most of their outbound investments on U.S. real estate and that trend will almost certainly continue despite the tariff rattling in Washington. The EU market has limitations and the Asian market is not currently as attractive, so diversification of the portfolio often depends on a U.S. asset base. Popular asset classes and geographies among German investors today include office and logistics properties in large U.S. cities, including both primary and secondary markets.

[5] *Markets rattled by Italian and Spanish political turmoil (The Guardian, May 29, 2018)*

[6] *Why Germany's Real Estate Market Could Shrink After 50% Jumps (Bloomberg, Dec. 13, 2017)*

Canada

More of the same from the largest investor in U.S. real estate.

Canada's real estate market is mostly dominated by domestic institutional investors. It is difficult for overseas investors to break in, as they must compete with Canadian pension funds with lots of cash on hand and very low tax rates. In addition, local brokers may favor local buyers making it more difficult for inbound investing unless they have a local partner. Finally, changes to tax regulations (involving cross-border financing, Goods and Services Tax, and certain provincial Lead Transfer Tax) have presented further challenges which necessitate more advanced tax structuring than formerly required.

On the other hand, Canada leads the way in U.S. inbound investing, and today's economic and regulatory climate points to continued Canadian investment in U.S. real estate assets for the foreseeable future. The reduced U.S. corporate tax rate under tax reform helps to level the playing field with the Canadian market. New rules under U.S. tax reform also allow Canadian companies to realize tax savings leading them to further establishing a U.S. base and putting property management expertise on the ground. Finally, 2015's PATH Act enabled qualified foreign pension funds such as Canadian pension funds to invest in U.S. real estate with little to no tax leakage while no longer needing partners as long as they invest through a private real estate investment trust (REIT) structure.

Canadian investors likely allocate so much investable capital to U.S. properties due to proximity and familiarity. Not only can they easily scout and manage developments from home, but their exposure to American people and media give them a natural understanding of the U.S. business environment.

Canadian investors are typically drawn to major U.S. cities, where their real estate investments are considered "safe." New York City properties, for example, might feature very steep pricing and competition, but returns have a high degree of confidence, and the assets are very liquid given intense worldwide demand for New York real estate. They are also increasingly targeting fast-growing, business-friendly cities in the Southeast, such as Miami and Atlanta. Getting a site approved and built in these cities is relatively simple for developers, compared to the slower, more stringent permitting process in Canada.

"For Canadians who are exposed to American news and culture on a daily basis, the learning curve for entering U.S. markets is nearly flat. There may also be an aspirational element. Buying a Class A asset in a world-famous city like New York or San Francisco may be a bit of an ego boost and a way to get noticed back home."

— Jonathan Newton, Real Estate Tax Partner, KPMG in Canada

Japan

Masses of cash available: Where will it go?

> “Japan’s real estate market has become a focus for a lot of foreign investors who don’t want to take a political or economic risk. Japan is stable from a rule of law perspective. And the economy is doing well—not double-digit growth, but chugging along.”
>
> — David Lewis, Real Estate Tax Partner, KPMG in Japan

“What you see is what you get” might be a good slogan for real estate investing in Japan.

Japan’s political stability, coupled with its continued economic recovery, has made it an active market for global real estate investors in recent years. Extremely cheap debt and low borrowing rates[7] continue to attract inbound investors who view the country as a safe haven. But while investors view Japanese real estate assets as relatively low-risk, they do not expect huge returns, given high real estate prices, steep competition from local investors, and massive amounts of domestic capital available.

The biggest overseas investors into Japan come from the United States and close Asian geographies, such as Korea, Hong Kong, and Singapore. Inbound investments into Japan have historically been focused on opportunistic real estate, but as property prices improve and yield expectations come down, more money is now moving toward core, especially in Tokyo. With Japan hosting the 2020 Summer Olympics, the hotel sector is currently very popular given the undersupply of certain grades of hotel space needed to host athletes and tourists for the Games.

Interest in investing outside of Japan has significantly increased among the Japanese in recent years. Improving profitability among domestic companies and very cheap access to cash gives many Japanese investors the ability to compete for even the highest-end trophy properties. In addition, changing regulations are making it easier for Japanese companies, especially Japanese REITs, to invest offshore and expand their asset base.

Japanese companies looking to invest overseas have a massive core of cash available. In fact, besides GPIF, the Japanese government pension investment fund, with assets of approximately $1.5 trillion and similar in reserves,[8] there is also the government-owned Japan Post Bank, with assets of approximately $1.9 trillion,[9] and Sompo Japan, Japan’s insurance company, with total assets of approximately $112 billion.[10] All of these entities are investing heavily overseas in alternative asset classes including real estate.

Japanese investors are typically methodical and investments tend to take a fair amount of time to come to fruition. But once Japan’s sovereign wealth funds make a move into a foreign market, the flood gates may open as other investors, including pension funds and asset managers, follow suit.

The United States is likely to be a big beneficiary of future Japanese real estate investment. Most Japanese outbound investments find a home in U.S. gateway cities such as New York and Los Angeles. In addition, the reduction of the U.S. corporate income tax rates has made it more attractive for Japanese investors to enter the U.S. markets.

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[7] *Tradingeconomics.com*

[8] *Government Pension Investment Fund (GPIF) Investment Results Q1 2018*

[9] *Japan Post Bank Co Ltd (Balance Sheet and Other Financial Statements from Investing.com accessed 8/20/2018)*

[10] *Sompo Japan NPN (Balance Sheet and Other Financial Statements accessed at 8/20/2018)*

China

Infrastructure opportunities follow "One Belt, One Road" trade routes.

As an investment destination for foreign capital, China has slowed a little. While key foreign sovereigns and funds have been pursuing investment strategies, overall there is a slowdown of foreign capital deployed into China as competition from local capital has increased following government restrictions, making it more difficult for Chinese investors to gain approval for foreign real estate investment.

China's expansive One Belt, One Road initiative may change investment flows. The program is designed to develop infrastructure and connectivity in the countries on the historic land and maritime trade routes from Asia to Europe.

Although the program is still in the early stages—and it is not without controversy[11]—China's state media says more than $1 trillion has already been invested in One Belt, One Road.[12] Today, Chinese corporations are buying substantial assets along the planned trade corridors—both within and outside of their borders—for transportation, utilities, communications, and other infrastructure redevelopment projects.

As the Chinese government pushes for more investments to fund the One Belt and One Road initiative, foreign investors may also be able to capitalize as either developers or financiers of adjoining real estate assets. However, it remains to be seen exactly how and where foreign investment can benefit. In addition, many of the emerging markets where opportunities may emerge come with a high degree of geopolitical and economic risk.

Chinese investors often have a strong desire to own and control property abroad, but it is not generally easy for them to do so. Outbound investment in real estate is on the Chinese government's restricted list and certain companies are reducing their foreign investments to shore up their balance sheets. As they rationalize their portfolios and bring stability to the balance sheet, we expect to see capital start reemerging from these foreign markets, but the time frame is unclear.

"One Belt, One Road is a way for China to export some of its capacity in construction, utilities, and infrastructure expertise. For foreign investors to participate, they must be aware of the country risk. The program is probably not yet ready for mainstream infrastructure and real estate funds, but venture capital type funds may be interested."

— Chris Abbiss, Global Head of Real Estate Tax, KPMG in China

[11] *Just what is this One Belt, One Road thing anyway? (CNN.com, May 11, 2017)*

[12] *One Belt, One Road, One Trillion Dollars – Everything You Need to Know in One Essay (CGTN.com, January 1, 2017)*

Luxembourg

> **Given its low effective tax rates and its broad array of investing options, real estate funds looking to access the rest of the EU and feeder funds coming out the EU are both attracted to Luxembourg as a possible location for their operations.**
>
> — Pierre Kreemer, Real Estate & Infrastructure Leader, KPMG in Luxembourg

What Luxembourg lacks in size, it may make up for in investment opportunity. This high-income market is known as a flexible and innovative location for real estate investing, with a broad range of investment vehicles (limited partnerships, special limited partnerships, etc.) and levels of fund regulation (unregulated, semiregulated, or very regulated).

Luxembourg attracts a diverse array of investors and large amounts of institutional capital, but it is primarily used as an entranceway to the EU markets. Many real estate fund managers invest through Luxembourg for its treaty network and the EU participation exemption.

As part of the changing tax landscape in the EU, the use of Luxembourg as a center for the fund manager has also changed as there has been more focus on its substance as the back office for the funds.

U.S. tax reform: Stay tuned

The Tax Cuts and Jobs Act,[13] signed into law on December 22, 2017, significantly changed how people, businesses, and foreign entities are taxed in the United States. However, tax reform has not substantially reshaped the U.S. real estate landscape—yet.

The reduction of both the corporate tax rate and as a result, the reduction of FIRPTA for some investors was positive for the industry, attracting more capital to the U.S. real estate market. But for the most part, the industry is still waiting for guidance on implementing the tax reform changes, such as the impact to corporate blockers and REIT structures. How the corresponding law changes are interpreted may impact deductions and exemptions and therefore structuring and investment decisions. Until the Treasury moves forward with regulations, real estate investors are managing uncertainty while basically operating status quo.

As foreign investors evaluate the impact of tax reform, the tax landscape is not driving most of their direct investment decisions, especially institutional investors with longer time horizons. U.S. tax reform is intended to fuel growth in the economy, create jobs, generate more cash flow, and extend the already historically long real estate up-cycle.

With positive fundamentals, inbound investing continues to be high. But with yields low, traditional funds are pursuing new strategies, including niche asset classes, such as manufactured housing and data centers, higher leverage and new geographies, including strong secondary and tertiary markets such as Austin and Denver.

“The real estate industry tried not to ask for too much from tax reform legislation, and overall, the benefits were measured. It’s not entirely clear how to apply many of the rules in actual circumstances, which makes planning to get the benefit of rule changes very tricky right now.”

— Carolyn Bidwell, Senior Vice President, Brookfield Properties

“U.S. tax reform is creating gray zones and we’re waiting to see how regulators interpret ambiguity in the law. The big question is how the Federal Reserve reacts to the increase in the deficit. If they react due to fear of inflation, it may slow down the economy. But if interest rates move parallel to growth rates, it’s all good news.”

— Dino Christoforakis, Head of Transactions-North America, AFIAA, Swiss Foundation for International Real Estate Investments by *Avadis*

“The objective of the most important tax legislation since the 1980s was to kick start the economy into higher GDP performance which in turn would lead to increased demand for all sectors of real estate. By not asking for outsized incentives for a healthy real estate sector, the industry recognized that solid real estate fundamentals should continue to be the driving force, having learned from the mistakes that bedeviled Reagan’s tax cut in 1981.”

— Dene Dobensky, Real Estate Tax Partner, KPMG in the U.S.

[13] *Congress.gov*

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About KPMG's Real Estate practice

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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