

Dublin Outreach Conference: Structures and Strategies Panel

AFIRE hosted its 2006 Outreach Conference recently in Dublin, with the theme “Coming to America.” One of the sessions examined investment, legal and tax strategies and structures that can help foreign investors, Irish in particular, to address their risk, performance and tax concerns when undertaking investment in the United States.

The panel was moderated by Bob Weaver, managing director of Morgan Stanley Real Estate. The four panelists were Kevin Lynch, founding partner of The Townsend Group; Gerard de Gunzburg, a principal at Macquarie Capital Partners, Ltd.; Mike Gaffney of KPMG in Dublin; and Ian Gleeson, head of property with the National Pensions Reserve Fund of Ireland. Each spoke from a different perspective on

the topic of investing in US real estate from abroad: namely those of the advisor, the placement agent, the tax advisor and “the guy on the ground pulling the trigger,” as Weaver put it.

Weaver began the panel session with a quick overview of economic and property market conditions in the US. The last several years have seen very strong economic activity in the US, Weaver said, arising particularly from sustained profitability, increases in fixed investment and in the demand for labor. The latter is a particularly good sign for real estate investors, he said, because labor demand will drive demand for commercial and residential real estate. He mentioned some countervailing forces as well, including accelerating interest rate increases, slowing

CHART 1: Top Employment Growth Cities (2006–2008)

- Long-term real estate values driven by employment and population growth
- Top employment growth projected to occur in the South and West



● Top 15 in % and Absolute Employment Growth ● Top 15 in % Employment Growth ○ Top 15 in Absolute Employment Growth

Source: U.S. Bureau of Labor Statistics, Moody's Economy.com, Morgan Stanley

CHART 2: What's Driving the Privatization Wave?

For Companies/Management

- Regulatory burdens taking their toll
- Operations challenged by short-term earnings focus and limited growth prospects; difficult to buy and sell assets
- Limited financial flexibility given leverage constraints
- Stocks at or close to all-time highs
- Management can monetize their stock/option holdings and return to private market where greater wealth creation opportunities generally exist

For Private Investors

- Opportunity to acquire large portfolios of assets, generally at a discount to their individual retail valuations
- Opportunity to control a platform for making further investments
- Robust financing markets/ability to increase leverage significantly
- Opportunity to deploy significant equity capital
- Size and complexity of transactions reduces competition

in the housing market and high oil prices (an area in which he reported disagreement with Morgan Stanley's institutional forecast of declines).

The overall favorable conditions have led to very strong capital flows into real estate, Weaver said, and he projected new allocations of between \$50 and \$60 billion to the sector in 2006, a "really big number, even for the US." One factor, he said, is pension funds just undertaking involvement with the asset class. When a large public pension fund begins to flirt with real estate, he noted, it brings a lot of money to the table, even if the percentage allocation is small. Recent returns, Weaver emphasized, strong in both absolute and percentage terms, have also attracted interest.

The continued demand, he offered, "has proven once and for all" that, over time, "non-correlating assets are necessary in a mixed investment portfolio." Accordingly, he said, even when real estate product is expensive and difficult to procure, investment managers find that they must proceed, seeking the returns and diversification that real estate brings to a portfolio.

Referring to observations from earlier

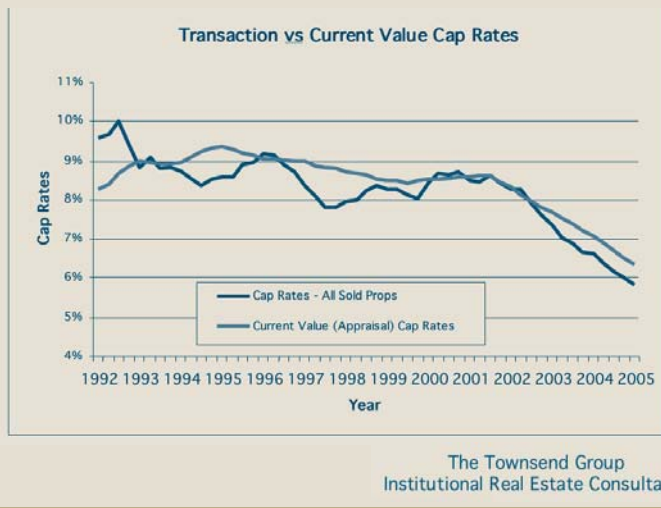
speakers that cap rate compression seems to have abated, Weaver agreed. Still, he said, "we think, in certain markets and certain circumstances, increases in net operating income (NOI) will trump increases in cap rates." He stressed, however, that this was not a blanket statement, rather an emphasis on particular opportunities (mentioning a couple of specific multi-family deals as an example).

Weaver described 2006 as "the year of recovery" in the office sector, underpinned by job growth, which will support increases in apartment rents and occupancy. Greater than expected absorption of industrial space will support capital values there, he said. Additionally, in certain markets even hotels show potential (he mentioned an actual decline in the stock of hotel space in New York City due to condo conversions).

Addressing geographic markets in the US, Weaver presented what Morgan Stanley has dubbed the "smile states," highlighting the fact that the local markets the firm sees as holding the greatest potential for growth are in states that, mapped out, depict a smile shape, running from the Pacific Northwest states through Texas and back up to the northeast. See Chart 1.

CHART 3: Introduction to US Markets

Capital inflows continued to compress cap rates as illustrated below in the analysis of the NCREIF Property Index, but the pace of compression has been slowing



One trend Weaver talked about was what he described as a major privatization wave in which, for a variety of administrative, operational and market reasons, public entities are finding it beneficial to adopt a private format. With real estate (and its alternatives) currently expensive, and where managements may be concerned about regulatory burdens, as well as in certain other circumstances, many have found that they can make more money in the private than the public format. “The fact is that real estate entrepreneurs can make more money in private structures than on the New York Stock Exchange,” Weaver said. Joint ventures and commingled funds, he elaborated, provide a better opportunity to create wealth. See Chart 2.

Against that backdrop, Weaver called on Kevin Lynch, a founding partner of Cleveland’s Townsend Group (“by far the largest real estate consultancy”) to present the advisor’s perspective on “strategies and structures.” In contrast to the morning’s assessment of particular markets and perspectives, which he described as a

“bottom-up” perspective, Lynch asked the audience to reorient to top-down thinking. Specifically, he said, individual and institutional investors need to think strategically about the broad question of what is to be accomplished by investing in real estate. A broad strategy, he said, must relate to such factors as the overall diversity or risk profile of a whole portfolio of financial investments. He stressed the importance of considering an overall portfolio, rather than viewing the real estate allocation as its own objective, or as a way to sample the market. This might

be a particularly jarring reorientation, he suggested, for Irish institutional investors who, in contrast to their counterparts in the US, Europe and Asia, are relative newcomers to the topic.

As Weaver had, Lynch focused on the global availability of capital. It’s “plentiful” across the world’s real estate markets, he said, noting that his own clients’ mandates for 2006 include more than \$30 billion of new allocations to real estate, much of which comes from brand new entrants (some from Ireland). Echoing Bob Weaver’s point about the impact of such new entrants, Lynch pointed to, the case of the University of California. “When the (UC) regents test the (real estate) water at 3 to 4 percent, it amounts to \$3 billion,” he said.

Even in the face of rising interest rates and flat (to declining) cap rates (the latter detailed in Chart 3), Lynch said, “we don’t see any letup in capital flows.” The reality, he said, is that the returns on real estate, despite negative income growth, stand up favorably against returns on stocks and bonds. As such, he stressed, real estate



returns are fairly priced and price levels are in accordance with their historic position between prices of stocks and bonds. Capital flows into real estate, he said, support the idea that allocations are determined in the context of alternative assets and the need for diversification. He detailed deposit queues waiting to get into Townsend's real estate investments as evidence of the continuing flow: for core investments he showed a total of more than \$5 billion, and for all types \$8 billion (not even its peak value of late). The cash inflow, he said, is still very dramatic.

As far as specific opportunities, Lynch said most are in non-traditional style investments, including what he described as enhanced and high-return opportunities (see Chart 4). Specifically, he mentioned Asia, India, Europe and Latin America (especially Mexico). Such is the locus of opportunity, he said, "because the yield junkie has to go to alternative ways of getting the yield."

As a warning about the indirect fund approach to entering the US market, Lynch revealed a dramatic and persistent dispersion and volatility in returns between specific high-return real estate investments. The 7,200 basis point range of the 5-year returns on his sample group makes clear the importance of fund selection in opportunistic investing, he said. It's not enough to consider a fund's absolute the level of returns, he said, because there can be a large disparity between top and average performers.

Taking the broadest perspective, Lynch stressed that the US market is large and diverse and represents a sizable portion of global commercial real estate. As of 2005, its share of high-grade world-wide investable real estate is about a third. Over time, Lynch opined, real estate has demonstrated its ability to provide high returns (over a ten-year period average annual returns have

been as high as 12, 14 and 18 percent in the aggregate for core, enhanced and high-return sectors). With increased globalization, innovation and transparency, the US market provides a variety of tax-effective fund opportunities for non-US investors, and they include open-ended, diversified formats that allow constant rebalancing. Consequently, he concluded, conditions are ripe for non-US investors to diversify using both closed- and open-ended funds to produce a portfolio of properties.

Next up was Gerard de Gunzburg, who focused on the numerous advantages of working with specialized, product-focused operating companies in foreign real estate investing. In this context, he specified, he was talking about companies that are totally focused on a specific sector or property type.

Most investors diversifying out of their home markets, de Gunzburg said, are doing so to seek some combination of additional yield, increased risk-adjusted returns or diversification. Each of the typical formats for such investments (multi-investor funds, partnerships and joint ventures, one-on-one investment, direct ownership and REIT formats) brings advantages and challenges to the mission, he said, and the involvement of a local partner can help to develop the advantages and overcome the challenges.

Furthermore, offered de Gunzburg, the relevance of operating partnership arrangements will continue to increase because of demographic trends. Allocations to real estate will increase as the population ages and investors seek more and more investment (as opposed to earned) income, he said. He cited significant transaction volume and a three-fold increase in the amount of capital in real estate in the US since 2001, with 6 percent, or \$16 billion, coming from non-US sources. Such increase in demand presents certain challenges to investors, challenges specialized operating

companies can help them address to particular benefit, de Gunzburg said. Specific problems and the corresponding opportunities he detailed include:

Access to product/difficulty deploying capital. A specialized operating partner can provide access to transaction pipelines where a foreign investor may not have effective contact. (A partner itself producing product through development can be even more effective in this context, he noted.)

Adequacy of in-house staffing to manage foreign holdings. Foreign investors can leverage a local operating partner's on-staff professionals in such areas as research, acquisition, management, accounting and disposition, without the need to hire these directly.

Difficulty gaining market expertise and access to off-market deals. By virtue of access to a local partner's contacts, virtually any deals would be available to non-local investors.

Increased transparency and competitive market conditions make it difficult to achieve outstanding performance. Local partners may have expertise and focus to make "outperformance" possible. For example, local operating companies are in constant contact with tenants, giving them insight into future tenant needs and emerging trends.

Alignment of investor and manager interests is enhanced when both parties share tangible interest in the outcome.

To demonstrate these points, de Gunzburg described the experience of a non-US bank, which he assessed as similar in profile to many represented in the audience. Through joint venture relationships with operators in the US and Europe, he said, this investor has established and underwritten a program to be sold to its high-net-worth investors. Since its inception, the program has reached total capitalization of almost \$3 billion with investor equity of

\$791 million. It consists of assets identified for either outright acquisition or development strategies, and has been assembled with no operating staff in any of the investment destinations. De Gunzburg cited strong relationships with the specialized partners and efficiencies of scale (work on multiple assets with each of five partners). A majority of the assets (70 percent), have gone into non-traditional sectors, he said.

Moving on to tax concerns for Irish investors going to the US property markets, Michael Gaffney gave an overview and described some particulars. US-destined investment is a bit of a new trend in Ireland, Gaffney said, and the Irish parties venturing out have for the most part not been institutions. On the whole, he said, the US tax situation for Irish investors is "not too bad," except where state and local taxes kick overall rates up into ranges that raise concern for Emerald Islanders. In most cases the level of capital gains rates, which he characterized as generally in the 20-30 percent range in the US, is comparable to Irish rates, and the availability of credit in Ireland for tax paid in the US eliminates the risk of double taxation, he explained. US transfer tax rates are also mostly comparable, although the US inheritance tax is a shock to the Irish, he said, because they are accustomed to Ireland's straight tax exemption for inheriting spouses.

While up to now most Irish investors to the US were individuals, more Irish companies and institutions have begun to venture out, Gaffney said. It has become clear that they are somewhat averse to the US regime because of its generally higher rates than those faced by corporate payers in Ireland (many of which are exempt in Ireland and the UK because of their collective fund nature). Corporations in Ireland usually pay either 12 percent on corporate income or 20 percent on passive



activity, versus about 35 percent in the US (a level he described as a gross generalization, but illustrative). Still he noted, allowance for depreciation in the US can alleviate the difference, he said, while cautioning about the details.

Gaffney described a general caution in Ireland about “big, highly-leveraged investments in non-euro jurisdictions,” particularly because of potential foreign exchange risk in such investments. This attitude, he pointed out, creates opportunity for banks or other intermediaries to design products that would manage such risk, especially as institutional activity increases.

While usually it would make sense for Irish investors to keep structures simple and buy even foreign assets directly, he said, the limited liability corporation (LLC) structure in the US has offered a couple of advantages. Such indirect investment, when US assets are financed by local borrowing, helps avoid “big wobbly fluctuations in gross value,” he said, because the value of the shares is net of the debt. Additionally, the LLC structure has made it possible to avoid the problem of having profits “trapped inside a company,” he said, since the sale of shares in an LLC can be treated as a sale of assets.

As for other forms of investment, Gaffney said that collective investments and syndications are becoming more common. REITs are “wonderful tax-free entities,” he said, and the US REIT works well for Irish investors (it’s tax-free, and withholding at liquidation can be offset by credits available in Ireland). One drawback to the REIT structure is the burden of the many restrictions, however, such as those on the level of plant and equipment holdings. Land dealing and development are more rare among Irish investors to the US Gaffney said, and often represent cases of Irish builders and developers expanding their business, rather than seeking real estate

investments per se.

Summarizing his advice on structure for Irish investors to the US, Gaffney offered the following:

For individuals or small family groups planning long-term investment in real property, the LLC structure seems to be the most popular and offers multiple advantages.

For a big syndicate, a REIT format is best.

For a trading portfolio, or anything with more yield than capital appreciation, a transparent entity such as partnership is probably best so that the US tax is creditable against the Irish income tax (“which if you’re careful should be in the mid-20s,” he said).

The final speaker, the “man on the ground” implementing such grand concepts, was Ian Gleeson. Gleeson is head of property for the newly constituted National Pension Funds Reserve of Ireland, a somewhat atypical investor at this point in its life. According to Gleeson: The NPRF’s charge is to provide funds to cover state pension payments. As a start-up (formed in 2001) its strategy has changed since inception and its 8 percent allocation to real estate was only recently adopted (in 2004). The Funds’ value is €16.6 billion, expected to increase in value to between €25 and €30 by 2009 and to €140 billion by the time it begins payouts in 2025.

The strategy for the new property portfolio is indirect investment on a global basis, Gleeson reported. Geographically, there is a bias toward its home neighborhood of Europe, and by investment style the bias is toward value-added and opportunistic approaches. The latter, he acknowledged, is quite aggressive, due particularly to the fact that the fund has no payout liabilities for almost 20 years. More specifically, he said the portfolio is intended to consist of 20 percent opportunistic, 50 percent value-added and 30 percent core investments, a profile with which planners are comfortable, even given the current state of prices on core assets.

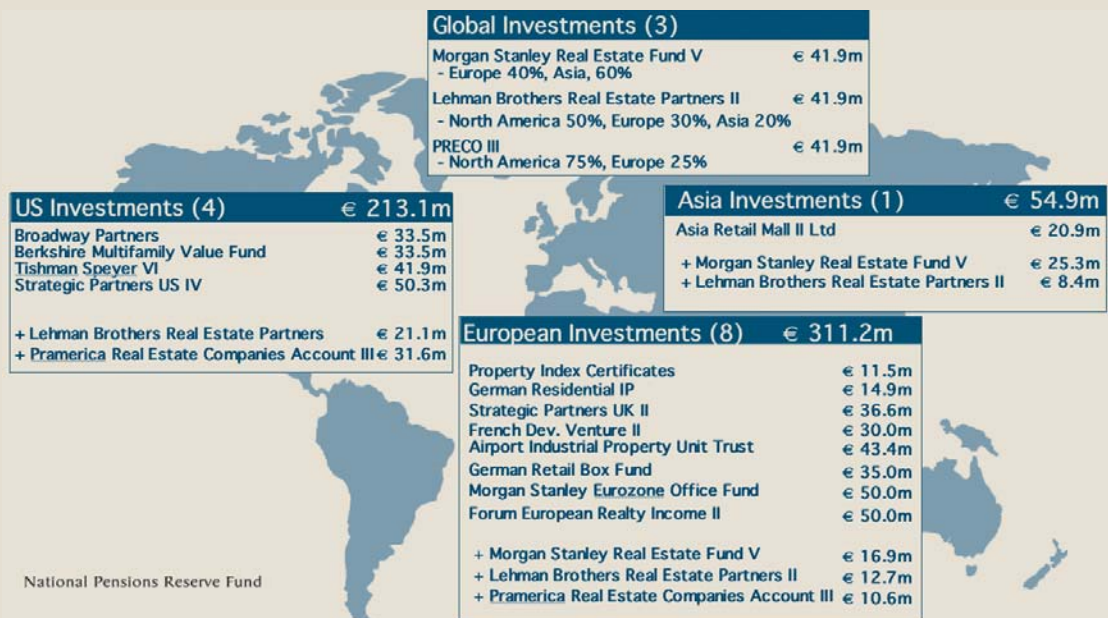
NPRF’s activity to date has produced 16

real estate investments, Gleeson said, in the amount of €577 million. By geography, the distribution of the holdings is about on target with the plan and by investment style it is close, though somewhat under in core and over in opportunistic situations, which deviation provides no discomfort for the moment, he said. In chart form (see Chart 5), Gleeson detailed the holdings meticulously, noting greater difficulty finding private equity funds in Europe, where the form is not as far developed as in the US. The portfolio so far consists of a variety of real estate-specific investment funds and instruments.

Closing out the session, a question from the audience was directed to Michael Gaffney about the surge, over the past five or so years, in US real estate investment coming from Ireland. What has driven this increase, asked the questioner, what is attracting the investors?

Gaffney cited a number of factors to explain the development. First, he said, the Irish have “gotten richer” of late, spurring investors to look overseas, itself a new phenomenon. As a consequence of increases in investable income inside the country, he said, there is a perception that local investment opportunities are drying up, he said, and even the nearby UK market “is one with limited capacity.” He also mentioned natural links (presumably cultural) between Ireland and the US. Finally, he noted financial variables as well. Although it is somewhat counterintuitive, he said, weakness in the dollar may have attracted Irish attention to the US as a destination for investment. “Of course if you want to bet on the dollar you don’t have to buy a building,” he said, but the currency change may have piqued his investing countrymen’s interest. ★

CHART 5: National Pensions Reserve Fund Investment Activity



16 separate investments for a total consideration of €577.4m
(c. 150 potential opportunities reviewed)