

# Shanghai, Mumbai and Dubai

*From the panel discussion at AFIRE's Outreach Conference in Dubai*

A panel with first-hand experience discussed opportunities and complications of investing in today's emerging markets at a recent joint conference hosted by AFIRE and the Union of Arab Banks in Dubai. Their topic was lyrically titled "Shanghai, Mumbai and Dubai." Ian Hawksworth, managing director of Capital & Counties, and executive director of Liberty International, coordinated the discussion as moderator. Panel participants were Richard Price, managing director at ING Clarion; Robert Lee, director of development for Nakheel; and Nick Silvers, vice president in Credit Suisse's real estate finance and securitization group.

Price launched the session with a general discussion of capital flows as they pertain to real estate markets across the globe. He described an expanding

global universe of real estate, currently valued at about \$21 trillion (US\$). A chart showed the largest portion of that total (41%) located in Europe, 33% in the Americas and 26% in the Asia Pacific region. He reported continuing, and growing, capital flows into real estate worldwide (Chart 1), with a growing portion crossing borders from mature to emerging markets like China and India. Investors from mature markets are no longer just "kicking the tires" in emerging markets, he said, they're actually putting down money as well. To indicate the levels of activity, he described the experience of some colleagues who had recently heard a series of proposals from eight new Asian high-yield real estate funds, all sponsored by what Price described as "credible groups." If all of these funds were successful, Price said, they would



**Nick Silvers**, Vice President, Real Estate Finance and Securitization Group, Credit Suisse; **Robert Lee**, Director of Development, Nakheel; **Richard Price**, Managing Director, ING Clarion; and **Ian Hawksworth**, Managing Director, Capital & Counties, and Executive Director, Liberty International

represent something like \$40 billion of gross assets acquired in the Asia-Pacific markets. He found the prospect both interesting and scary, he said, because “if all that money is to get invested, the terms have nowhere to go but down.”

As for what factors are driving these flows, Price cited the emergence of securitized products, increasing transparency in debt and equity markets, and declining risk premiums in developing markets. As these markets evolve, returns are “harmonizing” somewhat, he said, which is not an entirely surprising accompaniment. He even suggested that the issue of relative returns and compensation for different risk factors is becoming somewhat less relevant as the emerging markets become more transparent and investors become used to operating “in all kinds of environments.”

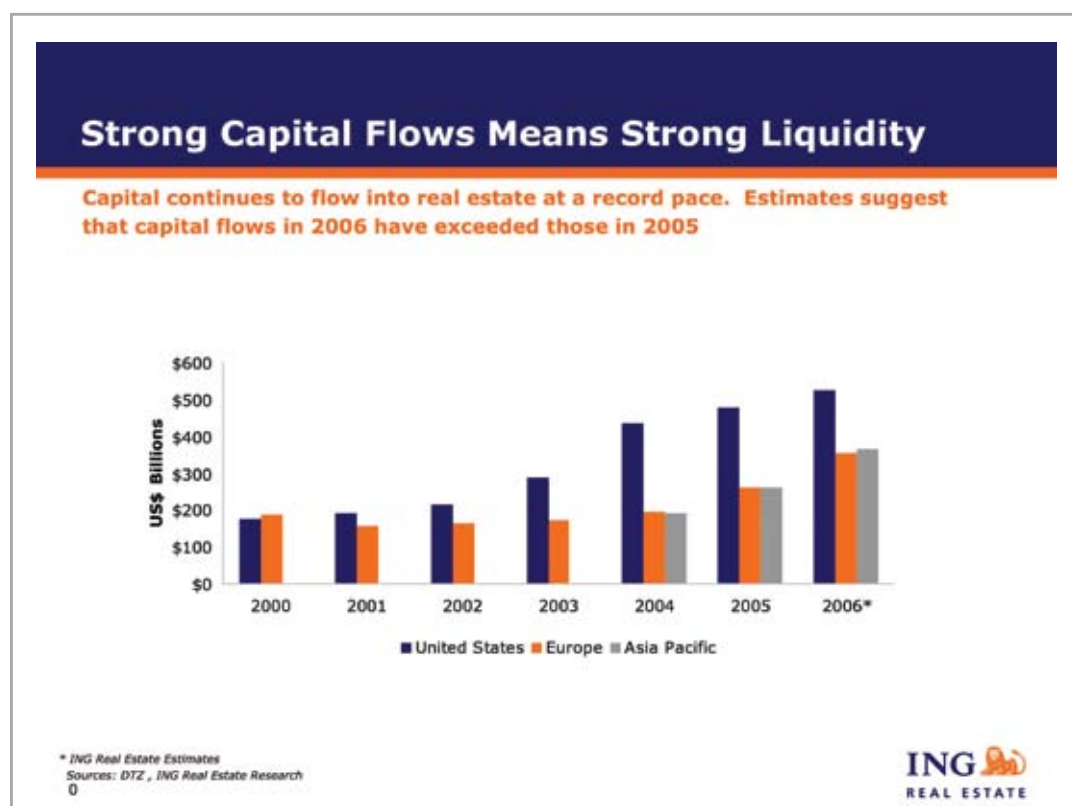
ING Clarion considers three indicators in determining risk in markets around the world, Price said: a Jones Lang LaSalle transparency index, the IMF’s country risk classifications, and an in-house

index produced by ING’s own wholesale bank. Based on this analysis, he said, the real estate market worldwide “is getting less risky.” He cited the example of Japan, which has moved from medium to low risk in about nine months, “through the emergence of its REIT sector.” Overall, Price said, the ING analysis puts about 86% of the roughly \$9.5 trillion of investable real estate around the world in low-risk markets (which, he noted, “should give us all plenty to do”). Only about 10% is in the high-risk locales, he said, although they are of course the markets with maximum economic and demographic growth, “which we all know drive real estate returns.”

### Dubai

Moderator Hawksworth called on Robert Lee to discuss why investors should take on projects in Dubai. “The real question,” Lee retorted, “is why have you waited so long?” Referring to Price’s presentation, Lee mentioned a map that showed “zero” investment in the Middle East (Chart 2), describing the depiction

Chart 1



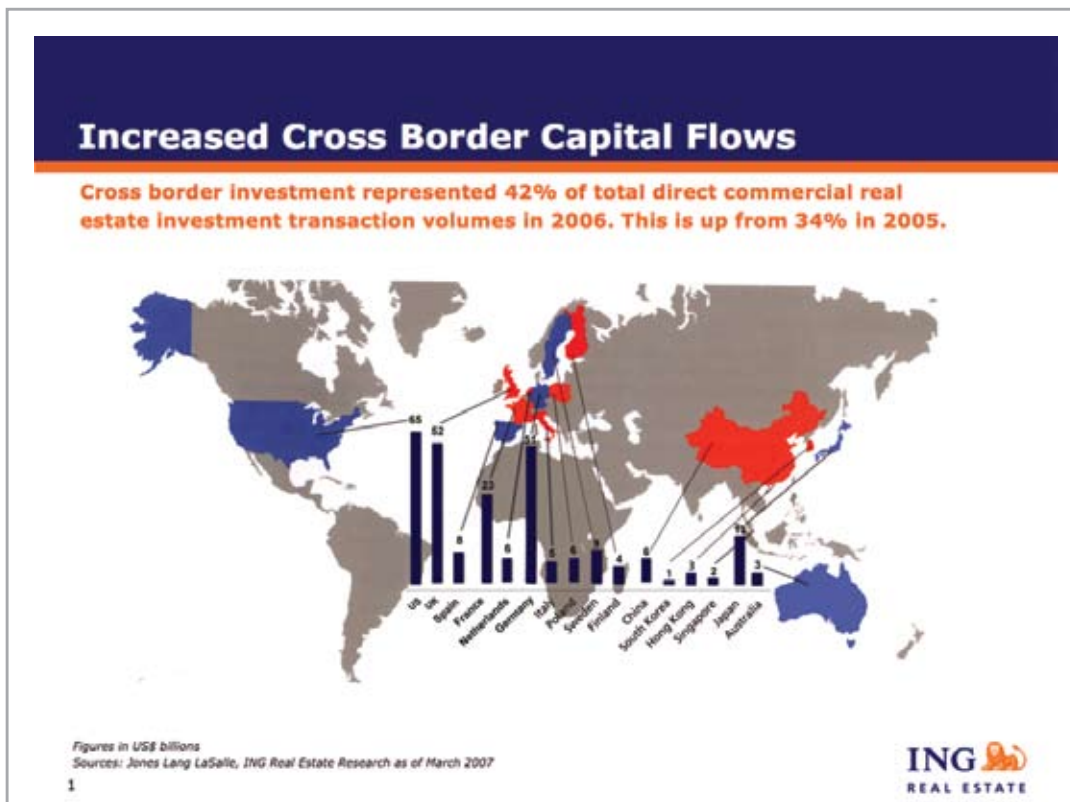
as accurate until recently. “There was no opportunity to invest in the Middle East from an investor’s point of view,” Lee said. “The risk was high and legal and financial systems and structures did not exist to warrant substantial international investment.” But the situation is changing, he reported, and Dubai is becoming the center of investment activity in the Middle East.

A visit to the area evokes “an innate sense of coming opportunity,” he said, though particulars are not always clear. Systems have been developed in Dubai in the past two or three years to provide added financial and legal security, particularly in comparison to the other Gulf Cooperation Council (GCC) countries, he reported. Some of Dubai’s neighbors are moving forward in these areas, “but Dubai is leading the way” in putting in place legal, transparency and financial standards. While investing in Dubai takes a bit of work and may continue to present “interesting” challenges, Lee said, it’s no different than the world’s other emerging markets, and it can be simpler and

safer. In this connection, he stressed the benefit of working with a good local partner.

Extending the topic to the broader GCC, Hawksworth asked Nick Silvers how to get invested in the Middle East. What is the “pot of gold” for the foreign investor, he asked. Silvers agreed that Dubai is the leader, followed by other GCC constituents, some of which have “even greater resources for development” (such as Qatar and Abu Dhabi). Credit Suisse, he said, both aggressively supports regional sponsors (such as DK, Istithmar and Aldar), financing and supporting their international projects (he mentioned New York and Europe), and opportunistically supports development within the region, referring to these respectively as off-shore and on-shore strategies. In 15 months, he said, Credit Suisse has lent almost \$8 billion in such off-shore activity, and it has closed \$300 million in on-shore loans in six months, with another \$3 billion in the pipeline.

Chart 2



Hawksworth asked whether all of the many opportunities in the region can be developed. Not all will come to full fruition, Silvers acknowledged, “but many will, and many of these will be the leaders for the next decades.” He mentioned The Pearl in Qatar as one of several projects that “will become irreplaceable parts of the portfolio. We may look back and wish that we had done more of the opportunities that exist today.”

This idea of local organizations becoming global counterparties is not typical, Hawksworth observed, noting that such relationships have not arisen in other emerging markets. So he put the question to the panelists: Is the drive of global capital to get invested in these markets, or is it to develop partnerships for counterparty activity in the developed markets? “Yes,” said Richard Price, conveying that both influences are reflected in the movement of global capital. Explaining more fully, he pointed out that it is possible to identify a typical cycle even in the developing markets (he cited Dubai, China and India, currently in different phases). Specifically, he said, activity progresses from the development of the market through “a shortage of quality real estate product,” huge development booms (as in Dubai now, where 25% of the world’s construction cranes are deployed), absorption and “settling into more normative cycles.”

Meanwhile, he said, global investors “are looking at an ever-broadening opportunity set” while trying to get invested, the later itself increasingly difficult as returns compress. But a stampede of investors looking en masse for better returns outside their expensive home markets won’t necessarily find them, he said. “There aren’t necessarily better returns just by going offshore.” But in the face of the “ever-broadening opportunity set,” with increasing asset allocations to a broader range of investments (beyond stabilized, income-producing assets) and in search of greater portfolio diversification, Price said, investors often find a friction between the pure diversification motive and getting the money invested. “Quite honestly,” he offered, “sometimes strategy goes out the window” in

favor of an unexpected opportunity, and at times “it would be wrong not to be opportunistic.”

Firms like his that manage other peoples’ money, Price said, do seek to develop relationships with both financial investors and real estate professionals, and in emerging markets may help them expand globally, a trend he predicted will become long-term. In that vein, he predicted an outflow of money from China to the US and Europe, much as capital has flowed from the Middle East for years.

Noting the talk about relationships and multiple forms of diversification (investors coming into emerging markets and domestic players from emerging markets moving out into the global arena), Hawksworth asked the panelists what to look for in a relationship with a GCC-based organization. Lee focused attention on what the foreign capital source must do, more than what it should look for. Things in the Middle East happen “at a very dynamic pace in terms of execution, but relationships develop at a glacial pace,” he said, especially from the perspective of westerners. Foreign investors must be prepared to present and establish themselves with a local GCC counterpart not just as an opposite party financially, but as a well-known, trusted partner, which can take time. “We don’t build contractual relationships,” Lee said, “we build partnerships.” However difficult it is to describe the process, it is even more difficult to achieve, according to Lee, who described having seen pairings almost fail because the foreign party was too rushed.

Nick Silvers took a different perspective. GCC-based companies like Arcapita and Istithmar, which will be the future big names in the region, he said, are not just raising money for a specific sector (as are some of their developed-market counterparts). As a result, he said, they will be able to take a patient, strategic approach to investing globally. The big western opportunity funds, particularly in the US, Silvers said, have raised significant amounts in the last year or so, but must invest that money in the markets specified. In the US, he offered, that amounts to tens of billions of dollars going into “almost forced

investments.” The GCC groups will face investment opportunities in the US that are almost bond-like, he said, while retaining the flexibility to pursue “40+ percent-type returns elsewhere.”

“So why should I put my money in China as opposed to the US,” Hawksworth prodded, “isn’t the US a better market?” “It depends on the purpose of the investment,” Price responded. For current income, the US is indeed better than China, where taxes erode only-recently comparable returns,

he said. While clear not to suggest that one has to go to China to make money in real estate, Price proposed two approaches in China for now. The first was high-churn development activity focusing on residential properties in primary (and increasingly in secondary) cities, sold to the middle market, in partnership with good Chinese developers. The second was buying core assets, intending to hold them through multiple cycles, in anticipation of returns through better pricing. Such investments “will look pretty anemic” in the first few years, he said, but as markets continue to grow, especially in core business districts in major Chinese cities, the assets will become increasingly irreplaceable.

After some discussion comparing the latter strategy (not entirely favorably) to buying leasehold properties in San Francisco or New York, and to the prospects of doing the same in the GCC, Hawksworth asked if the only reasons to be in China are as a developer or hoping for substantial rental growth. “What about office space in Beijing?” “I wouldn’t touch office in Beijing now. I’d be getting a lot of money ready to buy distressed post-Olympic” property, Price said, confirming his expectation of “significant pain” in the market after the Olympics.

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On the subject of “becoming a developer in China” (Hawksworth’s formulation), Price confirmed the need for a partner. Also important, he said, is to distinguish between factors that you can and cannot

control. Shareholder status in China, he said, may or may not bring any actual control, for example, and the alternative is to work with partners you know are reliable. Experience-based knowledge of a development partner is especially important in this setting, Price said, because “every presentation is about the biggest and best project in town.” With a

proven partner you can be sure your group is able to follow through on its roles. “There have been times when (our partner) has made more money than we have, but then we’ve made more than we expected to.” Such success can strengthen the relationship, he said, and emphasized the scalability of the model, noting that it’s very hard to build a business in China one deal at a time. Lee agreed, adding that a good local partner may be able to simplify a developing market by knowing about variables the foreigners don’t perceive.

Hawksworth asked for discussion of what locals look for or need in an international partner. “In fact, why would local developers need international partners when they could borrow as much as they needed from Credit Suisse?” Lee pointed to the impact of successful foreign investment ventures in developing the credibility of the market as a safe destination for investment. “You need international investors to come and be successful and profit over a period of time.” Coming to Dubai, making money and leaving “is part of the model we use.”

Hawksworth contrasted this with his own experience in Hong Kong where, he said “we spent most of our effort trying to keep foreign investors

out” because the market had sufficient capital and debt markets to support the activity. Now nobody can get money invested in Hong Kong, and Dubai has some similarities, he said. Why in these cases does foreign capital help, he asked. Silvers offered two points pertaining to emerging markets. He said the outside capital does create legitimacy for the markets, and does so quickly, as frenzy and news coverage arise about capital chasing opportunity. Secondly, foreign capital brings expertise from elsewhere, and local partners gain by being chosen from among their competitors. Price addressed the case of China, where there is ample liquidity within the market. But foreign capital sources have had relatively good success in closing deals, he offered, and foreign capital helps Chinese companies working to become listed on overseas stock markets. These benefits, he said, offset the marginal return sacrificed to the foreign partner.

## India

Moving on to India, Nick Silvers described a very aggressive approach. “India is a very unique market,” he said, and although Credit Suisse is in the debt financing business, it sees opportunity in Indian equity as well, particularly over the next three to five years. Debt markets are emerging as laws to facilitate securitized lending are developed, he said, although there is as yet no formal CMBS market in the offing. “But we are so bullish, we’re not waiting.” The organization is aggressively pushing equity, he said, and has partnered with merchant banking groups in doing so. Projects include hotel development in Pune and other investments, and he described the activity as “a strong statement about the market, coming from a Swiss entity.”

“Now I’m confused,” Hawksworth reacted, “the bank has become a developer?” Price also reacted strongly. Acknowledging that opportunity in India is evident to anyone “with a commercial bone in his body,” he urged getting “some perspective.” These are risks that we wouldn’t take at home, he commented. “Would Credit Suisse build a hospital in Switzerland? No!” His concern, he said, is that investors may regret rushing into India, complaining that they are operating beyond their range of comfort and level of expertise. He espoused the view that there is a relatively small opportunity set in India, and that ING, for one, can’t do its core business there, namely buying income-producing property. “And if all you’re doing is buying capital, you’re very late to the game,” he concluded, clarifying that the criticism is not directed only at Credit Suisse. Lee also predicted a correction in India, as too much money is chasing too few good deals. The country also has challenges in the nature of its social infrastructure that weaken its promise for foreign investors, he said, and progress there is needed before development capital can feel secure.

Hawksworth asked panelists to contrast China’s infrastructure to India’s, drawing a variety of comments. Price noted that China has invested heavily in infrastructure. “The lack of any participative



Burj Al Arab in Dubai

democracy” gives the government the freedom to achieve its aims, he said, describing the effort as “mostly ahead of the curve.” He pointed as an example to the impression one gets traveling through some of the new airports in China, which “can leave you wondering whether China is really a developing market.”

Summarizing, Hawksworth identified several themes for investors in emerging markets, concluding with one he pointed to as particularly significant:

- The importance of infrastructure (one reason for Dubai’s success, he said, is that it has such good infrastructure).
- The importance of a motivation beyond simple diversification attracting investors to the emerging markets.
- The need to actually build a business over time (rather than engaging in a series of contracts).
- An interesting shift in the willingness of global capital to take risks (sometimes risks greater than would be acceptable in home markets).
- The increasing importance of finding and developing actual product.
- Most important, building symbiotic relationships that confer benefits in both directions, in multiple ways; “giving partners access to what you do best,” including development, capital markets and other skill sets.

A questioner from the audience asked about what kinds of deals are available and what return characteristics investors are looking for, and the responses were fairly specific. Price said that, for the residential projects he described, ING expects returns of at least 20%, after Chinese taxes of 20 to 30%. He also stressed that although there is an impression to the contrary, “it is entirely possible” to take earnings out of China and that, while complicated, it’s easier than it was several years ago. The scale of the projects sometimes shocks foreigners, he said, describing the smallest of ING’s deals as involving about 2 million square feet (at which there was indeed a small rumble

heard from the audience). Prime commercial real estate in China brings IRRs in the low- to mid-teens according to Hawksworth, with initial yields of 6 to 8%. He advised investors to be sure to find deals in which they can expect to do reasonably well in the first cycle, “because in such leasehold investments it’s very difficult to recoup your investment after a bad start.” Important elements are project selection, he said, and a prediction of growth in the city. Returns are similar in India, he said, although size restrictions on foreign investors can affect the scale of projects.

Another questioner asked about the fact that the markets Price had characterized as the most risky are attracting great amounts of foreign direct investment, and that the foreign investors do not appear to be requiring additional returns to justify the additional risk. “Why are foreign investors buying in some of these riskier environments at high prices when the US offers cheaper, more stable alternatives?” Recapping ING’s three-pronged analysis of market risk, Price stressed that within a given tier, all markets and all investments are not equally risky. The analysis is intended “to provide a framework to perceive the risks and the returns needed to justify them,” he said. Within this, participants must factor in the type of investment (e.g., core vs. opportunistic) and rates should reflect the content of the project’s risk as well as that of the country and sector. The questioner pursued this issue, insisting that recent deals in Turkey, for example, suggest that foreign investors are not in fact adjusting for the component risks. Lee suggested that the willingness to invest is sometimes based on perceptions of how land values will appreciate. He offered as an example the case of Japanese purchases of real estate in Vancouver in the 1970s. An investor who expects the land value to increase so much that the price of entry appears to be a bargain may not care that the price of entry is relatively high, he explained. Hawksworth added that the phenomenon is not only relevant to emerging markets. “We see exactly the same thing occurring in London today,” he said. Right now, traditional

London investors are out of the market, he reported, because it's too expensive. But there are foreign investors who see value for themselves of a different proportion than what the locals perceive. "If you see value that others don't, then that's opportunity for you," he said, "and whether you're right or wrong, time will tell."

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Hawksworth brought the conversation around to touch briefly on the REIT sector in emerging markets. Silvers characterized the development and expansion of the trusts globally as very encouraging, and predicted that their popularity "will legitimize and benefit emerging markets everywhere." Price focused on the risks of seeing REITs as a panacea. The emerging markets, he said, need to develop long-term local capital that will promote maintenance and preserve the value of property. Such markets need to move away, he said, from strata title sales into diverse hands. The current mismatched financing of long-term assets by short-term bank and opportunistic equity capital, he said, leads to volatile cycles and the potential for significant losses. Lee agreed, noting that

the growth of REITs in emerging markets is demand- rather than supply-driven. He drew the comparison to the development of time-share markets in the US in the early 1970s, which (though not on the same scale) arose out of the surplus

of unsold apartment property.

Closing out the session, Hawksworth gave each of the panelists an imaginary \$1 billion and asked them in which single emerging market they would invest it. Price chose suburban retail in China. "Not WalMart-style retail," he clarified, but support retail "for the massive new towns developing around the cities. Just plain neighborhood retail." Lee advocated industrial warehousing space, in any of the session's three featured locales. All of the attention in India is currently on the front end of the market (retail and residential development), he pointed out, and the supply end of the supply chain is being neglected. Silvers was direct in choosing retail or hotels in India. ★

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