

# THE INSTITUTIONAL REAL ESTATE LETTER

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## NORTH AMERICA

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## Emerging Markets Offer a Mixed Bag

### Brazil Looks Like a Rising Star

by Larry Gray

*In the aftermath of a global economic recession, institutional property investment in emerging markets has declined. But the BRIC countries, for the most part, continue to march ahead.*

In 2001, Goldman Sachs economist Jim O'Neil coined the term BRIC to denote the fast-growing developing countries of Brazil, Russia, India and China. These new markets were flush with opportunity and everyone seemed to want to take part. The credit crisis and resulting global recession, however, quickly changed the investment landscape and investors' plans and strategies.

Today emerging market opportunities look quite different to U.S. institutional investors, as both yields and risks have changed. A majority of tax-exempt investors — pension funds, endowments and foundations — plan to “play it safe” in 2010, emphasizing investments in core assets and real estate debt, focusing primarily on domestic properties, according to *Tax-Exempt Real Estate Investment 2010*, the annual plan sponsor survey conducted by Institutional Real Estate, Inc. and Kingsley Associates. Looking long-term, however, investors cannot afford to ignore the demographics in the BRIC countries and other emerging markets and the related demand for new, modern buildings, whether

it's residential, office, retail or industrial. A number of plan sponsors are reviewing their real estate portfolios, their allocations and their strategies.

“We are seeing an interest from investors trying to determine the appropriate amount of international exposure and the best way to implement that exposure,” says Terri Herubin, principal and portfolio manager, at The Townsend Group.

“Some investors are looking at taking advantage of emerging market stocks, adds Herubin. “Some have refined that to the REIT markets. Other investors are looking to access private real estate investment, but are aware of the time constraints on those funds to deliver returns within a specified investment period.”

Relative to the investment opportunity, the attractiveness depends on the goals of the investor and their risk profile, notes Guy Jaquier, president, Europe, Asia and private capital at AMB Capital Partners. “For example, if you have an allocation of money and you're just looking for a safe 8 percent return with transparency, then stabilized assets in the United States are a great place to invest,” says Jaquier. “On the other hand, if you're looking to deploy capital and seek higher growth and you're willing to accept some higher risk, then you start looking at countries like China and Brazil, where

there is growth and the ability to get outsized returns.”

### A MIXED BAG

While the BRIC countries still possess the promise of strong economic growth and expanding middle-class populations with increasing affluence, the events of the past two years have created clear distinctions between the winners and losers of the emerging markets.

Marvin Zonis, a consultant and political economist who heads Marvin Zonis + Associates Inc., thinks it's time for a new emerging market acronym.

“Russia really needs to be removed from the BRICs,” says Zonis. “I’m in favor of adding Indonesia and changing it to BICI [Brazil, India, China, Indonesia]. In Italian it would be pronounced *beechie*.”

Jaquier agrees with his assessment on Russia. “If you look at emerging markets and put the BRIC countries as a class, relative to pension funds, I haven’t seen anyone interested in Russia, whether today or a few years ago,” says Jaquier. “A couple of years ago, India was an exciting play, but now we’re not hearing of anyone wanting to put new allocations to India. As far as China, there is some interest by U.S. pension funds, but I think European and other Asian countries are generating most of the interest.”

No doubt, the big loser since the economic downturn has been Russia. Like the other BRIC countries, Russia has a growing middle class with increasing purchasing power, but political impediments, rampant corruption, lack of transparency and the country’s economic volatility raise red flags for investors. The country’s economic over-reliance on the energy sector — approximately 65 percent of Russia’s export earnings are attributed to oil and gas — and its declining and aging population separate it from the other BRIC countries and raise questions about its prospects for sustainable long-term growth. In 2009, Russia suffered a sharp economic contraction of 6.5 percent.

As noted in a recent article in the University of Pennsylvania’s Wharton School of Business’ publication *Knowledge@Wharton*, “Another destabilizing factor [in Russia] is the effect of concentrated ownership in



**Moscow’s Meltdown:** The Russian property market and national economy have lagged behind their emerging market counterparts.

the hands of a few billionaires, and the risk of capital flight from this small group, which has happened on more than one occasion and leaves the economy open to sharp and volatile outflows of capital during hard times. In the final quarter of 2008, as the financial crisis deepened after the collapse of Lehman Brothers, \$164 billion flowed out of Russia’s capital account.”

“It seems to me more likely than ever that Russia will be even a bigger loser in the future,” Zonis continues. “The true face of Russia has emerged, which is to say it is basically a gas and oil exporting state with no indigenous economy; the people are living off of the revenues of the oil and the gas. Russia doesn’t produce anything that is of any sophistication that can be competitive on the world markets. Further, I believe, we are entering an era when shale gas will be discovered in Europe and elsewhere in the world. The implications of that for Russia are very serious because its ability to have major influence in Western Europe from its export of gas will, in my judgment, diminish.”

Indonesia, on the other hand, may offer more bullish prospects, according to Zonis.

“Indonesia is a winner,” says Zonis. “Indonesia, which, of course, is the world’s largest Muslim country,

has made a pretty satisfactory transition to democracy and has been very successful on staying on top of Islamic extremism.”

The country has made marked economic advances under the government of President Susilo Bambang Yudhoyono. Reforms in the financial sector and GDP growth in recent years — Indonesia posted economic growth of 4.5 percent in 2009 — have helped to reduce public debt and strengthen the economy. However, the country still must struggle with the issues of poverty, unemployment, inadequate infrastructure, corruption and a complex regulatory environment.

India is another big winner, according to Zonis. “I’m impressed by the spike in investment going on in India’s infrastructure sector, which has been the big holdup to economic development,” Zonis says.

As far as real estate investment, however, investors in India, in general, have been frustrated. India, while full of promise, still presents challenges to foreign investors due to widespread corruption, layers of bureaucracy and a lack of necessary infrastructure, which, as Zonis notes, is a precursor to sensible development.

“There was a lot of interest in emerging Asian markets pre-crisis and equity capital went into places such as India,” states Victoria Sharpe, man-

aging director and CEO, Pramerica Real Estate Investors – Asia, an affiliate of U.S.-based Prudential Financial. “It turned out to be somewhat like an Armageddon for a lot of people. Because of the financial pullback, there were huge value declines. You don’t really hear about many success stories in these markets.

China has received accolades as the engine pulling the global economy out of recession. A January 2010 report by the International Monetary Fund forecasts 10 percent GDP growth in China this year, up from 8.7 percent last year, as the country’s economy leads a broader Asian recovery.

“The current investment landscape in China is quite healthy,” continues Sharpe. “But most of the activity is coming from domestic capital in China. Foreign investors, due to the recent financial decline, have really pulled back. Opportunistic-type returns are not readily available in Asia now. I don’t see U.S. pension funds coming to Asian markets because the risk-adjusted returns that they require just aren’t there. Why take on more risk to get a 10 percent return?”

Many investors are wowed by China’s strong economic growth and urbanization trend, but the country is not immune to business cycles, says Zonis. “I think bubbles are being created in certain industries, including real estate,” he explains. “China is now spending about 50 percent of its GDP on investment, and a lot of that, of course, is investment in real estate, both housing and commercial. I think a bubble in terms of production capacity also has been created. There will be a time when China will hit a wall and the bubbles will burst, causing growth to fall sharply, and there will be political unrest because the government won’t be able to create jobs for its people. I don’t know if that will happen in two years or five years, but it will come.”

Brazil, meanwhile, is becoming the darling of emerging market investors. “As far as the interest in Brazil, it’s as if the past two years haven’t happened,” notes Gene Reilly, president, the Americas, AMB

Capital Partners. “There’s a lot of interest. The economy slowed but didn’t stagger. We’re speaking to a number of investors that want to go beyond their target allocation in Brazil to get in at the right time and then bring the rest of their portfolio into line later. Many investors are still very enthusiastic about Brazil and want to get their investments started sooner rather than later.”

### BRAZIL SCORES

Brazil is indeed on a roll. Building upon its impressive rebound from the global economic recession, the country has high aspirations with its recent selection as host of the World Cup in 2014 and the Olympic Games in 2016. In addition, the economy, which currently ranks eighth in the world in terms of size, should receive a significant boost in coming years as recently discovered deep-sea oilfields are developed.

Brazil’s GDP should grow at a healthy rate of 5 percent to 5.5 percent in 2010, according to economic forecasts. In 2008, before the global economic recession, foreign direct investment in Brazil registered \$45 billion, second only to China among emerging markets. Among the BRIC countries, investors have warmed to Brazil because it is a democracy, it doesn’t have religious conflicts or

hostile neighbors, and its economy is not dependent on demand for one or two exports.

During the past decade, Brazil has managed to put its economy in order through prudent monetary and fiscal policy. Further, government stimulus efforts — tax incentives on cars and housewares, in addition to the \$15 billion low-income housing plan — put into place during the slowdown have been largely successful to date. These aspects coupled with increased foreign direct investment, increased wages, political stability, strong demographic trends and greater availability of credit present an attractive argument for real estate investment in Brazil.

“We have seen rekindled interest [in Brazil] from institutional investors seeking growth in their portfolios,” says Jack Koch, a principal with The Townsend Group. “With unleveraged returns targeted in the mid-20 percent range, the question today focuses around the opportunity cost of putting capital to work in an emerging market versus investing in a developed market with perceived less risk at home. On my last trip to Brazil, I ran into several LPs expressing that the country was back on their radar and they were planning on commitments this year with the intention to



**Beautiful Brazil:** Brazil is the largest foreign direct investment (FDI) recipient in Latin America, attracting an estimated \$45 billion in 2008, according to a recent United Nations report.

diversify their portfolios a bit away from the distressed opportunities they were looking at in other locations around the globe.”

“Unlike the still nascent distress play emerging in post-bubble U.S. and Europe, the market opportunity in Brazil is very different,” explains Fred Gortner, managing director, Paladin Realty Partners, which has been active in Brazil’s residential market for more than 10 years. “Brazil is a demand-driven secular growth play with stronger real estate fundamentals and better investment visibility because it is not dependent on market timing or distress pricing. The Brazil real estate opportunity is being fueled by the same long-term growth trends described in Tom Friedman’s book, *The World Is Flat*: a large population of young people entering the workforce, rural to urban migration, rising middle class, prudent government policies and strong economic growth.”

These trends have created enormous pent-up and growing demand

for all kinds of “basic needs” real estate, such as affordable housing, neighborhood retail and warehouse/distribution facilities.

Carlos Della Libera, executive adviser to Brazil’s state housing secretary, recently quantified his country’s huge demand for low-income housing. According to Libera, 29 million new homes are needed by 2020. Government subsidies, regulatory reforms relating to property titles that enable freer commerce, and increased bank lending are driving demand.

AMB, which made its entry into Brazil in 2008, sees similar strong demand for distribution facilities. With a focus on the major markets of São Paulo and Rio de Janeiro, the firm has a good-sized pipeline of projects and is currently ramping up its operations with plans to add to its team and attract additional institutional co-investment capital.

“Brazil has a populous government that is also pro-business,” says Reilly. “Specific to our industry, Bra-

zil has a growing middle class and essentially no base of modern distribution product.”

Count real estate mogul Sam Zell as another believer who is bullish on Brazil. His private company Equity International has invested more than \$500 million in partial ownership of two residential construction companies, Gafisa and Tenda, as well as BR Malls, one of the country’s largest builders of shopping centers.

While Brazil’s future looks bright, the country still needs to make improvements in a number of areas, including education, infrastructure, tax and labor reform, poverty, and crime.

### WEIGHING RISK/REWARD

Clearly the E7 countries are emerging as the world’s economic powers of the future (see “New World Order,” left). Demographic trends in these emerging economies — as well as trends in the G7 countries such as aging populations and shrinking work forces — will drive real estate strategy. However, international investments, and especially investments in emerging markets, involve a number of additional risk considerations.

“Investors’ awareness of and fear of risk has immensely increased, especially in emerging markets, over the course of the past few years,” says Zonis. “At the same time they are realizing they are not going to get the capital appreciation they hope for in the developed markets of the world. So emerging markets look better and better in regard to returns.

“It seems to me, however, there are two massive caveats,” cautions Zonis. “One is the fact that just because these countries will have more robust growth does not necessarily mean that any particular investment will perform better than an investment in the U.S.; and second, there is still lots of risk in the emerging markets.” ♦

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## New World Order

The new decade will be characterized as the point at which the largest emerging economies catch up with and prepare to overtake the established leading economies, according to new research by PricewaterhouseCoopers (PwC) titled *Convergence, Catch Up and Overtaking: How the balance of world economic power is shifting*.

The research paper is based on projected GDP at purchasing power parities (PPP) for the G7 economies (Canada, France, Germany, Italy, Japan, United Kingdom and United States) relative to the emerging E7 economies (China, India, Brazil, Russia, Mexico, Indonesia and Turkey). PwC suggests that, by 2019, the output of these two economic groupings will be neck and neck, but this parity will not last for long as the E7 will retain much stronger growth potential. From 2020 onwards, the E7 will break away from the G7 with combined E7 GDP being projected by PwC to be around 30 percent higher by 2030 than total G7 GDP.

“These projections suggest that China could be the largest economy in the world as early as 2020 and is likely to be some way ahead of the U.S. by 2030,” notes John Hawksworth, head of macroeconomics, PwC. “India could grow even faster than China after 2020, however, and will also move rapidly up the global GDP rankings. Indeed, by 2030, our projections suggest that the global top 10 could see China leading the GDP rankings followed by the U.S., India, Japan, Brazil, Russia, Germany, Mexico, France and the U.K.”

The report concludes: As the last decade has clearly shown, the world will look very different by the middle of this century from what it did at the start.

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