Globalization of real estate capital flows

Raj Bhandari and Tim Morris

Raj Bhandari and Tim Morris provided the Global Executive Forum with fundamentals on the growth of the public real estate market in India and globally.

RAJ BHANDARI is principal at West University Capital. He has 20 years of real estate experience in the areas of principal investment, development and management including with Hines and Bakers Trust. Bhandari is actively evaluating several investment and development opportunities in India. Bhandari has been instrumental in the formation of SUN-Apollo Indian Real Estate Fund, which is currently raising $300 million in equity. Previously he represented Hines and its real estate fund in India. Bhandari has a BSc from the University of Bombay and an MBA from Kellogg Graduate School of Management.

India’s real estate market: On the radar screen at last

Not so long ago, real estate in India failed to arouse much interest from global or domestic investors, said Raj Bhandari. "Indian banks and Indian pension funds were largely not allowed to invest in real estate in India. It was almost completely financed by entrepreneurs and end users. If one wanted to buy a house or apartment a few years ago the odds were that they paid the entire purchase price in cash. Mortgages were generally too expensive. Add to that the fact that real estate in India was expensive and one of its cities (Mumbai) was ranked as one of the most expensive in the world.

"As to my personal experience in India, in 1996-97, I was the only person in India representing an institutional real estate investment firm when I represented Hines’ real estate fund with Morgan Stanley and TCW." After India conducted underground nuclear tests in early 1998, the Fund withdrew from the Indian market. Two years ago, Bhandari once again returned to India to explore opportunities in real estate. "People like Morgan Stanley and Hines basically said, 'Thanks, but no thanks. India is not on the radar.' " Likewise, a year and a-half ago, at one of the largest real estate trade shows in the world, "there was not a single desk or representative from India." Fast forward to 2005 and you find "almost every major real estate conference listing an Indian panel," said Bhandari.

“Approximately 15 firms at present including some of the largest real estate firms in the world are currently seeking to set up shops in India, including Morgan Stanley, Blackstone and Apollo." Bhandari attributes this newfound interest to a piece of Indian legislation enacted in February 2005 which relaxed government restrictions on foreign direct investment in real estate. The new FDI guidelines “opened the floodgates” of foreign investment into all sectors of India’s real estate market.

But Bhandari noted, “It’s still a very, very, young and emerging market, similar to what you may have seen in the US in the 1930s or 40s. India’s real estate market has not matured to the level where one can get accurate and reliable numbers on market size, etc.; the information just doesn’t exist. Information for a subset, which includes newer developments in larger metros, there are more reliable numbers – on rental rates, market size, cap rates, etc. But this subset is a small portion of the total market.” The mortgage market is fueling real estate investment domestically.

“The mortgage market as a percent of GDP in India is one of the lowest, partly because historically the interest rates have been higher in India and tax benefits have been lagging. But that has changed,” said
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Bhandari, pointing to the greater availability of mortgages along with a lowering of interest rates. “In 10 years the interest rates have gone from approximately 15 percent to about the current 8 percent.”

**10th largest GDP**

“The fact that India is the tenth largest economy by GDP can be misleading,” said Bhandari. “The numbers - more than a billion people – are what make it the 10th largest economy. The average income of an Indian, meanwhile, is comparable to some of the poorest countries in the world: around $650, $700 per year.” However, the average annual income doesn’t tell the whole story. According to Bhandari, the purchasing power of India’s middle class, which numbers 200 million, is the real driver “Incomes of middle class Indians are growing by approximately 15 percent a year. The middle class is increasingly becoming urban and consumption oriented.” As an example of how consumer patterns have changed, Bhandari offered these statistics: “In 1991, 150,000 cars were sold. The sales at present are around a million.”

Reforms have stimulated growth in other areas. “In 1991, there was only one airline company in India; today there are eight domestic carriers. And India has become the world’s second largest market for aircraft manufacturers, a vast change in just the last 10 years.

“Organized retail outlets are also growing. One example is malls, projected to grow from 30 in 2005 to around 300 in 2008.” India’s highly educated, lower-cost workforce, which is drawing foreign companies to outsource various business processes to its shores, will continue to fuel growth in the country and ramp up demand for real estate, said Bhandari.

**Obstacles?**

“Infrastructure is a big problem. People sometimes are building Class A office buildings before there is a road to get to them. Highways are being planned and built rapidly but it’s going to take time for the country to put in place an infrastructure that one expects from an economy of its size. For example, trains, the preferred form of transportation for most Indians, require large infrastructure upgrades. Three or four major airports are being privatized and Bangalore, one of the fastest growing metros and one everyone hears about as being the Silicon Valley of India, will only now have an international airport.” A guest remarked, “India is still a country with enormous poverty and little infrastructure. But for what they have, they have really produced outstanding results.”

**J. TIMOTHY MORRIS** is a managing director of Morgan Stanley, serves as the global chief financial officer of Morgan Stanley’s real estate investing business, is the global chief investment officer of the Morgan Stanley Real Estate Special Situations Fund II and is an investment committee member of the Morgan Stanley Real Estate Funds. He previously served as the co-head of Morgan Stanley’s European real estate investing business in London and spent the previous 13 years in New York and Hong Kong assisting real estate clients in accessing the international debt and equity capital markets. He received his BS in finance from Indiana University.

**Global investing: Competition for capital creates opportunities**

“Morgan Stanley has been investing in real estate since 1990,” said Tim Morris. “We have invested in 17 markets around the world ranging from Western Europe to Japan, China, Hong Kong, Taiwan, Singapore, Thailand and Brazil.” About 50 percent of Morgan Stanley’s $40 billion of real estate holdings is in the United States, 25 percent in Europe and 25 percent in Asia.
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The ability to allocate capital to multiple markets equates to better risk adjusted returns. “Our total returns have been 21 percent back to investors over a 15-year period of time.” Japan is Morgan Stanley’s largest and best performing market, with a workforce of 120 people. “We started investing in Japan in 1997 and the return has been about 37 percent,” said Morris.

“All real estate is local. So we now have 19 offices around the world including London, New York, Milan, Beijing, Shanghai, Mumbai, Tokyo and Hong Kong. The other aspect of international real estate investing is to have good local partners; you can’t do it by yourself.” Identifying those partners takes a lot of time, he added. Morgan Stanley has “close to 200 operating partners around the world.” In China, the challenge has been to figure out who has what it takes to qualify for partner. “The prospective partners are all young, strong companies that are ambitious but they need a lot of help from us to get to the level where they can deal with international institutional investors,” said Morris.

In the international marketplace, “there’s a big transformation of real estate taking place,” he said. “It’s going from nontraditional real estate owners and moving in bulk to organizations like Morgan Stanley Real Estate Funds. We manage the properties for a couple of years, stabilize them, improve them and start to show a positive story. Then we sell them out on the retail side. That wholesale-to-retail trade has been a big market for us.” Typically the buyers in these transactions are local investors.

Western-style properties have set the standard worldwide; consequently, “the architecture has become very homogeneous,” said Morris. “It would be very sad if one day you wake up and can’t tell whether you’re in Hong Kong, Mumbai or Shanghai. But that’s kind of where it’s going.”

Market highlights

Morris identified what he called “interesting markets and opportunities.

- “Japan’s JREITs, which started about five years ago, are now a $20 billion market. We think it’s probably going to $60 billion over the next five years. The dividend yield of the JREITs, many of which are portfolios of Class A office buildings, is at about 3.5 percent. It’s going to make a lot of sense for a lot of capital to find its way into JREITs.

- “In Russia, Moscow is a city of 12 million people and there is a huge need for housing just as there is in India. There is no lack of capital in Moscow today but clever real estate groups don’t want to be associated with some of that capital because it comes with a lot of baggage.

- “China is a very under-retailed market. Wal-Mart has extremely ambitious growth plans in the country. They want to have 400 stores there in 10 years. You can’t own land as a private investor but you can get a 70 year lease. In other situations like Hong Kong, there are fairly well-established ways to renew that lease when it expires and investors don’t seem to be deterred by this restriction.

- “India’s poor infrastructure is going to be one of the big challenges. Morgan Stanley is starting to look at real estate investments there. Eighteen months ago the rules were such that the only thing we could invest in was 200 acre master planned communities, which contain so much risk we would never do it.

“Capital doesn’t matter anymore; everybody’s got capital. If you’ve got access to deals, that’s the most precious commodity in these markets today.”
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- “Mexico has a housing shortage of five million housing units; they’re building about 350,000 a year. The demographics spell opportunity for investors: 700,000 new household formations a year; 60 percent of the population under the age of 30; a median age of 24.

- “Turkey is a phenomenal market. Istanbul with 12 million people does not have a Western covered shopping center anywhere. The new mortgage law that went into effect Nov. 1 is going to change the way people spend the small and precious capital they have because the first thing they’ll want is a nice place to live. So you’re going to see a lot of investments there. Turkey is definitely a market that is up and coming and getting a lot of interest.

- “Spain is a great call in the developed markets. It’s got higher growth and the interest rates are low for what’s going on in that market. So capital is going to continue to flow into Spain as long as that growth continues and interest rates are where they are. I think you’re going to see it in all the European Union ascension countries.

- “Europe is a very exciting place to be an investor. The various countries are still competing with each other for capital and capital competition among these governments creates opportunity. One government does something that turns out well and other governments copy it and tries to do it better. The competition continues to create good investment opportunities.”

A pan-European environment would be a turnoff for investors. “In Europe we want Europe-specific opportunities and country specific opportunities because the cycles in these countries differ from one another. A pan-European block would flatten everything out and make it less interesting to us as professional investors.” Social issues at the local level will keep this from happening, he added.

Capital is flowing freely across borders in search of opportunities. That makes capital less of a prize. “What we say to people right now is that your competitive advantage in landing a good investment is not capital; everybody’s got capital. If you’ve got access to deals, that’s the most precious commodity in these markets today.”

To illustrate this point, Morris referred to a transaction involving a publicly traded company that Morgan Stanley took private a year ago. The company was Canary Wharf, a $10 billion office estate in London. “It took us only six phone calls to raise the capital based on our ability to control the deal internationally and then go into syndication.”

Billions of dollars in capital earnings are piling up in the oil producing countries. “At $60 a barrel, the oil countries are flush with cash and they have a hard time figuring out how to get that money invested. “So we are benefiting tremendously from people coming to us — as I’m sure all the international managers are — wanting to write checks for $200 million to $400 million a pop and asking how soon we can get it invested,” said Morris.

“We’re seeing a lot of that capital and the deals that we’re pursuing are big and complicated and must be worked out. We’re not just buying an office building.”
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### World Development Indicators database

**World Bank, 15 July 2005**

**Top 20 Countries**

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*a. Data includes the French overseas departments of French Guiana, Guadeloupe, Martinique, and Réunion.*