USAA Real Estate Company

RISING FOREIGN CAPITAL FALLS ON U.S. REAL ESTATE

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Direct commercial real estate acquisitions by foreign investors have risen for four consecutive years, topping $37B in 2013, the most since 2007. These acquisitions also comprised more than 10% of all real estate transactions in the U.S. for 2013.[1] A recent survey by AFIRE, which represents 21 countries and 200 investing organizations, suggests this may be the beginning of a long-term trend as 81% of respondents intend to increase their investments in U.S. real estate – far more than any other country. This trend is a reflection of the positive sentiment regarding the U.S. real estate market. However, the flood of foreign capital may contribute to an environment that limits the pool of attractive acquisition opportunities available to real estate fund managers.

Broadly speaking, U.S. real estate assets are getting expensive. According to Green Street, on aggregate, institutional-quality property values are 10% higher than previous peak-levels reached during 2007. We believe that the surge in foreign capital is partly to blame, specifically in Tier 1 markets where more than half of all direct foreign real estate investments have occurred since the recession ended.[2] Due to strong competition for quality assets, property valuations in Tier 1 markets have risen to the point that an increasing number of fund managers are gravitating toward secondary markets in search of higher yielding assets.

Furthermore, capital from foreign investors helped increase dry-powder, or uncalled capital, to record levels in the first half of 2014. We think that dry-powder has also accumulated because fund managers are struggling to identify acquisition opportunities worthy of deploying capital. A recent Preqin study found that 47% of fund managers surveyed are reviewing more opportunities for each investment made versus 12-months ago. Yet, overall transaction volumes were up during this same period. This gives us reason to believe that many fund managers are scouring through a massive amount of potential deals in order to find attractive return opportunities, and/or they are securing lower-yielding deals in an effort to deploy capital.

Ultimately, attractive real estate acquisitions are harder to find when compared to just a few years ago. Furthermore, we expect fund managers will cast a wider and deeper net into secondary markets while also considering niche property sectors – in order to generate higher yields – if the inflow of foreign capital becomes a long-term secular trend.

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[1] Of course, this understates total foreign investment activity in the U.S., as a large component of foreign investment in U.S. commercial real estate is via investment in U.S. funds versus direct investment.
[2] Tier 1 markets are in this article defined as NYC, DC, San Francisco, LA, Chicago, and Boston.

Dr. Will McIntosh
Global Head of Research
Phone: 210-641-8416
Email: will.mcintosh@usrealco.com

Mark Fitzgerald, CFA
Research Analyst
Phone: 210-690-6706
Email: mark.fitzgerald@usrealco.com

John Kirk, CCIM
Research Analyst
Phone: 210-690-6715
Email: john.kirk@usrealco.com

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