USAA Real Estate

Foreign investment in US real estate — Now more than ever

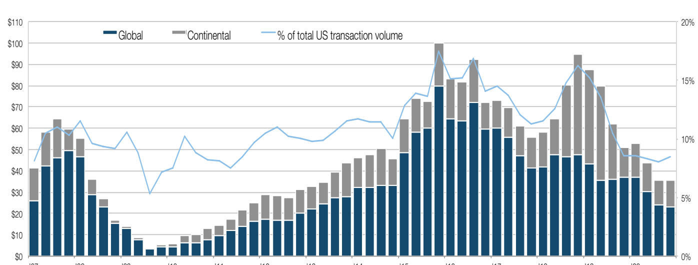
The United States is one of the world's leading real estate markets for cross-border capital. Past return performance, favourable growth and demographics, a strong legal infrastructure, and a diverse asset base consistently attract foreign investors. Since 2010, foreign investors have invested more than $2.2 trillion in US commercial real estate (CRE).[1] The COVID-19 pandemic slowed the acquisition activity of cross-border investors, but not more so than that of domestic investors. The initial fear that foreign investment in US CRE would come to a halt due to restrictions on travel and political uncertainties did not transpire. This article examines recent cross-border investment activity and explores why now, more than ever, represents a good opportunity for foreign investors to invest in US real estate.

Foreign investment down, but not out

Cross-border investment in US CRE was down in 2020, but deal activity of domestic and cross-border investors fell at similar rates. Foreign investment in US CRE fell by 31 percent to $35.5 billion, matching the decline in overall investment. Cross-border capital represented 9 percent of all CRE investment in the United States during 2020. This is short of the pace of cross-border investment during the period from 2015 to 2019, when the figure averaged 13 percent. However, cross-border activity plummeted to just 5 percent in the aftermath of the last global recession.[2]

Notable spending by groups headquartered in Canada, South Korea and Germany alleviated fears that foreign investors would desert the United States. However, geographic proximity had a pronounced effect, with deal volumes from neighbour Canada down by only 10 percent from a year earlier. Investment from Europe fell more sharply, down 40 percent from 2019 levels. European investors rebounded in the fourth quarter, with the pace of acquisitions up 17 percent from a year prior. Although German investors pulled back their purchases by almost a third, they were still amongst the top three sources of capital into the United States last year. Additionally, groups from the United Kingdom and France spent more on US CRE in 2020 than in 2019.[3]

Exhibit 1: Global and continental direct acquisitions in the United States (trailing, four-quarter data, $ billion)



Sources: Real Capital Analytics, USAA Real Estate Research

Prospect of stability ahead

Foreign investors were still net-buyers of US CRE in 2020, a trend that was consistent across investors in all regions. After an initial pullback, pent-up demand ratcheted up spending towards the end of the year as transparency in pricing improved for some asset types. This is a testament to the strength of the economy and the fundamental attractions of the market. Fourth-quarter data reflects a continuation of economic recovery, albeit growth moderated towards the end of the year. Consensus estimates suggest robust growth in 2021 of 4 percent to 6 percent, spurred by robust government stimulus, ramping up of vaccinations and easing lockdown restrictions.

The Biden administration is expected to use its political capital to enact an accommodative, pro-growth agenda to get the economy back on track, which should ultimately bode well for CRE. One thing many are expecting is political stability — real estate markets, like all markets, favour stability. As the US economy continues to recover and grow, it is likely foreign capital will ramp up investment.

Attractive opportunities for investment

Cross-border investors still view US CRE as a stable, safe investment. According to the *2021 Investment Intentions Survey* from PREA, both European and Asia Pacific–based investors favour the United States for out-of-region investments. Core is the investment style identified by the greatest number of investors as currently being the most attractive in the United States.[4] Appetite for core investment assets remains strong, with foreign investors leaning towards solid performers like industrial, multifamily, healthcare, and life sciences properties. The industrial sector was strongly in favour in 2020, capturing 31 percent of all cross-border investment, a record high for the sector. The industrial market fundamentals remain strong, owing to accelerating tailwinds associated with ecommerce, on- and near-shoring, and a shift from "just in time" to "just in case" inventory levels. Offices are still considered a viable investment, despite the near-term reduction in demand. The office sector accounted for a 31 percent share of cross-border investment in 2020, smaller than the 40 percent share of all cross-border investment seen from 2011 to 2018, yet still significant. Private real estate debt also presents an attractive proposition, at a time when returns from risk assets have been pushed to all-time lows. Whole loan strategies can offer returns in the 8.0 percent range, which, compared with similar European strategies, feels very attractive.[5] The inevitable pressure for investors to put capital to work is expected to continue to fuel demand for US assets. With greater clarity on future revenue streams, foreign buyers should become much more active, especially once travel restrictions are eased.

Relative value

Past performance relative to other parts of the world, as well as the scale and liquidity of the US market, continue to fuel demand from foreign investors. Certain countries have limited investable product at home, which has contributed to the compression of their core capitalisation rates and, thus, the desire of investors to look elsewhere for yield. With sovereign bond returns very low in many developed economies, capital flows from abroad into US CRE should remain strong. The United States looks particularly attractive because of its strong job creation and overall economic growth.

The latest jobs report and changes in policy expected out of the new Biden administration have helped the 10-year Treasury inch up so far in 2021. However, the spread between CRE capitalisation rates and bond yields remains well above long-term trends. Despite challenges in the market, US CRE is still priced attractively relative to other asset classes. Current corporate yields are low, ranging from 1.90 percent to 2.52 percent across the Barclay's investment-grade indices.[6] As shown in Exhibit 2, capitalisation rate spreads are currently wide of their 30-year average. With government and corporate bond yields still relatively low, this should help to reinforce allocations to US CRE assets.

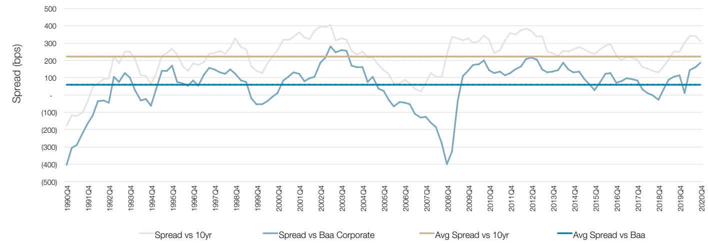
Lower hedging costs

When investing in US real estate, foreign investors must decide if they should hedge currency risk. Institutions in many countries around the world that are investing in the United States are required by law to hedge the equity portion of their investment, most notably Korean institutions and German open-ended funds.

The cost of hedging currency exposure is related to the interest rate differential between the United States and the other currency's country or region, known as the cost of carry. The last several years have seen dollar-hedging costs rise for many foreign investors as a result of monetary tightening from the Federal Reserve (Fed). Particularly hard hit were those investors whose home currencies had been faced with negative interest rates. In the past, prohibitive hedging costs had deterred some foreign investors from buying US assets because they eroded returns.

However, since the Fed reduced rates at the beginning of the COVID-19 pandemic, hedging costs have come down significantly. Annual hedging costs for European investors are just 77 basis points currently, approximately one-third of the 2.24 percent cost in the beginning of 2020, and well below the cyclical peak of 3.37 percent in late 2018.[7] The Fed has pledged to keep interest rates near zero until 2023. The expectation of accommodative Fed policy suggests that lower currency-hedging

Exhibit 2: Cap-rate spreads to 10-year Treasury & corporate bonds



Sources: NCREIF, Bloomberg, USAA Real Estate Research

costs are generally here to stay in the near term. With the gap between short-term interest rates around the world narrowing, the change in the cost of carry in a hedging programme can have a material impact on overall performance. A lower-for-longer environment is also conducive to a weaker US dollar. This could make US CRE more attractive to foreign investors. If this continues for the next two years, the United States could well benefit from increased foreign capital inflows.

Diversification

The size of the professionally managed global real estate investment market is estimated to be worth \$9.6 trillion, and the United States continues to be the largest market, representing more than \$3.4 trillion in terms of investment opportunity.[8] Powerful diversification benefits can be achieved by spreading investments across different regions and markets. Despite the significant home bias within existing real estate portfolios, there are plans for out-of-region capital deployments this year, and the United States is in focus. Obviously, any investor needs to decide about the merits of a US real estate allocation given their own portfolio composition and objectives. But now, more than ever, one would do well not to ignore the positives. Given the relative liquidity and political stability, the United States will continue to attract foreign investors. For many, a window of hedging with exceptionally low cost has opened up, with the additional prospect of even securing a currency gain on top of asset returns for some investors. Although virus-control measures and travel restrictions continue to impact parts of the world, an upturn in cross-border investment will likely occur this year.

Notes: [1] Real Capital Analytics; [2] Real Capital Analytics; [3] Real Capital Analytics; [4] PREA, *Investment Intentions 2021*; [5] Net returns, prior to hedging; [6] As of 5 March 2021; [7] Bloomberg; [8] MSCI, Real Estate Market Size 2019/20

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CORPORATE OVERVIEW

USAA Real Estate provides co-investment, acquisition, build-to-suit and development services for corporate and institutional investors, and arranges commercial mortgage loans on behalf of affiliates. The Amsterdam-based operation is actively engaged in developing, acquiring and managing institutional-quality real estate investments, primarily through its pan-European logistics venture, Mountpark Logistics EU.

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