Where in the World ...?

Global Fund Raiser Ron Dickerman Evaluates Capital Flows into Real Estate

Ron Dickerman, president & founder of Madison International Realty L.L.C., spoke with *CPE* editorial director Suzann Silverman about where real estate investment dollars are coming from and where they are being invested today.

Q. What countries' investors do you find are most interested in commercial real estate right now?

A. Real estate has really become a structural component of almost any institutional real estate portfolio. If you walk into any institutional investor, no matter where they are, and you say, "What is your percentage allocation for real estate?" virtually everybody will have an answer. The other thing going on is real estate is becoming a larger component of what they do. So we've been seeing quite a lot of announcements of XYZ Pension Fund is raising their real estate allocation bucket from 6 percent to 9 percent or 8 percent to 12 percent. Those may sound like small movements, but when you're talking about a $20 billion pension fund, that is a fair amount of capital. So that's point one.

Point two: In a world where fixed income rates of return are very skinny, people have always looked at real estate as a current dividend-yielding play. I think that's also driving the attractiveness of the asset class. What we're starting to now see is lots of capital flowing from different points in the world—certainly coming from Asia, and within Asia, China, Korea, maybe a couple of points of Hong Kong. The Middle East has always been a big investor, both from the sovereign wealth funds and some of the private families and private capital. And then you're seeing a little bit of money coming from Germany. We've seen some capital coming from pension funds who are in the United States who are trying to go direct.

It's really been broad-based. If I had to pinpoint it, though, I would say more capital is flowing from Asia than ever before. And it is interesting: If you look over the decades, it comes from different places at different times. Back in the 1980s, it was the Japanese, and then it was the Middle East. And now it definitely feels like China and Korea are where lots of the money is coming from.

Q. On the flip side, where do you see global investors most wanting to invest now?

Executive Summary

Madison International provides equity to commercial real estate owners and investors seeking to sell partial ownership interests, joint venture, monetize value or restructure their balance sheets. It recently closed an $825 million fund, the largest in its history, with 40 percent of it already invested. In the past two years, it has invested about $600 million worth of capital and returned about $500 million to its investors.

A. They're very, very hungry for U.S. gateway cities. Top of the list would be New York, San Francisco. A few years ago, you would have included Boston and Washington, but Washington has waned a little bit. We've actually seen that with yields, where the government has been pulling back on spending and the market's gotten a little bit stagnant. Boston has also been slow to recover as quickly as New York. But when we were traveling around in Korea, every investor said they wanted New York. That's what they want.

(But) when you compare the relative opportunities, the U.S. feels a little overbought and a little frothy, considering all the capital coming in here. Certainly Europe is on everyone's hit parade. If you asked any global investor two years ago, they would have said, "Europe is too early; we're concerned about the breakup of the euro, and we're not doing anything there." That has totally turned upside-down, where now Europe is probably the primary focus of investors because they view the economic recovery to be well behind the United States. ...

The big issue with Europe is there's a little bit of a ticking time bomb as it relates to demographics: The population is declining in most of the major countries of Europe, and you need to be really careful about investing outside of the major metropolitan areas for that reason. We've had business in Europe for a long time, and we've made some really interesting investments there, but we've stayed to the prime assets in capital cities with long-term leases, where we can harvest the dividend yield and we can buy interest from distressed sellers.

Madison International Realty has acquired stakes in significant properties around the world, including *(from left to right)* Songbird Estates' ownership of Canary Wharf in London; the Statoil office complex in Oslo; 384 Post St. in San Francisco's Union Square, wholly occupied by Saks Fifth Avenue; and 655 Madison Ave. in New York City.

Q. How much have you found the extended discussion of FIRPTA to be impacting foreign investment in the U.S.?

A. We've been active in something called the Invest in America Coalition, which is a lobbying group to try to lobby Congress to amend the FIRPTA laws. … FIRPTA definitely impacts global investor appetite for U.S. real estate. We court investors all around the world. When you're in any jurisdiction outside the United States and you talk about where they're looking to invest … the minute you bring up U.S. real estate, the first reaction is, "How do I handle the tax issues? How do I handle FIRPTA?" It literally feels like you travel with one hand behind your back, because low-returning strategies in the United States are really difficult for these foreign investors because of the leakage that comes out of the returns because of FIRPTA.

Q. What do you see happening currently with U.S. investors' interest in buying overseas?

A. Europe has gone from totally hands off to being on the top of everybody's list. A couple years ago, you'd pick up *The Wall Street Journal* and every day it was the breakup of the euro, Greece is going to secede, or Portugal is going to pull out, or Spain is going to default. And yields were 7, 8 percent. Now it's totally turned around. You never, ever hear about anything going on with the euro. In fact, most of the bond yields in some of these sovereign nations, even Spain, have come down to, like, 4 percent. So the risk of default is virtually nil. From our perspective, that's completely changed investor sentiment. The swing-set has swung around the other side, where most U.S. investors now have a pretty strong appetite to invest in Europe.

Prior to that, everybody was crazy about Brazil. Brazil was the place where capital was flowing into infrastructure and real estate because of the demographic growth and the fact that there just wasn't a well-developed infrastructure. Now there is a big correction in Brazil, there is some social unrest there and the whole thing has turned the other way, so no one really is focused on Brazil right now.

Russia is sort of off the table because of corruption. China, people are looking at a downdraft and a little bit more of a correction, although I think people are intrigued with China. But when you peel back the onion, if you really ask people, “Have you made money in China?” most of the people say, “No.”

Q. What is the appetite for risk right now among global investors?

A. It’s an interesting marketplace because people feel like the good stuff is priced at a premium. Everyone wants to own Class A in major gateway cities of the United States and maybe even London. I think London and New York are at the very top of the list in terms of investor preferences. The problem is, it’s gotten too frothy for most rational investors. I think they’re faced with almost the same conundrum they were faced with in, say, 2005-2006, where they wanted to buy the best but didn’t really feel like they wanted to pay the five cap or the four cap.

I think the big bogie is rising interest-rate risk. Everyone is concerned about Federal Reserve changes in policy and rising interest rates. Everyone believes that rates will rise. The question is: Over what period of time? So then the question is: How do you buy at a four-and-a-half cap rate in a rising interest-rate environment and think that you’re going to make money? A lot of investors are saying: Maybe I shouldn’t be looking at the prime stuff; I should be going to second-tier markets and buying either prime or core. Or I should be looking at value-add strategies where I’m enhancing my return through value-add.

The only thing that I keep saying is: Just make sure you know what your risk-return profile is. That’s exactly what people did in 2005 and 2006, and they got their heads handed to them because second-tier markets don’t hold their value nearly as well. And value-add strategies tend to get turned upside-down in times of economic dislocation, where you can’t lease the building and you can’t get the rents that you pro forma-ed, and you’ve got a leveraged capital structure, so you have to feed the debt service.

Q. Do you find a different appetite for risk among some overseas investors versus U.S. investors?

A. I think it’s the U.S. investors that are willing to take the bigger risk. ... The gold standard for opportunity fund investing is Blackstone. ... People will take a different risk investing in a fund if it’s Blackstone, because there’s strength in numbers and their track record is really good.

Q. Where in the world do you see the best opportunities for the types of investments that you seek?

A. We still believe that prime assets in gateway markets will always hold their value the best in a down cycle and recover most quickly in an up cycle. So we are not going to second-tier markets. We are staying in major capital cities of the United States. We have offices in London and Frankfurt, and we invest selectively in major capital cities of Europe: Frankfurt; Munich; Paris; Amsterdam; Oslo, Norway. ... That’s been part of our strategy for many years, and we’re continuing to stay focused on it.

Q. Where are you expanding, and what areas are you most concerned about? And are there any areas that you’re specifically avoiding that you might have previously considered?

A. London is a market that we’re still focused on but proceeding with some caution, just because it’s probably at the top of anyone’s list for desirable markets to buy. Other than that, there’s not a market that we have necessarily turned

Among Madison International's global investments are such iconic properties as the Trianon Building in Frankfurt *(top)* and One California Plaza in Los Angeles *(bottom)*.

cold on that we used to be hot on. There are some markets that are countercyclically out of favor—markets like Washington, D.C. ...

The other market in that category is Paris. Because of what's going on with taxes and the fiscal situation in France, Paris is out of favor with major investors. There are a lot of companies that feel like they can't operate there anymore because of the tax environment. ... But the question is, is that a countercyclical buying opportunity or is it something you should stay away from? We're watching it very closely.

Q. How are you hedging against the risk in London?

A. We're trying to avoid bidding cap rates way down and prices way up. We're trying to find differentiated entry points to make investments. And we're not participating in competitive bids. ... We've also been selling things we own in London. We sold the Lloyd's of London insurance building that we owned on Lime Street that was in a joint venture. And we sold the Devonshire House (in December 2013). It was the highest price ever paid for an office building.

This is a great time to be trimming your portfolio and taking chips off the table. It's a good time to be a seller, as long as you feel like the markets are fully recovered. The great conundrum driving our investment business is that most investors think that we're mid-cycle in the United States. Rents have continued to rise as the U.S. economic recovery gains traction and the job machine kicks in. Why would you sell your building now if rental rates could go up next year and the year after that? You probably want to hold it for a couple years. There's a little bit of a balancing act there.

Q. What are some of your most interesting recent investments?

A. We have been buying up shares of a German syndication that owns the Saks Fifth Avenue store in Union Square in San Francisco from German individual investors who want liquidity. The building itself is a trophy asset. We've been buying it at several hundred basis points of cap rate above where we think the property would sell in an orderly marketplace. It's a real arbitrage, and we like that a lot. We own about a third of the L.P. equity now, and we're continuing to buy it. The property is 100 percent triple-net leased to Saks, and it's unleveraged.

The other thing we did is we took a stake in something called Songbird Estates, which is the listed property company that owns 75 percent of Canary Wharf. We think Canary Wharf is just a fabulous submarket of London, one of the highest-quality office neighborhoods that exists there, leased long term to some very high-quality credits. It was a chance for us to enter the ownership at an off-market price. The shares have gone up about 50 percent in value since we bought them about a year ago.

Q. Given where global economies are now, are you finding certain types of opportunities more than others?

A. We're focused on capital partner replacements where they're looking to exit ownership of JV interests. And we're also providing joint venture equity to sponsors who want to sell a partial piece of their building in order to take some chips off the table, put some money to work somewhere else but keep a significant stake in the building to participate in the future rental growth, the NOI growth and the capital appreciation. ... We have a very active JV program. ... We have no management and leasing expertise; we're purely financial investors. But we can also write pretty big checks because of our financial underpinning. ... You may be aware that we bought half of Forest City Ratner's New York City retail portfolio about two years ago. That was a great example of a friendly joint venture that's worked out extremely well for both parties, where we helped them monetize some of their embedded equity. CPE