Foreign capital remains hungry for US commercial real estate

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Despite the Fed's upcoming rate hike and increased volatility in global markets, the US remains a top destination for commercial real estate investment.

Well into the second half of 2015, the U.S. continues to prove itself as the land of opportunity — at least for commercial real estate investments.

Events such as China's economic slowdown, unrest in the Middle East, and tumbling oil prices have fueled global capital flight toward quality. Balancing the aversion to risk with a demand for higher yields, investors are turning to the U.S. as a safe haven for their assets.

Last year, total foreign capital poured into North American commercial real estate reached $45 billion. Do not expect this trend to slow down: nearly $33 billion in foreign capital was injected into the U.S. during the first six months of this year, according to Real Capital Analytics. In fact, overseas money is so bullish that it will likely account for the largest increase in the availability of equity capital, followed closely by pension funds, hedge and opportunistic funds, and private local investors.

While Canadian investors have traditionally invested more capital annually than their foreign counterparts, the share of investment coming from Asia, and especially China, is rapidly catching up. The past two years have witnessed an explosive rise in outbound capital flows into real estate from Chinese institutional, corporate, and high net worth investors.

Chinese real estate firms have typically entered overseas markets not only to expand financing channels, but also to foil tightened government policies against property development in China. What began with China's sovereign wealth funds and tier-one insurers cautiously acquiring overseas high-profile trophy assets a few years ago has now extended to mid-tier insurers and corporate investors.

Changing destinations

Whereas the overwhelming majority of foreign capital was once solely interested in gateway markets like Miami, New York and San Francisco, foreign investors have begun to broaden their appetite, becoming more active in alternative or secondary markets such as Boston, Washington, D.C., Chicago, Dallas, Denver and even Atlanta, narrowing the pricing and volume gap between the larger, more liquid metro areas and their smaller peers.

As these buyers venture beyond core coastal markets, second tier cities have become a viable substitute to traditional urban centers for real estate investment, especially those that attract high-paying technology and biotechnology jobs in cities. Denver, which currently leads Forbes' list of the Best Places for Business and Careers, is a notable example. Since 2013, cross-border transactions amount to a whopping $1 billion, of which $460 million occurred this year.

This dynamic is even more evident in Atlanta. At number five, this metro also ranked high on Forbes' list of the Best Places for Business and Careers and has, since 2013, received over $1.5 billion of foreign capital, of which more than $1.1 billion stems from transactions this year. When talking about foreign investment in U.S. real estate, expect the next decade to be dominated by cities with these qualities.

Despite the fact that U.S. commercial real estate prices have eclipsed their 2007 peaks, cap rates, or the rate of return on a real estate investment property based on the expected income the property will generate, remain higher than in other developed countries, driven primarily by higher benchmark Treasury rates.

Cap rates do not only depend on interest rates, but also on market risk premia and economic growth rate, which in the US is expected to grow at an annual rate of 3% in 2015.
The Fed's imminent rate hike has many investors concerned over the health of cap rates. Although cap rates have historically plunged in periods of rising interest rates, this performance has been in milieu of a multi-decade compression cycle for USTs and cap rates. For example, the yield on the 10-year US treasury rose around 110 basis points from September 2003 to June 2007, while cap rates on commercial real estate transactions dropped roughly 150 basis points.

By historical standards, average cap rates are still significantly higher than the interest rates available for financing, leaving ample room for rates to inch higher without rattling the property markets. Interest rates, a topic that is never skipped among investors, should be of much less concern to foreign investors, who typically buy assets of significant scope and on an unlevered basis, and are therefore significantly shielded from the volatility in pricing metrics.

Proving equally buoyant, the underwriting discipline of both equity and debt remains pivotal to sustainability. Investors and lenders alike remain scrupulous, structuring deals with greater vigilance. It is becoming evident that one basic global challenge in today's commercial real estate markets is too much capital and not enough investment opportunities.

Brokers, but more importantly advisors, will play a pivotal role in seizing those opportunities and bridging the gaps between buyers and sellers.