U.S. CMBS – Five Compelling Attributes for Foreign Investors

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The U.S. market remains the top destination for foreign real estate investment, according to a recent survey published by Jones Lang LaSalle which noted $39 billion of foreign investment in 2013, representing a 40% increase over 2012. Capital flows in 2014 surpassed 2013 levels and investment activity continues to increase. According to the Association of Foreign Investors in Real Estate (AFIRE), a recent survey indicated that 81% of respondents, "intend to increase their portfolio of assets in the U.S. [as it] is perceived to provide a stable environment in which to invest and is the best market for capital appreciation." While sales of iconic U.S. properties such as The Waldorf Astoria for nearly $2 billion to Anbang Insurance Group of China or a minority interest in The General Motors Building to a venture comprised of the Chinese developer Zhang Xin and Brasil's Safra banking empire for an imputed value of over $3 billion are making headlines, foreign capital is also investing across the capital structure, not just in the equity, but in the debt.

The General Motors Building – NY, NY

While sovereign funds from countries such as Singapore, China and Norway are well known investors, many newer entrants are making significant inroads into the U.S. real estate market, or have announced plans to do so, including investors from South Korea, Malaysia and the Middle East, among others. These institutions are fluent in the U.S. market, are comfortable with the economic recovery and continue to see the United States as a large, liquid and stable "safe haven" for investing. As large scale "trophy" assets become more difficult to source and as property prices continue to climb, particularly against a backdrop of record low interest rates across the globe, foreign investors are increasingly looking to the debt markets as a means of fulfilling their U.S. real estate allocations.

The Waldorf Astoria – NY, NY

This paper examines five primary attributes that make U.S. commercial real estate debt (CRE Debt), and CMBS in particular, a compelling investment for foreign investors, including: 1) favorable tax treatment, 2) increased visibility/exposure to the U.S. real estate market, 3) the ability to precisely pin-point risk and reward (from AAA to unrated), 4) liquidity and confidentiality, and 5) current income. With global interest rates near zero, U.S. CRE Debt provides investors with a liquid, discreet and current paying instrument secured by hard assets in a stable and growing economy.

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Background

As illustrated below, interest rates are at historically low levels on a global basis. Low interest rates, particularly in Asia and Europe have led to increased allocations by sovereigns to U.S. real estate as a greater "total return" investment and as a portfolio diversifier. Further, many investors, including those from China, Norway and Korea who have historically not been as active in the U.S. as other sovereigns, have substantially increased their investment activity in the U.S. in order to fulfill their portfolio allocations. However, as larger equity investments, from hotels to office buildings, have become increasingly challenging to source, and increasingly expensive, seasoned and relatively newer entrants alike have uncovered real estate debt as a compelling alternative, or as a complementary asset class, to their equity investment strategies that provides diversity, liquidity and current income.

Exhibit 1
Ten Year Sovereign Debt Yields (December 2014)

United States	2.3%
Canada	1.9%
United Kingdom	2.0%
Netherlands	0.9%
Germany	0.8%
Switzerland	0.3%
South Korea	2.7%
Japan	0.4%

Source: Bloomberg

Exhibit 2
Foreign Capital Invested in U.S. Real Estate (December 2014)

Year	$ Billions
2004	$14
2005	16
2006	31
2007	38
2008	15
2009	4
2010	12
2011	25
2012	28
2013	39
2014 Est.	42
Total	$264

Source: Real Capital Analytics

As noted above, global investment in U.S. real estate is steadily on the rise and at record levels. In addition to traditional participants, new entrants are joining the landscape daily with immediate demands for U.S. allocation.

Attribute #1 — Favorable Tax Treatment

One of the challenges for foreign investors investing in U.S. commercial real estate equity is the Foreign Investment in Real Property Tax Act (FIRPTA) of 1980 which requires non-U.S. investors to pay a 10% withholding tax on the sale of U.S. property investments. Such a tax puts foreign buyers at a competitive disadvantage and diminishes their overall returns. While the White House has proposed a repeal of the FIRPTA tax, which, if enacted, could have a major impact on increased U.S. investment, no such repeal has been put into place. Until the time of repeal or diminution, if ever, CRE Debt in most forms (and CMBS, in particular) is exempt from such adverse taxation, giving it a competitive advantage against similarly priced equity, as illustrated below.

Exhibit 3
Dilutive Effects of FIRPTA on Equity

	CMBS Investment	Equity Investment
Pro Forma Gross Return	10%	10%
FIRPTA Tax (10%)	0%	(1%)
Net Returns	10%	9%

CMBS debt is exempt from FIRPTA and other U.S. taxation and qualifies for exemption from U.S. withholding under the "Portfolio Interest Exemption" as long as the investment is purchased (versus originated, thus making it part of "a U.S. trade or business"), remains in the form of a loan (versus being foreclosed upon or containing an equity participation), is "debt-for-tax," and remains unleveraged. While there may be solutions that address certain of these exemptions, such as creating off-shore "blockers" in the case of a foreclosed asset, CMBS debt, plain and simple, is exempt from FIRPTA and other U.S. tax and thereby represents an advantaged way to access U.S. real estate.

Attribute #2 — A Logical First Step Providing Visibility and Exposure to the U.S. Property Markets

A compelling attribute of CMBS for off-shore investors is the visibility and exposure that CMBS provides into a variety of sponsors, asset classes and geographic regions at attachment points that are by definition senior to, and thereby more conservative than, the corresponding equity. Since CMBS bonds may be acquired in denominations as small as $1 million and up to as large as $500+ million, an investment of just $10 million could create exposure to as many as ten different CMBS trusts with financial reporting and performance visibility on as much as $15 billion of real property across the country. Such broad exposure could represent an ideal "first step" in approaching the property markets to gain valuable insights and perspectives about regions, economic trends, property types and sponsors.

Further, since many of the country's top-tier private equity real estate sponsors, including Blackstone, Brookfield, Carlyle, Cerberus, Colony, Fortress, KKR, Starwood, Tishman Speyer and Walton Street Capital, among others, are significant CMBS issuers, typically in single-name securitizations (e.g. Hilton Hotels, Equity Office Properties, The Grace Building, Rockefeller Plaza, etc.), CMBS can represent an excellent way to gain exposure to a particular manager and to better understand their investment style as a precursor, or as an enhancement to investing in one of their funds.

"In the current environment debt returns often exceed equity returns."

CMBS investing represents an attractive entry point for investors desiring to learn more about the U.S. property market and is a very useful tool for understanding property trends across the country in real time. CMBS offers robust property-level reporting for investors including occupancy, rental rates and cash flows, all of which can be used to better understand individual markets/assets and to generate investment ideas.

Attribute #3 – CMBS Allows Investors to Pin-Point Risk and Reward Along the Capital Structure

A challenge to traditional real estate equity investing is that the owner, while bearing all of the investment's potential upside, also bears all of the transaction's downside, often with binary outcomes. Investing in CMBS, on the other hand, allows investors to pin-point their exact level of desired risk and reward through the tranching of the CMBS, sequentially from AAA (the most senior level with the least risk and least return) to the unrated or mezzanine tranche that carries the most risk and most return (while remaining senior to the equity). Additionally, unlike equity investing which has limited liquidity, CMBS investments carry daily liquidity.

As illustrated below in the original CMBS capital structure for Blackstone's acquisition of Equity Office Properties from Sam Zell in 2007, the CMBS transaction afforded investors a way to access Blackstone's expertise and assets through the debt. However, unlike the equity, in which there was only one way to invest – through Blackstone's private equity fund at an implied basis of $400 per square foot – the CMBS allowed investors access to the investment in 19 distinct tranches of debt ranging from the senior AAA bonds at $91 per square foot or 23% loan-to-value (LTV) through the BBs at $183 per square foot or 46% LTV. Additionally, since the CMBS was outstanding for seven years, investors could trade in-and-out of the CMBS at various entry points as a proxy for the health of the overall U.S. office market.

Exhibit 4

Equity Office Properties Capital Structure at Closing
($ Millions except per square foot data)

	Rating	Face	Loan to Value	Loan per Sq. Ft.
Assumed Debt		$1,217	7%	$28
GSMS 2007-EOP Trust:				
A1 - CMBS	AAA	2,773	23%	91
A2 - CMBS	AAA	585	26%	104
A3 - CMBS	AAA	607	29%	118
B - CMBS	AAA	370	31%	126
C - CMBS	AA+	432	34%	136
D - CMBS	AA	220	35%	141
E - CMBS	A+	238	36%	146
F - CMBS	A	215	38%	151
G - CMBS	A-	142	38%	154
H - CMBS	BBB+	142	39%	157
J - CMBS	BBB	395	41%	166
K - CMBS	BBB-	214	43%	171
L - CMBS	BB+	534	46%	183
Total CMBS Trust Debt		6,867		
Mezzanine I		187	47%	188
Mezzanine II		799	51%	206
Mezzanine III		799	56%	224
Mezzanine IV		799	60%	242
Mezzanine V		799	65%	260
Mezzanine VI		561	68%	273
Total Mezzanine Debt		3,944	68%	273
Total Debt		12,027	68%	273
Implied Equity		5,669	100%	401
Total Value		$17,696		

Source: Offering Circular dated June 2007

Whether floating or fixed-rate, whether senior or junior in the capital structure and whether secured by a single-asset, single-borrower, or pooled transaction, CMBS allows investors to precisely pin-point risk and reward for a specific transaction at a specific point in the cycle to best fulfill their investment criteria and risk/reward tolerance.

Attribute #4 – CMBS Provides Liquidity and Discretion

Two other important advantages of CMBS investing, as compared to equity investing, are liquidity and confidentiality.

First, CMBS investments are liquid making them effective portfolio allocation tools. The securities are easily divisible to customize and manage portfolio risk. CMBS can also be adroitly used to fill portfolio allocation gaps while earning current income. Equity investments, on the other hand, depending on the format (stand-alone transaction or private equity fund structure) may require three-to-six months to properly market and sell (for a stand-alone investment) and, in the case of private equity, may be subject to a restrictive lock-up period. Further, "bite-sizes" are difficult to control as a typical equity investment is "all-or-none" and not divisible by tranching. Additionally, CMBS is a materially easier way to deploy investment capital as compared to direct equity investing due to its liquidity and the approximately $1 billion of average daily trading volume.

Second, CMBS investing is confidential. Investments in CMBS, whether in the primary or secondary markets are confidential as there is no "deed-of-record" as there is with a direct property acquisition. By way of example, an investor could acquire various tranches of Hilton Hotels, including distinct pools of specific assets, often in $100+ million increments, without any press coverage. However, the direct acquisition (equity) or sale of any of these assets would receive substantial media attention. CMBS investing therefore allows investors a way to discreetly invest, accumulate and dispose of trophy assets (through trading the related CMBS debt), without signaling their portfolio positions to the marketplace.

Attribute #5 – CMBS Provides Current Income and is Easily Hedged

A compelling attribute of CMBS is its current contractual income that is paid monthly. Further, investors are able to choose between floating-rate and fixed-rate assets and can customize duration by CMBS vintage to best fulfill their asset/liability needs. Because fixed-rate CMBS benefits from strict call-protection (protection from early repayment), interest rate risk can be easily and accurately hedged, if need be. The current income component of CMBS is highly complementary to the typical "J-Curve" of traditional property investing where substantially all of the return is harvested upon realization. Therefore, CMBS can play an important role in portfolio management by off-setting the J-Curve often associated with real property ownership through its current income.

Conclusion

Foreign investors seeking exposure to the U.S. property market should consider CMBS as an essential component of their U.S. real estate investment strategy. For a newer entrant, CMBS, as compared to direct property investing, provides a tax-efficient means of participating in the market at attractive valuation points while also providing current income, liquidity, confidentiality and market access/visibility. As illustrated in the table below, compared to traditional direct property investing, CMBS offers numerous competitive advantages.

Exhibit 5

Competitive Advantages of CMBS vs. Real Estate Equity

	CMBS	Equity
FIRPTA Tax (10%)	None	Yes
Market Visibility	Broader	Narrower
Pin-point Risk	Yes	No
Risk Level	Lower	Higher
Liquidity	Yes	Limited
Current Income	Yes	Limited/J-Curve

For the foreign investor that may already have U.S. property exposure, CMBS provides current income to off-set their "J-Curve" direct investments. CMBS also provides an efficient means for an investor in a private equity fund to effectively "co-invest" (through the CMBS) in assets where the investor seeks increased exposure. Additionally, existing investors benefit from CMBS by gaining valuable exposure and insight into markets that may lead to follow-on investments via direct equity.

Exhibit 6

Comparative Financial Indices Pre/Post Financial Crisis

Index	Pre-Crisis	Post-Crisis	Change
NAREIT Index	4,000	5,486	+37%
DJIA	14,000	16,700	+19%
10 Year UST Yield	4.65%	2.29%	+51%
Corporate Spreads (bps)	140	121	+14%
CMBS AAA Spreads (bps)	**20-40**	**90**	**-2-5x**

Sources: Bloomberg, NAREIT, Talmage Research

In all, for the variety of reasons outlined above, CMBS should play a role for off-shore investors in their U.S. real estate allocation, either as an attractive and efficient stand-alone entry-point investment or as an easily managed and liquid current pay complement to their existing portfolio of equity investments. Lastly, CMBS, as illustrated above, remains cheap to other U.S. indices as it has yet to fully recover from the global financial crisis, hence making investment in the asset class opportune. ■