

Paul Hastings

PH PERSPECTIVES

**Real Estate: Global Asset Class,
Local Opportunities**

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Real estate (RE) as an asset class has been at the heart of the current market turmoil in Western economies, notably in sub-prime and commercial mortgage-backed securities (CMBS). Governments and the industry are working to put the sector – and its financing – back on more solid footing. The process has resulted in opportunities and issues in a number of markets beyond those immediately affected by the downturn. At the same time, the Asian real estate market has continued to grow and diversify.

Despite their contrasting fortunes, these markets nonetheless offer substantial opportunities for Asian investors looking in to and out from the region. The rapid growth in Asian property as an asset class has drawn investors from around the globe. Similarly, the creation of programs such as the Public-Private Investment Partnership (PPIP) in the U.S., designed to help work out troubled real estate assets, is rumoured to have brought investors such as the China Investment Corporation (CIC) into the U.S. market, while distressed property assets in other developed markets have attracted investors from around the world.

Making sense of the real estate market at either the local or global level can be difficult in any environment, particularly in today's era of low liquidity. Taking advantage of the right opportunities requires both judgement and experience. In this article, leading Paul Hastings real estate lawyers give their perspectives on the global and local real estate markets. The lawyers are experienced in almost every key market tempting today's Asian investor.

Philip Feder, chairman of the Paul Hastings Global Real Estate practice and head of the London office, provides the global viewpoint. Global Real Estate Partners Joel Rothstein and David Blumenfeld provide the Asia perspective. Joel is Paul Hastings' longest serving and most senior real estate lawyer in Asia and is based out of the Beijing and Tokyo offices where he advises clients on an Asia region-wide basis. David is the vice chair of the Shanghai office, the co-head of the China Real Estate practice, and the chair of the Asia Hospitality practice. He has recently been involved in the formation of some of the first foreign-managed, RMB denominated private equity funds in China.

Taking a global view

Perspectives from Philip Feder

Looking at the market, which RE sectors and geographies are bottoming and which are showing signs of sustainable growth?

There has really been one area where we have seen consistent activity -- buying and trading of AAA-rated commercial mortgage-backed securities, the safest debt tranches. Everything else is in limbo. There are so few transactions, so little buying and selling below that AAA band, that pricing is difficult and the spreads that are achieved are very wide. Essentially, without a stream of transactions, there is no basis to make valuations, and without valuations, pricing activity freezes. What is also handicapping the market is that financing has slowed considerably.

That said, everyone is anticipating change, because nature abhors a vacuum and this freeze cannot continue forever. But it will be several months yet before we start to see broader signs of life. The people who will drive the new wave of activity will be the private equity and hedge

funds. The sovereign wealth funds active in the market earlier have retreated, and are largely licking their wounds after some major losses, but they will be back. In the meantime, private equity houses are putting together new funds to give them the dry powder to go back into the market when the right opportunity presents itself.

In terms of global markets, I am positive on China as the government is going to do everything it can to support the investment market, making it easier for people to both enter into – and as importantly – exit from the market. The current upswing in values reflects that. Is it a potential bubble? The prime Asian markets – Beijing, Shanghai, Hong Kong, Tokyo and Singapore -- will always draw in investors. However some second tier cities in the region may find it harder to match the growth achieved in the top tier destinations.

What role does the U.S. market play in this?

The U.S. remains a major influence on the global real estate sector, both for its size and because many RE products and structures originated there. It remains a draw for investors, including through the workout of its current problems.

One such structure that I expect to see migrate from the U.S. to other jurisdictions is the PPIP, which the U.S. launched in May 2009. The idea of using private sector asset management expertise to nurture and extract the value from portfolios of troubled assets actually originated during an earlier real estate crisis, when the savings and loan industry collapsed in the late 1980s. In simple terms the government takes over a troubled institution and sells its assets while maintaining a stake to ensure the taxpayer benefits from any upside. You are seeing variations of this in a number of countries whose banks are carrying portfolios of distressed property and other assets. We may see a further evolution of this where a third party “bad bank” is created, independent of the government, that runs the process at arm’s length and distributes assets to maximize the eventual returns.

What are the key challenges and opportunities for investors seeking to enter these areas or manage their exposures?

The challenges are pretty clear. In this market, underwriting criteria are a key concern. All investors should expect to see lower loan to value ratios, and expect lenders to exercise much more stringent due diligence about fundamentals, ranging from the deal structure to tenancy arrangements. Sellers and buyers alike must face the reality that financing is simply not as easy to come by in many markets. That makes it tougher for buyers to decide to do a deal and will force sellers to be realistic about pricing.

In terms of opportunities, property in prime locations remains an asset that will continue to draw in investors – I am thinking here of the major cities of the U.S., Asia, and Europe. At the moment I would steer investors away from the property markets in Central and Eastern Europe, as well as the second tier cities and countries in the regions we mentioned.

CMBS – a total nightmare or a potential goldmine?

The CMBS market is suffering from “irrational pessimism”, a contrast to the “irrational exuberance” of Alan Greenspan’s terms at the Federal Reserve. Everyone has convinced themselves that there is no good story there. Yet smart investors have been buying up AAA bonds at great discounts because everyone is so down on the market, and they are going to make a lot of money eventually.

It is important to distinguish between the CMBS and RMBS markets – the latter was adversely affected by the sub-prime debacle. Poor underwriting created an overhang of potentially souring loans which are still feeding through the system. In general, commercial property loans were more carefully made and underwritten, and financed somewhat more tightly.

That is not to say the sector is without issues: a general depression in consumer activity and continued, growing unemployment will hit consumer segments such as retail properties, malls, and hotels.

How have RE portfolios fared in the high profile insolvencies? What impact will this have on RE deal structures and investment?

That's a tricky one to generalize about because of the way debt tranches interact in a full-blown restructuring varies by sector and geography. Holders of the more senior, secure tranches have fared better, but the past two years have not been good ones for holders of lower grade debt. It will take time before people have any appetite to take and hold higher risk tranches in these transactions.

However, the unwinding of a major corporate in any sector can potentially release substantial real estate portfolios, and a number of funds have carefully targeted this segment of the market.

What do you feel are the best strategic and financial investment choices in the U.S. and global markets?

That is a very hard call to make in today's market. When faced with great uncertainties, investors naturally tend to focus on prime markets – the main financial and urban centers. These will continue to be a safe bet, as the bulk of their business base is not going anywhere. Such "core" real estate assets keep their appeal over time. The periodic inflation and deflation of values in even prime markets is part and parcel of the real estate cycle, and longer term investors approach the market with that in mind.

Frankly, real estate is an asset class that investors will always want to hold as part of a well rounded portfolio. The major institutional investors such as insurers and pension funds will remain in the market, although I expect they will stay more cautious and conservative until things settle. As a firm, we are seeing U.S. investors actively on the hunt for deals in Asia, including Australia, as well as in core European markets.

How will changes to the availability and price of leverage affect the REIT and Private Equity Real Estate markets?

REITs come in and out of fashion depending on the state of the equity markets. They thrive when equity raising is easy, which it is now. The downside is their emphasis on short-term income as opposed to asset appreciation; as we enter an inflationary cycle, that mix becomes more complex. The private equity model offers a lot more flexibility, both in the way investments are managed and the fact that earnings can be retained or reinvested to develop the portfolio.

The generous leverage private equity funds used in the past is a thing of the past. The investments they make now require them to pay real money – e.g., their stakeholder's funds (i.e., equity) - rather than use bank funding to build their portfolios. So private equity's fee and profit model is going to have to be revisited. Funds must have much tighter control of costs and overheads, and approach investment structures in a more disciplined way.

The impact of this on the real estate market will be significant, because it will maintain the downward pressure on prices. When you are spending your "own" money you tend to make safer, more conservative choices about both your investments and prices you are willing to pay for them. The new reality, low and slow growth, will feed into this phenomenon.

Finally, the real estate market will have to adjust to the disappearance of a large number of lenders. With much less competition for their business, investors and real estate developers, fund creators, and managers will find that financing is much more expensive. We will see a return to the old days of relationship banking – where fund providers will expect to see a bigger turn, and a broader spread of business from, the institutions with whom they do business and to whom they lend money.

Philip Feder, who leads Paul Hastings Global Real Estate practice, has extensive experience representing investors on transactions in the U.S., Europe, Asia, and the Middle East. He has worked and advised on domestic and international real estate transactions, with emphasis in finance, acquisitions and dispositions, and real estate loan workouts and restructurings. His clients include private and institutional real estate investors and lenders including pension funds, investment banks, commercial banks, opportunity funds, and insurance companies.

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Making sense of the Asia market

Perspectives from Joel Rothstein and David Blumenfeld

Picking up on Phil's positive comments on Asian RE, how is the sector changing in line with the expansion in asset values?

The Asia real estate industry is going through a process of growth and continuing transformation. The most obvious manifestation of this transformation is the "institutionalization" of the industry. As part of this process, we see the rise of large listed real estate developers, the introduction and spread of non-recourse financing, the development of Asia home-grown real estate private equity funds, and the rise of professional property and asset management. Of course, Asia is a very diverse market and the markets in different countries have reached different levels of maturity. Nevertheless, one thing is certain, property is increasingly being treated as an institutional asset class which can be owned, managed, and traded. Although there are still many obvious differences amongst the markets, increasingly, the real estate business in Asian markets from Tokyo, to Beijing to Mumbai is becoming more and more like the real estate business in markets like New York, London, or Sydney.

The key for many long-term players in Asia is figuring out how they can profit from the institutionalization process. For some private equity funds it may mean trying to launch or advise a domestic RMB investment fund in China. For other investors it may mean forming a strategic relationship with an Asia-based insurance company that desires to create an investment portfolio of real estate assets. For yet others, it may mean forming an asset management or advisory company to assist institutional sponsors and investors in creating real estate investment trusts and other trust and financial products linked to real estate assets.

Of all the Asian real estate markets, the Chinese market tends to attract the most attention. What does the institutionalization process mean for foreign investors into China?

Many long-term foreign players interested in China are trying to join in and capitalize on the institutionalization process. Over the past one to two years we have seen less traditional single asset investment deals, such as acquiring an individual office or commercial property, or a joint venture with Chinese developer to develop for a specific real estate project. Instead we have seen bigger picture strategic investments or ventures which link up to the institutionalization process. For example, we are seeing foreign investors investigating acquiring interests in or forming strategic relationships with Chinese trust companies in order to provide an investment platform for providing debt and equity investments in real estate-related trust products. We are seeing foreign investors acquiring the shares or debt of offshore structured Chinese real estate development companies in an attempt to gain general exposure to the growth of the China real estate market. We are also seeing interest amongst private equity funds in developing parallel offshore and onshore fund structures in an effort to capitalize on the growth and development of the private equity domestic fund industry in China.

There are also opportunities in China for RE service providers. Great strides have been made in recent years in introducing international standards and practices in property and asset appraisal, management, design and planning, and operations. Many of the international players have already entered the market and have made an impact. Nevertheless, the industry is still in its formative stages and there are still untapped opportunities, particularly in China's growing second and third tier cities.

On the domestic industry side in China, what changes do you expect from institutionalization?

There will inevitably be consolidation in the industry. Larger developers with better access to capital, better resources, and a brand name will squeeze out smaller undercapitalized

developers. At the same time, the domestic Chinese real estate industry will ultimately need to alter the traditional real estate development and investment model. Under this model, real estate projects are developed utilizing a strata title sales strategy. With this approach, all kinds of buildings from retail buildings, to office buildings, to residential buildings are sold off in pieces to investors via strata title sales. Historically, in China's years of fast-paced growth and urbanization, this has been an effective method for financing and exiting projects. The main problem with this strategy is it does not create institutional real estate assets that can be owned and managed as an effective unit and traded as an institutional investment asset. With the strata title sales strategy, once the development process is completed and the multiple strata units sold, the new building is owned by numerous disparate investors rather than by a single institutional owner and operator. If China is to develop its institutional real estate investment sector, including, among others, real estate funds and REITs, it will be critical for the industry to create real estate assets that institutional owners and investors can own and trade.

As the Chinese development industry moves away from the growth centred strata title sales model, we will also see changes in government policies, which will alter the real estate sector's relationship with government. Until now, the government generated substantial revenue from land grant premiums charged to developers who obtained land grants from the government. When there is plenty of land or appetite to develop, that model works. But at some stage, all governments need a more dependable, renewable revenue source, and we expect to see the introduction of a property tax at some point. That will shift the focus from growth to sustainability of income for local governments.

How do you assess Asian investors' appetite for RE exposure outside the region and within?

Asia-based investors are beginning to look beyond their borders. For example, this summer Joel spoke at a program at Harvard University co-organized by Harvard University and Tsinghua University. The program on business and legal issues was targeted at senior executives from Chinese RE companies. One of the most popular topics covered at the program was actually China outbound real estate investment issues and strategies.

In many Asian markets the potential "international" investor community is still relatively small. Many local property developers, apart from the larger multinational ones, will not look abroad as long as there is money to be made locally. Where there is particular interest and real potential is among funds, including sovereign wealth funds and some of the more aggressive privately sponsored fund vehicles. In addition to the process of the institutionalization of the Asia RE industry, there is also the process of the globalization of the Asia RE industry. RE investors in Singapore, Hong Kong, China, and elsewhere in Asia are increasingly becoming part of the global investment community. Not only are U.S. and other Western investors looking cross-border to diversify investment portfolios, but increasingly, Asia-based investors are also looking cross-border to diversify by looking at various Western and developed economy markets for opportunities, including distressed debt and property opportunities.

Within Asia, many markets are still relatively small. Cross-border investment tends to favor larger and more liquid markets such as China, Japan, India, or Korea. In the long term, these countries will most likely generate global RE players and investors just as they have already and will in the future foster the development of global companies in other industries. This is especially so given the drying up of liquidity in Western markets, enabling Asian banks and funds that have been somewhat shielded from the crisis to be the interesting players in the future.

How do you see the Asian CMBS market evolving?

For the most part, the only developed CMBS markets in Asia with repeat issuances are in Japan and Korea, but most prominently Japan. In fact, Paul Hastings played a leadership role in the development of the CMBS industry in these countries. The earliest CMBS deals done in the later 1990s to around 2002 were for the most part, cross-border deals, structured to international standards. These deals typically included detailed offering memorandums,

paying agents, registrars, and servicers; all the traditional bells and whistles of an international CMBS deal.

Then starting around 2002 CMBS markets became very domestic in focus. In Japan, it was discovered that it was not necessary to create cross-border complicated structures in order to successfully market an issuance. A CMBS deal utilizing a trust beneficiary interest structure or domestic special purpose entity bond structure could be marketed to a small group of investors. In Japan's low interest environment, there was a ready pool of domestic investors prepared to purchase Yen-denominated deals and essentially hold the CMBS to maturity. The CMBS industry prospered and the market saw record levels of issuance.

Similarly in Korea, over time the market became increasingly domestic as cross-border issuances were superseded by purely domestic deals that relied upon Korea's domestic securitization law for issuances. The global economic crisis has created a significant downturn in CMBS deals around the world, including in Japan, the region's largest CMBS market. As for China, for many years the investment community has been hoping for the growth and development of a vibrant securitization market in China. The stresses in the global securitization industry, however, will likely delay further development of the China securitization market. Governmental regulators may remain reluctant to open the market to this structured financing method, which has been the source of many issues in other markets.

Although we do not see a resurgence and recovery in Asia's CMBS market, there are current opportunities in this sector for opportunistic investors in the Japanese market. In Japan, many CMBS deals are not widely held. Consequently, it may be possible to acquire a controlling interest in a CMBS deal in Japan. In other CMBS markets, securities have been so widely dispersed that you can't really get control of the deal as you can in Japan. We actually advised a hedge fund planning to do just that. We see Japan as a very interesting market for distressed debt investors. Not only are the securities closely held, but the special servicers are unsure what to do with defaulted loans. This represents real opportunity for the right investor.

Do the U.S. and European CMBS and RE debt markets provide opportunities for Asian-based investors?

While there will always be one-offs in investment terms, if we are talking about setting up a US\$1bn fund specifically targeting distressed RE debt in the U.S., we are talking about a relatively small pool of prospective investors, but they are certainly out there. Big financial institutions/funds in China, like CIC, large PRC insurers, or other large State-Owned Enterprises (SOEs), as well as some Japanese institutions and other large Asian funds, are all active or potential investors.

In addition, a number of formerly Asia-based bankers and real estate funds managers with international financial institutions and funds have recently moved back to their home countries as a result of the current economic crisis. Some of the more entrepreneurial bankers and managers are setting up new investment platforms and trying to source funds from Asia. So there is a lot of expertise spread around that market and the globe. Individuals who know about distressed assets, who have been in Asia, will undoubtedly use their contacts in Asia to raise funds and go after distressed asset and debt opportunities in their home country markets in the U.S. and Europe.

Do you see a divergence arising between the appetite for exposure to real estate debt by Asian financial institutions and their Western counterparts?

Many of the international banks that have been at the forefront of international non-recourse real estate financing in Asia over the last decade have either exited the market or cut back on resources and capacity. In the face of the current global economic conditions, financial institutions across the U.S. and Europe have decided to reduce their exposure to real estate debt financing. The Asia outposts of these same financial institutions, for the most part, have followed suit and have severely cut their RE lending platforms.

Going forward in the next few years, Asian-centred banks will increasingly dominate Asia

RE lending. For example, in China, we are seeing loans that were originally made by major international banks being taken out and refinanced by Chinese financial institutions.

This highlights the real intersection of the global economic crisis and its impact on Asia: international banks are paring their RE exposure globally as well as in Asia, even though the fundamentals in Asia might be better than elsewhere. These international players are not going to jump back into Asian RE lending until they also jump back into their home markets. Instead, in the meantime, the real actors will be the Asian-centred funds and banks.

Looking ahead, where do you expect to see Asian RE by the end of 2010?

Through the remainder of 2009, the international RE investor activity in Asia will likely remained muted. At the same time, the levels of domestic RE investor activity in Asia will likely vary significantly from market to market, with the level of activity depending upon the performance of the overall economy of the individual country. Nevertheless, the long-term story for Asia's largest countries is still the story of growth and development. We are optimistic that the growth story and the opportunities created by growth and transformation will only become more apparent by the end of 2010.

What is certain is that by 2010, new players and strategies will emerge. The more strategic long-term investors are laying the groundwork now. Those that establish the relationships, remain true to economic fundamentals, and take advantage of the institutionalization and globalization of Asia real estate, will ultimately be the most successful.

Joel Rothstein has over 14 years of experience advising clients in Asia. Working out of our China and Japan offices, he regularly advises international and domestic investment banks, financial institutions, opportunity funds, and real estate developers and investors in China, Japan, and other Asian markets in real estate structured finance and capital markets transactions, fund formation, distressed debt and company acquisitions and restructurings, and complex cross-border joint ventures and investments. He has participated in structuring, documenting, and implementing a number of landmark transactions and investment programs in both the United States and in Asia.

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David Blumenfeld, who co-heads our China Real Estate practice and chairs our Asia Hospitality practice, represents private equity funds, investment banks, and other capital markets clients in China real estate acquisition, joint venture, and financing transactions, including the acquisition by public auction of real estate assets and real estate companies. He is involved in the formation of some of the first foreign-managed, RMB denominated private equity funds in China. He also represents equity investors in hotel transactions across Asia ranging from joint development platforms to individual repositioning transactions.

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