WORDS **OLIVER SALMON** AND **CHARLOTTE RUSHTON**

CROSS-BORDER INVESTMENT AND THE FUTURE REAL ESTATE MARKET

We're at an inflection point in the global macroeconomic and geopolitical environment. How cross-border investors respond will affect the evolution of real estate capital markets

After decades of economic integration, global cross-border flows of people, trade and investment have plateaued. Since the global financial crisis (GFC), the annual number of state interventions that are harmful to commerce has consistently exceeded liberalising interventions by a factor of more than five, according to Global Trade Alert. Trade wars and military conflict have regularly punctuated the last decade, providing the headlines for what the IMF calls "policy-driven geoeconomic fragmentation".

Real estate assets are highly localised, with revenue streams mostly contingent on regional dynamics. Yet real estate capital markets are highly globalised – in part due to the presence of institutional capital such as sovereign wealth, pension and insurance funds, all with global investment mandates.

Last year, cross-border investors accounted for 20% of global commercial real estate transactions by value (ranging from more than 40% in Europe, to around 25% in Asia Pacific and 10% in North America), according to MSCI Real Capital Analytics, having peaked at almost 30% in the mid-2010s. However, as the data considers the location of the buyer only, it ignores the global capital channelled indirectly into the market via third-party asset managers.

The way in which cross-border investors respond to an inflection point in the global macroeconomic and geopolitical environment will be key to how real estate capital markets evolve in the future.

A hybrid asset class

There are two primary types of foreign investment: direct investment (FDI), which is typically long term and generally involves an active ownership of a business interest; and portfolio investment, which is more short term and passive in nature, and is generally limited to the purchase of listed securities and other financial assets.

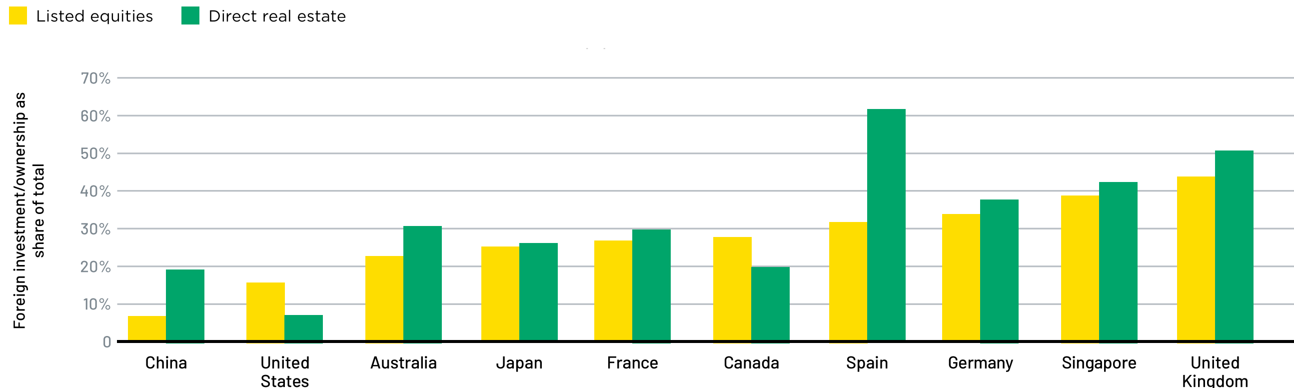
Cross-border real estate exhibits the characteristics of both. It is medium to long term – investors typically work to a five- to ten-year business plan – and generally involves direct ownership with some operational input into an asset. It also aligns with FDI, in that the key drivers of returns are similar. At the broadest level they're based on economic growth as opposed to portfolio flows, which are strongly correlated with interest rate differentials.

However, real estate also exhibits characteristics of portfolio investment. It is more "internationalised" than FDI, broadly mimicking financial markets in this regard, and is dominated by private and institutional money managers – often with a strategy to diversify away from listed markets and boost risk-adjusted returns.

Cross-border investors have, in the past, typically favoured larger, newer assets and gravitated towards "gateway" cities. Environmental certifications such ▶

GETTY IMAGES

Foreign participation in private and listed markets



Source: Savills Research using MSCI Real Capital Analytics and OECD. Based on latest available data

as BREEAM and LEED have provided a strong signal of building quality to non-domestic investors, reducing the information asymmetries of competing with domestic institutions. Over the past decade, the global market share of cross-border investors has averaged over 45% for these certified buildings.

These investors are often more thematic in strategy – particularly long-haul[1] capital, given the dominance of institutional money. This is evident in a recent shift in investment allocations, with long-haul capital at the forefront of a rotation away from offices and towards the logistics sector, in line with a shift in relative returns.

'Slowbalisation' not deglobalisation

The GFC brought to an end a period of "hyperglobalisation" that started in 1990 with China's accession to the World Trade Organisation (WTO). Global integration has since stalled as the pace of trade liberalisation slowed, and enthusiasm for globalisation has waned amid rising geopolitical tensions and stagnant economic growth.

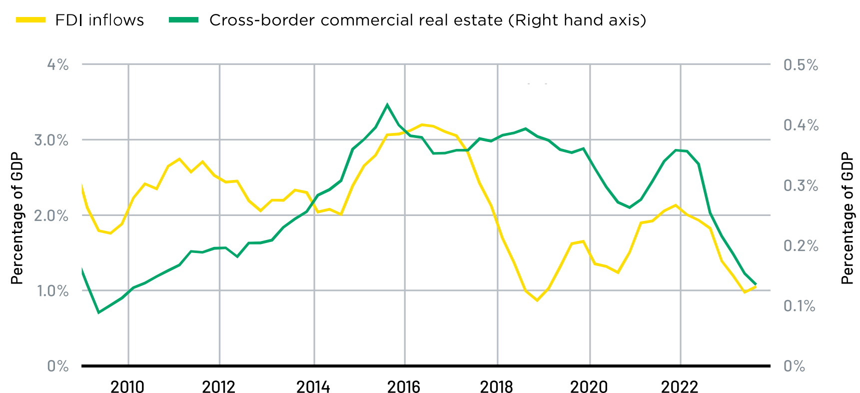
Some cross-border interactions – such as those of direct investment – are now showing signs of unwinding or deglobalising. Others, such as the more integrated market of global trade (and the complex value chains that underpin it), are better characterised by the term "slowbalisation".

The real estate market falls into the latter category. As a share of global GDP, cross-border real estate investment continued to rise through the first half of the 2010s before stabilising during the second half, when wider FDI flows were shrinking. A recent decline can largely be explained by cyclical factors, as opposed to structural.

Given the opaque nature of real estate markets, cross-border activity is highly concentrated in the largest, most liquid and transparent markets. These typically perform well when benchmarked with indicators of ease of doing business, governance, rule of law etc. Over two-thirds of non-domestic investment over the past decade occurred in markets with no discernible statutory restrictions on real estate.[2]

However, this is changing. Cross-border investors have diversified into new markets over the past decade, despite levelling off in aggregate. In

FDI and cross-border real estate investment



Source: Savills Research using MSCI Real Capital Analytics and Macrobond. Aggregated data of top 10 cross-border real estate markets: Australia, Canada, China, France, Germany, Japan, Singapore, Spain, the UK and the US. Four-quarter moving average.

[1] For the purposes of this article, "long haul" is defined as any extra-regional flow of capital, e.g. Americas to EMEA or Asia Pacific.
[2] Based on analysis of the OECD FDI Regulatory Restrictiveness Index.

2014, the largest five cities (London, New York, Paris, Sydney and Tokyo) accounted for over 30% of non-domestic transactions globally. Last year, the same cities received just 18% of global capital. Second-tier markets have matured through this period and investors have become more sophisticated and diverse, supporting a wider dispersion in global investment, a trend that is likely to continue.

Cross-border investors have also increased risk appetite as markets have matured. While private capital continues to favour core assets (although this can vary by source), private equity and other institutional capital is increasingly looking to own and/or create best-in-class assets, irrespective of nationality.

Long-haul capital invested for the short term

Real estate broadly mirrors other markets when it comes to the distribution of global transactions. Research shows that distance is a core variable in predicting cross-border investment. This aligns with the "gravity" model that's used to predict wider flows in global trade, migration and capital.

This is intuitive. It is inherently more risky to invest abroad, where institutional knowledge may be lacking in comparison with domestic investors. These information asymmetries are likely to increase with distance, given that barriers around cultural and business practices, language etc also tend to increase with distance.

With increased risk comes increased volatility. Long-haul capital is generally more variable than short-haul capital, and so more prone to extreme deviation when faced with an inflection in the prevailing risk environment. This was evident during the GFC, the Covid-19 pandemic and the recent interest rate-driven downturn. Cross-border capital also tends to gravitate to safe-haven markets during periods of heightened uncertainty.

As the largest, most liquid market, the US is the global safe-haven real estate market. At the forefront of the current cyclical decline in global cross-border investment, North American institutions have scaled back their global activity and focused instead on deploying at home. This is most evident in the office sector; US outbound investment in 2023 fell by nearly 90% compared with pre-pandemic levels, despite the domestic market experiencing the weakest fundamentals.

GETTY IMAGES

A conscious decoupling

The cost of geopolitical tension is high. The IMF estimates that in a worst-case scenario, global GDP losses due to geoeconomic fragmentation could amount to 7% – equivalent to the size of the UK and Japanese economies combined. Outside direct conflict, the primary catalyst is the decoupling of the two economic superpowers, China and the US, which together are responsible for the majority of policy interventions impacting the global economy over the past decade.

However, there is limited direct evidence of an explicit decoupling in real estate markets. China maintains a relatively "closed" capital account. Controls on "irrational" outbound investments in restricted sectors (including real estate) were tightened in 2017 to stem capital outflows and support the yuan. This was the principal driver of a sharp decline in China's outbound real estate investment activity (as opposed to rising geopolitical tensions with the US).

From a peak of more than $30bn a year in 2017 (much of which was deployed in the US), outbound real estate investment dropped to a low of

AN INCREASINGLY FRAGMENTED WORLD WOULD WEIGH ON FUTURE REAL ESTATE RETURNS VIA WEAKER ECONOMIC GROWTH

$2.3bn last year, with only 11% deployed in long-haul markets.

Inbound investment, by contrast, has remained relatively resilient. US investors continued to buy Chinese property throughout the trade war instigated by the Trump administration in 2017, while APAC investors significantly increased deployment into China and Hong Kong, and the origins of capital showed no obvious delineation into "China-leaning" or "US-leaning". The recent slowdown in investment into China is primarily linked to its structural economic slowdown and weakness in the domestic property sector, rather than geopolitics, although the latter makes China a more challenging investment destination for certain institutions.

Future-gazing at cross-border activity

Real estate capital markets are unlikely to see significant disruption from deglobalisation or geoeconomic fragmentation. Bilateral cross-border investment is typically conducted among "friends", which means limited disruption from any intensification in existing geopolitical tensions. The same cannot be said for global trade in goods, direct investment or migration.

However, as real estate is a GDP-linked asset class, an increasingly fragmented world would weigh on future returns via weaker economic growth. Assets leveraged to sensitive sectors – such as logistics centres integral to the distribution of strategically important goods; life sciences critical to providing access to healthcare; or politically sensitive sectors such as residential – are also at risk of geopolitical events. But risk and opportunity are two sides of the same coin, and the same sectors will provide opportunities for cross-border capital to invest and gain exposure to these same geopolitical trends (such as nearshoring/onshoring etc) and diversify from home markets.

Global investors are demonstrating an increased desire to invest in non-domestic markets, which will support a cyclical recovery in cross-border investment as risk sentiment improves (particularly long-haul capital). China has turned more insular in its approach to global integration in recent years, and is unlikely to relax capital controls to induce a recovery of outbound Chinese investment, which at its peak accounted for around 10% of global cross-border activity. But

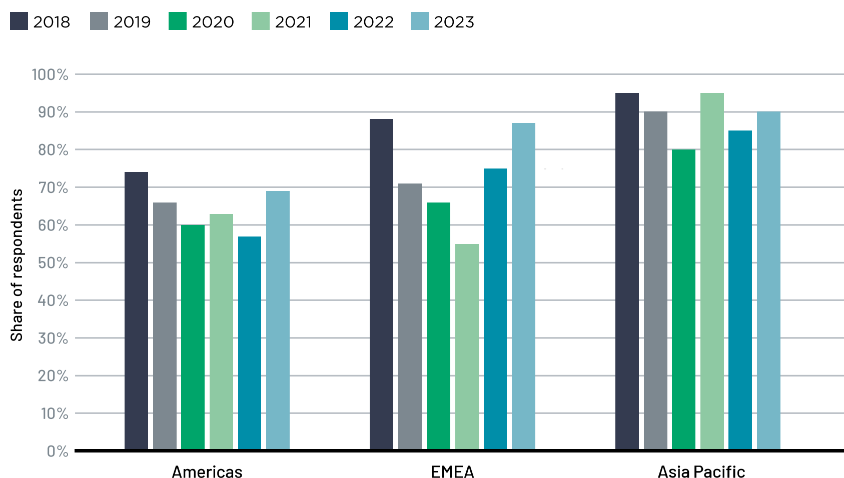
64%

OF GLOBAL INVESTORS IDENTIFIED GEOPOLITICS AS A KEY ISSUE IMPACTING THEIR INVESTMENT DECISIONS IN 2024

$145BN

THE VALUE OF CROSS-BORDER REAL ESTATE INVESTMENTS IN 2023

Institutions planning to invest outside of their domestic region



Source: Savills Research using 2023 Institutional Real Estate Allocations Monitor

large US private equity groups are expected to return to global markets, and to the office sector, as values rebase and investors recognise the nuance in the returns profile of the sector outside the US.

Rasheed Hassan, Head of Cross Border Investment at Savills, expects that the absence of Chinese capital will be offset by growth in other sources of investment. "Major money managers in other locations, such as Australian pension funds, will need to diversify from their home market, given their current concentration of domestic real estate investment," he says. "Canadian pension funds are also likely to continue to expand their operations in European and Asia-Pacific markets."

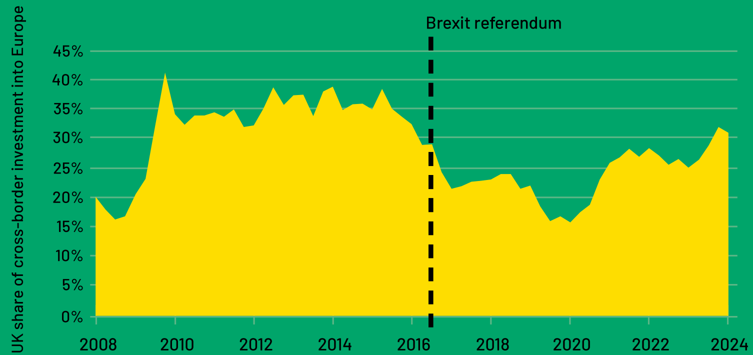
There is also more potential for investors in Asia, excluding China, to grow their global presence. Institutions in the region are generally under-allocated to real estate compared with their US and European counterparts, and generally exhibit less of a home bias within those allocations.

"Overall I'd say it's relatively easy to identify the gaps certain investors have not yet explored," says Hassan. "But it's harder to find the patterns of what they'll do in the future – and why."

He gives a final word of caution: "Diversification is always a good base reason to want to explore new markets. However, entering certain geographies remains challenging. In Asia, for example, only a few markets are both easily investible and provide compelling returns for long-haul investors, while the US market can be difficult to access despite its size, absent strong local partners." ■

GEOPOLITICS MATTERS

Post-Brexit UK is reclaiming its position as the eminent cross-border market in Europe



Source: Savills Research using MSCI Real Capital Analytics

While the spillovers of deglobalisation may not be obvious in real estate investors' actions, geopolitical tensions do still weigh on their behaviour. A survey conducted by industry associations ANREV, INREV and PREA showed that 64% of global investors identified geopolitics as a key issue impacting their investment decisions in 2024, behind only interest rates and inflation in order of importance.

Looking back, we can see how geopolitical events have directly impacted investment. After the Brexit referendum in 2016, the UK's share of cross-border inbound investment in Europe fell from around 35% to less than 20% by 2019. This was despite the positive currency arbitrage following a sharp decline in the sterling exchange rate. While there were other factors at play at the same time, the uncertainty surrounding what Brexit actually meant did serve to dampen sentiment for some around investing in the UK. Since 2020 (when Brexit became a reality), the UK has reclaimed its position as the eminent European cross-border market.

Elsewhere, following Russia's invasion of Ukraine in 2022, many investors ceased activity in the region, with investment in European markets bordering Ukraine, Belarus and Russia falling sharply. In 2023, investment in these markets fell by a combined 72% against the 10-year average – compared with a 34% decline in aggregate global investment over the same time period.

'DIVERSIFICATION IS ALWAYS A GOOD BASE REASON TO WANT TO EXPLORE NEW MARKETS'