

Friends in the right places

Hazards await investors looking to exploit foreign markets. Ric Lewis's strategy combines global outlook with local knowledge



Lewis: start from the top down

Institutional investors have long been intrigued by the idea of expanding their property investment holdings to international markets. But a number of high-profile errors of judgment in the early 1990s cooled this enthusiasm.

Today, these same investors have come to recognise that the world has "gone global". They have noticed the inter-relationships among global capital markets and the resultant impact on their holdings. They believe that international diversification of their portfolio should mirror that of their stock and bond portfolios.

Debate over this strategy centres on two topics: how to avoid the repetition of past mistakes, and how best to design an international investment strategy that capitalises on today's markets.

In considering the latter, they have found that the opportunity costs – the time, money, and human resources necessary to acquire sufficient knowledge to devise a prudent international investment strategy – are quite high. Combine this with most investors' desire to be compensated for the risk of investing and managing investments in unfamiliar markets – "the international risk premium" – and one is left with few strategy options.

In the US, investors view private equity fund vehicles as a good way to gain experience in foreign markets. These seek to take advantage of:

- imbalances in local capital markets, for example, providing growth capital to "out of favour", but fundamentally sound, sectors of the property market;
- opportunities to provide "relationship" financing to well-focused entrepreneurs; or
- changing demographic, political, geographic and economic trends.

Return requirements

The return requirements for risk capital like this are usually well above the acceptable returns for core property returns in the same markets. Combined with aggressive gearing (at the property or fund level), total returns to investors are also quite high. Given some investors' perception of the risks related to "foreign" investment, these returns must be high enough to entice investors to venture outside of their home markets.

While these "opportunistic" investment strategies provide investors with increased return performance, they are not a particularly effective way for institutional investors to achieve meaningful diversification or to gain knowledge about

different markets. Many opportunity fund managers have focused on major markets (usually capital cities) of targeted countries, because these markets are accessible and market information is readily available. This approach discounts the correct reason to target a market for property investment: because it represents the best risk/return trade-off for the investor.

Critical ingredients

Most investors, including these private equity funds, do not have the resources to assemble what are the most critical ingredients for a comprehensive, diversified property investment strategy. These critical ingredients include:

- A comprehensive research-based "point of view": investors need to choose markets and investment opportunities based on an assessment of relative value and projected investment performance. These assessments must be grounded in comprehensive economic and property-level research and an understanding of the property and capital markets. A well-designed strategy starts from the top down, comparing and contrasting investment possibilities on a global, continental, country, regional and local level.
- Local market knowledge: after developing a top-down point of view, an investor needs the ability to test this view at the local (country, regional and market) level and to execute the strategy in the local market. Real estate remains a business that is played on the local level and is based on supply and demand fundamentals, inside information and quick action. Foreign investors need experienced local partners (agents and advisers) who recognise the potential of a partially formed scheme or partnership and match this scheme with the best source of capital before the opportunity is marketed.

Far too many property investors have been misguided by the surface similarities between their domestic market and international markets. Others have settled on the correct strategy only to be betrayed by the difficulties presented by the operating, management and investment practices of their partners and service providers in foreign markets.

The most astute international investors recognise the hazards and are prepared with quality information as they implement their strategy to "think globally and act locally".

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