UNDERSTANDING THE BARRIERS TO REAL ESTATE INVESTMENT IN DEVELOPING ECONOMICS

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Abstract

The investor's appetite for global investment has accelerated since the mid 1990s. International or cross border property investment has boomed, and indirect property investment (investing through securities such as REITs, and through unlisted funds) has become commonplace. International real estate investment through unlisted funds has become the approach of choice, and has included 'core' strategies, through which capital has been allocated largely to developed markets, and 'opportunity funds', which have also allocated capital to developing and emerging markets.

In a previous paper presented at IRERS 2008, Baum (2008a) related the number of unlisted real estate funds investing in developing economies to simple economic and demographic variables. Using all markets outside north America and Europe as an imperfect proxy for the developing world, we showed that the popularity of markets was explained largely by population and GDP per capita, but that there were interesting outlier observations - countries receiving much more, or much less, investment than the model predicted.

In this second paper in a series of three, we show that academic literature suggests that distortions in international capital flows may be explained by a combination of formal and informal barriers. Through a limited survey of investors, we have further refined our understanding of these barriers in the real estate context. This is the first such examination of the inhibitions to a free flow of cross-border real estate capital.

In a third paper we will use a more extensive survey of investors and fund managers to examine how these theories explain current practice, and will suggest specific reasons for certain countries receiving more, or less, investment than their fair share. The implications of this third paper will be relevant for investors in their choice of target markets and for governments wishing to attract more cross-border capital.

1.0 Introduction: globalisation and investment

Financial globalization has enabled investors worldwide to diversify assets and therefore to distribute risk and to direct capital to places where productivity and expected returns are high (Quinn, 1997). During the late 80s and early 90s, new technologies facilitated the transfer of funds from country to country and improved the internationalisation of assets (Garrett, 2000, Talalay, 2000, Sassen, 2006). An increased investor appetite for global investment in equities and bonds, and later property, has fuelled this global boom in international institutional investing and has helped to push down barriers to foreign direct investment (FDI).

In, 2009 the flow of global FDI capital was 21% of global GDP (Lahiri, 2009), and FDI and loans are the dominant types of investment received by many emerging markets (Daude and Fratzscher 2008). For example, Daude and Fratzscher's 2008 survey of 77 countries found that: " in our sample the average share of FDI in total foreign investment is 46% for developing countries, but only 22% for developed countries".

In the case of real estate, financial globalisation helped to create new investment vehicles that solved many problems that are characteristic of this asset class (Baum, 2008). International or cross-border property investment has boomed, and indirect property investment (investing through securities such as REITs, and through unlisted funds) has become commonplace. International real estate investment through unlisted funds has included 'core' strategies, through which capital has been allocated largely to developed markets, and 'opportunity funds', which have also allocated capital to developing and emerging markets (Baum, 2009).

As a result, cross-border property investment grew more quickly than domestic investment over the period 2000-2007, as evidenced by various publications by INREV (the Association of Investors in Non-Listed Real Estate Vehicles) and private research company Feri Property Funds Research (Property Funds Research, various) and publications by most firms of leading real estate brokers (for example, CB Richard Ellis and Jones Lang LaSalle).

Running in parallel with this development has been a boom in listed real estate markets, especially in the Real Estate Investment Trust (REIT) format, and in the number and value of unlisted property funds. The 3 growth of the listed REIT market is largely a matter of public record, while investing in unlisted real estate vehicles has become an increasingly standard route to attaining international real estate exposure. In the context of this paper, the change has had two main impacts: first, international property investment has boomed; second, indirect property investment (investing through securities and funds) has become the standard.

The globalisation of business activity was, prior to 2007-8, a continuing process, driven both by the conversion of ownership of successful companies from domestic to multi-national concerns, and by the increasing opportunities offered to corporations and institutional investors and banks to own overseas assets through globally-traded stock markets. The result has been a surge in foreign direct investment, with Asia-Pacific a particular beneficiary. In this region real estate investment (the construction of manufacturing facilities, for example) accounted for more than 40% of all foreign direct investment in the decade to 2001. Both occupier demand and the ownership of corporate real estate facilities have become increasingly driven by the needs of the multi-national enterprise.

European and global cross-border investment also increased in popularity throughout the 1990s. In the City of London, for example, foreign ownership rose from around 4% in the mid 1980s to 45% at 2006 (Lizieri and Kutsch, 2006). Diversification by institutional investors is a powerful driver of this activity, while other investor groups seek higher returns by playing the global property cycle. If returns going forward in the US property market are perceived to be disappointing, US money will look abroad (Moshirian and Pham, 2000). The rise of international benchmarks and improvements in data provision, coupled with globalisation in general and the growth of the international investment house in particular, have added to the appeal of international investment. Sheer weight of money drives some funds such as the Abu Dhabi Investment Authority (estimated assets: around $1tr) to place its investments abroad.

The world's top investors have gone global. According to Property Funds Research data, of the top ten global investors seven have global real estate portfolios and the other three have announced plans to invest in global real estate for the first time. It is now unusual among large investors not to have a global property strategy. Currency hedging is, however, expensive and difficult to achieve efficiently (Lizieri, Worzala and Johnson, 1998) and vehicles are rarely fully hedged. This problem leaves investors at the mercy of currency movements. Other perceived difficulties, including the dangers of operating from a distance with no local representation, increases the attraction of investing internationally through liquid securitised vehicles and unlisted funds.

Two dominant styles of international real estate investment vehicle have emerged since the 1990s, driving much of the recent international activity. These are distinguished by the objective being pursued. The key drivers for investing outside the domestic property market and buying global property are the increased opportunities for either or both of (i) diversification and (ii) enhanced return. These potential benefits come at a cost of increased complexity of execution. The diversification drive has been characterised by core and core-plus property funds, and the search for return by value-added and opportunity funds. This latter property fund type has commonly explored emerging markets. While some researchers argue the importance of locality amidst the globalisation theories (Leyshon and Thrift, 1997, Daniels, 1996, Talalay, 2000, Sassen, 2006), and others argue that investment in Western Europe, North America and the Pacific Rim still represent the majority in terms of volume of activity (Lizieri, 2009), it is clear from Baum (2008) that property investment in emerging markets had become very common prior to the credit crunch of 2007-8.

Investors and fund managers typically allocate capital to regions and countries before selecting buildings or funds (Baum, 2009). The main argument for country relevance is that social interaction, provided by spatial proximity, helps to build trustworthiness and rapport, which are important factors that help to obtain market information (Leyshon and Thrift, 1997, Agnes, 2000). For this reason, geography still matters for portfolio choice, savings and investment, and can have a great influence on investor's decisions and returns (Stulz, 2005). In this context, some countries attract less capital than others as a result of barriers, both actual and perceived.

In the literature of international trade, gravity equations are widely used to explain bilateral trade flows in terms of GDP, distance and other factors that can be considered as barriers. These factors include language, technology and available information between countries (Garmaise and Moskowitz, 2004; Portes

and Rey 2005, Daude and Fratzscher 2008). However, gravity formulas have their shortfalls, mainly to do with omitted variables in the model (Anderson and Van Wincoop, 2003), and they do not seem to fully explain asymmetries found in cross-border investment particularly regarding developing economies. Geographers argue the relevance of locality and the existence of barriers, but this argument is also supported by economics, as markets, costs, competition and government regulation are seen as the four pillars of globalisation, and foreign direct investment is usually attracted to large local markets with good local labour (Daniels, 1996, Case et al., 1999, Hoesli et al., 2004) and with low entry costs. Barriers to international investment create costs, both direct and indirect.

The production of high quality real estate needs to be financed through large scale equity and debt capital. This is especially required in emerging and developing markets which are short of such real estate capital. This requires entrepreneurship represented by equity capital or foreign direct investment (FDI). If actual and perceived barriers to investment influence investor behaviour, then large and more advanced economies will always dominate in real estate investment, and a levelling-out of economic prosperity may be inhibited.

Surprisingly, the investor's perspective is rarely reported in academic literature. (For a review, see Henneberry and Rowley, 2002, and from a sociological perspective see Knorr Cetina and Preda, 2006. For the particular case of real estate see Crane and Hartzell (2008)). By enquiring about investors' behaviour, the research set out in this and the following paper will examine those economic and socio-cultural issues underpinning decisions and the role of barriers to investment in the new globalised society and economy.

This paper is divided into four parts. In the first part we discuss the background to global real estate investment and summarise paper 1. In the second part we summarise the research methods we use. In the third part we discuss formal and informal barriers to international investment, and modify these findings for the real estate market by reference to a set of interviews with investors. In the last section we present our conclusions.

2.0 Research objectives and method

Our research intends to add to previous studies of investment barriers at both economic and sociological levels by conducting an empirical study of foreign direct investment in real estate in relation to country's GDP and population, and also by looking at investor's attitudes towards these developing economies.

The main objective of this work is to confront quantitative data and qualitative responses from investors, in order to have a more accurate picture of the formal and informal barriers affecting the countries under study. Our aim is to address those barriers and find the reasons behind investor's decisions in relation to developing economies; why some countries receive real estate capital and others do not; how investors make their decisions; how much they know about barriers, and in particular which barriers they consider more important.

We will set out a classification of the formal barriers that are embedded in the country's laws and regulations and the informal barriers related to political and cultural issues.

Paper one (Baum, 2008)

Through a simple model, we relate the number of funds targeting particular countries to population and GDP per

capita. (This work was more fully described in Baum, 2008). Data was collected from Property Funds Research (PFR) from 1990 to 2007. We defined the developing or emerging markets as the regions outside Europe, Australasia and North America, and focused on the largest 55 countries in these regions by population. The investors in the funds we identified as targeting emerging markets are concentrated in the non-developing and non-Asian markets. The most common domiciles include the U.S., Australia, Canada, the UK, the Netherlands, South Africa, Germany and Switzerland. We found that both GDP per capita and population explain the number of unlisted funds targeting emerging markets. Population is a stronger driver. There are several interesting outliers, meaning countries whose observed investment does not fit well with predicted investment.

Countries with high population and low investment include Indonesia, Pakistan, Bangladesh, Nigeria, Ethiopia, Egypt, Iran, Congo, Myanmar and Colombia. This list includes 7 of the world's 20 most populous countries. Countries with high GDP per capita and low investment include Taiwan, Saudi Arabia and Venezuela. Several explanatory hypotheses are possible, but these are reserved until the further analysis to be described in paper 3 has been completed. Countries with a low population but with high investment include Argentina and South Africa. Countries with low GDP per capita but with high investment include Vietnam, India, Philippines and China.

Paper two (Baum and Murray, 2010a)

In this second paper, we undertake a literature review to identify the barriers which inhabit the general world of international investment. We summarise and report academic work that explains barriers to investment. We also undertook a group of interviews with property investment professionals in order to develop a classification of barriers to international real estate investment. We set out to explain the extent to which the general barriers are likely to affect real estate investors, which are most likely to be important, and whether there are any real estate-specific variables that create barriers.

Paper three (Baum and Murray, 2010b)

In paper three our aim is to confront practitioners with academic theories, thus following Bourdieu's and Foucault's methodology of connecting and bouncing from theory to practice and from practice to theory for the development of new findings and paradigms. We will conduct semi-structured interviews with key investors and fund managers, and following completion of this we plan to hold a round table discussion. The questions for the semi-structured interviews have been drawn from the outputs of this paper.

3.0 Formal and informal barriers to foreign investment: a review

Some countries try to eliminate or lessen the impact of those barriers that are most likely to segment the local market from the global capital market. These barriers have been classified by academic work into formal and informal or direct and indirect barriers. The formal or direct are those that affect the *ability* of foreign investors to invest in emerging markets, for example in the form of taxes and laws; the informal or indirect barriers are those that affect investor's *willingness* to invest, mainly due to reservations regarding cultural or political issues (Nishiotis, 2004). In an investment context, we offer the view that formal barriers are *known variables* which will affect either the ability to invest or the net return delivered; informal barriers represent risks which may affect the ability to invest or the net return delivered.

Previous studies have listed barriers affecting the trading of goods, the setting up of companies, the openness of the stock markets or a mix of all. The most important barriers to global equity-market integration are said to be: poor credit ratings, high and variable inflation, exchange rate controls, the lack of a high-quality regulatory and accounting framework, the lack of sufficient country funds or cross-listed securities, and the limited size of some stock markets (Bekaert, 1995).

While the academic work addressing formal and informal barriers is rich, Eichengreen (2001) provides the only overview we have located, although this paper is not intended as a comprehensive literature review on the subject. Furthermore only some barriers listed by Eichengreen (2001) or Bekaert (1995) affect real estate, which by definition tends to be less liquid than other investments.

Lahiri, for example, defines FDI as "a long-term investment by a non-resident, but with control (a 10% or greater share)" (2009, p. 1). This author also explains that there are different types of FDI, ranging from the development of new buildings, the expansion of existing ones, acquisitions and (in case of multinationals), mergers. It can be deduced from this that the barriers to investment between the parent and host country will be different depending on the type of investment. For example, tax incentives that a multinational receives for relocating its manufacturing plant to a host country have been known to be more substantial than those received by an insurance company investing in commercial property in the same country (Lahiri, 2009). On the other hand, other costs such as skills levels of the working population may not be considered a barrier to real estate but will be for producers.

For the purpose of our study, we have concentrated on those papers that address the barriers most likely to affect real estate investments. In this context, one of the contributions of this research will be a critical and comprehensive literature review on barriers to real estate investment. As stated above, there is very little literature on this topic which is directly addressed at the real estate asset class. However, Jones Lang LaSalle, a leading advisory firm, produces a Real Estate Transparency Index, first published in 1999, latest version 2008. In classifying market transparency, this survey-based measure uses judgements about the following:

a) the availability of investment performance indexes;
b) market fundamentals data;
c) listed vehicle financial disclosure and governance;
d) regulatory and legal factors; and
e) professional and ethical standards.

This information is used to arrive at a single index measure, with the highest transparency score in 2008 awarded to Australia and the US. The opaque markets included Algeria, Belarus and Cambodia. The JLL transparency survey looked at 11 countries in the Americas, with Canada and the United States the most transparent; semi-transparent markets included Brazil, Chile, Mexico and Columbia; Costa Rica, Panama, Peru, Uruguay, Venezuela and the Dominican Republic remained as markets marked by low real estate transparency.

The Middle East and North Africa region had the lowest average transparency when compared to other surveyed regions. Asia Pacific contains high transparency markets such as Australia and New Zealand, but also houses Cambodia, which is classified as having an opaque real estate market. India, China and Vietnam were 2008's most improved markets in the region while Indonesia, Malaysia and South Korea

showed little improvement. We suggest that this index is a measure of informal barriers to investment, to be further discussed later.

3.1 Formal barriers

There are different types of formal barriers, which include restrictions to capital accounts and legal barriers which relate to taxes and to ownership of foreign assets. For the purpose of our initial survey we presented a list of all formal barriers drawn from our academic literature review that are likely to occur in real estate investments, and asked interviewees to rank them according to their importance and how likely they were to deter them from investing in that country. We also asked them to justify their view.

'Push and pull factors' are terms used in economics to explain international capital flows. Push factors can be related to the lack of lending in the investors' country, while pull factors are related to the risk-return relationship in the host country (Montiel and Reinhart, 1999). While push factors explain external reasons why investors choose to go abroad, pull factors can help to explain geographical asymmetries in capital flows. Pull factors include some countercyclical policies that some countries apply when faced with a surge in the inflow of capital, for example capital controls.

Restriction to capital accounts

Capital controls affect the ability of investors to repatriate their investment. If domestic savings are scarce in the host country, it is likely that capital account transactions will be restricted. A common direct restriction could be the imposition of a minimum period of investment (Bekaert, 1995). It follows from this that restrictions on international financial flows are less prevalent in high-income countries with large domestic savings (Eichengreen, 2001). Although recent research has shown that capital controls do not affect the inflow of FDI (Montiel and Reinhart, 1999) our preliminary survey shows that real estate investors are likely to consider restriction to capital accounts a high barrier.

Among those who gave a high rank to the issue was an experienced global fund manager who used to work for a large insurance company and is now founding partner of an investment firm. He explained that some years ago his firm invested in China and decided later to double the investment in that country. Sudden political and legal changes meant that it took two years to get the money out. Another interviewee, a global advisor to a large American firm of commercial property researchers, agreed. In respect of China *"..if the thing goes wrong, don't ever expect to get your money out"*. In general and in our preliminary survey, there were no low ranks suggested for this issue and restrictions to capital accounts appears as a medium to high barrier to investment.

Legal barriers

Legal barriers arise from the different legal status of foreign and domestic investors. This could be in the form of ownership restrictions and/or the imposition of higher taxes (Bekaert, 1995). For example, governments in both developed and developing countries often impose ownership restrictions as a means of ensuring domestic control of local firms, especially those firms that are regarded as strategically important to national interests (Eun and Janakiramanan, 1986).

By analysing data from 16 different countries including developed and developing ones, these authors explain that even within the same country the fraction of equity that can be held by foreigners can be uniform across all firms, can vary across different industries with some industries closed to investment by foreigners, or it could be the case that foreign investment is banned from the country completely.

The degree to which this restriction applies varies greatly, and research in this area is usually done case by case. As explained by one of our interviewees, a lawyer from a prominent international firm with experience in the Latin American real estate markets, there are restrictions on ownership around coastal areas in Brazil which usually force foreign investors to find a local partner. Not surprisingly, most participants in our preliminary survey considered this an important barrier, giving it the maximum score. One of the participants and head of research of a large investment firm stated that a good legal framework *"is probably the most underrated and important thing in a modern economy"*. Others expressed a view that *"countries will not attract investment if they have problems with their land, legal system, contracts"*. China was mentioned as an example of a country with a complicated legal system, and also the place where foreign lawyers are not accepted and local ones cannot be trusted. When interviewees were questioned specifically about ownership restrictions, the general view in our preliminary survey was that this was not a great barrier. As the majority stated, these problems are usually solved by using a local partner.

Taxes and costs

The residence principle means that incomes from foreign and domestic sources of residents are taxed at equal rates, while incomes of non-residents are tax exempt (Razin et al. 1998). However, as this author explains, this is not always the case and this ideal tax structure is often altered, thus affecting capital flows. Countercyclical policies mentioned above in the context of pull factors can also include tax benefits, for example in cases when countries need to increase FDI.

The costs associated with holding foreign securities in a portfolio include transaction costs, information costs and differential taxation. Academic studies concentrate on differences in the taxation of capital gains and repatriation of capital (Demirguc-Kunt and Huizinga, 1992). After analysing 18 developing countries, these authors conclude that developing countries should acquire a policy of lighter taxation on capital gains than on repatriation of capital in order to avoid discouraging physical investment.

Researchers have typically single out these barriers and created models that consider their impact on investment. Black (1974) and Stulz (1981) built their analysis based on a two-country (domestic/foreign) single period model, taking into account transaction costs, information costs, or differential taxation. Both assume that this cost can be represented as proportional taxation, and both models show that the world market portfolio will not be efficient for any investor in either country. Stulz also shows that some foreign securities may not be held at all in the domestic investor's portfolio. The academic view is therefore that high costs and taxation are deterrents to investing in a foreign country. Real estate is no exception to this rule.

In our preliminary survey opinions were divided among those who considered that costs had little importance because they were compensated in returns, those who consider costs as a high barrier but only in cases where the investor could not find a local partner, and those who simply consider high costs as a barrier.

Survey participants were asked specifically about capital gains taxes. Some considered this to be a medium to low barrier, stating that these were operating costs that can be compensated for in expected returns. Those who considered this an important barrier also mentioned tax transparency, without which the target market could be a hostile environment to investment.

3.2 Informal barriers

Informal barriers to international investment arise because of differences in available information, accounting standards and investor protection. There are also risks that are especially important in emerging markets (Emerging-Market-Specific Risks or EMSRS) such as currency risk, political risk, liquidity risk, economic policy risk and macroeconomic instability (Bekaert and Harvey, 2002, Nishiotis, 2004). Legal and title risk is a real estate issue that we can add to this group.

Political risk

Politics can influence economic decisions and the country's degree of openness to foreign investment. For example, some authors argue that democratic governments are less likely to impose capital controls (Brune et al., 2001, Quinn et al., 2001). This is explained by the fact that democracy comes with increased rights and citizens' ability to press for the removal of restrictions on their investment options (Eichengreen, 2001). From these authors it can be inferred that investors will be deterred from investing in non-democracies.

However, most interviewees considered political regimes to be a medium to low strength barrier to real estate investment. Among those who gave a medium to low rank to this issue was the managing director of a large UK bank with experience in international lending. He pointed out that dictatorships have the ability to change all the rules completely, and it was supposedly much harder for Western government types *"to renege on a certain set of rules that everybody understands"*. However, he did not consider political regimes a high barrier, as he believed that that some regimes can be even clearer in their policies than democracies: *"It is black and white with states like Qatar, where there are two people that control everything"*.

A fund manager agreed: *"There have been some authoritarian places that can be stable and the other way round. Egypt is quite stable but not a complete democracy, while Greece is a democracy but not very stable. I suppose that authoritarian regimes tend to be quite traumatic in periods of change"*. However, he agreed with the academic view that if all things are equal *"you will go for the more stable democratic regime, simply because you are more likely to get a reliable legal framework and because democracies by their very nature tend to have less changes in direction"*.

Others considered that the risk comes with the territory and *"If you're going to a non-developed country the chances are that you are going to have a political system that doesn't operate openly"*.

Among those who regarded this as a a medium rank issue was a fund manager who stated that the barriers were not so much related to the political regime as to the legal structure, and the main question should be *"is it a regime that is pro business or pro taking the money and then won't let you take the money out?"*. Another investor considered politics a barrier based on his previous experience, stating that he had experienced changes of government where new restrictions were imposed that affected property, but still invests in non-democracies like Russia and China. This position seems to reinforce our view that population, wealth (and growth) are strong drivers for investment and that informal barriers have little effect in such cases.

Academic research also highlights the importance of pressure from powerful groups within countries. The relationship between politics (for example. the degree of democratization), financial reforms

and future economic growth have been widely studied by Dennis Quinn (Quinn, 1997, Quinn et al., 2001), whose ideas were summarised in the previous section. In addition, it should be pointed out that the most important difference between emerging and developed markets is the much more prominent role of politics in emerging markets and their larger public sectors, which can act as pressure groups (Bekaert and Harvey, 2002). Pressure groups are at the heart of political instability and can add substantial risk premiums to returns and therefore deter foreign investment.

North (1990) distinguishes between formal institutions (laws, rules) and informal behaviour. The state is the third party enforcing the laws while at the same time confronting the trade-offs between disorder, control and constitutional liberalism. The author's main argument is that if political efficiency is guaranteed, property rights are respected and economic efficiency can be achieved (North, 1990). The way in which these institutions are constructed vary greatly from country to country (Fukuyama, 2004) and the main aim of comparative economics is to study these differences and their effect on investment.

The tendency for those regimes that represent the interests of workers seems to be to apply controls while capitalist governments are unlikely to do so, which add extra risks to non-democracies (Alesina and Tabellini, 1989). Some of our interviewees disagree with this, stating that pressure groups also act in democracies: *"In the case of Marbella, where the local government just stopped all new developments, this was a populist idea".*

By contrast, the stock of FDI has been suggested to be less sensitive to corruption.

"We present evidence that the share of inward FDI and also foreign loans is highest for countries with weak institutions and poorly developed or badly functioning capital markets. Therefore, although FDI may have beneficial effects on the economy, a composition of foreign investment that is heavily tilted towards FDI is likely to be a signal of some fundamental weaknesses of the host country economy, thus providing support for the argument of Hausmann and Fernandez-Arias (2000) and Albuquerque (2003)" (Daude and Stein 2004).

In capitalist economies, public and private institutions can change or establish new economic rules. In other words, they can shape the characteristics of a country (laws, culture, history, politics, economics, and so on), how the institutions are shaped and how much the state intervenes affects the country's economic performance, risk and investment. Even though it seems that economic stability is an important factor for investments, some interviewees expressed different views: *"we cannot control what happens in the market, interest rates and all that, so we tend to focus I would say 80% of our efforts on the analysis of the individual asset and not what is going to happen to the city of x, y, z".* But this interviewee also added that economic stability matters and that *"people have forgotten that until recently. It is interesting to see how capital is flowing to those safe havens because they have that stability. I think is a difficult one because there are certain places where if you are making opportunistic investments you may not worry about it all because it is a high risk anyway".*

Currency risk

Currency movements can have a dramatic impact on equity returns for foreign investors. A possible irony of international investment is that many developing economies manage to keep exchange rate volatility lower than that which is typical in industrial economies. This is not surprising as many developing economies try to peg their exchange rates to the U.S. dollar or

to a basket of currencies (Bekaert, 1995). (A critical literature review on currency risk and international real estate investment can be found in Sirmans and Worzala, 2003.)

Our preliminary survey indicated that this is an important risk and the main question that an investor poses before investing is whether or not is possible to hedge the currency: *"If you are somewhere like China you can't really hedge, so, you end up with horrible debates, and this is an important matter, you can't ignore it. If you are thinking of investing where the currency is going down the pan, it doesn't matter at what time you get out, because it is not worth anything. There are hours and hours of debate about what to do with the currencies if you cannot hedge".* Another commented: *"This is something that is a key part of the business. You should hedge if you can, because we are property investors and not currency specialists. That will add to your costs, and this is a major concern when hedging costs are very high or hedging is impossible".*

Liquidity risk

Liquidity also presents a problem for direct investment in private real estate. This type of risk not only captures the time it takes to execute the trade, but other factors such as direct and indirect costs of trading and the risk and uncertainty concerning the timing of selling and the achievement of the expected sale price (IPF, 2004).

Replies to our survey regarding liquidity were diverse, although the majority stated that this was a high barrier. Among those was a fund manager who stated that liquidity issues were once more a high barrier since the 2008 collapse of the economy: *"One of the massive things about the crash was liquidity. This time last year everybody was running for liquidity".* For this reason he stated that in the near future *"investing institutions will up their proportion of cash, bonds and listed equities, because of liquidity issues".* This suggests a withdrawal from less liquid emerging markets.

Among those who rated liquidity as a medium to low barrier was a head of research of a large firm of investors who stated that the answer was different if you were a property developer than if you were an investor. For the former, lack of liquidity was a problem, but for an investor, illiquidity can turn into an advantage because *"if you're buying the only office building in a small town, that will be reflected in the price".* For others who also gave a low score to this question, liquidity was part of the business: *"if you go into somewhere because you think other people will follow, the trend will create liquidity".*

Crucial in the issue of liquidity for emerging property markets, especially for opportunity funds which try to buy and sell in a short space of tie to maximise return and performance fees or carried interest payments, is the prospective 'take-out'. Who will buy the property when the investor sells it? Emerging markets are likely to have less well developed local institutions and investment funds, and international owners are less likely to be represented. In addition to potential shortages of equity players ready to buy, there may also be a shortage of bank debt. Local investors may find it hard to raise the cash to buy a property if there is no local debt available, and international buyers will often use local debt to lay off some currency risk (Baum, 2009) - so if debt is unavailable liquidity can disappear. This is a critical problem for a closed ended, limited life unlisted property fund.

Cultural barriers

Despite the empirical research which attempts to price different type of risks, there is some evidence that investment

decisions are also based on sentiment (Lizieri, 2009). As stated before, investors' behavioral attitudes have been the subject of recent research (Bailey, Kumar, and Ng, 2004, Graham, Harvey, and Huang, 2004) but further analysis is needed in order to disentangle economic bias based on GDP and population from the influence of formal and informal barriers when it comes to making real estate investment decisions at an international level.

Interviewees in our preliminary survey all agreed that there were cultural barriers, exemplified when dealing with countries with certain religious beliefs. Even in those cases, however, the general view was that there were solutions available such as using specialised lawyers that could make the deal compliant to the religious beliefs of the locals. Sometimes the cultural barrier can be subtle: one of the interviewees was involved in the foreign development of a research laboratory which included facilities for animal testing, and said: *"in the UK we would have never got involved in that but in [X] they didn't even understand why we were so worried about it".*

While investors say that cultural barriers do not affect their decisions, they do state that precedence has an influence in their country of choice: *"I think in my business you look at precedence. Historical deal and track records can have an influence on people. Some people went to France in the 70's and that went horribly wrong and that stopped other English people from coming here for 20 years. The history of deals, what happened to those deals and why they went wrong are influential".*

An important cultural factor that was mentioned in the survey and has not been studied by academics was related to communications, and in particular the language barrier, which was related to the level of education in the targeted country and familiarity with a culture and language by westerners, especially American and British. This is important in the property world because real estate is not a screen-based, centralised market.

Others mentioned the imperative necessity of building a relationship of trust when a local partner is needed: *"People don't see things the same way, and you are often not sure what it is that your money goes into, because of cultural misunderstanding, corruption or fraud. I think the human nature side of this is terribly important [...] I as an Englishman travel abroad as a tourist and all I can use are my normal senses, and I depend heavily on finding somebody that I can relate to and understand".*

It could be the case that the targeted country has all the conditions for investment but a failure to find the right local partner could jeopardise the business. Others are willing to take those risks: *"Somebody told me that the key in India is to find somebody and build up that trust and then don't trust them, be prepared for something to go wrong, and to be let down".* Others commented on the ethical issues of a deal that can upset and affect lots of people: *"We have ethical guidelines about what types of tenants we can have, what we can do and what we can't do".*

Geographical barriers

As we explained in the introduction to this paper, there are theories that contest the inevitability of financial globalisation, claiming that geographical barriers still exist (Goldberg et al). The general view in our preliminary survey was that the ability to visit the country of investment (especially if no visa is required, and time differences are minimal) was a definite advantage. It was also considered an advantage for decision-making. One interviewee stated that people underestimate how exhausting it can be to travel and hold meetings: *"you have to manage the distance so you can*

go and spend a week somewhere do the negotiations and come back, because as soon as someone knows that you have a plane to catch, negotiations slow down, and then you give things away".

The view of this interviewee was that even when operations are run from a central office in the home country of the investor, people still need to visit the target market, as real estate is a *"global market, local asset"*. Others considered that geographical proximity is an important factor mainly because people now do not buy on trust: *"today people like to know more, and every piece of real estate is different so you need to go there [...] people don't rush to buy things without local due diligence, and that slows things down".*

Legal and title risk

A critical real estate issue is the risk of defective or unenforceable title. This is an issue in newly democratised markets such as the Baltic region and central, eastern and south-eastern Europe, where prior claims preceding communist state ownership can complicate acquisitions. This can be insured in many cases, but remains a risk in some. In Buenos Aires, methods of piecemeal or tiered development can lead to multiple ownership and a scarcity of institutionally acceptable single title assets. The issue of state title 'resumption' has been problematic in Zimbabwe, and adds to the conception of title and legal risk associated with political risk. *"Why take this risk or pay excessive costs of due diligence or insurance, especially when currency risk is also present, unless prospective returns are huge?"*

4.0 Conclusions

Formal and informal barriers to international investment are important in determining cross-border real estate capital flows. Formal barriers are prevalent in real estate markets because real estate ownership is easily regulated, real property is easily taxed and capital controls can be applied to real estate assets as easily they can to any asset type. This may act to leave domestic investors in a better relative position and exclude foreign buyers.

Informal barriers are equally challenging. The large lot sizes involved in real estate means that diversification is less easily achieved (Baum, 2007) and this leaves systematic country risks with investors. Currency and title risks in particular are likely to loom large in investor thinking. In an equity portfolio, emerging market currency risk can be diversified; for a real estate investor, this may be impossible, meaning that hedging is required, but this can be very costly or even impossible to achieve.

The different formal and informal barriers we find to be of likely significance in international real estate are listed in Table 1.

In paper three our aim is to confront practitioners with these theories through semi-structured interviews with key investors and fund managers. Through this we aim to relate the real estate under-investment and over-investment in emerging markets we identified in paper 1 to the different formal and informal barriers listed in Table 1, and to reveal the implications of this for investors in their choice of target markets and for governments wishing to attract more cross-border capital.

Table 1: Formal and Informal Barriers to Real Estate Investment

Formal barriers	**Informal barriers**
Ability to invest	*Willingness to invest*
Restriction to capital accounts	Legal and title risk
Legal barriers	Politic risk
Taxes and costs	Economic stability
	Currency risk
	Liquidity risk
	Cultural barriers
	Geographical barriers

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