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A Payoff at the End of a Rocky Road

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By Carl Gaines

Equity International sold its ownership interest in Shanghai Yupei, the other, also a homebuilder, has since been sold. In October, one of two initial investments the firm made a couple of years ago; China's growing middle class and GDP. According to McDonald, it's stake—is one of the firm's current access points to the fruits of second- and third-tier Chinese cities and in which Equity owns a funds the group launched, for example, focused on Mexico.

Colombia, China and India too attractive to resist. Earlier of a growing middle class can make spots like Brazil, Turkey, Colombia, China and India too attractive to resist.

Thomas McDonald, the chief strategic officer at Equity International, says the Chicago-based company ‘began investing in China a couple of years ago, initially in the homebuilding sector.’ China, whose 2010 GDP hit $5.5 trillion, according to data from the World Bank, saw total foreign direct investment that year top out at $105.7 billion. Much of this was the result of real estate investors and developers trying to take advantage of the country’s booming economy.

McDonald says that Equity International tends to concentrate on the larger countries in terms of GDP and population. Earlier funds the group launched, for example, focused on Mexico.

Shanghai Jingrui Properties Co. Ltd.—a homebuilder that targets China’s growing middle class and GDP. According to McDonald, it’s one of two initial investments the firm made a couple of years ago, the other, also a homebuilder, has since been sold. In October, Equity International sold its ownership interest in Shanghai Yupei Group Co. Ltd., an owner and operator of warehouse and distribution centers, to Global Logistics Properties. With tenants like Itochu and Bosch Siemens, the facility had benefited greatly from the developed infrastructure.

By the Portman Ritz-Carlton Hotel. The years leading up to the project opening, Baisiwala says, were spent working out legal concerns and deciding where and what would be built. “Generally when we enter a new location we spend quite a bit of time up front just understanding the market, the players, building some key relationships and then going from there,” he notes.

In China, however, if you swoon, you lose. Seemingly overnight, massive transportation systems appear, as cash-strapped Chinese developers and US investors hitch their wagons together, hoping to keep up with the swift pace. “If there’s any place in the world where infrastructure challenges can be met and resolved quickly, it’s China,” McDonald says. “There were times when we’d travel to a secondary or tertiary city there, then come back in a year and find that an eight-lane superhighway would be built that’s 50 or 50 miles long. That kind of activity happens in China. It doesn’t happen anywhere else. Infrastructure as a bottleneck to growth is more of an issue in places like Brazil and India than China.”

For the most part, Baisiwala agrees, though he says infrastructure issues don’t necessarily hinder growth as long as the demand is there. Take India, for instance. Despite a smaller GDP, at $1.7 trillion for 2010, India’s rapid growth and consumption are sparking real estate needs that don’t go away, regardless of the less-developed infrastructure.

“There are a lot of young people coming out of college, picking up jobs, and looking at buying real estate and consuming other goods and services,” Baisiwala says. “Even though, from a global-benchmark perspective, infrastructure in India may appear to lag behind other parts of the world, it doesn’t mean that people locally don’t want to consume. You still need a house and you still want to go out and shop, eat and entertain yourself.”

Portman Holdings has been focusing on the housing needs of the consumers Baisiwala mentions, primarily through Margosa Heights, a 987,000-square-foot apartment development in Pune, southeast of Mumbai. Margosa Heights consists of 978 middle-income, for-sale units and is being developed in phases through 2014. The development has a retail component as well. “In India, our key focus right now is the residential asset class and, specifically, residential for the middle to premium market.”

Baisiwala says, adding that Margosa Heights has “been selling well.”

Though he declines to give specific dollar amounts invested in either India or China, he says that in China “the deal sizes tend to be somewhat larger, because of the nature of the market. Relatively, in terms of money that we put out, China tends to have slightly larger deal sizes, but it’s not that we’re investing more in China than in India—it’s just a function of the market and pricing.”

The Chinese and Indian economies may be in full growth mode, but they’re not the only areas attracting capital. Investor interest continues to filter to other emerging markets as well. Frederick Gortner, managing director at Paladin Realty Partners in Los Angeles, says that in Latin American presence affords it access to a group of workers that mirrors the US Baby Boomer generation. Gortner says that, much like this generation fueled decades of growth in the US, “in Latin America, 30 million or so people are going to enter the workforce over the next two decades—half of that in Brazil alone.”

Paladin currently has more than $4 billion in assets in Brazil, Mexico, Peru, Costa Rica, Colombia and Chile.

“We’ve invested over $800 million of equity in more than $5 billion of assets across three Latin American funds,” Gortner says, adding that the firm is currently in the middle of a new fund raise. Paladin’s most recent fund was Latin America Investors III, which, combined with a sidecar, amounted to $534 million. According to its website, Paladin “seeks to achieve annual returns in excess of 25% after taxes on its emerging-market investments using conservative amounts of leverage, which averages less than 50% of cost.”

Brazil’s infrastructure challenges are being addressed, since the country is hosting the 2014 World Cup and 2016 Summer Olympics. However, barriers to entry remain—namely, the complicated nature of local zoning laws.

“The zoning laws can seem quite Byzantine,” says Jeff Gannings, a senior vice president at RREEF Associates, a global design firm headquartered in Washington, DC with projects in Brazil and other Latin American countries. “You figure out the rules of the game and how to work within them and maximize the development.
Then you end up going back to the local authorities several times to ask questions, which they’ll then clarify. It’s sometimes challenging in Brazil, especially on a smaller site.”

One of RTKL’s current projects is the Panamibi Collection, a shopping center between the Morumbi neighborhood and the Panamibi District in Sao Paulo, a city whose metro area population is around 20 million, according to data from the CIA’s World Factbook. “We’ve been involved in a number of shopping centers over the years in Brazil,” says Gunnin, who adds that the client, Gazit Brasil Ltd., was looking to take advantage of the fact that zoning would allow for a bigger retail component there.

Gazit Brasil was “interested in maximizing the value of the property, because what existed there was a grocery store and a small shopping center, though zoning would allow for a lot more development,” he states. Gazit is still in negotiations with the city to finalize the project, which will consist of multiple levels of retail, filling a local void for upscale shopping options.

Retail is expanding in India as well, as evidenced by a 400,000-square-foot, luxury mall RTKL is working on in the city of Kolkata. Spencer’s Galleria will be the third largest luxury retail destination in the country, according to an RTKL spokesperson. And in China, the firm’s design for a multi-use project in Jiangsu Province was selected by Jiangsu Shagang Group Hongrun Real Estate Development and is scheduled to open by the end of 2015.

Despite the demand being generated for China’s burgeoning middle class, barriers to entry remain for real estate players. “As it relates to homebuilding, one of the obstacles is government intervention,” McDonald points out. For one, foreign investors are not allowed to own land in the country, so non-domestic companies must team up with local firms on developments. Then the home-building business requires land as the primary raw material, and relies on buyers who are reliant on financing as the ultimate consumers. Because both land and the mortgage market are controlled by the government, it “effectively can control all of the financing.”

This is both good and bad, McDonald says. On one hand, it keeps the industry from getting too far ahead of itself in terms of the formation of a bubble. On the other, he says, “It’s never going to be able to grow for an extended period at the same growth rates that we, for example, experience in Mexico or Brazil. That’s an obstacle for us.”

Still, McDonald understands the rationale, adding, “you can still capture a large part of the market by growing at a slower rate.”

Portman Holdings’ Baiswalva is likewise uncerned about oversupply or a bubble in China. He sees the familiar—perhaps reassuring—hand of supply and demand economics at work. “In real estate, or any industry where you’re manufacturing a product and then selling it, it’s specific points in time there may be imbalances between demand and supply,” he says. “Real estate goes through cycles like any other industry, and that’s going to happen in every market, including China. But at an overall market level, we really don’t have concerns about oversupply or a bubble forming.”

A well-formed strategy for entering a market is key, since location is not a one-size-fits-all option. Paladin hasn’t invested in China—due in part to the firm’s size relative to the market, Gunnin says. Even within the firm’s key geographic area of interest—Latin America—there are variances that exist from country to country. While Paladin looks at “all investor-friendly markets,” in the case of some countries, the political leadership can mean that no further study into that market is warranted.

“We don’t like political risks, even if it’s just what we think is misguided political leadership,” Gunnin says. “We’ve never had Venezuela on our radar screen and likely never will as long as President Hugo Chavez is there. We’ve been studying Argentina for a long time and see some attractive opportunities, but we haven’t been comfortable with the political leadership for most of the past decade.”

In addition to political concerns, of course, are those about the global nature of sovereign nations’ economies. With the economic and banking crises in Europe, shocks occurring in one region of the world will most likely be felt in another.

“Global economies are more linked now than they’ve ever been,” Gunnin says. “That demonstrated itself in the financial crisis of ’08 and ’09, and certainly today as Greece, and Europe as a whole, try to deal with their debt situation. ‘So Latin America, notwithstanding its demographics, strong banking sector and its growth opportunity, isn’t immune to what’s happening in the rest of the world.’”

As far as strategy is concerned, what might be most important are boosts on the ground—strong local partners in each market able to carry out the research and due diligence required before an investment or project moves forward. Paladin, for example, relies on its partners in any given region, through Gunnin points out that the company does have a location in Sao Paulo. He says that central and eastern Europe—Turkey in particular—may be next for the group if research on the ground continues to be favorable.

The firm has also studied South Africa in detail, he says. McDonald says that Equity International, whose investments in emerging markets include Egypt and Colombia, researches locations “on a pretty micro level,” going in and working with local business partners. “They are the experts in their markets,” he says.

“They’ll have as good and evolved a view as anybody in terms of the growth opportunities in those specific markets for the product and the buyers that we’re catering to.” In fact, he says that in Brazil, Equity International’s diversity of investments is “a reflection of partners and the ability that we’ve had to find world-class partners in a diverse collection of sectors.”

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