

# FOREIGN INVESTMENT IN U.S. REAL ESTATE

## Current Trends and Historical Perspective



Prepared by the Research Division of  
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## I. Introduction

The expanding globalization of the world economy has spurred increased investment and trade across international borders over the last several decades. The trend towards more international investment and trade was accelerated in the 1990's by several economic phenomena. The demise of the Soviet Union opened a vast area to the global economy that had previously been isolated from the free world and its markets. Furthermore, the emergence of fast growing, highly populous, developing countries -- such as India, China, and Brazil -- accelerated investment and trade even further.

The United States has historically been an attractive place for international investors. International investors are drawn to the U.S. because of its strong private property rights, independent judiciary, growth oriented tax law, and liquid capital markets. Because of these benefits, foreign investment in the U.S. has increased approximately 40 fold over the last 4 decades on an inflation adjusted basis.

The increased prevalence of foreign trade and the U.S.'s growing reliance on external financing have made foreign investment in the U.S. vital to the overall performance of the U.S. economy. In particular, foreign investment provides numerous salutary benefits which include:

- Job creation/economic activity due to the establishment or expansion of foreign firms in the U.S.
- Lower borrowing costs for U.S. businesses and governments entities due to foreign investment in U.S. securities markets

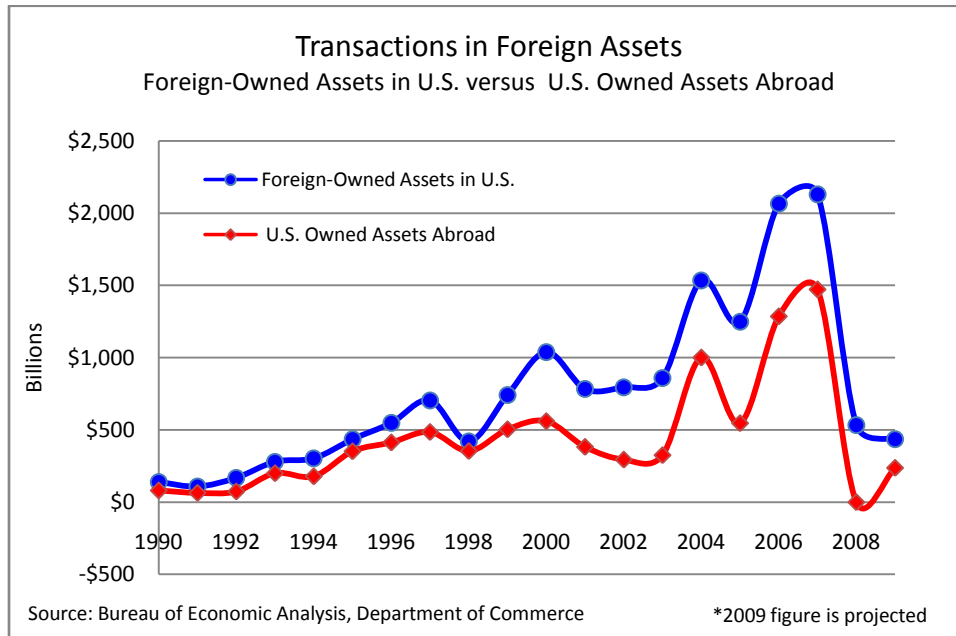
This paper discusses the impact of foreign investment on the U.S. economy, and in particular, the U.S. real estate sector. It is organized in five parts. Part two details recent trends in international investment in the U.S. and U.S. investment abroad. Parts three and four examine the impact of foreign investment on the U.S. commercial and residential real estate markets respectively. Part five summarizes some of the key findings of the paper.

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<sup>1</sup> Source of photo on first page is: Public Domain Clip Art, Central Park City Skyline April 12, 2008.  
<http://publicdomainclip-art.blogspot.com/2008/04/central-park-new-york-city-skyline.html>.

## II. Recent Trends in International Investment

Foreign investment<sup>2</sup> activity has been affected substantially by the recent recession. Prior to the recession, foreign investment in the U.S. reached an all time high in 2007 of \$2.1T. Since that point, foreign investment in the U.S. has declined precipitously to \$435B in 2009, an 80% decline from the peak. U.S. investment abroad followed a similar pattern; it reached its peak of \$1.5T in 2007, and has since fallen to \$100M in 2008 and \$237B in 2009. The pattern of foreign investment in the last two years suggests that the decline in foreign investment was not isolated to the U.S. but took place worldwide following the 2008/2009 recession.

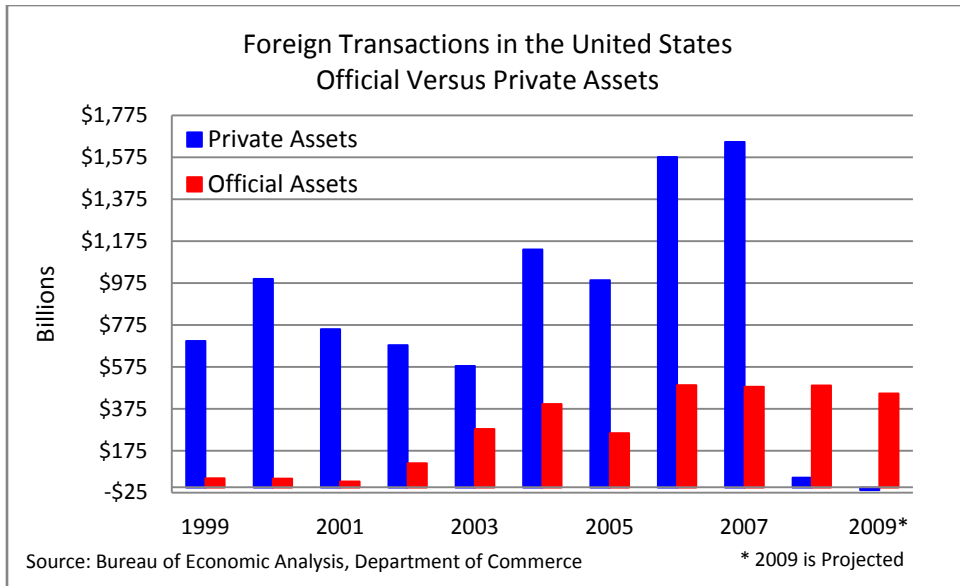


As foreign investment in the U.S. declined during the recession, the share of foreign investment made via private assets<sup>3</sup> declined commensurately. In 2008 and 2009, the foreign investment in the U.S. that did take place was almost exclusively done by foreign governments, through the purchase of official assets.<sup>4</sup> Purchases of official assets in 2008 and 2009 remained consistent with pre-recession levels of approximately \$500B. In sharp contrast, private foreign investment in the U.S. was non-existent over that time frame. Investment in private assets collapsed from \$1.65T in 2007 to virtually none in 2008 and 2009.

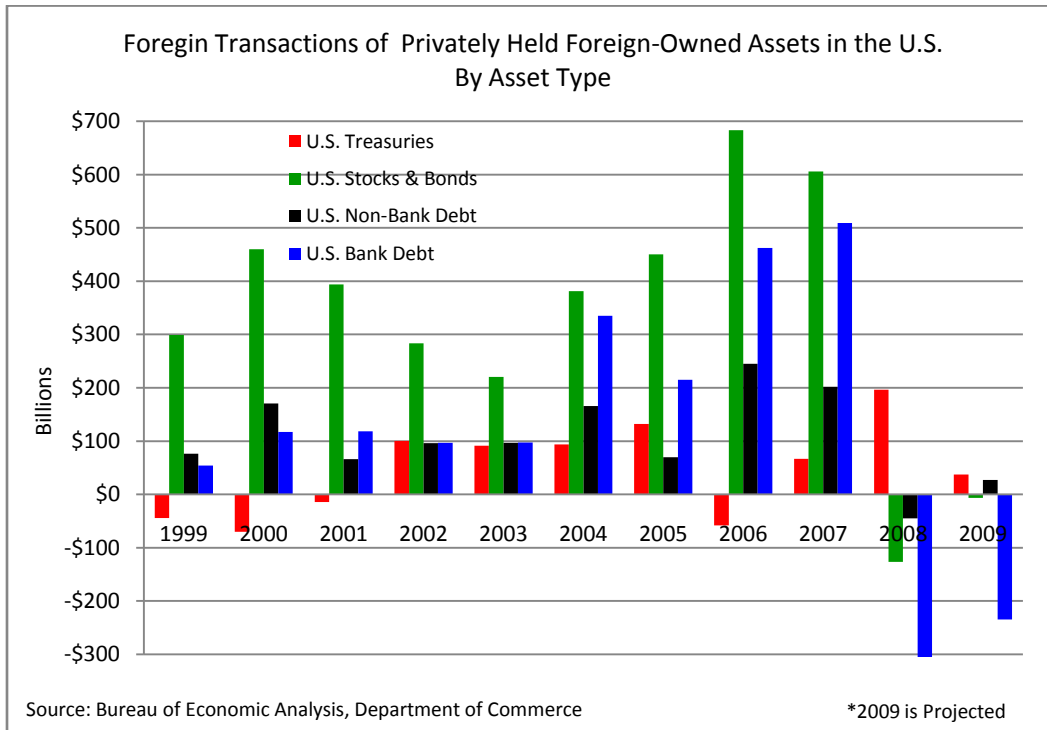
<sup>2</sup> Foreign investment, in this case, is defined as transactions in financial assets and liabilities between U.S. residents and non-residents. Transactions are measured on a net basis, purchases less sales. Transactions include net purchases of stocks, bonds, currency, gold, government debt, *et al.* Note that foreign direct investment, which will be discussed later in this paper, is a subset of foreign investment. For further information, please refer to the Bureau of Economic Analysis, "Balance of Payments (International Transactions)" financial account data ([www.bea.gov/international](http://www.bea.gov/international)).

<sup>3</sup> Private assets are those assets that are purchased by foreign residents. Private assets exclude investment made by or on behalf of a foreign government.

<sup>4</sup> Official assets are those assets and liabilities that are purchased by a foreign government to be held primarily as reserves. Purchases of official assets are typically made by either a finance ministry (a foreign equivalent of the U.S. Treasury Department), a central bank (a foreign equivalent of the U.S. Federal Reserve), or another entity acting on behalf of the government.



Private foreign investment in the U.S. declined during the recession primarily because of large divestitures of U.S. bank debt. Foreign private investors, on net, sold \$327B of U.S. bank debt in 2008 and another \$235B in 2009. This is in stark contrast to the large purchases of U.S. bank debt (\$200-500B) during the real estate boom of 2004-2007. In addition to selling large amounts of U.S. bank debt, foreign private investors largely avoided U.S. stocks, bonds, and non-bank debt in 2008 and 2009. Foreign private investors primarily purchased U.S. Treasury securities in 2008, buying nearly \$200M in that year. However, in 2009, private investors even avoided investing in U.S. Treasury securities.



The fallout from deleveraging of over-valued assets was severe. Stock prices declined by approximately 50% from peak-to-trough during the 2008/2009 recession for Australia, Brazil, Canada, Germany, Japan, South Korea, United States and the United Kingdom. The magnitude of losses was comparable to the 2001/2003 recession, but the rate at which stocks were losing value was much more rapid in the 2008/2009 recession. In the most recent recession, stocks went from peak to trough in anywhere from 6 to 22 months. Brazil was the quickest of the selected countries to recover at 6 months, and the United Kingdom was the slowest to recover at 22 months. In the 2001/2003 recession, stocks values went from their peak to trough in a range of 21-39 months, or approximately twice the time of the 2008/2009 recession. The rapidity at which stocks were declining in value in the 2008/2009 recession reflects the heightened urgency of investors to divest themselves of rapidly souring positions. It also helps explain the near seizure of foreign private investment in 2008 and 2009.

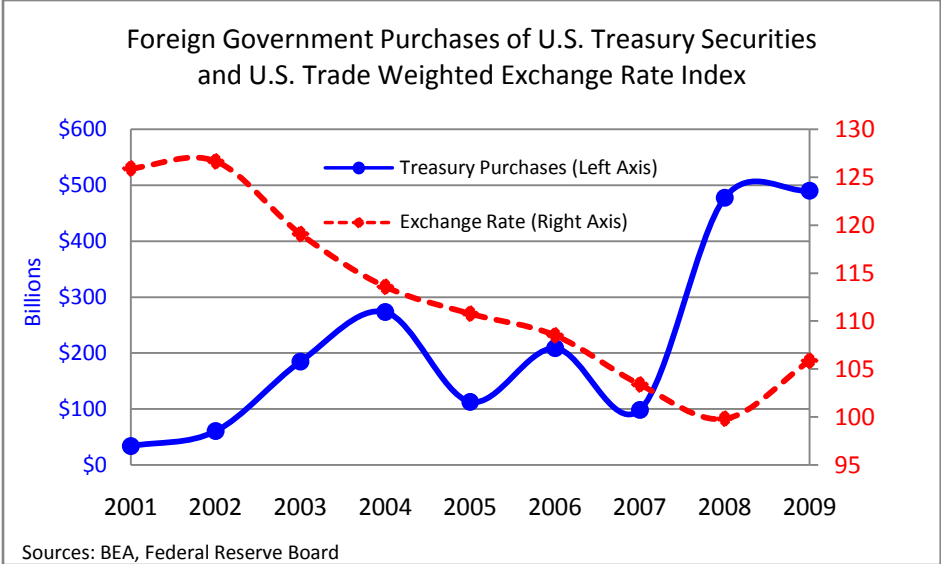
<b>Stock Market Performance Over last two Recessions for Selected Countries</b>								
<b>2001-2003 Recession</b>								
Description	Australia	Brazil	Canada	Germany	Japan	S. Korea	U.S.	U.K.
% Chg-Peak-to-Trough	-17.1%	-49.2%	-43.8%	-68.1%	-60.1%	-44.1%	-43.6%	-44.5%
Months-Peak-to-Trough	21	31	26	36	37	39	30	39
<b>2008-2009 Recession</b>								
Description	Australia	Brazil	Canada	Germany	Japan	S. Korea	U.S.	U.K.
% Chg-Peak-to-Trough	-50.2%	-49.6%	-43.5%	-50.1%	-57.3%	-46.4%	-50.8%	-44.3%
Months-Peak-to-Trough	17	6	9	17	20	13	17	22

Source: Wall Street Journal/Financial Times

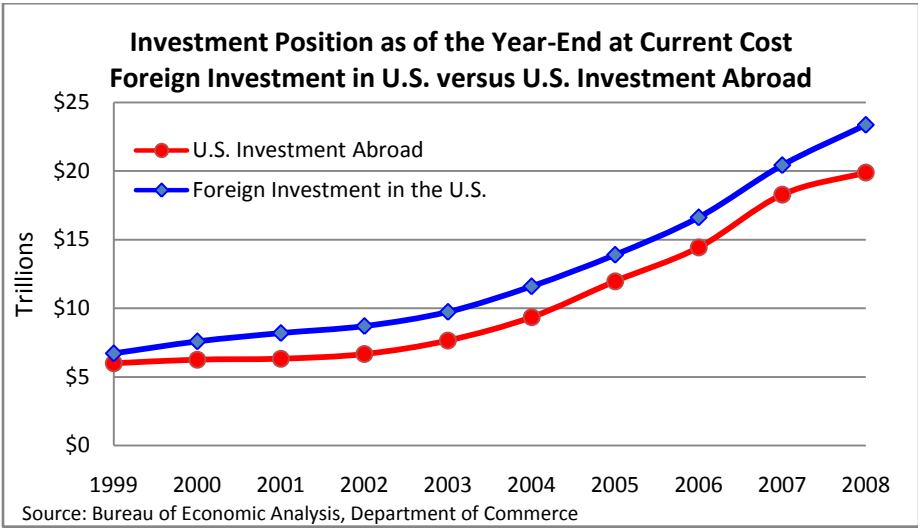
Amidst the 2008/2009 recession, the U.S. Dollar (USD)<sup>5</sup> appreciated in 2009 as foreign investors -- primarily foreign governments -- sought the safety of the U.S. treasury market during the global downturn. Foreign governments purchased \$477B of U.S. Treasury debt in 2008 and \$490B in 2009. Both amounts represent an approximate 400% increase in purchases from 2007. The influx of foreign governments into U.S. Treasury securities helped to reverse the previous trend of depreciation of the USD due to persistent fiscal and trade deficits. The USD increased 6.1% in 2009<sup>6</sup>. However, the USD still has declined by approximately 7% over the last 5 years and 9% over the last 10 years.

<sup>5</sup> The value of the USD is measured by the Federal Reserve Board's Broad Trade Weighted Exchange Rate which is an average of the U.S. exchange rate for each of its trading partners, weighted by the relative amount of bilateral trade between the U.S. and its trade partner.

<sup>6</sup> In particular, the USD increased by 13% between the third quarter 2008 and the first quarter 2009 on a trade weighted basis.

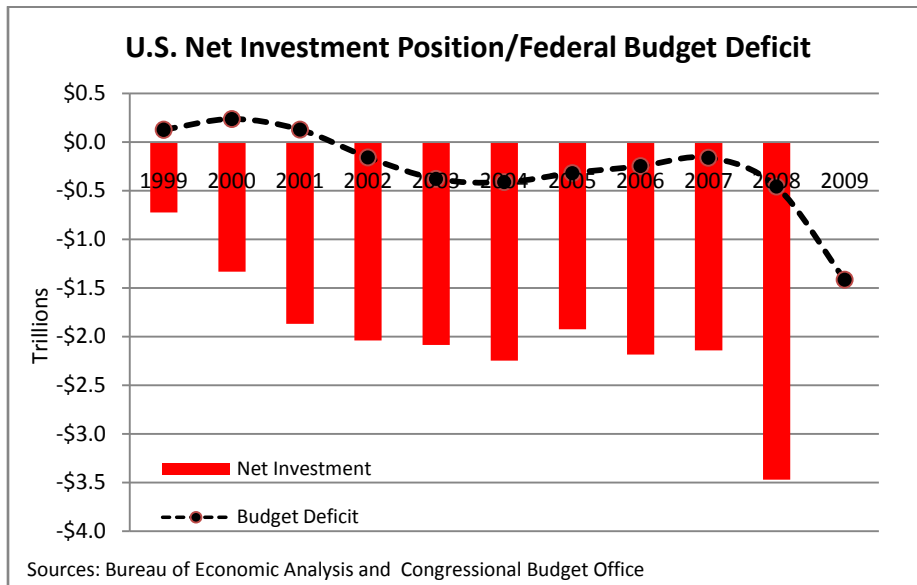


The international investment position<sup>7</sup> -- available only through 2008 -- shows both an increase in the current value of foreign claims on U.S. assets and U.S. claims on foreign assets in 2008. Foreign claims on U.S. assets increased by 14% in 2008 to \$23.4T, while U.S. claims on foreign assets increased by 8.8% to \$19.9T in 2008.



<sup>7</sup> The U.S. international investment position is a point in time snapshot, as of the end of the year, of the value of U.S. investments made abroad. Similarly, the foreign investment position refers the same snapshot of the value of foreign investment made in the U.S. Investment position is measured by a current cost approach based on replacement value.

The negative U.S. net international position should widen as U.S. federal government budget deficits are expected to be near \$1T annually for several years. These large persistent deficits will require commensurate increases in foreign purchases of U.S. Treasury securities to finance them.



The 2008/2009 recession in the U.S. has precipitated a sharp shift in international investment from foreign private investors investing in private U.S. assets, to almost exclusively, foreign governments investing in U.S. Treasury Securities. This has had a large impact on sectors of the U.S. economy that are dependent on private capital markets to finance transactions such as the commercial property market.

### III. Foreign Investment in U.S. Commercial Real Estate

The U.S. commercial property market has been significantly affected by the 2008/2009 recession. In particular, the confluence of an excess in supply of commercial property and severely diminished demand for commercial space has precipitated both a decline in commercial rents as well as rising vacancies. Furthermore, the market to buy or refinance commercial properties is relatively non-existent in its present form. Although the commercial market is projected to ameliorate beginning in 2011 based on improvements in the broader economy, the current market environment is somewhat bleak for commercial real estate.

Given this environment, it is not surprising to see that foreign acquisitions of U.S. commercial properties declined substantially in 2008 from all time high levels in 2007. The decline in foreign acquisitions was broad based, across all property types, ranging from a 93% year-over-year decline in retail space in 2008, to a somewhat more modest 57% decline in office space over that same time frame.

<b>Foreign Acquisitions of Commercial Properties 2007 and 2008 - \$ Millions</b>				
Use	2007	2008*	Change	% Change
Apartment	\$3,686	\$1,039	-\$2,646	-71.8%
Industrial	2,902	332	-2,569	-88.5%
Office	17,967	7,783	-10,185	-56.7%
Retail	14,477	1,014	-13,463	-93.0%
Hotel	11,541	1,658	-9,884	-85.6%
<b>Total</b>	<b>\$50,573</b>	<b>\$11,826</b>	<b>-\$38,746</b>	<b>-76.6%</b>

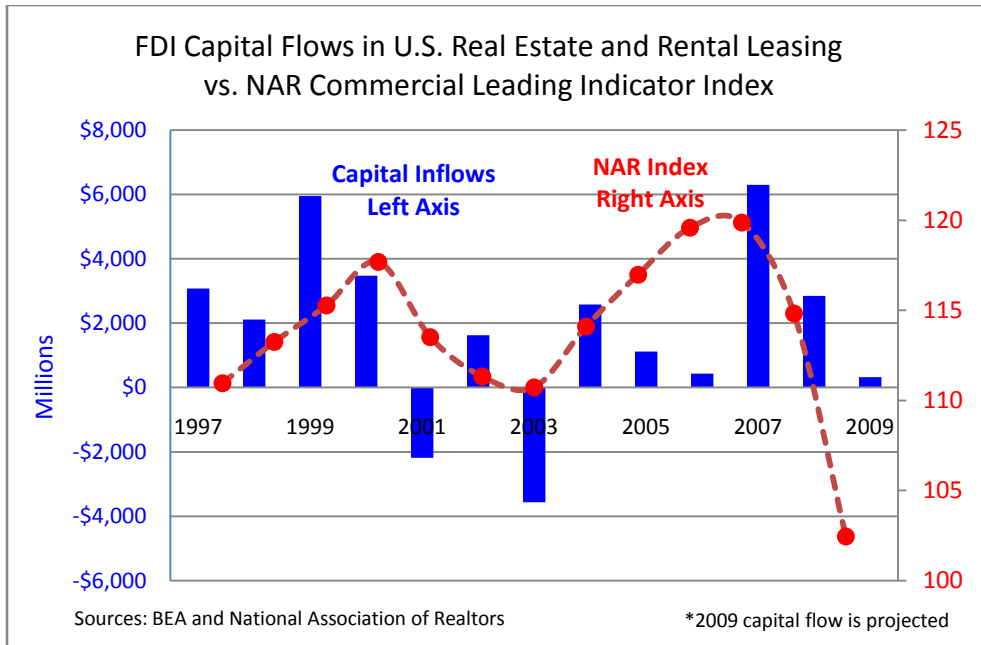
\*2008 numbers are annualized based on data through October

Source: Real Capital Analytics

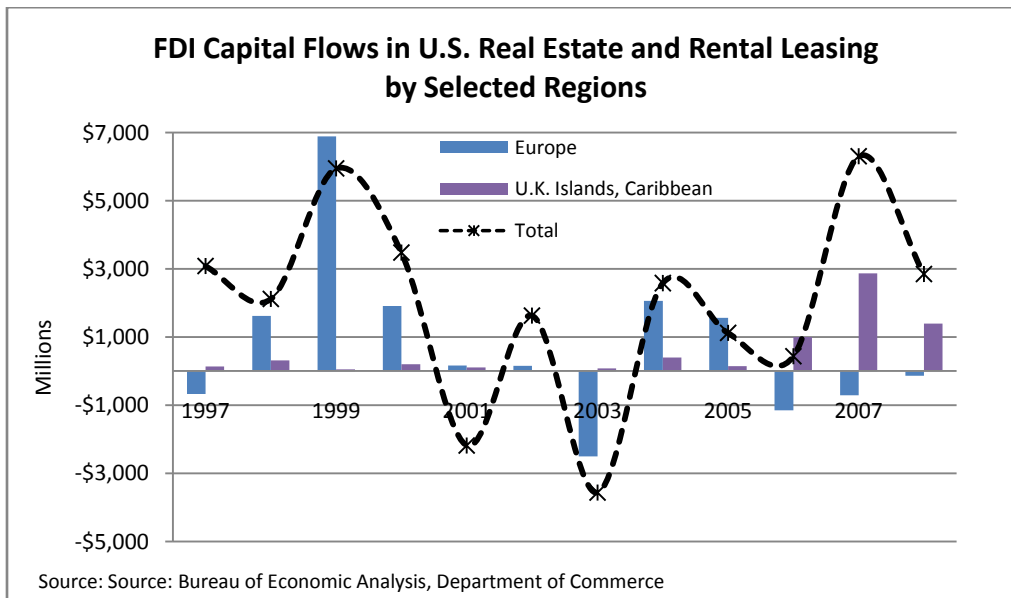
Foreign Direct Investment (FDI), measured by capital inflows<sup>8</sup>, in the U.S. real estate and rental leasing sector (RRLS) is another way in which to assess foreign participation in the U.S. commercial market.<sup>9</sup> This data largely confirms what the acquisition data above indicated, but gives a better historical perspective as well as additional depth of information. This RRLS is comprised primarily of companies that rent/lease real estate, as its name suggests. FDI in the U.S. RRLS reached its peak in 2007 at just over \$6B. FDI has since declined fairly precipitously to \$2.8B in 2008 and \$327M in 2009. The decline in FDI follows the broader cycle of the commercial property market, as indicated by NAR's Commercial Leading Indicator Index. NAR's Commercial Leading Indicator is down 14.5% in 2009 from its peak in 2007.

<sup>8</sup> Foreign Direct Investment, as measured by capital inflows, is the dollar value of transactions made by a foreign parent company in a U.S. affiliate. Transactions may include the establishment of a new foreign-owned business in the U.S., the expansion of an existing foreign-owned business in the U.S., or the acquisition of an existing U.S. business by a foreign parent. For a foreign parent company to qualify as a foreign direct investor, it must possess at least a 10% ownership stake in the U.S. affiliate. Furthermore, for the transaction to be considered FDI, funds used for the transaction must be raised outside the United States. Please refer to the Bureau of Economic Research for further detail ([www.bea.gov/international](http://www.bea.gov/international)).

<sup>9</sup> Note that the acquisition data from Real Capital Analytics and FDI data from the BLS will not match one another in dollar value as the former represents the foreign acquisition of commercial property and the latter represents foreign investment in U.S. businesses in the rental and leasing sector.

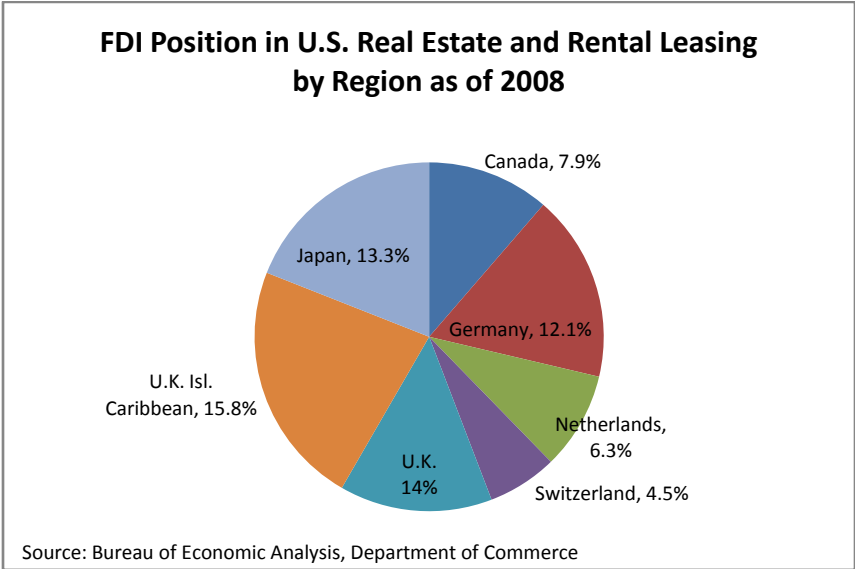


Investment made by European entities has comprised a significant portion of FDI in the U.S. RRLS since the late 1990's.<sup>10</sup> However, beginning in 2006, investment from Europe slowed considerably, and there was a commensurate rise in investment from the U.K. Islands in the Caribbean (e.g. Cayman Islands). For example, in 2005, FDI from Europe was \$1.5B. In 2006, despite a buoyant U.S. real estate market, European FDI was a negative \$1.1B (i.e. money was leaving the U.S.), while investment through the U.K. Caribbean Islands was \$1B for that year. Presumably, most of this change reflects a preference for using financial centers such as the Cayman Islands versus European centers such as London.



<sup>10</sup> Note that the BEA classifies the nationality of the foreign investor for FDI (balance of payments data) as the location of the foreign investor, notwithstanding the fact that the ultimate beneficial owner might reside in a different foreign country.

The countries shown below represent 70% of the total FDI position<sup>11</sup> in the U.S. RRLS as of the end of 2008. Of the \$52B of net claims by foreigners, \$8.2B or 15.8% of it is attributable to investment made via the U.K. Caribbean Islands. European countries -- such as the U.K. proper, Switzerland, and the Netherlands -- had sizeable positions ranging from 4.5% to 14% (in the case of the U.K.) of the total position in 2008. In addition, Japan had a 13.3% investment position. Finally, data for Australia was suppressed for 2008. However, in 2007 Australia's FDI position in the U.S. RRLS was \$7.3B, or 15.1% of the \$48.1B total position for that year which is comparable to the U.K. or Japan.



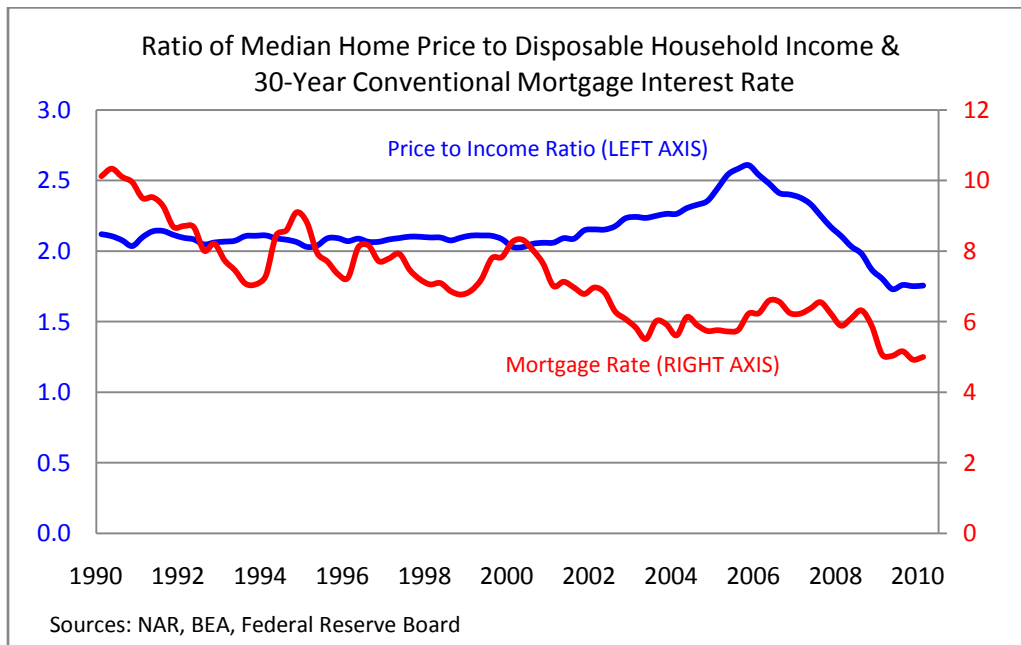
The commercial property market in the U.S. is currently beset by both excess inventory and reluctance on the part of lenders to increase their current exposure to the market by lending further. Thus there is very little demand on the part of investors, domestic or foreign, to acquire commercial properties or begin new projects. The commercial market should improve as broader fundamentals in the economy improve; most notably employment and consumer spending, which should bolster property cash flows and improve capitalization rates, which in turn will help to stabilize commercial investment.

<sup>11</sup> FDI position is the net value of the claims foreign entities have on U.S. affiliates as of the end of a given year. Note that claims include debt owed by the U.S. affiliate to the foreign parent as well as the equity position of the foreign parent in the U.S. affiliate. The term 'net' is used because a U.S. affiliate may for example, make a loan to the foreign parent. Thus, the FDI position is net of any claims that the U.S. affiliate has on the foreign parent. Also, a foreign parent company must possess a 10% ownership interest in its U.S. affiliate to be considered a foreign director investor in the U.S., as was the case for capital flows. FDI position is calculated on a historical cost basis.

#### IV. Foreign Investment in U.S. Residential Real Estate

In contrast to the U.S. commercial real estate market, the U.S. residential market for existing homes has begun to show considerable improvement in 2009 and the first quarter of 2010. There were approximately 5.2M existing home sales in 2009, which was 300K greater than the 4.9M sales in 2008. Growth in existing home sales in the second half of 2009 and first quarter of 2010 increased to 5.5M units on a seasonally adjusted annualized basis. Home prices have also stabilized in the range of \$170,000-175,000 over this period, with distressed properties, on average, accounting for nearly 30% of existing home sales over that time frame.

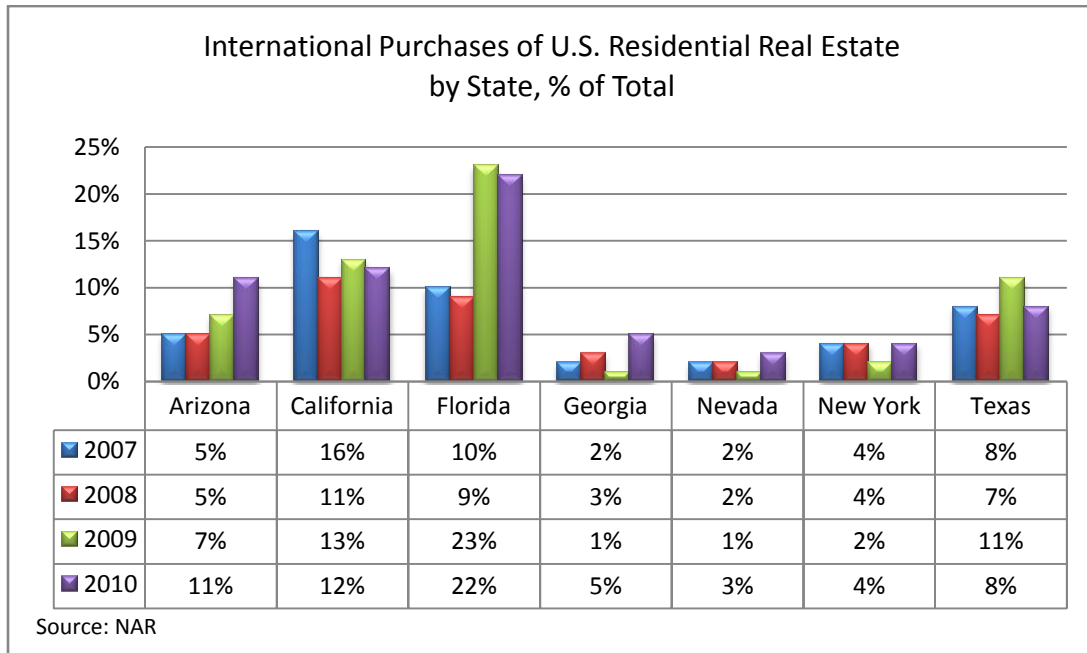
Despite the recent resurgence in the U.S. residential market, residential prices still remain below historical norms. From 1990 to 2002, the ratio of the median home price to disposable household income averaged approximately 2.1, with very little variation from the mean. During the housing boom, the U.S. price to income ratio increased substantially due to surging home prices and reached its peak of 2.6 in the fourth quarter of 2005. The price to income ratio has subsequently declined to its current level of 1.8, based on falling home prices, which is far below the historical norm of 2.1. The 30-year conventional mortgage interest rate is also near its historical low of 5%. The combination of lower prices and interest rates suggests that conditions in the U.S. residential housing market have been very favorable to potential buyers.



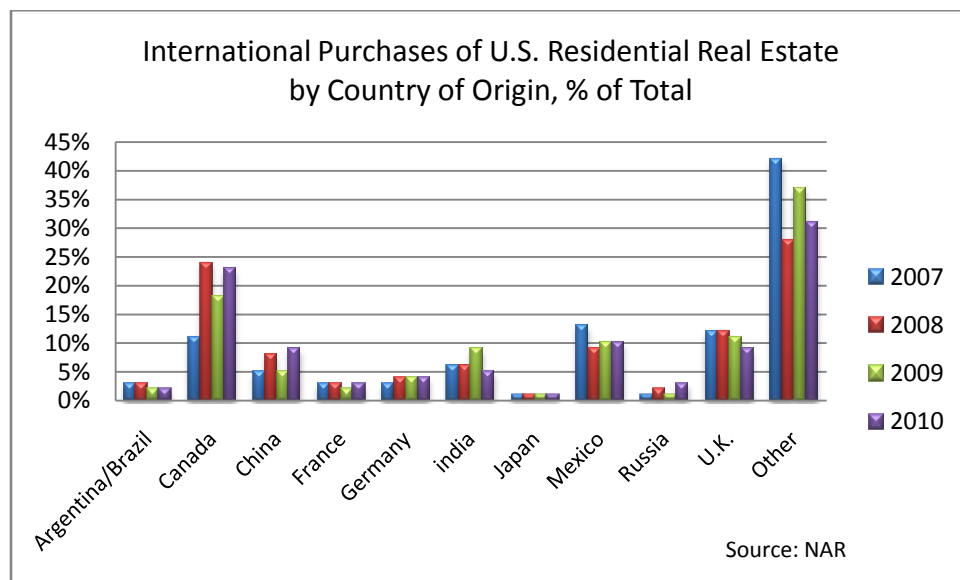
In the event, foreign investors took advantage of the aforementioned conditions in the U.S. residential market in 2009/2010. For the twelve months ending April 2010, foreign purchases of U.S. residences totaled \$64 billion. This is almost twice the \$36 billion in foreign transactions that took place during the twelve months ending April 2009. The percent of dollar volume represented by foreign transactions increased from 4.3% in 2009 to 7.1% in 2010.

Most of the foreign purchases in U.S. residential real estate were located in four states – Arizona, California, Florida and Texas. These four states accounted for 54% of all international transactions in the twelve months ending April 2010. This compares to only 38% of all foreign transactions in the twelve

months ending April 2007. Not surprisingly, states with a large number of distressed properties in vacation areas such as Florida and Arizona exhibited the biggest increases in foreign purchases. Foreign purchases in Florida and Arizona increased from 10% to 22% and 5% to 11% of all foreign transactions in the U.S. respectively between 2007 and 2010.

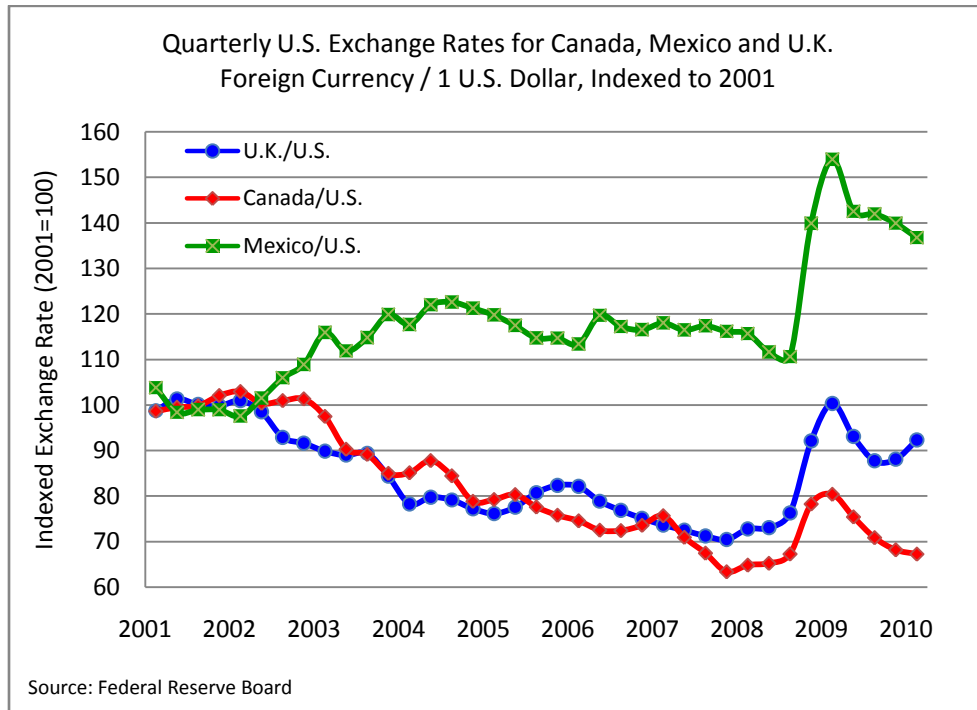


Of those countries investing in the U.S. housing market, four countries accounted for approximately 50% of all buyers for the 12 months ending April 2010. Canada accounted for the most international transactions in 2010, 30% of the total. The United Kingdom, Mexico and China were also active investors, where each represented approximately 10% of international purchases.



A portion of the increased international activity in the U.S. residential market may be attributable to depreciation of the U.S. Dollar (USD). The USD had depreciated by 16%, 11%, and 8% against the

Canadian Dollar (CD), Mexican Peso (MP), and U.K. Pound (UKP) respectively between the first quarter of 2009 and the first quarter of 2010. This followed a spike in the USD's value between late 2008 and early 2009, as investors sought the safety of U.S Treasury Securities. Between 2001 and 2010 the USD has depreciated against the CD and UKP by 30% and 10% respectively. In contrast, the USD has appreciated by nearly 40% against the MP over the same time frame.



The confluence of historically low U.S. real estate prices, low mortgage rates and, especially in the case of Canada, a depreciating USD have helped to effectuate a substantial increase of foreign investment in U.S. residential real estate for the twelve months ending April 2010. The majority of the foreign investment has taken place in warm weather states that are particularly exposed to distressed properties (such as Arizona and Florida). If the same market conditions that led to an increase in foreign investment continue to manifest themselves, foreign investment should remain robust in the near term.

## **V. Concluding Remarks**

Foreign investment in the commercial and residential real estate sectors trended in opposite directions in 2009/2010. For example, in the commercial sector, FDI in the U.S. RRLS declined by approximately 90% in 2009 (\$2.8B in 2008 versus \$327M in 2009). In contrast, foreign investment in residential homes nearly doubled over the same time frame (\$36B in 2008/2009 versus \$64B in 2009/2010). This disparity largely reflects the relative timing of the downturn in the residential and commercial markets as well as the financing conditions in each market.

The residential housing market reached its apex in 2005; three years before the deterioration in this market would ultimately spill over into the broader economy in 2008. In contrast, the commercial sector only began to deteriorate at the same time the overall U.S. economic began to stagnate, in 2008. Thus the commercial market will naturally improve only with a lag following the improvement of the residential market, and timed relatively contemporaneously with U.S. job growth and consumer spending growth.

Lending conditions are much more difficult in the commercial real estate market than in the residential market. Lending for commercial properties is largely non-existent despite very low medium and long term interest rates in the overall economy. This is in stark contrast to the residential market, where credit worthy borrowers can obtain, with relative ease, financing at historically low rates (near 5%) in large part due to the direct government intervention in the residential credit market via purchases of mortgage backed securities and mortgage guarantees.

Although foreign investors have dramatically reduced their investment in U.S. commercial properties in 2008 and 2009, foreign investment should improve as fundamentals in the commercial market stabilize. Attractive prices and a relatively weak dollar should entice foreign investors to return to U.S. commercial real estate. In regards to the residential market, low interest rates, a weak dollar, and attractive prices in traditional vacation areas should continue to attract foreign investment commensurate with recent levels.

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