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**Understanding the Barriers to Real Estate Investment in Developing Economies**

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**Abstract**

Baum (2008a) related the number of real estate funds investing in developing economies to simple economic and demographic variables, and showed that, while the popularity of markets was explained by population and GDP *per capita*, some countries receive more or less investment than the model predicted. Why is this?

In this paper we undertake a literature review to identify the barriers which inhibit international real estate investment. We test our initial findings by questioning property investment professionals through semi-structured interviews. By doing this we were able to verify our list of barriers, identify those barriers which are most likely to affect real estate investors, and to indicate whether there are any real estate-specific variables that create barriers which have not received any academic attention. We show that distortions in international capital flows may be explained by a combination of these formal and informal barriers.

**Understanding the Barriers to Real Estate Investment in Developing Economies**

## 1. Introduction: globalisation and investment

Financial globalization has enabled investors to diversify their assets on a worldwide basis, and also to direct risk capital to places where productivity and expected returns are high (Quinn, 1997). During the late 1980s and early 1990s, 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).

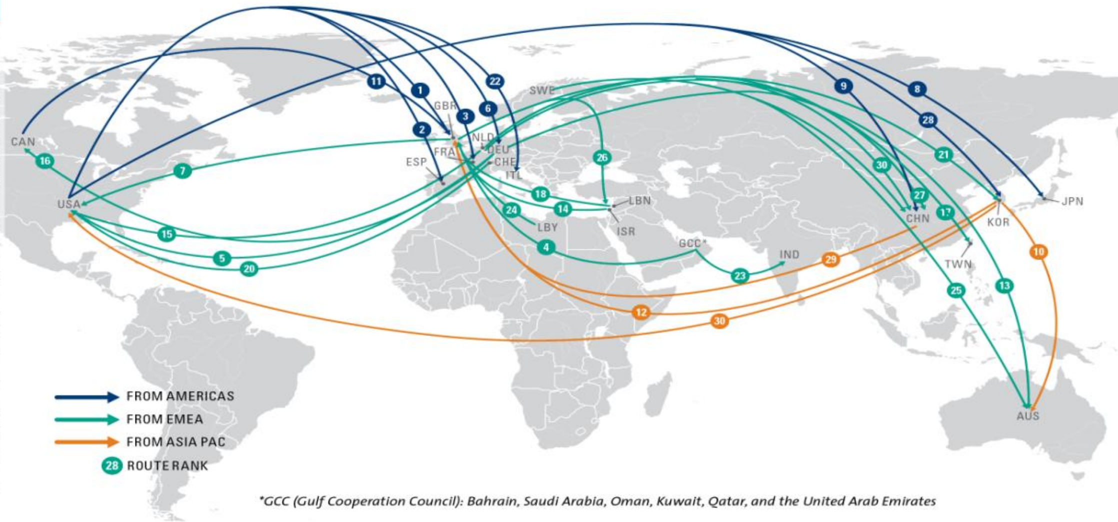
Figure 1 shows real estate capital flows from source to target country according to data held by Real Capital Analytics (RCA) for 2009. The largest flows were from the USA to the UK, and it is clear that a small number of highly developed economies dominate this map.

In 2009 the stock of global FDI capital was as much as 21% of global GDP (Lahiri, 2009). In addition, FDI and loans (in contrast to shorter term portfolio investments) are the dominant types of investment received by many emerging markets (Daude and Fratzscher 2008), and even though the benefits of FDI to developing economies are still debated in academic circles (Fernández-Arias and Montiel, 1996 and Lahiri, 2009),[1] it is both the preferred method of investing in those markets and a sign of a country's attractiveness and growth prospects.

[1] All four issues of volume 18 of the *International Review of Economic and Finance* (2009), to which Lahiri provides an introduction, have been dedicated to the advantages and disadvantages of FDI, particularly in cases where the host country is an emerging economy.

**Figure 1: Real Estate Capital Flows, 2009**

| Rank | | Route | | $ Mil | |
|---|---|---|---|---|---|
| '09 | '08 | Source | Target | '09 | '08 |
| 1 | 3 | USA | GBR | $7,844 | $4,952 |
| 2 | 17 | USA | ESP | 1,914 | 1,151 |
| 3 | 6 | USA | FRA | 1,750 | 2,693 |
| 4 | 4 | GCC* | GBR | 1,532 | 3,684 |
| 5 | 5 | DEU | USA | 1,197 | 3,039 |
| 6 | 1 | USA | DEU | 892 | 9,599 |
| 7 | 43 | GBR | USA | 826 | 404 |
| 8 | 2 | USA | JPN | 799 | 5,288 |
| 9 | 8 | USA | CHN | 644 | 2,152 |
| 10 | 113 | KOR | AUS | 639 | 86 |
| 11 | 24 | CAN | GBR | 593 | 826 |
| 12 | — | KOR | GBR | 574 | — |
| 13 | 59 | DEU | AUS | 567 | 270 |
| 14 | 110 | ISR | GBR | 514 | 90 |
| 15 | 70 | NLD | USA | 412 | 234 |
| 16 | 36 | DEU | CAN | 389 | 496 |
| 17 | 79 | NLD | TWN | 339 | 193 |
| 18 | — | LBN | GBR | 328 | — |
| 19 | — | GBR | KOR | 308 | — |
| 20 | 58 | CHE | USA | 306 | 273 |
| 21 | 176 | SWE | CHN | 299 | 24 |
| 22 | 10 | USA | ITA | 292 | 1,677 |
| 23 | 182 | GCC* | IND | 284 | 21 |
| 24 | 83 | LBY | GBR | 251 | 173 |
| 25 | — | SWE | AUS | 228 | — |
| 26 | — | GBR | ISR | 222 | — |
| 27 | 66 | NLD | CHN | 220 | 237 |
| 28 | 7 | USA | KOR | 209 | 2,272 |
| 29 | — | CHN | GBR | 202 | — |
| 30 | 86 | KOR | USA | 166 | 163 |




*Source: Real Capital Analytics 2010*

In the case of real estate, financial globalisation has helped to create new investment vehicles that solved many of the problems that are characteristic of this asset class (Baum, 2008b). International or cross-border property investment has boomed, and in parallel with this change indirect property investment (investing through securities such as Real Estate Investment Trusts (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), private research company 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 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.

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 institutional real estate 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 a domestic property market are perceived to be disappointing, capital 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 (with estimated assets of around $1tr) to place its investments abroad. Others, such as the Government Investment Corporation (GIC) of Singapore, are forced by government regulation to invest outside their domestic markets.

Home bias remains an observable phenomenon. Imazeki and Gallimore (2010), for example, find clear evidence of this even in funds of liquid real estate stocks (portfolio investment rather than FDI). They refer to 'barriers' and to 'deadweight costs' inhibiting an optimal diversification strategy. A deadweight cost (also known as excess burden or allocative inefficiency) is a loss of economic efficiency caused by monopoly pricing, externalities, taxes or subsidies. This is likely to affect real estate FDI much more than it affects portfolio investment.

Nonetheless, the world's largest real estate investors have become global investors, albeit relatively recently. 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, but remain barriers to international exposure by asset managers.

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 (2008a) that property investment in emerging markets, especially by unlisted opportunity funds, had become 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 arguments for country relevance are to do with the way data (for example, national government economic growth and inflation statistics) is collected and made available, the influence of national regulations, currencies and taxes, and the interaction facilitated by spatial proximity helping to build the trust and rapport which is vital as investors gather market information (Leyshon and Thrift, 1997, Agnes, 2000). For these reasons, geography still matters for portfolio choice, savings and investment, and can have a great influence on investors' decisions and returns (Stulz, 2005). Of course, this is even more relevant in international real estate investing, as spatial characteristics are a key feature of the asset class.

Some countries attract less capital than others as a result of barriers, both real 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, such as language, technology and available information between countries (Garmaise and Moskowitz, 2004; Portes and Rey 2005, Daude and Fratzscher 2008). However, gravity formulae have their shortfalls mainly to do with variables omitted from the model (Anderson and Van Wincoop, 2003), and they do not fully explain asymmetries found in cross-border investment, particularly as they relate to developing economies.

Geographers argue the relevance of locality and the existence of barriers, and this argument is also supported by rudimentary economics. Markets, costs, competition and government regulation are seen as the four pillars of globalisation. It is argued that 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 dominate real estate FDI, and (given the relevance of real estate investment and, especially, real estate development as a driver of economic development in emerging markets (Lapoza, 2007), a levelling-out of economic prosperity may be inhibited. We should therefore be concerned to understand the barriers to cross-border real estate investment, both real and perceived, for the benefit of investors seeking diversification and return, and for the benefit of governments seeking to promote domestic economic development.

This paper is divided into four parts. Following this introduction, the second part summarises our objectives and research method. 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 fourth and final section we conclude by summarising the barriers that affect real estate FDI and summarise the academic and practitioner views of the importance of these barriers.

## 2. Research objectives and method

Our research is designed to add to previous studies of investment barriers and to focus this work in the context of real estate FDI, and in particular to focus investor's attitudes towards developing economies. Our *aim* is to address those barriers and to identify their relevance to investors' decisions in relation to real estate investment (including development as a form of investment) in 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 first undertake a literature review to identify the barriers which inhabit the general world of international investment. We then focus on those barriers that appear particularly relevant to real estate. We 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.

We conducted 20 semi-structured interviews with experienced real estate fund managers, lenders and investors, largely UK- or USA- based. We were interested in confronting real estate practitioners with academic studies of barriers to general FDI in order to find out which barriers were considered especially relevant to this asset class. To do this we used a semi-structured questionnaire including a list of barriers drawn from the academic literature and asked interviewees to rate them using a scale of 1 to 5, with a score of 1 indicating a low or unimportant barrier and a score of 5 indicating a high or important one. The questionnaire also included questions on politics, cultural and geographical issues which were used to prompt illustrations of their experiences in emerging markets. Each interview, which lasted between 40 and 60 minutes, was recorded and then transcribed. We then looked for common themes and average scores, and barriers were grouped and ranked.

## 3. Formal and informal barriers to foreign direct investment: a review

'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 or not, pull factors can help to explain geographical asymmetries in capital flows. Pull factors include some counter-cyclical policies that some countries apply when faced with a surge in the inflow of capital, for example capital controls.

Some countries try to eliminate or lessen the impact of the barriers that are most likely to isolate the local market from the global capital market. These barriers have been classified by academic work as *forma*l and *informal* or direct and indirect barriers. The formal or direct barriers are those that primarily 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 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 tends to be different from– in particular, less liquid than - other investments.

Lahiri defines FDI as *"a long-term investment by a non-resident, but with control (a 10% or greater share)"* (2009, p.1) and explains that there are different types of FDI, ranging from the development of new buildings, expansion of existing ones, acquisitions of companies and, in the case of multinationals, mergers and relocations. 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 contemplated. 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 transport and the level of skills of the working population are not likely to be a barrier to real estate investment, but will be a deterrent for producers. Working from this broad overview, we next focus on separating the formal and informal barriers.

## 3.1 Formal barriers

Given our definition of formal barriers, it is clear that they must include restrictions on the removal of capital and legal barriers which relate to the foreign ownership of local assets. For the purpose of our 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.

### *3.1.1 Restrictions 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); less common are absolute bans on the removal of capital from domestic banks. It follows from this that restrictions on international financial flows are less prevalent in high-income countries with large domestic savings (Eichengreen, 2001) and more common in developing economies. Although recent research has shown that capital controls do not affect the inflow of FDI (Montiel and Reinhart, 1999), our survey shows that real estate investors consider restrictions to capital accounts to be a very high barrier indeed.

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. Political and legal changes during the period of ownership of the asset meant that it unexpectedly took two years to repatriate the capital.

### *3.1.2 Legal barriers*

Legal barriers arise from the different legal status of foreign and domestic investors. This could be in the form of ownership restrictions, which will clearly affect real estate investors (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 to real estate ownership varies greatly, and research in this area is usually done case by case, given that there are often differences in practice *within* countries as some land is more sensitive to nationalist protectionism. (A newsworthy and extreme example of ownership restrictions affecting real estate is the expropriation of 'foreign-owned' land in Zimbabwe.) 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. And this is not a problem that is restricted to emerging economies. A fund manager interviewee recalled having to find a local partner in order to acquire a property asset that is was close to a military base in Switzerland, where the government had imposed restrictions on foreign owners. The general view in our survey is that these types of restrictions can often be solved by finding a local partner. For large global investment firms that have offices and are sometimes considered as 'local' in more than one market this may not be a serious issue.

### *3.1.3 Taxes and costs*

The residence principle means that incomes from the foreign and domestic income sources of residents of one country are taxed at equal rates, while incomes of non-residents are tax exempt (Razin *et al* 1998). However, as this author explains, this idealised tax structure is often altered, thus affecting capital flows. Counter-cyclical policies mentioned above in the context of control of capital accounts (push and pull factors) can also include tax benefits designed to attract foreign investment, for example in cases when countries need to increase FDI.

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 promote a policy of lighter taxation on capital gains than on repatriation of capital in order to avoid discouraging long term investment.

The costs associated with holding foreign securities in a portfolio include transaction costs, information costs and differential taxation. Researchers have created models that measure the impact of these costs 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 and differential taxation. Both models show that the global 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, and Imazeki and Gallimore (2010) find a strong domestic bias in funds of real estate securities due to 'deadweight costs' and other barriers. The academic evidence suggests that high entry costs and taxation are both deterrents to investing in a foreign country.

In our survey, however, the majority of interviewees considered costs to be a relatively weak barrier to cross-border real estate investment. In emerging markets in particular, entry costs can be compensated for by high expected returns (implying that interviewees expect there to be some market inefficiency, otherwise prices would be bid up by locals); and the expected holding period for real estate FDI (as opposed to portfolio investment) is sufficiently long for costs to be effectively amortised. Interviewees considered this to be a high barrier only where there was no possibility of finding a local partner.

### 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 such as currency risk, political risk, liquidity risk, economic policy risk and macro-economic instability (Bekaert and Harvey, 2002, Nishiotis, 2004). Title risk (referred to in Baum, 2009) is a specific real estate issue that we can add to this group.

### *3.2.1 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 delivers increased civil liberties and improves the 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.

In our survey most interviewees considered unattractive 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 a 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 democratic governments "*to renege on a certain set of rules that everybody understands*". However, he did not consider political regimes to be a high barrier, as he believed that authoritarian regimes can be even clearer in their pro-capitalist and pro-investment policies than democracies.

A fund manager agreed: "S*ome authoritarian states can be stable and some democracies – say Greece – can prove to be risky".* However, he agreed with the academic view that (all things 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 abrupt changes in direction.*"

Among those who regarded this as 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, the attitude of the political class to business and economic growth and its attitude to foreign investment. The specific concern expressed was to do with the potential imposition of capital controls. 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, although this can affect domestic investors equally badly. This position reinforces the view that economics and demographics (population, wealth and growth) are strong drivers for investment

(Baum, 2008) and that informal barriers have relatively little effect where such drivers exist. The relationship between politics (for example the degree of democratization), financial reforms and future economic growth have been widely studied by Quinn (1997, Quinn et al., 2001).

Academic research also highlights the importance of pressure from powerful groups within countries. 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.

In this regard investors are concerned about groups with government influence. The head of a US-based real estate fund that also invests in infrastructure pointed out that this can be an extremely politicised area to invest due to the power of lobby groups.

### *3.2.2 Institutions, the rule of law and corruption*

North (1990) distinguishes between formal institutions (laws, rules) and informal behaviour. The state is the third party enforcing the law and 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 ways 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.

To measure this effect, academics have focussed on a range of indicators including political stability and political regimes, civic activities and property rights, and corruption. The literature referring to the quality of institutions and economic growth is therefore extensive (for a review see Aron, 2000), but the most interesting point for the purpose of our study is that academics have been divided in terms of the effect that corruption can have on a country's economy. Some argue that FDI is not affected by it, while others point out that corruption deters investment (Aidt, 2009, presents the latest discussion of the topic).

In our survey the general opinion was that corruption, while damaging, was unavoidable in emerging markets; and it seems that some investors are willing to accept a certain degree of corruption in order to complete a transaction. The difficulty lies in quantifying what degree of corruption they are willing to accept and how they use middlemen to avoid a direct connection with it.

Corruption is particularly difficult for institutional fund managers who declared, when interviewed, that they will not become involved in an economy perceived to be corrupt. Some interviewees pointed out the impact of tightening regulations such as money-laundering controls, but noted that these are not globally standardised. This could be a barrier to entry for countries with weak institutions and high levels of corruption.

### *3.2.3 Economic stability*

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 (North, 1990). 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 country or city.*"

### *3.2.4 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 survey indicated that this is an important risk, and often 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 highly charged debates- this is an important matter, you can't ignore it. There are hours and hours of discussion about what to do with the currencies if you cannot hedge*". Another commented: "*This is something that is a key part of the business. We should hedge if we can, because we are property investors and not currency specialists. That will add to costs, and this is a major concern when hedging costs are very high or hedging is impossible".*

### *3.2.5 Liquidity risk*

Liquidity risk captures the time it takes to execute trades, other factors such as the direct and indirect costs of trading, and risk and uncertainty concerning the timing of selling and the achievement of the expected sale price. The risk that arises from the difficulty of selling an asset is important in portfolio investment, but is less commonly referred to in FDI literature. In real estate investment, liquidity risk is generally a more serious issue (IPF, 2004).

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 time to maximise their (internal rate of) 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 developing or emerging markets. 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 hedge 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.

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: "*One of the massive casualties of the crash was liquidity. This time last year everybody was desparate for cash*". 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 the head of research of a large firm of investors who stated that the importance of this issue differed between property developers and investors. For the former, lack of liquidity was a problem, but for an investor accurately anticipating improvements in the liquidity of an illiquid market can deliver excess returns.

*3.2.6 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' behavioural 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 stock and flows from the influence of formal and informal barriers when it comes to making real estate investment decisions at an international level.

Interviewees in our 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 with 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*". Others cited difficulties in doing business between between Europe and Asia caused by language barriers and the pace at which business is conducted. Some pointed out the fact that making slow progress could be a deliberate negotiation technique used against time-limited foreign buyers.

For others economics and transparency clearly over-ride local culture. Even religion is irrelevant as long as the geopolitical situation is stable. 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 70s 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 but which has not been fully reported in academic literature is 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 considered the history of their own (UK) companies and the way they began to expand, stating that their diversification activity started with the former British colonies and expanded from there. Real estate is a local business, and negotiations are human activities and not electronic, so knowledge of the culture is crucial to build good relationships and achieve transactions. (The policy of Westfield, the largest listed property company in the world in 2010, is indicative. Originally Australian, Westfield invested as at 2010 in the US, Canada, the UK, Australia and New Zealand.)

Others mentioned the imperative of building a relationship of trust when a local partner is needed: "*People don't see things the same way, and often you are 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*".

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 investment. For large funds with offices across the world this does not seem to be a problem, and usually the way they branch out is by contacting ex patriates in the host country. If that is not possible, then the usual way is to develop relationships with locals over a long time period.

### *3.2.7 Geographical barriers*

Some theories contest the inevitability of financial globalisation, claiming that geographical barriers remain significant. The general view expressed in our survey confirmed this to a considerable extent. The ability to visit the country of investment (especially if no visa is required, and time differences are minimal) was thought to be 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 that you can go and spend a week somewhere, complete 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*."

A fund manager from a large investment company stated that proximity helped. Reflecting on the way his company invested he pointed out that activity tended to be clustered (US, UK, France Germany, and, in Asia Tokyo, Beijing and Hong Kong). He also pointed out that 70% of the global real estate market was located in these places, so in his view it was worth creating hubs to approximate a local operation. To him the idea of studying possibly 30 countries, and another 30 legal and tax systems in order, to add an extra 15% to the investment portfolio by value was simply not worth the cost. Others agreed that the market in the host country has to be large enough to be worth opening a local hub, as geographical or cultural problems (such as language and time zones) are reduced and can be accommodated within the local company

### *3.2.8 Legal and title risk*

Our survey showed that the lack of a good legal framework is considered seriously problematic among investors. Confidence in the legal system and the courts is vital for investors if faced with any of these barriers *"so that if you have a legal wrangle with the government you still have a chance of winning".* China was often mentioned as an example of a country with a complicated legal system, and also the place where foreign lawyers are less well accepted than local practitioners.

Protection in the case of tenant default and the risk of defective title are other examples of the legal risks seen as important by the investors we interviewed. In cases where tenants default, then the different political systems of countries become relevant especially when landlords seek enforcement and/or compensation. As one of our interviewees explained: "*In Europe, if your tenants don't pay it can take you months to get them out. In Texas if that happens you go back the following week and simply put a padlock on the door."*

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 risk can be insured in many cases, but not in all. In Buenos Aires, for example, methods of piecemeal or tiered development can lead to multiple ownership and a scarcity of institutionally acceptable single title assets. This problem is not particular to Buenos Aires; many Latin American cities present the problem of 'informal markets', the gradual populating of land around the peripheries of major urban centres that not only lacks infrastructure but also clear legal title (Abramo 2010). 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?"* In summary, problems regarding land title are fundamental and mission-critical. Others expressed a view that "*countries will not attract investment if they have problems with their land, legal system, contracts*".

## 4. 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 as 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's 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. This shows that there is a difference in the impact that restrictions to capital accounts have on general FDI and on real estate investment. Real estate investors consider this to be a high barrier, and the size of the host market and the opportunity have to be substantial to justify taking this risk. In the case of legal barriers and taxation, however, investors in our survey were more inclined to think that these problems have a solution, and the discrepancy between the academic papers and the results of our survey highlight the particularities of real estate FDI. A host country could be much more inclined to offer tax and cost benefits to a company that is seeking to relocate its manufacturing plant to their country than to a real estate investor. But even if investors agreed that they are ways around formal barriers, they also agreed that the informal ones are much more difficult to evaluate and to measure.

**Table 1: Barriers to Real Estate FDI**

| FORMAL | |
|---|---|
| 1 RESTRICTIONS TO CAPITAL ACCOUNTS | |
| GENERAL FDI | REAL ESTATE |

| | |
|---|---|
| Is not affected | A high barrier |
| | |
| 2- LEGAL BARRIERS | |
| GENERAL FDI | REAL ESTATE |
| Equity held by foreigners can be limited, and foreign investment may be banned from the country completely | Ownership restrictions are clearly a very high barrier, but such restrictions can be overcome by JV |
| | The host country must have a good and reliable legal system |
| | Problems with tenants can be difficult to deal with in certain countries |
| 3- TAXATION AND COSTS | |
| GENERAL FDI | REAL ESTATE |
| High taxation of foreign owners is a strong deterrent to investing in a foreign country. | This is not a high barrier as long it is believed tax can be compensated for by high post-tax returns |
| INFORMAL | |
| 1- POLITICAL RISK | |
| GENERAL FDI | REAL ESTATE |
| Investors will be deterred from investing in non-democracies | Low barrier if the country has a strong economy and acceptable legal framework |
| Pressure groups are at the heart of political instability and can add substantial risk premiums to returns | Low barrier, although infrastructure investment can be a very politicised area and a problem for developers |
| 2- INSTITUTIONS, RULE OF LAW AND CORRUPTION | |
| GENERAL FDI | REAL ESTATE |
| Perceived corruption deters FDI | Medium barrier: corruption deters investors |
| 3- ECONOMIC STABILITY | |
| GENERAL FDI | REAL ESTATE |
| Is an important factor in attracting FDI | Medium barrier |
| 4- CURRENCY RISK | |

| GENERAL FDI | REAL ESTATE |
|---|---|
| Currency movements can have a dramatic impact on equity returns for foreign investors | A very high barrier if investors cannot hedge or if the cost of hedging is too high |
| 5- LIQUIDITY RISK | |
| GENERAL FDI | REAL ESTATE |
| Not a high barrier in FDI | A high barrier |
| 6- CULTURAL BARRIERS | |
| GENERAL FDI | REAL ESTATE |
| Some evidence that investment decisions are based on sentiment and cultural issues | Religion is not a high barrier; language and education are important; local partners are helpful |
| 7- GEOGRAPHICAL BARRIERS | |
| GENERAL FDI | REAL ESTATE |
| Geographical barriers are decreasing | A medium barrier unless local hubs are used, in which case the market must be large |
| 8- TITLE RISK | |
| GENERAL FDI | REAL ESTATE |
| | A very high barrier: countries will not attract FDI if investors have problems with title |

This paper set out to examine the barriers affecting real estate FDI. We found three formal and eight informal barriers. We also found that informal barriers are much more difficult to measure than the formal ones, and our interviewees consistently expressed the view that there was a certain degree of political turmoil, of corruption, of cultural and geographical distance that they were willing to accept.

More research is needed to quantify formal and informal barriers as they exist at the individual country level, and to use these measures to explain cross-border real estate investment flows.

APENDIX 1

**List of Interviewees**

| | |
|---|---|
| Regional Managing Director, Real Estate Advisory, EMEA | Bank |
| Managing Director. European Head of Investments | Fund Manager |
| Real Estate Industry Leader, MENA | Consultancy Firm |
| Founding Partner. Executive Chairman | Fund Manager |
| Chairman | Real Estate Consultant |
| International Director, Head of European Strategy | Fund Manager |
| President and Chief Executive Officer | Real Estate Consultant |
| Head of Real Estate | Fund Manager |
| Chief Executive Officer | Fund Manager |
| Chief Executive Officer | Fund Manager |
| Joint Chief Executive | Fund Manager |
| Partner | Lawyer |
| Deputy Chairman | Property Company |
| Global Advisor | Property Research Firm |
| Head of Research | Fund Manager |
| Group Research Director | Property Company |
| Real Estate Advisor | Wealth Manager |
| Head of Strategy | Fund Manager |
| Chair, Investment Committee | Fund Manager |
| Chief Investment Officer | Fund Manager |

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