

# Global Real Estate Now

Insights, observations and research\*

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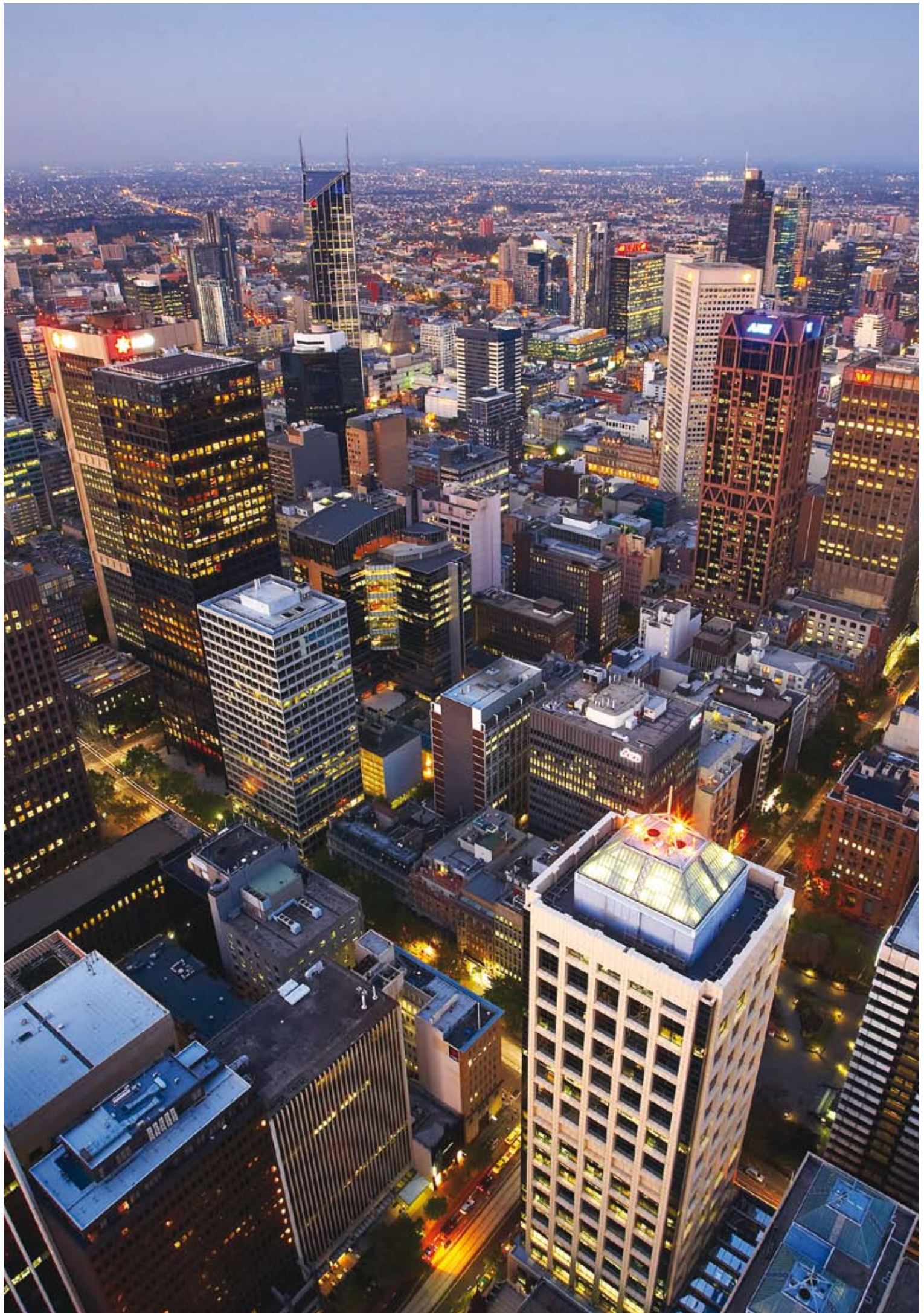
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# Foreword

Dear Reader:

Welcome to the June 2008, edition of PricewaterhouseCoopers<sup>1</sup> *Global real estate now* magazine.

The past few months have been a time of tremendous uncertainty for many sectors of the global financial community. What began as an unexpected decline in one sector of the residential property marketplace – subprime home mortgages – gradually morphed into a major cataclysm that eventually spilled over into the commercial property sector and continues to impact a wide array of major institutions, companies and individuals.

How this unfortunate episode evolved – and where the major culpability lies – is the focus of *'Real estate and the credit crunch: lessons we should have learned long ago'* by David Baranick, PricewaterhouseCoopers (US).

In *'Emerging trends in real estate® 2008,'* by Chuck DiRocco of the Urban Land Institute and John Forbes, PricewaterhouseCoopers (UK), we review the results of our recent surveys for North America, Asia/Pacific and Europe for a combined assessment of what investors in each geographic area are thinking and how they feel the current economic challenges will pan out.

*'How the south is won: European investors enter the Latin American real estate market,'* by Martin van der Zwan, PricewaterhouseCoopers (The Netherlands) and Alvaro Taiar, PricewaterhouseCoopers (Brasil), describes prospects for this fast-growing emerging market.

*Thin capitalisation rules in selected central and Eastern European countries,'* by Glen Lonie and Stefan Falis, PricewaterhouseCoopers (Czech Republic), takes a look at the various tax regimes in different Eastern European countries and implications for foreign investors.

Two of the world's most exciting markets are also explored in: *'Moving to another leisure-driven real estate development in the Middle East: firm foundations of just sandcastles in the sky'* by Kate Simpson and Howard Kingsbury, PricewaterhouseCoopers (Dubai); and *'Foreign investments in India's real estate sector: tax regulatory overview,'* by Tushar Sachade and Samip Barlota, PricewaterhouseCoopers (India).

*'Back to the future: restoring confidence in the Australian listed property trusts sector'* by Tim Peel and James Dunning, PricewaterhouseCoopers (Australia), discusses how the real estate industry in Australia is poised for a comeback.

Finally, our Tech Corner feature, *'Are you ready for XBRL?'* by Mike Becker and Scott Metro, PricewaterhouseCoopers (US), looks at how internet-savvy business reporting tools are revolutionising the way companies report and share information.

Needless to say, we are offering a full plate for your consideration.

As always, we hope you enjoy this issue of *Global real estate* now and we welcome any thoughts or observations you might have. We also welcome your suggestions for future articles of topics to be addressed. In the meantime, if you have any questions or comments you would like to share, please feel free to email me at: [henrik.steinbrecher@se.pwc.com](mailto:henrik.steinbrecher@se.pwc.com).

Kind regards,



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<sup>1</sup> "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopersInternational Limited, each of which is a separate and independent legal entity.



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# Emerging trends in real estate® 2008

'Fear is back' was the key sentiment of the *Emerging Trends in Real Estate Europe* report published by PricewaterhouseCoopers and the Urban Land Institute at the MIPIM Real Estate Conference in March. How does this compare to the sentiment in the Emerging Trends United States and Asia Pacific reports published in the Autumn of 2007?

The three *Emerging trends* reports produced jointly by PricewaterhouseCoopers and the Urban Land Institute cover a total of 92 markets in countries throughout North America, Europe and the Asia Pacific. The 2008 editions of *Emerging trends in real estate* are the 29th edition in North America, the 5th in Europe, and the 2nd in Asia Pacific Region.

The publications are based on detailed face to face interviews with the industry's leading authorities conducted by PricewaterhouseCoopers partners and directors along with ULI researchers. This is combined with survey responses to give a consensus view of respondents. It contains predictions for individual property sectors as well as markets, along with insights regarding real estate capital markets and the economy in general.

As real estate becomes a more global asset, it is also important to compare investor sentiment towards Europe, Asia and the United States.

In the 2008 European *Emerging trends* survey, investors were asked to rank European real estate against other assets and other regions. Asia came out consistently at the top and the United States consistently at the bottom. Although the sentiment as to absolute returns may have diminished since the start of the year, there is little to suggest that the relative confidence levels between the continents has moved. This direction is also consistent with the findings of the *Emerging trends in real estate Asia* and *Emerging trends North America* reports that were published in the autumn.

Real estate capital markets seemed to be the largest concern in the 2008 *Emerging Trends* reports.

Real estate capital markets seemed to be the largest concern in the 2008 *Emerging trends* reports. Even though most interviews for 2008 *Emerging trends* were conducted mid-year 2007, there was a sense that real estate capital markets throughout North America, Europe and even the Asia Pacific region were starting to slow. To no surprise, the most discussed topic is the lack of capital, especially coming from the debt markets. 2008 will be a tough year for all real estate markets and lenders, due to a lack of liquidity caused by US subprime problems.

In Europe, one survey respondent stated: 'It's tough. I haven't known debt markets like this since 1991;' and another: 'A lot of banks have been whacked in the balance sheet and their ability to lend is impaired. It is not clear who still has the capacity or appetite.' An executive in the United States believes: '...subprime may have accelerated the debt market blowup, but the blowup was coming anyway.' Asian real estate seems to be the safest; however financial statement exposure to subprime investments continues to come to the table. If anything sentiment has become more gloomy since then with the collapse of Bear Stearns and the announcement of further subprime write-downs.

Until lenders are able to rebuild their balance sheets the capacity to lend will remain dented and confidence will not return to the inter-bank market.

Things only look to get tougher, survey participants seeing debt underwriting standards becoming more stringent in the coming year. In addition, the consensus believes debt will be harder to find and will cost more.

Things only look to get tougher, as all three publications found survey participants seeing debt underwriting standards becoming more stringent in the coming year. In addition, the consensus believes debt will be harder to find and will cost more. Depending on who you are, where you are, how much you want, and what you are willing to pay for it, borrowing is still possible. At this point, lenders in the best shape are local and regional banks that have a deposit base. 'We can get reasonably priced debt in continental Europe...regional banks,' said one real estate executive, and 'Balance sheet lenders remain very keen to do business with us,' remarked a core investor.

Regardless of local and regional lenders, debt capital is drying up and stopping many real estate deals in the pipeline. A market that has seemed to come to a complete stop is commercial mortgage-backed securities (CMBS). A US based executive believes that the origination and structuring of 'inherently risky investments' without appropriate risk premiums was just one reason for the shutdown. Obviously, many investors miss the constant flow of debt into the market, but one European executive believes that 'the positive of the subprime crisis is that, because it

ties up lending, it kills off speculative development.' Asian property investors aren't facing the same stoppage, however securitised financing structures such as CMBS and collateralised debt obligations (CDOs) are still fairly new.

With a decline in the number of leveraged buyers, long-term institutional equity opportunities are on the horizon. According to *Emerging Trends Europe*: 'Equity is back on the march in a big way,' and 'The market is great for pure equity players only.' In 2008, institutional investors, private property, and open-ended funds look to lead all others as the primary source of equity capital. These investors plan to focus on their markets, but take advantage of diversifying their assets beyond local regions. Much of the real estate-focused capital crossing into the United States, Europe and the Asia Pacific continues to originate from the Middle East, the Asia Pacific region, and Australia, according to the survey. One interviewee said: 'US institutions are pulling back, but sovereign funds and other Middle Eastern money are there to replace it.' Change in real estate financial markets is not always bad, as an executive stated: 'It's going to come back to 'real' real estate people and [fewer] financial players.'

Since equity capital is available and yield compression in many major markets is limited, real estate investors are looking for other markets to watch. This can be seen throughout all three *Emerging Trends* publications.

In Europe investors have moved east as Moscow and Istanbul top the table for returns.

In Europe investors have moved east as Moscow and Istanbul top the table for returns. Many interviewees stated: 'Moscow is booming.' The top-ranked city is 'top for rental growth.' Out of all 27 cities, Moscow ranks first or second in buy recommendations for all major

property types, with retail being investors' main interest area. One interviewee agrees: 'The big story continues to be retail – the market has huge depth and breadth.' New opportunities are often followed by new challenges: 'It is not easy to get access to sites; without local partners, market entry is difficult;' while another executive stated: 'There are huge opportunities, but bigger risks.' Survey participants agree, rating Moscow the riskiest city out of all 27.

North America participants 'favoured' real estate markets that continue to focus on 24-hour cities or global, gateway markets.

In North America interviewees and survey participants 'favoured' real estate markets that continue to focus on 24-hour cities or global, gateway markets. One interviewee strongly agreed: 'You need to be on global pathways.' Seattle leads this list and has gained further status as the preeminent US global gateway. Other global gateway markets that top the list over the fast growing interior suburban cities included New York, Boston, Washington and Miami on the East Coast, San Francisco, and Los Angeles on the West Coast.

Asia Pacific region yield compression generated by this continuous flow of capital has greatly reduced opportunities and returns in many of the top real estate markets.

In the Asia Pacific region yield compression generated by this continuous flow of capital has greatly reduced opportunities and returns in many of the top real estate markets, although certain first-tier markets, such as Shanghai and Beijing, should still be able to benefit with rent increases to satisfy bottom-line requirements. Asia Pacific survey participants still rank investment prospects in major markets as Shanghai, Singapore, Tokyo, and Beijing first, second, third, and sixth, respectively. However, the sheer volume of money in these markets makes it more difficult by the day to find property.

Overall ratings for property investment prospects are down compared with last year, and if anything sentiment has become more negative since the interviews for the reports were conducted in mid-year 2007.

The top three major property sectors – retail, mixed use and hotels – were ranked as modestly good investment and development prospects.

However in the 2008 *Emerging trends Europe* survey the top three major property sectors—retail, mixed use, and hotels—were ranked as modestly good investment and development prospects. On the investment side, the retail sector leads the chase, with the Southern, Central, and Eastern Europe markets in the crosshairs. One interviewee said: 'While some markets in Central Europe are reaching saturation, the best opportunities are seen in the new European markets east of the EU members.' Looking at development, mixed use leads the rest just as the sector did in the 2007 report. The continued importance of mixed-use properties follows city and urban planning efforts looking to add urban value and

multifunctional use. 'Mixed-use schemes [are] becoming more prevalent as urban regeneration becomes more important,' claimed one developer.

North America interviewees and survey respondents ranked industrial/distribution properties and apartments first, noting that both property types provide 'steady income flows' while supply/demand remained in balance. Regarding apartment properties, interviewees noted that demographic trends—more echo boomers becoming of adult age—combined with continued chaos in the single family housing markets argued effectively for steady occupancy and growth in income. The US's propensity to import a significant portion of its consumer goods bolsters the case for continued allocations of capital to modern warehouse and distribution facilities. Hotels dropped back in the rankings as the cycle matures and investors worry about the impact of a slowing economy on the twin drivers of business—travel and tourism. Overbuilding, especially in the suburban markets, remains an issue. Retail owners face the serious concern of 'Consumer Exhaustion' as the economy slows and many analysts mention the 'R' word (recession). While fortress malls seems well positioned, B and C quality malls may suffer if retailers reduce their number of stores. Single family housing is expected to remain challenged and under pressure for a considerable period.

In the Asia Pacific region, the hotel sector tops the list of real estate performance prospects, followed by the office sector, which led all others in 2007. Hotel growth looks strong as there continues to be demand for rooms in most of the major cities. One respondent stated that 'hotel investment and development will be very active in 2008,' while another developer noted a focus 'on luxury resorts, hotels, residential, and service outlets' over the next five years. 'I see big demand for hotel

rooms in major cities like Delhi, Mumbai and Bangalore.' On the development front, residential (for-sale) properties come out on top. Not all cities would agree, but an increase in urbanisation, second-home markets, and household income supports this sector's strong growth.

Survey responses show that investors have allocated the largest portion of their portfolios to development, followed by core investments.

As economies and markets continue to grow in many areas, the focus on development grows as well. Overall, survey responses show that investors have allocated the largest portion of their portfolios to development, followed by core investments. According to one person interviewed: 'Many of the traditional pension funds and insurance companies that had hoped to buy a standard investment and hold it for a combination of income plus capital growth now have to take development risk.'

Emerging Trends Europe focused on lack of proper infrastructure, green issues, and human resources.

Regardless of the various opportunities, each region covered in *Emerging Trends* expressed certain concerns. *Emerging Trends Europe* focused on lack of proper infrastructure, green issues, and human resources. Infrastructure is often looked at as a long-term, fixed-income investment strategy by many large institutional investors. According to RREEF, the European economic infrastructure market was worth between €4 trillion and €5 trillion in 2006 to 2007; or as one executive stated: 'Infrastructure is a huge growth area.' Concern about environmental issues and creating green properties are two of the hottest topics of discussion throughout Europe. Many of the *Emerging Trends* interviewees are already greening up: 'We install geothermal heating;' 'Water cleansing with plants;' 'Energy and electricity from green sources.' However, many still dismiss greenness until higher rents are rewarded or threats of penalties for not meeting standards are enforced. Finally, across Europe there seems to be a decline in 'quality human capital.' A lack of skilled employees at all real estate levels often leaves management scrambling and many projects not as successful as projected. As one executive stated: 'There is a lot of average.'

In *Emerging Trends North America* interviewees noted specific concerns regarding the rate of job growth, increases in construction costs, and prospective increases in interest rates. Surprisingly, terrorism and immigration did not receive as much attention as in prior surveys. Similar to Europe, one new issue gaining traction is the variety of 'green' initiatives being applied to to-be-constructed as well as existing properties.

Finally, even though survey results show investors still will look to Asia Pacific real estate, certain topics are still of concern, including an oversupply of foreign exchange reserves, rising occupancy and staffing costs, a lack of market transparency, and the interventionism of regional governments.

Certain topics are still of concern, including an oversupply of foreign exchange reserves, rising occupancy and staffing costs, a lack of market transparency, and the interventionism of regional governments.

Regardless of a projected real estate market slowdown, survey respondents and interview participants say they believe that there still are investment and development opportunities throughout the United States, Europe and the Asia Pacific. With less in the market, many true real estate investors will return to the fundamentals of being an owner or a developer. For those with cash to invest the problems that are besetting those that have overstretched themselves are producing bargains. The critical question remains when to get back in the water.



# Global real estate and the credit crunch

## Lessons we should have learned long ago

The recent fallout from the credit crunch – including the soaring rise of residential mortgage defaults, plummeting housing values, lack of liquidity for commercial real estate investment, a spate of Federal Reserve interest rate cuts, the International Monetary Fund’s estimate that there would be more than \$1 trillion in losses tied to the collapse of mortgage-backed securities, the sudden submersion of Bear Stearns and the subsequent ascension of the Fed to its new role as apparent go-to guarantor of private investment banks – has spurred a wave of intense debate about the root causes of the ongoing crisis, as well as who is most to blame for not seeing the problems approaching.

In the US, this kind of commentary is often referred to as ‘Monday morning quarterbacking’ or having ‘20/20 hindsight.’ While there no doubt is some advantage to be gained in analysing how we came to where we are, there is no guarantee that such lessons will protect us from having to face a similar sort of reckoning 5, 10 or 15 years in the future. After all, for those who remember the Savings & Loan Crisis of the late 1980s – it’s not like we haven’t been here before.

As a practical matter, maybe all we need to do is relearn some of the simple, common sense lessons that our parents long ago taught us (or should have).

### Save for a rainy day.

In the aftermath of 9/11, American consumers were advised by their political leaders that the best thing they could do to reinvigorate the nation’s sagging economy would be to go shopping. And that is just what they did. In the months that followed, consumers racked up ever higher levels of debt on their credit cards and by taking out second and third mortgages – taking advantage of low interest rates and using the constantly increasing market values of their homes as a private bank account to maintain the good life.

According to *The New York Times*, domestic financial debt grew from \$8.5 trillion to \$14.5 trillion between 2001 and 2007, with home mortgages’ share rising from \$4.9 trillion to almost \$10 trillion during that time. By 2007, total indebtedness was three times the size of the gross domestic product, a level not seen since the Great Depression.<sup>1</sup>

### If something sounds too good to be true, it probably is.

Indeed, over the past five years or so, the US housing markets and commercial property markets enjoyed an unprecedented period of appreciation in values – fueled in part by a steady, strong economy and a federal monetary policy that kept interest rates low (perhaps, in hindsight, artificially so).

Across the country, residential mortgage lenders competed fiercely with one another to provide homeowners and would-be homeowners with more and more piles of money for the purchase of new housing, vacation homes, cars and whatever else suited the borrowers’ fancies. Incidences of so-called ‘no money down’ loans began to multiply while lenders began to pay less and less scrutiny into borrowers’ income verification. Growing numbers of borrowers took advantage of this new-found ‘easy money’

<sup>1</sup> ‘What Ails the American Economy? Everything, and There’s Worse to Come,’ Barry Gewen, *The New York Times*, 21 April 2008, p. E7.

and saddled themselves with increasing levels of debt that it would be difficult to repay. The era of the 'subprime' mortgage had arrived in full force.

Increasing numbers of homeowners who found themselves overleveraged and unable to keep up with upwardly readjusted mortgage payments began to slip into default – all this as they watched the market value of their expensive homes steadily decline.

Eventually, increasing numbers of homeowners who found themselves overleveraged and unable to keep up with upwardly readjusted mortgage payments began to slip into default – all this as they watched the market value of their expensive homes steadily decline. In the meantime, thousands of these higher-risk mortgages began to be bundled together and re-sold into the securitisation marketplace and sold to willing buyers both in the US and overseas.

### There is safety in numbers.

Basically, securitisation is the transformation of illiquid financial assets, such as individual mortgage loans, into readily-marketable securities. In the US, the lion's share of residential mortgage securitisation is done through the

Federal Home Loan Mortgage Corp. (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Freddie Mac and Fannie Mae accomplish this process by bundling together mortgages and then selling claims on those pools, while also providing a guarantee against default on the resulting mortgage-backed securities. On the commercial side, Wall Street firms like Goldman Sachs and Lehman Brothers, and the securities arms of major banks like Citigroup, J.P. Morgan and Wachovia, sell securities backed by similar asset pools in the form of rated bonds.

In short, assets are gathered, packaged, carved up into different categories that reflect the risk appetite of various types of investors – including insurance companies, pension funds and private equity funds – and resold. These investors decide upon the type or level of investment they are willing to make depending on sophisticated risk/reward models that take into account a range of factors, such as valuation, profitability, quality, momentum, volatility, historical performance, etc.

The advantages of securitisation have, in a relatively short period of time, proven to be multi-fold – giving investors access to broader, more efficient, more stable sources of capital. In theory, securitisation is an efficient process that rests on an assurance of systemic transparency, wherein information is constantly verified, updated and disseminated to all interested parties – resulting in more reliable valuations, better internal management controls and a fairly liquid secondary marketplace.

### You can have too much of a good thing.

Unfortunately, the process does not always run as modeled. Increasingly lax scrutiny, together with overly aggressive underwriting on the part of mortgage lenders led to higher and higher levels of inherent risk in their respective mortgage portfolios. This inherent risk subsequently filtered through into

the residential and commercial mortgage securitisations that were created from these loans as they were bundled together and underwritten with the flawed assumption that real estate values would continue to rise. At the same time, the expansion of mortgage credit, combined with the creation of a myriad of new, complex financial instruments such as collateralised debt obligations (CDOs) helped fuel even higher levels of leveraging and speculation, while at the same time obscuring what exactly was being contained in these exciting, innovative instruments – and the level of risk that they carried.

Increasingly lax scrutiny, together with overly aggressive underwriting on the part of mortgage lenders led to higher and higher levels of inherent risk in their respective mortgage portfolios.

What resulted has been described by at least one analyst as a slow-moving train wreck. In a sense, the market had become something of a self-perpetuating machine. Wall Street firms would provide warehouse financing to accumulators of mortgage loans. These accumulators in turn, would securitise them and then sell to the marketplace. The marketplace, in turn, would buy those securities and then repackage them into CDOs. This process churned round and round in an increasingly frothy stream with the system generating renewed liquidity for itself each time.

### All that glitters isn't gold.

About a year ago, as the first headlines began to appear indicating that there were problems in the subprime area, the chief financial officers and chief investment officers of institutions holding these securities began to reexamine their underwriting standards as well as the nature of the assets in their portfolios. Then, in the second quarter of 2007, alarms from the rating agencies began to sound concerning evidence of lax underwriting standards on commercial loans. By the third quarter of 2007, investors began to worry about the commercial real estate sector as similarities to the problems that led to the decline of the subprime residential market began to appear.

Recognising that the process was spinning out of control, investors began to pull back, concerned that many CDO and CMBS transactions had become too risky. Many investors left the market entirely or demanded sharply higher yields. The devaluation of these assets led many lenders to stop lending, as well as to begin hoarding cash out of concern about the possibility of rising defaults.

Many investors left the market entirely or demanded sharply higher yields. The devaluation of these assets led many lenders to stop lending, as well as to begin hoarding cash out of concern about the possibility of rising defaults.

The result was a sudden tightening of the spigot for new capital – along with an ongoing series of stark re-evaluations and write-downs on the value of portfolios held by many banks and other institutions, as well as the amount of leverage that was actually held on their balance sheets. Indeed, at least a few of the highest profile players in that game – witness Bear Stearns – have wound up paying what might be termed the ultimate price for their miscalculations.

At the same time, the private equity and hedge funds that do have available capital have been waiting to see if the market has further to fall before they commit new funding. As a result, the lack of willing new capital continues to overshadow the current economic environment. As more and more mortgage loans come to maturity, money for refinancing is increasingly tight and a growing number of extensions are being granted either formally or informally. Delinquencies are edging up and financing for new transactions is subsequently harder to come by as well.

### Don't believe everything you read.

If lack of confidence is at the heart of the paralysis in the current marketplace, certainly the rating agencies have played a contributing role. For many years, government regulators and investors' shareholders have relied on the credit rating agencies to be the so-called 'watchdogs' of the securitisation process.

In hindsight, however, that reliance may have been short-sighted. Recent front-page news stories have focused on the level of relationships that link credit agencies with the Wall Street firms that hire them to rate their securitisation packages. The implications are troubling. After all, agencies can only issue ratings if the firm that puts together the security hires them to do so.

### Caveat Emptor – Buyer Beware.

Ultimately the rating agencies may have provided higher quality ratings than the underlying assets warranted. Some suggest that any overt culpability is less to blame than the fact that the agencies' underlying models were fundamentally flawed or failed to recognise the increasingly aggressive underwriting that was being done by the originators. The fact remains that the system failed, as too many securities were offered out at AAA ratings that – again, in hindsight – may have had no business having such a rarefied stature.

Even so, it needs to be emphasised that – thus far, at least – that little, if any, AAA paper has suffered cash losses, and, indeed, there have been very few defaults in the commercial real estate sector.

### Don't be greedy.

In 1987, Hollywood released the movie 'Wall Street,' Oliver Stone's rumination on the excesses of corporate raiders in the mid-1980s. The memorable mantra of the lead protagonist, uber-raider Gordon Gekko (played by Michael Douglas) was 'Greed is good.'

The fact is, while the ratings agencies certainly helped facilitate what went on, at the end of the day, they are neither the issuers nor the buyers of the securities. Realistically, the investor community needs to recognise its share of the blame.

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The velocity and froth that accompanied the rush to ‘do deals’ created a highly competitive environment that led both issuers and investors to act in favour of the greater greed rather than the greater good. Deal backers continually pushed the envelope to squeeze out the extra nickel, while lenders were encouraged to continually cut a better deal to attract willing borrowers, driven by a huge influx of new investors into the marketplace who relied on others rather than demonstrating an adequate level of responsibility, prudence and thoughtfulness in their own investment due diligence.

### Every cloud has a silver lining.

It is often said that the first step towards a cure is the recognition that there is a problem. More and more, what we are hearing in the financial markets is increased recognition that the loose credit that existed was unhealthy. The real estate markets simply could not sustain the price compression and the continual build-up of real estate values while at the same time making debt available at higher and higher loan-to-value ratios, tighter and tighter cash flow ratios, and so forth. It was a crisis waiting to happen. And in the long-run, it should lead to a return to more stable, rational business cycle. Sometimes a healthy dose of fear may be necessary.

The fact that a problem was recognised and some action was taken may have been the start of a rebuilding of consumer confidence.

At the same time, the Fed’s sudden move in March to step in and protect Bear Stearns provided a calming psychological salve for many worried investors who fretted that a Bear Stearns bankruptcy would set off a falling stack of dominoes and do irreparable harm to the nation’s faltering economy. The fact that a problem was recognised and some action was taken may have been the start of a rebuilding of consumer confidence. As Federal Reserve Bank of New York President Timothy Geithner told a congressional committee after the bailout: ‘A sudden, disorderly failure of Bear would have brought with it unpredictable but severe consequences for the functioning of the broader financial system and the broader economy.’<sup>3</sup>

### Don’t bite off more than you can chew.

The subsequent calls for a drastic restructuring of the nation’s financial regulatory oversight system likewise show that serious attention is finally being paid to the problems. But how many of the proposed plans will (or should) get implemented is debatable – and in fact is being debated quite actively. Part of the proposed plans would shift key responsibilities for Wall Street oversight from the Securities & Exchange Commission to the Fed, while doing away with another financial oversight body, the Office of Thrift Supervision.

Such a restructuring would be a major undertaking – not something that will happen overnight – and certainly would require the participation and agreement of the US Congress. Needless to say, in a presidential election year, the odds of quick, bipartisan action are long, at best.

### Sometimes the cure can be worse than the cold.

But whether or not federal regulators can or should be the ultimate catalyst for change is also a moot point. Even the unprecedented step to bail out Bear Stearns from likely bankruptcy has had its detractors. After all, in a free market,

3 ‘Fed’s Bailout Is Questioned By Ex-Staffer,’ Greg Ip, *The Wall Street Journal*, 29 April 2008, p. C1.

actions have consequences. Those who make misjudgments must be held accountable. By not allowing Bear Stearns to fail, the argument goes, the Fed may be enabling decision-makers at other institutions to take equally imprudent actions with the belief that they, too, will be bailed out with now-available public support.

There is also a somewhat schizophrenic perspective in regard to what federal officials are proposing versus what they are doing. At the same time that they are calling for stricter regulation of mortgage lenders, federal officials have actually been backing off regulations – in one instance allowing Fannie Mae and Freddie Mac to reduce their capital reserve level in order to free more money up for the markets. There are many, however, who view that as an utterly unwise move. In the past, the problem with the banking institutions was that there was not enough capital back-stopping the loan positions, which created risk to the banks. But if the Fannie/Freddie move is any reflection, it would appear that the Fed is encouraging a return to lower reserves in order to put money into an economy that is teetering on the brink of recession.

The federal government's actions thus far (including the quarter-point rate cut made by the Fed on April 30) do not address any of the long-term issues that also impact on the broader economy, such as the continually shrinking dollar and growing inflationary pressures.

By freeing up additional capital the Fed would appear to be exacerbating the problem of loose money by not allowing the markets to adjust to an equilibrium that is rational.

If there is one key issue to address in this far-reaching crisis, it is the problem of loose money and the over-availability of capital in recent years. How that gets regulated with private companies is still unclear, but it is an important question because a lot of that money has been coming from private equity. By freeing up additional capital the Fed would appear to be exacerbating the problem of loose money by not allowing the markets to adjust to an equilibrium that is rational.

### **It's always darkest before the dawn.**

The securitisation market is by no means dead. There are tremendous advantages in it. Remember, it was this instrument that basically got us out of the crunch of the late 1980s and early 1990s. It was the creation of the securitisation model that was used by the RTC to sell loans to interested investors that helped drive that recovery.

Naturally, there will be differences. The more esoteric structures will change. Certainly the CDO market will be reconstituted. Maybe the investments will look a little different, but they will come back. We are seeing some positive signs already. A number of new funds have popped up. Some call themselves distressed

funds or opportunity funds. But the fact is there is plenty of capital supporting them to buy into debt instruments of some sort at the right price.

The shakeout that we are currently experiencing will, in the long-run, prove to be a healthy correction for what has been a segment of the marketplace known for innovation and creativity.

The shakeout that we are currently experiencing will, in the long-run, prove to be a healthy correction for what has been a segment of the marketplace known for innovation and creativity. The most experienced players will no doubt learn from their mistakes and undertake proper steps to correct the deficiencies in the process.

The real estate market will come back. On that point there really isn't much conjecture. What is not as clear-cut is exactly when it will come back – will it take 12, 18, 24 or 36 months? In addition, what will it be like when it does come back?

The answer to those questions will (and should) have more to do with Adam Smith's Invisible Hand of the Free Market than any massive regulatory restructuring or, worse yet, government bailout.

One thing that is clear is this simple observation – the more things change, the more they stay the same. We have been through major economic upheavals in the past – the Great Depression of the 1930s, the Oil Crisis and Stagflation of the mid- to late 1970s, the Savings & Loan crisis of the late 1980s and early 1990s. Each time we have emerged largely intact; scarred a bit, perhaps; changed a bit, certainly; but also stronger and wiser for having gone through each crisis.

We have faced crises of confidence in the past and no doubt we will do so again in the future. Once confidence in the real estate markets rebuild, and investors resume their proper places on the playing field, we no doubt will witness the re-emergence and revitalisation of the perception of real estate as a steady, preferred and reliable investment class.



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# Eye on Asia

## Foreign investments in India's real estate sector: tax and regulatory overview

With its burgeoning population, India has always faced a need for increased housing. Amongst middle-class families in particular there is a huge demand for housing facilities, a demand that is driven even further by increased per capita income and the availability of cheap housing loans fuelled by a booming Indian economy.

With many foreign companies entering into India to capitalise on the business opportunities in a booming economy, the demand for commercial space (primarily spurred by industries such as IT and IT-enabled services, retail and hospitality) has also hit the roof. Commercial property rates at prime spaces and real estate deals are reaching record highs.

Demand for housing facilities is driven even further by increased per capita income and the availability of cheap housing loans fuelled by a booming Indian economy.

As a result, the existing infrastructure facilities are immensely burdened and need to keep pace with the rapid globalisation of the Indian economy.

The various regulators in India [the Department of Industrial Policy and Promotion ('DIPP'), the Securities & Exchange Board of India ('SEBI') and the Reserve Bank of India ('RBI')] are faced with a difficult challenge: to attract foreign investment and at the same time check speculation in the booming real estate sector.

This article gives a brief overview of the tax and regulatory framework governing foreign investment in the Indian real estate sector and the key challenges faced by a foreign investor while structuring investments in Indian real estate companies.

### Routes for foreign investment

India prohibits direct foreign investment in real estate property, except on investments by non-resident Indians ('NRIs'). Foreign investment has to be made through Indian real estate companies.

India prohibits direct foreign investment in real estate property, except on investments by non-resident Indians.

Foreign investments in India could typically flow under the following routes:

#### 1. Foreign Direct Investment ('FDI') route

FDI in real estate companies is governed by the conditions of Press Note No. 2 (2005 series) issued by the DIPP. Under the Press Note, FDI is permitted in Indian real estate companies only for undertaking construction development projects (housing, commercial premises, hotels, resorts, etc).

The Press Note specifies various conditions to be complied with, such as the minimum area to be developed, minimum capitalisation norms, a three-year lock-in period for foreign investment, compliance with regulations of the respective state government/municipality, etc.

There are a number of interpretative issues surrounding the applicability of the conditions under the Press Note in various circumstances. Though the Ministry has clarified certain issues, many other issues still await suitable clarifications.

Further, the conditions of the Press Note are inapplicable to investments in Indian companies engaged in the following activities:

- Setting up of industrial parks/Special Economic Zones ('SEZ'); and
- Establishment and operation of hotels.

### **2. Foreign Institutional Investment ('FII') route**

FII investments are undertaken under the Portfolio Investment Scheme. Hitherto, this route was meant for portfolio investments in Indian listed companies on the stock exchange. However, the regulations have since been liberalised to allow investments in unlisted companies.

The conditions under Press Note No. 2 are inapplicable to FIIs. There is an ongoing tussle between the various ministries and regulators as to whether a lock-in should be prescribed for FII investment in pre-IPO deals. Recently, the Government has clarified that investments by registered FIIs under the Portfolio Investment Scheme (which also permits investment in unlisted companies), would be distinct from FDI and as such would be outside the purview of conditionality specified in Press Note 2. However, many quarters believe that the regulators may still be uncomfortable with pre-IPO placements and a specific clarification is needed to establish this beyond doubt.

Further, there are restrictions on the maximum investment that can be undertaken by an FII in a single company. The maximum investment allowed by each FII is 10% of the share capital of the company. There is also an overall restriction of 24% on aggregate FII investment in a single company, which can be increased by the Indian company up to the sectoral cap. There is presently some doubt as to whether an Indian company engaged in non-FDI-compliant projects can increase the limit beyond 24%.

### **3. Foreign Venture Capital Investment ('FVCI') route**

The FVCI route is another possible route for foreign investments in unlisted companies in India. The earlier restriction on investment in the real estate sector by FVCI was removed by the SEBI.

However, to check unrestricted foreign inflows in non-FDI-compliant projects, the RBI has kept on hold all applications for FVCIs contemplating investments in the real estate sector.

### **4. External Commercial Borrowings ('ECB') route**

The ECB route was another route under which foreign borrowings were permitted for integrated township projects until recently. The RBI has, however, closed this route by placing a blanket prohibition on any investment in real estate companies.

However, ECB is allowed in certain specified infrastructure facilities (such as industrial parks). Recently, this route has been further restricted with a limit of USD 20 million per borrowing company per financial year being placed on ECBs for rupee expenditure, and that too under the approval route. Further, ECBs are also subject to various other stringent conditions such as eligible borrower, recognised lender, average maturity period, all-in-cost-ceilings, cap on rupee expenditure, etc.

The tightening of the regulatory framework for the real estate sector amidst substantial liberalisation of exchange control regulations (towards full capital convertibility) clearly points out the sensitivity with which Indian regulators are dealing with this sector. This poses significant challenges for foreign investors in structuring their investments in an Indian real estate company, some of which are dealt with in the ensuing paragraphs.

**Tightening of the regulatory framework amidst substantial liberalisation of exchange control regulations points out the sensitivity with which Indian regulators are dealing with this sector.**

#### **Instruments for undertaking investment**

Until now, investments were permissible in equity shares, preference shares and convertible debentures. This provided some flexibility to foreign investors for structuring their investments based on their commercials. However, recently, to curb usage of the FDI route for effective borrowing, the DIPP and the RBI have mandated that all investments in India by way of preference shares and convertible debentures need to be compulsorily convertible into equity within a specified period; otherwise such investments would be treated as ECBs.

Accordingly, under the FDI route, the following funding options are available:

1. Equity shares;
2. Compulsorily convertible preference shares ('CCPS'); and
3. Compulsorily convertible debentures ('CCD').

Each funding option has its own specific characteristics and implications and the optimum option or a mix of various instruments needs to be chosen dependent upon the commercials of the project.

#### **Capital structuring**

The Indian company law places various restrictions and conditions on repatriation of capital. Considering the commercials of any given structure, it is critical to design the capital structure appropriately to enable timely repatriation by the foreign investor in a tax-efficient and regulatory-compliant manner.

The following are the various modes of repatriation available to the foreign investors:

##### **1. Interest on CCD**

Presently, in India, there are no thin capitalisation norms. Therefore, structuring the investment by way of CCD (also called mezzanine financing) offers an opportunity for an Indian company to benefit from tax breaks at 33.99% (the maximum rate) and taxation in the hands of the foreign company at lower rates, if the investor is a resident of a tax-efficient investment jurisdiction.

**Structuring the investment by way of CCD offers an opportunity for an Indian company to benefit from tax breaks.**

However, some recent court decisions have observed that CCD being compulsorily convertible into equity is effective equity even before conversion. A specific ruling of the higher courts or a suitable clarification is needed to do away with the controversy surrounding this issue so that interest can be claimed deductible by the Indian company. Further, in the case that the foreign investor and the Indian company are treated as Associated Enterprises, such interest should be at an arm's length pricing.

**2. Dividends on shares**

Under the Indian exchange control regulations, dividends on CCPS can be paid up to the Prime Lending rate of the State Bank of India plus 300 basis points (presently this works out to 15.25%). However, no cap is specified on dividends on equity shares.

Indian Company law requires dividends to be declared only out of profits and after prescribed transfer to reserves. Dividend Distribution Tax ('DDT') is applicable in the hands of the Indian company at 16.995% on the dividend amount. Such dividends are, however, exempt in the hands of the shareholder.

**3. Buy-back of shares**

Under Indian company law, an Indian company is permitted to undertake buy-back of shares subject to various conditions. Buy-back is permitted only out of specified sources (i.e., free reserves, securities premium and fresh issue of shares of a different kind).

The Exchange Control regulations also allow buy-back of shares under the automatic route subject to compliance with documentation, pricing and reporting norms.

Gains arising on buy-back of shares are treated as capital gains in the hands of the investor. In the case that the shares are held by a company resident in a tax-efficient jurisdiction, such capital gains could become non-taxable in India.

Company law also allows private limited companies to issue equity shares with differential rights. This offers an innovative structuring opportunity whereby shares are issued with differential rights to the foreign investor and the Indian developer.

It is critical to design the capital structure in a manner that maximum monies could be repatriated by the foreign investor by undertaking buy-back of shares considering the various conditions on buy-back under Indian company law and the pricing norms under the Exchange Control regulations.

**4. Sale to promoters/third party**

Sale to promoters/third parties is another mode of repatriation of capital. In the case that the shares are held by a company resident in a tax-efficient jurisdiction, such capital gains could become non-taxable in India. In the case of exit by sale to Indian residents, it is critical to ensure compliance with the applicable pricing norms under the Exchange Control regulations.

## 5. Capital reduction/liquidation of the company

Capital reduction/liquidation are other ways under company law by which repatriation could be undertaken. Both require court approval. Any gains on capital reduction/liquidation could, however, be treated as dividends to the extent of accumulated profits of the Indian company, leading to a DDT implication in the hands of the Indian company.

### Promote structures

Generally, in India, the local developers possess the expertise and land, while foreign investors contribute the capital. In such cases, foreign investors generally agree a preferred waterfall structure (also called promote structures) whereby they mandate a preferential payment of capital and pre-agreed IRR. Once this is achieved, the Indian developer gets a preference on the remaining profits of the project. It is critical to structure the arrangements appropriately through use of differential rights shares/convertible instruments to ensure that the commercially agreed waterfalls are achieved.

To achieve tax efficiency in the hands of the foreign investors, it is important that the investment is structured through a tax-efficient investment jurisdiction.

## Jurisdictions for foreign investments in India

The key jurisdictions preferred for inbound investments in India are Mauritius, Singapore and Cyprus.

### 1. Mauritius

Mauritius is the preferred jurisdiction for investments in shares of Indian companies, it being blessed by the Apex Court in Azadi Bachao Andolan's case. However, recent high-level delegation meetings between the officials of the two countries, followed by the strengthening of the norms relating to the issue of Tax Residency Certificates in Mauritius, do give rise to the possibility of a future renegotiation of the Tax Treaty. Introduction of anti-abuse Treaty provisions in the domestic income tax law also cannot be ruled out.

### 2. Singapore

Singapore is another jurisdiction, under the Treaty, in which capital gains earned by a Singapore resident are not taxable in India. However, the Treaty provides for a limitation of benefits clause, whereby a company set up with the prime objective of availing Treaty benefits is not eligible to take advantage of the Treaty benefits. Also, there is a controversy in Singapore on the characterisation of income of investment companies as business income or capital gains. Further, the protocol to the Singapore Treaty also states that the capital gains tax exemption under the Treaty will remain in force so long as the Mauritius Tax Treaty is not amended. Foreign investors therefore generally prefer Mauritius over Singapore as a tax-efficient investment jurisdiction.

### 3. Cyprus

Another possible jurisdiction is Cyprus, which is similar to Mauritius and currently exempts capital gains under the Treaty. At the same time, there is no limitation of benefits clause under the Treaty. Further, while interest is taxable under the India-Mauritius Tax Treaty at the local Indian tax rates (except in the case of Mauritius banks), interest under the Cyprus Tax Treaty is

taxed at a beneficial rate of 10% on a gross basis. One of the conditions for availing this rate is that the recipient should be the beneficial owner of such interest. The concept of beneficial ownership under the Treaties entered into by India is largely untested and hence the interpretation is guided by general law and international precedents in this respect.

However, recent news reports suggest that India is reworking its DTAA with Cyprus to incorporate capital gains tax in source state or a limitation of benefit clause. One needs to weigh the chances of such renegotiation while contemplating investments through such jurisdictions.

### Tax incentives for real estate

Like many emerging economies, India offers a host of tax incentives for specified real estate activities, some of which are summarised below:

#### 1. Infrastructure facility

- Developing or operating and maintaining or developing, maintaining and operating any infrastructure facility.
- Infrastructure facility is defined to mean Roads, Bridges, Rail System, Highway Projects including housing or other activities being integral part thereof, Port, Airport etc.
- 100% of profits eligible for deduction for 10 out of 15/20 years subject to conditions.

#### 2. Industrial parks

- Developing, or developing and operating or maintaining and operating an industrial park.
- Business to commence before 31 March 2009.

- 100% of profits eligible for deduction for 10 out of 15 years subject to conditions.
- New industrial park scheme, 2008 notified. The new scheme is substantially tilted in favour of industrial parks developed for manufacturing units rather than commercial units (i.e. IT, IT-enabled services, retail, etc.), rendering a big blow to developers of IT parks.

#### 3. Housing projects

- Developing and building housing projects approved by local authority before 31 March 2007.
- 100% of profits derived from such projects eligible for deduction subject to certain stringent conditions.

#### 4. SEZ

- Developing SEZ notified on or after 1 April 2005 under the SEZ Act.
- 100% of profits for 10 years out of 15 years eligible for deduction.
  - Minimum Alternate Tax inapplicable.
  - Dividends out of current income exempt from DDT.
- SEZ Act and SEZ Rules to be complied.
- Other tax incentives such as exemption from excise duty/ customs duty, etc.

#### 5. Hotels and convention centres

- Hotel business or building, owning and operating a convention centre located in specified area (Delhi and specified adjoining districts).

- Hotel to be constructed and start functioning and convention centre to be constructed between 1 April 2007 and 31 March 2010.
- 100% of profits eligible for deduction for five years subject to conditions.

#### 6. Hotels and hospitals

The following other tax incentives have been proposed by the Finance Bill 2008.

- 100% tax holiday for five years to hospitals located anywhere in India other than in excluded areas, Such hospitals should be constructed and start functioning from 1 April 2008 to 31 March 2013; and
- 100% tax holiday for five years to new two-star, three-star or four-star hotels located in a UNESCO-declared World Heritage Site. Such hotels should be constructed and start functioning from 1 April 2008 to 31 March 2013.

#### Other issues

Apart from the above, foreign investment in Indian companies also faces issues similar to those applicable to any private equity investor investing in India.

Some of the issues relate to:

- Characterisation of gains (business income v. capital gains);
- Permanent establishment issues;
- Substance issues;
- Structuring the overseas management company and the Indian advisory company; etc.

Each of the above requires appropriate structuring to mitigate tax risks in India.

#### Structuring is critical

The fast-growing real estate sector has tremendous opportunities to offer to foreign investors. However, this industry is also subject to various challenges, especially in light of the various developments on the tax and regulatory front.

Each real estate investment has its own challenges in terms of securing the interests of the foreign investor as well as the local Indian developer (in the case of a joint venture). It is critical to ensure that investment by foreign investors is structured appropriately from a tax and regulatory perspective to realise the full benefits from their investments.



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# Eye on Australia

## Back to the future: restoring confidence in the Australian listed property trusts sector

For the last few years Australia's listed property trusts (LPTs) have outperformed the ASX 200 Index, the benchmark index for the top 200 companies in Australia. This is despite the fact that LPTs, known as Real Estate Investment Trusts (REITs) in other countries, are traditionally viewed as a defensive investment occupying a position in the risk reward spectrum somewhere between government bonds and other listed equities.

The outperformance in recent years is the result of property trusts becoming more complex and taking on more risk, through:

- Expansion overseas;
- Financial engineering and higher gearing; and
- Adding funds management and development activities.

The outperformance has reversed over the last six months as share prices of many property trusts have fallen dramatically in response to the US subprime crisis and its ancillary impacts on the availability and cost of debt, expectations for fund growth and property values.

With some well-publicised collapses in share price, many property trusts are now trading at a large discount to net tangible assets (NTA) and are under pressure to restore investor confidence. So what does the future hold for the property trust industry in Australia, and what will it take to restore investor confidence?

### Brief history of the Australian LPT sector

Australia has one of the oldest and most developed REIT regimes in the world. The first REIT was listed in the Australian Securities Exchange (ASX) in the 1970s. There are now approximately 34 REITs trading on the ASX. The ASX 200 Index includes 21 REITs with total assets of \$164 billion. Below are the top 10 LPTs in Australia based on total assets; the table also shows their gross market capitalisation (See Figure 1).

Figure 1: Top 10 Australian LPTs total assets & market capitalisation

Name	Total assets (\$billion)		Market capitalisation (\$billion)	
	12/2007	12/2006	As at 03/03/08	As at 01/01/07
1 Westfield Group	50.8	48.9	33.1	37.0
2 Stockland	15.1	10.8	9.6	11.3
3 GPT Group	14.0	12.0	6.4	11.4
4 Dexus Property Group	9.7	9.0	4.6	5.1
5 Goodman Group	9.6	7.7	7.1	12.6
6 Centro Properties Group	8.0	5.9	0.4	7.5
7 Mirvac Group	7.7	6.3	4.0	5.6
8 CFS Retail Property Trust	7.3	5.9	4.7	4.9
9 Macquarie Office Trust	6.1	4.4	2.0	3.1
10 Centro Retail Group	5.9	2.6	0.8	1.1
<b>Total</b>	<b>134.1</b>	<b>113.6</b>	<b>72.6</b>	<b>99.5</b>

Source: Thompson Financial, Financial Statements on ASX website.

Outperformance has reversed as share prices of property trusts have fallen dramatically.

Originally the model was simple. REITs raised capital through listing on the ASX, mixed with a moderate amount (often 20-40%) of debt. Manageable levels of debt, usually at a fixed interest rate, enhanced yields to investors and the steady rental income flowed through the vehicle to provide steady quarterly or half yearly distributions to investors. The weight of money flowing into superannuation schemes through mandatory employer contributions increased demand for such a low-risk investment. Steady cash returns provided an income for pensioners to live off whilst their income was protected against inflation through fixed or inflation-linked rental review clauses in property leases. The long-term trend of upward property valuations also provided an increase in their capital base and hedged their investment against inflation.

Transformation of the index over the last few years

For a number of reasons, over the last 10 years, the Australian REIT industry has moved away from this simple model to take on more risk and allow for greater investment returns:

Shortage of available assets under management

The Australian core commercial property market is one of the most highly securitised in the world in that 95% of retail property and 70% of office property is institutionally owned. There is very little available stock for purchase by LPTs in

Australia, and this has meant property trusts have had to either look overseas for continued growth or develop their own assets.

Desire to take locally developed property funds management expertise overseas

Given the long history of the local REIT market in Australia LPT fund managers were well placed to use their expertise to expand offshore. The local LPT sector is now substantially invested offshore. 23 out of the 34 LPTs in Australia have at least one asset overseas, and of the Top 10 LPTs shown above, 45% by value of their assets were overseas at 31 December 2007. This has brought with it all the risks associated with offshore investment, such as foreign exchange risk, more complex investment structures and frequently the need to enter into joint venture arrangements with new business partners more familiar with the local market. Understanding the local market is often the toughest thing to get right.

The Australian LPTs which pioneered investing offshore were Westfield and Macquarie, which set up funds that were entirely invested in overseas assets (particularly in the US). They were followed by a number of the existing domestic LPTs which expanded their Australian portfolios to include overseas assets, usually located in the US and Europe. Over the last three to four years a number of more specialised funds dedicated to specific markets, such as Japan, have emerged.

Australian REIT model has been to take on more risk to allow for greater investment returns.

### Financial engineering

Financial engineering has become a more common term in the last 12 to 18 months to describe what happens when property fundamentals take a back seat while other levers are pulled to generate cash yield. The lower rental yields available in other jurisdictions together with withholding tax leakage from overseas investments mean underlying property returns are lower than those historically seen in the Australian listed sector. Lower income yields have met with resistance, particularly among retail investors in the Australian listed sector, who have not embraced the concept of total return as readily as that of distribution or cash yield.

The local LPT sector is now substantially invested offshore – 23 out of the 34 LPTs in Australia have at least one asset overseas.

In its simplest form, financial engineering means debt. Gearing levels have in many cases across the sector risen as property fund managers have taken advantage of the large gap between rental yield and the cost of debt. While the industry norm may be in the range of 20-40%, gearing levels of 50-80% have become more widespread. Australian trusts investing in Japan in particular tend to be geared between 50-60%, taking advantage of the very low interest rates in Japan. Problems have emerged in the last six months with understanding the true level of gearing when combined with complex corporate structures which may include layers of joint ownership and equity accounting. The true gearing level cannot always be determined by looking at the balance sheet and dividing debt by total assets.

Besides gearing, REITs have increasingly turned to derivatives to enhance returns. Initially, derivatives were simply a way of guaranteeing the dollar amount of distributions which would be paid when overseas rent was repatriated to Australia. Some funds went further in hedging their 'net investment' overseas, looking beyond the natural hedge of overseas property being offset by overseas debt, to hedge the remaining net assets. Other funds are content not to hedge this component because they take the view that they do not intend to repatriate the investment overseas.

However some structures in the last three years went further still, adding a cash component to distributions derived entirely from hedges. Funds invested in Japan use the interest differential between the Australian dollar and Japanese yen to generate cash to distribute from cross-currency swaps. In some cases this can boost the distribution yield of the fund by 30-40% of the distributable income of the fund. While this makes the headline distribution yield attractive, these techniques are rejected by some fund managers on the basis that there is always a cost to the hedge. For example Winston Sammut, managing director of Sydney-based property securities fund manager Maxim Asset Management, said he does not take into account the value of an 'in the money' derivatives book in deciding whether or not to invest.

Gearing levels have risen as property fund managers have taken advantage of the large gap between rental yield and the cost of debt.

**Funds management activities**

A significant number of the large property trusts in Australia are now 'stapled' to their management company. This offers the investor access to the streams of income derived from ongoing asset management and one-off advisory fees on transactions. This has helped to boost share prices and earnings multiples for stapled entities, particularly in a period of rising asset prices and ready access to debt and equity capital with which to generate deal flow.

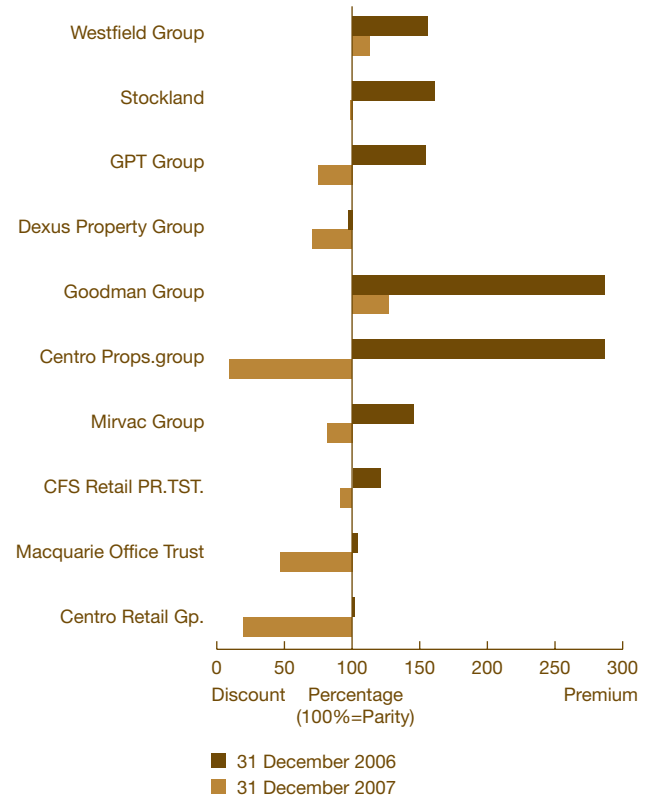
Now investors are questioning the value of stapled businesses. Purchasing funds management businesses based on an earnings multiple creates intangible assets and goodwill. The carrying value of these assets is now under pressure – as property values fall, funds under management fall and therefore so do fees. The outlook for one-off transaction fees is also less positive with the number of transactions likely to decrease due to less access to debt.

Investors are increasingly wary of the quality or sustainability of earnings in the sector.

Investors are increasingly wary of the quality or sustainability of earnings in the sector. Many strip out the impact of one-off transactions such as asset sales and question the ability of management to control or repeat such transactions.

Set out opposite is a table which shows how the share price as at 1 January 2007 and 18 March 2008 has changed relative to the net assets per unit of each the 10 LPTs shown above

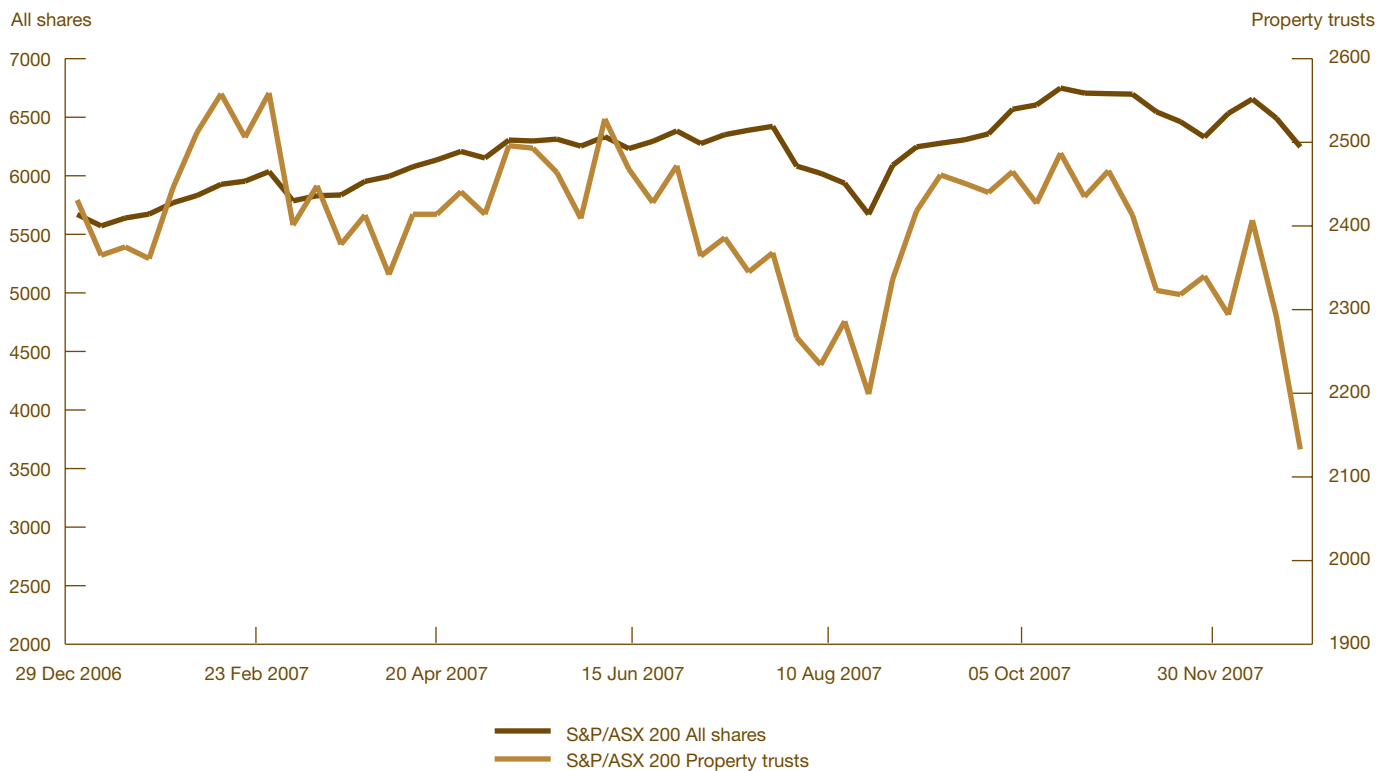
Figure 2: Share price as a % of net assets per unit



Source: Thompson Financial, Financial Statements on ASX website.

(Note: Net assets per units calculated based on financial statements as at 31 December 2006 and 31 December 2007 respectively). It demonstrates how premiums to net asset backing have been cut across the sector and in a number of cases LPTs are now trading at a discount to their net asset backing (See Figure 2).

Figure 3: S&P/ASX 200 vs. S&P/ASX 200 property trusts



Source: Thompson Financial.

### Effects of global uncertainty

While the techniques above fuelled the outperformance of the sector over the last few years, the increased risk profile taken on is more apparent with current market conditions and is reflected in share prices driving the sudden underperformance of the sector over the last year. This is demonstrated by the sharp fall in the performance of the S&P/ASX Property Trust index relative to the S&P/ASX 200 Index (See Figure 3).

The increased risk profile is reflected in share prices driving the sudden underperformance of the sector.

The global credit crisis has caused lenders to reprice debt to the REIT sector and in extreme cases withdraw sources of funding. This affects the outlook for distributions for all property trusts, but investors have reacted swiftly to funds requiring imminent refinancing. Where refinancing cannot be achieved swift asset sales are required, bringing into question asset valuations and in extreme cases threatening the ability of stapled structures to continue to manage the real estate vehicles and therefore control fee income streams. The problem is compounded where access to new equity is restricted by the low trading prices of funds, meaning capital raising is dilutive.

Finally investors are factoring in expectations of real estate asset write downs in markets where capitalisation rates are expected to rise. This has had the biggest impacts on funds with exposure to European property and lower grade US property. In Australia the market has until now remained buoyant, with demand for office space pushing rents up in major centres and the retail sector remaining healthy despite a long succession of interest rate rises. However the outlook may not be as positive with cap rates likely to rise in response to interest rate rises to re-establish the natural premium of property yields over bond rates.

Investors have lost trust in the sector. Retail investors have dramatically cut the amount of new investment they are allocating to LPTs via property securities funds.

Investors have lost trust in the sector. Retail investors investing in unit trusts through online investment platforms provided by major fund managers in Australia (known as WRAP platforms) have dramatically cut the amount of new investment they are allocating to LPTs via property securities funds. One major WRAP provider which receives \$400m to \$500m per month in funds through its platform has seen the amount directed towards property fall from an average of 13% in 2007 to under 2% in January 2008.

### Back to the future: outlook for the next year

The next year is likely to be a year of consolidation of LPTs in Australia as they look to regain some of the confidence lost by investors in the last six months. So what will be the priorities for funds looking to rebuild shareholder value?

**Focus on 'sensible' level of gearing**

The best-performing funds in the last few months have been the 'traditional' property trusts, with low levels of gearing in the traditional range of 20-40%. Funds which have grown rapidly or relied on cheap and abundant debt are changing strategy to sell assets and bring gearing down.

**Management competence**

Management need to provide the market with a clear strategy that is subsequently executed. For those funds with capacity to grow, regular updates need to be provided to investors demonstrating successful delivery of growth. Where funds undertake property development they will need to demonstrate that it is fully funded and still accretive at a higher cost of debt. In other cases announced plans may be as simple as selling some assets to bring down gearing.

**Clarity of reporting**

The investment community wants to get a clear vision of the risks and cash flows of each REIT. Maturity profile of debt, compliance with loan covenants, gearing, source of earnings and a clear understanding of structures are key issues requiring a response to restore investor confidence.

**Sustainability of earnings & distributions, shift to total return focus**

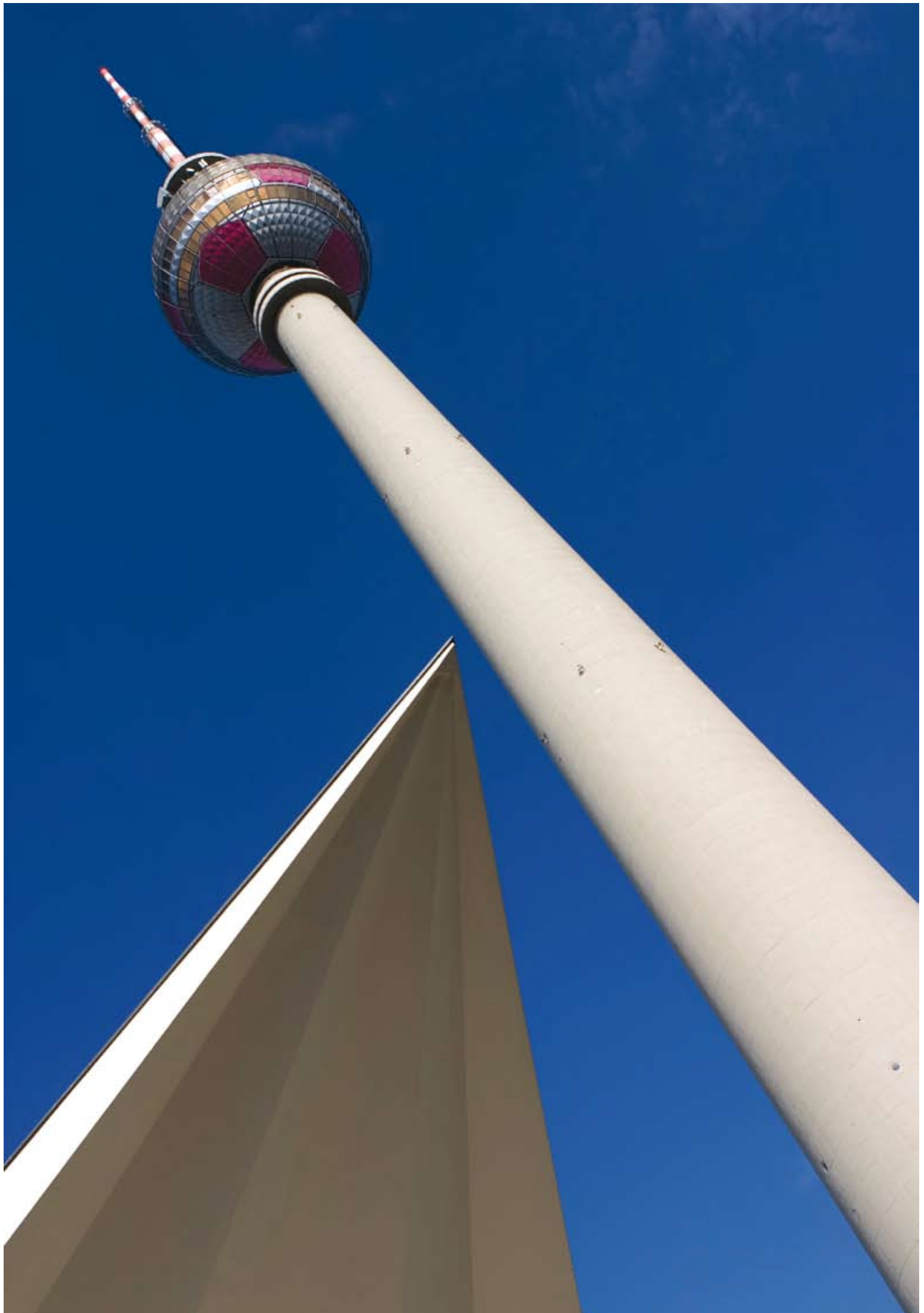
More scrutiny will be placed on the extent to which earnings are based on rental returns and funds management activities compared with those that rely on one-off transaction fees or profits generated from asset sales. Where funds use financial engineering, investors will question the extent to which distributions 'topped up' out of derivatives or returns of capital can be maintained. Where distributions are reduced to more sustainable levels LPTs, investors may need to accept total return rather than distribution yield as a key metric in measuring performance.

**Quality of assets**

The weight of money chasing real estate assets in Australia over the last few years has narrowed the yield gap between prime and lower grade assets. Those with higher quality assets are likely to perform better as the outlook for valuations becomes less optimistic.

**Scrip for scrip transactions**

With low share prices issuing new equity is likely to be dilutive, but consolidation within the sector is likely. As the amount of new debt available to LPTs has been reduced dramatically as banks cope with the credit crisis, LPTs will have to turn to scrip-for-scrip deals as a source of capital for merger activity.



# Eye on Europe

## Thin capitalisation rules in selected Central and Eastern European countries

One key element addressed in structuring the financing of any real estate investment involves thin capitalisation rules, which may limit the deduction of interest expenses for tax purposes. This article discusses some of the main features of these rules in selected countries of the Central and Eastern European region. The countries addressed include Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia, which are all EU member states.

### What do the thin capitalisation limitations mean?

The availability of a tax deduction for interest costs on any borrowings for financing a real estate investment typically has a major influence on the return on investment. Many countries have introduced specific rules limiting the deductibility of interest on borrowings where gearing substantially exceeds the borrower's equity. Most often, specific rules exist to limit the interest deduction on certain borrowings, particularly related party debt.

Thin capitalisation rules base the interest deduction on the fulfilment of a debt-to-equity test focusing on the split of financing between internal debt and equity.

These rules are known as thin capitalisation rules. Thin capitalisation rules usually base the permitted interest deduction on the fulfilment of a debt-to-equity test focusing on the split of financing between internal debt and equity. If the test is not met, the interest deduction may be partially or wholly disallowed for tax purposes.

### Rules differ from country to country

Although the rules in substance follow the same idea, there is little conformity to be found among the countries of the CEE region. Even though these rules exist and have been implemented and in Bulgaria, the Czech Republic, Hungary, Poland and Romania, they show significant differences. As always the devil is in the details, a good example being the differences in the components of debt and equity for the purpose of the test. Interestingly, no thin capitalisation rules currently exist in Slovakia, but they are being reintroduced with effect from 1 January 2009.

The rules in all countries provide for a debt-to-equity test. Currently the debt-to-equity ratio applicable for Bulgaria, Hungary, Poland and Romania is 3:1. In the Czech Republic a more beneficial ratio of 4:1 may be found. In Slovakia, the ratio will be 6:1. The rules basically state that the interest on any debt exceeding the ratio is generally considered to be tax non-deductible.

As noted, material differences exist in the definition of debt subject to the thin capitalisation rules in each country. Under the rules in Slovakia, debt includes only liabilities to related parties as defined in the relevant law. This was also the case for the Czech Republic until 2007. In 2008 new rules came into effect extending the debt subject to thin capitalisation rules to also include unrelated third-party debts including bank debts. In Poland debt includes only liabilities to certain direct shareholders or direct 'sister' companies. Hungary and Romania

use a more extensive definition of debt including third-party non-bank debt, while in Bulgaria debt is defined as all liabilities of a particular company towards related and unrelated parties.

In Romania, debt is primarily defined to include long-term debts with a maturity exceeding one year.

Dissimilarities may also be observed in the definition of 'equity'. Under the Bulgarian, Czech, Romanian and new Slovak rules, equity for thin capitalisation purposes includes most components of equity, such as share capital, retained earnings and other capital reserves. On the other hand, according to the Polish rules, equity is principally understood as registered share capital for the purpose of debt-to-equity test. In Hungary, the accounting valuation reserve is generally disregarded for thin capitalisation purposes (as well as the period's profit or loss).

### How are interest costs restricted?

In most of the selected countries, if the debt-to-equity ratio is exceeded, the interest arising on the part of the loans exceeding the ratio will not be tax deductible. This is the approach taken in the Czech Republic, Hungary, Poland and Slovakia.

If the debt-to-equity ratio is exceeded, the interest arising on the part of the loans exceeding the ratio will not be tax deductible.

According to the Romanian rules, if the debt-to-equity ratio is exceeded, the entire interest expense arising on loans from parties other than credit institutions, with a maturity exceeding one year, plus the related net foreign exchange losses, are non-deductible.

Bulgaria has adopted a different approach. Under the local rules, even if the debt-to-equity ratio is exceeded, the interest costs may still be fully or partially tax deductible, depending on the accounting result before interest of the Bulgarian company. A formula set out in the law is used to determine the tax-deductible amount. Also, interest costs on bank loans and finance leases are not subject to thin capitalisation restrictions unless the bank or finance lessor is a related party to the borrower, or the loan/finance lease has been secured by a related party.

Depending on the accounting result before interest of the particular Bulgarian company the relevant interest costs may be fully tax deductible or partly or wholly restricted based on

a specific formula provided in the law. Further, under the Bulgarian rules the term 'interest' includes all financial costs accrued in relation to funds borrowed.

Restricted interest costs under the Bulgarian rules can be carried forward and deducted for tax purposes in the following five tax years if the particular company has sufficient accounting profits. On the other hand, interest costs that are non-deductible based on the rules in the Czech Republic, Hungary, Poland and Slovakia may not be carried forward for potential future deduction. The Romanian rules also provide the possibility for deduction of the restricted interest costs in subsequent tax periods if the debt-to-equity ratio falls under 3:1 and within a certain interest rate percentage set by the law.

**In Bulgaria, restricted interest costs can be carried forward and deducted for tax purposes in the following five tax years if the particular company has sufficient accounting profits.**

In addition, under the Czech and Hungarian rules, if the restricted interest is paid abroad, the excess interest is reclassified as a dividend and this generally attracts withholding tax in the Czech Republic (Hungary has no dividend withholding tax). No such regulations are provided in the Bulgarian, Polish, Romanian and Slovak rules.

**Taxpayers are subject to a review by the tax authorities in the CEE region during tax audits.**

Another feature of the new Slovak rules is that they will only apply where the average of all the Slovak borrower's loans from related parties in a particular year exceeds SKK 100 million (around EUR 3 million).

#### **What is the practice of the tax authorities?**

The application of the rules by taxpayers is usually subject to a review by the tax authorities in the CEE region during tax audits. The scrutiny of the Polish and the Romanian tax authorities has to be especially noted in this regard. Further, the application of the rules in Poland may in practice be subject to certain changes due to interpretations and binding rulings that may be issued by the local tax authorities.

On the other hand, experience in Bulgaria, the Czech Republic and Hungary has not shown thorough attention from the tax authorities to this area so far. This may, however, not be precluded, as each tax review differs on a case by case basis.

### Are any changes in the rules expected?

Material changes were introduced in the Czech rules as of the beginning of 2008. The new rules apply to all debt including bank financing, there is a maximum allowable rate of interest, and the restrictions are extended to apply to all finance costs, not only interest.

The debt-to-equity ratio on related party debt was tightened to 2:1, and for other debt a ratio of 6:1 in 2008, and a ratio of 4:1 from 2009 onwards apply. Certain benefits may be obtained during the transition period until 2010, during which the newly proposed rules do not apply to debts drawn down before the end of 2007.

As noted above, Slovakia currently has no thin capitalisation rules, but they are being introduced with effect from 1 January 2009. The main features of these new rules are outlined above and in Figure 1.

Based on the available information, no legislative amendments to the rules are currently being considered in Hungary, Poland and Romania.

### Conclusion

There is wide variation in the thin capitalisation rules in the CEE region. Bulgaria, the Czech Republic and Romania have already introduced tight regulations in this area, and Slovakia is introducing thin capitalisation rules from 2009. Given the variety of rules and anticipated changes there is a need to monitor the capital structure of companies established in the region in order to ensure optimal project returns.

Figure 1: Summary of the main features of the current thin capitalisation rules in Bulgaria, the Czech Republic, Hungary, Poland and Romania

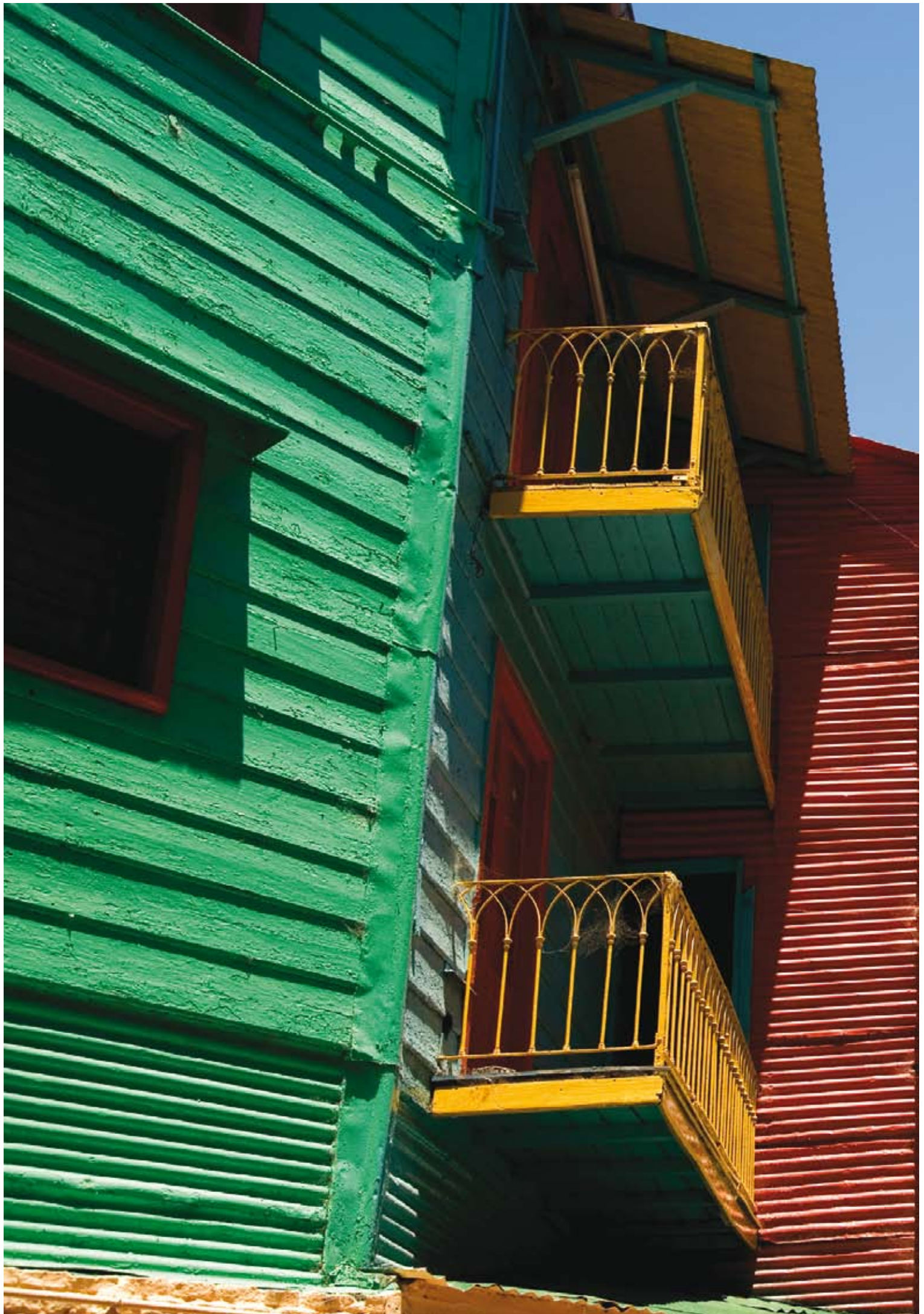
	Bulgaria	The Czech Republic*	Hungary	Poland	Romania	Slovakia***
Debt-to-equity ratio	3:1	2:1 for related party and 6:1** for unrelated party debt	3:1	3:1	3:1	6:1
Definition of 'debt'	All liabilities	Liabilities towards all parties	All (loan and debt types of) liabilities except those towards banks	Liabilities towards certain direct shareholders or direct 'sister' companies	All liabilities except those towards credit institutions	Loans from related parties
Definition of 'equity'	All components of equity	Most components of equity	Most components of equity except accounting valuation reserve and the period's profit or loss	Registered share capital (certain exclusions may occur)	Most components of equity	Most components of equity
Earning stripping rules	No	Yes	No	No	Yes	No
Possibility for carry forward of restricted costs	Yes	No	No	No	Yes, within a certain interest rate percentage	No
Reclassification of interest as dividends	No	Yes	Yes	No	Yes	No

\* new multi-criteria rules introduced as of 1 January 2008, transitory regime during periods 2009 and 2010.

\*\* to be tightened to 4:1 as of 2010.

\*\*\* to be introduced from 1 January 2009.

Source: PricewaterhouseCoopers



# Eye on the Americas

## How the South is won: European investors enter the Latin American real estate market

Fuelled by high digit economic growth over the past few years, a stable political climate and steadily decreasing risk indicators, European investors have set their eyes on the Latin America real estate market.

Mexico is the front runner with a real estate market that has grown to maturity through US investments.

Within the region Mexico is the front runner with a real estate market that has grown to maturity through US investments. Brasil runs a strong second with significant international interest and high future potential as one of the four so-called BRIC countries.<sup>1</sup> Argentina and Chile round out the top echelon. Other Latin American jurisdictions also attract investments but often these are sector-specific; for example, both Costa Rica and the Dominican Republic have been targeted by investors in the leisure industry and have seen some major hotel resort deals as a result.

In this article we concentrate on the four jurisdictions in the top echelon: Mexico, Brasil, Argentina and Chile.<sup>2</sup> Rather than addressing the local specifics in detail we discuss how to structure investments into these jurisdictions from a European investor's perspective. For the purpose of this article we assume that the European investors will invest in a local property company rather than own the real estate direct. Any tax planning to reduce local taxes is equally assumed to be done at the level of the local property company.

### Getting started

As with all investments there are some general concepts that apply and that dictate the parameters the investors can play with: how the investors themselves are taxed, regulatory constraints, exchange controls, etc. Our main focus for this article is how to structure the investments in a tax-efficient way.

In cross-border situations the impact of international double taxation is mitigated by tax treaties concluded between the relevant jurisdictions. Historically Spain and Portugal have strong ties with the region; hence it is not surprising that Spain has the most extensive treaty network with the Latin American region including the four jurisdictions in our top echelon. Portugal has treaties in place with Mexico and Brasil, has signed a treaty with Chile and is currently negotiating a treaty with Argentina. The Netherlands and Luxembourg, as typical locations for holding companies, also have extensive treaty networks. The Netherlands has tax treaties with Mexico, Brasil and Argentina. Luxembourg has tax treaties with both Mexico and Brasil.

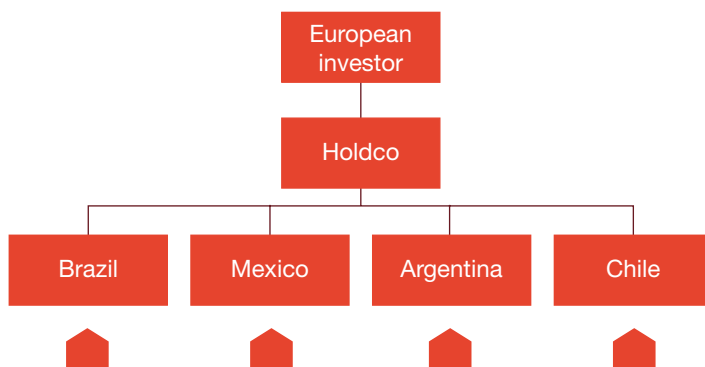
Not surprising that Spain has the most extensive treaty network with the Latin American region.

<sup>1</sup> 'BRIC' stands for Brasil, Russia, India and China, the 'Big Four' fast-growth economies in the world today.

<sup>2</sup> A tax treaty has been signed between Portugal and Chile but awaits ratification before it enters into force.

For the purposes of illustration, let us assume a situation in which a European investor will be investing in all four jurisdictions. Schematically this can be depicted as follows (See Figure 1)

Figure 1. One European investor, four jurisdictions



Source: PricewaterhouseCoopers

Below we analyse each investment jurisdiction separately and suggest how to optimise the corporate structure for each specific investment. In our analysis we refrain from commercial considerations such as the (non) desirability of having to maintain multiple entities in multiple jurisdictions. While this may make the exercise to a certain extent academic, it also provides practical guidance on the tax issues relevant for investments in the respective jurisdictions.

### Brasil

Based on domestic tax law, Brasil does not levy a withholding tax on dividend distributions. As such, the investor does not require the benefits of a tax treaty to reduce such withholding tax. However, investors into Brasil should be mindful of the Brazilian capital gains taxation that arises upon repatriation of the investment out of Brasil. Unfortunately, none of the tax treaties that Brasil has concluded mitigates such tax, except for the tax treaty with Japan. Considering the Japanese tax system, with corporate income tax rates at 40% and higher, re-routing investments via Japan is unlikely to be a viable option for most European investors. On the other hand, Brasil

does offer an attractive tax feature in the form of allowing interest payments on the equity of a Brazilian company to be tax deductible at 34%.<sup>3</sup> Such interest payments are subject to a 15% interest withholding tax but are potentially tax exempt at the level of the recipient if such recipient jurisdiction qualifies the income as dividends and it is covered by their participation exemption regime.

### Mexico

Similar to Brasil, Mexico does not levy a withholding tax on dividend distributions under its domestic tax law. Again, as a result no treaty protection is thus required to mitigate such withholding tax. The thing to watch with a shareholding in a company the assets of which consist mainly of Mexican real estate is that the gain, if any, on the sale of such company is subject to Mexican capital gains tax. This provision equally applies to the sale of (foreign) companies that own the Mexican real estate assets indirectly. However, two of Mexico's tax treaties offer protection against such tax on an indirect sale: the tax treaties with The Netherlands and Luxembourg.<sup>4</sup> A typical holding structure for Mexican real estate investments would thus include a double layer so as to allow the sale of the bottom holding company by the top holding company.

Under its domestic tax law Mexico offers a preferential tax treatment for certain types of exempt investors such as pension funds – the so-called 179 exemption. Subject to certain conditions, such investors may cause the Mexican company investing in Mexican real estate to be pro rata exempt from Mexican tax on the pro rata part of the shares held by such investors. For example, if a Dutch pension fund holds a 30% share interest in a Mexican real estate company, potentially 30% of the income earned by the Mexican real estate company is exempt from Mexican tax. The 179 exemption does not cover all types of income but notably exempts from Mexican corporate income tax rental income and capital gains on the sale of real estate assets, exempts interest payments from interest withholding tax,<sup>5</sup> and protects against the Mexican capital gains tax on the sale of shares. There are good arguments to make that the 179 exemption also extends to Mexico's current asset tax. The flat tax that was introduced

<sup>3</sup> None of the tax treaties with Spain, Portugal, The Netherlands or Luxembourg offers a reduced interest withholding tax rate.

<sup>4</sup> In principle both tax treaties offer protection against the Mexican capital gains tax, however, for technical reasons the wording of the Dutch tax treaty is stronger and thus preferred over the Luxembourg treaty.

<sup>5</sup> Mexico does not levy a dividend withholding tax on dividend distributions.

by Mexico's tax reform effort and that effectively replaces the asset tax contains wording that supports the same position, i.e., exemption, with respect to the flat tax. Investors eligible for the 179 exemption will thus prefer to hold their investment in the Mexican real estate company direct.

### Argentina

Dividend distributions by an Argentinean company are in principle not subject to dividend withholding tax. However, if and to the extent that the income out of which such dividends are distributed has not been subject to Argentinean corporate income tax, an equalisation tax of 35% will apply. Under the Spanish and Dutch tax treaty such equalisation tax is reduced to 10%. The Spanish tax treaty offers an added benefit in that it offers protection against the Argentinean net wealth tax levied at 0.5%, which the Dutch tax treaty does not.

### Chile

Although the Spanish/Chilean tax treaty reduces the Chilean dividend withholding tax to 5%, the protocol to the tax treaty states that the reduced rate shall not apply as long as the Chilean tax system provides for a full tax credit for the dividend withholding tax, which is currently the case. Dividend distributions thus continue to suffer an effective 18% withholding tax (35% reduced by 17% corporate income tax).

The above analysis results in the following optimal corporate holding structure.<sup>6,7</sup> (See Figure 2).

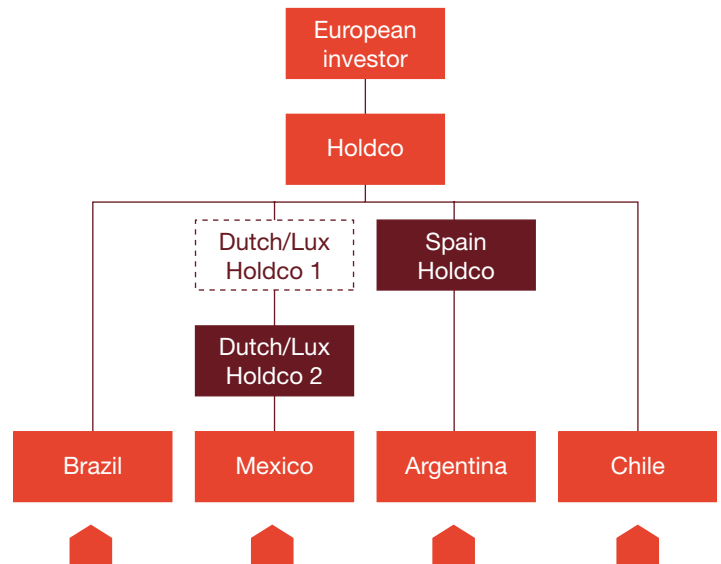
As is true in any holding structure, it is essential that the respective holding companies maintain sufficient physical and economic substance to be respected as viable holding companies by the tax authorities of the relevant jurisdictions. If not, tax authorities may deny the benefits of their tax treaties to such entity and/or claim taxing rights over (part of) the income earned by such entity.

### Conclusion

In this article we have analysed some of the relevant tax consequences of European investors investing into real estate located in Latin America. We concentrated on the four

jurisdictions that currently attract most attention: Mexico, Brasil, Argentina and Chile. Each of the jurisdictions has its own specifics and requires tailor-made solutions. Nonetheless, we have addressed the typical structuring issues and suggested a holding structure that incorporates the suggested solutions. Although the various Latin American real estate markets are maturing quickly, many still include unexpected pitfalls for the unwary investor, especially in regard to exchange control and legal issues. It is thus essential that advice is sought from local counsel on tax, legal accounting, regulatory and exchange control issues. Nonetheless, for those investors that have safely avoided the pitfalls, Latin America offers attractive returns on their investments.

Figure 2: One European investor, with an optimised investment structure across four jurisdictions



Source: PricewaterhouseCoopers

6 As indicated, we refrain from commercial considerations such as the (non) desirability of having to maintain multiple entities in multiple jurisdictions.

7 The structure diagram does not reflect the preferred position of investors eligible for the Mexican 179 exemption.



# Eye on the Middle East

## Leisure-driven real estate development in the Middle East: firm foundations or just sandcastles in the sky?

In recent years there has been an increasing focus in the Middle East upon the development of non-oil-based industries. Strong inbound investment and high liquidity within the region have led to impressive economic growth and diversification, in particular in real estate and financial services.

Strong inbound investment and high liquidity within the region have led to impressive economic growth and diversification.

GDP across the region has grown an average of 5.4% over the last five years, with two countries (Qatar and UAE) now ranking in the top 20 globally in terms of GDP per capita.<sup>1</sup>

A key component of this diversified growth has been the encouragement of inbound tourism, which has seen an average of 10% growth per annum across the region over the last five years, higher than the global average of 3%.<sup>2</sup>

Arguably the most successful of the Middle East countries in this arena has been Dubai, whose achievements in terms of global branding have been impressive. However the grand designs often associated with Dubai – the ‘world’s first’, the ‘world’s tallest’, the ‘world’s only’ – are increasingly characteristic across the region. Development is taking place on a mass scale – as demonstrated by the estimated pipeline of up to USD3 trillion in infrastructure projects in the Middle East region over the next 20 years.

This paper examines the ambitious plans for tourism growth across the region and considers whether these plans are achievable and sustainable or just ambitious ‘sandcastles in the sky’.

### Dubai – Leading the march with a strong global brand and ambitious plans for growth

In recent years the UAE and Dubai in particular, has been leading the way in embracing the tourism, leisure and hospitality sector. In 2006, the RSP Group Hospitality Market Watch survey ranked the UAE as the most competitive and dynamic destination in the Gulf Cooperation Council.

Dubai has experienced unprecedented growth in the number of tourist visitors in the last six years: increasing 96% from 2.8 million in 2000 to 5.5 million in 2006.<sup>3</sup> A recent survey cited Dubai as one of the most popular Christmas vacation destinations for Britons; at the same time the European market overall dominates the sector, representing over 33% of visitor numbers in 2006. This should be seen as an important source market for future growth – as both Germany and the UK rank in the top three globally in terms of outbound visitor numbers.<sup>4</sup>

Another factor that should not be overlooked is the proportion of intra-regional tourism – 31% of visitors to Dubai in 2006 were from other Middle Eastern countries. With a significant proportion of the Middle East population aged under 25 years, there is potential for the growth of a strong intra-regional tourist market.

<sup>1</sup> IMF World Economic Outlook Database, 2007.

<sup>2</sup> World Tourism Organisation (UNWTO) – International Tourist Arrivals, Average Annual Growth 2000-2005.

<sup>3</sup> Dubai Department of Tourism Commerce and Marketing.

<sup>4</sup> World Tourism Organisation (UNWTO).

In Dubai, the supply of new hotel rooms has, to date, not kept pace with increases in demand. This has resulted in exceptionally high hotel occupancy rates – averaging 82% in 2006, with averages in the five-star sector of 89% – impressive when compared to typical occupancy rates of approximately 75% in more mature markets.

A key to Dubai's success has been effective marketing of the 'Dubai Brand' globally. There are few who are not aware of the Burj Al Arab, the world's first seven-star hotel. This world-beating attitude characterises the ambitious growth plans for Dubai. Future supply is forecast to grow from the current 30,000 rooms to approximately 65,000 by 2010, with another 60,000 rooms expected to be supplied between 2011 and 2020, much of which will be provided within Dubai's pipeline of globally unique mixed use developments.

A key to Dubai's success has been effective marketing of the 'Dubai Brand' globally.

The Palm Jumeirah, the first development in Nakheel's 'Palm Trilogy' is reaching completion, with the first residents already having taken occupancy. The Palm Jumeirah will boast the first Trump International Hotel in the Middle East and The Atlantis Palm Resort – a 1,500-room hotel, hosting the largest water park in the region. These are just two of the 30 hotels (and approximately 10,000 hotel rooms) expected to open on the Palm Jumeirah in the next few years.

The next instalments in the Palm Trilogy (the Palm Jebel Ali and the Palm Deira) along with Nakheel's other major developments, the World Islands, with its 300 man-made islands located just off Dubai's shoreline, and the Dubai Waterfront Project, are part of Dubai's strategy to add approximately 1,000 additional kilometres of coastline to Dubai (whose natural coastline is just 70 kilometres, almost all of which already has been developed). It is not yet known how many additional hotels will be provided on these three developments.

Also under construction is the Burj Dubai, which is currently set to be the world's tallest building, standing at over 800 metres, and which will house a 250-room Armani hotel (a joint venture between Armani and EMAAR Hotels and Resorts).

Still, the biggest single cluster of tourist-focused development is currently planned inland in the Dubai desert. 'Dubailand' is a vision of the largest entertainment and leisure development in the world, comprising of a number of theme parks – including Universal Studios – and significant leisure and entertainment facilities as well as Mall of Arabia (the largest shopping mall in the world). This inland development will also boast Bawadi – a 10-kilometre strip of hotel and leisure development, which will house 51 hotels (providing 60,000 hotel rooms) by 2020, including Asia Asia, which is planned to be the largest hotel resort in the world housing 6,500 rooms once complete.

Future supply is not just limited to these major tourist and luxury leisure destinations. The budget hotel sector is also set to make big inroads into Dubai and the wider Middle East region with brands such as Holiday Inn Express, EasyHotels and Premier Inn amongst others announcing significant new openings in the region in the coming years.

The budget hotel sector is also set to make big inroads into Dubai and the wider Middle East region.

Whilst Dubai has recently dominated the UAE hospitality sector (accounting for 78% of the UAE's hotels in 2005), Abu Dhabi, in particular, is looking to re-address the balance.

### Abu Dhabi – Sustainable tourism designed to encourage the eco-tourist, cultural and business visitors

The Abu Dhabi tourism sector traditionally has been dominated by the business traveller (accounting for up to 75% of demand), with the majority of visitors (54%) originating from other Arab countries.<sup>5</sup> Abu Dhabi has experienced lower average occupancy rates than its neighbour Dubai (reaching 78% in 2005), however it

5 Abu Dhabi Tourism Authority

has also experienced severe shortages of supply at peak times such as during major conference events where in some instances visitors have been accommodated offshore on cruise ships.

Not to be outdone by its neighbour, Abu Dhabi also has impressive plans to boost its tourism and business travel sector and has ambitions to re-address the visitor balance, increasing the share of leisure tourism to 41% by 2015, and the meetings, incentives conventions and exhibitions (MICE) sector to 8%.

## Abu Dhabi also has impressive plans to boost its tourism and business travel sector.

The Emirate can already boast its own 'seven-star luxury' in the form of the Emirates Palace Hotel, and has plans for over 70 new hotels over the next 10 years.

Abu Dhabi, with a coastline containing some 200 natural islands, has significant ecological resources. The Tourism Development and Investment Company (TDIC), the development arm of the Abu Dhabi Tourism Authority (ADTA), is clear in its objectives of developing a sustainable tourism portfolio which embraces all aspects of Abu Dhabi's heritage and culture while protecting its natural resources.

Arguably the most high profile of the Abu Dhabi developments is Sadiyat Island where the Emirate has pulled off a major coup in the art world, by signing up both the Louvre and the Guggenheim. Both museums are being designed by world renowned architects (Jean Nouvel and Frank Gehry respectively). In addition there will be a Zaha Hadid-designed Performing Arts Centre and a Maritime Museum designed by Japan's Tadao Ando.

In addition to the cultural district and housing for 150,000 residents, once complete, Sadiyat Island will also house 29 hotels (including an 'iconic' seven-star property) and boast 19 kilometres of beach front.

Another major tourist-focused development in Abu Dhabi is that of Yas Island, which will incorporate a Formula One race track, with 2009 slated as the year for the first Abu Dhabi Formula One Grand Prix and a theme park based on the Ferrari brand.

Abu Dhabi's other major beachfront developments include Reem Island, Al Raha Beach, and Lulu Island, all of which will focus on providing much-needed residential accommodation as well as housing additional hotels. Further down the coastline in the Western Region of Abu Dhabi, developments include new hotels at Liwa, Jebel Dhanna, Sir Bani Yas, Dalma and on the Bahraini Islands.

## Equal ambitions beyond the UAE

Whilst not developing on a scale and pace that can match the UAE, other countries in the region also have ambitious plans for capturing their share of the tourist market. In many instances, large mixed-use developments are being seen as the key to successful growth. Such developments each provide a mixture of residential freehold, luxury hotels, serviced apartments and increasingly a fractional ownership or timeshare offering. Each also comes with all the trimmings of leisure and entertainment facilities (such as golf courses and marinas) and conference facilities, all designed to encourage year-round occupation and economic sustainability.

Developing in this manner provides the attraction of returns from residential sales which can be used to balance the lower and longer term returns from the leisure and hospitality-driven components.

Some of these mega developments include:

- **The Pearl, Qatar:** A 366 hectare man-made island, designed as a Riviera-style residential and leisure community which will include a significant residential offering as well as housing three luxury five-star hotels, restaurants, leisure and entertainment facilities.
- **The Lusail Development, Qatar:** A 32 sq km beachfront development, scheduled for completion in 2010. This, the largest real estate development in Qatar, will provide accommodation for over 200,000 people, as well as 10 resort hotels, golf courses and retail outlets.

- **The Blue City Project, Oman:** An ambitious coastal development which, on completion, will provide accommodation for over 250,000 residents and will aim to attract two million tourists.
- **The Wave Muscat, Oman:** A tourist-focused resort development built around a Greg Norman golf course and including a major nature reserve as well as four 'World Class' hotels and a 300-berth marina.
- **Durrat Al Bahrain, Bahrain:** A 20 sq km man-made island development which upon completion will house up to 35,000 residents across 13 man-made islands. The development will include two luxury five-star hotels, marinas, retail, restaurant & entertainment facilities and an 18 hole golf course.

### Once it is built will they come...?

When one considers any of these major developments in isolation there is no question that they are very impressive and to date there seems to have been little trouble in finding willing investors keen to capture promised high returns on investment. The sceptics would argue, however, that the region is operating in silos, and that there surely cannot be enough future demand to sustain this pace of development.

It is certainly a tall challenge if these countries are going to attract a sufficient share of the global tourist market to sustain the forthcoming supply. Each country or Emirate must not only compete globally, but perhaps almost more importantly each must be able to cope with the substantial competition on its own doorstep.

These nations are confident that future demand will be able to sustain their grand ambitions.

It is clear that these nations are confident that future demand will be able to sustain their grand ambitions, driven largely by strong projections for the growth in inbound tourist numbers in

the region. Growth projections in Dubai for example range from a 'cautious' 14 million tourists per year by 2015<sup>6</sup> to a more ambitious 15 million tourists by 2010.<sup>7</sup> Overall tourist numbers across the Middle East are forecast to grow at approximately 6.7% year-on-year between 1995 and 2020 against a world average of 4.1%.<sup>8</sup>

Many cite the quality of infrastructure as a key differentiator in the pace at which this 'emerging' market has been able to grow compared to some other locations and providing world-class transportation facilities is seen as the key to future growth. Ten of the leading Middle East airports will invest a combined USD3.6bn in new airport construction by 2012, providing capacity for an additional 318 million passengers per annum.<sup>9</sup> Dubai Airport is doubling its current capacity with a third terminal and is in the process of building a new airport in Jebel Ali with a potential capacity of 120 million passengers by 2017. Abu Dhabi and Qatar are also constructing mega-capacity airports – with Phase 1 capacities of up to 20 million and 24 million passengers respectively, both of which will double these capacities upon full completion.

The development of so many major airports within such a small catchment area seems to defy all economic logic. In a traditional market environment this could be expected to result in disastrous oversupply. However, as a recent study by the Centre for Asia Pacific Aviation concludes, this may not be the case. The impact of the new generation of long haul carriers with a range of up to 8,000 nautical miles has made the Middle East a 'one stop hop' to almost anywhere in the world, therefore making the 'catchment' area of these airports potentially unlimited.

An inevitable by-product of this role as a global transportation hub is the potential for attracting significant numbers of inbound tourists, given the growing level of traffic 'passing through' the region. The challenge for the tourist market therefore is not to attract visitors to the region in the first place, but rather to increase the average stay duration of these visitors from the one- to three-night stays currently experienced, and encourage visitors to consider the Middle East as an 'end destination' rather than a stop-over point.

6 World Trade and Tourism Council.

7 Dubai Department of Tourism and Commerce.

8 UN World Trade Organisation, Tourism 2020 Vision.

9 Centre for Asia Pacific Aviation.

Another significant driving force in the growth of tourist numbers is the emergence of Low Cost Carriers (LCCs) in the region. This aviation sector experienced 102% year-on-year growth in 2006.<sup>10</sup> Air Arabia, operating out of Sharjah, the neighbouring Emirate to Dubai, was the first low cost carrier launched in the region in 2001. Since its launch, passenger throughput in Sharjah airport has risen from one million passengers in 2002 to over three million in 2006 – impressive when measured against a population in the Emirate of just 750,000. Several others have followed suit across the region, many with similar success stories, and there are more new players to come, with Dubai the most recent Emirate to announce plans for its own LCC.

The emergence of LCCs provides a tool for releasing the huge untapped potential of the intra-regional travel market – which currently represents an average 46% of total tourist numbers, low when compared to Europe where 80% of tourist arrivals are accounted for by intra-European travel. Given the low average age of the Middle East population, it seems inevitable that this sector is on the verge of significant growth.

Key to success will be to differentiate themselves from their immediate neighbours and provide sufficient interest for visitors to both stay longer and return to the same destination again and again.

#### So if they come, which destination will they choose?

Given these characteristics, it is hard to argue against the level of optimism across the region. However, the key to success for a sustained tourist market in each of these countries will be to differentiate themselves from their immediate neighbours and

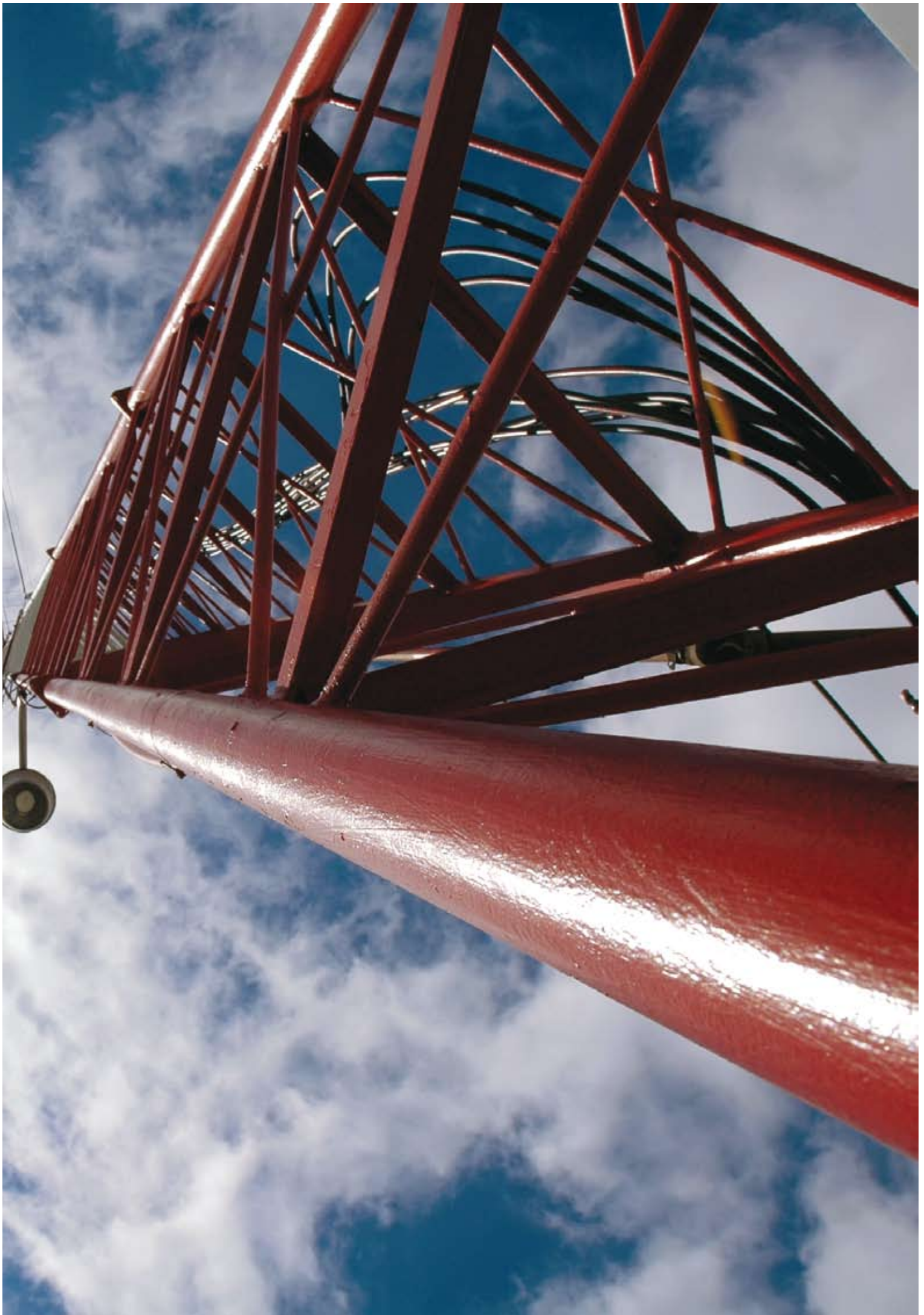
provide sufficient interest for visitors to both stay longer and return to the same destination again and again.

The challenge is to create sufficiently differentiated tourist identities (be it the experienced-based destinations such as those offered in Dubai or the cultural offerings of Abu Dhabi). The hosting of major sporting events is also seen as an important tool to placing destinations on the global tourist radar. Bahrain is currently a stop on the Formula One Grand Prix circuit, and Abu Dhabi is set to join the tour in 2009. Qatar hosted the 2006 Asian Games, and there is talk of both Qatar and Dubai putting forward Olympic bids in the future. Dubai already boasts a number of major sporting events such as the Dubai Gold Cup (the richest horse race in the world), the IRB Dubai Rugby Sevens, ATP & WTA Dubai Duty Free Tennis Championship and PGA Golf's Desert Classic.

If each of these destinations are to realise their potential, they must ensure that they keep an eye on their neighbours and minimise the risk of potentially destructive 'sibling rivalry' through ensuring sufficient local branding and through the preservation of local identities and natural resources. It is also important that each country focuses its 'branding' and market offering upon its target markets, be it Western travellers such as those from the growing Central and Eastern European market, or intra-regional Middle Eastern travellers. Different source markets have different tastes and requirements, and to ignore any one group in favour of another could prove costly.

It is inevitable that not every development in the pipeline will succeed. Several 'big ticket' destinations may well fail to live up to their hype, however it is more likely that this will be as a result of insufficient planning or differentiation and the existence of better offerings in the neighbouring markets than through a lack of overall demand. Whilst significant potential exists for tourist-led real estate development in the Middle East, it will take careful planning both on a strategic and a project by project level to ensure long-term success. What is clear is that if sheer determination and governmental support are enough, the Middle East will firmly establish itself on the map as a major long-term player within the global tourism market.

<sup>10</sup> Centre for Asia Pacific Aviation.



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## Tech corner

### Are you ready for XBRL?

XBRL, or 'eXtensible Business Reporting Language' is rapidly growing as the preferred and, in some cases, the required method of business reporting for companies in diverse industries worldwide. In 2008, it is estimated that over two million companies around the world will report in the XBRL format.

In the United Kingdom, Parliament is requiring that XBRL be used for all future tax filings with HMRC – the Revenue and Customs agency.

**In 2008, over two million companies around the world will report in the XBRL format.**

In Singapore, the Accounting and Corporate Regulatory Authority reconfigured its processes and systems to accept XBRL financial statement filings by listed companies as of 1 November 2007. Singapore's long-term goal is to allow companies to file a single set of financial statements that satisfies the reporting requirement of multiple government agencies such as the Inland Revenue Authority, the Monetary Authority and the Singapore Exchange.

The Netherlands Taxonomy Project (see Figure 1) claims a potential reduction in compliance costs of €350 million annually.

In the United States, the Securities and Exchange Commission (SEC) has achieved significant milestones including a successful voluntary XBRL reporting program for which the market capitalisation of participating companies has exceeded \$2 trillion. Additionally, the SEC transformed its public-company disclosure system, EDGAR, to allow for submission and searching of XBRL data. And in September of 2007 it reached the key milestone for the completion of the XBRL taxonomy and data tags for US generally accepted accounting principles (GAAP).

These examples represent a very small portion of the XBRL initiatives that are currently in progress throughout many government agencies, organisations, and public/private companies worldwide. Figure 1 includes a link to many other examples of XBRL projects.

#### What is XBRL?

The non-technical definition of XBRL is an electronic, open standard (licence fees are not required) for the publishing, exchange, and analysis of business information. XBRL makes it easier to prepare, publish, validate, analyse, and report business information. It allows for a single instance of data entry and then the automatic conversion to various formats. The information can be reliably extracted and analysed across companies with minimal manual intervention.

**XBRL is an electronic, open standard for the publishing, exchange, and analysis of business information.**

The developers of XBRL include a consortium of over 550 companies, organisations and government agencies around the world. Currently, one of the challenges for XBRL market adoption is the design of the taxonomy schemes that describe common reporting concepts, relationships and rules.

**XBRL** can be more technically defined as a combination of the following components:

**XML** – An international general purpose extensible mark up language promulgated by the World Wide Web Consortium. XML technologies form the foundational attributes for XBRL.

**XBRL** – A dialect of XML designed specifically for business information. XBRL is promulgated by international consortia comprising more than 550 organisations from over 27 countries.

**Taxonomy** – The practice of organisation and classification of information into structured categories and relationships. Taxonomies are currently available for the common reporting elements included in IFRS, US GAAP, Basel II, and many others. Taxonomy schemes bring contextual meaning and structure to the elements included in company reports.

The development of taxonomies for business reporting is a collaborative effort including preparers, analysts, consumers and investors. In real estate, the collaboration of organisations and associations such as NAREIT, Green Street, RealComm and OSCRE; accounting and auditing firms; property management and accounting system vendors such as Yardi, MRI, CTI, Timberline, SAP and JD Edwards; and public and private companies will need to unite to build out the real estate industry taxonomy elements most relevant for reporting.

**XBRL Global Ledger Taxonomy** – A taxonomy that has been developed to enable the efficient movement, consolidation, analysis, and reporting of financial and business information from disparate sources such as different accounting systems within an organisation.

**XBRL reduces costs associated with business reporting and creates better market efficiencies for the public at large.**

### What are the benefits of XBRL?

Government agencies can be credited with initiating many XBRL initiatives for the primary purpose of reducing costs associated with business reporting and creating better market efficiencies for the public at large. More specifically, XBRL provides the following benefits:

- Drastically reducing the time and cost required to produce reports;
- Improving the transparency of information relevant for management and investor reporting and decision analysis;
- Increasing the amount of time available for analysis. With no keying of data, analytic models can be automatically populated, thus freeing up time for analysis;
- Improving the quality of reports. Automatic validation and simple verification can ease manual efforts, and increase quality of the reported information;
- Improving access to disparate data stores and the application consistency of business rules thereto.

With XBRL, government agencies will be able to reduce the administrative costs of accepting and validating accuracy of the voluminous reports received each day. Analysts will benefit through more efficient analytical, search and comparison capabilities. Companies filing XBRL reports with government agencies will benefit from being able to report their results more effectively and at a reduced cost.

In addition, within each industry sector XBRL will provide specific benefits.

In the real estate industry, where income-producing properties are purchased and sold in significant volumes, and mergers and acquisitions are common, the advantages of XBRL are numerous. Although XBRL financial reporting will most likely be mandatory in the near future, those real estate companies that quickly embrace and understand the advantages of this technology will more quickly be able to realise many of the benefits of XBRL, such as:

- The ability to obtain and transform real estate industry data into meaningful and useful business intelligence;

- Reducing the cost of due diligence by eliminating the time-consuming task of data entry for analysis of single property or portfolio acquisitions;
- More efficient, timely, and accurate transfer of accounting balances and detailed transaction data from the seller's accounting system to the buyer's accounting system during property acquisitions and dispositions;
- Improved alignment of data for internal reporting purposes, such as property-to-property comparisons of lease income, CAM and management fees;
- Identification and understanding of physical space data and impact on revenue optimisation;
- More efficient and timely analysis of revenue trends and comparison to other properties, markets and external data;
- More in-depth analysis of occupancy data and relationships to incentives and external factors;
- Automation of the aggregation processes of manual spreadsheets such as consolidations, budgeting/forecasting and projections;
- Creation of an internal corporate standard chart of accounts (SCOA) which can enhance transparency across internal data warehouses for improved management access and analysis.

These benefits, as well as the pending mandates for XBRL reporting by many government agencies, should offer clear motivation for real estate companies to begin deepening their understanding and planning for implementation of XBRL in the near future, if not already started.

Figure 1: XBRL References and Additional Information

XBRL Projects Examples	<a href="http://www.xbrl.org/ProjectDetails">http://www.xbrl.org/ProjectDetails</a>
XBRL Products and Services	<a href="http://www.xbrl.org/XBRLinAction">http://www.xbrl.org/XBRLinAction</a>
'Approved' and 'Acknowledged' Taxonomy Schemes	<a href="http://www.xbrl.org/Taxonomies">http://www.xbrl.org/Taxonomies</a>
Securities and Exchange Commission (SEC) – Interactive Data Spotlight page	<a href="http://www.sec.gov/spotlight/xbrl.shtml">http://www.sec.gov/spotlight/xbrl.shtml</a>
SEC Public-Company Disclosure System	<a href="http://www.sec.gov/edgar.shtml">http://www.sec.gov/edgar.shtml</a>
Netherlands Taxonomy Project	<a href="http://www.xbrl-ntp.nl/english">http://www.xbrl-ntp.nl/english</a>

Source: PricewaterhouseCoopers

## What will it take for real estate companies to implement XBRL?

Implementation of XBRL will require an investment of time and capital. The level of investment will depend on each company's accounting and business intelligence (BI) applications, and how XBRL-friendly they are or are planned to be. Currently, many of the leading real estate accounting applications provide the ability to generate financial reports in formats such as paper printout, MS Excel, HTML and XML. Notably, XBRL is not included in this list. However, if you are using a BI application such as Hyperion, Business Objects, or Cognos in addition to your core accounting application(s), then XBRL support most likely is currently available through the BI application.

In addition, many benefits of XBRL GL can be gained today with middleware/mapping tools such as Altova Mapforce which can reach into most databases and map the data to/from XBRL GL. There are also many other XBRL products and services that support data conversions, processing, analysis, tagging, custom taxonomy design (for internal reporting and analysis) and more. See Figure 1 for links to a list of companies providing XBRL products and services.

## Are you ready for XBRL?

The power of XBRL is clear and proven. Real estate companies that adopt this technology will not only be able to take immediate advantage of the many benefits, but will also be prepared to satisfy the XBRL reporting requirements that will increasingly be mandated by regulators and reporting agencies globally.

# Our network

PricewaterhouseCoopers' real estate network comprises highly skilled, experienced professionals including accountants, surveyors, lawyers, analysts, consultants, tax and corporate finance specialists as well as senior executives with hands-on experience at the very top of the industry. We offer in-depth experience in a broad range of financial accounting, auditing and reporting issues, tax advice for transactions, investment fund and carried interest structuring, securitisations, asset due diligence, transaction support, valuation management, corporate finance, M&A and finance-raising.

PricewaterhouseCoopers regularly produces surveys, newsletters and brochures on real estate industry issues as well as hosting a variety of client-focused events.

If you would like receive further copies of this publication or would like more information on the other Real Estate publications listed, please contact Senior Global Marketing Manager Dan Lavis at [dan.lavis@uk.pwc.com](mailto:dan.lavis@uk.pwc.com)

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- Asia Pacific Investment Management/Real Estate (IMRE) Newsletter
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- Emerging Trends in Real Estate® – Europe
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