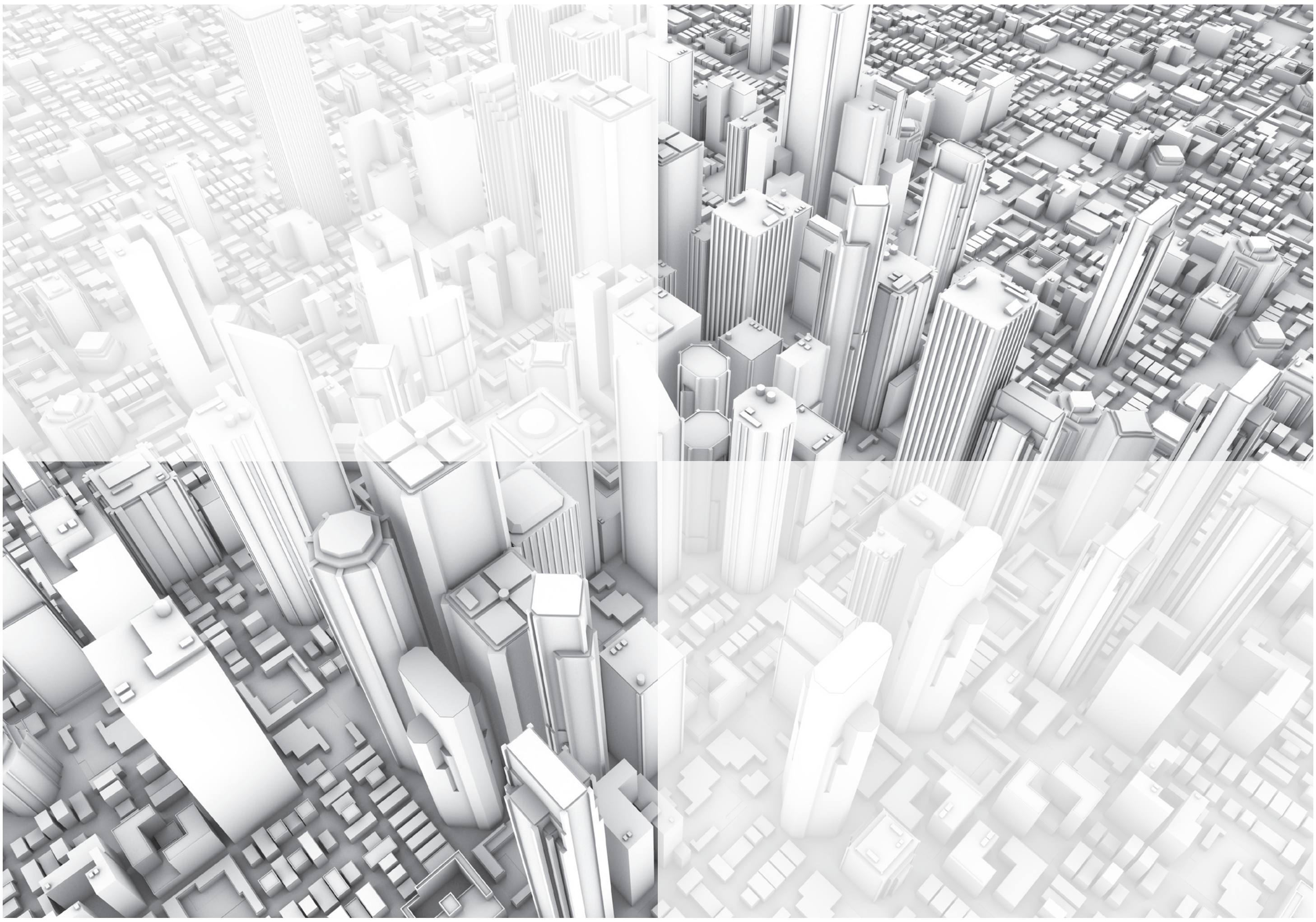
WORLD ECONOMIC FORUM

COMMITTED TO IMPROVING THE STATE OF THE WORLD

Industry Agenda

Real Estate Strategy Meetings and Dialogues 2012 and 2013

Infrastructure & Urban Development Industries



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Introduction

This September, Wall Street observed the fifth anniversary of one of the most spectacular bankruptcies in history. On 15 September 2008, the investment bank Lehman Brothers filed for Chapter 11 bankruptcy protection due to its disastrous sub-prime investment practices. This remains the largest bankruptcy filing in US history, which sent unprecedented financial shocks around the globe. In 2008 alone, the global financial crisis and the collapse of the US housing bubble destroyed over 20% of real net worth of aggregate US private households.

In the midst of the financial crisis, world leaders had to make courageous promises to reform financial regulation. Among prominent examples for financial institution regulation in the US and the European Union are Dodd-Frank, Basel III and the Volcker rule. Many of the regulations still have to be implemented. When executed, they will establish tougher capital standards through more restrictive capital definitions, more rigorous risk-weighted asset requirements, additional capital buffers and stricter minimum capital ratios. As a consequence, the reforms will fundamentally impact profitability and transform the business models of many banks, which in turn will affect their lending practices in the real estate sector to both owners and constructors.

With the implementation of financial regulations, governments will be obligated to more closely monitor financial institutions and invest in early warning systems to better intervene in future bubbles or other financial crises. Regulatory bodies will have to prepare for this role. In the meantime, monetary policies might already be fuelling the next bubble in global real estate markets.

The slow recovery of the US economy in the first two quarters of 2013 currently limits the need for building activity. Gains in employment might help strengthen the economic expansion, but tight land inventories and rising mortgage rates may temper the pace of the industry's recovery. As a consequence, in the past 12 months, US construction spending increased by only 5%. However, consensus among analysts indicates that 2014 will show much improved growth prospects after several years of depressed markets.

01: The Lehman Brothers company sign for Auction after bankruptcy at Christie's. London, UK

Summary

This report summarizes the real-estate-related discussions facilitated by the Forum over the past 12 months and highlights the key takeaways from the sessions.

Through a series of meetings – held in New York on 3 October 2012, Hong Kong SAR on 19 March 2013 and New York on 2 October 2013 – leaders from the Forum's Real Estate Development Industry community identified several pressing issues that could potentially be addressed through a new initiative to be launched at the World Economic Forum Annual Meeting 2014 in Davos-Klosters, Switzerland.

In this year's strategy meeting, the critical issues, risks and trends that the real estate development and investment industries should foresee and address in the coming years were discussed. Furthermore, it was determined how these industries, together with the World Economic Forum, will be able to shape an action plan to address the identified issues.

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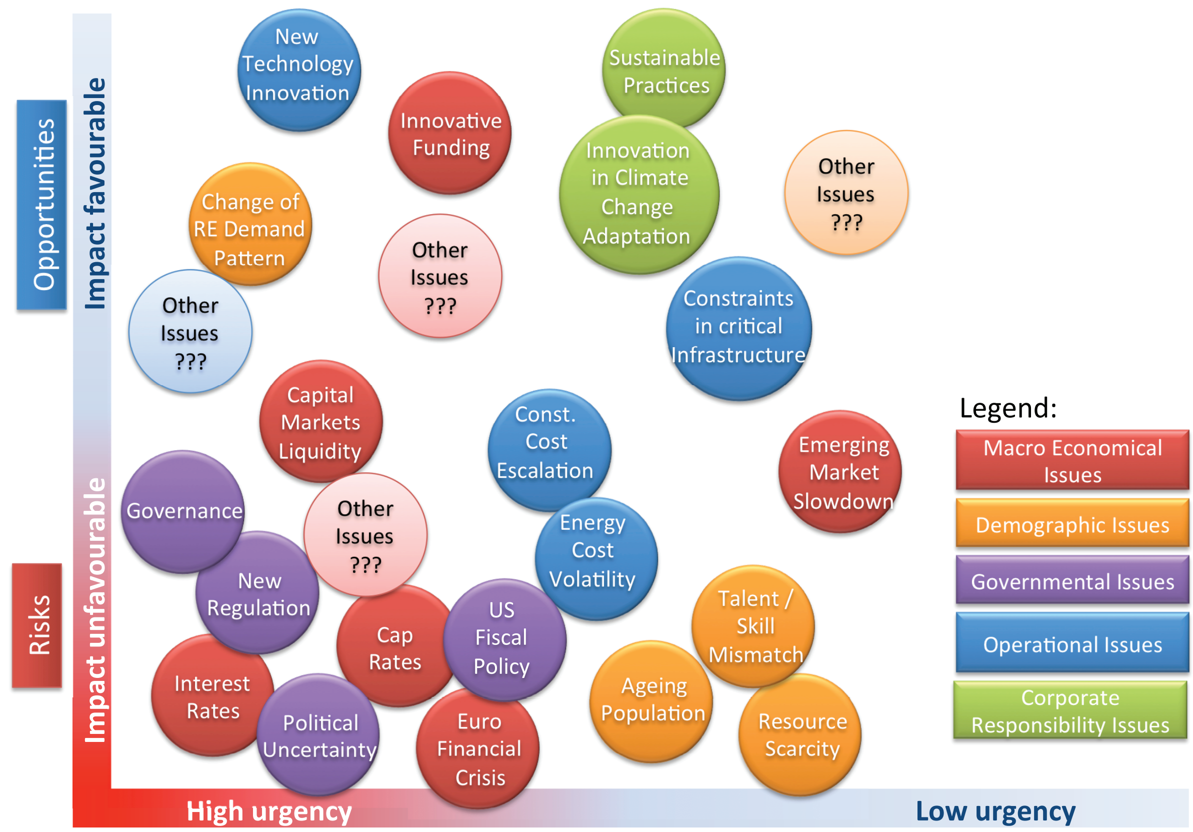

During the most recent real estate strategy meeting, held in New York in October 2013, executives from the real estate industry defined the agenda for a comprehensive multistakeholder initiative. The aim is to have the initiative mandated at the Annual Meeting 2014 in Davos-Klosters. The participants mapped out the role of the Forum and its key stakeholders in preparation for the launch during the Governors Meeting in Davos.

A group of experts described the most relevant risks the industry will be exposed to in the short term, and underlined the advantage of the Forum as a convening platform in addressing them. The participants identified the following key issues, which could be the focus of next year's discussions:

– How can foreign investors and domestic markets overcome the current obstacles in cross-border real estate financing?
– How can innovative financial models and novel financial instruments be applied effectively to enable an integrated infrastructure and real estate funding approach, which could unleash unprecedented growth opportunities?
– How can municipal-level governance in emerging markets be strengthened to better stimulate public infrastructure and, subsequently, real estate investment?

It was confirmed that one of the above topics should be addressed in a comprehensive multistakeholder initiative led by the World Economic Forum.

01: Generic perception map on real estate issues that helped select and prioritize current issues, risk and trends

Key Takeaways from Recent Discussions

Strategy Development for the Real Estate Industry

This year's Industry Partnership Strategy Meeting for Infrastructure & Urban Development was held in New York on 2 October 2013. The meeting was an opportunity for industry experts to provide diverse perspectives and expertise on key topics, with a particular focus on the future agenda of the real estate industry. The following summarizes the key takeaways.

- How can foreign investors and domestic markets overcome the current obstacles in cross-border real estate financing?
  - Currently, there is significant cross-border financing interest in global markets, in particular in North America, Europe, China and India. Cross-border property investment grew more quickly than domestic investment during the period 2000-2013. Experts anticipate a steady annual cross-border real estate acquisition growth in the next three to five years, as Asian investors increasingly diversify abroad. As a consequence, Asia will become a significant source of capital for other parts of the world. Transactions sourced from one region and invested in another already reached record levels in 2013. Much of the money will come from prominent Asian investors, such as sovereign wealth funds, which made property investments in the US or Europe valued at almost US$ 10 billion in 2012. International investors made US$ 8 billion in US commercial property purchases this year through April, a 25% jump[1] from the same period in 2012. Similarly, analysts expect that over the next 12 to 18 months, there will be increased demand from US and European investors in the emerging markets, but with a different risk-return profile: Asian investors are interested in assets with lower risks and moderate yields, while US and European investors are looking for greater returns in emerging markets with slightly higher risks. However, the interested parties do not have enough knowledge on how domestic real estate markets work and on how to best allocate their investments. Formal and informal barriers to international investment are important in determining cross-border real estate capital flows[2]. Formal barriers are prevalent in real estate markets because real estate ownership is regulated, real estate property is taxed and capital controls can be applied to real estate assets as easily as they can to any other asset type. This may leave domestic investors in a better relative position and exclude foreign buyers due to significantly higher transaction costs. Despite the willingness to invest, considering the complexities and barriers, there is presently not sufficient transfer of knowledge to the key potential foreign investors.
- It was proposed that the Forum could facilitate a discussion on cross-border financing in real estate, the current barriers and how to mitigate related risks. Interested stakeholders will include governments and the real estate and financial services and investor industry sectors.
- How can innovative financial models and novel financial instruments be applied effectively to enable an integrated infrastructure and real estate funding approach, which could unleash unprecedented growth opportunities?
- Infrastructure is critical for housing and commercial real estate, e.g. office space and retail space, considering the substantial growth rates of many urban centres in the world. Common practice constitutes a lack of collaboration between the real estate sector, which is predominantly privately funded, and infrastructure, which is commonly publicly funded. But ultimately, real estate has to be linked to infrastructure. Therefore, there should be an inherited need for an integrated planning and financing approach. However, this is currently not the case:
    - Who could and should be in that space?
    - How can capital be put to better play with better use of the current knowledge by applying existing financial instruments in an innovative approach?
  - Specifically, real estate investment trusts (REITs), and infrastructure REITs in particular, are now becoming available across the world, including in emerging markets. The ability of REITs to invest in infrastructure assets provides a great opportunity to invest capital in a tax-efficient manner by acquiring new infrastructure as well as mitigating the growing infrastructure gap due to deferred maintenance. Furthermore, REITs could offer significant advantages over the classical fund model, such as used in conventional public-private partnerships, as a way to raise and distribute capital by providing higher liquidity, easier refinancing, capital market access and a more favourable taxation environment[3]. Moreover, infrastructure companies could explore tapping into the breadth and depth of the REIT capital markets to fuel their growth strategies. The unusual collaboration with real estate developers might enable unprecedented opportunities by providing integrated funding through REITs as well as integrated technical and user-centred solutions for both the real estate and the infrastructure sector.

[1] Bloomberg, "World Chasing US Yield with 25% Deal Jump: Real Estate", Hui-yong Yu and Kathleen Chu, 4 June 2013, 6:00 PM GMT+0200.
[2] Andrew Baum et al., "Understanding the Barriers to Real Estate Investment in Developing Economies", School of Real Estate and Planning, Henley Business School, University of Reading, United Kingdom, 2011.

[3] Deloitte, "REITs and Infrastructure Projects – The Next Investment Frontier?" 2010.

- It was proposed that the Forum could play a convening function that might be interesting for various stakeholders from governments and the real estate, infrastructure and financial services sectors.

- How can municipal-level governance in emerging markets be strengthened to better stimulate public infrastructure and, subsequently, real estate investment?

  - Municipal finance was identified as a key to providing suitable levels of required infrastructure and civil services, which will enable real estate development, in particular in emerging markets. In many regions of Africa and Asia, municipal financing by issuing municipal bonds is not yet developed and sufficiently implemented. Therefore, there is a high demand in these regions for models of municipal finance, in the public sector but also in the private sector. However, many obstacles still have to be addressed. Key governmental institutions such as the judiciary, law enforcement and civil services have not been reformed and strengthened to keep pace with urban and real estate development. But more importantly, the levels of fragmentation, corruption and self-interest among leaders in national, state and local governments are still strikingly high. Structural reforms to strengthen governance in all levels of government are urgently required[4]. In the case of India, governance might be the biggest issue, since the legal framework is in place but successful implementation and effective execution of municipal finance models (e.g. public-private partnerships, municipal bonds) are still a challenge. Despite a series of reforms[5] in the early 2000s that were initiated by the Indian government to strengthen local-level governance, there are still issues of governance at the local level and some important challenges for urban local government institutions in India. These problems relate to the extent of participation and rule of law in the municipal decision-making process, transparency in the planning and implementation of infrastructure projects, and level of efficiency in various municipal management and finance practices.

- Which concrete steps would be necessary to mitigate or resolve the problems caused by municipal-level governance practices in India and in similar emerging markets?

- It was proposed that the Forum could facilitate discussions between the real estate sector and municipal governments to exchange experiences and best practices.

[4] Jason Miks, "Governance in India Is Broken", Cable News Network, 19 August 2013.
[5] Rumi Aijaz, "Chalenges for Urban Local Governments in India", Asia Research Centre (ARC), London School of Economics and Political Science, 2006.

Key Takeaways from Past Discussions

Strategy Development for the Real Estate Industry

Last year's Industry Partnership Strategy Meeting for Infrastructure & Urban Development took place in New York on 3 October 2012. The meeting was an opportunity for stakeholders to discuss key topics, with a focus on the future of real estate in the global economy. The following questions were deliberated:

1. What is the future of real estate financing in light of the economic recession, new regulations, the shifting role of shadow banking and new investment sources, and the changing dynamics of capital flows?

2. How will broader economic, social, political, environmental and technological trends impact the real estate sector in terms of increased pressures, unforeseen challenges and new opportunities?

A key takeaway of the discussions was that traditional banking practices are no longer the backbone of financial markets, since they have been gradually replaced by shadow banking practices (with a turnover of more than US$ 60 trillion in 2011). Shadow banking will become increasingly attractive as the regulation of the traditional banking sector will lead to more conservative lending practices. This effect will be magnified since proposed regulatory reforms will have a limited effect on shadow banking institutions (securitization, hedge funds and REITs). Past experience also shows that proposed regulations will not fully control financial risks, due to information failure, bounded rationality, principal-agent failure and responsibility failures. Therefore, participants concluded that to benefit from a shadow banking market (e.g. low cost of credit, increased liquidity/supply), regulation should also focus on the shadow banking sector and 1) introduce control instruments to implement the appropriate incentives; 2) increase transparency and accountability; and 3) deleverage the shadow banking sector.

Furthermore, the US government's role in the housing finance market and the future of government sponsored enterprises (GSEs) were discussed. The panel acknowledged the main root cause of GSE failure during the sub-prime crisis as the mispricing of mortgage default risk. The session determined that in the next three to five years, certain actions have to be taken on the current structure of GSEs in order to retract their role in lending. Private capital should replace GSE financing by reducing the size of mortgages that can be guaranteed, by shrinking current GSE portfolios, by levelling the playing field between GSEs and private capital through regulation, and by introducing regulatory incentives for private capital (e.g. facilitate covered bonds). Ultimately, three basic outcomes are likely: 1) most likely, GSEs will be liquidated; however, other outcomes could be 2) the reprivatization or 3) the restructuring of the GSEs into a non-profit structure. Several options would be possible to replace or modify GSEs: the politically most viable alternatives could be a) to provide secondary guarantees to private lenders; b) to privatize GSEs, which might have political implications; c) to provide a structured government intervention in crisis times; or d) to restructure GSEs into government utilities in combination with establishing a regulatory framework that would suppress GSEs' profit-making ability.

Real Estate Roundtable

This year's Real Estate Roundtable was held in Hong Kong SAR on 19 March 2013 with the title "New Paradigms of Real Estate and City Development in Asia Pacific". The discussions concentrated on development and uncertainties in global financial markets, which have had a significant impact on Asia Pacific's economic progress. The region's rapid urbanization and changing demographics have also posed unprecedented opportunities and challenges for city planners, policy-makers and industry leaders. Within this broad context, the main objective of the roundtable was to provide a neutral and multistakeholder platform to propose solutions to the following questions:

- What are the trends that will significantly shape real estate developments in Asia Pacific?
- How can the real estate sector and other stakeholders best prepare for these trends?

Key takeaways of the roundtable centred on demographic development, latest trends in Asia, real estate financing and capital markets, real estate innovation (smart cities) and the impact on real estate and urban development. There was consensus among participants that residential and commercial markets in Asia are strong, supported by strong debt capital markets with global demand for high yield providing significant liquidity from banks. However, the economic outlook still remains uncertain and, consequently, it was not clear how sustainable the current positive real estate bond market performance will be.

Real estate development is largely driven by demographic factors in Asia Pacific. Subsequently, developments are very specific to local markets: a) growth in the Philippines is largely driven by the employment markets; and b) Asian emerging cities increasingly start to think about the impact of excessive growth and how to mitigate its negative impacts. The panel identified a need for education in land use practices, particularly for suburbs; c) India tries to capitalize on the growth of their young population to sustain economic growth; whereas d) Japan's mature and slowly growing real estate market is dominated by an ageing population. Discussions also focused on topics around real estate financing and capital markets, including investment flows in and out of Asia.

Acknowledgements

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The Infrastructure & Urban Development Industries community aims to serve as a forward-thinking, valuable and internationally recognized partner for all stakeholders involved in infrastructure and urban development. It shapes the sector's agenda to convene leaders, raise global awareness, conceive frameworks and prepare actionable recommendations in the context of improving the state of the world.

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