FOREIGN DIRECT INVESTMENT IN CHICAGO REAL ESTATE

ARE FOREIGN INVESTORS DIFFERENT FROM DOMESTIC INVESTORS?

by

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Submitted to the Department of Urban Studies and Planning
in Partial Fulfillment of
the Requirements of the Degree of
Master of Science in Real Estate Development

at the
Massachusetts Institute of Technology

July 1987

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During the two month research and production period for this study, over 50 individuals were contacted and interviewed. These interviews were of critical importance and I wish to thank those individuals who shared their time and their knowledge with me. Without their assistance, my work would have been much more difficult.

I would like to extend a special thanks to the National Association of Realtors (NAR) who sponsored this thesis as part of a broader study examining foreign investment patterns in the United States. In particular, I would like to thank Mariam Meyer, Manager - International Operations of the NAR, Fred Flick, Director of Economic Research, and Sean Burns, Economist for their personal time and assistance.

I would like to extend an additional thank you to the faculty and staff at M.I.T.'s Center for Real Estate Development for all of their help and support.
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ABSTRACT

The nature and level of recent foreign equity investment in commercial real estate in Chicago, Illinois was analyzed as one part of a larger study in which the transactions involving foreign investors within three individual markets (Los Angeles, Washington, D.C., and Chicago) are being studied to analyze current foreign direct investment patterns in the United States. This study identifies foreign investors active in the Chicago real estate market and determines if and how the foreign investors in this market differ from domestic investors.

The findings indicate a foreign interest in approximately seven percent of the existing office supply in the Chicago metropolitan area and nearly 10 percent in Chicago's central business district. Although less than comparable estimates in Los Angeles and Washington, D.C., the findings indicate that foreign investors are active in the Chicago real estate market. This participation by foreign investors, especially Japanese investors, is likely to increase in the foreseeable future.

Additional findings include the following: significant differences exist among foreign investors active in the United States; the longer foreign investors are active in U.S. real estate, the more they appear to resemble domestic investors; foreign investors have strong product preferences; some foreign investors are willing to pay a premium for some types of U.S. real estate; foreign investors have a longer term view, foreign investors tend to be more relationship oriented than domestic investors and; foreign investors prefer to structure simple transactions.

Thesis Supervisor: James McKellar
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Chapter 1
INTRODUCTION

PREFACE

Several cities in the United States tend to have a disproportionate share of foreign investment in real estate, most notably major cities on the Atlantic or Pacific coasts such as New York, Washington, D.C., Los Angeles, and San Francisco. Few studies published to date have attempted to analyze why some cities have attracted more foreign investment than others and if there are significant differences in the way that foreign and domestic investors behave within these markets. The focus of this study is to determine the level and the nature of foreign investment activity in one major city that appears to fall outside the sphere of interest of these foreign investors, namely Chicago. Secondarily, this study attempts to determine if foreign investors in the Chicago market behave differently than their domestic counterparts. This investigation is one part of a larger study concurrently being conducted to determine foreign investment activity in commercial real estate and the differences between foreign and domestic investors in three U.S. markets: Chicago, Los Angeles, and Washington D.C.
SUMMARY OF FINDINGS

Significant differences exist among foreign investors currently active in the United States, as is the case with domestic investors. On one level these differences reflect national cultural traits. Japanese investors look for different types of investments than do Dutch investors. For example, Japanese investors are not willing to purchase suburban properties at this time although Dutch investors are. On another level, foreign investors differentiate themselves by investor type. Just as a U.S. pension fund is different than a U.S. syndicator, a foreign pension fund has different investment criteria and preferences than does a foreign syndicator. These differences are more significant than any commonalities that might be used to generalize the form of foreign investment.

The longer foreign investors are active in U.S. real estate, the more they appear to resemble domestic investors. The differences that initially arise between foreign and domestic investors with respect to product preference, location preference, and risk posture tend to diminish over time. As these differences diminish, transactions between foreign and domestic parties begin to more closely resemble those between domestic parties. For example, Dutch
investors are willing to invest in suburban properties. Sources report that when these investors began acquiring U.S. real estate, they were not interested in suburban properties. This is similar to the reluctance of Japanese investors today. Japanese investors have only been major players in U.S. real estate since the early 1980's and are not willing to purchase properties in the suburbs at this time.

Foreign investors of all nationalities and types exhibit a strong preference for downtown, "class A" office properties. Foreign entities have a cultural reference point for downtown office properties. Furthermore, these properties often command international recognition and are perceived by foreign concerns to be less risky than alternative investments.

Some foreign investors are willing to pay a premium price for some types of U.S. real estate, but not for all types of real estate. Not all properties sold to foreign entities are able to command high prices. Those that have historically commanded higher prices are downtown and landmark properties in major U.S. cities that are both well located and substantially leased. Foreign entities will bid lower on other types of properties with which they are culturally unfamiliar or which they perceive to represent a greater risk. Since there is little documented evidence of
foreign purchases of residential, industrial, and suburban properties, one can assume that foreign entities would bid less for such properties since properties are sold to the "highest bidder."

In a recent transaction in Chicago, RREEF purchased a 600,000 square foot downtown office building for $75 million, or $125 per square foot.¹ A foreign investor has recently agreed to purchase a downtown Chicago property for over $250 per square foot which may set the precedent for future investments in the market.

Foreign investors tend to have a longer-term view. In other cultures, holding periods are traditionally longer than they are in the United States and, as a result, there are lower turnover rates. "Mitsubishi Estate Co., Japan's largest owner of real property is said to have never sold a major property in its 50-year history."² Furthermore, foreign entities consider the United States a safe haven for capital and are interested in investing their capital in this country for a longer period of time for capital preservation purposes.

Foreign investors tend to be more relationship-oriented than domestic investors. They tend to establish long-term relationships and generally would prefer to deal directly without the use of intermediaries. However, since they are
unfamiliar with the United States and with the ways of doing business, they like to align themselves first with an intermediary who can aid them in their search for investments and provide them assistance in negotiating with domestic parties. This is the basis for what often is an on-going relationship. With the exception of some of the larger domestic insurance companies, who often deal time after time with the same domestic real estate firms, domestic firms tend to be more transaction-oriented than foreign investors and do not depend heavily on relationships with investment advisors.

Foreign investors tend to structure simpler transactions, by American standards, on their purchases because of the structures with which they are culturally familiar, usually all-debt or all-equity. What often results are all-cash purchases and straightforward deal structures. For example, "investment vehicles, such as limited or general partnerships, do not exist [in Japan] and Japanese laws concerning similar Japanese entities are not well developed...Real estate deals are almost never financed on a non-recourse basis and the concept of the convertible mortgage is unknown in the domestic context."³

Chicago is not currently a first choice for foreign investment and most foreign entities who have invested in this market have been active in other markets in the United
States prior to pursuing investment opportunities in Chicago. Foreign investment (excluding Canadian investment) in existing office space in the Chicago metropolitan area since the beginning of the decade amounts to roughly seven percent of total office space in that metropolitan area. In Los Angeles, foreign investment comprises 51 percent of office space in the central business district, and in Washington, D.C., foreign investment accounts for 12 percent of the supply of office space.⁴,⁵

Foreign investors are likely to be more willing in the future to invest in Chicago properties. Foreign investors in this market tend to favor downtown office buildings although there are examples of foreign investment in both suburban office properties and regional malls. As opportunities in other popular foreign investment markets become saturated, as prices in these markets continue to increase, as foreign portfolios of U.S. real estate grow in size, as familiarity with the Chicago market increases and, as the Chicago market begins to show signs of recovery from the current trend of overbuilding, it is expected that foreign investment in this market will increase.

The Japanese are beginning to feel more comfortable with Chicago. This indicates a likely increase in their purchases in this market. In 1986, two projects were announced involving Japanese investment in Chicago. One
transaction involved debt only. As of July, 1987, 10 additional projects have been identified representing Japanese direct investment in downtown Chicago. Foreign investment advisors and local brokers have also indicated that the Japanese are actively studying the Chicago market and seeking investment opportunities in the Chicago area.

There are opportunities for Chicago real estate professionals desiring to tap foreign sources of capital in this market. Specifically, there are opportunities for developers, management firms, leasing agents, brokers, and lawyers to interface with foreign interests in foreign investment transactions in the Chicago area to generate fee income from leasing and management of foreign owned properties, to arrange favorable project financing, to participate in joint venture arrangements with foreign entities, to sell properties, or to act as an intermediary between domestic sellers and foreign buyers of Chicago real estate.

DEFINITIONS AND ASSUMPTIONS

Foreign direct investment in this study includes only commercial property transactions in which the foreign entity involved has an equity investment. For the purpose of this analysis, debt having the characteristics of equity is also assumed to be an equity investment (i.e. participating or
Although Canadian investors have historically been and continue to be quite active in property ownership and development in the Chicago real estate market, preliminary research indicates that Canadian firms are virtually indistinguishable from domestic firms due to the length of time that they have been active in U.S. real estate, their proximity to the United States, as well as their long standing affiliations with U.S. real estate firms. Therefore, this study focuses on non-North American investors. This is not to imply that Canadian equity investments are not a significant force in the Chicago market, but due to the limited time frame in which this study was conducted, they have been excluded from the research and analysis.

METHODOLOGY AND ORGANIZATION

The analysis of foreign direct investment in Chicago uses a case-study approach based on personal interviews, on-site whenever possible. Initially, a sample of 26 transactions involving foreign entities that have taken place in the Chicago market were identified through contacts in the area. After identifying these specific transactions, the American and foreign principals involved in these transactions, the intermediaries associated with both
parties to the deal, the prominent real estate professionals involved on a local, Chicago level, and those involved in real estate on a national level were interviewed when possible at length. Over 50 people were contacted in Chicago and in New York City by phone and in person. Using these cases and the related interviews, the relative level and nature of foreign investment activity in Chicago as well as the perceived differences in foreign investment behavior in the Chicago market were then deduced and analyzed.

As background, Chapter Two briefly summarizes and discusses foreign investment activity of all types in the United States.

Chapter Three introduces Chicago from a demographic, economic, and a real estate perspective, both historically and currently. It discusses the attraction of Chicago for any investor, foreign or domestic, and compares Chicago with other major cities in the country.

In addition to summarizing general foreign strategies and objectives for U.S. real estate investment, Chapter Four describes the foreign perception of the Chicago market, specifically why certain foreign entities decided to invest in this market.

After identifying general perceptions and strategies, Chapter Five offers summary descriptions of four transactions that have been closed in Chicago over the past
several years that have involved foreign investors of different nationalities and types. Three pending transactions are also briefly discussed. This chapter presents the fundamental aspects of the transactions including the parties involved, the property description, and the deal structure. These four cases and the descriptions of the pending transactions highlight the diversity of deals are currently being negotiated or that that have been transacted over the past several years in this market.

Americans often assume that foreign investors are different from domestic investors. Identifying and understanding these differences, when they occur, are important for U.S. real estate professionals seeking to work with foreign investors. Different cultures have different preferences for product types, geographic regions, and deal structures. Different cultures also behave differently with respect to how they make decisions and what they are willing to pay for U.S. real estate. Chapter Six addresses, from a domestic perspective, how foreign investors are perceived to be different from domestic investors in Chicago.

The final chapter offers analysis and conclusions of the current foreign investment activity in Chicago, highlights foreign investment trends and projections for this city, and speculates on the opportunities created for
real estate professionals in this market to tap foreign sources of capital.

LIMITATIONS OF THE RESEARCH

The field research was affected by severely constrained time limitations, the reticence of field sources to divulge information and provide specific facts on particular transactions and, the continued reliance on often broad and general opinions without the benefit of corroborating facts.

This paper was researched and produced over a two-month period. Unfortunately, with such a limited time to cover a broad subject, one can barely scratch the surface of foreign investment in a market the size of Chicago. Therefore, the work must be seen as a starting point with more fieldwork required as a basis for more definitive conclusions.

In addition to the time limitation, information was hard to assemble because of the difficulties in gathering the data for this study. This seemed to be a problem endemic to Chicago and not encountered by other researchers in similar investigations in Washington, D.C. and Los Angeles. From the outset, there were difficulties in identifying property owned by foreign entities in the Chicago area because of an Illinois state law that in essence protects the anonymity of property owners and the methods by which they own property. Protecting
The confidentiality of real estate transactions seems to be a preoccupation of many companies and individuals in the Chicago market. Furthermore, information was often difficult to obtain from the advisors of foreign investors because of the confidentiality of the fiduciary relationship between advisors and their clients. Additionally, one Chicago real estate professional suggested that the owners of property in Chicago deliberately try to keep a low profile, and there is often a long chain of intermediaries involved that further disguises ownership of property. Beyond that, no clear reason was given for this apparent obsession with anonymity.

This inability to access market information was not solely a problem of this researcher. A prominent international investment advisor has encountered similar difficulties in gathering data in Chicago as is illustrated by the following excerpt from a recent marketing study. "Tracking major office building transactions in Chicago is difficult because of the confidential nature of most deals and also because the trust structure in the state of Illinois limits the availability of information concerning building ownership."\(^6\)

Subsequent to identifying foreign-owned properties in Chicago, there was often reluctance on the part of those involved to divulge specific information regarding the
transactions. It was also difficult to speak with "both sides" of any given transaction. Many of the foreign investors active in the Chicago market do not have offices in the city nor do many maintain U.S. offices. Therefore, much of the information on foreign perspectives and strategies came out of conversations with international advisors representing foreign clients. Whereas difficulties such as these did exist to some extent in the other markets being studied, they did not exist to the extent that they did in Chicago.

Limited information on foreign investment in Chicago is also partially due to the lack of such investment as compared to other U.S. cities like New York, San Francisco, Los Angeles, and Washington, D.C. In the related studies that assess foreign investment activity in the Los Angeles and Washington, D.C. markets, 27 transactions involving foreign equity investment were identified in the Los Angeles central business district, which has 28 million square feet of space, and 70 such transactions were identified in Washington, D.C.'s 58 million square foot CBD. In Chicago's CBD, which has over 95 million square feet of space, there were 19 transactions identified involving foreign investors.

In many instances, the parties involved in the transactions with foreign investors were not comfortable
giving out information. In comparison to other markets, Chicago real estate professionals seem to be more guarded in disclosing market information. Whereas there were many professionals in the Chicago market who were very helpful and informative, there were equally as many who declined to discuss specific transactions. This characterization of the Chicago market is surprising given that the real estate industry relies so heavily on the free exchange of information. A guarded climate could account, in part, for the lower level of interest by foreign investors in the Chicago market.
Chapter One

Endnotes


3 Ibid, 3.


7 Smith and Whalen.

5 Hodge and Roberts.
Chapter Two
AN OVERVIEW OF FOREIGN INVESTMENT IN THE U.S.

FOREIGN INVESTMENT IN THE UNITED STATES

There has been an increasing amount of foreign investment activity in the United States. Each year over the past several years, annual foreign investment has exceeded the previous year's investment. Foreign investment in the United States is traditionally categorized as either portfolio investment or direct investment. Portfolio investments represent approximately 75 percent of total foreign investment in this country and include investments in various financial assets such as stocks and bonds, mortgage related securities, and deposits in U.S. banks. The U.S. Department of Commerce estimates that foreign entities invested $750.9 billion in U.S. portfolio investments in 1985.¹

According to U.S. Commerce Department statistics, nearly 52 percent of foreign portfolio investments in the United States are made by the western Europeans, the largest source of foreign portfolio investments in this country.² Ranked second largest in dollar volume of portfolio investments in 1985 are the Japanese. Sean Burns, a research economist with the Forecasting and Policy Analysis
Division of the National Association of Realtors, explains, "The Japanese contribution alone is $30.5 billion. This represents 25 cents of every dollar in foreign portfolio investment in the United States."\(^3\) Exhibit 1 identifies the portfolio investment according to the nationality of the investor.

The other general classification of foreign investment, contributing 25 percent to the total foreign investment in the United States, is direct investment.\(^4\) According to the U.S. Commerce Department, foreign direct investment is defined as "the direct or indirect ownership by a foreign entity of 10 percent or more of the voting securities of an incorporated business enterprise, and a 10 percent or more interest in real property."\(^5\)

Foreign direct investment is difficult to estimate due to the nature of reporting requirements in the United States. For example, investments are often reported at book value which disguises the market value of these investments and other estimates rely on information from published articles.

1985 Commerce Department estimates attribute $183 billion to foreign direct investment in 1985, an 11 percent increase from 1984 investments.\(^6\) Exhibit 2 identifies the amount of foreign direct investment according to the nationality of the investor.
FOREIGN INVESTMENT IN U.S. REAL ESTATE

Based on U.S. Commerce Department statistics, in 1980, foreign investors of all types and nationalities purchased $3.5 billion worth of U.S. real estate. Using U.S. Commerce Department estimates, 1985 foreign direct investments in U.S. real estate ($18.6 billion) represent approximately 10 percent of total 1985 foreign direct investments in the U.S. According to estimates from Salomon Brothers, Inc., compared to domestic investment in U.S. real estate, foreign investment accounts for "slightly over one percent of the total value of all developed real estate in the United States. Hence, the total impact of foreign investment in U.S. real estate is still relatively small in comparison with the overall size of the market." Amounting to $18.6 billion in 1985, direct foreign investment in real estate represents approximately two percent of the total foreign investment in the United States in this year. Total foreign investment includes the $750.9 billion invested in portfolio instruments and the $183 billion directly invested by foreign entities in the United States in 1985.

Of all of the foreign investors who own property in the United States, investors from Great Britain and the Netherlands have invested the most capital on an annual basis as Exhibit 3 illustrates. In the past several years
the Japanese have increased their investments in the U.S. dramatically.\textsuperscript{10} Much has been written about Japanese investment in the past twelve months, and their acquisitions of highly visible properties have drawn much press coverage. However, Japanese investors were not major players in U.S. real estate until the beginning of the 1980's and have approached this country cautiously. Judging from the number of transactions and the dollar amount of their purchases, Japanese investors are definitely becoming increasingly prominent actors in the U.S. real estate market. Japanese investments in the United States have at least doubled from 1985 to 1986, and it is estimated that the Japanese invested between $2.5 and $3 billion in U.S. real estate in 1986.\textsuperscript{11} Japanese investment is expected to double again in 1987, during which time Japanese investors are expected to purchase an additional $5 to $6 billion in U.S. properties.\textsuperscript{12} Exhibit 4 illustrates annual Japanese real estate investment in the United States since 1980.

Although much recent attention has focused on the Japanese, it is important to remember that they are still new players in the U.S. real estate market. Furthermore, in annual investment and in total dollar volume, Japanese investment has yet to surpass that of English and Dutch investors. In 1985, Japanese investment slightly exceeded one billion dollars. English investments in U.S. real
estate totaled $4.6 billion in 1985 while Dutch investment totaled $2.3 billion during this same period. However, preliminary estimates for 1986 indicate that Japanese investors will surpass both the Dutch and the English in acquisitions of U.S. property this year, making the Japanese, the largest source of foreign investment in U.S. real estate in a given year. Exhibit 5 compares the percentage of foreign investment in U.S. properties according to the nationality of the investor in 1980 and 1986.

WHAT MAKES REAL ESTATE AN ATTRACTIVE INVESTMENT FOR FOREIGNERS?

There are numerous published articles and reports speculating why U.S. real estate is an attractive investment for foreigners. Reasons consistently cited in these articles include:

*Exchange Rate Differentials. A weak U.S. dollar, compared to foreign currencies, increases foreign purchasing power enabling investors to get more product for their currency.

*Lack of Domestic Investment Opportunities. Foreign countries, including Japan, The Netherlands, Germany, and England, have few domestic real estate investment opportunities. This is caused by the unavailability of
product and the scarcity of developable land. For cultural reasons, property owners in foreign countries hold properties for longer periods of time than is common in the United States. As a result, the turnover rate for investment grade properties is low in foreign countries thus limiting investment opportunities.

*Tax Advantages. The United States offers lower tax rates than many foreign countries, with the exception of Japan. This reduced rate can increase overall returns, however measured, in U.S. real estate investments.

*Higher Yields. In many foreign countries yields on real estate investments are lower than yields derived from equity investment in U.S. real estate. In the United States, owners of real estate can often capture yields between 8 percent and 10 percent. According to analysts at Jones Lang Wooten, yields in London average between 4 to 5.5 percent, in the Netherlands 6 to 6.75 percent, and in Frankfort 5 percent. Clearly, sustained yields in excess of those found in home markets would attract foreign investors.

*The United States Trade Deficit. The United States currently exports more than it imports which gives foreigners U.S. dollars to spend. Trade surpluses coupled with the lack of domestic investment opportunity and the desire to preserve capital encourages foreign investment
outside their countries. According to Arthur Mitchell, a partner in the New York law firm Coudert Brothers, "Last year [1986] Japan registered a $51 billion trade surplus with the United States alone."\footnote{17}

*The Political and Economic Stability of the United States.* The United States is considered by foreign investors to be among the safest political and economic havens in the capitalistic world; it is as a safe place to invest and preserve capital for the long term.

*Portfolio Diversification.* Investment in U.S. real estate is often used as a portfolio diversification strategy for foreign investors for many of the same reasons appealing domestic investors. The size of the U.S. real estate market, the largest in the free world, and the variety of investment opportunities available within individual U.S. markets provide ample diversification alternatives for foreign and domestic investors.

*Globalization of the world's financial Markets.*

This consists of the merger of the world's financial and capital markets into a single global capital market... Differential rates of deregulation in major nations, plus differences in the initial traits of their financial markets have created large discontinuities and anomalies in the process of merging these markets. These discontinuities are generating many arbitrage possibilities... The recent flow of foreign capital into U.S. real estate is part of such arbitraging.\footnote{18}
From the statistics, it appears that foreign investment of all kinds in the U.S. is significant in dollar amount and is increasing in volume annually. However, relative to the overall size of the U.S. real estate market, foreign direct investment in real estate accounts for less than one percent. Foreign investment in Chicago is an even smaller component of total foreign investment in the United States and of total foreign investment in real estate. Before specifically analyzing foreign investment in Chicago, it is necessary to understand the fundamentals of this market and its attraction to investors.
Chapter Two
Endnotes

1 Sean Burns, "The Contribution of Foreign Portfolio and Direct Investment to the U.S. Housing Market in 1986," (January 1987).

2 Ibid.


4 Burns, "The Contribution of Foreign Portfolio and Direct Investment to the U.S. Housing Market in 1986."

5 Ibid.

6 Ibid.


8 Burns. "The Contribution of Foreign Portfolio and Direct Investment to the U.S. Housing Market."


10 Tsui, "Japan: The Land Rush."


14 Tsui, "Japan: The Land Rush."

15 Downs, "Foreign Capital in U.S. Real Estate."


Chapter Three

CHICAGO: AN OVERVIEW

Chicago is often referred to as the "Windy City" and "The City of Big Shoulders." Chicago is remembered for such things as the 1871 Chicago Fire, the world's tallest building - the Sears Tower, the antics of gangster Al Capone, and "signature" architecture.\(^1\) Prior to 1987 when Atlanta's airport volume exceeded that of Chicago's, O'Hare International airport had the distinction of being the busiest airport in the world.

There is far more to Chicago than this. Chicago officially became a city on March 4, 1837, and its economy has substantially grown and changed in its 150 year history. Chicago is and has been for some time the commercial and financial center for the midwest region of the United States. As early as the 1850's, Chicago was known as the commercial center for manufacturing and transportation in the nation's midsection. In 1849, the Chicago Board of Trade was founded adding a new aspect of commerce to the city.\(^2\) The volume of contracts traded on the Chicago Board of Trade reached a record high in 1985. This volume was more than the combined volume of the next three futures exchanges - the Chicago Mercantile Exchange, the Commodity Exchange of New York, and the New York Mercantile Exchange.\(^3\)
Chicago is also home to the Midwest Stock Exchange which is the second largest stock exchange in the nation.4

CHICAGO DEMOGRAPHICS AND SIZE

Following New York, whose 1985 population was estimated at 8.4 million, and Los Angeles, whose population was estimated at 8.1 million in this same year, Chicago is ranked the third largest metropolitan area in the United States with an estimated 7.3 residents in 1985.5 According to an analyst at Landau and Associates, although it is less than 2 percent per year and affected by the tremendous migration from the "rust belt" to the sunbelt, Chicago's population growth in the last decade [1970-1982] has outpaced that of all major cities in the north and central regions of the United States.

Chicago is situated on Lake Michigan and covers 4,654 square miles.6 Since approximately half of this land is undeveloped, future expansion of the area has few physical limitations other than Lake Michigan to the east.

According to census data, the median age of Chicagoans is 29.8 years, younger than the national average of 30.3 years. In 1985, the median household income in the city of Chicago was estimated from census data to be $19,667.7
CHICAGO'S CHANGING ECONOMY

As in many northern urban areas at the turn of the century, Chicago's economy rested upon manufacturing and industry. However, in many of these cities, Chicago included, the economic groundwork has shifted to the service industries over the past decade.

More than a century ago, Chicago was perhaps best known for its shipping services. Having the advantage of being located in the center of the nation, the city was a distribution point linking the East to the West. As a transportation hub, Chicago has always prided itself on its network of transportation facilities. According to the Investment Research division of Jones Lang Wooten, "to transport products across the continent, the city possesses a network of airports, railroads, waterways, and expressways that carry more passengers and cargo annually than any other location in North or South America." 8

Well before the turn of the century, Chicago became known for industries such as meatpacking, manufacturing, and steel making. Chicago was also a metropolis for agriculture as well as the center for agricultural machinery. 9 By the 1960's, Chicago's economic base was comprised of industries such as metals, electric machinery, food processing, nonelectrical machinery, fabricated metal products, chemical and allied products, and printing and publishing. 10 In 1987,
Chicago continues to be ranked number one in gross manufacturing sales in the nation.\textsuperscript{11}

In the last decade, Chicago has experienced a dramatic loss of manufacturing jobs. Both the steel-making industry and the surrounding agricultural farms in the Midwest have experienced troubled times. "The metropolitan area has lost 28,100 manufacturing jobs since 1984, but has made up for this with gains in the wholesale/retail sector and in service employment."\textsuperscript{12} During this same time period, service sector employment in the Chicago metropolitan area has increased. This sector currently provides 75\% of all jobs in Chicago according to estimates by Landaur and Associates. Although this sector of the economy is expected to continue to grow, this growth rate is diminishing slightly.\textsuperscript{13}

Not only has Chicago's economy been transformed from one which was traditionally based on manufacturing to one that now is primarily a service center, Chicago is also becoming better known as an international city and has recently been aggressively marketing itself to international firms.\textsuperscript{14} In addition to being home to almost 80 Fortune 500 companies,\textsuperscript{15} it is estimated by an analyst at Collins Tuttle that Chicago is now home to nearly 90 of the top 100 banks in the world. Jones Lang Wooten's \textit{Downtown Chicago Office Market Report} indicates that:

"The city's financial sector is based on banking
and trade and has been rapidly expanding its international scope. Commercial bank deposits rose 13.8 percent over the past year [1985] to reach more than $11.0 billion, making Chicago one of the largest banking centers in the world...In turn, many foreign banks have opened branches in Chicago. The presence of Japanese financial institutions is most pronounced with 16 branches in Chicago, followed by Canada with 8, France with 7, Italy with 6, Great Britain with 5 and West Germany with 4.16

With global banking an emerging trend, Chicago is well situated to take advantage of these opportunities and to expand its financial services to the region. Considering its broad and diverse economy and its wide financial, trade, and manufacturing base, Chicago provides a good location for both domestic and international firms. According to Neil Bluhm, president of JMB Realty, "Chicago has become a magnet for foreign companies...The city is dealing with an increasingly sophisticated marketplace."17

In addition to finance, trade, and manufacturing, Chicago is also nationally recognized for its retail activity. In 1985, Chicago recorded $41.7 million in retail sales and was ranked second behind Los Angeles, with recorded retail sales of $51 million and ahead of New York City, with retail sales valued at $41.4 million.18
THE REAL ESTATE MARKET IN CHICAGO

According to sources close to the market, over 13 million square feet of new office space was constructed in Chicago during 1986. At the end of the first half of 1987, the total office supply in the Chicago metropolitan area was near 160.5 million square feet, making the Chicago metropolitan area the third largest office market in the country behind New York and Los Angeles whose metropolitan office markets contain 429 and 282 million square feet of space respectively. According to the Chicago Association of Commerce and Industry, "data indicate the total value of the Chicago area's real estate was more than $200 billion, trailing only Los Angeles and New York."

According to real estate professionals active in the Chicago market, vacancy rates are averaging close to 12 percent in downtown Chicago. In the Chicago suburbs, the vacancy rate is substantially higher, reaching almost 20 percent. "The downtown Chicago vacancy rate has remained below the national average over the past decade and fluctuations in the vacancy rate over this period compare very well with the trends experienced by most other U.S. cities." With the amount of current construction activity, national and local real estate analysts expect vacancy rates to continue to rise further as more projects are completed. Exhibit 6 illustrates vacancy trends in the Chicago office
Real estate brokers and analysts in Chicago report that asking rents in downtown Chicago range from $24.00 to $30.00 per square foot, net of taxes and operating expenses, for newly constructed class A office space. This compares to asking rents of $22.00 to $25.00 in Los Angeles. Rents in New York City are reported to be $50.00 per square foot and increasing. One project in Washington, D.C. was asking $45.00 per square foot although this is unusual in this market. Rents in Washington, D.C. approximate those of Chicago. Effective net rents in Chicago's central business district generally average $16.00 to $18.00 per square foot, a 20 to 30 percent reduction of the quoted rents.21 As in other overbuilt markets across the United States, concessions are common. According to an analyst at Landaur and Associates, "the lease concession package today can include as much as 2 years free rent on a 10-year lease, $35.00 per square foot tenant build-out above building standard, and buyout of an existing lease, or other cash payment to tenant."

Industry professionals estimate the absorption of office space in Chicago to be close to 2.5 million square feet per year.22 According to a study recently conducted at MIT, America's Office Needs 1985-1995, it will require 4.3 years to absorb the vacant space in the Chicago market.23
Construction activity has been brisk in the Chicago area. According to a report jointly published by the Center for Urban Affairs and Policy Research at Northwestern University and the Chicago Department of Planning, *Downtown Development: Chicago 1985-1986*, during the last five years, in excess of 20 million square feet of both new and renovated space was completed in Chicago. According to this same report, there are currently nine million square feet of space under construction, and "during 1985-1986, $2.2 billion was invested in 148 new, adaptive re-use, or renovation projects that were (or about to be) completed within a growing downtown." Exhibit 7 illustrates inventory, construction and renovation, absorption and vacancy trends in the Chicago downtown market since 1984.

According to an office market study conducted by Jones Lang Wooten, "Chicago, America's third largest urban metropolis, lies at the cross-roads of the country. For well over a century, it has been a transfer point for transcontinental goods and travelers, as well as the industrial, agricultural and transportation center of the American Midwest. It has also become, in more recent years, the country's leading center for finance and trading in Midwestern commodities." From a real estate investment perspective, Chicago is
an attractive market. It is the third largest city in the United States, it is the third largest office market in the country, it is ranked first in gross manufacturing sales, second in retail sales and has active stock and commodity exchanges. There is also a major financial presence in Chicago.

As are other real estate markets in the United States, Chicago is overbuilt and vacancy rates are expected to climb further in the years to come. With few physical or artificial restraints on the supply of space, the market has the potential to become more overbuilt than it currently is.

According to real estate advisors, foreign investors initially assimilate and thoroughly examine fundamental demographic, economic, and real estate trends in a market prior to any site specific investment analysis. Whereas the preliminary analysis may indicate that Chicago is a healthy and attractive market for investment, it is necessary to go beyond these factors and determine on what basis foreign investors enter this market.
Chapter Three

Endnotes

2 Ibid, 18.
3 "Chicago Board of Trade: History Made during Another Year for CBOT," Commerce, 84, (April 1987), 77.
5 The Chicago Association of Commerce and Industry, "The New Chicago."
6 The Chicago Association of Commerce and Industry, "Why Locate in Chicago?"
7 Landaur and Associates.
8 Jones Lang Wooten Investment Research, 1.
9 Heise, 20.
12 Jones Lang Wooten Investment Research, 3.
15 Ibid.
16 Jones Lang Wooten Investment Research, 6.
17 Jensen, "Chicago's International Flavor."
18 The Chicago Association of Commerce and Industry, "The New Chicago."


20 Jones Lang Wooten Investment Research, 14.

21 Ibid, 17.

22 Ibid.


24 Mary K. Ludgin and Louis H. Masotti, Downtown Development (Chicago: Center for Urban Affairs, Northwestern University and The Department of Planning, City of Chicago, 1986), xvii.

25 Jones Lang Wooten Investment Research, 1.
Chapter Four

WHY CHICAGO?

PERCEPTIONS AND STRATEGIES

WHY THE U.S.?

Deciding to invest in Chicago is one part of a broader strategy to invest in the United States. As was briefly mentioned in Chapter Two, there are several macro-economic reasons why foreign investors choose to place large sums of capital, which totaled $18.4 billion in 1985 according to Commerce Department statistics, in U.S. real estate.

To summarize, these macro-economic factors influencing foreign investment activity in the United States include: (1) the diverse U.S. economy, (2) the exchange rate disparities, (3) the lack of investment opportunities in foreign real estate markets, (4) the higher yields often obtained by investing in U.S. real estate compared to alternative real estate investments in other countries, (5) the political and economic stability of the United States, and (6) the size and diversity of the U.S. real estate market which presents opportunities to foreign investors to satisfy their portfolio diversification objectives.

The importance of these various reasons for foreign investment in U.S. real estate varies not only according to the nationality of the investor, but also according to the
investor type. Beyond these macro-economic conditions that make U.S. real estate investment appealing to foreign investors, there are a multitude of investment opportunities in the United States from which investors must choose. A fundamental decision that these off-shore investors must contemplate is: In what city should this investment take place?

WHY CHICAGO?

According to several international real estate advisors, foreign investors initially study the entire United States carefully and cautiously making comparisons between the different regions and major cities within these regions prior to targeting certain cities for investment. Although current patterns of investment do not seem to bear out this kind of analysis because more than market facts influence where to invest, these advisors feel that foreign investors try to get an overall feel for the United States before formulating overall investment strategies and pursuing specific investments. Given that the acquisition of U.S. real estate is an attractive investment vehicle for foreign capital, there are clearly some U.S. cities that seem to be more appealing to foreign investors than others given the large amount of investment activity generated in these cities. For example, rough estimates indicate that
foreign equity investment represents 51 percent of the office space in the Los Angeles central business district, and that foreign equity investment represents 12 percent of the Washington, D.C. central business district. Exhibit 8 identifies the regions of the United States that have been primary investment choices for foreign investors.

Until recently, foreign investment has been primarily bi-coastal; that is, concentrated in major metropolitan areas on both coasts of the United States. The author knows of no studies to date that have determined the dollar amount of foreign investment in Chicago or any studies that have compiled a list of transactions involving foreign investors in this market. Rough estimates from the Chicago Association of Commerce and Industry speculate that foreign investment in Chicago could be as much as 15 percent ($900 million) of the $6 billion in total 1985 investment in new buildings.

Using the property data gathered for this study, out of 160.5 million square feet of office space in the Chicago metropolitan area, almost 11 million square feet, or slightly over seven percent, of existing office property can be attributed to foreign equity investment. In the Chicago central business district, there is evidence of foreign investment in approximately 10 percent of the existing supply of office space. These are very crude estimates due
to the time limitations of the study and to the limited amount of data that was available because of the limitations discussed in Chapter One. No attempt was made to statistically verify the results. There is no doubt these estimates would be greater if Canadian investment had been included. Square footage was not available for all of the projects identified. In such cases, an average of 500,000 square feet was substituted for the actual square footage. Furthermore, the estimate does not reflect partial interests retained by domestic joint venture partners since most often the percentage of partial interests was not known.

The absolute accuracy of the number is not as significant as its relative importance. Whereas estimates indicate that foreign investment in the Chicago metropolitan area is less than that in Washington, D.C. or in Los Angeles, these estimates do indicate the presence of foreign investors in the Chicago market. There is no doubt that there are additional properties owned wholly or partially by foreign investors that have been overlooked.

There are additional problems in estimating equity investment. It is very difficult to track capital flows. Although on the surface, there appears to be a prevalence of transactions involving all-cash purchases in Chicago, there is no way to determine if these properties have been financed either overseas or domestically subsequent to the
According to those interviewed, foreign investors choose to invest in Chicago properties for many of the same reasons that they choose to invest in other cities. These reasons include Chicago's size, its economy, and its attractive investment opportunities, the same factors that influence domestic investors.

The Size of the Market. Compared to other U.S. cities, Chicago is ranked third largest in terms of population. Downtown Chicago's office market is the second largest in the United States, having 95 million square feet of space. Since the majority of foreign investment has been limited to the largest cities in the United States, it seems that the size of a city holds some importance for foreign investors. However, as statistics indicate, and as illustrated by Exhibit 9, even though Chicago is ranked third in size, Chicago does not appear to be ranked third in appeal to foreign investors.

Saturation of Alternative Markets. According to foreign investors and international advisors, there appear to be economic reasons motivating foreigners to invest in Chicago. As a result of the recent investment activity on the coasts, prices of and competition for prime commercial properties have increased in these markets. Real estate industry analysts believe that these markets are now
becoming saturated as well as expensive. Chicago, on the other hand, offers foreign investors opportunities to invest in U.S. real estate at lower absolute prices per square foot than they would pay in Los Angeles, New York, or Washington, D.C., their current favorites.

A recent study of Chicago's office market conducted by Jones Lang Wooten Investment Research reports that "Quality buildings at prices averaging between $100 and $150 per square foot are beginning to attract foreign capital seeking stable, long-term investments that many regard as a 'better buy' when compared to similar buildings in Manhattan that have been selling for more than twice as much." 6

Japanese investors are currently negotiating to purchase two downtown office buildings in Chicago. "Building Number One" was completed in the early 1980's and is selling for slightly over $130 per square foot. "Building Number Two" was completed one year ago and the Japanese investor has agreed to pay almost $270 per square foot for a 50 percent interest in the project. Even at almost $270 per square foot, this seems cheap compared to sales prices that generally fall into the $300 to $500 range in both Washington, D.C. and Los Angeles. Unfortunately, there is not enough sales data to determine sales price patterns in this market. However, foreign investors appear willing to pay a broad range of prices for properties in the
market.

Diverse Economy. In addition to the size of Chicago and the recent sales prices of property in the market, which are assumed to be less expensive in comparison to alternative investment opportunities in other cities, foreign investors invest in Chicago because of its broad and diverse economy. As mentioned in Chapter Three, Chicago has a diverse and mixed economy. Many real estate investors, domestic and foreign, have felt the recent sting from their investments in single-industry towns, such as Denver and Houston, where vacancy rates have soared due to the depression in the oil industry. In a May, 1987, Real Estate Forum article, Daniele Bodini, president of American Continental Properties Group, reports "Many major institutions invested in what they considered to be the 'blue chip' properties in the sunbelt cities only to see the asset value of their buildings drop considerably." 7

Established International Presence. The number of international firms with offices in Chicago indicates foreign interest in the area. As mentioned in Chapter Three, there is a growing international component to the city's economy due in part to the growth in the international banking and services sectors. This produces a corresponding demand for additional office space and increased foreign recognition of the city. Deregulation of
banking systems around the world has contributed to an emerging global banking system. This enables foreign banks to compete with domestic banks in the provision of services to domestic clients.

Although the number of international firms that have offices in Chicago is increasing, preliminary research indicates that there are no foreign real estate companies with offices in Chicago. Most foreign investors who own property in Chicago base their U.S. real estate operations out of New York City or Los Angeles, where they currently own property or are actively pursuing acquisitions, if they have offices in the United States at all. The presence of offices seems to be directly related to investment activity in the area. It does not make sense, from an economic standpoint, to staff an office unless there is enough activity to justify the expense. Furthermore, offices of international investment advisors are not prevalent in Chicago. According to these advisors in New York City, many of these firms are establishing, re-establishing, or expanding their Chicago branches which is a possible indication of increasing foreign investment interest in Chicago.

**Product.** Foreign investors have a noted preference for high profile, "signature" products. These are buildings thought to be well-located and having notable architecture
or other features. Many of the transactions in Chicago have involved what local and national real estate professionals consider prestige and landmark properties. In addition to being "high profile", these properties, with the exception of new construction, are also more often than not substantially leased to credit tenants. In the case of development transactions, there is often a preleasing requirement as a prerequisite for foreign involvement as many U.S. markets, including Chicago, are becoming overbuilt. Recent development projects to which foreign investors have contributed equity have minimum pre-leasing requirements of 30 percent. Therefore, the availability of what foreigners consider to be investment-grade properties contributes to the amount of foreign investment activity in Chicago.

**Familiarity.** Prior to investment, foreign investors must not only be familiar with, but also comfortable with a market. Recognition becomes an important component of foreign investment when domestic approval is required prior to investment. In Japan, all investments by Japanese life insurance companies, trust banks, and pension funds must be approved by the Ministry of Finance. Other foreign countries also have various domestic approval requirements. Foreign pension fund investments usually need to be ratified by a board of directors. Disparities in the amount of
properties owned by different foreign investors in Chicago may be the result of some foreign countries being more familiar with Chicago. English, Dutch, and German investors have had a presence in the Chicago market since prior to the beginning of the decade. Japanese investors, however, have only been publicly active in Chicago since 1986.

Personal Networks. According to those involved in transactions with foreign investors in Chicago, foreign investors enter Chicago on the basis of relationships and personal networks. Investors are introduced to Chicago and to investment opportunities in this market through both existing and new relationships, directly and indirectly. Various intermediaries often bring domestic sellers and foreign investors together. Intermediaries that have been involved in transactions in Chicago include: (1) local and national brokers acting on behalf of both buyers and sellers, (2) international advisors and consultants, (3) investment bankers, (4) lawyers, (5) institutions such as life insurance companies and foreign and domestic banks, and (6) previous joint-venture partners.

Domestic real estate investors also use various intermediaries, but to a lesser extent. Most of the larger domestic investors have in-house departments responsible for identifying acquisition opportunities, analyzing markets and investments, and closing transactions.
Foreign investors initially retain intermediaries to obtain market information and investment advice in markets with which they may not yet be familiar or to aid in the negotiation and structuring of transactions. These intermediaries are often retained after the transaction has closed to monitor investments, to search for additional investment opportunities, and/or to help develop investment strategies for the foreign entity. Some foreign investors make more use of intermediaries than others. This is largely dependent on the foreign investors' knowledge of markets and U.S. business practices which in turn is dependent on the length of time they have been active in the United States. In Chicago, a majority of the foreign investors have dealt primarily with intermediaries in New York City, who in turn have established the local contacts and relationships in Chicago on behalf of their foreign clients.

Intermediaries are not always involved in Chicago transactions between domestic real estate entities and foreign investors. In some instances, property was marketed directly to foreign concerns by domestic sellers. This practice of direct contact and negotiation may become more commonplace over time as relationships are established between domestic and foreign parties.
Chicago is similar in size, economy, and product to other cities that have attracted foreign investors. In addition to these reasons, foreign investors enter this market as the result of industry networking. These factors are not unique to the Chicago market as all of these elements are present in other markets such as New York and Los Angeles. One feature that differentiates Chicago from other markets is its location. Situated in the middle of the United States, Chicago offers foreign investors who are heavily invested in coastal cities a chance to diversify their holdings of U.S. property. Additionally, Chicago offers off-shore investors proximity to industry, some of which is foreign-owned.

Portfolio Diversification. Chicago provides foreign investors, whose investments are heavily concentrated in one region of the United States, an opportunity to geographically diversify their portfolio of U.S. real estate. Domestic firms often diversify real estate portfolios in this manner as well.

Proximity to Industry. With Chicago considered the capital of a region dominated by industry, foreign investors have opportunities to invest in real estate that is close to industry, especially to the foreign manufacturing plants. With several Japanese auto and electronics plants located in the central United States, investment in Chicago offers
these investors proximity to these investments. As more of these facilities are established, familiarity with the region is also likely to increase.

Why Chicago? Not unlike the reasons foreign investors cite for investing in other U.S. cities, foreign investors express interest in Chicago because of its size, economy, and product. Personal relationships also attract foreign investors to the city, as well as opportunities for portfolio diversification and the opportunity to be close to foreign industry.

WHY NOT CHICAGO?

Since Chicago is similar to other U.S. markets in which there is a demonstrated interest by foreign investors, why then is it not considered by real estate analysts and foreign entities to be a "tier one" choice for investment? Even though Chicago is the third largest city in the United States and has a diverse economy in addition to investment-grade property, many real estate professionals on both a local, Chicago level and a national level nevertheless feel that this alone is not enough to stimulate foreign acquisitions of property in this area.

As of July, 1987, according to those interviewed, some foreign investors continue to express concern, and most remain cautious, regarding investment in the Chicago market.
Reasons frequently given by both domestic real estate professionals and foreign concerns for why there is not a greater volume of foreign investment in this market include the unavailability of product (stemming from property ownership traditions in Chicago and from domestic competition), the softness of the market, unfamiliarity with the area, and the perception of risk in the market.

"Things Just Aren't Changing Hands." Many of the domestic sources interviewed emphasize that Chicago is "owned" by the major U.S. life insurance companies. One real estate professional commented, "It seems that there are not enough buildings to fit what they [foreign investors] want that aren't already owned by deep pocket owners." Industry analysts speculate this ownership pattern produces a lack investment-grade property turnover in the Chicago metropolitan area. Whether this is a real or a perceived lack of product in Chicago cannot be substantiated from the data collected since only properties with foreign ownership were identified. Real estate analysts in the market report property sales are not frequent occurrences in Chicago. However, according to a Jones Lang Wooten Chicago office market report, at least seven properties have been sold recently in downtown Chicago. Others in the industry speculate that the "Chicago mentality" of property ownership is to "build, mortgage, and hold."
The Soft Market. According to real estate professionals active in the Chicago market, there appears to be a disinclination to sell properties at this time. This is attributed partially to the softness of the market. In addition to the previously mentioned current ownership trends in the market, analysts and property owners feel that the reluctance of property owners to dispose of property stems from the inability to receive adequate returns on properties due to the high vacancy producing a corresponding flat rent scale. One real estate professional speculates, "There is more talk than deals" in Chicago and another professional added, "Things just aren't changing hands." Without product for sale, there are no investment opportunities available to foreign investors who want to acquire real estate in Chicago.

Twelve percent vacancy rates in Chicago, compared to cities like Washington, D.C. and New York City whose vacancy rates are currently 9.9 percent and 9.8 percent,9 further suppress foreign investment. An environment where the supply of space exceeds demand less appealing to those foreign investors who are looking for safe, risk-free investments that will produce a steady cash flow. Many foreigners are not comfortable with nor are they willing to take leasing risks, and the high vacancy rates in the market often signal increased risk to foreign investors.
Lack of Familiarity. In addition to the "Chicago mentality of property ownership" and the soft market, a reason given frequently by real estate professionals explaining why Chicago has not been a more popular choice for foreign investors is that the city is not yet as well known in the foreign countries from which the investment capital originates. According to those who represent foreign clients, Chicago is not a "port city." As mentioned previously, one of the reasons that foreign investors invest in a city is in part due to recognition. One real estate professional working with Dutch investors commented that Chicago is the most underrated city by foreigners primarily due to their unfamiliarity with the city.

What makes many of the "popular" investment cities attractive to foreign investors is that these cities are familiar not only to the U.S.-based representatives of the foreign companies, but also to those who must approve the transactions in their home countries. Foreigners "know" Washington, D.C. because it is the capital of the United States. Foreigners also recognize New York City as a world financial capitol. There is a large Japanese population in Los Angeles which contributes to Japanese recognition of that city. Clearly, because Chicago is landlocked and ranked third it does not command the same recognition as do these other cities. It is much easier to sell an investment
"back home" if it is in a city known there, because in essence, only one "sale" needs to be made; that of the property itself. When those that approve transactions are not familiar with the market, an additional "sale" needs to be made; that of the city. It is possible once Chicago becomes better known, together with the other factors making investment in this market attractive, foreign investment activity will increase.

Domestic Competition. Industry professionals speculate that competition for properties also limits foreign investment in Chicago. Currently, many feel pension funds and life insurance companies, both domestic and foreign, are competing for the same types of investment properties. In addition to the competition, one professional suggested that, in Chicago, it is much easier to submit properties to domestic firms because these domestic firms maintain offices in the city, whereas access to foreign entities can be difficult. To tap foreign sources of capital, the domestic party must approach a foreign investor directly or through an intermediary in New York City. Additionally, if domestic investors have the ability to respond more quickly to investment opportunities than do foreign investors, foreign investors may miss out on investments in Chicago.

Another form of domestic competition about which investment advisors express concern is the lack of supply
restraints in the Chicago market. Development in Chicago is neither physically restrained, because of the large amount of undeveloped land, nor artificially restrained through zoning or development controls. Because of the potential for competition without rigid restrictions on supply, foreign investors perceive more risk in this market over the long run. In both Los Angeles and in Washington, D.C., there are restraints on supply resulting from stringent zoning regulations and development controls imposed by those cities. Although there are some development controls in Chicago, they are not nearly as restrictive as in other cities. For example, due to various restrictions in the Washington, D.C. market, it is estimated that in 12 years there will be no remaining space on which to build. With restrictions on supply, foreign investors are assured that their properties will remain occupied and therefore generate the projected cash flows.

Distance Relative to Alternate Investment Opportunities. Although Chicago has the second busiest international airport in the world, Chicago is still more difficult to get to, from a time standpoint, than other U.S. cities on either coast. For a foreign investor to get to Chicago, the trip from home is at least three hours longer; therefore, foreign investors tend to keep their interests "closer to home" and in better-known cities.
There is little doubt that there are good reasons for foreign investors to invest in the Chicago real estate market. There are equally as many conflicting reasons explaining why foreign investment activity has not reached the levels it has in other U.S. cities. Specific strategies of foreign investors give additional insight on what basis they may enter this market.

FOREIGN STRATEGIES FOR U.S. INVESTMENT IN COMMERCIAL REAL ESTATE: A NATIONAL PERSPECTIVE

Foreign investment in real estate is expected to increase nationwide.\(^{11}\) Japanese investment alone is expected to double in 1987.\(^{12}\) According to their advisors, foreign entities, such as English and Dutch investors, who have held property for some length of time are beginning to re-examine their portfolios of U.S. properties and either refinance these properties or sell them. The traditional markets seem to remain strong as top locational investment choices for foreign investors. Those that represent foreign clients also commented that investments in the sunbelt are no longer of interest due to the failing economies of many of these cities. Foreign investors instead are focusing on markets that have a broad and diverse economic base which they feel are able to sustain fluctuations in different sectors of the economy.
Development There is increasing evidence that many foreign investors are becoming involved in development ventures as opposed to investing exclusively in existing properties. Of the 26 transactions identified in Chicago, seven represent investments in development projects, two of which are hotel properties. Industry professionals speculate that development opportunities may increase in attraction to foreign investors because of foreign investors' inability to locate existing products, their increasing familiarity and comfort with both domestic markets and joint-venture partners, and their inability to continue to compete for prime properties.

For foreign investors who are having difficulty locating existing investment property, development opportunities in most markets are abundant. In 1986, 13 million square feet of space was developed in Chicago. An additional 5.2 million square feet of space is expected to come on line in 1988 and 1989. Domestic developers often look to foreign sources of capital for debt and/or equity financing. Foreign investors who participate in development ventures can mitigate their exposure to risk by negotiating master leases, pre-leasing requirements, preferred returns, and convertible debt. All of these types of arrangements have been negotiated in transactions between foreign and domestic parties in Chicago. Joint ventures with domestic
firms also allow foreign concerns to participate in and to learn about U.S. development and markets through their affiliation with an experienced partner. Participating in development projects enables foreign investors to take advantage of opportunities to increase their knowledge and understanding of the market, to secure a low-risk position, to obtain acceptable yields, and to invest in prime property. Industry sources were quick to comment that many foreign investors are beginning to realize if they want to own "the best," they are going to have to "get in" at the development stage.

Suburbs Some real estate industry analysts project a trend of foreign investment in the suburbs. This is most likely, however, for investors from those countries who have a cultural reference point for suburban development or those investors who are familiar with the United States. In Chicago, there are Dutch, German, English, and Middle Eastern investments in suburban office properties and regional malls.

Suburban investment is not popular among all foreign investors. The Japanese have yet to invest in the Chicago suburbs. One Japanese investor who was interviewed speculated that the Japanese will have to eventually enter the suburban markets as opportunities to invest in major cities become less frequent. However, downtown properties
are the preferred investment for most foreign investors because they feel these are safer investments because downtowns exhibit stronger recovery trends following soft-market conditions. A foreign investor's willingness to invest in suburban properties is a function of cultural familiarity with the suburbs and the risk posture of the foreign investor. Both of these factors are largely determined by the length of time the investor has been active in the United States.

Financing An alternative to direct equity investment in real estate that has been popular in the past and continues to be prevalent in today's real estate markets is foreign debt financing. This mitigates the risk to the foreign investor. One Chicago real estate executive commented that this is attractive to both sides of the transaction: the domestic firm is able to obtain low cost financing, often 100 basis points below domestic financing, and the foreign entity is able to assume less risk in the real estate investment.

Landaur and Associates states in a June, 1987 report:

Japanese banks have earmarked tens of billions of dollars for financing commercial property in the U.S. They have captured the $50 million-plus segment of the commercial mortgage market because of higher lending limits, quicker loan closings, and rates just below those offered by American banks. According to industry experts, as of the spring of 1987, there are no more than five to 10 single-source U.S. lenders willing to bid on
quality real estate deals of $100 million or more, while 20 Japanese banks stand ready to quickly submit offers.

FOREIGN STRATEGIES FOR REAL ESTATE INVESTMENT IN CHICAGO

A majority of those interviewed consistently repeated one major point: Chicago is currently being closely monitored by foreign investors and their advisors. Most of these advisors are predicting an emerging trend of increased foreign investment in the city. There is evidence that international advisors and investment bankers are expanding or establishing offices in the market to service the requirements of their foreign clients. Whereas the real estate market is considered by real estate industry analysts to be overbuilt and therefore weak at the present time, they do not consider Chicago to be as overbuilt as other U.S. real estate markets, namely the cities in the "oilpatch" region (Texas, Oklahoma, and Colorado) of the United States whose average metropolitan vacancy rates have soared to 31.9 percent. Both domestic real estate professionals and foreign investors feel foreign investment activity should substantially increase as excess supply is absorbed and as foreign familiarity with the market increases, providing there is product for sale.

Since the beginning of 1987, there has been a dramatic increase in Japanese investment in Chicago's central
business district. Since late 1986, four projects have been announced involving Japanese capital. These projects are: the Nikko Hotel; Xerox Center; Prudential Plaza One and Two; and 101 North Wacker Drive. Reports suggest this is merely the tip of the iceberg. When contacted, representatives of major Chicago real estate companies admitted to being involved with various Japanese investors in current negotiations. However, since these transactions have not been finalized, the properties cannot be publicly disclosed or the specifics of the transactions discussed at this time.

Seven such transactions, all located in downtown Chicago, were identified. If completed, these transactions will represent foreign investment in more than 5.5 million square feet of space.

Of the 26 recent transactions in the Chicago market involving foreign sources of capital, nine are development projects, one is a renovation project, and seven are suburban properties. Twenty-three out of the 26 properties are office buildings, two are hotel projects that, when completed, will add over 1,000 rooms to the city's existing supply of 20,000 rooms, and three of the recent foreign equity investments in the Chicago metropolitan area are in regional malls.

There is not universal agreement among real estate experts regarding the status of Chicago as an existing or as
a potential target city for foreign equity investment. Some industry sources do not consider Chicago a primary city for foreign investment at this time. Others report that the Chicago real estate market is being closely studied, and that Chicago properties are being actively sought by foreign investors. Both Japanese and Dutch investors have recently added Chicago to their lists of target cities, according to representatives of these foreign investors. With the exception of one foreign investor active in Chicago, the foreign investors who own property in the Chicago metropolitan area have real estate investments in other cities, primarily coastal cities. The one exception to this, a Japanese investor who does not currently own property in one of the favorite investment cities, said that his company's investment in Chicago resulted not because Chicago was a first choice, but rather because his firm was unable to locate investments in the other major cities. In the process of seeking real estate investments in the United States, the opportunity to invest in Chicago was presented to this firm by a Japanese bank. It was only after being approached by this Japanese bank that the Japanese investor began to study the Chicago market.

Partially due to the recent presence of Japanese investors, many professionals interviewed believe Chicago may be becoming a first tier city for foreign investors.
Judging from the seven known transactions currently being negotiated, there appears to be foreign interest in real estate investment in Chicago. In addition to foreign investors pursuing investments within the market, there are several U.S. firms who are currently marketing property in Chicago to foreign investors. For example, JMB, which is headquartered in Chicago, has recently set up an office in Tokyo hoping to attract foreign investment. Chicago is perceived by both domestic and foreign parties to be an attractive investment environment. There are definite reasons why foreign investors would want to invest in Chicago. They include the following: its size; its diverse economy; the saturation of alternative investment opportunities; the established international presence in Chicago; product availability; its international recognition; personal networks; portfolio diversification opportunities and; proximity to industry. Acknowledged strategies and recent investment behavior seem to indicate that foreign investment in the Chicago metropolitan area will increase in the foreseeable future. However, as Chapter Five clearly indicates, just as there is no such thing as a "typical" domestic investor, there is no such thing as a typical foreign investor or a typical deal structure in the Chicago market.
Chapter Four
Endnotes

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Chapter Five

EXAMPLES OF FOREIGN INVESTMENT IN THE CHICAGO MARKET

The initial data-gathering for this analysis focused on identifying specific Chicago properties owned wholly or partially by foreign investors which were purchased from 1980 to the present. Every attempt was made to identify as many foreign-owned properties in Chicago as possible. However, there is no doubt that there are omissions in the data. Whereas, due to the limitations discussed in Chapter One, it is impossible to report on the universe of transactions that have closed in this market, the following four cases and the three pending transactions were chosen to highlight the diversity of deals that have taken place over the past five years or about to take place in Chicago. Although 26 foreign-owned properties were identified, in many instances, because of the issue of confidentiality, there was a corresponding difficulty in obtaining specific information with respect to the transactions. In those cases where confidentiality was an issue, the identities of the parties involved in the transaction and the properties have been ommitted. Exhibit 10 lists the 26 transactions involving foreign investors in Chicago.
THE PLAYERS

Although English, Dutch, German, and Middle Eastern investors have all been active in the Chicago market at least since the beginning of this decade, the recent foreign investment activity has been primarily Japanese, as is indicated by Exhibit 10, paralleling their activity in the rest of the nation, although to a lesser extent.

As with foreign investment in the United States in general, the players in Chicago have changed over time. The current players at any given time are those with capital. In the 1970's, both nationally and in the Chicago market, because of oil prices, Middle Eastern investors were active. In the early 1980's, Western European investors dominated foreign investment in real estate. Currently, in the mid to late 1980's, Japanese entities are the new wave of foreign investors pursuing U.S. real estate investments.

In addition to investors representing different foreign countries involved in Chicago real estate, the types of foreign investors in this market are a diverse group and include: wealthy individuals, pension funds, life insurance companies, construction companies, pooled funds and consortiums. Most foreign investors in the Chicago market prefer to keep a very low profile, as do the domestic investors in this market. Looking at such a diverse group
both in terms of nationality and investor type makes generalizations on foreign investors in Chicago not only difficult but also inappropriate.

CASE STUDY #1: 55 WEST WACKER DRIVE

In November, 1986, 55 West Wacker Drive was sold to a Dutch investment firm, Wilma Realty, Inc., after three months of arms-length negotiation with Combined International, a U.S. insurance company. The property was originally under contract to a domestic real estate company, (Julius) Trump Interests, who then approached Wilma for equity financing. Sources suggest Trump and Wilma had a previously established relationship in other real estate ventures. When Trump subsequently changed its mind about the purchase, Wilma, having already committed to an equity participation in the deal, stepped in to become the sole purchaser of this property.

55 West Wacker is a 200,000 square foot office building. Now 18 years old, this building was originally a single-tenant building, first as the headquarters of Blue Cross and Blue Shield and later as Combined International's headquarters. Although a prominent building in a prestigious location in Chicago's central business district, the building was sold by Combined International because their demand for additional space could not be accommodated.
on the existing site. They currently lease 300,000 square feet in a building completed in 1986.

The building was appraised at $22 million and was initially marketed to single-tenant users at an asking price of $26 million. According to an intermediary involved in the sale, potential single-tenant users expressed little interest in purchasing the building at the time because the lease concessions available in the market made leasing a more economical alternative to equity investment. According to this same professional, domestic investors were also interested in acquiring the property and, like Wilma, submitted bids at deeply discounted prices from the original asking price of $26 million. Wilma's offer to purchase the property was $16 million, the most attractive offer made.

Wilma Realty is in the process of completing the renovation of this formerly single-tenant building to a multi-tenant speculative office building. In addition to the $16 million purchase price, sources in the market speculate the renovation will cost as much as the property. Contributing to the overall costs of the renovation is the complete removal of the asbestos in the building. Although not required by law, the new owners insisted on removing even the VAT flooring which contains insignificant amounts of asbestos. As of June, 1987, there seemed to be much interest in the building but, as the leasing agent for the
property reported, there are no signed lease commitments for any space. One local real estate executive speculated this investment represents the riskiest venture undertaken by a foreign investor in the Chicago market.

After purchasing 55 West Wacker, Wilma retained a local real estate firm to co-develop, lease, and manage the building. Recently, Wilma sold a 50 percent interest in the building to a Dutch real estate investment trust, VIB N.V. "VIB N.V. is an open-end real estate investment company with the tax status of an investment trust. The shares of VIB are quoted and traded on the official market of the Amsterdam stock exchange."\(^1\)

55 West Wacker represents Wilma's first and only purchase in the Chicago area. The company has other U.S. real estate investments in Atlanta, Miami, and Los Angeles and has been active in U.S. real estate for 10 years. The president of Wilma said that they had no plans to pursue additional investments in Chicago until they see the outcome of 55 West Wacker. Not only was this Wilma's first acquisition in Chicago but, a representative from Combined International said that this was Combined International's first real estate venture making it difficult for him to speculate on differences in foreign investor behavior.

In addition to the development, management and leasing services provided by Klaff Realty, Wilma has retained the
services of another local real estate firm to monitor the construction, leasing and management of the property. The executive vice president of Klaff Realty, who at first was skeptical of the involvement of another party, said that the relationship has proved particularly beneficial and has expedited the decision making process substantially.

CASE STUDY #2: PRUDENTIAL TOWERS

The Prudential Towers joint-venture represents the first publicly acknowledged infusion of Japanese equity capital into Chicago by a major Japanese life insurance company. The deal is a joint-venture for a 50 percent interest in both the existing One Prudential Plaza and the recently begun Two Prudential Plaza. The equity infusion from Nissei has been estimated to be $140 million.² The general partners in the joint-venture agreement are Prudential Life Insurance Company and Nissei Realty. Nissei is the U.S. subsidiary of Japan's largest insurance company, Nippon Life. Prudential is the largest insurance company in the world.³ "Nippon began evaluating the [U.S. real estate] market in 1978 -- three years before the Ministry of Finance permitted direct investment by Japanese life insurance companies."⁴

After less than six months from the initial presentation to closing, the transaction closed just before
years-end on December 29, 1986, according to James Purinton, the General Manager of Prudential Development's Chicago office. Prudential and Nissei had done business prior to this venture when Prudential sold the Crocker Tower in San Francisco to Nissei in late 1986.

The deal is structured as a general partnership with Prudential acting as the developer (of Two Prudential Plaza) and as the managing partner. A local firm has been retained as the leasing agent for the buildings. Prudential is authorized to make the day-to-day decisions regarding the property although Nissei remains an active partner, who must be consulted on any major decisions.

The 41-story One Prudential Center was built in the mid 1950's and is currently being renovated. It is substantially leased and contains 1,100,000 square feet of rentable area. The Leo Burnett Company, the building's major tenant occupying 225,000 square feet, will vacate their space when their lease expires in 1989 at which time they will move into 500,000 square feet in their own headquarters building currently under construction.

Two Prudential Plaza is expected to be completed in April, 1989. The new 64-story tower will have approximately 930,000 square feet of leasable area. McGraw Hill has already committed to a minimum of 75,000 square feet and a major law firm has committed to 32,500 square feet.
Purinton stated the project is timed so that combined occupancy of both Prudential Plaza One and Two never falls below 60 percent.

Purinton suggested the deal structure of this project is not unusual compared to other deal structures they have negotiated. With respect to foreign investor behavior, he felt it was unusual for a foreign investor to participate in a venture that was essentially one-half development. Although no specifics were cited, Purinton emphasized the deal was structured so as to mitigate the risks of this development for the Japanese investor who he believes has a tendency to be risk averse. Purinton also commented that, in comparison to other transactions involving Japanese investors covered in the press, Nissei was able to make a decision relatively quickly even though ultimate approval came from Tokyo.

CASE STUDY #3: THE NIKKO HOTEL

October, 1987, is the anticipated completion date for the 450 room Chicago Nikko Hotel. The hotel is a joint venture between Tishman Realty and Construction and Japan Airlines(JAL) with a participating mortgage provided by Sumitomo Realty.

Tishman and JAL were introduced through a personal network, according to a former employee of Tishman. A U.S. architect, of Japanese ancestry, was aware that JAL wanted a
site in Chicago for a hotel and approached Tishman in the winter of 1985. JAL subsequently arranged for Sumitomo's participation in the transaction. Sumitomo does not normally finance hotel ventures. Their participation in this transaction evolved from a close business relationship between JAL and Sumitomo. One year after the negotiations were begun, the deal was completed.

Nikko Hotels, JAL's U.S. development subsidiary, has targeted several U.S. cities in which they plan to purchase or develop hotels to establish a chain of hotels in the United States which will complement their flights. JAL intends to generate hotel business by offering travel packages to tourists who both book flights on Japan Airlines and reserve accommodations at a Nikko Hotel. JAL has been increasing flights into Chicago's O'Hare airport and therefore selected Chicago as one of six U.S. cities targeted for hotel developments. The other cities are: New York, San Francisco, Los Angeles, Washington, D.C., and Atlanta. In New York, Nikko has purchased the Essex House from Marriott, and in San Francisco, Nikko bought plans for a hotel that was already designed. The Chicago Nikko represents the first hotel in the planned chain that has been designed and developed by JAL.

The project is estimated to cost $74 million of which $68 million is being provided by Sumitomo in the form of
participating debt. There is approximately $6 million in equity in the project.

JAL considered several sites for the hotel in the Chicago area. According to a former employee of Tishman who was involved in the negotiations, JAL selected the site for several reasons. The Japanese appeared to be enamored not only with the proximity of the site to the center of town, but also with its location on the Chicago River. This real estate professional suggests that the importance of water in the Japanese culture, as is evidenced by the presence and importance of the river in Osaka where JAL is headquartered, were important in the ultimate site selection.

The site was attractive because the deal could be put together fairly rapidly due to a pre-existing relationship between Tishman and the seller of the property. Tishman had developed relationships with both JAL and with the Canadian landowner enabling Tishman to negotiate an equitable deal on behalf of the Japanese fairly rapidly.

Sources suggested some inconsistencies in the development objectives of the two parties. The Japanese were looking beyond this particular hotel, to the establishment of their U.S. chain. Since this is the first hotel they are developing, Nikko is hoping to make a statement and to establish a presence in the United States. Of ultimate importance to JAL is the long-term goals and
viability of the chain, not necessarily of this one hotel. On the other side, Tishman does not want to be in the position of operating a hotel over the long run.

**CASE STUDY #4: 101 NORTH WACKER DRIVE**

In March, 1987, the *Chicago Tribune* reported a joint-venture between Metropolitan Life Insurance Company and Dai-Ichi Seimei America Corporation, Dai-Ichi Mutual Life Insurance Company's U.S. subsidiary. Dai-Ichi is the second largest insurance company in Japan and Metropolitan Life is the second largest U.S. life company. The transaction involved the sale of a 50 percent interest through a general partnership arrangement in 101 North Wacker Drive.

101 North Wacker Drive was built in 1980. The 24-story building is headquarters to Hartmarx who occupies approximately 185,000 square feet of the total 567,000 square feet. The building is currently 95 percent leased, according to a source at Metropolitan Life.

101 North Wacker has changed ownership several times according to Charles Palmer, president of the Palmer Group. In 1983, Palmer, co-developer of 101 North Wacker, sold their partial interest in the property to German investors, The Lendhorf Group, who in turn sold their interest in the building to Metropolitan Life in 1985. Prior to the sale of the property to the German investors, Palmer reported he had
spoken to Dai-Ichi regarding 101 North Wacker. At that time Dai-Ichi was unwilling to take the equity risk and instead was only willing to negotiate a debt and equity position. According to Palmer, Dai-Ichi had the opportunity to obtain higher returns through an equity participation.

The relationship between Metropolitan Life and Dai-Ichi was established through Metropolitan's New York office with little involvement from their Chicago office. The partnership agreement establishes Metropolitan Life as the managing partner. The property is leased and managed by a local real estate firm.

A vice president at Metropolitan Life feels that the only difference in dealing with a foreign investor was Dai-Ichi took longer than would a domestic firm to complete the due diligence process. Because all decisions had to ultimately be made in Tokyo, he reported an unusually long time frame in negotiating and completing the transaction.

PENDING TRANSACTIONS

The transactions that are pending in the Chicago area are as diverse as those that have closed. All known pending transactions involve Japanese investors. One of these transactions involves a Japanese construction company and a local developer. This joint-venture involves the development of a 650,000 square foot office building in
downtown Chicago. The Japanese construction company will own a 60 percent interest in the project and the remaining 40 percent will be retained by the developer. Construction is expected to begin as soon as the transaction is finalized.

The Japanese construction company, in addition to taking an equity position in the project, will act as the construction consultant during the construction period for which they will be paid a fee.

Another transaction currently being negotiated between a domestic insurance company and a Japanese insurance company is a joint-venture as well. The Japanese investor intends to purchase a 50 percent interest in a newly constructed office building, completed in late 1986 in the heart of Chicago's financial district. Pending approval from the Ministry of Finance, the Japanese institution will pay $210 million for the 50 percent interest. $70 million of the total is debt. Currently, the building is approximately 50 percent leased.

This property was marketed directly to the Japanese investor. The domestic life insurance company's marketing strategy was to initially identify a comparable Japanese institution and then to offer this Japanese investor an exclusive right of first refusal to participate in the
joint-venture. The domestic institution felt that this approach would appeal to Japanese investors' sensitivity to publicity and competition and would ultimately justify a larger price.

To price the joint venture participation, cap rates and per square foot sales prices of other acquisitions on the east and west coasts were used. Those involved in the transaction felt that "Chicago should be priced like other cities." Chicago comparables were also not used because not many buildings have sold recently in Chicago. Whereas this price may be competitive with other cities, it is substantially higher, on a per square foot basis, than other recent sales in the Chicago market. The property is expected to yield approximately nine percent.

The U.S. realty subsidiary of a Japanese life insurance company has been negotiating for the past eight months with a Chicago developer and a large U.S. corporation regarding a major development project in downtown Chicago that will add almost two million square feet of office space to the Chicago office market in two phases of development. The domestic developer originally intended to finance the project with a credit master lease and by selling bonds through a Japanese bank. Instead, the developer is issuing bonds underwritten by a major investment bank and the
Japanese bank is giving a letter of credit. This Japanese bank approached the Japanese life insurance company who has agreed to provide a convertible second mortgage on the project.

The building is expected to be completed in 1989 and is currently 70 percent leased. Upon completion, the building is expected to lease for $36.00 per square foot.

A vice president of the U.S. subsidiary of the Japanese insurance company involved in the transaction reported the investment opportunity was presented to them prior to the company identifying the Chicago market for investment. Before agreeing to participate in the transaction, they reviewed the Chicago market with which they were unfamiliar. This is their second transaction in the United States, the first being a limited partnership interest in 13 properties with Trammell Crow. With the hopes of better understanding U.S. markets and deal structures, this firm has recently hired an American trained in real estate to analyze their transactions. The vice president stated that while their specific strategies regarding investment in the United States are in the formulation stage, they hope to form a "real American company," a company whose employees are American versus Japanese. They feel that Americans are more familiar with U.S. real estate markets and thus have established information networks within these markets. This
vice president feels that hiring Americans will give his company a competitive advantage over other Japanese companies who do not employ Americans. Although having American employees, decisions will continue to be made in Tokyo. Furthermore, with an experienced and domestic staff, this may reduce their need for intermediaries.

As Exhibit 10 illustrates, the transactions indicate the presence of Japanese, Dutch, Swiss, Middle Eastern, and German equity investment in the Chicago real estate market. In addition, these transactions illustrate the presence of foreign life insurance companies, construction companies, development companies, wealthy individuals, and pension funds in the area. The deals range from joint ventures to 100 percent fee simple purchases and involve both debt and equity.

From the cases described, some differences between foreign and domestic investment behavior should be readily apparent whereas other differences may be more subtle. Since a variety of nationalities and investor types are active in Chicago, it is difficult to generalize behavioral differences between foreign and domestic investors. However, Chapter Six discusses some of these general behavioral differences between foreign and domestic investors in Chicago.
Chapter Five

Endnotes

1VIB N.V. Annual Report 1986


4Ibid, 34.

In addition to the obvious language differences, domestic sources often assume foreign investors behave differently than domestic investors. To determine if this perception prevailed in Chicago, real estate professionals involved in transactions with foreign investors were asked to comment on differences in negotiating and dealing with the foreign investors they were involved with. If these sources had had prior involvement with foreign investors, they were also asked to comment if and how these differences have changed over time or if there were differences between foreign investors of different nationalities. The discussions focused on whether or not there were differences, between foreign and domestic investors, in investment motivations, deal structures, decision making, strategies, management of properties, and pricing.

As mentioned previously, it is quite difficult to make generalizations due to the wide scope and the diverse nature of foreign investors and investment activity in Chicago. To complicate matters further, just as there is no such thing as a "typical" foreign investor, there is no such thing as a
"typical" domestic investor with which to compare foreign investors.

WHAT DRIVES FOREIGN INVESTMENT: MOTIVATIONS

What motivates foreign investors to acquire property in the United States and in Chicago has previously been described in both Chapter Two and in Chapter Four.

Some of the motivations that encourage foreign entities to invest in the United States are the result of cultural differences between different nationalities. There are general incentives that motivate foreign investors which are not applicable to domestic investors. For example, the economic situations in foreign countries (such as trade surpluses), the exchange rate disparities that make U.S. real estate investments both affordable and profitable, as well as the limited investment opportunities in other countries all serve as incentives to foreign investors but have essentially no bearing on domestic investment decisions.

Foreign and domestic economic conditions, exchange rate disparities, and attractive investment opportunities motivate foreigners to invest their capital in the United States but not specifically in any one region or city. Based on information received regarding specific transactions in Chicago, it appears that, with the exception
of macro-economic factors, foreign investors are motivated by many of the same things that induce domestic investment in this city. Both foreign and domestic investors have similar, yet not identical, goals and strategies. In addition, both foreign and domestic investors are motivated by favorable investment yields, diversification objectives, relationships, and investment opportunities.

Foreign and domestic investors have similar, if not identical, underlying investment goals. For example, the objectives of any pension fund, foreign or domestic, are essentially the same - asset and liability matching. Pension funds, foreign or domestic, are charged with assuring that their current assets will be able to cover their liabilities in the future. Therefore, both foreign and domestic pension funds are interested in safe investments that are guaranteed to produce future cash flows sufficient to cover these liabilities.

Both foreign and domestic investments are driven by returns anticipated from real estate acquisitions. Yield requirements, for any investor, vary according to the perceived risk of an investment. What is an adequate yield to one party, however, may not be acceptable to another. For example, in Japan, where yields on downtown Tokyo property average two percent, a six percent yield in the United States is more appealing to a Japanese investor an
alternate investment in Tokyo. A six percent yield seems low to a domestic investor who is accustomed to eight to ten percent yields. Therefore, in a qualitative sense, adequate yields must be derived from investment. However, quantitatively, what yields are acceptable depends to some extent on the nationality and investor type. Lower yields, by American standards, are often acceptable to foreign investors because of the safe nature of the investments.

Existing relationships between foreign and domestic parties also encourage foreign investment in the Chicago area. Foreign concerns appear to be much more relationship-oriented than their domestic counterparts. Foreign investors often complain, in negotiating with domestic parties, domestic firms are more concerned with closing the transaction and moving on rather than building a relationship. There is evidence that an investment will be undertaken in Chicago on the basis of a prior relationship. One transaction that has yet to be completed is based upon an ongoing three-year relationship between a domestic insurance company and a comparable Japanese institution. Another transaction involving Wilma Realty (Case Study #1) was initiated through its established relationship with a U.S. developer. The real estate industry functions on personal networks and it is no different when foreign investors are involved.
Foreign and domestic investors are motivated to invest in Chicago properties as a portfolio diversification strategy to geographically balance their portfolio of U.S. real estate. Since there was only one foreign investor identified who owned more than one property, there is no evidence of product diversification in the Chicago market by foreigners. The two properties owned by a Dutch pension fund in the Chicago metropolitan area are both 200,000 square foot suburban office buildings. Domestic players in Chicago are more inclined to invest in Chicago for geographical diversification, and within the market for product diversification as well. At this time, foreign investors seem to concentrate more on geographic diversification within the United States as opposed to product diversification within any one market.

What motivates both foreign and domestic investors is a combination of factors. It appears that investment motivation is both property-specific and investor-specific. For example, location, joint-venture partner, yields, and attributes of the physical property are all important factors that are analyzed by both foreign and domestic investors. In a May article in Real Estate Forum, Naohiko Mogami, a Japanese native and a vice president at Bank of America's investment real estate operation in San Francisco explains that "they [the Japanese] may have slightly
different priorities than their American counterparts, but it should not be forgotten that they are driven by the same investment motivation as U.S. investors: getting the most economic benefits possible within their investment criteria." (emphasis added)¹

Similar motivations for investment contribute to competition between foreign and domestic investors for the same property. However, this competition seems to be restricted to downtown prestige properties in major cities and is not prevalent to the same extent in the suburbs or with other property types.

DEAL STRUCTURE

In examining recent transactions in Chicago, there appear to be differences in how a foreign investor approaches structuring a deal than how a domestic firm would approach the same transaction. Foreign investors approach and structure deals with domestic firms and institutions differently than if both parties in the transaction were domestic. Foreign investors often attach different levels of importance to different return measures in property valuation, use a longer time horizon in investment analysis, take different risk postures, and structure simpler transactions.
Sources commented on the importance/non-importance of different return measures for different investors. For example, many domestic firms tend to give more weight to the internal rate of return. Whereas foreign firms may compute this return measure, they seem to value the cash on cash return more.

Foreign investors evaluate investment property over a longer time horizon than do domestic investors. Most of the foreign investors in the Chicago market extended their property analysis to include income and expense projections for anywhere from 20 to 40 years into the future. Different nationalities also seem to have different time horizons. Some Japanese investors operate on a 25-year time horizon and one source reported that an English investor operated on a 40-year time horizon. Because of this difference, projections and pro formas were carried out for a longer time period and the long term appreciation potential of the property was often deemed more important to the foreign investors than the short term cash flow. Short term cash flow may increase in importance to foreign investors if they heed the recommendations of their advisors in the U.S.

Foreign investors are typically stereotyped as being risk averse. In the Chicago market risk aversion is more a function of investor type than the result of being "foreign." There were transactions in which the domestic
parties reported structuring the deals so as to mitigate the risk to the foreign party through master leases, pre-leasing, and guaranteed preferred returns. Just as often there were entrepreneurial firms involved in Chicago real estate ventures that were willing to take both leasing and development risks for a larger return than they would normally expect from "risk-free" investments. Risk aversion appears to be directly related to the length of time and the familiarity with the Chicago market, as well as the length of time that the foreign investor has been active in U.S. real estate.

What seemed to surprise some domestic parties in transactions involving foreign purchases of Chicago properties was the frequency of all-cash purchases. They did not feel this would occur in transactions involving only domestic firms. However, this may be somewhat misleading because it is difficult to track capital flows and therefore it cannot be determined if these properties were financed subsequent to their purchase.

A majority of those interviewed feel a transaction involving a foreign party is similar to what would result from the negotiations of two domestic firms. Each party in a transaction has a different risk posture and brings a different set of variables to the table that enable trade-offs to be made.
Often the deal structure is similar to that of a domestic structure because of the domestic intermediary involved on behalf of the foreign client who is ultimately charged with structuring the transaction. These intermediaries are familiar with domestic deal structures and U.S. legal requirements as well as with their foreign client's investment requirements. Since these investment objectives are often determined with the help of a domestic advisor, what ultimately results is a deal that looks very similar to a transaction involving two domestic parties.

As is the case with domestic transactions, the ultimate deal structure results from who brings what to the table and what there is to divide. Each party enters negotiations with certain goals and objectives, and one would expect if foreign investors ultimately have goals and objectives similar to domestic investors, deal structures would be similar as well.

DEcision Making

Depending again on the nationality and the type of foreign investor, there are differences in how decisions are made. Differences in decision making specifically relate to the amount of time involved to negotiate and close a deal. In Chicago, some domestic parties involved in negotiations with foreign entities reported it took longer to negotiate with these foreign parties whereas others noticed no
differences in the amount of time it took to close the transaction. One source stated that it took his firm longer to negotiate with a domestic institution because of the U.S. legal requirements with which to comply. With domestic approval a prerequisite for investment, it is not surprising that decision making sometimes takes longer when a foreign party is involved. However, this does not always hold. For example, several of the transactions in Chicago were closed in six months or less which is not unusual, from a domestic perspective.

Of all the foreign investors, the Japanese investors are most often accused of requiring an extensive length of time for analysis and negotiation of investments. Arthur Mitchell, a partner at the New York law firm Coudert Brothers, stated in a speech "In the past, Ministry approval has taken from three to six months; many recent transactions have been approved within 30 to 45 days. Many insurance company executives believe that as more and more transactions are done, the entire process will be accelerated further." In another speech, Mitchell commented that "Some of the lack of speed can be attributed to unfamiliarity with the market in general or certain market practices in connection with the negotiation and documentation of real estate transactions." Mitchell continued:
Another factor highlighted by many commentators is the so-called ringi system under which all relevant executives both in the United States and Japan are consulted concerning the decision to purchase a particular property. It has been reported that this process may take between 30 to 60 days and can involve up to 10 separate stages. Also, the speed with which a company can make a decision will depend in great deal upon the stage that it has reached in its real estate acquisition program.

Domestic real estate professionals cannot rely on the assumption that Japanese investors require more time to make decisions. A more valid assumption for domestic professionals is that the ultimate decisions and approval will be made in Japan. With more experience in U.S. real estate, increased confidence in U.S. markets, and established relationships, Japanese investors are capable of making quick decisions. In the Prudential-Nissei joint-venture (Case Study #2), the parties were able to negotiate and close the transaction in six months after Prudential's initial presentation to Nissei, according to James Purinton of Prudential. Also, one source stated that because of the number of transactions certain Japanese firms have completed in the United States, the Ministry or Finance, is beginning to process these firms' requests more quickly since a previous relationship has been established between the MOF and those firms that are active investors in U.S. properties. Furthermore, some sources speculate that
Japanese investors are learning in order to take advantage of opportunities and to compete with domestic investors, they must make investment decisions quickly.

In addition to nationality, decision making is often a function of the investor type as well. Certain types of investors are required to have domestic approval whereas others, such as wealthy individuals, are not. Several professionals suggested decision making is likely to be expedited if all of the information can be assembled in a timely fashion. This, in combination with pre-established relationships, is likely to produce quicker decisions.

STRATEGIES

Many of those interviewed believe foreign investment strategies are a function of the investors' knowledge and understanding of U.S. real estate markets. This knowledge and understanding in turn is linked to the length of time that the foreign investor has been active in the U.S. real estate market.

Differences in investment strategies between foreign and domestic investors are most apparent with respect to locational preferences, product preferences, and the aggressiveness of the investment strategy.

One strategy that differentiates foreign investors from domestic investors is their geographical and locational
preferences for investment. Most foreign investors demonstrate a preference for major metropolitan cities such as New York and Los Angeles. According to several investment advisors, in addition to favoring large cities, foreign investors, depending on the length of time they have been active in the United States, are often unwilling to pursue suburban properties. Out of the 26 transactions identified in this study, seven represent suburban investment, three of which are regional malls. Foreign investors may not pursue suburban properties because prices of suburban properties are often lower than their minimum investment amount. For example, according to one intermediary, Sumitomo will not invest less than $100 million in any one transaction. There are few suburban properties in Chicago that can satisfy this investment criteria. This difference seems to become significantly less pronounced with the length of time an investor has been investing in U.S. real estate. Suburban properties in Chicago are owned by Dutch investors, an English investor, and a Middle Eastern investor. One German investor purchased a suburban shopping mall in Chicago but sold it to a domestic firm just three months after the acquisition.

Property type preferences can be another distinguishing factor between foreign and domestic investors. According to a source at Jones Lang Wooten, the Japanese in particular
are not interested in "pre-war" buildings because most Japanese investors think that new buildings have the longest lasting value. Sources report, in Chicago foreign investors are reluctant to invest in buildings completed before 1980. In other cities, buildings completed since 1970 are suitable for investment. Of primary interest are well-located, downtown, substantially leased office buildings. Foreign investors are also inclined to invest in hotel developments. Two such hotel developments are currently under construction in Chicago by both Swiss and Japanese interests. Domestic investors often prefer not to invest in hotel properties.

Foreign investors do not seem to be as aggressive as domestic investors with respect to the amount of risk that they are willing to take. Foreign investors have traditionally focused on well located, prestige office buildings in major cities. They often spend a long time and are extremely cautious analyzing investment opportunities and often will not take leasing risks. Foreign investment and operating strategies extend over a longer time horizon than do many domestic investors. Foreign investors tend to be painstakingly careful and diligent in their analysis and rely more heavily on assumptions made in their evaluations.

In a report on Japanese investment in U.S. real estate conducted at MIT's Center for Real Estate Development, Nippon Life's investment strategies for U.S. real estate
acquisitions are identified. The authors feel confident that this is a typical investment strategy that holds for most Japanese life insurance companies:

Nippon Life seeks long-term, stable real estate investment in the United States that is compatible with the nature of funds available to life insurance companies. It avoids speculative investments such as those that promise short-term capital gain. An insurance company like Nippon Life has to make sure that every effort to minimize the investment risks that accompany high-return ventures is taken. This investment policy means that the company has focused on existing prime buildings in financial districts in major cities...It is reluctant to invest in growing cities, suburban areas and development projects because it believes that such investments are speculative and vulnerable to changes in the state of the economy.

VIB N.V., a Dutch real estate investment trust, with one third of its total portfolio in U.S. real estate investments, identifies its strategy in its 1986 annual report:

VIB's investment strategy is clear: spread of risks, project management under its own control and ownership of large projects through joint-ventures. A small part of the portfolio is invested in development projects...The investment strategy is directed towards the goal of ensuring shareholders attractive dividends and growth in value of their shares. Another goal is to limit risk through the spreading of the portfolio, geographically as well as regarding kind of projects....Development projects will only be considered if the inherent risks can, as much as possible, be left with partners or companies which are specialized in this area...Efforts to invest in office projects are primarily concentrated on cities like Boston, Chicago and Washington D.C. Also the area to the south of Los Angeles and the city of San Francisco have VIB's interest.
Like domestic investment strategies, the strategies of foreign investors are constantly reviewed and changed. Many of the new Japanese investors are still in the process of formulating strategies for U.S. real estate investment. Investment strategies also differ relative to nationality and investor type.

Many of the Japanese strategies involve the formalization of relationships. They appear to be much more relationship oriented than do domestic investors, who they often regard as more transaction oriented.

**MANAGEMENT OF PROPERTIES**

Many foreign property owners in Chicago hire local firms to manage and to lease their property. This is similar to a domestic investor entering a new market with which the investor is not familiar. In this kind of situation it is not economically feasible to hire a staff to monitor the property. Management difficulties arise from the distance a foreign investor must travel to directly monitor property operations as it would with a non-local, yet domestic, property owner with the exception of the greater travel distance involved. This perhaps is becoming decreasingly important with the presence of U.S. subsidiaries. Some of these U.S. subsidiaries are managing
properties for their own account, however this has yet to happen in the Chicago area. Generally, however, with foreign investors in the Chicago area owning only one property, they rely on either a joint venture partner or will hire a local firm to direct management and leasing efforts.

Foreign property owners also often retain advisors as asset managers. This added dimension to the management of property gives the foreign entity additional security and comfort. Most foreign property owners visit their acquisitions several times a year. Many of those interviewed felt that foreign property owners were quite meticulous regarding the management of their U.S. properties. This is most likely caused by the long time horizon often involved in foreign ownership and their reliance on long term property appreciation. The Japanese are particularly involved in property management.

PRICING

Partially due to the inability to obtain sales data, it was difficult to find corroborating evidence in the Chicago market that foreign investors had paid more than a domestic firm would in the same situation, which is a prevalent notion and a misleading expectation concerning foreign investors. Japanese investors, in particular, are willing
to pay a premium for a prestige and low-risk property. Most people involved in transactions in Chicago reported the prices paid by foreign investors were fair market prices, often negotiated by a domestic advisor on behalf of the foreign entity.

In two Chicago transactions in which sales prices were disclosed, foreign investors appeared to have paid more for these properties than a domestic investor would have paid. In one transaction (expected to close in September, 1987) between a domestic real estate company and a private Japanese investor for a downtown office building, sources report the Japanese investor used a lower than market rate cap rate to determine the offer price. A representative for the seller reported although cap rates of nine percent are typical in Chicago, this investor imputed the value of the property using a cap rate of eight percent. In another transaction, which is expected to close around the same time between a domestic life insurance company and a Japanese insurance company, the sales price was based on comparables in other markets such as Los Angeles and New York City. As a result, the sales price of over $250 per square foot is substantially higher than Jones Lang Wooten Investment Research estimates of recent sales prices of between $100 and $150 per square foot in the Chicago office market.7
Whether or not foreign investors in fact pay more is difficult to ascertain and most of the information is speculative since many of the actual sales prices are confidential. Also, because of confidentiality, it is difficult to determine sales prices paid by domestic investors for comparison. Therefore, it is not possible to compare sales prices with any accuracy to determine if there are in fact real differences. According to those interviewed, it seems that the Japanese are becoming increasingly sensitive about the transactions they are negotiating because of the recent press coverage which portrays Japanese investors as reckless buyers. The Japanese are most diligent and cautious in their analysis of potential deals and the prices they are paying, they feel, are being misinterpreted as being careless rather than just a premium for quality, long term appreciation and risk mitigation.

WHAT CAUSES DIFFERENCES?

Different cultures, differences in how business is conducted as well as distance cause differences between foreign and domestic investors. One real estate professional in Chicago commented that the ways of doing business in Europe are different than in the United States. These differences tend to cause differences in opinion
between domestic and foreign entities engaged in business transactions. Business practices in Japan are also different.

Are foreign investors different from domestic investors? Yes and no. Some foreigners appear to be more "different" than others. Those appearing most different are those investors having the least amount of experience in the market.

Thus it appears that foreign investors in Chicago differ slightly from domestic investors in a qualitative sense. That is, they are motivated by many of the same factors that appeal to domestic investors. However, there are demonstrated quantitative differences manifested in different yields, holding periods, the time required for decision making and perhaps in prices.
Chapter Six

Endnotes

1Real Estate Forum, May 1987, 42, "The Japanese and Their 'Yen' for United States Real Estate."

2Arthur Mitchell, "Remarks before Crittenden's Foreign '87 Symposium: Legal Aspects of Foreign Investment from Japan" (Sheraton Centre Hotel, New York, 25 March 1987), 5.


4Ibid., 14.


Chapter Seven

FOREIGN INVESTMENT IN CHICAGO: OUTLOOK AND OPPORTUNITIES

THE FUTURE OF FOREIGN INVESTMENT IN CHICAGO: TRENDS AND PROJECTIONS

According to local and national real estate professionals, the future of foreign investment in the United States depends on a number of factors, including the strength of the dollar relative to other currencies and the economies of other countries. Clearly, the future of foreign investment in Chicago is directly tied to that of the United States. Those interviewed feel foreign investment activity in Chicago has the potential to increase. This is based on the assumptions that market vacancy rates will decline, that absorption of space will increase, and that investment opportunities, corresponding to the known preferences of foreign entities, will be available. Many seem to think as opportunities on the coasts become expensive and limited, foreign investors will be prompted to look more closely for investments in the Chicago market.

There is already some evidence of increased foreign investment activity in the Chicago market, caused by the presence of Japanese investors. In 1986, the Japanese had
publicly committed to only a 450-room hotel and a $50 million mortgage. Since the beginning of 1987, two additional joint-venture projects (The Prudential Plazas and 101 North Wacker) representing 2.6 million square feet of space in downtown Chicago and involving Japanese equity participation have been announced. By year's end 1987, the Japanese may double their 1986 investments in Chicago by purchasing in excess of five million square feet of space in seven projects in Chicago if the transactions that are currently being negotiated close.

Those interviewed feel several factors contribute to increased foreign investment in Chicago such as its size, its broad and diverse economy, and the presence of international firms. Additionally, portfolio diversification objectives and proximity to industry may prompt foreign investors to pursue investments in the Chicago market. Many feel that Chicago may become a first choice as a target city for real estate investment for foreign investors. As those in the industry refer to it, Chicago may become a "first tier city." According to international advisors, preliminary evidence of Chicago's increasing popularity among foreign investors is illustrated by Japanese and European investors who have added Chicago to this target list and are actively seeking property in the area.

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For foreign investment in Chicago to continue at its current level and to increase, several things need to occur within the market: the market must begin to show some signs of recovery, foreign confidence in the city must increase, and there must be investment opportunities made available to foreign investors. Additionally, factors exogenous to the market such as limited opportunities and saturation of other U.S. real estate markets could further add to increased foreign investment in Chicago.

Real estate professionals who have done business with foreign investors report foreign investors are very diligent in trying to learn and understand market behavior and trends. Furthermore, real estate is an industry dependent on the flow of good information. If the current trend of limited information on transactions continues, it may take foreign investors more time than in other cities, such as Los Angeles or Washington D.C., to develop this understanding of the market and to feel comfortable pursuing investments in the city.

OPPORTUNITIES FOR REAL ESTATE PROFESSIONALS

Because of the demonstrated foreign investment interest in Chicago and because of the differences in the way that foreign investors behave, there are opportunities for domestic real estate professionals, such as property owners,
brokers, lawyers, managing and leasing agents, and developers, to tap foreign sources of capital. Domestic real estate professionals may have opportunities to generate fee income, to arrange favorable debt or equity project financing, to participate in joint venture arrangements with foreign entities, to sell properties, or to act as an intermediary between domestic sellers and foreign buyers.

Real Estate management and leasing firms have opportunities to generate fee income from foreign sources by managing and leasing foreign-owned properties. Most, if not all, of the foreign-owned properties in Chicago are managed and leased by local agents. Since the foreign property owners in Chicago do not have offices in Chicago nor the degree of expertise in the market, they thus form ongoing relationships with local experts to manage and lease their properties.

Foreign entities have demonstrated a willingness to finance properties in the Chicago area with both debt and equity or some combination thereof. Real estate professionals seeking to refinance existing properties or to finance new developments may find foreign investors a ready source of capital. The cost to the domestic party seeking to obtain this low cost financing often includes agreeing to master lease the property, fulfill pre-leasing requirements, and guarantee preferred returns. These arrangements
mitigate the risk to the foreign investor. Sometimes, it may take longer to negotiate the transaction, which is one more factor to be considered by domestic parties hoping to structure transactions with foreign entities.

Several Chicago firms have successfully marketed and sold total or partial interests in property to foreign investors. In some cases, the foreign investor paid a premium, by Chicago standards, for the property. If foreign investors continue to add Chicago to their list of target cities for investment, there is an opportunity for local sellers of properties to possibly receive higher prices for their properties than if they were sold to domestic firms. This is dependent on the properties themselves and the competition in the market.

Brokers who have a thorough knowledge of the Chicago market have the opportunity to align themselves with both foreign investors who are looking for property and with sellers who are seeking to dispose of property. Foreign investors have a need for complete market information. They will often spend a long time investigating the market prior to acquiring property. Brokers are in the position to expedite market data collection and to make foreign investors aware of investment opportunities in the market.

The best way for domestic real estate professionals to tap these vast capital resources is to establish
relationships with a foreign investor either directly or through a local or national intermediary. It was already mentioned that direct relationships can sometimes be difficult to establish. Often, intermediaries outside of the city act to bring foreign investors together with domestic real estate developers, brokers, and leasing and managing agents. It appears that having contacts with investment bankers and international investment advisors in New York City, and possibly with their branches in Chicago, often precedes foreign investment in Chicago. Therefore, it would seem logical for Chicago real estate professionals to develop networks with those professionals in New York City until direct relationships can be established with foreign investors or foreign investors begin to more actively pursue Chicago investment opportunities.

SUMMARY OF FINDINGS

Significant differences exist among foreign investors by both country and by investor type. In Chicago, different nationalities of investors prefer different types of properties, have different levels of experience in the Chicago market, and have different risk postures. These preferences also vary by the type of investor. Whereas a Japanese airlines is willing to undertake the development of a hotel, a Japanese insurance company is only willing,
thus far, to enter into a joint venture arrangement with a large domestic institution.

The longer a particular foreign investor is active in U.S. real estate, the more they behave like domestic investors. The Canadians, who have been investing in Chicago for some time are almost indistinguishable from domestic investors. However, the Japanese, who are relatively new to the Chicago real estate market are more apt to behave differently than would a domestic investor with respect to decision making, deal structure, risk posture, and product preference.

Foreign investors of all types exhibit a very strong downtown preference. At this time, most foreign investors in the Chicago market exhibit a strong downtown preference with the exception of regional suburban shopping malls. Those interviewed feel that downtowns are apt to recover faster following soft market conditions than would the suburbs. Cultural familiarity with suburban markets is not as great in foreign countries as it is in the United States, and because foreign investors tend to go to places they know, major downtowns are most often familiar to foreign investors and to those who must ultimately approve the transactions at home. Of the 26 transactions identified, 19 (73 percent) are prestige downtown office properties.

Some foreign concerns are willing to pay a higher price
for some types of U.S. real estate. Not all types of real estate are able to command high prices from foreign investors. The Japanese have demonstrated that in Chicago they will use a lower cap rate than would a domestic investor, for a downtown office property. This same investor is not inclined to invest in the suburbs and therefore would pay less than the market clearing price. More than likely, a domestic investor or another foreign investor who is comfortable with the suburbs, would outbid the Japanese investor for a suburban property. What foreign investors are willing to pay more for are those properties that they see value in over the long run. Those properties right now are mostly prestige, downtown office buildings that have been built since 1980, and are substantially leased to credit tenants.

Foreign investors tend to have a longer term view. The longer time horizon is evident both in the analysis and the projected holding period. Reasons why foreign investors tend to operate on a longer time horizon are culturally derived and stem also from their goal to preserve capital. Longer holding periods in foreign countries are common. Furthermore, since the United States is perceived to be a safe haven for capital, foreign investors are interested in investment in the U.S. to preserve this capital.

Foreign investors tend to be more relationship oriented
than their U.S. counterparts. Foreign investors are used to dealing directly in transactions, and thus do not have a reference point in their home countries for all of the intermediaries typically involved in U.S. real estate transactions. The Japanese in particular are unfamiliar with the use of lawyers and with the volume of legal documentation necessary in transactions with domestic parties. In the United States it is often difficult for them to feel comfortable with and to understand the multitude of intermediaries and paperwork involved in transactions. Foreign investors indicate a preference to form on-going relationships with domestic parties. Domestic investors seem to prioritize completing the transaction rather than forming an on-going relationship.

Foreign investors tend to structure much simpler deals, by American standards, on their purchases. Frequently transactions that involve foreign purchasers are more straightforward than transactions involving domestic parties. Often the purchases are all cash as well.

Chicago is not currently a first choice for foreign investors and most who have invested in this market own property elsewhere in the United States. Foreign investors have demonstrated their preference for investments in coastal cities over investments in Chicago. Foreign equity investment is present in 51 percent of the properties in the
Los Angeles CBD, and 12 percent of the Washington D.C. market.\textsuperscript{1,2} In Chicago, foreign investment represents less than 10 percent of the total inventory of space in the Chicago metropolitan area.

Foreign investors are willing and likely to invest in Chicago properties. As saturation of other markets continues, prices for properties in these markets increase, and Chicago becomes more familiar to foreign investors, foreign investment activity in this market should increase. Foreign investors have indicated that Chicago is an appealing investment environment because of its size, its economy, its growing international presence and its location and, some of these investors have already added Chicago to their list of target cities for U.S. investment.

The Japanese are beginning to feel more comfortable with Chicago and should increase their purchases in this market. If Japanese trade surpluses continue to be substantial and exchange rates remain favorable, the Japanese will increasingly look to Chicago for investment opportunities to diversify their portfolios of U.S. real estate. This trend has already begun as is evidenced by the number of recent Japanese transactions in the market. Japanese investors, including a construction company, a life insurance company, and a private real estate company, are expected to double their purchase of Chicago real estate in
1987. Intermediaries suggest that the Japanese are studying the market closely now and when they feel more comfortable, they will increase their investments.

There are opportunities for Chicago real estate professionals desiring to tap foreign sources of capital in this market. Real estate professionals can position themselves to take advantage of the differences that exist between foreign and domestic real estate investors. Opportunities exist to generate fee income from both management and leasing of foreign owned property, to arrange debt and equity financing for existing product and new construction, to provide valuable market information to new entrants into the market, and to arrange and negotiate transactions between foreign investors and domestic real estate professionals.

Due to the limited time frame during which this study was conducted, it by no means offers conclusive trends regarding foreign investment in Chicago. It would probably be useful for further research to be conducted regarding each nationality separately rather than grouping foreign investors together.

This study gives several examples suggesting that the behavioral differences between different nationalities are most likely greater than the differences between foreign,
taken as a whole, and domestic. The biggest explanatory variable for the differences that exist among foreign investors is the length of time they have been in the United States.
Chapter Seven

Endnotes


Exhibit 1
Portfolio Investment by Nationality of Investor, 1985

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Europe</td>
<td>250,525</td>
<td>311,462</td>
<td>60,937</td>
<td>51.8</td>
</tr>
<tr>
<td>Canada</td>
<td>24,771</td>
<td>25,328</td>
<td>557</td>
<td>0.5</td>
</tr>
<tr>
<td>Japan</td>
<td>50,304</td>
<td>80,789</td>
<td>30,485</td>
<td>25.9</td>
</tr>
<tr>
<td>Latin American Republics &amp; Other Western Hemisphere</td>
<td>165,657</td>
<td>184,516</td>
<td>18,859</td>
<td>16.1</td>
</tr>
<tr>
<td>Other</td>
<td>142,119</td>
<td>148,822</td>
<td>6,703</td>
<td>5.7</td>
</tr>
<tr>
<td>Total</td>
<td>633,384</td>
<td>750,917</td>
<td>117,533</td>
<td>100.0</td>
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</table>

### Exhibit 2

**Foreign Direct Investment by Nationality of Investor, 1985**

<table>
<thead>
<tr>
<th>Region or Country</th>
<th>FDI Position 1984</th>
<th>FDI Position 1985</th>
<th>Change in FDI Position 1984-1985</th>
<th>Percent of Total Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Europe</td>
<td>108,211</td>
<td>120,906</td>
<td>12,695</td>
<td>69.1</td>
</tr>
<tr>
<td>Canada</td>
<td>15,286</td>
<td>16,678</td>
<td>1,392</td>
<td>7.6</td>
</tr>
<tr>
<td>Japan</td>
<td>16,044</td>
<td>19,116</td>
<td>3,072</td>
<td>16.7</td>
</tr>
<tr>
<td>Latin American Republics &amp; Other Western Hemisphere</td>
<td>16,201</td>
<td>17,050</td>
<td>849</td>
<td>4.6</td>
</tr>
<tr>
<td>Other</td>
<td>8,841</td>
<td>9,201</td>
<td>360</td>
<td>2.0</td>
</tr>
</tbody>
</table>

**Total** | 164,583 | 182,951 | 18,368 | 100.0 |

## Exhibit 3
### Foreign Direct Investment in Real Estate in the United States
#### 1980-1985
(Dollars in Millions)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Countries</td>
<td>6,120</td>
<td>8,689</td>
<td>11,397</td>
<td>13,946</td>
<td>17,761</td>
<td>18,557</td>
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<tr>
<td>Canada</td>
<td>1,158</td>
<td>1,770</td>
<td>1,882</td>
<td>2,106</td>
<td>2,844</td>
<td>2,580</td>
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<tr>
<td>Europe</td>
<td>2,254</td>
<td>3,475</td>
<td>5,035</td>
<td>6,638</td>
<td>8,255</td>
<td>8,821</td>
</tr>
<tr>
<td>European Comm. (10)</td>
<td>2,119</td>
<td>3,450</td>
<td>4,651</td>
<td>6,224</td>
<td>7,714</td>
<td>8,238</td>
</tr>
<tr>
<td>Belgium</td>
<td>4</td>
<td>9</td>
<td>11</td>
<td>10</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>France</td>
<td>24</td>
<td>24</td>
<td>24</td>
<td>28</td>
<td>66</td>
<td>26</td>
</tr>
<tr>
<td>Germany</td>
<td>493</td>
<td>651</td>
<td>780</td>
<td>815</td>
<td>966</td>
<td>1,049</td>
</tr>
<tr>
<td>Italy</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>3</td>
<td>0</td>
<td>(b)</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>23</td>
<td>28</td>
<td>29</td>
<td>25</td>
<td>0</td>
<td>24</td>
</tr>
<tr>
<td>Netherlands</td>
<td>999</td>
<td>1,507</td>
<td>1,742</td>
<td>2,189</td>
<td>2,471</td>
<td>2,325</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>567</td>
<td>1,220</td>
<td>2,051</td>
<td>3,140</td>
<td>4,135</td>
<td>4,623</td>
</tr>
<tr>
<td>Denmark, Greece, Ireland</td>
<td>2</td>
<td>7</td>
<td>11</td>
<td>12</td>
<td>42</td>
<td>(b)</td>
</tr>
<tr>
<td>Other Europe</td>
<td>135</td>
<td>225</td>
<td>384</td>
<td>414</td>
<td>541</td>
<td>583</td>
</tr>
<tr>
<td>Sweden</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>80</td>
<td>150</td>
<td>300</td>
<td>324</td>
<td>393</td>
<td>444</td>
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<tr>
<td>Other</td>
<td>56</td>
<td>75</td>
<td>84</td>
<td>90</td>
<td>148</td>
<td>139</td>
</tr>
<tr>
<td>Japan</td>
<td>264</td>
<td>302</td>
<td>394</td>
<td>457</td>
<td>744</td>
<td>1,054</td>
</tr>
<tr>
<td>Australia, New Zealand, and South Africa</td>
<td>56</td>
<td>55</td>
<td>60</td>
<td>61</td>
<td>120</td>
<td>117</td>
</tr>
<tr>
<td>Latin America</td>
<td>1,979</td>
<td>2,566</td>
<td>3,273</td>
<td>3,816</td>
<td>4,664</td>
<td>1,808</td>
</tr>
<tr>
<td>South and Central America</td>
<td>233</td>
<td>268</td>
<td>313</td>
<td>379</td>
<td>372</td>
<td>307</td>
</tr>
<tr>
<td>Panama</td>
<td>171</td>
<td>185</td>
<td>216</td>
<td>275</td>
<td>256</td>
<td>139</td>
</tr>
<tr>
<td>Other</td>
<td>62</td>
<td>83</td>
<td>98</td>
<td>103</td>
<td>116</td>
<td>108</td>
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<tr>
<td>Other Western Hemisphere</td>
<td>1,746</td>
<td>2,298</td>
<td>1,959</td>
<td>3,437</td>
<td>4,292</td>
<td>4,507</td>
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<tr>
<td>Bermuda</td>
<td>61</td>
<td>111</td>
<td>119</td>
<td>108</td>
<td>151</td>
<td>110</td>
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<tr>
<td>Netherlands Antilles</td>
<td>1,437</td>
<td>1,880</td>
<td>2,547</td>
<td>2,973</td>
<td>3,715</td>
<td>3,945</td>
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<td>U.K. Islands, Caribbean</td>
<td>228</td>
<td>245</td>
<td>238</td>
<td>273</td>
<td>369</td>
<td>399</td>
</tr>
<tr>
<td>Other</td>
<td>20</td>
<td>43</td>
<td>55</td>
<td>83</td>
<td>57</td>
<td>47</td>
</tr>
<tr>
<td>Middle East</td>
<td>(b)</td>
<td>362</td>
<td>542</td>
<td>592</td>
<td>709</td>
<td>746</td>
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<tr>
<td>Israel</td>
<td>(c)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>(b)</td>
<td>362</td>
<td>542</td>
<td>597</td>
<td>709</td>
<td>745</td>
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<tr>
<td>Other Africa, Asia, and Pacific</td>
<td>(b)</td>
<td>160</td>
<td>212</td>
<td>271</td>
<td>423</td>
<td>430</td>
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<tr>
<td>Memorandum - OPEC</td>
<td>300</td>
<td>373</td>
<td>551</td>
<td>610</td>
<td>707</td>
<td>737</td>
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</table>

b - suppressed to avoid disclosure of data to individual companies.
c - Less than $500,000

Exhibit 4

Annual Japanese Real Estate Investment in the United States

<table>
<thead>
<tr>
<th>YEAR</th>
<th>INVESTMENT ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$264 million</td>
</tr>
<tr>
<td>1981</td>
<td>$302 million</td>
</tr>
<tr>
<td>1982</td>
<td>$394 million</td>
</tr>
<tr>
<td>1983</td>
<td>$457 million</td>
</tr>
<tr>
<td>1984</td>
<td>$744 million</td>
</tr>
<tr>
<td>1985</td>
<td>$1.2 billion</td>
</tr>
<tr>
<td>*1986</td>
<td>$2.5 to $3.0 billion</td>
</tr>
<tr>
<td>*1987</td>
<td>$5.0 to $6.0 billion</td>
</tr>
</tbody>
</table>


Exhibit 5

Percentage of Foreign Holdings of U.S. Properties

- Netherlands: 28.7%
- Germany: 14.2%
- Japan: 7.6%
- Canada: 33.2%
- England: 16.3%

1980
Total Investment $3.5 billion

- Netherlands: 16.9%
- England: 27.1%
- Japan: 28.8%
- Germany: 10.2%
- Canada: 16.9%

1986
Total Investment $14.8 billion

*preliminary estimate
Source: U.S. Department of Commerce

Exhibit 6

DOWNTOWN VACANCY
1976-1986

Exhibit 7
Chicago Office Market Performance and Rental Growth

<table>
<thead>
<tr>
<th>Year-End</th>
<th>Inventory*</th>
<th>New Construction and Renovations*</th>
<th>Absorption*</th>
<th>Vacancy (%)</th>
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<tbody>
<tr>
<td>1984</td>
<td>85.8</td>
<td>3.7</td>
<td>3.3</td>
<td>10.4</td>
</tr>
<tr>
<td>1985</td>
<td>89.5</td>
<td>3.7</td>
<td>3.2</td>
<td>10.6</td>
</tr>
<tr>
<td>1986</td>
<td>94.4</td>
<td>4.9</td>
<td>1.8</td>
<td>13.3</td>
</tr>
<tr>
<td>1987</td>
<td>98.3</td>
<td>3.9</td>
<td>1.8</td>
<td>14.9</td>
</tr>
<tr>
<td>1988-89</td>
<td>103.5</td>
<td>5.2</td>
<td>3.6</td>
<td>15.7</td>
</tr>
</tbody>
</table>

## Exhibit 8

FOREIGN INVESTMENT IN U.S. REGIONS: 1985

<table>
<thead>
<tr>
<th>Region</th>
<th>Amount (In Millions)</th>
<th>Percent Of Total</th>
<th>Transactions Number</th>
<th>Percent Of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Midwest</td>
<td>$110.7</td>
<td>3</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Northeast</td>
<td>381.2</td>
<td>11</td>
<td>28</td>
<td>21</td>
</tr>
<tr>
<td>Southeast</td>
<td>978.9</td>
<td>27</td>
<td>33</td>
<td>26</td>
</tr>
<tr>
<td>Southwest</td>
<td>1,761.8</td>
<td>49</td>
<td>44</td>
<td>33</td>
</tr>
<tr>
<td>West</td>
<td>362.9</td>
<td>10</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>Total Known Investment</td>
<td>$3,595.5</td>
<td>100</td>
<td>132</td>
<td>100</td>
</tr>
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</table>

### Exhibit 9
Regional Origin of Foreign Real Estate Investment in Major U.S. Cities, 1979-1983
(Millions of Dollars)

<table>
<thead>
<tr>
<th>Origin</th>
<th>Amount (Millions of Dollars)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$13,220.9</td>
<td>100%</td>
</tr>
<tr>
<td>Canada</td>
<td>$8,024.3</td>
<td>100%</td>
</tr>
<tr>
<td>North America</td>
<td>$3,716.4</td>
<td>100%</td>
</tr>
<tr>
<td>South America</td>
<td>$681.9</td>
<td>100%</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>$872</td>
<td>100%</td>
</tr>
<tr>
<td>Other Countries</td>
<td>$2,089</td>
<td>100%</td>
</tr>
<tr>
<td>Total</td>
<td>$13,220.9</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Region</th>
<th>New York</th>
<th>Dallas</th>
<th>Houston</th>
<th>San Francisco</th>
<th>Los Angeles</th>
<th>Miami</th>
<th>Denver</th>
<th>San Diego</th>
<th>Boston</th>
<th>Seattle</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>1,355.0</td>
<td>1,482.2</td>
<td>521.4</td>
<td>1,001.0</td>
<td>1,046.2</td>
<td>632.1</td>
<td>672.5</td>
<td>497.0</td>
<td>339.0</td>
<td>477.9</td>
<td>13,220.9</td>
</tr>
<tr>
<td>Percent</td>
<td>18%</td>
<td>19%</td>
<td>6%</td>
<td>12%</td>
<td>13%</td>
<td>8%</td>
<td>8%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>100%</td>
</tr>
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</table>

### Exhibit 10
Foreign Investment in Chicago

<table>
<thead>
<tr>
<th>DATE</th>
<th>COUNTRY</th>
<th>PROPERTY</th>
<th>DOMESTIC PARTNER/SELLER</th>
<th>INVESTOR</th>
<th>FORM</th>
<th>SQ.FT.</th>
<th>PROP. TYPE</th>
<th>PRICE</th>
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</thead>
<tbody>
<tr>
<td>1986 JAPAN</td>
<td>PRUDENTIAL PLAZA</td>
<td>PHASE I</td>
<td>PRUDENTIAL</td>
<td>NISSEI REALTY</td>
<td>E-JV</td>
<td>1,100,000</td>
<td>OFFICE</td>
<td>$140,000,000 (E*)</td>
</tr>
<tr>
<td>1986 JAPAN</td>
<td>PRUDENTIAL PLAZA</td>
<td>PHASE II (D*1989)</td>
<td>PRUDENTIAL</td>
<td>NISSEI REALTY</td>
<td>E-JV</td>
<td>930,000</td>
<td>OFFICE</td>
<td></td>
</tr>
<tr>
<td>1985 SWITZERLAND</td>
<td>HOTEL</td>
<td>SWISS GRAND</td>
<td>(D)</td>
<td>SWISS AIR</td>
<td>E</td>
<td>647 ROOMS</td>
<td>HOTEL</td>
<td>$125,000,000 (P)</td>
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<tr>
<td>1987 JAPAN</td>
<td>AT&amp;T CORP. CENTER</td>
<td>(D*1989)</td>
<td>STEIN &amp; CO. (developer)</td>
<td>JAPANESE LIFE CO D-E</td>
<td>1,900,000</td>
<td>OFFICE</td>
<td>$350,000,000 (P)</td>
<td></td>
</tr>
<tr>
<td>1987 JAPAN</td>
<td>(PENDING)</td>
<td>U.S. DEVELOPER</td>
<td>JAPANESE ENTREPRENEUR</td>
<td>E</td>
<td>350,000 + OFFICE</td>
<td>$47,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985 JAPAN</td>
<td>NIKKO HOTEL</td>
<td>(D*1987)</td>
<td>TISHMAN REALTY &amp; CONSTRUCTION</td>
<td>JAPAN AIR LINES</td>
<td>E-D</td>
<td>450 ROOMS</td>
<td>HOTEL</td>
<td>$74,000,000</td>
</tr>
<tr>
<td>1986 NETHERLANDS</td>
<td>55 W WACKER</td>
<td></td>
<td>COMBINED INTERNATIONAL</td>
<td>WILMA REALTY/ VIB N.V.</td>
<td>E</td>
<td>200,000</td>
<td>OFFICE</td>
<td>$16,000,000</td>
</tr>
<tr>
<td>1983 SWITZERLAND</td>
<td>10 S LA SALLE</td>
<td>(D*1987)</td>
<td>FIDINAM</td>
<td>E</td>
<td>750,000</td>
<td>RETAIL/OFFICE</td>
<td>$100,000,000 (P)</td>
<td></td>
</tr>
<tr>
<td>1981 NETHERLANDS</td>
<td>D’HARE CORP. TOWERS</td>
<td></td>
<td>BRAID WARNER DUTCH PENSION FUND: SSP</td>
<td>200,000</td>
<td>OFFICE</td>
<td>$12,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987 JAPAN</td>
<td>(PENDING)</td>
<td>?</td>
<td>?</td>
<td>OFFICE</td>
<td>?</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1986 JAPAN</td>
<td>XEROX CENTER</td>
<td></td>
<td>SUMITOMO TRUST &amp; BANKING</td>
<td>D</td>
<td>755,000</td>
<td>OFFICE</td>
<td>$50,000,000</td>
<td></td>
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<tr>
<td>1987 JAPAN</td>
<td>(PENDING)</td>
<td>CHICAGO DEVELOPER</td>
<td>?</td>
<td>900,000</td>
<td>MIXED-USE</td>
<td>?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SOURCE</td>
<td>DATE</td>
<td>COUNTRY</td>
<td>PROPERTY</td>
<td>DOMESTIC PARTNER/ SELLER</td>
<td>INVESTOR</td>
<td>FORM</td>
<td>SQ FT</td>
<td>PROP TYPE</td>
</tr>
<tr>
<td>----------------</td>
<td>-------</td>
<td>-------------</td>
<td>---------------------</td>
<td>--------------------------</td>
<td>-----------------</td>
<td>------</td>
<td>-------</td>
<td>-----------</td>
</tr>
<tr>
<td></td>
<td>1980</td>
<td>NETHERLANDS</td>
<td>THREE FIRST NAT'L PLAIA</td>
<td>GERALD NINES</td>
<td>ROYAL DUTCH SHELL</td>
<td>D</td>
<td>?</td>
<td>OFFICE</td>
</tr>
<tr>
<td></td>
<td>1986</td>
<td>ENGLAND</td>
<td>NORTHBROOK COURT</td>
<td>HOMART</td>
<td>BROSEVENOR INTERNATIONAL</td>
<td>E-D</td>
<td>1,304,045</td>
<td>REGIONAL MALL</td>
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<tr>
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<td>NETHERLANDS</td>
<td>OAKBROOK TERRACE</td>
<td>BAIRD WARNER</td>
<td>DUTCH PENSION FUND: SSP</td>
<td>D-E</td>
<td>200,000</td>
<td>SUBURBAN</td>
</tr>
<tr>
<td></td>
<td>1987*</td>
<td>JAPAN</td>
<td>?</td>
<td>CHICAGO DEVELOPER</td>
<td>JAPANESE CONSTRUCT. CO.</td>
<td>E-JV</td>
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<td>OFFICE</td>
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<tr>
<td></td>
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<td>NETHERLANDS</td>
<td>COLUMBIA CENTER (D*)</td>
<td>FIFIELD DEVEL CO</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>SUBURBAN</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td>SAUDI ARABIA</td>
<td>500 N MICHIGAN</td>
<td>RUBLOFF</td>
<td>PRIVATE INDIVIDUAL</td>
<td>E</td>
<td>600,000</td>
<td>OFFICE</td>
</tr>
<tr>
<td></td>
<td>1980</td>
<td>SAUDI ARABIA</td>
<td>OAKBROOK INTNAT'L</td>
<td>?</td>
<td>E</td>
<td>300,000</td>
<td>SUBURBAN (4 BLDGS)</td>
<td>OFFICE</td>
</tr>
<tr>
<td></td>
<td>1986*</td>
<td>JAPAN</td>
<td>XX LASALLE</td>
<td>U.S. INS. CO.</td>
<td>JAPANESE INS. CO. E-JV</td>
<td>785,000</td>
<td>OFFICE</td>
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<td></td>
<td>1983</td>
<td>GERMANY</td>
<td>LINCOLN MALL</td>
<td>JAYMONT</td>
<td>LENDHORF GROUP</td>
<td>E</td>
<td>?</td>
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</tr>
<tr>
<td></td>
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<td>GERMANY</td>
<td>CHICAGO RIDGE MALL (1)</td>
<td>JAYMONT</td>
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<td>?</td>
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<td>?</td>
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<td>303 W. MADISON</td>
<td>JAYMONT</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

(D*198X) - Development project/completion date
(E#) - Estimate
(P) - Total project cost, foreign equity investment unknown
E - Equity
D - Debt
* - Pending transaction
(1) - Property sold one month after purchase to domestic firm.

**This list is not all inclusive and no doubt some foreign owned property has been overlooked. While every attempt was made to be accurate, there may be some inaccuracies in the data.**
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