

INTERNATIONAL REAL ESTATE DEVELOPMENT:
MEXICO AS AN EXAMPLE

by

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ABSTRACT

What risks and regulations impede expansion opportunities available to U.S. developers in the international arena? How can these potential impediments be mitigated? This thesis explores the basic legal, regulatory, cultural, economic and political issues involved with international development using Mexico as an example.

Methods of managing international risks are identified and outlined. These include: monitoring and forecasting political and economic trends; hedging; investment diversification; joint ventures.

The thesis concludes that one of the best tools for managing the uncertainties involved in developing abroad is a joint venture with a firm from the host country. Criteria for a successful cross-border joint venture is described.

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INTRODUCTION

"American developers surveying the economic scene in the 1990's have had cause for despair. Few American lenders are making loans of any type, and residential, industrial and commercial products, including hotels and resorts, are overbuilt in most areas of the United States. The American developer or real estate investor has two choices: wait for the domestic market to come back or look beyond the U.S. borders for realistic opportunities."¹

D. Ellsworth & M. Capaldi
Morgan, Lewis & Bockius.

"A stagnant domestic real estate market and other economic factors are encouraging U.S. participation in foreign real estate joint ventures. U.S. real estate developers and capital sources are increasingly examining the development and ownership of commercial properties abroad."²

R. Leber-*Lord Day & Lord*
R. Singer-*Solomon Brothers*

Quotes such as these appear in many real estate journals as American developers and investors scramble to find realistic opportunities. Currently all sectors of the U.S. domestic real estate industry are under-performing. According to calculations made by William Wheaton, a professor in the MIT department of economics, there is enough excess office space in the nation right now to, in effect, supply the needs of business for the rest of the decade. Wheaton writes;

¹D.Ellsworth & M. Capaldi, "An American Developer's Guide To International Real Estate Investment", *Vacation Industry Review*, Spring, 1992, p.1.

²R Leber, R Singer, "International Real Estate Joint Venture", *The Journal of European Business*, Jan/Feb., 1992, p.41.

"New development will likely not be warranted until towards the end of the decade."³

Given this situation facing U.S. developers at home, many are looking beyond the borders. The regions of Latin America, South East Asia and Eastern Europe all promise great opportunities in the near future. However, development outside one's local area can be very difficult as cultures, languages, laws, taxes and politics are very different from country to country.

This thesis will examine the regulations and risks involved in international development, and , using Mexico as an example, will examine suggested methods to mitigate these barriers to entry. Research has been conducted through a literary search and interviews with developers currently operating abroad, lawyers specializing in foreign ventures and government regulators. Literary sources include: trade journals, business magazines, investment guides, newspaper articles, government regulatory brochures, and developers reports.

Mexico is used throughout as an example of the different regulations and risks American developers should take into account. Past and current economic situations in Mexico have been examined, as have the risk management techniques of

³W.Wheaton, "The Prognosis for Real Estate: An inevitable Recovery?", *MIT Center for Real Estate - Working Paper #40*, Jan, 1992, p.13.

American developers currently working in Mexico. The research has been used to suggest methods of mitigating the risks involved in investing in this area.

CHAPTER 1

U.S. DEVELOPMENT ABROAD

U.S investment in real estate abroad is not a new phenomena. Soon after the founding of the United States, citizens began investing in the Spanish / French colony of Louisiana, and later in part of Mexico known as Texas. Later substantial investment in the monarchy of Hawaii. The extent of American real estate interests abroad is not known due to the fact that there is no requirement for reporting such investment.

In a Guide to International Real Estate Investment, Mary Alice Hines makes the point that in the past it was not only easier to invest in U.S. real estate than in foreign real estate, but U.S. real estate offered higher yields and lower risk. However, the current real estate situation in the U.S. has changed things quite drastically. Hines writes:

"The investor has been shown by recent investment yield reports that diversification of investment on an international basis pays. If expansion of the firm is the company policy, the overseas real estate market may need to be tapped one way or another."⁴

Developing countries usually offer a much higher rate of return on the investment due in part to the higher risk, but also due to the developing economies and increasing general

⁴M.A.Hines, "Guide to International Real Estate Investment", *Quorum Books*, 1988, p.3

wealth. This fact combined with the desire to diversify internationally have been the leading reasons for developing abroad. In their book, International Real Estate Investment, Dudley Hinds and Nicholas Ordway write:

"There is also a sense of Ego satisfaction associated with ownership of real estate in another country due in part to the prestige associated with something exotic."⁵

American developers are very capable in their own local markets and, likewise, foreign developers are very capable and know how to operate in their local environment. There would be little point in an American developer attempting to compete abroad if there was no comparative advantage over the local developers. Hinds and Ordway have identified the four most common conditions under which U.S. developers can have a significant advantage over the locals:

1) *The foreign development is for American clients that the developer already has a working relationship with.*

The least risky kind of foreign venture for U.S. developers, is one geared to American markets seeking developments abroad. The U.S. market can be analyzed and understood, and financing in the U.S. can often be obtained. A U.S. developer with a corporate client seeking a plant and office

⁵D.Hinds & N.Ordway, "International Real Estate Investment", *Real Estate Education Company*, 1983, p.7

complex, built to its own standards in another country, will not find it hard to locate a land owner willing to contribute property to the venture. Other U.S. markets to be tapped include industrial and agribusiness firms needing employee housing, tourists looking for resorts, business travelers needing hotels, and households seeking vacation homes or retirement homes.

2) *Superior technology in construction methods or innovations that are locally adaptable.*

Superior technology in the U.S. is not necessarily superior in other countries as labor costs can often be much lower. For example, in Mexico concrete slab pre-fab housing is more expensive than brick construction laid by conventional methods. However, many American developers such as Hines Interests and Tramwell Crow have found opportunities where the superior engineering design and other construction innovations from the U.S. act as assets in entering foreign markets.

3) *Superior access to financing.*

American developers can often obtain financing at home for foreign projects, especially those for a U.S. market. Mexico, for instance, lacks pension, life insurance or other long-term institutional funds.

4) *Failure by local builders to recognize a potential segment of local market demand.*

Experience gained in the U.S. can often be transferred to other countries. For instance, identifying an untapped market for single-family homes for households who can not afford expensive custom built homes, but who want something better than apartment or condominiums. Applying the expertise and experience gained from building large scale production of site-built homes in the U.S., for instance, might be a new concept to local developers. The developer should remember that many less-developed countries have inadequate data for researching local markets, and that the competitive edge is only temporary. Whether the product be single family homes, car-wash establishments, or something else, any initial advantage will vanish in time as local builders and other foreign builders belatedly recognize the untapped market themselves.

It is beyond the scope of this paper to analyze more than one country's situation, although the lessons that we learn from one country may be generalizable to other countries. In order to familiarize the reader with the current real estate market in Mexico, an overview follows.

CHAPTER 2

THE MEXICAN MARKET OVERVIEW

HISTORICAL OVERVIEW

Mexico has suffered through two decades of economic and social instability beginning during the inefficient and unusually corrupt administration of President Luis Echeverria (1970-1976). In an attempt to control foreign investment, the Echeverria government passed the 1973 Law to Promote Mexican Investment and Regulate Foreign Investment. This law took matters from bad to worse. Its Mexicanization provisions required that at least 51 percent of the equity in all corporations or ventures be owned by Mexicans. This caused a chronically capital short country to effectively shut the door in the face of foreign investment. Foreign currency reserves at the central Banco de Mexico were quickly drained as anyone with pesos converted them to dollars. In August of 1976 the peso was devalued, acting as a catalyst to a decade of difficult economic conditions. After 22 years of the peso being traded at 12.50 to the U.S. dollar, its value in relation to the dollar was cut in half. The currency erosion continued in earnest for the next 15 years and now trades at approximately 3,100 to the dollar.

With Echeverria's successor Jose Lopez-Portillo (1976-1982) it was more of the same. With oil prices soaring, foreign banks were willing to loan Mexico over a hundred billion

dollars. With the collapse in oil prices of the mid-1980's, Mexico suffered a severe depression and spiraling inflation as well as further currency value erosion. Lopez-Portillo, blaming not only foreigners but Mexican bankers as well, nationalized the banks, thus losing any remaining popular confidence in the government.

MEXICO TODAY

Lopez-Portillo's successors have represented a new breed of politician-technocrats dedicated to the progress of their country and its people. The job of restoring faith in the government fell to President Miguel de la Madrid (1982-1988) and his successor, Carlos Salinas de Gortari (1988-1994). Their administrations have enacted sweeping policy changes in an attempt to rebuild the country's economy. Restrictions on foreign investment have been dramatically relaxed, the banks are being returned to private ownership, and cordial relations have been established with the United States. Jorge Castaneda, the director of foreign investment for the Government of Mexico has characterized the effects of these changes as salutary. According to Castaneda, the rate of inflation fell dramatically, from a peak of 159 percent in 1987 to just 15 percent in 1991 (see exhibit 1), and hard currency reserves have risen to a near record \$14 billion.

EXHIBIT 1

MEXICAN ECONOMIC INDICATORS 1989 TO 1991

Source : Mexican National Economic Program for 1990-1991

	<u>1989</u>	<u>1990</u>	<u>1991</u>
Gross National Product (billions of Pesos)	511.5	654.3	791.7
Gross National Product (% real change)	3.1%	3.9%	3.8%
Annual Inflation Rate	19.7%	29.5%	15.0%
Financial Deficit (% of GDP)	5.6%	4.3%	1.9%
Primary Balance (% of GDP)	8.3%	7.5%	6.9%
Total Imports (billions of dollars)	23.4	28.5	31.6
Non-Oil Exports (billions of dollars)	14.9	17.1	19.0
Oil Exports (millions of barrels per day)	1277.8	1263.1	1360.0
Oil Price (average in U.S. dollars)	15.6	19.3	17.0

In the last five years the foreign debt has dropped from 76.3% to 38.6% of Gross Domestic Product. Likewise Mexico has decreased its budget deficit from 16% to 1.9% of GDP. The number of enterprises that are controlled by the government has been reduced from 1,200 in 1982 to 200 in 1992. Gross National Product has grown at an average of 3.2% over the past five years. The Bolsa (stock market) has been one of the world's top performers, up 4,000 percent (in U.S. dollars) since 1982. Foreign investment is estimated to exceed \$30 billion, with almost two-thirds of it coming from the United States.

Mexico today has the fourth largest oil reserves in the world and is a leading petroleum exporter, as well as a leading producer of silver, sulphur, zinc, copper, coal and iron ore. The country is also an important manufacturer and exporter of

petrochemicals, auto parts, electronic products and pharmaceuticals. The economy is supported by a transportation infrastructure that includes more than 200,000 kilometers of paved road and 26,000 kilometers of railroad. It is also served by 74 airports, 33 of which handle international traffic, as well as 76 maritime ports making it a prime location for future development.

James Pollak, the ex-director of the real estate investment banking operation of Banco Nacional de Mexico, feels that the climate in Mexico for foreign investment is extremely favorable in 1992. Mexico, with a population of more than 84 million and a growing middle class, is a consumer economy of great potential. The nation offers vast natural resources and a large pool of inexpensive labor. The minimum wage is generally under \$2 an hour. Free trade is a high priority of the government and the barriers to foreign participation are diminishing rapidly as the need for capital is recognized. The cost of land, construction and operation of real estate, whether it be commercial, industrial, residential or resort/hotel, is as much as 50 percent less than in the United States.

THE NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

On April 7, 1991, presidents Salinas of Mexico and Bush of the United States met to discuss plans for the North American Free Trade Agreement. This tripartite agreement would bind the economies of Canada, the United States and Mexico into a single economic trade zone acting as a counter-weight to a united Europe and the Orient. The agreement would allow for duty-free imports and exports across the borders as long as the agreed upon North American content requirement is achieved. (Products considered made in North America will likely have to be at least 60% made in one of the participating countries). In addition, an internal free trade agreement implies tariff protection from those not participating in the agreement. It is likely that tariffs on certain imported items from countries outside the free trade zone will be increased.

A recent article in Business Week suggests that although there is a consensus in all three countries in the Free Trade Agreement concerning the necessity of such an agreement, there are political realities that have to be faced in each country. Paul Magnusson of Business Week writes:

"Representative Terry L. Bruce (D-Ill.) figures a North American Free Trade zone is a good idea. But

he's not willing to abandon the broom-makers of downstate Illinois to get it."⁶

There are also the loud objections of certain interest groups in all three countries that command a great deal of political power. The Business Week article goes on to state:

"Now negotiators have to deal with opposition to NAFTA from manufacturers of cement, glass, athletic shoes, auto parts, and furniture; sugar, peanut, and tobacco growers; citrus, cucumber, and tomato farmers; tuna and pepper canners; and a dozen others who have come out of the woodwork to oppose parts of the treaty. They are joined by a diverse army of "public interest" lobbyists and groups, including Ralph Nader, the AFL-CIO, the Sierra Club, even the united Methodist Church Board."⁷

Political and economic annalist seem to be in agreement that it is unlikely George Bush would dare provide the Democratic Congress with a viable political issue to use against him in a post-recessionary election year. The Wall Street Journal reports that in Canada there is widespread resentment of the existing Free Trade Pact with the U.S.:

"Some experts warn that Canada, where free trade agreements are about as popular as the flu, might withdraw or refuse to sign some sections."⁸

⁶P.Magnusson, "How many broom-makers does it take to kill a trade pact?", *Business Week*, July 20, 1992, p.29

⁷ibid

⁸B.Davis, "Sweetheart Deals", *The Wall Street Journal*, Wed., July 22, 1992, p.1.

Likewise, an article in the *Globe and Mail Report on Business* states that many manufacturing jobs have been lost to the U.S. due to the lower taxes and salaries. The report quotes manufacturers' associations as saying:

"Ontario in particular is the scene of an almost giddy rush to the United States and Mexico....Stateside offers cheaper labour, industrial land, free workforce training , lower corporate taxes, mortgage interest deductability and in eight states no state personal income tax."⁹

For these reasons it is doubtful that the North American Free Trade Agreement will be passed before 1993. However, some form of pact seems inevitable and promises to further spur the already booming need for developments in Mexico.

Developers contemplating projects in foreign countries must first research the past and current economic situation in the host country; as has been done in this chapter. The next step for a developer should be a due diligence search of all the pertinent regulations affecting development by foreigners. An example of the issues that must be addressed follows.

⁹A.Walmsley, "Turning the Tide", *Globe and Mail Report on Business*, June, 1992, p.22.

CHAPTER 3

FOREIGN LAWS AND REGULATIONS

FOREIGN INVESTMENT REGULATIONS

In setting out to develop in a foreign country, the U.S. developer is an alien. The first problem is whether or not an alien is permitted to own any interest in a company or property in the foreign country, and, if so, what kind of interests. Many nations ban foreign ownership of businesses or real estate, but often will grant "concessions" to alien business entities. The current laws regarding foreign ownership and foreign investment in a country must obviously be analyzed carefully before any projects are considered.

Much of the credit for the growing strength of the Mexican economy, for example, is due to the restructuring and liberalization of government regulations regarding foreign investment. In an article for *Global Production Magazine*¹⁰, Jorge Castaneda, the director of foreign investment for the Government of Mexico, states that regulations now permit foreign investors to have 100 percent ownership in 70 percent of the Mexican economy. These changes were brought about in the new regulations issued in 1989. Castaneda explains that in the Foreign Investment law written in 1973 some sectors were reserved for the state, namely, petroleum and

¹⁰J.Castaneda, "New investment regulations make it easier to do business in Mexico", *Global Production Magazine*, Sept/Oct, 1991, p.10.

hydrocarbons, basic petrochemicals, the exploitation of radioactive minerals, mining, electricity, radio and telegraphic communications. Some sectors were reserved for Mexicans: radio and television, urban and interurban automotive transportation, domestic air and maritime transportation, gas distribution and exploitation of forest resources. The law also created the Foreign Investment Commission which imposed many regulations on land ownership.

The 1989 regulations introduced an automatic proceeding which gives foreign investors the opportunity to incorporate or establish a 100 percent foreign ownership company in Mexico. This can be done without any permitting process as long as the company's activities do not fall within the commission's list of regulated activities. Jorge Castaneda has identified six conditions for this automatic proceeding:

- 1) The investment in fixed assets must not exceed the equivalent of U.S. \$100 million.
- 2) The resources must come from abroad.
- 3) Industrial facilities may not be located in Mexico City, Monterey or Guadalajara.
- 4) There must be a cumulative even balance of payment (inflows equals outflows) for the first three years of operation. This excludes the initial investment and imports of materials, parts, equipment, payments of interest and royalties.

- 5) Only 10 percent of the total payroll created may go to foreigners.
- 6) Adequate technology must be used, and all environmental and regulatory laws must be observed.

According to Castaneda, building, construction and installation businesses fall under the regulatory category of 100 percent ownership with Foreign Investment Commission (FIC) approval. This approval is on a case by case basis, however approval is automatic if no response is received from the FIC within 45 days of the filling of the application to incorporate.

The new foreign investment rules also include provisions to allow foreign investors to increase their holdings in existing operations to a majority share under clearly specified conditions. In addition, Trust Mechanisms have been created to allow foreign investors to enter into joint ventures with Mexican companies in certain business sectors previously reserved for domestic investors, and allow for the creation of new financial instruments that expand the opportunities for foreign investors to participate in the Mexican capital markets.

ACQUIRING AND DISPOSING OF REAL ESTATE

American developers are accustomed to absolute ownership of real property, typically a "fee" interest which allows owners and their heirs and successors full use of the property indefinitely, and freedom to sell the property to anyone at any time. Laws in some nations limit the length of time during which a foreign investor may hold real property, and other nations restrict ownership in strategically important areas such as border zones and coastlines.

In a report to the Urban Land Institute, Fernando Orvananos, president of Burnham de Mexico, writes that foreign individuals who are legal residents of Mexico may now own real estate outright, but foreign companies may not, although they may lease. However, as Orvananos writes:

"Foreigners now can own 100 percent of certain Mexican companies, and can obtain permission to own real estate through those companies. This path is made easier if the suggested projects are attractive to government by virtue of location, job creation and capital investment."¹¹

The Mexican Constitution, adopted in 1917, declared a ban on foreign ownership within a "prohibited zone" of 100 kilometers (64 Miles) of its borders and 50 kilometers (32 miles) of its coastline. The 1973 Foreign Investment Law

¹¹F.Orvananos, "Mexico City", *Urban Land Institute Market Profile*, 1992, p.2.

authorized some restricted foreign ownership of Mexican land. This law upheld the ban on outright foreign ownership of properties within the prohibited zone. However, through the beneficial interest in an authorized Mexican bank trust, or **fideicomiso**, foreigners could have the beneficial rights over land within the prohibited zone for up to 30 years. Legal title to the property itself is held in trust by an authorized Mexican national bank for the use and benefit of the foreign beneficiary.

Until recently the Foreign Investment Law mandated that at the end of the 30 year period, the foreign owners had to sell the property to a Mexican national or a corporation that excluded any foreign participation. However, in 1989 the Salinas government issued regulations that dramatically liberalized the 1973 Foreign Investment Law. Mexican law now expressly provides that at the end of the thirty year term of the trust, upon request, the Government will automatically issue a new permit for an additional thirty year term. Also, if an interest in real estate held under trust is sold or conveyed, the transferee can obtain a permit which provides for a new thirty year term, regardless of the remaining amount of time on the original trust.

TAXATION

American developers in foreign countries face the difficulty of dealing with complex tax laws and regulations affecting their investments. Developers must concern themselves with the tax laws in their home country, taxation by the host country, and the interplay of the two sets of tax laws. Just as in the U.S., developers who purchase real property interests in other countries must contend with a broad range of taxes such as: income tax, capital gains tax, land speculation tax, land development tax, value added tax or even vacancy tax. (Some countries impose an extra tax for vacant buildings or unused agricultural land to encourage full utilization of property.)

Mexico has historically imposed very substantial taxes on income and property transfers. In the past the Federal government could tax up to ten percent of the value of the transfer of real property. The state could take another two to eight percent, and notary and registration fees could cost an additional one percent each. Likewise the highest personal income tax rate was in excess of 70 percent.

The new 1989 regulations have shown far reaching efforts by the federal government to attract foreign investment. The income tax rates were dramatically reduced to 35 percent which is in line with rates in the industrialized countries. Withholding restrictions on profits and dividends were

removed, and withholding on interest payments was reduced to 15 percent. Taxes were restructured in such a way that foreign tax credits could be claimed in the U.S. and other foreign countries for taxes paid in Mexico. The transfer tax paid by the buyer on the transfer of real property has been lowered to 8 percent and was set to be as low as 2 percent by 1993.

All businesses in Mexico are subject to a value-added tax (VAT or in Spanish, IVA) at a general rate of 15 percent (6% along the border). This tax is also imposed on the sale of timeshares. However, at this time, Mexican tax authorities exempt the sale of certain club memberships from the VAT, even where the membership program is part of a timeshare project structure.

ENVIRONMENTAL REGULATIONS

"Few nations have environmental laws as rigorous as those of the United States, though comprehensive laws and standards are the norm in western Europe. The nations of Eastern Europe have serious pollution problems, but only now are struggling to establish environmental protection agencies and do not yet have comprehensive anti pollution laws. Because the third world nation have not been industrialized so long as the United States, they

are only now seeing public pressure for strict environmental guidelines."¹²

American developers must be familiar with any and all environmental and land use laws that will affect a given project. The enforcement of environmental laws is increasing in most countries and should, therefore, be taken very seriously.

Mexico's environmental laws parallel those of the United States, although Mexico's enforcement activity has lagged behind its Northern neighbor. A recent treaty gave the U.S. Environmental Protection Agency joint enforcement powers in the border area, however, and Mexico has recently begun to strengthen its own enforcement organizations.

Mexican federal environmental legislation, and enabling regulations and technical standards apply to all companies doing business anywhere in Mexico. For certain types of operations, state and municipal legislation and ordinances also apply, although few states or municipalities have enacted them. In a report for multinationals wishing to invest in Mexico¹³, Baker & McKenzie, (the largest law firm in the world) with offices in Mexico and the U.S., lists the most pertinent environmental requirements as:

¹²D.Ellsworth & M. Capaldi, "An American Developer's Guide To International Real Estate Investment", *Vacation Industry Review*, Spring, 1992, p.3.

¹³T.Shoesmith, "Investing and Manufacturing in Mexico", *Baker & McKenzie*, 1991, .

1) The disposal in Mexico of hazardous waste, as defined in the applicable technical standards, derived from imported materials, is absolutely barred. Non-hazardous waste derived from imported materials may be disposed of in Mexico only if approval is obtained from the Mexican Customs Department. Likewise, there are no companies authorized by the Ministry of Urban Development and Ecology (SEDUE) to dispose or recycle, hazardous materials or waste resulting from imported materials. The importation, exportation, transporting and handling of any hazardous raw materials, hazardous products or hazardous waste, must be carried out in accordance with Ecological Waybills which must be obtained for every shipment. Any storage of such hazardous raw or waste materials must be in facilities which comply with special specifications set forth in the regulations.

2) In order to operate, all manufacturing plants and developments must obtain a license from SEDUE covering all aspects of their manufacturing or development activities. Along with the application for the Environmental Operating License, a statement must be filed regarding the potential impact of the company's operations on the environment. This statement could lead to a requirement for a full environmental impact study if the authorities deem it to be warranted.

3) Only residential water discharges are exempt from the requirement of obtaining a Residual Water Discharges registration from SEDUE. Registration is required for any and all other water discharges.

4) Any change in the information provided to SEDUE under the application for any of the license or registrations listed above must be reported to SEDUE. A permanent physical inventory or log of all hazardous materials in the possession of the company at any given time must be kept, and it must be available for inspection by SEDUE. Companies that generate hazardous waste must file biannual reports with SEDUE.

The laws and regulations affecting international development are many and varied. The most common, and most important to take into account have been highlighted in this chapter. However, there are other obstacles to international development that must also be taken into account by the prospective developer. These are the risks that exist in international development that are less of a factor when developing at home. The next chapter will highlight some of the more important risks that must be considered before steps are taken to develop abroad.

CHAPTER 4

RISKS INVOLVED IN INTERNATIONAL DEVELOPMENT

Developers in any country are influenced by risks associated with real estate, but for international developers the influence is magnified. International developer's face additional risks not normally found in the developers home country that require special consideration. In her book, Guide to International Real Estate Investment, Mary Alice Hines wrote:

"Generally comparative yields indicate that higher investment yields are associated with investment that reflects higher risks. In international real estate investment most participants are trying to increase their investment yield without adding comparable amounts to the total risk complexion of the investment."¹⁴

In order to mitigate the additional risks associated with international real estate development, one must first understand the risks. The major risks include: Political Risks, Cultural-Social Risks, Economic and Exchange Risks.

¹⁴M.A. Hines, "Guide to International Real Estate Investment", *Quorum Books*, 1988, p.99

POLITICAL RISKS

An investment in real estate is highly vulnerable to the actions, inactions or failures of governments due in large part to its immobility and non-liquidity. Any assessment of risk in an investment; therefore, it must take into account the stability, quality and attitude of government. Political risks can be divided into three broad groupings :

- 1) Risks stemming from actions of the foreign government. These would include such problems as expropriation of property (with or without just compensation), rent controls, and administrative risks such as discriminatory treatment of foreign investors.
- 2) Risks stemming from internal or external political instability. These would include acts of terrorism, war and various types of domestic turmoil.
- 3) Risks stemming from actions of the U.S. government. These would include any confrontation politics between the U.S. and the host countries government as a result of which investors are treated as pawns. For instance, a trade embargo placed on a given country would clearly leave the American businesses in that country in a very bad position. Also included would be any attempts by the U.S. government to control the business practices of its citizens abroad, and various tax disputes.

American developers have always sought assurances of stability and permanence relative to their investments in Mexico. Although Mexico has significantly relaxed its regulations regarding foreign investment, it has done so without the federal Congress formally amending the associated statutes. The North American Free Trade Agreement (NAFTA) will seek to eliminate restrictions on investment by nationals of the other agreement parties. This could provide the sought-after level of stability and continuity desired by most U.S. developers. It is very likely that Mexico would formally amend its foreign investment statutes if the NAFTA is passed. A wise investor will, of course, assess these different political risks and look for ways to manage them. A U.S. developer who wishes to invest in Mexico should make sure that the rate of return is high enough and the payback period short enough to justify the risks being taken.

CULTURAL - SOCIAL RISKS

There are many cultural and social risks to doing business in one's own country that are avoided almost instinctively. The experiences gained over the years of business dealings, knowing what is proper etiquette and practice, comes naturally to a local practitioner. However, attempting to apply what has been learned in one's own country to international real estate practices can lead to surprises and mistakes. There are many cultural, social and physical differences between the U.S. and other countries. The

developer should examine and be prepared to deal with the following differences : language patterns, attitudinal patterns, social and legal patterns, and activity patterns.

Language

The U.S. has people from many linguistic and ethnic backgrounds, but its language is basically English and its culture is substantially unified. Although several million Americans speak English as a second language, it is, for all practical purposes, the language of business and government. Attitudes, concepts and values are influenced by language, as are business negotiations. Therefore, there are risks associated with incorrectly using various elements of human communication such as words and grammar, body language, forms of address and humor. In Mexico, for example, it is very easy to be misunderstood if one does not understand the forms of communication used at the business transaction level. When General Motors attempted to sell the Chevrolet Nova in Mexico, they were surprised at the lack of interest from the buyers. They soon came to the realization, after spending millions of dollars on advertising, that "no va" translates to "it doesn't go."¹⁵ These misunderstandings sometimes lead to humorous situations, but often times lead to serious breaches of etiquette or termination of business dealings.

¹⁵M.Rick, "To Make Mr. Rick's List, a Company Must commit a Major Blunder Abroad", *The Wall Street Journal*, March 13, 1981, p.27.

Attitudinal Patterns

Attitudinal patterns underlie the motivations to purchase or lease real estate space and should, therefore, be carefully considered before any project is begun. All cultures have somewhat different perceptions toward the physical environment (time and space), emotional structures, friendships, status, work attitudes and ethics than do Americans. For instance, the concept of time and efficiency is more flexible in Mexico than in the U.S. Delays in performing contractual obligations are accepted business risks that must be accounted for. Likewise, what is considered crowded space in the United States is often considered spacious in Mexico.

Emotional structures represent the subtle ambience of a culture. Such elements as color, music, forms and shapes of things, symbols, and packaging must be considered by the real estate developer. By failing to account for these emotional structures, one's chances at success will be greatly diminished because the product will not be met with approval by the customers.

Foreign attitudes towards contracts are not always as rigid as those in the U.S. Due to America's constant litigation, contracts play a major role in keeping business relations going. In Mexico, developing friendship patterns is just as important as having a good contract. There is great

reluctance to deal with others until there are assurances as to the character and honesty of the business associate. The theory underlying this dependency on friendship was well articulated by a Latin American businessman:

"If I can't be friends and he is not simpatico, I can't depend on him to treat me right. If we could be friends, he would feel obligated to me and this obligation would give me some control. Without control, how do I know he will deliver?"¹⁶

The concept of status is very important in Mexico. Although there is no class system or caste system (as in India), there are attitudes differentiating certain groups. Those of direct Spanish descent consider themselves of higher social-business status than those of mixed Spanish - Mexican Indian descent (Mestizos). Even though a majority of Americans would disagree with such concepts, it is advisable to avoid selecting intermediaries of higher or lower social status as there will be difficulty in conducting business.

Work attitudes are especially important for those developers interested in real estate that depends on a great deal of local labor. Projects such as hotels, restaurants, agricultural investments and industrial sites, depend greatly on the local labor for their success. Knowing the habits and

¹⁶E.Hall, "The Silent Language in Overseas Business", *Harvard Business Review*, May-June, 1960, p.95

attitudes of the work force is, therefore, very important as a bad working relationship can easily result from cultural misunderstandings. For instance, Joseph Woodard of Koll International, a subsidiary of the Koll company of Newport Beach (one of the largest development and management firms in the West), explained, in a telephone interview¹⁷, that Koll International entered into two projects in Mexico with its own construction company from the U.S. The different work attitudes and construction practices between the Mexican subcontractors and the Americans made for a difficult working environment. After trying to cope with the differences, Koll International found it easier to leave the American laborers in the U.S. and act as construction managers managing Mexican general contractors.

Ethics are often culturally based, and an entire chapter could be dedicated to this topic. David Ellsworth, a senior partner in the international law firm of Morgan, Lewis & Bockius, states in a report for *Developments Magazine*¹⁸, that what is considered unethical in the United States is often considered sharp business practice in Mexico. Attention should be paid to the ethical reputation of any possible business partners. According to Ellsworth, gifts, indirect payments and outright bribes given to public officials are illegal in Mexico as they are in the United States. However,

¹⁷J.Woodard, Telephone interview, July 23, 1992.

¹⁸D.Ellsworth, "Mexico Invites Foreign Investors in Tourism", *Developments*, Sept., 1990.

they are not only tolerated, they have become ingrained in the society, and business is very difficult if not impossible without them. Most American developers will be faced at one time or another with the decision to do business the Mexican way or give up and go elsewhere. This can lead to a great deal of risk because in addition to going against one's personal conscience, there is now a risk of violating U.S. law. The Foreign Corrupt practices Act passed by Congress in 1977, provides for fines up to \$10,000 for individuals, and up to \$1 million for corporations for illegal payments to officials in other countries. Ellsworth suggests that American developers wishing to operate in Mexico should, therefore, tread warily and seek good legal counsel whenever there is a question of ethics involved.

Social and Legal Patterns

Doing business in another country requires an understanding of its political and social systems. To understand these systems it is necessary to learn something of the history of the country.

Mexico's history, for example, can help explain many facets of the social and legal makeup of the country. The Spanish conquest of Mexico was brutal, displacing the native population entirely in some areas, and in others, superimposing themselves on the natives through intermarrying. This process aided in setting the scene for a

tough and somewhat corrupt society. In contrast, the westward migration of the English in the U.S. and Canada was a more constructive search for opportunity and freedom, paving the way for a democratic society. The 1810 proclamation of Mexican independence from centuries of Spanish domination heralded a chaotic 19th century during which the Mexicans fought Spain, Texas, the United States, France and themselves.

"The wars with the United States were mostly over real estate, a good thing to remember when trying to understand what may appear to be overly sensitive property laws and regulations. Texas, California and a lot of other choice real estate were part of Mexico just 150 years ago."¹⁹

Such different histories have produced drastically different social patterns and laws that reflect those patterns. the system of law in the United States is a modified version of English Common Law. This system relies heavily upon the precedents established by prior decisions. Mexico's legal system is more in line with that of most continental European countries. This system has been called Roman Law, Civil Law, and Code Law. This system relies more on lengthy codes than upon judge-made law. The real estate developer who is going to deal with someone in Mexico needs an attorney who is

¹⁹J.Pollack "Mexico is saying Bienvenido to Foreigners", *Urban Land*, November, 1991, p.23

sensitive to the differences and knowledgeable of Mexican law.

Activity Patterns

Activity patterns are influenced by language and by attitudinal, social and legal patterns. Developers must examine such activities as meals, domestic living, shopping, distribution, transportation, working and recreation. These activities all differ between the U.S. and other countries, and help define the type of real estate development that will be successful in a particular location. As an example, in Mexico the major meal is at midday and is often eaten at home. This causes a lunchtime traffic jam that lasts for approximately two hours. As a result, workers prefer to live as close as possible to their places of work to avoid the problem of a double rush hour even if the dwelling place is more crowded than it otherwise would be.²⁰

ECONOMIC and EXCHANGE RISKS

Investing across international borders subjects developers to extra economically based risks that could be avoided by staying solely at home. Not only must the developer worry about the risks affecting a real estate project within the host country itself, but also the investor must worry about what happens when the money is transferred back home.

²⁰J.Seibert, "Concepts of Marketing Management", 1973, p.492

Economic Risks

General economic conditions affect all real estate investments in a country. The supply and demand of goods and services influences economic conditions to the greatest degree, and when there is an imbalance of supply and demand, inflation often results, leading to currency devaluation.

The greatest economic risk in Mexico today is the staggering population growth according to Fernando Orvananos, the President of Burnham de Mexico a multinational commercial real estate firm (the Mexican affiliate of John Burnham & company)²¹. Orvananos predicts that at the current population growth the Mexican economy must grow at an average of 4% per year just to keep the employment level constant. The current government has firmly committed itself to the most comprehensive economic reform in Mexico's history. The goal of the major changes with regards to the structure of the Mexican economy and its relation to foreign investment is to unleash the considerable economic potential of Mexico. This process is to be accomplished through a program of deregulation and privatization internally, and by removing the structural impediments to foreign investments (see chapters 1 & 2). The Mexican economy has rebounded with amazing vigor. The economy has been growing at 3.8% per year and inflation has been reduced from staggering levels of 159% per year to 15.9% per year. However, despite these pivotal

²¹F.Orvananos, "Mexico City", *Urban Land Institute Market Profile*, 1992.

changes in Mexico's foreign investment regulations and the resulting changes in the economy, there are still significant obstacles and impediments which discourage U.S. and other foreign banks from making real estate loans in Mexico. The continuing double digit inflation rates, although drastically lower than before, still pose a threat to U.S. lenders, as does the fact that President Salinas has put all his eggs in the Free Trade Basket. The unequaled growth of the Mexican stock market, and resulting return of the private capital that had left Mexico in the early 1980's, have been primarily spurred by the notion that a Free Trade Agreement would be signed amongst the U.S., Canada and Mexico by mid 1992, according to a recent ABC News poll of Mexican investors²². The poll also showed that if the North American Free Trade Agreement is not signed by the end of President Salinas' term in 1994, a more socialist government could likely be voted into power and reverse the steps that have been accomplished over the last four years.

²²ABC News Poll, "Mexico and Free Trade", ABC Nightly News, July 14, 1992.

Exchange Risks

One of the most important factors affecting the value of income that a developer would like to repatriate is exchange rate risk. As the value of a currency (in terms of other currencies) changes over time, the currency value of the real estate investment changes. As the currency used for asset valuation appreciates, the value of the asset in terms of that currency appreciates, and visa versa.

The major forces responsible for the majority of changes in exchange rates between any two countries are the inflation rates and the interest rates. Mexico's higher inflation rate compared to the U.S. has caused the wide disparities in purchasing power of their perspective currencies. If the Mexican inflation rate can be kept in check, and further devaluation of the peso avoided, there would be less risk of converting U.S. dollars to pesos on a long term basis. Likewise, interest rates play an important role on exchange rates. Mexico's higher interest rates help retain a higher value for the peso due to the investment funds that flow from other countries to take advantage of the high interest rates. However, the higher interest rates also make it very difficult to borrow pesos for a real estate project and still make it profitable. As stated earlier, Mexico lacks pension, life insurance or long term institutional funds. On the other hand, the Mexican financial system has seen some reforms including the liberalization of bank deposit rates

and replacement of the former legal reserve requirement mechanism. As a result banks now have greater lending capacity to serve the private sector. For example, Koll International was recently granted a \$55 million loan by Mexico's foreign trade bank, Banco Nacional de Comercio Exterior (Bancomext). The loan, according to Vice-President of resort operations Joseph Woodard, has been used to get the infrastructure construction underway for two golf oriented resorts in Los Cabos²³. Funding of this magnitude for a U.S. developer by a Mexican bank is unprecedented and is an example of President Salinas' efforts to attract foreign investment in Mexico and to generate support for a Free Trade pact between the U.S. and Mexico.

The importance of evaluating exchange rate risks cannot be overstated. In the short run, any developers looking for quick returns on an investment must make sure that the forecasted profitability from a venture must adequately compensate for exchange rate changes or the profit projections will be greatly distorted. Likewise, long-run investment holding periods can be greatly affected by exchange rate changes due to the economic performance of a country.

These risks must be carefully analyzed by the prospective developer to determine whether a project's return is

²³J.Woodard, Koll International, Telephone interview, July 23, 1992.

sufficient to warrant the increased risk. There are, however, methods of lowering (mitigating) the effect of the risks identified above. Some common risk management techniques will be discussed in the next chapter.

CHAPTER 5

MANAGING INTERNATIONAL RISKS

The previous two chapters have described the major foreign regulations and risks a developer should identify before undertaking any international real estate investment. This chapter will outline the basic strategies that can help the developer mitigate these risks. Methods of risk analysis and management used by major multinational corporations will be discussed, as will the risk management programs of a leading American real estate developer currently working on projects in Mexico.

A good risk management program is defined by Nicholas Ordway in an article in the *Appraisal Review Journal*, as;

"The process of taking economically justified steps to: 1. limit an investor's exposure to uncertain or risky events that can lead to financial loss, and 2. permit an investor to exploit unexpected profit opportunities."²⁴

Managing Political Risk

There seems to be a consensus, in the literature regarding risk management: the best hedge against political changes is to constantly monitor and forecast the political situation in the host country. In an article for the *Harvard Business*

²⁴N.Ordway, "Professional Real Estate Risk Management", *Appraisal Review Journal*, Fall, 1980, p.62

Review²⁵, R.J.Rummel and D. Heenan have identified four approaches that multinational corporations use to analyze political risk. They are:

Grand Tours. This approach suggests that corporate executives take an inspection tour of the country targeted for a possible investment commitment. The authors criticized this approach because the executives are usually only exposed to very selective information, and are insulated from political and economic realities of the country visited.

Old Hands. These are individuals who claim to have knowledge about a country due to their past experiences in diplomatic service, the military or through extensive study in or contact with the country. This method of gaining information on the political risks of a country is also criticized by the authors because often the knowledge gained from such middlemen is superficial or outdated.

Delphi Techniques. This approach uses a panel of experts to help reach a consensus evaluation on selective elements influencing the risk of investing in a particular country. To be of any value, the authors suggest that the panel must have accurate listings of most important underlying determinants of political risk, and must be made up of experts who have timely and professional knowledge of the country in question.

²⁵R.Rummel & D.Heenan, "How Multinationals Analyze Political Risks", *Harvard Business Review*, Jan-Feb, 1978, p.67.

Quantitative Methods. Analysts use statistical tools to predict future trends and show mathematical relationships among the variables. A number of consulting companies, such as Political Risk Services in Syracuse, N.Y., are now providing quantitative risk studies. According to the authors, these studies are of limited use because they often come up with conflicting evaluations.

These methods of monitoring political risk are very typical for large multinational corporations, and are often used by larger real estate developers with the resources to do so. However, most real estate developers do not have the contacts or the financial resources to efficiently use these approaches. Nicholas Ordway in his article "Professional Real Estate Risk Management"²⁶, states that the most important steps to developing a useful monitoring and forecasting program are as follows:

1. Learn enough about the country and its people to recognize what signs are relevant.
2. Identify the relevant sources of information about the risk categories such as people, newspapers, and other media.
3. Define patterns and trends. Find out which political and economic forces influence the investment climate in the country under study.

²⁶N.Ordway, "Professional Real Estate Risk Management", *Appraisal Review Journal*, Fall, 1980, p.62.

4. Pay attention to the occurrence of independent events such as elections, political assassinations, announcement of new economic policies, and construction of major capital projects by both the private and public sectors.

5. Continue to revise assumptions about the safety of the investment climate. Use as many different sources of information and approaches to analysis as you can handle easily and afford.

These steps are often accomplished through the use of local partners. Allowing others to participate in the risks of a single investment spreads any loss among several investors, not just one. This is particularly suitable investment strategy for reducing downside risks in international investments. For example, participation of a local partner can reduce the risk of expropriation or other political risk problems because a project that is partially owned by local citizens is less likely to be expropriated or face administrative discrimination.

Managing Cultural and Social Risks

Many of the steps taken to mitigate political risk can be applied to cultural and social risk management. The important thing for an American developer to remember is that there are critical differences between how things work in the U.S. and how they seem to work in foreign countries. It is important to keep an open mind and educate oneself on the

host countries language, attitudes, social patterns, legal patterns, and activity patterns. Similar to political risk management, the process of cultural and social risk management is often made easier through the use of joint venture partners. Local partners can contribute local expertise and knowledge of local market conditions as well as cultural and social advice.

Managing Economic and Exchange Risks

In the book "The Multinational Mission"²⁷, the authors suggest that economic risks stemming from changes in the local economy of the host country are best dealt with through forecasting and diversification of investments. Economic changes can best be forecasted through a careful study of the economic history and trends of a country, combined with a constant monitoring of the current political and social changes that could lead to changes in the economy. The authors suggest that product changes and marketing changes can be made by multinational corporations in order to best deal with the impacts of any forecasted changes in the host country economy. This theory might work well for a multinational manufacturing firm, however, real estate projects are inflexible by their very nature. To attempt to change a project half way through completion because of forecasted changes in the economy would be almost impossible.

²⁷C.K.Prahalad, Y.L.Doiz, "The Multinational Mission", *The Free Press*, 1987.

Another method of managing economic risk, diversification of investments, is discussed in the book Managing Across Borders. This method of spreading risk among several investments appears to be a more attractive solution for the real estate developer or investor. The authors, Christopher Bartlett and Sumantra Ghoshal write;

"A number of studies have shown that diversification of investment with some foreign investment mixed with domestic U.S. investment have improved overall annual portfolio yield and have minimized the variability of the overall yield over the investment holding period."²⁸

Ideally a real estate portfolio would have enough properties to offset the effects of economic changes on any one property (unsystematic risk), and be spread out over several areas to offset the effects of economic changes on the overall market (systematic risk). If the developer is only involved in one or two projects, it is very difficult to find two investments that have perfect negative correlation (one property is affected positively and the other negatively by the same economic change), thereby making it very difficult to mitigate economic risks. In order for a diversification strategy to be successful, it is necessary to include many (the authors recommend at least 20) investments in one's portfolio to reduce the unsystematic risk.

²⁸C.Bartlett, S.Ghoshal, "Managing Across Borders", *Harvard Business School Press*, 1991, p.137.

In the book International Real Estate Investment, the authors write;

"Protection from exchange rate risk is best accomplished through hedging."²⁹

Hedging is the process of taking steps to protect something of value that is subject to risks by acquiring another thing that is subject to risks that offset the original risks. Hedging is usually used to protect against short-term fluctuations in exchange rates. Long term fluctuations in foreign exchange rates are theoretically offset by inflation or deflation within the country involved. In International Real Estate Investment, the authors discuss two types of Hedging. The first matches liabilities and assets through the use of lending and borrowing of funds. A developer whose assets are denominated in a weak currency would seek to create liabilities in the same currency as a protection device. If there is a devaluation, the losses on the assets would be offset by gains from a reduced real interest cost on the devalued liabilities. The second uses a foreign exchange futures market. Successful hedging of this sort depends on the investor's ability to evaluate the price differential between the spot market price of a currency, and the futures market price, as compared to the risk in the changing exchange rate. Hedging is a complex undertaking that should

²⁹D.Hinds, N.Ordney, "International Real Estate Investment", *Real Estate Education Company*, 1983, p.226.

be studied carefully before being used as a risk management technique. Advice should be sought from the international department of a major bank or from a currency specialist with and accounting firm.

Risk Management Example

Hines Interests, a large developer-contractor from the United States has had success in Mexico through their own brand of risk management strategies. Hines has relied on a fifteen year relationship with a joint venture partner in Mexico to mitigate most risks involved in the development process. In a recent telephone interview, Tom Bacon, vice-president for U.S. acquisitions for Hines, said;

"The key to being successful in a foreign country is the relationship established with a respected, trustworthy joint venture partner."³⁰

Hines has recently started work on a 120,000 sq.ft. office building in Mexico city in a joint venture format. The joint venture involves Hines and a private Mexican company contributing equally to the project. The political and social risks involved are in large part mitigated by the fact that foreign nationals are involved with the project from start to finish. Any governmental problems involving permitting, acquisitions of land, zoning, land use regulations and environmental concerns are handled by the

³⁰T.Bacon, Hines Interests, Telephone Interview, June 23, 1992.

Mexican partners. They have the contacts and the know how to make their way through the bureaucratic labyrinth that makes up the Mexican government. Likewise the local partners supply market information, as well as any cultural or social expertise. Hines supplies development, design and construction expertise assuring that the project will be of the highest caliber possible. The Hines' name also carries a great reputation among U.S. firms as producing high caliber office buildings. This reputation, combined with the existing business contacts in the U.S., can be translated into a great asset for attracting American firms wishing to locate an office in Mexico.

Economic and exchange rate risks of the venture are mitigated in various ways. First the building is to be sold in condo form, eliminating any long term effects from economic fluctuations. Second, construction will not be commenced until the first major tenant is found which will represent approximately 50% of the building. Once a major tenant is found, construction will proceed as quickly as possible. This strategy aids in cutting the losses if there is a major economic downturn in Mexico before the building can be sold. Third, in order to manage exchange rate risk, all contracts are carried out in U.S. dollars, and the project is financed with 100% equity. This protects Hines from the downside of exchange rate and interest rate changes, and the corresponding currency devaluations. The joint venture

method of risk management seems to have worked successfully for Hines as the relationship with the Mexican partners has lasted 15 years.

Despite the potential for conflict, many companies routinely (and successfully) use joint ventures to mitigate the risks involved in international development. With the increasing use of this form of risk management, business leaders must think about the more effective ways of structuring and managing the interface. The next chapter will examine the strategy, structure, and management methods that have in the past proven to be the most successful for international joint ventures.

CHAPTER 6

JOINT VENTURES AS A RISK MANAGEMENT TOOL

"Corporate leaders are beginning to learn what the leaders of nations have always known: In a complex, uncertain world filled with dangerous opponents, it is best not to go it alone."³¹

The research for the previous four chapters has shown that entering a joint venture with a host country partner is an effective tool for mitigating the risks involved in international development. Further research has been conducted to examine what the keys have been to successful joint ventures. This chapter will discuss the findings.

Acquisitions and Mergers vs. Joint Ventures

Acquiring or merging with foreign companies has been the favoured route towards globalization for U.S. firms in the past. However, the difficulty in successfully integrating merged operations and, therefore, in turning potential value into actual value creation raises some doubt as to their overall success. Mergers and acquisitions often fail to take place or succeed. This is due in part to the complex nature of mergers and acquisitions. There are often problems with management of the interface between the acquired and acquiring companies. In some countries, protectionism often

³¹ K.Ohmae, "The Borderless World", Chapter 8-"The Global Logic of Strategic Alliances", New York, 1990, p.114.

does not allow for acquisition or merger by a non national firm. There is also the problem of valuation uncertainties. The fear of overvaluation may prevent acquisitions from taking place. These uncertainties combined with the resources required for acquisitions, greatly limit the feasibility of such strategies.

In many circumstances joint ventures can overcome the difficulties associated with acquisitions and mergers, especially when a firm desires to enter a new geographic market with related business. Cross-border joint ventures work better for expanding existing businesses into new geographic regions than do acquisitions or mergers. In a recent Harvard Business Review survey, The Way to Win in Cross-Border Alliances³², research showed that 60% of joint ventures that involved partners with different geographic strengths succeed versus a cross-border acquisition success rate of 8%.

Cross-border joint ventures offer an expedient way to crack new markets, to gain skills, technology, or products, and to share fixed costs and resources with a foreign partner. Joint ventures limit the financial risk and circumvent many of the barriers encountered in acquisitions and mergers. Joint ventures, however, do raise their own difficult issues

³²See: J. Bleeke, D. Ernst, "The Way to Win in Cross-Border Alliances", *Harvard Business Review*, Nov-Dec., 1991, p.127-135.

of strategy, organization and management, some not always dissimilar from the issues confronted by acquisitions. These issues will now be summarized and recommendations about methods of implementation will be addressed.

Strategy

The most important steps in creating a joint venture are: 1) having a thorough understanding of the strategic goals and objectives of the proposed venture, and 2) the selection of a compatible partner.

Strategic Objective

A joint venture involves the cooperation of two inter-dependent parties for a singular business purpose, when these two parties have different cultural backgrounds, achieving personal chemistry and similar business goals becomes that much more difficult. For this reason a concise and well planned objective must be delineated before any partner search is started. This objective should include a thorough analysis of the strategic benefits that will be derived from the venture as well as the expected goals. A clear understanding of a firm's own objectives is a definite prerequisite to any successful joint venture agreement.

Once the strategic objectives of a firm have been determined, a due diligence process is necessary to understand the basic legal and political issues involved in international

development. In an article for *The Journal of European Business*³³, Richard Leber and Rick Singer identify these issues as: host country regulations, government approvals, political instability, zoning and land use laws, environmental laws, construction requirements, taxes rent control and standard cultural practices.

Partner Selection

The selection of a partner is a crucial part of a successful joint venture. The more time and care placed in the selection process will have a direct effect on the ultimate success of the venture. A U.S. developer should consider the ability of the local partner to contribute knowledge of the local political situation, economy and customs of the country. These requirements could also include technological superiority, business reputation, prior experience, financial capability or even land owned by the partner. The partners should have very similar strategic goals for the joint venture, and should be similar in the perceived value of what is offered to the venture. Joel Bleeke Bleeke and David Ernst wrote for the *Harvard Business Review*;

"Relatively weak firms should avoid entering joint ventures with strong firms as this will create an unnecessary feeling of dominance by the stronger firm. Partners should have related business in different geographic areas with minimal geographic

³³R Leber, R Singer, "International Real Estate Joint Venture", *The Journal of European Business*, Jan/Feb., 1992, p.42.

overlap. This will reduce competitive conflicts that could arise."³⁴

Once a potential partner has been selected, an exchange of certain limited information is necessary to determine potential compatibility regarding strategic goals, financial strengths and weaknesses, management structures and ideologies. If enough similarities exist, and a decision is made to proceed to a working joint venture, there are many organizational and structural issues that have to be addressed.

Structure

Comparative Advantage in Bearing Risk

Real estate development involves many entities with differing levels of risk aversion and risk management capabilities. Under the economic principle of comparative advantage, the sum of the risk of both parties in a joint venture is minimized when each party assumes the risk it is best able to manage. The concept of comparative advantage has been applied to structuring alternative financing arrangements for investors by Donald R. Lessard³⁵ of M.I.T. The basic concept behind comparative advantage is that every person, firm or country has a different area of expertise that gives them an

³⁴J.Bleeke, D.Ernst, "The Way to Win in Cross-Border Alliances", *Harvard Business Review*, Nov-Dec., 1991, p.127.

³⁵D.Lessard, "Alternative Finance for Less Developed Countries: A Primer", *World Bank Training Program in International Debt and Finance*, Sept. 13, 1991.

advantage in that area. If many people, companies or countries are put together to work on one project, it is best to allocate each group the task, and corresponding risk, in which it has an advantage.

Real estate development is rarely a single party enterprise and often involves many participants. Each participant brings a set of skills and resources to the project that is different to the other participant's contributions. For example, differing inputs include; investment capital, design expertise, construction knowledge, market knowledge, brokerage services, management of the development process, management of the operational phase, and other factors of production. There are also different components of risk that vary substantially for each participant, such as operating risk, financial leverage, local market effects, political effects, cultural effects, capital market effects, and regulatory effects. According to Lessard, development deals or real estate investments should be "engineered" so that ideally the party with the advantage in any given area should be responsible for that input to the project. Likewise, the party best able to mitigate a particular risk, should bear that risk.

For example, let us take the case of a joint venture between a U.S. investor with a large, diversified portfolio of assets, and a Mexican developer with local market knowledge

and political contacts, but not much in the way of a diversified portfolio. The developer should bear the risk of (and receive a reward for) the day to day construction process as well as the political and cultural risks described in the previous chapters. Likewise, the U.S. investor presumably has an a comparative advantage in capital management expertise, which implies that it should be able to diversify and hedge against exchange rate and interest rate fluctuations. The structure of the joint venture between these parties should be such that the risks which cannot be borne efficiently by one participant should be shifted to the other thus minimizing the sum of the risks of all parties.³⁶

Financial Structure

Certain financial structural forms work better than others. In The Way to Win in Cross-Border Alliances survey, it was found that alliances with an even split of financial ownership are more likely to succeed (60%) than those in which one partner holds a majority interest (31%).

"When one partner has a majority stake, it tends to dominate decision making and put its own interests above those of its partner. Both partners tend to be worse off as a consequence."³⁷

³⁶D.Lessard, "Alternative Finance for Less Developed Countries: A Primer", *World Bank Training Program in International Debt and Finance*, Sept. 13, 1991, p.14.

³⁷J.Bleeke, D.Ernst, "The Way to Win in Cross-Border Alliances", *Harvard Business Review*, Nov-Dec., 1991, p.132..

The survey also found that the most important difference between 50/50 ownership and minority equity is the trust developed in the relationship. Each partner has an interest in seeing mutual success for the venture. When ownership is uneven, one partner usually exercises too much control, and therefore, loses the trust of the minority partner. Firms wishing to create a joint venture should first attempt a simple project with their chosen partner in order that a degree of mutual trust may be established prior to the more complex projects. Once a good working relationship is established, a 50/50 equity relationship should be considered as it will allow for easier management of the venture.

Legal Structure

The contractual or legal agreements established between Joint venture partners will depend greatly on the complexity of the task that the venture has been set up to undertake. A joint venture involving a non complex task could be very successful with a simple non-contractual agreement. However, a more complex task will often require a contract with special provisions for international business. These provisions include, but are not limited to, tax treatment, structure and the underlying purpose of each party for entering the agreement.

Management

In structuring a joint venture, the issue of financial ownership should be separated from managerial control. In the U.S. 51% ownership is usually equated with 100% control. This is often not the case in projects where control of the activities in a foreign market must be left to those who are more knowledgeable of said market. If managed very carefully, joint ventures can be highly successful. However, with improper or insufficient management, many joint ventures are doomed to fail. Parent companies often have different views on what constitutes good management. Some firms believe that short-term performance is crucial; others think that building a solid base for the future is more important. Conflicts like these result in confusion, frustration and slow decision making that can place a joint venture at a distinct competitive disadvantage. In a report prepared for the Harvard Business School's "Multinational Enterprise and the Nation State" project, J.Peter Killing writes:

"Independently managed joint ventures avoid such conflicts by allowing each firm to manage their own respective side of the project."³⁸

This form of management is very successful for non-complex tasks; however, the author warns that with complex tasks, shared management or a dominant parent should be used whenever possible.

³⁸J.P.Killing, "How to Make a Global Joint Venture Work", *Harvard Business Review*, May-June, 1982, p.121.

Killing explains that having a dominant parent joint venture reduces the amount of conflict that originates from differing managerial philosophies. However, dominant parent ventures often lack the trust that is necessary for a successful project, a trust that is easier to achieve with shared management agreements. Using shared management, on the other hand, may cause problems at the onset such as communications problems due to language barriers, differing attitudes toward time, the importance of job performance, material wealth and flexibility to change. However, according to Killing, using managers and staff from both companies will add to a greater trust and a mutual understanding of each partner's needs.³⁹

In order to determine which managerial form would be more suitable for a given project, Killing suggests two rules to follow⁴⁰:

- 1) If one parent's skills can readily be transferred on a one time basis, the other parent should dominate the venture. A local partner should always make the key decisions if a foreign partner's input to the alliance is purely technological skills or assets that can be transferred on a one time basis.
- 2) If the operating skills of both parents are crucial to the success of the venture, a shared management approach is

³⁹ibid, p.122.

⁴⁰ibid, p.127

appropriate. A shared management venture will result in better decisions than either parent could have made on its own, although the process of making these decisions will be slower than in a dominant parent venture. In order to alleviate some of the delays, the joint venture general manager should be given as much autonomy as possible.

As circumstances change, parents should be willing to modify the management structure to accommodate the new needs of the joint venture. Flexibility to meet the inevitable challenges and changing conditions will play an ever-expanding role in the partnership's long term survival.

Summary

The research work suggests that the benefits of joint ventures for real estate developers wishing to enter foreign markets are numerous, and may outweigh the involved difficulties and risks. The joint venture serves as a very helpful tool to mitigate the various risks involved in cross-border development. The risks involved in joint ventures can often be reduced quite drastically if some basic issues are recognized early, and corresponding sensitive approaches are applied. The required preconditions or sources of problems usually concern psychological and cultural issues much more than technical ones. A certain general attitude that allows for cross cultural understanding, the willingness to accept, learn about and apply different country specific rules seem

to be the predominant factors in joint venture success. The following recommendations seem to represent the crucial aspects of those successful joint ventures already in place:

1) First enter a simpler joint venture project with the chosen partner, in order that a degree of mutual trust may be established, prior to the formation of the more complex joint venture agreement.

2) Create an agreement with no unnecessary organizational complexity, bearing in mind that it has to be capable of accomplishing the task for which it was created. The key to success is to create a joint venture that is simple enough to be manageable.

3) When deciding on the organizational structure of a joint venture, future project managers should be included in the negotiations. The goals and organizational structure of the joint venture should be clearly understood by the partners, and defined in the strategic context and organizational language of each partner.

4) Compatible speed and equal time frame are crucial to a smooth working relationship. All firms work at different speeds in their identification, analysis and response to given issues. These differences must be taken into account in designing the collaboration process.

5) Mutual understanding and ability to communicate is made easier by an investment in understanding each others organization and ways of doing business. Such mutual comprehension can be achieved by setting up special task forces, offsite workshops and joint projects.

6) The involvement of managers should be staged. When managers are quickly assigned to a project with a foreign firm, miscommunications and lack of mutual understanding and trust can easily result in withdrawal into formal interactions that are unlikely to be effective.

7) The best workable approach over time is treating the joint venture as an evolutionary relationship, susceptible to adjustments and revision as the strategic interests of the partners evolve and as their willingness to contribute to the venture shifts.

8) Use of the comparative advantage concept provides a good framework through which to evaluate and allocate risk. Risk mitigation is best accomplished through risk engineering, with each party bearing the risks it is best able to mitigate. This technique implies that the total risk of the joint venture is minimized.

CONCLUSION

There are many legal, business, social and political issues that must be taken into account by American developers moving from the security of their own country into the variegated world of international development. Some of the most important regulations and risks facing a developer considering international investment have been identified. The regulations that must be evaluated very early in the due diligence process include: foreign investment regulations; laws affecting the acquisition and disposal of real property; taxation requirements; and environmental regulations. The risks involved include: political risks, cultural and social risks, economic and exchange rate risks.

The research has shown that with proper due diligence it is possible to mitigate the majority of the risks and regulations involved in international development. The U.S. developer should anticipate that the proper due diligence will be both costly and time consuming. Any money or time saved during the due diligence process could result in significant losses or delays later.

Methods of managing international risks have been identified and outlined. They include: monitoring and forecasting political and economic trends, hedging, diversifying the

portfolio of investments and entering into joint venture agreements.

Monitoring and forecasting political and economic trends can be accomplished through various methods.

Examples include; using a panel of experts to advise on the risks involved; using quantitative analysis of patterns and trends in the past political and economic landscape to help predict future events; or using local individuals who have contacts in the foreign government.

Hedging is used to protect against short-term fluctuations in exchange rates. Matching liabilities and assets through the use of lending and borrowing of funds, or using a foreign exchange futures market are the recommended approaches to this type of risk management.

Diversifying the portfolio of investments is best accomplished by having enough properties or investments in a portfolio to offset the effects of economic changes on any one property.

Joint venture agreements appear to be the strongest single tool for managing the risks involved in international development. The research has shown that successful joint ventures have many similarities. Successful joint ventures have had clearly delineated strategic objectives that both parties understood, and agreed to, in their own business language. The partner selection process matched partners with related businesses in different geographic areas with minimal geographic overlap, as well as matching the value of

each partners contribution to the venture. The structure of a joint venture is very important to its ultimate success. Joint ventures should be structured so that a party with any advantage in any given area should be responsible for the risks corresponding to that area of expertise. Financial structure is similarly very important to the ultimate success of a joint venture. The research has shown that 50/50 equity arrangements have a better success rate than those in which one partner holds a majority interest. However, management of the venture is dependent on the transferability of skills. If one partner's skills can readily be transferred, the other partner should dominate the management. If the operating skills of both parents are crucial to the success of the venture, a shared management approach is appropriate. Any party considering participation in an international joint venture must engage domestic and local counsel and other local experts for the purpose of obtaining detailed advice regarding the specific factors, which are beyond the scope of this thesis, underlying the participant's particular investment decision.

There are more risks and regulations involved in developing internationally than developing at home. However, with the proper due diligence, and use of effective risk management techniques, it is possible to mitigate many of these risks, thus taking advantage of the competitive yields found abroad.

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