

# Overseas Property Investment: Risks and Rewards

Managing the foreign exchange risk of investing in markets outside the UK



As increasing numbers of property companies and funds seek the enhanced yields of overseas markets, attention should naturally focus on the associated foreign exchange risk implications.

## Natural Hedges

Particularly for larger property companies, investing on their own account, hedging is often relatively easy. Denominating term debt in the same currency as the asset provides a natural hedge, while many companies are in a position to provide equity through the use of a foreign currency-denominated overdraft facility which, again, acts as a natural hedge.

## Retail Investors and Enhanced Returns

For property funds, however, particularly those offering investment opportunities for retail investors, equity invested will be at risk from a depreciation in the currency of the investment (often euro) versus the investors' currency of account (often sterling or the US dollar).

In such a case, the foreign exchange exposure should be hedged as a matter of course with derivative instruments. Indeed, if interest rates in the currency

of the investment are lower than those of the accounting currency, investors will actually see their return enhanced through locking into the current foreign exchange rate. For example, UK-based investors into the eurozone currently enjoy a yield enhancement of some 1.6% as a result of protecting themselves against foreign exchange risk. Despite this, many investors continue to assume that there is always a monetary cost to hedging.



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### The Significance of Credit

Although the market currently pays UK and US investors to hedge their investments in, for example, the eurozone, a crucial factor in the hedging process is that of credit. With the exception of purchasing an option to protect the foreign exchange risk, and paying the up front premium associated with these instruments, a feature of all other 'costless' foreign exchange hedging products is that they will produce a credit risk for the provider.

Particularly in the case where a 'beauty parade' of banks is invited to tender for the provision of debt facilities, lenders will nearly always be inclined to offer more generous terms on a credit line to hedge foreign exchange risk if the hedging line is negotiated at the outset as part of the

package for the term debt facility. Otherwise, a facility ends up being negotiated without allowance for foreign exchange hedging and the subsequent consumption of credit for hedging purposes eats into the debt facility, reducing the fund's ability to gear up its equity.

### To Hedge or Not to Hedge

In considering a hedging strategy, a careful early assessment of credit facilities is crucial. The benefits of hedging must be pragmatically considered against the cost, either in terms of option premium or credit usage, the latter of which leads to a reduction in gearing and hence potential returns. Nonetheless, our experience is that, particularly with regard to the preservation of capital, investors are often prepared to forgo some potential return in exchange for protecting their original investment.

For this reason, those funds offering investors the choice of being hedged will typically attract capital more easily than those offering no such choice.

Some investors, of course, regard the foreign exchange exposure that goes with overseas investment as being desirable as part of a balanced portfolio. In response to this, some funds are now offering 'hedged' and 'unhedged' investor sub-classes, in order that investors may choose whether or not to hedge foreign exchange risk. We have always regarded this approach as optimal.

