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Foreign Exchange: Making a transaction smoother, and providing the best economics for the investor

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Foreign investors have been a major force in New York commercial real estate, accounting for over 20% of commercial property purchases since 2007, with Chinese and Canadian investors in the top spot for 2013 YTD according to Real Capital Analytics. The presence of foreign investors means that real estate is no longer safe from the impact of the volatile currency markets. According to James Nelson of Massey Knakal, "We have seen a lot of demand coming from China, South America, and Europe for commercial properties in New York. Foreign investors are parking money here as a safe haven, and most are doing deals with 100% equity, making them a very attractive option for sellers."

The strong impact of foreign investors along with the high cash component of transactions underscores the importance of currency conversion pricing and process. First, it is important to understand how conversion pricing actually works when an investor is converting their home currency into U.S. dollars. There are two components of the conversion; transaction fee(s) and spread. The latter, typically the more important component, is often ignored. Some banks and money transfer agency services may advertise a low transaction fee, but that is often meaningless when dealing with FX conversions. The spread is the margin above the "interbank rate." The interbank market can be defined as the systemic short term trading of currencies by banks and other financial institutions, and the interbank rate is derived as a byproduct of the supply and demand of trading currencies, as well as other geo political and macro economic factors. As currency markets are decentralized, there is not a single, global exchange to confirm the interbank rate, although rates on Blooomberg are relatively accurate.

Many foreign investors may use their banks for conversion, however this is not always the optimal scenario, particularly for small and mid-market clients. The large FX banks trade over $100 billion per day in volume, so for them a transaction even of $10 million is relatively small and will be priced with a higher spread than larger transactions. Using a firm that specializes in small and mid-market transactions will often provide a much better outcome on the rate. For example, a bank may charge a spread of 50 basis points on a transfer of $10 million, which equates to $50,000 of spread over the interbank rate. The spread charged is highly dependent on the investor's relationship with the bank among other variables.

While using a transfer service may provide a better outcome than a bank, many transfer services are not very transparent with their pricing. The agent on the other end of the line is typically trying to figure out how sophisticated the customer is, and will price rates accordingly, so there can be a wide disparity in rates even within the same transfer service. An investor should call several transfer services to get quotes, and determine what spread each is charging (or use one that charges a standard rate over the interbank to avoid this process). When doing this, it is important to know the exact rate down to 4 decimal places to compare since currency markets can move quickly, and a 10 or 20 basis point difference is significant when dealing with larger sums.

As currencies can move over 1% daily, protecting one's principal may also be a very important component of a transaction, and there are several products available to do this. These hedging products may have the benefit of reducing the risk of exchange rate movements, however they may also negate the positive impact of currency appreciation of the investor's currency. For many investors, another important consideration is the longer term impact of currency movement on their property cash flows as well as the eventual exit. Choices for hedging include forwards, options, non-deliverable forwards, and currency swaps. Most buyers use forwards that provide for physical delivery of the target currency at an agreed upon date, which may solve both the currency risk and conversion in one step. However, due to the regulatory burdens of Dodd-Frank, most banks will not enter into hedging contracts with customers that are not existing clients, so investors will need to work with other services to obtain hedges if desired.

The currency markets can be complex and fast moving, so speaking with experts who understand both the currency markets and real estate can be very useful in making a transaction smoother and providing the best economics for the investor.

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