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CADIM: THE CHINA AND INDIA REAL ESTATE MARKET ENTRY DECISIONS

It was decision time. Late in the evening on January 15, 2008, Richard Dansereau, president and chief operating officer (COO) of Cadim, sat alone in the boardroom overlooking the Montreal skyline. Cadim was the real estate arm of the Caisse de Dépôt et Placement du Québec (Caisse), Canada's largest pension fund management firm. Fernand Perreault, the chair of the Caisse real estate group had recently charged Dansereau with recommending whether Cadim should enter India, China, or both on a long-term basis to diversify its global real estate holdings and take advantage of the growth these two countries were experiencing. The fund's investment would potentially amount to hundreds of millions of dollars and could lead to substantial returns; however, these investments carried considerable risks. The due diligence had been done and the options narrowed, but it was up to Dansereau to make his final recommendation to the board tomorrow.

CAISSE DE DÉPÔT AND CADIM

The Caisse de Dépôt et Placement du Québec (Caisse) was the largest institutional investor in Canada. Based out of Montreal, Quebec, the institutional fund manager managed funds for public and private pensions, insurance plans and organizations. The Caisse oversaw more than $245 billion in assets and carried out more than $12 billion in transactions daily, including the buying and selling of securities and real estate. Despite its size, the Caisse had consistently outperformed the market over extended periods (see Exhibit 1).

Cadim was one of three real estate divisions of the Caisse. The first was Ivanhoe Cambridge, which invested in shopping malls, and the second was SITQ, which invested in office buildings and business parks. Cadim focused on the residential and hotel markets with its mandate to innovate and to take advantage of promising opportunities for above-average returns. The company's strategy was to partner with top-tier local real estate companies to ensure that their project management had sufficient local experience and connections to be successful.

According to Dansereau:

> When you go to Rome, do as the Romans do. You cannot force the North American way on them, but have to work with them and slowly evolve a process in between. The fundamental element is to have a local partner. It helps you to present yourself to the market with local eyes and ears. The due diligence on the partner is vital to ensure that they understand and respect your core values but are still able to get the deal done on the ground.

Cadim held considerable investments in North America, Europe and Asia. As of 2007, real estate holdings made up 18.7 per cent of the entire Caisse portfolio, for which Cadim was responsible for approximately one-third.

RICHARD DANSEREAU AND THE CADIM TEAM

Richard Dansereau was president and chief operating officer of Cadim. His duties included managing Cadim's interests in a network of real estate companies established in North America, Europe and Asia. He had joined the Cadim team in October 2000 as vice-president investments and had worked his way up to become president and COO.

The other key team members were Tony Messina, vice president investments, who led the negotiations with partnerships for new ventures; Claude Lavigne, director of investments, who was Cadim's senior management specialist on India and had been managing the deal flow and relationship with partners in that area of the world; and Sylvain Charpentier, vice president investments, who was Cadim's senior management specialist on China and had been responsible for managing Cadim's network of partners, including the firm's satellite offices worldwide.

CADIM'S SITUATION

According to members of the Cadim team, the average real estate returns in most of the developed world's real estate markets were well below the Cadim target of a 14 per cent risk-adjusted[1] internal rate of return (IRR) for stable, developed market investments. From a portfolio perspective, individual deals could be found with returns that were satisfactory, but not enough to bring the entire portfolio's returns into the target range. Thus, making exceptional performance was a very difficult task (see Exhibit 2). However, in developing countries, the average returns available were considerably higher and presented an interesting opportunity.

In Asia, Cadim was significantly invested in Japan and Korea, but these investments were mainly through funds that were managed by a third party. Cadim strongly preferred to be involved in the decision-making process, but had zero ground-level experience investing in either China or India and had no regional offices (see Exhibit 3).

[1] Risk adjusted returns allowed managers to compare investments with dissimilar levels of risk. If an investor was satisfied with a 10 per cent return on an average property in the home market, a premium would be needed to consider an equivalently attractive investment in a riskier country. For example, the investor might require 14 per cent before being willing to consider investing in a less politically stable environment. This additional 4 per cent was the risk premium or risk adjustment.

THE CADIM COUNTRY ASSESSMENT PROCESS

According to Dansereau:

> Our chairman asked us "If you are not invested in China and India, I want to know why and if you are invested in China and India, I want to know why." He has a Ph.D. in economics from Western [The University of Western Ontario] and is very focused on macro factors. He really provoked us to think out of the box and open up to more emerging opportunities.

Cadim's goal when examining new countries in which to invest was to find markets where they felt comfortable investing for the long run. With the dollar amounts involved (tens or hundreds of millions per investment), quick in-and-out strategies were not generally effective and required too much staff time because the due diligence process was the same for short deals but required new projects to be located and researched far more often.

The company began its due diligence by looking at the macroeconomic fundamentals to assess whether an investment showed a strong trend and foundation for mid to long-term future growth. Cadim first examined how real gross domestic product (GDP) growth and GDP per capita compared with other potential countries. Management then investigated whether the population was growing significantly, migrating to new locations, changing its buying behavior or getting richer. Also considered were the stability and magnitude of inflation, an important consideration in real estate deals involving debt financing.

If the country still looked favorable, the next question was whether Cadim could fill a significant unmet market need. Cadim examined whether the country had a major shortage of a particular type or quality of real estate. Cadim also investigated whether the country lacked experienced operators who could run properties professionally and maximize value extraction, which was one of Cadim's strengths. Finally Cadim examined whether any other unique circumstances created a significant opportunity for above-average returns.

Once opportunities had been identified, Cadim looked at the risks and assessed whether they were manageable and sufficiently counterbalanced by the attractiveness of the opportunity. Risk premiums could change significantly, depending on the amount of liquidity in the market, the "trendiness" of the investment location and other factors influencing investor sentiment. When significant capital was chasing few deals, the spreads (the average increased compensation for bearing additional risk) between New York and Mumbai might only be a couple of basis points (a basis point was one-hundredth of one per cent). In times of tight liquidity, this spread could widen to 10 per cent or more. Cadim needed to assess whether the current risk premium seemed reasonable.

CHALLENGES OF DOING BUSINESS IN RAPIDLY DEVELOPING COUNTRIES

An often stated concern about doing business in developing countries was corruption. Corruption was defined by Transparency International as "the abuse of public office for personal gain" and was quantified in Transparency International's corruption perceptions index (see Exhibit 4). According to various Cadim team members, corruption was a very real concern because in some cases conducting business without encountering corruption was unavoidable (when attempting to obtain building permits for example).