Global Scientific JOURNALS

GSJ: Volume 7, Issue 9, September 2019, Online: ISSN 2320-9186
www.globalscientificjournal.com

# THIS CASE DEMONSTRATES THE RISK INHERENT IN CROSS-BORDER REAL ESTATE INVESTMENT: THE USA EXPERIENCE



## Submitted By-

*Dr. Seema Thakur*
*SGT UNIVERSITY*
*GURUGRAM*

# The Case

Tina and Tommy were somewhere between confused and angry. It seems the check they were about to receive was much smaller than anticipated. But why and by how much they still didn't really understand.

Tina and Tommy (T&T) considered themselves pretty savvy real estate investors. They owned a custom home near Patagonia, Arizona that Tim, a retired homebuilder, had designed. His wife Tammy was a real estate broker in Tucson where they also owned a home. Given their backgrounds and past real estate investments, they were stymied as to how this deal had seemed to go so wrong.

Ten years ago T&T purchased two beachfront condominiums in a Mexican resort Community. Since they purchased while still in the design/build phase they were able to secure the condos at a greatly reduced price of 150,000 US$ for each unit which was well below the price at completion. One condo was for their personal use (unit 1) while the other (unit 2) was purchased as a vacation rental.

Using various websites such as VRBO (vacation rentals by owner) and Home Away, T&T had been successfully renting their vacation unit for the past eight years. They had been able to rent often enough that revenues had exceeded expenses on unit 2 each year. Virtually all of the renters had been Americans and therefore all of their rental revenues had been received in United States currency (US$). All of their expenses, property taxes, utilities, and condominium fees, were paid in the local currency, the Mexican peso (MXN). Over the years the US$ had gained in value compared to the peso but the changes had been mostly gradual and hardly noticed by T&T.

After six years of living in unit 1 on a part-time basis they had decided to sell that unit and Purchase a single family dwelling in the same community for their personal use. Their timing Was not particularly good since they listed the condominium for sale when the economies in the U.S. and Canada were significantly depressed. Most Mexican resort properties were bought and sold by Canadians and Americans. After two years on the market they finally received an offer, which they considered acceptable.

The offer was made through their realtor Skip Heard of Heard Resort Properties International (HRPI). The buyer was a young Mexican national woman working for one of the area

Maquiladoras. Although somewhat unusual in Mexico, the buyer was going to finance the purchase by entering into a mortgage agreement with a Mexican lender.

Like the vast majority of properties HRPI listed, T&T's condo was priced in U.S. dollars. The negotiated selling price of the condo was $250,000. The contract to purchase/sell was dated July 9, 2015 with an anticipated closing date of August 25, 2015. In order to provide some certainty for the buyer and the lender, the buyer, seller, and lender entered into an exchange rate lock. The rate was fixed at 15.5 Mexican pesos per U.S. dollar, which was the exchange rate at that date.

In early August T&T started looking seriously for a new home in Mexico. T&T anticipated they would net about $220,000 from the sale after paying capital gains tax (Mexican), real estate commission, plus other necessary legal fees that total approximately 12% of sale proceeds. They anticipated that this would be more than enough to buy the kind of home they

Wanted. However, they were quite surprised when they received an Estimated Closing Statement on August 19 (see Exhibit One) indicating they would receive only 236,280 US$ before considering taxes and fees or about 207,927 US$ net of fees and taxes. T&T immediately called Skip and demanded an explanation. Skip referred them to the exchange rate lock they had signed on July 9 and explained that he had no control over how currency markets fluctuated. The Greek financial crisis and Puerto Rico's default had conspired to wreak havoc with exchange rates worldwide. He said it was possible exchange rates would decline somewhat prior to the actual close which could lessen their 'pain' but obviously he could make no guarantees.

In the week following their receipt of the Estimated Closing Statement currency markets were again shaken, this time by China's reported economic slowdown and devaluation of the Yuan. As a result, many investors fled most emerging economies' currencies and Mexico was not spared. By the time the closing date arrived the exchange rate was 17.2 MXN to the US$.

At the closing, T&T received a check for 198,256 US$ (see Exhibit Two) representing the net proceeds of the sale. They were more than a little upset regarding the amount they received and continued to agonize over what had gone wrong.

| Exhibit One | | |
|---|---|---|
| **ESTIMATED CLOSING STATEMENT** | | |
| **19 August 2017** | | |
| | | |
| **Paid by BUYER** | | |
| Sales price | 280,000 | US$ |
| Locked exchange rate | 15.5 | |
| Converted Sale price | 3,975,000 | MXN |
| | | |
| **Paid by SELLER** | | |
| Capital gains tax and legal fees | 232,500 | MXN |
| Real estate commission @ 6% | 232,500 | MXN |
| | | |
| **Due to SELLER** | 3,610,000 | MXN |
| Anticipated exchange rate | 16.4 | |
| US Check to SELLER | 207,927 | US$ |

*Exhibit Two*

| | | |
|---|---|---|
| **CLOSING STATEMENT** | | |
| **25 August 2017** | | |
| | | |
| **Paid by BUYER** | | |
| Sales price | 280,000 | US$ |
| Locked exchange rate | 15.5 | |
| Converted Sale price | 3,975,000 | MXN |
| | | |
| **Paid by SELLER** | | |
| Capital gains tax and legal fees | 232,500 | MXN |
| Real estate commission @ 6% | 232,500 | MXN |
| | | |
| **Due to SELLER** | 3,610,000 | MXN |
| Current exchange rate | 17.2 | |
| US Check to SELLER | 198,256 | US$ |

## Questions

1. When considering the rental unit, given the past eight years' gradual decline in the value of the Mexican peso and ignoring U.S. taxes, are T&T better off financially or worse off? Explain in detail.

2. Why did the buyer and lender find it necessary to lock the exchange rate for the sale of the condo?

3. Were the buyer and lender subject to currency exchange rate risk the same as the sellers?

4. What steps could the sellers have taken to mitigate the exchange rate risk on the sale of unit 2?

## Authors

**Dr. Seema Thakur**
**Assistant Professor of Finance, Department of commerce and Management. SGT University, Gurugram.**