Australian Property Insights

Strategies for foreign investors

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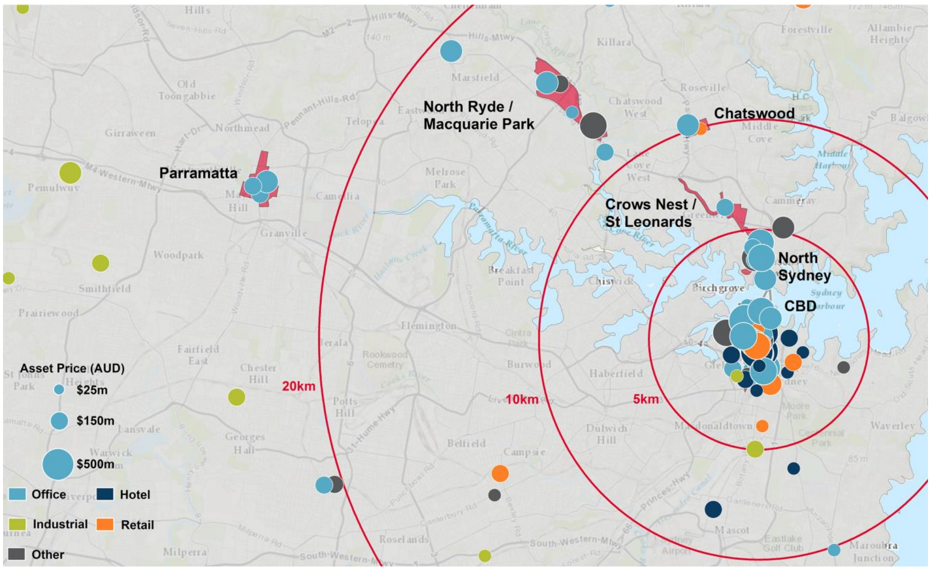
Contents

- Australian commercial property remains an attractive destination for international investors. While interest remains high, foreign investment has declined sharply over H1 2016.
- The data highlights that foreign investment to date has mostly focussed on the core markets, however available stock in these markets has tightened.
- With the current market conditions expected to continue, the following report identifies a number of strategies international investors may wish to review in order to facilitate investment in Australian commercial real estate:
    - Diversify across geographies: Opens up a greater range of investment opportunities across markets outside of the core CBD markets of Sydney and Melbourne.
    - Diversify across sectors: Opens up a diverse range of opportunities outside of the office sector, but requires sector specific knowledge.
    - Joint Ventures: Co-investment helps mitigate risk for the incoming investor as well as gaining access to local knowledge. This approach requires co-alignment of investment philosophy between partners.
    - Purchase platforms: Opportunities remain to secure smaller cap A-REITs as well as looking to entities in alternative sectors. However, entry price is a potential barrier for some investors.
    - Outsource expertise: Has the benefit of providing assistance throughout the process from identifying investment strategy and buyer representation through to asset management. At each step local market expertise can be leveraged.

Map 1

Foreign investment in Greater Sydney by sector, 2013-16



Source: Cushman & Wakefield

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Foreign investment in Australia

Ongoing attraction…

Foreign investors have been a prominent part of Australia's commercial real estate investment landscape since the GFC. From a low of just $1.5bn in 2009, equivalent to 16% of the total, foreign investment volumes have since trended upward. Foreign investment reached a new peak in 2015 at $15bn or 51% of Australian commercial real estate transaction volume (Figure 2).

Interest in Australia has been driven by relatively attractive yields in an otherwise low-growth environment across much of the developed world. This has been supported by solid economic growth, which is expected to continue over the near term, and exceed forecast GDP growth in the US and Europe.

…but investment volumes declining

In 2016, many of the fundamentals that make Australia an attractive destination have not changed. However, there has been an appreciable decline in foreign investment in Australian commercial real estate over H1 2016. At the halfway point in the year, foreign investment in 2016 is down 30% year-on-year (y-o-y), while investment by domestic entities is up 13% y-o-y.

The decline in offshore investment volume is partly due to 2015 numbers being boosted by large portfolio deals including CIC's $2.5bn office portfolio and Ascendas's $1bn industrial portfolio purchases. However, volumes have also declined due to limited investment opportunities.

Offshore focus on core markets

The current wave of foreign investment has brought with it an array of new entrants into the Australian investment market. Understandably, investors new to the Australian market have tended to focus on the most mature and liquid markets as well as sectors with lower ongoing management requirements. This has meant a focus on Sydney and Melbourne CBDs and a preference for office assets.

As a result, offshore investors have been the dominant purchasers of Sydney CBD commercial real estate (Figure 3). On average, 30% of their annual investment volume has been deployed into Sydney CBD, the vast majority being office assets, with almost 60% targeting office assets in general across the country (Figure 4).

Limited stock for sale

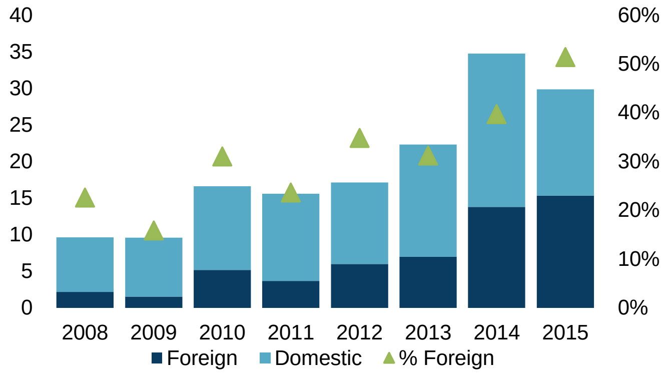
Part of the reason for the decline in overall transaction volumes, despite the weight-of-capital seeking investment opportunities, is a reluctance by owners to release stock from core markets due to limited reinvestment opportunities as well as owners seeking to take advantage of the expected uplift in office rents in Sydney and Melbourne due to soft supply pipelines.

Conversely, some domestic institutions are willing to sell non-core stock for capital redeployment, whilst private investors and corporations are also sellers in non-core markets.

In line with this, domestic entities have been able to increase purchase volumes by looking beyond core markets (Map 2). In contrast, to-date, offshore investors have not adjusted purchasing behaviour in this way (Map 3).

Figure 2

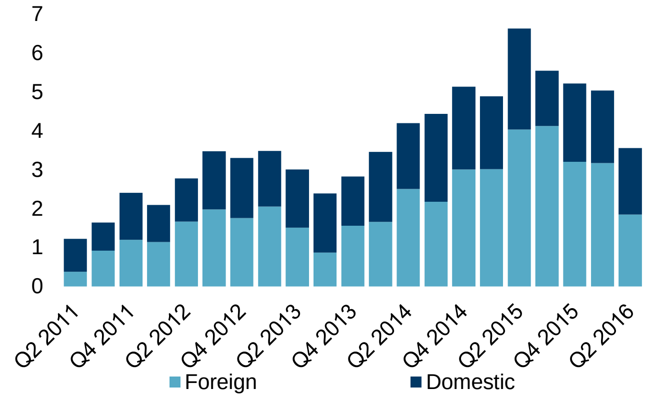
Annual domestic vs. foreign investment ($bn)



Source: Cushman & Wakefield

Figure 3

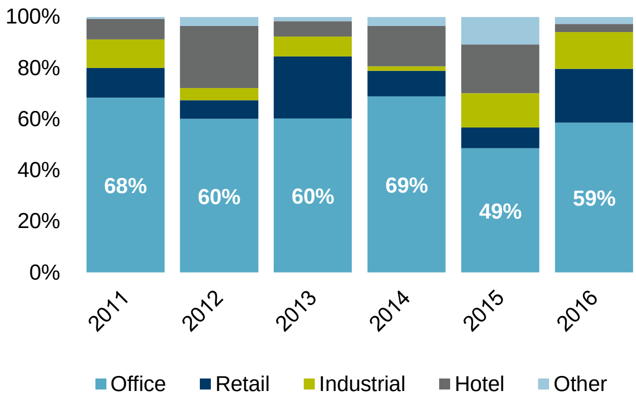
Rolling annual investment in Sydney CBD by purchaser type ($bn)



Source: Cushman & Wakefield

Figure 4

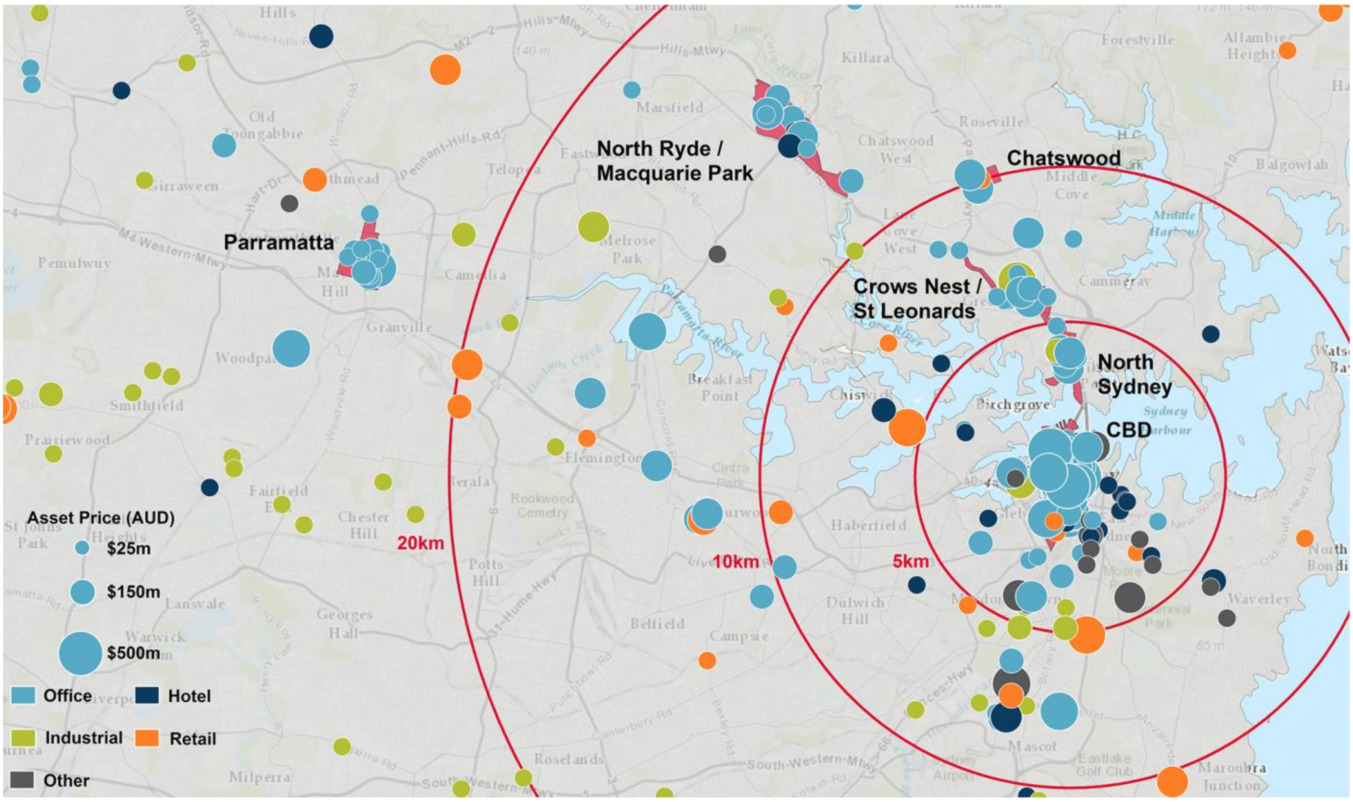
Proportion of foreign investment by sector, year to Q2



Source: Cushman & Wakefield

Map 2

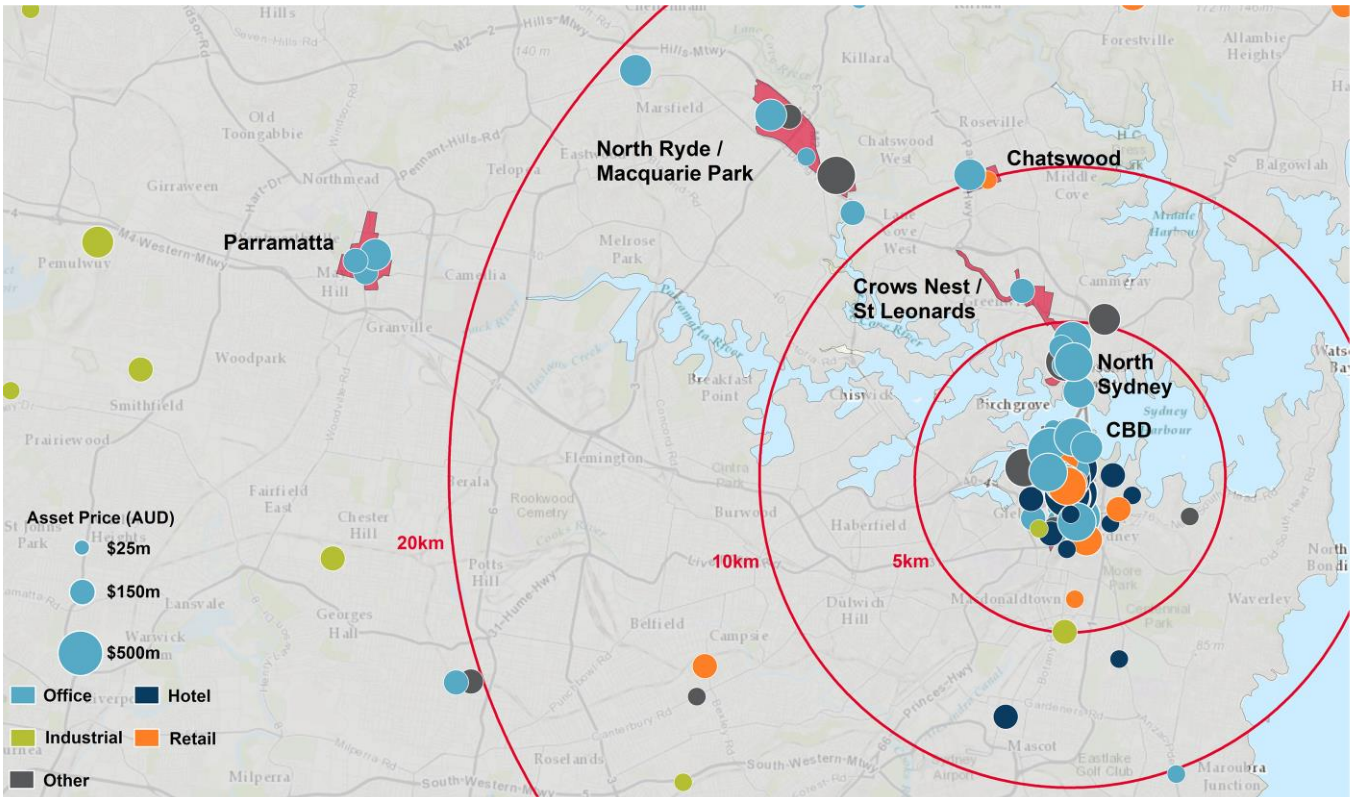
Domestic investment in Greater Sydney by sector, 2013-2016



Source: Cushman & Wakefield

Map 3

Foreign investment in Greater Sydney by sector, 2013-2016



Source: Cushman & Wakefield

Strategies for investment

While core stock should continue to come to market, if current conditions persist, the volume is not only unlikely to meet demand from investors but also be hotly contested. The following sections outline strategies offshore investors might consider for Australian commercial property investment in a low stock, high demand environment.

Diversification: across sectors

As highlighted in Figure 4 and Map 3, offshore investors are predominantly focused on the office sector. Whilst there has been an ongoing interest in the hotel sector, beyond this, offshore investors have historically been less active in the retail and industrial sectors which together have accounted for less than 25% of investment volume over the past three years. Diversification across sectors not only presents a greater range of opportunities to invest, but also to accumulate a portfolio with a diversified risk profile.

Where investment has occurred in the retail and industrial sectors, it has generally been focused on the larger shopping centres, regional centres and above, or in newly constructed distribution centres and warehouses.

However, like the office sector, super-prime assets in retail and industrial come to market comparatively less frequently. For example, liquidity across regional centres over the past six years has been below 2.0%, while for CBD centres the figure is 3.2%. In contrast, the liquidity for smaller centres such as neighbourhood and sub-regionals sits at 9.4% each. There is emerging evidence of offshore investors starting to target these assets with Blackstone recently purchasing several smaller retail centres, as part of portfolio deals, from both Scentre and Vicinity.

In the industrial sector, excluding the Ascendas portfolio purchase, Mapletree and Cache Logistics have been most active amongst offshore purchasers, acquiring nine assets between them over the past eighteen months. Aside from these transactions, offshore investors only purchased seven further industrial assets over the same period.

There are also likely to be opportunities in more niche sectors, such as retirement/seniors housing & care, self-storage, car parks, data centres or petrol stations, which to date have been largely overlooked by offshore entities. Those who have been active have tended to make one-off purchases such as DCI who acquired Woolworth's data centre in Eastern Creek, and Chow Tai Fook teaming up Far East Consortium to purchase Festival Towers car park in Brisbane

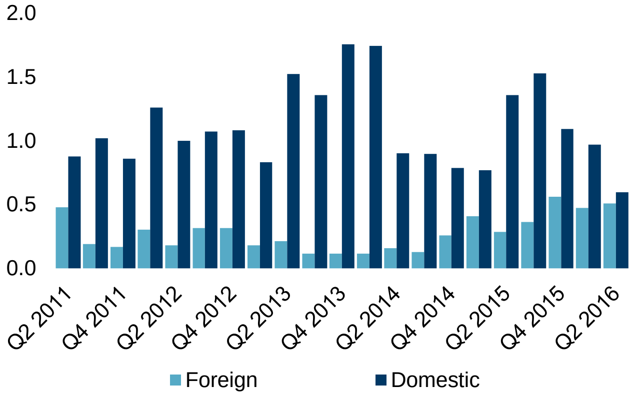
Diversification: across geographical markets

Only a third of offshore investment was dedicated to markets outside of Sydney and Melbourne CBDs or national portfolios. The equivalent figure for domestic investors is nearer 60%.

Limited liquidity, potentially greater volatility and a preference for 'gateway' locations means offshore investors usually make their first purchases in Sydney and Melbourne and only then look to markets such as Brisbane, Perth, Adelaide or Canberra. However, there are signs offshore investors are looking beyond Sydney and Melbourne with Brisbane in particular becoming an area of interest (Figure 5). For example, AEP Investment Management and Deutsche Asset & Wealth Management have both recently made significant investments in Brisbane.

Figure 5

Rolling annual investment in Brisbane CBD by purchaser type ($bn)



Source: Cushman & Wakefield

Foreign investors have been more active in executing investment strategies in non-CBD office markets. While most purchases have been made by investors with longer connections to Australia, there are instances of new investors acquiring assets in non-CBD locations. South Korean-based FG Asset Management have been one of the most noticeable with acquisitions in Box Hill (Victoria), Greenway (ACT) and Albury (NSW). South Korean institutional investors were also behind the purchase of 1 Woolworth Way, Bella Vista (non-CBD Sydney) from Mirvac.

Key aspects of these purchases include that they were:

(i) significant purchases, and so efficient from a deployment of capital perspective;

(ii) leased to blue-chip tenants including Federal Government and ASX-listed companies; and

(iii) cap rates were higher than for comparable assets in CBD locations.

Sectoral Diversification

Pros	Cons
More investment opportunities	More complex asset management
Diversify risk	Lack of knowledge on market
Potentially, higher cap rates	

Geographical Diversification

Pros	Cons
More investment opportunities	Lack of knowledge on market
Diversify risk	Smaller, less liquid markets
Higher cap rates	Potentially, more volatility

JVs, capital partnerships and wholesale funds

Adopting a Joint Venture (JV) approach, provides several benefits including: access to new opportunities, cost sharing, mitigation of risk as well as gaining access to local expertise and management platforms. The positives, though are not one-way. Local investors can benefit from a capital partner to secure larger assets and portfolios than they would otherwise have been able to target. An example being the Canadian Pension Plan Investment Board's joint venture with Dexus in the 2014 takeover of the Commonwealth Property Office Fund.

Lend Lease was able to gain access to capital via Qatar Investment Authority, among other investors, partnering in the Lend Lease One International Towers Sydney Trust.

While these are both high profile, large office transactions there are examples at smaller price points. UK-based Grosvenor partnered with local investment manager Propertylink to acquire Riverside Corporate Park in the Sydney suburban office market of North Ryde. As yet, there has been limited JV activity outside of the office sector between local and offshore entities, with Heitman and National Storage REIT being a recent exception. This is likely linked to more restricted offshore buying activity outside of the office sector, but represents an opportunity for new investors.

Within this partnering arrangement, incoming capital partners can target local experts that meet their investment mandate requirements. Some local operators are only active within a specific sector, whereas others are active across multiple sectors. Furthermore, some investors are known for depth of experience in sourcing and managing core-plus or value add opportunities rather than in core stock or development plays.

Purchasing platforms

Current economic conditions are conducive to merger and acquisition (M&A) activity. Indeed, according to Pitcher Partners, deal value from M&As in Australia jumped from approximately \$80bn in 2014 to almost \$140bn in 2015. The property sector has also seen an increase in entity level transactions.

Large foreign institutional investors, including Pension Funds and Sovereign Wealth Funds, have acquired many of the largest portfolios that have been brought to market. They have been so effective that on a rolling annual basis, as at Q2 2016, offshore investors were responsible for 85% of the investment volume in national portfolios (Figure 6). Over the past year, CIC and Ascendas transacted on the two largest portfolio deals in 2015, with Blackstone the acquirer of the largest portfolio in 2016.

While the larger, higher profile targets have now transacted, there still remain potential opportunities to acquire smaller-cap A-REITs as well as looking to entities in alternative sectors.

Activity of this nature provides the benefit of rapidly building scale while also presenting the opportunity to retain local expertise in the management of the portfolio. However, this approach also requires significant capital outlay in the initial acquisition phase, which may be beyond some investor types.

Local service providers and outsourcing

Finally, for those requiring more financial and decision-making control over their assets than a JV or capital partnership may allow, but without wishing to build a substantial presence, then foreign investors could consider leveraging expertise from local service providers. For example, Cushman and Wakefield can assist with:

(i) developing investment strategies across Australia and New Zealand;

(ii) identifying investment opportunities and buyer representation;

(iii) Introduction to suitable joint venture partners and investment managers;

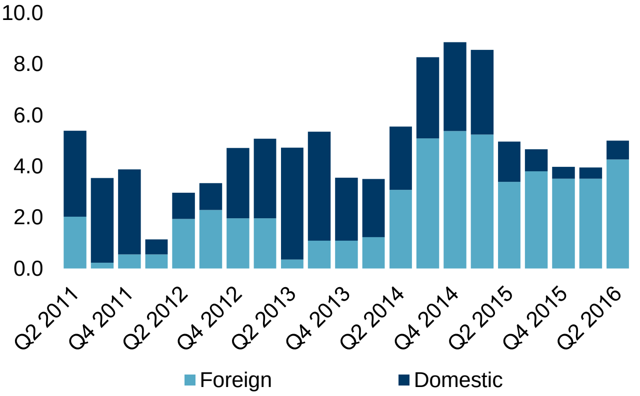
(iv) asset and project management;

(v) valuation; and

(vi) asset divestment.

Figure 6

Rolling annual portfolio investment by purchaser type (\$bn)



Source: Cushman & Wakefield

JVs and Capital Partnerships

Pros	**Cons**
Leverage local knowledge	Less control of asset
Select partner with co-alignment	Potential lack of co-alignment with partner
Mitigate investment risk	

Purchasing platforms

Pros	**Cons**
Build scale quickly	Higher purchase price
Geographical coverage	Often attracts a premium to value
	Limited opportunities

Conclusions

In the ongoing global search for yield, investors have increasingly targeted commercial real estate to take advantage of the higher returns and relative value on offer. Within the Asia Pacific region, Australia has been a key investment destination, which has supported buoyant investment volumes to date.

As the current market cycles continues to extend in duration, opportunities for core stock have started to become more limited. Domestic investors have responded by becoming more active across a greater array of sectors and geographical markets.

The response across foreign investors has been more mixed. Those who have a long-standing connection with Australia have tended to react in a similar manner to domestic entities. Newer market entrants though have maintained a focus on a diminishing pool of core assets. It is these investors who could benefit from adopting a wider approach and harnessing local expertise to achieve their investment goals.

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