(L-R): Wayne Lasky, Rob Hattersley, Michael Weaver and Bruce Wan

Duel dynamics

International capital has such an appetite for core real estate that Australia's gateway markets have become subject to global forces as much as domestic. By Florence Chong

Photography by Britta Campion

Global appeal: *PERE*'s roundtablers discuss Australia's recent cap rate compression

In a relatively small market by world standards, and one where most core assets are securitized, global investors targeting Australia will increasingly need an exclusive calling card to get into its key gateway cities.

They will need to forge a close working relationship with Australia's largest integrated property groups to access assets from their deal or development pipelines, typically through clubs or joint ventures.

If portfolios of assets are what these institutional investors seek, they will most likely need to partner with one of Australia's large listed REITs to access prized assets, which more than likely will be locked in public vehicles or wholesale funds.

Increasingly, they will have to look outside the box at alternative asset classes like student accommodation. These leftfield options are rapidly gaining attention and attracting serious investment and finance.

In short, Australia is all about 'partnership culture', according to the participants in the 2015 *PERE* Australia Roundtable held in Sydney in August. The right partners will open the door to opportunities, they say.

They agree that scarcity of supply, coupled with both global and domestic demand, has heightened competition for Australian real estate.

Until recently, Australia was perceived as a market where yields were high and prices were behind those of key global capital cities. Australia offered good value.

That is now changing as capitalization rates compress and yields shrink.

Bruce Wan, Macquarie Group real estate strategist, says: "Sydney and Melbourne have come into the price adjustment cycle fairly late. Australia has only started to see genuine cap rate compression since about 2014."

"In the global cyclical context, Australia is still a lagging market. Prices move ahead first in Hong Kong and London, the most liquid and the largest markets in the world, followed by, for example, Manhattan and Paris."

Roundtable participants were struck by what they call the 'pretty sharp price' paid for the Morgan Stanley-controlled Investa Property Trust in July. The 20 percent premium paid for the portfolio may well set a new benchmark for core Australian commercial real estate.

"The level of demand for Investa, both in the number of bidders and the quantum of dollars involved, reflects the scarcity value of high quality core assets," says Rob Hattersley, chief investment officer of Lend Lease. "There is plenty of capital, but quality deals are limited."

China Investment Corporation (CIC) bought the Investa portfolio for A$2.45 billion (€1.6 billion; $1.8 billion) on a passing income yield, believed to be in the range of 4.5 percent to 4.7 percent.

"Foreign investors are taking foreign pricing into the

Australian market," says Wan, noting that the Investa transaction price is comparable to what is currently paid for office assets of this size and quality overseas.

So far this year, says Wan, there have been just two other office deals globally with a ticket size of more than A$2 billion. Those were done on yields of around 4.5 percent.

Wayne Lasky, founding partner and managing director of MaxCap Group, a Melbourne-based property debt and investment company, says: "The pricing might look sharp if you just look at the transaction alone. You need to understand that relative to other opportunities outside of this country, there aren't many core assets of this type and of this scale available."

Michael Weaver, manager of private markets, covering real estate, infrastructure and private equity and private debt with Australia's A$34-billion Sunsuper, says that even if the premium was steep, it still makes sense for a new investor to the market seeking exposure. Nonetheless, long-term property investors might have been a little surprised at the sharp yield of the transaction, he admits.

Hattersley agrees that investors with more mature programs, which have invested through various cycles, feel less pressure to deploy capital today than those which are new and need to build up scale in Australia. "They are the more visible investors today."

Roundtable participants say rising valuations are unlikely to derail the strong inflow of foreign capital into Australia. Large institutional investors, like sovereign wealth funds and global pension funds, are lifting their exposure to real estate in key markets, including Australia, where relative to the global market, the yield spread is still attractive.

Weaver says that in the current global environment, with bond rates as low as they are, investors look for other income-producing assets. That means property and infrastructure that can be counted on for steady cash flow in a low-growth, uncertain world.

But global capital remains discerning, with a disproportionate bias towards key cities in half a dozen developed countries.

Wayne Lasky

Founding partner and managing director
MaxCap Group

Lasky is responsible for business strategy, execution, key stakeholder relations, risk and compliance with MaxCap. He has 15 years of real estate and finance experience, from working from all sides of the table as an originator, lender, asset manager, real estate investor and developer, project manager and property manager.

Rob Hattersley

Chief investment officer, investment management
Lend Lease

Hattersley's key role is to manage Lend Lease third-party capital, which participates in the group's asset platforms around the world. Increasingly, he works with sovereign funds and global pension schemes. Hattersley has been involved in the real estate and funds management industry for more than 24 years and sits on the executive board of an industry body, the Hong Kong-based Asian Association for Investors in Non-listed Real Estate Vehicles (ANREV).

Bruce Wan

Global real estate strategist
Macquarie Capital

Wan has more than 17 years of experience in economic and investment market analysis. He joined Macquarie in 2008 as a leading contributor to the bank's private capital market business through the provision of real estate market analysis and strategy advice for major global pension and sovereign investors. Working broadly across Macquarie, he also provides analysis and advice for a range of personal and business banking and corporate lending businesses.

Michael Weaver

Manager of private markets
Sunsuper

Weaver is the portfolio manager responsible for property, infrastructure and private equity and private debt at Sunsuper, one of Australia's largest and fastest-growing super funds. Weaver was a portfolio analyst before being promoted in 2010 to his current position. He is one of six portfolio managers who report to Sunsuper's chief investment officer, David Hartley.

"Melbourne and Sydney are considered genuine gateway cities, and, as such, investors have a different outlook on value in these markets," says Lasky.

Hattersley confirms that large global investors are city allocators, not country allocators. "They pick major gateway cities, be it London, New York or Sydney."

The *2015 Wall of Money Report*, published by property consultancy firm DTZ, ranks Sydney and Melbourne ahead of Singapore and Hong Kong, the other two Asian Pacific cities on the list of the 15 most preferred destinations for global capital.

Wan says Australia accounts for just 2 percent of the global economy, but global capital allocates a relatively higher weight to Australia, particularly where there is an Asian mandate. "They will start with Japan and Australia because these are strong, developed economies. In time, global capital will find its way into other countries in Asia, like China and India."

"There is plenty of capital, but quality deals are limited."

-Rob Hattersley

Lasky says: "After 20 years of geopolitical positioning, Australia is now regarded as a bona fide member of Asia Pacific. When it comes to global allocations, Australia is clearly punching above its weight."

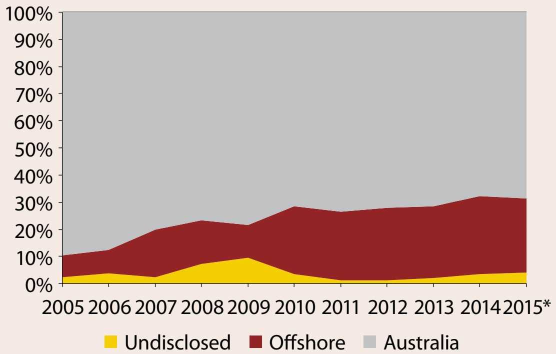
"Australia gets on the radar as part of Asia, but more importantly, because of the quality of its real estate and its managers." says Weaver, who is a global investor himself. "It is also one of the easiest places in which to get invested."

"Global investors can find alignment with different managers in Australia. These relationships have been established for longer than any you can find elsewhere in Asia."

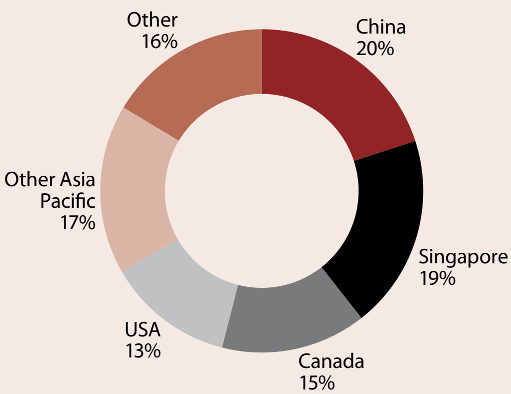
Australia's Asian invasion

According to broker JLL's latest research, offshore capital has played an increasing part in Australia's property investment market, especially Asian capital.

Share of total transactions, 2005 to 2015*



Foreign buyer origin, 2014 to 2015*



Source: *JLL Research* **as at 2Q 2015*

Getting comfortable

Weaver says global interest in Australia has been enhanced by the devaluation of the Australian dollar and low interest rates. In Australia, interest rates are at the lowest they have ever been. This, he says, has made buyers more comfortable to invest on either a hedged or an unhedged basis.

"Compared to a year ago, the same asset in Australia is 22 percent cheaper for buyers from China and the US because of the currency effect; 15 percent cheaper for the UK and 14 percent for Singapore," says Macquarie's Wan.

Borrowing spreads in Australia have fallen in line with the official Australian rate, which at 2 percent is at an historical low. Most investors to Australia have access to a competitive cost of capital, according to roundtable participants.

Hattersley says the US is poised to raise its interest rates, and a huge amount of money has been deployed into the US and Europe over the course of the last two or three years. "This will have people focusing back into markets like Australia," he says.

According to Jones Lang LaSalle research, foreign investors in Australia accounted for 31 percent of all transactions by value in the first quarter of 2015, up on last year's 28 percent, with Chinese investors outspending Canadians, Singaporeans and Americans.

Wan says: "Fundamentally, a lot of wealth is being created in China. Even with GDP growth of 7 percent, Chinese corporates, insurance companies and managed funds continue to see a lot of income growth. As the capital barriers come down, more of this capital will have the option to invest overseas."

Chinese buyers are inclined to flex their financial muscle when they first step out of their home markets, he says. "When we talk to them, they are very keen for prime trophy assets in tier one markets.”

Hattersley says some large global investors are disinclined to participate in market bids. “They either want to do off-market deals or appoint an adviser to bid for them.”

But foreign investors often find that, when it comes to bidding for assets, canny and aggressive domestic buyers outfox them. Domestic pension funds and Australian REITs have returned to the market with a vengeance in the past two years after lying low in the initial post-GFC period.

Says Wan: “Foreign investors only ever account for 30 percent to 40 percent of Australian transactions. The balance has always been the Australian domestic player, and that balance of the power will be hard to change. It has been steady for a number of years.”

Barangaroo development: helped Lend Lease to diversify its capital sources

The Australian economy is the 12th largest in the world, but its pension pool is the fourth largest, Wan observes. “There is a big disconnect between capital and investment opportunities in Australia. There is something like A$2 trillion in pension fund assets growing at A$100 million every year. Ten percent of that is notionally allocated to real estate.”

Generally, Australian pension funds buy to hold. Even during the global financial crisis, when heavily indebted Australian public vehicles were forced to sell assets, Hattersley says the majority of Australian super funds held on to the direct real estate allocations they had invested with unlisted wholesale funds demonstrating good tolerance to market volatility.

“Melbourne and Sydney are considered genuine gateway cities, and, as such, investors have a different outlook on value in these markets.”

-Wayne Lasky

Since the beginning of 2014, Australian entities have raised A$7.6 billion in private capital. Much of this was raised by existing funds, managed by the likes of QIC, the Brisbane-based fund manager, and listed REITs, including DEXUS Property Group and Mirvac. These groups operate in the core office and retail sectors.

Hattersley says Lend Lease raised A$1.8 billion last financial year. “The capital came into a range of products from existing funds, clubs, pooled vehicles and joint ventures.”

Visitors to Australia are often surprised to find that 70 percent of investment grade real estate in Australia is securitized.

True strategic partnerships

Global and domestic buyers access assets through their long-term partnerships with large Australian groups such as Lend Lease or the Goodman Group, Australia’s largest industrial assets developer. Both have big global footprints.

Hattersley says: “Sophisticated capital will work to form true strategic partnerships with these Australian groups. They will have a small number of partners in each of the countries in which they want to be, and will work with them to scale up their investment.”

He says the build-to-core approach is certainly a strategy many of the larger pension and sovereign funds have now adopted to give them exposure to the Australian market. They see it as an efficient strategy through which to gain access to new buildings. Importantly, adds Hattersley, they are buying into next-generation assets.

Lend Lease creates assets from its large development book, with a range of offerings that include prime office and retirement villages in locations around Australia.

In November last year, Lend Lease introduced the Qatar Investment Authority (QIA) into its core commercial real estate fund (APPFC). In February this year, QIA followed this initial investment in the Australian market by investing alongside APPFC and Lend Lease into a new Lend Lease managed trust, which will own the A$2 billion International Tower 1 at its Barangaroo urban regeneration project in

Australia commercial real estate transaction volumes, 2005-2015

Source: *JLL Research* **as at 2Q 2015*

Sydney.

"For a development company, it is a very effective way to build out its development book, diversify funding sources and recycle capital," says Hattersley. "And the sophisticated capital partners end up owning the asset you are creating,"

In such forward funding arrangements, Lend Lease, as an example, does not need to use debt during the project phase. Instead it pays its partners a coupon rate, roughly in line with the debt cost of the day, for the use of their equity during construction. The partners take ownership on completion.

"But depending on the debt level decided by the investors on completion, we will bring some debt into the asset," says Hattersley. Typically, Lend Lease takes on the role of co-investor as well as asset and investment manager.

"Foreign investors are taking foreign pricing into the Australian market."

-Bruce Wan

Wan reinforces the point that relationships are the key to securing investment opportunities in Australia as they are for a number of other markets. Macquarie Group routinely brings investment propositions to its capital partners.

Recently, Macquarie set up a $400-million club with the Australian logistics property specialist, Logos, CBRE Global Investment Partners and Canada's Ivanhoé Cambridge. Through the vehicle, the partners will target the China's logistics market.

Alongside their public vehicles, many of Australia's largest property groups, including Lend Lease, DEXUS and Mirvac, manage large wholesale funds that own some of the nation's best core real estate.

Hattersley says that when these managers need to raise capital, they are often supported from within their existing investor base, which provides pre-emptive rights to new equity issuances.

Additionally, in the current environment where access to quality deal flow is challenging, many investors actively participate in available distribution reinvestment plans (DRPs) as an efficient avenue through which to marginally increase their allocation to real estate.

Unless they are able to participate in an existing wholesale fund, or have established a joint venture or club relationship with Australian property groups, new global investors will have to explore innovative approaches to secure assets.

One option is to take over a listed REIT or a wholesale fund and to then take the vehicle private. Last year, Canada Pension Plan Investment Board (CPPIB) partnered DEXUS to take over Australia's former Commonwealth Property Office Fund in a A$3 billion deal. The REIT is now run as an unlisted fund under the management of DEXUS.

"As an investment house, when we take M&A opportunities to large investors they are usually quite receptive, because buying assets on a piecemeal basis in an open competitive bidding process in Australia is both difficult and expensive," says Wan.

He adds: "If there is an opportunity to take a large platform of assets, where they can deploy quite a large check and get control, that would be attractive to them. So we can reasonably foresee more M&A opportunities over the next couple of years."

The fundamentals of the office market in Australian capital cities have remained relatively weak since the global financial crisis. Although leasing is gradually improving in stronger markets like Sydney and Melbourne, landlords continue to pay high incentives to literally 'buy' tenancies to protect their occupancy rate or to kick-start new projects.

Participants say incentives can range up to 30 percent or more on the face value of rent, but there is evidence that net absorption is increasing in these biggest markets and that vacancies are falling. Rental increases will follow, and hopefully incentives will moderate in future.

But seasoned investors such as Weaver remain skeptical that a recovery in Australia's office rental market is imminent. He has heard the prediction once too often.

Unlike past cycles, there is no overbuilding either in Sydney or Melbourne. Certainly, there is no speculative development because lenders demand a reasonable pre-commitment before they are prepared to fund a project.

The supply glut in the early 1990s is not being repeated, even though a huge project like Barangaroo will increase

Sydney's prime office stock by 5 percent when it is completed in 2017. In the 1990s, Wan says 20 percent was being added to Sydney prime office stock over three years, compared to 6 percent over a similar period today.

Hattersley also believes that even though there are a number of development sites with approvals in Sydney today, these are unlikely to get underway until developers have tenants in place.

Lasky says Australia's banks have learned their lessons from the 1990s crash, when they were left holding non-performing loans. The development market today is 'a lender-driven' market and will remain so for some time, he says.

With core real estate so hard to come by, foreign investors are being persuaded to look at alternatives, often out of sheer necessity to find a home for their capital.

"Most global large institutions would be willing to look at any property style investment as long as a reasonable business or investment case can be made."

-Michael Weaver

Weaver says: "We have A$3 billion in our property portfolio out of A$34 billion under asset management, and we are one of the fastest-growing super funds in the country, so we are always looking for new areas for investment, both here in Australia and offshore.

"Most global large institutions would be willing to look at any property style investment as long as a reasonable business or investment case can be made."

"We've invested in holiday and tourism parks in Australia, and are receiving good yield and strong returns from them. However, by their nature, they are alternative asset classes and generally they are not that big, so for larger global investors, most of these asset classes are going to be too small for them to bother with unless there is scale. That is one of the key challenges."

Says Wan: "The key is to create different types of investment grade assets to suit different risk appetites. This is the challenge in a capital-abundant world." He says Macquarie has helped a broad range of entities invest in both emerging and developed markets, including Australia.

Lasky says: "We need to understand the fundamentals in specific strategies, for instance, in student housing. There is absolutely a massive under-supply of student accommodation in Australia."

Australia is the world's third most popular destination for foreign students after the US and the UK. Education is regarded as 'a rising star' in Australia's export sector.

Macquarie's Wan agrees. "There is a very strong and compelling case for various alternative classes like student accommodation, and with a major sovereign, someone like us can bring that sort of niche sector into a fully investment grade sector."

"There is going to be a structural repricing associated with that." But, he adds, getting scale is very much a challenge in terms of acquiring any alternative asset.

Macquarie brought Singapore's sovereign wealth fund, GIC, in to co-invest in student housing last year. The partners formed a joint venture to buy a majority stake in Iglu, an Australian student accommodation provider with a property portfolio worth about A$150 million. "We were attracted by the relatively high yields," says Wan.

Hattersley says the Lend Lease experience has been that asset creators lead opportunities in these niche sectors globally. As a group, he explains that Lend Lease is participating in urbanization through large urban regeneration projects in Australia, Asia and Europe. The group also has a strong delivery capability in the US, and is actively starting to utilize its balance sheet with partners in this market.

Hattersley: development approval doesn't necessarily mean immediate construction

Wan: sees no turning point in the US or Australian economies or property markets

for Australian commercial real estate.

"We will continue to see demand exceeds the supply of assets and, given progressive tightening of cap rates, we will pay a lot of attention to leading signals of economic and market tipping points," predicts Wan.

"We are looking out to 6 months, 12 months or 24 months ahead for signs of a change in market conditions. So far, none of these indicators are suggesting that sort of turning point in the economy or in the commercial real estate market in the US and Australia," says Wan.

These projects provide access to a range of different types of investment class opportunities, whether they be mainstream office, retail, logistics, student accommodation or retirement villages. "We are a large participant in all those sectors, and we require capital partners in all of them," he says.

"So at the end of the day it is about access to the best deal, and about the right risk-return profiles, and being able to recognize that, at a certain point, the liquidity of a cycle can be challenging, " he says.

No outstrip

Given exponential growth in capital globally and the demand for assets in core markets, such as Australia, is it conceivable that capital will one day outstrip supply of real estate for investment?

Not likely, according to Weaver. "Australia is a relatively fast-growing economy and we will build more office towers, shopping centers and industrial sheds as its population grows," he says. "But I suspect capital could grow faster than supply. The alternative then, is to look offshore. And that is what many Australian funds are talking about."

Looking ahead, the *PERE* participants are bullish about the outlook

Although more subdued in his expectations, Hattersley is cautiously optimistic, believing that Australia is in for 'a long cycle of positive returns', buoyed by continuing capital inflows and a relatively benign low interest rate environment.

He says the current cap rate compression in not likely to continue and will stabilize, resulting in asset performance becoming more reliant on underlying operating fundamentals.

Ultimately, says Weaver: "Global capital is borderless and values are relative, so if it can't see value in Australia, the capital will go elsewhere." □

Sydney: subject more to international forces today