Part of the world

Foreign investors take heed of what Australian property markets have to offer

by Alex Frew McMillan

Australia is no longer the "Terra Australis Incognita", or "unknown land of the south". It is very much on the map.

Unfortunately, this also leaves it increasingly buffeted by foreign breezes. The country has now gone an incredible 100 quarters — 25 years — without a recession (defined as two consecutive down quarters). But will Australia's economy retain its titanium coating? Mining, its mainstay, is scrubbing its way through a very tough patch. And companies from China, Australia's main trading partner, are no longer lining up to buy what it produces.

Former two-time Prime Minister Kevin Rudd shifted the Australian economy very much toward its neighbouring continent in an effort to play a major role in "Asia's century", but that means Australia's fortunes are intertwined with global forces it cannot control.

In aligning its fortunes with China, is Australia leaving itself exposed to the gale-force winds that have stormed through the rest of the world? And what does that mean for investors looking to put money to work in a nation that previously seemed a sure bet?

Advantages over Asia

Australia has several advantages over Asia — or "Asia Pacific", if Australia is allowed to expand the definition a little. The transparency and rule

Photo courtesy of MAB Corp Pty Ltd

The recent A$71 million (US$54 million) purchase of Melbourne's 221-unit Quest NewQuay Docklands apartment-hotel development is part of a joint venture formed between the Qatar Investment Authority and Singapore's CapitaLand subsidiary, Ascott Ltd, in 2015.

of law is strong, notes Marc-André Flageole, Asia Pacific portfolio manager at Presima. And unlike a city such as Singapore, where real estate investors often only get title to land on which their investment stands, it offers free title, and investors actually can own land Down Under.

Those kinds of perks are here to stay. The Aussie interconnection with the rest of the world has shunted its major markets centre stage, in the eyes of some investors. "The major gateway cities of Sydney and Melbourne have become truly global cities for many prime real estate investors," says Steve Bulloch, head of Australia at PGIM Real Estate. "I think a lot of the larger investors are now looking to hold a long-term allocation to Australian real estate."

Another reassurance to investors is leases are long, with clearly-marked annual escalations in place that make income streams easy to predict.

Weird fluctuations of the currency

Flageole notes investors from his native Canada who have been very active Down Under, have Canadian dollars that are currently correlated with the Aussie equivalent.

One peculiarity of the Australian property market is a lower Australian dollar against the US dollar should propel investment into the country, particularly from US investors. But the correlation has traditionally been inverse, remarks Bulloch. Foreign investment has been strongest during times of currency strength.

Will that change with Australia's increased connectivity and appeal? It seems so. Amid this period of a relatively weak Aussie dollar, PGIM Real Estate is "seeing a lot of foreign interest, although I think other factors, like transparency and relative yields, are a bigger driver," explains Bulloch. "We are also seeing a much more diverse range of foreign investors into Australia."

The residential market is finely poised right now, says Bulloch. And this time around, the currency relationship appears to be functioning "normally". The cheaper currency is encouraging strong participation from international investors, who are favourably comparing Australian prices with those in their domestic markets.

"After many years of undersupply, we have now seen strong price growth and a considerable supply response in the apartment market, so the markets are now delicately balanced," adds Bulloch. Local banks have tightened lending criteria for apartment projects substantially, and new foreign investment controls have been introduced to assist affordability.

"We think the risk of a significant correction is low, but price growth could be muted for some time," he concludes.

The Motherland

Top of the agenda for Australia in terms of real estate investment, however, is likely not Asia. The United Kingdom's June vote to leave the European Union has really shaken up the international property-investment scene. Opinion has been all over the place about how to respond to that decision; the result was a shock, even for the people who supported Brexit.

"You had quite divergent views making up that camp, which partly explains why there wasn't a plan for victory," notes Simon Rubinsohn, the chief economist at the Royal Institution of Chartered Surveyors. "Clearly, it was also fairly unexpected. As a result, there's an awful lot of work to be done."

Norway's US$850 billion Government Pension Fund Global, the largest retirement fund in the world, soon cut the value of its British property portfolio by 5 percent to reflect the vote. That sounded like bad news. Then shortly afterward, it pounced on a deal in London's Oxford Street, buying a retail and office property for £124 million (US$154 million) from Aberdeen UK Property Fund. It said it was the quickest property deal it had ever done.

Some major investment managers have been under pressure from their own investors to offload assets, and there are buyers ready to pounce on such deals. China Vanke Co, China's largest residential developer by sales, paid £115 million (US$143 million) for Ryder Court in Mayfair, its first office building in Britain. That presents a rental yield of 4.3 percent, according to Reuters. Seller Henderson Global Investors acquired the asset in 2013 for £82 million (US$102 million) from LaSalle Investment Management.

Those kinds of opportunities may divert capital from markets such as Australia. On the other hand, spooked and risk-averse investors may turn to safe-haven markets, such as Sydney and Melbourne, while they determine a course for their investments in the United Kingdom and, indeed, the rest of the EU. France and Italy already have many voices calling for their departure from the EU, as well.

Will the EU make an example of Britain to deter the others? It is possible, but not likely because too much is at stake. Germany, the biggest EU player, is already making conciliatory noises. But the shape of Britain's departure is far from clear. One of the first things new Prime Minister Theresa May did was pay a visit to German Chancellor Angela Merkel to tell her there would be no progress in triggering Article 50, the official start of departure, in 2016. Prior to that courtesy call, though, May also told the world, "Brexit means Brexit."

But what, exactly, does it mean? No one knows. Norway and Switzerland have different approaches to the European Union, Norway allowing free movement of labour and Switzerland having a slightly more arms-length approach. It seems British banks want a "Swiss-plus" model, however they define that. A lot of negotiating is involved, and that has only just begun.

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Business as usual – or better

For Australia, Brexit is likely either a distraction or a positive. It has cast a shadow over European growth, and perhaps even global growth, in the eyes of Thomas Au, the head of Asia Pacific real estate research at Invesco Real Estate. But it should not hurt real estate all that much.

"We believe the bleaker economic outlook is likely to suggest key central banks in the world maintain their easing bias, with possibilities to expand current monetary easing programmes in order to support growth," says Au. "This could continue to drive capital into stable, income-yielding assets, such as real estate."

Australia's real estate is likely to remain a target for global investors, given the relatively-higher yields Down Under, notes Au. Currently, the yield spread over government bond rates is higher than historic levels, and Sydney and Melbourne have positive gearing and stable fundamentals, he adds.

Through its subsidiary Ascott Ltd, Singapore's CapitaLand and the US$335 billion Qatar Investment Authority formed a joint venture last year that has now made its Australian debut with the A$71 million (US$54 million) acquisition of the 221-unit Quest NewQuay Docklands apartment-hotel development in Melbourne. In addition, the US$185 billion Chikyoren — Japan's Pension Fund Association for Local Government

Sydney's Pitt Street Mall

Officials, and one of Japan's "Big Four" — has appointed UBS Asset Management to manage overseas real estate. Both transactions are only likely to deepen interest in high-yielding Aussie property, although investors should bear in mind Australian yields are a bit artificial because tenants receive a number of incentives when they sign a lease.

PGIM Real Estate is optimistic Japanese institutional interest in Australia will return. A very big and diverse chunk of change had been heading from Tokyo to the "Wide Brown Land" but, of course, that was disrupted when Japan's property bubble burst in the 1980s. Now, Japanese real estate companies are diving into Australian residential projects and bringing along strong skillsets to partner with good local operators.

"Real estate lending is another area Japanese property investors have been participating in for a while, and I expect to see them become more active," notes Bulloch. This is not surprising at a time when Japanese interest rates have turned negative and major investors are desperate for yield. "The local banks have become very selective and have opened the door to offshore banks," says Bulloch.

Fundamentals in Sydney and Melbourne

When it comes to rental incentives, Au thinks they will decline as the market improves, creating positive net-effective rent growth. "The investment market remains buoyant, with a significant weight of capital seeking a limited number of opportunities, providing for further yield-compression opportunities," he believes.

Retail-tenant demand is strong in both Sydney and Melbourne, with new supply in the form of expanded and redeveloped properties. Many international retailers are only now making a beachhead in Australia, so they are prime customers for top-notch assets that can house flagship stores. Investor demand and higher rents have driven yield compression, notes Au.

There have not been a lot of transactions of late — only because good-quality properties are not coming on the market, according to Presima's Flageole. He also notes the cheap cost of funding makes the country attractive for international investors.

Au does not see a lot of clouds on the horizon for Sydney and Melbourne. "The investment market remains robust and momentum is forecast to continue, with further yield compression underpinned by the current levels of investment demand and the competitive debt markets," he asserts. Some structural change is occurring in the nature of demand for logistics space, with traditional manufacturers giving way to third-party logistics and transport-oriented tenants. But they are more than capable of filling that void, it seems.

You have to be careful outside of Sydney and Melbourne, however, says Au. The fundamentals are weaker, and a glut of supply, as well as the dull sound of the mining boom ending, are negatives.

Au believes investments outside Australia's two largest cities have to be asset-specific. That involves scrutiny of the tenants, as well as weighing the weighted average lease expiry.

"An asset with a long WALE with strong tenant covenant could help counter some short-term risk from the market perspective," explains Au, shedding some light on Invesco Real Estate's thought process. "There could also be distressed opportunities due to tightening financing and poor property-level performance for investors looking for higher returns."

Given this, a growing number of foreign investors seeking core or higher-return prospects from their real estate investments have discovered at least one good place to look on the map these days — Australia. ❖

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