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Australia roundtable 2021

ROUNDTABLE

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A market awaiting a strong return

The pandemic has not put foreign investors off Australian real estate, say participants at PERE's Australian roundtable. They imagine its potential growth once it is over, writes Mark Cooper

The covid-19 pandemic derailed a generation's economic progress by sending the Australian economy into a technical recession in 2020. A renewed lockdown in New South Wales this year may produce another quarter of falling GDP. However, the panelists at *PERE*'s Australia roundtable are confident that growth will bounce back strongly as the pandemic eases, especially as the nation's closed borders have not kept out the foreign capital which continues to seek Australian real estate.

Rob Percy, chief investment officer at listed manager Cromwell Property Group, says: "I think the outlook is pretty positive over the medium term. There will still be some sectors that will struggle from the slow vaccine rollout and borders being closed. But the amount of capital from diverse sources that still see Australia as a really attractive destination is not going to change any time soon."

While the panel admitted that Australia's vaccination program had been slow compared with other developed markets, the consensus was that a post-lockdown recovery would be swift, as it was after the first lockdowns in 2020.

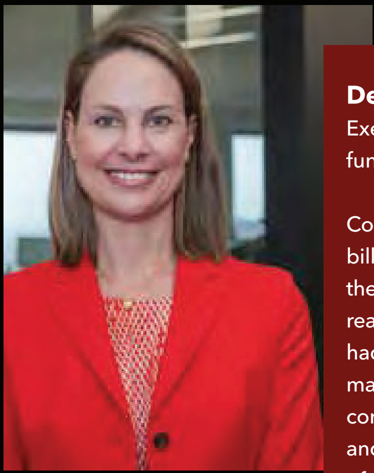
Louise Kavanagh, chief investment officer and head of fund management in the Asia-Pacific region at manager Nuveen Real Estate, says: "Prior to the latest lockdown, the Australian economy had rebounded despite the effect of border restrictions on the education sector – the third-largest services industry – and tourism. So, once the border restrictions ease and education is booming again, tourism returning, it bodes well for Australia."

The pandemic effect knocked back Australian real estate deal volumes, data by analytics firm Real Capital Analytics shows. Rolling four-quarter transaction volumes fell from A$63.95 billion ($46.95 billion; €40.06 billion) in the final quarter of 2019 to A$40.96 billion in the final quarter of 2020. However, they began to recover in the first quarter of 2021 and improved in the second.

Deborah Coakley, executive general manager, funds management at Australian listed manager Dexus, says: "Our investors, which have either Asia-Pacific mandates, or are investing purely in Australia, still see the relevance of most asset classes for their portfolios, and covid-19 does not seem to have abated any of that interest. Given the low interest rates and high employment rate, aside from the current cycle of lockdowns, Australia continues to be viewed very positively by investors."

There has been particularly strong interest from domestic private investors, the roundtable participants agreed, as the low-interest-rate environment and concern about global stock markets pushed capital into yield-bearing real estate.

Australian managers, which typically syndicate private capital, have been doing strong business says Greg Lapham, head of Australia at manager Savills Investment Management. "There seems



Deborah Coakley
Executive general manager,
funds management, Dexus

Coakley has been leading Dexus' A$20 billion funds management platform, one of the key businesses for the Australian listed real estate investor, since 2017. She has had a varied career with roles in property management, human resources and consulting for companies including Qantas and Deloitte. She is a non-executive director of the Property Council of Australia.

Tjarko Edzes
Director, Asia-Pacific,
Bouwinvest Real Estate Investors

Edzes has been running Bouwinvest's Asia-Pacific real estate business since 2014 and has a target to grow its investments in the region to around A$3 billion within two years, out of a global total of $20 billion for the Netherlands-based group. Edzes is based in Sydney. Prior to Bouwinvest, he worked for CBRE Global Investors and Unibail-Rodamco.

Louise Kavanagh
Chief investment officer and head
of fund management, Asia-Pacific,
Nuveen Real Estate

Hong Kong-based Kavanagh joined Nuveen from Invesco Real Estate in 2017 and became CIO and head of APAC fund management at the $134 billion manager Nuveen this year. Prior to Invesco, she worked for Deutsche Bank and is also a global governing trustee of the Urban Land Institute.

Greg Lapham
Head of Australia,
Savills Investment Management

Lapham took up his current role with Savills Investment Management in March 2020, after 10 years with Blackrock's Asia-Pacific real estate team and its precursor company, MGPA. For his new role, Lapham has returned to Australia, where he began his career in real estate and finance, working for companies including National Australia Bank and PwC.

Rob Percy
Chief investment officer,
Cromwell Property Group

Percy has been with listed Australian real estate group Cromwell for nearly a decade and in his current role with the A$12 billion manager since 2018. Cromwell has operations in Europe as well as Australia and New Zealand, as well as a Singapore business. Percy previously worked for Investec Bank Australia.

to be plenty of capital, particularly with domestic high-net-worth individuals and private investors. The smaller transactions within the real estate market are challenging to take down as there are so many privates active in the sub-A$50 million market and keen to put money to work. The syndicators have all stepped up their transaction sizes as there is a lot of money that people don't want to just leave in the bank at zero return."

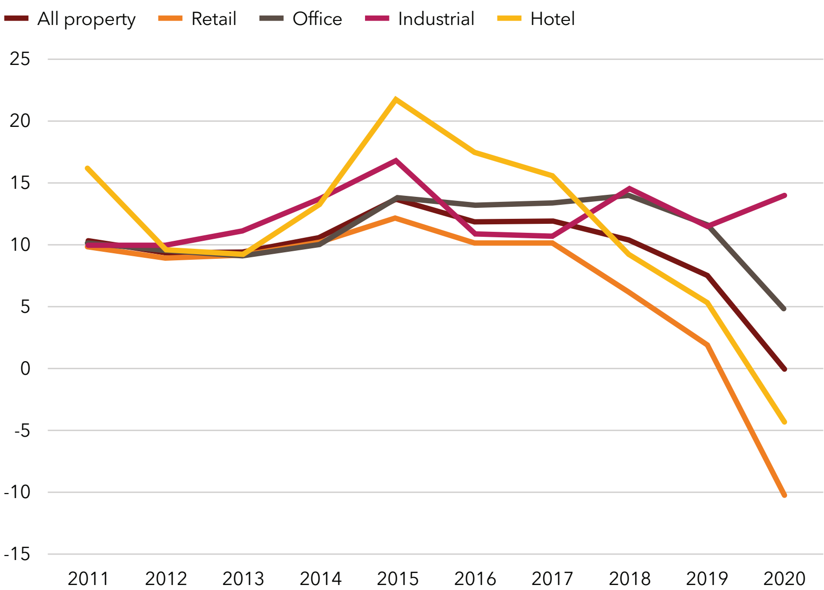
Percy agrees, adding: "The amount of retail and high-net-worth capital looking for a home in Australia at the moment is huge and has been growing significantly over the past 12 to 18 months."

Lapham, meanwhile, suggests overseas investors have been more cautious. "Offshore capital tends to be looking to put money to work with managers they've worked with before, as they can't physically get together with new managers, so track record and established relationships are important."

However, participants agreed that overseas players already established and with teams in Australia were still keen to invest and able to execute.

> *"Some offshore investors are expanding their investments in Australia much more than they were prior to the pandemic"*
>
> **DEBORAH COAKLEY**
> **Dexus**

Australia all sector annual returns (%)



Source: PCA/MSCI

Bouwinvest Real Estate Investors is one of these, says Tjarko Edzes, Sydney-based director, Asia-Pacific at the Dutch pension manager. "We have been quite active in Australia over the past year, partially because our Asia-Pacific office is here," he says. "It has been very good to be based here during the pandemic. And we see more groups indeed opening an office here either for their regional office or just for Australia."

Small but important part

Australia is one of the world's most transparent markets and, as Edzes points out, one of the largest core markets in Asia-Pacific, despite its relatively small size. "Australia is actually a small part of the investible universe; the real estate market is 8 percent of the Asia-Pacific region. However, if

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> **TJARKO EDZES**
> **Bouwinvest Real Estate Investors**

you look at the ANREV benchmark, it's almost 70 percent because many large open-ended funds participate in that benchmark. Core investors have a higher weighting to Australia relative to where it sits within the universe, perhaps one-third of the regional allocation and that's where we sit as well."

Nuveen's Kavanagh says: "Australia is probably the first port of call for much of the foreign capital coming into Asia-Pacific, and that is because the legal, tax and commercial real estate framework is very similar to countries like the US and UK. Over the past 12 months, we know that 40 percent of the transactions were carried out by foreign buyers. In the past, this was mainly North American and Asian capital. But now we've seen a shift to Europeans being at the forefront."

European capital backed one of the deals of the year so far: the sale of a 50 percent stake in 200 George Street, Sydney. AMP Capital sold its share of the building to Australian listed group Mirvac and the UK's M&G Real Estate, the investment management arm of insurer Prudential, for A$575 million, the deal reflecting an initial yield of 4.1 percent. Australian media reported that overseas investors including Allianz Real Estate, Blackstone Group, Hong Kong's Link REIT and Nuveen Real Estate also made bids for the asset.

Coakley says: "Most of the public market processes, whether for single assets or portfolio sales, have shown that offshore investors are active in the Australian market. Some offshore investors are expanding their investments in Australia much more than they were prior to the pandemic. Recently, we have seen some US and European investors more active in investigating and researching the market than they were 18 months ago."

Edzes agrees: "We expected to see more caution due to the pandemic. But people are taking the opportunity to buy quality and expand their footprint in the prime office sector."

The Australian office sector, which performed relatively well in the pandemic, is still showing positive total returns for 2020. Sydney in particular has benefited from stock being withdrawn from the office market to allow for construction of new transport infrastructure. The works have been a double advantage to investors, restricting supply in the short term and boosting the city's productivity in the longer term.

Kavanagh says: "We are seeing a lot of offshore capital which is quite optimistic about Australian offices, particularly east coast offices, where there is still a significant spread between property yields and the 10-year bond rate. We are keen on Sydney offices. It is one of the most diversified economies in Australia. Obviously it's cosmopolitan, it's got the tourism market and quality of life and it's the first port of call for immigrants.

"So, I think it has a lot of underlying strengths that will carry it through the recovery cycle post-pandemic. We are seeing leasing momentum as well coming back into Sydney. Pricing is tight and may tighten further, but the yield remains attractive for core office in Sydney."

Re-thinking offices

In both the UK and US, the rise of homeworking has caused several observers to claim that city centers in general and the office sector are likely to perform worse in the long run. However, the participants poured cold water on this view, suggesting Australian workers were eager to get back in the office when able, and that investors still had confidence in the sector. "I think

> *"We're seeing a lot of non-bank lenders growing and broadening their offering in the debt space"*
>
> **LOUISE KAVANAGH**
> **Nuveen Real Estate**

Industrial domination

The Australian industrial and logistics sector saw total returns rise in the upheaval of 2020 and investors are still bidding en masse for the best assets

ESR PHOTO

The industrial and logistics sector has been on a significant growth trajectory across the world. Australia has not been exempted. The country has just seen a landmark deal, where sector specialist ESR teamed up with Singapore sovereign fund GIC to acquire the A$3.8 billion ($2.8 billion; €2.4 billion) Milestone portfolio from Blackstone Group.

The deal saw "logistics yields entering office territory and staying there," says Louise Kavanagh, chief investment officer and head of fund management, Asia-Pacific at Nuveen. Indeed, ESR said the acquisition price reflected a yield of 4.5 percent, only 40 basis points above another landmark deal, the sale of a stake in 200 George Street, Sydney, a prime office asset.

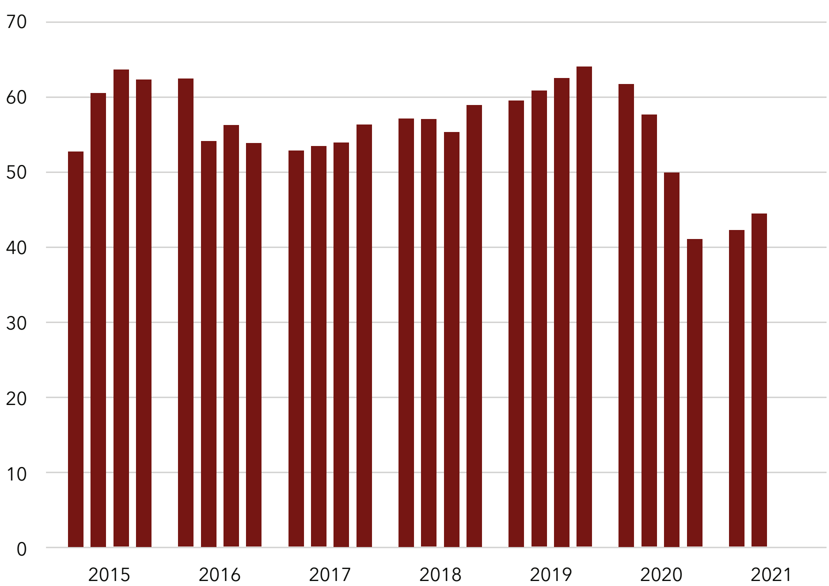
Even more significant was the amount of capital which lined up for the deal says Greg Lapham, head of Australia at Savills Investment Management. "This deal was all that people in real estate talked about for a while and there were still something like five bidders in at the very end."

The amount of capital lined up for Milestone suggests the logistics market has further to run in Australia. More than 50 parties are understood to have requested data room access for the Milestone portfolio. Interest continues despite the nation not suffering the same land constraints as Asia-Pacific markets such as Japan or China.

Kavanagh recalls: "I used to run some industrial portfolios in Australia 15-18 years ago and to look at where yields are at the moment makes my mind boggle."

> *"If there are distressed vendors, there could be a buying opportunity, especially where there is potential for a change of use. However, I have not seen any signs of distress yet and we have even seen hotel portfolios trading at a premium to book value"*
>
> **GREG LAPHAM**
> **Savills Investment Management**

Australian quarterly rolling four-quarter investment volumes 2011-21 ($Abn)



Source: Real Capital Analytics

people are keen to get back to the office; it remains a place to build culture, foster learning and development, and be creative and collaborative," says Percy.

"That need is definitely not disappearing. How people use their space might change, and landlords that can adapt to meet these needs will be valued. Flexibility is also important, especially for smaller tenants. Most companies have been embracing agile working for some time now and what we've been through in the past 12 to 18 months has demonstrated that it can work. Long lease office is still very much in demand and that is definitely not going to change."

Coakley also stresses that embracing agile working did not equate to abandoning the office. "Flexible working should not be confused with the location of work; homeworking is just a

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> **ROB PERCY**
> **Cromwell Property Group**

part of the picture," she says. "For some people, homeworking creates problems and is not actually the flexibility they need."

Nonetheless, she says occupiers are rethinking how they use office space, which will lead to changes in the future. However, the "new normal" is by no means set in stone. "Demand for flexibility is changing office design, alongside demand for sustainability, and now, wellness and safety. As new office space is designed and fitted out, we will see how new ways of working, with more collaboration space, less density and more flexible working, pan out. However, all our research suggests rather than the office footprint dramatically changing, it will be how that space is used that will be the evolution."

Retail property has seen difficulties in Australia due to the rise of online shopping. Retail total returns fell to 6 percent in 2018, from 10 percent a year earlier, PCA/MSCI data shows. In 2019, retail total returns fell to less than 2 percent and the pandemic drove a negative return of 10.37 percent. However, the panel expressed optimism about the sector's future, particularly for non-discretionary retail, while recognizing the sector faces challenges.

Coakley is positive about retail landlords' ability to adapt to the challenges of online shopping. "I think most mall owners have been remixing their malls for a very long time now," she says. "Quality retail space will remain relevant because of its geographical prominence within a community for other uses like healthcare, gyms, medical offices and government service provision. However, the big issue for a number of the malls is going to be what happens with the larger retailers who occupy big parts of the overall footprint."

Edzes adds: "Retail, especially neighborhood retail, looks more attractive today. But I think the big question for retail is: what is a sustainable rent in the longer term?"

His question is particularly apt for larger malls that rely on discretionary spending, such as fashion, says Lapham. "If you replace discretionary tenants from your retail mix, you're dropping rents significantly. You need some level of discretionary retailers because they pay over A$1,000 per square meter, whereas medical providers, for example, might pay A$450. There is an offset to the lower rent as with a stickier, longer lease from a medical provider; you'll probably get some adjustment through an improvement on the cap rate."

On the future of retail real estate, Kavanagh notes: "People are looking for experience: they want food and entertainment for the family. So the mall of the future needs to cater to that demand for social interaction and community."

However, the rise of online shopping and demand for home delivery may also come to the aid of moribund retail space. "In other Asia-Pacific markets, such as China, South Korea and Japan, retail space has been successfully repurposed as last-mile logistics space," she says.

Hospitality's mixed fortunes

Hospitality also saw returns slump into negative territory in 2020, as Australia closed its borders. The picture is not all bad, however, says Lapham. "There is a split between the five-star business hotels, which have experienced the biggest impact from the virus, and locations which cater to the domestic market, which have done very well, such as Byron Bay," he explains.

"It will be interesting to see how the sector develops as people start going overseas again. While the CBD business hotels are unlikely to immediately witness the same traffic as previously because a lot of business can be done via Teams or Zoom now, we would expect footfall to rise when international travel resumes, and domestically businesspeople have a lot of relationships to catch up on."

The amount of capital in the market generally seems to be staving off distress and none of the participants report evidence of fire sales. However, hospitality may offer opportunities in this regard, says Lapham. "If there are distressed vendors, there could be a buying opportunity, especially where there is potential for a change of use. However, I have not seen any signs of distress yet and we have even seen hotel portfolios trading at a premium to book value."

A number of the participants are investing in niche sectors, often those with an operating element, in an effort to boost yields and to tap into future growth. The most often cited is data centers, while healthcare and linked sectors are also attractive: Australia has the most developed senior housing market in Asia-Pacific.

Edzes says: "We are looking at a data center investment; data center development is attractive today because the spread between yield on cost to expected stabilized yield is quite good. However, it is a very different sector – arguably infrastructure, not real estate – so you really need to partner with a specialized operator."

An area that has been of growing interest to managers has been debt. For some years, Australia's 'big four' banks have been pulling back from the sector and focusing mainly on plain vanilla lending, creating opportunities for non-bank lenders. Some of these have been specialist private credit firms. However, real estate firms, including Dexus, have become more and more involved.

Nuveen's Kavanagh says: "Optimism across the real estate sectors and record low interest rates is driving capital into debt markets. We're seeing a lot of non-bank lenders growing and broadening their offering in the debt space, such as pension funds and insurance companies which are seeking diversification and defensive returns via debt. Non-bank lenders are less regulated, which broadens the scope for longer tenors and higher loan-to-value ratios. However, the weight of capital has compressed returns, which might push some investors back into equity strategies."

The tight market has also led to several players seeking to grow through mergers and acquisitions. For example, Dexus is merging its Dexus Wholesale Property Fund with AMP Capital's Diversified Property Fund to create a A$15 billion fund and is also in the process of acquiring APN Property Group, a smaller listed real estate company.

Cromwell's Percy says: "It has been interesting to see a number of M&A deals in the market. I think it's a sign of the times that people are starting to grow through M&A, reflecting the volume of direct real estate dealflow in the current environment, and desire to build funds under management."

The mood in Australia is upbeat, albeit with a tinge of frustration as players are keen for the market to really get going once more. Nonetheless, even though the country's property markets have faltered, there is a sense their place in the investment universe has proved justified. Edzes says: "Australia also compares relatively well to other Asia-Pacific markets in terms of transparency and, even though it's expensive today, yields are still a little bit higher than other parts of the region." ■

Niche notions

There are a host of newer real estate sectors with an operating aspect these days. But all have capital chasing them, pushing certain investors to take a contrary look at less-loved sectors

Greg Lapham: "I think a lot of people ran away from retail, due to the threat of e-commerce. However, what's being shown during Covid is that everyday convenience neighborhood retail is extremely attractive."

Deborah Coakley: "We have seen heightened interest from investors in healthcare property and it's a sector we are very active in. Many of the healthcare providers are looking for new state-of-the-art infrastructure, and this demand for newer assets, in turn, provides development opportunities for investors."

Tjarko Edzes: "We have invested in the disability housing sector. We are longstanding investors in the residential sector in its various forms and particularly like the positive societal and environmental contribution we are delivering through this investment, which we will look to expand in the next few years."

Rob Percy: "We have some exposure to retirement living. There is a wave of fully funded retirees who are demanding more in terms of lifestyle and also end of life care. It's a difficult sector to crack, but if you can get a good product, this is another sector that will only show more demand."

Louise Kavanagh: "We like Sydney as one of the data center key locations in Asia-Pacific, along with Hong Kong, Singapore, Tokyo and tier-one Chinese cities. The challenge is being aligned with operators who have access to power, which requires regional government support."