

Australian Office Yields Attract Investors: Real Estate

By Nichola Saminather - May 29, 2013

Investors are scooping up Australian office buildings at the fastest pace since the end of 2011, attracted by yields that beat those in New York and London.

Mirvac Group (MGR) agreed this month to buy seven properties for A\$584 million (\$571 million), while Dexus Property Group (DXS), the country's biggest listed office landlord, paid almost A\$1 billion since April for two developments. Investa Property Group, which controls more than A\$7 billion of office buildings across the country, has raised money from Swedish and Australian pensions for additional purchases.

As much as A\$7 of capital is chasing every A\$1 of prime-office assets in Australia, up from A\$2 in 2011 and the strongest demand since 2007, according to broker Jones Lang LaSalle Inc. The surge in investor interest is part of a global search for assets that offer higher returns as central banks around the world push interest rates to record lows.

"The rental market is soft in the Australian context, but Australia is probably looking strong compared with the U.S. and Europe," Rob Sewell, Sydney-based head of office investments at Jones Lang LaSalle, said in a telephone interview. For offshore investors, "lower returns in Australia will still be a better return than their home markets."

Higher yields on offices in Australia reflect muted price growth since Lehman Brothers Holdings Inc. collapsed in 2008, ushering in recessions in the U.S. and Europe. Sydney office values have risen less than 3 percent each year since 2010, after declining 6.7 percent in 2008 and 12 percent in 2009. They rose more than 13 percent in 2006 and 2007, according to researcher Investment Property Databank Ltd.

Yield Comparisons

About A\$2.1 billion of offices valued at more than A\$5 million changed hands in the first three months of 2013, 31 percent higher than a year ago and the most since the last quarter of 2011, property broker CBRE Group Inc. said.

Prime offices in Australia's major cities offered yields as high as 7.9 percent in the first quarter, according to Jones Lang LaSalle. That compares with 5.25 percent for London City prime offices

above 40 million pounds (\$60 million), and between 4 percent and 5 percent for prime offices in central business districts in New York and San Francisco, the broker said.

Premium offices in Sydney were valued at an average A\$16,235 per square meter (10.76 square feet) in the first quarter, down from A\$18,095 five years earlier, data from broker Savills Plc (SVS) show.

REITs Recovery

One force behind the increase in transactions are Australian real estate investment trusts, which raise money from investors to buy properties. They have re-emerged as acquirers after selling properties for liquidity during the credit squeeze that followed Lehman's collapse. The biggest domestic REIT stocks rose 25 percent in the past 12 months and traded at an average 3.6 percent premium to net tangible assets as of May 23, turning around from a discount in April, Morgan Stanley data showed.

Australian REITs have access to as much as A\$6 billion of equity and debt financing, assuming an increase in average debt to 32 percent of equity from the current 26 percent, CBRE said. They made A\$650 million of office purchases in the first quarter, almost a third of all transactions, the broker said.

"With a strong focus on capital management and solid levels of inflows into the listed sector, A-REITs are expected to be more aggressive buyers this year," Stephen McNabb, head of Australian research at CBRE, wrote in a March report. A still-wide yield differential to global markets means "foreign investors are likely to continue to support the Australian commercial property sector, although they may face more competition from domestic investors."

Better Returns

Mirvac, the country's third-biggest diversified property trust, agreed this month to buy five offices in Sydney, one in Melbourne and the Allendale Square in Perth from GE Capital's local property unit at an initial yield of 7.8 percent.

Dexus and its Wholesale Property Fund said they would buy a Perth office site with three buildings for A\$434.8 million this month, after paying A\$543.9 million in April for a Brisbane property. The capitalization rate -- a measure of investment yield that contracts as prices rise -- was 8 percent on the Perth acquisition and 7.25 percent on the Brisbane purchase, according to Dexus.

Investors are lining up to buy offices even as rents edge lower and vacancy rates rise. Companies are cutting costs and consolidating work space amid modest economic activity. The Reserve Bank of Australia has reduced borrowing costs by 2 percentage points over the past 19 months to a

record low 2.75 percent, joining global counterparts in embracing cheap credit for an economy where inflation is contained, mining spending is predicted to crest and credit growth is subdued.

Cap Rates

The central bank could cut rates even further as a slowdown in mining investment, which made up 60 percent of the nation's gross domestic product growth last year, threatens to leave a significant economic hole, Pacific Investment Management Co.'s Adam Bowe and Robert Mead wrote in an article on the fund manager's website today.

Business confidence declined 4 points to -2 in April from the previous month, a private gauge showed.

Dexus is buying because it expects "compression in capitalization rates" based on investor demand, Sydney-based Chief Executive Officer Darren Steinberg said in a telephone interview. "This is the first time in my career that I've seen such strong demand when fundamentals are weak on average."

Sydney offices had an average capitalization rate of 8.8 percent as of April 30, compared with 5.7 percent in London, 5.2 percent in Manhattan and 3 percent on Hong Kong island, according to Real Capital Analytics.

The highest-quality office buildings could see capitalization rates compress by as much as 70 basis points over the next two years, CLSA Asia Pacific Markets forecast last month.

Falling Rents

Sydney-center office rents will fall 4.5 percent by the end of 2013 from two years earlier while Melbourne rents will drop almost 10 percent and Perth 6.4 percent, according to broker Colliers International.

The average vacancy rate rose to 9.5 percent in Sydney's city center in the three months to March 31 from 8.4 percent in the previous quarter, according to Jones Lang LaSalle. That compares with a vacancy rate of 11.8 percent in downtown New York in the first quarter and 15.6 percent in Chicago.

Prospective tenants, particularly in the financial hubs of Sydney and Melbourne, remain wary given the economic outlook, London-based broker Knight Frank LLP said.

"We are increasingly cautious for the outlook for demand, vacancies, incentives and therefore rental growth," Morgan Stanley (MS) analyst Lou Pirenc, who forecasts a recovery in 2014 unless economic conditions worsen, said in a January report.

Overseas Investors

Canada Pension Plan Investment Board and local pension funds Telstra Super and First State Super pumped almost A\$1.5 billion into Lend Lease Group's Barangaroo redevelopment in Sydney in July.

Australia accounted for 45 percent of all direct real estate investment into the Asia-Pacific region in the past two years, excluding funds from within the area, Jones Lang LaSalle said in a March 26 report. Foreign buyers are attracted by one of the few nations with a AAA-credit rating, Pete Carstairs, general manager for research at Investa, wrote in a March report.

The foreign-investor base of Morgan Stanley-owned Investa's unlisted fund has grown from 5 percent "several years ago" to a quarter now, Carstairs said in the report. The fund received A\$87 million from Swedish pension fund Forsta AP-Fonden and A\$50 million from Australian aviation industry pension fund AvSuper in February.

Top End

Most overseas investors prefer top end, often newly built, offices in central locations, with long leases, Carstairs said. Still, as competition for these assets builds, they're starting to look at "non-core opportunities due to the tightly held nature of the core market," he said.

Hines Global REIT Inc., a Houston-based closely held property trust, in March agreed to acquire an office building in Chatswood, a north Sydney suburb, for \$91.2 million. It also paid \$128 million this month to buy an office building in Fortitude Valley, 2 kilometers (1.2 miles) northeast of central Brisbane, according to an e-mailed release.

"Investors, both domestic and offshore, will start to invest in secondary markets where there's been limited new space and not much development activity," said John Marasco, Melbourne-based managing director for investment sales and capital markets at Colliers.

Property Bank Australia Corp. favors Sydney's northern suburbs to the city center, said Gus MacKellar, director at the Perth-based property manager that undertakes "counter-cyclical" below-A\$60 million investments.

"We're buying at inflated cap rates" of around 9.5 percent, MacKellar said. "We'll see those markets having reasonable rental upside over the next three to five years, and significant yield compression as they return to favor."

To contact the reporter on this story: Nichola Saminather in Sydney at nsaminather1@bloomberg.net

To contact the editor responsible for this story: Andreea Papuc at apapuc1@bloomberg.net