Foreign Investment in Australian Commercial Property

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Foreign investors' demand for commercial buildings in Australia has been strong in the past few years, as captured by their rising share of transaction values. Foreigners have generally purchased established properties, although there has also been some interest in developing new commercial buildings or converting existing buildings to apartments. These purchases have probably boosted net financing to the sector and also construction activity.

Introduction

Commercial buildings comprise offices, shopping centres, industrial facilities and hotels, and are generally owned by commercial landlords and institutional investors rather than their occupants.[1] Investors own commercial buildings for their relatively predictable rental income and the typically low correlation of their values with those of other assets, such as equities and bonds.

Demand from foreigners for commercial property in Australia has been strong in the past few years. The available data suggest that foreign investment in Australian commercial property has increased significantly since the mid 2000s, both in gross terms and after accounting for divestments by foreign institutions. Since 2008, foreigners have accounted for around one-quarter of the value of major commercial property purchases, up from one-tenth in the previous 15 years. This article discusses the factors that underlie this trend, and the effects of foreign investment on commercial property and the Australian economy.

The Legislative Framework and Approvals for Foreign Investment

In Australia, foreign investors are allowed to purchase existing commercial buildings as well as vacant sites to develop. To purchase commercial properties, 'foreign persons' must first obtain approval through the Foreign Investment Review Board (FIRB) in any of the following circumstances:

- the land is vacant;
- the foreign investor is a foreign government investor; or
- the building is already developed and sells for $54 million or more (the threshold is lower for heritage-listed buildings and higher for investors from New Zealand and the United States).[2]

To date, nearly all proposals for investment in commercial property have been approved, although some conditions may have been applied regarding the subsequent development of vacant sites.[3]

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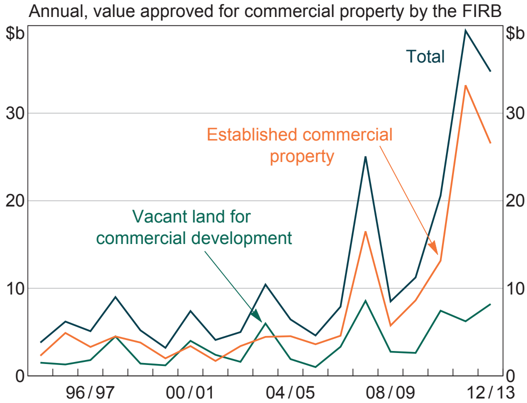
1 This article does not discuss commercial investment in greenfield land for residential development.

2 The monetary thresholds for established commercial property are indexed annually on 1 January (except for the $5 million threshold for heritage-listed commercial properties). South Korean and Japanese investors will also have access to the higher threshold once free trade agreements with South Korea and Japan enter into force.

3 For a full set of definitions and the legal restrictions and allowances, see the Foreign Investment Review Board website (www.firb.gov.au).

The FIRB publish data on approvals for proposed foreign investment on an annual basis. The value of these approvals has increased substantially in recent years, from $11 billion in 2009/10 to nearly $35 billion in 2012/13 (Graph 1). Approvals to purchase established commercial properties increased most significantly, while approvals to invest in vacant land also increased from a low base.

Graph 1
Approvals for Foreign Investment
Annual, value approved for commercial property by the FIRB



Source: FIRB

Approvals data do not, however, provide an accurate estimate of the value of actual direct foreign investment. The Bank's liaison with industry participants suggests that vendors often require interested foreign buyers to obtain foreign investment approval before bidding, and several approvals may be granted to different foreign investors for the purchase of the same building, which may then ultimately be sold to a domestic entity. In addition, purchasers of developed commercial properties do not need to seek foreign investment approval for properties valued at less than $54 million, or less than $1 078 million in the case of private investors from New Zealand or the United States. The FIRB data also do not provide information regarding the type of property for which approval is being sought – be it an office building, shopping centre, industrial facility or hotel – nor the type of foreign investors (e.g. sovereign wealth funds, pension funds) gaining approval or the country in which they are based. Furthermore, since foreign investors do not need approval before selling properties, the data provided by the FIRB cannot be used to estimate the value of net investment by foreign investors.[4]

Trends in Foreign Investment

Several real estate services firms collect detailed information on major commercial property transactions involving Australian and foreign institutions. Importantly, unlike the FIRB's data on foreign investment approvals, these data cover actual transactions. However, there are also a number of other differences between these data and those reported by the FIRB. Specifically, the transaction-level data provided by real estate services firms:

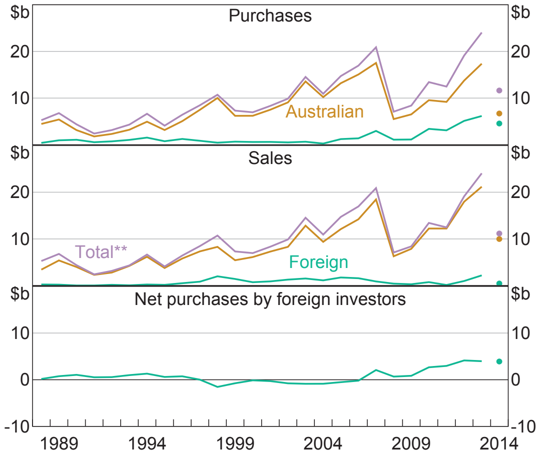
- record purchases valued at more than $5 million, thereby capturing transactions that fall below the thresholds enforced through the FIRB[5]
- classify investors based on the location of their headquarters, whereas the FIRB classify foreign investors depending on whether they have a foreign controlling interest
- relate to transactions of offices, shops and industrial properties, whereas the FIRB approvals data also include applications to purchase hotels and motels from 2009 onwards.

These transaction-level data show that while foreign investors have been purchasing Australian office, retail and industrial properties since the late 1980s, the purchases and sales by foreign investors were both around $1 billion per year for much of this period, resulting in negligible net investment by foreign investors. Foreigners' purchases of commercial property increased sharply in the mid 2000s, and have exceeded foreigners' sales in each year for nearly a decade (Graph 2). Foreigners have accounted for around one-quarter of the value of commercial property purchases in Australia since 2008, up from one-tenth in the previous 15 years. Foreign

4 See FIRB (2014, pp 15–19) for methodological and data caveats.

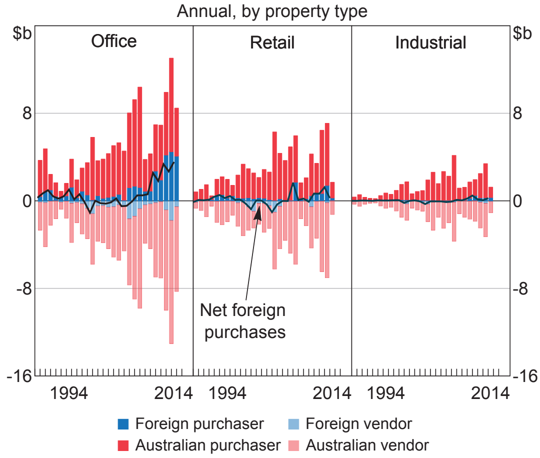
5 The transaction-level data may not record some purchases involving foreign investors if they are not well publicised or the entities remain confidential.

Graph 2
Commercial Property Transactions*
Annual, by investor nationality



* Data for 2014 are for the six months to June 2014
** Includes a small number of transactions for which the origin of the purchaser or vendor was not identified
Sources: JLL Research; RBA; Savills

Graph 3
Commercial Property Transactions*
Annual, by property type



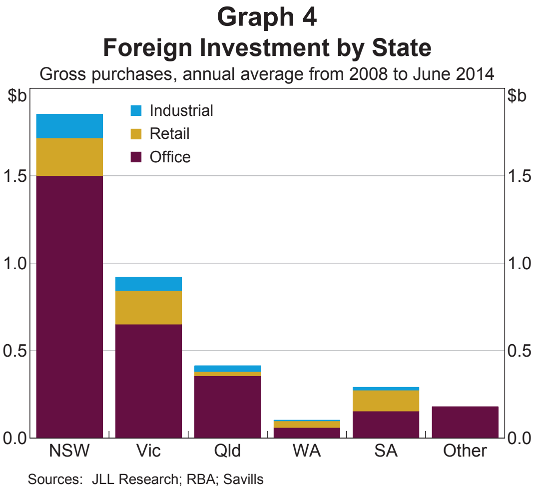
* Data for 2014 are for the six months to June 2014
Sources: JLL Research; RBA; Savills

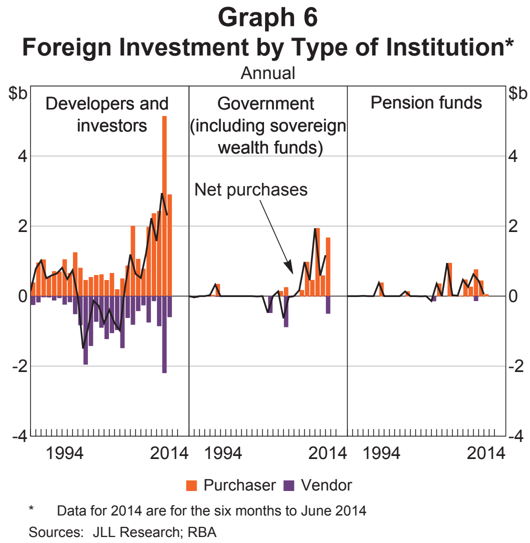
buyers were especially active in the first half of 2014, purchasing nearly $5 billion worth of commercial property, about 40 per cent of the value of properties that were sold. Net purchases (which also account for sales) by foreigners amounted to $4 billion in the first half of 2014, close to its level for all of 2013.

The recent increase in foreign investment has been most pronounced in the market for office property. Foreigners' purchases have accounted for around one-third of the value of turnover of office buildings since 2008, with purchases consistently exceeding the value of foreign sales (Graph 3). The value of foreign purchases of retail and industrial assets has also increased, although purchases by foreigners accounted for only around 15 per cent of the value of these transactions in the past few years. Foreigners' preference for office buildings partly reflects the greater availability of large, high-value buildings. Retail and industrial assets are generally smaller, with lower values, and are often owned by wealthy private investors rather than large institutions.

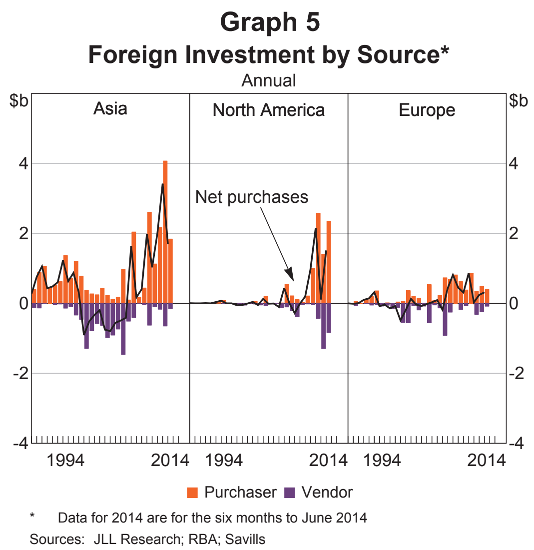
Foreigners have been most active in acquiring commercial properties in New South Wales, reflecting the larger size of its market and an apparent preference by overseas investors for property in the state. Since 2008, foreign buyers have accounted for 40 per cent of the value of purchases in New South Wales, compared with 20 per cent of turnover in Victoria, Queensland and Western Australia. Foreigners' preference for New South Wales reflects their strong appetite for office buildings in the Sydney CBD, which industry participants attribute to the greater liquidity of the market and the large amount of prime-grade office space (Graph 4). In contrast, foreigners' purchases of retail and industrial assets have been more evenly distributed across Australia. In liaison, analysts note that investors that purchase a building in one state often acquire buildings in other parts of Australia as well, partly reflecting the significant costs involved in researching a country's legal arrangements and market structure. As a result, many industry participants anticipate foreign investment broadening out beyond New South Wales in coming years.

The transaction-level data also provide information on the type of foreign investors and their nationality (based on the location of the investor's headquarters rather than the original source of funds). These data show that foreigners from many parts of the world have become more active in Australian commercial property markets, although much of the rise in net investment in the past few years reflects an



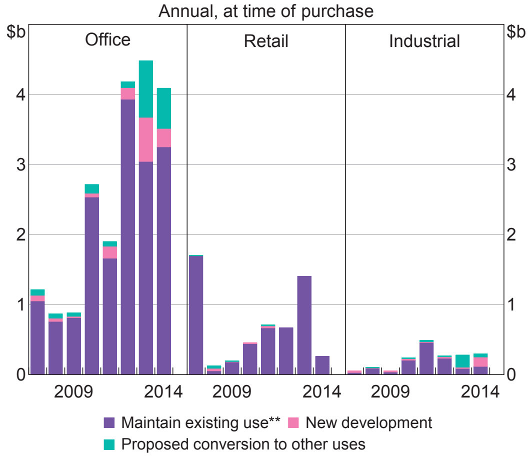


increase in purchases by investors based in Asia and North America. Net investment from Europe has also increased, albeit by much less (Graph 5). The recent increase in net foreign investment has been driven by private institutions such as listed trusts, investment firms and developers (Graph 6). Pension funds and government-related entities, mostly sovereign wealth funds, have also increased their exposure to Australian commercial property, accounting for nearly one-third of foreign purchases since 2008, following very little activity in the previous two decades.



Foreigners have tended to purchase existing buildings, with purchases of sites to develop less common (Graph 7). This preference reflects foreigners' desire for commercial buildings as passive investments, valuing both their relatively predictable income stream and the low correlation between their prices and those of other assets. In addition, foreigners may lack the country-specific expertise required to develop new properties. There have been some examples where foreigners have purchased sites to develop, although the direct effects on construction activity have been small. In 2013, for example, foreign buyers invested a little over $600 million in sites and buildings to develop as new office buildings, which was around one-tenth the value of office construction activity that commenced in the year. In cases where foreigners have been involved in developing new buildings, they have often partnered with a domestic firm, which was better placed to absorb the majority of the risk associated with construction costs and securing tenants. In recent years, foreigners, particularly from Asia, have also become more active in purchasing older office buildings to convert to other uses, especially apartments. Almost all of these investments have occurred in Sydney, where available and centrally located land is relatively scarce

Graph 7
Foreign Purchases by Intended Purpose*



* Data for 2014 are for the six months to June 2014

** Includes property purchased for investment, refurbishment or by owner-occupiers

Sources: JLL Research; RBA

and demand for apartments has been particularly strong, from both domestic and foreign residential buyers.[6] Since demand for lower-quality office space has been weak, developers suggest in liaison that residential apartments represent the 'highest and best use' of these sites.

Industry participants point to a range of factors to explain the strength in foreigners' demand for Australian assets in recent years. Most notably, yields on Australian properties are high relative to those on comparable assets overseas, although differences in leasing conditions make direct comparisons difficult. In addition, even though conditions in Australian commercial property markets are weak relative to history, they are stronger than in many other advanced nations. Research analysts add that foreigners are attracted to Australia's exposure and proximity to Asia, combined with a transparent system of property rights. Nonetheless, Australia is not the only nation experiencing strong capital inflows into commercial property. Several other advanced nations have also recorded substantial investment from North America and Asia, owing to the low cost of capital, the low level of returns on alternative assets, particularly bonds, and the growing stock of available capital at pension funds and sovereign wealth funds. In general, analysts do not expect these factors to unwind soon, and so many expect foreign investment in Australia to remain strong in coming years.

6 See Gauder, Houssard and Orsmond (2014) for a discussion of foreign investment in residential real estate.

Economic Effects of Foreign Investment in Commercial Property

The increased demand from foreigners has had several effects on Australian commercial property markets. As noted by analysts, the strength in foreign demand has contributed to the recent increases in capital values, which have occurred even as leasing conditions have remained subdued. This has probably helped to support construction activity, partly by allowing domestic developers to diversify their activities.

While not particularly active in leading the development of new buildings, foreigners have contributed financing, directly or indirectly, to new construction activity. As discussed above, some foreigners have purchased shares in sites and buildings that the existing owner was in the process of building or expanding. Foreigners have also purchased existing buildings from domestic firms that went on to 'recycle' this capital into the development of other new buildings in Australia. By providing funds and pushing up capital values, foreigners have effectively supported the financial position of domestic developers and enabled them to undertake additional construction activity. Foreign purchases have also enabled domestic firms to diversify their portfolios by purchasing or developing buildings in other regions or sectors.

Although foreigners have been most active in the New South Wales office market, these indirect effects on construction activity have been much broader, since many domestic developers operate across several states and sectors. The construction activity that has followed these sorts of transactions has contributed to the stock of commercial space available to tenants, placing downward pressure on the rental costs faced by occupying firms. As discussed above, foreigners have been active in purchasing lower-quality office buildings to convert to apartments, particularly in and around the Sydney CBD. This activity is likely to help alleviate the shortage of land, and raise the stock of housing in areas where demand for housing is strong. More generally, greater development activity overall also leads to more work and employment in the construction industry, and provides further benefits to domestic manufacturers of building materials.

Foreigners' appetite for Australian properties has also enabled domestic firms to limit their use of bank funding, which is useful given the risks commercial property can pose to financial institutions during downturns (Ellis and Naughtin 2010). The greater foreign presence potentially adds to the sensitivity of capital values to variations in economic conditions overseas. For example, an adverse shock overseas could cause foreigners to try to divest Australian assets to cover liabilities offshore. However, relative to other assets, commercial properties are less likely to be sold urgently, since the selling process can be protracted and incur substantial transaction costs. The effect of deteriorating international conditions could also be lessened to the extent that pension funds and sovereign wealth funds continue to account for a greater share of foreign purchases, since these institutions are less likely to be influenced by temporary changes in their own country's economic conditions. Also, the greater foreign ownership of commercial buildings may reduce the volatility of Australian property values to the extent that domestic business cycles are not perfectly correlated with those in other economies.

Finally, the recent increase in foreign investment in commercial property may have placed upward pressure on the value of the Australian dollar. However, these amounts have been small relative to total capital inflows (of $93 billion in 2013), and the effect will have been mitigated to the extent that some foreigners financed their purchases by borrowing from domestic banks in Australian dollars, in part to hedge currency-related balance sheet risk.

Conclusion

The available data indicate that foreign investment in commercial property has increased in recent years, with foreigners having accounted for around one-quarter of the value of commercial property purchases in Australia since 2008. The higher demand for Australian buildings has been broad based across a range of institutions from Asia and North America, although sovereign wealth funds and pension funds have accounted for a greater share of foreign investment more recently. Foreign buyers have typically purchased existing buildings, enabling domestic firms to sell assets for higher prices, supporting their financial position and freeing up capital to be used on new developments. To date, foreigners have shown a preference for purchasing office buildings in New South Wales, but analysts expect foreigners to spread into other markets as they become more familiar with Australia. In any case, foreigners' acquisitions have benefited developers operating in several states and sectors, and so the indirect effects on construction activity have not been constrained to the New South Wales office market. ✠

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