AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive | 27th November 2015

Foreigners Buying Real Estate???

Last week I spent some time looking at property developments owned by Australian listed property trusts in Sydney from Lakemba and Parramatta in the west, to Lend Lease's shiny new Barangaroo development on the harbour. What was clear from looking at much of the urban regeneration projects was that the target audience for the real estate product being developed was not local buyers, but rather offshore buyers particularly from China.

Whilst there is no shortage of articles in the press about the evils of foreigners buying Australian real estate, as the fund manager of a Listed Property fund I am only concerned about the supply and demand for property and its influence on the valuations of the Trusts held in the portfolio. In this week's piece we look at the impact of foreign investment on Australian property.

History

As a young nation Australia has been a net importer of foreign capital to develop property since Arthur Phillip sailed through the Sydney Heads in 1788 to found a Georgian offshore detention centre. This initial development of Australia cost the British taxpayer £84,000 to transport 732 petty thieves from the London slums in 11 ships with the capital goods necessary to sustain a new colony. Foreign capital has been required to develop projects and buy real estate from the Sydney Harbour Bridge, the iron ore mines in the Pilbara to the $6 billion urban regeneration project that Lend Lease is undertaking at Barangaroo on Sydney Harbour. According to the Foreign Investment Review Board (FIRB), foreign investment in Australian real estate (both residential and commercial) over the last year has increased from $51.9 billion to $74.6 billion. Whilst Chinese interests are demonized in the media as "buying up Australia", their $12.4 billion dollar investment only accounted for 16% of the total value of Australian real estate bought by foreigners.

Residential Real Estate

Residential property comprises a small portion of the ASX200 A-REIT property index (namely a portion of Stockland, Lend Lease and Mirvac's earnings), but generates emotive newspaper headlines, especially when foreigners are portrayed as pricing domestic investors "out of the market". FIRB and RBA data shows that foreign investment in Australian residential real estate has risen from around $6 billion annually in the 1990s to more than $33B in 2014 with 2015 expected to be significantly higher. This figure arguably understates the offshore demand for real estate, as it does not account for individuals with dual citizenship acquiring domestic real estate.

Not surprisingly the data shows that foreign purchases appear to be mostly concentrated in new rather than established dwellings, in higher rather than lower-priced dwellings, in medium and high-density dwellings rather than detached, and in inner-city areas of Sydney and Melbourne rather than other locations. This occurs as FIRB will generally approve applications if the property purchased adds to the housing stock, whereas the approval to buy existing dwellings is more problematic.

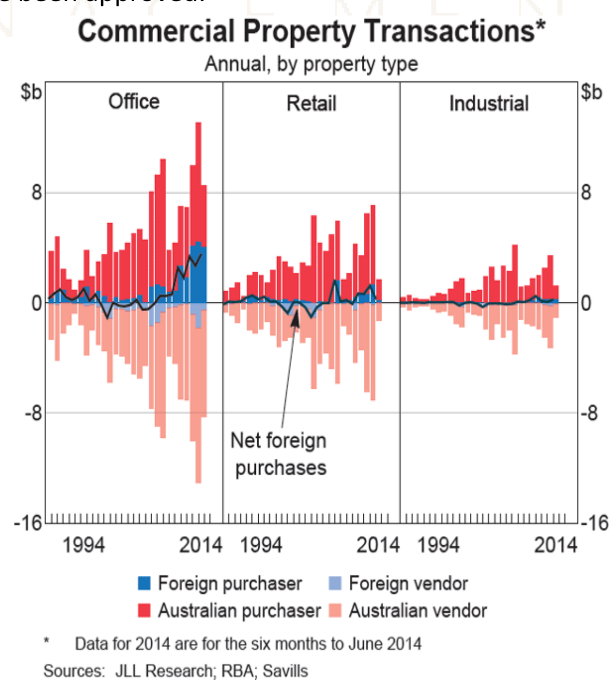
This demand not only provides a boost to residential developers such as ***Mirvac***, but has led ***Dexus*** to sell lower grade office buildings to developers for residential conversion and ***Goodman*** to re-zone industrial property for residential use. These sales have boosted earnings as they were completed at significant premiums to the book value of these properties.

Last week we looked at ***Mirvac***'s (MGR) Ovo project at Green Square on the way to Sydney airport. MGR sold 224 apartments in one day at an average of $13,000 per square meter. This equates to $700,000 for a one bedroom apartment without parking or $900,000 to $1 million for a two bedroom apartment with one bathroom. Whilst this seems pretty expensive, it is rather tame compared with ***Lend Lease'***s (LLC) Barangaroo apartments on Sydney Harbour, which saw 159 apartments being snapped up within 3.5 hours of going on sale, priced at $40,000 per square meter; in-line with New York or Hong Kong luxury apartment prices. As approximately 50% of the apartments sold were purchased by investors, it would be surprising if the rental yields achieved will be in-line with investor expectations. We estimate that the yield likely to be achieved in these Sydney apartments after strata fees and council rates is likely to be between 3.2% and 3.6%, obviously below both the cost of debt and the current yield being offered by listed property trusts.

Commercial Real Estate

Whilst residential property generates the headlines, foreign buyers have had a far greater influence in the commercial property sphere. Similar to investing in residential real estate, foreign buyers have to obtain FIRB approval where the buyer is a foreign government or when the building sells for greater than $54 million. To date nearly all proposals for investment in commercial property have been approved.

Foreign buyers have been especially active accounting for 25% of the value of major commercial property purchases since 2008, up from 10% over the period 1993-2007. However in 2014, foreign investors accounted for over half of the commercial property trades, purchasing just over $35 billion worth of developed assets. This interest is primarily confined to the prime grade office market in Sydney and Melbourne, with little foreign buying of retail and industrial property. According to the RBA the source of this buying has been foreign developers and investors with a spike in sovereign wealth fund investment. Geographically these investors have primarily come from Asia and North America. The effects of quantitative easing have kept interest rates low and buoyed the interest in Australian commercial property. The excess liquidity has opened up property earnings yield differentials between Europe (3.4%) and Japan (2.4%) and Australia (5%) and has boosted the valuations of Australian property trusts.



In 2015 the deal of the year has been Chinese sovereign wealth fund China Investment Corporation (CIC)'s purchase of nine office towers from Investa. This trade was done at $2.45 billion on an income yield believed to be in the range of 4.5%-4.7%. The transaction is expected to reprice the market upwards for core CBD office towers and effectively imports global office tower valuations into the Australian market. Another example of foreign investment in trophy Australian CBD property was the Qatar Investment Authority's investment in Lend Lease's $2 billion commercial Tower 1 at Barangaroo South.

Stocks that Benefit

The companies that have the greatest exposure to offshore demand for Australian apartments are ***Mirvac***, ***Goodman*** and ***Lend Lease***. However, investors should be aware that the earnings benefit is diluted amongst the other property owned by these diversified listed property trusts. Furthermore we are seeing a range of foreign developers (mainly Asian) entering into the Australian market with development applications currently submitted for 15,617 apartments. This number excludes the site of Aurora's Sydney headquarters that has been bought by China's Dalian Wanda Group for $425 million, and is expected to be converted into a 185 meter high luxury residential tower.

Additionally building materials companies should continue to see increased demand for their products, though we would be cautious in over-estimating the impact. From meetings with the construction managers at various projects, it was clear that a large amount of imported materials were being used in construction namely glass and steel. Further there are minimal bricks and clay tiles used in high rise apartments which are not going to boost earnings for ***CSR*** and ***Boral***.

Looking at commercial real estate, the office trust landlords have seen the biggest impact from foreign buying, as rising asset values have boosted asset values (net tangible assets per share). ***Dexus*** and ***Investa Office Trust*** as the major owners of prime-grade Sydney and Melbourne CBD office assets have seen the greatest benefit, has these are the assets being targeted by foreign investors due to prestige and liquidity.

Our View

Foreign investment in Australian real estate provides a range of benefits from delivering capital growth in existing assets, increasing the tax base to providing jobs in the building industry. Whilst the press often runs articles demonising foreign buyers pushing up prices, these buyers and in particular those from China, focus on a limited sub-set of the Australian property market namely apartments in certain areas of Sydney and Melbourne close to public transport. What concerned me over the past week was the heavy reliance on a single class of buyer in the developments seen around Sydney. Major changes to Chinese economic policy, such as harsher capital controls could dramatically restrict the pool of buyers and thus the development profits earned by these property trusts. Accordingly we have minimal exposure in the Aurora Property Buy-Write Income Trust to developers as we are concerned about the sustainability of this earnings stream.

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- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**
- **HHY Fund (ASX code: HHY)**

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