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A special supplement to *PERE* magazine

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Crowded house

In this column last year I described the appetite demonstrated by institutional investors for institutional grade real estate investments in Australia as fast becoming insatiable. Today, this is still the case.

In the sale of nine offices from its Investa Group holdings by Morgan Stanley Real Estate Investing to the China Investment Corporation in July, we just witnessed an investor willing to pay a significant premium to secure a strategic footing in the country.

The deal, which is explored at depth in this special magazine, has been described as a re-pricing of Australia's core market. International institutions and managers are competing among themselves for the best assets, leaving domestic buyers in their wake. The same has been happening in other gateway markets for some years now.

CIC is understand to have paid 20 percent more than the second place bidder in a supposedly 25-strong chasing pack to secure the offices. The state investor obviously felt the outlay was worth it.

But why? Australia accounts for only 2 percent of the global economy. Does global capital need to allocate a greater relative weighting to its real estate? Certainly in the commodities crash-hit markets of Perth and Brisbane, but also in the more robust markets of Melbourne and Sydney, occupational demand – the lifeblood of any property investment – is nowhere near as promising as the cap rates might suggest they should be. Rent free periods remain a common part of the leasing dialogue.

Currency devaluation and low interest rates will have something to do with it. Further, the widely-predicted near-term raising of interest rates in the US and Europe could well see competition for Australian property intensify even more, and soon, so that's an argument for buying today. In the case of CIC, some onlookers feel China's current economic malaise is provoking more urgency for it to expatriate capital. You could argue a long-hold perspective justifies the premium paid. Australia's consistent and transparent rule of law and regulatory framework will always be a point of attraction too.

There is no getting away from the fact that this country's prime real estate market resembles a crowded house. But that is not to say there are not opportunities for institutional capital providers to deploy their resources. There are voices in this magazine that would point to Australia's constrained credit markets, particularly for residential development, where value can be found. Forays are being made in asset classes like student accommodation and childcare property too.

For certain, Australia should be part of any international, institutional property portfolio. To what degree at this lofty part in the global market cycle remains a debate - one we've looked to frame in this publication.

Regards,

Jonathan Brasse
Senior Editor

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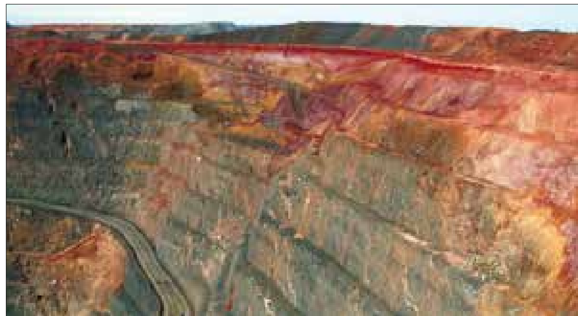

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ISSN 1558-7177
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Winner of 2014 Best Commercial Trade Magazine

PERE is published 10 times a year by PEI

To find out more about PEI please visit: www.thisisPEI.com

Printed by
Hobbs the Printers Ltd
www.hobbs.uk.com

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Horses for courses

There were major core equity plays by private real estate investors and managers in Australia in the last year. For opportunistic investors, credit strategies were slated to be more popular

1 CBRE predicts increased RE debt investment

Australia was pegged as one of the most opportunistic markets in Asia for real estate debt investments.

A report released by property consultancy firm CBRE in July listed the country as an attractive destination for institutional investors such an insurance companies and pension funds which want to invest in long-term senior lending deals in the commercial property sector.

The report, which analyzed the real estate debt market in Asia, predicted the demand for debt investments by non-bank lenders in the region would increase, buoyed by a scarcity of quality core assets for equity investments, and low bond yields.

Australian dollars: Australian credit strategies slated to become more popular among international investors

Since pure real estate debt structures are yet to evolve in Asia, debt investments are being made via opportunistic real estate funds. According to CBRE's *Asia Pacific Investor Intentions Survey 2015*, private equity real estate funds currently make up 42 percent of the total debt investments in Asia and institutional investors comprise 20 percent.

Each market in the region has different types of debt structures in demand. For Australia, the report identified long-term senior lending, with a tenor of seven to 10 years as the most popular form of credit. Borrowers in the country have been keen to secure these loans at the current low interest rates before a widely anticipated rate hike by the US Federal Reserve.

In other key debt markets such as India and China, preferred equity and mezzanine financing deals were more popular, largely thanks to a scale back in development finance by banks.

As stringent regulations on bank lending continues to be enforced globally, the market for debt investments will grow further, according to the report. The BASEL III framework, for instance, which is set to be in place by 2019, would toughen the underwriting requirements for lending.

2 GIC's mega shed sale

One of the largest ever direct industrial property portfolio sales in Australia is nearing its completion.

At press time, GIC's near $1 billion industrial and logistics property portfolio in the country was reportedly in the final stages of being sold to the Singapore-headquartered real estate investment firm Ascendas, according to a report in *The Australian*.

While no official confirmation on the sale has been released yet, local media reports have indicated Ascendas has emerged as the preferred bidder for the portfolio which hit the market earlier this year in April. Australian property firms such as Dexus Property Group and GPT Group were also believed to have contended for the portfolio, according to industry sources.

GIC: calling time on Aussie shed holdings

Colliers International and JLL were appointed to handle the sales process for the 25 asset-portfolio spread across the country. The assets, most of which are Grade A properties, are understood to comprise more than 6.45 million square feet of lettable area.

GIC has been selling off its non-core holdings in Australia and the portfolio sale is a continuation of that, buoyed by the high demand for industrial assets in the country, according to an industry source.

GIC's industrial holdings in Australia essentially comprise two separate portfolios. One is the firm's 80.1 percent interest in a five-year joint venture partnership with Australand, which was formed in 2011 with a target investment value of A$450 million (€280 million; $311.5 million). Australand had initially seeded the venture with eight industrial properties.

The other portfolio consists of a number of directly owned properties, which include a portfolio of industrial properties GIC had reportedly acquired for more than $200 million from the Salta Property Group in 2010. This deal was understood to be GIC's first direct investment in the industrial sector in Australia.

3 Ivanhoé's first Australia direct investment

In April, Ivanhoé Cambridge, the real estate arm of Canada's second-largest pension fund, La Caisse de dépôt et placement du Québec, announced the acquisition of a 25 percent stake in Sydney's Liberty Place in partnership with The Blackstone Group.

The two firms acquired the interest from LaSalle Investment Management in a deal valued at A$240 million (€153 million; $174 million) and reflecting a yield of 5.6 percent.

The news of the deal was first released in February but, at the time, Ivanhoe's participation in the investment had not been revealed.

The deal marked many firsts. For Ivanhoe, it represented its first direct real estate investment in Australia while for the New York-based private equity firm Blackstone, it was its first ever core-plus real estate acquisition in Asia.

Liberty Place: a deal of many firsts

Commenting on the deal, Christopher Heady, head of real estate for Asia at Blackstone, said that Liberty Place fit the firm's core-plus strategy extremely well as a high quality, well-leased asset in a global city.

The 42-storey office tower is the headquarters of the Australia and New Zealand Banking Group (ANZ) in Sydney. The remaining interest in the tower is owned by the unlisted GPT Wholesale Office Fund, a $4.8 billion fund launched in 2006 by the Australian property group GPT, which has a 50 percent stake in the tower, and the Australian superannuation fund-backed ISPT, which has a 25 percent stake.

"We are enthusiastic about the opportunity to invest in Australian real estate. Blackstone's strong knowledge of the Australian market and its established presence in Australia have been key to the success of this transaction," Rita-Rose Gagne, executive vice president, growth markets for Ivanhoé Cambridge said in a statement announcing the deal.

Following the acquisition, Ivanhoé Cambridge was also understood to be looking at increasing its investments in Australia as well as other parts of Asia-Pacific.

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4 LASALLE'S MACKIE RELOCATES TO AUSTRALIA

Ian Mackie, a founding member of LaSalle Investment Management's team in Asia, announced in April that he would be returning to his native Australia, to Brisbane, after two decades in Singapore.

5 CROMWELL ACQUIRES VALAD EUROPE

Brisbane-based investment house Cromwell Property Group acquired Valad Europe, the London-headquartered property business of the larger Valad Property Group of Australia, in January this year for €145 million in a deal that reflected an EBITDA multiple of approximately 6.4x.

6 KKR'S A$103M RETAIL BUY

New York-based private equity firm Kohlberg Kravis Roberts (KKR) made another addition to its Australia portfolio in February when it teamed up with the Abacus Property Group in a 60:40 partnership to acquire the 232,037 square foot Oasis Shopping Centre in Queensland for A$103.5 million (€70.22 million; $80.24 million).

7 MSREI ACQUIRES CHILDCARE DEVELOPER

In February, Morgan Stanley Real Estate Investing acquired Australian Childcare Projects (ACP), an Australian developer and operator of childcare facilities and services via its eight global opportunity fund, Morgan Stanley Real Estate VIII Global, for up to A$20 million initially.

8 APG FORAYS INTO STUDENT HOUSING

Dutch pension manager APG Asset Management formed a A$220 million joint venture partnership with Scape Student Living to develop, own and manage direct-let student accommodation facilities across Australia. The deal marks APG's first student accommodation investment in Asia Pacific.

9 BLACKSTONE'S RECORD EXIT

The Blackstone Group sold Gold Fields House in Sydney to the Dalian Wanda Group, the Chinese property developer, in a deal valued at A$415 million, representing an office record price per square meter in the city of A$18,000.

10 ALTIS' SWEEPS A$320M IN FIRST CLOSE

Altis Property Partners raised A$320 million in the first closing of its third investment vehicle, Altis Real Estate Equity Partnership (AREEP) III fund in December last year, exceeding the fund's original capital raising target in a single close. A hard cap of A$400 million was set for the fund.

The deal that repriced the market

Onlookers describe MSREI's A$2.45 billion sale of Investa assets to CIC as signaling the top of the Australian commercial real estate market, reports Florence Chong

In the end, it came down to dollars and cents.

China Investment Corporation, one of Morgan Stanley Real Estate Investing's (MSREI) largest investors, was prepared to stretch that little bit more to A$2.45 billion (€1.63 billion; $1.79 billion) to clinch a prized portfolio of Australia's premium office towers.

CIC offered A$35 million to A$50 million more than rival bidder, the Abu Dhabi Investment Authority (ADIA), which, too, is a large investor in MSREI funds.

It was a tight race. *PERE* understands there was another bid from a consortium, backed by a sovereign fund and a large pension group, at A$2.38 billion.

When MSREI announced the sale in February, a field as large as 50 parties, reportedly including some of the world's biggest names in the global property market like Blackstone, Brookfield, and Fosun, sought due diligence information.

Says an investment banker, who requests anonymity: "Clearly, there was a lot of interest in a portfolio like this. The question is: who were the really credible bidders?"

"Ultimately, when you are talking about a $2.45 billion acquisition, and when you add stamp duty and other costs, it is about writing a $1.3 billion equity check. Very few groups could do that, and that is assuming 50 percent leverage."

Longtime supporter

CIC, which has $650 billion in assets under management, has long been a strong backer of the US investment bank. In 2007, it acquired 10 percent of Morgan Stanley at a cost of $5.6 billion.

CIC has consistently invested in MSREI funds. It is said to be a large investor in MSREF VI and MSREF VII and also in MSREF VIII Global, which closed in July, after the bank platform raised almost $1.7 billion.

Although missing out on the Investa properties, ADIA can in some respects be considered a seller. "ADIA was a cornerstone investor in MSREF VI and the MSREI Special Situations Fund, along with a significant co-investment in Investa," says a source. "So in that sense, it already owns a lot of the investment. It is both a buyer and a seller."

"ADIA's position was that if it can roll the money it expects from the sale and then plough it back into the assets and become a direct owner, that will have been a very good deal." However, says this executive, who is familiar with the bidding process, "ADIA wasn't ever going to go crazy on the price."

ADIA worked with an Australian partner, DEXUS Property Group, in the Investa bid.

When approached by *PERE*, DEXUS reiterated that the company and its partner were working within set parameters.

"We are very disciplined in the way we allocate capital. There are metrics that make sense to us and we are happy to bid up to those metrics. But this was obviously beyond those parameters," Darren Steinberg, DEXUS chief executive, says.

Another industry leader, who asked not to be named, says: "CIC had a strong incentive to pay that much more. They are getting their dollars out of China into a transparent market where there is rule of law and good solid long-term prospects. Australia ticks all of those boxes."

Yet another source points out that CIC must have also taken into account the substantial 'discount' afforded by the devaluation of the Australian dollar in the past year when putting its bid together.

MSREI down under

May 2005: MSREI and Singapore's GIC buy prime office block Chifley Tower & Plaza, in Sydney CBD, and the Royal Pine Resorts in Queensland for around A$700 million from Japan's Matsushita Investment and Development (MID)

November 2006: MSREI partners Singapore investor Tuan Sing to buy the Grand Hotel Group, owner of six hotels, including the Grand Hyatt Melbourne, for A$271 million

September 2007: MSREF VI and a Special Situations Fund take over Investa Property Group for A$6.6 billion, including debt

March 2011: Investa buys management rights and a 2.4 percent stake in the then ING Office Fund, since renamed Investa Office Fund, from ING Real Estate

December 2011: MSREF VII buys loan book of A$660 million from Bank of Scotland International (BOSI)

January 2012: MSREF VII buys the A$1.1 billion Orchard Funds platform, since renamed Arena Funds Management

June 12: MSREF VII joins Blackstone Group and Deutsche Bank to buy second portfolio of BOSI property loans with a face value of A$1.8 billion

Although CIC first came to Australia in 2010 with a rescue package for the Goodman Group, a global logistics development and investment management firm, and subsequently took a 42.5 percent interest in Goodman Trust Australia (GTA), one of the firm's vehicles, CIC's direct exposure in Australia is actually limited to a single asset, Centennial Plaza on the southern edge of Sydney's central business district, which it bought for A$305 million in late 2003

The Investa portfolio, valued at A$1.9 billion on balance sheet at December 31, 2014, is said to yield an annual rental income of A$145 million. The sale price reflects a 20 percent uplift in the value in six months.

Says Steinberg: "What you are seeing is a repricing of the core office sector in Australia in line with global pricing expectations. The majority of investors looking for assets are global players. "

126 Philip Street, Sydney: this and others like it will bolster CIC's direct property holdings in Australia

MSREI's original outlay

The yield achieved is reminiscent of what was in market during the property boom in the lead-up to the GFC, when MSREF VI paid A$6.6 billion to buy the listed Investa Property Group (IPG). It then took IPG private.

The offer of A$3.08 per security represented a 56 percent premium to IPG's net tangible asset value at December 31, 2006.

MSREI installed its own management, with Scott MacDonald as chief executive and chairman, after taking the public company private. MacDonald, described as 'the man MSREI turns to run its acquisitions', has worked for Morgan Stanley in Europe and the US.

"Morgan Stanley has done a good job in installing the management team, which skillfully navigated Investa through the global financial crisis. If it was a public company, it would have been forced to raise equity or sell to protect its loan covenants," says the chief executive of a leading Australian REIT. It did neither.

Having resisted an early sale of Investa, MSREI can now exit its investment at what seems like the peak of another property cycle in Australia.

But has MSREI recouped its investment in Investa? The firm declined to comment when approached about the investment.

One source told *PERE*: "Despite the jaw-dropping price, I have been told that it is unlikely that MSREI would get back its capital because of the 90 percent leverage on the initial acquisition. When the GFC hit, and property values dropped, it tipped in more capital."

Another observer says: "None of us know whether MSREI will recover all its equity investment. Remember, you are not comparing apples with apples. The portfolio that was in the original Investa is not the same as the one that the firm is exiting out of."

The MSREI strategy for Investa from day one was to divest assets and bring in co-investors to the unlisted Investa Commercial Office Fund to de-risk and lower its exposure, says a source. "And it did. It sold assets to the listed and unlisted trusts, managed by Investa."

"In the final analysis," comments another industry insider, "when it compares Investa with other investments that it made at that time in other parts of the world, I think Morgan Stanley will say that Investa has performed much better than the others." □

June 2012: MSREF VII buys a majority stake in Retire Australia for A$142.5 million as JP Morgan reduces its interest

September 2014: Sells half interest in Grand Hotel Group for A$124 million to Singapore's Tuan Sing Holdings

September 2014: MSREF VII begins selling ARENA's assets, valued at A$550 million

January 2015: MSREF VII and JP Morgan sell Retire Australia to Infratil and NZ Super Fund for A$640.2 million

February 2015: MSREF VIII invests in Australian Childcare Projects for undisclosed sum

February 2015: Sales process of Investa Property Group begins

July 2015: Completes sale of Investa to China Investment Corporation for A$2.45 billion and in final negotiation to sell management platform and a residual land bank reportedly for about A$420 million

MSREI scales down under

The firm has gone from buyer pre-GFC to seller today, reports Florence Chong

A decade after it ventured into Australia, way ahead of its global peers, Morgan Stanley Real Estate Investing (MSREI) appears to be calling time out.

At the time of writing, MSREI was on track to collect gross sale proceeds, totalling more than A$4 billion (€2.7 billion; $2.9 billion) as it offloads its largest Australian investments.

MSREI is continuing to acquire down under. In February, it bought a childcare business, and it is in advanced negotiations for an A$120-million stake in an office block in Perth. But such investments pale into insignificance when compared with past acquisitions.

Industry sources told *PERE* that MSREI's experience in Australia has probably been mixed in terms of financial returns.

But operationally, it has left its mark. Those who have followed MSREI's journey in Australia say that in all its investments, including Investa, it has successfully restructured the businesses, and placed them on strong financial footings.

Sonny Kalsi: lead MSREI's charge pre-GFC

Riding on a wave of liquidity in the pre-crisis world, when it raised a record $8.8 billion for its sixth opportunity fund, MSREF VI, MSREI was a voracious investor in Australian assets. At the peak, it controlled assets valued at more than A$10 billion. From the perspective of a private equity investor, at the time MSREI had no equal.

The bulk of its Australian investments were held in MSREF VI and in its successor fund MSREF VII, also known as G7.

It was Sony Kalsi, then co-head of MSREI and chief architect of its Asia Pacific investment strategy, together with the firm's Australian team, headed by Steve Harker, who drove the Australian adventure.

The first purchases were the blue chip Chifley Tower and Plaza in Sydney's central business district and the Royal Pines Resort on Queensland's Gold Coast for about A$700 million in 2005 from Matsushita Investment and Development (MID) of Japan. Kalsi brought Singapore's sovereign wealth fund, GIC, into the MID deal. The assets were later split, with GIC taking the office tower and MSREI the Gold Coast hotel and resort.

At the time, MSREI already had a joint interest in the Grand Hotel Group, owners of five-star hotels in Australia. Its partner was the Singapore-listed Tuan Sing, which has owned 25 percent of Grand Hotels since 1997.

But it was its takeover of the then-listed Investa Property Group for a massive A$6.6 billion, that stunned the Australian property market - both for the premium paid and the size of the deal.

The global financial crisis in 2008 caused MSREI considerable pain. Plans to float a public vehicle with Investa assets were stillborn. MSREI went on to buy the management platform of a listed office trust, ING Office Trust, into which it sold stakes in the two best buildings, in Sydney and Melbourne, held on the Investa balance sheet.

MSREI continued to invest in Australia through MSREF VII, which attracted $4.7 billion by 2012.

In two deals, the first independently and the second in tandem with Blackstone Group, and Deutsche Bank, the MSREI fund bought loan portfolios mostly located on the Gold Coast, with a combined face value of A$2.4 billion from the UK's Bank of Scotland. Most of the debt portfolio, including a Melbourne retail outlet that fetched A$125 million, has been sold.

MSREI also took over the Melbourne-based fund manager, Orchard, which managed assets totalling A$1.1 billion. It injected AS$200 million into the business and renamed it Arena Funds Management. A source says: "MSREI rescued Orchard from a shambolic situation. Otherwise it would have folded, leaving thousands of small investors suffering a total loss."

MSREI also made a foray into the retirement sector with JP Morgan as its joint venture partner in Retire Australia. After an aborted attempt to float that business, it was sold to Infratil, a listed New Zealand infrastructure investor, and the sovereign wealth fund, New Zealand Super Fund, for A$640 million.

Here again, says the source, MSREI backed Retire Australia's management providing capital when required and building value into the business. The cash-strapped business needed to ward off its creditors.

MSREI would not discuss its strategy for Australia when approached by *PERE*, but former MSREI head of Asia, Hoke Slaughter, told an investor conference in 2012 how the country was the third-biggest MSREI destination and that investments such as Arena Funds Management were a 'classic recap play' for the group.

He spoke of his conviction that value would re-emerge as capital was established and management executed its strategy. MSREI has been quick to take advantage of a resurgence in demand for Australian real estate. Few could fault its timing in selling its largest investments there. ◻

Opportunities amid the contrasts

Qualitas MD Andrew Schwartz explains to Florence Chong that opportunistic returns can be found in Australia if you make comparisons with other markets

Australia has a multi-billion-dollar market for non-bank alternative debt, opportunistic debt and equity providers wanting to capitalize on the unique characteristics of its commercial real estate funding market. That is the overriding message from Andrew Schwartz, group managing director of Melbourne-based real estate investment firm, Qualitas Property Partners.

According to Schwartz, this is especially relevant today as Australia's traditional commercial mortgage lenders tighten their criteria to a range of borrowers, most particularly developers of multi-family residential apartment projects.

The volume of residential apartment development has reached dizzying heights as developers respond to pent-up demand and an influx of migrants and foreign investors from Asia seeking to park their cash.

But there is a funding void in the Australian market, according to Schwartz. "If I was an overseas investor, trying to understand the nature of opportunities in Australia, I would look at the different capital market dynamics in Australia versus those in the US or Europe to understand what is giving rise to the demand for debt and equity capital. It is this difference that has given rise to both the debt and equity funding opportunities in Australia," he told *PERE*.

Schwartz: seeks opportunities across the capital structure

Schwartz explains that, unlike other developed countries, Australia does not yet have an established alternative institutional private capital market. Australia's big four banks issued around 90 percent of all commercial mortgages in Australia, currently totaling A$232 billion (€150 billion; $169 billion) in the past 12 months, according to figures from the Australian Prudential Regulation Authority.

This compares with 40 percent to 60 percent in the US or Europe, says Schwartz, who now spends a significant proportion of his time interacting with US and European investors.

US and European alternative debt markets are both more developed and deeper compared to Australia, says Schwartz. In the US, for example, debt funds have raised some $45 billion year-to-date. US and European investors view debt as a core product to be held within their portfolios.

By Schwartz' estimation, overseas investors understand alternative debt as an attractive investment asset. "It is a well-worn path for them," he says.

As he puts it, an opportunity emerged in Australia for an alternate capital market in the two years to three years following the global financial crisis, when banks tightened their lending to property.

A number of mezzanine debt lenders used that window to move into the market. Since then, demand for mezzanine debt has been increasing, and Schwartz has seen his own firm's involvement in this market grow.

Today, even with an improved liquidity situation for banks, new prudential regulations on capital adequacy have again caused a widening of the funding gap.

Australian banks are imposing stricter lending criteria, and this is especially noticeable in the residential development sector, where the loan-to-value ratio has increased. Major lenders are concerned about their total exposure to residential as well as potential overheating in Australia's housing market.

Says Schwartz: "Broadly speaking, and depending on the asset class, Australian banks typically lend to 60 percent or 65 percent of project value. The balance is made up of mezzanine debt, preferred equity, and equity.

"Banks typically require one-times presale cover of their debt. For instance, if the project development cost is $100 million, banks will provide $60 million on first mortgage on the basis that the developer has $60 million worth of unconditional presales of the apartments."

In Australia today, strong demand for apartments in key cities, especially Sydney and Melbourne, has meant that projects are usually sold out, sometimes before the first sod is turned.

The requirement for presale contracts is to mitigate market risk of the project and to add to balance sheet strength. In other words, Schwartz says, the lender is not taking all the market risk with its loan.

He adds that the practice of preselling a project is a distinguishing feature of the Australian residential development market. Sales contracts are all in full recourse to the purchaser and typically the default rates on sales contracts have been low, at 1 percent to 3 percent of total contract value.

In overseas markets, he says, there is the concept of progress payments as an apartment block is being built. "In Europe, a developer can call for capital on a progressive basis from the purchasers."

Implicit in this approach is that the buyer contributes to the development funding of the project, which reduces the need for

bank finance, including mezzanine debt and preferred equity.

"In Australia, we have what is known as a 10-90 contract system, where buyers put down a 10 percent deposit on the price of an apartment and pay the remaining 90 percent when they take possession of the completed apartment.

"It is that lump sum completion payment system that is creating a market for the alternate debt and capital providers in Australia," says Schwartz.

This equates to many billions of dollars of funding opportunities currently available.

Look to Australia's housing

Australia's residential sector presents sustained growth potential into the foreseeable future. Net inflows of migration to Australia are contributing to population growth, which is underpinning ongoing demand for housing.

In Sydney, several years of under-building have created a big shortfall in available homes, and industry experts claim it will take several years to bring the market back to equilibrium.

This opportunity is not lost on some debt investors, including institutional investors and pension funds from the US and Europe, which look to Australia as a land of significant opportunity. Schwartz says there is more capital than supply in Europe and the US, and margin spreads are falling in those markets.

"When we look at like-for-like deals, returns in the US or Europe are significantly lower relative to Australia. We are seeing mezzanine debt finance in some markets at single digit returns of 8 percent to 9 percent IRR."

He says the returns in Australia have been 'mid-25 percent' for equity investments and from 'mid-teens' to 'low-20 percent' for mezzanine debt.

Returns are lower in the US and Europe because of the quantum and availability of capital in these markets. Australia has not seen an abundance of cash to the same extent as other parts of the world.

While debt is a core business for many European or American institutional investors, Schwartz believes an opportunistic approach is best to capture these returns in a market like Australia.

Importance of being local

Australia is a parochial market. Schwartz explains: "The development sector is a small and strongly relationship-based market. Capital providers in this market have relationships with developers to ensure a pipeline of deal flows."

"At any one time, for example, Qualitas is working on transactions of a collective alternative capital requirement of A$100 million."

"Some offshore players with a significant balance sheet have come to Australia wanting to deploy capital, but to make their economics work they need to source transactions generally of at least a $30 million check size. Without infrastructure on the ground, those overseas entrants have been unsuccessful in Australia because they lack access to quality deal flows."

The problem has dawned on some offshore investors, which are today starting to talk to local groups that have strong origination and relationship networks, Schwartz says.

He says his firm regards itself as having a multi-product strategy ranging from non-opportunistic core property debt, opportunistic debt (outside of accepted bank lending parameters) and a non-listed property high-value equity strategy.

The most important thing when taking on transactions is the risk-return, and that determines whether to take a mezzanine debt position or an equity stake in a transaction, he says.

"When you are in an opportunistic business, it is really about understanding what are your client's needs given their specific situations," he says. Qualitas has adopted a strategy of working through the whole capital structure, offering first mortgages, mezzanine debt and taking preferred equity. On occasion, it has invested pure equity. "We have provided unitranche loans and preferred equity and have participated in joint ventures," says Schwartz. "Having that experience across the whole of the capital spectrum gives us a strong insight into the entire market.

"If you have a solely credit or equity mandate, then you are really limited in the range of products you can provide to a particular client. Some clients are happy to pay a coupon rate for capital, others prefer mezzanine debt and yet others are happy to share the risk and reward alongside the capital provider. We have a management strategy in respect of each of those risks, and we have the benefit of keeping an open mind on how we can structure a transaction." In the absence of having such a broad mandate to be involved from debt right through to equity, the only way to compete is on pricing and on underlying terms, he says, adding that an opportunistic investor should not want to be so limited.

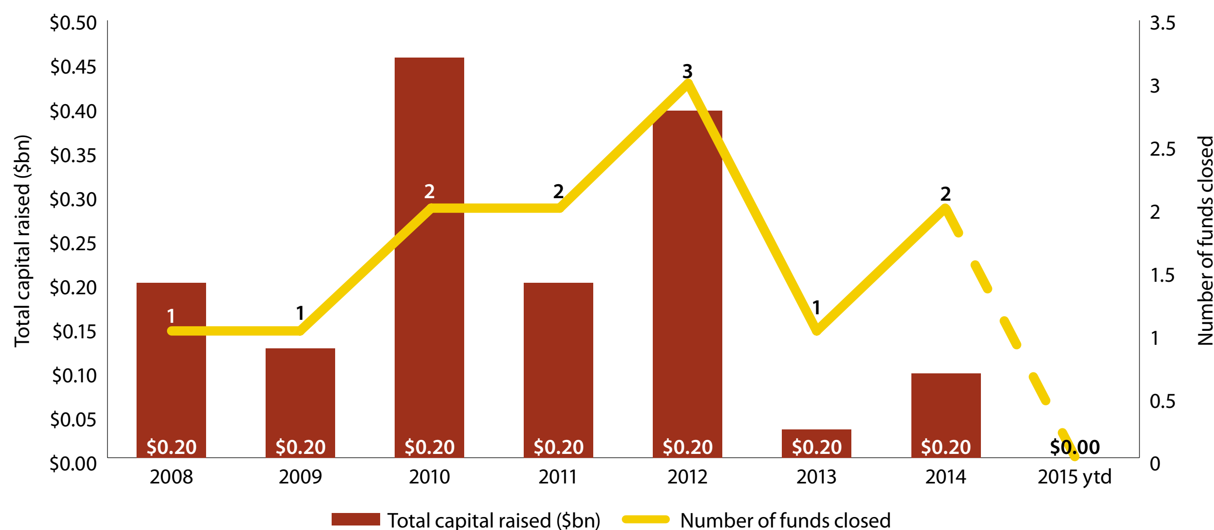
Broad experience, he says, is necessary to assess risks associated with development projects. With its in-house equity investment capacity and debt evaluation capacity, Qualitas can move from a debt position to equity when it detects issues emerging from a loan. It then becomes involved in the active management of a project should it be necessary.

"To date, our transactions have been split almost evenly between debt and equity on a total check size of around A$500 million," he says. The total value of assets involved is around A$2.5 billion.

Over the next 3 years to 5 years, Schwartz expects Australia will see an increasing availability of capital, as more investors become alive to the aforementioned funding shortage. And this, he believes, will challenge the supremacy of Australia's largest banks in the market. ◻

An underground scene

As the research from *PERE's Research & Analytics* division demonstrates, the world of Australian private equity value-added and opportunistic real estate is somewhat limited to a handful of firms and their fundraisings. The most equity raised for higher risk and return strategies since the global financial crisis happened in 2010 and 2012



Down a scale

Some of Australia's biggest real estate names like Lend Lease and Goodman Group have operated opportunistic real estate vehicles focused on Australia, but typically these have been at a smaller scale when compared to their core strategies or, in the case of Goodman, its international development strategies. Meanwhile, boutique firms like Altis are among a small, but expanding, number of firms growing opportunistic investing businesses.

Opportunity and value-added funds raised for Australia

Fund Name	Fund Manager	Current Size ($m)	Year Close	Fund Strategy	Fund Sector
Altis Real Estate Equity Partnership II	Altis Property Partners	$258.88	2012	Opportunity	Diversified, Industrial, Office, Retail, Multi Family / Residential
Goodman Australia Development Fund (GADF) - Joint Venture	Goodman Group	$229.34	2010	Opportunity	Industrial
Lend Lease Real Estate Partners 3 (LLREP3)	Lend Lease	$229.34	2010	Opportunity	Retail, Industrial
ISPT Development and Opportunities Fund No. 2	Industry Superannuation Property Trust	$199.90	2008	Opportunity	Office, Multi Family / Residential
Eureka Development Fund 2	Eureka Funds Management	$125.53	2009	Opportunity	Diversified
Altis Real Estate Equity Partnership I	Altis Property Partners	$111.72	2011	Opportunity	Diversified, Industrial, Office, Retail
Tivoli Development Fund	Folkestone	$103.55	2012	Opportunity	Multi Family / Residential
Gresham Property Fund 4	Gresham Property	$88.67	2011	Opportunity	Diversified
ARA Summit Development Fund I	ARA Asset Management	$80.00	2014	Value Added	Office, Retail, Industrial
Aviva Investors Australian Value Enhanced Logistics Strategy (AVELS)	Aviva Investors	$35.21	2012	Value Added	Industrial
Aviva Investors Australian Value Enhanced Logistics Strategy II (AVELS II)	Aviva Investors	$32.44	2013	Value Added	Industrial
Aviva Investors Australian Value Enhanced Logistics Strategy III (AVELS III)	Aviva Investors	$15.28	2014	Value Added	Industrial

Mining's property headache

The property market in many regions in Australia continues to reel under the resources slowdown. By Arshiya Khullar

Big drop: falling commodities prices have dealt a blow to certain Australian property markets depending on the mining sector for demand

Four years ago, 18 Edgar Street, a humble three-bedroom cottage with a pale pink and blue exterior located in the heart of Port Hedland, a thriving iron-ore town in Western Australia, was valued at an astronomical A$1.3 million (€817,000; $911,000).

In August this year, the 1960s-built fibro asbestos cottage was reported to be under offer for around A$400,000. Earlier in February, the property even passed in at an auction for A$360,000 unsold.

If the property's seven figure valuation during the peak of the mining boom in Australia in 2011 was an exaggeration, the over 70 percent drop aptly exemplifies the industry's gloomy situation today.

It has been over two years since the resources bubble burst in Australia, turning many mining-focused regions such as Port Hedland into clusters of vacant houses, but the downturn is far from over. Tumbling commodity prices, particularly of iron ore and coal, and the volatility in the financial markets globally, has continued to impact the real estate sector in many pockets across the country, not just in mining towns but also adjoining cities such as Perth that historically have attracted more institutional capital.

"It's the worst I've seen it in 28 years in the mining industry", a local resident from Muswellbrook, a town in New South Wales, was quoted in the *Propell Mining Report* as saying. "Everyone is getting out. Three hundred houses are for sale in my town, three in my street, and rental prices have collapsed on older weatherboard houses from A$1,000 a week to A$200."

Carnival over

Of the 21 significant mining towns in Western Australia, Queensland and New South Wales, the *Propell Mining Report*, released in April this year, lists Blackwater, Moranbah, Karratha, Emerald, Muswellbrook and Gladstone as the six most affected towns where house sales have dropped by over 50 percent. In 2011, these towns had an estimated 3,000 house sales in total. That number dropped to 1,225 in 2014.

The report, titled *The carnival is over*, attributes the slowdown to a scale back in mine expansion plans and harbor dredging (done to build new port facilities) due to environmental concerns, and more importantly, falling commodity prices.

Calling the situation abysmal, Tristan George, director of the mining properties team at property services giant CBRE, highlights the importance of the price of coal which dropped to around A$58 a ton in July as compared to A$142 at the peak in 2011. Iron ore, another bulk commodity, dropped to A$58 a ton, a 150 percent decline from A$190 per ton in 2011.

Naturally, the production activity of mining companies has ground to a near halt with many companies limiting the use of their mining town centers for care and maintenance purposes.

Mathew Tiller, national research manager at LJ Hooker, an Australian property services firm, explains how the property market went from boom to bust: "In some of the mining towns when these big projects started, there was limited housing stock. When projects kicked off between 2003 and 2008, employees started moving into these towns, and investors jumped in. Rental yields went up by 10 percent to 15 percent. That caused capital growth and both rents and prices tripled or quadrupled during that time. What we are experiencing now is a correction of that overshoot."

More than two years in, and the correction continues to wreak havoc in many places in Western Australia, where 30 percent of its economic output depends on mining revenues, and Queensland, where the composition is 9 percent. In the town of Murrumba for instance, where housing prices have already dropped by 37 percent, CBRE's George says they are likely to drop 30 percent more over the next five years.

Spillover effect

Of salience to *PERE* is the impact of the resources slowdown

on commercial real estate and institutional investment in the sector. Owing to their smaller size, the actual mining towns in Australia haven't yet developed as likely investment destinations for institutional capital. But cities such as Perth and Brisbane, lying within close proximity to the mining towns, have attracted more institutional capital and they have been adversely impacted by the resources downturn.

When project capacity building was at its peak during the mining boom, Perth for instance saw inflated levels of demand for commercial space, according to Stephen McNabb, head of research, CBRE Australia.

"In Perth, the historical average of net absorption of office space per annum is 215,278 square feet. The net absorption of office space in 2012 reached close to 430,556 square feet, attributed to mining operators or businesses that supported capacity building in the mining towns. That is expected to run at least until 2017, and we're unlikely to see that replaced," he says.

CBRE's data suggests rents in the city's core central business district have now dropped by almost 40 percent in the last two years and McNabb expects them to further drop by 10 percent to 15 percent over the next few years. Property prices in the city are understood to have dropped by 2 percent to 3 percent in the last 12 months, according to Tiller, due to lack to demand.

"At the height of the boom, incentives were nil. Now as space becomes available, rent-free incentives have started to rise, and tenants have the upper hand in negotiations," says Tiller.

In August, Morgan Stanley Real Estate Investing (MSREI)-owned Investa Group released its 2015 results for the Investa Office Fund (IOF), its listed real estate investment trust that has $3.1 billion in assets under management. The fund reported a 2.4 percent decline in net profit to $179.2 million, largely on account of poor leasing conditions in Perth and Brisbane.

"If Brisbane is tough, Perth is even tougher," Ming Long, fund manager for IOF, said during the results announcement. "Perth is normalizing the highs of the resources boom. With forecast supply set to come by the end of this year, we expect the current vacancy of 17.4 percent to increase to 23 percent. White collar employment is improving, but it will not offset what is happening in this normalization."

In terms of investments, Perth is largely believed to attract more domestic institutional and retail investors while the larger overseas institutional investors trickle into larger cities such as Sydney and Melbourne.

While the mining industry downturn hasn't impacted investment volumes in the commercial or residential sector from a nationwide perspective, local real estate brokers say the composition has changed.

"It has taken shift away from mining and resource-focused regional centers and directed investors towards stable or traditional capital city markets such as Sydney or Melbourne," says Tiller.

A premium commercial asset in Sydney for example currently trades at an average yield of 5.5 percent, according to data by CBRE, while the yields in Perth are as high as 7 percent.

Green shoots

Such rebalancing in the economy is prompting the optimists to look for other positive signs amidst the slowdown. With lower commodity prices and a depreciating Australian dollar, exports are expected to increase in the mining industry.

In Tiller's view, economies of some of the more diversified mining towns that house student universities and attract tourists and are not solely reliant on commodities will slowly begin to perform better.

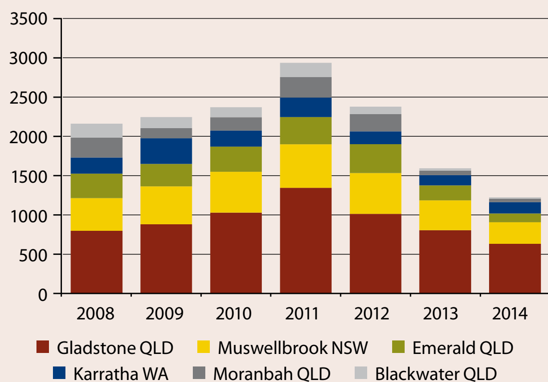
"While mining may have reduced demand, the fall in the Australian dollar has counteracted that in some respects and provided some stability for the property market especially in markets like Cairns (Queensland) due to the diversification of regional economies," he says. "Once property prices rebalance in Perth, and the Western Australian economy becomes diversified and attracts tourism and education, more industries will move to Perth."

Certain local property investors and brokers *PERE* spoke with are eager to term the slowdown as a cyclical correction of the market. Few of them, however, were able to forecast when a turnaround might happen. In the absence of any near-term recovery, it remains a wait-and-watch game for property investors. □

Empty auctions

Mining towns most affected by the slowdown have seen house sales and prices plummet in recent years

Number of sales



Source: *Propell Mining Report, 2015*

Next generation of lenders

Australian commercial real estate debt is increasingly carving its place as a stand-alone asset class in institutional investor's portfolios as traditional lending sources dry up, writes Wayne Lasky, managing director at MaxCap Group

There exists a significant opportunity for institutional investors to fill a growing funding gap down under.

Disciplined capital deployed with specialist manager skill will find relative value financing residential development, commercial real estate assets with value-add strategies and non-traditional real estate sectors such as hotels and student accommodation.

The four major Australian banks remain the dominant lenders with 86 percent of $193 billion in Australian commercial real estate (CRE) debt exposures and less than 0.3 percent provisions (funds set aside to pay for anticipated losses).

This has been described as the 'goldilocks period' for the major banks, but as the singer Bob Dylan opined, 'the times they are a changin'.

The banks are now being forced to increase their Common Tier One equity to risk-weighted assets ratio up to 7 percent by 2019. In response, they have retracted further down the risk curve and thereby are increasing the pre-existing funding gap.

With a shallow pool of lenders, borrowers often face aggregation issues as banks are restricted by how much they can lend to any borrower.

Talking at a MaxCap Group event, the former Prime Minister of Australia, Paul Keating pointed out that: "Other institutions will have to do things in the spaces traditionally left to banks, such as property development, and we will see a shift in the balance in financing this industry."

There is little doubt the current one-size-fits-all CRE debt approach cannot prevail much longer; a view supported by MaxCap. I recently stated at an industry event that real estate

Mitigating circumstances

MaxCap has identified four major risks that institutional investors considering investments in Australia's residential developments should consider.

RISK	MITIGANT
Sponsor	-Best in class developers with appropriate experience and financial capacity to fund potential cost overruns. Guarantees (personal or corporate)
Cost overrun	-It is standard practice for a building contract to be a 'fixed price and time contract' containing an appropriate liquidated damages and liability regime. - Independent Quantity Surveyor costing, buildability, construction program and feasibility analysis undertaken to support the costings and timeframe in the contract. - In addition to cost overrun bank guarantees, a contingency allowance (typically 5 percent of contract sum) is included and drawn, subject to the financiers discretion for the purposes of meeting variations - Extensive due diligence to ensure the architect, builder, project manager and QS have the necessary experience and expertise to complete the project within the projected time and within the costed budget.
Delivery	- Adequate security is to be taken over the respective corporate entities. - Tripartite agreement between the mortgagee, borrower and builder entitles the mortgagee to 'step in' to control the Project under certain conditions. - The builder is typically Tier 1 and provides 5 percent of the construction contract in the form of bank guarantees as bonding.
Settlement (exit)	-It is generally a condition precedent in Australia that the dollar sum of unconditional apartment presales is sufficient to cover 80 percent to 100 percent of debt before funding commences. If a purchaser defaults at settlement (currently 0.2 percent - 0.5 percent for capital cities in Australia), the developer is entitled to keep 10 percent purchase deposits and generally has recourse for any losses sustained in reselling. - A certified legal opinion is required to confirm purchaser contracts. - A certified legal review to confirm soundness of the purchaser sales contract is also required.

is idiosyncratic in nature and requires diverse bank and non-bank lenders to provide a robust finance system to support real estate activity in Australia.

MaxCap was among the first investment managers to introduce institutional capital to mezzanine debt strategies in the post-global financial crisis (GFC) era and we have built on this recently by introducing a market leading whole loan offering. We have found that institutional investors have been attracted to these conducive market conditions and to those firms that can demonstrate deal velocity with high-calibre borrowers.

Lasky: looking to replace Australia's restricted banks

On the table

For unitranche facilities - a unified offering of a traditional first mortgage and mezzanine debt in one facility - expect 6 percent to 8 percent net returns a year. This product is particularly appealing to borrowers that face aggregation challenges with the major banks and for those that recognize the virtues of opening up a lending channel with a non-bank lender. Specialist asset managers are typically very nimble, able to conduct detailed credit processes and document loans to commence lending in a relatively short timeframe. Other savings are more obvious such as only paying one set of fees.

This is a nascent product offering in the Australian context, but we have already witnessed demand from a broad borrower base. For example, MaxCap recently dealt with one of Australia's premier publicly listed real estate development and investment companies on a Sydney development. The developer was precluded under internal policy from taking additional gearing in the form of mezzanine debt, but could access the higher gearing (approximately A$90 million) under one loan, via a unitranche facility.

In terms of achievable returns for CRE debt strategies in Australia, we're seeing mezzanine funding able to deliver net returns of between 12 percent and 17 percent a year. With the major banks retracting down the risk curve, offering lower loan to value ratios (LTV), the amount of equity needed is at historically high levels. For developers with a large pipeline, mezzanine debt provides the benefit of capital efficiency, enabling them to leverage their balance sheet across more projects. Getting their equity working harder also generates a higher return on developer equity.

From the manager's perspective, we value deals that have a clear exit within a defined timeframe. In this way, they closely characterize fixed income investments. In Australia, residential developments with pre-sales that cover 100 percent of debt in addition to construction contracts on a fixed price and time basis are good examples of this. Notwithstanding, we selectively provide mezzanine debt for stable assets with less defined exits. Last month we closed a deal on a major five star hotel in Melbourne at an 80 percent LTV.

Home advantage

Particularly in the current market, the highest returns have come from funding residential developments. Importantly, the risks involved funding developments are known upfront and are assessed and effectively mitigated by a specialist investment manager before funding commences.

Timing is important and credit quality remains very high in Australia. This ensures robust due diligence and that conditions precedent to lending are maintained and must be achieved in all circumstances. By funding late, the financier is able to eliminate numerous risks such as planning, market and environmental risks. The table opposite highlights the key development finance risks and outlines typical mitigants used to deliver strong risk-adjusted returns.

In the global search for value, emerging investment strategies such as commercial real estate debt are increasingly being considered by major institutional investors. Today, this has become particularly true in the land down under. Specialist Australian CRE debt managers provide new avenues to deploy investment funds with scale whilst offering strong relative value and genuine downside protection. ◻

About MaxCap Group

MaxCap Group is a leading Australian commercial real estate debt and investment specialist and has managed in excess of A$3.6 billion of commercial mortgages. The Group is an established investment manager for a number of major private and institutional funds. Complementing the investment management business is a strong Australia-wide pipeline of investment opportunities including development and investment facilities. The Group is proud to count amongst its clients many of the industry's largest and most respected commercial real estate players, and a growing number of internationals looking to establish partnerships with trusted local CRE debt experts. Funding solutions include end-to-end finance across the entire capital stack, with a particular focus on the provision of structured finance lending (second mortgages, preferred equity) and senior debt (first mortgages and unitranche loans).

(L-R): Wayne Lasky, Rob Hattersley, Michael Weaver and Bruce Wan

Duel dynamics

International capital has such an appetite for core real estate that Australia's gateway markets have become subject to global forces as much as domestic. By Florence Chong

Photography by Britta Campion

Global appeal: *PERE*'s roundtablers discuss Australia's recent cap rate compression

In a relatively small market by world standards, and one where most core assets are securitized, global investors targeting Australia will increasingly need an exclusive calling card to get into its key gateway cities.

They will need to forge a close working relationship with Australia's largest integrated property groups to access assets from their deal or development pipelines, typically through clubs or joint ventures.

If portfolios of assets are what these institutional investors seek, they will most likely need to partner with one of Australia's large listed REITs to access prized assets, which more than likely will be locked in public vehicles or wholesale funds.

Increasingly, they will have to look outside the box at alternative asset classes like student accommodation. These leftfield options are rapidly gaining attention and attracting serious investment and finance.

In short, Australia is all about 'partnership culture', according to the participants in the 2015 *PERE* Australia Roundtable held in Sydney in August. The right partners will open the door to opportunities, they say.

They agree that scarcity of supply, coupled with both global and domestic demand, has heightened competition for Australian real estate.

Until recently, Australia was perceived as a market where yields were high and prices were behind those of key global capital cities. Australia offered good value.

That is now changing as capitalization rates compress and yields shrink.

Bruce Wan, Macquarie Group real estate strategist, says: "Sydney and Melbourne have come into the price adjustment cycle fairly late. Australia has only started to see genuine cap rate compression since about 2014."

"In the global cyclical context, Australia is still a lagging market. Prices move ahead first in Hong Kong and London, the most liquid and the largest markets in the world, followed by, for example, Manhattan and Paris."

Roundtable participants were struck by what they call the 'pretty sharp price' paid for the Morgan Stanley-controlled Investa Property Trust in July. The 20 percent premium paid for the portfolio may well set a new benchmark for core Australian commercial real estate.

"The level of demand for Investa, both in the number of bidders and the quantum of dollars involved, reflects the scarcity value of high quality core assets," says Rob Hattersley, chief investment officer of Lend Lease. "There is plenty of capital, but quality deals are limited."

China Investment Corporation (CIC) bought the Investa portfolio for A$2.45 billion (€1.6 billion; $1.8 billion) on a passing income yield, believed to be in the range of 4.5 percent to 4.7 percent.

"Foreign investors are taking foreign pricing into the

Australian market," says Wan, noting that the Investa transaction price is comparable to what is currently paid for office assets of this size and quality overseas.

So far this year, says Wan, there have been just two other office deals globally with a ticket size of more than A$2 billion. Those were done on yields of around 4.5 percent.

Wayne Lasky, founding partner and managing director of MaxCap Group, a Melbourne-based property debt and investment company, says: "The pricing might look sharp if you just look at the transaction alone. You need to understand that relative to other opportunities outside of this country, there aren't many core assets of this type and of this scale available."

Michael Weaver, manager of private markets, covering real estate, infrastructure and private equity and private debt with Australia's A$34-billion Sunsuper, says that even if the premium was steep, it still makes sense for a new investor to the market seeking exposure. Nonetheless, long-term property investors might have been a little surprised at the sharp yield of the transaction, he admits.

Hattersley agrees that investors with more mature programs, which have invested through various cycles, feel less pressure to deploy capital today than those which are new and need to build up scale in Australia. "They are the more visible investors today."

Roundtable participants say rising valuations are unlikely to derail the strong inflow of foreign capital into Australia. Large institutional investors, like sovereign wealth funds and global pension funds, are lifting their exposure to real estate in key markets, including Australia, where relative to the global market, the yield spread is still attractive.

Weaver says that in the current global environment, with bond rates as low as they are, investors look for other income-producing assets. That means property and infrastructure that can be counted on for steady cash flow in a low-growth, uncertain world.

But global capital remains discerning, with a disproportionate bias towards key cities in half a dozen developed countries.

Wayne Lasky

Founding partner and managing director

MaxCap Group

Lasky is responsible for business strategy, execution, key stakeholder relations, risk and compliance with MaxCap. He has 15 years of real estate and finance experience, from working from all sides of the table as an originator, lender, asset manager, real estate investor and developer, project manager and property manager.

Rob Hattersley

Chief investment officer, investment management

Lend Lease

Hattersley's key role is to manage Lend Lease third-party capital, which participates in the group's asset platforms around the world. Increasingly, he works with sovereign funds and global pension schemes. Hattersley has been involved in the real estate and funds management industry for more than 24 years and sits on the executive board of an industry body, the Hong Kong-based Asian Association for Investors in Non-listed Real Estate Vehicles (ANREV).

Bruce Wan

Global real estate strategist

Macquarie Capital

Wan has more than 17 years of experience in economic and investment market analysis. He joined Macquarie in 2008 as a leading contributor to the bank's private capital market business through the provision of real estate market analysis and strategy advice for major global pension and sovereign investors. Working broadly across Macquarie, he also provides analysis and advice for a range of personal and business banking and corporate lending businesses.

Michael Weaver

Manager of private markets

Sunsuper

Weaver is the portfolio manager responsible for property, infrastructure and private equity and private debt at Sunsuper, one of Australia's largest and fastest-growing super funds. Weaver was a portfolio analyst before being promoted in 2010 to his current position. He is one of six portfolio managers who report to Sunsuper's chief investment officer, David Hartley.

"Melbourne and Sydney are considered genuine gateway cities, and, as such, investors have a different outlook on value in these markets," says Lasky.

Hattersley confirms that large global investors are city allocators, not country allocators. "They pick major gateway cities, be it London, New York or Sydney."

The *2015 Wall of Money Report*, published by property consultancy firm DTZ, ranks Sydney and Melbourne ahead of Singapore and Hong Kong, the other two Asian Pacific cities on the list of the 15 most preferred destinations for global capital.

Wan says Australia accounts for just 2 percent of the global economy, but global capital allocates a relatively higher weight to Australia, particularly where there is an Asian mandate. "They will start with Japan and Australia because these are strong, developed economies. In time, global capital will find its way into other countries in Asia, like China and India."

"There is plenty of capital, but quality deals are limited."

-Rob Hattersley

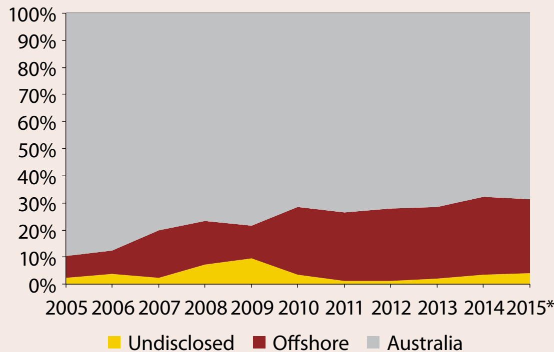
Lasky says: "After 20 years of geopolitical positioning, Australia is now regarded as a bona fide member of Asia Pacific. When it comes to global allocations, Australia is clearly punching above its weight."

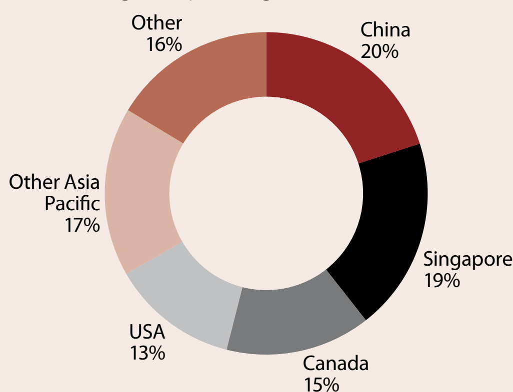
"Australia gets on the radar as part of Asia, but more importantly, because of the quality of its real estate and its managers." says Weaver, who is a global investor himself. "It is also one of the easiest places in which to get invested."

"Global investors can find alignment with different managers in Australia. These relationships have been established for longer than any you can find elsewhere in Asia."

Australia's Asian invasion

According to broker JLL's latest research, offshore capital has played an increasing part in Australia's property investment market, especially Asian capital.





Source: *JLL Research* **as at 2Q 2015*

Getting comfortable

Weaver says global interest in Australia has been enhanced by the devaluation of the Australian dollar and low interest rates. In Australia, interest rates are at the lowest they have ever been. This, he says, has made buyers more comfortable to invest on either a hedged or an unhedged basis.

"Compared to a year ago, the same asset in Australia is 22 percent cheaper for buyers from China and the US because of the currency effect; 15 percent cheaper for the UK and 14 percent for Singapore," says Macquarie's Wan.

Borrowing spreads in Australia have fallen in line with the official Australian rate, which at 2 percent is at an historical low. Most investors to Australia have access to a competitive cost of capital, according to roundtable participants.

Hattersley says the US is poised to raise its interest rates, and a huge amount of money has been deployed into the US and Europe over the course of the last two or three years. "This will have people focusing back into markets like Australia," he says.

According to Jones Lang LaSalle research, foreign investors in Australia accounted for 31 percent of all transactions by value in the first quarter of 2015, up on last year's 28 percent, with Chinese investors outspending Canadians, Singaporeans and Americans.

Wan says: "Fundamentally, a lot of wealth is being created in China. Even with GDP growth of 7 percent, Chinese corporates, insurance companies and managed funds continue to see a lot of income growth. As the capital barriers come down, more of this capital will have the option to invest overseas."

Chinese buyers are inclined to flex their financial muscle when they first step out of their home markets, he says. "When we talk to them, they are very keen for prime trophy

assets in tier one markets."

Hattersley says some large global investors are disinclined to participate in market bids. "They either want to do off-market deals or appoint an adviser to bid for them."

But foreign investors often find that, when it comes to bidding for assets, canny and aggressive domestic buyers outfox them. Domestic pension funds and Australian REITs have returned to the market with a vengeance in the past two years after lying low in the initial post-GFC period.

Says Wan: "Foreign investors only ever account for 30 percent to 40 percent of Australian transactions. The balance has always been the Australian domestic player, and that balance of the power will be hard to change. It has been steady for a number of years."

Barangaroo development: helped Lend Lease to diversify its capital sources

The Australian economy is the 12th largest in the world, but its pension pool is the fourth largest, Wan observes. "There is a big disconnect between capital and investment opportunities in Australia. There is something like A$2 trillion in pension fund assets growing at A$100 million every year. Ten percent of that is notionally allocated to real estate."

Generally, Australian pension funds buy to hold. Even during the global financial crisis, when heavily indebted Australian public vehicles were forced to sell assets, Hattersley says the majority of Australian super funds held on to the direct real estate allocations they had invested with unlisted wholesale funds demonstrating good tolerance to market volatility.

Since the beginning of 2014, Australian entities have raised A$7.6 billion in private capital. Much of this was raised by existing funds, managed by the likes of QIC, the Brisbane-based fund manager, and listed REITs, including DEXUS Property Group and Mirvac. These groups operate in the core office and retail sectors.

Hattersley says Lend Lease raised A$1.8 billion last financial year. "The capital came into a range of products from existing funds, clubs, pooled vehicles and joint ventures."

Visitors to Australia are often surprised to find that 70 percent of investment grade real estate in Australia is securitized.

"Melbourne and Sydney are considered genuine gateway cities, and, as such, investors have a different outlook on value in these markets."

-Wayne Lasky

True strategic partnerships

Global and domestic buyers access assets through their long-term partnerships with large Australian groups such as Lend Lease or the Goodman Group, Australia's largest industrial assets developer. Both have big global footprints.

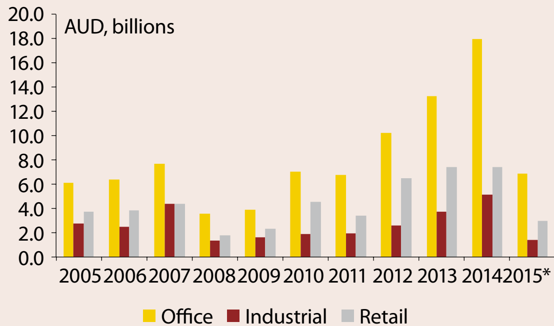
Hattersley says: "Sophisticated capital will work to form true strategic partnerships with these Australian groups. They will have a small number of partners in each of the countries in which they want to be, and will work with them to scale up their investment."

He says the build-to-core approach is certainly a strategy many of the larger pension and sovereign funds have now adopted to give them exposure to the Australian market. They see it as an efficient strategy through which to gain access to new buildings. Importantly, adds Hattersley, they are buying into next-generation assets.

Lend Lease creates assets from its large development book, with a range of offerings that include prime office and retirement villages in locations around Australia.

In November last year, Lend Lease introduced the Qatar Investment Authority (QIA) into its core commercial real estate fund (APPFC). In February this year, QIA followed this initial investment in the Australian market by investing alongside APPFC and Lend Lease into a new Lend Lease managed trust, which will own the A$2 billion International Tower 1 at its Barangaroo urban regeneration project in

Australia commercial real estate transaction volumes, 2005-2015



Source: *JLL Research* **as at 2Q 2015*

Sydney.

"For a development company, it is a very effective way to build out its development book, diversify funding sources and recycle capital," says Hattersley. "And the sophisticated capital partners end up owning the asset you are creating,"

In such forward funding arrangements, Lend Lease, as an example, does not need to use debt during the project phase. Instead it pays its partners a coupon rate, roughly in line with the debt cost of the day, for the use of their equity during construction. The partners take ownership on completion.

"But depending on the debt level decided by the investors on completion, we will bring some debt into the asset," says Hattersley. Typically, Lend Lease takes on the role of co-investor as well as asset and investment manager.

Wan reinforces the point that relationships are the key to securing investment opportunities in Australia as they are for a number of other markets. Macquarie Group routinely brings investment propositions to its capital partners.

Recently, Macquarie set up a $400-million club with the Australian logistics property specialist, Logos, CBRE Global Investment Partners and Canada's Ivanhoé Cambridge. Through the vehicle, the partners will target the China's logistics market.

Alongside their public vehicles, many of Australia's largest property groups, including Lend Lease, DEXUS and Mirvac, manage large wholesale funds that own some of the nation's best core real estate.

Hattersley says that when these managers need to raise capital, they are often supported from within their existing investor base, which provides pre-emptive rights to new equity issuances.

Additionally, in the current environment where access to quality deal flow is challenging, many investors actively participate in available distribution reinvestment plans (DRPs) as an efficient avenue through which to marginally increase their allocation to real estate.

Unless they are able to participate in an existing wholesale fund, or have established a joint venture or club relationship with Australian property groups, new global investors will have to explore innovative approaches to secure assets.

One option is to take over a listed REIT or a wholesale fund and to then take the vehicle private. Last year, Canada Pension Plan Investment Board (CPPIB) partnered DEXUS to take over Australia's former Commonwealth Property Office Fund in a A$3 billion deal. The REIT is now run as an unlisted fund under the management of DEXUS.

"As an investment house, when we take M&A opportunities to large investors they are usually quite receptive, because buying assets on a piecemeal basis in an open competitive bidding process in Australia is both difficult and expensive," says Wan.

He adds: "If there is an opportunity to take a large platform of assets, where they can deploy quite a large check and get control, that would be attractive to them. So we can reasonably foresee more M&A opportunities over the next couple of years."

"Foreign investors are taking foreign pricing into the Australian market."

-Bruce Wan

The fundamentals of the office market in Australian capital cities have remained relatively weak since the global financial crisis. Although leasing is gradually improving in stronger markets like Sydney and Melbourne, landlords continue to pay high incentives to literally 'buy' tenancies to protect their occupancy rate or to kick-start new projects.

Participants say incentives can range up to 30 percent or more on the face value of rent, but there is evidence that net absorption is increasing in these biggest markets and that vacancies are falling. Rental increases will follow, and hopefully incentives will moderate in future.

But seasoned investors such as Weaver remain skeptical that a recovery in Australia's office rental market is imminent. He has heard the prediction once too often.

Unlike past cycles, there is no overbuilding either in Sydney or Melbourne. Certainly, there is no speculative development because lenders demand a reasonable pre-commitment before they are prepared to fund a project.

The supply glut in the early 1990s is not being repeated, even though a huge project like Barangaroo will increase

Sydney's prime office stock by 5 percent when it is completed in 2017. In the 1990s, Wan says 20 percent was being added to Sydney prime office stock over three years, compared to 6 percent over a similar period today.

Hattersley also believes that even though there are a number of development sites with approvals in Sydney today, these are unlikely to get underway until developers have tenants in place.

Lasky says Australia's banks have learned their lessons from the 1990s crash, when they were left holding non-performing loans. The development market today is 'a lender-driven' market and will remain so for some time, he says.

"Most global large institutions would be willing to look at any property style investment as long as a reasonable business or investment case can be made."

-Michael Weaver

With core real estate so hard to come by, foreign investors are being persuaded to look at alternatives, often out of sheer necessity to find a home for their capital.

Weaver says: "We have A$3 billion in our property portfolio out of A$34 billion under asset management, and we are one of the fastest-growing super funds in the country, so we are always looking for new areas for investment, both here in Australia and offshore.

"Most global large institutions would be willing to look at any property style investment as long as a reasonable business or investment case can be made."

"We've invested in holiday and tourism parks in Australia, and are receiving good yield and strong returns from them. However, by their nature, they are alternative asset classes and generally they are not that big, so for larger global investors, most of these asset classes are going to be too small for them to bother with unless there is scale. That is one of the key challenges."

Says Wan: "The key is to create different types of investment grade assets to suit different risk appetites. This is the challenge in a capital-abundant world." He says Macquarie has helped a broad range of entities invest in both emerging and developed markets, including Australia.

Lasky says: "We need to understand the fundamentals in specific strategies, for instance, in student housing. There is absolutely a massive under-supply of student accommodation in Australia."

Australia is the world's third most popular destination for foreign students after the US and the UK. Education is regarded as 'a rising star' in Australia's export sector.

Macquarie's Wan agrees. "There is a very strong and compelling case for various alternative classes like student accommodation, and with a major sovereign, someone like us can bring that sort of niche sector into a fully investment grade sector."

"There is going to be a structural repricing associated with that." But, he adds, getting scale is very much a challenge in terms of acquiring any alternative asset.

Macquarie brought Singapore's sovereign wealth fund, GIC, in to co-invest in student housing last year. The partners formed a joint venture to buy a majority stake in Iglu, an Australian student accommodation provider with a property portfolio worth about A$150 million. "We were attracted by the relatively high yields," says Wan.

Hattersley says the Lend Lease experience has been that asset creators lead opportunities in these niche sectors globally. As a group, he explains that Lend Lease is participating in urbanization through large urban regeneration projects in Australia, Asia and Europe. The group also has a strong delivery capability in the US, and is actively starting to utilize its balance sheet with partners in this market.

Hattersley: development approval doesn't necessarily mean immediate construction

Wan: sees no turning point in the US or Australian economies or property markets

These projects provide access to a range of different types of investment class opportunities, whether they be mainstream office, retail, logistics, student accommodation or retirement villages. "We are a large participant in all those sectors, and we require capital partners in all of them," he says.

"So at the end of the day it is about access to the best deal, and about the right risk-return profiles, and being able to recognize that, at a certain point, the liquidity of a cycle can be challenging, " he says.

No outstrip

Given exponential growth in capital globally and the demand for assets in core markets, such as Australia, is it conceivable that capital will one day outstrip supply of real estate for investment?

Not likely, according to Weaver. "Australia is a relatively fast-growing economy and we will build more office towers, shopping centers and industrial sheds as its population grows," he says. "But I suspect capital could grow faster than supply. The alternative then, is to look offshore. And that is what many Australian funds are talking about."

Looking ahead, the *PERE* participants are bullish about the outlook for Australian commercial real estate.

"We will continue to see demand exceeds the supply of assets and, given progressive tightening of cap rates, we will pay a lot of attention to leading signals of economic and market tipping points," predicts Wan.

"We are looking out to 6 months, 12 months or 24 months ahead for signs of a change in market conditions. So far, none of these indicators are suggesting that sort of turning point in the economy or in the commercial real estate market in the US and Australia," says Wan.

Although more subdued in his expectations, Hattersley is cautiously optimistic, believing that Australia is in for 'a long cycle of positive returns', buoyed by continuing capital inflows and a relatively benign low interest rate environment.

He says the current cap rate compression in not likely to continue and will stabilize, resulting in asset performance becoming more reliant on underlying operating fundamentals.

Ultimately, says Weaver: "Global capital is borderless and values are relative, so if it can't see value in Australia, the capital will go elsewhere." □

Sydney: subject more to international forces today

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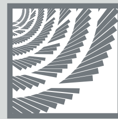
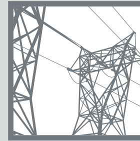

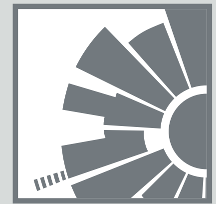

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Needle movers

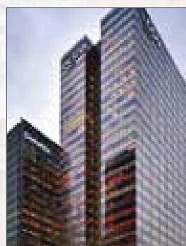
Singapore's GIC, Australia's Future Fund, Morgan Stanley and Blackstone were among the 10 biggest real estate investments in Australia in the past year.

1. **What:** Investa Property Trust, stakes in nine office towers, predominantly in Sydney and Melbourne, including Deutsche Bank Place in Sydney and 120 Collins Street in Melbourne
When: July 2015
Value: A$2.45 billion (5.7 percent yield)
Buyer: China Investment Corporation
Seller: Morgan Stanley Real Estate Investing

The story: The deal represented the largest-ever direct investment in Australian commercial real estate. The portfolio was held on balance sheet at around A$1.9 billion at the end of December 2014. The sale price reflected a 20 percent premium. Annual rental income was believed to be around A$145 million, and when high incentives offered to tenants were taken into account, the passing cash yield was said to set a new benchmark for a portfolio. Investa Property Trust co-owned some of the buildings with two other vehicles in the Investa group.

2. **What:** Waterfront Place and Eagle Street Retail, Brisbane, Queensland 639,892 square feet of space
When: June, 2014
Value: A$635 million (6.35 percent yield)
Buyer: DEXUS Property Group
Seller: The Future Fund and Stockland

The story: This was the biggest single asset transaction in the past year, significantly in Brisbane, a market that is suffering the effect of a global slump in commodities demand. Yet, the sale delivered a 46 percent capital gain to the Future Fund, which acquired a 50 percent stake in 2011 for A$216 .4 million. At the time, Future Fund's head of property, Barry Brakey, commented that the decision to sell was driven more by the life cycle of the asset than the current market. Despite a 10 percent vacancy in the tower, Darren Steinberg, DEXUS' chief executive officer, said DEXUS and its wholesale property fund viewed it as 'an excellent long term core investment'.



3. **What:** CBW Building Complex, Melbourne, Victoria, two office towers, with retail, comprising 875, 113 square feet of space
When: September, 2014
Value: A$603 million (6 percent yield)
Buyer: GPT and GPT Wholesale Office Fund
Seller: CBUS Property

The story: Local and offshore buyers hotly contested for the assets, located at the 'Corner of Bourke and William'. The prize went to Australia's oldest listed REIT, GPT. GPT's chief investment officer, Carmel Hourigan, said Melbourne was a market which would offer positive growth over five years. The acquisition lifted its portfolio weighting in the Melbourne office market to 36 percent. CBUS completed the project in 2010. In what was billed by Australia media as 'the largest sales appointment in Australia', the spoils went to Colliers International and Savills, which handled the billion-dollar-plus sales.

4. **What:** 700 Bourke Street, Melbourne CBD Office tower with 630,000 square feet of space
When: September, 2014
Value: A$434m (approximately 5.7 percent yield)
Buyer: AMP Wholesale Office Fund
Seller: CBUS Property

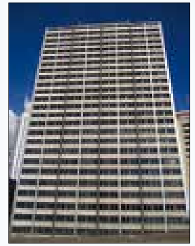
The story: This was sold in tandem with the CBW Complex. With the two sales, vendor CBUS Property, a division of superannuation fund, CBUS, has lifted its war chest by just over A$1.1 billion to fund existing and future development pipeline. The asset is attractive because of a 15-year lease to National Australia Bank, one of Australia's big four commercial banks. AMP Capital Investors had been on an acquisition trail to grow vehicles under its management, including the AMP Wholesale Office Fund, following an A$2 billion capital raising last year.

5. **What:** International Tower 1, Barangaroo, Sydney, a 49-storey tower with 101,000 square feet of space
When: June, 2015
Value: A$525 million for a 37.5 percent stake (5.5 percent to 6 percent yield)
Buyer: Qatar Investment Authority
Seller: Lend Lease

The story: The transaction set a new benchmark in Sydney and demonstrated the hunger of international capital for Australian trophy assets. Tower One carries a price tag of A$2 billion. The building, due to be completed in 2017, will be held in an open-ended trust, with QIA and Lend Lease, both holding 37.5 percent interests, with Lend Lease the remaining 25 percent. Towers 2 and 3 have been sold to international pension funds and domestic super funds. The three large towers form the heart of the A$6-billion Barangaroo project, currently the largest urban regeneration project in Australia.

6. **What:** 1 Alfred Street, known as Goldfields House, Circular Quay, Sydney
Value: A$415 million:
Buyer: Dalian Wanda
Seller: Blackstone

The story: After more than six months of negotiation, Blackstone finally let the ageing office building go to Dalian Wanda. The price astonished many, who said it would have fetched considerably less if sold as an office building. The value to the Chinese developer is the redevelopment potential. Asian and Chinese developers have paid top dollar for B-grade buildings in the CBDs of Melbourne and Sydney, planning to redevelop them into residential towers. Wanda Dalian has a billion-dollar plan to build a five-star hotel, shops and luxury apartments. Agents expect two-bedroom apartments to cost around A$5 million each, while the penthouses are expected to fetch as much as A$100 million each.



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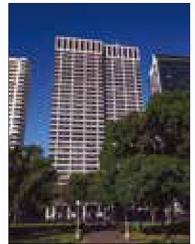
7. **What:** 175 Liverpool Street, Sydney, 29-storey office building, 515,000 square feet of space
When: November 2014
Value: A$392 million
Buyer: Shimao Property
Seller: GIC

The story: Agents originally expected the building to sell for around A$300 million, however, frenetic demand from Asian developers pushed the final price to A$392 million. This was GIC's first office investment in Australia, bought in 1996 for A$125 million. That acquisition marked the start of a decade or more of GIC buying in Australia, under the guidance of Seek Ngee Huat, former president of GIC Real Estate. Like other astute investors, GIC has started to take profit from its Australian investments and has earmarked 25 assets, valued at around A$2.5 billion, including a billion-dollar industrial portfolio for sale.



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8. **What:** Mount Ommaney Shopping Centre, Queensland, a shopping mall of 613,548 square feet of space
When: October 2014
Value: A$416 million
Buyer: TIAA-Henderson (75 percent) and Federation Centres (25 percent)
Seller: AMP Capital Investors

The story: This marked the entry of TIAA Henderson Real Estate, owned by US financial services group, TIAA CREF, into Australia's tightly held regional shopping centre investment market. Unlike offices, regional shopping centres in Australia rarely come to market and when they do, competition is fierce. According to Lachlan MacGillivray, Head of Retail Investment Services with Colliers International, there is in excess of A$10 billion of available capital chasing major retail centres in Australia. TIAA Henderson said the deal underpinned its long-term strategy to build a sustainable business in Australia.

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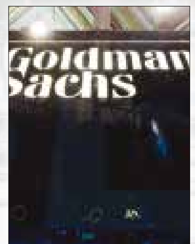
9. **What:** Arena Portfolio, office and retail buildings located in three states
When: Jan-May 2015
Value: A$405 million
Buyer: Anton Capital, on behalf of Goldman Sachs, and private Australian investor Precision Group
Seller: Morgan Stanley Real Estate Investing

The story: These assets were held in funds run by Arena Funds Management, previously Orchard Funds Management. Morgan Stanley bought the platform in 2011 'as a classic recap play'. It injected A$200 million into the business, restructured it and then rebranded it as Arena Funds Management. Morgan Stanley began last year to wind up its Arena investment and to divest about A$500 million worth of real estate held in three frozen funds. Through Anton Capital, Goldman Sachs secured the Arena portfolio of five office buildings. The US investment bank also recently backed an Australian manager, Propertylink, in an A$300-million office and industrial deal.



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10. **What:** 101 Miller Street and Greenwood Plaza, a 27-level premium office tower with some retail, 487,539 square feet of space
When: October: 2014
Value: A$305 for a 50 percent stake; blended yield 6.5 percent
Buyer: TIAA Henderson
Seller: Eureka Funds Management

The story: TIAA Henderson Real Estate reportedly outbid Blackstone Group and Australian funds manager ISPT to buy the stake in what has been described as 'one of Australia's limited stock of 35 premium office towers'. The listed Mirvac Property Group holds the other half stake in the 16-year-old building, which occupies an entire North Sydney CBD block. Eureka executives are known to be keen to recycle capital to pursue buying opportunities outside CBD locations. They hold the view that CBD prices are overheated because of 'an extreme weight of capital' chasing assets.

A$2.4 billion

The amount that China Investment Corporation (CIC) paid to acquire the Investa Property Trust from MSREI

5.2 percent

Exit cap rate reflected by the sale of Melbourne's Spencer Outlet Centre by Blackstone and MSREI for A$125 million to a private investor

$174 million

Was paid by Australian fund manager QIC for San Francisco's The Shops at Tanforan, its first fully-owned property investment in the US

6.4x

EBITDA multiple reflected by the purchase price of €145 million paid by Cromwell Property Group to acquire Valad Europe

7.9 percent

The annual yield reflected by the price paid by KKR in partnership with Abacus Property Group to acquire a Queensland shopping center

25 percent

The size of the stake in Sydney's Liberty Place acquired by Ivanhoé Cambridge in partnership with Blackstone, marking its first direct investment in Australia

A$18,000

Record price per meter paid by Dalian Wanda Group to acquire Gold Fields House in Sydney from The Blackstone Group

5,000

Beds to be developed in student accommodation centers across Australia by a joint venture partnership between APG Asset Management and Scape Student Living

21 years

Time spent by LaSalle Investment Management's Ian Mackie in Singapore before his decision to relocate to Brisbane was announced in May

12

New childcare centers to be developed by Australian Childcare Projects, the firm bought by MSREI in February

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