Charter Insight

Global Trade & Commercial Real Estate Investment - A FIRB Review

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RESEARCH

Prominent attention and public discussion about offshore investment into Australian real estate has overwhelmingly focused on residential assets. Given the competing functions of residential real estate as an investment as well as responding to basic physical and social needs there is, rightly, greater scrutiny regarding the possession and use of this particular asset class.

It should however not be overlooked that a significant proportion of offshore real estate investment, ranging from global institutions to high net worth individuals, has still been directed to Australia's commercial property markets.

While significant sums of money are invested into Australia's commercial real estate market, the simplistic interpretation of FIRB data to accurately quantify international investment is highly flawed. The requirement to trigger a FIRB approval represents a significant capital sum which is inconsistent across multiple investor types and countries. These approvals overlook investment from relevant investor classes and lead to difficulties in drawing meaningful conclusions from the data.

HIGH THRESHOLDS AND LOW ACCURACY

Due to the significant capital thresholds required to trigger a FIRB approval for commercial property, the use of FIRB data in isolation significantly under-represents the true level of investing in commercial assets by foreign interests. Depending on the property type, investor type or country this trigger point can range from $0 to $1.134Bn as of 2018.

See Figure 1 Below - FIRB Approval Thresholds by Investor Type 2018

This high trigger requirement is further complicated by the ability for non-residents to own a commercial strata interest without needing FIRB approval. The value of the interest, rather than the asset, must exceed the trigger value so that foreign ownership of a 50% interest in a $1.5Bn asset may not require FIRB approval if the investor is from a country with a $1.134Bn threshold value (as of 2018). Ultimately an investment that does not trigger a FIRB approval is not recorded in the public FIRB data.

FREE TO TRADE - SOME INVESTORS MORE EQUAL THAN OTHERS

The thresholds for FIRB approval differ depending on the individual investor profile and whether the foreign investor's country of residence has a Free Trade Agreement (FTA) with relevant commercial real estate partner agreements with Australia (these agreements are not in all FTA agreements). As future FTAs are ratified, thresholds for FIRB approvals will also adjust.

In many instances, the nature of commercial real estate lends itself to institutional ownership, which will look to maximise the earning performance of the asset and

Figure 1: FIRB Approval Thresholds by Investor Type

INVESTOR	COMMERCIAL	THRESHHOLD	COUNTRIES
Private Investor with Free Trade Agreement	Vacant Land Developed Commercial Land	$0 $1.134Bn	Chile, China, Japan, New Zealand, South Korea, United States and Singapore
Private Investor with No Free Trade Agreement	Vacant Land Developed Commercial Land	$0 $261M	All Others
Foreign Government Investors	All Interests	$0	All

SOURCE - FIRB

Jonathan Mayes
Senior Analyst - Charter Research
jonathan.mayes@charterkc.com.au
T +61 (0) 3 8102 8823

promote leasing of the asset. This is in contrast to perceptions of vacant dwellings (which have led to the introduction of a vacancy levy) as well as land-banked development sites in the residential market.

Investment in strata titles within institutional -grade assets creates an additional layer of complexity. Offshore investment into strata commercial real estate is likely to fall below FIRB thresholds. Smaller commercial assets (at least less than $252M), the likely target of High Net Worth Individuals (HNWIs), will be excluded from FIRB approvals data and will result in a much lower reported foreign investment figure compared to actual investment.

Ultimately, given the profile of investors from major countries with which Australia has ratified FTAs, any assessment of commercial real estate FIRB approvals data will effectively only reflect major asset transfers, portfolio transactions and foreign government purchases at best without due consideration for cumulative investment across smaller assets.

FREE TRADE AGREEMENTS AND COMMERCIAL REAL ESTATE INVESTMENT

As FTAs with commercial real estate partner agreements are progressively ratified, this will increase the FIRB threshold for investors from those respective countries that previously had no agreement. Commercial FIRB approval figures will therefore be materially impacted and comparisons to historic FRIB data will become increasingly irrelevant.

By ranking FIRB approvals by country relative to their FTA status with Australia, we can consider the extent of shortcomings in drawing conclusions from FIRB data for foreign investment into commercial real estate.

The majority of countries with the highest value of Real Estate FIRB approvals (Commercial and Residential), are also Australia's FTA partners with real estate partner agreements. See Figure 2.

Figure 2: Top Ten [FIRB FY 16] Real Estate Investor Nations and Agreement Country Investor Status

RANK	COUNTRY	FTA PARTNER AGREEMENT
1	China	Yes
2	United States	Yes
3	Singagpore	Yes
4	United Arab Emirates	No
5	Canada	No (potential through CPTPP)
6	Hong Kong	No
7	Malaysia	No (potential through CPTPP)
8	Japan	Yes
9	South Africa	N
10	South Korea	Y

SOURCE - FIRB (FY2016) & DFAT (2018)

Notable recent changes to, or new, Free Trade Agreements with real estate partner agreements impacting commercial property thresholds include:

- Increase in lower threshold from $55m to $252M (indexed) or non-sensitive uses in 2015 (all non-government investors).
- United States (March 2013).
- China (December 2015).
- Japan (January 2015).
- South Korea (December 2014).
- Singapore (January 2018).

The recently agreed in principle Comprehensive and Progressive Agreement for Trans Pacific Partnership (CPTPP), if enforced, could add more major real estate FIRB approval countries that qualify for the higher threshold. Of further consideration is that as FTAs are ratified, historic FIRB data reflects on the conditions that prevailed in the year of publication and are not revised to reflect the new conditions. This lack of continuity in FIRB data limits the ability to perform accurate time series analysis leading to misinformed and/or false conclusions. Indicated falls in commercial FIRB approvals can therefore be the result of shifting thresholds and FTA agreements rather than changes in international investor participation.

SUBURBAN OFFICE MARKETS AND LOWER VALUE COMMERCIAL ASSETS

Investment in commercial assets by international HNWIs across lower-value commercial assets, such as suburban office or retail buildings, will not be measured by FIRB approvals data. Nonetheless this international capital still cumulatively amounts to a sizeable quantum of foreign investment into Australia.

See Figure 3 Below - Value of Commercial FIRB Approvals by Type - Australia (FY2013-FY2016)

Exclusion of offshore investment into lower-value assets further challenges the validity of aggregate FIRB data (commercial and residential) by country or category. Relying on this data for conclusions regarding offshore investment will likely lead to significant under-reporting of actual investment.

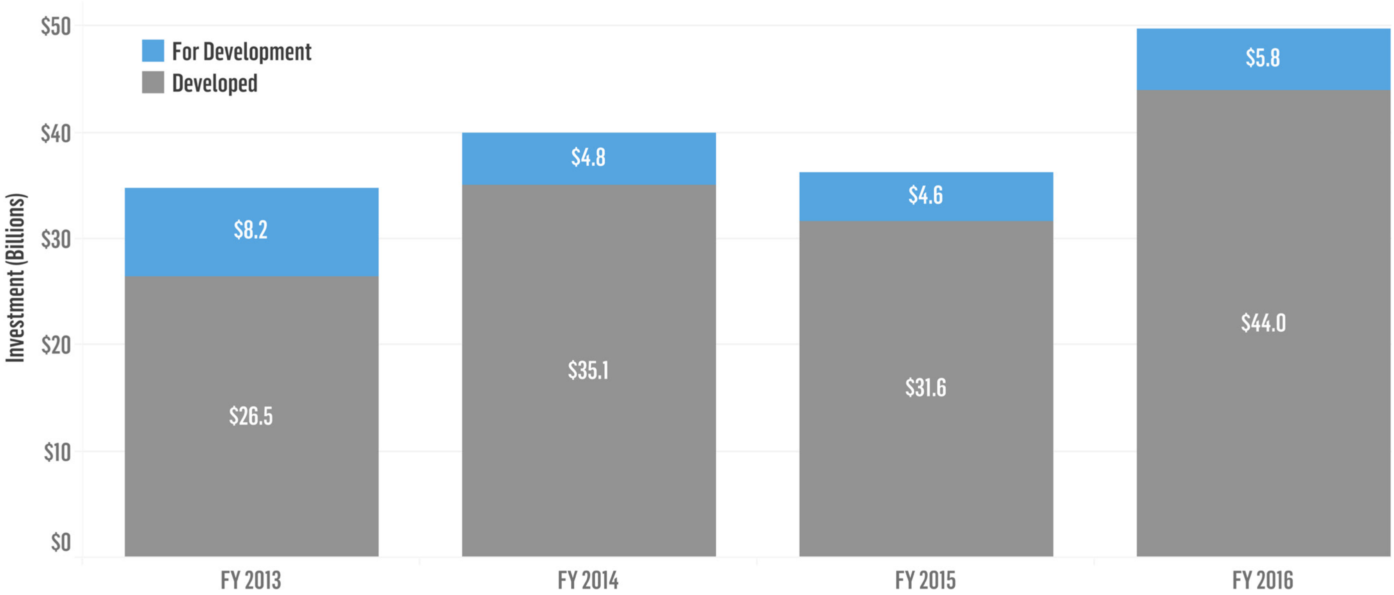
See Figure 4 Next Page - Value of Commercial FIRB Approvals by State (FY2013-FY2016)

QUANTIFYING INVESTMENT: WHAT FIRB SAYS

While comprehensive time-series analysis of FIRB data relating to Commercial investment is not possible there are still some interesting narratives from looking into FIRB data (even a broken scale can help determine relativity).

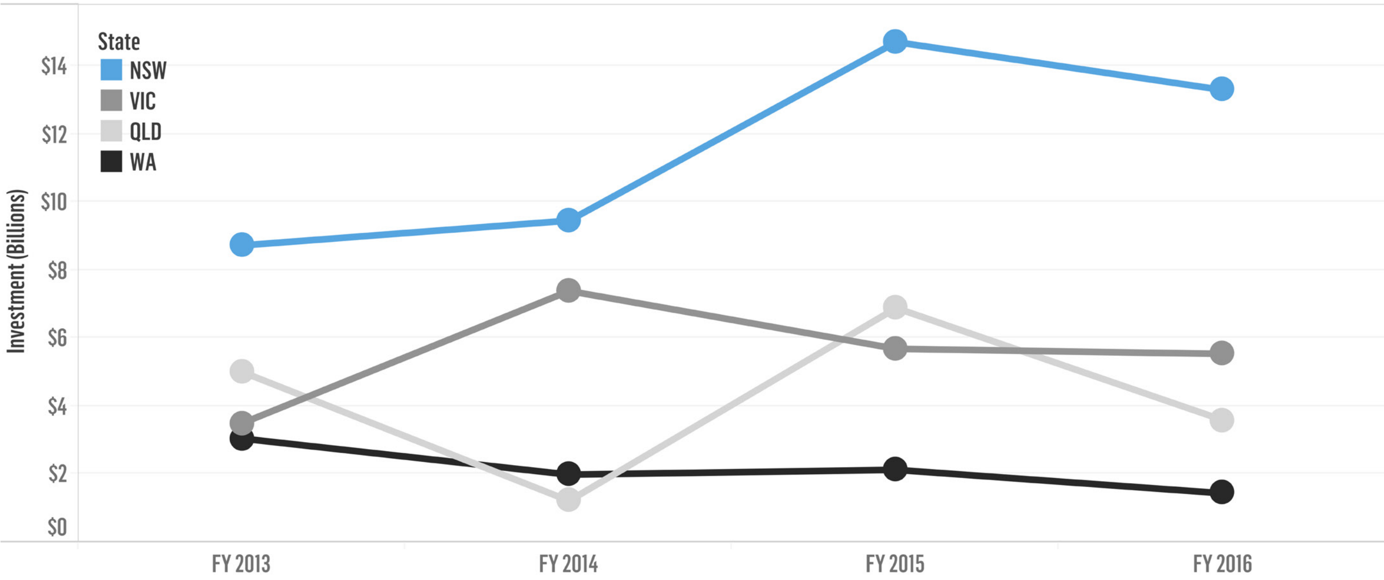
There is a specific focus on improved ("developed") commercial assets, rather than assets "for development", highlighting Commercial assets held for income from institutions rather than for development. There was significant increase in FIRB approvals through FY16, despite CHAFTA coming into effect through this period.

Figure 3: Value of Commercial FIRB Approvals by Type - Australia [FY2013-FY2016]



SOURCE - FIRB

Figure 4: Value of Commercial FIRB Approvals by State (FY2013-FY2016)



SOURCE - FIRB

NATIONAL COMMERCIAL FIRB APPROVALS

NSW has been the primary focus of Commercial FIRB approvals (with consideration for assets and respective values that qualify for an approval) with Queensland and Victoria interchanging as the next highest destination (although Victoria is less volatile than Queensland, with regard to values of FIRB approvals for commercial real estate investment.

COMMERCIAL INVESTMENT BENEFITS

There are additional benefits to foreign purchasers (especially HNWIs) that invest in commercial assets that do not exist for offshore residential investors. This includes:

- No Stamp Duty Surcharge (7% in Victoria, 8% in Sydney and 3% in Queensland for residential).
- No Vacancy fee (1% Capital Improved Value).
- No FIRB application fee.

Fewer regulatory hurdles are also required except for high thresholds (above $261m or $1.134Bn depending on country and investor).

If viewed through the lens of a dispassionate investment, commercial real estate offers investors a means of regional diversification with comparable returns to residential assets, potential development upside through a change of use and at a lower transfer cost (all else being equal) for international investors in commercial real estate assets.

The perception that some offshore purchasers have ulterior motives for investing in residential real estate, such as to domicile funds in safe havens may be correct to some extent but it would appear that commercial real estate assets offer a cheaper means of achieving this objective rather than via residential investments.

CONCLUSIONS

The simplistic use of aggregated FIRB data as a means of measuring commercial real estate investment is fundamentally flawed given how, when and what type of data is collected. The thresholds that determine the application of FIRB regulations can increase with FTAs, which reduce the requirements for FIRB approval for investors from member nations and lowers the measured FIRB approvals without consideration for actual underlying investor activity.

Ultimately, commercial real estate increasingly now provides cheaper transaction costs for international investors (investing below the FIRB thresholds) through the avoidance of FIRB requirements and associated levy's with less regulatory hurdles to own, especially for HNWIs looking to diversify their portfolios.