Observations on Global Property & Infrastructure Markets

Europe & North America Research November 2013

Frontier Advisors Pty Ltd

International Research Issue 04

Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture.

Our research team

Chris Trevillyan and Tom Frederick from our Real Assets Research team travelled to the United Kingdom, Brussels, the Netherlands, Canada and US in November 2013, meeting with a range of property and infrastructure oriented managers and visiting key assets. More than 20 fund managers and other organisations operating in these markets were visited onsite as part of this research.

Chris Trevillyan

Tom Frederick

QE & interest rates

It is hardly ground breaking to identify the inevitability that interest rates on government securities are expected to rise in coming years. However, this is clearly a key theme across markets globally that investors are considering.

Virtually every manager we met with during this research spent some time discussing Quantitative Easing (QE) tapering[1], rising interest rates and potential impacts on investments.

In many cases, managers had undertaken specific research on the likely impact of rising interest rates, which was not surprisingly skewed towards a positive (or not negative) outcome for property and infrastructure investments. The general consensus was that although asset yields (e.g. capitalisation (cap) rates[2] for property) are historically quite low in absolute terms, relative to government bonds the spread remains above historical averages in many regions/markets.

They argue this is providing a “cushion” and while the spread will likely reduce from current levels, cap rates will not necessarily increase as government bond yields rise.

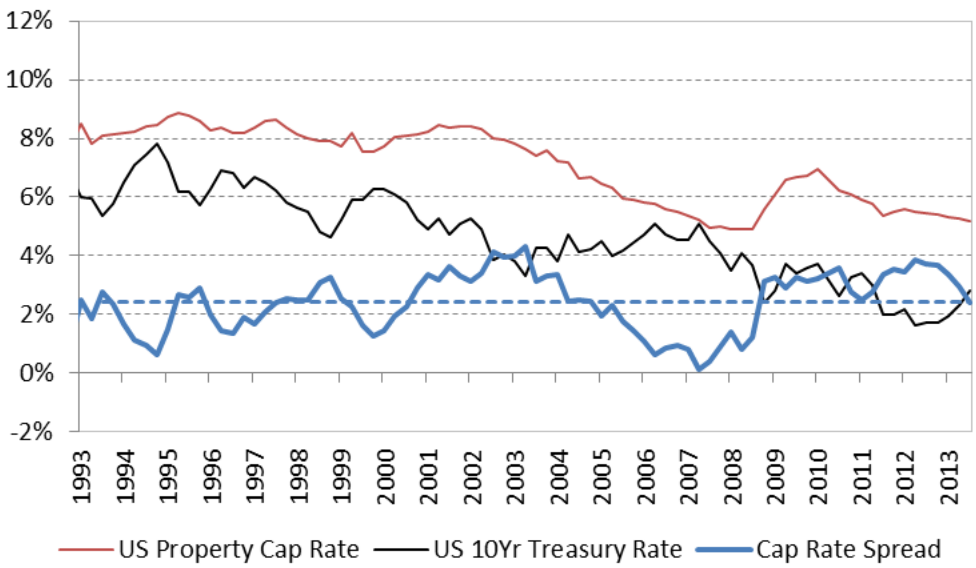
Secondly, there is the expectation increases in government bond yields will likely be linked to improved economic growth and potentially some increase in inflation, which will drive growth in asset revenues (e.g. property income and also CPI-linked cash flows from infrastructure assets).

Prudential Real Estate Investors, for example, noted that historically during rising interest rate periods, growth in net operating income (NOI) of US property was 4.7% p.a. versus 2.4% in non-interest rising periods.

We have reviewed a range of data relating to property cap rates and bond yields.

The US property cap rate spread above 10 year government bonds has been on the high side but with recent bond rate increases and cap rate declines it is now at around the long-term average spread of 2.4% (see Figure 1).

Figure 1: US cap rate v 10 year bond rate



Source: NCREIF, Federal Reserve, Frontier

1: *Quantitative easing tapering* refers to the US Federal Reserve reducing its efforts to increase money supply and keep interests rates low by buying securities (eg Government Bonds)
2: *Capitalisation rate* estimates the annual return on an investment by dividing net income by value

QE & interest rates continued

If government bond rates were to increase by 1.0-1.5% then the spread would move quickly below the historic average. If the spread was to remain at the historic average level, then property cap rates would also expand.

In Australia, the compression in property cap rates has been much less (from 7.5% in 2010 to 7.2% currently) and the spread above Australian 10 year government bonds is higher at around 3.5% (Figure 2). This means Australian property potentially has greater capacity to withstand interest rates rises without asset devaluation.

Given the heterogeneous nature of the infrastructure sector it is difficult to obtain meaningful sector level valuation data.

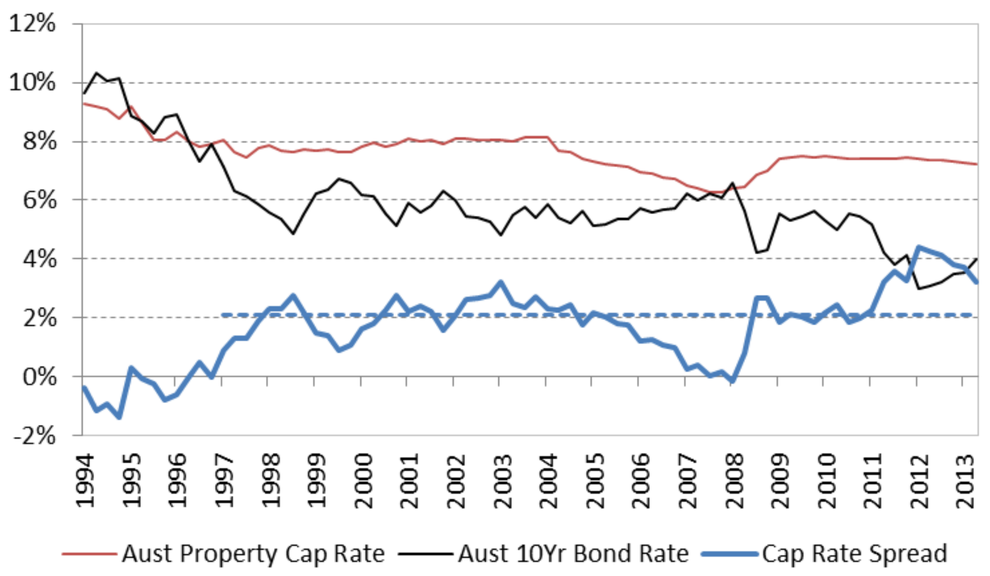
However, discount rates appear to be contracting (based on the sample of unlisted infrastructure assets that Frontier monitors and what we observed in person). However, they still provide a meaningful premium above government bond rates (often incorporating a specific “alpha” factor to allow for current low interest rates).

A key consideration is that property and infrastructure are long dated investments that are particularly impacted by a change in the valuation multiple. We estimate that unlisted property has a modified duration of around 15 years and for infrastructure, depending on the asset, this may be even more.

Therefore, as a rough estimate, an increase of 1.0% of the valuation multiple (e.g. cap rate) could lead to 15% or more decrease in the valuation of the investment. Significant growth in earnings would be required to offset that level of capital depreciation if it were to occur.

Managers are generally relying on (and expecting) the Fed to efficiently manage the exit from QE and near zero interest rates, so an increase in interest rates will be in congruence with stronger economic growth and therefore strong asset fundamentals (e.g. higher rents and lower vacancies in property), rather than a possible outbreak of inflation and /or loss of consumer confidence.

Figure 2: Aust cap rate v 10 year bond rate



Source: IPD, RBA, Frontier

Core is king

It was clear from our meetings with managers and investors that demand is clearly focussed on “core” assets (in infrastructure and property) and competition to acquire is particularly high, be it regulated utilities, office properties in London or retail malls in the US.

This is being driven by large pension and sovereign wealth funds allocating increasing capital into alternative real assets, and looking for large scale, lower risk, but higher yielding than government bonds, investments.

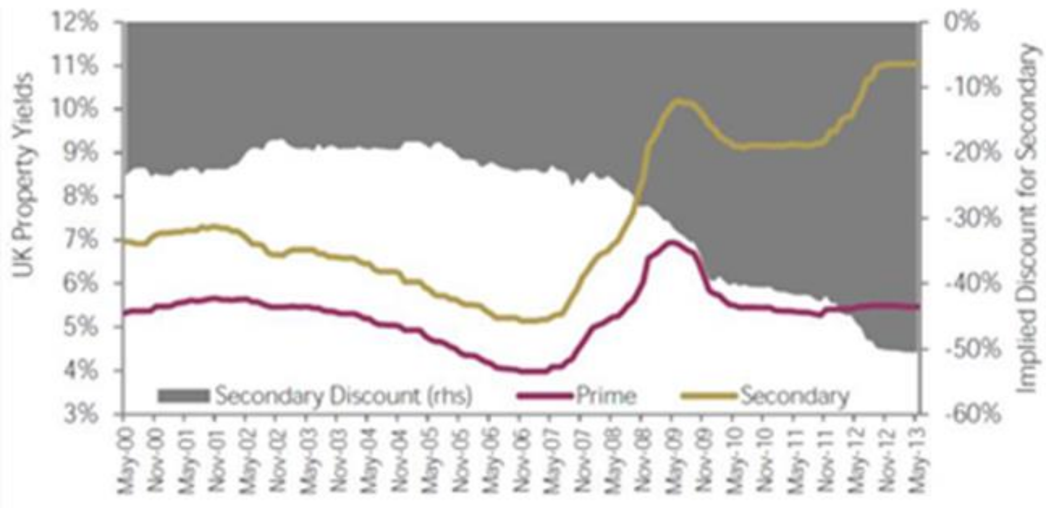
It means the pricing gap between core and non-core assets can be quite large.

Figure 3 shows the divergence in yields between prime and secondary UK office properties, while Figure 4 on the next page shows the significant yield spread for smaller scale UK property assets.

Managers (in both infrastructure and property) are actively seeking out opportunities that are not straight core (e.g. “complicated” transactions and /or assets requiring some repositioning activity).

Managers are trying to identify an “edge” (e.g. strategic partner, fully equity funded) to avoid a straight cost of capital competition, although we are highly sceptical of most claims of “proprietary deal flow”.

Figure 3: UK office yields



Source: CBRE

Core is king continued

However, the "opportunity" to invest in non-core assets is not necessarily clear cut.

Assets are "secondary" for a reason and market fundamentals may be quite weak, transactions are more complicated, often require "value-adding" strategies, and scale may be limited. Additionally, pricing may be attractive relative to other asset classes but still low in an historic context.

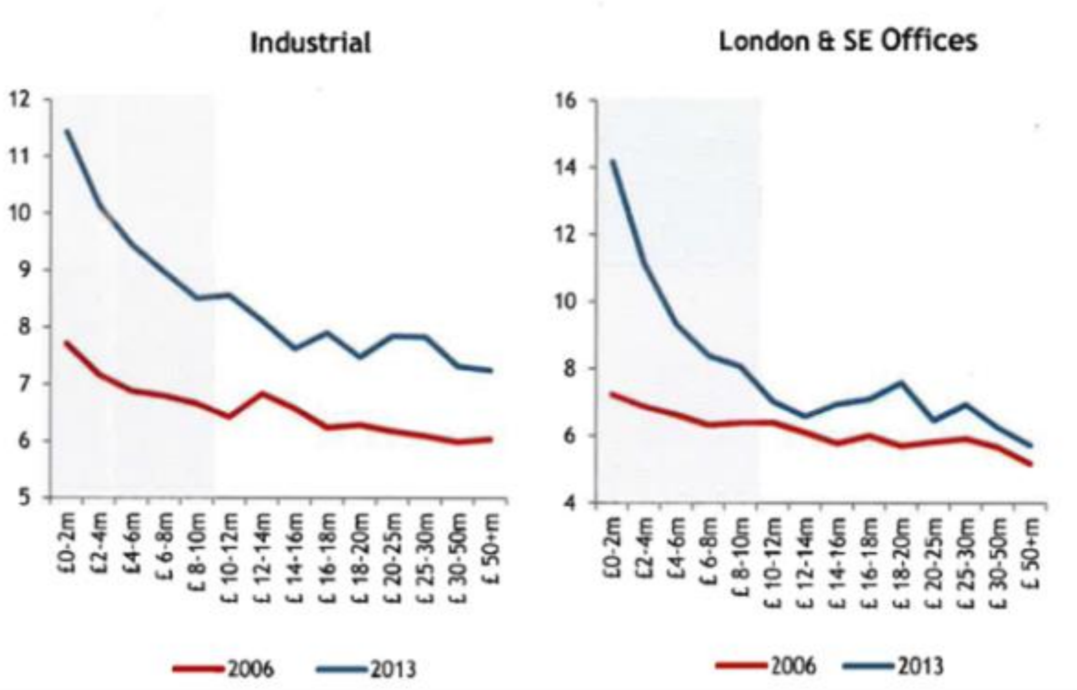
Is moving up the risk spectrum the desired strategy at the current point in the cycle?

Our conclusions are that investors need to be selective, to identify high quality, experienced, active managers in targeted segments of the market that offer attractive risk adjusted returns.

In the current market, the optimal strategy may be a more downside protected approach that will not necessarily receive all the upside if secondary assets re-rate to core assets but is not reliant on this re-rating occurring and will provide a healthy risk adjusted return in a number of potential scenarios.

This means the more attractive alternatives will be very niche and opportunistic in nature, for example, mezzanine debt, UK secondary market property or New York residential repositioning.

Figure 4: UK property equivalent yields



Source: AEW, IPD

European infrastructure

Some investors view Europe in general as a secondary market. However, sentiment is materially less negative (in some cases positive) than 12 months ago and certainly from two years ago, when discussions were fixated on whether the Euro would survive and what economies would fail next.

There are still major issues requiring major structural reform and there is little expectation of strong economic growth but perhaps some stabilisation.

Significant capital is being invested in European infrastructure by global investors, particularly in core markets as discussed in the previous section, and there are emerging signs of increased interest in peripheral European markets.

Increased capital inflows and demand for infrastructure assets suggest a pessimistic outlook for acquisition returns in European infrastructure, for example UK regulated assets appear to be transacting at as low expected returns as at any time in the past.

This may continue to play out through 2014 and pricing may become even more stretched.

However, the potential offset to the increased demand of capital to invest in the sector is the potential supply of European infrastructure investment opportunities in the coming year.

Managers we met with provided as extensive a list of potential deal pipelines as we have seen in the past, including large scale continental European utilities, regional airports, telecommunications companies, power generation and renewables, roads secondaries and seaport expansions. Obviously, not all potential transactions will progress to closed transactions.

However, these deal pipelines assume little government privatisation activity, which based on the relatively slow pace in previous years is probably a reasonable assumption, although it would be expected that government funding issues will at some point drive privatisations.

Therefore, although demand is clearly high and increasing for European infrastructure investment, the large supply of opportunities may be supportive of new investment in the coming year, and selective opportunities may be quite attractive.

Managers visited

Access Capital Advisors	AMP Infrastructure Europe	Arcus
Rockspring Investment Management	Deutsche Asset & Wealth Management	Prudential Real Estate Investors
IFM Europe	Aquila	Bastion
Brookfield	Northleaf	IFM New York
I Squared Capital	Macquarie	AEW Europe
Europa Capital	European Investors Inc	Franklin Templeton
Henderson Global Investors	Hastings	Resolution Capital
Challenger	Sentinel	

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