FRONTIER ADVISORS

20 years

Observations on Real Assets

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Frontier Advisors Pty Ltd

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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. We would be pleased to meet with you in person to provide further detail on these observations.

Our research team

In July 2014, members of Frontier's Real Assets Team travelled to the UK, Canada and the US. A focus of this trip was to meet with a range of key cross border global pension fund investors in Canada and the US to discuss their approach to real assets. Our discussions covered a broad range of themes from a variety of perspectives, allowing us to capture a sense of what some of the major global real asset investors are thinking, and of the key issues currently on the table. In addition, Frontier sought out a wide-ranging cross section of dynamic and innovative real assets managers in the mid-market and core plus market segments. These managers see their competitive advantage as utilising local knowledge, skills and networks, combined with transactional and management experience. Indicative forecast returns discussed were in the range of 8-15% p.a. (net), dependent upon market segment and extent of leverage.

Tim Stringer

Gilly Zimmer

Tom Frederick

Background

The post GFC world of real asset investing has emerged as a period of fundamental change in focus, with global capital allocators in the leading pension funds focussed on the benefits and characteristics of real estate and infrastructure, namely low volatility and high income cashflows, with capital value growth.

Major investors are looking for high-quality real assets where value is directly linked to growth in the real economy and with exposure to markets where investment income is indexed to inflation and thus partially hedged against future inflation risks.

As a result, there has been an increasing trend for major investors with a global perspective to rebalance their portfolios by increasing their allocations to real assets.

These investors are generally long term holders, not active traders, and tend to allocate a bulk of their portfolio to the higher grade assets and locations, with expectations of generating returns from these assets through the longer term investment cycles.

Larger funds over the short term tend to be naturally capped on their infrastructure allocation, given the nominal dollar amount to invest is significant and the opportunities to make investments are relatively limited at any given time.

Some major pension funds have significant allocations to real assets in their multi asset class funds, being well above average levels found in many Australian institutional investors.

Frontier had the opportunity to meet and discuss these developments with thirty five fund managers across the UK, Canada and the US, along with five major North American investors, to discuss their approach to real assets, their views on the current marketplace, and their outlook for the various sectors in the medium term.

Collectively, these investors manage around C$580 billion, with approximately C$88 billion invested in property and infrastructure. Three of the five funds have in excess of 15% real assets exposure, with one approaching 30%.

While the majority have been investing in real assets for a significant period of time, two of the five investors are relatively new to the infrastructure sector.

Interestingly, three of the five funds have established their own separate businesses to make and manage their property investments with one also establishing an infrastructure management subsidiary.

Discussions held with the pension fund investment teams covered a broad range of themes and a variety of perspectives, allowing Frontier to capture a keen sense of what some of the major global real asset investors are thinking, what their individual approaches to investing in real assets are, and some of the key issues currently on the table in terms of both challenges and opportunities.

Given the evolution of the larger global pension funds, there is much to compare and reflect upon when looking at the inevitable move by Australian superannuation funds to employ capital into real assets globally.

Growing allocations to real assets

Current target allocations to real assets vary across the investors we met with and range from 6% to 45%, where typically the more experienced investors (up to 20 years of experience) have the larger target allocations. What was consistent among investors (regardless of existing allocation, funds under management or fund growth), however, was a clear trend of looking to increase their allocations to real assets over time.

One investor is now cash flow negative but is aiming to materially increase its allocation to real assets over the short to medium term.

The investors are generally not too concerned about liquidity, and are tackling the illiquidity issues of the asset class through a larger allocation to cash and having a very good knowledge of the secondary market.

Expanding teams and nimble investors

Direct investors in Canada range from pure financial investors to having investment and strategic operational teams across geographies and sectors.

Some very large investors have built out their teams to include ex-industry leadership to assist in due diligence and asset management. Most large Canadian funds are very heavily resourced across transactions, asset management and research/macro analysis and all teams we met with are looking to increase resourcing in the near term, particularly as it relates to asset management.

Those investors that are relatively new to real assets, or without the significant scale of the largest funds, have smaller investment teams and rely exclusively on fund managers and commingled funds.

Given this limited experience, minimal resources and often complicated governance structures, these investors are unlikely to change the way they access real assets in the medium term.

Many larger investors are pushing ahead into emerging markets in response to the level of competition for core assets in the OECD markets.

While pressure to invest has created the need for many investors to move into new markets and/or up the risk curve, the key enablers for investment have historically been the level of internal resourcing and agile governance structures.

The more active investors rely on a dynamic governance structure, where boards and committees can respond in real time (e.g. being available at 48 hours notice).

In addition, the internal teams at these funds also have significant delegated authority, while additional approvals (i.e. board approval) are typically required for an investment of greater than US$500 million.

Teams have the authority to make an investment of less than US$200 million and, in some other cases (e.g. investments greater than US$200 million but less than US$500 million), the CIO has authority to sign-off on new investments.

Such governance structures have enabled these investors to consider direct investments that require very tight turnaround times - anecdotally, a very large direct real estate opportunity was agreed and finalised in two weeks.

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Shared concerns on a competitive market place

All investors agreed the core real asset markets are highly competitive and very expensive.

Within the infrastructure sector, the consensus view is that pricing is likely to increase further (as the unofficial 9-10% required return threshold that many investors benchmark against - directly or loosely - has been breached), and that equity returns will continue to compress.

In the property sector, prime assets in the top markets are transacting at extremely tight yields - Lend Lease's 30% stake in Bluewater, a prime retail shopping centre in the UK, was sold on a yield of approximately 3.85% to Hammerson.

On the debt side, investors are looking to take advantage of the current liquid environment to lower debt costs and extend maturities where possible but are very wary of rising interest rates and as such not looking to over extend assets.

Concerning property, the use of leverage offshore is more pronounced than in the Australian context, however in terms of debt, the GFC appears to have shaped funds' thinking, with a considerable focus on the potential downside of excessively high levels of debt.

All investors Frontier met with take a conservative approach to gearing, and coverage ratios, and see refinancing in the infrastructure sector as a real risk in the medium term, particularly as the currently level of liquidity across institutions, banks, pension funds and more recently Collateralised Loan Obligations (CLOs) persists.

Property observations on the capex cycle

As markets continue to get stronger and gain momentum, many of the major pension fund investors and fund managers that Frontier met with are identifying more risk being transferred from vendor to purchaser.

The underwriting assumptions and due diligence processes associated with achieving their desired returns demand that the internal teams are adequate in terms of both numbers and skills to execute the types of major transactions occurring in global cross border deals.

Understanding the investment case and price paid as compared to the current market value is a key area of focus for the investment teams.

In some markets this has moved too far from fair value, and cap rates of the best premium assets in some gateway cities have been bid down to levels that do not provide value and fail what some see as the initial screening test.

In these situations, when "information advantages" are minimal, investment becomes a cost of capital shoot out.

The pension funds are looking for innovative things to do, rather than just writing larger and larger cheques.

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New and interesting sub-sectors and geographies

In response to market pricing, there is a clear trend of investors broadening their views on portfolio construction, including core-plus strategies and some non-traditional sectors, in some cases moving up the risk curve with managers expert and experienced in these markets and asset classes.

In the infrastructure sector, greenfield investments and emerging markets are being considered, while some have already made the charge into select markets such as Latin America (Peru and Chile) and the Czech Republic.

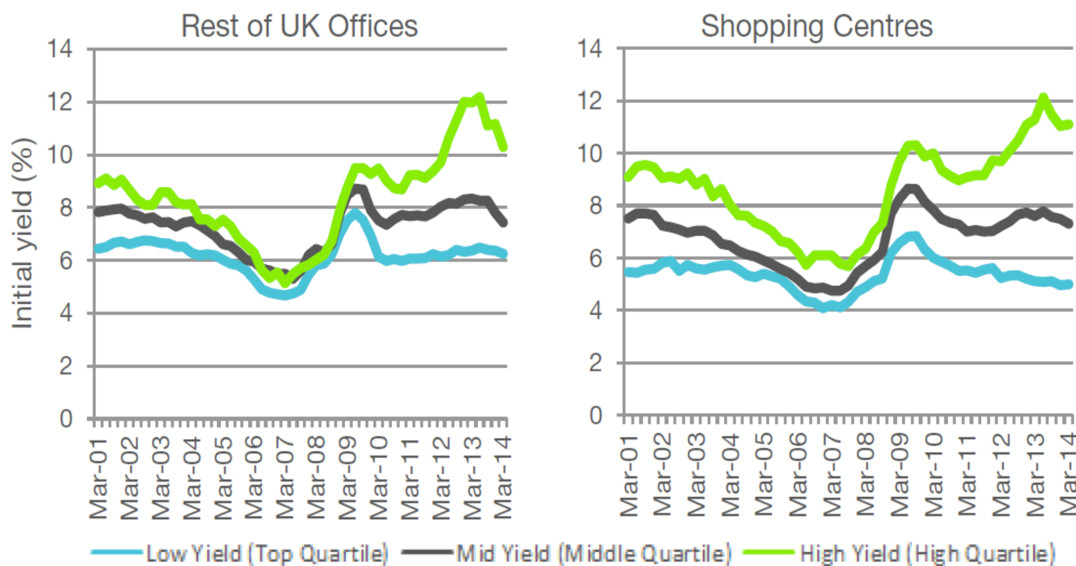
Although investors are talking up the opportunity set in Asia, particularly in China and India, few have made the bold move and for those that have, the capital deployed to date has been minimal and into relatively small strategic investments.

In the property sector, value-add strategies (short lease or material capital expenditure requirements), regional markets (Manchester in the UK) and "riskier" (e.g. southern European) markets are being targeted.

Yield compression at the prime end of the property market has, in some regions such as the UK, had a significant influence on the velocity of the yield compression experienced in the secondary markets.

As seen in Chart 1, yields have compressed more quickly than in previous cycles (within a period of 18 months) and generally caught most investors in the secondary market off-guard.

Chart 1: UK property market yield compression



Source: IPD

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What about ESG?

All direct investors seek solid governance in their investments and at a minimum, require negative control of key issues. Further, investors that have built out operational teams with extensive asset management experience are targeting co-control or majority control in all new investments being made.

From "E" and "S" perspectives, awareness to date has been more limited. There is, however, general consensus among all the investors we met with that environmental and social issues are important for long duration assets, such as infrastructure and property, and will form a much larger part of their due diligence and asset management going forward.

Boards are also becoming more active on these subjects, requiring more detail than was previously provided.

As such, it will be no surprise to see ESG becoming a more critical aspect of investment and board papers on new investments being made (by investors and fund managers) into infrastructure and property in the medium term.

Most large Canadian funds to date have been direct investors in infrastructure and property. However, with an increasing focus on markets other than their own, some investors are considering using partners and/or local managers.

This is a new approach from a governance perspective, but should help them in not only overcoming some of the logistical issues (e.g. time zone differences), but also cultural and relationship (e.g. bank) obstacles when approaching new investments in unfamiliar regions and sub-sectors.

The divergence of property sub-sectors

One of the after-effects of the GFC has been the polarisation within the real asset investment markets between prime and secondary assets.

Less obvious has been the division within the prime segment of the market, where we are starting to see a "super-prime" sector emerging.

Driven by a combination of economic necessity, a search for yield in a highly liquid environment, and an increase in allocations by pension funds and institutional groups, there is a relatively small number of super prime assets being targeted globally by a growing volume of capital.

The strong demand for these assets from investors is mirrored by tenants – retailers in the UK and US are gravitating to the best shopping centres, often closing stores in the regional and sub-regional centres in the process.

Facing a challenging retail environment and competition from online retailing, these retailers are prepared to make a loss on their physical occupancy at a leading shopping centre, on the justification that it provides exposure to the consumer and a showroom for online shoppers. This is reflective of a trend in the retail sector of "the strong getting stronger".

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It’s getting “infra” tough out there …

A consistent message from global investors in North America and fund managers across Europe and the US is that infrastructure deals are getting tougher to close and the amount of work required up front is significant.

The pipeline is still reasonable, particularly in the US energy sector, but the time spent on transactions is increasing and in some cases there is no certainty that an outcome will be reached (particularly in US privatisations).

Most investors are avoiding auction processes given the competitive environment at present and are seeking exclusivity/bilateral negotiations from vendors.

Further, a lot of the deals being completed have been originated by the buyer (not the vendor) as investors proactively seek new assets.

It is no surprise then that investors are spending a lot of time up front formulating a deal and setting up a management team prior to approaching the vendor with a “fully baked” trade.

Certain fund managers are finding that vendors are willing to accept a lower price if a deal can be done swiftly and value can be achieved elsewhere in their business as part of the transaction.

Given this state of affairs, investors seeking a new offshore fund manager should pursue proactive, patient and resource heavy teams who are willing to go the full nine yards in order to get a deal done.

Otherwise, the likelihood is that the manager will either be overpaying for an asset via a competitive auction process or will miss out on real value through these negotiated deals.

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Conclusion

The world is getting smaller. There is a growing pool of capital emerging that seeks global cross border exposure to real estate and infrastructure of institutional quality.

But the over-riding driver is the hunt for yield. With global bond market yields at multi-decade lows (and in some cases, multi-century), and with the outlook for capital growth subdued, yield has become a core driver of investment returns.

Capital flows are now truly global for unlisted real assets. The impact of global capital pursuing good quality real assets is pushing yields lower and pricing higher.

Additionally, as markets continue to get stronger and gain momentum, many major investors are identifying that more risk is being transferred from vendor to purchaser.

We do not envisage a slowdown in the pursuit for real assets in the short term.

In fact, we are expecting demand for core quality real assets to drastically increase, influenced by growing allocations and a widening investor base. Investors need to bear this mind when seeking access to infrastructure and real estate in the near term.

Ultimately, the key to successful global investing will be to ensure investments are made on the basis of buying the underwriting assumptions that create value and meet expected return profiles, and to identify the best managers who have superior skills and due diligence processes associated with achieving the desired returns.

This demands that internal teams are adequate in terms of both numbers and skills to execute the types of strategies, programs and transactions occurring in local markets.

Having the ability to identify these skills and opportunities represents, in itself, a further significant challenge for investors.

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