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International research insights from Frontier Advisors

Real Assets Research Team

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

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Under the global umbrella

In June 2015, members of the Real Assets Team completed an extensive research trip throughout the US, meeting a group of high quality commercial property managers and also spending significant time physically inspecting both individual assets and various markets. In this paper, we comment on some of the key themes we observed on the trip, covering important aspects about real estate investment across the US. We also outline some of the local nuances associated with investing across the US relative to the domestic market.

US real estate opportunities

"A market 10 times larger and 30 times more complex"

Property fundamentals are universal

Real estate operates in an inefficient market, with the ability for skill, experience and judgement to exploit superior information, and drive value through asset management strategies. There is a very large opportunity set across the US offering the investor the ability to outperform over the long term.

Perhaps the most striking but seemingly obvious thematic we concluded in the US is that **real estate fundamentals are universal**.

The objective of real estate owners, is to ensure three dimensional space can be converted to a growing, long-term income stream, relying significantly on the health and growth of the individual industries that occupy the space. Key to understand is the influences on cash flow and the influences on ownership rights – the same applies here at home as it does in the US.

Further, the essential attributes of supply and demand operate across the US markets in the same fundamental way as per the Australian property markets. Whilst local factors and information will drive specifics around execution of a given asset management strategy, it is particularly clear the key ingredients and structure of a business plan for an office asset in Boston or an industrial warehouse in Chicago are no different to corresponding assets in Sydney or Melbourne.

This should provide domestic investors with comfort that investing in commercial property in the US can and should be supported by the same fundamental understanding of property investment principles and asset management strategies that have been "tried and tested" in our home market.

Whilst this sentiment may appear obvious, part of the reason we point it out is that Australian investors have historically concentrated their portfolios to Australia on account of being "more familiar" with their own market. Again, while investing in the US requires an understanding of the local markets with support from seasoned local professionals, the "art of investing" is no different and this should be kept in mind when thinking about property portfolio construction on a global basis.

Market scale creates opportunity

The Australian commercial real estate market is around 3.5% of the global commercial real estate market. By comparison, the US is close to 40% of the global real estate market, and thus is more than ten times larger than the Australian market, but undeniably thirty times more complex! This is because it is important to understand there may be up to fifty or more prime markets across all sectors in the US, and that, depending on the methodology for identifying sub-markets, there is upwards of 200 sub-markets that may be appropriate for institutional investment.

For example, the Melbourne office market predominately comprises the CBD precinct and CBD North (i.e. St. Kilda Road), which in total are around 4.5 million square metres (sqm). The LA County area by comparison comprises dozens of office markets (e.g. Downtown, Tri-Cities, Westside and South Bay) which in total, comprise around 18 million sqm – **the difference in scale and depth of the US relative to Australia is very tangible.**

Benefits of a US property exposure

One of the benefits of investing in US real estate markets, in addition to their sheer depth and breadth, is the **availability of a greater selection of sectors, supplementing the 'standard food groups' of office, retail, and industrial.**

A principal sector of the market that has become institutionally mature over the past twenty years, is the multi-family residential sector. The US provides a significant market to get access to residential investment property.

In addition, there are substantial markets that offer self-storage, High Street retail, medical office, student accommodation and seniors living, permitting far greater diversification by property type and industry profile.

The tech story

In terms of drivers of tenant demand across the US, there are clear winners and losers, and to no one's surprise, the **TAMI (tech, advertising, media and information) sector is leading growth across all industries**. It has accounted for a substantial proportion of net absorption across US office markets, both on the West and East Coasts.

Most office markets have been improving, with employers facing a war for talent, particularly in the TAMI-based industries. These companies are making an effort to attract top talent by locating in cities and suburban areas that are well serviced by transit facilities. This may present a real challenge for the traditional, more remotely located suburban office parks (and multi-family) that do not offer such linkages.

Cities like Boston, New York (Mid-Town South), San Francisco, San Jose and Seattle are experiencing strong demand by this segment of the market. Many of the properties inspected in these markets by Frontier were occupied by tech-based companies and many high-rise office buildings currently under development have been substantially pre-committed by names such as Salesforce, LinkedIn and Uber.

There has been a substantial change in the work environment and requisite office fit-outs. Creative, funky space is a hot feature within the TAMI industries, reflecting for example unfinished ceilings, concrete flooring polished with epoxy-resin, large and open common areas with full-service kitchens and game areas to provide "thinking space", high quality amenities including an on-site gym, etc. A real battle is on amongst office property managers to spec out space in a way which differentiates from adjacent office stock to avoid falling into the "commodity office" bucket.

The millennials

Multifamily has recovered resiliently post the global financial crisis, and demand is extremely strong from the newly employed 'millennials' who are moving into apartments and delaying home ownership. In fact, home ownership has fallen from 69% to 64%, providing a substantial pool of renters. There is now a very wide range of options in multifamily including new attractive high-rise apartment buildings and high quality garden townhouses, supported by a focus on re-urbanisation.

Frontier inspected an interesting group of properties in Brooklyn, undergoing substantial gentrification, becoming an emerging neighbourhood attracting large numbers of millennials (particularly 20 to 34 year-olds). The main retail area of Williamsburg-Brooklyn has become especially appealing and is developing into a "millennial magnet", characterised by a mixture of attractive architectural styles, interesting and trendy retail shops, walkability, and direct access via the Metro subway to Manhattan. Rental growth in this area is expected to be well above average due to these features and the significant rising incomes associated with the millennials.

Industrial and e-commerce

The industrial sector has experienced a number of years of well below average construction starts. Occupancy levels are at seven year highs, with the flow on effect of e-commerce driving strong tenant demand for both distribution and "last mile" locations. It is interesting that there is a potential blurring of the lines between major retail users and industrial distribution. There are many retail businesses that are currently implementing strategies to use their large formats as not only retail shops, but distribution centres for their e-commerce business.

One manager noted that because a significant amount of online purchases within the US relate to products being purchased from within the US, foreign currency movements are not nearly as correlated with the e-commerce trend (as has been the case in Australia for example). Another interesting point noted was that **Amazon is now the largest single user of industrial in the US**. As a result, they are a major influence on the supply and demand story for industrial and are therefore closely monitored by the astute industrial property investors.

Retail, e-commerce and the neighbourhood

The retail sector, like many markets across key western real estate markets, is competing and readjusting from the growth in e-commerce – much more so in the US than we have observed domestically. This re-adjustment period is expected to persist and continue to take market share from the traditional "bricks and mortar" retail real estate.

Supporting retail is a dynamic and evolving market for fashion trends, convenience, services and out-of-home dining. A key theme in retail is the need for competing and re-adjusting, effectively building synergies with e-commerce. This re-calibrating of the retail sector will see the best shopping centres that dominate their trade area and have fortress-like characteristics, continue to attract tenants and grow rental income.

Urban retail in-fill locations benefiting from rehabilitation and urbanisation should also perform strongly. **A noteworthy point about the neighbourhood convenience centres is that, in the US, the industry structure for supermarkets is much more competitive and less concentrated than domestically.**

Whilst in Australia there are only two supermarket majors who anchor most centres, in the US there are 10 to 12 large, nationwide chains, each with differences in their product offer who can anchor a centre. This allows investors in convenience-based retail to achieve more product differentiation and portfolio diversification on account of greater breadth and availability in the US supermarket sector (another example of greater market scale driving opportunity).

Key risks and opportunities

The expansion in technology based businesses and emerging technology companies, continues to drive strong growth and is both a key engine-room for a number of real estate sectors but also potentially a major risk. The substantial success of these industries and the very positive flow-on benefits downstream to the real estate industry, have built up a material concentration in some markets. As a result, **many of the institutionally managed US core property portfolios may be over-exposed in any tech-based downturn**.

Technology-oriented businesses appear to be substantially more solid than compared to the frenzy of the 2000 tech boom and bust. It is likely however that many of the tech companies that are driving office leasing and apartment demand, will eventually be subject to consolidation or, experience challenges to their business models. It is also likely at some stage that there will be a market correction in this sector which would cause significant pain for portfolios over-exposed to technology.

The recent sharp and unexpected decline in oil prices has particularly impacted energy-based companies in locations such as Houston, Dallas and Denver. This subsequently shocked many industrial properties in these markets and managers are treading more carefully in terms of their portfolio exposures.

A consistent theme seen across most Western markets, is that core institutional grade real estate is in strong demand, and the risk premium for secondary markets and secondary assets has widened, with a clear preference for core property in core locations. This will drive investors into secondary markets looking for higher returns and will also introduce an element of higher risk, particularly to those investors unfamiliar with the risk profiles associated with secondary markets, secondary assets and the competences needed to be successful.

A central premise, clear in discussions with all managers Frontier interviewed, was that **stabilised office buildings in many of the major markets, are currently trading at prices below replacement cost**, and well below replacement cost in secondary markets. In other words, rents have not reached an economic level to justify a new building in many locations. This will help keep new supply in check and the majority of managers expect rental growth to continue at a strong clip, with many opportunities to look for lease renewals to market rents, achieving levels well above current passing rents. The office sector is a classic late-cycle outperformer and this cycle is expected to be no different than past cycles.

Under the global umbrella

In the main, pricing for all real estate sector types has improved post the global financial crisis period. Many markets have recovered resiliently, however there is a clear preference for coastal locations, both East Coast and West Coast. **The limited new construction that has occurred over the past five years and what is currently expected to occur over the next few years, will provide many opportunities for core-plus strategies.**

Investment in quality buildings, in quality locations, that however have been under-managed, under-capitalised, require repositioning, renovating or are well below market rental levels, is likely to reap enhanced rewards.

There may be opportunities to develop, where substantial tenant pre-commitment in the stronger urban areas is achieved, with the objective being to "build-to-core".

In discussions with many of the managers there was an upbeat and optimistic attitude regarding the next few years in the real estate market.

However, it is important to understand there are a number of risks associated with the current market. The US market is viewed as being around mid-cycle, and ultimately, like any cycle, it will enter a flatter period at some stage. The managers' general expectations are that this is still a number of years away.

Key ingredients of manager success

The essential tools and ingredients for success, required by first-class managers are global. A key theme evident from every fund manager CEO and senior leadership group interviewed, was the fact real estate firms are people businesses – people are their only assets.

There is an enormous focus and emphasis on the importance of forging strong and trusted relationships and having exceptional relationships with operating groups in the marketplace. Managers see that key to driving successful real estate investment is having resilient, dedicated and experienced people who are experts in the local markets in which they operate.

Equally important is the importance of a clear, strong and galvanising organisational culture, and disciplined processes, that do not restrict entrepreneurial skill and actions.

In every discussion had with the US managers, there were a number of key themes that were repeated in virtually every conversation. The central focus was on the importance of understanding local linkages. Market knowledge and understanding, market awareness and local expertise, were consistent focal points from discussions with each of the CEOs, fund management teams, research teams, through to the asset managers and their teams. Vying for the local know-how, superior information, the best quality local insights, is seen as absolutely paramount to exploiting the inefficiencies evident in all real estate sub-markets.

Discussions with the various asset management teams embedded within the manager organisations were unanimous on the need for having clarity around the investment objectives, underwriting approaches, and understanding clearly that the assets themselves are where the "rubber hits the road" in terms of investment performance.

Each of the groups within each fund manager gave the impression of being absolutely clear on their role and the importance of their role in delivering and exceeding the underwriting assumptions built into each of the assets business plans.

Ultimately, **the consistency in the key tenets of success across the various managers we met with provides a pointer as to the necessary areas that prospective investors must gain comfort in when selecting the right group of managers to partner up and invest with**.

This necessitates a detailed review and understanding of a manager's specific set of skills and experience in their relevant local markets, the depth and track record of the senior professionals within the business, not just in the fund management team, but in the executive leadership team, as well as each of the research, underwriting, capital transactions and asset management functions. All of that needs to be supported by an understanding of the firm's culture – why? Because culture is the bottom line that drives a manager's behaviour and decision-making when markets are rallying and when markets are falling.

Differences in debt

On the debt side, it was interesting to observe that many asset loans "attach" to an asset. When that asset is exchanged, the incoming owner is in some cases obligated to assume the existing loan agreement. Whether or not an asset is encumbered with an existing loan has important implications on the liquidity for that asset and potentially its value to prospective purchasers. Managers need to be acutely aware of managing encumbrances within their existing portfolios and ensuring encumbrances are properly underwritten and structured in each acquisition and divestment.

Another key observation is that the depth and range of lender types in the US extends well beyond the bank-dominated Australian market. Not only does this mean a more competitive and more liquid debt market in the US, it also creates more flexibility for borrowers in their capital management strategies.

The ability to borrow out to much longer durations at potentially lower costs means managers have a greater ability to better match the duration of their property leases to debt duration. Combined with the fact virtually all US property loans we looked at did not feature loan-to-value covenants (which are commonplace for Australian property debt), assets and portfolios in the US can support higher leverage levels without commensurately increasing risk relative to what is possible in Australia.

Differences in nomenclature

Finally, an important aspect of understanding offshore markets, is the different packaging of metrics around property income, cash flow and value.

Across the US, key differences observed relative to the domestic market were as follows:

- Tenant leases classify rents on a square foot (sf) per month or year basis.
- Generally the duration of core property leases are between 5 and 10 years, with fixed annual rent increases and no market rent review.
- Tenant incentives quoted usually only reference costs contributed to tenant improvements on a dollars-per-sf basis (per month for industrial). Letting up allowances/free rent are normally separately accounted for.
- The expression and inclusion of outgoings varies considerably and a keen understanding is required to establish clarity around gross, adjusted-gross, net, triple net, and semi-gross rents.
- The citing of capitalisation rates as expressions of a comparative equated yield, is often misleading to directly apply against the convention of an Australian capitalisation rate. There appears to be a broad definition and understanding across the US market about a "stabilised yield on cost". However, this is something that is more generic and general than useful as a comparative analysis tool, particularly given it is subject to the underwriting vagaries of each manager.

Also noteworthy is that transaction costs are less than half that experienced in the Australian market and vary depending upon the US state and local county in which the transaction occurs.

The land of opportunity

Whilst Frontier only scratched the surface in developing a fundamental understanding of the nuances of the US real estate market over a three-week period, the most important aspect we took comfort in is that the fundamentals of real estate investment and the economics of real estate and of successful property fund managers are truly universal.

Ultimately, experience and judgements have a large effect on the decision-making process in real estate. It is important to ensure a formal, systematic portfolio configuration that will potentially optimise the ultimate risk-adjusted returns from a global property exposure and provide the required mix of strong income yield and sound capital growth over time.

In real estate, "skill matters" and this is a key competitive advantage that only the right managers can offer investors. Direct property, relative to financial assets, is an inefficient asset class that enables skill, experience and expertise to exploit under-managed assets, assets with potential for repositioning or imperfections of a particular market place.

All sectors of the direct real estate market require active management to ensure maximum performance is extracted. Many managers promote themselves as being active, but only some in reality have the right business model and culture, depth and breadth of skill and experience and client-obliged structures required to openly encourage true focus and active management, through the long term cycles associated with direct property. Knowing what areas and aspects to look for are critical in getting the manager selection decision right.

Being able to identify truly skilled managers is one of the key determinants of investment performance.

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