FRONTIER ADVISORS

Frontier International

International research insights from Frontier Advisors

Real Assets Research Team

Issue 18, November 2015

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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European Research Trip November 2015

Introduction

In homage to the 400th anniversary of Christopher Columbus' (in Spanish - Cristobal Colón) voyage to America, in 1893, the city of Madrid erected two monuments in the Alonso Martinez district, an area today known as Plaza de Colón.

On arriving in Madrid, we (members of Frontier's Real Assets Team) walked to the Plaza de Colón and reflected on how different Australia might be if Columbus had met the east coast of Australia – perhaps Australians today would be speaking Spanish, providing a more direct lineage to Continental Europe!

Standing in the Plaza de Colón, we could not speak Spanish but, like Columbus before us, we had a clear purpose to our travel – assembling an international real estate program. It is however, unlikely we will be commemorated in stone for our achievements in this area, but nevertheless!

In this trip, Frontier purposefully examined Pan-European property fund managers, undertaking extensive asset inspections and market immersion to develop views on how best to evaluate and assemble a Pan-European real estate exposure. We did not discover a new America…

This trip and our ongoing Pan-European research forms part of implementing Frontier's preferred property configuration approach, which is based on consideration of the international real estate investment universe.

Pan-Europe – Pie in the sky?

One of our first key observations is the notion of investing in a truly Pan-European strategy is more like a pie in the sky, i.e. it is not an achievable nor desirable reality. Even within European countries, we found property allocations are best achieved with a targeted city-based approach (e.g. London vs. Munich vs. Madrid) rather than a broad-brush regional approach. Further, the significant depth and size of the London and Paris office and retail markets means these two cities tend to feature most prominently in many strategies that label themselves as "Pan-European".

Still universal

Drawing on Frontier International Issue 14 (US Research June 2015), the proposition that property fundamentals, in terms of drivers of return and research outcomes, are consistent worldwide, absolutely holds true in Europe. In this respect, Frontier views that the optimal international property investment approach, given the importance of megatrend influences such as demographics, urbanisation and technology, is to view the global property investment universe as one large opportunity set. Within this, select major metropolitan areas and provinces should be evaluated as part of the market selection and asset selection process.

Under this approach, national and state political policies and regulations covering tax and local planning laws, are simply different rules in the local game which can be dealt with by expert managers with appropriate tax, legal and consultant advice. Crucial in this process is the need to have heavy reliance on the best and most experienced local expertise available. Given this, investor focus can then shift to the national and urban economies, partner selection and building up property portfolios based on fundamental analysis.

Might look different, same old flavour

When domestic investors conjure up an image in their minds of a core property, they might imagine a towering glass clad skyscraper or a multi-level shopping centre. They also typically imagine a shiny and new façade because a pretty building is a better building, right? There are plenty of those in Europe.

However, from a fundamental perspective, there are four main attributes which define the “core-ness” of a given property – location, lease covenant, legal/regulatory/ planning frameworks and physical characteristics. Across these attributes, core properties in Europe differ from Australian core properties, but still score highly in each case.

For example, some core office buildings we inspected in the City of London were originally built in the early or mid-1800s, long before Australia was even federated! Others inspected were new builds reflecting redevelopment of sites damaged in the Second World War. Others still included more “traditional” glass skyscrapers like the famous Gherkin and The Shard. This combination of new and old, features more in cities that historically experienced war damage whereas other cities that went relatively untouched (such as Madrid) have more office stock that has been preserved over long periods. In this respect, heritage listings and sightlines are crucial to understand, particularly where redevelopment is being considered.

Further, while in Sydney and Melbourne, a large floor plate might be 1,500 to 2,000 square metres, some buildings in London have floor plates in excess of 5,000 square metres – this by virtue of the notably larger land parcels that were commonplace in pre-industrial times.

While the “image” of a core property in Europe may be different to core property in Australia, the investment characteristics – specifically, the attributes that drive risk and return, are indeed the same. As we have said before, this should provide domestic investors comfort that extending their property portfolio construction internationally is a logical step for materially enhancing access to core property opportunities and long term investment performance.

European property industry observations

The Pan-European pooled property fund sector is relatively immature compared to Australia and the US. Many fund strategies and portfolios have limited histories and are sub-scale. Further, there is a meaningful number of new Pan-European strategies currently being developed or launched. Our research has unearthed a number of quality partner opportunities for domestic investors with managers early in the product lifecycle, allowing those investors to be much more meaningful participants, accessing stronger investment terms and deals.

Importantly, as with the US and at home in Australia, the "standard model" for success in property requires local market presence and expertise.

We are mindful of some Pan-European managers who base themselves out of one city (e.g. London) and invest in offshore markets on a FIFO (fly in fly out) basis. There is no substitute for time and presence in each of the key local markets and, with different regulations, market conventions and cultural barriers to deal with, we contend that sourcing and appropriately underwriting deals cannot be optimally undertaken by FIFO managers.

That said, in Continental Europe, despite our introductory comments, most deals are negotiated in English! This is to provide neutrality across the vendor and purchaser – you do not have to speak Spanish to buy an office in Madrid...

Creating core and asset management

In today's market, we observed many European core managers employing strategies to avoid overpaying for on-market acquisitions. This is a truly global theme that is also playing out in Australia and the US. These strategies include "build to core" with a combination of forward-funding arrangements and negotiated profit and risk sharing.

Many managers are buying assets situated in a locational fringe (e.g. adjacent to an established core location). Others are increasing weightings to higher yielding logistics which has in fact seen market yields on logistics undergo notable compression in recent times.

Across the board, however, leveraging asset management to create value rather than simply buying and maintaining yield is a very consistent theme evidenced across all European property managers. This aspect of the investment process has matured significantly over the past five years and will no doubt only grow in importance going forward, particularly as opportunities to source underpriced assets become more scarce. This is equally consistent in an infrastructure context as for property. Part of this is a clearer and growing emphasis on ESG performance and we have been impressed by the commitment of many Pan-European managers to improving sustainability and energy efficiency across their portfolios.

Foreign exchange

Depending on the specific strategy under consideration, for Australian investors, a Pan-European investment may invoke exposure to various currency pairs, key of which include AUD/GBP and AUD/EUR.

For most Pan-European portfolios, we found that non-Euro currency investments do not feature prominently and are mainly limited to the Sweden (krona), Norway (krone) and Poland (zloty).

Interestingly, the approach to managing foreign currency exposure varies considerably across Pan-European managers. In some cases, the investor has flexibility to manage the currency exposure themselves. In other cases, fund managers can also hedge (partially or sometimes fully) depending on the currency pair in question (e.g. more liquid currency pairs such as GBP/EUR can be hedged more cheaply than less liquid currencies).

The ability for the fund manager to utilise asset leverage that is match-funded (i.e. the same currency) to the asset can also provide a cost-effective partial hedge.

Ultimately, whilst currency is an important risk that domestic investors allocating to Europe must consider and manage, there are a range of currency management options available to accommodate a broad range of investor types.

Gearing – not just financial

In Europe, the use of gearing can often be tax-advantageous and significantly reduce transaction costs. For example, in France, acquisition duty is determined on the basis of the equity being transacted (i.e. net asset value rather than gross asset value). This heavily incentivises the use of structural gearing during an acquisition which can then be adjusted down to an appropriate strategic level. This is one of the reasons why many of the major core/core-plus funds permit a relatively higher level of gearing (e.g. 30% to 40%) but, in practice, those managers often do not maintain gearing at or near this level

Germany: safe and spread out

Whilst every country and indeed major MSA within Europe deserves special attention, the German property market is quite nuanced relative to the rest of Europe, particularly the UK and France.

In the core property markets of Germany, prime core assets are viewed by market participants as “stores of wealth”, with tight yields often only pricing in low or even no rental growth, much unlike core property in other developed markets.

This is because rent indexing is very modest in most German leases which philosophically reflects a significant averseness to inflation that is widespread amongst market participants (in light of the hyperinflation period that occurred post the First World War).

One asset manager commented that it is not uncommon to see rents (in select properties) remain flat over a five year term; continue to be flat through a market review; and remain flat in the subsequent lease term.

Valuation practices are also nuanced in Germany relative to other markets. For example, independent valuers are slow to make adjustments to market rents and capitalisation/discount rates, with appraised values tied more heavily to passing cash flow and the strength of the lease covenant.

Noting these features of the German market, it is unsurprising that through the GFC, German property markets experienced a much shallower decline in capital values.

In this respect, Germany often serves as a ballast as part of a Pan-European property portfolio, providing stable rents and capital values, albeit with lower rental growth sometimes being the trade-off.

Another interesting feature of Germany’s real estate fundamentals relates to the population distribution, which is highly decentralised creating a polycentric model. The “Top 7” cities account for less than 20% of the population. As such, outside of the office sector, a large proportion of the core property universe (particularly retail and logistics) is located outside the Top 7 cities.

The transit market is very strong in Germany with most of the country land-locked. A lot of shipping volumes travel from Amsterdam up the River Rhine, flowing through to Duisburg which is a large shipping port. These flows create a lot of investment opportunities in logistics.

These nuances of the German market provide an important case for the approach that is required in building out a Pan-European property exposure – a highly selective approach to market selection supported by local market specialists is critical.

European markets: Current state of play

As a backdrop to the opportunities across Pan-European markets, it is necessary to consider the risk profile of the current property market. Compared to previous property market cycles, it is fair to say there is currently a lower level of systemic risk with lower system leverage and low levels of new supply.

There is generally a far greater awareness amongst fund managers and investors of the risks associated with elevated debt being used, with greater amounts of equity being invested compared to past cycles. Further, there is a higher awareness of the risks associated with core and secondary real estate. These dynamics hold true in the US and Australia.

There is also quite a divergence of economic recoveries in the business cycles across Pan-European markets, with the UK (primarily London) well advanced into a recovery phase, whilst Continental Europe, both Western and Central, is encountering different and generally earlier stages of economic recovery.

There is wide-ranging and improving occupier demand, however, as an investor, it is important at this point in the cycle to be discerning. Whilst space market fundamentals are generally sound across markets in terms of new supply, vacancy rates are slightly above long-term trend levels.

However, there are some prime central CBD retail markets that have extremely low vacancies of sub 2%, and indeed some office markets that have vacancy rates below 4%.

Pricing

Pan-European markets have posted strong real estate returns over the past couple of years, with the highest returns emanating from the stronger economies and those economies more advanced in the economic cycle. The impact of cross-border real estate investment is seeing a normalisation of international pricing, adjusted for country risk.

European pricing, particularly in the gateway markets of London (West End retail and City of London offices) and Paris (CBD offices and Avenue Montaigne retail) appears to be ahead of market fundamentals, in-part reflecting the market's reaction to expectations for the lower for longer interest rate environment and the scarcity of assets available in these gateway locations.

Looking forward over the next couple of years, expectations are for a market wide deceleration in total returns, with yields maintaining current low levels and possibly rising over the next 3 to 4 years in response to a combination of improved tenant demand, rental growth and possibly modest interest rate increases. The variation in the pace of this occurring across sectors and markets will be wide, and generalisations are dangerous.

Consistent with the observations which emerged on Frontier's recent US property trip, investing for the next decade and more requires some key areas of focus on megatrends that are likely to drive investment growth over the long term.

For example, urbanisation is alive and well across the UK and Europe. In London, new infrastructure development is enhancing city transport linkages. London's significant new 'Crossrail' project, due for completion in 2019, is having flow-on effects to real estate around the key stations associated with this new transport link.

Conclusions

After almost three weeks in Europe, key tenets for investing successfully in Pan-European property were unearthed. As a starting point, domestic investors should be mindful that "Pan-Europe" effectively represents an opportunity set – only through careful market research and suitable manager due diligence and selection can the right markets and sub-markets be identified.

As we have stated previously, a key imperative for success is to identify those managers that offer a truly skilled and experienced capability that is supported by local market resourcing, experience and expertise.

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