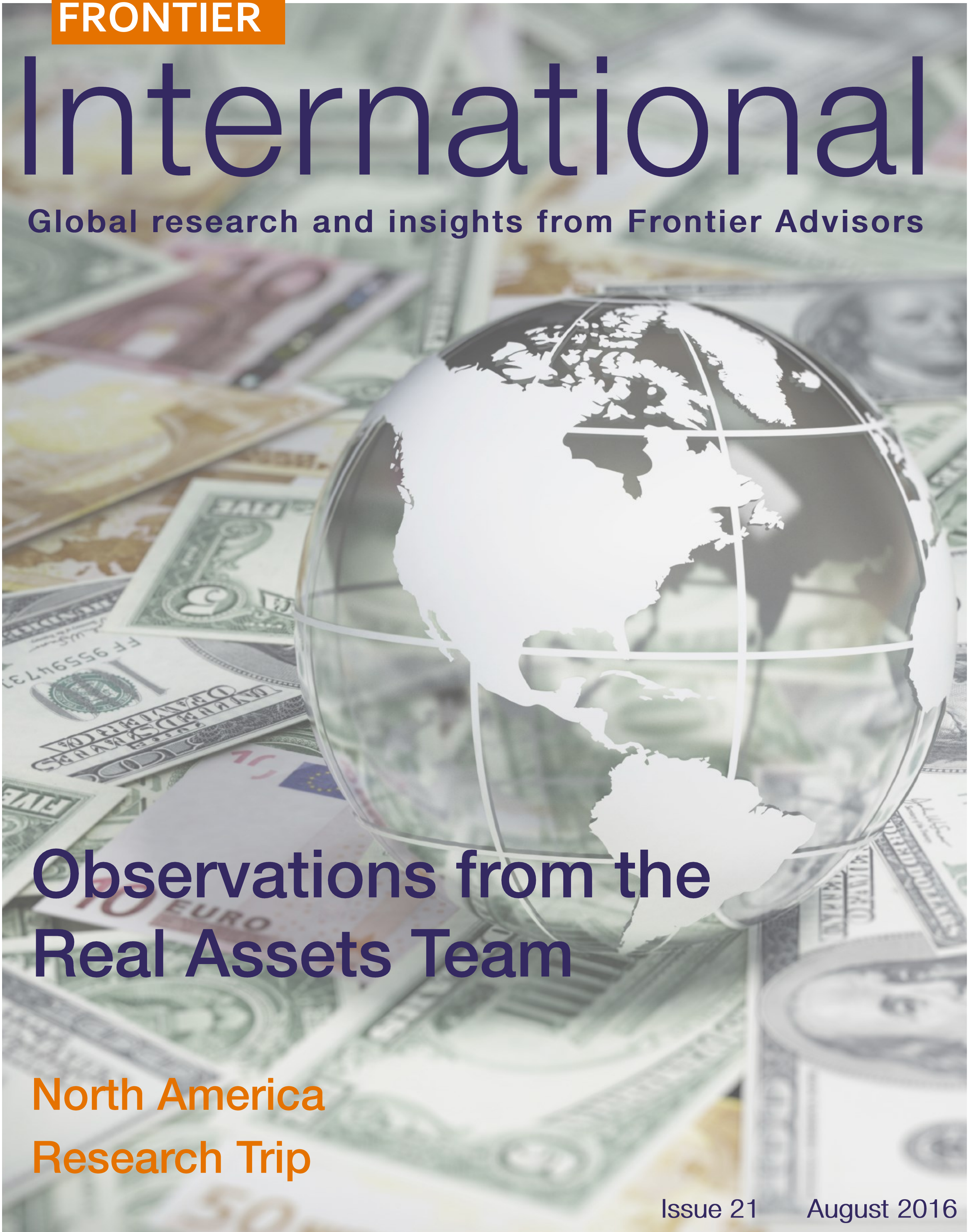
FRONTIER

International

Global research and insights from Frontier Advisors



Observations from the Real Assets Team

North America Research Trip

Issue 21 August 2016

FRONTIER ADVISORS

USA Today
Who holds the Trump card?
Buyers or sellers?

Right the way through the US, we immersed ourselves in markets and onsite inspections, visiting properties containing a vast array of work environments.

From East Coast to West Coast, it is obvious that the digital era and computerisation has brought about significant changes to work practices.

In some cases, the employer and employee relationship has been turned on its head.

AUTHOR

Tim Stringer

Tim is a Principal Consultant and Head of Property at Frontier, having joined the firm in 2014. His responsibilities at Frontier include providing real estate consulting advice to Frontier's clients, and involvement with strategy, investment and manager research.

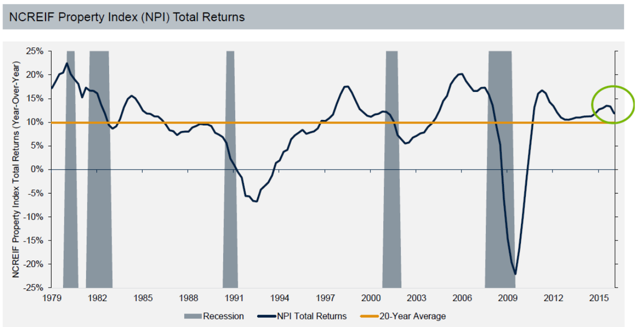
Tim has 30 years of experience in the commercial property sector, having held senior executive, fund management, portfolio management, and advisory roles with Colonial First State Global Asset Management Property, where he was CEO, Summit Capital Advisors, and AMP Capital Investors.

Tim has completed a Graduate Diploma in Property from RMIT University, holds an Associate Diploma in Valuation from RMIT University, and is an Associate of the Australian Property Institute.

What about the cycle?

As each US real estate cycle passes, it's essential to have a framework to understand and analyse where the market is going. It's also important to recognise that every cycle is different than those that precede them.

Chart 1: Annual US Returns NCREIF 1979-2016



Source: NCREIF

Looking at past lessons learned, most of the real estate downturns, have stemmed from over exuberance, developing an oversupply of new space, combined with a plunge in economic growth. Past cycles have also seen considerable style drift, where investors chased higher returns without adequately assessing appropriate risks. These periods have shared higher than average levels of leverage and illiquidity.

Frontier believes that adherence to a well-defined US core property strategy, combined with investing for the long term, through cycles and following clear long-term themes, will deliver strong risk-adjusted returns over the long term.

Fundamentals

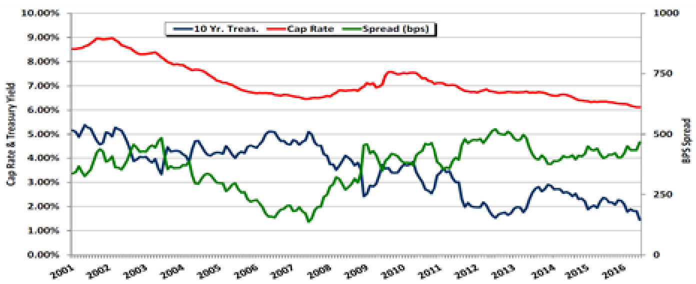
The US space markets and capital markets are inseparable. Ignoring warning signs about pricing and market risks can be perilous.

This occurred in the late 1980s and early 1990 property recession, which drove property values down for many a year. The US market today is far more efficient in terms of information and understanding of information through industry benchmarking, transparency and high-quality data availability. This in turn provides a more professional industry, with the tools to better understand future demand and supply impacts.

Demand for commercial real estate space tends to follow the national business cycle, although regional and sometimes even local variations do occur. This can be seen across the US in locations such as San Francisco and Seattle, which are driving substantial tenant demand via growth in the tech sector. Major companies such as Amazon, Facebook, Apple, Google, Salesforce and many others are driving strong demand within these markets.

Risk premiums in real estate are linked to the capital markets and space markets and it is clear today, that the risk premium above 10 year treasuries is at historically high levels, creating a reasonable buffer for any future interest rate rises.

Chart 2: Risk premium over bonds



Source: Eastdil, Real Capital Analytics, May 31, 2016

Megatrends

To postulate about the current cycle and its future direction requires analysis of the factors that help explain differences from past cycles.

One factor that's very clearly impacting real estate markets in the US is the demographic shifts that are occurring, and expected to continue over the next 30 to 40 years. The current elongation of the US cycle is being helped by the low level of speculative new development controlled via the rationing of capital through tougher regulations imposed on lenders.

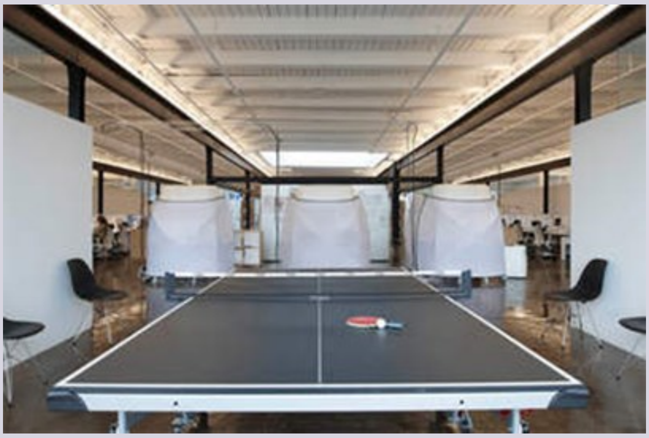
The urbanisation of the major gateway cities continues to drive demand for major redevelopments such as the colossal Hudson Yards development in New York, the largest single development since the Rockefeller Centre (built 1930s/1960s), equivalent to 1/3rd of the entire Melbourne CBD floor space.

The new workplace!

Our experiences uncovered unfamiliar terms and practices such as: 'hump day' (Wednesday which is the hump in the week to get over); hump day being optional attendance in the office; a doggie bed (with dog) and bowl next to your desk; Apple Mac laptops as far as the eye can see; couches and bean bags, the new work space replacing desks; sci-fi looking phone booths for private phone calls; a kitchen that has two beer taps - a pale ale and a larger (available all day and no charge for staff); and no pre-agreed timeline for annual holidays – you can take as few or as many as work dictates.

This is the world of the millennials (ages 18 to 33 y.o.), who are America's most racially and ethnically diverse generation ever. They are political and social liberals, they're social media wizards, highly educated, not terribly religious and slow to marry and have kids. These are the staff who occupy vast amounts of creative office space, converted turn-of-the-century 'brick and beam' inner urban warehouses and factories.

More recently, major companies such as Google, Linked-In, Microsoft and Salesforce are developing new age, exceedingly efficient buildings that offer uber cool creative space, large open floor plates and highly attractive 'funky' work environments.



Shining a torch on the cycle

So where are we in the US cycle and what are the risks in the mature phase? Returns over the last five years for core real estate, have been above long-term averages, driven by both cap rate compression, but also strong rental growth.

Returns to the end of June 2016 for the ODCE funds index show an annual total return of 12.71% p.a. over a five-year period, and of 11.82% for a one-year period. The most recent quarter shows a total quarterly return of 2.13%, reflecting the expected slowing in performance, given most commentators expect the cap rate compression cycle has run its race.

A long-term professional and expert in US real estate made the comment that this is the "most disrespected recovery ever". The US property market is characterised by a strong backdrop of sound economic growth, high levels of net absorption of space, modest supply, rising values and rising rents.

The return expectations for quality, well located US core property, post the cap rate compression cycle, are for strong rental growth over the next few years, delivering total returns in the order of 6% to 8% unlevered. In fact, the most recent return forecast consensus, published by PREA, shows investors are expecting returns in the order of 8½% for 2016 and 6½% for 2017, a considerable decline from the five-year return as discussed.

When compared to the current US 10-year bond rate of circa 1.5%, these total returns still provide significant risk premiums and a buffer built into pricing. The current cycle, whilst having recovered substantially in terms of pricing levels during the GFC, has not been as robust and volatile a recovery in terms of new supply. It has been a steady recovery with certain markets outperforming due to the mega drivers of technology, demographic change and urbanisation.

“Tech-tonic” influences

A vast amount of office real estate across the US is occupied by the technology sector, which has a substantial representation in many of the gateway cities. For example, the company Amazon has its home in Seattle (a market of similar size to the Melbourne CBD). Amazon occupies close to 20% of the Seattle office market, representing close to 900,000 m². The technology sector has invaded real estate markets in many ways like never before.

It appears to be a mature technology sector that many observers say is too large and varied to suffer the same fate as the tech bubble of the 2000s. One of the key differences today is that tech companies are profitable and generate cash. The general consensus across the US real estate research houses is that the outlook for the tech sector is positive. However, they pointed out it’s important to note performance among individual companies will be varied. Not all Unicorns (company valuations of $1 billion or more) will be successful, some will fail, some will be taken over by other companies.

Amazon South Lake Union Presence, Seattle

Source: Colliers International Research, Seattle

Demographics drives demand

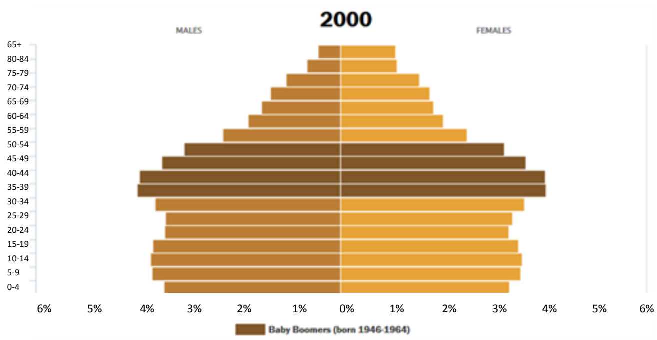
According to the US Census Bureau, the total population of the US was 319.9 million people in July 2014. This was an increase of more than 36 million people from the 2000 census and more than 10 million people since 2010. Population growth in the US is currently just under 1% per annum, however despite a modest slowdown in growth, the number of Americans continues to expand tremendously, with the total population in the US expected to increase by more than 90 million people by the year 2050.

To put this in context, the 27 nation Eurozone (EU) has a current population of just over 500 million, with the OECD projecting the EU population to grow by only 15 million people by 2050. The only country projected to have a larger increase in total population than the US over the next 35 years is India, with a population currently four times that of the US. Many major developed economies such as Japan, Germany and China, are projected to show a net loss in total population over the next few decades.

The US has a demographic transformation unfolding, creating a population where the majority is non-white and the demographic age pyramid has a rectangular shape, rather than a barbell shape. By 2050, there is likely to be as many Americans over the age of 85 as there is under the age of 5. This will create a vast array of opportunity, both within the economy and the real estate market, for space that houses businesses focused right across the demographic spectrum of cohorts.

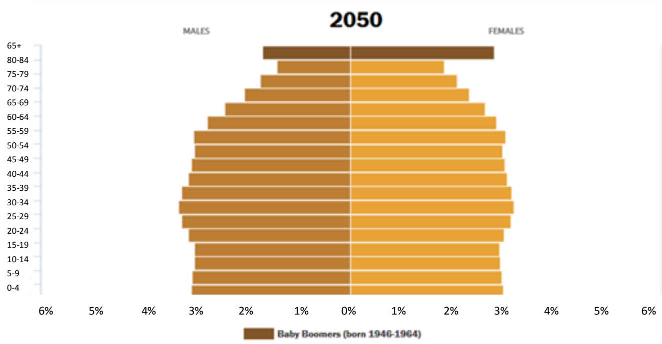
This period of demographic change, should create copious opportunities in real estate markets. Changing demands will create great opportunities within the real estate market, including office space, retail space, industrial distribution, healthcare, storage and student accommodation, just to name a few. The most obvious opportunity across the US is represented by the sheer size of the mounting population that will require property to meet their growing needs. The US is clearly one of the few growth markets available across the developed world, providing access to high-quality real estate investments.

Chart 3: Demographic Cohorts 2000



Source: The Next America, Paul Taylor, April 10, 2014

Chart 4: Demographic Cohorts 2050



Source: The Next America, Paul Taylor, April 10, 2014.

The positive economic and property market forecasts for net population increase is hard to overstate and provides a long term opportunity.

The economic lighthouse

The economic growth outlook is that the US will perform better than its global competitors.

That said, the modest level of growth and paring back of expectations has created a more cautious consumer across the US. Real consumer spending is running below the pace of previous expansions, averaging less than 3% p.a. over the last two years. The US labour market has shown remarkable resilience. The US added 587,000 jobs during the first quarter of 2016, and approximately 2.4 million jobs in the past 12 months. The job openings and labour turnover survey (JOLTS) showed total job openings of 5.8 million, the highest ever reported, while unemployment claims were the lowest since 1974. Overall, the labour market appears very healthy. Looking forward, uneven growth, volatility and uncertainty are expected to persist in the near term. Much of the uncertainty associated with economic variables remains outside US borders. The influence of the BREXIT vote, the impact of the slowing Chinese economy and the volatility associated with emerging markets, act to generate uncertainty and a flight to quality. Ultimately, when assessing the likely outlook for real estate growth within the US, it compares well against most other alternatives.

Show me the money

Capital is expected to continue flowing to US real estate markets, as investors seek safety and security. Given the low level of global 10 year bonds, the flow of capital to real estate and the quality of gateway cities within the US, it's reasonable to expect cap rates to remain at current levels for some time.

Going forward, with cap rates expected to remain low, the importance of active asset management and improving operating income is the key to performing well. This is when true skill, experience and expertise comes to the fore, in both stock selection, sector and market selection, active asset management and value adding behaviour.

Frontier spoke to a number of industry leading managers, brokers and financiers. They clearly indicated that today there are divergences between core real estate, in high quality locations and strong markets, and secondary markets with greater perceived risks. With additional caution creeping into the market as pricing remains elevated, the secondary market is finding that pricing is starting to blow out. Both the brokers and fund managers commented that secondary assets of a 'commodity' nature, are hard to move and difficult to finance. In the secondary space, where yields are at 7% to 8%, it's a buyers' market. The opposite is true when speaking about quality core assets, well located in preferred locations, it's a sellers' market.

The known unknowns

The known unknowns that will likely impact over the longer term on US real estate performance, include politics, environmental sustainability, climate change and changing energy sources and needs. Technology will continue to have a significant impact on real estate. Examples include continued improvements in e-commerce and the uncertainty of that impact on bricks and mortar retail and the impact the advent of driverless cars will have.

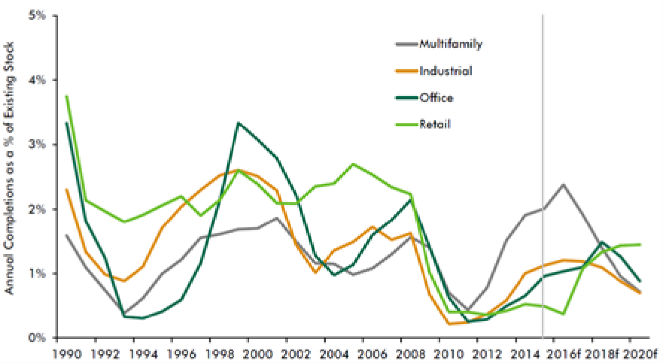
The US presidential election, will resolve itself in November. Both the candidates are notable at this point for being two of the most disliked candidates in American history, polarising figures that will present challenges for US leadership over the course of their term. A Trump presidency may likely lead to a period of continued impasse, which would have a muting effect on economic growth in the US. A Clinton presidency with extensive government experience, is likely to be run more along the lines of business as usual.

Going forward, those investors that see change offering great new opportunities, will hold the trump card!

Smile at the bank manager

One of the issues with new supply of real estate (development), is that it is not as readily reduced as it is created. Supply should depend on current and anticipated demand by tenants, construction costs, and the availability of capital. Often however in past cycles, capital availability has been the primary determinant of development in real estate. Typically, developers will build if they have the money, especially if it's someone else's.

Chart 5 – Completions as % of Existing Stock



Source: needed!

As the chart above shows, construction and new supply has been constrained. Whilst the US commercial lending markets remain healthy and interest rates offered by banks and financial institutions remain attractive, there has been a tightening of capital available for new development.

Regulations recently introduced including Basel III, Dodd Frank and those relating to HVCRE (high volatility commercial real estate) exposures, have created a situation where speculative development is difficult to finance. For example, the HVCRE loan requires a borrower to contribute at least 15% of the real estate value appraised on the basis of a completed value project. This must be in the form of cash or unencumbered readily marketable assets. All regulations have limited both the level of leverage able to be applied as well as reducing the overall riskiness of investment.

Interestingly, one of the major real estate financiers described behavioural changes that have been occurring within lending institutions in recent times. Whilst there is a clear requirement to have commercial real estate lending policies in place, these have been historically 'filed' in the bottom drawer and rarely referenced.

Lenders now are referring directly to these policies and procedures and adhering to them strictly to ensure they do not fly in the face of the regulators. These practices and regulations are tightening up lending procedures and helping to ensure a long term balance within real estate markets. Whilst, as expected, certain sectors of the real estate industry have responded negatively to the rules, from an investor's perspective, these rules help protect the market and focus lenders on cashflow durability and high credit quality loan opportunities.

Orienteering

So, in this new world of historic low benchmark interest rates, a 'Goldilocks' environment exists for commercial real estate in the US. Who holds the trump card in the marketplace? Is it a buyers' market or it is a sellers' market? It's clear that the highest quality core real estate continues to be preferred and offers a high level of liquidity.

However, as the market grows more cautious and selective, secondary markets and assets are experiencing a 'buyers' market phase. In some of these secondary locations, such as suburban commodity style office, it is extremely difficult to attract investor attention and indeed find adequate finance.

The last word

Frontier is focused on developing a high-quality real estate exposure for clients, based on an international opportunity set. The US comprises in the vicinity of 40% of total commercial global real estate, as compared to Australia's 3%. The most important aspect in developing our property configuration is focusing on a targeted risk exposure, and following the clearly articulated themes and areas of focus within this paper.

Given the expected strength of the US economy over the long term, the deep and strong technology sector opportunities, the long-term growth profile, positive demographic implications and the regeneration and urbanisation of gateway city locations, the US real estate market provides a liquid and interesting opportunity for long-term investors.