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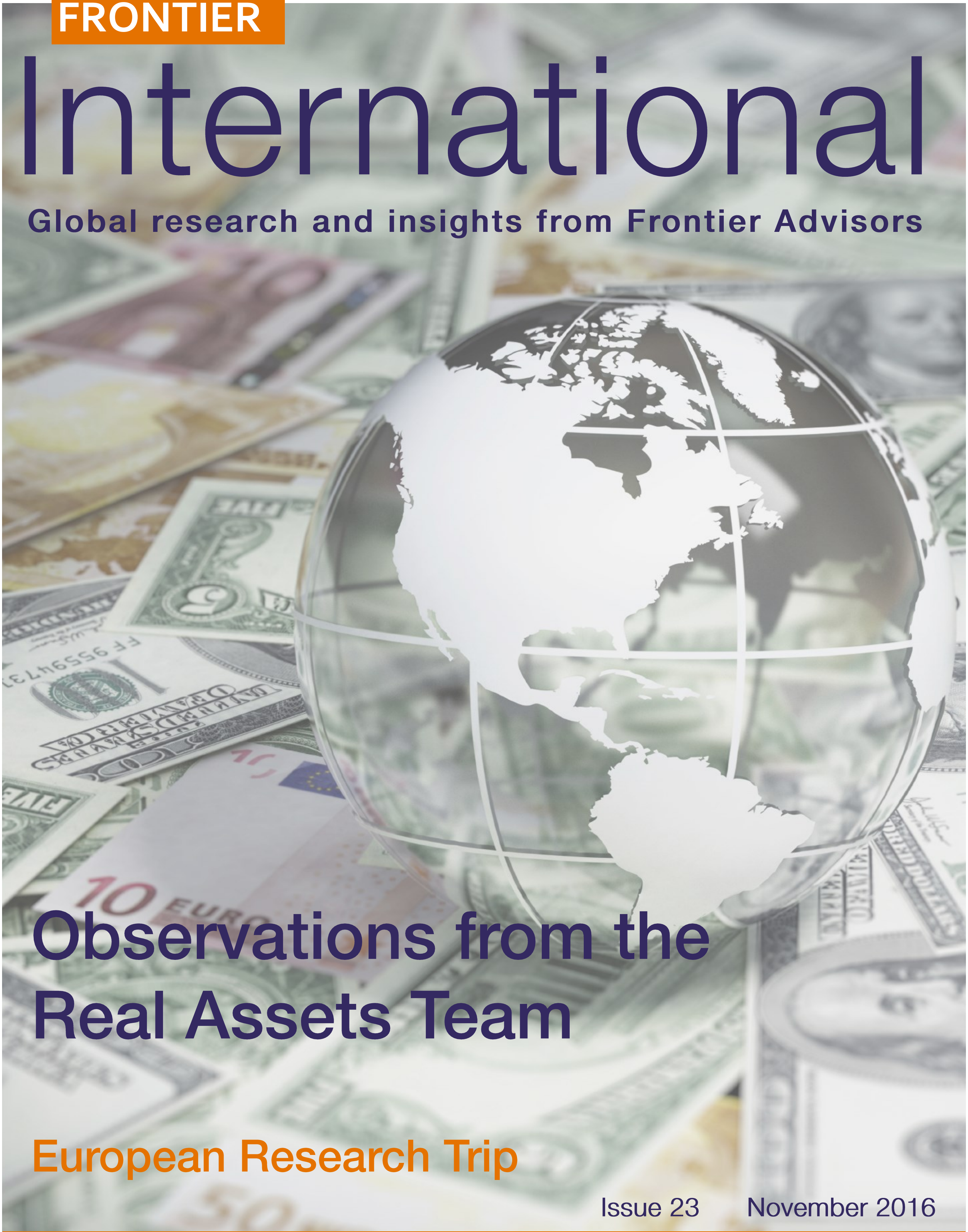


Observations from the Real Assets Team

European Research Trip

Issue 23 November 2016

FRONTIER ADVISORS

Part A: London property and BREXIT

We examine whether the influence of geopolitics has substantial impacts on the flow of global cross-border investment capital to even the most mature and highly attractive markets.

Part B: European infrastructure investment

Europe is a market providing great opportunity for infrastructure investors with government encouragement of infrastructure investment and supportive legislative regimes. Frontier's infrastructure team recently spent two weeks in Europe exploring the trends, opportunities and challenges facing investors seeking to deploy infrastructure capital into this key investment region.

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.

Peter Siapikoudis

Peter is a Principal Consultant and heads our infrastructure research and advisory team.

Peter is a former senior executive at Hastings Funds Management where he was CEO and Portfolio Manager of The Infrastructure Fund (TIF) and Hastings Hancock International Timberland Fund.

With over twenty years of industry experience, Peter has a varied and extensive background having worked as a fund manager, investor, asset consultant and held various investee company board positions.

Peter holds a Bachelor of Economics with Honours from the University of Monash and a Graduate Diploma of Applied Finance and Investments from Finsia. Peter is also a Fellow of Finsia and a Fellow of the Australian Institute of Company Directors as well as a Member of the CFA Institute.

Michael Sofer

Michael is a Senior Consultant at Frontier. He leads our Quantitative Solutions Group, which provides bespoke financial modelling and quantitative analytics to clients. He is a member of the real assets team, with a focus on infrastructure advice, and provides general consulting to clients. Michael began his career at Frontier in 2010.

Previously, he worked at Bilfinger Berger as a financial Associate in the Project Finance team. he role entailed developing financial models for large-scale infrastructure assets, specifically Public Private Partnership transactions.

Michael completed a Bachelor of Commerce and Bachelor of Aerospace Engineering (Hons) at Monash University. Michael is also a CFA Charterholder.

Part A: London property and BREXIT

With a full quarter now having played out post BREXIT in the United Kingdom (UK), the uncertainty that this brought about has been directly felt in commercial real estate markets. Straight after the vote, there was a flurry of activity with UK retail property funds chasing liquidity. However, more recently the market has been characterised by a level of lethargy and, in some cases, wide gaps between buyer and seller expectations have emerged.

The pro BREXIT supporters promote the belief that London will thrive in the medium to long-term, through increasing its internationalisation and by being able to manage its own trading relationships and regulatory environments.

The Central London office market sits within the City of London, which is calculated to be the sixth wealthiest place on earth. It has many unique physical and cultural features that combine to create the fabric and attraction as a location for business. London is Europe's largest city by population, with 8.6 million residents as at the 2015 census. Within London there are 300 languages spoken, more than any other city on the planet. Of the resident population, 37% were born outside of the UK, of whom 67% were born outside of the European Union (EU). This makes London the second largest immigrant city in the world after New York. A total of 40% of London is comprised of protected green spaces.

In total, 52% of non-UK born Londoners do not hold a British passport. London is home to significant populations from a wide array of international communities and religious backgrounds (including atheists who comprise 20% of London's population). London is, in terms of groups born outside of the UK, equivalent to Ireland's second largest city, Sweden's fourth largest city and France's sixth largest city. Poland contributes London's largest immigrant population, followed by India.

A little known fact is that in London it is illegal to die in the Houses of Parliament. The reason behind this law is that the Houses of Parliament, also known as the Palace of Westminster, are a Royal Palace, and anyone who dies there is entitled to a state funeral. This law was recently voted the most absurd in Britain, narrowly beating Liverpool's legislation that bans women from going topless in public, unless they work in a tropical fish store!

A significant global market

The UK is the second biggest global real estate market and London has very often been the most highly traded city globally. Investors have started to take a bearish view of how London commercial real estate will perform over the short to medium term.

According to JLL Research, transactional volumes are down 36% in local currency terms and even more in US dollar comparisons (41% over the first three quarters). Much of London's investment activity over the past few years has been heavily driven by overseas investment, and this obviously reflects on the cautiousness in which investors are currently behaving.

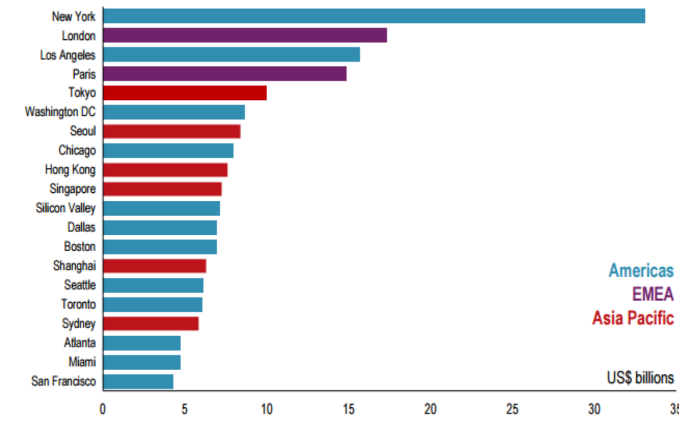
London is the main financial centre within the EU despite not being a member of the Euro and is responsible for many of the primary financial functions of the Eurozone. In addition, however, London sees itself as more than just the EU's financial centre. The city is striving to be the global business centre for Europe inside and outside of the EU. This is evidenced through initiatives such as the effort to establish London as the primary offshore centre for trading Renminbi, a target which was achieved in April 2016 (taking over the mantle from Singapore).

As a centre for finance sector employment, London has seen substantial employment growth over the past twelve years with the workforce in 2004 estimated at 1.9 million people and in 2016 at 2.5 million people. The resident population of London is projected to grow by 13% per annum until 2025, compared to 6% per annum for the UK as a whole. Office employment is forecast to grow by 15% per annum over that same period in Central London, and at approximately 9% per annum for the UK as a whole.

Over the past 15 to 20 years, London has evolved into the global property market we know today. Quantitative easing in the US, UK and Europe has diverted substantial amounts of capital into commercial real estate, which has been chasing yield, with London the number one global destination. Over the past two or three years, sovereign wealth funds, large global institutions and pension funds have focused on investing considerable amounts of capital in this market.

Approximately 70% of deals completed in Central London in 2014 and 2015 were to cross-border overseas investors. This wall of money put pressure on prices and created a pricing premium for large trophy assets. This dynamic had not really previously been witnessed in this market.

Chart 1: Largest global capital inflow cities



Source: JLL Research

Table 1: Most actively traded cities

Rank YTD 2015	Rank YTD 2016	City	YTD 2016 (US$bn)	YTD 2015 (US$bn)
1	**1**	New York	**33.1**	36.7
2	**2**	London	**17.3**	29.1
5	**3**	Los Angeles	**15.7**	12.8
3	**4**	Paris	**14.8**	14.8
4	**5**	Tokyo	**10.0**	13.6
7	**6**	Washington, D.C.	**8.6**	9.6
23	**7**	Seoul	**8.4**	4.4
6	**8**	Chicago	**7.9**	9.8
11	**9**	Hong Kong	**7.6**	7.5
14	**10**	Singapore	**7.2**	5.1

Source: JLL Research

A tale of many markets

The Central London office market can be divided into five discrete markets, each in turn comprising a multitude of submarkets. Traditionally, London was divided into the West End, Midtown, City and Southbank. More recent years have seen the emergence of the City Fringe market to the east of the City market, which houses a number of more creative type tenant uses and "hip" regeneration of older, low rise buildings.

In the past six to seven years, driven by major strides in technology, the traditional clusters of occupier types and sectors have started to disburse across Central London. In today's Central London market, there is a variety of occupational mix which is extensively diversified by sector. There is quite an even distribution of around 20% across banking and finance, professional services, the services sector and, more recently, the emerging TMT (technology, media and telecommunications) sector, which now plays a major role in the tenant market.

Whilst Central London office demand has been consistent at around 1 million m² per annum over the past decade, 2016 has seen a sharp pullback in tenancy demand. The consistent and strong demand over the past decade has led to low vacancy rates, with the market responding through the delivery of a number of new, iconic, landmark towers. This has been in a period where there has been an ongoing amount of supply withdrawals from the market, where buildings have been relatively obsolete and converted to other uses including residential.

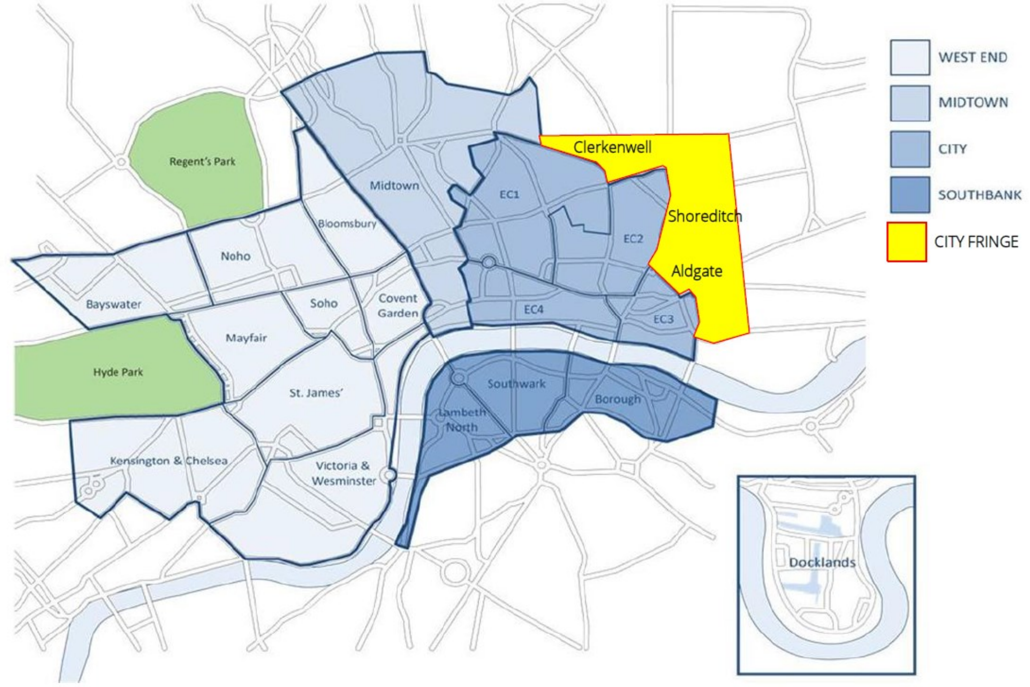
Chart 2: Central London office development

Source: JLL Research

According to JLL Research, London prime city office rents were stable in the third quarter of 2016, while West End rents fell 4.2% and showed the first rental decline since 2009.

This is an indication of softness in the leasing market and it is expected that net effective rents will come under pressure over the next 18 months and see downward realignment.

Figure 1: Central London office markets



London office market and BREXIT

London, particularly the City of London office market, has been on the front line of the battle for BREXIT. The City office market houses some of the most substantial employers associated with facets of membership of the EU. With the potential impact on UK growth probably being felt more by the potential downsizing of the London white-collar employment market, this could have a large impact on London commercial real estate.

BREXIT has introduced a high level of cautiousness amongst tenancy occupiers, as well as investors who see these uncertain times within the market as a signal to sit on the sidelines. Tenants are currently unwilling or reluctant to sign up to 10, 15 or 20 year leases, typical of London commercial real estate, when there is so much uncertainty. Many tenants are showing a preference to extend their existing leases until there is greater clarity around the future for both their businesses and the market.

Whilst there has been an increase in the level of construction activity within the City of London over the past few years, a number of projects that were underway have delayed their planned completion dates, with the expected peak of new office supply occurring in late 2019.

The market is definitely swinging in favour of the tenant, with potential tenancy demand reducing and supply of space increasing, causing a lift in vacancy rates off a low base and the propensity for landlords to be more willing to negotiate.

Prior to BREXIT during 2016, pricing had started to falter with institutional investors taking a more cautious approach than the enthusiasm that swept the market over the prior three to five years. In their place, private overseas investors have been very keen to target prime high-quality assets, however with a very specific requirement for investing in freehold as compared to leasehold, long lease expiry profiles, prime locations and highly specified buildings—"Platinum Prime".

The market's view is that over the last 12 months, they have been paying "last year's prices" (a premium over current market levels) in isolated circumstances to access trophy deals.

It is very important to note that, for all other assets that do not satisfy the extremely strict and narrow criteria of quality and income durability, commentators are suggesting that market pricing has indeed fallen in the City in the vicinity of 15% to 20% or more. This has not, as yet, been supported by transactional activity, however it will become very interesting during 2017 when transactions start occurring under the new regime of uncertainty about the severity of BREXIT - that is, Soft or Hard.

The last word

So in fact it does seem that major geopolitical events can have significant influence over the short term on even a major international Gateway market such as London. Based on anecdotal evidence, and discussions with experts with many years of experience in the local London market, the view is that market pricing peaked in the summer of 2015 and the correction is well on its way.

BREXIT was not the only driver of the correction and, in a sense, if anything, it has decelerated the correction as investors have adopted a wait and see approach. Pricing for assets which are characterised as having long-term wealth preservation features, as some term Platinum Prime deals, are holding up. For the rest of the London market, it appears that pricing has started to fall and may indeed fall as far as 20% or more. This will be on the back of softening tenant demand and a correction in pricing.

The much vaunted wall of money for London has thinned out, and has focused on a very narrow set of criteria and exclusively on the smaller Platinum Prime assets available in the market.

On a positive note, the opening of London's CrossRail line is expected to create a substantial structural boost to areas within close proximity to stations on this line. This expected correction in pricing will provide some potential opportunities to buy into one of the pre-eminent global Gateway cities. There are also substantial opportunities emerging in the regional UK centres, however this is a subject for another time.

Commercial real estate markets have always, and will continue to, operate in long-term cycles. Within these cycles, there will be periods of exuberance and cautiousness and the evidence is that the next Central London cycle has already started.

Part B: European infrastructure investment

European governments are encouraging increased infrastructure investment to support population growth, technological advancement and a move to cleaner energy production. Businesses are seeking financial partners to help them expand their operations or buy their ancillary infrastructure assets. In addition, a number of closed-end higher risk infrastructure funds are divesting "built-to-core" assets.

Investors face a number of challenges. Beta, being the concept where a “rising tide lifts all boats” in terms of positive asset performance through interest rate compression, is largely dead. Many of the opportunities are small and inherently risky, requiring a deep understanding of the landscape and an ability to aggregate and build platform businesses. The high level of competition is actually driving a wedge between superior managers of assets and those who are not as strong. We believe (unlike the past decade) those investing around the current vintage year will see a strong differentiation in returns depending on what they have bought and how it was managed.

In the second part of this Frontier International, we set out our views on best practice in acquiring, managing and divesting European infrastructure assets, and cover some of the key trends we observed on our trip.

Best practice

The European infrastructure investment market is one of the least homogeneous in the world. Despite some common frameworks through the EU, each country is unique in terms of the political, social and economic landscape. This drives a regionally different set of infrastructure opportunities and how they are to be approached.

Given the heterogeneity in the European market, it is evident that local market expertise is a prerequisite for success. However, far from guaranteeing success, it is only an entry-level feature required to compete with intelligence in these markets. Here are some interesting best-practice approaches observed on our trip.

Do your homework early

The simple reality is that it is difficult to avoid public auctions, especially if you specialise in core infrastructure investment. However, this does not always result in poor outcomes for investors. The assets are complex, the processes are short (so vendors can filter out opportunistic non-serious investors) and vendors want to see a well-defined and aligned business plan. Being a serious competitor, and still achieving a desirable outcome, requires investors to do their homework early (sometimes years in advance of an asset coming to market) to understand the asset and the market. This provides a significant informational advantage when it comes to preparing and successfully executing on a binding bid in a live, time-constrained, competitive process. While it is an expensive and time consuming process, it is required in order to successfully acquire public auction assets and still achieve commercial returns without overpaying.

Maintain a deep network for origination

While government tenders for infrastructure are typically highly visible to the market, corporate transactions (e.g. a large manufacturer writing a PPA for power supply to its factories) can be “under the radar”. The latter features significantly in European deal flow. Having an extensive panel of contacts to draw on is essential in originating these opportunities. Furthermore, they can also assist in creating opportunities by matching demand and supply of capital. Without them, the pool of available opportunities (which are attractive) can be significantly smaller.

Don’t be complacent with asset management

While it is clear that higher risk opportunities (e.g. greenfield construction) require significant hands-on asset management, it doesn't mean that core brownfield assets manage themselves.

The need for highly engaged asset management is particularly relevant in the current market environment where interest rates are already low: it is difficult to foresee a continuance of the beta effect (rate compression) supporting returns to the same degree. Higher quality investors are always trying to drive a culture of continuous improvement and innovation in their portfolio companies, regardless of the stage of life. Complacency is a sure path to redundancy. We believe, over the next ten years, even core brownfield assets will exhibit a significant deviation in outcomes depending on the level of engagement and active management by the investor.

Infrastructure is a risk profile, not an asset class

Infrastructure cannot be pinned down to particular asset types (e.g. carparks, pipelines, airports). Rather, the asset class is defined by the risk profile of the cash flows purchased by investors. Core infrastructure is characterised by very stable and certain long-term cash flows. Core Plus cash flows are less certain, and opportunistic infrastructure even less so. It is tempting in the current environment to accept greater risk (be it in the financing strategy, corporate strategy or growth assumptions) in order to maintain targeted returns. This is blurring the lines between infrastructure risk profiles and can turn a Core asset into Core Plus, depending on the assumptions made to hit the base case returns. Again, better investors stick to a very disciplined process and are willing to walk away from deals if the assumptions required to be competitive are inconsistent with the risk profile of their strategy.

Attain positions of influence

Following on from the earlier point on the need to be highly active in managing assets, it follows that investors require the necessary influence (directly through majority positions or indirectly through aligned partners) to drive strategy in investee companies. An aligned, but diverse, board composition is able to generate robust discussions, influence outcomes and effect positive change. By contrast, a fragmented board can work at cross-purposes and stymie progress and growth.

Trends

While each European country tends to present quite specific sectoral focuses, Frontier was able to glean a few Pan-European themes that are defining the infrastructure opportunity set. The best investors are not only keenly aware of these but also know how and where to capitalise on them.

Growth in renewable energy

Onshore wind and solar power in particular are providing an increasingly significant (but varied by country) contribution to Europe's power generation. This is being driven by improvements in technology (moving towards cost parity with other forms of generation), strong demand from corporates for greener sources of energy and bold government targets (e.g. the European Parliament's directive to source 27% of power from renewable energy by 2030). In France, the recently enacted French Energy Transition legislation has set the target at 32% for the share of renewable energy in the final energy consumption of France. The target for electricity is 40% . The primary reasons for including renewable energy in existing infrastructure portfolios seems to be for diversification and ESG contribution, rather than return enhancement. While it varies by life cycle stage, most investors are targeting 10-12% per annum net returns.

Growth in communications

Data consumption is growing exponentially as cities and people become increasingly reliant on smart technology, wireless communications and enhanced computing power. This presents significant opportunities to invest in the upgrade and expansion of telecommunications infrastructure, be it communications towers, fibre optic cable or data centres. The market is being driven by government initiatives to roll out better infrastructure to support broader coverage (especially in rural areas) and also corporate asset disposals. Notably, the Nordic region presents as an advanced market with significant capex still underway. It has one of the highest levels of connectivity and internet penetration in the world.

Capital starvation

A common theme across Europe is the presence of capital starved divisions within larger organisations. In the infrastructure context, this encompasses a broad array of infrastructure assets, ranging from energy to communication to transport. These divisions often need to compete for capital with each other, and operate on short-term budgets. This is not conducive to long term infrastructure value creation and, as a result, they typically experience underinvestment and underperformance relative to their potential. Financial owners, such as infrastructure investors, are able to operate these divisions as independent businesses and are much more willing to invest long-term growth capex. This results in more streamlined and commercial enterprises able to capture growth and deliver value. As mentioned, the challenge for investors is being able to successfully originate attractive risk-adjusted infrastructure opportunities.

Need for greenfield

Europe is facing a large infrastructure gap as it seeks to deal with an ageing population, environmental change and ageing infrastructure more generally. This extends to electricity transmission, transport, renewable energy, social infrastructure and natural gas pipeline assets. In addition to government-led projects, corporates are also looking to expand their services to customers. Financial partners such as institutional infrastructure investors, are attractive propositions to corporates as they will fund the infrastructure but leave the operational benefits to accrue to the firm itself. They can also assist with setting up commercial structures during the greenfield stage to enhance the asset's saleability upon project completion. In return, infrastructure investors often end up with investments in essential supporting infrastructure, with long-term contracts and aligned partners. Critical to success in greenfield investment is having the correct risk management approach and experience.

Smarter regulators

We are witnessing a trend towards smarter and more focused regulators, pushing regulated asset companies to innovate and deliver superior services to customers. The days of passively capturing the delta between what the regulators assume is an efficient model and what companies can actually achieve now belongs in the past. It is becoming harder and harder for regulated companies to outperform. By way of example, this can be seen in the UK water industry where the regulated companies are experiencing quite differentiated performance outcomes. Investors in these businesses need to encourage innovation as a theme and drive a culture of best practice, otherwise they risk the regulator taking away any excess returns being earned. There is now a much larger range in potential returns that companies can generate in a regulatory period and, inevitably, this will lead to winners and losers. Those companies with the best management teams and best business plans will be able to outperform. Conversely, once a company is on the path of underperformance, it will be very difficult to catch up as the frontier is forever shifting.

This is further compounded by the fact that economic regulators are also now incorporating the use of rewards (in addition to penalties), which is driving better performance relative to an approach based only on penalties. This is also shifting regulatory regimes to an outcomes framework that encourages a focus on what really matters to consumers, and to give companies the space to innovate and react to local priorities and circumstances.

Best practice ESG

The highest quality infrastructure investors pursue ESG measures, not as a matter of compliance but rather as a fundamental tenet of their investment strategy. While all investors and investment managers will say this is true, the differentiation becomes apparent when discussing the degree to which ESG features in investment due diligence, decision making and interaction with partners and stakeholders. Furthermore, there is scope for cross-fertilisation of ideas and best practice. This enables investors to benefit from economies of scale aspects of ESG and financial performance of their investments.

The last word

It is true that greater levels of competition, and the wave of first-time capital, is putting prospective infrastructure returns under pressure, particularly for brownfield assets. Frontier saw this playing out in Europe as much as in any other regional market.

However, Europe is also a market that presents tremendous opportunity for sophisticated investors and, perhaps contrary to popular belief, it is not solely confined to the higher end of the risk spectrum. There is scope for investors to earn decent risk-adjusted returns, whether it be in the core, value-add or opportunistic infrastructure markets.

The challenge is that these opportunities are not generic. Sector-specific, region-specific and asset-specific dynamics will have a defining impact on outcomes for investors. Gone are the days where being indiscriminate will achieve positive outcomes. More so than ever, investors need to be discerning with their partners, their advisors and their assets.

The European infrastructure market as a deployment destination is an attractive one for investors. The key is where to look and how to execute.

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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