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International

Global research and insights from Frontier Advisors

Observations on Real Assets

North American Research Trip

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

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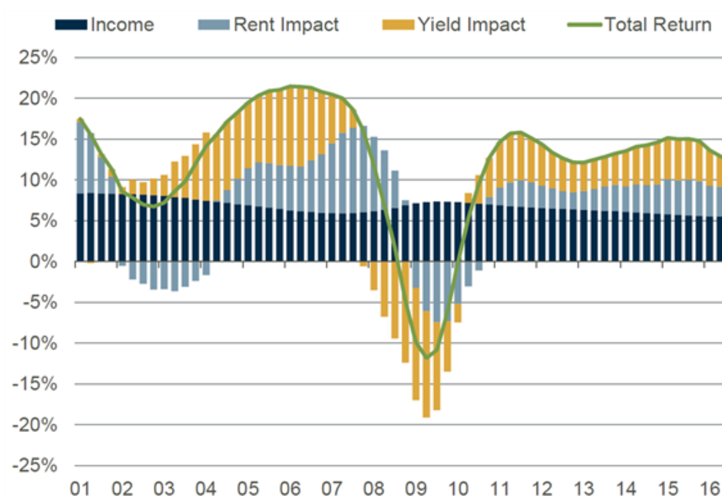
Part 1: Reflections on the US real estate market

The US commercial real estate market has performed strongly over the last three years, with a healthy recovery since the global financial crisis (GFC). Low bond yields across capital markets, an economic backdrop creating growth in business and employment, and a real estate market displaying strong fundamentals and characterised by limited speculative development and modest levels of new supply (in most sectors and markets), have all contributed to multiple drivers of return as demonstrated in Chart 1.

Chart 1: US prime property market return attribution analysis



Source: Cushman Wakefield, JLL, CBRE, Colliers, PGIM

With this backdrop, investors have enjoyed strong and improving returns, driven by a combination of growth in net operating income (NOI), improving market rental levels and a progressive compression in capitalisation (cap) rates. This has delivered to investors double-digit returns from high quality, core real estate. In this environment, it has been less about the individual skills of the investor and their managers, and more about "a rising tide lifting all boats"[1].

Looking forward, US real estate market fundamentals are relatively strong, but returns are nevertheless decelerating. Income growth is both cyclically and historically strong, but cap rate compression is slowing, and in some cases reversing. The outlook for the next three years is therefore more focussed on income, propelled by cash flow and income growth, and this has seen a reset to prospective high single-digit returns.

[1] The favourite property cliché of Tim Stringer, Principal Consultant and Head of Property at Frontier.

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Capital markets have adjusted to this environment, with lenders only willing to lend on high-quality assets, with substantial pre-commitments and low loan-to-value ratios, and there are very few lenders active for riskier assets and developments. Equity investors are still willing to accept some modest development risk though, but are conservative.

Comments by US sectors and regions are as follows.

- Over the next three years we expect the industrial and office sectors to outperform the multi-family and retail sectors.
- The strong tailwinds in the industrial space, from both the secular driver of e-commerce and the cyclical drivers of general economic growth and an improving housing market, should support strong NOI growth for the sector going forward.
- The office sector should also see strengthening NOI growth from improved tenant demand over the next few years. We are expecting the sector to have the strongest NOI growth of the four during this period, but there is more uncertainty around the office sector as the secular trend of "densification" remains a headwind.
- Multi-family will likely trail during the next three years, due to pressure from supply on NOI growth, but we expect returns to improve towards the end of the three-year forecast period as the supply pipeline dissipates thanks to a tighter construction financing environment (which should help restrain new construction after 2017).
- We expect the retail sector to be the weakest of the four during the next few years. Retail NOI growth will be evident from long term leases signed during the GFC being renewed at a higher rate, but store closures will weigh on rents, causing the sector to underperform.
- From a geographic perspective, the best opportunities will likely be in the technology and Sunbelt markets, although other major markets will also have some attractions. Job and population growth should be strong in the Sunbelt, which includes Phoenix, Dallas, South Florida and Southern California. However, a number of these markets, such as Phoenix, have fewer barriers to supply, and investors should not expect to hold assets for the long term there. Southern California and South Florida do have more supply constraints, and investments in these markets will more likely outperform over the long term.
- Additionally, though the outlook varies by property type, Austin, San Jose, Portland, San Diego, Seattle, Oakland and Denver are viewed positively due to employment and wage growth driven by the technology sector.
- Boston, due to growth in the technology and biotech sectors, and Washington, due to the end of government austerity and the prospects of stronger spending, should also yield investment opportunities. However, urban areas in both markets should outperform the suburbs.

We note though that real estate is inherently a cyclical asset class, experiencing long upward trajectories, periods of modest growth and, at times, downturns driven by a combination of high levels of supply, recessionary economic periods and lack of tenant and investor demand. Each of the previous cycles and corrections in markets across the US have been caused by different issues, and indeed each cycle is very different than the last. There are peculiar attributes that have driven past cycles and, while important to understand those drivers and to apply learnings to future cycles, it is therefore very difficult to draw absolutely clear conclusions about future behaviour of commercial property markets.

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Nevertheless, from hereon, and at this mature point in the commercial real estate cycle in the US, it will be very important to look carefully at the quality, experience and expertise of investment managers in terms of their asset management, and property management, proficiencies. High-quality asset management cannot be taken for granted and, not only can skilful asset management have a significant impact on the investment return, but a high-quality asset manager with the necessary experience, skills and judgement will outperform the rest of the market via optimal market rents, keeping vacancies low through tenant retention and managing capital expenditure judiciously.

The best asset managers allocate significant resources to continually review and evaluate the performance of each of their portfolio properties. Important in this process is:

- Managing various costs of operation and having clear planning for improvements in upgrading building systems at appropriate intervals;
- A focus on maintaining and enhancing revenue, and on seeking opportunities to replace existing leases with more favourable leases;
- Monitoring assets for operations and performance, and generating very clear reports against well-developed budgets, including regular visits to the site to gather intelligence about each aspect of the property and comparing it against conditions in the local market to ensure the property is well positioned within that market;
- The development of a high-quality operating budget, which is reviewed periodically, with short-term needs and prospects regularly assessed; and
- A strategic review of each asset annually, which provides a qualitative forward-looking analysis focusing on the property's marketing plan to attract new tenants - this is an aspect that requires creativity to ensure that potential actions, that can materially improve returns, are implemented.

As we note frequently, Frontier puts a great deal of effort and focus in our property manager selection process on understanding the quality and potential of a manager's asset management team. In assessing this, we consider their: ability to achieve optimal market rents, high occupancy rates and low tenant turnover; reputation for high quality management of both tenants and the property; use of modern sophisticated operational tools; judicious capital expenditure; and understanding of, and compliance with, local state and federal laws.

This focus is now particularly important as the "cyclical tide starts to recede"[2] and the best investment and asset managers will become clearly visible in performance terms.

[2] Tim Stringer's second favorite property cliché.

Part 2: Defensive strategies for the mature stage in the property cycle

This mature point in the US commercial real estate cycle is encouraging some thinking in the US property sector as to how to position a portfolio to defend against future flat, or adverse, market conditions. As a large, diverse and dispersed property market, the US provides more active levers to address this issue and, at the same time, provides insights for inbound investors.

In this Frontier International we explore some of the key defensive strategies currently being considered, or actively employed, by US core property fund managers in managing their assets and portfolios. The six strategies observed are as follows.

- Fine tuning the strategy of a fund.
- Optimising asset characteristics and asset quality.
- Adjusting geographic allocations.
- Tilting sector allocations.
- Effective asset management and an active approach to portfolio construction.
- Active management of capital.

Some or all of these strategies were cited in discussions with fund managers, or observed directly in fund portfolios, on our trip and these are noted where appropriate.

Strategy

Fund managers we researched in the US on this trip were in the core or core plus spaces of the US commercial real estate market. Nevertheless, the better managers were actively considering the current stage of the property cycle and tuning their strategies accordingly, in particular repositioning into more defensive strategies.

Over the property cycle, US property managers adjust their portfolio weight to core property, and strategic investment guidelines are typically in place for core and non-core property allocations. These guidelines both direct managers' investment decisions, and guide investors on a particular fund's risk appetite. Non-core property allocations typically include strategies such as value-add, development and opportunistic property and, across the Frontier suite of US core property managers, strategic caps to non-core property are typically around 15% of the portfolio.

Given the maturity of the cycle, we expected to observe reductions in managers' allocations to non-core property, and we have seen this to be the case. We noted non-core property allocations trending down to around 5% to 10% of portfolios, with some managers allocating less than 1% to such strategies. In addition, US core property managers are reducing portfolio exposure to development risk at this point in the cycle.

Asset income characteristics

In our Property Quarterly of June 2015, Frontier addressed in depth the importance of income in assessing real estate. Long-term historical returns for property show income comprises, on average, approximately 75% of total return, a ratio to which we see the US commercial property sector moving to going forward as compared to the more recent post-GFC period where at least 50% of total return was attributable to capital growth (see Chart 2).

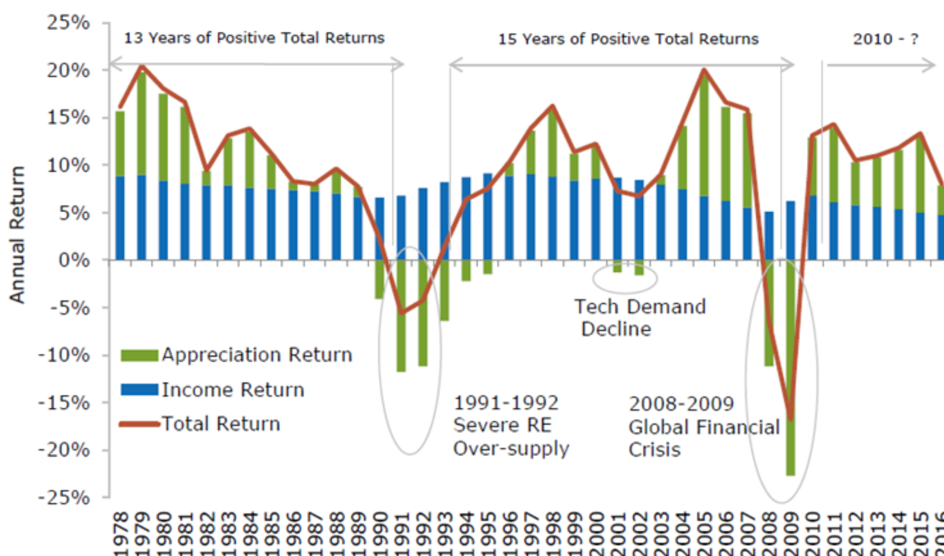
Optimising a property's annual net operating income (NOI), and reducing its volatility, is a key defensive strategy for property managers. In most cases, lease structures and lease expiry profiles are the dominant variable in NOI, and therefore are the principal focus.

Interestingly, in the US there are a couple of schools of thought amongst US core property managers regarding the approach to a portfolio's lease expiry profile at this point in the US property cycle. Some are weighted average lease expiry focused, looking to lock in key tenant lease renewals early in exchange for further potential rental growth that may be possible down the track, but is nevertheless currently uncertain. The fund manager in this case is reducing income risk from the equation, particularly if a higher than average number of leases are anticipated to expire in three to five years. There may be sector or submarket drivers behind such tactical strategies, but nonetheless it is generally an active asset management decision and strategy.

As a second approach to lease expiry profiles, there are fund managers that project material upside in NOI and therefore will wait until the point of expiry to execute on lease renewals to maximise growth opportunities. In these cases, tenant concentration may not be an issue and/or is supported by forecasts of limited supply in the market at the time of expiry.

Both strategies can be effective defensive approaches to protecting NOI, and it is important to investigate these strategies in detail to determine a fund managers overall approach to income preservation, and to tactically maximising NOI growth whilst demonstrating effective risk management. In general, fund managers researched by Frontier in the US are very active in maintaining high occupancy levels to protect future cash flows.

Chart 2: NCREIF Property Index total return history



Source: NCREIF, Clarion Partners – Long term average returns: income 7.3%, capital growth 2.1%, total 9.6%.

Geographic allocations

The US is a diverse and large real estate universe where local markets do not move synchronously with one another. Performance and volatility diverges a lot, as shown in Chart 3. Note too that higher beta markets are generally the higher performers, and in many cases are also markets with higher liquidity. The interactions of performance, risk and liquidity factors are key issues for consideration by US core property managers when determining geographic areas of focus within the defensive frame.

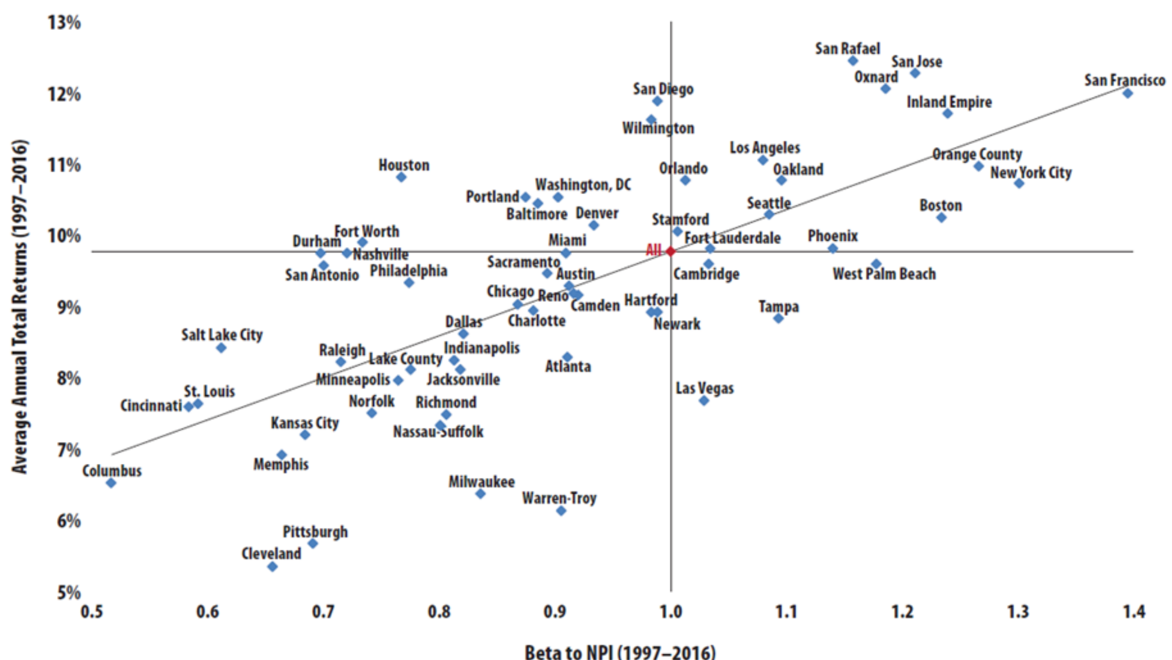
For example, at the upper right of Chart 3 is San Francisco, a favourite of institutional investors and a highly liquid property market which has shown it can ride through any cyclical volatility in the local economy. San Francisco is exposed to cyclical industries, such as technology, that can produce occupational demand volatility, although the property market benefits from population density and a heavily regulated planning environment. A long-term investor in this market can therefore generally be rewarded through higher returns in exchange for weathering this cyclicality.

By contrast, Columbus, Ohio, at the lower left of Chart 3 has an abundance of land and a dominant government and education sector, and limited levels of transaction activity, although it is subject to far lower cyclical volatility in occupational demand.

Certainly, in theory, a savvy market timer could take advantage of more stable Midwestern city property markets, such as Columbus, when facing an economic slowdown or maturing property market, before returning to higher beta cities as the economy recovers. However, liquidity in the different markets (which also reduces cyclicality of some cities) creates difficulties in executing on a strategy to exit these markets at the preferred time in the cycle, and the more liquid investment can consequently be considered the more defensive option.

Given that market selection is not as simple as theory suggests in executing a defensive geographic strategy, Frontier's observations are that US core property managers' portfolios in general focus on neutral to higher beta (and hence more liquid) cities such as San Francisco, Silicon Valley's San Jose, Los Angeles, Orange County, Seattle, Boston's Cambridge, New York, Chicago, Denver and Washington D.C. The large core property managers' open-ended pooled funds value the defensive benefits of the higher liquidity, and also have the ability to ride through cities cyclicality.

Chart 3: Market betas and average annual total returns



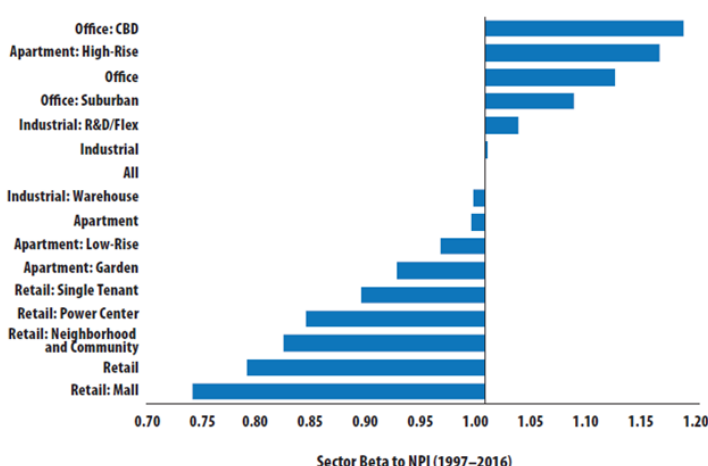
Source: NCREIF, Deutsche Asset Management

Sector allocations

Historically, the US office market has displayed greater sensitivity, compared to the US retail sector, to wider economic cycles, with the multi-family and industrial sectors being closer to a market neutral beta (see Chart 4). The rationale is that, during recessionary periods, company redundancies increase and reduce overall staff numbers, and company bankruptcies result in office space rationalisation. For the retail sector during these periods, whilst consumer spending growth may slow or reduce, longer retail lease terms, compared to other sectors, help weather the economic cycle. The industrial sector shares some common demand drivers to retail, although shorter leases render it subject to higher cyclicality. The multi-family sector is more resilient than the office sector too and, though households may delay house purchases, they will continue to meet lease obligations although short-term one-year leases do introduce income volatility.

In the current market, we noted a consensus among US core property managers on a market weighting for both the retail and office sectors. Certain industrial assets (e.g. retailers' order fulfilments centres) are currently a focus for core property managers, as a rotation from lower quality retail assets, and this is seen as improving defensive portfolio characteristics going forward. Finally, US fund managers are reflecting the current oversupply in the multi-family sector in terms of lower sector weightings, comparatively.

Chart 4: Sector betas to the NCREIF Property Index

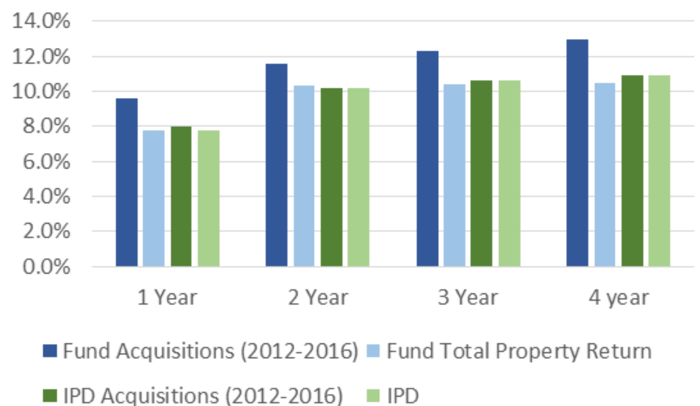


Source: NCREIF, Deutsche Asset Management

Asset management and portfolio configuration

In an inefficient real estate market, the skill with which the properties are acquired, disposed and managed is an important component of the final return delivered to investors. As noted in the previous section, in this mature phase of the real estate cycle, the quality of, and expertise in, asset management will be a key driver of outperformance by the best managers. As an example of the potential value, Chart 5 provides some of the positive upside generated by a US core property manager that Frontier researches. This upside has been delivered in a period of strong property markets and would be further emphasised in the expected flatter performance environment we are facing.

Chart 5: Total unlevered property return



Source: Sample manager, Frontier

The previous section of this Frontier Line also highlighted the key aspects and attributes associated with an effective asset manager, and won't be repeated here. Combined with considered portfolio construction, these contribute to the defensive characteristics of assets and portfolios.

For example, we observed on our trip that the better US core property managers were looking to secure more durable cash flow by acquiring assets with longer leases, selling assets with shorter leases and, where possible, negotiating with tenants to pre-emptively extend existing contracts.

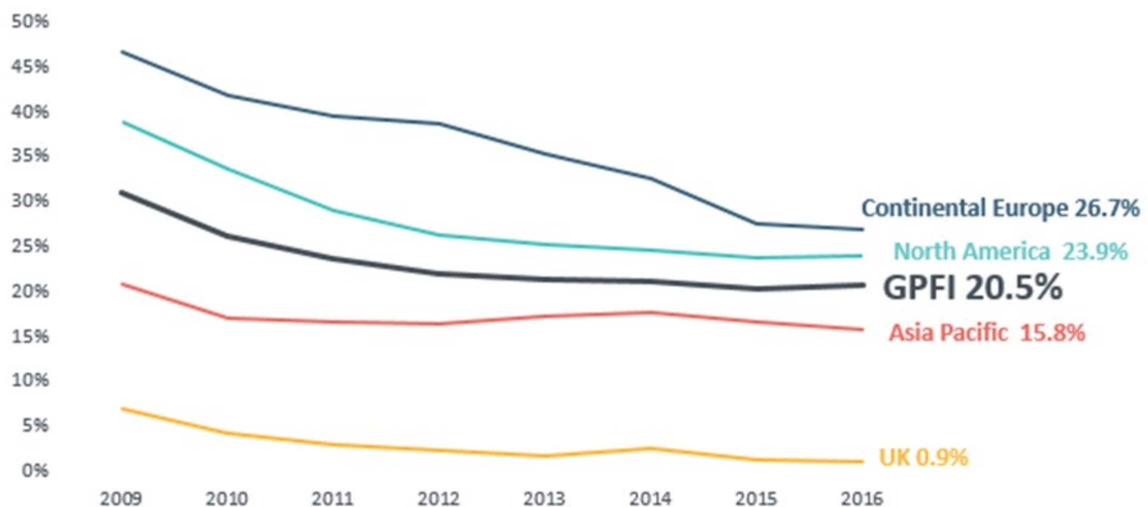
Similarly, we noted that fund managers are focussing on replacing assets occupied by less creditworthy tenants in exchange for stronger income profiles and that fund managers, over the last few years have been recycling capital into higher quality, dominant assets.

Capital management

The level of debt is an important consideration in a property portfolio, and there has been a notable global downward trend in aggregate portfolio leverage in recent years (see Chart 6). The US commercial property market is no different, with de-leveraging improving the defensiveness of portfolios. Our research on US core property funds confirms the broad evidence in Chart 6, with most portfolios carrying historically low levels of debt.

Balance sheet, and asset management is also important in managing debt defensively. Fund managers can defensively manage leverage by reducing debt at the point when (or before) changes in economic conditions translate into transaction evidence that negatively impacts asset valuations. Sufficient cash reserves on balance sheet may also be relevant to address contingencies such as re-leasing costs and capital expenditure for required refurbishments, and to also opportunistically exploit acquisition opportunities during periods of market distress. Finally, where leverage is used, debt maturity profiles warrant close monitoring to ensure risk is minimised as a property approaches its refinancing date, and valuation changes and cash flows need to be observed and managed continuously at the asset level to ensure refinancing success.

Chart 6: Leverage by region over time



Source: MSCI

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The last words…

We find ourselves now facing a lower return environment in US core property. During our recent trip to the US, and in discussions with local managers, we observed all aspects of investment management theory and practice being tested and challenged by this point in the cycle. Importantly, the US core property managers we met with are already thinking about, and preparing portfolios for, this late stage in the property cycle via the defensive strategies highlighted.

Repositioning assets and portfolios in a property cycle is a considerable challenge. Pleasingly, many of the best managers we researched saw this as a core part of their value proposition, and are actively preparing their funds for a potential market flattening and/or downturn through effective implementation of defensive strategies.

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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