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Real Assets Research Trip

US Niche Sectors – Sunshine on the Sun Belt Region

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

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Introduction

People have and will continue to be drawn to warm climates, new jobs in defence, tech/electronics, aerospace and healthcare. Above all, housing and lifestyles are more affordable than California or NY where state taxes are two to three times higher.

As core total returns compress to mid-single digits in a lower-for-longer interest rate environment, Frontier's Property Team embarked on a search for real estate investment opportunities that are expected to withstand macro-economic cyclicality and shocks. The focus of our trip was four-pronged:

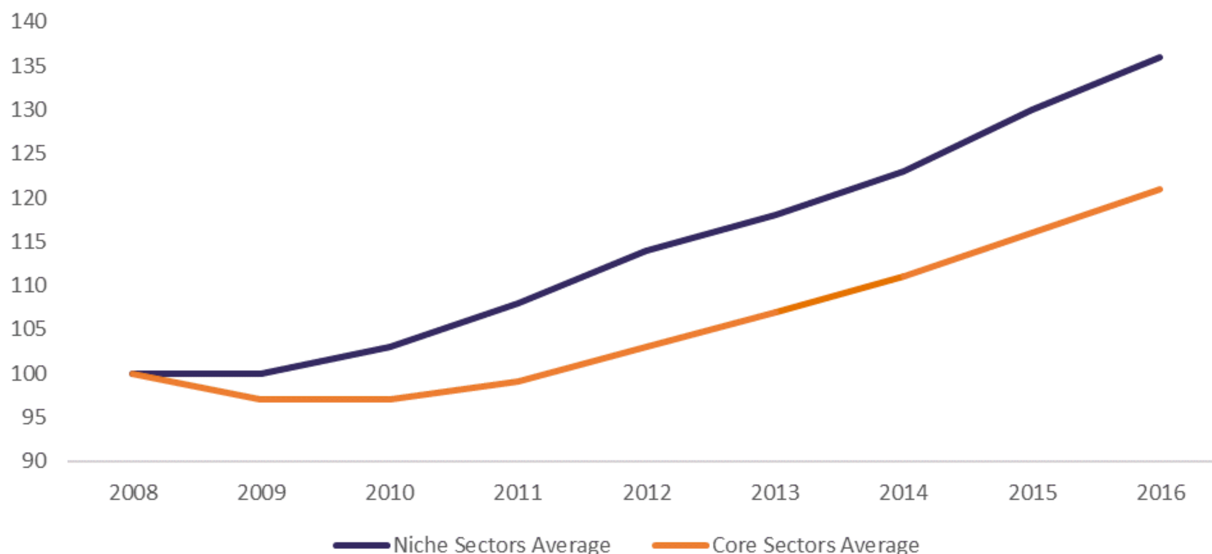
- An introduction to Japanese multi-family, logistics and supermarkets (separate paper to be released February 2020);
- An update on US Core sectors (covered in our Real Assets Quarterly paper);
- Investigation of US Niche (or Alternative) sectors which is covered in this paper; and
- To gain an understanding of the growth of "Sun Belt" cities.

Knowing that specialist niche sectors are underpinned by burgeoning demographic demand such as ageing populations and the need for properties offering both living and accessible care, the focus of our trip was to better understand the opportunity set. The US, the deepest and largest real estate market globally, has outsized demand for housing, healthcare and associated uses. Extending that continuum of care, life sciences/bio-med scientists in the quest of cures for chronic illness or longevity are increasingly requiring lab space in close proximity to universities and pools of local talent.

We believe these needs will be transformative for real estate, continuing to drive strong income growth in niche sectors relative to the broader market as a whole (Chart 1).

As the historically defensive retail sector and office sectors undergo disruption to varying degrees, Frontier believes niche sectors can provide a complementary fit for long-term portfolios.

Chart 1: NOI growth—traditional vs niche



Note: Major sectors includes office, industrial, retail and multi-family; alternative (Niche) sectors includes healthcare, self-storage and student housing.
Source: Kayne Anderson, Green Street Advisors

What are niche sectors and why the Sun Belt focus?

Non-traditional real estate types such as various housing segments (workforce, seniors, student), healthcare, medical offices (MOB) and life sciences/bio-medical laboratories generally fall under this category. They typically are operationally intensive, requiring a strong grasp of tenant space requirements. In our 2019 Property Configuration for Frontier clients, we flagged the following secular trends that are benefitting from a global groundswell as being complementary to core allocations:

- Demographic changes: The two fastest growing cohorts globally are the baby boomers and millennials. We believe this will place high demand on senior housing, healthcare and workforce housing;
- Urbanisation: As populations grow, migration to cities rises in search of employment, housing, schools and leisure. This heightened demand, in our opinion, is expected to create a trend for mixed use precincts and buildings; and
- Technology and innovation: Shopping preferences are having a profound impact on retailing, logistics and e-commerce. We also expect several disruptors to emerge such as data shells and life science laboratories.

Long leases (except in housing), strong income yields and consistency of returns characterise these sectors well. Niche sector pricing offers a healthy spread to traditional core real estate. The opportunity to position allocations while they are on an upward trajectory and at attractive pricing at the present time is strong.

We believe they provide solutions for a variety of Frontier clients either via funds for smaller clients or co-investments for larger commitments.

Why the Sun Belt region? It's all in the "Smile Line"

The region, shown below, stretches across eighteen states in the Southeast and Southwest and includes seven of the ten largest US cities, as well as many mid-size metropolitan statistical areas (MSAs).

Sun Belt region and major cities

Source: Moody's Analytics, Clarion Partners

It's all in the "Smile Line" (and Boston for good measure).
Business-friendly; lower cost of living, lower taxes and importantly, twice as affordable as SoCal or NY.

Over the next decade, the Sun Belt population growth is expected to accelerate by an additional 19 million people (+13%), whereas non-Sun Belt states are forecast to rise by only 3 million (+2%).

A pro-business culture, largely enabled by fewer and less onerous taxes and regulations, has spurred significant private sector growth in these regions. The US Tax Cuts and Jobs Act (2017) has provided a huge impetus for jobs growth in the longest expansionary period of US history (although there may be some signs of growth easing). Additionally, the introduction of the Qualified Opportunity Zones (QOZ, 8,760 nationally) are benefiting many lower-income, urban real estate markets.

For example, the economies of the QOZs in Austin, Texas, are projected to grow to nearly three times the US national average over the next five years.

Overall, lower taxes and cost of living within the Sun Belt, combined with strong jobs, GDP and wage growth is expected to attract millennials (expected to be 75% of the workforce population by 2030[1]).

These factors present a compelling need for all kinds of real estate from homes to schools, entertainment and workplaces in these Sun Belt states.

Some Statistics

The Sun Belt now holds about 50% of the US national population (equivalent to 163 million people in the Sun Belt), which is expected to rise to about 55% by 2030.

Total employment in the Sun Belt region grew by 12 million (+20%) versus 9 million (+12%) in the non-Sun Belt over the past decade.

There are 8,760 Qualified Opportunity Zones (QOZs), nationally. Austin's QOZs are projected to grow nearly 3x the US national average in the next five years.

Booming needs-continuum

While the broader economy supports business and consumer confidence/consumption, the following demographically driven segments are generally less sensitive to macroeconomic shocks and volatility. We believe they provide low volatility and smooth returns for a variety of Frontier clients seeking a higher income focus.

Housing – a paradigm shift

The US is experiencing a critical housing shortage and unaffordability issue. By many reports, the US market requires an additional five million units per year by 2030. Despite an uptick in completions in 2017 and 2018, the supply of new multi-family space is decelerating.

Currently, a long build-up of challenges and stagnated policy has exacerbated the problem, compounded by rising land and construction costs. According to Clarion Gables, a multi-family specialist, state taxes can account for up to 32% of total development costs.

The characteristics of apartment markets vary by location. Typically, high barrier markets – notably West Coast markets such as Los Angeles and San Francisco (most restrictive planning regimes) – are likely to remain strong. However, the unaffordability issue (defined by rents constituting 30% of median income) is creating net migration loss to more affordable cities such as Austin, Dallas and Nashville where rents are still close to half of Los Angeles and New York. We expect these cities to mature in the next 10+ years which changes supply/demand dynamics and unaffordability.

Frontier inspected a number of assets across a variety of strategies from Class A (top of line, luxury accommodation offering concierge service, club facilities including pool, gym, BBQ and home offices) to Class B or C in Los Angeles, San Francisco, Austin, Dallas and Nashville. Rental differential is wide from $5,500 per month for two-bedroom Class A in California to $3,500 in Austin or $1,000 per month in Nashville (Class B to C). **Will Austin and Nashville become the Los Angeles and New York of the future?**

[1] Forbes. *The Millennial Arrival and The Evolution of the Modern Workplace*. 2018

Workforce

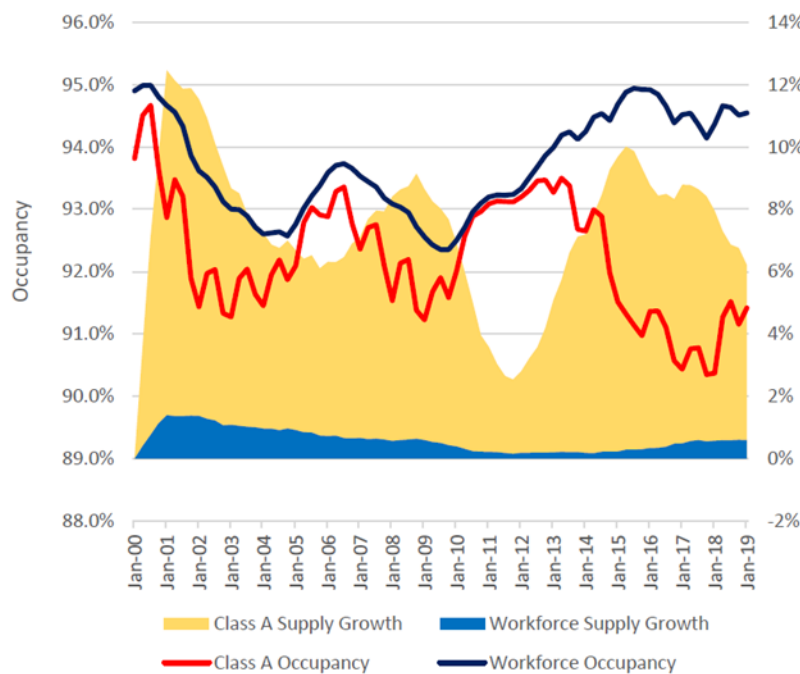
For the reasons noted already, demand for workforce housing, which targets middle-income “essential” workers including police officers, firefighters, teachers and health care workers, is escalating. Typically, these workers are a good credit risk, and live in two-income households but find that homeownership or renting within close proximity to their work is still unaffordable.

Most of the US rental market is unregulated with little or no rent control laws (except recently in California and New York). As a rule of thumb, tenants will spend 30% of their pre-tax salaries on housing, with that ratio rising to 50% in gateway cities or areas such as Manhattan, Los Angeles and San Francisco.

Workforce housing is distinct from affordable housing (government subsidised). In Australia, the sector is referred to as Key Worker Housing. Workforce occupancy rates are more stable than Class A assets (Chart 2). Net supply is minimal (less than 1%) whereas Class A supply was markedly higher (6% between 2018 and 2019).

Frontier met a manager with a unique social slant that works with banks which are required to re-invest into their community if they lend or invest in funds under the Community Redevelopment Act (CRA). To achieve this, banks can invest in workforce housing where 51% of tenants must earn 80% of Area median Income (AMI) or below.
The manager also offers social after school programs, hosts regular events and provides adults with technology training. To monitor performance, bridge reports to the IRIS - Global Impact Investing Network.

Chart 2: Class A vs workforce occupancy, supply and supply growth



Source: CoStar Analytics

We see a strong opportunity set for workforce housing across diverse geographies likely to benefit from the long-term confluence of favourable fundamentals.

Senior housing

Accommodation ranges from hospitality to healthcare, with social services provided based on the acuity levels and care required. At the low end of the acuity spectrum, age restricted apartments, or active adult communities, primarily provide residents with a community of other 55+ year old residents, along with some limited social activities. Generally referred to as Independent Living Units (ILUs), operators offer limited healthcare services, food service, and home maintenance services along with social events such as group outings, movie nights, or education courses.

Assisted living communities provide more hands-on supervision, including assistance for those who need help completing daily living activities. Many seniors housing communities offer multiple levels of care, from independent living to memory care, in one community.

There is an array of senior living property types and the distinctions among them are largely based on the level of healthcare offered (Chart 3).

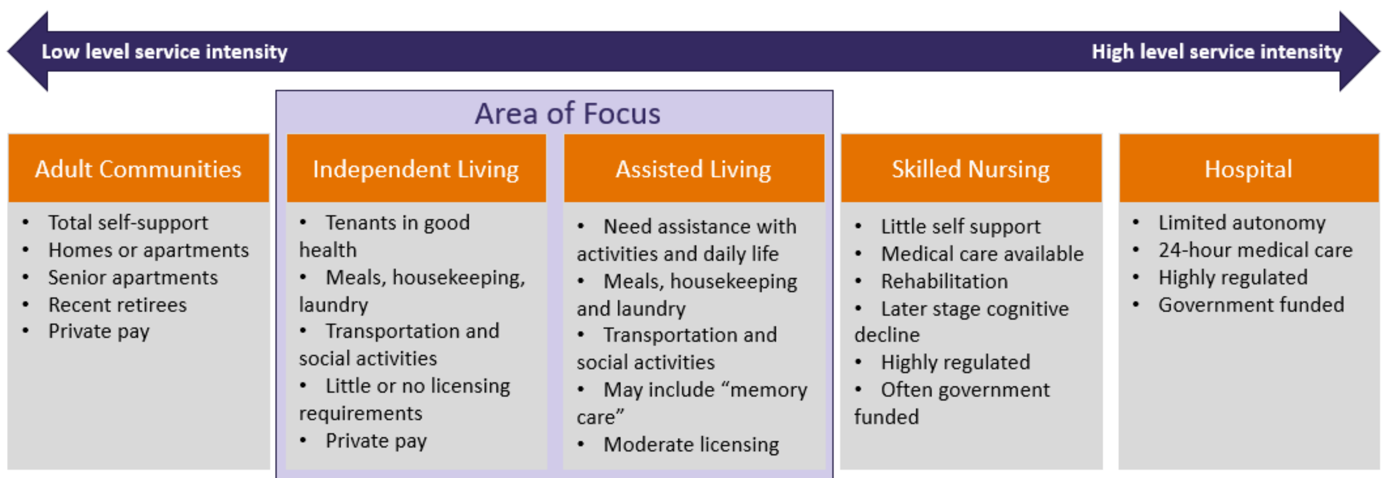
Operating characteristics relative to traditional real estate, include a services-heavy operating environment, often highly specialised management personnel, fragmented market ownership, and a mix of private-pay and government-reimbursed residents.

The number of U.S. residents aged 75 or over is forecast to grow significantly, exceeding 30 million by 2030 and 42 million by 2037. Even at currently projected completions of 39,000 units per year, and doubling in a decade, the volume of senior housing units needed will far exceed supply[2]. The senior housing market is currently a US$1.5 trillion sector and is expected to grow to US$3.0 trillion in the next 10 years[3].

Supply has risen to meet some of this demand, dampening rental growth, but opportunities remain attractive in the medium-term. Demand drivers are poised to strengthen rapidly over the coming decade. Currently, penetration rates (the percentage of adults residing in this type of accommodation) are low because senior living is prohibitively expensive for most households.

Frontier noted that assisted living rents can reach in excess of US$6,000 per month (and more with rising care levels, which places it out of reach for most individuals.

Chart 3: US senior housing options continuum



Source: PGIM 2019

[2] PGIM: Evaluating the Case for Investing in U.S. Senior Housing
[3] Virtus Real Estate Capital

Frontier found that the majority of managers operate across a highly defined spectrum of senior healthcare needs.
For example, one manager we met focuses on major markets (no secondary markets) and high-quality assets that are under managed. Key targets are "private-pay" (not Medicare or Medicaid reimbursable) residents with predominant exposure to the independent living segment, while a smaller focus on assisted living is also considered. The product type is very high quality, with the typical tenant having 3x the average net worth.

An Austin based manager runs a series of funds across the risk spectrum as a Hybrid Allocator. The majority of this manager's residents are private pay. Residents pay monthly rent + services depending upon the amount of care they need (meals, medication reminders, dressing, grooming, transportation, etc.).

The mantra is **'inuring societal needs'** meaning education, healthcare and workforce housing. They admit these sectors have more idiosyncratic risk, are more operationally intensive and so a lot of time is spent with local operating partners 'in the weeds' ensuring cultural integrity and corporate development.

A third manager we met is another senior-housing owner and operator with property management and development capabilities. Like the other two, this manager also operates on a pure 'private pay' rental model. Its senior living strategy is to develop, redevelop, acquire and recapitalize senior housing properties in the San Francisco Bay area, Southeast, Washington DC and markets with high multi-family ratios and family wealth.

The key downsides Frontier observed are: underestimating underwriting of lease-up periods in low barrier markets, new competition and higher than forecast turnover of residents. Highly labour intensive, senior living is also characterised by increased operational risk.

We see the demand/supply imbalance and increased construction/labour costs as exacerbating the shortage of senior housing. Reduced care delivery costs and technological advancements will provide more efficient real estate solutions and potentially greater upside.
Frontier sees a strong opportunity set but, the operational risks tend to be greater than in other housing sectors.
It is therefore paramount that investments are paired with highly skilled operators.

One manager described their offerings as a *"Cruise Ship Living on Land"*

- All meals are prepared fresh, on a daily basis with sushi size portions for Assisted patients enabling dining with dignity.
- Equine therapy and massage therapy from local university trainees
- 99% of tenants come from local market.
- Majority of enquiries are from daughters of patients via social media.

Healthcare: Life sciences/bio med

The continued need for the development of new drugs, novel medical therapies and innovative research has created growing demand for sophisticated life sciences facilities that can accommodate the range of life sciences uses usually staffed by people from academic, research, or medical institutions. The National Institutes of Health (NIH), founded in the late 1870s is the primary US government agency responsible for biomedical and public health research. MIT in Cambridge, Massachusetts is a prime example of a sub-market with crucial access to talent and high demand from the healthcare sector. In a market of 12.5 million square feet (circa 1.2 million square metres), there is immediate demand for up to 2.5 million square feet (circa 233,000 square metres) in Cambridge alone. A very low vacancy rate (0.7%) continues to put upward pressure on rental levels. Frontier met with Bio-Med Realty, a specialist real estate company (now owned by Blackstone) and toured a few facilities in Cambridge. They report rental uplifts on new leases in excess of 15% and rental growth rates of 10% per annum.

This is a highly specialised segment within the real estate sector created by the ongoing demand for specialised building solutions for participants - office, laboratory research and computing needs. Base physical requirements of high floor-to-ceiling heights, floor loads for heavy equipment, multi-redundancy power supply and docking make these assets highly specialised but equally, more expensive to develop. Talent is key to supporting the research efforts. Tenants are often 'sticky' and long net leases (between 15 to 20 years) are not uncommon. We note that until a new cure/idea/innovation is found, research is typically a loss-making exercise and funding often relies on venture capital funding and university endowments, posing challenges to the long-term credit quality of some tenants.

Large pharmaceutical firms (shown in Chart 4 below) such as Pfizer, Novartis and Takeda are some of the bigger tenants creating demand in university towns such as Cambridge, Stanford and Nashville.

Life sciences participants tend to cluster to benefit from positive synergies, working business relationships with nearby tenants and access to a group of like-minded employees. Boston and the San Francisco Bay area have become the predominant clusters in the US. These clusters are located in places where a favourable environment exists combining innovation, lifestyle and culture. Other primary life sciences markets such as greater San Diego, CA, New York/New Jersey, suburban Maryland, greater Seattle and the Research Triangle in North Carolina have developed around universities well reputed for medical research.

Frontier toured LabCentral an established startup sponsored by stalwart sponsors (noted in Chart 4) where scientists rent out a desk and laboratory facilities – a WeWork equivalent in Bio Med.

The sector is tightly held and achieving scale can be challenging. However, this provides an opportunity set for experienced managers Frontier has been monitoring. Duke University and MIT reportedly use one such manager as their off-balance sheet partner for their strong relationship with a dominant Boston life sciences real estate specialist Bulfinch. Another has partnered with Longfellow, and an emerging operator in the space.

The sector requires highly specialised buildings for industry participants. Despite the demand being high as evidenced by a 0.5% vacancy rate, Frontier sees that some tenant risk exists: while big pharmaceuticals have strong credit, bio-tech ventures could pose funding risk. Additionally, the sector is difficult to access. As such, a diversified strategy with an allocation to this sector is preferred to a discrete allocation.

Chart 4: Leading names in the bio med industry

Source: BioMed Realty, Boston (A Blackstone investment)

Medical offices buildings

A change in the policy of insurers over a decade ago resulted in patient care moving from in-hospital to outpatient care, sparking an evolution of the medical office market. Those with insurance were given the choice of facility, specialists and locations and were reimbursed for making this switch. The healthcare industry had to swiftly adjust to this new business model, resulting in hospital operators and related service providers acquiring medical office buildings and signing up practitioners.

Most outpatients have a strong preference to be within 1 mile of their local medical centre with easy drop off access and strong transportation nodes, making this sector a very locally driven dynamic.

The sector is relatively stable with historically higher occupancy rates relative to traditional core office (Chart 5).

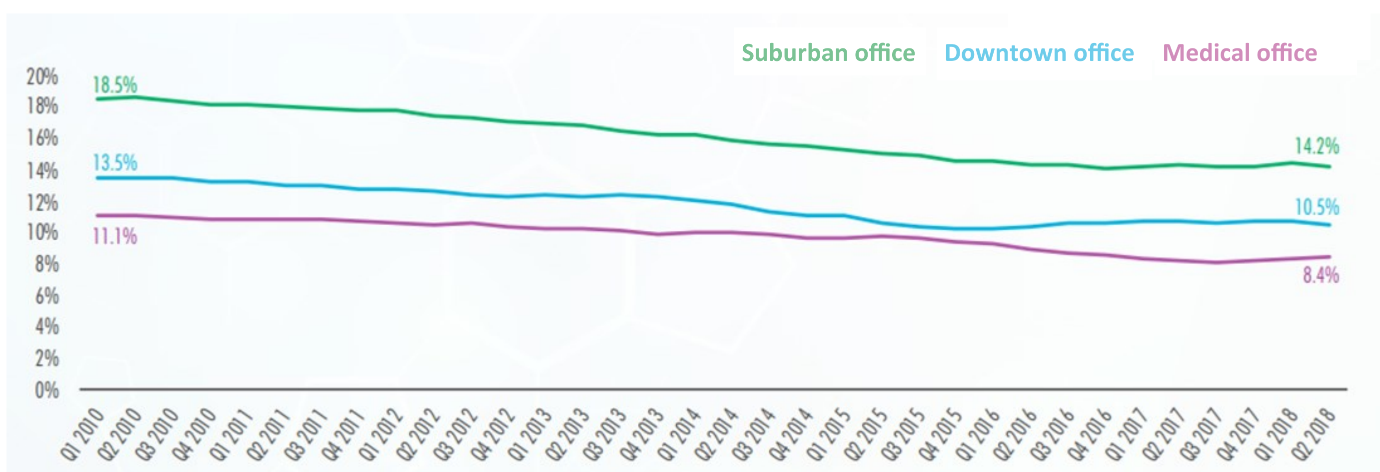
It is worth noting that 2018 saw the largest volume of completions since 2009 in large Sun Belt markets with rapidly growing populations while simultaneously registering highest absorption rates (Phoenix, Houston, Dallas/Ft. Worth and Atlanta)[4].

However, new supply is lagging demand as construction financing can be challenging to obtain. As a result, the sector has only grown by 1% per annum over the last three years despite the sticky nature of tenants and high retention rates (85% to 90%).

The ageing US population is driving meaningful healthcare and medical office demand. After age 65, Americans seek a medical professionals' opinion an average of seven times annually, between 45 and 65 this reduces to four times p.a., and below 45 it drops to two. As such, CoStar estimates seniors will require just over 1.0 square metre of medical office space per person, more than twice that of the total population.

The additional medical office demand generated by seniors alone is estimated to be 18.4 million square metres. Of the 219 million insured population, 179 million are on employer sponsored health plans, creating a significant opportunity set (reportedly circa $1.5 trillion of real estate).

Chart 5: Medical office occupancy versus conventional office



Source: CBRE Econometric Advisors, CBRE 2018

[4] CBRE Econometrics, CBRE Research 2018

Although the ageing demographic bodes well for the sector, some strategies can require a high level of operational intensity in managing refurbishments with sitting specialists and their expensive equipment. Alignment between fund manager and local operator is paramount. Frontier observed a range of platform structures with both entities investing equity in funds or a part ownership stake in the local operating partner.

Other risks which could impact demand include an acute shortage of physicians[5] which may force the industry to become more efficient and innovative and regulatory changes to the national healthcare policy.

Repurposing for improved patient experience. Frontier observed a trend for failing retail malls being converted to medical offices. Health care tenants tend to take long leases because of the high capital cost of fitout and therefore have a strong motivation to stay put, often willing to pay higher lease rates than the retailers that previously occupied the space.

As the pool of traditional retailers shrinks, landlords see enormous benefit in these 'sticky' tenants. As one manager noted, "The cross-industry attraction among retail landlords and health care providers is mutual. In today's competitive market, hospital systems want access to patients where they live and work, so that their 'customers' do not have to drive across town to a flagship hospital campus."

Emergency rooms, clinics, labs and even micro-hospitals in underserved areas and near large patient pools are growing in popularity because a well-designed facility in a familiar location with easy parking reduces stress for patients and their families.

Frontier inspected a mall in Nashville, Tennessee, where approximately 50% of the total lettable area has been converted into medical office. The top floor, which is entirely leased to the medical arm of Vanderbilt university, provides a full suite of out-patient services. Some of the retail tenants include TJ Maxx, Ross Dress for Less, Burlington and a number of eateries such as Chipotle, Logan's Roadhouse and Panera Bread. The impact of high foot traffic means that medical patients also have a positive effect on the retail component of the centre, which was fully leased and reportedly trading strongly.

The story continues in Chestnut Hill, Massachusetts. The Bulfinch Companies transformed the former Atrium Mall in Chestnut Hill, Massachusetts, into the 286,000-square-foot Life Time Centre, a facility dedicated entirely to health care and fitness uses. Tenants include Life Time Athletic, the Dana-Farber Cancer Institute, Newton-Wellesley Hospital and Colorado Centre for Reproductive Medicine.

Frontier believes the Medical Office sector could offer a solution for investors to aggregate portfolios on a programmatic basis and achieve scale as the assets are stabilised, benefitting from the sector's defensive cashflow profile.

Medical office conversion— Nashville

Source: One Hundred Oaks

Medical office conversion – Atrium mall

Source: The Bulfinch Companies, Inc.,
© Peter Vanderwarker Photography

[5] Association of American Colleges, CoStar

Data centres

If the late 19th and early 20th centuries were defined as Australia's "Gold Rush", the 21st century can be classified as the global "Data Rush". The introduction of smartphones, cloud computing and content subscription/streaming platforms, combined with ever-improving download speeds and content quality (high definition audio and visual), has resulted in exponential growth in data consumption (as depicted in charts 6, 7 and 8). It is worthwhile highlighting that this growth is not expected to abate. Mobile data usage, for example, is expected to grow at a 38% CAGR over the next 10 years[6]. Next generation applications (5G, Internet of Things, smart cars) are further increasing the need for low-latency data transmission. To facilitate this demand, an increasing backbone of data infrastructure is required.

Every time a topic is "Googled" on a mobile cellular device, the search request is wirelessly transmitted to a mobile tower/small cell cite and travels via fibre to a data centre. The same process applies anytime a query is sent to the "cloud" (which in reality more closely resembles a warehouse). Data centres power, cool, connect and house IT hardware. Key characteristics of a data centre are:

- Direct proximity to a major fibre network.
- Access to abundant, cheap and uninterruptible power (10x the amount of commercial office).
- Significant amounts of cooling equipment.
- High level of security.

There are four key segments of the data centre market. These are noted in chart 9.

While the capital investment, return metrics and risk factors (i.e. technology) of co-location facilities lend themselves to infrastructure investment, data shells have characteristics akin with real estate; limited complexity and long leases executed with high credit tenants. For the tenants, data shells allow them to avoid the comparatively low ROIC of real estate investment, while still retaining the benefit of designing, owning and operating the hardware that aligns with their technical expertise.

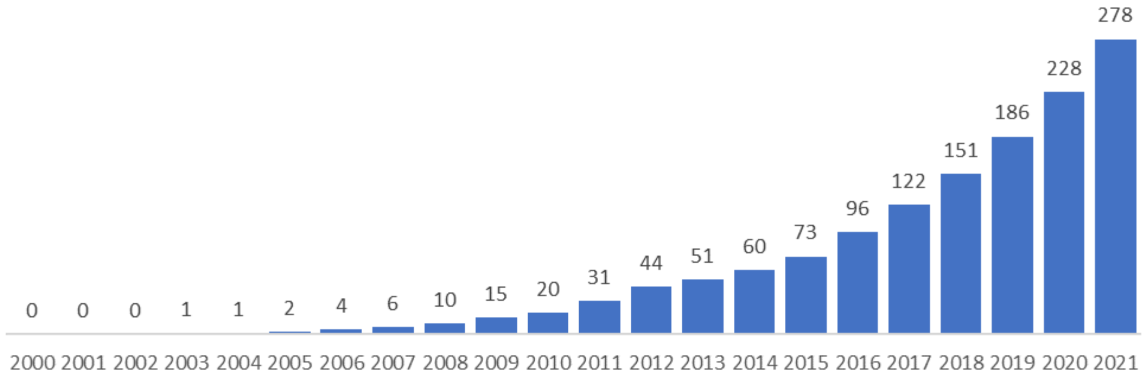
Given the desire to improve latency (response time) and limit the cost of rolling out new backhaul capacity (fibre optic cable), data centre tenants typically seek to locate in large hubs. Major markets include the financial hubs of New York and Chicago, the tech hubs of San Francisco, Seattle and Portland; the population hubs of Dallas, Los Angeles and the centre of Government in Washington DC/Virginia.

Although the growth drivers are clear and return metrics are attractive, the high level of asset specialisation, single tenant exposure and pace of technological change create additional risks for investors. As such, the need for skilled management in this space cannot be overstated. In addition, there is increasing supply competition in some segments of the market, limiting rental growth.

Chart 6: 60 Seconds of the internet in 2017

Chart 7: 60 Seconds of the internet in 2019

[6] *GI Partners*



Source: Blackchamber
Note: One exabyte is equivalent to one billion gigabytes

Chart 9: Key segments of data centre market

	Tenant-owned data center	Leased data shell	Wholesale colocation	Retail colocation
Who owns what? (Landlord / Tenant)	Land (Tenant)	Land (Landlord)	Land (Landlord)	Land (Landlord)
	Building shell & floor (Tenant)	Building shell & floor (Landlord)	Building shell & floor (Landlord)	Building shell & floor (Landlord)
	Fiber & power connects (Tenant)	Fiber & power connects (Landlord)	Fiber & power connects (Landlord)	Fiber & power connects (Landlord)
	HVAC system (Tenant)	HVAC system (Tenant)	HVAC system (Landlord)	HVAC system (Landlord)
	Power delivery unit (PDU) (Tenant)	Power delivery unit (PDU) (Tenant)	Power delivery unit (PDU) (Landlord)	Power delivery unit (PDU) (Landlord)
	Batteries and generators (UPS) (Tenant)	Batteries and generators (UPS) (Tenant)	Batteries and generators (UPS) (Landlord)	Batteries and generators (UPS) (Landlord)
	Cages / racks / partitions (Tenant)	Cages / racks / partitions (Tenant)	Cages / racks / partitions (Tenant)	Cages / racks / partitions (Landlord)
	Servers (Tenant)	Servers (Tenant)	Servers (Tenant)	Servers (Tenant)
Lease size	NA	>150k sq.ft.	>2,500 sq.ft. or >500kw by cage or pod	<2,500 sq.ft. or <500kw by rack or cabinet
Lease duration	NA	10 – 15 years	5 – 10 years	3 – 5 years
Investment basis	NA	approx. $200/sq.ft.	approx. $1,200/sq.ft.	approx. $1,200/sq.ft.
NOI yield (1)	NA	7% – 8%	10% – 12%	12% – 15%+

Source: Blackchamber

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Self-storage

Self-storage exists to facilitate the excess, unplanned or transitory space needs of individuals and businesses. Attracted to the relatively higher yields, modest capital needs, low correlation to traditional real estate types and historically high occupancy, self-storage has attracted increasingly levels of attention from institutional investors. Indeed, a number of US core funds now include a dedicated allocation to the sector.

Self-storage is most typically used to facilitate the storage of goods that can't fit in the home. However, space might also be used for a myriad of other reasons; commercial (inventory, supplies), seasonal, (sport equipment, vehicles), unplanned (change of family status, relations moving in/out), and planned (renovation, migration). In the US, demand typically increases in late spring and softens in late summer, consistent with school, housing and migration movements of the population.

Leases are typically month-to-month, which is positive in strong rental growth markets, but can be challenging if growth subsides.

As job losses may result in individuals either downsizing or moving in with family/friends, some investors believe that self-storage may have some counter-cyclical demand drivers. However, in a recession it is likely that non-essential expenses (such as storage) are foregone or there may be an increase in lease delinquencies.

Modest capex requirements and lack of incentives help to maximise net operating income, self-storage is operationally intensive. Real estate taxes and property management fees are the key cost centres, resulting in a typical gross-to-net income spread of 40%, which is consistent with the US multifamily sector.

Increasing demand for self-storage has reduced any material yield premium across the sector, while a similar supply response is resulting in rental growth easing. Competition in the sector has meant that skilled operators now rely on dynamic pricing software and digital market methods.

While these are not always proprietary methods, operators with deep data sets and established processes have an informational advantage over some peers. Similarly, the specialised nature of self-storage means that poor management can result in meaningful asset underperformance.

Overall, self-storage may make sense from a diversification standpoint, however, the years of outsized returns on stabilised assets are likely behind us.

Chart 10: Average annual returns vs. coefficient of variation in US REITs (1994-2018)

Source: NAREIT; Heitman Research

The final word...

Eds, Meds, Beds and B-Meds rule

While returns across traditional core sectors in the US have plateaued (except for Industrial) non-traditional property types (niche or alternative) have been attracting growing interest. Favourable demographics driving burgeoning demand are expected to support a number of needs-based real estate sectors, most notably housing, health-related uses, education and bio-medical uses. With rapid technological advancements and increased cloud computing, data centres equally stand to benefit but at this early stage more work is required on deciphering whether data shells (with in place long-term leases) are too narrow a focus.

Frontier likes the Sun Belt markets, characterised by affordable housing and schools, lifestyle quality, lower state income taxes, which is expected to deliver sustainable growth in high barrier top MSA markets. Unaffordability in gateway cities is at an all-time high with gateway rental growth tending to become tepid, except for Logistics and bio-med/ tech hubs. We expect that the demand/supply imbalance, while compounded by restrictive state and municipal planning, rising land costs and increased construction costs, will yield a growing opportunity set with seasoned managers. We think as new entrants and capital enter these sectors over time, yields will compress. Hence, the next few years provide a compelling window to capture future upside.

The niche sectors are not without risks:

- Operating company/partner is higher than traditional sectors (more operationally intensive) and should be clearly identified and understood.
- Low barrier markets with potential for future oversupply should be avoided.
- Growing interest from institutional investors with entry queues as reported by some managers which raises the question of whether the yield spread between core and niche sectors is sustainable over the longer term.

Demographically driven segments are generally less sensitive to macroeconomic shocks and volatility. This is due to the most basic human need for accommodation, healthcare and education over generations and cycles.

Most niche sectors can provide lower volatility and smoother returns for a variety of Frontier clients seeking a higher income focus and some capital appreciation as these sectors mature. As the historically defensive retail sector and office sectors undergo disruption to varying degrees, Frontier believes niche sectors are a good, complementary fit for long term portfolios. The existing Frontier Real Estate Configuration allows for these sectors ('other' bucket).

Accessing the investment opportunity

Core to Core Plus, Value-Add and Opportunistic strategies are available depending on an investor's risk appetite and return expectations. Diversified or specialist funds can be accessed from US$20 million or large investors may choose to co-invest (typically in excess of US$200m).

- If you are underweight property, an allocation to Niche sectors can help address this, and typically at more attractive pricing compared to traditional sectors.
- Smaller investors with no overseas exposure can progressively tap into these opportunities and/or gain significant scale not possible through large open-end funds.
- Larger investors with a preference for more direct exposure can invest in compelling tranches or consider teaming with local operating partners.

On our recent trip to the Sun Belt, Frontier met with several US up to ten managers most with a demonstrable track records in niche sectors. We inspected a number of their assets and are keen to further share our insights with you. We welcome your interest. Please don't hesitate to call us to discuss any ideas.

Next steps – Frontier will..

- Continue to monitor these sectors and identify a list of strategies and managers for further due diligence and ratings;
- Assess whether sector specialist or diversified funds are better suited to achieve meaningful scale;
- Meet with clients in H1 2020 to present ideas and identify client appetite for new investments (niche/ traditional); and
- Identify implementation options for a variety of client needs (big, small, medium).

Caution!
Not all Sun Belt markets are "high barrier"
Only cities with longer term sustainable growth are desirable

25 years

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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