FRONTIER ADVISORS

20 years

The Frontier Line

Thought Leadership and insights from Frontier Advisors

ESG and Fees in Property

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Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $230B in assets across the superannuation, charity, public sector and higher education sectors. The fact our advice is fully independent of product, manager or broker conflicts, means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

The Frontier Line explores a range of investment issues and ideas to explain and illuminate areas for investors to be aware of and be thinking about. Our specialist and sector research teams constantly review and discover topics to provide new perspectives and enrich understanding of critical risks and opportunities.

Tony Singh is an Associate Consultant working in our Real Assets Team. Tony provides investment strategy advice across a range of large and small superannuation and corporate clients. His fund manager and investment research coverage extends across multiple asset classes with a specialised focus on the unlisted and listed property and infrastructure sectors. This includes extensive due diligence and ongoing monitoring of pooled funds and direct investments through all phases of the investment lifecycle.

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ESG and Fees in Property

Environmental, Social and Governance (ESG) issues continue to evolve in the property landscape as a distinguishing element between new and ageing assets and as a major factor driving required capital expenditure for asset owners.

At the same time owners and acquirers are facing a relatively stable period for fees associated with their property assets. However, just as there is diversity in responses to challenges of ESG concerns, we are also seeing diversity in approaches to fee structures and disclosure requirements.

ESG Trends

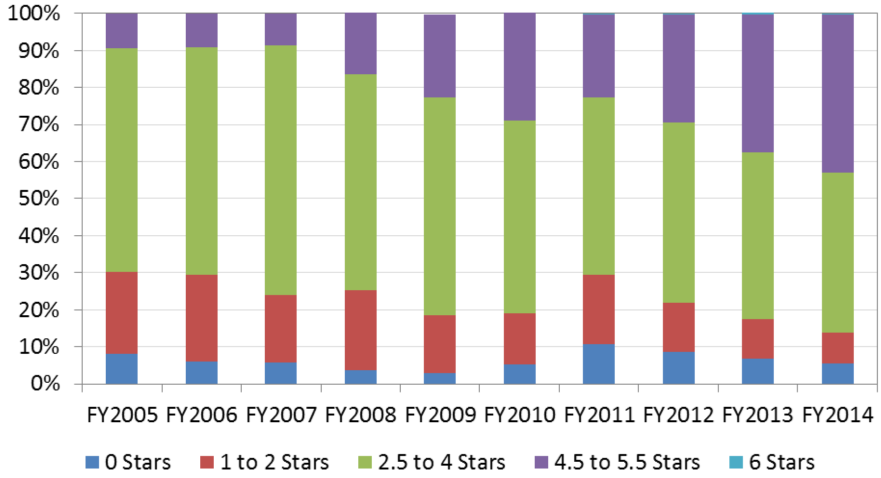
While environmental performance across property assets has been at the forefront for some years, corporate governance was often a poorly managed aspect of many property investments throughout much of the last decade. More recently however, tougher regulatory requirements, improved disclosure of conflicts of interest, stricter requirements around shareholder reporting, and increased market familiarity amongst investors has seen governance amongst property managers improve substantially.

Energy and water efficiency is widely recognised as an important economic issue that, without proper management, can create the potential for operational leakages, asset obsolescence, and inferior investment performance outcomes. Major corporate tenants are following the lead of government bodies by insisting on minimum operating efficiency levels for their tenancies.

In response to this, property managers are mandating sustainable designs in new developments, improving the efficiency and sustainability of their existing assets and, in some cases, divesting assets where it is not economically feasible to achieve a reasonable level of efficiency.

Looking forward, we expect these trends will continue with the ongoing operation of large premises a significant expense and potential leakage. At this point in time, the rating system for the operating efficiency of retail assets is much less developed than for commercial office buildings. However, some fund managers have begun to report on retail asset performance and as this practice becomes more widespread, it will enable broader analysis of operating efficiency across property types.

Chart 1
NABERS Energy Ratings by Financial Year



Source: NABERS, Frontier.

Chart 1 shows the NABERS energy rating profile for the entire rated pool of Australian office assets, using data provided in the NABERS 2013/14 Annual Report.

Of the NABERS rated office assets, around 43% carry an energy rating at or above 4.5 stars, reflecting a 5% increase from last year and a 20% improvement since FY2011. This rating is generally the minimum requirement for government agencies (and more recently, some corporates) seeking new tenancies. For these assets, the breadth of potential tenants is far greater when space is offered to the market.

In general, managers may justify upgrading a 2.5 to 3 star asset (looking at the cost-benefit analysis and expected payback periods).

For very poor rated assets (1-2 stars), the costs associated for retrofitting are more difficult to justify, particularly in light of higher alternative use.

These economics have in-part driven the proportion of poorly rated assets lower in recent years, for example, as reflected by secondary grade stock withdrawals in the Sydney and Brisbane CBD office markets over the past two years.

Recent PCA/IPD data illustrates that assets featuring a Green Star certified design and assets with a strong NABERS Energy ratings (≥4 stars) have generated relatively stronger total returns over each of the past four financial years, when compared with non-Green Star and low-rated NABERS Energy assets, respectively.

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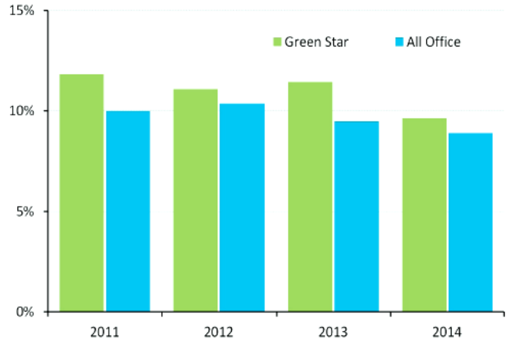
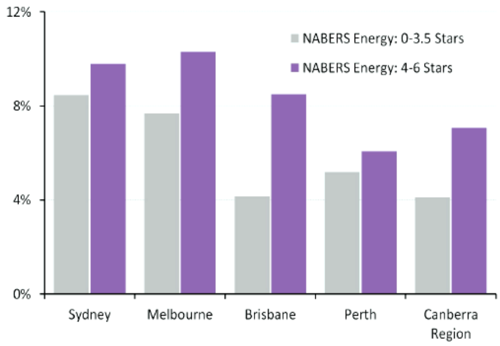
Chart 2
Green star vs all office



Source: PCA/IPD.

Chart 3
Performance by NABERS energy rating



Source: PCA/IPD.

While the stronger performance of Green Star assets and higher rated NABERS energy assets may be attributable to a number of factors, the bulk of the outperformance comprises a stronger contribution from capital growth. This in-part reflects the ability of landlords over these assets to charge higher rents and achieve stronger occupancy, lower operational/capital expenditure leakages, and also reflects stronger investor demand which supports higher pricing.

The data supporting the Charts 2 and 3 now covers 92% (or $56 billion) of IPD's office assets databank and with four full years of history now observable, the link between sustainable property designs, strong operational efficiency and superior investment performance appears to be well supported, at least in an Australian context. Anecdotally, this is further supported by a greater focus on sustainability initiatives and investment we have increasingly observed across Frontier's core property manager universe over the past five years.

Trends in fees

The level of fees observed for unlisted property in Australia remained relatively stable over 2014. There continues to be quite a wide range in total fees which is in-part driven by the varying revenue models employed across the core property manager universe. Products being managed under a "cost recovery" revenue model are providing core property management for a flat fee of 0.3% to 0.4% p.a. On the other end of the spectrum, core managers with a commercial (profit-focused) revenue model are charging 0.5% to 0.8% p.a. with some featuring performance fees in addition to this. These figures exclude underlying asset/ property management charges and expense recoveries.

There were a number of new products/ mandates launched by property managers throughout 2014 and some of the key features/trends observed (and indeed actively negotiated by Frontier where possible) have included:

A greater prevalence of base management fees being linked to net asset value rather than gross asset value (which eliminates the incentive for managers to increase leverage on the basis of increasing their fee revenues).

Greater alignment in the structuring of performance fees (where applicable), with appropriate hurdle levels, excess returns being measured after base fees, as well as clawback and high watermark provisions.

Improved requirements for disclosure and market-benchmarking of fees paid to parties related to the manager (this relates particularly to managers that also provide in-house asset management, property management and development management services).

More structured provisions around expense recoveries (e.g. what type and level of expenses can be recovered in total?).

These shifts have fostered stronger alignment with Frontier's fee-for-alpha principles, the MySuper fee legislation, and requirements around performance fees set out in the SIS Act (s29VD).

For core-enhanced/value-added strategies, fees have generally remained at a premium to core property but for more recent product offerings, the fee enhancements noted above are being increasingly incorporated by managers, providing for more attractive net-of-fees investment outcomes to investors.

For global unlisted property, fees continue to remain relatively expensive, with some offshore managers choosing to adopt "private equity style" fee structures (i.e. high base fees charged on committed capital with a sizeable performance fee component). However, this is not a "rule" per se and there are some managers, particularly covering lower risk core property strategies, who are offering more tenable fees for Australian investors when the level of expected net returns, the quality of value-added services, and the depth of the manager's research platform is taken into account. Further, total fees can in some instances be reduced through no/low-fee co-investments although this is more relevant for larger clients.

For active global REITs managers, rack-rate fees remained stable over 2014, with the "sector-specialist" nature of managers in this space commanding fees of around 0.5% to 0.8% p.a., depending on scale and the level of active management employed (e.g. managers with more fundamental, benchmark-unaware processes generally command a higher fee).

Conclusions

The combination of the ongoing addition of newly developed buildings with strong ESG credentials coming onto the market, and owners upgrading older buildings, has seen almost half the market now being rated above 4.5 star NABERS. The significance of more efficient operations coupled with the ability to attract or retain tenants, positions these assets strongly and likely to outperform the broader market. The application of environmental efficiency, whilst a standard feature of the office market, has been far slower in the shopping centre industry. We expect this to evolve over the next five years with the larger managers already being more proactive in this area.

Frontier is well known for our long-standing focus on aligned and appropriate fee structures and within the property sector we are seeing evolution here as well. As with all areas of institutional investment there is increasing pressure on fees around property investment and management. We believe the market will see a new period of innovation around the way fees are structured to provide greater assurance for both owners and managers.

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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. With around $230 billion in funds under 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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