Observations on Real Assets

North American Research Trip

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Frontier Advisors Pty Ltd

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

Our research team

In November 2014, members of Frontier's Real Assets Team travelled to Canada and the US, with a focus on reviewing opportunities in unlisted property and infrastructure. This note explores our observations on these market sectors.

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Introduction

US core property markets have been subject to large capital inflows, with many investors now considering opportunities further up the risk curve as a consequence. One of these sectors is value-add property strategies – an interesting sector but not without its challenges. These are complex strategies to analyse due to the structure of the offerings, the strategies employed and the markets they operate in. In addition, any due diligence of these ideas needs to consider the property market and cycle itself, including the cycles within cycles that impact the ability to realise the stated objectives of the strategies (for example, one strategy is selling to the core market or "build to core" – is this the right point in the market cycle for this idea?).

The US is currently undergoing an energy revolution – there is a strong political agenda to reduce carbon emissions, and domestic supply of oil and gas is forecast to increase exponentially. Amidst this rapidly changing energy landscape, can our larger clients access attractive risk-adjusted opportunities? What is the availability of deals with limited direct volume and price exposure and downside protection (i.e. true infrastructure-like cash flows)? How are managers dealing with intensely competitive auction processes?

Our trip explored these issues in depth. In this trip note, we summarise our views on these markets, and what we found to be critical considerations for investors looking to take advantage of what is widely expected to be the developed world's primary driver of economic growth for the foreseeable future.

We met with the following managers in the Real Assets space.

Property

- Cornerstone
- Jamestown
- CBRE Investors
- Invesco (at its annual real estate conference)

Infrastructure

- Starwood Energy Group
- Macquarie
- Morgan Stanley
- Caledon Capital Management
- Northleaf Capital Partners
- Aquila Infrastructure Management
- Bastion Infrastructure Group
- IFM Investors
- Hastings Funds Management Limited
- I Squared

Core-plus infrastructure – power hungry?

On our trip we met some very impressive core-plus and opportunistic infrastructure managers. All had large and/or very experienced teams with significant sourcing, structuring, execution and asset management experience. In addition, they maintain a comprehensive network of industry contacts and strategic partnerships.

The idea is to leverage expertise and contacts to source unique mid-market assets outside of public auction processes. These assets require a degree of repositioning, restructuring and recontracting such that they do not appeal to larger listed players (which seek fully de-risked and stable assets to complement an already well developed portfolio of bond-like cash flows), but are not so opportunistic as to attract private equity funds. Contrary to what many managers proffer, this is an incredibly competitive area of the market, where high calibre teams and networks make all the difference.

While all are considering different assets, a focus on the US energy market was dominant. Here are a few of the energy market sectors currently being considered.

Renewable energy generation

The US Environmental Protection Agency's Clean Power Plan proposes each State reduce its CO_2 emissions rate to meet specific standards by 2030. Increasingly stringent environmental regulation, combined with cheaper alternative fuel sources, is driving the retirement of coal-powered generation plants and encouraging investment in alternative forms of energy generation, including renewable energy.

Managers are considering greenfield and secondary opportunities in wind, hydro and, to a lesser extent, solar. Flexible providers of capital that can move quickly are able to take advantage of developers' requirements for project finance or capital recycling.

Conventional gas generation

The US Federal Government's push to retire coal-powered generation is similarly driving new investment in both greenfield and brownfield gas-fired generation. Managers are finding opportunities in those assets that do not have long term contracts already in place, where they add value through recontracting with local municipalities looking to secure long term supply, and have growth optionality through capacity expansion. While in the long term conventional gas generation may be partially disrupted by renewables, the forecast exponential increase in gas production will contribute to the favourable economics for fossil fuel generation. While many try to source these opportunities on an exclusive or limited auction basis, they tend to be highly visible and competitively bid. Prudence is required in some markets due to the potential for overvaluation.

Mid-Stream Energy

The large energy focus is a product of the changing energy landscape and the shift to gas through coal displacement. Infrastructure opportunities are largely around access, being pipelines, storage and export facilities. However, more niche opportunities also exist in ancillary services, such as water treatment of fracking water, mineral extraction from produced water and sand supply (for fracking). These are all mid-stream opportunities. Fully contracted and de-risked assets are being extremely competitively bid and many are avoiding this space, rather looking at core-plus type investments. These typically have sufficient contracting for downside protection, but involve taking a market view (be it through re-contracting or repositioning). Direct merchant risk is avoided. In this space, many deals come to market - a large and/or experienced team with strong industrial relationships is key in being able to source the appropriate risk-adjusted opportunity.

More details can be found in Frontier's recently completed Frontier Line on shale gas.

Is selling to MLPs a sustainable strategy?

Given the skew towards energy investments, a strategy common to many is to de-risk these assets and re-deploy them into the core market, primarily to Master Limited Partnerships (MLPs), which are characterised by extremely low costs of capital.

MLPs are a US construct, being limited partnerships that are publicly traded. They combine the tax benefits of partnerships with the liquidity of listed securities. The key benefit, however, is as a flow through entity, it can avoid paying US corporate income tax. This provides extremely low costs of capital (~6% based on dividend yield). MLPs are akin to the dividend imputation concept in Australia. A key restriction is that MLPs can only be formed around specific businesses, being largely energy focused. This means most MLPs invest in infrastructure assets with strong and secure cash flows.

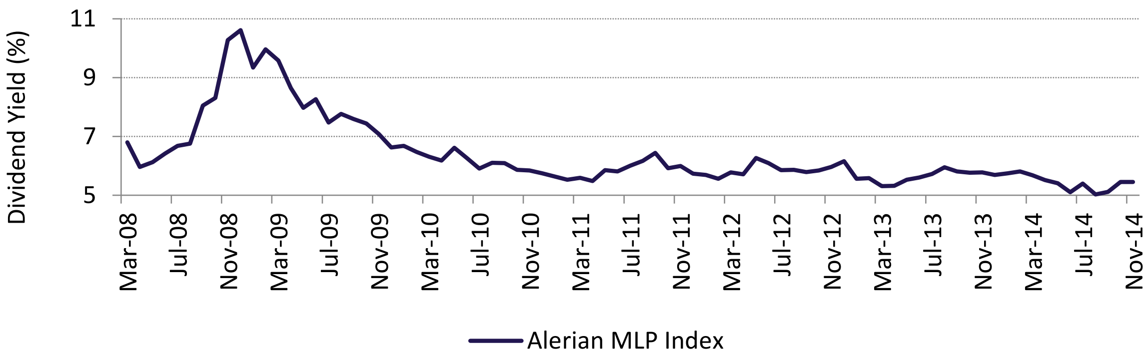
In recent years MLPs have been extremely appealing to investors. This is a function of their consistent dividends and their high yield relative to bonds. The high demand for MLPs has driven their share prices up and their dividend yields down. As the chart below shows, dividend yield is at a historic low. A low dividend yield translates into a low cost of capital, and a low cost of capital enables MLPs to buy assets on low discount rates and high prices. It is therefore profitable for an asset manager to buy an asset at a discount rate of 12-14%, de-risk it, and sell to an MLP at 6-8%.

Now, what will happen when interest rates start to rise? This will make MLPs considerably less attractive to investors as better opportunities become available elsewhere. A lower MLP share price raises the dividend yield and consequently raises the cost of capital. In turn, this lowers the price MLPs can afford to pay for assets. We are concerned this puts at risk the general strategy of "building to core".

We place this risk within the broader context of a growing demand for high quality core real assets, driven by increasing allocations and a widening investor base. We believe this strong demand will continue to support core pricing over the short to medium term.

Of course, it is difficult to predict how the environment for these assets will evolve. However, we are confident that investors looking to invest in core-plus or opportunistic infrastructure require a manager with substantial depth of experience and a well-established network of contacts. This will enable it to compete on the value of its business plan for an asset, rather than on cost of capital alone.

Chart 1: Dividend yield for the Alerian MLP Index



Source: Bloomberg.

US value-add property

In response to continued tightening in US core property markets, many continue to look further out the risk spectrum, which is an inevitable response but one that we believe needs in depth research and consideration in the current environment.

US property markets over 2010-13 saw large amounts of capital directed mostly towards core property from both US and non-US institutional investors, some investing in unlisted property for the first time, and many of whom were re-allocating from government bonds due to very low bond yields.

This has not subsided in 2014 and trophy assets (or "über-core" assets, as they are occasionally referred to) in major gateway cities are prone to cost of capital shoot-outs, with cap rates in the low-4% level as a result.

For example, whilst we were in the US it was announced that TIAA-CREF and Norges Bank Investment Management had paid US$392 million, for 800 17th St., Washington D.C., or US$1,075 per square foot, a new record price for that market, with the price rumoured to be at or below a 4% initial yield. This underlines the perception of trophy gateway city office assets (including in major US cities such as Washington D.C. and Manhattan) as "bond-like" income, particularly for large pension/sovereign wealth funds that are relatively new to the sector.

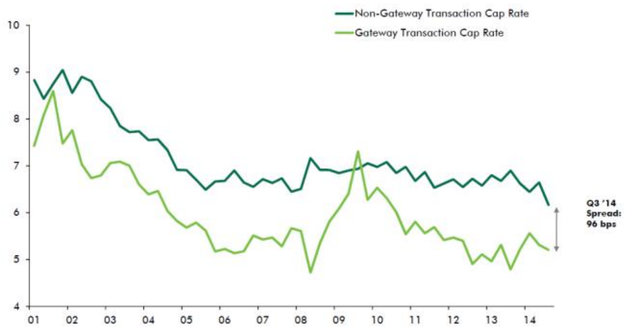
It appears now that investor appetite in 2014 in the US is starting to focus on core-plus, value-add and opportunistic funds as a result. Our GIRA partner, Segal Rogerscasey, has seen client appetite grow in this area and pension funds we met on the trip likewise saw this as a key future focus for their property portfolios.

It appears 2014 will be a post-GFC record year for fund raising for closed-end property funds, and the dry powder of those closed-ends funds is at a record US$220 billion at 30 September 2014, compared to US$167 billion at December 2007 (source: Preqin).

The early signs of a creep up the risk spectrum are hard to pinpoint in any specific numbers, but cap rates on US gateway markets versus non-gateway markets is one of the more commonly used proxies for prime versus secondary markets. The gap remains wide in most markets (e.g. office), but has begun to compress a bit in the multi-family apartment sector for example.

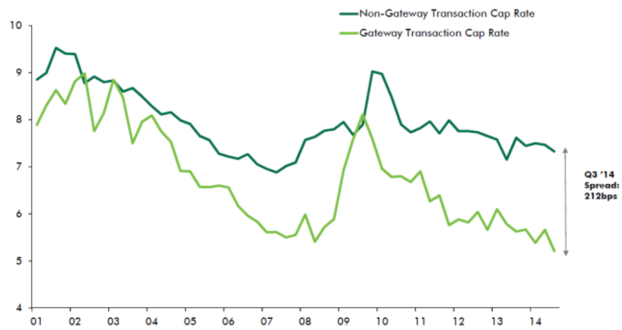
This sector was the first to rebound from the GFC and, in many ways, its cycle is 12-24 months ahead of other sectors. A key question, therefore, in examining current value-add opportunities is the likely path and level of pricing from here in the sub-sectors that these strategies target.

Chart 2: US Multi-family apartment cap rates



Source: CBRE, Real Capital Analytics.

Chart 3: US Office cap rates



Source: CBRE, Real Capital Analytics.

Note: Gateway cap rates are an equally weighted average of cap rates in Manhattan, Washington D.C., Boston, Los Angeles and San Francisco

US value-add property

A number of value-add and opportunistic property strategies make their returns by buying well, “fixing well” and selling well. One phrase sometimes heard in this environment is that, with a buoyant (or overly buoyant) core property market, one should be looking for strategies that sell into that core market.

The problem with this approach currently is that managers are underwriting a “sell to core” or “build to core” strategy, with an explicit or implicit assumption that conditions in the core market will remain this buoyant upon exit, commonly 3 to 7 years from acquisition. If some steam comes out of the core property market in the next 3 to 7 years, as some forecast, then pursuing strategies that often rely on the core market as buyers is a low value strategy.

The risk then is, for the US at least, by the time investors identify a value-add/opportunistic manager, and that manager buys assets, and then (years later), looks to sell those assets to the core market, the cycle may have turned.

In addition, the use of debt to enhance returns in these strategies appears to be on the rise, from already high levels when compared to Australian standards (Americans’ love affair with leveraged commercial property is well documented). We heard the phrase “mid-6s unlevered (IRR) and low-9s levered” a few times, with acquisitions even in core funds sometimes now being underwritten at circa 50% LTVs. Debt on property can be secured very cheaply (much lower than in 2006/07 for instance) and it is likely to be very accretive in the short to medium term. That debt does need to be refinanced though, either by the current owner or the next owner, and investors need to be aware that debt markets and leasing markets may both be less buoyant in the exit period.

Hence, given the risks identified above, in looking at closed end US property funds, the due diligence process needs to ensure that the manager underwrites conservative exit assumptions, both philosophically and in practice.

For similar reasons, the return dispersion is, not unexpectedly, much greater in value-add and opportunistic strategies (Chart 4), which makes manager selection even more vital than core, where “unlisted property beta” is the predominant driver of returns.

Chart 4: US Property return dispersion by style[1]

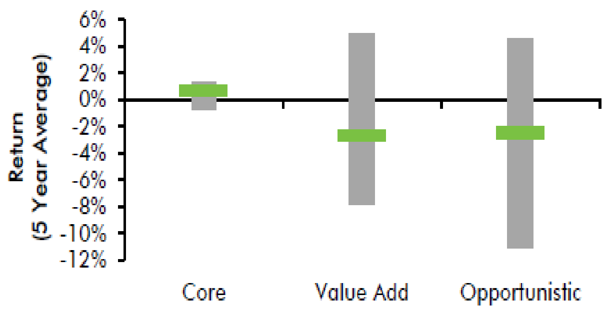


Table 1: US Value-added fund returns by vintage year[1]

Vintage Year	Number of Funds Reporting	Net IRRs (to 31 March 2013)		
		Top Quartile	Median	Bottom Quartile
19999	6	17.9	14.3	10.7
2000-02	5	18.2	17.8	13.3
2003-04	5	9.8	7.4	6.1
2005	6	-7.6	-13.7	-18.9
2006-07	8	13.8	4.2	-9.8
2008-09	n.a. (too early)			

Source: CBRE, NCREIF, Townsend

1. The returns are as calculated in the former Townsend/NCREIF surveys for value-add and opportunistic strategies (which ended in 2013) and the NCREIF NFI-ODCE Index for core strategies.

US value-add property

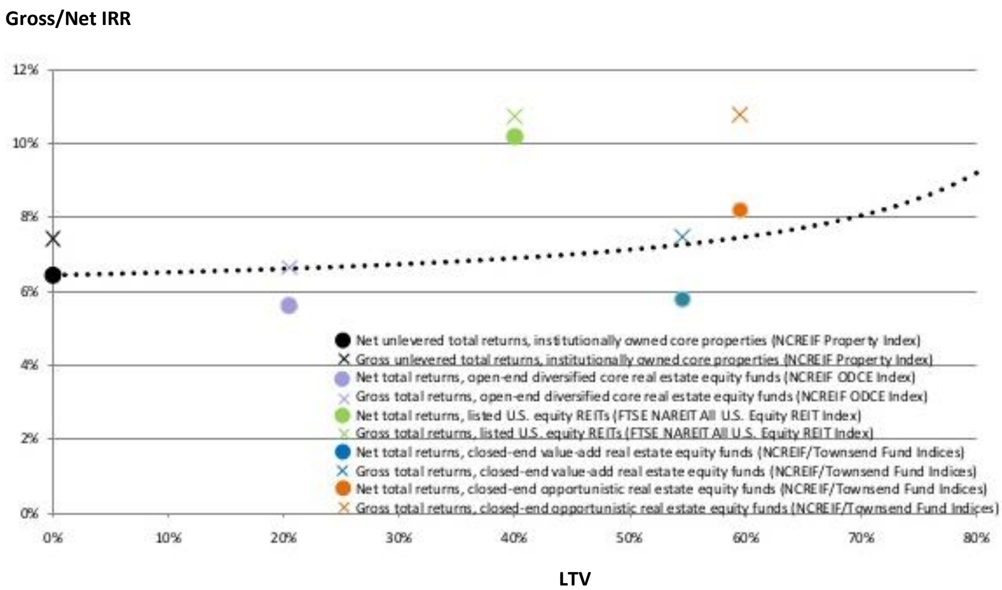
Another factor we continue to watch as investors move up the risk spectrum in the US is the pent up demand for development. As values continue to rise above replacement cost (as seen already in major markets like Manhattan and Washington D.C.), this encourages development activity. Many markets are still digesting over supply issues from the GFC. A surge in construction activity, whilst positive for the US economy, could be a handbrake on all parts of the US property risk spectrum.

Lastly, like many non-core strategies in the US over the last decade and a half, average net returns (as distinct from gross) have been below expectations for the value-added sector. Chart 5 shows US property average returns by style, both net and gross, and relative to average leverage over the 1988 to 2013 period. Moving from the left of the traditional unlevered core strategies has not brought the rewards that investors should expect, nor has leverage been used to enhance returns to a significant degree on average. The overall higher level of fees of some of these strategies is obviously a drag as well.

The dispersion from the average is quite large for the value-add and opportunistic strategies. This needs to be kept in mind when looking at this chart along with the specific period examined (large amounts were raised from 2005 to 2007 and invested in tough markets thereafter, which may not repeat), and the fact many funds in these figures will not have achieved full exit of their portfolios yet.

The performance of the value-add strategy relative to both their lower risk and higher risk peers is nevertheless curious and may or may not be an across the strategy issue or a consequence of being "behind the cycle". In either case, it warrants further examination when considering and configuring an appropriate and diverse US multi-sector strategy along with the current point in the risk/return cycle for all US property sectors. These are issues Frontier intends to examine in more detail in 2015.

Chart 5: US Property net and gross returns and average leverage by style 1988 – 2013



Source: NAREIT, NCREIF, Townsend

Conclusion

In the face of ultra-low interest rates, investors have been encouraged to rotate out of fixed interest investments into those asset classes that offer more attractive yields.

US core property and infrastructure have been attractive targets for much of this capital. Alluring features have included: the reasonable risk adjusted spread to long term government bonds; the unlisted nature of the assets providing Sharpe Ratio improvements; and the GDP-linked exposure to a recovering US economy. However, now these core markets are increasingly characterised by competitive auctions that require either aggressive underwriting assumptions or lower expected returns to win.

This is a general comment of course and does not imply that opportunities no longer exist in the US core market. The reality is, however, that investors are increasingly giving thought to investments higher up the risk spectrum.

Common US property sectors considered as a consequence are value-add strategies and opportunistic strategies. These are particular and differentiated sectors relative to core property, with somewhat different relative pricing, fees and strategy approaches. As we have highlighted in our discussion of value-add strategies, there are many issues to consider when considering these strategies as part of a diversified US property configuration, not least of which is pricing and the current point in the property cycle. There are pricing and demand pressures becoming evident in the US property market, and these may impact non-core property strategies in a different and compound way as the cycle plays out.

Clearly, and as with infrastructure generally, the entry price and the sector cycle should be key issues addressed in due diligence on opportunities in these higher risk sectors of the property market.

These are some of the many considerations factored into our real assets view. The fact remains, in the short term, with many investors looking to substantially grow their real asset allocations, the current weight of capital may continue to support pricing across many areas of the market.

For real assets, the US represents a complex and rapidly evolving landscape. This trip emphasised to Frontier the importance of a highly skilled manager with a large, experienced team able to source the right deals, negotiate downside protection, prudently manage financing risk, have the right strategy in the first place and be incentivised to sell well.

At Frontier, we are focused on seeking out managers that meet all, not some, of these key criteria. A US focused strategy must have a demonstrable and structural competitive advantage. To this end, we have found meeting teams' onsite to ascertain the subtleties of their approach is critical.

Our trip showed attractive opportunities still exist in the US. However, an undifferentiated approach in such a large and complex market seems unlikely to work unless "the rising tide continues to lift all ships".

All of which provide a menu of interesting areas for Frontier to examine in depth in 2015, as we work to assist our clients in designing and implementing their offshore real asset strategies.

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