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The 'real' power performer

It is no secret that super fund performance over the past decade can be largely attributed to real assets, mainly property and infrastructure. But how is this hot asset class going to maintain its position in a lower for longer environment? **Darren Snyder** reports.

01:
Danny Latham
head of infrastructure investment Australia, CFSGAM

02:
Greg Maclean
global head of infrastructure research, AMP Capital

A story widely celebrated in the superannuation industry, investment in property and infrastructure assets has delivered consistent growth-like returns to those who matter most – the members.

Industry super funds in particular are seen as pioneers of first-class property and infrastructure investment models. As Industry Super Australia chief economist Stephen Anthony told Financial Standard recently, physical or real assets have generated about half of industry super funds' outperformance over the past two decades.

The July Rainmaker Benchmarking report backs this outperformance theme. It shows industry superannuation funds with a higher allocation to property and infrastructure have outperformed retail funds in the 12 months to 31 May 2016, and over the longer term.

Colonial First State Global Asset Management (CFSGAM) head of infrastructure investment Australia, Danny Latham[01], says infrastructure – whether listed or unlisted – has proven itself to be resilient for more than a decade.

"If you look at a lot of the fundamental characteristics of infrastructure – its stability of revenues, some inflation linkages, some correlation to GDP, as well as downside protections – I think the sector has been a very strong performer both pre and post the GFC," Latham says.

Is infrastructure overvalued?

In absolute terms, Latham adds, infrastructure's returns may have come down in recent years but compared to other asset classes, there is still plenty of value.

"There's a lot of talk as to whether the sector is overheated and the returns too low. I think in a low growth, low return environment, clearly the buyers of assets are all seeing value relative to what the alternatives are," he says.

"If assets are being sold at nine or 10 times returns, then it's interesting [to note] those returns as a premium over bonds, which are probably higher than what they've been over the past 20 years."

In a recent white paper on equity infrastructure valuations, AMP Capital global head of infrastructure research Greg Maclean[02] said fulsome prices paid in unlisted transactions during the past couple of years have raised concerns that unlisted infrastructure may be overpriced.

"High prices have been paid for assets that have been privatised, particularly in Australia. While this reflects the strong demand dynamic, the higher prices transacted also reflect an expectation that the private sector will deliver early efficiency gains," Maclean says.

He expects there will be some improvement in unlisted asset availability in the next five years "with the supply of new infrastructure assets expected to increase by approximately US$100 billion between 2016 and 2020."

Room to grow

Last month the McKinsey Global Institute released a paper updating its previous estimates on the world's infrastructure needs. It believes that between 2016 and 2030 the world must invest about $3.3 trillion per year in economic infrastructure just to meet expected rates of growth.

"If the current trajectory of underinvestment continues, the world will fall short by roughly 11%, or $350 billion a year. The size of the gap triples if we consider the additional investment required to meet the new UN Sustainable Development Goals," the McKinsey paper says.

It says infrastructure investment has declined as a share of GDP in 11 of the G20 economies since the global financial crisis "despite glaring gaps and years of debate about the importance of shoring up foundational systems."

McKinsey says Australia has spent more on infrastructure to date than it will need to spend going forward. It increased spending after the crisis and "has achieved near-universal access to infrastructure services—but its quality score lags behind what would be expected for a country of its income level." The report also gives credence to Australia's capital recycling systems.

Where both AMP Capital and CFSGAM agree is that although valuations vary across direct infrastructure, there is plenty to like about mid-cap assets (less than US$1billion) over large cap assets.

According to Maclean's research, mid-cap infrastructure assets have traded at transaction prices consistent with historical valuations, suggesting that value remains in the segment. However, since the start of 2016, a couple of transactions appear to be priced above historical valuations.

CFSGAM's Latham says value in the mid-market space can be found in OECD markets and primarily in transportation and utilities assets. "We've found no shortage of assets to buy and all the money we've raised over the last 12 months has been fully invested. We're not sitting on big queues of dry powder – we've got the opposite problem, we've been investing it too quickly," he says.

Boutique fund manager Infrastructure Capital Group (ICG) runs two Australian-based funds with a mid-cap focus. Managing director Tom Laidlaw said the sector is appealing to investors such as super funds, endowment funds, high net worth money managers and fund of funds.

"The large cap space sees anywhere between zero and five transactions a year in Australia. In mid-market on average there are about 20 to 30 transactions every year," Laidlaw says.

He says the firm's own research showed in each transaction there was always a shortlist or four or five parties. In the mid-cap space, in the binding bid phase, it normally comes down to one to two parties. He says this automatically means your chances of winning are better.

> *There's a lot of talk as to whether the infrastructure sector is overheated and the returns too low.*

"I'd like to say it means you get a better deal but it doesn't. Only time will tell whether you got a better deal. It means for us and our competitors' we can be choosier for our bids. If we do three deals in a year we're usually very happy," Laidlaw adds.

Infrastructure Capital Group recently sold ANZ Stadium, which it held via its Diversified Infrastructure Trust, to the NSW government for an undisclosed figure. It had held the asset since 2007 and Laidlaw said it was a good example of an investment where a business could be improved and still deliver strong returns.

"We picked it up off ANZ Bank and the lending group and back then it was up to the late 20s in the number of events held per year. Last year it held about 45 events and made about $29 million in earnings before income and taxes," Laidlaw says.

Infrastructure partnerships

As part of the stadium's sale ICG managed to maintain the site's day-to-day catering operations through its VenuesLive Management Services business. Laidlaw says getting involved with the stadium management team and improving the business saw a significant value add whereby the catering business has now picked up six other deals in NSW and it's just won the catering contract for the new Perth Stadium.

ICG was also recently awarded a mandate to manage the Northern Territory government's new $1 billion infrastructure fund. The government will contribute $300 million and seek to raise another $700 million. ICG will soon be establishing an office in Darwin to run the new fund.

What these examples show is the shift from reliance on a traditional infrastructure fund and investors turning towards direct or co-investment models and partnerships.

CFSGAM's Latham says there was once an erroneous perception that assets tended to look after themselves. "The reality is they're dynamic businesses in many cases. Take Brisbane Airport, Anglian Water – these are big assets that require active management," he says.

Becoming an infrastructure investor, he adds, is more than just paying lip service. Latham cites Brisbane Airport as an example where a consortium of investors, including CFSGAM, has reduced potable water consumption by 80%. "It makes sense environmentally but it also makes sense economically," Latham says.

Industry super fund Cbus has in recent times taken more control in the shape of its portfolio

03:
Kristian Fok
executive manager investment strategy, Cbus

04:
Sarah Shaw
global portfolio manager and chief investment officer, 4 Dimensions

and now heavily considers co-investing alongside managers as well as competing directly in tender opportunities.

Cbus executive manager investment strategy Kristian Fok[03] said earlier this year the $33 billion fund can become involved in infrastructure developments earlier rather than competing at the equity stage - something that can be achieved especially through Cbus' property division.

"A lot of infrastructure assets have heavy and discreet property elements. Bring something to the table rather than just equity and it's a path they [vendors] will be pursuing," Fok told the CMSF conference.

The listed market

Rainmaker's latest benchmarking report puts paid to the idea that investment in listed infrastructure and property is also adding to super fund out performance.

The researcher says property has continued to provide a significant positive impact on fund investment outcomes, with listed property recording a positive 15.3% return in the 12 months to 31 May 2016. Australian equities, often the largest asset class in many balanced funds, contributed a negative 2.3% return.

AMP Capital's global listed infrastructure team says at 31 December 2015 there were about 300 listed infrastructure companies worldwide with a combined market capitalisation of US$2.1 trillion. The firm added this means the investment opportunity for listed infrastructure is about seven times the size of direct infrastructure.

With this in mind, AMP Capital head of global listed infrastructure Tim Humphreys says that over time pension funds and other institutional investors will increase their portfolio allocations to listed infrastructure, "most likely funding out of global equities but also potentially out of unlisted infrastructure and bonds."

According to the equity infrastructure valuations white paper, which was co-authored by Humphreys, following the GFC until 2014, global listed infrastructure equities were undervalued and trading below their long-term expected trajectory. Now "we estimate that global listed infrastructure is approximately 20% undervalued relative to long-term history."

Global portfolio manager and chief investment officer at 4 Dimensions Infrastructure, Sarah Shaw[04], says infrastructure assets are being caught up in what is a politically driven environment.

"We just saw Brexit, we just saw the Spanish elections end in a stalemate, we've had Australian elections now and the US coming up at the end of the year. All these are significant drivers not necessarily representing fundamental value in terms of sentiment within the market and that's something you have to address as an investor," Shaw says.

As a fund manager Shaw will look through the politics. She oversees the 4 Dimensions Global Infrastructure Fund that was launched to retail and institutional investors in March this year.

"In terms of infrastructure it comes down to quality and value. There are companies and stocks with strong balance sheets and looking for growth competing against unlisted funds and pension funds which are willing to accept much lower growth," Shaw says.

"That's the one issue that we have to monitor and make sure our companies don't start overpaying for growth in what is an incredibly low interest rate environment."

Infrastructure Capital Group's Laidlaw is of the opinion that listed valuations were expensive three years ago but "they've pretty much all doubled since then."

"I've got to say in this lower for longer interest rate environment, if you're a believer in that theory and thinking listed infrastructure funds are just yield players – well barring any dislocation events, they're going to keep trending up just on their yield. Now is it warranted, probably not, but it doesn't rule out they're going to do really well in the foreseeable future," Laidlaw says.

The social element

Cbus' Fok says the fund has been looking at investment models in affordable and social housing with a particular interest in affordable housing debt. The fund believes the super industry can and should play a role in helping to improve the supply of affordable housing for Australians, but it needs the federal government to help build structures to facilitate it.

In a recent submission to Treasury, Cbus encourages the government to help establish structures to facilitate affordable housing bonds that could be used to help finance the much needed housing stock. It recommends a large intermediary aggregator that would issue bonds to investors and finance large-scale affordable housing providers.

Australian Unity Real Estate Investment general manager Mark Pratt[05] says social infrastructure is an area the firm is continuing to watch and invest, with a particular focus on healthcare.

"Given the demand in health and health related infrastructure there will continue to be demand for private capital to support those developments," Pratt says.

He adds Australian Unity is already a proponent for the Herston Quarter redevelopment in Queensland – an initiative organised by the state government for a health-focused redevelopment adjacent to the Royal Brisbane and Women's Hospital. Pratt says this is one example of where previous infrastructure partnerships will lead to further investment in social infrastructure.

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Playing with fire

First State Super recently added to its real asset portfolio with by investing in the development of a new world class training facility for Fire & Rescue NSW (FRNSW).

First State Super chief executive Michael Dwyer said the investment is a great example of the way the $50 billion puts its members' money to work. He said it will provide tangible benefits to the community and secure strong investment returns to build members' retirement savings for the future.

The FRNSW Academy forms part of First State Super's growing real asset portfolio that includes Bankstown and Camden Airports, the International Convention Centre Sydney, New Bendigo Hospital and Sunshine Coast University Hospital.

The Fire & Rescue NSW Academy is scheduled to open in 2017 on a six hectare site in Erskine Park in Sydney's west. It will replace the existing Fire & Rescue NSW training college at Alexandria, which is more than 40 years old and about one-third the size of the new site.

The new facility will feature purpose-built training props to simulate fire, rescue, hazardous-materials and other emergencies. It will also allow for training activities not possible at Alexandria, including live burns.

About 150 permanent roles will relocate to the academy, and there will be up to 350 people at the campus on any given day, including recruits and course attendees.

First State Super, which owns the land and will fund the development of the facility through Altis Property Partners, did not disclose the size of the investment. FRNSW will have exclusive access to the facility under a leaseback arrangement for up to 25 years.

Property overtaking infrastructure

Investment manager, Invesco, says real estate investment is growing faster than infrastructure among sovereign investors. In its fourth annual Global Sovereign Asset Management Study the firm found that for the first time fewer sovereign investors expect to increase allocations to infrastructure.

Invesco says allocations to real estate have risen from 3.2% in 2013 to 4.3% in 2015. It adds global sovereign investors expect to increase global and local allocations into real estate more than any other asset class in order to meet diversification and absolute return objectives.

05:
Mark Pratt
general manager, Australian Unity Real Estate Investment

06:
Violet McDonald
real estate investment analyst, Standard Life Investments

This is largely attributed to real estate investments carrying fewer execution challenges than infrastructure, where sovereigns have encountered difficulties in deploying their assets. Investors told Invesco there are an increasing number of credible global real estate asset managers, and a long list of developers and operators to build partnerships. Invesco adds more than 62% of sovereign investors globally are underweight infrastructure, relative to their target allocations.

TH Real Estate says the property outlook for Asia-Pacific is subdued compared to preceding years, but there is opportunity to be found in Sydney, Melbourne, and Tokyo office and retail sectors, as well as the China outlet mall sector.

"Asia-Pacific is at a crossroads. After the global financial crisis in 2008, co-ordinated global monetary easing and expansive fiscal stimulus helped to invigorate domestic conditions, and revive industrial and export demand. This has also driven asset pricing to near-record-high levels. However, China is slowing, as policymakers try to engineer a managed soft-landing to allow an orderly deleverage from the high levels of debt that has accumulated, currently estimated at close to 300% of GDP," TH Real Estate head of research Asia-Pacific, Harry Tan says.

Australian property value pockets

Other global and Australian real estate managers are keen to talk up Sydney and Melbourne too. Standard Life Investments (SLI) real estate investment analyst, Violet McDonald[06], says of the Asia-Pacific markets she follows, Australia is currently one of the strongest and the outlook is positive.

"On a three year average return forecast Sydney and Melbourne offices rank favourably relative to other markets we follow. Real estate yields are at the higher end of the spectrum internationally, leaving a comfortable margin over long term bonds and room for further yield compression. Rental growth is expected to remain muted for reasons including spikes in new supply and a fragile, but stable economy. Incentives remain relatively high but are expected to decline steadily. The economies of Sydney and Melbourne are well diversified and we anticipate sustained tenant demand," McDonald says.

SLI also recently updated its house view on Brisbane offices from a light to neutral weighting.

Qualitas group managing director Andrew Schwartz says there are unprecedented levels of new apartments coming into the main cities – particularly in pockets of Brisbane, Sydney and Melbourne. However there are some significant investment hurdles, and Schwartz says increasing constraints on foreign buyers could impact supply over the medium term, leading to price increases.

"It's possible that prices for new apartments will rise in the medium term, due to the lack of new starts to meet demand in 2020 and beyond. Most of the cranes in the sky right now are the result of last cycle projects. Once they are finished, and if positive migration continues, investment in supply will be required," he says.

"Any excess supply will be absorbed by the market over a short period of time, due to continued strong migration levels. For instance, Melbourne is recording migration of 90,000 per annum compared to 30,000 per annum in the early 1990s."

Qualitas generally notes the proportion of foreign buyers to local buyers has been steadily increasing over the last two years, and having 40% of total buyers being foreign is common on many projects.

For Australian Unity's Pratt, the office markets in Sydney and Melbourne are also looking attractive because "their absorption is positive and so rentals are increasing in certain places and good quality properties are still well sort after." As a guide to the sector's success the firm recently placed its Australian Unity Office Property Fund on the ASX.

Pratt cites the firm's investment in 468 St Kilda Road (Melbourne) as an indication of where office investment is providing good value because the floor plates are slightly smaller and more flexible, and small to medium-sized businesses are looking for floor space not in the CBD but with easy access to it. "I think St Kilda Road is one of the stronger performing office sub-sectors in Australia," Pratt says.

Australian Unity's Healthcare Property Trust also recently reached $1 billion in funds under management and Pratt says this is an indication of investors recognising the benefits of long-term leases in a sector that has continuing demand and reaches the ageing demographic in Australia.

"As other core sectors and cap rates compress I think health care will be seen as an attractive alternative. Some healthcare operators are looking to better their balance sheets, help manage their funding and pipelines and work with a capital partner like us to do that – I think you'll see more of that coming," Pratt says.

"Property is well positioned going forward. There are some sectors where, certainly in the listed market, some things might be getting towards the top end of their pricing range but for others they're well priced.

He adds property is seeing significant demand from retirees looking for income in retirement or building up for their retirement. "We continue to see demand for real estate from retail investors, your mum and dad investors and the SMSFs and the like – it's off the back of the continuing spread between the risk-free rate. One of the negatives of low interest rates in Australia is what it does to self-funded retirees and where they're able to source income for their retirement." FS

Aussie commercial property

Centuria unlisted property funds chief executive Jason Huljich says the obvious choice for commercial property investors is Sydney.

"The NSW government is focused on building and improving infrastructure, the Sydney Metro (rail) is coming, and the new airport at Badgery's Creek seems certain to go ahead. These factors will continue to have a positive impact on property values," Huljich says.

He says research by CBRE shows unprecedented activity, in particular from offshore buyers, catapulted commercial property sales to $28.4 billion in 2015. Of this, offshore buyers accounted for $11.7 billion, or 41% - the highest annual percentage on record.

"And for the first time, offshore buyers acquired more office property than domestic buyers. Sales were dominated by Asian investors, but other offshore groups are also increasing – Europeans and Americans also see Australian property as a safe haven, and Sydney and Melbourne as global gateway cities," Huljich says.

He cites figures compiled by Colliers International that show Sydney is now the third most popular destination for global offshore investors, with only London and Manhattan more popular, albeit by a large margin.

"The value of the AUD no doubt plays a part, but it isn't the only factor. Historically low interest rates globally have meant that our interest rates, close to 2% above other major developed markets translate into very favourable yields from property compared with offshore alternatives, even with the cost of hedging taken into account. Yields from Australian office property in 2015 were in the range of five to 8%, compared with two to 4% on offer in some global markets," Huljich says.

However not all commercial property is equally appealing. The chief executive says premium office tower valuations have been stretched, and haven't represented good buying opportunities for investors.

"Many offshore investors are now looking more closely at A and B grade assets and, in the case of offshore buyers, properties which lend themselves to residential conversion. When we recently sold two office properties, both of which were suitable for redevelopment, 75% of the offers we received were from offshore groups," Huljich says.

He says Centuria is a value buyer, meaning it will consider all markets, including counter-cyclical buys, if it can see long term value. This opens investment to properties which will deliver an attractive income yield, but also present opportunity for capital refurbishment, and re-positioning via active management. Centuria's aim is to identify properties where it can add between 5 and 10% per annum through improvements.