IPE REAL ESTATE

Australian investors: Heavy lifting

September/October 2016 (Magazine) **By Florence Chong**

With the fourth-largest aggregation of pensions assets in the world, Australia's superannuation industry is being forced to propel itself offshore and into new markets. ***Florence Chong*** *reports*

With Australian individuals and employers pouring more than AUD100bn (€69bn) into their superannuation funds each year, the task of working that money has become monumental. It is a task made all the more difficult when billions of dollars in offshore investment is chasing the same small pool of assets in a country of just 24.4 million people.

Australia has the world's fourth-largest pension pool. At some AUD2trn, it is equivalent to 126% of the country's GDP. Super assets are projected to increase by 8% a year to reach AUD9trn by 2035 – 330% of GDP, according to Rainmaker, a leading Australian financial information group.

That overflowing river of cash poses a major challenge for chief investment officers seeking to achieve Australia's industry benchmark return of CPI plus 3-5%.

Unsurprisingly, many are recalibrating their return expectations and allocations in this 'lower for longer' era. Interest rates are at unprecedentedly low levels, and quantitative easing in key developed countries has depressed the global bond market. Some now say that if bond yields continue to contract, investors may be in a situation of having to pay to own government bonds.

The search for higher returns has brought illiquid assets like property and infrastructure to the fore. Meanwhile, super funds with existing exposure to property are being pushed to look beyond traditional core office and retail to niche segments – debt, student housing, senior housing, development and agriculture.

Infrastructure, where monopolistic airports and ports are selling at almost 30 times earnings, is prompting some funds to look to listed infrastructure as an alternative asset choice. Welcome to a new uncharted investment territory.

Generally, Australian super funds stick to what they know best – equities, bonds and fixed income. Most still allocate at least 50%, and up to 70%, of their funds to domestic and international shares. They also have around 30% in bonds and fixed income. Real assets – property and infrastructure – account for 20% or less.

Ken Atchison, who advises the superannuation industry, says there are some differences in how industry funds (not-for-profit), retail funds (bank owned) and corporate funds (sponsored by an employer) are allocated. Industry funds are relatively overweight growth assets compared with retail funds and corporate funds, and they are relatively underweight Australian fixed-interest assets in favour of property, infrastructure and alternatives.

A spokeswoman for the Association of Superannuation Funds of Australia says: "Australia has among the highest exposures to equities and alternatives, so super funds have been pro-active in ensuring that investments are sufficiently diversified to maximise returns."

"It is a very challenging time for many reasons, not least of which is the ongoing political and economic volatility around the world"

Paul Howard

Despite frequent market gyrations, funds insist that equities continue to deliver strong returns. Sam Sicilia, chief investment officer of AUD20b industry fund Hostplus, says: "The dividends that shares pay is the only place that you are getting yield from today. We are now destined for lower inflation, lower interest rates, lower returns for much longer."

Paul Howard, acting general manager investments at the €39bn industry fund REST Industry Super, says: "It is a very challenging time for many reasons, not least of which is the ongoing political and economic volatility around the world. Asset valuations are very high."

Daryl Browning, chief executive of ISPT, says the quest for yield in a low-interest-rate environment is a global phenomenon. "There isn't a week goes by when we don't get enquiries from Europe and Asia," says Browning, who manages AUD12.2bn of core property on behalf of 30 not-for-profit super funds and government agencies.

"Return expectations are moderating. We raised this issue in 2012 with our investors because we could see that interest rates around the world were moving lower – and that this implied a lower return regime," he recalls. "People are debating whether this is the peak of a cycle or whether we are midway through a different cycle."

"People are debating whether this is the peak of a cycle or whether we are midway through a different cycle"

Daryl Browning

Many agree that the property market is mimicking the hubris of 2007-08. Browning says: "You need to be patient, to have a long-term strategy, and to stick to that strategy – but maintain flexibility at the same time."

ISPT has been able to buy core assets because, he says, "opportunities do arise as circumstances and markets change".

Sicilia says: "I am disappointed if I am unable to deliver 10% to my members. However, if all that is available is 4%, 5%, or 6%, then our job is to try to capture as much of that as we can."

He adds that accumulation funds like Hostplus have more flexibility when investing than defined benefits or sovereign wealth funds. The latter require a certain level of returns to ensure that they remain solvent, with sufficient money to pay all their obligations.

Hostplus members are young people – a characteristic of the hospitality industry. “From when they become our members to when they retire is typically 40 years and, in future, if the retirement age goes up to 70 years, it would be 50 years,” Sicilia says. “If you are able to tolerate illiquidity, then you should invest in unlisted assets like real estate, infrastructure and private equity.”

Between 40% and 50% of Hostplus is invested in property, infrastructure, credit, private equity, and other select alternatives such as student housing. It receives an annual inflow of AUD2.4bn and has been investing in alternatives and infrastructure since the early 2000s – more than 15 years before its peers even thought about such asset classes.

Howard says REST “would like to own more property and infrastructure because we like those types of assets”. Discipline, however, is holding the fund back from participating in what he calls “a sometimes crazy chase for very expensive assets”.

Howard notes that listed infrastructure is available at multiples in the mid-teens compared with the high-20s for private infrastructure assets.

First State Super, Australia’s second-largest not-for-profit super fund and one of the more forward-thinking ones, has gone down the route of public-private partnerships (PPPs). It is a majority equity partner in the AUD2bn Sydney Light Rail project, and recently took up a 90% interest in the AUD400m Lendlease Public Infrastructure Investment Company. The Lendlease vehicle owns two hospitals in Victoria and Queensland and the redeveloped Sydney Convention Centre complex on Sydney’s Darling Harbour.

“In all PPPs, we have long-term concessions to provide a service, whether it is transport, health or entertainment,” says Damien Webb, head of income and real assets at First State Super. “So long as we meet the set KPIs [key performance indicators] in the delivery of those services, we will receive a cash flow from the government. It is guaranteed income.

“But we don’t take patronage risk. For example, we won’t invest in toll roads because, if people don’t take your toll road, your equity could be at risk.”

Credit or debt is an established investment option overseas, but this not the case in Australia. Yet times are changing, and some funds are taking a closer look at the asset class.

The AUD100bn AustralianSuper and the AUD10bn-plus Hesta Super were among the first to invest in debt after the 2008 global financial crisis, awarding a combined mandate of AUD400m to Australian non-bank lenders.

In recent months, AustralianSuper is believed to have given a mandate of about AUD$150m to a specialist debt fund manager to finance residential developments.

First State Super has attempted to enter the Australian debt market but, so far, opportunities have been elusive. Ireland and the UK have been the most fertile markets for the super fund. Webb says First State Super has lent millions in commercial mortgages in these two markets, especially in Ireland.

Webb believes that, in the aftermath of the Brexit vote, some UK clearing banks have withdrawn from lending to some categories – and that this could open up new lending opportunities.

Webb is similarly looking for market dislocations in Brazil, a country currently beset with economic problems. He hopes to source opportunities through Brookfield Property Partners.

Does this mean that First State Super is moving up the risk curve? “Risk is not static,” replies Webb. “I would argue that the risk in core property is at the higher end, given current prices and cap rates.”

Australian super funds tend to be domestically focused, but with shrinking opportunities and intense competition, both from domestic and foreign investors, they are reluctantly looking outside Australia.

Browning says: “Increasingly, the big super funds run global portfolios. There is renewed interest in international opportunities, but many have not done anything yet.”

Two years ago, AustralianSuper (see AussieSuper: Been there, done that) mandated global managers to source core office and retail assets in the US, Europe and the UK. Its biggest exposure is in the UK, where it is undertaking a £3bn urban rejuvenation project in Kings Cross, London, with Hermes Investment Management.

Meanwhile, REST is now investing in the US with Greystar, the large US multifamily developer/operator, in a US$350m venture.

Sicilia says Hostplus uses specialist managers to do the legwork. They have the skills and local contacts, he says. And from his perspective, if he is able to get them to reduce their fees, he immediately accrues “a riskless return”.

Hostplus allocates roughly 40-45% to international investments – split almost equally between equities and unlisted assets. “Needless to say, globalisation affects everything, including asset allocation,” says Sicilia. “And it is inevitable that we will have much more offshore than in Australia in future.”

Several super funds told IPE Real Estate that new options for future investment are being explored. Webb says new categories could include the retirement and aged care sector, student accommodation and, potentially, data houses.

But all this is work in progress.

REST and Hostplus already co-invest with several other Australian funds in Campus Living Villages, the owner of some 40,000 student living units in four countries.

Paul Howard sees student housing as having similar aspects to core infrastructure, offering long-term contracted revenues. “Most Australian tertiary institutions receive subsidies from, or are underwritten by, governments,” he says. “This reduces credit risk.”

Investment in agriculture is also creating a new buzz as fund managers look to take advantage of Australia’s strategic plan to become Asia’s breadbasket.

First State has invested AUD150m in Select Harvest, which grows almonds, while REST has AUD250m allocated to the Warakirri Agriculture Trust, which grows cotton in the Eastern States and in Western Australia.

Howard says: “We have been invested in the Warakirri Agricultural Trusts since the late-1990s, and in the early-2000s became the sole investor when AustralianSuper exited.”

But, he adds, it can be difficult to make money from agriculture.

Howard sees agriculture as a diversifier. “It is about making sure that we have exposure across the asset classes. Some will be counter-cyclical and others will have a correlation to broader market movements.”

But industry consensus is that core property is still the name of the game. One portfolio manager, who runs a state government super fund, told IPE Real Estate: “The core market has been good for us. We’re still getting strong returns, but they will moderate and the cap rate has come down.”

Browning says: “Ultimately, we get better relative value from the core market. At the end of the day you get your return from the risk you are taking.”

AussieSuper: Been there, done that

The AUD100bn (€69bn) AustralianSuper fund decided to ramp up its exposure to property and infrastructure assets three years ago as a response to the dwindling returns expected from other asset classes. It was a move that gave AustralianSuper – known colloquially as AussieSuper – a headstart in building a buffer in the 'lower-for-longer' world.

Mark Delaney, AussieSuper's chief investment officer, says a decision was made then to address the fund's underweight position to real assets. "We adopted the view that interest rates are going to stay lower for longer and we sought to increase our exposure to property and infrastructure," he says. "We have since increased these holdings substantially."

"Property and infrastructure prices... are unlikely to go up substantially"

Mark Delaney

And, as an early starter, the pension fund has been richly rewarded. "Our property returns – income plus appreciation – have been in excess of 30% cumulatively over the last three years," says Delaney.

"It is probable that property and infrastructure prices can remain at this level, but they are unlikely to go up substantially. Returns from infrastructure are very asset-specific with the better-performing assets delivering cumulative returns in the high-30s over three years".

Today, Aussie Super's first-mover advantage is becoming harder to replicate. "The main challenge in the current global environment is that very low levels of interest rates globally have led to a re-rating of the equities market and a substantial increase in the value of properties and infrastructure assets," Delaney says.

This situation, he says, is limiting the fund's ability to deploy new capital because he is not prepared to pay unacceptable prices for assets.

AussieSuper began casting a wider net in the global market two years ago, and has steadily built up a sizeable portfolio of offshore property. Early this year, it invested a further AUD900m in the 27-hectare mixed-used office, residential and leisure site development at King's Cross in London.

The additional investment, which lifted its stake in the Kings Cross project from 25% to 67.5%, was made on the basis that it is "one of the most important and biggest city centre regeneration projects in Europe".

The fund has increased its investment in London's Kings Cross

In 2015, AussieSuper completed two transactions in the US worth a total of almost AUD2bn. These were a 49.9% stake in Brookfield Property Partners' office portfolio in Washington DC, and a stake in the Ala Moana shopping mall in Hawaii.

AussieSuper's hunt for suitable infrastructure investment overseas continues as it consolidates its presence in Australia's infrastructure market. The fund is part of a consortium that in 2013 bought Port Botany and Port Kembla in New South Wales for AUD5bn. It is also a member of the Transurban consortium in the AUD7bn Queensland Motorways deal in Queensland in 2014.

Today, property and infrastructure makes up around 20% of AussieSuper's balanced fund, which accounts for 75% assets under management. AussieSuper receives annual contributions for its 2m members totalling between AUD5bn and AUD6bn each year. It is Australia's largest industry super fund.

Delaney says the fund is fully invested, adding that the public markets of equities and fixed income is very deep and liquid. The public market, therefore, offers more opportunities than the private market.

"We continue to be active in the property market in looking for properties and building relationships," he says, pointing out that the assets AussieSuper has been able to secure came through its network of relationships in Australia and overseas. Delaney is also looking at the debt market, which he notes is becoming increasingly attractive "to every pension fund in the world".