Interview with Eric Byrne on Multi-Managers Real Estate

A broad investment universe

The multi-manager real estate industry has boomed in recent years. Eric Byrne explains how the Multi-Managers Real Estate (MM-RE) business navigates market changes to provide superior access to investments with attractive fee savings to clients.

1 In a low-yield market with increasing volatility, what benefits does real estate offer in a multi-asset portfolio?

Real estate will remain an attractive addition to a multi-asset portfolio thanks to its relatively high yield and comparative stability. The lowered volatility in value is principally due to the significant income component in total returns. This is driven by the contractual lease structure and the tenant's obligation to pay rent. This income component varies from 70-90%, depending on the market. Furthermore, while real estate demand is closely linked to economic performance, the length and structure of leases can, if properly managed, provide some insulation against both economic downturn and inflation. The combination of these features ensures a relatively low correlation with other asset classes and therefore core real estate can act a ballast to a multi-asset portfolio, as well as a higher-yielding alternative to government bonds. In an era of increasing volatility and uncertainty, this can be a valued reassurance to long-term investors.
All real estate investors will typically have a home bias to a greater or lesser degree. This is perfectly reasonable, given it is the market which they are most familiar, in which they operate, and likely where they carry a majority of their liabilities. Additional international real estate to a predominantly domestic portfolio can benefit investors in a number of ways.

Firstly, real estate cycles differ across markets, providing diversification benefits and market entry/exit timing opportunities. These can both enhance risk-adjusted performance.

Secondly, expanding into global markets provides access to a much wider real estate universe. This enhances liquidity but also provides investment opportunities by sector, market maturity, or risk profile that might not be available in an investor’s home market.

Finally, it is worth noting that many investors first assume they need an additional return to compensate for going abroad, necessitating a move up the risk curve. While this might be appropriate for certain portfolios, it is also reasonable to assume that investors should take additional risk in the market they know best, at home, and at least initially expand into best quality, core global real estate. Ultimately, it depends on an investor’s own objectives, but core global real estate can certainly provide an expanded, diversified, risk-adjusted return enhancing addition to any domestic real estate portfolio.

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What are the options accessing global real estate?

The evident starting point for global real estate is the straightforward acquisition of direct properties. However, in addition to the scale and cost needed to implement such a strategy, is the staggering complexity of undertaking due diligence in multiple jurisdictions with differing practices, tax, and currencies. In contrast, gaining exposure via listed securities can be a low cost alternative to acquire diversified exposure and access expert management without the enormous funds needed for a direct portfolio. Investors also benefit from higher levels of liquidity. The downside is that, in the near term, these shares are as volatile as the wider stock market. In between direct investment and the public markets lie the unlisted funds, which may be closed-ended or open-ended. They offer a balance between volatility and liquidity, though not all investors may be eligible to invest in them or find them tax efficient, especially cross-border.

Alternatively, other groups could pool resources with like-minded investors and mandate a fund-of-fund manager or multi-manager platform with the operation of their real estate exposure. Here, rather than investing directly or indirectly through a single unlisted fund, a portfolio of unlisted funds is selected by a manager and actively positioned. This removes the concentration risk of being exposed to a single fund (or manager) but adds a layer of fees in recognition of the manager’s ability (and direct time costs) to select and carry out due diligence on funds which are assessed to offer good risk-adjusted returns for a particular strategy.

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Is now a good time for clients to invest in real estate as it looks expensive today based on historical values? If so where should I be focusing my investments?

It is comparatively late in the property investment cycle and current entry prices for good quality real estate look elevated relative to history. However, global interest rates remain historically low and it is a reasonable assumption that though they will likely rise, they will not return to their historical averages. Not only does this mean real estate will remain favorably priced vis-à-vis other lower yielding asset classes like fixed income. It also means that the risk premium for real estate over and above the risk-free rate will likely remain nearer to its long term average, despite the higher entry prices. Furthermore, the development cycle has been less pronounced this time around, particularly in Europe. This means we are facing a potential economic slowdown with less construction in the pipeline. All else being equal this means less downward pressure on rents and values.

Nevertheless, in this context we still recommend broad sector and geographic diversification with tactical large exposures in sectors and markets which are benefiting from long-term structural changes. This means a focus on logistics, in particular the types of assets serving large urban communities. We also favor alternative sectors which are growing in importance thanks to demographics, like aged care or student housing. We have a preference for markets which have lagged in their recovery and/or where supply is very tight, including but not limited to parts of continental Europe.

Finally, we recommend a focus on asset-specific value-enhancement initiatives, i.e. identifying specific strategies that will improve the income stream of an asset. We believe this is the angle to outperform now that we are late in the cycle and market capital value growth is slowing to a halt.
In 2019 we expect an acceleration of some of the trends we witnessed in 2018, though the driver of the slowdown may well be switching from higher interest rates and their impact on pricing to slower economic growth and the impact on rents. In either case, first and foremost we expect a further moderation in global property returns and an increasing emphasis on income. This has been a trend in place since the peak of the market in 2015 and an outlook for which we have been positioning our product strategies for some time.

Secondly, we expect a continued polarization in property performance. The retail sector is going through massive structural change and this will alter the very structure of the asset class. It will not disappear and some of what used to be considered retail will disappear, replaced by efficient logistics stock and e-commerce, while some of what used to be leisure will be incorporated into retail. In 2019, however, elevated capital expenditure and widespread investor pessimism will see retail values under pressure outside the most dominant assets and the best catchments. At the other spectrum stands industrial which is benefitting from the structural change in demand as well as institutional capital flows which have permanently altered its relative valuation. We expect this sector to continue to perform well.

Finally, we believe there will be an increase in perceived volatility, but this will have little direct impact on property values. Political risk, whether Brexit, European budgets, or US government shutdowns, will dominate headlines and raise uncertainties, but it is only where this affects real estate demand and the structure of the economy that it will be reflected in property values. It is our experience that political risk tends to be over-estimated in the short term and its effects misunderstood and/or under-estimated only in the long term.

The MM-RE business has grown from around USD 6 billion to USD 15 billion in the last three years. There are two main reasons for this.

The first is our family of commingled funds has seen significant inflows from a wide range of investors including pension funds, insurance companies, family offices and HNW clients. Their main reasons to invest have been the attractive uncorrelated returns compared to other asset classes, the diversification benefits which provide low volatility, the liquidity options, the passive hedging of the currency exposure and income focused returns in this low interest rate environment.

The second reason our MM-RE business is seeing growth has been through winning large institutional mandates. We provide bespoke real estate portfolios tailored to clients’ needs. These mandates have a range of strategies from core low risk investing, to value-add medium risk, and opportunistic higher risk investing. In addition, within the mandates we are investing in the more concentrated co-investments to provide targeted exposure of assets and property portfolios. While these investors are typically large in terms of assets, their real estate teams are generally quite small and need to rely on our specialist MM-RE team to construct their portfolio’s and execute their real estate investments.
How is the MM-RE business able to deploy this capital quickly while still maintaining good investment performance?

First and foremost, we focus on our existing clients to ensure we meet their investment performance targets. In the second half of 2017, we restricted inflows into our family of commingled funds to protect investment performance from the impact of large inflows. In 2017 and 2018 combined, we still invested around USD 5 billion across our Multi-Manager platform.

One way we have done this is through fund formations. Our Research & Strategy team identified certain sectors and countries that we believe will outperform the broader market. We then identified specialist real estate operators that have a high quality seed portfolio of assets and worked with them to create an open-ended fund vehicle. This allows us to deploy our capital quickly as the founder investor buying into these assets, while getting significant fee discounts. An additional benefit is the liquidity for our holding should we need it later on down the line as the fund develops overtime. To date, we have completed over 10 fund formations that have deployed around USD 2 billion in sectors such as US logistics, European and Japanese residential and US medical housing.

Other ways include through the secondary market where we have focused on specialist funds providing targeted investments. Investors have a variety of reasons to sell these positions, but by moving quickly and in scale we have been able to deploy around USD 1.5 billion this way over the last few years.

We have also been able to deploy capital effectively via co-investments mainly for our mandate clients allowing concentrated investments in a particular asset or portfolio. Finally we have recently closed a recapitalization in the US senior housing sector accessing this area at an attractive entry price will deploying capital quickly.

Given the scale of our fund investing and real estate relationships we are able to get access to a wide range of high quality co-investments that we can offer to our clients. A co-investment is typically a large single or portfolio transaction that is too big for a real estate fund to absorb. The General Partner of the fund will offer part of the investment to existing investors of the fund to invest alongside the fund therefore getting concentrated exposure to this asset or portfolio. This is also attractive to investors as the fees are typically discounted, and the assets given their size, are hard to access. For our mandates we have been active in this area over the last few years. This is an area we are looking to expand in and believe it to be a very attractive way for larger investors to access real estate in a targeted way.

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Value-add investing is where you are typically taking some tenant risk. This means you are targeting a property that is “unloved”, needs some renovation, but is fundamentally a good asset in a good location. So some or all of the existing tenants leave and as an investor you are willing to invest some capital expenditure into the building to improve or reposition it. This is with the goal to get new tenants in who are willing to pay higher rents and improve the value of the property.

This strategy is a good one as you can find managers that can truly create value, rather than just take excessive leverage or risk for the sake of it. This means sourcing the "unloved" assets at the offset, gaining a good entry price into the deal, and having the skills to renovate or add value to the building effectively. It’s important to be disciplined in selling the property to maximize the return to the investors.

Through our mandates we have invested in 25 value-add funds over the last eight years and realized double digit returns for our clients. We believe this strategy to still be appropriate and have a number of mandate investors where we are executing this strategy.

Environmental, Social and Governance (ESG) factors are playing a much larger part in investors’ decision making across the asset management industry and that is also the case for real estate. In addition to reviewing a fund’s ESG policies, we consider how it incorporates these policies into the fund strategy, how it reports its ESG strategy to its investors, what relevant laws and regulations impact the fund, and any sustainability initiatives the fund is already participating in. This information is then incorporated into the investment decision making process.

The industry has woken up to the importance of measuring performance against external benchmarks through the increased range of sustainability measures and standards such as the GRESB assessments. In 2018 for example, 32 of the underlying funds from our flagship commingled funds, participated in the GRESB assessments representing 79% of the overall product. 30 of these funds were awarded a Green Star status, which is the highest recognition available and overall, the aggregated score was above the benchmark average. Buildings with better sustainability scores not only enhance performance whilst benefitting the environment, but sustainable buildings also command higher rents to also benefit investors.

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Notes: 1 All data as at 31 December 2018, unless otherwise stated.
2 Equity includes both invested and committed assets.
3 Based on 30 June 2018 holding NAV plus remaining capital to commit to each target fund and including future planned commitments.
4 Of Assets under Management for all funds eligible to participate in the GRESB Assessments. Scores based on 2018 GRESB Assessment and UBS Asset Management, Real Estate & Private Markets.