Offshore Property Investing - Thoughts on the Investment Process

Tim Stringer, *CAIA*
Frontier Advisors

Investment offshore is an established component of most Australian institutional investor portfolios, and has been for some time. However, investing in offshore direct property has not featured heavily due to the more challenging nature of this asset class.

In this article, we discuss some of the key aspects associated with investing in direct property overseas, along with a few of the more interesting and important structural differences between key offshore property markets and the Australian market.

The offshore property opportunity

Why broaden the property investment set?

A common misconception is that investors ought to receive a premium for investing globally. In fact, real estate fundamentals are universal and unaffected by borders. Like other financial instruments (e.g. bonds and equities), it is generally accepted that the benefit of international investing outweighs the risk associated with offshore markets. We believe this thesis also applies to real estate, with due consideration to tax and liquidity issues.

Frontier identifies four key reasons for extending a property portfolio configuration to include investment in international property markets. These are highlighted here.

A vastly expanded market size and opportunity set

Published estimates place the institutional global property market at in excess of US$25 trillion. This creates an enormous opportunity to strategically position property portfolios in accordance with desired objectives via the larger set of options in markets and sectors, and the wider set of skilled local investment managers.

Improved investment performance characteristics

Offshore property returns in the key core sectors are broadly comparable to domestic core property returns, but subject to different cycles and influences, and hence can dampen the sometimes more volatile return profile in Australian direct property. It should be noted, however, that, globally, there is a far wider dispersion of returns compared to a pure domestic property portfolio. This divergence of return profiles between markets does, though, allow prudent investors to enhance portfolio performance over the longer term.

Diversification benefits

All real estate markets are reliant on the influences of local supply and demand factors (as well as that of the broader capital market) and, hence, return correlations are generally a lot less between offshore markets than they are within domestic markets. This creates significant scope to reduce the overall volatility of returns through a diversified portfolio.

Management of overall risk adjusted returns

Generally, real estate performance is correlated to the economic growth of the country and, over time, GDP growth should improve occupier demand and, in turn, drive higher rents. This is a key reason why country selection influences the ideal property portfolio configuration. There also needs to be a focus on how risky the separate markets are in isolation, and on how they interrelate. Higher returns are generally, but not always, associated with higher risks, and an optimised global property allocation can offer a higher return per unit of risk than that of any individual country.

Strategy and configuration areas of focus

Key areas of focus and assessment in developing a global property strategy and configuration include the following.

The availability and value of top-down and bottom-up research from local experts

Property markets operate in dynamic and cyclical environments, requiring regular research, meticulous monitoring and often revision of the decision-making systems and processes themselves. Better investment decisions offer the surest way to achieve higher investment returns while managing investment risks.

The relatively inefficient real estate marketplace is often described as the last bastion of entrepreneurship

Investors can alter the nature of investment returns and risks, by changing the nature of their involvement in real estate investment. The best investment managers make judicious use of available research, use appropriate tax shelter provisions, choose the best locations within markets, and manage assets in a highly professional and experienced manner, leading to consistent strong performance.

Consideration of the key risks

This can include: local market real estate fundamentals and specifics; economic environment driving tenant demand; leverage and the capital markets; the local legal system, including controls over highest and best use of land and constraints over supply levels; political issues impacting development and tenant demand; currency overlays and hedging; tax implications and efficient structures; liquidity driven by depth and size of markets; market transparency and knowledge of nuances; and the nature and structure of investment vehicles for accessing direct property.

A particular focus by global investors has been on the challenges associated with foreign tax regimes with respect to direct property. Investing globally is likely to mean that returns on real estate available to local investors are not always available to offshore investors, including Australian. Whilst investment vehicles can be structured to achieve efficient income and tax pass-through, this may not always be possible, particularly where investing via established pooled funds which may well have embedded sub-optimal tax structures.

The goal is to implement a tax efficient structure that allows the Australian investor to achieve their required after-tax return. Whilst an added complexity and risk, there are now examples currently of Australian funds investing offshore, both directly and in pooled vehicles, which provide an efficient after tax outcome.

Approaches of global institutional investors

Frontier has met with a number of major domestic and international, cross border property investors over the past 18 months to understand and compare the approach taken to ensuring the best decision outcomes for international/cross-border investing. The key offshore investors met with include: Ontario Teachers' Pension Plan; Caisse de Dépôt et Placement du Québec; Canada Pension Plan Investment Board; PGGM; Pensioenfonds ABP; and Blue Sky Group. Key take outs from the discussions (and with some of our major local investors) are as follows.

- The key commonality with these groups is that they are willing to commit the necessary resources, both people and financial, spending time in offshore property markets to ensure that decisions are made on the basis of being very informed and of a high conviction.
- One critical issue is the misconception that investors should require a premium for investing globally. Among the group of investors above, it is generally accepted the benefit of international investing outweighs the risk associated with offshore markets.
- Issues faced historically by global investors were similar to those experienced by Australian funds and their global property allocations, particularly those entered into at the height of the 2006/07 property market. These include the use of overly complex and expensive fund of fund structures, an excessive use of leverage, a lack of skilled local market operators, unacceptable fee leakage and poor market timing. They learnt that there is no requirement to behave differently than you would at home when building a sensible, domestic property core portfolio. The approach should be the same, just using the international opportunity set as the universe for investment.
- The pension funds met with all have the pre-condition of a formal analysis of real estate managers, which proceeds in a logical and rational fashion. Successful long-term investing involves the development of a clear investment strategy and deep analysis of investment opportunities, providing the necessary information with which to make

sound decisions. Completed investments are then closely monitored to provide feedback, allowing for correction in strategies where required and ensuring suitable future investment performance.

- Many of the international investors Frontier met with, and that Frontier has observed, view real estate investment as akin to buying a new business, with each property having a distinct set of physical, market, legal and financial characteristics. They see that a detailed and thorough understanding of this complex set of attributes, and how they translate into investment returns and risks, is far more likely to lead to successful long-term investment decisions. Moreover, they effectively and proactively manage the investment process.

Investment process fundamentals

The decision making framework

Analysing real estate investments involves a diverse group of interrelated activities such as market analysis, financial analysis, capital structure analysis, review of decision making and tax strategies. Ongoing investment decisions require an evaluation of the risk and return profile of the alternatives relative to an investor's strategy. In making decisions over a time horizon that includes both short and long-term considerations, short-term success is important in order to succeed over the long-term. Although the majority of decisions are generally "go" or "no go" investment choices, investing ought to focus on maximising the value of the overall portfolio.

To build out an offshore property portfolio as one portfolio, rather than as individual investments, decisions should be made on the basis of an overall real estate investment strategy. Investors must develop a strategy that defines the nature and measurement of the returns and risks that are acceptable to the investor. Each new investment that is made can then be evaluated in the light of its impact on the current portfolio, its relationship to other assets in the portfolio and the combined impacts to the overall investment plan.

Due diligence

Due diligence is about considering the elements of a proposed offshore property investment that will influence its future investment performance in an absolute and relative sense. Specifically, primary due diligence assesses the important aspects of a fund and its investment program, the investment manager that has oversight of the program and is representing the investor's interest, and also each of the key property specific, and portfolio specific, issues.

Determining an appropriate level of manager and market due diligence cannot be prescribed by formula; it is instead determined by the investment structure, property type and level of market knowledge of the individual conducting the process.

The due diligence process does not necessarily only involve a decision or a recommendation; rather, at a minimum, it confirms that requisite tasks have been performed, pertinent issues addressed and critical information has been identified and disclosed. It should also confirm that designated standards, including acquisition policies and criteria, as well as legal and regulatory guidelines, are being complied with and that the decision processes have been appropriately adhered to.

A comprehensive due diligence process involves consideration of issues at multiple levels: that of the investment manager, the fund or program; that of the actual professional managing the fund or program; and that of the particular or proposed properties that comprise the portfolio. The assessment of a particular investment fund or program will therefore normally consider and review seven critical elements.

1. Management.
2. Property quality.
3. Alignment and compensation.
4. Investment criteria.
5. Current and future portfolio composition.
6. Rights, responsibilities and decision-making processes.
7. Liquidity and exit strategies.

A comprehensive due diligence would normally necessitate a review and inspection of physical assets, or a representative cross section, and a review of geographical and locational attributes of the significant exposures. This due diligence validates that the manager's strategy is replicated by its actions, and the investment plan is consistent with the outcomes.

Other more property specific issues that should be considered, include: the local economy; supply demand balances; the property's competitive position within the respective markets; general condition of building improvements and building age; planned and needed capital expenditure; the nature of the lease tenure and credit worthiness of cash flows; taxation factors; historical investment performance; reasonableness of assumptions in the underlying financial analysis; validity of the cash flow modelling; physical environmental risks; regulatory compliance; and a review of the key senior management and decision making processes.

Beyond the physical attributes of the properties within the portfolio it is also important to gain an understanding of: the various neighbourhood and local sub-regional influences; market size; sources of demand; competitive market supply; aspects of financing and ownership structures; the tenant market; typical lease arrangements; typical property operations; typical approaches to management; historical financial performance; ESG; and local legal and planning issues.

Having an understanding of the above approach provides an understanding of the likely outcomes associated with an offshore property investment. In today's world, real estate due diligence is improved from decades past but the wide dispersion of rigour and professionalism remains. The current trend in institutional property investment noted above applies greater emphasis on assessing not only a managers' capabilities, adaptability and investor focus, but on asset selection and the merits or otherwise of markets, submarkets, sectors and subsectors.

Selecting markets to allocate to

International real estate investment has been growing substantially post the GFC, however it does present sizable decision making, organisational and managerial challenges above and beyond the challenges involved at a local investment level. Many of these challenges are indeed inherent in the choice of real estate as an investment medium in any case, but they are accentuated for Australian investors by the time-distance gap, and the different socio-economic and cultural nuances associated with national and regional markets.

An additional time and cost commitment is required in the initial decision to examine the feasibility and opportunities of where to invest an international real estate commitment. Frontier believes the best approach is to look at country and local market variables, being conceived of as macro and micro issues. The macro issues conceptually relate to reducing systematic risks for portfolio allocation across particular international markets. By extension, international diversification should reduce portfolio systematic risk, especially if the portfolio was previously composed of assets principally with a home market bias. Micro issues are more orientated towards those factors that determine systematic risk.

Having developed a view of a limited number of macroeconomic or political variables and selecting some, somewhat arbitrary, performance cut-off benchmarks, a list of target country markets can be achieved. Having reduced the investment universe to anywhere from 10 to 30 regions, the urban market selection process begins, following a similar methodology but matched with greater emphasis on actual performance expectations.

In our view, the best international investment approach is to view the world as one large economic system, wherein major metropolitan areas constitute significant regional economies. National political changes and bureaucratic regulations are then simply different rules in the local game, which can be dealt with through appropriate tax and legal advice. Crucial to this process is the reliance on the best and most experienced local expertise available. The focus then becomes on fundamental analysis of the urban economy and the broader local real estate market trends.

The manager interface

Australian institutional investors should expect the organisations that advise, consult and represent them, and the managers that they invest through, to walk-the-talk of commitment to a prudent real estate investment process. This means adopting the appropriate strategic approach, combined with the prudent acquisition, operation and disposition of property investments. Given the heterogeneous nature of real estate, and the confidence and belief that many in the real estate industry possess, there is a need for the investor's advisor (as well as the investor) to fully understand the nature of the investment they are making and the similarities and differences between the numerous options and opportunities.

Without effective due diligence prior to an investment, no amount of strategic insight and/or operational/dispositional brilliance can overcome the debilitating risk associated with a marginal (or worse) property investment, or the consequences of overlooking a major weakness in the property, market, manager or investment structure. We should expect to have implicit trust in the manager and then we need complete assurance and confirmation that, everything that is supposed to be done, is in fact done. Trust is a necessary, but by no means a sufficient, precondition for institutional real estate investing. Finally, perspicuous substance must back up the absolute confidence of the manager-investor relationship.

Lessons from the GFC

A number of international property investments made prior to the GFC have subsequently performed poorly. This was primarily due to unprecedented and largely unanticipated market declines, however, the issue was exacerbated by some gaps in manager and market due diligence. Indeed, in many cases, self-promoting managers were successful in pitching their deal making capabilities as the primary assessment criteria relative to the traditional analysis criteria. This skew can lead to a lesser understanding of the proposed market's risk exposures and a reduced examination of the representations made by the manager.

As noted, Frontier's approach to property research and due diligence is that it is fundamentally a means to confirm whether an investor's expectations are likely to be achieved. The importance of this due diligence process is set out above, and the important flow on from the GFC on this issue is that investors require greater confidence that their expectations, on which they make their financial commitments, will be realised.

Therefore, an approach to market, manager and property investigation centred on increasing the likelihood that realised results will be consistent with expectations is critical. Future shortfalls should not be attributable to a lack of insight and understanding of the initial investment case and parameters. Post GFC, Frontier has implemented a "deep-dive" due diligence approach that we believe is a crucial part of the investment process, irrespective of the investment strategy being pursued. Our approach seeks to minimise reasons for underperformance, reasons that should be discovered through a professional, careful and thorough assessment prior to the decision being made to go forward with the investment.

Implementing due diligence

The greater the degree to which an investors' investment policies, strategy, portfolio composition and property investment criteria are clearly articulated, the better the implementation of the research and due diligence. For research not in the context of a particular investment, the due diligence assessment necessarily needs to be more general than precise. However, the greater the granularity of objectives for a portfolio's configuration, the more precise the investment investigation should be, with the depth and parameters expressly articulated.

The practicalities of completing an offshore direct property due diligence requires strong cooperation between the various parties to the idea proposed, including direct access to senior management within the investment management community, access to a large and diverse collection of researched documentation, and physical access to properties and markets, in addition to significant pre-planning and preparation to identify what information is needed, in what format and during what time frame.

In conclusion, it is worth noting that the comprehensiveness of research, due diligence and investigation required for offshore direct property investment is still evolving; there is no standard imposed by regulation, endorsed by professional associations or generally accepted by the advisor community. What might be considered adequate by one institutional investor, could be considered totally insufficient by another. Regardless, the research, due diligence and investment process needs to question and confirm critical assumptions and information, and be a comprehensive investigation of those factors that will likely influence an investment program, and an offshore property investment's probable investment performance.

Offshore property - some local market differences

Offshore direct property investing has, in general, much more of a local aspect to it than any of the other major investment sectors. Indeed, offshore property markets tend to have many local market peculiarities and traditions, much more so than other international investment sectors that domestic institutions have successfully invested in in the past

Hence, in closing, we thought we would outline some of the more interesting and relevant local market differences, vis a vis Australia, for developed direct property markets of the US, UK, France, Germany and Portugal.

- In Germany, when a commercial transaction is agreed and about to be completed, representatives from both the buyer and seller must provide a full set of contract documentation to a notary. The notary is required to read every word of the contract whilst both parties are in attendance. Complex contracts can indeed take up to a couple of days to complete this process.
- In France, most commercial leases are indexed to a CPI annual rent review. If, throughout the duration of the lease, the rent climbs above 25% over the initial rent, and the CPI reviewed rent is greater than market rent, the new rent must revert back down to market rent. This is despite any conditions and terms within the lease to the contrary. The typical commercial office lease generally has a term of three, six or nine years. In the six and nine year lease, the tenant has a statutory imposed right to break the lease term, through a break option, after three years. Whilst under certain circumstances this can be negotiated out of the lease, it changes the long-term certainty associated with the cash flow.
- In Portugal, the courts take a rather borrower friendly approach to any action taken by lenders for enforcement of covenants such as loan to value ratio. If a lender is in breach of the covenants, and the bank wants to take enforcement action, the courts take the view that, as long as the borrower is paying the interest, then the covenants outside interest being paid are not enforceable.
- In the US, the most obvious example of a difference in the commercial marketplace is the availability of long-term fixed rate debt of 10 to 15 years. This compares with that available in Australia of up to five years. The sources of debt are dramatically broader, with 6,000 banks, numerous life insurance companies, agencies such as Freddie Mac, a CMBS markets and numerous debt funds. The debt market is the deepest, widest and most flexible in the world. In fact, the "right customer" can generally borrow on the basis of non-recourse, unsecured, interest only loans.
- Another US nuance is where the transaction of an asset has a loan in place. Because of the long term and fixed rate nature of loans and the associated large prepayment costs, transactions on assets are completed on the basis that loans "flow with the asset" from vendors to purchaser. The loans generally have transfer rights; these are critical to ensure that the asset can be transferred and not encumbered by unusual terms or conditions. The right of transfer is generally transferable to future downstream transactions. This makes the type of financing decision very important.
- The US has many state based regulations and taxes that are unique to the individual states, and there are elements like mortgage-recording taxes on the debt which, for example, in the city of New York is 2.5%. There is a vast variation in transfer taxes (state stamp duties) and there are also numerous local customs and laws required to be aware of and understood. Indeed, in some US states, the local custom is that the seller pays the stamp duty and not the buyer.
- In the US, leasing terms and conditions vary across the country, from triple net leases to full-service leases and everything in between. We note that, in the shopping centre market, it is highly unusual for landlords to be able to roll out a standard specialty shop lease, with most tenants, particularly national tenants, looking to impose their own specific terms and conditions. This slows the process down immeasurably.
- Finally, in the US it is pretty much standard procedure, by virtually all commercial office tenants, to have leasing reps/tenant advisors acting on their behalf in leasing negotiations with landlords.

The final word...

The concept of cross border investing should be developed on the theme of a single look through portfolio approach, which identifies the different sectors and markets that will provide varying returns at different periods of the cycle, increasing the benefit and scope of providing better risk adjusted returns. In taking an international approach, an ideal portfolio construction will be focussed on multiple markets, properties and property types in light of the heterogeneous nature of the international market. The low correlation of returns likely to be achieved implies there is scope for significant risk reduction through pursuing an international, cross border strategy.

The focus for an international investment strategy is that it is supported by long-term trends, such as the growing importance of large gateway cities, environmentally sustainable economic growth and technology driving e-commerce, trade logistics and work/leisure environments. Given the target markets that are identified in both Australia, US and pan-European markets, it will be important to maintain a disciplined approach and not be enticed into acquiring lower quality, non-core assets when it seems that it will be safe and returns will be sound.

Secondary asset return premiums may not necessarily compensate, over the long term, for the heightened risks taken. It is crucial to appoint managers that are experts in the chosen grades and sectors, and not align to managers without the necessary skills, experience and proven track record.

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Author Bio

Tim Stringer, *CAIA*
Frontier Advisors

Tim is Principal Consultant, Head of Property and leads Frontier's property research and advisory effort. His responsibilities at Frontier include providing consulting advice to Frontier's clients, and involvement with strategy, investment and manager research.

Tim has 30 years of experience in the commercial property sector, having held senior executive, fund management, portfolio management, and advisory roles with Colonial First State Global Asset Management Property, where he was CEO, Summit Capital Advisors, and AMP Capital Investors.

Tim has completed a Graduate Diploma in Property, an Associate Diploma in Valuation and is an Associate of the Australian Property Institute.