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REAL ASSETS
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Applying a 360-degree approach to property allocations

Executive summary

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- Applying a universal approach to property allocations can offer investors an opportunity to achieve superior risk-adjusted returns throughout the property occupancy cycle. The unique characteristics of the real estate asset class, combined with visibility on the underlying cash-flow streams, is what enables real estate investors with a deep understanding of the property cycle to implement a 360-degree approach to their property strategy and portfolio allocations.
- In practice, applying a 360-degree approach to property investment consists of looking at the four-quadrant universe in a given market or region to assess the underlying risk-reward characteristics, as well as market pricing for the entirety of the capital stack and various investment vehicles.
- Traditionally, each quadrant has been priced in isolation with specific capital sources driving pricing based upon regulatory constraints. A number of market participants price a given property investment relative to other asset classes rather than comparing debt and equity pricing on the same underlying property or, if applicable, to comparable quality listed property company stocks or bonds. The result is pricing that is often disconnected with the inherent risk-reward relationship up and down the property capital stack and across instruments.
- By combining a more universal approach to property portfolio construction through the cycle and constantly monitoring relative value pricing across the four-quadrant property-investment universe, property investors could optimize their overall risk-adjusted return profile. Of course, this approach is anchored on a manager's ability to "read the cycle" and find relative value trades up and down the capital stack and across the various investment instruments but, ultimately, it could be a real alpha generator.
- In addition to portfolio construction, this universal approach to property could be used to create blended real estate products that seek to circumvent some of the inherent difficulties in building property allocations while remaining firmly rooted in offering underlying property-level investment performance.

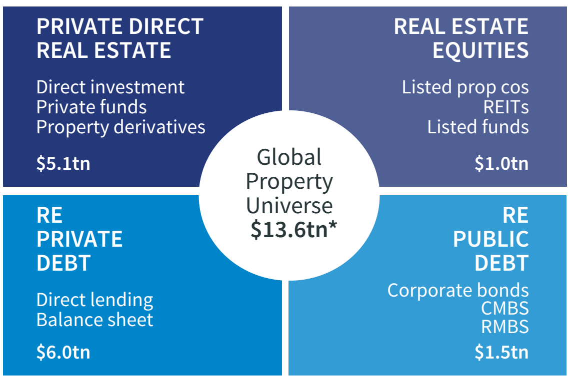
The unique characteristics of property combined with visibility on the underlying cash-flow streams, enables real estate investors with a deep understanding of the property cycle fundamentals to implement a 360-degree approach to their investment strategy and portfolio allocations. Applying this universal approach to property allocations can, we believe offer investors an opportunity to achieve superior risk-adjusted returns throughout the property occupancy cycle. In addition to superior risk-adjusted returns, a 360-degree investment approach can yield portfolio characteristics geared towards specific attributes, such as inflation linkage and certainty of income driven by recurring cash flows as well as a shift away from benchmarks towards a more total return/IRR driven portfolio strategy.

Unique asset class characteristics lead to inefficient market

Real estate assets are fixed and heterogeneous in nature, with an acquisition process that is both time consuming, given due diligence requirements (physical asset technical inspection, legal review, etc.), and expensive (transfer tax, agency fees, etc.). In addition, the best properties tend to be large, lumpy assets whose individual lot size maybe inaccessible to small and medium sized investors requiring a diversified property portfolio.

The capital intensive nature of the asset class has led to a diverse capital market comprising four quadrants of property investment: public and private, debt and equity (Figure 1). While publicly traded instruments are generally more readily available, the liquidity of each quadrant varies from time to time and, ultimately, a desired investment may not be available on the open market at any given time. This dynamic is accentuated at inflexion points in the cycle, when a large bid-ask spread causes liquidity in some market segments to dry up. However, this is precisely when some of the best investment opportunities can arise. Market participants who are agile, prepared with a deep understanding and have broad reach in a local market can often benefit from a first-mover advantage to reset pricing and unlock market liquidity.

Figure 1: Property investment universe



Source: DTZ Money into Property 2015.
* This estimate is based on the investment grade stock held by different investor groups and excludes some categories which are not investable such as owner-occupied space

As direct property is not traded on a centralized exchange, there are a number of added complexities in terms of data and market transparency compared to traditional equity and fixed income markets.

The end result is a real estate marketplace comprised of relatively low transparency and asymmetric information. This inefficient market environment can provide a source of relatively high risk-adjusted returns to those investment managers who have access to quality information through active participation and local exposures. Furthermore, the lack of frequent transaction data for the analysis of return distributions often necessitates the use of appraisal based valuations. This brings about a timing lag between when index data is released and what is occurring in the spot transactional market. There is a growing trend of transaction-based indices in the most liquid global markets but the majority of private markets continue to have low transparency and asymmetric information. These factors, combined with the inherent cyclicality in occupancy rates (due to the lead time for new supply to respond to demand growth) create a relatively inefficient marketplace with accretive relative-value investment opportunities.

Segmenting property cash-flows to differentiate property investment risks and target a specific portion of the capital stack

Real estate investment performance is driven by two cash flow periods (Figure 2):

- recurring rental income during the holding period and
- sale proceeds at the end of the holding period.

In the short to medium term, how a property's rent roll corresponds to the underlying occupational market cycle will largely determine the cash flow performance of a property asset during the holding period. Additional risks beyond the traditional occupancy cycle include tenant credit default risk and, in the case of initial vacancy, expected versus realised lease up periods. Given the time it takes to construct a new building investors generally have visibility on the short-term (i.e. 18-36 months) outlook for rental value growth. This translates into predictable, stable, inflation linked cash flows, especially in the short to medium term with a focus on fundamental analysis.

By contrast, the longer time horizon for asset disposal exposes property investors' equity capital to the wider financial markets and their impact on the real estate capital market pricing.

Depending upon macroeconomic conditions and prospects for property performance, investment alternatives and relative value pricing which drives asset allocations and capital flows, the cap rate applied to an underlying income stream can vary which has a direct impact on the equity capital value and/or ability to refinance/repay any outstanding/maturing debt.

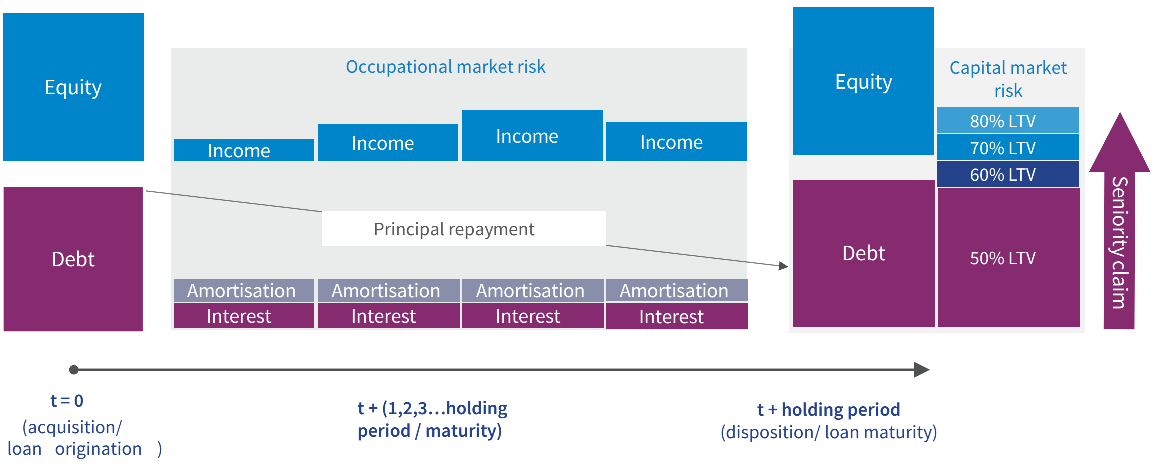
From a debt provider's perspective, the initial holding period cash flows would cover interest payments and any amortization while loan repayment upon maturity would be paid out of sale or refinance proceeds.

In contrast to the debt cash flows, which are fixed and agreed at origination, equity investor cash flows are comprised of the residual excess above these debt payments.

Applying the approach to commercial real estate (CRE) investments: it's all about relative value

Real estate exposures have traditionally been allocated from wider alternatives, equities and fixed income allocations. For multi-asset portfolios, private equity direct real estate investment has been allocated from an alternative investments bucket, with listed real estate equities exposures held within an overall equities portfolio and public and private debt allocations included as part of a wider fixed income allocation. In effect these silos have created market pricing (within and between the four quadrants of property) that ignores the inherent risk/reward relationship up and down the property capital stack and creates an opportunity for investors who consider a 360-degree approach to property to exploit these inefficiencies by applying a holistic and agile approach.

Figure 2. Holding period cash flow distribution across the capital stack*



Source: AXA IM – Real Assets

* The cash flow, risks and capital structure depicted are for illustrative purposes only and the actual capital structure, cash flows, and risks associated with a particular real estate investment will depend on the terms and structure of such investment and may differ materially from the example above

In practice, applying a 360-degree approach to property investment consists of constantly assessing relative value and liquidity across the four-quadrant property investment universe. This approach can be applied to a specific portion of the capital stack but across various investment instruments (i.e. horizontal relative value) or across the entirety of the capital stack (i.e. vertical relative value) to compare debt and equity risk-reward tradeoffs. When taken together both of these approaches offer a holistic view of property pricing in light of the inherent risk-reward relationship up and down the property capital stack and across instruments for a given property market or region. By leveraging a strong conviction/view on the market fundamentals, and pricing of debt and equity portions of the capital stack, an investment can target a specific portion within the capital stack. The equity portion of the capital stack offers the opportunity to capture the upside in a rising market or alternatively, debt investments can seek to mitigate downside risk by being in most secured debt portion of the capital stack.

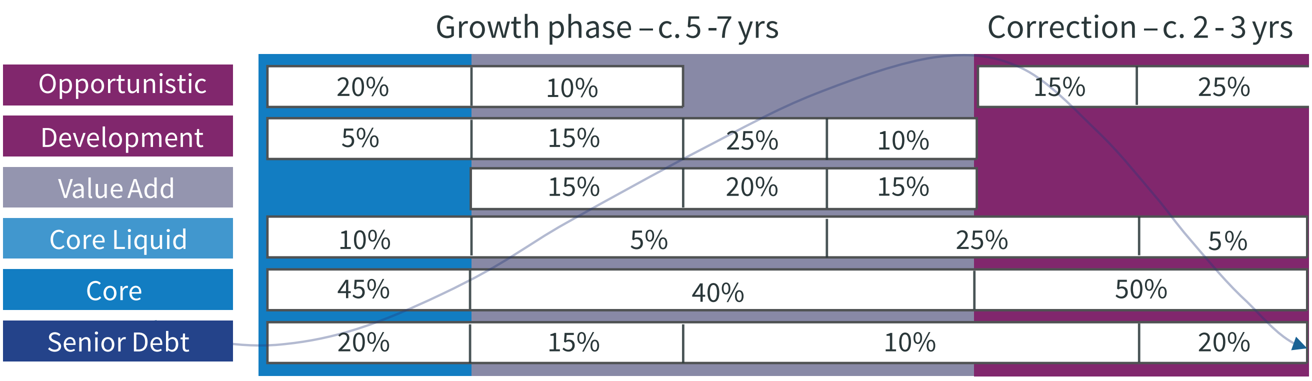
360 approach may provide a framework for a more targeted risk adjusted return approach to portfolio construction

If we consider the cycle position in a broader context of portfolio construction, then we could utilise this 360-degree approach to calibrate an overall real estate allocation across the cycle based upon a given investor's underlying risk threshold. At the foundation of a property portfolio should be a core holding of unleveraged core properties, as 100 percent fee ownership affords owners the ability to control their own destiny with the asset. This can be achieved either directly or in a fund format depending upon investor size. An open-ended fund structure provides investors an exit option without forcing a fund liquidation at the wrong time in the cycle.

Outside of the core anchor holding which focuses on income, value-add and development risk could be added during the growth phase of the cycle to aim to exploit the higher property-level total returns available when the market is expanding and rents are growing. We believe opportunistic and senior-debt investments may offer better investment opportunities and liquidity during the adjustment phase of the cycle when distressed situations create deal flow for opportunistic strategies and lending margins widen at the same time that LTVs drop on depressed real estate values. Further, we believe, listed real estate companies (REITs) can be used to maintain full exposure to underlying property performance whilst providing the added benefit of daily liquidity. These exposures can not only widen the investable universe of a wider property portfolio but can also fill the timing gaps arising from the time it takes to deploy capital into the various private-market strategies as the occupancy cycle evolves.

Figure 3 shows a hypothetical example of how an investor targeting an eight percent per annum property return could use this approach in practice to calibrate a property portfolio over the course of an occupancy cycle. Over and above this property cycle–focused allocation strategy, investors could also tailor their overall

Figure 3. Example allocations through the cycle to target an 8% average portfolio level return



Source: AXA IM – Real Assets
Allocation depicted is for illustrative purposes only and is intended to show the strategy that AXA IM – Real Assets would adopt if it was a low risk investor looking to design its own real estate portfolio. Such allocation is not intended to be investment advice to the recipient and does not take into account an particular needs of the recipient. Definition of investment styles is based on AXA IM Real Assets' own subjective interpretation of each such investment style.

property portfolio towards a specific industry segment mix or particular macroeconomic growth themes, as property performance is directly correlated with the local economic market prospects — some of which are more geared towards a specific industry segment than others (e.g. Silicon Valley real estate exposure to the technology sector).

In combination, the four quadrants of property comprise the comprehensive real estate investment universe available to investors. By considering opportunities across the entirety of the capital stack and across all real estate investment instruments, investors open up a wider universe which can enable a more targeted strategy approach to be implemented. For example, investors looking to build a targeted property portfolio seeking to capitalise on strong convictions and/or some of the larger mega-trends impacting global economies (demographics, rise of online shopping, growing influence of millennial generation, etc.) may find it difficult to source transactions on the private real estate markets directly; however, the listed real estate universe may offer immediate access with an existing portfolio and in-place management platform. By incorporating this more holistic approach to real estate allocations, investors and managers can overcome some of the pitfalls emanating from the traditional silo investment approach.

Shifting away from benchmark index towards a total return approach

Many academic reports have shown that real estate indices suffer from a number of deficiencies including valuation lag, appraisal bias and constituent bias. While progress continues to be made on improving global property benchmarks, including the development of various transaction based indices in the most liquid property markets, most continue to suffer from structural nuances which hamper like-for-like comparisons. The heterogeneous nature of property investments and use of appraisal based valuations makes it unlikely that a one-size-fits-all index will successfully emerge for the asset class in the foreseeable future. Investors willing to move away from a traditional index benchmark approach could construct property portfolios based upon this risk-based approach, anchored on a deep understanding of market fundamentals and a holistic view of the investable universe. In breaking down the traditional silos, and considering the four quadrant universe in its entirety, the risk-reward trade-offs and opportunities across the capital stack and instruments could be exploited to achieve superior risk-adjusted returns over the entirety of the cycle.

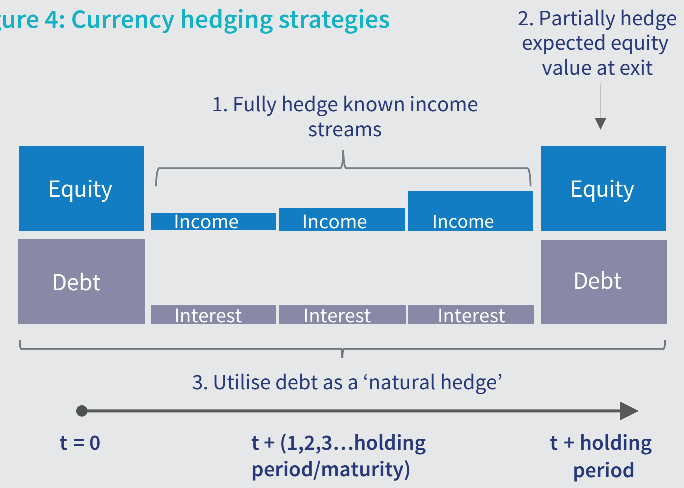
Managing currency risk to aid international diversification

Underlying property fundamentals vary across geographies and while capital markets continue to merge globally, the combined differences may provide natural diversification opportunities for investors willing to diversify internationally. A cross-border property portfolio can improve the efficient frontier of a multi-asset investment portfolio which has increasingly encouraged large, global institutions to expand their real estate exposure beyond their domestic borders.

International property investing inevitably involves managing currency risk. For larger institutional investors who manage a diversified international multi-asset portfolio, currency hedging can be more efficiently done at a portfolio level rather than an individual asset level as there can be efficiencies gained from looking at overall currency exposures as some individual investment exposures may offset one another. Furthermore, as some larger investors are able to take a longer term view of international investments, it could make sense to not fully hedge foreign investments as current spot pricing already reflects market expectations.

At a property level, future rental income streams, along with sale proceeds, must be estimated in order to enact hedging strategies. Once values are estimated they can either be partially or fully hedged, through the use of either forward contracts or options. As owners tend to have more visibility on rental income, it may be more practical to fully hedge these short-term cash flows. By contrast, cash flow related to the asset sale or refinancing, where the bulk of the overall investment's cash flow by value tend to emanate, is far more uncertain as the timing is far into the future and dependent upon interim capital market movements, so this may be more practical to partially hedge. Furthermore, foreign investors can reduce the terminal equity value at risk by utilising leverage for foreign purchases which in effect acts as a currency hedge (Figure 4).

Figure 4: Currency hedging strategies



Source: AXA IM – Real Assets
Note: for illustrative purposes only

Conclusion

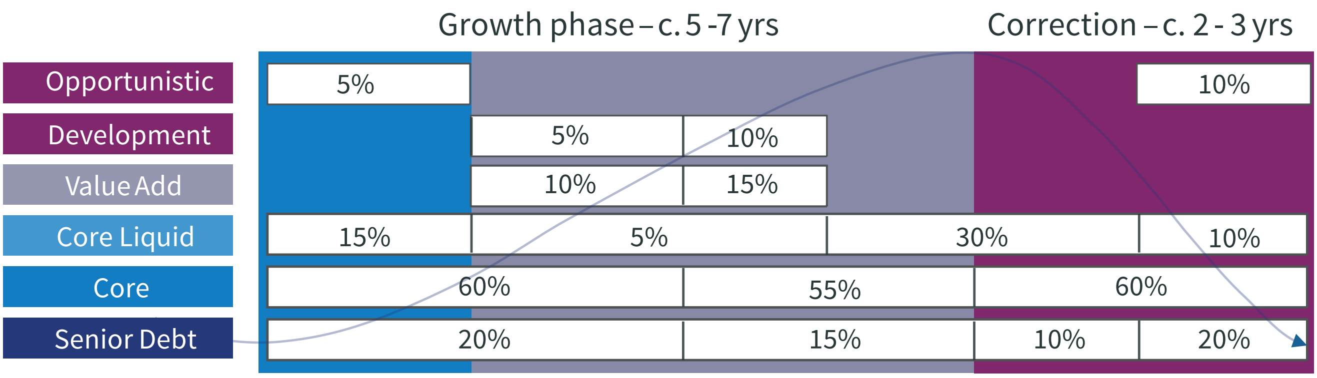
By applying this more universal 360-degree approach to property portfolio construction through the cycle and constantly monitoring relative value pricing across the four-quadrants, property, investors could potentially optimise their overall risk-adjusted return profile. This approach is anchored on a manager's ability to perform fundamental research and read the cycle in order to find relative value trades up and down the capital stack and across the various investment instruments.

In addition to portfolio construction, this universal approach to property could be used to create blended real estate solutions that seek to bypass some of the inherent difficulties in building property allocations while remaining firmly rooted in offering underlying property-level investment performance.

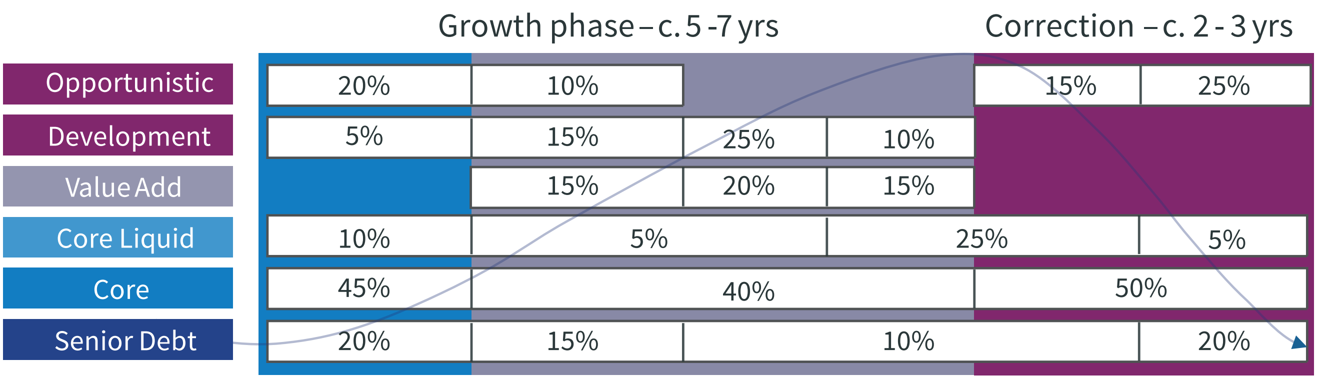
Deploying capital into direct property takes time and traditionally involves a significant commitment period which can sometimes take more than five years to implement. By utilising a 360-degree approach to the asset class, investor allocations can be tailored to an investment target be it return orientated, catering to liquidity needs, risk threshold or a wider combination of objectives. Furthermore, by working with investment managers that offer the full suite of property investments these tailor made portfolio solutions can be more readily implemented and monitored over the course of the cycle.

Appendix:

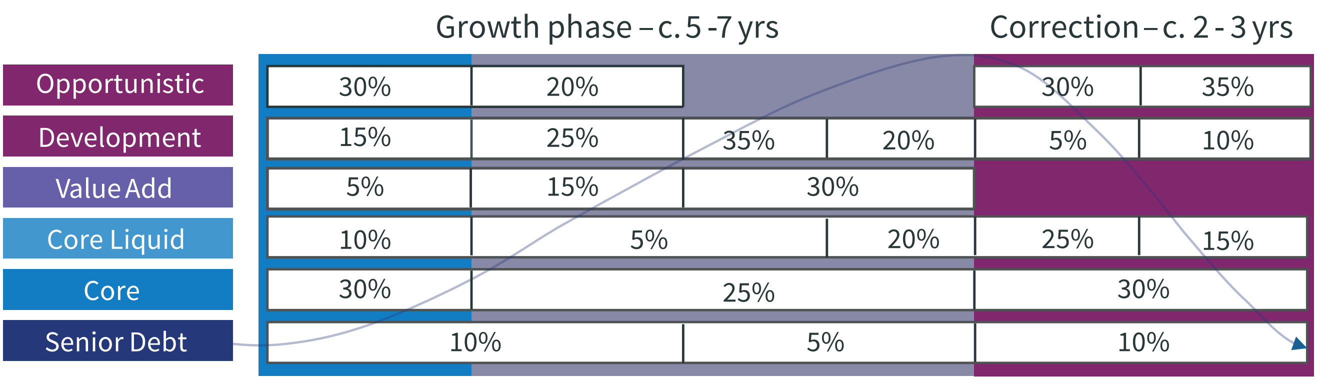
Example allocations through the cycle to target an 6% average portfolio level return



Example allocations through the cycle to target an 8% average portfolio level return



Example allocations through the cycle to target an 10% average portfolio level return



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