April 2016

HEDGENORDIC

Nordic Allocators
Seeking low-risk Yields flock to Infrastructure

Infrastructure
The better option for exploiting Emerging Market growth

Key risks
For Real Estate in 2016

Real Estate
Still in a Sweetspot!

Real Estate & Infrastructure
A Sweetspot in the alternative investment space

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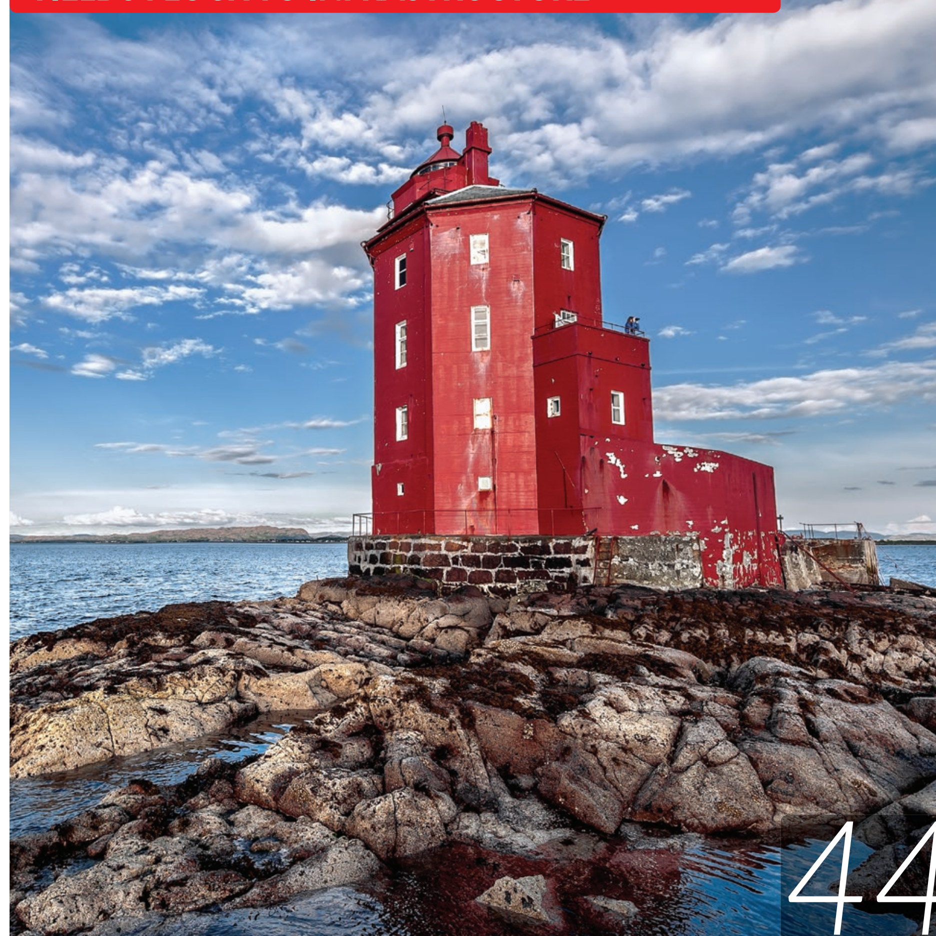

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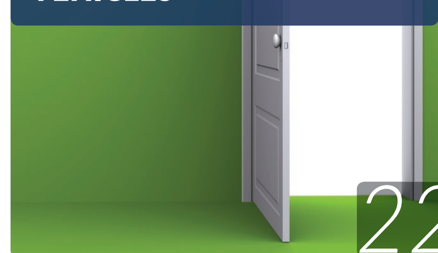

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

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The Editor

a sense of awe...

The first, deep and lasting impression I recall having from a building, or any man made structure as a boy was an early interest in the Egyptian pyramids of Giza. I was fascinated by the vastness of the constructions, the enormous amount of effort and energy, manpower and resources going into the construction, the infrastructure around it providing housing, schools, entertainment, medical facilities, places of worship, markets, food, water for the workforce, the transportation of material and – as I learned later, the enormous costs in relation to ancient Egyptian GDP. And until today, I get a sense of awe just thinking of the magnitude of the undertaking.

Building the great pyramid today would take five years, and cost five billion Dollars

While the great pyramid was originally built by tens of thousands of workers over the course of nearly 30 years using strength, sleds and ropes, building the pyramid today using stone-carrying vehicles, cranes and helicopters would probably take 1.500 to 2.000 workers around five years, and it would cost to the order of 5 billion Dollars. An absolutely staggering amount, yet only a fraction of the costs and efforts the ancient Egyptians put into the project. But then of course, the risk / return figures for the landlord and investor - the Pharaoh - matched up! Allocating taxpayers' money to engage cheap labor for the perspective of eternal life as a God in wealth and pleasure carries an appealing intrinsic ROI.

Most of us can relate to investing in real estate, aspiring for an own apartment, house, or farm to retire on. Typically it will be the largest material investment we will make during our lifetime. Some may even accumulate enough wealth to make or contribute to a comfortable, work free living generating income by renting out an apartment or agricultural land.

It seems only natural then that also as an investment case, real assets such as real estate or infrastructure projects enjoy natural sympathy. As sober, disciplined investors we want to get the risk return metrics right (and may they be set lower than what Khufu had in mind) and have a good, solid understanding of what is out there and how those instruments work. We still painfully feel the shock that went out to the financial crisis in 2008, that epicentered from the US mortgage market.

This special report on infrastructure and real estate investments strives to scratch the surface of the vast landscape of real assets and highlight some of the tools available to Swedish and Nordic investors, specifying some of the products available.

Kamran G. Ghalitschi
CEO / Publisher HedgeNordic

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2015 – A RECORD YEAR FOR TRANSACTIONS IN THE NORDIC REAL ESTATE SECTOR

By Jonathan Furelid – HedgeNordic

2015 was another record year for transaction volumes in the Nordic real estate sector. Low interest rates, strong economic development in the Nordic region and a lack of high yielding investment options elsewhere has propelled interest in Nordic real estate investments to a new high.

The transaction volume in the Nordic real estate sector reached a new record high in 2015. According to numbers from Pangea Property Partners, the transaction volume reached 40 billion euro during the year, translating into 36% growth from the year before. Growth was particularly strong in Norway and Denmark where volumes more than doubled.

The strong increase in transaction volumes was driven by mounting interest from foreign real estate investors. Foreign investment accounted for 35% of total transaction volumes during the year which is the highest level seen since the financial crisis, Pangea states.

Commercial real estate has been the most sought-after investment in the Nordic area during 2015, where transactions have been made to record high price levels. Of particular interest was commercial properties in prime locations – an investment area with scarce supply characteristics.

The growth in real estate investments can be tracked to a number of driving factors, according to leading real estate advisory firms.

First of all, the solid GDP-growth, particularly in Sweden, is supporting business activity and demand for commercial property. A high demand for modern, space-efficient properties in prime locations and a low degree of vacancies has sent rents to levels not seen since the days of the IT-bubble. Low interest rates also supports the demand for real estate overall. Another factor having a positive impact on real estate demand is the lack of yield to be found elsewhere.

Although demand for real estate has been strong overall, there are some regional characteristics worth highlighting with regards to the Nordics.

Norway and Denmark are seeing the highest growth in transactions. Despite a troubling oil sector, vacancies in central locations in Norway remain stable and transactions reached record levels last year, where cross boarder transactions due to a favourable exchange rate and low interest rates triggered demand. Denmark is experiencing continued high interest for properties in prime locations. The fact that the country allows for investors in commercial properties to borrow 60 percent of the capital invested is a supporting factor, particularly given the current low interest rate environment. Finland has, despite a stagnating economy, seen prime location rents remaining stable and transactions are increasing. In Sweden, transactions are much focused on the Stockholm area. Demand for office buildings is high, both among local and foreign investors, and transaction volumes are expected to stay elevated but stable, according to real estate advisor JLL.

The prognosis for 2016 is for the Nordic real estate market to build on recent strong numbers with some pointing to worsened financing characteristics (increased capital requirements on banks) potentially causing transaction levels to decrease from the high levels seen in 2015.

According to real estate advisor DTZ, transaction volumes have continued to rally in the first quarter of 2016. In Sweden alone, the volume in the first quarter amounted to 28.5 billion SEK which is the second largest number for a quarter during the last 10 years.

NORDIC TRANSACTION MARKET

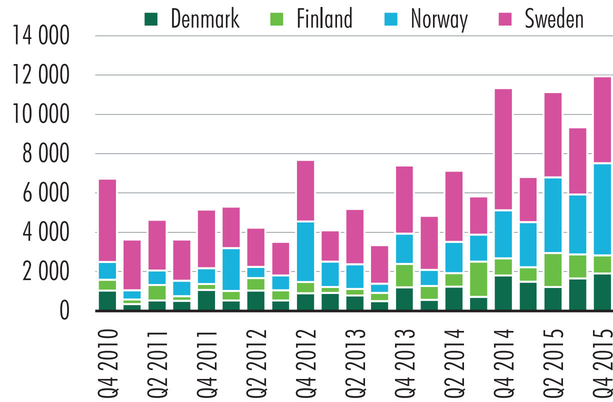
Q4 – transaction activity in the Nordic region resulted in a record quarter, with a total investment volume reaching approx. €12bn, which is an increase of 28% when compared to the previous quarter. It's thus the strongest quarter since the year 2010. The investment volume was mainly driven by large cross-border deals as well as large portfolio deals.

A STRONG YEAR FOR ALL NORDIC COUNTRIES

Denmark, Finland and Norway saw investment volumes increase when compared to 2014.

By tradition, Sweden has been the largest contributor to the Nordic transaction volume, and year 2015 was no exception – the Swedish volume ended up at approx. €15bn representing 37%. However, Norway witnessed a record year with an investment volume reaching up to the whole of approx. €14bn, which is an increase with 122% when compared to previous year 2014.

Denmark contributed to approx. €6.2bn (16%) and Finland approx. €4.6bn (12%) of the total investment volume in 2015.



A RECORD YEAR FOR THE RETAIL SECTOR

2015 posted an uptick in retail investments for the Nordic market. Driven by deals mainly in Norway, but also Sweden and Finland, the retail transactions ended up at €10,1bn, representing 26% of the total investment volume. When compared to 2014, the retail deals increased with 166% across the Nordic region.

However the office sector dominated in 2015, with an investment volume of €13,3bn, representing 23% of the total volume. Compared to previous year 2014, it's an increase with 25%.

When compared to the European sector allocation, the Nordics continued to differ slightly in Q4. The other sector dominated the difference, representing 38% (€4.5bn), thanks to large residential deals in Sweden and Denmark.

2015 – STRONG FOREIGN INVESTORS' ACTIVITY

As predicted, we continue to see an increase in interest and net buying trend from international investors, despite domestic investors still dominating the markets across the region. On average, the foreign share of the total Nordic transaction volume represented 29% for Q4 and 40% for the whole year 2015.

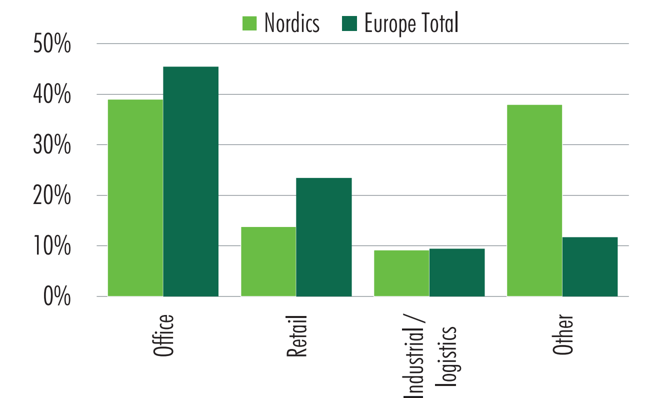
Investors' investment criteria are widening, both in terms of geography and investment profile; a result of the demand-supply imbalance.

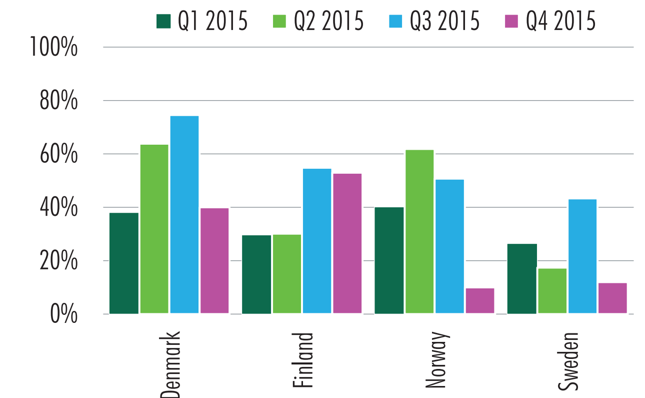
SHARPENING YIELDS DURING 2015

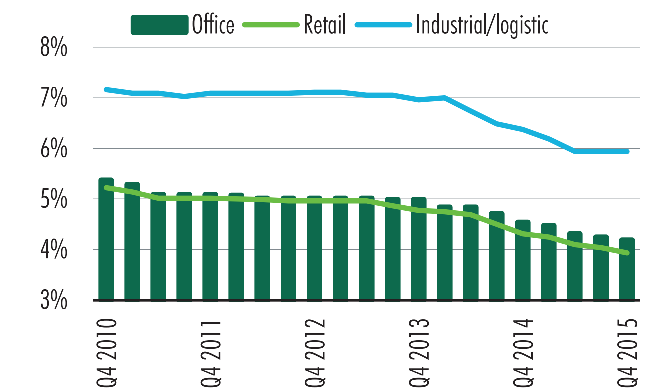
Attributable to increased demand from international investors and favourable financing costs, 2015 witnessed a pressure downwards on prime yields across the region, which is reflected mainly in the office and retail sectors.

OUTLOOK

We expect a continued strong investment market across the Nordic region during 2016, with high activity from both domestic and foreign capital. The investors are expected to continue diversifying into regional cities and alternative assets.







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14BEUR
35% of 2015 Nordic Investment Volume

12% of 2015 Nordic Investment Volume

6.2BEUR
16% of 2015 Nordic Investment Volume

15BEUR
37% of 2015 Nordic Investment Volume

PROMISING START OF THE YEAR WITH 10% GROWTH Y-O-Y

Preliminary figures for Q1 2016 point towards another strong quarter ending at 7.6 Billion Euros.

Finland witnessed an exceptionally strong quarter with 144% growth y-o-y. Retail was the most traded asset type in Q1, representing over half of the total volume.

Norway, on the other hand, has seen a contraction of the Q1 investment volume by 53% when compared to the same quarter last year. This is still slightly higher than the five year average although it seems that the euphoria from 2015 has calmed down, as the market normalization continues.

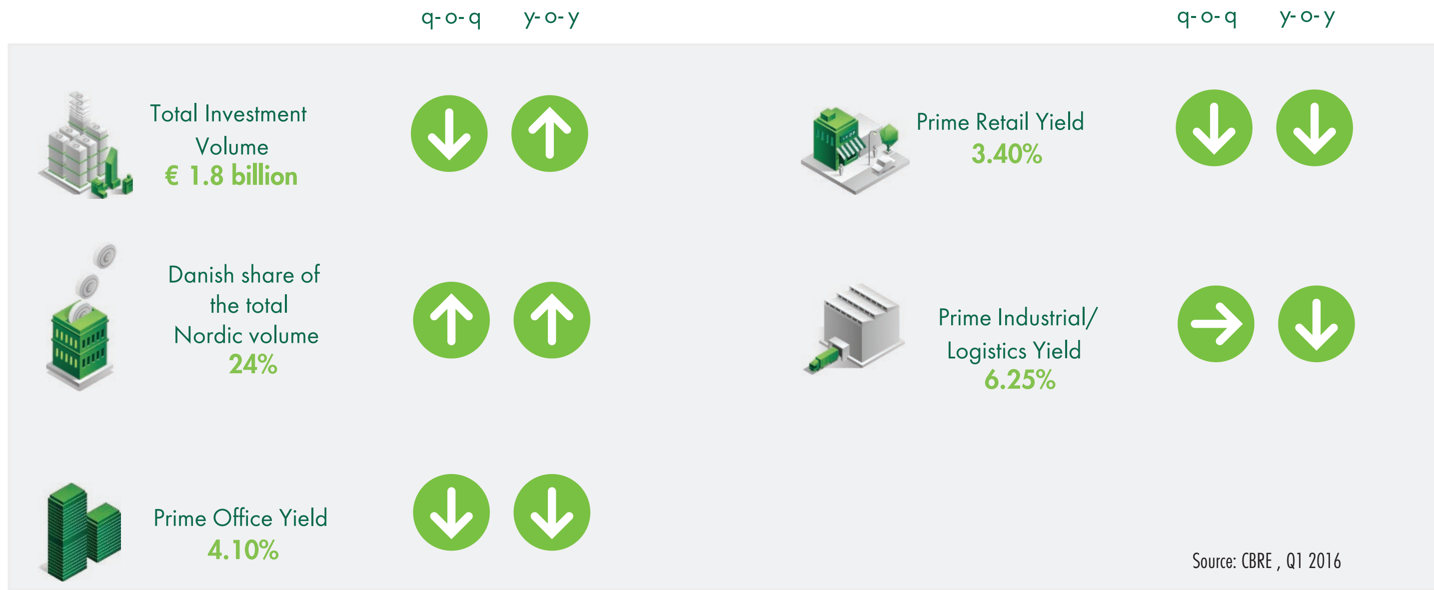
The Swedish market records strong interest from international capital sources and an increase in the net buying trend for the non-Swedish investors. For Q1 2016 cross border deals ended up at 0.9 billion Euros, representing the whole or close to 30% of the total transaction volume.

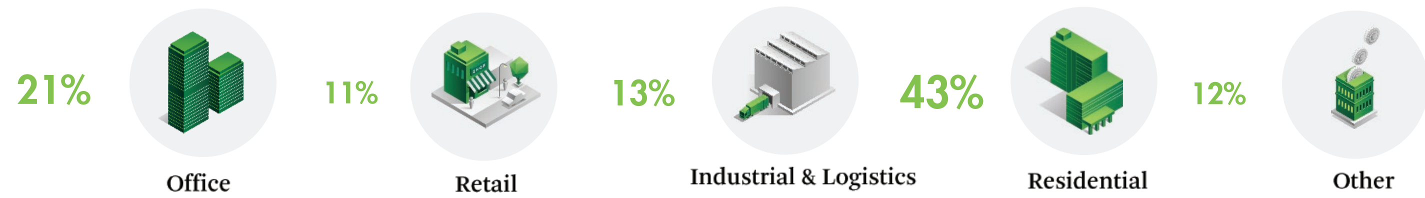
According to preliminary figures, the Danish investment market has seen an increase by 10% y-o-y. Large deals and portfolio sales dominated this quarter.

Prime yields remained stable or contracted across the region. Going forward, the trend is expected to be strong to stable.

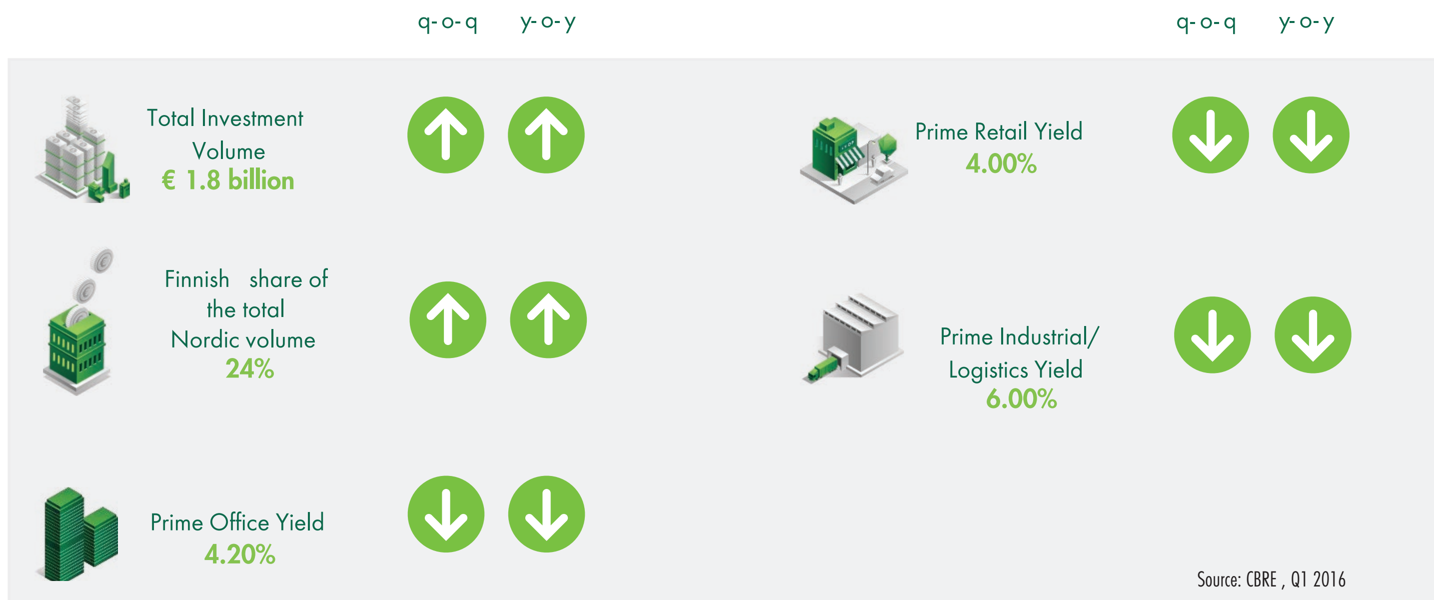
NORDIC REAL ESTATE INVESTMENT Q1/2016

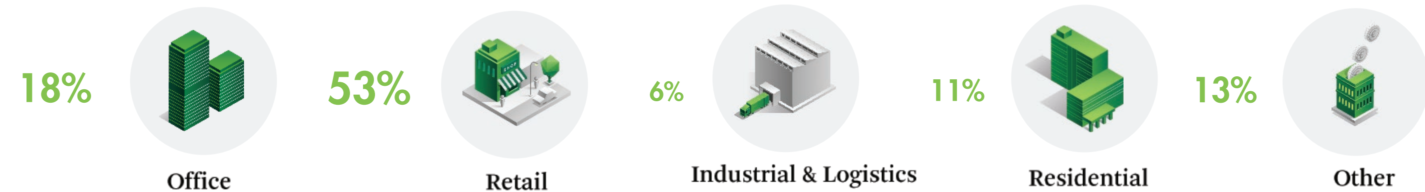
DENMARK



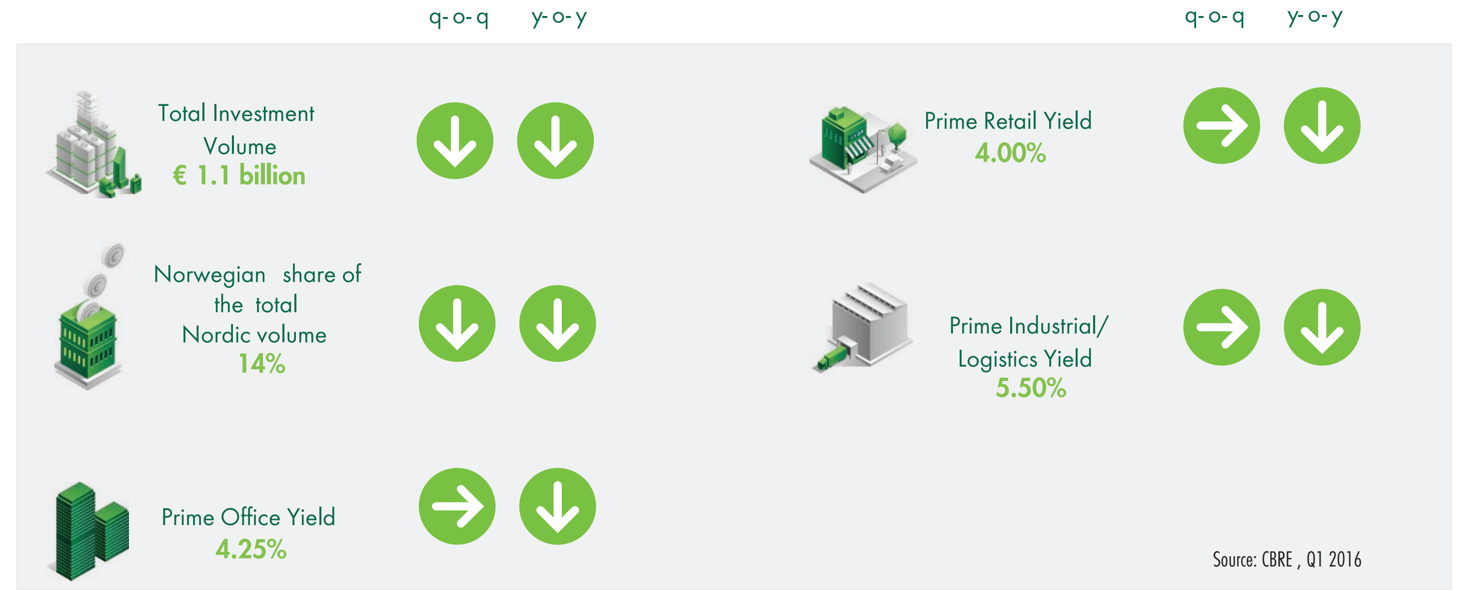


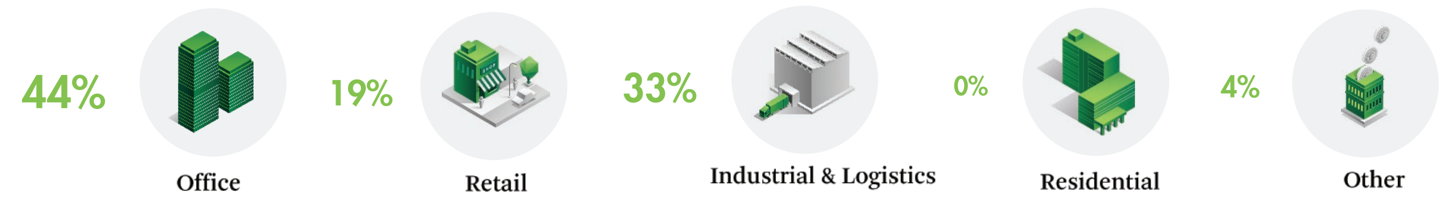
FINLAND



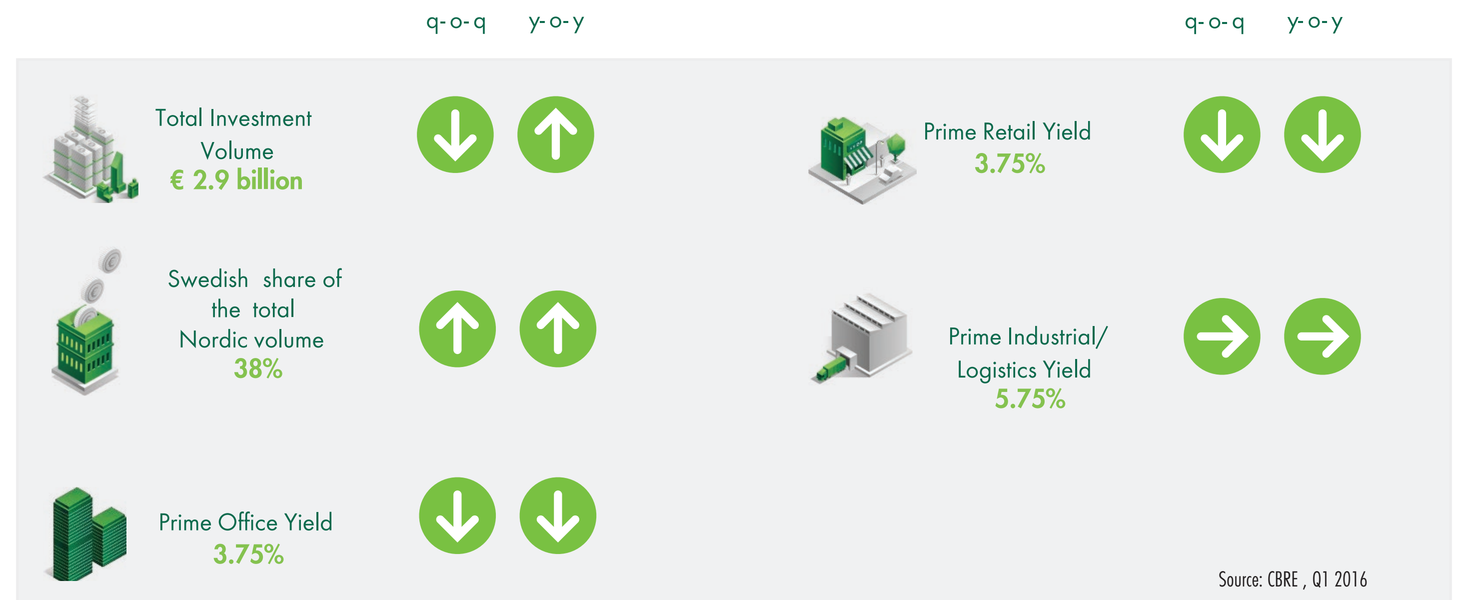


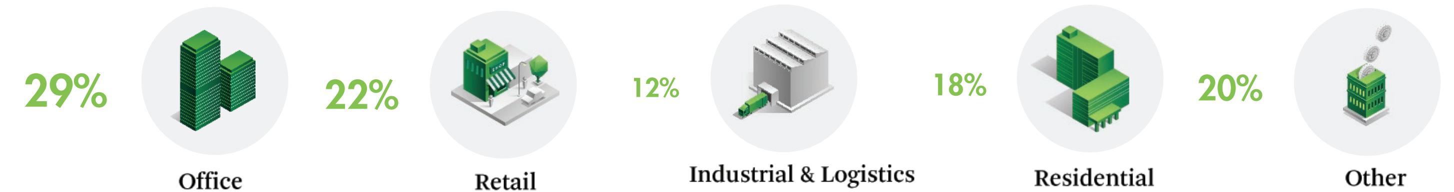
NORWAY





SWEDEN





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REAL ESTATE & INFRASTRUCTURE INVESTING

BY HAMLIN LOVELL / HEDGENORDIC

Growing Allocations

Pension funds have, for many years, been huge investors in real estate and infrastructure and OECD surveys show this applies globally. Prequin Real Estate Online suggests that current allocations to real estate are between 5% and 15% of assets for the majority of pension funds- and most have target allocations higher than their current allocations. Indeed, 19% of pension funds intend to allocate more than 15%, as shown in Figure 1 on page 15.

Pension funds are not the only ones warming to the asset class. European commercial real estate investment finally overtook its 2007 peak and reached a new high of EUR 246.3bn in 2015, according to Cushman and Wakefield.

Infrastructure globally saw 661 deals worth $349 billion in 2015, and infrastructure firms have $108bn available to allocate. Meanwhile, institutional investors intend have earmarked another $120bn for infrastructure in 2016, reports Prequin.

Allocations to infrastructure appear to be somewhat lower than to real estate, averaging 3.9% of assets, Prequin research suggests. But infrastructure weightings sometimes come under other headings. Some investors have created a separate category for their infrastructure investments, while others group infrastructure under the umbrella of "alternatives", "private equity" or "real assets".

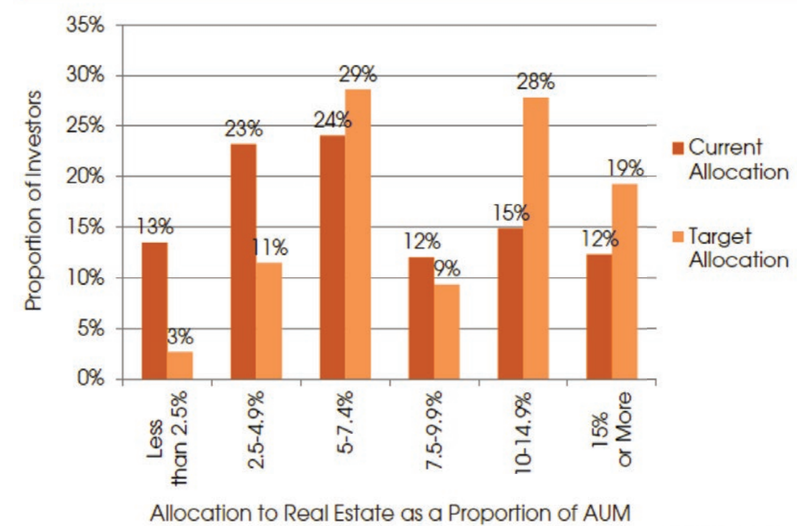
Some 52% of infrastructure investors are planning to increase their allocations, Prequin find. All Europe-focused unlisted infrastructure funds raised more than their target in 2015, say Prequin. A milestone was marked with the Hinkley Point C Nuclear Power Station: at $18bn the largest deal since 2008.

Yields Are Still Competitive

Many reasons lie behind these allocations. Though price appreciation is compressing yields, the yields on offer from commercial real estate and infrastructure, compare well with those on equities and far surpass those on government debt.

Prime office and retail yields range from 3% in Paris to 4% in Stockholm and 5% in Warsaw, with warehouse rents about 1% higher, according to JLL. With a some capital appreciation on top of the yield, commercial property can still satisfy the return targets of most European pension funds. A survey from CREATE-research found that 51% of European pension funds target returns of less than 5%. Even the 20% of European pension funds aiming for higher returns, between 6.6% and 8%, may find some infrastructure equity assets yield within this range. Or they make be constructive on the outlook for capital growth: Cushman and Wakefield forecast total returns of 9% from European property in 2016 from both yield and capital appreciation.

Fig. 1: Distribution of Private Sector Pension Funds' Current and Target Allocations to Real Estate



Source: Preqin Real Estate Online

Inflation-Related Assets

The pattern of returns also matters. When Eurozone inflation, around zero, is well below the ECB's 2% target, and when some European countries intermittently descend into mild bouts of deflation, it may seem odd to worry about inflation. But many defined benefit pension funds have liabilities closely linked to inflation, so it is natural for them to seek real assets that also bear some relation to the rate of inflation. Government bonds linked precisely to inflation indices are trading at extreme

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valuations, partly due to captive demand from pension funds and also because trillions of euros of nominal Government bonds now offer negative yields. The yields on real estate and infrastructure might not be mechanically linked to exactly the same inflation index as pension fund liabilities, so cannot be used for perfect asset/liability matching or immunisation. But there should be a reasonable degree of alignment between the inflation-related part of returns on property and infrastructure, and the inflation-related element of pension fund liabilities.

Strong Performance

In 2015, both yields and capital appreciation contributed positively to returns in European commercial property. The UK and Sweden are some of the largest and most liquid markets in Europe. Both generated strong returns. The IPD UK Monthly Property database is based on 51 funds owning property with a capital value of GBP 51 billion. Returns in 2015 were 13.6%, with offices in the lead at 17.9%, and industrial second at 17.2%. Even retail property delivered returns of 8.8%, in a year when the UK stock-market fell 7%. Interestingly, listed UK property equities fell by 8.7%, illustrating the extra volatility of investing in property through quoted funds, companies or REITS.

The IPD Annual Sweden property index is based on 42 funds with a capital value of 586 billion SEK. Returns of 14.1% in 2015, were comprised of 4.9% from income and 8.8% from capital growth. Though 2015 was an exceptionally strong year, the ten year average of 8.3% is also a level of return that most pension funds would be happy with.

Some 76% of investors feel that "infrastructure investments have met or exceeded their returns" according to a Prequin survey. The IPD Global Infrastructure Direct Asset Index launched in late 2014, and at that time returns over the prior five years had annualised between 14% and 16%.

Investment Vehicles – Listed and Unlisted

The largest allocators, such as Norges Bank pension fund or Canadian pension funds, invest directly into unquoted property or infrastructure assets. Others prefer fund structures, which are usually unlisted. Both listed and unlisted infrastructure funds can own assets directly, or invest in listed equity or debt of infrastructure companies, so they can be dubbed "funds of funds". Still other pension funds invest directly into the quoted equity of firms that own property or infrastructure assets.

Listed equities entail extra volatility. Many infrastructure equities performed badly in the 2008 crisis, as they were perceived to be derivatives of the stricken credit markets, which raised fears about breaching debt covenants and refinancing borrowings. Indeed, some listed infrastructure equities cancelled dividends in late 2008 and did not resume paying them again until 2011. Once again, in 2015 many US-listed infrastructure companies have sold off in sympathy with high yield bonds.

Yet five infrastructure funds listed on the London Stock Exchange (LSE) are, in February 2016, still trading at premiums to NAV as investors are hungry for their high yields. In contrast, some emerging market infrastructure funds, and some commercial property companies listed on the LSE, are now trading at discounts to NAV, which could be attractive to opportunistic investors who can stomach the volatility. In the USA, Mandatory Limited Partnerships (MLPs) have seen extreme falls in their share prices and are thought to be trading at deep discounts, according to some asset managers. Some MLPs own oil and gas pipelines but some own infrastructure utterly unrelated to energy. MLPs' income is distributed tax free and most countries also have tax efficient Real Estate Investment Trust (REIT) structures allowing the same. However, unlisted, private equity style fund structures remain most popular for real estate and infrastructure, and some of them are not leveraged.

Platforms, such as the UK's PIP (Pension Infrastructure Platform) and others in Switzerland, Italy and the Netherlands, are designed to allow pension funds to pool their resources and share the costs of infrastructure investment. So far, these platforms have only gathered a small percentage of capital flowing into infrastructure. For now many pension funds choose specialist managers rather than follow a DIY approach.

Politics and Regulation: Risk and Opportunity

Yields on infrastructure can be higher than on real estate partly due to the 'wild card' of political risks as governments or regulators will generally define the permitted tariffs, or rates of return, on assets such as airports, toll roads, and gas, water or electricity networks. Governments also dictate policies that can shape the market for the end use of infrastructure assets. For instance, many utilities in Europe have been terrible investments over the past few years, cutting or cancelling their dividends, partly because EU and local eg German energy efficiency rules have helped to reduce electricity consumption, as has consumer demand for more energy efficient vehicles and appliances.

Unless investors can obtain from governments irrevocable assurances that are binding upon their political successors, there is always some risk of politicians reneging on commitments – or worst of all, imposing retrospective, or backward-looking taxation. For example, in 1997 the UK's Labour Government imposed a retrospective "windfall tax" on profits of privatised utilities. More recently, motorway toll road concessions granted by France's conservative government were later changed by France's Socialist government, which in April 2015 froze tariffs and also required profits above a certain threshold to be paid to the government.

Radical, populist political parties on both sides of the political spectrum could represent an even greater threat to infrastructure investors. For instance, left wing Podemos in Spain wants to cut electricity prices, which might impact some infrastructure assets. Similarly, Hungary's right wing Jobbik political party has won support on a platform of cutting utility prices.

Hamlin Lovell, CFA, CAIA, FRM

Hamlin Lovell is Contributing Editor of The Hedge Fund Journal, which has published since 2004. He is also Head of Research at outsourced hedge fund research provider Tomlinson Research. Hamlin sits on the London Chapter Executive of the CAIA Association. He has previously been a government economist, equity analyst, and fund of hedge funds portfolio manager. Hamlin contrubutes to HedgeNordic special reports as freelance journalist.

Key RISKS for global real estate in 2016

Christian Nilsson

"Aviva Investors view is that capital growth will still be a sizeable component of returns in 2016"

by Aviva Investors

Aided by extremely loose global monetary policy, capital values have experienced a strong recovery since the crisis. At Aviva Investors we believe this period of very strong capital growth has largely run its course and the window to capture significant yield compression is passing quickly.

At Aviva Investors we believe that the strongest part of the cycle is largely behind us, however, our near-term outlook for real estate remains positive. We believe that core real estate will continue to attract investor demand in 2016 for the following reasons:

- Unprecedented monetary stimulus is supporting real estate investment, and will continue to do so. Despite property yields currently being at very low levels, spreads over long-term sovereign bond yields are still substantial in most markets due to extremely low interest rates. This is particularly true in Europe. A lot of concerns have been aired about the tightening of rates and the potential impact on commercial property. Rising bond yields will put upward pressure on property yields in the US and some Asian markets over a five-year period. But the gradual likely pace of interest rate rises, along with solid rental growth, should prevent a sharp increase in US yields in 2016.

- The occupier outlook is generally favourable. Developers have acted with more caution than in previous cycles, waiting for occupier demand to show stronger signs of expansion before committing to new projects. As the occupier recovery continues in 2016 restrained supply should drive decent rental growth. Notable exceptions to this are US apartments, central-eastern European offices, Singapore offices and resource-dependent Australian cities, where supply risks are prevalent.

Our view is that capital growth will still be a sizeable component of returns in 2016, but investors should expect returns to be primarily driven by income over the medium term. It is crucial that investors recognise the nuanced distinctions between markets at different stages of the cycle.

Some markets are starting to exhibit signs of being in the more mature phase of the cycle. Pricing signals in the US are being watched closely. Real estate investment trusts are trading at wide discounts to net asset value and property looks expensive relative to comparably-rated corporate bonds.

Late-cycle characteristics are also evident in other markets that are further along in their recovery. Central London yields look incredibly expensive and the UK is seeing a strong appetite for portfolio deals as well as 'alternative' real estate sectors. In the rest of Europe we feel most markets still have further to go in the cycle and the occupier recovery is also strengthening.

In Asia, we foresee a softer economic outlook for 2016 compared to historic trends. Asian property markets were among the first to see recovery post-crisis. In markets such as Singapore logistics and Hong Kong retail, occupier weakness has led to falling capital values in recent quarters. The Chinese slowdown also looms over the region and will play a significant role in the fortunes of Hong Kong and Singapore real estate markets in 2016.

"It is crucial that investors recognise the nuanced distinctions between markets at different stages of the cycle."

Below we outline the key macro risks that we are on alert for, and the ramifications these could have for real estate markets.

Potential upside risks

Global monetary policy becomes more accommodative

Despite the US Federal reserve's recent rate hike, the monetary environment will remain accommodative for some time yet. Our view is that central banks will hold off on any further large expansion. However, there is a possibility that central banks may be spurred into action if pressure builds from weak data points.

Draghi assured the market at the end of 2015 that the European Central Bank (ECB) is poised to act should inflation and growth continue to disappoint. If inflation remains too low it is possible we could see an acceleration of the purchase programme in the second half of 2016.

The Bank of Japan's balance sheet expansion is already very extensive. Yet the possibility of further stimulus cannot be discounted – especially if the upcoming 'Shunto' wage negotiations disappoint and evidence of demand-driven inflation fails to materialise. Monetary loosening elsewhere could hold back the pace of tightening in the US.

Looser monetary policy would be supportive of real estate valuations. In such a scenario we would expect investors to be more willing buyers of real estate even at historically low yields.

Strong economic rebound in Japan/ Europe

Our central scenario is that both regions will see economic recovery continue at a sluggish pace. However, if companies become sufficiently confident to increase investment, or if previously reluctant consumers reduce saving significantly, then this could lead to a self-sustaining recovery.

In this scenario, domestic demand should strengthen and inflationary pressures will come through from wage growth. This would result in stronger occupier markets. With supply restrained in most developed markets, this would translate to higher income growth as vacancy rates improve sharply and rental growth becomes robust. Secondary cities where growth momentum is strong and real rents have not yet surpassed pre-crisis levels would outperform. A strong rebound in fundamentals would also make new construction viable and create opportunities for core development strategies.

Potential downside risks

A hard landing in China

China's slowdown will continue for many years yet. Our view is that that the state will intervene where necessary in order to deliver a controlled slowdown towards a consumption-led economy. If the transition is managed poorly, or the slowdown is sharper than expected then the ramifications will be more serious. In extremis, expect property price collapses in major cities and/or a banking crisis.

A credit crisis could lead to a rapid cooling in the housing market and possibly a strong price correction in Tier [1] cities. Contagion would likely spread to the bond market where highly-leveraged developers heighten the risk of widespread defaults. Slower land value appreciation would also harbour a risk for debt-laden local governments which rely heavily on property revenues.

Outside of China a rapid slowdown would have a significant impact on risk appetite. Real estate markets in Hong Kong and Singapore would be hit hardest. Slower growth in China is already affecting exports throughout the region, and trading economies are likely to bear the brunt of a sharper downturn.

> "There is upside potential for some property classes, such as the German private residential sector."

Logistics assets in these markets will have markedly lower prospects, as a slower global trade impacts tenant demand.

Office sector demand would also be vulnerable as expansion by mainland financial institutions would likely decelerate, especially in the event of a banking crisis. The Hong Kong retail sector, which is already facing both cyclical and structural headwinds, would become more vulnerable to capital losses and declining rents. This could present a window for opportunistic core investment for distressed assets.

Geopolitical risk in Europe

The migrant crisis is likely to persist and tension among EU members will intensify regarding appropriate action. In the long term, it is likely that the demographic boost to the continent will help ameliorate headwinds caused by an ageing population. There is upside potential for some property classes, such as the German private residential sector. However, the immediate impact could be a rise in political fragmentation across the region. Greater uncertainty could decrease foreign investor confidence and deter long-term occupier commitment.

Britain's referendum over EU membership is also on the horizon. The likelihood of 'Brexit' currently appears fairly low but it is a possibility. In the immediate aftermath of a 'yes' vote there are a number of macroeconomic risks that could emerge. These could have negative impacts on the investment performance of UK real estate in the short term, the direct being a period of illiquidity.

Over the medium-to-long term there is less cause for concern. Regardless of the outcome, the UK is likely to retain close ties to the EU. Central London offices appear to be the only occupier sector exposed to major risk from a UK exit, in particular the City, which could be impacted by weakening financial services.

Bond rout

A long-held fear is that the liquidity created by extremely loose monetary policy could gain traction and generate strong inflationary pressures. This could arise if bank lending increases rapidly and money aggregates rise sharply.

Bond yields would rise steeply and central banks would likely resort to aggressive interest rate tightening in order to rein in inflation. In this scenario investors would become highly risk averse. An increase in bond yields would weaken the relative pricing argument for investing in real estate. Real estate markets where current pricing offers the smallest buffer over government bond yields would be most vulnerable to capital losses.

Given that underlying fundamentals are weak across all economies, an unexpected increase in bond yields would be extremely damaging to the global recovery. Occupier markets would weaken significantly as businesses face higher borrowing costs. Income risk would likely become elevated as the probability of tenant default increases. In such a scenario, assets with strong tenant covenants will offer better income security and are likely to outperform.

1 Source: Aviva Investors as at 30 September 2015

Company profile

Aviva Investors is a global asset management business providing focused investment solutions to clients including pension funds, sovereign wealth funds, insurance companies, government bodies, wealth managers, charities and high net-worth individuals. We operate around the world, employing over 1.200 people in 15 countries1. Together our clients have entrusted us to manage over €360 billion, including more than €33 billion in real estate assets1. The investment strategies we provide span all major asset classes and numerous specialist investment areas. As a global business, we have expert professionals in every major investment region. This enables us to deliver local market expertise to clients around the world.

REAL ESTATE INVESTMENT VEHICLES AND THE TREND TOWARDS AN OUTSOURCED MODEL

By Jonathan Furelid – HedgeNordic

Real estate and infrastructure investments have attracted increased interest from institutional investors in recent years. At the same time, the regulatory regime surrounding these asset classes has tightened and brought increased oversight and complexity for asset managers wanting to set up investment vehicles. In an interview with HedgeNordic, Dirk Holz, director of real estate and private equity at RBC Investor & Treasury Services (RBC I&TS), discusses how evolving regulatory frameworks are influencing the way new investment vehicles are structured.

HedgeNordic: Institutional investors are increasingly turning their focus upon real estate and infrastructure investments. Why do you think that is?

Dirk Holz: Investing into real estate and infrastructure has been a long standing investment strategy in certain countries such as Canada, the US or the UK. In Northern and Continental Europe, the trend towards investing into these asset classes is a relatively recent phenomenon, partially triggered by the low interest rate environment causing investors to seek alternative sources of yield.

The maturity of the real estate investment sector also differs between jurisdictions. Investment managers in the UK and the US benefit from an advanced investment infrastructure, but the market in Continental Europe is more nascent, starting two decades ago with open ended fund structures through which many German-based funds invested into Sweden.

> **"Increased attention to investor protection is spurring interest from institutional investors."**

In addition, regulators in Europe and the United States have introduced measures to ensure alternative investment solutions are placed within a regulated framework with appropriate governance and oversight. This increased attention to investor protection is spurring interest from institutional investors who seek vehicles that comply with their strict internal investment and compliance policies.

HedgeNordic: What trends do you see in structuring through on- and off-shore domiciles?

Dirk Holz: Increased regulation has changed the landscape for managers wanting to set up funds. If an asset manager is looking to invest into the Nordics and attract local investors, it is likely they will set-up a local structure. However, managers looking to reach a wider audience tend to set-up a different structure that complies with the relevant regulations in each jurisdiction. Across the EU these structures would fall under the Alternative Investment Fund Management Directive (AIFMD), which was introduced to harmonize the EU's framework for regulating alternative investment fund managers.

> **"If an asset manager is looking to invest into the Nordics and attract local investors, it is likely they will set-up a local structure."**

The main hubs for setting up European alternative fund structures are Luxembourg and Ireland. For private equity structures, the UK is often the jurisdiction of choice. Investments in Swedish real estate can be achieved through any of these hubs through holding companies or Special Purpose Vehicles, (SPV).

Luxembourg is a regulated off-shore jurisdiction, so very few of the properties and shareholders of the funds are based there. As many European institutional investors are required to invest through AIFMD compliant structures, they typically utilise Luxembourg or Ireland-domiciled funds. In contrast, North American asset managers continue to leverage Delaware and Cayman Island structures to attract non-European investors.

The strategy to attract retail investors, however, has previously been focused on a domestic solution that requires a local presence. That may change when the European Long Term Investment Fund (ELTIF) comes into effect offering a pan-European regime for alternative investment funds.

> **"The strategy to attract retail investors, however, has previously been focused on a domestic solution that requires a local presence."**

The ELTIF will allow managers of real estate funds to raise capital from institutional and retail clients across the Member States of the EU. It is likely to strengthen the position of Luxembourg and Ireland as the leading European centres for long-term funds and international hubs for cross border fund distribution.

HedgeNordic: What trends do you see among real estate and infrastructure asset and fund managers?

Dirk Holz: Historically the back and middle offices of fund managers selectively chose what to perform in-house and what was to be outsourced to a third party supplier. While this is still the case today, there is an upward trend in more being outsourced. Fund managers are looking to rationalize their operational efficiency and mitigate the risks involved while also gaining the expertise that a specialist provider can bring.

With the increase in regulatory requirements coupled with an appetite to widen distribution markets, fund managers are also consolidating their relationships with one or two service providers. In doing so, further improvements in operational efficiency and risk can be achieved as standardisation and ever increasing automation in reporting and governance is delivered.

At RBC I&TS, our commitment is to support institutional funds which are based in regulated offshore jurisdictions such as Luxembourg, Ireland, the Channel Islands (Jersey, Guernsey). We also support accounting services for Delaware and Caribbean structures to support US-based fund managers targeting global investment money.

Dirk Holz, Director, real estate and private equity

Holz is responsible for the global real estate, private equity and infrastructure product management and development within RBC I&TS. In this role he focuses on developing new services, support regulatory changes, expanding real estate and private equity services worldwide and he is heavily involved with new clients during the formation and structuring discussions.

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INFRASTRUCTURE – THE BETTER OPTION FOR EXPLOITING EMERGING MARKET GROWTH

BY JONATHAN FURELID – HEDGENORDIC

Emerging Markets (EM) have been subject to large foreign investor flows during the last 20 years, as equity investors have bought into the growth stories of developing economies. However, the negative market sentiment in 2015 and for much of the last five years has sent a harsh reminder that buying into emerging market equities is coupled with a lot of risk, and that the dependence on global growth factors cannot be disregarded.

”Infrastructure gives you the best of two worlds, it allows you to benefit from the growth prospects in emerging markets while being less impacted by external factors such as dampened growth outlooks, US dollar strength or a slumping oil price. Simply put, you get a performance driver that is more linked to local conditions and that has a ”real asset” attached to it”, Kostiander says continuing;

left to right: Aki Kostiander (Managing Director, UB Real Assets/portfolio manager REITs), Tuomas Kallunki (portfolio analyst), Tomi Suominen (portfolio analyst) and Pekka Niemelä (portfolio manager infrastructure)

Aki Kostiander, head of Real Assets at Finnish asset manager United Bankers (UB), argues that infrastructure investments is a better way to tap into the growth prospects of emerging markets compared to holding a broad equity exposure to these markets.

By holding a portfolio of what he refers to as ”monopolistic infrastructure companies”, Kostiander and his team, together with Mr Pekka Niemelä who is managing the UB infrastructure funds and investments, seeks to invest in those companies that are best positioned to benefit from the strong positive trends that are linked to infrastructure investments. UB currently run two infrastructure equity funds. One global OECD countries only fund and a separate emerging markets infra fund. Investments include listed companies within electric utilities, water, airport services and marine ports. Especially the emerging markets infrastructure theme has gained momentum in recent years because of the impressive performance in some of these infrastructure related sub sectors.

”We invest in infrastructure companies that have an extremely advantageous position, almost monopolistic, in their respective fields. By doing so we make sure to be part in the ongoing increase of government expenditures linked to infrastructure projects in China in particular.”

Currently, almost 50 percent of the holdings in the ”UB EM Infra” fund is in China, a market that sees continued infrastructure spending despite slowing growth numbers overall.

”We continue to favour China despite the fact that growth numbers show signs of slowing down. The government has pursued infrastructure investments as its primary element of counter-cyclical policy and will remain doing so for the foreseeable future”, Kostiander argues.

According to a recent McKinsey study, China spent an average of 8.5% of its GDP on infrastructure investment each year between 1992 and 2011 and plans continued massive investments ahead. In 2020, China intends to increase the number of airports to 240 compared to 175 in 2010 and to double the length of expressways during that same period. China also looks to significantly expand its railway network and capacity of container terminals.

”China´s ambitious plan to continue to build out its infrastructure feeds right into what we believe will benefit the companies in our portfolio today. We currently have 43 holdings in sectors ranging from airports and harbors to toll roads and gas pipelines”, Kostiander explains.

In selecting companies to the portfolio the team at UB follows a rigorous quantitative screening process that allows them to filter out candidates on an ongoing basis. The approach is highly bottom-up resulting in portfolios that deviate quite significantly from the industry benchmarks, both in terms of sector and geographical exposures.

”Quite frankly we are benchmark agnostic, as a result, we tend to get exposures that deviate quite significantly from widely recognized indices, both in terms of sectors and geographical regions. Our fund holds much higher weightings in infrastructure sectors that we believe are close to monopolistic business models. In constructing our portfolio we are not targeting index weights, we are looking for absolute returns to reasonable risk exposure. As a matter of fact we do not have benchmarks for any of our funds. This way we can't hide behind an index, we have to allocate our capital from a clean slate every time we make an investment decision”.

The benchmark agnostic approach enabled the UB EM Infra Fund to significantly outperform the market in 2015, gaining 3.9% in a year when the S&P Emerging Markets Infrastructure Net Total Return Index in euros fell by -1.5%. Some of this short term outperformance is related to the fund having a smaller weighting in Brazil than the index. But the outperformance is even greater over the long term. Since inception the UB EM Infra Fund has returned 8.9 % p.a. and the above mentioned index only 1.0 % p.a. (30th of October 2007 to 31st March 2016). During this same period emerging market equities have had an annualized negative -0.38 % return (MSCI Emerging Markets Net Total Return Index EUR).

Looking forward, Kostiander believes that there are now parts of the market that look interesting from a valuation standpoint.

”We have been underweight Brazil for quite some time but are now looking into that market again. Valuations have come down significantly and the currency has also seen a massive depreciation. This could provide a good entry point and a good long term investment opportunity for us, ” Kostiander concludes.

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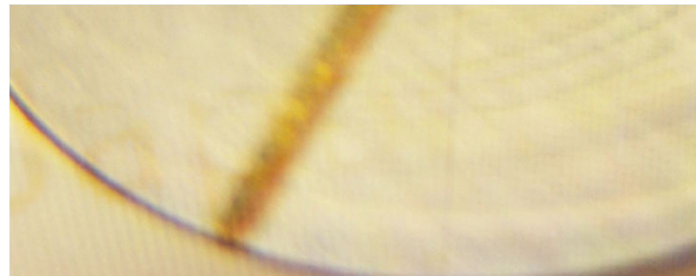
by Pirkko Juntunen – HedgeNordic

Real Estate: Alpha vs Liquidity

They say timing is everything. Many argue that the time is right for investing in real assets given the fluctuating commodity markets, uncertain economic growth in emerging markets and volatility in global equities driving a repricing of assets around the world.



This, in conjunction with the persistent low-return/ low interest-rate environment, is resulting in many institutional investors struggling to gain sufficient returns to meet their liabilities. A move towards illiquid assets to protect themselves from market volatility and reap the rewards of illiquidity premia is therefore being seen.

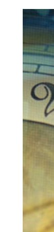
AEW will capture this shift in mentality and the nascent European recovery through its newly launched fund AEW Europe Value Partners.

The Fund, as with private equity products in general, is higher up the risk scale than most pure real estate funds, offering value-added investments to institutional investors and targeting a total net return of 12% to 14%. Returns are expected to be driven by asset repositioning through active management, rather than participating in momentum plays. The Fund's ultimate exit strategy is to create assets that are of interest to large institutional investors.

Rob Wilkinson, CEO of AEW Europe, said the overall macro-economic backdrop is improving in Europe with reduced volatility in capital markets and a more positive general momentum. "Despite the obvious disparity between countries and regions, the general trend is positive, even if recovery is lagging the US. Countries such as the UK and Germany as well as the Nordic region are already seeing improving economic conditions, increasing the prospects for growth in Europe over the next 5 years" he explained.

Recovery will remain patchy and the effects of the Global Financial Crisis (GFC) are still creating opportunities in some markets. "The difference or mismatch in core versus non-core pricing remains attractive and creates opportunities, driving value-add returns," Wilkinson said, noting that despite the recent cap-rate compression, capital values remain low in some markets.

This backdrop lends itself to focus on the cities and sectors most likely to benefit from the economic recovery, he noted.



"The difference or mismatch in core versus non-core pricing remains attractive and creates opportunities"

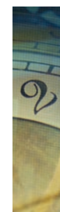
Strategies AEW is prioritising are office repositioning, neighbourhood retail and multi-let industrial. "In the logistics sector we are looking at new moderns warehouse spaces in transport hubs. E-commerce companies such as Amazon want more space and more modern space. This is a counter-cyclical investment as returns are dependent on global flows, not just Europe", he explained.

In the office space AEW is looking to target cities with strong economic and employment growth as well as a strong service sector, taking advantage of rents and capital values being at historic lows. Similarly in the retail sector, AEW is interested in areas where the population is growing and consumer spending is increasing, anticipating growth in rental income.

Wilkinson said that although both the retail and office sectors have been impacted by technology it has not led to their demise. "A few years ago we heard that online shopping would be the end of the high street but this has not happened and is not likely going to. It has been proven that retailers with good online presence combined with physical shops are performing the best. People research online but often want to go to a shop to actually buy the goods," Wilkinson said.

"The office sector is a similar story in that it was predicted that technology would result in people working remotely, reducing the demand for office space. However, many industries could not survive if

the workforce worked from home so office space in good locations will always be needed," he added.



> **"Office space is used differently these days and the acquisitions have to reflect this."**

Wilkinson said that the key is to acknowledge change and to adapt and evolve. "Office space is used differently these days and the acquisitions have to reflect this. Occupiers require open-plan and hot-desking as well as added-value services such as leisure and goods deliveries facilities among other things," he said.

In addition, environmental and green issues are also top requirements by occupiers, who are looking for energy efficiency and to reduce costs. "The types of requirements vary between countries but what is common, and has changed over the past few years, is that what used to be more of social aspect is now an economic one. Cost reduction as a result of energy efficiency is often the driver, rather than the environmental aspect per se," he explained, adding that regulatory changes also play a part.

Apart from the UK, France and Germany, as well as the Benelux region, AEW Europe is also keen on the Nordic region. "It is an attractive region and although each of the countries are different they all share a relatively positive economic picture", Wilkinson said.

AEW Europe recently did a core deal in central Copenhagen with long-term investors. "We see this as a solid market and are looking do more in the region," he said.

The Copenhagen deal was done without a partner but Wilkinson said that he would expect the majority of the deals in the Nordic region to be done together with a local partner. "There are challenges for an outsider because it has a strong local real estate market. Using a local partner is vital in order to be able to source deals," he said.

As investors pile capital into real assets, including real estate, many also question if anything is different this time and whether enough was learnt from the GFC. Wilkinson believes that lessons were learned and that investors are more vigilant when it comes to understanding their investments.

During the time of cheap leverage many investors forgot or ignored the fundamental characteristics and took on more risk than they should have, resulting in both overleveraging and style drift, Wilkinson said; "before the GFC, value-add could be leveraged up to 75-80% whereas our fund has a maximum of 60%, which is now more the norm".

The Fund has a Euro500 million target equity with a duration of 7 years from first closing. Wilkinson believes that AEW Europe's competitive advantage lies in the dedicated private equity real-estate team's benefitting from the much larger and wider pan-European platform, giving them greater access to deal flow, in-house asset management capabilities and a detailed understanding of what end product core, institutional buyers are looking for.

AEW has over 30 years real estate investment experience with over US$53 billion in assets under management, of which $19 billion is in Europe.

Swedish residential rental properties – an overlooked investment opportunity

By Jonathan Furelid – HedgeNordic

Lars Swahn, CEO
Svenska Bostadsfonden

Due to favourable supply/demand characteristics, the Swedish residential rental property market has offered compelling returns to risk over the last three decades. Rental properties however are yet to make it as a meaningful allocation in most institutional portfolios. Lars Swahn, CEO of Svenska Bostadsfonden (SBF) – a property fund investing into Swedish rental properties, explains why there is reason for institutions to consider the private rental sector as a strategic allocation and why Sweden is an interesting market in this context.

"The residential rental property market in Sweden is experiencing a structural shortage of rental housing today, in a majority of areas with great demand. This means interesting investment opportunities in this segment of the Swedish property market. There is still a substantial lag of construction activity across the country. According to Boverket (the Swedish Government Analysis Agency), some 600,000 rental apartments are missing today in order to meet demand. Given that, and that the cost of producing new apartments is still relatively high, the shortage is likely to persist for quite some time", Swahn explains.

In addition to this, the segment is substantial, today some 1,5 million flats which means a market value of some SEK 1,300 to 3,500 billions (depending if you count second-hand, upgraded or re-placement value).

The market is owned half by private investors and half by local governments and is very fragmented, which together with the shortfall and standardised design across the country, opens up for interesting investment opportunities in the future.

It was by realizing the shortfall of rental properties, and the stable income streams generated from the regulated rental market in Sweden, that Lars Swahn decided to set up a real estate fund focusing on this sector back in 2003. Today, Svenska Bostadsfonden manages some SEK 3 billion in aggregated assets across its different funds. Investors include some 3,500 private individuals, companies and smaller institutions, as well as 15 larger institutional investors.

> **"According to Boverket some 600,000 rental apartments are missing today in order to meet demand."**

"Early on we did our homework on the rental market in Sweden, building on the experience gathered from previous real estate ventures in Sweden and abroad. Our vision was to offer a compelling and stable long-term investment opportunity for investors seeking alternatives to equities

and bonds as well as to other real estate investments", Swahn recalls, continuing;

"The long-term imbalance between supply and demand creates a favourable position for us and our investors. The regulation of rents that we have in Sweden acts as an important buffer in times when there is a slower development in the rental property market. It simply makes returns both more predictable, and less volatile, which is a feature particularly sought-after by institutional investors".

Today, Svenska Bostadsfonden holds properties in strategic locations in some 20 cities across Sweden, where the investment team behind the fund has identified good growth prospects and a housing shortfall. The fund currently holds investments in some 3,500 apartments and serves around 10,000 individuals, as tenants, through five regional offices focusing on servicing and managing the apartments in order to assure good tenant relations, low vacancies and good value creation over time.

> **"Investors in real estate will benefit by viewing it as a strategic long-term investment with the goal of yielding steady returns at a very low risk profile."**

"We take a very "hands on" role in the day-to-day management of the apartments we own, we genuinely believe this to be a key-factor to success instead of just passively owning and relying on an outsourced model when it comes to the day-to-day management of the flats.

Since the inset 2003, the model used by SBF has been successful generating risk-adjusted returns in line with the stated return target of 8-10% per annum after fees, and slightly higher returns within the institutional funds. According to Swahn, the factors that have been the main drivers of performance so far are likely to persist. However, he emphasizes that the low interest rate environment, that has worked in their favour up until now, is a factor to observe going forward.

"When buying properties, we partly finance these projects using bank loans in order to create leverage. The low financing costs have of course worked to our advantage in the current low interest rate environment. If financing costs rise in the future, this could temporarily, but only temporarily, have a somewhat negative effect. This is because in the regulated rental model, the interest cost is included as a general ingredient in calculating and agreeing new rents, which balances, and over time eliminates, that initial effect. In the long-term a more normal interest level than today is more favourable for Swedish Residential rental properties. Hence the long-term development of a more normal interest-level is quite acceptable to us as an investor in the market. We typically work with conservative levels of leverage, given the stability of this regulated residential investment, currently standing at some 60/65 percent to market value."

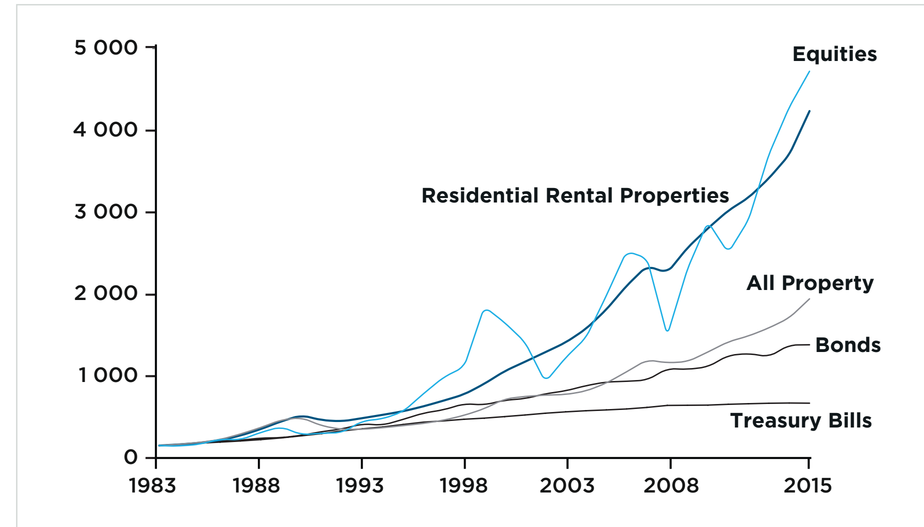
The investment horizon as defined by the exit periods in the funds offered by SBF is 7-10 years. Shorter for our Private Funds and longer for the Institutions. Over time SBF aims to create value through buying strategic objects at market price and realising profits by participating in the long term general rental growth. However with the important addition of Upgrading projects that results in rental increases significantly higher than only passive management would create. Then by selling properties onwards or making conversions to owner occupied apartments, which also creates significant wind-fall profits when achieved. In the latter case the property goes from a regulated sector to a non-regulated sector, with markedly higher, some 2 to 3-times, capital values.

Swahn highlights the long-term view and patience required to become a successful investor in Residential let property.

"Investors in real estate will benefit by viewing it as a strategic long-term investment with the goal of yielding steady returns at a very low risk profile. There is a secondary market for fund units in our Private funds, but most of the value (some 50% to 60%) is realized towards the end of the defined investment period (taking into account full capital growth). Hence it makes good sense to hold the investment up to exit. Even though liquidity is limited, we keep our investors informed about the development through regular valuation updates and there is normally a market to off-load shares in the Fund if that should be deemed important for the individual investor. In the Private funds a market-maker/or recognised market quotation is used.

As an institutional investment, Swahn sees residential properties as a good diversifier to a traditional multi-asset portfolio and highlights that these investments also offers diversification benefits to other real estate investments and quoted property shares that are affected by the volatility of the stock-market in general.

INVESTMENT OF 100 SEK DURING THE PERIOD 1983-2015 WHEN INVESTING IN DIFFERENT ASSET CLASSES



"From an institutional perspective, I also see added value in combining residential rental properties to other real estate investments such as commercial properties (retail, offices and industrials) which are all much more volatile and exposed to the economic ups and downs in general. Rental properties are less sensitive to economic downturns, particularly in the Swedish regulated market, and would balance the exposure to commercial real estate in the case of economic conditions turning weaker."

Swahn sees a markedly increased interest among institutions for residential rental properties as the asset class now has become more recognized also by larger institutions. The increased regulatory environment following the AIFM-directive, under which Svenska Bostadsfonden operates with full approvals, has also given institutions more comfort when considering these type of investments.

"So far, residential properties have been a somewhat overlooked investment opportunity from the institutional side, partly because of the fact that there has been a shortage of pooled investment vehicles targeting this market. As the number of investment options have increased, and as the regulatory rules have become increasingly standardized, we now see an markedly increased demand from institutional investors, both in Sweden and abroad.

Svenska Bostadsfonden received its AIFM-license in March of last year and had a first closing of its most recent fund "The Swedish Institutional Residential Property Fund 2" during the fourth quarter of last year, next closing will be in the second quarter of 2016.

> **"Residential properties have been a somewhat overlooked investment opportunity from the institutional side."**

"We have had commitments in the first closing which has already made it possible for us to complete our first two transactions of properties in the newly launched fund. Going into the next closing, we see continued strong interest in our offer and we are already analysing several investment opportunities which means we are able to put investor´s funds to work relatively quickly. This is going on as we speak, Swahn hints.

QUICK FACTS SVENSKA BOSTADSFONDEN

- Founded in 2003
- Sweden's fastest growing public real estate fund, that focus solely on Swedish residential rental property, addressing both to the Private- and Institutional sectors.
- Manages some 3,500 apartments, servicing some 10,000 tenants in 20 cities across Sweden.
- Has its own property management organisation working out of 5 offices from Luleå in the north to Malmö in the south and servicing both its tenants and investors.
- Is developing and aiming at doubling its assets under management over the coming 2-3 years, as the underlying markets show exceptional strong demand from tenants.

By Hamlin Lovell – HedgeNordic

IS THERE A BETTER WAY TO INVEST IN PROPERTY?

Stephen Hayes

Property offers diversification from other asset classes, improving the risk/return profile of a portfolio. Owning or managing property can generate stable and predictable income streams from long term lease contracts. This rental income can also grow over time due to demand, or contractual escalation clauses that can be fixed, or inflation-linked, or both.

The diversity of investment grade property assets is seen in high quality shopping centres; Central Business District (CBD) office buildings and suburban office buildings; logistical warehousing; hotels, health care, and retirement assets; residential property; and niche, high-growth real estate assets such as self-storage facilities and data centres. Thus real estate can indirectly tap into the growth of both public and private sector spending across all industries.

VALUATION ANOMALIES

Investing directly into property can entail significant transactions costs, and in early 2016 First State are of the opinion that some unlisted property assets are changing hands at very elevated valuations, particularly in Europe. As Head of Global Property Securities, Stephen Hayes explains, "We only invest in publicly traded property securities, and find some listed property companies are trading at marked discounts to their reported asset values, with the average being 10%. It is often overlooked, but assets bought at a discount have higher yields. A listed property stock purchased at a 20% discount to its asset value, could offer income 25% higher than would be obtained by investing directly into the assets at the prevailing valuation."

Differences between listed and unlisted assets are only one valuation anomaly that First State identifies within and between segmented global property markets.

Lower interest rates have clearly resulted in higher valuations for unlisted property assets, but the broader property sector need not be perceived as a 'bond proxy'. "We have witnessed listed property equities performing well during periods of rising interest rates," Hayes continues, "Indeed, rising rates are often the benign symptom of a strengthening economy, which contributes positively to demand for property." First State has a constructive outlook on economic conditions in selected regions. The USA is forecast to grow by 2.5% in 2016, and unemployment has dropped to an eight year low of 5.1%, both of which beget high occupancy and robust rental growth. The UK is another economy where First State envisages continuing economic expansion, though the manager is cognizant of Brexit risk.

A GLOBAL - AND LOCAL - INVESTMENT PROCESS

The ability to take active views and rebalance positioning is another core advantage of investing in listed property stocks, which trade daily. In contrast, the time taken to dispose of unlisted property, and then redeploy the proceeds elsewhere, makes it more difficult for managers to dynamically reallocate and emphasise their preferred segments of the property markets. "We maintain diversification by geography, sector and asset type to mitigate unintended risks and benefit from the relatively low correlation amongst sub-sectors of quoted property markets," explains Hayes, "we also seek to focus on what we view as the most promising areas."

A global perspective means First State is not locked into the cycles of specific markets, such as Australia or Canada, which are facing headwinds from weaker commodity prices, or Europe, which has deep-rooted structural economic weaknesses and heavily indebted governments. "Rather than replicating a global index, we pinpoint the type of assets we want to invest in within each geographic region. Though slower economic growth is manifest in China and Japan, top quality office space in Hong Kong Central and Central Tokyo remains scarce and sought after, with high occupancy and low vacancy rates," says Hayes.

Even in those markets that are showing faster economic growth, such as the US and UK, First State has its favourite sub-sectors. Once again, coastal offices in the US and prime office space in London are able to command impressive increases in rents, with London vacancy rates down to 15 year lows amid a dearth of new supply. Some of First State's preferences have a more contrarian flavour however; though internet retailing clearly threatens some traditional retailers, selected class A shopping malls in the USA appeal to First State's North American team.

As well as assessing macroeconomic forecasts and modelling supply and demand in specific cities, First State's specialist regional teams, on the ground in four continents, (North America, Europe, Asia and Australia) carry out active field research, including 500 or more company visits per year and asset tours. "We have a team of six portfolio managers and five analysts with an average of 15 years' experience and focus exclusively on listed property. We follow a globally consistent process of fundamental company and stock research, employing proprietary analytical techniques and valuation models, looking at metrics including leverage, quality and liquidity. We also incorporate ESG (Environmental, Social and Governance) factors across all investment processes, from initial screening to ongoing engagement with companies over issues such as investor rights," concludes Hayes.

TAX EFFICIENCY

Listed property assets are usually tax efficient. Though tax policies vary between countries and can change over time, most developed countries have created Real Estate Investment Trust (REIT) structures, to incentivise investment into capital-intensive property development that is vital for economies and societies. REITs typically do not pay corporate taxes so long as at least 90% of profits are distributed as a dividend. This can provide high and stable dividend yields for income investors - or the yield can be reinvested to compound over time for growth investors.

THE CASE FOR REAL ESTATE INVESTMENT TRUSTS

BY JONATHAN FURELID – HEDGENORDIC

Aki Kostiander, head of Real Assets at Finnish asset manager United Bankers, discusses why Real Estate Investment Trusts, also known as REITs, should be part of institutional portfolios looking to diversify into real estate investments.

REITs, an exchange traded investment vehicle for real estate that is tax exempt from corporate tax, has for long existed on the U.S. market. In Europe, the utilization of REITs in institutional investment portfolios is a much more recent phenomenon and is still far from the preferred choice when it comes to real estate investments.

In an interview with HedgeNordic, Aki Kostiander, who has been a REIT portfolio manager for over 10 years at Finnish asset manager United Bankers, discusses the benefits of adding REITs to an institutional investment portfolio, why he thinks institutional investors are yet to embrace the REITs concept, and why it makes sense for investors to avoid cheap index trackers and instead focus on quantitatively managed portfolios of REITs.

HedgeNordic: Could you give a brief introduction of the REITs concept and how you at United Bankers work to build investment portfolios of REITs?

Aki Kostiander: REITs is a legal structure that allows real estate companies to invest in real estate without being subject to corporate tax. Instead most of the returns are required to be paid out as dividends to investors in the REIT, who in turn pay taxes on these dividends. This way the dreaded double taxation problem is evaded. REITs are exchange traded, meaning that you as an investor typically get daily liquidity on your holdings It is like any other listed stock producing daily net asset values.

The difference of REITs compared to exchange traded real estate stocks is, as a consequence of the differences in taxation, that the REIT has no incentive of applying excessive leverage to its investments. As a result the REIT becomes more of a pure real estate portfolio, rather than a mixture of high debt instruments and real estate development.

Our approach to investing in REITs is through building what we define as alternative beta portfolios of REITs based on a quantitative approach. We filter out REITs that are good value rather than look at the market capitalization or index composition. This means that we significantly deviate from the different index solutions available on the market today that are based on market capitalization weightings.

We are very much bottom-up as we look for value in individual REITs, but we also have a macro view on top which decides how the portfolios are tilted given the macroeconomic cycle, i.e. how we position between commercial properties vis-à-vis retail properties, for example.

The dividends paid out from the REITs in our portfolios are always re-invested meaning that as an investor you get a compounding effect from that side as well if we do our job well. The compounded cash flow returns over time in a REIT portfolio is what makes them perform so well against other asset classes and the stock markets.

HedgeNordic: What is the appetite for REITs investments among Nordic institutions today?

Aki Kostiander: The REITs legislation is very much linked to national REIT frameworks, and since there is no such thing as a REITs legislation in the Nordics, this has to some extent made Nordic institutions a bit hesitant to incorporate REITs in their investment portfolios, since they are not so familiar with the theme. Historically, REITs have also been lumped together with financial stocks rather than treated as a separate asset class, which I think has blurred the lines between what category to put REITs in. Mostly investors think of them as being a niche stock market sector and treat them as ordinary double taxed listed property stocks.

REITs should really be considered on their own merits. It has outperformed both equities and real estate private equity looking at it historically. It is also a much more liquid asset compared to the direct real estate investments made by institutions today through private equity deals. One often talks about the so-called illiquidity premium when discussing direct real estate investments, i.e. you should be offered a liquidity premium to be part of an investment with scarce liquidity. Regarding REITs the situation is the opposite. You can get a liquid property investment with a discount when in fact you should be paying a premium for it.

HedgeNordic: What value do you see for REITs in a multi-asset portfolio?

Aki Kostiander: Adding REITs to a portfolio of traditional assets such as stocks and bonds greatly enhances the efficient frontier. REITs should be seen as a good diversifier and has added a lot of value compared to both equity and real estate investments over time. The fact that REITs have seen periods of increased volatility in times of equity market distress, such as that experienced in 2008, I believe has a lot to do with the fact that it has historically been linked to the financial equity category. This is likely to change as the large index providers will launch separate REITs indices in August this year, which will more clearly distinguish the asset class. This index classification change by MSCI, S&P and Dow Jones will be a big thing for REITs this year.

HedgeNordic: What are reasons to use an active strategy in the REITs space rather than go the index tracker path?

Aki Kostiander: We believe an alternative beta strategy makes a lot of sense in the REITs space, particularly given that the passive money today has pushed valuations to extreme levels for those REITs that make part of market capitalization weighted indices. To mention one example, the largest REIT in the Europe is Unibail, it is currently traded at a 30 percent premium compared to its underlying real estate holdings. The simple reason being that

Aki Kostiander, Head of Real Assets at Finnish asset manager United Bankers

it is the largest REIT in the index and that the passive money flows in the direction of these names regardless of their valuation. Would you over the long term want to buy real estate at such a high premium? I wouldn't, especially when we can substitute these expensive index blue chip REITs with clearly cheaper mid cap names.

HedgeNordic: Why do you think it makes sense for an institution to outsource its allocations of REITs to an external asset manager such as yourself, rather than building an in-house portfolio of REITs?

Aki Kostiander: We have a long experience from selecting and constructing portfolios of REITs and our quantitative screening process has proven to add significant value over time. By outsourcing the portfolio management you get access to an alpha source without having to deal with much of the administration associated with corporate actions, re-investment of dividends, re-balancing of portfolios etc.

HedgeNordic: Why do you think it is a good opportunity to invest in REITs now? Is REITs a good option in an environment of rising interest rates?

I view the current macro backdrop as very interesting for REITs investments. We have low interest rates coupled with very low inflation; the only place to look for compelling real returns is more or less within the real estate sector. The current net yield for real estate assets is somewhere around 5-6 percent, which could be geared up to offer a yield of up to 10 percent. Real estate also provides you with an inflation hedge, as the sector is indexed to inflation numbers, at the same time the value of properties usually follow the development of consumer prices over the long term.

The way I see it real estate offer the best of two worlds, in a low interest rate environment with deflation you have solid real returns compounding. If interest rates would rise, they typically do so in conjunction with rising inflation numbers. Historically speaking, REITs have usually done well in environments of rising interest rates and rising inflation. However, if interest rates rise without inflation following, that of course poses a risk to real estate and REITs, but I do not see that as the most likely scenario at this point.

HedgeNordic: You also run a REIT hedge fund. Could you tell us more about it?

Yes, the fund is called UB Real REIT and it is an on shore non-UCITS fund that is a leveraged long-only REITs and property stocks fund. The fund can hedge out a part or all of the equity market risk and sometimes also interest rate risks. So we try to capture some of the property market alpha and minimize the equity market related impact on volatility. We have a core portfolio of best of breed REITs globally that we feel comfortable with over the long term.

We then add thematic positions in any property market related themes we feel could add value, and on top of this we make mean reversion bets on REITs and property stocks that are either event related or in our opinion mispriced by the market. We can for instance leverage up the portfolio to some 100-150% REITs and then short equity market risk so that our delta is e.g. between 0.25-1.00. We have a lot of leeway in the hedging and leveraging so the fund could at some point have a zero hedge and a very high exposure to REITs. So far, after a careful start, the fund has been running for almost four years and returned 8.5% annually with a volatility of 10.3 %.

ATTRACTIVE YIELDS

Tom Mansley, GAM Investment Director

Gary Singleterry, GAM Investment Director

US MORTGAGE BACKED AND ASSET BACKED SECURITIES

By Hamlin Lovell – Hedgenordic

"Divine providence brought us together with GAM" says GAM Investment Director Gary Singleterry, who has worked in the US mortgaged backed securities (MBS) markets from their beginnings. In 2014, he and fellow GAM Investment Director Tom Mansley were managing institutional money at the eponymous firm they co-founded, Singleterry Mansley Asset Management (SM). Investment management was the only in-house activity with everything else (including back office, marketing, legal and compliance) outsourced. Meanwhile, "GAM was seeking a US MBS manager as the asset class was not a substantial part of its fixed income offering" Singleterry recalls. The partnership is a perfect fit: GAM now has a US MBS team with a combined 50 years' of experience, also including Investment Manager Chien-Chung Chen, while Tom and Gary have the infrastructure and support they need to grow their business further. The team benefits from an open flow of idea sharing amongst other GAM fixed income fund managers.

Now sitting in GAM's New York office, Gary and Tom run $800 million[1] across a number of accounts. GAM successfully launched a dedicated UCITS product in 2014, based on the master investment strategy managed by the team since 2002. The launch of GAM Star MBS Total Return UCITS was informed by GAM's long experience in structuring UCITS funds, and it has already raised assets of $400 million. "Most of the accounts are run broadly pari passu bar some credit rating restrictions and some other minor regulatory and legal restrictions, depending on whether the strategy is based in the US or Europe" confirms Singleterry.

RETURN TARGETS

In this profile we focus on the UCITS fund, which targets returns of 3-5%pa over cash. The SM track record since October 2002 (which GAM audited for GIPS compliance purposes) has delivered considerably more than this target, annualising at 12.9%. However, Singleterry explains that three years – 2008, 2009 and 2010 – when outsized returns came from the extreme dislocations around the credit crisis, account for beating the return target. Stripping out these three years, the track record has been within the range of 3-5% over cash, and presently Singleterry does not see bargain basement asset pricing that would lead him to increase the return target. Singleterry even admits that if MBS spreads tightened substantially, he would prefer to revise down the return target rather than take additional risks in order to maintain it.

UNLEVERAGED AND LIQUID

For now Singleterry is confident about attaining the return target, without using fund balance sheet leverage, which is not anyway permitted in this particular UCITS fund (the team separately manage a hedge fund strategy that does employ moderate leverage through repos). Though the UCITS could obtain implicit leverage through derivatives, such as buying swaps or futures, it has done very little of it so far.

Daily dealing with five days notice on the UCITS is feasible because US MBS is a huge $7 trillion market, second only to Treasuries. While MBS sometimes sees lower liquidity on dry or stressed market days, "it remains comparable to corporate high yield credit liquidity with daily quotes available for most of the book", Singleterry observes. The strategy does not invest in instruments 'marked to model'.

LOW INTEREST RATE SENSITIVITY

Singleterry's macro view is that the US economy faces a structurally slower growth path, due to escalating taxes, debt and regulation. This, combined with the persistent mountain of public and private debt, have more or less eliminated the Federal Reserve interest rate cycle and Singleterry does not expect any steep rate rises.

Nonetheless, the objective of a lowly-correlated return profile means that interest rate duration stays within tight limits of between plus and minus three years. This is maintained in several ways. Much of the portfolio is comprised of floating rate instruments, such as ARMS (Adjustable Rate Mortgages) which naturally have very low duration. Additionally, "interest rate exposure is hedged through IO strips (which have negative duration) and through shorting Treasury futures" Singleterry explains. In early 2016, duration for the UCITS fund was around one year. That partly explains why the strategy's return pattern over the past 30 months has shown virtually no correlation to the BAML US MBS index. As well, 100% of the BAML index is made up of agency securities, which exhibit a high level of interest rate sensitivity, and have lately moved closely with Treasuries. Neither Treasuries nor most agencies currently offer yields that meet Singleterry's target return level however.

With very little interest rate risk, then, Singleterry's big picture portfolio construction choice is whether to emphasise prepayment risk or credit risk. An unconstrained mandate permits him and his team to max out on either and they have made accurate calls: the strategy has made money every calendar year since 2002, through several credit and prepayment cycles.

Before the 2008 crisis, SM were almost entirely invested in agency securities as the manager preferred to take prepayment risk and correctly judged that credit risk was severely under-priced. Since 2008 the pendulum has swung the other way. Post-crisis, multiple layers of regulations, from local state regulators to the Dodd-Frank CFPB, apply to originators and servicers, and have the effect of improving the credit quality of mortgages, Singleterry argues. Another new regulation - imminent risk retention requirements - might impact some marginal issuers but will not affect most issuers, he expects. Overall, in April 2016, Singleterry is reasonably relaxed about prepayment risk, because he thinks with mortgage rates at historic lows of 4% most borrowers who are able and willing to refinance have already done so. Mortgage lending standards have somewhat relaxed from the tightest levels lately but remain much tighter than pre-crisis, Singleterry thinks.

CREDIT RISKS ATTRACTIVE

But Singleterry finds credit risk more compelling than prepayment risk since 2009, hence the additions to the portfolio have been predominantly non-agency securities. Carefully selected, and mainly senior, credit risk is what Singleterry wants to own now. This partly reflects his view on benign US housing market conditions. "Excess inventory has been absorbed leaving a healthy housing market in balance. With home ownership back down to 64% there is plenty of pent up demand, and affordability is good with house prices nationally still below the peaks of 2006" Singleterry explains.

Consequently, Singleterry finds selected housing-related credit risks attractive. The UCITS fund has 87.9% in non-agencies, of which 68.5% points is in single-family residential mortgages. The portfolio is geographically well diversified over the US and the managers' research process includes detailed loan analysis, such as loan-to-value, geographic distribution and credit score distribution. For structured credit, Singleterry also scrutinises prospectuses to get a handle on metrics such as priority of cash-flow payments for different tranches. For mortgage derivatives, such as interest-only (IO) and principal only (PO) securities, the team are also experienced at modelling and analysis. In addition the manager owns some commercial mortgage backed securities but much of the underlying collateral here is generally not corporate risk related offices but rather residential multi-family properties that get lumped into the CMBS bucket.

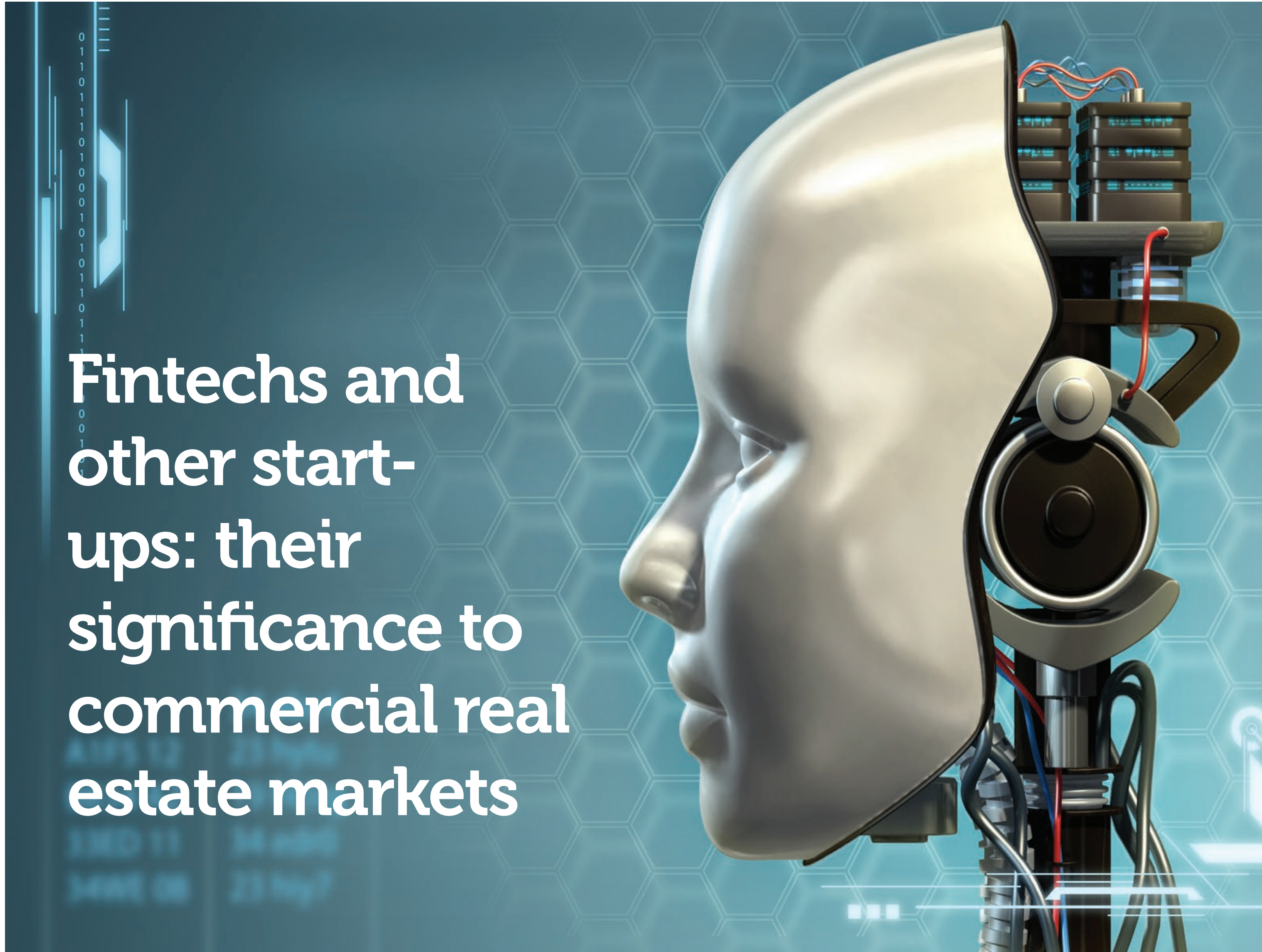
NON-MORTGAGE ABS

Singleterry's mandate allows them to diversify beyond property-backed ABS, into paper backed by collateral including auto loans, student loans, and credit card receivables, but it is currently corporate credit CLOs that Singleterry finds most appealing outside the mortgage space. "Single A-rated Mezzanine tranches of Collateralised Loan Obligations (CLOs) can pay as much as 6% and have a cushion of more junior paper below that will absorb losses first," he illustrates.

SENIORITY PARAMOUNT

This form of credit enhancement is also an essential feature of the MBS team's exposure to sub-prime and Alt-A mortgages. Singleterry explains how mortgages that were sub-prime 10 years ago look very different today - as most of them are up to date with payments, so might not be classified as sub-prime. The borrowers may still have relatively low FICO scores for reasons such as occasional late payments or low incomes, but Singleterry finds the risk/reward attractive in specific parts of the capital structure. Singleterry tends to buy senior tranches, or sometimes mezzanine tranches that will soon attain senior status after senior paper is repaid. Singleterry makes no bones about the fact that he does expect some default-related losses from these underlying mortgage loans – but expects senior paper to be protected by substantial subordination from junior tranches taking the first hits on losses. "With ten years of history on these loans we have some confidence about estimating losses" Singleterry says, and his team's own, even longer, track record is appealing to investors.

[1] As at end March 2016



Fintechs and other start-ups: their significance to commercial real estate markets

by Thomas Beyerle, MD
Head of Group Research, Catella

In the European office space markets, banks and insurance companies traditionally account for approximately 25 % of the demand per annum. Their business models are currently being challenged by fast and innovative start-up companies – and this will have an impact on future demand for office space.

Demand for office space declining among traditional finance businesses – fintechs penetrating the market
The finance sector is currently undergoing a process of fundamental change. A comparison over time of the number of employees in this sector shows that, while there were 9 % more people working in the sector at the major European hubs in 2014 compared with the ten previous years, the demand for office space nonetheless fell by 17 %. This suggests that space is being used more efficiently. And now there is an additional market factor, with the emergence of fintechs. And it is doubtful as to whether this market factor can offset the emerging shortfall in demand.

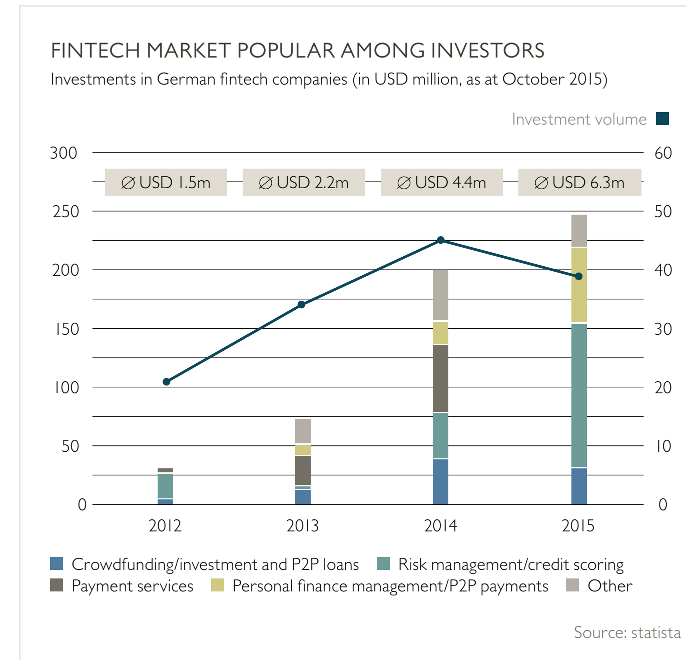
The term 'fintech' is a portmanteau word combining 'financial services' and 'technologies', and represents a class of IT start-ups that are setting out to muscle in on the shares of the market held by traditional banks, insurance companies and financial service providers. The array of companies within this segment ranges from mobile or Web-based payment systems to account management and investment concepts and strategies ("robo advice"). What they all have in common, however, is that they are doing away with physical service provision in favour of digitisation – the customer is increasingly becoming the producer of the services.

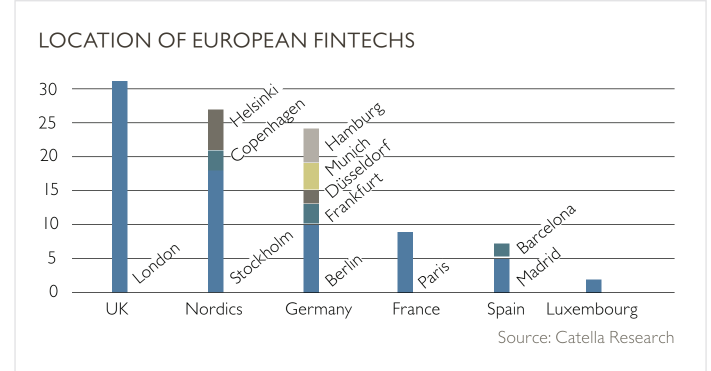
The 'visible' bank (service) at a location is increasingly becoming invisible. Concrete fintech services include:

- Banking: fast, individual and straightforward account management
- Insurance: customer-oriented insurance concepts Loans: granting private loans and providing apps to compare loans
- Payment transactions: new payment methods with low transaction costs and straightforward processing
- (Share) trading: new portfolio management concepts and optimisation of investment strategies

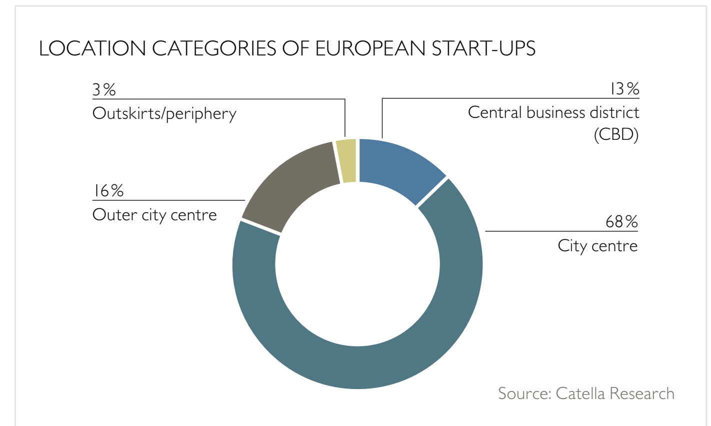
It is not currently clear what impact the emergence of fintechs will have on office space demand in the local real estate markets. Having said that, there does appear to be a fintech 'DNA' with regard to where they set up business. One thing which certainly is clear is that the investors have high expectations of the market. They are betting billions on their future success.

There are now more than 12,000 fintech companies around the world. The majority are based in the UK, followed by the Scandinavian countries Sweden and Finland. The UK is a major market which is very tech-savvy. London's financial centre is currently acting as a catalyst. The growth driver in the Scandi- navian countries is a desire to be international.





Our analysis indicates that the vast majority of European start-ups prefer inner-city locations. These are often a city's 'in' districts, which boast a high concentration of businesses, ease of access and a wealth of trained manpower.



The number of fintech start-ups in Germany is growing fast

While there were around 40 fintech start-ups in Germany a year ago, this number had risen to around 250 by the beginning of November 2015. Approximately 40 % of these companies are based in Berlin.

Start-ups are increasingly being founded in particular in the areas of loans, private banking, investment and insurance. They focus on front-end products, user-friendly apps or online platforms that are able to meet the customers' needs more quickly and more simply in a 24/7 environment than the solutions offered by traditional banks.

Compared with the USA, the European market for start-up companies is still relatively opaque. New user needs in the areas of co-working/shared working spaces, labs and smart production are still in the development stages.

Short-term commitment preferred

Long-term leases pose an inherent systems risk for start-ups: office space involving a long-term commitment can soon become too large or too small for such companies. Virtual offices in business centres (fintech campuses) are therefore ideal and are a great alternative to conventional office space rental: the overheads risk is reduced to a minimum and the outward appearance is representative of the company.

Although virtualisation is on the increase, physical customer accessibility is now more important than ever before. This is just one of the reasons why we expect the trend of agglomeration to continue in the main European banking districts.

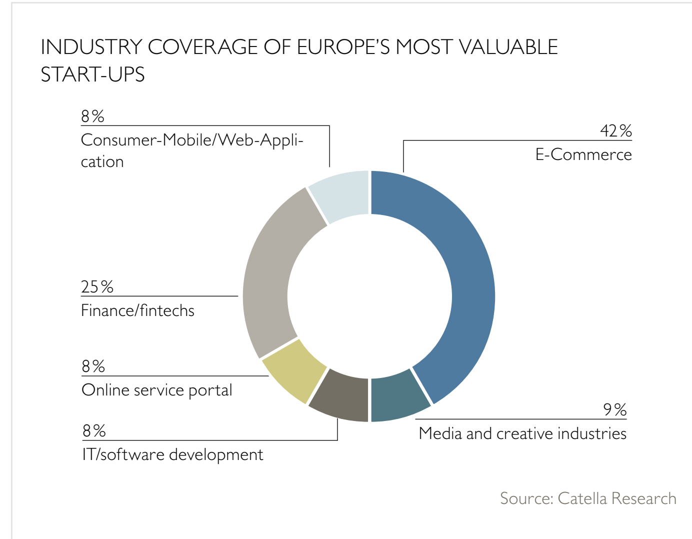
Our analysis has highlighted the following real estate-related effects and developments:

- Rising rent levels due to high demand for office space Short-term leases (1–3 years)
- Concentration in city centres – especially in central locations Flexible work models (co-working/shared working space) Modern workplace (with/without office furniture and equipment)
- Mergers and acquisitions of established start-ups by large corporations (level of demand for fintechs)

FINANCIAL SERVICES OCCUPANCY RATE IN EUROPE (IN 2014):

Locations	Occupancy rate of financial service companies in %	Occupancy rate of financial service companies in m²
Copenhagen	10.0	20,000
Berlin	10.0	64,500
Frankfurt	36.0	122,400
Düsseldorf	6.7	15,550
Munich	4.8	22,600
Hamburg	5.4	28,350
Madrid	13.3	38,050
Barcelona	6.0	12,150
Paris (IDF)	6.2	133,550
London (Central)	25.0	211,250
Luxembourg	29.0	50,750

Quelle: Catella Research



Fintechs only partially offsetting decline in demande

Fintechs will not replace the traditional financial service companies overnight. Nonetheless, they represent serious competition for the established market players – competition which is able to keep its customers satisfied with very high transparency and a comparatively high degree of service orientation. Catella Research expects to see demand for office space in the traditional banking sector in Europe fall by around 30 % between now and 2020, with approximately half of this drop potentially being offset by the new fintech segment. According to forecasts, the office space difference will then probably reappear in the market as residential space.

Thomas Beyerle

Over the last 30 years

BEST RISK ADJUSTED PERFORMER

The strategy of Svenska Bostadsfonden is focused on stable growth, preservation of capital, value added and deliver annual dividends by investing in Swedish residential properties.

Svenska Bostadsfonden (SBF) is a Swedish fund manager running portfolios of Swedish residential properties. The strategy, which has been running since 2003, is now available in a new closed-end institutional fund. The manager has exited 8 funds since inception which has returned approximately 8 percent per annum despite the financial crisis since 2008.

The Fund manager launched their first institutional fund in 2011 together with some of the Blue-chip Nordic institutional clients with a forecast of a double digit annual return. SBF are currently launching their second institutional fund to continue the successful strategy.

Svenska Bostadsfonden Institution 2 AB is characterised by:

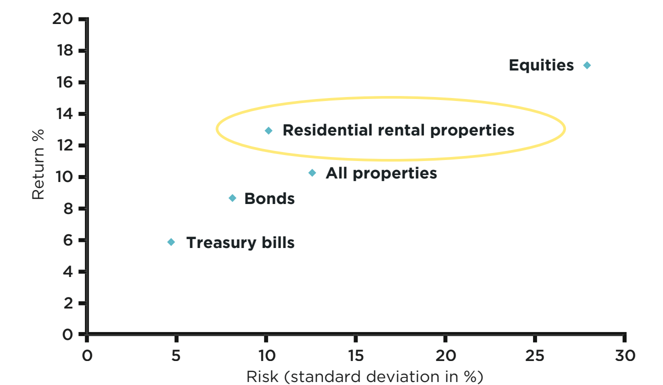
» Focused property fund with an attractive return profile with annual dividend payments

» Substantial under supply – Long term supply and demand imbalance creating attractive investment opportunity

» Limited downside risk – Assets can be acquired at a third of the replacement cost

» Highly experienced and focused fund manager with proven track record and performance through economic cycles

Return and risk 1985–2015



The graph shows that investments in residential rental properties has had a two-figure annual return together with a limited risk.

Source: SFI/IPD Swedish Property Data Bank and OMX Stockholmsbörsen. Average annual return.

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SVENSKA BOSTADSFONDEN

"Lots of new investors are coming into this asset class. We have to be careful not to be the last guy in the queue."

by Aline Reichenberg Gustafsson – HedgeNordic

Nordic Allocators

seeking low-risk yields flock to infrastructure

The sheer size of infrastructure projects keeps smaller investors outside the tent and helps compensate for a shrinking illiquidity premium.

In this Ice Age of fixed income returns, real estate and infrastructure have become asset classes of choice for those looking to obtain stable returns with low risk.

Given long-term investment horizons and often lower risk, infrastructure and real estate investments can be used to complement the institutions' bond portfolios. Other alternative assets are more commonly used to complement institutions' equity portfolios. For example, at Nordea Life & Pension in Denmark, the customers demand has recently shifted towards life cycle products, which means products where risk diminishes as the pension policyholder ages. In order to achieve the right mix, explains Soren Tang Kristensen, Head of Alternative Investments & Real Estate, asset classes are divided in two categories. The

Peter Ragnarsson, PRI Pensionsgaranti

Soren Tang Kristensen, Nordea

Peter Kjærgaard, Nykredit

high-risk category includes private equity, hedge funds and high-risk illiquid credits, whereas the low-risk category includes real estate, infrastructure and of course low-risk credit. Today's ageing pension policyholders need sufficient returns from the low-risk category, and more in the form of cash yields than long-term value appreciation. This is why Nordea turned particularly to real assets already 15 years ago. At the beginning, forestry and timberland were the team's main focus. Later, more traditional infrastructure segments were added at the low end of the risk spectrum, such as toll roads and utilities.

Three years ago, Nordea identified a need for an increased infrastructure portfolio and a new strategy was implemented which was recently awarded a prize from Institutional Investor. As part of this strategy, four focus areas are defined within infrastructure: forestry, traditional infrastructure, renewables and public–private partnership (PPP). The last area was the trickiest to develop, as accessing PPP means getting into competition with other bidders to enter a consortium.

At Nykredit Asset Management, infrastructure has entered the radar screen of the team, even for private clients' portfolios. Many clients relied on mortgage bonds for enhanced fixed income returns and they are now looking for alternative stable returns over longer time horizons. Peter Kjærgaard, CIO at Nykredit Asset Management explains that "the DNA of our business is to constantly look for investment types used by institutional investors and translate them for smaller investors". For the type of infrastructure product Nykredit now offers its private clients, focus is on low risk, long-term, stable income-generating projects such as energy- or transportation-related investments.

For Peter Ragnarsson who recently joined PRI Pensionsgaranti as Head of Alternative Investments, infrastructure is still unexplored territory but it is obvious that introducing this asset class to the allocation will help boost the returns of the low-risk part of the portfolio. So far, low-risk alternative investments were mainly made in real estate.

In fact, real estate now constitutes approximately one third of the alternative assets portfolio, a proportion that will grow if all commitments made so far are drawn.

As part of risk diversification within alternatives, Ragnarsson is looking at private equity, direct lending, insurance-linked securities and infrastructure, but he recognizes that the first infrastructure commitment may take longer to achieve. In this pursuit, he will focus on funds that can deliver stable returns at a low risk over time. "We don't want to chase the last basis point of return for a considerably higher risk", he says.

Real estate and infrastructure, such as other alternatives like private equity allow investors to collect an illiquidity premium, which is what institutional investors with long time horizons have been looking for. "The illiquidity premium has become smaller, says Kristensen, and competition has become very high on core real estate assets. For example, he mentions, in Denmark, big office 10-year lease properties yield 4.25-4.5% right now, which is not very high compared to covered bonds, especially if you consider the risk of the tenant moving out at the end of the lease, or the need for refurbishments etc."

The main difference between infrastructure investments and real estate is the size and the length of the commitment. By nature, infrastructure projects require very long-term commitments and very large pools of funding. According to Kristensen, this can be easily observed in windfarm projects. "Land projects look too expensive right now, but for offshore wind the prices are not as excessive because they are sizeable investments and more complicated, therefore competition is lower."

Hence fewer investors have been traditionally interested in accessing infrastructure in general, and not everyone would have had the ability to do so. "Lots of new investors are coming into this asset class", warns Kjærgaard. "We have to be careful not to be the last guy in the queue. That's why we not do invest directly. We always invest alongside professional investors and use them as references." Furthermore, it is much less likely that an institution will make direct investments in infrastructure projects than in real estate where smaller size investments are widely available.

The need for diversification makes it impossible unless the allocation to infrastructure is very large in absolute terms. Club deals would be easier to finance, but it presupposes an alignment of interests for the club members. Timelines, return requirements often diverge, which makes it difficult to achieve. In addition, evaluating such investments would require very large in-house teams.

Access through Fund Structures

The best instrument to access the asset class is through infrastructure funds. At Nordea Life & Pension, the goal is to invest through 8 to 10 funds with 6 to 12 investments each, which means access to approx. 80 to 100 different projects. For Kristensen, manager selection is very important. "We select on a best of breed basis", he says. As Ragnarsson describes it, the manager selection process is different for these funds compared to other

alternative investments he is familiar with because relying on quantitative metrics related to track record is often out of the question.

The fact that these funds have up to 25- or even 30-years time horizon makes it even harder. So far, it has been possible at PRI Pensiongaranti to invest approximately SEK 1 billion in 10 real estate funds which have 10 to 12-year lock ups, and that with a team of only 4 people, of which 1 person focused on alternative investments. Kjærgaard explains that extra time and resources are needed in the selection process of infrastructure funds due to the size and time-frame of the investment. His team also relies extensively on external advisors. For him, the high cash-yield component is key.

With such projects, terminal value is less important, which takes down the overall risk level. "Off-shore windmills are a good example, he says. It takes 3 years for the windfarm to be up and running but then it only takes 6 to 8 years for the notional to be repaid." His team therefore looks for funds that focus on these types of investments, which he refers to as core infrastructure funds. Another important aspect is the mix between greenfield and brownfield projects. Brownfield projects provide a better visibility as they already exist but they tend to be more expensive.

Fees, Thresholds and Competition

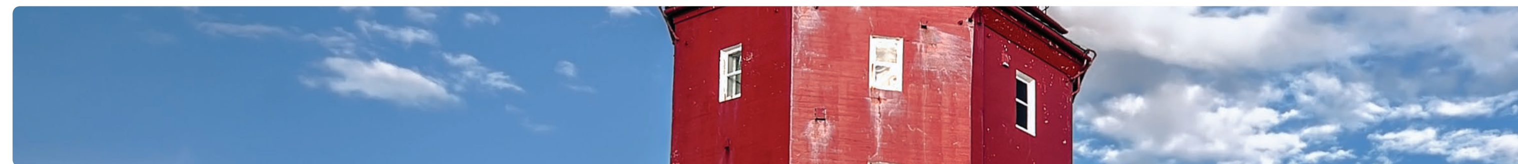
When it comes to fees, there is no absolute acceptable level for Ragnarsson. "As a principle, he says, we want to keep the fees as low as possible of course, but if you want to have a good manager, you sometimes need to accept higher fees." One of Kristensen's worries is that, with asset prices being driven up by many new entrants in the asset class, acceptable returns will have to be lower. However, the hurdle rate above which performance fee is paid is often fixed at 8% for example. "That rate has not changed in the past few years, he explains, even though yields have come down. The risk is that managers step up on the risk curve and choose assets that may not have infrastructure characteristics. For some funds perhaps the risk will become closer to private equity risk than infrastructure risk."

Kjærgaard worries about the current sale price of some infrastructure assets. In general, he agrees, infrastructure investments have to be entered into over the long term. Therefore, short-term fluctuations in the market, including, e.g., oil prices, should not be of any concern. But he says, "it looks like some assets are being sold too expensively right now. We should all think about this. There is a potential for a bubble, especially if too much leverage is used." In addition, political risk could increase. Infrastructure asserts tend to be regulated; regulations and subsidies can change. "With a volatile political backdrop, we have to keep this in mind, he adds.

So far, it is rare that changes have been backward looking, but it could happen in the future." Theses are risks inherent to the asset class, but according to Kjærgaard the returns are currently still sufficient to compensate for these risks if you select the investments carefully.

According to Kristensen, interest in core infrastructure is partly depended on the Solvency II regulation. In the near term we expect some changes in the regulation, which will reduce the capital charge on core infrastructure assets. So far, infrastructure had to be treated as tier II capital with a capital charge of 49%, but recently, Brussels has proposed a new definition which allows some infrastructure investments to be categorized as "qualifying infrastructure", and thereby get a charge of 30% versus 49% in previous delegated act. "Due to the Junker plan", describes Kristensen, "the EU needs to make a lot of new infrastructure investments. This will be easier to achieve with lower capital requirements."

In order to qualify for the reduced capital charges, infrastructure assets must first meet the Solvency II definition of infrastructure and second satisfy a set of criteria defining qualifying infrastructure. "It will primarily be the core infrastructure assets which are in scope, as the asset needs to generate predictable cash-flows and withstand stressed conditions", Kristensen explains. "Besides that as an investor you need to establish internal models for ministration and risk mitigation, so it requires a lot of effort and internal resources to obtain the lower capital charge." Some investors may not have the internal resources to prepare the documentation and will instead continue to apply a higher capital charge.



Peter Norhammar
Head of Swedish Equities, Portfolio Manager
Alfred Berg Kapitalförvaltning

Real Estate is still in a sweet spot

by Jonathan Furelid, Glenn Leaper – HedgeNordic

Alfred Berg's real estate expert Peter Norhammar currently manages over SEK 12 billion across two funds. Alongside Alfred Berg Fastighetsfond Norden, a fund investing in Nordic real estate companies, he also heads the Länsförsäkringar Fastighetsfond, a real estate fund that surpasses SEK 11 billion in assets under management.

In an interview with HedgeNordic, Norhammer gives his views on the Nordic real estate market, on what he thinks of current valuations, and on how he identifies winners within the sector. And here is what he had to say:

HedgeNordic: Before we dive into the real estate markets, can you tell us a little about your background?

Peter Norhammar: I have worked as an analyst and as an equity fund manager since 1998. Prior to this I was a real estate appraiser, which comprised commercial housing as well as apartment buildings. I joined Alfred Berg in January 2014 from SEB where I managed SEB's real estate fund, among other responsibilities.

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HedgeNordic: What would you say distinguishes you from other real estate fund managers?

Peter Norhammar: I have a background from the real estate industry. I studied real estate economics at the Royal Institute of Technology in Sweden, and in my early career days I valuated real estate starting from the bottom, which gave me a lot of valuable experience. In addition, I possess an extensive network within the real estate industry, which I believe gives me a certain informational advantage vis-à-vis the competition. We are the largest investor in numerous real estate companies, which allow us to have connection with the top management of many companies. This is not to suggest that we have access to insider information, but that we maintain a running dialogue with people in leading positions.

Considering my experience within real estate valuation I also reckon that I am in a position to easier identify inaccuracies related to questions of valuation. I know which control questions to ask. Moreover, I believe I have a good feel for where the real estate sector is heading.

HedgeNordic: So what you think will happen going forward? Have real estate valuations reached a peak, or will they continue rising?

Peter Norhammar: I am optimistic, and have been so for many years. I have communicated a simple message for at least the last two years and that message is still intact. This sector is in a sweet spot.

Demand for commercial and residential real estate is connected to economic development. GDP growth in the Nordic countries has been relatively strong, particularly in Sweden. The positive economic development has created an increased demand for commercial premises and residences. We have also seen a powerful trend in urbanization, not just in Sweden, but in the whole of Europe. Large cities grow larger and GDP growth is channeled through a small amount of cities, which easily leads to excess demand.

The supply side is also favorable. Very little is being built to meet demand, irrespective of whether it is offices, warehouses or industrial buildings. This is why market rents have been rising over the last years, and the trend is still ongoing.

HedgeNordic: Is there not a risk that there will be development based on speculation and that the current excess demand will instead turn into an excess supply when the market turns?

Peter Norhammar: Today the whole industry is extremely professionally managed. Those in top positions have modern educations and studied the 1990's crash, when there was over-development taking place. Today's CEOs will not repeat the same mistake. One does not start constructing new buildings based on speculation without a clear demand for the new space. The risk that there will be excess supply is low. Risk-averse CEO's aim to work for sound rental property development. Seen from an historical perspective, speculative loans have diminished considerably and today´s loan-to-value ratios (LTV) are generally speaking at sound levels. Today´s LTV levels are lower than during the last years.

HedgeNordic: But what risks do you see? What would make you reevaluate your optimistic view on the sector?

Peter Norhammar: We presently have this fantastic yield-gap in the real estate sector. In other words, the yield from a real estate investment compared to its borrowing costs is at a high level. Historically speaking this lead to large amounts of capital seeking real estate exposure, which can have negative consequences. There is, for example, a danger of too much unprofessional capital flowing into the sector, investing in properties at too high valuations. If interest rates suddenly rise, the yield-gap will rapidly close. Another risk is if current CEO's are too tempted to take advantage of the yield gap and, despite knowing the risks, start building on pure speculation. If I see signs of such behavioral changes I will start getting worried.

The gap can also be closed from below, meaning we could get strongly rising interest rates turning into increased borrowing costs. Investments made at a 1-3% interest rate are then no longer profitable. If interest rate hikes are caused by rising inflation then real estate developers will recuperate on the revenue side, but if interest rates rise just because banks are looking to increase their margins, then that is bad news.

The worst-case scenario would be a new financial crisis where banks do not lend at all simply because there is a lack of funds. The sector is dependent on a well-functioning banking system, as it is an assets-intensive industry.

HedgeNordic: What do you look for when you choose a real estate company to invest in?

Peter Norhammar: I focus very clearly on the quality of my holdings, companies that historically have been able to generate high return on equity. Those who succeed in doing this and who, at the same time, manage to grow the business, are obviously doing something right. These companies tend to trade at higher multiples but valuation is in this respect subordinate. It still seems that highly valued companies are those that will generate the best total shareholder return going forward.

> "VERY LITTLE IS BEING BUILT TO MEET DEMAND, IRRESPECTIVE OF WHETHER IT IS OFFICES, WAREHOUSES OR INDUSTRIAL BUILDINGS."

I have a clear underweight in larger companies and overweight in smaller companies. The reason is that smaller companies are in a better position to grow and can make greater use of the yield-gap. It is simply easier to obtain growth when one is small.

Another factor I take into consideration is ownership. Companies with clear ownership and where owners are part of the company's management, tend to outperform. Among these I think Balder, Sagax and Klövern are worth mentioning.

HedgeNordic: There have been a number of new real estate companies listed on the stock exchange. Do you think these companies measure up?

Peter Norhammar: The stock exchanges have become stricter with their requirements for listed companies and I find the quality of the new introductions has been good. We have, for example, participated in Hemfosa and Pandox since the very beginning. However, I generally view new introductions with a certain skepticism as history shows that they tend to underperform during their first year as listed companies.

HedgeNordic: If one believes that there is a housing bubble, is it then the wrong time to invest in your funds?

Peter Norhammar: We invest to a very limited extent in housing developers. A majority of our investments are instead made in companies with exposure to commercial real estate, such as office locations. Here valuations have not developed at the same pace at all as housing prices. In the last 10 years, housing prices in Sweden have risen by 8.5 per cent per year, with corresponding figures for commercial real estate at 2.5 per cent. I do not think one can speak of a bubble.

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Mike Weston, PiP

PENSION INFRASTRUCTURE PLATFORM (PIP):

FCA Authorisation Paves Way for More UK Pension Assets into Infrastructure

by Pirkko Juntunen – Hedgenordic

The UK's Pension Infrastructure Platform (PiP) is now in the starting blocks to launch its first in-house fund, following recent authorisation by the Finance Conduct Authority (FCA). The Fund aims to raise £1bn from pension funds looking for investment opportunities in core UK infrastructure assets. Target return is 2-5% above retail price index, and it is expected to invest in 15-20 assets for diversification purposes.

In an interview for HedgeNordic with Mike Weston, CEO of PiP, he explained how "PiP has already mobilised commitments to invest £1 billion, half way to its original target of investing £2 billion in UK infrastructure by UK pension funds. PiP initially established itself in the market by partnering with other fund managers, but FCA authorisation provides the foundation for the next stage in our growth – the launch of our first multi-strategy infrastructure investment fund managed internally by PiP, which will aim to provide the long-term, low risk, inflation-linked cash-flows that UK pension schemes continue to seek."

Pension Funds and Market Purposes

PiP was created in 2011 to encourage and facilitate pension fund investments in UK infrastructure assets. The Pensions and Lifetime Savings Association (formerly the National Association of Pension Funds), Pension Protection Funds and nine other UK pension funds (Founding Investors) established PiP with the aim of developing a range of infrastructure investment opportunities for pension funds, by pension funds. The establishment of PiP and development of initial opportunities has been funded by loans from the ten UK pension funds, to be repaid following the successful launch of new investment opportunities.

PiP decided to launch a number of initiatives whereby they would ultimately structure infrastructure investment vehicles to meet the needs of UK pension funds. PiP would use the combined buying power of the Founding Investors to obtain suitable management expertise at attractive fee rates. Once an initial close for Founding Investors has been achieved, the investment opportunity is then offered to other UK pension schemes and institutional investors.

A number of PiP Founding Investors have also committed equity to one of the consortia bidding to build and operate the Thames Tideway Tunnel, also known as the London "Super Sewer".

Complexity, cost and lack of access have been the main reasons many long-term institutional investors, such as pension funds, have steered clear of the investing in infrastructure, despite the advantages in a low-interest rate, low return environment.

Weston added how "historically, the market hasn't been structuring deals to give pension funds what they want. Deals are typically structured along Private Equity lines, pursuing higher returns over a relatively short timescale and with high-leverage that strips out inflation-linkage. Fund managers also charge high fees to match these high returns. So pension funds have found it difficult to access the market and have had to pay through the nose for an imperfect product."

Expanding Infrastructure, Expanding Scale

Prior to joining PiP in 2014, Weston was CIO at DMGT, with responsibility for the company's pension scheme investment strategy and the performance of the scheme's broad range of external asset managers. The previous 20 years, he worked as an Investment Director in the City of London managing institutional equity portfolios at asset management firms such as Hermes and Merrill Lynch Investment Managers.

"Investing in infrastructure was pioneered by the largest and most sophisticated pension funds in Canada and Australia, particularly within the energy sector, e.g; natural gas and natural gas infrastructure. Large US and Dutch funds followed suit, but the assets class has only recently made its way into the asset allocation of other European institutional investors.

Citing the examples of Canada and Australia, Weston said PiP is "happy to collaborate with international pension schemes in a number of ways - as fellow members of consortia to buy particular assets and as potential investors into the PiP fund. Although our primary purpose is to facilitate UK pension scheme investment into UK infrastructure, we would not turn away like-minded international schemes attracted to the UK opportunity. The more scale we achieve, the more important player in UK infra we will become, and the more investments we will be able to make."

In fact, collaboration is something Weston stresses as a key to success, and ultimately beneficial for all concerned - including pensioners - rather than competing for the same assets, thereby driving prices up.

In October 2013, Dalmore Capital was selected to raise, manage and operate a PPP Equity Fund for PiP. At first close, the fund raised £260m from five of the Founding Investors. Further closes have subsequently been held, and the Fund is now over £500m. In February 2015 agreement was reached with Aviva Investors to launch a second fund, focussed on small-scale UK solar PV installations. This fund reached a first close in June 2015, with a commitment totalling £131.5m from four initial investor pension schemes.

The FCA authorisation will not change PiP's relationship with these existing managers, Weston said, adding that the funds will continue as they are, working to the existing mandate.

Growing Team, Meeting Targets

As a fully-fledged infrastructure investment manager, PiP experienced the need to boost its in-house staff. Weston has expanded the team and appointed Ed Wilson as its first investment director, and Paula Burgess as COO, both joining in 2015.

Wilson joined PiP from Lloyds Commercial Banking Division, where he had worked since 2006. For the last two years he was responsible for the Utilities, Infrastructure and Energy sectors. In this latter role, Wilson was responsible for developing new solutions for clients seeking to grow their infrastructure and energy businesses, whilst helping the bank to maximise its returns from activities through the efficient use of capital. Before Lloyds, he worked at Bank of Scotland and Halifax Plc. Wilson has spent his entire career in the financial services sector since graduating from Oxford University.

For her part, Burgess was the Head of Assurance at CCLA prior to joining PiP, where she was responsible for Compliance, Risk Management and Internal Audit arrangements. Paula also worked for 10 years at Russell Investments in a variety of Compliance, Risk Management and Regulatory roles. She has a total of 17 years' experience in the asset management industry, is a graduate of the University of Leicester, and holds an MBA from the Henley Business School. While PiP fell short of the overly ambitious target set by the UK Treasury of raising £20bn, it is now arguably in a better position to be more than a mere administrative tool to distribute pension assets to infrastructure projects. The FCA authorisation, and its willingness to collaborate beyond the UK, may make it easier to achieve the target in the future.

List of Founding Investors

- BAE Systems
- BBC
- British Airways
- BT
- Lloyds TSB
- Strathclyde
- West Midlands
- Pension Protection Fund
- London Pension Fund Authority
- RPMI (pension administrator for Railpen and Electricity Pensions)

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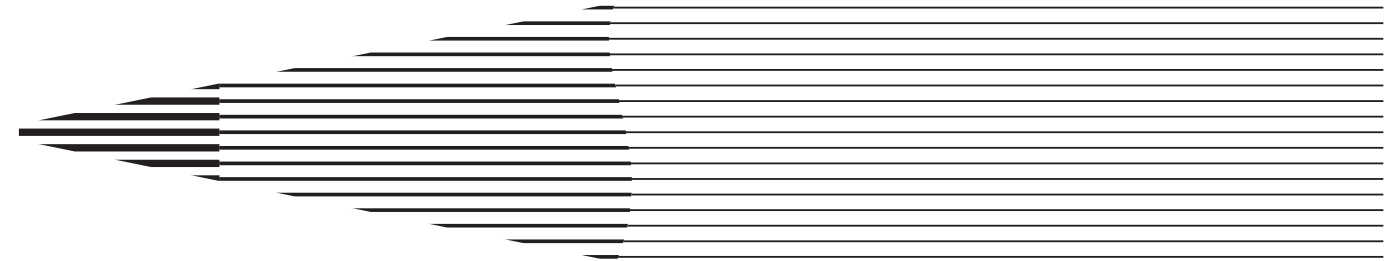

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