Long-term investment in a short-term environment

Steve Leigh, managing director of global real estate at QIC, talks to *PERE* about the challenges and opportunities in the retail sector for institutional investors

***PERE:** Where should retail be placed in an institutional investor's portfolio these days, and what do you have to do to get predictable, consistent returns from it?*

Steve Leigh: Retail will span both core and value-add; but it remains, in our portfolio at least, a core to core-plus strategy, with active management remaining the key influence. In terms of total returns across the two markets, net returns in Australia are 7-9 percent, and for similar risk in the US, 8-11 percent. In private equity, there is more focus around the supply-sale condition, or trading. Active management, for us, refers to capital reinvestment, both defensive and offensive – asset refurbishment, extension and the like. To ensure this, one model is for a partner to be a full operating partner with management skills in-house. We wouldn't seek to partner with another passive investor and then for us to use third-party operators, for instance.

Leigh: total-return, open-ended vehicles best suited to retail

***PERE:** The retail sector is experiencing a lot of disruption, in terms of retailers increasingly asking for things like shorter, more flexible leases and more break clauses. How can liability-matching capital like yours reconcile with the quick-changing occupational needs of retail's occupiers?*

SL: There's always been disruption in retail, but there's no doubt that the pace of change has accelerated. That means we have had to be more dynamic in our management, particularly when it comes to remixing our malls and churning tenancy. We seek to downplay areas that are highly disruptable to digital, and replace them with less disruptable categories. We have to be very active with how capital works, because that balance can only be achieved in a more wholesale way by virtue of mall refurbishment and mall expansion. In our experience with retail, we've seen a large increase in exposure to tenants offering an experience or a service to the consumer, like health.

The other retail category that is growing very quickly is food and beverage. We've seen a rapid de-weighting of exposure to dominant categories of the past, like apparel and department stores. In our Australian portfolio, a decade ago about 40 percent of our exposure was to department stores; today it is just about 30 percent and it is continuing to decline, even as the occupancy has remained the same. Actually, in a break from the past, the fate of malls and their department stores is becoming less correlated worldwide.

7-9%

Australia net returns from retail real estate

8-11%

US net returns from retail real estate

***PERE:** What types of retail are best for the different kinds of institutional investors, and what kinds of investment vehicles are best suited for accessing the retail asset class currently?*

SL: The capital we represent is usually sovereign and pension funds – and for those kinds of capital, we are focused on regional mall assets. We think that large, dominant malls better suit the long-term investor, so they can grow funds under management and fund dividend investment plans. These unlisted sources of capital are focused on total returns, and are less dependent on regular cash distributions.

On the other hand, the closed-ended, defined benefits funds require more liquidity, so they would be better suited to a listed exposure. We focus on the former kind of investors for the most part because we believe that total return, open-ended vehicles are best suited for retail, bearing in mind that especially in US there is a need for a formal mechanism to provide liquidity at semi-regular intervals. The US is simply more accustomed to closed-ended funds, which has affected perceptions of liquidity and returns – they've become accustomed to that style. So we think the solution is an open-ended fund with liquidity mechanisms at similar intervals to the maturity date of a closed-ended fund – that way people have the option to take liquidity, but not the compulsion. This is not a normal vehicle, of course, and it is an ongoing process of education and demonstration.

***PERE:** Public and private investors don't seem to have the same concerns regarding underlying profits in retail, despite looking at the same assets; why would that be, and what effect does it have on the market?*

SL: We do see this mismatch between the asset

Impressive: US household and consumer's capacity to deal with economic events

value and the trading price of the stock – retail stocks often trade at discounts to the underlying assets. Obviously, traded assets always have greater volatility. But public investors also have a different, shorter-term investment horizon than the unlisted investors, because they are more likely to trade and more exposed to short-term investor sentiment. The obvious question is then who's right and who's wrong; and looking through the noise of market volatility, there is ample evidence that retail assets trade at prices not vastly different from their stated price, so we are not too concerned about mismatch or possible bubbles. But given the added volatility, where the market may be headed is more public-to-private deals, because there can be wide discounts to the trading price.

Now, the panic of the public investors does make institutional investors more concerned – undeniably so. It elongates the process of education, so investors have to take more time to understand the risk. In our experience, we tend to make great progress with people who hold real assets in their current portfolios, because they've had similar experiences across cycles. There's no hotel, logistics or retail assets that haven't gone through periods of disruption, so, for those investors, they've had some experience dealing with the noise and then observing the reality. For less experienced investors, the need is there to be extremely transparent and let them look inside the model and look at the assets.

PERE: *What are some of the most common questions you encounter when trying to pitch a retail investment in the US?*

SL: There's the broader concern (which applies to all real assets) about the risk for expansion and yield – basically, cap rate expansion compared to the risk-free rates. For example, they might ask whether pricing has reached its peak in terms of yield? Will it only be a slow unwinding of those yields from here on, as risk-free pricing moves up? And that's a very valid question, but we look closely at the spread between the capitalization rate and the real risk-free rate (the bond rate minus the rate of inflation). When we see that the spread remains wider than the long-term average for those asset classes (retail in this case), we think there is a buffer available to absorb a gradual increase in interest rates. After those points, investors are focused on the business risk for the mall occupants, which involves the health of the consumer, potential for digital disruption, and so on. Those three points take up about 90 percent of our time. After that, it's very asset-specific questions, often regarding regions and buildings.

Our reasoning for coming to the US is that it's a very resilient economy – the US household and consumer's capacity to deal with economic events is very impressive, and its ability to bounce back from adverse economic conditions is an attribute we're attracted to. We're heartened by strong employment numbers, the recommitment of wage growth and the solid levels of US consumer confidence. □

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