Investors may find higher yields in Asia and emerging markets. The Abu Dhabi Investment Authority recently acquired a 50 percent stake in a three-asset portfolio of hotels in Hong Kong in a deal that values the buildings at US$2.4 billion. One of the properties, the 381-room Hyatt Regency Tsim Sha Tsui, is located in one of the tallest skyscrapers in Kowloon.

The global hunt for yield

Investors are going farther afield and exploring alternatives in a low-return environment

by Lauren Parr

Five years into the global economy's recovery, interest rates remain low by historical standards. As such, investors' hunt for yield is intensifying. Fixed-income returns are low, and stock market returns are volatile, pushing investors into alternatives such as real estate.

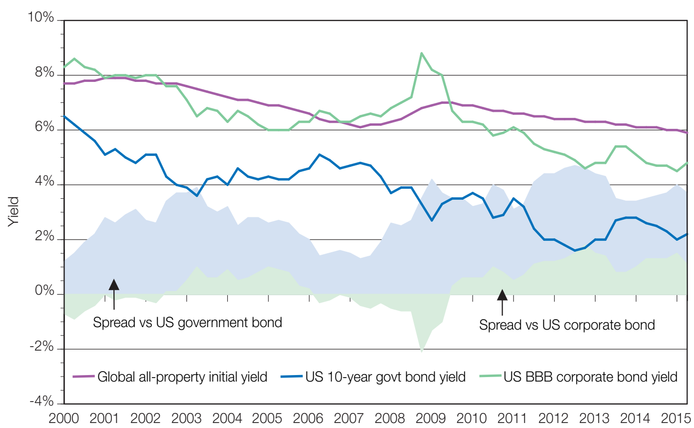
As the recovery in the global economy and real estate markets transitions into a broader cyclical upswing — with activity supported by improving underlying growth prospects, a favourable policy environment, lower energy prices and stronger US consumer spending — the weight of capital targeting property continues to increase, and transaction volumes continue to grow.

Institutional Real Estate, Inc's FundTracker database reflects five years of steadily increasing amounts raised for real estate funds around the world, crowned by 2014's US$91.7 billion — nearly twice the US$46.8 billion raised in 2010. In addition, global property deal flow rose by 9 percent to US$770 billion in 2014, according to Real Capital Analytics. And prime cap rates have declined to pre-crisis lows in several major markets. Yields in London, Hong Kong and San Francisco, for example, are now lower than they were prior to the global financial crisis.

"It's becoming increasingly difficult, with interest rates as low as they are and investors having turned to property several years ago now, to replicate the fixed-income yields they were used to achieving," says Russell Chaplin, chief investment officer – property of global investor Aberdeen Asset Management. "Yields have moved lower for better-quality stock across the globe. There doesn't seem to be a top-down free lunch."

Schroder Real Estate has acquired the Bosch-Areal property in Stuttgart, Germany, for more than €100 million (US$113 million). The mixed-use property was acquired on behalf of a German client. Sascha Harms, head of real estate investment, Germany, with Schroders notes, "This asset is … a relatively defensive component in our investment strategy and, given the strength of the Stuttgart leasing market, we are anticipating a highly-stable cashflow with upside potential from active asset management."

Global all-property prime initial yield vs US bond yields



Sources: US Federal Reserve, OECD, Cushman & Wakefield, CoStar, JLL, Colliers International, Pramerica Real Estate Investors; as at August 2015

Where to now?

The question is, with so much liquidity pushing down returns, where can investors find the yields they need to fulfil their requirements?

In terms of pricing, the United States and the United Kingdom are broadly ahead of the pack. Europe is some way behind, and Asia and emerging markets are lagging further. While higher yields are on offer across Asia, it is not a like-for-like comparison because different risks are associated with investing in those markets.

Investors agree life is tougher at this point in the cycle than it was two years ago. But despite record-low cap rates, real estate remains a good place to be relative to other lower-yielding asset classes.

"We're into the second half of the real estate cycle, which means the low-hanging fruit is gone. You can still find opportunities, but you need to put in more work to uncover value," says Kye Joon Lee, director – Asia with Clarion Partners.

Core or higher?

Investors face a dilemma: to invest in the core end of the market, where returns look low in a historical context, or push for higher returns by taking on greater risk. An ongoing focus on stable income in gateway cities based on the prospect of rent increases, coupled with a move toward secondary assets, peripheral markets, alternative sectors and debt products as part of a broader search for yield over the past 18 months, provides evidence of both strategies.

"The way we try to do this is by looking bottom up at assets, which means we're more concerned about the micro of an asset — where it is within a particular locale," explains Chaplin. As a long-term value investor, Aberdeen leans toward lower-risk positions when the market looks stretched, while homing in on "less obvious assets" that can deliver a pricing advantage.

"We're not necessarily looking for long leases but a durability aspect, which means an investment can be characterised by a series of very short leases as long as it provides us comfort that people will re-lease if a tenant left," he says.

As risk appetite grows, investors increasingly are looking beyond traditional mainstream sectors to alternatives such as student housing, healthcare, hotels and leisure.

"We see a huge amount of opportunity in the residential, private rented sector in the UK, which is establishing itself as a future mainstream opportunity for institutional investors. The nation hasn't built enough housing so, with an attractive supply/demand imbalance, the prospect for rents going up is compelling," says Richard Gwilliam, head of M&G Real Estate's property research.

With little cap rate compression on the horizon in developed markets, investors have an increasing reliance on rental-rate growth prospects to drive returns.

Core/core-plus investor TH Real Estate is also focusing on maximising rental income. Says Mike Keogh, an associate director of research and strategy, "It isn't so much a global hunt for yield today; it's a hunt for rental growth. If you've got that, you get outperformance and are cushioned from a potential pricing adjustment as borrowing rates start to normalise."

Investing in faster-growing, late-recovery markets that offer potential for accelerated rental growth is one of the three best risk-adjusted opportunities today, as identified by a Pramerica Real Estate Investors research paper, *The Search for Yield*. PREI, which operates as Prudential Real Estate Investors in the Americas, Japan and South Korea, recommends investors target office and retail assets in government centres and housing-bust markets such as Madrid, Miami and Phoenix, where low supply growth has created potential for rents in CBD areas to grow quickly from a low starting point.

PREI also advocates value-add investing in core markets as a means of earning excess returns via income growth. Little pipeline stock and an ongoing lack of capital expenditure across Northern European cities and established markets in developed Asia Pacific, including Hong Kong, Japan and Singapore, imply a significant opportunity to refurbish and reposition city centre office assets, explains the report. Strong leasing conditions in US office markets mean value can be found in taking on vacant space in the country's gateway cities.

Developing story

"Some of the best-yielding opportunities now, if an investor is willing to go up the risk curve further, [are] on the development side, which can provide an extra 200 basis points of yield on mature assets," notes Presima's Vincent Felteau, a portfolio manager for the Asia Pacific region. He sees value in master-planned developments, which often combine an office complex with ground-level retail, anchored by good transport connectivity.

"Because these projects are planned by a group of experienced developers, usually taking a longer-term investment perspective, we find they provide a very attractive yield over time versus buying one-off assets, which in this environment are getting very expensive," explains Felteau.

The development model is attracting growing investor interest across established global markets.

Build-to-core "is a good area to be looking," in Gwilliam's book. "It's a cheaper way to do it than buying off the shelf, and you're creating a core product at the end of it, with the caveat that this only works in stronger locales with solid fundamentals, where demand is coming back and where there is not much in the way of supply of new prime space."

Rendering of 2929 Weslayan in Houston. The 254-unit multifamily tower — the city's tallest — has been developed as part of National Real Estate Advisors' build-to-core strategy on behalf of the firm's open-end commingled fund in a US$43.5 million joint-venture equity investment with PM Realty Group.

US-based National Real Estate Advisors' managing director Kevin Verdi questions, however, whether "it may be time to shift away from more equity-oriented, build-to-core investing toward types of debt: construction loans, mezzanine debt and preferred equity," given development yields for core projects have compressed.

"At this stage in the economic cycle, in which stronger supply-demand fundamentals and increased rents have been mostly offset by increased land prices and rising construction costs, a more secure position in the capital stack can result in a lower-risk and higher-return outcome when compared to an equity investment," argues Verdi.

Debt and distress

Many investors have turned to debt investing in their hunt for yield; private debt funds raised US$23 billion globally in 2014, according to the FundTracker database.

An opening for alternative lenders has been generated by rising transaction volumes, a stronger growth outlook, and regulatory changes such as Basel III, which restricts bank financing at higher loan-to-value ratios. Yet even in this realm, available returns are diminishing as pricing is driven down by continued low interest rates and increased competition among debt providers.

Global backdrop at a glance

Even with extreme cap rate compression in the United States, where the economy is in expansion mode and interest rates are likely to rise first, the outlook for real estate is strong, given high tenant demand yet muted new development. The market's transparency, stability and liquidity will continue to attract investors from around the globe, particularly from Asia as domestic markets are too shallow for investors to remain focused there.

The UK economy looks particularly healthy, with GDP growth forecast to be the strongest of the G7 nations for the second year running. With greater confidence among businesses and consumers, in an environment where little new stock has been delivered over the past seven to eight years, rental growth is picking up strongly and spreading out across the country.

Dramatic variation can be seen across continental Europe's economies. France is still trying to get into recovery mode, for example, while Spain has made enormous strides but is nowhere near regaining what it lost during the global financial crisis. Yet it is difficult to ignore what is an important economic block, despite recent issues surrounding a potential exit from the euro zone by Greece. Europe is expected to continue to draw global capital in search of relative value.

Set against a backdrop of ultra-low interest rates, Asian markets are very difficult at present. Following stellar performances in core markets such as Tokyo, Australia, Singapore and select provinces in China, yields have come in in line with very strong rental growth. Gaining exposure is one of the biggest hurdles, and markets often are accessed via investing in listed companies or taking a partnership approach.

Standout performers include Sydney and Melbourne, where cap rates are still higher, rental projections are steady, and institutional-quality investments are aplenty.

— Lauren Parr

"Debt investing was a better opportunity two or three years ago. Today, LTVs are gradually moving up, and opportunities are drawing in; the window of opportunity is slowly closing," acknowledges Gwilliam.

One sector where Rocaton Investment Advisors still feels positive on returns is European distressed real estate. "If you're an investor that doesn't require an immediate yield, buying distressed assets from a bank, bad bank or other motivated seller relatively cheaply, fixing and repackaging them before eventually selling off, can be one of the best investments you can make on a global basis," says founding partner David Morton.

Changing trends

Another area of capitalisation for investors, notes PREI, relates to changing market patterns driven by structural trends, which provide an opportunity to tap into long-term growth potential. *The Search for Yield* highlights ongoing urbanisation as a basis for converting older, low-value office, retail or light industrial space to residential use in major cities such as Frankfurt, London, San Francisco, Sydney and Tokyo. Growing discretionary income across developing Asia and Latin America provides another incentive for development of modern residential and retail assets.

"One of the things we definitely see as an opportunity globally is tied into a very big-picture trend of shifting consumer sales from bricks-and-mortar retail to online sales, benefiting the logistics market in most of the world," adds Mike McMenomy, CBRE Global Investors' global head of investor services.

He lists emerging economies in Europe, such as Poland, where there is a burgeoning market for e-commerce, as well as the emerging market of China, where logistics infrastructure is beginning to develop, as among locations that reflect a strong investment thesis.

"Strategies that are buying into the prospect of stable and growing income, whether through rental growth or repositioning, from core to improving or developing assets, all make sense today," says Robert Gilchrist, chief executive of European asset manager Rockspring Property Investment Managers.

Opportunities in aggregate are becoming scarcer as yields have come in over the past year or two. But, because of low inflation, the real rate of return is still fairly high, and property as an asset class remains a good value compared to fixed-income investments. "There are still attractive pockets of value out there; you just have to know where to look," insists Gilchrist. ❖

Lauren Parr is a freelance writer based in London.