Episode 14: Real Estate and Property in the Current Environment

Matthew Strotton - Real Asset Management (RAM) & **David McDonald, CFA** - **IMAP's Investment Specialist** discuss:

- Targeting the healthcare and essential services retail sectors
- Investing here in contrast to other asset classes
- Investment opportunities & considerations
- Approaching investment in the sector

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This podcast series is not meant for retail investors, but instead is meant for financial advice and investment professionals. Please refer to IMAP's website **https://imap.asn.au** for more details.

David McDonald - IMAP (00:18):

Welcome to this podcast in the IMAP independent thought series.

Today, we're going to be looking at investment in real estate and particularly looking at some defensive sectors within real estate and how they can provide some defensive income for clients. Joining me to talk about this today is Matthew Strotton.

Matthew is the head of real estate with real asset management. Welcome Matt.

Matthew Strotton - Real Asset Management (00:43):

Good morning, David. Great to be here.

David McDonald - IMAP (00:46):

So Matt, perhaps to start with, you can give us a bit of a background. I know you are focused on very specific areas within the real estate market.

Do you want to just perhaps run us through the sectors you look at and then we'll talk a little bit more about why those sectors

Matthew Strotton - Real Asset Management (01:02):

Here at Ram, we have two central focuses in terms of real estate sectors that we invest and manage in.

One is the healthcare sector across Australia. And this is a whole variety of we cover a whole variety of uses there from private hospitals through the medical center, daycare centers GP clinic, so on and so on and so forth.

In addition to a sub sector of the retail asset class, which we call essential services retail.

This is the type of retail locations that are central to, to our communities within Australia that are often in comprise your daily needs, shopping and services, obviously, including supermarkets as well as supporting healthcare and other localized offer.

David McDonald - IMAP (01:49):

So, would you describe those sectors as less economically sensitive? Would that be a good description? They sound like fairly defensive areas.

Matthew Strotton - Real Asset Management (01:59):

Yes, absolutely. Defensive and resilient, defensive in the face of a certainly shifting economic conditions…. not just top down, and what might be seen as the material issues are with respect to interest rates and inflation, but also at a community, and a household level.

These are locations that from in with respect to retail, visitations are always going to be in continuous need because of the, the requirements for our, our households in terms of supermarket goods and, and daily needs and services, but importantly, with the ongoing and continuous requirements to ensure our personal health is maintained and, and being available to, to healthcare uses is has been fundamental to our strategy and continues to shine through in an array of particular economic scenarios even through the pandemic, which really introduced a whole array of our disruptors across many real estate asset classes, accepting both healthcare and those essential service goods and services that that continued to be required by all of us on a day to day basis, and healthcare in terms of its resilience.

Not only did our underlying tenants continue to perform quite strongly through the pandemic, but what we've also seen is effectively an increase in demand coming out of the pandemic as a lot of particular operations or any sort of requirements at a personal level, healthcare wise were deferred and are now being taken up.

So, we're seeing a an increase in demand for space of our healthcare operators because of that.

David McDonald - IMAP (03:44):

Right…that makes sense. You know, obviously a lot of us weren't going into offices and department stores and the like were closed down for a while even, but we still had to go to the supermarket, and the farmers.

Matthew Strotton - Real Asset Management (03:57):

Yes, that's right. That's right.

David McDonald - IMAP (03:59):

And does the healthcare and the retail combine in some of your properties?

Matthew Strotton - Real Asset Management (04:06):

Yes, that's a great question. It means that more and more we're introducing, or at least going to acquire localised retail assets that do incorporate healthcare facilities, like what might be a local GP clinic, or a day hospital also combined with allied healthcare allied healthcare are uses that are peripheral to your traditional hospital providers, including physiotherapy, dental services and also include the pharmacies and all of these additional offers.

Those uses we specifically focus when we incorporate new tendencies within our retail properties. And as we look to master plan and develop our retail properties, we are continuously looking to augment traditional retail with healthcare and allied healthcare uses.

David McDonald - IMAP (05:00):

Right, I guess the one thing that strikes me is with healthcare, obviously aging population is probably going to boost demand. Is that an area that is probably growing more than real estate generally, do you think?

Matthew Strotton - Real Asset Management (05:19):

It's a great question. I mean as a student of real estate we've all been preparing for how the dynamics of our real estate sectors are going to change with an aging population.

But in addition to that, as a fundamental driver for the need for space in healthcare, combined with that, we also are seeing all of our communities, all of us, and our families having a greater life expectancy at the same time we are effectively cultivated by government policy, on the need, and the desire to ensure that we're far healthier and in term, and preventing any longer term illness is also at the forefront of our thinking.

Which introduces the need for a greater range of healthcare uses that guides government spending towards the healthcare sector, which continues to be sustained spending for all governments.

As an introductory fact in 2019/20 this spending area was $143 billion, which is around 26% of government tax revenue and an increase of around 24% from the prior year.

So, this continued support from the government to nurture a healthy community is a very strong feature of the industry.

And all of these features combine to continue to support the health of our tendencies and our operators and our partners that take up our real estate space. And as I said, that continues to contribute to the defensive and resilient nature of the income in these real estate properties.

David McDonald - IMAP (06:53):

That's interesting. Matthew, you mentioned there, the government spending and support, I guess we're seeing at the moment with high inflation occurring, that a lot of people are passing through 10, 15% price increases for everything from chocolate to breakfast. Central is the fact that the government is the main funder of these healthcare services, a bit of a restriction there. And I would imagine the dentists, the physios, et cetera, probably don't have a lot of pricing power. Would that be a fair statement?

Matthew Strotton - Real Asset Management (07:27):

I think with the government's spending, that underlying support is going to ensure that the operators can remain defensive through what we anticipate to be a relatively short term spike in inflation. I think it'll underpin the health of our operators such that they can endure these spikes in prices if they can't immediately follow or flow through those additional costs.

David McDonald - IMAP (07:51):

And the tenants, the sort of essential retail as you called it, and the allied healthcare and so on, I'm guessing perhaps smaller businesses compared to the coals and the Woolworths of the world. So how does that go in terms of lease terms and the security of the rent and things like that?

Matthew Strotton - Real Asset Management (08:15):

Yes, naturally underpinning a local supermarket anchor or grocery at community-based center is going to be further enhanced and sustained with a long term lease with a supermarket, like a Coles or a Woolworths or an Aldi.

And that does allow us to introduce supporting uses like fruit, and vegetables and even hair salons, all of those daily, weekly visitation requirements that you would expect in a community center.

It's rare for us to have a retail holding that is not anchored by a supermarket.

If we were to contemplate a holding like that, it may represent a different proposition. It might be neighboring property to what we call a central community node. And all of us are familiar with this. It's not just an area where you can stop and visit Woolworth's, but you have a whole array of local retail and service uses that are in your community.

And these can be owned and operated by multiple landlords. But if your holding is effectively or forms part of that broader node, then it continues to sustain the need for space in those particular properties. And you can achieve quite significant rental uplifts over time.

David McDonald - IMAP (09:31):

Okay.. so when you're talking to advisers' clients about these funds, do you think they normally would look at it as a defensive rather than a growth asset? Is that a fair description?

Matthew Strotton - Real Asset Management (09:48):

That's a great question, David. I think so in one respect. For example, these types of holdings across the "A" retail sector today are sort of either side of early 7% income yields projected on current pricing, what however, most defensive real estate landlords, (and we certainly put ourselves in this particular bucket), are always looking at ways to add value to our existing portfolio. And this might be the expansion of a particular retail property.

I mean, right now, we're in discussions with one of our private hospital providers where we have three of their properties in the portfolio. And in the prior cycle, this hospital operator would have contemplated an expansion model, which might be the introduction of a brand-new hospital within a trade area that they were targeting.

However, with the rising cost of land that we've witnessed in this last cycle, we're now heavily engaged to expand existing facilities.

Now that additional development… that addition of value within the portfolio provides what I term a level of alpha additional value that we look to create year after year after year.

So not only are you enjoying a secure, highly secure defensive and resilient income yield, your manager is also working to introduce that additional outperformance on an annual basis. And we're very active in that respect.

David McDonald - IMAP (11:25):

Okay. I think that the other interesting area is valuations, particularly with listed funds. How often do you value the properties and has that changed much in the last couple of years, given all the big economic, and COVID impacts we've seen?

Matthew Strotton - Real Asset Management (11:45):

Yes, absolutely David, we value all of our assets at least annually. And most of our peers are very similar in that respect. We are starting to see cap rates particularly in secondary locations and beyond the asset

classes we invest in, and I'll elaborate on that a little, as this is what's symptomatic of an early lead into, to the real estate cycle.

So, with interest rates rising and the expectations that some of our competing sectors like retail and some of our weaker office holdings that we've seen in the market, are starting to move out a little bit in terms of pricing.

I'm really interested to see how the appetite to invest and or acquire in our particular asset classes goes from this point.

Some of our weaker properties, I wouldn't be surprised if we've seen Cap rates move say 25 basis points, possibly 50 basis points, but all evidence we've seen in terms of transactional activity within the space continues to support cap rates for smaller community-based retail properties and of course, healthcare.

So, I am personally seeing in this environment, (and I anticipate a little more capital expansion), and this is a delight for me to say, but I would prefer to be in defensive asset classes like healthcare and lower order community-based retail.

David McDonald - IMAP (13:18):

Do you think Matt do you think the changes that we've seen from COVID are likely to be on going in terms of people working from home more, and we've been seeing the coffee shops in the suburbs booming and the ones in the city quite empty that, that type of thing?

Matthew Strotton - Real Asset Management (13:40):

Yes. There's no doubt David. Consumer patterns have changed the day-to-day activities of our office workers across the country.

Has it changed permanently? I think you will see that corporations across the country have effectively recognized that there is going to be a work from home policy.

And I think at a variety of levels that's going to remain for the foreseeable future. Does that, or will that affect the potential supply dynamics and capital return & capital market dynamics of the office sector?

I think it has to, it has to roll through, but the market is quite efficient also. So, what might have been some mooted supply for some of our markets across the country will no doubt start to start to decline.

And as that supply starts to reduce over time, then the take up of space commensurately improves those dynamics. So, I think the market will move a little bit more over time to reflect those changes in consumer patterns, but having an exposure beyond a pure urban or city based real estate exposure and contemplating regional or even country exposures is certainly an interesting topic to consider

And those changing patterns really have benefited more of our regional or non-urban locations across the country.

David McDonald - IMAP (15:11):

Okay thanks… just changing tack a little bit, the other macro topic at the moment obviously is interest rates. And we've seen quite a few RBA hikes already, the economists and the market particularly are pricing in a few more. I am just wondering what impact that has on your business?

What sort of debt levels do you run on the rising rates are a bit of a headwind for the business?

Matthew Strotton - Real Asset Management (15:36):

Yes, I think I'll talk about Australia generally Australian our listed Retail sector for example, is quite conservative in the use of leverage. I think if you were to take the average of all of our peers that are in

the Retail sector, we are either side of say 30% leverage, and there is quite an active approach to hedging those positions and ensuring that interest rate volatility is maintained within a certain band.

Now having said that, the continued concern over what is going to be potentially another one or two rate rises, has been to a degree been reflected in current pricing.

Most of our peers and most of the sector, I think have already withstood the RBA rises and are incorporating future additional rises into the future.

Matthew Strotton - Real Asset Management (16:31):

What I'm closely monitoring, (and I'm sure we all are) .. is just how much of a cold Australia continues to catch from the USA in terms of in terms of economic uncertainty led by rising inflation and whether or not interest rate rises are going to address that.

I do feel just like we have witnessed in the prior two cycles here in Australia, that we are going to fair this this cycle far more far more healthily, certainly than I think our USA friends, and to that end, keeping an eye on where interest rates effectively are going to stabilize is a very important topic for us to monitor.

So, keeping an eye on the interest rate curve, keeping an eye on the 10 year bond yields and forward-looking curves for movements inwards is always going to be a very important one to monitor.

And that would suggest to us when that occurs, which I believe it's very close, (certainly between now and the end of the year we will have visibility on that) suggests that interest rates will stabilize within the near term within the near 12 or 18 months.

David McDonald - IMAP (17:39):

Right. Circling back to part of our original conversation, you are not too concerned about the impact in terms of retail spending and the sort of centers you are looking at?

You wouldn't think that high rates are going to stop people going to a supermarket or a pharmacy so much as maybe not buying clothes and shoes?

Matthew Strotton - Real Asset Management (18:07):

I think the rising cost of inflation and the recalibration of household expenditure always affects retail naturally. It affects all of us across all of the operating fundamentals of all our tenants and retailers.

The strength of supermarkets for example, is that they can pivot quite rapidly in terms of their internal offer. So, they can shift what might be a greater focus on more expensive luxury items through to more daily needs budget items that respond to their local neighborhood.

I've seen that for many, many years Woolworths and Coles are exceptional at being able to do that and respond as are all our grocery operators.

And if there is a period of time where both unemployment and average wages don't catch up to that increased inflation, I would anticipate that period of time to be short lived, as rising labor and income costs address the rising cost of living.

David McDonald - IMAP (19:14):

OK. Perhaps one final thing Matt. I was just curious, if there's anything we haven't really covered here that comes up when you're talking to potential investors, or current investors and financial advisors? What sort of things are often the front of their mind?

Matthew Strotton - Real Asset Management (19:32):

Well, you have had great questions today David.

I think the point that I really emphasize with my team is to be continuously looking for ways to generate added value.

We talk about portfolios being core, and real estate can easily fall in that bracket because it's such a strong, and consistent yielding investment.

But as a group, and certainly as your listeners are looking to consider exposures in real estate… is to look for managers that are continuously looking at ways to increase value to your portfolio.

This can be as simple as being far more aggressive, far more anticipatory in terms of increasing rents with your tenants or being active in terms of:

- extending lease terms
- potentially recalibrating rent review profiles from fixed to CPI or a hybrid
- through to adding value by extending existing properties or
- remixing existing assets, engaging closely with your operators, particularly in the healthcare sector who tend to view the world far differently than a traditional retail or office tenant.

Matthew Strotton - Real Asset Management (20:44):

Building relationships with our operators is a very important part of our business, understanding their wants and needs.

Are they looking for expansion space?

Are they looking to introduce a new facility within a neighboring trade area through to more comprehensive value add and redevelopment options, always looking either within the existing privilege within our properties, or recognizing deficiencies within the supply of space, either in healthcare retail, within our trade areas, and actively looking also to acquire assets that introduce supporting fundamentals to add value over time as well looking for managers that aren't sitting on their hands.

And I'm pleased to be a manager in this country where I see Australians generally always be looking towards the horizon in terms of adding value.

I think we are a very defensive and active market generally.

David McDonald - IMAP (21:39):

That's great. This has been a very good discussion on what's really quite interesting subsector within the real estate market and certainly something that seems to have good defensive characteristics there.

So, it just remains for me to thank **Matthew Strotton from Real Asset Management** for taking part in our podcast today.

And also, a reminder that you are welcome to attend IMAP's upcoming Independent Thought Conference in Melbourne on Tuesday, the 18th of October 2022.

This is an opportunity to see and hear the portfolio managers and consultants who are involved day to day in running managed accounts.

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