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This Week's Top Articles

Real estate social infrastructure is coming of age

Adrian Harrington

Investors are increasingly turning their attention to real estate social infrastructure sectors such as childcare, seniors housing (manufactured housing, retirement villages and aged care), student accommodation, government premises (police stations, courthouses, etc), medical and health facilities as legitimate investment options.

Positive drivers

The growth in real estate social infrastructure opportunities is primarily being driven by:

- demographic and social changes - our aging population is increasing the demand for seniors housing and health services, higher participation of females in the workforce and the growing number of 0-5 year olds is increasing the demand for childcare whilst the rise of international students is one reason the student accommodation market is booming
- the demand for better quality facilities – operators (tenants) and their customers are requiring higher quality facilities. For example, the childcare sector is moving from 'child minding' to early learning which is changing the design and layout of centres away from converted houses, the health care sector is being driven by advances in medical technology and procedures and the aged care sector, supported by government regulation on quality standards, is increasing the demand for higher quality aged care facilities
- government financing and budget constraints - the public sector's ability to fund the level of infrastructure required to meet the needs of the community is under pressure and governments are increasingly seeking private sector participation
- relative high population growth rates and greater density and urbanisation of our major cities - increases the need for investment on social infrastructure assets that support communities both in the inner city and on the urban fringes and
- the growing realisation that operators should focus on their core business - managing and delivering services to the community rather than the provision, ownership and management of the underlying real estate assets.

Drivers add to the investment quality

Real estate social infrastructure is an attractive real estate investment given:

- relatively high yields – social infrastructure assets typically have yields of between 100 and 150 basis points higher than major office, retail and industrial assets
- attractive lease structure - a combination of a long duration initial lease term of circa 10 years plus, inflation protection given rental increases are typically linked to CPI changes and a triple-net structure which means that all capital expenditure and refurbishments related to the asset are paid by the tenant
- stickiness of tenants – tenants are inherently linked to their premises due, in many cases, to the specialised nature of the assets, particularly the internal fit-outs
- strong demand - the favourable demand drivers (noted above) for early learning, health and medical, student accommodation and seniors living
- government support - many of the social infrastructure sectors receive some form of government subsidies or payments and
- the attractive investment characteristics – social infrastructure assets typically exhibit low volatility and generate consistent cash flows as a result of the less cyclical demand drivers, and therefore, offer a low correlation with other asset classes, resulting in attractive diversification benefits for investors.

Risk of investing in social infrastructure

The benefits of social infrastructure assets need to be considered in light of the risks.

The key risk to investors is the specialised nature and often the critical importance of the operator leasing the asset. Owning a private hospital is a highly-specialised asset and having a well-capitalised and competent hospital operator such as Ramsay Health Care is critical. Successful investing in this sector requires a sound relationship between the operator (sometimes a government agency) and the real estate owner and an understanding of the underlying businesses operating within the facility.

Also, social infrastructure sectors to varying degrees have high levels of government regulation and intervention which are susceptible to change. However, this can also be a positive, especially if the government is partially or fully underwriting the cash flows of the sector.

While the increased operating leverage and other industry risks clearly warrant a risk premium, the sectors risk-reward profile has improved greatly as many of these social infrastructure sectors have grown and matured. For many of them, they are no longer a cottage industry. Consolidation of operators in the early learning, health and aged care sectors is well underway. Many of the operators are publicly-listed companies such as G8 in the early learning sector, Ramsay Health Care and Primary Health Care in the healthcare sector and Japarra, Regis and Estia in the aged care space.

Listed and unlisted investment options

There are now five sector specialist A-REITs and four sector specialist real estate developers and managers listed on the ASX providing exposure to early learning, manufactured housing, retirement, aged care and health/medical (Table 1). It is early days, as these entities represent less than 0.5% of the entire listed A-REIT and real estate manager or developer sectors. By way of comparison, social infrastructure real estate represents more than 20% of the market capitalisation of the US REIT Index.

Table 1: ASX Listed Real Estate Social Infrastructure – November 2015

A-REIT	Sub-sector	S&P Sub-sector Classification	Market Capitalisation $m
Folkestone Education Trust	Early Learning	A-REIT	535
Ingenia Group	Manufactured Housing/ Retirement Villages	A-REIT	410
Arena REIT	Early Learning & Medical/Healthcare	A-REIT	403
Generation Healthcare REIT	Medical/Healthcare & Aged Care	A-REIT	393
Aspen Group	Manufacturing Housing/ Caravan Parks	A-REIT	164
Aveo	Retirement Villages	Real Estate Manager/Developer	1,509
Gateway Lifestyle	Manufactured Housing	Real Estate Manager/Developer	663
Lifestyle Communities	Manufactured Housing	Real Estate Manager/Developer	254
Eureka Group	Manufactured Housing	Real Estate Manager/Developer	124

Source: IRESS

The performance of the social real estate focused A-REITs has generally been positive. The two best performing A-REITs in the S&P/ASX300 Index over the three years to 31 October 2015 were both real estate-related social infrastructure A-REITs – the

Folkestone Education Trust (early learning) and Ingenia (seniors living) with total returns of 30.8% p.a. and 24.7% p.a. respectively, outperforming the S&P/ASX300 A-REIT Index's 16.0% p.a.

The unlisted market is also embracing the real estate social infrastructure sector. Three notable unlisted social infrastructure funds are the Australian Unity Healthcare Fund which owns more than $760 million of hospitals, medical clinics, nursing homes, day surgeries, consulting rooms, rehabilitation units, radiology and pathology centres; the Folkestone-managed CIB Fund which owns a portfolio of police stations and courthouses leased back to the Victorian government; and the Transfield-managed Campus Living Villages Fund which owns a portfolio of student accommodation facilities in Australia, New Zealand, the US and UK.

Real estate is not only the big end of town

Much of the real estate media focus is on large office buildings, major shopping centres and infrastructure assets like toll roads and ports. Social infrastructure features solid demand drivers, the evolution of tenants from cottage industry operators and attractive investment characteristics. We expect real estate social infrastructure (both listed and unlisted) to attract more longer-term investment capital and become a viable component of many more real estate investment portfolios.

Adrian Harrington is Head of Funds Management at Folkestone Limited (ASX:FLK). This article is for general education purposes and does not address the needs of any individual.

Australia's pending refinancing revolution

Peter Sheahan

(Editor's note: Guy Debelle, RBA Assistant Governor, made an important speech on benchmarks at a Bloomberg conference this week. He cast doubts over the accuracy of BBSW, the benchmark against which billions of dollars of transactions are priced, including hybrids. There is a substantial amount of funding done at directly negotiated rates, with no reference to BBSW, and low turnover in the interbank market means banks are less willing to use BBSW. A consultation period is underway).

Mortgage broker websites, newspapers and television screens are awash with competitive offers on variable rate mortgage products from a wide array of smaller financial institutions. Names like Mortgage House at 3.79%, ING at 3.99% and Gateway Credit Union's variable rate special of 4.09% are examples raising the volume of conversation about loan refinancing and new loan competition.

In July 2014, the Reserve Bank Governor, Glenn Stevens, when asked about how the increased cost of capital for the banks would be passed on, stated:

"…I imagine it will be passed on in some mortgage rates from the major banks. It is supposed to, that is the point …"

"It is for the banks to decide what they do, but if they made that adjustment nobody should find that surprising or controversial. The whole point of [the FSI recommendation] was to change the competitive landscape between the majors and the others … you can't do that unless some process adjusts…"

The majors are not the only players now

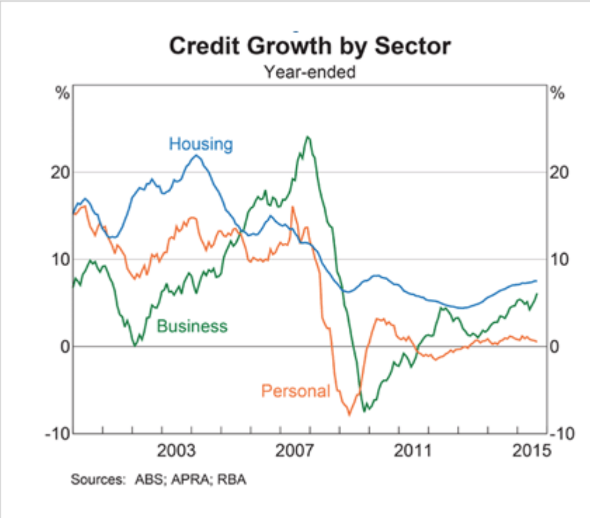
Traditionally, 80% of domestic mortgages were written by the big four banks. If APRA's macro prudential regulations and capital ratio improvements are designed to promote healthy competition, then it seems to be succeeding.

As a result of the out of cycle rate rises by the four major banks in mid-October, sourcing the cheapest deal in Australia will be an emerging psyche in borrowers' minds. A clear price differential is now in place for this be a mainstream pursuit. Nightly news bulletins have recently drawn attention to the great deals on offer through smaller lenders. I expect this to gather momentum until each individual lender achieves their growth targets.

In the last few weeks, more than half a dozen institutions ranging from large regionals, to mutual banks and smaller credit unions, have told me the momentum under mortgage lending for them is intensifying.

To fund this growth, their holdings of surplus liquid assets will be run off in the initial phase as banks see this as the lowest cost funding source. Then they will increase rates on at call and term deposits in the second phase of funding.

Recently, within a few days, one bank redeemed all its excess liquid holdings to meet its expected loan drawdowns. It has run a successful solar panel related lending campaign which has brought a new borrower demographic. It has now engaged its clients on 'ReFi' (refinance) opportunities and is having considerable successes. Conversely, some of the major banks' treasury departments are winding back rates due to a clear void in demand in the early stages of their new financial year.



Put simply the regulatory intentions are having an effect. Possibly the variables are in place and the time is right for demand at smaller banks to exceed all expectations.

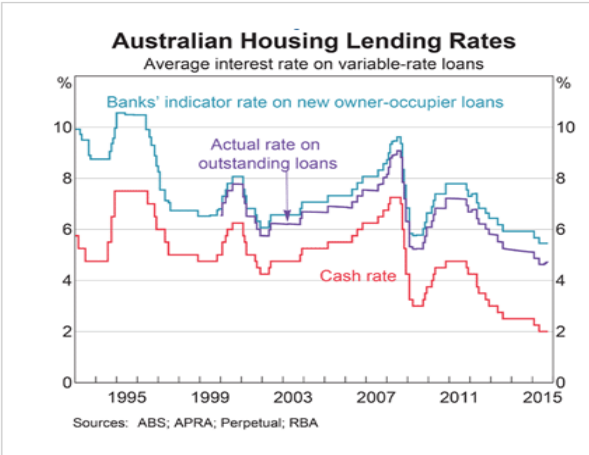
In the last four years, I have not witnessed a period where smaller banking institutions have been overly challenged to fund asset growth. I think the next three months will be more difficult for their funding. I foresee 'ReFi' taking off as a crusade by customers who refuse to pay for a stronger big four bank system. I will be surprised if customers are truly willing to pay the differential of 50-80 basis points on their loan to a big four bank.

The key question is, will borrowers have both the desire and the time over the Christmas holiday period to 'make the switch'? There is a clear opportunity for a valet service business to emerge and assist all existing mortgagees who will not make the switch because it appears all too hard!

Funding the loans is the challenge

The real challenge for smaller banking institutions will be successfully funding the demand. Liquidity holdings will crimp to minimal buffers by those who market their price differential most aggressively, or incentivise the mortgage brokers to place them front and centre in the 'ReFi' battle or new lending campaigns. Mortgage brokers currently arrange about 50% of household mortgages. Their influence in marketing the price advantage of the smaller more aggressive banking institutions will be a key factor in this competitive opportunity.

But this opportunity may be limited to the strict growth targets approved by each banking institution's board. If a campaign achieves the percentage growth target expeditiously then the 'special' may be withdrawn. Marketing of the next best offer will be critical to the longevity of this 'ReFi' phenomenon. But even small percentage improvements in market share will increase real profitability and viability of the smaller banking institutions who have endured years of tough economic competition in the fight for survival.



Term deposit rates are rising as a result

If organic funding by the smaller banks proves challenging through normal channels, then middle market and institutional funding opportunities will arise. Middle market councils, federal and state agencies and religious organisations will be the first source of non-client deposits. I have already found banking institutions' Negotiable Certificates of Deposit (NCD) levels have pushed out from +0.30% to +0.50% this month for 90 days, and more than likely will push out further. The market is questioning what the prime bank BBSW rate set really means when so much activity is done away from the majors at substantially higher rates. Indeed, very little major bank paper is traded on many days.

This funding demand from smaller banks will potentially resume the dynamics of a positively sloped yield curve on all tenors out to one year and beyond rather than the inversion currently evident between six months and two years.

Overhaul of short term pricing dynamics

The pursuit of dependable 'sticky' funds and the challenge to loyalty at rollover may be the new game in town if smaller banking institutions tap real ongoing demand through competitive price dynamics. Substantial change is happening in the way short term deposits and BBSW are priced, with potential implications for millions of investors and borrowers who use these benchmarks.

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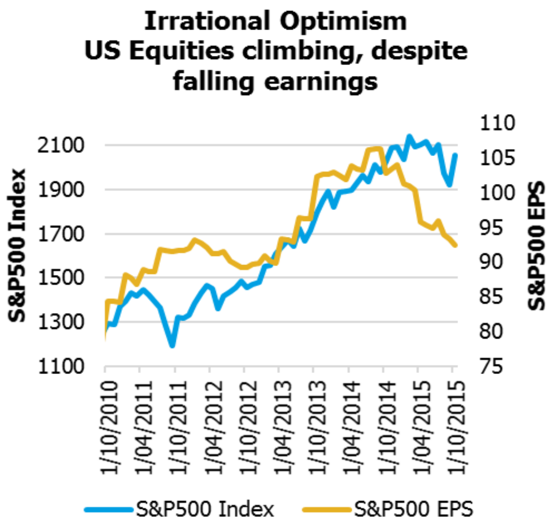
World economy will be 'slower for longer'

Craig Swanger

For some years, most analysts have been expecting stronger economic growth but it has failed to eventuate. The problem is that equity investors fail to recognise the market is over-heated because it has been propped up by ultra-low interest rates for so long. The big question is what happens when the US starts to increase interest rates? Slow economic growth is leading to slow earnings growth which doesn't justify the current level of irrational optimism facing most markets.

Irrational optimism

The final phase of a bull market is typically signalled by irrational optimism. In this phase it doesn't matter what news or data comes from the real world, the financial world can read it as positive.



That phase is well into its final throes right now, as illustrated by October's 'bad news rally'. This rally started with the poor employment figures from the US, followed by concerns expressed by some of the world's most powerful central banks about the global outlook, and then rounded off by poor earnings growth figures from US corporates.

In essence, three events that should be a signal for a weak outlook for equities instead sparked a rally. This just isn't rational.

Irrational economists

As each year has progressed since the GFC, optimistic forecasts have been revised downwards, then the predictions for the following year are for much higher growth, and around we go again.

This year was no different. At the start of the year, the International Monetary Fund (IMF) had forecast 4.0% per annum global growth. They have already reduced that forecast to 3.1%, and the reality is more likely to be 3.0% or lower.

There are two reasons for this persistent bullish outlook. The first is job security: no Wall Street researcher or bank economist wants to publish a negative outlook unless they are very sure about it. Negative outlooks do not encourage people to borrow more money or to invest more. Even the IMF has a positive bias because they don't want to inadvertently reduce economic growth by scaring consumers and businesses into spending less.

The second reason growth has been persistently lower than expectations is because everyone is assuming that conditions will revert to the way they were prior to the crisis. But the evidence is heavily against a return to historic averages, at least for the next ten years or more.

Three reasons to expect slower growth

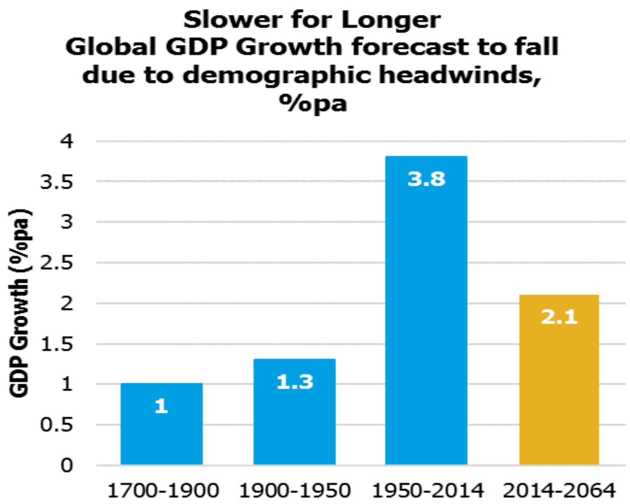
Slower global growth is anticipated over at least the next decade due to:

1. The western world's baby boomer generation retiring over the next 10-20 years means less consumer spending and lower economic output. Assuming no major increases in productivity, for example, from technology, this factor alone will push global growth down to nearly half the pace of the last 60 years.

2. Fiscal austerity across the US and Europe will continue.

3. China's inevitable but painful transition to a consumer-led economy has reduced emerging market growth, and will do so until India is able to pick up the reins in ten years or more.

A possible fourth but unpredictable cause of lower growth stems from the challenge of ending ultra-low interest rates in the US, Europe, UK and Japan. This has helped the US economy to climb out of recession and appears to be slowly working in Europe, but it has the undesirable side effect of encouraging borrowing to invest. It supports financial markets more than the real economy and therefore the wealthy over the less wealthy.



(Source: FIIG Securities forecast).

At some time, central bank support must end, but markets have become addicted, so the withdrawal process could be highly volatile. Increase rates too quickly, and markets could collapse. Increase them too slowly and asset prices could rise even further, causing more damage when the bubble eventually has to burst. Witness for example the irrational response that Wall Street had in September when the US central bank decided the economy wasn't healthy enough to increase interest rates. On the live coverage of the announcement from the Fed, Wall Street traders could be heard cheering in the background, despite the obvious negative implications.

Currency and bond markets predicting slow increase in rates

Unlike the stock market, bond markets have been telling us for some time now that growth will not return to pre-GFC rates and so interest rates will not rise to previous heights. Bond markets are currently predicting that interest rates will remain below long term averages for the next ten years at least. The US government's 10 year bond yield is 2.02% p.a., implying their cash rates probably won't rise above 3.5% p.a. over the next 10 years. Similarly, the Australian 10 year government bond yield is currently 2.65% p.a. which implies that the RBA's cash rate probably won't get above 3.75% p.a.

Similarly, currency markets have started to price in an expectation that rates will remain very low in Europe and Japan, and that even the US will keep rates much lower than the past despite its stronger economy.

The reason for this is the 'currency wars' raging globally, in which central banks are keeping interest rates low to keep their currencies low. A lower currency means that an economy's exports are more competitive. The EU, Japan and China are all using this method, meaning that if the US were to increase rates rapidly, the USD would rise quickly against other currencies, their exports would become more expensive and therefore less in demand, and their economy would be hurt.

All of this adds up to interest rates being very low globally, regardless of the strength of the US economy, until Europe and Japan, and maybe even until China, can repair their economies.

Impact on Australian investors

A slower global economy and the already weak Australian economy are expected to lead to the Australian dollar falling to 65 cents. It could go lower if the slowdown in China worsens or if we have a steep housing market correction. Slower growth is also bad news for anyone expecting equity market returns to return to historic highs. Slower economic growth must lead to slower earnings growth, which eventually has to be priced in to share prices.

It's a risky strategy to rely on bank term deposits to provide an income to live on. A slower global economy will mean that all central banks will hold interest rates very low for years. With this global backdrop, and with the Australian economy also weak, the RBA is unlikely to increase interest rates for many years to come. It is even possible that bond markets, despite setting their expectations low, are still being too optimistic about growth.

Year after year Wall Street's equities-biased analysis predicts that growth will return, so they expect company earnings to rise, which justifies high equity prices. But year after year, they have been proven wrong.

My conclusion is that the global economy and equity earnings will remain stubbornly slower for the next decade at least. Low economic growth means bond yields will remain lower than expected. For investors, particularly those reliant on term deposit earnings or dividends to fund their lifestyle, it's time to rethink your strategy.

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Dealing with time zones when pricing global ETFs

Matthew Leung

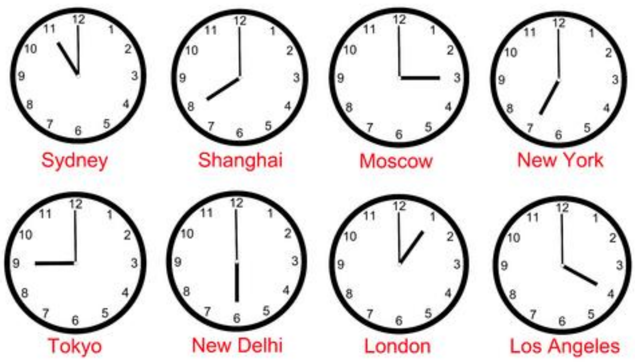
Many investors wonder how Exchange Traded Products (ETPs), including Exchange Traded Funds (ETFs) that track international markets are priced on the ASX when the underlying offshore markets are closed. Australians often find out how the US market has performed overnight by listening to the news whilst heading to work or reading the paper with their morning coffee. This can lead to some confusion, as although a news report might say the S&P 500 or the NASDAQ has moved by a certain percentage overnight, this price change is often not exactly reflected in the opening price of funds (which aim to track these indices) when the ASX starts trading from 10.00am.

A typical question we receive is "The S&P 500/NASDAQ etc. did +% or -% last night – why isn't my fund doing the same?"

Futures markets continue to trade when stock exchanges are closed

There *is* a ready answer. These differences are explained by the differing time zones in which the international exchanges around the globe operate, and the fact that futures markets operate continuously around the clock even when certain exchanges are closed.

We'll use the [BetaShares NASDAQ 100 ETF (ASX Ticker: NDQ)]() as an example (and ignore the effect of currency fluctuations).



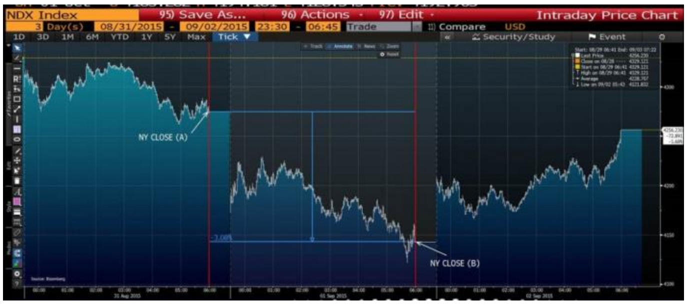
When tracking its benchmark index (the NASDAQ 100 Index), NDQ has performed well since inception. The chart below shows NDQ vs. the NASDAQ 100 Index. Although you can't see it, there are actually two lines being plotted here (the two lines are virtually indistinguishable from each other).

Period 26 May 2015 to 30 September 2015. Source: BetaShares. Past performance is not an indicator of future performance.

Time zones and fund pricing

The charts below show the respective returns of the NASDAQ 100 Index and the Nasdaq 100 Futures Market on 1 September 2015 (NYC Time) and examine how these reconcile with the pricing of the BetaShares NASDAQ 100 ETF when it opened on the ASX on 2 September 2015.

At the close of the US 'cash' equities markets at 4pm (New York time) 1 September 2015, the value of NASDAQ 100 Index – based on shares trading on this market – was down 3.08% on its closing value of the previous day. This is the figure typically quoted in news reports in Australia over morning coffee. These reports will say, for example, "the Nasdaq closed down 3.08% today."



Yet it should be noted that the ASX market won't open until 10am Sydney time, or around 4 hours (depending on daylight savings) after US equity markets have closed. Will the 3% decline in the market still be relevant? After all, market sensitive news is still being released. Indeed, it is often the case that companies release important new information after the US cash equities markets (like the New York Stock Exchange) have closed for the day.

New information is in the price when ASX opens

This new information is reflected in the NASDAQ 100 Futures Market, which continues to trade even *after* the US equity market has closed. The chart below shows the price of the NASDAQ 100 Futures. As might be evident, the futures price tracks the actual Nasdaq 100 cash index quite closely when US equity markets are open.

The gap between the second red line and the green line, however, shows the performance of the Nasdaq-100 Futures prices *between* the time of the US equity market's close and the ASX open. As seen, on this day, the NASDAQ 100 Futures price rallied by 1.16% in this period, perhaps reflecting the release of some positive market news.

Here's the important point: the market makers involved in the Australian-listed NDQ ETF will set opening prices for the Fund with reference to the NASDAQ-100 Futures market as at ASX's market open. It is the best indicator of fair value while the US equity market is closed.

The opening bid-offer prices of NDQ ETF will reflect the *higher* NASDAQ-100 Futures price at the time the ASX opens. What's more, the closing bid-offer prices of NDQ ETF will reflect the price of Nasdaq-100 Futures at around the ASX close at 4pm Sydney time.

It follows that the overnight percentage changes will reflect the percentage changes in the NASDAQ-100 Futures price at the time of the ASX close the day before and at ASX open the following morning. Due to the timing gaps with the opening and closing times of the NYC, these movements will often not mirror those of the actual NASDAQ physical index.

To be precise, the actual opening and closing recorded prices of NDQ ETF will depend on the time at which the first and last trades take place on that day, which should be close to 10am and 4pm respectively though not necessarily exactly at those times. That means that if, for example, the last trade of NDQ ETF takes place at 3.45pm then the closing prices will be reflective of the Nasdaq-100 Futures price at 3.45pm.

Matthew Leung is a Business Development Associate at BetaShares Capital, a leading provider of Exchange-Traded Products (ETPs). Please note the charts are larger and easier to read on our website.

Great businesses where customers do the work

Jason Sedawie

What business would you like to own? For some, the dream might be McDonalds, Subway or even the local Laundromat, all potentially good businesses. But some new companies have more compelling operating models. Uber owns no cars, Facebook doesn't pay for its media content and Alibaba, the world's largest e-commerce site, has no stock to store. They're all great businesses because they require little inventory and have low capital costs. They also become better businesses as they get bigger because of the network effect (see Facebook below). Some businesses like Tripadvisor have customers that do their work for them. That's a fantastic business model - customers make the business better for free.

You are the content

Facebook doesn't buy TV shows. It's a reality show that is you. Your posts are the content. Unlike other media businesses, Facebook doesn't pay money to produce shows or write off shows you don't like. It makes money from your content by placing advertising within your newsfeed. On average, 1 in 20 posts have an advert. In the past 12 months, their global average revenue per user was $10.47. Australia is not broken out but the average US user brings in $34.

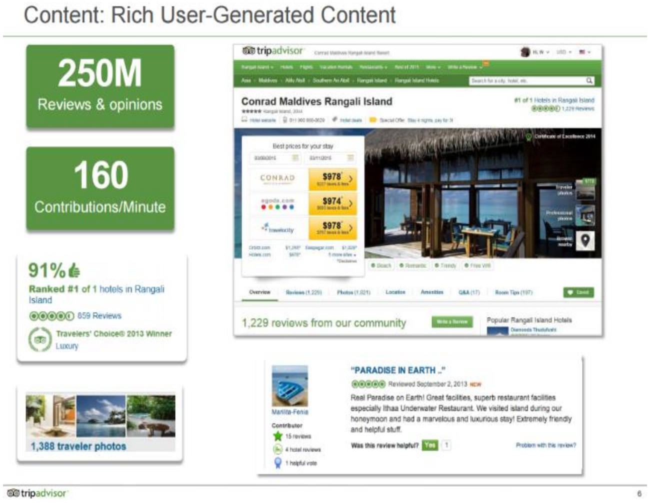
All those likes you click add up. Facebook needs 70 likes to understand your personality better than your friends. With 250 Facebook likes, a computer can know you better than your spouse. Facebook has a Superbowl-like audience every day where advertisers can target specific customers with a compelling alternative to television advertising. Facebook doesn't need to market to sign up new users. Current users help Facebook grow for free as they send out links to sign up friends. The network effects are strong with one billion daily active users. A past example of the network effect is the telephone. The more people who own telephones the more valuable the telephone is to each user. Facebook is the same.

The average gross margin (sales minus costs of goods sold) for S&P500 companies is 33%. A large gross margin means greater potential profitability. Facebook's unique business model delivers its 83% margin. The majority of expenses are employees researching and developing new services such as Instagram, instant messaging with WhatsApp and virtual reality with Occulus Rift. According to Nielsen, the average Australian spends 1.7 hours a day on Facebook. It's easy to admire a new age media company that doesn't pay for the content that drives the business.

Customers working for you

Tripadvisor is a similar user-generated model. It is the world's largest travel site allowing travellers to plan and book their perfect trip. Tripadvisor doesn't employ staff to write hotel reviews, their customers do it for them. Every day, the CEO wakes up and customers have added thousands of more reviews every night. I personally like the sound of this business.

Tripadvisor has 250 million reviews on 5.2 million places to stay, eat and things to do. You couldn't hire enough staff to build it. Frequent reviewers receive virtual badges and you can guess how much that costs. Users are even willing to write reviews on small mobile screens. Like Facebook, it has a virtuous circle where more reviews lead to more traffic which leads to more reviews. Tripadvisor employs only 3,000 staff compared with 18,000 staff at Expedia and 12,700 at Priceline. Gross margins are even larger than Facebook's at 96% (that's not a typo). The majority of expenses are sales and marketing, such as television advertising. As the diagram below shows, customers (free employees) add 160 contributions a minute.



Source: Tripadvisor 2Q Investor Presentation

Can the business scale?

Apart from user-generated content, other good businesses involve companies that can grow and scale with little additional staff. As an ex-accountant and fund manager, I appreciate the benefits of scalability. Good people are hard to find. As accounting or law firms grow, they need to add more staff as they win new business. However, as a fund manager grows they don't have to increase staff numbers commensurately. Look at the success of Magellan and Platinum. Magellan manages $39 billion with only 90 staff.

Another great business model is one that involves large-scale exchange traded funds (ETFs). There is none of the key man risk associated with star portfolio managers, and it's hard to underperform a benchmark when you create it. In most sectors, ETFs are highly scalable with few of the limits to capacity evident for specialist managers such as hedge funds or small caps. In fact, as an ETF attracts more money it becomes more valuable to customers as liquidity and trading increases. For example, the US ETF provider, WisdomTree (represented in Australia by BetaShares), employs 124 people to manage $60 billion.

High gross margins and scalability

There are many great businesses out there but technology tends to top the list. The reason why the NASDAQ is one of the best performing indexes is because their companies tend to have high gross margins and scalable business models. Anyone in an operating business would love to have these characteristics. It's hard finding good staff and attracting customers. Let your customers do the work and scale your business!

Jason Sedawie is a Portfolio Manager at Decisive Asset Management, a global growth-focused fund. *Disclosure: Decisive holds Facebook in its fund. This article is for general purposes only and does not consider the specific needs of any individual.*