Real Estate

Here for the duration

Long income real estate as a distinct real estate investment class

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We live in uncertain times. For many investors, uncertainty may offer opportunity. But what of those for whom resilience and a steady income stream over the long term is more important than near term outperformance? What constitutes an acceptable reward for investment risk in a world where 10Y bunds produce a negative nominal yield? In such circumstances, it takes creative managers and patient capital to find a solution, and in this paper we argue that the burgeoning European long income real estate ("LIRE") fund market presents investors with an appropriate strategy to meet present circumstances, and to prepare for whatever the future may hold.

The problem

Mature pension plans have seen the assets on their balance sheets swell in recent years, as declining risk-free rates and central bank asset purchase schemes have inflated values across most financial asset classes. On the face of it, this shouldn't be much of a problem – but at the same time, these rising asset values have made it more difficult for some pension funds to meet their current cash demands. For pension plans that hold mostly high-quality corporate and government debt, these traditional mainstays of a portfolio are in many cases no longer capable of providing the income needed to cover payments to current beneficiaries.

The solution

In the search for a low-risk alternative, we believe that European LIRE investments provide an opportunity to bridge the gap left by fixed income allocations. In particular, the following characteristics of LIRE investments stand out:

Secured long-term cash flows

The defining characteristic of LIRE is of course that it is rented for the long term. By LIRE, we mean investment in property with a fixed minimum lease term of at least 14 years, but generally specialist LIRE fund average lease terms can be expected to be 20+ years; whereas a more standard core real estate fund will often have an average lease term in the range of 7-10 years.

Investment grade counterparties

Covenant is key. The value of LIRE is dependent in large part upon the resilience of its income stream. A long lease duration but poor credit does not truly count as a "long income" asset – since the risk of vacancy or credit loss is high regardless of the contractual obligations of the tenant

Tangibility

In contrast to fixed income and equity allocations, real estate provides ownership of a tangible property asset. Even in the situation where an asset falls vacant, there is a long-term residual value which is preserved – often with the potential for a change of use in the future providing an additional backstop to values.

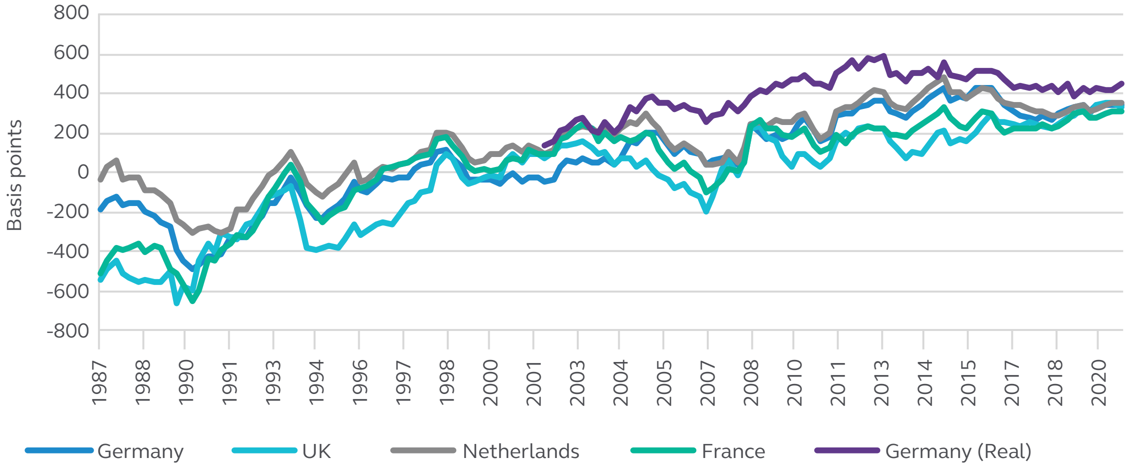
In respect of long-term residual value, LIRE investors must also consider future risks (e.g. climate events) as well as the changing investment market. LIRE investors should target high quality buildings that proof against potential future legislative interventions, especially with regard to environmental sustainability.

Yield premium (inflation-linked)

Even though yields have fallen across property markets in recent years, they have not kept pace with falling bond yields. As a result, European prime real estate now enjoys a healthier spread over nominal government bond yields than ever before, at approximately 300-350 bps. LIRE rents are also typically indexed to Consumer Price Inflation ("CPI"), and so arguably the more appropriate comparison is against real government bond yields, in which case the spread is even more generous, providing an additional approximate 100 basis points of income return.

Exhibit 1: Prime real estate currently provides an uprecedented spread over government debt

Spreads (Prime office vs government 10Y)



Source: Property Funds Research, Marcrobond, April 2021

Cometh the hour

For the following reasons we believe the present moment is particularly appropriate for the growing European LIRE fund market.

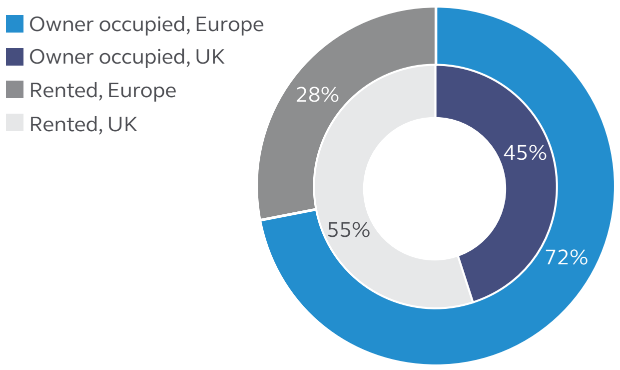
1 Our base case assumption is that continued monetary easing will unlock pent-up corporate and consumer demand and drive near term economic growth. This has the potential to prove an opportune moment for investors in real estate in general, who would benefit from strengthening occupier demand while still enjoying a historic yield premium against other asset classes. Further, we believe that over the medium term, government and corporate bond yields are likely to stay low and LIRE investments will continue to provide relatively attractive risk-adjusted returns.

2 Investors today are faced with inflationary uncertainty. There are risks on the upside as central banks indicate that they will tolerate some above-target inflation while the recovery takes hold; but equally deflationary risks pertain as the full damage of the pandemic becomes clear and the potential for new variants and lockdowns persists. Against this backdrop, an investment which provides exposure to CPI through long term contracted rental income is attractive, and even more so given that LIRE lease contracts often also include a collar and cap, limiting exposure to deflation.

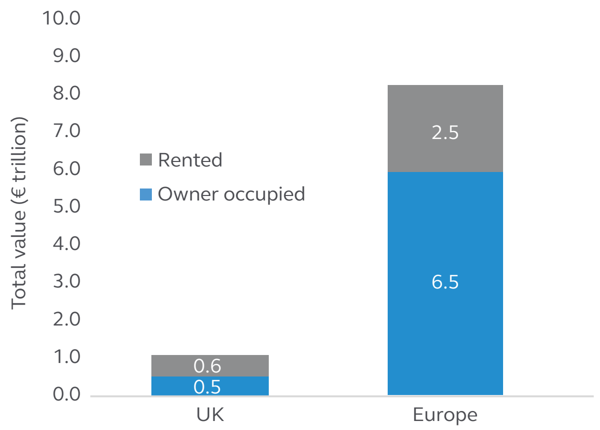
3 The LIRE fund market in Europe is still at an early stage. There has been a perception among real estate investors that long-term lease contracts are unattainable in most European occupier markets. Although they are rare when compared to the UK market, opportunity abounds. LIRE funds will often target sale-and-leaseback transactions as a large portion of the property that they will source. Given the European owner-occupied commercial real estate market is estimated to be 13 times larger than in the UK, the investment universe is huge. The trick, of course, is being able to access this deep potential market – and this is another reason why the moment is opportune: large corporate occupiers do not necessarily wish to be investors in real estate, especially at a time when many companies are beginning to understand the level of capital expenditure required to meet the growing efficiency, sustainability and wellness demands being made of modern workplaces. Capital that can bear the up-front demands of building and refurbishing high quality real estate will be rewarded by an occupier who is committed to the building, and who has realised proceeds for productive reinvestment in their own businesses.

Exhibit 2: The European LIRE market has the potential to dwarf that of the UK

Owner-occupied vs rented commercial stock



Total UK and European estimated commercial real estate stock



Source: Savills, MSCI, Blackrock, Property Industry Alliance, Principal Real Estate Europe, IPE. All data as of 2017.

Summary

The most important feature of the European LIRE strategy remains its potential for resilience and securing a steady income stream backed by strong credit, rather than its capacity for growth. Even if rates and yields begin to rise in the future, the current spread provides significant headroom before LIRE yields are likely to follow suit. For defined benefit pension schemes following a liability matching strategy, future rate rises come with a corresponding increase in the discount rate applied to liabilities, and so this risk is tolerable in any case. Above all, real estate remains a tangible asset, with the potential for long term capital preservation and even enhancement, as long as the property is wisely selected.

In the meantime, investors ready to withstand the illiquidity of LIRE can benefit from long term inflation-linked cash flows with highly credible counterparties – and all at a highly attractive yield premium.

Risk considerations

Investment involves risk including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

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MM12143 | 05/2021 | 1637002 - 12/2022