For Investment Professionals only

M&G INSTITUTIONAL

Investment intelligence

European long lease real estate: a defensive alternative

M&G INVESTMENTS

August 2018

- In a low yield environment, institutional investors are seeking long-term, secure and growing cashflows
- Long lease real estate offers inflation protection and smoother rental payments than traditional real estate
- Long lease real estate has the potential to generate comparable total returns to a traditional core real estate strategy over the long term, with lower volatility
- There is scope for a significant yield premium over equivalent-rated public bonds, offering attractive relative value and a buffer against potential pressure from rising long-term interest rates

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

In a world in which income can be challenging to find, secure and growing cashflows are sought after by pension funds, insurers and other institutional investors.

European long lease real estate – in which a property freehold is sold by its occupier and leased back on a long-dated lease – can offer long-term, typically inflation-linked income streams with usually less volatile returns through a market cycle than traditional real estate.

In Europe, expectations are for interest rates to remain low in the medium term and there is significant uncertainty on the direction of future policy.

In this environment, long lease real estate can supply predictable, contractual cashflows from tenants' rental payments, over lease terms of usually 15 years or longer. These cashflows can offer a significant yield premium over both government bonds and corporate bonds of comparable credit rating, providing a buffer against the impact of interest rate rises.

At a time when the medium-term outlook for European real estate is for returns to be driven by income rather than capital growth, long lease real estate is likely to offer a lower-risk alternative as a consequence of the longer lease terms and periodic rent reviews linked to inflation.

This paper compares investment in long lease strategies with traditional real estate and public bonds.

We use available data for Europe, where the long lease real estate market is still developing and where we launched the first pooled fund (the M&G European Secured Property Income Fund, 'Euro SPIF') in 2015 – alongside our experience of the more mature UK long lease real estate market, where we have invested since 2000, initially for our parent the Prudential, and manage the largest UK long lease fund, the M&G Secured Property Income Fund ('SPIF').

Long leases and inflation protection

The European economy continues to strengthen, with a broadening of economic growth across its major markets, discussion of potential tightening in monetary policy, and expectations for inflation to rise.

Against this changing economic backdrop we anticipate increasing demand by institutional asset owners for inflation hedges and assets to cushion against interest rate rises, to protect against changes in the economic climate while continuing to secure attractive yields.

European long lease real estate incorporates a number of features that have the potential to support these investment goals.

Long-dated, contracted cashflows with inflation-linked rent reviews offer a long-term match for inflation. The long leases are also associated with lower letting risk compared associated with traditional real estate, meaning cashflows are more predictable and secure over the long run.

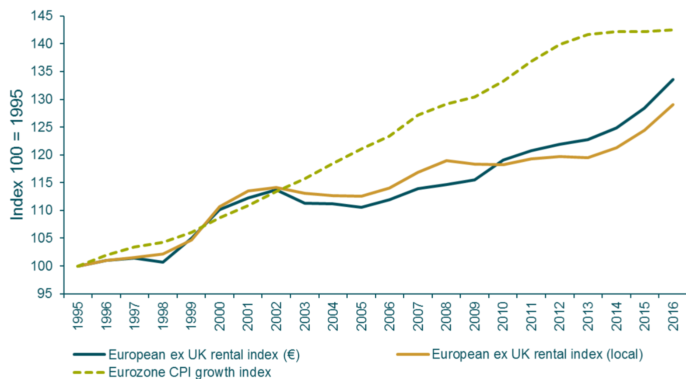
In addition, the inclusion of rent review floors and/or upwards-only review clauses in many long lease contracts can help protect performance in a low or negative inflation environment. Conversely, at times of high inflation any fixed and/or capped elements in a lease can marginally limit the ability to track inflation.

A long-dated inflation match supported by protective features

Since the early 2000s, Eurozone inflation has outpaced rental growth in the European real estate market. Over the period 2002 to 2016, rental growth, as represented by the IPD All Property European ex-UK Rental Growth Index declined in real terms by an average of 0.5% per annum. Over this period, a long-term lease with rent reviews linked to inflation would have outperformed a traditional real estate lease.

Europe's rental market is now catching up as the economic recovery accelerates. In the near term, a larger proportion of real estate returns are likely to be driven by income, underpinned by rental growth, given the significant yield compression already seen across asset classes including property.

Inflation: Eurozone CPI vs European (ex-UK) rental growth



Source: Bloomberg, IPD, as at 31 December 2016

Over the long term, real estate rental growth should broadly track the rate of inflation. This scenario implies that long lease real estate would perform in line with the traditional rental market over many years.

Yet in relative terms, long lease real estate incorporates less real estate risk, since the long-dated leases reduce the letting risk associated with traditional real estate. Long lease assets are consequently significantly less exposed to the volatility associated with occupier supply and demand dynamics, and to risks associated with re-letting, such as the need for capital expenditure. This results in an attractive risk-reward profile and lower volatility of returns.

The importance of this potential advantage is further highlighted by the fact that during the period 2001 to 2016, approximately 80% of returns generated by the European IPD All Property (ex-UK) Index were attributable to income returns. With this trend anticipated to continue, institutions seeking smoother returns may benefit from the ability of long lease real estate to offer long-term, predictable cashflows.

The impact of interest rate movements

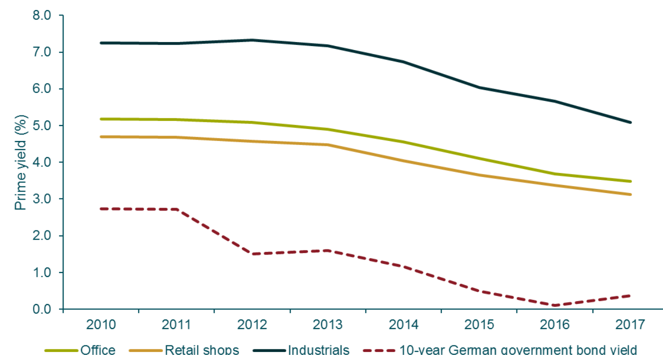
European long lease real estate also offers defensive characteristics should interest rates in Europe rise. The sector has a number of fundamental drivers, including relative value to traditional real estate, market supply and demand dynamics and long-dated bond yields.

Higher government bond yields would be expected to push up yields in real estate over time. For long lease real estate, the long end of the yield curve is most relevant due to the extended lease lengths. These can range from 15 years to 50 years or more: for example, Euro SPIF had a weighted average lease length of over 30 years as of 31 March 2018.

In Europe long-dated government bond yields remain relatively low. European real estate continues to offer a significant spread over the equivalent government rates, as demonstrated in the chart below. This chart uses traditional real estate data in the absence of European long lease data, but long lease real estate offers a comparable spread over government yields.

The data suggests that if government rates were to rise further there would still be a healthy spread 'cushion' offered by real estate and long lease real estate. Further, real estate offers a significant income premium above equivalent bond yields.

Yields: European property vs German government bonds



Source: Bloomberg, JLL Western Europe (ex-UK) Prime property yields, as at 31 December 2017

Increasing real yields at the long end of the yield curve may be seen in an improving economic environment. In this scenario, traditional real estate would be expected to be perform strongly, given its link to the underlying economy. Long lease real estate would be expected to correlate with traditional real estate, although with a less volatile return profile.

The combination of higher interest rates and improved economic fundamentals may result in better rental growth prospects for both traditional and long lease real estate. Inflation also tends to be higher in a positive macro environment and therefore rental payments linked to inflation in long lease real estate would be expected to benefit from these uplifts.

The global economy is likely to prove to be reasonably sensitive to changes in interest rates, suggesting movements in government yields may be limited. In addition, the long end of the yield curve is driven by long-term expectations, which tend to be less volatile than the short end of the curve. EuroSPIF does not use structural gearing, which also minimises sensitivity to interest rate movements.

However, if rises in government rates are driven primarily by higher inflation, the CPI linkage inherent in a typical long lease real estate asset can offer a high degree of protection.

We therefore believe long lease real estate is likely to prove resilient in a rising rate environment and should continue to offer strong relative value compared to alternative investments.

Credit risk and the 'illiquidity' premium

The long-term, contractual cashflows associated with European long lease real estate can be compared with expected returns on a relevant long-dated bond to assess the reward to investors as compensation for risk.

Below, we analyse the expected asset-level returns for certain long lease real estate assets, based on three scenarios that make different assumptions for end-of-lease-term capital value. This shows a significant return premium to compensate investors, reflecting the additional credit risk of the investment above a government instrument, and the relative illiquidity of real estate.

All of these assets incorporate periodic rent reviews with explicit CPI linkage to provide inflation protection. Additionally, investors may benefit from the potential capital value upside of the real estate at lease expiry as assets are repositioned or leases extended.

1. Retail bank, Spain

In May 2017, we acquired a portfolio of 15 bank branches let to Santander. The leases had a contracted time to lease expiry of 27 years, with inflation-linked rent reviews based on the euro-area Harmonised Indices of Consumer Prices (HICP) measure. At the time of purchase, Santander had a credit rating of BBB and market capitalisation of €84 billion, making it a systemically important bank on both a European and global basis.

As at the date of acquisition, our base case underwritten returns were expected to generate a 131 basis point (bps) spread over the 30-year Spanish government bond.

Forecast real return (per annum)	Upside	Base case	Downside
Santander portfolio	**4.33%**	**4.15%**	**3.96%**
Gross spread over Government of Spain*	1.49%	**1.31%**	1.12%
Gross spread over Government of Germany**	3.36%	**3.18%**	2.99%

*30-year Spanish Government Bond: 2.84%, as at 12 April 2017
**30-year German Government Bond: 0.97%, as at 12 April 2017
Source: M&G, Bloomberg. All returns are calculated gross of fund expenses

2. Municipality, Sweden

In January 2018, we purchased a newly developed care home in Visby, Sweden, let to the local municipality. The lease length was 25 years with 75% of CPI reflected in annual rent reviews. The credit profile of the lease is very strong given that if the municipality defaults, the Swedish state is obliged to honour the lease. Furthermore, land supply is constrained in the region, supporting the fundamental real estate value, which also has potential alternative use at lease end.

The return premium available on this sale and leaseback, based on M&G's forecast base case capital value, would be 230bps per annum over a 20-year Swedish government bond. The value of the asset need only be 35% of the purchase price at lease expiry to outperform the bond.

Forecast real return (per annum)	Upside	Base case	Downside
Visby care home	**4.13%**	**3.80%**	**3.45%**
Gross spread over Government of Sweden*	2.63%	**2.30%**	1.95%
Gross spread over Government of Germany**	3.13%	**2.80%**	2.45%

*20-year Swedish Government Bond: 1.50%, as at 8 November 2017
**20-year German Government Bund: 1.00%, as at 8 November 2017
Source: M&G, Bloomberg. All returns are calculated gross of fund expenses

3. Hotel, Germany

In December 2016, we acquired the ground rent of a hotel in Munich, Germany. A ground rent is a freehold land ownership with right to receive an affordable rent payment from the building owner, often for a very long period (in excess of 100 years). Rents are contractually linked to CPI and are set at a very low level at inception in order to remain affordable over the long term.

Expected returns from the investment are forecast to be 344bps above the 30-year bund. Assuming a BBB corporate credit rating with associated spread of 180bps, the illiquidity premium would be 164bps, offering strong relative value, long duration and inflation protection.

No upside scenario is assumed given the very long investment horizon of the ground rent transaction.

Forecast real return (per annum)	Base case	Downside
Munich hotel*	**4.14%**	3.11%
Gross spread over Government of Germany**	**3.44%**	2.41%
Gross spread over BBB corporate bond***	**1.64%**	0.61%

* The ground rent lease term is 199 years, but for purpose of the returns calculations, it has been limited to 50 years
** 30-year German Government Bund: 0.70%, as at 9 June 2016
*** Theoretical 30-year instrument derived using a BBB bond spread of 1.80% over bund, Bloomberg, as at 4 May 2018
Source: M&G, Bloomberg, as of 4 May 2018. All returns are calculated gross of fund expenses

Delivering inflation-linked total returns with lower volatility

Returns from long lease real estate can be less volatile than traditional real estate investment, owing to a number of factors related to the nature of the leases.

At the point of acquisition, over two-thirds of the value of a typical long lease asset comprises the present value of the contracted cashflows. Such income streams are key to delivering smooth performance during market downcycles, as there is a high degree of certainty in relation to future cashflow and much less reliance on traditional real estate factors, such as occupier demand and building vacancy rates.

The long lease terms also mean that the residual value of the real estate asset at lease-end has a smaller impact on the value of the overall asset compared with traditional real estate. This lowers the sensitivity of long lease real estate capital values to the property cycle. Furthermore, the predictable nature of rental changes means smoother payments over the long term.
The lower volatility associated with long lease strategies can be evidenced with our UK long lease strategy (SPIF), which launched in 2007 so has a longer performance track record than Euro SPIF.

Features of inflation-linked long lease strategies

- Long-term contracted cashflows, offering income security and smoother returns
- Periodic rent reviews linked to CPI
- Leases are often 'triple-net', meaning that costs of real estate ownership, such as property taxes and capital expenditure, are the occupier's responsibility
- Access to capital upside potential via exposure to the real estate at lease expiry

The chart overleaf shows SPIF's performance versus the UK traditional real estate index (MSCI UK All Properties). Over the ten years since the strategy launched, SPIF's standard deviation of 4.75 is substantially lower than the 5.22 standard deviation of the MSCI Index. Such lower volatility in performance is accountable to the long-term, predictable income streams

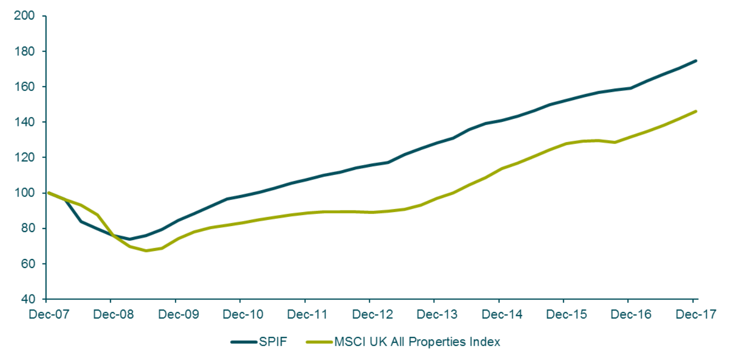
delivered by the leases and the characteristics specific to these contracts.

SPIF has also experienced strong performance in this time. The fund experienced a smaller capital value decline during the downturn in 2009, followed by a faster recovery. Conversely, traditional real estate has outperformed long lease real estate over recent years as the market has recovered, which is to be expected given the higher sensitivity of traditional real estate to capital values. However, SPIF has outperformed the UK index on a 10-year basis.

In our view therefore, long lease real estate offers institutional investors an attractive and defensive alternative exposure to real estate that has the potential to deliver enhanced income with inflation protection and attractive risk-adjusted returns compared to more liquid fixed income securities.

Long lease real estate can typically also offer lower volatility of performance than traditional real estate investment, while still being exposed the long-term capital upside potential from owning real estate.

SPIF: total performance vs UK real estate



Source: M&G, MSCI, as at 31 December 2017. SPIF returns are calculated net of fees

Contact

Andrew Swan
+44 (0)20 7548 2375
andrew.swan@mandg.co.uk

Henry Barstow
+44 (0)20 7548 3469
henry.barstow@mandg.co.uk

John Atkin
+44 (0)20 7548 3466
john.atkin@mandg.co.uk

Sunita Dey
+44 (0)20 7548 3393
sunita.dey@mandg.co.uk

www.mandg.co.uk/institutions
institutional.clients@mandg.co.uk

For Investment Professionals only.
This document reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. Past performance is not a guide to future performance The distribution of this document does not constitute an offer or solicitation. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information given in this document has been obtained from, or based upon, sources believed by us to be reliable and accurate although M&G does not accept liability for the accuracy of the contents.

The services and products provided by M&G Investment Management Limited are available only to investors who come within the category of the Professional Client as defined in the Financial Conduct Authority's Handbook.

M&G Investments is a business name of M&G Investment Management Limited and is used by other companies within the Prudential Group. M&G Investment Management Limited is registered in England and Wales under number 936683 with its registered office at Laurence Pountney Hill, London EC4R 0HH. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. **JUL 2018 / IM-1808_UK**