For Investment Professionals only

Income secured on real assets

An M&G Institutional perspective

April 2017

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. Where past performance is included, please note that this is not a guide to future performance.

Pension schemes are maturing and becoming cashflow negative, leaving trustees and investment consultants to think of new solutions to help them meet their obligations. In that respect, real assets can play an important role and offer a broad range of investment possibilities which provide secure income streams. Each real asset investment approach has its own characteristics so investors can blend their exposures to each to achieve diversified streams of predictable, high-quality income to suit their own needs.

Real assets come in many guises

Real assets can be described as assets that have a tangible existence and an investable value. Examples include real estate, land, infrastructure, forestry, agricultural and other commodities, like oil and precious metals. Not all real assets generate income however. For example, gold's value is intrinsic and it does not provide an income stream.

What challenges can real assets help resolve for investors needing income?

The expectations for the flow of income required from a pension scheme will not be constant over time. A number of factors influence the amount of income needed, including the rate at which workers retire and begin drawing their pension, how long they receive their pensions for and the impact of inflation on what they receive. As well as being positioned to be able to deliver an income stream for pensioners, a defined benefit (DB) pension fund needs to have a strategy to overcome or avoid any funding deficit. Though none can be guaranteed or relied upon to deliver on a continuous basis, real assets may help achieve some key requirements of that strategy and if successful, provide the following beneficial features to both pension schemes and other long-term investors.

Real assets offer	Benefits	Key delivery strategies
Inflation-linked income	Regular increases in the income flows, to combat the effects of rising prices	• Real estate equity • Long lease real estate • Infrastructure debt
Long-term income	Assets expected to generate income well beyond the maturity of most long-dated public bonds	• Infrastructure equity and debt Long lease real estate •
Secure and reliable cashflows	Cashflows are usually contractual and predictable. Generally secured on a particular asset, providing a degree of protection	• Real estate equity and debt • Long lease real estate • Infrastructure debt
Diversification and a broader opportunity set	Extend the range of income generative strategies beyond traditional financial assets like bonds and equities	• All

Source: M&G Investments

A PRUDENTIAL Company

M&G INVESTMENTS

Real estate – some key income-generating real estate strategies

Directly invested real estate

Investing directly in real estate can take the form of buying an existing building, developing a new property, or investing in a fund that does the same. Income is generated by receiving regular, contractual rental payments from the tenants. The income actually achieved will depend on a combination of idiosyncratic factors, such as the property type and location, the facilities it offers and the credit quality of the tenant.

Income levels of 4% or more per annum (p.a.) are currently available in the UK market. The lease will stipulate its length and how frequently the rent will be reviewed, with increases based on prevailing market conditions. Any rent increase may help the income stream to keep pace with, or even exceed inflation and underpin the growing value of the property. Regular rents will typically be received quarterly, with fund payments to investors likely to be via quarterly or semi-annual distributions.

Risks include the possibility that the income stream could be interrupted or temporarily reduced: if a new tenant cannot be immediately found at the end of a lease there may be an income gap (a "void" period) or rental income reduced by "tenant incentives" such as rent-free periods. Investors can benefit from having an experienced team managing their investment that understands the market and, in providing extensive, high quality credit due diligence, helps to insulate the investor from market risks.

Long lease real estate investment

A secured property income strategy can take three principal forms. A **sale and leaseback** focuses on achieving secured income from long-term leases to high-quality tenants, with rents subject to contractual uplifts, either linked to an inflation measure or at a fixed rate. Leases are usually agreed with a corporate tenant for an extended period, frequently decades. The assets can be viewed as having characteristics similar to that of an inflation-linked corporate bond, with a corporate body committed to delivering an income stream, linked to inflation, over a long period. Terms are likely to be set to encourage tenants to commit to long leases, frequently attracting them by offering lower rents than would be available for shorter contracts. Using this approach, the risk of experiencing void periods can be reduced, though it cannot be erased. Security of income is the strategy's primary consideration and rental income is typically the main driver of returns. Historically, income achieved has generally exceeded the yields on long-term UK government and corporate bonds and in recent years' income yields have been in excess of 4% p.a. though that premium might not endure.

Case study: Genesis Housing Association

- 401 well-located residential units in Stratford, London
- 35-year fully repairing and insuring lease to a single A-rated tenant (rated by Moody's)
- Annual rent increases linked to RPI, between 0-5%
- Potential for long-term capital growth from London's residential property market

A key advantage is that this particular stream of income is secured, with backing provided by the real estate itself. Evaluating our long-lease tenants like we do for corporate bond issuers and assigning a credit rating is central to M&G's investment process when investing in long lease real estate. If a tenant's credit quality is poor, we will require extra security in the form of the property itself. Similarly, if the property is of lower value but we perceive the tenant to be "investment grade" quality, we may still invest.

An **income strip** transaction structure is a second approach to long lease investment. In this case, all the value is represented by the inflation-linked income it delivers since, at the end of the lease agreement, the tenant has the option to buy back the freehold for a nominal sum. These will be very long-dated, with leases often contracted for over 40 years.

Income strips have a profile similar to a repayment mortgage where, on the final payment, nothing further is owed by the borrower, who then owns the property outright. Alternatively it may be viewed as a fully-amortising inflation-linked bond, secured by a real estate asset. Importantly, 100% of the portfolio's income will be contractually linked to inflation. However, the annual uplifts in the underlying rents themselves are likely to be capped at 5% though also have a floor at 0%, which prevents rents from declining in periods of deflation.

Case study: Bangor University student accommodation

- 602-bed student residence with extensive on-site facilities
- 40-year fully repairing and insuring lease directly with the university, which had a buyback option at lease end for a nominal sum
- Annual rent increases linked to UK RPI, between 0-5%

Investors can appreciate the clarity of income strips since all the cashflows can be anticipated and valued, to form part of a liability-matching strategy. The individual investments tend to be rated as investment grade, due to the high quality of the occupying tenants and long-term returns of 1.5% - 2.5% p.a. above RPI (retail price inflation) are possible.

Ground rents are the longest form of sale and leaseback arrangement, offering pension funds another way to generate predictable, inflation-linked income secured by a real asset. The longer term cashflows can help pension funds go further with matching the duration of their liabilities. As leases will often be in excess of 100 years, with either commercial or residential tenants, the cashflows constitute the vast majority of returns on each investment. This is the case in spite of the fact that the investor retains ownership of the real estate, because of the extremely long investment horizons involved. Ground rent set at an affordable level can offer further security of the cashflows to investors, as it will represent only a modest element of a tenant's total costs.

Real estate debt

Income can also be generated by investing in commercial real estate (CRE) debt. Investors provide a loan to an owner of commercial property and receive regular coupons, similar to a bank providing an individual with a mortgage to buy a home.

The income stream can be at either a fixed or a floating interest rate, with the actual rate being largely influenced by the seniority of the debt, the loan-to-value ratio (LTV) and the credit rating of the loan. A lower LTV carries less risk, so will be eligible for a higher credit rating, implying that a borrower could face a lower interest rate. CRE debt typically has a shorter term, with three to five years being common. In the European markets, where most CRE debt is usually at a floating rate, a margin of 1.5-2.5% above a short-term reference rate (e.g. Libor or Euribor) is common for senior CRE debt, with higher margins available on junior or subordinated debt.

A key attraction of a CRE loan lies in the security that the underlying physical asset provides to the lender, though there may be differing levels of seniority of debt offered within the capital structure, providing different risk and return profiles. Prudent lenders will undertake extensive due diligence on a property's cashflow predictability and sustainability. Financial covenants are set at the beginning of the transaction and are designed to serve to provide alerts to the lender of any deterioration in the income or the property value.

Case study: Project Sputnik

- M&G provided a £70 million whole loan facility secured against a Premier Inn hotel in Shoreditch, London
- The property is in a desirable part of central London and has a secure income stream from the long lease in place with Premier Inn, providing strong interest coverage
- The loan benefits from comprehensive covenant package

Despite the predictability of future cashflows, borrowers always have the right to repay their loan at any time. To mitigate this risk of prepayment, lenders often benefit from prepayment penalties within the loan in the

event the borrower decides to repay early. Unlike other real asset investments, the income stream is typically not linked to inflation but, given the shorter term of most deals, that may be less of a concern to investors.

Infrastructure and how it can deliver income

Utilities, transport networks, renewable energy projects and communications networks are all examples of investable economic infrastructure assets. Some physical buildings, particularly those in the public sector such as social housing, hospitals, student accommodation and schools are considered as social infrastructure, though outside the public sector they can be closely related to real estate.

The primary characteristics of an infrastructure investment, each of which can have significant influence on the income flow and overall risk and return profile, are:

- Essentiality – provision of necessary asset and essential services
- High barriers to entry / exit – a dominant market position can arise from significant barriers to entry for competitors and barriers to exit for customers
- Longevity – long-dated cashflows supported by long-life assets
- Stability of cashflows – reliable cashflows, often regulated, arising from the asset's steady use or availability
- Security – ownership of, or recourse to, specified assets provides enhanced protection in case of default
- High debt recovery rates – significantly greater rates of recovery in the event of default than for normal corporate debt have been experienced in the past, though that success may not repeat
- Low correlation to the economic cycle – in many cases infrastructure assets provide strong diversification within a portfolio, though correlations are not static and may change detrimentally
- Cashflows linked to inflation – revenue streams may be contractually linked to inflation, regulated or, in some cases, rise generally with volumes linked to the broad economy

The scale of future infrastructure opportunities

Estimates for the scale of the infrastructure need vary, but it is apparent that the scale of current infrastructure investment is dwarfed by that need. Recently the European Council approved a two-year extension, to 2020, to the European Fund for Strategic Investments (EFSI), also known as the "Juncker plan", and simultaneously increased the target for new investment across the European Union (EU) to €500 billion.

In October 2016, US financial giant, Citi, published a report suggesting that US$58.6 trillion of global infrastructure spending would be required in the period to 2030, in order to achieve the OECD forecast growth rate of 3.8% p.a. (source: Citi GPS: 'Infrastructure for Growth')

Infrastructure equity

Pension funds, like most other investors, will normally achieve ownership participation in infrastructure through unlisted pooled fund vehicles. Income streams can originate from various sources. Utility companies charge for providing gas and electricity. Other sources may be rents, access charges, fees or the receipt of subsidies. Whatever its form, income received may be distributed, usually quarterly or semi-annually.

The benefits of using a pooled fund approach to investing, thereby allowing for greater diversification among other attractions, are well known. The advent of pooling for some local authority pension schemes may make it easier to gain access to attractive infrastructure opportunities, by increasing the scale of individual investments they can share participation in.
Brownfield opportunities (broadly assets that are already

Case study: Calvin Capital

- Calvin Capital supplies gas and electricity meters to utility companies. Its key customers are UK utilities, including British Gas. Contracted to purchase, install and maintain meters on behalf of customers
- Once a meter is installed, cashflows are contracted for its 10-20 year useful life and additional compensation may be received should a meter be removed before the end of that working life. There is a low level of technology risk
- Strong yielding asset with stable, long-term, low risk cashflows providing an essential service and with high barriers to entry

in the operational stages of an asset's lifecycle) can usually generate stable, long-term income, with target yield levels of 6-9% p.a. being typical. Returns from investing earlier in a project's lifecycle, at the greenfield stage, where design planning, and construction are still being undertaken, may be as much as 15% p.a. The greater return potential reflects the additional risks associated with the initial project stages, and there may also be a period of time before income begins to come on stream or is less than envisaged. Greenfield projects may have lifecycles of 25 years or more over the course of which their overall expected returns may be spread.

Infrastructure debt

Investors can access the asset class by taking direct risk on large infrastructure corporates or by financing specific projects through the use of limited recourse debt, which relies not on the strength of a large corporate but on the cashflows arising from the specific project being financed. Corporates tend to be "perpetual" while projects have a life which is limited either due to the length of a concession or the new project's economic viability. For this reason, corporate infrastructure debt is usually in bullet form (like most other corporate debt) whilst project finance debt is generally fully amortising, so the average life of an investment is likely to be less than the final maturity of the debt.

Case study: Lightsource renewable energy

- £247 million deal with a portfolio of 33 UK solar parks
- Long-dated index-linked debt paying a premium to comparable liquid assets
- Amortising loan with a weighted average life of approximately 11 years
- Investors benefit from secure government-backed revenue streams

Investors can access both these types of infrastructure debt through either the public or private markets, although large corporates which rely on regular access to debt typically raise finance through the issuance of listed corporate bonds issued via the public markets. Other forms of debt open to both corporate and project finance infrastructure debt include private placements or loans. The main difference in the form of debt chosen is its liquidity. Whatever form it takes, infrastructure debt will usually pay a regular income stream over the long-term, which can be fixed-rate (including index-linked) or floating.

Currently, the margins available for investment grade assets are about 1.5-2.5% p.a. over government bonds of equivalent maturity, with higher margins, up to 8%, being possible for sub-investment grade assets, depending on the various risks associated with the deal such as credit, market or regulatory risks.

The investment is also usually well-protected from adverse events. Loans against specific assets have strong covenants and security of shares in the borrower, the assets and key contracts. Typically, investors can expect very high recovery rates or a low level of loss given default. Research by Moody's, of project finance transactions since 1983, shows an 80% average recovery rate in case of default with the most likely outcome being 100% recovery of debt, which was achieved in almost two thirds of cases. Such success in the recovery of future impairments cannot be guarantee, however.

Why use real assets to achieve an income?

Looking to real assets to deliver an income can be beneficial to a long-term investor.

- Income levels available are typically higher than for traditional assets of similar credit quality
- Inflation-linkage is a common feature for real asset income streams, which can help to provide some match to the obligations of most pension liabilities
- Income streams are usually contractual and reliable over the long term, aligning them more closely with the term profile of the accompanying liabilities, though defaults or impairments remain possible
- Underlying assets provide clear security over the intended cashflows and may be expected to offer strong downside protection
- The long-term nature of the investments broadly reflect the objectives of pension funds, allowing time to capture any illiquidity premium available

M&G's approach to real assets

M&G takes a pragmatic and cautious approach to investing, aiming to build portfolios of assets that meet the client's requirements by identifying value opportunities through detailed analysis and due diligence. We prefer to be patient for the opportunity to invest at the right price, not being a forced buyer at the wrong price.

Its dedicated real estate business is an income-driven, long-term specialist global property investor, with over 150 years of experience and offers strategies to invest directly in real estate or indirectly through pooled vehicles. M&G also has a leading long lease real estate investment platform, managed by specialists from the Real Estate and Fixed Income businesses, collaborating to source and structure unique transactions for its UK and international clients.

Our Real Estate Finance team specialises in commercial real estate finance and our ability to offer both senior and junior commercial mortgage debt in the UK and Western Europe debt makes us one of the few asset managers able to offer both solutions to investors. Real estate finance strategies may be accessed in both segregated mandates or in pooled vehicles.

Infracapital, the infrastructure investment arm of M&G, draws on a long heritage of infrastructure investment at Prudential Group, which includes a 1935 investment in the Carsfad hydroelectric dam in Scotland. Infracapital has expertise in both brownfield and greenfield infrastructure markets, which gives clients the flexibility to gain exposure to the asset class at all stages of the development and management cycle.

M&G's team of infrastructure debt specialists has been in place since the late 1990's making it one of the longest-established and most active asset managers in the infrastructure debt market. The team looks for value in both public and private markets, and senior and junior debt, depending on investor preference. Drawing on structuring specialists from project finance and corporate credit, we have expertise in all the key sectors of the asset class, including transportation, utilities, public sector, social housing, renewable energy, and universities. Participation in the asset class can be achieved through pooled vehicles as well as in segregated mandates.

For more information contact:

Andrew Swan	+44 (0)20 7548 2375	andrew.swan@mandg.co.uk
John Atkin	+44 (0)20 7548 3466	john.atkin@mandg.co.uk
Henry Barstow	+44 (0)20 7548 3469	henry.barstow@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**

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. Where past performance is included, please note that this is not a guide to future performance.

For Investment Professionals only.
The distribution of this document does not constitute an offer or solicitation. Past performance is not a guide to future performance. The value of investments can fall as well as rise. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and you should ensure you understand the risk profile of the products or services you plan to purchase.

This document is issued by M&G Investment Management Limited. 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. They are not available to individual investors, who should not rely on this communication. 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. M&G does not offer investment advice or make recommendations regarding investments. Opinions are subject to change without notice. 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.

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. IM-178/0417 MDII