INFORMATION FOR INVESTMENT PROFESSIONALS

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Bringing our expertise to long-leased real estate

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In a low-yield environment, investors seeking to de-risk their portfolios are increasingly turning to alternative assets offering attractive risk-adjusted returns over gilts and inflation. The case for real estate-backed solutions within matching portfolios is well established, and our combined property and credit capabilities – and consistent investment approach – are well suited to provide value to clients from this asset class

Pension schemes have long sought the tangible, strong and lowly correlated returns offered by UK real estate, underpinned by capital value and rental income growth – irrespective of their funding status or cash flow needs. This has never been clearer than in the current investment environment, where the asset class offers a 400+ basis point income yield advantage over UK gilts[1].

The potential performance and diversification advantages gained by including real estate within balanced portfolios is well understood. The challenge for pension schemes has always been how to access the illiquidity premium offered by the asset class while mitigating the associated risk. As a consequence, real estate has traditionally been associated with the growth component of pension fund portfolios. But as schemes mature and cash flow needs increase, the inclusion of the asset class within matching portfolios is now being explored.

[1] Columbia Threadneedle Investments comparison of (1) MSCI Monthly Index Net Initial Yield 5.06% and (2) FTSE Actuaries UK Conventional Gilts All Stocks Index Gross Redemption Yield 1.02%, November 2019

The secure income profiles generated by long-leased real estate provide characteristics suitable for these portfolios. Unlike shorter-let traditional real estate assets, where capital volatility can dominate returns, properties let on long leases (typically 20-plus years) to strong tenant covenants provide predictable, asset-backed "bond-like" cash flows. These are typically indexed or benefit from fixed rental increases, providing tangible real income returns from a stable capital base.

Tenant covenants, selected to minimise credit risk profile, can be monitored to ensure such risk remains within strict tolerances throughout the life cycle of the assets. These are selected to ensure they stand the test of time and remain relevant in a changing economic, demographic and social environment.

Taken together, these positive characteristics prove compelling, offering lower volatility than traditional balanced real estate portfolios, but higher returns than other assets with matching characteristics. By way of illustration, long-leased UK real estate delivered total returns of 8.6% per annum over the decade to the end of Q3 2019, reflecting a premium of +2.8% per annum over UK nominal gilts and +5.4% per annum over RPI inflation[2].

Mitigating risk

As with all asset classes, investment is not without risk. In the case of real estate, the restructuring of the retail landscape and associated use of insolvency remedies including company voluntary arrangements (CVAs) and "pre-pack" administrations have become the most visible symbols of the industry's short-term challenges.

The answer, however unimaginative, lies in forensic due diligence, oversight and governance. Assessment of risk requires a comprehensive understanding of both credit and property fundamentals on a tenant-by-tenant and asset-by-asset basis. When appraising potential investments, consideration must be given to both company credit worthiness and the property-level profit contribution to a tenant's businesses. This due diligence minimises the impact of CVAs and administrations on our portfolios. Rent exposure to tenant failure has been less than 1% annually over the past five years[3], much of which has been mitigated via lease restructures, assignments or new lettings to alternative occupiers.

Long-lease strategies with mandates to mitigate risk should seek to reduce this exposure further, and this is where our experience as a global manager of £146.5 billion of fixed income assets[4] gives us in-depth knowledge of industry sectors and credit issuers, which we layer on top of our property understanding to provide a clear insight into both industry and company risk. We believe this approach, applied on asset acquisitions and subject to on-going monitoring, provides a compelling opportunity to deliver superior risk-adjusted returns.

So, where is the opportunity?

The popularity of real estate within matching portfolios has seen exponential growth of the market over the past few years. The opportunity set has expanded to include income strips (self-amortising cash flows), as well as more traditional ground lease and direct-let assets. The underlying operational assets now encompass numerous uses (for example healthcare, leisure, hotels, residential and retail) requiring tenants to amortise capital over lengthy periods of time.

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[2] Columbia Threadneedle Investments AREF/MSCI Long Lease Funds sharp ratios compared to AREF/MSCI All Balanced Funds, 30 September 2019
[3] Columbia Threadneedle Investments, 30 September 2019
[4] As at 30 September 2019

In such a diverse and increasingly complex market, where does the opportunity lie? Our analysis of secure income transactions[5] completed between January 2018 and September 2019 identified a 90-basis point pricing differential in favour of smaller assets under £30 million. This is partly explained by the huge growth in the size of funds managing long-lease assets: as funds scale, they trend towards larger assets to keep pace with investor demand. By way of illustration, the most established long-lease funds within the AREF/MSCI UK Long Income Property Fund Index attribute less than 25% of their portfolio value to assets under £25 million[6].

By contrast, the average lot size of properties managed within our UK balanced strategies is just £6.8 million[7]. We believe that within open-ended portfolios, smaller lot sizes offer pricing and diversification benefits, which is why they have always formed the core component of our portfolios. By applying the same philosophy to the long-lease market, focussing on smaller assets other managers miss or discount, we have sourced a pipeline of purchasing opportunities in excess of £1 billion, which allows us to effectively deploy capital.

Key differentiators

We believe a strategy investing in long-leased real estate is complimentary to that of our UK balanced funds, tailored to investors seeking a reduction in their risk exposure while generating income returns in excess of gilts and inflation. Our consistent real estate investment approach and depth of resource across asset classes provide several key differentiators which mean we are well positioned to deliver value for our clients from this asset class:

- Elements of our established investment philosophy (smaller lot sizes, flexible buying strategy) deliver pricing and diversification benefits
- Fully integrated real estate and credit expertise enable forensic asset-level due diligence, allowing us to fully understand risk and deliver sustainable risk-adjusted performance
- Effective investment resource with proven deal-sourcing track record ensures efficient deployment of capital (speed to market)

For further information please contact James Allum, Client Director, UK Real Estate.

[5] Completed investment transactions £1M-£300M providing 15+ years WAULT and rental indexation. Data provided by Savills, Knight Frank and CBRE, aggregated by Columbia Threadneedle Investments, 30 September 2019
[6] Columbia Threadneedle Investments AREF/MSCI Long Lease Funds sharp ratios compared to AREF/MSCI All Balanced Funds, 30 September 2019
[7] As at 30 September 2019