WHITEPAPER

The case for European long lease real estate

Contributing to more certain investment outcomes

March 2021

For today's investor

AVIVA INVESTORS

Contents

Introduction

In today's low yield world, high quality assets generating predictable income streams with inflation-linked uplifts are highly prized by investors. The search for income is intense in continental Europe, where the European Central Bank has used conventional and unconventional policy to maintain liquidity and suppress borrowing costs for years. Furthermore the Covid-19 crisis has led to an unprecedented fiscal and monetary policy response, which will most likely suppress interest rates for years to come.

Long income real estate let to high-quality tenants typically on at least 15 year leases, can have distinctive advantages for long-term institutional investors who struggle to meet their return requirements through traditional investment strategies. With the 10-year German Bund yields negative, long income yields in the region of four per cent may have obvious appeal.[1]

European long income real estate seeks to:

- Provide low volatility, contractually-secured cash flows with low exposure to the property cycle
- Offer an attractive return premium over low yielding European government and corporate bonds of equivalent risk and duration, in exchange for reduced liquidity
- Provide an inflation and interest rate hedge for investors who have long-dated, inflation-linked liabilities
- Enhance protection against corporate defaults, relative to corporate bonds, through ownership of the property

Adding European long lease real estate to a diversified portfolio can bring investors greater certainty over the timing and scale of cash flows. In this paper we explore how the asset class can be used as an alternative or a supplement to holding traditional fixed income assets, and the potential role in diversified portfolios. Although property is less liquid than exchange-traded assets, the resulting yield uplift can be attractive for investors with long term horizons.

1. Indicative yield, based on pipeline transactions. Source: Aviva Investors, as at February 2021.

Defining long lease real estate: Putting the lease structure centre stage

"The primary focus is on the lease credentials – on its length, amount of inflation protection and the strength of the lessee's covenant."

Long lease structures provide longevity. Lease lengths in this segment of the market in continental Europe are typically at least 15 years, compared to around three to seven years for 'traditional' real estate. The contracted income stream is a major component of the value of long lease property. For this reason, long lease real estate is sometimes referred to as high lease value property. Compared with conventional real estate, much less value is derived from the exit value, since the large part of the value is in the cash-flow.

Secondly, tenants tend to offer strong covenants and low default risk. The lessees are typically governmental bodies or investment grade companies. Thirdly, rents are usually linked to the Consumer Price Index (CPI), or another form of indexation, which is likely to protect the income stream against inflation.

Due to these characteristics, there are significant differences in the investor's decision-making process compared with traditional real estate. For a long lease real estate investor, the primary focus should be on the lease credentials – in particular length, level of inflation protection and covenant strength.

The ESG attributes of buildings are of heightened importance to long lease investors due to their greater time horizon. As well as assessing the quality of assets at the stage of acquisition, long lease investors may be able to find opportunities to invest in sustainability-enhancing initiatives within their portfolios. As a result of tenants' long-term occupation of buildings, they often have more interest in their sustainability criteria, which can reduce their energy costs and improve their customers' or employees' experience . Landlords can provide these investments in exchange for lease extensions or higher rent, whilst improving the long-term resilience of the asset, to the mutual benefit of investor and tenant.

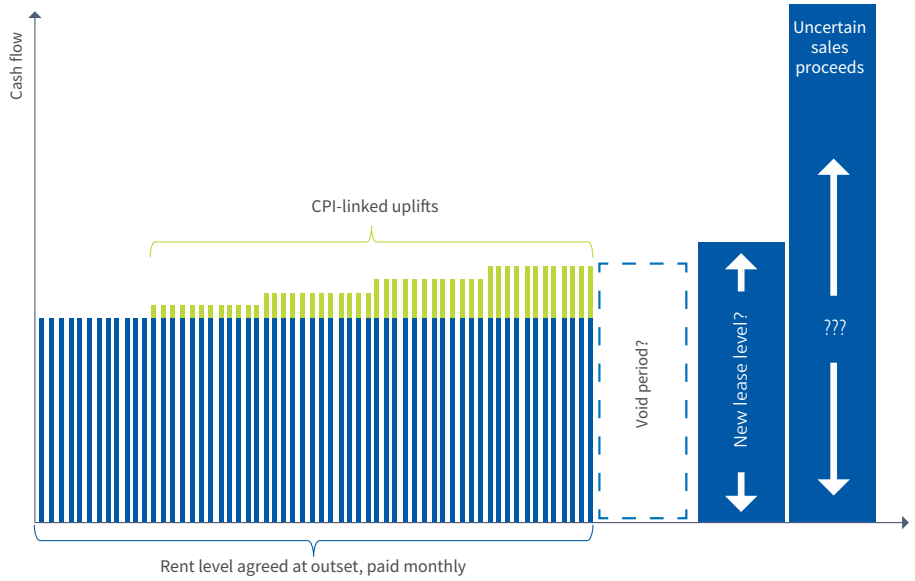
In addition, leases on long lease real estate may be triple net, making the tenant responsible for all costs relating to the asset, including property taxes, building insurance and maintenance. Even where this is not the case long lease investors' exposure to operational and capital expenditure is generally much lower than in traditional real estate due to the secure long term of the leases and quality of tenants. As such, long lease real estate may provide a more stable and predictable stream of income return coming from contractually secured rental payments, rather than equity-like capital return.

In contrast, traditional real estate investors typically focus on how challenging it could be to let (or re-let) a building. In this scenario, location, micro-location and building quality are very significant, as are the opportunities that might arise from active management – from changing the tenant mix, refurbishing or redeveloping the property. The ability to let a building and the rent achievable are both strongly linked to the economic environment at the time, making traditional real estate much more economically sensitive than long lease. Furthermore, the capital return accounts for a higher share of total return than long lease real estate. The capital return is driven by the exit value, which is subject to considerable market risk due to the real estate cycle.

Adding greater certainty over the timing and scale of cash flows

In continental Europe, traditional property is typically subject to CPI-linked rent reviews. Income may be affected by void periods when leases end or tenants default. The asset is re-leased based on market conditions at the time. Sale proceeds can vary due to the cyclical nature of the real estate market. The focus is on driving value and return by timing the market right and by active management of the buildings and its tenants. The majority of the value typically lies in the sales proceeds. There is more uncertainty of cash flow and capital expenditure over the hold period of the investment and there is an uncertainty of the value and sale proceeds at the end of the term. (See Figure 1, below.) Sales proceeds typically account for 50-60 per cent of the total return of the investment but are subject to the highest market risk.

Figure 1. **Cash flow from 'traditional' real estate - a CPI-indexed 5-year lease**



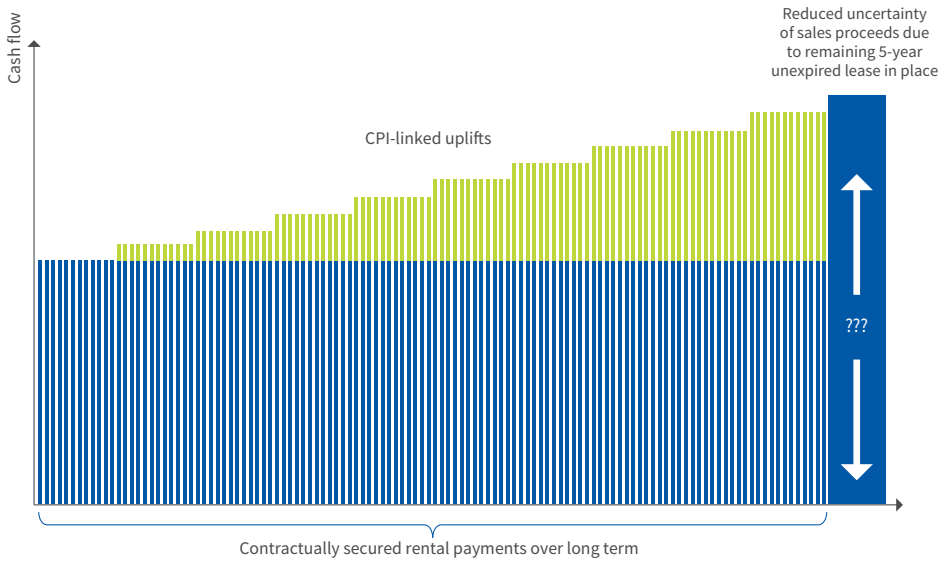
For illustrative purposes only. Source: Aviva Investors.

> *"Investors in long lease real estate have greater certainty about real expected returns than investors in traditional real estate."*

In long lease properties, lease contracts typically extend to at least 15 years and are secured with strong covenants, intended to reduce the inherent risk in the asset. The majority of the value of the asset will be in the contractually-secured rental income stream as opposed to the capital value of the asset (as with traditional real estate).

The rental income is more predictable and can be linked to inflation via indexation. The income streams therefore also provide an attractive hedge against interest rate and inflation risks. The exit value only accounts for about 20-30 per cent of the total return of the investment, this means there is less market timing risk. (See Figure 2, below.)

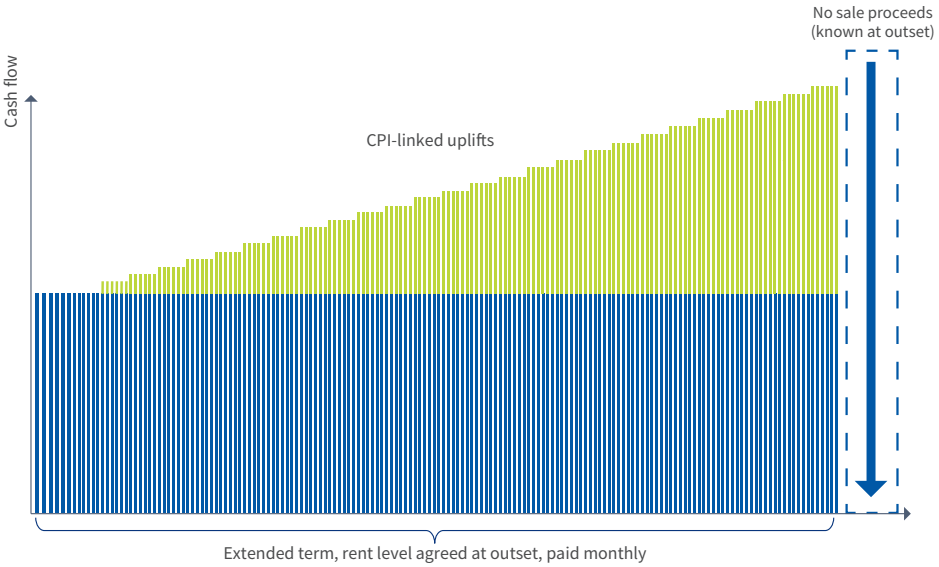
Figure 2. **Cash flow from long income real estate (A CPI-indexed 15-year lease)**



For illustrative purposes only. Source: Aviva Investors.

A long lease can also be structured in such a way that the property is passed back to the tenant upon expiry. This means, the total investment consists of contractually secured, 100% predictable cash-flows with market risk reduced to a minimum. These amortising lease structures or income strips are more common in the UK, but are increasingly used on the continent for asset owners who want to unlock a large part of the value of their real estate, without giving up the control over it.

Figure 3. **Cash flow from fully amortising long income real estate (A CPI-indexed 30-year lease)**



Source: Aviva Investors – for illustrative purposes only.

"As investors are secured creditors, they face the same default risk as corporate bondholders, but with recourse to the underlying property."

Risk and return characteristics

1. Lower risk than unsecured debt

Investors in long lease real estate derive most value from the income associated with the lease. They carry less exposure to the changing capital value of the asset, which is typically hard to predict. Focusing on strong covenants helps minimise default risk and investors also have the benefit of ownership of the property.

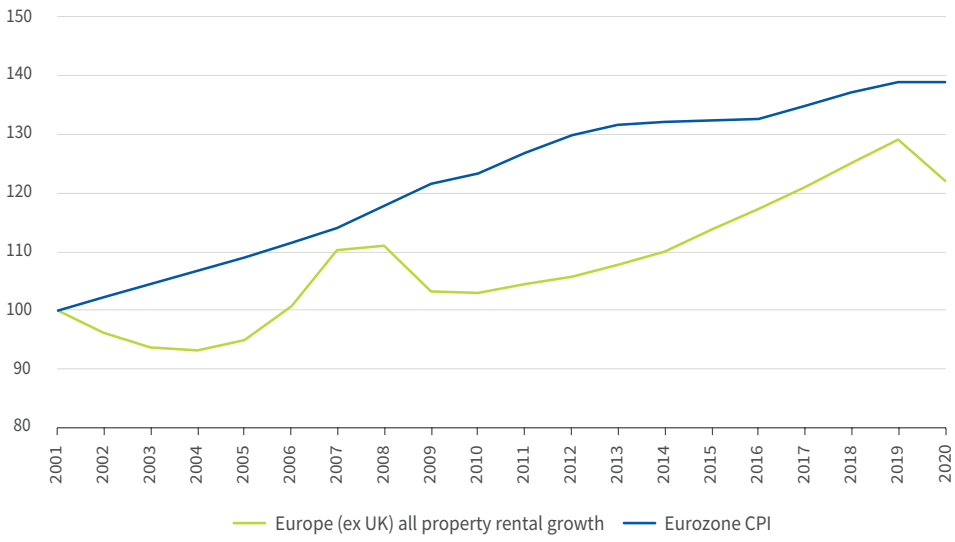
2. Attractive returns relative to liquid assets

Real estate assets are significantly less liquid than bonds and investors are rewarded with a premium to reflect this. However, for investors seeking long term, largely predictable income streams, the lower level of liquidity tends not to be a prime concern. Indeed, long-term investors may benefit from a higher income return compared to corporate bonds with the same credit risk. Overall, we expect demand for better-quality long lease assets to grow, which should increase liquidity.

3. Inflation protection

Long lease continental European property assets, with their explicit links to inflation, can be a good match for institutional investors' liabilities and cash flows. The strength of inflation protection varies market-by-market. Since the early 2000s, euro zone inflation has outpaced rental growth. Over this period, a European long lease portfolio with inflation protection mechanisms would have outperformed a traditional real estate portfolio.

Figure 4. **Comparing European inflation and rental growth trends**



Source: Eikon Datastream, PMA as at February 2021

Role of European Long Lease Real Estate in diversified portfolios

Long lease real estate can play a number of useful roles in diversified portfolios, helping to de-risk property exposure and supplement fixed income holdings.

De-risking property exposure

Long lease real estate can be a comparatively low risk form of property investment, due to its focus on lease term and the quality of tenants. Property investors may therefore reduce the overall risk of their portfolios through selective exposure to long lease real estate. Investors may be particularly minded to increase their allocation to long lease real estate when they view the prospects for occupier markets in traditional real estate to be weak or negative. At these times, a focus on long lease real estate could be beneficial for portfolio performance.

> *"Investors may be particularly minded to increase their allocation to long lease real estate when they view the prospects for occupier markets in traditional real estate to be weak or negative."*

Providing an alternative to fixed income

Low interest rates and quantitative easing have made it difficult for insurance companies, private and public pension funds and other portfolio managers to meet their return requirements within their risk budgets. It has also made de-risking from equities to government bonds more difficult. As a result, many institutions have been increasing their allocation to alternative asset classes, including real estate.

Underfunding has become a dominant issue for corporate pension schemes in several European countries. Reallocating some exposure from traditional fixed income to long lease real estate might allow these pension funds to achieve higher returns without taking on increased risk, aside from illiquidity.

Another driver of demand is the short supply of index-linked government bonds in some European markets. These assets, and in particular long income real estate, offer a good match for institutional investors' liabilities and cash flows.

In Germany, inflation-linked federal bonds and notes accounted for just four per cent of total tradable government debt as at February 2021. This ratio is a little higher in France - 11 per cent as at the end of 2020. This compares with a 23 per cent share of index-linked gilts as a portion of the UK gilt market.

Providing a defensive strategy in times of crisis

In spite of the coronavirus pandemic, yields in many European real estate markets were at an all time low at the beginning of 2021; a result of prolonged loose monetary policy. Therefore long-term returns are likely to be driven more by income than capital growth. This means that long lease real estate is likely to offer a lower-risk alternative due to contractually-secured cash flows based on longer lease terms and rents linked to inflation. Furthermore, long income real estate funds can be more resilient during times of market corrections. Throughout the pandemic rent collection of long income assets let to high quality counter parties has been strong and valuations have generally held up. In contrast, in traditional real estate, many tenants have either been unable to pay their rent or have requested payment holidays, which in turn means landlords are facing a loss of income. Moreover, reduced demand for office and retail space has led rental values to fall, long income assets with rent reviews linked to inflation are isolated from this. Looking back to previous crises, in the UK Aviva Investors' flagship UK real estate long income strategy lost only 19 per cent in value during the financial crisis in 2008-2009 whereas the UK Balanced Fund index lost over 40% in value in the same period (see figure 5).

COVID-19 has undoubtedly had a major impact on economies and financial markets globally. Whilst the social distancing measures imposed caused a significant short-term hit to business activity, many governments announced an unprecedented array of fiscal measures to attempt to mitigate the impact on businesses and individuals. Despite vaccines being rolled out across Europe, the emergence of new variants poses risks to the recovery and it is unclear the extent to which some activities will be able to return to normal or the long-term impacts of the pandemic. As governments begin to withdraw their support there will likely be heightened business failures for several years. In this environment thorough credit analysis of long income assets' tenants is especially important.

3. Federal Republic of Germany Finance Agency, as at 18 February 2021
4. Agence France Tresor, as at 18th February 2021
5. United Kingdom Debt Management Office, as at 18th February 2021

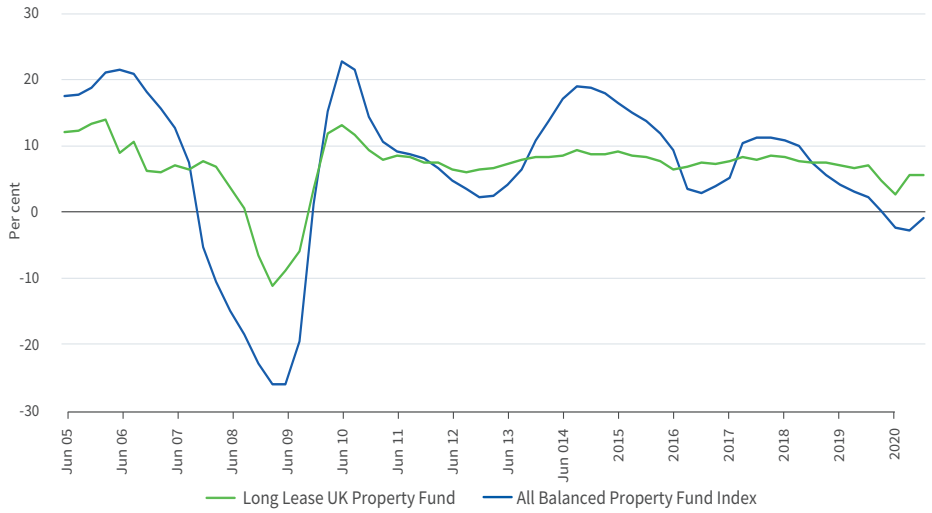
> *"In a downturn, long lease real estate is likely to be more resilient than traditional real estate."*

Key portfolio considerations

Across a full business cycle, it would be expected that long lease real estate would provide slightly lower returns than traditional real estate, but with significantly less volatility. We would expect long lease real estate's high-income security to lead it to outperform during a downturn.

For example, the volatility of returns from UK long lease real estate was lower than the UK All Balanced Property Fund Index between 2005 and end of June 2018, with less pronounced peaks and troughs (see Figure 5, below). The standard deviation of total returns in this period was 3.69 per cent for long income, and 7.34 per cent for the property market as a whole. As might be expected, total returns on long lease real estate were lower than on all direct real estate in 2005 to 2006 and 2010 to 2018, but higher during the downturn of 2007 to 2009. (UK data is cited here, as there are few established European long lease comparators.)

Figure 5. **Lower volatility of returns from UK long income than the wider UK market Rolling 12-month performance**



Source: Returns (net) from Aviva Investors' UK Long Income Strategy referenced for illustrative purposes, due to lack of data from long-running European long income benchmarks. Source: MSCI, Aviva Investors, as at 31 December 2019. UK All Balanced Property fund chosen to show wide comparator against an index showing all UK property.
Past performance is not a reliable indicator of future results

Adding long lease real estate can therefore improve the defensive credentials of a traditional real estate portfolio, as well as increasing its diversification. When added to a portfolio of liquid assets, it can provide comparable diversification benefits to traditional real estate, while helping investors to match their liabilities and/or cash flows more effectively.

Impact of adding leverage to long lease real estate

The longevity and security of income characteristics of long lease property can make it very suitable for adding debt. Long-term bond yields in Europe are close to record low levels, and at low loan-to-value (LTV) ratios, lenders are willing to provide finance at slim margins. As a result, a high spread differential exists between the cost of debt and initial yields, making the use of some leverage, at a prudent level, potentially accretive to returns.

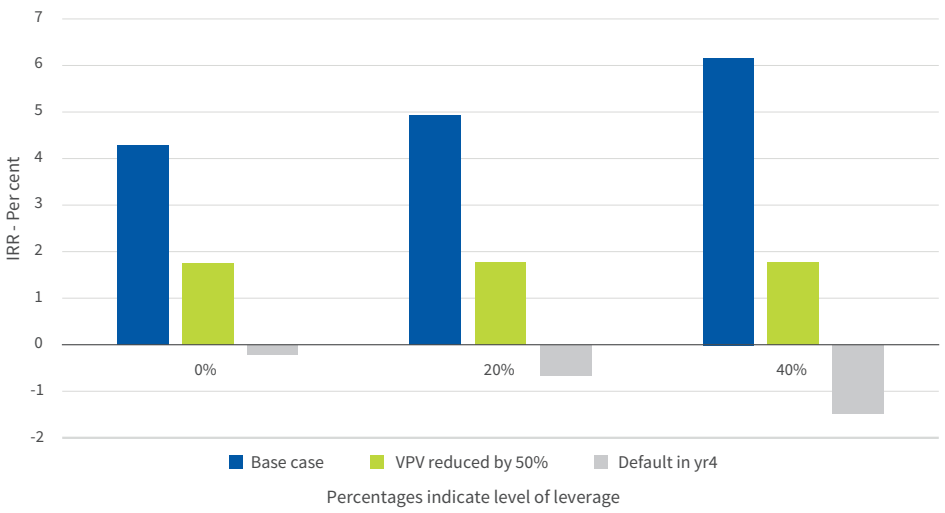
We assessed how the performance of a theoretical property with a 15-year lease would be impacted by being leveraged at different LTVs using fixed rate ten-year debt and refinanced for the remaining five years. We compared three scenarios:

- The base case being the property is held for the 15-year duration of the lease and then sold at vacant possession value (VPV)
- We reduced the VPV by 50 per cent
- Simulating a tenant default in year four and having to sell at VPV

The results, summarised in Figure 6 below, show that typically a severe left tail event would need to unfold for the leverage to have a negative impact. This means a default of the tenant early in the holding period. Such a default is typically avoided by focusing on institutional grade tenants with strong covenants.

It is worth noting that the appetite to provide fixed-rate debt currently weakens for terms of over ten years and therefore long lease assets will usually be subject to re-financing risk. For the results shown in Figure 6, we have assumed that euro zone yields progress according to that implied by the current yield curve. In the case that interest rates are higher than currently expected at the time of re-financing, this would negatively impact returns. Weighing this factor against those discussed in the previous paragraph, we feel that 20% LTV is an appropriate target for a long income strategy, which increases returns under the base case without adding too much volatility to the potential performance outcomes.

Figure 6. **Scenario analysis: using ten-year fixed rate debt to enhance returns. Leverage vs IRR under different scenarios**



For illustrative purposes only. Source: Aviva Investors, as at February 2021.

Conclusion

Long lease real estate can offer greater income predictability than traditional real estate and lower exposure to capital value volatility. These defensive qualities can also prove especially attractive during periods of economic weakness and heightened market volatility, such as the situation created by COVID-19. This defensive asset class also provides a strong illiquidity premium and thus an attractive yield pick-up relative to bonds of comparative risk.

Leases with inflation linkages continue to be highly sought after in a market where there is a scarcity of inflation-linked investments. Although yields on long income real estate are lower than at any time in the past, the premium relative to low-risk fixed income remains attractive.

Key risks

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Certain assets held could, by nature, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile. Investors may not get back the original amount invested.

Long-lease assets are expected to be comparatively resilient at stress points, but may lag when traditional real estate markets are booming.

Investments in real estate may not be able to be sold, realised or liquidated when you want because real estate assets may not always be readily saleable. If this is the case, we may defer your request or instruction regarding your investment. Investors should also bear in mind that the valuation of real estate is generally a matter of valuers' opinion rather than fact.

Contact us

Torben Dunkel
Head of Institutional Sales DACH
torben.dunkel@avivainvestors.com
+49 69 25 78 26 115

175404-01032022