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The new safe haven

Making the case for European real estate long income

Tim Perry and Isabel Gossling

It takes Aviva Investors

Tim Perry
Senior Associate Director, Real Assets Research

Main responsibilities

Tim is a senior associate director in the Real Assets Research team. He plays a key role in assessing relative value between sectors and asset classes within real assets and providing guidance on funds' investment strategies. Tim has a particular focus on infrastructure equity and long-income real estate.

Experience and qualifications

Prior to joining Aviva Investors, he was a senior investment analyst in real assets research at Willis Towers Watson.

Tim holds a BSc in Biology from the University of Bristol and is a CFA charterholder.

Isabel Gossling
Co-Fund Manager, E-RELI

Main responsibilities

Isabel is Co-Fund Manager for Aviva Investors' European Real Estate Long Income Fund (E-RELI Fund). She is responsible for supporting the Fund Manager in delivering the Fund's strategy including progress of asset management and value-add initiatives, and sourcing and managing acquisitions for the Fund. Isabel is also part of the dedicated RELI Origination Team where her role is to source and create investment opportunities across a variety of assets in the RELI space for the UK and European RELI Funds, and to manage transactions through to completion. She is responsible for leveraging the established UK RELI platform and expertise to support the continued growth of the E-RELI Fund.

Experience and qualifications

Isabel has over a decade of real estate experience working on both equity and debt transactions in the UK and Europe. Prior to joining Aviva Investors, she worked at PWC where she was a lead real estate advisor on high value acquisition, funding, and restructuring transactions in the UK and mainland Europe, advising both investors and lenders. Before PWC, Isabel worked at Cushman and Wakefield in the valuation and investment agency teams.

She holds a BSc (Hons) in Economics & Economic History from Bristol University, an MA in Property Valuation & Law from Cass Business School and is a member of the Royal Institution of Chartered Surveyors (MRICS).

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Introduction

A defensive asset class offering stable, long-term and inflation-linked income.

With inflation hitting multi-decade highs, central banks in major developed markets have finally been forced to abandon the long-running era of easy monetary policy; interest rate hikes rather than cuts characterise the new regime. At such times, when government bonds are less of a safe haven, investments offering resilience and stable returns are hard to find. Real estate long income offers the potential to deliver on both counts.

Real estate long-income strategies are underpinned by a focus on the quality and duration of rental income: investing in properties let to investment-grade public and private sector tenants on leases with secure contractual terms of at least 15 years.

> Real estate long-income strategies are underpinned by a focus on the quality and duration of rental income

The asset class aims to provide investors with secure and predictable, inflation-linked income returns and low volatility through market cycles. It demonstrated impressive resilience through the COVID-19 pandemic and showed similar strength during other episodes of market turmoil.

In this paper, we explain:

- Why the characteristics of long-income real estate are particularly relevant for long-term income investors and the role of the asset class in diversified portfolios
- How the structures of long leases offer vital protections to investors
- The growing importance of ESG considerations in real estate long income.

Risk and return characteristics

1. Secure long-term cashflows, with low volatility and reduced exposure to market and economic cycles

Investors in real estate long-income strategies derive the majority of value from the contractually secure and consistent income returns associated with long leases to investment-grade tenants. The combination of lease duration and credit quality maintains the continuity and stability of cashflows through economic and market cycles, including periods of stress.

2. Attractive income returns

Long-income strategies aim to provide investors with secure and long-term bond-like cashflows. As real estate assets are significantly less liquid than bonds, long-term investors, for whom shorter-term liquidity is less of a concern, are typically rewarded with an illiquidity premium – in essence, a higher income return versus bonds of similar duration.

Similarly, long-income assets are typically associated with higher and more stable income returns than traditional real estate strategies. Over the past three years, long-income strategies delivered c. 80 basis points of additional annual income return versus core European real estate strategies, with a typically higher average tenant credit rating.[1]

1. Rolling annual income return of Aviva Investors' E-RELI Fund (average tenant credit rating of A - A+) versus that of MSCI's Pan-European Quarterly Property Fund index (PEPFI) to Q2 2022.

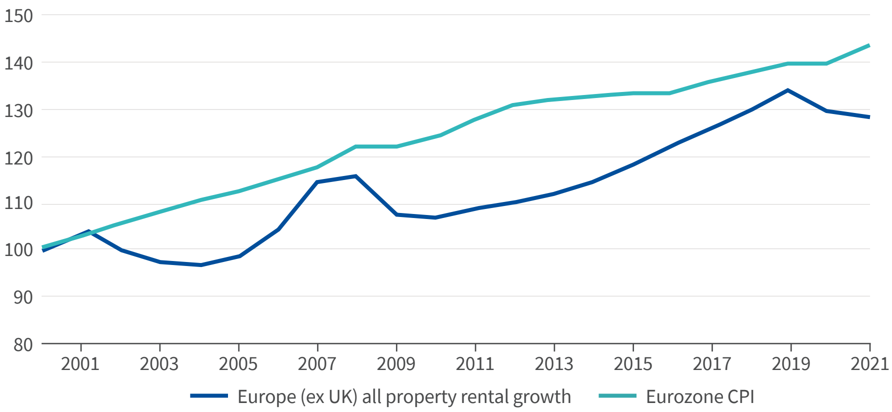
3. Inflation protection

European long-income property, with its explicit links to inflation through indexed-linked rental uplifts, can be a good match for institutional investors' liabilities and cashflows, providing a relatively cost-effective source of long-term inflation protection. Since the early 2000s, eurozone inflation has outpaced market rental growth. Over this period, a European long-income portfolio with inflation protection mechanisms would have experienced stronger and more consistent income growth than a traditional real estate portfolio.

European long-income property can be a good match for institutional investors' liabilities and cashflows

The supply-chain disruption caused by the COVID-19 pandemic and the war in Ukraine has led eurozone inflation to hit record levels in 2022. Moreover, deglobalisation, ageing populations and the need to decarbonise economies are all likely to create long-term inflationary pressures. For these reasons, the value of inflation-linked assets is heightened, especially where there are no caps on rent reviews, as is usually the case in European long income.

Figure 1. **Comparing European inflation and rental growth trends**



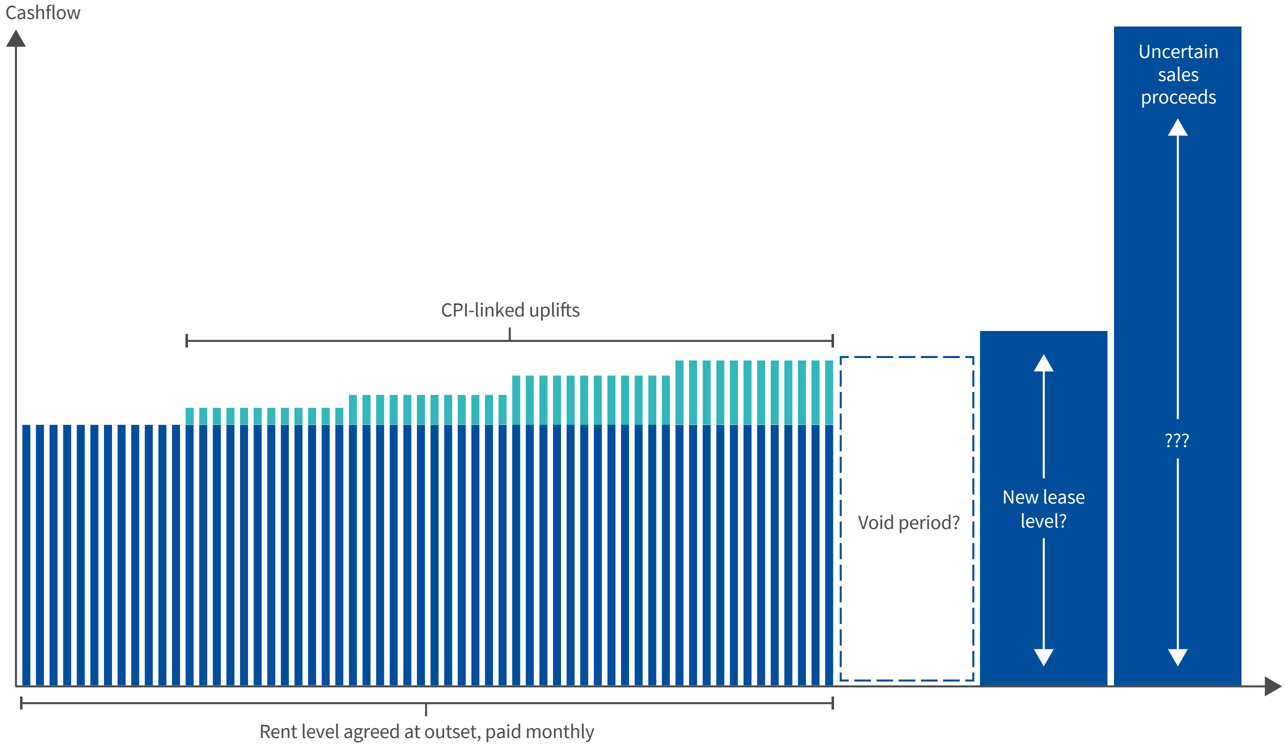
Source: PMA. Data as of August 2022.

Putting the lease structure centre stage

Long-income real estate strategies are characterised by a particular focus on the security and duration of income, which is distinct from traditional real estate investment approaches. Figures 2 and 3 compare investment cashflows associated with traditional and long-income strategies.

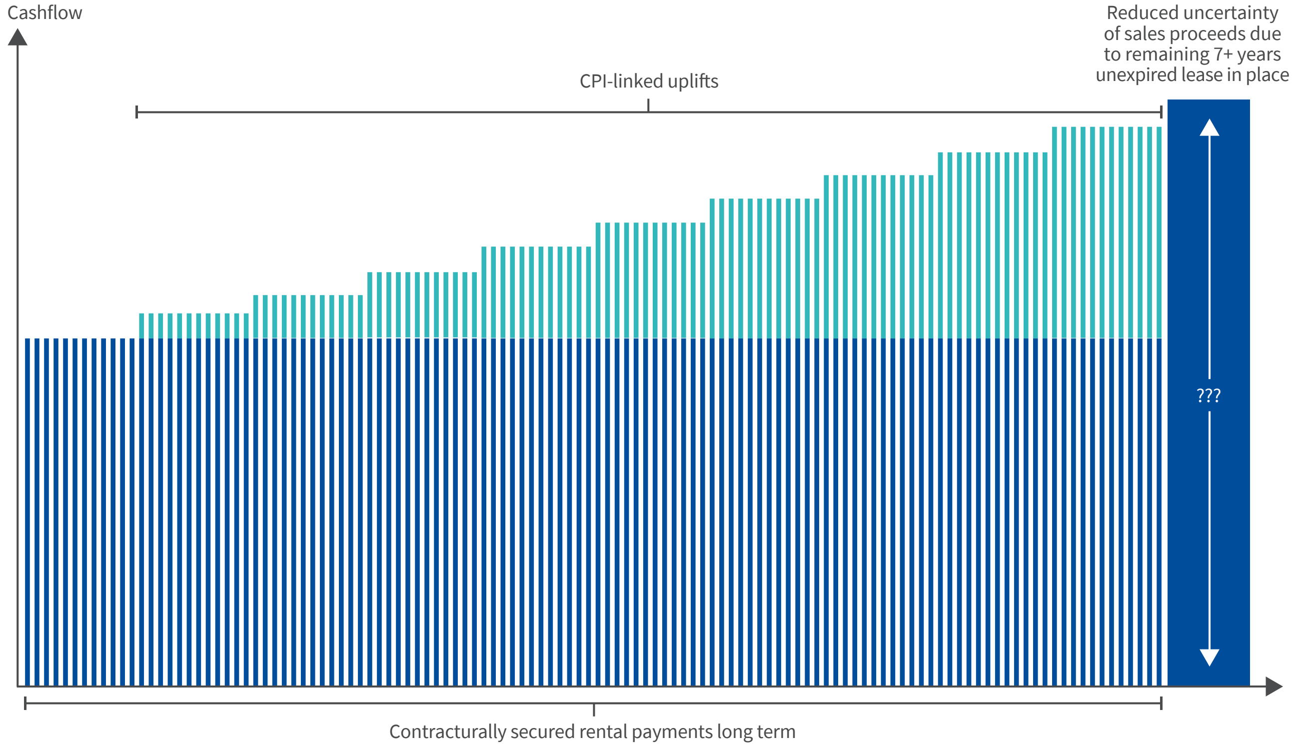
Traditional European real estate strategies typically invest in assets let on leases with secure terms of around three-to-seven years and with CPI-linked rent reviews during the lease term. Income during the investment period may be affected by void periods when leases end or tenants default and operating and capital expenditures are incurred.

Figure 2. **Cashflow from 'traditional' real estate (A CPI-indexed 5-year lease)**



For illustrative purposes only.
Source: Aviva Investors, August 2022.

Figure 3. **Cashflow from long-income real estate (A CPI-indexed 15-year lease)**



For illustrative purposes only.
Source: Aviva Investors, August 2022.

At lease expiry, the property is re-let, reflecting prevailing market conditions. The cashflow over the hold period is therefore relatively uncertain, with the ability to re-let a building and the rent achievable strongly linked to the economic environment.

The strategic focus is on driving value and returns through delivery of the target business plan and successfully taking market risk (see Figure 2). Sales proceeds typically account for approximately 80 per cent of the total return performance and are subject to the highest market risk, making returns relatively volatile.

In contrast, long-income assets are typically associated with lease contracts of at least 15 years and tenants with strong covenants, intended to reduce the inherent risk in the asset and long-term cashflows.

The lessees are typically governmental bodies or investment-grade companies. Leases will more often provide for the tenant to be responsible for all costs relating to the asset, including property taxes, building insurance and maintenance. Even where this is not the case, long-income investors' exposure to operational and capital expenditures are generally much lower than for traditional real estate due to the secure long-term nature of the leases and tenant quality. Income during the investment hold period is therefore more predictable.

Long-income investors' exposure to operational and capital expenditures are generally much lower than for traditional real estate

As rents are usually linked to inflation, the income stream is also relatively protected in real terms over the long term, with reduced exposure to cyclical market rental growth. The majority of asset value will be in the contractually-secured rental income stream, with the capital return at exit accounting for around 30 per cent. This means there is significantly lower market timing risk, as Figure 3 illustrates. Long-income strategies will also usually be relatively less exposed to the fluctuating cost of debt (as a typically low levered strategy) and construction costs, both of which are rising.

Life Science development in the Netherlands, acquired by Aviva Investors E-RELI Fund in 2019.

ESG considerations within real estate long income

The ESG attributes of buildings are of heightened importance to long-income investors due to their long-term investment horizons. In particular, assets need to demonstrate long-term resilience to the possible effects of climate change and less obsolescence risk. This requires a highly selective approach to acquisitions and a targeted asset management programme to protect value.

There is scope to make material improvements to assets at comparatively low cost

As holders of relatively stable portfolios, long-income investors have a good opportunity to invest in sustainability enhancing initiatives. As a result of their long-term occupation of buildings, tenants often also have more interest in the ESG attributes of their accommodation in terms of brand reputation, alignment with their own ESG commitments, energy costs and the quality of the environment for customers or employees.

Our experience suggests there is scope to make material improvements to assets at comparatively low cost through effective landlord and tenant collaboration and careful monitoring of energy consumption. More significant investment by landlords to reduce carbon emissions, to the mutual benefit of long-term tenants and landlords, can be done in exchange for lease extensions or increased rents. This helps protect and enhance long-term returns and improve the quality of the asset for the tenant.

Consideration of the social impact of buildings over the long term is also important. Social infrastructure assets such as education, healthcare or social housing lend themselves well to long-income strategies as tenants are usually stable public-sector entities, requiring security of long-term occupation.

Demand in these sectors is supported by long-term demographic trends. Investment in this sub-sector provides ownership of assets of important social value that are often difficult to replace and, where well-maintained, typically see a high probability of lease renewal, further extending the duration of cashflows.

Beyond social infrastructure, asset class coverage for long-income strategies is broad, with a focus on secure long-term income fundamentals, including life sciences, alternatives and core corporate assets.

Solar photovoltaic (PV) installation funded by one of Aviva Investors' UK long income funds at a large distribution centre, producing 1,980 MWh of clean energy and avoiding an estimated 1,027 tonnes of carbon dioxide emissions each year.

The role of European real estate long income in diversified portfolios

Real estate long income can play a number of useful roles in diversified portfolios, helping to de-risk property exposure, supplement fixed-income holdings and provide stable income returns through the cycle. It can also be an attractively priced long-term inflation hedge.

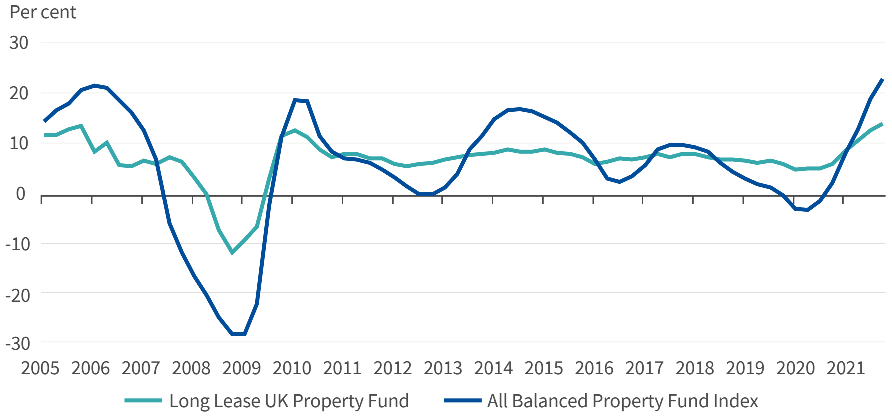
De-risking property exposure

Due to its reduced exposure to cyclical market variables and more stable through-the-cycle income yield, real estate long income can be an effective diversifier in more traditional real estate portfolios.

Across a full business cycle, the asset class would be expected to provide slightly lower absolute returns than traditional real estate, but with significantly less volatility. Higher income security means it is also more likely to outperform during a downturn. Investors may, therefore, consider increasing their allocation to real estate long income when they view the prospects for occupier markets in traditional real estate sectors to be weak or negative, and the outlook for capital growth to be more uncertain.

Real estate long income can help de-risk property exposure, supplement fixed-income holdings and provide stable income returns

Figure 4. **Lower volatility of returns from UK long income than the wider UK market, rolling 12-month performance (per cent)**



Past performance is not a reliable indicator of future results.

Note: 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. UK All Balanced Property fund chosen to show wide comparator against an index showing all UK property.

Source: MSCI, Aviva Investors. Data as of March 31, 2022.

Over the long term, the higher expected and greater consistency of income returns associated with long-income strategies mean they are capable of outperforming traditional real estate strategies on a risk-adjusted basis. The volatility of returns from UK long-lease real estate was less than half that of the UK All Balanced Property Fund Index from 2005 to the end of March 2022, with less pronounced peaks and troughs (see Figure 4). The standard deviation of total returns in this period was 4.3 per cent for long income, and 11 per cent for balanced property funds.

Higher income security means real estate long income is more likely to outperform during a downturn

During the global financial crisis of 2007 to 2009, long income outperformed on an absolute and risk-adjusted basis over the full period shown (UK data is cited here, as there were fewer established European real estate long-income comparators).

An alternative to fixed income

Notwithstanding the recent increases in interest rates, real estate long income continues to provide an attractive income yield premium over government bonds of a similar duration. In addition, the asset class provides exposure to a defensive real estate portfolio with potential for capital growth. Therefore, reallocating some exposure from traditional fixed income to real estate long income may allow institutional investors, such as pension funds and insurers, to achieve higher returns without meaningfully increasing risk.

Another challenge for investors with inflation-linked liabilities is the short supply of inflation-linked government and corporate bonds in some European markets. In Germany, inflation-linked federal bonds and notes accounted for just five per cent of total tradable government debt, as of June 2022. This ratio is a little higher in France at 12 per cent, as of April 2022. This compares with a 24 per cent share of index-linked gilts in the UK.

> The short supply of inflation-linked government and corporate bonds in some European markets is a challenge

Long-income real estate, with its explicit inflation linkage in the leases, offers a good match for institutional investors' liabilities and cashflows, protecting real income over the long term.

A defensive strategy in times of crisis

Russia's invasion of Ukraine has made the global economic outlook highly uncertain, disrupting energy markets and supply chains (that have yet to fully recover from COVID-19), and exacerbating inflationary pressures across Europe. In response, central banks are being forced to raise interest rates, running the risk of triggering a recession.

Real estate long income would be expected to offer some defence against this uncertainty and resulting market volatility due to the relative security and stability of income returns. With rents linked to inflation, the sector should also prove more resilient in the event inflation becomes more persistent.

As mentioned earlier, real estate long-income strategies have historically outperformed during market corrections from an income and capital performance standpoint. Throughout the pandemic, rent collection of long-lease assets was strong and valuations generally held up. Our European real estate long-income strategy, for example, maintained 100 per cent rent collection throughout. In contrast, rent collections in traditional real estate fell and landlords faced a loss of income.

It is also worth noting our flagship UK real estate long-income strategy lost 19 per cent in value during the global financial crisis of 2007-2009, compared to a 40 per cent loss by the UK Balanced Fund index in the same period (see Figure 4).

> We expect relatively stable real estate long-income capital values through this current cycle

We expect relatively stable real estate long-income capital values through this current cycle, supported by higher yields going into it (versus core real estate) and continued resilience of income returns. Stronger inflation-linked uplifts in rents should also partly mitigate the impact of market-driven outward shifts in yields on capital values.

Key takeaways

- Real estate long-income can offer greater income predictability than traditional real estate strategies and lower exposure to capital value volatility. During periods of economic uncertainty, with significant risk of inflationary pressures persisting, real estate long income can provide valuable income growth and capital value protection
- The asset class offers the potential of an illiquidity premium over bonds of comparative risk and duration, making it an attractive substitute to traditional fixed income for investors over the long term
- The increased time horizon of long-income investors makes them especially well-placed and motivated to collaborate with tenants to find mutually beneficial means of improving the efficiency and carbon emissions of buildings

Key risks

Investment risk

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. Investors may not get back the original amount invested.

Return profile

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

Real estate risk

Where funds are invested in real estate, investors may not be able to redeem any units in the fund when they want because real estate assets may not always be readily saleable. If this is the case, we may defer a request to switch or cash in shares or units.

Valuation risk

Certain assets held in the fund 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.

Important Information

Contact us

Aviva Investors
St Helen's, 1 Undershaft
London EC3P 3DQ
+44 (0)20 7809 6000

www.avivainvestors.com