Update on drivers in real assets

Q3 2019

Assessing impacts of a possible downturn in the euro zone on private assets

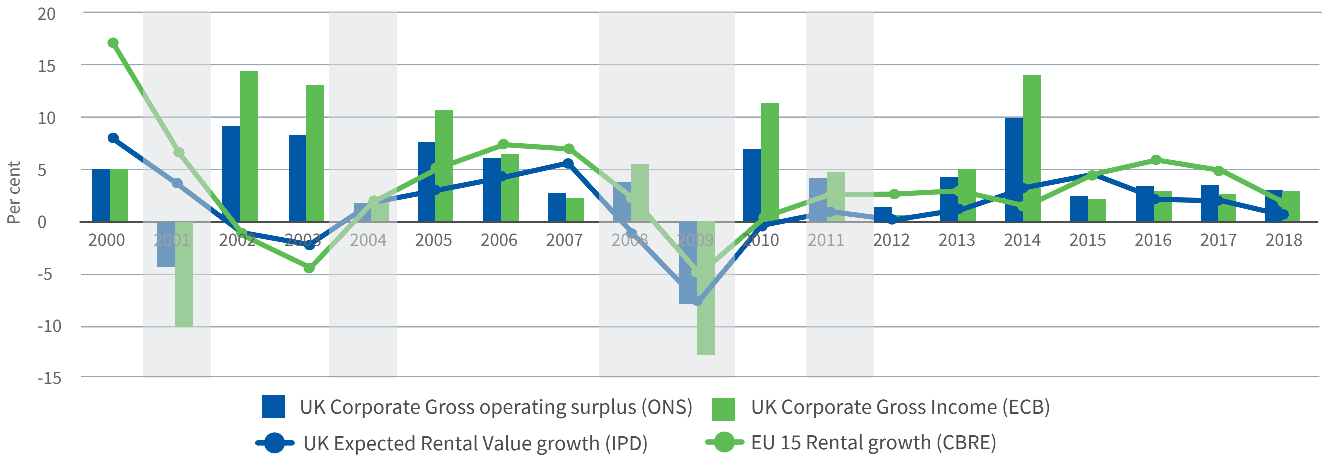
The European Central Bank's decision to re-start asset purchases in September at €20 billion a month highlights more cautious sentiment in the euro zone. While our central scenario is for growth to moderate rather than decline sharply, we look at the impact of a possible downturn for holders of private assets, trying to anticipate the uneven impacts of slower economic growth.

Focus on cash flows

Long income real estate, infrastructure or corporate borrowers with contracted or regulated revenues are likely to see their cash flow generation relatively unaffected, while corporate borrowers in competitive sectors would be most exposed. Historically, corporate profits have been more volatile than rental yields.

Cash flows derived from real estate vary with the economic cycle but to differing degrees. Parts of the market have short leases and tend to exhibit a strong correlation between GDP growth and rental values (such as high street shops). These are exposed to a downturn. Other areas feature longer leases, with low correlation between GDP growth and rental values, and are therefore more defensive.

Figure 1. **Through the cycle: tracking the cash flow of corporate and property borrowers**

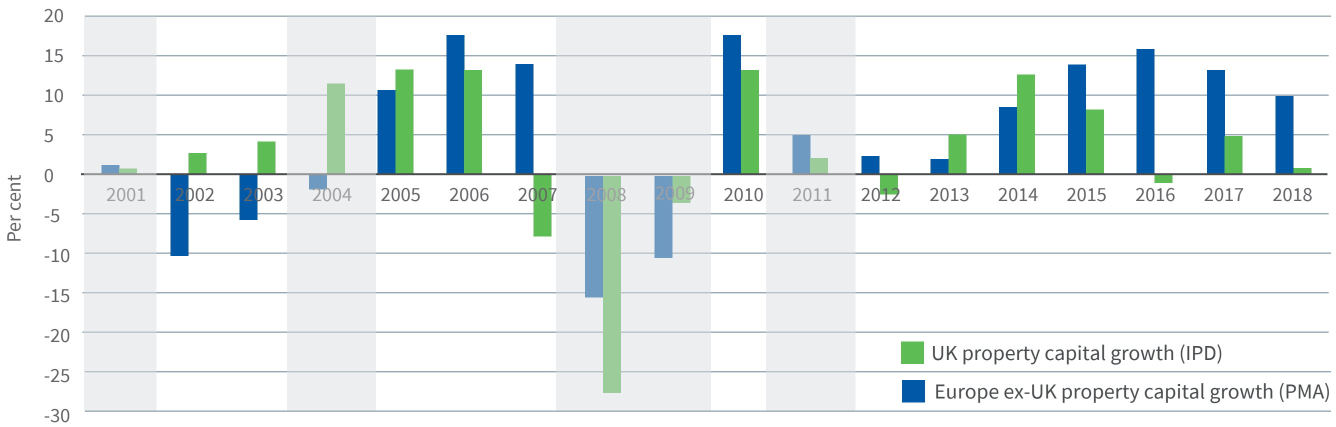


Shaded areas: years where GDP growth fell by more than 1% vs. previous year. Source: Investment Property Databank (IPD), European Central Bank, CBRE Global Investors. As of 2018

Valuation outlook

Secured lenders would benefit from additional protection. Infrastructure asset values are likely to be quite stable, with the exception of economic infrastructure with strong GDP linkages – e.g. ports, or those exposed to commodity prices. On the other hand, property values are more strongly correlated to economic cycles.

Figure 2. **Through the cycle: change in property value**



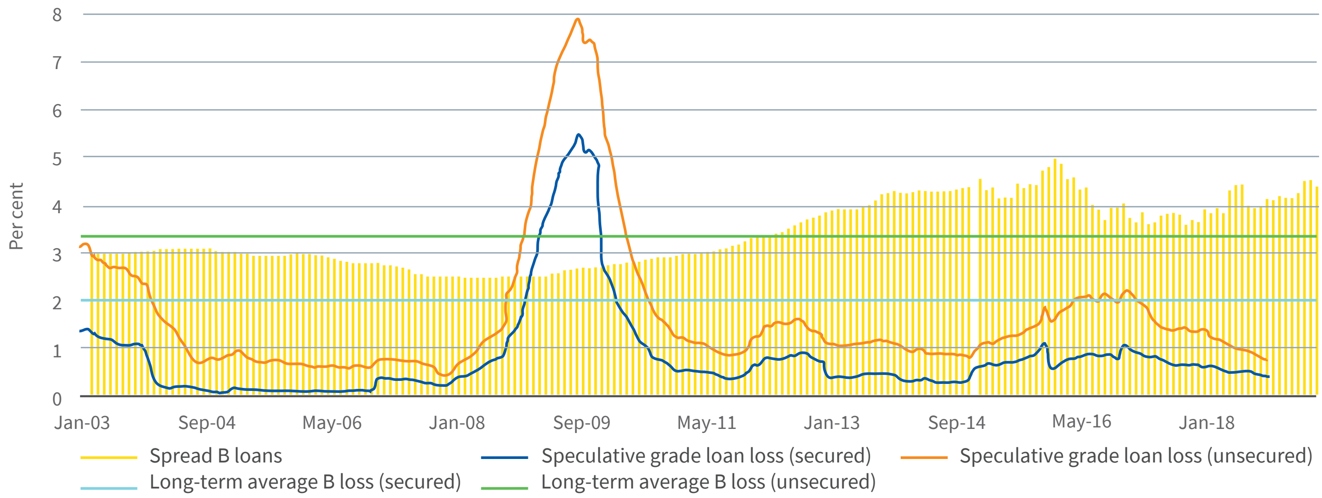
Shaded areas: years where GDP growth fell by more than 1% vs. previous year. Source: UK Office for National Statistics, OECD, PMA, IPD, Aviva Investors. As of June 2019

Importance of security and ranking in the capital structure

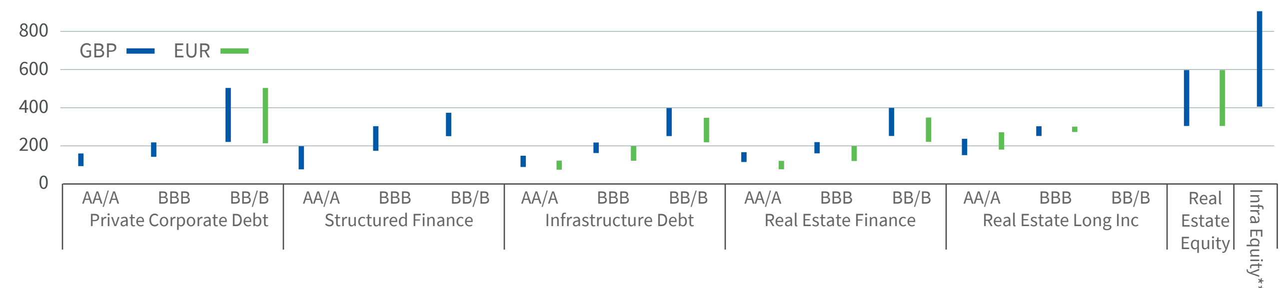
Senior secured creditors would be comparatively well placed. Institutional real estate loans extended at up to 60 per cent of property value can absorb a shock consistent with the average drop in property values experienced during the Global Financial Crisis. Unsecured lenders or second lien lenders are more exposed.

The same holds true for corporate lending. The graph below compares average losses for various tranches of corporate debt compared to the average interest income for leveraged loans. The average spread is not substantially above the long-term average loss for unsecured creditors (in green), illustrating the value of security.

Figure 3. **Margins and credit losses**



Indicative spreads p.a.*



* Additional yield above comparable government bonds **High quality: unlevered infrastructure with largely predictable cash flow. Source: Aviva Investors (for illustrative purposes only). Data as at 30 June 2019. The future returns and opinions expressed are based on Aviva Investors internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature.

Risks: Illiquidity: Alternative Income assets are significantly less liquid than assets traded on public markets. Where funds are invested in infrastructure/real estate, investors may not be able to switch or cash in an investment when they want because infrastructure may not always be readily saleable. If this is the case, we may defer a request to redeem the investment. **Valuation:** Investors should bear in mind that the valuation of real estate/infrastructure is generally a matter of valuers' opinion rather than fact. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Past performance is not a guide to future returns. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Past performance is not a guide to future returns.

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