The case for LGPS investment into real estate long income

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The need for Local Government Pension Scheme (LGPS) investors to explore alternatives to fixed income investments is becoming ever more apparent. The current low yield environment, increasing member maturity, declining active members and reduced cash flow positivity make diversification increasingly important.

At CBRE Global Investors we believe that real estate long income offers a potential solution to LGPS investors. The attractiveness of the investment class, the types of opportunities available and the key considerations when investing are outlined in this article.

Real estate long income is a low risk, long term investment strategy. The returns are primarily driven by the rent generated from long dated, typically inflation-linked leases. This can be particularly attractive to LGPS investors as their pension liabilities are explicitly linked to CPI inflation.

Intuitively real estate long income strategies can offer a solution to LGPS investors but what risk and return characteristics can LGPS investors expect?

Historically, when compared with fixed income and traditional real estate strategies, real estate long income has illustrated attractive risk adjusted returns (Figure 1).

Long income real estate also offers diversification benefits for investors with existing exposure to real assets. Long leases and index-linked rental uplifts lower the correlation with the wider business and real estate rental cycles – a characteristic particularly attractive in times of depressed rental growth.

However, risk and return are only part of the story. Real estate long income investments can be structured to provide tailored cashflows that meet an LGPS's duration and inflation needs. These liability matching cashflow types can be broadly split into the following three categories;

Conventional leases: The investor benefits from a lease with recourse to a tenant counterparty. The contracted cashflow is typically in excess of 15 years. The income is typically increased in line with inflation and the property interest is retained by the investor upon expiry of the lease.

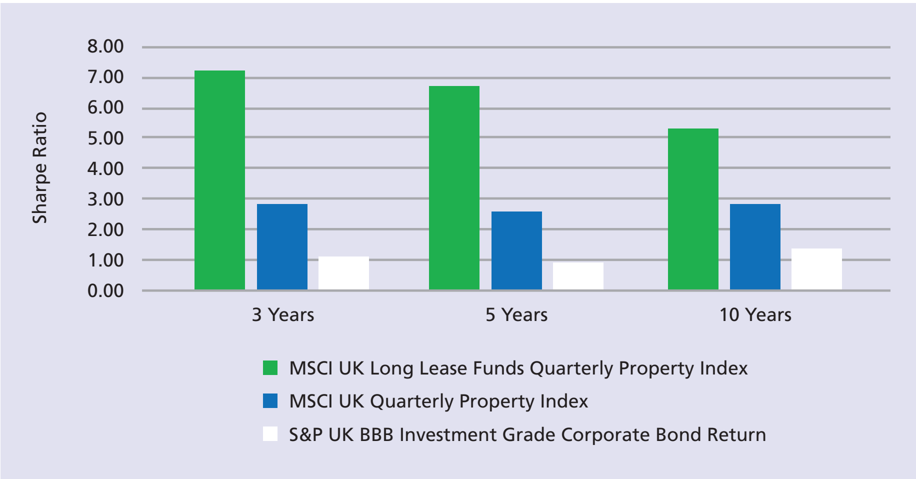
Ground rents: The longest of all contracted cashflows with leases typically in excess of 100 years. Typically, income is contractually increased in line with inflation. The rent received and the amount invested are at a significant discount to underlying market value therefore providing security in the event of tenant default.

Income strips/Amortising leases: Similar to conventional leases but with the investor typically benefiting from a longer lease (30 years or more). Upon expiry of the lease, a third party (usually the tenant) benefits from an option to purchase the real estate for a nominal value (typically £1).

Real estate long income is flexible and can be argued to have various attractions, but what are the key considerations for LGPS investors to be cognisant of when investing?

Real estate long income is a long-term investment. The credit strength of a given investment is typically derived by the level of collateral provided by the property, especially in the case of ground rents, or the financial strength of the tenant counterparty, which is principally the case for conventional and income strips assets.

Figure 1: Asset Class Sharpe Ratios



Source: CBRE Global Investors

NB: Past performance is not necessarily indicative of future returns

Whilst the type and level of credit quality varies between investment structure, in our view the attractiveness of the property is always of paramount importance. This is especially true in times of potential distress, including the prevailing climate driven by Covid-19.

The historical temptation of some real estate long income investment managers has been to take a binary tick-box approach to investing, with an exclusive focus on investments which are let to an investment grade tenant at the time of acquisition and exhibit the required term and inflation hedging characteristics. This approach ignores the quality of the asset upon which the cashflow is secured. This is particularly risky given the long-term investment horizon of the strategy and potential for deterioration of the underlying tenant during this period.

Historically, in any typical 12 month period, approximately 4-5% of investment grade corporates are downgraded from investment grade to sub investment grade.[1] This is a significant proportion if you are reliant upon long-term, continued maintenance of investment grade ratings for the security of your investment.

This volatility is amplified in periods of distress such as those witnessed in the Covid-19 environment. Rating agency, Standard & Poors, estimates that across EMEA, 8% of BBB-rated corporates could be vulnerable to downgrade during 2020.[2] When this volatility is combined with poor underlying assets, the capital and income vulnerability of investments becomes heightened.

We therefore believe that the key to success when investing in real estate long income is to combine the science of structuring the required cashflow characteristics with the skill of gaining access to attractive real estate fundamentals.

Due to the long-term nature of the investments this is key at both the point of acquisition and throughout the hold period. Appraising real estate fundamentals requires significant experience and the list of factors to consider is extensive with some outlined below:

Sector selection: Gaining exposure to sectors which exhibit characteristics that are structurally defensive over the long term as well as providing sustainable income streams. This occurs where long-term underlying occupational demand drives rental growth in line with the contracted inflation linked uplifts received from the investment.

Vacant possession value coverage: Investing in assets where the value of the vacant property is sustainable in comparison with the investment value of the property.

Viable alternative use: Gaining exposure to assets and locations which are supportive of alternative uses, if in the future, the current use is no longer viable.

Market rental coverage: Investing in assets where the rent achievable from alternative tenants is in line or in excess of the income received from the property.

In summary, managed correctly real estate long income can provide tailored cashflows which meet LGPS requirements whilst also offering attractive risk-adjusted returns when compared with other comparable asset classes and strategies. However, this is contingent upon not only targeting appropriate cashflow characteristics but also ensuring that the underlying property fundamentals protect investors over the long term and specifically in times of distress.

1. S&P Market Global Intelligence, Michael Rae, Peter Brennan 23 April 2020
2. S&P Market Global Intelligence, Aleena Haroon 9 April 2020