UBS Asset Management, Real Estate & Private Markets

Long-income property investment meets investor needs

Recently, Jonathan A. Schein, senior vice president, managing director of global business development at Institutional Real Estate, Inc spoke with Howard Meaney, head of global real estate UK at UBS Asset Management, Real Estate & Private Markets. The following is an excerpt of that conversation.

It's no secret that investors are looking for additional income. Why are you so enthusiastic about a long-income property strategy to meet their needs?

Long-income strategies have several characteristics that make them particularly suitable for today's income-seeking institutional investors. Pension funds face huge issues in meeting distributions to their pensioners. In an environment of low interest rates and high asset values, investors are often finding themselves taking on more risk to achieve the same level of returns they realized just a short time ago. Continuing to add risk to their portfolios simply isn't sustainable for most institutions. Long-income property can help mitigate this dilemma by providing stable income based on contractual real estate leases. This means returns have a core real estate return profile, while the risk profile is similar to fixed income.

When we say long income, how long is long?

Leases would typically be for an average lease duration of 20 years but, at the fund level, this could drop to 15 years, allowing for the expiration of time. We have negotiations underway on healthcare properties that will be let on 25-year leases and for even longer on some garden centres.

What are the advantages of these long-term leases?

The primary advantage is stable, predictable income. The leases are nearly always subject to inflation-linked — either annual or five-year — upward-only rent review or benefit from a pre-agreed form of rental uplift. Modeling cash flow for both the operator or tenant and the owner is, therefore, simplified. Thus, if you have a 25-year lease in place, you would continue to receive the rent and increases agreed to when the lease was signed, allowing the landlord to benefit from a known income stream throughout any market volatility. The upward-only nature of the review provisions protects revenue to the investor, while the CPI or other inflation-sensitive indexes can provide an inflation hedge as rates rise. Therefore, this type of investment fund provides stable, increasing income in both good and bad times. For example, at the height of the 2012–2013 euro zone crisis, UK balanced-fund returns dropped to near zero percent, while long-income funds remained relatively stable and above 6 percent per annum. Assets with long-term secured income and, in particular, those with inflation-linked rent increases will be largely immune to any short-term negative impact on rental values, and also benefit from having no vacancy during a period when reletting space would be difficult.

So, these funds are particularly good in today's climate, when the outlook is a bit uncertain?

Exactly. With real estate values back to their precrisis peak in most major markets, and a political climate that has introduced a high level of uncertainty into the markets, the current outlook for real estate is challenging, with rental levels across most traditional segments forecast to come under downward pressure. Simultaneously, CPI inflation is rising and is set to exceed 3 percent in the UK this year, which adds further intrinsic value to index-linked leases. The benefits of having a long-term secured lease that can outlast a period of volatility and potentially-weakened occupational demand has a clear attraction for investors.

Why would an occupier want to be tied to such a long-term lease?

Certain occupiers are prepared to take these 25-year leases because their businesses require that they be committed to a specific location and asset. These could include medical facilities, student housing, high-end retail, restaurants, hotels and others that find staying in one place improves their success. They are willing to tie themselves to a long lease in exchange for the guaranteed space at a predictable price.

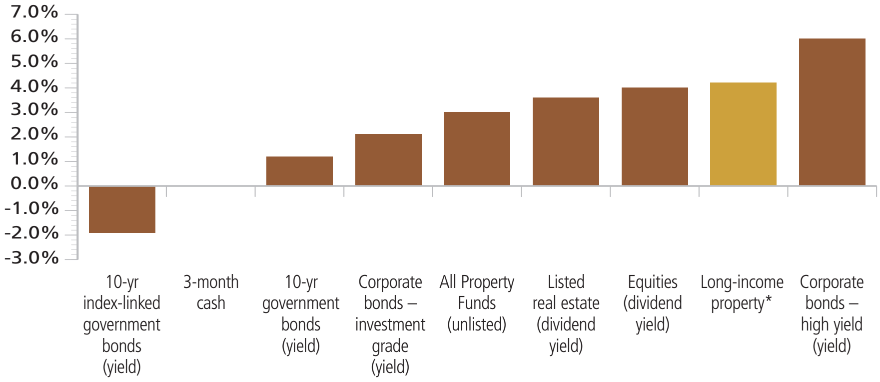
Are these single-tenant assets?

Yes. We are talking about single-tenant assets with long-term, secure leases. Most traditional funds diversify their tenant base by having multiple tenants within one building. Long-term property portfolios, on the other hand, diversify by including multiple tenants in a single portfolio. We can diversify risk across the number of properties, geographies and industries to provide much better diversification than found in a multiple-tenant asset.

Where would this investment fall on the risk spectrum?

We see this falling between traditional real estate and corporate bonds, but a lot depends on the manager. We have to be very astute in terms of the quality of the real estate, the creditworthiness of the tenant and the sustainability of the tenant's business. The future growth prospects for the tenant's particular industry are crucial. Businesses that did not exist 15 years ago are now some of the largest on the planet. You do not want tenants to be part of the industry that gets overtaken by these new businesses. The premise of this product is based on the length of the lease, so if you are relying on 25-year leases for stable income, you

Figure 1: Current income return/dividend yield across asset classes (% p.a.)



Sources: Datastream; MSCI-IPD; NCREIF; UBS Global Asset Management, Real Estate & Private Markets as at Q1 2017
*Income return taken from a weighted average of funds reporting to the MSCI fund index. Past performance is not a guide to the future.

want to make sure those tenants are still in business 25 years from now.

What are the expected returns?

We expect these investments to generate a safe 4.75 percent net distribution. We regard this as a healthy return relative to other income generating assets at the moment, as illustrated in Figure 1, which provides a comparison of long-income performance against other asset classes. This is a pure income-generating vehicle with little capital movement. If it is possible to achieve better yields, which we think we can do, then distributions are likely be a little higher.

Are there certain sectors that lend themselves better to these long-term leases than other sectors?

Typical average leases in the traditional real estate sectors run about seven years in the UK now. So, these are not the sectors we are looking at. Occupiers that are more prepared to take on long leases are in the more non-traditional sectors, where their business is embedded in the real estate. This would include assets such as hotel, leisure facilities, healthcare, children's nurseries and garden centres. It can even be student housing, where a university will take a 25-year lease on a student accommodation block. It is the operational nature of these types of assets that make them the right properties for long-term leases.

What are some of the challenges to long-term property investments?

The length of the lease, which is the prime advantage, also introduces the main challenges. These tend to be very bespoke assets, suitable specifically for the tenants seeking to occupy them for 25 years. There is no guarantee that they will be suitable for another tenant at the end of that time. To avoid the scenario of owning empty real estate, we look for assets that could be occupied by alternative tenants and, therefore, have underlying site value and underlying real estate value. We always consider wider demographic trends and the surrounding growth in our asset locations, where there may be multiple future uses for the land. This should safeguard against some of the end-of-lease vacancy risks. Occupational demands have been changing and will continue to change in the future. For example, supermarkets grew from neighbourhood stores to mega stores with 100,000 square feet of space — and are now shrinking back to more manageable, focused sizes. Today, you would have a very hard time reletting those large mega-supermarket spaces because the big operators are now looking to reduce the accommodation they actually need on these properties. These are the types of situations we try to foresee and avoid.

With all the positives that you've outlined, have you actually seen interest in this investment vehicle from investors?

Absolutely. Although we have been focused on the UK market, we have had investors from the Continent and Asia also showing interest. That should not be surprising. Investors everywhere are looking for assets that offer positive returns in an environment currently made up of an ageing population, unconventional monetary policy and increased financial-market regulations which, in turn, have depressed real interest rates. As such, they are recognizing that long-income property has the potential to provide sustainable income, as well as offering attractive long-term real estate characteristics. The risk-and-return profile makes this a positive addition to many broader portfolios. We believe that their low-volatility, secure-income returns, coupled with inflation-linked and upward-only rental increases, make this a good time to invest in the asset class, and we are finding that investors agree.

Contributor
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CORPORATE OVERVIEW

UBS Asset Management's Real Estate & Private Markets business actively manages investments around €86 billion globally and regionally within Asia Pacific, Europe and the US, making it one of the largest asset managers in real assets worldwide. Our capabilities span the risk/return spectrum, from core to value-add and opportunistic strategies. We offer direct real estate and infrastructure equity and debt investments, plus indirect exposure to leading real estate, infrastructure, and private equity managers. Investors can access our diverse product range across open- and closed-ended private funds, investment trusts, listed funds, REITs and bespoke separately-managed accounts.

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