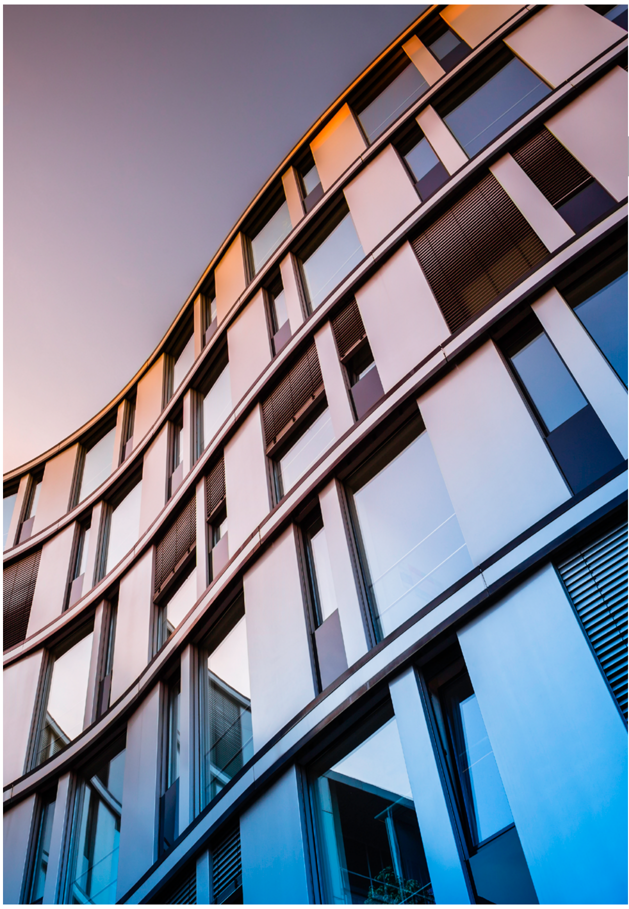


OCTOBER 2022

The Appeal of UK Core Long-Income Commercial Real Estate Investing:

An Attractive Alternative to Traditional Liability Matching

Key Takeaways

- Strong inflation protection via lease indexation
- Proven liability matching and low volatility
- Out-performance versus other asset classes across all time series
- Driving positive change towards a low carbon economy

Defined Benefit ("DB") Pension Schemes in the UK have traditionally sought required levels of investment return via investing across a balanced strategy, including conventional liquid investments such as bonds and equities, together with more illiquid alternative assets such as real estate, private equity and infrastructure. As DB schemes move towards maturity, the need to de-risk typically skews investment portfolios towards the security and certainty of fixed income. At the same time, reducing inflows increase trustee focus on liquidity.

Prolonged periods of quantitative easing across developed economies, initially post-Global Financial Crisis ("GFC") and more recently through the global Coronavirus pandemic, have driven asset pricing. Together with other extraneous factors such as ongoing war in Ukraine and resultant supply chain disruption, these combined forces have led to widespread and persistent inflation, rising interest rates and fears of recession. This dynamic has created extreme volatility across bond and equity markets creating an unstable investment backdrop, an uncomfortable dynamic for mature DB schemes required to support more retirees for longer. This so-called pension *timebomb* is starting to tick loudly for many such schemes.

> The UK investor has limited choice when it comes to meeting long-term income needs. Despite having less liquidity, private markets, and more specifically real estate, could be the best answer.

So, how can core UK real estate provide a solution to what is becoming one of the defining problems of our time? One answer is via a well-structured, well-executed long-income strategy, enabling schemes to achieve stable and dependable index-linked liability matching over periods of 20+ years, whilst also providing longer term distributable income returns of up to 4% per annum. At a period in the cycle where comparable duration gilts provide sub 2%[1], this can offer real appeal as a diversifier and a welcome boost to scheme returns.

The key to such *bond proxy* investing is to execute within clearly defined risk parameters, ensuring that income streams are long in duration, secure in nature and progressive via inflation linked indexation. Core long-income investing into UK real estate can achieve all of these things if deployed within a strategy that targets secure income and strong terminal residual land values. Furthermore, with returns generated via a series of direct asset ownerships, the ability to acquire and manage within a sustainable framework can ensure responsible ESG investing.

This paper explores the case for investing into UK core long-income real estate as part of a balanced investment strategy for mature DB pension schemes.

1 British Government Securities, June 2022. Quarterly average yield from British Government Securities, 10 year Nominal Par Yield: Bank of England (IUQAMNPY).

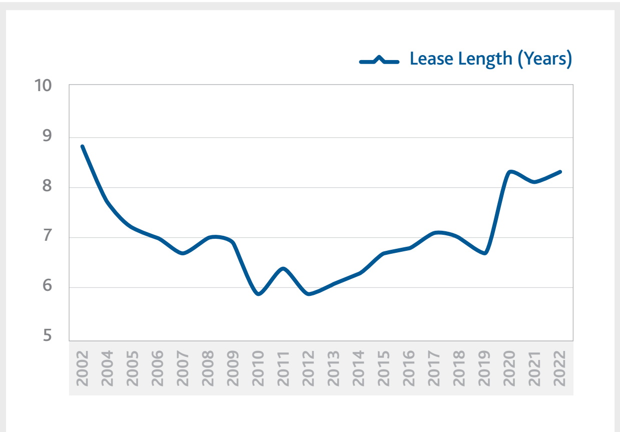
Definition of Long-Income Real Estate

Long-income real estate in the UK market describes property with leases of typically 15 years unexpired or longer. For context, approximately 94% of all leases in the UK are shorter than 15 years[2] and the average commercial lease duration stands at 8.3 years (**see Figure 1**).

A lease term of more than 20 years can provide stable, predictable cash flows for the duration of the lease or investment hold. The annual depreciation (and with that, potential capital value decline) associated with a shortening lease term is less impactful for longer leases, especially for unexpired terms of 25+ years. This offers lower volatility than shorter duration leases, where the spectre of pending lease expiry weighs heavily on asset valuations and can cause big fluctuations through the economic cycle.

The MSCI UK Long Income Property Fund Index comprises £17.5bn[3] of real estate with most constituent funds seeking to maintain an unexpired lease duration in excess of 20 years. Notwithstanding a quarterly net inflow of £1.4bn capital into the index over the last 3 years (versus an almost £6.5bn outflow of capital from Balanced Funds over the same period)[3], this represents less than 11% of the overall MSCI UK Quarterly Universe[4] and indicates the increasing scarcity of such stock in the market. It is this lack of available investment stock, rather than any lack of investor appeal, that presents the most significant barrier to entry into the market.

FIGURE 1 | Unweighted Lease Length (Years)



Source: UK Lease Events Review (MSCI & BNP Paribas Real Estate, November 2020) & MSCI, December 2021. Lease data based on the unweighted full term; ignoring breaks and including short leases.

The Appeal of Long-Income

Real Estate in the Context of UK DB Schemes

The unprecedented fall in global interest rates in the decade that followed the GFC has seen a number of DB pension schemes turn to Liability Driven Investment ("LDI") strategies to manage their interest rate and inflation risk. LDI strategies now form 53% of the pension market versus 30% seven years ago (**see Figure 2**).[5]

FIGURE 2 | UK Pension Investment Strategies (£m)

Source: Investment/Asset Management in the UK. The Investment Association, September 2012-2021.

Wider factors are underpinning this significant strategic shift including socio-demographic trends and, in particular, an ageing and growing UK population.

A combination of maturing pension schemes – fewer existing workers expected to fund increasing numbers of retired former workers – along with an expectation of lower returns moving forwards, as economic conditions become more challenged, is likely to create greater risk of a funding shortfall.

In the current volatile environment for UK fixed income, liability-driven investors can look towards real assets as a liability matching alternative to investment-grade credit and index-linked government bonds.

Real estate – in particular long-income real estate – can meet both value growth and liability matching objectives with secure fixed income-type cash flows (in many cases linked to inflation) and capital value growth potential in the long term. The all-property equivalent yield currently stands at 4.9%[6] (MSCI UK Long Lease Funds equivalent yield at 4.2%[7]), representing a 286 bps pre-inflation yield arbitrage over long-dated UK Gilts (**see Figure 3**).

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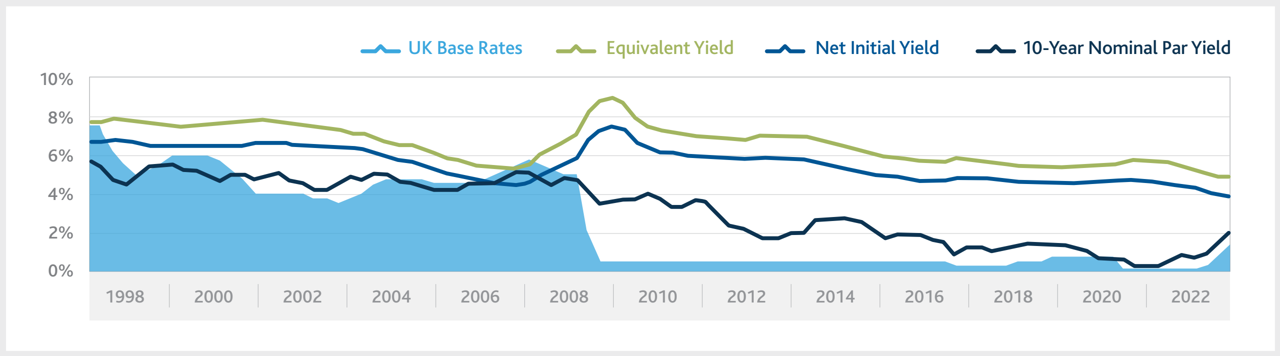
2 UK Lease Events Review (MSCI & BNP Paribas Real Estate, November 2019). **3** Property Fund Vision Handbook Q2 2022. MSCI/AREF, June 2022. **4** MSCI as at 31st June 2022. **5** Investment/Asset Management in the UK. The Investment Association, September 2012-2021. **6** MSCI UK Quarterly Property Index, June 2022. **7** MSCI UK Long Lease Funds in Quarterly Universe, June 2022.

FIGURE 3 | MSCI UK Quarterly Property Index Equivalent Yield vs Gilts vs Base Rate (1998 – 2022)



Source: BASE RATE: Bank of England, Official Bank Rate. MSCI UK Quarterly Property Index Equivalent Yield. 10-Year Nominal Par Yield: Bank of England, 10-year Nominal Par Yield.

Whilst this has reduced in recent months it still sits comfortably when measured against the longer term 30-year average.

Real estate has been a staple asset allocation for pension funds since the early 1970s, with weighted average allocations at c.5% for UK DB schemes.[8]

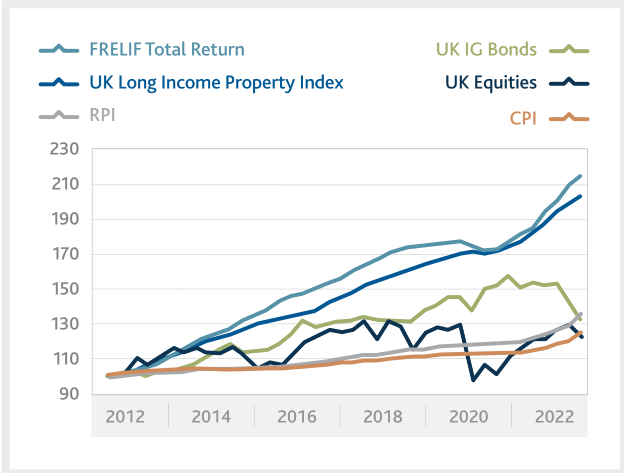
According to Aviva Investors' November 2021 Real Assets Study, almost half of respondents from insurance companies and pension funds across Europe, North America and Asia (including UK pension funds) want their allocations to real assets (including real estate) to increase and long-income is amongst a handful of sub-sectors that have "the best defensive characteristics and will appeal for some time yet".[9] This sits well alongside broader LDI strategies.

As shown in **Figure 4** UK long-income property has outperformed other asset classes over a 10-year period, with less volatility throughout with the tangible underlying value attributed to buildings and the land upon which they sit helping to provide a catalyst for capital growth over the longer term on top of the secure, long let and progressive income streams. In addition, having a strong correlation to RPI (98.1%) compared to that of UK IG Bonds (85.2%) & UK Equities (44.6%) adds further to the relative appeal of long-income real estate investing.

A Diversifying Asset Class

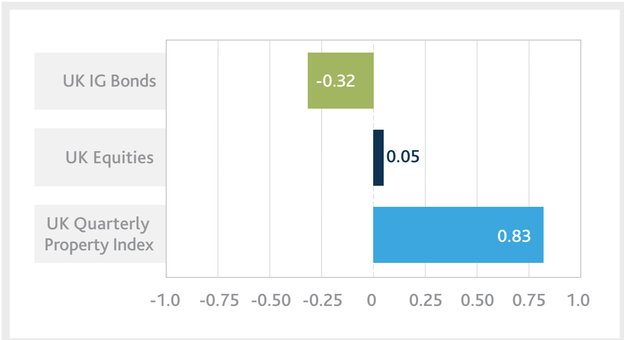
Diversification benefits have long been a driver for real estate allocations in multi-asset portfolios. The characteristics typically associated with underlying real estate of income stability and progression, scope for capital growth and tangible asset worth have served to counter the traditional shortcomings of illiquidity and imperfect information. These positive attributes are emphasised in long-income strategies, often reducing volatility and resulting in low correlations with traditional asset classes (**see Figure 5**).

FIGURE 4 | Annualised Total Returns



Source: Fiera Real Estate, June 2022 for the Fiera Real Estate Long Income Fund, UK (FRELIF).MSCI, June 2022. UK REAL ESTATE: MSCI, Long Income Open-Ended Property Fund Index, GBP. UK EQUITIES: FTSE 100 Index, GBP. UK IG BONDS: S&P U.K. Investment Grade Corporate Bond Index, Total Return, GBP.

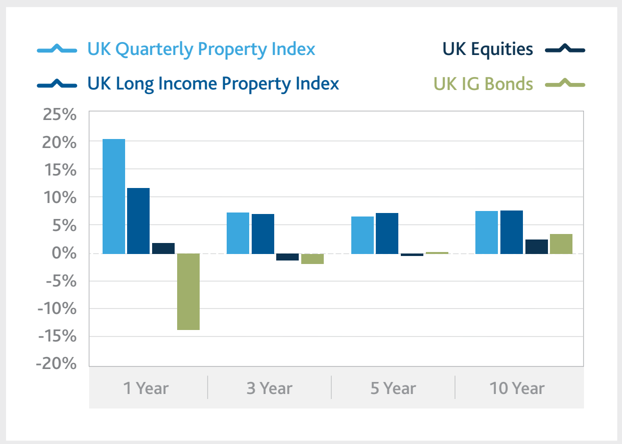
FIGURE 5 | UK Long Income Fund Index Correlation with Traditional Asset Classes



Source: MSCI, June 2022. UK REAL ESTATE: MSCI, IPD UK Quarterly Property Index. UK EQUITIES: FTSE 100 Index, GBP. UK IG BONDS: S&P U.K. Investment Grade Corporate Bond Index, Total Return, GBP. (June 2012 – June 2022)

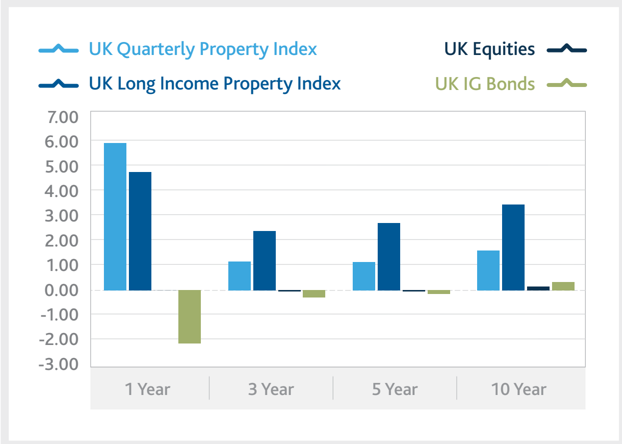
8 The Purple Book. Pension Protection Fund, December 2021. 9 Real Assets Study. Aviva Investors, November 2021.

FIGURE 6 | Annualised Total Returns



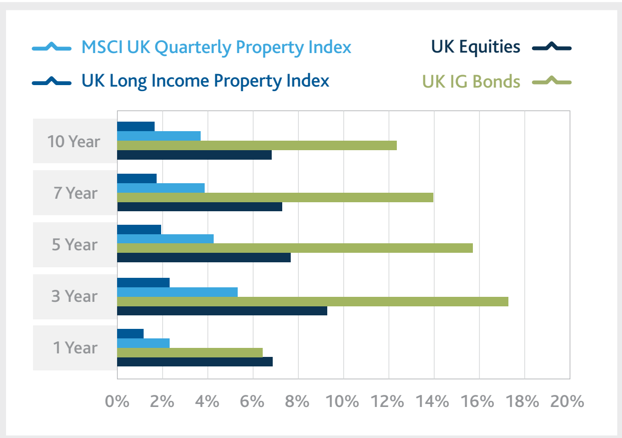
Source: MSCI, June 2022. UK REAL ESTATE: MSCI, IPD UK Quarterly Property Index, GBP & Long Income Open-Ended Property Fund Index, GBP. UK EQUITIES: FTSE 100 Index, GBP. UK IG BONDS: S&P U.K. Investment Grade Corporate Bond Index, Total Return, GBP.

FIGURE 8 | Sharpe Ratio Across Asset Classes



Source: MSCI, June 2022. UK REAL ESTATE: MSCI, IPD UK Quarterly Property Index, GBP & Long Income Open-Ended Property Fund Index, GBP. UK EQUITIES: FTSE 100 Index, GBP. UK IG BONDS: S&P U.K. Investment Grade Corporate Bond Index, Total Return, GBP.

FIGURE 7 | Standard Deviation Comparison to June 2022



Source: MSCI, June 2022. UK REAL ESTATE: MSCI, IPD UK Quarterly Property Index, GBP & Long Income Open-Ended Property Fund Index, GBP. UK EQUITIES: FTSE 100 Index, GBP. UK IG BONDS: S&P U.K. Investment Grade Corporate Bond Index, Total Return, GBP.

Attractive Risk-Adjusted Returns

Generally delivering less volatility and higher total returns than both equities and bonds, UK commercial real estate, in the wider sense, can offer investors an attractive risk-adjusted position across their portfolios (**see Figure 6, 7 and 8**).

Looking at the standard deviation as a comparable measure of risk across asset classes, the volatility of real estate appears low relative to traditional asset classes. Long-income investing typically carries the lowest volatility of returns across the wider real estate market.

Income is a Consistent Driver Throughout Cycles

The relative low volatility of real estate is, in part, due to the high proportion of total return derived from income. In the last 20 years, approximately 74% of real estate total return has come from income.[10] Through contractual rent obligations with tenants, real estate offers a stable and predictable cash yield to investors through the property cycle. Long leased assets to strong tenant credit are able to provide the greatest certainty.

Owing to the potential for income growth, crystallised through rent review provisions in leases and new lettings, discounted cash flows from a real estate investment provide a match to pension scheme liability cashflows that can outstrip conventional UK fixed income. This is even more prevalent with index-linked rent review mechanisms, within long, full repairing and insuring ("triple net") leases where the cost burden rests with the tenant for the duration of their tenure.

Accessing the Long-Income Market

There is a predominance of shorter leases being signed across all sub-sectors of the UK commercial real estate market. This has been further exaggerated post-COVID-19 pandemic meaning that long-income investors need to adopt a more creative approach to deal sourcing and execution in order to regularly deploy capital into this dwindling market segment.

The current excess of investor capital over available qualifying stock makes it very hard for pension scheme investors to access long-dated real estate unless they have real estate teams active

10 MSCI UK Quarterly Property Index since inception (March 2001), December 2021.

FORWARD FUNDING PRE-LET DEVELOPMENT PROJECTS

Occupiers are more likely to make a long-term lease commitment on brand new, ESG exemplar, future-proofed assets where occupational obsolescence is low and broader sustainability and technology goals can be factored into the design and development process. Early engagement from investors helps minimise the risk of future asset stranding and enhances long-term asset liquidity. As a general rule, the older the building, the shorter the lease commitment.

Where long leases can be secured for new developments, there is an opportunity for long-income investors to forward fund such assets at a pre-determined yield, subject to a full pre-letting to a specific tenant or tenants. This type of high quality, institutional-grade stock is sourced from local property developers and therefore managers with the best developer relationships have a significant advantage.

SALE AND LEASEBACKS

Successful long-income investors are able to work with large corporations to identify sale and leaseback opportunities across all sub-sectors of the market. This requires corporate relationships at both local and national levels in order to identify mission critical assets where businesses are prepared to enter into 20-year leaseback arrangements, allowing them to extract capital from their balance sheet for re-investment.

ALTERNATIVE SECTORS

Whilst leases across all mainstream sub-sectors of the market including offices, industrial and retail have been getting shorter, lease duration across alternative sectors (such as hotels, student accommodation, car parks and senior living) have remained long due to the value occupiers place in each property as an operational asset. Accordingly, long-income funds tend to have a concentration towards alternative assets to ensure lease duration is maintained at a portfolio level.

This has caused some challenges for long-income managers over the past 24 months as government enforced lockdowns have caused trading to cease. Operators have been unable to generate “virtual” revenues in sectors such as the hotel or leisure markets. This inability to trade, coupled with a government moratorium on landlord legal action for the pursuit of owed rent has left some managers exposed. The key in this instance is not to place an over reliance on operational assets within an underlying real estate portfolio but instead focus on Covid “winners” such as industrial, logistics and food retail together with those assets that transcend economic cycles and are more focussed on longer term demographic “mega-trends” such as affordable housing and care.

in that area of the market and deep relationships across all procurement channels. For most investors therefore, access to market will be via one of the UK long-income real estate open-ended funds, with entry and exit points on quarterly unit dealing days. However, depending upon timing within the market cycle, gaining exposure to these funds can take time with associated opportunity costs where delays are incurred.

The key to deal sourcing and execution, and therefore timely deployment of capital, is ensuring deep and local penetration into the market on a comprehensive and nationwide basis via a structured and entrepreneurial approach. At Fiera Real Estate, we have a one-third ownership stake in eight regional property development businesses covering all of the major commercial hubs around the UK. This provides our long-income fund with a first call on funding long leased projects delivered by some of the most active development businesses in the UK. **These local operating partners provide additional access points to the market in the key areas to the left.**

How to Manage Risk

Earlier in this paper, we considered how income makes up a large proportion of total return for real estate investors. This is even more pertinent for long-income investing where collecting and protecting income is the principal determinant of success. **Risk management strategies are therefore important for all long-income investors with a sharp focus on each of the following key areas:**

› Environmental, Social & Governance (“ESG”) Focus

With recent growth in sustainable and *impact* investing, policy centred on the three pillars of sustainability (ESG) now sits at the heart of real estate.

The adoption of best practice techniques through an asset’s lifecycle requires a joined-up approach between owner and occupier. With the help of a strong managing agent team (as the principal interface with all occupational tenants) together with in-house and external ESG advisors, investment managers can ensure consistency when measured against international benchmarks such as the Global Real Estate Sustainability Benchmark (GRESB).

At Fiera Real Estate, we recognise the importance of integrating ESG issues within our investment management processes and the lifecycle of each held asset. This starts with a pre-acquisition ESG checklist and is monitored throughout the period of asset ownership via annually updated ESG asset plans.

These in turn feed into the Net Zero Carbon (“NZC”) pathway strategy which for our Long Income Fund is targeting a market leading 2035 for achieving NZC status.

Tenant Analysis and Credit Risk Management

Counterparty (or tenant) risk is particularly relevant for long-income real estate where a long lease is a big commitment for both occupier and owner. The owner must be certain a tenant has long-term plans to stay in occupation and the financial strength to service growing rental payments contracted under the lease.

Tenant risk can be mitigated with a selective acquisition strategy, rigorous credit analysis (both pre-and post-purchase) and strong governance processes. A guarantee from a parent or group company might also offer additional security of income where the tenant might not be acceptable on its own.

A thorough due diligence process and peer evaluation is vitally important for good investment, either through rejecting at initial screening or flagging potential issues.

Most investors perform this function either via a dedicated in-house credit risk team or alternatively via third party credit review and analysis – typically from one of the larger accountancy practices. An additional layer of governance, such as an independent Credit Committee, can further mitigate the counterparty risk of successful acquisitions.

Positive Correlation with Economic Growth and Inflation

Rental income linked to inflation (typically CPI or RPI) or contractual minimum uplifts can provide a progressive income stream that hedges inflation. Whilst most such leases will also include a rental cap, the addition of such a check on the overall rental level ensures rents do not get too far out of kilter with the underlying market rental value, which would otherwise have a negative impact on the capitalisation rate applied to any given asset. Such an arrangement also provides at least a partial inflation hedge and ensures that the rental burden does not become too onerous for the underlying tenant during inflationary periods within the economic cycle. These provisions are preferable over typically much more volatile standard upward-only open market reviews, particularly for DB pension schemes where liabilities are invariably inflation-linked.

High Quality Real Estate

Cash flows generated from an investment underpinned by high quality real estate will generally show lower levels of occupational and functional obsolescence. High quality can be determined as modern institutional-grade properties that are *built to last* and have a valuable alternative use that can be unlocked at the end of the lease term.

Longer leases naturally provide more opportunity for an asset to physically depreciate (wear and tear) during occupation. Full repairing and insuring leases place the legal obligation on the tenant to maintain the property in good condition and to return it in the condition it was in at the start of the lease. This ensures future cost exposure is kept to a minimum for the landlord.

Well-Located Assets

Properties in established commercial locations or within urban areas (close to transport infrastructure and community uses) can offer greater value protection and liquidity to investors. The risk of over-renting (where the rent paid exceeds market rent) associated with long index-linked leases can be reduced, in part, by investing in areas with strong socio-economic drivers that help fuel underlying rental growth.

Experienced Team with Embedded Processes and Strong Track Record

As a heterogenous asset class, it is important to have a structured process for assessing new opportunities and an experienced team of investment professionals to identify the right opportunities with appropriate risk-adjusted returns. In a market with low supply relative to demand, having a strong track record and deep access to local markets are key differentiators.

Active Asset Management

Effective asset management is integral to maximising and defending asset value. **A successful investor will monitor an investment through the lifecycle of ownership including:**

i. Ongoing monitoring of tenant financial strength;
ii. Active monitoring of investment risk (including ESG related risk);
iii. Ongoing review of contractual obligations;
iv. Solving technical challenges as they arise; and
v. Identification of upside opportunity.

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Fiera Real Estate's UK division is an investment management firm, which focuses on both creating and actively managing core assets for investors. The UK business was founded in 1992 (as Palmer Capital) and directly manages over £990 million Assets Under Management (AUM).

Its vertically integrated business model has been achieved by backing nine regional property companies in the UK.

This has created a pan UK platform of partnerships that allows investors to access some of the best deal flow and entrepreneurial managers within the centralised framework provided by Fiera Real Estate. Fiera Real Estate manages globally over USD5.9 billion of commercial real estate through its investment funds and accounts.

Fiera Real Estate is wholly owned by Fiera Capital Corporation, a leading multi-product investment- management firm with more than USD121.4 billion AUM. Fiera Capital provides Fiera Real Estate with access to global investment market intelligence, which enhances its ability to innovate within a framework that emphasizes risk assessment and mitigation.

Contact

Rupert Sheldon
Head of Core REIM, UK
rupert.sheldon@fierarealestate.com

Anne-Marie Keane
Director, UK
anne-marie.keane@fierarealestate.com

Charles Allen
Head of UK Real Estate
charles.allen@fierarealestate.com

property@fierarealestate.com
fierarealestate.co.uk

The Key to Successful Investing Into UK Core Long-Income Commercial Real Estate

For DB schemes seeking to diversify into real asset investing, long-income UK commercial real estate can provide an appealing option with scope to deliver attractive risk-adjusted, liability-matching returns over the longer term.

That said, the relative strength of investor demand, coupled with a small and declining investible universe creates challenges for new entrants wishing to deploy capital into the market.

The key is to identify a manager with a strong track record for delivery and execution, with unique access points into the market and with a top down sector allocation that minimises exposure to the more at risk operational assets which have, in some cases, experienced rental shortfalls during recent COVID-19 lockdowns. This ensures speedier capital deployment to access returns.

Whilst market access and risk management are paramount, ESG is an area of ever-growing importance to investors across the globe. A well-structured sustainability framework – particularly where ESG policy can be tailored through development, and sale and leaseback transactions – helps to set apart managers with the best credentials.

Rupert Sheldon
Head of Core REIM, UK

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