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Real Asset Investment in Today's Market

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There has been a step change in the market environment since the beginning of the year. The global economy has experienced heightened risks from geopolitical tensions, elevated inflation, and monetary policy tightening.

There are growing fears the global economy is entering a new period where stagflation (one where persistent high inflation is combined with very low to no economic growth) or an outright recession is approaching, particularly in the UK, as the recovery in economic growth post the peak of the pandemic has been sluggish compared to the rest of the world. Like all global central banks embarking on monetary tightening, 2022 saw the Bank of England shift to a trend of increasing the base interest rate with the hope of achieving a soft landing (economy slows down but avoids recession), but markets are currently assigning a low probability to this outcome.

Key Issues

Today's market environment is set to be a challenging one for growth assets and investors alike, and is likely to test the robustness of portfolios. In our view, the three key issues at the top of investors' minds today are:

Inflation – While a degree of inflation is positive for growth markets we have gone beyond a point where inflation is helpful. Current inflation levels represent a risk investors need to have firmly on their action list.

Broad market uncertainty – Policy tightening is expected to reduce demand and stop prices from rising quickly, but this has increased the risk of a recession. The future growth of traditional asset classes, such as equity, is therefore uncertain and subject to reaction from global government policies and statements.

Environmental, Social and Governance ("ESG") concerns – ESG risks are now widely considered as financially material, however, many investors are only at the start of a long journey of addressing these risks in their portfolios. Investors are no longer only focusing on climate change as we are seeing social impact coming into focus.

What role does Real Assets have to play?

This market environment has brought increased interest in the Real Assets classes as investors see them as having strong ESG credentials and also more suitable in elevated inflationary level environments compared to traditional growth asset classes. . But to be clear, real assets are better suited but not completely immune.

As a case in point, we expect traditional investments in Balanced Commercial Property to struggle with capital values and rental income not keeping up with inflation in the short term as increasing rents in a cost-push inflationary environment is difficult. An environment with rising interest rates and a recession in the UK will be a challenge for valuations with capital values expected to fall in the near term. In addition, these investments are also facing the risk of stranded assets if they cannot upgrade existing stock quickly, from an energy efficiency point of view, as corporates increasingly set net zero targets for the buildings they use. The change to working from home is also a new factor playing out in the office space. All of this could impact returns through asset stranding or significant capex outlay.

However, certain Real Asset subsectors perform better in inflationary environments in various degrees, particularly those that rely on income yield, as the ones below.

Long Lease Commercial Property

Long lease commercial property typically secures long term agreements with inflation linked (often capped) increases in the rental terms, provided tenants remain, rents can keep up with inflation.

Residential Property

Residential property has similar uplift terms, but the sector is more reliant on occupier demand which has historically been driven by economic growth. Other sub areas such as **social and affordable housing** occupy a particular niche in the market and are sometimes supported by government backed rental payments, making them more defensive (although government budgets are also under increasing pressure).

Infrastructure

Infrastructure projects tend to secure long term (10-20 year) contracts where the income is contracted, subsidised or generated via a corporate purchase agreement often with some degree of uncapped inflation linkage - although a "social cap" (a non-contractual cap based on market or societal expectations) may apply.

Given the focus on climate change, demand for the **renewable energy** sub sector has increased over the years. This evolving asset class has seen increased investment into the advancement of various technologies, for investors this is key pivot for ESG focused assets. Similarly for investors focussed on the "S" of ESG, real assets provide a number of options across **social housing and social infrastructure.**

What About Valuations?

Net Operating Income

- 2 key components:
  - Earnings or rental income with inflation linked uplifts should increase in a high inflationary environment. Property uplifts are often capped contractually. Infrastructure, although mostly contractually uncapped, can be "socially capped".
  - High inflation is likely to feed through to interest rates rises which can increase the cost of debt for leveraged assets, although a lot of debt can be fixed rate and hence less affected.
- In general, for high quality and well underwritten assets. We expect the inflationary uplifts to offset the higher cost of debt. This should increase operating income (and so yield) as inflation levels pick up.

Discount Rate

- Asset discount rates are often constructed as a risk free rate (typically a nominal interest rate) plus a risk premium.
- In the short term:
  - High inflation leading to interest rates rises, is likely to put increase discount rates, but the impact is not 1:1 as the interest rates used are often "smoothed".
  - Risk premium is more complicated and is calculated by independent valuer who takes into account a variety of other factors including comparable transactions.

$$\text{Value of asset} = \frac{\text{Net operating Income}}{\text{Discount rate}}$$

Value of Asset

- In periods of high inflation
  - Over the shorter term we expect a boost to the net operating income and yield, whilst overall impact on asset valuation is uncertain and asset specific - dependant on the quality of asset, underwriting and level of leverage. An additional downward pressure in recent months is the need for pensions schemes to create liquidity quickly as interest rates have risen.
  - Over the longer term (in line with 3-5 year uplifts) we expect a boost to operating income and robust valuations levels for long term and high quality assets.

Where are the new opportunities?

Key Characteristic

The table below outlines the key investment characteristics of Real Assets. These also tie in with the key issues investors are facing in today's market.

Inflation linked income	Typically generate cashflows which are asset backed. This means they are income producing which help provide stability in returns and help with cashflow needs of investors. Revenues and so income are often either directly or indirectly linked to inflation.
Diversification	Low correlation with traditional growth markets and exposure to longer term macro-economic trends such as population growth, urbanisation, digitalisation or the energy transition.
ESG	Given their tangible nature ESG is often inherently linked in Real Asset classes. There is a broad and evolving range of approaches available in the market, addressing both the E and the S.

Opportunities in Today's market

Structured correctly, Real Asset classes can provide long term contractual returns which increase with broadly in line with inflation over the long term, along with other attractive investment and ESG characteristics. We are therefore seeing more institutional investors, with long investment horizons, allocating to Real Assets than ever before.

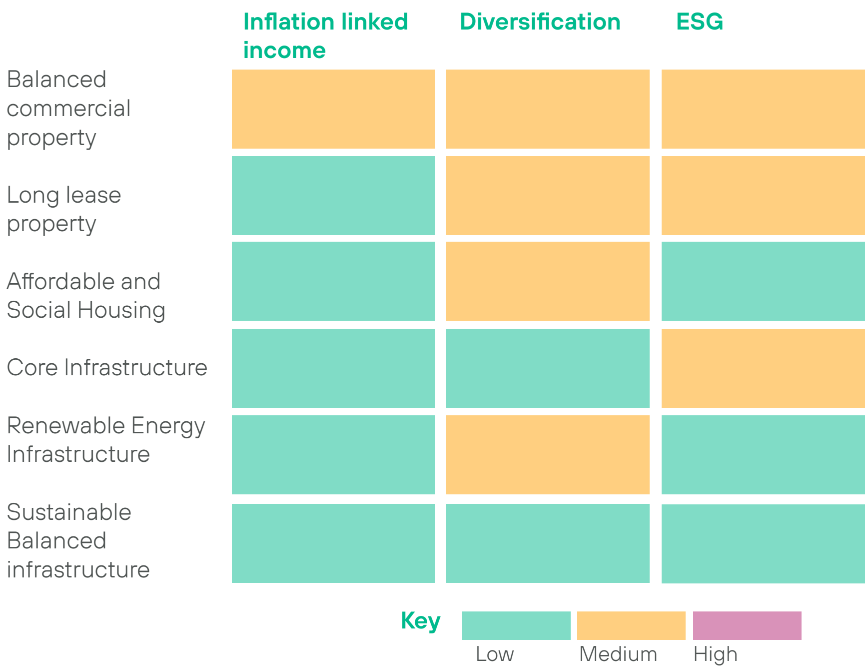
We believe the traditional benefits of the sector still remain, and long-term allocations in well diversified long lease commercial real estate and diversified core infrastructure sectors continue to hold merit.

However, as we see the market environment shift and institutional offerings evolve, we now also see attractive investment opportunities in:

- **Renewable Energy Infrastructure:** Investments in wind, solar, battery storage, and some of the newer technologies such as hydrogen infrastructure
- **Sustainable Diversified Infrastructure:** In addition to renewables investments in other areas such as digital networks, utilities and social real estate
- **Affordable and Social Housing**: Investments in mass market affordable housing, supported housing and care homes

There are other evolving areas such as Natural Capital which focuses on Forestry, Agriculture, Ocean and Biodiversity. This in an evolving area and Isio will be drafting a separate paper to address this space in more detail.

Heat map



Real Assets is an attractive asset class for clients who can afford a certain level of illiquidity and are looking to construct efficient portfolios with low dependence on volatile, public equity markets. The inflation linked income and strong ESG characteristics make this asset class even more attractive in this current environment.

Given the current market dynamic, as interest rates have risen sharply in a short space of time, a lot of investors need liquidity and are selling assets to restructure their portfolios to provide this. Whilst this may add to the pressure on asset valuations in the short term, we believe this creates an opportunity for investors with capital to deploy and a long term investment horizon and there may be an attractive entry point.

If you would like to discuss how Real Assets could fit in your portfolio please get in touch with your isio consultant.

The Real Asset Classes: Key Characteristics

Real Asset covers a wide range of asset classes and approaches.
The table below provides an overview of some of these:

	Commercial		Residential		Infrastructure	
Attribute	**Balanced Property**	**Long Lease**	**Private Rented Sector**	**Affordable Housing and Social Housing**	**Infrastructure Equity**	**Renewable and Sustainable Infrastructure**
Expected Returns (net)	Track or outperform market based benchmark	Yield of 3%-5% or linked to inflation	IRR: 6-8%	IRR: 4-6%	IRR: 8-12%	IRR: 7-10%
Income returns and Inflation Protection	**No direct linkage:** Greater reliance on capital growth for return	**Direct linkage:** Income is contractual with CPI/RPI rental increases with caps and floors	**Direct linkage:** Income is contractual and typically has fixed increases set in line with long term inflation expectations	**Affordable:** Income is contractual with CPI/RPI rental increases with caps and floors **Social:** Contractual CPI based rental increases set by government policy	**Direct linkage:** Depends on asset, often a mix of contractual CPI/RPI (often uncapped) revenue uplifts on the regulated and contracted assets. Some assets are exposed to fixed increases or open market pricing.	**Direct linkage:** Contractual and often subsidised, mix of CPI and RPI (often uncapped). Some assets are exposed to fixed increases or open market pricing
Diversification	Shopping centres, Supermarkets, Offices, Industrials	Student accommodation, Office, Hotels, Industrial, Healthcare	Residential property	UK Affordable housing, Supported housing, Care homes, Nursery	Global Toll roads, Airports, transport, Energy, Water, Storage	Global **Sustainable:** Renewables, Digital, Transport, Utilities **Renewables:** Wind, Solar, Battery storage, Digital, Transport, Hydro, Energy efficiency
ESG Profile	Limited options. Some early-stage funds with ESG focus launched - primarily net zero targets.	Some focus, long term leases allow better management to improve ESG standards of buildings.	Limited options Funds focus on social drivers.	Inherent social focus to the asset class. Often funds have a tangible climate element too (i.e., delivery of climate friendly housing stock)	Core Balanced infrastructure often has a strong governance and stewardship element.	Renewables has an inherent climate impact element. Sustainable can focus on the social aspect in addition to the climate impact.
Sector Issues	Macroeconomic environment challenging for Commercial Property Assets are facing the risk of not meeting net zero targets Net investor flows to Core Balanced have stalled		The market is fragmented with a variety of diversified and more niche approaches available. Political/regulatory risk which has the potential to negatively effect returns.	Nascent asset class for the broader institutional investment market in the UK. Reputational issue of passing through full inflation to underlying tenants.	Transition of non-ESG friendly sectors in existing Core Bal-anced portfolios is underway with funds are looking to rotate existing portfolios to a stronger ESG position. Potential for significant capex outlay which could negatively impact returns in the short run.	Significant interest and capital in the renewables market, could dampen the demand/supply dynamics for investors.

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Contact

Please get in touch if you would like to discuss this further.

Ajith Nair
Head of Investment Research
ajith.nair@isio.com
+44 (0)207 1236 003

Andrew Singh
Head of Real Assets Research
andrew.singh@isio.com
+44 (0)131 202 3916

Aneesa Rehmanji
Deputy Head of Real Assets Research
aneesa.rehmanji@isio.com
+44 (0)118 338 4426