

# Long Lease Real Estate - A Revised Role for Real Estate in Pension Funds

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# Long Lease Real Estate

- Research questions and contribution
- What are long lease real estate funds? How have they grown?
- Pensions and real estate context
- Data and performance
- Empirical approach
- Results
- Conclusions

# Long Lease Real Estate – Aims etc.

## Research Questions

- Why have long lease real estate funds grown?
- What are the characteristics of long lease real estate funds?

## Contribution

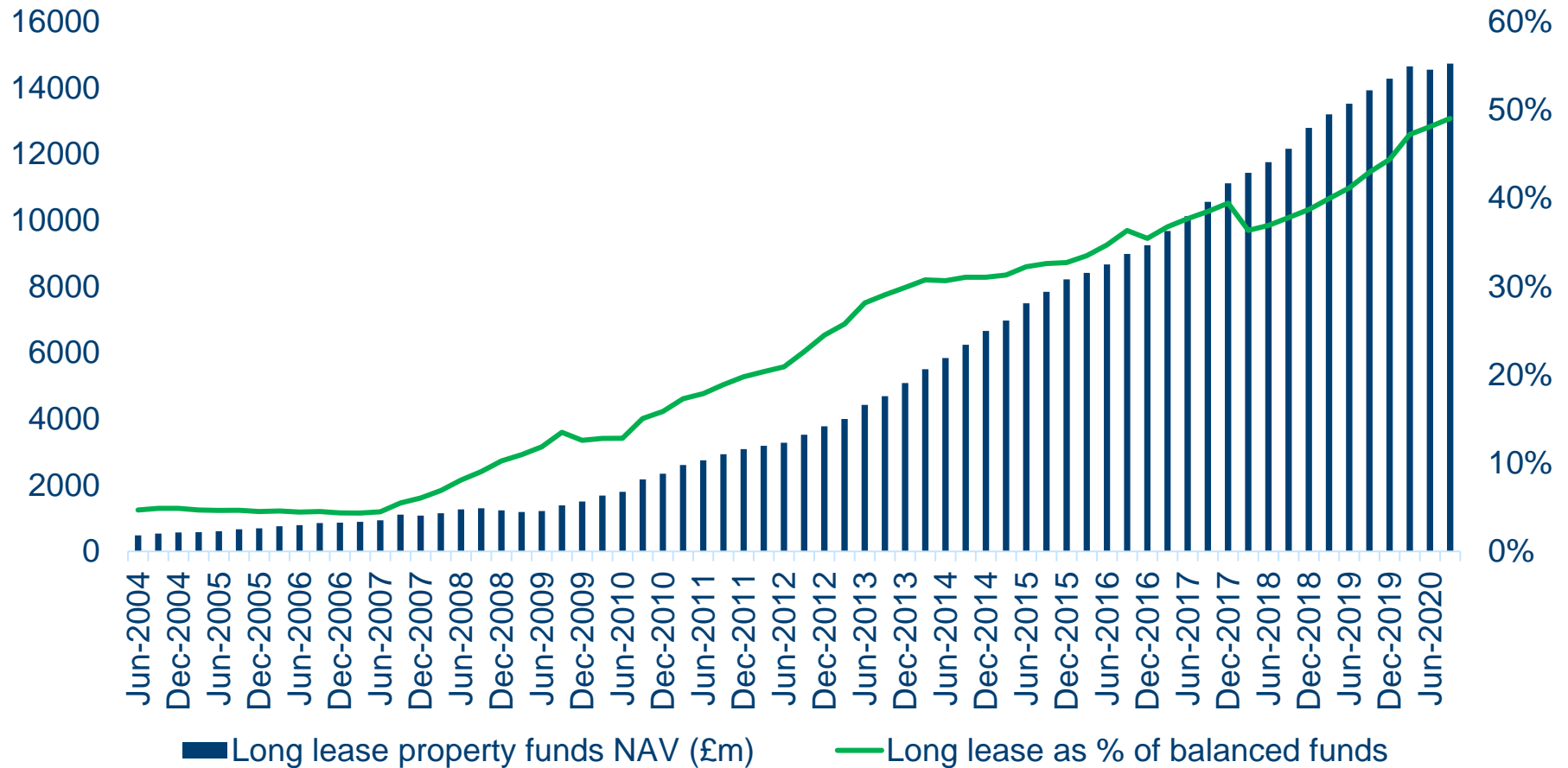
- First paper to comprehensively review this segment of real estate
- Identifies they are different from balanced property funds, they are far less sensitive to the general real estate market but despite their long income characteristics they are not a reliable short term liability hedge.

# Long Lease Real Estate Funds – What are they?

*“Funds with a non-property specific performance objective to outperform long-term bonds or gilts. Funds typically maintain average unexpired lease lengths of over 15 years. Lease length, tenant quality and minimum leverage, in addition to a diversified portfolio, aims to maintain consistent long term income.”* Source: MSCI/AREF

- Objectives are to out-perform gilts (42% by NAV) or deliver a real return (43%) - not benchmarked against property or property fund indices.
- Over 50% of income from leases > 20 years 1% from leases < 10 years compares with balanced funds 57% <10 years and <5% over 20.
- Heavily skewed to “other” - universities, HA, hotels etc. (46% v 10%)
- No gearing

# The Growth of Long Lease Real Estate Funds

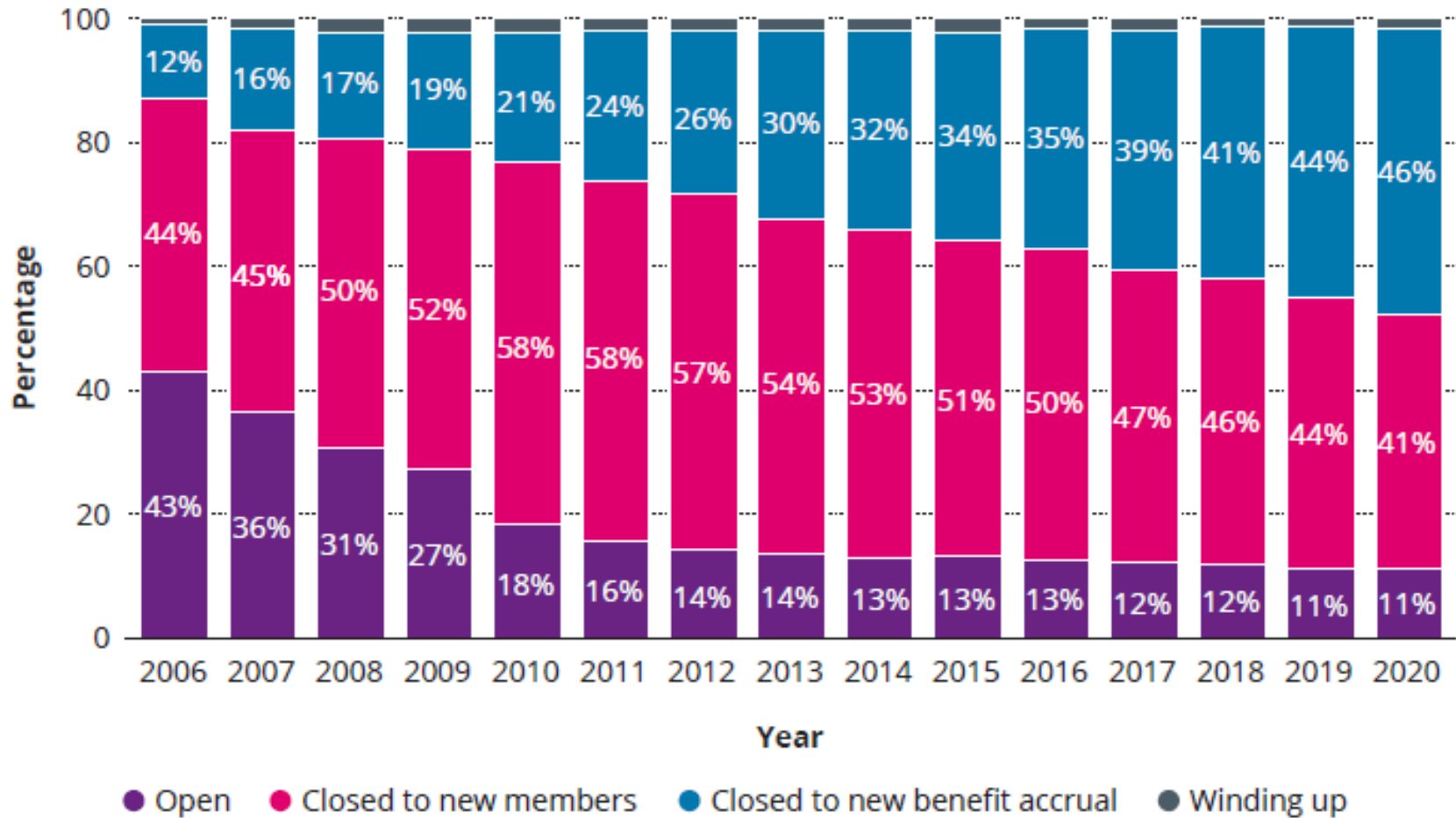


# Pensions Context

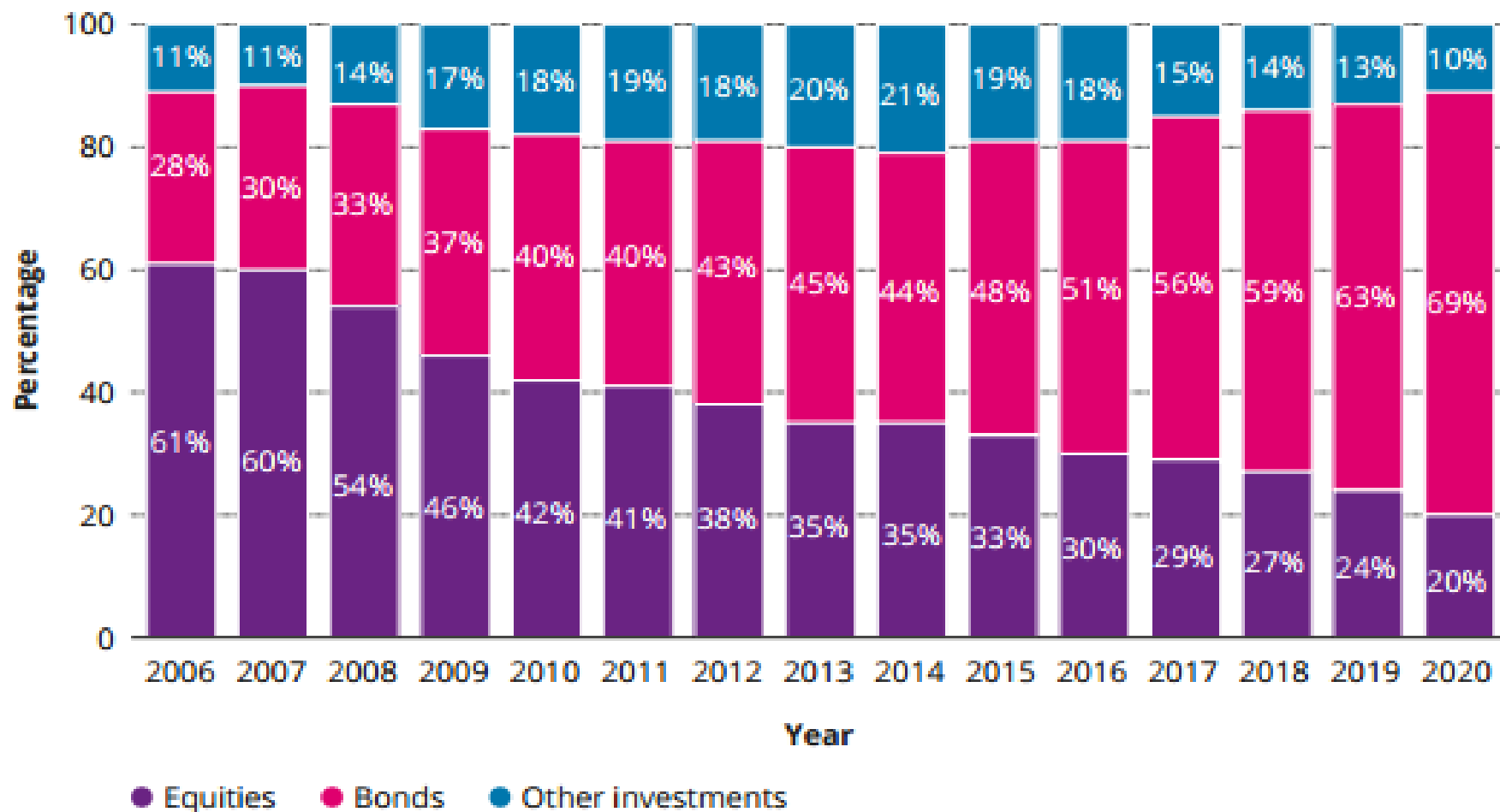
- Maturing schemes
- De-risking and focus on LDI and CDI
- Hunt for yield
- Regulatory guidance on diversification and long lease property:

*“Your scheme’s matching asset portfolio may comprise only physical (ie non-derivative) assets, e.g. fixed or index-linked gilts, corporate bonds, long-lease property and some forms of infrastructure”* TPR

# Maturing DB Pensions – Pension Fund Status

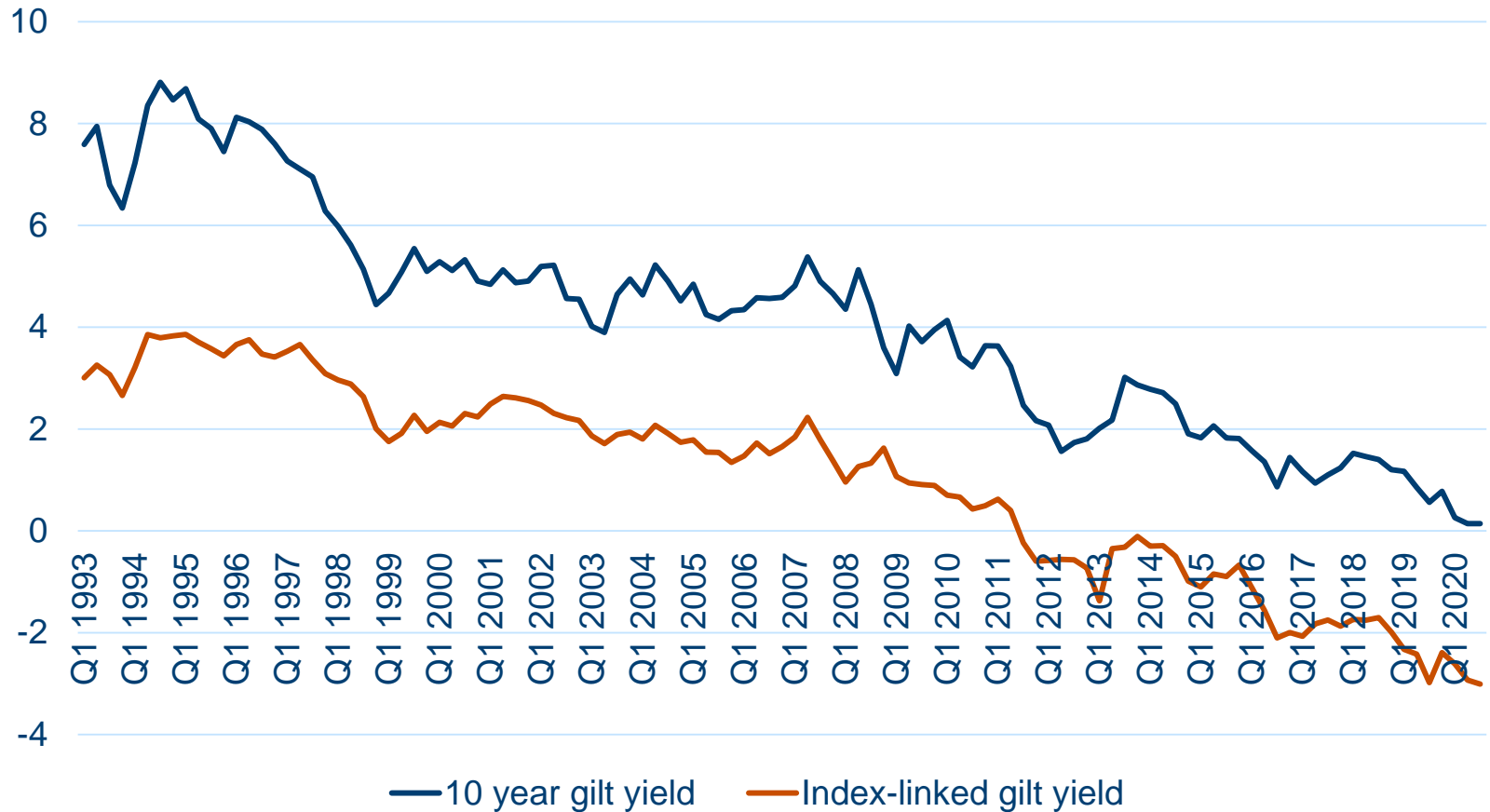


# Maturing DB Pensions – Asset Mix





# Fall in yields – The “hunt for yield”



# Real Estate Context

- General real estate downturns in GFC and retail-led decline in 2019/20
- Post-Brexit referendum and 2011-13 period also had falls in values
- Decline in lease lengths and terms without breaks
- Rise of the CVA in retail

Value of property = Value of contracted rent (VL)+ Value of rental growth beyond lease contract (VRG) + Value at expiry (VRES)

High credit quality fixed uplift long lease real estate VRG=0 and VL explains most of V. Expect discount rate applied to lease payments to be key driver of value for long lease real estate.

# Data and Summary Performance

	Long Lease Property Funds	Balanced Property Funds	MSCI Monthly Property Index	Gilt Total Return Index
NAV £bn Sept 2020	14.8	30.0	37.0	
Net Gearing Sept 2020	-1.9%	-6.9%	0	
Exposure to “other” (%)	45.5	10.6	5.4	
Annualised Rtn Sep 2004 -20	6.6%	4.8%	6.1%	6.1%
Mean Qtly Return	1.6%	1.2%	1.6%	1.6%
Mean Annual Return	6.9%	5.5%	6.9%	6.2%
Max “Drawdown”	-19.7%	-39.0%	-36.7%	-7.1%
SD Quarterly returns (ann’d)	4.1%	7.0%	7.1%	6.8%
SD – Annual returns	7.1%	12.3%	12.4%	5.2%
Sharpe Ratio	0.75	0.33	0.43	0.90
Minimum Quarterly Return	-5.9%	-13.4%	-13.5%	-7.1%
Skewness	-1.4	-1.8	-1.7	-0.1
Kurtosis	4.7	5.0	5.0	0.3

# Empirical Approach

Is relative performance explained by sector mix? Shift share to account for sector structure:

$$WMR_{it} = \sum (M_{S,t} * w_{S,I,t})$$

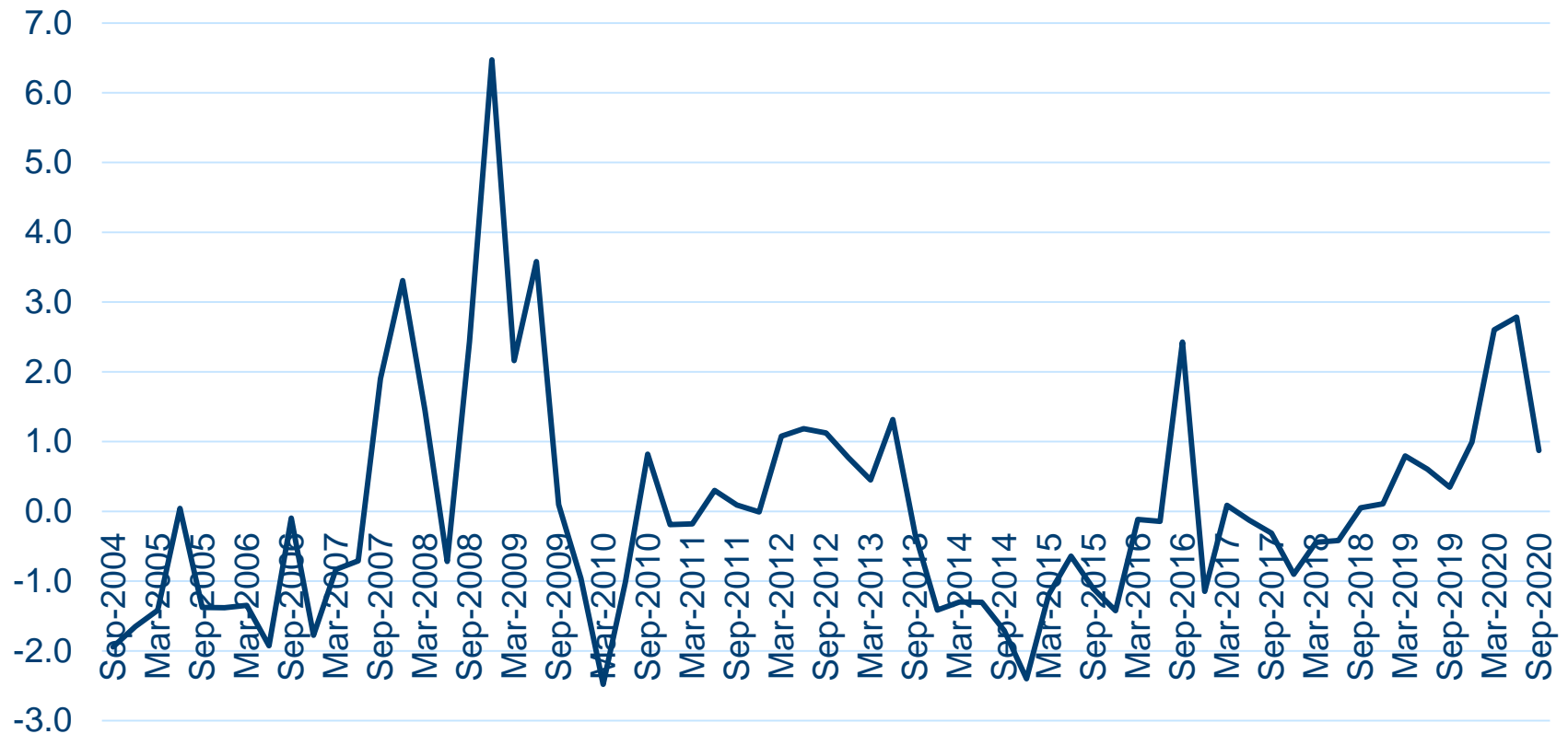
How much are long lease funds and balanced funds driven by bond yields and the general property market and a specific long lease factor?

Regression with controls for property market return, gilt yields, economic growth, size of fund:

$$Total\ Return_{it} = \alpha + \beta_1 LongLease_{it} + \beta_2 X_{it} + \varepsilon_{it}$$

# Results: Shift Share

## Differential Quarterly Returns



# Results: Regression

	(1)	(2)	(3)
	Total Return	Total Return	Total Return
MSCI	1.000 <sup>***</sup>	1.072 <sup>***</sup>	1.004 <sup>***</sup>
	(28.41)	(35.28)	(25.03)
NAV	0.000	0.000	0.000
	(0.97)	(1.32)	(1.11)
LongLease	<b>1.870<sup>***</sup></b>	<b>5.354<sup>***</sup></b>	-0.386
	(2.63)	(6.12)	(-0.59)
Yield10Y	-0.008 <sup>**</sup>	-0.008 <sup>**</sup>	-0.009 <sup>*</sup>
	(-2.56)	(-2.32)	(-1.73)
GDP_growth	-0.081	-0.045	-0.146
	(-0.93)	(-0.56)	(-1.15)
LGDP_growth	0.411 <sup>**</sup>	0.370 <sup>**</sup>	0.414 <sup>**</sup>
	(2.35)	(2.24)	(2.45)
MSCI*LongLease		<b>-0.581<sup>***</sup></b>	
		(-6.50)	
Yield10Y*LongLease		0.009	0.019
		(1.38)	(1.53)
Crisis			-1.319
			(-1.62)
Crisis*LongLease			<b>8.967<sup>***</sup></b>
			(4.16)
Constant	-2.574 <sup>***</sup>	-2.977 <sup>***</sup>	-2.092 <sup>**</sup>
	(-2.93)	(-3.67)	(-2.57)
N	507	507	507

# Conclusions

- Long lease real estate has out-performed and had lower risk – reflecting differential performance rather than sector mix.
- Growth probably partly reflects this historic performance and partly TPR guidance and the increased maturity of pension schemes.
- There is short-run co-movement between long lease real estate and direct real estate but it
- ....but over the medium to long run long lease real estate is tightly linked with the bond market.
- *The Pensions Regulator position that long lease real estate is suitable for matching purposes in pension funds is supported by this research.*