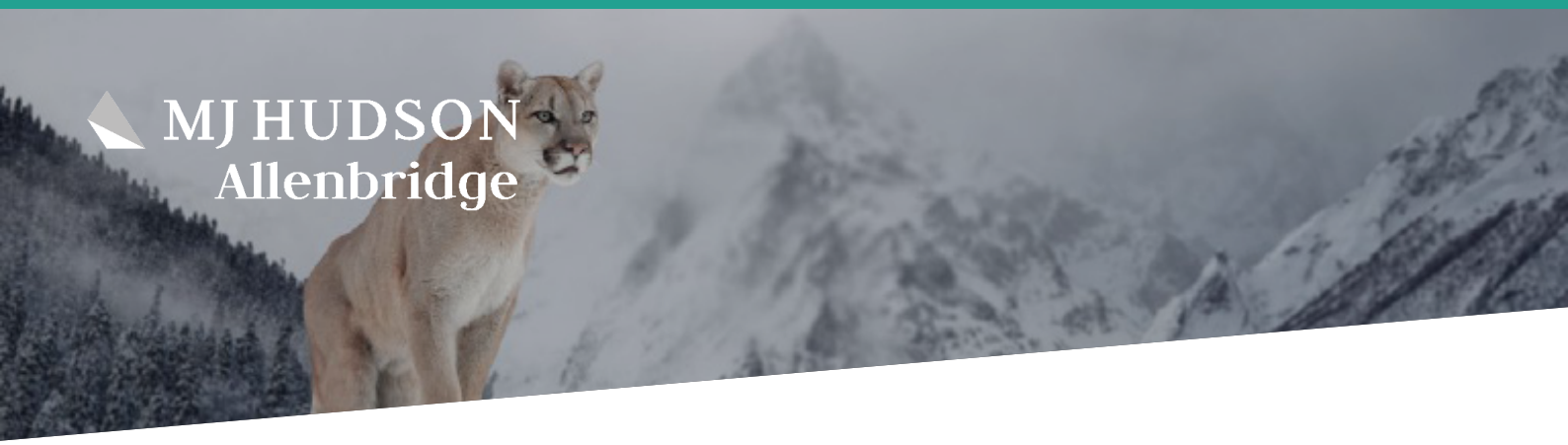

Vantage Point - November 2020

Real assets in a COVID-19 world

In this paper, we discuss some of the real asset, namely infrastructure and real estate, investment trends that have been brought to the fore during the COVID-19 crisis, from accelerating digitalisation to the decline in retail property. We will explore how asset classifications are likely to develop in response to these long-term trends and why it is important for investors to maintain clear oversight of their allocations and avoid drifting from intended risk exposures. Now more than ever, diversification and a disciplined approach to leverage are key to successfully navigate the constantly changing landscape. Furthermore, we will provide our insights into what investors should think about in order to capture the best opportunities, and to reposition and/or manage their portfolios efficiently, throughout these unprecedented times. The points we cover apply equally to equity and debt, in our opinion, except where highlighted.

In their hunt for yield, in the predominantly low interest rate environment of the last few years, investors have increasingly looked to allocate to real assets, in order to gain exposure to streams of typically stable and inflation-linked cashflows. Since the COVID-19 crisis hit, central banks have been swift to react, like in recent crises, to use monetary policy to stimulate the economy; as such, interest rates and government bond yields have been pushed even lower than the already historic lows prevailing over the last decade, while equities have performed in quite disparate and unpredictable ways; for example, while the S&P 500 has been reaching new highs, the FTSE 100 is over 20% below its January 2020 level. Against this backdrop, the substantial resilience that certain types of real assets have shown so far through the pandemic, such as regulated utilities obligated to maintain service, only serves to increase the relative attractiveness of the asset class, although inherent risks still remain.

In the midst of lockdowns and the immediate aftermath, the volume and number of transactions across real assets slumped, as deals were put on hold due to market uncertainty and the inability to accurately price assets. While the impact of the outbreak continues to evolve and deal activity is slowly resuming, we are already seeing the emergence of significant trends which we expect to drive continued interest in and returns for real assets.

Asset classifications are shifting

Prior to the pandemic, we noted that real estate and infrastructure were not homogenous asset classes; while at the highest level there are common themes, of course, there are sub-asset class groupings such as core, core-plus, value-add and opportunistic which each have different value drivers and risk/return profiles (*as outlined in our December 2019 report, 'The paradox of infrastructure investing: at the crossroads' (https://www.mjhudson.com/download/the-paradox-of-infrastructure-investing-at-the-crossroads/?hilite=%27paradox%27%2C%27infrastructure%27%2C%27investing%3A%27%2C%27*

crossroads%27)) and 'Current Opportunities and Trends in Real Estate Investing' in January 2020) (https://www.mjhudson.com/newsletter/current-opportunities-and-trends-in-real-estate-investing/). The pandemic has undoubtedly disrupted the definitions further, changing which assets fall into which strategy bucket, through the acceleration, and even reversal, of some key structural trends. Assets that were once considered relatively low risk and stable now may no longer be thought of as so, while others previously considered to be new and incidental may be becoming thought of as essential and "core".

For example, offices with reliable tenants and long-term leases in prime locations have long been considered core real estate assets, but a shift towards remote working en masse may change this. The pandemic has led to a dramatic expansion of the number of people regularly working from home, and those that can do so may be forced to work remotely for the foreseeable future. This trend looks set to continue. Our clients certainly think so, with 73%(1) of those surveyed believing that more people will be working from home, more often, in the future (*to read more about our working from home survey please click here (https://www.mjhudson.com/download/how-is-working-from-home-working-out/)).* We may see the place of office assets in core strategies diminish or, alternatively, it may be that offices able to adapt to a post COVID-19 lifestyle, with air filtration systems, health and wellbeing facilities and larger spaces to accommodate social distancing, take the "core" title, whilst those that are unable to adapt are forced further up the risk spectrum or become obsolete.

Some of the winners from a shift in behavioural patterns include data centres and fibre networks, both of which provide resources needed for remote working. We have seen both real estate and infrastructure managers increasingly committing to data centre and digital infrastructure investments, in recent years; this trend has been accelerated by the shift to remote working, throughout the pandemic. This shift involves a transfer of energy and data consumption from offices to households, leading to a rebalancing of Internet consumption away from city centres, potentially requiring infrastructure changes, and putting pressure on residential property to become more energy and heat efficient. Consequently, secular choice will likely drive an increased desire for renewable energy, which will, in turn, shift renewable energy production and distribution into core infrastructure.

Thus, it is important for investors to be aware that assets that once fitted a particular strategy specification may now be shifting away from that description and that both managers and investment portfolios may be drifting across the risk spectrum, and not just in one direction.

Opportunities lie where structural trends have been reinforced or altered

Significant growth in e-commerce has been eroding the physical retail sector for several years now. As pandemic-induced lockdowns have forced much of the physical retail sector to shut down for extended periods, greater numbers of consumers have moved online, furthering this trend. This has exacerbated the threat to the stability and reliability of rent payments that was already a pre-Covid feature, exemplified in the UK by the company voluntary arrangements entered into by House of Fraser and New Look, amongst many others. In September 2020, industry body Revo warned that, in the UK alone, retail rent arrears could exceed £2billion, after less than 50% of rent was expected to be paid in Q3 2020 (2), and, according to BDO, US retail chains had closed over 10,000 outlets during 2020, as of mid-August (3).

As a result of the move to internet shopping more generally, we are likely to see a continued increase in demand for warehouses and logistics. Greater areas of holding space for inventory are needed to accommodate this demand, and additional equipment, such as cooling units for online food retail, will also be required. We note there has also been a significant shift from "just in time" to "just in case" supply chains, leading to increasing demand for both large scale warehouses and smaller distribution centres. This presents both opportunities and threats to the sector, however, as assets come under increasing pressure to adapt to changing trends in consumption and a post COVID-19 environment, from the level of digitalisation to their ESG credentials.

The secular trend of digitalisation and automation has also been accelerated by the impacts of the pandemic, representing a key area of growth and a significant opportunity for investment. As previously mentioned, the shift to homeworking

combined with lockdowns leaving many housebound, has led to soaring demand for data centres and other digital infrastructure. We see this trend of digitalisation continuing over the long term, as access to internet is expanded across the globe.

COVID-19 has also reinforced the growing focus on ESG. In terms of the environment, the pandemic has highlighted the benefits of transitioning away from fossil fuels towards renewable energies; enforced lockdowns have reduced carbon emissions, owing to fewer journeys being made and industrial activity being restricted. This was, for example, especially noticeable in China, where emission levels fell dramatically when it went into lockdown but returned almost to pre-COVID levels when restrictions were lifted (4). The outbreak has also had knock on effects on the social side, with heightened scrutiny of working conditions, health and safety, and governance of supply chain infrastructure. This means that owners are now expected to do more than simply hold their assets, putting the onus on them to add value through service quality improvements and enhanced governance.

As well as reinforcing existing trends, COVID-19 may also lead to new ones. One sector that may see significant change is the universities sector, such as increasing the number of remote-learning courses, or potentially shortening the length of the courses in view of the significant debt consequences that arise for the majority of students. Such changes would undoubtedly impact purpose-built student accommodation, which has been a property sector *darling* for the last decade. If the shift to online learning persists beyond the pandemic, or if the length of courses is indeed shortened in future, then the sector will experience significant change. Furthermore, if the following decade is more economically depressed, how students think about indebtedness may lead to fewer people attending university, at all, which would adversely impact both the finances of universities (a number of which are already believed to be in financial stress) and the demand for purpose-built student accommodation, which had historically been under-supplied in most parts of the UK.

What this means for investors...

The pandemic is set to weigh heavily on the industry outlook for some time, especially if we are in for multiple waves of COVID-19 (as many countries have already experienced). While some of the initial consequences are likely to dissipate in the near term, other impacts of the pandemic are likely to persist, and some may not yet even be apparent. In the short term, investors are having to navigate their investments through a challenging period of distress; they must make decisions as to whether they are going to hold on through the cycle, and wait for values to recover, or rather decide to rebalance portfolios. Below, we highlight what we believe are some of the key considerations for real asset investors at this time:

Risk profiles – As we have highlighted above, it is important that investors re-evaluate the types of assets that accord with strategy definitions as changes arise and make the necessary strategic adjustments to their portfolios. Otherwise, they risk style and risk profile drift; what was once typically classified as a "core" asset (for example an airport), may not be so for much longer. Investors should also be wary not to fall into the value trap: while some assets will be cheap now due to uncertainty of the overall impact of the virus, others will *appear* cheap because they are likely to ultimately become obsolete in light of longer-term structural shifts, thus moving up the risk spectrum.

Diversification – We are seeing significant bifurcation between and even within sectors. Therefore, as always, we highlight the importance of holding sufficiently diversified portfolios to prevent overexposure to individual sectors and assets which may be disproportionately impacted by the pandemic and resulting trends. Diversifying exposures by manager, region, risk profile, sector, and vintage years, help to reduce the overall risk in any portfolio.

Leverage – In prior periods of distress, we have seen that over-levered deals can often be the worst performers, if leverage was being used as a significant driver of returns. As such, a sensible approach to leverage will be key to avoiding write-downs or write-offs, within any real asset portfolio. This leaves aside the question of the availability of debt and the price of it. The relationship between leverage levels that managers take on and the rate of expected asset value growth will likely be under closer scrutiny than during the decade that has just passed. In infrastructure, it may be the case that a particular

project will not be feasible without incurring a large amount of debt, and this may be acceptable if that project is expected to yield reliable cashflows. This might not be the case in other real asset segments with less reliable cashflows. Investors need to be mindful of this.

Alignment – While ensuring strong alignment between the interests of investors and portfolio managers should always be a priority, we believe heightened focus on this topic during both the due diligence and monitoring process is paramount, at this time. For example, transactional asset managers often pick up fees for completing a transaction, while investors have to "live with" the transaction to eventually see the reward. It is important to be mindful of potential imbalances at times of stress (such as now particularly if the number of investment opportunities for a manager is lower than usual. Investors can deal with this by ensuring that they are comfortable with, the manager's investment process and procedures for determining which transactions should proceed, especially managers they are less familiar with.

Liquidity – In times of distress, it is common for investors to favour more liquid strategies and, therefore, listed, or open-ended vehicles. It is not unusual, however, for these funds to halt redemptions in times of crisis. Hitherto, during the COVID-19 pandemic, an estimated £12.5bn(5 of investors' cash was stuck in UK property funds, alone. It is important to note that investor redemptions are not the sole cause of these trading suspensions; in the UK, there are regulations in place requiring particular types of funds to suspend trading when there is material uncertainty about the valuation of at least 20% of their portfolios (6. Therefore, liquid, open-ended investments may not necessarily provide the liquidity expected during times of stress, and investors may have to hold a greater proportion of assets having cash like qualities to counterbalance the typical illiquidity of real assets.

Value versus growth – The decade to come feels like it will be a more economically difficult one than the last and, therefore, the sustainability and reliability of income will likely be more highly prized than in the 2010s, when there was more desire for growth. Assets with clear growth potential, such as data centres will likely still be viewed through that lens but historically well-established asset classes such as office and retail may well segment between those with more reliable income versus those with less certain prospects. Investors will need to consider value versus growth in terms of their particular asset-liability matching needs. Guidance may need to be sought, to help decision-making on the balance between the most attractive and reliable sources for either.

Debt – Debt investments can offer an attractive way into the real asset market, providing much needed stable income, as well as (generally performing better in a downturn than equity investments. At times, higher risk debt can even produce returns that are higher or equal to those received by equity investors and additionally benefit from loan documentation protection. Going forward, there will very likely be a reversal of recent trends that have led to covenants and other lender protections being diluted. Debt may be in shorter supply as lenders become more conservative about projects they are prepared to finance and the basis on which such will occur; in an echo of what occurred post the global financial crisis, loan-to-value levels have already fallen and lending margins have increased, albeit not to the same extent as with the previous crisis. This may be the time for investors with less familiarity with the multi-dimensional opportunities in real asset debt markets to become more cognisant of them and the potential benefits on offer. For other investors, with existing exposures, it would be timely to ascertain whether, given the current market conditions, the degrees and areas of exposure are still appropriate.

Valuation – Valuers will find it more difficult than normal to perform asset valuations as there is less transaction evidence to assist them in the process. We may see valuation ranges being given rather than single figures and this may not be just about investments; this may also be about the ongoing value of portfolios which may have consequential solvency-related issues. In our view, this is a short-term issue while we are going through maximum COVID uncertainty, which is reminiscent of the global credit crisis and its immediate aftermath.

Conclusion

2020 has undoubtedly been a rollercoaster year, and as we approach 2021, the only thing that remains certain is uncertainty; the knock-on effects of COVID-19 will continue to impact investor portfolios for years to come. As we have

explored, above, there will likely be substantial opportunities for growth in real assets, driven by the trends we have outlined, while there will be implications for others such as transport, education and even the justice system. Tactical calls to capitalise on short term momentum are hard to make without a sufficient volume of transaction activity, and hence, for the time being, in our opinion, investors should focus on strategic calls, gradually capitalising on structural trends.

In recent manager selection exercises, we have highlighted relevant issues which were perhaps not immediately grasped by investors, such as the heightened importance of digging ever deeper into a manager's investment strategy. While important, it is not enough just to understand strategies that managers have been running and considering how successful they have been; it is essential to properly understand the strategy they see as being most important both during and after the period of the pandemic. Given the acceleration of various trends, particular attention should be paid to exit strategies, as successive buyers will have evolving priorities. As mentioned in our previous article, but ringing even truer in these uncertain times, thorough fund due diligence and manager selection remains a key part of the process of allocating successfully to real assets.

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Overview

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