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LGIM Real Assets

Real Assets 2022 outlook: all change

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Summary

- The growth in private markets has been one of the most prominent investment themes of the past decade.
- We see this as structural, with a number of factors pulling investors towards private markets and pushing them to seek complementary exposures to public markets.
- Elsewhere, the emergence from the pandemic will lead to a focus on infrastructure investment, upgrading and repurposing real estate assets and corporate capital expenditure.
- In terms of inflation, real estate and infrastructure can provide a buffer but this should be derived from assets with specific hedging characteristics.
- The transition to net zero and the drive to deliver social impact present investors with a rich and diverse source of investment opportunities.
- Private market assets should continue to play an increasingly important role in helping investors achieve their investment and ESG objectives.

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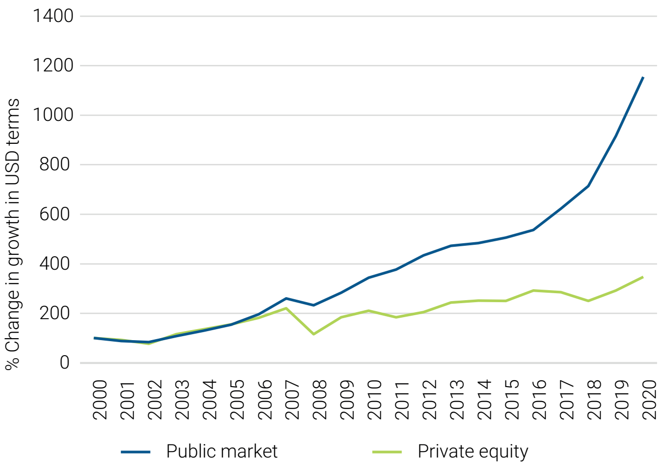
The push and pull of private and public markets

The growth in private markets, helped by institutional participation, has been one of the most prominent investment themes of the past decade. Private equity assets under management have increased by a factor of nine since 2000, compared to three for public equity.[1] COVID-19 did nothing to disrupt the trend and we expect growth to continue in 2022.

This is often put down to the search for yield, diversification, cashflow and secure income. That said, these factors don't necessarily explain why private markets, with their relatively higher complexity and trade-offs in terms of liquidity, have garnered so much attention. So, what has changed to make the structural characteristics of private markets more attractive?

On the up: growth of global private equity net assets vs public mrket capitalisation



Source: World Federation of Exchanges and Prequin, as at end 2020.

The complexity premium as an increasing share of investment return

The secular decline in real interest rates has put greater focus on the premium offered by private investments. Private assets vary widely in terms of how easily they can be bought and sold; in a number of cases, they could be as liquid, or even more so, than certain areas of the public markets. But there is no doubt that investing privately typically comes with a degree of complexity that requires some compensation. Whatever we call it, that premium has proven more important as yields have been squeezed, particularly in the wake of the global financial crisis and, more recently, the pandemic.

Concentrating public markets

Public markets are also changing, with a growing number of large companies increasingly dominating indices, and a falling number of new entrants. In the 10 years to September 2020, the top five issuers within the MSCI World Index broadly tripled their weight, from 5.1% to 14.3%. By 2020, all five were information technology companies, an interesting contrast from 2010, when two of the top five were oil and gas companies.[2] The number of listed stocks in the US essentially halved between 1997 and 2017 in the US, from 8,000 to 4,000. Similar trends have been seen in Europe.

New kids on the block are staying private

In recent years we have witnessed a reduction in IPO activity and more public firms being taken private.[3] High growth firms that have historically provided investors with exposure to growth sectors and new business models via listed equities are now tending to stay private for longer. This underlines the potential role private markets play in providing investors with income, diversification and access to growth opportunities.

With great power comes great responsibility

With complexity comes a greater need for oversight. Public markets undoubtedly enable investors to express their beliefs through investment, divestment and engagement. Crucially, however, investors in private markets can also exert significant direct control over how their investments are managed.

The idea of outcome-based investing is broadening to such an extent that investors are increasingly aligning their investments with environmental and social, as well as financial, outcomes. For instance, so far in 2021, specialist renewable energy infrastructure funds have raised $27 billion globally, more than at any time in the past decade.[4] We expect to see growing investor interest and emphasis on governance, diversity and inclusion – both in portfolio investments and in managers.

Stepping up

As we head into 2022, three themes are shaping our thinking in the areas of real estate, infrastructure and private credit investing: the emergence from COVID-19, the return of inflation, and ESG and impact investing.

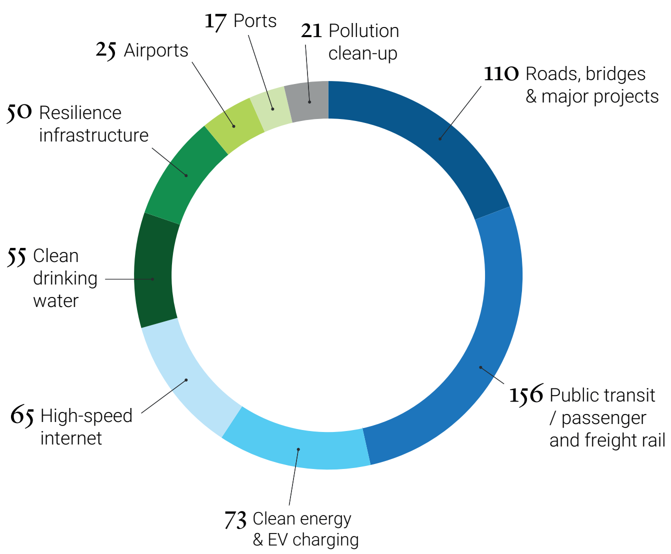
[1] World Federation of Exchanges and Preqin as at end of 2020.
[2] MSCI, The Rise of Market Concentration, September 2020 (retrieved 22/11/2021).
[3] Blecher, "Private Inequity: Private Markets and the Death of the Micro-Cap Stock", 2020.
[4] Preqin as at November 2021.

Emergence from COVID-19

We have learned not to second-guess the COVID-19 virus. While consensus forecasts suggest further economic recovery in 2022, we should remain prepared for bumps in the road. The COVID crisis has created new challenges for a number of asset classes. It has also accelerated existing trends, for instance, in the evolving role of the office, as well as higher ecommerce expenditure resulting in change in the retail landscape. At the same time, 'build back better' will have profound implications for infrastructure, real estate and corporates in the relevant sectors:

- The UK, EU and US have committed to invest heavily in infrastructure as a key driver of future growth ('build back better'). The US infrastructure bill amounted to nearly $600bn of new spending, while the UK plans to invest £200bn in infrastructure over the next five years. Given the constrained public finance position, we expect the private sector to provide enabling capital. This should lead to a strong pipeline of investment opportunities in clean energy, transport, and digital infrastructure, as well as real estate-led city regeneration.

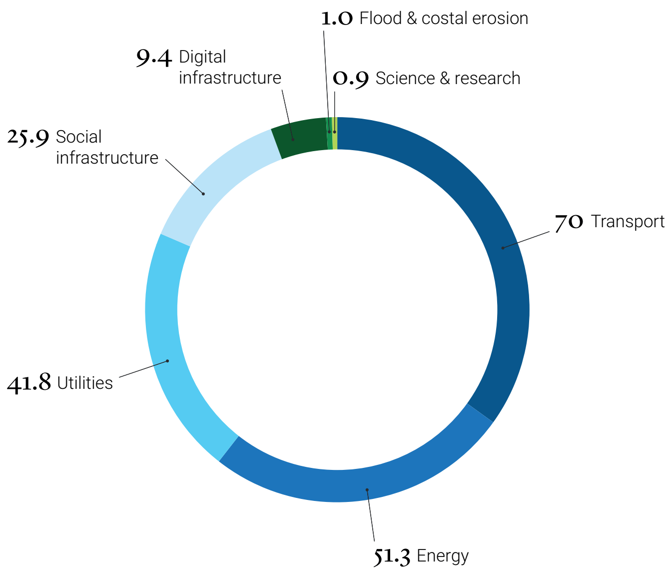
US 'new' spending in infrastructure bill ($bn)



Source: White House press release as at November 2021.

- More generally, companies are now shifting their focus from cost cutting to business investment. The Q3 2021 Deloitte CFO survey[5] indicated greater emphasis on increasing capital expenditure, particularly in new technology. Corporate borrowers are turning to the private credit markets to fulfil financing needs, supporting a pipeline of investment opportunities across a range of sectors and business types.

UK planned investment pipeline 2021 to 2025 (£bn)



Source: Analysis of the National Infrastructure and Construction Pipeline, August 2021.

- Within real estate, the industrial and residential sectors have been key beneficiaries of structurally robust demand. While we remain positive on the fundamentals of the industrial sector in the short term, we are cautious as to how long the level of return growth can be sustained given the sector's strong run thus far.

- The role of the office for companies has been, and remains, a subject of intense debate. We continue to believe that high quality, accessible offices will play a significant role for most service businesses. But there is no doubt that the bar of what 'good' looks like has risen, significantly increasing divergence in value between asset qualities.

- The retail sector continues to deal with the structural challenge of higher ecommerce volumes and rising costs, although we are seeing tangible examples of successful repurposing that create a renewed, wider role for buildings previously associated only with shopping. Meanwhile, the greater use of turnover-based property leases has, among other changes, driven a better alignment of interests between retailer and investor.

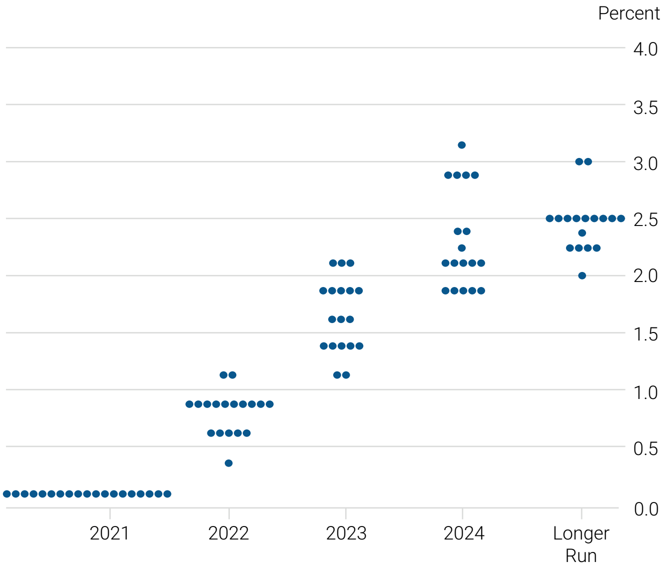
[5] www2.deloitte.com/uk/en/pages/finance/articles/deloitte-cfo-survey.html

- The need for occupier engagement was clear before COVID as new entrants drove service levels higher, leaving more passive real estate investors exposed. The pandemic has accelerated this theme, with pragmatic and principled engagement being necessary to manage rental collection, especially in the most exposed occupier sectors. Investors increasingly recognise that technology, such as LGIM's Vizta platform, can drive engagement further. Furthermore, they believe that social value initiatives, where occupiers and landlords jointly undertake community activities, can be an excellent way to make a positive local impact while improving relationships.

Inflation as a renewed concern for investors

Interest rates remain at historically low levels, with many countries still on emergency COVID-19 rates. The market expects the US Federal Reserve and Bank of England to wind up QE and raise policy rates imminently. That said, barring an unexpected shift in structural conditions, we believe rates are likely to remain below historical averages over the medium term.

Joining the dots – US interest rate expectations



Source: US Federal Reserve dot plot as at December 2021. Assumptions, opinions and estimates are provided for illustrative purposes only.

Inflation in developed economies, however, is currently at levels not seen for decades. While the structural drivers for potential long-term deflation have not changed, breakeven inflation rates illustrate that markets are currently more concerned than economists about persistent increases in costs.

Whether in the short or longer term, this highlights the requirement to hedge inflation as a more pressing issue for investors. Real estate and infrastructure are often viewed as effective ways of hedging inflation. While this can be true, the devil is very much in the detail.

Both asset classes have segments or strategies which provide a contractual link to inflation, for example long-income property (credit tenant leases in the US), and certain social infrastructure and regulated utility assets in the infrastructure space. These can be a useful addition to an investor's wider inflation-hedging strategy. Beyond contractual protection (where inflation-linked increases are embedded), other asset types offer protection by 'pricing power', where a healthy balance of supply and demand influences the ability to pass inflation onto the end user.

An increasing number of real estate portfolios are tilting toward operational exposure which aligns investors' cashflows with the revenues and profits of the business conducted on, or from, the premises. With the right expertise and focused on the right assets, we view this as a potential source of alpha.

Inflation in construction costs and material prices in all sectors associated with capital expenditure requires mitigation. A key area of due diligence is to stress test the viability of a project to withstand input cost inflation as well as supply chain disruptions. This requires greater supply chain visibility and agile management.

ESG and impact investing

ESG is not just about managing downside risks. It's also about allocating capital to solve the biggest environmental and social problems we face today as we move towards a future of net zero carbon emissions and inclusive growth. In our view, the transition to net zero provides one of the greatest investment opportunities in our generation.

Investors with a long-term horizon have a key part to play. We note above the large financing requirements related to decarbonising the energy and transport sectors. The real estate industry needs to carry out a multi-decade programme of capital expenditure to improve the energy efficiency and carbon intensity of its existing buildings, which in the developed world account for the majority of the stock that will exist in 2050. The aforementioned supply chain issues in the construction sector could create significant practical difficulties in achieving these aims, at least in the medium term, increasing risks around stranded assets.

There is increasing evidence of financial value being delivered by stronger environmental standards in buildings. As an example, recently released data showed that 'greener' offices in central London (BREEAM rating 'Outstanding') have generated a rental premium of 12.3% versus other high quality but non-certified buildings.[6] Such data builds confidence that repositioning can be financially beneficial.

For those with capital to deploy, the net zero transition is creating both new asset types and financing opportunities:

- Direct capital towards climate and social solution creators: in 2021, LGIM financed providers of elderly healthcare, fibre broadband in underserved areas and heat pumps, amongst other examples of climate and social solutions. We are seeing an increasing number of opportunities that will meet institutional investor requirements in areas as diverse as hydrogen, sustainable agriculture, and carbon capture.

- In the area of transition finance, there is scope to support borrowers with their environmental and social impact objectives. In 2021, LGIM executed its first net zero-specific loan to a university college, where the proceeds will be ring-fenced for the implementation of their net zero strategy. In other cases, LGIM has offered coupon reductions linked to ambitious environmental or social KPIs. We expect a growing pipeline of sustainability-linked loans as corporates try to deliver net zero and positive impact.

Private markets – providing a range of opportunities

The events of the past several years have underscored that even for long-term assets, which we typically view private market exposures to be, agility and a forward-looking mindset are rewarded. In a complex environment, we believe the range of opportunities in real estate, infrastructure and private credit is rich and diverse. Notably, such projects are supported by, or aligned with, governments' investment plans and the transition to net zero. All of this points to a sustained increase in the role for private market allocations in helping investors achieve their own long-term investment and ESG objectives.

[6] www.knightfrank.com/research/article/2021-09-02-the-sustainability-series

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