The case for net lease/sale-leasebacks in Europe

Introduction

2022 was no doubt a challenging year the European economy and European commercial real estate ("CRE"). Investors and occupiers have had to adjust quickly to a new regime of higher financing costs, lower liquidity and slower economic growth. In this context, defensive real estate strategies such as net lease/sale-leasebacks can provide an attractive opportunity for CRE investors. These strategies can enable investors to access stable, more secure and inflation-linked cashflows, in addition to longer-term capital appreciation potential and diversification benefits. This article reviews the drivers and merits of European net lease investment in Europe at this point in the cycle.

What is net lease?

Net lease property typically consists of real estate let on long-dated, inflation-linked leases. These leases are typically double/triple net, whereby the tenant is contractually obligated to pay for most or all of property related expenses, insulating income from unforeseen increases in these costs. A key characteristic of net lease property is that a significant portion of returns is derived from contractually fixed income instead of more volatile capital growth.

For this reason, net lease investments are often regarded as the most "bond-like" type of CRE investments. Although the net lease sector, like other fixed income investments, is sensitive to movements in interest rates, it can offer effective inflation protection through CPI-indexed leases, which help grow/preserve the value of investment. With inflationary pressures expected to remain elevated, this investment attribute is particularly desirable.

A large and growing market

Net lease property is typically sourced via sale-leasebacks ("SLB") or build-to-suit structures ("BTS"). The European SLB market has grown substantially over the past decade. EMEA corporate disposals reached a post-GFC high of €29.2 billion across 670 disposals during 2021[1], roughly double the volume in 2010.[1] Overall, the European corporate-owned real estate market is estimated to be worth €5.7 trillion.[2] SLBs allow corporates to monetise 100% of the value of their real estate, eliminate refinancing risks and typically allow corporate sellers to retain operational control of the assets. Furthermore, corporates tend to have a relatively higher cost of capital compared to real estate investment funds. By selling CRE to an investor, the corporate can replace its own "expensive" capital with "cheaper" fund capital and focus resources on higher-returning purposes within its core business.

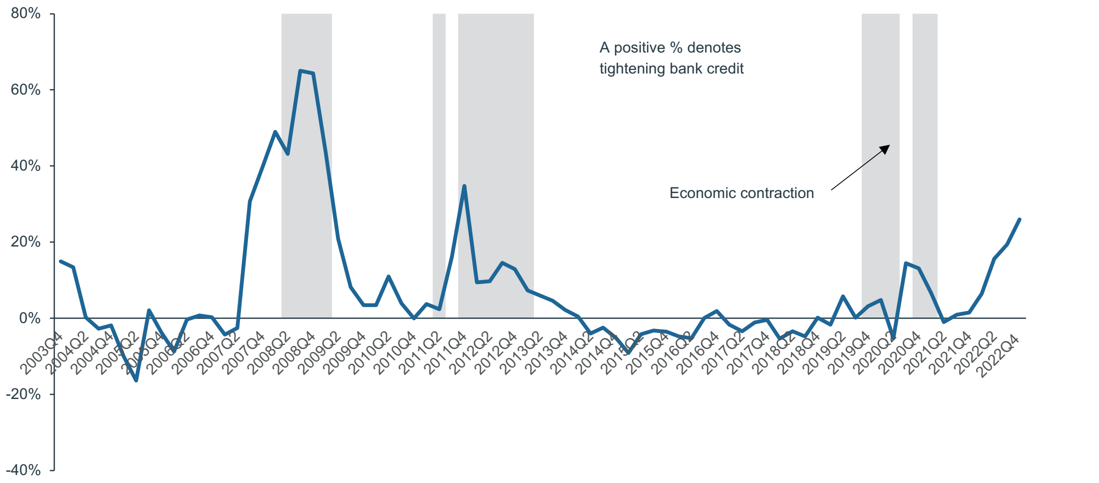
Why the market is growing

Going forward, there is a strong argument that an increasing number of corporates will turn to SLBs as an alternative financing method due to the following reasons:

- **Tighter credit standards:** The latest ECB Lending Survey indicates that Euro area banks are continuing to tighten their credit standards (Figure 1).[3] During Q4 2022, firms' net demand for loans decreased for the first time since the beginning of 2021 as a result.
- **Lower bond market liquidity:** Bond financing may also prove less attractive for corporates due to rising interest rates, while the uncertain inflation outlook and prospects of further interest rate hikes have dampened investors' appetite for corporate bonds. These two forces played out in a sharp reduction in high-yield bond issuance during 2022. Only €18 billion were raised through BB+ (and below) rated bonds during Q4 2022, compared to €45 billion raised during Q4 2021.

  Between 2021 and 2022, the average yield-to-maturity for B-rated European corporate bonds increased to 7.52%, from 5.15%.[4]
- **ECB's balance sheet reduction:** ECB will allow bonds worth €15 billion (monthly average), acquired under its Asset Purchase Programme, to expire without reinvesting them. In doing so, the ECB will suck further liquidity out of the system, possibly further incentivising corporates to seek alternative financing channels.

Figure 1: European banks are tightening credit standards



Why invest in net lease in Europe?

Historically, net lease property has delivered attractive risk-adjusted returns relative to balanced CRE portfolios. The appeal of net lease strategies in Europe can be traced back to several factors:

- **Less volatile, income-driven returns:** A key benefit of net lease stems from that virtually all return tends to come from secure contractual income and contractual CPI increases. Returns are therefore, typically, more stable and predictable than from strategies where return depends on capital growth.
- **Inflation protection:** European net lease cashflows are typically pegged to CPI. This attribute sets apart long-let commercial property from typical fixed-income investments with similar return profiles. While inflation in Europe looks to have peaked,[5] long-term inflation expectations remain historically elevated. Falling and ageing population, tight labour markets, risk of renewed supply chain disruptions, slowing globalisation/de-globalisation and the cost of the green transition may all contribute to above-average inflation in the years to come even as some of the current inflationary pressures abate. Investors can also leverage with fixed-rate debt, resulting in an inflation multiplier effect.
- **Untapped opportunity:** Relatively few specialist investors are active in the European net lease space and are mostly focused on core return profiles. While some US investment managers have been active in this space since the 1970s, only in the late 1990s have net lease funds made their appearance in Europe. To date, moreover, such funds have overwhelmingly been UK-focused. Investors thus may have the potential opportunity to secure competitively priced long income at this point in the property cycle.

Conclusion:

Inflation, economic volatility and uncertainty are likely to remain features of the European economy in 2023, and possibly beyond. Investors ought to consider capital allocations to defensive, income-focused strategies such as net lease, which historically has delivered attractive risk-adjusted returns and provides diversification and inflation protection benefits. Moreover, the European net lease market has a large potential pipeline of investable product due to mounting stress in corporate credit markets and higher own-occupancy rates in Europe. Finally, the relative immaturity of the European net lease property market combined with the ongoing correction in values may further enhance the return profile of investment.

FOOTNOTES:

1 Source: JLL "Raising Capital from Corporate Real Estate", 2022.
2 Estimate based upon a recent study from INREV and EPRA that found that approximately 35% of the €8.8 trillion European commercial property market is held as investment, and by extension, 65% is owner-occupied.
3 Source: Q4 2022 Euro Area Bank Lending Survey.
4 Source: Debt Watch Europe, 2022 Annual Review, PWC.
5 Source: Eurostat.

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