AVIVA INVESTORS

QUARTERLY UPDATE ON DRIVERS IN ILLIQUID ASSETS Q1 2019

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In our regular update on real assets:

– We assess real estate positioning in the late stages of the cycle;

– Check interest in real assets in a period of Brexit-related uncertainty; and

– Illustrate the spreads achievable across private assets of varying credit quality.

Key themes:
Real estate: Steady debt flow in Q1 amid Brexit cacophony, while investors assess late cycle positioning

REAL ESTATE | ASSESSING OPPORTUNITIES AND LATE CYCLE POSITIONING

At this late stage in the property cycle, European real estate investors are being relatively poorly compensated for taking on extra risk, so positioning defensively is the most appropriate course of action. While flows into riskier parts of the real assets universe may slow, prime assets are expected to remain in demand and less likely to experience significant repricing.

Despite moderate returns in Continental Europe (we expect prime European commercial real estate to return around 3.4 per cent annualised 2019-2023 versus 14.2 per cent 2014-2018), the risks around supply and leverage are significantly weaker than in the last cycle. However, creating income growth is still possible through selective active management and repositioning.

As some direct investments are expensive, real estate debt and real estate investment trusts (REITs) are becoming more compelling. For instance, investors in real estate debt can expect to receive income with little capital value risk – provided capital is sensibly lent.

Meanwhile, in the UK, as parliamentary discussions on Brexit have stepped up, some foreign parties have become more cautious. There have been comparatively few transactions on "trophy" properties, as foreign buyers consider the potential outcomes of current political process. Long income – where indexed leases are set at the right rent to the right tenant – continues to be a safe haven on a risk-adjusted basis.

On the other hand, there has been an active flow of smaller property transactions that require finance across the full credit spectrum. This includes retail, offices, hotels and student accommodation. Owners have been seeking to secure funding in anticipation of increased volatility, which has benefitted long-term debt investors as foreign banks have been less active. As a result, while real estate transactions have declined in Q1 (see chart), there has been a steady flow of new real estate debt investment opportunities. And although the near-term effects of a hard Brexit on deal flow is uncertain, we expect to see decent opportunities, particularly for UK lenders, throughout the rest of the year.

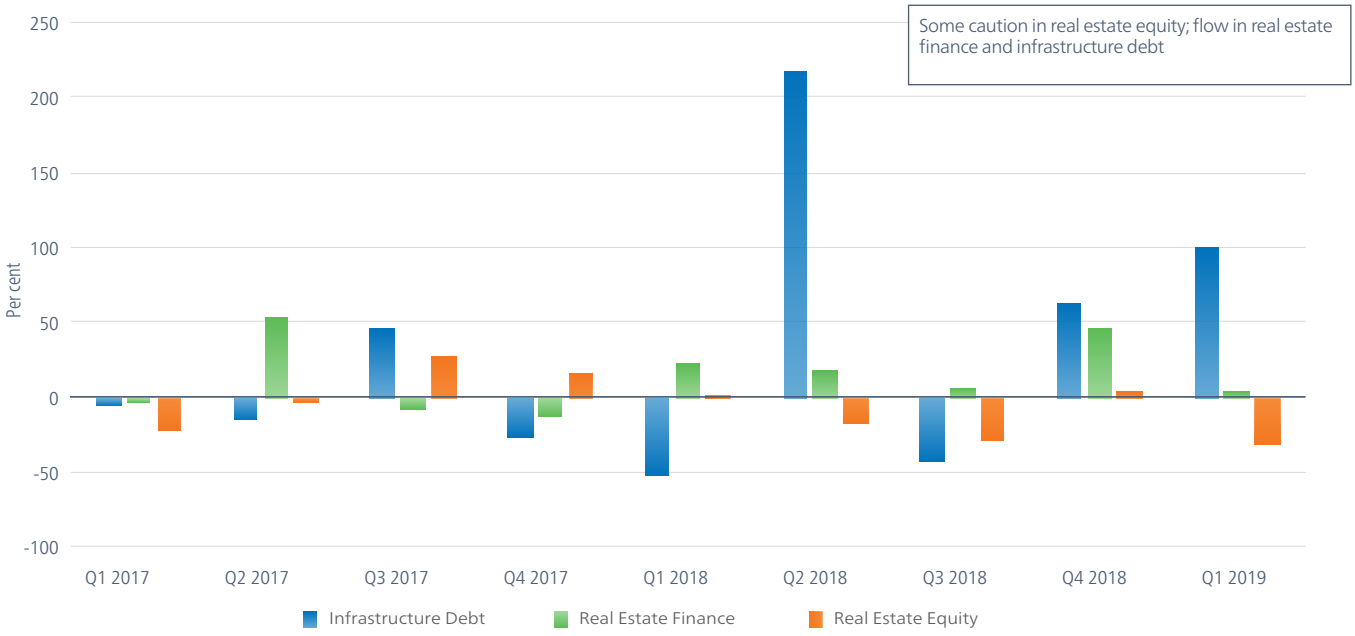
Infrastructure Debt: refinancings continue to drive volume

INFRASTRUCTURE DEBT: REFINANCING ACTIVITY CONTINUES TO DRIVE VOLUME AS INVESTORS SQUEEZE THE REFINANCING LEMON TO THE LAST PIP

As in the UK property market, there have been few large infrastructure acquisitions in the first quarter, with more activity in continental Europe. However, refinancing activity and smaller acquisitions has driven a steady volume of new debt transactions.

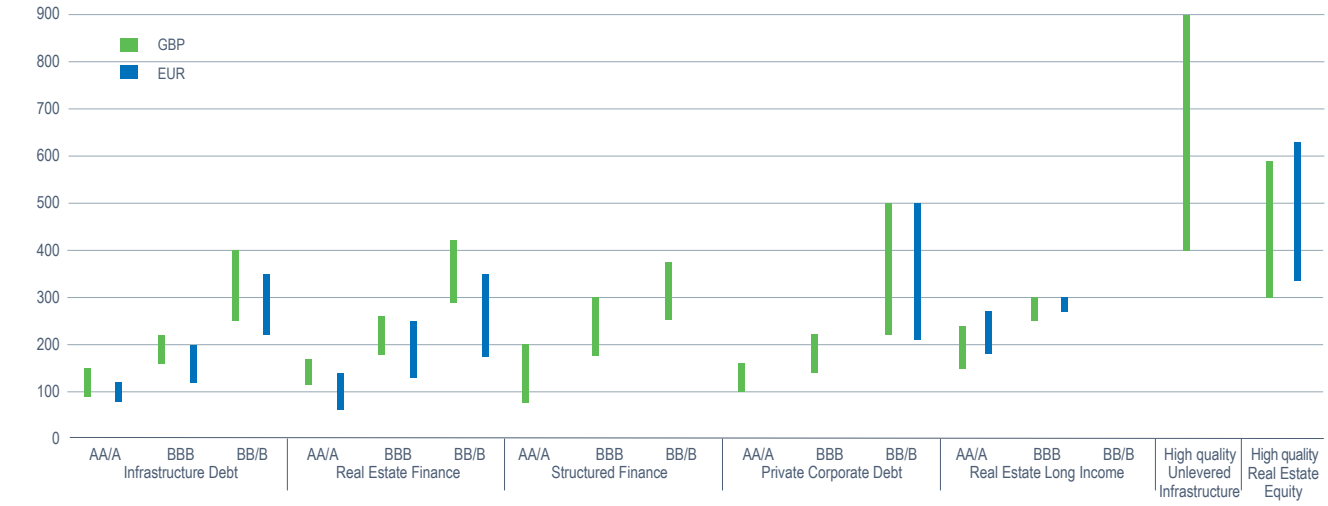
After a hectic fourth quarter, largely spent closing transactions, sponsors have approached 2019 with more benign financing conditions than were expected 12-months ago and may be able to further optimise their portfolios. UK PFI refinancings have been delayed by the need to obtain government approval but are gaining momentum. All these factors have contributed to a robust pipeline in Q1. However, with the new infrastructure programme ('greenfield') remaining slow, we believe this momentum could be difficult to maintain for another year.

Year-on-year % change



Source: Aviva Investors, as at 29 March 2019

Indicative spreads p.a.*



* Additional yield above comparable government bonds **High quality: unlevered infrastructure with largely predictable cash flow.
Source: Aviva Investors (for illustrative purposes only). All data as at 29 March 2019. The future returns and opinions expressed are based on Aviva Investors internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature.

RISKS

ILLIQUIDITY: Alternative Income assets are significantly less liquid than assets traded on public markets. Where funds are invested in infrastructure/real estate, investors may not be able to switch or cash in an investment when they want because infrastructure may not always be readily saleable. If this is the case, we may defer a request to redeem the investment.

VALUATION: Investors should bear in mind that the valuation of real estate/infrastructure is generally a matter of valuers' opinion rather than fact. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Past performance is not a guide to future returns. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Past performance is not a guide to future returns.