

M&G Income Strip Strategy

Q4 2023



Key information

Fund structure
**Guernsey Property
Unit Trust**

Inception date
4 July 2014

Unit Class (GBP)
Reinvestment or income

Anticipated return
**UK index-linked
gilts +250-300bps***

Dealing price
Nav minus 1.25%

NAV
£767.1 million

Distribution frequency
Quarterly

Valuation frequency
Monthly

Leverage
No structural gearing

Source: M&G, as at
31 December 2023.
*return anticipation over the
medium to long term based on
today's values and inflation.

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance and there is no guarantee the objective will be achieved.

Risks associated with this fund

The views expressed in this document should not be taken as recommendation, advice or forecast.

Credit risk: The fund may be exposed to the possibility that a tenant will not meet their lease obligations.

Liquidity risk: Where market conditions make it hard to sell the fund's investments at a fair price to meet investors' redemptions, the Board of the fund may temporarily defer redemption requests as provided for in the fund's Investment Memorandum.

Interest rate risk: Changes in interest rates may adversely affect the market value of some of the fund's investments.

Property risk: Real estate values can be affected by a number of factors beyond the fund's control and may be subject to long-term cyclical trends that can give rise to volatility in valuations.

Please note this is not an exhaustive list; you should ensure you understand the risk profile of the products or services you plan to purchase.

- The investment policy of the fund is to invest in a diversified portfolio of commercial real estate in the UK seeking to add value through stock selection and asset management.
- Environmental and social characteristics are considered within the fund's investment process, including setting binding elements, as well as aspirational targets relating to reducing the impact of the real estate assets on the environment, supporting the well-being of occupiers, and encouraging community engagement which are monitored using performance indicators, and external industry ESG benchmarks (such as GRESB).
- The strategy is actively managed and has no benchmark.

Summary

The strategy provides bond-like, inflation-linked, amortising cashflows which are well suited to matching long-dated liabilities. These are typically backed by prime UK real estate, but without residual property value exposure.



What is an income strip?

As its name suggests, these transactions 'strip' or separate the stream of cash generated by a lease from the underlying real estate, so that the income stream represents 100% of the value of the investment. With an income strip the tenant retains the option to buy back the real estate asset at lease end for a nominal sum, for example £1. Income strips therefore offer an occupier the benefit of raising long-term funds against their real estate holdings, while retaining ownership of the freehold when the lease ends, so long as all lease payments are fulfilled.

From an institutional investor's perspective, an income strip provides long-dated (c.40-year), investment grade, inflation-linked cashflows with an attractive yield, which are typically used for matching UK defined benefit pension scheme liabilities. Secured against business-critical UK real estate, these assets are sourced in a mature and diverse market offering access to a wide range of public and private sector counterparties including local authorities, the NHS, universities and operating companies.

Income profile

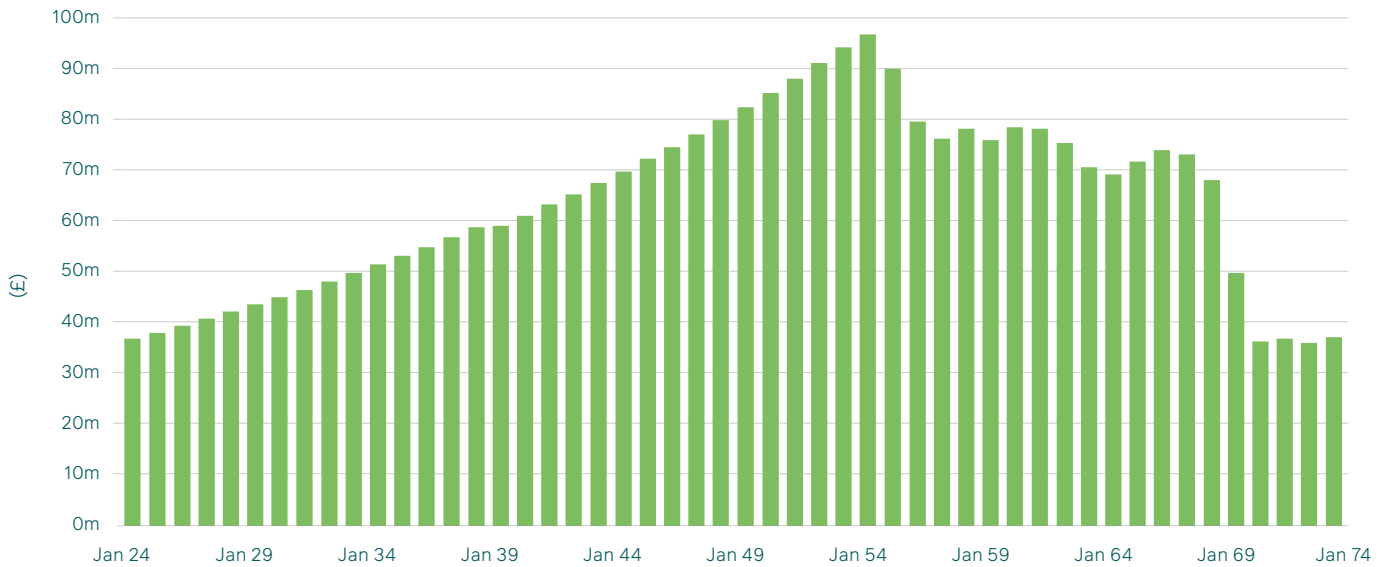


Valuation profile



Past performance is not a guide to future performance. There is no guarantee the objective will be achieved.

Strategy 50-year cashflow forecast (A-/inflation-linked)



Source: M&G, illustrative.

Portfolio summary

The portfolio comprises assets which are key to the ongoing operational or constitutional objectives of the tenant, hence the tenants’ willingness to sign up to such long-term leases and their desire to retain ownership of the real estate interest in the long-term.

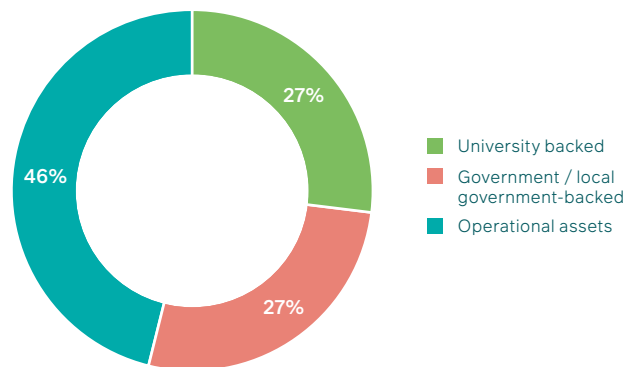
The fund’s key metrics are attractive, with a long weighted average lease expiry (WALE) of 44 years (to the first break) and 100% of income linked to inflation. The fund is diversified across a range of sectors with a high public/quasi-public sector weighting, with a weighted average credit rating of A-.

Who should invest?

Ideally suited for institutional investors with UK-based, long-term inflation-linked liabilities, these cashflows are typically available at a significant yield premium to UK index-linked gilts and have complementary features. For example, income strips have a higher yield throughout the term and are fully amortising (akin to an inflation-linked mortgage), with no large, inflation-linked principal repayment at maturity, as with index-linked gilts. In our opinion, this smoothed income stream with higher regular cash flow receipts make it ideal for long-dated cashflow-matching portfolios.

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Tenant weighting by income

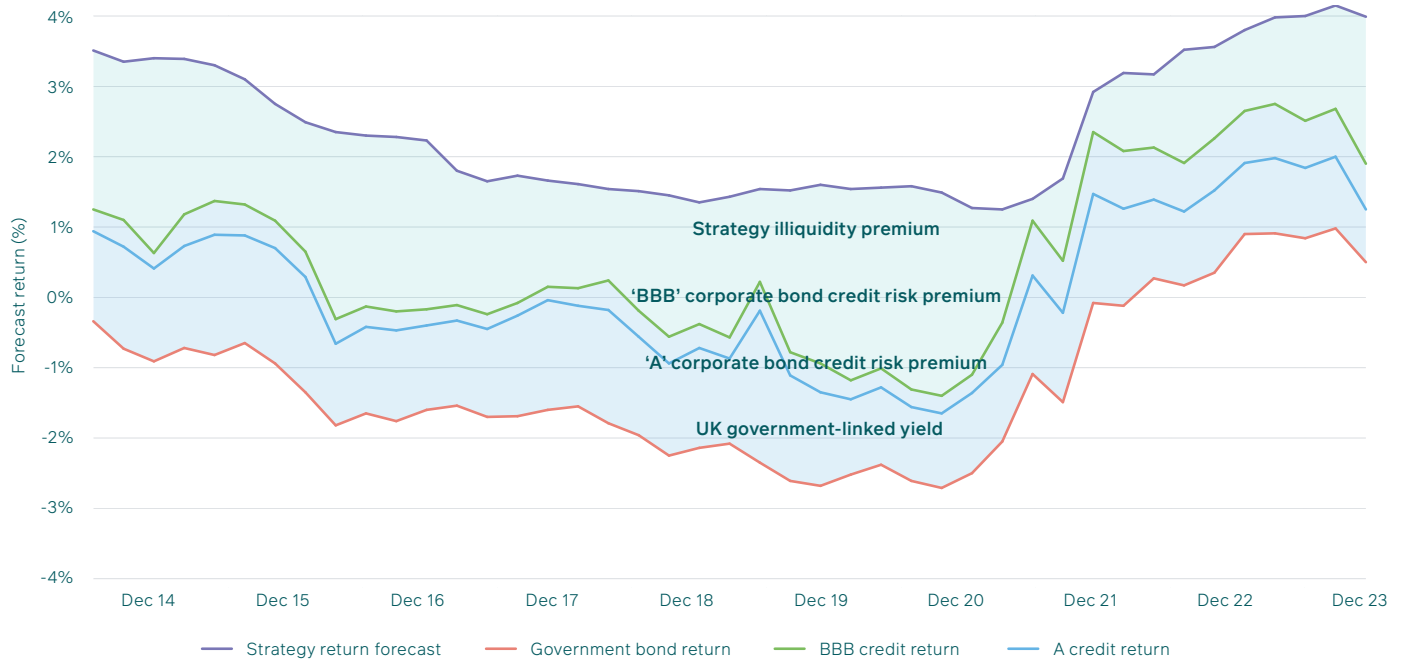


Source: M&G, 31 December 2023. Assuming the current portfolio.

Attractive relative value versus public and private credit markets

In M&G's experience, income strips tend to provide amongst the most attractive illiquidity premia available across private credit markets. As at 31 December 2023, the fund provided an illiquidity premium of 324bps to UK index-linked government bonds, representing an illiquidity premium of 122bps/190bps versus BBB and single-A public markets respectively.

Strategy illiquidity premium – Real



Source: M&G, iBoxx, and DMO, 31 December 2023. Forecast returns are not guaranteed.

Example assets

Rochdale town centre regeneration

In addition to creating long-dated and inflation-linked income for pension schemes, income strip funding can in many cases deliver projects which make a tangible difference to communities, support the NHS or enhance educational infrastructure. In Rochdale for instance, a large town in Greater Manchester, we have funded the £80 million Rochdale Riverside development, which is designed to reverse a long-term downward spiral of reduced footfall and consumer spending in the town centre that has led to retail closures and further decline.

Following its completion in April 2020, the council has estimated that the development will bring in an extra 2.1 million visitors and £150 million in retail expenditure each year. Overall, the development has created 1,450 local jobs and an estimated net additional £22 million gross value added (GVA) over a five-year period for the local economy. Around 40% of construction labour was also sourced from the local borough.

The scheme was funded on a 35-year inflation-linked lease (annual reviews to RPI, 0-5%) to Rochdale Borough Council*.



*Further information can be found on:

[https://democracy.rochdale.gov.uk/documents/s81803/Rochdale Riverside retail leisure update.pdf](https://democracy.rochdale.gov.uk/documents/s81803/Rochdale%20Riverside%20retail%20leisure%20update.pdf)

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There is no guarantee the objective will be achieved.

The Harborne Hospital: mixed NHS and private hospital, Birmingham

The Harborne Hospital is a newly developed hospital on the Edgbaston NHS campus in Birmingham which the strategy funded alongside a development partner. The facility completed in September 2023 and will be operated by HCA, a leading provider of private medical care in the UK and USA. It provides 72 NHS beds and 66 private beds with access to a new radiotherapy unit and various specialisms including dialysis. Linked directly into the existing Queen Elizabeth Hospital by a footbridge, it is designed to provide extra capacity in private healthcare in an underserved area, support provision of NHS services, and help attract and retain NHS talent. The hospital was funded on a 40-year inflation-linked lease (annual reviews to RPI, 0-5%) backed by University Hospitals Birmingham NHS Foundation Trust and offers attractive 'E' and 'S' characteristics for the fund's investors.



Environmental, Social and Governance (ESG)


- Market-leading ESG performance measured by GRESB (real estate property fund benchmark)
- Targeting net-zero carbon by 2050
- 57% of the fund (by value) has Green Building Certification or is pending certification
- Significant element of the portfolio comprises assets developed in partnership with local authorities, universities and the NHS which create jobs and gross value added for the local economy, contribute to social infrastructure via higher education, and support the NHS.

Solvency II

The strategy would need to be treated on a case-by-case basis and the treatment of these assets will be dictated by whether the insurer operates under the standard formula or internal model.

The market is one of unrated private lease obligations without exposure to market movements of the property, and has the added benefit of collateral.

M&G have considerable experience in working with insurers operating under risk-based capital frameworks. As of December 2023 we manage approximately £17bn of external assets on behalf of external insurance clients, most of whom are bound by Solvency II, and £200bn of internal assets within our insurance business firmwide (Prudential included). As such we are in a strong position to assist with the calibration of capital requirements of these instruments.

We would encourage any schemes interested in learning more to contact our team directly on the details below. 

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All Charts and Data: M&G, 31 December 2023, unless stated otherwise.



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