Institutional investors are typically a conservative group, but after years of quantitative easing and low interest rates they are increasingly willing to push the boundaries out for yield. Although many opportunities are tempting, industry participants are cautioning investors to read the fine print before taking the plunge.

**Private lending**
To date, private lending is among the biggest themes as defined benefit schemes are desperately seeking long-dated cashflows to match their liabilities. New avenues are being opened by banks withdrawing from lending due to stricter capital and leverage requirements, but as Aon Hewitt partner and head of the firm’s UK investment consulting practice Tim Giles warns, investments in this space have different risk/return profiles and institutions need greater due diligence upfront.

“These are illiquid and heterogeneous asset classes that require different governance structures,” he says. “If institutions take too long to make a decision they could miss the opportunity. We have also seen cases where pension funds pile into these less liquid asset classes and follow a crowd but it is too late because the prices have risen and the returns are not as attractive.”

One area where there are not that many takers is Amsterdam’s infamous red light district. The city started the area’s clean up in 2007 after officials said it had become a magnet for criminal gangs, but institutions as well as private investors were reluctant to invest in the neighbourhood because of the seedy reputation. Earlier this year though Dutch agricultural workers’ pension plan and the pension scheme of Rabobank acquired a 35 per cent stake in the 1012 Inc investment fund that is named after the postcode.

The fund, which holds an initial portfolio of 133 buildings, has an annual dividend income target of 4 per cent. The pension funds had a change of heart because they were given the rights to acquire...
land for four lucrative residential developments worth €150 million outside the city’s main A10 ring road. Moreover, the terms stipulate that no property is allowed to be used for prostitution or drugs, although that does not apply to the sale of sex toys, at least until the lease runs out.

Amsterdam is also in the middle of a housing boom fuelled by a shortage of homes, economic recovery and ultralow interest rates. House prices in the city exceeded their pre-2008 financial crisis peak in the first quarter, according to the national statistics office. The result is that competition for real estate assets is fierce and the returns are strong – in the 10 per cent to 15 per cent range compared to the near zero of Dutch government bonds.

M&G has also been a big player in the alternative property sector, pumping more than £1 billion over the past two years. Fewer eyebrows may have been raised but their transactions were also not run of the mill. The most notable were the £233 million deal for six hospitals with healthcare provider the Priory Group, as well as the £173 million sale and leaseback on a portfolio of 52 bingo clubs with leisure firm Gala.

Also worth a mention were the £92 million purchase of 39 health clubs from the Bannatyne Group on a ground lease basis, and the 50 per cent stake in the £240 million acquisition of 18 car auction sites across the UK from British Car Auctions for 18 car auction sites across the UK.

“The aim is to buy the right quality assets and create lease structures that deliver investment grade-style cashflows that are inflation protected and contracted over the long term,” M&G secured property income fund manager Ben Jones says. “For example, the Gala Bingo deal was underpinned by affordable rents set at below market levels yet offered a net initial yield of just under 8.5 per cent and 25 years of inflation protection. However, we have been doing this for a very long time and have been selective early movers into many of these markets.”

Insurance linked securities
A variation on the bingo hall investments is the €100 million worth of insurance linked securities issued by Gibraltar-based Lottoland this spring to protect it against the risk of punters hitting the jackpot. Investors were offered four different levels of risk, with the expected probabilities of losses ranging between one-in-eight and one-in-40, with commensurate returns of between 5 per cent and 15 per cent depending on the risk involved, and the number of customers who make bets.

Although the risks are at the higher end of the spectrum, these securities are in demand because they are uncorrelated, not only with wider financial markets, but with other ILS, such as catastrophe bonds. In addition, other participants are branching out from weather-related bonds, with Credit Suisse coming to the market with a SFr220 million bond that hedges against operational risks.

Another first was the £220 million bond by Virgin Airline, which used its Heathrow landing slots as collateral. Pension Corporation Inc was the biggest investor with a £75 million chunk of the deal, which was constructed by Macquarie and rated privately by Moody’s Investor Services. The key benefits were a low initial loan-to-value ratio that decreases over time and strong demand for Virgin’s predominantly trans-Atlantic slots.

Another noteworthy deal in the insurer’s portfolio was the £70 million of Consumer Prices Index (CPI)-linked secured debt issued by the Church of England Pensions Board through a special purpose vehicle targeted to fund subsidised retirement housing for clergy.
However, the Virgin deal underscores the need for careful analysis and robust due diligence. “We spent a long time getting comfortable with the deal,” PIC head of fixed income Mark Gull mentions. “We wanted to ensure that it was structured properly and that demand for the landing slots was secure. The key in any deal is to have a credit team that can do the analysis and understands the structure. You do not want to be in a situation where you have to sell the assets.”

The same is true for the recent £4.2 billion Thames Tideway project, which will be the length of 250 football pitches and stretches from east to west London. Allianz Investors is leading a consortium comprising of Dalmore Capital, Amber Infrastructure, Swiss Life Asset Managers and International Public Partnerships. A private company, set up by the government and Thames Water, will own, manage and finance the sewer during construction, with one-third of the cost being contributed by the company, while the remaining £2.8 billion will be raised from private investors.

The institutions will receive an income from the project from the very start, while the government will indemnify them against a number of risks. However, the National Audit Office (NAO), the government’s spending watchdog, has raised questions over a financial plan for the project that would leave taxpayers footing the bill in the event of cost overruns or a fresh crisis in global credit markets.

Other areas being explored by fund managers such as Aviva Investors are telecommunications, battery storage, rolling train stock field and solar panels. Earlier this year, the fund manager struck a deal to provide £200 million in debt finance to Govia Thameslink Railway (GTR) while it is also focusing on providing high-speed broadband to areas outside of main cities. Three years ago, it invested in a 10-year deal to finance an optical ‘Fibre to the Home’ broadband network for over 174,000 homes in the Netherlands.

“We have the Infrastructure Income Fund, which is unlevered and targets an 8 per cent per annum income by investing in low carbon and social infrastructure,” Aviva Investors head of investment strategy-global investment solutions John Dewey says. “One of the challenges of non-traditional investments is that by definition they are all different and if, for example, we decide to take on construction risk, we have to make sure that there are the right resources, skills and track record to manage the project.”

Although private lending seems to be the most popular, real assets such as timber are also carving a wider space in portfolios. “It not only generates stable cash flows but is also a good diversifier,” OM Asset Management head of international business Olivier Lebleu underlines. “We invest in plantation forests in the US that are sold for commercial use both locally and internationally as well as for wood pellets for renewable energy in Europe.”