Fidelity INTERNATIONAL

Assessing the sensitivity of tenant income risk to disruption

An overview of Fidelity Real Estate's approach

July 2020

Rental recovery rates have now become a key metric for real estate investors as we try to assess and forecast the impact of the COVID-19 crisis on our tenants and real estate markets. At Fidelity, tenant due diligence and understanding income risk has always been a key part of our process. This latest period of disruption has served to highlight that understanding our tenants' business model, the risks they face and the resultant impact on their ability to pay their rent is pivotal to delivering investment outcomes to our clients. We have further enhanced our process of tenant and business model due diligence, taking into account a more comprehensive view on the sectors within which our tenants sit, to ensure that our analysis is as forward looking as possible. In this document we explain the process we employ to assess the income at risk and forecast rental recovery rates across our portfolios.

Risk and Research expectations

Our Risk and Research Team uses a quantitative based approach to give each tenant a score based on their expected level of income risk, this is known as the Fidelity Income Risk Score (FIRS). The FIRS score is graded from 1-5, with 1 being the lowest risk and 5 being the highest risk, and is made up of 3 components:

1. Tenant Financial Strength
2. Tenant Default Probability
3. Sector rating (based on Fidelity's in-house view of sectors, including default risk, and external sector leverage ratios)

These 3 components are scored and equally weighted to give the overall FIRS score. Aside from the qualitative sector views of the Fidelity Research Analysts, the FIRS score is made up of quantitative data. Other factors such as GDP forecasts of tenant's local economy (NUTS3 region) are also taken into account with the FIRS score when considering the income risk for a particular tenant.

Factors considered in building Risk and Research's expectations of income risk:

Bottom Up		Top Down	
Tenant level Data	Default probability	Sector Rating	Research analyst views
	Financial strength		Fixed income sector default probability
			Fidelity Pulse Survey
			Equity market leverage ratios

Fidelity Income Risk Score (FIRS):	1	2	3	4	5

Source: Fidelity International, July 2020

Fund Manager and Asset Manager expectations

Independently of the Risk and Research team, the Portfolio Management Team also forms their own view of how at risk the income is for each tenant, which is based on a combination of qualitative insights about the tenant/sector and quantitative data, examples of which are shown in the graphic below. Each tenant is given a score on the basis of low, medium or high risk, or 1,2,3 respectively.

Factors considered in building the Portfolio Manager's expectations of income risk:

Sector vulnerability to COVID	Historic collection rates
Tenant financial strength	Discussions with tenants and agents
Government incentives	Insights from industry bodies
Existence of a guarantor / rent deposit	

Portfolio Manager (PM) expectation: % income at risk

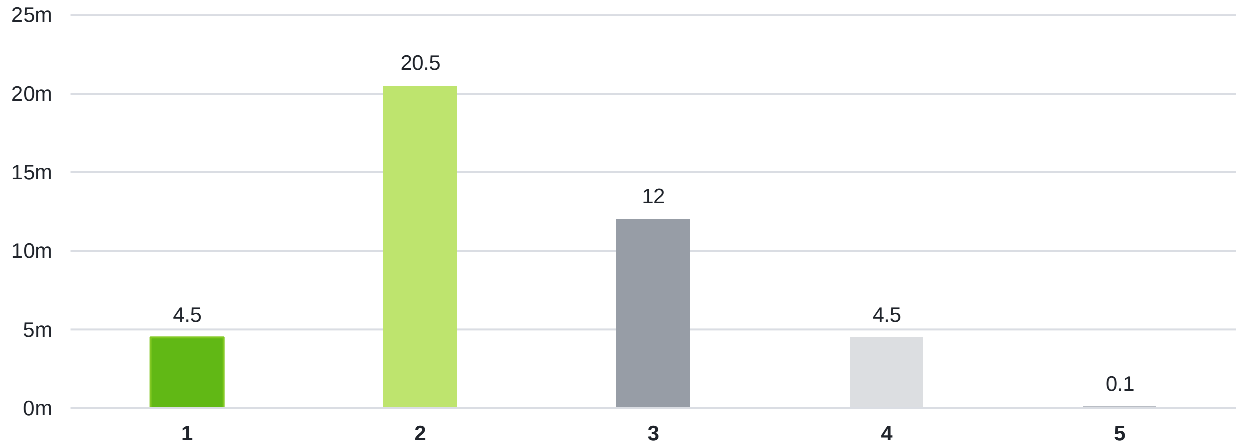
Source: Fidelity International, July 2020

Comparison of expectations

The FIRS and PM expectation of income at risk for each tenant are discussed, with particular attention paid to any conflicts or outliers, between the Risk and Research Team and the Portfolio Management Team.

Considering both the FIRS and PM Score, ensures that the individual circumstances affecting each of the tenants as well as the wider trends in the market are fully understood. Including both quantitative and qualitative input also ensures that the analysis is forward looking and provides a fuller overview of the potential risks.

Total rent by FIRS



Source: Fidelity International, May 2020. Data shown for Fidelity Eurozone Select Real Estate Fund.

Case study: Toom

Toom are a large German DIY store chain who we have exposure to across 4 of our German retail warehouse assets. We bought our first asset let to Toom back in 2016, and an attractive yield of 7.4%. Based on discussions with Fidelity's equity and fixed income research analysts we believed that the market was unfairly discounting DIY retail assets in Germany as a result of the turmoil in the wider retail market when in fact exposure to Toom could offer a sustainable long-term income stream thanks to a successful business model. At 6.6%, the average purchase yield of our Toom assets represents a circa 1% premium to equivalent food anchored stores. Today, Toom represents 7.8% of total portfolio rent and circa 40% of our exposure to the Consumer Discretionary sector.

toom ▶ Tenant FIRS score ▶ 2 | PM expectation ▶ 0% income at risk

Let's look at how these numbers breakdown:

Tenant FIRS Score

Tenant level risks

Default probability* ▶ 1

The default probability score is based on data from Dun & Bradstreet and predicts the likelihood that an organisation will obtain legal relief from its creditors or cease operations over the next 12 months. It is derived from a broad range of financial indicators and company characteristics that have been found to be predictive of company failure.

REWE Zentralfinanz eG is the ultimate parent company of Toom, therefore for the purpose of assessing default risk we look at them. REWE Zentralfinanz eG is a large, well-capitalised company, which is reflected in their default probability score of 0.04%.

Financial strength* ▶ 1

To assess financial strength we use the metric of net worth, which is equal to total assets minus total liabilities, to measure REWE Zentralfinanz eG's financial strength. Relative to the rest of the portfolio, REWE Zentralfinanz eG's net worth of €6.7bn places it in the lowest risk group.

*Data from Dun and Bradstreet, as at end of May 2020.

Sector rating

Toom, being a DIY retail store, is classified in the GICS (The Global Industry Classification Standard) sector of Consumer Discretionary.

The sector rating score for Toom is 4. There are 4 underlying components which make-up this score:

Research analyst views	5

Research analyst views encompass the traditional views of our Real Estate Research Analysts together with input from Fidelity's wider research platform, including our equity and fixed income analysts. This enables us to get a more comprehensive view of the outlook for the Consumer Discretionary sector.

The Consumer Discretionary sector has been one of the sectors hit hardest by lockdown, due to retail stores across Europe being required to close. This will likely have had a significant impact on firms' cashflows. In the longer term, it is expected this sector could continue to suffer as the rise in the online shopping trend has been amplified by the crisis. As a result, the sector receives the highest risk score from our Research team.

Fixed income sector default probability	2

Toom is classified as 'retail' by Fixed Income sector classification. Our Fixed Income Research Analysts calculate the sector default probability by using the credit spread of major high yield retail issuers in Europe. The sector default probability for the retail sector is 3.6% as at the end of May. Our score of 2 is based on the default probability relative to other sectors and reflects capital market views on this industry against a bigger backdrop that includes, but not just limited to, the COVID-19 crisis. This ensure that we have a balanced view that is not too heavily biased just to the current situation.

Fidelity Pulse Survey	5

This score is based on the results of the Fidelity Pulse Survey which is currently sent out on a monthly basis to all Fidelity equity analysts and a select group of credit analysts asking them a series of questions on their outlook for the sectors they cover. In May's survey, respondents anticipated FY 2020 earnings for the consumer discretionary sector could be cut by 54% if the COVID-19 crisis turns out to be a full year issue. 50% of respondents said leading indicators in the sector were negative and 35% said positive. Relative to responses for the other sectors, consumer discretionary is deemed to have one of the more negative outlooks.

Equity market leverage ratios	3

We look at the leverage ratios across sectors and countries for all active equities listed on Thomson Reuters. The leverage ratios considered are free cashflow yield, current ratio and interest coverage ratio. The score of 3 is determined by comparing the leverage ratios of the German Consumer Discretionary sector relative to the leverage ratios for the rest of the sectors across countries we have exposure to within the portfolio. The free cashflow yield for the German Consumer discretionary sector is 3.5%, the current ratio is 1.2 and the interest coverage ratio is 14.4 as at the end of May 2020.

Taking an average of these 4 scores gives you the overall sector rating score of 4.

Portfolio Manager (PM) expectations

Based on discussions with Toom, our knowledge of the German market, and the fact that DIY stores have been allowed to remain open throughout the crisis in Germany, we expect that 100% of the rent will continue to be collected from Toom.

Conclusion

Incorporating forward looking information and data from Fidelity's equity and fixed income analysts into our quantitative model of tenant income risk provides valuable additional insight that builds upon the more backward-looking D&B tenant risk data that we have typically used to assess tenant risk. Although the FIRS score distils a number of drivers into a single score, the ability to analyse the individual elements of the score provides a deeper dive into understanding tenant and sector risk and provides a platform for sense checking the more qualitative data collected on the tenant. It also helps portfolio managers gain a deeper understanding of the risks in the individual businesses as they negotiate with tenants on rent deferrals, rent holidays or changes to their leases.

While this was developed as a tool to support decision making and income projections in a time of crisis, it will a useful addition to the quantitative tools we utilise in our investment process to help us navigate an increasingly disrupted market environment.

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RE2020079