European Long Income Property

Secure real asset-backed income for pension funds and insurers

Part of Alpha Real Capital's Cashflow Driven Investing series

Alpha Real Capital

A combination of low European government and corporate bond yields and an uncertain macroeconomic environment have led institutional and other real money investors to seek alternative sources of long-dated secure income to meet their liabilities.

With expectations for European real and nominal yields to remain low (see chart 1) and the uncertain macroeconomic environment set to continue, European Long Income Property offers investors the opportunity for a significant yield pick-up over government and corporate bonds with comparable credit quality.

We define Long Income Property as real estate let on long leases where the covenant strength and/or property/income over-collateralisation offer defensive value characteristics for investors. The long-dated contractual inflation-linked income provides returns that are primarily driven by income rather than capital. The returns are expected to be less volatile through market cycles than those of traditional real estate, whilst providing an inflation hedge for both the income received and capital values over time. Further, Long Income Property valuations are less sensitive to interest rate fluctuations than more liquid secure income alternatives and so potentially more defensive against rising rates. Sector and geographic diversification can help insulate investors against macroeconomic and asset specific real estate risks.

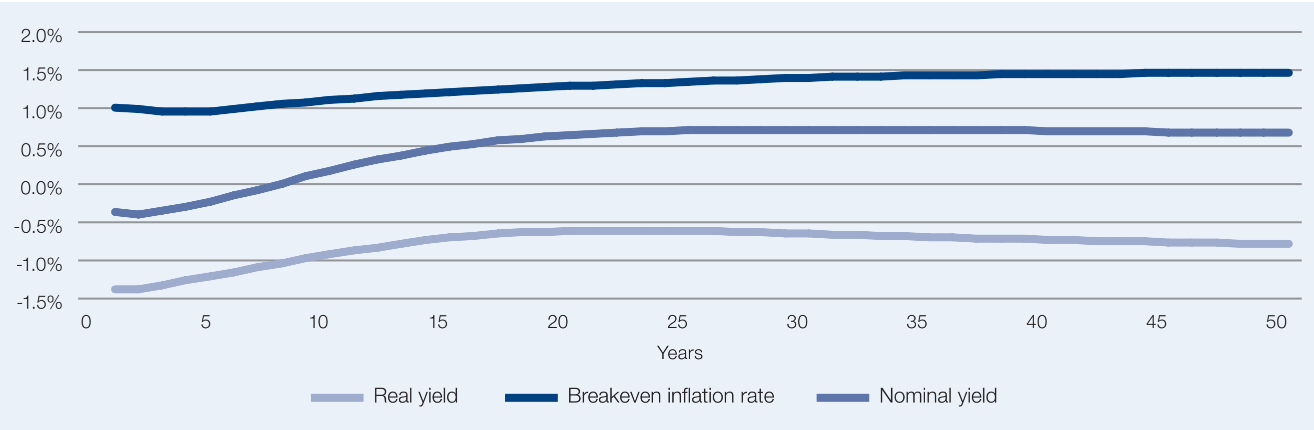
The Eurozone has a large pool of freehold, owner-operated (over 69%)[1], high quality, income generating assets that are well-suited to Long Income Property. This fact, coupled with owner occupiers' increasing acceptance of selling the freehold to release capital tied up in real estate, as part of an efficient capital structure, helps provide a large supply of investment opportunities. Following on from a successful track record with Long Income Property in the UK, Alpha believes that the preference of acquirers and asset owners is for a solutions provider, rather than a product taker, who will work in a proactive, consultative way to structure transactions that meet their current funding needs and also facilitate long-term rent sustainability.

Key points

- Institutional and other real money investors should consider investing in European Long Income Property to achieve an attractive risk-adjusted yield pick-up over low yielding European government and corporate bonds to help meet their liabilities
- Long Income Property, which is real estate let on long leases, generates low volatility, secure, inflation-linked contractual income-based returns, that are less sensitive to rising rates than liquid alternatives
- Acquirers and asset owners of European real estate are increasingly accepting Long Income Property as a way to release capital, benefiting from a permanent covenant-lite source of finance that reduces refinancing risk and can lower their weighted average cost of capital
- To invest successfully, Alpha believes it is crucial to understand what investors are trying to achieve and proactively originate opportunities to meet their requirements as well as the long-term needs of asset owners
- The investment focus and choice of structure should be driven by the relationship between income security, covenant risk and asset quality whilst also considering the impact on Environmental Social Governance ("ESG")

This report looks at what Long Income Property is, why it is an attractive investment, how it can be assessed, and what is required to invest in European Long Income Property successfully. The paper also provides a snapshot of the implications of IFRS 16 and why the benefits of lease financing still remain after its implementation.

Chart 1: Low yield environment - European nominal, real yields and breakeven inflation[2]



1 Private Debt Investor, May 2019 2 Barclays capital – swap rates, EURHICP, 30 June 2019

What is Long Income Property?

Long Income Property is real estate, let on long-dated, typically inflation-linked leases for between 15-200 years, (depending on the structure). Unlike traditional shorter-dated leases, the contractual income stream forms the largest component of the expected return, rather than capital values (see chart 2 which shows that the longer the lease term of the structure, the greater the source of expected return is from income rather than capital). The leases are typically fully repairing and insuring, with all property costs and insurance being the responsibility of the leaseholder.

Long Income Property comes in a number of different structures including: ground rent, income strip (amortising) and other long lease property (for example sale and leasebacks). Table 1 sets out some of the key differences between the structures.

The choice of a suitable structure is driven by the covenant risk and asset fundamentals. Tenants with strong credit profiles can unlock the full market value of the underlying property in long lease property and income strip transactions, whereas tenants with weaker credit profiles can take advantage of their property collateral to credit-enhance their position in ground rent transactions. It is also possible to create hybrid structures in between the three structures mentioned by varying, for example the yield, Loan-to-Value ("LTV"), term, and/or amortisation profile.

Chart 2: Present value of expected future cashflows

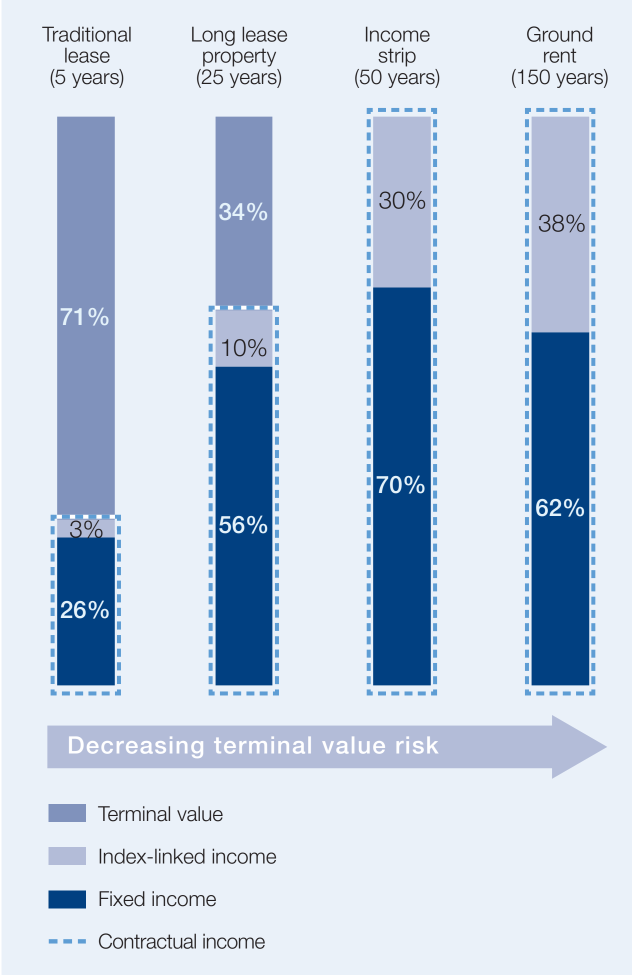


Table 1: Example Long Income Property structures

	Ground rent	Income strip	Long lease property
Typical lease length	+70 years	25-70 years	15-35 years
Gross initial yield	2.50-3.50%	3.00-6.00%	3.50-7.00%
Amortisation	0 or 100%	100%	0%
Typical effective LTV [1]	30%-40%	80%-100%	100%
Lease rent	Below market rent	At or below market rent	Market rent
Rent review	Typically inflation-linked, Annual to 6 yearly or threshold-linked		

1 LTV is the capital raised against the unencumbered freehold value

Benefits of lease financing for asset owners and acquirers

- Capital structure optimisation - release additional capital to reinvest back into their core business, at a lower weighted average cost of capital than traditional financing
- Reduces refinancing risk in contrast to bullet bonds or bank loans
- Bespoke structuring facilitates financing in smaller lot sizes
- Raise finance through an alternative source to traditional bank financing and without entering negative/restrictive covenants
- Removes real estate valuation risk from operating business

Case study – Alpha completes ground rent transaction on €1.2 billion hotel portfolio

In March 2019, Alpha completed a ground rent transaction over three central London hotels on behalf of the Index Linked Income Fund ("ILIF"), a UK focused commercial ground rent fund which invests on behalf of institutional investors.

The transaction was part of the circa €1.2 billion purchase of the hotels by Queensgate Investments LLP ("Queensgate"), the owner of Generator Hostels and the Kensington Forum hotel. Queensgate leased the hotels to Fattal Hotel Group, a leading international hotel group that operates around 200 hotels in 17 countries, under the Jurys Inn and Leonardo brands. The hotels will receive significant new investment by Fattal with the St Pauls and City hotels rebranded to the Leonardo Royal luxury brand. The Holborn hotel will become Fattal's first Nyx Hotel property in the UK.

ILIF's investors will benefit from long-dated, inflation-linked cashflows with a yield pick-up over conventional bonds, secured by a portfolio of high-quality assets. The location and quality of the properties will support the long-term income generating capabilities and value of the Fund.

The transaction demonstrates Alpha's ability to work very closely with real estate owners and operators to deliver flexible long-term capital solutions. The new investment takes ILIF's total assets past €1.6 billion across more than 500 properties.

Data as at 31 March 2019

Chart 3: Expected cashflow and LTV over time

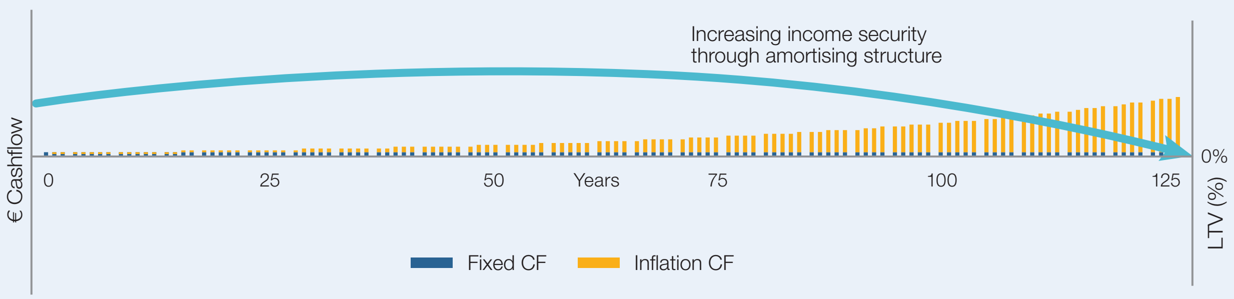
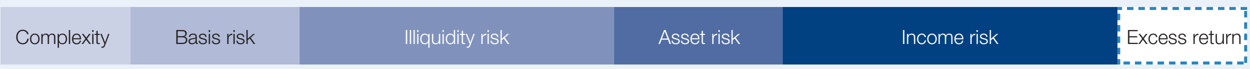


Chart 4: Return relative to 5 year index-linked gilt

As part of the assessment process, Alpha used the framework set out on page 6, to assess if the expected return compensated investors for the risks being run. The transaction benefited from an expected excess return.



Where does Long Income Property sit within pension fund and insurers' investment strategy?

Increasingly investors are building on the traditional Liability Driven Investing ("LDI") approach of splitting a portfolio between liability hedging and return seeking assets by adding a third class of assets which are specifically focused on generating secure, long lasting income. Long Income Property sits within investors' secure income portfolio, which combines shorter dated liquid credit investments with longer dated illiquid exposures. This approach can help to meet the cashflow requirements of institutional and other real money investors whilst also providing a yield pick-up over government bonds.

Required return		LDI		Secure income		Asset growth
Liabilities + x% return[1]	=	Assets to hedge liabilities	+	Assets to generate predictable cashflows	+	Risky assets to generate capital return
		Includes government bonds and swaps		Includes liquid credit, infrastructure, real estate debt, Long Income Property		Includes equity, private equity, hedge funds and traditional real estate

1 % return is the return required from secure income and assets growth assets to meet liabilities

Why invest in European Long Income Property?

Attractive risk-adjusted return – potential to deliver a significant net yield pick-up over government and corporate bonds (with comparable credit quality) and an attractive risk-adjusted return (see table 2).

Income security – the investor (freeholder) typically has first ranking title in the event of tenant default, which is underpinned by the property value and/or income over-collateralisation and/or the credit quality of the tenant. Further, the contractual cashflows have lower letting risk compared with traditional real estate on shorter leases, meaning cashflows are more predictable and secure over the long run.

Inflation protection – the majority of Long Income Property targeted by Alpha have rent reviews that are linked to inflation, providing inflation protection to the rental income received and also to the underlying freehold capital value. The inclusion of a rent review floor or catchup provisions (e.g. no negative rent reviews) in a lease can help protect performance in a low or negative inflation environment. Conversely, the inclusion of a cap can reduce the ability to track inflation in highly inflationary environments. The cap does however act as an important feature to enhance the credit and long-term sustainability of an investment by preventing the rent from increasing higher than the earnings of the underlying operating business.

Duration – institutional and other real money investors with long-dated liabilities, can use the long-dated inflation-linked cashflow streams to match their liabilities. Further, in the long-run, Long Income Property yields tend to trend in line with changes in government bond yields, providing a natural interest rate hedge.

Low volatility – the inflation-linked income stream and defensive nature of the asset, typically results in lower expected volatility (from an income and capital perspective) through market cycles, compared to traditional real estate. At a time of macroeconomic uncertainty, returns driven by income rather than capital value growth, offers an attractive, lower-risk alternative option for investors.

Portfolio diversification – investors gain access to different return drivers versus liquid and traditional real estate assets, helping to enhance investors portfolio diversification and provide a lower range of expected outcomes. Sufficient diversification is possible with opportunities across alternative and core real estate sectors and geographies.

Large pool of freehold properties – the Eurozone has a large pool of freehold, owner-operated (over 69%)[2], high quality, income generating assets that are well-suited to Long Income Property. This, coupled with owner occupiers' increasing acceptance of Long Income Property as a way to release capital tied up in real estate as part of an efficient capital structure, helps provide a large supply of investment opportunities.

2 Private Debt Investor, May 2019

Table 2: Long Income Property vs other secure income investments

Typical features	Ground rents	Income strips	Long lease property	European Single A corporates[2]	European BBB corporates[2]	Private infra debt BBB[4]	CMBS BBB[3]	Direct lending (senior corporate loans)[5]
Gross IRR	4.50%	5.00%	6.00%	0.70%	0.90%	2.10%	2.20%	5.50%
Spread over European nominal yield[1]	3.85%	4.35%	5.35%	0.75%	0.95%	1.50%	2.50%	5.40%
Maturity (years)	70+	25-70	15-35	7	7	10-30	3-5	6-8
Return drivers	Illiquidity, inflation, credit	Illiquidity, inflation, credit	Illiquidity, inflation, credit	Credit, interest rates	Credit, interest rates	Illiquidity, inflation (if applicable), credit, interest rates	Credit	Illiquidity, credit
Asset liquidity (days)	180	180	90	1	1	90	1	90
Inflation linkage	Yes	Yes	Yes	No	No	Either	No	No
Interest rate hedge	Long run only	Long run only	Long run only	Yes	Yes	Yes	No	No
Risk level	Very low - low	Very low - moderate	Low - moderate	Low	Moderate	Moderate	Moderate	Moderate +

1 Barcap – Spread over nearest maturity Euro swap rate Q2 2019 , 2 S&P Eurozone index Q2 2019, 3 AFME Securitisation Data Report – Q1 2019, 4 Schroders Infrastructure Financing - an overview, 5 Deloitte - Expanding into new markets

Asset risk assessment – yield decomposition

In assessing Long Income Property opportunities, the expected return should reflect the yield demanded for running various risks. Alpha uses the framework below to help assess if the expected return from an investment opportunity is compensating investors for the risks being run:

Illiquidity risk – the risk of holding an asset that cannot quickly be converted into cash at fair market value. This is a reward for investing for the longer-term. Institutional and other real money investors should be comfortable holding a part of their allocation to illiquid assets as long as there is still enough liquidity to meet their required payments through economic cycles.

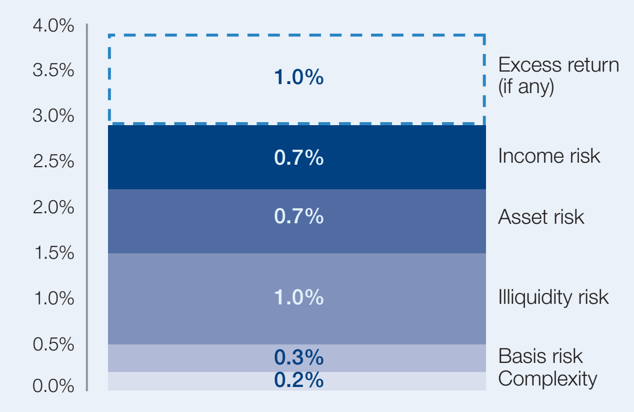
Income risk – the security of rental income (covenant/credit risk) is the sustainability of a tenant's business model and the ability to replace or recover lost income in the event of default. Long Income Property targets assets with a high degree of income security based on the quality of the covenant and/or property collateral.

Asset risk – captures the volatility and risk of obsolescence over time as well as the uncertainty of the exit/terminal value. The longer the contracted cashflows the less significant the terminal value risk (see chart 2) as the income received dominates the total return. Income strips and amortising ground rents remove terminal value risk by having fully amortising structures.

Complexity risk – the risk assumed as a result of the additional upfront and ongoing complexity of investing in Long Income Property.

Basis risk – measures interest and inflation risk, and the risk that the value of the asset does not move in line with bond or swap-based liabilities. Long Income Property investments carry varying degrees of basis risk. The correlation of rent review profiles to local inflation and the sensitivity of valuation changes to local risk free interest rates needs to be assessed.

Chart 5: Assessing Long Income Property – example spread over government bonds



How should a manager best approach investment into Long Income Property?

Finding high quality off the shelf yielding assets is a challenge in the current low-yield environment. To invest successfully, Alpha believes the following are required:

1. Understand the needs of investors

A subtle but important point is understanding what investors are actually trying to achieve and structuring investments to meet their requirements, rather than sourcing "off the shelf" investments and subsequently trying to make them fit investor needs. Experience shows that this approach results in a better risk-adjusted return for investors.

2. Proactive origination

The most effective way to access opportunities is to source investments directly by working collaboratively with owners, acquirers and advisors of real estate, and to establish long term sustainable structures. Proactive origination is centred around an understanding of:

- Markets that have a suitable legal framework and that are likely sources of suitable transactions
- Owner occupier/acquirer drivers – (see page 4)
- Market drivers for transactions (e.g. M&A, refinancing & expansion)
- Flexibility – creating structures that meet owner occupier/acquirer needs and facilitates long term sustainability

3. Security of income

Originating assets directly this way requires experience in credit and real estate research and analysis and deal structuring. Alpha approaches each opportunity from a fixed income rather than an equity mind-set, undertaking a detailed look-through analysis into the security of the underlying cashflows with a specific focus on downside protection and consistent performance. It is important to focus on the relationship between income security, covenant risk and asset quality, assessing the sustainability of a tenant's business model and the ability to replace lost income in the event of default.

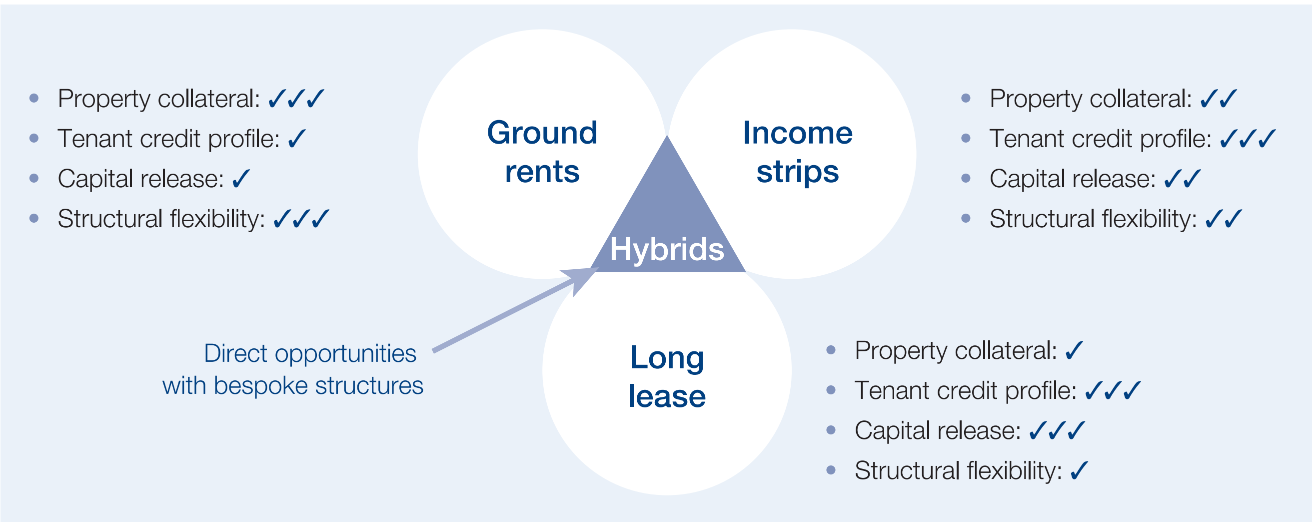
4. Environmental, social and governance ("ESG") considerations as part of the investment process

Given the long-dated nature of the assets, a successful strategy needs to be cognisant of the fact that the way in which buildings are designed, built, managed and occupied, significantly influences their impact on the environment and affected communities.

Through the implementation of socially responsible policies, sustainability related risks, for example: climate change, site contamination, use of hazardous materials and local community impact, can be successfully managed.

It should be noted that, in Long Income Property, the day-to-day operation of the assets are under the control of the operator (leaseholder) and engagement with the freeholder is periodic in nature with the level of influence afforded to the freeholder related to preserving collateral.

Chart 6: Selecting the appropriate structure to facilitate long-term sustainability:



A summary of the new accounting standard for leases – IFRS 16

After nearly 10 years of consideration, the International Accounting Standards Board (“IASB”) issued IFRS 16 in 2016, effective from the start of 2019. This accounting policy change treats all leases consistently, with operating lease liabilities brought on balance sheet (along with a corresponding asset representing the rights of use for the leased property), which will result in optical changes to lessees’ financial statements[1]:

Impact on the Income Statement	Impact on the Balance Sheet	Impact on the Cash Flow Statement
▲ EBITDA	▲ Lease assets	▲ Cash from operating activities
▲ Operating profit and finance costs	▲ Finance liabilities	▼ Cash from financing activities
◀▶ Profit before tax	◀▶ Equity	◀▶ Total cash flow

- Operating rent previously expensed, will now be added back, increasing EBITDA which will effectively become EBITDAR
- The rental expense will now be split into interest and depreciation affecting the income and cashflow statements
- Profit before tax is expected to decrease in early years due to the front-loading effect of interest recognition. As the lease term approaches maturity, profit will be higher than the equivalent operating lease accounting

However, because credit analysts have adjusted for leases in their metrics historically, the accounting change will have a limited impact on the perception of credit risk, e.g. Moody’s[2] early studies indicate no impact on credit ratios for 73% of ratings reviews under IFRS 16 compared to IAS 17 operating lease-adjusted analysis. Removing analyst assumptions relating to lease adjustments is arguably a positive consequence of IFRS 16.

Benefits of lease financing remain:

Companies can still transfer real estate risk to investors in this way. It is a covenant-lite source of financing that reduces refinancing risk and can lower the weighted average cost of capital.

Interest in income strips will rise:

With the accounting playing field levelled across income strips and other forms of long leases, we believe there will a pick-up in demand for amortising leases and commercial ground rents from owner operators.

1 PwC: A study on the impact of lease capitalisation, IFRS 16 the new leases standard
2 Moody’s: Few surprises from early adopters of IFRS 16 Leases; 2018 accounts should reveal more

Conclusions

Since the Global Financial Crisis, the decline in government and corporate bond yields in Europe has left institutional and other real money investors seeking alternative, secure income generating assets in order to help meet their liabilities.

Alpha believe European Long Income Property, including ground rents, income strips and other long lease property, can specifically meet these income requirements by providing an attractive risk-adjusted return whilst complementing the existing matching and growth assets held.

With Europe's large pool of owner-occupied income generating assets and increasing acceptance of Long Income Property as an efficient source of capital, now is an opportune time for investors to consider this emerging asset class.

Alpha Real Capital - at a glance

Alpha Real Capital is a specialist investment management group focused on income security from real assets. We invest in asset-backed income from real estate, infrastructure, and lending, with an emphasis on long income and inflation protection. Founded in 2005, Alpha is owned by its partners and has over €3.6 billion of assets under management, including commitments.

Alpha's European Long Income Fund ("ELIF"), focuses on asset backed, secure inflation-linked income streams through commercial ground rents, long lease property (e.g. sale and leasebacks) and income strip structures. Target sectors include alternatives, healthcare and core real estate.

ELIF – sector diversification with opportunities across alternative and core real estate markets

Alternatives

- Hotels & Hospitality
- Holiday parks
- Leisure
- Automotive
- Student accommodation
- Data centres
- Education

Healthcare

- Care homes
- Supported living
- Assisted living
- Medical facilities

Core real estate

- Distribution/Logistics
- Business parks
- Office
- Industrial
- Selective retail (including supermarkets and retail warehouses)

Alpha – long income assets

Ground rents

- Income and capital over-collateralised
- Completed over €900 million of M&A driven transactions
- Supported the refinancing of over 300 properties
- AUM c. €2,220 million

Long leases

- Broad sector exposure across alternatives and core real estate
- Majority of income inflation-linked
- AUM c. €600 million

Social real estate

- Provision of social accommodation and infrastructure
- Typically, long-dated leases supported by direct and indirect public sector support
- Provides a positive social impact
- AUM c. €120 million

AUM (including committed capital) as at 31 March 2019

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