IFRS 16

End of the road for long-lease property or an opportunity for investors and operators?

Part of Alpha Real Capital's Cashflow Driven Investing series

Alpha Real Capital

Key takeaways

The introduction of IFRS16 has levelled the accounting playing field across the different long lease structures. We anticipate this will lead to an increase in demand from investors and operators for those which were previously subject to less favourable treatment, such as income strips and commercial ground rents.

What is changing?

After nearly 10 years of anticipation, the IASB issued IFRS 16 in 2016, effective from the start of this year. This accounting policy change will treat all leases consistently and result in optical changes to lessees' financial statements.

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 compared to traditional financing.

What is changing?

On 13th January 2016, the International Accounting Standards Board (IASB) issued IFRS 16, a new accounting standard which supersedes IAS 17. IFRS 16 is mandatory for periods starting on, or after, 1 January 2019. IFRS 16 will lead to a rise in reported debt (vs. IAS 17) as operating lease liabilities will be brought on balance sheet (along with a corresponding asset representing the rights of use for the leased property).

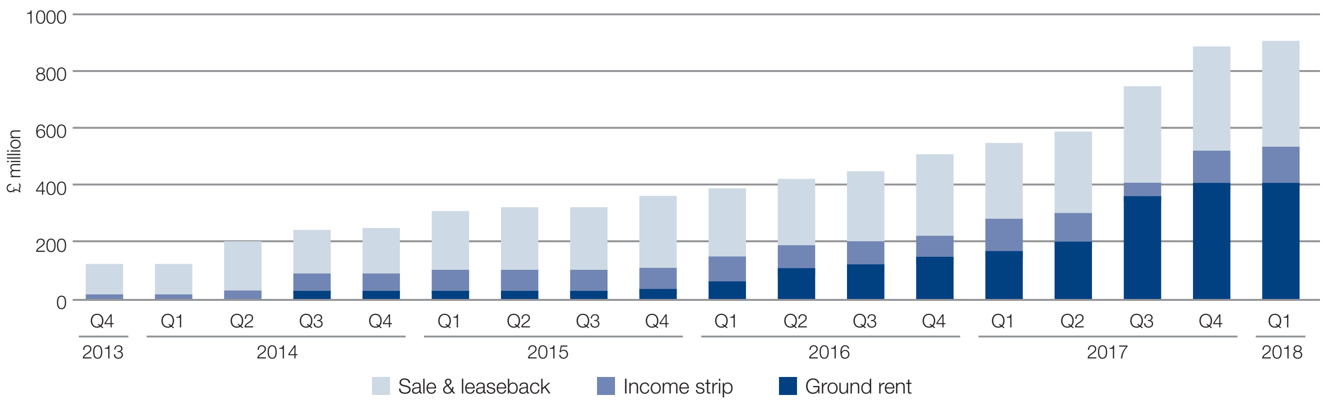
Expected impact

Alpha Real Capital believes the introduction of IFRS 16 Leases will not materially impact the supply of long lease property, albeit we do expect a positive shift in balance towards other long lease structures such as commercial ground rents and income strips, as the changes are already incorporated in investment and property management decisions. Importantly, neither business fundamentals nor cash flow generation capacity change as a result of this accounting change.

Demand for secured income remains robust (see chart 1), as it continues to provide a significant yield pick-up over risk free assets. Investor desire to achieve a high proportion of returns from income rather than capital makes long income property particularly attractive for institutional investors.

Chart 1: Strong demand for secure long income

Long income sector index[1]



1 CBRE: Long income study

"Estimated $3.3 trillion of operating lease liabilities outstanding", according to IASB

Although IFRS 16 will lead to a material increase in reported debt compared to IAS 17, it will also increase reported assets and operating earnings. Industry reports, such as PwC's global lease capitalisation study[2], suggest the accounting change will nearly double reported debt for retailers – a lease-heavy sector, whilst EBITDA will rise (PwC: +41% median expectation for retailers) as operating rent can be added back.

Key changes to the primary financial statements on adoption of IFRS 16

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[3] early studies indicate no impact on credit ratios for 73% of ratings reviews under IFRS 16 compared to IAS 17 operating lease-adjusted analysis. Nonetheless, removing the need for analyst assumptions relating to lease adjustments is arguably a positive consequence of IFRS 16.

A level playing field in accounting treatment for amortising leases is expected to increase supply of income strip leases

Benefits of lease financing remain

- Capital structure optimisation allows companies to release more capital to reinvest back into their core business, at a lower weighted average cost of capital
- Reduces refinancing risk in contrast to bullet bonds or bank loans
- Bespoke structuring allows companies to raise financing in smaller lot sizes
- Allows companies to raise finance through an alternative source to traditional bank financing and without entering negative/restrictive covenants
- Removes real estate risk from the operating business, and transfers it to investors

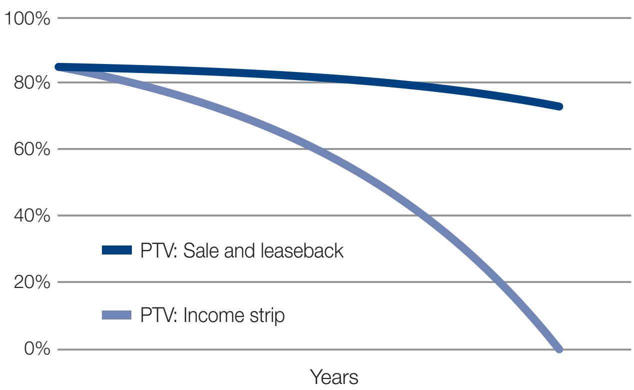
2 PwC: A study on the impact of lease capitalisation, IFRS 16 the new leases standard
3 Moody's: Few surprises from early adopters of IFRS 16 Leases; 2018 accounts should reveal more

Income strips: beneficial to owners and investors

Amortising leases, also known as income strips, were mostly on-balance sheet as finance leases under IAS 17. Alpha Real Capital believes the implementation of IFRS 16 removes the primary disincentive (compared to other long lease structures such as traditional sale and leasebacks) for companies to consider amortising leases as part of their capital structure. Income strips (and most ground rents) enable operators to retain full ownership of the property on expiry of the lease. The amortising nature of an income strip and the very long lease terms of commercial ground rents also remove the refinance risk faced with bonds and bank financing or the need for a re-gear at the end of the term as is the case with reversionary sale and leaseback leases.

Institutional investors, with a need for cash flows, are typically attracted to income strips and commercial ground rents by their secure, long-dated, inflation-linked, amortising profiles and expected yield pick-up over risk free rates. Returns are achieved from index-linked cash flows, with strong covenants, and gradually reducing price-to-value over the term (see chart 2). As the lease term approaches maturity, owners' propensity to default diminishes significantly given the full ownership of the property is achieved at lease expiry.

Chart 2: Reducing price-to-value (PTV) in income



> "Investors benefit from the inflation protection, defensive nature of the asset class, and risk reduction over the term. This can create a beneficial situation for investors and property owners alike."

However, a key challenge in developing these investment opportunities is the origination and structuring of leases with bespoke requirements. At Alpha Real Capital, we benefit from our relationships with private equity sponsors and direct owners/operators to originate deal flow. Alpha's Index Linked Income Fund (ILIF) has deployed c. £1.4 billion of capital (as at 31 March 2019) into long income deals since 2015, with the majority of investment originated and structured by Alpha Real Capital.

Structuring such leases also requires close collaboration with property owners and careful consideration of their needs and requirements. With our extensive expertise in pricing and structuring transactions with varying lease terms, loan to values, rent review flexibility, and small or large transaction sizes, Alpha Real is ideally positioned to identify and create optimal structure/s that reflect the needs of all parties involved. Indeed, our ability to balance the risk adjusted returns sought by our investors with the creation of sustainable lease rents for property owners lies at the heart of our successful track record since our first long income fund launch over 3 years ago.

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 billion of assets under management, including commitments.

Ground rents

- Income and capital over-collateralised
- Completed over £750 million of M&A driven transactions
- Supported the refinancing of over 300 properties
- AUM c. £1,850 million

Long leases

- Broad sector exposure across alternatives and core real estate
- Majority of income inflation-linked
- AUM c. £500 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. £100 million

* AUM (including committed capital) as at 31 March 2019

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