Market monitor – Q1 2019

Alpha Real Capital

Summary

Inflation

- Annual UK CPI fell 0.2% to 1.9% over the quarter, continuing the downward trend since August 2018. The decline was supported by falling goods prices within the recreation and culture sector
- Annual UK RPI fell by 0.3% to 2.4% over the quarter. The fall was greater than CPI due to air fares, which have decreased, having a larger weight in RPI than CPI
- Despite the above, UK inflation expectations remained relatively flat over the quarter and across the curve (see RPI swap rate chart)

Bond yields

- Real Gilt yields have decreased over the short, medium and long term, reflecting a lower path of expected future cash rates, with shorter dated bonds having the largest decrease. The decline is largely driven by investors sentiment from the recent Brexit uncertainty
- Nominal Gilt yields also decreased across the curve, mainly driven by reduced real yields

Credit spreads

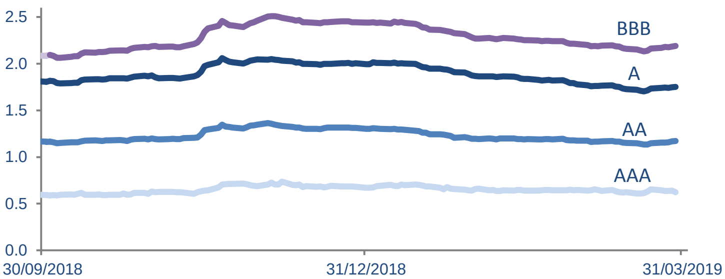
- Investment grade credit spreads narrowed across the board, a reversal of the widening in the previous quarter where higher-quality corporate bonds generally outperformed their lower-quality counterparts

Macro picture

UK GDP (y/y)	1.4%	**UK RPI (y/y)**	2.4%
UK BOE base rate	0.75%	**UK CPI (y/y)**	1.9%
March 2024 real gilt yield	-2.5%	**March 2040 real gilt yield**	-1.9%

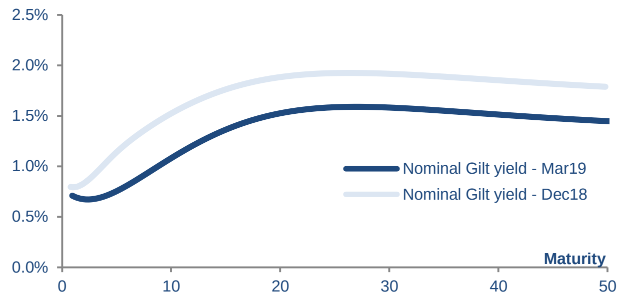
Sources: ONS, Barcap, Reuters, FT.com, 31 March 2019 or latest published figures

UK credit spreads



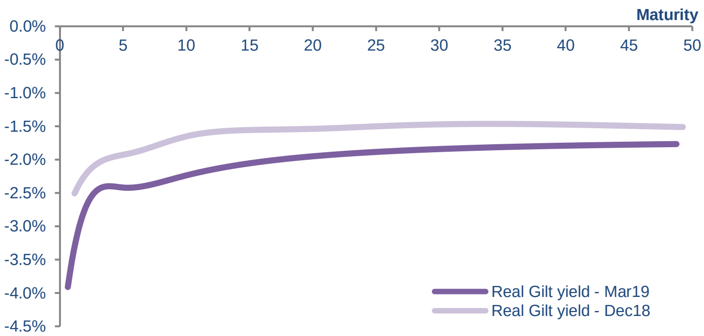
Source: Thompson Reuters, IBOXX non-financials +15 year indices – 31 March 2019

Nominal Gilt yield forward curve



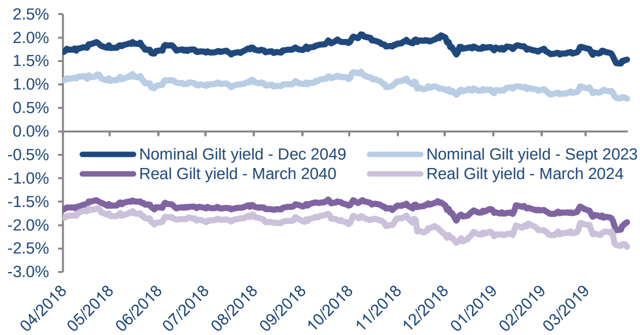
Source: Barcap – 31 December 2018 and 31 March 2019

Real Gilt yield forward curve



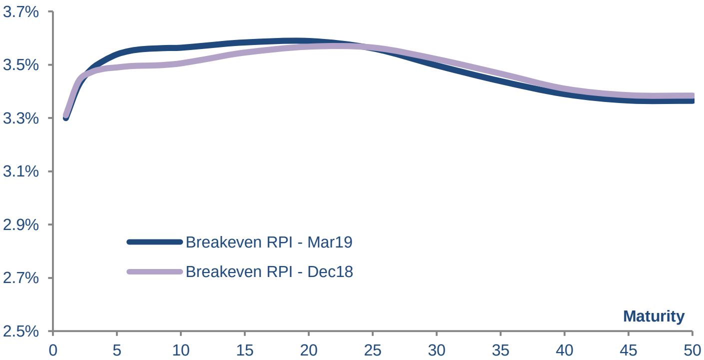
Source: Barcap – 31 December 2018 and 31 March 2019

Historical nominal and real yields



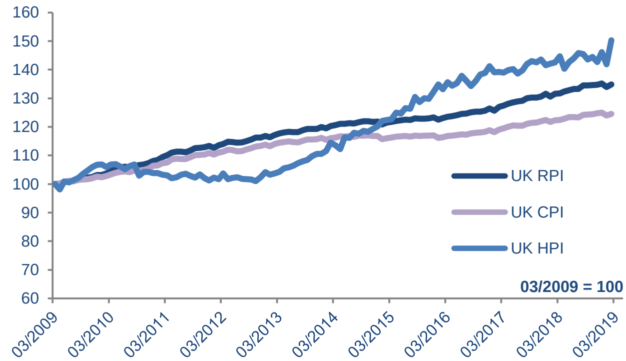
Source: Barcap – 31 March 2019

RPI swap rate



Source: Barcap – 31 December 2018 and 31 March 2019

RPI, CPI and HPI historical returns



Source: Thomson Reuters, ONS – 31 March 2019

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 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, 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.

'Level playing field in accounting treatment for amortising leases could increase supply of income strip leases and commercial ground rents'

Benefits of lease financing remain

- Capital structure optimisation allows companies to release higher capital to reinvest back into 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 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 operating business, transfer of real estate risk to investors

Income Strips: beneficial to owners and investors

Amortising leases, also known as income strips, were 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 also removes 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.

"Investors benefit from the inflation protection and defensive nature of the asset class and risk reduction over the term which 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 bespoke 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 (31 March 2019) into long income deals since 2015.

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 term, loan to values, rent review flexibility, and small or large transaction sizes, Alpha is ideally positioned to identify and create optimal structures 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.

Contact

For the full publication please visit: www.alternativerealcapital.com/media/

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