Commercial ground rents as a compelling fixed income alternative

With bond yields at all-time lows, where else can investors turn for contractual cashflows?

Part of Alpha Real Capital's Cashflow Driven Investing series

Alpha Real Capital

We believe that long-dated ground leases on commercial property, also known as commercial ground rents, should be considered a bond-like asset class but possess many characteristics superior to traditional fixed income instruments.

Executive summary

- Commercial ground rents can be seen as a fixed income instrument – with property collateral – rather than simply a real asset
- There are compelling reasons for liability-aware investors to consider an allocation to commercial ground rents, even as a potential substitute for part of a fixed income allocation
- We explore and compare some key attributes across both bonds and commercial ground rents:

Risk	Return
Volatility	Value
Illiquidity	Indexation

- Relative to bonds, we believe that commercial ground rents, when structured correctly, can offer enhanced returns without increasing risk, and can maximise downside protection
- Commercial ground rents may provide a better cashflow match against long-dated, inflation linked liabilities

Compared to public and private fixed income alternatives, allocating to commercial ground rents:

- Improves downside protection through greater security cover
- Generates a meaningful risk-adjusted yield pick-up
- Represents an efficient use of illiquidity budget

What are commercial ground rents and why are they bond-like?

Commercial ground rents are long-dated (generally over 75 years) rents paid by a corporate tenant to a freeholder for the use of a property asset. All costs associated with the property and its day-to-day management are typically the responsibility of the leaseholder. Rent reviews are usually tied to inflation, providing inflation protection to both income and underlying freehold capital value.

Ground rent values are approximately 30-40% of underlying property values, and starting rents typically represent 8-15% of operating asset EBITDAR or a fraction of market rent. Security is achieved through most senior rights as the freeholder, as well as the significant over-collateralisation of the income and capital.

Unlike traditional property investing, ground rent investors are not exposed to commercial property market cycles in the same way – akin to taking debt rather than equity risk. Terminal value of the asset (at the end of the lease) is negligible or zero in present value terms, with the value of the ground rent instead representing the value of the future rental cashflows. By providing an expected long-dated secure income stream, the asset class demonstrates fixed income characteristics. In cases where the tenant is granted the option to buy the property back at maturity for a nominal sum, the ground rent can be thought of as a fully amortising index-linked secured bond.

Thus, given the contractual nature of the cashflows, it is more natural to view ground rents as closer to fixed income instruments than commercial property (which is why some asset managers categorise long lease property strategies in their fixed income range).

Commercial ground rents are often compared against commercial property or other forms of long lease property, but what about the more logical comparison against Investment Grade credit – the "default" asset class for liability-aware investors? Table A at the end of this paper illustrates the similarities and differences and highlights why commercial ground rents exposure can be complementary or used as a (partial) replacement to corporate fixed income.

Key investment characteristics

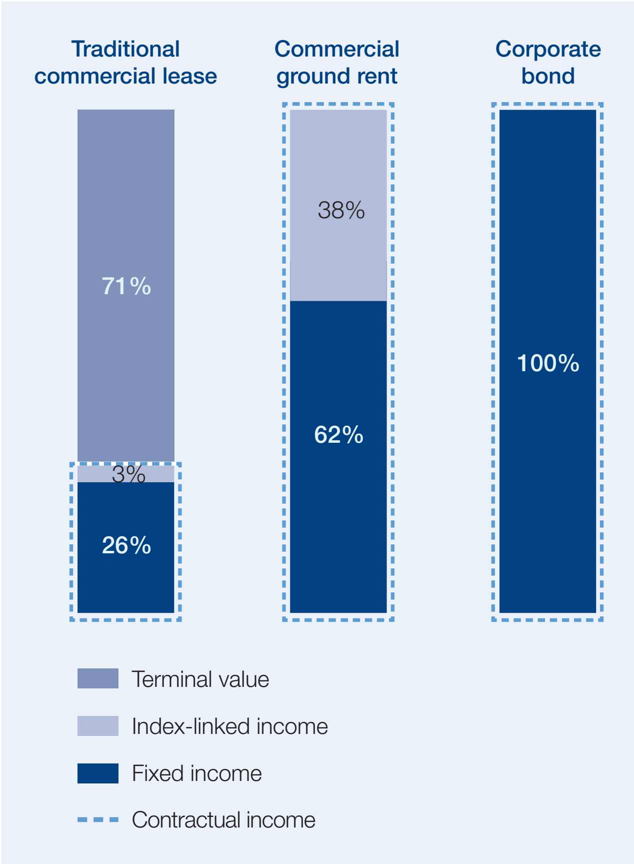
RISK

- Given the capped upside of fixed income investing and therefore the difficulty in making up credit losses, avoiding downside risk events is critical in bond investments and the same is true of commercial ground rents.
- There are no recorded commercial ground rent defaults. Should one occur, investors have the benefit of a freehold ownership (effectively first charge) over the property (ahead of any mortgage providers) and, given the collateralisation, expected recoveries would often be higher than for corporate bonds even in stressed value scenarios[1].
- Modelling the (probability of default and loss given default) risk profile internally, we believe ground rent transactions have an equivalent credit rating in the BBB to AA range, clustered in the single A category.
- Investors including pension funds who favour passive credit exposures, e.g. through buy and maintain allocations or index-tracking bond funds, should note that there has never been a riskier time to invest in Investment Grade credit indices: compared to previous cycles, the proportion of outstanding Investment Grade bonds with BBB ratings (the lowest Investment Grade rating) is high, having risen steadily over the last decade from less than a third to around half of the total US and European market today[2].
- Within an Investment Grade strategy, taking the decision to allocate away from (weakening) credit indices to commercial ground rents can also serve to diversify sector exposures as commercial ground rent transactions would often be exposed to operators or sub-sectors that are not represented meaningfully in the public debt markets (e.g. specialist healthcare). Additionally, it could be argued that bond indices' exposure to cyclical industries is becoming more pronounced. For instance, BBB-rated unsecured industrials now account for approximately 15% of these credit indices (a 10x increase over the last 20 years).
- Unlike corporate bonds, there is also no refinancing risk associated with long-dated, amortising commercial ground rents.

RETURN

- As shown in the returns decomposition graphic (Chart A), return drivers for commercial ground rents are materially different compared to traditional commercial property leases, showing far more similarly to corporate bonds. In most cases, all the cashflows are contractual (no residual property value risk), unlike traditional commercial leases where over 70% of total expected returns are attributable to reversionary or terminal value. By comparison, long lease transactions (sale & leasebacks) also possess significant (30-40%) terminal value risk.
- Income generated from commercial ground rents is around 2.5-3.5% p.a. but capital appreciation can also be expected as growing (inflation-linked) rents are capitalised, giving an expected IRR of 5-6%.

Chart A: Indicative return profiles



1 According to Moody's Annual Default Study (February 2019), long-term recovery rates (1983-2018) have averaged 64% for First Lien Bank Loans, 55% for Senior Secured Bonds, and 34% for Senior Unsecured Bonds.
2 Source: ICE BofAML Corporates indices. The BBB proportion is 35% (June 2019) for the Over 15 year Non-Gilt index – an index that is often employed in UK DB pension funds' corporate credit allocations.

- Whilst ground rent historical performance is not available for periods as long as bonds, CBRE have published annual total returns for commercial ground rents of over 10% for the period December 2013 to March 2019. Yield compression has been witnessed over this period, contributing to total performance.
- Unlike bonds, movements in interest rates do not affect the short-term valuation changes in ground rents but, over a long-time horizon, commercial ground rents would be expected to exhibit interest rate sensitivity, otherwise known as duration.
- Total expected returns expressed as a spread over the yield offered by long-dated Index-linked Gilts is typically in the 350-450 basis points (bps) range, and potentially higher given recent reductions in real Gilt yields. This is a significant spread pick-up over risk-free returns and, on a risk-adjusted basis, we believe it offers very good value.
- A like-for-like comparison to real asset-backed securitisations is less straightforward but CMBS tranches with 40% LTV are generally rated AAA and, therefore, offer a far tighter spread than equivalently collateralised ground rent transactions.
- Naturally, investors will seek to compare returns to similarly rated, long duration corporate bonds. The over 15 year Non-Gilts index, for instance, which at the end of June 2019 had a duration of 15 years and a weighted average A rating, has a yield of just 2.7% (140bps spread). Since the inception of the index (November 2000), it has returned an annualised total return of c.7%.

ILLIQUIDITY

- One obvious distinction between corporate bonds and private market asset types like commercial ground rents is the level of asset liquidity. Naturally, the yield offered by the latter adequately compensates for the relative illiquidity, the so-called illiquidity premium.
- Many pension fund investors are concerned about their overall liquidity, particularly relating to meeting near term liability payments and transfers, but in our view are too conservative in their approach to liquidity budgets. Instead of viewing illiquidity premia as the extra yield on offer from allocating to less liquid strategies, one could also view it as the opportunity cost of unnecessarily holding liquid bonds. Holding liquid credit effectively costs the scheme 1% every year compared to an illiquid substitute (that offers an illiquidity premium of 1%), such as commercial ground rents[3]. This should be considered alongside other scheme costs.
- It should be noted that the liquidity of corporate bonds is also less deep than years gone by as banks have shrunk their balance sheets. Transaction costs for even well-traded bonds are around 50bps.
- As would be expected, transaction costs for property assets are higher, factoring in stamp duty and other transactional expenses. However, units of funds can trade on the secondary market at levels that compensate the original investor for these entry costs.

INDEXATION

- A defining characteristic of commercial ground rents is the indexation of the rent to inflation (usually RPI), often on an annual basis. The contractual index-linked uplifts contribute about half of the expected lifetime rent cashflows.
- Beyond Gilts, the fixed income universe of index-linked bonds is relatively shallow, particularly for longer dated maturities in which pension funds are most interested, and present in a relatively limited number of sectors, such as utilities and housing associations. Given the demand / supply imbalance, the few issues that exist are consequently very keenly priced.
- Additionally, having the ability to create collared rent review structures in commercial ground rent transactions, e.g. upward-only RPI-linked reviews, with a cap of say 5%, provides an opportunity to match better the inflation linkage of pension liabilities.

VOLATILITY

- As mentioned above, ground rents demonstrate far less (short-term) interest rate sensitivity than bonds, one reason why volatility of returns is lower for commercial ground rents (over 2%[4]).
- More fundamentally, valuation changes in ground rents are cushioned by the significant levels of over-collateralisation present, giving them more resilience through the cycle. Over the global financial crisis, the peak-to-trough experience (June 2007 to June 2009) of the commercial property sector was a 44% fall in value (source: CBRE); applying a similar stress would take the effective LTV of a typical commercial ground rent from 40% to 71%. This might have only a negligible effect on expected loss for the transaction and only a modest valuation adjustment, certainly compared to full “equity risk” commercial property.

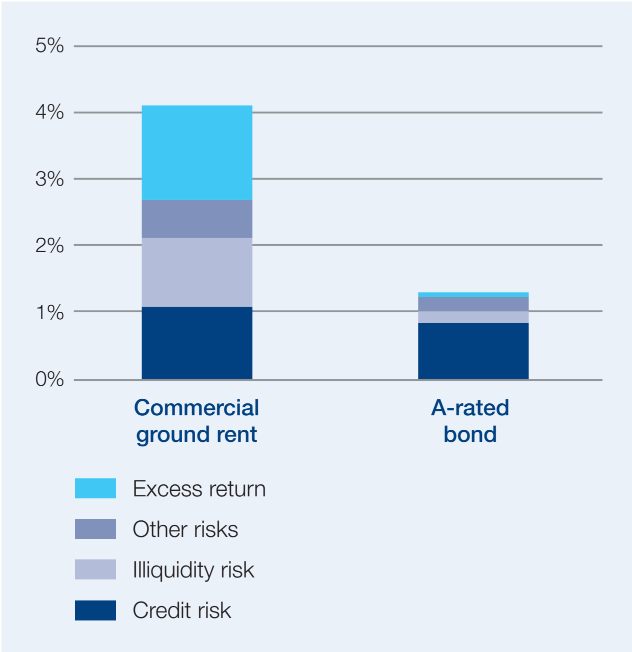
3 To illustrate: if we assume a 1% illiquidity premium for commercial ground rents (vs. corporate bonds) and take a mid-sized pension fund (£500 million) with a 50% fixed income allocation. Let’s consider the cost of keeping 10% of that allocation, or £25 million, liquid (instead of switching the exposure into commercial ground rents). The illiquidity premium available for that portion of the portfolio is £250,000 p.a. equivalent to the cost of one litre of bottled water every 10 seconds (day and night) – an appropriate image for the cost of this excessive liquidity.

4 Standard deviation of 12 month rolling returns December 2013 to March 2019, source: CBRE. Longer time series data (25+ years) are available for residential ground rent funds, which demonstrate very low levels of volatility.

VALUE

- Viewed through several lenses, we believe commercial ground rents offer superior value to bonds.
- Some fixed income investors like to analyse the Sharpe ratio, returns per unit of risk (as measured by volatility). Over the 5 years to the end of March 2019, whilst long-dated Index-linked Gilts[5] have shown an impressive performance (10.7% p.a.), the Sharpe ratio has been only 0.80x, compared to 6.11x[6] for commercial ground rents. The comparison is also flattering against corporate bonds: indeed, the highest rates, longest-dated corporate bonds have exhibited the lowest (even negative) Sharpe ratios (last 20 years) of any fixed income asset class.
- Commercial ground rents offer a considerable excess spread compared to traditional corporate bonds of a similar risk profile, as illustrated in this schematic spread decomposition (Chart B). According to CBRE, the spread pick-up for commercial ground rents over A-rated corporate bonds has ranged from 2.8% to 4.3% p.a. and is currently circa 3.4%.
- As mentioned previously, the asset class also offer good value in terms of entry cost recoverability: in the current market, investors could realistically assume they could sell their units in the secondary market for a premium over NAV to reflect the point that any investor acquiring the units would avoid needing to pay a dilution levy if they acquired existing units.
- Above and beyond the benefits of commercial ground rents over bonds, it should also be noted that extra "alpha" is achievable by partnering with an investment manager that can directly source and structure attractive, bespoke ground rent financings.

Chart B: Spread over Gilts (illustrative)



So is it a free lunch?

Investing successfully in commercial ground rents requires a breadth of investment management skills, spanning credit research, real estate expertise including an intimate understanding of operational real estate, deal structuring ability, asset management, and – importantly – an origination capability.

Originating, transacting and ongoing management of commercial ground rents are notoriously specialist skills which is why the asset class rewards investors with a healthy spread premium. Assuming the right manager is mandated, pension funds can reap the portfolio benefits of this kind of allocation as a fixed income alternative.

How we think about overall risk

In assessing the relative risk / attractiveness of opportunities, we consider all aspects of a transaction and its long-term risk profile. This assessment includes the underwriting of the tenant's credit risk, the sustainability of the sector and the real estate itself (including the evaluation of alternative use).

All of these factors are reflected in the scorecard we use to risk-rate a given transaction. Having an investment team with a broad background (across credit, operational real estate, and commercial property investing) helps us to make highly informed judgements on each long income property transaction.

5 FTSE Actuaries UK Index-Linked Over 5 years index
6 Source: CBRE

Table A: Comparing commercial ground rents against long-dated, Investment Grade credit

	Commercial Ground Rents	Corporate Bonds (Long-dated, Investment Grade)	Corporate Private Placements
Tenor and profile	• Typically >75 years • Typically fully amortising	• Up to 30 years generally • Bullet repayments	• Can be longer but not by much • Bullet or amortising profiles
Returns	• Distribution of 2.5-3.5% p.a. • Gross IRR 5-6% (Gilts+350-450bps)	• Gilts+50-200bps	• Small pick-up to corporate bonds
Volatility	• Low volatility: more akin to fixed income than commercial real estate	• Low volatility compared to growth / higher risk assets	• Similar to corporate bonds
Risk	• Equivalent to Investment Grade (probability of default) • Expected full recovery of capital on default	• Investment Grade • Partial recovery (35-70%) expected in Event of Default	• Investment Grade • Partial recovery (35-70%) expected in Event of Default
Sensitivity to interest rates	• Over the long-term, valuations would be expected to respond (negative correlation) to risk free rates	• Yes, duration more pronounced in the short-term	• Yes, similar to corporate bonds
Sensitivity to inflation	• Explicit inflation linkage, albeit with collars (e.g. RPI 0,5) usually applying • Inflation impacts running yield as well as capital returns	• Majority of universe nominal rather than index-linked	• Can be structured with indexation
Income and principal security	• Super-Senior ranking • Property security • Over-collateralised (rent cover c.10x, value cover c.3x)	• Pari passu with other Senior debt • Typically unsecured • Collateralisation (2.5-5x EV/debt) but relevant only for secured bonds	• As per corporate bonds
Recovery mechanism	• Vacant possession sale or via a new tenancy	• Enforcement through insolvency proceedings (whether secured or unsecured)	• As per corporate bonds
Covenants	• Significantly less onerous than packages for secured debt	• Generally “cov-lite”	• Potential for range of maintenance and incurrence covenants
Investment management costs	• Lower end of private asset management fees • All property costs responsibility of leaseholder	• Relatively low ongoing management costs	• Fees typically between liquid credit and private assets
Liquidity	• Illiquid; adequately compensated for in pricing	• Liquid	• Illiquid; often no illiquidity premium offered in pricing
Diversification	• Access different return drivers vs. liquid assets (and traditional commercial real estate) • Exposure to sectors under-represented in Fixed Income markets	• Exposure limited to bond issuers • Limited number of long-dated, index-linked securities	• Majority of exposure to public bond issuers
Scalability	• Can build a diversified portfolio at scale	• Strategy can accommodate scale	• Min lot size c.£50m • Difficult to achieve diversified scale

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.

Ground rents

- Income and capital over-collateralised
- Acquired over 500 commercial properties as part of corporate M&A / refinancing transactions
- AUM of over £1.9 billion

Long leases

- Broad sector exposure across alternatives and core real estate
- Majority of income inflation-linked
- AUM of c.£400 million

Social real estate

- Provision of social accommodation and infrastructure
- Typically, long-dated leases with direct or indirect public sector support
- Provides a positive social impact
- AUM of over £100 million

* AUM (including committed capital) as at 30 June 2019

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