Value drivers of long income property

A high-level overview

Part of Alpha Real Capital's Cashflow Driven Investing series

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Alpha Real Capital

Executive summary

Long income real estate is a fast-growing investment class for pension funds and other institutional investors such as insurers. It is increasingly recognised as a form of alternative credit; however, risk and return profiles vary between different types of long income property investment, with some sub sectors being much more comparable to bonds than others. Understanding the various value drivers is essential in order to structure investments and portfolios appropriately to optimise risk-adjusted returns. For example:

- Inflation collars adopted in rent reviews can make a material difference to returns, i.e. annual RPI (0,3) is expected to deliver growth 1% p.a. lower than uncapped RPI
- To understand long-term rent sustainability it is important to look beyond established property market metrics such as Estimated Rental Value ("ERV"), i.e. by analysing the fundamental long-term sector, business and property risks

The risk of failing to underwrite reversionary value ("RV") adequately is often an overlooked or under-estimated consideration, particularly when investors are focused on achieving a specific headline performance target. For example:

- For a typical reversionary long lease, IRR is twice as sensitive to property value growth than changes in inflation; indeed, a 1 percentage point change in annual property growth assumptions can impact IRR by >0.5% for a typical reversionary long lease

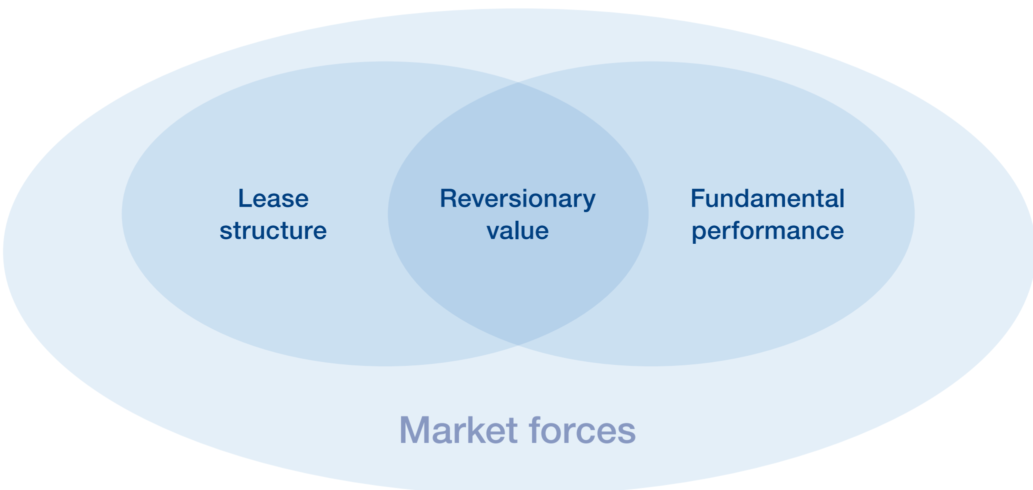
Long income property can complement the performance drivers of other Cashflow Driven Investing ("CDI") strategies.

Long income property is real estate, let on long-dated, typically inflation-linked leases for between 15-200 years. Long income property comes in several different structures including commercial ground rents, income strips (amortising) and other long lease property (for example sale and leasebacks).

Unlike traditional shorter dated commercial leases, the contractual income stream of long income property is a larger (or in some cases the sole) component of the expected return, compared to capital appreciation.

This paper seeks to identify the main value drivers of long income property, including:

- Fundamental drivers: tenant credit quality, rental cover (relative to the underlying net operating income of the asset), and the sector and property fundamentals;
- Lease terms: rent review frequency, cap and floor on the rent reviews, the reference index (e.g. RPI, CPI, fixed, or Open Market) and lease length;
- Reversionary value: exposure to re-letting or selling the property at the end of the lease.



Long income property – risk & return drivers

1 Fundamental performance drivers

As we have explained earlier and in a previous publication[1], long leases (especially fully amortising ones) can be thought of as an alternative form of fixed income instrument. Using bond parlance, we can assess fundamental risk in terms of probability of default ("PD") and loss given default ("LGD").

Rent affordability

When thinking about the PD of long income property, the issue of rent affordability is key. Setting the initial rent too high, or being exposed to unsustainable tenants / sectors, can undermine the stability of the cashflows (the prime attraction of this asset class).

In assessing rent affordability, investors often turn to the evolution of ERV as a guide to changes in underlying profitability; however, this overlooks the fact that ERV is simply the result of demand / supply pricing for space.

Not only should investors consider initial affordability, but due consideration should be given to industry drivers that may significantly change the rental cover over the duration of the lease (as has been seen in the retail sector over the last 10 years for example).

Value sustainability

For LGD, the primary drivers will be alternative use and prevailing market values (in turn driven by market rent and yield developments). For transactions where the full market value is not being released, the starting effective gearing and expectation of the sustainability of an appropriate collateral cushion over time must be considered, as they will heavily influence the LGD risk.

Due to the length of leases, it is very important to assess long-term industry trends and demand drivers together with building suitability / flexibility when assessing the propensity of the building to hold and grow its value over the period of the lease.

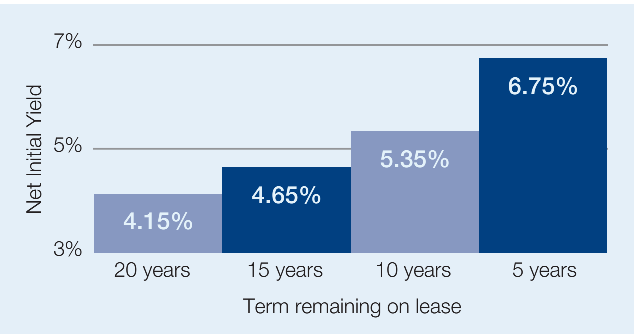
Asset-specific considerations, such as asset quality, tenant appeal, ESG risks and barriers to entry, clearly play their part in LGD too.

Because of the material impact of Company Voluntary Arrangements ("CVAs") on value, and the increasing frequency of their use in certain sectors, they must be considered for UK assets, particularly as CVAs can impose losses on landlords without a default having actually occurred.

2 Lease structure

Term – the longer the lease, the greater the credit risk of the tenant / alternative tenant; on the other hand, signing tenants up to longer leases provides more cashflow certainty for that asset and, therefore, is generally reflected in a tighter yield (see Chart 1 for indicative yields by lease length).

Chart 1: Indicative impact of lease length on Net Initial Yield for commercial property



Source: Alpha Real Capital, illustrative average NIYs across a range of UK long income property sectors

Rent review frequency – whether the rental amount is contractually uplifted on an annual or 5 yearly basis can significantly affect the return profile of the property on account of the time value of money (see Table 1). Additionally, investors concerned with volatility should appreciate that capital value changes will be smoother for assets with annual rent reviews, everything else being equal.

Table 1: IRR impact moving from 5 yearly to annual rent reviews

Ground rent	125 year lease – RPI (0,5)	+c.0.2%
Income strip	50 year lease – RPI (0,5)	+c.0.3%
Long lease property	20 year lease – RPI (0,4)	+c.0.2%

Source: Alpha Real Capital

1 "Commercial ground rents as a compelling fixed income alternative" - https://alpharealcapital.com/news

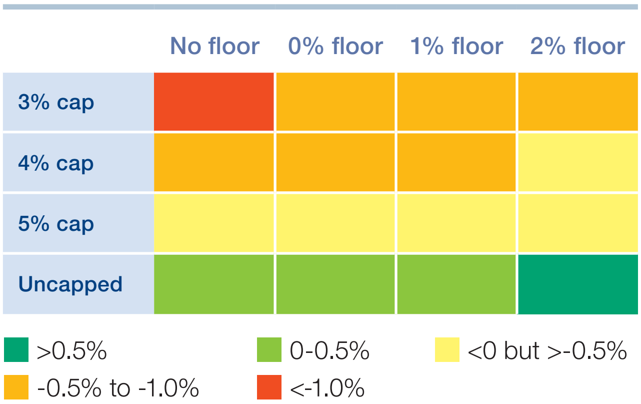
Indexation – for long lease property, rental growth is often linked to inflation but subject to a relatively tight inflation collar (e.g. RPI floored at 0% and capped at 4% – (RPI (0,4)), whereas for ground rents and income strips, the most common inflation linkage is RPI (0,5). Investors should be aware of the potential mismatch between actual RPI and contractual rental growth rates, where for example annual RPI (0,3) is expected to deliver growth 1% lower than uncapped RPI (see Table 2).

It is (slowly) becoming more common for long lease property rental uplifts to be linked to CPI. In the UK, the historical wedge between RPI and CPI has been 80-90bps on average (although relatively volatile), so investors should consider if the yield effectively compensates them for the lower expected rent reviews with CPI-linked leases. The proposed changes to the calculation methodology of RPI may impact this wedge.

Other (secondary) lease structure value drivers include: forward-starting nature, presence of a development period, tenant buyback optionality at maturity, whether the lease falls inside or outside the 1954 Landlord and Tenant Act, and the wider transaction structure (debt secured against property, presence of head lease, etc.).

> Investors should consider if the yield effectively compensates them for the lower expected rent reviews with CPI-linked leases.

Table 2: Expected change in annual rental growth by moving from RPI-based uplifts to collared RPI



Source: Alpha Real Capital, Deloitte

3 Reversionary value

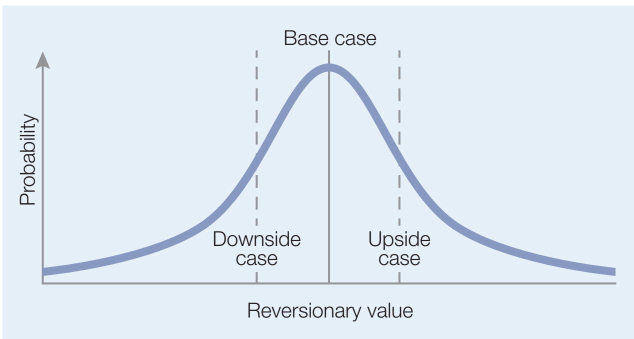
Reversionary value risk is run in long lease formats, but is most acute in traditional sale and leasebacks where the reversionary value is an inherent part of the transaction and represents a meaningful proportion (20-40%) of the expected total cashflows.

An example of RV assumptions used to underwrite a recent 20 year lease transaction (NIY: 4.4%) is shown in Table 3. In assessing the volatility that investors are exposed to, a sophisticated approach to modelling a range of RV outcomes is crucial, rather than simply taking Day 1 Vacant Possession Value and inflating at, say, RPI (as is commonly done in the industry). Assumptions used should be empirically sensible and theoretically sound if they are to have any chance of proving accurate.

Measuring how quickly value can be eroded by RV changes is a core component of any financial modelling, not least because of its significant potential impact: for a typical long lease transaction, the deviation to Base Case IRR is approximately twice as sensitive to a 1 percentage point movement in RV growth compared to a 1 percentage point movement in inflation expectations.

Table 3: Reversionary value sensitivities

Assumptions	Downside Case	Base Case	Upside Case
ERV growth p.a.	1.0%	2.0%	3.0%
Re-letting NIY (in 20 years)	5.5%	4.5%	4.0%
Re-letting rent-free period	2 years	1 year	0 years
Reversionary value	£55.7m	£89.5m	£128.0m
RV % purchase price	83%	134%	191%
Implied growth p.a.	**-0.9%**	**1.5%**	**3.3%**
Relative to RPI	***-3.9%***	***-1.5%***	***+0.3%***
Gross IRR	**4.37%**	**5.78%**	**6.99%**



4 Market forces

Interest rates – movements in risk-free rates, particularly long-term trends, can affect the capitalisation rates, and therefore valuations, of property assets over the medium term.

Illiquidity – investing in this sector should carry a risk premium to reflect the illiquidity and relative complexity of these transactions.

Market supply / demand – demand for secured income assets continues to grow apace and outstrips the volume of high-quality long lease assets being generated. This has led to some compression in yields over recent years and highlights that returns can fluctuate in response to these market dynamics or investor sentiment.

Mitigating risks & overall investment assessment

Risks	Mitigation
Fundamental transaction risk, such as credit risk	• Understand the fundamental credit and asset risks and mitigate in the structure of deals or through the underwriting assumptions. All too often investors focus on effective LTVs (and LGDs), whereas we believe it is is equally important to focus underwriting on long-term sector drivers and business sustainability (PD). • Underwriting should not only to be based on Day 1 but also on projected coverage ratios (considering any amortisation) and the use of stressed scenarios, giving due consideration to sector risks (including cyclicality resilience, competitive risk and long-term demand, and industry-wide property risk factors).
Inflation linkage	• Having an inflation cap in the rent review may reduce the degree of inflation linkage but it limits the risk of becoming over-rented. • Appropriate pricing for the cost of the inflation collar offered. For example, consider inserting a floor of 1% to offset the drag or increasing the start yield to compensate. • Similarly, price in the impact of 5 yearly versus annual reviews, everything else being equal.
Term & illiquidity	• Fully amortising structures (e.g. income strips) will lower the term risk. Preference should be given to employing hybrid structures can deliver a term acceptable to both investor and tenant. • As a “matching asset”, long leases held to maturity earn investors a premium to compensate for their illiquidity. • A concern sometimes raised by pension investors is that illiquid property assets may not be able to be used in a buy-in/out. However, market evidence has shown that the assets could be realised (often covering original transaction costs) within the timeframe it would take to agree and transact a buy-in/out.
Construction risk	• Appropriate safeguards include phased drawdowns, performance bonds, use of escrow accounts, step-in rights etc. • Appropriate pricing to compensate for perceived risks relating to forward commitments / fundings where there is a construction phase.

Naturally, investors should not view these risks and mitigants in isolation, not least because the factors can overlap. An holistic transaction assessment framework must be employed, and one that is flexible enough to enable all kinds of long lease property to be compared in a consistent manner. (Alpha’s framework for asset risk assessment is explained in another thought piece[2].)

> We believe it is better to focus underwriting on long-term sector drivers and business sustainability.

2 This can be found in our thought leadership paper: “European Long Income Property: Secure real asset-backed income for pension funds and insurers” - https://alpharealcapital.com/news

Comparison to other illiquid CDI strategies

Long income property investments lend themselves very well to CDI strategies due to their inflation linkage, long duration and high degree of contractual cashflow. However, how do the return drivers for long income property compare to those for other asset types well suited to CDI, such as renewable infrastructure assets and lifetime mortgages?

These real assets share some common risk / return drivers, namely illiquidity and (in different forms) inflation sensitivity. For renewables, in addition to illiquidity and inflation, the key drivers are natural risk (wind / sun) and power prices (offset by subsidy regimes in some cases). For lifetime mortgages, otherwise known as equity release mortgages, an illiquidity premium is also present, the inflation linkage is the growth in the value of houses (i.e. HPI) and longevity is the remaining primary returns driver.

Lessons learned & implications

A variety of factors matter in assessing potential returns from long income transactions, some of which can be mitigated, e.g. **through thorough underwriting of the credit, business risk / sector, and asset**.

Like other investment types, viewing opportunities through a **risk-adjusted lens** is paramount. We believe, on the whole, investors can be well rewarded for the risks run, if the risks are underwritten and priced appropriately.

The portfolio implications of allocating to this asset class include **risk factor diversification** as well as **improved liability-matching** given the highly contractual nature (often index-linked) of cashflows.

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 £3.8 billion of assets under management, including commitments*.

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

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

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