Commercial Ground Rents

Investment opportunity in a time of adversity

Part of Alpha Real Capital's Cashflow Driven Investing series

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Alpha Real Capital

The UK long income real estate market continues to grow rapidly and now stands at around £30 billion[1]. Pension schemes and insurers are the primary investors, attracted by the availability of high quality, inflation-linked cashflows at significantly higher yields than comparable government bonds.

For pension schemes, including these 'bond-like' assets in their portfolios can reduce the reliance on very expensive government bonds (and LDI) to help cashflow match their longest-dated liabilities, whilst for insurers some of these assets can achieve advantageous treatment under Solvency II.

What originally started as a long lease[3] market dominated by sale & leaseback[4] transactions has now expanded into other structures with income strips[5] and commercial ground rents[6] seeing significant inflows of capital in recent years. For investors the choice of different structures provides flexibility to tailor the specific outcome that they are targeting (in terms of yield, duration, income security and level of inflation protection), while for owners and acquirers of real estate it provides further options to optimise capital raising.

The COVID-19 pandemic has impacted almost every investment asset class, with long income real estate being no exception. However, the more defensive and resilient structures utilised in this segment, such as high-quality commercial ground rents, social real estate and quasi-public income strips, have so far weathered the storm extremely well. This is evidenced by the recent resilience of valuations across these structures. The high rent collection rate for these high-quality long income real estate assets also reflect and further reinforce their defensive nature.

Key take-aways

- **Commercial ground rents are the fastest growing[2] segment of the long-income real estate market.**
- **For real estate owners or acquirers', they can provide an efficient way to raise capital and for investors they can help cashflow match their longest dated liabilities rather than having to rely solely on very expensive index-linked gilts.**
- **Over the coming 6 to 12 months, as refinancing and M&A activity is expected to significantly increase the availability of high-quality commercial ground rents, now could be the perfect time to invest.**

Looking ahead, challenges remain, but the impact of COVID-19 is also expected to create opportunities for investors in the long income real estate market.

In particular, over the next 6 to 12 months, we expect a significant increase in refinancing and M&A activity that will make commercial ground rents an even more attractive investment opportunity than usual.

So what are commercial ground rents and why there is a market in the first place?

Commercial ground rents are the fastest growing segment of the long income real estate market. Over the past five years the sector has grown from virtually nothing to around £4 billion[7] in size, with around £1.5 billion[8] of new deals completed in 2019 alone. We expect this trend to continue, with both supply and demand increasing going forward. In particular, there are already clear signs that the recent pandemic has led to heightened interest by owners in the ground rent structure.

In order to understand why this is the case, it is important to first understand what commercial ground rents are.

A commercial ground rent is a financing structure whereby a real estate owner or acquirer sells the freehold land to an investor and simultaneously agrees a long-term (generally over 75 years) lease with them to continue using a real estate asset.

1 Source: Alpha Real Capital estimate – based on market sources.
2 Source: Alpha Real Capital estimate – based on 5 years period to 31 December 2019.
3 Long lease market – where the lease 20+ years and rental uplifts are pre-agreed at the outset, usually having an explicit link to inflation.
4 Sale & Leaseback – where a real estate owner sells the freehold real estate asset to an investor and simultaneously enters into a lease (typically 20+ years) with them to continue using the asset.
5 Income strip – like a sale & leaseback transaction, but the owner also pre-agrees that they have an option to purchase the real estate back at the end of the lease (typically 30+ years) for a nominal amount (e.g. £1).
6 Commercial Ground Rent – like a sale & leaseback transaction, but instead of selling freehold real estate, the owner just sells the land and simultaneously enters into a lease (typically 75+ years) to continue using the asset.
7 Source: Alpha Real Capital estimate – based on 5 years period to 31 December 2019.
8 Source: Alpha Real Capital estimate – based on market sources.

For investors, the key characteristics of a commercial ground rent investment are as set out in the table below:

Very long duration	• A typical duration[9] of the cashflows is 30 to 40 years. • The only other investible asset currently available in the market with that duration are the longest-dated government bonds with yields near or at their historical lows (and in the case of index-linked gilts real yields are actually negative)[10].
Inflation protection	• Rent reviews can be effectively tied to inflation (if properly negotiated, e.g. annual RPI(0,5)), providing inflation protection to both income and underlying freehold capital value.
Investment grade quality cashflows	• Security is achieved through being the most senior in the structure as the freeholder, as well as the significant over collateralisation of the income and capital. • As a result, these investments are usually equivalent to investment grade credit rating in the BBB to AA range, typically clustered in the single A category.
Illiquidity premia	• As a private market asset, commercial ground rents benefit from an attractive illiquidity premium relative to listed alternatives (although liquidity options do exist).
Enhanced diversification	• The asset class' defensive nature and unique structure should also provide an attractive diversification benefit at the portfolio level.
Gilt spread	• The current[11] spreads over equivalent index-linked gilts is 350bps to 450bps p.a. depending on the deal characteristics.

To bring all this to life, the diagram below shows an example cashflow profile of an actual investible portfolio of commercial ground rents and its key investment characteristics[12].

Figure 1: Example cashflow profile of an actual investible portfolio

Duration	38 years
Inflation linkage	100% (86% annual RPI(0,5) and 14% other RPI linkage)
Credit rating	A-rated equivalent
Net gilt spread	420 bps pa
Number of assets	540
Portfolio value	£1.7 billion

Given the characteristics and contractual nature of the cashflows, commercial ground rents share more with fixed income instruments than commercial property, which is why some asset managers categorise long income real estate in their fixed income range.

As shown above, the investment case for commercial ground rents is compelling. By including these assets in portfolios, investors can reduce reliance on expensive government bonds while also receiving an attractive return for the amount of risk taken. The inclusion of an exposure to commercial ground rents could also enhance diversification at total portfolio level. However, investors need to be comfortable with the nature of the risk taken and the illiquidity of the underlying assets.

9 This is implied interest rate sensitivity and average lease length 100 + years.
10 Based on market conditions as at 30 June 2020.
11 Source: Alpha Real Capital - Indicative pricing based on market conditions as at 30 June 2020.
12 Source: Alpha Real Capital – Cashflow projections and portfolio characteristics are based on the position of the Alpha Real Capital's Index-Linked Income Fund (ILIF) as at 31 March 2020. ILIF invests in UK commercial ground rents and targets to deliver a long-term net return of 2% over long-dated index-linked gilts.

To better understand why supply is there to meet that demand, and indeed to structure successful sustainable commercial ground rents, the asset owners' and acquirers' perspective must be considered. For them, commercial ground rents can be a very effective refinance or acquisition tool when compared to other forms of capital. The four main reasons for this are set out below.

For some private equity firms, commercial ground rents have become an important tool to help secure deals whereas for the owners of real estate, value can be created by monetising the freehold. The latter point can be illustrated via a stylised example below where 10% of value is created. It is representative of the market dynamics where a typical range is 5% to 15%.

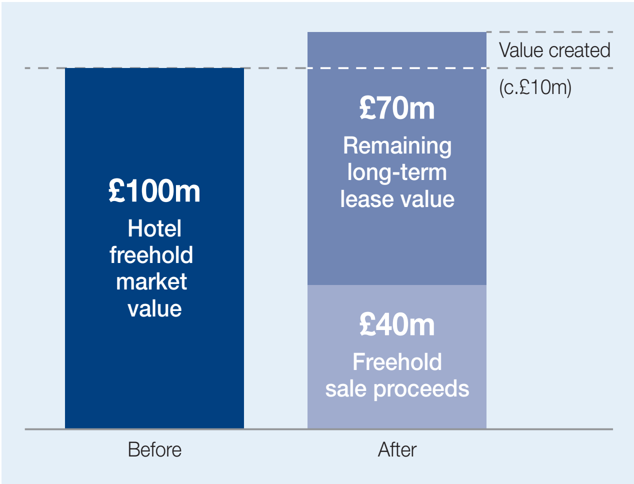
Lower cost of capital	• When compared to other forms of finance, ground rents can contribute to a lower cost of financing. This helps boost returns for owners of real estate and acquirers in M&A deals.
Leaseholder flexibility	• The leaseholder maintains freedom to operate the real estate asset without any onerous restrictions.
Permanent capital	• Given the very long-term of the lease, the proceeds from the sale of the freehold provides effectively 'permanent' capital that does not carry refinance risk associated with other forms of finance.
Remaining lease valuation	• The remaining long leasehold (after ground rent is paid) still holds significant value that can be used as collateral for other forms of capital (e.g. senior or mezzanine debt).

An example of how a ground rent transaction can create value for an owner of a central London hotel

- The central London hotel is valued at £100 million[13].
- The sale of a freehold land to an investor as part of the ground rent transaction could generate net proceeds of £40 million[14]. This capital can be used for refinancing or other purposes.
- The remaining long-term lease is valued at £70 million[15]. This is the value remaining for the owner of the long-term lease for the hotel after the land has been sold.
- By optimising the structure through the creation of the long leasehold interest, this transaction has the potential to generate an additional £10 million of value (i.e. £40 million + £70 million - £100 million).

The above dynamics help to illustrate why commercial ground rents have been the fastest growing segment of the long income real estate market over the last five years.

Figure 2: Impact of introducing a ground rent transaction



13 In this example the freeholder of a central London receives £5m net operating income ("NOI"). Based on a 20x multiple (market standard valuation approach for that location) it gives its owner a market value of £100m.

14 Based on current pricing, a ground rent for a hotel with that market value and location is expected to be around £0.9m with a Net Initial Yield ("NIY") of 2.10% (7.5% transaction costs). This would generate net proceeds of: £0.9m/(2.10%*(1+7.5%)) = c.£40m.

15 The remaining long leasehold, with NOI (after ground rent is paid) is £4.1m (i.e. £5m less £0.9m) is valued at a 17x multiple (market standard reflecting the size, location and type of lease), giving the owner of that lease a market value of c. £70m.

Why now is an opportune time to invest in commercial ground rents?

As we begin to emerge form COVID-19 lockdown, over the next 6 to 12 months we expect a significant increase in commercial ground rent deals coming to the market.

The primary drivers are the following supply-specific factors:

Reduced liquidity	• Multiple sectors are struggling for short-term liquidity, which can be achieved by releasing capital through ground rents.
Increased financing costs	• Traditional financing costs have increased so ground rents will become an even more attractive funding alternative for certain acquirers and operators.
Banks looking to de-lever	• Banks are looking to operators to provide new equity into existing positions to reduce leverage. Ground rents represent a low-cost option to provide this equity.
Wider opportunity set	• The change in circumstances apply to many quality assets with sustainable mature income which previously saw no need for a ground rent. For example, high quality ‘trophy’ assets owned by family offices may need liquidity injections and this could be the first and potentially the only opportunity to access these.
Heightened M&A activity	• Due to the current environment, distressed sale and consolidation M&A activity is expected to increase and require attendant financing options.

Alongside these drivers, for certain deals we expect improved terms when it comes to pricing and security.

The improved pricing is based on current market conditions and increased credit spreads. As a result a return premium could be applied to some commercial ground rent transactions of up to 20bps p.a.[16] in addition to the normal spread of 350 to 450bps p.a. discussed above.

Furthermore, improved security can be attained by setting the quantum of the ground rent at a lower proportion of the market value of the asset and setting the rent at a lower level of EBITDA[17]. Of course, as the asset starts to recover these ratios would improve even further.

In conclusion, the expected increase in supply and with potentially enhanced terms presents an opportune time for existing investors to increase their exposures, and for new investors to establish allocations to commercial ground rents within their portfolios.

If you would like to find out more about how Alpha Real Capital can help you achieve your objectives, it would be our pleasure to explore this with you.

16 Source: Alpha Real Capital, indicative pricing based on market conditions as at 30 June 2020. The range depends on many factors and is subject to change.
17 EBITDA – Earnings Before Interest, Tax Depreciation and Amortization.

About Alpha Real Capital

Alpha Real Capital LLP is a specialist real assets investment manager focused on secure income strategies. We invest in UK and European assets with predictable secure long-term cashflows to help our clients meet their liabilities.

We provide market leading and innovative real asset solutions across a range of investments such as commercial ground rents, UK renewable infrastructure, social real estate and lifetime mortgages, combining operational real estate expertise and fixed income skills.

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