Real Assets: Security in the eye of the storm
Looking forward from 2020

'There are decades when nothing happens and there are weeks when decades happen'. 2020 had too many weeks for which this rang true.

New Year celebrations were more about the passing of 2020 than the arrival of 2021. Yet 2020 may come to be remembered as the year of the great acceleration, with many positive shifts in the way we live and work happening in weeks rather than decades.

2020 also delivered Brexit and an important US election result, however COVID-19 continues to dominate economies and markets. As we come out of the latest lock-down the full effects of the massive fiscal and monetary stimulus administered in response to the pandemic are yet to emerge. The pandemic has allowed us all to take stock and there is a widespread desire to build back better. For investors, this has accelerated climate change initiatives and highlighted that capital allocation can and should have a positive social impact. In no other asset class is this more directly achievable than in the real asset space.

Against this backdrop, and given the increased interest in allocating to real assets, we look back and ask how was 2020 for long-income real assets? What value did they add to investor portfolios? And what are the prospects for long-income real assets going forward?

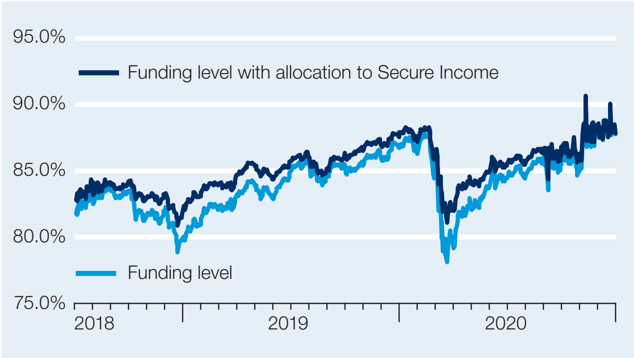
2020 – the year of resilience

Investors hold real assets for a number of reasons. Not only can they be a good match to long-dated inflation linked liabilities but they also offer higher yields than government bonds thanks to spreads that can be much more attractive than those available from other, more liquid and publicly traded assets.

For long-income real assets specifically, an additional feature is reliable cashflow, indeed many investors classify these assets as 'secure income assets'. They expect them to deliver a secure income stream, and lend a degree of stability to their portfolios. In short they expect resilience. The pandemic turned out to be an unwelcome test of this thesis.

In the chart opposite we have modelled the funding level of two typical pension schemes[1]. The schemes only differ in that one has no allocation to long-income real assets while the other has a total of 10% allocated (spread equally between Commercial Ground Rents ('CGR'), Social Real Estate ('SRE') and Renewables, funded equally from sales of equities and corporate bonds).

XYZ Pension Scheme – funding level



In March 2020, pension scheme trustees were not only faced with rapidly deteriorating funding levels but more immediately there were potential liquidity issues to think about. A wide range of industries faced uncertainty and some covenants weakened overnight. Many sponsors requested to defer pension scheme contributions. To compound matters, at one point a spike in nominal interest rates meant potential liquidity calls from Liability Driven Investment (LDI) managers, although thankfully this situation reversed quickly.

In the midst of this volatility, stable cashflows from secure income assets would have helped schemes meet pension and other payments without being forced to sell liquid growth assets. This is demonstrated in our example above, where the scheme with investments in secure income assets would have participated more in the subsequent spectacular bounce back in risk assets. At the lowest point, the funding level of the scheme illustrated would also have been 3% higher, considerable protection especially for the many schemes that had end-March 2020 actuarial valuation dates.

Our analysis shows that even a modest allocation to secure income assets can increase portfolio resilience during periods of market volatility such as those seen at end March 2020 and during the market falls in 2018. This resilience can help pension schemes avoid being forced to liquidate assets at an inopportune time and maintain a long-term investment strategy.

1 80% funded. Liabilities: 18 year duration, 70% inflation linked. Allocation: 30% Equities, 25% sterling corporate bonds, 10% distributed equally to Property, High Yield Debt, Emerging Market Debt, 35% LDI (achieving 70% inflation and interest rate hedge)

Resilience varied by asset type

Resilience is about both income and valuation and long-income real assets held up through the volatility on both fronts. Income has clearly been resilient. Quarterly rent collection rates in 2020 from traditional property on standard leases have been around the 75% mark[2]; this compares with CGR rent collections of greater than 90% through the year (with catch up payments expected in full).

While there were significant variations between traditional property sub-sectors (ranging from less than 50% in leisure to 100% in Social Real Assets), investors typically invest on a diversified sector basis and are generally exposed to the average collection rate. The circa 20% higher collection rates for CGR assets demonstrates their relative resilience to economic shocks.

On the valuation front, returns were positive for long-income real assets, with capital growth generally beating the RPI (of 0.9%) for the year, in some cases by a considerable margin. It is worth noting that CGR and SRE assets were the first to have the material valuation uncertainty clause removed. Wind renewables, for example, also showed good capital returns, with robust income return through the year despite variable pricing in energy markets in 2020 due to COVID.

What is behind the resilience?

In 2020, central banks and governments directly supported people and businesses. This immediate relief and the implicit promise of more support if needed helped markets post positive returns by year end. While secure income assets also benefit from this support, when we look closely, we find that there are other reasons why these assets are naturally positioned for resilience.

The private market nature of the transactions means there can be no short-cut to due diligence. When selecting assets and structuring the transactions investors can really focus on security, and the process naturally leads to a close working relationship with tenants and operators from the outset. This was a great positive during 2020 as it meant a good level of communication with counterparties through a difficult period.

Looking at specifics

- In Commercial Ground Rent transactions, over-collateralisation is a key feature that underlies the resilience in this asset class. Versus traditional real estate investment models, this distinct feature means that CGR counterparties have an increased capacity and desire to continue rental payments.
- The commercial ground rent leases, for example, are typically 30-40% of the unencumbered value of the asset. This means that the real estate asset coverage is typically multiple times the value of the ground rent.
- CGR transactions also require a deep understanding of the sector and business models underpinning the operating asset and stress testing these to ensure the rental income is well covered. Typically ground rent payments are covered 6-7x by operating cashflow, giving a much greater resilience to dips in operating performance than traditional property.
- Ground rent leases are effectively a form of super-senior debt and have a unique place in the capital stack of operating businesses. The existence of junior lenders in the debt structure also enhances the security of income as it is also in their interest to ensure lease rents are kept up to date.
- Social Real Estate comprises assets in the education, housing and healthcare sectors. Rental income is typically backed by local authorities (and ultimately government) and therefore high quality. The assets provide essential services, which gives them their own source of resilience through business cycles. Through the pandemic, based on our experience, rental payments were paid in full and on time.
- In renewables portfolios, spreading by geography and power source ensures less variable power generation. Where necessary, managing power price exposure also leads to greater predictability of income. For example, in 2020 power consumption and prices fell significantly for a period due to COVID-19, and a disciplined approach to hedging this exposure, (valuing predictability over upside risks) would have been positive.

Another benefit of private market transactions is the ability to customise contracts to build in deal-specific features or mitigate specific risks. For example CGR lease contracts typically provide some protection against changes to the inflation index. Therefore, RPI inflation increases on income beyond 2030 will not automatically fall to the lower CPIH inflation level, as is expected will be the case for holders of index-linked gilts.

Building well diversified secure income portfolios is another source of resilience. For example, during 2020 an over-reliance on the hotel, retail and office sectors may have exposed some long-lease portfolios to more risk. A more diversified approach, including exposure to non-cyclical sectors such as healthcare and education would have helped both income and valuations, as would exposure to UK leisure sectors in the face of restricted foreign travel.

What is the outlook for real assets?

As we write, the roll out of the vaccine in the UK at least, is happening at pace. However, a global roll out may well take us beyond 2021. Economic prospects in the short-term will largely depend on how this story develops. In the longer term, the legacy of the pandemic is likely to be the lasting impact on how we live, work and do business in the future. It will be difficult to predict how we get there, but with some luck this will emerge over decades and not weeks. While the virus and its impacts will provide the backdrop in 2021, there are two underlying themes that were at play pre-pandemic, and will continue to be particularly relevant going forward.

Lower for even longer

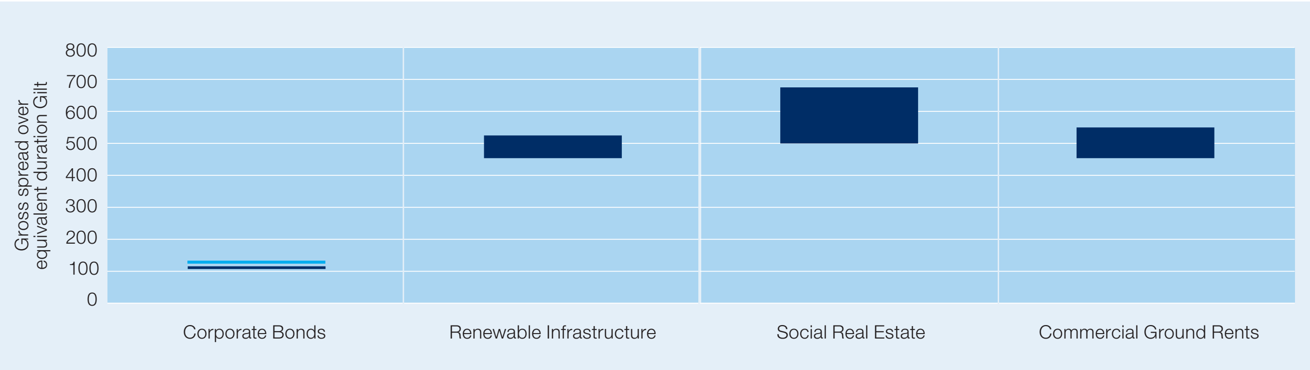
The response to the pandemic followed the financial crisis playbook from over a decade ago, but this time with greater size and speed, and with fiscal support thrown in for good measure (weeks rather than decades again).

The combined effect of low central bank policy rates, continued operation of quantitative easing programs and a lack of supply of assets that match institutional liabilities – despite high government borrowing – means forward looking return expectations remain low for all asset classes.

Investors are therefore looking for yield to improve portfolio returns. The recent news of US high yield bonds yielding less than 4% for the first time ever and multi-billion pound leveraged buy-outs being funded with unsecured debt at even lower yields suggests yield is being prioritized over security.

The chart below compares the additional yield above equivalent maturity government bonds available on different asset classes. It shows that secure income real assets remain attractive, importantly without the loss in credit quality we are seeing elsewhere.

Additional yield above government bonds



Adding to the attractive returns, demand is also driven by the fact that more pension funds now need to meet pension payments directly from their asset portfolios. Assets that provide stable, high quality income increases their ability to pay member benefits as they fall due. Monetary and fiscal policy have arguably created higher uncertainty around inflation, with an inflation spike becoming a plausible tail risk scenario. Inflation linked cashflows are therefore attractive to meet inflation linked payments with secure income assets such as CGR or SRE

Demand is expected to continue for these assets. On the supply side, we are seeing a strong rebound in deal flow after a COVID induced slow-down in 2020. For example in Commercial Ground Rents, M&A and other capital raising activity drives supply. Added to this pent up M&A demand the working capital requirements to rebuild after COVID are leading to strong supply dynamics. Ground rents are increasingly becoming recognised as a good source of long-term patient finance[3], this provides a wider set of opportunities and should help to build more diverse commercial ground rent portfolios.

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3 https://www.ey.com/en_ie/strategy-transactions/why-commercial-ground-rents-can-offer-a-strong-alternative-to-standard-debt-finance

ESG

The Environmental, Social and Governance theme specifically impacts supply and demand for Social and Renewables assets, providing a tailwind for these asset classes and also for Commercial Ground Rent assets where ESG considerations are either embedded in the selection process or intrinsic to the tenant. The other related and well sign-posted initiatives are the intention to 'build back better' after COVID, and the upcoming COP 26 conference in Glasgow. Indeed the UK Government's 10 point plan for a green industrial revolution specifically targets green energy initiatives. These themes bode well for an increasing supply of investment opportunities.

ESG has been a growing theme for a long time for pension schemes, however the regulatory requirements around disclosures and demonstrating that ESG is factored into decisions has recently become much more concrete. Add to this that many pension schemes are pro-actively committing to sustainability goals, such as net-zero targets and one can see how assets with ESG credentials will be in demand.

While the environment has been the main focus to date, the 'S' in ESG is now getting much more attention. In particular, 2020 underlined the importance of essential services to wider society. In a recent paper[4] we characterised this as a 'perfect storm' – growing needs from an ageing society for social care, and therefore a need to increase and upgrade such assets. These needs are unlikely to be met by public financing, leading to a £50bn+ opportunity for private investment.

An opportune time to improve portfolio resilience

It is clear that secure income real assets have shown resilience through the pandemic, and there are good reasons why this should continue. Long term themes that are at play – investors looking for high quality income and sustainable, impactful investments – are also supportive of secure income assets.

Pension schemes have generally enjoyed improved funding levels in 2020, and this may be an opportunity to improve portfolio resilience by investing in secure income real assets, for example by de-risking from equities or switching matching assets to enhance yields on that part of the portfolio. Given the attractive yields, secure income assets may also present an opportunity to help meet ESG objectives without sacrificing risk-adjusted returns.

4 https://alpharealcapital.com/social-real-estate/

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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Social Real Estate

A £50 billion secure income opportunity?

Commercial Ground Rents

Investment opportunity in a time of adversity

Lifetime Mortgages

A scalable, diversifying Cashflow Driven Investment for defined benefit pension schemes

Value drivers of long income property

A high-level overview

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