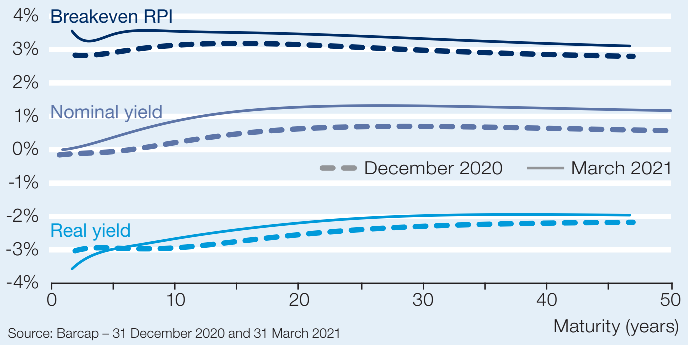
Market Monitor: Q1 2021

Alpha Real Capital

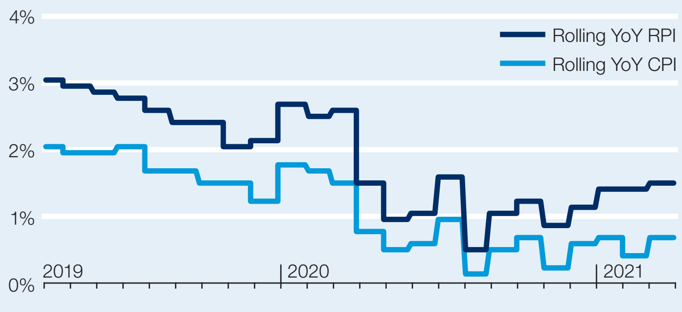
Rates, inflation and credit spreads

Gilt yield curves



Source: Barcap – 31 December 2020 and 31 March 2021

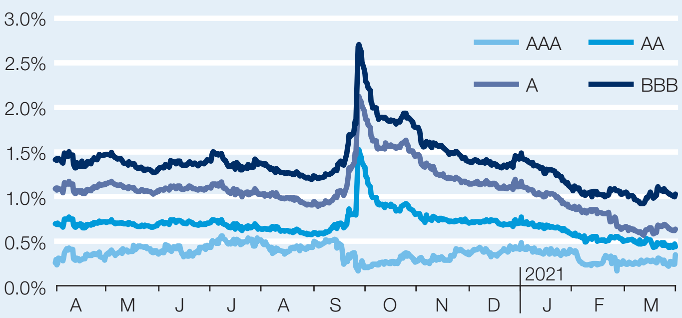
12 month rolling inflation



Source: ONS - 31 March 2021

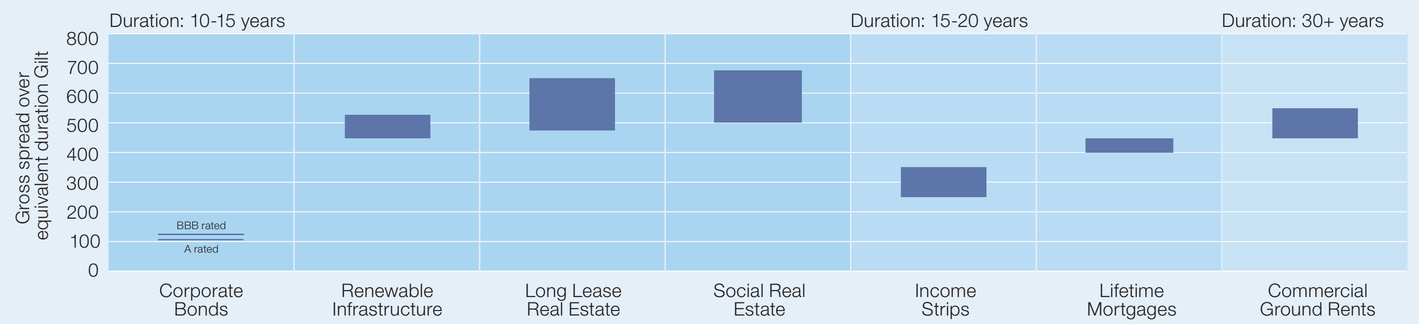
- Real Gilt yields have increased over the quarter at the medium and long end of the curve. They fell at the short end. The increase is primarily driven by higher Nominal Gilt yields over the medium and long term.
- Inflation expectations have increased across the curve after recent and upcoming relaxations of Covid restrictions in the UK. The larger increase in expectations for shorter term inflation has driven the fall in short end Real Gilt yields.
- Investment Grade bonds have continued to benefit from a "flight to quality"; credit spreads for UK Investment Grade bonds remain tighter than pre-Covid levels. Spreads for AAA rated bonds have started to increase slightly as investors are prepared to switch to lower credit quality assets in search of higher yields.

Credit spreads



Source: S&P Capital IQ 10 year non-financial GBP bonds, Z-spread – 31 March 2021

Secure income market update



Spreads remain compelling for secured long income assets

- As the Covid-19 period lasts, resilience continues to be demonstrated across Long Lease real estate markets, most notably for high quality Income Strips, Social Real Estate and Commercial Ground Rents.
- Spreads over Gilts for Long Lease, Social Real Estate, Income Strips and Commercial Ground Rents have decreased by 25bps. This is primarily driven by the increase in Real Gilt yields at the longer end of the curve.
- Spreads for Renewables Infrastructure have decreased by 75bps, primarily due to the recent uplift in Nominal Gilt yields and long-term expectations on corporate tax and power prices.
- Lifetime Mortgage spreads remain broadly unchanged.

Asset class definitions

Renewables Infrastructure: 15+ year inflation-linked cashflows from unlevered wind and solar infrastructure assets subject to Feed-in Tariff (FIT) or Renewable Obligation Certificate (ROC) regimes.

Long Leases: 15+ year inflation-linked leases on commercial real estate. Traditional sale & leasebacks fall within this market.

Social Real Estate: 15+ year inflation-linked leases on real estate assets that accommodate or facilitate social activities or services.

Income Strips: 30+ year inflation-linked leases on commercial real estate where the lessee has an option to purchase the real estate back at the end of the lease for a nominal amount (e.g. £1).

Commercial Ground Rents: 100+ year inflation-linked leases on commercial real estate, with a higher degree of rental and value cover than a traditional sale & leaseback.

Lifetime Mortgages: portfolio of loans from individual borrowers aged 55+ seeking to release equity from their property; the coupon rolls up (rather than cash-pay) and the mortgage is repayable on death or when entering long-term care.

Sources: Alpha Real Capital (for illustrative purposes only and for typical transactions available to pension schemes in these asset classes). Data as at 31 March 2021. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Alpha Real Capital nor as advice of any nature. Source of corporate bond spreads: S&P Capital IQ 10 year non-financial bonds – 31 March 2021.

Is it time to consider switching some of your Index Linked Gilts into Commercial Ground Rents?

Many pension schemes are long-term holders of Index Linked Gilts. Usually holding them as part of a liability matching portfolio for hedging, collateral or liquidity purposes. However, as funding levels improve and the need for leverage falls it may be an opportune time to review alternatives to holding low yielding Index Linked Gilts.

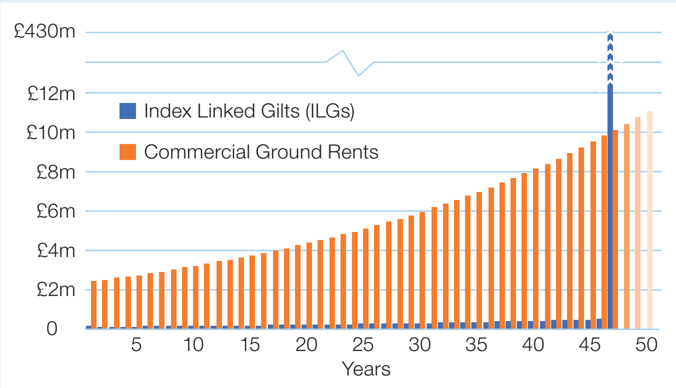
Currently many income generating assets are not expected to provide acceptable returns. In this environment, Commercial Ground Rents (CGRs) may be the low risk, higher yielding alternative that investors are looking for to enhance portfolio expected returns.

We take a closer look at some of the reasons why investors should consider a switch.

A better cashflow match than Index Linked Gilts

The chart compares cashflows from a £100m holding in the longest dated index linked gilt (maturing in 2068), with the cashflows from holding the same amount in ILIF (our Commercial Ground Rents fund.)

Portfolio cashflows: Commercial Ground Rents vs. Long dated Index Linked Gilts (£100m invested)



Source: Alpha Real Capital, for illustrative purposes only.

- The income generated is significantly higher for CGRs, whereas for ILGs the income is very much back-end loaded. That is due to the inflation-linked principal repaid at maturity.
- The higher income level from a secure asset gives more investment freedom to the pension scheme to pursue opportunities and avoid having to sell assets to meet pension payments (for example).

Attractive risk-adjusted returns

CGR spreads are not only attractive but the income stream is very secure by design.

Commercial Ground Rent can be thought of as long-term lending collateralised by real estate assets. A key feature that enhances security is over-collateralisation.

- CGR transaction 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.
- Ground rent payments are typically covered 6-7x by the cashflow generated by the operating business. Stress testing the business model for resilience is a key component of the underwriting process.
- CGR is effectively a form of super-senior debt. Having junior lenders (such as banks) in the debt structure also enhances the security of income as it is also in their interest to ensure rents are kept up to date.

Better protected RPI link

CGRs are private market transactions. Investors can therefore negotiate contracts in a way that addresses specific risks and concerns. A relevant example in the context of Index Linked Gilts is the link to RPI.

RPI will be reformed from 2030 such that the index will be in line with CPIH – a more acceptable inflation measure. Historically RPI increases have been around 0.7% p.a. higher than CPIH. The reform means Index Linked Gilt holders will receive lower coupon payments.

In contrast, rental payments from CGRs will not automatically fall to the CPIH level, this is because the contracts provide protection in scenarios where the RPI index is redefined. This means there is a compensatory mechanism that aims to maintain the rent increase levels.

This change can have a significant impact on the value of Index Linked Gilts. For example, theoretically the 2068 index-linked gilt price could fall by more than 20%. Arguably, the market has not fully priced the impact, and may be pricing in a scenario where index-linked gilt holders do get compensated. At this time however, the indications are that the probability of compensation is very low.

CGRs therefore protect the level of inflation increases better than Index Linked Gilts. If indeed the index-linked gilt market has not fully priced RPI reform then a switch into CGR before this happens would be well timed.

CGRs therefore may offer superior protection against rising inflation compared with Index Linked Gilts. Whether a switch from ILG to CGR makes sense is a scheme specific consideration, however there are compelling reasons to explore this question.

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