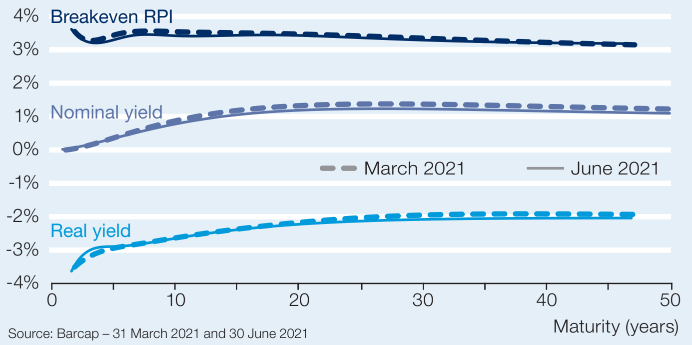
Market Monitor: Q2 2021

Alpha Real Capital

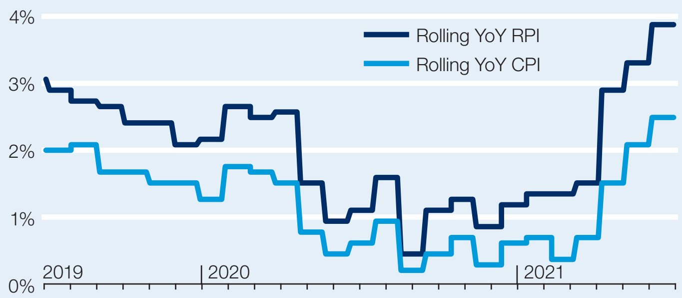
Rates, inflation and credit spreads

Gilt yield curves



Source: Barcap – 31 March 2021 and 30 June 2021

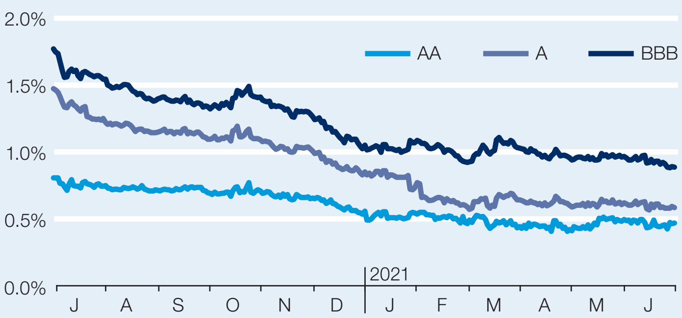
12 month rolling inflation



Source: ONS - 30 June 2021

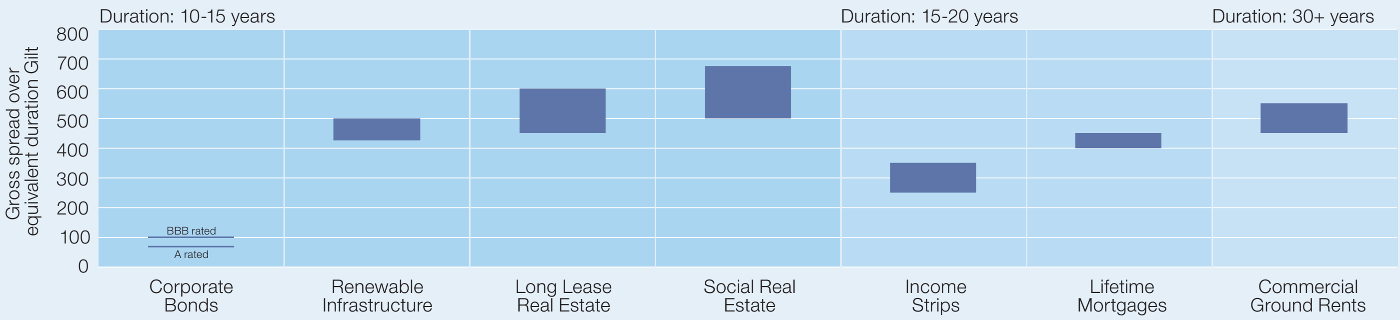
- Real Gilt yields decreased over the quarter at the medium and long end of the curve and increased at shorter terms. The decrease is primarily driven by the fall in Nominal Gilt yields over the medium and long term, driven by the expectations that Central Banks may pull back on stimulus in the next 12 months.
- Actual inflation hit a two-year high in May, with CPI slightly above Bank of England's 2.0% target. Rebounding demand due to easing of Covid restrictions, higher commodity prices and the base effects played a role in the increase, which is likely to continue in the short term. This did not impact the market levels for the expected RPI over future periods, suggesting these were already priced in.
- 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. This signals investors are not yet prepared to move away from 'safe haven' assets. Note that we have excluded AAA bonds this quarter after four out of the seven bonds comprising this category in the index matured.

Credit spreads



Source: S&P Capital IQ 10 year non-financial GBP bonds – 30 June 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 remained unchanged from the previous quarter.
- Spreads for Renewables Infrastructure have decreased by 25bps. Sustained strong demand for the asset class has led to the compression in spreads over the quarter despite the headwinds of higher corporate taxes and lower long term power price forecasts.
- Lifetime Mortgages continue to 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: 15-20+ year inflation-linked leases on operational real estate across the housing, healthcare and education sectors.

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 30 June 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 – 30 June 2021.

Focusing on the ‘S’ in ESG – Is it time to consider Social Real Estate?

In recent years, investors have been adding exposure to alternative real estate sectors. This is because of the long-term, inflation-linked nature of leases, the income security offered and the attractive risk adjusted returns available. Covid-19 has accelerated this shift as it has brought into question the prospects for traditional sectors such as office and retail. Investors therefore continue to diversify into real estate alternatives, especially those that have demonstrated relative resilience through the pandemic.

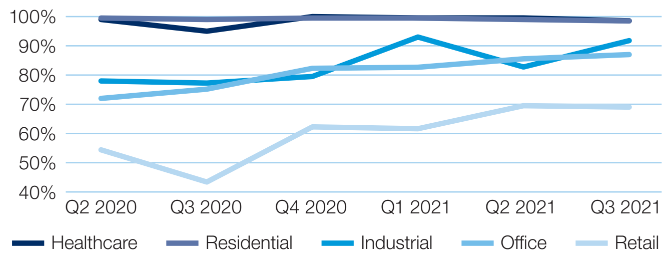
This shift by investors has also been supported by growing regulatory pressure and stakeholders’ increasing focusing on ESG (Environmental, Social and Governance) considerations.

Social Real Estate – **investments in real estate assets including housing, healthcare and education facilities** – can deliver for investors on all of these fronts. We briefly discuss some of the sector’s key characteristics that support this assertion.

Durable demand, resilient income

A distinctive feature of Social Real Estate sectors is that demand is driven by demographic shifts in society – these are structural and long-term in nature, as opposed to being cyclical and economically-influenced (as in say, the retail sector). One well observed demographic shift is that the UK’s population is growing and ageing. This increases demand for public services and the assets they are delivered in. In addition, as these services tend to be essential and not optional, the demand is underpinned by public sector funding. Such funding certainty was evident during the Covid-19 pandemic[1], as it ensured tenants were able to continue to pay rents in full and on time across Alpha’s Social Long Income Fund, with similar patterns observed across the market. This was not the case in all sectors as chart below shows.

UK REIT rent collection rates



Source: Goodbody Real Estate, Alpha Real Capital
Note: 27 REIT and propcos, reported rent collection rates at 30 June 2021

1 100% collection for Alpha’s ‘Social Long Income Fund’ since the onset of the Covid-19 pandemic in Q1 2020

2 HM Government – Investing in a Better World, 2019

Scale opportunity for ongoing deployment

Analysis of the sectors highlights a capacity shortfall and a lack of modern, efficient, purpose-built stock. By way of example, the replacement of smaller care homes or those with non-market standard facilities (shared bathrooms, for example) could alone require £6 billion of funding. Equally, the primary care investment requirement to replace existing GP practices considered not fit for purpose is estimated at £17 billion or more before population growth is factored in. Homelessness and temporary accommodation solutions could require more than £10 billion whilst a day nursery shortfall may be of a similar magnitude.

Even based on conservative assumptions, this **represents a £50 billion+ opportunity** across all of these sectors.

Whilst a number of specialist REITs and responsible or impact funds have already deployed capital into Social Real Estate, the scale of the investment opportunity is large and significantly untapped. Institutional investors seeking to deploy significant capital over the medium to long-term can therefore be confident of the opportunity to do so. The wide-ranging needs means investors will achieve sectoral and overall portfolio diversification, securing assets that have shown remarkably resilient performance.

Double bottom line returns – Social and Financial

Investments in social real estate can deliver financial returns. Importantly, they can also produce quantifiable societal benefits, satisfying investors’ social targets as part of ESG strategies.

Stakeholders’ expectations continue to evolve along these lines. For example, over 70% of UK pension scheme beneficiaries say they not only want their investments to avoid causing harm but also to achieve good for people and the planet[2]. The quest is therefore to find assets that not only meet return objectives but also align with social and responsible investment aspirations.

By engaging with third-party social value specialists, the Social Profit Calculator, Alpha have been able to quantify the impact of its social fund. The fully-diversified target portfolio will deliver £4.88 of social value for every £1 invested, highlighting the multiplier effect that allocations to social real estate can achieve – in addition to financial returns, not at the expense of them.

Allocations can also align with United Nations Sustainable Development Goals, contributing to alleviating a wide range of societal challenges, particularly when investing through a diverse strategy. Alpha’s fully diverse social real estate portfolio could contribute to 12 of the 17 SDGs.

Social Real Estate provides long-term, inflation-linked income streams, which have proven to be resilient in the recent challenging period. The social benefits of investing in housing, healthcare and education are achieved in addition to financial returns, not at the expense of them – underpinning a strong case for them to be a cornerstone of investor allocations.

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Alpha Real Capital

For more information about Alpha Real Capital LLP, its funds and key personnel visit: www.alpharealcapital.com

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