European Commercial Ground Rents

An Introduction

Part of Alpha Real Capital's Cashflow Driven Investing series

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Alpha Real Capital

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Commercial Ground Rents ('CGR') provide investors with index linked cashflows that have bond-like characteristics and offer property owners an attractive form of long-term finance. The parties to a CGR are akin to a borrower and lender, although the relationship is governed by a lease not a loan.

For investors (the 'lenders') CGRs are an asset that provides secure long dated inflation-linked cashflows that have a higher return than other assets with similar characteristics, for reasons we explore later. For the long leaseholder (the 'borrowers'), it is a source of long-term, low cost capital that can serve to reduce the overall cost of their capital structure.

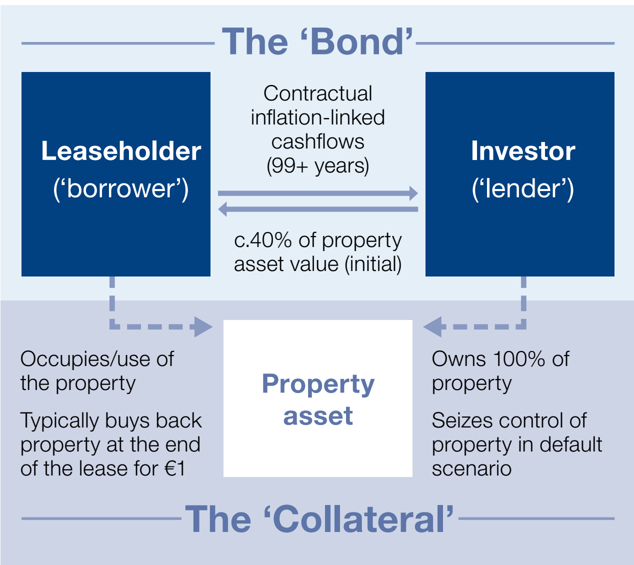
These characteristics have meant that in the UK, CGRs have been the fastest growing segment of the long income real estate market in recent years, growing from virtually nothing to c.£4 billion in just over five years. We are now seeing potential for similar growth in Europe. In this paper we seek to answer a few questions to provide a better understanding of this asset class and why investors should consider including CGRs in their portfolios.

What is a Commercial Ground Rent?

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 lease back (generally over 99 years) allowing continued use of the property.

Technically, whilst this is a real estate transaction, the effect is to create a long-term inflation linked bond-like structure for the investor. The property asset acts as collateral, in case the leaseholder defaults on the agreed lease payments (as with any mortgage or debt instrument), increasing the security of the 'bond'.

The structure of a Commercial Ground Rent



Looking at the CGR structure in more detail

- At the outset, the property asset is acquired by the Investor at between 30% to 40% of the market value (effectively the 'Loan to Value'), at the same time a lease is created and the seller of the property asset becomes the Leaseholder.
- Depending on the jurisdiction, the property asset includes the land and any operating asset on that land or a right for the Investor to take ownership of both the land and the building in a default scenario, typically in situations where the Leaseholder stops paying rent.
- For the duration of the lease, the Leaseholder makes rental payments to the Investor – these payments are typically inflation linked. In return, the Leaseholder enjoys the use of the property.
- Depending on what is agreed between the parties, the lease may also provide a right for the Leaseholder to buy back the freehold interest at the end of the lease for a small nominal sum (usually €1) making the transaction fully amortising.
- The Investor effectively gets 100% ownership of the property asset at outset and receives inflation-linked payments for the duration of the lease. If lease payments are not met the Investor can take possession of the asset and benefit from the value uplift provided by overcollateralisation.

The market for CGRs in Europe

While the CGR market in Europe is emerging, transactions in various jurisdictions have completed thus proving the legal and commercial business case.

There are good reasons why the market should grow, and we could see a repeat of the exponential growth that has occurred over the last five years in the UK market.

European Commercial Ground Rents – what is the growth potential?

To answer this question, we look at two things.

Firstly, we discuss the jurisdictions where we are seeing activity and where we are participating in deals. We show the size of the pipeline and how this splits by geography and sectors.

Secondly, we compare the UK and European markets and highlight the similar dynamics at play in Europe currently versus the then nascent UK market of five or so years ago.

Activity in the European CGR market

In Germany and the Netherlands in particular there is a long history of ground rents being used by local government, royal, or church bodies as a means of allowing people to use strategic land but maintain overall control and ownership. By way of example, ground rents are commonly used by airport and port authorities or in central London by the Crown or other royal estates. Commercial ground rents use this same legal framework, but apply this 'old technology' for a financial purpose rather than just control.

Over the last three years we have seen a small number of these transactions being used for financing reasons across Europe. As investor capital allocated to such transactions increases, as has happened in the UK, the demand from property owners to use CGRs as a financing tool is likely to increase.

In the charts [overleaf] we are showing an illustrative tracker of Alpha Real Capital's current pipeline of opportunities identified by sector and jurisdiction. It is considered that an **opportunity exists for us to deploy €250 million growing to €500 million per annum.**

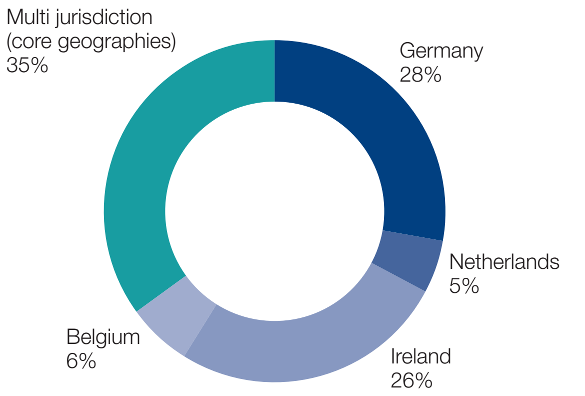
A word on security of income

Commercial ground rents provide a very strong risk-adjusted return for investors.

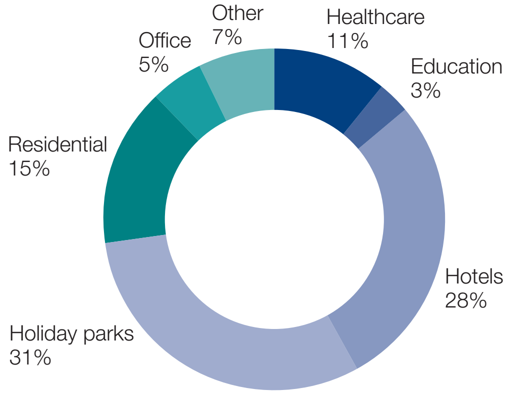
- Ground rent leases are effectively a form of **super-senior debt** and have prior ranking in the capital stack of the operating businesses (the Leaseholder).
- The existence of junior lenders in the debt structure **enhances the security of income** as it is in their interest to step-in to ensure lease rents are kept up to date.
- In Commercial Ground Rent transactions, understanding the sector and business models underpinning the operating asset and stress testing these to ensure the **rental income is adequately covered** is important.
- **Over-collateralisation** is a key feature of the contracts. As mentioned above the commercial ground rent leases are typically 30-40% effective 'LTV' of the un-encumbered value of the asset. This means that the real estate asset coverage is typically multiple times the value of the ground rent.

Current pipeline of €250m, growing to €500m per annum

Geographic distribution



Sector distribution



How large could the market be?

In the UK over the past five years the sector has grown from virtually nothing to over £4 billion in size, with around £1.5 billion of new deals completed in 2019 alone. 2020 was subdued due to the pandemic however activity has increased in 2021 with signs that the recent pandemic has led to heightened interest by owners in the ground rent structure.

The signs of growth are similar to what we saw in the UK a few years ago:

1. Growing interest and acceptance from real estate owners/acquirers and their advisors of CGRs as a financing option.
2. Banks and other lenders becoming familiar with and comfortable sitting alongside CGRs in the capital stack of a borrower.
3. Jurisdictions such as Germany, Netherlands, Ireland and Belgium having similar legal protections for investors.

In addition, the cross fertilisation of ideas where parties involved in Europe that have looked at or completed CGR transactions in the UK is an additional positive factor, as is the post pandemic need to rebuild businesses.

In the table below we compare the UK CGR market with Europe where we conservatively estimate the market size could equal that of the UK with potential to surpass the UK in the medium term given the larger multi jurisdictional opportunity.

UK	Europe
Current Market size >£4 billion	Current Market size <€250 million
Potential Market Size up to £10 billion	Potential Market size €10-€15 billion
Fastest growing part of long income market in the last few years	Nascent market with opportunity for growth
Now becoming standard asset class	New investment grade asset class
Historic legal framework used to create a compelling and efficient way of owning real estate	Similar historic legal frameworks in all core target countries allow for a similar investment product
High risk-adjusted returns	High risk-adjusted returns

Commercial Ground Rents – Three broad sectors with a diverse range of sub-sectors and asset types

Core real estate	Healthcare / Social	Alternatives
Office / Serviced offices	Care homes	Hotels
Industrial/distribution	Specialist care	Data centres
Business parks	Education	Student
Supermarkets	Medical facilities	PRS
Specialist Retail	Children day nurseries	Automotive
		Leisure/pubs

What makes CGRs attractive to investors?

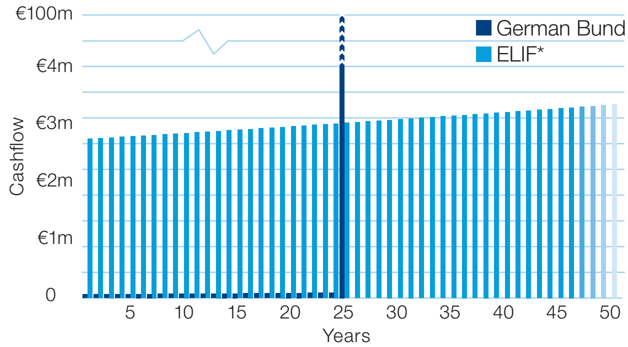
Commercial Ground Rents can be an attractive asset for many investor types. This is because they help meet three objectives common to all investors.

1: The **income generation** objective

Most investors invest to meet liabilities, and an asset providing a set of contractual cashflows to help meet these liabilities will be attractive.

Typically, the cashflow profile can be very attractive versus other assets providing contractual cashflows. The chart on the right compares CGR cashflows with a portfolio of long-dated inflation linked German government bunds. For investors pursuing 'cashflow driven investment' strategies, CGRs can be one of the core assets of such a strategy.

Portfolio Cashflows: European Long Income Fund versus German Bund (€100m Invested)

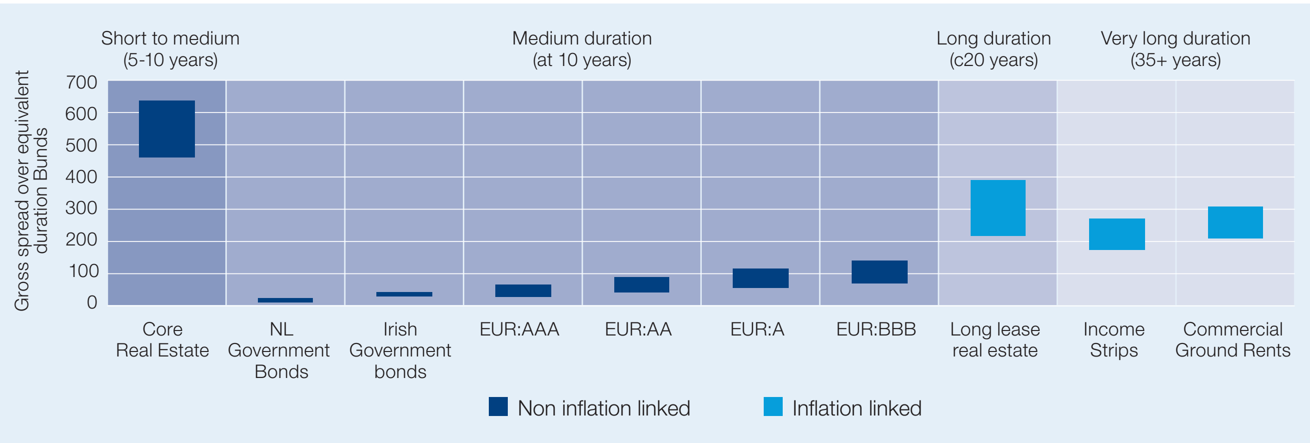


* This is the Alpha Real Capital 'European Long Income Fund', the cashflows are based on a model portfolio consisting predominantly of Commercial Ground Rents.

2: The **return** objective

The forward looking returns available on many high quality investments are currently at historic lows and investors are searching far and wide for yield. The nascent nature of the CGR market means that this is a relatively untapped source of return. In the chart below, we compare the spreads - above German government bonds of comparable maturity and nature (i.e. real/nominal) - currently available on public fixed income assets and also in the long-income real estate investment space.

Higher yielding secure income opportunity



The spreads available of European CGRs are based on our experience as active participants in the market.

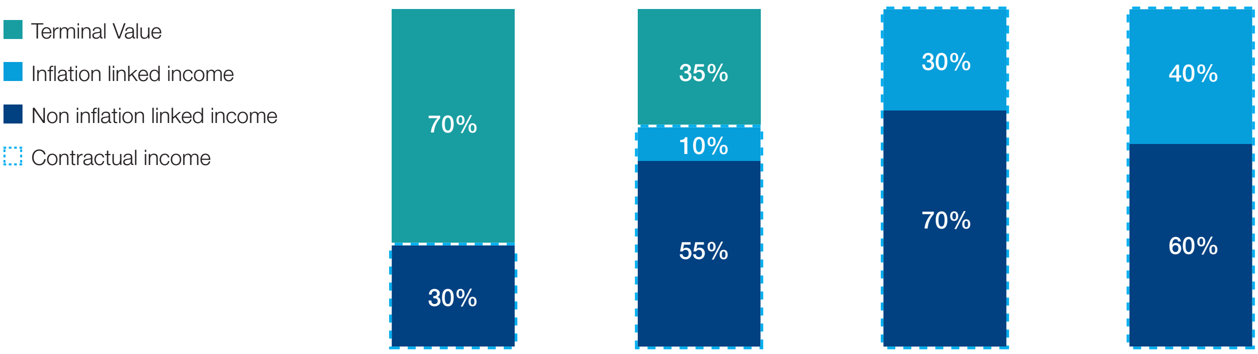
Focusing on the spread comparison versus public market fixed income assets, the chart shows that the spread available for what is typically an investment grade asset can be more than 2% higher than lower credit quality publicly traded corporate bonds.

3: The **risk management** objective

When making a comparison with other long income real estate assets, it is worth taking a closer look at the risks driving the return.

While CGRs have a lower spread versus core real estate and more traditional long-lease real estate these areas both have a high level of direct exposure to the price of the property asset at the end of the lease contract effectively meaning that somewhere between 35% and 70% of the return is a contingent on what happens at the end of the current occupational lease. This risk is not present in CGRs as the return is driven from the long term cashflows with little or no reliance on the 'reversionary' value risk , thus making the spread available very attractive on a risk-adjusted basis.

Fully contractual inflation-linked long-term income



	Core Real Estate	Long lease real estate	Income strip	Commercial ground rent
Typical lease length	5-10 years	15-35 years	25-70 years	70+ years
Gross IRR	6% to 10%	5% to 9%	3% to 6%	3.5% to 6.5%
Reversionary Risk	Very High	Low to medium	Zero	Zero
Asset collateralisation	100%	100%	80%-100%	30%-40%
Income collateralisation Lease rent	Market rent	Market rent	At or below market rent	10-20% of market rent
Cashflows contractually linked to inflation	No	Often	Always	Always

Investors always look to improve risk-adjusted returns whenever possible. This can mean investing in assets that help to match the interest rate and inflation characteristics of their liabilities or can improve the diversification of their overall portfolio. While the importance of each of the above objectives will vary by investor type, by geography and by regulatory jurisdiction, CGRs can be beneficial for a wide range of investors, be it a Dutch pension fund or a German insurance company.

A note on classification for asset allocators

In our experience, asset allocators can face a dilemma when deciding how to classify CGRs. On the one hand, as discussed above if classed as a property asset without looking at the underlying risks, then CGRs can appear relatively unattractive. On the other hand, due to the property focused nature of the businesses being underwritten CGRs are not always classified as fixed income investments.

While investors will come to their own formulations in this regard, our approach is to regard CGR as an alternative credit instrument that falls in the intersection of fixed income, property and private markets transactions – and requires a commensurate blend of skills for successful investments to be made.

CGRs demonstrate that a rigid classification of assets by type could lead to missing good opportunities.

Why are CGRs attractive to borrowers?

To understand this market a good question to ask who are the 'borrowers' and why are CGRs attractive to them?

A CGR contract can be considered as a financing tool for the Leaseholder. It offers a source of long term capital that is low cost, has a predictable servicing cost and is 'quasi permanent' without refinance risks. Further, CGRs offer a compliment to conventional real estate finance, meaning they are one part of a capital stack along with traditional bank debt.

Where CGRs are used by owners or acquirers of real estate as a financing option, they are typically looking to operate businesses where real estate is a core component. The origination of a large proportion of CGR assets is therefore driven by M&A activity or existing businesses looking to re-finance.

The main reason property owners/acquirers use CGRs as a means of borrowing is that they are able to reduce their cost of capital by releasing value from the real estate assets embedded in their business. The leaseholder retains the right to use the property and there are no onerous restrictions in place; their operational interest with a CGR in place is akin to an 'effective freehold interest'.

CGR works in a number of ways to enhance value for borrowers

- The level of rent under a CGR contract aims to be sustainable in the long term and therefore typically well below market levels. This translates to a lower cost of borrowing.
- The Leaseholder interest has significant value as it retains the majority of the income generated from the property (i.e. EBITDA less the payment of the CGR rent to the Investor) and the long lease interest can be used as collateral for securing additional debt.
- The long-term nature of the CGR contract effectively eliminates refinancing risk.
- The adjustment of rent in line with inflation rather than rent reviews susceptible to property market cycles creates servicing predictability.
- CGR interests are aligned with bank financing in seeking income and not capital gains. This provides a stable super-senior element within a financing stack which is complementary to bank finance being raised on the borrower's long leasehold interest.
- If the borrower fails to pay the ground rent, the bank has full statutory step-in rights to protect its own collateral. The bank may marginally reduce the multiple it lends and/or increase its borrowing cost, but when blended with the CGR remains more efficient than traditional senior and mezzanine finance.

Summary

The Commercial Ground Rent market in Europe has the potential to grow rapidly, replicating the successful growth we have seen over the last few years in the UK. Initial transactions have happened, providing proof of concept to many stakeholders. In particular, owner/acquirers have been able to understand how CGRs help to reduce their cost of capital. We are thus seeing a potential pipeline of €250m, growing to €500m p.a. as being sustainable, and this is across a diverse set of sectors. Investors on the other hand, faced with a low return environment may find that including CGRs in their portfolios can help them meet their investment objectives.

While each investor will need to consider the risks in the context of their portfolio and objectives – for instance CGRs are currently a relatively illiquid asset class – reasons to explore allocating to CGRs is compelling.

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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Commercial Ground Rents

Investment opportunity in a time of adversity

Commercial ground rents as a compelling fixed income alternative

With bond yields at all-time lows, where else can investors turn for contractual cashflows?

European Long Income Property

Secure real asset-backed income for pension funds and insurers

Lifetime Mortgages

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

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

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