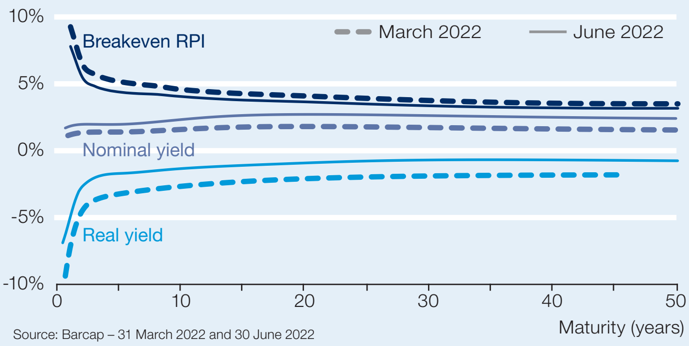
# Market Monitor: Q2 2022

Alpha Real Capital

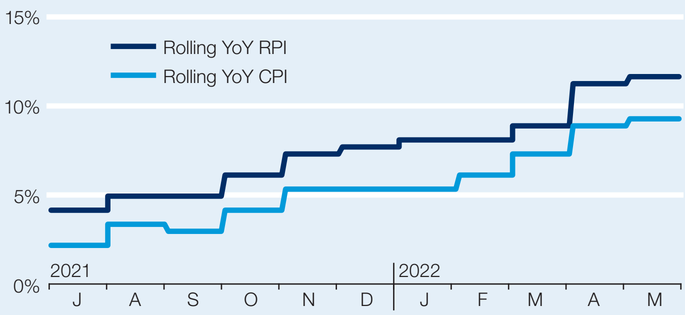
## Rates, inflation and credit spreads

### Gilt yield curves




Source: Barcap – 31 March 2022 and 30 June 2022

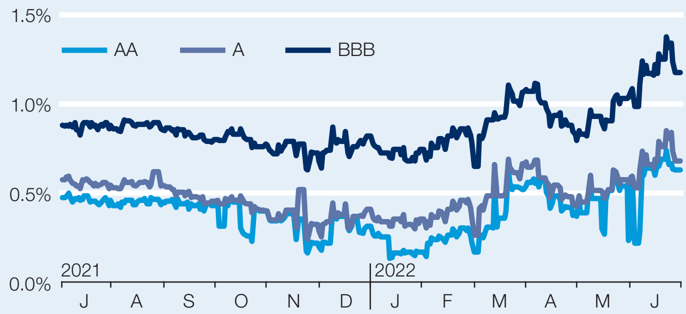
### 12 month rolling inflation




Source: ONS – 30 June 2022

- Real Gilt yields increased c. 125bps on average over the quarter at short, medium and long ends of the curve.. Nominal Gilts also increased by c. 70 bps in the shorter terms and above 80 bps at longer maturities. The short-term increase is primarily driven by expectations of continued Bank Rate increases to fight inflation.
- Inflation continued its upward trend over the quarter. RPI (CPI) rose c. 11.7% (c. 9%) in the last 12 months. Shortages in goods and the labour force; supply-chain bottlenecks; higher energy and food prices were key drivers of the recent uptick. In June 2022, the Bank Rate was raised from 1% to 1.25% to combat inflation.
- 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. The uncertainty provoked by the war in Ukraine continues to impact on the spread volatility, as does growing fears of recession, explaining the upward trend.

### Credit spreads




Source: S&P Capital IQ 10 year non-financial GBP bonds – 30 June 2022

## Secure income market update


### Spreads remain compelling for secured long income assets

- Spreads over equivalent nature risk-free yields for Long Lease, Social Real Estate and Commercial Ground Rents have tightened by 120 bps from the previous quarter. This is because asset yields have remained stable while the underlying risk-free yields have increased. In contrast, Income Strips, which are more reactive to movements in risk-free rates, have tightened by 60 bps.
- Spreads for Renewables over risk-free real rates shrunk by 125bps, while over nominals they have tightened by 70bps.
- As the higher-than-expected inflation period lasts, the inflation linked nature of the assets (albeit typically capped) has acted to support valuation and pricing. We discuss the impact of higher interest rates on Commercial Ground Rents on page two of this market monitor.

### 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.

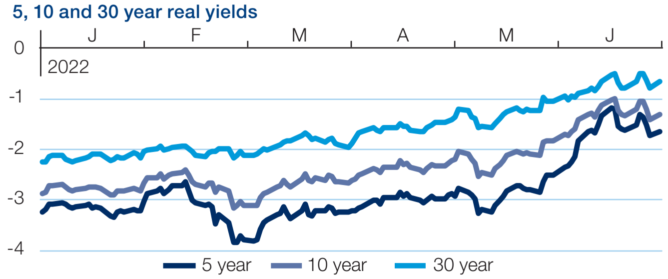
Sources: Alpha Real Capital (for illustrative purposes only and for typical transactions available to pension schemes in these asset classes). Data as at 30 June 2022. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating 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 2022.

## Why Commercial Ground Rent valuations remain stable despite higher interest rates

**As CGR assets are long-dated and inflation linked, they are more sensitive to changes in longer dated real interest rates. Although CGR are not explicitly priced by discounting future cashflows, thinking about the asset class in this way can help inform our understanding of sensitivity to changes in interest rates.**

As CGR assets are long-dated and inflation linked, they should be more sensitive to longer dated real interest rates. The chart below shows that both long-dated and short dated real interest rates have increased. As we discuss further below, we would expect that if higher interest rates persist for an extended period, this would eventually feed through into valuations. To date however, we have not seen this feed through into CGR yields, and as a result the derived spreads versus index-linked risk-free assets have fallen as real yields have risen.

**5, 10 and 30 year real yields**




We discuss a number of factors that may help to explain why this is the case:

- **Liquidity** – CGR are illiquid and priced less frequently. As a result, the impact of higher interest rates will take some time to feed through to valuations.
- **Valuation methodology** – Interest rates are not a primary short-term driver of CGR yields in the same way as they are for other assets which are valued using discounted cashflows. Rather, the methodology is more akin to traditional property valuation. This type of valuation is influenced by a host of other factors that can be specific to the location and type of operating asset involved, and this may require bespoke and expert input.
- **Higher inflation levels** support an increase in valuation of these assets. The fact prices have not fallen highlights the inflation protection provided by the contractual inflation linkage in CGR assets. The expected impact can be broken down into two components:
  - **Surprise inflation** (higher than expected) means all future cashflows are uprated by the level of unexpected inflation that has occurred. This has been substantial (for example, 12 month RPI was at 11.7% in May 2022, much higher than the expected inflation embedded in the price originally paid for these assets). Although the rental payments for CGR are typically capped at 5% p.a., surprise inflation acts to mitigate the impact of interest rate increases.
  - **Inflation expectations.** There will also be a positive impact if expectations of future inflation (break-evens) increase.
- **Security of the asset**
  - The over-collateralisation inherent in CGRs is a source of security. Income cover is typically around 8x the operating revenue and asset cover around 2.5x the ground rent financing. This means rental levels are relatively affordable and the 'loan to value' is low.
  - As the freehold owner of an asset, an investor in a CGR effectively enjoys a super-senior position. Failure to pay resulting in forfeiture of the lease would theoretically allow the freeholder to assume ownership of the operating asset.
  - As we would expect to see higher quality credit assets outperform lower quality credit assets in a deteriorating economic scenario, the secured, investment-grade, inflation-linked cashflows from CGRs are likely to be attractive in a scenario where there is a flight to credit quality.

### Do we expect prices to fall?

Given the level of interest rate increases and the likelihood that interest rates may continue to rise a natural question is whether prices will eventually reflect the new environment? To answer this we look at what factors influence the two parties to a CGR transaction and where transaction pricing could be headed.

CGR tenants are the owners/acquirers of the operating asset, and the CGR will form part of their financing. They are effectively the supply side of the CGR market.

- As other financing options become expensive with rising interest rates and increasing risk aversion, CGR may become relatively attractive. This will tend to increase supply and (all other things equal), push CGR yields higher.
- However, if tenants are worried about inflation (they may not be in a sector where inflation can be easily passed through to end customers) or think they may be able to refinance at lower rates in the future, they may not be as keen to enter into long-term CGR contracts, this would reduce supply and constrain any increase in yields.

Where these forces balance out will be tenant specific, varying by business sector and a tenant's capital requirements given their business strategy.

Institutional investors are the demand side of the CGR market. Pension schemes looking to invest will be allocating based on where they find themselves in their funding journey given recent market moves. As always they will also be comparing versus the prospective returns available on other investments they could make, allowing for the risks taken.

Despite the volatile markets, higher real rates mean most pension schemes have healthier funding levels. This means they may be looking to de-risk into cashflow generating assets that offer good returns and also reduce the burden on their LDI portfolios to hedge liabilities. If spreads continue to be attractive versus the risk/return offered by alternative cashflow generating assets then higher demand could support CGR prices.

**We continue to see demand for CGR from pension schemes. We are also seeing demand from other institutional investors. This indicates that demand may lead to spreads above risk-free rates continuing to fall, thereby providing support to CGR prices.**

## Contact Alpha Real Capital


**Please get in touch with your usual Alpha Real Capital representative or contact:**

### Client Solutions

+44 (0) 207 391 4780

clientsolutions@alpharealcapital.com


# Alpha Real Capital

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




04 5039 0722