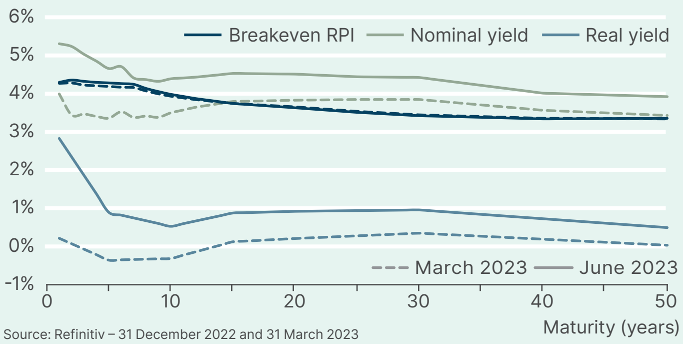
Market Monitor Q2 2023

AlphaReal
Real assets. Real security.

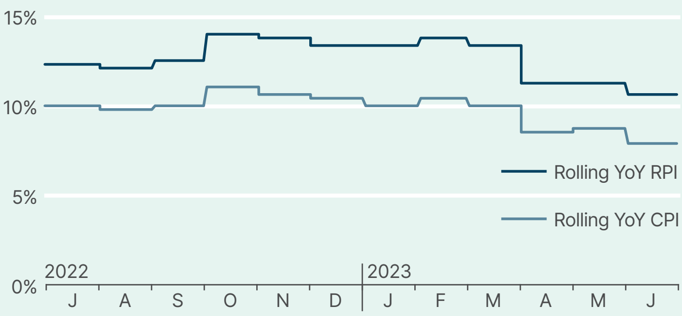
Rates, inflation and credit spreads

Gilt yield curves



Source: Refinitiv – 31 December 2022 and 31 March 2023

12 month rolling inflation



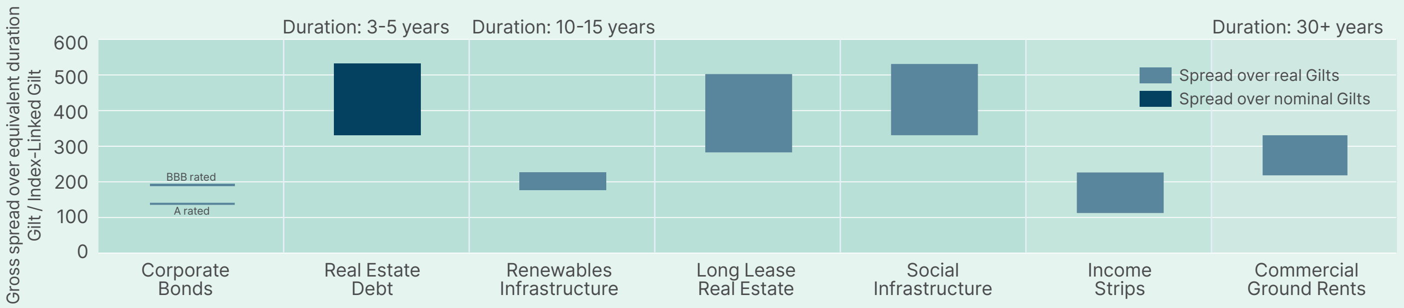
Source: ONS – 30 June 2023

- Yields on Nominal and Real Gilts substantially increased across all maturities over Q2 2023.
- Nominal rates increased by c130bps at 5Y maturity while at longer maturities increases were between 60 to 80bps. Real yields increased similarly across the curve.
- Market derived inflation expectations remained at similar levels over the quarter across maturities. Actual inflation prints reduced modestly over the quarter, the 12 month CPI increase was 7.9% for the month of June this compared with 10%+ prints in each month of Q1. Nevertheless, inflation in the UK remains elevated compared to the more rapid decreases seen in the US and Europe in recent months and the Bank of England is expected to remain hawkish for longer as a result.
- Spreads on non-financial corporates were rangebound, ending the quarter slightly lower than at the beginning of the quarter.

Credit spreads

Source: Refinitiv 10 year non-financial GBP bonds – 30 June 2023

Secure income market update



Spreads remain compelling for secured long income assets

- Spreads over risk-free yields for Commercial Ground Rents remain unchanged, spread to real rates remain largely unchanged due to softer yields. Income Strip spreads remain unchanged in line with valuers' latest views.
- There were no changes in the spreads for Social Infrastructure whilst the spreads for Long Lease were pushed out by 25bps at the top end.
- Spreads for Renewables over the equivalent duration gilt fell by 50bps at the bottom end to 175bps. We note that the upward shift in gilt yields is not being fully reflected in both valuation discount rates and pricing, so spreads are lower this quarter. The range is narrower this quarter reflecting current pricing activity.
- As the higher-than-expected inflation period lasts, the inflation linked nature of the assets (albeit typically capped) has acted to maintain values and spreads

Asset class definitions

Senior Investment Debt: 5-year interest and fees cashflow from senior investment term-loan secured against core real estate where interest is comprised of a margin over either SONIA or BoE base rate.

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 Infrastructure: 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).

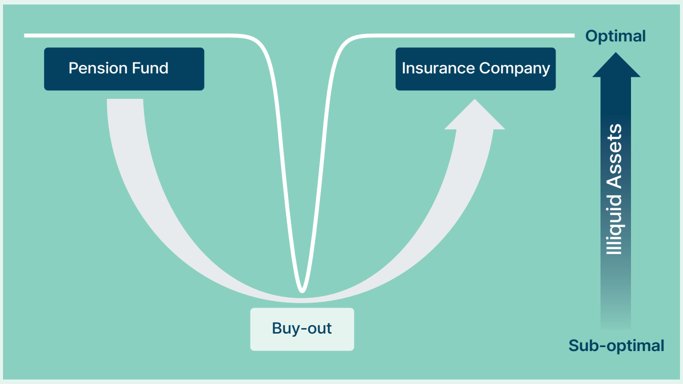
Commercial Ground Rents: 100+ year inflation-linked leases on commercial real estate, with a higher degree of rental and value cover than a traditional sale & leaseback.

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 2023. 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 2023.

The liquidity kink

Many UK pension funds can afford to buy-out with an insurer, but face the 'liquidity kink'.

This is where they are forced to sell illiquid assets prior to transacting with an insurance company, while the insurer is likely to use the cash or gilt assets transferred to buy very similar assets to those that were recently sold by the pension scheme. This is particularly true for assets that are a good match for long-dated and inflation-linked liabilities. The 'liquidity kink' leads to inefficiency and higher costs that are ultimately borne by pension scheme members.



This 'liquidity kink' will impact many of the pension funds now moving into surplus as a result of higher rates. Consultancy LCP estimates that almost 18% of schemes are fully funded on a buy-out basis, and 45% are at least 90% funded. Many more pension schemes will be faced with the 'liquidity kink' than anticipated.

To help pension schemes manage any 'liquidity kink', We summarise below the main ways schemes can address illiquid asset holdings. See 'The liquidity kink revisited – illiquid assets and buy-out transactions', for a more extensive discussion.

Schemes can take advantage of a market more willing to accommodate illiquid assets in buy-out transactions. We suggest six approaches to illiquid asset holdings that schemes can consider for a more efficient, cost-effective buy-out.

Redemption of units in normal timeframes

For example, a six-to-12-month timeframe can be enough given how long buy-out transactions take.

Premium payment

It is common for insurers to allow a small amount (up to 5%) of the premium to be paid at the end of the post-transaction data cleansing period, typically a 12-to-18-month process. Combined with the time it takes to plan and implement a transaction, a scheme could have up to two years to make good the last 5% of the premium, which provides considerable additional flexibility to sell illiquid assets.

Deferred premium

Where schemes need further flexibility, some insurers offer the ability to defer more of the premium for longer. For example, it might be possible to defer up to 10% of the premium for five years. Some insurers also offer lots of flexibility around when the deferred amount is paid, for example making good the whole amount deferred only at the end of the deferral period. There would likely be an interest charge for premium deferral, but it is then straightforward to undertake a cost-benefit analysis of the deferral.

Deferred start

Under this option, a scheme only ensures its future benefit payments starting 'N years' from transacting. As the first 'N years' cash flows remain a liability of the scheme, the buy-out premium payable is lower, and this could be structured so the premium is at a level that avoids the need to sell illiquid assets. However, the scheme does still need to meet benefit cash flows in the first 'N years'. If the scheme's illiquid assets provide income, this could be used to meet those cash flows. There may be other options such as short-term finance or borrowing from the sponsoring employer that could bridge the gap to fund those cash flows and avoid selling illiquid assets. Deferred start solutions are typically more suitable for more mature schemes with a decent proportion of their liabilities relating to retired members.

Financing

Where a deferred premium or deferred start are not feasible or desirable options, a scheme could look to borrow against the illiquid assets to provide the liquidity so that the buy-out premium can be met in full, but without the scheme having to sell illiquid assets with a haircut.

Sponsor asset transfer

A scheme's trustees and sponsor would need to take appropriate advice, but it may be an option for the sponsor to agree to take any illiquid assets, to avoid the need to sell them. In return, the sponsor would provide the scheme with the funds to meet the insurance premium. This is likely only to be an option for larger employers and where the illiquid asset is material enough to make this worthwhile.

The 'liquidity kink' is a live phenomenon for many pension schemes, what is encouraging though is that the industry is actively innovating to accommodate illiquid assets in buy-out transactions. This is underpinned by the growing appetite from insurers to hold illiquid assets. This bodes well for schemes with a longer investment horizon, as they can more confidently take advantage of the illiquidity premium knowing that insurers are becoming more open to taking on the right kind of assets as part of a buy-out transaction.

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AlphaReal
Real assets. Real security.