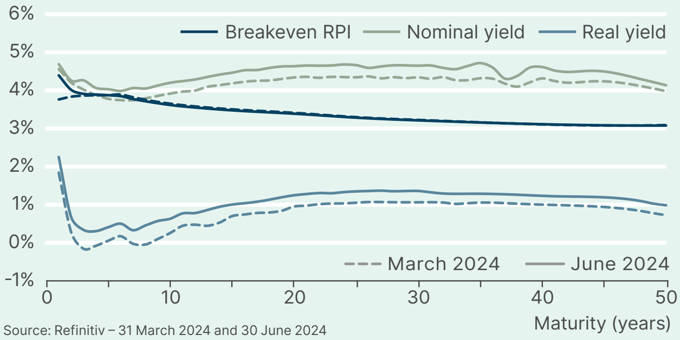
Market Monitor Q2 2024

AlphaReal
Real assets. Real security.

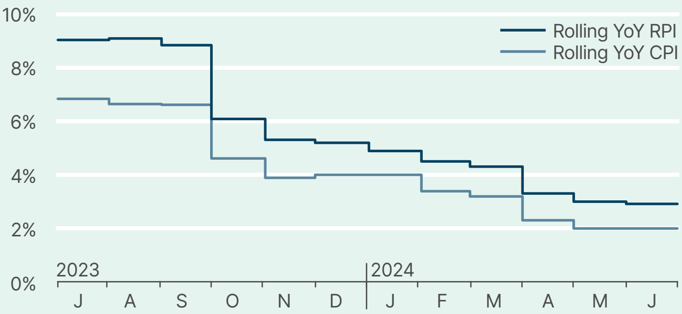
Rates, inflation and credit spreads

Gilt yield curves



Source: Refinitiv – 31 March 2024 and 30 June 2024

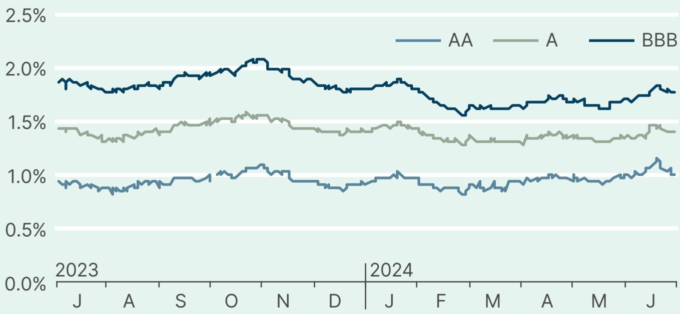
12 month rolling inflation



Source: Refinitiv – 30 June 2024

- We saw an upward move in both nominal and real gilt yields over the quarter. The nominal curve increased by an average of 26 basis points (bps), while the real curve increased by 31 bps.
- Inflation continues to fall toward the BoE target, following the trend of the previous quarters. YoY RPI rate at the end of May was 3%, while the CPI rate 2%.
- Interest rate cut expectations are continuing to be pushed back as they have been all year but are forecasted now to be August/ September 2024.
- Across the quarter, non-financials corporate credit spreads hovered around 95bps, 135 bps and 170bps for AA, A and BBB rated securities, respectively. During the quarter we saw higher volatility in credit spreads compared to recent quarters.

Credit spreads



Source: Refinitiv 10 year non-financial GBP bonds – 30 June 2024

Secure income market update

Spreads remain compelling for secured long income assets

- Spreads over risk-free yields for Commercial Ground Rents remain unchanged. Income Strip spreads also remain unchanged. We note that valuations have stabilized over the past few months.
- Spreads for Renewables have tightened this quarter to 2.25% over 12-year gilts at the low end, and 3.25% at the top end. This is due to underlying valuer discount rates remaining stable this quarter, while the risk free rate has increased.
- The top end of Social Infrastructure increased by 15bps, whilst the bottom end increased by 30bps; valuations remained stable across portfolios and there was a lack of transactions in the market generally.
- Investment and development debt spreads pulled in at the bottom end to 300bps whilst the upper end remained the same.

Asset class definitions

Real Estate 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.

Renewable 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 2024. 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: Refinitiv 10 year non-financial GBP bonds – 30 June 2024.

Unlevered infrastructure
The optimal route to funding the transition to clean energy

Investors can access renewable infrastructure through debt or equity. Our approach uses unlevered equity. Investing on an ‘unlevered’ basis is where the investor takes equity ownership of the whole infrastructure project / capital structure and gains full control of the assets.

We summarise how such an approach to renewable infrastructure (specifically UK solar and onshore wind) could help investors and might be the most optimal route to access renewable infrastructure in the UK right now.

Comparing the approaches

The table below compares different ways of financing renewable infrastructure. We seek to illustrate how an unlevered equity approach currently provides a more attractive investment profile for investors compared with investing using a debt or levered equity approach.

Simplified comparison of conventional debt, unlevered equity and levered equity approaches to investing in renewable infrastructure

	Debt	Unlevered equity	Levered equity
Net Return (IRR) p.a.	5-7%	7%-8%	10%+
Expected volatility	Lower	Lower/medium	Higher
Cashflow certainty	Higher	Medium/higher	Lower
Contractual inflation-linkage	None	Medium/higher	Lower
Control over asset	Lower	Higher	Medium
Speed of execution	Medium	Higher	Medium

While the table compares approaches across a number of factors, we would highlight the following benefits of an unlevered approach:

Improved risk-adjusted returns. Whilst leverage can be a useful tool to boost return, especially in the low interest rate environment seen over the last couple of decades, our view is that using **leverage in the current high and uncertain interest rate environment is currently less accretive to investors’ objective of getting better risk-adjusted returns.** Debt can add volatility to the value of a renewables investment and also added uncertainty to the cashflows generated by the investment.

We believe cash buyers can have an edge in deployment. Cash (unlevered) buyers can offer sellers more certainty of execution versus having a buyer who needs debt to finance the investment. This is because leveraged buyers have to factor in the practicalities of raising debt as part of the acquisition process. This can introduce risk into the process and in our experience **developers of clean energy assets generally prefer cash buyers due to the added deal certainty**.

An additional benefit of not having any leverage is greater manager flexibility and control over assets. This is because there are no **debt related covenants and restrictions to observe that can stop managers maximising value for the equity owner**. An example of this is more flexibility on the type of revenue stream chosen; that is either through merchant electricity sales or longer-term fixed price contracts (Corporate Power Purchase Agreements).

To summarise, an unlevered approach to renewable infrastructure investment can mean better risk-adjusted returns, easier deployment of capital into renewables assets and fewer restrictions on maximizing value for the investor.

Contact us

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