

# Commercial Ground Rents

What type of pension schemes should invest?

2024



Over the last two years or so there has been a seismic change in the UK pension scheme investment landscape. The Pension Protection Fund<sup>1</sup> reports that the solvency ratio on a full buy-out basis has improved from 74% (with only 8% of schemes being in surplus) in March 2021 to 112% in March 2023 (with 63% of schemes being in surplus). This means that buying out with an insurance company is now affordable for many private sector schemes. However, trustees now have more to consider before handing over actuarial surpluses to insurance companies and many schemes are potentially looking at longer-term investment horizons.

## What type of pension schemes should invest in Commercial Ground Rents?

In this insight we:

- 1 Revisit Commercial Ground Rents (CGRs) as an investment that can help pension schemes meet their long-dated and inflation-linked liabilities.
- 2 Provide an update on how the CGR market has evolved and what pension schemes should therefore factor in when investing in CGRs.
- 3 Discuss the type of pension schemes for which CGR investments are the most suitable.

<sup>1</sup> (Pension Protection Fund) PPF Purple Book 2021 and 2023. The PPF 7800 index funding level improved from 103% to 134% over the same period.

# What is a CGR?

A CGR is an asset backed by operational real estate, structured to generate secure, long-term, inflation-linked income. CGRs are created by transacting the freehold of a property and a leasehold at the same time.

→ The owner of a property sells the freehold to a third-party investor. In a CGR transaction this is typically sold for around 40% of the value of the combined freehold and leasehold (market value).

→ The third-party investor leases the property back to the original owner (or potentially another party) under a long-term lease. This would typically be for 40+ years. As this is a bilateral transaction, the rent can be negotiated in a bespoke manner, which means it is possible to create a rent linked to inflation, with a cap and floor.

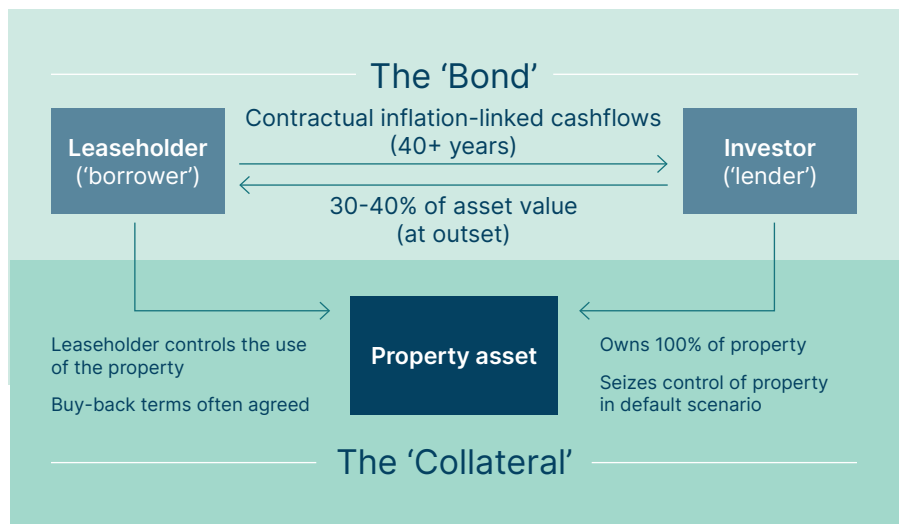
In this way, the owner/acquirer becomes the tenant and the ground rent investor becomes the landlord, as illustrated in the diagram.

## CGRs have similar features to bonds

- Long dated (can be >40 year) lease
- Asset typically acquired at 30-40% of value
- Lease set at below-market rent
- Rent is typically paid quarterly
- Annual to 5 yearly rent reviews linked to inflation

### Typical leaseholder requirements

- Pay for maintenance, property costs, insurance and taxes
- Freeholder's consent to make alterations or sell its lease



One way of looking at this is that a 'bond-like' asset is created that is a long-dated, inflation-linked financial asset with highly secure cashflows.

It is worth highlighting that CGRs are not the same as residential ground rents. While both use similar legal technology, CGRs are entered into willingly by two commercial counterparties, one seeking capital, and the other providing it in exchange for a return. This is why CGRs have not been affected by recent government initiatives like the Leasehold Reform Act.

# Some key benefits of the CGR structure for pension schemes

|                                      |   |
|--------------------------------------|---|
| <b>Returns (Illiquidity premium)</b> | CGRs can play a dual role within a pension fund's overall portfolio; as a matching asset and also as a return seeking asset contributing to the growth portfolio. The latter is enhanced by the illiquidity premium of 1% to 2% currently available versus comparably rated public market credit.                     |
| <b>Highly secure</b>                 | CGRs are overcollateralised and this leads to security of income and an investment grade rating; the rental income is backed by income generating operational real estate assets with x7 cover ratio for rent and the asset cover ratio is c2.5x (40% loan to value).   |
| <b>Cashflow matching</b>             | CGRs are good cashflow matching assets for pension funds as they are long-dated and inflation linked. They can be a core holding in a Cashflow Driven Investment (CDI) strategy.  |
| <b>Portfolio diversification</b>     | Through CGRs pension funds can access sectors and companies that are otherwise difficult to invest in. CGRs can therefore be complementary to public market credit exposures. In addition, some of the sectors are more resilient to market and economic cycles due to the essential nature of the services provided. |

## Recent developments in the CGR market

The entrance of bulk annuity insurers as buyers of CGRs is a key development in the UK CGR market over recent years. To our knowledge, over the last 18 months or so, around £1.5 billion of CGR investments have been made by insurers. Insurers, for regulatory reasons, are structuring their CGR investments in certain ways. These are worth bearing in mind for pension schemes investing in this asset class.

→ **The average term of leases has become shorter.** Insurance regulation demands tighter asset liability matching than for pension funds in the UK. As a result, CGR lease lengths have become shorter to better match the liabilities of insurers.

→ **CGRs have been structured as debt.** Insurers' requirements have driven the debt structuring of CGR cashflows into long-dated, inflation-linked loans or notes in recent years. Based on publicly available information, over £1 billion of transactions have been executed in this format since late 2022 across various sectors including hospitals, supermarkets and hotels. Many of the loans or notes created have been assigned credit ratings by external rating agencies.

# CGR investments could be suitable for pension schemes

## 1 Private sector defined benefit (DB) pension schemes

These fall into two broad categories

### Schemes looking to run-on

Whether aiming for low dependency (low risk) or looking to grow a surplus, these schemes are likely to adopt a CDI approach. This approach prioritises meeting pension payments as they fall due, and this core objective guides investment strategy. **CGRs could be an ideal asset class for these types of schemes, given the features described earlier.**

### Schemes targeting buy-out

The traditional CGR structure may not be appropriate for these schemes due to their illiquidity constraints. However, the recent developments in the CGR market discussed earlier means that appropriately structured **CGR assets could be classed as 'insurer friendly' and be appropriate for those schemes targeting buy-out as they can be passed directly to an insurer.**

## 2 Local Government Pension Schemes (LGPS)

LGPS funds are currently well funded and are generally open to new members and accrual. **They are therefore naturally placed to invest for the long term and harvest the illiquidity premium.** Many are looking to de-risk to protect their funding positions while also seeking cashflow generative assets to meet increasing pension payments, enhancing the appeal of CGRs.

## 3 Defined Contribution (DC) Pension Schemes

Another set of potential buyers of CGRs are DC pension schemes. **These schemes are looking to invest in illiquid assets, something which is supported by the UK government.** The secure income generating characteristics of **CGRs could be a good fit for DC decumulation portfolios, where members start to draw income from their pension savings.**

## Key takeaways

In this paper we have shown

- 1 Commercial Ground Rents can provide pension schemes with highly secure, long-dated and inflation-linked cashflows.
- 2 Insurers entering the CGR market has led to shorter maturities and CGRs being structured as debt instruments. Pension schemes investing in CGRs may want to factor these 'insurer friendly' features into their CGR investments.
- 3 Corporate DB, LGPS and DC schemes could all benefit from the attractive characteristics of this asset class.

As pension schemes look to reset their objectives and align their portfolios, we believe that investing in CGR assets should be on the agenda.

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## Contact us

Client Solutions  
clientsolutions@alphareal.com  
www.alphareal.com

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