

Why are UK insurers investing in Commercial Ground Rents?

2024

AlphaReal is a specialist real assets investment manager. We estimate that UK insurers have invested over £1.5 billion into Commercial Ground Rents (CGRs) over the last 18 months or so. As a leading player in the UK CGR market, we have engaged with several market participants as interest from insurers has accelerated. This paper seeks to explore the drivers of the increased level of interest in the market and why insurers are investing in CGRs.

Why are UK insurers investing in Commercial Ground Rents?

In this insight we will:

- 1 Introduce CGRs and identify the characteristics that make this asset class attractive to insurers.
- 2 Offer insight into how insurers have driven the evolution of the CGR market.
- 3 Consider Matching Adjustment eligibility and regulatory capital treatment.

CGRs are a property-backed asset class with strong credit features that are particularly attractive to insurers with long-dated, inflation-linked liabilities, such as annuity writers.

With an effective LTV of approximately 40%, strong income cover and asset overcollateralisation, the CGR lease can create a financial asset with an investment grade credit profile, typically an A rating. Maturities can be structured between 40-60 years,

although with CGRs typically fully amortising over the term, the Weighted Average Life (WAL) is shorter. CGRs are private assets which offer an attractive illiquidity premium when compared to similarly rated corporate bonds.

Key features of a CGRs

High quality secure income

Investment grade credit rating (internal)

Tailored cashflows to match liabilities

Long-dated, contractual, inflation-linked and MA eligible

Scaleable, attractive return

Illiquidity premium of 100+ bps versus similarly rated corporate bonds

ESG alignment

Target Environmental and Social impact ambitions

The CGR market is growing and has seen the entry of several new investors in recent years. In the primary market, each transaction is unique and needs to be created which involves expertise in originating and structuring deals as well as real estate, credit and fixed income skills.

AlphaReal is a specialist in CGRs and we can support insurers entering this asset class for the first time, as well as those wishing to scale up exposure or looking for bespoke structures.

Market background

The UK Bulk Purchase Annuity (BPA) market is growing rapidly and competition is strong. Investing in a broader range of assets can help insurers price competitively and grow market share.

A record £49.1 billion of BPA transactions were completed in 2023, representing around 226 pension schemes de-risking with an insurer. LCP, the pension consulting firm, estimates that around 20% of pension schemes (c. 1000 schemes with c.£275 billion of liabilities) could afford to buy-out their liabilities immediately. Demand over the next five years is projected to be £360 billion.

Given the scale of the BPA opportunity, insurers are exploring alternative asset classes alongside traditional assets to help them compete in a growing market that is attracting new participants. Indeed, many insurers are looking to increase illiquid allocations from the industry average 40% of their portfolios to 50%¹. Combined with projected bulk BPA transaction activity, we estimate this may mean as much as £180 billion of demand for private market assets from insurers.

As long-dated, investment-grade assets with an attractive illiquidity premium, an allocation to CGRs can help insurers meet their investment objectives.

¹ HSBC Global Research: UK LDI/BPA Pensions end-game opens new chapter for insurers (May 2023)

What are Commercial Ground Rents?

A CGR is an asset backed by operational real estate, structured to generate secure, long-term, inflation-linked income which can be tailored to match liability cashflows.

CGRs are created from a set of property transactions. A property can be decomposed into (i) a 'freehold' which is the right to occupy and use the property in perpetuity; and (ii) a leasehold, which is the right to use and occupy a property for a finite period of time, usually starting as soon as the leasehold is written. 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 combined value of the freehold and leasehold (effective loan to 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 with the leaseholder entitled to buy back for £1 at maturity, making the asset fully amortising. 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.

Pursuant to these transactions, the owner/acquirer becomes the tenant, and the ground rent investor becomes the landlord. This is shown in the diagram below. One way of looking at this is that a 'bond like' asset is created that is a long-dated, inflation-linked financial asset which is fully amortising with highly secure cashflows.

What's in it for the tenant?

- For an owner, the transaction releases capital which can be used to improve or expand their business.
- For an acquirer, the transaction means they can fund the acquisition alongside equity and bank financing (usually lowering the overall cost of capital).
- The rental payments are affordable, and the capital is long-term. For example, they won't have to refinance every few years at prevailing interest rates.

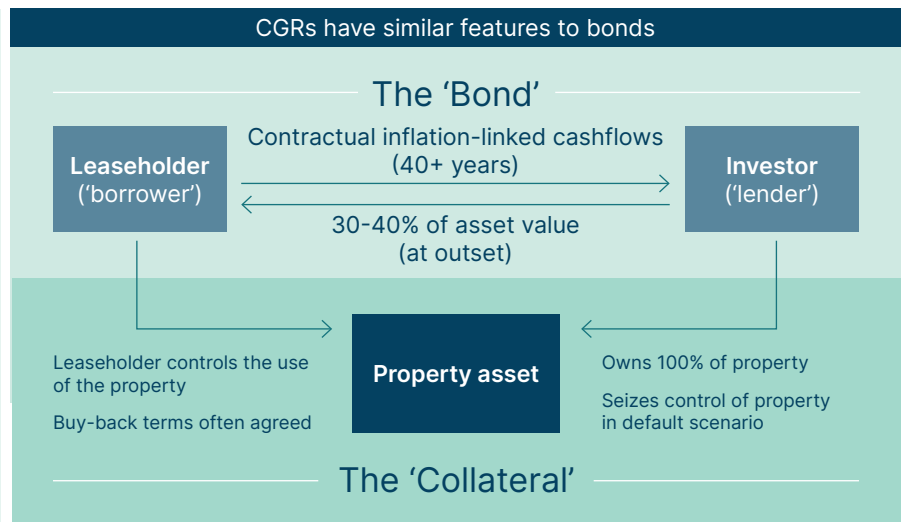
CGRs are therefore a growing, alternative source of financing for the real economy.

Commercial ground rents are a popular financing structure for real estate owners

- 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



Why are CGRs different to residential ground rents?

CGRs are not the same as residential ground rents. While both use similar legal technology, CGRs are entered into consensually 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.

How has the entrance of insurers driven the evolution of the CGR market?



The average term of leases has become shorter

With their long-term liabilities, pension funds have historically been the traditional buyers in the CGR market. Transactions with very long lease lengths (>100 years) were the norm. As pension liabilities shift to bulk annuity insurers, these insurers have started to become significant investors in the CGR market. Insurance regulation demands tighter asset liability matching than for pension funds in the UK. Consequently, CGR lease lengths have become shorter to better match the liabilities of insurers.

AlphaReal is aware of insurers that have transacted CGRs with shorter term leases – as low as 40 years – to fit in with liability profiles and associated regulatory constraints.



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 many other asset classes. Larger transactions are typically syndicated to a few insurers (a 'club deal') while those of smaller scale are often bilateral in nature. Many of the loans or notes created have been assigned credit ratings by external rating agencies, while others have been rated internally by insurers. CGRs have been reformatted as regulation friendly debt instruments, and we see this as an innovation that will drive further CGR market growth.

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What makes CGRs attractive to life insurers?

CGRs may be attractive to insurers as they provide secure, long-term cashflows which may help to match long-term liabilities. In addition, they offer attractive risk/return characteristics and may also have the potential to align investments with ESG ambitions.

Like all investors, insurers seek investments that provide attractive risk-adjusted returns that are additive to their current asset (and liability) mix, helping them better meet objectives.

A combination of higher spreads through an attractive illiquidity premium and potential capital efficiency could assist commercial objectives such as improved profitability and growing market share. In this context, regulatory considerations are particularly important for insurers.

High quality secure income

The cashflows produced by CGRs can be considered very secure. This stems from significant overcollateralization from the real asset backing the contract.



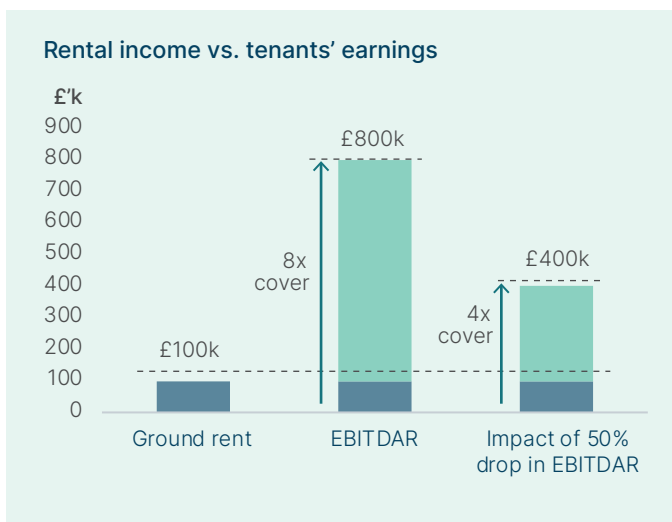
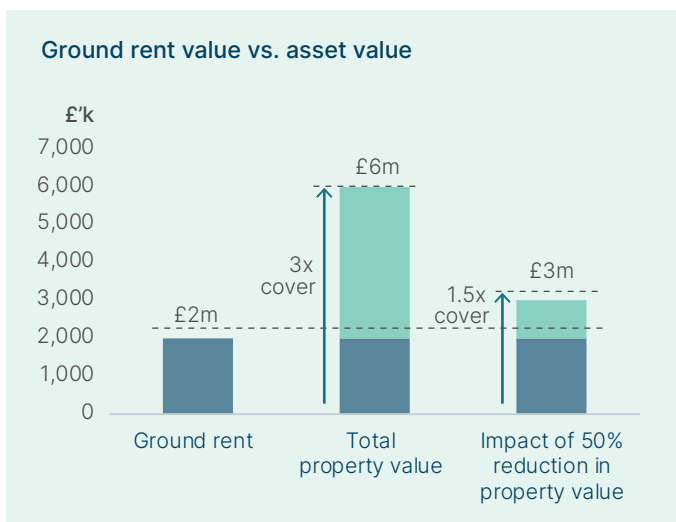
The freehold is purchased for 30% to 40% of the asset's market value. This can be considered equivalent to a LTV on a traditional real estate loan. This means the amount of the CGR is typically collateralized between 2.5x to 3x by the real estate asset, and a severe (60% or more) fall in the market value of the asset would be required for the freehold interest to be lower than the CGR purchase amount.



With an investor owning the freehold of the property over a typical term of 40-60 years, sensitivity analysis and a detailed understanding of the location is important. This includes assessments of alternative use for the building, alternative tenant operators and the robustness of the income cover and asset overcollateralization under stress scenarios.



The level of rent under the lease agreement is set well below market, typically at around 15% of EBITDA. The starting rent and review mechanisms are structured at a level to ensure the rent is likely to remain affordable given the tenant's business model and the sector in which they operate.



Security of income is achieved through overcollateralisation and affordability of rent

These key features, a relatively affordable rental payment and a low LTV, work in combination to ensure a high level of income and capital security. In a worst case (default) scenario, as the freeholder, the investor has recourse to the underlying real estate. In a typical asset capital structure, banks are often comfortable lending against the long leasehold when there is a CGR in

place. In the event of financial stress for a tenant, such banks are highly incentivized to cover the ground rent payments to preserve the value of their own security.

Another source of security is that investors in CGRs can build diversified portfolios across sectors, including those which can perform through economic cycles due to

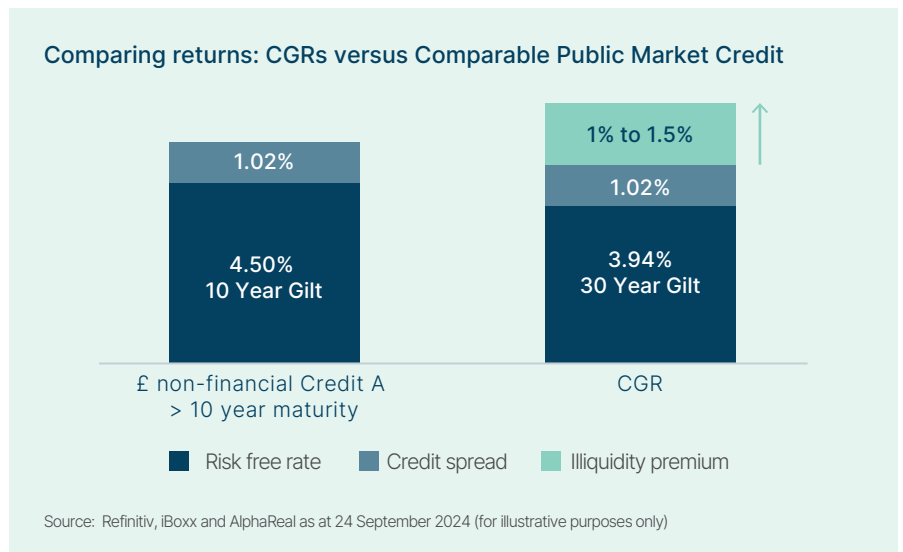
the essential nature of the services provided. It is also worth noting that for some of these sectors, exposure is not available via public markets, which provides opportunity for diversification at a total portfolio level.

Assessing returns

When making asset allocation decisions, it is important for investors to be able to compare risk-adjusted returns between assets on a consistent basis. While individual investors will have their own approach to asset allocation, we illustrate in the diagrams below a high-level framework showing CGRs have some similarities with fixed income.

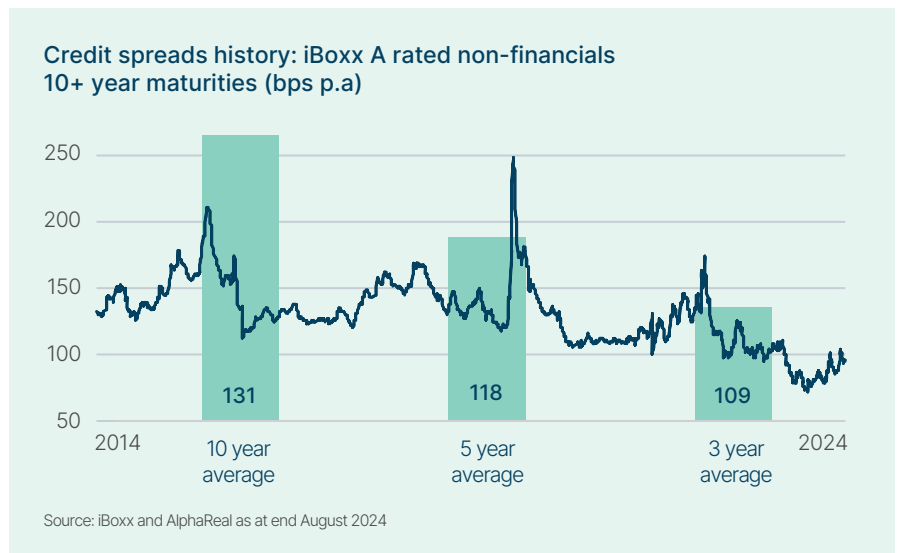
In this chart we decompose the internal rates of return currently achievable on CGRs into a risk-free component and a spread. We show this alongside a decomposition of the current yields available for a Sterling non-financial corporate bond index.

The spreads available on CGRs are based on our experience as active participants in the market. There is a variable but typically significant illiquidity premium over publicly traded corporate bonds of a similar credit quality. In our experience this illiquidity premium can be 100+ bps but at times has been significantly higher.



Currently, the credit spreads available on similarly rated Sterling public credit are at historic lows, as this chart indicates. For insurers that do not require immediate liquidity, the premium CGRs offer presents an opportunity to capture and compound the illiquidity premium over time.

Assessing the risks of investing in CGRs occurs at the intersection of property and credit investing, and this is where AlphaReal's expertise lies. AlphaReal has used its experience in both areas to develop an internal credit rating methodology for CGRs.



Three broad sectors with a diverse range of sub-sectors and asset types

Commercial Real Estate

- Office / serviced offices
- Industrial/distribution
- Business parks
- Supermarkets
- Specialist retail

Healthcare / Social

- Care homes
- Specialist care
- Education
- Medical facilities
- Children day nurseries

Alternatives

- Hotels
- Data centres
- Student
- PRS
- Automotive
- Leisure / pubs

Tailored cashflows to meet liabilities

CGR assets can be tailored to match long-term, inflation-linked liabilities. There is a shortage of long-term, inflation-linked assets to match similar liabilities and CGRs provide a potential source of supply.

Insurers typically need to meet long-term liabilities with inflation-linked cash outflows payable over decades.

CGRs can have maturity dates 99+ years into the future. However, maturities can be tailored to meet

investor requirements, for example recently insurers in the UK have transacted CGRs with maturities between 40 and 70 years.

The rental payments in CGR assets are linked to an inflation index and can include caps and floors.

Investors have demonstrated their ability to tailor the specifics of CGR investments to meet their requirements and we expect this to continue.

Another potential benefit of including a matching asset in the portfolio is that it may lead to less reliance on traditional hedging activity. Holding matching assets, albeit illiquid, may justify a smaller liquid/derivative hedging program and a commensurate lowering of the risks and costs associated with such programs.

While the fit for annuity liabilities should be clear, CGRs can also be a good fit for other types of liabilities, such as periodical payment orders (PPOs).

ESG alignment

ESG is an important area for every investor, and this is no different for life insurers. Real assets such as CGRs can help to contribute towards investor goals in this area.

AlphaReal believes that identifying, measuring, and managing ESG factors can play an important role in ensuring attractive risk-adjusted returns over the long term. We seek to take a quantitative approach to integrating sustainability factors, as we believe this can enhance risk management as well as support consideration of ESG factors into pricing, and ultimately, help identify opportunities.

At AlphaReal, ESG is fully embedded in the investment process for all CGR investments. ESG factors are considered both when making investment decisions and on an ongoing basis through engagement and stewardship.

For further information on how ESG is integrated in our investment process for real estate, including an overview of our ESG Scorecard, please see our Responsible Investing and Corporate Responsibility Policy.*

* <https://alphareal.com/wp-content/uploads/2024/07/Responsible-Investing-Corporate-Responsibility-Policy-2024.pdf>

Regulatory treatment of CGRs

Our experience working with insurers has highlighted some general themes to consider.

Matching Adjustment (MA) eligibility

Under Solvency UK, insurers can benefit from holding assets that match their long-term (MA eligible) liability cashflows. This is especially true when these assets provide a higher return for the risks retained by the insurer, as the spread above the 'fundamental spread' can be used to increase the discount rate used to value liabilities. This feeds through to a lower liability valuation and knock-on benefits in lower capital requirements.

Given the contractual nature of the cashflows, CGR assets appear to be suitable for MA. As CGRs are typically inflation linked they will work best for inflation-linked liabilities (although contracts with fixed uplifts can also be structured). We are aware that some insurers already invest in CGRs and benefit from MA.

Capital treatment of CGRs

Most UK insurers will use an internal model. Based on our understanding and experience working with UK insurers, the capital treatment can be favorable and can be comparable to similarly rated corporate bonds.

Such an outcome together with the higher returns than public credit means CGRs are an efficient asset class for insurers. We see CGRs as a complement to insurers' existing portfolios and to diversify public credit exposures.

Key takeaways

- 1 CGRs are an increasingly popular investment for UK insurers. A CGR is a bond-like asset with highly secure long-dated and inflation-linked cashflows that are a good match for an insurer's long-dated liabilities. CGRs also offer an illiquidity premium of 1% to 1.5% and portfolio diversification benefits.
- 2 While many pension funds have historically invested into CGRs, in recent times insurers have meaningfully entered the market. As a result, the market has evolved. CGR maturities have shortened from 100+ years to 40+ years to tightly match liability cashflows and CGRs have been reformatted as regulation friendly debt instruments.
- 3 Several insurers already invest in CGRs as an approved Matching Adjustment asset and high volumes (c£1.5 billion to date) have been transacted.

In a booming bulk annuity market, where insurers are looking to deploy capital efficiently to compete, CGRs are an asset class well worth considering.

AlphaReal is a specialist real assets investment manager. We focus on secure income strategies that deliver predictable, inflation-linked cashflows to support our clients in meeting their investment objectives.

We provide market leading innovative real asset solutions across the UK and Europe, specialising in commercial ground rents, social infrastructure, renewable infrastructure and alternative credit.

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