London Borough of Croydon Pension Fund
Date: 6 March 2013
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UK Commercial Ground Lease Investments

Executive Summary

- This note brings to the Officer's attention the idea of UK commercial ground lease investments which can serve as an alternative to index-linked gilts and provide a return linked to inflation.
- Defined Benefit pension funds have long-dated inflation-linked liabilities, so it is sensible to invest in inflation-linked assets. Many pension funds also have a long term investment horizon and do not need to hold high levels of liquid assets.
- Whilst there are reasons to expect that return-seeking assets should out-perform inflation over long time horizons, there is no guarantee. For this reason we recommend allocations to assets that offer contractual links to inflation. For pension funds, the natural long term liquid assets with this inflation linkage are index-linked gilts. However, real yields on index-linked gilts are at historically low levels which are unattractive.
- We have identified freehold commercial ground rents as an opportunity offering long-dated cash flows (in excess of 100 years) with good linkage to inflation albeit with a higher yield than index-linked gilts (ground rents will typically transact at yields of 3½% to 4%).
- We would expect nominal returns of 5%-5 ½% per annum net of fees (equivalent to a real return of 2%-2½% per annum above our long term inflation assumption).

What are commercial ground rents?

- The investor will own the freehold of a property subject to a ground lease.
- A ground lease is a long lease, typically 100 years or more, granted by the freeholder on a plot of land (or land and buildings) in return for an annual ground rent. The ground rent is typically 5-10% of the income from the land and buildings.
- At the end of the lease the land and building normally revert back to the freeholder.
- We have a preference for commercial ground rents as opposed to residential ground rents because the latter is affected by potential enfranchisement under UK law (that is, the right for a tenant/s to acquire the freehold ground rent from the landlord).

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Key Features

Income security

- Freehold ground lease investments offer considerable protection for the investor against both tenant default and falling rental values.
- In most cases, the tenant of the ground lease, i.e. the head leaseholder, will rent out the property to an end user to occupy the property. Under UK property law, if the head leaseholder does not pay the ground rent, the freeholder can potentially terminate the lease whilst leaving the occupying tenant unaffected. If such an event occurred, the freeholder would then end up receiving 100% of the rental income. Hence the head leaseholder (or administrator) should always continue to pay the ground rent because the potential loss is very significant.
- Ground leases are protected against most falls in occupational market rental values. This is because the ground rent usually represents a small percentage of the property's total rental income and is usually legally structured in such a way that the rent cannot decrease at a review.

Capital security

- Unlike a default on sovereign or corporate debt (which might lead to a total loss of capital) a default by a head leaseholder could lead to the owner of the freehold ground rent receiving a significant capital windfall. Effectively, the lease on the land would cease (but had already been paid for), and the freeholder would become entitled to the rent from the under-tenants (subject to any vacancies that might exist) or be able to create a new ground lease interest. In this sense, a ground lease can be considered an over-collateralised investment and extremely secure.

Reviews linked to inflation

- Whilst ground rents are traditionally reviewed to a proportion of the property's market rent or rent passing (historically with long dated review patterns, for example every 21 years), there are an increasing number of ground rent opportunities explicitly linked to inflation (usually RPI, but potentially other measures such as HPI or LPI) with shorter rent review cycles (annually or every three, five or seven years). Our preference would be for freehold ground rents reviewed on a shorter rather than longer frequency.
- Based on current pricing for freehold ground rents, we would expect an initial income distribution yield (net of all fees) of approximately 3%-3½% per annum.

Lease length

- As we have already highlighted, an attractive feature of freehold ground rents is that the income is payable by the head leaseholder to the freeholder over a very long time period.

Considerations

- Given high entry and exit costs (total round trip costs of c7.5%), ground leases should be viewed as a long term investment on a buy-and-hold basis.
- Portfolio construction will be driven by the specific characteristics of each freehold ground lease investment rather than market related considerations (for example, relevant weightings to the office, industrial and retail sectors).
- Although they offer pension schemes access to long dated inflation linked cash flows, the mark-to-market valuation of a freehold commercial ground rent is unlikely to be an exact match for movements in the mark-to-market of a scheme's liabilities.
- We would estimate the annual total expense ratio (including manager fees) for a freehold ground rents portfolio to be approximately 50bps.

How to invest?

- There is a relatively limited investible universe for freehold commercial property ground rents. It is difficult to provide an accurate figure as to current pipeline as ground rents are typically created rather than already being in existence.
- Freehold ground rents do not trade that frequently in the marketplace. Accordingly, it is therefore very important that a fund manager has the right skill set and the ability to source and/or structure opportunities.
- Timescales for investing:
  - For smaller allocations, where a client is seeking to invest through a pooled fund, we estimate that it would take approximately 9-12 months to get fully invested.
  - For clients seeking to commit a larger amount (c£100m-£300m) and therefore looking to go down a segregated route, we estimate that it could take up to 15-18 months to build up the target allocation.

Conclusions

- We believe that ground rents are an interesting investment opportunity capable of providing a stable and long term income stream with potential inflation linkage.
- We are happy to provide further information on this asset class and how to access it, should this be of interest.

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