Liability matching with real estate – an alternative approach

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Real estate is a hybrid investment in which a major component of its return, typically about 50% in most UK portfolios, has the characteristics of fixed-interest stock, while the remainder is more akin to equities. The relatively high "fixed-interest component" of UK commercial property derives from the nature of UK leases. These are quite long by European standards, typically between five and 15 years in length, but can sometimes be much longer. Furthermore, there are options to review the rent, usually every five years and, in the UK, these are almost invariably in an upward direction. Assuming a tenant does not go bankrupt, these arrangements mean that UK leases provide a minimum income for a defined period of time which can be discounted just like that of a Gilt or bond.

The remaining 50% of the value of a typical UK portfolio, the "equity component", is derived from the value of the land and buildings at the end of the lease and from any increase in rents which may be received at rent reviews. This value is less certain as it depends upon demand and supply, either for existing or alternative uses.

Every property is unique, and the split between the fixed income and equity components differs greatly with each asset. This article focuses on properties that have characteristics similar to bonds. With the collapse in bond yields since the financial crisis, real assets have proved popular with pension funds keen to find alternative liability-matching investments. We consider that there are three types of property that meet this criterion:

Type A: The entirety of the investment's value is derived from the defined minimum income received under the lease.

Type B: Ground rents where the rent being paid by the tenant is a low proportion of the estimated market rental value.

Type C: Let to good quality tenants on long leases (20 years or more) often with some form of inflation linkage.

In more detail:

Type A

These investments have no residual value when the lease has finished. They are entirely reliant on the rental payments net of costs and expenses to generate the return. Examples include income strips – where the tenant has the option to acquire the property at the end of the lease for a nominal sum – or buildings in unusual locations or with bespoke uses that have uncertain or low value alternative uses. In these circumstances the tenant has to be an undoubted covenant.

Type B

In contrast to Type A, it is the building or site that determines the value of these investments rather than the financial strength of the tenant. Assuming that the building or land has wide appeal to alternative occupiers, ground rents are very low risk as tenant default actually presents an upside for the investor to relet the property at 100% of rental value, resulting in the income increasing by a significant multiple. In reality this upside is unlikely to be obtained as the lease itself has considerable value and in a default scenario would be sold by the tenant's insolvency practitioner to another occupier.

Type C

These properties are far more common than Types A or B. They are let at the market rental value, with the income

component comprising typically 60-80% of the investment's value. Accordingly, to assess the risks fully, the investor needs to think carefully about both the financial strength of the tenant and the residual value of the land and buildings at the end of the lease. Until recently, supermarkets accounted for a significant proportion of Type C properties, but their share has declined as structural changes have contributed to deterioration in the credit rating of the main retailers and a fall in residual values. By contrast, there has been a significant increase in demand for investments in "alternative" sectors such as hotels, cinemas, healthcare, student housing, car parks and social housing which offer sustainable rental income streams underpinned by strong operational performance and valuable alternative uses.

Based on current market pricing, the above types of investment offer prospective real returns between 2-4% pa. with Type B properties at the bottom end of this range due to their lower risk. Although prices are a little expensive relative to "conventional" real estate and history, demand continues to grow as these returns are considered to be attractive in the context of negative prospective real returns from index-linked Gilts.

One of the challenges for those seeking liability matching property investments is supply, with ground rents and income strips being particularly scarce. Investors have broadened their horizons into new sectors, and one area that we believe is particularly interesting is Shared Ownership housing. It provides an attractive combination of Types B and C – long duration, inflation-linked income streams underpinned by high residual values.

Background to Shared Ownership housing

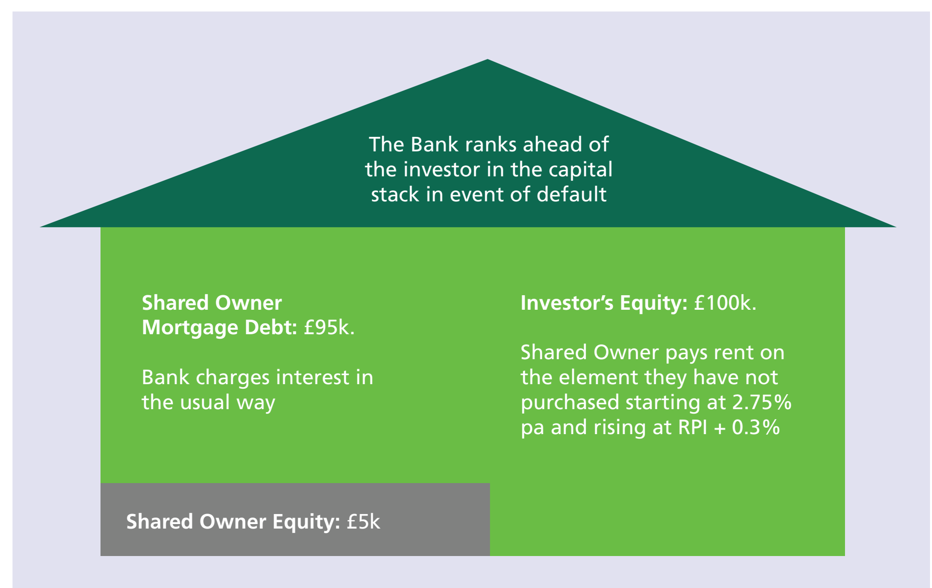
Shared Ownership housing was introduced in 1988 by the government as a way to support the aspiration of lower income households to achieve home ownership. Under a Shared Ownership Lease ("SOL") the Shared Owner ("SO") will buy a proportion of the property at the market value (a minimum of 25% and a maximum of 75%) and pay a rent on the remainder. Over time, the SO can buy more of their home in stages (minimum tranches of 10%). On each occasion, the tenant pays a sum equal to the market value of the proportion being acquired with a commensurate reduction in the rent payable. This process is called "staircasing". Ultimately, the SO can become the sole owner of the home.

How does it work?

To demonstrate SO in practice, we describe below a portfolio that we acquired last year from Derwent Housing Association on behalf of a Local Government Pension Scheme.

- It comprises 218 individual houses and flats. The number of individual SOs provides the investor with a diverse income base.
- The Housing Association retains responsibility for all day-to-day management under a long-term (250 year) management lease for which it receives a fee based on a percentage of the rent collected. This ensures compliance with regulatory rules.
- The Housing Association deals directly with the SOs, being responsible for collecting the rent, arrears, lease

Figure 1: Example of how Shared Ownership works with a £200,000 house with the Shared Owner buying 50%



Source: CBRE Global Investors

compliance and service charge management. This shields the investors from any reputational risk associated with dealing with individual residents.

- Our client's ownership stake in each unit averages 52.5%. The remainder is owned by the SOs through a mixture of equity and mortgage debt.
- The average unexpired term of the SOLs is 92 years.
- The SOs are responsible for the maintenance and insurance of their homes.

Returns from this investment are driven in three ways:

1. The rent being paid by the SOs. This starts at 2.75% of the Open Market Vacant Possession ("OMVP") Value of the unacquired element of the house or flat and rises each year with inflation plus a small margin. On this portfolio, the average rent increase is RPI+0.3% p.a.
2. Staircasing. The purchase price reflects a discount to the OMVP Value of the individual houses/flats of usually between 25-40%. As such, staircasing provides a potential additional revenue stream as, when they decide to buy more of their properties, SOs pay the full OMVP Value as determined by an independent RICS valuer.
3. Capital growth as house prices rise (or fall) over time.

The price paid reflected a net initial yield of over 4% pa. and the investment is forecast to deliver a real return in excess of 4% pa. net of costs over a 25-year hold period. The risks are low as the tenant owns a share in their house so defaults have historically averaged only 0.06% pa. Even when defaults do occur, the fact that the investor has purchased at a discount to OMVP Value protects its equity.

The investment has an additional attraction of meeting clients' corporate social responsibility objectives through boosting investment in social housing to help alleviate the housing shortage, particularly for keyworkers[1] who may not otherwise be able to get on the ladder. Current government policy is seeking to increase institutional investment in the social housing sector, particularly in Shared Ownership. For example, in December 2015, the Mayor of London and Greater London Authority announced that 1,000 new Shared Ownership homes are to be developed with major institutions. For this reason, and given the attractive risk-adjusted returns on offer, we expect pension fund investment in Shared Ownership to increase significantly in the next few years.

Summary

With bond yields set to remain low for the foreseeable future, demand for secure, inflation-linked real estate will continue to grow. Given the constrained supply of suitable opportunities, the challenge is to originate sensibly-priced cashflows which provide reliable long-term income streams. We believe that alternative assets, like Shared Ownership, can be attractive investments for pension funds, helping to meet their liabilities over the long run.

1. An employee who provides a vital service, especially in the police, health, or education sectors