RESIDENTIAL GROUND RENT INVESTMENTS
SEPTEMBER 2010

OVERVIEW

Residential ground rent investments are a relatively unknown asset to the majority of mainstream property investors. However, against the backdrop of the economic and property sector turbulence of the past two and a half years, they have provided the secure income and low risk profile that most investors have been striving for. They have been seen by many investors as a way to diversify their portfolios and better manage risk in their property exposure.

INTRODUCTION

Residential ground rent investments are created by the freehold/ leasehold structure in England and Wales. The ground rent is the annual consideration payable to the freeholder in return for granting the long leasehold interest to the lessee.

STRUCTURE

Modern residential leases are drafted by housebuilders to create tangible and transferrable investment value for the freeholder of the property. The table below illustrates the common features of modern residential lease clauses:

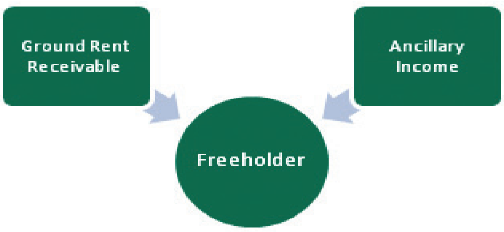
Clause	Details
Lease Term	125 to 999 years
Initial Rent	£100 to £250 per annum
Rent Review Frequency	5 to 33 year intervals
Rent Review Type	Fixed uplift, Retail Price Index, House Price Index, % capital value of the property

Fixed review types are most prevalent with increment levels ranging between £150 and £250. The most commonly found lease length is 125 years.

THE INVESTMENT OPPORTUNITY

Residential ground rent investment portfolios are usually traded on a multiplier (years' purchase, commonly known as YP) or a gross yield applied to the ground rent income. However, unlike both traditional residential and commercial assets, the return generated from the investment is not solely derived from rental income ("Hard Income") and capital appreciation. Ancillary income ("Soft Income") can be generated through the provisions of the lease.

The "Soft Income" produced by residential ground rent investment portfolios includes the premiums payable to the freeholder from lease extensions and income which can be generated from the arrangement of buildings insurance cover for the lessees. These ancillary income streams can help to substantially increase total returns from the asset.

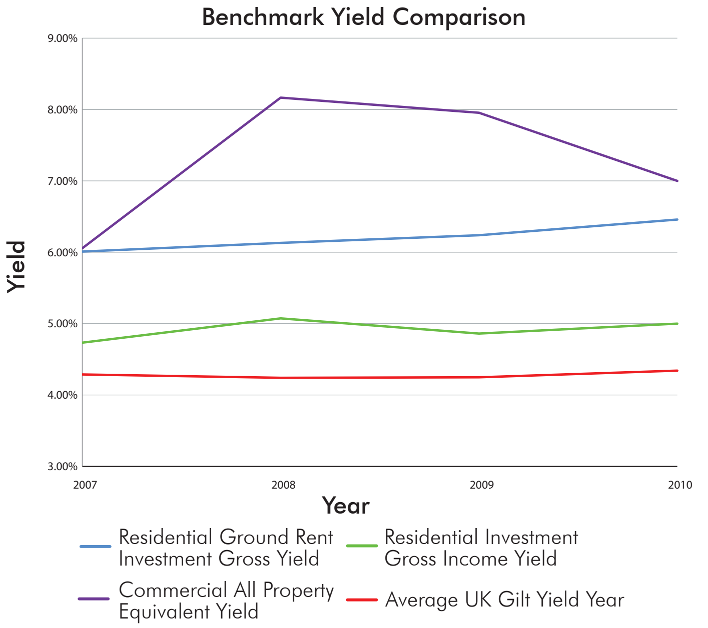


Residential ground rent investments constitute one of the most secure and low-risk property assets available. The investment is secured against the vacant possession value of the long leasehold interest. Ground rent investments are often compared with Gilts, fixed-income annuities and long-dated bonds in terms of their investment profile. However, it is perceived that the total returns available from ground rent investments significantly exceed those available on these financial instruments. Many therefore view residential ground rent investments to be a significantly under-valued asset class at current pricing levels.

YIELD COMPARISON

Residential ground rent investment portfolios differ quite substantially from other property asset classes in terms of their yield profile. Residential ground rent investments have remained relatively insulated from the value drops that have affected the wider residential market in the last two years.

The structure of each residential ground rent investment portfolio varies widely depending on the number of units, review type, review frequency and weighted unexpired term. Based on CB Richard Ellis analysis, the graph below compares benchmark gross yields for non-reversionary (long leasehold interests with over 80 years unexpired) residential ground rent investment portfolios against other property yields as well as against UK Gilts:



Source: IPD, CB Richard Ellis, UK Debt Management Office. 2010 data based upon latest IPD quarterly updates, latest UK Debt Management monthly statistics and CB Richard Ellis forecasts. It is acknowledged that the yield profile of a gross yield differs in that of equivalent yield however we consider this to be the most appropriate comparison.

Yields have remained relatively stable over the past three years for residential ground rent investment portfolios. Commercial property yields have exhibited greater movement. The residential investment sector has seen a modest weakening in yields however the yields displayed are heavily weighted towards investments situated in Central London. CB Richard Ellis would expect gross income yields for residential investment portfolios as a whole across England and

CBRE
CB RICHARD ELLIS

Wales to be weaker and to have varied to a greater degree over the last three years. Importantly the graph demonstrates the relative gap in yields between UK Gilts and ground rent investments. We would also point to the spread between commercial property yields and residential ground rent investment gross yields. The inherent security and non-volatile nature of ground rent investments in comparison to commercial property investments would suggest that the pricing of residential ground rent investments is currently attractive.

THE RISKS

Ground rent investments are subject to a number of risks, some of which are unique to this asset class. These include:

LEASE EXTENSIONS AND ENFRANCHISEMENT: during the term of the lease there is the potential risk that a leaseholder will seek to extend, or as a group a number of leaseholders collectively enfranchise their leases. Under statute law in England and Wales, at lease extension or enfranchisement, the lessees pay a premium to the freeholder in return the ground rent reduces to a peppercorn. The freeholder could therefore potentially lose the rental income receivable.

PORTFOLIO SIZE: the relatively low rents payable on each individual unit means a substantial portfolio is required to maximise all investment benefits. There is a risk that smaller investors may find their income return significantly eroded by the cost of operating a residential ground rent investment portfolio. Small investors will find it difficult to generate the economies of scale that their larger competitors benefit from.

REPUTATIONAL RISK: as with all residential investment assets, ground rent investments can expose the investor to reputational risk. A freeholder's reputation can be significantly damaged if lessees view that they are not fulfilling their lease obligations. Issues can arise in the provision of repairs and maintenance, issuance of management charges and the calculation of service charge costs.

MANAGEMENT INTENSIVE: there is a significant management responsibility and cost involved with ground rent investment portfolios. Responding to leaseholder's requests and queries can be both time consuming and costly.

INDEX LINKED RENT REVIEW UPLIFTS: a significant proportion of ground rent investment rent review clauses are index linked. Common index linked provisions include: RPI (Retail Price Index) uplifts, uplifts based directly or indirectly upon HPI (House Price Inflation), uplifts based upon the average earnings index. An investor with a portfolio dominated by any of these provisions may be vulnerable to movements in the economy or residential sector.

POLITICAL/LEGAL RISK: government intervention in the ground rent investment market remains an issue. The most recent changes have been in the Commonhold and Leasehold Reform Act 2002. It is widely considered that further legislation may be necessary to regulate investors who, in some cases, could be considered to have been neglecting or overemphasising their obligations to leaseholders.

THE BENEFITS

There are a range of reasons for investing in the ground rent investment sector. In our opinion the main benefits include:

PREMIUMS: if the lessee decides to extend or enfranchise their lease, a premium is payable to the freeholder. Under statute law this compensates the freeholder for loss of ground rent income, the potential reversion of the property to the freeholder at the end of the lease and any marriage value which may be payable if the lease has less than 80 years unexpired. In practice, the freeholder will often seek to extend the lease inside of the 1993 Act. The ground rent investor therefore accepts a lower premium than that which may be achieved in an extension outside the 1993 Act in exchange for the rent not reducing to a peppercorn. Freeholders will often seek to increase the rent and strengthen the review provisions in the new lease as part of an extension outside the 1993 Act. Subsequently, the investment value of a ground rent investment can often be strengthened as opposed to weakened at review.

ECONOMIES OF SCALE: major benefits for any large scale ground rent investor are the economies of scale that can be generated from large portfolios. Efficiencies can be secured on both the collection of ground rent income and ancillary income. Many adopt a call centre model for the management of their portfolios. Management is often undertaken through an internal management arm or outsourced to a third party specialist. These economies can increase returns considerably and likewise reduce operating costs per unit.

INCOME SECURITY: the freeholder has the right to commence forfeiture proceedings on non-payment of ground rent or other charges. As the ground rent payable makes up a small fraction of the market value of the leasehold interest itself, the lessee, or even a mortgage provider, is unlikely to risk forfeiture through non-payment. Ground rent investments are therefore considered to be secured against the vacant possession value of the long leasehold interest.

VOLATILITY: ground rent investments have remained relatively insulated from the value drops that have affected the residential market over the last two years. Ground rent investment returns have tended to be weakly correlated to residential or commercial property returns. A common benchmark for comparison has been long-dated Gilts and fixed-income financial instruments. This low risk profile has meant demand for this secure asset class has remained comparatively stable over the last two years.

A number of the potential risks associated with residential ground rent investments can be mitigated:

Risk	Mitigating Factor
Lease extensions and enfranchisements	Lease premiums and extensions outside the 1993 Act
Portfolio size	Economies of scale, call centre business model
Reputational risk	Proficient internal management or outsource to a competent third party manager
Management Intensive	Potential to increase returns and reduce costs through economies of scale
Index Linked Rent Review Uplifts	Diversified and balanced portfolio incorporating a range of rent review provisions
Political/Legal Risk	Any potential changes to legislation or new regulatory measures will take a number of years to be introduced

THE MARKET

Many perceive the ground rent investment sector to be a closed market in which only specialist investors operate. Although this is true to an extent, the ground rent market is well established with

CBRE
CB RICHARD ELLIS

investments trading frequently.

It is difficult to calculate the total size of the residential ground rent investment market due to the structure, age and diverse ownership of housing stock in England and Wales. CB Richard Ellis estimates of the total value of residential ground rent investments produced by newly completed private residential flats in the period 2005 to 2010 are shown in the table below:

Estimated value of Ground Rents for newly completed private residential flats

Period	(£ million)
2005-2006	190
2006-2007	190
2007-2008	195
2008-2009	150
2009-2010	105
Total	830

Source: CB Richard Ellis, Department of Communities and Local Government statistics

The figures above do not include the value of a significant number of houses completed during this period which are subject to long leases with a ground rent payable. Newly built houses subject to long leases are still prevalent (particularly in northern England) however the size and value of this part of the ground rent market is considered small. It must be taken into consideration that not all of the ground rents referred to in the table will be sold; some housebuilders prefer to retain the freehold of their developments whereas other housebuilders retain their grounds rent investments so they can be packaged into a larger portfolio to be sold to an investor at a later date. We would estimate that the aggregate value of transactions annually traded would be significantly above these levels as critically, this does not include the value of existing mature portfolios (i.e. those containing long leases over 5 years since lease commencement) regularly traded between ground rent investors.

INVESTOR PROFILE: ground rent investors often differ in terms of their investment criteria; the majority focus on the 'drier' portfolios which comprise modern leases in which ground rent income and potentially ancillary income can be generated. These 'drier' portfolios contain no opportunity in the medium term to achieve lease premiums. A smaller number of operators focus on portfolios with reversionary potential, where lease premiums are achievable in the short to medium term.

The market comprises a limited number of investment companies with significant portfolios as well as numerous smaller investors. Investors range in size from the few largest investors owning over a hundred thousand units to private individuals owning the freehold of a nearby flatted block consisting of a few ground rents. There are a small number of dedicated funds which exist solely to invest in ground rent portfolios in England and Wales. These funds have continued to provide stable returns in spite of the economic and property sector turbulence of the past two and half years. Thus far, there has been a lack of major involvement from mainstream residential and commercial property investors in the sector. Lack of scale and management responsibility are often cited as key barriers.

TRANSACTIONAL ACTIVITY: there is a perceived lack of transparency in the ground rent investment market as a whole. Portfolios trade relatively frequently with the majority of portfolios of scale (£500,000+ lot size) being bought from housebuilders or traded directly between ground rent investors. Larger portfolios (£5 million+) trade infrequently due to the significant number of units required to create portfolios of such size.

Portfolios are generally sold privately, without wide marketing. A significant number of small portfolios, particularly reversionary portfolios, are sold via auction rather than through private treaty.

THE MARKET TODAY: the past 24 months has seen low interest rates and low returns on typically non-volatile investments such as Gilts. This has attracted a number of new entrants and further investment into the ground rent investment market. A wide variety of smaller ground rent investors have accounted for a significant proportion of portfolio purchases over the past two years. Prior to this, the few large investment companies in the market had tended to dominate transactional activity.

We have found that ground rent investors are struggling to source the quantity of stock they require. Supply of new portfolios is also constricted due to the lack of house building over the last 24 months. Alternative sources of stock such as Housing Associations and local authorities are being considered by some investors.

As shown in the graph on page 1, CB Richard Ellis has established that in spite of the demand/supply imbalance, there has been a softening in benchmark gross yields (i.e a reduction in YP). On small lot size non-reversionary portfolios, strong gross yields of below 5% (20 YP) are still being achieved. On larger lot size portfolios of non-reversionary ground rent investments gross yields are commonly weaker. We have found that on these larger portfolios, over the past three years there has been a softening of gross yields of between 50 and 100 basis points. We envisage this is largely a result of the wider economic conditions and the difficulties investors have experienced in obtaining debt finance to fund their ground their ground rent investment acquisitions.

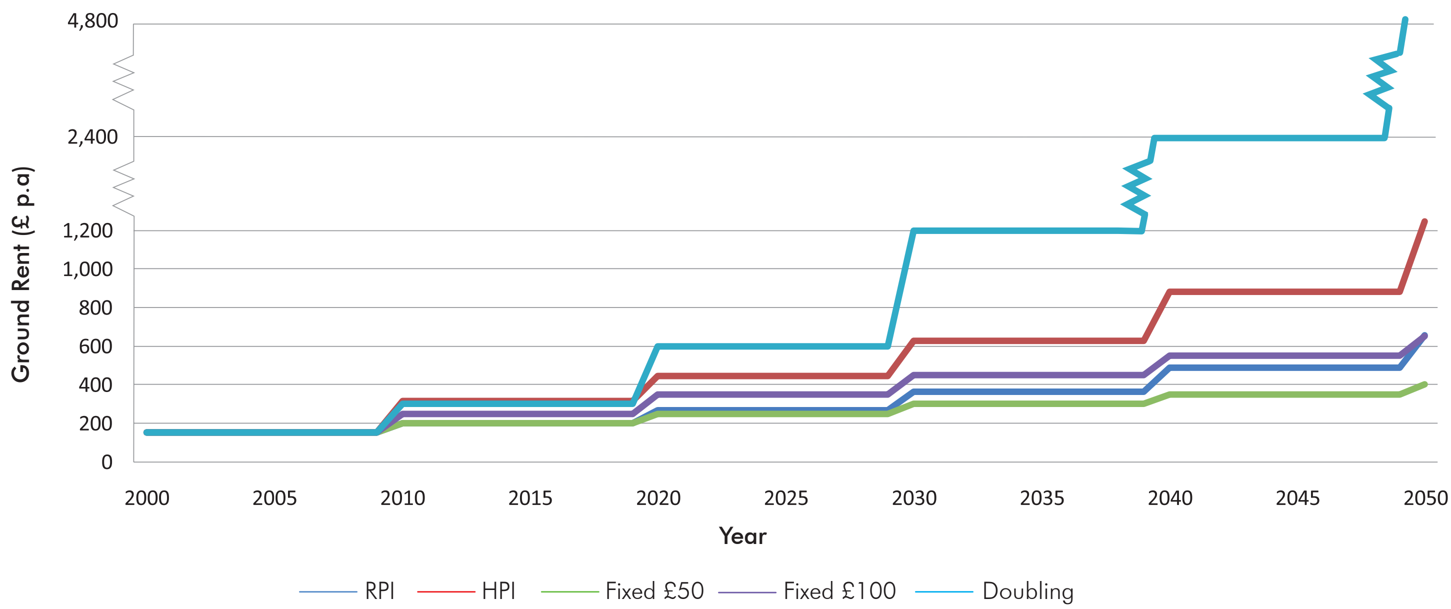
THE FUTURE: CB Richard Ellis expects a continued demand/ supply imbalance in ground rent investment portfolios over the next few years. With interest rates at their current level and low returns available on similar risk financial instruments we foresee that there may be further new investment into the sector. However, investors with existing relationships with housebuilders or a pipeline of future portfolios and access to funding will be the dominant investors in the sector.

THE PERFECT GROUND RENT

Housebuilders have their own distinct way of structuring long leases, with a range of clauses and specific rent review provisions. These rent review provisions are critical for ground rent investors who have been keen to influence the manner in which these clauses are configured.

CB Richard Ellis' analysis indicates that a balance needs to be sought when structuring ground rent review provisions in long leases. A review pattern which increases the rent too quickly has the potential to affect the future saleability of the long lease hold interest. It is likely that potential purchasers of the long lease may be deterred by a high level of ground rent. This may have a knock-on effect on the future ancillary income of a portfolio, such as the lease premium values achieved and also there may also be a reputational risk of being associated with charging high levels of ground rent. Although this may not affect the investment value of the ground rent investment portfolio in the short term, it could adversely affect the portfolio's marketability and ultimately its value in the medium to long term. Some ground rent investors, in spite of their attractive future income profile, will not purchase ground rent investments where the ground rent increases too quickly and to an unsustainable level.

Ground Rent Profile - 10 Year Review Provisions



*Initial rent of £150 p.a. Rent reviewed every 10 years. Long term averages utilised beyond 2009, RPI estimated at 3% and HPI at 3.5%.

Overleaf is a graph displaying the rent escalation of a hypothetical ground rent investment under various review patterns. The doubling provision increases the ground rent at a level far greater than the other review provisions. In 2050 the ground rent would stand at £4,800 p.a. for a doubling provision whereas the other review provisions would range between £400 and £1,244 p.a.

CB Richard Ellis has found RPI uplifts to be most attractive for investors. RPI uplifts provide relatively strong rental growth which does not detrimentally affect the future saleability of the long lease interest. They produce the least volatile income which does not correlate to the property market as a whole. RPI linked ground rent investments also fit a number of investors' criteria of an asset which provides a hedge against inflation. HPI uplifts are common but are considered to be more volatile, and would link the income to the wider residential market, which a significant number of investors may not want to correlate to. Fixed and doubling uplifts are popular but the uplift amount is critical as well as the review frequency. In some cases the fixed uplift amount can be too low, being eroded by inflation, and in other cases too high and detracting from the future value of the portfolio.

We consider a rental uplift pattern of every 10 years to be optimal. This provides a regular review without becoming too frequent as to cause administration issues or to create discontent among lessees.

SUMMARY

Residential ground rent investment portfolios offer low risk, stable returns for investors. The returns available tend not to correlate with residential or commercial property assets. In uncertain times such as the past two and a half years, the sector has provided an ideal investment opportunity for parties looking for a low risk profile asset. We envisage a continuation of new investment into the sector and it is likely that there will be future compression in gross yields with YPs increasing.

Any investors looking at the sector must be aware that that in order to develop a large scale portfolio, an in depth understanding of the sector is required as well as relationships with housebuilders and existing ground rent investors. Furthermore, in spite of the low risk profile, investors must be aware of the significant management and legal responsibilities which ground rent investments entail.

For more information regarding the Residential Ground Rent Investments, please contact:

Jonathan Stickells MRICS
Director, Residential and Regeneration Valuation
t: +44 (0)20 7182 2083
e: jonathan.stickells@cbre.com

James Castle MRICS
Surveyor, Residential and Regeneration Valuation
t: +44 (0)20 7182 2731
e: james.castle@cbre.com

CBRE
CB RICHARD ELLIS