Valuation & Advisory, Q4 2015

Long Income – Commercial Ground Rents Continue to Outperform

Q3 IPD Long Income **2.10%**

Long Term Gilt Blend **12bps** (2.44% → 2.57%)

UK RPI 30 yr Swaps **-4bps** (3.50% → 3.46%)

Tesco Bond Blend **55 bps** (5.95% →6.50%)

*Arrows indicate change from previous quarter.

Figure 1: Bond and Yield Movement, Q4 2015

Rate	Sep 2015 (%)	Nov 2015 (%)	52-week high (%)	52-week low (%)	Trend
UK RPI 30-Year Swaps	3.50	3.46	3.55	3.24	↓
RPI Swaps (blended)	3.49	3.44	3.42	3.38	↓
UK Gilt, 2042 Expiry	2.47	2.61	2.89	2.14	↑
Gilts (blended)	2.44	2.57	2.88	2.14	↑
Tesco Bond (blended)	5.95	6.50	6.50	5.28	↑
Social Housing Bond (blended)	3.87	4.03	4.03	3.24	↑
Prime Foodstores	4.25	4.25	4.25	4.15	↔
Prime Commercial Ground Rent	3.00	3.00	4.25	3.00	↓
Prime Budget Hotel (excl. London)	4.50	4.50	5.00	4.50	↓
Prime Budget Hotel (London)	4.25	4.25	4.75	4.25	↔

Source: CBRE Yield Data, Bloomberg

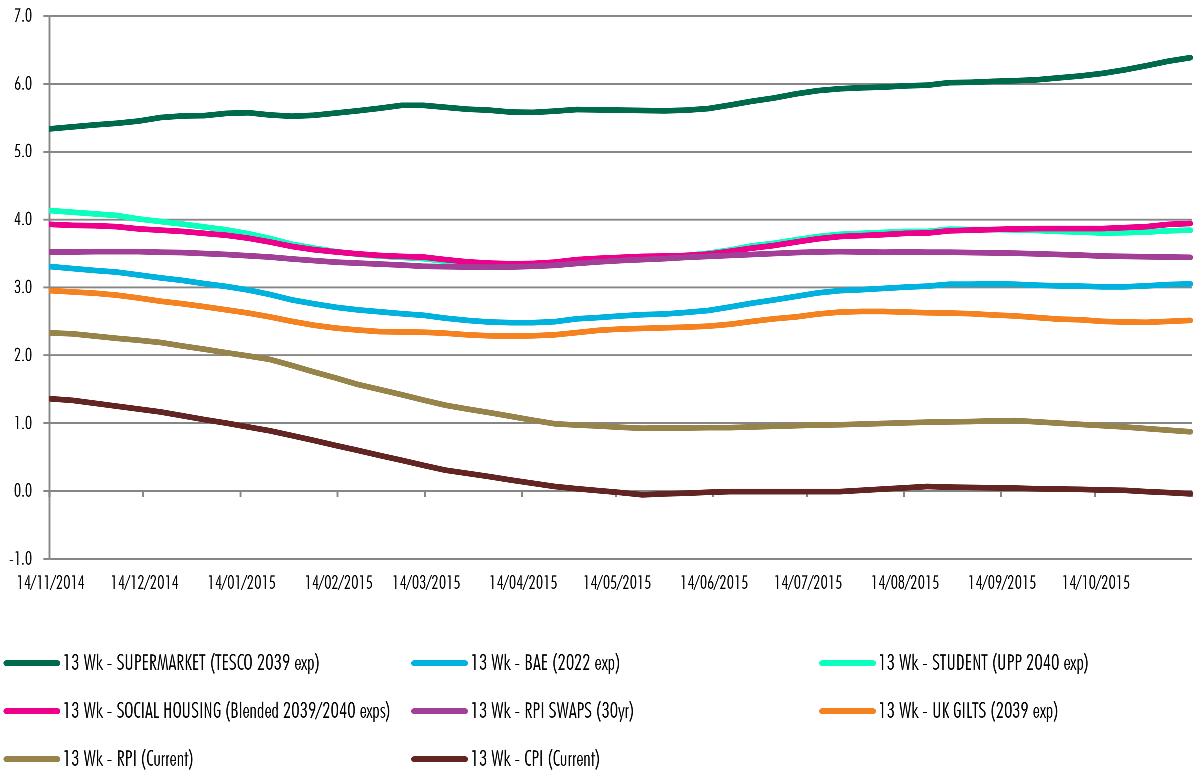
LONG INCOME MARKET TRENDS

- The IPD Long Income Property Fund Index has reported a Q3 return of 2.10%, and an annualised return of 8.20%. This compares to the All Property Fund Index, which reported a Q3 return of 3.30% and annualised returns of 14.50%.
- Blended yields on long dated Gilts have continued their upward trend, softening 14 bps to 2.61% over the quarter. Spreads on Tesco debt continue to widen, with social housing bonds following suit due to regulatory changes.
- RPI swap pricing has come in slightly, due to Eurozone QE and a slightly softer economic outlook.
- Yields on income strip transactions strengthened over the quarter, as institutional demand for secure income continues to outstrip supply.

Marketview Highlights

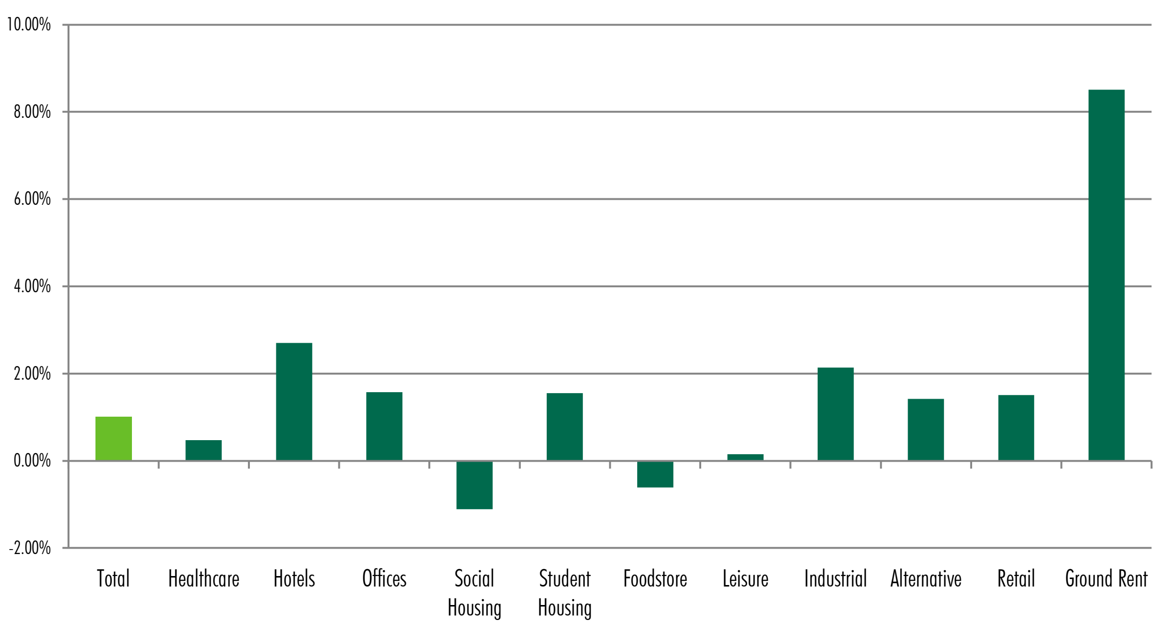
- Commercial ground rents record their strongest quarter since Jan 2014, with value growth of 8.51%.
- James Castle – Residential – Analysis of the residential ground rent market, key transactions and outlook going into 2016.
- CBRE Long Income Index – Q3 performance, valuation weightings and sector specific index figures, offering transparency in the market. Total index growth of 1.02%, with hotels and industrials showing strong sector performance.

Figure 2: Government Gilt and Corporate Bond 12 Month Yield Tracker



- RPI Swaps (blended) are the average of 30, 40 and 50 year RPI SWAPS. They are the 4 week average as at 25 August 2015.
- Gilts (blended) are the average of Treasury Gilts with 2039, 2042, 2049 and 2060 expiries.
- Supermarket Bond (blended) are TSCOLN 5.805% (57 expiry), TSCOLN 6.038% (39 expiry), TSCOLN5.189% (29 expiry).
- Social Housing Bond (blended) are Notting Hill Housing Trust (42), Hyde HA (40), L&Q HT (40), Sovereign HC Plc (39), Affinity Sutton Capital Markets (38), Sanctuary (39), Genfinance (39), Circle Angular (38)

Figure 3: CBRE Long Income Index – Q3 Capital Returns



JAMES CASTLE - RESIDENTIAL GROUND RENT INVESTMENT

Photo: James Castle – Residential

INTRODUCTION

The market for Ground Rent investments continues to move at a rapid pace. In spite of the recent resurgence in housebuilding there remains a fundamental demand and supply imbalance. This, coupled with the historical low yield fixed income environment, has pushed pricing upwards. The market is now largely dominated by long term capital, whether this is institutional funds or investors backed by fixed debt financing of over 60 years. Given the escalation in pricing in recent years the market has become increasingly polarised. A synopsis of market activity of the last few years is considered below:

PORTFOLIO ACTIVITY

Over the last three years we have witnessed an unprecedented level of portfolio transactions. A number of ‘ long term’ investors, or developers who have historically retained their freehold ownerships, have sought to capitalise on current pricing points and exit, or partially exit their holdings. In a sector where nearly all lot sizes are under £2 million, there have been some 10 transactions over £10 million over the last 18 months.

Perhaps of more significance have been the large scale portfolio transactions. Whether these transactions are a reflection of the ‘highs’ of current market pricing, or a nature of circumstance, they have provided benchmark transactions of a scale not previously experienced in the sector before. Historically significant transactions from the perspective of the market include:

- Long Harbour’s circa £93 million acquisition of the ground holdings of the former Brandeaux Fund in early 2014.
- Portfolio acquisition of Berkeley Group’s historic freehold portfolio for £99.8 million in June 2014.
- The acquisition by Long Harbour of a portfolio owned by a large ground rent investor for a reported £240 million in September 2014.

Transactions of the above scale are unprecedented in the residential ground rent sector. We consider further transactional activity on this scale to be unlikely given the recent availability of long term finance (60 years plus) to larger investors. However, given current pricing levels, in the short-term market consolidation in small to medium sized portfolios is likely to continue.

MARKET POLARISATION

Given the escalation of market multipliers over recent years, the polarisation in pricing between investors has become more pronounced. On portfolios in excess of £1 million, three or four particular investors tend to dominate bidding at similar pricing levels, beyond this there is often a major divergence in pricing.

There is a more pronounced spread in pricing for smaller lot sizes, or assets not deemed ‘prime’ in terms of their attributes i.e. developer covenant/planning uncertainties or low underlying collateral levels. Institutional interest on these lots can be limited, with significant discounts in pricing being reflected. The buyer pool is likely to be made up of smaller investors who are generally more conservative in their bidding. We anticipate a continuation of this trend with a focus amongst ‘top tier’ investors on larger ‘prime’ investments.

PRICING

Pricing within the ground rent market has continued to strengthen. We estimate transactional volumes over the past two years to have been in the region of £200 million per annum (excluding the scale portfolio transactions aforementioned). Demand from both market participants and underlying fund investors remains strong due to the low interest rate environment and the knock on effect in fixed income yields.

As can be seen there has been an unprecedented strengthening in multipliers and what we consider to be a potential rebasing in pricing. Multiples on new 10 yearly RPI linked investments stand at 34x multiple (2.94% gross yield) in Quarter 4 2015 reflecting a 15x (2.32 basis point) movement since December 2011 (Figure 4).

Our current benchmark multipliers as at Q4 2015 represent as follows:

REVIEW TYPE	MULTIPLIER (YEARS PURCHASE, YP)	GROSS YIELD
5 year RPI	38	2.63%
10 year RPI	34	2.94%
15 year RPI	29	3.45%
25 year RPI	25	4.00%
25 year doubling	25	4.00%

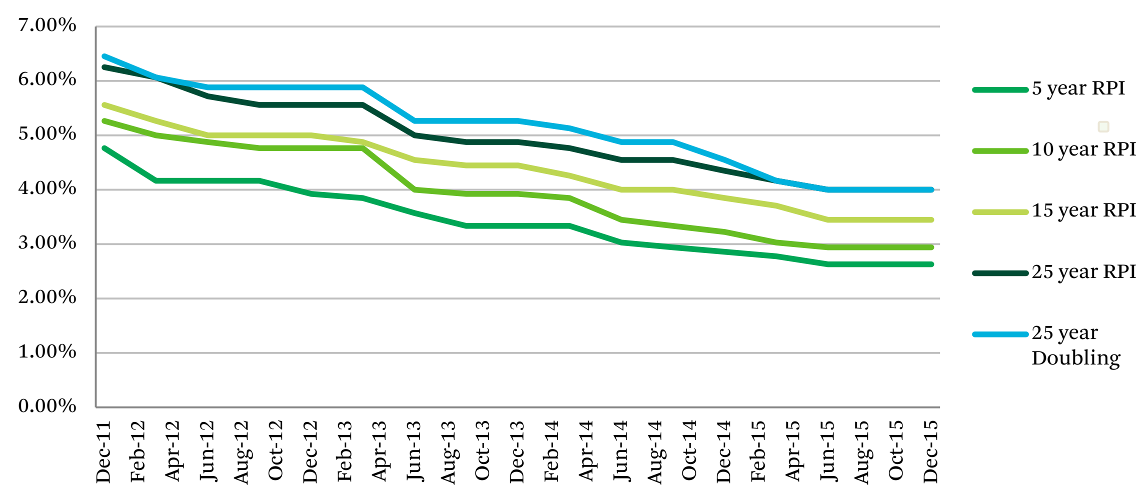
A more recent trend evident over the last few months has been the relative stabilisation in pricing with no major strengthening in pricing over quarter 3 and 4 2015. Whether this reflects a short term abatement in rises, or a longer plateauing in pricing levels remains to be seen.

A limiting factor to future strengthening may be the tight spread between market pricing and individual investor benchmarks. In addition we are sensing investor nervousness about potential policy rate rises and the consequences for fixed income yields.
In our opinion any interest rate rise is likely to affect market pricing from both an equity and debt perspective.

SUMMARY

As this brief note summarises there has been significant activity within the ground rent sector over the last few years. In the short term we envisage a continuing of the consolidation which has occurred over the last few years, particularly of medium sized portfolios. Whether the stabilisation of multipliers in recent months reflects a short term pause or a new phase in activity is debatable. In the medium to long term we believe any interest rate increase is likely to have implications for all investors.

Figure 4: Gross Yield movement



We recognise it can be difficult to draw generalities in a market where assets can have different attributes to different investors. However, the established pricing metrics remain review type and review frequency which are displayed in the graph and table in this article.
Multipliers/gross yields assume freehold, good quality well located town centre scheme with lot size of over £500,000, new leases with 125 plus year terms, full years to review, modern ground rent amount, insurance and management retained by third part management company therefore no ancillary income from these sources, 'normalised' notice fee provisions, no rental or service charge arrears.

CBRE LONG INCOME INDEX

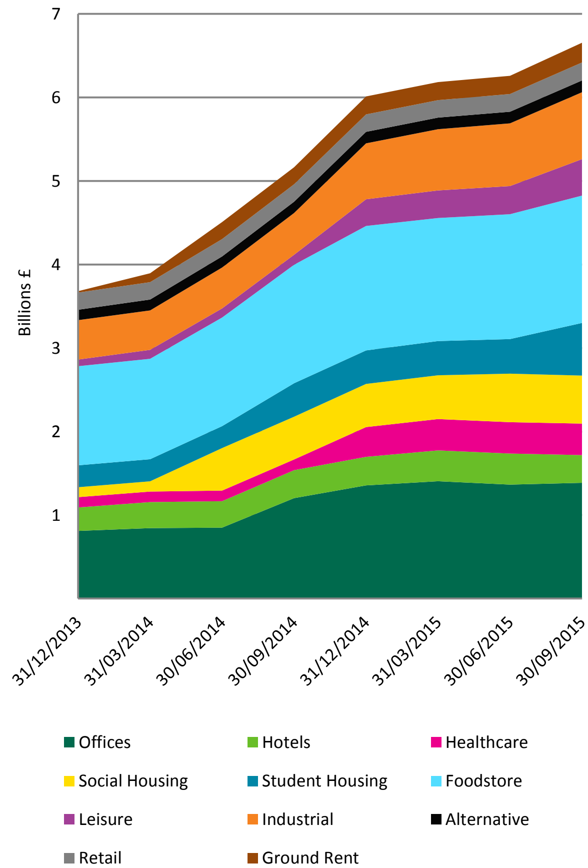
SECTOR PERFORMANCE

The CBRE Long Income Index grew by 1.02% over Q3, and has recorded a twelve month gain of 3.94%, which is slightly less than last quarter's figure of 4.09%. Commercial ground rent capital values increased 8.51%, the strongest quarterly performance since the indexes inception. Industrials showed continued growth, increasing 2.14% over the quarter, accompanied by the hotels sector with 2.70% (Figure 6).

MARKET TRENDS

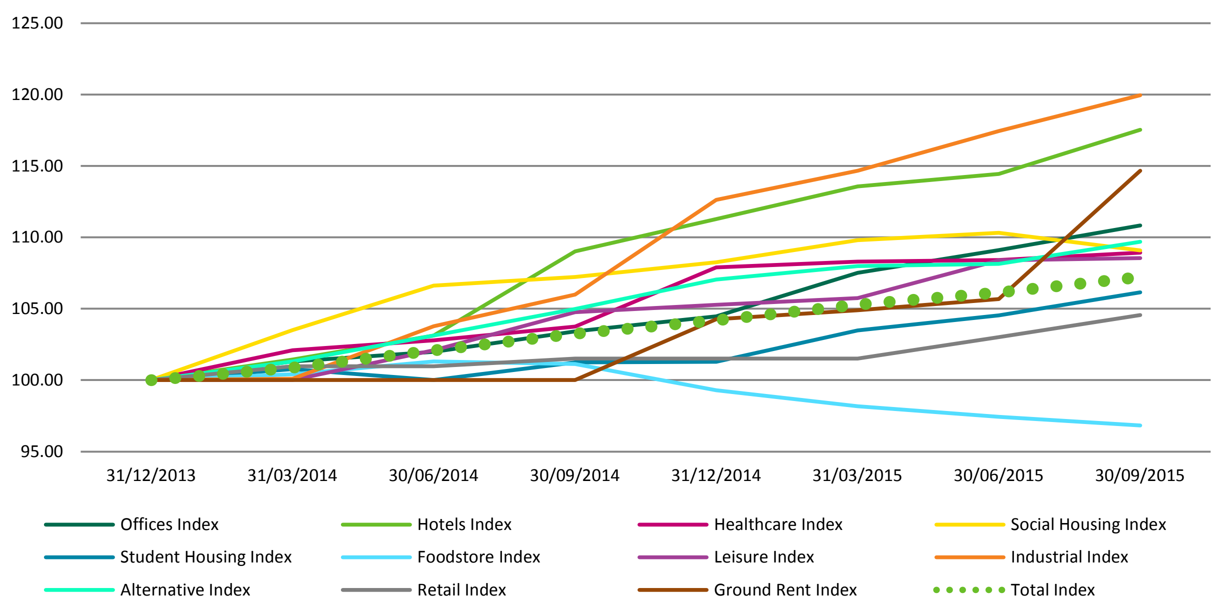
2015 has been another year of growth for the Long Income Funds driven in particular by commercial ground rent investments and specialist asset classes, notably leisure and healthcare. Pricing across all sectors appears to be stabilising with the exception of commercial ground rents and rare high quality income strip investments, where supply falls significantly short of demand. We expect to see a similar pattern in the first half of 2016 with no shortage of capital available for secure long income investments.

Figure 5: Index Weightings



Source: CBRE Valuation Data 2015

Figure 6: Long Income – Capital Value Indices



Source: CBRE Performance Data 2015

CBRE - LONG INCOME TEAM

The CBRE Long Income Team specialise in the valuation of secure long lease inflation matching investments. Led by Lee Bruce, the team combines a wealth of valuation experience and specialist markets expertise to deliver added value for our clients.

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