Spotlight
Ground Rents

Spring 2012

SUMMARY

Ground rents are set to become an attractive investment in a growing market

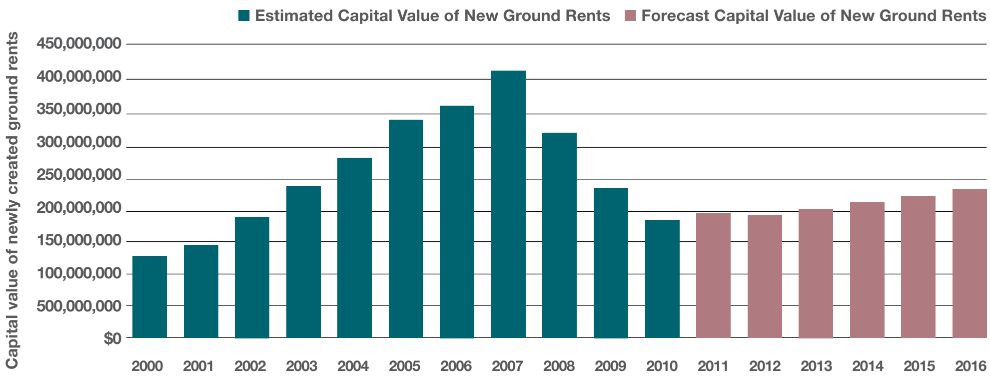
- We estimate that the English house-building industry is currently generating new ground rents worth approximately £180 million a year.

- This is down from the 2007 peak when we estimate that ground rents with a total capital value of £400 million were created.

- However, our forecast for housing delivery over the next five years shows that we can expect the market to continue growing from current levels to delivering product with ground rents worth £230 million by 2016.

GRAPH 1

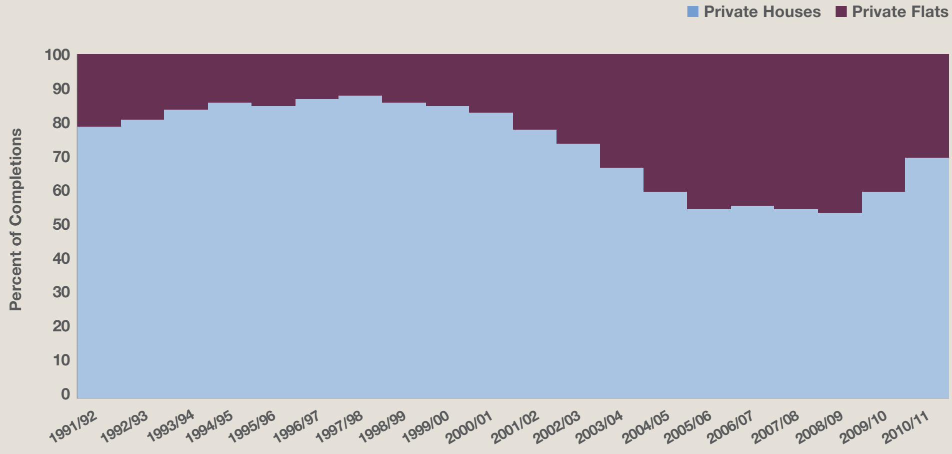
Estimated Capital Value of New Ground Rent Products Created Annually



Graph source: Savills Research

GRAPH 2

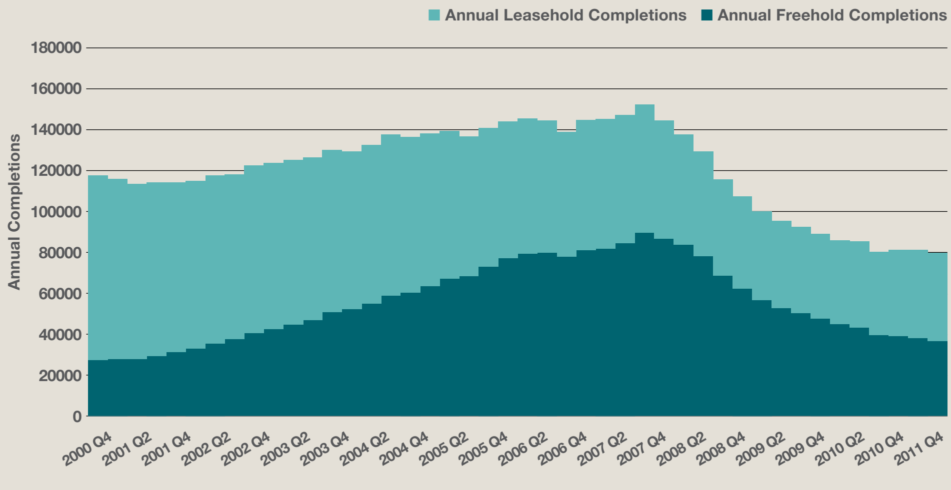
Private Completions by Type of Property



Graph source: CLG

GRAPH 3

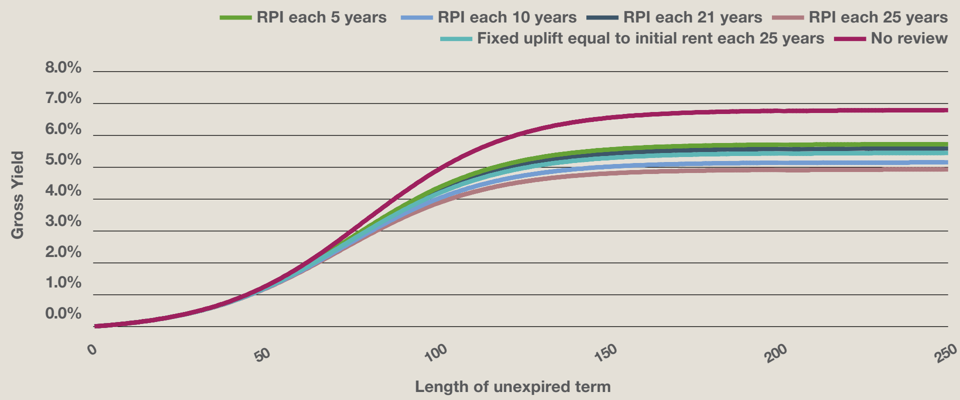
Completions by Lease Type



Graph source: CLG & HM Land Registry

GRAPH 4

Estimated Gross Yields by Rent Review Pattern and Length of Unexpired Term Ignoring Reversionary Value



Graph source: Savills Research

Although the market is small in size compared to many asset classes, it provides an attractive investment opportunity due to the high yields relative to the level of risk involved. Historically the market has been dominated by a small number of niche investors buying directly from developers. Although this is an easy process for the developers, in this era of constrained development finance we believe that they could realise better prices by offering their ground rent portfolios to the wider market.

Size of the market

Following new planning policy in 2000, the density of new build increased substantially while shifting focus onto urban brownfield sites. This resulted in the construction of large numbers of new flats (as a share of new build completions, flats went from 17% in 2000/01 to 45% in 2005/06).

When combined with rising levels of housing supply, this led to an increase in the number of leasehold properties and hence the number of potential ground rents that could be offered to the market.

This period was also characterised by a boom in lending and house prices. With development finance easily available, ground rents were often at the bottom of the pile. They typically represented a value of circa 1% to 2% of the long leasehold value which, at certain times during the last housing market cycle, could have been less than one month's rise in house prices. Accordingly there was no rush by developers to realise the value they offered.

With the onset of the credit crunch, the availability of mortgage lending and development finance collapsed and private housing completions fell from a pre-crunch peak of 150,000 units per annum down to 80,000 units per annum.

This has been combined with an increase in the proportion of houses being delivered due, in part, to constraints on mortgage lending secured against new build flats and stronger demand from equity rich households.

Despite this there are still 36,000 units with an attached ground rent that could be offered to the investment market each year and at current market prices, equating to a market value of approximately £180 million which we are forecasting to increase to £230 million by 2016.

The size of the total market transacted each year will be even larger than this as some assets may be traded on the secondary market and developers may have delayed realising the value of their ground rent portfolios until some time after the physical completion and sale of the underlying unit.

Pricing ground rents

Historically ground rents have been priced on a simple multiple or "years purchase" of the passing rent. That multiple was informed by the lease length, the rent review pattern, and the ability to collect ancillary income. There are broadly four types of ground rent beyond the basic fixed rent with no review, which typically feature review periods of 5, 10, 15, 21 or 25 year periods. These are:

- Doubling each rent review period;
- Increasing by a fixed amount each rent review period;
- Rebased against the retail price index (RPI) at the end of each period;
- Rebased against a percentage of the capital value of the underlying property at the end of each period (location typically has limited influence on the value of a ground rent except in this case).

In recent years, with the increased sophistication of the market, a more measured approach has evolved; specifically forecasting the anticipated income, and then pricing according to risk.

> "Although the market is relatively small in size, it provides an attractive investment opportunity due to the high yields relative to the level of risk involved"
>
> Neal Hudson, Savills Research

Using a set of basic assumptions, we have modelled a theoretical income stream with different types of ground rent review patterns and length of the unexpired term (note that this does not include any receipts from lease extensions) and the resultant gross income yield is shown in Graph 4.

From the patterns shown, we can see in products with unexpired terms of less than approximately 125 years yield is driven down by increases in the reversionary value of the property. For unexpired terms greater than 125 years, the value of the product is determined by the type and frequency of rent review period combined with the macroeconomic assumptions within the model namely the discount rate, long term inflation expectations and house price growth.

As would be expected, a product with no rent review would tend to have the highest yield as the value of the income stream is eroded by inflation over time while a review pattern linked to RPI will trade for lower yields due to an element

TABLE 1

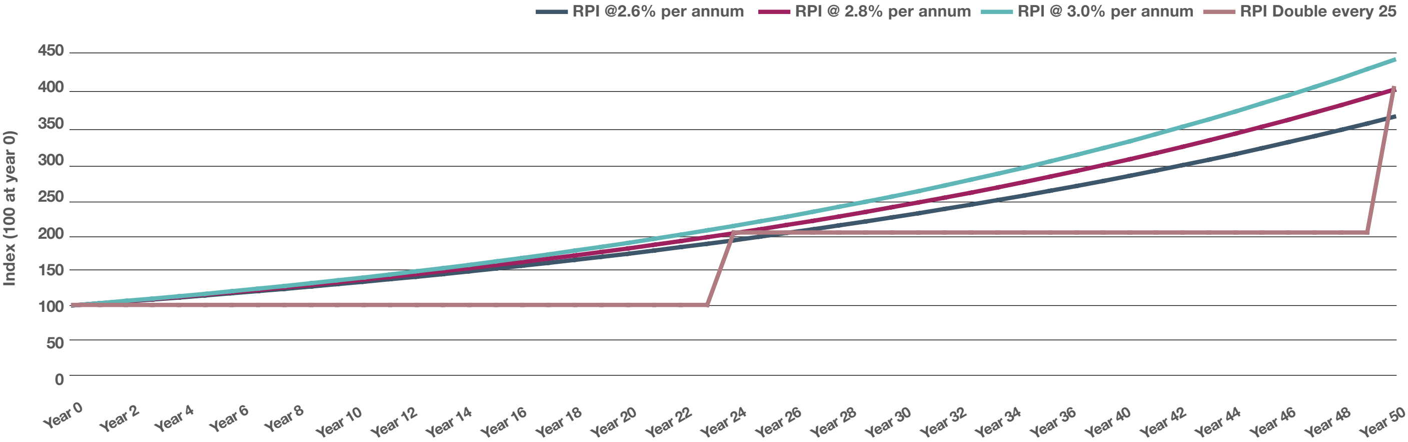
Estimated Gross Yields by Rent Review Pattern Ignoring Reversionary Value

	Gross Yield for Unexpired Term of			
	100 years	125 years	150 years	200 years
RPI each 5 years	3.9%	4.6%	4.9%	5.0%
RPI each 10 years	4.0%	4.8%	5.1%	5.2%
RPI each 21 years	4.3%	5.1%	5.5%	5.6%
RPI each 25 years	4.4%	5.2%	5.6%	5.7%
Fixed uplift equal to initial rent each 25 years	4.2%	5.0%	5.3%	5.5%
Double each 25 years	4.1%	4.8%	5.0%	5.2%
No review	4.9%	6.1%	6.6%	6.8%

Table source: Savills Research

GRAPH 5

Ground Rent Income Stream by Review Type and Inflation Assumptions



Graph source: Savills Research

of inflation protection, with short review patterns offering better protection than longer periods.

As long as this does not detract from the value of the long leasehold interests, the value of the ground rent interest can be improved by creating more attractive rent review terms at shorter intervals.

Consequently some house builders and developers have begun offering products with five year rent review periods. As well as improving the value of the product, investors also show some preference for them because it can enable them to re-gear the portfolio more frequently.

As previously mentioned, the macroeconomic assumptions can dramatically shift the relative attractiveness of different types of review pattern. For example, if the rent review is based on a doubling of rent every 25 years then this review type equates to annual growth of 2.81% realised every 25 years.

If long term inflation expectation are above this growth rate then ground rents, with revaluation based on RPI should trade at a premium (lower initial yield). By contrast if inflation expectations are lower than 2.81% per annum then the doubling income stream should trade at a premium to an RPI review lease.

Ground rents overview

An unusual yet attractive investment

Ground rents are not conventional real estate investments. Whilst owning a ground rent brings with it both rights and responsibilities that are shared with owners of other forms of property, ground rents have some unique characteristics. These come together to produce an investment that is unusual in the property sector, but which can be very attractive in the current environment, as Piers de Winton and Guy Halsey explain:

Secure income stream

The income for the owners of ground rents comes through the operation of leases under which there is a commitment to pay low levels of rent for typically 125 or 999 years. Because the ground rent is usually a nominal sum, the leaseholder is incentivised to pay under the threat of losing their property if they fail to do so and therefore the risk of default is minimal.

In the event of a leaseholder default, the leaseholder's mortgagee will typically pay to avoid forfeiting their security and should there be further default, the freeholder has the right to forfeit the lease and gain vacant possession of the property. Default is therefore extremely rare.

Attractive in current market

The financial crisis has resulted in a re-appraisal of risk with asset classes that were previously thought to be secure proving anything but. In the midst of this, the strong fundamentals of ground rents, particularly the combination of over-collateralisation with a defined and predictable inflation hedge, have proved increasingly attractive.

Consequently during 2011, the ground rent market was characterised by an increase in interested parties with a number of new investors making much publicised high profile entries to the market.

Enabling development

With investors being more aware of the returns that can be generated from ground rent portfolios, the increased competition has driven some investors to forward commit to purchase the freehold ground rent element of a development. This improves the development's cash flow and can help the developer to secure funding at the pre-development stage, therefore improving development viability.

Ancillary income

There is frequently the opportunity to collect income in addition to that produced directly by the ground rents, through lease extensions, administration fees/consents, and insurance commissions.

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