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WHITEPAPER

When equity becomes debt: The untapped potential of amortising-lease real estate

By Luke Layfield

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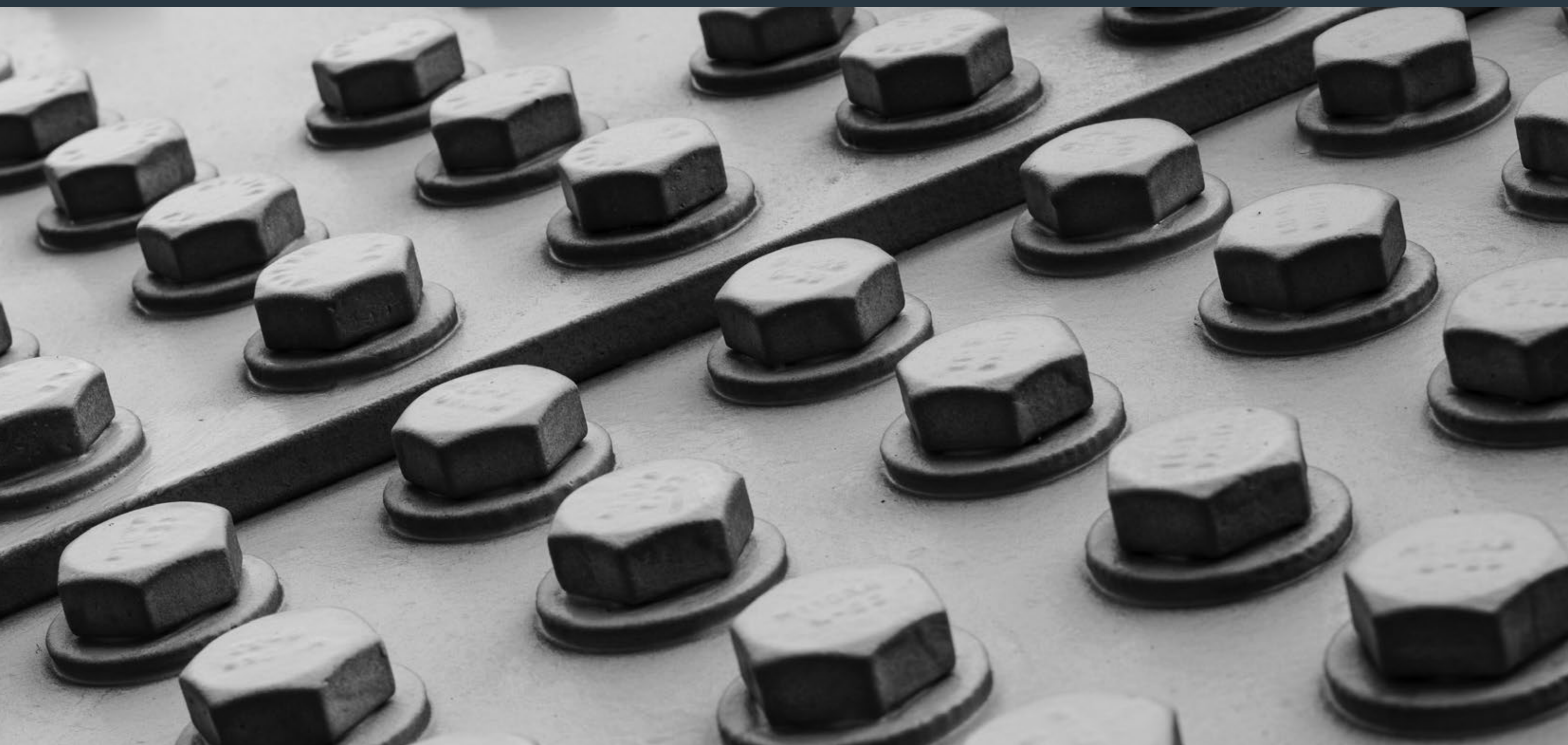

For today's investor

Luke Layfield, CFA
Fund manager

Main responsibilities

Luke manages the REaLM Commercial Assets and REaLM Social Housing Funds, which seek to deliver secure income by investing in long-term inflation-linked leases to high quality tenants, as well as managing the REaLM Multi Sector Fund, which provides access to a diversified pool of commercial real estate, ground rents, social housing and renewable infrastructure assets. He also manages the Inflation Plus mandate for the London Collective Investment Vehicle, which aims to provide secure and inflation protected income to the London Borough pension schemes through investment in a range of long-term contractual cashflow assets.

Experience and qualifications

Luke joined Aviva Investors in 2008 and previously led the portfolio analysis team, where he was responsible for the financial underwriting of transactions and quantitative portfolio analysis. He has previously worked on the Real Estate Research team and as an analyst for the UK specialist real estate funds.

Luke holds an MSc in Real Estate Investment from Cass Business School and an MA in Politics and Economics from the University of Cambridge. He also holds the Investment Management Certificate and is a CFA® charter holder.

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Introduction

Pension schemes seeking new alternatives to low-yielding bonds may find amortising leases a compelling option, as Luke Layfield explains.

Over the last decade, as defined benefit pension schemes have closed to new members and future accruals, their liability profiles have matured and funding levels have improved. These factors have driven schemes to de-risk their investment portfolios, moving from strategies focused on capital return to those targeting contractual income. Such strategies have also played a vital role in meeting pension liabilities as a growing number of schemes have become cashflow negative.

Finding suitable assets to meet schemes' need for income, however, has become more challenging in recent years as traditional income sources - gilts and investment-grade credit - have seen yields driven down by ultra-low interest rates and general risk aversion among investors.

COVID-19 has exacerbated the situation; in response to the economic crisis, the Bank of England has extended its asset purchase programme of gilts and corporate bonds by £300 billion and cut the benchmark interest rate to 0.1 per cent. These measures have put further downward pressure on bonds: yields on ten-year gilts had fallen to 0.2 per cent towards the end of September from 0.8 per cent in mid-March.

In response, investors are turning to gilt substitutes; assets that provide secure and long-term contractual cashflows and an attractive return pick-up over gilts.

> Amortising leases, also known as income strips, offer an alternative to established gilt substitutes.

While private debt and long-income real estate have for some time fulfilled this need for defined benefit schemes, a less familiar asset class – amortising lease real estate - has yet to be fully exploited. Amortising leases, also known as income strips, can offer an alternative to established gilt substitutes; they aim to provide secure, long-term cashflows at attractive relative pricing, as well as cost-effective inflation protection.

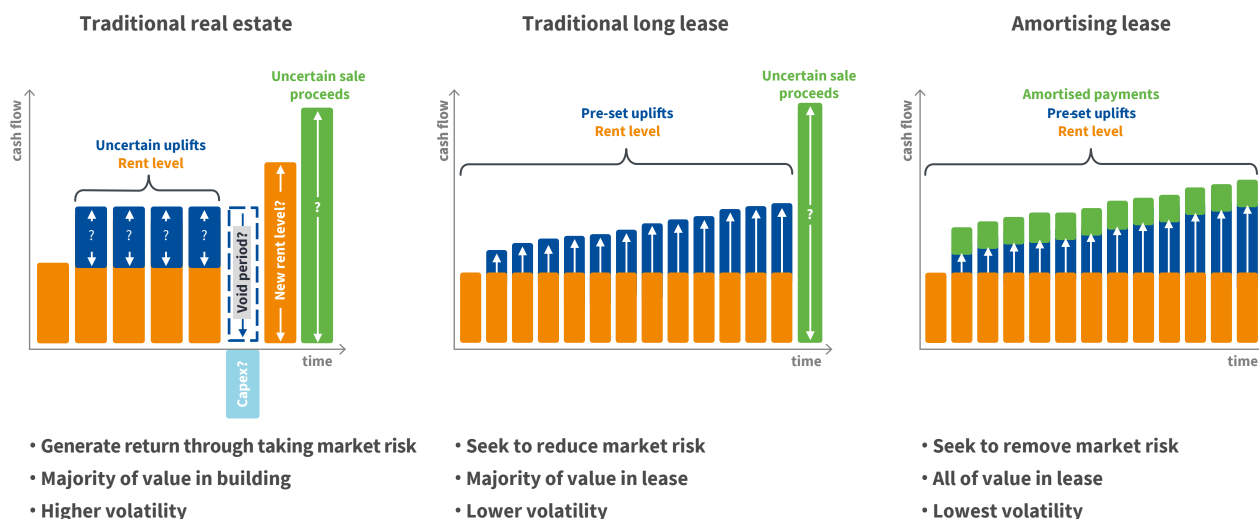
Amortising leases: An explainer

While traditional real estate investment involves taking and managing market risk, long-lease real estate is focused on cashflow certainty. Its main value is in long-term, index-linked leases to high-quality tenants, with the market risk essentially deferred for many years.

An amortising lease goes one step further, with a structure that removes the real estate market risk entirely to provide a pure fixed-income cashflow profile, akin to a debt investment. At the end of the lease term, the asset will revert to the tenant or a related party on the condition they have paid all their rent. It is therefore similar to a repayment mortgage, with the tenant repaying the loan over the course of the lease and owning the asset at maturity.

Figure 1 shows how differing cashflow profiles are created from real estate and how an amortising lease has a cashflow profile equivalent to a fully amortising loan, transforming an equity asset - real estate - into one with a debt cashflow profile.

Figure 1. **Creating a debt cashflow profile from real estate**



Source: Aviva Investors for illustrative purposes only.

> For pension schemes, the predictable, inflation-linked and low-risk income generated from an amortising lease can be an attractive way to meet their liabilities.

In recent years, amortising leases have become a popular financing solution, particularly for public sector entities, because the tenant retains long-term ownership and control of the asset. A lease can also be structured to provide more flexibility than traditional loans, particularly in the case of development funding.

For pension schemes, the predictable, inflation-linked and low-risk income generated can be an attractive way to meet their liabilities. Tenants are typically local authorities, other government or quasi-government entities, and investment-grade companies; the covenant strength of these entities provides greater certainty over cashflows. The amortising nature of the investment offers additional comfort to investors, as the lease obligation of the tenant is paid down but the underlying real estate (providing security on the lease) should increase in value over time.

Since the economic value of the transaction expires at the end of the lease term, when the asset is returned to the tenant, the cashflows provide a more precise tool to match pension liabilities than bonds or traditional long-income real estate. In the case of bonds, investors receive principal in a single payment at maturity; for traditional long-income real estate, investors will own the underlying asset at the end of the lease, which could add uncertainty around valuation and operational risks.

The ultra-long nature of amortising leases, which typically range between 30 and 50 years, aligns well with the time horizon of pension liabilities. They also offer an attractive source of inflation protection, with rents explicitly linked to price increases and therefore scheme liabilities.

Figure 2 highlights an amortising lease financing, where Aviva Investors is supporting a council-led regeneration scheme. This illustrates the positive environmental, social and governance (ESG) impact an amortising lease strategy can have, alongside the financial benefits.

Figure 2. **Funding town-centre regeneration in Stevenage with an amortising lease**

BEFORE

As part of an ambitious regeneration plan, Stevenage Borough Council wanted to buy and redevelop Queensway, a tired parade of shops in the town centre. The Council is looking to reposition the area towards more leisure uses – including a restaurant and gym – to drive footfall back to the town. It is also refurbishing the office space above to drive local employment and adding 116 residential units, 20 per cent of which will be affordable.

Aviva Investors provided the financing for this initiative through a 35-year amortising lease with annual RPI rental uplifts. We view the investment as a mutually beneficial partnership. The amortising lease structure allows the Council to retain long-term ownership and control of the town centre; at the same time, we can protect investors from the residual value of the asset at the end of the lease and create bond-like cashflows to match their liabilities.

The rent the Council pays under the lease is significantly lower than the rent it expects to generate on the new scheme. This will provide an ongoing income stream for the Council to reinvest within the borough, and a significant buffer if the project doesn't perform as expected. There is also the benefit of local jobs created (200 during construction and 80 ongoing), the local council tax and business rates generated, and the place-making benefits of a revitalised town centre.

Our investors benefit through a secure 35-year income stream from a high-quality tenant, with security over a newly refurbished town-centre asset and annual inflationary growth.

AFTER

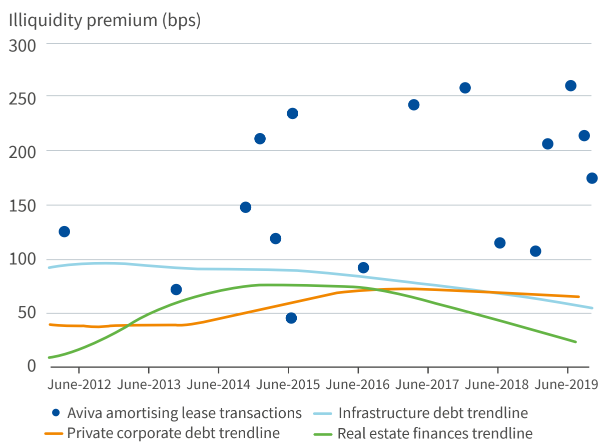
Debt-like risks, equity-like returns

Amortising lease investments provide excellent cashflow-matching properties, as good as or better than other gilt substitutes. As a less discovered asset class, they offer these characteristics at attractive relative pricing. This presents opportunities for pension schemes to secure enhanced returns for similar levels of risk.

Our analysis shows that while providing the same defensive qualities as a debt investment, amortising lease investments offer a higher illiquidity premium than debt and higher risk-adjusted returns than debt or real estate.

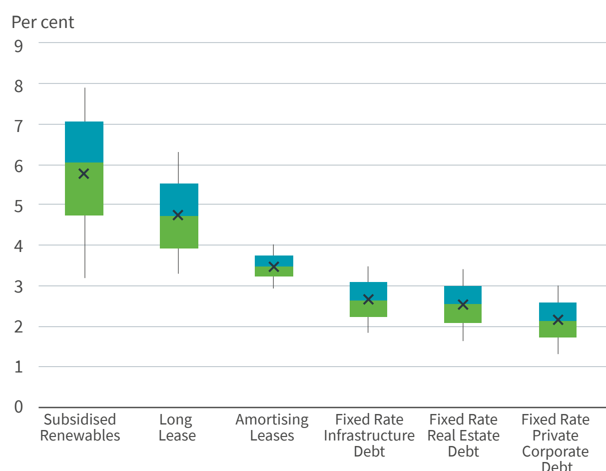
> While providing the same defensive qualities as a debt investment, amortising lease investments offer a higher illiquidity premium.

Figure 3. **Illiquidity premia: Amortising leases vs. other real assets**



Source: Aviva Investors, August 2020. For illustrative purposes only.

Figure 4. **Return spread over index-linked gilts**



Source: Aviva Investors, August 2020. For illustrative purposes only.

Schemes looking to de-risk may consider switching to amortising lease from higher risk real estate or infrastructure assets, while schemes seeking higher returns could benefit from substituting lower returning debt investments for this versatile asset class.

Figure 3 shows the historic trend line of the illiquidity premium for key gilt substitute transactions in real estate, infrastructure and private corporate debt over time. This is the excess return secured relative to publicly listed debt of the same credit rating and maturity.

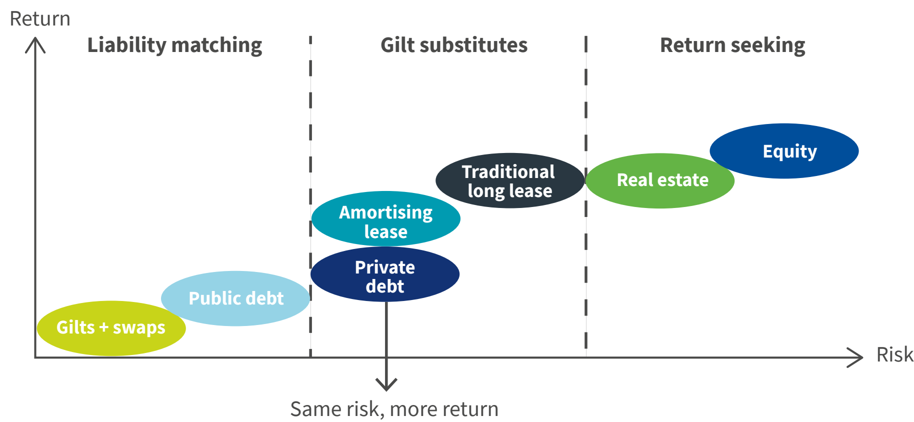
We have also overlaid the illiquidity premium generated on all amortising lease deals originated by Aviva Investors over the same timeframe, which demonstrates a significant return pick-up over debt of comparable credit quality.

Figure 4 illustrates our own proprietary analysis, providing a forward-looking assessment of risk and return for various asset classes used as gilt substitutes by pension schemes. This analysis is based on a Monte Carlo simulation, which computes thousands of possible scenarios to determine the most and least likely outcomes based on the main drivers of return for an asset class. The resulting dispersion of returns reflects the volatility of an asset class, with those prone to more extreme outcomes considered more volatile and riskier.

The box-whisker plots in the chart show the average expected return for each asset class (relative to index-linked gilts of the same maturity), as well as the level of dispersion or risk around this expected outcome. The results show that amortising lease investments offer the highest prospective risk-adjusted return. While exhibiting similar volatility to debt asset classes, they do this with a much higher expected return. And, while expected to generate slightly lower returns than long lease or renewable infrastructure, their significantly lower volatility means they also compare favourably on a risk-adjusted basis.

Our analysis suggests amortising leases offer a compelling case for inclusion in any pension portfolio. Schemes looking to de-risk may consider switching from higher risk real estate or infrastructure assets, while schemes seeking higher returns could benefit from substituting lower returning debt investments for this versatile asset class.

Figure 5. **Amortising leases within the investable opportunity set for pension schemes**



Source: Aviva Investors, August 2020. For illustrative purposes only.

As mentioned earlier, the credit quality of tenants is vital to support the long-term contractual cashflows from an amortising lease investment to ensure a comparable performance experience to debt. There is no benefit in having long-term contractual cashflows if the tenant is not going to be around to service them: this would leave investors more exposed to the underlying equity risks of the property. An amortising lease strategy should therefore focus on investment-grade tenants that can provide greater security of income and exhibit less capital volatility through the cycle.

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What's the catch?

Whether your main measure of risk is credit ratings or volatility, amortising leases offer the prospect of superior risk-adjusted returns. This begs two key questions: what is driving that and is it too good to be true?

The excess returns are primarily a function of market inefficiency, a common characteristic in private asset classes (which gilt substitutes tend to be). Amortising leases are a relatively newer and less mature asset class compared to private debt and traditional long-lease real estate and, as such, have to date attracted interest from only a small pool of sophisticated pension schemes, resulting in less pricing pressure.

Another reason for the returns on offer is that amortising leases are one of the only sources of long-duration, high-credit quality contractual cashflows yet to be monopolised by insurance investors. Although they can provide stable and secure cashflows that can benefit from favourable capital treatment under Solvency II regulations, few insurers have gone through the internal and external review processes to model and onboard a new asset class requiring specific regulatory approval.

The excess returns available from amortising lease investments are primarily a function of market inefficiency, a common characteristic in private asset classes.

So, while pension schemes have been priced out of many long-duration private debt transactions by insurers, or forced up the risk curve to take on loans with shorter maturities, more reinvestment risk or softer prepayment protections, amortising leases remain attractively priced for pensions' cost of capital and a good match for their long-term liabilities.

It could be argued that with a smaller pool of buyers, amortising leases are less liquid and should therefore command a higher illiquidity premium. However, pension schemes are well placed to manage this risk; it is also reasonable to ask whether private loans, which are seldom traded, are any more liquid.

Clearly, the equity ownership of amortising leases creates some differences with debt investments. Firstly, the security and credit quality of the investment comes primarily from the covenant strength of the tenant, rather than the underlying value of the real estate asset. While a senior real estate loan will only extend to around 50-60 per cent of the underlying asset value – meaning a lower expected loss if the borrower hits financial difficulties – amortising leases are more geared at the outset. Instead, they are reliant on a low probability of default and losses occurring based on the credit strength of the tenant.

The amortising nature of the investment does, however, increase the real estate security over time, providing additional protection in terms of counterparty risk and the value of the asset. Our analysis indicates a secured credit rating, based on expected losses, would typically match or be better than the unsecured rating, even on day one.

Nevertheless, the recovery process for amortising leases has not been tested to the same extent as traditional debt investments. In the event of a debt default, the legal documentation will specify a lender has an accelerated claim for the present value of future capital payments, often at an advantageous discount rate (known as a "spens clause").

In the case of amortising leases, a lease document is not so prescriptive, and the lack of historic defaults means there is no clear precedent to point to. However, we can look to expert legal advice that suggests the recovery process in the event of a tenant default would be similar to debt, with the landlord having a claim for the present value of future rents owed, discounted at the current equivalent gilt rate (less any value recovered from the real estate asset). An amortising lease claim would also benefit from the ability to recover more than the present value of the rents in the event the real estate asset was worth more than owed. Such an outcome is not available to debtholders, where the amount of recovery is capped by the loss.

Another risk that debt investors need to manage – prepayment risk – is absent in a lease. Debt investors usually mitigate the risk of a borrower repaying early – and forcing the lender to reinvest at an uncertain future interest rate – with a "spens clause", imposing a punitive discount rate.

Leases, on the other hand, cannot be prepaid. A more relevant consideration for landlords is the ability of the tenant to assign to another party, which could be of a lower credit quality. An amortising lease strategy will either prohibit assignment or limit its impact, by imposing a credit hurdle on assignment for example, to protect the promised cashflow.

Finally, amortising lease strategies often involve the funding of a development period. Any development risk is heavily mitigated through pre-letting to a high-quality tenant and transferring the risk on cost and timing of delivery to a third-party developer. The characteristics of a development period can be factored into the credit and risk analysis of the transaction and priced appropriately, just as they can for any loan. When structured with the proper protections, these tend to be rated investment grade throughout.

What's in it for the tenant?

While there are some technical differences in structure and operation between an amortising lease and a loan, the economics are broadly the same. Why then, if amortising leases offer outsized returns to investors, would counterparties choose this financing option rather than take apparently cheaper debt?

The answer comes down to the additional flexibility and freedom an amortising lease can provide. Firstly, because the landlord mainly relies on the tenant's covenant strength rather than the real estate asset, more debt can be extended relative to the value of the building or project (up to 100 per cent). Similarly, because the focus is on the tenant rather than the asset, a lease is far less onerous in terms of reporting covenants – such as loan-to-value and income coverage ratios – which are standard requirements on a loan.

Furthermore, lease financing a development can provide greater flexibility than other forms of debt such as government loans or bonds, potentially resulting in more efficient use of capital and certainty on funding costs. Traditional borrowing generally requires the borrower to immediately draw down the entire funding amount, or otherwise take additional risk because the cost of funds can vary if drawn over time.

An amortising lease, however, can be structured to allow funds to be drawn down as and when work is completed, with a third-party developer taking the risk on timing. The tenant's rental payments are fixed from day one, giving both investor and borrower more certainty during the development period. The tenant can also benefit from partnering with an expert real estate development funder, who will closely monitor the delivery of the project (as it is part of their security) and share their expertise to ensure the delivery of a high quality building on time and within budget.

Opportunity knocks

These factors have led to a significant and growing pipeline of opportunities to provide finance for central and local government, NHS bodies, universities and highly-rated corporates.

Although amortising leases have not yet been widely embraced by pension schemes, they have the potential to help meet the income needs of maturing schemes; namely, a reliable and consistent fixed-income cashflow profile and attractive returns relative to both gilts and their more established substitutes.

Investors willing to do the work to understand a less familiar asset class could reap significant benefits from an allocation to an amortising lease strategy.

Although amortising leases have not yet been widely embraced by pension schemes, they have the potential to help meet the income needs of maturing schemes.

The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Investments can be made in real estate, infrastructure and illiquid assets. Investors may not be able to switch or cash in an investment when they want because real estate may not always be readily saleable. If this is the case we may defer a request to switch or cash in shares or units.

Notes

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