ULI UK CAPITAL MARKETS ROUNDTABLE

8 September 2022

This roundtable in September was to discuss the state of UK real estate capital markets for both equity and debt investment. Its conclusions are to be debated at a broader ULI UK Capital Markets Forum event on 25th October. There has been a surprising degree of volatility since then, particularly in the UK, which should make for an interesting discussion on the 25th.

The roundtable took place against a background of increasing economic uncertainty: a weakening underlying economy teetering on recession; discretionary retail demand including online weakening; rising inflation and rising interest rates. This had yet to fully feed through into real estate values. The price of UK FTSE 350 REIT shares, which had been volatile since the late spring, had seen dramatic falls immediately prior to the roundtable. This had not been reflected in private market valuations. Participants felt that this was more to do with a lack of activity in the market and thus an absence of transaction data. The listed real estate market is a forward indicator, whilst valuation at the property level is a lagging indicator.

The participants at the roundtable noted the lack of immediate trigger to sell assets, although there was a widespread view that circumstances were building towards a change.

Prophetically, it was noted that the defined benefit pension schemes heading into buyout faced specific challenges. The denominator effect and potential liquidity issues raised in the discussion have indeed come to a head more rapidly than perhaps anticipated at the start of September, and will no doubt be part of the discussion later in October. There is a broader defined benefit pension scheme challenge – real estate and real assets have been receiving an increasing allocation from a declining pot. At some point this is going to reverse.

Rising interest rates and a reduction in the availability of debt could also be a trigger for greater transactional activity. Although debt levels are generally lower than in the Global Financial Crisis, this may not provide protection. In the GFC, it was often the borrowers with relatively reasonable levels of gearing, but who had breached loan covenants, that faced the greatest attention from their lenders. The banks were less enthusiastic about tackling borrowers who were completely underwater. The absence of the latter this time around may be of limited consolation to the former.

There is also a lot of debt coming up for refinancing over the next couple of years. The shift in interest rates has probably been the biggest change since the 2021 roundtable when the expectation was that interest rates would remain low for longer as the country emerged from the impact of Covid-19. Obviously this has moved further and faster since the start of September. The other major pressure to sell may well be obsolescence. This is discussed later.

If there is a trigger for sales activity and values fall significantly, then this is bad news for some but an opportunity for others. For investors with undrawn capital commitments, market dislocation can be attractive. This was particularly the case for those whose dry powder is in Dollars rather than Sterling. The ebb and flow of the currency since the roundtable has been quite something, so this will no doubt be a major topic when the debate is continued later this month. Despite the potential currency play, there was a perception that the pool of available capital had become more domestic.

A key area of debate was potential impact of inflation. There was a general acceptance that although this is a global issue, the UK faces particular challenges, with inflation here likely to be more persistent. Further weakness of Sterling does not help, and the enduring impact of Brexit is both inflationary and removes some of the trade benefits that might usually accrue with a falling currency. It is also a contributory factor to significant labour shortages in the UK that in turn increases the risk of further, wage-driven inflation.

Against this increasingly turbulent background, there are also significant structural issues for the UK real estate market. The staple food groups of the real estate diet are facing challenges this year. Offices face uncertainty regarding long-term working patterns post-Covid, changes to the requirements for retail have accelerated, and industrial is coming to the end of an amazing bull run. There are questions too for residential in a market where affordability becomes more of a challenge.

For both offices and retail, the accelerating change in the nature of the demand is rendering swathes of existing stock obsolete. The “E” in ESG, and in particular the requirement for a pathway to net zero, is also going to become an increasing factor. Where is the capital going to come from to address this, particularly if the increasing focus on embedded carbon makes it less acceptable to knock it all down and start again?

In theory there is available capital for deployment into real estate as an asset class – money is still pouring into retirement provision and the allocations to real estate and real assets more generally remain in place. However, accessing that capital is becoming much more challenging: investors are sitting on their hands and delaying decisions. This was felt to be across the board. How long will this last before the current challenges become an opportunity? Capital was felt to still be available for more niche strategies in the “new economy”, but how niche does it actually need to be to be attractive in the current environment?

The consensus was that any manager wanting to succeed in raising money at the moment needs a very specific and clearly articulated story. There is also the challenge, which had been flagged in the equivalent roundtable in 2021, that many of these niche areas are highly operational in nature. Do investors and lenders have the skills to evaluate them?

Longer term, there is a capital challenge for which the industry has yet to find an answer arising from the switch from defined benefit to defined contribution pension investment.

The final topic covered in the roundtable, and one that increases in prominence year by year, is the importance of ESG. Whilst there was consensus that it had continued to grow as a priority, there was less consensus as to what this means in practice and whether "ESG" as a single, all-embracing term remains helpful. The "E" is more clearly defined, and increasingly regulated, although even here there are significant concerns regarding "greenwashing" and a failure to look at the bigger picture. In particular, it is all very well investing in new buildings that are exemplars of energy efficiency on completion, but what about the embedded carbon cost and the operational carbon once the buildings are occupied? These will add to the challenges of mapping a pathway to net zero for the real estate investment management industry. The challenges are even greater for the "S" and the "G". All of this represents a significant risk, but also an opportunity.

The roundtable took place against a background of economic uncertainty, rising inflation, rising interest rates, a cost of living crisis eroding affordability, and nervous investors questioning the trajectory of the UK. The intervening six weeks will not have improved matters, all of which provides much material for debate on 25th October.

Thank you

A huge thank you to our sponsors **Greenberg Traurig** and our participants for their willingness to share their knowledge.

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