ULI UK CAPITAL MARKETS ROUNDTABLE

23 May 2023

This roundtable in May 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 on 27 June.

The roundtable saw a continuation of the background from the previous year - economic uncertainty: a weak underlying economy teetering on recession; weak discretionary retail demand including online; high inflation and high interest rates.

This has fed through into subdued transactional activity for real estate as an asset class. Very few deals are closing at the moment, with one very notable exception, although things are starting to move that might lead to actual activity in the future. There is a lot of bilateral discussion underway, but there is a big spread between what buyers want to pay and what sellers want to receive.

The notable exception to the dearth of action is Blackstone, which has been an extremely vigorous buyer of logistics assets.

Despite the paucity of activity, some participants felt that the current transaction constipation was showing signs of impending movement. This is being driven by a combination of increasing realism and perhaps slightly further out the looming cliff-edges for some of closed-ended funds coming to an end or debt needing to be refinanced.

One particular prediction from the 2022 roundtable that proved prophetic, and was discussed again this year, was that de-risking pressure was building significantly for corporate defined benefit (DB) pension schemes heading into buyout. This was brought into rapid focus when the denominator effect and potential liquidity issues highlighted at the 2022 roundtable were dramatically accelerated by the fallout from the Liz Truss / Kwasi Kwarteng fiscal event in the Autumn.

Another pressure flagged in the 2022 forum that remains a huge challenge, particularly for offices, is the rapidly accelerating obsolesce as a result of environmental factors and changing working patterns.

The future of the office was hotly debated. There was general consensus that the Covid lockdowns had accelerated an existing trend, but there was disagreement over the extent of the impact. Some felt that the risk was overblown and that the pendulum would swing back at least part way. Others felt that this what we have seen so far is only the start of the transition, particularly in respect of environmental considerations and the risk of stranded assets.

This is a complex conundrum already faced by retail – swathes of properties that are no longer fit for purpose, but an embodied carbon cost of demolishing and rebuilding that is also profoundly unattractive. In many regional towns and cities, the cost of retrofitting "grey to green" may exceed the value of the finished asset. Where the numbers do stack up, "grey to green" was identified as an attractive investment strategy.

This was also linked to the broader opportunity of creating premium workspace for employers looking to lure their staff back to the office, for which there is another conundrum that is outside of the immediate control of the developer – for those considering a return to the office, the quality of the commute is seen as being as important as the quality of the destination. In the premium workspace of the future, technology and smart buildings will be key.

Another aspect of the changing work environment was felt to be a premium for flexibility. An investor which in the past would have sought out a large office building let to a single occupier on a long lease is now looking for smaller, multi-tenanted properties.

Another area of debate was in respect of the previous darling of real estate investment: logistics. This had seen a significant pricing movement over the last year, but the general view was that the tenant fundamentals remain strong. Is this enough to prompt a swift price recovery?

In contrast to the general gloom regarding traditional asset types, there was widespread optimism for those investing in some of the newer, perhaps more niche areas including life sciences, health, education and data centres, all of which were felt to have growing demand and a limited supply. Self-storage was also flagged. Although no longer really niche, the same dynamics were felt to apply to the various forms of residential, with particularly strong interest in single family housing.

Many of the challenges at the asset level are equally applicable at the investment vehicle level – it is a fragile market for raising equity and for secondary transactions. Apart from general lack of appetite, many traditional equity investors have been hit by revaluation issues and the denominator effect. Performance challenges in underlying funds over the last couple of years have also hit distributions and returns of capital, limiting the amount of cash to reinvest. The Middle East was felt to be a notable exception, with investors still being replete with capital to deploy. Unfortunately, this capital has plenty of options and long queues of managers at their doors.

Another interesting side of the debate on sources of capital is the increasing importance of the individual relative to the traditional institution. Family offices, wealth managers and private banks are seen as increasingly important, looking further over the horizon, and the huge growth in the global mass affluent.

The changing investor mix is having an impact on the nature of investment in vogue, with participants at the roundtable noting a bar bell effect – a greater interest in higher risk, higher return value-add and opportunistic strategies at one end of the spectrum, and at the other, appetite for the risk adjusted returns offered by debt. Traditional core and core-plus investment in the middle was felt to be suffering at the moment, although this needs to recover for the higher return investments to have a viable exit. There is another bar bell, which is investors deploying most of their capital with big name managers where they will not face so much scrutiny if things go wrong and small allocations to very niche players, with the bit in the middle again losing out.

The secondary market for fund positions is facing the same challenge as the asset level - a big spread between what buyers want to pay and what sellers want to receive, and this is also having a knock-on effect for appetite in the primary market.

Debt capital markets have not been immune from market volatility, and as with equity capital, there are both challenges and opportunities. Many existing loans are secured over failing assets. Banks have been kicking the can down the street, taking action only when their hands are forced. Regulatory scrutiny may be the trigger – lenders cannot simply roll over the debt at the same pricing when the risk has risen significantly. Borrowers may not be able to afford the increased cost.

For new entrants to the market, the vista is attractive, with the view that there were both opportunities to lend and capital available to fund it. Around the participants at the roundtable, borrowers thought that interest rates had peaked, whereas the lenders thought that there was still further increase to come.

As in previous years, the final topic addressed by the roundtable was the increasingly crucial topic of environmental, social, and governance (ESG) considerations. Despite the broader economic challenges this remains a high priority. Within this, the environmental aspects are the most advanced, with significant developments over the last year from both a regulatory and a real estate industry perspective. On the latter, there have been a number of initiatives that have moved forward significantly, including the ULI's own C-Change initiative (see here).The challenges of embodied carbon has already been mentioned.

A further obstacle is measuring operational carbon / Scope 3 emissions once buildings are occupied by tenants. There was pretty universal agreement that gathering data will be the biggest challenge, although this is helped by improving technology, which can be installed in new buildings and in retrofitting projects.

The roundtable concluded with the participants picking their investment hot tip for the next year. There was no consensus with life science, data centres, self-storage, retail warehouses with a food anchor, sustainable logistics, luxury leisure, digital health, quality offices (regional and London) single family housing, student housing, fund secondaries and debt all being nominated.

Thank you

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

Chair

Steven Cowins, Greenberg Traurig

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Write-up

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