

ULI UK CAPITAL MARKETS ROUNDTABLE 2024

This roundtable at the beginning of June 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 3rd July.

The roundtable saw a continuation of the key theme of the previous two years, subdued transaction activity against a generally gloomy economic background. The mood was, however, slightly more optimistic, with some signs that transaction activity is starting to pick up, at least in the UK. Activity here is up on last year, but not up as far as the market had anticipated it would be now a year ago, so positive, but still with a sense of disappointment. There was general acceptance that real estate performance is cyclical and this is the cycle being worked through. It was also noted that transactions are either taking a lot longer or are in a rush – there is nothing in the middle.

Transactional activity in the “living” sector continues – in build to rent, affordable housing, student accommodation and various forms of retirement accommodation. There is also the start of activity in out-of-love sectors as private equity investors seek out bargains.

One aspect of this that is unusual is that the UK appears to be heading into the market turn ahead of the United States. There is very little transaction activity in the US – what limited activity is taking place is in industrial and multi-family. However, the pricing gap is closing, so there is at least travel on the right trajectory, but it is behind the UK.

The UK faces a major additional challenge from the disruption to the domestic institutional market. In times of volatility, there is a tendency to retreat to domestic investment. In the UK, there has been a significant change with the acceleration of corporate defined benefit (DB) pension schemes heading into buyout. This has been an important topic at the roundtable during the previous two years, and remains a major concern. The exiting DB money is yet to be replaced by defined contribution (DC) investment.

This is happening at a point at which there is a looming need for additional capital.

A key area for which a capital need was identified was the impact of the debt funding gap. This is a global rather than a uniquely UK phenomenon. The rise in borrowing costs and the pressure for lower loan-to-value (LTV) ratios, particularly for refinancing, creates a need for additional equity to plug the gap. The LTV challenge is made worse by falling values.

Since the global financial crisis, regulatory changes for banks have reduced their capacity to lend. This is a process that continues, with further changes on the way. Changes in capital rules for German banks was cited as an example. This has encouraged the shift from bank to non-bank lending, although non-bank lenders themselves are increasingly in the cross-hairs of global regulators.

Managers are continuing to successfully raise debt funds. Some concern was expressed as to whether investors always fully understood the underlying products and if they were properly able to understand the differences. Are some investors effectively getting debt returns for equity risk?

Existing lenders are focussed on managing through issues on their portfolios. There is a lot of activity in ensuring that loans never reach the point at which they are in default – rolling loans forward with three to five year extensions.

The roundtable considered the challenges and opportunities for some of the key asset types. The most significant concerns were for offices. The gap between the good and the bad in offices has widened dramatically, much as it did for retail a decade ago. The current market has had a polarising impact. Two key aspects were felt to need office investors to have a new skill set:

- The premium office today that attracts staff back in needs to be a destination with a variety of additional services, having many of the features of a top hotel. Understanding the end user is key;
- There is a demand for flexibility. A large office building that would have been let to a single occupier on a long lease is now much more likely to be multi-tenanted property on shorter leases.

For all of this, operational expertise is key. A related issue that was flagged is that traditional lenders were felt to be deterred by operational risk. However, some investors are actively attracted to operational risk because they think that they can add value.

In terms of the impact on the need for office space of working from home, it was noted that this be limited if people are coming in three days a week, but all come in on the same three days.

Despite the challenges, some managers are managing to raise money for office funds. The view was expressed that there are two ways to make money from this:

- Running in the opposite direction to the herd;
- Investing in areas where demand and supply are in imbalance.

In summary:

- Lease lengths are shorter;
- Risk of breaks is higher;
- Capital expenditure requirements are higher;

- The structural and economic cycles have coincided.

The challenges for retail assets have been well-publicised and continue. There was a counter-view that for many assets, the bottom had been reached and opportunities are starting to emerge.

As in the previous two years, there was consensus that the main investor interest is in beds and sheds.

In the case of the former, activity in the “living” sector has already been flagged. The impending general election and a likely change of government could have an impact as housing and improvements in the planning system are high on the agenda. There was a general consensus that stability of political leadership in this area is the biggest wish. As one participant quoted, “If you know the name of the current housing minister, you probably are the current housing minister”. Rent controls could kill investment, so there was concern at the possibility of any move in this direction.

For the latter, there was general agreement that the position had changed since last year and that money was chasing sheds again. Managers are looking to raise capital again. Two particular niche areas were also flagged, cold storage and self storage. It was flagged that pricing discipline is vital but also challenging in such niche areas. It is also difficult for investors to know who are good operators.

The process of raising capital has generally become much harder. Capital raising periods are extending. One participant suggested seven meetings over a six to nine month period is now typical. One particular issue flagged is the knock-on effect of the lack of transaction activity discussed at the start of the roundtable. Funds are not exiting underlying investments so capital is not being returned to investors. Investors are not receiving the money to redeploy.

The final topic addressed was the importance of environmental, social, and governance (ESG) considerations. This remains a complex area, and the attitude of investors varies. In the US, there is a veritable chasm between the attitudes of pension plans in red states and blue states. For pooled funds, this creates a significant challenge.

ESG considerations apply across a spectrum:

- Capital is available for “impact funds with a capital ‘I’” and for funds with green positive attributes;
- For real estate investment more generally, ESG needs to be considered all the way down the chain from the investor reporting requirements down to the detailed operational matters at the asset level, with an increasing need to work with tenants to meet data requirements;
- Both investors, lenders and buyers of assets are becoming increasingly concerned about the risk of ESG driven accelerated obsolescence as assets

become “stranded” by changing climate regulations. ESG concerns will catch even those for whom the whole concept is anathema.

Thank you

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

Chair

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