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ROUNDTABLE

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UK real estate's rocky road to recovery

After a period of political and economic turbulence, not to mention real estate market paralysis, participants in PERE's UK roundtable anticipate calmer waters ahead. By Stuart Watson

In April, local elections in the UK delivered the expected result: a near wipeout for the Conservative Party, which lost almost half of the council seats it was defending, as well as almost every regional mayoral contest. Expectations that a general election later this year will see 14 years of Conservative rule give way to a Labour-led administration are hardening into near certainty.

For the participants in this year's *PERE* UK roundtable discussion, certainty is a welcome thing, following as it does a prolonged period of political turbulence that saw the UK withdraw from the European Union, combined with both the covid-19 pandemic and the global supply chain and inflation shocks that disrupted the UK real estate investment market.

"Investment and bond markets like certainty and stability, and with the general election we have a big change on the horizon. But because everyone expects the change, it becomes a certainty and it's part of everyone's decision-making already," says Steven Cowins, partner at law firm Greenberg Traurig.

A year ago, roundtable participants were still assessing the fallout from the Autumn 2022 "mini-budget" that spooked markets, caused the bank rate to spike and precipitated the end of Liz Truss's short-lived term as prime minister.

"The reaction was immediate and painful. Investors stopped allocating to the UK and all the transactions we were working on halted and most of them never came back," recalls Ellis Sher, chief executive officer of development finance provider Maslow Capital, which is part of Arrow Global Group. "But the government acted just in time to reassure bond markets, and the picture is very different today."

Because of that period of political turbulence, global capital markets are still applying a penalty to the UK, observes Daniel Mahoney, head of European research and strategy at LaSalle Investment Management. "If you look at default swap spreads on sovereign debt, the UK is priced to have a higher probability of default than Germany, Australia or Canada. And the spread between UK gilts versus German government debt is extraordinarily wide. That penalty may not be fully deserved or logical, but it makes the UK more attractive in terms of relative pricing."

Kilian Toms, a managing director responsible for CBRE Investment Management's real estate partners strategy, notes the same phenomenon. "The UK is among the global markets that are looking attractive right now. It is a very institutional, investable market, and following other periods of volatility, including after the global financial crisis, it has repriced quickly.

"Therefore, global investors looking for relative value should consider the

PHOTOGRAPHY: **RICHARD DAWSON**

Ellis Sher

CEO and co-founder
Maslow Capital

Sher co-founded property lending business Maslow in 2009, which was fully acquired by Arrow Group in August 2023. He heads the European direct lending business for Arrow, a pan-European opportunistic credit and equity platform with €80 billion of assets under management.

Daniel Mahoney

Head of European research and strategy
LaSalle Investment Management

Mahoney joined LaSalle in 2008, relocating from Chicago to London two years ago to become the business's Europe head of research and strategy. LaSalle, the independent investment management subsidiary of JLL, manages around $89 billion of real estate and debt investments globally.

Kilian Toms

Managing director, real estate partners strategy
CBRE Investment Management

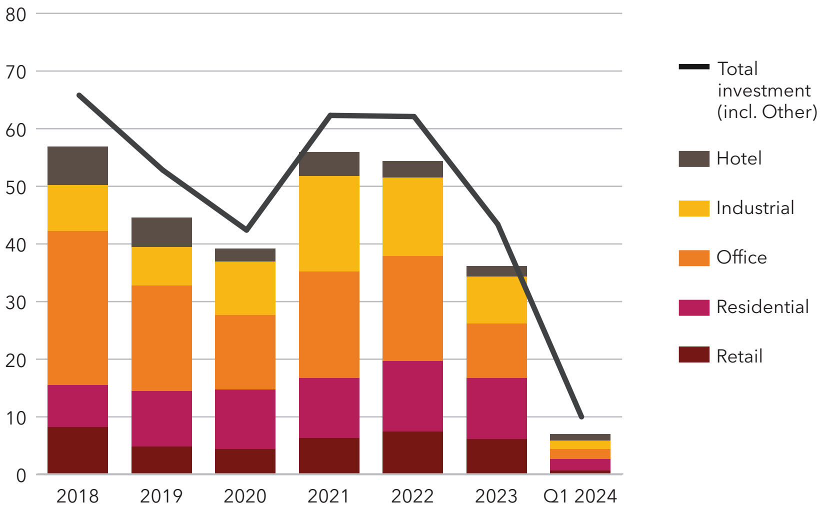
Toms joined CBRE Investment Management in 2023 from international private markets adviser Sera Global, where he was a partner and head of EMEA liquidity solutions and secondaries. He is managing director of CBRE IM's real estate partners strategy, which focuses on indirect investments through GP- and LP-led secondaries.

Steven Cowins

Partner
Greenberg Traurig

Cowins is global co-chair of the real estate funds practice at Greenberg Traurig, one of the world's top law firms by revenue, employing more than 2,650 attorneys, including over 700 focused on the real estate sector worldwide. He advises private equity real estate clients on fund formation, joint ventures and M&A.

UK investment activity has remained subdued, with residential outstripping office as the most invested asset class in 2023, but total activity fell by 30% to just £43.3bn (£bn)



Source: CBRE

UK as a place where it makes sense to dig deeper into the market fundamentals and assess whether assets are appropriately priced. With that said, a more complex tax system is always a consideration when global investors invest in the UK."

Sher adds that UK real estate markets typically adjust more swiftly than their continental European counterparts. "Repricing seems to take place more quickly in the UK, so UK real estate markets tend to recover sooner after a downturn."

Mahoney says the UK real estate market has consistently topped JLL's annual Global Real Estate Transparency Index. "The UK is the world's most transparent real estate market. And it has lived up to that big reputation through this correction," he adds.

Because of a lack of transactions, the repricing that has taken place has been based largely on sentiment, not on evidence, suggests Toms. "That creates a higher likelihood that the expansion in yields will overcorrect or overshoot. That is another reason why we are starting to see green shoots. And if a general election can create the prospect of five to 10 years of stability following this period of disruption, that is another layer that can make the UK even more attractive."

Every private placement memorandum for a UK fund written by Greenberg Traurig emphasizes the market's transparency, liquidity and rule of law, says Cowins. "I am hearing from managers that the UK seems a hugely investable place at the moment, if you can find opportunities. The politics theme has given way to a macroeconomic one centered on interest rates."

"Global investors looking for relative value should consider the UK as a place where it makes sense to dig deeper"

KILIAN TOMS
CBRE Investment Management

Canary Wharf seeks reinvention

The participants consider the East London business quarter's battle to stay relevant in the face of office sector disruption

The future of Canary Wharf has become a hot topic in UK real estate circles. In recent years, occupiers including HSBC, ratings agency Moody's and law firm Clifford Chance have all abandoned the London Docklands office district, prompting questions over its long-term viability. In April, landlord Canary Wharf Group agreed to contribute £150 million to the refurbishment of Morgan Stanley's European headquarters as part of a deal to retain the US bank and stem the bleeding.

The roundtable participants have observed, with keen interest, attempts by Canary Wharf's owners, manager Brookfield Property Partners and sovereign fund the Qatar Investment Authority, to maintain its relevance. "The transformation of Canary Wharf and how it operates will be fascinating to watch," says Maslow's Ellis Sher.

"It is very difficult to reconfigure large office floorplates. But there is more life science-related activity and residential development, and the owners have deep pockets so they can afford to take their time." He doubts whether the yield spread between offices at Canary Wharf and properties in central London sufficiently reflects the greater risk associated with the former, however.

Even though property there is cheaper, Canary Wharf could be regarded as less attractive on a risk-adjusted returns basis than London's City and West End, says CBRE IM's Kilian Toms. "In those established office hubs, you might get a lower return, but you can more confidently assess the likely occupier profile and price the demand."

Nonetheless, Canary Wharf retains a substantial tenant base including Morgan Stanley and fellow US investment bank Citigroup, which announced in 2022 that it would spend £100 million to refurbish its owner-occupied office tower. LaSalle IM's Daniel Mahoney believes the district will find a way to continue to thrive. "In 10 years those occupiers will still be around and a lot more people will live there. There is already a mix of uses at Canary Wharf and the momentum of that transformation will continue."

Interest rate cuts

The Bank of England's Monetary Policy Committee increased the UK base interest rate at 14 consecutive meetings, rising to a peak of 5.25 percent in August 2023, since when it has remained stable. At the beginning of the year, three or more cuts were expected during 2024, says Mahoney, but those expectations have been dialed back: "Markets are now pricing in two interest rate cuts starting mid to late summer."

Inflation, which fell to 3.2 percent in March by the Consumer Price Index measure, is expected to slow further, bringing it close to the Bank's target rate of 2 percent. That will be the key determinant of the pace of rate cuts, says Mahoney.

"There is some prospect that the news on inflation could be better than we have seen recently, because of the way that the energy price cap is going to impact the stats over the next few months," he adds.

Uncertainty over whether interest rates would continue to rise, followed by ambiguity over when they would fall, has made for extremely challenging conditions in which to get deals over the line. Figures from broker CBRE show UK total annual investment volume in 2023 decreased by 30 percent to just £43.3 billion ($54.6 billion; €50.4 billion).

While rates were still rising rapidly it was impossible for managers to plan, raise equity or know what the cost of debt was going to be from month to month, says Sher.

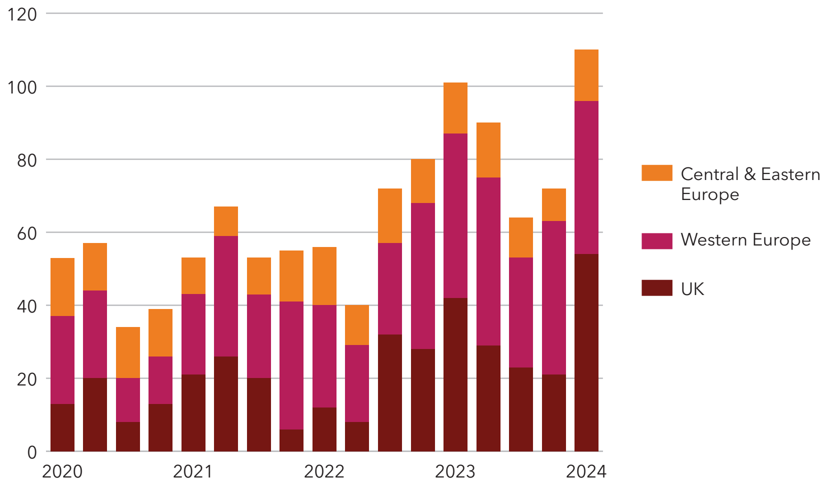
"That environment was not investable. Borrowers just needed the rate changes to stop. Now that rates have settled, risk appetite has returned," Sher adds.

Hopes that activity would pick up in Q1 2024 have been dashed, however, with CBRE recording a quarterly figure of £9.9 billion, 23 percent down on Q4 2023, and 7 percent lower than Q1 2023.

Furthermore, MSCI data records a spike in the number of terminated deals and for-sale properties being pulled from the UK market in Q1, an indication that continued uncertainty is still dampening activity. "The hope that interest rates are going to come down, and the mistaken expectation that they were going to come down sooner, has left sellers hanging on hoping to get more of their equity back. And it's that hope value that is putting a brake on the number of transactions," says Cowins.

On the flipside, reduced liquidity arising from the recent period of volatility may generate opportunities

Signaling continued uncertainty, the count of failed transactions hit a post-GFC high in April as sellers held out in hope of interest rate cuts



Source: MSCI Real Assets

for longer-term investors seeking an enhanced risk-adjusted return, argues Toms. "There is pent-up seller demand because that volatility and differing expectations of true value have left a lot of sellers on the sidelines."

Repricing could encourage buyers with capital to deploy to become more active this year, although they will be highly selective, he says. "We are buying into opportunities that are not based on asset-level distress, but more on capital structure distress. If you come in and help rebalance the capital structure, or provide capital to finish business plans in the GP-led secondaries space, there is tremendous opportunity."

While sellers have been reluctant to come to market, transaction volumes are also being suppressed by an "equity crunch" depriving buyers of ammunition, suggests Cowins. "It is the lowest blind pool fundraising market on record. Because of the low transaction volume, distributions to the LPs are down, so they can't reallocate capital to their existing or new GPs to allow them to transact."

He expects the message that rates will stay higher for longer to begin to filter through to sellers, resulting in more activity later in the year, however. Mahoney agrees: "Our expectation is that volumes will improve so that 2024 is higher than 2023. But it will be quite a gradual recovery," he predicts.

Capital markets

UK domestic capital allocations for real estate have been impacted as local direct benefit pension schemes, which provide a guaranteed income level to pensioners, turn away from the asset class in order to improve their liquidity profile. Consequently, billions of pounds of investments in UK core property funds are queued for withdrawal.

Data goldrush

Blackstone gambit demonstrates how artificial intelligence growth is sparking investor interest in the UK data center sector

In April, mega-manager Blackstone revealed proposals to develop a £10 billion data center campus in Blyth, Northumberland, on a derelict site previously earmarked for the abandoned Britishvolt electric vehicle battery factory scheme.

Far from being regarded as the province of infrastructure funds, the sector is a key target for many UK real estate investors, says Steven Cowins, evidenced by Greenberg Traurig acting for several managers working on data center acquisitions.

Owners of well-located sites with sufficient power capacity are confident enough about the strength of occupier interest to be bullish in their negotiations with potential tenants, says Sher. "Anecdotally, demand seems to be stratospheric because of forecast future investment in artificial intelligence. We haven't seen a lot of that in the UK compared with the US yet, but the players in that sector need to resource up ahead of the curve."

AI computing firm Nvidia is talking about "mind blowing numbers" that it wants to invest in data centers, concurs LaSalle IM's Daniel Mahoney. "For that reason, getting exposure to the sector will be important for diversification, because if investors don't have a slice of that pie, they are implicitly betting against it."

In such a rapidly evolving market, investors should be wary of the potential for assets to become obsolete, however, with demand evaporating once current leases expire, cautions CBRE IM's Kilian Toms. "The risk of investing in a long-lease data centers play is very different than a develop-to-core strategy where managers can utilize what we already know about the direction of travel to create future-proofed assets," he says.

"The good news is that where they are looking to exit real estate, they are taking a measured approach and can wait until the pricing is appropriate," says Mahoney.

It is feared that withdrawals could be particularly detrimental to UK regional property markets, in which DB pension funds were key investors.

Mahoney does not believe the trend will have a major impact on long-term investor demand for regional real estate, however.

"The local government pension scheme funds are here to stay, and as pricing becomes more attractive areas outside London will start to pull in more cross-border capital," he says.

Indeed, the diversity of international capital flows into the market is one of the UK's strengths, he adds. "Even when the domestic market is subdued, there will be a capital source from somewhere else in the world."

The participants debate whether international capital providers have a greater appetite for UK-specific funds or for pan-European vehicles that also encompass the UK.

During a recent fundraise, Sher found the latter preference was more widespread. "More investors wanted the diversification of currency and collateral, and understandably they didn't want to have a single country exposure that can potentially damage them through an event like the Liz Truss debacle."

If investors want to deploy at scale, particularly through sector-specific strategies, a pan-European scope allows them to access more opportunities, says Cowins. But for a value-add strategy, some find it simpler to employ a UK-only structure. "As soon as you put the UK and Europe together and include the Nordics, the currency issue begins to raise its head."

Because of repricing and diversification benefits, US investors should be interested in the UK for value-add, opportunistic and debt strategies, but right now it is a challenge to attract transatlantic capital, says Mahoney. Partly that is because US capital providers are deterred by the office segment's troubles in their own market. "And expected returns in the US are

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ELLIS SHER
Maslow Capital

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>
> **DANIEL MAHONEY**
> **LaSalle Investment Management**

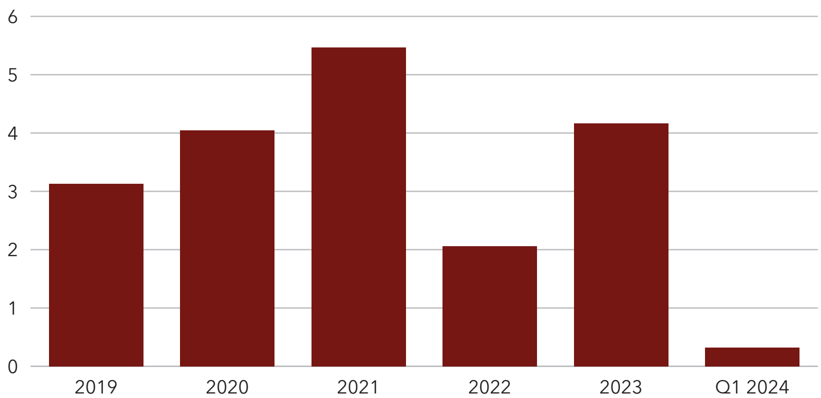
significantly up on two years ago too," he adds.

Loved and unloved sectors

The conversation turns to which UK property sectors currently offer the most attractive characteristics to investors. Toms says CBRE IM has identified three segments where demand is underpinned by secular themes. The first two are current global industry favorites: the living sector, particularly affordable and student housing, where Toms says "there is strong demand near the top universities from both domestic and international students," and logistics, given "online sales penetration continues to be high in the UK, and there are many demand drivers that create both rental growth and sticky tenants."

Toms' third pick is self-storage. The floor space of an average dwelling in the UK is less than half that of US homes, and many buyers and tenants can only afford smaller properties. "The utilization of self-storage in the UK is very high relative to the rest of Europe, and

Fundraising for UK real estate strategies increased in 2023 ($bn)



Source: PERE

it is an institutional market here," he says. "We will start to see more utilization from commercial or small business tenants too. There is also still a huge amount of consolidation that needs to happen, and as portfolios of scale are built up, that will allow more institutional capital to target the sector."

The participants also perceive potential in some of the UK's "unloved" sectors and locations. "Some managers have started looking again at retail," says Cowins. "They are telling us they can get double-digit yields on rebased, often inflation-linked rents."

"Yields are already beginning to tighten for UK retail park assets as investors realize that they offer excellent relative value, and assets attract more bidders," adds Toms.

Sher anticipates that over the next few years currently neglected assets in the UK regions will start to show value. "Managers will look at these unloved properties and say: 'Wow, because of the pricing I just cannot ignore them any more. I've got so much room to make mistakes that I'm just going to do it.'"

To take advantage of such situations, Arrow's most recent fund, Arrow Credit Opportunites II, is focused on sectors where negative sentiment means there is limited liquidity, but opportunistic returns can be achieved by lending against high-quality assets, he says.

The participants agree that where investors are brave and smart enough to acquire the well-located, ESG-compliant office assets that will continue to capture tenant demand, they too will generate attractive returns. "I have been surprised by the strength of the City of London office market," says Mahoney. "We are seeing nearly 10 percent prime rental growth year-on-year."

Turbulence in real estate markets always creates a buying opportunity when assets reach the right price point. In the UK, that moment has been reached in some sectors, and appears near at hand in others. Moreover, the prospect of calmer waters ahead will further embolden investors. Nevertheless, substantial risks remain, so the message from the roundtable is that the opportunity will be a granular one, requiring on-the-ground managerial expertise to source deals and generate value. ■

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STEVEN COWINS
Greenberg Traurig