Steady As She Goes?

An overview of the UK real estate market

Q2 2024

Overview

At present, the UK economy is doing a passable imitation of a vintage Rolls Royce: gliding along at a serene pace over some bumps in the road, without much in the way of acceleration or cornering, and with some well-worn interiors. To extend this analogy, UK real estate is riding along inside the car - an enjoyable ride for those who are prepared and appreciate the details, but somewhat stressful for those who are running late for refinancing deadlines. In this note we outline the latest in the key macro factors that we are paying attention to and set out what we are seeing in the main UK property sectors.

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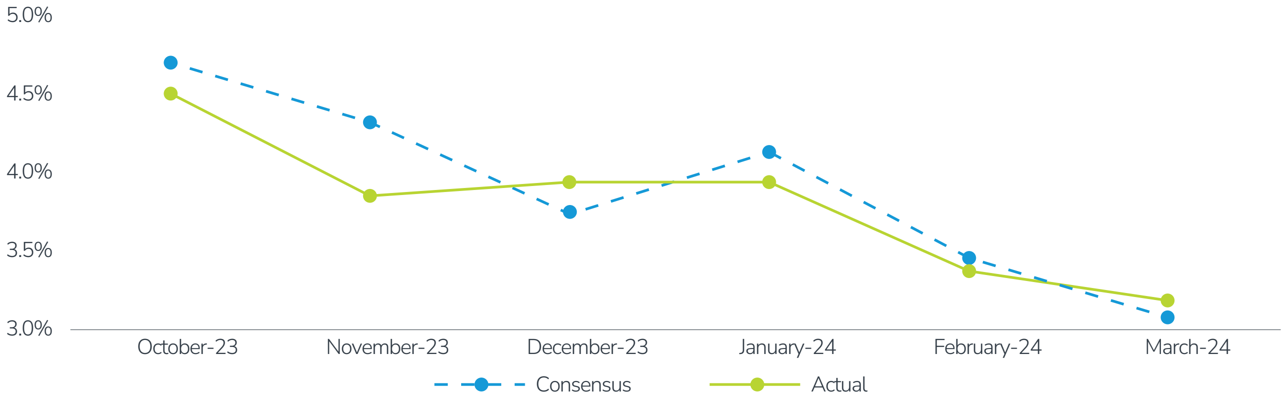
What We're Paying Attention To

Inflation

In our previous note, our key takeaway was that investors should be prepared for inflation volatility, and indeed the inflation print has surprised to both the upside and downside over recent months. The general trend is downwards but it remains unclear where and when UK inflation will settle, as it is influenced by multiple, interacting factors. It could well end up largely in a 2%-4% band, but it is equally possible that it could undershoot the 2% target and hit 1% or thereabouts before correcting.

Inflation Prints:
Consensus vs Actual Number



Source: Reuters; The Financial Times

What this means for real estate investors

- We still favour explicit rent inflation linkage, or shorter unexpired lease terms, to hedge inflation exposure and capture inflation-led rental growth
- Sectors more exposed to inflation, such as hospitality or leisure, should start to become more attractive as inflation begins to stabilize at lower levels

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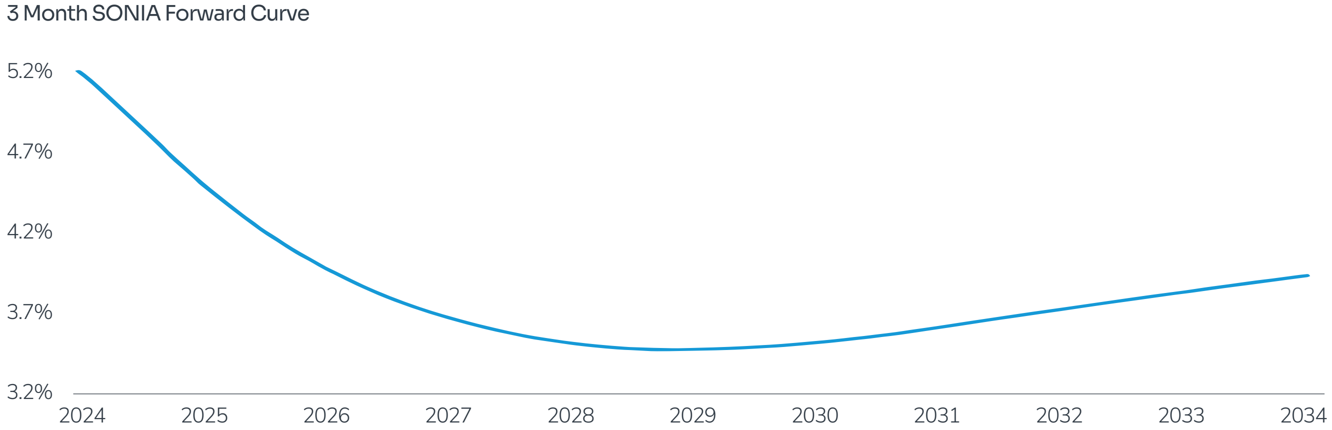
Interest Rates & Financing Costs

As expected, interest rates have plateaued at 5.25%. The Bank of England maintained the 5.25% rate at its March meeting, which means that the interest rate has remained at this level since August 2023. Variations in the market forward curve now reflect differing expectations of how quickly rates will decrease through 2025, rather than any expectations of further increases, and these differing expectations are in turn driven by volatility in the inflation data.

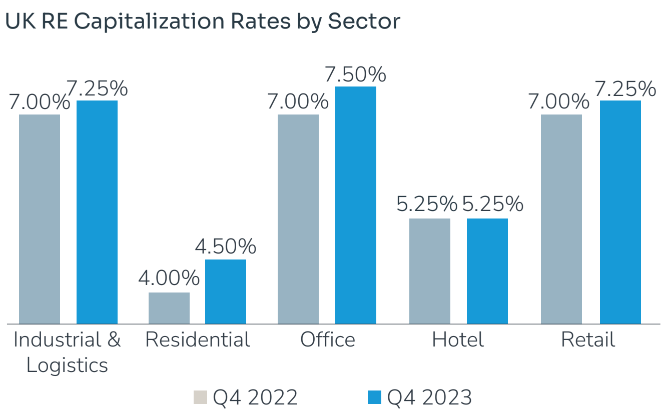


Source: Chatham Financial, 17 April 2024

This has meant that UK real estate financing costs are now broadly stable, albeit at the new, higher, level. Lender appetite, risk premiums, and available loan-to-value ratios are also steadying. This provides helpful stability and predictability for investors, but does not ease refinancing pressure for existing borrowers, some of whom have been hanging on in the hope that financing costs would decrease in the near term.

What this means for real estate investors

- Capital market conditions are likely to stay broadly the same until the summer. This provides predictability for new borrowers but means that those hoping for lower costs soon to ease refinancing pressures may be forced into taking action
- We continue to favour higher cap rate sectors that mitigate the impact of higher interest rates, and those where rental performance remains resilient
- Lenders continue to emphasise energy efficiency, whether through borrower upgrade plans or existing certifications, as they face sustained pressure to improve their loan book's energy profile

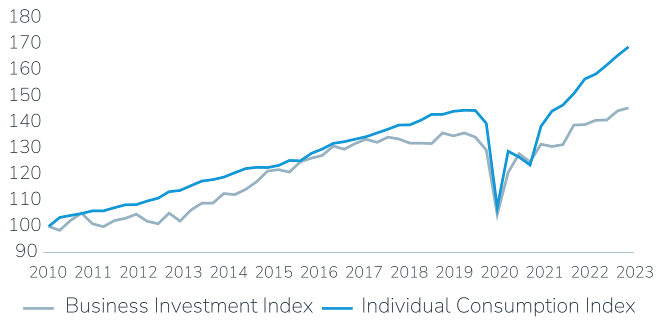


Source: Knight Frank, excludes London and prime assets

Economy

Much as with inflation data, UK GDP has been both better and worse than consensus expectations over recent months. There has been a lot of media commentary around the initial GDP data showing a mild contraction across H2 2023 (-0.1% in Q3 and -0.3% in Q4), however the UK's Office for National Statistics (ONS) notes that historically the average revision between the quarterly GDP initial estimate and the final estimate is +0.2%, so it may well be that the cyclical low ends up being the mildest brush with a technical recession. At the same time, unemployment has remained near cyclical lows, consumer spending is still resilient and gross capital formation has continued a steady acceleration.

UK Consumption & Investment Index



Source: Office for National Statistics

With green shoots appearing in the UK private equity market, we think that this economic backdrop continues to favour defensively positioned private equity strategies, particularly around business services.

What this means for real estate investors

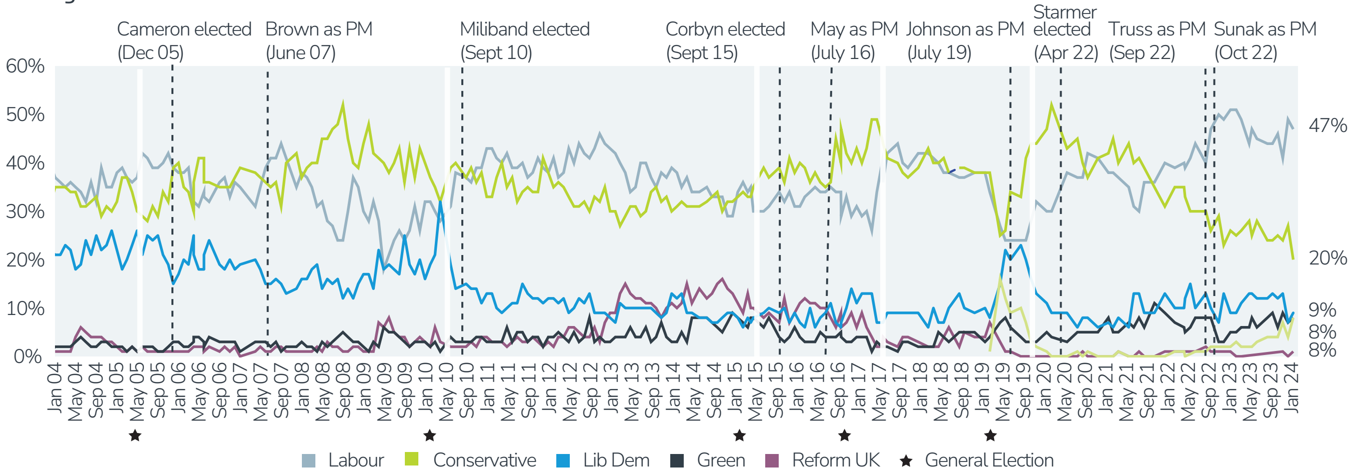
- Continue to be mindful of tenant sectors: we prefer diversification and sectors making up the backbone of the UK economy
- Focus on the affordability of the real estate: this keeps a property's potential occupier base large, provides downside protection, and offers an opportunity where firms or individuals opt for cheaper space

Politics

A UK General Election is due by January 2025 at the latest; most expectations are now for November 2024. Labour has been consistently polling 15-20 points ahead of the Conservatives, however recent polls have shown an even greater Labour lead, driven by a contraction in Conservative support. Expectations are still for a Labour majority at the next election, but bearing in mind that pre-election polling in the UK has often overestimated the size of the lead, we remain mindful of the chances of this being a relatively narrower majority than anticipated, or Labour requiring some form of coalition or working agreement with other left-of-centre parties.

At the same time, resulting Labour caution over its election manifesto means that it is often hard to see much clear water between them and the Conservatives in terms of economic or fiscal policy. This again supports the trend of steady but unspectacular predictability for businesses in the UK.

Voting Intention



Ipsos Political Monitor, March 2024

Planning and Development

One thing that both Labour and the Conservatives agree on is the impetus to speed up the planning system to encourage more development, particularly housing. However, a slow and complicated planning system is only one reason for a slow development pipeline at the moment – build cost growth has eased but build costs remain elevated, development finance is expensive, and exit pricing is subdued, so many projects are finding it difficult to make the numbers stack up. In addition, there is an emerging planning debate over 'embodied carbon'– that is, the relative impact of refurbishing older buildings and retaining the carbon that is embodied within their steel, concrete etc., versus demolishing them to build a modern, highly efficient building. In some areas, this could lead to a presumption in favour of refurbishment over new build and could well slow further rather than speed up planning, which could potentially have a significant impact on the amount of, and type of, space that can be delivered.

What this means for real estate investors

- UK developments are probably not for all investors, especially where planning risk is involved, and a healthy appetite for risk is warranted
- However, for this very reason, there should be some interesting opportunities that arise over the coming months
- At the same time, a reduced development pipeline is supportive for existing assets and may feed through into stronger rental growth

Property Sectors

Central London Offices

What we are seeing:

For those predicting the death of the office, here are some unexpected datapoints from central London, from Gerald Eve:

- 2023 saw just over 6m sq ft of office completions, the second highest level on record after 2018
- Q4 2023 take up was 4.4m sq ft, the largest quarterly number since Q4 2018. 2023 annual take up of 11.8m sq ft was only down 3% from 2022, and perhaps more interestingly, only 10% lower than 2017
- As a result, despite the near record level of completions, availability *fell* for both Q3 and Q4 2023, to end the year at 8.8%
- Mayfair and St James's are almost at their lowest availability level for the last decade

So, while certainly not all is golden in the central London office market, the immediate future seems rather rosier than many would have thought a year or two ago.

Regional Offices

What we are seeing:

The dam appears to have broken and there is now a more widespread acceptance of the new cap rate climate – broker estimates for prime cap rates in the major UK cities have largely moved out 50-75bps to 6.75%-7.0%, amid more deals in progress and hence more valuation evidence. This compares to prime cap rates of 4.75%-5.0% at Q4 2021.

However, lender caution remains over office occupancy dynamics and energy efficiency upgrade costs, and careful underwriting is key – this sector can show significant differences between headline yield and true underlying income / total return.

Industrial

What we are seeing:

Healthy rental growth has continued in 2023 and into 2024, albeit easing from the very strong levels in 2022, and the occupational market remains robust.

Cap rates remain elevated, with some stability now at the prime end but elsewhere continued pressure from high underlying interest rates and refinancing timescales.

In general, the industrial market, and particularly the multi-let industrial market, is offering in our view the most attractive combination of investment characteristics.

Residential (Built to Rent and Single Family Rental)

What we are seeing:

Savills data shows that the UK Build to Rent sector has now passed the 100,000 unit milestone, with a further 53,800 units under construction at end 2023 and an additional 112,800 units in the planning pipeline.

The difficult cap rate environment in 2023 meant that owners of completed, stabilized assets preferred to hold them - this has led to a lack of transactions which has kept cap rates tight, but has also meant that of the c. £4.5bn invested in Build To Rent in 2023, c. 80% were to fund developments, of which the majority were outside London and the core UK cities as the sector continues to mature [data again from Savills].

Student Housing

What we are seeing:

Sale volumes and pricing remain healthy, and undergraduate applications for the 2024/25 academic year are broadly flat year-on-year, but there is some emerging concern over parts of the market most exposed to overseas graduate students, where September could show the impact of the tightening in visa applications. At the same time, affordability (particularly for UK domestic students) remains a key focus, which may start to limit rental growth potential in some areas.

Retail

What we are seeing:

Amid a general lack of enthusiasm about retail property, you may be surprised to learn that 2023 saw an all-time high in investment in UK supermarkets, up 77% on the 10-year average. Institutional investors are currently keen on these longer term, inflation-linked income streams, although the robust cap rates for the higher rated tenants mean that these investments aren't an obvious value play.

What's In A Name? Cap Rates and Net Initial Yields

Investors will be familiar with the term 'cap rate' for real estate investments in the US. The UK works on the basis of 'net initial yield', which is broadly the same as 'cap rate' but with one key difference: whereas 'cap rate' is the property's Net Operating Income (NOI) divided by the purchase price, 'net initial yield' (NIY) is the property's Net Operating Income (NOI) divided by the purchase price plus acquisition costs.

What this means is that for the same purchase price and same NOI, the reported US cap rate will be higher than the reported UK net initial yield. The net initial yield will however be a truer reflection of the income return, as it shows net income divided by the total cash outlay at acquisition.

Oversimplifying somewhat, to calculate the net initial yield, the UK market uses standard purchase costs which are usually 6.8%. This figures accounts for stamp duty, agent and legal fees, and due diligence costs. Clearly, an acquisition's actual purchase costs may differ from 6.8% for various reasons, but it is useful to have a standardized number to allow an apples-to-apples comparison between different deals.

From an investor's perspective, it is helpful to show the practical effect of this difference, in terms of what the equivalent US cap rate would be for a varying UK net initial yield

Net Initial Yield	5.00%	6.00%	7.00%	8.00%	9.00%
Equivalent Cap Rate	5.34%	6.41%	7.48%	8.54%	9.61%

At Arcapita, when we refer to UK real estate, we use the term 'cap rate' for convenience, as this is what our investors are accustomed to. However, we calculate it on the basis of 'net initial yield' to be consistent with the UK market practice. Therefore, when comparing to US real estate, bear in mind that a UK cap rate will reflect c. 7% higher income return than the same cap rate in the US.

Arcapita's Focus

In summary, we see the UK continuing on its steady path over the coming months, heading into a likely autumn General Election. Inflation should continue an uneven descent and we may see a Bank of England rate cut, albeit probably only after the Fed has commenced its downward path. In this environment, attractive investment returns are available but need to be earned – in our view this favours active management and a targeted approach.

Within UK real estate, we continue to favour an active investment strategy focused on properties with shorter, staggered lease terms, a diverse income stream, and affordable rents that can be grown through active management. Within this strategy, our preferred sector is UK multi-let industrial, offering an attractive combination of cyclically high cap rates, sustainable income return, and capital growth through focused asset management.

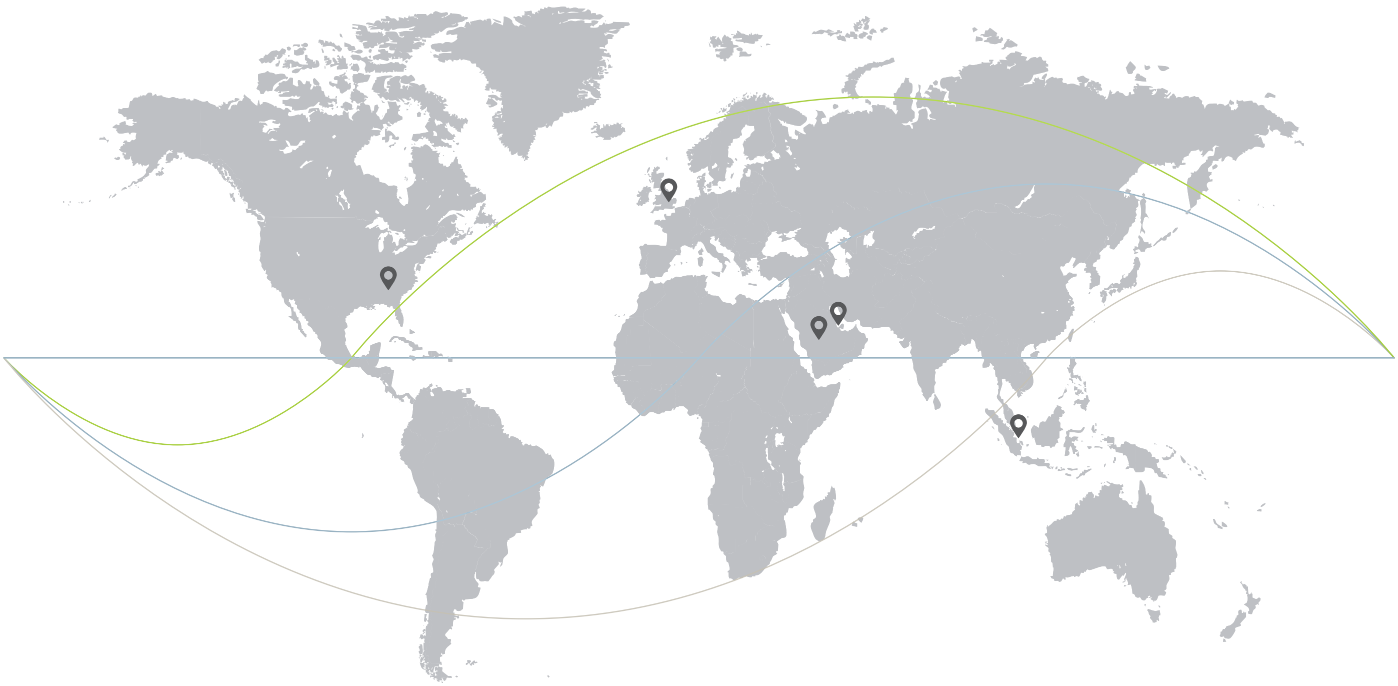
We also continue to favour strategies focused on upgrading buildings' energy efficiency, as we have confidence that by increasing their appeal to occupiers, lenders and investors will deliver additional return over the medium term.

ARCAPITA

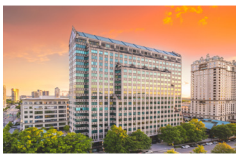
Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, and Singapore, Arcapita's management team has completed transactions worth a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



United States



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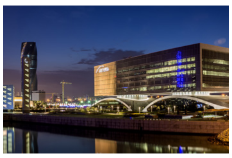

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