ARCAPITA

UK Real Estate: Unlocking Opportunities

November 2023

UK: Overview

In a period of economic volatility, some things are reassuringly familiar: for instance, Manchester United is still talented but inconsistent. In a similar vein, despite the tight labour market, high inflation, and rising interest rates, the UK economy has remained resilient. This resilience has implications for the UK real estate and private equity markets. In this note we summarise the key macro factors influencing UK real estate, and provide our thoughts on the main UK property sectors over the coming months.

UK: Key Influences

Inflation

Inflation has been elevated in the UK, as elsewhere, due to post-Covid supply/demand effects, but is now lowering further due to Bank of England interest rate increases (and to the reduction in the money supply, if you take the monetarists' position). There is plentiful debate over exactly where the inflation data is heading in the coming months, but in our view the key takeaway is that investors should be prepared for inflation *volatility*.

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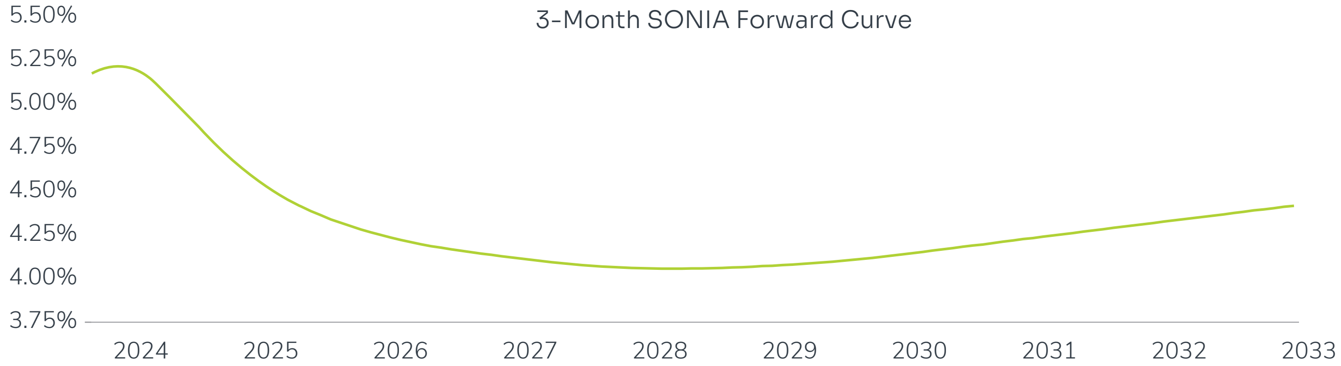
Impact on real estate strategy

- Favour explicit rent inflation linkage or shorter unexpired lease terms, to hedge inflation exposure and capture inflation-led rental growth
- Balance shorter lease terms with diversified income and staggered lease events for downside protection and active management opportunities
- Be mindful of sectors more exposed to inflation, such as hospitality or leisure

Interest Rates & Financing Costs

Interest rates have risen to address elevated UK inflation, and the market now expects a plateau at or near the current level of 5.25%. The market forward curve reflects a limited further increase, then a decrease through 2025.



Source: Chatham Financial, 31 October 2023

The combination of higher interest rates (particularly the key 5-year swap rate) and increasing lender margins has led to UK real estate financing costs rising significantly over the past 18 months. At the same time, cautious lenders have pared back Loan-to-Value ratios and loan covenants. Together with the higher financing costs, this has led to lower leverage being available. This in turn creates refinancing pressure for existing borrowers, who face being unable to secure the same amount of debt on refinancing, as they have expiring.

Not all property sectors face equal pressure though. Conscious of the regulatory capital impact of sub-performing and non-performing loans, shareholder wariness around press reports (especially in the US) on office markets, and their own ESG policies, lenders are working to shift their loanbooks towards the industrial and living (residential, student housing etc) sectors and away from offices and retail, and focusing on properties with existing green credentials or energy efficiency upgrade plans. Those assets on the right side of this lender focus are relatively buoyed; those on the wrong side are, in our view, facing substantial structural headwinds.

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Impact on real estate strategy

- Residential (Build To Rent and Single Family Housing): few mature assets and institutional equity, plus similar rent growth expectations, have meant little cap rate change
- Student Housing: impacted by higher financing costs, and transaction volume is down, but rental growth to date has largely offset the impact
- Industrial: higher cap rates, driven by higher financing costs, despite ongoing rental growth. Institutional equity favours the prime end of the industrial market, so coupled with rent growth expectations, prime cap rates remain below financing costs. Elsewhere, cap rates have increased and are now accretive to financing
- Regional Offices: cap rates heavily impacted by higher financing costs. Finance is scarce, and expensive where available, given lender concerns around rental performance, vacancy, and energy efficiency upgrade costs
- London West End Offices: a big focus of UK and overseas equity rich private capital, investing for long term capital preservation. Lot sizes, investor strategy and cap rates all factor against using debt
- Retail: less impact, if only because debt was already scarce and expensive

In general, we favour higher cap rate sectors that mitigate the impact of rising interest rates, and those where rental performance remains resilient

UK Economy

Contrary to media consensus, UK GDP has been revised up significantly for 2021 and 2022, showing that UK economic performance is on par with France and ahead of Germany. Unemployment remains near cyclical lows and consumer spending has remained resilient and gross capital formation has accelerated for the first time since Brexit.

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

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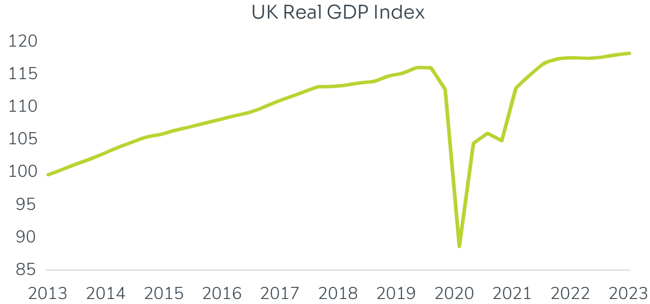
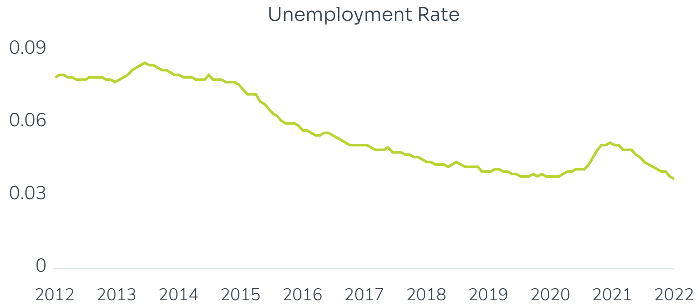


Source: Office for National Statistics



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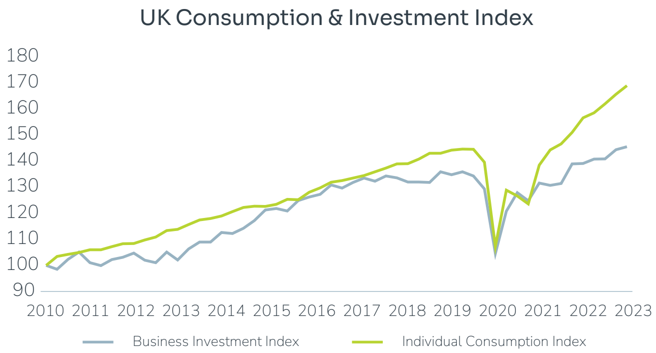
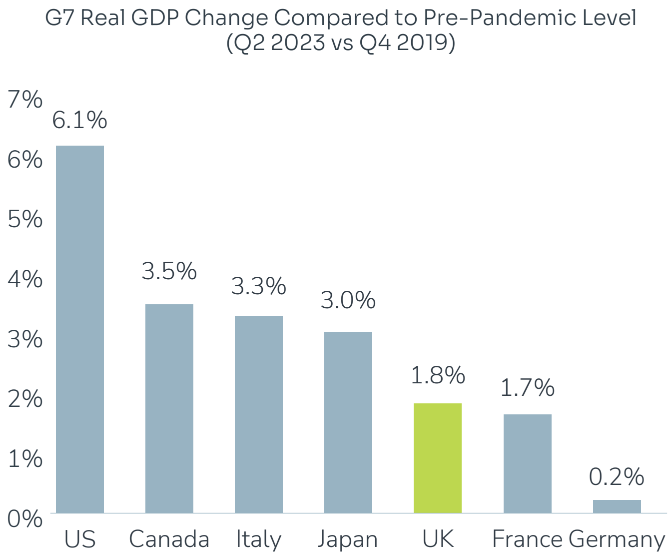


Source: Office for National Statistics

Some economic commentators continue to expect a near term recession; however, the latest BOE and IMF forecasts do not foresee a UK recession in 2024 or 2025.

Impact on real estate strategy

- Be mindful of tenant sectors: we prefer diversification and sectors making up the backbone of the UK economy
- Focus on structural requirements: housing, warehousing/logistics, student housing, commercial firms that need a physical presence (e.g. building trades, manufacturing, automotive)
- Be wary where occupiers do not need to be present (in a specific space, or generally): work from home ("WFH") for office occupiers, business travel hotels, multi-channel retailers
- 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



Source: OECD as of 10/10/2023

UK Politics

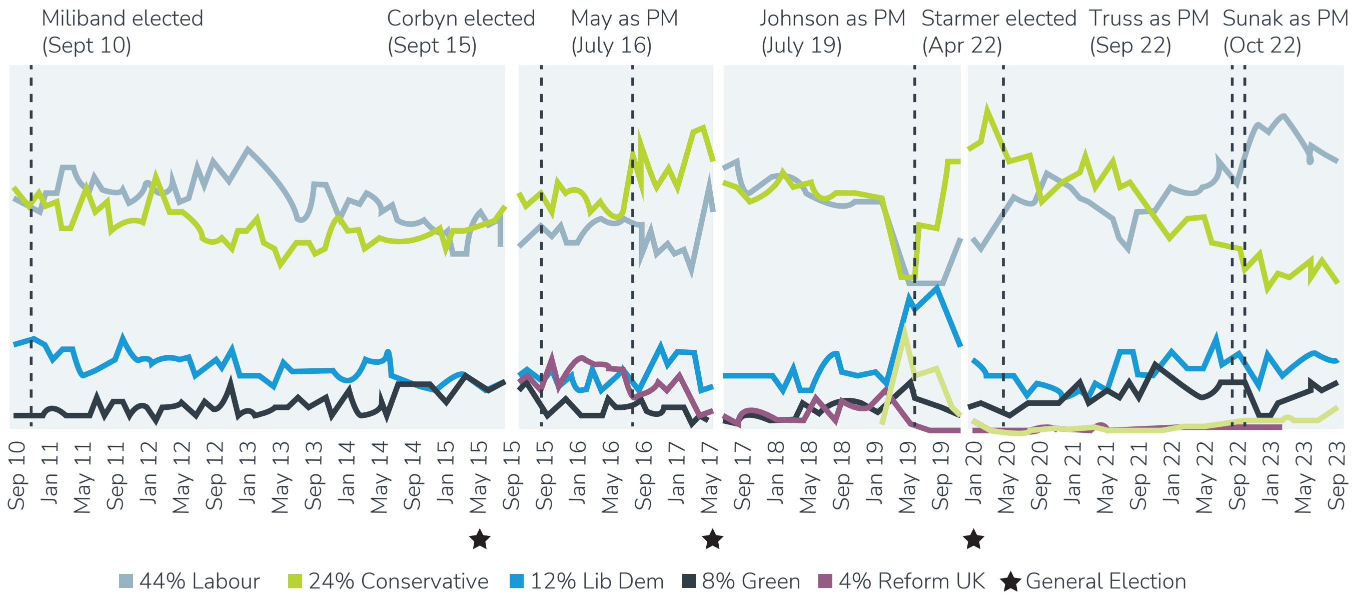
A UK General Election is due by January 2025 at the latest; most expectations are for October 2024. Labour is consistently polling 15-20 points ahead of the Conservatives, comparable to the run up to the 1997 election where Tony Blair won a comprehensive victory over a long-in-the-tooth Conservative government. Expectations are for a Labour majority at the upcoming election.

In his search for 'wedge issues' for political positioning ahead of the election, PM Sunak is highlighting items impacting consumer costs in the short term – pushing out phase-in dates for EVs and home gas boilers, pro-motorist policies (rather than policies limiting urban motor use), plus some broader consumer issues such as residential rental reform and a gradual phase out of smoking, and a redirection of transport infrastructure upgrades to northern UK.

Labour is aligned with the Conservatives on the broad fiscal framework, but has a marked emphasis on delivering the net zero transition, and on increasing housebuilding and the supply of social and affordable homes.

Expectations are for a Labour majority at the upcoming election

Voting Intention



Source: Ipsos

Net Zero

The UK is legally bound to achieving net zero by 2050, and has carbon budgets already set out to 2033 with independent statutory oversight. In other words, the net zero flightpath is already set and there is limited space for manoeuvre.

Sunak is expressing a position to delay some of the consumer facing aspects, but in practice it is difficult for the government to legislate against the existing framework before the election – due to timing, parliamentary opposition and the above regulatory constraints. Instead, this appears more a delay in taking these steps forward.

Should they win the upcoming election, Labour may push to accelerate the transition to net zero

The most recent polling results show Labour leading Conservatives ahead of the upcoming election, and with Labour's emphasis on the importance of, and opportunities arising from, net zero and the green transition, we expect an accelerated government push around net zero, energy efficiency requirements, renewable energy, and decarbonization.

But this is just the government aspect. Elsewhere, the UK is not waiting for the government to formalize existing proposals. As highlighted already, lenders view energy efficiency and EPC ratings as key for their loan portfolios, so investors are pushed to comply, either through existing certification or upgrade plans, to be able to secure financing. This may have a limited impact right now given the cost of finance, but as the cost is expected to ease in the near to medium term, this should lead to a clear value gap between financeable and lender-averse properties.

Similarly, lower cost institutional equity is focused on assets compliant with the proposed EPC thresholds for commercial real estate (EPC C in 2027 and EPC B in 2030). UK institutions have not waited for the government to formally agree these levels, and so these 2027 and 2030 thresholds have become the de facto market standard. As a result, we also expect to see an emerging value gap between properties and portfolios that meet the requirements of this lower cost institutional equity, and those that don't.

Lastly, it is perhaps easy to overlook, but occupiers (both companies large and small, and individuals) are generally in favour of more energy efficient buildings – they save on energy costs, they can lock in occupancy beyond 2027/2030 and in the case of many companies, they have existing ESG policies that they are looking to comply with.

Impact on real estate strategy

- Proposed EPC thresholds have become a de facto market standard, and we expect a Labour government in October 2024 with an active net zero legislative programme thereafter
- We expect an ESG-compliant supply crunch up to 2030, with downside value risks to stranded assets but offering enhanced attractiveness and value for compliant properties
- Favour value creation through energy efficiency upgrades – through increased occupier demand, through financeability, and enhanced appeal to lower cost institutional equity

Geo-politics

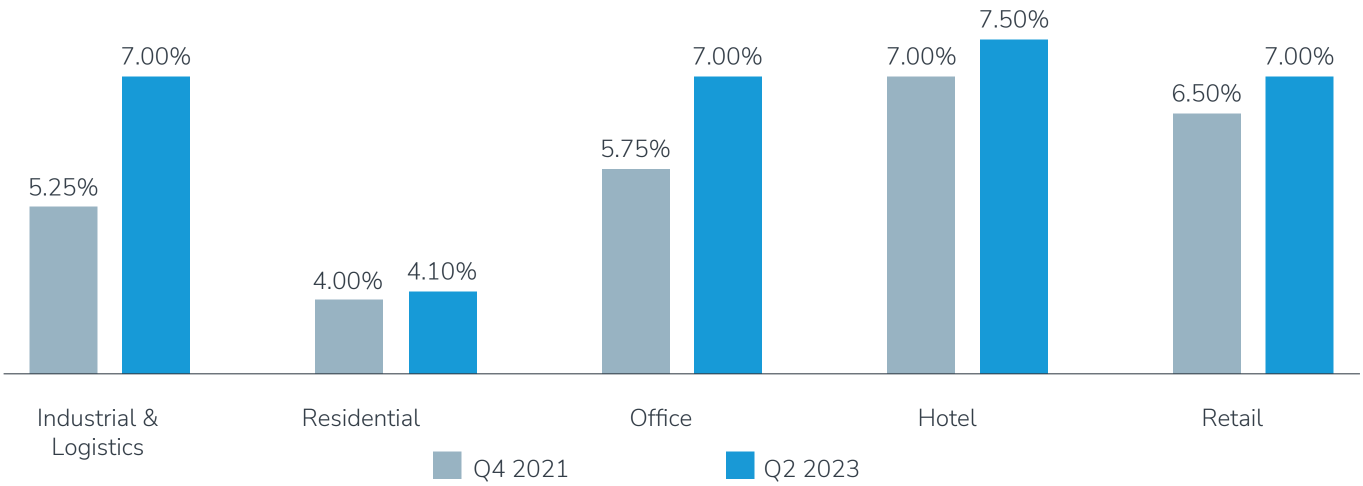
Given the current context of global uncertainty, we anticipate the UK will continue its position as a global haven for real estate and private equity investment. UK commercial real estate's combination of landlord friendly market structure, liquid and open capital markets, and attractive income returns compared to peers, provides a strong foundation for capital preservation and sustainable income return. Addditionally, UK commercial real estate is not burdened by many of the taxes and regulations that are present in UK personal residential real estate. Coupled with an attractive FX rate at present for USD denominated investors, the UK should continue to appeal to investors conscious of geo-political exposure elsewhere in their portfolio.

Impact on real estate strategy

- London West End offices (that elusive Mayfair or St James's freehold) are some of the most consistently sought after safe haven assets, and we expect them to remain in strong demand – underpinned by healthy tenant demand and rental growth, particularly for prime, high-ESG offices
- We also favour defensively positioned, liquid assets across sectors – especially those showing a strong, sustainable income return

UK Property Sectors

UK RE Capitalization Rates by Sector



Source: Knight Frank, excludes London and prime assets

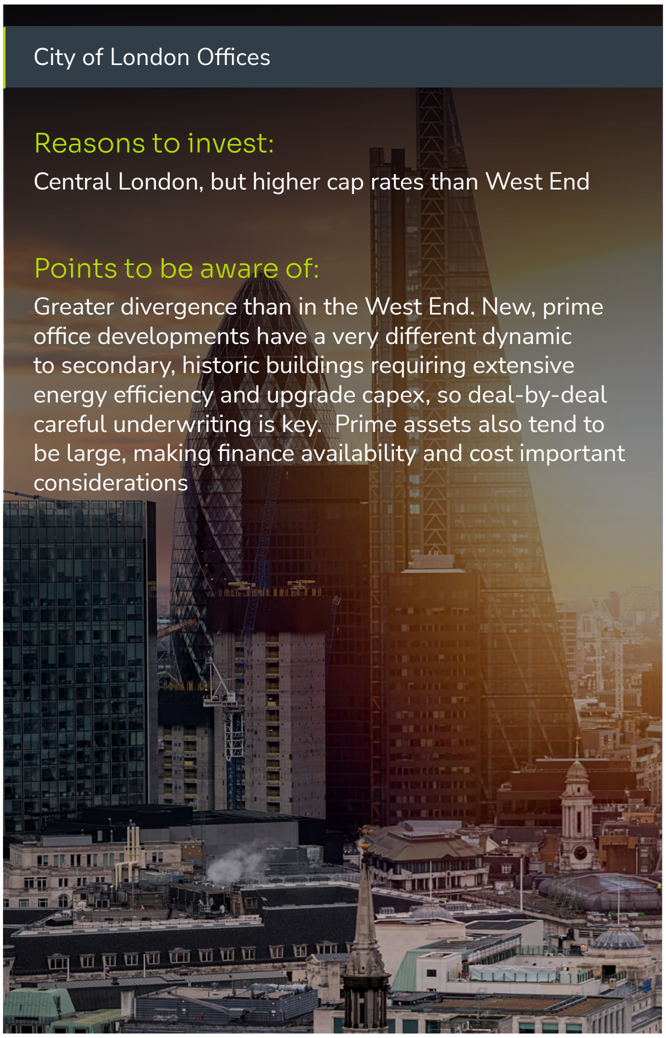
London West End Offices

Reasons to invest:

Global safe haven, good tenant demand and rental growth for prime, high ESG buildings

Points to be aware of:

Cap rates remain low and below financing costs, so smaller lot sizes remain most liquid



City of London Offices

Reasons to invest:

Central London, but higher cap rates than West End

Points to be aware of:

Greater divergence than in the West End. New, prime office developments have a very different dynamic to secondary, historic buildings requiring extensive energy efficiency and upgrade capex, so deal-by-deal careful underwriting is key. Prime assets also tend to be large, making finance availability and cost important considerations

Regional Offices

Reasons to invest:

The hunt for an underpriced gem. Worries over WFH / office occupancy, rent dynamics and energy efficiency upgrade costs mean institutions and lenders are both wary of this sector – capital is scarce, and expensive where available. However this gives the opportunity to find those assets where these concerns may be overblown and relative pricing is attractives

Points to be aware of:

Not every high yielding sale is an underpriced gem. 'Buyer beware' rules, and careful underwriting is key

Industrial

Reasons to invest:

In our view, multi-let industrial offers the most attractive combination of investment characteristics:

- Inflation protection: shorter lease terms and diversified income
- Higher cap rates
- Structural supply shortage and large occupier base
- Viable value creation through energy efficiency upgrades
- Favoured by lenders and institutional capital

The same rationale holds for single let logistics, only that a much larger investment is needed to achieve a similarly diversified income, and the tenant base is less broad

Points to be aware of:

At the prime end of the sector, and especially around London, cap rates remain lower than financing cost. Same squeeze, less juice?

Residential (Built to Rent and Single Family Rental)

Reasons to invest:

Another attractive combination of investment characteristics:

- Inflation protection: currently annual leases and granular income. The rental reform bill in Parliament would provide for longer tenancies, so greater income stability, but what effect might this and a Labour government's programme have on rental growth going forward?
- Structural supply shortage: Labour would like to significantly expand affordable housing supply, but how difficult will this be and how long might it take?
- Favoured by lenders and institutional capital

Points to be aware of:

Two headwinds: very little existing, stabilized stock and relatedly, cap rates remain largely unchanged. The market is still maturing

Student Housing

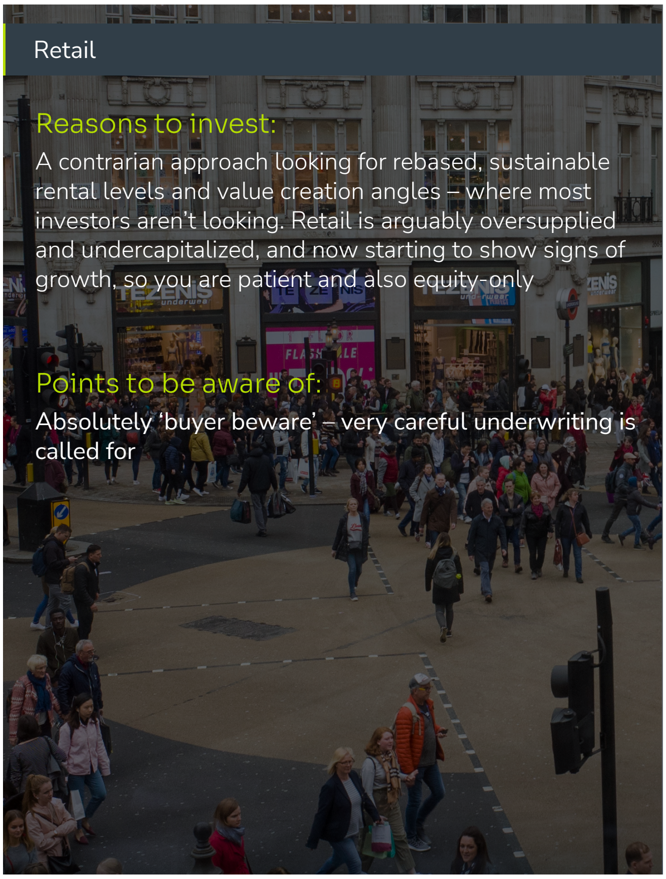
Reasons to invest:

The third sector in the triumvirate of attractive investment characteristics:

- Inflation protection: structural supply shortage, though not all university towns are equal
- Inflation protection: annual contracts (even with the upcoming rental reform), although operational costs and energy use are also impacted
- Favoured by lenders and institutional capital
- Energy efficiency upgrades can feed directly into the bottom line

Points to be aware of:

To date, rental growth has largely offset cap rate increases from higher financing costs, but are there limits to medium term rental growth? Careful underwriting is key, as each university town can have markedly different supply and potential rental growth dynamics



Retail

Reasons to invest:

A contrarian approach looking for rebased, sustainable rental levels and value creation angles – where most investors aren't looking. Retail is arguably oversupplied and undercapitalized, and now starting to show signs of growth, so you are patient and also equity-only

Points to be aware of:

Absolutely 'buyer beware' – very careful underwriting is called for

UK PE: Turning the Corner

After over a year of subdued activity, including lower transaction and investment volumes, and falling multiples, there are signs of changing tides in UK private equity. 2023 fundraising activity is on track to be ~60% higher than 2022 levels and near all-time highs, indicating robust investor demand. Deal activity has increased quarter-over-quarter in two straight quarters, from Q1 2023 to Q3 2023. Additionally, investment banks are reporting an acceleration of pitch work for H1 2024 sale processes.

In 2022 and H1 2023, asset owners elected to postpone sale processes, in the hope that multiples would rebound to 2021 levels. However, the recent activity and preparations to launch sale processes indicates that sellers are now accepting of current valuation multiples. Possible reasons for this change in mindset include asset-level growth in EBITDA over the interim ~2 years, thus driving enterprise values to levels that allow sellers to achieve their return hurdles, fund or debt term limits, or pockets of distress. Whatever the reason, this change in mindset offers hope for more investment opportunities and for deal activity to rebound in 2024.

Arcapita's Focus

In summary, the UK economy and macroeconomic story remains resilient, with the move towards net zero remaining in place despite recent rhetoric from PM Sunak. These developments, combined with the current attractive exchange environment for USD denominated investors and the UK's stable, defensive positioning, reinforce UK real estate's position as an attractive asset class for global investors and form the bedrock for optimism in exploring investment opportunities.

Amid the dynamic economic landscape, our strategic focus remains on real estate asset sectors that align with secular, long-term trends that are durable through economic cycles. Notably, we identify Residential and Industrial sectors as our favoured asset classes, given the supporting underlying trends that form the foundation for robust demand. Both sectors benefit from shorter, staggered lease terms, a diverse income stream from occupiers, and rents that can be grown through active management. We also have confidence that strategies focused on upgrading properties' energy efficiency will drive additional return over the medium term, through enhancing their attractiveness to occupiers, investors, and lenders.

With pricing in the Industrial sector at a cyclical low, we believe the current environment offers an opportunity to secure an attractive basis that will benefit from a highly favourable combination of strong, sustainable income return, and capital growth through active management and energy efficiency upgrades. We have conviction that this strategy presents the most compelling investment opportunity in UK real estate since the post-GFC vintage.

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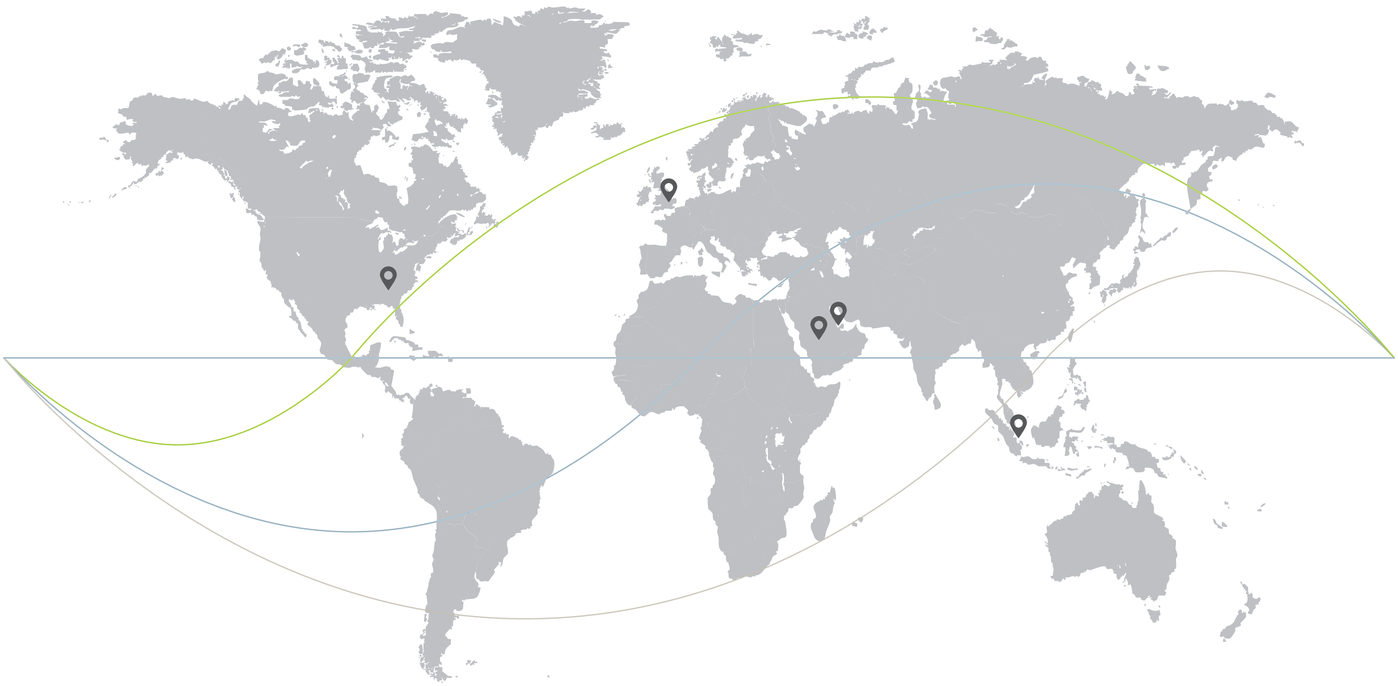
ARCAPITA

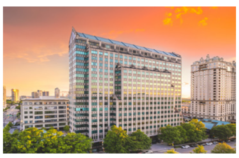
Overview

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 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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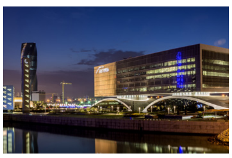

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