UK Real Estate

Back to School

A new Government, brighter outlook and strengthened opportunities

September 2024

Overview

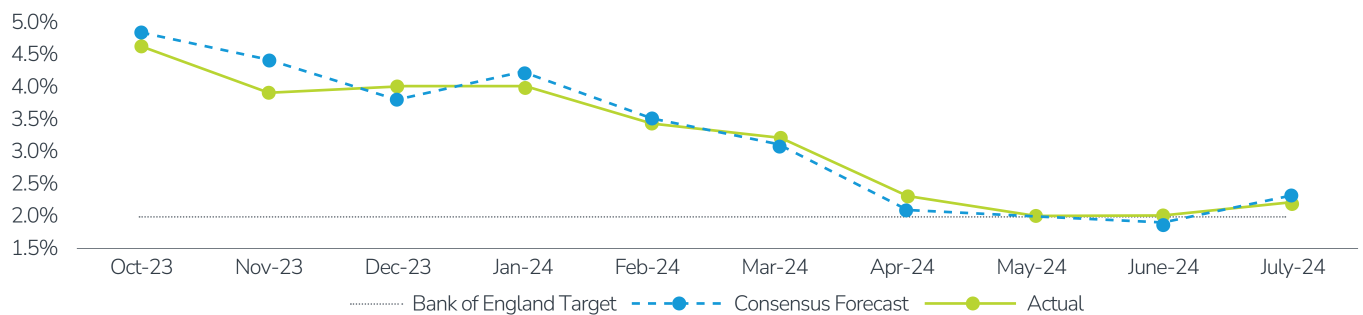
It is a new school year, a new football season and a new UK Government. After an exciting summer of sport, it is time to head back to school for more steady progress – for UK real estate as well as for the country at large. In this note we outline the latest in the key macro factors that we pay attention to and update what we are seeing in the main UK property sectors, plus we look in more detail at the student housing sector.

What We're Paying Attention To

Inflation

UK inflation has fallen over 50% from its level of 4.5% in October 2023, and after coming in at exactly the 2% target in May and June it rose slightly to 2.2% in July. While we had anticipated that inflation could even get below 2%, it now seems more likely that with downwards pressure from lower energy costs receding, inflation could settle in a 2% to 2.5% band for the rest of 2024. This would provide a helpfully benign environment for real estate investment, and compares to inflation expectations of 3.0% in the US and 2.4% in the Eurozone.

October to July Inflation Prints:
Consensus vs Actual Number



Source: Reuters; The Financial Times

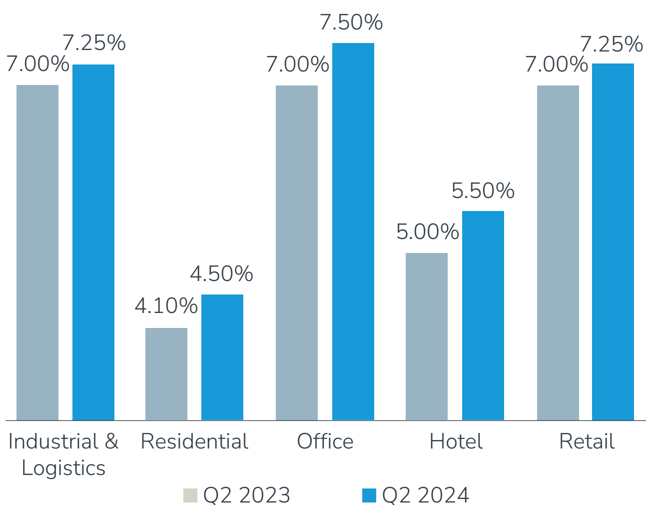
What this means for real estate investors

- We still favour explicit rent inflation linkage, or shorter unexpired lease terms, to hedge inflation exposure and capture inflation-led rental growth. While short term inflation expectations are moderated, this provides protection in the event of another inflation surge.
- Sectors more exposed to inflation, such as hospitality or leisure, are becoming more attractive as inflation and wage growth begins to stabilize.

Interest Rates & Financing Costs

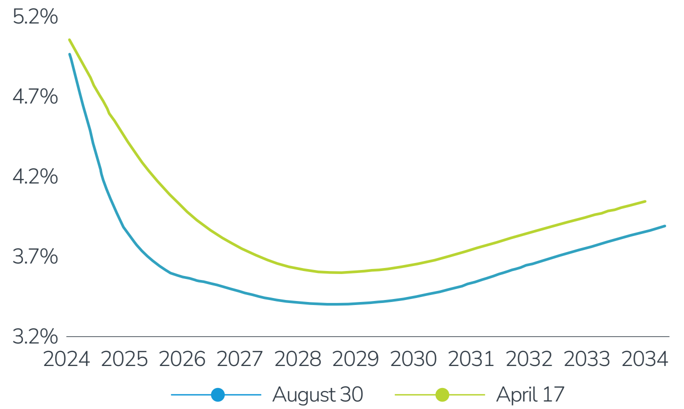
The Bank of England delivered a 25 basis point cut in the interest rate at the end of July, taking the base rate to 5.00% after a year when the rate had plateaued at 5.25%. Together with moderated inflation expectations, this has led to a clear shift in the forward curve, compared to April 2024 (see chart to the right) – the market is currently pricing in 50 basis points of cuts by early 2025 and a further 50 basis points of cuts by summer 2025.

UK RE Capitalization Rates by Sector



Source: Knight Frank, excludes London and prime assets

3 Month SONIA Forward Curve



Source: Chatham Financial, 30 August 2024

This compares to market expectations of 175 basis point cuts by the US Fed over the next 12 months, and 150 basis point cuts by the ECB, pointing to a market view of the UK base rate seeing a premium of c. 25 bps to the US and c. 150 bps to the Eurozone in summer 2025.

From a UK investment perspective, this has a number of implications. At a domestic level, it means that UK real estate financing costs should remain broadly stable, with a gradual improvement over the medium term, and with lender appetite, margins, and available loan-to-value ratios also steady – this continues the supportive predictability of the UK market environment. Secondly, with expectations of smaller short term decreases in interest rates compared to the US or the Eurozone there is a longer horizon to acquire UK real estate at attractive cap rates and also the prospect of medium term exits in a lower interest rate environment - this should benefit disciplined investors. Finally, the anticipated interest rate premium in the UK should provide support for GBP compared to USD and EUR, which can provide an additional upside for USD denominated investors.

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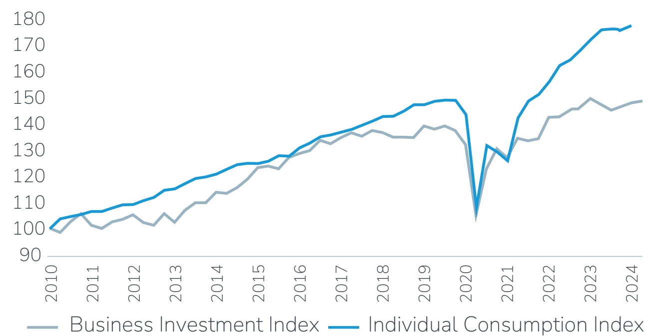
What this means for real estate investors

- Capital market conditions are likely to stay broadly the same for the next several months. This provides predictability for new borrowers but continues to exert refinancing pressure on some existing owners
- We continue to favour higher cap rate sectors that can derive the greatest benefit from this higher interest rate environment, 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. This is likely to be supported by new measures from the new Labour government
- USD denominated investors may be further attracted by the anticipated interest rate premium in the UK and its potential impact on USD:GBP

UK Economy

The latest data shows that UK GDP grew by 0.7% in Q1 2024, the fastest growth since 2021, and by 0.6% in Q2 2024. At the same time, unemployment has remained near cyclical lows, declining to 4.2% in Q2 2024, and consumer spending continues a steady growth trend. While there is no guarantee that this will be a long lasting position, it is interesting to note that on GDP growth and unemployment rate, the UK is now showing better metrics than the US, despite market expectations of higher interest rates than the US over the coming year.

UK Consumption & Investment Index



Source: Office for National Statistics

This economic backdrop appears supportive for UK private equity strategies. Indeed KPMG note that the level of UK mid-market transactions in H1 2024 appears to be normalising, down 11% from H1 2023 but importantly up 25% from the pre-Covid level in H1 2019, and despite higher financing costs, UK companies continue to be attractive, with over 40% of M&A deals involving an international buyer. In particular, business services is emerging as a clear winner in UK private equity, with Grant Thornton reporting that the share of business services deals has risen from 34% in H1 2021 to 44% in H1 2024.

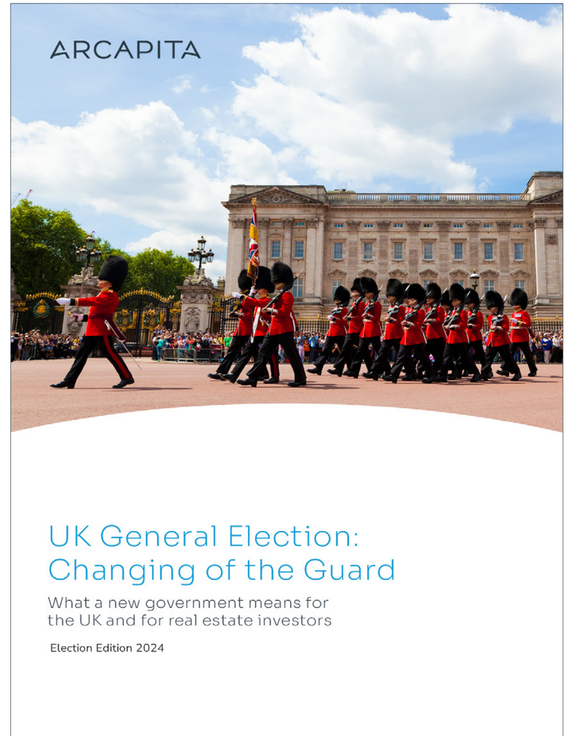
What this means for real estate investors

- We continue to prefer income diversification and sectors making up the backbone of the UK economy, but investors should be feeling more comfortable with an increasingly large proportion of the UK tenant base
- While consumer and business spending has remained resilient, we still favour real estate with affordable rents, as occupiers remain attentive to their cost base and to provide greater scope for income growth over the short/medium term

UK Politics

As recounted in our recent UK update, **UK General Election: Changing of the Guard**, it is a new term for the Labour party after securing a convincing majority at the UK General Election on July 4. With high expectations following the election victory, PM Sir Keir Starmer and the Labour party have been active in the following weeks on new initiatives. The King's Speech on July 17 set out the new Government's legislative programme for the next year with 40 bills, the second highest number of bills since Tony Blair's initial victory in 1997. These 40 bills contained measures addressing Labour's key focus areas, including planning, transport, employment rights, border security, policing, health and residential rental reform.

In terms of economic and fiscal policy, there has been a lot of political noise as new Chancellor Rachel Reeves triangulates between managing expectations from the public and internally from the Labour party, and seeking to pin blame on the outgoing Conservative administration. However it appears likely that the new Labour government will follow a similar flightpath to the previous Conservative government, albeit with the balance tipped more towards increased taxation than towards spending cuts. The first Labour budget is scheduled for October 30, following which the details of Labour's economic programme will be clearer.



UK Property Sectors

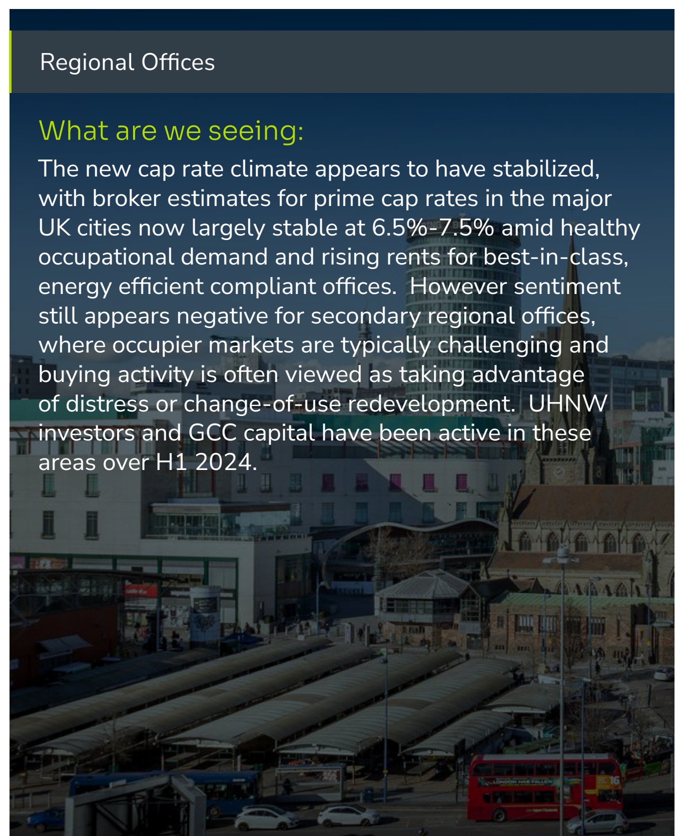
Central London Offices

What are we seeing:

According to data from central London specialist BDG Sparkes Porter, the West End office market continues to display healthy metrics:

- Demand for office space has increased 13% over H1 2024, particularly for units over 10,000 sq ft
- Prime rents continued to grow, albeit at a more moderate growth rate than in 2022
- Supply is constrained, especially for ESG compliant space that is particularly sought after by occupiers, with JLL reporting the vacancy rate for new build office space at just 1.4%.

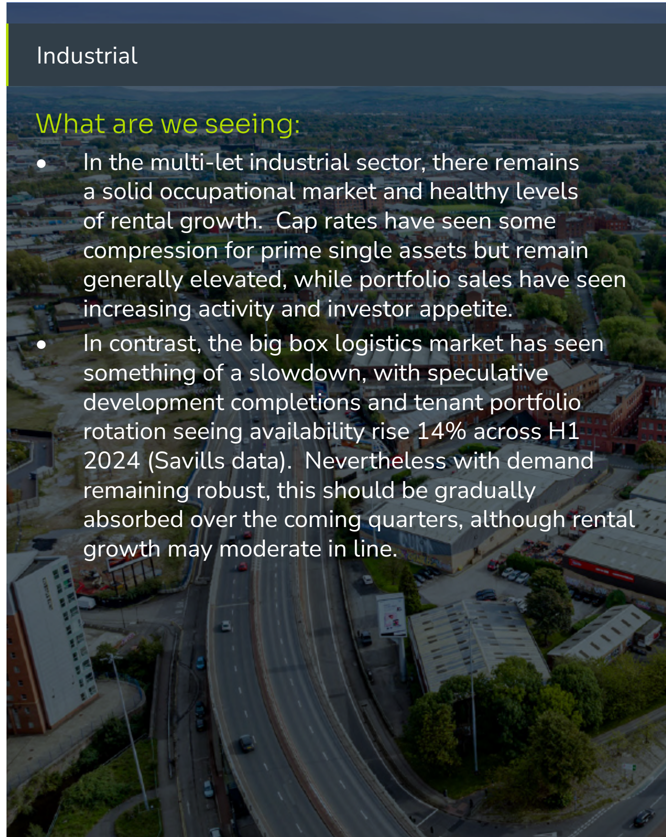
Investor activity remains limited, with transaction volume down 60% compared to the long term average. Savills records central London office investment volume as £2.9bn for H1 2024, with smaller deals being the focus of UK private investors, and US private equity and European investors also active.



Regional Offices

What are we seeing:

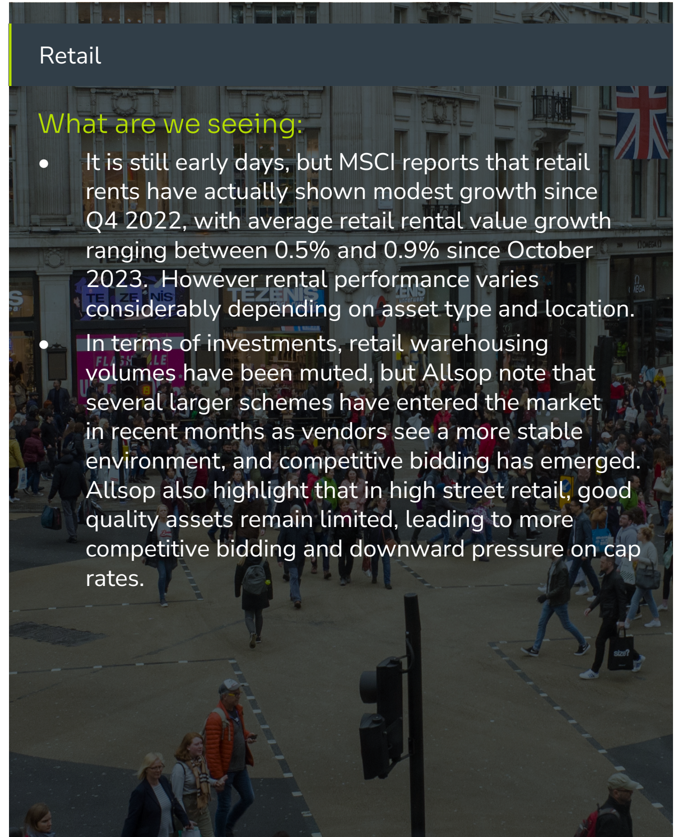
The new cap rate climate appears to have stabilized, with broker estimates for prime cap rates in the major UK cities now largely stable at 6.5%-7.5% amid healthy occupational demand and rising rents for best-in-class, energy efficient compliant offices. However sentiment still appears negative for secondary regional offices, where occupier markets are typically challenging and buying activity is often viewed as taking advantage of distress or change-of-use redevelopment. UHNW investors and GCC capital have been active in these areas over H1 2024.



Industrial

What are we seeing:

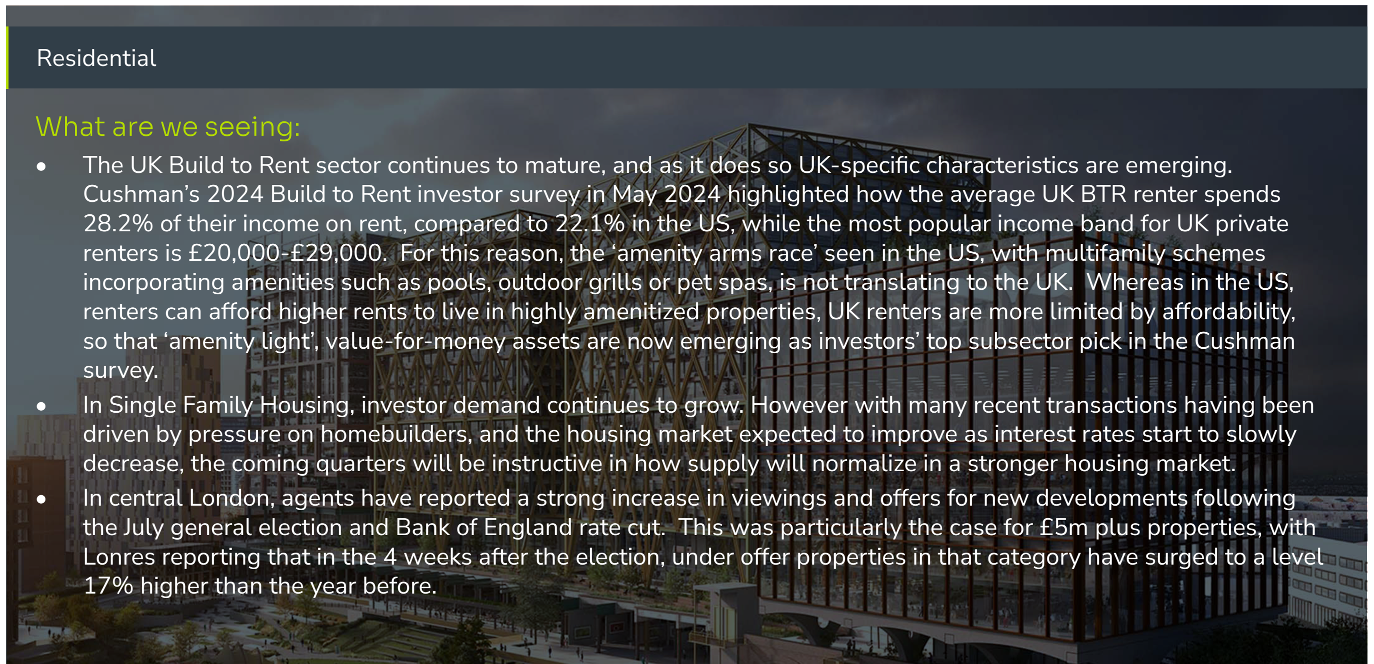
- In the multi-let industrial sector, there remains a solid occupational market and healthy levels of rental growth. Cap rates have seen some compression for prime single assets but remain generally elevated, while portfolio sales have seen increasing activity and investor appetite.
- In contrast, the big box logistics market has seen something of a slowdown, with speculative development completions and tenant portfolio rotation seeing availability rise 14% across H1 2024 (Savills data). Nevertheless with demand remaining robust, this should be gradually absorbed over the coming quarters, although rental growth may moderate in line.



Retail

What are we seeing:

- It is still early days, but MSCI reports that retail rents have actually shown modest growth since Q4 2022, with average retail rental value growth ranging between 0.5% and 0.9% since October 2023. However rental performance varies considerably depending on asset type and location.
- In terms of investments, retail warehousing volumes have been muted, but Allsop note that several larger schemes have entered the market in recent months as vendors see a more stable environment, and competitive bidding has emerged. Allsop also highlight that in high street retail, good quality assets remain limited, leading to more competitive bidding and downward pressure on cap rates.



Residential

What are we seeing:

- The UK Build to Rent sector continues to mature, and as it does so UK-specific characteristics are emerging. Cushman's 2024 Build to Rent investor survey in May 2024 highlighted how the average UK BTR renter spends 28.2% of their income on rent, compared to 22.1% in the US, while the most popular income band for UK private renters is £20,000-£29,000. For this reason, the 'amenity arms race' seen in the US, with multifamily schemes incorporating amenities such as pools, outdoor grills or pet spas, is not translating to the UK. Whereas in the US, renters can afford higher rents to live in highly amenitized properties, UK renters are more limited by affordability, so that 'amenity light', value-for-money assets are now emerging as investors' top subsector pick in the Cushman survey.
- In Single Family Housing, investor demand continues to grow. However with many recent transactions having been driven by pressure on homebuilders, and the housing market expected to improve as interest rates start to slowly decrease, the coming quarters will be instructive in how supply will normalize in a stronger housing market.
- In central London, agents have reported a strong increase in viewings and offers for new developments following the July general election and Bank of England rate cut. This was particularly the case for £5m plus properties, with Lonres reporting that in the 4 weeks after the election, under offer properties in that category have surged to a level 17% higher than the year before.

Student Housing - A Less Uniform Market

As the new academic year starts, it is a good time to dig deeper into the student housing market to investigate some contradictory viewpoints. On the surface, student housing investors and agents remain bullish, with rental growth expectations over the coming years typically between 3%-6% p.a. off the back of a record 8.0% national rent growth for the 2023-24 academic year (AY) and analysis centred on the ratio of total students to PBSA (Purpose Built Student Accommodation) beds. At the same time, the UK media has seen a regular series of stories highlighting some significant drops in international student applications, lower ranking universities fighting to fill places and mounting concern over the financial stability of some parts of the university sector. How do we reconcile these two narratives?

In short, the UK university landscape is less uniform that some may assume, and the present narratives are largely the result of its tiers becoming more differentiated. To see this, it is helpful to look more closely at the on-the-ground dynamics in demand, supply, income and investment pricing.

Demand

According to data from UCAS, the UK university applications service, the total number of UK university acceptances is up 2.6% for AY 2024-25. Within this there is a 6% rise in acceptances for UK 18 year olds, the largest cohort at 57% of applicants. Non-EU acceptances were down a marginal 0.2%, although Chinese acceptances are down 5.8% year-on-year and are 16.9% lower than in 2021.

This all seems generally positive and supportive for the PBSA sector. However, there are nuances.

According to UCAS data as at June 30, UK undergraduate applications were down 1.6%, with a 2% decline in international undergraduate applications. The acceptances mentioned above are from the universities, and students still need to confirm the acceptances – students will naturally apply to multiple universities and will go for their 'best' option if they have multiple acceptances. This applies to international students as well as UK ones: UCAS data notes that two thirds of international undergraduate students have applied to other countries as well, though the Student Housing Consultancy highlights that 40% of international undergraduates and the majority of international postgraduates apply outside of UCAS, so the UCAS data doesn't capture the overall dynamic of international applications or acceptances.

Data from Enroly, the service that many UK universities (some Russell Group, but mainly younger institutions) use to manage international student applications, suggests that international student numbers may decrease 30% in AY 2024-25, though the Student Housing Consultancy notes that with Russell Group universities likely less affected than younger institutions, the overall UK decrease in international students may be in the 10%-20% range. This is in line with UK study visa applications down 17% in January to June 2024.

This drop in higher-paying international student numbers seems to explain the increase in university acceptances – fewer international students means more course vacancies, and a fight by universities to fill them through issuing more acceptances. Indeed, it is the high-tariff (i.e. the upper tier) universities leading this charge, with their AY 2024-25 acceptances up 9.3%. This will likely encourage students with multiple acceptances to 'trade up', such that the squeeze becomes concentrated in the lower ranking universities, who are already impacted by a higher decrease in international student numbers.

This then is the expression of the increasing differentiation between university tiers. High-tariff, particularly Russell Group, universities should remain sought after by UK and international students and are expanding acceptances to ensure full occupancy. As we descend down the tiers, there is then a gradual decrease in applications, a squeeze from students 'trading up', and increasing course vacancy – and it is in lower ranking universities that one should therefore expect financial instability. So from the perspective of real estate investors, there is a resulting differentiation in the demand for PBSA, and achievable price points, in different universities and cities.

Supply

What about the supply of beds for these students? Agents' brochures tout the imbalance between total students and PBSA beds, highlighting how a majority of students are unable to access PBSA and the implicit effect on rental growth.

However Dan Smith at the Student Housing Consultancy underlines how this reading can be misleading in understanding the effective supply-demand imbalance. He notes that when assessing student demand, one must first consider how many students are part time, online or living at home, and when looking at supply, one must also consider HMOs (Houses of Multiple Occupation, the classic 'student digs') and especially Build to Rent Residential. Increasingly, a significant percentage of Build to Rent Residential occupancy comes from students, and the growth of this sector is now having a marked effect on PBSA supply-demand dynamics.

Income

In short, effective student housing supply-demand in some locations can be much more marginal than some investors may think, which as we enter the new academic year can affect occupancy, rental growth potential but also the cost base (as more marketing spend may be required to fill the beds). If the decrease in international students discussed above does materialize, this may then impact occupancy at higher end PBSA assets, with a cascading effect down the tiers as operators battle to lift occupancy. This may then lead to a moderation in rental growth compared to current expectations, although the effect will likely be very dependent on an asset's micro-location, price point, room mix and operations – this means that detailed underwriting should become ever more important to investors.

Any impact on occupancy or room pricing would in turn impact on asset revenue, as would any increased marketing spend undertaken to mitigate this. At the same time, anecdotally investors are often already surprised by variance between preliminary cost budgets used on acquisition, and actual costs incurred during ownership, which may affect achieved returns, so further impacts could cause some unwelcome surprises. On the other hand, as UK inflation has eased, pressures on operating costs for UK student housing investors has lessened, which may mitigate any impact.

Investment Pricing

UK student housing has to date been insulated from the rise in interest rates in 2022-2023, with yields for prime London assets rising slightly from 3.75%-4.0% in 2021 to 4.5%-4.75% in 2024, and prime regional assets remaining unchanged at 5.25%-5.75%. This can largely be attributed to strong rental growth in this time, albeit with an accompanying lower level of transaction activity.

Looking forward, the occupational dynamics discussed above could quite feasibly lead to greater differentiation in pricing between PBSA assets supporting upper tier, Russell Group universities and those servicing lower ranking institutions. Cap rate compression for prime assets appears less likely, so that the effect may be more through cap rate expansion for weaker properties. There may also be more attention paid to operators and brands, as is common in the hotel sector. BLME's recent report Opening the Door highlights that student housing is a familiar and attractive asset class for GCC investors, with nearly 70% of survey respondents focusing on PBSA in the next 12 months. We would agree with this, although we would caution that investors will benefit from extra scrutiny of student housing investments at present.

Arcapita's Focus

Slowly but steadily, the UK's economic situation has continued to brighten. In terms of inflation, unemployment rate and GDP growth, the UK now compares favourably with the US, while expectations of an interest rate premium to the US allow investors to be positioned for higher relative cap rates and potential FX appreciation.

In addition, the new Labour government's economic policy should broadly follow the existing policy flightpath and the reality of a sizeable parliamentary majority and a politically stable outlook compares favourably with events elsewhere, reinforcing the country's positioning as a safe haven for investment.

This environment should see the range of UK investment opportunities widen, including in private equity, while in our view the most attractive investment returns still favour active management and a targeted approach.

Within UK real estate, we maintain our highest conviction on active investment strategies focused on properties with shorter, staggered lease terms, diverse income streams, and affordable rents that can be grown through active management. Within this strategy, our preferred sector continues to be UK multi-let industrial, offering an attractive combination of sustained higher cap rates, durable 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 increasing their appeal to occupiers, lenders and investors will deliver additional return over the medium term, while there is scope for Labour to strengthen the regulatory approach in this area.

Conversely, we would maintain a watching brief on residential and infrastructure markets while Labour outline their policies on planning and regulation, as the opportunities for international investors in this sector may evolve accordingly.

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.

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