Urban Land Institute
United Kingdom

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ULI UK Capital Markets Forum 2015

At ULI's latest annual UK Capital Markets Forum, a group of Europe's top real estate investors, lenders, market analysts and advisers provided their insights into the latest sector trends. This ULI InfoBurst is a summary of their discussion.

"There is a theme of risk protection, with less sensitivity about absolute return."

"The debt market is competitive and developed but it hasn't got away with itself in the same way it did eight years ago."

"Investors are finding that they don't need to be too aggressive in their assumptions to hit their target returns in Spain."

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DENTONS

Healthy capital flows:
Institutional investment capital continues to flow into European real estate. Driven by successful US and Euro equity markets, fund managers - especially the long established and experienced - are facing pressures to invest as allocation targets for real estate remain bullish.

Given such allocations, Europe's perceived value relative to North America, and the fact that institutional capital is finding all asset classes expensive, investors are less inclined to take note of the health warnings flagged by fund managers.

"I continue to be amazed that, even post-election, people aren't taking the risk of a UK exit from the EU seriously by pulling back from the UK. But this is because while investors may not love where we are today they like even less some of the other places they could otherwise invest."

The UK continues to be a magnet for overseas capital, relative to the continent. Geopolitical risk is enhancing liquidity in the UK market, as nervous investors flee their own domestic markets - providing safe havens for investors from China, Russia and southern Europe among others. *"There was £64bn invested last year and this year will be the same - that's historically high."*

London, as ever, is the prime beneficiary of this trend and trading levels in the UK are reported to be higher than they've ever been. Investment in central London's commercial property market reached £20.5bn in 2014, marginally below the last investment peak in 2007 when £20.6bn was traded – according to Cushman & Wakefield.

While the investment pressure on UK capital means the regions will begin to see more interest over 2015, the opportunities in these areas of the country remain limited because rental growth is scarce.

In this respect it may be wise to wait to make a move to regional UK markets at the point when the economic recovery translates into rental growth, which will hedge against interest rate rises as and when they occur.

Strategies shift:
While appetites for real estate investments are robust, day-to-day investment strategies have evolved to reflect a distinct change to those in evidence pre-crisis.

Institutional investors are looking for longer-term strategies as they are repatriated with capital invested pre-crisis.

Open-end vehicles that allow redemptions are also popular routes to North America and European markets, with a smaller portion of capital allocated to value added or opportunistic funds. *"Investors are placing capital in vehicles they can pull out of when they choose - that is a theme we're seeing in Europe."*

Caution is being exercised in various ways. Institutional investors are wary of placing capital in un-seeded vehicles, while the risk of the real estate that a fund manager buys has become a greater focus than it has been historically.

Risk protection, predictability of return and downside protection are high priorities. As a consequence there is today less of a focus on loan to value ratios and generally more equity invested in deals to de-risk investments than in prior cycles.

"There is a theme of risk protection, with less sensitivity about absolute return. Investors are offering lower hurdles for promote to keep the tone of the funds in a style they want. De-risking is a top discussion point."

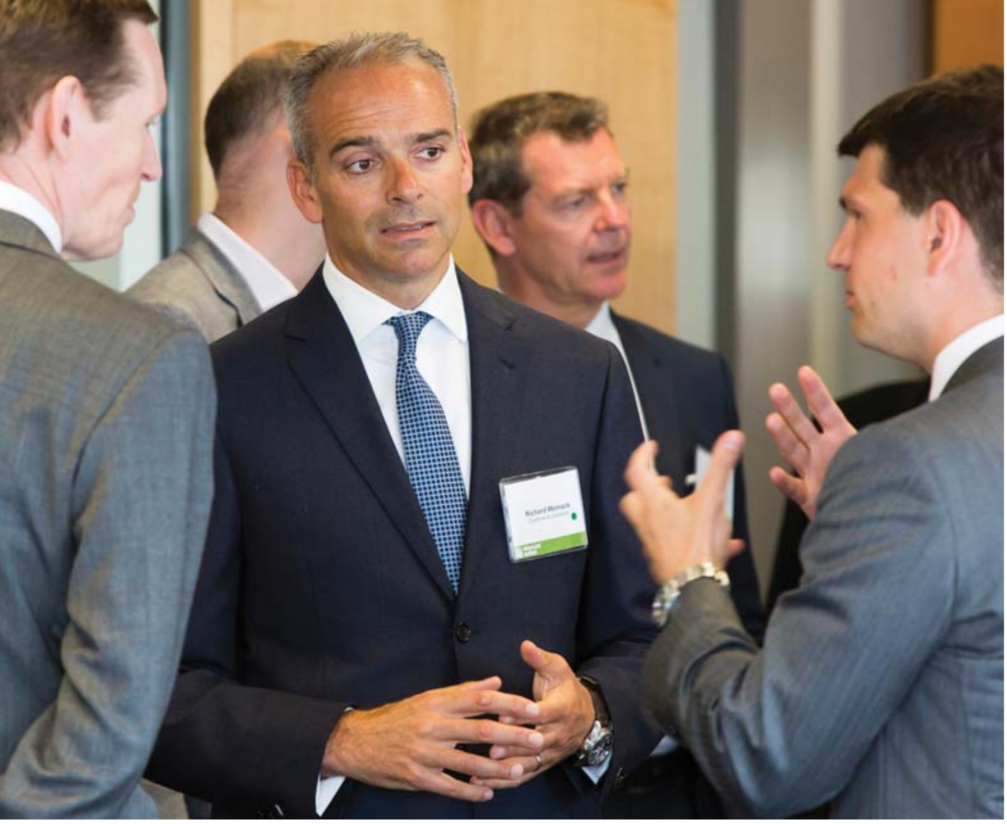
Debt markets transform:
In tandem with these changes in the equity market, a transformation is also underway in the debt landscape - particularly in the UK.

The market has seen a proliferation of debt players. Banks battered by the crisis are returning to the market, and there is more choice for loan-seekers.

As real estate investors can borrow for *"five, seven or 10 years or longer quite easily"*, the entrance of pension and insurance money is seen as a positive evolution of an industry once dominated by bank lenders.

However, there are other changes that reflect the debt markets - like the equity markets – still register the lessons of the crisis.

While major loan transactions - such as the recent HSBC Tower deal - suggest margins are decreasing, these are examples of special cases in which property is being financed because of a strong lease covenant rather than the real estate itself.



Where banks are financing underlying real estate, loan to value ratios and margins are remaining sensible. *"It is a market that is competitive and developed but it hasn't got away with itself in the same way debt markets did eight years ago."*

So although those seeking loans for core assets may have a wider range of lenders to choose from, availability is not deep. *"Most lenders aren't making a lot of loans, they're just looking for the perfect asset. Some banks are only back in the market for large portfolios and select deals."*

Meanwhile there is opportunity for experienced debt investors to expose inefficiencies in a capital stack, combining flexible capital with good structuring experience to structure a deal that is more attractive for a sponsor. *"There are gaps in the market where there isn't a macro banking solution. But you have to have a quasi investment banking attitude to play."*

The *"biggest question"* for all lenders is how quantitative easing will unwind. There's a lurking anxiety over what will happen if this unwinding process happens as interest rates go up. But this outcome feels remote as delegates expect that the process will be long, and that interest rates will stay *"very low"* for a while to come. *"We're not likely to see upward pressure on interest rates until we see real underlying growth or sustained improvement in fundamentals."*

Spain divides opinion:

Spain is still the opportunistic face of the European investment market, and the numbers of those prepared to take those risks there are increasing; while deals in Spain were relatively easy to come by two years ago, the market has become crowded and early in the day investors are now finding it difficult to compete.

Much of the capital entering Spain is doing so on the premise that it is one of the few European markets where investors can argue the case that growth will occur.

However, Spain remains a distinctly opportunistic proposition. While growth may materialise, it could be a long time coming and much longer than the two-year horizon that deals are often being structured around. *"People are betting on a huge recovery in a short amount of time."*

Investors also need to remain clear-eyed about what are currently weak fundamentals. While a capital tsunami into Spain persists, the leasing and rental markets show *"no growth"* and many asset classes are suffering over-supply issues. *"A lot of equity capital will be disappointed. Capital markets are way ahead of fundamentals, there's no doubt about it."*

EU instability is also lessening the attraction of the southern European market, and the rise of left-wing coalitions in municipal politics is also a concern.

Those prepared to take calculated risks on this basis are advised to seek out opportunities outside of the mainstream asset classes.

Spain's hospitality sector, which is undergoing huge change and reorganisation, is one. *"We are looking at hotels, and we're buying shopping centers. If you target the mainstream it is crowded but you need to go down the sides, where we find liquidity is low and pricing is slightly better."*

The listed markets are similarly drawn to Spain. Listed investors identify the country as a clear and compelling opportunity.

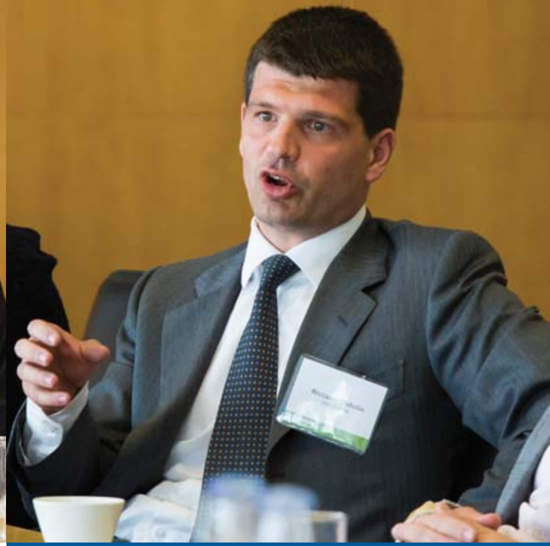
Despite the fact that Spain's listed sector is not particularly large, public market investors - like direct investors - are attracted by the idea that the country is still early on in the recovery and that a correction in property values is unlikely. *"Investors are finding that they don't need to be too aggressive in their assumptions to hit their target returns in Spain, currently."*

And for the next couple of years, investors believe they can underwrite investments given that debt availability is improving and that equity availability is rising significantly.

Listed market promise:
Elsewhere the appetite from listed investors for the European public markets is also strong. This is on the expectation that this historically small and fragmented market could transform into a more developed and successful publicly listed market, as in North America and Asia Pacific.

One key effect of this enthusiasm is that investors are willing to look at companies that are externally managed or have private equity-style fee structures, or are not as transparent as they could be. *"Investors are willing to look through these issues and be pragmatic."*

Despite its promise, delegates warn there are *"a lot of red flags"* to consider. Real estate volumes are high, yields are at all time lows, while last year M&A activity in the listed real estate sector accounted for 15% of public market deals despite accounting for just 2% of the overall market capitalisation.



There is also wariness that the situation can change quickly, and delegates encourage caution over this issue of political risk. *"Brexit and Grexit seem to be being ignored but things like that can have a meaningful effect."*

For now, however, the view is that as long as bond markets remain where they are and interest rates stay low, which is anticipated, real estate equities will continue to be positive.

About ULI
The Urban Land Institute provides leadership in the responsible use of land and in creating and sustaining thriving communities worldwide. It is an independent, global, not-for-profit organisation supported by members representing the entire spectrum of real estate development and land use disciplines. Founded in 1936, ULI has 35,000 members worldwide. National Councils are ULI's country networks which organise local events and activities. ULI UK is the largest National Council in Europe with over 700 multi-disciplinary members.

The ULI UK Development Forum is a new initiative convened by ULI UK, building on ULI's long history as a neutral, non-lobbying membership organisation for real estate industry leaders. The Development Forum has been created to provide a mechanism for the development community to gain exclusive insight, share challenges and ideas to break down barriers and to explore new ways of delivering major development and regeneration opportunities.

The ULI UK Capital Markets Forum took place in May 2015. It is an annual invitation-only event. The following organisations were represented:

Bank of England
Baupost Group International
Benson Elliot Capital Management
Cale Street Partners
Cerberus European Capital Advisors
Cushman & Wakefield
Dentons
Eastdil Secured
H.I.G. Capital International Advisors
Hodes Weill & Associates
Internos Global Investors
Laxfield Capital
Lipton Rogers Developments
Morgan Stanley
Oaktree Capital Management
Orion Capital Managers
Patron Capital
Pramerica Real Estate Investors
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