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VOL 14 | ISSUE 5 | JUNE 2018 | [perenews.com](http://perenews.com)

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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

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**UK**  
Roundtable 2018

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Photography by Marcus Rose

## Facing the music

There may be trouble ahead for the UK real estate market, but investors must find ways of deploying their capital nonetheless. [Stuart Watson](#) reports

**T**he British like the image of a nation of people who soldier on with a stiff upper lip no matter how dark the outlook. It is a cliché that could be applied to

Theresa May's government, which, at press time, was still staggering on bravely, or some might argue perversely, in the face of a variety of political blows, Brexit-related and otherwise, and worsening economic data.

It could also describe the UK real estate investment market, which, despite the

obvious political headwinds, has remained remarkably robust. UBS calculates the 2017 all-property total return for UK commercial real estate at a vigorous 10.3 percent, and the early months of 2018 have continued in the same vein.

And yet black clouds are visible on the horizon. The possibility of a breakdown in Brexit talks with the EU remains a very real possibility. GDP growth in the first three months of 2018 was a sickly 0.1 percent, the

**“The challenge is about identifying the right product to acquire when we are so late in the cycle”**

**Kiran Patel**



**From left:** Kiran Patel, Steven Cowins, Andrew Angeli, David Skinner, Jeremy Bishop

weakest quarterly figure for five years. Roll that backdrop together with a property market that has never looked so expensive and it is unsurprising that the five real estate professionals gathered at the Shard building on London's South Bank for *PERE*'s UK roundtable strike a cautious note.

The quintet comprises four asset managers: Andrew Angeli, head of European strategy and research at CBRE Global Investors; Jeremy Bishop, co-founder of Oxenwood Real Estate; Kiran Patel, chief investment officer at Savills Investment Management; and David Skinner, global head of strategy and portfolio management at Aviva Investors; as well as lawyer Steven Cowins of Greenberg Traurig, who is hosting.

**“If you are able to see through potential capital volatility the income side of the equation still looks very attractive”**

**David Skinner**

First the good news. “If we look at expectations of what the market was going to do at the beginning of last year, and what actually happened, they are fundamentally different. The consensus was saying 2.25 percent total return and we saw over 10 percent,” says Angeli. “That is because of robust capital markets, but also occupiers performing very well, and we are on track to do that again this year.”

Skinner concurs that tenant demand has held up well: “In the prevailing context for the past 18 months, it is surprising that occupiers have remained as sanguine as they have. Outside of the retail sector, which has structural issues, take up and demand for space has remained reasonably robust.”

The participants identify logistics as an asset class that has driven continued investment performance. Bishop remains bullish about prospects for the sector. “In logistics there is a phenomenal structural story around e-commerce. We think it is a relatively stable asset in a rapidly-changing world,” he says.

### Going down

However, there is a strong feeling among the group that the most likely trajectory for the market from this point is a descent.

“Yields can go only so far down. In an environment where interest rate rises are expected, all investors will want more return relative to the risk-free rate,” says Patel. “The question is how far rents can continue to rise and support capital values. That might be affected by pockets of increased office supply, in the City of London in particular. Meanwhile, the affordability issue in the West End means rents can't keep going up there, either.”

Brexit has created uncertainty, but for real estate investment there are more pressing concerns, argues Angeli: “For us, Brexit is no longer the primary risk for the UK market. In London it is the looming supply threat that we will probably see in 2019, and the absolute level of asset prices given where we are in the cycle.”

Skinner predicts a modest decline in capital values in the second half of this year could restrict real estate returns to around 5 percent in 2018. “Capital is becoming much more discriminatory and

**“Overwhelmingly what has kept us busy over the last 18 months has been beds and sheds”**

**Steven Cowins**

**Andrew Angeli****Managing director, head of European strategy and research, CBRE Global Investors**

Angeli joined CBRE Global Investors, the fund management arm of US-based brokerage firm CBRE, in 2007. He works in CBREGI's 165-strong London team, which manages £11 billion of direct real estate assets in the UK in core and value-added strategies.

**Jeremy Bishop****Co-founder, Oxenwood Real Estate**

Bishop founded Oxenwood Real Estate with Stewart Little in 2014. The pair were previously founding shareholders of property company London & Stamford, before its flotation in 2007. Investment manager Oxenwood invests across the risk spectrum and currently manages a £560 million portfolio.

**Steven Cowins****Partner, Greenberg Traurig**

Cowins advises clients in establishing real estate funds and joint ventures, structured acquisitions and dispositions of real estate, and investment in alternative asset classes. US-based Greenberg Traurig employs 400 lawyers in the real estate space globally, including a 65-strong team in the UK.

**Kiran Patel****Chief investment officer, Savills Investment Management**

Patel is CIO of a business that maintains 18 offices worldwide and invests principally in Europe and Asia. In the UK it employs 75 and manages assets valued at just over £4 billion in core-plus and value-added strategies. Prior to joining Savills IM Patel worked at AXA Real Estate.

**David Skinner****Global head of real estate strategy and portfolio management, Aviva Investors**

Skinner has accountability for the formulation of fund-level strategy and asset allocation decisions within the real estate business of the asset management arm of insurer Aviva. He leads the company's 100-strong UK real estate team, managing around £15 billion of direct investments.

I think that will continue to be a theme for the rest of this year and into next year."

The trophy deals seen last year when some of the City of London's biggest office towers changed hands have been absent in 2018, partly as a result of capital controls imposed on Chinese investors, but also because sterling has rallied somewhat after its post-referendum slump. "For any currency-minded investor that story has evaporated quite quickly," says Angeli.

Some overseas investors may be deterred by changes to the UK's tax code in 2019, predicts Cowins: "The capital gains tax rules are about to change for offshore investors and our view is that will affect behavior in the third and fourth quarter this year and into the first half of 2019."

Patel sums up the conundrum facing real estate asset managers in the UK market today: "The challenge is about identifying the right product to acquire when we are so late in the cycle. If you could, you would probably sell all of your real estate at this point, but no asset manager has that luxury, so you have to look at how to reposition your properties and portfolios according to the view you take of where we are in the cycle."

**Rebalancing portfolios**

Aviva Investors has been doing just that. The house has been a net seller in 2016 and 2017, divesting around 200 smaller properties valued at around £2 billion (\$2.7 billion; €2.3 billion) in each of those years. Skinner says disposals will continue on a similar scale in 2018. "We have been rebalancing all of our portfolios to invest in assets in markets where people really want to live, work, play and learn and with a focus on high quality assets that will be able to attract tenants all through the cycle."

Some managers in the value-added and opportunistic spaces are still raising funds nevertheless, says Cowins: "Managers probably see some opportunities coming out of companies like Aviva selling smaller assets. It is certainly not a bad time to be raising a fund, but most people are cautious about where they invest given the stage in the cycle."

While capital values may come under pressure, real estate is still valued as a source of income, he adds: "If you look on a multi-asset basis, where do you put your cash? Do you put it in the stock market? That is also trading at record ratios and has volatility that real estate doesn't. In that context, given where interest rates are now, and are likely to be in the medium term, on a purely income basis, real estate doesn't look too bad."

While investors seeking total return are likely to seek to reduce their exposure to real estate at present, those whose primary focus is on securing a source of income will



## Crossing the city limits

The UK's local councils are increasingly willing to buy investments outside their boundaries

Local authorities in the UK are accounting for a growing proportion of buying activity in the domestic real estate investment market. Research by consultant Carter Jonas shows local councils spent £3.8 billion on commercial property assets between 2013 and 2017.

The trend has not escaped the notice of the roundtable participants, several of whom have sold properties to local government buyers. Angeli says: "Last year, an analysis we undertook showed local authorities accounted for about 5 percent of transactions in the UK market, up from less than 1 percent 10 years ago. They have become a more formidable part of the market, even though still only a small sliver of it."

Some boroughs are seeking to acquire assets within their own boundaries to facilitate local regeneration and economic development efforts, often providing long term support for shopping centers that are struggling in a difficult retailing environment.

However, others are buying investments outside their own areas in an attempt to exploit the arbitrage between investment yields and the very low interest rate loans available from the UK government's Public Works Loan Board. That provides them with a steady income stream which can augment revenues from taxation and from central government grants that have been eroded under the current government's austerity program.

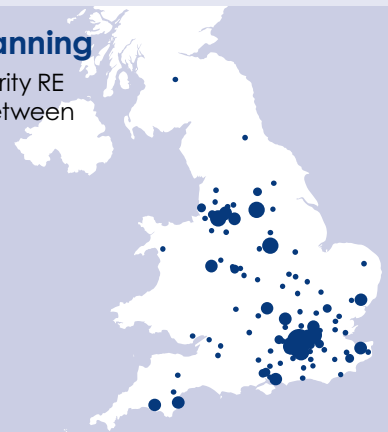
That tactic has sometimes proved unpopular with traditional investors, says Skinner: "They usually want relatively long-term, 10 year-plus, stable income. Because they can borrow at government bond yield rates rather than commercial finance rates, they can pay higher prices than the rest of the market will pay. On the other hand, as net sellers of UK real estate over the last two years, we have benefited from local authorities' acquisitive status, and when they invest locally their acquisitions can act as a catalyst for regeneration, employment growth and improvement of the housing stock and public realm."

### Council planning

UK local authority RE investments between 2013 and 2017

Investment (£m)

- 1-25
- 26-50
- 51-100
- 101-250
- 251-500
- 500+



Source: Carter Jonas

## The build-to-rent question

Why is Britain seemingly so slow to catch on to US-style multifamily housing?

In the face of a severe ongoing housing supply shortage, particularly around London, investors in the UK have been hoping to see the emergence of an institutional multifamily housing market on the US model. To date, however, those expectations have remained largely unfulfilled. “Apart from logistics, the other asset class we wanted to do was build-to-rent residential, but we decided not to because we couldn’t get the scale quickly enough. We had recently started the business and at the time we found it a challenge to find residential deals that were good value,” says Bishop.

Skinner adds: “It is a nascent market from an institutional perspective. I believe it will be an asset class in its own right in time, but the stock doesn’t exist on any meaningful scale, and while that is changing, it is expensive and low-yielding, and it is more profitable to build to sell rather than build to rent in most circumstances.”

Some developers embarking on ostensibly for-rent residential developments are actually underwriting them on the basis of breaking them up and selling individual units, adds Angeli. Moreover, he believes there may be a more fundamental problem with the asset class: “There is some trepidation about whether a copy and paste version of the US model will work in the UK. There are strong cultural forces here which suggest that will not be successful. Brits just aren’t willing to pay for amenities the way people do in the US.”

Skinner suggests a separate use class for build-to-rent residential would help prevent developments from being broken up and sold off. Angeli agrees that the sector needs more state support, but he doubts that it will be forthcoming: “If you look at any budget over the last decade, home ownership has been systematically incentivized. But the result has been limited new housing supply while prices continued to rise ahead of earnings.”



**Tempered enthusiasm:** skeptics are doubtful about US multifamily taking off in the UK

continue to seek out secure real estate investments, suggests Skinner.

“If you are able to see through that potential capital volatility, as long-term institutional investors are, the income side of the equation still looks very attractive,” he says.

## Customers not tenants

The participants agree the pressing need to provide resilience through the property cycle places an even greater premium on identifying assets that will retain value in the face of long-term structural change and digital disruption.

Technology is changing the amount and type of retail and office space that occupiers want, and that has inspired a change in attitude among property owners, says Skinner: “One of our big themes is how we retain clients or tenants – customers – in that environment. We are trying not to use the word ‘tenant’ because it is associated with the historic adversarial relations between landlord and tenant. We need to be providing our customers with a more service-orientated approach with a view to maximizing retention.”

Angeli agrees with that analysis. “The current permutation of serviced offices is forcing us to consider becoming operators. We are increasingly talking the language of hospitality and looking to bring people into our business with experience in the sector because those are ultimately the skills that are required to keep customers happy,” he says.

Learning from the hotel and leisure sectors is also shaping new trends in residential property, observes Cowins. “Co-living has been one of the fastest growing areas – smaller units with more shared services. Operators and developers like the Collective are providing lots of additional services – gyms, yoga classes, cinema nights – trying to create a customer-focused living space.”

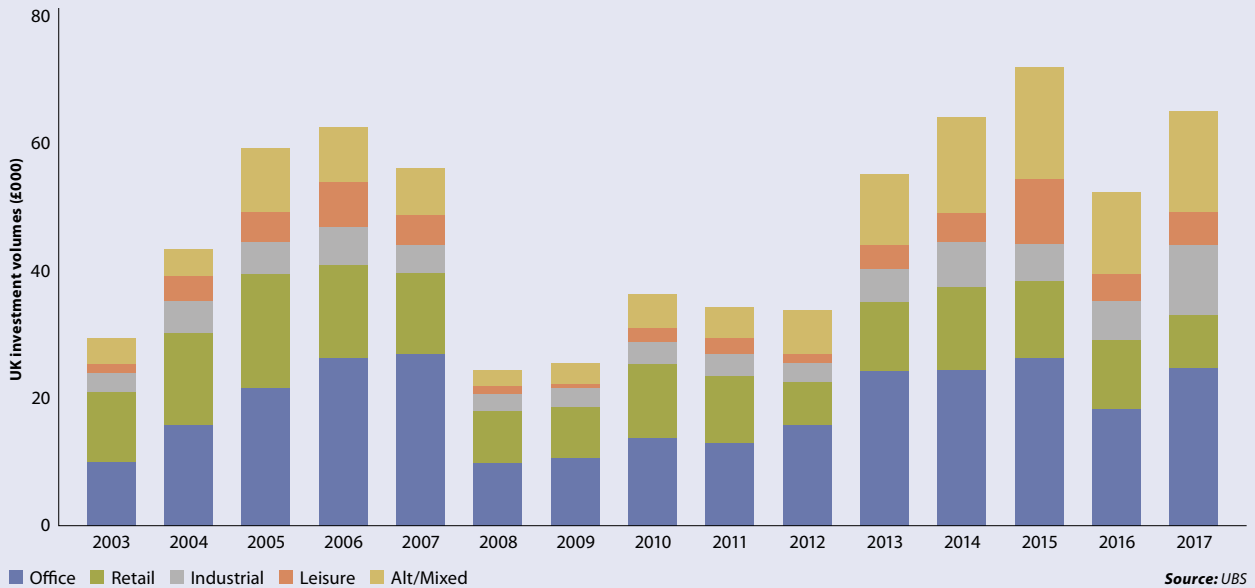
In some forward-looking industry forums, discussion has turned to the potential throughput-based leases that provide occupiers with ultimate flexibility by basing the cost of occupancy on their actual use of space. That will be a step too far for most property owners, argues Patel.

“You would require a different return for that because of the volatility it would produce,” he says. “What works for a customer may not work for a landlord given the income distribution that you have to provide to your investors. There also has to be a trade-off in price for flexibility and good quality service.”

Investors are still drawn by traditional lease structures, adds Bishop: “Part of the enduring appeal of the UK market for investors is our triple-net leases and upward-only rent reviews. Don’t underestimate that.”

## Shops to sheds

Against a recovering post-Brexit vote marketplace, logistics real estate deals have accounted for a greater proportion of overall transaction volumes, while retail deals have decreased



## Beds and sheds

In the context of a market that is facing cyclical and structural pressures what strategies are the best bets for maximizing risk-adjusted returns?

“Overwhelmingly what has kept us busy over the last 18 months has been beds and sheds,” observes Cowins. “Almost every fund we have worked on has been about that in one form or another. On the sheds side, it varies from the shiny logistics assets, if you can find them, to the grittier multi-let industrial estates. Meanwhile, in the residential sector, we are working on a couple of student housing mandates. And then you have build-to let in various guises.”

There is continuing rental growth in the logistics sector and continued potential to make value-added returns, claims Bishop.

“Tenants want to lock in their costs so that they are willing to engage with us to prolong leases,” he says. “GLP’s purchase of Gazeley is a very good example of what is going on in that market. It was a platform-based transaction and a big development play in the UK. Pricing is strong, but logistics has a lot of structural runway left.”

Patel suggests it is difficult to deploy capital on a large scale in the value-added and opportunistic spaces in the UK, but nimble managers able to buy smaller lot sizes may still find room for maneuver. “If

you can go into sections of the market that are more illiquid you can touch on retail, which is an unloved sector where there is less competition,” he says. “That can get you a higher leveraged income return and then a flip on the capital side so you can obtain double digit returns.”

Savills IM is pursuing a related strategy in retail warehouses. “That is slightly higher-yielding than other sectors, so you are going in with a slightly higher income return, but there is still often a lot of repositioning you can do,” says Patel.

Skinner adds that regional offices are one of the few areas of the UK market that still offer relatively good value on a risk-adjusted basis. Aviva Investors is targeting acquisitions in Manchester, Birmingham, Cambridge and the Thames Valley. “We are looking for areas with good population growth, high levels of education, and a high propensity to retain students educated there,” he says.

While London retains a strong appeal for overseas investors, the remaining pockets of value within the UK market are becoming increasingly difficult to find. The roundtables conclude that some capital is now looking toward continental

Europe first because of its better prospects for growth. Nevertheless, for the present, the UK real estate market is still keeping calm and carrying on, even though the future holds less promise than before. □

**“Pricing is strong, but logistics has a lot of structural runway left”**  
Jeremy Bishop

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