Urban Land Institute

United Kingdom

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ULI UK Capital Markets Forum 2014

At ULI's recent UK Capital Markets Forum, **25 of Europe's top real estate investors**, **lenders** and **advisors** provided their insights into today's trends. This ULI InfoBurst summarises the discussion that took place.

Europe's real estate markets are reviving. Equity is plentiful, debt has started to flow more freely and occupiers are beginning to sign new leases. The recovery is still patchy, however: some markets have roared ahead, prompting concerns that pricing has outrun fundamentals, while other markets remain in the doldrums.

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Overseas capital targets europe

International capital continues to flood into European real estate, with the UK attracting the brunt of this flow. *"Last September the stagnation broke. Real estate was no longer a bad word. The engine started to move."*

There appears to be no let-up in the Asian money targeting Europe, while Middle Eastern capital is also on the rise. In 2013, overseas buyers accounted for 43% of the record £53bn spent on UK real estate.

Much of this is foreign equity from institutions, sovereign wealth funds, REITs and private investors who are focused on the UK's capital city. *"As world disorder becomes a theme, we will see more capital coming to London."*

North American money is also coming into Europe *"in a big way"*. Much of this is opportunistic capital, but it also includes a wide spectrum of other strategies: debt, core plus and value added.

Across the Atlantic, the economic recovery in the United States is translating into improving real estate markets. Transaction volumes are up to pre-crisis levels, and pricing in many cases is above the 2007 peak, with cap rates for prime retail at 3-4%.

But for foreign investors in the US, FIRPTA (Foreign Investment in Real Property Tax Act), which imposes income tax on the sale of property assets – remains a challenge. *"We're seeing a lot of capital looking at the United States and coming back to Europe because on a relative basis, it is more compelling."*

However, one set of new players is causing concern: the US hedge funds, which command large volumes of opportunistic-style capital. The struggle to secure returns in liquid strategies is pushing hedge funds into the real estate arena, where they are now outbidding the more experienced real estate players by significant margins. *"They are re-pricing the market. It is what went wrong before – buying illiquid assets with short-term debt. It's something to watch closely."*

Credit eases

Debt too is now flowing much more freely. Although Europe's credit markets have not recovered as much liquidity as those of the United States, banks and financial institutions are lending more senior debt. Notably, two UK platforms - Eurohypo's and Deutsche Postbank's – have been acquired by US lenders – Wells Fargo and GE Capital – who plan to grow these businesses significantly.

On the continent, German credit markets are now very competitive, as domestic banks jostle to make up the ground they lost during the last three to four years. In France too, the credit market is very active and after a four-year hiatus, Spanish banks are starting to lend again.

Non-bank lenders are also playing their part in Europe. Insurance companies are assuming a bigger role, as the regulatory regime of Solvency II treats real estate debt favourably. However, the incentives for North American insurers to set up shop in Europe have lessened. Though diversification remains a valid reason, the 100 bps pickup in yield that the UK commercial mortgages offered over the US equivalent just twelve months ago has essentially disappeared. *"That being said, it's a big jump to go to a new market and build a platform."*

Capital-raising by debt funds is on the up as well. However, the mezzanine funds that have been raised for European real estate are finding that margins have tightened to the point where they are being priced out of the market; deals are difficult to find. Some of these funds are turning to whole loans, which they then syndicate, selling the more senior parts of the stack, while others are working with senior lenders to provide a packaged solution.

CMBS has also made a comeback. In the US, banks are back into it *"with a vengeance, while in Europe there has recently been the first multi-loan securitisation post-crisis, with more issues in prospect."* However, the caveat is that CMBS has never been a large market in Europe: *"You need to be realistic about what you can execute."*

Stockmarket revival

The public real estate markets are also reviving in Europe, with 14 initial public offerings raising £2.7bn last year. These included large German residential specialists LEG and Deutsche Annington, plus Irish and Spanish company launches. The trend looks set to continue this year, with the €1.25 billion flotation of Merlin, one of Europe's largest-ever REIT IPOs.

There is, however, some concern over *"cash box"* IPOS: flotations of real estate companies that have yet to assemble a portfolio of real assets and are generally externally managed – an arrangement that needs a careful alignment of interests.

The better quality listed real estate companies are now also able to access another source of attractively priced capital, via the unsecured bond market. Low yields on sovereign debt and a dearth of bond issuance has created massive pent-up demand from insurers and other fixed income investors for this type of debt. For example, a few months after its IPO, Deutsche Annington was able to raise €600m via a 6-year bond priced at 3.125%. Deutsche Annington subsequently accessed the US bond market with the largest-ever issue by a European property company: $1bn.

As competition among lenders has increased, the margins on secured debt have fallen significantly, less so for unsecured debt. Underwriting, meanwhile, remains conservative across Europe, *"with the exception of London"*. On the prime end, leverage has not yet been pushed too much higher, as many equity investors introduced restrictions on LTVs after the last cycle. However, with the advent of whole loan providers and more mezzanine players working with senior lenders, higher leverage *"is inevitably going to come, likely within the next six months"*.

Capital moves to the regions

With more credit available, the volume of deals has picked up substantially. Debt is also becoming more freely available for regional assets. Local banks are starting to fund local entrepreneurs and investors, so the universe of buyers has expanded, properties are selling more quickly and at higher prices. *"We're seeing that type of transaction happen across Europe."*

Hence, liquidity is returning to selected regional markets, most notably in the UK. Since the prime London market is locked down by sovereign wealth funds and other big equity players, investors searching for value and income are prospecting further afield.

Many are domestic, but some international investors have also started to look beyond London. Regional shopping centres and logistics are popular, as are offices, but selectively, in cities like Bristol, Edinburgh, and Birmingham.

Where's the growth?

European economies are recovering, and some occupational markets are clearly starting to revive. For occupiers, London is *"becoming expensive"*, with quoting rents for West End offices as high as £150 per square foot which may create a ripple effect as firms move to reduce costs.

However, while many are comfortable with the prospects for rental growth in the UK, there are question marks over other European markets. *"Germany is still very attractive but very expensive, very flat in terms of growth; in France, it is mainly Paris and maybe a little bit of La Défense. In Ireland outside Dublin, nothing has changed."* Spain, in particular, *"feels a bit frothy"*. Some doubt whether its market performance can justify the *"huge"* appetite for assets there.

The concern is whether property prices have run ahead of fundamentals. The opportunities to earn high returns in Europe through financial engineering or betting on yield compression have narrowed significantly over the last year. Competition for prime/core is intense, and similarly, there are large amounts of capital chasing distress.

Hence, investors are looking at strategies that will grow the cash flow of properties rather than pure capital markets plays. *"You need to be doing something with the asset to be generating a 20% plus return."*

Core plus or value added investments, taking some leasing risk and using moderate leverage are thought to offer the best opportunities. *"If you have the capital, you could probably back up the truck and do that for the next two to three years."*

Moreover, the current shortage of core property is likely to persist for several years, which is leading some equity investors to move up the risk curve into development: *"not a crazy thing to do with core capital."*

Investors are moving into a broader range of real estate, as well. *"Anything that has an annuity-like income flow to it is massively in demand: student housing, healthcare, and self-storage"*. The hotel sector is also attracting attention.

But it is residential real estate in London that is generating a massive amount of interest. At latest count, there was £12bn of international capital focused on development sites, with 100-150 towers planned– a *"staggering number"*.

The ULI UK Capital Markets Forum took place in May 2014. It is an annual invitation-only event. The following organisations were represented:

AXA Real Estate Investment Managers
Bank of England
Baupost Group International
Benson Elliot
CBRE
Cerberus European Capital Advisors
DekaBank
Deutsche Bank AG London
Eastdil Secured
Goldman Sachs
Green Street Advisors (UK) Limited
Lonestar Management Europe
M&G Investments
MetLife Investments
Morgan Stanley Real Estate Investing
Mount Kellett Capital Management
Nabarro
Pramerica Real Estate Investors
RBC Real Estate Capital Partners
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