2022 real estate: Dry powder. Refinancing. Rising interest rates. Explosive returns. Trophy assets.

Arab Banker caught up with Paul Bulstrode (Senior Manager at VG), Ayda Habboush (Partner at Trowers & Hamlins) and Mike Williams (Group Partner at Collas Crill) to make sense of an enigmatic real estate market.

***ARAB BANKER*: Before and during Covid there were reports of plentiful liquidity and "dry powder" being held by real estate investors. Has this changed and how are you seeing the market today?**

AYDA HABBOUSH: The market is buoyant, busy and people want to do deals. I don't think Covid has had a negative impact; it did delay purchase activity at the start of the pandemic as investors were not able to travel but once restrictions started to lift, activity quickly started to ramp up, but yes, the delay has resulted in a build-up of dry powder.

The other impact is a question of in what and where investors should deploy capital. When investors are looking to invest or expand into the UK, they need to consider that high inflation is causing interest rates to rise, and that might have an impact on their existing portfolios.

Additionally, lenders' appetite for certain sectors and asset classes has shifted. A changing retail sector, as we all know, is probably not the most popular sector now. So, investors need to adapt to and think about what they are investing in and when the most appropriate time to strike is.

PAUL BULSTRODE: I agree; we saw that covid delayed purchases for foreign clients, specifically our Middle Eastern investors who like to physically see the assets which was less possible during the pandemic. It is now a question of where investors can find value with so much demand for assets. Picking up on the point about lenders, we're seeing quite a few refinancings at the moment including short one- or two-year agreements with the option to renew thereafter. At the same time, on certain assets where value has not appreciated, it is requiring investors to allocate additional equity funding to satisfy loan-to-value requirements.

MIKE WILLIAMS: I would add that in terms of the deal flow, we see that a full spectrum of investors, from sovereign wealth funds to high net-worth individuals and family offices, private equity, and pension funds, are continuing to do deals. We are however hearing that some of the challenger banks and some of the non-bank lenders appear to currently be seeing a pause on deal flow because of the price of money going up and inflation. I think they are pausing to see how they should price things.

Paul Bulstrode

Ayda Habboush

Mike Williams

Political and public sentiment toward tightening of regulation around beneficial ownership of UK assets has resulted in the introduction of the long-awaited UK Register of Beneficial Ownership. How has this been received by your clients and what impact has it made on their choice to invest in UK real estate?

MW: Whilst a register such as this deals away people's privacy, it is not the only reason why investors use offshore vehicles and, for this reason, I think the impact is likely to be muted. Jersey is attractive to real estate investors for a host of reasons; for instance, a Jersey property unit trust can make tax transparency elections which can be helpful to investors in some countries. And if you're holding UK property through a company or a unit trust, then there's no stamp duty on the transfer of the shares or units, whereas there would be stamp duty if you transfer the property in your own name.

PB: From VG's perspective, there remain a lot of unknowns. The Register expands the UK's interest beyond the People with Significant Control Act (PSC) in respect of companies, to oversees ownership of UK property and land. We don't expect that this new legislation will cause any significant issues. Where assets are held, the responsibility for filing will largely rest with professional trustees, like VG. What remains unclear in the case of Jersey trust structures is when an individual related to the trust might satisfy one or more of the conditions requiring them to register. These trusts are largely used by our Islamic client base for UK land and property and represent about 40% of my team's business. We are still waiting for the rules to be clarified.

AH: This is such a new piece of legislation; people are only just starting to wake up to the fact that it exists. It's not yet in force, so no one has had to actually do anything yet, we are waiting for the Government to advise when the legislation will take effect. And so, I don't think we can right now say, with any sort of fair judgment, what the impact will be. That said, I don't think it will have a negative impact. I think there may be some noise about privacy. However when the Government introduced the PSC register some years back, it didn't have a negative impact on overseas investors doing business in the UK. People just got on with it and I think people will just get on with this. The key point for real estate investors is to work with your lawyers and advisers from now to ensure you have got your house in order for when the legislation comes into force, particularly those with larger portfolios.

There has been a value explosion in real estate markets. Is this a UK or global trend and do you expect to see prices continue to increase?

PB: The UK and US are where we've seen a hike in transactions more recently, but specifically the US property market has seen some incredible value changes; from 2016 to January 2022, we've seen an astronomical increase in value, with some assets delivering as much as 80-90% returns. The market has slowed a little now, but it's increasingly difficult to find value in certain sectors because the prices are continuing to go up. Prices will be affected by interest rates, but we don't expect demand or transaction volume to dissipate.

AH: The level of transactions has been very high but, because of the lack of availability of stock, or good stock and stock in the right sector and of the right asset class, prices are inevitably being driven up. It has got to the point where it's becoming a pipe dream for some investors to find logistics and distribution units because that is the trophy asset of the moment. Owners are holding on to them and buyers are being priced out. We are finding that some investors are simply realising that if they want good yields, they need to turn to other asset classes like the still popular out-of-town retail parks perhaps, a sector in which we are seeing a large increase in interest.

Commentators are hinting that there might be a global recession; do you agree and what impact will this have on the real estate market?

MW: According to the world economic outlook, growth is expected to drop from 5.7% last year to 2.9% this year. So, a recession isn't predicted either internationally or in the UK. But it's certainly the case that if there is a downturn in the market, there may be buying opportunities if there are distressed sellers. But at this stage it doesn't appear that there will be a recession. As Paul and I have said, demand is still quite strong for UK real estate because the UK is among the world's largest economies and is seen as a stable place to invest in the longer term.

AH: As Mike has said, I don't think a recession has officially been predicted, but if indeed we do go into recession, this may force some investors to sell or be forced to sell by their lenders which may present some interesting opportunities for those with dry powder who are ready to pounce when the time is right.

PB: Any downturn would enable opportunities in other areas, predominantly equities, and that is where some money otherwise allocated to real estate may go which would provide opportunity for our other VG clients or indeed those real estate clients who have a wider investment base. But we do not expect there to be a large negative hit on real estate activity in the medium term. There may be some price adjustments or delays in sale.

Covid prompted a shift in the sectors, jurisdictions, and source of funding flow within the market. What trends are we seeing today?

MW: One area in which we expect there to be increased competition is in sustainable buildings. We see two things. Then first is demand from tenants for more energy efficient buildings that are economical and consistent with their corporate values. Second is the need to refurbish existing real estate that won't meet increased regulatory requirements that come in in 2030. Savills produced a report earlier this year in which they said about 80% of the current stock of commercial property stock won't make the grade.

PB: I think you're right. If you've got an asset that needs to be adapted for 2030, then you either do it or you realise that it's 2022 now and you're not going to get much value from your asset in its current state. People will either need to refurbish the buildings and make them compliant or sell their properties to a developer who is prepared to do so. It depends on what type of asset you have got. A lot of companies are having to do the development themselves to a point where they can adapt the whole building for the new tenants that are coming in.

AH: You need to make sure your assets meet ESG requirements and that they meet tenants' requirements. People are looking at their supply chains when it comes to assessing ESG and for a landlord or an investor, your supply chain means your tenant. As Paul has rightly said, there's not much time between now and 2030. It is also worth mentioning that lenders have a say too and were one of the first players in the market to introduce ESG compliance requirements in facility agreements. If an investor is refinancing or if looking for new lending, then commercial real estate lenders will look at how ESG compliant and how sustainable the asset is is in deciding whether or not to grant that finance or renew facilities.

And in terms of the financing?

MW: In terms of the UK real estate space, although we do some work for Middle Eastern asset managers and high net worth individuals, much of our work involves working for Islamic lenders, and we see on the Islamic side that the Abu Dhabi Islamic Bank is very, very active in providing Islamic financing.

PB: The majority of our client base's current funding requirement continues to come from Islamic lenders, but conventional financing remains important too. A few years ago, it was all bank lending, but now we're seeing others coming to the party, in particular firms where the base capital comes from a number of private individuals. From an equity point of view, most of our investment into UK real estate comes from Middle Eastern investors who we see broadening the types of assets they are buying.

AH: We have recently been seeing some Sharia boards, especially the Sharia boards of Middle Eastern investment banks, start to look at different asset classes that they would not have previously looked at such as supermarkets and hospitality, depending on the makeup of the non-Sharia element of those assets.

We see Far Eastern investors continuing to come to the UK as well, the majority of whom are Malaysian and Sharia compliant. Surprisingly, we are starting to see some Korean banks entering the UK real estate market as the new player in the conventional financing market.

With markets so buoyant and high competition for property, prices have risen. What opportunities are there for existing and new entrants to the real estate market?

PB: The UK is still by far the favoured jurisdiction. We have seen increased US exposure, but in my 15 plus years of US real estate experience, US real estate and its investors have seen changing structuring advice. European real estate has its challenges regarding tax but, with the correct structuring advice, this can be mitigated. Sector wise, we're pleased to see interest in hotels picking up particularly those who saw the pandemic as an opportunity to rebrand or modernise.

AH: Things are starting to look up in the hospitality industry, which is good news for investors, but it is obviously not as buoyant a sector, especially for Middle Eastern investors as out of town retail parks and logistics centres, and even offices. That's not necessarily a bad thing because it means that investors, especially Middle Eastern investors who traditionally only looked at London, are looking at the wider regions now. Retail parks and the logistics distribution centres are, by definition, out of town therefore people are looking out of London and that will direct more investors towards other cities and areas in the UK which may result in better yields.

MW: As a Channel Islands based law firm, the majority of the transactions on which we work relate to UK real estate. The UK is seen as a stable market and safe place to invest, although assets offering the 6% yield that many investors seek have become increasingly difficult to find. The decline in sterling and increased price of oil may also have fuelled activity. We have been told by some clients and intermediaries that some investors have turned toward the US and Europe to achieve a higher yield. ■