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## UK roundtable 2022

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# UK managers seek to stay one step ahead

*Real estate investors are targeting value-add and core-plus strategies in response to rapidly evolving market conditions, writes **Stuart Watson***

These are unsettling times in the UK. The febrile atmosphere is due in large part to global events: the pandemic, war in Ukraine, inflation and supply chain disruption. But Brexit has also played a part, as new political and economic links, whether friendly or adversarial, remain to be forged with the country's European neighbors.

The four participants in PERE's UK roundtable discussion are all tasked with serving their capital providers and clients within a disorderly environment marked by rapid change. For them, working through those changes to transform real estate assets and portfolios, and maintain returns, is the challenge of the moment. Increasingly, they are meeting this challenge by turning to value-add and core-plus strategies.

"The asset class is innovating, changing and adapting," says Frank RoccoGrande, founding partner at investment manager Deutsche Finance International, whose offices in London's Mayfair district hosted the discussion. "Real estate has become a lot more operational and customer-centric. It needs to be future-proof because ESG now looms large over everything. The convergence of these factors is forcing GPs to change their strategy and their products to meet the evolving needs of real estate occupiers and institutional investors."

Managers have adjusted the structures through which they look to deploy institutional capital, observes Steven Cowins, co-chair of the global real estate fund practice at law firm Greenberg Traurig. "The sharpshooters that focus on a single sector or geography

would probably have raised a small fund five or 10 years ago. Instead, they do a separate account with a big investor, typically from the US, Canada or the Middle East. They are raising a lot of money, but doing it through non-traditional fund structures tailored to their investors."

What the occupational market wants today is very different to the contents of any real estate manager's strategy papers before the pandemic, says John Benham, manager of BlackRock's UK Property Fund. "We have seen the market pivot really quickly. Real estate facilitates how society operates, and that has changed rapidly in the last couple of years, which has been telling for everything from capital raising to sector allocation. For example, there has been so much additional demand for logistics that everyone has joined the dance and

PHOTOGRAPHY: RICHARD DAWSON



### Frank RoccoGrande

Founding partner  
Deutsche Finance  
International

RoccoGrande established DFI in 2016. The pan-European private real estate platform manages assets valued at \$3.6 billion, around a third of which is in the UK. The business is an independently-managed part of Deutsche Finance Group, a global real estate investment manager, with around \$11 billion of assets under management.

### David Inskip

Head of UK real assets  
research, CBRE Investment  
Management

Inskip oversees the research capabilities of the UK business of CBRE Investment Management and sits on the UK investment committee. The global real estate investment manager's 200-strong UK team manages around £16 billion (\$20.1 billion; €18.8 billion) of domestic assets, held in separate accounts and pooled funds.

### Steven Cowins

Partner  
Greenberg Traurig

Cowins is global co-chair of the real estate fund practice at Greenberg Traurig, one of the world's top 50 law firms by revenue, employing more than 2,400 attorneys, nearly 650 of whom specialize in the real estate sector. His practice focuses on private equity real estate matters, advising clients in establishing funds and joint ventures, and on real estate M&A.

### John Benham

Portfolio manager,  
BlackRock UK Property Fund  
BlackRock

Benham manages BlackRock's UK Property Fund. With £3.4 billion (\$4.2 billion; €4 billion) of assets under management, the open-ended core and core-plus vehicle is the largest pooled real estate fund managed by the US-headquartered multinational asset manager, which also offers an array of core to value-add strategies globally.



grabbed a partner, so that there are now operators and capital married up and competing for every deal.”

RoccoGrande argues that many of the most attractive opportunities available to real estate investors in this period will be value-add repositioning related to transforming assets to fit the emerging market paradigm. “There will be a lot of landlords that don’t have the capital or the expertise or the wherewithal to transform retail, office or mixed-use assets to meet the needs of the next 10 years and more.”

### Fundamental reset

Our roundtable participants agree that existing office assets will need to be transformed to meet elevated ESG and

*“Some inflationary elements may remain for the mid-term, so we need to adjust our business plans, and maybe even our return expectations”*

**FRANK ROCCOGRANDE**  
DFI

wellness standards if they are to avoid obsolescence, and that the process will generate investment opportunities.

However, Benham notes that in the UK, it is much more difficult to reposition regional offices compared with space located in the capital.

“In London, values are more than £1,000 (\$1,226; €1,178) a square foot in most of the investable markets, and your contractor may charge you between £150 and £200 a square foot to refurbish the space.

“In the regions, values are half the London level or less, because rents are much lower, but the refurbishment cost will be the same. There will need to be a fundamental reset of values in some of those regional markets if we are to deliver regenerated stock viably, somewhat like we have already seen happen with retail property. A lot of people have lost money in that process, but you can now selectively strike retail deals at a rebased value that creates a sustainable cashflow from the businesses operating out of that real estate.”

The pace of change means that real estate owners need to develop a deeper understanding of their tenants’ operations if they are to adjust their terms to satisfy both parties in a lease agreement while avoiding vacancy, says David Inskip, head of UK real assets research at CBRE Investment Management. “One of the silver linings of the pandemic is that some of those channels of communication have opened up. In the UK, even knowing the turnover of retail and hospitality tenants has sometimes been a challenge. But difficult circumstances have brought customers to the table to talk who would not have been interested before. It has also been helpful with signing green lease terms. It is an extra effort for the tenant to do that and they don’t always see the immediate reward, but the pandemic has been an opportunity to reset relationships and have more open conversations.”

Green lease clauses are crucial

## Turning points

### Participants select their pivotal UK real estate deals from the past year

#### David Inskip

**Canada-headquartered asset manager Brookfield buys a £330 million retail warehouse portfolio from UK REIT Hammerson in May 2021.**

“You very rarely see a deal which comes right at the absolute inflection point of the market. Liquidity for that sector was very poor at that point and a previous sale of that portfolio had already fallen out of bed in 2020, with the buyer writing off their deposit to get out. The net initial yield was reported to be 8.6 percent. But there has been an incredible turnaround in that segment and the value will have increased sharply over the past year. It will be interesting to see if that recovery can spread to other parts of the retail market.”

#### Steven Cowins

**Blackstone’s €21 billion recapitalization of its Mileway European Logistics platform in February 2022.**

“GP-led secondaries are a huge trend. It used to be what managers did with bad assets and zombie funds. Now, it is what they do with their best assets because if you’ve got great strategic pieces of land and investments, why would you sell them when you can continue to add value and provide value to the investors? There are clear and present conflict issues and they have to be managed very carefully. But with transparency, disclosure and good investor relations, you can get price discovery, which is the key that helps unlock the conflicts. That transaction proved the process through which having a robust price discovery mechanism produces fair value for the investors, while enabling the GP to maintain control over the assets.”

#### Frank RoccoGrande

**Life sciences specialist Kadans Science Partner**

**announces a £500 million team-up with Canary Wharf to build a 22-story tower providing 750,000 square feet of lab office space in London’s Docklands.** “Kudos to them for breathing new life and establishing a new product type in an area of the city where its relevance as a real estate market could be questioned. No-one would have said that’s a natural place for a cluster. It is not next to a university or a hospital. But it does have good transport links, including the new Elizabeth line. Because land values in London are so high, it is difficult to repopulate areas with the innovative new uses that are needed. Kadans are being bold and thinking about creating an ecosystem in the long term. For life sciences in general, the Oxford-Cambridge-London golden triangle will be the market-leading area for Europe.”

#### John Benham

**Firethorn Trust sells its portfolio of UK logistics sites and completed buildings to Cain International for £550 million in March 2022. The London-headquartered property company will be retained as developer and asset manager of the assets.**

“Firethorn amassed that portfolio, banked what must be an impressive profit and have gone back in with Cain to try to build out a larger £1 billion-plus platform. Over the last 18 months, major new money has come into that sector to take it through the next stage of this cycle. Values have continued to increase but every time you come across a yield that appears tight, it turns out to be justified because strong occupational demand is producing rapid rental growth. To be flippant, in some ways the worst thing you can do with industrial currently is to let it, because the rent has already increased before the ink is dry on the lease.”



Northampton Cross:  
Firethorn Trust’s first  
UK development

because of the data they provide, says RoccoGrande. If owners are unable to measure energy performance, it will not be possible for them to establish a baseline for improvements. Benham would like to see the UK government emulate some other European territories in ensuring that every tenant communicates their energy usage to their landlord. “At the moment, the landlord community is willing, and every corporate tenant has a net-zero plan, yet making the two come together to actually create progress can be really difficult without that visibility of data.”

### Active management

Many large UK office tenants are already locked in long leases, often in spaces that are not up to current ESG

*“Real estate facilitates how society operates, and that has changed rapidly in the last couple of years”*

**JOHN BENHAM**  
BlackRock

standards. These spaces may become obsolete on lease expiry, with a consequent risk to the value of assets held within long-income funds. Benham argues that those owners can turn the situation to their advantage, however. “People think that long-income managers buy with 15 or 20 years left on the lease and sell at 10 years. But if both landlord and tenant are willing, they can refurbish a building and re-sign another 15-year term. The fund can then sell the asset or retain it. Good long-income managers will have to manage their portfolios more actively. But ESG is actually the opportunity, not the threat.”

The key to resolving such situations is a strong relationship between owner and occupier, says Inskip. “When you are entering into new leases, you need to consider not just the strength of the tenant’s finances but also whether you are aligned and can work together with them. A positive feature of long-term cashflows is that they can help to offset the capex required to improve assets.”

Redevelopment and repositioning are becoming a more widespread feature of investment strategies, says RoccoGrande.

This means that inflation is increasingly at the forefront of managers’ minds. “You see it in steel prices, in wages, in contractors not wanting to give you a fixed-price contract, or sometimes not even wanting to bid for work anymore,” he says.

While the UK is less exposed to soaring fuel prices than Germany, because it is not so dependent on Russian fossil fuel, the risk of wage inflation may be greater, RoccoGrande says. “Post-Brexit, the UK labor market does not have as much flexibility as continental Europe. Some inflationary elements may remain for the mid-term, so we need to adjust our business plans, and maybe even our return expectations. We are already factoring in larger contingencies in our budgets.”



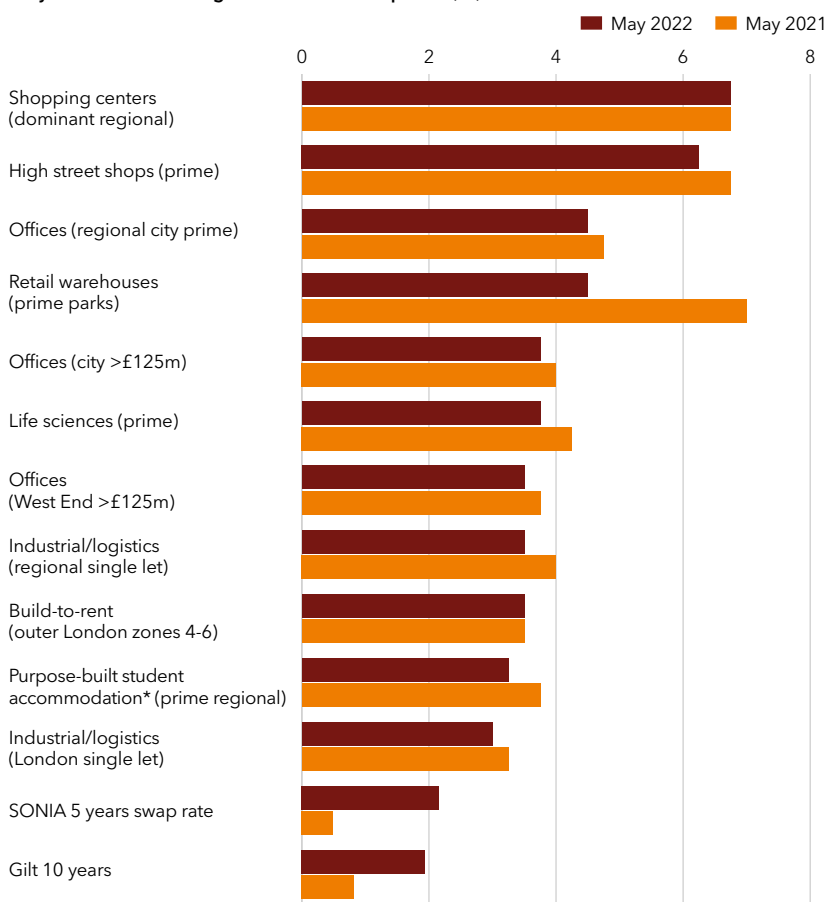
### Additional contingency

The cost of delivering logistics development has surged over the past 18 months, says Benham. But “phenomenal” rental growth over that period has compensated landowners. “For land bought at today’s prices, your assumptions need to be loaded with an additional contingency of 10 to 20 percent, because costs will increase. Rising costs will also impact offices. The cost to fix them has just gone up, and there is still some uncertainty over who will take those offices and what kind of space they will need. There are opportunities there, but questions remain what product you should be delivering.”

“At investment committee, one of the key metrics on construction costs is the date that you got the price,” adds Inskip. “You want it to be literally within the last week, whereas previously three months might have been an acceptable window. There will also be lengthy discussions around the finances of the contractor that you’re using, because unfortunately we are sure to see some contractors fail over the coming 12 months.”

Increased financing costs will pile

UK yields stable or stronger over a 12-month period (%)



\*25 year FRI leases  
Source: JLL

## Still an Englishman’s castle?

### Single-family rental landlords storm the UK homes market

Once a stronghold of owner-occupiers, the UK housing market is changing. “Residential is currently the institutional asset class of choice. Within that you have a host of sub-sectors, which are all expanding. But it is single-family residential that is probably the fastest-growing build-to-rent sector in the UK at the minute,” claims Greenberg Traurig’s Cowins. Changes to the tax environment that make buying-to-let less attractive for small mom and pop investors have prompted them to sell, creating space for institutional landlords, says Inskip. “More professionalism in the sector is a good thing for society because every time you see a tenant

satisfaction survey in the buy-to-let sector, the results are very poor,” he argues. DFI’s RoccoGrande notes that the sector is starting from a very low base. “We are seeing institutions in the US buying single-family, as well as multifamily. But the story is still new in Europe.” He expects rapid expansion, however, enabled by the use of technology.

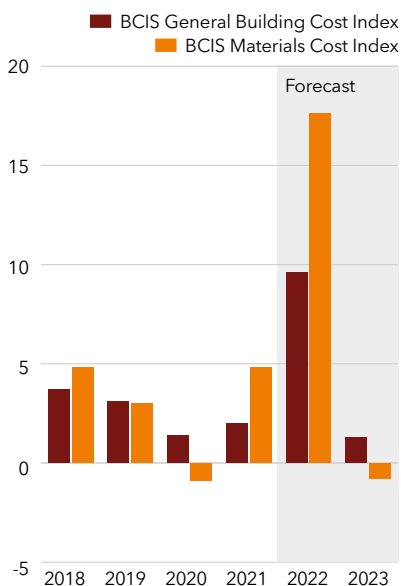
“We are seeing a lot more opportunities, with innovative groups using data mining to create an architecture for portfolio construction. Because capital is global, a lot of the same players are active in other markets, so they are already familiar with single-family.”



*“Managers are raising a lot of money, but doing it through non-traditional fund structures tailored to their investors”*

**STEVEN COWINS**  
Greenberg Traurig

Construction cost inflation set to surge in 2022 (%)



Source: BCIS, November 2021

further pressure on business plans, says Cowins. “Lenders can see risks everywhere. The loan-on-loan market paused earlier this year, which will make debt scarcer and therefore more expensive. Private credit funds are still one of the booming areas of fundraising, with lots of equity shops establishing a debt arm as well. But loan pricing will inevitably be on the up nevertheless.”

**Yield spread**

With interest rates ratcheting up to combat inflation – the Bank of England raised its base rate to 1 percent in May – fixed income returns are also rising, reducing the arbitrage between bond yields and real estate yields. What does that mean for the attractiveness of an asset class that many institutional

investors have favored as a fixed-income proxy in recent times?

The nature of the threat varies between property sectors, argues Inskip. “With logistics, although the yield spread might be coming under pressure, there is still confidence that income growth is sustainable. Therefore, people are drawing more of a comparison to index-linked gilts in that there is a pretty good inflation hedge in industrial currently because the supply-demand balance is so tight that there is a lot of pricing power there for landlords. In other property types, like some of the retail classes, the yield spread is still very wide indeed. If you have confidence that there has been rebasing of rents, and you can maintain that income stream, you are still comfortable there as well. It is

the middle ground, such as commodity-type offices, which are most at risk. Yields are still relatively low, but there is a question over whether they will be able to consistently generate rental growth.”

Investors will allocate more capital to longer-term core-plus and value-add strategies to maintain as much of the gap between bond and real estate yields as possible, predicts RoccoGrande.

“They will probably have to accept a little bit less return, and a longer duration for the manager to execute their business plan. But as long as the institutional investors and the managers are aligned over what that product and business plan and duration should be, it is not an existential problem at all. It is just about resetting objectives to create a sustainable product.”

Such considerations are, of course, a global problem for the real estate sector, and not unique to the UK, which offers some distinct opportunities to investors. “The UK is the largest, most diversified and probably the most innovative student accommodation market in Europe. It is still a very attractive destination for international students,” says RoccoGrande. The build-to-rent multifamily housing sector is expanding rapidly, he adds, as well as less mainstream living space asset types, such as single-family residential and micro-living. “Planning rules are starting now to catch up with the need for that accommodation. We will see a lot more of that type of product in London and in the regional UK markets.”

“If you go back 10 years in the UK IPD balanced fund benchmark, offices made up around 35 percent and retail 45 percent, whereas they are now both below 30 percent. Broadly speaking, that allocation has been replaced by industrial and also by the alternatives, such as student housing, residential, hotels and healthcare,” notes Benham.



*“In the industrial space, performance has peaked. The occupier market is strong, but the majority of yield compression has to be behind us now”*

**DAVID INSKIP**  
CBRE Investment Management

Logistics, both around London and in the UK regions, still exerts a strong attraction for investors. Pricing is steep, however, and Inskip offers a slight caveat: “In the industrial space, performance has peaked. The occupier market is strong, but the majority of yield compression has to be behind us now. We have to look to rental growth to be the main driver of returns. We still see attractive opportunities to buy in the space. But at the same time, we are weeding out assets where we will not be able to capture rental growth.”

With so much turmoil affecting the various UK real estate sectors in different ways, the roundtable participants are acutely aware of the need to be alert and ready to respond to the changes that the market will inevitably be subject to in the coming months. ■

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