Issue #113

Real Estate Finance

UK Real Estate Digest

Private equity done waiting as portfolio deals prime the market

The investment market for much of 2024 has been characterised by hesitancy. Would-be buyers seem to have been waiting for a clear signal to act. Waiting for the Bank of England to cut rates, and then for the election to play out, and now it seems, for the Budget.

The big beasts of private equity however have clearly decided that the time for waiting is over. This has been most evident for sizeable but relatively granular portfolios, where private equity buyers have dominated the bidding and, more often than not, come out on top.

Notable examples include the recent acquisition of Charles Street Buildings Group by Lone Star, the pending sale of the Balanced Commercial Property Trust to Starwood, and the anticipated purchase of the Aberdeen Property Income Trust portfolio by GoldenTree. All three trades have overlapping characteristics which tell us something about the mindset of the buyers.

Their view would seem to be that cyclical risk has receded, and that market pricing reflects an attractive entry point, but that idiosyncratic risks remain elevated. By spreading the risk across broad portfolios of relatively bite-sized assets, they can deploy large amounts of capital, whilst avoiding the inherent illiquidity of the largest assets, in what remains a very thin investment market.

They are able to acquire these portfolios at an apparent discount to break up value by providing vendors the convenience of a single transaction, whilst being confident in their ability to flip some assets quickly, thereby helping to deliver their target IRRs. Along the way, they will undoubtedly acquire some weaker assets that they would not have targeted individually, but they will believe that is a risk worth taking at this point in the cycle.

The direct investment market has been at pandemic lock-down levels for much of this year, but the bold moves made by a small group of private equity investors should in time start to filter out into the wider market as they work through their newly acquired portfolios.

Commercial Property Returns

According to MSCI, average commercial property capital values edged up by 0.3% in September and are now only very marginally down compared to the start of the year. Nonetheless, average values remain almost 25% below their June 2022 highwater mark.

Retail Warehouses have been the strongest performing sub-sector so far this year, with asset values up by 2.9% on average. Capital values are still 17.2% down from their peak, yet over the same period rental values have risen by 2.5% on average. Recovery for shopping centre values has been more muted, whilst shop values continue to drift downwards.

Industrial values have been edging up gradually since March, and that recovery picked up pace in September, with average values in the sector now 1.5% higher than they were at the start of the year. Values are still 25.5% off their June '22 peak, even though rental values have risen by 16.1% over that same period.

Offices remain the underperformer, with values off by 5.4% on average so far this year. That average is flattered by the West End (-2.9%), with most regional markets off by high single-digits. Notably however, rental values have risen to some extent in all regions so far this year.

Capital Growth to September 2024 (%
Source: MSCI Monthly Index

%	1 Month	1 Month	12 Months	From Jun '22 Peak
All Property	0.3	0.3	-2.8	-24.6
Retail	0.4	0.5	-2.3	-19.0
C London Offices	-0.4	-0.7	-7.9	-26.3
Regional Offices	-0.5	-1.2	-12.4	-37.2
Industrial	0.6	1.1	0.8	-25.5

Investment Market Activity

Preliminary data from RCA suggests that £2.3bn worth of transactions closed in September, a slight increase on recent months, but still a modest total in what has been a very slow year. The cumulative total for the first 9 months of the year is just over £30bn, broadly on a par with last year, yet barely half the total from the same period in 2022.

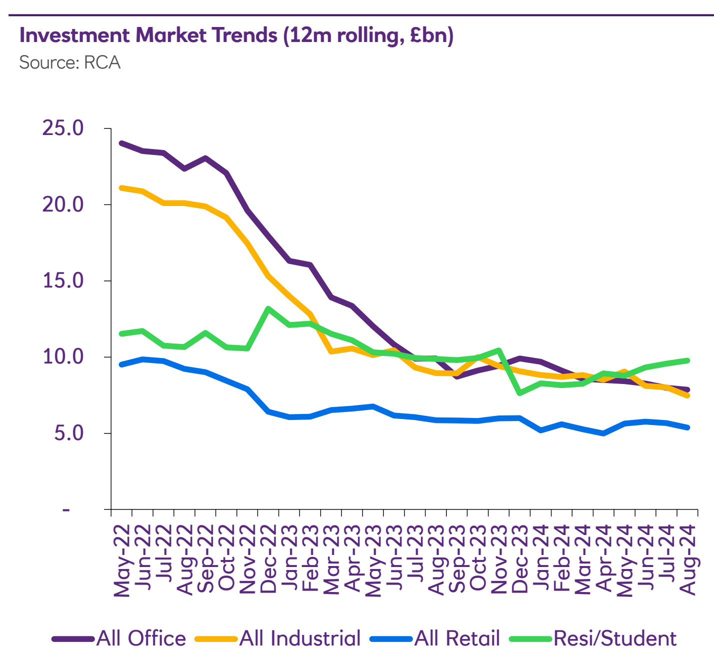
The largest deal to complete in September was the acquisition of Charles Street Buildings Group by Lone Star for a reported £600m. The portfolio comprises of 40 assets, and is heavily weighted to logistics, but also includes some offices, retail parks and supermarkets.

The largest single-asset deal of the month, and the largest City office trade of the year so far, was the purchase of Atlantic House, Holborn Viaduct, by Royal London Asset Management for £180m. The asset, which is let to Hogan Lovells for two more years, was originally marketed for sale at around £215m in March.

Various deals of note closed in the Retail sector. British Land acquired two retail parks from Brookfield for £172m. Realty Income also continued to hoover up retail parks with the acquisition of Arnison shopping park in Durham for £107m. M&G took full control of Cribbs Causeway; paying a reported £100m to the creditors of former JV partner Intu. Frasers Group acquired Fremlin Walk Shopping centre in Maidstone for £35m (£71/sq ft).

Almost £1bn was invested into the Industrial sector in September, across 40 deals. Notable deals included Mirastar and KKR buying 890,000 sq ft of logistics assets from Peel, Macquarie and Ivanhoe Cambridge for £115m, and LondonMetric acquiring a portfolio of six logistics assets from Clay Street Property for £78m.

Investment Market Trends (12m rolling, £bn)
Source: RCA



Market Yields

With mixed messages from the MPC, and an unclear story from economic data, medium-term interest rates drifted out again over the last month. Nonetheless, at the time of writing, the forward curve was implying six quarter point base rate cuts between now and the end of next year.

CBRE report a mixed picture for benchmark yields, with compression either perceived or anticipated for industrial and retail warehouses, but further softening expected for regional offices and secondary high street retail. For many sectors there is simply too little evidence to provide a clear picture.

Where there has been good transactional evidence, it is increasingly showing that buyers are having to sharpen their pencils secure their targets. This is most notable for retail warehouses, where CBRE estimate that yields hardened by 25bp last month and are in by around 50-75bp so far this year. Although there has been a notable uptick in interest for shopping centres, CBRE do not yet perceive that this passed through into keener pricing.

Multi-let Industrial also continues to attract capital, drawn by the significant reversion on offer, and CBRE consider that prime benchmarks for regional estates hardened by 25bp last month, to 5.0%. They anticipate further hardening of yields for both prime and good secondary estates.

Benchmark prime yields (%)
Source: CBRE

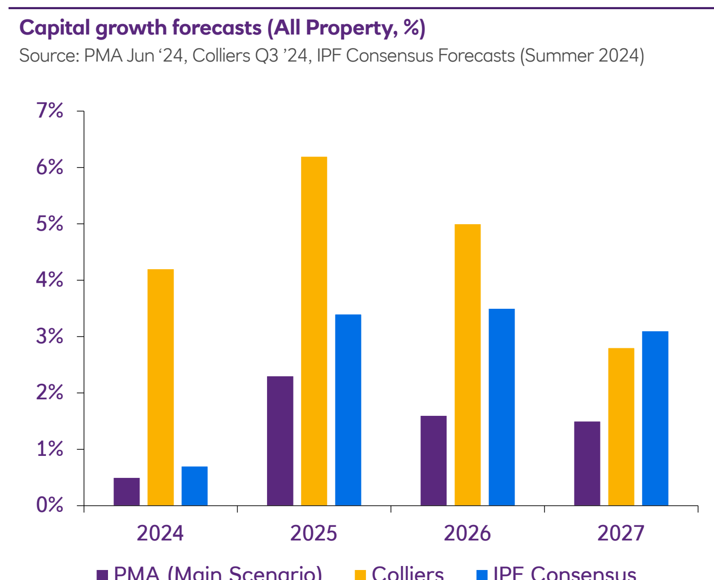
%	Oct 24	Nov 24	Dec 23
Regional City Office	6.50	6.50	6.25
Retail Park (Open)	5.50	5.75	6.25
High Street Shop	6.75	6.74	7.00
Regional Multi-let Ind	5.00	5.25	5.25
Regional Cities BTR	4.35	4.35	4.35
Regional Student (Direct)	5.00	5.00	5.00

Auctions

Data from market analyst EIG shows that the commercial auctions market has been active in recent months, with lots, sales and total raised all up by more than 8% year-on-year. However, the success rate was relatively modest at 69%, suggesting that investors remain price sensitive.

The auction by Acuitus in late September was their largest book of the year to date, with 66 lots listed. £28m was raised from sales, reflecting a success rate of 75%. Industrial assets remain in high demand, including an estate in Warwicksire which sold for £2.52m, reflecting an initial yield of 6.7%. A county court in Torquay, let to the government until 2030, sold for £1.25m (9.3%).

Capital growth forecasts (All Property, %)
Source: PMA Jun '24, Colliers Q3 '24, IPF Consensus Forecasts (Summer 2024)



Market Forecasts

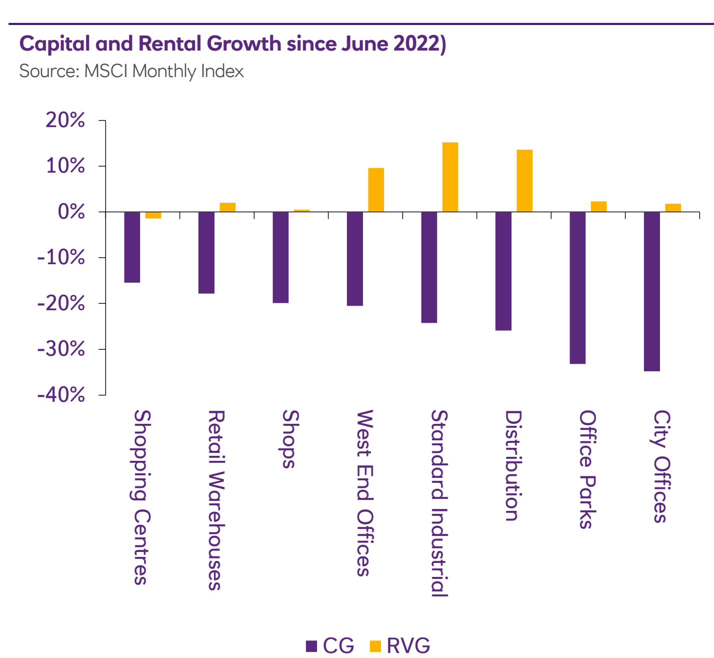
The latest base case from independent forecasters PMA assumes that base rate is cut to 3.5% by early 2026, and that economic growth picks up gradually over the next two years. Under this scenario, average commercial property values are expected to rise by a cumulative 8% over a five-year horizon.

The Industrial sector is expected to deliver the fastest growth, with capital values predicted to grow by almost 20% over the five-year horizon. This is expected to be underwritten by rental growth of c15%, considerably slower than in recent years but still robust by historic standards.

PMA predict that rental growth will be almost as strong for Central London offices, at 15% over 5 years, but that capital growth will more muted, at 8.4% over the same period. They are more bearish for regional offices, notably in the South East, where they expect capital values to decline by a further 10%. This would take the cumulative decline from 2019 to almost 50%.

PMA also take a relatively downbeat view on Retail, with only Central London forecast to deliver material capital appreciation over the next five years (+13%). In contrast, they view the decline of smaller regional high streets as inexorable, with values falling by a further 15% by 2029.

Capital and Rental Growth since June 2022)
Source: MSCI Monthly Index



Looking Forward

Some corners of the commercial property market are already experiencing reasonably healthy levels of liquidity. Industrial estates continue to appeal to a wide range of investors, with significant reversion promising short-term gratification. Retail parks are also increasingly sought after, with rebased rents, low vacancy rates, and active occupier demand providing a compelling proposition. In both sectors, active buyer demand is now exceeding the availability of stock at current valuations, and as a result pricing is edging upwards as would-be buyers are forced to sharpen their pencils. Central London retail has also shown flickers of life with a few notable deals proceeding in recent months. However, transactional activity elsewhere remains muted, with buyers and sellers showing little sign of urgency, and as a result values are largely moving sideways.

We are now well into the final quarter, traditionally the busiest of the year, yet it is still not clear whether 2024 will end with a bang or a whimper. The backdrop is in many ways quite promising. First, having rapidly rebased to reflect higher interest rates, valuations have now largely stabilised. Second, interest rates are now trending downwards; at the time of writing the forward curve implies six more cuts to base rate by the end of next year. Third, occupier conditions have been surprisingly benign, even where investor caution is most profound. According to MSCI, the much-maligned retail and office sectors have both delivered moderate growth on a sector average basis, whilst anecdotal evidence suggests that certain sub-sectors are doing considerably better than that. It seems anomalous for all these factors to align, yet for the investment market to remain moribund.

Private equity giants, with the capacity to spread their risk across a very wide asset base, have made the first move. Only time will tell whether this triggers a late surge of deal activity towards the end of the year, or whether most investors will continue to sit on their hands waiting for one more signal.

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