Investec

OUT OF THE ORDINARY

Past the eye of the storm

Future Property 2
June 2024

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In the 22 months since we published our first Future Property report, the UK economic and commercial real estate sector picture has changed dramatically.

Driven by a surge in interest rates, the UK real estate sector has witnessed a rapid repricing, a significant transformation in how spaces are used and occupier demands, along with inflationary pressures not seen since the early '90s.

Introduction

The private client cohort, primarily comprising entrepreneurs and high-net-worth individuals, would no doubt prefer to be operating against a less volatile backdrop. However, the very nature of these investors and developers – early adopters with the flexibility to buy when they see value, and develop and refurbish properties in anticipation of an increase in demand and developers – means that the current market dislocation is presenting some of the most compelling opportunities seen in a long time.

We have the evidence to back this up. Investec's 35-strong real estate lending team enjoyed a robust 2023/24 financial year, committing £809m of investment and development senior debt across a mix of structurally undersupplied and dislocated sectors, representing a 21% year-on-year increase.

The survey's findings suggest that developers are more confident across nearly every asset class, with the Living sector having some of the best prospects. Having also been an early predictor of the office sector recovery, the 13 percentage point increase in the appeal of the sector to investors and developers, the largest of all the sectors, suggests our intuition was correct.

Encouragingly, this aligns with our strategic focus to increase the loan book weighting towards Living development, building on Investec's strong legacy and making the most of the recent slowdown in new projects.

The increasing appetite to undertake development and repositioning projects, coupled with the importance private clients continue to place on both environmental and social considerations, aligns with another of our focus areas – what we call transitional lending.

Across all sectors, we are working with our borrowers to credibly decarbonise their portfolios, either supporting refurbishment work that improves energy performance certificates (EPC) or repurposing older buildings and taking them back into beneficial use. The 'social' element of environmental, social and governance (ESG) is also becoming a greater focus, which is reflected in the report's findings.

The message is clear: there's strong appetite for UK real estate from investors and developers with the conviction and experience. As capital values look to have reached an inflection point, and with a little help from policy makers and an improving macroeconomic backdrop, we anticipate an upturn in activity in the months ahead.

Shivani Goolab
Investec Head of Private Client Lending, Real Estate Finance

Executive summary

Our 2024 Future Property report makes for optimistic reading. We surveyed 110 high-net-worth individuals with a combined total net worth in excess of £6bn who are all investing in or developing UK real estate. Compared to our inaugural report in 2022, there is a clear sense of both growing optimism and activity levels. The higher interest rate environment of the last 18 months has failed to detract private client investors from increasing their exposure to UK real estate. Indeed, the UK remains a top destination for real estate capital and there is a sense of confidence that the macroeconomic picture will soon improve.

We conducted detailed interviews with four leading UK real estate entrepreneurs: Andy Woods, Investment Director at CEG; Gary Sacks, Chairman and CEO of City & Docklands; Henry Smith, Founder of Aitch Group and Tribe Student Housing; and Miheer Mehta, Founder of Sterling Rose Homes.

The views of our respondents echo what we are seeing in the market. According to Knight Frank[1], private capital invested US$338bn globally into commercial real estate in 2023, which equates to 49% of total investment. This is slightly higher than the 48% reported in 2022 and the highest share on record.

> Amid this high level of investment, one of the most revealing findings from our survey is an increasing appetite for development. Developers in particular report a much higher level of activity than in 2022, including an increase of 23 percentage points for industrial, 16 percentage points for residential and 13 percentage points for office.

Following a tough 2023, respondents are also bullish on the direction of travel for total returns, although significant barriers remain.

The impact of the recent volatile backdrop is evident in respondents' answers, with a clear flight to quality demonstrated by the types of strategies developers are planning.

Respondents are moving down the risk spectrum, focusing on high-quality buildings that are sustainable and flexible to meet the demands of today's tenants, indicating where the best rental growth prospects are.

ESG factors continue to be important, although the survey shows a clear shift from the 'E' to 'S' emerging. Reducing the environmental impact of real estate remains vital, but it is also costly.

Developers and investors are increasingly looking at other ways to deliver impact through sustainable projects that support communities, an increasingly important consideration for stakeholders, while also generating a financial return.

Highly appealing and delivering strong returns, residential remains the stand-out asset class for both developers and investors. This builds on the findings of our 2023 Future Living report[2], when 62% of institutional investor respondents said they expect their portfolio allocation to the Living sector to increase over the next five years, compared to just 40% in 2021.

With higher interest rates continuing to make buying a home unaffordable for many, the residential for rent sector has become even more appealing for developers, albeit with questions around its own affordability, high land values and construction costs.

Reflecting the value-add expertise of the private client cohort, the report reveals a major bounce back for the office sector and the growing opportunity to repurpose older office assets. Where there is an opportunity to create prime office space, competition is high.

Where there is the opportunity to acquire good value secondary or tertiary office space, or underutilised retail space, there is a clear appetite for repositioning, primarily into residential.

This year's report provides wide-ranging insights into the mindset of developers and investors. Across the UK, it is evident respondents believe there are opportunities for those who have the expertise and local market knowledge.

1. Navigating the recovery (knightfrank.com)
2. Future Living report 2023 | Focus | Investec

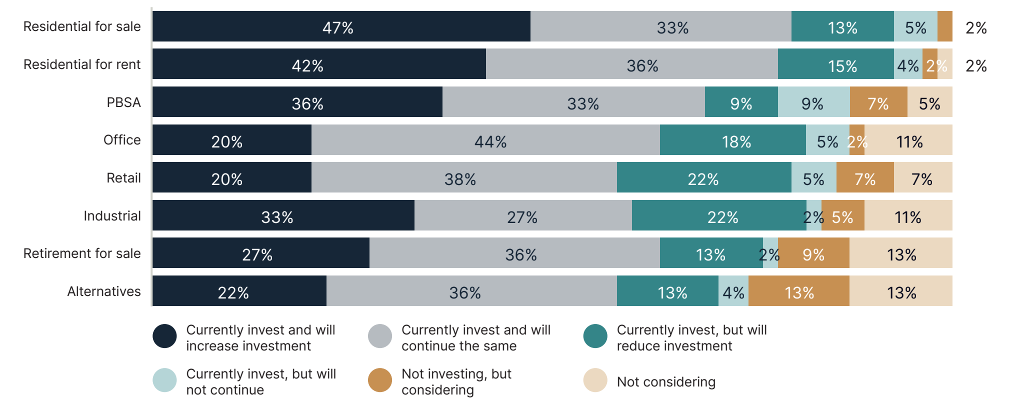
01

The *macroeconomic* landscape

Both investors and developers are investing more in 2024 than in 2022 and are more bullish about the market. The percentage of respondents currently investing in all asset classes has increased in the last two years, other than retail. Overall, 72% of respondents are optimistic about the UK real estate market and 99% believe the UK is an appealing market.

Henry Smith, Founder of Aitch Group and Tribe Student Housing, said: "I remain positive that the economic situation will improve, hopefully with a new government who will change the planning system and give something to first-time buyers, as well as kickstarting the construction industry and the housing industry. Watch this space."

INVESTMENT ACTIVITY



Across every asset class other than alternatives and retirement for sale, the most common prediction was that total returns will increase rather than stay the same or fall. However, only in the residential for sale (67%) and rent (62%) sectors do the majority of investors expect total returns to increase over the next three years.

Almost two-thirds (64%) of respondents believe that UK real estate capital values are at, or very near, the bottom. However, there isn't a clear consensus. On one hand, some people are reporting that values have plummeted considerably.

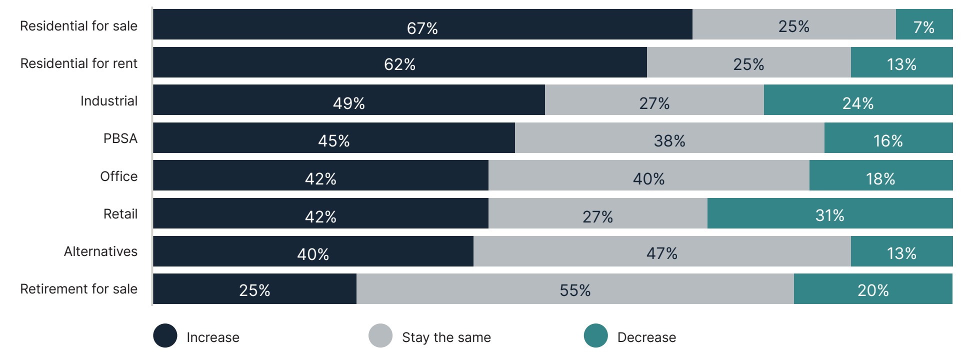
Our returns targets have been slashed. We have some sites where we've secured planning and developed, but they're only worth a little more than what we initially paid for them. All of the gains I would expect have been completely diminished.

On the other hand, a lack of supply in certain areas is already pushing values upwards.

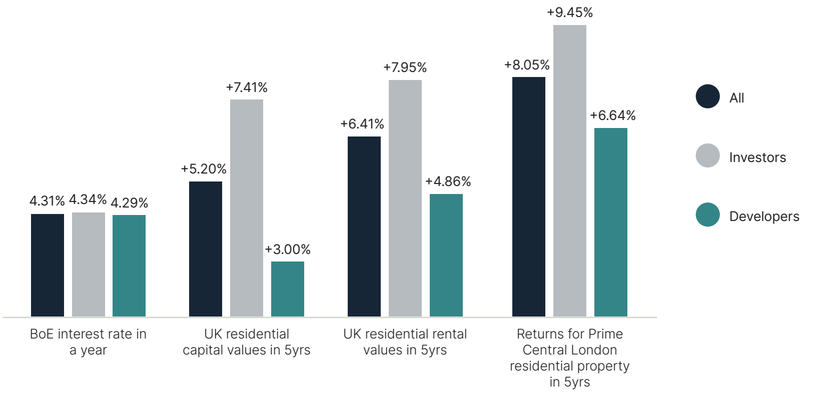
"The positive for the property sector, particularly the office sector, is we've never operated in the period where the supply in the city centres and outside London is so constrained," said Andy Woods, Investment Director at CEG. "You've got tenants that have a lease event three years away coming out now to talk to developers about pre-lets, because they can already see that there is nothing available to suit them currently and there's nothing likely to come forward."

> "I remain positive that the economic situation will improve, hopefully with a new government who will change the planning system and give something to first-time buyers, as well as kickstarting the construction industry and the housing industry. Watch this space."
>
> **Henry Smith, Founder of Aitch Group and Tribe Student Housing**

EXPECTED CHANGE IN TOTAL RETURNS OVER NEXT THREE YEARS



AVERAGE PREDICTIONS FOR THE MARKET



Savills' February 2024 UK Commercial report[3] predicts that the overall average total returns will be closer to the long-run benchmark averages of 8–10% per year than they have been in recent years. Meanwhile, CBRE's UK Index figures for 2023 suggest that after a fall in capital values each of the last two years, growth measured over three months has been improving since December 2023[4].

Investors are particularly optimistic about UK residential capital values, which they believe in five years' time will have risen by over 7%. Developers are not quite as optimistic, thinking they will rise by only 3%. Investors are also more optimistic about returns for prime central London residential property in five years, which they believe will increase by 9.45%.

> "If you're a good operator of property and you concentrate on scarce markets, then I think you'll get rental growth that is going to surprise you. And we're already seeing this in our portfolio. We're seeing pretty strong rental growth across most of our properties because they are so undersupplied."

Andy Woods, Investment Director at CEG

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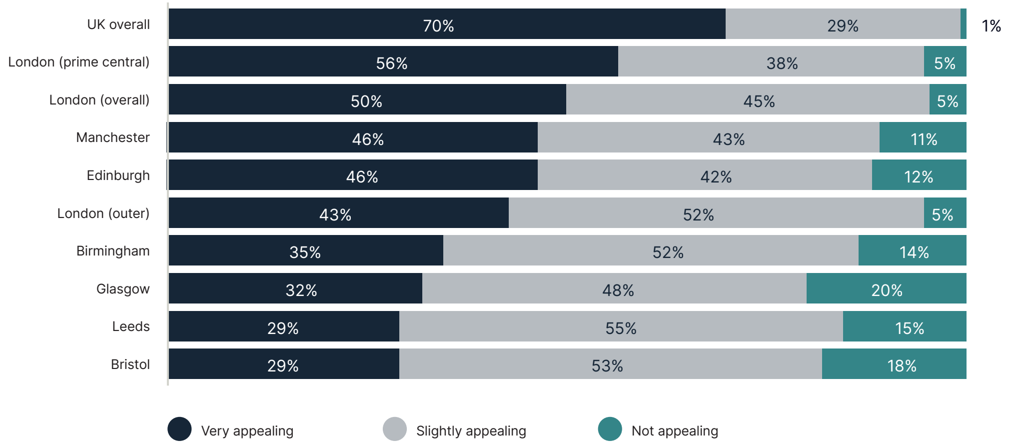
3. https://www.savills.co.uk/research_articles/229130/356159-0#
4. December fall in CRE values compounds 2023 decline | EG News (egi.co.uk)

REGIONAL APPEAL



> "We are seeing more and more opportunities for development in the residential sector in commuter towns around the country."

Shivani Goolab, Investec Head of Private Client Lending, Real Estate Finance

Across the UK

Looking at the market regionally, the most appealing cities are still London – especially prime central London, which 95% of respondents said is appealing. However, the capital has seen a slight decrease in appeal compared to 2022 where 50% of respondents believe London is 'very appealing' compared to 63% in 2022. This drop is consistent across all cities, except Edinburgh and Manchester.

"We are seeing more and more opportunities for development in the residential sector in commuter towns around the country," said Shivani Goolab Investec Head of Private Client Lending, Real Estate Finance. "This is especially true for single family rental, which is less of an urban product that appeals to families seeking good quality rental homes in desirable, suburban locations".

Taking the UK as a whole, overseas investors still find the market attractive. CBRE's 2024 European Investor Intentions Survey[5] ranked the UK as the top European destination for cross-border investment, with investors pointing to its discounted rates and high return potential. However, to make regional real estate more attractive, 88% of our survey respondents agree that continued government investment outside London is key.

"Today's attitude to regional investment is better than it was 15 years ago, but there are still major imbalances," said CEG's Andy Woods. "International capital will always come to London first. So, we believe that on a risk-adjusted basis, the regional returns are probably stronger. The rebalancing of the UK economy is a much bigger challenge than people like [former Prime Minister] Boris Johnson might let you believe; you can look at office property as a proxy for how difficult regional imbalances are."

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5. 2024 European Investor Intentions Survey | CBRE

02

Opportunities and *challenges*

Respondents continue to feel the impact of the tough economic landscape of the last few years.

"Generally, returns have been below average over the last three years and it's more about survival than growth," said Miheer Mehta, Founder of Sterling Rose Homes. "Brexit, Covid-19 and interest rates have all compounded the impact of any reasonable profit margin."

However, there is a belief that economic stress is easing. Overall, most respondents believe the Bank of England base rate will fall to 4.5% in the next 12 months. Investec's Economics team expects two 25 basis point rate cuts in the second half of 2024, with a further 100 basis points of Bank rate reductions to follow over the course of 2025. However, respondents are cautious.

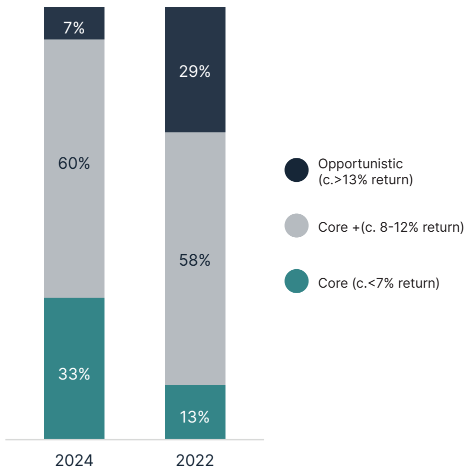
"We believe that they're going to come down but I don't expect or trust anything until it happens," Aitch Group's Henry Smith said. "Buying on the belief that rates are going to reduce is a gamble."

Gary Sacks, Chairman and CEO of City & Docklands Group, has a similar view. "We're still in the storm," he said. "We've maybe passed the eye of the storm but there's still some bumping around to do before the sun comes out."

Against this backdrop of continued uncertainty and with the real estate market increasingly characterised by the bifurcation between best-in-class buildings and the rest, developers are displaying a clear flight to quality. Two years ago, 29% were targeting a return of more than 13%, compared to 7% in 2024. The proportion of developers targeting a core return (less than 7%) has increased nearly threefold from 13% in 2022 to 33% this year.

"In terms of development appeal, the flight to quality is clearly materialising," said Investec's Shivani Goolab. "Occupier demand is biased towards best-in-class products, hence developers pivoting towards assets that will deliver core returns."

STRATEGY FOR BEST RELATIVE RISK-ADJUSTED RETURN



> "We're still in the storm. We've maybe passed the eye of the storm but there's still some bumping around to do before the sun comes out."
>
> **Gary Sacks, Chairman and CEO of City & Docklands Group**

From 'E' to 'S'

Balancing profit and purpose remains central to respondents' strategies, with 81% agreeing that there is a clear link between more sustainable development/investment and financial upside. This puts transitional lending front-of-mind for many investors.

However, investors continue to be the most influential and demanding stakeholder group around sustainability. This reflects how central the energy transition has become to UK policy and evolving occupier behaviour, the government and tenants have overtaken internal motivation as the most influential.

What the report clearly shows is the shift from environmental to social concerns. Respondents believe that social impact is the most important ESG factor when developing or investing in real estate, selected by 42% of respondents compared to 16% who selected carbon footprint.

"The S is just as important as the E," CEG's Andy Woods said. "If you're trying to get planning permission for development, I think your social impact is very important for the local authority and the local community, perhaps more than the E."

One of the reasons social impact is overtaking environmental concerns in terms of importance is the cost involved. Several respondents believe that when developing schemes, focusing on social value could bring greater benefits due to the high costs of environmental measures. A report from the Social Market Foundation suggests that maximising social value in real estate can lead to a 5% uplift in an asset's market value[6].

"ESG considerations are definitely featuring less because of the cost and where we are in the cycle," said City & Docklands' Gary Sacks. "On the S side, in terms of our interactions with tenants, we are probably making even more of an effort."

6. Social value roadmap for real estate | Social Market Foundation (smf.co.uk)

Miheer Mehta said that Sterling Rose is focusing efforts on measures that have a direct impact on local people, particularly for smaller developments.

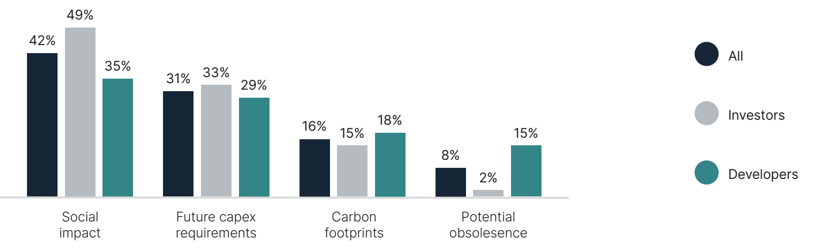
“At sub 50 units per site, there is very little environmental impact that can be made which is cost effective and, ultimately, this is a key factor,” he said. “There are wider things that we are focusing on that include the Sterling Rose Scholarship through which we have partnered up with Whitgift School to assist children with the academic ability but not the financial backing, to optimise their future education.”

However, environmental concerns remain important. Some 88% of respondents agree that the EPC rating of a property is a key investment criterion. Four-fifths (80%) agree that minimum energy efficiency standards regulations should be a political priority.

Tenants still also prioritise environmental performance of a building. JLL research shows an average green rental premium of 7.1% across major cities in North America, 9.9% in Asia Pacific and 11.6% in London[7]. This desire for high environmental performance is creating a shortage of such properties, particularly in London.

“Outside big corporates, a lot of businesses are interested in sustainability, but aren’t prepared to pay a premium rent for it,” said CEG’s Andy Woods. “But if you’re a large financial or professional services business, which has made scientific-based climate change pledges in its annual report, then you’re going to have to take a building with higher environmental credentials. There’s a shortage of those, and you’re going to have to pay a premium rent for them.”

MOST IMPORTANT ESG FACTORS WHEN DEVELOPING OR INVESTING IN REAL ESTATE



7. How sustainability-conscious tenants are assessing new space (jll.co.uk)

Barriers to investment

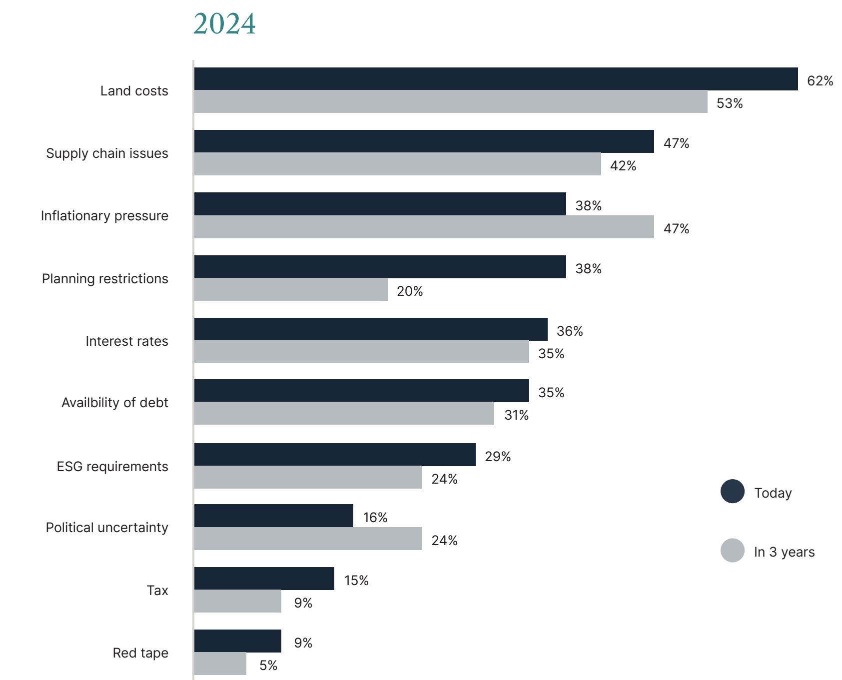
Developers displayed a greater concern for almost all obstacles in the sector than two years ago, aside from tax and red tape. Developers consider land costs the biggest barrier to investing by far; 62% of respondents believe it is an obstacle today, compared to 33% in 2022. This is expected to fall; 53% believe it will be an obstacle in three years’ time.

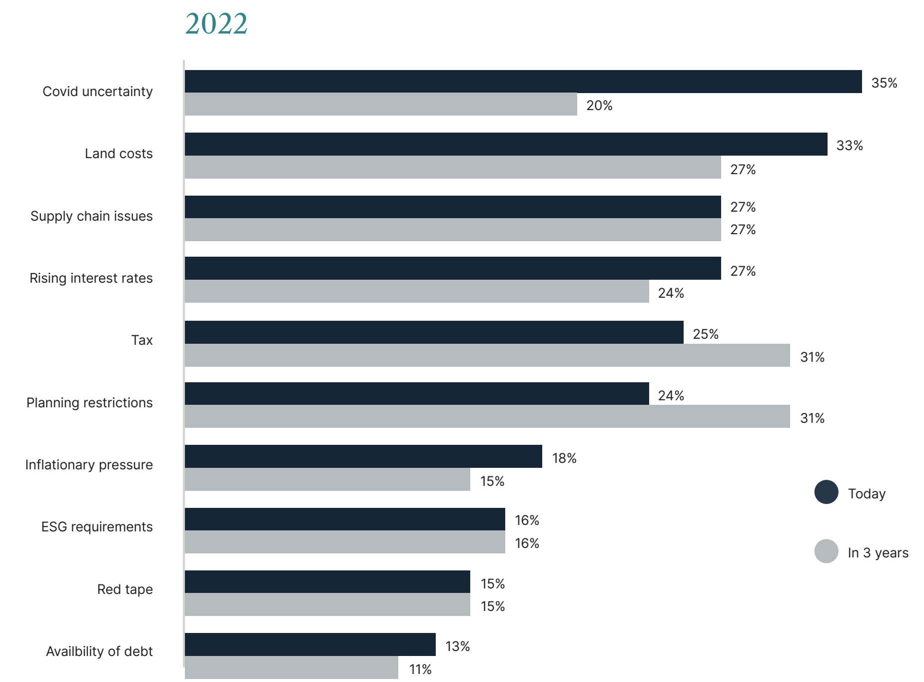
“We have not seen the adjustment in the land costs, which I’m amazed about,” Aitch Group’s Henry Smith said. “I believe people are holding on, waiting for interest rates to reduce. Even then, I believe it’s going to be difficult to make a profit on anything that was purchased in the last three years.”

Planning restrictions have jumped as an obstacle for those polled from 24% to 38%, while 69% agreed that the UK planning system has become more, rather than less, restrictive. Encouragingly and possibly reflecting how vocal the Labour Party has been on the topic, the 38% figure falls to 20% in three years, the greatest decrease of all obstacles.

Along with supply chain issues, which have been heavily impacted by global political situations, inflationary pressure is considered a greater concern. We found that 38% of respondents believe it is a barrier today, compared to 18% in 2022. This barrier and political uncertainty are not expected to ease significantly in the next three years.

BIGGEST OBSTACLES TO INVESTING





03

A *view* across sectors

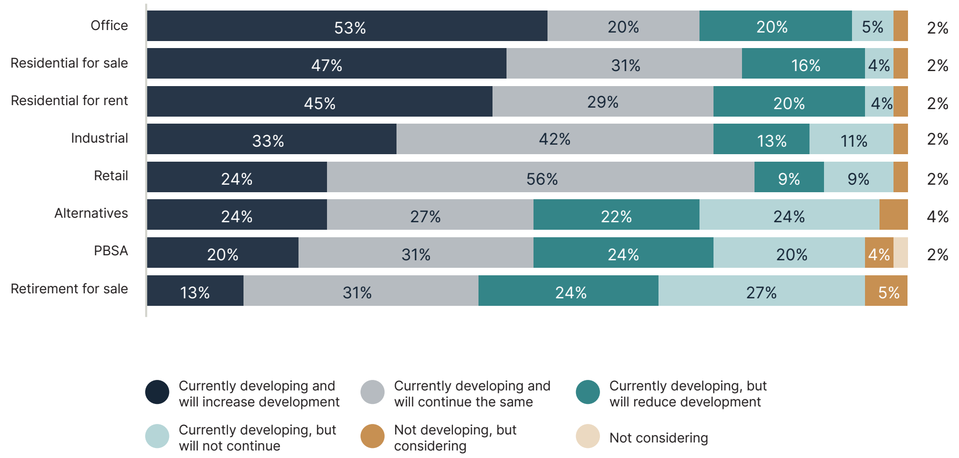
The survey results present contrasting sentiments from investors and developers regarding sector appeal. Residential still leads the way for investors, and residential for rent and purpose-built student accommodation (PBSA) have both risen in appeal. While all sectors are seeing increased investment activity, retail and industrial have both fallen in priority among investors.

Developers are reporting an even higher level of activity across all asset classes. Industrial has seen the biggest rise in activity, with a 23 percentage point increase in respondents who say they are actively developing. However, big drops in development are expected in the next three years for several sectors, including alternatives, PBSA, retirement. Only 44% plan on continuing the same level of investment in retirement.

Investec's Shivani Goolab attributes developers' current bullishness to the fact they've been out of the market for some time. The UK has seen a period of significant decline in development activity, driven by higher borrowing costs coupled with construction and labour cost inflation. According to data from the Hays/BCIS Site Wage Cost Indices, construction site wages increased by an average of 4.7% in the second quarter of 2023 compared to the second quarter of 2022.

"There has been a reduction in acquisition activity for new developments over the recent past but given structural undersupply especially in the Living sectors and Grade A office space, there is a clear opportunity for developers who can follow their convictions and have ready capital to deploy," said Investec's Shivani Goolab.

DEVELOPMENT ACTIVITY



CHANGE IN PERCENTAGE POINTS FROM 2022 (CURRENTLY DEVELOPING)

Retail	Office	Alternatives	PBSA	Residential for sale	Residential for rent	Industrial
+5	+13	+14	+15	+16	+16	+23

The office returns

Following a highly turbulent time for the office sector, the survey results signal a significant bounce back. Office is now the third most appealing asset class from an investment perspective, up from seventh, selected by 35% of respondents in 2024 compared to 23% in 2022. This is being driven by occupier requirement clarity, and the repricing seen in the sector. However, this higher level of appeal is against the offer of a lower risk-adjusted return.

"Looking at the office sector, the capex requirement has increased dramatically," CEG's Andy Woods said. "You need to do more to make it lettable. Tenants now have a minimum requirement in terms of design quality, the level of amenities and the sustainability rating, much of which is tied in with the broader return to office issues. For a lot of incumbent landlords who bought an office building five years ago, this dramatic shift in occupier expectations has caught them off guard."

According to Carter Jonas, the average annual rental growth for all offices was 2.8% in March 2024, up from a post-pandemic low of 0.8% in January 2023[8]. Data from Remit Consulting suggests that March 2024 was also the strongest month for office occupancy since May 2021[9].

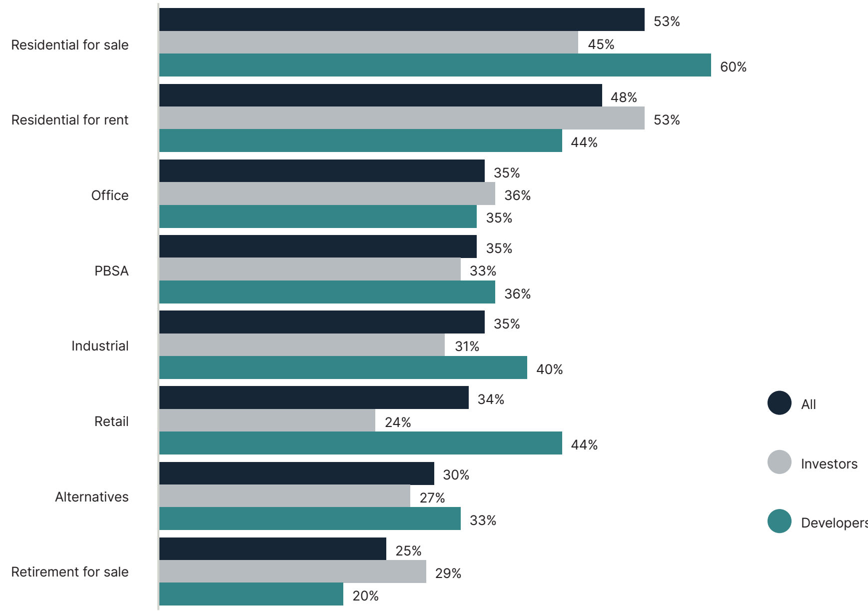
If an office offers a high enough specification, an investor or developer can be confident it will let. For investors and developers able to take a longer-term view, respondents believe that now is an opportune time to invest.

Data from BNP Paribas Real Estate[10] on the rental performance of best-in-class offices revealed that in Birmingham, Bristol, Cardiff, Edinburgh, Glasgow, Leeds, Liverpool, Manchester, Newcastle and Sheffield, prime rents rose on average by 7.6% between the first quarter of 2023 and the end of March this year, the biggest jump since 2001.

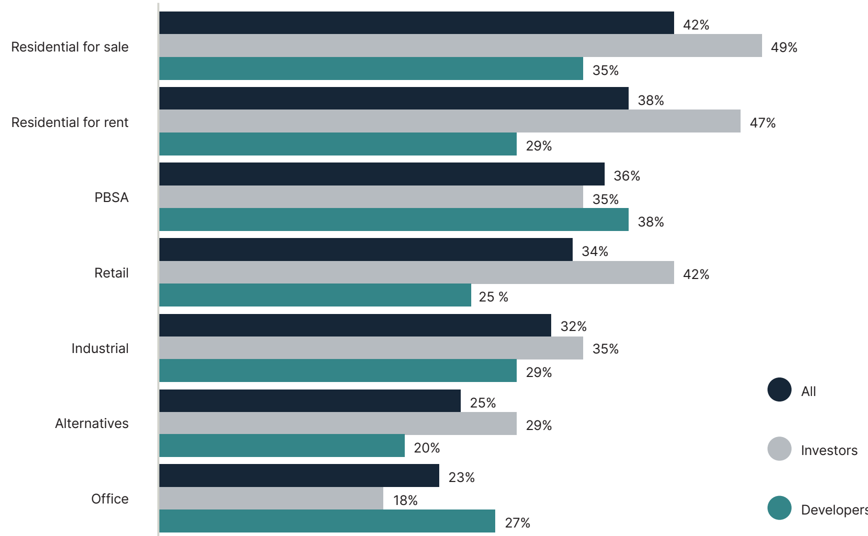
8. Commercial Market Outlook | Carter Jonas
9. News Release: March Update - Monthly figures show national office occupancy hit their highest levels amid public and private sector push (remitconsulting.com)
10. www.realestate.bnpparibas.co.uk/2024/may/uk-regional-office-market-report-q1-2024

APPEAL

2024



2022



> I believe the office sector will turn a corner when rates come down. I believe now if you went into that sector you could make some fabulous buys if you had the belief in the price, if you looked at the five-year swap rate and you were buying them for that.

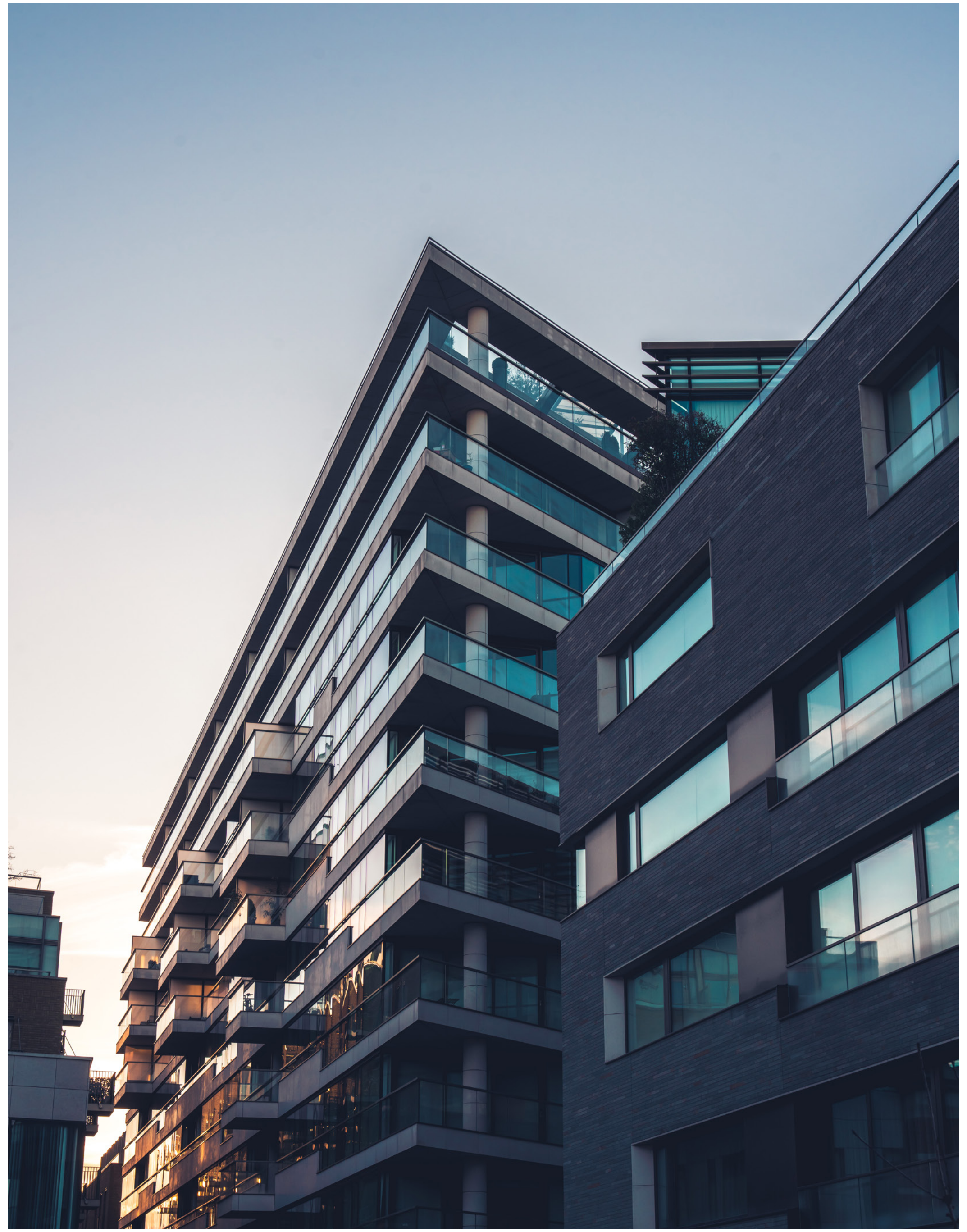
Henry Smith, Founder of Aitch Group and Tribe Student Housing

For offices that don't lend themselves to reinvestment to provide higher-quality space, respondents are keen to make the most of opportunities to reposition secondary or tertiary assets.

"Office values have been declining in line with market sentiment and yield shifts," Investec's Shivani Goolab said. "This has offered developers credible opportunities to add value through repurposing or redeveloping non-prime office buildings."

When respondents were asked why they are interested in repositioning offices, opinions were mixed. Many people cited shifting working patterns. Other reasons for selecting office-to-residential conversion include the more compelling demand drivers, that it can be a relatively quick and easy conversion, and assets are often in prime central locations with good transportation and infrastructure. Office to industrial was also popular, due to a higher yield, a lack of supply and ease for adaptation for industrial purposes.

Offices aside, the conversion of retail to residential was the most selected repositioning opportunity, though this is more popular with investors. Reasons for this include that it presents an easier opportunity with the growing demand for urban housing, good value and highly desirable locations.



Residential strength

While the office sector has bounced back, residential remains the most appealing sector. To investors, residential for sale is the most active sector; 98% are currently investing. Investec's Shivani Goolab attributes this high level of activity to continued elevated demand in the sector due to the UK's structural undersupply of homes.

However, residential for rent is also now a top investment priority for investors; 96% are currently investing in this asset class compared to 84% in 2022, the largest increase of any sector. PBSA has seen the second largest rise in popularity; 87% of investors are now active in the sector compared to 71% in 2022.

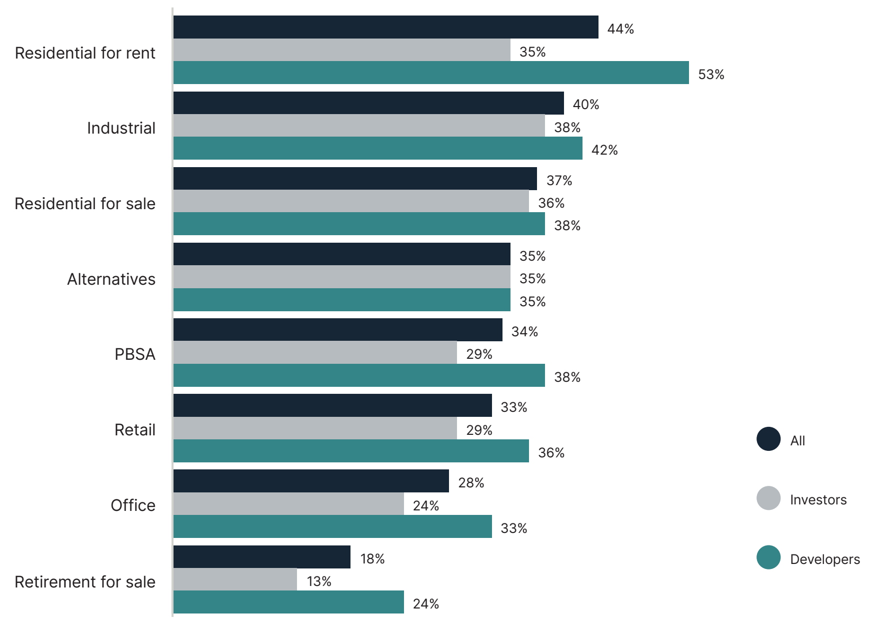
"Residential is the most appealing asset class as returns are remaining very steady and the outlook is very positive," said City & Docklands' Gary Sacks. "Rents are going up due to lack of supply and wage inflation."

Statista Research Department[11] forecasts that residential rental rates in the UK will increase by almost 18% until 2028, which includes an increase of 5% in 2024. On the residential for sale side, annual price growth currently stands at 1.7% according to Rightmove[12], the highest level for 12 months.

Respondents also see the risk-adjusted returns as strongest for residential sectors. More than half (53%) of developers see residential for rent as offering the best risk-adjusted returns. Overall, respondents see only residential for rent and residential for sale as offering both high return growth and high appeal.

"Office and city centre residential offer the best risk adjusted returns," CEG's Andy Woods said. "We really like the city centre residential rental market because if you look at where the UK is compared to European countries, there is such an issue with getting on the housing ladder and affordability."

BEST RISK-ADJUSTED RETURN



> Residential is the most appealing asset class as returns are remaining very steady and the outlook is very positive. Rents are going up due to lack of supply and wage inflation.

Gary Sacks, Chairman and CEO of City & Docklands Group

11. www.statista.com/statistics/323657/uk-wide-prime-property-rental-price-growth/
12. www.telegraph.co.uk/money/property/house-prices/house-prices-close-new-record-high-may-not-last-long/

Conclusion

Our latest Future Property report presents a compelling case for UK real estate, with a clear shift in sentiment from resilience against a volatile environment to one poised for activity. Although challenges remain, the supply/demand dynamics in many sectors (most noticeably residential), as well as the UK's enduring appeal, the improving economic backdrop and scale of asset repricing, are providing opportunities.

The strength of respondents' interest in repositioning assets highlights the need for value-add strategies. Following a period of near stagnant development, the office sector is back on the radar of investors and developers, but the focus is limited to prime assets; a glut of secondary and tertiary office spaces sits unlet. For an entrepreneurial investor, these assets are set to provide a rare value play to repurpose properties into assets today's societies need.

While respondents' views on the current investment landscape are more positive now than in 2022, they also demonstrate a belief that the outlook will improve further. There is still significant change to come in the UK. A general election looms and views on how far interest rates could fall will impact both developers' and investors' decisions.

This report does, however, display a brighter outlook that cannot be ignored. If respondents are to be believed, the next 12-24 months will bring a higher level of activity and improved returns across all sectors.

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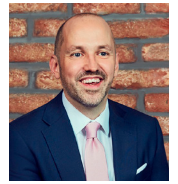

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