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Real Estate of Mind: Key UK/US Real Estate Insights for GCC Investors in 2023

Following our inaugural Real Estate of Mind round up (see here) of trends in the sector earlier this year, as 2022 draws to a close, we have set off on the road once again to connect with clients and friends alike in Bahrain, Kuwait, the UAE and Saudi Arabia to see what 2023 holds for the GCC investors investing into the international markets.

The article will focus primarily on the UK, with a section on the US as we are excited to have had our US partners on the road with us this time around.

Thanks to our clients and friends for their thoughts and invaluable insights. We would welcome further feedback.

So here it goes our second Real Estate of Mind round-up...

INSIGHT 1: STILL IDENTIFYING ASSETS

In the last round-up, we highlighted the interest in assets such as logistics, industrial, student housing and commercial offices. Appetite remains high in these sectors but we have seen a new area of focus emerge for the GCC investors - the "build-to-rent" sector. These assets are purpose-built rental communities, designed from the outset for the rental sector, providing security of tenure for the tenants as well as professional management services.

The build-to-rent sector (known as “multi-family” in the US) is a well-established investment sector for GCC investors investing into the US. Conversely, historically in the UK ownership of property has been key. As the cliché goes, an Englishman’s home is his castle. However, as property is becoming even more expensive to purchase and, as interest rates creep up, the concept of ownership is becoming more out of reach for most people and this attitude is having to change. Forget castles; rented housing is the only available option for many. There is also a shift in the British mindset in terms of flexibility - whether it is not wanting to be tied down to a particular job or a location or to a particular life-style. The combination of such factors has paved the way for a substantial rental market and the growth of the build-to-rent sector.

The build-to-rent sector is not a new asset class for the UK market, but it is definitely an asset class of growing interest to our GCC clients and friends.

INSIGHT 2: CASH IS KING

Following the introduction of actual and proposed tax cuts earlier in September, we saw the British pound fall and hit its lowest level against the US dollar in over 40 years. Although this has affected international investor confidence to an extent, there is no doubt assets are now much cheaper if buying in US dollars (or currencies pegged to US dollars). Hence, there are opportunities for those with cash who can benefit from the dollar pound exchange rate.

The exchange rate has cheapened UK property a great deal, and those sitting on cash are looking for opportunist acquisitions without obtaining bank financing (primarily because such financing costs are currently very high, currently sitting at 6-7% all in rate for a 5 year fixed term). Those investors will then look to refinance as and when the finance market in the UK stabilises.

INSIGHT 3: THE PRICE IS RIGHT, AFTER ADJUSTMENTS

Over the past months the general consensus has been that the UK property prices cannot continue to rise at the current levels. There is a belief that inflation, an increase in financing costs and the prospect of a recession will bring property prices down. We have heard estimates that such a reduction in price is likely to be between 10-20%. Although this is yet to translate into actual deals, the market is currently seeing a 5-10% reduction in prices.

INSIGHT 4: SUSTAINABILITY

Logistics continue to be a favoured sector, however the supply demand issue means that the requisite GCC investor yields are not achievable. We discussed last time development of such logistic assets. This time we heard about retro-fitting existing logistics assets to firstly comply with the new UK regulations and secondly to add capital value on the exit with respect to such assets. This is particularly of interest if the capex required to update the relevant asset is minimal and thus does not impact overall yields.

GCC investors are aware and focused on the impending UK regulations and the real need to comply with those in the very near future. This is very much in line with the popular data often being quoted that "*80% of the buildings that will be around in 2050 have already been built today*".

INSIGHT 5: DEBT FUNDS

As identified last time, establishing debt funds to provide both senior (mainly in the UK) and mezzanine (mainly in the US) debt to borrowers of real estate continues to be viewed as a real alternative to direct investments into real estate. The significance of obtaining legal and tax advice to navigate the legal, regulatory and tax framework cannot be stressed enough here.

INSIGHT 6: THE US

Finally, a few observations made by our US colleagues noting that the majority of GCC investments continue to go into the US real estate market (in terms of numbers and actual transaction volumes).

Inflation has spurred the Federal Reserve into action, which has dramatically increased interest rates in 2022. The size and speed of the increases have created price dislocation in the real estate market and increased the cost of borrowing. As a result, some investors are considering alternative strategies in the short to intermediate term.

There has been a significant slowdown in transaction volume, both as a result of pricing uncertainty and changes in the capital markets. Because mortgage debt has become more expensive, buyers' underwriting does not support previous valuations based upon static income and cap rates, and as a result, buyers are willing to pay less for the same assets. We are seeing pricing come down for certain properties and deals getting re-traded on price, particularly where the due diligence period has not expired.

In addition, the rise in interest rates has put pressure on property owners where they have an upcoming debt maturity. These owners are looking at refinancing with often substantially worse terms than the current debt facility. For some property owners, rising interest rates are having a negative effect on debt covenants and interest payments for floating rate loans without hedges. Those properties are at risk of being over-leveraged and underwater.

Another chilling effect on transaction volume is that lender underwriting standards have tightened, and there are fewer lenders in the market than during the first part of the year. This is a double-whammy for the real estate purchaser or owner, as the available financing is not only more expensive but also tougher to find.

Depending on how interest rates affect liquidity in the US market, there may be buying opportunities for well-positioned investors.

The Committee on Foreign Investment in the United States (**CFIUS**) has broad authority to review transactions involving non-US investors into US businesses and assets, including real estate. Notably, in February 2020, CFIUS implemented final regulations of the Foreign Investment Risk Review Modernisation Act of 2018 (**FIRRMA**), which expressly authorises it to review controlling and non-controlling foreign investment in real property. Prior to the adoption of FIRRMA, CFIUS could only review an acquisition of real estate if it was part of a transaction that could result in control by a foreign investor of a US business. CFIUS jurisdiction continues to be expanded and clarified, most recently through an Executive Order issued on September 15, 2022 by President Joe Biden. The bottom line is that CFIUS exercises substantial authority to define and act on national security risks as it determines necessary or appropriate. In connection with investing into the US, CFIUS counsel should be consulted to understand the latest applicable rules and regulations.

FINAL WORD:

In times of distress it is our experience the likelihood of disagreements between parties increases, for example between borrowers and lenders and between owners and asset managers. When a business faces distress, every cent is important, and parties will be looking at all means to save money and increase revenue. Those contracts that were negotiated in the good times and put in the bottom draw are now going to see the light of day. Many precedent setting court cases have arisen from a financial crisis and we are expecting an up-tick in court cases and disputes generally as we move through this current economic cycle.

And finally, with the recent appointment of Rushi Sunak as the UK prime minister all eyes will be on the fiscal plan due on 31 October. Sunak's first and arguably most significant job will be to reassure the markets that Britain has a credible economic plan.

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