UK Cities DNA

The New Case for UK Commercial Real Estate

September 2024

The second of twelve insight papers in our UK Cities DNA initiative – putting real estate supply and demand in the context of the economic direction of travel.

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A relatively resilient market amid global uncertainty

- The UK frequently ranks first or second as a destination for cross-border real estate investment.
- The UK's ongoing magnetism of liquidity is being driven as much through new and emerging factors as it is traditional strengths and selling points.
- New factors include exposure and commitment to growth sectors (e.g. technology, life sciences and green energy) and a pipeline of structural reform, infrastructure development and productivity improvement...
- ...underscored by more established fundamentals, such as a solid legal framework, the English language, a beneficial time zone, favourable lease structures and a competitive tax regime.

As global economic, financial and real estate landscapes continue to strive to break free from the shackles of a global pandemic, geopolitical-driven elevated inflation, interest rates at a level unseen by a whole generation of decision makers and a slew of other structural shifts, investors are increasingly refocusing their attention on global real estate gateways, with the UK emerging as a prime destination.

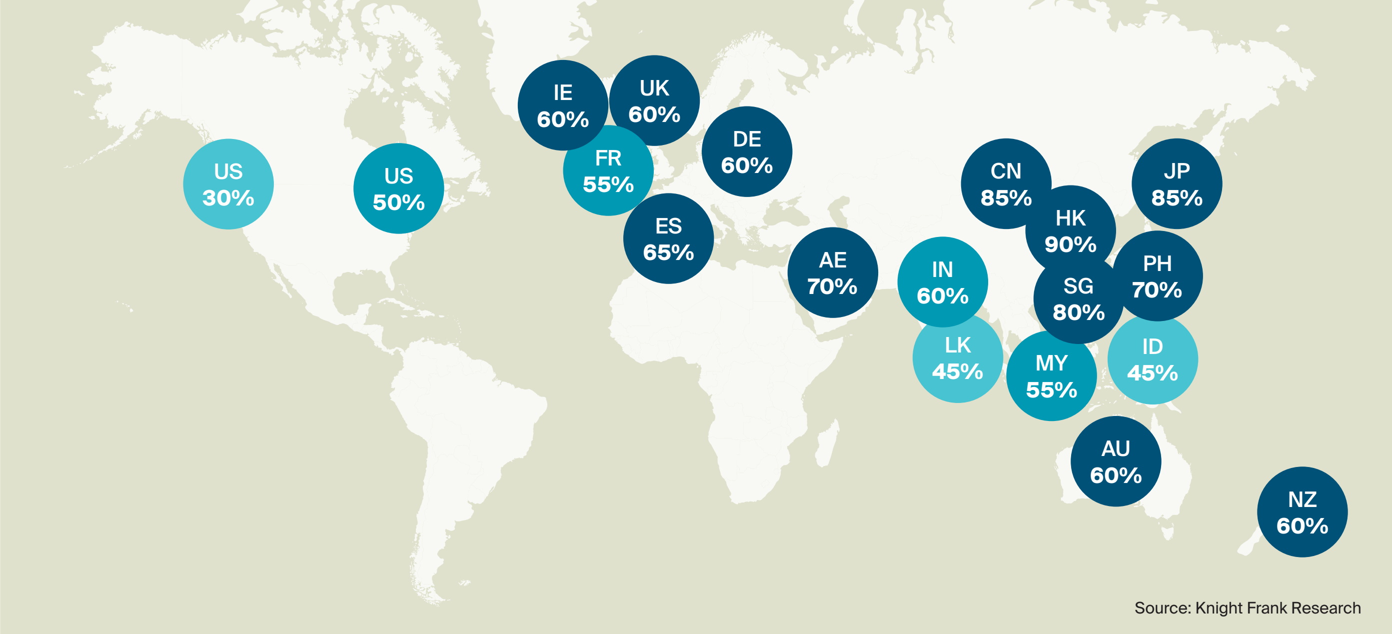
Whether driven by private equity looking for opportunities, global institutions drawing on local office expertise or supported by family or lifestyle connections for high-net-worth individuals, the UK is continuing to attract the capital that is out there, catering to a range of objectives, from global diversification or wealth preservation, to exploiting cyclical opportunities.

To illustrate, at the time of writing, the UK stands as the number one global destination for inbound capital. Except for a brief third place ranking after the US and Germany in 2018 / 2019 (amid pre-Brexit uncertainty), over the last decade, the UK has consistently ranked first or second as a destination for cross-border real estate investment. This magnetism of liquidity is not confined to London alone; over recent years, an average of 55% of inbound capital has flowed into regional markets, compared to an average of 38% in the pre-pandemic years.

BUSINESS AS USUAL?

It is important to acknowledge that the UK is not experiencing 'normal' levels of investment. The UK has been impacted by the significant retrenchment in activity globally, particularly driven by US investors affected by a dislocated home lending market and domestic office market

Fig 1: Global office attendance

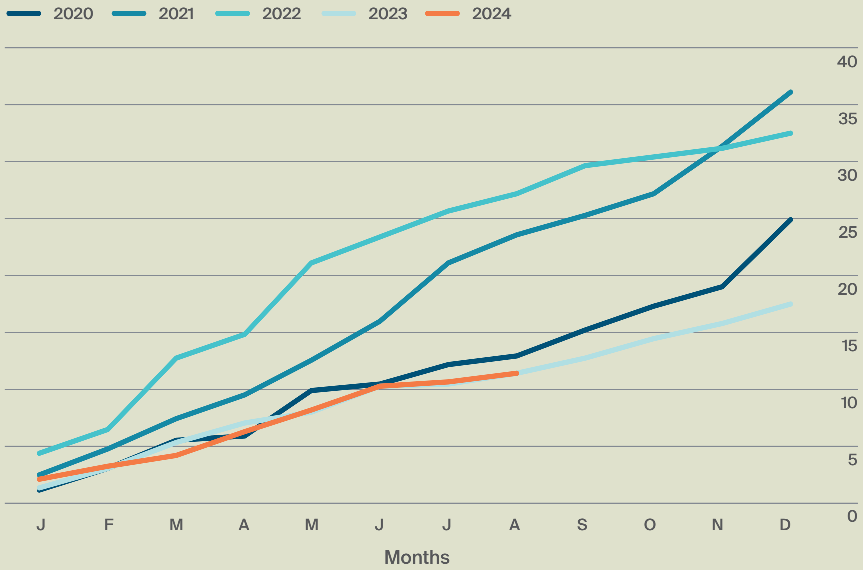


Source: Knight Frank Research

> “This magnetism of liquidity is not confined to London alone; over recent years, an average of 55% of inbound capital has flowed into regional markets, compared to just to an average of 38% in the pre-pandemic years.”

Fig 2: Inbound UK volumes are showing relative resilience

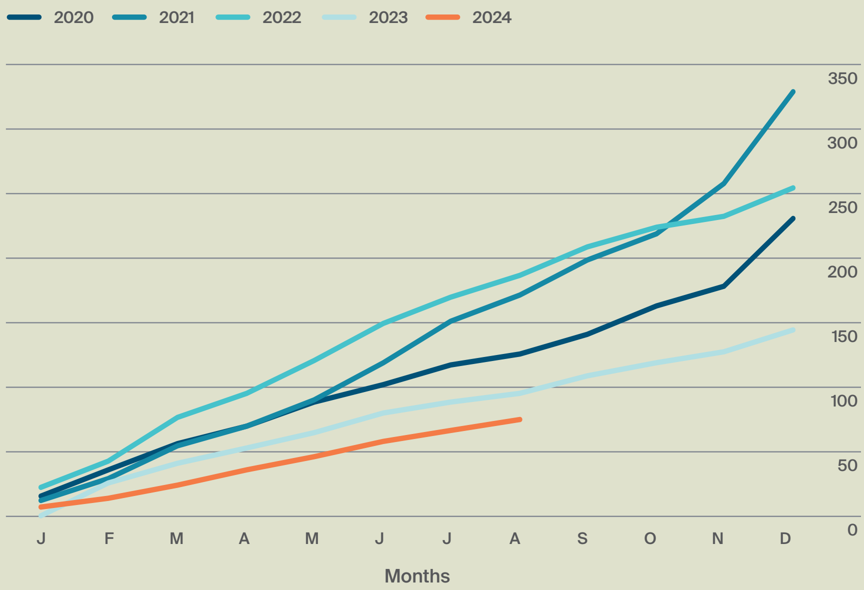
UK cumulative cross-border real estate investment volumes (£bn)



Source: Knight Frank Research, MSCI RCA

Fig 3: YTD global cross-border real estate investment activity remains below recent years

Cumulative cross-border real estate investment volumes ($bn)



Source: Knight Frank Research, MSCI RCA

woes, which some US investors are (incorrectly) assuming must be happening everywhere. To illustrate the recovery in activity we are seeing in the UK, in London Transport for London Journeys are back at pre-pandemic levels.

This drop off in investment by the US, the largest global contributor to global real estate activity, has meant that inbound UK real estate investment activity is largely on par with last year’s over the year to date 2024. Nonetheless, in a year where global volumes are at record lows, the UK is capturing a notable share of the activity that does occur, illustrating its relative resilience. This pattern is the same whether looking at all UK inbound investment or the UK regions excluding London.

THE UK’S “SELLING POINTS”

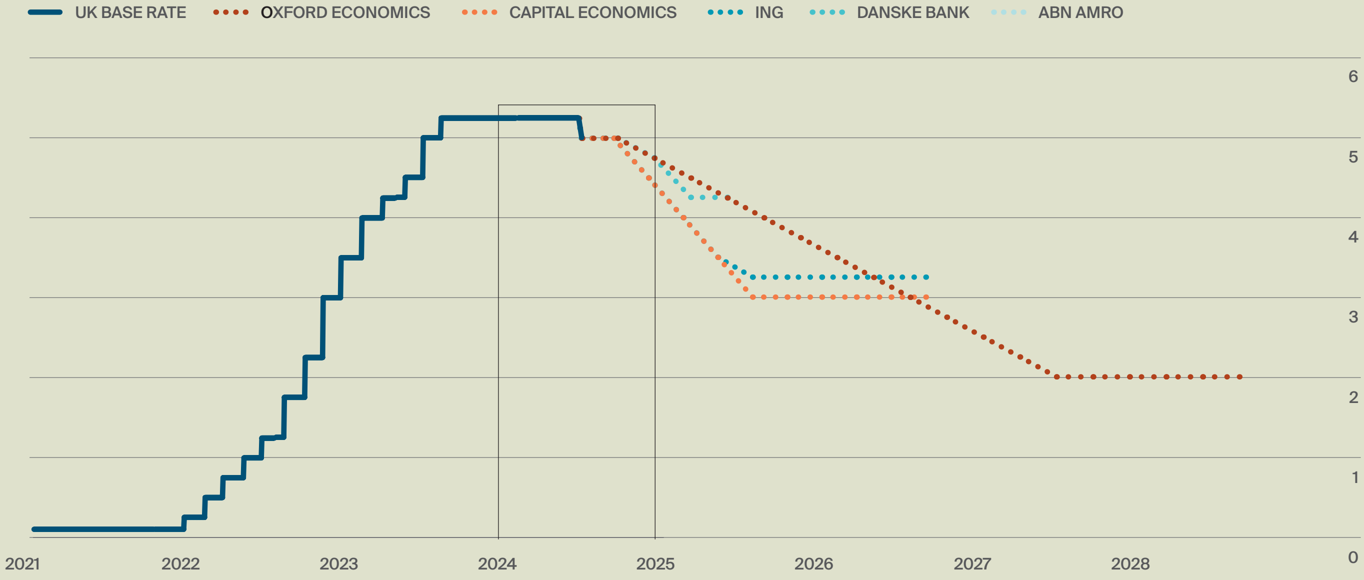
So why do investors continue to look to the UK? What makes UK commercial real estate an appealing proposition? Several factors contribute to this enduring interest, ranging from the country’s strategic advantages to its robust market fundamentals.

The UK’s historic place as destination for overseas investment, attracting a significant share of global and regional corporate headquarters has been supported by the country capitalising on its strategic advantages. These include its legal framework, the English language, and its time zone, which bridges the gap between the Americas and Asia. These factors, along with favourable lease structures and a competitive tax regime, have all contributed to the UK being a hub for international capital, enterprise, and talent.

The lease structures in particular offer several potential advantages to investors, particularly in terms of income security and growth potential. In a standard UK lease with upward-only rent reviews, the initial income set at the start of the lease remains certain, with only the uplifts expected at each rent review uncertain – but capped to the downside at the existing rent, assuming no tenant break options are exercised or default.

Fig 4: The UK's interest rate policy has turned a corner

UK base rate outlooks (%)



Source: Knight Frank Research, Bloomberg, Capital Economics, ING, Macrobond, Oxford Economics, Danske Bank, ABN Amro

Additionally, triple net leases, where tenants cover maintenance, insurance, and taxes, are common in the UK. More generally, tenants are legally obliged to pay rent, whereas companies can choose if they pay a dividend, an advantage of direct real estate.

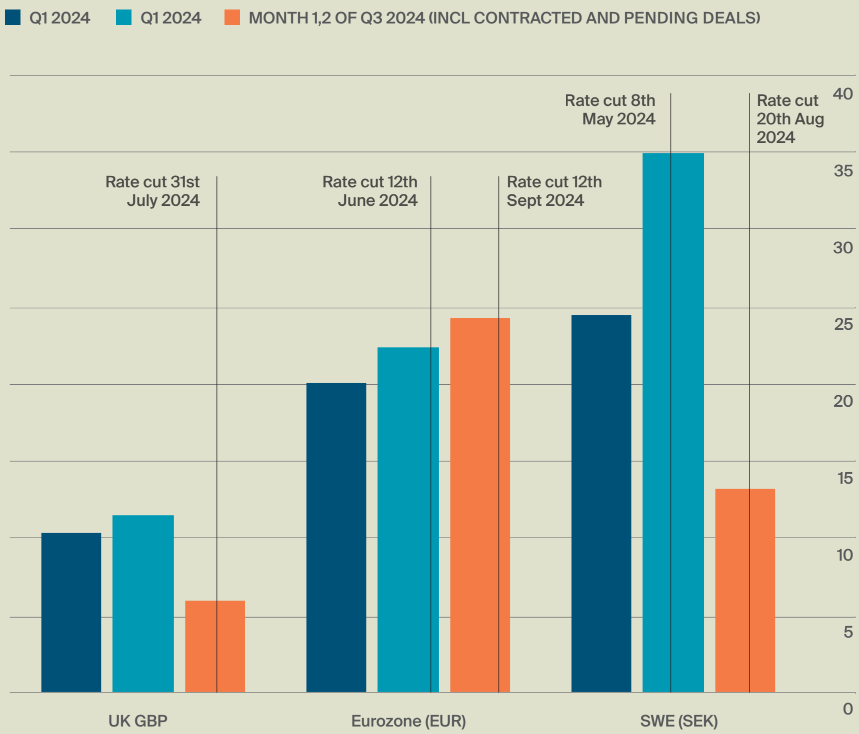
With the recent election of a Labour government demonstrating a relative stability dividend across financial markets and the Bank of England having implemented their first rate cut, we have additional tailwinds which are set to support UK commercial real estate, whether investors are looking for wealth preservation and a store of value, diversification, or cyclical and other strategic opportunities.

The actualisation of the interest rate cut does appear to have led to increased momentum of Q3 contracted and pending deals in the Eurozone and Sweden, where the central banks previously cut rates, suggesting this will also act as a tailwind to the UK real estate investment outlook.

Based on the above, we do expect to see an increase in UK real estate activity over the year ahead, even if this isn't currently expected to be 'v' shaped, with our Knight Frank Active Capital forecasts[1] suggesting inbound real estate activity will accelerate over 2024, if not yet back to 2022 levels.

Fig 5: There are signs of increasing transaction activity in markets with rate cuts

Quarterly all property investment volumes, including quarter 3 to date contracted and pending deals (bn)



Sweden's early rate cut supported a 44% increase in volumes QoQ in Q2, while the ECB's end of quarter rate cut has been followed by Q3 to date completed, contracted and pending deals already above the full Q2's level of activity. The Bank of England cut was one month into Q3.

Source: Knight Frank Research, MSCI RCA

[1] https://www.knightfrank.com/active-capital

THE NEED FOR A MORE DETAILED NARRATIVE

In order to find comfort in this recovery and assess the continued resilience of UK real estate, while the 'old guard' drivers of the UK commercial real estate market remain as relevant as ever, it is important to assess what else underpins the future success, particularly as newer sectors, from data centres to the residential sectors to life sciences and beyond develop and as traditional sectors continue to evolve.

The UK is currently well-positioned to benefit from growth in several dynamic sectors, such as technology, life sciences, and green energy. These sectors are not only expanding but also driving demand for specialised real estate, from office spaces tailored for tech companies to laboratories and manufacturing facilities for life sciences.

Additionally, the new UK government's stated focus on infrastructure development and productivity improvements creates opportunities for investors in commercial real estate. The noted importance of data centres and desire to ease planning to build these, as well as the push for green finance are examples of initiatives set out in the Labour manifesto that have direct and indirect implications for the CRE market.

UK COMMERCIAL REAL ESTATE AS AN OPPORTUNITY FOR SUSTAINABILITY GOALS

Sustainability has become a critical factor in real estate investment decisions. The UK is a leader in green building standards; the first building assessment was undertaken by Watford-based Building Research Establishment in 1990, which has since morphed into BREEAM, one of the most recognised international certifications. This is illustrated by the UK having more than 15,000 BREEAM New Construction certified projects, over 70% of which are outside of London. Even so, with the majority of building stock 'brown' there presents opportunities for these buildings, where they have good bones and a good location, to be refurbished to a green standard, as set out in our *Knight Frank Sustainability Series*.

Furthermore, the new UK government's manifesto pledge to support positioning the UK as the global centre for green finance, should further support decarbonisation. Already, bank lenders use sustainability as a screener for loans and the continued integration of sustainability into finance and investment strategies is likely to further drive demand for properties that meet high environmental standards, creating opportunities for developers and investors who can deliver on these requirements.

> "The lease structures in particular offer several potential advantages to investors, particularly in terms of income security and growth potential."

THE UK FINANCING ARENA: A DIVERSIFIED LANDSCAPE

More generally, the UK's financing landscape is one of the most diversified in the world, with a strong presence of both bank and non-bank lenders, the latter emerging following the Global Financial Crisis. This diversity provides at least a part solution to the funding gap, in a way that isn't present in other countries with bank-led real estate lending.

> "We have additional tailwinds which are set to support UK commercial real estate, whether investors are looking for wealth preservation and a store of value, diversification, or cyclical and other strategic opportunities."

While we are likely seeing a peak in loan maturities this year (see below for an example of the London office market related loan maturities), relatively low proportions of non-performing loans and real estate exposure on banks' books means that we haven't seen the levels of distress in the loan market that many were expecting.

Fig 6: Peak of loan maturities in 2024

London office loan maturities by year

Source: Knight Frank Research

> "Although swap rates in the UK remain higher than the Eurozone, the waning of rates are supportive of making debt relatively more accretive, unlocking additional activity within the UK, by the many investors who are reliant on debt financing.

Moreover, we are starting to see swap rates moderating. While swap rates remain significantly higher than they were in 2019 (relevant assuming a typical 5-year loan term), this gap is starting to wash through. Average rates in 2020 were 0.11%, but reduced investment activity in 2020 compared to 2019, plus the fact that some debt will have been refinanced early, means likely less debt with pressured interest cover ratios as we move into 2025.

Swap rates are also becoming relatively more accretive. 5-year Sonia (UK) swap rates have adjusted downwards over the last year (-98bps) to a greater degree than SOFR's 75 bps adjustment (US) or Euribor's 81bps adjustment (Eurozone) over the same period and the trend overall is downwards, even if not at a rapid pace. Therefore, although swap rates in the UK remain higher than the Eurozone, the waning of rates are supportive of making debt relatively more accretive, unlocking additional activity within the UK, by the many investors who are reliant on debt financing.

CYCLICAL INDICATORS

The UK's reflationary slowdown in activity is further through than in many other markets, indicating it is further ahead in terms of the cycle trough.

Looking at capital values there are indications that, supported by strong occupier markets, capital values are starting to stabilise and in some cases, such as some prime

Table 1: 5-year Sonia swap rates have moderated by ~ 100bps YoY in the UK

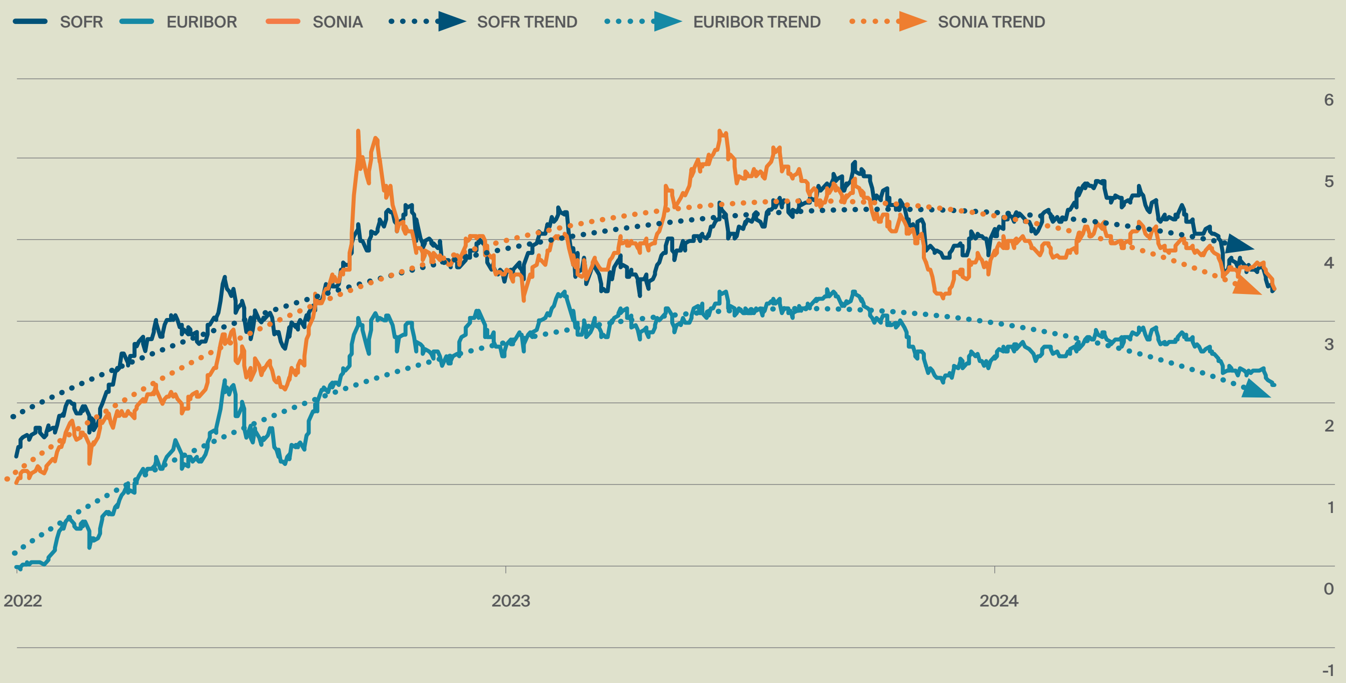
5-year swap rates (%)

	2019 average 5 year swap %	2020 average 5 year swap %	Current 5 year swap rate %*	Current swap rate change to one year ago (bps)*
GERMANY	-0.24%	-0.43%	2.24%	-81
UK	0.69%	0.11%	3.42%	-98
US	1.94%	0.58%	3.12%	-75

*Extracted 15/9/2024 Source: Knight Frank Research

Fig 7: Policy divergence reflected in swap rates

5-year swap rates (%)



Source: Knight Frank Research, Macrobond

"The UK commercial real estate sector offers a window of opportunity for investors at the moment where we are seeing increasing economic and financial tailwinds amid an investment landscape of relatively thinner competition."

London offices, even increase. At the UK level, retail warehouses, shopping centres, logistics and residential are four examples of sectors with positive capital value growth over the three months to June 2024, according to MSCI.

The re-emergence of private equity into the UK CRE market is also an early sign of recovery. The UK has been the largest recipient of cross-border Private Equity investment over the year to date by some margin ($5.3bn into UK real estate, vs $1.5bn into Japan, the second largest recipient of PE investment). More than half of this investment has been into the regions outside London, across predominantly the hotels and residential sectors, followed by office, logistics and retail. This matters because while private capital more broadly is usually first to the market following a slowdown, being typically less encumbered by debt requirements and investment committees, private equity investors specifically, are also nimble and highly informed early movers into recovering and new markets, poised to take advantage of first mover opportunities. They therefore act as a leading indicator of where other investors are likely to follow.

Indications are that the UK commercial real estate sector offers a window of opportunity for investors at the moment where we are seeing increasing economic and financial tailwinds amid an investment landscape of relatively thinner competition.

GROWTH SECTORS AND EMERGING MARKETS

The UK is well-positioned to capture demand in more emerging real estate markets such as the residential sector and data centres.

The UK is the second-largest cross-border market globally for residential real estate investment, trailing only the US. The market offers a variety of investment opportunities, from co-living spaces, Purpose Built Student Accommodation (PBSA) and build-to-rent (BTR) developments to traditional residential properties. Given the growing proportion of investors seeking to access the residential sector, this remains a key area of focus.

This relative attractiveness is also not new. Over the last decade the UK has consistently ranked among the top destinations for inbound residential investment and in 2022 actually outperformed the US as the top destination for cross-border capital flows. With a majority of global investors looking to target this sector, according to our Active Capital research, the UK, with its nascent yet growing residential sector, is well placed to absorb some of this demand. The new government's focus on streamlining the planning process and promoting the construction of new homes is likely to support an increase the supply of residential properties, creating opportunities for investors and developers.

Moreover, the emphasis on sustainability in planning and development is expected to drive

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In addition, the UK government's focus on expanding data centres presents another opportunity for investors. As the demand for data and digital infrastructure grows, the need for specialised real estate, such as data centres, will increase. The government's support for this sector, coupled with the UK's strategic location and robust digital infrastructure, makes it an attractive market for investment. Our research has shown that the UK is already a European leader when it comes to data centre capacity, both in relation to what is already in existence, as well as in the pipeline for future development.

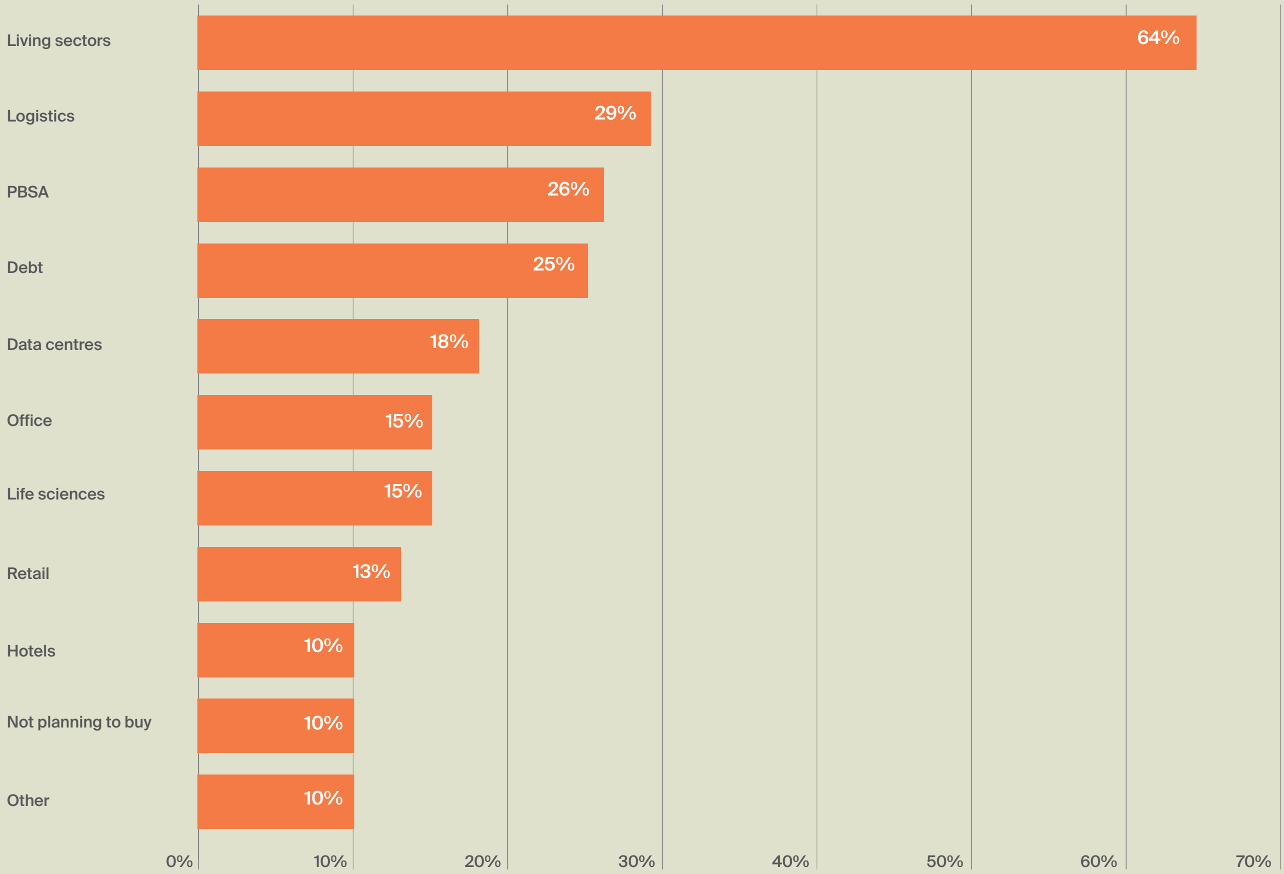
Fig 9 illustrates a number of drivers which make UK real estate compelling – but we mustn't forget the classic stalwarts that contribute to the UK continuing as a gateway investment destination for commercial real estate:

A GLOBAL LANGUAGE AND STRATEGIC TIME ZONE

English remains, at least for now, a global language of business. This linguistic advantage simplifies communication and negotiations, making it easier for international investors to navigate the UK market.

Fig 9: Living sectors a key target for investors

Active Capital live webinar poll results: which top 3 global sectors are you targeting over the next 18 months?



% shows the proportion of respondents that are targeting the given sector

Source: Knight Frank Research

Additionally, the UK's geographic position offers a unique time zone advantage, sitting conveniently between the East and West. This makes it a natural location for global operations, supporting occupier markets across a wide range of sectors.

STRONG PROPERTY RIGHTS, TRANSPARENCY AND LEGAL FRAMEWORK

The UK boasts a well-established legal system that provides strong protection for property rights and offers high levels of governance. This legal environment enhances the transparency and security of property transactions, making the UK one of the most attractive real estate markets globally. The direct property market in the UK is also one of the most transparent in the world, with comprehensive data available to support informed decision-making.

EASE OF ACCESS AND CONNECTIVITY

The UK is making it increasingly easy for international investors to visit and engage with the market. London Heathrow, just one of several London airports, was the most connected airport globally last year, with more than 57,000 international connections, according to OAG. Additionally, fast E-gates are available to entrants from almost 40 countries, facilitating smooth and efficient travel.

Being able to physically visit and assess properties is particularly important for an asset like direct real estate, which is tangible and often requires on-the-ground evaluation. This is especially true for investors whose decision-making processes are centralised outside of local offices.

INNOVATION-LED CITIES AND WORLD-CLASS UNIVERSITIES

The UK's innovation ecosystem is another key draw for investors, particularly in cities that are leading the charge in technological advancements. The country is home to some of the world's top universities, which serve as hubs for research and development, attracting talent and fostering innovation. Cities like London, Cambridge, and Oxford, part of the so-called "Golden Triangle," are at the forefront of this trend, offering opportunities for investors in sectors such as life sciences, technology, and advanced manufacturing, supported by enhanced infrastructure, including a third railway station for Cambridge which is planned to connect back up to Oxford.

As part of our Active Capital research, we identified almost twenty above average Innovation-Led Cities across the UK. This analysis was based on over 150 thousand data points across 288 global cities and used innovation inputs ranging from the ability of universities to work with local industry to generate spillover effects (UN Sustainable Goal 9 Benchmarking), to the degree of grassroots groups related to setting up new businesses or interests in technology and strength of university research. We did this recognising that innovation is key for commercial real estate. Innovation is a long-term driver of resilient economic growth and helps drive wealth and attract and retain the talent that is needed to support well-functioning real estate, whether retail, office, residential or otherwise.

A RESILIENT CASE FOR UK COMMERCIAL REAL ESTATE

Bringing this together, the UK offers a relatively resilient environment for investment, supported by a diversified economy, robust legal framework, and a transparent and business-friendly environment. The country's growth sectors, combined with a pipeline of structural reforms, present opportunities for investors and developers alike.

While the traditional attractions of the UK – such as the rule of law, language, and time zone – remain relevant, it is the new developments in technology, sustainability, green finance, and regional growth that are shaping the future of the UK CRE market. Investors who recognise these trends and position themselves accordingly will be well-placed.

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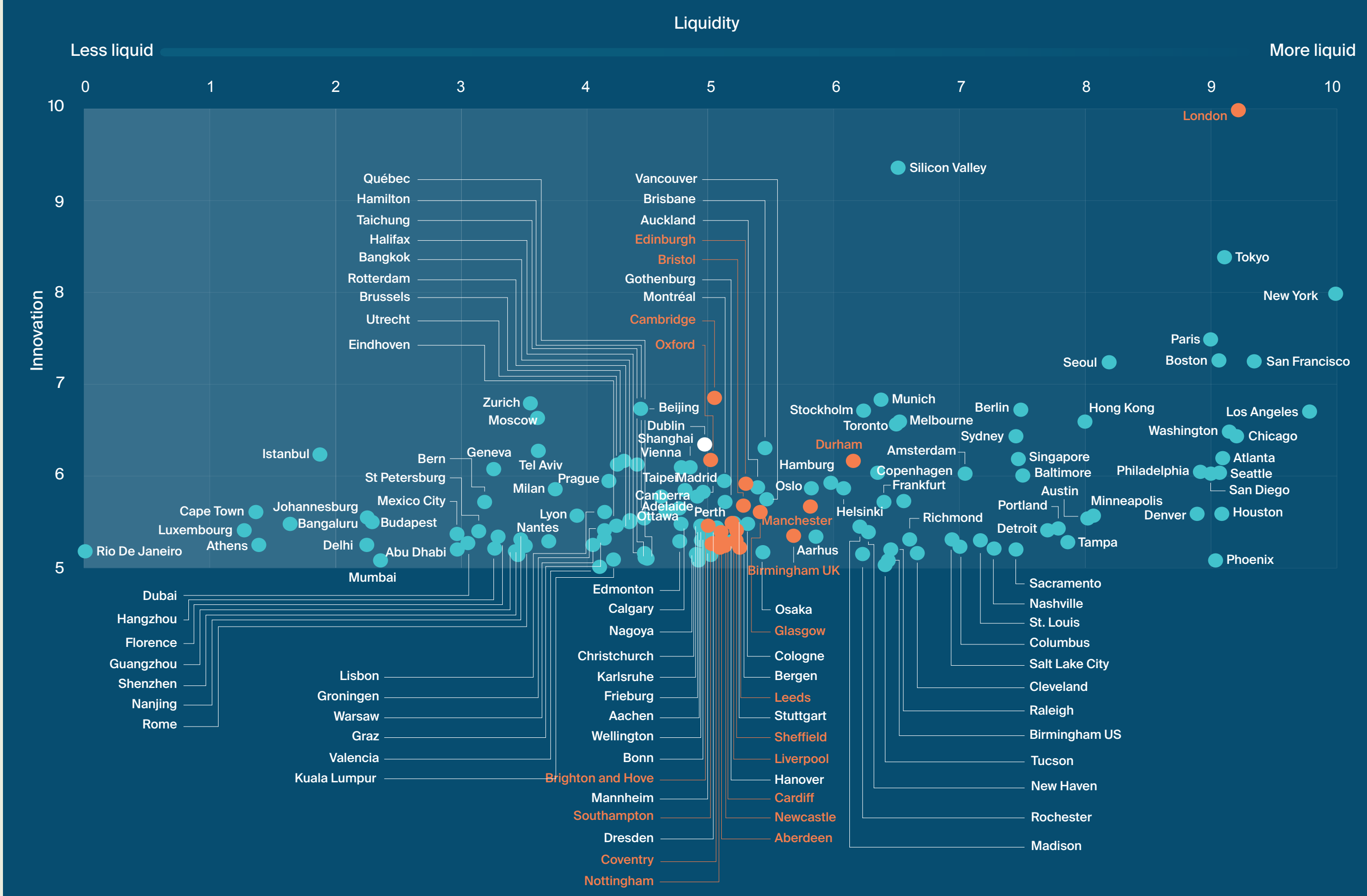
Fig 10: innovation led cities



Source: Knight Frank Research

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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