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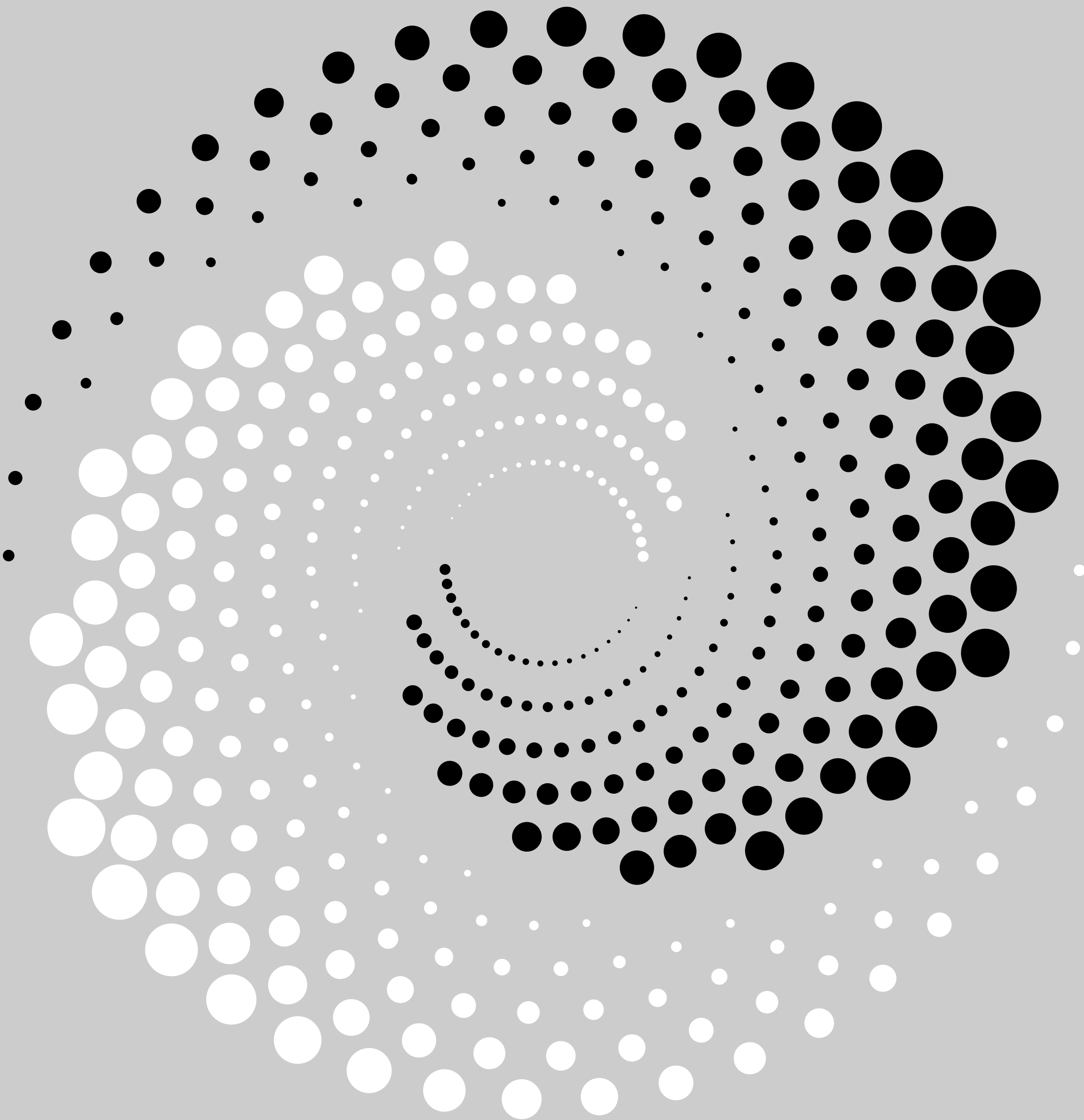

UK roundtable 2020

ROUNDTABLE

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Compromise is the key for private real estate amid the covid-19 pandemic

Three UK managers and a lawyer agree reaching accords with tenants and lenders alike will be critical as the coronavirus crisis ravages property markets. By Stuart Watson

As the participants met by videoconference for *PERE*'s UK roundtable, the country was beginning to regain its balance after the initial vertiginous jolt caused by the onset of covid-19.

More than 37,000 deaths testified to the human cost of the pandemic, however, and the economic impact of the eight-weeks-and-counting lockdown was becoming apparent. In the first week of May, the Bank of England pegged interest rates at their record low of 0.1 percent, issuing warnings that GDP could shrink by 25 percent in the second quarter and by 14 percent over the course of 2020. First quarter GDP was down 2 percent, dragged down by March's GDP of -5.8 percent.

The economy remains on state-sponsored life support, with official figures showing that 23 percent of the workforce has been temporarily laid off under the furlough scheme. The four real estate professionals taking part agree this necessary intervention masks the underlying damage. Frank RoccoGrande, co-founder of London based manager Deutsche Finance International calls this a period of "purgatory" during which the shape of the future recovery, and the severity of the pain that investors, occupiers and financiers must suffer, is obscured. It is also an ideal time for contemplation, however: for surveying the havoc wrought so far and for looking tentatively forward to the investment opportunities that may ultimately emerge.

Operational friction

The manner in which the UK real estate industry has managed to carry on its business, despite the enormous challenge presented by social distancing has come as a pleasant surprise to the participants. "Operationally, this has been way smoother than any of us could have expected," says Alex Price, UK chief executive of Canadian manager Fiera Real Estate. "Even five years ago, we would have struggled, but fortunately, in the meantime, technology has moved on."

Most everyday operations at the participants' firms have been digitized already, making the transition to remote working smoother than it might have been otherwise. The remaining operational friction points have been leftover old-fashioned practices, such as posting legal notices, the need to sign documents and getting tax ID numbers from shuttered municipal authorities.

Embarking on new business remains challenging, though. "Fundraising is definitely more difficult for a physical asset class like real estate. Investors want to walk the streets around the building and see what it looks like,"

Steven Cowins

Partner, Greenberg Traurig

Cowins is a partner at international law Firm Greenberg Traurig, part of a more than 400-strong global team focused on the real estate sector. Based in London, he leads the UK private equity real estate team advising clients on establishing funds and joint ventures, and M&A in real estate.

Alex Price

UK chief executive, Fiera Real Estate

Price leads the UK arm of Fiera Real Estate, formerly Palmer Capital, which was bought by Canadian manager Fiera Capital in 2019. The UK business manages around £1 billion ($1.2 billion; €1.13 billion) of third-party capital, investing solely in the UK. As well as being a private equity investor, the firm is also a part owner in 10 UK regional development companies.

Frank RoccoGrande

Founding partner, Deutsche Finance International

RoccoGrande co-founded London-headquartered DFI with Gavin Neilan in 2016. The firm manages around €2.5 billion of assets in the UK and Europe, and is the direct real estate investment arm of Deutsche Finance Group, a Munich-based global investment manager which manages some €6.5 billion of capital overall.

Colin Throssell

Head of Europe, Nuveen Real Estate

Throssell is responsible for leading the 300-strong European team of Nuveen Real Estate, which manages real estate assets on behalf of third-party capital as well as its parent company, TIAA. Nuveen has around $133 billion of real estate globally, including $31 billion in Europe, around half of which was located in the UK at the end of 2019.

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> **FRANK ROCCOGRANDE**
> **Deutsche Finance International**

says Colin Throssell, head of Europe at London-based manager Nuveen Real Estate. Price adds: "Buying and selling buildings is tough because you can't carry out a survey. But buying land is somewhat easier."

Investors have been innovating to try to keep fundraises and portfolio deals alive, observes Steven Cowins, a partner at law firm Greenberg Traurig. "We are already seeing workarounds through how deals are structured, such as deferred consideration, with some of the balance paid when more normalized market conditions return."

Technologies that support secure digital record-keeping and property transfer could draw increased industry attention, muses Throssell: "This crisis will force real estate to adopt technology more quickly. It will be a real shot in the arm for blockchain. We need to be savvy and repeatable in how we do business, rather than doing surveys and re-measuring every time we transact."

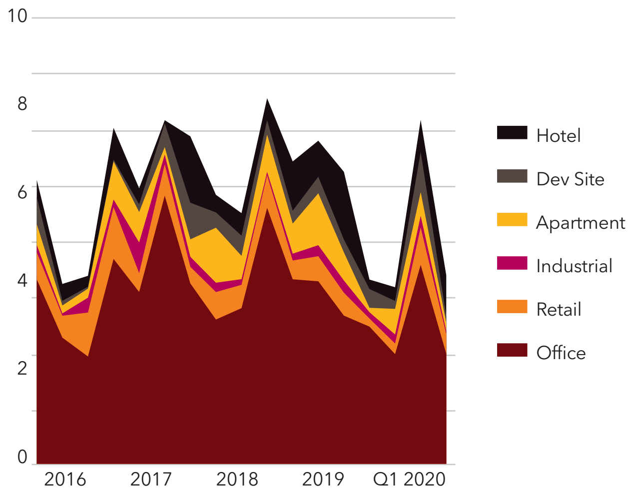
Burning red lights

One of the most tangible early effects of the pandemic on real estate has been tenants defaulting on rental payments. In a survey of UK managers, London-based management consultancy Remit Consulting found the proportion of quarterly rent collected when due on the March 25 "quarter day," or in the following 28 days thereafter, varied greatly by sector. While 80 percent of office occupiers, 79 percent of residential tenants and 72 percent of industrial businesses paid their rents, only 52 percent of retailers were able to meet their obligations.

"Once we come out of this, a lot of landlords and real estate investors will be under the microscope, being judged for how they behaved and reacted in this time, and we always have to be cognizant of that fact," says RoccoGrande. "We have to show empathy, understand the position of counter-parties and work to find a common solution."

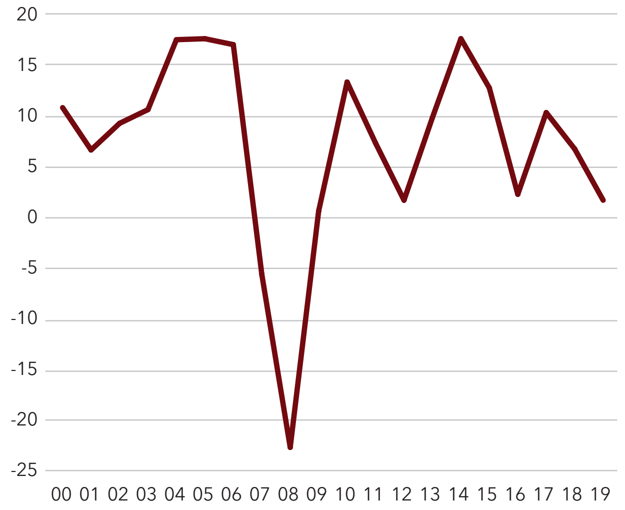
Each conversation with a tenant struggling to pay rent is unique because of the complex set of factors involved, says Throssell: "Managers want to do the right thing by tenants and protect the value of their property in the medium term. But they have to take into account government requirements, their

UK transaction volumes by sector: Deal activity had already begun to decline before the lockdown, with Q1 2020 recording the lowest first-quarter total in the past five years (£bn)



Source: Real Capital Analytics

UK annual total returns: All-property returns declined to 2.2% in 2019 (%)

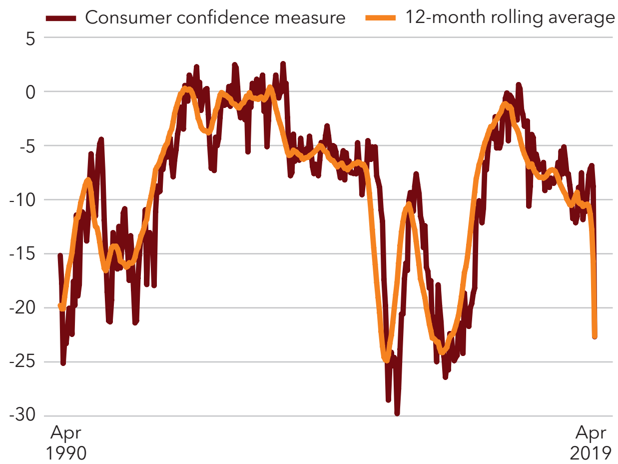


*Figures from December of each year
Source: MSCI UK Monthly Property Index

UK construction activity collapses: The IHS Markit/CIPS purchasing managers' index for UK construction dropped from 39.3 in March to 8.2 in April, the lowest level since the survey began in 1997

Source: IHS Markit/CIPS

UK consumer confidence: Level falls to lows not seen since the financial crisis



Source: Resolution Foundation analysis of European Commission

insurance contracts, their leases, and what their fund mandate allows them to do. Then you also have leverage. So what does your bank allow you to do without their permission?"

Most property owners are behaving responsibly, observes Cowins. "We are not seeing landlords giving complete rent forgiveness. But we are seeing a lot of deferred payments and also potential asset management opportunities where the landlord says, 'If you extend the lease, or re-gear the terms, then we will restructure the rent.'"

The lockdown did not begin until the end of March, and the participants agree that the current level of non-payment, particularly for operational assets and in hard-hit sectors such as retail, hotels and direct-let student accommodation, may be just a taste of what is to come. "It is going to get much worse," predicts Price. "We have already written letters to all our customers about their rent due in June to say, 'If you anticipate any problems paying, let's address this now.'"

The current absence of "burning red lights" in the office sector will not last, warns RoccoGrande. "That will only persist for so long without some sort of road map about how each market is getting out of the lockdown – maybe another month or two maximum – but beyond that you will start to see cracks there as well."

Liquidity first and foremost

Given the likely disruption to income returns, it is unsurprising that RoccoGrande's investors' principal concern is "liquidity first and foremost." He says: "Investors were very interested to understand how the portfolio was positioned – less about the medium-term, but about the short-term liquidity impacts. A lot of LPs were doing re-ups and they were used to getting regular distributions when making commitments. That has inverted and there are a lot of GPs coming out and making capital calls that weren't anticipated. That has drawn on liquidity."

There is relatively little that managers can do to alleviate the impact of this unique and global economic shock, says Throssell, which makes communication with capital providers more vital than ever. "You are not going to be able to outperform the market at an asset level to a large degree. So you have to make the difference by being a strong communicator and very honest about where the issues may be. Investors want to understand what their position might look like, but they are quite accepting that we cannot give them 100 percent clarity at the moment."

There is a much lower appetite for new acquisitions, suggests Price. "In the UK, we seem to have had a heart attack when it comes to transactional activity compared with some continental European markets. Most investors are not in the mind space to be talking about what they will be buying. Generally, they are still wanting to make sure they haven't got any problems coming down the tracks."

Nevertheless, fundraising activity is continuing, says Cowins. "We have had several fund closings since the crisis started, which shows that investors can still commit. But that is much easier for re-upping investors than new ones. We have also seen investors delaying their decisions or withdrawing from discussions, some because the denominator effect of what is happening in the equity markets is affecting their internal allocations to real estate. Existing asset portfolios are causing some concern, partly because it is hard to do due diligence, but also because there is uncertainty about what the real value of those assets is now."

The three managers agree that where just months ago investors wanted more seed assets in funds, now they value dry powder more highly. RoccoGrande comments: "For the first time, investors view a blind pool as a great thing because you won't have the perception of having bought assets at pre-covid values."

Alongside tenants, owners and managers, lenders have also shown themselves willing to compromise, says Throssell – up to a point. "We are finding banks very flexible, particularly on interest coverage ratio and loan-to-value type waivers, and they are looking through this period of severe disruption to the end of the year, although non-payment of interest is still a step too far. It does concern me, however, that when some of these loans have had two or three quarters of interest

Whatever happened to Brexit?

The burning issue at the turn of the year has quickly been subsumed by the pandemic

It was as recently as January 31 that the UK formally withdrew from the EU. However, covid-19 has relegated it to a side issue, at least as far as real estate managers are concerned. "It feels like the market had already digested Brexit before this current crisis, so it already felt like a relatively dead topic. If you look at the way London offices were performing pre-Covid-19, it didn't give you a portent of doom," says Throssell.

RoccoGrande expects the UK, and its capital city in particular, to continue to attract corporate occupiers and investment capital. "You will still have the rule of law, the connectivity, the infrastructure, and the school system. The UK is also in charge of its own monetary policy and does not have to argue and haggle with 26 other EU member states, so we have a high degree of conviction in London and the UK in general compared with other pan-European alternatives."

The Brexit saga and associated disruption may be far from over, however. The transition period under which existing trading arrangements continue to apply is due to expire at the end of the year. Under the withdrawal agreement, if the UK wishes to exercise its option to extend the transition period by one or two years it must inform the EU by June 30.

"The UK government is saying we are going to leave at the end of the year come what may. I think the strategy is to railroad the Europeans into giving us some sort of deal that gives us the best of the options available in trade, services and niche areas like fisheries," speculates Price. "Any sensible government would try to address these issues early on to create stability. But I suspect that given the other global issues that are going on the key open areas of negotiation will not be discussed, let alone agreed, before June, and it will come racing back onto the agenda towards the end of the year."

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waivers and start to become classified as non-performing, how long banks can afford to give forbearance to borrowers because of the effect on their own capital positions from a UK slotting regime perspective."

RoccoGrande adds that a distinction needs to be drawn between regulated lenders like banks and alternative debt finance providers: "There are a lot of debt funds active in the UK and they tend to come at it a bit differently because they have more flexibility."

Level of distress

As the debate moves into its later stages, the participants seek to identify the opportunities that inevitably follow any period of dislocation. Which asset types will provide the best and most defensive returns in the post-covid-19 world?

It is agreed the pandemic will bring to the fore some pre-existing themes. Logistics was perceived as being favored by structural factors only likely to intensify, while the decline of retail has accelerated. "Things already happening are being put into fast forward," says Cowins. "For residential that is a great opportunity and a big test. Industry bodies like the British Property Federation are trying to position private rented sector residential as one of the post-coronavirus drivers of the economy, much like house building was after the Second World War."

Fiera is continuing to buy residential sites, says Price, and to develop and invest in long-let new industrial and office assets, which he expects to perform well regardless. Throssell believes nascent alternative asset classes like medical office and data centers will receive a boost, while RoccoGrande predicts that increased support for life sciences will drive demand for laboratory offices in the UK.

He adds opportunities may be available within existing portfolios: "A lot of what we do is change of use, repositioning and redevelopment, so this is an opportunity to bring forward business plans and turn defense into offense."

Distressed buying opportunities

will inevitably emerge. "We have had a few people approach us on deals, but we haven't yet seen the level of distress that we expect eventually. I think that will come through more in the second half of the year," predicts Price.

He argues shopping centers may be among the first wave of distressed assets, providing opportunities for redevelopment as existing tenants become increasingly willing to surrender their leases, and local authorities to contemplate change of use.

Open end, closed gate

Why have long-term UK real estate funds frozen withdrawals again?

In March, many of the UK open-ended property funds, including those operated by investment managers Aberdeen Standard Investments and Janus Henderson and the insurers Aviva Investors and Legal & General Investment Management, were "gated," preventing investor redemptions. Several such vehicles had taken similar actions in the recent past during periods of Brexit-related uncertainty. "The difference this time is that this is not about liquidity," says Throssell. "Those funds did not see a pickup in redemptions before they were suspended. It was a response to the way the government is seeking to regulate them."

Cowins explains the freezes were prompted by new rules due to come into force in September that will force managers to suspend trading if there is "material uncertainty" about valuations of their fund portfolios. Once the current turmoil is over, they are expected to open their gates again. However, he cautions: "I still think that sector needs to be looked at because it has the issue of putting daily liquidity on top of an asset class that is inherently so illiquid. A couple of the open-ended funds locked up last year ahead of this happening because there was a rumor that there was going to be a run on them."

Fiera has told investors that it will defer subscriptions or redemptions for its own quarterly-traded open-ended fund for six months because it, too, has a material uncertainty clause, reveals Price. "We are a quarterly fund, so we have a bit of time to deal with issues. But funds with daily liquidity in this type of market have a fundamental mismatch, and that problem will get bigger as the defined contribution market grows and the defined benefit market shrinks," he says.

Some open-ended core-plus managers are establishing more flexible structures that address liquidity concerns, adds Cowins. "They don't have to sell to meet a redemption. It is only if the redemption queue goes beyond a certain size you have to apply any sales proceeds to meet it."

Adventurous investors might be inclined to buy hotels and leisure assets where they perceive long term defendable value, suggests Throssell. "If you were to go truly counter-cyclical that is where the serious money will be made if there is distress. Opting to pursue the logically popular, 'herd' options of logistics and residential probably isn't going to deliver that sort of value. It would, however, be a very brave call and would need incredibly high conviction."

However, moving too quickly is fraught with danger, argues RoccoGrande. "Even if an amazing distressed portfolio was to cross our desks tomorrow, we would probably slow-walk it at this stage, because it would always be at the back of our minds that we might be catching a falling knife. I firmly believe that now is not the time to be hunting deep for new acquisition opportunities. We are not equipped to adequately underwrite anything until we start to see the band-aid come off and how things evolve in the second half of this year."

The consensus around the virtual table is that it will be six to nine months before the dust settles and the market is able to accurately value the cashflow on assets once more. Once that stage is reached there will follow a buying opportunity and capital could return at scale swiftly thereafter. Throssell says: "Given the wall of capital that is still out there chasing yield, and that, at the moment, other asset classes are suffering as badly as real estate, if not more so, the opportunity gap could close quite quickly and 2021-22 could be back to a full-strength market."

At the moment, though, none of the roundtablers would claim to be able to predict what the market landscape of two years hence will look like, and in the meantime for some sectors of UK real estate, the period of covid-19 purgatory will likely involve much temporary suffering. ■


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