Real Estate Q&A - UK

Anne Breen, head of real estate research and strategy at Standard Life Investments says that commercial real estate has become an increasingly global market. "*The UK is further into the recovery phase than many other western markets – but still looks attractively priced, with income yields roughly 3 per cent higher than gilts.*" Lawyer Monthly speaks to Peter Sugden from Mayer Brown to find out how exactly Real Estate in the UK has fared over the duration of 2010...

Q What have been the key trends with regards to investment in commercial real estate in 2010?

(a) Prime Property: Investor demand for prime property has remained strong throughout 2010 particularly during the first two quarters, and a shortage of supply has driven yield compression. Competition has been tough particularly for Central London prime assets, where properties are achieving in excess of the asking price and transactions are completed in short timescales. There is stiff competition from foreign investors and trophy buyers, who are willing to pay more to secure the right properties.

(b) Secondary Property: most investment activity has centred on Grade A properties in the office and retail sector and conditions have remained difficult in the secondary market, where demand for poorer quality stock is still low and debt is difficult to source.

(c) Real Estate lending: loan origination has been very limited, with continuing low LTVs, higher margins and relatively limited supply (both in terms of available lenders and available loan capital) and restriction of lending to better quality assets only.

(d) Restructuring/Enforcement: whilst debt restructuring has been increasing, there has been considerable reluctance from the banks to enforce unless absolutely necessary. This has meant the volume of available distressed assets has remained low.

(e) Hotels: improving occupancy rates (especially in London). Looming Olympic Games (especially for London) and significant foreign capital seeking trophy hotels and even boutique hotels (as a must have alongside the car, the boat, the watch) has seen high level of activity in this sector from investors.

Q Has litigation continued to increase between real estate owner and occupier?

Whilst real estate litigation continues to be a busy area, just to say owner/occupier disputes have increased is an oversimplification. These relationships show increasing creativity and sophistication. Deals which seek to unlock a property's value for both sides are being done around rent reviews and break options. The upturn in the first part of 2010 saw decreasing tenant defaults and insolvency. However, dilapidations and service charge disputes are increasing as some owners look to tenants to fund capital expenditure and occupiers try to reduce outgoings. There are continuing issues around consents and breaks, as owners fight to maintain investment value and occupiers struggle with documents agreed in a different market.

How has environmental legislation impacted the sector?

Although clients are interested to hear about “green leases”, these have not been embraced on a large scale. However, the CRC Energy Efficiency Scheme has generated a significant amount of work in certain sectors (particularly the date centre sector) as landlords and tenants struggle to allocate the costs of the scheme between them and agree how to mitigate the impacts of the scheme. We have seen sophisticated landlords and occupiers actively seeking to mitigate the effects of the CRC by structuring their energy contracts.

The recession heavily impacted the real estate sector, how has the industry progressed in 2010?

There is a consensus that the banks are starting to unlock assets, although progress continues to be slow. This shortage of supply together with the lack of new developments coming to the market has driven up pricing.

However the shortage of supply of good quality properties has increased rents and brought in the incentive packages on offer for new lettings.

There remains a wide difference in pricing between the real estate market in London and the rest of the UK.

Essentially the sector has "flat lined" in 2010. However, the outlook for 2011 for mainstream real estate remains mixed. We believe that investment interest in good quality assets will remain strong, although there will continue to be a shortage of supply. Office development in particular has slowed down and there is a marked reduction in the completion of new developments. This is likely to continue next year, through until 2013/2014.

What do you feel were the top real estate stories for 2010?

1.1 The consistency of foreign investment in prime and good quality assets, and investors who are not reliant on new debt.

1.2 Improvement in performance in the hotel and leisure industry both in the UK and globally and demand for UK, especially London, hotel opportunities.

1.3 Major occupier activity remained focused on prime assets. Many occupiers of secondary property have taken advantage of upcoming lease expiry and break dates to negotiate reduced rents and incentive packages. There is concern that occupiers are becoming more cautious and the government spending cuts will have a negative impact on this sector.

1.4 The lack of enforcement or workouts of distressed debt by the banks. There is a consensus that the major financial institutions cannot afford to write down the value of distressed assets, especially the large volume of secondary and tertiary assets, and may hold onto properties until market conditions improve; which could be some years hence.

1.5 Increasing interest in less conventional real estate assets such as technical real estate e.g. data centres. **LM**

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