

The UK commercial real estate market: Timing is everything

YAHYA ABDULLA highlights the reasons why the UK real estate market is attractive to Islamic financial institutions and conventional investors globally.

Despite the economic difficulties plaguing Europe, the UK is expected to maintain its top three position as a global destination for commercial property investment in 2011, placed behind China and the US. After some expected volatility over the past few years, prime yields have started to stabilize, averaging 5.7% across all sectors.

Demand (although focused in London) remains strong with significant competition for the best quality assets; and with the 2012 Olympics less than one year away, we can expect increased interest in the coming 12 months. With a favorable interest rate policy (all-in debt costs of around 4.5%), demand for finance is also increasing. However as with most western markets, the main activity is driven by equity players.

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The lack of financing does create an opportunity for cash rich Islamic financial institutions (IFIs) to penetrate the market as equity buyers. Opportunity also exists with regards to capturing a

greater share of the financing market. While IFIs need to ensure that rates are competitively priced when compared to conventional peers, the more stringent/conservative approach provided by IFIs should not only be viewed as a safer long-term option, but also as a credible alternative to the limited conventional finance available in the market.

With a greater supply of investment products in London, activity has increased in the retail and secondary offices market, with few grade A office opportunities coming to market. Investors are experiencing a steady flow of industrial/logistics stock, but much is still secondary, often in portfolios released by the banks.

Key attractions

- Prime rents stable or rising
- Large and mature market
- A range of buyers/sellers generating strong liquidity
- Sophisticated property formats and deals/debt structuring
- Attractive lease structures
- Start of bank action to restructure loans and release opportunities

Source: Cushman & Wakefield

What makes the UK real estate market attractive to IFIs and conventional investors globally?

The UK authorities have historically taken a proactive step towards engaging with IFIs seeking to implement regulations which are aimed at attracting the Islamic market and ensuring neutrality when compared to conventional financial institutions. This approach has ensured that the UK remains well placed to warrant its ranking as the Islamic financial hub of Europe. As far as the real estate market is concerned, a significant transaction track record (conventional and Islamic), a reliable regulatory/legal framework, strong market liquidity brought about by a variety of buyers and sellers and an ample supply of investment grade opportunities are a few of the attractions.

As indicated in Figure 1, there is volatility in UK yields across all sectors. However this creates an inherent probability of yield compression and hence ensures greater returns through capital appreciation for those who are able to effectively time their entry. The extent of the improvement in the UK commercial real estate market is clear when we look at the statistics, with close to a 50% increase in 2010 investment volumes (EUR42.81 billion [US\$61.81 billion]) compared to 2009 (EUR28.89 billion [US\$41.69 billion]). This increased demand is reflected in the recent yield compression across all sectors (office, retail and industrial).

Figure 1



Source: Cushman & Wakefield

Property market

2009 investment volume	EUR28.89 billion (US\$41.69 billion)
2010 investment volume	EUR42.81 billion (US\$61.81 billion)
Change from 2009	48.2%
Interest rate (December 2010)	0.5%
Currency (December 2010)	US\$1 = 0.86 GBP EUR1 = 0.86 GBP
Rent measurement	GBP/sq ft/yr

Source: Cushman & Wakefield

As mentioned earlier, the retail segment, with its exceptionally diverse offerings, has seen dramatic demand in recent quarters. Flagship luxury brand high street real estate, insulated from the global financial crisis, continues to attract aggressive international bids – indeed, the benefits of a quality retail real estate

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asset are clear given the limited volatility in retail yields over the past few years. The office segment, the most popular among IFIs, has seen a modest increase in tenant enquiries, most notably in the technology, media and telecommunication sectors. While profitable investment opportunities currently exist, we must not overlook the fact that yields are close to pre-crisis levels, as mentioned earlier; and because of the clear cyclicity of the UK office market, it is important to time market entry appropriately. Nevertheless, if IFIs are willing to consider multi-let office buildings, the value addition through asset management may allow for better investment returns when compared to single let office buildings (despite the current yield profile).

Stronger manufacturing demand is helping the industrial sector, while the distribution market is benefiting from e-commerce and other internet fulfilment needs. Yields associated with this segment are traditionally higher than those in the office/retail segment and assets can often be structured into attractive income-generating products.

Though the actual assets may not be as aesthetically attractive as a centrally located office, the potential for above average profit should more than compensate for out-of-town locations and relatively unattractive buildings.

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A variety of local, Middle Eastern and Asian Islamic financial institutions have capitalized on the UK real estate market, typically preferring to focus on the office segment. Based on my recent discussions

with a number of IFIs, it is good to see logistic/industrial assets being actively pursued, especially as there are relatively superior returns available and potential for yield compression if the right assets are selected.

A favorable regulatory framework combined with a diverse variety of investment grade real estate assets, should persuade more IFIs to consider a portfolio approach to the UK market.

Conclusion

It is worth studying market yields and getting advice from local experts in order to best capitalize on the opportunities presented by the UK real estate market. With conventional banks beginning to release their real estate portfolios, there will be many under-valued opportunities coming to the market and it would be good to see IFIs taking advantage of this. (2)

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