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UPDATE

The state of real estate

Update prepared by John Rochester and Alana Gillies-Ridout (Guernsey).

As we emerge from the global pandemic, and wrestle with the effects of the UK's recent mini-budget, against the backdrop of the ever-changing macro-economic environment, Mourant's John Rochester and Alana Gillies-Ridout apply a global perspective to the real estate asset class, to assess what the real state of real estate may be.

In 2019, during what we then considered to be a period of VUCA (volatility, uncertainty, complexity and ambiguity), Professor Dr. Garbeil Felbermayr, president of the Kiel Institute for the World Economy put it nicely: 'in a phase like [our present one], people buy property, so uncertainty is actually helpful to this sector'. Fast forward three years, and that uncertainty is now both amplified and compounded so we have to ask, will there come a point, or indeed have we already reached the point, when that uncertainty is no longer 'actually helpful', even for the real estate market? At the recent EXPO Real real estate conference in Munich, attendance reached almost pre-pandemic levels, but this was without doubt the question at the forefront of most of the industry's minds. There are myriad factors which play into this question, and we examine some of those below, alongside some ongoing and current themes.

Rapidly rising interest rates

It has been difficult to keep up with the UK government's decision making in recent weeks, but as things stand, the value of sterling is decreasing and interest rates are on the rise following the news of tax cuts, energy subsidies, and increased borrowing.

On 22 September, the Bank of England raised rates by 0.5% to 2.25%, the highest rate for 14 years and subsequently announced that it would also prop up the gilts market and buy long-term dated bonds. Even more recently, Fitch lowered its UK GDP forecast for 2023 following what it referred to as 'extreme volatility in UK financial markets'. It now seems likely that interest rates will rise sharply again in November to fight inflation.

The consequence of this for the real estate market is that the cost of borrowing will rise, making it more challenging for sponsors to obtain the financing needed to buy, develop and operate real estate assets. The five-year swap rate used by commercial property borrowers has now soared above 5%, and Goldman Sachs predict that gross financing costs for the listed companies it covers will rise by 75% over the next five years as a result of these higher rates. Borrowers unable to cover the increased costs of refinancing their facilities may then be forced into distressed sales.

What value such sale assets may realise is very much open to question - that same Goldman analysis warns of a negative impact on the value of UK commercial real estate, predicting a fall of 15 to 20% across the sector between June 2022 and the end of 2024.

All of these factors, combined with an expected sell-off by pension funds seeking to liquidate assets in response to the market turmoil, have lead to a relatively gloomy outlook across the industry.

The growing impact of ESG on real estate

For a variety of reasons, particularly an increased focus and vigilance by investors, ESG is now being considered in far greater depth at credit and investor level than it was even a short two or three years ago.

Lenders are ever more mindful of climate risk in their underwriting process – and of course many lenders are doing so in compliance with their own ESG policies, or 'net-zero' targets. The inevitable regulatory requirements on the ESG credentials of real estate assets are focussing the minds of sponsors, many of whom are 'de-carbonising' their assets in anticipation. The challenge for those involved in the real estate environment is to find tangible economic returns which may flow from enhanced sustainability practices and targets – returns which may well arise in the future, but perhaps aren't being immediately seen in the short term.

The ESG credentials of assets will also impact on valuations. Consultants are scrambling to bring to market software tools which will analyse a building's ESG compliance, and assess what effect that may have on its overall valuation – essentially reporting on the delta between an asset's perceived value and its true value, catering for any remedial works or other ESG related expenditure.

We anticipate that there will be a rush to retro-fit buildings in the coming years to comply with the expected regulation – not only will purchasers therefore factor that into their valuations, but we may also see existing owners increasing or amending their facilities to fund these works.

A challenging retail environment

The wider global economic environment and the increasingly challenging cost of living crisis will also impact on the commercial real estate market – particularly retail. The shopping centres which were blamed in part for the 'death of the high street' several years ago are now themselves struggling. Owners and managers of large retail units are seeing those assets underperform, with the obvious consequence that they may not be able to meet their obligations under financing arrangements.

Whilst lenders will surely not be in a rush to enforce against underperforming assets in a world where the underperformance is more global than attributable to a particular owner or operator, we are likely to see increased activity on amendments, extensions, consents and variations on existing facilities – for those sponsors who can afford the fees.

There is also likely to be a material uptick in repurposing of commercial real estate – life sciences assets are at a premium, so shopping centres and even office spaces are already being converted to plug that gap.

Conclusions

There is no escaping the fact that the mood music in the real estate industry is sombre. For the reasons outlined above, the market is bracing itself for a quieter final quarter. We are moving from 'so far, so good' to 'wait and see'. Indeed, the high deal volumes we have seen in the previous twelve to eighteen months may themselves exacerbate the situation, as with many financiers, sponsors and PE houses having achieved their targets for the year already, any appetite/pressure to move deals in otherwise imperfect conditions has waned/eased.

That said, we anticipate some ongoing activity in this area, most likely revolving around amendments to existing facilities, consensual work-arounds on defaults, exploration (though not necessarily triggering) of enforcement options, repurposing of assets, and perhaps some distressed disposals. We have to believe that the current market turmoil will gradually settle over the coming months, with 'new' deals returning as we move into 2023.

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