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2024: Ready, steady... go!

Dentons UK Real Estate
Market Predictions 2024

Grow | Protect | Operate | Finance

2024

Introduction



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On 18 January 2024, Dentons held its prestigious annual Real Estate Market Predictions event at which our panel of esteemed experts provided their forecasts on the anticipated trends and developments in the property market for 2024. This report integrates that unique insight with our own views to offer a comprehensive perspective on the year ahead.

Reflecting on the sentiment that might have prevailed had this event taken place in December 2023, it is likely that both our panellists and participants would have expressed a more cautious outlook. However, as we step into 2024, there is a palpable sense of optimism, driven partly by the prospect of a fall in interest rates. Confidence in the market is on the rise, but it is contingent on a sustained period of stability.

Hence, the theme for 2024 could well be characterised as “ready, steady...go!” with the big question being who will trigger the starting siren and when.

Ready

2023 market conditions have fuelled accumulated demand

Going into last year there was a feeling that, while the start to the year might be rocky, the market would pick up and opportunities would arise. While for some 2023 was a great year, the majority found that the interplay of factors such as high interest rates, high inflation and geopolitical factors resulted in a slow burn market that lacked impetus, with lower-than-expected transaction volumes and protracted deal closures.

The anticipated surge in distressed asset sales did not materialise as many sectors (particularly beds and, perhaps surprisingly, retail) showed great resilience, and the measures enacted following the global financial crisis helped to buffer the market and ensure that banks and lenders were, and are, much better capitalised to avoid a liquidity crisis.

That lack of deal volume and, by extension, data points for valuations contributed to 2023 being characterised by uncertainty and encouraged caution and inactivity.

2023-early 2024: a window for strategic asset repositioning

One advantage of a slowdown in 2023 was the opportunity afforded to stakeholders to exploit asset management strategies ahead of the potential market upswing in 2024.

Recognising that effective asset management requires customisation to the specific sector involved, stakeholders are adapting their approaches accordingly. For example, the trend towards more operational real estate

has underscored the benefits of enlisting external experts to maintain a competitive edge in certain sectors, such as BTR and student accommodation.

Unexpected advantage of Truss economics

The repercussions of the economic strategies implemented in 2022, often referred to as “Truss economics”, have unexpectedly positioned the UK at an advantage at the start of 2024 to some of its European counterparts and the US, as the UK was forced to feel the pain of yield shifts far earlier.

Debt remains available

For those seeking debt, there was plenty of liquidity for good assets in 2023 and, consequently, a lot of competition. That liquidity looks set to continue in 2024 with some particularly interesting propositions around mezzanine finance (see below).

For those refinancing in 2024, the advice is to get ready for discussions early and well in advance of maturity dates.

Conclusion

The cumulative impact of 2023’s market dynamics prompted a widespread adoption of a “wait and see” approach. In doing so, this has set the stage for a potential market acceleration in 2024. This pent-up readiness can be seen in the uptick in enquiries from 2023 onwards from parties eager to capitalise on this year’s market potential.

"Uncertainty around certain sectors just sort of played into people being patient and people waiting and seeing."

Ben Chittick, Head of European Asset Management, Harrison Street

"2023 was the best year we've had. From an acquisition perspective, we did more last year than we've done probably for 15-20 years."

James Stevens, Head of Investment – Global Real Estate, Aviva Investors

"What were the transaction volumes last year? Normally, the UK CRE market is about £60 billion. Last year, around £30 billion and so the capital flows were sitting on their hands waiting for more certainty."

Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

"[of 2023] Why would you buy an office for 4-5% yield, when you can put your money in a bank account and get 5%?"

Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

"In the face of an uncertain transaction market, with such little transactional evidence on where those assets would trade, we extended hold periods rather than launch sales processes."

Jane Stockdale, Head of European Capital Markets, Heitman

"But there is quite a lot of dry powder, I feel, waiting for clarity... it was just too uncertain last year."

Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

Steady

UK election expected to have minimal impact

2024 is poised to be a pivotal year for global democracy. More than 2 billion voters will be casting their votes in elections across 60 nations.* One of those nations is, of course, the UK.

The consensus from our panellists was that, barring any shock policy announcements, the election should have little impact on real estate beyond perhaps a slight pause in the market in the run-up to the polls. Instead, the primary concerns are twofold. First, the risk of a hung parliament resulting in a lack of decisive government, at a time when clear direction, particularly on housing and infrastructure, is needed. Second, the prospect of new rent control regulations in the UK which could undermine investor confidence in the critical housing sector.

In terms of policy, one insightful panellist rightly noted that commercial real estate is often more influenced by policies targeting other sectors. For example, tax incentives aimed at stimulating investment in the UK TV and film industry have had a ripple effect generating demand for those specialised real estate spaces. This underscores the need for a holistic review of investment strategies.

“If you look at history, elections make little impact on the economic outcomes of the country. Having said that, people do pause...”

— Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

Boring gets the vote

Our panellists agreed on the need for a more stable and consistent government approach to key areas, such as infrastructure and housing. In many ways, boring is good.

Housing is a critical issue. The recent high turnover of housing ministers has potentially distracted from the significance of the housing crisis facing the country and, in turn, its impact on levelling-up and productivity. As such, greater consistency of personnel combined with a focused, clear and meaningful policy is needed to tackle the issue and allow private business to leverage its strengths to respond to the market.

The discussion touched upon issues with the planning system, suggesting that while a comprehensive overhaul would be ideal, in the short to medium term the focus should be on better investment to resource the system we have and less tinkering with the legal framework in order to promote stability and adjustment. This reflects a wider issue that the market needs time to adjust to significant policy and legal changes (for example, the Building Safety Act 2022) if it is to maintain investor confidence.

“People put it on the planning authority and there is just not the investment... The same person dealing with your loft extension is dealing with a multi-billion pound regeneration scheme and trying to balance the politics... So, just investing would be a huge step forward.”

— James Stevens, Head of Investment – Global Real Estate, Aviva Investors

“I wonder whether what the market really needs is stability, predictability and political will.”

— Roy Pinnock, Planning Partner, Dentons

Steady navigation through office market turbulence

The office sector is currently navigating a confluence of challenges including rising interest rates, the capex burden of ESG (Environmental, Social and Governance) upgrades and the shift in occupational patterns due to the increasing prevalence of remote working. As one panellist noted, offices are now a choice.

Drawing parallels with the retail sector's struggles over the past five years, there is an important takeaway: strategically positioned assets that are well managed can emerge from challenging times more efficient and robust.

Despite the headwinds facing the office market, owners of well-located properties who can secure the necessary capital for improvements should remain steady and maintain their course. By devising a strategic, compelling and clear upgrade plan, they can attract both investors and lenders to position their assets favourably for the future.

*Statista – <https://www.statista.com/chart/31604/countries-where-a-national-election-is-was-held-in-2024/>

(21 January 2024)



Interest rate movements

The big question in the room was when interest rates are going to be cut.

This was unsurprising given how interest rates permeate market dynamics by impacting, for example, the cost of debt and asset allocation (why would you put money into real estate if you can get comparable returns on other asset classes with less risk?).

Encouragingly, the consensus from our panel was that there would probably be rate cuts in the second half of the year. One panellist even suggested up to three rate cuts before the end of the year.

“There is significant liquidity in the mezzanine space. It’s actually a really interesting space. The questions are: do you want it, can you pay for it?”

Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

Attractive debt propositions

The debt market is currently generating some excitement with prevailing sentiment indicating we may be nearing the market’s nadir, presenting logical incentives for debt investment. Although asset values may fall further, there is a degree of downside protection now in place, offering the potential for attractive returns from debt-focussed strategies.

As highlighted by one of our panellists, there is an identified funding shortfall that needs to be injected into the debt stack. This injection could materialise through various avenues: equity contributions amassed during the previous low-interest rate era (though this source is likely nearing depletion), expansion of the security pool with unencumbered assets or the introduction of mezzanine financing. Interestingly, the mezzanine sector is attracting new market entrants eager to capitalise on opportunities, targeting tranches of between 45 to 60 percent (compared to mezzanine tranches historically of between 60 to 75 percent) that are getting a mezzanine return.

“But what you are actually asking is who is going to go first? Who’s going to be brave and do it? And I think that once that starts to unlock, we are going to have quite an interesting back half of the year.”

— Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

“I think 2024 is going to be unclogging the plumbing a bit.”

— Ben Chittick, Head of European Asset Management, Harrison Street

“Inevitably we are going to have more scenarios where banks or lenders have to step in because there is no viable solution and it normally is where there is not a very clear use case for that asset going forward without significant investment, which is why the office space is so challenging.”

— Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

Beyond normal – a resurgence of the real estate market

The reality is that, while parties may not have been under pressure to sell in 2023, parties cannot sit and hold forever, thereby setting the stage for increased activity in 2024. That activity is expected to be supported by accessible financing options and strong fundamentals underpinning sectors such as life sciences and beds.

While some degree of distress in the market may be inevitable, the concept of a widespread “wall of distress” was met with scepticism by at least one of our panellists.

Considering the expected decline in interest rates and the accumulated demand from 2023, it is anticipated that the market will experience a gradual upswing as we approach the latter part of 2024. Although this upward trajectory may not be swift, it is expected to build steadily, signalling a period of progressive growth and opportunity. The market’s trajectory may not align with traditional notions of “normality”, especially given the myriad of recent disruptions that have redefined the status quo (for example, Covid, Brexit and geopolitical events), but it will mark a resurgence of a dynamic UK real estate market.

“With the faster repricing in Europe, particularly the UK... some US investors may see a window of opportunity.”

Jane Stockdale, Head of European Capital Markets, Heitman

“If I was a mezzanine provider at the moment, I’d be feeling pretty happy that I’d be able to invest my capital this year.”

Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

I don't think normal exists anymore. The pace of change...there is always something happening that is having an effect on the underlying economic use, the capital markets, the debt market, where capital flows from within the world. And that's going to continue. The key is stepping away from watching the news cycle and looking at what the structural trends and themes are.”

— James Stevens, Head of Investment – Global Real Estate, Aviva Investors

Sector views

Hotels

Hotels have seen a terrific bounce back from the peak Covid years and are looking attractive.

“The overall picture for the hospitality sector remains optimistic, notwithstanding the continuing economic uncertainties and the ongoing global tensions. We are seeing continued strong demand for hotel assets in 2024 with performance aided by the recovery of international travel and returning corporate demand.”

Simon Masri, Real Estate Sector
Leader, Dentons

Offices

Clearly there are challenges, but with the right asset and the right strategy there are still opportunities.

“For the office sector, the retail parallels are huge.”

— James Stevens, Head of Investment –
Global Real Estate, Aviva Investors

“It’s like what happened in retail but for different reasons. But it’s quite similar in the fact that it is that confluence of influences that is making it hard. But of course if you’ve got an ESG plan, an ESG strategy, if it is in a good location, then there is optimism about changing that into an ESG-compliant asset but it does need investment.”

— Madeleine McDougall, Head of the
Real Estate & Housing, Lloyds

“So, if people want an office, an office for many businesses is a choice. It is not a necessity, it is a choice.”

— James Stevens, Head of Investment –
Global Real Estate, Aviva Investors

“In 2024, the office sector presents a strategic landscape, with investor focus shifting towards asset-specific considerations, propelled by cooling inflation, falling borrowing costs, and promising rental growth prospects, while anticipating a rise in prime office rents, increased development and refurbishment starts, and a changing work dynamic with the embrace of ‘hybrid’ work”.

— Robert Wyatt, Real Estate Partner, Dentons

Retail

Retail put in a good year in 2023, proving itself more resilient to the cost-of-living crisis than perhaps was expected and generating excitement from some quarters.

[James’s] pick for investing £100 million into 2024 was into supermarkets on the basis that they are essential but low maintenance, and should be easy to refinance.

“I like certain sections of retail at the moment.”

— Madeleine McDougall, Head of the
Real Estate & Housing, Lloyds

“For the first time in many years, there is a real sense of optimism around retail, particularly prime assets. Savvy investors with operational expertise and partnering with experienced consultants can benefit from significant opportunities to maximise values.”

Daniel Lowen, Real Estate
Partner, Dentons

Beds

The underlying fundamentals for the beds sector remain strong, underpinning continued interest and rental growth.

“You’ve got to track various aspects in student accommodation. Monitoring university performance, international student demographics, and market dynamics. It’s essential to assess whether the market is established.”

— Ben Chittick, Head of European Asset Management, Harrison Street

“We feel positive about the underlying fundamentals.”

Ben Chittick, Head of European Asset Management, Harrison Street

“We will continue to pivot towards residential.”

— Madeleine McDougall, Head of the Real Estate & Housing, Lloyds

“Whilst new housing supply continues to fall significantly short of the Government’s ambition of 300,000 new homes being delivered in England each year, demand from tenants will remain strong, supporting rental growth.”

— Laura Gowing, Real Estate Partner, Dentons

Data centres

Given the exponential growth in the amount of data being produced, data centres present a compelling proposition.

One of Madeleine’s choices for investing £100 million in 2024 was into the data centre sector.

“As our use of data increases all the time (and will increase further with more businesses adopting AI) the data centre sector as an operational asset class provides significant opportunities for the real estate investor.”

— Tom Dalton, Real Estate Partner Dublin

Life sciences

There is continuing demand in the life sciences sector. However, the sector is naturally fast-moving and the challenge for real estate is keeping up with what the sector wants in terms of demand for space.

“The life sciences sector is positioned to see dynamic growth, with innovation clusters emerging across key cities and international universities looking to establish campuses in the UK, as the emphasis on life sciences as a top investor preference resonates, driven by structural change, restrained supply and robust rental growth prospects.”

John Arey, Real Estate Partner, Dentons

“They [life sciences companies] move much quicker than real estate... they get their funding... have a breakthrough, eureka! They are ready to go. Real estate cannot catch up as quickly as they want us to. So, there is demand out there.”

— Ben Chittick, Head of European Asset Management, Harrison Street

Logistics

While not necessarily standing centre stage, logistics still offer a compelling proposition.

The I&L sector remains one of the most sought after among real estate investors, particularly with private equity. As well as the continued attractiveness of core assets with strong covenants and ESG credentials in portfolios, value add opportunities are increasingly attractive in the current market for greater returns, all exacerbated by predicted rental growth which is still looking strong. Logistics play a crucial role in a real estate strategy, representing a proven and resilient asset class poised for the next cycle. The industry continues to evolve to meet ongoing consumer demands.

— Alex Coulter, Real Estate Partner, Dentons

Some final thoughts

“I expect activity to pick up in the second half of the year as we see more certainty around the direction of travel for interest rates and in construction costs. There is clear opportunity in the debt markets as higher returns can be achieved for less risk than would have historically been associated with them. However, for those looking to put their money in to bricks and mortar, I expect the beds sector to provide the best opportunities.”

— Brian Hutcheson, Real Estate Partner, Dentons

“All singing and dancing ESG future-proofed prime office space is where it is at in 2024. Secondary space will become a bigger (empty) problem as tenants opt for better alternatives and investors balk at the necessary investment to make the asset (or is that liability?) attractive to the market, especially whilst interest rates continue to remain high. Even if/when rates fall, there may be more attractive sectors to invest in. Longer term there is a policy issue where the costs of redevelopment outweigh the risk of investment. That being so there risks being significant unwanted stock that may not be ESG compliant, reducing available space and not advancing the green agenda either. The law of unintended consequences is perhaps predictable.”

— Bryan Johnston, Practice Group Leader, Dentons

“The sector is crying out for stability and predictability in planning to help release investment into repurposing existing assets and delivering new homes across a variety of asset classes. The panel rightly underlined the need to think about fundamental reform of the system as best served by resourcing it properly and ensuring that the political will to deliver matches the ambitions for positive change, rather than further technical change.”

Roy Pinnock, Head of UK Planning, Dentons

And the last word...

In 2024, we stand at an inflection point in the UK economy and in UK real estate shaped by a decade of regulatory change that has profoundly changed the real estate sector. The 10th anniversary of the Prudential Regulatory Authority’s implementation of the supervisory slotting criteria in January 2014 marks a critical turning point in risk management in the banking sector. This regulatory measure, introduced in response to the global financial crisis, has led to a significant decline in lending exposure to development by UK banks – a 63% overall reduction since inception. This decline has changed the real estate landscape, limiting the available high-quality investment stock and at the same time contributing to the extraordinary yield compression seen in the UK and Europe prior to the latest rate tightening cycle.

“Moving forward into the next phase, interest rates remain a central theme in economic predictions. The current elevated rates and debt costs are not accretive to real estate generally and have slowed the pace of new development projects further. Amidst these considerations, the Bank Rate is forecast to begin falling on June’s summer solstice and to continue to fall throughout 2024 and 2025. Bond rates will follow suit but, like the Bank Rate, will settle at a new higher global equilibrium level than before the rate hikes began. This will limit the potential for achieving real estate investment returns through yield compression alone. The next five years, therefore, will require a more opportunistic approach to real estate investment, emphasising development, repositioning and value-added capital expenditures to create value and grow income streams. The new environment will demand strategic and adaptive investment strategies. For the UK economy as a whole, this will prove crucial. Government policies to stimulate business investment in technology and capital equipment to improve productivity, linchpins for their growth strategies, will require new, adaptable and fit-for-purpose high-quality space. Carpe diem!”

— Dr Walter Boettcher, Head of Research and Economics, Colliers

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