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Contemplating stagnation

The UK general election resulted in a hung parliament – precisely the result the participants in *PERE*'s UK roundtable feared. By Jonathan Brasse

You might have thought that on 6 May, there would have been an air of optimism among the participants of *PERE*'s UK roundtable debate on the country's investment prospects. After all, as of January, the UK economy was at last producing GDP growth again, following a record six quarters of recession.

But on 6 May, the day that nearly 30 million British voters took to polling stations across England, Scotland, Northern Ireland and Wales to determine their next government, *PERE*'s roundtable participants – MGPA's chief executive officer for Europe, Alex Jeffrey, Frogmore Real Estate Partners' managing director, Paul White, and Ernst & Young's head of real estate, hospitality and lodging for Europe, the Middle East, India and Africa, Dean Hodcroft – remained firmly apprehensive. The common fear was the continuation of a stagnating economy by a hung parliament (whereby no one party can govern outright as it lacks an overall majority vote).

Those fears were confirmed a day later, with the UK facing its first hung parliament since 1974. At the time of press, a coalition government had been formed led by the Conservatives and supported by the country's third party, the Liberal Democrats.

The future of the economy was a central concern for both parties during the election and the noise from the conjoined political parties was one of uniformity in their approach to dealing with the country's worrying budget deficit – currently more than 12 percent of UK GDP, according to the European Commission.

Our roundtablers may have been unaware at the time of our debate, exactly what was to unfold. But they did consider, somewhat prophetically, the fallout of a split government. Indeed, in between croissants and coffee, the overarching sentiment from the top floor of the Hilton hotel in Mayfair's Park Lane, London, was of concern.

"A hung parliament is what we don't want," warns White. "All we'll see is another election within 12 months and in between that, politicians will try to score points off of one another. This will be economically unhelpful to us." Jeffrey chimes in: "A hung parliament could be very risky. With all the parties assuming there will be another election, their steps could be populist in nature and that is not what we need."

While both parties are, for now, in agreement on a deficit reduction plan and have agreed not to hold another general election until 2015, political commentators have already voiced reservations as to whether this alliance will hold. The roundtable view is that a coalition government could result in a run on confidence in the UK bond market, as has been seen in Southern Europe. While the table feels a strong Conservative leadership would have been best placed to make the tough decisions needed to enable the UK to meet is £170 billion-plus debt burden, they must now settle for a Conservative coalition government instead.

Regardless, Jeffrey predicts: "The new government is going to have the shortest honeymoon in living memory because they are going to have to take some drastic steps and that is going to act as a dampener generally on the real estate market." Indeed, one first step taken in the days following the roundtable was to call for an increase in capital gains tax from 18 percent to 40 percent on all non-business assets – undoubtedly something that will affect the country's real estate market.

But as the old saying goes, every cloud has a silver lining and Jeffrey is already thinking about opportunities stemming from a government in need of producing capital receipts to reduce its debt. "Whoever wins will be downsizing the government's real estate footprint, whether it be occupational space or ownership. The SW1 estate (the government's most prominent London postcode) will be reduced in size, there will be decanting of staff and the sale of assets," he says.

Lateral thinking

Such lateral thinking is a must for private equity real estate firms looking to get ahead in the UK. It isn't that there are no viable assets to buy, it's just there remains a bid-ask mismatch. White's UK-focused Frogmore Real Estate Partners II opportunity fund closed in August 2008 on £200 million (equivalent to €235 million; $291 million today) but since that time, it has made only two acquisitions, 1237 acres of residential land outside of Oxford for £36 million

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and a portfolio of 20 mobile home parks across the country for £17 million – slim pickings considering what Frogmore has been offered.

"We have seen a pipeline of £30 billion a year since 2006," says White. "This year I think we are seeing between £500 million and £600 million of assets a week, so we can't say we aren't seeing stock. We are just not seeing stock at a price we want to pay."

MGPA too has had minimal exposure to UK real estate in recent times, having sold its whole UK portfolio in 2006. Its pan-European MGPA Europe Fund III closed on equity commitments of €841.5 million in 2007 but has made only one outlay in the UK itself, opting to focus on continental Europe instead. Like Frogmore, MGPA has selected residential development land as a viable play, purchasing Lands Improvement Holdings, a development land company which controls 2,600 acres of land across the UK, from Clerical Medical Investment Group for £52.5 million – a 60 percent discount to peak valuations, Jeffrey says. He sees the investment as long-term owing to undersupply and increasing demand, particularly for affordable housing.

Jeffrey sees higher growth in countries like Poland where MGPA has also invested recently. He says: "I personally find it difficult to reconcile the prices being paid at the moment with the weakness of the UK economy."

The table notes two London deals that typify current market conditions. The first is the purchase by Swedish billionaire Stefen Persson of the former Dickens & Jones retail block on Regent Street for £225 million from private equity real estate firm Delancey and property company Shearer Property Group, in a deal reflecting a 4.75 percent yield. The second is the £240 million sale of Draper's Gardens, a City of London office block, by Morgan Stanley Real Estate, and property companies, The Canary Wharf Group and Exemplar Properties, to German open-ended fund manager, Deka – reportedly at a 5 percent yield. "On a pound-per-square-foot basis those are probably lower than the market peak because rents have come down but I still find those prices difficult to understand from the buyer's perspective," Jeffrey says. Perhaps it's no coincidence that in both deals private equity real estate firms were sellers.

Naturally eyes are on the UK's biggest lenders to real estate, particularly Lloyds (which has a UK loan book of £70 billion) and the Royal Bank of Scotland (which has a £55 billion book), to see what attractive opportunities might avail via distressed scenarios although none of the roundtablers are holding their breath.

Ernst & Young's Hodcroft suggests the banks have learned from the experience of their US counterparts in the early 1990's when the RTC, in effect, led to fire sales and investors being handed "a huge slug of value". Instead they are moving slowly and diligently before deciding on how to manage their real estate exposure. "A lot of the restructuring work that we do is being conducted informally," Hodcroft says. "For us, it is about helping banks with structured solutions and conducting independent business reviews, for example, but we are generally not yet at the stage where we are going through masses of formal procedures such as receiverships and administrations and that is very different to the last downturn."

There have been murmurs from the bank-

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ing sector that, when the banks do bring assets to the market, private equity-style funds may not be invited to bid through a fear of handing out assets on the cheap to "vulture' investors as they have been bailed out with tax-payer money.

"In late 2009 there was a lot of gossip about whether private equity firms would be left out in the cold by the banks," Hodcroft says. "There was negative sentiment around hedge funds, private equity, opportunity funds and all of those people supposedly involved in 'murky financial engineering'. It seemed like a populist argument – something that played neatly into the hands of politicians. But a lot of that I think is misguided and the supposed role of private equity in the credit crisis seems to have been commented upon by many but truly understood by few. It would be wrong to freeze out private equity."

So will the negative perception surrounding private equity dissipate now the election is over? "It will have to," Hodcroft adds, "because when you peel back the layers of the argument there is not really much more to it than pure sentiment. More importantly, it's illogical to block out a huge pile of equity waiting to sort out a huge problem that needs resolving." All talk about how welcome private equity real estate firms are as recipients of banks assets, however, is agreed as somewhat notional given that UK banks are only marketing for sale assets they believe could be sold in a strong market, hence not very much.

The NAMA sidestep

With caution and restraint in abundance, the table feels there is relative uncertainty about pricing, something Hodcroft believes could possibly have been avoided if the UK had adopted a "bad bank" vehicle like Ireland's National Asset Management Agency (NAMA), rather than allow for its toxic assets to remain with its banks in perpetuity.

Hodcroft suggests: "There is, at least, a plausible argument for a NAMA-style solution instead of the current UK solution. Sure, you'd take a lot of pain upfront but maybe you'd establish a market clearing price and avoid a series of painful further write-downs or elongated stagnation." That said, neither Jeffrey nor White see much value in pursuing assets secured by loans that have already entered Ireland's toxic bank.

March saw the first transfers of troubled property loans made by three Irish banks and two Irish building societies into NAMA, but Jeffrey says he is deterred by the tender process any bidder must go through to take advantage. "We see interesting opportunities arising from loans that might go into NAMA but where the sponsors are looking to achieve something better than they might receive from NAMA." Most loans are purchased by NAMA at 50 percent of their original intended value but Hodcroft says some Irish banks have succeeded in finding more lucrative alternatives. Some, he says, even managed to sell loans at par outside the NAMA process.

By natural progression, the table finds itself discussing current bank lending habits. White says that while banks are lending more conservatively – the current loan-to-value ratio available in the UK is up to 65 percent at a price of 200 basis points over the bank's five-year swap rate – his firm is now borrowing more conservatively. "We wouldn't borrow at 65 percent. We've had offers as high as 70 percent. We just don't feel comfortable at that level." White suggests an LTV ratio of 60 percent is currently a better borrowing cap for Frogmore.

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Jeffrey says those banks actively lending to UK real estate (German banks are most active, although UK banks are still honouring long-standing relationships) are currently highly selective on what and who they lend to. Development exposure is out, but they are willing to absorb a little more risk than they were, such as leasing or repositioning risk. In absolute terms, however, the lending universe in the UK is shrinking and White sees this as an opportunity for would-be lenders to make their play. "There is a massive gap for new entrants," he says. "I'm half expecting the likes of the Chinese and others to step in."

Nowhere to hide

Much has been made about the possible damaging fallout of the looming European Union's proposed Alternative Investment Fund Management directive, but this roundtable is putting a brave face on things.

"Regulation is coming whether the industry wants it or not," Hodcroft says. "Things like more transparency, better clarity of reporting, independent assurance from third party firms like ours and more focus on internal controls will, in the short term, lead to a bit of pain for fund managers. It will inevitably erode returns. But longer term, regulation is not a bad thing." Hodcroft believes, if delivered appropriately, the directive could make real estate more "institutionally investable" and would help "kick-start true professionalism on a much more widespread basis in the fund management sector". He also believes that more regulation will offer investment managers a yard stick as they compete to be "best in class".

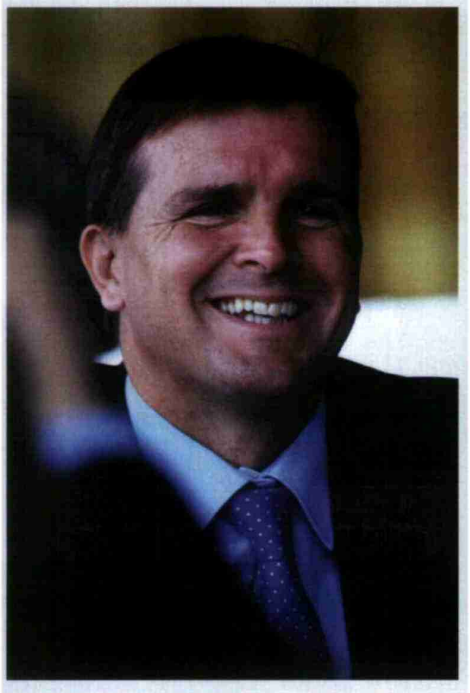
Jeffrey agrees: "I don't see regulation as a huge threat," he says, "but we have to guard against it going too far." Top of Jeffrey's concerns is the over-regulation of staff remuneration. "If we are going to be told we can't pay cash bonuses then that means it would be difficult to compete for talent with those companies that find themselves outside the legislation. That could be damaging for us as our assets really are our people." Jeffrey is keen for the recruitment world not to become distorted as a result.

White believes the best way to ensure regulation doesn't become overly burdensome is for the sector to have more of a collective voice, something it currently lacks. White is a director of the British Property Federation, a lobbying body that represents the UK real estate sector to the government. While it has had success lobbying in areas such as REITs, it has yet to fly the flag for private equity real estate firms. "I have no doubt it would be an issue for them," says White, "but whether they are the right group for this issue, I don't know."

Given the recent struggle between the country's politicians, the notion of sector damaging "populous" decisions, as Jeffrey puts it, remains very real. Perhaps a lobbying body is just the antidote UK private equity real estate needs to enable the sector to shrug off any bad PR and engage with a real estate market in need of more clarity. In the meantime, the roundtablers must go about their business as best they can. ◻

Dean Hodcroft
Partner – head of real estate, hospitality & construction for Europe, the Middle East, India and Africa
Ernst & Young

Hodcroft is an Ernst & Young long termer having been with the firm for 22 years, in which time he has focused largely on real estate advisory services such as advising public and private companies, public sector bodies and large corporate occupiers as well as private equity and opportunity fund managers on their real estate transactions and issues. He leads a team of more than 3,500 staff across Europe, the Middle East, India and Africa. Hodcroft says the firm is currently engaged in providing restructuring services, particularly to the UK banks. The firm is also advising on a number of administrations such as that of Icelandic bank, Kaupthing. The majority of Ernst & Young's investment advisory work is currently across mainland Europe.



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Paul White
Managing director
Frogmore Real Estate Partners

White is a real estate veteran with more than 40 years of real estate experience. He is responsible for overseeing and managing the 52-staff strong UK-focused company. Following his appointment as managing director of Frogmore Estates in April 1995, White led the company as it increased its pre-tax profits from approximately £15 million for the year ending June 30, 1996, to £55 million for the year ending June 30, 2000. He then led the firm's privatisation in January 2001 which led to it being renamed Frogmore Property Company. Between 2002 and 2005, Frogmore invested approximately £690 million of equity before White evolved the company again when he launched Frogmore Real Estate Partners in January 2006. The platform has raised £530 million over two funds, closing on £200 million for the latter fund in August 2008.

Alex Jeffrey
Chief executive – Europe
MGPA

Jeffrey is one of MGPA's founding shareholders and has been with the company and its previous owner, Sydney-based developer and fund manager, Lend Lease, for 11 years. While at Lend Lease, Jeffrey held a senior role devoted to capital transaction activity globally. Prior to working for Lend Lease, he spent 11 years in various banking roles at HSBC and JPMorgan. Based in London, he currently oversees MGPA's 100-staff strong team in Europe across six offices as well as the firm's European fund series, which to date, have amassed $2.3 billion of capital. Investors in MGPA's funds include pension and sovereign wealth funds from around the world, of which 40 percent are from North America, 20 percent from Australia, 20 percent from the Middle East and 20 percent from Europe.

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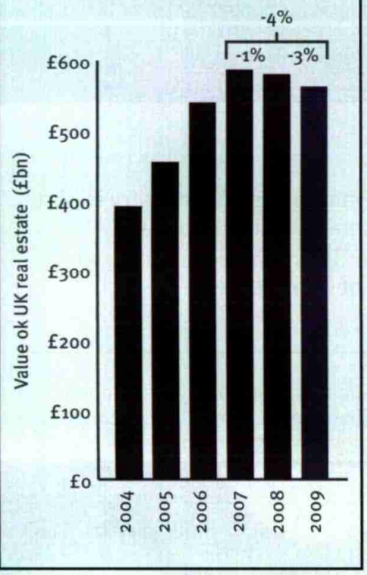
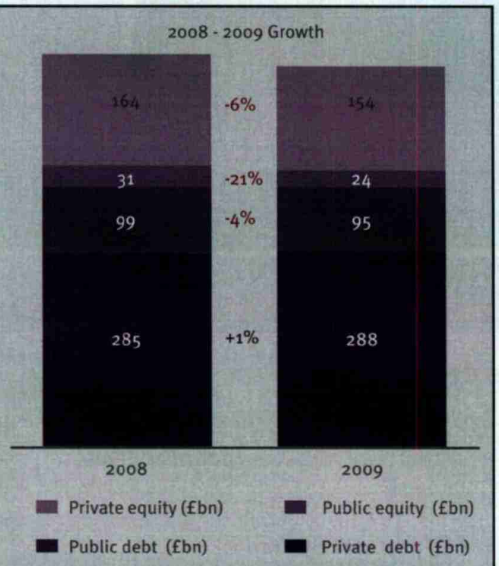
The UK market at a glance

Last month, property services firm DTZ released its 36th annual 'Money into Property' report, which provides an extensive overview of the UK real estate market. Here are some of its key findings.

Despite declining last year by 3 percent in sterling terms to £562 billion, the value of UK invested stock (investment grade real estate) is set to increase by 12 percent over the coming two years, according to property services firm DTZ.





DTZ says that private equity in real estate decreased in value by 6 percent to £154 billion in 2009, better than the 18 percent decrease it suffered in 2008, which coincided with a 26 percent fall in capital values.

The firm recorded £22.8 billion of property transactions in 2009, a similar proportion to the £22.6 billion recorded for 2008 but far off the £46.5 billion and £47.8 billion recorded in 2007 and 2006 respectively.