The year ahead for the Real Estate sector ...
What issues will have an impact on the real estate market in 2012?
Introduction

Growth and stability continue to elude the UK economy as it teeters on the edge of a potential double-dip recession. For the real estate sector, this means traditional sources of debt finance are still in limited supply. Investment is increasingly concentrated in prime markets like London, markets now fuelled by ‘safe haven’ money from the Middle East and international investment funds from the US, Canada and Asia.

Alongside the economic challenges sit issues ranging from online retail’s impact on high-street landlords to changing home ownership demographics. Against this backdrop, Osborne Clarke’s real estate experts have identified the important issues for the sector as it seeks to keep its head above water through a widely anticipated choppy 2012…

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The future is prime … and outside Europe?

Fund managers will increasingly focus on prime as attitudes to risk have hardened rather than eased. Continued investment conservatism means the peripheral Eurozone markets and anything secondary in the principal markets will be hit hard. Interest will be consolidated in the prime markets of the UK and Germany.

The drive for growth will be focused on the alternative investments in these safe-haven markets. Alternative investments like student accommodation, residential, food retail, ground rent, logistics and, possibly, debt. However, this might not be driven by Solvency II as we wait to see the impact of David Cameron’s “No” on sticky pan-European regulation.

As we move through 2012, investors’ drive to out-perform may eventually entice the more adventurous to look outside Europe to the high-growth but perceptibly stable economies like Australia, Brazil and possibly Asia. The US may come swinging back into favour too. However, given recent geo-political events, it is unlikely we will see significant interest in the Middle East or Russia for the time being.

More bank sales, more restructuring

Next year, 2013, marks a significant cut-off point for the banks’ balance sheets as Basel III comes into effect. Given this, 2012 is likely to see banks looking to offload more of their non-core real estate assets. There were a number of debt portfolio sales that completed in 2011 and that trend is set to continue as certain lenders look to reduce their exposure to real estate or to exit the UK real estate market altogether. There will also be an increased focus on restructuring those loans that are in default as banks seek to actively manage their balance sheets, with an increasing amount of individual sites coming to market, although not in the volumes some would like to see.

Inevitably, ‘refinancing gap’ will become the buzzwords of 2012 as the next wave of loan maturities approaches. It remains to be seen whether a further round of ‘extend and pretend’ will be needed. For those new entrants looking to enter the UK debt market, then, there are likely to be significant opportunities. Insurers are likely to strengthen their senior debt lending platforms as real estate lending becomes more attractive than direct real estate investment due to changes brought about by Solvency II.

This year is likely to be another challenging one, with banks becoming increasingly more risk averse due to continuing economic instability and higher capital requirements. Selective lending will become more prevalent as banks seek to limit their exposure to prime assets in established UK markets that are fully let.

Alternative funding gathers pace

Sources of alternative funding sparked by Basel III’s likely restriction on the total amount of money that banks can lend on real estate projects was the hot topic of 2011.

In 2012 we will see less talk and more action as interest gathers pace in the run-up to 2013 when the higher minimum capital requirements for banks will begin to bite. Additional pressures will also surface as the Government’s non-bank lending task force makes its recommendations on practical measures to help develop alternative sources of finance. These recommendations are due ahead of the 2012 Budget.

Up to now, talk on alternative funding sources for real estate projects has ranged from discussions around alternative deal structures that utilise early cash generation to new entrants to the market, including insurers, pension companies and private equity investors. There is no doubt that Solvency II is likely to entice insurers into the senior debt space.

In 2012, we expect the bond markets to gain in popularity, with the minibond market possibly providing a new way to fund both small-scale and larger projects through access to the capital markets without the normal overbearing and costly formalities. The retail bond market is also likely to play a more important role given that the London Stock Exchange is seeking to promote this market with a new electronic trading platform.

Finally, a revival in mezzanine debt is on the cards. Squeezed out by bank debt in the 2000s, mezzanine is likely to be back in vogue. Although more expensive, its attraction is that it can be used to replace part of the equity in a project, thereby increasing the IRR for the equity piece.

Aligned to these alternative funding trends, we expect to see continued interest from investors in creating commercial ground rents for a variety of property assets. The assets that are in short supply, such as large storage and distribution centres, may be good candidates for this sort of funding structure.
Sustainability

Is there value in green?

Last year’s announcement by CBRE that it intends to incorporate sustainability into its UK property valuations for the first time was an important moment in the long-running debate on whether a green building automatically provides a premium on value.

However, although CBRE’s position shows that the likely shift towards a green premium has begun, the take-off is likely to be sluggish. Indeed, the 2012 position is likely to remain that green does not automatically provide a premium on value. And, until there is a marked change in economic conditions and capital values, there is likely to be limited market appetite to pay more for a sustainable building.

Interestingly, over the next 12 months that position could be in direct contrast to the uptake in the actual ‘greening’ of commercial and domestic buildings. This will be driven by regulatory stimuli in the form of the Feed-in Tariff (FIT), the Renewable Heat Incentive (RHI) and the Green Deal (launching in 2012). Rapidly reducing capital and installation costs for micro-generation technologies like solar photovoltaic and energy efficiency measures will also be crucial in stimulating both retro-fit and new-build sustainability take-up.

Public-sector housing stock (through registered providers) is likely to be at the forefront in this area, especially as 2012 is the final year of the Community Energy Savings Programme (CESP) and the Carbon Emissions Reduction Target (CERT).

Competition in the energy services market

This year will see increased demand from commercial landlords, house-builders and local authorities for portfolio ‘energy services’ delivered by energy service companies (ESCOs). To date this has been a fragmented market dominated by a few facilities management companies offering an energy performance contracting model borrowed largely from the US and Continental Europe.

With the introduction of the Green Deal in 2012 to sit alongside the FIT and RHI, as well as increasing utility costs, we are seeing considerable activity among more recent entrants in the ESCO market. These include existing players reshaping their service offerings and new (in many cases smaller and niche) companies offering these services.

Facilities management companies and specialist carbon management consultancies as well as the more established providers would appear well placed to maximise the ESCO opportunities in 2012. For the UK property market this injection of competition is good news, especially when many believed the ESCO market would be dominated by the big six utilities.

It is also good news that the service offerings are broad, encompassing outsourcing carbon reduction commitment compliance management; energy performance contracting; installing and monitoring smart metering technology; and operating and managing district heating and power.

The crucial test for 2012 is whether the finance is available to enable ESCO deployment. Much will depend on the attitude of funders and financial directors as to the level of guaranteed energy savings these schemes will deliver.

‘Light green’ leases in 2012

After many years of lawyers and the Better Buildings Partnership seeking to promote green provisions in leases, 2012 may finally see a shift. Tenants will remain averse to anything that has a price tag attached and landlords to anything that has an adverse impact on value.

However, partly driven by the conversion of the Carbon Reduction Commitment (CRC) into a tax, partly by a sense that green credentials are an increasingly valuable element of brand, and partly by concerns about future proofing of assets, we will start to see ‘light green’ provisions as a standard feature of leases.

This shift will be tentative at first, at least until the market makes up its mind as to the value implications and importance of sustainability, but green issues will finally start to gain traction. In 2012 this will be limited to protective measures (not to do anything to harm environmental performance, etc.) and/or to monitor/consult. There will be no significant financial price tag attached, save possibly in the apportionment of any CRC charge, but that will happen in years to come.
The residential market

Institutional investment in residential – inevitable?

The nascent market in institutional investment in residential property has yet to develop its full potential, but it could definitely start to find its feet in 2012.

Changing home ownership patterns will likely see rental property becoming as, and in some areas like London, more, important than owner-occupier property for the next two decades. This will potentially unpick the lock on increasing investment in the residential sector.

However, a word of caution – investors and developers cannot drive this on their own. The catalyst for significant growth will be the availability of cheap land from the Government, the right sort of product at sufficient scale and the right management in place. It will be interesting to see whether 2012 delivers.

The tentative re-emergence of the first-time buyer

With the Government introducing its new mortgage indemnity scheme in 2012, could we see the re-emergence of the first-time buyer? The new scheme aims to make 95% loan-to-value (LTV) mortgage products available to all buyers of new-build properties in England. Interest rates are expected to be comparable to 80-85% loan to value mortgages.

The plan is for the first loans to be available from spring 2012. However, the details are not yet in place. For this scheme to make any headway in getting first-time buyers back into the market and kick-start house building of smaller family homes, the Government needs to answer its critics on three fronts.

First the scheme has to be simple to administer, otherwise it will stumble before it gets off the starting blocks. It must also be fair to all buyers, taking into account price differentials will probably little more than a sticking plaster on a much bigger problem. There are just not enough available properties.

However, even if it’s successful, with household formation projections showing that 232,000 new homes need to be built in England each year to 2030 to meet demand, and only 100,000 built in 20101, the mortgage indemnity scheme is probably little more than a sticking plaster on a much bigger problem. There are just not enough available properties.

The Government needs a long-term strategy that tackles issues like the chronic planning problems and the current mortgage lending issues to get any traction in mobilising first-time buyers. Even if it manages this, any real solution in terms of getting homes built or renovated is still many years away.

New build value and volumes on the up

Surprisingly, during 2011 the shortage of new-builds reignited the new build premium – something we thought had been confined to the history books. The House Builders Federation reports a price rise of 12.1% on new builds versus a decline of 1.2% on pre-owned. This growth in the new-build sale price will continue into 2012.

There was also a steady sales market during the last six months of 2011, something that has sparked quiet confidence among house builders that we might have hit the bottom. This could mean house builders bucking the forecasts and increasing build volumes into 2012/13.

In terms of what is most likely to get built, there is currently a massive shortage of four/five bedroom family homes with garages and gardens. Demand for this type of property will continue and where market demand goes, funding will follow. The first-time buyer market is also still champing at the bit, so smaller units for first-time buyers will also be a focus. An appetite from house builders to look at apartments is also there, but that is probably one to watch.

Funding for new builds will continue to be a struggle, but as with the rest of the real estate market, residential developers are finding ways to move forward. Investment-fund and house builder innovation in the way they structure deals is helping to finance deals that might otherwise have fallen down in the current market.

The presence of overage in most deals now and in some case underage, where the landowner takes a risk on the price of land post planning consent, is an example of how things have changed and will continue to change.

As with commercial ground rents, we expect to see continued interest from investors in residential ground rents. The biggest challenge is likely to be the ability to build up the necessary scale given the continued constraints on the supply of new stock and availability of personal mortgages.

Section 106 … a wish for 2012

Quite often a small change can make a huge difference. If the Government wants to increase house building in the years ahead and meet its commitment to reducing red tape, it should make 2012 the year it sorts out the production of section 106 agreements.

An increasingly laborious and lengthy process, section 106 agreements are delaying house-building projects unnecessarily through complexity and a lack of adequate resource at a local level to deliver. A relatively simple wish that could make a significant difference!

1 As reported in Inside Housing magazine, using figures published by the Communities and Local Government Department: www.insidehousing.co.uk/news/development/house-building-hits-record-low/6513745.article
The battle for the high street

The retail blood bath continues with La Senza and Barratts Priceless just two of the latest high-street names to have problems. Unfortunately for landlords, pressure on their retail tenants is coming not just from the economy but also from longer-term structural changes to how the nation shops.

As demand continues to wobble, 2012 will see stubborn rents and increased rates liabilities driving many retailers to shed their worst-performing stores. The worst-performing retailers will need more drastic action, including pre-packs with opportunistic purchasers cherry-picking stores. Landlords will be forced to be ever more flexible as more retailers become distressed.

The trend towards increased polarisation between high-quality prime shopping centres and lower-quality centres will continue. This polarisation will also be played out at a regional level as depressed consumer demand will not be spread evenly across the UK. Secondary shopping centres are likely to become more service orientated.

Any mediocrity in retail will be punished. Retailers that fit into a clear segment of the retail sector are more likely to succeed. New entrants, including overseas entrants new to the UK, will take advantage of cheaper space but only in major centres.

Retailers with both an online and high-street presence are increasingly enjoying better figures from online sales than like-for-likes from its stores. The most successful will enjoy a fully functioning multi-channel offering. Partly as a result of growth in the online market, there is a shortage of available distribution centres in the UK, with a resulting fight for space in this area.

The big supermarkets will continue to take new stores and infill where planning consent for food is obtained. As with distribution centres, there will be a fight for space in this area with an increasing shortage of supply compared to the high street’s difficulties.

The Mary Portas review is likely to have limited impact in the short term. However, a light may well be cast on councils’ car-parking charges in town centres and also on councils’ letting policies for their own high streets.

Out-of-town still a concern

Out-of-town development continues to challenge the UK high street. In 2012, there will be increasing pressure on the Government’s Town Centres First policy in PPS4 and retailers’ requirements for appropriate edge-of-centre sites. This will be reinforced by the draft National Planning Policy Framework that reiterates the Town Centres First policy as well as the sequential test and impact assessments.

The ongoing economic situation will add to this pressure. We may well see councils granting edge-of-centre sites where there is a strong benefit to the local community (jobs, enabling development, etc.) despite the Town Centres First policy.
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**Infrastructure**

**The rise and rise of infrastructure**

As 2011 drew to a close, the topic of improving UK infrastructure was brought into sharp focus. Both the Chancellor’s Autumn Statement and the National Infrastructure Plan (TNIP – published in November 2011) have been responsible for infrastructure’s rise up the political and social agenda, with the latter affirming that “infrastructure networks form the backbone of a modern economy and are a major determinant of growth and productivity”.

Indeed, TNIP sets out the strategy for meeting the infrastructure needs of the UK in a manner that should help kick-start the economy. TNIP sets out a clear pipeline of 500 infrastructure projects, the finance required to deliver those projects (with a new approach to co-ordinating public and private investment in the area) and the role of government, in ensuring that the projects are delivered on time and to budget.

In the short term, a number of key details do need to be ironed out, not least the overdependence of TNIP on pension funds and institutional investors, but the outlook is much more positive for the real estate sector in the medium term. Rail and road infrastructure has been targeted for major improvements by Government, with £5 billion promised in this Parliament alone. An amount of £400 million has been earmarked for the house-building and construction sector, with the aim of revitalising residential developments a key driver for this.

Alongside these commitments, opportunities for infrastructure development are ripe in the digital business sector with the continued roll-out of broadband. Also in the renewable energy space, with a range of government-backed subsidies available for large or even smaller-scale energy infrastructure developments. These can be stand-alone or perhaps, as we are increasingly seeing, tied to new commercial or residential developments.

Finally, it is cheering to note that some aspects of infrastructure development are growing and look very strong into 2013. Most notably, student accommodation in higher education is high on many university agendas and we are seeing a steady stream of deals coming to market both for on-campus solutions and off-campus developments.

The pressing need for tackling waste, security of energy and reducing carbon is also driving a strong pipeline of anaerobic waste and biomass power schemes and we will see an increasing number of these being contracted in the coming years.
Regeneration

What next for enterprise zones?

Early 2011 saw the creation of 21 new enterprise zones with incentives including lower taxes and reduced regulation. Late 2011 saw government announcements around the need to invest in infrastructure. The success of the first is inextricably linked to the second. Would the most successful enterprise zone to date – Canary Wharf – have done quite so well without government investment in the DLR and Jubilee Line extension and enterprise zone allowances?

The focus for 2012 must therefore be on how regeneration and infrastructure planning are connected and, critically, adequately financed. Without this connectivity, we are unlikely to see the private-sector growth and wider regeneration objectives of the enterprise zones realised.

Much talk to date has been around the need to introduce Tax Increment Financing (TIF) into England. TIFs are a way of public funding infrastructure by securitising future business rates generated by a new enterprise zone to raise capital. The government has already made positive noises about TIFs, but there is nothing concrete yet in terms of a consultation process or implementation timetable. We could see some movement here in 2012.

Although undoubtedly one way of public financing of infrastructure, it is also a slight red herring in terms of being the panacea to our local public infrastructure funding needs. Perhaps 2012 will see a much broader debate about innovative ways for local authorities to raise the necessary funds. For example, might we see local authorities allowed to use business rates from enterprise zones to create an instrument that enables them to raise money on the bond market for infrastructure funding?

In the current climate, central government funding is unlikely to be as forthcoming as it was for the Jubilee Line extension. These enterprise zones will need to stand alone financially if they are to be a success story in the long run, in the same way as Canary Wharf. Fingers crossed that 2012 delivers.

Paying for green regeneration

A big question that the Government will need to tackle in 2012, and looking further forward, will be the extent to which the costs of green regeneration can be borne solely by developers. For example, achieving a zero carbon or code six home for a residential developer adds significant extra cost. With the consumer currently unwilling to accept a price premium, this cost is borne entirely by the developer.

Regeneration projects, like the Olympic Park area, are increasingly led by residential development. How the cost of building sustainable buildings is met will increasingly be an issue as regeneration in and around town centres starts to take root. The system as it currently works is a disincentive to regeneration and development.

To ensure green regeneration, the government will likely have to look again at how it makes this happen in 2012. Perhaps we’ll see a Government-owned green energy pool that contractors pay into and which government distributes to developers, owners, landlords and tenants as required to either green a new or retrofit an old building.
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