BE NEWS

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HOW TO MANAGE CAPITAL THROUGH ECONOMIC CYCLES

Leading industry voices came together for a roundtable discussion hosted by *BE News* and sponsored by Newcore Capital to discuss the key challenges and opportunities for capital management in the second half of the year

INDUSTRY GUESTS:

Andrea Carpenter, founder, Women Talk Real Estate

Anne Copeland, Social Impact Infrastructure

Charlie Ferguson Davie, co-chief executive and chief investment officer, Moorfield Group

Christian Janssen, managing director and head of real estate debt for Europe, Nuveen Real Estate

Bernd Kerner, director, Kerner Kapital

Hugo Llewelyn, chief executive, Newcore Capital

Rob Mills, deputy managing partner, Clearbell Capital

Sanjeev Patel, managing director, PPP Capital

Neil Sarkhel, chief operating officer, Newcore Capital

Neil Sinclair, executive chairman, Pristine Capital

Mickola Wilson, owner and director, Seven Dials Fund Management

Liz Hamson, editor-in-chief, *BE News* (chair)

This May, the UK moved out of recession as GDP grew 0.6% – the fastest growth seen in three years. However, at the INREV conference in April, the mood among the institutions remained subdued, with the stuttering economic recovery continuing to put a dampener on expectations of market recovery. Against an uncertain political and economic backdrop, many businesses in the capital management industry are struggling.

BE News hosted a discussion with leading UK fund managers and propcos to explore how to manage capital through difficult times. In addition to discussing what can be learned from previous cycles and what is different about this cycle, the panel of experts were asked to pinpoint the key challenges and opportunities for capital management in the second half of 2024 and under the new government in 2025.

The debate, chaired by *BE News* editor-in-chief Liz Hamson, kicked off with a scene-setting talk by Andrea Carpenter of Women Talk Real Estate, and author of *High Rise and Fall: the Making of the European Real Estate Industry*.

Carpenter discussed previous economic cycles and said: "There are some footprints for what we're seeing and how we are as an industry today, which maybe will help us think about how we deal with this challenging market."

House of cards

In the lead-up to the global financial crisis (GFC) in 2007-08, interest rates were a factor, but other things were also happening in the wider economic environment of the 2000s. In addition to government bond rates converging, the property industry saw a rise in debt.

"The Americans had brought over a really highly levered approach that kind of affected us and got contagious," said Carpenter.

Then the collapse of Lehman Brothers brought the house of cards tumbling. "We went into absolute meltdown and suddenly people were saying: 'We should actually probably drive value from our buildings.' 'I'm never using debt again.' 'I'm going back to driving my return through asset management,'" she added.

"Maybe we're in a different phase now where we work even harder. The structural change we've seen through retail and working from home means operational real estate is so much more hands-on now and it is more focused on driving value from buildings and really working with tenants and consumers.

Andrea Carpenter

Mickola Wilson

And of course, no one is going back to debt."

The panel were then asked if they thought the Labour government would introduce new opportunities and bring some positive sentiment to the market.

Seven Dials Fund Management's Mickola Wilson said there would be a "very optimistic and upbeat six, nine and 12 months, and then a bit of a reality check" – or, as Pristine Capital's Neil Sinclair put it, a "new manager bounce".

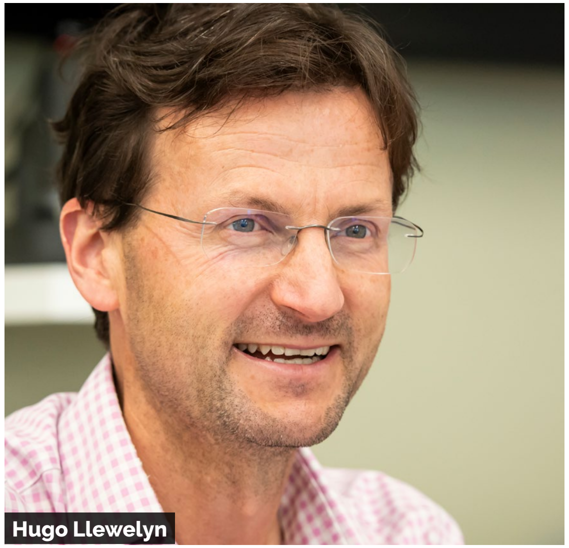
Wilson said that due to wider global political and economic issues, there were some problems that could not be "solved with enthusiasm". She added: "But hopefully they'll have got far enough down the road to make some meaningful changes in our industry at least".

> ***Hopefully [the government] will have got far enough down the road to make some meaningful changes***
>
> *Mickola Wilson*

According to Wilson, the new government should be able to push through proposed changes to the planning system given its majority in parliament. But in terms of delivering much-needed economic growth, she said: "It could be harder than the dialogue. I'm not saying they don't understand how hard it's going to be, but the reality check is inevitable at some point."

Sanjeev Patel, of PPP Capital, said the government had its "lovely ideas", but "these are not free and there's no magic tree", and it hasn't "explained that to the electorate".

He added: "These things cost billions. You must pay it back and you must raise taxes to do so. The government will be constrained no matter how much money they raise – they'll realise they can't do everything."



Hugo Llewelyn

Neil Sinclair

Rob Mills

Equating the global bonds market, and what's happening in the US, Newcore Capital's Hugo Llewelyn said "it is possible that the UK government will keep interest rates at 5%", not 1%, and "if that interest rate rises, driven by factors in other markets, depends on whether you want to lend to the American government or to us, and what's the relative price and the cost of currency".

Ahead of the Bank of England's decision to cut interest rates in early August from 5.25% to 5%, the panel were asked how much they believed interest rates would come down by. Sinclair correctly predicted the drop would only be 0.25%, and he expressed his concerns about the content of the upcoming Autumn Budget.

"I'm one of your cynical people," he said. "I read the King's Speech. Leopards don't change their spots, and some of the things in there are just anti-business, like the anti-employment things they're talking about and the anti-strike laws. That's not helpful. I don't know how you can create growth by suggesting what they're suggesting."

'Compelling option'

Meanwhile, Rob Mills, from Clearbell Capital, said most new governments have grand plans about how they are going to get lots of stuff done, but they often end up achieving less than they had hoped.

He added: "Although a non-chaotic, non-shambolic government is a low bar, it's something the UK hasn't had for a long time, and investors are responding to this. The UK looks like a compelling option compared with some other countries now, for example the US, France and Germany, which are grappling with their own issues."

Despite conversations mainly focusing around interest rates, Mills said inflation was where people's attentions should really be focused, "because that's what's going to matter". He added: "When you peel back the onion, everyone can see the extent of the problem. For example, services inflation is still running at 5% and it is likely to continue."

He continued: "Everyone is asking: 'Are they going to cut rates in three months' time?' But it doesn't really matter; it's more about whether interest rates will come down in the medium to long term. It's not about changing the short-term curve."

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Christian Janssen

Charlie Ferguson Davie

Bernrd Kerner

For Nuveen Real Estate's Christian Janssen, perspective is everything. He said that, yes, the market had experienced a dramatic 200- to 300-basis-point increase in rates in a very short period, "but in the longer term, rates are not particularly high".

Janssen said in the last decade, the UK had experienced "an abnormally low-interest-rate environment".

He added: "I'm not necessarily saying it's the 'new normal', but the notion that 10-year gilts at 2% or 1% is 'normal' is incorrect. Yes, the short end of the curve probably will go down – it's not going to stay at 5.25%, but most of real estate doesn't benchmark itself off the short-term end of the curve. They do it in five- or 10-year swap or gilt rates.

"Are we saying that interest rates will go back to 1% as they were a couple years ago? I strongly believe that they're not going back to those levels. I'm not in the market to forecast rates, but the forward curve is flat at 3% to 4%."

The discussion moved on to where the UK stands internationally under the new Labour government.

"We're being seen as being more stable," said Moorfield Group's Charlie Ferguson Davie. While the UK might have been happy with generally low interest rates over the last five years or so, the country "was on the naughty step and international investors did not want to touch the UK", he said.

Now, however, Ferguson Davie said investors would think about the promises Labour was making, "and the prospect of more stability [in the UK], and that looks good relative to Europe and the US", particularly with the US political system in a state of flux.

"I think it is probably going to be quite fractious and unstable [whoever wins the US election in November]," he continued. "People talk about the risks of civil war, and a lot of conflict, and that could lead investors from all around the world to put less money into the US."

Looking back at the 2008 financial crash and the financial crisis in 2011, the panel were asked what lessons the industry had learned from these bruising experiences and whether companies were more proactive than reactive at the time. Did they see what was coming in advance?

Liquidity 'drying out'

It's an interesting question from a lending perspective, said Bernd Kerner. While the GFC was approaching, he said you could see liquidity "drying out" in the markets, starting on the commercial mortgage-backed securities side and subsequently affecting syndication markets as well. In addition to interest coverage ratios (ICRs) and debt service coverage ratios (DSCRs), the debt yield became more important, he added.

"Following the increases in interest rates from the end of 2021 onwards, financial covenants like loan-to-value [LTV] and ICR/DSCR were still the lenders' main

Anne Copeland

When trying to market healthcare in 2002, people thought I had drawn the short straw

Anne Copeland

Neil Sarkhel

instruments to monitor transactions while the debt yield came more in focus with a view on the exit/maturity of a transaction," Kerner explained.

He said that in a low-interest environment, the focus on debt yields seemed to have slowed down, adding: "But all of a sudden you see interest rates going up and from a lending perspective, the exit is more important.

"That's why you look at the debt yield as well, and what's going to happen from an underlying cashflow perspective, especially in three to five years' time, and what's going to happen on the borrower's side.

"When the water got a little bit calmer but with interest rates remaining on a higher level than before the end of 2021, the ICR got more important again. Nevertheless, debt yields are not neglected, but from a lending perspective, I look at LTVs, ICRs/DSCRs and debt yields to form a view on a potential exit/refinancing scenario."

Healthcare risk

Talk then shifted to how the market today views popular assets like those in the healthcare and living sectors compared with 20 years ago.

"When trying to market healthcare in 2002, people thought I had drawn the short straw," said Anne Copeland of Social Impact Infrastructure. "I was given a lever-arch folder that said 'NOIR' – 'not office, industrial, retail'."

She explained that in relation to healthcare assets in particular, clients were worried about risk. "What they wanted to know was 'if an old person falls down the stairs, will my name be in the press?' 'What if someone dies?' I said: 'I can tell you that someone will die today in one of the buildings because it's end-of-life care, which, by definition, the pathway is death.'"

As a fund manager, Copeland said her intention was to tell investors that while they may not see the heady yield compressions that industrial or City offices may see, she never sees the opposite either.

She added: "If I'm boring, if I don't

Sanjeev Patel

Liz Hamson

surprise you, I've probably done my job well. Just deliver. Don't overpromise; just do what you said you're going to do. Look to those essential services where, effectively, private capital can fund UK plc, which is currently a great opportunity with the Labour government to step in at scale, for all of us."

Future outlook

To conclude the discussion, panellists were asked what they felt the biggest investment opportunity would be in the next five years and how optimistic they felt about capital markets up to 2029.

Neil Sarkhel, of Newcore Capital, said that in terms of capital potential and capital inflows, if the new Labour government continued to push for more onshoring, and for local pension teams to put the money into the UK, "because we're all looking for where those flows are and you're a forced investor of 5% of your balance sheet, that could be an inflow capital".

As we are currently at the bottom of the cycle, Patel said that he felt positive about the future, and that for the residential market in particular there was strong potential for growth.

"We still must house people so [there will be] stable demand, growing demand and opportunity, and rents will increase a little bit also," he added.

Sinclair summed up his prediction for the future in one word: "distress". "Being blunt, it's the opportunity," he said. "In the commercial world, we're starting to see quite a bit of it, not just from banks but from institutions. The levels of some losses are quite mind-boggling, but I'm optimistic."

Llewelyn said he was optimistic that the main spenders of money in social infrastructure, namely the government, whether through pension funds or central government funding, would adopt a new way of deploying capital through managers and that it was possible that the UK government would keep interest rates at 5%.

He added: "There needs to be a legal contract with your clients, your capital and your customers/tenants and there's a social contract as well."

Llewelyn said he hoped the future of institutional capital management in the UK would be "in favour of people who do both of those", adding: "So I'm optimistic, because at Newcore, that's what we're trying to do, and I hope that will see a change in how capital gets managed." □

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Sanjeev Patel