Rates Look Set To Stay Higher For Longer, But That Doesn't Mean All Property Values Will Fall

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The UK's challenging economic environment shows few signs of easing. To combat persistent inflation, the Bank of England increased interest rates by 0.5% in June, and markets now expect rates to peak around 6%

by the end of 2023 (https://www.bloomberg.com/news/articles/2023-05-27/former-boe-hawks-say-uk-interest-rates-headed-to-6-pain-level). Two-year gilt yields are at their highest level in 15 years (https://www.ftadviser.com/mortgages/2023/06/14/what-soaring-gilt-yields-mean-for-mortgages-and-pensions/).

So do higher-for-longer interest rates mean that property values should fall further? Not necessarily, Birchwood Director Kate Tovey said. *Bisnow* spoke to Tovey about where Birchwood views opportunities for real estate investors against the current economic backdrop.

Bisnow: What is your view on the impact of the current interest rate environment on real estate?

Tovey: We've seen differing degrees of value reset over the past 12 months, and while this happened faster in the UK than other European markets, the recalibration is not uniform.

Some commentators have looked to the relationship between interest rates and yields, but the two are not perfectly correlated. There have been periods historically where property yields have been both higher and lower than gilts.

Instead, a better benchmark for investors to consider may be total returns for a real estate strategy. Higher-for-longer interest rates doesn't necessarily mean that property values should fall further, although in an uncertain yield environment, the ability to underwrite cash flows and future rental growth is key.

For this reason, as a lender, we think it is important to be asset-led, examining individual supply and demand dynamics and other market trends. As the market accepts high interest rates, we see relative value coming through in high-conviction strategies, for which returns are primarily driven by income growth.

Bisnow: Are there sectors in particular that offer income growth?

Tovey: Certain asset classes are benefiting from a supply and demand imbalance, underpinned by current market demographics and trends. This supports the case for value stability and long-term growth from already-rebased values.

Two such areas are the residential and purpose-built student accommodation markets. There continues to be a structural undersupply in both these asset classes, exacerbated by high construction and materials costs.

Taking PBSA, the undersupply is having a significant impact on students. There are 2.2 million full-time students in the UK (https://www.cushmanwakefield.com/en/united-kingdom/insights/uk-student-accommodation-report), but the student-to-bed ratio is 2.39-to-1. In certain cities, universities cannot guarantee accommodation for all first-year students.

Bisnow: Residential aside, are there any areas of commercial real estate that present strong opportunities?

Tovey: The supply-demand metrics of the industrial and logistics sector also present opportunities. There are many factors influencing demand for space, including supply chain disruption due to the war in Ukraine, the pandemic and Brexit. Manufacturing businesses increasingly desire to create more robust supply chains through nearshoring (https://www.cushmanwakefield.com/en/united-kingdom/insights/nearshoring-opportunities-for-businesses), bringing production closer to where a product will be consumed.

Like the residential sector, investors are already displaying conviction in the strength of industrial and logistics. Yields moved out faster in this sector but are starting to come back because trends such as nearshoring and digitisation are already increasing demand for space in well-connected areas.

Income growth can also still be found in areas that some investors are now starting to avoid, such as offices. While there are a lot of negative headlines about offices, fundamentally, there is an undersupply of the highest-quality space, which is where everybody wants to be. There is demand for best-in-class offices that support the decarbonisation agenda.

As an example, we're still seeing rental growth work its way through in assets such as best-in-class offices with top ESG credentials. It's about finding those individual markets that have a growth story.

Bisnow: As mortgage rates impact consumer spending later in the year, what effect will this have on which assets produce income growth?

Tovey: Outside the more established sectors, opportunities can be found in alternative areas that derive income from need rather than discretionary spend and hence may be more insulated from the tough economy and cost-of-living pressures.

Some of these are more nascent sectors in the UK, such as life sciences or self-storage. Both are growing asset classes, and in this latter area, the UK has an undersupply relative to other global markets.

At Birchwood, we have flexible capital to lend across all asset classes and are looking to support borrowers to deliver their business plans, particularly in markets where there is a supply-demand imbalance and where their strategies align with our ESG-led investment thesis.

Bisnow: Given the current market backdrop, how is the lending landscape in the UK?

Tovey: Lower transaction volumes are certainly being felt across the debt market, too, although there is a weight of refinancings due which may no longer naturally fit within the parameters of traditional lenders.

Alternative lenders are well-placed to support borrowers with acquisitions or refinancing of high-quality real estate assets at rebased values.

As a recent entrant with significant committed capital available to lend, Birchwood takes a real estate-led approach to underwriting through current market volatility, with local decision-making. We are seeking appropriate risk-adjusted margins without use of back leverage or requiring syndication partners. This allows us to deliver with speed and certainty of execution.

Yields may still be recalibrating, but there are clear opportunities for thematic investment in quality assets where longer-term trends support income growth. Undoubtedly, a volatile market presents opportunities, but establishing an appropriate capital structure is more important than ever.

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