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Bank of London & The Middle East

Built to Last

Why Gulf investment in UK real estate will endure and expand

Executive Summary

Inward investment from the Gulf into UK real estate is ramping up in 2022. The economic development of regions outside London, coupled with the pandemic recovery, are taking the UK's investment appeal to the next level. The continuing appetite from investors in the Middle East is boosted by the longstanding cultural, commercial and legal advantages which have traditionally drawn investors to the UK.

To understand this growing appeal, BLME conducted in-depth interviews with experts from across the real estate market, who work with investors from Gulf Cooperation Countries (GCC) countries or invest themselves. The experts we interviewed work for businesses holding more than £60 billion of Assets Under Management (AUM) in total.

This research highlights a clear opportunity for GCC investors to unleash the post-pandemic potential of property assets across the United Kingdom, with regional markets' growth now outpacing London's.[1]

We find that the changing world of work, the UK government's 'levelling up' agenda, and – most importantly – the rapidly increasing value of regional property assets, have combined to make the UK's regions an exciting investment prospect for those in the GCC.

In a global economy currently defined by inflationary pressures, supply-chain disruption and interest rate rises - GCC investors continue to view UK property as a 'safe haven' for their capital, with the London market's stability presenting an opportunity for wealth preservation.

Sectors which bore the brunt of Covid restrictions, including pre-pandemic GCC favourites such as offices, are regaining market confidence, creating renewed opportunities for investors. Combined with the continued strength of sectors which experienced phenomenal growth during the pandemic, including industrial assets such as warehouses, the COVID-19 pandemic no longer poses a serious threat to investor confidence in British real estate.

For GCC nationals, this reignites the draw of the UK - a market to which they have long been attracted. Our research demonstrates that GCC investors place high value on Britain's cultural soft power. Investors cite schools and universities as influential in their decisions, as well as the wider business climate Britain offers – an economy which is the world's sixth largest, and a mature Islamic finance market.

[1] UK House Price Index - Office for National Statistics (ons.gov.uk)

The property market in 2022/2023 will be a challenging one. Investors and their partners must combine analysis and sound judgement when choosing their investments. Based on our research from this report and experience in the market, we are seeing the following trends:

- Investors concerned with wealth preservation should focus their attention on London. There may be less running yield and capital appreciation to be realised, but the city is viewed as a 'safe' investment bet – a strong option for wealth preservation
- Regions away from the capital, on the other hand, offer higher yield potential. GCC nationals looking for investments which are higher risk, but offer the prospect of stronger returns, should search outside of London. Equally, GCC investors with assets in London should look to diversify their portfolio by supplementing it with higher-yielding regional assets. For example, prime City of London office yields are currently at 3.75%, whereas their equivalent in the regions is 4.75%[2]
- Representatives of GCC clients should deepen their knowledge of regional investment opportunities. Pandemic-era travel restrictions made investors place more trust in their advisers to find deals – so advisors need to develop their understanding of the regions and collaborate with regional partners
- Investors should meet with metro or city mayors on their trade missions to the GCC, to understand more about their plans for the regions. Strong opportunities can be found in the UK's lesser-known cities
- Investors for whom Sharia'a compliance is a requirement should look to the UK for opportunities. The UK has more Islamic banks and lenders than any other Western country, providing the richest variety of investment options of any Western market for practising Muslims

[2] Savills' UK Regional Office Investment Market Watch, published in March 2022

London, or the regions?

London has long been a favourite destination for international investment – in 2019, 42.4% of Foreign Direct Investment (FDI) into the UK was made into London.[3] BLME is active in both London and the regions. 50% of BLME's current portfolio is within London and the M25, with the remainder in the regions.

London regularly ranks as the most active cross-border real estate investment market, boosted by perceptions of the city as the most transparent for real estate deals.[4] And our expert interviews show that this view has endured post-pandemic.

Seven of the eight real estate investment partners we spoke to said GCC clients still view London as the UK's most desirable location for property investment. However, this level of demand, combined with the weight of institutional capital in London, makes it a highly competitive market, as noted by a majority of interviewees. London's high property prices therefore mean that it offers lower yields, but greater stability, for investors.

> "Investing your capital in London property is important for investors with a focus on wealth preservation. The yield may not be as high as in the regions, however, London is likely to remain an attractive location for investment over the long term and offers a strong level of liquidity."
>
> Andy Thomson, Head of Real Estate at BLME

The regions, on the other hand, present an opportunity for higher cash-on-cash returns. By 2024, house prices in the Northeast are forecast to rise by 21.5%[5]. Investors looking to capitalise on this growth should consider assessing these markets for opportunity. Investment returns in Salford, meanwhile, have risen to a record high of 32.3% this year, inclusive of rental income and capital appreciation.

As Raney Aburdene, Head of Investor Relations and Business Development at Capital Trust, puts it: "Because London is so in-demand, so desired, more and more investors are looking outside of it. London has become quite saturated … it's very hard to get strong returns there nowadays. It's very safe."

Half of interviewees said that investors' usual first choice is London, before shifting to other locations because of price.

Why are the regions an exciting investment prospect?

Political factors like devolution, demographic changes such as London residents moving elsewhere amid the pandemic, and the potential for strong Return on Investment (ROI) make the regions an attractive investment prospect for GCC investors.

As regional investors share their success stories, confidence in assets outside of the capital looks set to grow further, creating a virtuous cycle for regional real estate investment. James Procter, Real Estate Finance Director at BLME, says that "confidence in investing regionally will continue to grow as more investors share success stories on yield and capital preservation. In the next few years, we may see even more regional diversification."

[3] Foreign direct investment, experimental UK subnational estimates - Office for National Statistics (ons.gov.uk)
[4] Real Estate Transparency at a City Level (jll.co.uk)

[5] UK Property Investment Pros and Cons

Pandemic-induced changes to working practices have been crucial to this phenomenon. Lockdown restrictions necessitated remote working, and even as restrictions ended, hybrid and flexible working continued to be the norm.

No longer required to commute to London offices, some of the capital's residents are considering moves to less expensive regional cities. According to a survey by the London Assembly Housing Committee, at the start of last year 15% of respondents wanted to leave the city as a result of the Covid-19 pandemic.[6]

The pandemic therefore accelerated a pre-existing pattern: investment into the UK becoming more evenly distributed between the regions and the capital.

Well before the outbreak of coronavirus, major firms across a range of industries were relocating their offices outside of London.

HSBC moved its retail arm from London to Birmingham at the start of 2018, and the Magic Circle law firm Freshfields moved to a 40,000 square foot property in Manchester in 2015. Salford is home to a 'media city' with a 380,000 sq ft, 20-story BBC office.

The UK government's 'levelling up' agenda has also strengthened the regions' economic prospects, and therefore GCC investor confidence. This year's Queen's speech set out the government's agenda including a "Levelling up and Regeneration Bill" and the establishment of a "UK Infrastructure Bank", designed to boost regional infrastructure.

There has already been an expansion of such infrastructure projects, boosting connectivity, growth, and investment. This can be seen particularly in the expansion of regional airports such as Manchester, Birmingham and Leeds Bradford.

> "High-profile national infrastructure projects, including new rail lines and airport expansions, will continue to stimulate investment in Britain's regions."
>
> Anna Barratt, Real Estate Finance Director at BLME

The Northern Powerhouse Partnership, meanwhile, was established in 2016 to increase economic growth in Northern England. It included High Speed 2, a railway line linking London, Birmingham, and Manchester. The Government has said that by 2033, every major British city will have its own city central station[7].

Devolution has also given the regions greater scope to court investment. For example, regional mayors now lead city-based (as opposed to national) trade missions, and have powers over physical infrastructure and transport.

What's clear is that there is momentum in the levelling up agenda. Infrastructure investment is increasing, and this will impact appetite for commercial property in the regions and subsequently valuations. Investors should therefore take opportunities to meet with metro or city mayors on their trade missions to the GCC, to understand more about their plans for the regions and sound out investment prospects.

[6] Survey: Londoners want to move house but still stay in capital | London City Hallstment Pros and Cons
[7] UK Property Investment Pros and Cons

Post-pandemic prospects

COVID-19 restrictions had a powerful impact on the UK property market. Work-from-home mandates lessened demand for office spaces, students reconsidered their accommodation, and hospitality assets dropped sharply in value as lockdowns and social distancing restrictions impacted dramatically on business models.

The market's post-pandemic recovery, however, has presented an exciting investment opportunity – on which GCC nationals are capitalising.

The UK was among the first countries to end COVID-19 restrictions altogether, thus boosting its property market – particularly the office sector and industrial, which are now returning as favoured options among investors.

RICS' UK Commercial Property Market Survey – Q1 2022 showed that, for the first time since 2017, the investment enquiries indicators are positive across all three traditional property sectors (office, industrial and retail). [8]

Three quarters of the experts interviewed for this report said sectors damaged by the pandemic are regaining investor confidence. According to Hayssam El Masri, Senior Executive Officer at Ento Capital, "The office sector needs time and stability, but the lifting of Covid restrictions has given more confidence to investors and activity will pick up. Most major companies are asking people to come back to the office for at least one day a week, and Civil Servants have come under pressure to return to their desks in Whitehall."

The office sector comprises 24% of all Middle Eastern investment into UK property[9] and there have recently been a number of deals underlining its ongoing appeal to the GCC.

The UAE's Oryx Real Estate Partners recently spent £100 million acquiring 3 Bunhill Row, a freehold office property in the City of London. Meanwhile, Saudi Arabian Sharia'a compliant asset manager Sidra Capital acquired Coca-Cola's UK head office in Uxbridge, in December, for £43.65m.

> "Offices are returning to pre-pandemic levels of popularity among investors. Nobody is as productive at home as they are in the office, and pandemic restrictions are now over."
>
> Tareq Hisham Hawasli, Co-Founder at Darin Partners

BLME has been supporting GCC investors with acquiring UK properties, and now has £300m of Sharia'a compliant facilities. The company is seeing new enquiries on a daily basis from existing GCC clients, and from new clients aware of the facilities we provide.

RICS' survey also found that headline rental expectations for the office sector turned from negative in Q4, to positive in Q1 of this year[10]. Boosted by growing demand, office landlords now expect their rental income to increase.

50% of the interviewees said that because of the pandemic, there has been more activity around industrial or logistical assets such as warehouses, and around 'essential' retail assets such as supermarkets and pharmacies. Experts also pointed out that these growing asset classes will continue to expand.

Raney Aburdene, Head of Investor Relations and Business Development at Capital Trust, pointed out that although pandemic-fuelled ecommerce made warehouses attractive, this appeal has not faded with the easing of lockdown measures, so they remain desirable to GCC investors.

Retail warehouses are seeing strong demand from Gulf investors because they are drawn to the long-term leases, inflation-linked rent reviews, and attractive yields which the sector offers.

Market confidence in physical retail, on the other hand, has not yet fully recovered, and there has been a 'flight to quality'. The outlook remains positive for prime locations in Central London, but investor confidence lags in secondary and tertiary retail (assets located in less desirable locations, further away from high streets and major centres).

Overall, though, the recovery of sectors damaged by the pandemic, combined with the continued success of those boosted by it, provides a strong outlook for UK property investment. 63% of experts interviewed for this report said the pandemic no longer poses a serious threat to investor confidence in UK real estate.

However, the instability of the global economy pre-pandemic had meant that investors are looking for long-income transactions, meaning leases of a decade or more. The real test will therefore come when these leases come up for renewal.

[8] RICS UK Commercial Property Market Survey
[9] Middle East investors set to snap up $1.5bn in UK commercial property in 2022 (thenationalnews.com)

[10] RICS UK Commercial Property Market Survey

Culture, commerce and the law

Our research finds that regional economic development and the pandemic recovery have created exciting new opportunities for GCC investment in UK property.

But this is in addition to the traditional factors which have long attracted GCC investors to the UK. GCC investors are attached (and in some cases have become more attached) to the longstanding cultural, legal, and practical benefits which the UK offers. These include a range of Britain's internationally renowned cultural exports, such as the Premier League, and the convenience of travelling to the UK from GCC countries.

Cultural Capital

For GCC investors, the UK's distinct cultural appeal is regularly viewed as one of its most attractive features. The UK, for example, consistently ranks in the top two countries globally[11] for the quality of its higher education institutions. Many GCC investors went to the UK's world-leading universities or boarding schools, and many want to send their own children to them.

The global influence of UK cultural exports play a key role, with uniquely British institutions ranging from the Premier League to the Royal Family enhancing its place in the consciousness of GCC nationals. Of the individuals interviewed for this report, three identified British cultural exports as a significant draw for the market.

> "GCC investors have an emotional attachment to the UK, and especially London. They are buying into a place where they may have studied, where part of their upbringing and many family holidays took place, and where they aspire to send their own children for further education. Other than tourism, the UK has two key pulls - its educational and medical facilities, and these will always maintain their internationally recognised status."
>
> Naseer Aka, Managing Partner at Lanesbrook Real Estate

The appeal of such exports is demonstrated by the fact that two of the Premier League's largest clubs, Newcastle United and Manchester City, have owners with close ties to Saudi Arabia and the United Arab Emirates respectively.

The most important facet of the UK's cultural appeal, however, is its language. Three interviewees identified language as a strong advantage the UK has over other European markets. Crucially, it provides a key boost to how transparent a country is seen as for doing real estate business – only one non-anglophone city, Paris, makes it into JLL's top twenty most transparent cities for real estate investment.[12]

[11] QS Higher Education System Strength Rankings (HESS) 2018 | Top Universities
[12] Real Estate Transparency at a City Level (jll.co.uk)

> "The UK is a well-known and popular market with Middle Eastern investors, particularly given the historical relationship between the region and the UK ... it is an English-speaking epicentre in Europe, where investors are used to putting their capital."
>
> Bassam Kameshki, Head of Middle East at Cordatus

Location, location, location

The convenient location of the UK also adds to its attractiveness to GCC nationals, especially in comparison to the world's largest market, the US. The UK is a shorter distance away than the US, and direct flights from Dubai are now available not only to London, but also to some of the big regional centres: Birmingham, Glasgow, Manchester and Newcastle. With pandemic restrictions on entry to the UK now a thing of the past, geographic proximity is a crucial benefit of investing in the market – as identified by a third of those interviewed.

As Andy Thomson, Head of Real Estate at BLME, points out, "It takes seven hours to fly from Riyadh to London, compared with 13 hours to New York … and the longer time difference makes doing business in the US a lot more challenging, especially when it comes to legal negotiations."

The commercial and legal environment

As one of the world's largest economies, with one of its most developed financial sectors, the UK's wider business climate makes it an appealing place to do deals. The Financial Ombudsman Service and the Financial Services Compensation Scheme ensure the protection and security which GCC investors look for.

Significantly, the UK has a larger and more sophisticated Islamic finance sector than comparable markets. Having assurance that an investment is Sharia'a compliant is important to many GCC investors, the vast majority of whom are Muslim.

Anna Barratt, Real Estate Finance Director at BLME: "The Sharia'a compliant finance offering is not as strong in the US. They offer a wrap-around conventional finance options, which is not sufficient for some GCC investors. In the UK, Sharia'a banking is much more established."

Of eight experts interviewed for this report

5 – Five said the UK's legal environment has strong investment appeal

3 – Three said the UK's cultural capital draws in GCC investors

3 – Three said the UK market's attractiveness comes from its wider business and economic climate

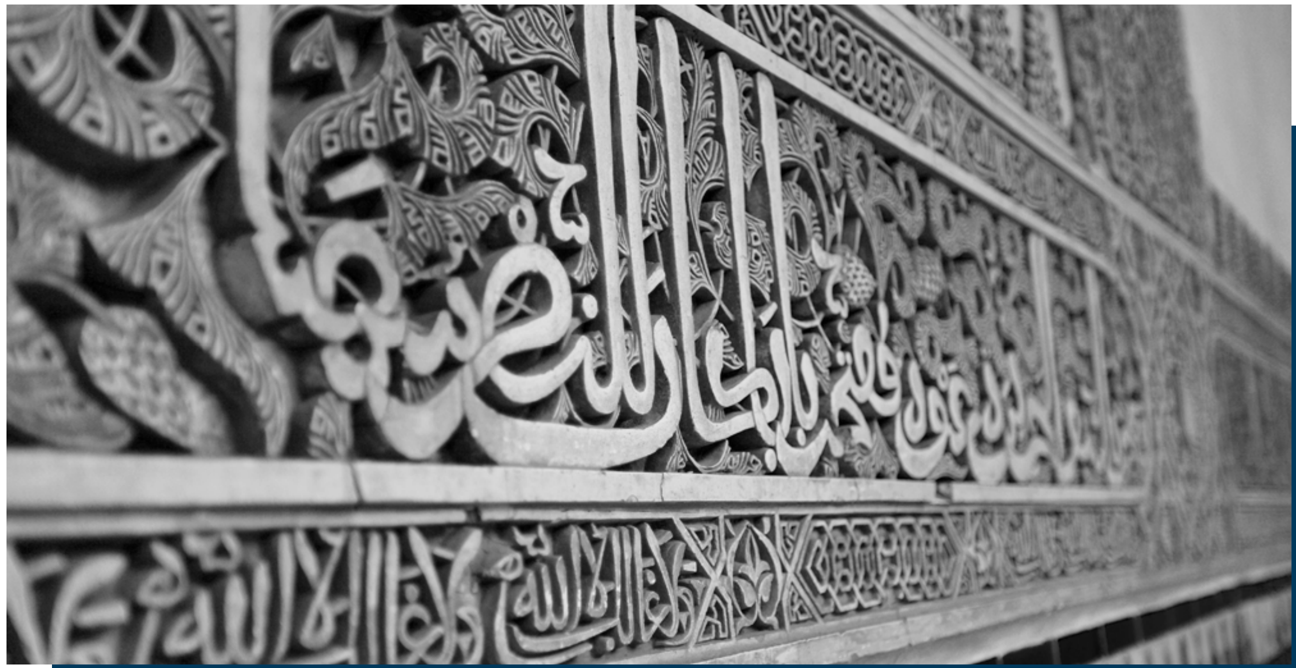
The UK has more Islamic banks and lenders than any other Western country[13], providing the richest variety of investment options of any Western market for practising Muslims. Since 2003, the UK government has passed legislation, most significantly the 2005 Finance Act, to make the Islamic finance sector as tax efficient as its conventional counterpart[14].

The UK offers dedicated, Sharia'a specific investment products, creating a bespoke service for Islamic investors. This sets it apart from, for example, the US, where Sharia'a finance options are 'wrapped around' conventional ones. The size and strength of Britain's Islamic finance sector is vital to investors from the GCC, a region where around 85% of all citizens are Muslim.

UK real estate also provides a favourable legal framework, with 63% of experts interviewed reporting that GCC clients are attracted to this aspect of the UK market. According to Scott McKinnon, Property Finance Director at Mutual Finance, "customers continue to enjoy and prefer the stability of UK property law compared to other jurisdictions in Europe."

The UK's favourable legal climate includes an absence of rent controls, a lack of restrictions on foreign investment in UK property, and lease structures which provide flexibility for landlords.

> "The UK is a proven market. GCC investors have been active here for the last 50 years and there is a degree of comfort around the legal framework and ownership rights. Long-income deals tend to have an investor-friendly legal framework, providing landlords with protection when deploying capital."
>
> Naseer Aka, Managing Partner at Lanesbrook Real Estate



[13] Britain has more Islamic banks and lenders than any other Western country (citywealthmag.com)
[14] Islamic Finance in the UK: Regulation and Challenges (isfin.net)

What are the risks?

Inflation, interest rates and investment

Although there is excitement and interest in the UK real estate market from GCC investors, there are risks that investors must balance and contend with.

The largest among them are the potential for the U.K. to enter a recession, inflation and interest rates. Prices are rising at their fastest rate for 40 years - UK inflation jumped to 9.1% in the 12 months to May, and is expected to reach double figures by the autumn.

In June, the Bank of England (BoE) increased interest rates to 1.25%, the highest level in 13 years, driving up financing and mortgage costs. A majority of the experts interviewed therefore identified inflation and interest rates as the biggest risks associated with investing in UK property.

For example, Hassan Farran, Head of Middle East Capital Markets at Cushman Wakefield, expressed concern about the effects of interest rates on borrowing: "There has been upward pressure on financing costs, and I wonder, what will that do to real estate pricing?"

When interest rates rise, bond yields rise, so people want to invest in bonds rather than properties, which are generally lower-yielding. Material and labour costs are particularly sensitive to increases in the rate of inflation, so construction is becoming more expensive.

> "The rising price of materials and labour has, in many cases, led to cost overruns. Interest rates and inflationary pressures will be the biggest issues faced by the UK in the coming period."
>
> James Procter, Real Estate Finance Director at BLME

Recent price rises, particularly in energy bills, also make tenant failure more likely – especially for hospitality assets such as restaurants and hotels, because those are the things consumers cut back on in financial difficulty.

As Scott McKinnon, Property Finance Director at Mutual Finance, puts it: "There are retail and restaurant tenants out there that are really struggling. Their energy bills have gone through the roof. Tenant failure is a concern."

There is a dual impact of increased costs, such as staffing and fuel, for retail and leisure businesses, coupled with potentially lower demand from consumers, due to the decrease in their own disposable income.

However, these risks are not restricted to the UK. The BoE's latest interest rate decision was preceded by, and arguably a response to, the US Federal Reserve's announcement of the highest increase in American interest rates for over two decades. US inflation, meanwhile, is at a 40-year high.

The issue of inflation is not exclusive to the UK market – but it is providing an advantage for it. The strength of dollar-pegged currencies in the GCC region against a weakening pound continue to make it attractive. Real estate is often considered an effective inflation hedge, and the UK is viewed as a financial 'safe haven' because of the legal protection it gives investors.

> "In today's economy, concerns around inflation and interest rates apply to most developed markets. The BoE's decision to raise interest rates was likely a response to action taken by the US Federal Reserve."
>
> Anna Barratt, Real Estate Finance Director at BLME

Conclusion

There are clear opportunities for GCC clients to invest in UK real estate. As one of the first European countries to end pandemic restrictions, sectors damaged by COVID-19 have begun to bounce back – and in some cases are looking stronger than ever. That is why Middle Eastern investors are expected to spend $1.5 billion this year on UK commercial real estate.

The longstanding desirability of properties in London, and the legal security which the UK offers investors, makes investment in the capital city a strong hedge against inflation – the most significant factor shaping today's global economy.

The regions, meanwhile, offer the chance to earn higher returns on investment. The continued development of infrastructure projects such as HS2 will power regional economic growth even more – with GCC investors in a strong position to capitalise.

This adds to the UK's existing advantages for attracting investment, ranging from its longstanding 'soft power' – with some of the world's most iconic cultural exports– to its internationally spoken language, favourable legal climate for landlords, and geographical proximity to the GCC.

As this report shows, the opportunities around UK real estate could spell a bright financial future for GCC investment in a dynamic UK market.

Interviewees

We would like to extend our thanks to the following individuals, who contributed to this report:

- **Bassam Kameshki**, Head of Middle East at Cordatus
- **Hassan Farran**, Head of Middle East Capital Markets at Cushman Wakefield
- **Naseer Aka**, Managing Partner at Lanesbrook Real Estate
- **Scott McKinnon**, Property Finance Director at Mutual Finance
- **Tareq Hisham Hawasli**, Co-Founder at Darin Partners
- **Raney Aburdene**, Head of Investor Relations and Business Development at Capital Trust
- **Hayssam El Masri**, Senior Executive Officer at Ento Capital
- A Senior Director at a leading commercial real estate services firm catering to GCC clients

Contributors to this report from BLME are:

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If you're keen to explore the opportunities in UK real estate investment, then please email the team at BLME:

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