UK Real Estate

A Spring In Its Step?

May 2025

Overview

Spring is in the air in the United Kingdom, and notwithstanding the market turbulence caused by the US tariffs, green shoots are evident in its real estate market. As the feeling of change we highlighted in our Investment Outlook 2025 continues to roll across the globe, there remains the chance of frosts and storms, but overall we look ahead to a generally predictable and gradually improving investment climate. In this note, we outline the latest in the key macro factors that we pay attention to and update what we are seeing in the main UK property sectors, plus we look in more detail at the central London residential market.

Summary

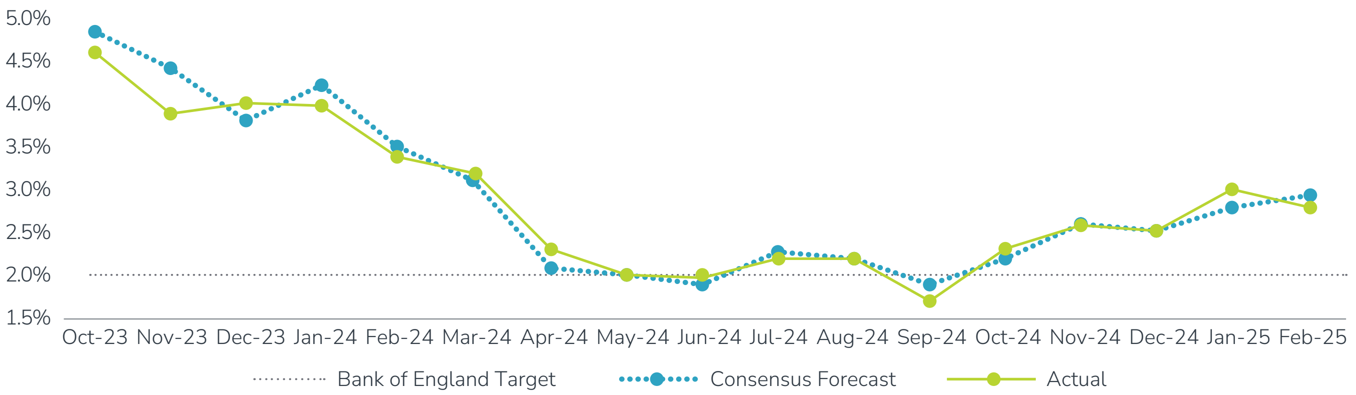
- UK inflation will fluctuate but should remain within a clear range
- Interest rates and financing costs should remain stable and broadly higher-for-longer
- Government is highly focused on growth initiatives given the current international trade frictions
- London residential real estate is a tale of two distinct markets

What We're Paying Attention To

Inflation

UK inflation has ticked up from its lows around 2% in summer 2024 to 3.0% in January of this year before settling to 2.8% in February. We had anticipated that inflation could run slightly hotter than its 2% target in the latter part of 2025, and it now looks as if inflation may fluctuate between 2.5% and 3.25% through 2025 - provided that it does remain within this range, this would be similar to the path that UK inflation took following its peak in the early 1990s. While the inflation range would be that bit higher, this outlook would still provide a helpfully benign environment for real estate investment: as rental income tends to provide a relative inflation hedge, this inflation outlook would give a sustained boost to income growth, particularly with shorter or inflation-linked leases.

October 2023 to February 2025 inflation prints:
Consensus vs Actual Number



Source: Reuters; The Financial Times

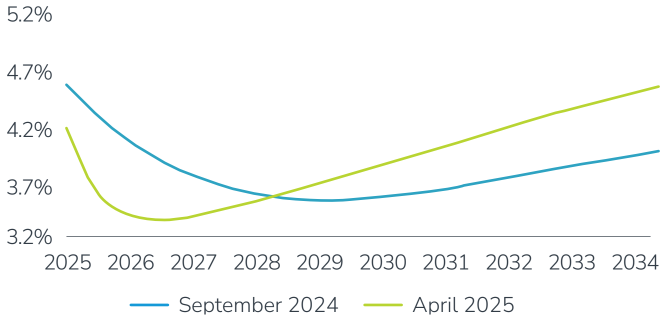
What this means for real estate investors

- We continue to favour explicit rent inflation linkage, or shorter unexpired lease terms, to hedge inflation exposure and capture inflation-led rental growth. While inflation is moderated but still fluctuating, this provides protection in the event of another inflation surge.
- Sectors more exposed to inflation, such as hospitality or leisure, became more attractive as inflation and wage growth reduced, although one may have pause until the inflationary path becomes clearer.

Interest Rates & Financing Costs

In light of the tariffs and trade tensions, the market is currently pricing a further four 25 basis point cuts during 2025 and 2026, which has resulted in a lower forecast bottom in the current loosening cycle. The market is now also pricing an earlier and steeper start to the next rising cycle.

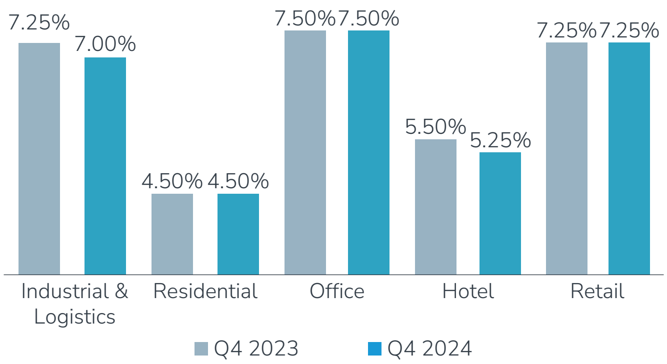
SONIA Forward Curve:
September 2024 vs April 2025



Source: Chatham Financial

This compares to revised expectations of cuts of 100 basis points by the US Federal Reserve and cuts of 75 basis points by the European Central Bank, pointing to a market view of the UK base rate seeing a premium of c. 200 basis points to the Eurozone and parity with the US by 2026. The market is currently expecting base interest rates of ~3.5% at the bottom of this loosening cycle compared to base rates of less than 1.0% from 2008 to 2022.

UK RE Capitalization Rates by Sector



Source: Knight Frank, excludes London and prime assets

From a UK investment perspective, this means expectations are currently for meaningful rate cuts in the medium term that give way to a relatively higher-for-longer environment in the longer-term, ultimately resulting in an ongoing window to acquire UK real estate at attractive cap rates compared to some other geographies In tandem, UK real estate financing costs should remain broadly stable, with lender appetite increasing (even for retail properties) and margins and available loan-to-value ratios steady. Together, this means a predictable UK market environment, with a medium-term interest rate outlook that can provide a favourable situation for exits in due course.

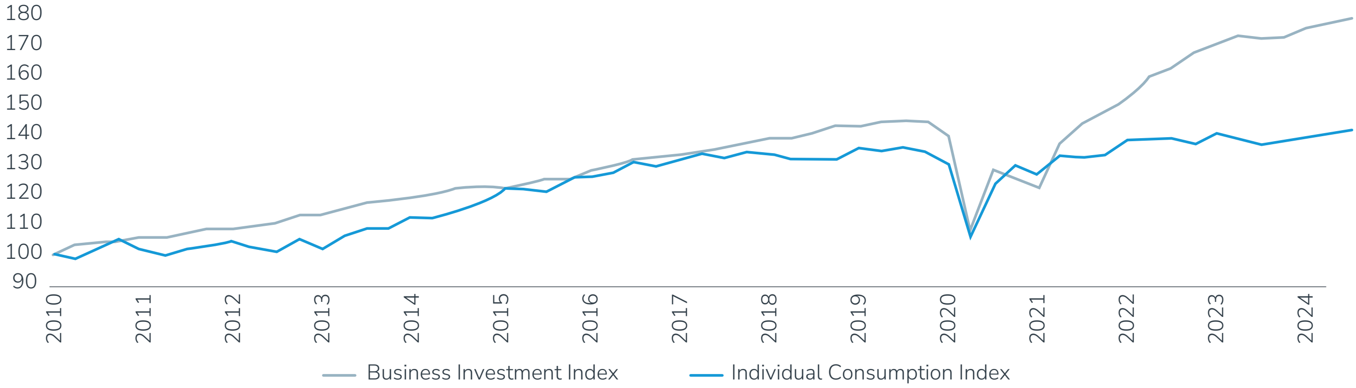
What this means for real estate investors

- Capital market conditions have remained broadly the same for some time and this is likely to hold for the next several months. Lenders may therefore start to exert more pressure on legacy properties where owners looked for short term financing extensions in the hope of a quicker decrease in interest rates.
- Lower rates in the medium term may create an attractive window to secure financing or refinancing, and may also entice some sellers with investments past their fund lifecycle to then seek liquidity.
- We continue to favour higher cap rate sectors that can derive the greatest benefit from this broadly higher-for-longer interest rate environment.
- Lenders continue to emphasise energy efficiency, whether through borrower upgrade plans or existing certifications, as they still face pressure to improve their loan book's energy profile notwithstanding new policies seen in the US.

UK Economy

The latest data shows that UK GDP has been essentially flat over the tail end of 2024 and the start of 2025 – not ideal, and influenced by the somewhat naïve doom-and-gloom rhetoric from the new Labour government, but by no means as bad as some media headlines might suggest. To be sure, the frosty weather could well continue in the short term as the new tax year started in April with some new tax headwinds, but the UK government is now hyper focused on growth policies, the UK appears relatively well placed in the current rearrangements of global trading patterns and tariffs, and there does appear a decent prospect of a potential trade deal with the US to sit alongside that under discussion with the GCC, so the medium term outlook is arguably a bit rosier than before.

UK Consumption & Investment Index



Source: Reuters; The Financial Times

What this means for real estate investors

- We continue to prefer income diversification and sectors making up the backbone of the UK economy, while being cautious on subsectors highly dependent on international capital flows.
- We still favour real estate with affordable rents and offering value-for-money.

UK Property Sectors

While Arcapita does not allocate across all areas of UK real estate, the following summarises what we are seeing in the main property sectors.Please refer to Arcapita's Focus (p10) to see how our views on the UK macro picture and real estate markets are reflected in our allocation focus.

Central London Offices

What are we seeing:

According to data from central London specialist BDG Sparkes Porter, the West End office market reinforced existing trends in H2 2024:

- Prime rents continued to grow, up 4.8% on average over the year, although interestingly BDG Sparkes Porter note that average Grade B rents declined 1.5% and Grade C declined 3.1%, emphasizing the premium for top tier ESG compliant space
- Letting volume was 2.3m sq ft for 2024, an underperformance over the 10 year average – but this lower volume was driven by a lack of larger deals in Mayfair, where only one deal transacted above 20,000 sq ft and there are currently only three units over 20,000 sq ft available in a supply constrained market
- Supply overall remains constrained, especially for ESG compliant space that is particularly sought after by occupiers, and with new construction remaining at low levels. JLL report the vacancy rate for new build office space remaining at still just 1.4%.

Investor activity continues to also be muted, with transaction volume remaining around 60% down compared to the long term average and only 12 assets trading over £100m. Savills records central London office investment volume as £6.4bn for 2024, with UK investors the major buyer group.

Regional Offices

What are we seeing:

- The new cap rate climate has clearly stabilized, with broker cap rate estimates largely unchanged throughout 2024. There remains strong occupational dynamics and rising rents for best-in-class, energy efficient compliant offices, with Leeds now achieving £48 per sq ft, while Manchester and Bristol are eyeing the £50 per sq ft threshold. However sentiment still appears largely negative for secondary regional offices and the definition of 'prime', top tier offices with supportive lender appetite is still narrow, so we would exercise caution when assessing superficially attractive cap rates for secondary assets.
- Overall, there is a clear difference in occupier and investor demand between top tier buildings and 'commoditized' stock, as more abundant supply and more limited demand (partly reflecting ongoing work from home dynamics) allows occupiers to be pickier for the time being.

Residential

What are we seeing:

- As the UK Build to Rent sector continues to mature, another feature emerging is a gradual stream of first generation, stabilized assets appearing on the market. These sales stem from their developers / funders looking to recycle capital; they enable more core/core-plus money to access the sector and also provide a useful market benchmark on pricing. As 2025 progresses, it should be clearer how the buyer pool for these assets stacks up, but it appears that private equity and UK institutions are likely to be prevalent.
- Single Family Housing saw a record investment volume in 2024 (£2.5bn according to Savills) and investor demand continues to expand, notably with Korean institution NPS providing investment manager LongHarbour with a £300m commitment, and new private equity entrants to the subsector. As with Build to Rent, development funding is still the dominant investment route, but stabilized assets are now coming to the market as investment oppurtunities. The number of these oppurtunities being bought to market should increase meaningfully over the coming quarters.

Industrial

What are we seeing:

- In the multi-let industrial sector, there continues to be a healthy occupational market and sustained rental growth. In contrast to regional offices, there is a structural lack of supply and a diversified occupier base that requires physical presence (there is no real work from home dynamic in this sector), leading to sustained occupier and investor demand across the range of building types.
- Build costs have moderated somewhat but it often remains challenging for developers to deliver significant new supply in a market with limited energy efficient compliant availability. Cap rates have seen compression for prime single assets but remain generally elevated, while portfolio sales are showing good activity and investor appetite.
- In contrast, the big box logistics market is more of a mixed bag. On the one hand, take up in 2024 was consistent with 2023 levels, with a greater diversity of occupiers taking space and a notable level of new manufacturing deals. On the other, the speculative development wave has not yet finished, which saw the vacancy rate rise to 7.2% and the highest supply level since 2011 (Savills data). Nevertheless with demand remaining robust and Savills noting that a sizeable chunk of take up is currently under offer, this availability should be gradually absorbed over the coming quarters, although it is likely rental growth will moderate in parallel.

Retail

What are we seeing:

- Quietly, and despite ongoing challenges in the business environment, the occupational market in UK retail property has been gradually improving. Retailers are busy reorganizing their physical footprint to adapt to the post-Covid world, retail parks saw near record levels of take up according to Allsop, and Cushman & Wakefield note that many leading shopping centres and retail parks are now at sub-5% vacancy and taking the opportunity to reorder their tenant line ups while pushing rents on. Even in the more tourist exposed central London market, Cushman estimate that the vacancy rates for Bond Street and Oxford Street have reduced from 20%+ to sub-10% in 2024, with average central London rents rising over 7%.
- In terms of investments, retail warehousing volumes ended 2024 with the highest transaction volume since pre-Covid and cap rate compression for top tier schemes has started to emerge. Good quality assets may be limited in 2025, setting the scene for more downward pressure on cap rates.

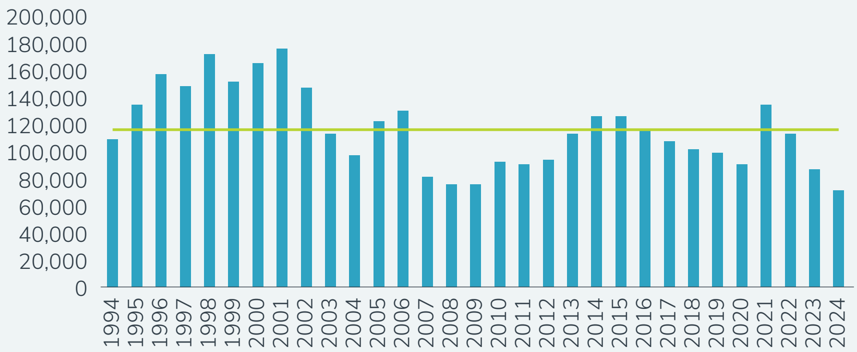
London Residential: A Tale of Two Markets

As spring arrives and London residential real estate enters its busiest period, it is a good time to survey the state of the market and assess what is going on behind the headlines. In 2024, mortgage rates continued to rise to the highest level since the early 2000s, despite cuts to the Bank of England base interest rate, discouraging many would-be buyers and thinning the overall buyer pool. At the same time, the supply of houses on the market continued to rise. Sales for 2024 were at their lowest level since 2009, and homes are on average sitting on the market for longer.

London Houses on the Market

Source: Home.co.uk

London Residential Sales Volume



Source: HM Land Registry

Given the above, it is unsurprising that the prevailing sentiment is that London residential is currently a buyer's market. Whether viewed from a total price perspective or price per square meter, 2024 marked the steepest decline in nominal residential values in the last three decades. The contraction in value steepens appreciably when viewed in real terms.

London House Price Index
(100=2004)

Source: HM Land Registry; HomeMetric

London House Price Growth by Submarket

	London	Prime Inner London	Prime Central London
2022-2024	(5.3%)	(5.1%)	(5.3%)
2014-2024	24.1%	14.8%	(10.0%)
2004-2024	140.0%	151.4%	166.2%

Source: HM Land Registry; HomeMetric

However, while assessing London residential real estate as a whole has its uses, it may miss some important dynamics. So to get a more nuanced view of what is happening on the ground, let us look at Prime Central London (PCL)[1] and Prime Inner London[2] separately. Each of these aggregates a number of areas with their own characteristics, but together illustrate a broader trend of international versus domestic buyers.

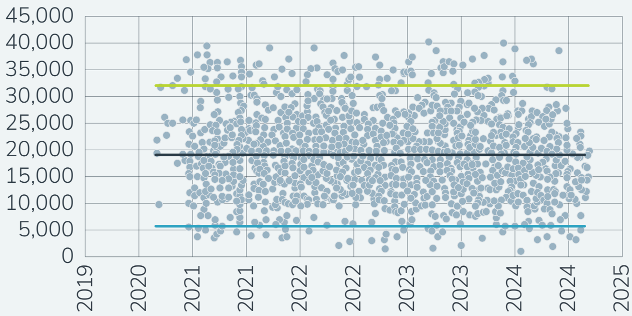
[1]Prime Central London includes post codes W1K, W1J, SW1W, SW1X, SW3, and SW7
[2]Prime Inner London includes the boroughs of Westminster, Kensington & Chelsea, City of London, Hammersmith & Fulham, Camden, Islington, Lewisham, Tower Hamlets, Hackney, Haringey, Southwark, Lambeth, and Wandsworth.

London Residential: A Tale of Two Markets

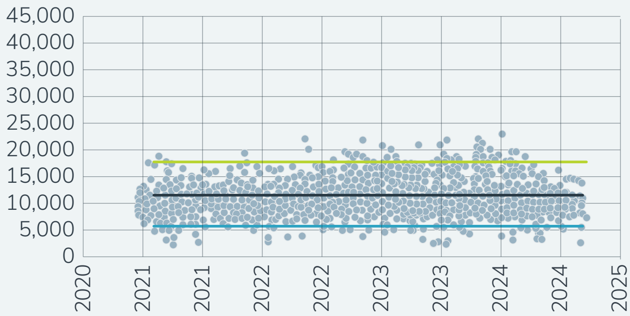
Prime Central London: Is It Real Estate, or Is It Art?

How much is a Picasso worth? A vintage race car? These are not commodities with prices you can look up on a computer exchange – each individual asset can vary significantly in price through its specific characteristics and the emotional pull it can deliver to different buyers. PCL residential real estate exhibits the same hallmarks and appeals to the same buyer base as fine art: characteristics such as the intricacies of the façade, the state of refurbishment, how lateral or vertical the layout is, the number of bedrooms or bathrooms, the size of the kitchen, the quality of natural light, the direction a garden faces or the side of the road the building is on, can matter a lot more than a basic price per square foot number in attracting a buyer. Equally, as with fine art, buyers tend to view PCL properties either as a broadly tax-efficient long-term store of capital or as a lifestyle asset, neither of which tends towards investing with an eye on just price.

Housing Value Dispersion in Prime Central London
(£ per m²)



Housing Value Dispersion in Prime Inner London
(£ per m²)



• Sales — 2 Standard Deviations Below Average — Average — 2 Standard Deviations Above Average

Source: HM Land Registry

For these reasons, PCL buyers tend to be internationally wealthy and equity rich and therefore less impacted by changing UK interest rates than their Prime Inner London counterparts. Why, then, has the number of transactions in PCL declined by c. 40% over the last two years (since the start of the current interest rate cycle)? Why are values broadly flat since 2014? While there is no definitive answer, there are some plausible explanations. Since 2014, there have been a number of wider geopolitical realities affecting demand, including Brexit, sanctions on Russian citizens (starting in 2014) and Covid, capital controls in certain popular buyer jurisdictions, as well as a development wave of high end new build units that started around 2012-15 which delivered into softer demand. At the same time, GBP has not recovered its 2014 high of 1.72 against the US dollar, which has led to a reluctance by many Dollar-denominated owners to realise FX losses on a sale. What is perhaps more interesting is the drop in transactions over the past 2 years given that availability is up. Anecdotally, this seems to be in large part because buyer preferences are currently for already refurbished, move-in-ready homes, given the present challenges with refurbishment projects in terms of planning, construction costs, and labour availability. However, precisely because of these challenges, there is a reduced number of such completed homes and a substantial amount of the availability is made up of houses or apartments that need upgrading – so there is a mismatch in terms of what supply is offering and demand is seeking, which is an indirect effect of the higher cost of capital, material, and labour.

London Residential: A Tale of Two Markets

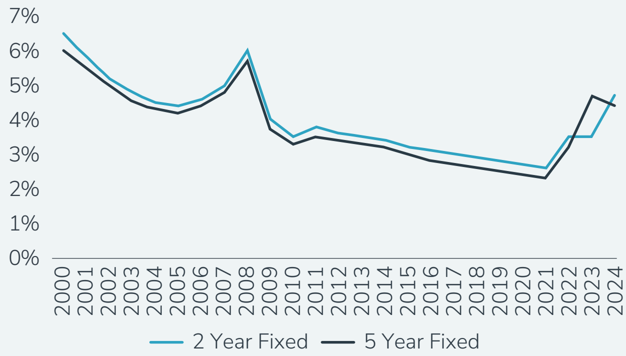
Prime Inner London: Home Sweet Home

Separately, what of homes in Prime Inner London – the ring outside of PCL? Compared to PCL buyers, buyers in this area (particularly of houses) are typically domestic with mortgage financing. Thus, pricing tends to be more sensitive to affordability, and while building characteristics are still important, price per square foot is a key consideration. In general, prevailing economic conditions, such as unemployment rates and wage growth, and mortgage rates tend to have a more direct impact on pricing in this sector.

As the chart to the right illustrates, the cost of servicing a mortgage of the same principal value was c. 30% higher in 2024 than it was in 2021 (prior to the interest rate increases), a direct result of mortgage rates increasing from 2.3% in 2021 to 4.4% in 2024. However, as wage growth followed inflation and higher interest rates, the effect on affordability has been more muted than one might think. Cumulative wage growth of c. 25% between 2021 and 2024 means that mortgage payments as a percentage of annual wages grew only marginally, from c. 18% to c. 19%, over the same period. At the same time, unemployment has been stable since 2021, hovering around multi-decade lows of c. 4%. These two factors combined – high wage growth and low unemployment – have meant a more modest decline in inner London residential prices than one might think given the generational increase in interest rates.

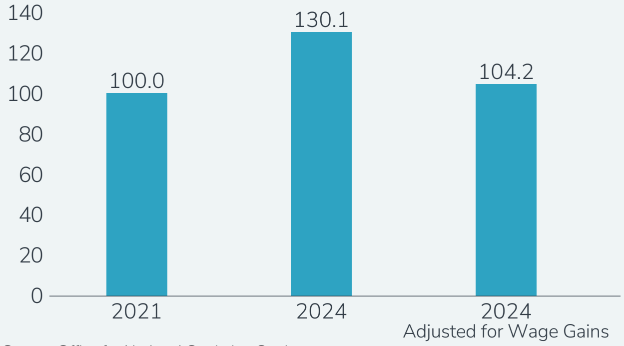
If wage growth has mostly offset higher mortgage costs and unemployment has been stable, what, then, accounts for the c. 5% decline in house prices from peak to current? Well, despite housing costs being stable relative to wages, everything else has gotten more expensive in real terms. The cumulative change in the retail price index, which measures inflation, from 2021 to 2024 was c. 33%, which far exceeds wage growth for the same period. This has left less wages and savings available for house purchases and associated costs. Additionally, anticipation of a widely assumed return to an ultra-low interest rate environment, such as existed before 2022, may have persuaded would-be buyers to wait for lower mortgage rates, further thinning the buyer pool.

Historical Mortgage Rates



Source: Statista

Housing Cost Index



Source: Office for National Statistics; Statista

Even then, different areas of inner London still show different dynamics. For instance, consider Fulham where price per sq ft has remained largely stable, in a relatively tight band, over the past few years. Often viewed as the affordable alternative to living in the PCL areas of Chelsea or Kensington, consistent demand and a general lack of new developments has seen rising interest rates result more in a reduced volume of deals rather than a decrease in price per sq ft. Alternatively, Walthamstow in north east London, which retains a village vibe, hipster culture and also a fast Underground link to central London, is still favoured as a rising area that attracts younger families and those seeking 'fixer upper' refurbishment projects. Here, price per sq ft has risen since 2022 despite the increases in interest rates, showing how even in a wider buyer's market, there remains scope to do well.

London Residential: A Tale of Two Markets

London Residential Outlook

So then, where might London residential real estate prices go from here? Well, at a wider level, when measured as a multiple of median income, London housing prices have fallen to 11.06x, a level not seen since 2015. This chimes with the perception of a buyer's market, but any glance at the UK media will show that this isn't taken for London housing being seen as generally affordable. Indeed, there is broad political agreement that higher housing development should be prioritized, to deliver affordable housing for the wide range of people that want to, and should, populate the city. However, on a practical level, it is difficult to see a substantial development wave that would lead to significantly lower residential prices as a result of greater supply, given the aforementioned constraints in terms of sites, planning, construction costs, and labour availability.

So with supply likely limited for the foreseeable future, the greater focus may be on demand, for both Prime Central London and Prime Inner London. For PCL, geopolitical factors remain and the removal of the UK's 'res non dom' (resident non-domiciled) framework adds a further headwind, however as with fine art there should remain a good depth of buyers for the right product. For Prime Inner London, the story is more about mortgage rates (certainly in terms of sales volume) and particularly, the attractiveness and relative affordability of distinct areas – nothing gets a Londoner's pulse racing like the realization of an affordable, improving area with upgraded transport links where a refurbishment project is enticingly available.

Foreign exchange rates also provide a complementary dynamic: lower levels of GBP have provided an attractive buying window for US Dollar denominated buyers, while an increase in GBP may tempt existing US Dollar denominated owners who may be considering selling. Indeed, the Pound Sterling has, in recent months, bounced back against the US Dollar and was recently trading at levels not seen since 2022. While movements in foreign exchange rates are hard to predict, it is noteworthy that President Trump seems to favor a weakened dollar, which may provide an incentive for US Dollar denominated buyers to take advantage of the current window.

Beyond this, an additional dynamic that is worth considering is the current buyer preference for completed properties, while many properties on the market require refurbishing. For those buyers looking to take most advantage of the current buyer's market, the greatest opportunities likely come from looking at those properties that require refurbishment. For those existing owners considering a sale, perhaps it is worth undertaking a targeted refresh of the building, to enhance the property's desirability and appeal to current buyers.

Arcapita's Focus

Gradually, and despite a lot of noise and the international tariff turbulence, the UK's economic situation has continued to see green shoots and sunnier days ahead. Certainly, there remains the risk of frost ahead and the global geopolitical reordering in progress has the capacity to complicate things, but as things stand the UK has continued to remain resilient through all the various challenges it has faced over the past several years, and offers a surprisingly stable investment climate going forward.

This higher-for-longer environment should see the range of UK investment opportunities start to widen, including in private equity, but in our view the most attractive investment returns still favour active management and a targeted approach.

Within UK real estate, we maintain our highest conviction on active investment strategies focused on properties with shorter, staggered lease terms, diverse income streams, and affordable rents that can be grown through active management. With the investment environment looking steady for the foreseeable future, we expect to maintain this stance for some time, and for there to be a good runway to take advantage of current opportunities. Within this strategy, our preferred sector continues to be UK multi-let industrial, offering an attractive combination of higher cap rates, sustainable income return, and capital growth through focused asset management.

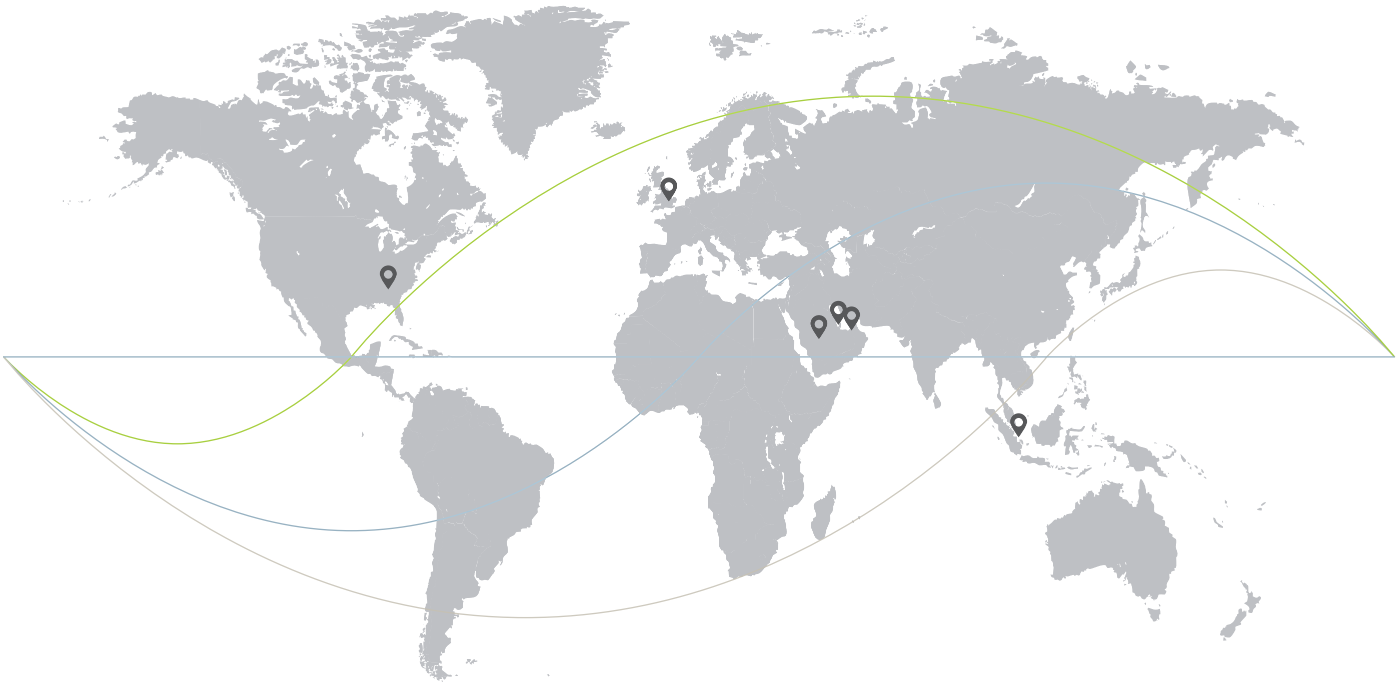
We also continue to favour strategies focused on upgrading buildings' energy efficiency, as we have confidence that these will deliver additional return over the medium term. While we observe a retreat from environmental priorities in other investment areas, we are confident that with the focus on energy efficiency and future-proofed functionality now so engrained in the mindsets of UK commercial real estate occupiers, investors and lenders, such upgrades will drive income and capital growth in the UK market over the coming years.

ARCAPITA

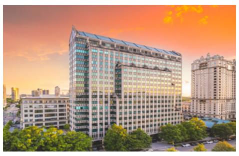
Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, UAE, and Singapore, Arcapita's management team has completed transactions worth a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



United States



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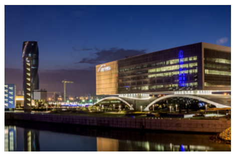

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