UK Real Estate Update

The Impact of Brexit on UK Commercial Property
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Summary

- The result of the EU referendum was unexpected and this has triggered major corrections across markets. Further volatility is anticipated in property, as elsewhere, as political and economic events unfold.
- The decision is expected to affect property values but analysts differ widely in their assessment of the impact
- We expect London offices to be the most vulnerable to correction with retail and the regions relatively resilient
- UK property is likely to be supported by the income return and the UK's position as a large, transparent and established market. A weaker sterling rate could encourage overseas investment
- In the longer-term, the changes brought about by Brexit have the potential to offer opportunity to the expert investor
- Prime, long lease, well-let property in thriving locations will be increasingly favoured by investors seeking security and performance in the years ahead.

The UK voted to leave the EU in the referendum on 23rd June. The result was unexpected and this has led to sharp falls in the financial markets both in the UK and in Europe, for sterling and for gilt yields as well as major disruption in the political sphere. This note is an initial attempt to assess the outlook for the UK economy and UK commercial property in the wake of the vote. The situation is evolving as participants adjust to changing conditions and this is likely to result in a period of market uncertainty and volatility. Our analysis assumes that the UK government will honour the result of the referendum and that the EU will do likewise and there will be no second referendum. This is by no means certain but it needs to be noted that once the exit process has been formally started there is no provision for notification to be withdrawn and so what happens in the next few weeks is critical. Our analysis is also restricted to the impact on commercial rather than residential property. We see three stages to the process in prospect, the immediate aftermath, the short-term outlook over the next two years or so (essentially the withdrawal period) and the longer-term impact (post withdrawal).

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The Immediate Response

The Economic and Political Outlook

We believe that the initial macro-impact will be felt keenly in the political sphere as the Conservative Party elects a new leader and re-groups and the Labour Party struggles with internal dissent. This political vacuum is unhelpful and may further affect the economy and financial markets especially if a UK general election is brought forward by Parliament or a Scottish referendum further complicates the picture.

In the domestic economic sphere, the Chancellor has abandoned plans for an emergency budget. Changes are likely to be announced in the Autumn Statement. Analysts believe that fiscal policy may be eased in response to the vote and the Bank of England has indicated that liquidity will be pumped into the system as needed to secure an orderly transition. Interest rates could be reduced and may well stay at low rates for a considerable period of time.

Although the Chancellor has announced that the UK is "open for business" and in good health, there were warnings of recession if the UK voted to leave the EU. The UK's credit rating has been reduced and analysts are downgrading their GDP forecasts. A weaker sterling may also lead to some increase in inflation.

Consensus GDP forecasts released ahead of the vote indicated that GDP growth could slip to 1.4% in 2016 under a Brexit scenario versus 1.9% under the main scenario which favoured Remain. This is disappointing and implies a fairly flat second half to 2016 but it is not disastrous. Despite the shock of the result, it needs to be remembered that the banking system is in a much stronger position than in 2008 and with a supportive fiscal and monetary policy and an economy in growth mode, the impact on the economy may not be as great as some people fear.

The Outlook for Commercial Property

Given the uncertainty, it is possible that many occupiers and investors in real estate may decide to hold back from major commitments until there is greater clarity. This could affect capital values and possibly rental growth over the next few months. There may be a move towards more defensive assets as investors adopt a "risk-off" approach. Hopes that a Remain vote would lead to a bounce-back in activity have been dashed and the slower pace of investment activity seen before the referendum is likely to persist.

The immediate concern for investors and fund managers is to determine the "true" level of pricing. The June valuations were generally prepared before the vote and there is no market evidence to underpin any change. The quoted sector can provide only limited guidance in such turbulent times.

Initial indications are that the banks, especially foreign banks, are reviewing their loans and that lower borrowing costs could be counterbalanced by higher margins but there are no signs of a major shift in policy as yet.

Few, if any, analysts see an immediate benefit to property from the vote. They do however hold widely differing views on the immediate impact of the result on property values. Real Estate Strategies (RES), taking the price changes on the listed market as their guide, are forecasting that yields could move out sharply leading to a 14% fall in capital values in 2016. Property Market Analysis (PMA) is refining its forecasts but was predicting a 7% fall in capital values this year under their Brexit scenario. Capital Economics is more sanguine and is estimating a 3% rise in capital values in 2016 which represents very little change from the 3.3% previously forecast. It may also be note-worthy that JLL is predicting an initial sharp downward adjustment to be followed by an upturn as new opportunities emerge. They see UK core markets as major beneficiaries and note that a weaker sterling may benefit property investment. We would also contend that lower interest rates and gilt yields could lead to more attractive pricing for property. However, this assumes that the risk premium is unchanged and we recognise that sentiment will be a key driver of performance in this period.

The Short-Term Outlook

The Economic and Political Outlook

The voting pattern in the referendum highlighted the polarity between different areas of the UK and by age grouping. A priority for the new government during this period will be to heal these divisions. We would expect more attention to be focused on the English regions to address their concerns. The SNP is likely to push for a referendum which if granted could potentially trigger independence and herald greater devolution within the UK.

The current period of political adjustment may delay the triggering of Article 50, which gives notification of an intent to leave under the Lisbon treaty, until greater political clarity and a new Prime Minister are in place. A framework for negotiations also needs to be agreed which may take several months, possibly longer. The two year time limit begins once invoked by UK government and agreed by qualified majority of the European Council. A UK parliamentary vote is not needed; and an extension is only possible by unanimous European Council vote. Once agreement is reached it must be signed off by simple majority in the European Parliament and a qualified majority in the European Council. In principle the UK remains a full member of the EU until the Article 50 requirements are met. In practice, some changes are inevitable and the planned UK Presidency of the EU Council in June-December 2017 has already been called into question. However, there are unlikely to be any substantive changes to working or travel practices in the near-term which may act to support sentiment.

The negotiations for withdrawal may coincide with attempts to set up new trading relationships. A number of options exist and Boris Johnson has prioritised favoured access to the market but early indications are that the EU will not be particularly supportive. The view from BMOGAM is that the most likely result is a UK customised option which will include Europe and the World Trade Organisation Area but crucially will not apply to financial services.

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The Outlook for Commercial Property

A survey by JLL taken before the referendum indicated little appetite for Brexit but also found that more than 60% of investors would not change their investment strategy in the event of a Leave vote. Whether this occurs in practice is another unknown but Brexit would be only one factor in any investment decision. Investors have been happy to invest in a UK outside the Eurozone and may be content to invest in a UK outside the EU.

PMA has issued some pessimistic preliminary forecasts indicating that capital values could fall by 15% in the event of a "messy compromise" and by 25% if the exit was especially acrimonious. Not all agree. JLL believes that capital values could fall by 10% in 2016/17 and Knight Frank believes that asset prices in the more robust sectors of the market will have recovered the lost ground by mid 2017.

We, alongside most other commentators, expect London offices to be disproportionally affected by the Brexit decision with the City and Docklands particularly hard hit given their dependence on the finance sector.. For London offices the figures are minus 30% and minus 40% respectively. Others have challenged this interpretation arguing that PMA is too pessimistic on rental growth and gilt yields. Capital Economics has made some slight reductions to their rental growth forecasts for 2016 and 2017 but this primarily reflects a downward adjustment in Central London office rents and generally they do not expect Brexit to affect rental levels significantly.

The Treasury assessment sees other office-based sectors as being at risk including professional services, pharmaceuticals, aerospace, IT and the automotive industry (which has a large office employment base in the UK) which could have some impact on the South East and regional office markets as well as London.

Retail could prove more resilient against the challenges posed by Brexit although threats from online remain. CBRE sees standard shops in Central London and supermarkets as the least vulnerable to Brexit. The industrial and distribution sectors present a more mixed picture with areas dependent on domestic retail faring better than manufacturing led facilities. Leisure could see a boost if lower sterling leads to rise in overseas visitors and more "staycations".

We would also expect there to be little appetite for large-scale development in this adjustment phase. This could have a positive impact in some markets if it restricts new supply in areas where demand is holding firm.

The Longer-Term Outlook

The Economic and Political Outlook

The withdrawal from the EU is a major event but only one of many factors affecting growth over the longer-term. Consensus estimates are that real GDP growth in the UK will average 2.0% annually in 2018-26 which is only marginally below the main projection. It is also significantly higher than the 1.5% per annum predicted for the Eurozone. There may well be some relocation activity by finance and insurance firms and some manufacturers which could affect employment but this is likely to be gradual and possibly linked to lease events.

We should also factor in some of the positives relating to the UK economy. The UK is the fifth largest economy in the world in terms of GDP making it a large market for international firms and providing a strong base for further expansion. We are relatively affluent, have a strong skills base, a growing population and an export trade which may benefit from tariff arrangements but is by no means wholly dependent on them to secure sales. London is a city of global importance and still has the advantages of time zones and/or language over its international rivals.

The Outlook for Commercial Property

It is still early days but property forecasters seem to expect some reversion. PMA projects that total returns under Brexit will be higher than under their main (Remain) scenario in 2019 and 2020. RES is predicting that in 2016-2020, total returns will be 2% pa lower on average but front-loaded. RES sees little impact on long-term rental growth at the all-property level and as a result argues that property may be better value in the next few months/years that it was prior to the vote.

Property is a long-term investment and although there is uncertainty, UK property does benefit from a relatively stable and attractive income return and a yield premium over gilts. The importance of a contractual income stream which is often long-term in nature should not be under-estimated. The UK has a relatively large, transparent and mature property investment market and an established legal system and tax regime which we believe will ensure that the UK remains attractive to a wide range of investors. This could be under-scored if a weaker sterling attracts greater investment from overseas and if it secures the interest of the carry trade.

The Brexit vote does herald an era of change but as the "new normal" is revealed, this is could offer opportunity to the expert investor capable of distinguishing between fundamental change and market noise.

Conclusions

The markets across all asset classes received a shock with the announcement of the Brexit result and there has been a knee-jerk reaction to unwelcome news and political and economic uncertainty. We would expect this to subside as the situation clarifies over time.

We do see a period of volatility in prospect but also opportunity. Investor caution may lead to a better environment to secure stock for those willing to commit.

We see the impact of Brexit being uneven across the market. Larger lot sizes could initially suffer disproportionately given the added risk attached to a large financial commitment. We would expect the investment market to be more affected than the occupational market, although both may be impacted. We would also expect London offices to see the greatest adjustment partly reflecting keen pricing ahead of the vote but also the changed demand dynamics in the occupier market and potentially reduced investor interest. In contrast, the regional markets and the retail markets may see greater stability. We have always contended that property is an asset-specific investment and we believe that prime, long lease, well-let property supported by strong fundamentals of local supply and demand will continue to offer investors security and performance in the years ahead.

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