Brexit: Impact on UK Property

August 2016

The UK public voted to leave the European Union on 23rd June, to the surprise of pollsters and economists. The result has raised uncertainty in economic and financial markets and has caused many to question 'what next?' This short paper outlines our views on what could be in store for the UK commercial property market over the next five years.

Highlights

- The UK's decision to leave the EU has raised uncertainty in the economy and financial markets and caused an immediate re-pricing in specific areas of the property market, with the REITs market and open ended funds suffering a sharp fall in values within days of the referendum result.
- The future path of the UK economy is reliant on the exit strategy. At this stage we think a 'soft exit scenario' with some restrictions to migration and partial access to the single market is the most likely outcome.
- We continue to believe in the internal strength of the UK economy and the commercial property market. Having said that, some sub-sectors are more at risk than others.
- Moderate capital value corrections in the range of 5-10% are expected across commercial property segments, compared to c.20-30% discounts seen in the REIT's market.

Sector Highlights

- Prime retail should maintain a relatively stable outlook, whereas secondary retail locations may be adversely affected.
- The office market will be significantly impacted (particularly Central London). However, short term price adjustments should raise buyer interest (particularly from overseas private and institutional investors), resulting in a swift recovery in values over the medium term.
- The industrial sector is expected to weather the impact of Brexit reasonably well given its greater reliance on the domestic economy (relative to previous years), increased growth in e-commerce and solid market fundamentals. Well located smaller industrial estates are expected to perform better than larger units and distribution warehouses with expected 5-year returns of 4.7% and 3.8% respectively.
- The alternative sector should also be less susceptible, with those segments offering longer dated, inflation-linked lease structures and favourable long term demand drivers retaining healthy levels of investor appetite.

Economic and Property Market Overview

The UK's decision to leave the EU has raised uncertainty in the economy and financial markets and caused an immediate re-pricing in specific areas of the property market, with the REITs market and open ended funds suffering a sharp fall in values within days of the referendum result. Given many official data releases are not due until August, uncertainty is set to prevail.

Whilst the impact of Brexit has raised uncertainty, it has had a limited effect on underlying economic fundamentals which have not changed significantly. In fact, the FT's Brexit Barometer suggests that despite market uncertainty weighing on consumer, business and household confidence, day-to-day spending has showed signs of improvement. Moreover, the quick election of Theresa May who has started to act decisively, has bolstered confidence in financial markets causing a rebound in the Sterling and equity markets. This was supported by the Bank of England's (BoE) decision to keep interest rates unchanged at 0.5% in July. Although an interest rate cut in August is likely, we support the current stance of the BoE and believe that looser fiscal policy in the form of lower taxes and some mitigation to planned spending cuts could provide a greater boost to the economy than lower interest rates.

We continue to believe in the internal strength of the UK economy and its leverage on both international politics and financial markets, particularly if the BoE and government officials continue to collaborate and act decisively. Having said that, the future prospects to economic growth is entirely dependent on the exit strategy. Figure 1 outlines a few plausible exit scenarios. We think an EEA or Soft Exit arrangement that introduces some restrictions on migration, partial access to the single market, and the freedom for the UK to negotiate trade deals outside the EU is the most likely outcome. It should limit the damage of the exit and help the UK economy recover quicker.

Against this backdrop, we expect capital value corrections in the range of 5-10% across direct property segments, significantly lower than the discounts of up to 30% seen in the REIT market and open ended property funds. The latter (i.e. REITs) is a more liquid market that reflects the exacerbated stress in the wider economic and financial markets to a greater extent. Moreover, indirect property funds have additional layers of management fees that put a significant pressure on return margins, particularly in the low interest rate environment.

Given our belief in the current strength of the economy and the fact that underlying market fundamentals have not changed significantly, we think the key issue for the UK commercial property is not about the disbelief in the market itself, but rather uncertainty.

The UK, whether in our out of the EU, is likely to maintain its safe haven status, and as political and economic stability returns, and investors' desire to capitalise on favourable exchange rates provides the transactional evidence and investor confidence to trade, this should result in any short term price adjustments (particularly in central London markets) to be quickly reversed.

Figure 1. UK Exit Scenarios from the EU

	Potential Agreements	Single Market Access	EU Immigration Control	Contributions to the EU budget	Liklihood of Occurance	Result
Less Likely	**EEA Liechtenstein**	Yes	Some	High	Very Unlikely	Access to the single market is granted along with restrictions on EU migration.
	EEA Plus	Yes	No	High	Unlikely	Access to the single market in goods and services, but not agriculture.
	World Trade Organisation (WTO) Agreement /	No	Yes	No	Somewhat Unlikely	Most damaging impact on UK economy, with the UK treated as any other non-EU country such as the US.
	An association agreement	Some	Some	Lower	Somewhat Likely	Tailored agreement which aims to discourage other members from leaving.
	EEA Minus / Messy	Some	Some	Lower	Likely	A bit more immigration control and a bit less access to the single market.
More Likely	**EEA / Soft**	Some	No	Lower	Very likely	Some access to the single market with additional tariffs and the freedom to sign deals with non-EU countries.

Retail

In the context of the wider property market, the retail sector should be more resilient and perform better than some other sectors of the market. The retail sector has already experienced a considerable amount of change, the rise in online-retailing has eliminated some of the weakest retailers from the high street, leaving a more resilient retail base in its presence. Thus, it is unlikely that Brexit itself will re-ignite this, instead we expect it will accentuate the current trend in market polarisation, with those locations having already struggled pre-Brexit, to be disproportionately affected, particularly if consumer confidence were to weaken further and the unemployment rate to significantly rise.

Although there has been a slight deterioration in consumer confidence following the referendum, it is unlikely that this will result in a severe drop in consumer spend in the short term. Labour market prospects still remain favourable and inflation and interest rates are currently low, supporting disposable incomes. With the uncertainty around the future outcome on the UK's position outside the EU to prevail over the next 12-18 months, this should provide some time for consumers to regain their confidence and spending patterns in the near term.

However, until confidence levels are fully restored, it is likely that consumers will cut back on big ticket spending (such as home improvements) which could have negative growth implications for the retail warehouse sector. There are also concerns on the inflation front, which could quickly rise if Sterling remains weak. If retailers decide to pass on any cost increases to consumers then this could reduce discretionary spend and dampen the consumer outlook over the medium term.

From an occupier perspective, the majority of retailers should be fairly immune from the effects of Brexit in the short term. Many retailers have hedged against currency fluctuations, which should support profit margins in the near term. Should Sterling remain weak against the US dollar over the medium term this could increase pressure on retail margins, as profits erode through rising import prices and cost push inflation. Retailers are already having to cope with an increased cost base due to the introduction of the national living wage in Spring of this year, and will be sensitive to any further market adjustments. The impact is expected to be amplified for smaller retailers that offer a less varied retail experience, causing many to struggle to compete against the major retail players with a multi-channel presence. Thus, there is a chance that we could see a rise in vacancy in secondary retail locations and off-prime high streets.

In contrast, prime pitches in destination locations should be able to withstand these changes. A positive impact may also be seen in the tourism industry, as the weaker pound makes holidaying in the UK more attractive. This should benefit retail and leisure destinations in popular tourist destinations, such as London and Brighton.

We are forecasting rental value growth to slow in the short term (2016) before moving to an average growth rate of 0.8% until 2020. Central and suburban London retail, retail in big towns, the Leisure sector and Restaurants should deliver better return prospects over the 5 year period.

Office

Central London Offices

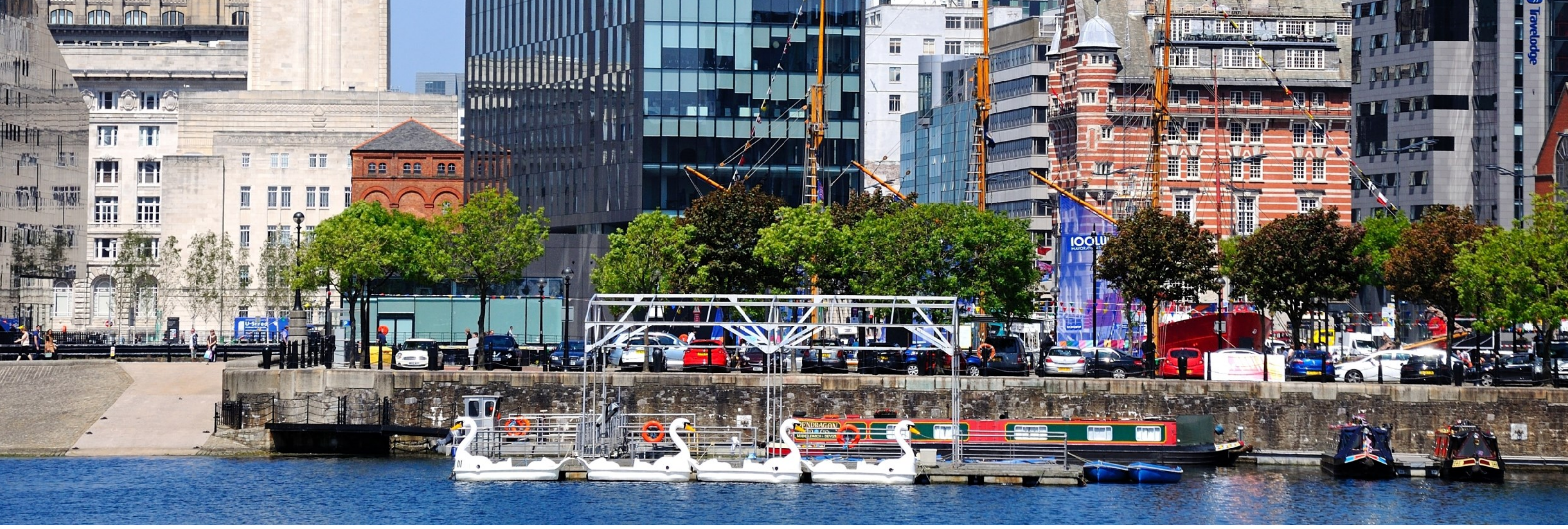
The central London office market is the most vulnerable to the effects of Brexit given its greater reliance on the financial sector (where c.40% of office space is let to this industry). Much of the downside impact will be dependent on the eventual settlement of the Brexit negotiations, whether access to the single market is granted, or the extent to which pass-porting rights (enabling the transfer of financial services to the rest of Europe) are retained.

Whatever the case may be, there is a possibility that some financial, asset management, insurance firms and other supporting functions that are directly involved in Euro denominated trades will be unwilling to wait for the dust to settle and will move forward with contingency plans to re-locate their EU trading staff to other European CBDs to reduce any disruption to their clients' service. However, it is unlikely that this will be the status quo for all, (given the associated costs and time in doing so), with other major corporate firms together with non-financial firms expected to keep long term investment and expansion decisions on hold, until greater clarity on the terms of Brexit materialise. As a result, occupier prospects are expected to remain muted in the short term, with the bargaining power shifting from landlords to tenants, as occupiers require less space, greater flexibility and more favourable incentives on lease terms.

It is hard to determine what the subsequent effect of increased re-location activity on vacancy and rental levels could be. London's occupier base has become less reliant on the financial sector post the global financial crisis (GFC), which should lessen the levels of old stock returning to the market, relative to prior years. However, the recent surge in the development pipeline (where c.14mn sqft of new space currently under construction) could lead to an oversupply of stock, at a time when demand is at its weakest, accentuating the level of rental declines.

It is fair to assume that some developers could postpone development projects given the heightened market uncertainty. Current forecasts by Capital Economics, suggests that if this were the case and only the space currently under construction is built, then vacancy rates could rise to a range of 8-12% over the next 5 years. In view of this, if you assume that the historic relationship between vacancy rates and rents holds true, then this could lead to rental falls of 10% (if the level of office based job losses were severe). Our central view is that rental declines will be most acute over the next two years, with rental falls of c.8% p.a. for the City office market, as financial companies return surplus space back to the market and take up levels across other industries remain muted. The West End should be less affected, but still susceptible to some rental declines given where rents currently stand against long term averages and the sector's strong correlation with the wider global economy.

However, favourable long term fundamentals, such as London's safe haven status, the strength of the UK's legal system, its convenient time zone and even potential government initiatives to reduce corporation tax could tempt other non-EU corporate firms to expand their footprint and develop new lines of business within the Capital. This could help the London office market to re-invent its image and deepen its current occupier base, supporting rental growth prospects over the longer term. Whilst an element of re-pricing seems unavoidable in the short term, given the shift in sentiment and investors' expectations for lower rental growth prospects, our view is that any short term price adjustment should raise buyer interest (particularly from overseas private and institutional investors), resulting in a swift recovery in values over the medium term.



Regional Offices

Demand prospects should be more resilient for the regional office market, especially given that the make-up of the occupier base is more heavily weighted to domestic firms. However, the market will not be fully immune. As demonstrated in Figure 2, there are a number of industries that could be impacted by having partial access to the single market, a general weakening in the economic outlook, or any near term changes to government austerity measures.

Figure 2. Impact of Brexit across UK regional industries

		Office markets most affected
Industries exposed to less favourable free movement deals, loss of pass-porting rights	**Tech**, **Finance**	M25 Offices, Major regional cities, Scotland
Industries vulnerable to the single market access & trade negotiations	**Automotive**	Midlands. Sunderland Merseyside, Swindon, Essex, Oxford
Industries exposed to joint licensing agreements with the EU	**Pharmaceuticals**	SE Offices
Industries exposed to EU regulations & EU funding	**Telecoms**, **Aerospace**	M25 Offices, South West, Midlands, Scotland
Industries vulnerable to changes in austerity measures bought on by a weaker economic climate	**Public Sector**	Regional office markets with a high exposure to public sector workers

Overall, rental growth prospects are expected to be more muted in the short term against a backdrop of lower businesses activity and delays in corporate decision making. However, with less exposure to European firms and financial services, lower levels of regional supply (especially grade A space, in the major regional cities) and an increased probability that developers will scale back speculative schemes in the near term, the levels of rental decline should be moderate in relation to the Central London Office market.

Performance prospects are expected to deviate by location, with core city-centre offices delivering better growth prospects over the next five years relative to out of town, suburban office locations, which remain prone to cuts in government spending and the centralisation of public sector functions to densely populated city-centres.

The outlook for Scotland's office market is also highly uncertain at present and could unfold in one of two ways. With many firms' customer base located in the UK, this could result in a number of office headquarters being transferred closer to their customers (in the UK). Then again, an independent Scotland with closer ties to the EU could make Scotland a favourable setting for firms that are already regulated by EU rules, to re-locate and continue to adopt a 'business as usual' approach within Scotland's borders.

Industrial

The industrial market is expected to weather the impact of Brexit reasonably well with a 5 year forecast return ahead of the All Property average. We believe the industrial sector will continue to be supported by strong investment and occupational demand for a few reasons:

Firstly, the vast majority (c.90%) of industrial goods, except for automotive, is targeted to the UK (c.70%) compared to 20% to global markets. This represents a great reliance on the internal strength of the economy and the potential to boost growth, in the case of Soft Exit, as the UK negotiates trade agreements with non-EU economies independently.

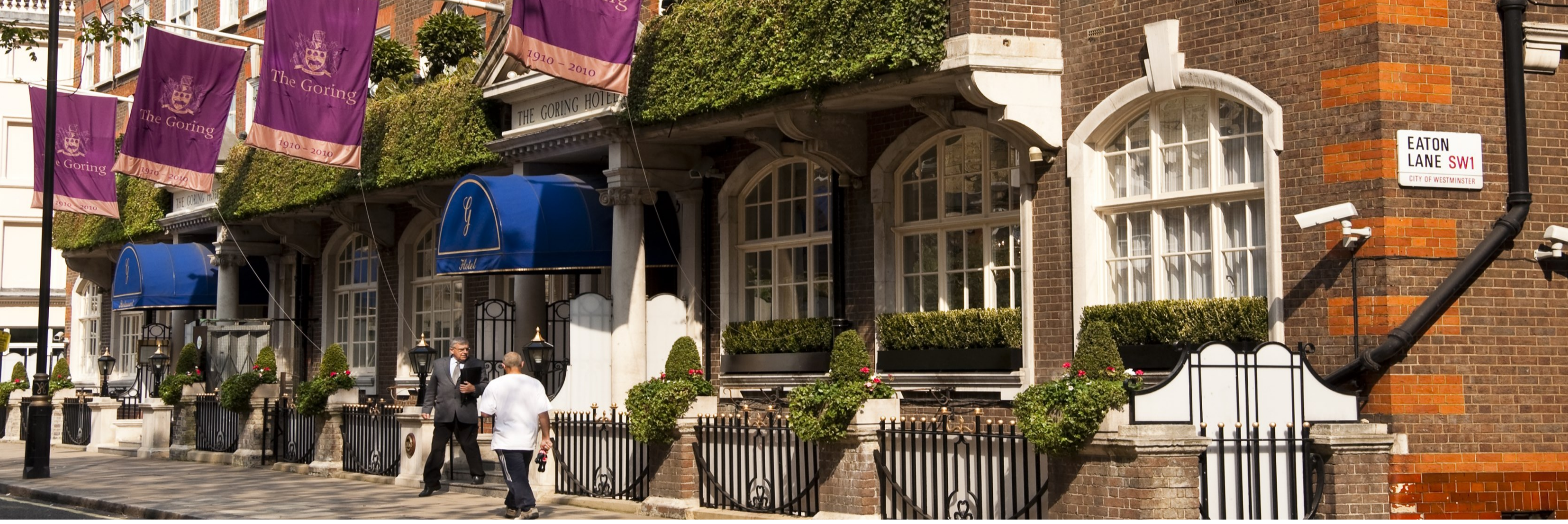
Secondly, exit negotiations are likely to keep Sterling at lower levels for some time, particularly if the BoE decides to lower the base rate to 0.25% in August. Therefore, any tariffs on exports should be more than offset by a weaker currency, stimulating external demand and therefore activity in industrial markets.

Thirdly, we believe that the occupational and investment markets should continue to benefit from businesses increasing their retail presence online as a result of technological advances - a megatrend that is likely to override the impact of external shocks, such as Brexit. There has been an exponential growth in online sales, which was responsible for c.50% of demand for industrial stock in 2014 and 2015. There is nothing to suggest that this will abate anytime soon.

Having considered the supply pipeline, we believe that smaller industrial estates located close to the economic hubs and transport links are likely to provide the best returns, ahead of that for standard industrials. Distribution warehouses may be hit harder by the elevated levels of supply and the potential for labour costs to rise, dampening operators' performance (due to a higher reliance on the European workforce).

As the property market experiences a capital correction in 2016, we expect income to continue to drive industrial returns. Industrial prime rents are less than 2% higher than their previous peak and have proved to be very resilient historically, with volatility a third of that of the office sector.

The industrial sector is relatively well positioned given its higher yielding profile. We forecast its income return of 5.4%p.a. will be ahead of the market, giving the sector an income advantage. Moreover, with the sector having delivered less volatility in rental growth historically, moderate falls in rents are more likely. On the whole, given strong sector fundamentals, we are expecting lower rental value falls for industrial sector relative to All Property, which should help reduce the impact of capital falls on total returns.



Alternatives

The alternative sector should be less susceptible to any adverse effects of Brexit, although each segment will have its own specific issues. Those areas that offer longer dated, inflation-linked lease structures, and where prospects are underpinned by favourable long term demand drivers should retain healthy levels of investor appetite, as investors seek the security of income in times of growing uncertainty.

Healthcare

The healthcare sector is a prime example of a sector that should be least affected by Brexit given its exposure to the features listed above and favourable demographic prospects. There could be some pressures on government run operators, if the levels of funding shrinks alongside any potential downturn in the domestic economy. Another key issue that could materialise is the difficulty in either retaining the current workforce or attracting new staff in areas such as the care home industry. Around 5% of the care home workforce are EEA nationals, whilst relatively small, any less favourable free movement deals could cause companies to lose cheap labour, resulting in higher recruitment and salary costs, reduced profit margins and a greater level of default risk across the sector. Overall, the sector should deliver total returns ahead of the market average, with primary healthcare (doctors surgeries) delivering better risk-return prospects compared to secondary healthcare.

Hotels

The devaluation of the pound should make the UK a more attractive holiday destination, boosting tourist numbers and discretionary spend by overseas visitors. There could well be a revival in UK visiting numbers as more people substitute trips abroad for a holiday at home.
However, with a weaker global economic growth outlook forecast for the five year period, and potential increases in operating costs both in terms of labour and imported goods, this could counteract some of the gains from increased tourism. Overall, the growth in revenue per room (RevPAR) is expected to remain moderate. From a investment perspective, prime hotels in resilient tourist locations are expected to experience smaller valuation adjustments.

Student Accommodation

Greater controls over immigration and the loss of current subsidies (such as the subsidised fee arrangements for EU nationals to an open market rate) could deter cost-sensitive EU nationals to study in the UK, however demand from non -EU nationals should still remain buoyant. Accommodation close to top tier universities should maintain better return prospects over the next five years.

Residential

The performance outlook for the residential sector will vary dependent on the location of stock. The outlook for Central London residential looks mixed. The sector is most vulnerable to a price correction, given where current pricing sits relative to long term trends, increases in stamp duty, higher levels of prime stock under construction and a potential drop in demand from high skilled workforce (financial service employees). However, a weaker Sterling could dampen these downside risks, as overseas buyers (with dollar denominated / pegged currencies) are enticed by more attractively priced stock. Elsewhere, the lower levels of residential stock outside of capital and greater lending constraints should support rental growth prospects on regional stock.

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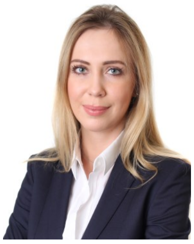

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