Research Blast

Brexit and UK real estate update – January 2021

There's a potential upside for UK real estate in 2021 with vaccine roll-out ahead of other markets and a no-deal Brexit avoided

The UK-EU agreement itself is patchy in some areas relevant for real estate and discussions will continue

The impact on the market will remain modest compared to the ramifications from COVID-19, but may impact the longer-term growth potential of the UK

A sigh of relief

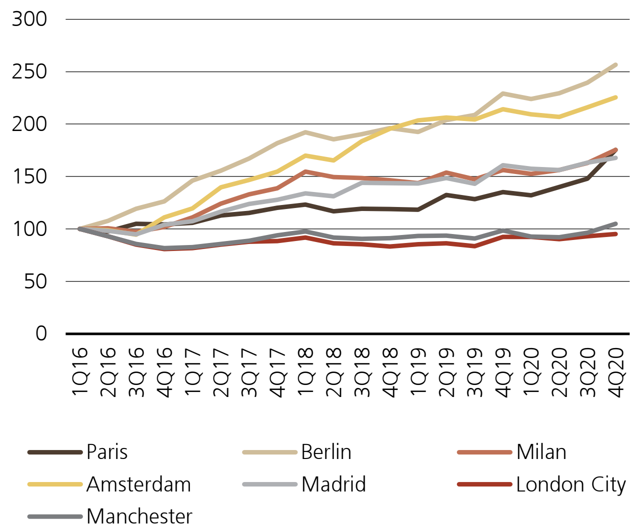
After three and a half years of tedious negotiations, a Trade and Cooperation Agreement (TCA) was finally reached between the UK and EU on 30 December 2020. Despite being the number one topic for discussion for much of this period, the reaction within the UK real estate industry has been surprisingly muted. COVID-19 remains the most pressing short-term challenge, but with a vaccine roll-out underway there is hope that normality is not too far away. And over the medium to longer-term, the terms of this deal will still have an impact on both the investment and occupational real estate markets in the UK.

Even within wider financial markets, the reaction to the TCA was relatively subdued. Sterling appreciated by 1.5% against the USD when it became clear that an agreement was likely to be reached before the deadline. This was a relatively small change considering some of the volatility we have seen since the referendum result. Part of the reason behind the modest reaction, is that some of the details in TCA are far from conclusive and negotiations surrounding these will undoubtedly continue for years. But the clear positive which can be taken away, is the significant risk of a no-deal has been removed from the table. And this may lead to the most important short-term impact for UK real estate, which is an improvement in sentiment from overseas buyers, many of whom had been cautious about the UK market due to the downside risk of a no-deal outcome.

Overseas investors and the pricing gap

Aside from the retail sector, the UK real estate market has performed relatively well in absolute terms since the 2016 referendum. However, when compared to other European markets which have benefited from strong levels of yield compression during this period, performance has been much weaker. Although Brexit is by no means the only factor here, the risk of a no-deal certainly contributed to the pricing gap which has emerged. Figure 1 below demonstrates in USD, that prime UK office values have remained broadly stable since 2016, compared to an increase of between 70-150% in other major European markets. Although low by historic standards, yields in the UK now look very attractive compared to other European markets. As an example, the prime yield spread between Paris CBD and London City (125bps), and London West End (100bps), is the highest it has been since 1991.

Figure 1: Prime office values index (1Q16=100)

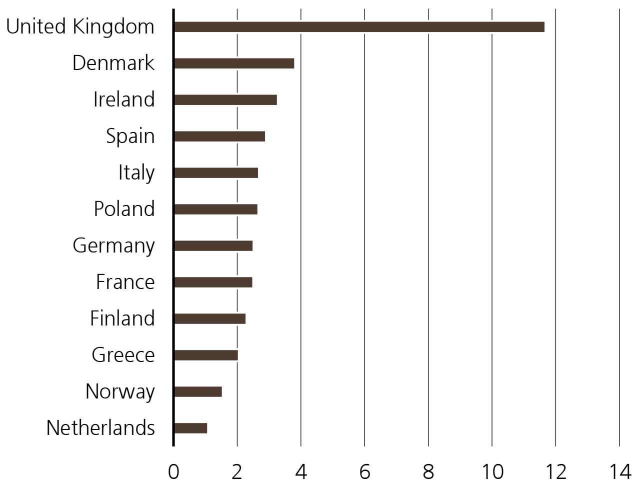


Source: JLL R.E. Search, 4Q20

This disparity in pricing has not gone unnoticed, and if we remember back to this time last year, there was very strong sentiment towards the UK, and London in particular. The large Conservative victory in the December 2019 election appeared to do enough to ease concerns amongst many investors. That political risk has now subsided even further with the TCA being agreed.

COVID-19 inevitably put investment plans back on hold, and travel restrictions made it particularly challenging for overseas buyers to come back into the market in 2020 as had been anticipated. But as Figure 2 illustrates, the UK is leading Europe in its vaccination roll-out, and it is not unrealistic to expect some return to normality in the second half of the year. If the UK does move back onto the agenda, those wide yield gaps with other European markets could start to move back in and provide a significant boost to returns.

Figure 2: Vaccinations per 100 people



Source: Our World in Data, 29 January 2021

Financial and professional services

Financial and professional services are the UK's largest exporters to the EU, accounting for around a quarter of total exports in 2019[1]. Despite the significance of these sectors to the UK economy, they have been largely left to fend for themselves to secure continued access to their largest export market. When the UK was still a member of the EU, professional accreditations for accountants, lawyers etc. benefited from automatic recognition, which will now be lost. All the deal does is provide a framework to establish mutual recognition of professional qualifications. Should industry bodies within the EU decide to no longer accept UK accreditations to operate in their jurisdiction, they would be perfectly entitled to do so.

Similarly, the arrangement for financial services is inconclusive. The TCA includes an agreement to try and reach a memorandum of understanding by March 2021 which might mean the two sides agree to recognize each other's rules. This is a process known as equivalence, which would allow the finance industry to trade across the UK and EU border. The UK has already offered reciprocal access to the UK market for EU banks, but EU regulators intend to wait and see what happens with UK banking regulations before making a decision. It is worth noting that the UK's competitive advantage over the EU in financial services has long been a contentious issue, and even if equivalence is granted by the EU, it could be withdrawn at short notice.

Whilst this all sounds somewhat negative for the office occupier market it will not come as a surprise to the affected industries. Financial service firms have planned for potential loss of access to EU markets since the referendum result. As part of this, most of the large firms have set up offices within the EU to channel business through without causing significant disruption to their Central London operations.

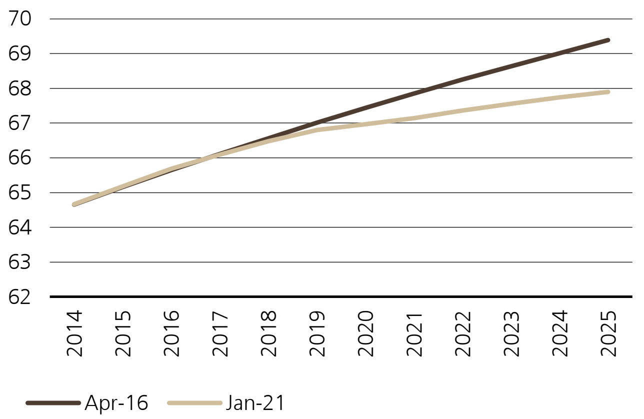
[1] House of Commons Library; Statistics on UK-EU Trade, 10 November 2020

What we are expecting to see going forward as a direct result of a formal arrangement not being in place is lower headcount growth in Central London, rather than significant loss of employment. And whilst financial and professional services are still key occupiers of UK office space, their importance has been surpassed since the GFC by the technology sector, which will have less direct implications from the UK leaving the EU. Restrictions of immigration is a potential drawback for this sector, although these roles will typically be highly skilled and workers still wishing to come to work in the UK technology industry should be able to qualify for a UK visa under the new rules. Despite being outside the EU, we expect London to remain a global tech hub and center of innovation.

Free flow of goods secured

As expected, the TCA provides far more detail on the future arrangement for goods, than it does for services. Importantly. there will be no taxes or limits on the physical goods which trade between the UK and EU. Additional paperwork is now required, which has caused some delays and issues particularly for highly time sensitive deliveries, such as live seafood. But for the most part it's business as usual for the export and import of goods between the UK and EU. For UK retail this is good news, or perhaps not more bad news is a better way to describe it. Challenges relating to COVID-19 and the accelerated structural shift towards online were always going to be far greater challenges in the short-term. But the avoidance of disruption in goods arriving and inflation due to new tariffs being introduced has at least not made the situation worse.

Figure 3: UK population forecasts (million people)



Source: Oxford economics forecasts, April 2016 and January 2021

Similarly, but reversed to the upside, COVID-19 and e-commerce will remain the key drivers of continued strong occupational demand for the logistics sector. Delays and congestion at ports would have put some pressure on the operators, although it is unlikely to have fed through into lower demand for logistics space. Probably the biggest long-term challenge to the sector will come from the changes in immigration policy (Figure 3). Most warehouses are a long way from full or even partial automatization and labor supply was a key challenge facing the sector even before the EU referendum. The points-based system will make it very challenging for low skilled labor to relocate to the UK, affecting both the supply of warehouse staff and delivery drivers over the medium to long- term.

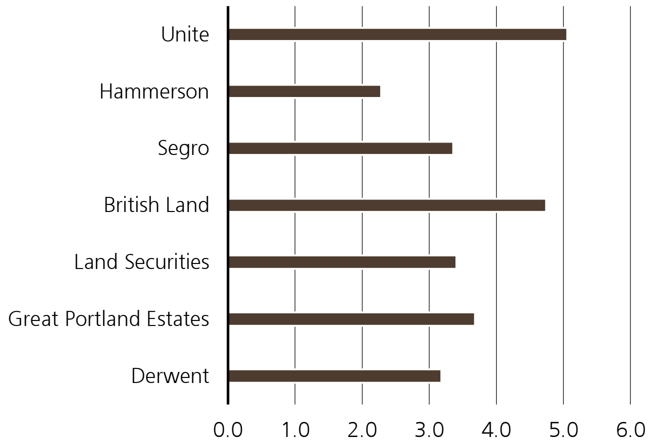
Higher student fees and lower EU numbers

There were no provisions made for EU students within the TCA and from the 2021/22 academic year EU students will revert to paying full international fees. These vary by course but are typically significantly higher than the GBP 9,250 domestic student rate which EU students had qualified for previously. Applications from EU students, which make up around 7% of total students in the UK, are expected to fall back considerably. The universities which continue to attract EU students are likely to be limited to the most prestigious, where the quality and reputation of the course may still warrant the higher cost.

Conclusion: A welcome relief but not a game changer

The reaction from the UK REIT market (Figure 4) is a fair reflection of the impact of the deal for UK real estate. Prices rose by between 2-5% during the period the deal was finalized, which reflects a sense of relief that a downside risk wasn't going to make the market even more challenging in 2021.

Figure 4: UK REIT price change* (%)



Source: Thomson Reuters Eikon, *price change from 21 December 2020 to 30 December 2020

Whilst there are ongoing uncertainties surrounding some specific sectors on the occupational side, the potential impact on the market is likely to be minor in the context of COVID-19 and the structural shifts we are observing. But the absence of the no-deal cloud which has been hanging over the UK since the referendum result in June 2016, certainly has the potential to improve sentiment in capital markets. In an environment of ultralow interest rates and inflation potentially returning, returns from UK real estate could start to look very attractive even if the market only makes up part of the lost ground on its European neighbors.

Real Estate Research & Strategy Team – Europe

Gunnar Herm
Zachary Gauge
Sean Rymell

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Real Estate Research – Europe

Zachary Gauge
+44 (0) 20-7901-5534
zachary.gauge@ubs.com

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