Research Blast

European Real Estate Market, Brexit Update June 2016

Brexit: The outcome

The UK vote to leave

The full impact of the vote to exit will take longer to emerge in the real estate market than other more liquid asset classes. Real estate transactions which would provide indications of the impact on pricing will take months to complete, whilst the valuation based property index in the UK will also have a lag in reflecting the impact of the decision.

(More) uncertainty

The decision to leave will result in an increase in uncertainty across the UK market which had already been building prior to the referendum, and both investment and occupational activity is likely to be further subdued as a result. Uncertainty over the Brexit issue is set to continue over at least the next two years (but probably longer) whilst a new agreement is negotiated. And as a direct consequence of last night's vote there is further UK political uncertainty following the resignation of PM David Cameron and an inevitable renewal in demand for a new referendum on Scottish independence. Externally, the Brexit vote is likely to give a further boost to populist movements already established in continental Europe, and with elections coming up in the next 18 months in Germany, Spain and France we may see further gains for populist parties, adding additional strain to the EU.

Impact on UK investment markets

The changing supply and demand dynamics in the investment market and heightened levels of uncertainty will inevitably lead to some outward correction in pricing over the short term, although we cannot predict the exact extent at this stage. The retail funds are the most likely to come under pressure to sell off assets if redemption demands rapidly build up, however foreign buyers including sovereign wealth funds and UHNW have the option to wait it out which will enable them to be more competitive on pricing should they decide to downsize in the market.

Leveraged investors on floating interest rates are in theory exposed to a spike in rates, however at the time of writing there has not been a run on UK gilt yields – in fact the opposite has occurred with 10-year gilts moving in by more than 30 basis points to a new record low of 1.02%. In contrast to 2007, the UK real estate sector is not highly leveraged and assuming the economy and occupational markets do not experience a complete collapse (which we are not forecasting), cash-flows will be supported and we should not see a large volume of forced sales which would potentially lead to a very severe correction in pricing.
In terms of markets, as cited before the referendum we expect London will have the most severe short term impact, due to the high dependence (c.70%) on foreign capital which drives the market and which is likely to be disrupted until the outcome has become clearer. Vendors which wish to sell during the aftermath of the vote will have to apply a discount, and the extent of this will largely come down to the level of pressure on the sell side. Outside of London the market is predominantly driven by domestic funds with capital committed to the UK, so are likely to see a less severe disruption to inward capital flows or money exiting the market. However, if the retail funds do come under pressure to sell assets, they are likely to sell off their non-core assets first which may adversely impact secondary regional markets. These markets also tend to have the lowest levels of liquidity during a period of uncertainty, and are most exposed to a slowdown in the occupational markets which will come about from the weakened economic environment.

Impact on UK occupier markets

Similarly to the investment market, heightened uncertainty typically leads to a slowdown in occupier activity with most companies likely to delay decisions until the outlook is clearer. The absence of new demand may place pressure on some landlords to reduce rental levels to try and stimulate new demand. It is likely tenants will also attempt to negotiate rental discounts at lease breaks / events to take advantage of what are likely to be challenging market conditions. Potential job losses could result in downsizing of real estate occupation. The full impact of this is largely dependent upon how severe the economic consequences of the vote to leave are, and it may take some time for these impacts to come through to the market. In the event of significant downsizing we would see a large volume of secondary stock coming to the market, at the same time as weak active demand, resulting in a significant correction in rental values.

Again, Central London is likely to experience the most severe short-term impact due to the vast number of international firms which are based in the city. However, we remain confident that the occupational market is not set to collapse. Whilst we would expect some of the large corporates to reconsider their European strategy in light of the exit vote, which could result in the transfer of some specific functions to alternative locations within the EU, we are not expecting any kind of mass exodus from London. But as there is a significant amount of speculative space under construction, particularly in the City market, which is due to complete next year, we will see a large volume of new supply coming onto the market at the same time as expansionary demand from occupiers is likely to remain very weak. We were already forecasting declines of -4% and -10% in the City and -3% and -8% for the West End for 2017 and 2018[1] due to the volume of new supply, but with the weaker demand outlook this is likely to be more severe.

Outside of London, the more domestically driven occupational markets are in theory less directly exposed to the implications of the exit vote, however could be more exposed to the overall slowdown in economic growth and weaker sentiment which we are expecting to set in during the aftermath of the result. We were negative on the prospects for rental growth in the weaker secondary markets prior to the exit vote, particularly on the retail side, and as these markets typically require a stronger level of economic output to support occupational levels than better quality space in established locations, the outlook for rental growth in these markets is particularly negative.

Consequences for Europe

Brexit is likely to increase political uncertainties in the rest of the EU. Lower corporate sentiment may also delay business decisions and can affect European occupier markets. However, EU countries and cities have broad based economies and do not have an overwhelming dependence on the UK economy. Growth in the eurozone has shifted towards domestic demand which provides a certain cushion. Development pipelines in continental European markets are also well behind London, which keeps the future supply situation in particular in city centers under control. Therefore an immediate reaction on rents is less likely but rental growth may slow a bit.

Political uncertainties may also influence real estate investors' sentiment negatively towards the rest of the EU and delay investment decisions. In contrast to the UK and in particular to the London market most European real estate markets are less dependent on non-domestic and in particular non-regional capital. Non-regional capital inflows are likely to soften in the short term as a result of the uncertainty. Eurozone investors may have a different view. The low bond and interest rate environment may last for even longer and in the absence of alternatives real estate may continue looking attractive. While non-regional capital has had a strong focus on larger lot sizes (above EUR 100 million) regional investors tend to concentrate more on smaller lot sizes of up to EUR 70 million. Consequently, lower demand from non-regional capital may have a bigger impact on big lot-sized assets than on small lot sizes. Paris and Frankfurt are one of only a few markets in continental Europe offering large lot sizes, in particular in the office sector. However, the financial markets of both cities may benefit on the occupier market side from a Brexit in the mid-term. Shopping centers tend to offer large lot sizes and over the last few years have been a focus of non-regional capital (in particular Asian and Middle Eastern) which may cause a slight softening in pricing.

Every cloud….

Currency: The depreciation of sterling means that non-sterling denominated investors in the UK market who are unhedged will suffer additional losses on top of the likely negative impact on capital values. On the flip side, for opportunistic investors this does create a scenario where UK assets could be acquired with GBP at its' lowest level since 1985 and assets available at a discount. For investors prepared to take a long term view of the UK market (10 years +) this presents an interesting opportunity. However, we would only focus on core assets with very strong covenants and WALTs which exceed the period of uncertainty and volatility.

Interest rates: The result means we are likely to remain in a lower for longer interest rate environment in both the UK and externally. There continues to be a vast amount of capital building up for deployment into real estate, some of which would have been targeted towards the UK. This may benefit some European markets, but yields for core assets are already at or below peak levels in most major cities. If yields in Europe do move in further, or even maintain their current level, it is hard to see UK yields moving out significantly above their current level as it will still present an attractive proposition against other real estate markets, and the near 0% returns on government bond yields.

[1] Source: UBS Asset Management, Global Real Estate Research & Strategy

Lending to real estate: At the time of writing there was no evidence of a spike in UK gilt yields and the Bank of England may contemplate additional easing. Although banks may apply an additional risk premium in their spread when lending to core property to reflect the heightened uncertainty, it is not likely to result in a significant increase in the cost of lending within this segment of the market. It is more likely to result in challenging lending conditions outside of core assets where banks were already risk adverse following the global financial crisis. This should create further opportunities for alternative lenders to fill this gap, however even higher levels of due diligence are likely to be required to negate the heightened risks in the market.

Global Real Estate Research & Strategy
Paul Guest
Gunnar Herm
Zachary Gauge

For more information please contact:

UBS Asset Management
Global Real Estate Research & Strategy
Zachary Gauge
Tel. +44-20-7901-5534
Zachary.gauge@ubs.com

www.ubs.com/realestate

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