PEI Alternative Insight
PERE
www.perenews.com

Beyond Brexit

Published: **01 September 2016**
By: **Mike Phillips**

Talk of the UK property market is dominated by the fallout from the vote to leave the EU. But the market is far from paralyzed and opportunities will slowly begin to emerge in the country.

In the UK, every conversation these days begins and ends with Brexit. It is impossible to discuss any element of UK real estate without thinking about how things might have changed on 23 June.

The overall effects of the UK's referendum vote to leave the EU on real estate specifically, and on business and society more broadly, are currently hard to predict. Nevertheless, there were some very instantaneous effects for bricks and mortar.

In the month that followed the vote, shares in listed property companies dropped by as much as 30 percent. Around £1.4 billion ($1.8 billion; €1.6 billion) of equity was withdrawn from UK open-ended funds for retail investors, according to data from unit trust sector body, the Investment Association, forcing funds to close

and assets to be brought to market to meet liquidity requirements. Major developments in the City of London were put on hold because of worries about occupational demand.

But things then quieted down. Real estate shares rose again, although at the time of going to press they remained below pre-vote levels. Some open-ended funds re-opened for redemptions again, while others sold assets at small discounts with a view to dropping redemption gates again soon.

With the initial volatility around the vote receding, the UK now enters a period of adjustment to a life that will be lived outside of the EU, and predicting how that life will impact real estate is difficult.

The key questions surrounding capital flows, occupier markets, and where the best opportunities will arise were debated by a group of senior real estate practitioners gathered together by PERE to discuss the UK market. At the table we have four fund managers and a lawyer: Jo Allen, chief executive of Frogmore; Andrew Angeli, head of UK research at CBRE Global Investors; Simon Martin, head of research and strategy at Tristan Capital Partners; Toby Phelps, partner at GreenOak Real Estate; and David Ryland, partner at Paul Hastings.

Stealing the focus

Beyond Brexit, the group examined some of the very long-term trends that are influencing the UK sector, such as changes in the retail market, and the continued reticence of UK institutions to invest in alternative sectors such as senior housing and private rented accommodation, in spite of the strong demographic arguments.

But getting away from the vote is difficult. One of the key questions exercising the UK is the attitude of global investors to the market following the referendum vote. Overseas investors accounted for a record 50 percent of investment volumes in 2015, according to data from London-based property advisory firm Lambert Smith Hampton, making them key to the market’s resilience. The view was that there was little unanimity among global investors, with some likely to avoid the UK and some seeing the Brexit vote as a potential opportunity.

“There are some for whom historically that level of currency movement has always been a buy signal, certainly from the Far East, particularly if you're a long term core investor,” GreenOak’s Phelps says. “A lot of the people we’re talking to missed out in the 2010 to 2013 window, felt pricing has been too high for the past 18 to 24 months, and feel this is the window.”

Frogmore’s Allen adds: “It depends on how long investors want to hold their real estate assets: if you're a long term investor, you’ll take a totally different view to pricing than those of us would in the value-add space where you’re looking to get in and to get out in three to five years. Some investors simply want to collect rent in a safe haven environment.”

For some investors, the potential for dislocation is creating palpable excitement. “I spent the two weeks after

the vote travelling: I left on the Sunday after the vote and went straight into meetings in the US," Tristan's Martin says. "There, the sense was 'that's interesting, where is the opportunity I can capitalize on?'

"You have to remember that these guys are living in a world where the yields on a large part of their portfolio are negative, so you have the Treasury market struggling to get returns and a lot of volatility in the equities market. For them, the idea of being able to buy 25 to 50 basis points cheaper is a decent value proposition if there is a group of motivated sellers they can take advantage of."

Some are less excited. "The reaction has been polarized," says CBRE GI's Angeli. "We had one UK local authority pension fund allocate £50 million for distressed opportunities that will arise from Brexit, and UK local authorities are not renowned for being that opportunistic and fleet-of-foot."

"But we also had calls with a large US investor and a large Dutch investor who said they would not be investing in the UK for the foreseeable future. They said there was no way that if they took a deal to their investment committees right now they would be able to get it through."

"As I understand it, a number of the German funds are now looking at the UK quite closely because they made a lot of money in the early 1990s from UK real estate and they are looking to see if the same conditions exist again as a consequence of market adjustment and currency depreciation," says Paul Hasting's Ryland.

"It comes down to how you asses the market going forward. Some private equity funds have found that over the past 12 months they have been 10 percent uncompetitive in bid processes. Now they're probably not because of the currency shift, but what are the correct assumptions you apply based on the uncertainty you now have? Similarly, some of our Far East clients are saying its 5 percent to 10 percent cheaper, but they still don't know to what extent they need to change their underwriting assumptions. It doesn't mean that it's good value just because it's cheaper."

What distress?

On the question of how the UK economy, and therefore leasing markets, will perform, it is of course still too early to say, with very little data other than forecast data currently available. But there is also a sense that there is unlikely to be a major shock to occupier markets.

"There are, of course, surveys tracking business confidence. But, if we witness office take-up and leasing transactions out into the Thames Valley and through to the regions, then we will be able to say that it has all settled down," Allen says. "The good news is that, generally, supply and demand sides are much more balanced than in previous cycles."

"There does seem to be a view that companies will be more reluctant to take longer leases in the City until they have a clearer view of how things will play out and may prefer to extend existing leases for say 2 years to 3 years. However, there is no real evidence as yet," says Ryland. 'There will also be an impact on existing

business plans. For example, if you bought a portfolio, say, 12 months ago in the regions and the business plan assumed growth, then this may be harder to implement now."

“Deal sweeteners are becoming increasingly common, so that’s shorter leases, more months rent free or increased capital contributions,” Angeli adds. “The majority of the leases we’ve signed post-vote were being worked on pre-vote and almost no Brexit clauses were executed, so it will take some time until we get a true picture – it’s probably not going to be until early next year. We’ve definitely reduced our rental assumptions over the coming couple of years, but, with that said, we’re also in an era of peak forecasting risk.”

Putting Brexit in an international context, Angeli says: “The concern internationally could be that everyone in the UK is myopically fixated on Brexit, when actually there are other concerns in the world. The impending Italian referendum and banking crisis, China’s economic situation, political fragmentation, terrorism, all of those things are still there, and arguably have intensified over the previous couple of quarters.”

“But compared to 2007 and 2008, it’s not nearly as severe. Back then, people were calling you up and asking how systemic is this, is there liquidity, can I get my money back? Now people are calling and asking where the opportunity is.” That type of attitude suggests that capital value falls across the market will be nowhere as dear.

Phelps adds that, again, when placed in the context of widespread global political instability, an event like Brexit does not actually place Britain that far outside the norm. “On a relative basis there is risk everywhere. There is risk in Europe and risk in the US - look at the election there. Trump is going to create uncertainty for the next few months. But how much impact does political uncertainty have on the underlying economy? If you look at the example of Spain, they have had an interim government for several months there now, and it hasn’t done anything to derail the recovery.”

With three of the five people gathered running value-add or opportunity funds, there is plenty of debate about whether there will be opportunities born of distress, and what kind of sellers might provide this. The consensus is that the best opportunities will not arise in the short term. The initial sales by open-ended funds, for instance, are deemed here as being far from distressed.

“If you look at that Boots investment transaction on Oxford Street, which Aberdeen sold at circa 3.5 percent [to Norges Bank Investment Management for £124 million], you have to ask: what’s the liquidity discount there?’ Allen asks. “It doesn’t sound a distressed disposal price does it?”

“Prior to the referendum, there was evidence that value-add returns might already have been factored into the pricing. The type of assets we target – ones that that need the capital expenditure which we can provide - haven’t been brought in volume to the post referendum market yet, perhaps because of the summer, but maybe because potential sellers are waiting for evidence of whether or not the values of this type of asset may have fallen.”

“We looked at a whole bunch of stuff that came from open-ended funds and were among the people that got

phoned. The reality is that it all went at way above what we were willing to pay for it" says Martin. "To me, what's actually interesting is how the players are responding to it, how the funds that are distressed are responding. Immediately they've come to market with a pre prepped package. How is the equity responding? They've stepped up at a 25 to 50 basis point discount to book value and does that feel like a distressed market? These structures have to be capital constrained for a significant period of time before the opportunities come out, so you have to wait for that time to pass first."

"There are some markets where you just sense values might have gone too far," says GreenOak's Phelps. "The technology boom, where rents have gone up in places like Shoreditch to £60 per square foot - you have to ask how the vote affects the occupier base there, and whether there has been some overpricing. And for certain large London residential projects values certainly got ahead of themselves. The question is, would we want to own them? Some are in areas where there has just been fundamental overdevelopment."

Top end nerves

London residential is an area that Allen also points to as both a potential challenge and a potential opportunity. "We made great returns in our second fund from high-end luxury residential schemes, like The Chilterns in Marylebone. But I think we'd be cautious about doing another prime Central London residential scheme at this time as we're nervous about current demand at the top end of pricing. But we all know about the imbalance between supply and demand for homes in London, which is going to continue and probably worsen as London's population grows. So, if the right schemes come along which will provide homes that are accessible to the transport network and within the price reach of ordinary Londoners (to buy or rent) then we will pursue those opportunities as part of our diverse portfolio."

Another potential opportunity is the lending market. Thus far, Brexit has not caused significant distress in the lending market, Ryland reports. But in the longer term, greater caution from banks could lead to an opportunity for alternative lenders.

"What we've seen so far is that there are some lenders who have been syndicating loans and used the market flex clauses to move the margin out by some 50 basis points," he says. "We've also seen the margins move out on regional deals and one or two banks pull out of deals in Northern Ireland. But the view is, it's not going to fundamentally change the risk weighting valuation of the assets on the bank's balance sheet, albeit there is a possible risk that more cash trap provisions will be invoked if values fall."

"Alternative lenders will see this as an opportunity to achieve greater margins. There could also be an increase in insurance companies making longer term loans, bearing in mind the further fall in gilt yields."

Alternative sectors such as senior housing, healthcare and private rented sector residential were the sectors that should be resilient to short-term shocks such as Brexit, due to the beneficial demographic and social trends of an ageing population and a need for good quality, affordable rented accommodation.
But in spite of these positive trends, they are being held back by a mismatch between the return expectations and the risk tolerance of both institutional and value-add investors. "I always think of the

[alternatives] sectors as being underpinned by services and things that people actually need," Allen says. "Those have to be of interest to us as value-add investors – because, given that they are based on need, they should be resilient and Brexit-proof. We are always evaluating which sectors we should be investing in now with a view to exiting when everyone else is getting in."

"I agree that the fundamentals of alternative sectors - and I wouldn't count student housing as an alternative now - look compelling, but there is a danger you can be too early," Phelps counters. "Institutional investors in the UK still don't know how to deal with alternatives, and so you can't be confident about the exit. If you had 10 years of data for a sector like senior housing or PRS showing that occupancy never dropped below 90 percent and income grew steadily, then you could help an institution to get comfortable. But until then, you need someone to take a risk, and funds like ours aren't willing to take that risk if we can't be confident about the exit."

On the question as to why US and European institutions seem more comfortable with investing in sectors like PRS, Angeli says: "We think that it will be difficult for PRS, in molds familiar to international investors, to get off the ground for cultural reasons. In places like the US, Germany, the Netherlands or Switzerland, there is a disposition to renting and less accommodative government policy. For at least the past decade, every UK Budget has made overtures to incentivize home ownership."

"Until the government backs PRS with some sort of pragmatic policy incentive, for instance through prescriptive zoning, I will be extremely skeptical about the sector."
The retail sector was highlighted as an area where other societal and structural trends were presenting opportunities. While buying large, dominant shopping centers is now seen as the sole preserve of large global pension funds or UK listed companies, the shakeout created by the progression of online retail is providing new opportunities for value-add investors.

"We are buying convenience-led retail at cap rates of 8 percent," says Martin. "Once you finance that, you have got a big coupon, and that allows you to ride out any volatility that might come about as a result of tenant defaults. As long as you are buying schemes where rents have rebased to today's market levels, you can run a great current income stream. The key is you have to find a partner that is a specialist in that area."

"We are also seeing that online retail, which five years ago, many people thought would kill retail parks, has actually breathed a new lease of life into them. Retailers on some of these parks have turned them into click and collect fulfilment centers, which has driven up rents. Retailers are seeing that they can pay £15 per square foot in an edge of town industrial unit, or £18 per square foot in a retail park, where there's ample parking, and people might come in to collect their order and buy something else."

In terms of the flow of capital for fund managers working in the UK, in spite of the fact that the investment market is seen as very far from grinding to a halt, the idea of raising capital for a UK-only fund in the current environment seems distant.

"We closed our third UK value-add fund last year, but we still go around the world talking to investors," says

Allen, “Whilst I can see that some people might think it might be challenging to raise a UK fund in the next six months - given the uncertainty we’ve talked about - the UK still maintains huge attraction to international investors and there seems to be an appetite and certainly curiosity from potential investors about the opportunities a potential ‘disruptor’ like Brexit might bring here."

“It would be hard to raise discretionary capital for the UK now,” adds Phelps.

Don’t judge by the cranes

Overall, the key factor to watch for the UK market in the coming months is how the London development market, particularly the City of London office market, plays out. But it is not so simple as to say that developers pressing ahead with development is a sign of confidence and therefore positive for the market.

“You need to look at who is going to build the pipeline everyone is talking about?” Martin says. “We know there was a lot of supply forecast to come to market in 2018 and 2019, so will that now get built? Rent forecasts are holding up because brokers have said that the development pipeline will be cut, in some cases by 60 percent. But what if people don’t put new supply on hold, take a bullish view and just build it out? The thing that could disrupt this is if people just build anyway as they find alternative sources of finance. The development pipeline for the City is large if people find a way to look through the risk.”

Phelps offered a counterpoint. “Big leasing transactions are the important ones to watch, the tenants taking space at 100 Bishopsgate, will they commit, will GAM come back and do their deal with Land Securities, in Victoria? You need to look at the projects that have already been started, like 22 Bishopsgate, and see if people carry on with them, either with their own resources or finding alternative sources of financing. If people can find alternative sources of financing, then that is a good sign.”

Look to the skies. All eyes are on the cranes in the City of London. At this point, they could either symbolize confidence, or the lack of reality that could bring a key market back down to earth with a large bump.

BIO

Jo Allen
Chief Executive, Frogmore
Jo Allen is responsible for the running of Frogmore and is a key member of the investment committee.Allen joined Frogmore in 1994 and has been involved in the asset and development activity for all of Frogmore’s transactions over the past 22 years. She has led the asset management of the Fund’s flagship assets including ‘Oriana’ – retail investment in the heart of West End.

Toby Phelps
Partner, GreenOak Real Estate
Toby Phelps is a partner at GreenOak based in London. Toby’s focus is GreenOak’s principal equity investing, asset management and advisory business in the UK and Europe. Previously, he was CEO at

Investa Office Fund ("IOF"), an Australian listed REIT. Prior to IOF, Toby was managing director and head of UK for Tishman Speyer Properties in London.

Simon Martin
Partner, Head of Research and Strategy and Investment Committee member at Tristan Capital
Simon has more than 20 years of experience in applied investment research and strategy and helped found the firm in 1999. He has been a consistent presence on the firm's investment committee since it raised its first fund in 2001. Simon led AEW's European research efforts from 1999 to 2008 and before joining the firm he headed DTZ's Fund Management and Investment Strategy Group.

David Ryland
Corporate Real Estate Partner, Paul Hastings
Ryland focuses his practice in commercial real estate with particular emphasis on UK and European property funds, joint ventures, clubs, property finance, structured acquisitions, cash flow repackagings, sales and leasebacks, sales and managed transactions and alternative asset classes including hotels.

Andrew Angeli
Head of UK research, CBRE Global Investors
Andrew is a senior director, having joined the company is 2007. He is responsible for overseeing and shaping the research capabilities of the UK business, both in terms of quantative forecasts and quantative analysis. He sits on the UK investment committee and the separate accounts oversight committee. Prior to his current role he had a pan-European research function and worked in the firm's Los Angeles and Paris offices.