DE-LINKED FROM BREXIT?

THINKING THROUGH THE CONSEQUENCES FOR "ALTERNATIVE" REAL ESTATE SECTORS

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In the few months since the UK unexpectedly voted to leave the EU, real estate investors have been grappling with what Brexit will mean for real estate. Given the lagging nature of economic data and property valuations, it is too early to say. But it is sensible to consider how the consequences are likely to vary across geographies and property types. Assuming an impact with a given degree of severity generally, which sectors are likely to be hit more than the market as a whole? Which should do better?

The most likely suspect for potential Brexit fallout is widely and correctly thought to be the City of London office market. "Passporting" rights that allow UK-based financial institutions to do business across the EU are at risk of being withdrawn. If that happens, the London office space footprint of banks, insurance companies, and asset managers could shrink. In the negotiations, passporting will be linked with other difficult issues, especially immigration. As such, uncertainty on the issue is likely to be protracted. Meanwhile, the City is facing a wave of new supply and cyclically high rents, suggesting downside potential is present even without the Brexit-related existential threat.

Best guesses of impacts on other UK property sectors are mixed. Prime high street retail and hotels are expected to benefit from the weaker pound, as cheaper sterling entices foreign shoppers and tourists into the UK and especially Central London. The outlook for shopping centres will follow that of consumer confidence generally, which fell sharply after the vote but has since rebounded. Logistics space demand is so strongly supported by secular e-commerce trends that we foresee no discernible impact.

Less attention has been devoted to the potential Brexit impact on "non-traditional" (i.e., "specialty" or "alternative") sectors. This includes the living sectors – encompassing private rented residential, student accommodation, and senior housing – as well as self-storage. In these pages and elsewhere we have advocated for their inclusion in investors' portfolios. We have argued that these sectors are benefitting from a structural decline in risk premia versus other property types, and that they are less susceptible to a downturn.

Given less comprehensive and less timely market data than is available for the major property sectors, it is not surprising that there is little hard evidence to draw on. We do know that the "other" category of the UK IPD Index performed better than any other sector in July, posting a -0.3% monthly return versus -2.4% for all property (City of London offices was the weakest at -4.0%). But it is still early; the full impact will only be known over months and years.

As such, we rely on economic intuition to reason through potential channels of influence. Just as concerns over passporting weigh on the City office market, what Brexit-driven factors are likely to affect non-traditional sectors? In this article, we go through each of these sectors, offering our thoughts and strategic recommendations.

CONTINENTAL EUROPEAN RENTED RESIDENTIAL

Continental European residential demand may actually benefit from Brexit to the extent that migration to the UK is redirected to other countries, improving their demographic outlooks. If EU citizens from the former Communist states in Eastern Europe or unemployed/under-employed youth from Southern Europe are no longer able to easily migrate to the UK, they may set their sights on other strong job markets, especially Germany, Scandinavia, Ireland, and the Netherlands. The potential for a shift of financial jobs to alternative financial centres such as Frankfurt, Amsterdam, Paris, and Dublin would provide an additional, if narrowly targeted, boost.

We also expect rented residential assets on the continent to benefit from "safe haven" investment demand. Rental regulation causes these assets to exhibit highly stable cash flows, which are in high demand by investors in times of uncertainty. This helps to explain the strong outperformance of German residential companies in the past few months. Since referendum day, Deutsche Wohnen shares are up by 15% and Vonovia by 10%. For comparison, the broader EPRA ex-UK index rose by 5% over

the same period, while the EPRA UK index fell by 6%.* Further monetary easing in the wake of Brexit should drive further yield compression given the bond-like nature of core residential assets in regulated markets.

** The above figures cover the period through 1 Sept.*

UK PRIVATE RENTED SECTOR (PRS)

Not surprisingly, the post-Brexit prospects for rented residential in the UK are somewhat less consistently rosy. Risks to the UK demographic picture represent the flip side of the possible demographic boost on the Continent. Around 35% of the recent population growth in the UK has consisted of net migration from the EU; last year, the UK population grew by 519,000, of which 184,000 came from the EU. Currently, EU nationals may freely live and work in the UK, although this right is likely to be revoked. Considering that the political mood which led to the Brexit vote is characterised by concern over immigration, it is reasonable to assume that any replacement work permit regime will be more restrictive.

Of course, it remains entirely possible that the UK government will agree to some freedom of movement in exchange for a favourable trading relationship. That said, negotiations have yet to begin and are expected to be lengthy. One outside risk would be a challenge to the status of the 2.2 million EU workers already in the UK. While a forced exodus is highly unlikely, some EU citizens may elect to leave anyway if they perceive the country to be less welcoming than before.

Yet it is important to not lose perspective. Assuming the UK population growth rate is cut by 35%, representing the loss of all EU net migration, the annual growth rate would be just above 0.5%. This would still make the UK's population one of the fastest growing in Europe, on a par with Germany and ahead of France, Italy, and the Netherlands. It would put the new incremental annual housing demand (65% of the widely cited 240,000 required homes per year = 156,000) much closer to, but still above, the supply of new homes (around 140,000 annually for the past five years). Given that there has been a deficit of housing supply versus demand going back at least a decade, the supply backlog and housing shortage continue under this scenario.

While the broader demographic story will take a long time to crystallise, the outlook for PRS in the near term will depend instead on the possibility of a confidence-induced housing slump. It appears that the UK housing market has weakened in the months since Brexit. Some forecasters are expecting a modest price decrease of 3-5%, whereas others are more pessimistic. If house prices do back off at the same time that interest rates fall, the relative attractiveness of renting may diminish for a time. Households that would have been just shy of being able to become homeowners may see their opening to buy a house, depriving the rental market of incremental demand. This might slow the lease-up plans of new build-to-rent schemes.

One final risk to watch is the government's response to any housing market dip. There is already talk of a major housing market stimulus plan, which would likely include a boost to supply (both for-sale and for-rent) and a subsidy to first-time buyers. While any help for build-to-rent developments would be a boon to investors in those schemes, government policy has, on past form, skewed in favour of home buyers. This could further tip the balance incrementally away from renting.

In the wake of Brexit we recommend residential strategies targeting the middle market with relatively affordable rental units, which should remain extremely scarce. However, we would be wary of submarkets with large exposures to financial sector workers.

STUDENT ACCOMMODATION

The impact of Brexit on the student accommodation market will depend on the interplay of a mix of positive and negative forces, operating on both short- and long-term timescales. In the short term, foreign demand for UK education will probably be boosted by the weaker pound. British higher education is, in essence, a luxury good consumed by Chinese and other international families; it should become relatively more attractive given that the USD cost of studying in the UK has fallen by 11% on the basis of currency alone since May. (This is the same factor that is currently boosting bookings at London's luxury hotels and retail sales on Bond Street.) Last year there were 284,000 non-EU students studying in the UK – around 16.7% of the total student population – and we expect this number to continue to grow. This will be good for the many higher-end student housing properties that are targeted at non-EU foreign students.

On the other hand, international students from within the EU could eventually see their tuition spike. Currently, these 100,000 students pay the same tuition as UK students (capped at £9,000 per year), but this is likely to change. We looked at six Russell Group universities and found that the ex-UK/EU tuition premium (for non-medical fields) ranges between 54% and 181%, depending on the course. Given the plethora of cheap or even free courses in the EU, the UK will likely be a less attractive option. A mitigating factor is that with EU students paying higher fees, they will become a more desirable target for university administrators, who may do more to woo wealthy EU students as they have long done for high-tuition students from farther afield. And, in any case, demand from EU-originating students is not currently a major driver of higher-quality purpose-built student housing.

A further long-term risk is the withdrawal of EU-funded research grants to UK universities. Currently, UK institutions receive a sixth of their research funding from the EU, amounting to £730 million per year. While the removal of these funds wouldn't impact student housing directly, and domestic replacements for these EU programs are likely to be created, there is a risk that reduced funding could eventually cause UK institutions to sink down the global league tables. This would make UK universities less attractive to international students.

Despite these risks, we are optimistic on the outlook for student housing in the UK. We expect that UK universities will remain globally competitive in the long run. Demand from foreign students held up well after the loss of the post-study work visa in 2012, and will probably do so after Brexit, owing to UK universities' quality and English-language instruction. The chronic shortage of housing in the UK also bears mentioning; Brexit won't eliminate the basic undersupply of beds suitable for students that exists in many cities.

For Continental European student accommodation, the story remains wholly unchanged. Product penetration should continue to grow from very low levels. Any potential Brexit impact will probably be confined to the possibility of a boost from EU students choosing to study on the Continent rather than in the UK.

We recommend a focus on UK student housing both at the affordable end (which is structurally underserved) and catering to international students. Properties which draw a large share of EU students face the greatest risks. It also makes sense to continue to pursue early-stage investments in Continental European student housing.

SENIOR HOUSING

We have often used the term "de-linked" to describe the fact that many drivers of non-traditional sectors stem from secular trends, not the economic cycle. A great example of this is the assisted living/care home sector, which is supported by the ageing of the population and longer life expectancies. In the UK, the private-pay care home market is also sustained by the long transition away from publicly funded care. Brexit won't change any of this. A few more Brits may even retire closer to home than on the Spanish Costas, which would be a positive.

One potential risk comes from the cost side. Care homes are operationally intensive assets requiring a skilled employee base. Labour costs have already come under pressure from the living wage and the general tightness of the labour market. Cutting off inflows of EU nurses won't help. But aside from a more careful underwriting of a project's ability to attract labour, we don't think senior housing strategies need to change due to Brexit.

SELF-STORAGE

Storage is another sector that is likely to be relatively "de-linked" from Brexit. We think UK sell-side analysts, eager to identify investable, liquid listed names with a correlation to UK housing, have overplayed the link between the housing market and self-storage. Our analysis and experience suggest that storage demand has a diverse range of drivers, including housing but also encompassing small businesses and uncorrelated events such as divorce. So far, we have not seen an impact from Brexit in our own storage portfolio. The trend toward increasing product awareness and pent-up demand in underserved areas should continue to be more important drivers of performance than Brexit. It makes sense to continue with strategies to build and modernise storage properties.

TIME FOR "ALTERNATIVE" TO SHINE

What Brexit will mean for property still remains mostly unclear. Indeed, some wonder whether Brexit will happen at all! Despite some specific risks, the living and other non-traditional sectors are in a relatively attractive position following the referendum. The likely outperformance of these property sectors will continue to make them attractive for inclusion in investors' portfolios.

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