POST-REFERENDUM UK:

still a land of opportunity for real estate investors

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Britain's plan to leave the European Union will, no doubt, present many challenges but also many opportunities. This holds true across multiple spheres, not least in the UK real estate market. We believe that the likely short-term volatility may open up some attractive investment opportunities in property markets where pricing has recently been overstretched (such as Central London), while other more defensive sectors – such as private rented residential and long lease property – will continue to offer attractive income streams for pension funds and other institutional investors.

ECONOMIC GROWTH TO CONTINUE

We expect that the ultimate outcome of the Brexit negotiations is likely to be one that meets the interests of both the UK and the EU, so we anticipate a 'soft' Brexit scenario in which the UK retains access to the single market, perhaps with compromises. This, coupled with potentially favourable trade deals with non-EU partners, means that the medium to long-term economic outlook remains benign, supporting demand for real estate from occupiers and investors alike.

In the short term, firms will likely put some hiring and investment intentions on hold, while consumers may decide to cut back on spending, particularly if goods become more expensive as a result of sterling's recent depreciation. However, while the economy may lose some momentum, it is important to note that the vast majority of forecasters expect that Britain will avoid a recession and that economic expansion, albeit weak, will continue in the near term (real GDP is forecast to rise by 0.7% in 2017, according to Consensus Economics).

PROPERTY MARKET: STARTING FROM ROBUST POSITION

In real estate, too, the landscape is very different to what it was in the run up to the global financial crisis – and the outlook is therefore brighter.

IPD All Property capital values remain circa 20% below where they were just ahead of the financial crisis, while the amount of debt secured on commercial property is approximately one third lower than in 2008, with loan-to-value (LTV) ratios at relatively more sustainable levels (almost 90% of loans had an LTV of 70% or less at the end of 2015)[1]. This suggests that the property market is now in a much stronger position to withstand any short-term economic or political uncertainty than it was eight years ago.

The occupier markets also offer comfort, with a lack of supply characterising many locations. The UK has just experienced seven consecutive years of construction running well below its historic average level. This period of restricted development – the likes of which has not been seen since the early 1990s – should lend support to rents in the short term, particularly in the more prime locations.

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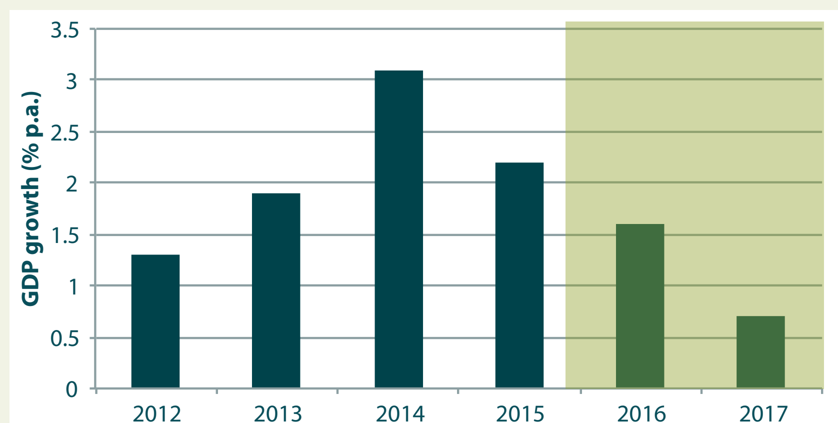
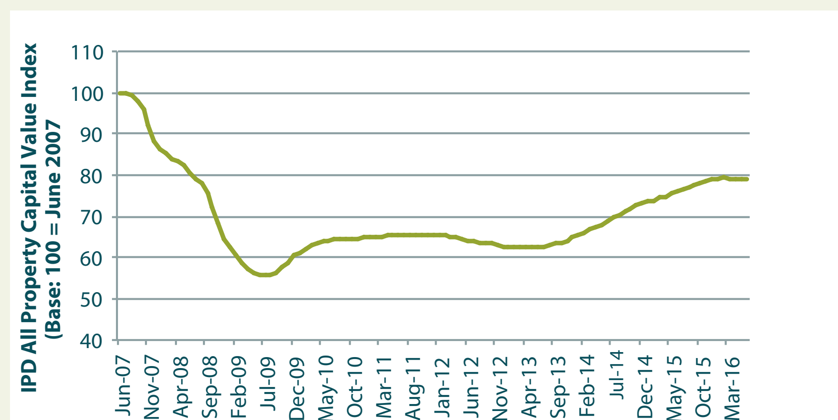
Crucially, overseas investors – both from Europe and further afield – still view the UK as a very attractive opportunity and London as a global safe-

Fig 1: UK expected to avoid recession despite referendum result



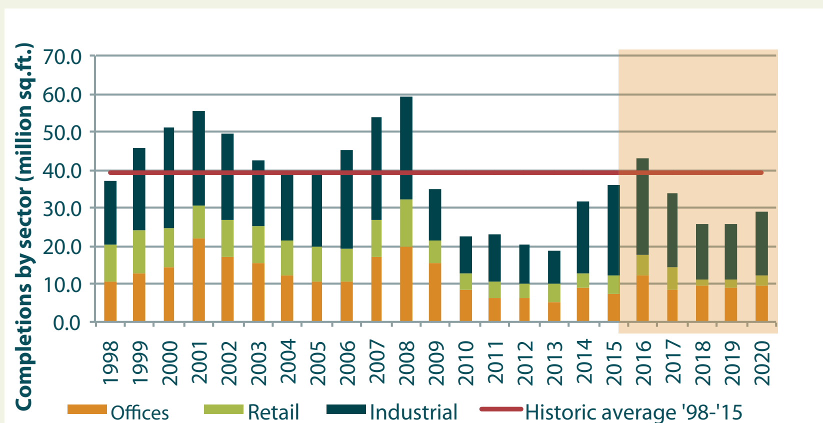
Source: Consensus Economics, July 2016

Fig 2: IPD All Property capital values 20% below 2007 peak



Source: MSCI, July 2016

Fig 3: Modest construction activity supports prices



Source: PMA, Summer 2016

Fig 4: M&G Real Estate view on post-referendum outlook for UK real estate markets

Market	Rental growth resilience and cumulative post-referendum capital value impact
Central London offices	Most impacted, hit particularly by exposure to financial services
Regional offices	Moderately impacted; more concern over Scottish assets with increased risk
Industrial and logistics	Modestly impacted: rental growth to slow but remain positive, limited yield rises
Retail	Moderately impacted, particularly for weaker retail assets/markets; supermarkets resilient
Private rented residential	Least impacted; could even improve as rents benefit from weaker house purchase activity

haven. From Germany to the Middle East, anecdotal evidence suggests that a number of institutions are already looking to take advantage of the recent depreciation of sterling, and we expect that any short-term falls in capital values will only increase this buying momentum.

For that reason, rather than a return to the sort of painful and prolonged "death by a thousand cuts" downturn that was seen after the collapse of Lehman Brothers in 2008, it looks likely that we shall see a short, sharp – but not catastrophic – adjustment in pricing as investors build an uncertainty premium into the property market.

Overall, we anticipate that the cumulative post-referendum decline in average capital values may amount to little more than 10% (with riskier assets and vulnerable markets suffering more, and with many other property segments impacted less). Helped by income, positive total returns are likely to come back in as soon as 2017.

POST-REFERENDUM OPPORTUNITIES: TOP TIPS FOR INVESTMENT

1. Exercise caution on Central London

By the middle of this year, Central London office values had surged to 20% ahead of where they were prior to the financial crisis and prime yields are at, or below, historic lows. This is also where Britain leaving the European Union is likely to have the most significant impact on occupier demand and, in the short term at least, this is where we expect larger overall falls in capital values.

Central London retail and residential also appear to be more exposed to the uncertainty created by the result of the referendum, particularly given the significant rises in capital values that have been seen in recent years. We therefore also expect these markets to underperform in the short term. However, such weakness could in turn create potentially attractive entry points for investors with a long time horizon.

2. Focus on prime or good secondary property in undersupplied markets

With uncertainty prompting greater risk aversion, we expect a renewed focus on prime assets, with investors looking for high quality buildings with high quality tenants in core locations. Good secondary property in undersupplied locations is also likely to see rental levels hold up relatively well, which in turn will likely lend support to yields.

Poorer-quality secondary and tertiary assets, however, are more exposed to any renewed economic weakness and vacancy rates on these types of properties are already very high. As a result, risk averse investors are likely to reject these assets in favour of more core property, so we expect greater capital value falls in these parts of the market.

3. Look to the most resilient sectors – residential, supermarkets, industrials

Although we do not expect the economy to fall into recession, taking a defensive position in the short term is likely to benefit performance. We see supermarkets as being one of the top performers over the next couple of years. This reflects, on the one hand, the defensive nature of the occupiers' business and, on the other hand, the long-term RPI-linked leases on offer to investors. Indeed, long income property generally, including in other sectors where these types of leases are prevalent, such as student accommodation, is also likely to prove more resilient.

Central London aside, the private rented sector (PRS) also demonstrates defensive qualities that will help to support capital values going forward. Weaker employment prospects and a cooling housing market are likely to push would-be buyers into the already under-supplied rented sector in greater numbers and for longer. As a result, significant potential exists for rental growth to offset any short-term weakness in house prices, particularly in the Rest of London/ South East market.

Returning to the mainstream markets, the industrial sector also stands out as a potential near-term outperformer. Traditionally more defensive due to its higher income return, weaker correlation with the economy and diversified occupier base, the sector is also likely to continue to benefit from ongoing structural change, even during this period of uncertainty. As a result, we expect that rental levels, and therefore yields, will hold up relatively well in comparison with the office and retail sectors.

On balance, while we do anticipate some short-term falls in capital values, these should remain relatively restrained given expectations of a subdued, but not dismal, economic outlook. With UK gilt yields having plunged to new lows, increasing the risk premium afforded to property, and equity markets particularly volatile, the bond-like qualities offered by commercial property continue to make the asset class appear very attractive on a long-term basis.

That said, in the face of economic weakness, investors may wish to protect their portfolios by adopting a more defensive position. We expect that prime/good secondary property will hold up relatively well in the short term, as well as assets with long, index-linked leases and the traditionally defensive sectors such as the PRS and industrial.

FOOTNOTE

1 De Montfort University, UK Commercial Property Lending Report, 2016

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