FEBRUARY 2019

Brexit

Implications for Real Estate

Economic outlook

Economic and political uncertainty in the UK has mounted as Parliament battles over what 'version' of Brexit to agree upon. It is unlikely that a deal will be reached until the eleventh hour and we are increasingly expecting some reworking with the likelihood of a short extension to the exit date. We recognise the remaining possibility of a 'no-deal' and continue to consider the ramifications throughout this paper but we believe it is more of a negotiating tactic rather than a likely outcome.

As previously predicted in our post-referendum outlook, the process of exiting the EU has unsurprisingly been long and complicated. We expect the **volatility in Sterling** to continue as politics plays out over Q1 2019. Following the referendum result, we witnessed a sharp fall in the value of Sterling, with the effective rate down c.15%, which has brought **inflationary pressures**, and CPI inflation peaked in November 2017, well above the Bank of England's target of 2%. A 'no-deal' outcome would likely trigger a further fall in the currency and a renewed squeeze on living standards. However, a 'rework and delay' outcome is unlikely to cause a sharp depreciation as markets have become accustomed to the higher level of uncertainty in the economy, with any decision bringing certainty that has eluded the currency since early 2016.

At the tail-end of 2018, **business confidence** has diminished in advance of the looming exit date. Indeed, this is common prior to any significant political event as corporate decisions are placed on hold until UK's position becomes clearer. According to PMI surveys, fears of potential supply chain disruptions arising from Brexit have led to manufacturers stockpiling raw materials and finished goods at near survey-record levels. Sentiment in the service sector is also down with business activity at the lowest level for over two and a half years, although it remains above the crucial 50 no-change threshold that signifies growth in the economy.

As we approach the exit date many businesses have taken **precautionary measures** as a 'no-deal' outcome has increased in likelihood. There is anecdotal evidence of last minute ramping up of plans particularly in regards to increased European presence, notably in the Banking sector.

We expect **GDP growth** to be weak in 2019, particularly in Q1 with businesses unlikely to invest significantly. Whether there is a recovery in economic growth in the second half of 2019 will be dependent on the Brexit decision but also the wider slowdown of the global economy, with the deceleration of the Chinese economy, and the trade tariffs imposed by the US, being the most noteworthy but not only factor in an increasingly muted outlook for growth.

Despite the significant headwinds, we believe the UK will remain resilient. It remains the fifth largest economy in the world and its **attractiveness** goes far beyond its access to the European market. It has a transparent market, talented labour pool, strategic geographical location, cultural benefits and English language. We believe that London is almost unparalleled in its abilities to attract global business both as a financial centre and with regards to comparison against other European cities. We believe its competitive advantage will remain despite being diminished.

The remainder of this outlook will focus on assessing the short term impact of Brexit on UK real estate markets.

Occupier market

Demand in the London office market has been robust despite uncertainty caused by Brexit. In 2018, take-up reached 12.8 million sq ft, up 30% on the 10-year average. We have seen several large acquisitions from the FAANGs (Facebook, Apple, Amazon, Netflix and Google) and serviced office providers over the last five years, with financial and professional services businesses continuing to transact as well. During the first quarter of the year, we expect activity to ease off albeit from a significantly high level.

The high level of **pre-letting** that we have seen over the last 5 years has driven the central London office market. However, despite the strong occupier demand for office space, there has been no real rental growth over the latter part of that period. Headline rents by and large have remained stable, held up by increased incentives and flexibility.

The constrained supply pipeline, especially in the medium term, coupled with pre-letting already accounting for c.50% of the deliverable space will mean that the market will continue to be supply-led provided long term demand trends remain. We expect to see a large gap in quality between those classified as 'Grade A' and 'Grade B'. We therefore expect demand to continue to be robust when good quality space becomes available.

The limited supply is likely to keep rents from falling significantly for prime stock, however there may be increased pressure on headline rents, as incentives are already at relatively high levels. The **secondary office market** is likely to see an increase in void rates and rental falls.

London could lose some of its European business to Europe as firms take precautionary measures although the evidence we continue to see is that they are likely to move only small relevant parts of their operations as opposed to whole sites. Indeed, WeWork has bet on Dublin by increasing its take-up over the last 16 months, in anticipation that Dublin may absorb some of this movement.

The **regional office market** also defied the pre-Brexit 'doom and gloom' as 2018 went to become a record year for take-up across the 'Big Nine' cities, totalling 10.7 million sq ft, 30% above the 10-year average. Government deals have been a large part of recent activity although the private sector has also been active with Barclays and Booking.com taking 470,000 sq ft in Glasgow and 225,000 sq ft in Manchester respectively.

Underlying **demand** in key regional cities is predominately from occupiers focusing on national business and is therefore relatively insulated when compared to London - from changes in any trade agreements. The thin pipeline across the regions mirrors that of London and with no real growth in 'Grade A' supply, and with a divergence between the quality of stock available we anticipate demand to be aggressive when prime stock becomes available. Thus, we expect positive rental growth for prime office space in key regional cities.

The impact of either 'no deal' Brexit or a 'rework and delay' outcome is likely to continue to have an adverse effect on the London and regional **development market**. Sentiment is down and developers are unlikely to take significant projects until the UK's position on Brexit becomes clearer. Indeed, margins could be significantly squeezed in this sector as the construction industry is a large employer of EU migrants, and with net migration from the EU already at a six-year low any further restrictions could further increase labour costs in addition to higher import and tariff costs.

The fundamentals in the **industrial sector** have remained resilient despite the uncertainty caused by the EU referendum. Activity is underpinned by the strong demand from online shopping and 'last-mile' delivery and Brexit is unlikely to overturn the benefits from the structural changes occurring within the industry. Online retailers, such as Amazon will continue to grow and demand space to fulfil e-commerce orders and 'last-mile' deliveries. We expect average UK rental growth in the industrial sector to continue to outperform the retail and office market, although below the circa 4% pa growth seen in the previous three years.

However, the industrial sector is not immune from a hard Brexit which could cause disruptions in the supply chain process, especially for **manufacturers** that are dependent on 'just-in-time' (JIT) production systems.

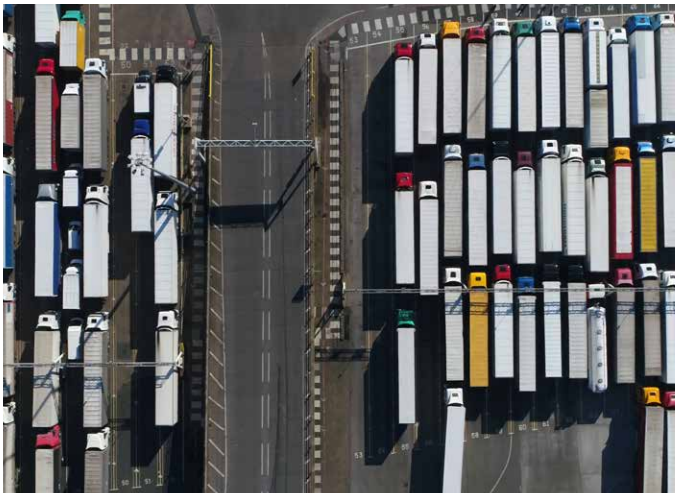
This is where supplies are delivered in small quantities but frequently in time for production in order to minimise the cost of storage. Many businesses across UK manufacturing, engineering and retail use the 'JIT' system and without frictionless trade these sectors are likely to experience added costs and delays.

The retail market had a particularly weak year, with multiple Company Voluntary Arrangements (CVAs) and store closures resulting from the structural shift towards online shopping, which now accounts for 20% of total retail sales. Although a structural change in shopping habits is the key issue to the sector, Brexit is likely to intensify cost pressures particularly for those with complex cross border supply chains which could be hit by increased tariffs and a weaker Sterling and inflationary pressures.

Adding to this, Brexit has been a drag on **consumer sentiment** with the GfK consumer confidence index dipping further into the negative territory in December 2018 amid concerns over the state of the economy in the run-up to the exit date. Individuals are already reluctant to spend on big items and another squeeze on consumer spending derived from a renewed depreciation or a fall in house prices could further dampen sentiment. We expect the squeeze on mid-market retailers to continue into 2019, and consequently the 'polarisation' of the market will continue. We anticipate average rental values to decline by at least 5% considering the headwinds that continue to face the UK retail market.

The impact of Brexit on the **alternative real estate market** is likely to be varied across sectors. For instance, demand for **healthcare** is likely to remain strong as demographic rather than economic factors are of more importance and an ageing population will continue to underpin demand. The **hotel** sector has benefited from weakening of the Pound since the Referendum, with a consequent boost in tourist numbers and a shift in its consumer base, with more leisure visitors compared to business visitors However, both sectors are a large employer of EU migrants, and a limit in supply of workers could lead to higher operating costs and constrain growth.

The **student accommodation** market could potentially be affected if barriers to study and work in the UK intensify. One of the reasons to study in the UK stems from the ease to apply for jobs in the UK. Visa restrictions could limit access to the UK job market post-study and thus deter some European students. However, we think that the quality of education at UK's top tier universities and relative value compared to USA will help to insulate student housing from a significant slowdown. Although, the impact outside Russel Group universities could be more challenging.



Housing market

Brexit has undoubtedly contributed to the recent pessimism around the **residential market** in addition to the longstanding issues around affordability and lack of investment stock for purchase especially in London and the South East.

The general nervousness as we approach the Brexit date has reduced the number of buyers and sellers in the market, and is acting as a dampener on prices despite the recent surge in earnings growth. In the near term, we expect prices continue to soften in London and the South East whilst **house price growth** across the regions is likely to remain broadly flat.

On the supply side, there is already a significant shortfall and although net EU migration is at a six-year low, it continues to add to the population as a whole in addition to a rising birth rate, longer life expectancy and a falling average household size. **New development** is fundamental to keep pace with demand. However, developers are becoming hesitant as we approach the crucial exit date and are reluctant to take on projects without knowing UK's position on Brexit. The public sector will continue to build although, build cost pressures are intensifying due to the lack of labour in construction for both skilled and unskilled workers. This would intensify in a no-deal outcome which would see a renewed depreciation and a rise in cost-push inflation.

The **Build-to-rent** sector has continued to grow, with activity now no longer confined just to London and the South East. We expect the growth to continue in 2019, albeit at a moderated pace, and there is already a significant pipeline under way. Build cost inflation will be fundamental in assessing the viability of developments.

A 'no-deal' outcome could lead to renewed depreciation and add pressure on the cost of imports, subsequently leading to build cost inflation. Nonetheless, investors remain positive about the outlook of the build-to-rent market and yields continue to move in.

Activity in **affordable housing** will remain resilient amid Brexit, particularly from REITs and private funds who will continue to have a strong appetite for investment. Demand is underpinned by a structural requirement, from the misalignment of supply and demand which continues to drive property prices up and increases the need for affordable housing in the UK.

Investment market

As we approach the 29th March 2019, many investors will opt for the 'wait and see' approach and hold off on transactions in the first quarter of 2019. However, there remains a significant **weight of global money** ready to invest in the UK property market. Indeed, according to INREV's Investment Intentions Survey 2019, there is €72.4 billion of capital intended to be spent on global real estate with the UK in second position, behind Germany, for investment in Europe.

Overseas investors have been buoyant as UK property assets remain good value for money. The fall in Sterling following the EU referendum led to another wave of overseas money into UK real estate. Although we have seen a drop off in their exposure across the regions in 2018, any renewed depreciation from Brexit-related shocks could further boost overseas interest. Brexit will undoubtedly play a large role in short-term investment decisions however, fundamentals in the UK real estate will remain strong and investors are unlikely to shy away from a transparent and liquid market, particularly for long-term investments.

London's office market has remained resilient as international investors continue to look past London's potential position in Europe and instead see London as the unremitting safe haven for investment, boosted by a surprisingly resilient occupational market, cheap currency and relatively attractive yields in comparison to other Tier 1 global cities.

Industrial assets will remain highly sought after with rental growth holding up, although to a lesser extent than the last few years. Continuing with the trend, we expect the industrial sector to be amongst the few sectors with positive capital gains in 2019. Likewise, **alternatives** characterised by long dated secure indexed income will hold value as demand is underpinned by demographics or technology and is fairly insensitive to Brexit.

Many investors will be looking to reduce their exposure to the **retail sector**, as even those retail assets with 15-year leases no longer provide a guaranteed income stream since many retailers may still have a high risk of entering CVAs in the meantime. We expect the retail sector to exhibit the largest capital values fall in 2019, owing to the structural change in the sector. However, as prices drift there will be opportunities for those prepared to take on risk to try and reposition assets in this sector. Local Authorities will have an increasingly important role in this market.

The office sector is perhaps most exposed to Brexit, particularly London which is likely to experience less activity in the first half of the year as the ramification of Brexit remains unclear. As a result, in London we expect **capital value growth** to remain weak for prime stock and decline for secondary stock. Whereas, the regional office market is expected to perform better and we anticipate capital values to hold for 'Grade A' space but the outlook for the secondary market is likely to be weaker in most locations.

The key question many investors will be contemplating is not whether to invest in the UK but when to invest. We expect the market to be slow in the first quarter, as both buyers and vendors take a 'wait and see' approach until pricing is established.

Overall, we expect the volume of investment activity in the UK real estate market to reduce in 2019 but remain above historic long term levels. There is a distinct possibility of a **Brexit bounce** later in the year following a period of inertia.

The **appetite to lend** by banks remains good, albeit there is a rising level of caution. Banks are much better capitalised than before the financial crisis, and having improved their balance sheets they are better placed to continue lending. Overall, the impact of Brexit is likely to be limited and other factors will play a larger role, with the pain dealt by the retail market meaning that for many lenders, checks on covenant strength have become ever more stringent.

Finance for development schemes will be dependent on the sector and perceived demand. We suspect lending for speculative developments will be tighter, although developments for space in the right location that are underpinned by good demand will continue to secure lending but at sensible levels.

Should you wish to discuss any details within this report please get in touch.

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