NOVEMBER 2019

Brexit Update

Implications for Real Estate

Economic outlook

Significant changes have occurred in the UK Parliament since our last Brexit paper in February 2019 which have affected the political landscape. However, as anticipated, the Brexit exit date has been extended once again to January 31st 2020 as the Parliament rejected to ratify the new withdrawal agreement within three days ahead of 31st October deadline with a general election in order to break the ongoing deadlock.

Since our last paper, key political events included Theresa May resigning following her withdrawal deal being rejected multiple times by Parliament. Boris Johnson was then elected as the Tory leader and consequently the new Prime Minister. However, he has faced his own set of challenges since he has been in office. He lost his working majority, failed to trigger a general election prior to 31st October, a new bill was passed to force an extension to the 31st October deadline and the UK's highest court ruled proroguing the Parliament was unlawful.

Nevertheless, Boris Johnson's withdrawal agreement won support in principle from 329 MPs against 229 MPs but the short timeframe offered to scrutinise the Brexit deal in just three days was rejected. This forced Boris Johnson to request an extension under the new Benn-Burt Bill. The Bill was designed to outlaw a no-deal scenario. The EU has now offered a 'flextension' to 31st January 2020, should the deal be ratified in advance. In the latest events, Parliament has agreed to a general election on 12th December. Despite all this, there has not been a material change in Brexit and the course it takes is largely dependent on the outcome of the general election. The likelihood of a 'no-deal' Brexit has diminished significantly but remains a possibility.

A Conservative majority would see the Brexit deal ratified fairly swiftly. However, a hung parliament could see the Brexit related uncertainty persist for longer with a series of potential outcomes ranging from further delay, ratification of the withdrawal deal or a second Brexit referendum. Nigel Farage's Brexit Party is the only party campaigning for no-deal outcome and consequently the risk of a no-deal outcome has receded.

In the meantime, the progress of Brexit remains unclear and prolonged Brexit-related uncertainty continues to adversely affect the UK economic outlook. This, combined with weaker global growth has contributed to a weakening in the GDP growth forecasts for the UK. In September, the Treasury further downgraded its economic growth consensus forecasts to 1.2% and 1% for 2019 and 2020 respectively. Only three months prior, forecasts for the economy were 1.4% for both 2019 and 2020.

As politics continues to play out over 2019, Sterling fell to its lowest level against the Euro and Dollar in a decade during August and then rose sharply in October following signs of a Brexit deal.

Despite this, CPI inflation in the UK fell to 1.7%, below consensus and the Bank of England's target of 2%. This largely reflects the fall in energy prices. However, there will continue to be upward inflationary pressure from rising real wages and low productivity growth.

Business confidence has remained subdued over 2019. Whilst manufacturers stockpiled in Q1, this was followed by a period of retrenchment during Q2 and a number of factory closures ahead of the original Brexit date. The latest manufacturing PMI index showed stockpiling recommenced in the lead up to the October Brexit deadline, although not enough to pull the manufacturing index into the expansionary territory. The outlook in the service sector improved slightly compared to September as businesses expect Brexit to be resolved early 2020, however sentiment remains weak and activity did not expand or contract in October. The construction sector remained firmly below the 50 no-change threshold as activity remained subdued due to Brexit-related uncertainty.

It is widely acknowledged that there will be an adverse effect on the economy in the short term from Brexit. However, the real challenge for businesses is the elevated uncertainty as Parliament continues to push for a Brexit deal. Sterling against the dollar and euro rallied following the news of the a new withdrawal agreement but remains cheap compared to pre-referendum levels as the future trading relationship between the UK and EU remains unclear. Despite this, the fundamentals of the UK economy 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, robust legal system, strategic geographical location, cultural benefits as well as the English language.

The remainder of this outlook will focus on updating the short term impact of Brexit on UK real estate markets from our February publication.

Occupier market

Demand in the London office market has been robust despite uncertainty caused by Brexit. Take-up continues to be well in excess of both the ten and five year average, with continued strong transactional activity for lots in excess of 50,000 sq ft, highlighting the fact that large businesses continue to commit to London.

The high level of **pre-letting** that we have seen over the last 5 years continues to drive demand with Q3 2019 seeing pre-letting account for over 30% of all take-up for the quarter. As a result, over 50% of the development pipeline is already let in advance of completion. We expect to see a large gap in quality between those classified as 'Grade A' and 'Grade B'. Larger occupiers have few options available, especially those with space requirements over 100,000 sq ft. Occupiers increasingly have to start their search much earlier in order to find suitable space. We therefore expect demand to continue to be robust when good quality space becomes available.

The current low levels of availability and constrained supply pipeline will continue to protect rental levels, although the increase in provision of serviced offices, as well as political uncertainty has hampered the potential for significant growth, despite low vacancy levels.

Going forward, marginal rental growth is expected in markets that are seeing a more pronounced lack of supply including the City Core. Rent free periods have recently decreased slightly for the best stock in prime locations, a trend which is likely to continue into the near future. Smaller office units are likely to see an increase in void rates and rental falls as they continue to compete with serviced office operators.

There continues to be a risk that some businesses may migrate some of their operations to other European cities. However, we believe businesses will still retain a large presence in the London. The city maintains its ability to respond to changing technology and provide a variety of spaces and places that allow companies to attract the best talent to grow and sustain their businesses.

The **regional office market** remains resilient in the face of Brexit uncertainty. Total city centre and out-of-town activity during Q3 amounted to 2.1 million sq ft, just above the ten year quarterly average. Although this is significantly short of the record levels of the last two years it is at a similar level to the referendum year 2016, the last time the market was so affected by political uncertainty. The second half of the year tends to show stronger activity but Brexit has impacted on occupier decisions this quarter, particularly for small to medium sized deals. Take-up is well above average for the largest size band but below average for the lower size bands. There has also been a wide divergence in demand between the cities this quarter, particularly the city centres. Over the year as a whole the larger cities, led by Manchester, are performing the best against their long term averages.

Looking forward all eyes rest on Parliament as it attempts to reach a satisfactory outcome to Brexit. Any continuing delay is likely to prolong the caution in the occupier markets. A positive decision will likely see an improvement in business sentiment, decision making and a reawakening of pent-up demand.

The Brexit extension to 31st January 2020 is likely to continue to have an adverse effect on the London and regional **development market**. Developers are unlikely to take significant projects until the UK's position on Brexit is clearer following the general election. 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 falls could increase labour costs in addition to higher import and tariff costs.

The **industrial and logistics sectors** have been resilient in the face of Brexit with activity underpinned by the strong demand from online shopping and 'last-mile' delivery. However, the sector is not immune from the economic impacts of Brexit. Manufacturers with supply chains closely linked to Europe have an increased risk of disruptions which could be costly.

Additionally, the positive effect of weaker Sterling has been partially offset by ongoing global trade tension and slower world economic growth.

However, the huge shifts in the retail market will continue despite Brexit, and retailers will still need to respond to changing logistics requirements. Indeed, the e-commerce sector was by far the most acquisitive during the first half of the year, accounting for almost 50% of take-up of the big-shed market. Thus, we expect rental growth in the industrial sector to remain resilient relative to all-property, although below the circa 4% pa growth seen in the previous three years.

The **retail market** continues to see headwinds with multiple Company Voluntary Arrangements (CVAs) and store closures resulting from the structural shift towards online shopping, which now accounts for almost 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.

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 will underpin demand. The **hotel** sector has benefited from weakening of Sterling since the EU 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 for EU students. 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, albeit the Home Office will increase the time allowed for international students to find a job from four month to two years. We also 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 Russell 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.

Typically September is the start of a rise in housing market activity however, buyers and sellers remained hesitant amid heightened political uncertainty in the run up to the now redundant October Brexit date. The lower number of buyers and sellers in the market is acting as a dampener on prices despite the recent surge in earnings growth. This holds true across all regions, with hesitation now spread beyond London and the South East.

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, the prolonged uncertainty in the economy has led to hesitancy from developers to take on projects without knowing UK's position on Brexit. This is exacerbating the long term supply problem and making it more difficult for the government to meet its target of building 300,000 new homes a year by mid-2020.

The public sector will continue to develop although, build cost pressures are intensifying due to the lack of labour in construction for both skilled and unskilled workers.

The **Build-to-Rent** sector has expanded, with activity now no longer confined just to London and the South East. Going forward, we expect moderate growth as there is already a significant pipeline under way. Build cost inflation will be fundamental in assessing the viability of developments. However, 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 have a strong appetite for investment. Demand is underpinned by a structural requirement, from the misalignment of supply and demand which keeps driving property prices up and increases the need for affordable housing in the UK.

Investment market

Annual transactions value dropped to circa £50 billion in the 12 months to Q3, down 20% but remains in line with the 10-year average. Brexit related uncertainty picked up ahead of the October Brexit deadline and investors have been more cautious. However, there remains a large weight of global money ready to invest, particularly for prime assets with long dated income and secure covenants.

Overseas investors see value in the UK, partly as a result of the fall in Sterling. Whilst Sterling has picked up slightly following the Brexit deal announcement in October, it remains relatively cheap as the deal has not been ratified and uncertainty persists. Consequently, transactional activity by overseas investors has slowed by 16% in the 12 months to Q3 2019 compared to the previous year.

Brexit will undoubtedly play a large role in short-term investment decisions. However, fundamentals in UK real estate will remain strong and investors are unlikely to shy away from a transparent and liquid market, particularly for long-term investments.

In the London office market, activity continues as international investors look past London's potential position in Europe and instead see London as a 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. However, transactional activity is still significantly behind where it was this time last year. Investor confidence remains fragile given Brexit market uncertainty, with volumes further limited by low levels of stock. The flight to safety is driving increased investor appetite for prime stock with long-term secure income streams.

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 that exhibits positive capital growth in 2020. Likewise, alternative sectors will continue to see strong demand and will maintain strong investor interest. This is particularly the case for those sectors that benefit from secure long-term income streams and those where demand is driven by major long-term shifts in demographics or technology.

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. However, investor demand for supermarkets has been robust despite the wider stress on the retail market.

We expect the retail sector to continue to exhibit the largest capital value falls, 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.

Overall, we expect the volume of investment activity to remain subdued until Brexit is resolved. There is a distinct possibility of a **Brexit bounce** next year following a period of inertia. This will be driven by the weight of capital which has been held back in anticipation of Brexit being resolved. We expect property yields to continue to drift upwards although the pace of the rise will depend heavily on the potential outcome for Brexit.

Property funds are experiencing higher scrutiny from the FCA following the recent announcement of a rise in investors withdrawing funds in fear of a no-deal Brexit. Property funds are better prepared to deal with a liquidity pressures compared to 2016, as they have built up larger cash buffers although a large 'shock' could still see funds have to dispose of assets quickly.

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 at sensible levels.

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

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