Research Blast

European Real Estate Market, Brexit Thoughts & Views – July 2016

The market needs to correct, not be forced to collapse

On the face of it, the past week has been a tumultuous one for UK commercial real estate. In the more liquid equity markets we have continued to see share prices for UK house builders and REITs slide, whilst the impacts of the Brexit vote are now filtering into direct, retail real estate funds. At time of writing, around half of the open-ended UK retail property funds have taken the drastic action of temporarily suspending redemptions. This was perhaps inevitable within a system which continued to offer daily liquidity on inherently illiquid assets. And once contagion sets in, it is virtually impossible to stop as it spreads from fund to fund, making redemption queues unsustainable. The fear factor has not been helped by the mainstream press latching onto the "turmoil" of the commercial property market and making predictions of the start of a new property-led financial crisis. Given all the noise which is being bandied around about the commercial property market being on the brink of collapse, now would be an important time to place some perspective on what has happened, and what could happen going forward.

The first thing to emphasize is that we are not facing the same situation with property as we did back in 2008. Lending to property since the Global Financial Crisis (GFC) has undergone rigorous regulatory changes to ensure that the leverage-led collapse of the market does not occur again. LTVs (loan-to-value) levels are significantly lower, providing plenty of equity to absorb a period of negative capital growth before borrowers reach a point of negative equity, particularly if you consider that virtually significant parts of UK real estate asset purchased between 2009–2014 will have also seen a fair amount of capital appreciation from the initial purchase price. The Bank of England's stress test is for bank lending to absorb a hit to prices of 30%, something we are not expecting barring a complete meltdown of the economy.

The second important thing to note is that retail funds in the UK account for a relatively small proportion of the total invested market. Total gross asset value of real estate holdings amounts to around GBP 20 billion, which is 10% of the IPD UK direct property index, and just 3.7% of the total invested UK market which includes the listed sector[1]. The vast majority of commercial real estate in the UK is held directly by REITs, institutions or funds managing institutional capital, private equity and – particularly in London – foreign buyers, including ultra-high net worth individuals and sovereign wealth funds. Of course any of these groups could decide to pull their money, either directly or indirectly invested, out of the market creating further negative pressure; however, there are good reasons at the moment to believe this should not happen on any kind of mass scale.

Most UK institutions are restricted to keeping the majority of their invested capital in the UK, so what alternatives would they have should they redeem? Gilts at less than 1%, cash at 0% or an equities market which is likely to go through one of its most volatile periods in history. And as these investors typically have pre-set targets for returns and asset allocations, it is unlikely there would be the sudden retraction from the real estate market that we have seen from retail investors. Foreign investors, who have bought into the market prior to the EU Referendum have even less incentive to withdraw as they will suffer a significant loss on the exchange rate when they convert back into their own currency, in addition to a hit on capital values by trying to sell assets at a very challenging time. If they are not under pressure, and their assets continue to deliver income, it is likely they will simply wait it out until sterling recovers and / or the outlook for the market stabilizes or at least improves.

The third thing which should be noted is that whilst little has changed in the retail fund market, lessons from 2008 have been learnt by the open-ended institutional funds, with many improving governance and rewriting redemption terms to avoid the situation the retail funds now face. Many of them have sacrificed liquidity in exchange for more stable exit mechanisms which reflect the timescales involved in selling large illiquid commercial real estate assets. This spreads the redemptions over a period of time, limiting both the impact on fund strategy and contagion spreading to other investors wishing to remain within the fund.

Inevitably pricing for UK real estate will have to correct to reflect the weaker economic outlook and in-turn a weaker outlook for rental growth and a heightened risk premium for being in the market during a period of severe political uncertainty. But what will determine the severity of the

[1] UK retail property fund exposure to direct UK real estate, not including equities of non-UK funds, IPD UK index total value and DTZ invested UK universe, Money into Property July 2016

correction is the weight of pressure on the sell-side, and if this forces a large amount of stock to the market at the same time as new buyers are retracting we end up with a market collapse, rather than a pricing correction.

But there really is no need for this to happen. If the retail funds are not forced into a fire sale they can release assets onto the market gradually which will limit the damage to the market. And further easing and or a cut in interest rates from the Bank of England, record low returns on government bond yields and on commercial property elsewhere in the globe should limit the outward movement UK real estate yields would undergo. Within this environment there is likely to be plenty of private equity and opportunistic capital which is waiting to snap up core UK assets at a discount, which will soon present a potential buying opportunity against the record low yields available elsewhere. And for non-sterling denominated investors, the weakness of sterling adds a further discount on the relative purchase price at entry which should stimulate some interest from the more footloose and opportunistic buyers. This demand should be sufficient to restrict any drastic outward movements in pricing when a managed sell-off begins.

So the biggest risk to the UK market at the moment is not the market itself but the sentiment surrounding it. Contagion has already spread and investors don't want to be left last in the queue which inevitably this creates a rush for redemptions. This sense of panic is then further exacerbated by the media and before long it becomes a self-defeating cycle. But it has only been two weeks since the referendum and there has been nowhere near sufficient time for the market to correct itself or any of the actual impacts of Brexit to be realized. The outlook is undoubtedly challenging, but at the moment there is a risk that investors in real estate will collapse the market themselves, rather than letting the market go through a natural process of correction and adjustment. We believe pricing should only collapse if forced sales become a dominant feature of the market; in 2008 the banks triggered this, while in 2016 it could be the investors themselves. The saving grace for commercial property at the moment is the retail investors alone do not have sufficient weight in the market to do this to themselves, and the institutional funds are in a much stronger position to deal with the challenges than they were back in 2008.

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