M&G Real Estate Perspectives

Brexit: implications for real estate

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The outcome of the referendum held on 23 June, 2016 is for the UK to leave the European Union. It is now over to the government to start the withdrawal process and the negotiations regarding the UK's future relationship with the EU and its other trading partners. Given this result, we outline our view on the likely impact on the real estate markets.

Executive summary

- Negotiation of new status and trade agreements to take at least two years
- In the short term, uncertainty is likely to lead businesses and investors to postpone plans, potentially impacting rental growth and capital values
- A broad portfolio, well-diversified across sectors and locations should help weather any headwinds
- For long-term investors any market turbulence could present attractive investment opportunities
- City of London offices likely to be the most impacted, while other sectors could also be affected but to a lesser degree
- In the medium to long term, the UK is likely to reassert its economic might and the fundamental attractions of its property market

Short-term impact: continued uncertainty

Now that the UK has decided to leave the EU, we expect uncertainty to continue while the UK negotiates its new status and trade agreements. This will take at least two years, although it is important to note that existing EU laws and regulations will continue to apply until the expiry of the two year period triggered by notification of intention to exit under Article 50 of the Lisbon Treaty.

Some financial instability and political upheaval is possible in the near term. A likely drop in business confidence, triggered by the uncertainty, could lead to firms cancelling/delaying investment decisions and reducing employment intentions, which would subdue prospects for GDP growth.

Currency weakness, BoE stimulus to help limit negative GDP impact

There has been no clear consensus on the economic impact of a Brexit, given the range of eventualities and debates over highly uncertain outcomes. However, most economists have estimated an overall reduction in UK GDP growth in the region of 1-3% over the coming few years, depending on the trade and other agreements reached. Sterling, which has been particularly volatile in the run-up to the referendum, is likely to weaken further, which may offer some support to exporters. In addition, the Bank of England is likely to pursue an even more accommodative monetary policy, with interest rate rises likely to be pushed back further into the future. Some commentators have suggested an interest rate cut or further quantitative easing (QE) may be on the table. These developments may serve to limit the extent and duration of any economic weakness.

Lower rental growth, fewer transactions likely in real estate

Although we don't expect to see the UK entering a recession, we accept that the weaker economic outlook means the property market will deliver more modest returns than the exuberance of recent years (but that, to a large extent, was already expected regardless of the referendum results due to our current more advanced position in the cycle). A simple regression suggests that a 1% reduction in GDP growth translates into IPD All UK Property rental value growth being 4% lower, with some sectors like central London offices being impacted more strongly.

The near-term uncertainty is likely to continue to manifest itself in a 'wait-and-see' strategy, with a number of businesses limiting their activity and investments while they reassess their future in the UK. In the property investment market, deal volumes had already slowed ahead of the referendum, and the raising of capital for near-term deployment appears to have eased. However, unlike the situation seen in the run-up to the financial crisis, this cycle's exceptional returns over the last few years have been fuelled, largely, by equity capital, not debt. As such, investors aren't as leveraged and we don't expect to see them rushing to sell their assets if values start to come under pressure.

Uncertainty may create investment opportunities for long-term and internal investors

For investors with a long time horizon, such as pension funds and institutions, any short-term pause or weakening in the UK real estate market can present attractive opportunities to acquire assets able to generate favourable returns over the long run. Meanwhile, compared to during the financial crisis, by being less reliant on debt financing and having fewer clients that need to raise funds, these types of investors will be less likely to sell even if capital values start falling.

With a further drop in sterling anticipated, UK property will become cheaper for foreign investors, potentially encouraging inflows from regions like Asia and North America.

Both benefits and downsides seen for rest of Europe

Brexit will also clearly have economic implications for the EU, with countries like the Netherlands and Ireland likely to be hit the hardest (due to their strong relationships with the UK and the size of their economies). Larger countries like Germany, a major UK trading partner, and France may also be affected. The Nordics and some other economies on the fringes of Europe may be more insulated. However, the overall impact from Brexit on the rest of Europe will almost certainly be significantly less than the impact on the UK itself, and there may even be some property markets in the EU, like London's competing financial centres, which become beneficiaries of businesses relocating from the UK. Furthermore, Brexit has come at a time when the European economy is in a much more robust state than it was a few years ago, and is improving rather than deteriorating.

Medium-term impact: negotiating the future

In the medium term, everything depends on the outcome of the negotiations. Given the existing integration and cooperation between the UK and the other EU members, there is a chance that the UK could renegotiate a deal which would enable it to retain, to a large degree, its current position. Indeed, it may be the case that exiting the EU does not result in exiting the single market. That said, we recognise, in the worst case scenario, that Britain could lose access to the key freedoms such as the free movement of services, goods, capital and people. On the flip side, it would no longer contribute to the EU budget and would have the opportunity to adopt a favourable regulatory regime for overseas investors and businesses.

As the details of the new era outside the EU become clear, firms will start adjusting to the new status quo; some will relocate but we expect that the majority will start investing again, with many expanding and demanding more space. Renewed occupier demand coupled with a shortage of new space due to deferred development would result in healthy rental growth.

On the investment side too, we expect any slowdown to be relatively short-lived. Property continues to look attractive compared to other asset classes (such as government bonds), and the UK market has many attractions in terms of transparency, liquidity, depth and diverse opportunities, which are likely to support continued investor inflows. Many factors contributing to the UK's appeal such as its legal system, property rights and tax regime are independent of its relationship with the EU.

Investment implications: balanced is best

Overall, given the large degree of ongoing uncertainty, we believe that a core portfolio that is diversified across the main commercial and alternative sectors as well as across the UK remains the optimal approach, albeit with underweight positions to those parts of the market most vulnerable to negative impacts. Investments in high-quality assets with robust fundamentals and income security should prove more defensive, and long income property with more bond-like characteristics should hold up well in a 'risk off' environment.

Offices in central London (the City and Docklands in particular) are likely to be the hardest hit. This is largely due to the prevalence of financial services firms and other multinational corporations who may need to relocate some of their operations in order to conduct their business in the EU. The likely drop in demand for office space will coincide with a significant supply pipeline that has been building up, which will suppress any potential rental growth. However, a softer landing for London offices could be achieved through developers postponing some speculative schemes, mainly those scheduled to complete in 2018 and 2019. Indeed, after a period of weakening, opportunities may arise to buy into London at a discount. It is also worth noting that large legal firms, predominantly based in the capital's Midtown, are likely to benefit from the huge amount of legal work that will be required as a result of the renegotiation process. **Offices outside of London** are likely to be impacted negatively through the weaker economy and also possibly through some firms downsizing their operations in the UK, but they are likely to be less adversely affected than those in London.

In the **industrial sector**, manufacturers of goods for export will, to some degree, be at the mercy of the UK's future trading agreements in a post-Brexit world. However, a weaker sterling should offer some help. In addition, the high cost of relocation for occupiers of industrial and logistics space and the difficulty of sourcing a specific unit in a short timeframe (with space increasingly built-to-suit) is likely to encourage companies to stay in their current locations in the medium term. Indeed, some large manufacturers have pledged their commitment to staying in the UK. Even if some international firms who prioritise access to the EU market were to relocate, it is possible that many will seek to retain exposure to an economy that has outperformed the rest of Europe in recent years.

The **retail sector** is unlikely to be particularly affected beyond the more general impact of a weaker economy (which would hit consumer spending and retailer demand for space). These effects would in our view be relatively temporary, and more defensive retail, such as supermarkets, is likely to hold up relatively well. Meanwhile, tourism, a significant source of consumer spending, is unlikely to be negatively affected, unless the UK imposes tighter visa controls for EU nationals. Tourists from the likes of the US, the Middle East, China and Australia, who generally spend more in the UK than EU visitors, are likely to continue visiting as before. Indeed, a weaker pound could attract greater tourist numbers to the UK and also drive an increase in domestic tourism as more Brits choose to holiday at home rather than abroad.

The impact on the **private rented residential sector** (PRS) is likely to be fairly balanced. In the longer term, housing demand may be impacted by any changes to UK immigration rules, although supply is also likely to react accordingly. In addition, some occupancy driven by financial and business employers in the City of London could be negatively affected. However, for the country as a whole, in the short term there could even be a pick-up in rental growth as more people choose to rent during the period of uncertainty.

Conclusion

Real estate is a long-term investment which has historically weathered numerous short-term bumps. In the short term, Brexit is likely to bring uncertainty to occupiers, developers and investors alike. Rents and capital values may come under pressure but that in turn may create attractive opportunities for experienced investors with long horizons.

In the medium term, the impact will depend on how successful the UK is at negotiating new deals on tariffs, freedom of movement and other such topics with the EU and the rest of the world as well as what other regulation it chooses to adopt.

Overall, we would expect real estate in the City of London to be the most vulnerable from the impact of Brexit, at least in the short term, while other sectors should see a more moderate impact. Core strategies investing in a diversified portfolio of lower risk high-quality assets, balanced both in terms of regions and sectors and ideally without too much exposure to central London, are best able to weather any volatility.

Real estate markets in the rest of Europe may not escape completely unscathed, but will likely be impacted to a much lower degree. There may even be some EU markets that actually benefit from businesses relocating from the UK. The European economy continues to improve and is now in a much more robust state to withstand any turbulence resulting from Brexit.

In the long term, we expect that the UK economy will adapt to the “new normal”, and the real estate market will reassert its strong position in the global investment universe thanks to its attractive long-term fundamentals.

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