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Brexit: The Impact on Commercial Real Estate

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Brexit has presented increased opportunities for investment in the UK commercial real estate market, with property funds offering discounted real estate assets and with overseas investors looking to invest in what they see as a discounted market[1]. While there is some uncertainty regarding value, lenders are still making funds available for real estate acquisitions and development; transactions are still taking place.

Immediate Brexit Impact

It is of note that feelings of uncertainty entered the market even before the referendum. Some commercial real estate buyers had demanded contract provisions which would enable them to pull out if the decision was to exit the EU. While it is unclear how widespread they were, what is clear is that some provisions are now being implemented[2]. That may be because of a genuine concern over economic conditions, or simply as leverage to enable the renegotiation of better terms, but it would not be unreasonable to suppose that some renegotiation on price is taking place.

Consumer confidence also has been hit. A survey carried out by market research consultancy GfK[3] in the immediate aftermath of the referendum result found that consumer confidence had dropped by 8 points to minus 9 in a few weeks, one of the biggest falls ever recorded[4]. Confidence has been much lower in the past, but the scale and speed of the fall is likely to fuel calls for the Bank of England to cut interest rates to encourage renewed spending (although, of course, the Bank of England, at the most recent meeting of the bank's monetary committee, in fact voted not to reduce rates).

In order to prevent outflows, a number of open-ended UK property funds have either scaled back their investment in the UK commercial property market (for example, Aberdeen Asset Management, which has reduced the value of its fund by 17 percent[5]), or have suspended trading altogether (for example, Standard Life, which shut its doors to investors on 4 July 2016[6]). Six property funds have now suspended trading[7], totalling some £18bn worth of investments.

Finally, both the money and equity markets have seen increased volatility[8]. Sterling initially recorded a 31-year low against the dollar of USD1.2796, and a three year low against the Euro of EUR1.1741—although those numbers have now recovered, to USD1.3236 and EUR1.1910 at the time this advisory was written. The FTSE100, composed mainly of multinationals whose revenues come from overseas (typically in USD), recovered quickly and at the time of writing is up 21% since February[9]. The Financial Times Stock Exchange (FTSE) 250, composed mainly of domestic corporates, also is recovering, but more slowly and remains lower than the pre-

1 Business Insider UK, 11 July 2016, available here.

2 Reuters, 11 July 2016, available here.

3 GfK website, available here.

4 *The FT*, 7 July 2016, available here.

5 *The Guardian*, 12 July 2016, available here.

6 BBC, 4 July 2016, available here.

7 Standard Life, Henderson Global, M&G, Columbia Threadneedle, Canada Life, Aviva

8 FTSE100 and FTSE250.

9 5,536.97 on 11 February 2016, 5,982.20 on 27 June 2016, 6,678.29 on 14 July 2016

referendum position[10]. In both cases, investor confidence has been helped by what has been a far-swifter Conservative party leadership contest than many had expected. Certainty is good, as evidenced by the fact that the markets continue to rise regardless of the appointment of Boris Johnson as Foreign Secretary.

Overseas Investors

As with all things, there are positive aspects to the current economic uncertainties.

Prior to the referendum, the United Kingdom had one of the most liquid and transparent markets in the world—a stable and secure, relatively liberal democratic government, an independent judiciary, and registries (both companies and land) that are open. That made it attractive to foreign investment, particularly in relation to commercial real estate, which for many years has been seen as a "safe haven" asset for those who wish to preserve wealth and to escape debt crises or other economic problems in their own jurisdictions.

It seems unlikely that this will change post-Brexit. The UK's form of government remains—and will remain—the same, regardless of any current political drama. The judiciary remains independent and respected, and the choice of English law to govern contractual disputes remains popular: statistics provided by the Commercial Court show that as of August 2013, just over 48 percent of cases before the Commercial Court involved *only* parties outside England and Wales[11]. And it is likely that the weaker pound will make investment in commercial real estate more, not less, attractive, as investors seek to acquire property at a discount. The most recent example of this is the announcement on 11 July 2016 that US property fund Madison International Realty is planning to spend up to USD1 billion in the UK real estate market[12]. The UK remains a safe and attractive jurisdiction.

Residential Property

Residential property is likely to continue to be an active market. Housing demand currently outstrips supply, hence the high levels of residential pricing, even following the referendum result, and the provision of more houses remains a central issue for government. Estimates put the need for additional housing at between 232,000 and 300,000 new units per year[13]. Whilst Brexit may well bring a correction (the Bank of England recently trimmed its forecast for house prices[14]), the fact remains that for many years, housing supply has fallen far behind demand. This is due to a number of factors, including an aging population, the sell-off of social housing stock, a reduction in the number of new affordable housing units and an increasing house price to income ratio which has seen new homeowners effectively priced out of the market.

Given all this, parties across the political spectrum have committed to increasing housing stock, with Labour and the Conservatives both committing to 200,000 units per year. Leaving aside the very large bucket of salt with which political pledges should be taken, it is not unreasonable to expect that there will continue to be investment (and consequently sales and financing) of land designated for housing.

Development

In relation to development, of the corporates affected by the falls in the FTSE 250, amongst the hardest hit were housebuilders and construction companies. At its lowest, the markets saw Taylor Wimpey down 28 percent, with Barratt Developments closely following with a 23 percent drop. However, new housing stock is required, and so it's no surprise that housebuilders have now recovered some of their lost value. Commercial contractors are likely to have a harder time as confidence in the sector is hit and business investment decisions—including, of course, decisions by corporates to move from one office location to another, or to grow, requiring larger premises—are likely to be deferred while negotiations with Europe are undertaken. Nevertheless, development transactions are still taking place.

Hotels

In regards to the hotel sector, few investors are predicting anything other than continued growth[15], with some enthusiastic about the possibility of investing in what is perceived to be a more reasonably priced market. For the hotel sector generally, occupancy

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10 12 month high 17,781.42 on 20 July 2015, 12 month low (pre-referendum) 15,178.80 on 11 February 2016. 14,967.86 on 27 June 2016 (a 14% drop from its previous high of 17,333.51) to 16,725.28 today.

11 *Legal Business*, available here.

12 Founder Ronald Dickerman said that 'the timing is perfect and we are looking to deploy a disproportionate amount of [the] fund into London'.

13 UK Parliamentary website, Key Issues for Parliament 2015: Social Protection, available here.

14 City AM, 15 May 2016, available here.

15 Serviced Apartment Summit Europe 2016, available here.

rates in the UK remain at their highest levels ever[16], average daily rates remain high[17] and demand continues to outstrip supply. The expectation is that some 16,000 new rooms will open in 2016[18].

Valuation Uncertainty

There is, of course, likely to be some valuation uncertainty. Commercial real estate transactions are (compared with residential transactions, at least) quite infrequent, and so for the moment there remains some uncertainty on commercial real estate pricing. That is likely to have both positive and negative effects. Positive because it will fuel interest in the sector from—most likely foreign—investors who will see opportunities to negotiate better pricing. Negative, because lenders are likely to be more cautious on loan pricing.

Financing

Despite the cautious behaviour of lenders, finance for commercial real estate transactions does remain available. There does seem to be some increasing hesitation on the part of foreign owned banks[19]. UK banks, do continue to lend, particularly after the Bank of England relaxed regulatory requirements (thereby releasing up to £150bn of lending) and indicated that further support would be available (most likely by a summer interest rate cut and by way of possible other monetary policy easing). The Bank of England did of course vote not to reduce rates or increase QE at the last meeting of the bank's monetary committee on 14 July 2016, but hinted that there may be further support given in August.

It is undoubtedly the case that the UK banking system is in a better position than it was during the 2008 financial crisis. Regulation is more robust, capital adequacy is greater, loan-to-value covenants are more sensible. The Funding for Lending scheme continues to be taken up by both retail lenders and challenger banks[20]. Lending is available. The issue now for lenders will be to ensure that returns remain at acceptable levels, but that is first and foremost a pricing issue. Transactions are still going ahead, and they will still need funding, and to the extent that, as a result of Brexit, some loan arrangements will become distressed, those arrangements will fall to be restructured. It is worth recalling that even during the heights of the 2008 crisis, lenders, for the most part, held back from calling defaults and instead saw it as an opportunity to reopen negotiations on price.

Conclusion

The Brexit referendum has had an impact on the commercial real estate market, notably with some transactions delayed and others that have fallen away. Funds are scaling back their investments, the money markets have seen volatility, some foreign lenders—but by no means many, and no UK-based lenders as yet—have stepped back from the UK commercial real estate market. But there have been other positive signs: the UK remains an attractive real estate market; the residential market may see a price correction, but a great deal of additional stock is still needed; finance is still available; and transactions are still happening.

The final word goes to Mark Carney, governor of the Bank of England, giving evidence at a Select Committee Hearing on 12 July 2016, "The financial system can withstand huge shocks. There will be growth."

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[16] 0.6% rise the regions, 0.3% rise in London, to 77% and 84% respectively—PWC Hotels Forecast 2016, available here.

[17] 0.35% rise in the regions, 2.2% rise in London at £69 and £145 respectively—as above

[18] idem

[19] United Overseas Bank, Singapore's third-biggest lender, has suspended lending into the UK real estate market, while DBS Bank has warned of 'foreign exchange and sovereign risks', *The Guardian*, 30 June 2016, available here.

[12] Bank of England, available here.

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