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UK Real Estate Predictions 2017-18

Uncertainty – the new status quo

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Contacts

Rob Thompson
London
D+44 20 7246 7707
M+44 7407 733372
rob.thompson@dentons.com

Jayne Schnider
London
D+44 20 7246 7711
M+44 7918 641617
jayne.schnider@dentons.com

Overview

In January 2017 we formed a panel of three real estate experts and asked them for their predictions for the coming 12-18 months. After 2016 was branded "the year of the unexpected", it seemed we were asking a lot. But as the end of the year approaches some significant events have unfolded – the start of Trump's presidency, Article 50 being triggered, more terrorism and tragedy, and Theresa May's snap general election which left the UK as far away as possible from the promised "strong and stable" governance.

So what impact have these events had on the real estate market and what predictions would the expert panel dare to make for the remainder of 2017 and beyond?

The panellists

Nick Leslau
Chairman at Prestbury

The youngest-ever chief executive of a listed company, Burford Estate & Property, and current chairman of investment adviser Prestbury and shareholder in Secure Income REIT, Nick is one of the UK's most successful property investors and has ridden out several property cycles. In July 2017 Nick was named Property Week's number one in the inaugural Power 100 listings for being the most influential property professional over the last 12 months.

Morgan Garfield
Managing Director at Ellandi LLP

Morgan established Ellandi in 2008. It is now the largest community shopping centre investor in the UK, managing 34 shopping centres with an aggregate value of more than £1.25 billion. Ellandi invests on behalf of a broad range of global and domestic equity. Prior to establishing Ellandi, Morgan was a managing director at Deutsche Bank with responsibility for its UK lending business.

David Phythian
Regional Head of Real Estate, London at HSBC

With over 25 years of real estate finance experience amassed at UCB Bank, the United Bank of Kuwait and a number of private property companies, David has been with HSBC since 2006 and is currently Regional Head of Real Estate, London.

Key predictions
made in January 2017

On the whole, our panellists were apprehensive yet optimistic about the year ahead. Brexit would undoubtedly cause uncertainty but it was thought that Theresa May could put minds at ease simply by triggering Article 50.

There could be difficulties in investment and finance, but the situation was not dire. In fact, there were areas picked out for growth including serviced offices and discount retail, and, crucially, the panel did not foresee that the appetite for foreign investment into UK real estate would be diminished.

Brexit shouldn't impact business as usual approach:

The general consensus was that Theresa May should get the ball rolling on Brexit. The increased uncertainty brought by a delay in triggering Article 50 was the biggest threat to UK real estate.

Trump of little concern:

Our panel was unconcerned by the then President Elect Trump. His focus would be business in the US that would have little effect on our domestic property market.

Retailers will proceed with caution:

The assumption was that retailers would exercise increased caution and that the market would be fairly static. The exception would be discount retail, with strong growth anticipated in this area.

Quantitative easing is the biggest risk to UK real estate:

Quantitative easing is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, such as government bonds. This process aims to directly increase private sector spending in the economy and return inflation to target.

Tax needs addressing:

To ensure it does not restrict business, Stamp Duty should be reformed and Business Rates need to be rethought, were the views of our panel.

Banks will only lend to experienced borrowers:

Borrowers with a track record, who are able to create value rather than sitting on yield, would likely do well, according to our panel.

Investors will still be attracted to the UK:

The panel foresaw little change in the appetite for foreign investment into UK real estate. There would continue to be a large amount of capital looking for a safe haven and the UK, being one of the most liquid markets on the planet, had depth and a benign political system that offered stability. Indeed, our panel remarked, UK political uncertainty was small fry in comparison to the situation in some countries.

Sector growth limited:

Capital returns were predicted to be flat, so emphasis should be placed on producing income. Key sectors for growth would be serviced offices and internet-based distribution. Investors needed to be clever enough to spot openings.

Increased interest in the care sector:

The UK's ageing population and the majority of the population not being wealthy would be issues worth looking at from a real estate perspective, said our panellists.

2017/18 Predictions

Looking ahead to the remainder of 2017 and onwards, what predictions would our panellists make? The following questions were put to them on an individual basis. The following is a summary of their views.

> **"The anticipated economic bumps have transformed into chasms"**
> - Nick Leslau

> **"The level of competition from overseas buyers for good product is making things difficult for domestic investors"**
> - David Phythian

> **"Concerned for the near and medium-term future of this country"**
> - Nick Leslau

> **"Market shrouded in uncertainty"**
> - Morgan Garfield

Q: What impact have you seen in the market post the general election and what do you anticipate going forward?

We asked our property market experts what impact they have seen in the market post the general election and how they believe the market will react going forward. Our panellists were fairly unanimous in their views that little to no impact has been witnessed in the market since the hung parliament and the subsequent minority government was formed. David Phythian of HSBC confirmed that HSBC is still seeing many buyers looking for product and funding in the market. David added that he did not anticipate the appetite for investment changing any time soon, particularly from foreign investors: "We have daily enquiries from overseas investors from all over the globe, but particularly the Far East and EMEA who are looking to buy product in the UK and predominantly London." A cautionary note was added by David, however, who said: "There is still so much interest in buying UK real estate, but the level of competition for good product is making things difficult for domestic investors."

No market fall post general election

Morgan Garfield of Ellandi LLP echoed David's views saying he had not witnessed an election fall or bounce, but this was because the market had already become very subdued post the UK's vote to leave the EU in June 2016. He had hoped that a definitive general election outcome would lead to more certainty post the Brexit vote, but Morgan said that, in reality, "we have more of the same, which is a market shrouded in uncertainty". For this reason, Morgan said, it was hard to anticipate what would happen next in the market as "the major investment headwinds are political, rather than economic".

Nick Leslau of Prestbury, who was a vocal supporter of the UK leaving the European Union, said: "Until recently I was really excited by the prospect of a post-Brexit UK, recognising that in the short term the economic road would be bumpy. But things have moved on fast, much faster than I ever imagined, and the anticipated economic bumps have transformed into chasms." Nick blamed ultra-low interest rates for making asset owners much richer and the poor relatively much poorer. Nick expressed greater concern than Morgan and David, perhaps reflective of the sectors Morgan operates in and the customer base that David works with. Nick stated: "Our property world cannot be unaffected and I am now concerned for the near and medium-term future of this country."

"Investment activity will flatline for the next six months"

- Morgan Garfield

"At worst an asset may cost slightly more in six to 12 months, but it is more likely that it will cost less or exactly the same"

- Morgan Garfield

"To win in this market any domestic investor has to be incredibly creative"

- David Phythian

"Real estate will be protected in the short term by ultra-low interest rates"

- Nick Leslau

Q: How do you think investor appetite will play out over the remainder of the year? And how will it vary from home-grown investors to overseas inbound investment?

"There are plenty of investors out there with money to invest," responded Morgan when asked what investor appetite is like. He went on to say that he wouldn't be surprised if we had a quiet end to 2017 with the potential for increased activity moving into 2018. Morgan believes the market may play out like this because very few investors feel the market is going to run away from them so they are left questioning whether now is the time to invest. "It's all a question of timing," Morgan said. "Given the market and political uncertainty this does not prompt investment now. At worst an asset may cost slightly more in six to 12 months, but it is more likely that it will cost less or exactly the same." For this reason he believes investment activity will flatline for the next six months.

Retail markets coming into play

Focusing on his retail sector, Morgan added: "We are witnessing increased enquiries for regional assets from overseas investors and high net worth individuals who are less disconcerted by IPD forecast and are more focused on securing an absolute opportunity – a high income return that Community Shopping Centres now offer."

Activity could stall

Nick's views were less positive: "I am trying to find some silver lining to our grey clouds, but it's proving very hard to do so." He went on to say that real estate will be protected in the short term by ultra-low interest rates, but this only delays the obvious, that the UK is becoming weaker and therefore our property market will also weaken. He did say that there will be some exceptions, such as prime properties, which still attract overseas buyers, but he warned that even they could become disheartened with the UK market. David agreed that he expected the appetite for UK real estate to stay with overseas investors and that "there is no easy way for a domestic investor to make money. They have to compete with elevated prices that foreign investors can afford to pay due to sterling being weakened. Ultimately to win in this market any domestic investor has to be incredibly creative in the way they produce value from an asset."

"Only the experienced and respected operators are able to obtain funding"
- David Phythian

"There will be no crash, but the rate of decline for all but the top-end real estate assets will increase"
- Morgan Garfield

Q: Financiers are looking to de-risk their portfolios and development debt is hard to come by. How do you anticipate this changing in the future, if at all?

All of our experts refuted the claim that development debt is hard to come by and argued that construction and development finance, and even some speculative development finance, is still available for the right investor. David said that the story that prevailed from the end of the financial crisis has not changed: "Only the experienced and respected operators are able to obtain funding in challenging markets, many of whom have structured their borrowing to cope if a build completes and sits empty for two to three years due to a dampened market."

Funding remains for the experienced

Morgan supported David's views by adding that the appetite from debt financiers to support projects is as strong as it has been in the past. He argued that if anything appetite is stronger. Morgan said: "The issue for financiers and investors is that they want to do big ticket London office deals, but these assets are being acquired by foreign investors often with overseas money from their domestic banks." Morgan believes this is leading to the more traditional lenders getting squeezed out of the London market and having to look in the regions of the UK for more creative lending opportunities.

Market correction, not crash

Morgan concluded his views by saying: "Unless there is a major market correction, I don't see the debt market softening. The financiers, such as UK and German banks, are well versed in preserving risk with LTV at 60-65 per cent – they simply aren't coming up the risk curve." Nick also agreed with Morgan and said that, "there will be no crash, but the rate of decline for all but the top-end real estate assets will increase. Much of the equity deployed in the past five years is very sticky – for this and the fact the market is no longer burdened with high debt levels, we must be grateful".

Q: Predictions for growth sectors – will there be any?

There is much talk in the market about the next growth sectors – what they could be and indeed if there will be any. Alternatives, such as the private rented sector, healthcare, care homes, education and student accommodation, are often bandied around. But all of our commentators agreed that it is hard to see any significant rental growth being created as these are all GDP reliant or government funding reliant. Healthcare and education are the two most logical options as they are driven by a huge demographic. Overall, Morgan said, "rental growth will be pretty anaemic across all sectors as it is very closely correlated to GDP growth, which we won't see a lot of in the near future. Ellandi's approach is to buy assets that have strong current yields and look at them as an absolute return investment, rather than trying to pick relative growth areas."

No sectors will offer easy money

David believed growth would be a mixed story across the sectors. Industrial yields have come in for at least two reasons: the fact that investors are looking for what might be the next growth sector; and changing consumer demand. However, David did say that "the industrial sector remains the darling of the UK with significant growth potential in it due to a lack of product and the requirement side being driven by the economy. And at the moment there is no indication that this will slow down, but not for one minute would I say that is a given."

At the other end of the scale, David said that there has been a slowdown in growth in the London residential sector and there are parts of London where the number of new units due to come to market is very high. Talking about broader sectors, David concluded that "student accommodation, care homes and PRS are all sectors that the market are talking about, but no sector offers easy money – investors have to be selective".

"The industrial sector remains the darling of the UK"
- David Phythian

"Rental growth will be pretty anaemic across all sectors"
- Morgan Garfield

> **"Out of dysfunctionality can come opportunity"**
> - Nick Leslau

> **"In 10-20 years time our exit from the EU may well have made next to no difference"**
> - Morgan Garfield

> **"The market will tick along with low volumes at a pretty unexciting pace with people acquiring assets"**
> - Morgan Garfield

Q: What impact do you think the ongoing uncertainty surrounding the UK's exit from the EU will have over next 18-24 months?

"That's the toughest possible timescale to comment on: we're not going to be out of the EU in 24 months as inevitably the process will be delayed. In 10-20 years time our exit from the EU may well have made next to no difference at all, but short term the key issue is uncertainty," Morgan stated. Overall he felt that the market will tick along with low volumes at a pretty unexciting pace with people acquiring assets, but with no knee-jerk acquisitions being made.

Cautionary approach will continue

David agreed that no one really knows what the market will look like post Brexit and noted that, "HSBC adds another layer of credit analysis when assessing deals that may be affected by Brexit. The questions being, what impact would leaving the EU have on this building's valuation and what effect could leaving have on tenant demand."

Brexit will become a damp squib

Nick, a supporter of Brexit, commented: "Brexit will become a damp squib negotiated by a neutered team and that is not what we need. I have always wanted a 'soft' Brexit and if that is what we achieve, however warped the manner in which it will have come about, then that is possibly one of the positives that will come out of this political mess."

Nick concluded: "On a more positive note, out of dysfunctionality can come opportunity. Some will undoubtedly panic and run for the exit, which might provide some interesting pickings for the courageous."

Conclusions: **Uncertainty is the new status quo**

A market shrouded in uncertainty seems to be the unanimous view that our market experts share. The outcome of the general election may have had little impact to date, but some argue this is because the market was already subdued due to the Brexit vote on 23 June 2016, and the market will continue to be protected in the short term by ultra-low interest rates.

Investors don't fear the market

There may be plenty of investors in the market with money available to spend, but with few feeling the market will run away from them why would they invest their money now when an asset could potentially be cheaper in six months' time? That uncertainty combined with foreign investors pricing UK investors out of the market is leading to a "why invest now?" culture. This could easily cause investment activity to drop. While the debt is available, funding is only being offered to the experienced operators, those that can demonstrate they have a creative way to make an asset produce a return income or those that have factored into their business plan a period of flat-lining.

Opportunities for the courageous

There may be no market crash, but a decline in values will happen as rental growth becomes even more lacklustre across all sectors. No sector can offer easy money so investors have to be calculating and selective in where they invest – meaning that in the short term the market will tick along, but it will be far from active or spontaneous. Out of this blip in the market – and it will be a blip, with the impact of exiting the EU being of little consequence to future generations of investors – opportunities will arise for those courageous enough to take the leap of faith while others sit on their hands and wait for the good times to return.

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