Brexit: Real Estate

A welcome market correction

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At a glance:

- Demand for UK property from foreign investors remains strong
- The spread between property yields and risk-free government bonds is the widest it's been in years
- Lower construction activity is helping correct serious under-capacity and skills shortages in UK

UK property stocks and real estate funds suffered as news from the referendum count rolled in. Some investors rushed to withdraw their money, causing several funds to suspend redemptions. But while that story grabbed the immediate headlines, most investors have been far more level-headed in their reaction. Soon after, most suspensions were lifted, and it seems likely some investors were switching from real estate funds to over-discounted property shares — not exiting the sector all together.

Since then, stability has started to return, helped by Theresa May's swift appointment, support from the Bank of England, and a recognition that Brexit is unlikely to trigger any substantial credit crunch or market crash.

If anything, the Brexit decision led to a welcome correction for UK real estate, both residential and commercial. Prices for both sectors eased around 10% to 15% — accelerating an existing trend of cooling transaction volumes, particularly in London. That cooling should help to sustain a cycle, which had appeared to be overheating, right through to 2018.

Opportunity knocks

The pound's dip to around $1.30 — an almost 15% devaluation — has delivered a significant further win for overseas investors. Combined with lower pricing, foreign investors can snap

up property for up to 30% less than a couple of months earlier. Suddenly the UK market offers better value than in three or four years.

We have seen some opportunists respond. For example, a client closed the funding of a West End development to an Asian investor, the week after the referendum, firmly at the pre-Brexit price. But so far, many are in 'wait and see' mode, at least during the summer lull. So are people right to hover on the sidelines?

In some respects, Brexit has helped the market. The Bank of England cut interest rates in August and it has signalled they will be lower for longer. This will help to underpin asset prices. Bond yields have similarly slipped to all-time lows. That means that with property yields moving out, the spread between property yields and 'risk-free' government bonds is the widest it's been for several years.

The Bank has also signalled its willingness to support lending by providing liquidity to the market. Although lending terms have inevitably become a little more expensive, there are few signs of banks withdrawing from the market and they remain well capitalised. Meanwhile demand from investors is strong.

The economy remains stable, despite gloomy predictions of an immediate meltdown after an 'out' vote. GDP growth is expected to slow to below 2% in 2017. We don't see inflation becoming a concern, despite the exchange rate devaluation, not least while oil remains sub-$50 a barrel.

While some developers may slow the number of projects in the pipeline, most will want to take full advantage of lower land prices. Most have low gearing, so there is little chance of damaging exposure there.

Questions over the City

The big question mark remains occupational demand, particularly for London offices and in financial services. The extent to which financial institutions will need to base more people in the EU — and less in London — will depend on the course of EU-UK negotiations around issues such as passporting and bank settlement. It is impossible to say right now what proportion of London's office stock that will affect, directly or indirectly, but there is bound to be some negative impact. How significant that is, and how far other positive impacts counteract it, time will tell.

Most deals that had been in motion before the referendum are completing. We are also hearing increasing reports of interest from Asian investors looking to take advantage of better value. Meanwhile, lower construction activity is actually helping correct the serious under-capacity and skills shortages in the market, which had been pushing up construction prices significantly.

Despite these concerns, the UK's historic strengths should endure. Britain is the most sophisticated and best-researched property market in the world. And importantly, it is a market that needs a lot of new housing. Theresa May's government has already re-committed to major infrastructure projects such as the High Speed 2 rail link, plus greater development outside London in the shape of the 'northern powerhouse' and the 'Midlands engine' initiatives. The referendum exposed some deep-seated social issues, and we expect tackling these issues by investing in, and rebuilding communities, to become an important objective for the new government.

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