



# Investing in real estate after Brexit

Laying solid foundations

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## At a glance:

- Only granular analysis of each asset can properly determine exposure to Brexit.
- Investors should stress test their financial models for volatility and downside scenarios.
- Track events but don't be a slave to every twist and turn in what is likely to be a period of heightened volatility.

Level-headedness returned to the property market after a strong initial reaction to the EU referendum result. But current calm is no indicator of future sentiment. The prime minister's vision for Brexit, set out on 17 January, may have been welcomed for its clarity, but political volatility is sure to rise as the EU and UK head into negotiations. And as market sentiment whipsaws between the optimism and pessimism around the shape of a deal, so sentiment towards the property sector could swing dramatically.

How should real estate investors frame their Brexit planning in that environment? And given the political and macro-economic situation, which assets in particular should be targeted and which best avoided?

## Asset-by-asset analysis

The reactions in the immediate aftermath of the Brexit vote were understandable. Fear of investing in City and Canary Wharf offices intensified due to expectations that Brexit would have a heavy impact on financial services businesses and the demand for office space.

Those fears have not entirely abated. Many column inches are still devoted to how London's status as a financial centre will be affected by – and even before – leaving the EU. This is not quite Project Fear – but it is forcing the industry to take a more granular view of its investments.

Real estate investors will need to demonstrate intimate understanding of the underlying demand for individual properties. Asset-by-asset analysis is critical if decisions are not





to come back to haunt investment professionals.

Equally important is investor relations for fund managers. When funds are acquiring or selling properties, investors should be completely clear as to the logic at work. Mapping the varying scenarios of demand for any given property in relation to Brexit will be a differentiating factor.

### Challenges in the City

City office buildings, particularly in sub-markets heavy with banking tenants and supporting businesses, will merit particularly close inspection. Asset owners could have difficulties if leases on half the floors of individual buildings come up for renewal within three years, because it is likely that banks will move at least some jobs out of London.

But the strengths of the insurance-dominated area around Lloyd's, in the eastern part of City, should not be

underestimated. The UK has enjoyed dominance in the global insurance market for hundreds of years – and it's hard to believe its leadership in this market will change, whether in or out of the EU.

It's also worth making a sober assessment of the potential alternatives, even if the Brexit negotiations don't go as well as hoped for UK financial services firms.

Many financial firms are currently assessing their options to relocate roles to other European financial centres to continue to service their customers after Brexit. The question is whether other European financial centres, such as Frankfurt could realistically absorb, say, 100,000 jobs from the City, which - with families in tow - might add 250,000 to its population over two or three years.

Much depends on the course of exit negotiations. Existing global financial centres such as New York, Hong Kong

and Singapore might be more likely choices for significant relocations, but time zone and other 'cluster' benefits mean that, in my view, it is unlikely the City will see the bottom fall out of its office market.

Real estate investors will need to understand at a micro level each building's resilience. Ultimately, investment decisions come down to strength of demand for individual properties and this might be based on either alternative use or redevelopment in some cases.

### Hard Brexit, soft intelligence

Nevertheless, the final shape of an exit deal will be critical. Prime Minister Theresa May's speech on 17 January set out her unwavering determination that the UK should leave the Single Market, under what has been termed a 'Clean Brexit'. At the same time, however, she underlined her commitment to delivering a smooth, orderly process and to support sectors such as financial services. She also spelled out her desire for the UK to have some form of customs agreement with the EU.

But despite a cautiously positive response from the business community, and currency markets, there remain significant questions

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over what the final deal will look like. Certainly, scenario planning in the City will now have stepped up several gears.

We can expect that planning to intensify further when Article 50 is invoked by the end of March. By then, investors and fund managers will be more used to background uncertainty and perhaps even the volatility. Yet in the absence of blow-by-blow coverage of negotiations, both the City and decision makers across the country will be relying on whatever stories leak out or speculation by political pundits.

The key issues for manufacturers, for example, will be whether the UK's goal of securing some kind of customs arrangement that ensures relatively frictionless trade can be achieved, or if not, the extent of tariff and non-tariff barriers that would have serious implications for working capital, inventory levels and 'just in time' supply chains. Property investment in the nascent 'Midlands Engine' and 'Northern Powerhouse' could hinge on these details.

Investment managers will need to be clear with their investors that they have looked hard at what the fallout might be – and the demand for the properties currently owned. And they must also be able to demonstrate what their various contingency options are.

### Stress-test your financials

Scenario planning and a granular analysis of individual property is therefore a must. At a higher level,

real estate investment managers should stress-test their various financial models so that they can be in a position to withstand volatility and a protracted downside.

Investors always, of course, want confidence that their funds will perform robustly. But in the run up to March 2019, they will almost certainly face their own pressures that might result in sudden redemptions or even a need to invest. It's worth remembering that the Brexit process will coincide with a febrile period for the world economy – where trade, growth and geopolitical risk will also play into investor sentiment in UK real estate.

Investing in funds with high levels of debt, for example, will be a tough decision, even just given the uncertainty surrounding Brexit alone. Fund managers will need to explain the strategy to bring that debt down if it's not seen as appropriate. Investors need to see that managers are proactively managing risk. In the words of maths teachers everywhere, this is a period where businesses will need to 'show their workings'.

### Track the news, but don't be its slave

No matter how detailed your scenario planning, the 'unknown unknowns' are bound to throw up surprises over the next couple of years. Contingency planning is a must. But there are also plenty of 'known unknowns', as Donald Rumsfeld famously said – events in the calendar that have uncertain outcomes and which could

have major impacts on investment decisions. For example:

- The timing of a UK general election – scheduled for 2020, but quite possibly much earlier. This might affect a host of other infrastructure decisions that will shape post-Brexit real estate sentiment.
- Elections in the Netherlands, France and Germany later this year. This should tell us more about the likely attitude of Theresa May's counterparties in the Brexit negotiations.
- Trump's economic and trade policies – these could have a major impact on real estate in the UK because much of the capital invested in London originates from the US. The relative attraction of investing in the UK versus the US and the likelihood of a US — UK trade agreement will have repercussions on our housing market and, particularly, on the commercial property sector.

It's important not to be a slave to events. But being ready for different outcomes and having the financial and operational agility to respond to them is vital. Vital – and particularly taxing when there's so much potential volatility.

Brexit will be a challenge for real estate fund investment managers. And investors have a right to expect level heads and detailed planning for every possible scenario.

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