

Research Blast

Brexit and Central London Update – June 2020



Economic stress should add further incentive for both sides to avoid no deal at end-2020.

However, perceived risks around Brexit may discourage overseas investors from targeting the market in the short-term.

Less competition for assets is opening up interesting opportunities for investors who are comfortable moving slightly up the risk curve.

Brexit moving back onto the agenda

It feels like a different era whereby every conversation around the UK commercial real estate market evolved around the topic of Brexit. Following the outbreak of COVID-19 in Europe, the issue was hardly mentioned. But as transactions in the UK start to move forward again, and various deadlines in the negotiation process edge closer and closer, we are starting to see more questions on this briefly forgotten topic.

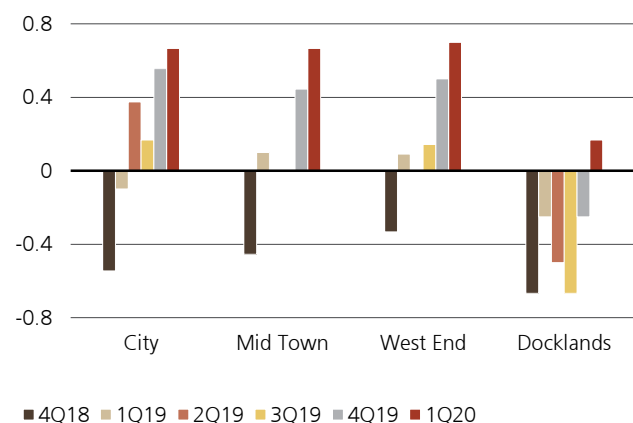
Understandably, very little progress has been made on negotiations since the outbreak of COVID-19. Talks which have progressed have been done via video conference, adding a further challenge to an already highly ambitious goal of having the future trade agreement agreed before the end of the transition period in just six months' time. And, as largely expected, the UK has ruled out extending the transition period beyond the year, which would have to be agreed by 1 July. So, we are back with the same two scenarios we have had since the middle of 2016: Brexit will either take effect at the end of this year with a deal in place, or without one.

Recap to pre-COVID 19

At the start of 2020 sentiment towards Central London had strengthened to levels not seen since 2010. As Figure 1 illustrates, investors had been warming towards the market throughout 2019. Sentiment improved further following Boris Johnson’s decisive election victory in December, which appeared to ease a number of political concerns which had subdued activity in the market since the referendum result. The discount to NAV for the two Central London office REITs – Derwent and Great Portland Estates – turned positive for the first time since 2015.

Aside from Brexit, the perceived risk of a Jeremy Corbyn led government subsided. And, although the risk of a no deal at the end of the transition period remained, there was enough comfort for a significant weight of capital to start to focus on the market again. The market was set for a very strong year of catch-up growth.

Figure 1: UK Investor Intentions Survey (net balance)



Source: PMA, 1Q20

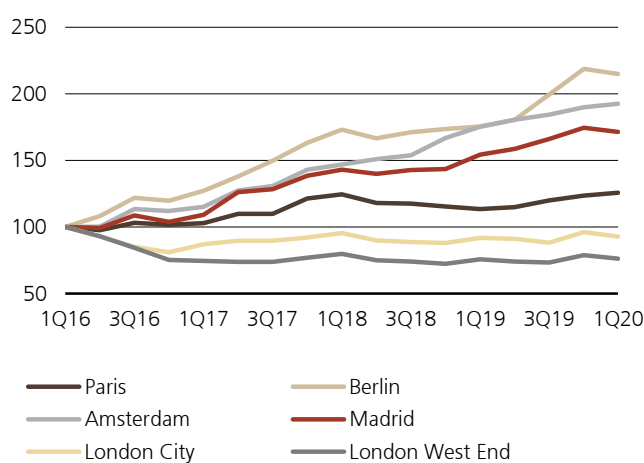
So what has changed?

In terms of the risks surrounding Brexit itself, very little. The chance of reaching a full trade agreement by the end of the year is now even smaller given the reduced time for negotiations. In reality outside of Boris Johnson’s government, not many people believed this was achievable even without the disruption of COVID-19. But there is a strong argument that the risk of a full no deal at the end of this year has actually subsided. Never say never, but it would be inconceivable for either side to add the strain of a no deal Brexit to an economy reeling from the sharpest contraction since WWII.

The most likely outcome remains, some form of skeleton agreement which can be called a deal, but really only handles most pressing regulatory issues which are required to keep trade moving smoothly after the end of the year. Further discussions into 2021 would then take place on the finer details. And, the recent concession from the UK that checks on EU goods coming into the UK will now be phased in from January 2021 to give firms time to adjust, gives further weight to this view.

Central London is suffering from all the usual challenges the COVID-19 outbreak has delivered. And with overseas investors making up c.75% of the market, the restrictions on travel have been particularly limiting on activity in the market. But in our view, many of the attractions of the market which were present at the start of the year, are still relevant. Yields in the City (4.25%) and West End (3.75%), retain an attractive margin over the sub-3% yields currently on offer in Berlin, Munich, Amsterdam and Paris. And as Figure 2 illustrates, prime office values in USD in Central London are still below the 2016 level, whilst other European markets have seen considerable capital growth.

Figure 2: Prime capital values USD index (1Q16 = 100)



Source: CBRE, 1Q20

De-risking presents an opportunity

Although a no deal outcome appears to be less likely in the short-term at least, investors have tended to de-risk since the outbreak of COVID-19. And whilst Brexit remains an uncertainty, investment in the UK retains a degree of political risk for international buyers.

We do see this creating an opportunity however for overseas investors who are prepared to take on some degree of political and currency risk, and for domestic GBP investors. Although we are not seeing any clear signs of distress in the market, with fewer active buyers some deals with attractive pricing are starting to emerge. Assets with very strong income are as expected seeing pricing levels hold up much better. But with yields on the strongest corporate debt and government bonds compressing since the outbreak of the virus, the yield spread between real estate with a comparable quality income has still widened.

But we are seeing more movement in the value-add space and this is where we believe the best value can be found in the current environment. Clearly there are short-term risks to this strategy, on both the occupational and political side. But the disruption to the market from COVID-19, plus the additional caution over Brexit, is generating a unique opportunity to source assets in very strong locations for investors. In particular, those who can take a long-term view of the market and accept some short-term volatility.



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