

UK & EMEA  
Research & Forecast Report

July 2016

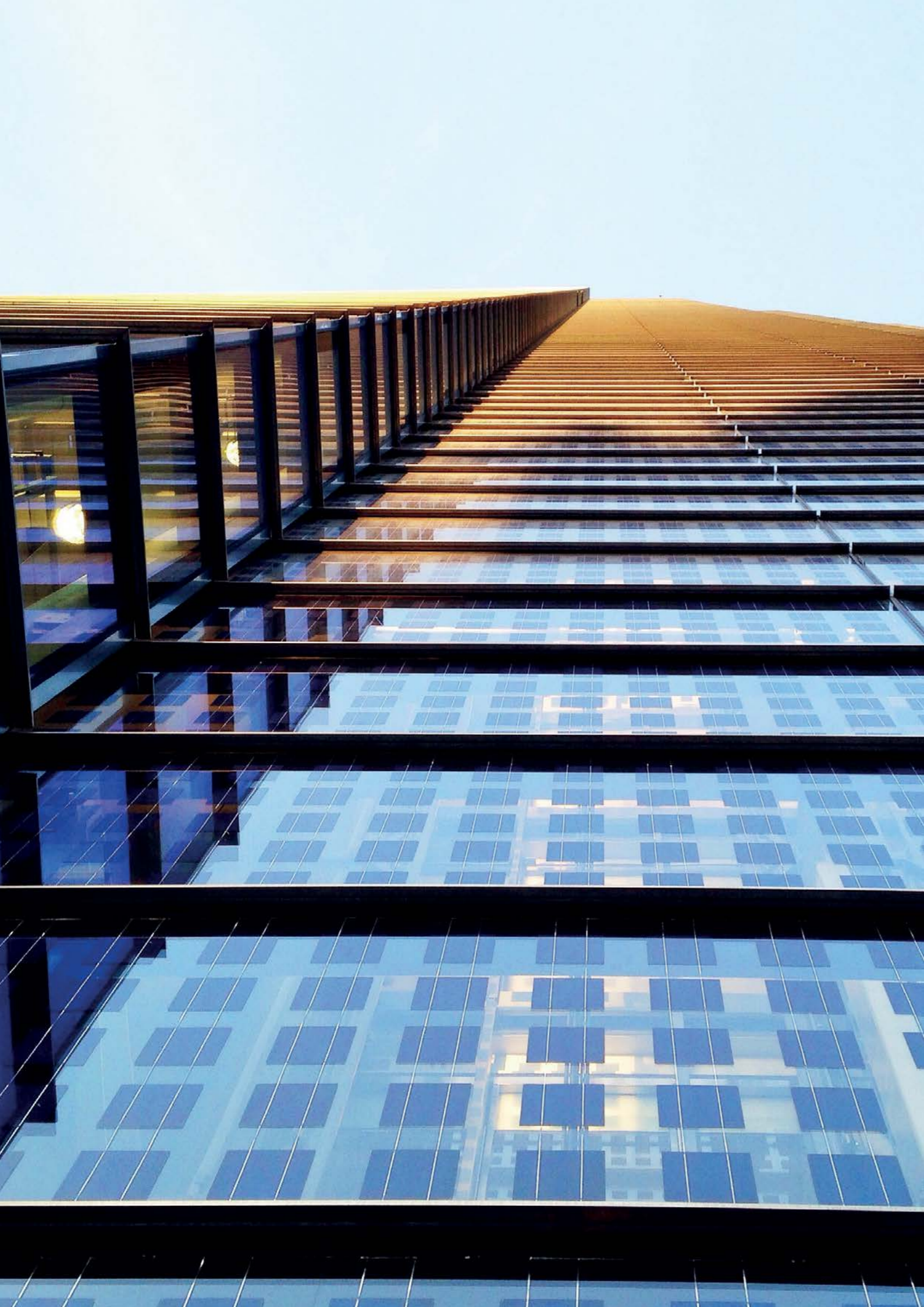


# POST-REFERENDUM

*Vote to Leave and its short term impact on UK commercial property*







## EXECUTIVE SUMMARY

- Post-referendum, the key word is 'uncertainty' and uncertainty can be seen as the enemy of investment.
- Expect no overall clarity about economic, fiscal and regulatory matters until the Autumn Statement in late November or early December, although we may see some signposts with the appointment of a new Prime Minister.

*“...uncertainty can be seen as the enemy of investment.”*

- If sterling and interest rate volatility remains in the range of expectations and Bank of England monetary policy accompanied by prudential regulation remains accommodative, a major correction in commercial property pricing may be avoided.
- The UK economy is supported by household spending which depends, to an extent, on the “wealth effect” generated by rising house prices. Business investment and exports are not likely to contribute more strongly to the economy until 2017. Given the reliance on household spending, the biggest domestic risk to the UK economy is a base rate rise, but the indications suggest that a reduction in the base rate is more likely, possibly on July 14th.
- The impact of post-referendum uncertainty on UK commercial property will be mitigated by: (1) an undiminished weight of global capital; (2) an increasingly desperate global search for yield; (3) retention of the UK's safe haven status; (4) lack of debt leverage; and (5) the strong cash position of UK banks and institutions.
- Income is king. Core and annuity assets are less at risk and deals are progressing in some sectors. Secondary assets, by risk profile, are impacted as support for leveraged deals is reduced by lenders and capital/asset management partnerships revisit the feasibility of development plans.

- Core pricing looks stable, although opportunistic cross border investors are ‘testing’ the market. Some attempts to negotiate on price have been successful, some have been rebuffed. With a number of UK property funds having closed to redemptions since the referendum vote, sales have already been announced and initial valuation evidence is expected to crystallise shortly.

- Developers in London will be tracking the occupier market very carefully. Developers in the regions will be tracking the Government's legislative agenda to see if regional development and infrastructure commitment slips (HS2 and the Northern Powerhouse).

- Impact on occupier markets will vary and trends will remain uncertain until the details of a new EU relationship are agreed. Household services, retail and leisure look stable, as well as domestic facing industrial distribution and manufacturing. Corporate Britain is sitting on its hands and business services appear most vulnerable.
- UK demographics and the weight of existing pools of expertise will act as ‘pull’ factors and protect the UK economy from large-scale business defections to EU cities. Other pull factors include the lack of alternative business infrastructure and unfavourable tax regimes in other parts of the EU.

*“Core pricing looks stable, although opportunistic cross border investors are ‘testing’ the market.”*

- The UK real estate market has embarked on a new journey, with the direction still unclear. Colliers will report on this journey as policy and sentiment adjust to a new norm.





## Referendum vote - impact on commercial property investment

In order to fend off the risk of a recession following the EU referendum vote, stimulus from the Bank of England (BoE) is likely to comprise looser monetary policy, with a cut to the base rate a possibility, perhaps on July 14th. Ultimately the decision is for the Monetary Policy Committee (MPC) to make, but Mark Carney has emphasised the need to support growth and lower borrowing costs rather than stabilise inflation, with the BoE governor fearing a deferment of consumption and investment, as well as labour market weakness. In August, the MPC will also be reviewing the use of alternative instruments e.g. Quantitative Easing.

George Osborne is planning to cut corporation tax from 20% to 15%, making it the lowest rate among major economies. The objective is to attract business investment, which has been adversely affected by the EU referendum result and the ensuing uncertainty. The move is part of a new five-point plan, which also includes intensifying efforts to attract investment into the Northern Powerhouse, attracting investment from China, support for bank lending and preserving fiscal credibility. Further, the Government Property Unit has announced a programme of civil service consolidation, largely driven by HM Revenue & Customs, that could generate demand for just under 5 million sq ft of office space in the English regional office markets by 2023.

Evidence of referendum related interruptions to the real estate deal flow are unequivocal, but equally evidence of deal continuity is also unequivocal, especially in core and annuity type assets. Momentum in both the investor and occupier markets has continued post referendum vote, but this may not be a realistic indicator of short to medium term activity.

The UK property universe is diverse and the risk spectrum very broad, defined by a combination of sector, geography and quality. At present, income is king and pricing is expected to remain firm for core and low risk assets. The exception may be Central London offices, where the high value and large lot size limits the buyer pool and concerns over Financial Services employment raises a question over future occupier demand. The small-scale quality end of the market looks like business as usual, with private buyers much in evidence. We also expect renewed interest in Alternatives, such as hotels, student housing and build-to-rent, where the occupational

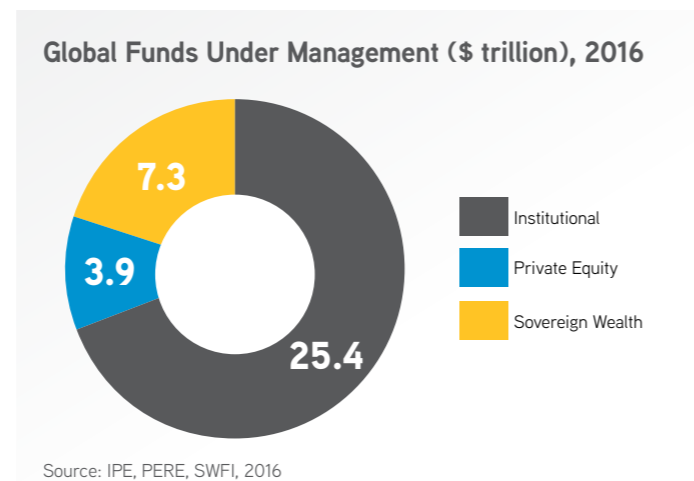
**“Global funds under management amount to around \$36 trillion and allocations to property are increasing.”**

markets remain strong. Beyond core and bond type assets, pricing is likely to adjust to new levels over time.

A number of open ended property funds (eight to date) have blocked redemptions. These funds had already seen outflows pre EU referendum and the leave vote resulted in a further sharp upturn in withdrawals, which cash buffers have been unable to satisfy. UK property stocks (REITs) fell back to post referendum lows as negative sentiment followed the announcement of fund “gatings”. While there has been some recovery, at the time of writing, share prices for the major REITs were down between 5% (INTU) and 24% (Workspace) since June 24th, which suggests that the market is pricing in a fall in capital values.

### Weight of capital

The key defining feature of the real estate investment market is the weight of capital coupled with the general lack of leverage. UK property will find powerful support from an undiminished and growing weight of global capital and an increasingly desperate international search for yield. A conservative estimate of global funds under management across all asset types, by institutions, sovereign wealth funds and private equity, amounts to some \$36 trillion. The search for yield in a world characterised increasingly by negative bond rates has caused institutional and other funds to increase weightings to property. Allocations to property have risen from an average of 8.9% of total funds under management in 2013 to 9.9% in 2016 and are set to exceed 10% by 2017. This trend is set to endure and new equity raised for property funds, globally, continues unabated. A one per cent increase in funds is equivalent to \$360 billion or about one-third of global property investment volumes in 2015.



### UK safe haven status intact

Despite a downgrading by rating agencies, the UK market looks to have retained its safe haven status. Credit default swaps and the cost of insuring against UK bond defaults rose modestly, but ten year bond yields have fallen by about 50 bps post-referendum. Part of the fall is attributed to expectations of weaker economic growth, lower interest rates and more quantitative easing, but part of the fall is also in response to greater demand for UK gilts. Domestic funds seeking to hold liquid assets may have been driving much of this demand, but global equity funds have seen large outflows, reflecting a general pivot toward safety. For commercial property, there is no evidence that UK gilt yields will exert pressure on property yields for the foreseeable future.

### Lack of leverage and cash buffers

The UK financial market is not over-leveraged and over-engineered as it was in 2007/08. The market is led by equity. Despite the headlines about fund redemption pressure, banks, large UK property funds and several REITs are in strong cash positions. This is no accident. Prior to the referendum, the Bank of England, through its Property Forum, suggested that funds should hold large cash positions to mitigate the impact of possible redemption pressure. The adequacy of these cash holdings is being tested. Some funds have already conducted sales over the first half of the year in anticipation of possible fund redemptions. In May, a net £360 million was withdrawn by UK investors from property funds (direct and indirect), or less than 2% of the estimated £25 billion total funds (Bloomberg, 5th July 2016).

### Pricing

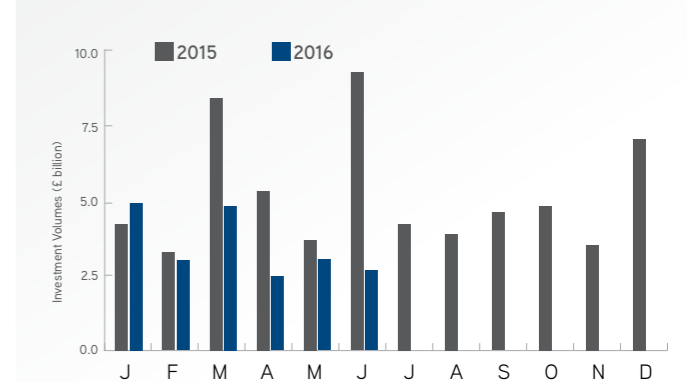
The referendum is crystallising ‘late cycle risks’. A number of funds have publically announced pricing adjustments to their funds, for example Aberdeen (-5% and -17%), LGIM (-5% and -10%) and F&C (-5%) due to redemption pressure. Selling activity has already been initiated by a number of these funds and some quick transactions are anticipated, but we believe that there is support for the type of income producing product that is being (and will be) marketed. Multiple bidders will limit the degree of discount achieved. So, despite low transaction volumes, evidence of new pricing benchmarks are expected reasonably soon.

In the last couple of weeks, numerous direct property investors, especially private equity funds, have cancelled or, more often, tried to renegotiate deals with the aim of securing a discount. Some have been successful, but some have been rebuffed by unleveraged owners, such as UK institutions. Colliers International is also seeing increased interest from Middle Eastern and Asian investors in both commercial and residential assets, often from potential new entrants. While much of this interest is opportunistic and the pricing expectations unrealistic, this is evidence that the UK remains a target, despite the referendum result. These investors have reportedly stocked up on sterling which they see as discounted by 10%, by way of example, a 10% discount on asset prices on top of a 10% discount on sterling is equivalent to a 100 bps of increased yield for some assets. Prices do not need to fall far before UK real estate attracts a whole new tier of investors.

### Transactional volumes

Volumes are down, post referendum, but are certainly not out. In the year to end June, over £22 billion has been transacted in the UK. While this is down on the exceptional volumes of 2015 by some 35%, it also suggests some market resilience in the pre-referendum period. In June, over £3 billion was transacted. The evidence, so

### Transaction Volumes, 2016



Source: Property Data Ltd

**“Transaction volumes are down by 35% on 2015 so far in 2016. But the data also shows some resilience in the pre referendum period.”**

far, suggests that transactions have slowed, post referendum and, increasingly, it looks as though pricing uncertainty will hold the market back. This is less true in the core and annuity end of the market, but secondary asset pricing is being tested. Given the summer period and the reluctance of funds to bring assets to an uncertain market, a degree of price uncertainty will be evident in the short-term. However, under pressure from the Financial Conduct Authority (FCA), some unithold funds will trade quite quickly. Evidence of new pricing benchmarks will be evident in the coming weeks and well before the quarterly fund valuations at the end of Q3 2016. In the meantime, smaller scale assets will continue to move across sectors, with an active private buyer market. Larger scale transactions will slow, but not stop, as both buyer and sellers re-evaluate.





### Impact on commercial occupier markets

Interpreting the occupational market is another matter altogether linked, as it is, to perceptions of the long-term prospects of the UK economy. Despite the cancellation of a large leasing deal (80,000 sq ft) to GAM in Victoria and sensationalised threats of corporate de-camping to EU cities, corporate planning momentum has pushed several sizeable deals over the finish line. Examples include Ocado, Amazon and a number of leasing transactions across the Central London office market, including a new record rent of £107 per sq ft at the Leadenhall Building in the City.

Initial post-referendum evidence suggests that retail and leisure operators are in business-as-usual mode. Even top end fashion operators with large import components are still looking for space in London. With consumer confidence reported as weakening in early July, it remains to be seen how sustainable the momentum is. Industrial leasing also looks generally unfazed. Large distribution deals (internet and food) are progressing, retail warehousing demand remains firm, particularly from bulky goods, although trade counters focussed on the building trade are exercising caution. London offices look to be the most vulnerable post referendum, but vacancy rates are at historic lows (c.3%), which will provide some support to rents. At present, regional office agents report both deals being completed and deals going ahead.

### Household services, retail and tourism

Those sectors that are linked to household services – medical, utilities, transport, distribution, retail, leisure and domestic goods manufacturing – will fare better due to projected demographic growth and an increase in UK household numbers. Retail demand, especially at the value end, will prove resilient, despite economic weakness. Discretionary retail, leisure and other operators will also find support from increased numbers of foreign and domestic tourists as weak sterling makes the UK attractive. A domestic boost from ‘staycations’ is also likely. In the recent past, in the depths of the Great Recession,

‘staycations’ added over £5 billion per year to domestic tourism spending. Given the evidence, coping and adapting to the new market disrupters, including internet traders or new leisure and hotel formats, may prove to be the greater challenge for operators, irrespective of evolving post referendum plans.

### Business services demand

The future for business, professional and technical services is the key focus of concern. Media reports emphasising business threats to decamp to EU locations to ensure ‘passport rights’ are very visible, if somewhat sensationalised. A few manufacturers have also suggested that new investment in the UK may be put on hold. While these may be real risks to the UK and to UK occupier demand, a key mitigating argument has to do with the inherent inertia of existing clusters of expertise, summarised below.

#### Technical clusters

- Require specialised pools of labour
- Investment in plant and machinery precludes easy relocation
- Reluctance to lose generational expertise in specific industry sectors
- Importance of institutional and academic links – Life Sciences
- Reluctance to withdraw funding from long-term projects, having borne high set-up costs

#### Financial services

- Critical mass of expertise already assembled in London
- FinTech well advanced
- Alternative locations, such as Dublin and Frankfurt, lack infrastructure and have physical limits to growth
- Paris unattractive to high earning talent due to personal and social tax regime; French business and employment legislation not attractive to new businesses

We are at an early stage of understanding the full implications for the UK economy and UK real estate market of departure from the EU. The UK real estate market has embarked on a new journey, with the direction still unclear. Colliers will report on this journey as policy and sentiment adjust to a new norm.





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**554** offices in  
**66** countries on  
**6** continents

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**\$2.5**

billion in  
annual revenue

**2.0**

billion square feet  
under management

**16,000**

professionals  
and staff

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