The Long Goodbye
UK investment in Brexit's wake

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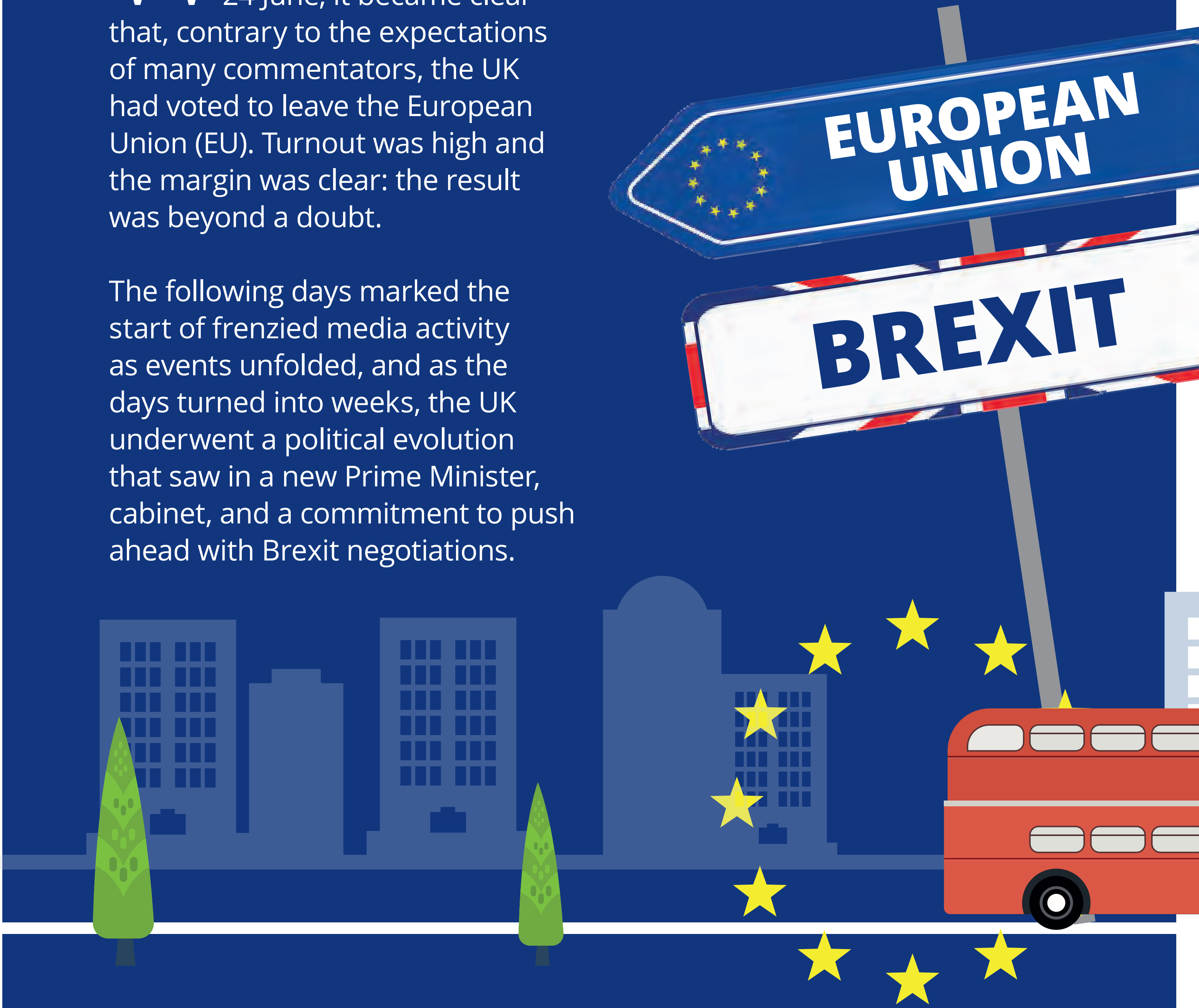
What a difference a day makes. As dawn broke on Friday 24 June, it became clear that, contrary to the expectations of many commentators, the UK had voted to leave the European Union (EU). Turnout was high and the margin was clear: the result was beyond a doubt.

The following days marked the start of frenzied media activity as events unfolded, and as the days turned into weeks, the UK underwent a political evolution that saw in a new Prime Minister, cabinet, and a commitment to push ahead with Brexit negotiations.



These events may be unprecedented in the UK's recent history, but will they really lead to the almost binary outcome for UK investment that some were predicting prior to the referendum?

Short-term volatility…

The extent of the impact on real estate investment quickly became a focus of discussion, both within the industry and also as part of wider economic commentary. Initially this was largely a function of the significant fall in the value of the sterling, which swiftly created a compelling discount to UK property for overseas buyers. Press reports picked up on anecdotal evidence showing a clear rise in interest from overseas investors in the days following the vote.

Overseas investors have played a very strong role in the UK's property market for at least the past 20 years, and in the last five, they have rarely accounted for much less than 50 percent of overall investment activity. For some, the sterling devaluation offers a way to reconsider a market that had become significantly more expensive in recent years.

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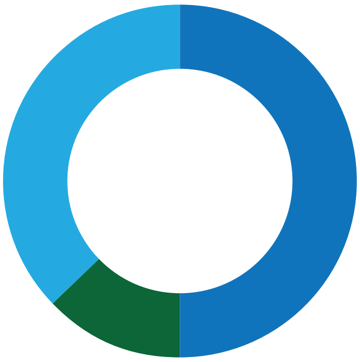
Share of Investment in UK commercial property, 2015



Source: Property Data

Meanwhile, the initial post-referendum stock market volatility saw listed real estate companies sell off, as concerns over future occupational demand and consumer confidence gained greater significance. The sector largely failed to join the subsequent stabilization seen across other areas of the UK's main stock indices. Shortly after, a number of property funds closed to redemptions, as they struggled to meet the liquidity requirements of rising number of investors that were attempting to cash-in their holdings.

...long-term focus

For all of the undeniable short-term disruption caused by the Brexit vote, investors have been quick to turn their attention to the medium and long-term picture. Some aspects, such as the ultimate political outcome of the vote, will remain difficult to forecast, even as elements of the eventual settlement start to become clearer over the next few years. Equally, important questions such as the likelihood that UK-based financial firms will be able to retain their passporting rights (which allow them to operate in the EU from a UK base) is hard to gauge at this stage, and yet may have particular consequences for tenant demand in parts of London.

What already does seem clear, is that the process of leaving the EU will take many years to be fully resolved. For most investors, "waiting until it is all over" is not a realistic option. In any case, to do so would risk missing out on some of the opportunities that will undoubtedly continue to exist during this period.

Sterling to the rescue?

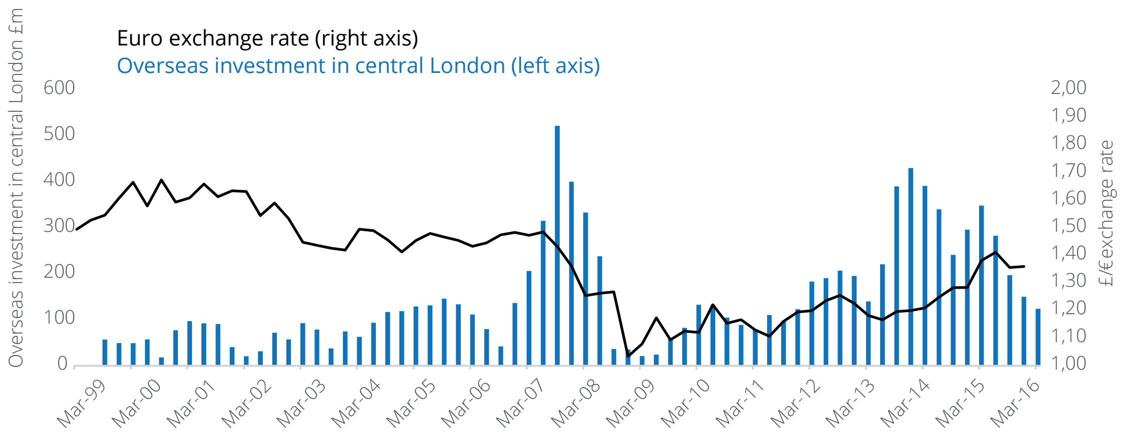
Firstly, there are a number of factors which could cushion the medium-term impact of the vote to leave. One is the weakness of the sterling, which has already sparked renewed interest among overseas buyers. However, more importantly than the individual deals seen so far, history shows that sterling weakness corresponds reasonably well with a sustained increase in the general level of overseas demand for UK property, ultimately supporting liquidity.

The impact of sterling weakness has not been the only reason that UK property has started to look like a better value: a number of the deals that have been struck since the vote have simply been priced more competitively, and IPD's recent data point to modest easing in capital values across most property sectors.

It could be tempting to see this as purely a result of the vote to leave, but while the referendum may have been the catalyst, a consensus around the softening of prices in 2016 had been forming for a year or more.

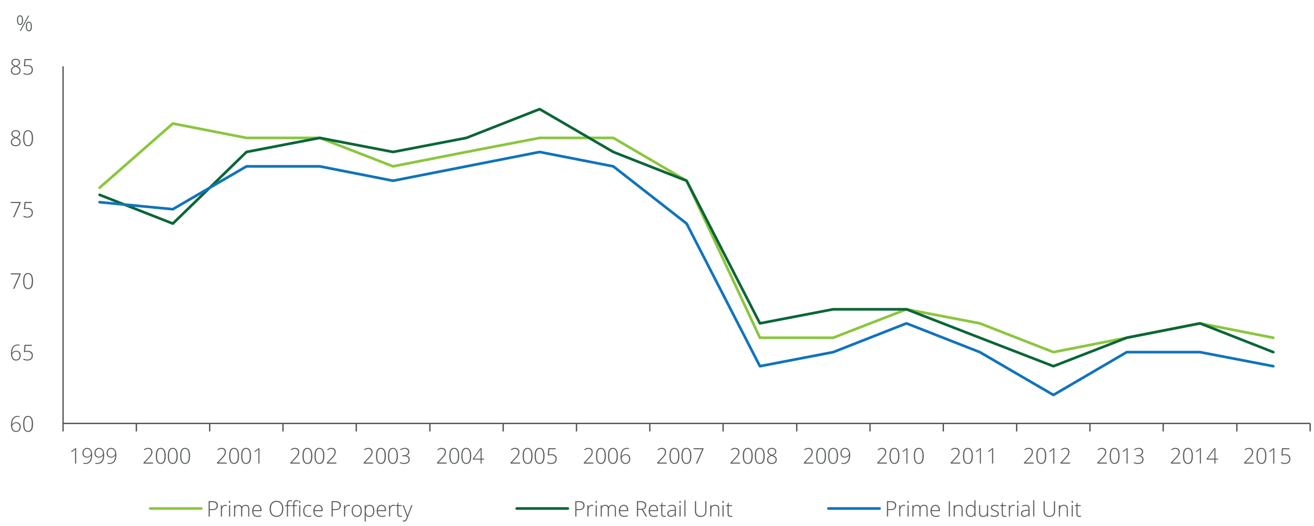
Crucially, loan-to-value (LTV) ratios both on built stock and developments are significantly lower today than in the years leading up to the 2008 downturn. This means that even if capital value declines were to accelerate, investors would be much further from breaching loan agreements than in the last downturn. Completing the virtuous circle, on the whole, owners and lenders are much better insulated from the distress situations of that time, reducing the risk that large numbers of forced sellers quickly push down capital values in the first place.

Overseas investment in central London



Source: Bank of England/Property Data/Deloitte

Max LTV



Source: De Montfort University

Should I stay or should I go?
Valid concerns are also being raised in relation to the medium-term outlook for leasing activity and rental levels. Evidence from Deloitte's Q2 2016 UK CFO survey, conducted in the weeks following the referendum, showed that the UK's large corporates were reining in their appetite for expansionary strategies, and focusing instead on cost reduction. In particular, hiring intentions have continued to fall, suggesting that, in aggregate, firms may be under less pressure to lease office space.

Yet even if these intentions turn to actions, a meaningful impact on office rents is likely to take time to become visible. Firstly, the combination of the relatively benign economic slowdown predicted and generally long lease terms means that many firms will be under no immediate pressure to downsize or move. Secondly, and perhaps more importantly, the low levels of current office availability in many large UK cities could go a long way toward offsetting the impact on rental levels, even if demand were to decline. In London, for example, vacancy rates are currently running at less than half the level that historically corresponds with rental falls.

Deloitte's Crane Surveys show that the UK's major regional cities have undoubtedly seen a recovery in office development over the past two years, but most are still simply making up for the dearth of delivery during the last recession.

In London, where the development pipeline is much greater, a large proportion of the space under construction today is already let, and developers may decide to postpone some speculative schemes that are not yet under construction. None of this can entirely guard against the possibility of more significant falls in rents, and it is certainly likely that the unseen incentives offered to prospective tenants start to rise. But it does suggest that the situation is likely to be more benign than during the global financial crisis.

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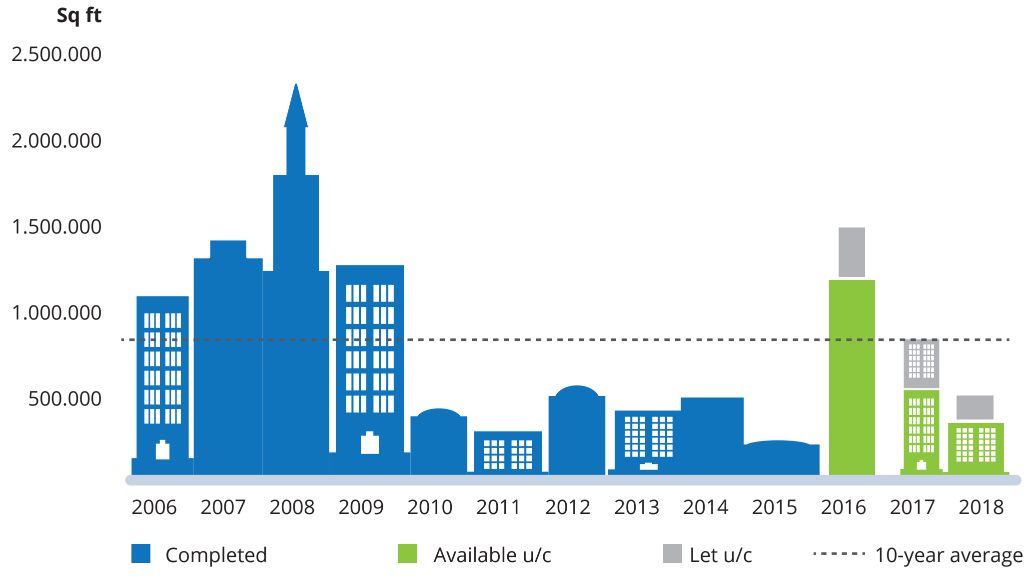
Office development pipeline - Birmingham, Manchester & Leeds



Source: Deloitte Real Estate

Looking further ahead

For some investors, however, it will be long-term, not medium-term considerations that matter most. EU membership undoubtedly enhanced the attractiveness of the UK's property markets on the global investment stage, but it was clearly not the sole factor at play. A deep pool of investible assets, strong legal and regulatory frameworks, and high quality "soft factors", such as cultural and education institutions are characteristics that the UK shares with other leading European investment destinations.

Naturally, however, London stands out as one of the world's few truly global cities. Deloitte research stands testament to the pace of growth within its high skilled workforce, already larger than that of any other global city and part of the reason for the prevalence of global headquarters.

The coming years may see changes to the structure, type of employment, and companies headquartered in London, but it is difficult to see that its position as a key global city will be challenged.

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City	London	New York	Hong Kong	Singapore	Paris	Sydney
Total of people employed in knowledge-based industries (Globaltown, 2013)	1,471,869	1,163,039	759,152	726,502	599,376	569,545
Total of people employed in knowledge-based industries (2016)	1,706,924	1,158,279	769,729	728,289	627,156	607,231
Absolute change	235,055	-4,760	10,577	1,787	27,781	37,686
Percentage change	16%	-0.4%	1.4%	0.2%	4.6%	6.6%

The UK as a whole also continues to present interesting investment opportunities, especially beyond the traditional office, retail, and industrial property. In 2015, investment in UK alternative property, such as student housing, healthcare, and motor trade related assets reached almost £9 billion, nearly 20 times the amount invested in 2009.

Student housing accounted for around half of the investment into the UK's alternative property types during 2015. However, as a large, growing, and aging country, there may eventually be even greater opportunities for investment within healthcare property.

Putting everything in perspective

The decision of the UK to leave the EU was a shock. The aftermath is in many ways much more mundane, and in the medium-term should not fundamentally alter the UK's position as a leading global investment market. Perhaps the broader perspective comes from thinking of property as a small part of the global investment market—one which has grown accustomed to chasing ever smaller yields. On that basis, whether London, the UK, or indeed other European cities and markets, property is likely to be an increasingly popular asset class.

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