THE UK REAL ESTATE MARKET

SPINNING THE WHEEL OF BREXIT AND COVID

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Market review: Spinning the Brexit and COVID wheels

There are now less than three months to go until the end of the transition period and, at the time of writing this article, substantial differences are reported between the UK and the EU with regard to agreeing a trade agreement.

As we stand at the end of October, the UK and EU have so far failed to reach agreement, but discussions are on-going after a stall in negotiations in mid-month. Both sides are calling for compromise from the other side on the key issues of fishing and state aid against a deadline that appears to be more flexible than feared.

COVID-19 has eclipsed Brexit in the headlines. The pandemic has compelled countries around the world to implement restrictions on people's movement that were barely imaginable at the beginning of 2020. Indeed, the International Labour Organisation (ILO) estimates that 2.7 billion workers, representing 81% of the world's workforce, were affected by these measures.[1]

From retail to offices, the way we work and live changed immeasurably, with a profound impact on real estate in the short term and inevitably 'game changing' over the longer term. Here we give thought to the potential impact of Brexit and COVID for the main commercial sectors, from a UK perspective.

Several key issues remain including:

- Structure and governance of the agreement
- State aid rules
- Security
- EU access to UK fishing.

More tangential but nonetheless important points requiring resolution including:

- Rules of origin regulations
- Mutual recognition of professional qualifications
- Short-term work provisions
- Data control.

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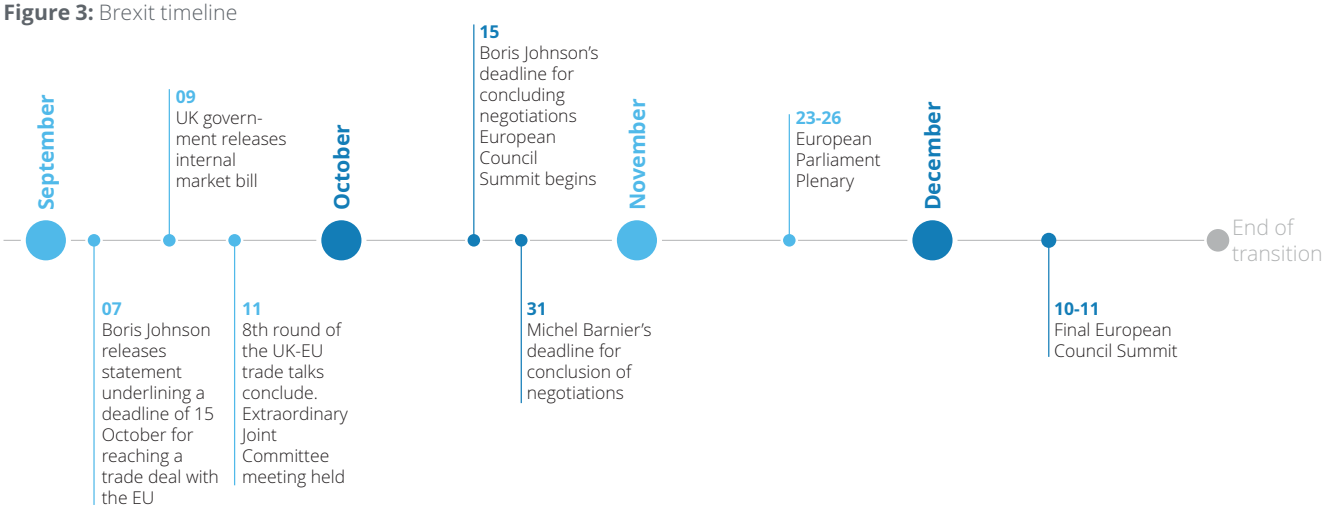
Figure 3: Brexit timeline



Source: Deloitte

Offices

Notwithstanding the periods this year of zero/reduced occupancy, the office sector has so far remained relatively resilient from an investment value perspective, with MSCI reporting a comparatively modest 3.4% fall in capital value in the year to July 2020.[2] Structural changes – prompted or accelerated by either COVID and/or Brexit – have emerged however that will affect the fortunes of some sub-sectors of the market more than others.

COVID impact

As the impact of COVID has evolved it is natural that businesses have where possible deferred decisions regarding new or additional occupational requirements. COVID has promoted universal trialling of working from home by a majority of office workers. Early results regarding the use of technology by home workers are positive, but the longer-term impact on the ability of the office to facilitate collaboration, foster learning, promote the development of networks and support peoples' wellbeing remains to be seen.

While occupational transactions across the market have taken place during lockdown, a not unexpected consequence of COVID is that businesses are reassessing both the size of their footprint as well as the nature of their future office requirements. This inevitably includes reviews of occupancy ratios and applying social distancing measures to reconfigure existing spaces, with enabling technologies to reduce costs.

An RICS survey in Q2 2020 found that 93% of respondents expected businesses to cut back on their office space requirements to some extent over the next two years. Additionally, 64% thought that demand for office space in suburban locations may displace the demand across urban centres.[3]

Supply is responding to this period of reduced demand. Deloitte's 2020 London Crane Survey reported a 17% reduction in the pipeline over the next two years, revealing a gradual reduction in future supply levels in the London office market.[4]

A range of future occupational strategies are possible, including 'hub & spoke' approaches as well as a recast mix between home and office working. Moving forward it is quite conceivable that occupiers' demands will become more exacting, precipitating a flight to quality in terms of specification, layout and location. Some organisations may decide they no longer need to return to an office: this is expected to be the minority rather than majority.

To determine what the future office footprint might look like, investors and occupiers can profile Minimal Viable Footprints (MVF). Recently, Deloitte Real Estate has produced guidance notes on how to assess the physical footprint and determine the MVF,[5] to meet operational efficiency and staff well-being needs as well as regulatory requirements.[6] [7]

Brexit impact

Since the referendum in 2016 and up to 2019, the UK and especially the central London office market witnessed sustained demand for new and refurbished office space, somewhat counter to Brexit expectations. In 2018 take-up was 30% higher than the 10-year average. Although much of the financial services industry has considered contingency plans for moving operations to EU countries, the originally estimated outflows have yet to materialise.

The Deloitte 2019 London Crane Survey found that the number of jobs transferred to European cities such as Frankfurt, Dublin and Paris has been considerably lower than originally expected.[1] The short to medium-term position on access to talent and business centricity appears to be placing London at the forefront for service sector occupier demand.

Brexit uncertainty itself has so far this year had limited market impact on office investment trading activity, but the potential to weigh more heavily on sentiment is present as we approach the end of the transition period – particularly if currency fluctuations re-emerge and influence cross-border appetite and pricing requirements.

Industrial and logistics sector

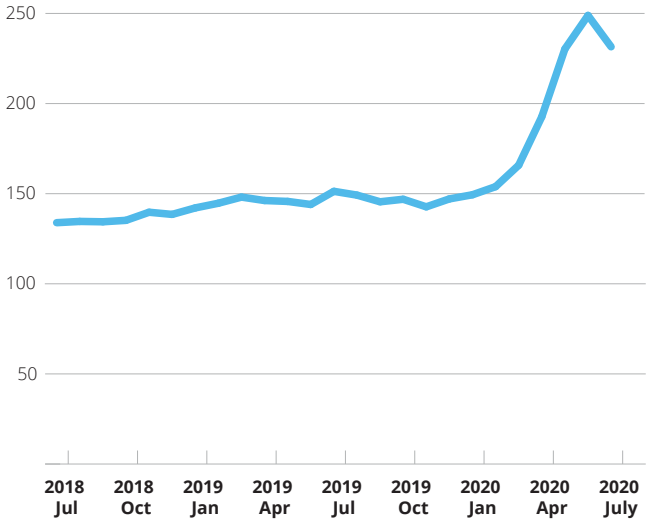
The industrial market has performed strongly compared to other commercial property sectors, with real estate values remaining broadly stable. Industrial-focused REITs and property company stock prices have recovered or, in some cases, exceeded the March 2020 highs.

The relative out performance of the industrial and logistics sector has been driven by COVID-19 related lockdowns accelerating the existing long-term trend of towards increased online retail spending.

According to Office of National Statistics, online retail's share of total retail spend increased from approximately 20% in February to almost 33% in May. The proportion of online sales declined in July to approximately 29% of all retail sales but online sales remained over 50% higher than pre-lockdown.[8]

Figure 4: Online retail sales levels remained strong despite a decline on the month

Value sales, seasonally adjusted, Great Britain, July 2018 to July 2020



Source: Office for National Statistics – Monthly Business Survey – Retail

This increased online retail spend is translating into high take-up of Logistics and distribution space as retailers and 3rd party logistics companies seek to meet demand.

According to Cushman and Wakefield, take-up reached over 35 million sq ft in the first nine months of 2020, which already exceeds take-up for the entirety of 2019.

Strong take-up has driven rental growth for logistics assets with average industrial rents growing 2.3% in the year to July 2020 according to MSCI whilst investment pricing has remained broadly stable with modest weakening limited to more secondary assets.

COVID impact

The increase in online retailing, equating to approximately ten years' of growth in a matter of weeks, is likely to result in increased occupational footprint requirements from online retailers, traditional retailers expanding their online offering, supermarkets and third-party logistics companies.

It is reported that Amazon alone will lease close to a further 10 million sq ft of logistics space by the end of 2020 (compared to 2019 when they took approximately 3.5 million sq ft).[9]

It has also been reported that Tesco is to make permanent 16,000 temporary jobs created during the lockdown, to support their rapid growth in online grocery sales. Hermes is adding 10,000 new jobs and DPD plan to increase their workforce by 6,000.[10]

The overall net effect on demand for industrial and logistics space will also be driven by the experiences of the manufacturing and traditional industrial sectors. Further national or local lockdowns have the potential to halt operations, disrupt supply chains and have a negative impact on demand for manufactured goods. The potential weakness of demand from traditional manufacturing tenants could temper the positive influence of logistics demand on the sector, from a rental growth and yield perspective.

Brexit impact

The potential effects of Brexit differ between logistics and manufacturing.
From the logistics perspective, real estate assets are a key part of a supply chain that will be heavily affected by Brexit. The movement of goods between the EU and the UK will become more complex irrespective of the outcome of negotiations. There are several key issues that will affect the flow of goods between the EU and UK, including border delays, road haulage operations and the working time directive restrictions.

- Border delays are likely due to the introduction of customs inspections and the requirement to complete export and import declarations and safety and security declarations.
- Road haulage will face several practical challenges such as the need for European Conference of Ministers of Transport (ECMT) permits to drive through the EU in the event of a no-deal Brexit which are limited in supply and the EU no longer recognising UK driving licences.
- Working time directive restrictions mean that the time drivers spend in border delays counts towards the maximum driving time permitted before a rest.

The UK has announced some measures to mitigate potential border delays, such as a phased implementation of checks. In any event, companies may seek to stockpile goods and could therefore need additional storage requirements, particularly near to the key border entry points.

From a manufacturing perspective, the potential effects of Brexit include the same issues facing the logistics sector but with several additional challenges:

- Supply chains face potential strain from border delays, and manufacturers will face new costs of complying with customs and safety declarations.
- Tariffs could become an issue for manufacturers, because if a trade deal is not agreed, the UK will trade with the EU on WTO rules. Tariffs will be 10% on vehicles moving between the UK and EU and 6% to 12% on some raw materials, clothing and textiles.
- Rules of Origin regulations will need to be complied with by manufacturers which means typically 50-60% of a product's inputs will need to be from the UK or EU.[7,8]

These issues have the potential to reduce further the profitability of manufacturing firms and in turn affect both the occupational requirements and covenant strength of tenants.

Like COVID-19, Brexit may affect logistics and manufacturing tenants and markets differently. Demand for logistics may see some short-term positives or minimal effects, whereas manufacturing demand may be affected adversely for the reasons set out above.

Retail sector

The retail sector retained its unenviable crown as the worst performing commercial real estate sector in the past year. According to MSCI, average retail rents fell by approximately 7.5% in the year to July 2020 which, coupled with an increase in investment yields by about 100 basis points on average, led to a fall in value of almost 20%.[10]

The ongoing structural changes within the retail sector have been exacerbated and accelerated by COVID-19. There has been a record high number of retail CVAs or insolvencies including Laura Ashley, Debenhams, Oasis and Warehouse, DW Sports, Bensons Beds, Go Outdoors, Poundstretcher Properties, Monsoon and Brighthouse. According to the Centre for Retail Research, as at 5 August 2020, 49 retail companies had failed in the year to date, accounting for over 3,000 stores and employing over 60,000 people.[11]

COVID impact

The 'lockdown' from 23 March 2020 required all retail outlets to close unless they were providing 'essential' goods and services such as pharmacies, grocery stores and post offices. This legal requirement was in place until 15 June 2020 when opening was then subject to social distancing precautions and subsequently the use of face coverings.

The impact on the retail sector was an unprecedented loss of footfall for the majority of retail occupiers for nearly three months. Footfall gradually recovered as lockdown restrictions were lifted but according to Springboard it was still approximately 30% below normal levels in mid-August.[11]

The impact on footfall varied widely between markets. Whilst coastal and historic towns performed relatively well due to 'staycations', some markets performed significantly worse. For example, footfall in London's West End was still approximately 60% below normal as at August 2020, due to a combination of reduced international tourism and widespread continued working from home.

Lockdown has also resulted in a very large increase in online sales as a proportion of total retail spending. This has accelerated a trend already under way pre-COVID, and only intensifies the structural challenges facing the sector. Growing levels of vacancy appear inevitable in the near term, and the challenges facing the sector are also precipitating a comprehensive re-think of the leasing and rental model.

Brexit impact

Brexit will have wide ranging implications for the retail sector regardless of the outcome of the trade agreement negotiations:

- Supply chain risks for the retail sector include the potential for stock shortages from border delays; increased costs from complying with post-Brexit import declarations for customs and safety which retailers may find difficult to pass on to consumers, and the requirements to train staff and upgrade existing systems to cope with the new rules.
- Tariffs may further affect retailer profitability as trading under WTO rules could give rise to payments of import duties that may be difficult to pass on to the consumer. Further, market access arrangements between the UK and third countries may change due to the UK losing the benefit of trade agreements between the EU and those countries.
- Staffing: free movement of people will end on 31 December 2020. EU/EEA citizens resident in the UK before this date will retain their rights to settle in the UK and access services under the EU settlement scheme. The UK has announced a new points-based immigration system from January 2021 including a salary threshold of £25,600, the requirement to have a job, be educated to an A-level standard and speak English. This may reduce the pool of relatively low-skilled and low-cost labour that the retail industry relies on and over the medium to long-term this could lead to an increase in staffing costs.

All these issues have the potential to present further challenges to a sector already facing unprecedented headwinds.[9]

Leisure and hospitality sector

In recent years this sector has endured a number of challenges in adjusting to increases in the National Living Wage, higher import costs due to sterling weakness and business rate rises. These have been exacerbated by COVID, with the loss of international tourism from March 2020, the collapse of business travel and the forced closure of restaurants, pubs, hotels and other leisure venues.

Unsurprisingly, this has translated into widespread financial stress for tenants, with many of the UK's most recognised restaurant brands entering into CVAs or administration, including Pizza Express, Byron Burger, Carluccio's, the Restaurant Group (Frankie & Bennys, Wagamama), Prezzo, Azzuri Group (Ask, Zizzi), Pret a Manger and Casual Dining Group (Bella Italia, Café Rouge, Las Iguanas).

MSCI has reported falls in capital value of approximately 17% in the year to July 2020 for leisure properties, with rents falling by approximately 2% and investment yields weakening by 100 basis points.[12]

COVID impact

The leisure sector was affected by the same lockdown restrictions as retail. It has since been subject to a phased reopening with restaurants, pubs and cafés permitted to open from the same date as retail premises; but bowling alleys, indoor skating rinks, indoor play areas, casinos and exhibition halls were required to remain closed until 15 August. As at the date of writing, nightclubs are still closed.

The sector has therefore effectively earned no revenue for almost three months during the lockdown period. Data from Open Table shows that the percentage of restaurants opening rose from a low of approximately 10% of available covers in the first week of July to 90% in the final week of August. Of those that did open, seated covers rose from approximately 65% in the first week in July to 100% by the first week in August.[13]

As well as dealing with revenue losses, operators have had to adapt to government social distancing guidelines, which has increased costs. The government sought to support the sector with its successful 'Eat Out to Help Out' scheme which delivered strong restaurant visit numbers, but only through August.

Putting the future course of the pandemic to one-side, the future direction of the sector depends on how consumers respond once government support is withdrawn, both in the short term (with the ending of the 'Eat Out to Help Out Scheme' on 31 August 2020) and also in the medium term with the withdrawal of furlough support at the end of October 2020 which could lead to increased job losses and dent consumer confidence.

Brexit impact

The impact of Brexit on the sector is hard to assess. The sector will face many of the same challenges as the retail sector, with potentially higher import prices for raw materials and food products, and a reduced staff pool with the ending of free movement.

A no-deal Brexit could however see sterling weaken against major currencies, making travel to the UK more attractive (subject of course to COVID restrictions).

Conclusion

The combination of COVID-19 and Brexit is inevitably creating many more "moving parts" within the real estate market to address and consider. Notwithstanding, since the Covid-19 related market "shock" in March, the majority of sectors have not necessarily witnessed particularly erratic adjustments, rather an acceleration and heightening of trends that were already in train – an exception being within certain of the Alternative markets where value is predicated upon trading levels. The situation continues to evolve as the implications of COVID-19 and Brexit develop. From a COVID-19 perspective, the race towards improved track-and-trace, treatment and ultimately a vaccine in due course will all have the potential to influence the markets – particularly those where value is most exposed to trading performance as well as occupier confidence. Brexit negotiations are equally at an important point, yet it would arguably – and perhaps cynically - have been somewhat surprising for agreement on the new trading relationship to have concluded early. Considering the deadline pressures there is an inevitability to the brinksmanship currently being observed as of the date of this publication and we will all watch with interest as the deadline approaches....and passes.

In this article we have attempted to capture impact of Brexit on a few sectors; however there is a requirement to monitor all sectors' trade nuances and the impact of COVID-19 over the coming weeks and months.