

THE IMPACT ON GLOBAL REAL ESTATE

Brexit Briefing



QUALITY AND VALUE

Global investors will seek sound income streams and concentrate on property fundamentals



SUMMARY

Reassessing risk and opportunity following Britain's decision to leave the EU

■ **Risk & World markets:** Uncertainty in the wake of Britain's EU referendum has changed the balance and perception of world risk, affecting all global markets to varying degrees. This has changed the prospects for real estate markets asymmetrically. Real Estate has characteristics which may be increasingly sought-after in uncertain times so caution on REITs and funds may be tempered by increased appetite for direct property ownership in particular sectors and jurisdictions.

■ **Real Estate characteristics:** Negative short bond yields in some countries and very low income returns

in many means that income-producing real estate should be increasingly sought after.

■ **European real estate:** European cities are among those showing the highest net effective income returns over and above local 10 year government bond rates. This suggests that prices have not yet reached a cyclical high and also that these markets are likely to show the highest income returns if rents remain stable or grow.

■ **Safe havens and income streams:** Real estate in stable jurisdictions with good title still offer investors a way

to store their wealth amidst turbulent markets. Rental premiums over gilt yields may be viewed as a bonus by some over and above this safe haven status so temporary fluctuations in capital values have little relevance to these longer-term-income investors.

■ **Global appetite for real estate:** While short to medium term worries on economic performance may keep Sterling and Euro currencies low, this will present buying opportunities, especially where debt availability is not an issue. Underlying fundamentals of supply, demand and rental growth will become key determinants of success.

→ Britain's vote to leave the EU on 23rd June 2016 and the subsequent political and constitutional turmoil that followed in its wake, introduced a very large dose of uncertainty into investment markets not only in the UK and the EU, but globally and so changed both the sum total and distribution of risk dramatically.

While some markets have realised that this perception of risk was overdone in certain sectors, and have recovered markedly, others remain subdued or have rallied only moderately. Some markets such as gold, the Yen and US dollar have strengthened significantly while Sterling, Euros and UK stocks, particularly REITs and construction, are still down (see Figure 1).

Unlike these assets, there is no real-time trading data in directly owned real estate so it will not be possible to precisely assess the impact of Brexit in either pricing or turnover terms for at least a few months but it is possible to look at the characteristics of property against other assets to begin to understand its potential positioning.

To do this, we consider in this note not only the key qualities of real estate in relation to other asset classes but also the relative position of different geographies. The following sections look at real estate in relation to:

1. Interest rates
2. Exchange rates
3. Geopolitical and cyclical risk

The key themes that emerge are:

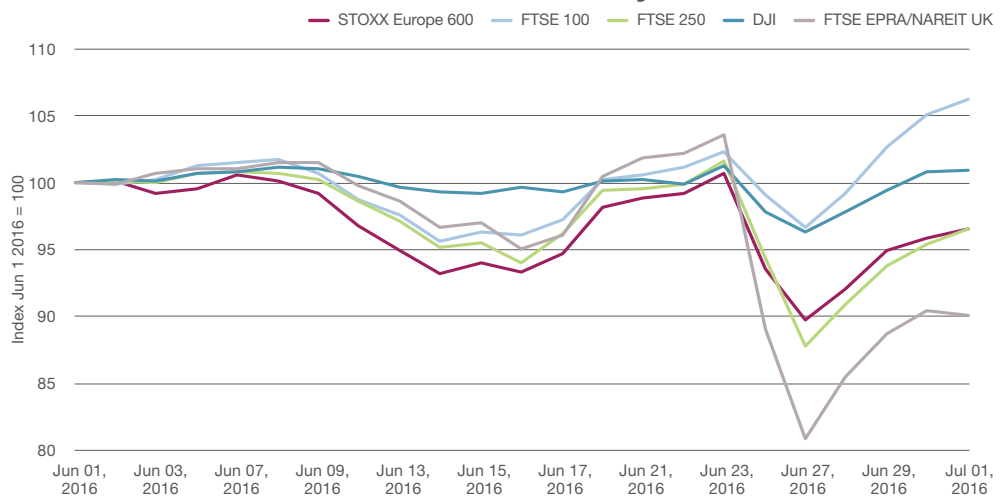
■ Globally, real estate will increasingly be sought after as an income-producing investment, with decreasing emphasis on capital growth, particularly where bond yields are low or have even turned negative.

■ The role of property in providing a safe store of wealth in 'safe haven', secure title, jurisdictions will come to the fore although this will be tempered by currency risk in places where currency may move down further against the investor currency.

■ A focus on real estate occupier fundamentals, and their impact on rental returns and prospects for rental growth, is inevitable and may present investment opportunities over coming months. →

FIGURE 1

Post EU referendum stock market volatility



Source: Investing.com



➔ ■ Buying opportunities will be most apparent for those with large war-chests and in dollar-denominated or Yen currencies who were already waiting for cyclical buying opportunities in some fully valued markets. This activity will be tempered by fear of economic downturns but, again, the longer-term nature of real estate investment will come to the fore.

■ Leveraged investors will be less prominent and opportunistic and unconventional investors with cash will be the most active globally. This may mean a larger proportion of private investors once again active in the market.

Interest rates and yields

In the face of rising global risk (and in the expectation of Bank of England base rate cuts), there appears to have been a flight to safety in the form of government bonds. At the end of June, the UK joined Japan and Germany in experiencing short-term negative bond rates (see Figure 2).

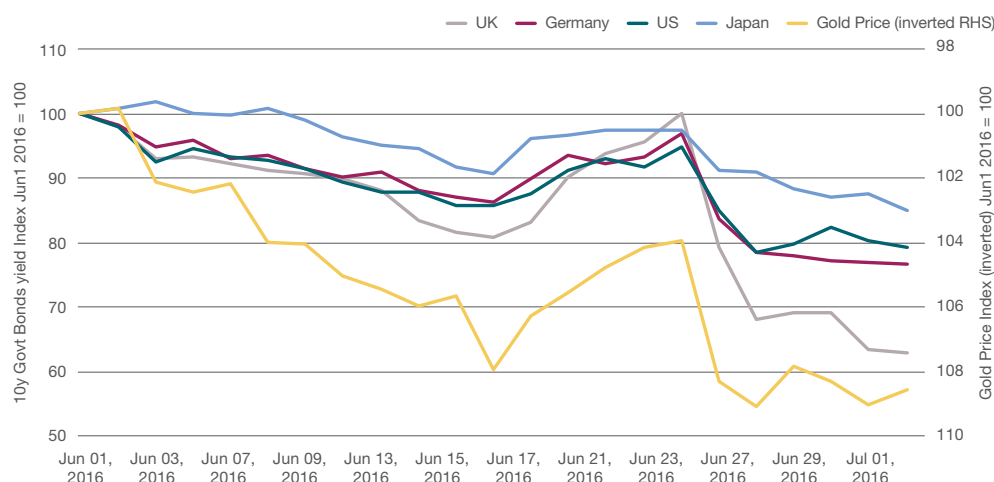
Expectations before the referendum were that UK and US base rates would start to move out in the near future. Fears in some fully valued markets were that rental growth would not keep pace. With expectations once again that base rates will stay lower for longer, or even drop, property yields have longer to move out and are more likely to do so through rental growth rather than capital contraction.

When the opportunity cost of money turns negative, any income-producing asset must start to have particular attractions. This potentially puts real estate into a new and different class for as long as the majority of tenants continue to pay rent. Under these circumstances, we expect fully let properties of all use types and classes with low void rates in deep markets to remain an essential part of any well-balanced investment portfolio.

However, we expect this also means that the fundamentals and the future prospects of both the market and the property will be carefully scrutinised by investors before purchase.

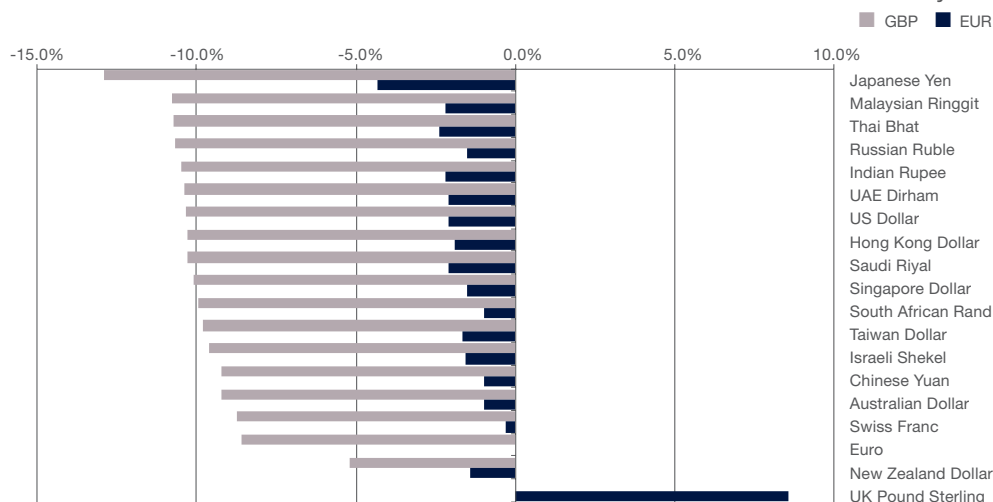
When the world is searching for income, investors are likely to be looking for both quality AND value.

FIGURE 2
Shift to safety 10 Year government bond yields and gold price (inverted)



Source: Central Banks, Bloomberg

FIGURE 3
GBP and EUR vs world currencies Movements 23rd June vs 1st July



Source: Bank of England

Exchange rates

The credit rating of the UK was instantly downgraded on the 24th June when the referendum results were known and sterling plummeted against most other currencies, even the euro which also suffered devaluation against the US dollar.

Currency volatility has added to the risks of placing investments in Euros or sterling for the moment but also offers opportunities for those holding US dollars, other dollar-pegged currencies and Yen to buy assets more cheaply. Figure 3 shows how currencies have moved since the eve of the referendum.

UK and European property has become significantly cheaper for US dollar and related currencies and especially for holders of Japanese Yen. We do not think these currency changes will give every dollar buyer a desire to buy UK and European real estate but it does mean that investment buyers will become increasingly focused on the fundamentals of yield levels and rental growth prospects. Real estate will look good value where these are present, particularly as expectations of more global volatility rise. The world is faced with further UK, US and European political change and elections, to cite just one element of risk, for example. ➔



→ Geopolitical and cyclical risk

Long before the Brexit vote, some degree of geopolitical risk related to the Eurozone seems to have already been priced into European real estate markets. Prime office investors at the end of last year, for example, were buying London on the same level of net effective yield, adjusted for bond rates, as other major world cities like New York and Hong Kong while Eurozone cities such as Paris, Frankfurt and Brussels had not seen the same degree of yield compression and some were being priced on the same risk-adjusted net effective yields as Chengdu and Manila (see Figure 4).

Yields have since moved in significantly in many European cities but some global investors' appetite for Euro denominated assets in a region of political uncertainty may have been somewhat impaired compared to other world regions. Global markets appear to think that the EU is not out of the woods yet.

Conclusion

In the very early days of global post Brexit reaction, and indeed in the days preceding it, stock market volatility has increased dramatically. Meanwhile, yields on lower-risk government bonds – even UK ones, have moved in, not out since the referendum. The search for safety is still on and the prospects for negative interest rates seems to have increased.

There is still appetite from global investors to put their money somewhere. It is becoming increasingly difficult to find asset classes and sectors which offer stable incomes and stability or safe

haven status. The price of gold, for example, rose by 6.4%, from US\$1,253/ounce to US\$1,333 over the four days to June 27th. Some other real assets, particularly real estate, may look only slightly less attractive to certain investors, particularly those seeking income as well as diversification.

There is a point, especially in countries with negative interest rates, like Japan, when the yield available from real estate in countries with secure tenure and socially safe environments and transparent markets looks compelling, despite increased risk and volatility. This is especially the case for cash investors seeking mid and long-term income streams. Recent currency strength, especially if it is expected to be temporary, makes the purchase of sound Sterling or Euro denominated rental income look cheap.

While expectations of economic growth may be receding in certain quarters, some cities and some countries are likely to do better than others and it is the most stable, high yielding sectors in safe jurisdictions that investors will increasingly be looking for.

Performance will be found, as always, in real estate locations where there is steady demand from growing populations, security of title, market transparency, limited supply plus long-term economic and growth prospects. Investors are likely to be looking for all these quality factors but looking for value too in the form of higher yields. Returns will be further enhanced in places where the currency strengthens over time so that income returns to foreign currency investors are improved. ■

6.4%

Increase in the price of gold over the four days to June 27

FIGURE 4
Grade A Offices December 2015

■ North America ■ UK ■ Far East ■ Oceania ■ Europe

Net effective yield less local 10yr bond rate (NOBEY)

New York Midtown	0.5%
London West End	0.7%
London City	0.8%
Hong Kong	0.8%
Sydney	1.0%
LA West	1.0%
Shanghai	1.3%
Chicago	1.3%
San Francisco	1.5%
Beijing	1.7%
Singapore	1.8%
Miami	1.8%
Warsaw	1.9%
Madrid	2.0%
Paris	2.3%
Tokyo	3.0%
Frankfurt	3.3%
Berlin	3.4%
Copenhagen	3.6%
Cologne	3.7%
Dublin	3.7%
Brussels	4.5%

Source: Deakin University, Savills World Research

Savills World Research team



Yolande Barnes
Director
+44 (0) 20 7409 8899
ybarnes@savills.com



Paul Tostevin
Associate Director
+44 (0) 20 7016 3883
ptostevin@savills.com



Vladimir Tikhnenko
Analyst
+44 (0) 20 7016 3043
vtikhnenko@savills.com

Savills plc

Savills is a global real estate services provider listed on the London Stock Exchange. Savills operates from over 700 owned and associate offices, employing more than 30,000 people in over 60 countries throughout the Americas, the UK, Europe, Asia Pacific, Africa and the Middle East, offering a broad range of specialist advisory, management and transactional services to clients all over the world. www.savills.co.uk or www.savills.com.

This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.