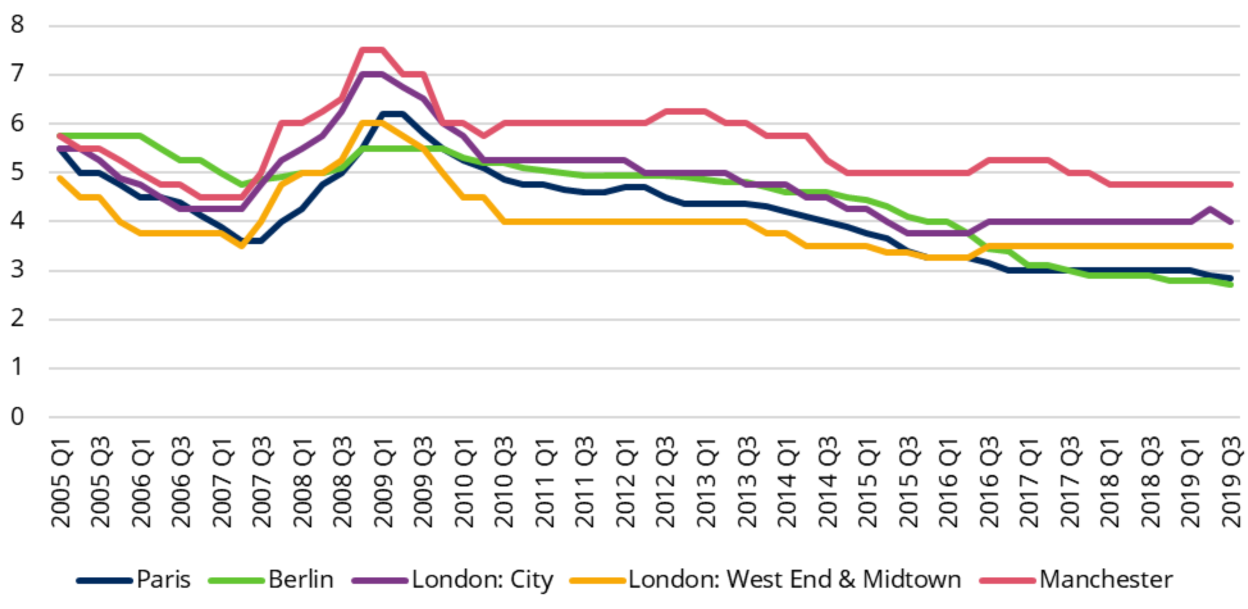
Beyond Brexit:
The Outlook for UK Commercial Real Estate

The vote to leave the EU in June 2016 has shaken UK politics and dominated the short-term outlook for the economy and commercial real estate ever since. The election of Boris Johnson's government with a big majority on December 12th means that the UK will almost certainly leave the EU at the end of January 2020.

The focus will then switch to the UK's future relationship with the EU and other countries and, in particular, trade deals; but worth noting, there will be a transition period in the interim to minimize disruption. The UK government faces a choice between on the one hand, tearing up EU regulations which will give it more latitude in trade negotiations with the US and other countries and on the other hand, maintaining easy access to the EU single market. While there is a wide range of opinions, the consensus is that Brexit will result in slower UK economic growth, because the boost from greater trade with non-EU countries will be more than cancelled out by weaker trade with the EU.

To date the main impact of Brexit on UK commercial real estate has been on liquidity. Although the investment market remains active, at least for office and logistics assets, both domestic and foreign investors have turned more hesitant since the start of 2019. The total value of investment transactions fell by 25% between the first nine months of this year and the corresponding period of 2018 (Source: Property Data).

Prime Office Cap Rates



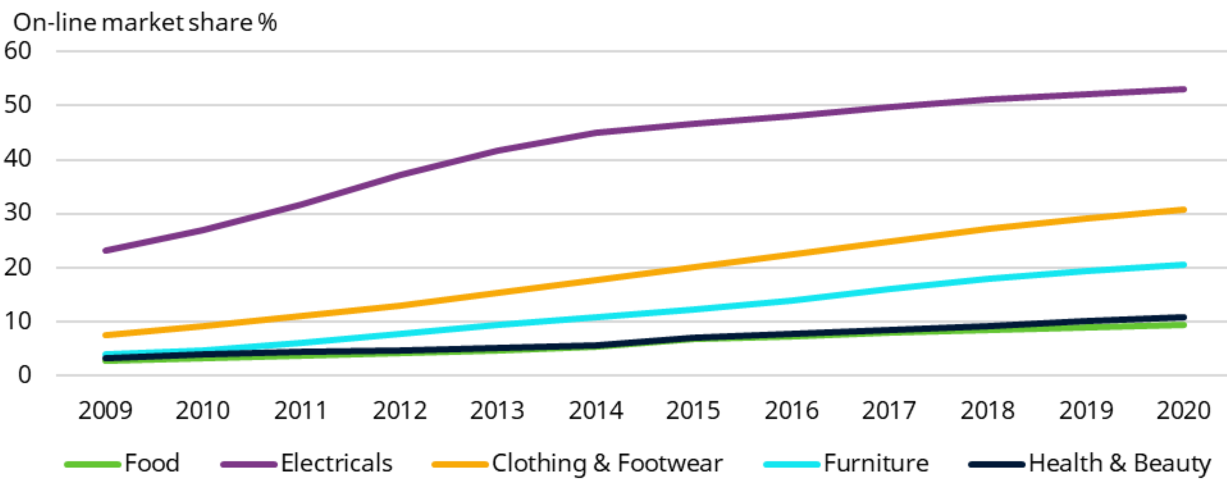
Source: PMA, October 2019

At first glance, cap rates appear to have shrugged off Brexit. Prime office cap rates in the City and the West End of London have been stable over the last two years at 4.0% and 3.5%, respectively and prime cap rates on offices in the main regional cities have fallen slightly. However, if we put the UK in a European context, then it appears that Brexit has affected investment pricing, by bringing an early halt to cap rate compression in the UK. Prior to the EU referendum in June 2016 prime office cap rates in the West End of London were either on a par with those in central Paris, or lower. By contrast, they are now 0.65% higher. It is possible that the decisive election result will trigger a new round of cap rate compression in London, although it is unlikely that the gap with Paris will close completely, given that interest rates are higher in the UK than the Eurozone.

However, while Brexit and future trade negotiations cannot be ignored they are not the only factors driving capital values and investment returns on UK commercial real estate. In addition, there are a number of long-term structural forces independent of the economic cycle (e.g. climate change, demographics, technology) which are creating both challenges and opportunities for real estate investors.

The London office market provides a good illustration. On the downside, demand for office space from financial services has weakened since the EU referendum, reflecting fears that London based banks will lose access to the EU single market. Around 25-30% of international financial transactions routed through London are intra-European (Source: BIS). On the plus side, tech, media and life sciences have continued to expand in London, attracted by the city's world leading universities and large pool of skilled people. Amazon, Apple, Google and Facebook have all committed to more office space in London since the EU referendum and there is also a vibrant ecosystem of local start-ups. Our London strategy is to focus on Bloomsbury, Shoreditch, Soho and Whitechapel which have strong bias to tech and media occupiers. We also like offices in certain regional cities such as Bristol, Cambridge, Leeds, Oxford and Manchester, which have strong universities and are growing as tech, media and life science clusters.

On-Line Retail Sales

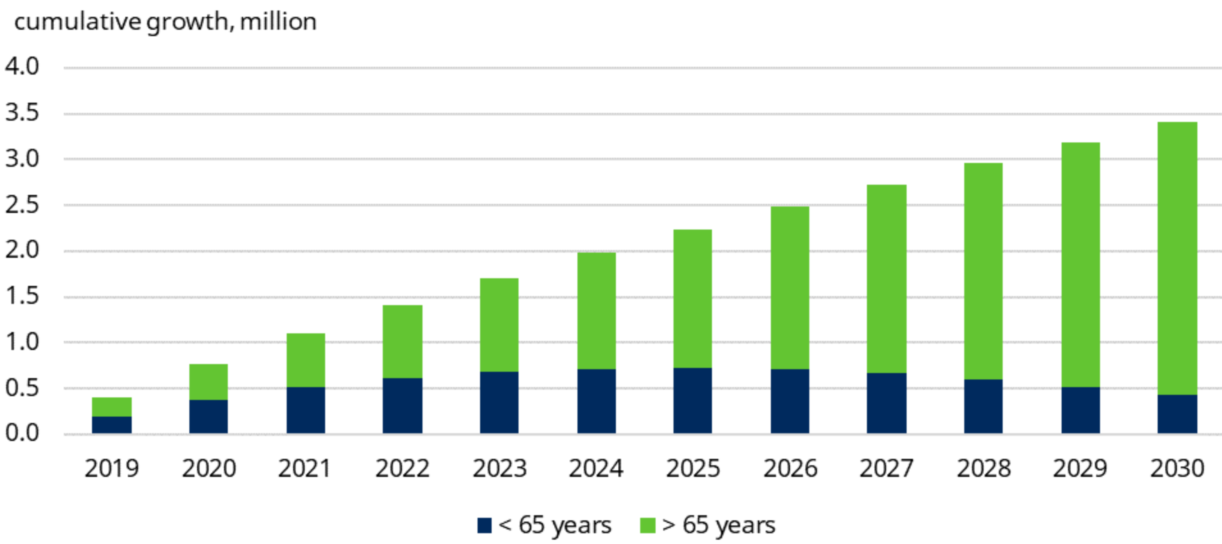


Source: Global Data, Schroders. November 2018

Demand for logistics space is also growing as retail sales migrate on line. UK consumers have been quick to embrace the internet and 19% of total retail sales are on-line, compared with 11% in the US (Source: BEA, ONS). Amazon has increased its UK logistics floorspace by 50% over the last three years as more third-party sellers use its platform and traditional retailers are also investing heavily in logistics, as they re-configure their supply chains. In general, we prefer multi-let last mile warehouse estates in city suburbs to big logistics units, because supply is more constrained. Cap rates are 5%, or higher (except around London) and the rental income is more diversified than in a logistics unit where the end of the lease creates a major binary risk.

It follows that retail real estate is struggling. While the sector is re-pricing, a cap rate of 7-8% today could quickly evaporate as leases expire and retailers fall into insolvency. The real opportunity is to convert redundant retail space into other uses, including hotels, offices and residential. That should be viable in locations where there is demand from competing uses and we see good potential to re-develop old stores in city centers and retail parks in affluent parts of southern England. It will be much more difficult to re-purpose secondary shopping centers in towns and cities with weak economies.

UK Population Growth by Age Cohort



Source: ONS, Schroders. October 2019. The opinions stated herein include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized.

Another part of the market benefiting from structural change is retirement villages. Tight planning laws means that there is a fundamental under-supply and less than 1% of people in the UK aged over 65 years live in a private retirement village, compared with 6% in the US (Source: JLL). The number of people in the UK aged over 65 years is projected to grow by 3 million, or a quarter over the next decade (Source: ONS) and they tend to be relatively wealthy, with a total net wealth of £4.7 trillion ($6.1 trillion). Residents of retirement villages are less likely to suffer from loneliness and perhaps as a result, they tend to stay fitter and healthier than other people of a similar age. We think there is potential demand for around 150,000 units in private retirement communities in the UK, three times the existing stock.

In conclusion, while Brexit has created uncertainty in the short-term, we believe that it has not halted the long-term structural forces which shape demand for real estate. While retail is struggling, we believe that offices in certain inner-city locations and regional cities, multi-let industrials, value add projects, and retirement villages have the potential to deliver attractive returns.