M&G Real Estate

As the U.K. shuts the door on the E.U., a unique window of opportunity is opening up

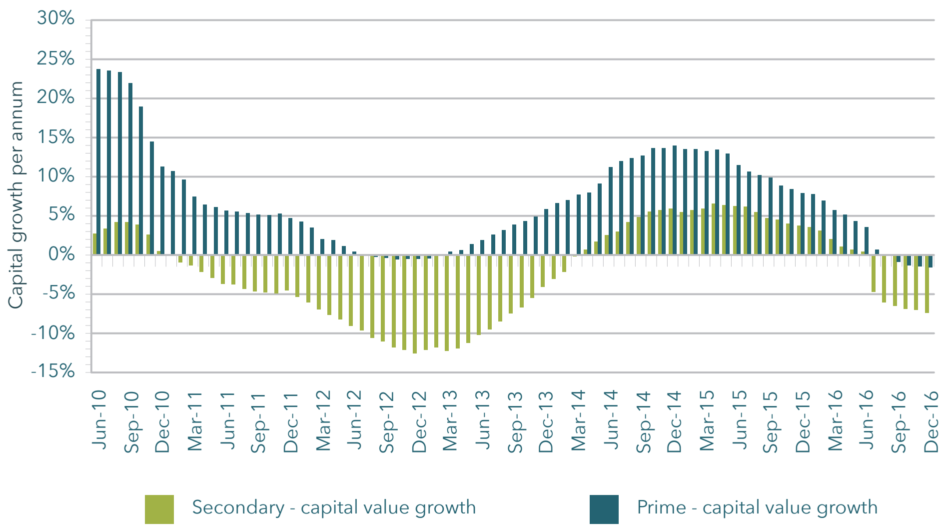
In June 2016, U.K. citizens defied the predictions of politicians and pundits alike by voting to leave the European Union. The reaction of the capital markets and of sterling was immediate, and it was volatile. The political and constitutional wrangling will play out for some time, with negotiations over the final form of the U.K.'s separation from the E.U. likely to test the markets in the short term. But for investors in U.K. real estate, this volatility is opening up an unprecedented window of opportunity, says Paul Crosbie, portfolio manager at M&G Real Estate in London.

What was the immediate impact of the referendum result on the U.K. real estate landscape?

The "Leave" victory sent the capital markets — and the currency — straight into shock mode. Sterling fell by over 10 percent against the U.S. dollar to a 31-year low immediately after the vote. Individual investors in open-end real estate funds also felt the shock, triggering a huge spike in redemptions that led most to suspend trading for several weeks. Higher levels of uncertainty have watered down institutional investors' appetite for risk and driven a flight further toward prime stock. The value of noncore real estate assets fell by 7.4 percent in the 12 months to December 2016, in part due to a lack of capital investment and in part reflecting leasing risks and challenges associated with post-referendum uncertainty.

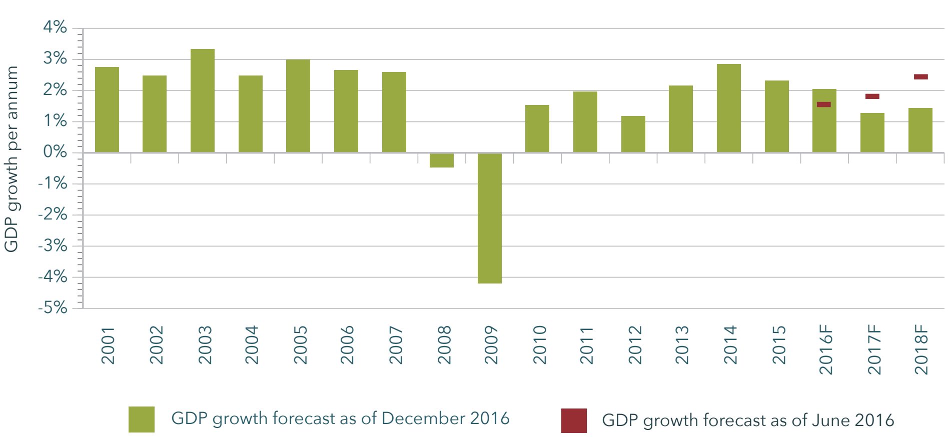
Non-core capital values experiencing greater volatility

Mispricing creates unique value-add opportunity



Sources: M&G PRT, CBRE (December 2016)

Evolution of U.K. economic outlook for 2016



Source: Experian (December 2016)

How have occupier fundamentals been affected?

Despite capital market volatility, the underlying occupier fundamentals are relatively unchanged. We're not experiencing the levels of oversupply that we saw during the global financial crisis, which is largely due to limited debt financing for new developments. This has kept the supply of high-quality, modern (or class A) space low, while demand across most sectors remains robust. The biggest risks are in Central London, where employment in financial services and related industries is under pressure and where there is 8 million square feet of supply on stream. Outside London, minimal new supply means that occupier fundamentals still look positive.

Have some sectors been hit harder than others?

Less than a year since the vote, it is too early to identify any particular stress,

Active management in action: London Square, Guildford

In uncertain times, investors tend to overvalue income security and misprice income risk. However, by taking on appropriate income risk in established locations, experienced investors can position themselves to generate outperformance. M&G Real Estate's London Square office development in Guildford demonstrated those principles in action, highlighting our ability to enhance value by repositioning assets towards core.

We acquired London Square, a 30-year-old office campus totalling 120,000 square feet at the edge of Guildford town center, for $55.1 million in December 2014. This southeast town has limited supply due to the tight planning restrictions associated with a historic center and the recent sale of several competing sites for residential development. With 60 percent of income set to expire three months post acquisition, we initiated a progressive $16.5 million refurbishment program almost immediately, including the creation of two new floors and a glazed atrium. The refurbished accommodation will command a new benchmark rent of $44.3 per square foot.

but occupiers with large-scale requirements are in some cases exercising caution, particularly in Central London. Even so, overall take-up has been resilient and more or less remained in line with its five-year average in both London and the main regional cities, while industrial take-up reached a record high in 2016, driven by retailer and online expansion. At the same time, overall vacancy rates for both office and industrial are near record lows at 6.5 percent, with class A modern supply closer to 1 percent or 2 percent.

So what does this outlook mean for investors?

Simply put, it means opportunity. With political uncertainty set to continue in the short term, we expect to see greater mispricing of risk. For experienced, active investors, this mispricing is opening up a unique opportunity to acquire good-quality, modern buildings in supply-constrained markets that offer scope for enhancement through capital expenditure or releasing. Investors with a deep understanding of the U.K. occupier markets will be best placed to take advantage of these asset-specific opportunities.

How long will this window stay open?

All the best opportunities tend to come with a finite timeframe attached, and post-referendum market dislocation is no different. We expect this mispricing — and the opportunities that come with it — to last at least as long as the Brexit negotiations themselves, until late 2018 or beyond. However, we believe that the most attractive opportunities will be clustered at the start of this timeframe — when the political uncertainty is greatest. So by investing now, investors should be well positioned to realize the enhanced value of their assets when the market upturn comes around.

With the referendum now well behind us, what's the latest outlook for the U.K. economy?

Now that the initial "noise" that followed the referendum result has subsided, the prospect of a U.K. recession has been replaced with more favorable forecasts for positive, albeit slower, growth over the next few years. The positive macro drivers that underpin the U.K. real estate market also remain in place. Online retailing continues to expand, increasing the pressure on retailers' supply chains and boosting demand for logistics space. Meanwhile, the trend toward urbanization continues, alongside a growing and aging population, while the supply of available land and buildings continues to diminish. In addition, central government continues to pursue a "pro-growth" strategy, spearheading major public infrastructure projects to open up regional centers with greater connectivity.

In a market environment like this, what does it take for investors to succeed?

An in-depth understanding of the occupier markets and, therefore, an ability to identify mispricing that others may miss. For investors with an established portfolio, the focus is on ensuring they own the best stock with the best chance of maintaining occupancy through this period of volatility.

For investors looking to the U.K. for the first time, or expanding their U.K. footprint, it's about looking beyond the current period of uncertainty and buying good-quality assets that will generate attractive income returns in the years ahead. We believe that in years to come, investors will look back at 2017 to 2019 as a period of either opportunity taken or an opportunity missed.

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