Legal update ——— August 2016

Inward investment
Brexit - implications and considerations for foreign investors interested in UK real estate

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The question posed to the UK electorate on 23 June 2016 was "*Should the United Kingdom remain a member of the European Union?*" The outcome of the referendum was that 52% of votes were in favour of exit. In light of this outcome, and with some of the dust having settled, Trowers & Hamlins LLP has re-examined the key considerations for investors, particularly those from overseas interested in the UK real estate market.

The full impact of the result of the referendum is not yet known and will in large part depend on the form that 'Brexit' will take. Predictions for the future landscape can be based on how Brexit will be modelled, the degree of separation from the EU and the difference in consequences of such routes for both the UK and the EU. Once Article 50 of the Lisbon Treaty is triggered, the UK will have two years to leave, unless such period is extended, during which time the terms of exit would be negotiated. It is possible that negotiations could continue for many years.

During this negotiation period there will most likely be a level of legal and commercial uncertainty while the precise implications are being determined. The key questions are what are the potential implications for parties interested in inward investment into UK real estate and how can foreign investors benefit from a post-Brexit Britain?

General considerations

While property law remains a national matter, Brexit is likely to have implications on the investment, regulatory and environmental frameworks which surround the UK's real estate investment market.

Historically, faith in the UK real estate market has often been down to economic confidence, as well as the market's openness and transparency. Given the UK's success in the commercial property investment market, attracting the highest level of commercial property investment in Europe in recent years, Brexit could have real impact on the property industry if the outcome affects how investors access the property market, or adversely impacts demand.

In the immediate wake of the Brexit vote, six property funds, including Aviva Investors Property Trust, Standard Life, M&G and Aberdeen Asset Management announced a temporary suspension of redemptions after a rush by investors to withdraw their cash. However, most of those funds are open-ended investment funds - there has not been a general fallout across all funds. Concerns were also being raised about the sustainability of major projects and the wider economic slowdown in the market in the initial aftermath of the vote.

Source: Fotolia

A report from the Royal Institute of Chartered Surveyors showed that 80% of their members believed that the fear of an uncertain future has stunted investment flows. Commentators have therefore suggested that this, combined with high property values in the UK, has created stifled demand for opportunistic inward investors poised to respond to a price correction. Craig Hughes, head of real estate at PwC has stated that "*uncertainty leads to volatility which equals opportunity. There is a huge amount of capital waiting*".

However, although initial reluctance may be fuelled by political uncertainty, changing markets can offer new opportunities. Together with the robust English legal system, the UK's attractiveness as an international business centre, transparency of the UK property market and its historic openness to overseas investment, should mean that the real estate market is unlikely to be affected by Brexit in the long-term. Indeed, on 13 July Aberdeen Asset Management subsequently lifted its suspension, although a dilution levy remains in place (but even that improved from 17% to 7% only last week). Legal & General also improved

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its levy on 18 July. Just over a month in, we are already seeing some stabilisation after the initial shock of the Brexit vote.

If property funds sell assets to release liquidity there may be attractive prime assets potentially available to investors that may not have been available otherwise. Property Week reported on 18 July that Aberdeen Asset Management sold an Oxford Street property for £124 million and that it has put other assets up for sale.

The report also mentioned that Henderson had put a Strand office on the market for £220 million and subsequently another office in Mayfair. There have also been suggestions that Standard Life is considering selling certain of its assets in the West End.

This suggests that, after perhaps a small dip in demand and market confidence, once the current political volatility subsides, investors from the US, Asia and the Middle East will see reasons for renewed confidence in the UK market.

Weakening of Sterling

Although investment volumes in the UK commercial property market slowed in the run up to the referendum, a number of market commentators have already suggested that the UK property market will become a more attractive arena for inward investment following the leave vote due to the dramatic fall in the value of Sterling and the favourable exchange rate.
According to analysts, the pound could fall as low as US$1.15 by the end of the year. The pound has already fallen by 8% to the Euro and 9.5% to the US dollar, a 31 year low. In addition, the Bank of England has just cut interest rates for the first time since 2009. At 0.25% the Bank of England base rate is now at a historic low. Some commentators believe that the currency savings will offset the increased cost of stamp duty and create profitable long-term investments.

Various investment managers have reported that they have already received increased enquiries from foreign investors keen to take advantage of the weaker pound in relation to sterling-linked assets, particularly commercial property. Property Week was informed that at least one Middle Eastern consortium was looking to take advantage of the falling pound. Asian investors have also shown increased interest in UK property investments, as the weak pound means they could recover as much as 20-25% on the currency exchange rate. Chinese international property portal Juwai.com is reported to have already received 30% more enquiries from investors than in May this year. The Guardian newspaper has reported that property agents have observed a shift from the big European institutions, who were major buyers of London real estate pre-Brexit, to private investors and corporates intending to benefit from currency changes.

Although some investors may be adopting a 'wait and see' approach until the exact terms of Brexit are negotiated, opportunistic investors appear to be already taking advantage of Brexit's immediate consequences.

Sector Specific Considerations

Of course, if investors or funds wish to purchase property for capital growth and income, the continued demand for property in specific sectors will be a consideration if they intend to work their assets once purchased. Tenants' demand for renting is therefore crucial.

Offices

Studies have suggested that the London office market is likely to be affected due to the fact that both domestic and international companies may reconsider their costs and requirements as tenants. Large banks and financial institutions have already indicated that they may relocate some staff to other EU jurisdictions. Ongoing access to the EU free trade area is likely to be integral to how attractive the UK remains as a business location post-Brexit. Indeed, Bloomberg has recently reported that in a worst case scenario London office prices could fall by up to 20% within three years. International firms benefiting from the 'passport system' that allows firms to use the UK as a gateway to the EU's single market has contributed to the UK, and London in particular, becoming the centre of the EU's financial services industry. If the UK loses access to the EU internal market or is considered to be too isolated from the EU post-Brexit, the relocation of London's international banks and financial institutions may become a reality.

Source: Fotolia

Nonetheless, on 18 July Property Week, the Financial Times and Reuters all reported that Wells Fargo has acquired a freehold office for circa £300m which reportedly represents one of the largest owner-occupier deals to be concluded in the City of London market in the current cycle. In addition, the Guardian newspaper has reported that private Middle Eastern investors have exchanged on a deal for 5 King William Street in the City of London, an office block leased to a Japanese investment bank, for approximately £90 million. Reports also suggest that another City office, 160 Aldersgate Street, is under offer to an overseas private investor from around £175 million and that a Singapore property developer has made an offer to buy an office block at 63 Queen Victoria Street for more than £30 million.

Hotels & Leisure

Initial indications are that the hotel and leisure industry may weather the storm better than other real estate sectors. The CEO of InterContinental Hotels Group has expressed his confidence that the drop in Sterling should result in a boom in overseas and domestic tourism as many Britons will choose to holiday at home, while overseas tourists are likely to take advantage of the advantageous exchange rate, providing a boost to the UK's hospitality industry. For instance, Best Western GB, the independent hotel group, reported that bookings from the UK and China increased dramatically the week after the Brexit vote. This view has been supported by research from travel wholesaler Tourico Holiday, which has anticipated a significant boost in bookings following the Brexit vote, with predictions that hotel room nights stayed in the UK will increase by 30% year-on-year in the second half of this year. However, other market research has suggested that Brexit could result in a reduction in the amount of EU residents visiting the UK, following fears that holidaying in post-Brexit Britain could be more expensive, and there are concerns that the industry could be affected if entering the UK from EU countries becomes more difficult, both for tourists and for EU workers in the hospitality industry.

The Guardian newspaper has reported that a consortium of Saudi and UK investors have made a bid for London's Grosvenor House hotel, with the group reportedly accelerating their offer to enable the Saudi partners to take advantage of the drop in sterling. In addition, a Hong Kong-listed real estate company bought a Travelodge in King's Cross from Henderson Global Investors for £70 million on June 29. The chairman of the purchaser said the uncertainty surrounding the vote had "*provided the company with an ideal opportunity to get in to the high-demand hotel sector in London, and the falling currency has made the deal more attractive*".

Investment in the hotel industry could therefore be a draw for inward investors. However, Brexit may negatively impact consumer confidence, meaning that the immediate prospects of restaurants and shopping centres could be less certain.

Student Accommodation

Student accommodation has in recent years been in strong demand. It is likely that demand in this sector will remain robust following the Brexit result, in a similar way to hotels.

Source: Fotolia

There is continued demand for student housing that provides premium facilities, which is attractive for foreign investors in relation to both property value and rental yield. Commentators also suggest that the fall in Sterling could result in an increase in demand from international students wishing to study in the UK, thus increasing demand for student housing.

Industrial Estates

Prime industrial real estate is expected to retain its value as demand for property let on long leases to strong retail tenants continues. Certain industrial and logistics assets such as units occupied by Amazon in Manchester and by DHL in the Midlands look likely to achieve yields of nearly 5%, the target expected before the Brexit vote. Amazon's Manchester warehouse came to market after the referendum with a guide price of £18.7m and a yield of 5.25% and is close to being sold for just under £20m. This sector therefore shows signs of buoyancy despite current uncertainty in the market.

Residential Property

Savills' briefing paper on the impact of Brexit on the prime housing market published in mid-July indicated that the diverse nature of the prime housing market could mean that the effects of Brexit will be uneven and vary by each submarket. Early indications suggest that some sellers have adjusted their price expectations and added caution is expected to follow the Brexit vote. However, the demand for housing, particularly in London, has not disappeared. According to estate agents Douglas & Gordon, residential instructions in London trebled the week after the result to leave. They reported interest from US$ buyers from Nigeria, USA, UAE, Russia and China due to the fact that, at the current exceptionally low exchange rate, London's prime areas are approximately 25% cheaper than they were 2 years ago.

Source: Fotolia

Guy Gittins of international property specialists Cherstertons said he spent the Friday morning following the referendum speaking to the head of a Middle Eastern bank who wanted a list of properties available for sale for clients. Countrywide estate agency stated that "*in the past month a £1m house has become about £100,000 cheaper for those buying in Roubles, Yuan, Euros, Yen or Dollars*".

These favourable conditions for inward investors may not last forever and some commentators suggest that it is currently one of the best times to buy a house in the last 6 years. London's housing bubble may be showing signs of bursting.

Conclusion

Although uncertainty will be a common theme until the terms of the UK's exit from the EU are negotiated and established, fear has subsided somewhat following the initial shock of the leave vote and opportunistic foreign investors could seek to take advantage of this uncertainty with a view to long term growth by investing while Sterling is potentially at its weakest point.
In the last cycle inward investment in London commercial property contributed towards the kickstart in the property market. Mark Cleverly, Arcadis' head of commercial development has commented that prices have been wavering for a while due to the changes in stamp duty and there is now a buying opportunity;

> "*More buyers means a more buoyant market, which can only be good news for the industry*".

Aside from the benefit of the weakened pound, the fundamental strength of the English legal system and the transparency of the UK property market remains. In particular, areas such as student accommodation, hotels and industrial units, may prove to be particularly resilient and may attract increased interest from foreign investors.

Foreign investors interested in UK real estate need to be considering the impacts of Brexit on their business and their options. Trowers & Hamlins can help you to prepare by considering the implications of Brexit for you.

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