THE PRESIMA globetrotter

Brexit: lessons and opportunities in REITs

BIG BEN, LONDON
source: pixabay.com

FLAGS, LONDON
source: pixabay.com

The "Brexit" vote surprised a lot of people. We will admit – we were surprised too.

Now, months after the June 23 vote to "leave," the process of withdrawal from the European Union continues to surprise a lot of people. In early October, new U.K. Prime Minister Theresa May said she will begin the formal Brexit process in the first quarter of 2017. She also hinted at the prospect of a so-called "hard Brexit," with limited access to the European Union.[1] Then, in November, the U.K. High Court ruled that Parliament must vote on whether the U.K. can start the process of leaving the E.U.[2] Clearly, this story has many more chapters.

In this paper we examine the lingering effects of the Brexit vote on listed REITs to find lessons and opportunities.

PRESIMA

Q4.2016

AUTHORS
Chris Blanchard, CFA
Peter Zabierek, CFA

CONTACT
Robin Marcoux
rmarcoux@presima.com
514-673-1303

Our 3 key takeaways are

1

"Sell first, ask questions later" can be a buying opportunity

2

Open-ended funds debacle highlights market inefficiencies

3

Not all property sectors are created equal (or, office and student housing are still cheap!)

1 The Guardian, October 2, 2016, *Theresa May to trigger article 50, by end of March 2017* by Jessica Elgot.
2 The BBC,November 3,2016, *Brexit court defeat for UK government.*

CURRENT U.K. PRIME MINISTER THERESA MAY AND FORMER U.K. PRIME MINISTER DAVID CAMERON
source: wiki/File:David_Cameron 27s_visit2.jpg

A commercial property slump, pre- and post-vote

In spite of all of the "uncertainty" in the commercial real estate (CRE) market caused by the June 23 referendum, some smoke has cleared. Analysts and investors have begun to sort through the referendum rubble to assess the remaining risks and opportunities and to attribute the causes of market moves to Brexit -- or something else.

One of the key findings during this period of contemplation has been that property was already topping off before Brexit. As the referendum date approached, investment into U.K. commercial property slumped to its lowest level in two years and prices for British real estate began to fall. According to the Financial Times, investors bought £9.8 billion of property during the second quarter of 2016, 18% lower than the previous quarter and 45% down on the same quarter a year earlier. At the same time, prices showed some evidence of decline: yields, which move inversely with prices, increased by 15 basis points, their first rise in two years, according to figures from Lambert Smith Hampton, a commercial real estate agency.[3] In sum, the market cycle looked as if it was in the late innings before the vote, and the outcome did nothing to turn the tide. Since the vote, average commercial property values have fallen by a total of 3.6% — 2.8% in July, 0.65% in August, and 0.21% in September, according to the IPD (Investment Property Databank) real estate index compiled by MSCI.

Time for predictions – or maybe not...

Most pontificators have hedged their bets with respect to the full effects of Brexit on the CRE market. For example, Philip Charls, CEO of the European Public Real Estate Association (EPRA) waxed "we should brace ourselves for a long period of volatility and uncertainty." "Risk aversion has reasserted itself and is likely to prevail in the short term," added Joe Valente, head of research and strategy for European real estate at J.P. Morgan Asset Management.[4] These murky musings are not uncommon.

3 The Financial Times Ltd., July 20, 2016, *UK commercial property investment slumped around Brexit vote*, by Judith Evans.
4 NAREIT®, September 29, 2016, *Brexit and the Aftermath for Property Markets*, by Sarah Borchersen-Keto.

But a few intrepid investors have offered more concrete predictions. For instance, LaSalle Investment Management, a real estate asset manager that handles $59 billion of assets, said it expected the downturn in U.K. commercial real estate to be tangible but relatively contained. "The correction in real estate pricing is expected to be largely restricted to the next 18 months,"[5] with yields increasing by 40 to 50 basis points by the end of 2017, the company predicted. Separately, Green Street Advisors in London says the firm has marked down London office values by 10 percent.[6]

As listed investors, we are often looking for clues in the direct real estate market for valuation evidence. Conversely, the direct real estate market often looks to the listed market as a harbinger of things to come. ■

WESTMINSTER PALACE, LONDON
source: pixabay.com

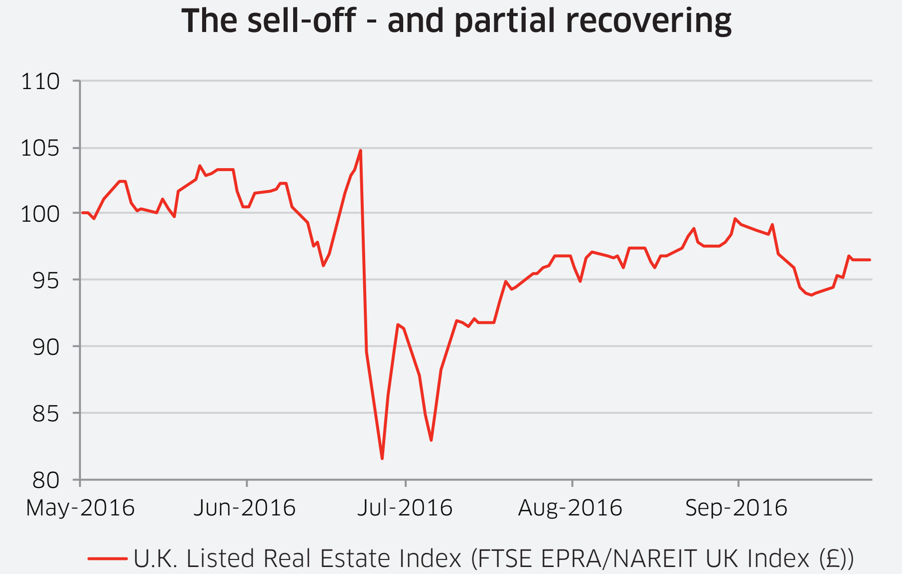
Takeaway 1

"Sell first, ask questions later" can be a buying opportunity

June 23 was a sleepless night for many investors, especially those who did not contemplate the "leave" vote. The U.K. broad equity index plunged 9% at the opening bell, as traders unloaded everything British. Worse-performing was the U.K. currency, which fell 11% against the U.S. dollar, magnifying the losses for foreign investors. This was the largest one-day loss in the history of the British currency and a 30-year low versus the US dollar. But by the end of the day, the broad index would end up down only 3%, a fraction of the initial drop.[7] Almost unbelievably, within three trading days, the U.K. equity index had recovered all of its losses and went on to touch new all-time highs over the next month.

5 LaSalle Investment Management: http://www.lasalle.com/company/news/lasalle-launches-its-2016-mid-year-isa-investors-should-seek-balance-in-mat
6 Op. cit, note 4.
7 Reuters, June 26, 2016, *Post-Brexit global equity loss of over $2 trillion worst ever: S&P*, by Edward Krudy.

Figure 1



Source: Bloomberg L.P.; Presima Inc.

The drop and then recovery in the broad index is understandable, as the largest constituents are multinationals with only a fraction of their business in the U.K. The future earnings of HSBC, British American Tobacco, British Petroleum, and Royal Dutch Shell all have limited correlation to the U.K. economy. In contrast, real estate is a local business, and happens to be one of the best-performing sectors in the U.K. over the last five years. Since the end of 2011, real estate had out-performed the broad index by 52% (as of the end of September 2016). The combination of being "local" and having outperformed proved a double whammy for property stocks. The U.K. listed real estate index fell more than double the broad index on the morning of June 24, touching an intraday low down 23% from the close the night before. Investors were making a quick exit before any decision was going to be made on whether multinationals and financial groups would have to pack their bags for Frankfurt or Paris.

The market fell for two trading days before finding a bottom. Trading volumes of the largest U.K. REITs was six times the normal average during those two days. In the following weeks, it would become clear that there were forced sellers who needed liquidity, no matter what the price. Some opportunistic traders stepped in to buy and sell for a quick profit, while other investors saw an opportunity to take a long-term position at an attractive valuation.

The bottom line is that the listed markets have a tendency to over-react to significant news events, good or bad. Longer term investors can make money by taking advantage of others' liquidity problems. ■

Figure 1 highlights the magnitude of the sell-off following the referendum.

THE "SHARD" BUILDING, LONDON

source: pixabay.com

THE CITY OF LONDON AS SEEN FROM ABOVE ST.PAUL'S CATHEDRAL
source: unsplash.com

LONDON EYE, LONDON
source: pixabay.com

Takeaway 2

Open-ended funds debacle highlights market inefficiencies

While listed property stocks traded freely in the days following the vote, all of the large so-called "open-end" direct real estate funds closed their doors to redemptions in the days and weeks that followed. Open-end direct real estate funds have become popular as they held the promise of offering investors exactly what they wanted: real estate returns, low volatility, and *liquidity* when needed. The key shortcoming of these funds, however, is that it is almost impossible to manage the inevitable liquidity mismatch that arises with a market hiccup like the Brexit vote.

The managers of seven funds totaling about £18 billion of assets suspended trading the week after the Brexit vote.[8] These funds halted withdrawals because they said that they did not have enough cash to immediately repay investors. Aberdeen Asset Management, for instance, originally said that it had no plans to suspend trading in its funds and that its property fund holds about 20 percent in cash. Later it said it will make a "dilution adjustment" to the Aberdeen U.K. Property Fund that will lead to a 17 percent decline in the fund's dealing price. Aberdeen also suspended redemptions so that investors who asked for their money back have time to "reconsider their orders." On July 21, 15 days after the firm's initial announcement, the discount was reduced to 10% and shortly thereafter liquidity levels were restored. On August 1, the Aberdeen fund reduced the discount level to only 5% as more evidence began to show that the market was functioning and pricing for assets was not going to happen at fire-sale prices.[9] While all of this came as welcome news to the market, the way it played out casts a permanent shadow on this fund structure, in our view. ■

Open-end funds structure and potential short comings (liquidity mismatch)[10]

- July 4: Standard Life U.K. Real Estate Fund £2.9 billion ($3.9 US billion) was the first to suspend dealing.
- July 5 to 7: Four other funds suspend dealing, and two funds (Legal & General Investment Management and Aberdeen Asset Management) imposed a "fair value adjustments" ranging between -15% and -17% for investors looking to redeem.
- July 21: Aberdeen Asset Management was the first fund to reduce the fair value adjustment , bringing it down from -17% to -7%.
- August: Funds reduced discounts as redemptions decreased and liquidity started to return.
- September: Clarity on the imminent removal of suspensions.

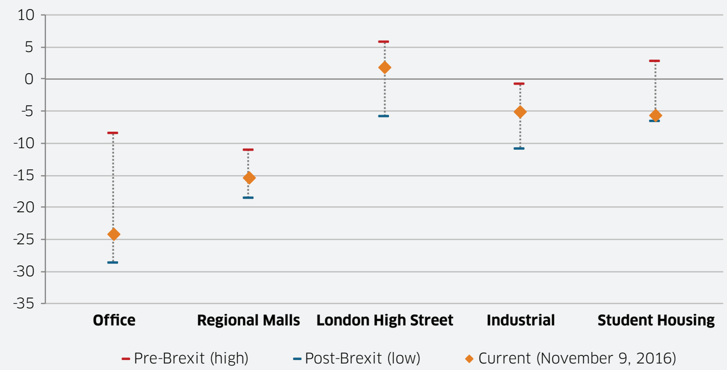
8 Reuters, June 27, 2016, *Number of UK property funds suspended since Brexit vote doubles,* by Simon Jessop, Carolyn Cohn and David Milliken.
9 Citywire.co.uk., August 12, 2016, *Aberdeen cuts property fund exit fee to 5%,* by James Phillipps.
10 Bloomberg L.P., September 12, 2016, *Brexit Property-Fund Turmoil Eases as 'Animal Spirits' Settle,* by Sarah Jones.

Takeaway 3

Not all property sectors are created equal (or, office and student housing are still cheap!)

Figure 2

Implied Asset Value (%)



Source: Bloomberg L.P.; Presima Inc; Company data.
Office (Land Securities Group, British Land, Great Portland Estates, Derwent London, Workspace), Regional Malls (Hammerson, intu Properties plc), London High Street (Shaftesbury PLC), Industrial (Segro, Tritax Big Box), Student Housing (The UNITE Group Plc).

As the dust settled, we believe there were clear winners and losers in the U.K. listed real estate market.

Figure 2 highlights the range of implied asset values based on stock prices for three points in time: **Pre-Brexit** (June 23), **Post-Brexit** (June 27) and **Current** (as of November 9, 2016) versus the latest audited assets valuations. Office and student housing stocks seem to remain cheap in the listed market.

Office property

Given Brexit's anticipated negative impact on U.K. office jobs, particularly on European banking functions performed from London, U.K. listed office stocks were the most negatively impacted by the vote to leave. Implied office property asset values fell an average of 29% in the two trading days following the Brexit vote (see Figure 2). We believe the main reason for the drop is the uncertainty as to whether financial firms would be able to continue European banking functions from the city. Financial firms, which account for a large share of office space in central London (31%), are still sorting out future plans in the city.[11] Although the details of future Brexit negotiations are still unclear, the office sector was one of the easiest ways for investors to reduce exposure to these risks.

A few facts about the U.K. financial services industry[12]

- Provides two million jobs in the U.K., of which a third are London-based;
- The U.K.'s largest tax paying sector;
- The U.K.'s biggest exporting industry;
- One of the largest Brexit-related risk is the potential loss of passporting rights for U.K.-based firms looking to sell to the European Union;
- Brexit may also restrict the free movement of banking professionals.

11 Deloitte Real Estate, *The London Business Footprint, The evolving financial sector,* 2015.
12 Grant Thornton, *The impact of 'Brexit' on the financial service sector,* April 2016.

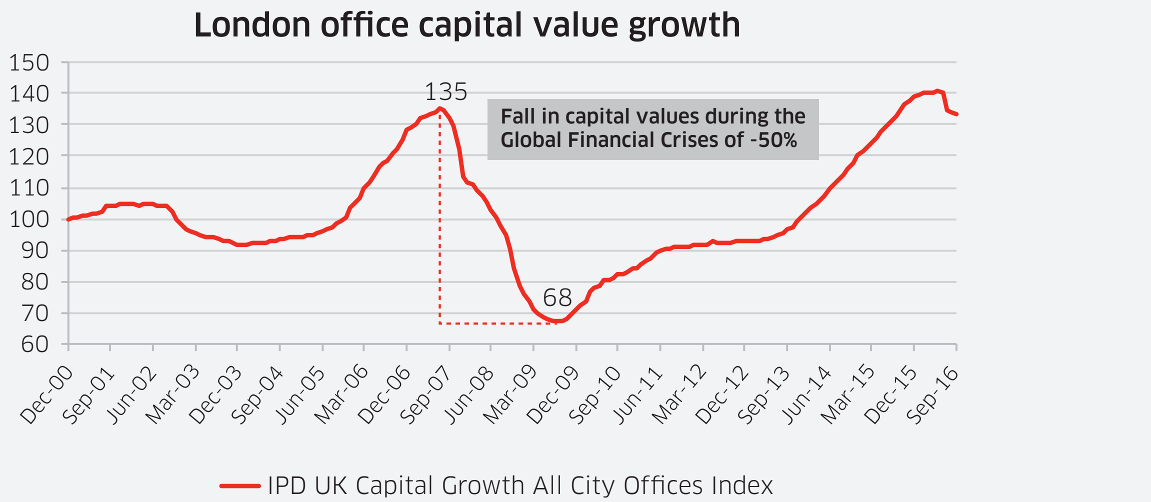
In addition to the financial sector, London has more recently become a top destination for the world's biggest Telecom, Media and Technology (TMT) companies. In the last year, Amazon, Google, Facebook and, most recently, Apple, have all signed significant leases in London to capitalize on the city's deep talent pool. Here as well, investors worry about possible immigration clampdowns and restrictions on the free movement of workers which might make it harder for cutting edge companies to attract talent. In a bid to attract the brightest technology stars of tomorrow, will Brexit tarnish the attractiveness of the city?

Pre-vote, investors appeared to already anticipate a small fall in commercial real estate values following several years of rising rents and construction volumes. On June 22, listed office property stock prices implied an 8% discount to their asset value, the most recent direct market valuation. Within two days post-referendum, however, stock prices implied a 29% discount (see Figure 2). Putting this into a historical perspective, London office capital values fell 50% during the global financial crisis (see Figure 3).

CANARY WHARF, LONDON

source: pixabay.com

Figure 3



Source: Bloomberg L.P.; Presima Inc.

Figure 3 highlights the capital value growth in the London office sector.

As of November 9, 2016, companies exposed to the office sector have recovered but still imply a discount of 24% on average (see Figure 2). This appears to be too large a discount given some of the recently completed deals in the private market. Since the vote, both leasing and investment transactions have been completed at or very close to where they had been priced before the vote. Private equity funds have been disappointed with the lack of distressed deals. Volumes are lower as there are few, if any, forced sellers. As a result, pricing levels generally have held up in the private market, particularly for smaller assets.[13]

Retail property

There are two distinct subsectors within the U.K. retail real estate market: regional malls and London "high street." In the trading days following the vote, regional mall stocks were the second-most impacted sector behind office companies. Discounts expanded to 19% below last asset valuations. Since the vote, mall owners' shares have recovered to imply a 15% discount to asset value. The market has seen several transactions pre- and post-vote at around the 5% to 10% discount level which would indicate the stock prices are fairly pricing the asset class (see Figure 2). The sell-off in this sector seems more justified, however, as the sector faces continued headwinds from e-commerce and U.K. consumers who may likely be impacted by higher goods prices due to the devaluation of the currency.

The story is not negative for all retailers, however, as high street London retail continues to boom. Post-vote, international tourists have taken advantage of the weaker British pound. Spending by foreigners on big-ticket items surged over 36% in August compared to a year ago, largely because luxury goods (in U.S. dollar terms) are now cheaper in London to France, the U.S. or China.[14] The stock market has been quite efficient in pricing in the positive trend with implied assets bouncing quickly back to a premium over last reported valuations for these retailers. We see that demand for high street retail assets continues to be strong.

13 Reuters, October 17, 2016, *Booming property auctions lift Brexit gloom in British real estate*, by Carolyn Cohn and Sinead Cruise.
14 The Wall Street Journal, October 10, 2016, *Cheap Luxury Goods in the U.K. Lure Shoppers*, by Saabira Chaudhuri and Simon Zekaria.

Industrial property

The industrial sector has been strong all year with high demand for large warehouses from retailers looking to better capture a growing amount of e-commerce sales. The referendum had little impact on the sector as any negative political outcomes are outweighed by the current shortage of modern logistic facilities serving the broader U.K. consumer. Post-vote there was a small dip in implied pricing levels to an 11% discount to their asset value but this has more recently bounced back to a discount of only 5% (see Figure 2). In the wake of the Brexit, there were a handful of industrial assets sold in the private market with little to no discount and as such, current stock prices seem to broadly reflect market conditions.

Student housing

It had been a relatively quiet year for student housing investment in 2016 until GIC, Singapore's sovereign wealth fund, announced at the end of September that it will buy a student housing portfolio in the U.K. from Oaktree Capital Management. This £700 million transaction demonstrated the continued interest in the asset class.[15] Most of the buyers of student housing assets over the last year have been foreign pension funds and sovereign wealth funds with generally long dated investment horizons. The Brexit vote was not a reason for these investors to liquidate assets and as such pricing has remained stable. Also worth noting is that at the end of September, two transactions were concluded at prices in line with book values (pre-vote). Similar to the high street retail assets, it is possible that student housing benefits from Brexit as the lower currency makes it more affordable for foreign students to attend some of the world's top-ranked universities. If demand for universities rises, so too should demand for purpose built student accommodations. Within the real estate securities universe there are only two companies offering access to this asset class and the stocks' implied pricing had held up well until a recent report[16] highlighted possible risks associated with rising supply and potential stricter visa rules for foreign students. Implied asset values appear now to offer an attractive values compared to recent market valuations in the sector. ■

THE TOWER BRIDGE, LONDON
source: pexels.com

15 Telegraph Media Group Limited, September 29, 2016, *Singaporean sovereign wealth fund snaps up £700m of UK student digs*, by Rhiannon Bury.

16 Morgan Stanley Research, October 28, 2016, *Unite Group: Deep Dive on Supply-Demand Dynamics.*

Conclusion

The Brexit referendum was one of the most widely-publicized and emotional in recent memory. In one of the more hyperbolic statements of the campaign a week before the vote, British journalist and author Matt Ridley wrote the following in a Wall Street Journal op-ed: "In voting Thursday on whether to leave the European Union, the British people face perhaps the most momentous decision since Henry VIII broke from the Roman Catholic Church in the 16th century so he could marry as he pleased."[17] There was no shortage of drama.

Equity and property markets, for their part, have reacted to Brexit not only with fear, but also with greed. There have already been clear winners and losers. On the winners' side, we have property markets like Sweden, where the listed real estate stocks are up 12% in U.S. dollar year-on-year, French property stocks, and high street U.K. retail property stocks. Investors seem to be pricing in the resilience of central London and the knock-on effects if property investors look beyond the British Isles. On the losers' side, we have much of southern Europe, including Italy, where the banking system has been dealt another blow with the Brexit vote. Other losers include the "open-end" property fund industry, which earned a thumbs-down after failing to deliver on its liquidity promise to investors.

The Brexit experience provides valuable lessons for investors for "next time." Lessons include: look to create "all-weather" portfolios, don't always trust polls, and be prepared to buy if the market over-reacts to bad news. But the value is not limited to the distant future. We believe that "Brexit" opportunities still exist today. In an environment of low growth and low rates, we see investors continuing to favor property's stability and yield. We also believe that property stocks that are trading at significant discounts to their net asset value, particularly in the office and student housing sectors, can be fruitful investments for those who are taking a longer-term view. ■

17 The Wall Street Journal, June 21, 2016, *The Business Case for Brexit,* by Matt Ridely.