Property Market No Longer As Safe As Houses

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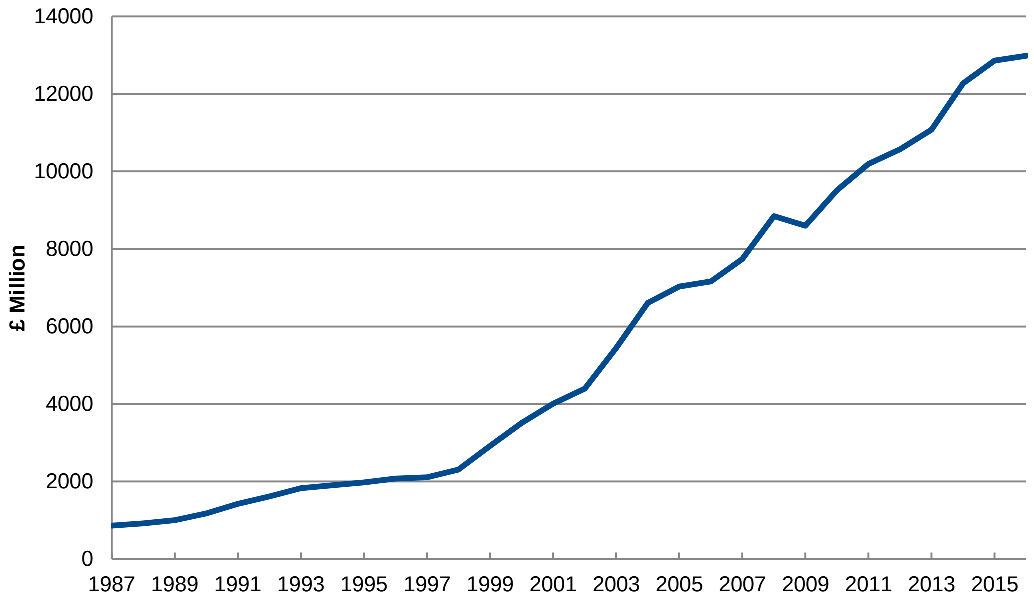
The UK real estate market has for some time been a major concern for successive governments, with strong property price growth at times seen as both an opportunity and socially undesirable by certain demographics. With the unexpected outcome of the Brexit vote in late June, the bubble in the property market may be close to bursting.

Commercial Property Demand

In recent years, demand for UK property has largely been driven by foreign investors attracted to the high yields and safety of UK real estate. Buyers from Singapore, China and EU countries account a significant proportion of London commercial property owners, with foreign shareholders responsible for 45% of all commercial property transactions since 2009 (BoE) and a similarly large percentage of UK property fund ownership, 45% in the Standard Life fund alone. Prior to the referendum, these inflows fell 50% in Q1 2016 over fears of a bursting property bubble, the threat of leaving the EU, and destabilisation in the domestic economy reducing the attractiveness of UK investments (BoE).

Total UK Property FDI Inflows: *FDI inflows into UK property have increased at steady rate after a momentary pause during the economic downturn in 2008-09.*



Source: Office For National Statistics

The UK's vote to leave the EU has significantly cut demand for UK commercial property, with London in particular expected to see demand shortfalls. Bearish sentiment and general uncertainty regarding the UK economy is expected to reduce and delay foreign investment, with a 'wait and see' policy commonly adopted among Chinese investors according to the National Development and Reform Commission. LSE research indicates a 20% fall in foreign investment can be expected in the long term as a direct consequence of the referendum outcome. The cancellation of Great Eagle Holdings' $330m London project is an early indicator of such a shift in sentiment.

The question of the benefits of a depreciated pound, down roughly 12% as of August 4th against the USD from a $1.49 referendum high, remains difficult to quantify. Announced investments by AMC Entertainment in London Odeon & UCI Cinemas (£921m), Wells Fargo's office headquarters (£300m) and Madison International's investment plans in London properties (£1bn) suggests depreciation may be a source of some demand resilience. However, with widespread forecasts of a worsening UK economic climate, the prevalence of this effect may be eroded in the coming months.

Pound Sterling: *Brexit has sent the pound to a multi-decade lows against the dollar, posting substantial losses immediately after the vote. Further depreciation or recovery remains uncertain.*

Source: Bloomberg

Property Demand Relies on Credit Access

Investment, both from overseas and domestically, may suffer from weaker access to finance following June's vote. The Singaporean lender UOB has suspended its London property loan programme over fears regarding exposure to commercial property prices while the Development Bank of Singapore has advised caution for those investing in the UK.

UK based banks Lloyds and RBS face similar issues over commercial property exposure of £18bn and £25bn respectively (JPMorgan). Loan to value (LTV) concerns have been reduced following 2008, with an average LTV of 46% and 66% on Lloyds and RBS portfolios. However, credit is likely to remain restricted given bearish market sentiment compounded by the risk of a UK property fund fire sale.

Challenger banks are especially vulnerable, with a lower total exposure of £17bn but a greater burden in LTV ratios. Research by JPMorgan indicates roughly 31% of challenger bank loans are over 70% LTV. Additionally, such loans are often of a higher risk, usually secured on subprime property. Exposure concerns in such banks, Metro, Aldermore and OneSavings, will likely manifest in poorer credit. BoE reports verify falling credit availability in the commercial real estate sector, with a fall of 11.5% Q/Q in Q2, and a further forecasted drop of 10.7% in Q3.

Macroeconomic Uncertainty Limits Demand

Brexit led demand shortfalls will likely be most apparent in London offices. The finance and banking sector stands to be the worst hit by the potential loss of single market access to the EU, with estimates of up to 80,000 finance jobs leaving London in the wake of Brexit (BCG).

HSBC, JPMorgan and Morgan Stanley are among the banks looking to relocate some roles. This is a major factor in weak sentiment regarding London commercial property demand. Fundamentally, the long term UK-EU relationship remains unclear, with uncertainty hindering investment.

Outlook for retail properties has suffered similarly under recession expectations and changing market conditions. Store costs have increased under a 50p hike in minimum wage in April, and multi-channel sales penetration has seen significant growth in recent years. The number of stores required to cover the UK market has fallen accordingly. Recent estimates suggest that just 80-100 stores are sufficient (FT).

Industrial property demand may receive some stimulus as a more competitive pound props up UK exports. Exporters stand to benefit from the pound decline against the Euro, a near 11% drop from a referendum high as of August 4th. However, with uncertainty regarding future single market access, along with an expected rally in USD priced inputs, largely driven by Chinese stimulus efforts, this effect may be dampened. Dependence on exports to the EEA, around 43.6% of 2015 export value (UK ONS), underpins these bearish expectations for industrial property.

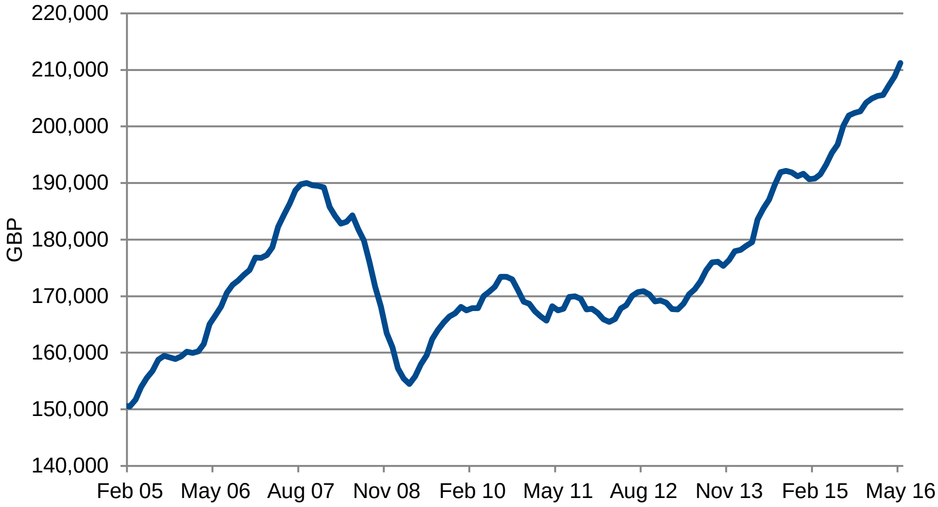
Demand Outlook

Outlook remains negative for the coming months, with Brexit aftershocks and lingering uncertainty discouraging investment. The fall of the Markit PMI index to a 7 year low of 47.7 in July provides a basis for these recessionary expectations. A slight rally may occur upon EU-UK trade assurances, but the demand outlook is expected to remain low until such fears are dispelled.

Residential Property Demand

Prior to Brexit, price hikes in residential high end property were largely underpinned by speculative foreign investment. Demand consistently outstripped supply, with the average UK house price rising year-on-year to £211,230 (Land Registry) in May 2016. Fears over a property bubble cooled price growth in the months to June, with the Halifax House Price Index finding growth in April, May and June at -0.8%, 0.9% and 1.3% MoM, down from the 2.2% peak growth in March.

UK Average House Prices: *After experiencing significant growth in recent years, fears of a growing property bubble are beginning to materialise.*



Source: Bloomberg

Brexit Creates a Bargain for Foreigners and Uncertainty Domestically

The question of post-referendum housing demand remains difficult to answer with any certainty. IHS Global Insight suggests a decline on the basis of falling consumer confidence and yield expectations, supported by slowing price growth in the build up to the June referendum. Predictions of London-based demand hikes under a new wave of foreign speculation contests this, with Stirling Ackroyd noting the weaker pound provides a £42,000 discount on the average London house price for European buyers.

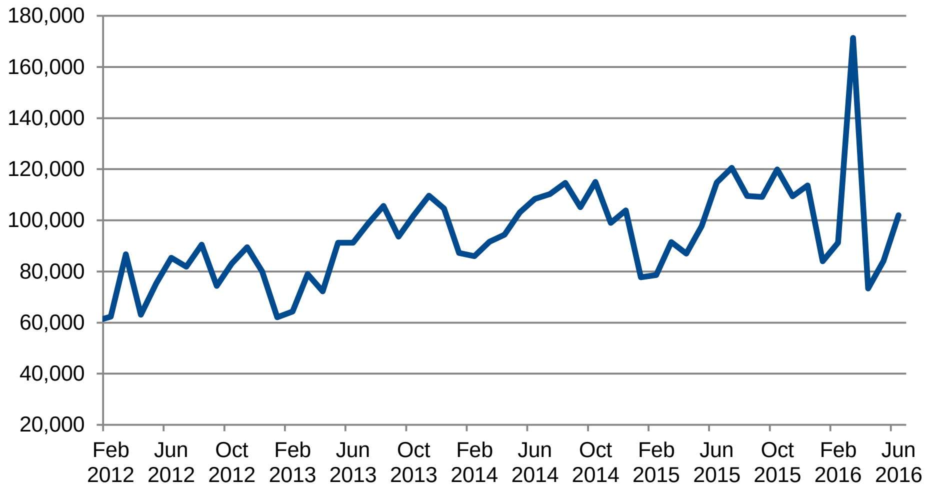
Initial statistics suggest there is some merit to predictions of a short term ‘Brexit boom’, with Knight Frank reporting a 29% rise in monthly sales following the June plebiscite, principally to Russian, Asian and EU customers. However, this rise in interest is likely limited to London luxury properties, which have traditionally been sought after by foreign investors.

In comparison to renewed foreign interest in London, reports of domestic customers, particularly EU nationals, pulling out of contracts over uncertainty and citizenship concerns suggest a more negative impact on domestic demand. LonRes has reported a 163% rise in the number of cuts to London property asking prices in the 12 days post-referendum compared to 12 days prior, and notes property completions fell 18% despite this. However, this demand shortfall seems concentrated in London, with Rightmove reporting a fall in UK average asking prices of only 0.9% in July. This is comparable to the 0.4% fall expected in summer as sellers price more conservatively.

Stamp Tax Squeezes Demand

The onerous stamp duty tax acts to dampen house demand for the higher priced residences, and rose 3% in April for Buy-To-Let and second homes according to HMRC data. This was also reflected in April sales and price figures, with property transactions reaching a high of 170,000 in March before retreating to 75,000 in April. Price growth mirrored these movements, at 2.2% in March and -0.8 in April. The tax hike is expected to further place further downward pressure on demand and transaction volumes.

UK Residential Property Transactions: *Transactions spiked in March as investors attempted to avoid a stamp duty tax hike before falling to a fresh year-to-date low ahead of the referendum.*



Source: Bloomberg

Mortgages provide some Demand Support

The mortgage sector functions as a barometer for interest in residential property, and delivered a strong performance at the start of the year, peaking at 73,200 approvals for house purchases in January (BOE). This was driven by a planned stamp duty hike in April investors attempted to avoid. Looking forward, demand in the mortgage sector stands to benefit from a historically low base rate of 0.25%, after the Bank of England moved to cut rates to a fresh record low, with banks and building societies offering rates as low as 2.39% (Coventry Building Society) for 10 years fixed.

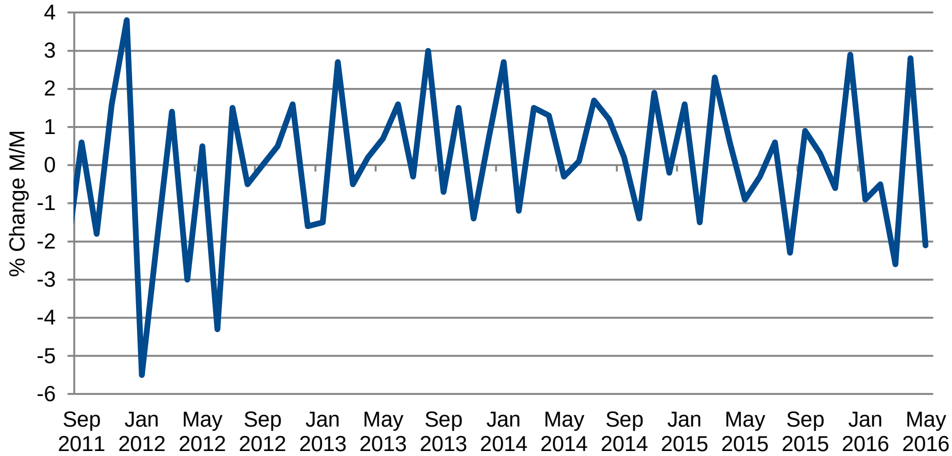
Demand Outlook

With a time lag in official statistics and ongoing political and economic events, the outlook for residences is subject to high uncertainty. However, foreign speculation remains largely London based and may only provide a short term boost, with forecasted lower economic growth and uncertainty set to dominate. Mildly bearish demand is expected across the UK, with expectations of more significant falls in London underpinned by a 163% rise in asking price cuts according to LonRes data.

Residential & Commercial Supply

The underlying support for real estate prices in recent years has been ongoing lacklustre performance in housebuilding and construction. Building registration figures consistently fell below government targets. The National House Building Council, which monitors 80% of the market, has reported 156,140 new homes registered in 2015. This puts the estimated 2015 total figure at roughly 195,000, approaching but still short of the government goal of 200,000 and the 250,000 figure needed to balance the market. The construction sector reflects this decline, with the Markit/CIPS construction purchasing managers' index falling to 46 in June from a peak of 57.8 at the start of the year. This decline in housebuilding and construction is likely partially attributable to sentiment issues. Housebuilding and construction firms typically exhibit high sensitivity to consumer and business confidence, a consequence of the significant time required to complete a housebuilding or construction contract. The uncertainties surrounding the EU vote and recent stamp tax hikes have played a particularly large role in the recent negative sentiment, with construction output contracting 2.1% MoM in May (UK ONS). Business confidence has slumped further in July, falling to -47 in the CBI industrial trends Index. This indicates confidence is at the lowest point since April 2009.

UK Construction Output: *Industry growth has seen significant volatility and lacklustre growth in recent years, further compounding worries.*



Source: Bloomberg

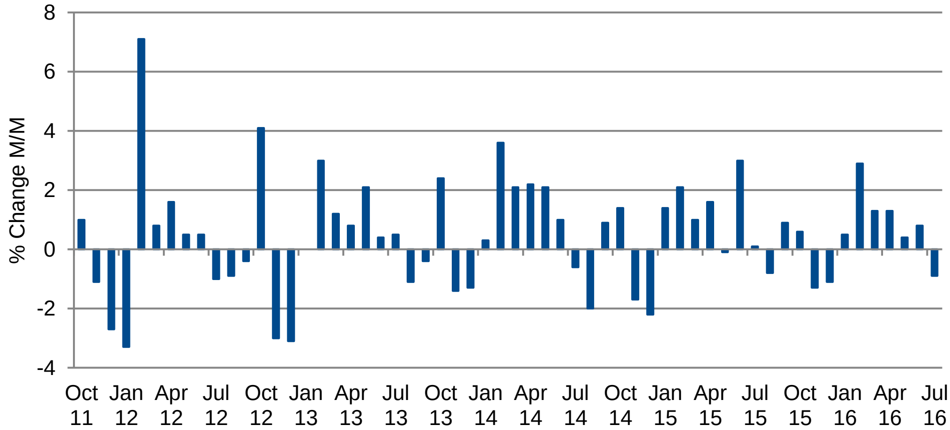
As an industry heavily dependent on both business confidence and foreign labour, property developers possess a particular vulnerability to Brexit. Developers Persimmon, Taylor Wimpey and Barratt Developments saw shares fall 25% during the 3 weeks post-referendum. Property agency Cushman and Wakefield reported an increase in the fall-through rate of commercial property deals, with 11% of deals across the UK renegotiated and 16% abandoned in the plebiscite aftermath. This includes high profile projects, such as the £465m purchase of Cannon Place by Union Investment. Under these circumstances, supply outlook remains bearish for coming months.

Supply seems set to fall with construction firms facing deteriorating order books and business confidence. A Royal Institute of Chartered Surveyors post-referendum survey showed a 45% increase in surveyors reporting a fall in new institutions. Supply lag supports the deficit, and the outlook remains negative until the onset of a significant price and confidence recovery. Recent ministerial comments regarding 'dealing with the housing deficit' suggest expanding supply may also be a governmental focus, possibly through easing planning restrictions.

Property Outlook

Some divergence will likely be seen in upcoming price shifts for commercial and residential property. The commercial outlook for the coming months is bearish on the back of the EU Leave vote, with the fundamental issues of business confidence and uncertainty unlikely to see any immediate resolution. The possibility of property fund fire sales may exacerbate this in the short term. Residential property prices are likely more robust with a short term boost in foreign demand and a long term supply deficit offsetting sentiment issues. Long term prices remain uncertain. However, a negligible 0.9% UK average asking price fall in July indicates a degree of resilience in the market. London properties will admittedly face larger price falls from Brexit. Despite this, it remains reasonable to remain bullish regarding prices in the long term despite cooling price growth. In both cases, the outcome of EU negotiations is likely to be hugely influential.

UK Rightmove National Asking Price: *Appetite post-referendum has dropped sharply after steady increases earlier in this year.*



Source: Bloomberg

UK property Funds

Brexit has dominated the concerns of UK based property funds in recent months, with fears over a fall in prices underpinned by the dependence of the UK property market on business and consumer confidence. The property funds of large money management companies such as Standard Life and Aviva hold exclusively commercial property, mostly prime real estate in London and the South East. Consequentially, funds faced collapsing portfolio values with the immediate portfolio write-downs averaging 5% NAV according to Bloomberg data and widespread expectations of further falls. A 5% average price fall is expected across UK commercial property in 2017 (KPMG), with a higher 10% fall predicted in London for 2017 (Merrill Lynch). Finance sector demand faces a particularly poor outlook, with the value of prime London office space predicted to fall 20% over the next 3 years (Green Street Advisors). This bearish outlook has hammered the share values of numerous property funds, with the shares of Standard life and Aviva losing 24% and 20.7% respectively in the 2 weeks immediately after the referendum. In many ways the situation has drawn comparisons to Bear Sterns, which faced similar, albeit more severe problems in the 2008 crisis.

Brexit Panic Induces Mass Withdrawals

The wake of Brexit has created a great deal of uncertainty regarding future UK economic and political affairs, compounding pre-existing economic uncertainty already felt by UK property investors. Fears of recession underpinned by Treasury and Bank of England warnings are expected to hold back customer spending and business investment (EY ITEM Club), with a Deloitte survey finding 73% of FTSE 350 companies 'less optimistic' regarding financial performance compared to 3 months prior to the vote.

The future of EU-UK relations, particularly single market access, is the primary driver of uncertainty with over 90% of CFOs surveyed by Deloitte suggesting that a clear direction regarding EU negotiation should be a government priority. Bearish UK property forecasts have largely been derived from fears over the prospects of these companies, the leaseholders and investors in property. In addition, Brexit related pound devaluation has caused additional concerns for certain investors. Manufacturers dependant on USD priced inputs and investors with GBP income but an alternative currency preference may face squeezed profits with continuing pound weakness and fears of further devaluation.

Real Estate Assets Falter in Liquidity

With the onset of uncertainty and Brexit driven portfolio devaluations, a run on the fund situation has developed as investors attempt to move capital to safe havens. With roughly of 45% of the GBP priced funds held by foreign investors preferring USD, JPY or CNY, pound devaluation has magnified this effect. Mass withdrawals placed pressure on fund cash and liquid asset reserves, with M&G and Standard Life holding 7.7% and 13.1% in cash respectively (Bloomberg).

The highly illiquid nature of property portfolios, compounded by ongoing uncertainty in the economic outlook, will squeeze the cash raising capabilities of funds. As of July 7th, the property funds of Henderson Global, Columbia Threadneedle, Canada Life, Standard Life, Aviva, M&G and Aberdeen Asset Management suspended trading, restricting access to roughly £18bn in total (Bloomberg). Aberdeen has since lifted its suspension following a significant write-down of impaired portfolio assets by 17% (Bloomberg). The remaining gated funds are legally required to review this suspension every 4 weeks.

The liquidity issues currently faced by property funds stem from the open-ended nature of such funds, with investors entitled to share redemption at any time. Fundamental requirements of the safety of such funds are the maintenance of an acceptable portfolio yield, bullish market sentiment, and the absence of mass withdrawals, as funds face a liquidity mismatch in a bearish property market. While funds offer liquidity on the basis of days, the portfolio assets of commercial property are only liquid on the basis of weeks or months. Liquid reserves offset this, but are quickly eroded by numerous withdrawals. Certain funds face further illiquidity through portfolio assets held as shares in other gated funds. M&G hold over 2 million Aviva shares, while Standard Life holds 2.4 million shares in M&G (Bloomberg). The suspension and devaluation of these shares has further reduced the ability of property funds to meet redemptions.

Despite the release of £150bn for lending under relaxed capital requirements, funds may struggle to secure new loans under falling collateral values, worsening credit ratings and concerns about bank exposure. Bearish expectations have led to increased caution in lending, with loan to value ratios on new loans decreasing an average of 10% according to the lenders Dragonfly Property Finance and London Bridging Finance. Foreign lenders, 42% of the market in 2015 according to a De Montfort University survey, have been advised to stress test loan portfolios before making new loans.

Property Fund Outlook

The sale of portfolio assets at discounted prices is currently being explored by funds as a means to quickly provide liquidity. Prime real estate is targeted, experiencing fewer uncertainty concerns and greater market interest. Flagship properties such as 440 Strand, 10 Hammersmith Grove and the BT Magna Park distribution centre have been marketed by Henderson Global and Aberdeen Investors. Early estimates suggest little price weakening, with buyer yield on Aberdeen bids only 0.5% higher than pre-referendum according to order flows on Bloomberg. Expectations are more bearish for properties lacking reliable tenants and London office property. The possible loss of passporting rights and single market access could lead to the relocation of significant finance and export firms, cutting demand and rents for commercial property.

Immediate Liquidity Can Come At a Price

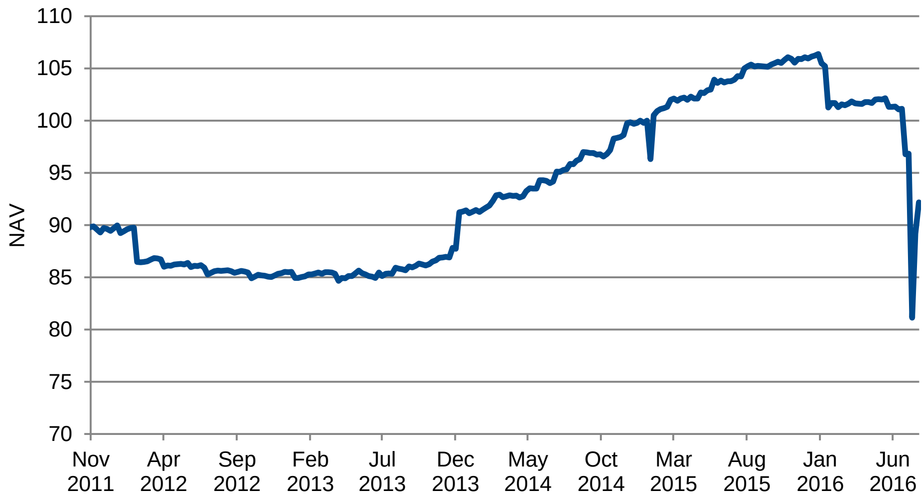
Steady demand from SMEs may help offset price falls, with the REIT Workspace reporting improving rents and sales for converted flexible office space. However, the possible onset of recession may see this decline. A steeper discount may be necessary on highly affected properties to secure immediate sale, with US investor Madison International expecting a 5-15% discount on its planned office and retail investment. The 15% discount on the sale of 2 Oxford Street properties by Aberdeen seems to justify these expectations.

Discounted sales raise the question of the potential dangers of a spate of cash generative property disposals. UK property funds collectively hold a £35bn (7%) stake in UK commercial property, and a larger stake in prime London property (BoE). Large quantities of discounted sales may squeeze prices and portfolio values with further implications for liquidity and investor confidence.

Property funds have attempted various approaches in curbing investor fears and withdrawals. Managers have encouraged shareholders to take a long term view regarding investment, and have reported fund activities and plans in a bid to reassure investors. Attempts to avoid excessive volatility have also been made in increasing portfolio revaluations from a monthly basis to weekly. Aviva has compounded these efforts with the announcement of a surprise dividend increase to 50% of earnings in 2017 from 42% in 2015.

Aberdeen Asset Management and Legal & General have taken an alternative approach by allowing redemptions at the cost of a cut on pay-outs representing the cost of providing immediate liquidity, 17% and 15% respectively.

Aberdeen UK Property Fund: *Aberdeen's UK property fund net asset value fell sharply as liquidity concerns and negative sentiment saw a wave of redemptions.*



Source: Bloomberg

This drastic approach has been somewhat effective. Aberdeen has seen a fall in redemptions and withdrawal of requests, with CEO Martin Gilbert stating that two-thirds of redemption requests are expected to be withdrawn (Bloomberg). The falling number of redemptions allowed Legal & General and Aberdeen to reduce the pay-out cut to 10% and 7%, indicative of abating investor fears. Aberdeen Share price recovered to £3.19 as of July 25th, supported by receding Brexit fears, takeover speculation and managerial guarantees that asset liquidation would not reduce portfolio quality for remaining investors.

The remaining funds are likely to remain gated until property sales have raised sufficient cash to meet expected withdrawal payments, estimated by Jefferies to be £5bn. Long term fund performance is greatly dependant on Brexit negotiations, given recent comments from Theresa May and her government, are not expected to formally begin until 2017 at the earliest. An exodus of finance companies and falling SME output under a recession may be a possible worst case scenario. Fund managers remain hopeful stable property income flows and use in portfolio diversification will help the market find its balance in time. Additionally, funds have seen some support from reduced uncertainty following recovering financial markets and the unexpectedly swift resolution to the Conservative leadership race. However, a glance at the fundamentals would suggest property funds still have some difficult times ahead.

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