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LaSalle INVESTMENT MANAGEMENT®

Research & Strategy

Briefing Note

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Taking Advantage of Uncertainty

Defining buy signals for UK real estate in an unpredictable market

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Despite many months of negotiation, debate and fervent speculation, the uncertainty surrounding the UK's future relationship with the EU has yet put to be put to rest *[see Chart 1]*. After failing to ratify the proposed Withdrawal Agreement ahead of the original deadline, the UK may still leave the EU with no guidance as to its future relationship. This *Briefing Note* explores the options which may become available to investors keen to take advantage of any market dislocation brought about by this ongoing uncertainty.

Executive Summary

The combination of uncertainty around Brexit, a slowing economy and a late-stage real estate market are all contributing factors to a projected fall in capital values for UK real estate over the next couple of years. Declines in many sectors are expected to be modest, whilst others, such as Retail, are more pronounced – principally for structural reasons. A No Deal Brexit is not our base case scenario, but the probability is not immaterial, and the repercussions would be more severe.

By comparing our Expected Returns with Required Returns, we can determine whether a sector is an underweight (sell), fair value (hold) or overweight (buy). This assessment sits alongside our DTU+E investment philosophy and is particularly but not exclusively relevant for Relative Return strategies. Given the macro environment outlined above and late stage of the capital market cycle, most sectors are currently an underweight recommendation:

- Industrials remain fair value despite record-low entry yields. Whilst the entire sector is appealing, we favour urban logistics over motorway junction logistics, due to the prospect of future rental growth. Whilst pricing in this sector is still fair value, finding stock is challenging.
- Most of Retail is an underweight recommendation. Yet only modest fall in value would bring the stronger subsector of Retail Parks back to fair value once again (c.5%). In this sector we recommend income-producing urban sites in top towns with bulky goods rather than high street retailers as the dominant tenant type. By contrast, the average Shopping Centre will need to see a significant price correction before becoming a fair value recommendation again (c.30%).
- Alternatives and City Offices are also not far from being fair value (c.10%), in stark contrast to West End Offices which will need to see a pricing correction far in excess of the base case forecast in order to achieve this (c.30%).

Out-of-favour assets such as secondary Retail may come to market from stretched borrowers, illiquid open-ended funds, or embattled retail REITs, but these are not buy recommendations. The listed market may also provide residential opportunities, and foreign investors may opt to downweight UK real estate altogether. However, unless a No Deal Brexit materialises, we do not expect to see many forced sellers or significant discounts to current pricing.

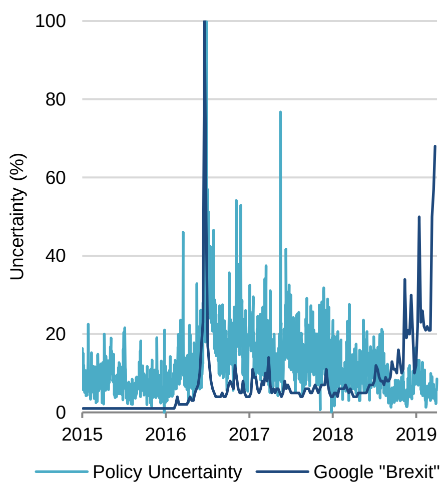
1. Setting the Scene

At first glance, the economy is in reasonable health, buoyed by unemployment at historic lows and the re-emergence of real wage growth. Nonetheless, the UK economy is showing signs of slowing. Macroeconomic concerns persist over stalling manufacturing, soft house prices, and a lacklustre business investment in anticipation of an unknown post-Brexit relationship with the rest of the world.

The real estate occupier markets are largely being driven by structural change (Logistics & Retail), flexibility & talent retention (Offices) and lifestyle (Alternatives). These drivers show no signs of abating and are largely agnostic of the Brexit outcome. Yet given the resilient but unspectacular economic backdrop, only the best locations and properties are seeing strong tenant competition put upward pressure on rental growth.

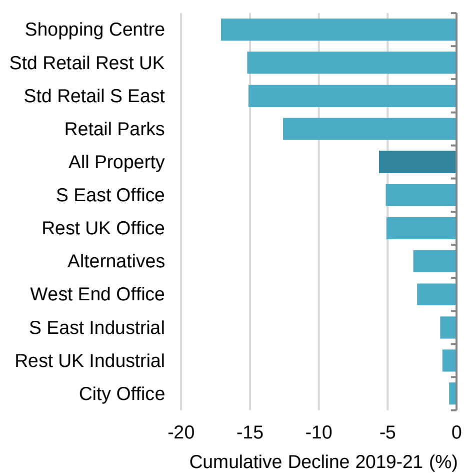
By contrast, Brexit is impacting real estate investment volumes, with Q1 2019 the lowest since 2012. Liability-matching assets are the only investments that are seeing continued investor demand. The general hiatus is set to continue until some kind of clarity over the type and duration of Brexit becomes apparent.

Chart 1: Policy Uncertainty & Brexit



Source: LaSalle (04/19) PolicyUncertainty.com (04/19) Google (04/19)

Chart 2: Capital Value Growth 2019-21



Source: LaSalle (04/19)

In our base case of a Long Hard Brexit, LaSalle expects All Property capital values to decline by 5-10% over 2019-21, with noticeable declines in Retail due to accelerating structural change. Most at risk are Shopping Centres, which will see the sharpest falls in capital values (15-20%) on top of 10% falls already recorded in 2018. Secondary schemes will do even worse. Least exposed are the Industrial sector, and a City Office market where yields will look attractive to international investors should a No Deal Brexit be averted *[see Chart 2]*.

Our strong conviction is that after an initial modest market correction the UK will recover reasonably quickly. Even if a No Deal Brexit were to manifest itself, the UK's transparent, dynamic means that it will adapt to a future outside of the EU. The long term should see little impact from current events, although the growth foregone and lack of investment over the last three years will be a short-term feature. In this context, the coming disruption and divided opinion could represent an ideal opportunity to deploy further capital.

2. Determining Fair Value & Buy Signals

LaSalle's long-established investment philosophy is based on combining the driving force of secular trends (Demographics, Technology, Urbanisation & Environmental Change) with superior stock selection and asset management. That is not to say, however, that pricing signals and relative value are not essential components of an investment strategy.

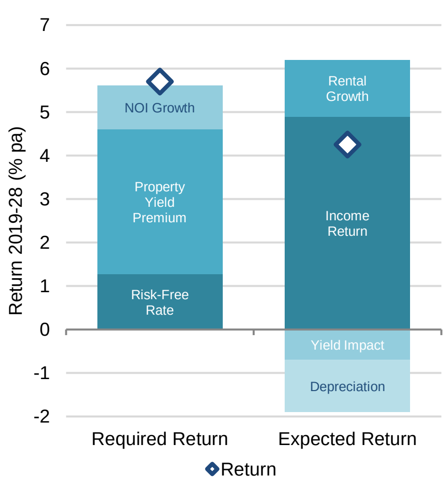
The concept of fair value is well-established in finance, and one which is frequently used to inform buy, hold and sell decisions. LaSalle have developed a fair value model that is most appropriate for a Relative Return strategy, although can also provide useful signals for other investment styles. When an investor's Required Return matches the Expected Return for any given asset/market then the opportunity could be said to represent fair value. We base the Required Return on the Gordon Growth Model, in which we add a real estate risk premium to the risk-free rate (the ten-year government bond) and factor in projected net operating income growth. The Expected Return is a market-level forecast, where the components include an income return, rental growth, yield impact, and depreciation.

We have sufficient evidence from back-testing the fair value approach that it can be a reliable indicator for macro market calls - particularly when considered alongside other market evidence[1]. Nonetheless, market forecasts are fraught with uncertainty and apply only to the average property in an average market, and so Expected Returns are therefore indicative only. Required Returns should arguably be more stable, but a move from Risk On to Risk Off in a No Deal Brexit environment, for example, would impact on the risk-free rate.

The fair value analysis informs which sectors we consider to be an underweight (sell), fair value (hold) or overweight (buy). We also stress test these assumptions to determine what additional change in capital values or entry yield would move a sector from an underweight to fair value, or from fair value to an overweight. This helps us pinpoint our buy signals with greater certainty.

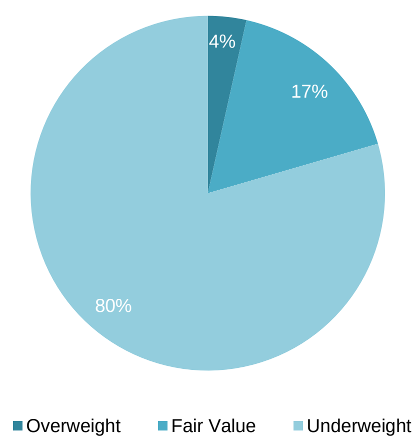
At the All Property level we find that the Expected Return of 4.3% pa for 2019-28 comes in lower than the 5.7% pa Required Return (underweight), even if we allow for a 10% margin of error range around the latter *[see Chart 3].* This is not surprising as arguably it would be unusual for real estate to represent fair value at this late stage of the cycle.

Chart 3: Expected vs Required Return



Source: LaSalle (04/19)

Chart 4: Fair Value Scenarios



Source: LaSalle (04/19)

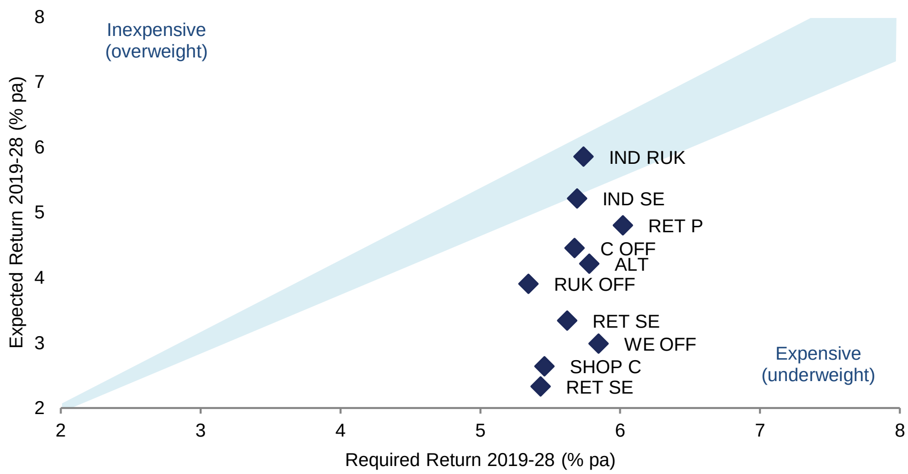
We ran simulations on the Expected Return to see at which point this underweight recommendation would change to either a fair value or even an overweight. This was achieved through manipulating any one, two or three of the main return components (income, rental growth and yield impact). We moved each of them both up and down by 100 bps in increments of 10 bps. The result was 200 different scenarios of Expected

[1] We ran the model back to 2002 which encapsulated c.60 sets of forecasts. All sectors were deemed an underweight by mid-2006 and overweight by mid-2009. City Offices were an overweight between 2003-06 in contrast to many other sectors. Industrials were an overweight between 2010-14.

Returns; only 17% of them resulted in a revision from underweight to fair value, and a further 4% to an overweight recommendation *[see Chart 4]*. Unsurprisingly, most of the scenarios which resulted in a change in recommendation required an upward revision of all three components. This gives us conviction in our current fair value assessment for All Property, and that it is going to take a sharp market movement to change this in the short term.

Fair value analysis at the All Property level is helpful for establishing a broad Risk On/Off approach to real estate as an asset class but this obscures opportunities at a sector level. This is particularly the case today, given the bifurcation between Retail and Logistics. When we run the analysis at the sector level we observe that both the Industrial segments are considered fair value – even at today's record low entry yields. All other sectors remain an underweight recommendation *[see Chart 5]*.

Chart 5: Expected vs Required Return

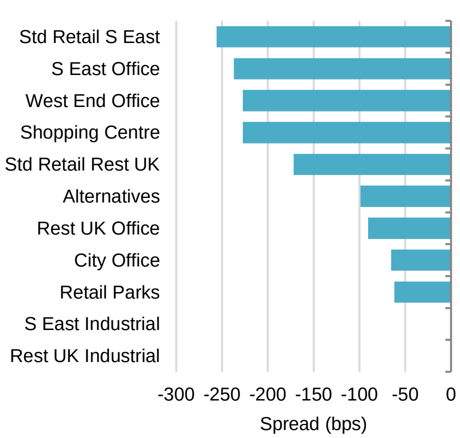


Blue shaded area represents fair value range of +/- 10%
Source: LaSalle (04/19)

An important consideration is also how far below fair value a sector's Expected Return is. This highlights the fact that both Retail Parks and City Offices are only slightly below fair value (60-70 bps), and Rest of UK Offices and Alternatives not much further below. It is interesting to note that whilst the drivers behind the relative fair value of Shopping Centres and West End Offices are very different, their Expected Returns' spread below fair value are similar (c.225 bps) *[see Chart 6]*.

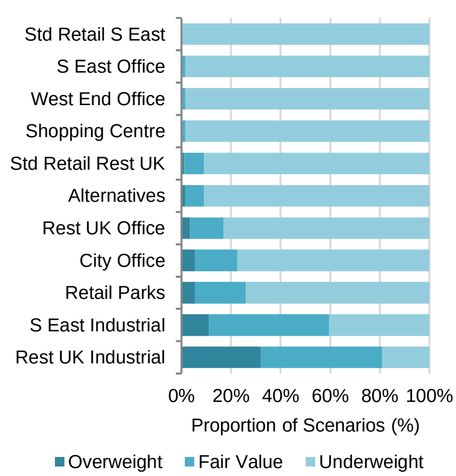
We apply the same scenario analysis used earlier for All Property at a sector level *[see Chart 7]*. For those furthest away from fair value, very few alternative scenarios result in a change in recommendation. Only for Retail Parks and City Offices is there a meaningful probability (>20%) of more favourable pricing, whilst Industrials were already attractive.

Chart 6: Spread Below Fair Value



Source: LaSalle (04/19)

Chart 7: Fair Value Scenarios

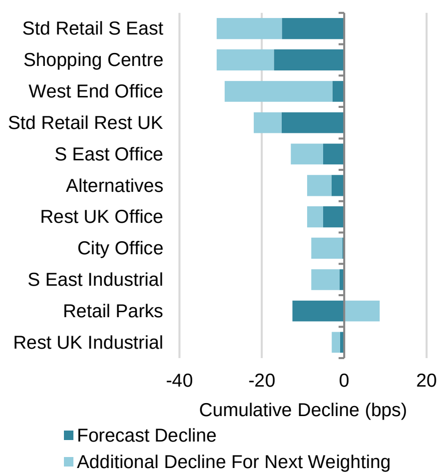


Source: LaSalle (04/19)

One way of interpreting the Expected versus Required Return would be to determine at what price an underweight sector today becomes fair value, or a fair value sector today becomes overweight. As this scenario requires all other components of the cash flow to remain unchanged we use these results with caution. The analysis suggests that struggling Retail such as Standard Retail South East and Shopping Centres would require c.30% off today's values in order to meet their Required Returns over the next ten years. The current forecast is for a 17% correction over 2019-21, and so an additional 13% would be required over and above the base case. West End offices require a similar total decline of c.30%, whilst we are only currently forecasting 3%, and so this sector is far less likely to see a change in recommendation. A number of stronger sectors need only c.10% or less to change recommendation; including Industrials, Alternatives and some Office segments. Retail Parks are the most interesting, as our current 2019-21 capital value forecasts would see the sector move into fair value territory over the next three years without any supplementary discount *[see Chart 8]*.

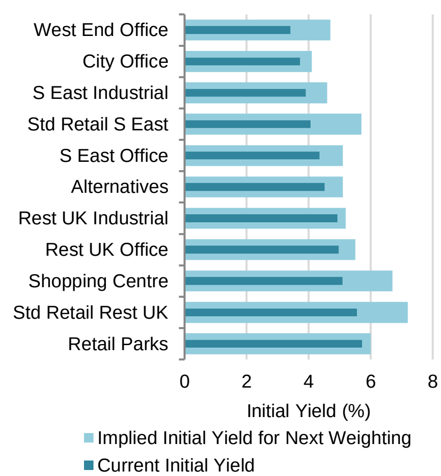
We can convert these changes in capital values into changes in initial yields[2]. Again, all other things being equal, initial yields in a struggling sector such as Shopping Centres would need to rise from their end-2018 level of 5.1% to 6.7% before being considered fair value. By contrast, as they are already closer to fair value, Retail Parks only need to see a 30 bps rise in initial yields, to 6.0% *[see Chart 9]*.

Chart 8: Capital Value Change



Source: LaSalle (04/19)

Chart 9: Initial Yield Change



Source: LaSalle (04/19)

[2] The Expected Returns model uses equivalent rather than initial yields, but acquisition pricing tends to be quoted in the latter. We therefore imply the changes required to initial yields from the proportional change in equivalent yields

3. Sources of Disposals

Only motivated sellers will consider disposals during a time of negative sentiment and falling values. This may be for a variety of reasons; including assets where borrowers have breached loan covenants, open-ended funds in need of liquidity, REITs/listed housebuilders looking to de-risk or raise capital, and investors who believe that the market will deteriorate further still.

Borrowers

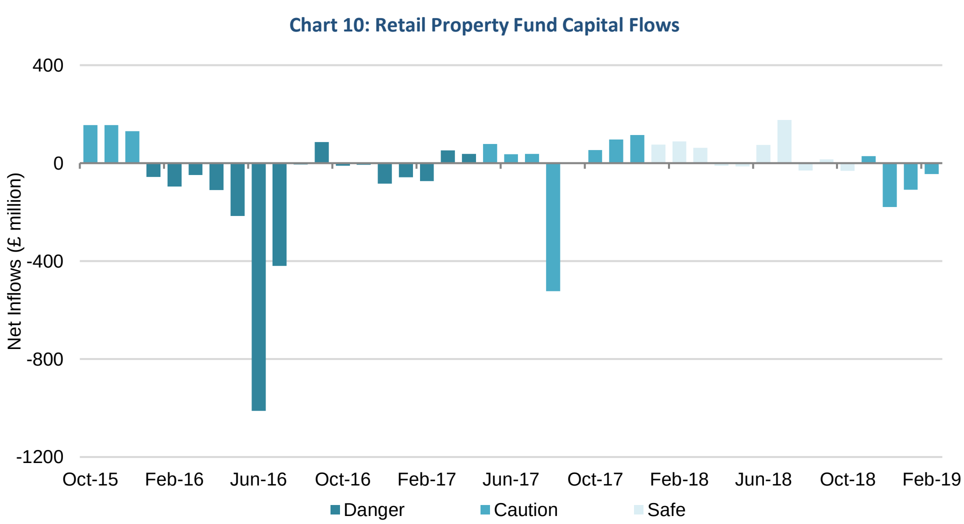
At the All Property level, borrower distress is only likely to result in forced sales in a downside macro scenario. A cumulative decline in values of c.20% over 2019-20 in a No Deal Brexit would suggest that the proportion of outstanding loans[3] to commercial real estate[4] at risk of breach (>85% LTV) is very small, at only 2%. However, certain sectors will see a sharper fall in values than this. For example, Shopping Centres are forecast to see cumulative declines of c.30%. Therefore, including lower LTVs (>70%) would increase the proportion of loans at risk of breach to 13%. In practice, these figures may be much higher as other loan covenants may have already been breached prior to this.

Whilst there may be some good assets which were too highly-geared and thus now need to be sold, the reality is that many forced sales within this category will be of poorer-quality assets or in sectors with the weakest prospects for occupier recovery. As a result, we expect few opportunities to emerge from loan covenant breaches, particularly if a No Deal Brexit is averted. Related to this, however, borrowers who require capital to cure their loan breaches may become forced sellers of other assets where they can achieve valuation.

Open-Ended Funds

In recent months, one of the indicators that has been pointing to a possible pricing correction on our *Capital Market Dashboard* is retail property fund capital inflows. This is because during the GFC, open-ended funds were in need of capital in order to meet investor redemptions. This led to asset sales in a falling market, and therefore frequently below valuation. Ultimately, many funds were forced to close or suspend. In total, UK open-ended retail client funds represent less than 7% of the UK real estate institutional holdings[5] but the perception of negative capital market spill-over effects is important.

History did not quite repeat itself following the EU referendum in 2016, as funds opted to close pre-emptively or include a fair value adjustment. Nonetheless, since turning negative in August 2018, in the seven months to February 2019 the retail property funds have seen cumulative outflows of £350 million. This is less than the run up to the EU referendum in June 2016 which saw c.£530 million of outflows[6], yet the *Capital Market Dashboard* indicator for this series was still advising caution *[see Chart 10]*.

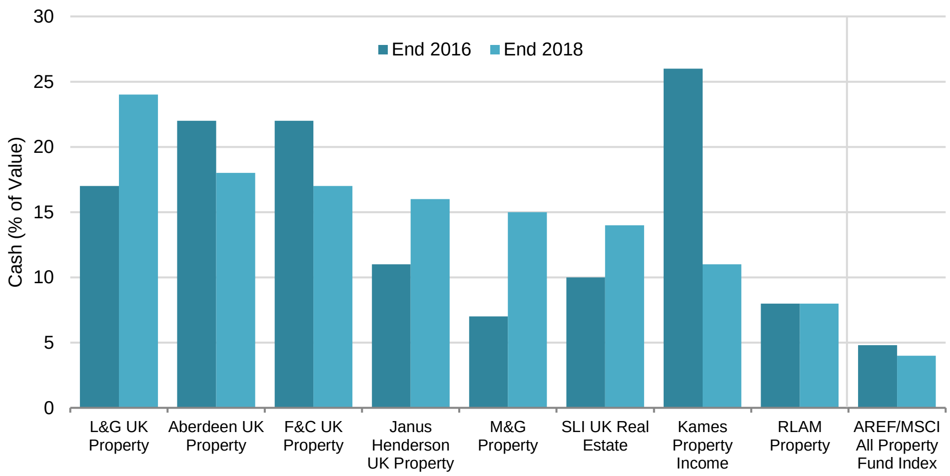


Capital Market Dashboard indicator refers to the Retail Fund Inflows recommendation, and in this chart example is lagged by two months to coincide with the release date of the fund data
Source: LaSalle (04/19) IMA (02/19)

[3] By value
[4] CRE Lending Survey (06/18) Cass Business School
[5] Retail funds AUM of £31.2 billion compared to estimated institutional real estate universe of £470 billion (LaSalle, IMA)
[6] Followed by a much stronger loss of £1.43 billion in the two months following the result

The reaction to a possible No Deal Brexit may be different to that of the EU referendum, not only because it should come as less of a surprise than the original vote. Upon reviewing the liquidity issues faced by the open-ended funds in the second half of 2016, the FCA proposed in late 2018 that these funds should suspend trading when an independent valuer expresses uncertainty about their value. Although welcomed by much of the real estate industry, it does suggest that forced sellers will be far fewer in number today than was the case three years ago. Moreover, on average the funds have reasonable and growing cash allocations in order to minimise forced sales. These tend to be noticeably higher than the industry average (which includes closed-ended funds) of 4% *[see Chart 11]*.

Chart 11: Open-Ended Property Funds Cash Holdings



Source: LaSalle (04/19) MSCI (12/18) Fitch Ratings (02/19) Legal & General Property, Aberdeen Standards Investments, BMO Global AM, Janus Henderson Investors, M&G Investments, Aberdeen Fund Managers, Kames Capital, Royal London AM (12/18)

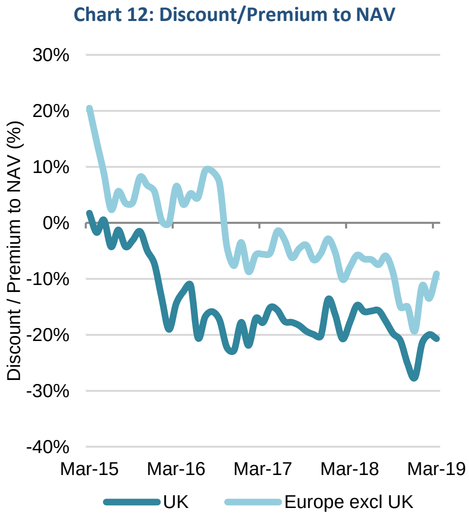
REITs & Listed Housebuilders

With share prices coming under pressure and steep discounts to NAV implying (amongst other things) eventual falls in direct asset valuations, listed property companies will likely be a source of transactions. At the end of March 2019 the UK listed market was trading at a discount to NAV of -21%, twice that of the rest of Europe *[see Chart 12]*. This masks a large divergence between strong and weak sectors, and also the impact of failed or rumoured M&A activity. For example, some operators in the Alternative sectors[7] are trading anywhere from a 15% to a 50% premium, whilst Retail owners[8] are trading between a -50% and -65% discount.

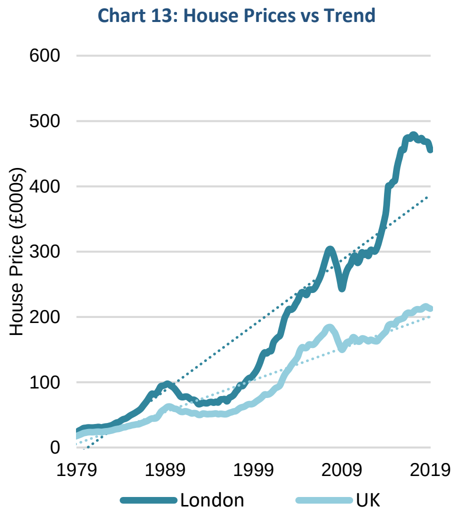
The housebuilders are also exposed to negative sentiment. In the immediate aftermath of the 2016 EU referendum, Berkeley Homes, Taylor Wimpey and Persimmon all lost almost a third of their value. Facing similar headwinds today, there may therefore be an opportunity for institutional residential investors to acquire private rented sector assets from, or partner with, these developers as they look to de-risk their portfolios.

Although they have been softening in recent quarters, London residential prices are still the furthest ahead from their trend growth, and so we expect the downward correction to be sharpest here. At Q1 2019 the average house price in London was 18% above its long-term trend, compared with just 6% for the UK as a whole *[see Chart 13]*. Although not a typical income-producing residential strategy, investors may nonetheless see value in the owner-occupier sector should values per square foot fall to a reasonable level. Acquiring residential developments under construction with a view to selling off-plan or upon completion is a higher-risk strategy but one that will appeal to certain investors.

[7] Primary Health Properties (Healthcare) Unite (Student Housing) Big Yellow, Safestore (Self-Storage)
[8] Hammerson, Intu, Capital & Regional



Source: LaSalle (04/19) EPRA (03/19)

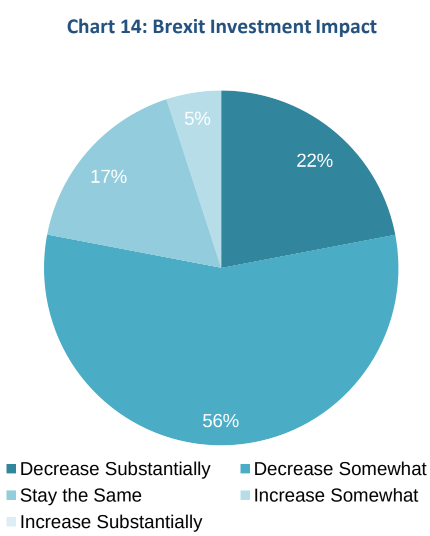


Source: LaSalle (04/19) Nationwide (03/19)

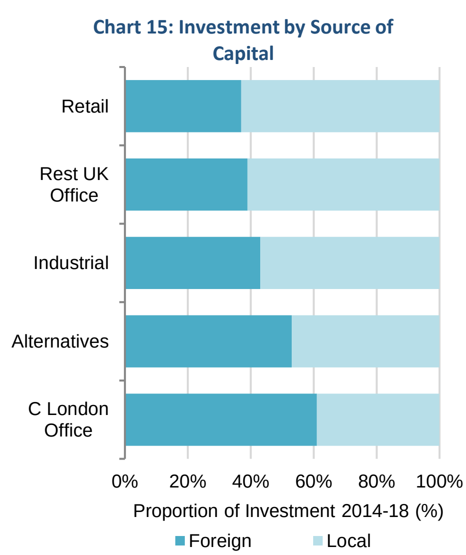
Risk-Off Investors

Given the choice, a rational risk-off investor that has decided to downweight UK real estate would not sell during a falling market. That is unless they believed that their loss would become further compounded were they to continue to hold. The latest consensus forecasts[9] expect real estate capital values over 2019-20 to decline by -3.5% for All Property, or closer to -13% for an out-of-favour sector such as Shopping Centres. To these we ascribe the assumption that at the time of production most contributors were anticipating a Soft and/or Long Brexit rather than a No Deal Brexit. We might therefore reasonably expect to see some investors selling at a loss of 5-10% for the average property, and at steeper declines for below-average quality assets. Long-hold investors can be profit-takers, and so rarely-traded trophy assets may also be sold – albeit we would expect little discount for these.

Consensus is that real estate investment volumes will decline if and when the UK leaves the EU, albeit again survey questions do not often make the distinction between different forms of Brexit. A recent survey of global investors reported that UK investment in 2019 is expected to fall substantially (22%) or somewhat (56%) *[see Chart 14]*. Whilst inactivity does not equate to sales, we can nonetheless assume that some risk-off investors will choose to sell. Foreign investors will be more likely and able to downweight the UK in favour of other countries. Therefore, markets and sectors that have seen significant activity from foreign investors in recent years are most exposed to negative sentiment. The clearest example of this is Central London Offices *[see Chart 15]*, which is at risk of losing banks to the EU. Risk-on and long-term investors should look to take advantage of these sales.



Source: LaSalle (04/19) PWC / ULI (02/19)



Source: LaSalle (04/19) RCA (12/18)

[9] IPF (02/19)