BTG Financial Consulting
INDUSTRY UPDATE

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Investors respond to change...

In the fourth update for the capital markets sector, BTG Financial Consulting discusses the influence of Brexit on investors' risk perceptions, investor and occupier demand, the broader economy, Europe and the US.

Markets and global investors have demonstrated considerable resilience in the period since last summer's Brexit vote ushered in a new era of geopolitics, as uncertainty fatigue prompts investors, companies and financiers to stick to the world of variables in their control and press on to close deals.

The fourth-quarter rebound in UK commercial real estate (CRE) transaction volumes surprised on the upside, but perhaps it should not have. Prices have held firm following the brief panic post-Brexit result, induced by retail investors, while the stalling of occupier decisions has been somewhat exaggerated. The fall in the value of the pound has served to make UK commercial property more attractive to overseas investors, while net debt pricing has remained broadly stable. All of which is supported by a resilient economy that grew by 0.6% during Q4 and by 2.0% over 2016, preliminary ONS estimates show, just 20 basis points lower than 2015. Economists forecast an uptick in inflation in 2017, which should eat into household spending and, in turn, modestly reduce GDP growth.

But these are unusual times. Geopolitics has the capacity to disrupt markets, investors' intentions and lenders' appetite – and may do so again over the course of this year – but recent evidence in CRE markets and beyond is of a stiffened resolve and an acknowledgement that pre-EU referendum bearish predictions were unfounded.

Macro Matters: from Trump and Brexit to the EU's Existential Threats

In the early weeks of 2017, this investor resolve still remains visible. In the US, the response to Donald Trump's ascendancy to the White House is a case in point. Rather than focusing on the longer-term dangers of US protectionism, markets are looking to the benefits of expected faster GDP growth and receding regulation, with subsequent inflation allowing the Federal Reserve to normalise monetary policy.

This optimism is evidenced in the symbolic shattering of the Dow Jones Index 20,000 threshold. The Trump administration's tax and infrastructure spending plans have prompted the IMF to revise its US GDP growth upwards to 2.3% in 2017 and to 2.5% in 2018.

But dangers – for the broader economy and potentially the CRE sector – still remain. One example is in President Trump's infrastructure spending, which is touted as potentially costing US taxpayers up to €1 trillion, triggering substantial US borrowing, which could be a rival to CRE debt as an investment option for global capital allocators. Furthermore, the potential repatriation of an estimated €2 trillion in US corporate debt, parked in European banks, would impact banks' liquidity.

Over in Europe, 2017 looks set to be the year when electorates throughout core EU member states pass judgement on the EU's fragile economy recovery and an unprecedented central bank stimulus experiment. Key federal elections in France, Germany, the Netherlands and, possibly, Italy could see the European political establishment overtaken by its own varying brands of populist politics. The European Central Bank's (ECB) extended quantitative easing policy will continue to support CRE pricing levels in 2017, with capital continuing to favour CRE over bonds. Although certain eurozone bond yields are expected to modestly rise this year, this is not by enough to reverse CRE's long-running relative value. Furthermore, interest rates are not expected to rise this year, or next, which will put a ceiling on bond yields increases. By contrast, eurozone prime property yields, although at historic lows, are unlikely to have yet found a floor.

In pre-Brexit Britain, financial markets again responded with relative calm to the Supreme Court's expected rejection of Prime Minister Theresa May's appeal over the use of royal prerogative to trigger Article 50 and kick-start the two-year EU exit process. The UK's EU exit leaves many unanswered questions and the spectre of increased costs for firms which have pan-European operations.

While the course of political events on the Continent over 2017 will shape the outturn of Brexit negotiations, May has warned EU leaders that no Brexit deal for Britain was better than a bad deal, in a thinly-veiled threat which could yet have tangible consequences for the financial and CRE sectors. Overall, perspectives divide along political lines. On the one hand, the view is that Brexit offers new opportunities with freedom from European business regulations. The counter view is that the lack of 'passporting' and single market access will lead to a rise in the cost of doing business for both sides; UK firms in EU and vice versa.

CRE Investors to Press on and Close Deals Despite Uncertainty

While events play out, CRE investors continue to capitalise on the opportunities that emerge. A resilient UK economy, combined with low borrowing costs and the weak exchange rate, will continue to ensure the UK's CRE markets are attractive relative to markets on the Continent and in the US, as well as relative to fixed income plays. Even in London, where markets look exposed to the fate of the financial sector and pricing is more stretched, investor demand has been supported. Notably, Asian investors from China and Hong Kong have capitalised on the 'double-discount' of falling prices – estimated at between 3% and 5% for London prime offices – and the fall in the value of the pound, slipping 17% relative to the US dollar and 11% relative to the euro.

More broadly, long-term money investors will likely use this period as a buying opportunity across the prime, long-leased UK sectors. Investors want bond-like assets, and pricing is reflecting that. Since the referendum, on balance, long-leased assets have risen in value, while shorter-dated properties requiring intensive asset management have somewhat slipped back. Logistics assets are also hot among investors as well as PRS, healthcare and student accommodation, all of which are seen as more Brexit-resilient as demand is driven by demographics rather than supply, yields and occupier trends. Indeed, Brexit has deepened the appeal of many 'alternative sectors' which will become more apparent over the year ahead. Elsewhere, regional offices are expected to benefit from a long-running trend of financial services firms relocating their back and middle office staff from London to regional UK cities.

While UK investment by domestic and global institutions is expected to pick up again this year, expectations are more mixed for the intentions of US private equity capital. Investment volumes in the UK CRE sector by US private equity funds slowed from cyclical highs in early 2016, reflecting the maturity of the cycle, which diluted future return expectations as well as a pre-EU referendum caution. There are two possible inter-connected explanations for this: achievable returns on CRE investment in the UK fell back last year; and the relative value of other jurisdictions, both on the Continent and back in the US, outstrip the UK now. But with pricing falling back somewhat in UK secondary markets – particularly for shorter-dated, asset management-intensive assets – it is arguably a time for renewed appetite among US private equity funds.

The answer, probably, is that it depends. US investors who are still sitting on large UK CRE portfolios will see their returns significantly eroded when they divest and convert back to US dollars, given the weakening pound. Indeed, divestment timing will be a difficult decision for many to take. Those with existing portfolios may be less likely to double-down, whereas those less dollar-denominated funds who are less exposed will likely feel increased motivation. Overall, 2017 forecasts for CRE transactional activity in the UK range between broadly in line with 2016's circa £51.3bn to up to £55bn, according to JLL and Capital Economics, respectively.

Elsewhere, in the UK non-performing loan (NPL) market, there are a number of 'mega trades' for private equity funds to compete for, including UK Asset Resolution's £16bn Bradford & Bingley UK residential mortgage pool and HSH Nordbank's £2.7bn London office-backed Project Leo. In addition, Nationwide continues to evaluate whether to sell off its residual UK NPL book after receiving unsolicited bids following its Q4 announcement of its intention to quit UK commercial property lending.

Credits Markets Pricing and Liquidity Looks Stable

Financing markets in the UK stabilised at the end of last year after a post-Brexit result spike in the region of 30 to 50 basis points for senior credit. For borrowers, the uptick in margins has been offset by the fall in the five-year swap rate – which rose 37 basis points over Q4 ending last year 72 basis points lower than at the end of 2015, virtually neutralising the all-in cost of debt.

Leverage offered by lenders on average reduced by around five percentage points, which gives mezzanine providers the opportunity to de-risk portfolios by financing lower down the capital stack. UK mezzanine pricing has widened since the third quarter, driven by repricing of risk and the withdrawal of liquidity from global investors. Over the course of 2016, there has been a fall back in borrower demand for mezzanine, leading to expectations of sector consolidation ahead.

Historically low yields on long-dated bonds continue to provide CRE investors with an attractive window to lock in cheap, long-duration debt. Despite this enduring trend, take-up of long-dated debt was proportionally lower last year, anecdotal evidence combined with the De Montfort Mid-Year Property Lending Survey suggests. This is explained by the increased complexity associated with longer duration loans, which prompted interested borrowers to delay decisions until this year. Insurers are quietly confident of a pick-up in longer-dated lending this year.

Theresa May's confirmation in mid-January that the UK will leave the single market as part of Britain's 'clean Brexit' has left financiers broadly unfazed, with the wide consensus that demand for credit will soften this year. In sum, pricing and liquidity will unlikely be much of a problem in 2017.

For Further Information

If you would like to discuss any of the issues raised in this update or would like to know further details about the services we provide to the sector, please contact me.

Mark Fry
Partner

T: 020 7717 5203
M: 07802 200275
E: mfry@btgfc.com

Co-authors

Mark Fry is a Partner at BTG Financial Consulting. Mark's experience in this sector gives him a valuable insight into the problems and issues that companies face.

James Wallace is Finance Editor at *CoStar News*.