Perspective: UK price premium looks likely to erode in a new chapter for real estate

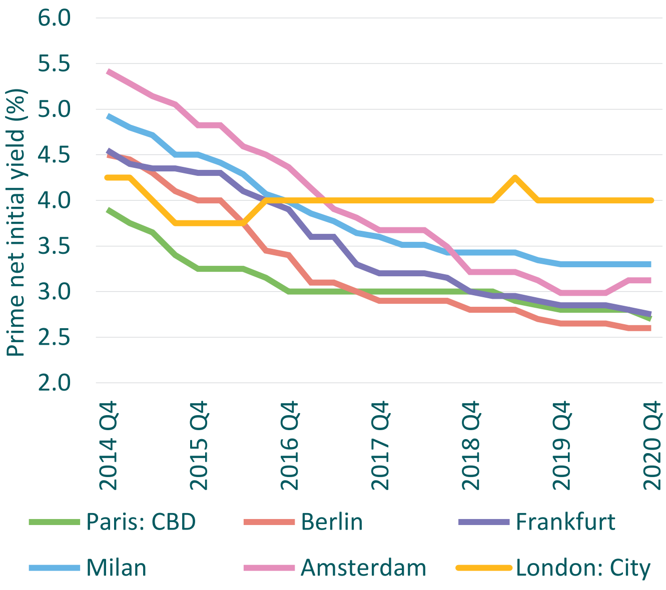
March 2021

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

- UK real estate pricing has been penalised by Brexit uncertainty since 2016
- However, we believe this will now begin to reverse following the UK's orderly departure from the European Union (EU)

Before the EU referendum, the city of London was the lowest yielding office market in Europe, after Paris' Central Business District. Now, it is among the highest yielding of the major markets. Even during the pandemic, core office yields compressed in major German markets, Paris and also Milan. But not in London.

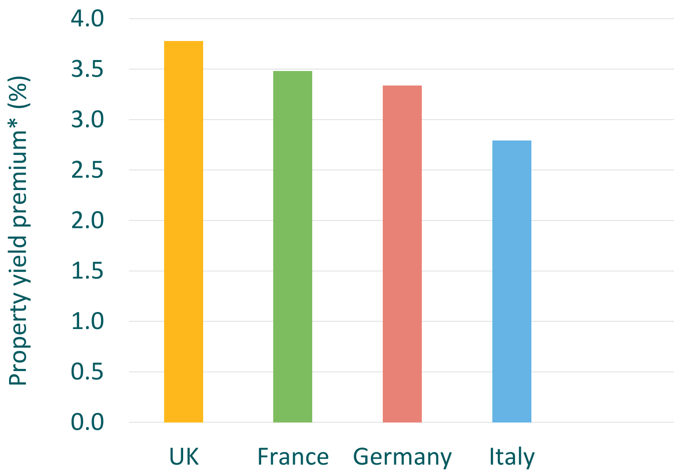
Figure 1. London property yields have remained elevated relative to other office markets



Source: PMA, October 2020.
Where past performance is shown, please note that this is not a guide to future performance

This dichotomy in yield movement could be a consequence of bond yields being higher in the UK, largely. But when looking at the property yield premium versus bond yields, the UK still offers a higher premium, in most cases. It cannot be justified by the pandemic, since all countries have been heavily impacted by COVID-19.

Figure 2. Property yield premiums are also higher in London



*Prime office net initial yields vs 10-year government bond yields

Source: PMA, OECD, Q4 2020.
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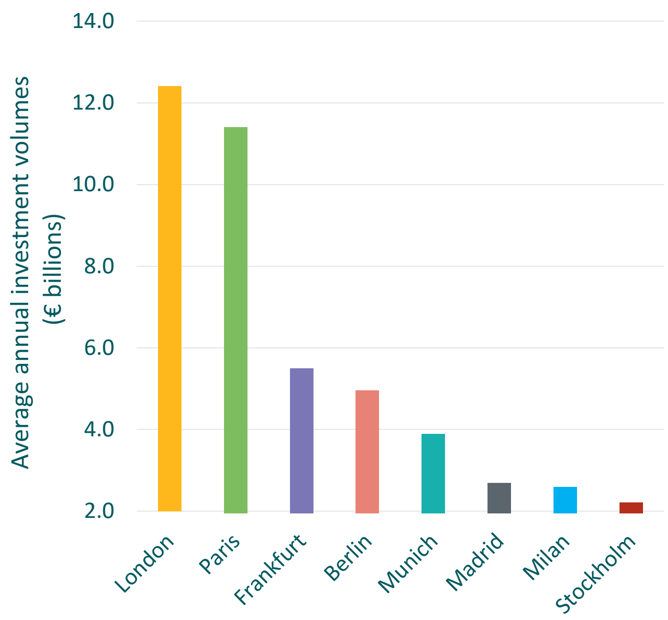
In our view, the explanation has to stem from Brexit uncertainty; only the UK has been affected by Brexit since 2016, and this is precisely the moment that property yields in the UK began diverging from their counterparts across the channel.

The natural question, therefore, is whether this is over. Now the UK has withdrawn from the EU with a trade agreement, are we getting back to normal again?

Fundamentally, we believe London yields should be among the lowest in Europe. Liquidity is second to none, the tenant base is deep and, from a cyclical perspective, supply risk is low. These factors should provide investors' confidence that their capital is well preserved in London.

Figure 3. Liquidity in London has been historically high



Source: PMA, October 2020.

Following the trade deal, there is certainly a lot more clarity; no 'cliff edge' Brexit, no trucks waiting at the border for days, no en masse migration of jobs. Given the circumstances, Brexit appears to have run as smoothly as could be expected.

We believe the pricing differential between London and other major European cities will now begin to erode, reinforced by structural strengths such as the London market's size.

Greater predictability creates a more positive investment environment

Certainly, there are still hurdles to negotiate. The particulars of the trade deal need time to settle. Some supply chains will have to adjust. This will imply more production in the UK in some cases, and less in others. But the trade deal in goods should bring more predictability, and is likely to be welcomed by exporters, traders, wholesalers and retailers.

Other aspects of the UK's long-term relationship with the EU are yet to be determined, including an arrangement for financial services.

At present, the UK regulatory landscape is very similar in the UK and the EU, which provides the UK substantial potential access to the European market.

The UK may decide to deviate from this framework, though the incentives to do so – or not – will be seen over time. In any event, larger financial services firms may pursue moderate expansion in continental Europe in the near term, in order to obtain specific regulatory approval to carry out certain activities, should they need to.

However, we believe there remains strong justification for a large share of the industry to retain UK roots. Crucially, London reflects a strong source of human capital, with a long history of innovation in financial services. It also represents a powerhouse in business services, technology and biotech. It is important to consider that the UK is one of most business friendly countries in Europe, second only to Denmark, according to the World Bank's Ease of Doing Business 2020 report.

Whilst uncertainty is not completely removed, there are reasons to believe that investment activity in the UK real estate market should recover, in our view. This should further support greater convergence in pricing with other European cities.

Accelerated trends are expected to shape UK real estate

Despite the above, it is difficult to disassociate the economic and financial consequences of the Brexit deal with the consequences of the COVID-19 pandemic.

Recovery from the pandemic will transpire, but the hardship endured by some of the corporate sector, including retailers, cinemas and hotels, will take time to mend, in the way that corporates, households and banks recovered gradually throughout 2009-12. Though caution is likely to prevail, greater political clarity will help businesses to prioritise decision making in their occupation; a clear strategy being essential to performance.

Consumer trends that have been accelerated by the crisis are expected to shape the real estate investment market into the next cycle. Technology has allowed us to sustain home working, which may prompt some people to rethink where they live – particularly young families that may already have been at the stage of moving further out of town. Cities are likely to remain the anchor, but the expansion of commuter belts could increase demand for single-family housing for rent in suburban locations with good transport infrastructure.

The ability to work more flexibly may also impact how much office space companies require. It is therefore important to focus on high quality, well connected offices and all types of residential property that is designed for the new era.

Investors may be able to capitalise on UK pricing as the fog lifts

Despite the current lockdown and economic impact thereof, the UK's long awaited withdrawal from the EU has dispelled a significant amount of uncertainty. Whilst the fog of Brexit has not cleared completely, the cliff edge of a 'no deal Brexit' has been avoided.

Pricing of UK real estate now appears an outlier when compared to many other leading global markets, and we expect that investors may be able to capitalise on this differential as it begins to normalise.

Furthermore, 2021 looks set to be the year of the vaccine, which will help to reduce uncertainty related to COVID-19. Such environment may well encourage some investors to increase their risk tolerance.