BTG Global Advisory
INDUSTRY UPDATE

Real Estate July 2017

At the crossroads

BTG Global Advisory provides comment on the implications of Brexit for the UK real estate market, particularly regional projects, some of which qualified for EU funding.

London has established itself as a dominant draw for international real estate investors in search of growth, stable income, and a safe haven for capital in a sometimes turbulent world. At the same time, Britain's regional cities have been pushing hard to attract and expand inward investment. So far, so good. Yet in the wake of the EU Referendum decision and the official start of negotiations, the inevitable question is whether confidence will prevail now Article 50 has been triggered and whether Scotland's agitation to succeed has been stymied by the General Election result.

It's worth remembering that many of Britain's regional cities had to completely reinvent themselves in the aftermath of manufacturing decline in the 1980s, especially in the North and Midlands. With their centres largely abandoned by residential communities and pocked with outdated retail provision and vacant light and heavy industrial sites, transformation has required radical rethinking and has seen the cores of cities such as Manchester, Liverpool, Leeds, Newcastle, and Birmingham changed completely.

Major projects in Edinburgh and Sheffield will engineer yet more reshaping of established UK cities, while government aspirations for a 'Northern Powerhouse' and promised infrastructure spend, led by proposed high-speed railway line HS2, will improve and speed up connections between cities and links to London. Retail is also often at the heart of urban regeneration and there are planned retail projects in Oxford, Barnsley, Hull and Sheffield, among others, plus a slew of local authority backed schemes as councils get impatient about private investment getting long-delayed projects off the ground. Yet the EU Referendum result and the decision to trigger Article 50 at the end of March, mean, inevitably, a period of uncertainty. That has only been exacerbated by the recent General Election result and its as-yet-unknown impact on the UK's negotiating position and aspirations.

David Inskip, Director, UK research, CBRE Global Investors, a major investor which has done a lot to compare and contrast city virtues across Europe, reflects: "Brexit is going to be a theme for 2017. Although the economy has performed better than expected and that's been positive for occupier markets in general, risk does lead to business uncertainty and that is bound to impact investment and hiring."

Despite these challenges, Inskip believes that real estate development has, largely, lagged requirements and this may prove to be the saving grace for many locations, while markets await the longer term shake out of the Brexit effect.

He points out that the UK's major regional cities have all enjoyed a strong past five years, notably Manchester which was the first to use its devolved powers to invest in infrastructure and which has captured quite a bit of the media and technology sectors.

On the flip side, that has meant more development than many of the other cities, where supply-side constraints should mean that most remain, at worst, stable. That said, Inskip points out that there are no signs of oversupply in Manchester.

Chris Darroch, Fund Director at Hermes Investment Management, also believes that ongoing urbanisation is driving opportunities, and says that the potential for sustained growth in regional cities "cannot be underestimated". Hermes still sees "enormous potential across the UK" and has been focusing its investment strategy on large-scale, mixed-use regional projects for many years now, including Paradise in Birmingham, NOMA in Manchester and Wellington Place in Leeds – as well as a PRS fund which has invested almost exclusively in the regions.

Cities Push for Retail-led, Mixed-use Growth

Two of the cities that have lagged the general regional upgrade have major plans under way. In Nottingham, intu is redeveloping two shopping centres, while Sheffield City Council and Queensberry became strategic development partners for the Sheffield Retail Quarter in June last year. The scheme will unite key retail areas in the city centre and, combined with Meadowhall – which itself has recently been extended – will make Sheffield a top ten UK retail location, according to Paul Sargent, Chief Executive of Queensberry, who believes it is the largest mixed-use scheme under construction outside London.

Sargent insists that, despite the overhang of Brexit, the issue is not finding overseas investors, but rather finding suitable investments for them to place capital. That, in part, is because of too much focus on London and the South East, he says, stressing that the challenge is to encourage inward investment into markets that foreign investors have so far ignored. Low transaction levels in many markets also complicate the picture, with fair price currently difficult to establish in some locations.

One clear change in the UK's approach post-referendum, is that cities and regions around the country are combining as strategic alliances, trying to capitalise on the greater critical mass created by scale. This was especially apparent at the recent MIPIM event in Cannes, Europe's biggest annual real estate gathering. For example, Leeds and Bradford came together to promote the scale of their combined catchments and youthful demographic, as did the various authorities in the Midlands, exhibiting under one umbrella.

At the heart of this area is Birmingham, which seems to have worn the mantle of the UK's second city more like a yoke than a crown for much of the past few decades. However, retail revitalisation of the Bullring, Grand Central and The Link has given the city a new retail and leisure heart and other sectors are catching up, says Ian Stringer, Regional Senior Director, GVA Bilfinger. "A lot is happening in the city," he says, pointing to the upcoming relocation of the HS2 offices from Canary Wharf, plus the arrival of Deutsche Bank, and HSBC choosing to headquarter its retail banking in the city.

Stringer believes that more political autonomy and cooperation in the West Midlands plus the upcoming Mayoral elections – within which former John Lewis managing director Andy Street is a candidate – should help maintain that sense of purpose and points to a "feeling of confidence I can't remember in a very long time" as retail and commercial development is supplemented by an increase in residential schemes in the city centre, reversing a trend towards the suburbs.

Indeed, significant investment is being pushed forward across the Midlands. Coventry City Council has chosen London-based Shearer Property Group to deliver the City Centre South mixed-use development. Shearer has already created a restaurant offer at Cathedral Lanes in the city and will lead the £360m development, which will transform a large part of the city centre. The 818,000 sq. ft project will include a major department store, three flagship stores, 50 new retail units, a hotel, cinema, restaurants, and residential units.

In March, Derby City Council exchanged contracts for the purchase of the former Debenhams building on Victoria Street and six related properties on Green Lane and Macklin Street. At the same time, it also exchanged contracts for the sale of Eagle Market to retail developer intu as a separate transaction. The purchase of the 110,000 sq. ft former Debenhams building, along with other key pieces of real estate, will act a catalyst to regenerate the Becketwell area of Derby, through a public/private partnership.

Derby City Council started the process of consolidating land in September 2014 and Deputy Leader of the Council, Martin Rawson, who has responsibility for regeneration, said of the move: "This area has been crying out for modernisation and development. There have been years of market failure to revive this part of the city due to fragmentation of property ownership and other factors; the council is now taking the lead to rectify these problems in order to stimulate investor confidence."

Indeed, despite a pause for breath as the market takes in the ramifications of the Brexit process, Inskip adds: "Lack of development while the major cities have been growing has led to low vacancy rates, although since 2015 there has been more investment so, paradoxically, we may see some additional supply just as many companies hit the pause button. This is likely to mean schemes due to be delivered further out could have their completion a little delayed."

He also points to growing markets, such as residential PRS. The UK government has recently pledged to not only a major house building programme to address a supply and demand imbalance, but also policies designed to encourage and help tenants in a shift away from house owning to a rental economy more akin to Europe and the millennial mindset.

Schemes Promoted Around the UK

Richard Merryweather, joint head of UK investment at Savills, adds that there are plenty of schemes reshaping the regions, with Birmingham's large mixed-use schemes such as Icknield Port Loop, the area around the new HS2 terminal on Curzon Street, and the redevelopment of Smithfield likely to appeal to foreign investors over the next three to five years. These schemes are a key focus for Birmingham City Council to attract foreign investment, redevelopment, and regeneration.

Cambridge and the surrounding areas are seen as a strong industrial location, due to good connectivity to the rest of the UK. The office, tech and biomed sectors continue to attract significant investment, but increasingly buyers are looking to diversify their portfolios and balance risk – especially with the ongoing economic uncertainty.

Meanwhile, Bristol's electrification of the Bristol line will give an opportunity for occupiers to attract London relocations, especially where couples could live between the two and commute each way. Manchester attracted the highest level of commercial property investment on record in 2016 (£551.48m), with German and US investors most acquisitive, followed by Middle Eastern and Far Eastern. Manchester appeals not only because of the potential discount compared to London, but as a global city with a big economy, large employment pool, and strong growth potential.

Leeds' economic growth, a strengthening financial services sector and large student population are attracting inward investment. The opening of the First Direct Arena, Trinity Leeds, and the £165m Victoria Gate shopping centre have raised the city's global profile. The delivery of the second leg of HS2 will deliver further economic stimulus, with the South Bank area being specifically developed as a European-style apartment living area for families with a strong community ethos.

Such optimism is supported by the latest UK real estate market outlook published by the UK's largest fund manager, M&G Real Estate, which predicts market turbulence will continue to gradually subside as occupier demand remains resilient, capital values are tentatively rising and the UK market remains particularly attractive to overseas investors as a result of weaker sterling.

M&G has produced a report entitled Life Beyond London, looking at regional opportunities.

"We see a lot of opportunity outside of London, specifically in the large regional cities such as Manchester, Birmingham and Bristol. Occupiers in these cities benefit from a skilled workforce, driven by globally recognised universities, cheaper labour due to lower living costs relative to the capital, and more affordable rents for commercial space," says Richard Gwilliam, Head of Property Research at M&G Real Estate. "This has led to the emergence of a 'north-shoring' phenomenon whereby businesses move operations from London. For investors, these conditions, together with the general lack of Grade A space in these cities due to low levels of construction since the financial crisis, provide solid rental fundamentals."

London Remains a Powerful Hub

And, of course, London remains the hub for investment. The West End will be reshaped by the completion of the Crossrail project in December 2018, with the City's BID New West End Company (NWEC) to run a summit this summer at the 500-days-to-go mark, says NWEC Chief Executive Jace Tyrrell. After an infrastructure project "a decade in the making", London is now getting ready to begin reaping the benefits of a transport project that is expected to bring a 25% increase in footfall to the heart of the city, he says.

"I don't think there is a city centre or shopping destination that wouldn't ache for that sort of increase," says Tyrrell. "Office occupiers, retail operators and leisure companies are all now beginning to think about how they configure their space to capitalise on this huge opportunity. It's important to get across the overarching message from the London Mayor that London is open for business."

Among other changes in the West End, detailed talks about reducing bus numbers as a result of Crossrail are also about to begin, helping to improve air quality and reduce congestion, an issue which has been a particular bugbear along primary retail avenue Oxford Street. Luxury retail area Bond Street is also undergoing a major revamp of its public realm to enhance the area.

Indeed, despite the challenges, the UK real estate market remains a safe haven for many investors and an attractive opportunity, according to Peter Cole, Chief Investment Officer of Anglo-French REIT Hammerson, which has shifted away from commercial to retail in its twin markets of France and Britain. Conceding that the next few years "might be a rough ride", he predicts that optimism about the market and performance levels that compare well with the US and much of Europe, give cause to be positive.

"After the shock of Brexit there does appear to be a 'let's go for it' attitude from the UK government, cities and companies," he says. "At the moment, there seems to be good demand for UK retail property from overseas."

Conclusion: A Country at the Crossroads

The UK regions have responded to London's domination of politics, economics and culture with increasingly vibrant determination, led by the ongoing success achieved in Manchester and a number of schemes – including the controversial ex-footballer-led St Michael's hotel, commercial and residential – continue to keep Manchester at the forefront of regeneration.

Yet uncertainty will undoubtedly impact investor confidence. Cheaper sterling rates make the UK look affordable, but if sectors such as finance and banking do experience job migration to cities such as Dublin, Paris and Frankfurt, then Britain plc will come under scrutiny. Since 2008 investors have shied away from uncertainty, whether created by demonstrable factors or market sentiment. No one knows what the next two years will bring and as Ian Cheshire, Chairman of department store chain Debenhams, said recently: "The last year is the first time where politics have had more impact than economics."

The same will undoubtedly be said of the next two years.

Scotland Awaits Brexit: Stability, for the Moment…

If the UK as a whole faces the uncertainty of Brexit, the EU Referendum at first meant that Scotland faced a 'double whammy' with strong SNP calls for a second independence referendum. The results of the General Election look to have halted that momentum in its tracks. The Scottish Cities Alliance has been pushing a range of investment opportunities in Aberdeen, Dundee, Edinburgh, Glasgow, Inverness, Perth and Stirling, and Stuart Black, Director of Development and Infrastructure, the Highland Council, says a series of UK government-backed City deals have been going some way to help take forward schemes that in the past would have relied on EU funding.

First Minister Nicola Sturgeon had run a campaign putting her desire to ask permission to hold a second referendum on Scottish independence at the fore. She was looking for a vote to be held between the autumn of 2018 and the spring of the following year. The inroads made by the Conservative party at the General Election suggest there is resistance, or at the very least, voter weariness over such a scenario, which now seems far less likely.

Scotland has a very stable economy with a high-skilled workforce and Cushman & Wakefield's chairman in Scotland, David Davidson, reflects of any further vote: "Indy Ref2 will be the third Referendum in four years in Scotland and we, therefore, have some perspective that we didn't have in 2014. Business has to go on. There is a point where businesses have to focus on the day to day. That was one of the surprising outcomes leading up to the 2014 Scottish Referendum and immediately following the Brexit vote. Activity levels were lower than in non-referendum years, but tenants with lease events relocated and investment properties traded. Glasgow and Edinburgh had robust levels of office take-up in 2016. While some investors sensed increased risk, some saw opportunity. Core international and UK capital was more risk averse, but others sensed opportunity."

BTG Global Advisory

One of the world's largest specialist independent insolvency and restructuring alliances. www.btgga.com