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BREXIT:
TIME FOR U.S. INVESTORS TO EXIT U.K. REAL ESTATE OR BUILD A PORTFOLIO?

BY JAHN BRODWIN AND FIONA FREEMAN

The recent vote in the United Kingdom to leave the European Union has had some immediate effects there—but how will they affect U.S. investors across the pond?

So far, the Brexit impact is being sharply felt in the banking and property sectors. These are being played out in two pressing issues facing Britain right now. They are:

1. The volatility of the pound Sterling's valuation against the dollar. The Sterling dropped to a 30-year low within one day and at the time of this writing, was valued at only $1.29, a threshold it has not seen since 1985.

2. Trading suspended on several UK property funds amid a post-Brexit rush by retail investors to exit the real estate asset class. The seven suspended funds are Columbia Threadneedle, Canada Life, Henderson, M&G, Standard Life Investments, Aviva Investors and Aberdeen Asset Management. This suspension (for an unspecified length of time) prevents investors from selling their investments, which in turn avoids large withdrawal demands the funds may not be able to honor in the short term. The trading suspension and the selling frenzy are significant for several reasons.

   - Citing lack of liquidity in the face of extraordinary circumstances (and sell offs), the suspended trading allows the funds to better manage cash flows, and conduct orderly asset sales in order to meet redemption obligations to investors. Banks have relaxed some restrictions in order to keep credit markets fluid and support the funds as they regroup, to avoid a market collapse.

   - So far, the suspension actions by these seven funds have frozen over half of the £25 billion in the Investment Association property sector (the IA is a trade association for the U.K. investment management industry). Open-ended property funds now own five percent of the U.K. commercial property market (up from two percent in 2007).

   - There is concern that other funds will follow suit, and that their forced selling of buildings could lead to a steep drop in commercial property prices, as occurred during the 2008 financial crisis in the U.K. Property prices had, till now, been steadily growing since then.

   - As people rebalance their books and divest their real estate holdings, there will be more inventory coming onto the market than has been available in the past six to nine months (given how tight the market became leading up to the referendum). This will soften prices as supply increases but by avoiding being forced sellers, the funds hope to control the level of discounts.

Right now London fund managers are moving substantial funds into other assets as nervous investors in Great Britain are trying to sell real estate holdings. Compounding this, the pound has lost value against the dollar rather quickly. Adding to the pressures, Continental (European) real estate is now becoming a more attractive target investment, and British REITs – another investment sector – continue to suffer from stock prices at significant discounts to net asset value, though this is hardly surprising with so many retail funds invested in REITs and an expected correction in U.K. real estate prices.

So what does the future hold for U.K. real estate assets and U.S. investors?

SHORT-TERM SKITTISHNESS, LONG-TERM GAIN

This volatility creates a favorable environment for U.S. investors with a higher risk tolerance and patience to invest in U.K. real estate. The somewhat knee-jerk reaction in the markets will subside in the shorter term (over the next two years, as the geopolitical challenges are tackled), which could lead to favorable long-term gain for investors in the U.K. real estate sector.

It will take some time to see a change, as real estate assets take time to sell. As the initial panic subsides and markets adjust, investors will have more inventory to pick from at levels that have not been available since 2007.

That said, the overall concern about Brexit's long-term effects are as linked to what will happen in the European Union rather than in just the U.K. Yes, the U.K. has some challenges ahead, but Brexit or no Brexit, London is not leaving its place among the world's financial capitals. Even if the EU must identify a new financial center elsewhere, London is here to stay.

The U.K. also provides a safe political harbor and its strong property laws make real estate a safe investment. It's an investor-friendly market. Buyers of commercial properties, who are seeking preservation of capital, understand that any downturn will be relatively protected; the real estate demand may soften but will not crumble.

AMERICAN INVESTMENT POTENTIAL IS FAVORABLE

In terms of American property investment in the U.K., investors who already own commercial property there are advised to be patient. Selling now is a short-sighted approach. The value of the pound will likely stabilize and then recover against the US dollar and the Euro, and the losses right now are only on paper; once the assets are sold, that loss becomes real.

For American investors who want to get into the U.K. market, the risk aversion created by current events will create favorable property investment opportunities as prices reset. One of the strong benefits of a cheaper currency is better economics for trading partners and a boost in tourism – the UK is on sale for overseas investors.

Look for more inventory to become available as real estate funds sell assets to enable them to lift trading suspensions; there will be near-term opportunities to buy from those whose positions require them to sell in a depressed market.

Overall, the issues caused by Brexit may prove to be more geopolitical than long-term economic. In time, the currency should recover, trade agreements will be worked out, and markets will achieve greater balance, including real estate. In the meantime, now is the time to take well-informed, considered decisions. In a cyclical industry, a correction in prices was bound to happen. Hold your nerve and there should be value to be found in these untested waters as the U.K. grapples with its post Brexit solutions.

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