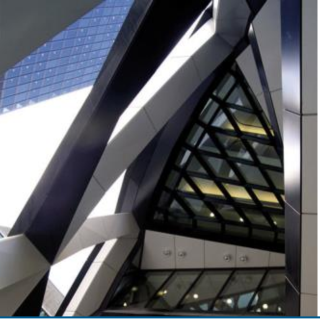

REAL ESTATE REPORT

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Real estate markets after the Brexit vote

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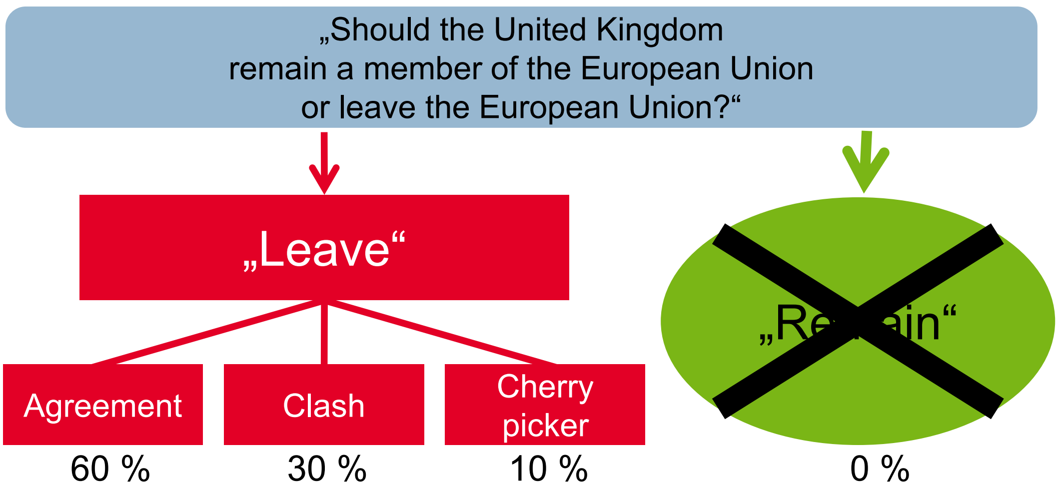
The British people have voted to leave the European Union. Following the vote, the government must still file the official request with the EU. After that the negotiation phase begins, which can last up to two years. Depending on the outcome of the talks, the effects on the British real estate market could be more or less severe. Other real estate markets, however, for example the Frankfurt office market, could benefit from Brexit.

1 Three Brexit scenarios

With respect to the coming exit of the United Kingdom from the European Union, we continue to differentiate three scenarios,[1] which will have repercussions of different severity on the real estate market. What is certain is that after the vote in favour of leaving the EU, the phase of uncertainty has been substantially extended – the timetable calls for a period of negotiations that could take up to two years. If it ends with a compromise (60 % likelihood), the negative effects for the British economy would be largely contained. However, the expected downturn in the British real estate investment market should be stronger than it would have been without Brexit. Residential and retail market properties would probably be less severely affected. Companies, especially in the financial sector, would see some restrictions on their access to the EU domestic market, though London would retain its role as a leading financial centre. The strains on the office market, especially in the capital, would thus be contained. We consider it far less likely that London will be able to secure clear advantages in the talks (scenario “Cherry-picking” with a 10 % likelihood) – in this case we would even see positive effects.



Source: Helaba Research

[1] On the Brexit scenarios see the detailed discussion in our publication “UK: To be or not to be in the EU“ of 16 March 2016.

Conflict scenario with substantial repercussions

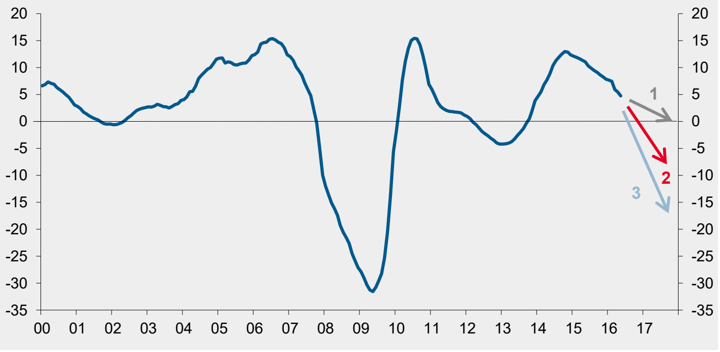
However, if there is no agreement within the stipulated timeframe, the unrestricted access to the EU domestic market would be lost. London as the headquarters of numerous non-European companies that access the European market from there would be affected by many moves to the continent – with clearly negative effects for the office market. A substantial portion of the financial business would also leave for other financial centres and provide impulses to the office markets there. The considerable losses in British exports and investment that would be expected under this scenario (30 % likelihood) would lead to pronounced losses in growth. In this case, the other real estate segments in addition to the office market would be affected by the slump.

2 Downturn in the British investment market

The British real estate market is comparatively far advanced in its cycle, and a weakening in the investment market was already apparent before the referendum. The extended phase of uncertainty during the negotiations will weigh further on the real estate market and will presumably intensify the downtrend. Many international investors will examine their exposure to the United Kingdom. Those who experienced an appreciation of 20 % and more in this market over the past few years could now try and take their profits.

Downturn even without Brexit

IPD Property Index UK, capital growth, % yoy



Sources: Datastream, Helaba Research (1)-(3) see text

Decline in real estate values likely

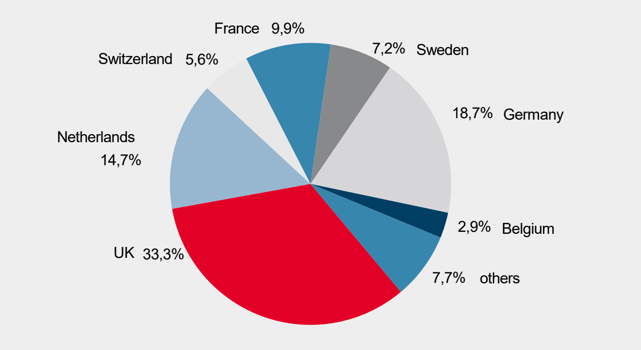
Even without Brexit, market participants were already anticipating a noticeable weakening this year and next. While capital growth for directly held commercial properties in the United Kingdom – as measured by the Property Index of MSCI Real Estate/IPD – still stood at 8 % last year, consensus expectation is that it will decline toward zero by 2017 (see arrow 1 in the chart). Accordingly, we posit a worse development in the compromise scenario: in this case, British real estate values should decline noticeably from their high level (arrow 2), but not suffer a crash. We see much more pronounced declines in real estate prices in the conflict scenario (arrow 3).

Slump in British real estate stocks

The strong reaction of British real estate stocks already indicates that the coming Brexit is not a “non-event” for the real estate market. For example, the national real estate stock index of FTSE EPRA NAREIT lost around 28 % in the first two trading days after the vote (a much sharper downturn than the UK stock market as a whole), while the corresponding index for real estate equities from the euro zone lost only 5 % (and thus less than the stock market as a whole). And one should bear in mind that British real estate stocks were already showing a clear underperformance compared to those in other European countries in the period leading up to the referendum. However, the UK is still the dominant real estate market within Europe, with a country weight of about one third (see chart below).

UK dominates European real estate equity market

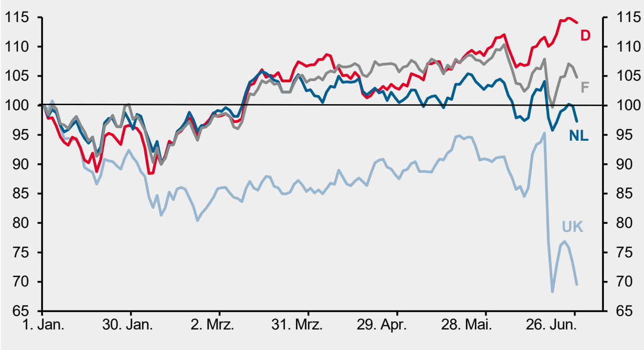
Country weights FTSE EPRA/NAREIT Developed Europe index*, %



* free float market capitalization, as of 29 February 2016
Sources: EPRA Statistical Bulletin, Helaba /Research

Sell-off of British real estate stocks

FTSE EPRA/NAREIT real estate equity indices, total return, 1 Jan. 2016 = 100



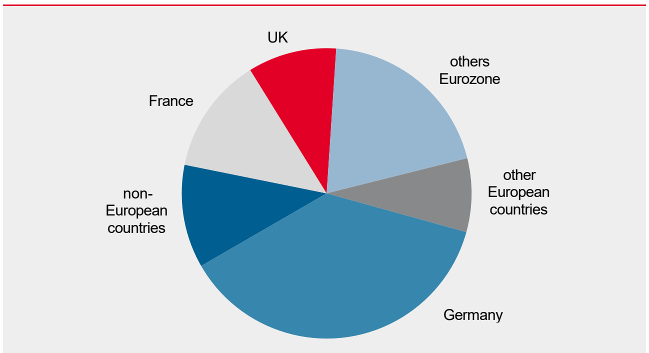
Sources: Datastream, Helaba Research latest 5 July 2016

London remains an important investment market

Brexit will not throw the importance of the British real estate market fundamentally in question. Even after an exit from the EU, the UK, with its dominant metropolis of London, will remain – ahead of Germany – the leading, most liquid, and most transparent real estate investment market in Europe. On the one hand, the sustained uncertainty could cause real estate investors to hold back in the UK and reduce their portfolio share of British real estate, at least temporarily. Other real estate markets, especially stable ones like Germany, could benefit from this investment demand. Still, the UK continues to belong into every regionally diversified international real estate portfolio. On the other hand, with lower real estate prices and against the backdrop of a favourable pound exchange rate, investors could soon become interested in a new engagement in the British real estate market – preferably in segments that will be less strongly affected by Brexit (such as retail and housing instead of offices). After a brief decline, the transaction volume could therefore pick up again. Repercussions should become apparent for the London office market already in the beginning of the uncertainty phase. Most recently, rental agreements often came with a Brexit clause and could now be cancelled, and the recent surge in office rents could come to an end. More pronounced effects could occur with new construction activity if a number of planned projects are postponed.

Important target market for German open-ended real estate funds

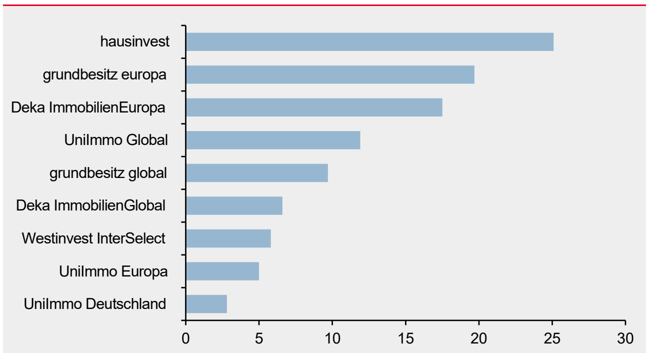
Regional distribution according to market value, %, end of 2015



Sources: BVI, Helaba Research

UK share in German open-ended real estate funds

Share of British real estate of market value, %



* most recent available figures (March-June 2016)
Sources: factsheets/reports, Helaba Research

For German private investors who hold shares in open-ended real estate funds, the negative repercussions of Brexit on their investment should be limited. In addition to changes in the value of British real estate, the sizeable depreciation of the pound plays a role here. At least the rental incomes in foreign currencies are usually hedged, which means that no disadvantages arise here for investors. According to information from the industry association BVI, the share of British real estate in the market value of open-ended real estate funds at the end of last year averaged around 10 %. After France (13 %), the UK was thus the second-most important foreign market (share of Germany: more than 37 %). Looking at the individual funds of the four largest providers, the share of British real estate fluctuates between around 3 % and 25 % (see chart above right). The expected negative effect of Brexit on British real estate will presumably be offset by positive effects in other real estate markets. This means that the total effect on an internationally diversified real estate portfolio can be minor if the two effects largely compensate each other.

3 Frankfurt office market – the big beneficiary?

Shift in jobs – but when and how many?

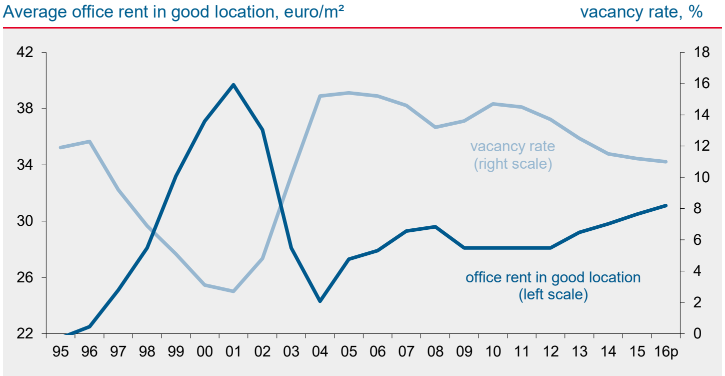
Of particular interest from a German perspective are the effects of the UK's exit on the leading financial centre in continental Europe, Frankfurt – and there especially the office market. That London will lose jobs in the financial sector due to Brexit is hardly questioned. However, it is still unclear how many jobs will be lost and how quickly. The process of shifting banking jobs will not happen overnight, but will presumably extend over several years and really pick up speed only when the result of the negotiations between the UK and the EU becomes clear.

Accordingly, no hasty assessments of how many jobs will eventually shift from London to Frankfurt are called for. However, a meaningful starting point can be the comparative sizes of London and Frankfurt. Thus, even a modest loss of jobs in London could result in a considerable employment gain percentage-wise in the much smaller Frankfurt and provide robust impulses to the office market there.

From London to Frankfurt: one example in numbers

Here is a sample calculation: London has around 400,000 people who work in the entire financial sector in the broadest sense (banking sector alone: around 144,000). A modest loss of 5 % would thus affect about 20,000 jobs. In what continues to be a difficult environment for banks, some would presumably disappear altogether (assumption: 20 %). Of the jobs that will be moved out, many, but by no means all, should land in Frankfurt. Other European financial centres like Paris or Dublin will get a "share of the pie" – in fact, one cannot completely rule out that various banks will move jobs to Asia. Since Frankfurt is well-positioned in the competition among the financial centres[2], it might be able to attract half of the affected jobs (in this sample calculation: 8,000). This would substantially boost banking employment in the leading financial centre of continental Europe. Even taking into account the moderate decline in the employment trend that we posited without Brexit, this would still lead to a plus on the order of 10 % in the Frankfurt office towers.

Frankfurt office market: good starting position for Brexit



Sources: Feri, Helaba Research

No extreme shortages of office space to be expected

In recent years, the vacancy rate in the Frankfurt office market was reduced noticeably from nearly 15 % to around 11 %. There are thus still some space reserves for an upturn in demand resulting from the Brexit. Nevertheless, some of the current vacancies presumably do not meet the needs of bankers coming from London in terms of quality and location. However, with a shift in jobs to Frankfurt that will presumably get under way only gradually, there are good opportunities to modernize some of these available spaces. One should also bear in mind that the per-capita spaces in

[2] On this see in detail our special publication: "Financial centre of Frankfurt: Making further headway", June 2016

London are traditionally much lower than in Frankfurt, and that one can posit a more efficient use of space also here after a move. Together with the expected completions in the coming years, we do not expect an extreme shortage in the Frankfurt office market. However, the vacancy rate will continue to shrink substantially and the trend in rents will be far more positive than it would have been without the Brexit effect. ■