AREF

The Association of Real Estate Funds

Great Brexpectations?

Opportunities and threats for real estate funds

A paper by The Association of Real Estate Funds

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Welcome
Deborah Lloyd
Chairman, The Association of Real Estate Funds

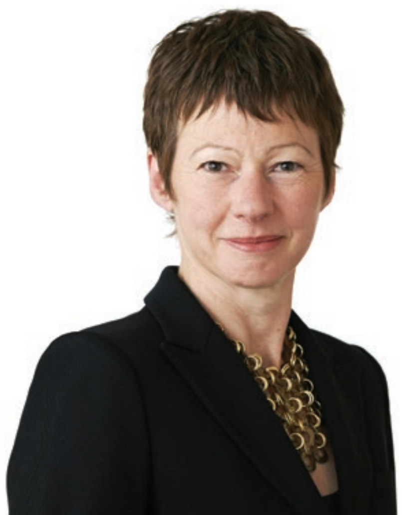
With Brexit just months away, we still have no certainty on what this means for the investment funds industry.

At The Association of Real Estate Funds we asked a selected group of experienced individuals, all grappling with different Brexit issues, for their views on the implications, opportunities and threats.

The responses we received were surprisingly diverse, as organisations hope for a soft Brexit and plan for a hard Brexit.

For an international institution such as Aberdeen Standard Investments, Brexit is about ensuring that activities and services received by clients remain uninterrupted

In fund administration, Vistra offers a prime example of how fund providers are reacting to those operational challenges.



For those with more of a UK focus, such as OLIM and the UK arm of CBRE, it necessitates taking risk off the table.

And for others, notably Toscafunds, Brexit is a chance to strengthen ties with China.

Such breadth of opinion reflects the broader Brexit conversation. But this report also confirms real unity in that real estate remains an asset class of choice. And, at AREF, we see that unity in action as we represent real estate in the debate.

The future of passporting products has been a major concern. So, we are fortunate that Mark Hoban, former Financial Secretary and now chair of the International Regulatory Strategy Group, has voiced his opinion on this crucial matter. The work of the group he chairs is vital to future free trade with EU clients and counterparties.

I would like to thank Vistra UK for sponsoring this report and all contributors for sharing their thoughts. AREF remains committed to bringing fund management groups, their advisers and investors together – so that everyone benefits from new ideas, information and best practice across every aspect of real estate fund investment.

We hope you find the report useful – whether opportunity or threat, it seems clear the industry has Great Brexpectations!

Michael Sheahan
Real Estate Operations Executive, Vistra UK

We see considerable opportunities though not without risk over the next few years.

The opportunities are found in questions of domicile, as fund groups prepare for the consequences of Brexit in the absence of certainty.

We are seeing clients build out their platforms quite substantially in Luxembourg and Dublin.

Our expectation is that the alternatives sector will continue growing significantly there and we are investing heavily in those elements of the business as a result: alternative fund administration, corporate, trust and fiduciary services.

Access to EU markets for non-EU managers is a core problem faced by a significant proportion of our clients and we support them through our third party AIFM offering.

At the same time we are seeing an increase in UK-focused investment products being established in the UK, in a direct response to Brexit. We are monitoring this trend and developing our business to support clients.

Overall, Brexit is encouraging further development of sector expertise in appropriate jurisdictions as functions and operations are expanded in these locations – our role is to support these changes.

The foreseeable risks lie around the AIFMD regime and passporting.

The overriding complication for the sector is the impact Brexit has on the AIFMD regime.

> “There are huge opportunities for the alternatives sector in Luxembourg and Ireland

There is a significant risk of a period of disruption and adjustment for our clients as a new model is developed and implemented for the UK.

The optimum Brexit outcome for the real estate fund industry would be retention of UK membership of the European Economic Area, allowing retention of passporting rights, though this seems off the table. The next best thing would be a UK-specific arrangement that achieved the same outcome. If that weren't to occur the UK would need to access passporting rights as a "third country".

It would be reasonable to expect a pragmatic solution, that gives AIFMD passporting rights to the UK, but there may be a period of disruption before this can be secured.

Like many people, I do worry about the overall impact of Brexit on real estate investment market performance in particular and on the economy more broadly.

But, as a global provider of services to real estate funds, Brexit will likely have only a small impact on us. We are using that stability, strength and scale to help clients navigate towards the opportunities.

Lord Oakeshott of Seagrove Bay
Co-Founder and Chairman, OLIM Property

The UK political situation is one of paralysis.

With nothing happening we have no sense of certainty about one of the biggest questions of our time.

That uncertainty is leading to greater costs as companies have to plan for every contingency.

I have sat in the House of Lords while amendment after amendment has been sent back to the House of Commons – and that puts the Government in a very tricky situation.

So at the time of writing, I would expect the odds to be about 40% chance of a soft Brexit, about a 40% chance of a much harder exit and a 20% chance of the UK not leaving the EU at all.

This need not be problematic for any real estate investors focused solely on the UK. My suggestion would be to look at defensive assets that can cushion any negative economic situation. This is exactly what we have been doing, starting the moment the referendum result come in.

We have weighted our portfolio towards safer, longer dated and inflation linked assets.

We have also extended lease lengths.

We are convinced that some of the riskier parts of the market are far worse than they look.

Two things worry us in particular: reduced consumer confidence and tenant hedging their bets on London offices.

> “What worries us more than Brexit is a hard left government

A weaker pound and a savage squeeze on real incomes have battered consumer confidence. We are seeing retail, restaurants and to a lesser extent, pubs suffering and we should expect that to continue, reflected in both yields and valuations.

It is also clear that the London office market is being artificially supported by large, blue-chip firms hedging their bets, until there is more clarity about the outcome of Brexit negotiations. WeWork and other serviced office operators are taking most of the new office space in London.

The moment we get shafts of sunlight through the Brexit clouds, many of the big firms will take those hedges off the table and make material decisions. That could mean some nasty shocks in London offices.

We are well positioned for these and other foreseeable Brexit eventualities.

But what worries us more is the possibility of a Hard Left, Corbyn/McDonnell government.

This would put a significant brake on continued investment from China and other international investors. Real estate benefits from such diversity of asset ownership and it would be hugely problematic if it were to be lost.

Dr. Savvas Savouri
Partner and Chief Economist, Toscafunds

> It would be foolhardy to expect anything other than a soft exit

The descriptions of the economy I hear every day are just not what we see at all.

All this negative talk belies the facts. And the economic facts are undeniable.

If you think the UK is heading for a hard exit from the EU you would sell the FTSE250, the IBEX and a raft of equities and sovereign bonds across the EU. But investors are not doing that, nor are they making any of the other obvious calls in material numbers.

We have seen some panic selling in real estate. This has been very helpful for our strategy because we picked up quality assets at almost fire sale prices. Our real estate exposure went up to £750 million and we want more.

You see signs pointing towards a soft landing everywhere.

EU firms and governments have such significant interests in the UK. Look at British transport infrastructure. You will see Deutsche Bahn owning several UK train and bus franchises, through Arriva, and enterprises run by the Italian, French and Dutch governments own other train and bus lines.

French institutions want UK shopping centres. Look at how Spain benefits from British tourism. Look at the many deep commercial links between Britain and the Republic of Ireland.

In fact just about the only EU government that doesn't have hugely profitable ties with the UK economy is the Grand Duchy of Luxembourg. And this is a very significant thing for real estate investment, as they seek to draw business from the UK.

So I think it foolhardy to expect anything other than a soft exit.

I would go as far as saying any talk of a hard exit also eclipses the conversation everyone should be having, which is how to engage more effectively with China.

China has no investment banks in the UK at the moment. We should be talking about how to attract those banks and trade with the wider Chinese economy.

China has been in the World Trade Organisation since 2001 and, as the UK transitions to his arrangement, we need to think about how Chinese investment can benefit the UK real estate market and UK real estate funds.

I would urge people to stop their petty obsession with a failing EU economy, obsessing about Slovenia and Malta. They should stop wasting time and money on outcomes that have no chance of happening, like the end of product passporting, and start thinking bigger. Start thinking China.

We are.

Alex Bignell
Head of UK, CBRE Global Investors

> Take industrials out of the equation and UK real estate performance looks very different indeed

In terms of preparing our management structures, our base case for preparation is a hard Brexit.

This is in no way an attractive proposition but we are preparing for it, as cost-effectively as possible.

With regards to the Brexit outcome itself, there is no reason why a pragmatic government cannot achieve a pragmatic solution, with an agreement on pass-porting and delegation that poses a minimum of disruption to market participants. There is an incentive on both sides of the Brexit negotiations to reach an agreement.

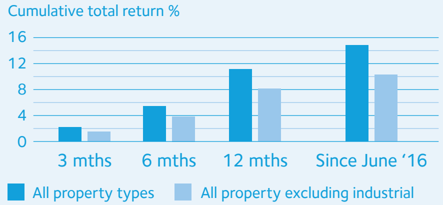
However, in terms of market performance there is a risk that rising uncertainty as matters remain unresolved could translate into a shock. This could lead to a repeat of the knee jerk reaction that followed the referendum result itself, with a fall in capital values seen in a short period.

Markets are challenging at the moment. Whether this is down to Brexit is open to question. It seems clear that many structural issues were there already – but Brexit has exacerbated them.

The economy is slowing and we were reaching late cycle. Where Brexit has had an accelerated impact is on consumer spending, which is down.

We all know how this has affected retail, which remains weak. I suspect the data does not fully reflect market fundamentals – a few deals may be all that is needed to mark valuations down across the retail sector. Higher quality shopping centres should hold up relatively better, and you can see tenant demand here; but you could not say the same about other parts of the retail sector including retail warehousing where conditions are polarized.

UK property market returns



Source: CBRE Global Investors. Data as at April 2018

I see this as potentially hugely problematic and it would be very reasonable to expect more voids here as time goes on and declining rents as it will be hard to backfill vacated space.

If you think about the extraordinary performance of industrials, this has buoyed real estate performance as a whole. But take industrials out of the equation and the market picture looks very different indeed. I expect further slowing in the overall UK property market.

There will be opportunities eventually. But for now, real estate asset owners will be relatively better positioned through Brexit if they are positioned defensively with prime assets and longer leases.

Victoria Brown
Head of Regional Management, EMEA Aberdeen Standard Investments

The overriding thing for us with Brexit is to ensure that the activities and services received by our clients remain uninterrupted.

This means access to products, client service and investment professionals.

Our many real estate investment professionals will see opportunities and threats in their portfolios as Britain moves towards the exit but our current focus is how we operate in Europe post 29 March 2019.

This means we are doing our utmost to ensure we retain the ability to sell our products into the EU and service our clients without undue impediment.

As you might expect, our base case is a hard Brexit and we expect to be ready well in advance of the March 2019 exit date, irrespective of transition agreements.

The most likely outcome appears to be third country status for the UK – which would put us on a par with US and Asian institutions doing business in the EU.

We engage regularly with our regulators within Europe, and they have been clear with us on their expectations around delegation and substance.

With respect to substance, this is not merely about numbers of people. It involves detailed agreement on leadership, governance, control and oversight.

> “Our focus is to ensure we can operate regardless of the outcome, and service our European business

We have long had a material presence in Luxembourg with the right levels of seniority and staffing levels. We are looking to establish a new MiFID entity in Dublin and are staffing that entity as appropriate which expands our current footprint in Dublin.

We do not expect to have to move portfolio managers into new jurisdictions as a result of Brexit. That desire for continuity for our clients forms a very strong part of our approach to the issue.

We are doing all of this in the most cost-effective manner possible. We do not want any clients to experience noticeable changes in the way their money is managed.

Mark Hoban
Chair, International Regulatory Strategy Group
Chair, Flood Re

It has been to the advantage of businesses across the EU that London has become Europe’s financial centre.

Access to London’s deep pools of liquidity, capital flows, innovation and expertise has driven down costs and improved choice for business.

This is underpinned by the ability to trade freely across borders within the EU – the so-called passport. Once we leave the EU, the passport will no longer be available to businesses in the EU trading into Britain and vice versa.

The IRSG has proposed a new model for cross-border trade that seeks to maintain similar levels of access to those that businesses enjoy now. That model guarantees access on the basis of the mutual recognition of each other’s regulatory regimes where the detail of regulation can diverge over time but deliver the same regulatory outcomes. Where that divergence is material and puts the achievement of the regulatory objectives at risk, then access could denied.

There is work to do: the EU’s current position is that the UK should be a third country, with an end to passporting, and this would reduce significantly the scope of services that could be traded cross-border.

But we are helping them understand the damage this would do to both institutions and consumers. Without it, we would see banks and others reconsidering their business models, perhaps even relocating to regions outside of the EU altogether.

> “Our proposal is a replacement for passporting that offers continuation and certainty

Moreover, consumers should expect to pay a much higher price for the same financial products and services they enjoy now. Such a situation benefits no one in the UK or EU.

There is broad and strong support for our approach from the financial services industry.

That support extends right up to Prime Minister Theresa May, given her commitment to a free trade agreement in the March 2018 Mansion House speech.

Whatever outcome the Prime Minister and her team achieve in the Brexit negotiations, the UK will continue to be the world’s leading financial centre. We hope that the EU will decide that it wants to maintain cross-border trade with the UK and continue to benefit from the advantages that brings.

AREF
The Association of Real Estate Funds

www.aref.org.uk

We represent the real estate funds industry.

Our work focuses on four mutually supporting areas:

1. The Code of Practice. AREF has a unique code of practice, that is widely recognised as the gold standard in corporate governance. With investors in real estate funds increasingly looking at governance, as well as environmental and social issues, membership of AREF enables a fund to use the code as a quality mark.
2. The Forum. AREF brings together stakeholders from across the real estate investment spectrum to discuss and debate topical issues, to learn and to network. We seek to bring the industry together to help influence its evolution, for the benefit of both the practitioners working in the industry and the investors in the funds.
3. The Lobby. With over 60 fund members, representing around £60bn AUM and nearly as many affiliate members, advisers and services providers for our fund members, AREF acts as the collective voice of the real estate industry.
4. The index. The majority of AREF's member funds choose to have their performance measured using the leading NAV-level AREF/IPD UK Quarterly Property Fund Index, allowing investors to compare the fund performance to appropriate alternative funds, either individually or at an aggregated level.

VISTRA

www.vistra.com

Ranked among the top three corporate service providers globally, Vistra is a versatile group of professionals, providing a uniquely broad range of services and solutions.

Our capabilities span across international incorporations to trust, fiduciary, private client services, and fund administration. We operate across 46 jurisdictions in over 80 cities throughout the Americas, Europe, Middle East, and Asia Pacific, employing over 4,000 professionals.

As a leading global player with expert industry knowledge and location specialists, Vistra has a deep understanding of the professional worlds of our clients, and a proven track record of offering highly versatile solutions, providing the people, processes, and products that help our clients get the most from their international business.

Great Brexpectations? was created by David Butcher, Communications and Content

David is founder and director of Communications and Content, a consultancy that specialises in differentiating its investment and financial clients.

www.communicationsandcontent.com

AREF
The Association of Real Estate Funds

If you would like to know more about our work on Brexit and other issues, attend an event or enquire about membership please get in touch:

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