Fundamental factors underpin the London commercial property market

The UK's decision to leave the European Union (EU) took many by surprise and, when coupled with the uncertainties surrounding the formation of the new British government, it led to short-term uncertainty and volatility in financial markets.

As the dust settles from the 23 June referendum result (universally known as 'Brexit'), Raed Hanna, Managing Director of the London-based property finance boutique Mutual Finance, considers whether London will be able to retain its place as the most attractive real estate market in Europe as the UK prepares to leave the EU.

London has always been one of the most diverse and culturally exciting cities in the world and a hugely popular destination for commercial real estate investment from the Middle East, and indeed the rest of the world. The immediate shock waves from the Brexit vote did of course have an impact on some property deals that were being structured or marketed at the end of June, but the property market is used to coping with political changes and world events and we saw that the market quickly digested the unexpected referendum result and, to a large extent, regained its poise over the summer.

Following the referendum result, there are some concerns that the property market could cool, but the situation is very different from 2008.

During the financial crisis of 2008, we saw a sharp drop in the value of office and commercial property funds and this led to big capital losses for investors.

Today, bank lending leverage is much lower than the 80%+ levels that we have witnessed in recent years – leverage of 60% or less is now much more common. As a result, if there is a sustained slowdown in economic activity, borrowers will not have huge bank loans to repay as they did in 2008 and the years that followed.

We should also remember that the London market was already starting to cool during the first half of 2016 and that activity levels always fall during the summer months. Looking beyond the two or three weeks that followed the referendum vote on 23 June, it is difficult to tell just how much of a fundamental difference Brexit is making.

Although the Brexit vote may depress the way in which investors feel about UK commercial and residential property prices, particularly in London, we at Mutual Finance are not

expecting rental incomes to fall. The main reason for this is that there is no supply 'overhang' except perhaps in certain areas of prime residential property.

Looking beyond the UK, London still retains many advantages for investors, and we expect that there are many reasons why London will retain its favoured position in the commercial property market, even as the UK negotiates its withdrawal from the European Union.

For example, London is an accessible market with very few barriers to entry and investment. In contrast, Switzerland, which is often seen as a safe haven for investors, strictly regulates the acquisition of real estate by non-residents. The Lex Koller requires 'persons abroad' to obtain a permit from the appropriate cantonal and federal authorities before buying real estate in Switzerland.

The Swiss authorities also limit the number of properties that are open to investment from non-residents. The number varies from year to year but, whatever that number may be at any given time, it is acting to inhibit non-residents investing in Swiss real estate.

Leasing regulations is another area where London has an advantage over many other international cities. The Fully Repairing and Insuring (FRI) lease, which is standard in the London commercial property market, places the obligation for managing and maintaining a building firmly on the tenant, with all the tenant's responsibilities clearly stated. The leases normally run for periods from five to 25 years, with the timing of rent reviews agreed at the outset. Leases often have provisions for fixed raises in rents and there is always the option to review the rents against open market values. Even when reviewed against the market, rents are subject to upward-only revisions.

The UK's Landlord and Tenant Act governs the terms and implementation of these leases, but landlords have an option to opt out, effectively rendering the leases 'outside the act' and giving landlords even greater flexibility.

Compare this against the commercial real estate market in Paris.

Commercial real estate leases in Paris are highly regulated and to a large extent follow a standard format prescribed in French law. Usually, commercial leases have a nine-year term which is fixed – much shorter than many of the leases in London. Furthermore, these leases have 'break clauses' at the end of every three years (after three years, six years and at the end of the full nine years).

Mutual Finance

Founded by Raed Hanna, Mutual Finance is a progressive and innovative financial intermediary specialised in structuring and raising leveraged debt for real estate development. Based in London's Mayfair district, the firm is one of the UK's largest financial intermediaries financing more than £750 million of asset-backed and real estate transactions during 2015.

Raed Hanna, Managing Director, Mutual Finance

"The structural factors underpinning the London market – laws, typical leasing structures, acceptability of different types of property assets – will continue to give it an advantage, over the long term, against other European cities."

Sitting tenants have a statutory right to renew, with the result that it can be hard to get vacant possession of a building, and this in turn hampers opportunities for redevelopment and innovative asset management.

Finally, the termination of the lease is subject to very unfavourable (for the landlord) procedural requirements, and if the landlord does not comply with these, he can be subjected to harsh penalties.

The German real estate market also has hurdles for investors and landlords. Leasing contracts typically do not impose undue burdens on landlords, but there are no guaranteed rent reviews and with short- to medium-term lease commitments landlords are working in an environment of considerable uncertainty.

Constraints on commercial finance in Germany also arise from the banking system. Much of German commercial property is financed through the Pfandbrief (covered bond) market, which is highly developed and mature, but which also has its own ideas on what constitutes appropriate leverage. As a result, loan to value ratios greater than 55–60% are unusual, and therefore more difficult to finance. Lower leverage levels such as these often restrict the return that can be earned on capital.

Some asset classes do not qualify for Pfandbrief financing with the result that alternative lenders have to step in to provide finance. In contrast, the London market takes a far more open and flexible approach to asset finance.

Looking further south across Europe to the Mediterranean region, we see continuing economic uncertainty. For example, in Spain – historically one of Europe's better performing economies – commercial property prices continue to be 30% below their peak in 2008. Such large discounts may offer buying opportunities, but they also highlight the huge volatility in prices that characterises many southern European markets.

The structural factors underpinning the London market – laws, typical leasing structures, acceptability of different types of property assets – will continue to give it an advantage, over the long term, against other European cities.

Furthermore, the City of London has always been able to provide the expertise and the financing needed to structure and execute large property transactions. Most European and US banks have lending platforms in London through local subsidiaries or branches. Developers and investors are used to sophisticated debt tranching through the capital stack, making the structuring of leveraged transactions much easier.

In the short term, uncertainty about the effects of Brexit are being balanced by developments in the monetary environment that are enhancing the attractiveness of London to investors.

The Bank of England's decision in early August to cut interest rates to 0.25% drew five-year swap rates down to 0.45% (plus credit spread and lending margin) making borrowing cheaper than it has been for many years. Furthermore, currency exchange rate changes since the Brexit vote have made London even more inviting for foreign investors.

"Leasing regulations is an area where London has an advantage over many other international cities."

We have seen several commercial property transactions agreed since the end of June. For example, investors from the Middle East have exchanged contracts to purchase 5 King William Street in the City of London. This is the UK headquarters of the Japanese investment bank Daiwa. It was purchased for about £90mn to generate a yield of about 3.6%. An investor from Singapore has made an offer for 160 Aldersgate Street, again in the City of London, for £175mn, to yield a little below 5%. These are the new offices of law firm DLA Piper.

So the overall picture that we are seeing is one of resilience to the Brexit decision. A few deals have been delayed, but deals are still being done, and there is no shortage of investors looking to take advantage of the underlying structural strengths of the UK property market – strengths that will be undiminished by Britain's departure from the European Union. ■

ABOVE: 5 King William Street, in the City of London, which was recently bought by Middle Eastern investors for about £90mn. LEFT: 160 Aldersgate Street, in the City of London, which was recently bought by an investor from Singapore, for £175mn.