Unpredictable Brexit outcome increases UK CRE credit risk

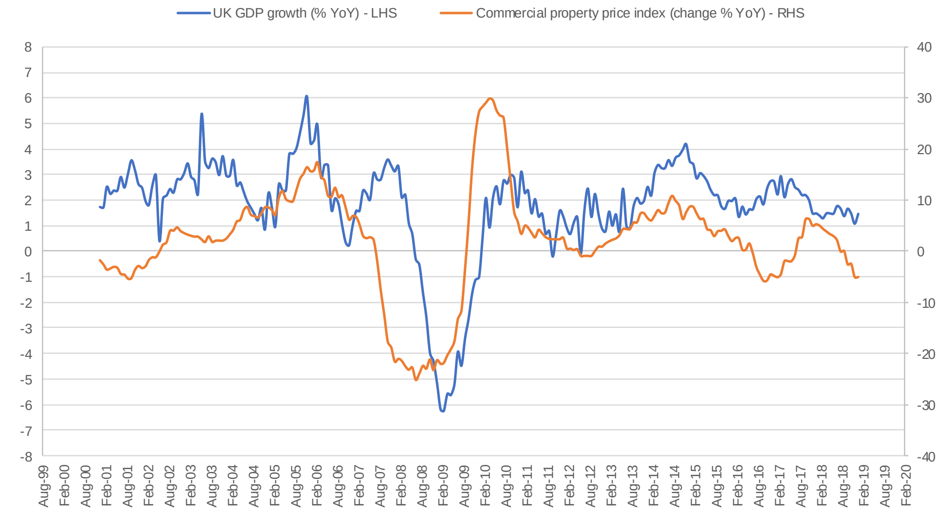
The combination of negative economic impacts from Brexit and a higher tax burden for foreign commercial real estate investors from April 2019 has adverse implications on the demand and affordability of UK commercial property. This increases the credit risk of CRE financing.

Credit instruments financing UK CRE will suffer from i) the adverse impacts of a slowing UK economy on default rates by tenants and ii) a decline in property values. The latter point increases the likelihood of value covenant breaches in loan contracts, limits refinancing opportunities and reduces CRE property liquidation proceeds upon enforcement. A new capital gains and rental income tax regime – effective in two steps: April 2019 and April 2020 – will add to declining demand.

Commercial real estate values are reacting negatively to increasing chances of a "no-deal" Brexit, even if this is not a central scenario for Scope. The Brexit process and uncertainties associated with inconclusive negotiations have negatively impacted demand for commercial real estate, in particular retail and office properties. Fading consumer confidence and weaker economic growth will impair the business models of tenants, which will further reduce demand for property (see Brexit-hit investment, weak exports and consumer spending show growing impact on UK economy).

The new tax laws remove the capital gains tax-exempt status of some non-resident investors and put rental income profits under the UK corporate tax code. The tax affects all types of real estate including residential real estate investments. Affected investors include foreign tax-efficient investment vehicles and non-authorised funds. While the impact for foreign institutional investors will likely be limited to the restructuring costs of their investment vehicles, other non-UK-resident investors could see a significant impact on their internal rates of return.

Figure 1: UK real growth versus YoY change in commercial property prices



Source: Office for National Statistics, Savills UK and Scope Ratings GmbH

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A weaker UK economy increases the risk of CRE financings

Lower CRE values and decreasing affordability increase the risk of covenant breaches

Scope expects a further decline in CRE prices in 2019, which may result in increasing CRE loan defaults and lower liquidation proceeds upon enforcement. Scope anticipates, however, that creditors will seek to restructure or refinance distressed loans to limit the damage of foreclosure in a soft market and maintain their business relationships.

Figure 1 shows that UK GDP and UK CRE property prices are highly correlated. Economic conditions are a significant determinant of UK commercial property prices, as a driver of demand and affordability. CRE property prices have declined 5% since Q1 2018 to-date. The resilience that CRE property prices exhibited through Q1 2018 was likely supported by the 8% nominal effective depreciation in sterling from 2016. This made UK investments more affordable for overseas investors and helped local businesses by boosting UK export growth. Scope expects this to be a temporary benefit, however, and one that that is fading as sterling has seen recent strengthening.

Scope sees a further slow-down in the UK economy in 2019. Over the longer term, domestic growth will continue to be dampened by Brexit-related economic uncertainty – with Scope projecting the UK's medium-run potential growth rate at 1.5%. The office market in London will be especially challenged by excess vacancies as a significant share of the financial services sector relocates to continental Europe or Ireland. According to EY, about USD 1trn in balance-sheet assets and more than 7,000 jobs will be relocated out of the UK due to Brexit[1]. As business investment fell 0.9% in 2018, Scope anticipates new investment in 2019 will remain limited in London in particular and in the UK more broadly.

Scope expects further economic slowdown in 2019

It is not only the financial services sector that will lower its CRE demand. Scope expects an overall economy-wide slow-down cutting the 2019 GDP growth expectation for the UK to 1%, from 1.5% previously and compared to 1.4% growth in 2018. This will have a direct and indirect effect on CRE prices. While general demand from corporates will be lower, affordability will also decline, as the weaker economy challenges the business models of tenants. In particular retail tenants are suffering under low consumer confidence but they are also facing the disruptive effects of e-commerce competition[2]. Prices may also come under further pressure as the relocation scenario provides current tenants with strong grounds to renegotiate rental terms in their favour.

CRE sub-sectors Scope expects to benefit from Brexit over the short-term are regional offices and industrial properties. With Brexit, manufacturing companies especially with only regional reach and generally located outside the larger cities, are more protected and expected to get stronger. This reflects positively on the demand and affordability of CRE properties in rural areas. Scope expects growing demand for domestic products, driven by increasing prices of foreign products as a consequence of Brexit-induced tariffs.

Additional stress from tax regime change

New tax regime for foreigners adversely impacts demand

Scope expects the new tax regime applicable to non-resident real estate investors to similarly have a negative impact on UK CRE prices, adding to the stress caused by Brexit. While the target is to harmonise tax codes, the measures effectively force money out. The new tax measures will make UK CRE investments less attractive to foreign investors, as they either create more costs or an additional tax burden. The UK government expects additional tax revenues of GBP 270m to 2024. This will result in a

[1] https://www.ey.com/uk/en/newsroom/news-releases/19-01-07-ey-financial-services-brexit-tracker-heightened-uncertainty-drives-financial-services-companies-to-move-almost-800-billion-pounds-of-assets-to-europe
[2] E-commerce disruption: Five trends to watch on Europe's high streets after Gerry Weber collapse

revaluation of foreign investors' fund allocations, which Scope expects to have a negative impact on demand for commercial properties through a reduction of the investor base.

Additional taxes reduce CRE attractiveness for investors

The new capital gains and rental income profit taxation rules have a direct impact on the internal rates of return of CRE investments for foreign investors, which would see lower taxation in their countries of residence. Non-UK pension schemes and most institutional investors will be among the tax-exempt investors. However, structures such as special purpose vehicles are generally in the scope of the new tax law. Therefore, even investments of institutional investors can become subject to the new tax or require additional costs for reporting necessary to qualify for tax exemption. The alternative would be to bear the costs for restructurings or unwinding and re-setup.

Regarding future investments, the impact for foreign institutional investors is probably limited. Investor groups such as high-net-worth individuals, family offices and funds that do not qualify as institutional investors will, however, find themselves in an adverse position.

Table 1 provides a brief summary of the changes that will become effective from April 2019.

Table 1. UK capital gains tax and rental income profit tax, current and future policies

Capital gains tax (CGT)	Current situation	Changes from April 2019
CGT on non-residential UK property	Currently not taxed	CGT will apply to gains achieved after April 2019, subject to a rebasing of property values
CGT on shares of UK property holding companies	Currently not taxed	CGT will apply to gains achieved after April 2019, subject to the company deriving at least 75% of its value from UK properties and the foreign investor's equity share exceeding 25%

Rental income profit taxation	Current situation	Changes from April 2020
Rental income profits earned by non-UK resident companies from UK properties	Taxed at 20%	Will become subject to the more complex UK corporate taxation ♦ Max. deductible interest expense @ 30% of EBITDA ♦ Expenses for hybrid financing instruments may not be tax deductible ♦ Limited loss-carry-forward ♦ Additional costs to adhere to quarterly tax payment regime

Source: KPMG and Scope Ratings GmbH

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