Market Overview: Quarter 2, 2019

Welcome to the second edition of our quarterly Market Overview, which aims to provide an 'at a glance' summary of key economic and real estate trends for our clients.

Whilst the ongoing Brexit negotiations have caused some investors to pause and take stock, we are witnessing others 'play the long game' by deploying their capital in the knowledge that long-let assets to good covenants and which demonstrate sound real estate fundamentals will see through any short-term economic and political uncertainty.

As always, all that glitters is not gold, particularly so in the quest for the hallowed 8% annual return.

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WORLD ECONOMY

Global

Early year sell offs in global stock markets led by the S&P 500 (up 13.3%) have rebounded. PMI data is still flattening but positive and the US still looks like the strongest of a weakening group. The Federal Reserve is now expected by the market to not tighten rates until mid-next year at the earliest and there is even talk of a rate cut. The 2yr / 10yr yield in the US curve inverted (very briefly) on 26 March causing general 'headless chicken' panic. The 2/10 curve inversion is seen traditionally as an indication of a recession with a 12-18-month time lag. A recession in 12-18 months is not really a reason to sell everything today, and the fact that Quantitative Easing has been in place for so long around the world also means the bond market no longer acts as the bell-weather it once did, because there is a structurally high demand for bonds not reflective of risk appetite. The continuing US / China trade issues have certainly slowed the two largest economies but there appears little reason to panic quite yet. This is particularly so as they are talking, and committed seemingly to do so, until there is a resolution (however long that may take).

United Kingdom

Brexit is wearing everyone out! Hopefully by the next Market Overview we can talk about something else.

Parliament took control of the process to debate alternative strategies to the exit deal currently on the table from the EU. There were eight options given and none received a majority of votes, demonstrating that Parliament as a whole has no more idea of what to do than the Government. As for GBP, USD is trading in a tight range awaiting an outcome, which is now postponed until at least the middle of April. Theresa May has lost her third attempt to get the EU backed deal through Parliament. Expectations are still that a form of deal is found eventually but the options now look like either a collaborative approach with Labour to agree a middle ground or a long extension to Brexit requiring a complete rethink and potentially a general election. By the time you are reading this Theresa May is odds on to have resigned, leaving a new Conservative PM to negotiate the commercial terms of the relationship post Brexit (assuming we have a Brexit).

Markets would welcome a long delay, keeping in play the potential revocation of Article 50, but if a general election were called (unlikely) and Labour were to win (more unlikely) markets would take a severe downturn given the very left wing, 'business unfriendly policies' that would be likely to come into play.
On the Sukuk side, there are a couple of Commercial Mortgage Backed Securities (CMBS) in the market currently with the AAA being marketed at +90 bp in Europe. The Taurus deal priced inside a week and was well oversubscribed. This has in turn brought in pricing on UK CMBS AAA to around the LIBOR +130bp level, as compared to LIBOR + 150bp at the start of the year indicating positive sentiment for the sector.

Our position remains unchanged - we still like the UK, particularly long income property where solid cashflows can ride out short term volatility. We expect any GBP denominated assets to lose in FX over the next year or two unless Brexit is avoided altogether, but long term we don't see a huge currency impact for investments of 2-3 years and above.

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Illustrative YTD Example of FTSE 100 v S&P 500 (US), Hang Seng (HK) and CAC (France)

Key: FTSE 100, S&P 500, Hang Seng & CAC

Europe

Italy is now officially in recession with Germany not far behind in a technical recession. Europe generally is a huge exporter to China so the trade war has a direct effect on the Eurozone economies. The periphery economies continue to underperform because they don't have an exchange rate with which to inflate their way out of trouble. The only way to address a balance of payments problem if you can't change your interest rate and your currency cannot depreciate to make exports cheaper, is to make the labour force (and general cost of goods sold) cheaper. That is our old friend austerity. But when you've been doing that for nearly ten years it doesn't work anymore.

Longer term, we expect the Euro project to fail. However, that is going to take a long time to play out and, in the meantime, we would look at the Netherlands and Ireland as interesting markets to invest into.

UK REAL ESTATE

We have seen a marked shift in investor sentiment towards the healthcare and hospitality sectors. In this second edition of our quarterly Market Overview, we assess the current opportunities in these sectors.

Healthcare

This broad sector covers various real estate types and uses, principally including elderly care homes, assisted living, specialist supported living, education, medical centres and hospitals. All integral requirements to the well-being of the UK population and are demographic-led key social infrastructure.

Care homes have risen to become a key investment focus with the main issue facing investment into this sector being the lack of investment grade tenants. With super-prime assets trading at 4.0% NIYs, the sector will likely now see further yield compression in secondary, rather than super prime, stock. In this middle ground, assets can be acquired for close to – if not below – the reinstatement value.

The asset class is not without specific risks, which can include: (a) regulatory risk, (b) operational business risks, (c) shortages of trained staff and (d) requirement for on-going capex. However, the asset class is needs driven, unlike most other real estate asset classes, and is further propelled by the demographics of the UK. As such, the demand for healthcare real estate continues to grow.

We see value in assets that require some capex invested to update the asset, such as ensuring care home bedrooms are all single use, with ensuite accessible bathrooms. The yield shift upon modernisation is, for us, a compelling proposition.

Hospitality

The hotels sector traded an impressive £7.4 billion in 2018, representing a 29% increase on the preceding year. As other sectors, such as commercial offices and retail, work through structural shifts in how they are best formatted and operated into the future, hotels are looking more attractive. As 'big data' becomes ever more available, investors are taking comfort from the statistical insights that can be brought to bear in the hotel sector and taking on more exposure.

It is perhaps not surprising that overseas investors, who can take an objective view on 'Destination UK', have invested the most over 2018. Asset allocators are increasingly seeing value in the alternatives space, with hotels being a reliable component. With strong growth in the price per key across the regions in 2018, we expect more to follow in 2019.

Notably, it was the regional cities of Edinburgh, Manchester, Glasgow and Liverpool that recorded the greatest price rises on a per key basis. London, a victim of its own success, slid back slightly by 13% in 2018.

The question for investors is to which income format they are drawn: franchised, managed, vacant, ground lease, or a variable lease. For larger investors, launching their own hotel operating platform may be the logical next step. For others, it is the expertise and branding of others that draws them to the sector in the first place.

The Middle East has been a significant force within hotel investments in the UK, making up 14% of the total investments in 2018. Transactions of note included acquisitions of The Caledonian Waldorf Astoria in Edinburgh, Grosvenor House in Mayfair and Travelodge at Heathrow Terminal 5. If our investor conversations are anything to go by, the GCC region's investment appetite for the hotel sector is far from sated.

LEGAL UPDATE

On 20 February, it was ruled in the case of Canary Wharf v European Medicines Agency that Brexit couldn't be used to 'frustrate' the European Medicines Agency's (the EMA's) lease of its office headquarters in Canary Wharf.

As an EU agency, the EMA was required to relocate its headquarters to Amsterdam following the UK's decision to leave the EU given that, had Brexit not been delayed, the UK would cease to have been an EU Member State after 29 March. The EMA argued that its lease should be treated as being 'frustrated' because (a) it lacked the legal capacity to use or profitably make use of the premises, and (b) the purpose of the lease, to provide headquarters for the EMA, was no longer viable, rendering it "radically different" from what was originally agreed. The landlord, Canary Wharf, sought a declaration that the EMA's relocation of its offices to Amsterdam and/or Brexit could not cause the lease to be frustrated.

The court ruled that whilst Brexit would affect the EMA's ability to operate in the UK, it wouldn't be impossible for the EMA to continue to have premises in London. It's worth noting that the Court's decision does not settle the question as to whether Brexit will or will not in all circumstances constitute a 'frustrating event', although many of us would agree that it now is!

ABOUT ROSETTE

Based in Mayfair, Rosette Merchant Bank LLP is an independent investment advisory and asset management firm specialising in commercial real estate, capital markets, supply chain finance and bespoke family office services. Our client base includes corporates, institutions, ultra-high net worth individuals and family offices in the GCC and Asia. Founded in 2003 and regulated by the Financial Conduct Authority, we have close ties to Kuwait and the rest of the GCC states.

Please get in touch with us if you wish to discuss the contents of this report in more detail.

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