RESEARCH

PROPONOMICS – MICRO VIEW

JULY 2016

UK FUNDS CLOSE THE GATES

At the time of writing, seven open-ended UK property investment funds have closed their 'gates' to redemptions; an event being presented with more drama than it deserves.

Headlines

Seven open-ended UK funds have closed their gates on redemptions, and more may follow

While this is being presented in highly negative terms, **it is in fact a case of safety mechanisms kicking in**

With the pound below $1.30 and 10 year government bond yields below 0.8%, **we expect any sales to be matched with buyers**

Most sectors in the property market are entering this downturn in a position of strength, **particularly offices and industrial**

The news is being seized upon as a sign of post-Brexit distress, although in reality it tells us more about short-term sentiment at this moment in time. Sentiment in the property market is changeable at the best of times.

What does this mean?

Essentially, a built in safety mechanism within an open-ended fund to help it cope with market volatility is kicking in, which helps to prevent fire sales through buying time for sentiment to stabilise, or for the fund manager to arrange an orderly sale of assets.

An open-ended fund draws in cash (a highly liquid asset) and uses it to buy property (which is far less liquid). The money can normally be requested back almost instantaneously, but the buildings owned by the fund take longer to sell. The funds maintain a cash buffer to service a typical flow of redemptions, but if there is a panic they have a safety mechanism that allows them to 'gate in' investors; who are told that due to exceptional circumstances they must wait to get their money back.

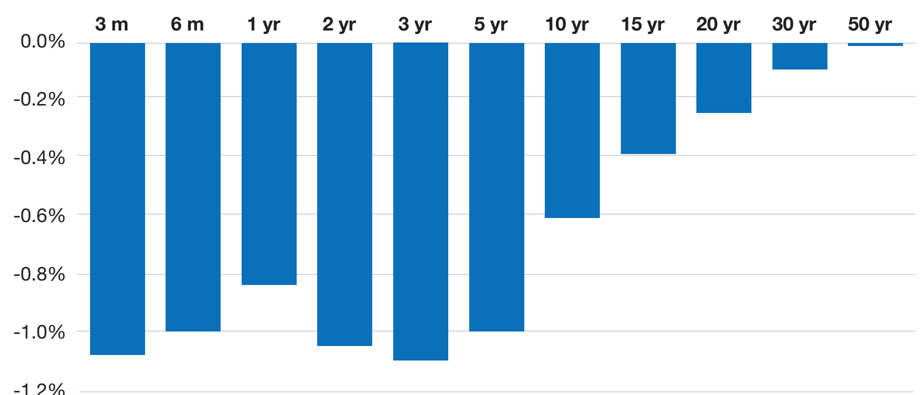
Once the gates are closed, funds gain time to sell assets to raise more cash. Also, the sense of panic may pass, so there is a 'sit it out' option for the fund.

So are we going to see forced sales?

We are certainly going to see stock come to the market, how 'forced' those sales will be is a matter of debate. The whole idea of closing the gates is to create a breathing space to avoid fire selling the buildings, but much will depend on the level of interest the assets receive when they reach the market, probably weeks or months from now.

So in reality the level of 'distress' in the market will be determined by the balance between assets coming up for sale, versus the number of opportunist buyers looking to enter the market. The pound is under $1.30 at the time of writing, which should draw foreign buyers in; although they may hold back in the short-term to see if it goes lower. The fact the new Prime Minister will not be in place until early September is another reason for buyers to wait for the time being.

FIGURE 1
Swiss Government Bond Yields



Source: Thomson Reuters

JAMES ROBERTS
Chief Economist

"Essentially, a built in safety mechanism is kicking in, which helps to prevent fire sales."

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However, the closed gates have also bought the fund managers time, and property yields on prime assets look very high compared to many other investments. Ten year UK Gilt yields are at 0.8%, while for Swiss bonds the entire yield curve is negative, right up to 50 years income.

Moreover, the current property cycle has not seen the excesses witnessed in 2006-2007, as debt levels are much lower, as are interest rates. Nor does the current situation have the feeling of systemic panic witnessed in 2007-2008. This also should work in favour of those who are selling.

The funds also hold property company shares, offering an alternative to selling buildings.

So why the fuss?

We are two weeks on from the referendum result, and some commentators want to show a cause and effect relationship, with the Brexit hitting property. However, the more important question is how well positioned is the UK property market to face a downturn?

Parts of the property market, such as retail warehouses and secondary shopping centres, were in a slowdown long before the referendum. These sub-sectors of retail are looking exposed and have a difficult summer and autumn ahead. Other parts of the property market, like offices and industrial, enter the post-Brexit environment with low vacancy rates and constrained development pipelines, so look well positioned to face what we anticipate to be far a less dramatic downturn than 2007-2009.

No section of the property market is going to come through the second half of this year completely unaffected, but just because it has started to rain does not mean it is time to build an Ark. There will be opportunities to buy assets cheaper than pre-referendum prices, but worst case scenarios, like the UK exiting the single market and the banks leaving London en-masse, will never come to pass. When that realisation sets in, the property market will quickly stabilise, as the systemic pressures and market excesses of 2007 are absent today.

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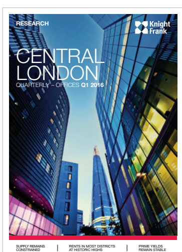

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