J.P.Morgan

'Brexit' Headwinds for U.K. Warrant a Focus on Continental Europe's Listed Property Sector for Income Returns

Paris, September 7th, 2016 – Investors in European listed property companies should avoid London offices and focus on companies in continental Europe that offer less risky income growth prospects, J.P. Morgan Chase & Co. analyst Tim Leckie told the European Public Real Estate Association's (EPRA) annual conference on Wednesday.

Tim Leckie, J.P. Morgan's real estate analyst, said: "The U.K. market is being buffeted by the headwinds of political and economic uncertainty following the momentous June 23rd "Brexit" vote to leave the European Union. These aren't going to lift any time soon, so while the slide in share prices has made the U.K. listed sector appear cheap, we recommend a focus on income-generating stocks in continental Europe that don't carry the Brexit risks. It's a remarkable change from a year ago, when the U.K. was Europe's most attractive listed property market in terms of rental and valuation growth prospects."

As Europe's major financial centre, London will feel the impact of the U.K.'s decision to quit the EU hardest, since banks and other financial services companies may lose the "passporting" rights that give them access to the Single Market. This will cut employment in London's financial districts, reduce demand for office space and lower rents, with inevitable consequences on property valuations, he said.

Leckie and his colleague Neil Green predict in a research note released earlier this week that in 2017 office rents in the City of London and the West End, two of London's most established office markets, will fall by 9% and by 4% respectively. This will depress property values by a total of approximately 11% during the next two years, they predict.

Since dividend payments by U.K. listed property companies do not exceed the average for the broader European market and given the risks triggered by the Brexit referendum vote, the J.P. Morgan analysts recommend that investors focus on continental European companies with stable cash flows that pay regular and attractive dividends.

Underscoring the emphasis on income-generating property shares is the background of record low or negative interest rates, underpinned by the European Central Bank's bond-buying programme, or quantitative easing (QE), and the Bank of England's decision in August to step up its QE programme and to cut its benchmark interest rate to 0.25%.

Leckie said interest rates in Europe are set to stay "lower for longer," encouraging pension funds and other institutional investors with payout obligations to search for higher-yielding income-producing investments. He drew parallels with the performance of Japan's listed real estate sector in the country's low-yield, low growth environment. He and his colleague Green have entitled their latest research note "Mind the (yield) gap: we double down on income."

J.P. Morgan recommends investors focus on the Paris office market, where the over-supply of space is starting to fall, reducing rental incentives and fostering prospects of rental growth as the French economic recovery slowly gathers momentum. It joins the office markets of Madrid and Dublin, where rental growth is already under way, Leckie said.

In the defensive retail sector, investors have already bid up the shares of the largest pan-European shopping centre operators, although J.P. Morgan recommends smaller operators with strong portfolios and solid cash flows. Another perennial favourite with investors is the German residential sector, because of its income potential, the analysts said.

Leckie concluded: "It's irrefutable that interest rates will stay low for the foreseeable future, bringing to the fore the importance of dividends and income. The risks from Brexit mean investors should shift their focus to Continental Europe. Companies with solid portfolios that offer regular and growing incomes, cover their dividend payments from their existing cash flows and have sufficient liquidity will be the ones that outperform."

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Notes to editors:

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