Brexit

LOGIC DICTATES
The EU referendum and its impact on UK commercial property

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HIGHLIGHTS

• Logic dictates that a referendum that could change the global political, economic and social order must have an impact on business confidence across all UK geographies and business sectors.
• Most public comment focuses on the impact of a vote to leave on the UK. This ignores pre-referendum impacts and relies solely on hypothetical arguments.
• Despite media focus on immigration and benefits, the real debate was linked initially to maintaining the dominance of London as an international global financial hub.
• The EU referendum is having a two staged impact on UK commercial property: (1) pre-referendum uncertainty and (2) post-referendum fallout.
• The most likely result, according to the polls and the bookmakers, is a vote to remain. Momentum from post-referendum relief rally may carry over into the traditional year-end surge and result in transaction volumes approaching record 2015 levels.
• Historical data suggests UK regional occupier markets (especially financial) are more sensitive to domestic political uncertainty than London. Short-term expansion and medium-term occupation is at greatest risk.
• Direct property investment markets are less sensitive to political uncertainty than leasing markets, but more sensitive to financial markets. Short-term investors are impacted more than long-term investors.
• Brexit is an unlikely outcome, but potentially very disruptive. No reliable historical data is available that captures the impact of a catastrophic political event on the commercial property market.
• Numerous alternatives to EU membership are tried and tested, but all require EU consent for preferential access to the common market.
• Numerous hypothetical Brexit risks are balanced by numerous theoretical mitigating circumstances.
• Despite the liquidity and transparency of the UK property market, the potential for a major disruption due to a Brexit is great. The period may be protracted due to domestic political fragmentation, lack of political consensus, experience and leadership.

LOGIC DICTATES?

One indisputable conclusion that arises when considering the literature on the UK’s looming EU referendum and possible EU exit is that there are many pertinent, but inconclusive answers, to many pertinent, but misconceived and agenda laden questions. Many would argue that only ‘scenarios’ can be offered and this is especially true when evaluating the theoretical impact of a UK vote to leave the EU. With respect to UK commercial property, these scenarios have less to do with impacts from the referendum itself (this is generally overlooked) and have far more to do with the subsequent fallout from a far from certain vote to leave the EU, or what is abbreviated by convention as Brexit (British exit), following the previous media inspired Grexit (Greek exit).

Logic dictates that a referendum that could change the global political, economic and social order must have an impact on business confidence across all global geographies and business sectors. In this context, concerns about the impact on UK property occupiers and investors in UK direct property seems parochial at best and trivial at the least.

Nevertheless, there is evidence that while professional and financial firms and funds have commissioned research, their commitment to consider the results has been half-hearted so far, with few professionals willing to believe that the UK referendum would return any result other than to remain in the EU. They may be right as the UK bookmakers odds show a 70% probability of a vote to remain in the EU.

In October 2015, at MIPIM UK in London, some 19 global institutional investors discussed Brexit and reached the conclusion that, irrespective of any geopolitical or macroeconomic shocks, global capital would continue to flow into the City of London (IPE, 21 October, 2015) and that Brexit would not be a ‘game changer’. No doubt this conclusion will be challenged by interested parties in the run-up to the referendum, but importantly, the finding betrays the ‘realpolitik’ - a business and government focus on the UK finance sector and the City of London that precipitated and defines the ‘real’ debate. Arguably, the opening salvos of the real debate began in 2011 with a number of law suits filed by Chancellor George Osborne in the European Court of Justice to do with the Euro clearing houses (T-496/11), the emergency short selling ban (C-270/12), the financial transaction tax (C-209/13) and bankers’ bonuses (C-507/13).

Cynics might suggest that immigration and benefits were late entrants to the ‘real’ debate and were originally conceived as something of a ‘red herring’ to distract attention from the substantive issues. The rise of the migrant crisis in 2015, though, has propelled immigration, benefits and, with it, the entire social agenda of the EU to the fore. The outcome of the referendum is, therefore, far less certain and far more emotive than may have originally been expected. The uncertainty that has arisen is, therefore, worth considering, even if focussed narrowly on UK commercial property.
How will referendum impacts be felt?

Like other business sectors, UK commercial property is already feeling the effects of a first stage impact which will continue through the referendum itself, irrespective of outcome. This is not yet reflected in recent data, but has been noted anecdotally. As demonstrated during the Scottish Referendum, or the recent UK general election, political uncertainty affects business confidence and decision-making, whether it concerns investment in new equipment, deciding about leasing new space or investing in a commercial property asset.

PRE-REFERENDUM
• OCCUPIER SENTIMENT
• INVESTMENT SENTIMENT
• FINANCIAL IMPACT

The EU referendum has a two-staged initial impact on UK commercial property.

POST REFERENDUM (REMAIN)
• RELIEF RALLY (Q3 16)

POST REFERENDUM (LEAVE)
• UK POLITICAL FRAGMENTATION
• REASSESSMENT AND NEGOTIATION 2016.18.20.

Likewise, a second stage impact will be felt in response to the actual outcome of the referendum. This may take the form of a ‘relief rally’, should the result be to remain in the EU, where business returns to normal, or it may take the form of an extended response over an extended period of uncertainty should the vote be to leave the EU. Membership of the EU provides for a two-year period to negotiate the terms of an exit, but political fragmentation in the UK would undermine the UK’s ability to negotiate. This is where the various scenarios fit in.

Impacts on UK occupier markets and sentiment

Arguably, property occupier markets are the most sensitive to real economic conditions as expansion plans of business occupiers ebb and flow based on expectations of future business growth. Business confidence measures and purchasing manager indices capture this. Business growth, in turn, expresses itself materially through demand for business space; hence, there is a direct link between GDP growth, business investment, occupier market demand, rental growth expectations and property investment appetite.

Occupier markets are less sensitive to the financial economy. Obviously, markets with exposure to financial companies such as London (55% of UK financial jobs) will feel the direct effects through employment levels, but occupier markets dominated by non-financial companies are less exposed. Debt and equity costs of operational capital may be important, but turnover and business outlook are the key business drivers. Decisions to expand or contract are driven more by economic outlook and order books than by cost of capital.

In the UK, these linkages are moderated by leasing structures that are designed to protect both tenants and landlords from market volatility. The average lease length in 2015 in the UK was 7.2 years. Prime commercial office leases, though, are typically 15 years or more, while hotels, supermarkets and industrial distribution sheds can have leases of 25 years or more with rents linked to inflation indices.

Considered together, the foregoing suggests that the UK occupier market structure mitigates against significant short-term contractions in leased space in a period of uncertainty. In London, a good deal of pre-leasing may also cushion any impact. What looks most at risk is short-term expansion and medium-term occupation. As noted previously, London is exceptional due to its high concentration of financial occupiers. Hence, London’s office market and economy is potentially more vulnerable than UK regional markets, except for those regional markets with high financial exposures, such as Edinburgh, Manchester and Bristol.

Impacts on UK direct property investment

In contrast to occupier markets, direct property investment markets, while sensitive to real economic conditions, are very sensitive to financial economic conditions, especially if you consider property to be a relative asset class. Financial capital is not tied to a location in the same way that real physical business premises (with physical plant and employees) are literally tied to a location. Hence, property investment markets are potentially more volatile and sensitive to changes in sentiment due to their exposure to a wider range of real and financial drivers than occupational markets which are driven primarily by the real economy alone. Furthermore, financial drivers go well beyond local GDP performance and include global interest rates, exchange rates, capital availability, regulatory environments and relative equity and bond market performance.

Insofar as all these drivers are sensitive to political events, too will local investment be sensitive. In fact, to a much higher degree than property occupiers, property investors try to anticipate future movements in both the real economy and the financial economy. In contrast to occupier leasing markets, investment markets have greater liquidity. This liquidity may have a price, but there are few legal constraints on disinvestment or the decision to sell an asset. In fact, retail investment funds have to sell into an adverse market in order to meet sudden redemption pressure by private investors. The market moves far more rapidly.
DOES DATA CONFIRM THE LOGIC?

The leasing evidence. Given the potential impact of the EU referendum, logic dictates that UK business and investor sentiment should already be feeling the impact and that UK occupier and investment markets should already be feeling the effects. The latest data is inconclusive, but what does historical data tell us about occupier and investment markets during previous periods of political uncertainty?

Despite the logic and anecdotal evidence from company activity levels, oddly, the data seems less compelling. The impact is equivocal. In the period of the Scottish Referendum, occupier market take-up figures show that total UK regional (ex-London) take-up fell prior to the referendum then recovered post-referendum. This might reflect a relief rally where leasing decisions that had been postponed were suddenly actioned. In contrast, London take-up increased pre-referendum, and fell post-referendum.

Office take-up data suggests differing regional impacts from Scottish referendum.

At face value, the data suggests that UK regional markets may be more sensitive to domestic political uncertainty than the London market. If the data is explored in detail, Scottish markets show a similar, if more extreme movement, as do regional markets with financial sector exposures such as Manchester and Bristol. The insensitivity of London’s market suggests that London’s economy is linked far more to the global economy and far less to UK domestic politics and the economy. Scottish independence was rejected so unfortunately, or perhaps fortunately, the impact of a cataclysmic political event was not captured.

The investment evidence. The impact of UK politics on the direct property investment market has similar incongruities. If the last three UK elections are examined, there is little evidence to suggest any consistent impact. In most cases, quarterly investment volumes fell within, or very near the range of normal volatility (one standard deviation). For the 2015 election, which was understood to be a close contest between contrasting ideologies, the data was inconclusive, the data suggests that, if a relief rally was to be observed, it might only be found in Central London in 2010, where foreign investors drove up volumes by an extra £1bn immediately after the election in June when the coalition government was announced. In 2005, post-election figures were pushed up in Q3 2005 by a single large deal, Project Dove (£1.3bn), which was a UK institutional led syndicate of long-term investors buying a 6.5m sq ft portfolio of assets across the full range of asset types.

Long-term investors less impacted. Consideration of the motives and players suggest that these deals would in all likelihood have gone through irrespective of outcome. In fact, if this methodology is extended across European markets and their elections, a similar pattern emerges with abnormal volatility explained by either a single exceptionally large transaction, or more often, explained by the normal seasonal pattern of activity. In all but one case (Italy 2012), investment volumes that substantially exceeded the normal range, all fell in the last quarter of the election year - consistent with the normal year-end rush across direct property investment markets.
Interestingly, in most cases, single large deals were linked to long-term investors—primarily domestic institutions and sovereign wealth funds that look beyond short-term volatility. This is especially evident in Spain 2008 and Italy 2012.

While it may be wishful thinking to conclude that property investors are driven solely by numbers and not politics, it is probably safe to conclude that long-term property investors, at the least, look well beyond short-term volatility, whether economic or political. In fact, over the last several years, Colliers International’s annual global investment surveys, without exception, show that property fundamentals and availability of finance always rank higher in investor deal calculus than sovereign risk, even during the period of Eurozone stress (Global Investor Sentiment Survey 2010 to 2015).

The historical property investment data available does not offer any cataclysmic political events to inform the potential impact of Brexit and, specifically, how long-term investors would be likely to respond. Logic suggests that long-term investors would probably adopt a ‘wait and see’ approach to new investment and would continue to hold long-term assets instead of selling into a weakened market. It is the short-term investors, especially investors looking for projects with two to three year exits, whom are likely to be most sensitive to sudden changes in the political environment. Exiting an investment in some vague 10 year period is a very different proposition to exiting an investment in a fixed period measured in months.

Arguably, the ‘don’t know’ respondents are of two camps: (1) don’t know and don’t care (unlikely to vote) and (2) don’t know, but are willing to be persuaded (likely to vote). The ‘don’t knows’ are also unlikely to have an emotional bias, otherwise they would not be undecided. Hence, any dispassionate assessment of the UK economic prospects suggests that a propensity to vote to leave by this group looks less likely. If this leap of faith is accepted, the poll evidence suggests that the most likely result will be to remain.

In contrast, UK bookmaker evidence is based less on ‘leaps of faith’ (hopefully), but rather on real opinion, accompanied by real cash that generates real odds ratios. The range of odds on Thursday 18 Feb 2016 before a deal had been reached in Brussels stretched from 1/3 (66.7%) to 4/11 (73.3%) to remain—the average across seven leading bookmakers was 71.6% to remain.

POST REFERENDUM IMPACTS

Only two outcomes are technically possible from the UK referendum itself. After careful consideration, the UK Electoral Commission published a 53-paged assessment that concluded that to avoid bias, the precise wording of the question and possible responses should be:

- Should the United Kingdom remain a member of the European Union or leave the European Union?
- Remain a member of the European Union
- Leave the European Union

Irrespective of result, any assertions about the post-referendum impacts on property can only be described as scenarios.

The vote to remain scenario. Oddly, the least discussed scenario is the impact on UK property of a decision to remain in the EU. This is striking, as a vote to remain is the most likely outcome, according to available data. National polls may be equivocal and the sampling methodologies employed problematic, but as of mid-February 2016 they suggest that 51% will vote to ‘remain’, 36% will vote to ‘leave’ and 16% simply ‘don’t know’.

"Short-term investors are likely to be impacted more by political events than long-term investors."
January 2016 volumes are not far off 2015’s record high. February is also seeing a steady deal flow.

The historical data suggests that a slowdown is likely across occupier and investor markets as the referendum approaches and, barring a vote to leave or some unforeseen economic or political calamity elsewhere in the world, that any slowdown will be reversed if the UK’s membership is confirmed. Furthermore, the relief rally would come in Q3 2016, normally a quiet time due to summer holidays. The rally could build sufficient momentum so as to carry over into a strong year end which, given on-going low interest rates and the undiminished weight of global capital, suggests that 2016 could rival 2015 by total investment volumes. This is especially true, if the current global economic volatility gives way to greater stability and investors across all asset classes move back into a ‘risk on’ environment. The early signs are already apparent, as equity markets begin to firm. Leasing markets would certainly see a new surge and probably lead to renewed interest in development activity.

A vote to leave - Brexit. There is little historical precedent to draw upon in order to form firm conclusions about where post EU membership will take the UK, let alone the UK commercial property market. A vote to leave would lead to a long-term UK pivot into a new set of international political and economic relations. Few doubt the ability of the UK to go it alone, just as few would doubt that Germany could go it alone were it to choose to leave the EU. Germany and the UK are the 4th and 5th largest world economies after the United States, China and Japan respectively. Furthermore, the UK is a key hub in the global financial system. The most compelling global political argument for remaining in the European Union must be the strength that is offered by sheer size. The EU’s collective economy in the world and would remain one of the key economies (including the UK) is estimated at $18.5 trillion (2014). 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A defined period of uncertainty. Simple logic suggests that the initial impact of a vote to leave would be negative by virtue of a sustained period of political and regulatory uncertainty. As noted above, EU membership includes provisions for a member’s departure and includes a maximum two-year period set aside for negotiating the terms of an exit and a new relationship. Within this period, there is little doubt that new relationships will be forged. The UK and EU would need look no further than the current set of EU relationships with other countries and supranational entities. The possibilities are limitless, but review of various sources suggests that the UK would find a relationship akin to one of the following models.

Despite these alternatives, the negotiations over continued EU market access would no doubt lead to considerable concessions by the UK to secure this access. Several observers have concluded that this would be tantamount to continuing to be governed by EU law without the prospect of being able to exercise influence. Given that a vote for Brexit is likely to precipitate a UK leadership challenge, it is not clear whether the UK government would have the focus, strength and experience to pursue the necessary negotiations effectively. This in itself is likely to extend the period of uncertainty.

THE HYPOTHETICAL RISKS OF BREXIT

When reviewing the literature on the economic impact of a UK exit, arguments usually focus on hypothetical economic risks. For the hopeful, several theoretical mitigating considerations are offered. For the less hopeful, the risks are usually presented as foregone conclusions. Nevertheless, the hypothetical arguments, like the previous leasing and investment data, are also equivocal.

Export trade. A key focus relates to the importance of the EU as an export market for the UK. The EU is, without doubt, an important export market for the UK, accounting for 45% of all UK exports in 2015. This share, though, has been falling since 1999 when the EU accounted for 55% of all exports. Trade diversification has been an active policy of government and will continue. The UK also has a deeply negative trade deficit (-£62bn in 2014) with the EU, that is, the UK imports more from the EU than it exports. In contrast, the UK has a positive trade balance (£28bn in 2014) in its non-EU trade. The trade surplus is driven by financial and business services exports in contrast to its substantial trade deficit in manufactured goods. The key fear is that the EU will impose its common external tariff and make these UK goods more expensive. The average tariff amounts to 4% by value (Capital Economics, 2015). A mitigating argument might be that the historic volatility of the euro / sterling exchange rate is 12%, so the increased customs duties fall within the range of normal exchange rate volatility. It does not appear to be a ‘game changer’ from this narrow perspective either for UK manufacturing or services sectors.

### Theoretical mitigation

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<th>Hypothetical risk</th>
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| International tourism & retail | • Independent of politics, driven by global economics and wealth  
                                 • Weak sterling means more tourists, although retail prices will rise |
| UK industrial | • ‘Factories are not just for Xmas’ – fixed investment is hard to move, concentrations of expertise is hard to find  
                          • Distribution linked to retail and domestic economy |
| Trade constraints, tariffs and costs | • EU common tariff (4%) within range of sterling volatility (±12%)  
                                            • Manufacturing trade deficit with EU  
                                            • Business / finance trade surplus with EU  
                                            • Export shift – re-targeting already underway  
                                            • EU trade %: 55% (1999) 45% (2015) |
| UK headquartering & the City of London | • Brass plating, tax and regulatory regimes paramount  
                                        • Expertise pool already established  
                                        • London occupier base diversified  
                                        • Fintech to overcome euro regulation / discrimination |
| Free movement of capital & labour | • Exit negotiation item  
                                         • UK needs controlled immigrants, problem is not EU specific |
| UK commercial property | • No EU common property market  
                                • UK market most liquid and transparent of global markets  
                                • Indispensable global finance hub  
                                • Advanced legal system |

“...For the hopeful, several theoretical mitigating considerations are offered. For the less hopeful, the risks are usually presented as foregone conclusions...”
Headquarters and the City of London. Another key risk is related to the role that the UK plays in hosting businesses that use London as a platform to trade with the EU. This is seen as a direct risk to London’s leasing markets. Without labouring London’s USPs (e.g. time zone, language, ease of doing business, legal system, pool of expertise, etc.), it has been suggested that the risk is mitigated by the possibility of ‘brass-plating’. Brass plating is the practice of setting up a nominal office in one jurisdiction, but producing the work in another. Recent high visibility discussions related to international taxation have highlighted the extent to which multinational companies will go to ‘optimise’ their tax environments. Tax regimes may prove to be the key driver of location, along with access to pools of relevant expertise, rather than legal jurisdiction.

Furthermore, it is argued by some observers that the rise of Fintech – the use of technology in developing new financial services models, will overcome regulatory risks such as requiring euro clearing from within the Eurozone. Such a regulation might be effectively subverted by Fintech initiatives linked to euro derivatives and ex-market trading. Likewise, much of London’s new tech businesses are heavy on intellectual property and light on physical trade. Around 30% of the UK tech sector is software development, data management and analysis (Tech Nation, 2016). London remains a key international centre for intellectual property law. In fact, London’s occupier base is already substantially diversified away from a strict reliance on finance and banking.

Other considerations and commercial property. Other topics could be added including, but not limited to data security, product harmonisation, regulatory harmonisation as well as geopolitical power and stability. Much can be made of the migrant crisis, although the contribution that migrants have made to the UK over the last two decades and given the UK’s demographic profile, this is clearly not solely an EU issue. The UK needs skilled migrants. Several detailed reviews of these and other issues are available from noted economic and business consultancy firms, but few commentators, aside from the UK property trade press, identify the risk to property has not been mentioned in the latest Bank of England Financial Stability Report (December 2015) which focusses instead on the threat from buy-to-lets and increasing commercial debt leverage in the UK. In fact, the word referendum does not appear within the report itself despite posing a considerable threat of financial market disruption. Interestingly, like many other parts of the economy, the EU has more to gain from engaging with UK commercial property than the UK has to gain from engaging with EU property. UK markets are far more developed and have far more transparency than other EU markets. Due to its concentration of financial expertise, the UK also offers the greatest efficiency in matching capital with investment opportunities across EU markets. As in finance, there is an unparalleled pool of commercial property expertise in the UK. What does not exist is a harmonised EU common market for property, nor is there one in the making.

CONCLUSION

No conclusive quantitative argument can be made that summarises the impact of a UK exit from the EU on UK commercial property in any definitive or meaningful way. All scenarios are hypothetical as to render any comprehensive analysis futile. Equally, the key problem is that the proponents of exit may not be moved by economic rationale alone. In contrast, those that are moved by economics are unlikely to need persuading. Most of the business and investment world would agree that a period of great uncertainty will follow any vote to leave the EU. Given that the most recent episode of equity market volatility looks disproportionate in contrast to otherwise sound fundamentals in advanced economies, the potential volatility accompanying a Brexit, irrespective of sound alternatives, as detailed above, seems greater and likely to lead to a protracted period of uncertainty. This will impact both occupier and investment markets – a short transactional pre-referendum hiatus will give way to a short- to medium-term disruption. Core market pricing will slip. Fire sales are unlikely as long-term investors are often un-leveraged, although redemption pressure on retail funds will no doubt bring a few core assets to market. The real impact, though, will be felt by short-term investors who require clear exits. Logic dictates that few clear exits are likely to be on offer during a period of unprecedented political and economic uncertainty.