Briefing Paper - BREXIT and Real Estate

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Part 1: How did we get here?

The immediate impact of the referendum result in the UK is starting to settle down. However, much uncertainty remains and this will have wide ranging impacts including many on the real estate sector. Whilst the UK market is obviously most exposed there may also be international consequences. However, to begin with; what led to the UK not only having a referendum in the first place but the country voting in favor of exit.

In many respects the UK has always been a reluctant member of the European Union. It joined the then EEC (European Economic Community) in 1973 and so divisive was that decision that only two years later in 1975 the country was given the option of leaving. Indeed 1975 and this year are only times that referendums have ever been held across the entire UK. Part of that reluctance comes from the UK's history and its island status, often keeping it one step removed from the affairs of continental Europe. However a reluctance to engage in partnership with continental Europe following 1945 was also influenced by the UK having to come to terms with the loss of global power as the majority of former colonies gained independence and the British Empire faded.

There has always been a strong Eurosceptic tradition in the Conservative Party, although historically the left wing was just as divided. During the 1975 referendum members of the then Labour Cabinet campaigned to leave, just as Conservative Cabinet members have done this year. In 1983 Labour's General Election Manifesto supported withdrawal. It was only in the nineties that Labour as a party swung more behind the EU. This large Eurosceptic tradition has resulted in numerous opts outs and special deals during the UK's 43 year membership in order to keep the sceptics happy.

1. During the eighties the UK obtained a "rebate" on the UK's contributions to the EU. The rationale at the time was that the UK was being unfairly treated as much of EU's expenditure was, and still is, directed to agriculture. UK farms tend to be larger and more efficient and thus receive a proportionately low share of farming subsidies. The result of the rebate is that the UK is currently reimbursed around £5bn of the £18bn gross annual contribution. As a result the UK actually pays a lower percentage of Gross National Income than any other EU member state. It is the only EU state to have such a rebate.
2. The UK was given an opt-out of joining the single currency, thus allowing the UK to retain the pound as well as an independent monetary policy and not face any restraints on fiscal policy. It has also meant that the UK has been somewhat protected in recent times from the crisis in the Eurozone.
3. The UK initially opted-out of the Social Chapter which covers areas such as employment protection and working conditions.
4. The UK also has an opt-out from the Schengen area which allows for passport free travel across EU states. This provides the UK with additional border controls. Only the Republic of Ireland, due to its relationship (geographically, historically and politically) with the UK, is also outside the

Schengen area. Indeed, not only are all other EU states part of the Schengen zone but so are all members of the European Free Trade Association (EFTA) which is made up of non-EU states such as Switzerland, Norway and Iceland.

5. The UK negotiated limits on the ability of the EU courts to rule on issues relating to the Charter of Fundamental Rights. Only Poland has a similar arrangement.
6. An opt-out is also present on legislation relating to "freedom, security and justice". This gives the UK a flexible opt out, allowing it to deal with each piece of EU legislation in this area on a case by case basis. Only Ireland (flexible opt out) and Denmark (full opt out) have a similar provision.

Despite these deals Euroscepticism in the UK has never gone away. The Conservative Party tried its best to rip itself apart during the nineties, whilst in more recent years the UK Independence Party (UKIP) has made impressive electoral showings. This was especially seen at the 2014 European Parliament elections where UKIP obtained more seats than any other party, 24 out of the UK's total of 73. Partly as a response to that election result and fearing the loss of seats in the 2015 General Election, the recently departed Conservative Prime Minister David Cameron made a commitment to holding an "in-out" referendum on EU membership. So that is how the UK got to that point but what factors led to a victory for the leave campaign? On the surface the rationale for staying in the EU was very strong. All major political parties, or at least their leadership, supported remaining. Furthermore, a majority of business leaders, economists, unions and world bodies such as the IMF and OECD were all in favor of remain. Yet in the most ill-tempered UK vote in living memory, with a Member of Parliament killed during it, 52% of the vote was in favor of Brexit. Why?

If we are honest, the *Remain* campaign was awful. It concentrated too much on the negatives of leaving, to the extent that the *Leave* campaign dubbed it "Project Fear", allowing them to side-step some of the key arguments in favor of staying in. Overall there was little sense of what positives came out of being in the union. The Labour party's leadership refused to join in a united *Remain* campaign, instead delivering a half-hearted campaign of their own. The result was a lack of co-ordination and clarity from the *Remain* side, allowing the *Leave* Campaign to set the agenda. This agenda focused on two key issues; immigration and "control".

For those looking in from outside the UK it is important to realize that the economics of remaining or leaving the EU were never really important factors in most people's decision. There are consistent arguments against the EU if you come from either a free-market libertarian viewpoint or from a left-wing socialist perspective. Those perspectives are incredibly different but there are rationales as to why libertarians and socialists may have voted to leave. However, libertarians and socialists do not make up 52% of the UK electorate. What the majority of the 52% voted on, was a combination of wishing to reduce immigration and "taking back control". Much has been said and commented upon both during and since the referendum campaign about the immigration issue and the increase in hate crimes since the referendum. One aspect that the *Remain* campaign never effectively communicated is that 75% of all immigration to the UK since 1991 has been from outside the EU. This is outside the provision of free movement across the EU and has always been entirely in the control of the UK government. If you are being cynical here it was not in the interests of either the Conservative or Labour party to highlight that it was their policies whilst in power, not the EU, which had failed to limit immigration.

Furthermore, many of the options which are now being considered in this post-referendum world would not reduce immigration. The Norwegian model is often cited as an example of what a post Brexit UK could look like. Norway isn't an EU member but has access to the internal single market of the EU through what is known as the European Economic Area (EEA). As part of its deal Norway has to comply with free movement of people. It also is part of the Schengen Zone, unlike the UK. In addition to free movement of people Norway also has to ensure the free movement of goods, services and capital. These are the so called "*four freedoms*". To gain access to the single market as part of the EEA Norway also has to enact a large proportion of EU legislation. Whilst Norway does makes large contributions to the EU it receives no funding in return. To benefit from schemes such as the *European Regional Development Fund* it must contribute in the same manner as EU members. It is estimated that this year Norway will make gross payments of over €800m, for a population of just over 5 million. Its net contribution per capita is pretty much the same as the UK.

The sovereignty issue is partly based upon not wishing to have to comply with legislation coming from Europe. Whilst the EU is undoubtedly a quite bureaucratic institution this argument did also play particularly well in a country that, as mentioned earlier, has struggled at times to accept the change in its global status since 1945. There is a Welsh word, ***Hiraeth***, which means "homesickness for a home you cannot return to, or that never was". It is very apt here. The *Leave* campaign played on many Britain's harkening back to an earlier time. This loss of global influence wasn't just in political or military terms but also economically. The post war years were not good for British industry. There was a marked reduction in manufacturing's share of both GDP and employment. In 1948 manufacturing (plus utilities and Oli & Gas) made up 48% of output, a proportion that had fallen to 14% by 2013. In common with most western countries manufacturing, especially in high volume low value goods, has shifted to cheaper markets over the last five decades. The remaining industrial base was saved either by increasing productivity, often therefore still having a major negative on employment, or by emphasizing high value areas such as aerospace, engineering and technology. Whilst all of the western economies have seen similar effects in the post war period no G7 country has seen manufacturing as a share of GDP fall by as much as the UK.

This is where a third factor comes into play and one that is not unique to the UK in 2015. Across the world we are seeing a rise in populist politics. Core to this is an anti-establishment viewpoint, arguing that the political and corporate establishment is out of touch. The key drivers of Populism have been the sluggish economic growth observed in many countries since the financial crisis close to a decade ago as well as heightened concerns over job insecurity. In addition, and key to the UK referendum result, it is often felt that globalization does not positively benefit the entire population. This is added to by concerns over increasing income inequality and the impact that migration may be having. These effects most often coincide and are most evident in areas of economic decline. What is of interest is that the *Leave* vote was often highest in the former industrial heartlands of the UK. These are populations who feel left behind by globalization. It is this that the political establishment in the UK failed to grasp, and arguably still have not fully comprehended. This wasn't just about immigration, tagging the leave voters as racists was always far too simple. It was about a feeling of despair and hopelessness. Those living in former industrial cities that haven't seen the benefits from globalization or more specifically the trade benefits the EU brings. It was quite noticeable how many leave voters were commenting on how the UK used to have a great manufacturing sector "before we joined Europe". People were actually equating joining the EU in 1973 and the decline in the manufacturing and industrial base that was particularly felt during the seventies and eighties. The irony here is that the EU has been the largest provider of regional funding to help de-industrialized areas. Those areas that voted to leave are in many cases the ones who have actually received the most EU funding over the last four decades and in turn will lose out the most in the future.

Part 2: What will the Future Bring?

The UK is slowly returning to what is currently passing for normality. The Conservative Party have elected a new leader following David Cameron's resignation and Theresa May has now taken office as Prime Minister. The speed with which that changeover occurred has helped; at least it meant that the UK avoided three months of a lame duck premiership.

To leave the EU the UK has to activate Article 50 of the Lisbon Treaty. This sets in motion a formal period of two years to negotiate withdrawal. There are three key issues here. First, is that the uncertainty will continue to impact UK. Secondly, that will not necessarily just last two years. The two year period is solely concerned with withdrawal. It is not necessarily the case that all of the future relationship between the UK and EU is confirmed by that point. Finally, while the EU will take priority this isn't just about that relationship. The UK will also have to confirm relationships in areas such as trade with countries outside of the union. Some countries may agree to a continuation of the EU negotiated relationships currently in place, some may not. It will though be interesting to see what the attitude of other countries is to entering into trade negotiations with the UK. On the one hand it may be that countries are reluctant to confirm trade deals with the UK before the final agreement with the EU is confirmed. Before then it will not be known what access those firms will have to the single market via the UK. That is naturally going to impact upon negotiations. However, there is a counter argument to that. It may actually be in the best interests of other countries to enter into negotiations now as they may feel they will get a better deal from the UK in the current environment. The uncertainty over the final relationship with the EU and the willingness of the UK to negotiate deals quickly may lead to them comprising more. What is however undeniable is that the uncertainty over the UK's position is not going to go away anytime soon, it is not just a two year horizon we are looking at.

Before we move onto the economic and real estate impacts of Brexit it should be noted that there will be extensive political consequences. It is likely that many of those consequences haven't come onto people's radar at this point; we certainly have all been living through a political soap opera the few weeks and months. One issue that did become apparent immediately was that the future of the UK itself is now up for debate. With the exception of London the rest of England, together with Wales voted to leave. However, the majority of the vote in both Northern Ireland and Scotland was to remain within the EU. Scotland only narrowly voted to remain in the UK in 2014. There is a real possibility that a second Scottish independence referendum will take place and at this point it looks extremely likely that the vote would this time be in favor of an independent Scotland and one that remains part of the EU. The issues in Northern Ireland are far more complex, but the disparity in the vote with the UK as a whole does raise many issues and especially the relationship with the Republic.

The immediate impact of the referendum was a shock on the markets, with Sterling falling to thirty year lows against currencies such as the Dollar. The UK equity markets also took a beating and whilst the FTSE 100 has subsequently recovered the more domestically focused mid-cap firms, proxied by the FTSE250 are still well down on their pre-referendum levels. It is anticipated that at least in the short term there will be a negative economic impact. If nothing else the uncertainty created by the result and the length of time negotiations with the EU and others will take, could lead to a postponement of investment decisions. However, as always there are also some positives. The weaker pound will provide some respite, at least in the short-run, for exporters. It should also be noted that this uncertainty will also impact the EU. As one of its largest members the exit of the UK will have a major impact upon the EU. Furthermore, it increases political risk, and especially that concerning possible further departures from the union. These factors can be seen that the Euro also fell significantly following the vote on June 23rd.

The longer-term economic impact is more debatable. The potential loss of access, if not totally then partially, to the EU single market will undoubtedly have negative impacts, however, there will be no doubt some positives alongside. For example, in the short-run exporting sectors will benefit due to the fall in Sterling. Generally, there will be quite different short-term versus long-term consequences as well differing responses across sectors. With respect to many issues there are numerous off-setting affects. Interest rates are a prime example in this regard. A lower pound may lead to inflationary pressure which on its own may suggest potential higher interest rates in the medium term. In addition, the negative impact on the UK's credit rating will also push market rates higher. This has already been with either actual downgrades or negative outlooks issued by Moody's, S&P and Fitch Ratings. However, it also needs to be considered how the Bank of England will respond. Given weaker economic fundamentals it may be that interest rates are actually reduced, at least in the short-run to provide a monetary stimulus. The recent statements by the Bank of England's Chief Economist, Andy Haldane, would support such a view. Therefore, what happens to interest rates is going to depend on the combination of all of the above factors, plus many more. Generally however, the economic outlook does not look too healthy over the short-run. The uncertainty created by Brexit will, by itself, impact confidence in the UK economy. Whilst Brexit may not by itself lead to the UK entering recession over the next 18 months, it will increase the likelihood of that event and more generally reduce economic growth.

Commercial Real Estate

The big issue at the forefront of the debate in the commercial sector is what will happen to the City of London and the financial services sector. These concerns are centered on whether London based institutions will still receive what is referred to as "passporting" rights, allowing them access across the EU. Whilst it is by no means the main reason why firms base themselves in London it is an added advantage. The likelihood is that some banks may reduce their London operations, but in all likelihood this will be at the margins and most institutions will keep the vast majority of staff in London. The City is by far the largest financial center in Europe and that isn't going to disappear overnight. It also has the advantage in that it can appeal to institutions via its light touch regulatory environment. This will no longer be constrained by EU wide policy, for example on bonuses. The big question mark is with those European institutions, such as BNP Paribas and Deutsche Bank, that have major London operations and if they will be tempted to repatriate large numbers of staff back to Paris and Frankfurt respectively. In the long-term a market that could benefit, depending on the outcome of various negotiations, is Edinburgh. In a scenario, which is not beyond the realms of possibility, where Scotland leaves the UK but remains in the EU, then financial institutions may move some operations north and join the strong fund management and insurance sectors already based in Scotland. Outside of the UK Dublin may also be another beneficiary of any outflow of the financial services sector from London. Given the differences in scale, even if there is outward movement from London it will not be that large from London's perspective, however, the positive impact on cities the size of Edinburgh or Dublin could be substantial.

The provincial markets outside of London are probably those most vulnerable to both any adverse economic affect and in therefore from a property perspective. A number of markets are already seeing weaker letting conditions, which in turn will obviously impact the development sector. However, any reduction in new supply will obviously have a positive effect as it will mitigate any decline in occupational demand and therefore provide some protection for rental values. The fall in Sterling may have some short-term positives, and this may be especially seen in the industrial and warehouse sectors. However, this needs to be offset against the long-term outlook which is perhaps less positive. In general it will be a common refrain that there may be quite different impacts over the short versus the long term.

Retail Real Estate

Economic uncertainty is not coming at the best time for the retail sector which is already under pressure from a wide variety of issues, including the continued impact of non-store channels and new entrants together with reduced margins. Fashion retailers are in particular suffering and also, due to their reliance on imported products generally invoiced in Dollars, are most exposed to Brexit and the fall in Sterling. Longer-term any rise in inflation due to both a weaker pound and increased tariffs obviously would have a further negative impact. It is going to intriguing to see how consumers are going to respond. If there is a negative impact on consumer confidence and spending it is most likely to impact high value discretionary goods, meaning the likes of electrical, furniture and department stores may see the biggest impact.

From a property perspective the retail sector has had to depend in recent years on the growth in food and beverage to prop up the declining footfall observed. However, even before the referendum was announced many analysts felt that the growth rate in food related outlets was unsustainable. It may have got retail through the immediate aftermath of the financial crisis but it far less encouraging this time around. Overall, the UK retail sector was facing major long-term challenges. The realignment of UK retail was happening anyway. Brexit may merely speed up that process.

More generally though it will be interesting to examine how retail spending patterns do respond to Brexit. It will provide commentators with an indication of the economic sentiment in the UK population; indeed generally retail will be one of the key indicators of the health of post-Brexit Britain.

Residential Real Estate

Whilst there are without question medium and long term economic concerns the housing sector may actually do okay in the short-run. The fall in Sterling does benefit overseas buyers, who especially in markets such as London have been important players in recent years. The London market had been quieter this year anyway due to a combination of concerns over the level of prices, a lot of supply coming onto the market and economic uncertainty. However, early indications are that there are some short term buying opportunities. Whether this actually materializes and if it is sufficient to prop up a jittery market is still to be determined, but it is not a foregone conclusion that the London market will see major price falls. What however does not help is that we are entering the quiet summer months and very small changes in sentiment could have a major impact.

The positon outside of London is far less rosy. The share prices of home builders have been particularly affected in recent weeks. In a parallel with the financial crisis of a decade ago it may be that those markets that see the largest negative impact are the former industrial areas. A decade ago this was due to their preceding house price appreciation being less underpinned by strong fundamentals and more by credit and mortgage market conditions. In contrast, in London stronger demographic and economic fundamentals meant a largely flat 2007-2009 rather than any meaningful declines. The irony of course here is that those regions that voted to leave are those most exposed economically and therefore potentially will see the largest fall in house prices.

The Investment Market

As already noted the underlying fundamentals looking forward vary quite significantly across the main property sectors. However, that is only one side of the equation and just as important is how will investors respond and this has already been quite interesting. Irrespective of ones view about Brexit and the underlying economic impact, it is unquestionable that it has caused uncertainty. If there is one thing that investors, irrespective of asset class, hate it is uncertainty. This was evident even before the referendum with investment volume in UK real estate down for the first six months of the year. We've already seen a widening of the yield gap between real estate and government bond yields. This is in part due to the fall in bond yields; however some property sectors are also seeing a softening in yields due to increased risk premiums as well uncertainty concerning future changes in capital values and the exit values that can be achieved.

It has been argued that the fall in Sterling could mean that overseas investment increases. In the core commercial sectors we are looking at a market with potentially prolonged economic and financial uncertainty, weaker fundamentals in a number of sectors and not much upside on capital values coming from yield. Yes a combination of softer yields and a weaker currency may be leading to 15-20% reductions in values in foreign currency terms. However, it effectively becomes a pure currency play and it is going to take a brave investor to increase exposures purely on that, especially as these are unlikely to be short-run positons. Furthermore, it needs to be remembered that given the amount of foreign investors already in the UK, and especially in London and the South East of England, they will need to offset any current opportunities with the fact that their existing UK portfolio has, in their domestic currency, just taken a big hit.

We also don’t know at this point how overseas investors will continue to view the UK. The real estate sector especially that in London has frequently been seen as a safe haven. However, we’ve already have had two Singaporean banks send negative signals in this regard. United Overseas Bank suspended underwriting new loans on UK property, whilst DBS issued an advisory note to clients highlighting the increased sovereign, economic and currency risks present. Generally on financing there is always the concern that if a correction in pricing does occur this will have knock on effects not only on the willingness of institutions to lend but also on the value of existing collateral. This in turn has negative connotations for the banking sector. UK banks were one of the equity sectors most affected in the immediate aftermath, in part due to this potential exposure. This is especially relevant as in some case they have not yet fully dealt with all of the problems arising from the financial crisis a decade ago. However, this in itself makes the views of overseas lenders that much more important. It is estimated that in 2015 overseas lending accounted for 42% of the UK market.

Very shortly after the referendum we saw significant events taking place in the fund sector. Within a couple of weeks a number of open-ended vehicles (managed by Standard Life, Aviva, M&G Real Estate, Columbia, Threadneedle, Canada Life and Henderson Global Investors) announced that they were limiting the withdrawal of funds by investors due to a rise in redemption requests. In itself this is not necessarily a sign of weakness in the underlying real estate market; rather it is a function of open-ended funds in real estate. Such vehicles have always faced the risk of a redemption run. Given real estate’s illiquidity it has meant that they are more vulnerable than comparable funds in more liquid sectors such as equities and fixed income. In these cases institutions are able to liquidate assets in a timely manner in order to cover redemption requests. In total we’ve seen seven funds with assets in excess of £7bn suspend trading. Other fund managers have addressed the issue by discounting the value of the fund, for example TH Real Estate by 5% and Aberdeen Asset Management by 17%. This has effectively made making a redemption request sufficiently unattractive. It may however have negative consequences if the broader market takes this as evidence of falling values. There is some preliminary evidence that these reductions are being used for re-pricing deals. On the positive side the speed of the response overall probably means that we will avoid the scenario seen in 2007 and 2008 when funds were forced to dispose of assets to satisfy liquidity needs. This in turn helped contribute to the major fall seen in UK commercial values.

Despite this in some respects being a technical restriction it does raise concerns. Firstly, the degree of redemption requests was obviously of sufficient magnitude that fund managers felt they had to act and do so quickly. This in itself raises question marks over investor sentiment. Secondly, that negative sentiment may itself be made worse by the actions of the fund managers. It has, if nothing else, reminded investors of the liquidity risk present in real estate, especially with open-ended funds. But let us be honest, this should not come as a surprise to a sophisticated investor. Less than a decade on from the financial crisis, much of which was associated in some shape or form with real estate, investors don’t really have any excuse to not be aware that real estate is an illiquid asset class and that this brings certain types of risk to the table. Individuals realize housing is illiquid, why can’t professional investors recognize the same issues apply to commercial property.

A medium-term implication of the redemption issue is that it may further encourage a growing trend towards “Blended Portfolios”. There has been in recent years a move in the UK for funds to have an adequate amount of liquidity. There has therefore been an increase in funds combining both private real estate market assets with a higher than normal amount of liquid securities. In some cases these are real estate related (e.g. REITs), in some cases cash or bonds. Some instances have been seen of pure replication portfolios. Blackrock, for example, launched an ETF that attempts to replicate the performance of the MSCI/IPD UK index purely with liquid securities. There has in recent weeks also been an increase in interest in funds using the real estate derivative market, in combination with short-term loan facilities, to provide the necessary liquidity.