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Savills World Research
European Research
July 2016

THE IMPACT ON EUROPEAN REAL ESTATE
Brexit Briefing

BREXIT BRIEFING

RETURN TO QUALITY

SUMMARY

Investors are expected to focus on quality assets and sound fundamentals

■ The decision of the UK to leave the European Union on the referendum of the 23rd of June has thrown Europe into unchartered territory. While Brexit is likely to have profound political implications for the EU, our economists expect the European economy to be rather resilient.

■ Government bond yields have dropped in the major economies in Europe, reflecting the risks in future economic growth, while global stock markets remain volatile. Against this backdrop income returns of prime European real estate still compare favourably and we believe that it will continue to attract investor interest.

■ We expect to see a return to quality, with prime assets in the German cities, Paris and the Nordic capitals in most demand. We believe that the secondary markets are more exposed to negative impact, weaker demand and price corrections.

■ In addition, some of the cities that are competing to attract a share of the banking sector activity, such as Paris, Frankfurt, Amsterdam, Dublin and even Madrid, could experience some positive effects on their office occupational and investment markets.

"As no country has left the EU before, the Brexit implications are still unknown. We expect investors to return to quality focusing on prime markets and assets benefiting from the stability and favourable returns of the prime European real estate sector." **Eri Mitsostergiou, Savills Research**

Economy

The United Kingdom's vote to leave the European Union on June 23rd has sent shockwaves across the globe and the initial shock of the outcome resulted in over $2.1 trillion in value lost in stocks globally and a drop in sterling to a 31 year low against the dollar.

Despite the substantial initial negative response from the European markets, the equity market reaction has been no worse than that seen during early 2016 China-related sell off. And while peripheral government bond spreads initially widened, they have since narrowed and yields remain very low. According to Oxford Economics, for now it seems unlikely that Brexit will trigger a major economic shock via the financial channel.

Following David Cameron's resignation after the referendum, the new UK prime minister Theresa May said she will set up a Brexit department, but she still needs to clarify what kind of relationship with the EU she wants.

The two year negotiation period for exit is causing tension between European leaders with the Leave campaign in no hurry to trigger Article 50 and the EU27 leaders keen to negotiate the UK's exit as quickly as possible to avoid further uncertainty and volatility.

So far, the German economy does not seem to have been affected by the UK's decision to leave the EU, with German officials confident that German businesses will be able to negotiate favourable trade agreements between the UK and Germany. With the fall of the pound, France recently overtook the UK as the world's fifth strongest economy.

It should be noted that the European economy has shown itself to be quite resilient to external shocks over the past couple of years. While sentiment measures did ease in the aftermath of the mid-2015 and early-2016 China-related financial market sell- offs, the declines were not especially marked. Domestic demand has grown quite rapidly since mid-2016, but the recovery is becoming less reliant on household spending as investment continues to pick up.

Oxford Economics believes that if Brexit turns out to be predominantly a trade shock and does not morph into a rather more malign financial market sell-off, the implications for the Eurozone are unlikely to be large. GDP growth forecasts have been downgraded slightly from 1.7% this year to 1.5% a year in 2017-19, reflecting lower export, investment and household spending. The forecasts for next year and 2018 are just 0.2% points lower than last month while 2019 is down 0.1% point.

Investment market

We have conducted an internal survey with Savills European experts regarding the potential short term impact of Brexit on our markets. With regards to the investment market, 45% of our local experts expect to have a positive impact, including Germany, Belgium, France, Poland and non-Eurozone Nordics. Another 45% believes that there will be no impact on their investment markets, including Italy and Spain.

As no country has ever left the EU before, Brexit brings great uncertainty in the markets, which is expected to continue in the short term. We believe that this could have a negative impact on investor confidence in the second half of the year.

For the time being investors continue to have strong appetite for European real estate. In the first half of the year the total investment volume in Continental Europe was at the same level as last year compared to -40% in the UK.

Lack of quality product, fewer large single asset and portfolio deals and potentially some uncertainty around the outcome of the EU referendum in the UK were the main factors for this drop in volumes.

The short term volatility in the financial markets and the uncertain political impact of Brexit could deter some overseas investors from Europe, such as institutional Asian and Middle Eastern capital or conversely redirect some investor interest from Britain to continental Europe.

We believe that investors who are committed to Europe will focus once again on safe havens and prime assets, benefiting from the wide positive yield gap between prime European real estate yields and long term government bond yields.

In the medium term, if the UK market experiences a softening in yields, the market might become more attractive to investors that can benefit from a combination of price corrections, weaker sterling and good income security.

As there is the possibility of the relocation of a number of jobs outside of the UK, particularly from the banking sector, the cities of Paris, Frankfurt, Amsterdam, Madrid and Dublin will be in the spotlight offering good prospects of rental growth.

Non-Euro (Sweden) and non-EU (Norway) Nordic markets, which already had a dynamic activity, last year, may attract further interest.

We might see higher risk premiums applied on secondary assets, while prime yields for the best assets should stabilise.

In terms of sectors, we believe that cross border investors will focus on prime offices in German cities, Paris, Amsterdam, Nordic capitals. In some instances investors will also look to benefit from a favourable outlook on the leasing markets, taking positions on developments and short leases.

Prime shopping centres and prime high streets in all major European capitals and well located prime logistics properties in major European hubs will continue to be sought after by investors.

As the focus will be on long term income and income security we expect sustained demand for alternative assets. This market segment, such as senior housing, healthcare, student housing, and apartments may not be affected as much from the economic and political uncertainty.

With 10-year government bond yields down in all major European economies, we expect the attractiveness of real estate to remain.

Occupier markets

Office

Based on the results of our local experts survey, in 67% of the markets where Savills has an office,

we expect the Brexit to have no direct impact on the office occupier market. In 22% it could have a positive impact notably in Paris, Frankfurt, Berlin and Brussels. In Dublin, we expect the impact of the Brexit to be negative in the short term due to the close economic ties with the UK.

Ultimately a negative knock on effect could come from a recession in the UK and an economic shockwave across Europe. Oxford Economics forecasts for Europe have been revised only slightly downwards and remain positive.

In this context, the labour market should continue to improve in most European markets and together with business investment, it will support office demand.

In the medium term, some markets may benefit from potential banking sector jobs relocation from London in EU countries. We believe that if the UK is unable to retain its financial passport, this could provide some European office markets with additional demand from the banking sector. Some companies including HSBC, Deutsche Bank, Bank of America, Morgan Stanley, or Goldman Sachs, widely supportive of a Bremain vote, already said they will move partially or totally their headquarters. Likely beneficiaries will be Paris, Frankfurt, Dublin, Amsterdam, Madrid or Brussels.

Nevertheless, if Mifid2 is enacted by the G20, it will mean that most financial services other than retail banking can be sold cross-border within the G20.

In most European markets the level of supply of grade A offices is limited and often restrains take-up. In our last European office market report we anticipated a rebound of development activity (22%); we still believe it will not be sufficient to meet the demand in most European markets.

Overall, the short term impact of the Brexit on the office occupier activity will be limited across Europe this year, we therefore maintain our last forecast according to which on average the prime office CBD rent will grow by 2.1% at year-end.

Retail

89% of the markets where Savills has an office or an associate office believe the Brexit will have no direct impact on the retail occupier market. Nevertheless, the uncertainty following the outcome of the referendum is likely to deter consumer confidence over the next few months.

Whether this will last or ease will depend on the ability for the UK and the EU and the speed in reaching an agreement. It will also depend on how the European economy will resist to the shock and if the purchasing power of European citizens is affected.

According to the latest Oxford Economics forecast, private consumption should grow by 8% in 2016 and 1.5% in 2017.

Multichannel and ecommerce retailers could be hit negatively in the long term when currency fluctuations stabilise, as online sales have much greater potential to be cross-border.

In the short term, the sterling dip to a 31-year low is probably the main drag for UK retailers or customers importing goods from the EU. However, some retailers could stand to gain from currency fluctuations.

In the long term, since imports from the EU would become more expensive and delivery times would be extended, we can assume retail trade between the continent and the UK will reduce. Parcels sent to non-EU countries such as Switzerland, Norway and Iceland face customs delays, red tape and tariffs of between 5% to 9% on average.

Logistics

Some UK based online retailers have seen a surge in European sales as European customers use the UK websites and lower valued currency to make purchases.

The implications for consumer confidence won't be fully understood until retailers start to report Christmas 2016 trading figures. At this point we will understand how hard the economy may be damaged, its implications for the retail sector and follow on impact for logistics real estate.

In the short term, very little will change in terms of trade flows, shipping routes and supply chain design. The uncertainty surrounding UK Brexit negotiations may mean isolated tenants choose mainland Europe to establish a presence rather than the UK.

Compared to 2007/2008, many European logistics markets have very low vacancy rates. We suspect speculative announcements particularly in the UK to slow in 2016. Providing take-up stays at average levels this will ensure vacancy rates and therefore rents will retain their upward trajectory.

Whilst there are possible implications for manufacturers, it should be remembered that the majority of the market is retail led. The structural changes in the retail sector(shift to online) will continue meaning the requirement for more warehouse space in the medium term will remain.

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