The EU referendum

Implications for commercial, rural and residential property markets

March 2016

SUMMARY

Short-term economic uncertainty will impact on all three sectors

■ The political battle lines have now been drawn ahead of the EU referendum on 23 June and there is much speculation as to what this may mean for UK and European real estate.

■ The polarised opinions being touted by the opposing campaigns – which are accompanied by claims and counter claims of scaremongering – do little to lift the fog. We have, however, endeavoured to provide a general overview of the possible impact of a Brexit on the commercial, rural and residential markets.

■ Generally, we believe that the medium-term implications of the result of the referendum are relatively unimportant for real estate. The fundamental attractions of all three asset classes have more to do with the assets themselves than whether they sit within or outside the EU.

■ However we do believe that short-term economic uncertainty could impact on transaction volumes across all three sectors.

■ A vote to stay in the EU would result in restored demand, though the extent of a 'relief rush' would vary from sector to sector. In the event of a vote to leave, such uncertainty would be extended to the period during which the UK renegotiates its relationship with the EU and other major trading partners.

■ The biggest direct risk is the potential long-term reduction in subsidies in the agricultural sector. In the commercial markets we do not feel that there is a substantial risk of companies relocating from London in significant numbers. While short-term risks in the residential sector are greatest in those markets where international buyers are most active, we believe the impact on the wider UK market remains largely dependent on domestic factors.

COMMERCIAL

Pre-referendum

The UK commercial investment and leasing markets are currently experiencing lower levels of activity than last year, with some decisions no doubt being delayed until after the referendum. This is typical of the run-up to most general elections, and also what we saw in the run-up to the Scottish referendum. Q1 2015, however, before the last UK General Election, was an exception to the rule, seeing a 57% rise in activity on Q1 2014.

In mainland Europe we're seeing slightly higher levels of indecision amongst EU-domiciled investors as they watch to see what the UK does, but deal flows in H1 2016 are expected to be broadly unchanged. Retail property might be affected by some short-term consumer confidence issues as the referendum date draws closer.

Post-referendum

If the UK chooses to remain in the EU on the new terms negotiated in February 2016, we forecast a rapid return of confidence leading to higher than normal deal volumes in Q3 and Q4 2016, and potentially some yield hardening due to competition.

The scale of this bounce-back could be considerable, with investment volumes in Scotland in the second half of 2014 after their referendum, being 45% higher than the norm for that period.

If the UK chooses to leave the EU we are likely to enter into at least a two-year period while the terms of exit are negotiated. Some occupiers are already preparing contingency plans for this and there is likely to be a period when they are more likely to renew leases rather than move, while they make their own plans about their European strategies.

Major London corporates are very unlikely to move their businesses from London to within the EU. However, their future headcount growth may be stronger outside the UK than in it, and this has implications for office take-up in London over the medium to long term.

For those which chose London as the location for their HQs in order to get a toehold in Europe, in the medium to long term some might move to within the EU, as may some European retailers. Finance occupiers are most concerned about the impact of a Brexit, although some have stated that if they did want to relocate this would be a long-term play and currently other major European cities do not offer the space or pool of staff required to support a move.

Retail property may experience limited medium-term impacts. Some retailers have suggested that employment costs might fall in the UK as some of these are related to EU legislation, but any change is likely to be minimal.

The impact on industrial occupiers is also likely to be relatively limited as, while many manufacturers rely on a wide European supply chain, their investment in plant and machinery in the UK is significant enough to rule out any immediate decisions to relocate. The most likely short-term impact will be increased operational and tariff costs for exporters at the point that their products hit an EU border.

In mainland Europe, leasing activity may see a medium-term boost as demand for office space in key alternative locations to London such as Berlin, Frankfurt and Paris rises. However, this activity may be undermined by potential further uncertainty if any other countries consider renegotiating their own terms of EU membership.

> "In the medium to long term the majority of non-domestic investors in UK commercial real-estate are likely to remain active in the UK, whatever the result of the referendum."

Over the short term, there will be a decrease in UK **investment activity** as some investors choose not to commit to the UK until there is more clarity on our position in Europe, the strength of the pound, taxation and legislation. However, given that investment volumes are likely to plateau anyway (as returns fall), a Brexit would probably hasten a rise in UK property yields, at least until investors view this as a buying opportunity.

In the medium and long term, the majority of non-domestic investors are likely to remain active in the UK, as their buying choices are driven by the unique security of the UK lease and the strong performance of UK assets, which are largely independent of the UK's position in the EU. Heightened uncertainty about the future of the EU itself post a UK departure may lead to lower deal volumes within the EU, but in the short term some top tier European markets will probably benefit from more investor demand. In the medium and long term, European investment volumes are likely to revert to normality, so long as the concept of the EU is not fundamentally damaged by a Brexit.

RURAL

Given UK farmers currently receive €3.2 billion of Common Agricultural Policy (CAP) funds annually – with CAP direct payments making up 60% of the average farm's net income – the EU plays a significant role in the current UK agricultural economy. In addition, 60% of the UK's food exports go to the EU and 70% of food is imported from the EU. Whatever the outcome of the vote on 23 June we need a positive and enabling platform for future rural and agricultural productivity.

Pre-referendum

As with other real estate markets, in the run-up to the referendum rural property is experiencing some uncertainty.

At present we do not have clarity on what farm policies and support may be introduced if we leave the EU: DEFRA Ministers have made it clear that it is up to those supporting an exit to develop proposals; to date politicians have only released their personal ideas. It is therefore impossible to provide a sensible analysis of future farm support impacts, but it is important to note that Norway and Switzerland have higher agricultural subsidies than the EU and this is an important reason why they are not members (subsidies account for over 50% of agricultural receipts in Norway and Switzerland, compared to about 20% in the EU).

Post-referendum

If the UK chooses to remain in the EU, current commodity prices will mean farm incomes will continue to be under pressure and the prospect of rising interest rates in 2017 will squeeze incomes further. This may make debt a significant issue for some farm businesses and may increase the number of farms coming to the market although, if this is the case, it is likely to be smaller farms. Overall, we don't expect supply to increase significantly. We expect average farmland values to come under pressure in the short term, with greater distinctions by reference to land quality and location.

If the UK chooses to leave the EU, there are various trade relationships that the UK could retain with the Union, depending on the level of integration desired. The most likely scenario is that trade in agricultural commodities would operate via a Free Trade Agreement, as recently negotiated with Canada and the USA. This would mean lower tariffs than under World Trade Organisation rules. Any tariffs would add cost to exports and reduce returns to farmers – although lower domestic grain prices might benefit livestock producers.

In terms of **subsidy levels**, as Phil Hogan, EU Commissioner for Agriculture, has suggested that the CAP already has a contract to support UK farmers until 2020 when the Multi-Annual Financial Framework ends, it is likely that in the event of a Brexit, farmers will have a couple of years' 'breathing space' to understand the new rural policy and make plans to adapt to it.

However, Labour and Conservative policy has historically been aimed at reducing the annual subsidy payment with a higher proportion diverted initially towards the public good. This suggests that the UK is likely to reduce direct support to farming further, which will probably be resisted in Northern Ireland, Scotland and Wales, if not in England. Nonetheless, indirect support such as agri-environment payments, the promotion of the public good and support for disadvantaged rural communities are likely to still feature and may be boosted.

With regard to **land values and rents**, in the event of a significant reduction in farm subsidies and therefore incomes (at least in the short term), the negative effect is likely to be greater on rents than land values, as the relationship between rents and agricultural profitability is stronger than for land values.

Uncertainty affects land market activity: prior to the UK joining the EU, and during each CAP reform negotiation, the volume of land marketed has reduced, recovering once the new position becomes clear. In terms of land values, when most countries joined the EU their land values increased, however in England they reduced and took four years to recover to their pre-accession level. Some commentators have suggested significant falls in land values, but without any detail on alternative policies it is difficult to predict. Values are already under some pressure.

Overall, in the medium and longer term, it is suggested that the agricultural sector will adjust and productivity could improve with a Brexit, similar to when New Zealand farmers lost their subsidy. However, there are unanswered questions about levels of support for the industry and this will create a measure of uncertainty in the short term.

> "We expect average farmland values to come under pressure in the short term with values being much more variable than in the past five years."

Commercial property saw a 57% rise in activity from Q1 2014 to Q1 2015

60% of the UK's food exports go to the EU and 70% of food is imported from the EU

Housing policy is a domestic issue and mortgage regulation sits with the Bank of England

RESIDENTIAL

Ultimately, the impact of the EU referendum is dependent on what the outcome means for the UK economy, given that housing policy is essentially a domestic issue and mortgage regulation sits with the Bank of England.

However we do believe that the UK housing market may be affected by associated economic uncertainty; both from the vote itself and, in the event of a vote to leave the EU, the two-year window for the Government to negotiate the terms of an exit.

"Ultimately, the impact of the EU referendum on the UK housing market is dependent on what the outcome means for the UK economy"

Pre-referendum

By affecting consumer confidence and people's willingness to commit to a house move, the referendum is expected to temper transaction levels and the general strength of demand.

Similar concerns were expressed prior to the UK general election in 2015. However, if we look at monthly transaction levels across the **UK mainstream market**, it is difficult to pinpoint a fall in general market activity prior to the general election, given that seasonally adjusted transaction levels were already on a downward path at this time, though the extent of the bounceback immediately post election suggests that sales were indeed suppressed in the pre election period.

With the outcome of the EU referendum far from certain, we could see a similar impact in 2016, although it is highly unlikely that it would cause the UK housing market as a whole to freeze. In the prime London markets, pre-election uncertainty had a much greater impact. In 2015 this was heightened because of policies that specifically affected the top end of the market, including a possible mansion tax and stamp duty changes introduced by the coalition in the 2014 Autumn Statement.

By contrast, in the first quarter of 2016 any uncertainty regarding the EU referendum has been offset by demand from those looking to beat the 1 April deadline relating to the 3% stamp duty surcharge on additional homes. Accordingly, we expect the impact to be more keenly felt in the second quarter of this year, particularly given the added political uncertainty from a London mayoral election in May.

Thereafter much will depend on the outcome of the vote.

Post-referendum

A **vote to stay** is likely to see restored demand, although we believe that any 'relief rush' is likely to be tempered by mortgage regulation in the mainstream market and taxation constraints among investors and in the prime London market.

Assuming a **vote to leave** Europe, a more prolonged period of uncertainty in the UK economy as an exit is negotiated has the potential to affect housing market demand, though the impact on values might be mitigated by a more prolonged period of ultra low interest rates.

Similarly we would expect overseas buyers in the prime markets of central London to be more cautious, despite the prospect of a weaker sterling that has previously been a catalyst for this source of demand. We also believe this sub-market is more exposed to the short-term risks to the financial services sector, which would make it more difficult to sustain a return to trend rates of house price growth.

However, whatever the outcome, there will continue to be a market once the uncertainty clears, albeit potentially more focused on needs-based moves. The drivers of death, debt and divorce, together with the needs of upsizers and downsizers, will continue to drive turnover.

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