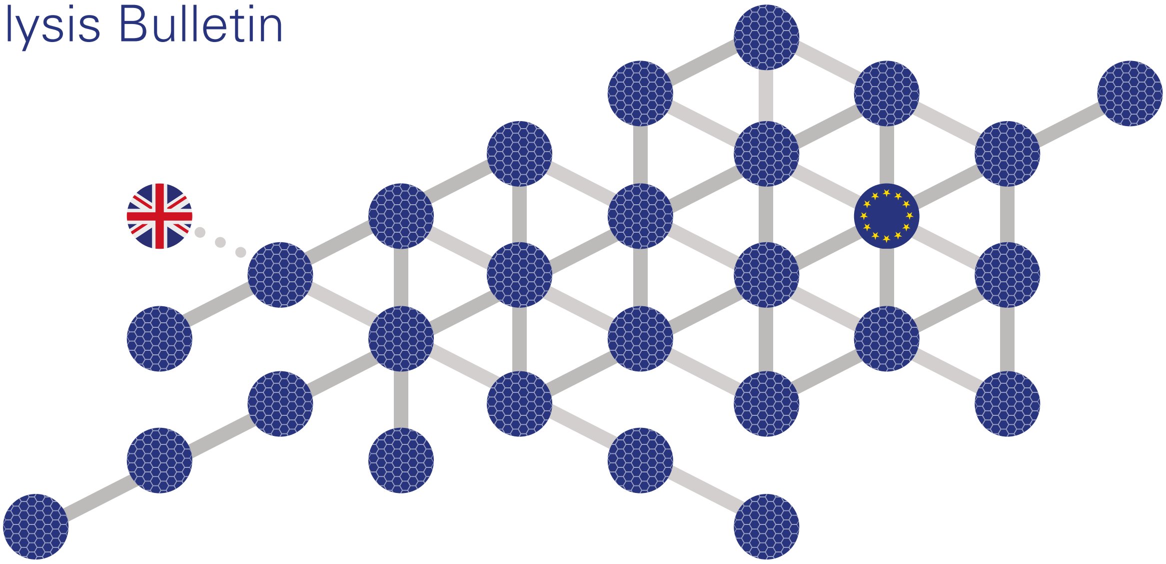
First published 14/04/16
Updated 29/06/16

SHEPHERD+ WEDDERBURN

Brexit Analysis Bulletin
Property



On 23 June 2016 the UK public voted in a national referendum in favour of leaving the European Union. There was an immediate impact on financial markets worldwide, impacting heavily on UK banks and property companies, but also creating a sharp decline in the value of the Pound. As was mentioned in our bulletin issued before the referendum vote, a period of uncertainty is generally bad for the commercial and residential real estate markets in the UK, and there is uncertainty both over the true impact of the UK leaving the EU and also, more immediately, political uncertainty within the present government and opposition parties. This briefing looks beyond the immediate to the potential longer term effects of the referendum decision.

The UK property sector – legislative framework

Despite the wide-ranging influence of EU legislation on the national laws of member states, property law for the most part falls within the scope of national oversight. Consequently, there are very few immediate legal repercussions for the UK property market, with the exception of certain sectors, such as investment fund regulations and, to some extent, planning and environmental regulations, that fall within the EU regulatory framework. The implications of the referendum decision on the UK economy as a whole is likely to have more impact on the property sector than the prospect of any immediate changes in legislation directly impacting on real estate.

However, sitting alongside the uncertainty of “what next” is now the Government decision to press on with taxation of non-residents’ profits from trading in and developing land (as announced in the 2016 Budget, but with provisions now to be introduced to the Finance Bill at Committee stage). This will have an impact of its own and is likely to compound any softening of commercial market conditions (the residential market has, of course, already seen the introduction of additional tax burdens on non-resident investors).

Uncertainty – the investor’s stumbling block

For those working in the UK property investment sector, the biggest concern is uncertainty and the instability that prolonged negotiations over the terms of the UK exit from the EU might bring. This could compound pressures on the investment market that were already being felt in the first 6 months of 2016. Various reports that have been issued indicate that investment in the UK property market dropped by up to 39% over the comparable period in 2015. We have seen some clients take immediate decisions to withdraw from the UK market, at least in the short term, whilst others are deferring a final decision on transactions to see if market instability will be short term or the shape of things to come for a longer period.

Foreign investment – outward or inward flow

Before the referendum vote, one forecaster wrote of a potential vote to leave as likely to entail “an immediate and simultaneous economic and financial shock for the UK, due to an expected drop in business investment, hiring and confidence, cease in flow of capital into the UK and a sharp fall in the value of the Pound” . This forecast was, of course, proved correct, particularly with regard to the value of the Pound[1]. Coupled with sharp reduction in the value of shares of FTSE 250 companies, it is likely that there may be a rebalancing of investment portfolios. With general falling sentiment, and the possibility that some investors will have overextended in the recent boom market, we anticipate, in common with most other commentators, a drop in investment values and transactional volume.

Research by Knight Frank LLP suggests that 49% of investors in the central London commercial and residential property markets are foreign investors. It is likely that the London property market will still be perceived to be a "safe haven asset" and therefore remain a key target for investment. Despite current uncertainty, a majority of overseas investors see opportunity to invest, driven by a belief that, whilst there may be some volatility for a period, the value of the Pound has probably already hit its nadir. It is also likely that inflation will now be a feature of the UK economy and so growth assets will be attractive to investors. Lenders, even main UK banks whose shares have been hit hard, are posting "open for business" signs, albeit there is a widely held view that pricing for deals will move and it will take time for lenders to feel comfortable whilst the currency and bond markets settle. Development finance may be more challenging, given both general market volatility and the potential impact on construction costs if the labour market becomes even more constrained.

Demand and Supply

The interaction of market forces affects demand and supply for property, especially with regard to the accessibility of the UK property market. Where entry and exit into the market become cumbersome, there is a possibility of investors diverting into other markets. The most vulnerable property sectors currently include central London commercial properties and offices, residential investments, student accommodation and properties in the South East generally, although we do expect that the market in other major cities in the UK may experience similar effects. Rumours are circulating that international and European companies, and specifically international banks, and other financial institutions, will relocate some of their operations out of the UK. Other industries and sectors looking to open a new plant or operations are also deferring decisions, particularly new operators who were looking to expand from the EU into the UK market. We have found less nervousness on the part of US and Middle Eastern based operators.

By one estimate 10million square feet of office space in and around the City of London could be subject to lease termination events by 2021 and it is clear that the terms of future engagement with the member states of the European Union, and particularly "passporting" of authorisations for financial services businesses, will have a major impact on occupier demand and values. Whilst we believe there will be a negative impact on rents and capital values, this could well represent an opportunity for domestic investors to buy back into a softer market, as the UK will remain a country with a highly skilled workforce and a market that large employers and consumer orientated businesses will wish to continue to access.

There are presently concerns, as indicated above, that developers relying upon subcontractors and construction workers from Europe will see something of a crisis within the supply chain, particularly given the emphasis in the Leave campaign that there should be restrictions on migration which would almost certainly have implications for free movement of goods and services within the UK and the rest of the EU. Costs of construction are likely to rise.

Conclusion

Many commentators have taken the view that, over the longer term, the impact of the UK leaving the European Union will be largely neutral. Many regulations which have an impact on the property sector, such as those relating to the environment, employment and conditions of workplaces, will not change as a result of the referendum vote. Whilst there may be an initial downward pressure on capital values, with the reduction in the value of the Pound, the indications are that overseas investors may well see even a period of uncertainty and instability as an opportunity, and the market could be significantly more active than in the run up to the referendum itself.

It is probable that the UK, even once Article 50 has been invoked, will continue to be an attractive market for investors, not just within the 2 years of negotiating terms of a future relationship with the EU, but because it seems there is a universal view that there will be a continued trading relationship between the UK and the remaining member states of the EU supporting continued demand for quality products in both the commercial and residential real estate markets across the UK.

[1]Katie Allen "Brexit Would Trigger Economic and Financial Shock for the UK" 25 January 2016 www.theguardian.com

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JOINING THE DOTS OF THE EU REFERENDUM

What next?

Shepherd and Wedderburn has been for many years offering balanced and impartial advice on how the different scenarios might play out in the event of constitutional change.

Now that the vote has been cast to leave the EU, members of our dedicated Brexit group continue to interrogate the regulatory and commercial issues and to advise clients on next steps and outcomes.

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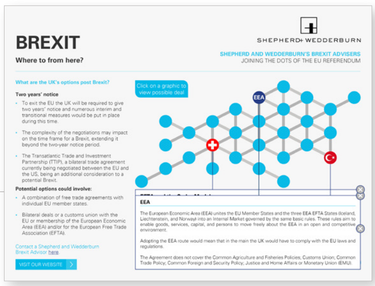
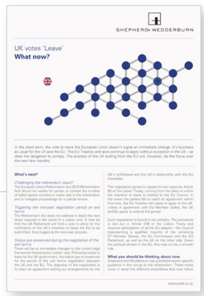


Click here to read our 'What now' Brexit bulletin.



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