EU Referendum: Making sense of Brexit - 5 days on

Briefing Note | 30 June 2016

Highlights

- The referendum results showed a majority of those voting in favour of leaving the European Union, although the next steps remain highly uncertain. Political and economic uncertainty is being reflected in currency and financial markets. Volatility will continue as a result
- Underlying economic fundamentals in the UK remain solid in comparison to previous downturns, although expectations are not surprisingly being downgraded
- **Occupiers** are taking stock; flexibility is likely to become fundamental to near term decision making. Longer-term impacts (loss of ‘passporting’) or benefits of Brexit still to play out
- **London office** occupier demand will be subdued in the near term. Low vacancy, coupled with an increasingly diverse occupier base, should prevent a dramatic fall in rents compared to previous market corrections
- High end **residential** in London is susceptible to weakened demand, although the fall in sterling will attract overseas demand from purchasers from dollar pegged markets – notably Middle East and Asia
- **Hotels** to benefit from weakened sterling and increase in tourism; likely adverse impact on costs. Prime hotel assets are less vulnerable to any price correction
- Occupier demand in **industrial** will soften; slowing speculative supply will support rents. Investment pricing will come under some inevitable pressure in the short-term
- **Retail** has responded well since 2008 to cyclical and structural change; retail spend is resilient, although not immune. Relevant and resilient retail will hold, weaker secondary is more exposed
- Demand for **alternatives**: healthcare, education and student accommodation will be supported by structural and demographic change. The investment market is still likely to be impacted in the short-term
- Indirect investment may have been oversold post vote, but has subsequently rallied. Direct real estate **investment** has paused to absorb the implications of the vote. Assuming occupational demand remains in better shape to previous downturns and favourable currency movements support overseas investor demand, impact on values will be contained.

Intense political uncertainty after Brexit vote

The shock of the Brexit result has been followed by a period of extreme political uncertainty. The country is now preparing for a new Prime Minister, with an opposition in turmoil and the very make-up of the UK under question. Constitutional issues over majority Remain votes in Scotland and Northern Ireland will be difficult to address over the longer term, with the latter particularly problematic given the land border with the Irish Republic.

Over a shorter horizon, the focus is Article 50 of the Lisbon Treaty, which sets in motion the process of the UK leaving the EU. Once activated, this sets the clock ticking on a two-year time limit for formal negotiation, among the other members of the EU, on the terms on which the UK will leave. It is worth noting that this process does not necessarily include the terms of the UK’s future trade relationship with the EU.

This may explain why outgoing Prime Minister, David Cameron felt this could only be triggered by his successor. Delay is not popular with EU politicians, who face multiple internal challenges of their own, but allows the UK to hold a position until domestic issues are resolved. It is now probable that a General Election will be called to ratify any proposed way forward. Once Article 50 is triggered, the process then becomes entirely defined by the EU. It is entirely possible that an exit could be negotiated through a separate route, but there is no appetite for this at present within the other member states.

While it is unclear how a Brexit settlement will look, the most desirable outcome would involve continued access to the single market, including EU-wide “passporting” rights for UK-based financial institutions, if the Conservatives hold the balance of power and the rest of Europe is willing (the so-called Norwegian model). This will require concessions on freedom of movement and with immigration a key issue for other Leavers, this contradiction may be hard to resolve. There may also be EU financial contributions required to secure access which, with no direct political influence, will be unpopular. In a mood of political and possibly economic crisis, however, voters may become more willing to accept compromise.

Potential chain of events leading to an Article 50 decision

- New party leaders in place (early September)
- Initial plans from UK party leaders
- Hints on concessions from EU leaders
- General Election (October/November)

Economic concerns mount

As expected, initial market reaction to the EU Referendum outcome was severe, not least because the result was so unexpected. Sterling fell 10% to a 30-year low against the dollar before a recent jump and by slightly less against the euro. In the meantime, the FTSE fell by 5-6% before a modest bounce on the Tuesday following the vote. Much sharper declines were seen for REITs, housebuilders and

banks, while some European bourses also saw significantly sharper falls than the UK. Yields on 10-year UK government bonds dropped below 1% for the first time ever, as investors bet on an interest rate cut.

On Friday morning, the Bank of England promised £250bn of funding to ease financial strains and hinted at impending interest rate cuts. We continue to expect a 50bp reduction in policy rates over the coming months. On Monday, the Chancellor appeared for the first time since the vote and delivered further reassurance to markets along with a reiteration of the UK's strong fundamentals to weather any instability. He has also since reiterated that the shock of Brexit will require tax rises and spending cuts at some point ahead.

Ratings downgrades were expected after the vote. S&P had been the only major agency to maintain AAA ratings for the UK, but cut by two notches to AA post-vote. Rival agency Fitch had already lowered its rating from AA+ to AA, on the view of an "abrupt slowdown" in growth. So far these changes have reinforced general pessimism, though any negative impact on market interest rates has so far been modest.

Soon after the vote, there was speculation on the future of some roles in London's Financial Services sector. An Institute of Directors (IoD) survey found that a quarter of members would instigate a hiring freeze, while many other businesses made negative comments about the impact of the vote. This anecdotal evidence adds to ongoing concerns across business, particularly surrounding the loss of "passporting" within the EU. We will be monitoring sentiment ourselves over the coming days and weeks and will use this to inform our next house view.

As yet, hard economic releases refer solely to the pre-vote environment. It will be later next month before the early signals start to appear and sentiment measures will be especially closely scrutinised. Business investment had already flatlined before the vote took place.

Meanwhile, Brexit scenarios have quickly become official forecasts as the short-term outlook is re-assessed. Forecasts for the economic impact vary but suggest a slowdown in UK growth. It is worth noting, however, that these analyses predate the vote and are likely to be revised in due course.

While it is unwise to underestimate the short-term challenges to the economy, it is also important to reiterate the healthy fundamentals that existed before the turbulence and will limit the downside:

- This remains a political not an economic shock
- Business and consumer confidence will be key, but impact could be eased by political progress
- Weaker sterling and lower borrowing rates provide an economic safety valve, while inflation rates are currently exceptionally low
- Financial distress is moderate with no repeat of the credit crunch in prospect and interest rates may be cut further
- UK financials are well capitalised and household and corporate balance sheets are healthier than before previous downturns.

Nonetheless, there is downside potential across all sectors.
UK prospects over the long term will depend on the type of trade agreement in place. Independent experts suggest a loss to UK output and incomes of up to 10 percentage points over five years, with the best outcomes from unrestricted labour movement and single market access, and the worst with reversion to WTO (World Trade Organisation) global trade agreements. There will be fiscal savings from EU exit, but these are likely to be relatively limited and will probably be offset by the costs of lower growth short-term. Beyond 2020, long-term economic performance is harder to gauge, but downside should reduce as uncertainty about the UK's future direction clears.

Property market impacts

- **Occupier demand** is expected to weaken in line with economic growth and declining business sentiment, with some sectors, such as financial services and manufacturing, disproportionately affected. This will take some time to play out in volume terms, but the impact on rents will be limited by tight supply
- **Investor sentiment** will deteriorate further subduing capital flows in the short to medium term
- There is likely to be a negative **capital value adjustment** over next two years. London segments remain most vulnerable to correction
- The **residential** market is expected to cool despite lower interest rates, but any correction will be mild. Prime London values – which have already seen some downward adjustment – may see some benefit from currency movement, despite other headwinds. Transaction volumes are likely to see more marked falls
- For property markets, the initial correction may be most severe, followed by an **upturn as opportunities re-emerge** in the UK and benefits of weak sterling are recognised. Much will depend on sentiment, relative pricing in Europe and progress on a new settlement for the UK.

The occupier perspective

Digest, consult and plan: Corporate occupiers are currently in a digest, consult and plan phase. With many businesses articulating a clear preference to remain within the EU, real estate teams are now engaging closely with executive leaders to assess and review CRE strategy in light of Brexit. Contingency planning has been occurring over a number of months at larger organisations, however any potential strategic relocation decisions are unlikely to be made until there is greater certainty on the EU/UK 'settlement' and associated trading, legal and operating considerations.

Uncertainty and hesitation: Market, currency and share price volatility, combined with the inherent complexity of predicting the political outcomes involved in Brexit, are leading many businesses towards greater hesitancy and caution. This caution is likely to impact sentiment, business investment levels and, potentially, hiring. A recent

IoD survey of 1000 business leaders conducted post-Brexit pointed to a quarter of firms freezing hiring, although a third expressed no change to hiring intentions. More than a third planned to reduce their investment plans.

Varied industry impact: The impact of Brexit will also vary considerably between sectors. Much of the initial focus in terms of equity market volatility has been on the financial services sector. The impact of any UK/EU settlement on the 'passporting' rights of financial services institutions to sell their services in Europe, or to trade in Euro denominated instruments from London, will be influential in long term location and portfolio strategy. These decisions will not be finalised in the short term. Many other sectors including life sciences, energy, healthcare and some consumer goods companies have stated the impact will be limited in the short term.

Flexibility will become more crucial: Flexibility was already becoming more critical for companies that are looking to transact. We expect lease terms will increasingly adjust to incorporate greater flexibility, allowing corporate occupiers to respond to the evolving political and diplomatic situation.

The investment perspective

Sell, huddle and open for business: The listed real estate market which, in all fairness, had become a proxy for overall Brexit risk (full UK exposure and a significant market cap to trade), has taken the biggest hit and markets initially priced in a 20-30% fall in underlying assets, but there has been a slight rebound. Some analysts have now called the sector oversold. In the direct market, investors have gone into a huddle internally to understand better the implications and to formulate a post-Referendum strategy. However, quite a few investors have said they are "open for business" as normal.

From risk-on to risk-off: Many of the trades in liquid markets were a reversal from the risk-on positions following the positive polls for Remain, into risk-off post the result, which has amplified some of the moves we witnessed over the last few days. Political uncertainty remains the main driver, but nevertheless we expect the market to find a new equilibrium over the coming weeks, and then the impact of new developments can be assessed.

Real estate occupier markets in better shape than in 2007: Most of the UK sectors are in relatively good shape from an underlying real estate perspective: tight demand-supply, pricing within reasonable limits, low levels of leverage and limited development. Although in some markets rents have risen, this has followed a deep fall after the Global Financial Crisis (GFC); excessive rental growth expectations have not been priced into bids. Funding costs are still well below very low prime yields unlike in 2007. So even if we are entering turbulent times, we are much better prepared than during the last crisis.

For direct real estate, the main risk is deteriorating occupier market conditions: With most of the uncertainty being priced in the listed sector, which may lead to some softening in direct real estate investment, investors will be increasingly looking for proof of weakness in occupier markets. For example, if the threat of relocating 'passporting' companies to European cities materialises, this will adversely affect future cashflows, which for a long-term income buyer is one of the main attractions of core real estate. Investors need to watch developments in occupier markets closely to understand the risks.

Sector focus

Offices

The major UK office markets have seen strong leasing activity and falling supply levels in recent years, with rents rising strongly as a result. The markets continued to see high levels of activity in Q1, but a slowdown has clearly taken hold since the referendum was announced in February.

The office market is directly exposed to the impact of Brexit and early indications are that take-up has reduced significantly in Q2. The City of London market is widely regarded as the most exposed; take-up in Q2 may drop below 1 million sq ft for the first time since 2012, well below the long term average of 1.4 million sq ft per quarter. Regional office markets are also expected to see significantly lower take-up in Q2.

The outlook for occupier demand in the near term is subdued, although this will take some time to play out. Larger corporates in particular are expected to delay decisions, and the financial sector exposed to the potential removal of 'passporting' rights for London-based firms to offer cross-border services across the EU. However, as availability is low, this is unlikely to result in a dramatic reduction in rents. Also, office demand in London has become more diverse, with less reliance on the financial sector in the aftermath of the financial crisis.

Looking outside the UK, in the major European cities, office leasing markets are firmly in recovery mode, with take-up in Q1 20% up on Q1 2015, with further increases in activity over Q2. The availability of business space is generally much higher than in the major UK cities, and consequently rents have not been subject to the same pressures. There has been speculation that London-based banks may re-locate some staff to cities such as Frankfurt, Paris, Amsterdam and Dublin, however these strategic decisions will take time, and are unlikely to be made until there is greater certainty on the new UK settlement with Europe.

Residential

Over the short term, housing demand is influenced by employment outlook, wage growth and the availability and cost of mortgages. The JLL central view of economic impacts from Brexit implies at least a moderate knock to housing demand from new purchasers.

In London, the perceived threats to the financial services sector may

reduce high-end domestic demand. However, a devalued sterling opens up a large buying opportunity, notably from the dollar-pegged currencies of the Middle East and in Asia. Paradoxically, Prime London may be the one housing market in the UK to see upward pressure in price, as a result of the referendum decision.

Mortgage lending is likely to remain robust, albeit skewed towards perceived safer locations. It is unlikely that lenders will follow should the base rate be reduced by 25 basis points. A moderate increase in risk aversion is likely, with a bias towards more conservative terms that will favour home movers over first-time purchasers.

Early reports from mainstream housebuilders are of consistent demand at pre-Brexit levels, in any event the sector is well funded and able to control supply in a spread of locations across the UK. We do not foresee a marked slowdown in demand from their traditional buyer base, with Government programmes continuing to subsidise new build purchases. Recent past has shown Government willingness to offer strong support for the sector in times of difficulty. On the cost side the mainstream housebuilders have preferred status with suppliers, so are relatively insulated from potential cost increases from a thinned labour pool or imported materials.

London developers may be forced to curb supply in response to rising costs, given a greater exposure to high-density schemes that require bigger financial commitments. This may serve to weaken supply and ultimately place upward pressure on price, particularly if there is an uptick in demand from international purchasers leveraging the currency arbitrage. What is undoubted is rental demand and so even if the for sale markets softens we anticipate some 'for sale' schemes will be switched to the burgeoning Build to Rent market, where institutional investment demand will continue to strengthen despite the Referendum outcome.

Hotels

The UK remains an attractive global destination, and the country's rich culture and heritage continues to draw international visitors, with London being one of the most visited cities in the world. The recent weakening of sterling in comparison to other major currencies will make the UK a more affordable destination for international travellers. In addition, we expect a rebirth of the "staycation", as domestic travellers choose to remain in the UK given the rising costs of foreign travel.

From a hotel operations perspective, there will be concerns around labour and costs. The UK travel and tourism industry relies heavily on workers from the EU. The cost of imported goods will also go up and may hit the bottom line for hoteliers, although this may be balanced by the increase in demand outlined above.

In the hotel investment market, we anticipate a re-pricing of hotel assets. The cost of borrowing may increase as the UK is now seen to be more risky. This, together with the economic uncertainty may lead to a reduction in capital values. UK yields are expected to soften by between 50 and 100 basis points with prime hotel assets the least affected.

The expected decline in values may attract more opportunistic investors, particularly those who can benefit from the weak sterling. Well-capitalised owners will take a "wait and see" approach until the market stabilises, which will constrain supply and lead to reduced transaction volumes.

Once the terms of the UK's departure are agreed, the longer term impact on the European hotel market will become clearer. Regulations that are currently in place, such as the free movement of goods and services, investment and people may need to be revisited. The Open Skies agreement, which represented one of the most tangible benefits of EU membership and allowed airlines such as Easyjet and Ryanair to flourish, is just one example.

Industrial

Short-term occupier demand for industrial and logistics space will be lower than if the country had voted 'Remain'. Businesses will put on hold decisions to acquire new facilities, given current uncertainties. In addition, foreign direct investment from manufacturing businesses is likely to decrease, as much of this is motivated by access to the European single market.

This implies a reduction in new supply, with developers and investors likely to proceed more cautiously given the current uncertainties. How these two changes play out in terms of rental growth is difficult to judge. The market had already seen significant rental growth over the past couple of years, and as a result this will probably moderate moving forward.

Anecdotally, many large warehouse operators employ significant numbers of migrant workers from EU countries. If this source of labour diminishes, this will exacerbate labour shortages and raise labour costs. Labour will become a more important location factor for some corporates; others will look to more automation as an alternative.

Investor demand is expected to weaken in the short-term. Despite a fall in bond yields since the vote, we expect a short-term softening in property yields, as investors make adjustments for a weaker occupational market and rental growth outlook and a higher level of risk. However, any short-term reduction in prices, combined with a weaker sterling exchange rate, could encourage more investor demand once immediate uncertainties die down.

The UK economy remains fundamentally strong and many of the factors that make the UK industrial and logistics market attractive to developers and investors will not change. Demand is also being driven by changes to customer-supplier trading relationships which require supply chain networks to adapt. Potentially, also, there could be a more active regional and industrial policy with the UK free from EU State aid restrictions. Amid all the uncertainties, one thing seems certain: disruptive change on this scale will create opportunities.

Retail

The vote to leave the EU brings a new dawn for retail & leisure in Britain and Europe, along with short-term uncertainty. The full implications will take time to manifest, but any medium to longer term negative impact on consumer spend is unlikely to be as severe as during the 2008 downturn.

To an extent, the impact of the GFC has kicked the industry into better shape, and significant structural change has already been largely absorbed by much of the retail market; the sector is arguably better positioned than in 2007. Underlying economic fundamentals remain strong; the UK consumer has adapted over recent years, and retail spend has become more resilient to economic shock. Spend in leisure has actually outperformed and has witnessed growth.

Retail proved relatively resilient throughout the GFC, with other elements of discretionary spend more impacted. While consumer confidence and spending power will undoubtedly be hit to some extent by Brexit, retail represents an increasingly lower proportion of household spend compared to the long term, making a repeat of this pattern of resilience likely.

Many retailers have hedged against a fall in sterling, but a prolonged fall in value will affect import costs and ultimately consumer prices and spending power in the longer term. Conversely, currency devaluation will reduce the costs of exports, which will benefit some domestic retailers and start-ups. Experts have agreed that minimising the rise in the cost of goods for consumers and providing certainty for retail businesses must be at the heart of the Government's plans for life outside the EU.

The retail investment market will continue to be redefined against the backdrop of uncertainty and ongoing structural change. As we have seen over the last eight years however, resilience prevails across the country. The right assets with core success attributes will continue to remain relevant, will compete for our time and spend and will become increasingly resilient to change. There is still significant value in relevant retail property, located in the right locations.

One thing is certain; there is no way that the UK retail market will remain unaffected by the decision to leave the EU, either positively or negatively. Change leads to uncertainty, it also leads to opportunity here and elsewhere in the EU; new pockets of resilience will emerge across the retail spectrum. Winners and losers existed in retail before the EU Referendum – in that respect nothing has changed.

Alternatives

Aspects of the healthcare sector, given their focus on an asset-rich, ageing population, are likely to be among those least affected by the outcome of the vote, particularly given the long-term income available in many sectors. However, as the majority of healthcare is still funded by the public sector, there will be implications produced by the impact of Brexit on public spending.

The student accommodation sector, too, would appear to be less vulnerable. While overseas students are crucial to its performance in London in particular, students from outside the EU, notably China, are arguably more important. Any potential reduction in EU immigration may make it easier for the UK Government to adopt a more flexible visa regime that might attract more non-EU students. Nevertheless Brexit does open up other longer-term risks to the sector, given the importance of EU academic grants.

Equally, sectors such as self-storage, while potentially affected by a drop in consumer spending and disposable income, will also benefit from potential house movers delaying the purchase or rent of a larger property.

What next?

This is the first in a series of notes exploring the impact of a potential Brexit on the UK property market. JLL Research will be monitoring key economic and market indicators and the developing political context and providing analysis when appropriate. The next note, alongside this, will look more specifically at the impact on different parts of the UK.

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