Braced for a Brexit?

In the second of a series of updates on the capital markets sector, BTG Financial Consulting considers the implications of a possible UK exit from the EU.

With a Grexit, unlikely, at least in the short term, the prospect of a far more significant departure from the European Union – the UK’s – continues to loom large.

Uncertainty remains over the probability of a ‘Brexit’ – which will be decided through a referendum by the end of 2017 – largely because the recently elected Conservative Government’s pitch to remain inside the EU hinges on a successful renegotiation of the UK’s membership.

In this article, we will first examine the implications of a Brexit according to the political macroeconomic as context to understand the second-order property investment consequences.

The global financial crisis, recession, austerity programmes and rising unemployment has seen hostility to the European Union rise right across the continent. The UK has been no exception.

Mr Cameron, backed by a Conservative-only Government but carrying expectations of Eurosceptic backbenchers who will demand a far-reaching and lasting deal, is yet to fully set out the details of his requirements, but the broad themes are expected to include:

• An opt-out on the core EU aim of “ever closer union”;
• National parliaments must be able to work collaboratively to block unwanted EU legislation;
• Safeguard the City of London and other financial centres outside the eurozone; and
• Curbing EU migration and significantly restricting benefits for new migrants from the EU.

Turning to the macro considerations – gauging the effects on business and consumer confidence and how that translates into domestic and foreign direct investment (FDI) following a potential Brexit is difficult.

Potentially, the UK could see big swings in asset prices and the sterling, with financial markets enduring a long window of uncertainty. Volatility will likely be correlated to the closeness of public opinion as we near the date of the in/out referendum.

The UK has been a key recipient of global FDI from EU member countries including, of course, capital flows into commercial real estate.

Many have suggested that FDI could be strongly adversely affected by a Brexit on the grounds that investments in the UK economy are often made with regard to the UK’s access to the rest of the EU.

For the property industry, the likely substantive impacts arising from the UK leaving the EU across the property market would affect investors, developers, occupiers and regulators.

According to a recent survey, more than 60% of investors surveyed believed leaving the EU would have a negative effect on the UK’s attractiveness as an investment location, with fewer than one in 20 thinking a Brexit would be positive from a property perspective.

The concern is in whether uncertainty surrounding the outcome of the EU referendum risks reducing the UK’s appeal as an attractive location for property investment.

The effects of a UK exit are unknown, particularly the terms on which the UK were to leave, which makes quantifying impact on investment, development, occupier markets, as well as replacement regulation, nebulous.

For foreign investors, the impacts around the London commercial property market will be most acute, given the scale of overseas capital flows which targets the London real estate market. Any dampening in the global capital flows into London and the broader UK real estate markets could impact the broader economy and, in turn, occupier demand.

London and the South East is currently home to headquarters of 60% of the top 250 global companies, such as AstraZeneca, Barclays and Vodafone.

A Brexit would have clear implications for office space demand from major multinational companies. Furthermore, if movement of skilled labour is to be restricted, wages would be pushed up creating a potential skills shortage, which ultimately would lead to a GDP drag.

Access to a skilled labour market is a key consideration for businesses, a lack of which could force occupiers to consider alternative locations for their headquarters, such as Frankfurt, Amsterdam or Paris, eroding London’s claim as the financial capital of the world.
The financial services industry, for which London is seen as the world’s pre-eminent global capital city, would be disproportionately at risk and in turn so would the related support industries, such as legal services, accounting and management consultancy.

The counter argument is that UK’s freedom from EU regulations would remove regulatory restrictions on the financial services firms, which could lead to an increase in London’s relative appeal. Inevitably, which of these two arguments proves correct is simply not yet knowable.

A recent comparable is the run-up to last September’s Scottish referendum, which caused a slowdown in second-quarter on transactional activity. But, of course, the impact of the UK leaving the EU is far more significant for property markets and global financial markets than Scotland leaving the United Kingdom.

Ultimately, fundamental drivers of growth will always be more important to property markets in the medium to long term, as evidenced by the bounce back in third-quarter transaction volumes once the Scottish people voted to remain part of the Union.

As one of the most liquid and transparent markets in Europe, the UK is likely to continue to attract significant capital flows even if it leaves the European Union.

But while uncertainty lingers as to what a Brexit would look like and how it would impact the economy and property markets, anecdotally, the current wisdom seems to point to an expectation of the UK remaining in the EU. This would ensure London retains its position as the pre-eminent real estate market investment location in Europe.