Research Blast

European Real Estate Market, Brexit Update April 2016

Brexit: Our expectations

Likelihood:
A vote to remain continues to be the more likely outcome and GRE research believes that the likelihood of this has increased marginally after Cameron achieved his reforms in Brussels. The polls however are largely inconclusive and varied, but the likelihood remains that as we draw closer to the referendum the undecided voters will err with the status quo rather than face the uncertainty of a Brexit. As a result, our main scenario is that a vote to leave remains a distinct possibility in the run up the election, but in a close result the UK votes to remain, in a similar manner to the Scottish independence referendum. Consensus and odds from bookmakers puts the likelihood of an exit at around 30%.

Run up to referendum
Under the main scenario, we expect real estate activity in the UK to drop off significantly until after the referendum. While data for 1Q is not yet available, anecdotal evidence from the market indicates that this has been the case with a significant decline in activity being reported. Overall the occupier side is likely to be slightly less affected, and domestic UK demand in particular should continue to tick over, but it is certainly likely any companies with exposure to European markets will put off relocation or expansion decisions until after the result is known. This is likely to have a pronounced impact in London where the vast majority of large global corporates who operate within the EU market are based. However we do not expect landlords to reduce rental levels in an attempt to stimulate demand during this period, with a preference to wait and see what the outcome is before acting. After a vote to remain, we expect pent up demand to come back to the market in the second half of the year, with a minimal overall effect on the market.

It appears the referendum is having an impact on the supply pipeline in London, and construction starts have fallen back significantly since the middle of 2015. With major speculative schemes highly unlikely to go ahead until the result is known, this will result in a c. 12 month delay in the expected delivery of supply in Central London, which could further prolong the period of rental growth into 2017, with the correction in rents coming through in 2018/19 assuming the schemes move forward in the second half of 2016 after a vote to remain.

We expect investment activity to slow significantly in the run up to the referendum. As there is not currently any additional pressure on landlords to sell, there is very little product being brought onto the market, with potential vendors clearly preferring to wait and see the outcome rather than selling at discount in the run up to the election. Without a significant discount, there is very little upside benefit for investors to make net purchases between now and the referendum given the strong likelihood of a negative short term impact of a vote to leave on values. As with the occupier market, in a vote to remain we see activity rebounding rapidly in the second half of the year as pent up demand is satisfied, this may place some very short term downward pressure on yields.

Vote to exit

Firstly the full implications of a Brexit will not be fully understood for some time after the result, and it is likely to be years rather than months before Britain's position within Europe outside of the EU is finalized. The major consequence of this for real estate markets is uncertainty on both the investment and occupational side, which tends to lead to a stagnation in activity.

A PMA survey of real estate investors clearly indicates that most (64%) would seek to downsize their existing exposure to the UK market to some degree in the event of a Brexit. With a further 21% indicating they would be reducing future exposure into the UK, this would inevitably lead to a situation where there was an additional amount of real estate stock coming to the investment market from the downsizers, at the same time as a reduction in the number of buyers which would be targeting it. We would also have to expect some reduction in the flow of capital from buyers not already in the market, who may reconsider their entry into the market, at least until the initial volatility of the situation has died away. This would inherently have negative implications for pricing across the real estate markets, and the most severe would likely be in Central London which has the highest dependency on foreign capital. This capital is typically more footloose than domestic capital and has the option to redeploy elsewhere in the globe.

On the occupational side, we would also expect the most severe consequences to be in London however the extent of this may be overplayed somewhat by the media. Whilst we would expect some large global corporates to reconsider their European strategy in light of a Brexit, which could result in the transfer of some specific functions to alternative locations within the EU, we are not expecting any kind of mass exodus from the City and the vast majority of global corporations in London are committed to a future whether the UK is or is not in the EU. Outside of London the more domestically driven occupational markets would in theory be less exposed, but would be more exposed from an overall slowdown in economic growth and weaker sentiment which comes about as a result of uncertainty in the aftermath of the referendum.

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