Directors' Briefing July 2016

Brexit - and life goes on

In the days since the UK Referendum vote to leave the EU, there has been much written on possible reasons for this monumental decision and what **may** happen next. Predominantly speculation of course and, perhaps unsurprisingly as this is most definitely a first, very little actual fact.

In this briefing we try to instill a little clarity to the current situation and look at any potential impact on the commercial property market. We will leave aside any comment on the reasons behind the vote, what this might say about current social divides in the UK, or, frankly, who was right and who was wrong. Those topics will occupy our politicians for years to come.

In answer to the basic question of where are we now in relation to the commercial property market and, more widely, economically, as someone quite wise once said "we are where we are"! The decision has been taken to leave the EU and whatever personal opinions may prevail, this will be implemented in some form or other.

Separation or Divorce

It is too early to say whether this will be an acrimonious divorce or that most elusive of partings, an amicable separation. Right now, nerves are still raw and the hurt of dissatisfaction is clearly keenly felt by all concerned.

As is always the case in any relationship when the need for a split becomes evident, much is said in haste and the speculation of who will get what is rife. It is perhaps therefore no bad thing that there will most likely be a pause before the UK issue the Article 50 divorce papers. Angela Merkel has suggested the UK need not be hasty in commencing proceedings, but ultimately the timing and the detail will be up to the new Prime Minister Theresa May.

Whilst the endless speculation and posturing rage on, one thing is clear - the process of separation will not be quick. Lord Hague recently commented in a speech to a property professionals' networking group that it took Greenland circa three years to negotiate a settlement of fishing rights when it left the European Economic Community (EEC) in 1985. The UK has fishing rights, farming subsidies, quotas, banking regulations, oil, and many other goods and services issues to negotiate. Separation, amicable or otherwise, will be a very lengthy process and whilst the tone of any future settlement might hopefully become clearer relatively soon, it will most likely be years before the deal is done.

The biggest challenge that this will cause the property market is uncertainty. Uncertainty for investors and occupiers. From this perspective a quick exit may look appealing, but that (as you will see below) could cause more problems down the line and is unlikely to be in the best interests of anyone.

Relative Position

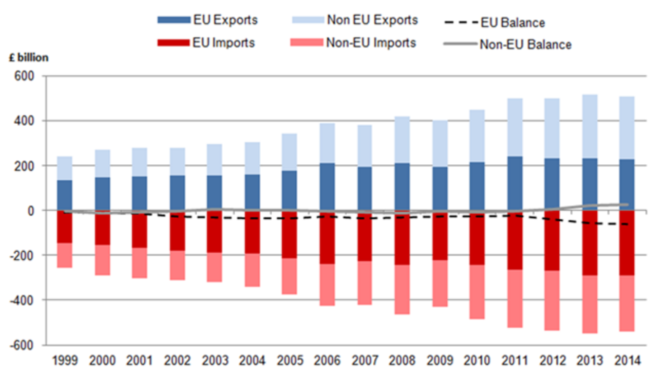
With this in mind, how can we navigate the months ahead and make the most of what is to come? Are we on the precipice of impending doom or at the doorway to new opportunity? The starting point in all situations of separation, is to begin by considering relative worth.

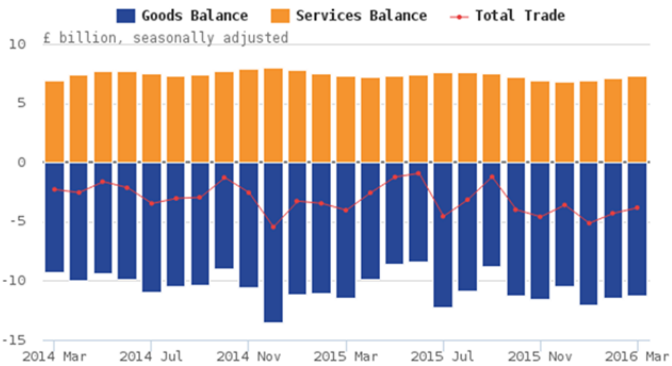
To put things into context, the IMF has Britain as the 5th largest economy in the world with our EU partners Germany 4th and France 6th. Pre-Brexit, the World Bank listed GDP growth for 2014 in the UK at 2.9%, Germany 1.6% and France 0.2%. Again pre-Brexit, in the OECD Economic Outlook 2016 paper, GDP growth for 2017 was predicted to be 2.0% for the UK, 1.7% for Germany, and 1.5% for France. So we are doing comparatively well amongst our economic peers.

Focusing on the EU, and taking a large pinch of salt, a figure occasionally quoted by the Leave campaign was that only 6% of UK businesses export to the EU. Even allowing for a certain amount of political 'massaging' in this figure, there is clearly a significant proportion of the UK economy which doesn't rely on or involve the EU. This silent but significant majority of the UK economy should not be forgotten. The EU is important, but it is not everything.

That said, trade between the UK and the rest of the EU is obviously significant for the economy and in terms of quantum, amounts to over £500bn per year (Source: ONS). A very substantial figure and one which makes the economies of the UK and the principal EU trading partners incredibly important not just to each other but also the rest of the world.

In terms of the relative position of the UK with the remainder of the EU, if you look at the trading figures in a little more detail, the UK has been running a trade deficit with the EU for the last 15+ years (SOURCE: ONS). Historically the EU has sold more goods to us and we have sold more services to them, with the balance overall being a deficit in their favour.





Arguably therefore, as net importers, the negative effect on the economies of the rest of the EU would be greater than on ours if an amicable arrangement cannot be found. Particularly as the remaining EU members would continue to be restricted in their ability to develop trading relationships outside the trading bloc under EU rules.

This is perhaps underlined by the fact that whilst the proportion of our exports going to the EU is undeniably significant and of critical importance to our current prosperity, this has been falling in recent years; 60% in 2000, 58% in 2010, and 47% in 2015 (SOURCE: ONS).

So what does all this mean? It means that, economically, we are just as important to the remaining EU economies as they are to us. Despite the continuous rhetoric and comment in the media on what should or should not happen now and possible punitive terms, the worst stance by either party would be to adopt a short term protectionist position on future trade.

The negative ramifications on all our economies would be dramatic if we could not find a way of ensuring this future trade continues. Common sense must surely prevail.

The Cold Light of Day

If one listens to the press, The City, to take one particularly visible example of the critical and profitable trade the UK undertakes with the EU, is doomed and Dublin, Paris and/or Frankfurt are to be the new financial centres of the world. For example, the German magazine, Business Insider, has already reported that they have heard from various sources that many major banks are set to relocate to Frankfurt and, just possibly, Dublin.

This is of course very nice for the cities named but the practical logistics and complexities of such a seismic shift in business operations from one country to another should not be underestimated. From the perspective of those that work with large corporate occupiers developing and implementing property strategies as we do, a wholesale move of operations to a new geographical location is a mammoth undertaking.

It would be a mammoth task even if there weren't any locational constraints to consider, which there are. Thinking about Dublin, at a pre-Brexit SIOR (Society of International Office Realtors) event in June this year, the mood in the room from the Irish agents in attendance was that 'Dublin was full' and that the skills routinely sought by new entrants to the city were often in short supply.

Frankfurt, as an alternative home for financial services, whilst being a trading hub throughout the centuries and an established financial centre in its own right, has a population estimated in 2015 at just circa 730,000 (SOURCE: WIKIPEDIA) whilst London boasts an estimated population of over 8.6m (SOURCE: WIKIPEDIA). According to the Business Register and Employment Survey of 2015, over 162,000 people were employed in financial services in The City and over 358,000 in Greater London. Significant numbers in their own right and this ignores all the ancillary support and services industries which work alongside the financial institutions on which we so depend.

The cities proposed as alternatives simply do not have the infrastructure or skilled workforce to absorb and support a wholesale move of the financial services industry within a very short timescale. The cost (and corresponding hit on profitability) would be prohibitive and the likely impact on operational performance catastrophic. To develop the infrastructure and skilled workforce needed in these locations to effectively support this industry would most likely take decades, as it did in London in decades past.

Of course, when thinking about the financial sector in particular we must recognise that much of the growth of London into the global financial centre it is now has been built off the banks' 'Passporting' rights allowing trade throughout the EU. This is of course now at risk and one item on the long list to be negotiated in the divorce settlement to come.

However, all things considered, the difficulties, risk, and costs of not finding an amicable way forward dramatically outweighs the benefits of any knee jerk flight to foreign shores. There has to be a better way and it is in everyone's interest to find it.

Away from the office market, the same is true for other property sectors.

The industrial property market, in terms of manufacturing and logistics, is highly linked with imports and exports and, again, it has to be in everyone's interest to find a solution that benefits both the UK and our trading partners in the EU.

The retail sector also relies on imports as well as benefitting from migration. Migration is key for the provision of staff for the leisure sector, and while the recent fall in the value of the pound will possibly boost tourism in the UK, the reduction in free movement of labour will have long term repercussions for these sectors and knee jerk decisions could prove detrimental.

A Lesson from History

So what does the current situation mean for property in general? Well to coin a well-used but apt phrase; 'whilst past performance is no guarantee of future performance', a quick look back at history might be a useful clue.

Taking the period since 1979 (the modern economic era perhaps) we have had a period in which, overall, most might think property as an investment and factor of production has fared pretty well. The Investment Property Forum for example, in its research paper Property & Inflation published in April 2011, shows property having continuously positive annual total returns of between 5.5% and circa 7% in this period.

During this time, we have had several major wars and conflicts (Falklands, Iraq, Kosovo, Bosnia, Afghanistan). The period started with IRA terrorism at home and now we have the threat posed by Isis. There was the Docklands bombing in 1996, 9/11 and 7/7 attacks, and we now have the Syrian crisis.

Politically in this period, we have had five different Prime Ministers, 13 years of Labour government, 17 years or so of Conservative rule and the rest was spent under a Conservative/Liberal Democrat coalition. We started with the winter of discontent, have had the miners strikes in there to overcome, and experienced more than one race riot along the way.

Economically, there have been two or three recessions, Black Monday, Black Wednesday, the Dot Com crash, the sovereign debt crisis, quantitative easing, the exchange rate mechanism, and of course the signing of the Maastricht Treaty to name just a few challenges successfully faced.

The lesson, if there is one, is that there are always events taking place in the world that would seem to be destabilising and disruptive and should stifle investment and enterprise. Yet despite all these, overall, our economy has prospered and property has remained attractive and performed well. Put simply, the economic world carries on.

Conclusion

To repeat; we are where we are. Although we can say very little for certain about the future, what we can say is:

- Yes, for the UK the world is going to be a different place to that which it would have been with a different referendum decision
- Yes, the process of separation from the EU is going to be lengthy and complex
- Yes, there will be much speculation and political comment/argument along the way which may well be unhelpful or biased towards party political position rather than economic good sense, and
- Yes, it will be some time before any actual facts about the likely shape of the future economic landscape will become clear.

However, what we can also say is:

- No, Brexit need not be a catastrophe, it is an opportunity
- No, economic meltdown need not necessarily ensure (although no promises on avoiding a political meltdown!)
- No, wholesale shifts in business operations to the near Continent are not guaranteed or, in the short term practically likely, and
- No, this separation need not be an acrimonious divorce - an amicable separation should not only be possible but is highly desirable for all concerned.

So, when the dust finally settles, there is every logical and vested economic reason imaginable to find a way through the issues now faced and to reach a workable compromise for the future.

Recent history has taught us nothing if not that the world is a tumultuous place, and it always has been. Nonetheless property generally remains a relatively safe haven and economies generally overcome the challenges they face in due course.

We should remember the UK economy is diverse and is as strong as any in the West. It will change through Brexit, absolutely. There will undoubtedly be those companies that now seek to resettle elsewhere but there may well be those that seek to enter, after all the UK is the 5th largest economy in the world. There will definitely be change and with change comes opportunity.

Once again referring to a comment by Lord Hague, he said that in his time as foreign secretary one of the most useful initiatives he put in place was to create a small team of experts as a rapid response group to react to global challenges as they happened. Far more effective, he said, than whole departments built within the Foreign Office undertaking planning and predicting what the next crisis might be before it happened.

For property, both for occupiers and investors, perhaps the same methodology should now be the recommended approach. Plan what, for sound economic reasons, should be located where, be prepared to react swiftly and decisively to opportunities as they arise, and then react to change as the future unfolds.

Until then, keep calm, prepare, and carry on.

Graham Halkyard
Director Global Occupier Solutions
E: graham.halkyard@avisonyoung.com
M: +44 (0)7865 594 701
T: +44 (0)20 7101 0200
avisonyoung.co.uk

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