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Implications of a UK Withdrawal from the EU: A Discussion Paper

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This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

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Implications of a UK Withdrawal from the EU: A Discussion Paper

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- to generate and inform debate amongst the IPF membership, the wider property industry and related sectors;
- to publish on current issues in a shorter time-scale than we would normally expect for a more detailed research project, but with equally stringent standards for quality and robustness; and
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Implications of a UK Withdrawal from the EU

1. A TIME OF UNPRECEDENTED UNCERTAINTY

A referendum on UK membership of the European Union is a real possibility. Prime Minister David Cameron has pledged to hold a vote during the early part of the next parliament and no later than the end of 2017, should the Conservatives win the next election.

This promise has placed the spotlight on how other political parties view the UK's European membership. Labour's position is that a referendum will not take place unless there is a substantial transfer of power from Westminster to Brussels. However, party members are pressurising Ed Miliband to offer a democratic vote on an issue that is already proving contentious among the public. The Liberal Democrats, meanwhile, have said a referendum would be held in the event of a new EU Treaty, but believe an exit would be "disastrous" for the UK.

As all parties position themselves around the issue, the political climate is uncertain in a way that feels unique. There is no precedent for determining the impact of a break-up of a proto-federal institution and even the debate over whether a referendum will, indeed, take place has created a distinctive brand of unpredictability.

How might this uncertainty affect the UK's property markets? On 3 March 2015 a number of senior industry professionals gathered to debate the potential effects of such political instability and to consider how an exit from the European Union could impact real estate in the near and long term.

What follows is a summary of this debate. While some issues found consensus, there were also varying views on the effect an UK exit would have, as well as differences in opinion as to the likelihood of a referendum taking place.

Overwhelmingly though, delegates were united in the view that many in the property industry were, as yet, unprepared for the various scenarios that could result from the political uncertainty that may emerge. As one contributor commented: "We are sleepwalking into this. The danger is the industry leaves it to the last minute to consider what the implications might be – investment decisions need to be taken sooner than that."

Anti-EU fervour not driven by rational debate

Fundamentally, participants were united in their view that Euroscepticism is not an agenda being shaped by rational economic analysis. Rather, it was argued, anti-EU feeling is being driven by a perception among voters that the free movement of people, guaranteed to EU citizens as a fundamental right, negatively impacts British jobs. It was also suggested that these perceptions are mainly held by those whose incomes have been squeezed by the rising forces of globalisation and technology. "UKIP, like the Tea Party in the US, represent those who've been disadvantaged by these influences," one said.

Moreover, delegates expressed concern over the rising nationalism, both across the region and worldwide. Finland's Eurosceptic, nationalistic right-wing party, the Finns Party, rose from near-obscurity to become the third-largest party in Finland in 2011. Germany's rising political force, the Alternative for Germany, argues that German interests have been subordinated to those of Europe. While the far-right party, the Sweden Democrats, won 13% of the votes in a general election and the Front National has made gains in recent local and European elections in France.

1. A TIME OF UNPRECEDENTED UNCERTAINTY

"This isn't only a UK issue. The concept of federalism, which is what keeps Europe together and the concept of nationalism, seems to be becoming a big area of debate wherever you go. If we look at the recent Mayoral elections in Chicago it was not a debate about Republicans or Democrats. It was a debate about nationalism and localism," volunteered one participant.

Conflict in Europe

Of even further concern to delegates was the prospect of conflict on the eastern borders of Europe, with Russian President Vladimir Putin's recent actions in Ukraine cited as a particular cause for worry. Some delegates suggested that the possibility of armed conflict in the region was being "factored into investment decisions". In some cases that meant they would be allocating more capital to the UK.

One impact of political tension within Europe would, delegates believed, lead to a reaffirmation of the UK as the safe haven for the region. "I've seen first-hand the consequences of this in Greece and Cyprus. All the traumas happening there have led to a marked evacuation of Greeks and their money and the destination is the UK. The Middle East crisis has led to people leaving with their money, too," one contributor said.

2. KEY INFLUENCES ON VOTERS

There was less of a consensus among delegates over whether a UK referendum would take place and what the outcome of that referendum would be if a vote went ahead in 2017, or sooner.

To begin the debate, delegates were presented with three possible scenarios (out of many) to consider, to paint backdrops against which a potential referendum may occur. It was noted that perceptions of Europe and its economic performance in the run up to a referendum will be important to establish, not least because 43% of UK exports are to Europe, equal to a seventh of UK GDP. Furthermore, EU companies account for half of the stock of foreign direct investment in the UK. The following scenarios set the scene against which potential outcomes for the UK property investment market were evaluated.

a) Slow recovery in the Eurozone

- The Eurozone economy is slowly gathering steam. All the major economies, other than Italy, grew in the fourth quarter of 2014 and the recent rally in business confidence suggests that companies are coming to terms with the Ukrainian crisis and the risk of Greece leaving the euro. While some countries need to implement further reforms to boost competitiveness, most Eurozone governments have now completed their austerity programmes, whilst the collapse in oil prices and low inflation have boosted households' real incomes. In addition, the start of quantitative easing (QE) has cut borrowing costs in southern Europe and triggered a sharp depreciation in the euro versus US dollar, which should boost exports.
- The consensus view is that the Eurozone economy will grow by 1.5% to 2.0% per annum over the next few years.
- There are certainly risks around this outlook, however. The main upside risk is that growth in the rest of the world economy is stronger than anticipated, which would benefit export-led economies in particular, like Germany. The main downside risk is that the sovereign debt crisis re-ignites, either because Greece leaves the euro or because deflation in the Eurozone becomes entrenched. There is a risk that business and consumers will defer purchases if they believe prices will continue to fall.

b) "Europe is in a mess. It could be in an even worse state by 2017"

- A more pessimistic outlook for Europe was also proposed. By the time a referendum on the EU is called in 2017, mainland Europe could be in deep economic distress and Germany in recession, along with the bulk of Europe. QE will have failed to cure Europe's economic woes.
- In 2016, or possibly this year, many freestanding European currencies, such as those of Hungary, Bulgaria, Poland, Czech, Croatia and Serbia, will devalue against the euro and compound the problems the Eurozone is facing in terms of "the nasty virus" of deflation. The UK is not affected because real asset prices do not become cheaper.
- Despite this picture, the UK is in a powerful position in Europe. As the fastest growing major economy in Europe, its strength is not interrupted by the speed bumps of the forthcoming election and a referendum.

2. KEY INFLUENCES ON VOTERS

c) "Trying to prove a negative [in a referendum] is very, very hard. Even the Scottish, who loathe being part of the UK, didn't vote to leave."

- The fear of leaving the EU is much greater than the reality once the political landscape is analysed. "The idea that we are cruising towards a referendum and it's a natural result is very questionable," said one.
- It is unlikely a referendum will happen. The polls [at the time of this discussion] indicate a 65% chance of Ed Miliband being the Prime Minister, either as a majority, or minority government. If that happens, then it is highly unlikely there will be a referendum.
- The Scottish National Party has surged in Scotland and could wield a great deal of power over a minority government. The SNP will demand the UK only leaves the EU if all four nations vote separately in favour of exit, knowing there is little chance the Scots will vote to leave the EU. On this basis, should the English vote to leave but the Scots choose to stay, a UK departure would be vetoed. This could lead to a division in the UK, with an upsurge in English nationalism pressing for an English independence referendum.
- If the polls are wrong and the Conservatives win the next election, then it is unlikely they will secure a majority. Therefore, a Conservative minority, or a coalition government, would lead the UK. In that circumstance, assuming he is returned as Prime Minister, Cameron may have to enshrine the referendum vote in some form of coalition agreement or attempt to pass it through the House of Commons in a minority government.
- But assuming that is achieved – and this would be difficult – a vote to leave the EU is very unlikely. "What we saw with the Scottish referendum is that trying to persuade people to vote for a change to existing arrangements which are familiar is very, very hard. Even the Scottish, who loathe being part of the UK, didn't vote to leave. It is terribly hard to get a negative; you are asking people for a change in the status quo. People don't vote for the unknown."
- Furthermore, unlike the Scottish referendum, when a lot of companies remained neutral in the debate, the business community would probably be publicly in favour of staying in the EU and be willing to fund a campaign against UK departure. "There isn't a trade union that doesn't want to stay in. The overwhelming voice in the media would be to stay in," said one delegate.
- "A lot of our clients see the greatest threat to their business as the UK leaving the EU. But another clear risk is the General Election in May. We could end up with an incredibly weak government," commented one. "You have more parties in government with more differing agendas. There is the Scottish National Party for instance – that's never been a factor before. The range of outcomes has broadened out enormously," said another.

3. POTENTIAL IMPACT ON UK ECONOMY

The government has stated that there is no definitive study of the economic impact of the UK's EU membership, or of the costs and benefits of withdrawal. Framing the aggregate impact in terms of a single number or consequence, or even irrefutably demonstrating that the net effects are positive or negative, is a very difficult exercise.

Estimating the costs and benefits are highly sensitive to assumptions about the terms upon which the UK would depart. Likewise, it was suggested that, although leaving the EU would free up the burdens of contributing to the EU budget and obligations to EU regulation, the necessity for a free trade agreement and for the UK to abide by EU product regulation means any cost saving would not be as large as the EU-exit optimists estimate.

While the above scenarios presented some visions of possible outcomes, it was agreed that any departure from the EU would be neither sudden nor clear-cut. Delegates debated, for instance, that a "yes" vote could result in a free trade model, in which the UK had access to the free market. It could also result in further exits by other European members – perhaps Ireland, or a north European trading bloc that included the UK, Norway and Switzerland.

"Even if we were to leave the EU, it won't be a black and white situation. There will be a two-year period of negotiation, at a minimum, before we can legally leave. During that time, the terms of withdrawal and the subsequent relationship will be determined, but all of that represents a huge period of uncertainty. So, while we are talking about withdrawal, to even talk about what withdrawal means is itself a grey area. That will lead to a prolonged period of uncertainty for those wanting to make decisions," said one.

Another argued that the UK would not be isolated internationally, as it could continue to re-orientate its markets towards economies in Asia, where the demographics are more favourable to growth. "Countries such as Italy have low birth rates and population growth. Do we want to be tied into a trading bloc where the demographics aren't favourable, or do we want to orientate ourselves to fast-growing economies?" On the other hand, another delegate pointed out that Asia and the Eurozone are not mutually exclusive and the UK could continue to grow its trade links with both regions.

The UK's net contribution to the EU budget is less than 1% of GDP. "There's a question of whether the savings would be outweighed by the loss of trade and investment," suggested one participant.

Delegates subscribed to the view of the Centre for European Reform that EU immigrants are a "boon not a burden". They argued that restricting EU immigrants, currently net contributors to the UK's public finances, would reduce GDP and result in a less skilled workforce and slower population growth, equating to a reduced GDP per capita, as well as reduced total GDP. "The government deficit is still 5% of GDP. If the economy shrinks it would make it harder to service that debt," one commented.

4. POTENTIAL IMPACT ON OCCUPATIONAL MARKETS

Considering these rather diverse scenarios, delegates then moved on to explore how an exit of the UK would impact the property markets, with several key effects identified. As one summarised it: "We have a lot of overseas investors. In terms of the potential exit of the UK out of Europe, I don't see it to be positive. It will have a negative impact in the short-term."

London office market

Bank and finance leasing activity is undergoing a resurgence. Leasing activity in the City of London has reached a 15-year high, with 7m sq ft of new lettings in the Square Mile in 2014, according to Cushman & Wakefield. Some of this demand is from the finance sector (e.g. banks, fund managers, insurance), but a significant amount is also from TMT companies like Amazon. But delegates expressed worries that this return to health would be impacted by an UK exit from the EU.

The effect of EU membership for the City of London has been to provide new European markets for banks and other financial firms based in the UK. London is the EU's largest wholesale financial centre and the City and Docklands form the centre of the Eurozone's financial system.

London is expected by IPF delegates to retain skilled workers who have moved to the city from overseas and who will continue to view the UK capital as a pre-eminent global location. "There isn't another obvious other place for them to go in Europe. Frankfurt doesn't have the same cultural attractions," one delegate observed. "The story we have been telling is that there is a deep pool of skilled labour and that is why companies come to London. Everyone buys into that cluster story. The key assumption is that the underlying forces of agglomeration remain powerful."

"However, we shouldn't underestimate how footloose international companies are and, if London loses its attractions as a business hub, there could be a major exodus. Wholesale finance could be moved to the EU," one remarked. "Clearly there'd be more pressure to move euro trade back to the mainland. If we weren't in the EU, we wouldn't have direct influence on financial regulation. So we might see French and German banks transfer trade in euros back to their home markets. EU regulation, meanwhile, would take a more market-sceptic view if we didn't have the UK arguing the Anglo Saxon view of laissez-faire regulation."

The view was reinforced by mention of a Financial Times article appearing last year, which reported that major institutions were believed to be drawing up contingency plans to move activities abroad amid concerns that the UK was drifting from the EU. Swiss, US and Asian banks that run their main European operations from the UK can currently provide services across the EU. But if the UK left the European Union, it is believed to be unlikely that foreign banks based in London would carry on benefiting from the same rights.

US-based banks, including Bank of America, Citigroup and Morgan Stanley, are considering Ireland as an alternative location for business currently conducted in London, the newspaper reported.

While it is foreseen that the hedge fund industry would capitalise on the uncertainty departure would create and, therefore, continue to be a robust occupational sector, it is expected that the City of London and Docklands, in particular, would suffer from a decline in leasing activity.

"The UK is very dependent on financial services. If the UK comes out of the EU and London's financial centre is severely affected then that won't be good for London offices, but the loss of jobs would also have a negative impact on London retail and industrial property and also the residential market" one delegate added.

4. POTENTIAL IMPACT ON OCCUPATIONAL MARKETS

As another said: "The growth of London happens over a generation and that isn't reversed if the UK doesn't have EU membership. London has enough of the real fundamentals – size, English language, history, a good place to live and work – to re-invent itself outside the EU, if that happens. The bigger long-term risk is a slower, imperceptible decline in London's status, meaning the balance of power slowly shifts to New York, or Shanghai. It will happen over 20 years and we'll [slowly] realise London isn't what it was. It won't just fall off a cliff."

UK outside London

Whether the UK benefits economically as a whole from any departure, certain sectors would be impacted more than others. IPF delegates were especially concerned that manufacturing in the UK would be affected by a decline in foreign direct investment.

Manufacturing occupiers have been very active in the UK market in recent months, boosting the industrial markets in the North East and West Midlands. DTZ reported that take-up in the North East reached 2.3m sq ft in 2014[1], the strongest year on record, with 1.4m sq ft of grade A deals completed, driven largely by manufacturing companies.

The professional services firm found that take-up was strong for manufacturing at 8.8m sq ft over the period, with Jaguar Land Rover the most active individual firm in the market last year, taking three buildings totalling 673,000 sq ft across the West Midlands.

Manufacturing firms have expressed disquiet over a change in the UK's relationship with the EU. Jaguar Land Rover's chief financial officer Kenneth Gregor recently said any split from the European Union would damage trade for UK business and cautioned against "barriers" that would arise if an exit went ahead.

IPF delegates were similarly conscious of the impact that an exit would have on those international businesses who have their UK or European headquarters outside London.

Emerging alternative property sectors

In its most recent statistics on property investment in the UK[2], JLL reported that the most dramatic change in sector allocations was in alternative asset classes. Student housing, healthcare and hotels accounted for 19% of transactions in 2014, up from just 3% in 2009.

But the growing acceptance of alternative asset classes as a more mainstream investment avenue could be halted by an UK exit argued delegates. An anti-immigration stance, foreseeable in a post-exit scenario, would also impact the university sector, delegates said.

The prospect of withdrawing from the European Union was described as 'potentially disastrous' by several British vice-chancellors in the 2014 survey of UK university leaders, conducted by PA Consulting for its 6th annual higher education report[3].

"If we weren't in Europe and had more anti-immigration policies, the UK would be less attractive to the best and brightest EU students. So this sector might suffer. For property, student housing is now a significant asset class" commented one IPF contributor.

[1] DTZ Property Times: UK Industrial H2 2014, 16 February 2015

[2] UK real estate investment volumes hit record £65billion in 2014, JLL 09 February, 2015.

[3] HERE BE DRAGONS How universities are navigating the uncharted waters of higher education, PA Knowledge Limited 2014

4. POTENTIAL IMPACT ON OCCUPATIONAL MARKETS

The residential market would also suffer in this new climate. Delegates proffered the notion that a continuation of current rates of immigration is implicit in house prices today. "That is the only way you can rationalise where house prices are – low supply combined with sustained immigration. This is one area where we can see a clear link between an exit from the EU and the property market," said one.

Others expressed the view that if immigration became more controlled, the UK could appear more closed to the outside world and alter the fundamentals that sell the UK internationally. "That really worries me," volunteered another. "We have had the same questions [about this] from Chinese clients. It may only be a couple of investors but they're big investors. I am slightly more troubled by this than some of the terms of this debate imply."

5. WOULD A UK EXIT DETER OVERSEAS CAPITAL?

"If an EU exit is on the table then it will create a long period of uncertainty, a slowdown in capital and ultimately impact on values."

UK property investment trading volumes hit a record in 2014. JLL statistics show direct real estate investment in the county hit a record £65bn in 2014, 3% higher than the pre-recession peak in 2006 and 16% higher than 2013's total of £55bn[4].

The UK is one of the most liquid commercial property markets in the world, accounting for 18% of all global transactions and overseas investors comprised just under half of transaction volumes.

Recent research by INREV[5] found €42.5bn of capital had been allocated to real estate by institutional investors across the globe and 45% of this is destined for Europe. Delegates discussed whether this capital would be re-allocated to other markets in light of the political and economic uncertainties.

It was reported during the debate that Chinese are "highly interested" in the vulnerable UK-EU relationship, with one delegate declaring that it was the "number one issue" for every Chinese investor he met.

While some considered China's continued investment in the UK property market could not be taken for granted in an exit scenario, there were those who believed that it could. "China wants what the UK has. It wants education, luxury goods, cars, business and legal services. It wants a Western hub so it can operate 24 hours a day. It won't be in Frankfurt, or Madrid. It will be in London. [China] won't see us differently if the UK leaves the EU."

Stasis for the investment markets

There was a firm view that a major impact on property markets would be a "long period" of stasis that would have a measureable impact on values. This would be the case both in the event of an exit, but also if a referendum were scheduled. "I think that we're at peak liquidity, not necessarily peak valuations. Money that is coming into the UK will slow up immediately but not necessarily exit. An international investor looking at the EU will stand back and wait."

Those that would remain committed would be UK funds obliged to place money into the UK market to meet pension commitments. Global investors with long-term investment horizons are also more likely to be influenced in their decision-making by trends in urbanisation, population shifts, etc. than by the relatively near-term effects of any exit.

Opportunistic funds undeterred

It is anticipated that investment of opportunistic capital could increase during the period of uncertainty in the run up to the General Election, as well as any brought about by a tabled referendum vote – as these types of investor would seek to invest while others held back.

"A potential vote and exit from the EU would have dramatic implications at the macro level, but there's a wide opportunity at the micro level," said one. "There will be a host of opportunistic investors that will jump on assets that others are running scared from, thinking they don't know what to do with industrial sheds and office buildings with value added plans."

[4] UK real estate investment volumes hit record £65billion in 2014, JLL 09 February, 2015.

[5] Investment Intentions Survey 2015, Snapshot Research, INREV January 2015

5. WOULD A UK EXIT DETER OVERSEAS CAPITAL?

Meanwhile it is anticipated that there would be a "tremendous slowdown in foreign investment across the EU. Asian and US money will slowdown and pause across Europe," said one.

Sovereign wealth funds undeterred

Delegates did not believe there would be any great change in the appetite of Sovereign Wealth Funds for UK property either. As one noted, the volume of inward investment from these investors into London last year was greater than the amount invested in Tokyo, Paris and New York combined. "Investors from Qatar and Kuwait will not be put off by an exit from the EU – they are long term," said another.

"Everyone knows about London's attractions. Even if the UK leaves the EU – and it is a big if – the market factors will largely remain in place," added another delegate.

More likely to negatively influence international investors were factors such as proposed reforms to liberalise tax rules – under FIRPTA[6] in the United States, legislation impedes overseas investment in the US real estate market. "Combine those factors with an EU exit and maybe capital will be pushed away."

[6] Foreign Investment in Real Property Tax Act 1980

6. CONCLUSIONS

The main conclusions of the round-table discussion were that:

1. The political outlook is very fluid. It is by no means certain that the Conservatives will be re-elected and be able to deliver on the pledge to hold an EU referendum. If a referendum is held, then the likelihood is that the UK will vote to stay in the EU. The referendum on Scottish independence demonstrated that people generally prefer the status quo and are reluctant to vote for the unknown.
2. It is difficult to know whether leaving the EU would do permanent long-term damage to the UK economy. Much will depend on the terms of any new trade agreements, inward foreign investment, restrictions on migration, etc. The UK's net contribution to the EU budget is relatively small at less than 1% of GDP.
3. The period between a new Conservative government taking office and a referendum is likely to be marked by a great deal of uncertainty. That period would be extended if the UK voted to leave the EU, as it would take some time to negotiate new arrangements with the EU and other countries. In this environment, occupiers would probably hesitate to sign new leases. It seems likely that those parts of the occupational market having the greatest exposure to the global economy would be most affected: the London office market, the industrial market in towns and cities where export-oriented manufacturers are a major part of the local economy and student accommodation.
4. The announcement of a referendum could lead to a long period of stasis in the investment market, as foreign investors adopt a 'wait and see' approach. Inflows of foreign capital may slow immediately, but not necessarily go into reverse.
5. Even if the UK were to leave the EU, the outlook for property remains relatively benign. One delegate summed it up thus: "The UK wouldn't be very different outside of [sic] the EU. There are so many reasons why you buy real estate – this is a very small part of it. And if the market does slowdown then we have proven in the last few years that you can do well with real estate in a low growth environment. It may be that investors can't achieve 20% total returns, but they can receive a decent income and property will do better than bonds over the next decade. These are much bigger considerations than if we leave the EU or not."

NOTES

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