Brexit Monitor

Impact on the real estate sector

pwc

Brexit, bricks and mortar

Real estate sector

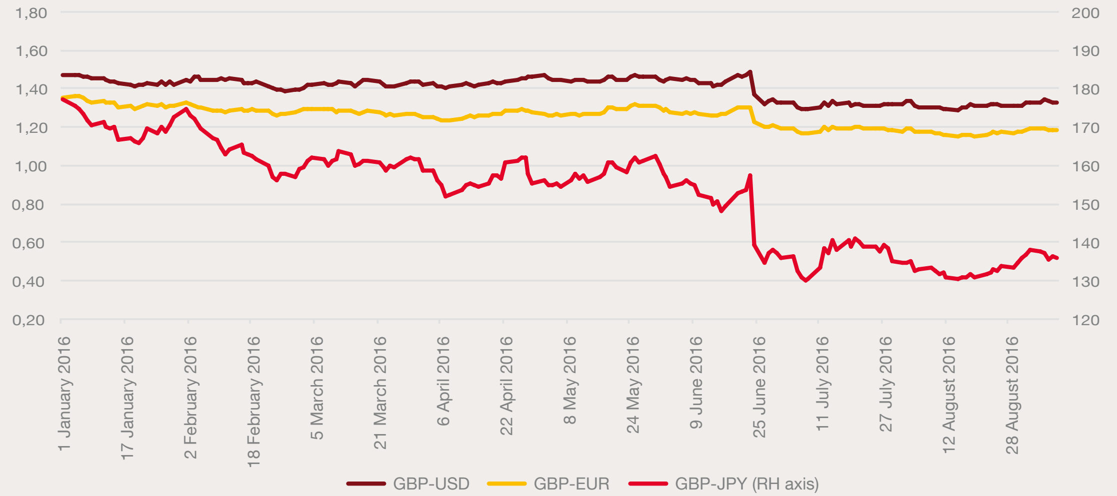
The outcome of the UK's EU referendum and looming exit negotiations , are affecting both the economy and the real estate sector. There are not only risks, but also opportunities, which we will discuss in this special focus on the Brexit impact on the real estate sector.

Shortly after the referendum outcome became known, the pound sterling to US dollar exchange rate dropped 10% to below 1.30 US dollar per pound, the lowest level for over 30 years. While the pound declined less against the euro, the yen gained strongly versus the UK currency in a flight for security, reaching the highest level since 2012. Investor demand for government bonds and gold also rose.

Unit redemptions following the referendum outcome increased to such an extent, that by the beginning of July, several real estate funds with a joint volume of approximately 18 billion pounds froze withdrawals[1]. This in order to avoid significant price declines, as a result of increased redemptions and panic selling.

The referendum outcome, and the political as well as economic uncertainty that stemmed from it, led some London-based companies to announce that they would reconsider alternative locations outside of the UK.

Exchange rate movements before and after the referendum



Source: Reuters.

1 Bloomberg, 'Panic' Brexit Withdrawals Freeze $23 Billion Property Funds, 7 July 2016 and The Wall Street Journal, U.K. Real-Estate Funds Question Redemption Strategies Post-Brexit, 6 September 2016.

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Relocation, from the Thames to the Main?

If UK companies will seriously consider re-allocation to mainland Europe, this will have an impact on demand for space, especially in established locations. We note however, that besides location, infrastructure, corporate tax and labour law, other factors will also play a role in determining an alternative location.

Frankfurt am Main will play a main role in vying for companies, as it has a competitive infrastructure and demonstrated that important financial institutions are willing to establish presence there. In case of increased demand for office space in the financial district, city centre and West End, prices will likely increase, due to a shortage of available space. However, in Frankfurt there is also office space available outside of the banking district.

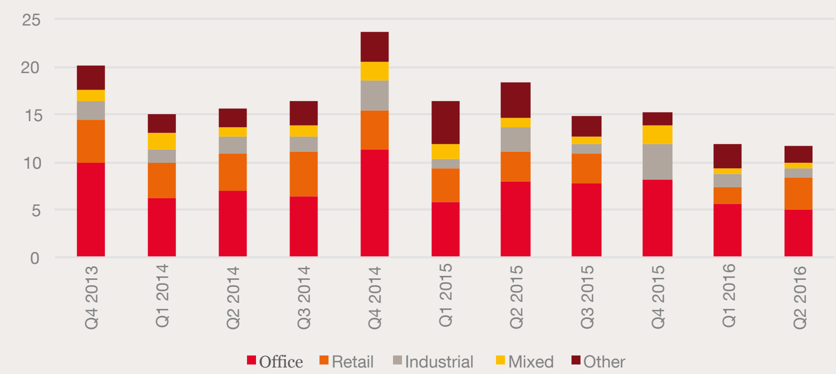
In one scenario outlined by Colliers International, a 2% re-allocation of employees in the London financial centre to Frankfurt, would lead to a 11% increase of financial employees in Frankfurt, and a subsequent decline in the central business district vacancy rate of 20%[2]. According to a survey by the Royal Institute of Chartered Surveyors (RICS), real estate experts foresee a rise of 3.5% in both rents and capital appreciation of German commercial property in the coming three years.[3] Moreover, experts foresee a decrease in incentives for new lease contracts.

The housing market in cities which attract new commercial tenants will likely benefit too, as an inflow of labour will lead to an increase in demand, for example in case of serviced flats. Consumer demand will also likely rise, stimulating the market for retail property.

In the past years, Germany has increasingly become the focus of international investors. From a real estate perspective, the peculiarity of Germany is that it has multiple headquarter locations. This caused uncertainty among investors in the past, and it also meant that German cities were not viewed in the same light as London or Paris. This is gradually changing. In particular cities like Berlin, Munich, Hamburg and Frankfurt are fast gaining the interest of non-German investors, leading to a significant rise in the volume of transactions. As was indicated in the PwC study "Emerging Trends in Real Estate Europe", this trend was already ongoing since last quarter of 2014 and third quarter of 2015. In this period the investment volume in these cities reached 27 billion euro.[4] It remains to be seen if these levels can be reached again, and whether the upturn will grow to level where it becomes self-sustainable.

The real estate sector in general responded calmly to the outcome of the UK's EU referendum and transactions continued to be carried out, often as buyers and sellers had already agreed on Brexit-related clauses. Some buyers were able to receive a discount on a preferred property in the UK. However, short-term price discussions are premature, due to the long-term nature of real estate investments strategies, and also in relation to a sustainable assessment of the UK market, in particular the London market.

UK quarterly real estate investments by sector, billion pounds



Source: CoStar Group.

2 Colliers International, Finanzstandort Frankfurt könnte vom Brexit profitieren, 20 June 2016.
3 Immobilien Zeitung, RICS-Umfrage zeigt hohe Erwartungen für Deutschland, 25 July 2016.
4 PwC, Emerging Trends in Real Estate, *Beyond the Capital; Europe 2016, January 2016*.

Increased investments in Europe

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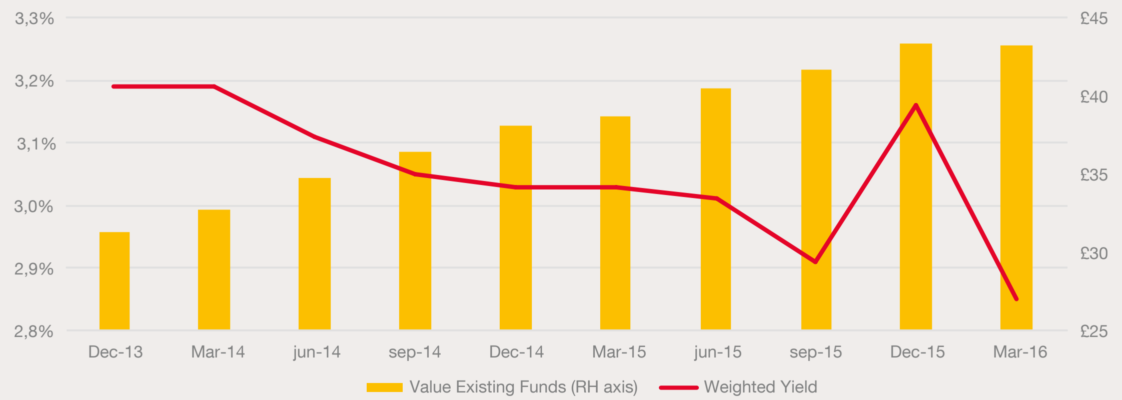
The picture is different for investment decisions that still need to be taken. Investors who were able to meet their European or EU quota by investing in the UK, may in case of a Brexit be forced to re-allocate investments towards the remaining EU countries. In addition to Germany, France, Spain and Italy are mentioned as investment targets or alternatives. An increase in transaction volumes in the European property market, and increasing pressure on margins are therefore likely. Prolonged restraint with respect to investments is not an option, and positive implications for the European real estate market are thus expected. In our newest issue of "Emerging Trends in Real Estate Europe" (scheduled for publication in November 2016) we will shed light on the regions and cities that investors now focus on.

It is interesting to take a look at the current situation in the UK, not only for overseas investors, but also for UK portfolio holders. It is in the UK that uncertainty is the greatest, and investor approaches vary from "sitting it out" to "immediate exit'. The media has dealt extensively with the closure of open-ended real estate funds, but compared to Germany, the investment volume in this area is rather low. Moreover, some funds have opened again for investors.

UK real estate funds, market value (in billion pounds) and yield (%)



Source: Association of Real Estate Funds.

As always, it pays off to observe the stock data, yield obtained and performance, long-term expectations and returns, investment horizon, term of financing arrangements and so forth. Real estate that is profitable in a sustainable way, will have a positive effect on the portfolio.
At the moment there is no record of panic selling, but some UK properties may be put on the market in order to take profit, or prevent discussions regarding the extension of financing.

Investment parameters and their adjustments after Brexit

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Rising vacancy rates, falling rents and a decline in investment spending could be possible consequences for the property market in London, if the UK leaves the EU. Market participants have stated that at least the prime segment in London is not expected to continue to grow.

In response to the referendum outcome, the Norwegian sovereign fund has adjusted down the estimated value of its UK real estate holdings by 5%.[5] According to the quarterly report of the sovereign fund, the vote to leave the EU has "triggered significant movements in financial markets and considerable uncertainty"[6]. It would be prudent to take into account that when the UK leaves the EU, this will have a negative impact on property values.

In the short term, and in case of most properties, no negative change of profitability is expected (not taking into account currency effects). Existing lease arrangements safeguard the profitability of property assets for the duration of the lease terms. However, when the end of rental agreements come in sight, there will be an increased focus on the assumptions used to determine rents. Likewise, it is expected to become more difficult to rent out vacant land. Tenants too will anxiously await the potential consequences of the UK leaving the EU. Hence there is ground for caution in the assumption that rents will continue to rise.

The situation is different regarding yields. The uncertainty following the UK's EU referendum, will lead to mark-ups of property yields, and these can push property prices lower. Here it is of particular importance to ensure an appropriate consideration of yield increases. The mark-to-market approach can quickly lead to significant yield increases, as we have seen during the financial crisis. The German view of real estate valuation is still characterised by a longer-term view, in comparison to the shorter-term view inherent to the UK mark-to-market approach.

For real estate in general, and in particular real estate funds, the holding period to sale becomes important , as well as the time it takes to sell a property at the predetermined market price. The time span to match realistic market expectations may hence increase. This is a major challenge for valuation experts who should make sure their results are feasible and that they align with the market.

5 Norges Bank Investment Management, Government Pension Fund Global, Quarterly Report Q2 2016, page 14.

6 Idem.

Uncertainty and disclosure requirements under IFRS

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There are various ways in which financial reporting of real estate companies, in accordance with International Financial Reporting Standards (IFRS),may be impacted by the UK's EU referendum outcome. The referendum outcome will have an impact on IFRS "subsequent events disclosures" reporting requirements, in relation to existing uncertainties and for companies publishing detailed financial statements for periods ending after June 23rd 2016. In this respect, qualitative and quantitative data for non-observable market parameters deserve special attention.

There is however no room for blanket valuation haircuts, not even when the current valuation report contains general restrictions regarding existing uncertainties. The fair value determination under IFRS requires the use of observable and unobservable market parameters, as well as the consideration of individual features and characteristics of the property being valued. Against this background, lump-sum reductions, without considering specific conditions for each property, are not appropriate.

Shifting borders for UK real estate funds?

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The discussion about the future of financial regulation is eagerly followed, since UK fund providers and funds may no longer benefit from passporting arrangements under EU directives, such as Markets in Financial Instruments Directive (MiFID) and Alternative Investment Fund Managers Directive (AIFMD). The extent to which UK funds and fund providers may rely of passporting under MiFID and AIFMD will depend on the final outcome of the UK's exit negotiations with the EU. This may involve additional expenses and disadvantages for UK based funds, compared to the current regulatory arrangements. Depending on the outcome of negotiations, UK fund managers and their funds, may in the future be subject to third country stipulations and related distribution rules. Other European fund providers too would then not be able to benefit from passporting from the UK. It remains to be seen how the current negotiations about a common capital market and the harmonisation of EU law will land, also against the backdrop of a new relationship between the UK and the EU.

Other implications, dependent on Brexit negotiations

The legal and tax implications of Brexit, will depend on whether the UK would remain a member of the European Economic Area (EEA) or any specific agreements reached in the case of a third party status. It will further be important whether market participants will be offered transitional arrangements, so that they can adequately adapt to any changes in the legal and fiscal environment.

Furthermore, it cannot be excluded that the UK, after leaving the EU and without an EU obligation, will transcribe some EU directives into national law to complete case law, that is shaped by common law, in many areas. The UK's exit negotiations should be followed with attention especially in the following areas that may affect cross-border contractual practice:

Free movement of labour: impact on cross-border recruitment

Taking into account the importance of immigration as a theme in the referendum, and the need to attract foreign labour in particular businesses, such as finance and agriculture, any developments on cross-border movement of employees will be of relevance. It is now generally assumed that the current free movement of labour will be restricted in the future.

Contract law: impact of the choice of law, arbitration and jurisdiction clause

The real estate sector will to a lesser extent be impacted by a potential introduction of duties on shipments to and from the UK. As far as supply contracts do not contain price adjustment clauses, long-term contracts could be amended by means of legal action, based on a serious change in circumstances. Accordingly, current negotiated arrangements should contain stipulations on how the parties involved wish to deal with future material adverse changes, as a result of the UK leaving the EU.

In the choice of law, it has so far been an advantage that EU law also applies to the UK. Numerous EU directives have indirectly led to legal harmonisation within the EU. When the UK leaves the EU, there is a risk of a progressive 'de-harmonisation' of law, and related to this, an increasing legal uncertainty. As such, the choice for UK law and jurisdiction should be carefully considered in new transaction agreements. Without adequate transition or succession planning, Brexit would also affect EU rules related to legal jurisdiction, and the recognition as well as enforcement of court rulings. In this respect, an even greater emphasis should be given to arbitration clauses in agreements.

Company law: freedom of companies and partnerships

In case of restrictions to the freedom of establishment, the EU's legal basis for UK company forms, like Limited Liability Partnership (LLP) and Public Listed Company (PLC) may be cancelled, if such entities have their administrative headquarters in an EU country like Germany.

In this case, a change of legal form could be required, for example to prevent the possible elimination of liability limits.

Privacy: impact of EU data protection regulation

Under the current EU Data Protection Directive, and new EU data protection legislation that will be applicable from 2018, the transfer and processing of personal data to a third country, is only permitted if a level of protection equal to that in the EU, is ensured in this third country. It is expected that once the UK leaves the EU , the UK will continue to comply with EU data protection legislation to prevent any competitive disadvantages.

Legal aid: competitive advantage through state aid

Depending on the future relation between the EU and the UK , EU rules regarding state aid may no longer apply to the UK. This could be a conscious result of negotiations on the UK side, or reductions in corporate tax could be used as a means to improve the competitive position of the UK. Any outcome is for now difficult to predict.

Income tax legislation: implications for property investors and service providers

There are several national tax systems that are influenced by EU or EEA membership. In the German case, this applies for example to additional taxation of income from foreign intermediate undertakings in line with the German Foreign Tax Act, deferral options for assets to foreign permanent establishments or tax-neutral processing under the German Transformation Act. However, there are also important EU tax directives, that do not apply to the current EEA countries (Norway, Iceland and Liechtenstein).
This is the case for example in relation to the Parent-Subsidiary Directive, the Interest and Royalties Directive, the Merger Directive and the Mutual Assistance Directive. Both tax neutrality in case of reimbursements, or the application of certain provisions from the Investment Tax Act for fund tax, currently still require EU or EEA membership. In these cases double tax treaties with the UK would gain significance, also for instance if these provide a lower level of protection in case of withholding tax on dividends. The tax consequences of Brexit would merit a closer individual analysis on the basis of the numerous current structures, as well as on any possible future structures.

Sales and real estate transfer tax law

In the area of transaction taxes, an important question for real estate enterprises will be whether a corporate reorganisation under the law of an EU/EEA member state in Germany still can be carried out in a land-purchase-tax neutral manner. Also in the area of EU harmonised VAT and in the relation with the UK, no longer existing custom borders, complex changes are expected. This equally concerns existing systems of tax exemptions, delivery destinations and last but not least, the sales tax rates itself.

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Take aways

In the short term the UK's vote to leave the EU has not had a significant impact on the real estate sector, despite some immediate effects on real estate funds following the referendum outcome. One important reason is the long-term nature of real estate investments and related agreements. A potential relocation of business activities from the UK to other countries, may however have a significant impact on the demand and supply of property in particular cities, resulting in price movements. For the time being, uncertainty prevails, and this may have consequences for yields and financial reporting. Legal and fiscal implications also depend on future agreements between the UK and the EU, but can to some extent be assessed by analysing current structures and future scenarios.

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