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BREXIT & REAL ESTATE AND CONSTRUCTION

CONTACT INFORMATION

Noel Clehane
BDO Global Head of Regulatory & Public Policy Affairs
noel.clehane@bdo.global

Tel: +32 2 778 01 30
Fax: +32 2 778 01 43

www.bdointernational.com

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HOW BREXIT WILL AFFECT THE REAL ESTATE AND CONSTUCTION SECTOR

The UK's vote on June 23rd to leave the European Union is likely to have significant effects on real estate and construction markets in the UK and beyond, both direct and indirect. Although Brexit, should it come to pass, will likely have no impact on the UK's largely devolved rules on property ownership and rental, or on land registration or transaction taxes such as stamp duty, it will affect a number of areas in the UK where EU rules apply. These would include energy efficiency, environmental restrictions on planning and development, infrastructure funding, procurement and employment amongst others.

It will take some time before the UK's new relationship with the EU is known and understood. In the meantime, the vote for Brexit is creating uncertainty in the economy and consequently in real estate markets, with a likely slowdown in investment in the short to medium term in the UK market as a result. There may also be consequential effects in the real estate and construction markets elsewhere.

This briefing, prepared with the assistance of external advisers, seeks to provide an initial overview of how the UK Real Estate & Construction sector might be affected by Brexit and the daunting domestic legislative challenge the UK will face on exiting the European Union.

It represents best efforts at predicting the situation in the later weeks of July 2016.

THE MARKET CHALLENGES AND OPPORTUNITIES

Although levels of inward investment in the UK commercial property market have been running at record rates in recent years, they reduced by almost half in the first six months of 2016. At the time of writing, more than £650m of deals in the City of London alone are reported to have been withdrawn since the UK's Brexit vote, with concerns over financial services companies possibly relocating elsewhere in Europe as the main driver. This is the key reason why a decreased demand for development as well as purchases of real estate can be expected in the short-term.

Institutional funds in particular appear to be withdrawing, at least temporarily from UK property activity. A number of open-ended property funds have suspended trading recently as investors have been drawing down the cash funds available until the underlying property can be sold. Near-term sales of property by these funds will further add to the supply of commercial properties on the market, pushing prices further down. Until it can be determined with more certainty how far economic predictions were over- or under-estimated, demand might be expected to remain depressed.

In the residential space, any reduction in employment and immigration will affect housing demand and is likely to lead to a decline in house prices. London stands to be most affected by this decline which on the other hand might be welcomed by many if it were to make homes more affordable in that region. At the same time, uncertainties in the financial markets will impact loan availability for prospective homeowners, landlords and house builders. That slowdown in investment in new homes and any future restrictions on immigration of skilled workers into the construction sector will not help to address the UK's chronic housing shortage.

Private wealth remains active nevertheless and international investors, especially those from the Middle East and Asia, may see the UK as an even more attractive market as the fall in the value of sterling provides an attractive entry point for large volumes of foreign capital.

The likelihood of interest rates remaining low globally may also result in the continued rise in real estate prices and investment in third countries such as Canada and Australia.

The potential surge of re-locating financial services and technology Multinational Corporations (MNCs) could result in significant positive real estate prospects for alternative European centres such as Paris, Dublin, Amsterdam and Frankfurt.

However, this will present its own trials as it will be critical to ensure that the necessary physical infrastructure is in place to facilitate relocation. The supply of office space, supporting infrastructure and housing are all key factors and present both opportunity and challenge for those in and outside of the property sector.

CONSTRUCTION, SKILLS AND PROCUREMENT

The impact of Brexit on the UK construction sector is likely to be mixed. Inevitably it will be affected by economic instability and any reduction in foreign investment into the UK. The supply of imported goods and services for the construction industry may also be affected by a weaker pound, making construction projects more expensive.

The biggest impact on the construction sector may well be the post-Brexit availability of skilled immigrant labour from the EU. Without free movement of workers, the cost of construction in the UK will likely rise where demand for labour outstrips supply. Significant infrastructure projects such as high speed rail links and nuclear plants could become difficult to deliver as a result. Currently, nearly 5% of construction workers in the UK are EU, non-British nationals. The UK will therefore need to focus on skills and training for UK nationals to meet industry demand if future arrangements with the EU restrict free movement of workers into the UK.

The European Professional Qualifications Directives provide mechanisms for the mutual recognition of professions across the sector, such as architects, civil engineers and surveyors

throughout the EU. The UK's exit negotiations will determine whether these directives will continue to apply to UK citizens working abroad and EU nationals wanting to work in the UK.

Public procurement may be one area where the construction sector in the UK could benefit. In the scenario where the UK is no longer bound by EU rules, public sector building projects could be open only to local domestic companies. The downside is that UK-based firms would be excluded from bidding for infrastructure contracts in other EU countries on an equal basis without owning or partnering with a local company.

In addition, if the future relationship removes the UK from the EU State Aid rules, the UK would be able to provide Government guarantees or direct financial support to large scale infrastructure projects if necessary.

Whatever the UK's eventual relationship with the EU, it is highly likely to want to retain a number of key pieces of **EU** legislation and EU standards that govern the sector. Some rules, such as the health and safety requirements for working at height, would be hard to justify changing.

Continuing to conform with others, like the EU's Construction Products Regulation, which sets out harmonised rules for testing and marketing construction products in the EU, would simplify trade. Indeed, construction materials manufactured in the UK will need to comply with the EU rules if they are to be exported to EU markets.

Similarly, the Eurocode standards that cover the design of structures have over the years replaced national standards and it seems unlikely that the UK would either return to the British Standards system or implement standards which diverge from the rest of Europe.

ENERGY EFFICIENCY IN BUILDINGS

Its' membership of the EU has been an important element in encouraging UK legislation and action to improve energy efficiency, particularly in buildings. The EU's ambitious energy savings targets (20% on projected use by 2020 and 27% by 2030) will fall if the UK exits the single energy market but will remain in place if not.

The Energy Performance of Buildings Directive (EPBD) introduced measures to reduce energy consumption, including compulsory energy performance certificates and display energy certificates.

It also established the requirement for all new buildings to be nearly zero energy by end of 2020, and placed obligations on companies to carry out energy audits.

Although these are unlikely to change substantially, a full Brexit would allow the UK to replace them with something more tailored to the needs of the UK market.

VAT RATES

The EU has strict rules on minimum VAT rates as well as regulations on when reduced and zero rates can be applied. The UK already applies reduced rates on residential energy, insulation and renovations and zero VAT on new construction.

After a full Brexit the UK would be able to set its own rates and could encourage investment in specific goods and services such as energy or water efficiency in buildings.

PLANNING AND DEVELOPMENTS

The requirements for environmental assessment of development projects derive mainly from EU law, including Directives on Environmental Impact Assessment, Strategic Environmental Assessment and Habitats Regulations Assessment. The impact on the UK's implementation of these pieces of legislation will depend on the exit deal that the UK negotiates with the EU: an EEA (Norway-style) deal will require compliance with EU law while other options would bring greater flexibility.

Even if the UK chooses a full Brexit and gains more scope to put in place its own system, it is nevertheless likely that new domestic legislation on environmental impact assessment would be required for the planning process.

Similarly, EU environmental directives relevant to water, waste, air and noise, have been implemented into UK law. Public opinion in these areas will make them politically difficult to reject or dilute once the UK has the right to determine its own direction.

EU Regulations on the other hand, such as REACH which governs chemicals, are applicable directly without additional UK law and so will fall off the statute book on the UK's exit. The UK Government will therefore have to determine whether it wants to replicate some or all of these rules in UK legislation. Whatever the decision, goods exported into the EU will need to comply with any relevant EU legislation before they can be placed on these markets.

FUNDING INFRASTRUCTURE PROJECTS

Brexit calls into question two primary sources of EU funding for infrastructure: the European Fund for Strategic Investment (EFSI) and the European Investment Bank (EIB).

The EFSI was the brainchild of European Commission President Juncker. It is not yet clear how Brexit will impact either the UK's contributions to the fund, at €8.5bn, the largest of any EU Member State and second only to that of China, or the EFSI's investment in UK projects. Those projects which have already received or were scheduled to receive funding will now face a period of uncertainty. Total investments to date by the various EFSI instruments in UK infrastructure projects amount to almost €2bn (as of June 2016). These EFSI investments were expected to trigger further investments of €8.2bn and create over 26,000 jobs in the UK.

Should any planned investment under the Investment Plan for Europe (which has become known as the Juncker Plan) be withdrawn, the UK would face the challenge of securing alternative funding for them. Although formally the outcome of the UK referendum has not changed the right of UK based project developers to seek EFSI funding, uncertainty about the potential consequences of a Brexit creates additional risk. As a result, the interest of investors in contributing to European funding for UK based projects could well diminish.

The EIB has invested around £42bn in the UK over the last decade, including loans for Crossrail, London Transport, the electricity transmission network in northern Scotland, water companies, projects at a number of universities, and hospitals. These are legally binding contracts and so will not be called in. However, it remains to be seen whether £580 million in loans for UK housing associations will go ahead later this year.

Unlike some other EU countries, the UK does not have its own long-term infrastructure bank so it is unclear where additional funding will come from for large projects post-Brexit. It is also not clear what will happen to the UK Government's 16% shareholding in the EIB.

WHAT NEXT?

Now is the time to identify opportunities and risks from this situation in collaboration with BDO experts.

The regulatory and public policy team at the BDO Global Office, in conjunction with external consultants, prepared this short paper to help you begin to understand the impact of Brexit on the UK Real Estate & Construction sector in the short, medium and long term.

The political situation is of course very fluid at the time of writing and doubtless there will be further developments and clarity as the months go on.