UK BREXIT

PROPERTY & CONSTRUCTION

UK Brexit affecting the UK property and construction sector

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Article 50:
Triggering article 50 of the Lisbon treaty to formalise Britain's exit from the EU is likely to occur in the first few months of 2017, while negotiations with the EU are expected to play out over the following two years or longer. The referendum is seen as advisory only, but the prime minister in recent statements has said the decision to trigger article 50 will be taken by the government without requiring ratification by both houses of parliament (though this may be challenged in the course of this year). Politically, the Conservative government is determined to trigger article 50, and it is considered unlikely that the House of Commons will directly challenge the will of the British people.

Commercial sector and fund redemptions: the property sector had been awash with caution and hesitancy. International investors require stability and some inward investment has been delayed until it becomes more certain whether and when the UK decides to leave the EU and what trading model it will adopt. On the other hand, the post-referendum fall in Sterling has made UK property much more attractive in foreign currency terms and much of the investment in central London since the referendum has been undertaken by international investors. After falling by an average of 23 per cent on the day after the referendum, UK real estate investment trust shares have since halved these losses, and turnover of City of London buildings in the third quarter is expected to be only 10 per cent below the same period a year earlier. Eight property funds had halted redemptions in the immediate aftermath of the referendum, but three have since resumed trading. Capital values fell by about 3% in July, but under 1% in August. The yield spread on commercial property to government bonds are at their highest since 2008, so there is still much caution in the market. Meanwhile, however, macroeconomic indicators of the UK economy have surprised on the upside and fears of a sharp correction have largely faded, without giving way to undue optimism.

Residential: The expected Brexit correction has not yet materialized. Prices have flattened out at high levels. Prices are expected to be largely flat for the remainder of 2016, showing a strong growth year on year. Predictions vary for 2017, but many commentators believe prices will fall by up to 5% in the course of the year.
Mortgage rates are at record lows, though mortgage lending slowed in July after a strong June, most lending is refinancing rather than to new buyers. The availability of mortgage finance is expected to decline until uncertainty clears and price trends become clearer. Affordability is still below long-term averages.
Sales volumes in July-August are expected to be down on the exceptional levels of June, and may reflect a normal summer lull or some Brexit effects. Transaction volumes were already falling in the months before Brexit and are expected to continue to drift down in the next year, especially at the higher end of the market, though the fall in the pound has made prices more attractive for overseas buyers. The overall picture is of a market softening from the very robust activity of the first half of 2016, but without exhibiting any signs of the previously expected sharp correction due to Brexit. Any slowdown in prime central London locations may in part be due to changes in the tax regime affecting overseas investors.

Construction: a sharp recent fall in the Purchasing Managers Index in June and July to around 45.9, its lowest level since June 2009, pointed to a further future fall in construction activity, with new orders particularly weak, continuing the long decline since early 2014. This was followed by a sharp recovery in August to 49.2, though still recessionary, and a further recovery in September to 52.3 indicating future growth in construction output. Construction output was stable in July, but still down 1.5% year on year, while orders in the second quarter picked up unexpectedly due mainly to housing. The overall picture is one of gradual decline since the strong activity of 2014-2015. There is no evidence that Brexit has yet contributed markedly to these trends. The construction sector has been squeezed meanwhile by rising wages. Cost inflation has reached the highest levels since July 2011.

Skills shortages: migrant workers currently fill around 12 percent of the approximately 2.9 million U.K. construction sector jobs. Joining the European Free Trade Association (EFTA) would mean EU nationals could remain in the UK and work. Remaining part of the European Economic Area (EEA) would entail free movement of EU labour. Negotiating bilateral agreements with the EU would likely reduce its free movement. Whatever the approach adopted finally by the UK, it seems probable, given the importance of immigration to the outcome of the referendum, that free movement will be reduced and the skills shortage in the sector, currently struggling with an ageing labour supply and high retirement rate, will be exacerbated, putting further upward pressure on wage rates and delaying project timelines.

Businesses moving abroad: the UK can expect some increase in vacancies across the sector as some businesses move their headquarters abroad, be it in the financial sector, for example, if US banks are unable to sell their services into Europe from London, or in the motor industry if the UK and EU erect tariffs. The speed of any exodus will depend on the speed of the negotiations and the clearing of uncertainty, but is unlikely to be rapid and the fall of pound sterling may well contribute to replacing this demand. The UK certainly appears to be taking a more global approach and looking harder for trading partners outside the EU.

EU funding of construction projects: the EU has traditionally funded many major regeneration projects and social housing retrofitting schemes. Funds, such as the European Regional Development Funding (ERDF), the Joint European Support for Sustainable Investment in City Areas (Jessica) and the European Structural Investment Fund (EUSIF) have provided valuable funding to the UK. It is uncertain, given the size of the government budget deficit and lack of clarity over whether any real savings will result in terms of monies paid into the EU, how UK government funding will be made available to replace that from the EU.

Price and margin pressures: Imports of building materials have already become more expensive due to the fall in the pound and, depending on pricing power in the market, will raise project prices or reduce margins. In general, access to foreign resources, tools and materials may be obtainable only at increased prices, although negotiations are not yet underway and the UK trade deficit does indicate the benefit the EU obtains for unfettered access to the UK market.

Red-tape: EU regulations are currently enshrined in UK law. While change is unlikely to be immediate, there would be scope for the first time to lighten the burden of this legislation by repeal, particularly in the area of health and safety and energy performance.

Bid costs: an end to tendering projects through the Official Journal of the European Union (OJEU) may for the future lead to reduced bid costs and greater opportunities for smaller and medium sized firms.

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