Deloitte.

CloserLook

Brexit: What now for US commercial real estate?

The world turned upside down?

The decision by voters in the United Kingdom to exit the European Union, known as "Brexit," was a surprising one: prognosticators in the days leading up to the vote assigned a fairly low probability for the "leave" supporters to come out on top.[1] Additional uncertainty related to the potential for additional EU member nations to seek an exit, or even for constituencies within the UK to seek their own path with respect to the EU, has the potential to further complicate an already challenging situation.

Financial institutions in the UK and Europe will bear the brunt of this event over both the short and longer term, as the timetable for full separation will take two years following invocation of Article 50 of the Lisbon Treaty. What about their counterparts in the United States? Some very large US firms operate globally, with a meaningful presence in the UK and Europe. For them, the impacts are more direct and immediate. But many more US financial institutions are purely domestic, so the impacts of Brexit will be part of larger regulatory and economic forces that may emerge as the UK executes its departure.

In the remainder of this document, one of a series of reports, we will explore the implications of Brexit for the commercial real estate (CRE) business in the United States, looking at financial, regulatory, operational, and strategic considerations for US CRE executives. Those interested in understanding the impact of Brexit on other financial industry sectors are encouraged to review our companion pieces in this series.

[1] Justin Wolfers, "Brexit Hits U.S. Stock Market Harder Than an Election," *New York Times*, June 24, 2016.

Implications of Brexit for US CRE

Amid all the uncertainty in the post-Brexit world, one thing is certain—US CRE firms will be challenged in doing cross-border business. And the situation can get exacerbated if Brexit has a cascading impact and other countries seek to leave the EU. That said, let's evaluate some of the initial implications of the potential changes for US CRE firms, which includes owners, brokers, and engineering & construction (E&C) players.

To begin with, it appears that Brexit is likely to have a positive impact on the US CRE sector. A potential flight to safety may result in an increase in inflow of global funds to US markets as they are considered relatively more stable and secure. CRE firms with limited to no exposure to the United Kingdom are likely to benefit from increased investments, higher transaction activity, and a resultant rise in property prices.

There is also a possibility that the US government may continue to maintain low interest rates. However, interest risk premiums on mortgage debt are expected to grow due to higher volatility and risk, perhaps offsetting any decrease in benchmark government rates.

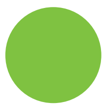
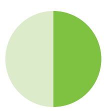
CRE firms that have an exposure to the UK will likely face volatility in the short-to-medium term. There may be downward pressure on demand and price in the UK property market, leading to a negative impact on development and transaction activity. The situation could be compounded as refinancing activity may be affected by a reduction in bank lending. Further, E&C companies with projects in the UK will also bear the brunt of any higher material import costs due to a weaker pound sterling.

Lower asset values can be very damaging for large institutional investors with exposure to the UK, as they are likely to have significant mark-to-market losses on their portfolios in the short-to-medium term. Heightened perceived risk will likely increase cap rates, and uncertainly about future demand for all types of real estate will likely drive down rental rates, resulting in value declines. Uncertainty about the implications of Brexit on the broader UK economy is expected to have negative implications on liquidity in the UK CRE transactions market, potentially making it difficult for these firms to exit their investments. UK CRE investors will need to reevaluate their capital commitments and exit strategies, although any stop-gap fiscal measure by the UK government could provide some relief.

Ultimately, uncertainty around future demand for UK real estate may reduce appetite for long-term investment and development. It will be interesting to gauge the relative attractiveness of the UK as a significant and transparent investment market as the situation unfolds over the next few years.

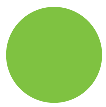
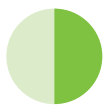
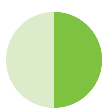
There are several considerations for US CRE firms in the post-Brexit era. We briefly examine some of the more important ones below.

Areas of focus

Strategy and business model		
Implications	**Scale of impact**	**Likely impact on US CRE companies**
Uncertainty and slowdown in UK economic activity		• Increased attractiveness of US CRE market as a stable and safe investment destination. • Higher transaction activity and cap rate compression in US CRE due to increased demand. • Inverse trends in the UK CRE market with negative impact on development, transaction activity, and prices.
Uncertainty around international expansion plans		• Need to revisit expansion plans in Europe, especially in UK. • Other EU financial centers such as Frankfurt, Paris, Amsterdam, and Dublin may benefit from increased demand. • Evaluate if potential short to medium-term asset value declines warrant a reduction in exposure to UK CRE or create buying opportunities.
Altered competitive positioning		• CRE owners, brokers, investors and E&C firms with relatively higher exposure to UK and EU are likely to be at a competitive disadvantage. • US domestic CRE investors will likely face more competition from the increase in foreign investments.

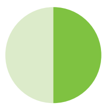
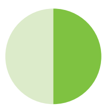
Key: No impact Minimal Moderate Material High

Areas of focus

Operations		
Implications	**Scale of impact**	**Likely impact on US CRE companies**
Potential earnings decline on UK exposure		• Firms may have to maintain EU regulatory compliance while preparing for UK regulatory scrutiny.
Tough financing environment		• Asset managers face potential cost increases stemming from regulatory compliance with differing country level agreements for firms with centralized UK-based European operations.
Shortage of talent		• CRE firms' UK operations could be impacted by shortage of talent and potential increase in labor costs due to limitations on migration.
Variability of tenants		• Tenants may reassess existing leases and negotiate rates and duration either due to their own business model assessment or regulatory changes.

Key: No impact Minimal Moderate Material High

Areas of focus

Regulatory strategy		
Implications	**Scale of impact**	**Likely impact on US CRE companies**
Uncertain regulatory scenario		• US CRE firms will have to navigate regulatory uncertainty with respect to their UK operations, even though the existing ones will continue until an agreement is reached between the UK and the EU.
Reassessment of legal and tax obligations		• Existing legal entity and investment structures will potentially need a reexamination. • Contractual obligations and arrangements with counterparties will need to be reconsidered.

Key: No impact Minimal Moderate Material High

Areas of focus

Financial

Implications	Scale of impact	Likely impact on US CRE companies
Continued low US interest rates		• Interest rates will likely remain low as the US Federal Reserve aims to support economic growth amid market volatility and a strong dollar. • However, interest risk premiums on mortgage debt are expected to grow due to higher volatility and risk, perhaps offsetting any decrease in benchmark government rates.
Weaker pound sterling		• Direct impact on capital values and earnings may lead to significant mark-to-market losses on UK CRE portfolios.
Reevaluate hedging strategies		• Companies will need to reassess short- and long-term currency hedging positions due to exchange rate fluctuations.

Contingency planning

Implications	Scale of impact	Likely impact on US CRE companies
Contagion effect on other EU nations		• It will be interesting to see how other EU nations respond individually and collectively as any contagion effect of Brexit would require CRE firms to evaluate their European exposure in entirety rather than just their UK exposure.
Ongoing political changes		• Upcoming elections in other major European nations such as France, Germany and the Netherlands could lead to a change in their leadership and eventually position on EU association.

Key: No impact Minimal Moderate Material High

Contacts

Industry leadership

Bob O'Brien
Vice Chairman and Partner
Global and US Deloitte Real Estate Leader
Deloitte & Touche LLP
+1 312 486 2717
robrein@deloitte.com

Deloitte Center for Financial Services

Jim Eckenrode
Managing Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Author

Surabhi Kejriwal
Research Leader, Real Estate
Deloitte Center for Financial Services
Deloitte Support Services India Pvt. Ltd.
+1 615 718 8364
sukejriwal@deloitte.com

The Center wishes to thank the following Deloitte client service professionals for their insights and contributions to this report:

Chris Dubrowski, Partner, Deloitte & Touche LLP
James O'Riordan, Partner, Deloitte UK
Christopher J. Spoth, Managing Director, Center For Regulatory Strategy, Deloitte & Touche LLP

The Center wishes to thank the following Deloitte professionals for their support and contribution to the report:

Michelle Chodosh, Marketing Manager, Deloitte Services LP
Lisa DeGreif Lauterbach, Financial Services Industry Marketing Leader, Deloitte Services LP
Saurabh Mahajan, Assistant Manager, Deloitte Support Services India Pvt. Ltd.
Seth Raskin, Marketing Manager, Deloitte Services LP
Neeraj Sahjwani, Senior Real Estate Research Analyst, Deloitte Support Services India Pvt. Ltd.

Deloitte Center *for*
Financial Services

Deloitte.