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Valuation after Brexit Uncertainty

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Thomas Rasche MSc. B.A. B.Arch.
Jon Reakes MRICS RICS Registered Valuer

Brexit aftermath

The Brexit referendum, held on Thursday 23rd June 2016, and subsequent result for Britain to leave the EU, has brought uncertainty. Immediate impact is visible politically and economically. At the time of writing, the political fallout includes the Prime Minister David Cameron resigning with a subsequent Conservative party leadership race and the Labour leader Jeremy Corbyn facing resignations and no confidences. Economically, Mark Carney, the governor of the Bank of England immediately announced preparedness for economic stimulus. Interest rates are now expected to remain low for longer than previously thought and set to possibly even lower values. The markets immediately reacted with a sharp drop in the value of equities, most hit were banks (RBS Market Cap dropped 35% after the result), property companies (British Land Market Cap dropped 34%) and construction companies (Taylor Wimpey Market Cap dropped 25%). Since the initial drop, some have trended slightly up, others down, with considerable volatility. Property valuation works within, and depends on these industries. Listed property valuation companies have similarly dropped in the region of 15% at the time of writing. Post Brexit, there is, and will be, a period of uncertainty and volatility (FT, 2016). [1]

Political crisis

The CEO of Barclays described this crisis as a political, not economic crisis (BBC, 2016). This is demonstrated with the leadership turmoil of the two major parties, as well as the political timetable of implementing Brexit changes.

Britain has to invoke Article 50 for it to leave the EU. As soon as it is invoked, it becomes a two-year process of separation. The start of this two-year process is being delayed, as it is Britain's prerogative to decide when to invoke it, despite the EU urging for immediate invocation. David Cameron, upon resigning, said that a new leader will be in place by the 2nd October (Whale, 2016). Once in power, a new Prime Minister will likely further delay the invocation. They will need to establish a roadmap, including a timetable for invoking Article 50, as well as all required negotiations.

The separation from the EU is distinct from the renegotiation of a new agreement(s) with the EU (Dougan, 2016). These include direct negotiations with the EU, as well as negotiations with third parties with agreements based on Britain being within the EU. This will require more than two years; it will require an extended, potentially indefinite, period.

There is considerable disquiet about the decision to leave the EU, given the economic and social implications, in light that it was only a marginal victory (Brexit polled 52%, Remain 48%). Recognising this political opposition suggests a third way may be pursued. These include:

- If politically acceptable, Article 50 may not be invoked (or delayed indefinitely), as there is no legal obligation for Britain to do so (Siddique, 2016).
- An online petition for a second referendum has exceeded 4M votes [2]. If held and resulting in remain, this could overturn the first referendum. A second referendum in the Republic of Ireland enabled them to ratify the Lisbon Treaty in 2009.
- Prior to Article 50 being invoked, parliament has to repeal the 1972 European Communities Act, which took Britain into the European Union. This could be voted down (Robertson, 2016).
- Another change, e.g. a change within the EU, enabling Brexit by other means.

However, the Conservative leader candidates all declare that they will pursue Brexit.

Economic context

Notwithstanding that this is primarily a political crisis, there is a strong economic impact. In the short term (next few months), the Bank of England response will be: “...the economic outlook has deteriorated and some monetary policy easing will likely be required over the summer.” (Carney, 2016, p.15).

Mark Carney, governor of the Bank of England, summarised the uncertainty (as distinct from risk): “there are at least three distinct types of uncertainty that influence economic performance … geopolitical … economic … political ...” (Carney, 2016, p.3-4). The uncertainty of Brexit is political, unlike the financial crisis of 2008 which was economic uncertainty, or the Arab Spring which was geopolitical uncertainty. Political uncertainty is the absence, or reduction of, institutional structures, frameworks, fiscal discipline etc. The interrelationship of these three uncertainties can be seen in Fig 1.

Carney continues: “While the effect on output is clearly negative, the effect on inflation is ambiguous. Uncertainty’s stultifying effects weigh on employment and aggregate demand, creating disinflationary pressures, while the freeze in resource reallocation can hold back productivity and aggregate supply, creating inflationary pressures. Higher uncertainty can also mean investment responds more sluggishly to demand stimulus.” (Carney, 2016, p.6). It is clear from this, that property will be impacted by reduced demand.

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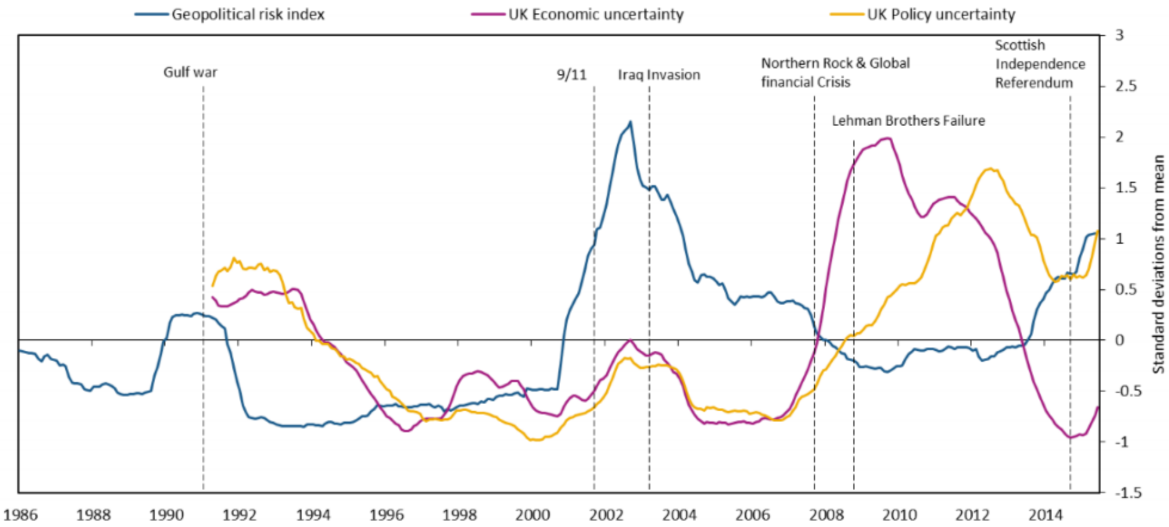

Fig. 1. Three eras of uncertainty: geopolitical from 9/11 to 2008; economic uncertainty from 2008 to 2012; and policy uncertainty today. Source: Bank of England (Carney, 2016, p.6).

Property valuations

The impact of the above on property valuations, is that political uncertainty and the subsequent reduced demand will decrease their values. The political crisis impacts attitudes to property, movement of people, etc. beyond the consideration of property just as a financial asset. The value is impacted by its utility value.

With very low interest rates being promoted, it would suggest that valuations should increase. However, it is the (non-financial) political uncertainty that counters this. Political uncertainty is the problem, with low interest rates being the response. It would be prudent to reflect on the uncertainty, more so than on the economic medicine. The risk premium should exceed the ‘medicine’, ie the percentage risk premium should be higher than interest rate cuts.

In the globalised world, property in the UK has been considered a safe investment. Reasons include rule of law, transparency, liquidity and political stability. The latter is now less certain and should reduce property values. However, the political uncertainty has, and will, impact the £Sterling exchange rate, implying that UK properties become more affordable for overseas investors. These two factors will have to find a new balance. If £Sterling weakness endures and causes inflation, the Bank of England could also raise interest rates. This is considered unlikely in the near future (Montague-Jones, 2016).

Cost of Money

Financial values of properties, in particular investment properties, quantify their utility value through future earnings, discounted back to present values. The discount rate is a figure derived from interest rates, lending rates, risk etc. The discount rate is the cost of money.

Given the context of political uncertainty, it would be appropriate to adjustment the discount rate upwards with a risk premium. The risks of volatility and reduced demand can be reflected in this regard.

An example valuation of a property's utility, given a higher discount rates:

	Discount rate =5%	Discount rate =1%
Rental income pa	20,000	20,000
Year's purchase at rate (in perpetuity)	x20	x16.7
	400,000	334,000

In this example, a discount rate rise of 1% reduces the value of the property by £66,000. This equates to a drop of 16.5%.

The Bank of England may well respond to the political uncertainty by reducing interest rates by 1+%. An example of how discount rates might be adjusted as follows:

Discount rate pre-crash	5%
BoE stimulus: reduced interest rates	-1%
Increased risk premium (reduced demand + volatility)	+2%
New discount rate post referendum	6%

After the referendum results were declared, market capitalisation of listed property companies dropped by approximately 20%. This is a comparable adjustment to valuations having discount rates rise by 1-2%.

The cost of borrowing, i.e. leverage, will increase with loan-to-value (LTV) ratios for senior debt and mezzanine debt reducing, and likely to accelerate. This will be coupled with a risk premium added into lender's margins, and a preference for prime property lending. The property investment market is expected to remain subdued for the latter part of 2016 (Montague-Jones, 2016).

Notes and Citations

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Authors

Thomas Rasche MSc.,B.A.,B.Arch.
3 Trelwaney Park
Brislington
Bristol BS4 4HD