

Brexit Client Briefing– Looking beyond the noise

On 23/06/2016 a narrow majority (51.9%) of British voters decided in a free and democratic referendum in favour of a Brexit. As democrats we accept such a decision and as a company we get on with it.

Below we would like to share some of our thoughts with you.

What the British people said

It is important to remember, that the key slogan of the “Out” campaign was “Take back control”. While individual reasons might differ, it seems that the British public was very unhappy how the European Commission interfered in areas of national importance it had not been elected to; its roots being that of a union focussed on commerce. The European commission was perceived as a self-appointed bureaucracy, which overruled or limited the UK’s institutions incl. the High Court and Parliament in Westminster, the ultimate sovereign in the UK, which is directly elected by and answerable to the British people. Unsurprisingly, such interference with revered democratic institutions caused significant consternation in the UK, a staunchly democratic country, which prides itself as being “the mother of parliamentary democracy”.

What the Brexit vote does NOT mean

The vote to leave was mainly a vote against the European Commission in Brussels and what is perceived as its excessive and not properly democratic interference. It is NOT a vote against Europe, NOT against Britain’s European neighbours, NOT against European cooperation and certainly NOT against European trade.

As a German citizen living in London for close to two decades, I can confirm that Britain is still a remarkably open, tolerant and open-minded country.

Common interests

According to the IMF Britain is the 5th largest economy in the world, just between two of its major trading partners (Germany 4th place and France 6th place). Trade between the other members of the European Union and the UK amounts to over £500bn per year (Source: ONS), making each side a hugely important trade partner for the other.

It is therefore our opinion that a messy and protectionist separation of trade between the remaining EU countries and Britain is in nobody’s interest and therefore not very likely, provided the political powers in Continental Europe exert the proper influence on the European Commission.

Both sides are clearly better off working together and finding a mutually beneficial solution. Indeed a spokesman of the German car manufacturers association (VDA) has already declared that tariffs etc. would not be in the interest of its members.

We therefore believe in an overall pragmatic economic solution, beneficial to both sides. There may be some limited reallocation of certain functions into Continental Europe, but it is generally recognised that tariffs, protectionism and trade-boundaries reduce wealth creation on both sides and so our base case is projects limited change.

The City of London

The City of London and its financial services could be singled out for a less favourable treatment, as the value of financial transactions is high and they are easy to regulate and tax. We believe that this is only one of the issues for the City of London, but neither the only one nor the most important one. Regulation in general, cost, reduced profitability and outsourcing are at least equally important. Whether Paris with its high tax rates, strong worker representation and focus on working hours is a competitor to London's Anglo-Saxon financial services culture is questionable and Frankfurt, while certainly important is a city of 724,000 inhabitants with a constrained residential market. This a.o. would pose some difficulties, given that the size of the financial services employment in Greater London is ca. 358,000, which is almost half of the total population of Frankfurt (cityoflondon.gov.uk and Frankfurt.de)

We believe that the City of London will retain its global importance but will evolve as it has done for centuries in line with the Britain's undiminished mercantile spirit. Indeed, when walking through the City of London, street names like Bread Street, Cornhill, Eastcheap, Garlick Hill, Ironmonger Lane, Lime Street, Milk Street etc. evidence the City's centuries old history as a trading hub in whatever commodity made money. And if we walk through the Eastern parts of the City of London today, we can already see the City of London playing host to the next big thing, an ever-growing number of tech companies, replacing financial services from their heartland. The City of London keeps reinventing itself providing in demand services and goods and will continue to do so. As the French would say: "Plus ça change, plus c'est la même chose!" (Alphonse Karr)

The key risk is a European Commission focussed on self-preservation and not on members

All our analysis is predicated on both the European Commission's and the UK's negotiators behaving rationally. We see the main risk in an aggrieved European Commission becoming vindictive and trying to make an example of Britain to deter further exit candidates and protect itself from the ensuing loss of power, importance, job security etc.

We see the Brexit negotiations as the litmus test for the European Commission's attitude towards the people it was created to serve. Will the European Commission put its emphasis on creating a mutually beneficial outcome for Britain and the remaining EU countries and thereby deliver on its promise to be an enabler of economic activity or will the European Commission be most concerned about self-preservation and retribution? The early comments of Mr Juncker that "Britain should start the exit negotiations as quickly as possible, ... however painful this might be" unfortunately indicate the latter. The old British adage "act in haste, repent at leisure" comes to mind.

Much more sensible was the response from the German chancellor and vice chancellor, who requested calm and consideration, which certainly befits the importance of the matter ("Eile mit Weile"). And herein lies the solution, in the NEW EUROPE, the prime ministers, finance ministers and foreign ministers of the EU member states must actively lead the decision making and negotiations. It is no longer sufficient to vote "Yes" or "No" on a proposal the Brussels bureaucracy has negotiated unsupervised.

This is a radical proposal, but the Brussels bureaucracy has not shown itself capable of negotiating in a transparent and member focussed manner as evidenced by:

- a) the TTIP negotiations, where the elected members of the various national governments are excluded and only can look at the European Commission negotiation papers in locked rooms, without being able to make copies or communicate the content to its constituents; and
- b) the debt negotiations with Greece, whose debt pile was repeatedly increased from unsustainable to utterly unsustainable.

The former evidences a complete lack of democratic transparency and willingness to engage with the European electorate, the latter evidences a complete lack of economical realism. The next Greek debt restructuring can only be months away.

We strongly call on the key members of the sovereign European governments to involve themselves early and deeply in the negotiations with the UK to ensure a mutually successful outcome. A combined ca. £500bn of imports and exports between the UK and the other members of the European Union are too significant to risk in unsupervised negotiations.

Active involvement of the various governments would also signify to their electorates, that their elected representatives do not simply outsource the most critical decisions to an unelected and unanswerable bureaucracy in Brussels. This active involvement of national governments will have to become the “New Normal for operations in the European Union”.

Dislocations, Risks and Opportunities

Article 50 of the Lisbon Treaty sets a time frame of 2 years for the withdrawal from the EU. Given the complexity, lack of precedence and human nature, a timeframe of 2+ years is the most likely outcome. During this period real difficulties, tactical leaks and parts of the press creating sensational stories, are likely to create dislocations in various markets, leading some parties to reduce or temporarily abandon activities, or consult with their stakeholders.

Much of this is procedural but it will consume time. We expect some dislocations and volatility in most markets, especially exchange rates and transactions falling apart. Given that our base case is that within 2 years matters will have calmed down and that Britain's long term global trade potential will not have changed materially, these dislocations could provide significant buying opportunities. In H1 2009 I acquired for my previous employers 131 Finsbury Pavement, a City of London office building for £45.5m, while the previous owner paid in excess of £65m, just 18 months earlier. This purchase was made at the height of the global financial crisis when transactions had ceased. Within 12 months the situation had changed significantly and the City investment market had sprung back to life. Of course, past performance is no guarantee for future performance, but it is worth remembering the above as we do not foresee the impact of Brexit being anywhere near as large as the global financial crisis, though the resolution is likely to take 24 months or more. (This does not constitute investment advice! Relevant and transaction specific advice should be obtained from a duly qualified source.)

We also remember that many overseas investors have in the past very successfully bought into the UK on the back of a weak British Pound and temporary dislocations in the market. It is very likely that there will be again significant opportunities for investors who access the right transactions and adapt their time-frame to market conditions.

Britain's mind-set has not changed

Britain's mind-set has not changed, it has not become insular and self-centred and has not turned away from its European neighbours. It still has a fantastic education system, great geographical position, a highly educated, creative and flexible work force, high professional standards, a robust legal system, great international connections, the English language, etc. Yes, there may be some changes depending on how the trade negotiations develop, but we are hopeful that common sense will prevail and see it therefore as unlikely, that "the bottom will fall out" of the market, though some transactions will stall because of Brexit.

We are more concerned about the impact on peripheral states of the European Union, especially those with large discontent populations, weak economies or both. This is where much more serious events could occur.

Please contact us if we can be of assistance

At AF Advisory we pride ourselves of thinking like principals and giving our clients unbiased and straight-forward advice, whether we arrange real estate finance or support you in real estate acquisitions or disposals in the UK or Continental Europe. Please feel free to contact us if you have any questions regarding the above or if we can help in real estate related matters.

Finally: European integration and commerce are not created in Brussels

The European Commission was created to and has done significant work standardising, assessing and adjusting the provision of products and services within the EU. This is the task it was created for. Most people recognise, at least some of the positive contribution this has made to product safety, consumer rights, competition etc. and the EC deserves credit for fulfilling its duties in that area.

It is however important to realise that European integration and commerce are not created in Brussels, only the framework is. European integration and commerce are created by every interaction started, every friendship struck and every commercial negotiation concluded between citizens or companies of the various sovereign European countries. This does not happen in Brussels but in our personal spheres and offices and it is upon all of us to make this happen to our mutual benefit, now more than ever.

Let's get on with it!

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