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REAL ESTATE FINANCE & ADVICE

THE HOLISTIC VIEW

Following the positive response to our client briefing on Brexit this is the first of our new monthly newsletters. As always we aim to provide holistic advice; as real estate and its returns are a derivative of the financial markets, the economy, social, political, demographic and technical developments. We will explore these and their impacts on the real estate markets in the UK and Continental Europe going forward. We base our view on our own and third party research and would like to especially express our gratitude to Dr. Savvas Savouri, Chief Economist of Tosca Fund and one of the leading economists in the UK, for kindly sharing his valuable insights on inflation and further research with us.

Please note that this is a newsletter only and does not constitute investment advice.

Given the continued uncertainty about Brexit and as a follow on from our initial research issued on 27/06/2016 (4 days after the referendum) this newsletter is based on our Post-Brexit talk given at the PropertyGrapevine, a London based land-economics society on 22/09/2016:

“Thank you for having me and please note there was a bit of a mistake in the invite as this talk was labelled as Brexit – and its impact on the real estate market. It should have said: “Brexit – the views of an anglophile German immigrant, who would have voted for Brexit!”

Having set out my views I feel it important to take stock, now almost 3 months after the vote:

5 scares immediately following the vote for Brexit

- The stock market took a dive, which was not great for many fund managers and stock brokers impacting on their performance and bonus.
- The Purchasing Manager’s Index of confidence fell sharply.
- There was a run on the real estate funds and seven had to close.
- Much of the UK real estate sales and financing came to a halt and with it the transaction fees of investment agents, lawyers, accountants, bankers and other advisors including us – ouch.
- The British Pound dropped significantly.

On top of this we lost a charming and well-spoken Eton educated prime minister and many of his former classmates.

It's a complete disaster.

And if that was not enough, for the first time in history the French are miffed with the Brits and even Barack Obama stopped by and told us not to break away from faraway lawmakers and tax takers. I mean he must know it, after all he comes from the country that hosted the famous Boston Tea Party and what an unmitigated disaster that turned out to be for the Americans…

ON A MORE SERIOUS NOTE – LET'S LOOK AT THE FACTS.

Stock market:
The stock market is back and above where it was before Brexit. So far for the wisdom of the markets.

Real estate funds:
Half of the funds have opened again or announced their intention to reopen/reduce their exit penalty. While the run on these funds may have been triggered by the Brexit vote, the structure combining daily liquidity in the fund shares with illiquid underlying assets is flawed. This is the key problem, Brexit was only the catalyst.

Transactions:
Many valuers have dropped the uncertainty clauses due to increased transactions since the vote, as there is now enough transactional evidence. Yes, some yields have move out, other transactions take place at previous levels and admittedly the City of London lettings market remains pretty soft while firms await further developments.

However, the employment figures in London remain strong according to the national statistics, but I admit that the statistical lag between the vote, the reaction and the statistical data gathering may not yet show the whole story. But it certainly does not feel like 2008, does it?

Purchasing Managers Index:
After a significant drop in July, the PMI has reached positive levels again in August and is now above its June 2016 level.

The Pound:
The drop in the Pound is an incredible boost for the UK and will have many positive effects.

Let's look at the GDP make-up of the UK:

Sector	Sub-sector	Percentage of GDP	Value in £ m
Service	**Total**	**79%**	**330,909.00**
Service	Government, education and health	19%	79,585.71
Service	Real Estate	12%	50,264.66
Service	Professional, scientific and technical activities and administrative and support services	12%	50,264.66
Service	Wholesale and retail trade	11%	46,075.94
Service	Financial and Insurance	8%	33,509.77
Industry	**Total**	**21%**	**87,963.15**
Industry	Manufacturing	10%	41,887.22
Industry	Construction	6%	25,132.33
Agriculture	**Total**	**1%**	**4,188.72**

Data: http://www.tradingeconomics.com/united-kingdom/gdp-growth)

- Manufacturing (10%), Professional and scientific & technical services (12%) will definitely benefit as the UK is exporting a lot of these.
- Education will benefit. The cost of world class education in the UK has just fallen by 10%-15% for international students, due to the exchange rate.
- Financial services, mixed impact.
- Wholesale and retail, mixed impact.
- Real Estate, mixed impact, as it is now cheaper for overseas investors to buy in the UK but some are worried about the future of the UK. As an aside, our firm received a dozen calls from value add and opportunistic overseas clients telling us "Please call us if you see something interesting!"

Exchange rate driven growth:
There has already been a small increase in manufacturing activity based on the new more attractive exchange rate. This increases profits and allows for overdue increases in salaries, which have stagnated for a long time. Companies can share the increased income with their employees, increasing disposable income and tax revenues and improving political stability.

Imported inflation:
The other benefit is the increased cost of imports. This will reduce imports, shifting purchases to goods made in the UK, which again has a positive impact on the UK economy.

The other positive impact will be imported inflation. We live in a world where inflation is too low and imported inflation could help an overdue return to a.o. "normal economics and monetary policy" including wage growth, interest rate increases, reduction of QE etc. all of which would benefit the entire economy and strengthen it in case there is another economic bump in the road.

Transfer of power:
As politics go the transition was quick and decisive. Theresa May and Philip Hammond have impressed us with their initial announcements and drive and we believe that this team is not only more representative of the wider UK population but that Mrs May could work closely with Mrs Merkel, Europe's most influential politician (though it is uncertain how long Mrs Merkel will remain in power), Mr Hollande (same question as with Mrs Merkel) and the other key politicians of the main European member states.

The economy seems in safe hands as Mr Hammond combines an Oxford trained mind with highly successful business experience. His announcement to balance the books, but not at any cost to the wider economy, has inspired confidence in a pragmatic and pro-business approach.

So far then the story in the UK is pretty positive. We are not out of the woods, but we are definitely not nearly in as bad shape as the Remain campaign had made out. In fairness though neither the Remain nor the Leave campaign covered themselves in glory. Given the proud democratic tradition of this country the electorate and the issue certainly would have deserved better information and less misinformation, emotions and showmanship. We see the declining trust between politicians and electorate as a key concern and these campaigns did not help building trust in either side.

Wider Economics:
As outlined in our "Brexit: Looking beyond the noise" client briefing of 27/06/2016, trade between the UK and the European Union amounts to ca. €500bn p.a. Below just some of the Continental European companies that maintain a very significant presence.

Company	Country	Approx. Global Employees	Approx. UK Employees	UK Employees in % of Global Employees	Subsidiaries
Telefonica	Spain	123,700	20,000	16%	O2 UK
Banco Santander	Spain	185,405	20,000	11%	Santander UK plc
BMW	Germany	116,324	18,000	15%	Mini, RollsRoyce
Axa	France	96,279	14,500	15%	AXA UK plc
Siemens	Germany	343,000	14,000	4%	Siemens United Kingdom
Airbus	France	138,622	10,000	7%	Airbus UK
Deutsche Bank	Germany	98,138	8,000	8%	Deutsche Bank United Kingdom
BNP Paribas	France	187,903	7,500	4%	BNP Paribas UK
Unilever	Netherlands/UK	173,000	7,000	4%	Unilever Uk & Ireland
Allianz	Germany	147,425	4,500	3%	Allianz UK
Daimler	Germany	279,972	3,500	1%	Mercededs-Benz UK
L'Oreal	France	78,611	3,500	4%	L'Oreal Uk & Ireland
Bayer	Germany	118,888	2,500	2%	Bayer Plc
Sanofi	France	113,496	2,000	2%	5 Subsidiaries
Societe Generale	France	148,322	2,000	1%	Societe Generale UK
Basf	Germany	113,292	1,300	1%	Basf Plc
Anheuser-Busch InBev	Belgium	154,029	1,000	1%	AB InBev UK Limited
SAP	Germany	74,406	1,000	1%	SAP UKI Ltd
Deutsche Telekom	Germany	227,811	1,000	0%	T Systems UK
Henkel	Germany	49,750	1,000	2%	Henkel Uk & Irelnd
EDF	France	148,024	1,000	1%	EDF Trading

(Data: AF Advisory Research, 2016.)

All the above companies and many more would bear the economic consequences of a mishandled Brexit negotiation. It is therefore our opinion that the above and many more companies will exert influence on their local politicians to ensure the European Commission does not inflict damage on them in its desire to make an example of Britain.

Passporting:
The question of passporting of financial services by accepting foreign regulator's approval shows another huge link between the UK and Continental Europe. Ca. 5,500 non-UK firms use their overseas regulation to do business in Britain and ca. 8,000 UK firms do business in Continental Europe on the back of their UK regulation. This interdependence is huge and it is in both side's interest to let things continue as they are without creating any significant hurdles. (Please see our "Brexit: Looking beyond the noise" briefing, to see our assessment of Paris and Frankfurt as competitors to London).

Trade agreements:
The UK will be free to negotiate its own trade agreements with the world. One of the obstacles of the EU was its size and disparity. It proved extremely challenging to agree on anything given how different the members are and the Brussels bureaucracy is not known for speed or efficiency. Therefore European trade negotiations take many years.

The UK on its own is in a better position to agree trade deals. We question President Obama's assertion that "the UK would have to go to the back of the queue". Given that the UK is the fifth largest economy in the world behind Germany, which is part of the EU, we suggest that if trade deals with other countries are negotiated in order of GDP the UK as part of the EU would be in fourth place and on its own in fifth.

Gross domestic product 2015		
Ranking	Economy	(millions of US dollars)
1	United States	17,946,996
2	China	10,866,444
3	Japan	4,123,258
4	Germany	3,355,772
5	United Kingdom	2,848,755
6	France	2,421,682
7	India	2,073,543
8	Italy	1,814,763
9	Brazil	1,774,725
10	Canada	1,550,537

(Data: World Bank, 2016)

This is certainly not the "back of the queue" and given the additional freedom and speed that not being part of the EU negotiations potentially provides, it seems to us that there could be an advantage in being able to dictate speed and terms that suit the British economy, rather than relying on Brussels to safeguard Britain's interests.

A rational approach is needed vs. the European Commission's approach:
The strong interdependence between the UK and Continental Europe dictate that a rational approach is needed on both sides. We pointed out previously that the UK's exit will have to be carefully negotiated to avoid unnecessary economic seizures which are not in anybody's interest.

We also pointed out in our "Brexit: Looking beyond the noise" briefing that our main concern is "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."

Mr Juncker has not wasted one moment to confirm our concerns by first hysterically announcing his demand that "Britain trigger Article 50 immediately" – not a very bright idea given the complexities and neither side being prepared and then appointing Mr. Barnier who brings with him a history of extremely contentious relations with Britain through his previous negotiations. If anything, Mr Juncker has confirmed that he puts his own personal interests and those of the EU bureaucracy ahead of the wider European (not just the UK) economy and electorate. This has raised ire in the UK and Continental Europe, especially in those economies who have a lot to lose in their trade with Britain. We therefore believe it is the responsibility of the national political leaders of Continental Europe, not the EU, to lead the negotiations. This brings us conveniently to

Politics:
The economy aside there are important political considerations that should impact the interactions with Britain.

The EU is in a serious crisis and the mood in local elections has swung against the current governments and to some extent against the EU who is perceived to have mishandled the migration crisis, the Greek crisis etc. Recent election results and the political tone in Germany and France, but also in Sweden, Denmark, Hungary, Poland and the Netherlands indicate that the very last thing European politicians trying to remain in power need now is an economic downturn. This would drive more voters away from the incumbent parties and their successors would be unquestionably more nationalist and less Pro-European.

Therefore the various national governments will be well advised to closely supervise the actions of Brussels to ensure that the European Commission, focussed on its own interests and survival, does not create any unnecessary economic fallout.

This is all the more in everybody's interest as the UK and Continental Europe share the same political and economic challenges and will have to cooperate in some form in all of them:

- Weak growth
- Too low interest rates
- Uncontrolled and excessive migration
- Islam inspired intolerance and extremism creating divisions in society and terrorism
- Disillusionment of the electorate with the political process and the political class
- Wide divergence of economic success
- Disruptive technology, that will increase disparity

If the UK uses its new powers wisely it can find better solutions to all the above problems than if it were part of the one-size fits all Eurozone.

A few examples:

Not being in the Euro gives the Bank of England the ability to set interest rates which fit the UK economy best.

Not being constantly overridden by the European Court of Human Rights will give the UK the ability to expel foreign trouble makers.

Not being overridden by the EU will give Britain the ability to manage migration better.

Going forward:
Sitting in the underground the day after the referendum I could not help smiling about the referendum. The whole world told Britain – "Don't do it!" and a majority of Brits, typically independent-minded waived to everyone saying "Thanks for your good advice. We'll do it anyway." or something like that.

And it is now on each of us to make it a success. Our politicians can only create the framework and we must not talk ourselves into a self-fulfilling depression. It is not warranted. Britain is not the same as it was in 1992 and the crisis is not the same as it was in 2008. We must keep this in mind and ensure we communicate this clearly nationally and internationally:

1. Britain is open for business.
2. Britain is a great place to do business.
3. Britain is a strong economy and will adapt to any changes as it always has, because its population remains creative, flexible, highly educated and very entrepreneurial.
4. Britain is a great country and will do well.

And on this note – I would like to end by asking you all to raise your glass to the continued success of this plucky little* country."

*little only if measured by landmass, as in sqkm Britain is smaller than many other European countries incl. Germany, Spain, Poland, Norway, Sweden and Finland.

As always we would be delighted to hear from you at af@afadvisory.com if we can be of any assistance or if you have any comments regarding this newsletter.

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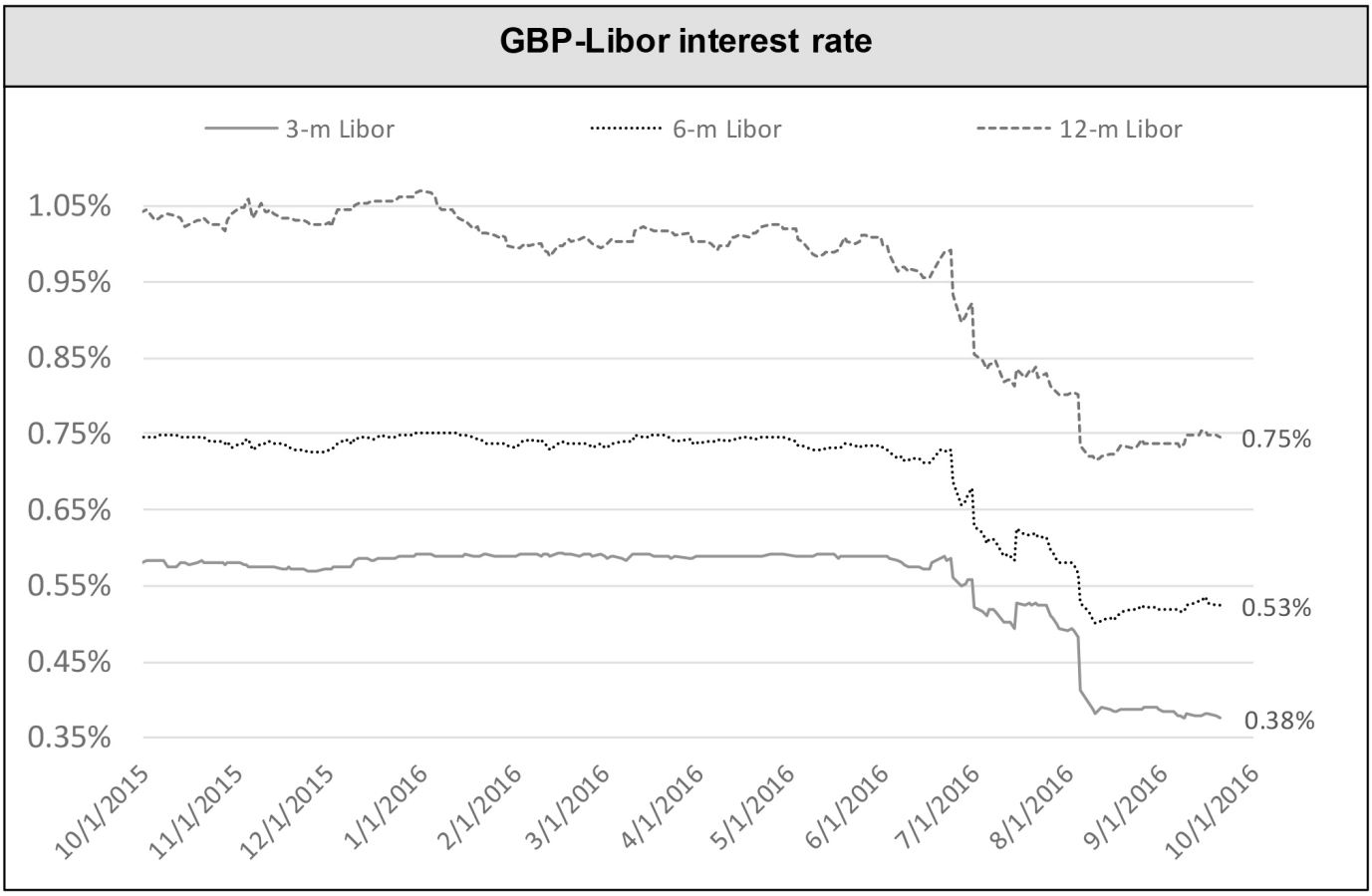
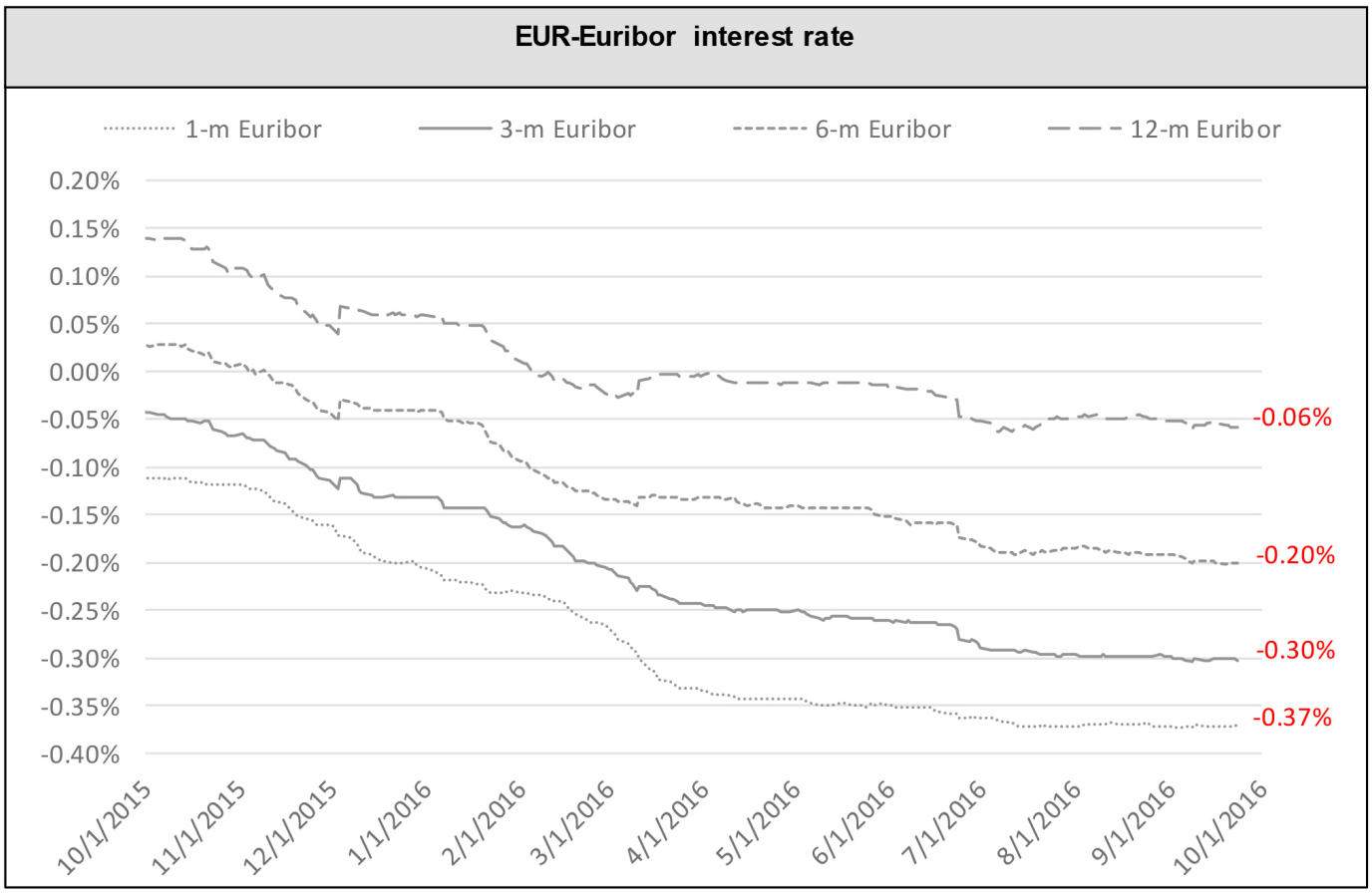
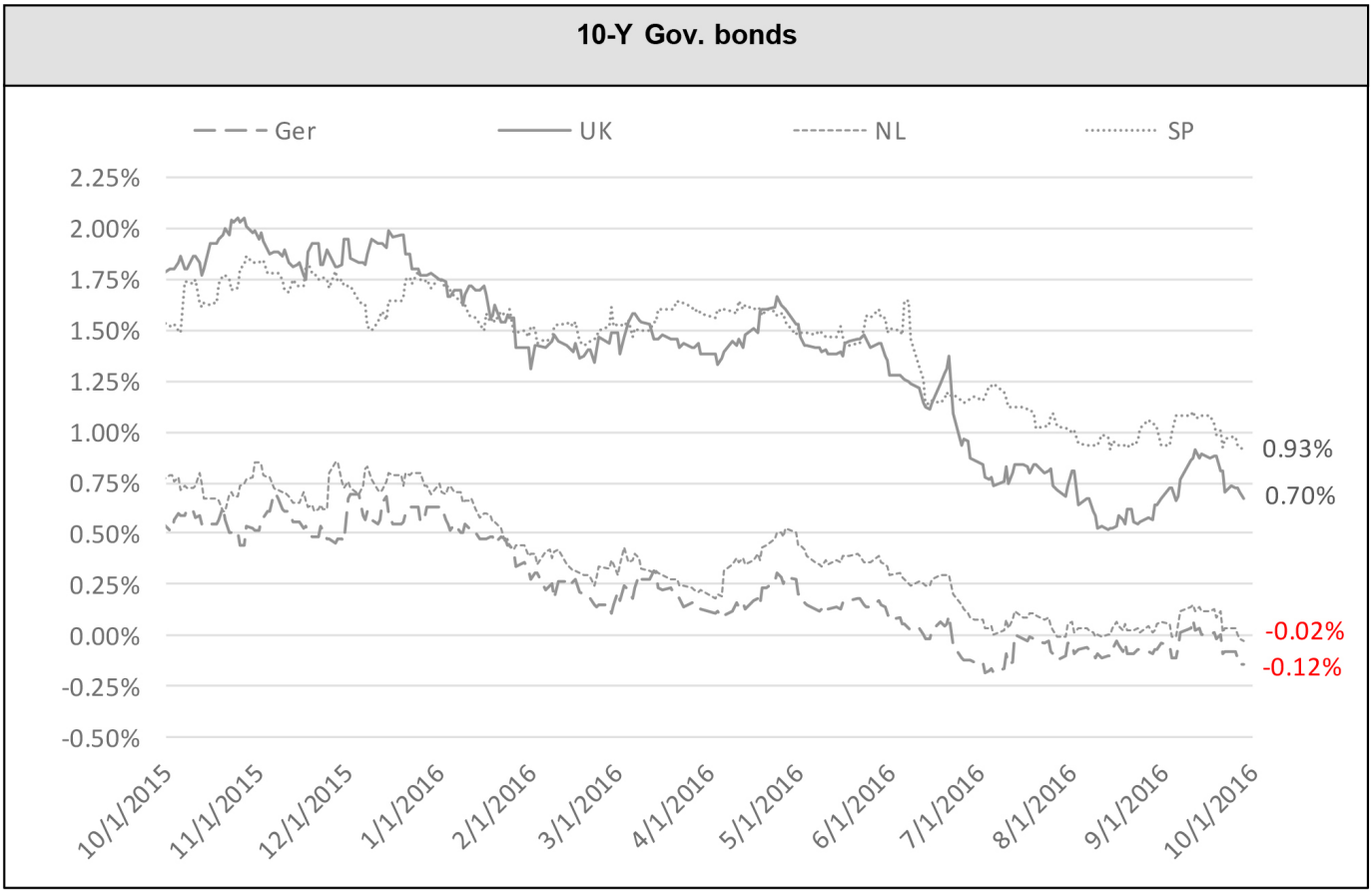
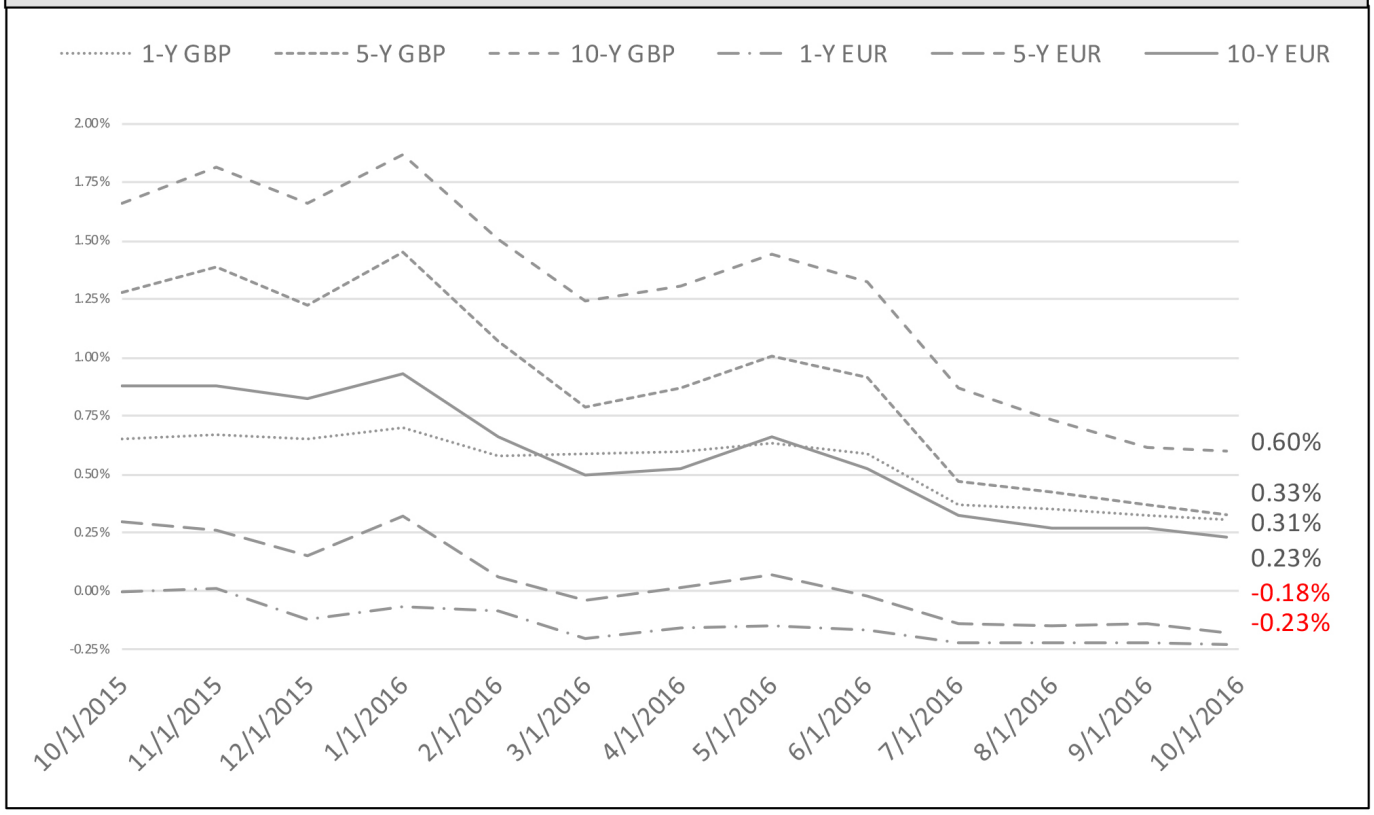
MARKET DATA







SWAP rates past 12 months



Exchange rate	Rate	52-W high	52-W low	1-Y change
EUR/USD	1.12	1.17	1.05	0.2%
GBP/USD	1.30	1.58	1.30	-14.29%
CNY/USD	0.1499	0.164	0.1492	-4.43%
EUR/GBP	0.86	0.86	0.69	16.92%

Index	Symbol	Rate	52-W high	52-W low
FTSE EPRA/NAREIT Eurozone Index	EPEU	2,528	2,604	2,075
FTSE EPRA/NAREIT UK Index	ELUK	1,715	1,982	1,533
STOXX® Europe 600 REITs	S8670R	107	127	94
STOXX® Europe 600 Real Estate	SX86GR	175	189	151
Dow Jones Europe Select REIT Index	DWEURT	1,044	1,277	915
DJ Europe Select Real Estate Securities Index	DWEURS	3,080	3,635	2,734

	Unemployment %		GDP growth QoQ %		Inflation YoY %	
Country	Q1 2016	Q2 2016	Q1 2016	Q2 2016	Q1 2016	Q2 2016
UK	5.0	4.8	0.4	0.6	0.3	0.4
Germany	4.3	4.3	0.7	0.4	0.3	0.1
Spain	20.0	20.0	0.8	0.8	-0.7	-0.9
Netherlands	6.4	6.3	0.6	0.6	0.6	0.0

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