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The Impact of Political Risk on Real Estate Investment: Evidence from the Scottish 'Neverendum'

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The role of major political events and decisions is an under-researched area of real estate economics even though they can have important ramifications. The biggest such event in recent times was the demise of the Soviet Union. In central and eastern Europe there was a wave of new countries created after the collapse of the Soviet Bloc in 1989 including the splitting of Czechoslovakia into the Czech Republic and Slovakia in 1992. The re-introduction of capitalism to these countries created opportunities for foreign investment in what were developing and immature real estate markets with high risk, weak information and legal structures. This era spawned a number of papers on the process and outcomes, that note the lack of real estate investment markets in these countries until at least a decade later (Adair et al, 2006; McGreal et al, 2002).

There has been less attention on the socio-economic issues linked to political events, such as referendums, for mature real estate markets. In fact the referendums of 1980 and 1995 in Quebec where the French speaking province of Canada unsuccessfully sought independence from the rest of the English speaking country did not stimulate any direct research into their real estate influence. The decision of the UK to leave the European Union (EU) in 2016, known as BREXIT, has led to monitoring exercises of its impact by real estate consultants but not within a formal academic framework (Stansfield, 2016; Cushman and Wakefield, 2017). This research is inevitably still in its infancy given the relative short period since the referendum. The purpose of this paper is to consider the role of political risk and economic uncertainty in real estate markets by particular reference to the recent experience of Scotland. Scotland is an interesting case study because it has experienced a series of concertinaed political events in a very short period encompassing two referendums and a general election that have challenged the status quo but left the long term constitutional outcomes unresolved. In the process the potential for fundamental constitutional change ebbed and flowed.

In 2014 Scotland voted to stay in the UK in an independence referendum and less than two years later the UK voted for BREXIT. One vote was for the status quo and one for change. In the referendums there were very simple binary questions but the ramifications are very complex and uncertain. The consequences are partly economic and partly political. The latter is demonstrated by Scotland voting to stay in the EU in the BREXIT referendum giving more impetus to a further independence referendum sometimes referred to as “indyref2”. The continuing prospect of another referendum is referred to here as the ‘neverendum’, a term coined in Quebec for a similar experience (Bryant, 2014).

A specific function of this paper is to develop insights into the roller coaster of real estate investment sentiment as these political events unfolded, and draw lessons on the role and impact of political risk. The issues may have a wide resonance across Europe. In Spain there has been a long term political movement for independence in the region of Catalonia that dramatically came to prominence in 2017. It has been encouraged by the success of the Scottish National Party in pushing for Scottish independence from the UK. The BREXIT vote too has brought calls for an Irish reunification referendum (Joint Committee on the Implementation of the Good Friday Agreement, 2017).

It is important at this juncture to make a clear distinction between a political event that creates economic uncertainty, the focus of this paper, and economic forces that create political risk and uncertainty. An example of the latter is the global financial crisis and the subsequent austerity policies in Europe that brought political instability. This problem was exemplified by the debt crisis of Greece that led to the people rejecting plans for government deficit reduction proposed by the EU in a referendum in July 2015. This referendum decision itself also heightened uncertainty at the time but the origins of the crisis was the weak economy (O'Brien, 2015). This paper is concerned with political events that cause uncertainty rather than in the reverse direction. Its focus on the impact of events is also distinct from the wide literature on the political risk for foreign direct investment in developing countries that is concerned with a nation's stability, corruption, law and order, etc (see Busse and Hefeker, 2007).

There are a range of sources of political uncertainty. Referendums, the focus of this paper, are one and typically a binary decision on a complex issue compared with say a general election where the vote is based on political manifestos. However, as the experience of the UK referendum in 2016 shows they do not necessarily provide clear cut decisions on the way forward. Even general elections can have unclear outcomes if there is an inconclusive result or a new untried politician/party wins such as in the 2016 US presidential vote. Political uncertainty can also arise from long term ruptures in society that come to a head such as the troubles in Northern Ireland that are seemingly intractable to resolve.

The paper begins by examining the role of political risk and uncertainty in the real estate market by reference to some examples, and hence draws out some lessons for the analysis. It then details the recent political events that led to what is referred to above as the Scottish 'neverendum'. The context to the paper is set out by examining the Scottish economy and the role of commercial real

estate. The next section examines the nature of the research problem together with the theoretical expected property market impacts of the neverendum. The paper then looks at published research on the short term consequences of BREXIT to assess its impact on the Scottish real estate sector. The primary research on real estate investment through the neverendum in Scotland draws on a combination of details of individual transactions, qualitative evidence from interviews with investment agents and time series data on yields. The conclusions draw some insights on the differential impact of political risk on property investment.

Political Risk, Uncertainty and Consequences for Research Methods

Political risk embraces potential consequences of government policy and leadership, political instability that may encompass policy conflicts, ethnic and social tensions and even (the prospects of) war. The measurement of political risk itself cannot be seen on a continuous scale, but more in terms of the probability of discrete decisions and consequences. These probabilities can change as political events inevitably occur, in some cases unexpectedly, and policies evolve and are amended. It may also be seen in global terms through a relative comparison of the stability of national governments, regimes and prospects and encompassing currency risk, but the issue also melts into foreign investment risk generally (Fraser, 1993). Political risk creates uncertainty and hence dampens investment. Political risk is also not stationary and so investment sentiment and associated risk premiums vary according to the instability. The consequences for research are now considered through a series of case studies that focus on how the changing political environment influences investment decisions.

The Northern Irish Troubles from the late 1960s are an example not only of investment risk but also of long term uncertainty about their resolution in the future. Violence between catholic and protestant communities began in earnest in 1970 and continued at different levels of intensity for almost a quarter of a century. The beginning of the end of the troubles began with a ceasefire by the Irish Republican Army in 31 August 1994, and was ultimately followed by the Belfast agreement in 10 April 1998 that provided the basis for the present devolved government of the province (approved by a subsequent referendum). Nevertheless political frictions have continued over the next two decades, and although the direction of travel has been clear the road has been bumpy (McKittrick and McVea, 2012). Uncertainty has risen again with the 2016 BREXIT vote as noted above.

The implications of the troubles for commercial real estate by the mid-1990s are described in Adair et al (1995). They report that despite evidence of good returns, including rental growth, from the 1980s by the early 1990s investment by financial institutions was low and they applied a risk premium to real estate investment. The housing market followed a very distinctive pattern compared with the rest of the UK reflecting the political environment. Average house prices once above the national average fell to the lowest of any region in the UK from 1988 to 1995 before recovering their relative position (Nationwide, 2018). In fact over the ten years following the Belfast Agreement to the end of 2007 average house prices rose 31% faster than for the UK (Halifax, 2015). The distinctiveness of real estate market trends demonstrate how they have been strongly influenced by the scale of the changing political risk.

A more specific example of political risk having an impact on real estate markets is given by the private rented residential sector in the UK. At the time of the First World War privately rented accommodation was the predominant form of tenure in the UK. It subsequently went into dramatic long term seemingly terminal decline, driven principally by state rent controls and security of tenure for tenants that were applied off and on for most of the century (although there were other factors). In effectively a two political party system these controls were removed (or reduced) by one government but would be reintroduced in some form with the election of a government of the alternative political complexion. With no perceived consistent supportive policy framework investment in the sector was negligible and by the 1980s the sector represented less than 10% of the housing stock (Crook and Kemp, 2010; Nevitt, 1970).

The final chapter in this rollercoaster began with the 1988 Housing Acts that reintroduced market rents and effectively removed security of tenure for all new private tenancies. But the key event really occurred in 1997 when a Labour government was elected committed to keep these measures, and a stable political consensus on the sector was established for the first time in almost ninety years. It provided an important platform for a rapid expansion in private landlordism over the subsequent decade underpinned by a new more liberal finance regime by banks (itself representing a reappraisal of investment in the sector) and persistent house price rises (Crook and Kemp, 2011).

These examples of political risk impinging on real estate investment sentiment are an introduction to the methodological tasks in this paper, and highlight a number of factors. The political influence is not normally a one off event, so that periods of policy on/policy off cannot be directly deciphered in terms of their impact on real estate market behaviour. The political risk impacts are not explicitly

tangible and can be seen differently by (types of) investors. In fact an investment vacuum can be seen as an opportunity by some investors. Political decisions/events/agendas shape real estate investment in an amorphous way and market outcomes are the result of interaction with other contextual influences, especially the property cycle.

The result is that it is difficult to assess the effect of political risk in terms of some counterfactual benchmark and this in turn means that quantitative assessments in isolation are not sufficient. Econometric modelling is not appropriate. It also means that it is difficult to present definitive hypotheses, for example political uncertainty may dampen investment but the scale of the uncertainty/sentiment is variable as political events unfold. The impact of political change can also be cumulative, as illustrated by the successive application of increased rent regulation followed by deregulation linked to governments of different persuasions through the twentieth century.

The underlying proposition of this paper is therefore that the greater the political change the more the potential and cumulative uncertainty that in turn can drive real estate investment. It also creates investment opportunities. With these prerequisites the paper examines the impact on commercial real estate investment of the political risk associated with the Scottish neverendum. To address this task the paper brings together investment trends, political events and measures of change in investment sentiment. The assessment of investment sentiment is derived from qualitative research based on interviews. Qualitative research is not an established part of real estate research but is essential here to assess investment sentiment. The first step is to consider the policy background.

Scottish Political Context

Ever since Scotland and England became one country with the Act of Union in 1707 there has been a movement for Scottish independence with armed rebellions in the eighteenth century. The Scottish National Party (SNP) was formed in 1934 but it was not until 1967 that it gained its first member of the UK Parliament at a general election. The unique position of Scotland was recognised by the formation of the Scottish Parliament in 1999 after a referendum with many devolved powers from central government (an equivalent Welsh Assembly was also set up with less powers). Nevertheless the debate about Scottish independence continued and the SNP won an outright majority in the Scottish Parliament in 2011 with a mandate for an independence referendum. In October the

following year the UK and Scottish governments signed the Edinburgh Agreement to hold a referendum.

The date for the referendum was announced in March 2013 and the vote was held on 14 September 2014. The SNP had had three years to drive the agenda for what agreed was a once in generation decision. The result of the election appeared decisively against independence with 55% voting 'no'. No sooner was the vote over that the SNP leader declared that no voters had been tricked or misled. Yes supporters quickly decided this was just the start of another campaign for the next referendum.

This campaign gained increased vigour when the SNP won virtually all Scottish parliamentary seats in 2015 UK election, 56 out of 59. It reinforced the public perception of the possibility/probability that there would be another referendum. The outcome of the BREXIT referendum heightened the political case with Scotland voting to stay in the EU. In October the Scottish First Minister announced the intention to hold another referendum, "Indyref2", if there was a 'hard BREXIT'. The Scottish government argued the UK out vote is the trigger for another independence referendum as it represented a significant political and economic change from the position at the time of the previous referendum. It demanded another referendum in late 2018/early 2019 but only the UK government has the constitutional power to permit one.

Table 1 The Political Timeline of the Neverendum

Prior to 2010
SNP wins majority of seats in Scottish Parliament in May 2011
Edinburgh Agreement in October 2012 with UK government to have an independence referendum
2014 and the lead up to Independence Referendum in September
The last quarter of 2014 following Independence referendum result
SNP win 56 Scottish parliamentary seats out of 59 in the UK General Election of May 2015
UK votes for BREXIT in June 2016 but Scotland votes to stay

Scottish First Minister announces in October 2016 intention to hold Indyref2 if hard BREXIT
SNP loses 21 seats in the UK General Election of May 2017
Scottish First Minister announces in October 2017 that any Indyerf2 will be held over until the BREXIT settlement is decided

The Scottish government's case was undermined in the UK General Election of May 2017 when the SNP lost 21 seats. The Scottish First Minister subsequently retreated from her earlier position and she announced in October 2017 that any Indyerf2 will be held over until the BREXIT settlement was decided. This was broadly in accord with the UK government's position.

The political timeline of the Scottish neverendum is summarised in Table 1. The Scottish experience has parallels with independence referendums in the Quebec province of Canada. The underlying issues in each country are very similar. Quebec held an independence referendum in 1980 in which 60% voted 'no'. Although this seemed clear cut ultimately a second referendum was held in 1995 in which the result was a very marginal win with 50.2% voting for the status quo. The Quebec independence movement is still campaigning for a third referendum although the moment appears to have past (Bryant, 2014).

As noted above the campaign for indyref2 was emboldened by the BREXIT vote but the 2017 General Election result substantially dented its arguments and put off the possibility until the BREXIT outcome is known. The timetable for the negotiation on the UK's divorce settlement from the EU and future trade arrangements envisages they are to be formally completed by March 2019. However, transitional arrangements have been set to stretch through to the end of 2020 so the neverendum has some time to run.

Scottish Economy and the Real Estate Sector

Before examining the impact of the 'neverendum' on investment it is essential to understand the Scottish economy and the real estate sector, together with their links to the UK. GDP per capita in Scotland is generally near the average of the regions of the UK while its unemployment rate is below

average. The Scottish and UK's economies are intertwined with the vast majority of Scottish exports going to the rest of the UK (Bell, 2016). This reflects the integration of the UK and Scottish economies, the culmination of three centuries of assimilation.

Edinburgh is the second largest financial centre in the UK, while Glasgow is the second largest retail centre. However, despite the substantial banking/finance sector only one large financial institution, Standard Life Aberdeen, is independently owned and based in Scotland. Similarly retailing is dominated by national chain stores with headquarters in London. Most prime real estate, whether it be in the central business districts of Scottish cities, shopping centres, etc., is owned by London based investors. Virtually all recent large developments in Scotland have been undertaken by property companies based in London and the South East of England. Funding decisions for development are also taken outside Scotland reflecting the Integrated UK real estate investment capital market. In statistical terms the Scottish real estate sector in 2013 accounted for just over 7% (£46bn) of value of commercial property in the UK, just below its share of GDP, and 6% of the investment stock (£22bn). To set this in context, over half of the UK investment stock is located in London and the South East of England (Jones and Trevillion, 2015; Mitchell, 2014).

Political Risk, Investment and Measuring the Impact of the 'Neverendum'

The neverendum is by definition not one simple event and is more a continuum of political votes with resultant impacts on real estate investment sentiment and expectations evolving over time. At the point of writing in 2018 it is certainly not a completed episode, and as argued earlier has some years still to go. Its beginning can be placed for practical purposes as the SNP victory in the Scottish Parliament in 2011 but since then there has been a political rollercoaster with concomitant potential varying implications for market/investment sentiment. Ten distinct periods can be distinguished as set out in Table 1 defined by reference to these political events in which sentiment could be risibly different.

The short term impact of a yes vote in the 2014 referendum would have brought investment uncertainty as the details of what it actually meant were negotiated. The same is now true of the BREXIT result for the UK. But it is also an integral element of the neverendum, although the difference is that the time period of uncertainty is even longer: beginning in 2014 it could stretch into the 2020s. Indeed, the message from the Quebec referendum experience noted above reinforces the expectation of another referendum that could be years in the future. Furthermore,

the long term economic decline of Montreal in Quebec has been noted as a prospective scenario for Scotland. Montreal has underperformed other cities since the first independence referendum in 1980. There has been no study of the precise real estate effects but it has lost symbolically the headquarters of major banks to Toronto and experienced low population growth relative to the rest of the country. The reasons primarily encompass the language barriers in attracting skilled workers and weak governance but the sovereignty issue has played its part. (Hadekel, 2014, 2015; Di Matteo, 2016).

The political risk of the neverendum is the consequences of independence. Many UK property investment funds have mandates that require assets to be located in the UK (see later). Commercial property investors must inevitably take account of the insecurity created by the independence risk. This risk to UK investors would include uncertainty about the political direction of a new country and the future of the Scottish economy. It would imply adding an additional risk premium by UK investors to required returns, in the form of higher required yields which will deflate property values. However, this risk could be interpreted differently by overseas funds with different investment mandates. It may even be seen as an opportunity for these investors.

The conclusion from this discussion can be summarised in the propositions that the political risk created by the Scottish neverendum has increased uncertainty reducing investment by UK real estate investors, and increasing property yields/ lowering capital values. There may also be a cumulative dimension of these negativities as the process becomes drawn out. Lower values also reduces the viability of development. In other words it has the same commercial real estate investment impact as independence, certainly in the short to medium term. But this analysis only takes us so far as it does not account for how the unfolding political events of the neverendum in Table 1 shaped investment over time.

To address this issue the paper brings together investment trends, political events and measures of change in investment sentiment. The variation in this sentiment is derived from qualitative research based on interviews with the investment partners of property consultants. It seeks to both explain the investment time series since 2010 and assess how relative investment sentiment changed through the events so far of the neverendum. Given the potential different perspectives the analysis distinguishes overseas and UK investors in terms of purchases and sentiment.

There are also the potential complexities on real estate investment outcomes caused solely by BREXIT. The next section therefore considers to what extent BREXIT affected real estate investment within the UK and Scotland up to the end of 2016, the period of the study.

BREXIT and Real Estate Investment within the UK

The BREXIT vote occurred on June 23, 2016, and arguably the result was unexpected although the opinion polls were on a knife edge. In the lead up to the referendum Land Securities, the largest REIT in the UK, sold £1.1bn of its assets in the six months up to the end of March. Its decision was based on "wider economic and political uncertainty increasing" even before the vote (Kollewe, 2016). The subsequent impact was closely monitored by the property industry. In the immediate aftermath investment into UK commercial property fell to a four-year low in the third quarter of 2016 (Stansfield, 2016). Cushman and Wakefield (2017) report that although nearly £18bn was invested in the second half of the year it was 27% lower than the £24bn in the previous six months.

The picture just in London was much more dramatic with property investment in the central area 55% down on the same period in 2015. Reflecting this collapse in investment there was an 8% fall in central office capital values over the final nine months of 2016 according to Real Capital Analytics. But while British investors were very cautious about investing the depreciation in sterling of 12% following BREXIT meant properties in the UK were cheaper for overseas investors. Figures vary but between 60% and 70% of central London property investment was undertaken by overseas investors over this period. Most of these investors were from the Middle East and Asia, together with the USA (Leahy, 2016; Cushman and Wakefield, 2017).

Investment in offices in London had been impacted by expectations of a decline in financial and business service employment as banks move staff to other cities in Europe. The prospects for provincial cities was seen as more secure. So while transactions volumes fell substantially domestic players were the dominant buying force in provincial cities, accounting for nearly 60% of purchases in the remainder of 2016 (Cushman and Wakefield, 2017). Overall the short term impact of BREXIT was on investment with transactions falling and yields rising/values falling. The negative impacts were focused on London rather than the rest of the UK including Scotland. However, BREXIT highlights differential real estate investment responses by international and domestic actors that is also likely to be true in the context of the Scottish neverendum.

Impact on Scottish Real Estate Investment of the Neverendum

From the discussion above the following hypotheses are outlined:

- Political risk created by the Scottish neverendum increased uncertainty and had a negative effect on sentiment, with reduced real estate investment by UK investors and increasing property yields/ lowering capital values. Increasing property yields in turn led to lower development activity.
- The degree of uncertainty/risk varied with political events through the neverendum, rising in the lead up to the referendum and then recovering quickly in the last quarter of 2014 with the remain vote. Uncertainty then rises again as a potential second referendum becomes more likely so that there is a cumulative negative impact on real estate investment sentiment.
- Political risk was interpreted differently by overseas from domestic funds because they had different investment mandates. It may even be seen as an opportunity for these investors (as seen in BREXIT).

These hypotheses are tested in three research steps.

The analysis brings together investment trends, political events and measures of change in investment sentiment and development activity. First, there is a scrutiny of investment time series patterns drawn from raw data on yields from CBRE and individual transactions data (that have been differentiated by UK and overseas investors) provided by Property Data from 2000. Second, development activity is assessed by a combination of local government statistics and reports by real estate agents. Third, the variation in investment sentiment is derived from qualitative research based on interviews with the investment partners of property consultants.

It addresses the first two hypotheses by reference to real estate investment and development time series since 2010, and assesses how relative investment sentiment changed through the events so far of the neverendum. Given the potential different perspectives set out in the third hypothesis the analysis distinguishes overseas and UK investors in terms of purchases and sentiment. Prior to this analysis recent trends in the Scottish economy and occupation demand are briefly summarised based on secondary sources as context and a platform for the research.

Context

The UK and Scotland experienced similar levels of economic growth over the years, 2013 and 2014. However, since the independence referendum the UK national economy has grown faster than in Scotland. In fact UK growth was 1.8% in 2016 compared to 0.4% in Scotland. Indeed Scottish output fell by 0.2% in the final quarter of 2016 (Scottish Government, 2017a). A major reason was not a response to the referendum but the collapse in the price of crude oil in the final half of 2014, with no subsequent recovery over the following two years.

The decline in oil prices contributed in particular to negative growth in the production sector of Scotland every quarter from the second quarter of 2015 through to the end of 2016. On the other hand services growth was positive in nearly every quarter since 2013 (Scottish Government, 2017b). This suggests that the negative elements of the economic performance were focused in Aberdeen, the centre of the oil industry, and only had a modest impact on commercial real estate sector in the main cities of Edinburgh and Glasgow.

The market evidence on occupation demand for offices reflects these statistics. The take up of Glasgow offices rose through 2013 and 2015. In fact it rose by 17% in the year to March 2015 (Ryden, 2015a). It declined in the year to March 2016 before broadly plateauing in the subsequent year, when take up in this year was greater than in 2012-13 (Ryden, 2017). Take up in Edinburgh also rose in the lead up the referendum and beyond. The year to March 2015 actually experienced the highest take up since 2000, although it has fallen away since (Ryden, 2015a, 2016a, 2017).

Ryden also report broadly static prime office headline rents over 2015-2017 in the two cities with a slight upward pressure bringing slightly reduced rent free incentives to prospective tenants (Ryden, 2015, 2016, 2017). The monitoring reports of property agent, CBRE (2017a, 2017b) paint a more positive picture. Prime office rents in both cities in the third quarter of 2016 are recorded at their highest levels with sharp rises since 2012/13. While Edinburgh and Glasgow have their individual cycles these statistics reaffirm the continuing growth in services and demonstrate the resilience of occupation demand to the neverendum. In other words the underlying market basics in the two main cities, the primary focus of real estate investment by financial institutions remained sound over this period giving no reason for a substantial change in investment sentiment from this source.

Findings

In this section the results of the three research steps are presented.

Investment

The impact of the neverendum on yields is given in Table 2 that charts the yields of prime offices in the two main Scottish cities, relative to the two largest English provincial cities, from 2000 on a quarterly basis. With the exception of one year, over 2009/10, it can be seen that yields in the Scottish cities were lower on average than Birmingham and Manchester from 2000 until May 2012. There is then a sea change in this relationship with yields on average higher in these Scottish cities through to 2017. Just before the referendum the differential rises to 50bps before halving in the next quarter after the no vote. It rises again to this level when the SNP win a landslide result in the UK General Election. In the subsequent period of the neverendum the differential only falls once below 25bps just after the BREXIT vote. While there are quarterly variations the cumulative effect of the neverendum is to increase this differential over time. Given the strength of the rental markets it appears that investors have been applying a risk premium of at least 25 bps to Scottish real estate over this period.

The implications of the neverendum for investment transactions are shown in Figures 1 to 4. The analysis presented here is based on transactions expenditure data so is subject to a caveat that it is not the same as the number of transactions. Figure 1 demonstrates the cyclical nature of transactions with the frenzy of activity in the boom of the last decade followed by a dramatic fall off following the global financial crisis. After five years of low purchases investment picks up in 2013 and 2014 but sinks away again after the referendum. In fact the purchases by UK financial institutions and publicly quoted property companies (REITs) alone plunge severely over 2015 and 2016. Purchases by these investors in 2016 are just above those of 2008 in the immediate aftermath of the global financial crisis.

The quarterly figures for UK institutional investors, presented in Figure 2, show that as the 2014 referendum approaches there is a decline in investment purchase activity only for a surge in the final quarter with the NO vote (although there are more transactions in quarter 4 generally). As it became clear there was likely to be eventually another referendum, bolstered by the favourable result for the SNP in the June 2015 UK general election, investment by financial institutions collapses in the second quarter. The result of the BREXIT vote in the following June when Scotland voted to remain in the European Union has an even more negative reaction on investment. There is virtually no UK institutional purchases in the following quarter, probably an all-time low in recent history. This final withdrawal may also be part of the national phenomenon noted above.

This picture is reinforced when we consider UK institutional investment (including REITs) in Scotland relative to the UK as a whole. The percentage of investment expenditure in Scotland of the total by these UK financial institutions falls to just 2.9% and then 2.1% in 2015 and 2016 respectively. In comparison the figure was 6.8% in the preceding two years. In fact 2015 and 2016 represent the two lowest percentages since 2000 when such records began. The average percentage prior to 2015 was 5.3% and on an upward incline.

While UK institutional investment was in retreat overseas investment as Figure 3 shows was at record highs. There is a massive gearshift in overseas investment in Scotland from 2014 on. The value of sterling against other currencies also fell from the autumn of 2015 putting overseas investors in a stronger purchasing position. The consequence is that UK institutional investors that had traditionally accounted for more than half of all purchase expenditure saw their share of sales nosedive. As Figure 4 demonstrates their percentage share falls significantly, and oscillates around 20% from the second quarter of 2015, and then to less than 10% in the latter half of 2016. Over the same period overseas investment has risen from 25% to almost 60%. While quarterly real estate data can be lumpy and therefore have some limitations the pattern seems robust.

In summary the neverendum therefore wreaked dramatic change in the pattern of transaction activity in Scotland with the decline in UK institutional investment and the growing importance of purchases from overseas investors. Within this overall trend there are clear stepped links in market activity to political events within the neverendum. As part of this process investment yields of Scottish real estate increased relative to England and the next section examines the consequences for development.

Development Activity

Government statistics on construction orders in Scotland reveal a plateau of activity in the lead up to the referendum and then a substantial jump in the fourth quarter of 2014. Orders then follow a downward trend, except for a sharp jolt in Q3 of 2016 just after the BREXIT vote. However, these statistics are not really fit for our purpose as commercial construction orders include offices, shops, entertainment, health, universities, garages and agriculture and so is more extensive than commercial property development. Some of this output is bespoke linked to occupation demand or not directly influenced by the economy, such as new university buildings. Unfortunately commercial property developments of offices and shops in any one year can be less than half the

total of such orders. To assess development activity in more depth the paper examines city centre office development in Edinburgh and Glasgow.

In Glasgow the city council reports only one city centre office development that had been completed in our study period and that was a bespoke building that received planning permission in 2013. There is just one other building under construction in 2017. There are other city centre office developments on hold, that had not been started by 2017, but had received planning permission – one in 2014, two in 2015 and two in 2016 (Glasgow City Council, 2017). The data published for Edinburgh is not directly comparable but Edinburgh City Council (2018) reports that the amount of office space with planning permission fell every year from 2012, so that by 2017 it was half that of 2012. There were no office completions in 2014 and 2015, and the number rose to three in 2017. Overall new office floorspace coming on to the market fell in both cities from 2014 on according to CBRE (2017a, 2017b). Development tapered off almost certainly as a result of the rising yields/falling capital values noted above, but almost certainly also because of the uncertainty engendered by the neverendum. To fully understand the underlying market motivations the paper now considers the changing underlying investment (and development) sentiment to the political events by reference to semi-structured interviews with investment agents.

Investment Sentiment through the Neverendum

The analysis is based on evidence gleaned from semi-structured interviews with the investment partners of five of the six principal commercial real estate agents in Scotland based on the level of business. All six were approached but no response was received from one. These agents represented clients covering approximately 72% of both investment purchase and sales expenditure in Scotland over the three years 2014 to 2016 according to CoStar data. The five interviewees presented very much a consensus on investment sentiment (so no tables are presented) through the neverendum. The main findings on the overall impact are as follows:

- As British institutional investors are risk averse they like stability, and held back on investment because of worries about the Scottish economy and independence. They were also concerned about their (UK) mandates in the case of independence. There was a fear that a rush or panic by funds to sell at the same time could flood the market. They are still aware of the bust after the GFC when some investors had to sell their best (most saleable prime) properties. This perception was exacerbated by the relative small volume of

transactions in Scotland that in turn creates specific risk for investments. This issue is illustrated by the fact that the Manchester market is twice the size of Scotland.

- The neverendum was the first time in a generation that life funds have applied a different risk premium in Scotland compared with provincial cities. One investment partner in particular noted.

  "…first time in living memory that investors have distinguished between Edinburgh/Glasgow and Birmingham/Manchester"

- Foreign investors were less concerned with the constitutional/independence issues. European funds have different mandates, and seek out investment opportunities in countries with stable political/economic systems. Foreign investors were therefore generally unconcerned about potential independence, and were looking for investments that tick the following boxes - good country, good tenant, and a large asset right in a city centre. Edinburgh and Glasgow are competing with cities across the continent including eastern Europe. In these circumstances yields for Edinburgh and Glasgow since 2014 look attractive as good value for money. One investment partner noted,

  "Yields well above 25bps over Manchester are very attractive for foreign investors".

- Overseas capital does not typically fund development in provincial cities as investors seek out standard large completed projects.

- There has been a famine of development finance with all components of development activity not financeable even if "it makes sense", and certainly not without a pre-let. While no speculative development over the neverendum occurred rents were rising/ incentives falling and conditions are ripe but funders lack confidence. One investment partner noted,

  "At the eleventh hour a funder pulled out on the basis of a potential second referendum".

  Banks have not provided development finance with 96% funds going to standing investments. Speculative development has recently started in Edinburgh but on a very small scale.

In terms of the movement through the political events that comprise the neverendum the investment partners were asked to rate investment sentiment on a digit scale from -10 to +10 through the time line given in Table 1. A zero score was allocated to the period before 2010 as a benchmark to compare sentiment with what was applicable before the possibility of independence seriously arose. Four out of five of respondents completed the task and the results are presented in Figure 5.

All agree that negative sentiment was prevalent from the Edinburgh Agreement in 2012 although 3 feel it began in 2011. This negative sentiment increased with the build up to the referendum representing a 5% negative fall in sentiment from 2010 with one respondent placing it as high as -7%. One investment partner noted,
"There were investment contracts were waiting to close dependent on a NO vote."

There is disagreement about sentiment in the immediate aftermath of the NO vote but a consensus that the favourable SNP showing in the 2015 General Election result (point 6 in Figure 5) brought increased negativity to the order of -7% (-10% for two respondents). One investment partner saw,
"*The referendum impact tougher than the bust after the global financial crisis as buyers vanished but underlying value was not changing."*

The negative sentiment increased marginally for three of the four respondents with the BREXIT vote (one substantially) in June 2016. The peak of negative sentiment comes when the First Minister announced the intention to seek a potential Indyref2 in October 2016 (point 8 in Figure 5). The tide changed with the 2017 General Election result that brought a substantial reduction in negative investment sentiment and this continued to decline as the First Minister announced a delay in Indyref2 until the BREXIT settlement is decided. The General Election result was seen as a watershed as it demonstrated that Scottish nationalist views were waning. However all four respondents agree that investment sentiment by UK fund managers towards Scotland in 2017 is less positive than in 2010 before the neverendum began.

Overseas investment sentiment takes a very different course. One investment partner saw overseas investment positive throughout the whole period, particularly from 2014. The other three partners see marginal negative sentiment (around -3%) from the BREXIT vote on, but the negativity subsequently drains away and on balance is positive by October 2017 compared with 2010.

This evidence from investment partners confirms that perceptions of political risk were driving investment decisions and can explain the patterns of market activity over the neverendum recorded in the previous section. The mandates of UK funds in particular coloured their negative views on potential Scottish independence and led to a lack of purchases and yields rising relative to English provincial cities. Development too has been starved of funding by banks. Even though the market believes the prospects for independence have receded the cumulative impact of the neverendum

has been negative, and investment sentiment by UK investors is still lower than in 2010. These findings confirm hypotheses 1 and 2.

On the other hand overseas investors were attracted by the relatively high yields that made property cheaper than in the rest of the UK. The difference in behaviour and attitude between overseas and UK investors was down to different perceptions of political risk and different investment mandates. Overseas investors saw investment in Scotland in pan-European terms and in this context the political risk of independence is very low. This differential investment activity between domestic and overseas investors affirms hypothesis 3.

Conclusions

While political risk is ubiquitous and an inherent element in all real estate decisions it is generally of minimal significance. However, it can be a highly significant influence on the market. Yet its impact is difficult to assess because political risk is often not the result of one single political decision. Referendums are a good example: they involve simple questions but generate uncertainty not only in the lead up to the event but also often through complex political consequences whatever the decision. There is generally not a simple point in time when market participants switch from one behaviour to another because of political risk. More often than not market outcomes depend on the interaction between political decisions and wider contextual influences. It is therefore problematic to judge the effect of political risk in terms of some differential from a norm or benchmark.

This view is reinforced by the analysis of the impact of the Scottish neverendum on commercial real estate. It was originally billed as a once in a generation event but a series of political events has conspired to create a 'neverendum' in which another is anticipated but no one is sure when. From this Scottish experience the analysis was consistent with the following hypotheses:

- Political risk created by the neverendum increased uncertainty and had a negative effect on sentiment, with reduced real estate investment by UK investors and increasing property yields/ lowering capital values. Increasing property yields in turn led to lower development activity.
- The degree of uncertainty/risk varied with political events through the neverendum, rising in the lead up to the referendum and then recovering quickly in the last quarter of 2014 with the remain vote. Uncertainty then rises again as a potential second referendum becomes

more likely so that there is a cumulative negative impact on real estate investment sentiment.
- Political risk was interpreted differently by overseas from domestic funds because they had different investment mandates.

The investment activities of overseas funds were supported by a decline in the value of sterling.

The lessons from this study is that even when the underlying basics of the property market are sound political risk can have a profound effect on investment sentiment. In this study the political risk has ebbed and flowed with the changing probability of constitutional change but ultimately has been a dampener on investment in Scotland. An element of the political risk can be deemed to be specific risk linked to UK institutional fund mandates that stems from concerns about possible forced sales with independence. In addition political risk is in the eye of the beholder with overseas investors in Scotland unfazed by the prospects of independence.

A more generic perspective of these results is that political risk, linked to political swings and roundabouts, can generate prolonged uncertainty and can create a cumulative negative effect on investment sentiment. The market consequences are in the form of yields rising (linked to a political risk premium) and transactions falling relative to historic norms even if occupation demand and rental growth are positive. The fall in property values associated with higher yields has important consequences in terms of a dearth of development and a wider legacy of a potential real estate constraint of economic growth. This study has been the first of its kind and further research is needed drawing on the views of investors and the experiences of political risk in other countries.

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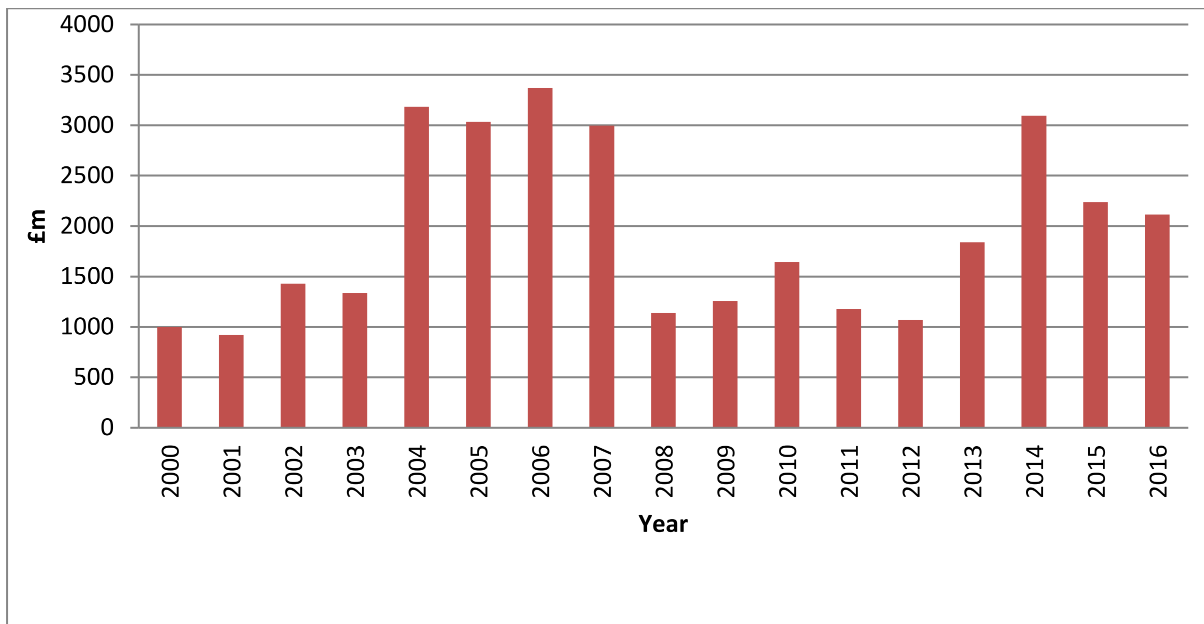
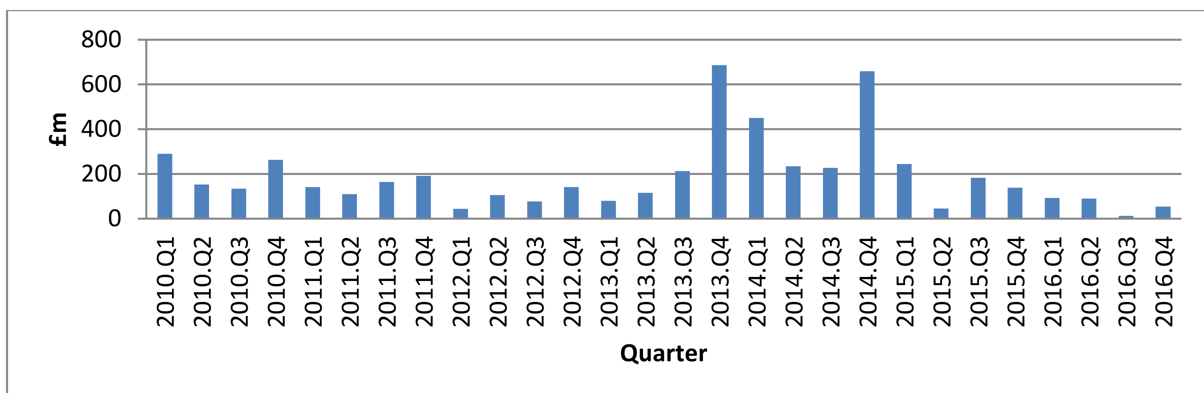
Figure 1 Annual Property Market Transactions Volume in Scotland 2000-2016



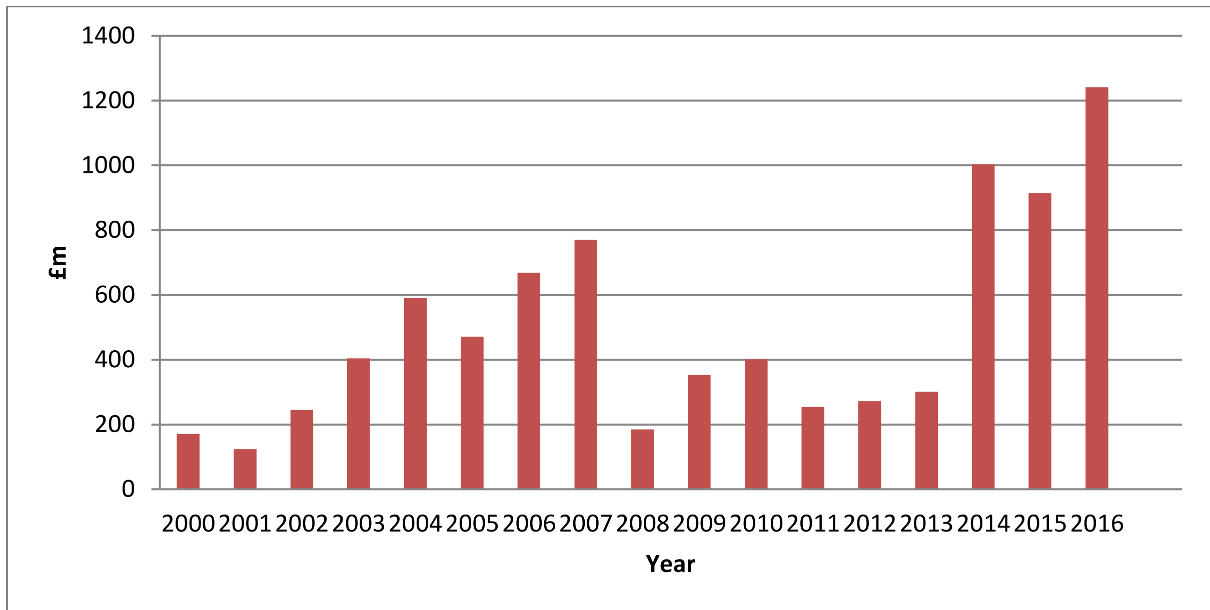
Source: Individual Transactions from Property Data

Figure 2 Quarterly Property Market Purchases by UK Financial Institutions and Public Property Companies in Scotland 2010-2016



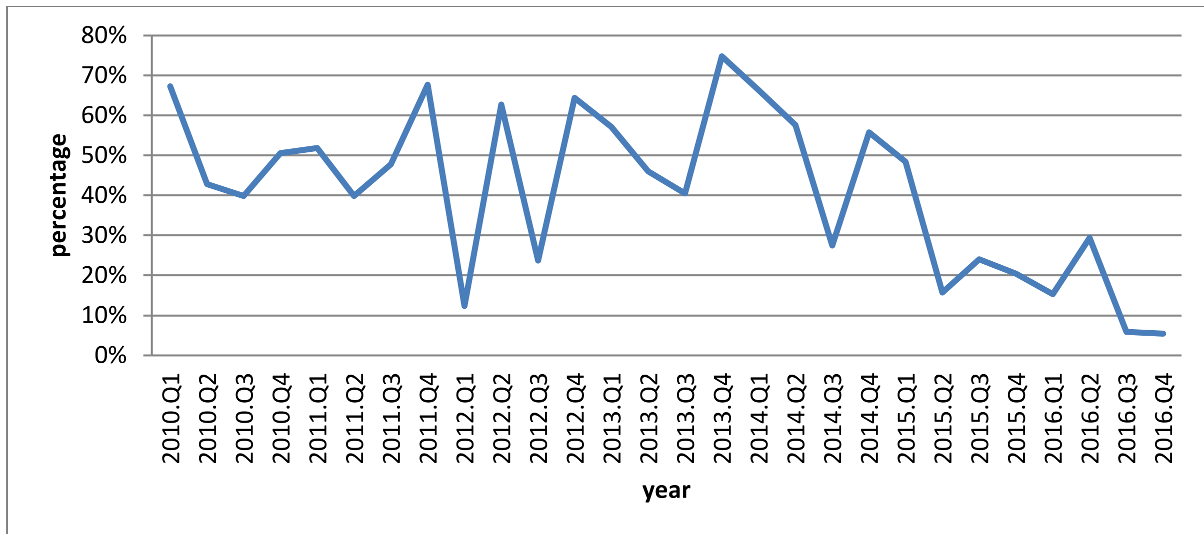
Source: Individual Transactions from Property Data

Figure 3 Annual Property Market Purchases by Overseas Investors in Scotland 2000-2016



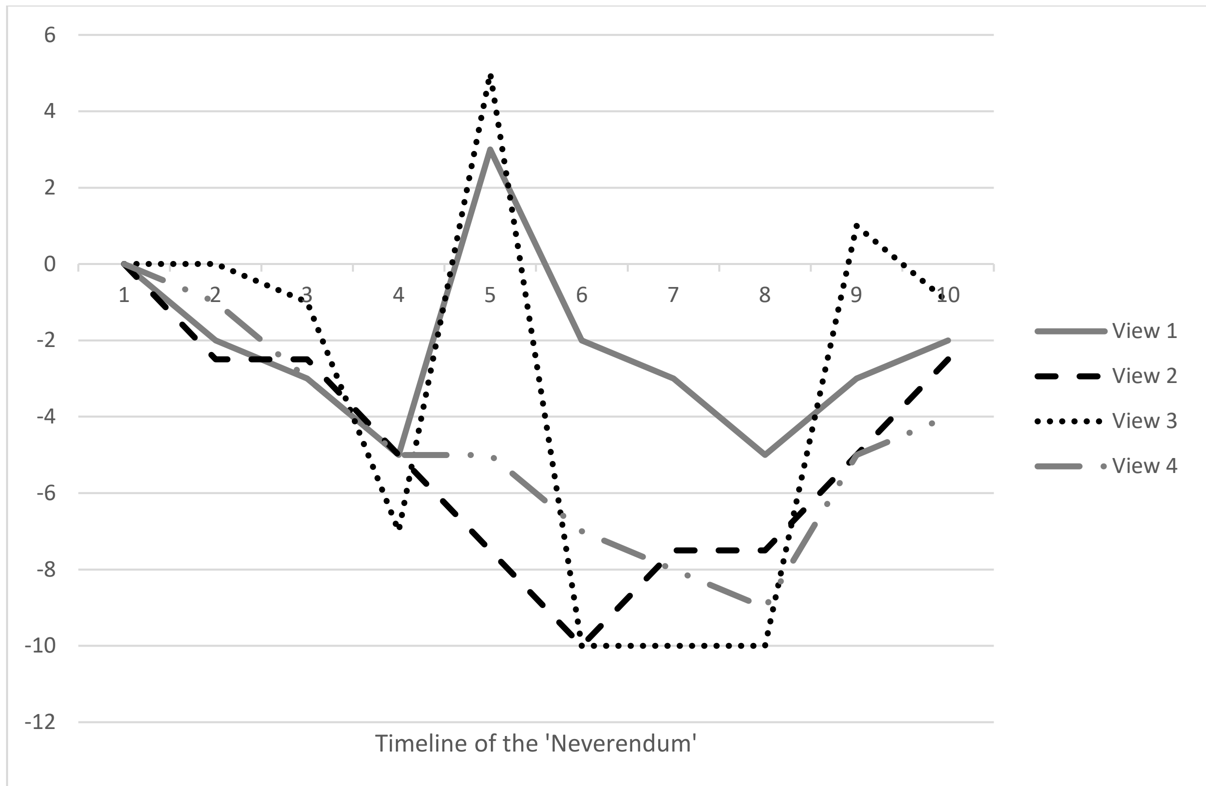
Source: Individual Transactions from Property Data

Figure 4 The Quarterly Percentage of Total Purchases bought by UK Financial Institutions and Public Property Companies in Scotland 2010-2016



Source: Individual Transactions from Property Data

Figure 5 Views of Investment Partners on the Changing Real Estate Investment Sentiment through the Neverendum Timeline



Points 1 to 10 are the time periods in Table 1 with 5 the immediate quarter after the independence referendum