Investment Property Forum

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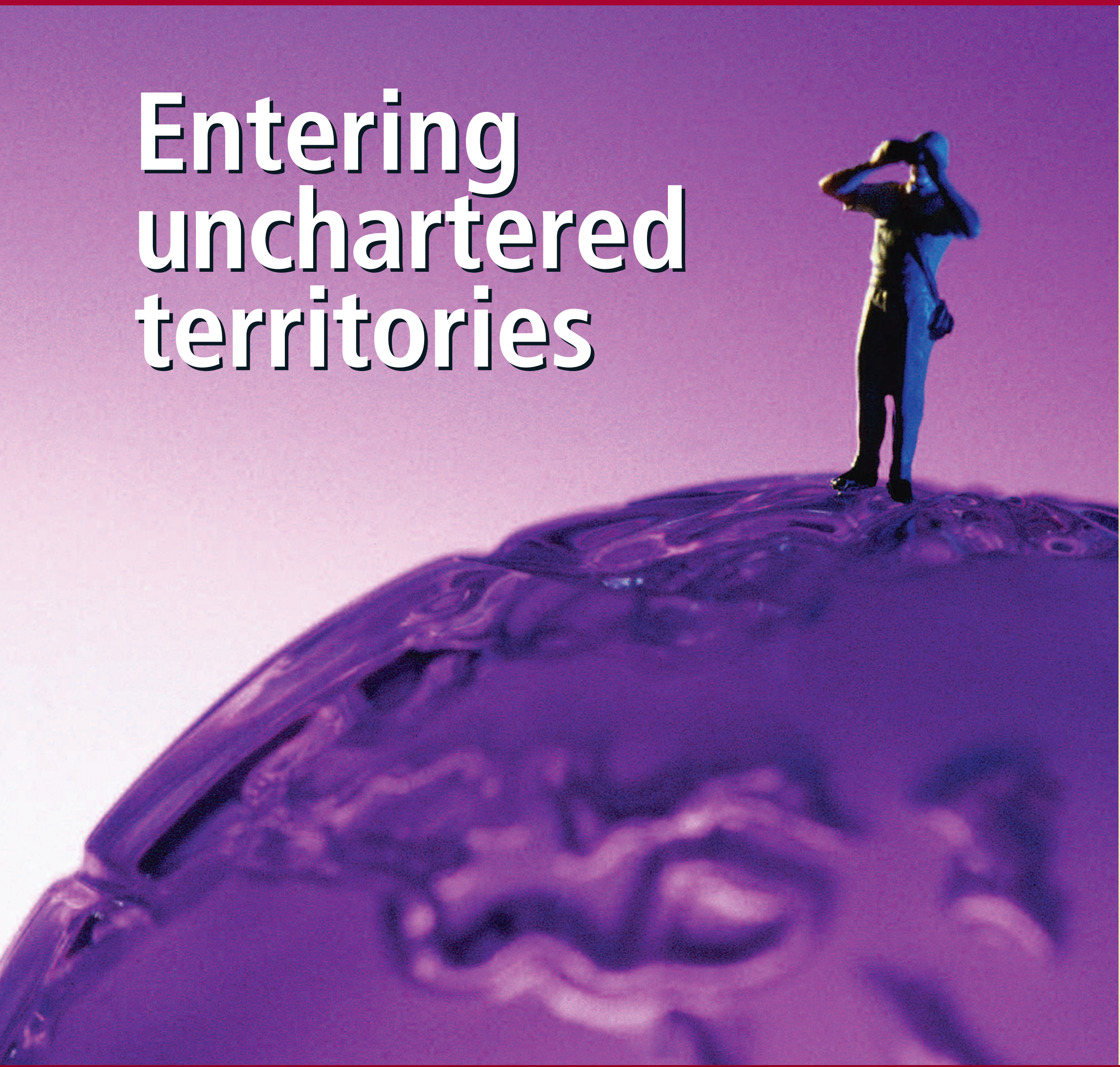
INVESTMENT PROPERTY FOCUS



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IPF Investment Property Forum

Annual Dinner 2007

Wednesday 27 June 2007

Ticket Price £125.00 (inc VAT)
per person (excluding wine and liqueurs)

The Grosvenor House Park Lane London W1 18:30 Pre-dinner drinks | 19:30 Dinner | Black Tie

Guest speaker: **Comedian Jimmy Carr**

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Please note that wine orders, hosted bars and special dietary requirements must be arranged directly with The Grosvenor House, contact details will be supplied on confirmation of your booking together with tickets and place cards.

For more information or to book, contact Ingrid Styles on 020 7194 7920 or email Ingrid on istyles@ipf.org.uk

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From the editor

This edition of Investment Property Focus looks at the prospects for the principal UK property sectors over the next 12-24 months compared with those for other property alternatives – be these in other geographical jurisdictions, property sectors or indirect rather than direct investment vehicles.

Robert Houston of ING Real Estate Investment Management looks at whether the 'Great Property Show' is coming to an end after four years of terrific performance. He argues that while the property is now more fairly priced compared with other asset classes, ING think UK total returns in 2007 are still likely to be in double digits (just!) with an average of 9.2% pa for 2007-09. Based on this, he argues that investors with an appetite for other European property markets should fund this from a higher overall asset allocation to property, rather than switching out of the UK.

Alex Walker of DTZ outlines his firm's recent analysis of the size and structure of the potential property investment universes in the Americas, Asia and Europe. This research suggests that the growth and performance prospects within developing property markets are considerable and the immediate challenges for investors are to identify the most appropriate entry routes and the key markets of opportunity.

The risks associated of investing in property outside the UK are considered in detail by Ben Sanderson of PRUPIM. His article draws on the content from the IPF's International Real Estate Investment module and looks at the issues of market transparency and liquidity, the costs of diversification, management and implementation, together with tax and currency fluctuations. James Stretton of JC Rathbone picks up on the risks associated with currency fluctuations and discusses the benefits of hedging compared with the cost, either in terms of the option premium or the impact on the debt facility.

Staying at home still offers opportunities to diversify outside the traditional property sectors. Rory Hardick of M3 Capital Partners considers the prospects for student housing, senior housing and residential buy-to-let, Peter Hobbs and Lonneke Löwik of RREEF look at infrastructure investing and Colin Lizieri examines the development of property derivatives market.

Underlying all of this is the question as to whether property has a significant role in the future multi-asset portfolio and, if so, how many properties does an investor need to track the market. Paul Mitchell discusses the first part of this question, drawing on the research carried out by him in conjunction with the University of Cambridge and Cass Business School. The forward-looking scenarios imply property allocations in the multi-asset portfolio in excess of current levels, although some investors talk about investing in infrastructure, using part of the property allocation. The number of properties required in any portfolio is addressed in a new IPF research project undertaken by Mark Callender, Steven Devaney and Angela Sheahan. The research concludes that the appropriate number depends on the risk tolerance of the fund's investors and that diversification is generally easier to achieve at the property segment than the all property level.

From the general to the specific – this edition of Investment Property Focus also looks at the possible benefits to the UK of hosting the 2012 Olympics and Alex Catalano talks to Stephen Hester of British Land about the company's change to REIT status and plans for the future.

Contributions to Investment Property Focus are always welcome, so please contact us with any ideas or contributions for future editions.

Sue Forster, Freeman Business Information

Addendum: We apologise to Philip Booth of the City University for a small but important error in his article entitled 'LDI - is it all it's cracked up to be?' in the November 2006 edition of Investment Property Focus. On page 5, he would like to clarify that his piece should have stated that, in his opinion, The Equitable had broadly followed an LDI strategy during most of its 230 years in existence and that this had assisted its survival until the events of the late 1990s.

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The Outlook for Property

Robert Houston, Chairman & CEO, ING Real Estate Investment Management UK

Robert Houston asks if the show is coming to an end or whether its run has been extended?

Mr Bear might be forgiven for thinking that the Great Property Show is coming to an end. After all, the sector has had four years of terrific performance and everything has to come to an end sometime doesn't it? Well, that is one point of view.

At ING Real Estate Investment Management however, we are more in Mr Bull's camp. We think that 2007 will prove to be another excellent year for property... not at the same dizzy levels as the past few years, but nevertheless still at very satisfactory double digits returns.

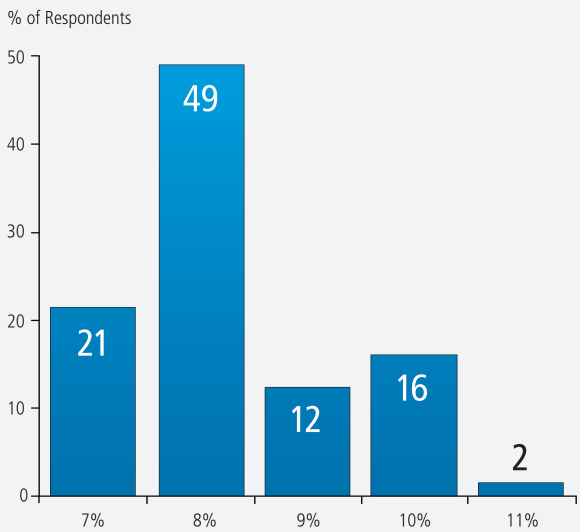
We would agree that the structural re-rate of the sector is just about over and property is now much more fairly valued relative to the other asset classes. However, the torrent of money from around the globe, still looking for a home, will ensure that current capital values should be sustained.

Our forecast for UK property total returns in 2007 is 10.6%. This appears to be rather more bullish than most other houses, but we believe that strong rental growth, especially in the Central London office market, will comfortably generate overall returns at this level. And if we are right then investors should be absolutely over the moon. But why?

As Figure 1 shows, 70% (21% + 49%) of investors (as measured in the ING REIM Annual Institutional Investors Survey) are only seeking 8% pa returns, or even less.

So, 10.6% total return for 2007 and an average of 9.2% pa for 2007 to 2009 would be a very satisfactory result for just about everyone.

Figure 1: Investors' required hurdle rates



Source: ING REIM Annual Survey, November 2006

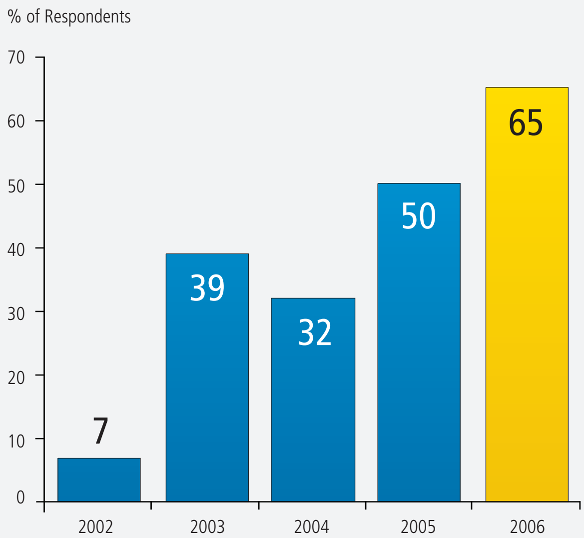
But let's be clear. Such baseline returns are not sustainable forever, and it is hardly surprising that we are starting to see investors gather into three broad camps:

As we have seen, the UK property market trackers will do just fine for the next few years. It may get a bit stickier for them in 2009 to 2011 but we are not expecting the roof to cave in. Overall, the outlook is pretty good; but of course 'pretty good' isn't good enough for alpha-chasers.

Alpha-chasers are now focusing on three lines of attack... UK value-added, development and European investment. We all know that you have to be careful with development, it's all about timing. But what about Europe?

Our Annual Survey shows a remarkable hike in institutional appetite for European investment and, if investors can find the right stock, we would agree that they should do rather well. One snag though is the high cost of the 'round trip' (sale fees and re-purchasing costs). So it may make sense funding this from a higher allocation to property than switching from domestic to overseas.

Figure 2: European investment appetite



Source: ING REIM Annual Survey, November 2006

If anything, our forecasts for Europe are probably on the conservative side, not least because of the leverage potential as there is still a small margin between net initial property yields and borrowing costs.

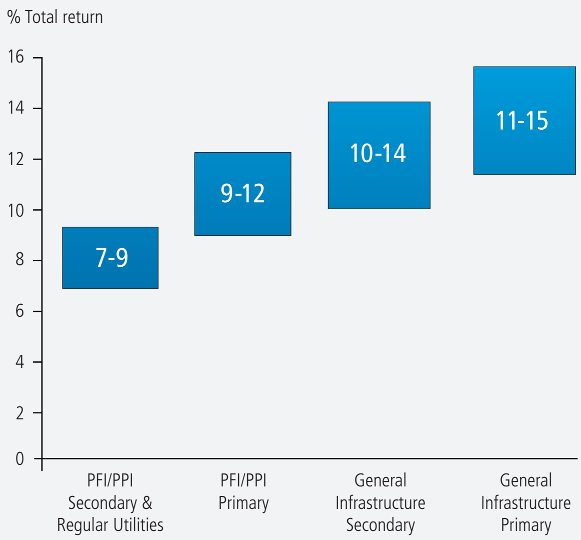
But a word of caution... Europe is a BIG place. There is not much depth in some of the markets and there are some bandits out there! So be careful.

Figure 3: Prime European total return forecasts

	2007 % pa	2007-09 % pa
European offices	12.0	11.3
European retail	12.3	10.5
European industrial	13.7	11.6
All European property	12.7	11.2
All UK property	10.6	9.2

Source: ING REIM Research

Figure 4: Infrastructure – anticipated returns



Source: ING REIM Research

So, with all this testosterone-driven alpha still to be satisfied, how come we are seeing the emergence of liability-managers chasing the other end of the investment spectrum – indexed linked long leases for example? Are they just doomsters? No. In fact, in their own way, they are alpha-seekers themselves, but that is alpha over the return from bonds. This is because these investors are basically bond investors looking for mis-pricing in someone else's backyard.

For instance, 10-year gilts are currently yielding 4.8% pa but index-linked gilts are priced down to a real return of just 1.5% pa. So, if you can get an index-linked lease to Tesco (AA rating) for 25 years at 4.75% pa real, you have to take the property option seriously, don't you?

And that is what the emerging markets of healthcare and infrastructure are about too. Their base return expectations may be at the lower end of the traditional property spectrum but they still look mighty handsome against gilts. In fact, investors wanting a bit more fizz than regular PFI/PPP deals can potentially enhance their investment returns by embracing the construction phase (primary) and overseas locations too. This should yield significantly higher returns. Mind you, don't forget the currency risk!

So, in my judgement, 2007 will be another excellent year for property. Not only will returns be way above investors' hurdle rate requirements, but the breadth of the market will expand to embrace alternative assets too. And we haven't even mentioned yet the impact that the burgeoning market in derivatives will have on property!

Internationalising your property portfolio

Alex Walker, Associate Director, DTZ Investor Consulting

Alex Walker looks at the opportunities emerging economies present.

It has been said that playing catch up is easier than being out in front and, to judge by the rapid development taking place in the world's emerging economies, this would certainly appear to be true. The changes that are occurring in global production, growth and capital investment are impacting dramatically on both the prospects for the developing world and the investment opportunities and decision making for more established markets. The intense focus on markets such as China and India in recent years, from both an economic and a property market perspective, is only the tip of the iceberg. The emerging market revolution has started and is set to have an even greater impact upon developed economies and global property investment over the coming decade.

Consider the key themes that have shaped international economies and investment markets since the turn of the new millennium and it becomes clear just how great an influence the emerging world is having:

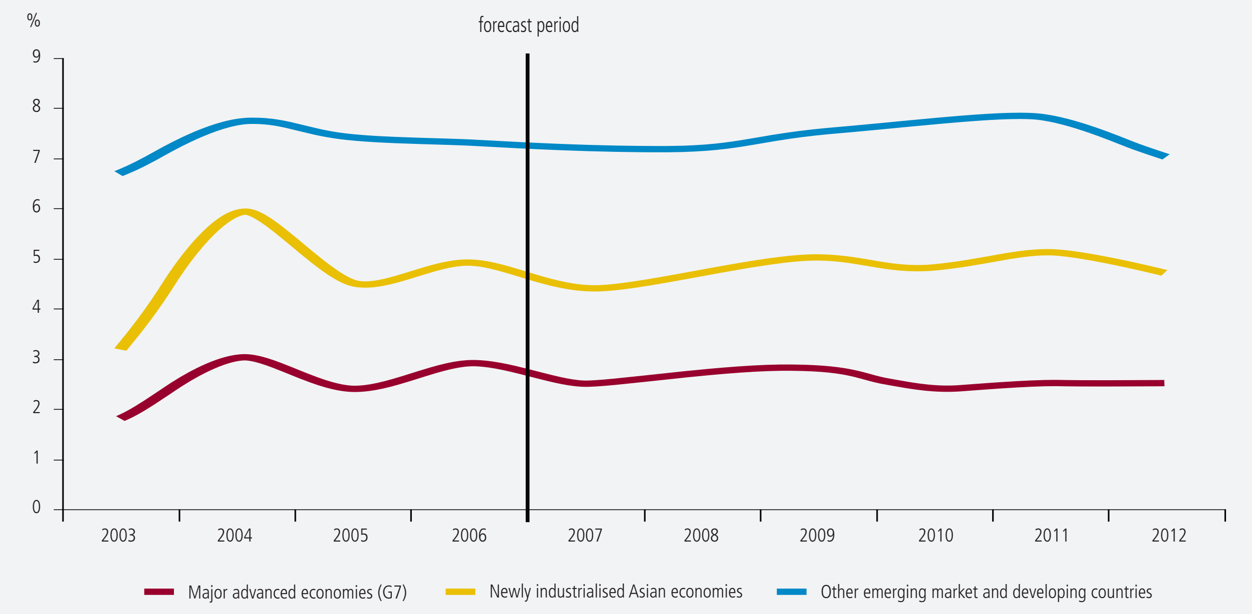
- World economic growth accelerating at record levels – since 2000, global GDP per capita has grown at an average of 3.2% pa, thanks largely to the performance of developing countries. The IMF forecasts that over the next five years emerging economies will grow by 6.8% pa compared to 2.7% pa for developed countries;
- Financing rates at sustained lows – low bond yields have been driven by emerging markets' stockpiling of foreign reserves, leading to a situation in which developing economies have been financing the current-account deficits of more established markets, particularly the United States;
- The taming of inflation – the accession of emerging economies to the global marketplace has served to push down the prices of labour-intensive goods and curtail wage inflation in developed markets; and
- Asset price bubbles – with limited inflationary pressure, central banks have been able to hold interest rates at historically low levels. Loose monetary policy has encouraged a glut of excess liquidity, which has been directed towards asset classes such as commodities, housing and commercial property.

Investment property markets

What, though, do these global shifts mean for property investors, and what approach should they be looking to adopt with regard to emerging markets? In recent quarters, DTZ has worked with an increasingly diverse range of clients seeking to increase their exposure to emerging markets. In part, it seems appropriate to suggest that this is a reflection of current pricing within the more established investment markets of the United States and Western Europe. However, for many institutional and other mainstream investors, increased allocations to Asia Pacific and South America are driven by an understanding of the long-term strategic growth story, particularly in Asia, and the prospect of significant outperformance and diversification.

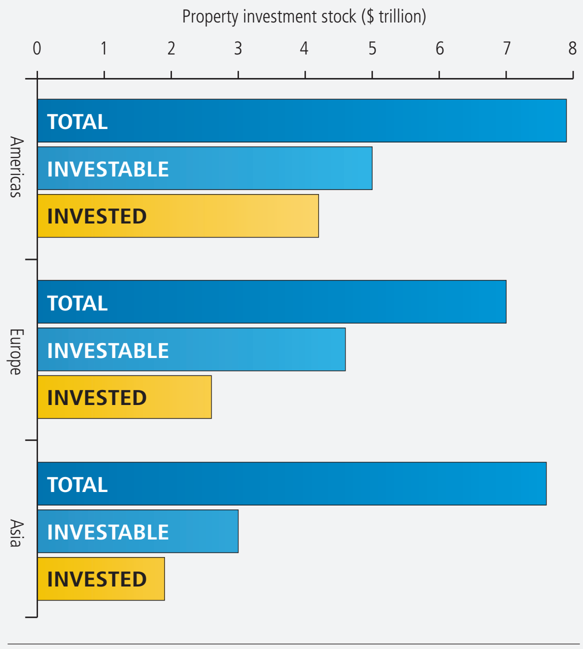
DTZ's most recent analysis of global property markets, and the first step in starting to develop a genuinely international approach to property investment, assessed the size and structure of the potential investment universe. In defining this investment pool, the focus was on three 'concepts' of property investment stock:

Figure 1: GDP growth forecasts, developed and emerging economies



- **Total stock** – the value of assets held within the investment and owner-occupational markets;
- **Investable stock** – an assessment of the future size of the real estate investment market, taking into account the potential for asset transfer from corporate and government owner-occupiers of real estate into the investment market; and
- **Invested stock** – the value of the current volume of real estate investment assets – that is to say those assets owned and leased with a view to generating an investment return.

Figure 2: Global property universe by region



Source: DTZ

There are several key messages that emerge from this top-level analysis:

- The three main regions of the Americas, Europe and Asia are broadly similar in terms of the total stock of property assets – to some degree, this reflects the recent economic growth and 'catch-up' of the Asia Pacific region;
- There is considerable variation in the levels of 'investable' stock between the United States and Europe on the one hand, and Asia on the other. While around two-thirds of total stock is investable in the more developed markets of Europe and the US, the equivalent figure for the Asian real estate universe is less than 40%;
- To some extent, this reflects a greater emphasis upon the owner-occupation of property assets in the Asia Pacific region and a less established history of asset transfer from the corporate and government sectors to the investment market (via sale and leaseback or other externalisation deals); and
- With regards the actual property investment market, the Americas (and more specifically, the US) is considerably larger than the other principal regions – indeed, in dollar terms, the real estate investment market of the Americas is estimated to be some 60% larger than its European equivalent.

In addition to the structure of global property markets, DTZ have also focused on current and future property market fundamentals relative to more established markets. Analysis of the Asian region, in particular, illustrates the extremely positive outlook for its emerging economies and property markets, despite recent concerns about the potential for overheating in some locations and sub-sectors.

- **Liquidity:** DTZ Research recorded $53bn of investment transactions in the Asian region in 2006, a 30% increase on one year earlier. Although, on an absolute basis, this remains considerably below the United States and Europe ($332bn and $159bn respectively), the rate of growth is considerably higher and DTZ expects this to continue over the medium term as the pool of investment-grade assets increases;
- **Pricing:** The property yield premium over financing costs is considerably greater in Asian property markets than in the US and Europe. While the yield premium over government bonds is negligible or negative in some key Western markets, the (prime office) yield gap in selected Asian markets ranges from 160 basis points in Singapore to around 480 basis points in Shanghai. We believe that further price appreciation will be a significant contributor to returns, supported by growing investor interest and capital allocations to the region;
- **Performance prospects:** At the regional level, DTZ Research forecasts that Asian office markets will record average annual rental growth of 6.2% pa over the four-year period to end-2010. By way of contrast, European office markets are forecast to record 2.2% pa, and US markets 3.2% pa. The equivalent figure for the UK alone is 3.5% pa. We anticipate that this growth is sustainable on the back of increasing domestic demand and an increasingly diverse base of international occupiers.

The risk-return trade-off

Although the growth and performance prospects within developing property markets are considerable, clearly there are still a number of risks that are associated with emerging market investment. If evidence of this were needed, the equity market volatility that characterised late February and early March, sparked by falls in the China's Shanghai Composite Index, was a sharp reminder. Typically, we categorise property investment risk from an economic, market, systemic and reputational perspective.

While many investors will be familiar with the type of risk that is associated with the first three categorisations – the strong property development focus within many emerging markets; the requirement for governments to stimulate domestic demand; and the immaturity of many countries' property investment frameworks for example – it is worth elaborating upon the reputational risks that can be associated with emerging market investment.

One key consideration in this regard relates to China, where there is a perception – particularly in the West – of widespread corruption, particularly in the construction and property market. However, evidence suggests that market corruption and malpractice are not as widespread as generally reported and that, indeed, where it does exist, it is typically confined to dealings between domestic investors and market operators.

Our view remains that the mitigation of reputational risk in the Chinese market, as it is in other emerging markets, is best served by investment with a mainstream, 'international brand name' manager that has a clear and defined approach to business processes in the market.

Selecting an appropriate entry route

This last point fits with our current focus upon indirect investment (through non-listed property funds) as the most appropriate means for many investors of accessing emerging property markets. Indeed, the rapid development of emerging markets is clearly having a significant impact on the indirect investment industry. In recent quarters, DTZ has been monitoring a wave of new fund originations targeting a variety of real estate strategies, particularly in the Asia Pacific region.

Unsurprisingly, much of the investor demand – and fund manager focus – has been on the 'powerhouse' markets of India and China. We are currently monitoring a number of specialist India funds that are seeking to raise around $4bn of equity capital. At the same time, specialist China property funds are targeting around $2bn of institutional equity.

Strategically, there are distinct differences between indirect investment vehicles that are operating in the United States or Western Europe and some of the principal emerging markets. In China and India, the focus of the funds is often upon property development rather than the acquisition of stabilised investments – a reflection of the market maturity in these emerging economies, restrictions upon overseas capital and the lack of a fully functioning secondary investment market.

This in itself requires a considered approach on the part of investors to identify those funds and fund managers that can provide 'best in class' access to emerging property markets although, in practice, some of the key issues are similar to the fund manager selection process that is typically implemented in more established markets:

- Access to product – with a limited universe of 'institutional grade' property, what kind of investment pipeline does the fund have access to?
- Partnership selection – the asset management industry remains less developed relative to more mature property markets, placing greater importance upon selecting the right local partner.
- Local market personnel – the ability to deliver a given strategy within less developed markets is enhanced by the presence of local market practitioners 'on the ground'.

The signs for indirect investment within emerging markets – as well as the potential for continued economic development – look positive. In September 2006, AREA, the first independent body for non-listed real estate vehicles in Asia was launched, seeking to share market knowledge, improve transparency and promote best practice standards. We believe that this will only serve to bolster consistency, fee transparency and pricing competition further over the medium term.

Conclusions

In summary, DTZ expects that the barriers to property investment in emerging markets will continue to fall and that the long-term story for the emerging world remains compelling. Indeed, the shifting balance between the developed and the developing world is at the stage where emerging economies now account for more than half of global GDP (at purchasing power parity).

And, from a wider perspective, property markets and the indirect investment industry will continue to benefit from the move towards free and open markets, transparent and flexible regulation, improved infrastructure and better levels of education. GDP growth forecasts suggests that emerging economies will continue to play catch-up on their more developed neighbours and the immediate challenges for investors are to identify the most appropriate entry routes and the key markets of opportunity. For indirect investors, coverage of the emerging markets is now a mainstream necessity. Both inward investment and product acquisition abilities are now highly significant should an investor or fund manager wish to remain at the forefront of the real estate investment industry.

Institutional investment into alternative sectors

Institutional investors are increasingly allocating capital to non-traditional real estate sectors. Rory Hardick balances the demographics behind the investment rationale with the operating risk investors may have to adopt to get exposure.

As the weight of capital allocated to real estate has grown, office, retail and industrial yields have fallen; creating an investment sourcing and pricing challenge for many investors.

As a result, investors have widened their scope to include new regions and new sectors, ranging from self-storage and senior housing to car parks and marinas. Even public service sectors such as hospitals and schools are being acquired by the more highly structured opportunity fund managers and specialist infrastructure investors. This tracks the growing institutional interest in wider infrastructure assets that share similar investment characteristics to traditional real estate sectors. Indeed several major European institutions have recently made significant allocation shifts away from real estate to pure infrastructure investments. While the range of sectors that investors are considering is broad, certain sectors are emerging as clear favourites: notably, student accommodation, senior housing and increasingly residential.

The attraction of the 'alternative' sectors is driven by two factors. Firstly, there are fewer investors chasing opportunities in these sectors and consequently, until recently, there has been greater availability of product at less competitive pricing. Secondly, many of these sectors offer portfolio diversification benefits since they are often less correlated with economic growth, which is the key driver of commercial real estate performance. Compelling alternative sectors are more likely to be driven by strong demographic or legislative factors which are typically less effectively exploited via traditional real estate sectors.

Student housing

Take, for example, the purpose-built commercial student housing sector in the UK, which, as of the December 2006 launch of the £1bn UNITE UK student accommodation fund, is emerging as a significant institutional asset class in its own right. UNITE's preliminary offering to institutional investors secured in excess of £310m of third party equity investment, largely from UK pension funds. Among other factors, institutions were attracted by the strong occupational demand characteristics and corresponding potential for rental growth in the sector. According to estimates from DTZ, the number of students in the UK is expected to increase by 1.6% pa to 2011, principally driven by the UK government's further education participation rate target of 50% amongst 18-30 year olds and the growing number of international students choosing to study in the UK.

On the supply side, universities are increasingly opting to outsource accommodation provision to the private sector allowing them to focus resources on education provision. Coupled with the poor quality of existing private rental stock and the more stringent landlord licensing requirements enacted by the Housing Act 2006, a significant opportunity for commercial operators has developed. In addition, many commercial student accommodation buildings are based in city-centre locations, where scarcity of land can pose a significant barrier to entry and protect the long term residual value of the investment.

Rory Hardick, Principal, M3 Capital Partners Ltd

What is more, the availability of data on the higher education population and the certainty provided by the academic year allow sophisticated operators to forecast occupation and rent levels with a high degree of accuracy, providing for a relatively smooth investment profile.

Senior housing

The demographic story is equally compelling in the senior housing sector. DTZ estimates that by 2050, the number of people aged over 65 will increase by 60% in the UK. Coupled with longer life expectancy, the number of aged people in need of care is estimated to increase by 200% to 1.3m by 2050. On the other hand, the supply of care home beds has fallen with the introduction of stricter health and safety regulations, which requires significant capital investment, reducing both the existing qualifying stock and acting as a barrier to new development.

Investment in the care home industry to date has been dominated by traditional private equity funds, and there has been significant consolidation in the sector. For example, over the past few years, Blackstone acquired Southern Cross, NHP and Ashbourne, creating a group with 28,000 beds in 580 properties. Blackstone subsequently floated the operating business in July 2006 after undertaking a sale and leaseback on many of the property assets.

However, institutional investor interest in assets with a lower medical care content is growing as demonstrated by Sunrise Assisted Living's recent £500m UK joint venture with Pramerica Real Estate Investors to assist with its UK development programme.

Market let residential

The stock of residential property in the UK dwarfs the commercial property sector. It seems likely that residential property let on assured short hold tenancies (market let residential) will become of greater interest to institutional investors (especially those who have historically been put off the sector by either regulatory controls or short term pricing concerns) as the longer term demographic and economic drivers are analysed and better understood.

What is clear is that a significant increase in net migration to the UK; a growing trend towards single occupancy households; and affordability issues for first-time buyers are all factors that are driving demand for rented accommodation. At the same time, the supply of new housing stock falls short of providing the necessary accommodation needs of the current professional generation. Research by the Department for Communities and Local Government shows that in the South East alone, there is a shortage of 25,000 new homes per annum.

Given the enormous scale of both primary home ownership and the buy-to-let sector, the short-medium term direction of house prices probably evoke more column inches than any other financial topic in the press. However for investment analysts assessing the supply and demand dynamics of this sector relative to others, many are beginning to feel that both rental and capital values will continue to grow positively over the long term.

From a portfolio perspective, residential property can add both strong performance and diversification. Research shows that total returns from residential property have out-performed all other property sectors and asset classes over the past 30 years, with relatively high risk adjusted returns and low correlation to other asset classes over that period.

Underwriting operating risk

While it is possible to invest in long term leases on certain properties in the alternative sectors, most often through sale and leasebacks, the opportunity to do so can be hard to find. Furthermore, it is unlikely that investment on this basis will yield the higher cash returns that investors are seeking by venturing out of the core allocation based sectors. A student accommodation block in central London which is on a long term lease to a university is as mainstream an investment as any FRI leased office building – and the initial yield will be comparably low. For example, typical net initial yields on student accommodation buildings that are let on a long lease to a university are in the order of 4.75% compared to the IPD all property initial yield of 4.57% at YE 2006.

As a result, many investors are willing to assume greater operational risk in order to attain a higher cash yield. In this case, the income derived from a property is not necessarily contracted on a traditional lease basis and is driven by the ability to extract income by managing an operating business within the properties. It is important, therefore, that investors are mindful of the additional risk that is being borne to extract above market cash returns from investments in alternative real estate sectors. Consider, for example, student accommodation, where rooms in direct-let properties are typically re-let on an annual basis. A thorough analysis of the sustainability of revenues requires an appreciation of the drivers of occupancy and rents year on year. This involves analysing factors such as the location of the building relative to both the university campus and the city's nightlife; the ongoing popularity of the university; supply of new accommodation; quality of the accommodation and the innovation of services offered to students (eg broadband points in each room; on-site launderettes and gym facilities).

Perhaps more important is understanding the operating costs incurred, which tend to be proportionately higher and more complicated than properties in core commercial sectors in the UK, where the UK institutional lease has somewhat uniquely evolved over time to pass such risk through to occupiers. For a portfolio of student accommodation buildings, the effective execution of marketing strategies or the effective management of the large staffing pool that is required to operate the buildings becomes critically important in determining net income to the owner. Figure 1 sets out an approximate example of the gross:net analysis that investors need to understand in making their investment in a direct let student property.

Figure 1: Gross:net analysis

	% of total revenue
Revenue	
Rental revenue	91.0
Other revenue	8.0
Commercial lease income	1.0
Total revenue	**100%**
Operating costs	
Marketing	(1.0)
Repairs and maintenance	(3.0)
Utilities	(10.0)
Variable costs	(1.5)
Property and associated costs	(2.5)
Sinking fund	(5.0)
Staff costs	(8.0)
Total operating costs	**(31.0)%**
Net operating income margin (NOI)	**69.0%**

Partner with specialist operators

Due to their operational nature, alternative real estate assets are often better managed over the long term by specialist operators that possess management infrastructure and a depth of knowledge that cannot be matched by generalist fund managers in their drive to secure funds under management. For example, market leading residential operator Grainger PLC is an integrated operating company employing nearly 250 people in eight offices across the UK. Grainger has developed multi disciplinary expertise in each facet of the effective management of market let residential. This is a sector that is often viewed by gung ho buy-to-let investors as needing minimal management whereas, in reality, careful yield management disciplines are needed to protect investors from the downside of the investment. Grainger assesses that the real NOI margin on residential is in the order of 65%, with its financial appraisal of this being carefully constructed in a similar manner to that set out in Figure 1.

Buy-to-let investors probably believe that margin is closer to 80%-90%. Clearly investors that invest without undertaking careful due diligence of the real NOI yield will be disappointed unless they are fortunate enough to experience significant capital growth.

By partnering with top-tier specialist operators, investors can manage their exposure to the operational risk that comes with what are really real estate backed businesses.

How far should institutional investment interest stretch?

What seems clear is that a number of alternative sectors offer both diversification opportunities and positive current returns relative to core property sectors and as such should definitely be on the radar of savvy institutional investors looking to match their current liabilities with cash yielding investments.

However, the craze for all things asset backed has heated up to such an extent that not just property companies but also institutions have been expressing interest in sectors such as caravan parks. Presumably they have been attracted by NOI yields in the region of 9%-10%. As a non-executive director of a caravan park operating company, I am a huge enthusiast of the sector. However, is it real estate and should institutions be investing in it from their real estate allocation? While there is significant asset backing to the business and that should be reflected in banking terms and to some extent in the methodology adopted by valuers, institutions should tread with care given that the average net operating margin is in the order of 20%-25%. In spite of the continuing need for affordable family holidays, generally stable occupancy since the birth of the sector in the 1960s and with zero new supply being allowed by planners, these assets need to be sweated intensely on an annual basis by their management to make an investment in them pay. Any institution that thinks they can passively sit upon such an investment will rapidly see their NOI yield diminish through their failure to manage the margin.

Institutional investors may not be equipped to underwrite such degrees of operating risk, most certainly should not be doing so on their own (i.e. without an operating partner) and need to carefully assess in each offering whether the returns being offered adequately compensate for the operating risk they might be assuming.

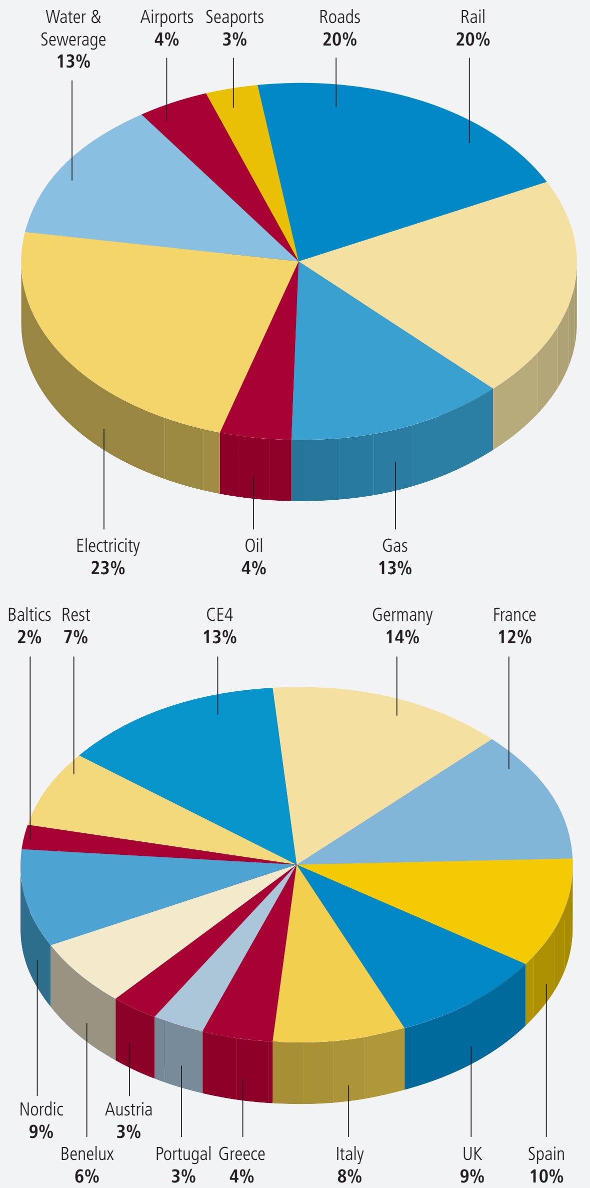
Infrastructure investing

Peter Hobbs, Head of Global Real Estate and Infrastructure Research, RREEF

Peter Hobbs and Lonneke Löwik look at the emergence of a new asset class.

'Infrastructure investing' has emerged to be one of most significant and fastest growing asset classes of recent years. This surge of interest has occurred for two distinct reasons. First is attractive market fundamentals; there is a strong demand for the use of infrastructure assets and a general shortage of supply and at the same time many governments across the world face financial difficulties, forcing them to raise infrastructure capital from the private sector. Second is the behaviour of the asset class, or its performance characteristics; such assets tend to have a high yield, steady growth in income and a low volatility. They also tend to have a very long duration, generally with a minimum of 30 years, but often 60 to 100 years, and they provide significant diversification benefits to bond and equity assets .

Figure 1: European economic infrastructure market share by sector and country



Source: RREEF Research

Although the asset class has grown dramatically in recent years, it remains 'emergent' and, as such, is subject to the risks and opportunities associated with the emergence of any new asset class. Investors starting to become familiar with the asset class need to understand precisely what it is and how it behaves. One of the more specific issues associated with the emergence of the asset class relates to the risk of the market overheating, with the potential for investor appetite to run ahead of the availability of investment opportunities. Given the significance of this potential issue, this short article explores the European infrastructure market in terms of its size and recent deal flow.

Scale and composition of the European infrastructure market

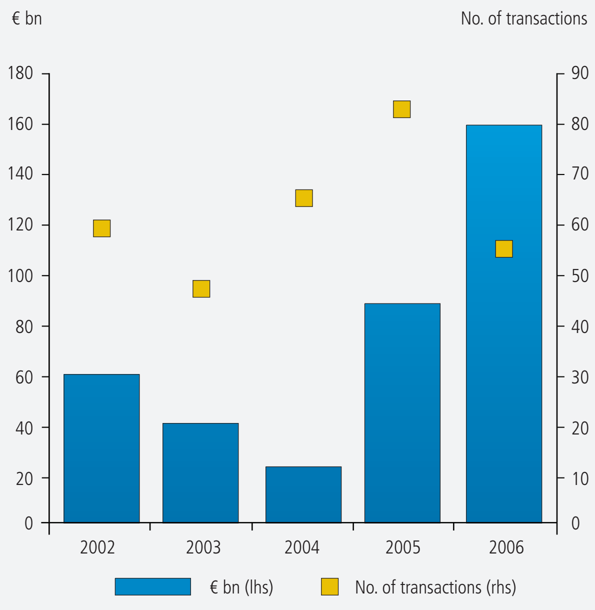
Although it is hard to estimate the precise value of the European infrastructure market, it is likely that the market represents around €4.5tn, similar to the scale of the overall commercial real estate market, and around 30% to 40% of the European equity and bond markets. The infrastructure market differs to equities and bonds in that much of the market remains relatively illiquid as it is owned by national governments or by corporate operators. An important trend over recent years is for national governments and corporate operators to refinance their infrastructure assets, enabling them to raise capital and to focus on their core public sector and business activities. At present, it is estimated that the 'liquid' infrastructure market, or the market that is not owned by government or corporate operators, represents around €1.4tn (around 30% of the total), with the bulk of this being in listed companies. A key issue facing the infrastructure market is the pace at which the liquid market will grow and this varies significantly by country and by sector.

As would be expected, there is a close correlation between the scale of a country's economy and the size of its infrastructure market. The largest five economies of Germany, France, UK, Italy and Spain, account for more than 50% of the overall European market, as shown in Figure 1. The market is broadly split between the transportation and utilities sectors. Within transportation, the road and rail sectors represent the largest value (around 20% each) and for utilities, the largest sector is electricity generation and distribution (22% of the total).

Recent transaction activity

These estimates of the scale and composition of the European infrastructure market are based on the overall, illiquid, market. A key issue facing the market is the pace at which private finance is able to enter the market, particularly given the scale of capital that has been raised to invest in European infrastructure assets. In this respect, it seems that the transaction flow has risen significantly over recent years, as shown in Figure 2. After averaging around €50bn between 2002-04, deal flow increased to around €160bn in 2006. The increased appetite for infrastructure assets from investors, coupled with the desire from government and corporate operators to make use of private sector finance, suggests that 2007 will be another record year in terms of transaction activity.

Figure 2: European infrastructure transaction activity

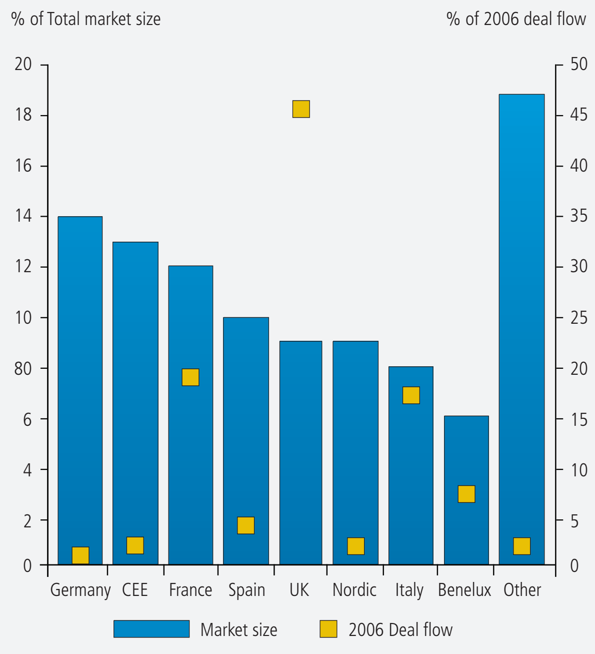


Source: Mergermarkets and RREEF

The nature of the transaction flow provides important insights as to how the infrastructure market is evolving. Although there is increasing pressure for governments to make use of private finance for their infrastructure assets, only around a quarter of the transaction value represented government privatisations. The majority has come from corporate and listed sectors, such as the BAA acquisition by Grupo Ferrovial, the sale of ABP and Peel Ports, the acquisition of Autostrade by Abertis and the sale of Thames Water by RWEAG, and this is set to continue over the near term.

The deal flow has also been heavily concentrated in the UK, representing close to 50% (Figure 3). This is based on the relative maturity of the UK privatisation process in terms of market liquidity and the well-established nature of the regulatory framework.

Figure 3: European infrastructure market size and 2006 deal flow



Source: Mergermarkets and RREEF

Prospects for the European infrastructure market

A combination of factors mean the level of investment activity, or the deal flow, in the European infrastructure market is set to continue to increase and to spread further across Europe and across infrastructure sectors. First, there is a need for capital investment due to the significant under-investment over the past decade and the continuing strong demand for the use of such assets. Second, the increasing fiscal pressures on governments which, coupled with the low rates of economic growth, increases the motivation to raise capital through the use of private sector finance in traditionally public sector infrastructure assets. Third, the maturing of the infrastructure investing industry, with investors, owners, governments and regulators increasingly coming to recognise the mutual benefits of introducing private sector finance into the operation of infrastructure assets.

The combination of these factors means that deal flow is set to continue to increase. This is likely to occur across all infrastructure sectors, with greatest concentration on the three main sectors of energy, water and transport (particularly road and airports). As with all emergent markets, there remains the risk that sectors of the market become overheated and this is particularly the case given the current high degree of liquidity across all asset classes. These risks are likely to be short term and temporary. The momentum behind the growth of the infrastructure deal flow suggests that it will not be long before the liquid or 'invested' market grows significantly in scale and critical mass, reducing the potential for the new wave of capital to destabilise the market.

The characteristics of infrastructure investing described here relate to mature or developed infrastructure where investment returns comprise mainly a stable income flow with modest capital growth linked to economic growth and/or inflation.

Issues in international real estate investing

Ben Sanderson, Director of Property Research, PRUPIM Real Estate Investment Management

Ben Sanderson asks if international investing is only for the brave?

With most participants in the UK property market agreeing that the recent run of extraordinary returns is now over, there is increased interest from investors who are looking to invest outside the UK. However this is a trend that applies not only to UK investors but also to an ever increasing number of investors from outside the UK who are looking to invest outside their traditional domestic markets. For example, authoritative surveys of cross border investment from Jones Lang LaSalle's Global Capital Flows publication and from the DTZ Global Money into Property study confirm the recent trend towards greater cross-border and inter-regional investment flows. Similarly, there has been a sharp increase in the number of potential investment vehicles available to investors, as measured in Europe by INREV. In an investment climate where financial deregulation, globalisation, regional integration and associated market integration have facilitated the growth of cross-border investment across all asset markets, international diversification is now becoming an important element of the real estate sector.

However, clearly, investors new to non-domestic investing need to be aware of the potential risks and pitfalls as well as focusing on the potential rewards. Since 2005 the IPF's Investment Education Programme module in International Real Estate Investment has been seeking to address these issues and inform participants of some of the risks in this area with the help of some of the leading experts in the field. This article draws on the content of this module and outlines some of the costs and benefits of international real estate investing.

Despite the growth in international capital flows in recent times, there is a widely recognised home-country bias in investment across all asset types but this is particularly marked in real estate allocations. For example, in the UK, institutional allocations to international property have historically been low and recent research suggests that only half of UK investing institutions had any assets outside the UK. Nearly all the investment assets were either in the European Union, the USA and members of the British Commonwealth. Although data is generally scarce, with notable exceptions, the shards of information tend to point to extreme caution about overseas property investment. Exceptions have concentrated upon single or a limited number of markets such as France and Spain.

The many, often rational, reasons for this home-country bias are related to the costs, risks and difficulties of investing internationally. In making a decision to invest in international property investors need to carefully consider these costs.

An international direct investor faces many disadvantages when competing with domestic capital. One participant on the IPE International module described international investing as 'swimming in someone else's shark tank' which, while an extreme analogy, is one that could be usefully borne in mind. The disadvantages and risks of international investment include low transparency and liquidity, the costs of diversification, management and implementation issues and tax and currency risk.

Costs and risks

Firstly, transparency and the availability of market information is clearly important to all investors. Non-domestic investors have a certain degree of geographical and psychological remoteness from international markets, meaning that at the outset, they will lack local knowledge and expertise. It may be obvious (but is still important) to state, that this lack of expertise may result in poor timing of investment and poor stock selection. It is possible to get around these risks, through either in-house research or the buying in of research and other services, however these extra costs of researching local markets effectively add to the transaction costs of foreign investors.

Furthermore, ex post, investors will clearly wish to monitor investment performance and undertake asset management decisions, as they would in their own domestic market, and a lack of market information and low transparency will hinder benchmarking and performance analysis. Investment performance measurement is particularly important because it provides a basis for making asset allocation and stock selection decisions. In the UK, performance measures are available at the sector and regional level. Many international markets do not have or have only recently developed reliable real estate market monitors. A further issue is liquidity will vary between markets and over time. Since the UK is regarded as having one of the most liquid direct real estate markets, UK investors will be faced with additional liquidity risk when investing overseas.

Secondly, given the 'lumpy' nature of real estate as an investment asset class, it will be difficult to achieve a highly diversified real estate portfolio without allocating a substantial proportion of funds to the real estate portfolio. Research suggests that that it may be only the largest global players who can resource the necessary research and implement a genuine global diversification strategy. Investors seeking to invest outside their domestic markets to insulate themselves against the volatility of their own markets should consider this issue carefully as it clearly has implications for the decision as to whether or not to invest internationally and the route one decides to take. The strong growth in the number of co-mingled real estate funds established to attempt to exploit the opportunity to develop globally diversified portfolios is driven by this issue.

Thirdly, there are the risks associated with the implementation of an investment strategy and the management of overseas assets. Many investors rely on their long established contacts and investment infrastructure to source, transact and manage properties efficiently in their domestic markets. Despite increased transparency in many international markets there are obvious difficulties in immediately replicating this sort of infrastructure in overseas markets, especially when one considers that there are extra layers of complexity involved in international investing, which will, for example, require extra knowledge of legal and taxation issues concerning landlord and tenant as well as consideration of currency risk. While the issues are not insurmountable, the particular taxation regime of an international market can have significant repercussions for investment performance. It should be possible to incorporate taxation implications, and the wider costs which sometimes accrue to non-domestic investors, into the pricing of an investment opportunity, although the resultant effect may be to exclude foreign investors from the market as they may only be willing to buy at a less competitive price than domestic investors. However, knowing the full risks and costs is important.

In terms of currency risk, returns on domestic real estate investments to foreign investors depend on expected domestic real estate returns and expected appreciation of the currency. Typically, currencies are significantly more volatile than property returns and can in both theory and practice dominate returns. Previous research on international real estate investment and exchange rate risk has explicitly recognised the potential of adverse movements in the currency markets to alter expected risk and return characteristics. Although the effects of currency fluctuations can be mitigated by hedging, many investors do not use hedging instruments due to their costs. Moreover many of the derivative instruments are short-term in nature and it would be difficult to find instruments to identify suitable hedging instruments over the longer term. A consideration of these risks and costs is vital.

Reasons for investing

So, given the costs and risks, why would investors place capital overseas? The rationale for investing internationally depends on the available risks and returns and crucially the starting position of the investor. At one extreme of the risk spectrum, there are exclusively domestic investors with no experience of international markets who may decide to make an international 'play' in a single market – presumably to take advantage of perceived mis-pricing and obtain higher returns. The risks and costs here are very different compared to organisations that either have or are seeking to establish larger diversified international portfolios, with appropriate management systems and business relationships in place and either have or are seeking in depth detailed knowledge of international markets. For the corporate sector, investment may be for operational or strategic reasons – a feature of many expanding retailers or logistics operators in recent years across Europe and Asia.

Both of these former investor types from the UK have, in large part, been attracted to investing outside the UK in recent years by a perception that the UK cycle is easing and that the market is now fully priced. These investors are taking a view that higher returns are available – either due to local market conditions or even seeking to take a view on currency moves or interest rate arbitrage. In research terms, this approach relies on the segmentation of markets, where well defined sub-sets of property markets (by either country or sector type) offer opportunities for identifying assets where investors are overcompensated for risk. International real estate investment, with its obvious and fixed segmentation, (i.e. clearly defined and different borders and jurisdictions) presents an enduring opportunity to take advantage of mis-priced risk. However, the idea of 'chasing high returns' as a motivation is only one possible driver for non-domestic property investing.

Longer-term investors may seek portfolio diversification and higher risk-adjusted returns from an international strategy. For institutional investors from small countries, the size of the local market may be insufficient in relation to available capital – clearly an important motivation for Dutch and Swedish pension funds – while overseas investment strategies are increasingly a factor in driving the flows of Australian real estate investment capital towards, Asia, Europe and the US. Also, wealthy individuals may be seeking politically or economically more stable environments for their capital – a feature of the UK commercial and residential market historically and in recent times in particular.

International diversification enables investors to reduce the unsystematic risk of investing in one economy or real estate market. Investors who are fully diversified internationally will be less exposed to one-off 'shocks' affecting local markets and, despite many taking the view that globalisation is ensuring that economic cycles are converging; there are still clear and distinct cycles in global real estate markets. Many investors are now using this argument when looking to invest in Asian real estate from a European base. However investors need to be aware of the importance of real economic diversification and not just following a process of geographical diversification. For example, investing in office property with global investment bank tenants in London, New York, Frankfurt and Tokyo will give an investor a large amount of geographical diversification but little economic diversification. When financial markets re-trench, the correlations between the returns on these assets is likely to be close to unity.

However, the level of diversification achievable depends on the allocation to international property. With a small allocation only a relatively small number of assets could be directly purchased, and thus high levels of specific risk would be incurred, limiting any gains from reduction of systematic risk. An indirect approach may help in this regard.

For investors looking to invest outside their domestic market the right strategy and approach depends upon the interaction of a wide range of factors including the nature of the proposed investment, investor size, objectives, risk and liquidity preferences, liabilities and operational needs of the investor, track record of the investor, nature of existing portfolio and home market conditions. Moreover, most investors cannot afford to obtain a fully diversified portfolio and must take on specific risk. Improving returns relative to the domestic market is feasible but with additional costs and risks of higher search costs, currency risk, lower liquidity and the ever present risk of buying (relatively) 'bad' assets. Clearly as international investment grows some of these risks and costs diminish but many remain – the well-informed investors will be aware of these costs and act accordingly.

Risk reduction and diversification in property portfolios

Mark Callender, Steven Devaney and Angela Sheahan examine the issue of how many properties are needed to track the market, one of the oldest chestnuts in property fund management.

This article presents the results of a new IPF research project analysing both risk reduction and diversification. Risk reduction is concerned with smoothing out the returns on a portfolio and it is a major priority for fund managers and investors seeking an absolute return target. Diversification is concerned with how closely the returns on a portfolio track the market and it is a key issue for fund managers and investors with a relative return benchmark who require a market return.

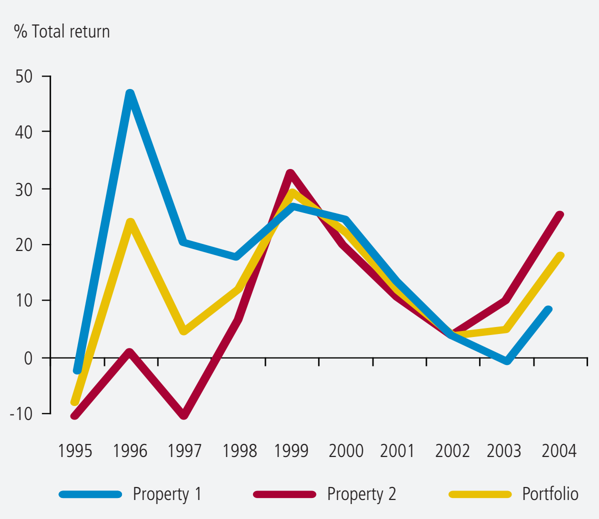
Individual property risk

All property investment involves an element of risk and investors have to deal with both systematic risks, which affect the value of all properties and specific risks, which are peculiar to an individual asset. Systematic risks include the state of the economy, changes in interest rates and the appetite of investors for property. Specific risks can be sub-divided into physical building risks and leasing risks. Physical building risk includes the design of a building, its susceptibility to obsolescence and its location. Leasing risks include lettings, expiries, renewals, the exercise of break clauses and tenant insolvencies. In general, leasing risks tend to have an immediate impact on performance, whereas the impact of physical building risks is more gradual.

Portfolio risk reduction

Risk on a property portfolio is usually measured by the standard deviation in total returns[1]. The bigger the ups and downs, the higher the standard deviation in returns. It is important to understand that portfolio risk is not simply the weighted average of individual property risks. Instead, it is a function of the standard deviation in individual asset returns, the weights of those assets and the extent to which the returns on the individual assets are correlated with each other. If the returns on the individual properties do not move completely in parallel, then the returns on the portfolio will be less volatile than the weighted average of the standard deviation in returns on each asset. In short, the whole is less than the sum of the parts. Figure 1 illustrates this phenomenon. The portfolio has a standard deviation of 11.4%, well below that of either individual property.

Figure 1: Risk reduction



In order to investigate fully the relationship between the number of properties in a portfolio and volatility, the project team created a large number of hypothetical portfolios composed of actual properties and then measured their standard deviation in returns over the 10 years to end-2004. The approach relied upon identifying a sample of 1,700 assets in the IPD which had been held continuously between 1994 and 2004 and then randomly combining them to create thousands of hypothetical portfolios of different sizes. The simulations were run firstly for portfolios of two properties, then for portfolios with three properties and so on, up to portfolios with 500 properties.

Figure 2 shows the range in the volatility of returns for portfolios of different sizes. Some portfolios with only a handful of properties saw relatively stable returns, but others had very volatile returns. What the chart demonstrates is that as the number of properties in portfolios increased, so the incidence of funds with very volatile returns decreased.

Figure 3 shows how, on average, portfolio risk reduces as the number of properties in the fund increases. There are two main conclusions.

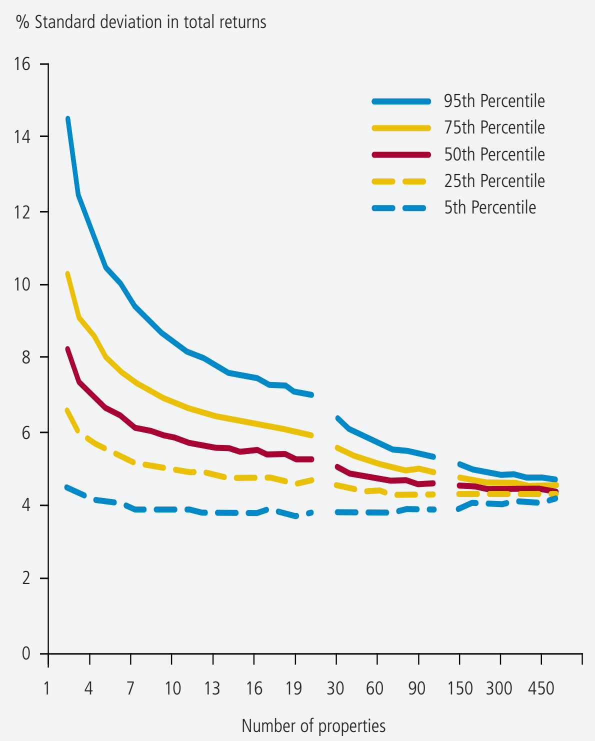
- Adding a second property to create a two property portfolio produces the single biggest reduction in risk and, thereafter, the marginal benefit of adding another property steadily diminishes. The standard deviation in returns on a portfolio with 30 properties should be two-thirds of that on a portfolio of three properties.
- However, although the marginal rate of risk reduction diminishes, it never quite reaches zero. Adding another property is always beneficial. It is therefore not possible to identify a particular size at which a portfolio can be said to have reached critical mass in terms of risk reduction.

Mark Callender, Head of International Research, Schroders Property Investment Management

Steven Devaney, Department of Real Estate and Planning, University of Reading

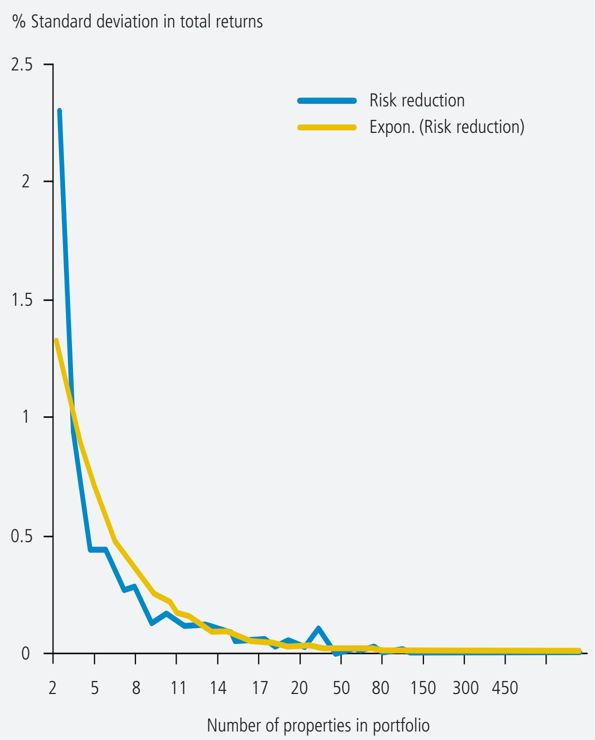
Angela Sheahan, Senior Research Analyst, Investment Property Databank

Figure 2: Standard deviation in total returns



Note: The gaps in the lines reflect changes in the intervals at 20 and 100 properties.

Figure 3: Risk reduction – the change 1994 to 2004 for simulated portfolios in the standard deviation



Diversification

Whereas risk reduction reflects the reduction of both specific risk and systematic risk, diversification is only concerned with the reduction of specific risk from a portfolio and with how well a portfolio tracks the market. Statistically, diversification is measured by the square of the correlation coefficient (R^2) between the returns on a portfolio and the market. If all of the variance in a portfolio's returns is explained by the market (i.e. $R^2 = 1$), then it is only influenced by systematic risk and is fully diversified because there is no specific risk left.

Figure 4 presents the results of measuring diversification for the same hypothetical portfolios that were used to measure risk reduction. It shows both the R^2 coefficient and the tracking error relative to the IPD Universe between 1994 and 2004. The results reveal, for example, that the market typically explains 69% of the variation in returns on a portfolio with 20 properties and 89% of the variation in returns on a portfolio with 100 properties. A portfolio with 20 properties typically had a tracking error of 3% per year relative to the IPD Universe over the 10 years to end-2004, double the tracking error on a portfolio with 100 properties.

It is clear that the only absolute answer to the question of how many properties are required to track the market is the entire population of all investment properties. In practice, the 'right' size for a portfolio depends on the risk tolerance of the fund's investors and the degree of importance they place on tracking the benchmark average return. Unlike in sampling theory where percentages are used to reflect the degree of confidence in the results, there is nothing particularly significant about achieving a 90%, or 95% level of diversification.

Figure 5 takes the research a step further to investigate whether diversification is easier to achieve in some segments than others. The results are indicative because in certain segments such as shopping centres or City offices, the number of properties held continuously in the IPD between 1994 and 2004 is quite limited. In general, while the data on the number of properties reveal that it is easier to achieve diversification within a market segment than at the All Property level – because the All Property average reflects a mix of diverse segment trends – they tend to dispel the notion that diversification is easier to achieve in some segments and than in others. The exception is Rest UK offices where diversification is more difficult to achieve, probably because the segment covers a large geographical area and Bristol and Edinburgh offices have on occasion performed quite differently from offices in Birmingham, Glasgow and Manchester.

However, if the issue is how much it costs to achieve diversification, taking into account variations in lot sizes, then a different picture emerges. (See two right-hand columns in Figure 5). Thus, the cost of creating a specialist standard retail, or industrial fund which was 75% diversified against its benchmark would be around £100m at end-2005 capital values. By contrast, the cost of constructing a specialist retail warehouse, or office would be significantly higher at £200m-£300m.

1 The IPF report Risk Measurement and Management for Real Estate Investment Portfolios (2002) provides a comprehensive review of alternative definitions and measures of risk.

Figure 4: Diversification at the All Property level 1994 to 2004

	Number of properties in hypothetical portfolios								
	1	**5**	**10**	**20**	**50**	**100**	**200**	**400**	**500**
R-squared[2]	0.17	0.45	0.57	0.69	0.82	0.89	0.94	0.96	0.97
Average tracking error[3] (%)	–	5.35	4.06	3.06	2.09	1.54	1.14	0.86	0.78

Figure 5: Diversification at market segment level 1994 to 2004

	Number of properties required to achieve diversification of:		Average capital value	Portfolio capital value £m required to achieve diversification:	
	50%	75%	£m end-2005	50%	75%
Std. Retail – South East	3	16	6.9	21	110
Std. Retail – Rest UK	2	9	6.7	13	60
Shopping Centres[4]	3	12	84.9	255	1,018
Retail Warehouses	3	12	24.9	75	299
City Offices[4]	3	10	22.2	67	222
West-End Offices	3	11	16.2	49	178
Rest of S.E. Offices	4	14	15.6	62	219
Rest of UK Offices	6	30	9.9	59	296
Industrial South East	3	11	9.4	28	103
Industrial Rest UK	4	15	6.1	24	91
All Property	7	30	13.4	94	401

The Executive Summary of the report is available on the IPF website.

The full report can be purchased from the IPF. Please contact Research Director, Louise Ellison, at lellison@ipf.org.uk or call her on 020 7194 7925

2 The R-squared value is the proportion of the variance in portfolio returns that is explained by the market. The R-squared can range from 0 to 1.

3 Tracking error measures the standard deviation in the differences in returns between a fund and its benchmark. The data show the average annual difference in percentage points per year.

4 Results for shopping centres and City offices are limited by the small number of held properties.

Multiple choice

Paul Mitchell runs his own consultancy, Paul Mitchell Real Estate Consultancy Ltd

How will property fit into a modern world multi-asset portfolio asks Paul Mitchell?

Property's role in a multi-asset portfolio has been clearly demonstrated over the last few years. At the same time, however, other new, 'alternative' forms of investment – hedge funds, private equity and so on – have also been sharing the headlines. With its returns expected to moderate, how will property fit with these new asset classes? This was the subject of a research project funded by the IPF/IPF Educational Trust and undertaken by Stephen Satchell and Shaun Bond from the University of Cambridge, Soosung Hwang from the Cass Business School, and myself.

The research involved extensive analysis of historic performance and 13 interviews with investors, fund managers and advisers, which largely informed the asset classes included in the analysis, e.g. private equity and hedge funds. Some markets did not feature. Listed real estate equity and high-yield and emerging market bonds and mortgage-backed securities, for example, were not seen as distinct asset classes but rather markets in which investors might give their fund managers discretion to invest as part of their respective equity and bond allocations. What was clear, however, was that direct property was being treated by investors as an asset class in its own right and not as an alternative asset class.

The team faced some challenges in building up the database of asset class returns. For example, as private equity and infrastructure investment is often through unlisted vehicles and there is no established market index, the corresponding investment trust indices were used as a proxy.

Hedge funds presented a challenge not only because of their short history but also because of the possibility of distortions in the observed index returns brought about by survivorship, selection and instant history bias (where good performing funds are overly represented in the index); past research has indicated that such biases may overstate underlying returns by 1%-3% pa.

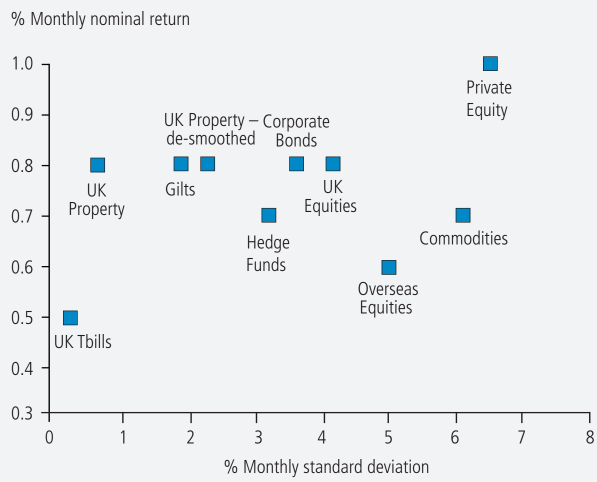
The availability of data for the alternatives also limited our analysis to the period starting from 1990. Figure 1 illustrates the risk and return characteristics of mainstream asset classes and the alternatives for 1990-2006. The key observations are:

- Private equity performed very strongly but with high risk;
- Corporate bonds and UK equities also performed well;
- Property and gilts performed similarly to corporate bonds and UK equities but with much lower levels of risk, such that they delivered by far the best risk-adjusted returns; and,
- Hedge funds were unexceptional – with comparable risk-adjusted returns to private equity and UK equities.

Further analysis revealed that property and commodities had a low correlation with the other asset classes and also that, statistically, hedge funds appeared to be a 'redundant' asset class because their performance mimicked that of other asset classes.

This analysis led to the conclusion that, historically, adding property to a multi-asset portfolio would have been the best way of reducing portfolio risk and of increasing risk-adjusted returns. By contrast, the contributions in these respects of alternative asset classes were more modest.

Figure 1: Asset class monthly returns and standard deviations, August 1990 to July 2006



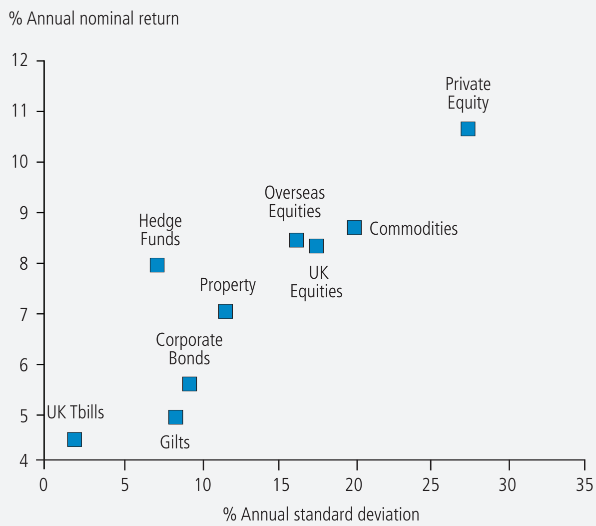
Source: IPF report

These conclusions, of course, relate to a period when property delivered exceptional risk-adjusted returns – something which investors believe will not be repeated in the future. Figure 2 illustrates the interviewees' expectations of return and risk for the mainstream asset classes and the alternatives. The much diminished prospective returns for gilts, corporate bonds and property are the most notable divergences from the historic performances shown in Figure 1.

There are two other important features to the patterns of risk and return illustrated in Figure 2. First, the assumptions portray a 'natural' ordering of risk and return with each asset class expected to deliver similar risk-adjusted returns. Second, hedge funds stand apart in promising comparable returns to equities but with less risk. Investors and advisers were also anticipating hedge funds to be less correlated with the other asset classes than historically.

However, a further and powerful attraction of alternatives – particularly hedge funds – was the potential they gave to skilled fund managers who could deliver an excess return (alpha) far greater than the limited amounts history shows good, active equity fund managers can generate consistently. This has been a major factor behind the shift by investors out of equities into hedge funds.

Figure 2: Asset class annual returns and standard deviations – prospective performances from the survey



Source: IPF report

Past research indicates that some fund managers from the alternative asset classes can persistently generate such alpha over their peers. Many of the investors in our survey were devoting significant resources to identifying such fund managers and the best strategies, and in expecting that this would pay-off, had relatively high performance expectations from their exposures. It is worth noting that during the research, there was a healthy debate between us on how sustainable the delivery of such alpha might be.

Leaving aside this debate, the forward-looking performance assumptions identified in the survey imply a less strong role for property in multi-asset portfolios than indicated by the historic analysis. However, property still features significantly; with implied allocations typically well above current levels. Furthermore, it plays a major role in portfolios across the spectrum of risk appetites. These expected performance characteristics also indicate a significant role for hedge funds in a multi-asset portfolio and a lesser one for equities than currently.

These themes were mirrored, in microcosm, in the strategies investors were adopting. Most had increased their exposures to alternatives and all were anticipating higher allocations over the next few years. The first steps into alternatives had invariably been through private equity, but the focus of recent and current attention was hedge funds. And these shifts into alternatives had been financed through reduced exposures to equities, not property.

Figure 3: UK pension fund exposures, June 2006

	All pension funds %	Top 50 %	£250m-£1000m %
Equities	64	63	68
Bonds (sovereign and corporate)	15	15	16
Index-linked	9	9	6
Property	8	8	6
Other[1]	3	3	1
Cash	2	2	3
Total	**100%**	**100%**	**100%**
% of sample:			
Exposed to property	60	92	63
Exposed to other	43	75	39
Of those invested, % with:			
Property exposure > 5%	82	89	93
'Other' exposure > 5%	16	14	28

Source: IPF report. Original data kindly provided by the WM Company

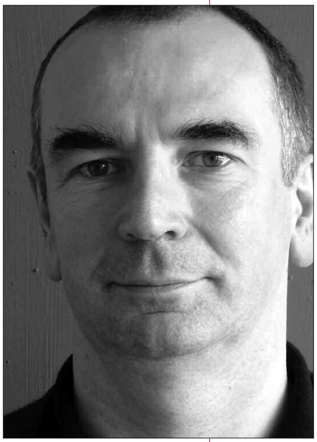
1 'Other' is predominantly hedge funds and private equity

Exposures to alternatives (see Figure 3 for pension funds) are currently around 3% and the discussions with interviewees and other survey evidence indicate that these will roughly double over the next few years. However, whereas investment in property is widely spread and typically at meaningful levels, in alternatives it is much more the preserve of the largest investors – and even here at very modest rates.

In illustrating how equities have been undermined and property unaffected by this shift to alternatives, it is also worth noting the strategies of the pioneering investors in the alternative asset classes. For example, the Yale Endowment has reduced its allocation to equities by 30 percentage points since 1990, a figure matched over the same period by the rise in its exposure to private equity and absolute return/hedge funds. At the same time, Yale's exposure to real assets (largely property but also forestry, oil and gas) rose by 15 percentage points as the allocation to bonds fell by a corresponding amount.

The conclusions of our research therefore were very positive for property. But to end on a thought provoking note, there was some talk amongst some investors of investing in infrastructure – the most bond-like of the alternatives – partly out of property. And to what degree can the best property fund managers persistently generate alpha? If there is significant potential like there has been in hedge funds to date, property will have a special place in a multi-asset portfolio – if not, might the property fund management industry be affected in the same way as its equity counterpart?

Pricing total property swaps: the evolution of market practice



Colin Lizieri, Professor of Real Estate Finance, University of Reading Business School

Colin Lizieri examines the development of the UK property derivatives market

There have been a number of efforts to establish property derivatives markets but, until recently, it has proved extremely difficult to establish markets with critical mass and trading liquidity. The failure of London FOX, along with regulatory constraints that limited the participation of many professional investors and investment vehicles proved a major stumbling block. However, the results of lobbying by industry interest groups – notably by the Property Derivatives Users Association (now the Property Derivatives Interest Group, operating under the auspices of the IPF) – created a market environment where active trading was a possibility. This was reinforced by the 2004 Finance Act, which confirmed property derivatives as falling in the 'standard' derivatives regime.

Since the 2004 Act, the market has grown rapidly, with an estimated £3.7bn notional cumulative trading value by the third quarter of 2006. The dominant form of transaction has been a simple contract-for-difference, over the counter, swap based on IPD total returns and LIBOR. However, more complex forms have emerged, and alternative products such as contracts based on the exchange-traded MSS FTSEpx fund or the Goldman Sachs IPD tracker product have appeared.

In the early days of the development of IPD total returns against LIBOR (both in the Trading Forums that gave potential investors an opportunity to investigate the use of derivatives and in early trading), there appeared to be considerable uncertainty as to the correct pricing principles and pricing levels to be applied. There seemed to be an implicit assumption that there should be a margin over LIBOR – say IPD total returns for LIBOR plus 300 basis points – but little explicit discussion of the basis for this. As a result, the IPF commissioned a team from the University of Reading Business School – Professors Andrew Baum and Colin Lizieri and Dr Gianluca Marcato – to review derivative pricing principles and to survey market participants, in an attempt to shed more light on developments in the UK commercial real estate derivative market. The research was undertaken in late 2005 and early 2006 with the final report published in September 2006. Since then, the market has continued to grow and become more sophisticated. To some extent, then, the survey results represent a snapshot of practice at that time.

Swap pricing models: Theoretical considerations

The starting point for any consideration of swap pricing is to consider a fixed to floating rate interest rate swap – e.g. a three year swap with a notional value of £10m and annual payments. We have an estimate of the future variable rate from LIBOR forward rates – which can be seen as unbiased and efficient estimates of future spot rates and so act as a discount rate for the payments. The recipient of the fixed interest rate receives three fixed payments and (notionally) the £10m contract value. The present value of the payments must equal the notional payments. Let us suppose that the three forward LIBOR rates are 5.25%, 5.50% and 5.75%. The present value of the fixed rate recipient's cashflow is:

$$R(1.0525)^{-1} + R(1.055)^{-2} + R(1.0575)^{-3} + 10{,}000{,}000(1.0575)^{-3} = 10{,}000{,}000$$

The unknown R is therefore £573,136. Thus the fixed rate interest rate is 573,136/10,000,000 = 5.73%. This then becomes the swap rate: given the information available today, both parties have a zero NPV investment. Were this not to be the case, then arbitrage would eliminate any differences.

The situation becomes more complex when dealing with financial market index swaps – for example, a LIBOR-FTSE-100 swap, where one party pays six month LIBOR payments for a set period, the counter-party pays the six monthly return on the FTSE-100 index. At first sight, it might seem that the recipient of LIBOR would need to demand an additional margin to compensate from the higher expected return on the equity index. However, this ignores both risk and arbitrage.

Figure 1: Fixed rate swap leg: zero net present value

Year	Cashflow £	Discount rate %	Discount factor	DCF £
0	-10,000,000	N/A	1.000	-10,000,000
1	573,136	5.25%	0.950	544,547
2	573,136	5.50%	0.898	514,935
3	10,573,136	5.75%	0.846	8,940,518
			NPV:	£0

In terms of risk, the FTSE cashflow is far more uncertain and volatile than the LIBOR leg: risk-adjusted returns must thus be higher. Furthermore, the party receiving LIBOR could, in principle, use the interest payments to borrow money, use the loan to buy shares and then use these to pay the FTSE leg of the swap. If they receive a margin over LIBOR, then this would represent abnormal profit – they could borrow more, buy more shares than were needed to pay the FTSE payments. Neither the FTSE payer and the LIBOR counterparty should be able to make risk-free profits. As a result, the expected margins in equity index-LIBOR swaps are low, with the margins representing the cost of managing the swap and the involvement of any third parties broking or facilitating the deal.

In considering the pricing of a commercial real estate total return swap, a critical question has to be 'why should the principles that govern equity index swaps not apply to real estate markets?'

Property derivatives: A different beast?

There are a number of distinctive features of real estate as an asset that make the pricing of property derivatives more complex. First, high transaction costs and illiquidity make it near impossible to assemble an arbitrage portfolio as described for an equity index swap. Even were it to prove possible, then there is a significant risk of tracking error (that is, of the assembled portfolio not behaving like the reference IPD index) given heterogeneity, high levels of specific risk and large lot size. It might be possible to use a unitised or securitised vehicle – but these are subject to leakage through management and performance fees, are generally geared and, if exchange traded, are exposed to capital market volatility.

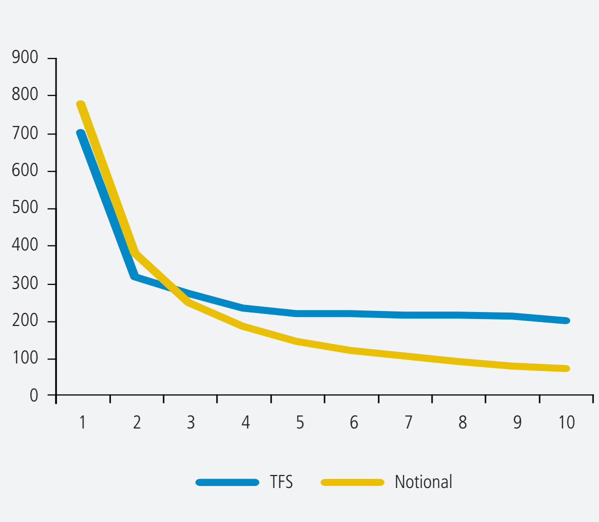
Second, there are issues concerning the nature of the IPD indices themselves – in particular, the fact that they are valuation-based and subject to smoothing. This, allied to strong short-term consensus over return forecasts, means there are strong a priori expectations about property performance over (at least) the first year of the swap. Given that the typical swap length is three years, the zero margin expectation from equity index swaps is unlikely to be reproduced in real estate derivatives. This does not imply that there should necessarily be a positive margin over LIBOR, although most of the market participants interviewed discussed pricing in the context of strong positive expected property returns.

One strong element that emerged from the research was the importance of transaction costs. The impact of high entry (and significant exit) costs is at its greatest with short holding periods. There are thus strong incentives to pay a margin over LIBOR if an investor wishes to gain or increase exposure to the property market for a relatively short period of time. Figure 2 shows the impact of transaction costs on returns for different maturities at September 2006. As can clearly be seen, the friction costs fall away sharply – as do margins.

However, this is not the whole story. As Paul Ogden of CBRE-GFI has pointed out, an investor wishing to reduce exposure to real estate over a short period faces similar transaction cost frictions. These frictions are not necessarily symmetric – for example, the present value of the costs is slightly lower but this is offset by the difficulty of re-acquiring the 'exact' portfolio sold. So the seller might accept LIBOR minus a margin to reduce return exposure while holding the assets. In effect, these friction costs create a spread around LIBOR, a window within which it might be rational to trade.

This model suggests that the pricing of swaps may reflect the balance of supply and demand at that particular time. If there are many more investors seeking to gain exposure to real estate product than those trying to reduce exposure, then one might expect to see positive margins, as it is rational to pay extra to avoid the friction costs faced in the direct, underlying asset market. Similarly, in a market dominated by investors seeking an exit, margins could be negative; at the time of writing, TFS are showing -125bp indicative margins on All Retail Property swaps, for example.

Figure 2: Transaction costs and LIBOR margins



It is important to stress that this does not mean that the observed margins reflect return expectations per se, although there may be short-term momentum effects that do relate to returns. It is more a function of the balance of buyers and sellers in a relatively immature market where critical mass and trading liquidity has yet to be achieved. Although the interviews and survey work in early 2006 did suggest that many market participants still had operated an implicit 'expected IPD–LIBOR' model, subsequent discussions and debates indicate that a more sophisticated approach is prevailing.

Derivative pricing in the future

In little more than three years, the total property returns swap market has gone from being an aspiration to becoming an actively traded and increasingly sophisticated market. This development has been accompanied by a growing understanding of the nature of swap pricing. The IPF research showed that expected-return driven models dominated early pricing practice. These have been replaced by an awareness of the benefits of using swaps to reduce friction costs in the underlying asset market – whether increasing or decreasing exposure to real estate.

As the market grows and the number of players prepared to take contrarian positions increases, it is likely that the margins to LIBOR will shrink. There is still likely to be a wider trading window than that observed in financial market index swaps due to friction costs and inherent property market characteristics. Other intriguing possibilities also emerge, including the use of exchange traded funds for arbitrage, the incorporation of pricing signals from REITs and the development of more complex exotic derivatives.

IPF Survey of European office forecasts January 2007

The Investment Property Forum has produced the results of its first consensus survey of European office market rental forecasts. The survey brings together the forecasts undertaken by European property analysts in much the same way as the IPF's UK Consensus Forecast project has done for a number of years in that market.

At the outset the IPF decided to confine the European Consensus Forecasts survey to office rental value growth in major cities, as it is likely to be impossible at this stage to assemble sufficient forecasts of all sectors across all European countries. But in due course it should be possible to extend the geographical and sector coverage, and ultimately to include total return forecasts.

Potential contributors were asked to send prime office rental forecasts for 24 major European centres. The growth forecasts provided by each organisation were then analysed to provide average ('consensus') figures for each market, together with the statistical ranges of observations around these averages.

This was first done on a pilot basis in spring 2006, when the feasibility of the project was tested with a positive outcome – enough contributions of sufficient consistency were provided to the survey. At that stage the results were confined to the contributors.

The survey collected prime office rental forecasts for 24 major European office centres for the calendar years 2006, 2007 and 2008, and also requested a three-year average forecast for 2006 to 2008 (if individual years were not available), and a five-year average for 2006 to 2010. The survey requested both the percentage annual rental growth rates and also year-end rent levels.

The definition of market rent used in the survey was 'achievable prime rental values for city centre offices, based on buildings of representative size with representative lease terms for modern structures in the best location'. Prime in this case did not mean headline rents taken from individual buildings, but rather rental levels based on market evidence, which could be replicated. All figures included in the survey were required to have been generated by formal forecasting models.

As with its UK Consensus Forecasts project, the IPF's independent position means that it can ensure the unbiased and confidential nature of the survey, by keeping all the data input to this project confidential. In this context, confidentiality means not revealing individual organisations' forecasts to any other party, not revealing the participation of any organisation without their consent and restricting access to individual firms' forecasts to the IPF researchers working on the project.

Data from nine organisations was included in the pilot study survey in spring 2006. A focus group from the initial participants reviewed the outputs and concluded that European Consensus Forecasts would provide a valuable addition to the information currently available to international property investors.

The number of contributors rose to 11 for the full survey which has just been completed, although some others who sent data could not be included due to the timing of their forecasts. The survey is currently restricted to forecasts of calendar-year growth, so that forecasts to mid-year points cannot be included. This should however mean that the update of the data early in 2007 will produce a larger group of contributors.

In order to preserve the confidentiality of individual organisations' forecasts, a minimum sample of four contributions has been agreed for average growth estimates to be shown. In the analysis, growth has been computed as the change in the average forecast rental value of the sample for any given period. For the first full round of the project, these averages have been produced for each of the years 2006, 2007 and 2008, and also annualised over these three years – because some organisations only produce three-year forecasts. Average five-year forecasts have not been published at this stage as for many office centres the samples are not sufficient, but again this situation should be rectified shortly with greater participation.

Figure 1: European office market prime rent forecasts

	Year rental growth forecast % pa			3-year forecast 2006-08 % pa
	2006	2007	2008	
Vienna	1.8	2.5	2.4	2.2
Brussels	0.8	2.1	2.5	1.8
Prague	0.8	2.0	2.2	1.7
Copenhagen	3.5	3.5	2.5	3.2
Helsinki	3.1	4.0	5.3	4.1
Paris CBD	3.4	4.7	4.9	4.3
Paris la Defense	5.1	5.1	1.6	3.9
Berlin	-0.5	1.8	2.6	1.3
Frankfurt	0.4	1.6	4.2	2.1
Munich	1.2	2.0	3.5	2.2
Athens	2.8	2.3	3.0	2.7
Budapest	1.3	1.5	1.1	1.3
Dublin	9.1	4.9	3.5	5.8
Milan	1.5	1.3	2.3	1.7
Rome	2.8	2.9	3.0	2.9
Amsterdam	1.8	2.0	2.2	2.0
Warsaw	2.1	1.1	2.4	1.9
Lisbon	-1.2	0.0	2.7	0.5
Madrid	9.5	5.8	4.5	6.6
Barcelona	5.0	5.1	3.8	4.6
Stockholm	3.2	7.0	6.1	5.4
London: City	13.7	8.1	4.5	8.7
London: West End	13.4	8.7	6.6	9.5
Manchester	8.0	3.3	3.6	5.0

Results highlights

London stands out as the most buoyant European office market over the next three years – not just in 2006, which was at least half over by the time these forecasts were produced, but also in 2007, when both the City and the West End are expected to show growth in excess of 8%.

For 2007, only Stockholm, with a forecast of 7%, comes close to the London market, and the Swedish capital is also expected to grow strongly in 2008. Few other Northern European centres are expected to rise by much more than 2% pa over the next three years, although some revival is expected in Germany and France by 2008. Dublin to some extent shares the UK pattern, with strong current growth tailing off over time, but still looking very healthy for the three years overall.

In Southern Europe, Spain contrasts with its near neighbours. Both Madrid and Barcelona should see growth around 5% over the medium term, while Lisbon in particular looks vulnerable with the lowest three-year average of all the 24 centres covered in the survey. Rome looks slightly more promising than Milan, with a similar level of expected growth to Athens around the 3% mark.

The more established markets of Central and Eastern Europe also appear to have had their day, at least for the time being, with Budapest and Prague registering two of the weaker prospects on the basis of this survey.

Notes

Consensus forecasts further the objective of the Investment Property Forum (IPF) to improve the efficiency of the market. The IPF is extremely grateful for the support those organisations which contributed to this publication, which has only been possible thanks to the provision of the individual forecasts.

The IPF welcomes new contributors for future surveys, so that the coverage of the market participants can be widened. If your organisation wishes to contribute to future surveys please contact Louise Ellison, Research Director at lellison@ipf.org.uk. Please note that subscribers receive a much more detailed set of statistical outputs than those shown in the table above – for each office centre the sample size, median and range of rental values are also provided.

UK Consensus Forecasts February 2007

This quarterly survey looks at property investment market forecasts and offers an insight into the range of forecasts of future property performance gathered from approximately 30 companies including fund managers, property advisers and equity brokers. The survey has become a key indicator of the UK commercial property markets performance expectations.

The total return forecast is 9.0% for 2007, following the 17.9% for 2006 reported by IPD. As with the last quarter there is a marginal increase in the consensus forecast for 2007. For 2008, the consensus has slightly increased to 5.2% up from a total return of 4.8%. A weak total return outlook for 2009 results from forecasts for increases in yields. More forecasters seem to believe that yields will increase in 2009, and indeed the consensus forecast for capital values is for a decline of -0.1%. This poor outlook for capital values is despite rental value growth; hence the conclusion is that yields will soften in 2008 and 2009.

Over 2007 to 2011 the consensus is at 6.2% pa, weaker than the past five years but still a real rate of return for investors.

GDP rose by 0.8% in the fourth quarter of 2006 (first provisional estimate), a faster growth than seen in the last five quarters. Employment and unemployment continue to provide mixed signals. The economy is seeing employment growth coupled with a small rise in unemployment. The housing market seems to be recovering with rising house prices and mortgage applications. The level of consumer debt is considered by some to be a more serious potential problem with the increase in the interest rate. Inflationary pressure is appearing with an RPI increase of 4.4% in December, accompanied by a 3.0% increase in the CPI.

The HM Treasury consensus economic forecasts of January 2007 show a slight increase in the GDP growth forecast to 2.5% for 2007, about trend growth. The Monetary Policy Committee further increased interest rates by 25 basis points at the January meeting to 5.25%, following the similar increase at the August and November meetings.

The demand for investment property remains very strong, with indirect funds continuing to attract large inflows of capital, especially from the private retail investors. Many institutional investors are increasing property weightings in their portfolios. However, the uncertainty about the outlook for property yields and capital values could, in time, reduce the demand and weight of money overhanging the market.

Key points

The total return forecast for 2007 has again increased, with an outlook of real property returns for the next five years.

- Total return in 2007 forecasted at 9.0%, up from 7.6% since the last survey.
- The average total return forecast is 6.2% pa for the next five years, still a real return for investors.
- Average All Property rental value growth is forecasted at 3.1% pa for 2007 to 2011 (inclusive).
- There is more evidence that many forecasters expect property yields to increase during 2008 and 2009, with some forecasts of yield increases in 2007.
- The total return forecast is slightly stronger for 2008 at 5.2%.
- Many forecasters expect capital values to be under threat in 2008 and 2009, with a consensus forecast of -0.1% fall in capital values in 2009.

Rental forecasts by sector

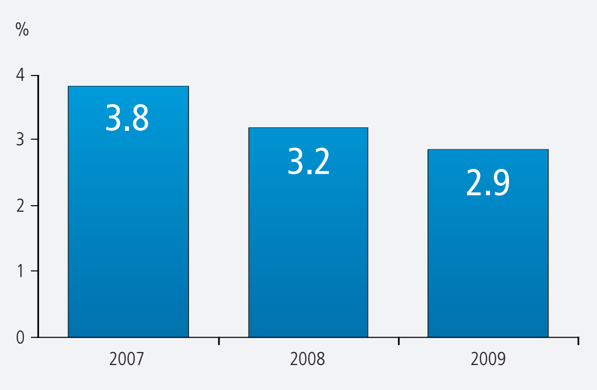
- Over the five-year period 2007 to 2011 (inclusive), offices to show strongest rental value growth at 4.1% pa, followed by retail warehouses at 3.4% pa.
- Pessimism for the 2007 and 2008 prospects for standard shops continues with some forecasts of falls in rental values.
- Sub inflation rental value growth forecasted for standard shops, shopping centres and industrial on the five-year view.
- For the next three years, London offices will be the strongest sector for rental value growth.
- London offices market recovery expected to continue in 2007 and 2008, with rental value growth of over 5.7% pa in West End offices and 4.2% pa in City offices for the next five years.

Sector returns forecasts

- All sectors will give real returns for 2007 to 2011.
- Sector total return forecasts show offices as the best performing sector for 2007 with a total return of 12.6% followed by industrial at 8.3%.
- On the five-year view, offices remain the best performing sector at an average total return of 6.9 % pa.
- Central London offices will perform outstandingly in 2007, with West End average forecast of 26.0% total return driven by rapidly rising rents.
- West End (11.2% pa) and City offices (10.8% pa) are expected to outperform all five of the main sectors on the five-year view.
- The weakest sector over the next five years is likely to be standard shops and shopping centres.

The average forecast is for 3.8% rental value growth in 2007, a 0.3% increase on the November 2006 forecast of 3.5%. For 2008 the average forecast is increased to 3.2% rental value growth.

Figure 1: All property rental value growth forecasts

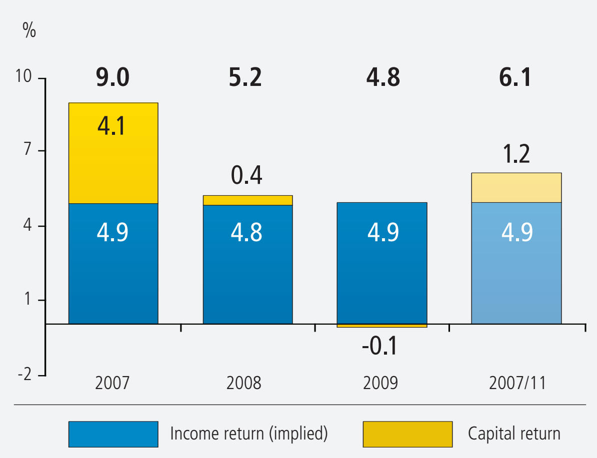


Thereafter, the consensus is for rental value growth of 2.9% in 2009. The annual average for the five years 2006 to 2011 is for 3.1% pa rental value growth.

The consensus outlook is for marginal real rental value growth for five years, when set against an inflation expectation of 2.5% pa.

The consensus for 2007 has increased to 9.0%, derived largely from rental value growth.

Figure 2: All property total return forecasts



The consensus is for much lower returns for 2008 and 2009, with just 5.2% and 4.8 % total returns respectively. All sectors contain some forecasts of falling capital values for 2008. The consensus is that capital values will fall by -0.1% in 2009.

All property survey results by contributor type (Forecasts in brackets are November 2006 comparisons)

Figure 3: Property advisors and research consultancies (16 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Maximum	4.8 (4.4)	4.7 (4.4)	4.8	6.3 (5.0)	2.5 (2.0)	2.8	11.1 (9.5)	7.4 (7.5)	7.3
Minimum	2.8 (3.2)	2.5 (3.0)	2.0	1.3 (-1.6)	-1.9 (-4.9)	-2.5	6.0 (3.2)	2.9 (0.1)	2.5
Range	2.0 (1.2)	2.2 (1.4)	2.8	5.0 (6.6)	4.4 (6.9)	5.3	5.1 (6.3)	4.5 (7.4)	4.8
Median	3.9 (3.5)	3.5 (3.5)	3.3	3.8 (2.8)	0.2 (0.0)	0.7	8.7 (7.7)	5.0 (5.0)	5.8
Average	**3.9 (3.6)**	**3.5 (3.5)**	**3.3**	**3.7 (2.1)**	**0.5 (0.0)**	**0.4**	**8.6 (7.1)**	**5.3 (5.1)**	**5.3**

Figure 4: Fund managers (14 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Maximum	4.8 (4.0)	4.4 (4.5)	5.6	7.1 (6.3)	4.5 (4.6)	2.8	12.0 (11.0)	9.1 (9.0)	7.4
Minimum	2.8 (2.6)	0.7 (1.5)	0.2	-0.1 (-1.0)	-3.8 (-5.0)	-3.0	5.1 (4.0)	1.0 (0.5)	2.0
Range	2.0 (1.4)	3.7 (3.0)	5.4	7.2 (7.3)	8.3 (9.6)	5.8	6.9 (7.0)	8.1 (8.5)	5.4
Median	3.6 (3.0)	2.6 (2.3)	2.1	4.2 (3.1)	-0.3 (-0.6)	-0.7	9.3 (7.9)	4.5 (4.4)	4.4
Average	**3.6 (3.2)**	**2.7 (2.7)**	**2.4**	**4.3 (2.6)**	**-0.5 (-0.9)**	**-0.9**	**9.2 (7.6)**	**4.4 (4.1)**	**4.1**

Figure 5: Equity brokers (4 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Maximum	5.4 (5.0)	4.3 (3.0)	3.0	7.0 (7.0)	4.0 (2.0)	2.6	12.0 (12.0)	10.0 (7.0)	7.1
Minimum	4.0 (3.6)	3.0 (3.0)	3.0	3.0 (2.8)	2.0 (1.5)	0.0	7.0 (7.0)	5.0 (5.0)	4.0
Range	1.4 (1.4)	1.3 (0.0)	0.0	4.0 (4.2)	2.0 (0.5)	2.6	5.0 (5.0)	5.0 (2.0)	3.1
Median	4.2 (4.1)	3.9 (3.0)	3.0	5.7 (3.6)	3.4 (1.9)	0.4	10.2 (8.5)	7.8 (6.7)	5.2
Average	**4.5 (4.2)**	**3.8 (3.0)**	**3.0**	**5.3 (4.3)**	**3.2 (1.8)**	**0.9**	**9.8 (9.0)**	**7.7 (6.3)**	**5.4**

Figure 6: All forecasters (34 contributors)

	Rental value growth %					Capital value growth %					Total return %				
	2007		2008		2009	2007		2008		2009	2007		2008		2009
Maximum	5.4	(5.0)	4.7	(4.5)	5.6	7.1	(7.0)	4.5	(4.6)	2.8	12.0	(12.0)	10.0	(9.0)	7.4
Minimum	2.8	(2.6)	0.7	(1.5)	0.2	-0.1	(-1.6)	-3.8	(-5.0)	-3.0	5.1	(3.2)	1.0	(0.1)	2.0
Range	2.6	(2.4)	4.0	(3.0)	5.4	7.2	(8.6)	8.3	(9.6)	5.8	6.9	(8.8)	9.0	(8.9)	5.4
Std. Dev.	0.6	(0.5)	0.8	(0.8)	1.1	1.8	(2.0)	2.1	(2.2)	1.6	1.8	(1.9)	2.0	(2.1)	1.5
Median	3.8	(3.5)	3.4	(3.2)	3.0	4.1	(3.0)	0.4	(0.1)	-0.1	8.9	(7.8)	5.0	(5.0)	4.8
Average	**3.8**	**(3.5)**	**3.2**	**(3.1)**	**2.9**	**4.1**	**(2.6)**	**0.4**	**(-0.1)**	**-0.1**	**9.0**	**(7.6)**	**5.2**	**(4.8)**	**4.8**

Notes

1. Figures are subject to rounding, and are forecasts of All Property or relevant segment Annual Index measures published by the Investment Property Databank. These measures relate to standing investments only, meaning that the effects of transaction activity, developments and certain active management initiatives are specifically excluded.

2. To qualify, all forecasts were produced no more than three months prior to the survey.

3. Maximum: The strongest growth or return forecast in the survey under each heading.

4. Minimum: The weakest growth or return forecast in the survey under each heading.

5. Range: The difference between the maximum and minimum figures in the survey.

6. Median: The middle forecast when all observations are ranked in order. The average of the middle two forecasts is taken where there is an even number of observations.

7. Average: The arithmetic mean of all forecasts in the survey under each heading. All views carry equal weight.

8. Standard deviation: A statistical measure of the spread of forecasts around the mean. Calculated at the 'all forecasters' level only.

Survey summary results by sector

Figure 7: Sector summary

	Rental value growth %				Capital value growth %				Total return %			
	2007	2008	2009	2007-11	2007	2008	2009	2007-11	2007	2008	2009	2007-11
Office	6.8	5.4	3.7	4.1	7.3	1.8	0.0	2.0	12.6	6.8	5.0	6.9
Industrial	1.7	1.9	2.0	1.9	2.6	-0.6	-0.5	0.3	8.3	5.0	5.2	6.1
Standard Shops	1.8	1.5	1.6	1.8	1.2	-1.2	-0.6	0.1	5.7	3.3	3.9	4.8
Shopping Centres	2.7	1.9	2.1	2.4	2.2	-0.6	-0.6	0.6	6.9	4.0	4.4	5.3
Retail Warehouses	3.0	3.0	3.3	3.4	2.7	0.5	1.2	1.9	7.0	4.7	5.6	6.2
All Property	**3.8**	**3.2**	**2.9**	**3.1**	**4.1**	**0.4**	**-0.1**	**1.2**	**9.0**	**5.2**	**4.8**	**6.2**
West End Offices	10.4	7.2	5.0	5.7	11.5	3.5	0.7	3.1	16.0	7.9	4.9	7.6
City Offices	11.6	6.9	2.7	4.2	12.2	2.9	-2.2	1.4	17.2	7.8	2.6	6.5

Of the 34 contributors at the All Property level, 32 provided sector forecasts, (16 property advisors, 14 fund managers and 2 equity brokers). In addition, 24 contributors provided West End office and City office segment forecasts, (11 property advisors, 11 fund managers and 2 equity brokers).

Acknowledgements

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Property advisors (includes research consultancies): Atisreal Ltd, CB Richard Ellis, Colliers CRE, Cluttons, Cushman & Wakefield, DTZ Consulting & Research, Experian Business Strategies, Fletcher King, GVA Grimley, IPD, Jones Lang LaSalle, King Sturge, Knight Frank LLP, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited, Unnamed

Fund managers: Cordea Savills, F & C Property Asset Management, Henderson Global Investors, HSBC Specialist Fund Management Ltd, ING REIM (UK) Ltd, Invista REIM, INVESCO Real Estate, Morley Fund Management, Prudential Property Investment Managers, RREEF Research, Schroder Property Investment Management, Scottish Widows Investment Partnership, Standard Life, Unnamed

Equity brokers: Exane BNP Paribas, Merrill Lynch, UBS, Unnamed

Building an Olympic legacy

What benefits is the UK likely to get from hosting the Olympic Games in 2012? Freelance journalist Tim Horsey reviews a recent IPF lecture.

Ralph Luck, Director of Property for the Olympic Delivery Authority (ODA), believes that the Olympic project represents a massive opportunity for the private sector to benefit from the regeneration of a major part of East London: more than a million square feet of B1/B2 space set to continue in use after the games.

Preparations are already well advanced on legacy projects, and the ODA is in the last throes of negotiations to appoint the joint developer to work alongside Westfield on the Stratford City mixed use project. The other major 'external' legacy will be the Olympic Village of just under 4,000 homes, which will not be permanently available for occupation until after the games. Luck feels it is important that the number of competing developments coming on stream at that time is limited, as overall estimates of the total number of homes to be created are as high as 40,000.

Stephen Jordan, Managing Director of Stations and Property for London & Continental Railways (LCR), partners in the Stratford City development, sees it as crucial that they have adopted a partnership approach in establishing development principles; so creating a positive planning context in what is an evolving local environment. Since the original Regeneration Agreement in 2002 for developing Stratford City's 125 acres, aspirations have changed considerably and the planned density has now almost doubled to 13.5m sq ft. The scheme is currently intended to comprise 4,800 homes, 5m sq ft of offices, 1.5m sq ft of retail/leisure and 2,000 hotel rooms.

Hosting the Olympics means accelerating the provision of transport infrastructure (the DLR extension is set to be completed early in 2010) and a faster planning process. But on the other hand, it has delayed the development of commercial zones and caused greater congestion around the site than would otherwise have occurred. This means that most of the commercial development will not now be completed until after the Games.

The long-term viability of Stratford City is seen as a key issue by all concerned, and there has been strong collaboration between LCR and the ODA so that the Olympics and Stratford City are being treated as one project. At the peak of construction there are likely to be 20,000 workers in the vicinity, but Jordan believes any expectations of increased construction costs should be unjustified.

He also insists that press stories which reported that Eurostar trains would not be stopping at the Stratford international station, were unfounded. The station will be fully operational around 2009-10, once the huge amount of construction traffic in the area has subsided and at that point, domestic Channel Tunnel Rail Link services will be running as well. Meanwhile in 2006 John Lewis committed to a retail tenancy in Zone 1, so that other anchor store opportunities are now under intense competition.

Richard Tibbott, Chairman of Locum Consulting, advisor on potential uses of facilities after the Olympics, believes it may be worth taking greater risks with the stadium facilities than plans to hand the main arena to a local Premier League football team would represent. He feels this would not be a world-class solution but a pragmatic compromise. For him a secure legacy will mean having a sustainable destination brand, which might for instance involve major athletics events being held in the arenas. Alternative visions include use as a venue for youth games, academies mentored by past Olympians, or a sports resort providing an attractive holiday destination. In any event, a successful legacy needs action now to build up brand awareness.

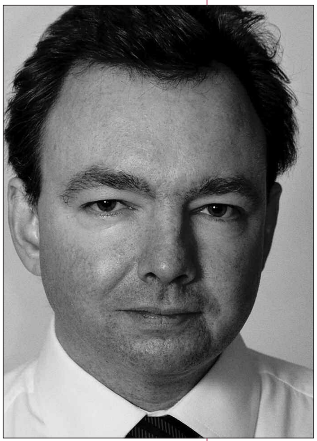
Eamonn D'Arcy, of the University of Reading Business School, examined the legacy question by looking at the impacts of recent major sporting events on other world cities. In previous games, gains were expected in terms of infrastructure, urban regeneration, economic competitiveness and international status. These were achieved with varying success for Barcelona, Athens, Turin and Manchester - but for London in 2012 the last two are clearly not major issues.

Tangible benefits from past games have included events facilities, transport and urban infrastructure. The intangible benefits are by definition more difficult to quantify, both in terms of their degree and also how far their effects spread through the country as a whole. There are also questions about how long after such events their influence on tourism and the wider economy persists.

D'Arcy believes that compared to recent European experience, London differs in not having significant urban redevelopment goals – there are no acute problems which need solving – and because the continental cities were all much smaller. Barcelona, in particular, built effectively on its Olympic legacy, at least over a 10-year time horizon, with further projects following on after 1992. Athens in contrast has suffered from not having clear plans for some of the facilities created.

In Barcelona and Manchester, property market players collaborated closely with the public sector, leading to relatively high returns on private capital. Private returns have also been high in Athens, but mainly due to speculative gains in an unstructured environment. Only in Turin have private sector returns been low – here because of business's weak bargaining position with the public authorities.

Foreign affairs

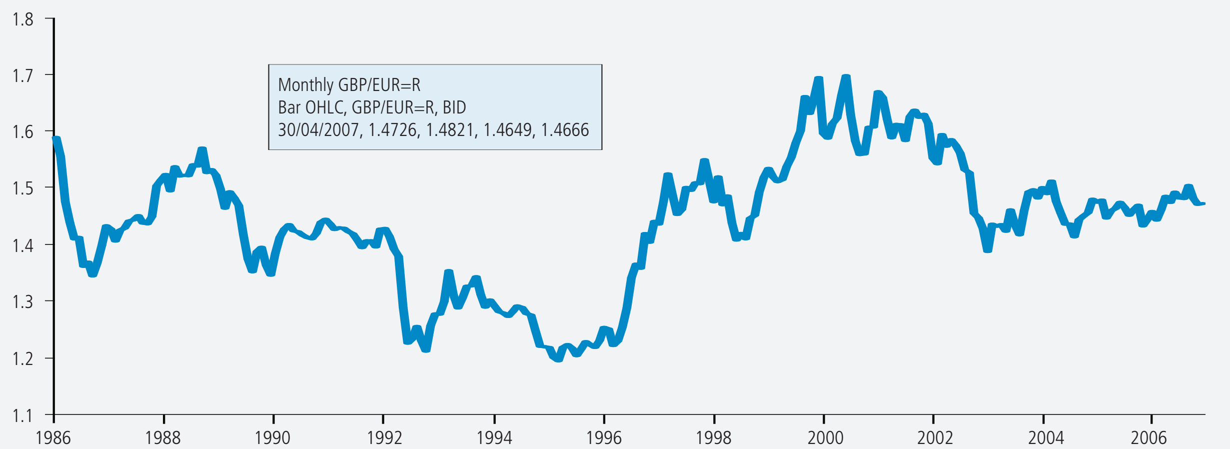


James Stretton, Director, JC Rathbone Associates Ltd

James Stretton looks at the ups and downs of currency fluctuations.

As more property companies and funds seek the enhanced yields of overseas markets, attention naturally focuses on the associated foreign exchange risk implications. While volatility in the foreign exchange markets has, of late, been relatively low, there is, of course, no guarantee that these benign conditions will continue. The GBP/EUR chart below shows the comparative calm of the last three years against the relative volatility of the preceding years. We have chosen to represent the exchange rate as GBP/EUR, rather than the market convention of EUR/GBP since for most readers (as also for most currency traders if the truth be known!) this will be more meaningful.
The recent relative stability of sterling against the euro, compared to the sharp sterling weakness as the UK wrestled with – and lost – its ERM membership in 1992, and the sharp sterling strength as the markets fell quickly out of love with the euro almost immediately after its inception, has prompted relatively little comment, since stable currency pairs rarely attract attention.

Figure 1: GBP/EUR Spot rate – monthly close



Source: Reuters

Some would say that the UK has achieved the best of both worlds, with GBP/EUR volatility at a remarkably low level without the unacceptable risk – from the perspective of a 'one size fits all' monetary policy – of eurozone membership. We should however reiterate that recent conditions in GBP/EUR have been extraordinarily benign.

As an aside, it is worth noting that levels of implied volatility of EUR/USD in the foreign exchange options market remain higher than those of GBP/USD. Although political enthusiasm for the UK's joining the euro has ebbed virtually to the point of extinction, with time it will, doubtless, resurface. Enthusiasts would do well to note that such a move, although by definition reducing GBP/EUR volatility to zero, would actually increase volatility against the dollar – the international currency of trade. For an economy as open as the UK, it is not at all clear that is a price worth paying.

For the UK investor in the eurozone, perhaps the greatest risk would be some sort of political crisis in Europe, although it is hard to imagine one that would lead to a meltdown of the currency. On the contrary, an increase in the GBP/EUR exchange rate is more likely to be brought about through a resurgence in the value of the USD. Sterling tends to track its value such that a strengthening dollar against the euro tends, albeit to a lesser extent, to coincide with a strengthening pound against the euro.

The USD has received a battering on the exchanges in recent months. While there are a number of reasons to sell the greenback, not least the twin current account and public sector deficits, with the (very debatable) perception in the market that the Fed is at the end of its tightening cycle and the persistent rumours that the Chinese are about to diversify their foreign exchange reserves, the dollar doomsters' arguments are well-rehearsed and, as such, have been thoroughly absorbed by the markets. In short, with so much bearish sentiment, it is not surprising that so far this year, the dollar has actually appreciated. Even so, with Germany's economy picking up strongly and euro interest rates rising, an argument for a sustained recovery in the dollar may appear to lack credibility from a short term perspective. Property, however, is rarely a short term investment and any investors who remain exposed to a weaker euro would be well advised to take advantage of any short term strength in the single currency in order to effect hedging at a potentially advantageous rate.

Natural hedges

Given that the vagaries of the currency markets have the potential to adversely affect the sterling value of a euro-denominated investment, it is reasonable to ask what can be done. Particularly for larger property companies investing on their own account, hedging against adverse currency movements is often relatively easy. Denominating term debt in the same currency as the asset provides a natural hedge, while many companies are in a position to provide equity through the use of a foreign currency-denominated overdraft facility which, again, acts as a natural hedge.

Retail investors and enhanced returns

For property funds however, particularly those offering investment opportunities for retail investors, equity invested will be at risk from a depreciation in the currency of the investment (often euro) versus the investors' currency of account (often sterling or the dollar).

In such a case, careful consideration should be given to hedging the foreign exchange exposure with derivative instruments. There is a fairly widespread assumption that hedging against foreign exchange risk always involves a cost. However, if interest rates in the currency of the investment are lower than those of the accounting currency, investors will actually see their return enhanced through locking into the current foreign exchange rate. For example, UK-based investors into the eurozone currently enjoy a yield enhancement of some 1.5% as a result of protecting themselves against foreign exchange risk.

Some managers of property funds with retail investors have said that not hedging is a deliberate policy since the managers' anticipation is that the euro will appreciate against the pound. That is a perfectly reasonable view; however, if it is genuinely felt, it should be expressed in the relevant prospectus so that investors have a full understanding of what they are committing themselves to. The vast majority of retail investors and, indeed, a large number of – particularly US-based – institutional investors leap at the chance to hedge foreign exchange risk on overseas property investment.

The significance of credit

Although the market currently pays UK investors to hedge their investments wherever interest rates are lower than those in the UK, for example in the eurozone, a crucial factor in the hedging process is that of credit. With the exception of bought vanilla options, a feature of all foreign exchange hedging products is that they are consumers of this scarce resource.

Particularly in the case where a 'beauty parade' of banks is invited to tender for the provision of debt facilities, lenders will nearly always be inclined to offer more generous terms on a credit line to hedge foreign exchange risk if the hedging line is negotiated at the outset as part of the package for the term debt facility. Otherwise, a facility ends up being negotiated without allowance for forex hedging and the subsequent consumption of credit for hedging purposes eats into the debt facility, reducing the fund's ability to gear up its equity. This point is particularly relevant for funds with an aggressive forecast IRR.

Hedging anticipated returns

The hedging of anticipated returns, given their unpredictability in terms of both timing and quantum, requires a high degree of flexibility to be incorporated into any hedging strategy. In practice, such flexibility can only be achieved through the use of 'long only' option strategies, though there are various means by which option premium can be reduced or deferred.

A false sense of security

Many investors, particularly in Eastern Europe, assume wrongly that by purchasing property in euro and charging euro-denominated rents they will be immune from currency risk. Counter-intuitively, this is not the case, since, should the local currency devalue against the euro, the property will have a tendency to become 'over-rented.' The better the tenant and the longer the lease, the more resistant will be the property to a reduction in value. However, property let on shorter leases to less creditworthy tenants will tend to trade more in line with property that is bought, sold and let in local currency. Unfortunately, in many countries where the market perceives there to be a serious risk of potential devaluation, interest rates are significantly higher than in the UK for that very reason. This implies a commensurate cost to any hedging strategy and it is currently impractically expensive to hedge property investment in Hungary, for example, where the market is trading on the basis of a 25% chance of a depreciation in the EUR/HUF rate from 253.60 to above 324.20 over the next three years. In such circumstances, the foreign exchange risk can only be avoided by not investing in the country. That said, short term protection could be achieved through the purchase of options if there was a perception, not yet in the market, that the domestic currency was about to come under pressure.

To hedge or not to hedge

The benefits of hedging must be considered against the cost, either in terms of option premium or credit usage. Investors are often prepared to forgo some potential return in exchange for protecting their original investment so those funds offering investors the choice of being hedged will typically attract capital more easily than those that do not. However, as some investors regard the foreign exchange exposure as being desirable as part of a balanced portfolio, many funds are now offering 'hedged' and 'unhedged' investor sub-classes, in order that investors may choose whether or not to hedge their foreign exchange risk.

Finally, whatever hedging structure is chosen, rates should be independently benchmarked against the market, in order to ensure competitive pricing. This is particularly important when more complex, option-based hedging structures are being considered, as these inevitably lack transparency compared with simpler structures.

General round-up

Forum News

Executive Director

Amanda Keane, IPF Executive Director, leaves the IPF in June after nine years with the organisation. Amanda, who returned from maternity leave in January, will be supporting the IPF Management Board with the recruitment of her replacement and will ensure a smooth transition.

Of her departure Amanda said:

"My decision to resign was certainly not taken lightly. As my personal circumstances have changed I can no longer give the role the full commitment it deserves, despite my very best efforts. I am very keen to continue to work playing an active role in an industry I hold very dear and plan to identify opportunities which are a better fit with the demands of a young family. It has been an absolute pleasure working at the IPF and I will miss it dearly. I leave behind an organisation in its prime and the future can only be positive with strong new team of directors to drive it forward."

IPF Executive

We welcome two new members of staff to the IPF Executive.

Louise Ellison joined us on 1 March 2007 as the new research director. She was formally Research Director for C-SCAIPE (Centre for Sustainable Communities Achieved through Integrated Professional Education) at Kingston University School of Surveying. Louise is a chartered surveyor with more than 15 years experience of property research, holds a BSc Estate Management and an MPhil from LSE.

Louise will take the IPF Research Programme (2006-09) to even greater success, building on the strong foundations of IPF research, established by the IPF/IPF Educational Trust Joint Research Programme (2003-06).

Christopher Naughton also joined the team in late March as the new education director. Previously with the Chartered Institute of Linguists, Chris will be responsible for both the informal CPD programmes both in London and the regions and also the formal post-graduate Investment Education Programme.

Chris replaces Sabrina Wisner who left the IPF in February to take up a position with Accenture.

IPF Annual Lunch 2007

At this year's IPF Annual Lunch, Dr Paul McNamara was awarded life membership of the Forum for his exceptional contribution to the work of the Forum and the property investment industry. Paul spearheaded the development of property derivatives, raised awareness of the importance of sustainability and also led the Forum's research agenda.

At the lunch, current Chairman, Ian Womack of Morley Fund Management, said:

"His vision and initiative in looking at the way the market may move and then the energy and enthusiasm with which he converts this to reality is remarkable. The board was unanimous in making this award."

Paul, who was completely taken by surprise at the lunch, said, "I would like to thank both the members of the Management Board of the IPF for bestowing such an honour upon me and my friends and colleagues at PRUPIM, especially Martin Moore, for helping me make the contributions to Forum life that I have made over the years."

In addition, at the lunch the IPF Diploma was awarded to the following individuals who have successfully completed the Advanced Education Programme:

- Vikram Aggarwal – HSBC Specialist Investments
- Matthew Allanson – Legal & General Property Limited
- Kevin Douglas – Inverthorn Capital Ltd
- Beatrice Guedji – Grosvenor Continental Europe
- Brian Kelly – Standard Life Investments Ltd
- Keith Manning – BP Investment Management Limited
- Dan Nicholson – Quintain Estates and Development PLC
- Martin Paul – Bedell Group
- Ilan Sebba – Allenbridge Group Plc
- Andrew White – Kier Property

Two prizes were also awarded for outstanding performance. Vikram Aggarwal of HSBC Specialist Investments was the winner of the John Whalley prize for the best performance overall among those who qualify for the Diploma and Martin Paul of Bedell Group won the module prize for the best performance in any one module delivered during the year.

Amanda Keane, IPF Executive Director, commented, "We are delighted to be able to award the IPF Diploma to yet another strong cohort of students. If you look back over the last seven years of our education programme the list of diplomates is starting to look like a who's who of property! This illustrates the central role the IPF is able to play in providing targeted investment education to its members."

The programme, renamed the Investment Education Programme in 2006, is the Forum's formal modular course aimed at busy professionals who want flexible education covering property investment and finance. Since its launch in 1999, more than 400 individuals have participated from a wide variety of organisations with over 80 students now having been awarded the full IPF Diploma.

The course is provided by Cambridge International Land Institute (CILI) on behalf of the IPF.

Special Interest Groups:

- *Property Derivatives Interest Group (PDIG)*

The Property Derivatives Interest Group continues to grow and had its second trading forum breakfast on 27 February 2007. Presentations were made by Ian Cullen of IPD and Tony Key of Cass Business School. Both these, together with the results of the trading forum, can be downloaded from the IPF website.

- *Sustainability (SIG)*

The IPF/IIGCC Sustainability Interest Group also held its second breakfast event in February at which Ed McCauley, Diligentia; Mathew Tippett, Upstream and David Shiers, Oxford Brookes University presented their thoughts on how to make assets 'greener' and therefore more financially attractive.

The presentations made at this event can be downloaded from the IPF website.

Regions

IPF presence in the regions continues to grow with around 25% of its members based outside of London. The regional boards chaired by Fiona Morton of Ryden in Scotland, Andrew Quinlan of Pinsent Masons in the North and David Allen of Atisreal in the Midlands work together with the Executive to put together a range of social and educational events. Four events have already taken place in the regions this year and have been very well attended with an exciting programme of other events planned for the rest of the year.

Research

Both the UK Consensus Forecast and the European Office Consensus Forecasts were recently published. These can both be downloaded from the IPF website.

Two major research projects have also recently been published:

- Index Smoothing and the Volatility of UK Commercial Property revisited
- Risk Reduction and Diversification in Property Portfolios

Members can download the Executive Summaries for both these projects from the IPF website and purchase the full report at a discounted rate.

In addition, two further projects will shortly be published:

- Planning policy and retail property market performance in English towns and cities – due spring/summer 2007
- Asset allocation issues in the modern world – due spring/summer 2007

Property Industry Alliance

The Property Industry Alliance (PIA) met again on 6 March. Among the actions was the establishment of a new sub group designed for members of the PIA to work together to improve the coherence and performance of the industry on sustainability and particularly energy efficiency and carbon reduction matters. The Green Property Alliance (GPA) as it will be known, aims to provide a framework to share information about sustainability projects, avoid duplication and play to the strengths of particular members and, where possible, to achieve collective buy-in to their implementation. Where gaps in coverage by members' work are identified, the group will commission specific projects. Key to the groups remit will be the presentation, where possible, of a united front in negotiations with Government. The GPA will focus initially on orchestrating a pan-industry response to the Government's implementation of the Energy Performance of Buildings Directive. In addition, it plans to produce a framework for the property industry to follow in the commissioning of new builds that will deliver low energy/low carbon buildings which will serve a similar purpose to the Government's recently published Code for Sustainable Homes.

The work from the PIA REITs committee continues under the chairmanship of Ian Coull. Its aim is to make sure that the legislation and regulation of REITs continues to move forward and to continue to improve the environment for all property-owning investment vehicles.

The PIA's Occupier Satisfaction Group also reported. The results of the study will be available later in the year.

Future dates for your diary

Midlands Region Annual Lunch 2007

20 April 2007: Birmingham (Burlington Hotel)

IPF Annual Dinner 2007

27 June 2007: London (Grosvenor House)

Annual half-day Conference 2007

13 September 2007: Edinburgh (Radisson SAS)

Midlands Region Annual Dinner 2007

18 October 2007: Birmingham (ICC)

Northern Region Inaugural Dinner 2007

14 November 2007: Manchester (The Lowry Hotel)

IPD/IPF Annual Conference 2007

22-23 November 2007: Brighton (The Grand)

British Land – a new era

Stephen Hester, Chief Executive, British Land

Alex Catalano talks to Stephen Hester about his latest move.

From March, British Land's chief executive, Stephen Hester, will look out over Hyde rather than Regent's Park. The UK's largest real estate investment trust has moved headquarters from its Nash terrace to new offices near Marble Arch.

"The business can be more effective in modern offices than in offices which should – and will – be converted back to residential," says Hester. It's also a marketing move: the new HQ, York House, is a British Land development. The subliminal message is: 'We provide modern offices for customers'.

"Real estate came late to the customer-is-king mantra. I believe it is very important that strategy and execution start with how customers are successful, how can we help them to be successful? Then we have best chance of making money," says Hester.

The shift from a three-storey Georgian rabbit warren to two floors of open-plan offices, neatly epitomises how much British Land has changed since Hester arrived just over two years ago. In that period he has reshaped the company, recycling over £3bn of property.

Out went British Land's residential and industrial holdings, as well as high street shops, provincial offices and business parks. In came more central London offices and out-of-town retail, a big chunk via the £811m acquisition of Pillar Property in 2005. British Land's £16.4bn portfolio is now tightly focused on these two sectors.

The company has changed in other ways, too. It now reports quarterly and there has been a complete change of guard at board level, culminating in Sir John Ritblat's move from chairman to Honorary President last December. There are new young faces on the management team as well. In January, British Land converted to a REIT, a move that means its UK rental income and capital profits will now be largely tax free. And it's all been achieved smoothly.

"When I set out to do this, I wasn't thinking in terms of changing British Land. I was thinking very carefully about the market in which we operate and compete, and how that is changing and how to be most successful," says Hester.

The 'big-picture angle' is that mature economies like the UK's are increasingly driven by service industries. "They create added value through people, and the space that people occupy has become more important in terms of its appeal, aiding teamwork, and how a company presents itself to clients."

Hence British Land's concentration on the UK's service hotspot, central London – almost all the company's £6bn office portfolio is here. It is playing the property cycle, developing 4m sq ft in a market that is in its second year of rental growth. This includes extending its Broadgate estate in the City with two new buildings: 201 Bishopsgate and a 35-storey tower.

"Towers now have a bigger role to play. The dominant space takers in 1980s and 90s were big investment banks who wanted big trading floors. Broadgate has become increasingly diverse as other services flourish, such as lawyers, accountants and architects trading from smaller floor plates," says Hester.

As well as building new space, British Land is freshening up existing properties, like Meadowhall shopping centre near Sheffield. "We are spending the thick end of £100m expanding it. One half will go on remodeling one wing: Sainsbury's has moved out and we're bringing in Next and Primark as anchors, which will improve footfall. The shift reflects changing customer needs," says Hester. The other half is going on refurbishing public parts.

Meadowhall is in British Land's books at £1.6bn and Hester wants to bring in other investors, perhaps by creating a fund or REIT– the exact route is being mapped out. "We are constantly looking at our standing investments, whether they are the best use of shareholders' money. If we think we can use the capital more effectively elsewhere, we will sell."

Hester has two simple rules: "One: whatever we do, we should be better than the next guy. Two: it should have a good chance of making money for shareholders. In real life these hurdles are more difficult than they look."

These rules drove the reshaping of the portfolio and have also kept British Land firmly focused on the UK, except for PREF, its European retail warehousing fund. This was acquired along with Pillar and BL invested another £164m in it. "We saw an international opportunity in a sector that was just developing in Europe. We have a dominant market position in the UK that can be leveraged, and are convinced returns will stack up." says Hester. "We went from nothing to the biggest player in out of town retail in Europe."

However, other ventures abroad are unlikely. "There are not that many geographical areas and types of property where I am convinced that we have something special to bring and returns haven't been beaten down," says Hester. "Real estate is unlike other businesses in that there are no scale economies in going global. And there are few true brands in real estate – occupiers don't care who owns the buildings, just what they cost."

Equally, British Land is unlikely to stray too far into other property sectors. "Although we will leverage our expertise, if there are enough connections to keep our hand in. We recently bought a bunch of restaurants, TGI Fridays, all on retail parks. We see linkages there," Hester explains.

The switch to REIT status has cost British Land £325m in entry charge, but liberated it from a £1.6bn of deferred taxes. The new tax-efficient regime makes it easier for British Land to recycle its capital.

"Incredible forces of globalisation have come to bear on property market. Real estate has been through an unprecedented period of repricing – that has been true of all assets that have dependable cash flow and asset backing," Hester says.

"We are moving into a market period where real estate returns to being a normal industry. The market is fiercely competitive – gains don't come for free. You have to work hard to make a good living."

Hester delivered a similar message when he reported British Land's third-quarter results in February. The first since British Land became a REIT, they showed the company outperforming Investment Property Databank's index on rental growth, but a lower-than-IPD rise in the portfolio's value of 7.7% for the nine months to December. Hester's warning sent a shiver through the sector's share prices.

"I knew what I said would be scrutinised, but I decided not to pull our punches. My view is that the best policy is to tell it how you see it, to all audiences. From time to time, you will scare people, or make people happy, depending on what they want to hear," Hester says, adding: "Maybe I'm just making a merit out of being blunt."

STEPHEN HESTER

"When you come into a new industry it's important that you are able to learn quickly, so the people you make decisions for and with think you are up to the job," says Hester.

As he acknowledges, Stephen Hester did not come to British Land at 46 with an extensive knowledge of the real estate market. He came from Abbey, where as chief finance and then operating officer he had spent the previous two years filling in a black hole left by the previous regime.

Before Abbey, Hester spent 20 years as an investment banker at Credit Suisse. His first job, on joining from Oxford, was assistant to the head of the bank.

"Credit Suisse was one of the original developers of Canary Wharf. I remember going with my boss, as a 22-year old, to a meeting with Margaret Thatcher to plead for special tax status for Canary Wharf," says Hester. Serendipitously, British Land now owns a 10% stake in the Docklands financial complex.

"As a corporate financier, I also touched on real estate in various ways. In mid 1980s I was an advisor to British Land. I got to know the company as I did various financings for them," explains Hester.

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