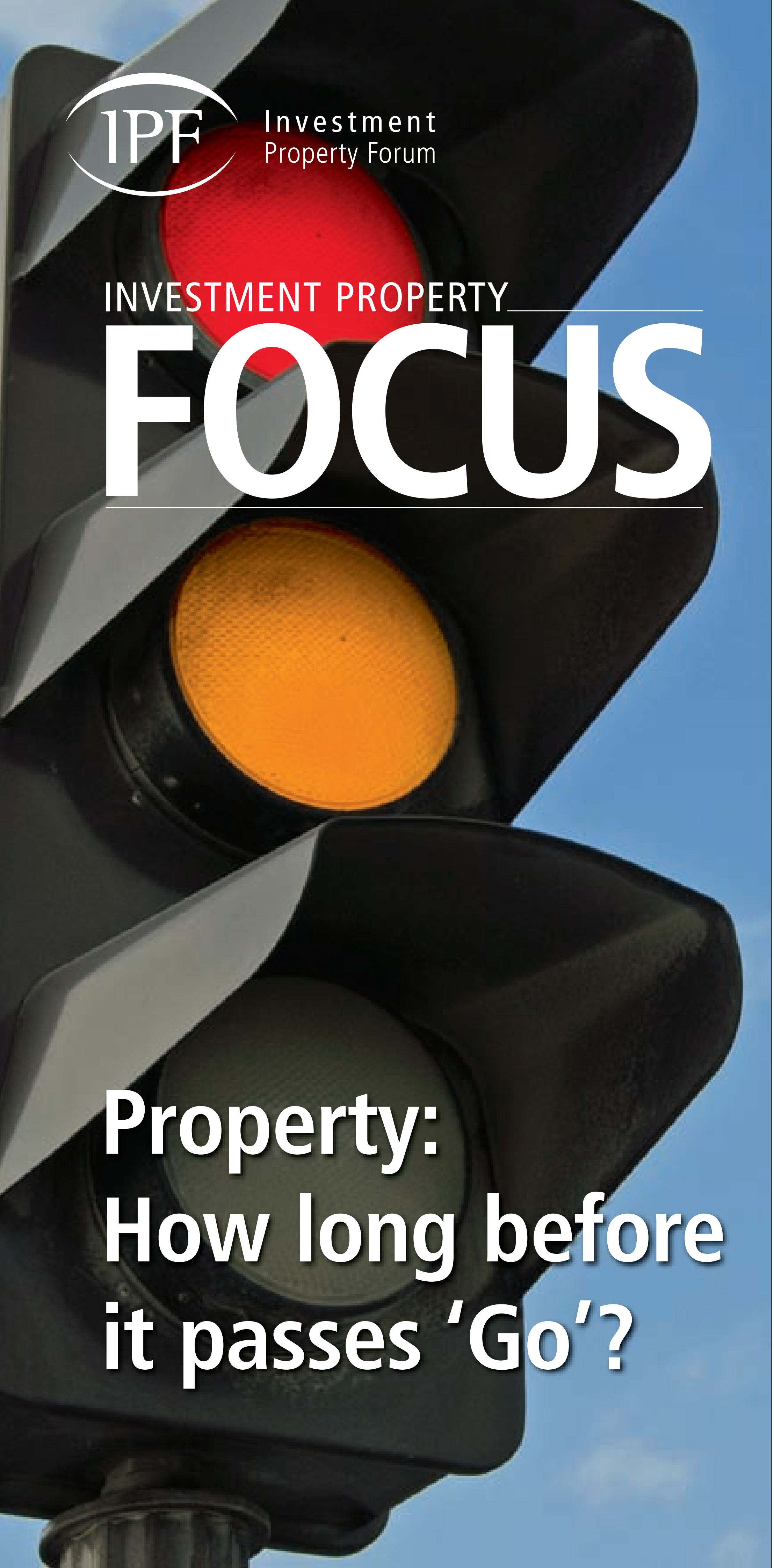


IPF Investment Property Forum

INVESTMENT PROPERTY

FOCUS

Property: How long before it passes 'Go'?

The Journal of the Investment Property Forum
Issue No. 19 | December 2011

In this issue:

The IPF Research Programme is an important provider of high-quality, independent research focused specifically on property investment. We can only continue to fulfil this role due to the support of our 22 research sponsors. We are very grateful to this group of companies for their support of the 2011-2015 Programme.

From the editor

Sue Forster, Executive Director, IPF

This edition focuses on finance. **Alex Catalano** of Real Estate Capital and **Elma Morris** of EMJS Consulting look at the potential for reviving the CMBS market and the likely availability of development finance respectively – both these pieces of work were sponsored by the IPF Research Programme. By contrast, **Tony Key** of Cass Business School looks at whether leverage enhanced property investment returns over a number of property cycles and concludes that, without the ability to time the market, it does not pay as a long-term strategy. The presentation at the Next Generation Group launch by **Graham Emmett** of NAMA, summarised on page 11, is a salutary lesson in what happens when using leverage goes badly wrong.

Aside from market issues, the availability of debt, or not, is being affected by regulation. **Sylvia Bowden** outlines the provisions that banks are required to make for capital set aside in respect commercial property leans under Basel II and the 'slotting' framework developed by the Basel Committee should banks find it difficult to develop internal compliant models. **Paul Ogden** of InProp Capital suggests that hedging solutions may potential improve the banks' capital requirements. Following the article in the previous edition by Ian Cullen of IPD on the appropriateness of the proposed 25% solvency capital requirement for directly-held property investments of insurance companies under Solvency II, **John Forbes** of PwC looks at the impact of these regulations on property funds. He concludes that Solvency II will be a major challenge for the fund management industry but may also be a stimulus for product development.

In the absence of debt finance, **Chris Brigstocke** and **Mark Simpson** of Squire Sanders Hammonds consider whether tax incremental finance (TIF) could be the panacea to town centre and other renewal projects, given its successful use in the USA.

Turning to existing investment property, **Stuart Morley** of GVA summarises the findings of this year's Occupier Satisfaction Survey, carried out by the members of the Property Industry Alliance (PIA) and CoreNet Global. While, on the whole, commercial occupiers feel that landlords provide a fair level of service, there remains a low level of satisfaction with service charge arrangements and poor level of engagement by landlords in respect of environmental issues. The latter is particularly surprising given the likely impact of sustainability related issues on property value going forward, as outlined by **Charles Woollam** and **Chris Edwards** of SIAM.

Property performance is also impaired by depreciation. **Neil Crosby** of the University of Reading and **Steven Devaney** of the University of Aberdeen have revisited their research funded by the IPF Research Programme in 2005 and consider variations in rates of depreciation between property sub-sectors and the impact of capital expenditure.

Stewart Womersley of Nabarro discusses the launch of the IPF Next Generation initiative and there is also an overview of the new **Nick Tyrrell Research Prize**, established to recognise innovative, high-quality applied research in real estate investment.

This edition of Focus also includes summaries of the survey of the IPF UK and European Consensus Forecasts in November.

The next edition will be published in April. If there are any topics you think we should cover, please contact me.

Editor
Sue Forster

Sub editor
Frankie Trailor

Design and production
Kevan Enticott
enticott design ltd
The Diary House
Rickett Street
London SW6 1RU
tel 0845 199 0129
www.enticottdesign.co.uk

IPF Executive

Executive Director: Sue Forster
sforster@ipf.org.uk
020 7194 7922

Research Director: Pam Craddock
pcraddock@ipf.org.uk
020 7194 7925

Associate Director – Education: Frankie Trailor
ftrailor@ipf.org.uk
020 7194 7928

Events Manager: Suleen Syn
ssyn@ipf.org.uk
020 7194 7926

Events Manager: Barbara Hobbs
bhobbs@ipf.org.uk
020 7194 7924

Membership Co-ordinator: Cheryl Collins
ccollins@ipf.org.uk
020 7194 7927

Accounts Manager: Jenny Hooper
jhooper@ipf.org.uk
020 7194 7923

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH
tel 020 7194 7920
fax 020 7194 7921
ipfoffice@ipf.org.uk
www.ipf.org.uk

UK CMBS – where now?

Alex Catalano, Real Estate Capital

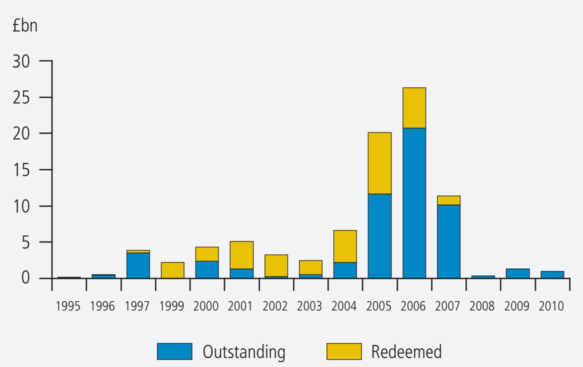
This article is based on the Short Paper 'The Outlook for UK CMBS' published in November by the IPF Research Programme. As part of the research, the author canvassed the views of key participants in 21 organisations involved in the CMBS market: banks, borrowers, investors, rating agencies, lawyers, servicers and advisers.

Re-establishing a sustainable market in commercial mortgage-backed securities (CMBS) will be challenging. The financial crisis provided an extreme stress-test for commercial property loans in the UK; destabilising the CMBS market, effectively shutting it down for almost four years, and also revealed structural weaknesses in the instruments. That said, it is important to note that most UK CMBS and loans are performing, indeed better than balance sheet bank lending. Loan-to-value covenants have been breached and maturities have been extended but, in most cases, bondholders have continued to receive their coupons. Of the £42bn CMBS loans that Standard & Poor's monitor, only 6.7% have missed an interest or principal repayment, against the 12.6% estimated for balance sheet loans by De Montfort University.

To relaunch an active market, CMBS requires a broader investor base. New investors will have to be convinced that the instruments are fit for purpose. Currently, a great deal of equity capital is looking for a profitable home in property. There is also some £356bn of UK property loans that needs refinancing, although a Savills' assessment suggests that up to half of the outstanding bank debt is too secondary to go into CMBS.

CMBS have only ever played a supporting role in financing UK property, accounting for 18% of the current bank lending secured on UK property, compared with 45% in the USA. For two boom years, 2005 and 2006, UK CMBS issuance spiked to £20-25bn annually (see Figure 1). But this level of issuance was fuelled by an overheated property market and investment banks' conduits. The latter, which originated loans and took them completely off the banks' balance sheets by selling them as CMBS to investors, accounted for the vast majority of the issuance in those years.

Figure 1: Public issuance of UK CMBS



Source: Bloomberg, BofA Merrill Lynch Global Research

Pre-crisis, most UK CMBS were bought by banks and structured investment vehicles (SIVs), which were mainly owned by banks but held off-balance sheet. The latter engaged in arbitrage by issuing short term (under one-year) debt at low interest rates and buying longer-term (over one-year) financial assets that paid higher interest, such as CMBS and asset-backed securities. Today, the financial landscape is very different and banks are very unlikely to play as big a role as investors in future. Basel III makes it more expensive for them to own CMBS, especially the riskier tranches. Also, several high profile defaults and disputes have seriously damaged CMBS' reputation.

Regulatory overkill

All the market professionals interviewed for this research are extremely concerned that a flood of regulatory changes will stifle any revival of the CMBS market. Firstly, Basel III is simultaneously increasing the amount of capital banks must hold to ensure solvency during periods of financial turmoil and making it more costly for them to hold CMBS, as noted above. Secondly, article 122a of the European Union's Capital Requirements Directive, now requires banks to keep 5% of an issue on their balance sheet. In combination, these two measures make CMBS more expensive for banks to originate and issue. They will not underwrite loans to securitise if it is not going to be profitable.

In addition, Solvency II will introduce a new risk-based regulatory regime for EU insurers. This too does not appear to favour CMBS.

Moreover, the increased information and reporting requirements that regulators are attaching to CMBS will place an onerous burden on issuers. CMBS loans will require much more transparency than those which are not securitised, setting up a regulatory arbitrage with balance sheet lending. Unless there is a level playing field, borrowers will naturally gravitate towards the less onerous option.

Where are the CMBS investors?

The banks are now constrained in their ability to invest in CMBS. However, there are others who might buy UK CMBS: notably, insurance companies, pension funds, asset managers, charitable and non-profit foundations and sovereign wealth funds. These equity investors channel a massive volume of capital into a wide range of financial markets but their participation in the UK CMBS market is currently quite small. Most invest in CMBS as part of their allocations to asset-backed securities, so CMBS compete with other securitised products such as car loans, residential mortgages and credit card debt.

Over the longer term, these institutional investors could and should become a much bigger force in the UK market. In the shorter-term, however, there are significant factors inhibiting these investors, not least Solvency II, which will transform how

European insurers allocate their money. As currently formulated, Solvency II will make it more expensive for these organisations to hold structured debt like CMBS, whereas gilts, covered bonds and loans secured on property are treated much more favourably.

Another issue for institutional investors is that many lack the in-house expertise to analyse CMBS. Unlike US CMBS or UK residential mortgage-backed securities, UK CMBS are not generally backed by large, geographically diversified pools of relatively homogenous assets that can be subjected to macro-level statistical analysis. They are much less granular, containing fewer loans. Thus, the quality of the location, building, tenant and borrower/sponsor is critical in assessing the collateral and the risks involved. It will take time for investors to establish their teams and become fully conversant with CMBS. For many, this will not be cost-effective and they may outsource investment to third-party asset managers who have the capacity to analyse and price CMBS.

Longer-term opportunity

It has been suggested that if UK CMBS were to offer longer durations and fixed-rate coupons, insurance companies and pension funds might be attracted to invest more. To match their liabilities, these institutions tend to hold more long-term debt than other investors, typically sovereign debt and corporate bonds. The US CMBS market works on this model, typically offering fixed rates for terms of 15 years or longer. The insurance companies and pension funds account for 16% of CMBS purchased. By contrast, most UK CMBS bonds are floating-rate bonds of short maturity (five- to seven- years). Generally, UK borrowers are reluctant to tie themselves into longer commitments as most turn their assets over a short time frame and want flexibility to sell or refinance the properties that provide their collateral security.

With longer dated, fixed-interest CMBS, early repayment is an issue for investors. In US CMBS, this is achieved by defeasance, where a borrower substitutes a government bond or other eligible security of equivalent yield as collateral for its loan in the CMBS. Investors continue to receive their payments and the borrower is free to sell or refinance the property. As most UK CMBS are short-term, floating rate securities, early repayment has not been a major issue. But in the UK, listed fixed-income bonds do include some version of a 'Spens clause', a formula which provides for a cash payment equivalent to the amount which, if reinvested in a gilt of equivalent maturity, generates the same cash flows as the original bonds. However, the activation of a Spens clause is prepayment, not defeasance, since the debt is repaid and bonds redeemed. For borrowers, the cost of releasing their collateral, whether through defeasance or a Spens-style prepayment, will depend on how interest rates have moved and what discount rate is used to value the cash flows. For investors, defeasance is deemed preferable because the loan (backed by new collateral) and bond remains live thus avoiding the need to reinvest their cash. Although there is no legal obstacle to incorporating it in CMBS, defeasance has not been used in the very few longer-term, fixed rate CMBS that have been issued in the UK.

If CMBS can lengthen their maturities, they can broaden their offer to attract new investors and borrowers. Some early securitisations, notably those of the Broadgate and Canary Wharf office complexes in London, were longer-term, fixed interest structures. If, as is likely, shorter-term bank finance remains tight, borrowers may be pushed towards longer maturities. Indeed, several UK property companies have recently started to diversify the length of their debt.

Arrangers

Article 122a of the European Union's Capital Markets Directive seriously restricts banks' ability to arrange and issue CMBS. It requires originators/issuers to retain an exposure to the debt, or as industry jargon terms it, 'keep skin in the game'. Since 1 January 2011, 5% of any new CMBS issue must be kept on the bank's balance sheet. With the Basel III capital weighting attached to CMBS, this makes securitisation more expensive for banks and constrains their capacity to lend. Supporters of this measure argue that it will promote good underwriting by banks, as they now have a stake in the longer-term performance of their issues. This, in turn, should promote the long-term health and sustainability of CMBS.

Borrowers

For some borrowers, the historic attraction of CMBS financing was its competitive pricing, especially on larger loans. However, many borrowers did not appreciate how inflexible and complicated securitisations could be when loans run into problems or, indeed, even with performing loans that they wanted to modify. In these cases, the time and expense of dealing with trustees and servicers and obtaining bondholder approvals can be substantial. Borrowers complained about being unable to negotiate with a single party with authority to act.

The vast majority of borrowers are likely to prefer balance-sheet loans with a relationship lender and would resist having their loans securitised. However, indications are that banks are taking a tough line with borrowers, insisting on a level of disclosure that supports CMBS and the right to securitise or sell a loan.

Re-engineering CMBS

Many of the problems associated with pre-crisis CMBS stem from poor underwriting and poor documentation. These issues are being addressed by industry groups and regulators. In particular, the 5% retention required by Article 122a is meant to promote better underwriting by aligning issuers' interests with those of investors. Documentation, too, is being overhauled (see below).

However, for the market to thrive, CMBS also needs re-engineering so that market participants, particularly investors, are confident that the product will work properly under stress. Put simply, CMBS need to be a less complex, more transparent product. In practice, this means fewer tranches of bonds, a sharper delineation of roles and more efficient procedures, plus better and more consistent information.

The main areas of concern are considered below:

a. Remunerating arrangers: Class X-bonds
This is the mechanism through which CMBS arrangers are rewarded in some issues: Class X-bonds capture the excess interest left over after the interest on the bonds and certain expenses have been paid. These bonds are not entitled to repayments of principal and do not have any claim on the underlying assets but, typically, they rank on a par with, or just below, senior bondholders for interest payments. The problem is that Class X's seniority has allowed the bondholders to continue collecting excess interest payments when an issue has run into difficulties. Investors have resented income which could be used to amortise loans, improve properties, or pay their coupons, going to Class X-bondholders.

b. Controlling 'tranche warfare'
When a securitisation runs into difficulty, different classes of bondholders may have very different views on what should be done, often based on the seniority of their tranche of bonds in the capital stack of the issuance. Where junior classes may favour extending a loan's maturity to give the borrower time to resolve issues, senior classes may want early enforcement and sale of the collateral to repay bondholders. The conflicting interests can make it extremely difficult to obtain the bondholder approvals that are required for action; in extreme cases, they lead to open warfare among (and sometimes within) the tranches.

c. Mezzanine debt
CMBS transactions often involve additional leverage in the form of mezzanine debt. Intercreditor agreements spell out the rights and obligations of these different classes of creditors, and traditionally, senior lenders have priority in payments and decision-making. As subordinate debt, mezzanine lenders typically had more limited rights to enforce or recover their debt, but in return received an additional reward for taking more risk. Intercreditor agreements are not standardised in the UK, and in pre-crisis CMBS, mezzanine lenders negotiated provisions giving them greater control, e.g. their consent might be required to amend the senior loan terms.

d. Bondholder consents and communication
Important decisions require bondholders' approval. However, like most European bonds, CMBS are not registered, so there is no central list of who the bondholders are or any mechanism for servicers to consult bondholders about changes and actions they may be considering, particularly on restructurings. Investors and servicers alike are frustrated by the difficulty in identifying and communicating with bondholders.

e. Trustees
The trustee holds documents and has the authority to act for bondholders, though typically delegates this authority to the servicer or special servicer. There is widespread dissatisfaction with the way trustees have exercised their role, being perceived to be more concerned with limiting their liability rather than taking decisions. It has been suggested that CMBS should incorporate an independent third party to act as liaison between investors and the trustee/servicers.

f. Servicers, servicing standards and fees
Servicers are the intermediaries linking borrowers, bondholders and the trustee. Primary servicers manage and monitor loans day-to-day, collecting payments from borrowers, distributing them and reporting to bondholders. Special servicers deal with loans that are seriously troubled or in default. Servicing standards in the UK tend to be generally worded, requiring the servicer to act as a reasonably prudent lender would and recover as much of a loan as possible. Servicers have usually acted for all classes of bondholders, a difficult role when different tranches may have very different interpretations of what this means in practice.

Both investors and servicers interviewed suggested that the most effective way of holding primary servicers accountable would be to give bondholders the sanction of replacing them without cause. It is also generally acknowledged that the current fee structure should be changed so that primary servicers are incentivised to take early action to solve problems ahead of a default.

f. Disclosure, transparency and standardisation
Investors, servicers, regulatory authorities and, indeed, some lenders and originators would like to see greater disclosure and more standardised documentation for CMBS. A more transparent market would help restore confidence in CMBS and create a more liquid market. It would aid investors and other market professionals better to understand, analyse and price CMBS and, thus, make better decisions. The issue is how to introduce greater standardisation without stifling innovation.

Article 122a of the European Union's Capital Markets Directive, requires sponsors and originators to provide investors with detailed loan-level information over the life of the transaction. This applies to new securitisations from 1 January 2011 and to existing CMBS where new exposures are added or substituted after 31 December 2014. In addition, the Bank of England is setting out new requirements that both new and existing CMBS must meet if they are to be posted as collateral with the Bank. From July 2011, originators/issuers have had to make all transaction documents, including intercreditor and servicer agreements, swaps documentation and trust deeds 'freely and readily available to interested third parties'. Later in 2011, the Bank of England will be introducing detailed guidelines for quarterly CMBS loan-level information and reporting.

The Commercial Real Estate Finance Council Europe has worked with the European Central Bank and the Bank of England to develop a standardised data template, European Investor Reporting Package (E-IRP) version 2.0, for this reporting.

Conclusion

Properly structured and underwritten, CMBS can play a significant part in financing UK real estate. But CMBS must broaden their appeal to institutional investors and it will take time for these to enter the market in a substantial way.

Lending: what goes wrong?

Tony Key, Professor Real Estate Economics, Cass Business School

The global financial crisis was triggered by real estate debt in the form of US residential sub-prime mortgage backed securities. Exposure to losses on commercial property lending made a significant contribution to the transmission of that initial shock through the banking system, including the failure of Lehman Brothers. Write-downs on commercial lending remain one of the larger sources of risk to weakened banks. Clearly, lessons need to be taken from recent history if we do not want to repeat it.

This paper comes in two parts. The first part argues that the recent crisis falls into a sequence of linked property and banking crises, which have become successively more severe. Managing that systemic financial risk of real estate will demand better risk management by banks, and better regulation of banks.

But if it misguided a bank to lend when it stands to lose some of its money, it must be plain foolish for investors to borrow when they stand to lose all of theirs. The second part of the paper is an attempt to improve investor understanding of how leverage impacts on property returns and risks. It deals in turn with the long-run impacts of leveraging core property returns, and the use of leverage in portfolio construction.

Real estate and banking crises

The general literature on the 200 financial crises since 1800 (on this topic see Reinhart and Rogoff's This Time is Different: Eight Centuries of Financial Folly) makes little reference to residential real estate risk to the financial system before 2007, and scarcely any reference at all to the risk of commercial real estate lending. The specialist literature on real estate records a series of crises over the last 40 years in which commercial real estate was a primary, though not always the sole, source of stress in the financial system. That series runs from UK Secondary Banking in the early 1970s through American Savings and Loans in the 1980s, Japan, Scandinavia and the Asian Crises of the 1980s to 'The Big One', the global financial crisis of 2007-08. These events form, arguably, a series that is rising in scale and scope: from specific parts of the financial system to all of it, from individual countries or regions to most of globe.

Each crisis has had its own blend of factors: some were linked to building boom and bust (like UK Secondary Banks 1970), some not; others were associated financial deregulation (like UK Savings and Loans in the 1980s), or new financial instruments (like Commercial Mortgage Backed Securities [CMBS] in the 2000s).

What, if anything, does the recent crisis add to the story? A first point is that it started with a form of debt – mortgage backed securities – which had been promoted as a solution to the problem. In the commercial sector, CMBS was supposed to cut off the over-extension of debt, because public markets would control the volume and price of loans better than bank lending officers, who are subject to incentives to their expand loan books. CMBS was also supposed to limit the impact of any lending meltdown on the financial system by spreading the risk from systemically important banks to many end-investors. That faith in the risk assessment of public markets was perhaps always implausible. The failure in risk distribution was more of a surprise, because in the out-turn banks sold a lot of the risk to other banks, which in turn compounded risk by heavily leveraging their own balance sheets. The lesson is that financial tools with the potential to manage and spread risk can be used to do the opposite.

A second lesson from the recent crisis is that globalised real estate markets, and globalised financial houses, amplified what might in itself have been a manageable problem – US sub-prime mortgages – into the most widespread real estate financing crisis in history. Secular trends toward indirect investment funds and cross-border investment, particularly in value-add and opportunistic strategies, drove up overall market leverage. Pro-cyclical tendencies in both the capital flows into these vehicles and the leverage applied to them can clearly exacerbate real estate financing problems, especially when they lead to fund terminal dates bunching into market downturns.

Global flows of capital and debt in real estate have, moreover, become increasingly concentrated into very large border-crossing fund management and lending institutions. Real estate markets that were predominantly national in terms of both capital flows and market participants are now highly open to cross-border flows mediated by global fund managers and lenders. In the 2000s, this structure proved highly successful in disseminating new investment and financing structures across countries, and then equally successful in spreading contagion.

Finally, the global capitalisation of commercial real estate investment has been expanded by increased investor penetration in developed economies, especially in continental Europe, and by the expansion of markets in transitional and emerging economies. It is the combination of growing market size, more mobile capital flows and raised leverage which has increase the systemic risk of commercial real estate lending to the global financial system.

Real estate leverage and deleverage

The classic accounts of asset price bubbles by authors such Irving Fisher[1] and Hyman Minsky[2] suggest that they start with periods of rising values, which attract debt financing, which accelerates the rise in values and so on, ending with a period of 'euphoria' as debt alone fuels further rises in value, and speculative buying based on the expectation that the rise in values can only continue to rise.

Bubbles burst when asset values have become so obviously disconnected from fundamental value that the market collapses of itself, or a random shock destroys buyer confidence, or there

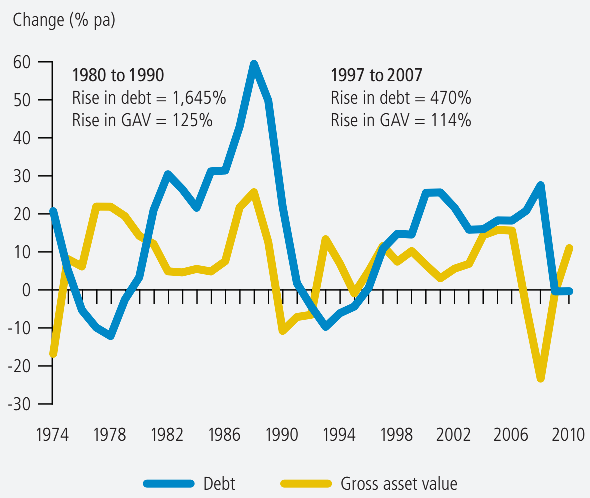
1 Fisher, I. 1933. The Debt-Deflation Theory of Great Depressions, Econometrica 1(4)

2 Minsky, H. 2008. Stabilizing an Unstable Economy. McGraw-Hill Professional.

are no more outsiders foolish enough to believe in further rise in prices, or lenders themselves have so overstretched their capital they cannot lend any more.

This strong association between UK lending and real estate booms and busts is demonstrated in Figure 1. The commercial real estate booms of the late 1980s and mid-2000s shared long periods of rising capital values, coupled with rises in debt which were larger by several orders of magnitude. Figure 1 also highlights some more surprising features of leverage around the peak of the cycle. First, that the volume of debt increases through the initial year or so of the fall in asset values – perhaps because borrowers call on credit lines the banks cannot withdraw or because banks fail to anticipate the extent of the eventual market fall. Second, that debt booms have been followed by an absolute contraction in lending lasting several years, with a total fall in debt of around 20% in both of the last episodes. Since the fall in debt coincides with a recovery in capital values, the early years of market upswings have been coupled with very long and large falls in leverage.

Figure 1: UK commercial property lending and gross market values 1974-2010



Source: IPD, Bank of England

Linked lending and asset price bubbles are undesirable for property investors, banks and, because of the knock-on effect on the financial stability of banks, everyone else. Basel III and a raft of other current proposals are intended to stop banks extending credit when they should not. Equally, investors should not just regard the last financing crisis as an unforeseeable shock and a one-off, but as an object lesson in impacts of leverage on real estate investment.

Leverage – does it pay?

Basic finance teaches us that leverage results in a return above that on underlying property so long as the property return is above interest rate and below underlying property when interest rates are above property return. The higher the loan-to-value (LTV) ratio, or the spread between returns and interest rates, the greater the gain or loss in return against underlying property.

Beyond this simple arithmetic, academic research tends to head off toward the analysis of credit risk in lending, such default and prepayment risks on mortgages and mortgage-backed securities, applying a lot of fairly advanced statistics. Conversely, industry discussion about debt heads off into the details of amortisation schedules and financing structures. This paper sticks with the simpler question of how leverage impacts on investor returns, as they would appear in the accounts of the investor.

Figure 2 (opposite) simulates the effects of leveraging observed property returns through all states of the market and several cycles, using the longest possible UK commercial property history. The results represent an investor buying the average portfolio and holding borrowing at a constant 60% LTV at an interest rate set at a margin of 130 bps over five-year swaps at the start of each year, and changed on all outstanding debt at the start of each year. Leveraged returns are calculated by the formula:

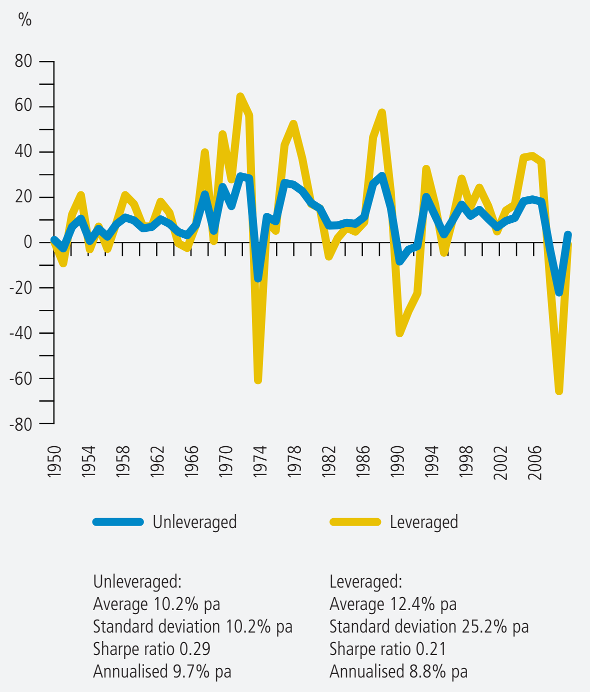
$$\text{Leveraged return} = \frac{\text{Unleveraged return} - \text{Debt charge x Loan-to-value ratio}}{1 - \text{Loan-to-value ratio}}$$

This simple simulation shows that moderate borrowing would have produced a small boost to average return, and a rise in risk by a factor of close to 2.5. The Sharpe ratio (average asset return minus average Treasury bill return, divided by asset standard deviation: or return over riskless investment per unit of risk) is used to measure risk adjusted returns. In this case, a Sharpe ratio of 0.29 on unleveraged property is reduced to 0.21 on leveraged.

Because Sharpe ratio measures return over the risk-free rate and it is assumed that property debt is priced at some margin over the risk free rate, the dilution of the Sharpe ratio through leverage is inevitable so long as there is a spread between risk-free rate and the interest rate charged on property loans.

Over the whole period, annualised leveraged returns run more than one percentage point per year below unleveraged returns. This is a result of the big leveraged losses in recent years. A fairer comparison of annualised rates of fitted trends, which avoids these end-point effects, still however shows an annualised return unleveraged of 11.0% against 10.4% leveraged. The comparison of annualised returns is less

Figure 2: Fixed leverage, annual returns, UK commercial property 1950-2009



Source: Based on Scott, The Property Masters, IPD, Datastream

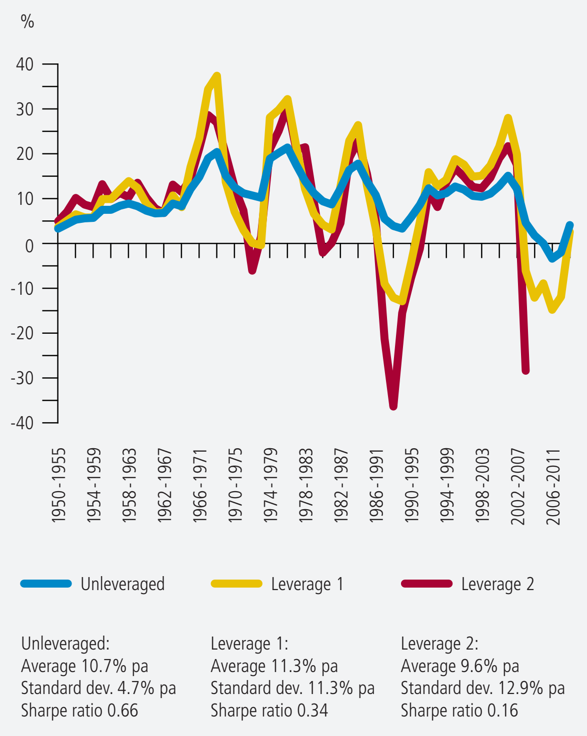
favourable than of average returns because sustained run-ups in value have tended to be followed by severe falls.

In case it is thought these results are specific to the UK, perhaps the product of the higher volatility of our market and its propensity to severe downsides, the same calculations have been run on 14 other countries. The period covered in each country, and therefore to an extent the impact of leverage, varies with the availability of property indices. But, broadly, the conclusions are much the same. With debt held constant at 60% LTV, leverage would have increased arithmetic average returns in 12 out of 14 countries, and increased risk in all countries by a factor of two or more. Annualised returns, however, would be lower on leveraged than unleveraged investment in six out of 14 countries. In all countries, leveraged investment would have a much lower Sharpe ratio.

In practice, transactions costs and delays mean that investors cannot buy into or sell out of the market year by year. So in Figure 3 the results are converted to five-year rolling periods (representing the results from average properties bought or funds launched in each of the last 59 years and held for the following five years), and shown as Leverage 1. The relative margins in returns and risks remain much the same, though on this basis the leveraged Sharpe ratio falls even further behind. There is a stronger left-hand tail in the distribution of leverage returns over five-year periods due to the deep troughs of the early 1990s and late 2000s.

The simple leverage model makes the unrealistic assumption that it is possible to hold constant level of leverage through swings in asset values: transactions costs and delays on the assets, and loan conditions on the debt, clearly make this impossible. The Leverage 2 calculation in Figure 3 adopts more realistic 'sticky' leverage ratios. It assumes a fund launched each year since 1950, leveraged with a fixed five-year loan at 60% of asset value at point of launch, and held for five years. The actual LTV will then vary through the holding period: LTV will fall as capital values rise through booms, and rise as values fall in slumps. So the benefit of leverage is diluted in the upswing, and the negative effects of leverage may be amplified by rising LTV through period of falling capital values. In other words, especially in deep and long downturns, the downside impact of leverage is increased. This perverse leverage effect means the even average leveraged return is below that on unleveraged property, risk is increased above that seen in the constant LTV simulation, and the Sharpe ratio falls even further below that on unleveraged property.

Figure 3: Variable leverage, 5-year rolling returns, UK commercial property



Source: Based on Scott, The Property Masters, IPD, Datastream

The conclusion is that leverage without the ability to forecast the market will not improve risk-adjusted returns to investors, and that if it is impossible to manage leverage ratios year by year, even rates of return unadjusted for risk may well fall well below those on unleveraged property.

In short, leverage without market timing does not work. Variable leverage combined with an ability to forecast the market, not surprisingly, could generate extremely strong performance. A simulation assuming 70% for all five-year periods in which returns have run above interest rates, and zero leverage in other periods, would produce a return of 14.4% more than three percentage points per year above unleveraged, with a risk of 7.3% and a spectacular Sharpe ratio of 0.94.

But to capture any of that potential leverage upside, an investor would need some market signal to pick out periods of strong and weak returns before they happen. Anyone who could do that would be able to boost returns on an IRR basis even further by timing capital injections and withdrawals on unleveraged investment without incurring the added risk of leverage.

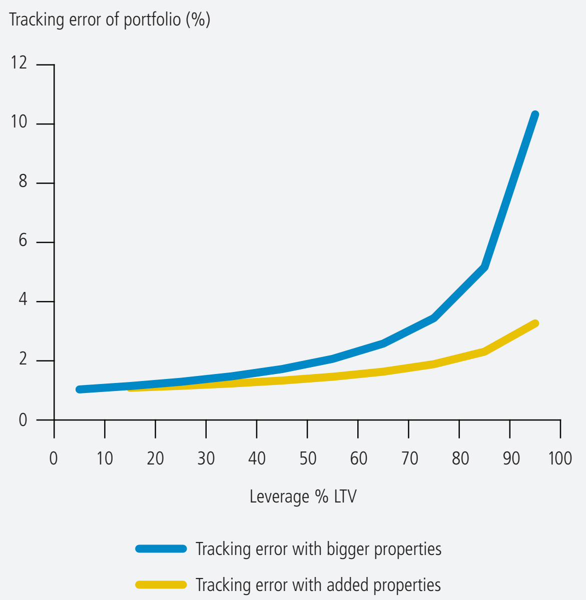
How does leverage change tracking error?

It can be argued the added risks of leveraging a portfolio are to some extent offset because the leveraged investor can hold more assets for the same amount of equity. If the individual assets are leveraged, the spread of returns across assets will be increased in exactly the same way as the spread of returns over time looked at in the last section. Leveraging a portfolio, of course, allows the investor to increase the gross asset value of properties held, therefore potentially to increase the number of assets held so increasing diversification and reducing the tracking error of the portfolio.

To calculate the size of this effect for a portfolio, we can take figures on the range in returns across individual assets from IPD. These show that assets held for five years have a standard deviation around the mean return of 8%. Estimating the portfolio tracking error at the standard deviation of asset returns divided by the square root of the number of assets, a portfolio of 60 buildings would have a tracking error of 1%. Figure 4 shows what happens to tracking error with increasing leverage in two cases: one in which added purchasing power is used to buy bigger assets, the second in which it is used to buy more assets of the same size.

Under both strategies, tracking error increases with rising LTV. But the increase is much gentler if leverage is used to increase the number of assets, and does not begin to steepen until LTV is above 60%. The calculation, ungenerously, does not assume that added assets are being deliberately selected for low correlation with existing assets. With leverage used for a deliberate diversification strategy, such as international investment, the diversification factor could easily be stronger.

Figure 4: Tracking error of a UK portfolio with varying leverage, 5-year compounded return



Source: IPD, author's calculations

Conclusion

Through the boom years of high property returns and low interest rates, leverage came to be seen as a default strategy for property investors, with borrowing at up to 60% LTV regarded as acceptable even for core investment vehicles.

The research underlying this paper used simulations of leverage applied to commercial property returns to demonstrate the practical implications of leverage through several cycles, and through periods with varying inflation, interest rate and property pricing. The results suggest that leverage, even at a constant LTV at 'prudent levels' would have produced only a modest boost to returns, and a reduction in risk-adjusted return, when compared to unleveraged property. The clear implication is that leverage without the ability to time the market, and preferably also to manage LTV ratios year by year, does not pay as a long-term investment strategy.

Slotting: Potential for commercial lending to be further restricted?

Sylvia Bowden

We have recently seen Eurohypo and Societe Generale pull out of UK commercial real estate (CRE) lending but there is the potential for bank lending in the UK to be further restricted.

When banks make commercial property loans they need to set aside a certain amount of capital as required by the Basel II accord which, in the UK, is interpreted and applied by the Financial Services Authority (FSA). Banks tend to use models to calculate the capital which they set aside against their CRE loans. For UK banks these models need to comply with the FSA's rule book (known as BIPRU) but a recent review by the regulator has found that most, if not all, of these models are not compliant with the existing rules. In light of this, the FSA is looking at imposing an alternative method, known as 'slotting', to calculate the capital requirement. This approach may result in banks having to hold more capital than they do currently.

This is significant as it has the potential to reduce lending to a property industry that is currently starved of financing and, as a consequence, it could conceivably lead to more secondary properties being put onto the market by receivers acting for the banks.

What is slotting?

The slotting framework as defined in BIPRU 4.5.6 (which was developed by the Basel Committee in anticipation of firms finding it difficult to develop internal ratings-based [IRB] compliant models for certain specialised lending asset classes) requires a CRE loan to be allocated to one of five categories with risk weights and expected losses as shown in Figure 1.

The risk weights determine how much regulatory capital is required for individual loans and the expected loss (EL) is broadly equivalent to the provisioning provided in p&l statements. This then determines the CRE risk-weighted capital and required pricing to achieve the desired return on equity (RoE) as shown below.

$$\text{RoE} = \frac{\text{Profit after tax}}{\text{Minimum capital}}$$

Minimum capital =

Exposure (Loan amount)
x Risk weighted asset %
x required capital (9%)

Those banks adopting 'Foundation' or 'Advanced' models under Basel II calculate risk-weighted assets (RWA)% as a factor of probability of defaults (PDs), loss given defaults (dependent on loan to value) and loan maturity.

The drivers for the allocation to categories are market conditions, financial ratios for debt service cover and loan-to-value, stress analysis, cash flow predictability, asset characteristics, strength of borrower and security.

The British Bankers Association (BBA) has expressed the concern that in weak markets with high refinance risk, the majority of loans could be slotted into the Satisfactory and Weak categories, leading to an increase in capital requirements beyond levels warranted on risk grounds. The Association observes that this could be pro-cyclical and a debate on modelling philosophy is on-going as to whether the inputs are at a point in time or through the cycle. It is being suggested that it may be better for banks to hold higher levels of regulatory capital when economies are strong and hold reduced levels at times of weak economies to ensure lending capacity is available to stimulate activity.

Next steps

The broader property industry should be monitoring carefully the implications of the imposition of a slotting approach and the likely timing of its implementation.

The FSA is believed to be re-considering draft guidance to clarify its interpretation of the slotting criteria. The indications are that

Figure 1: Slotting framework for CRE loans

Remaining maturity	Category 1 Strong	Category 2 Good	Category 3 Satisfactory	Category 4 Weak	Category 5 Default
CRE: Slotting risk weights					
Less than 2.5 years	50%	70%	115%	250%	0%
2.5 years or more	70%	90%	115%	250%	0%
CRE: Expected loss (EL)					
Less than 2.5 years	0%	0.4%	2.8%	8%	50%
2.5 years or more	0.4%	0.8%	2.8%	8%	50%

Source: BIPRU 4.5.6

the FSA is expecting that lenders will move to adopt slotting during H1 2012. Dependent on the capital results, the FSA may then opt to issue detailed guidance on interpretation after a consultation period with the BBA.

The way in which the FSA regulates the UK banks is, of course, not something that the property industry should expect to be able to directly influence, especially in this case as there are no new regulations being introduced.

However the detrimental effect on CRE that a combination of a large requirement for re-financing, the withdrawal of some overseas lenders and now the threat of greater capital requirements for domestic lenders cannot be ignored.

It is likely that a CRE debt famine would disproportionately affect the most politically sensitive areas of the economy – the regions. Recently the Government has intervened to ensure that small and medium-sized enterprises (SMEs) have access to debt finance. There may be a case to be made for the Government to take steps to ensure that debt financing is made available to support regional property and the lending upon which it depends in the current environment.

The IPF is continuing a dialogue with the BBA and FSA in order to keep members informed.

The Property Derivatives Interest Group (PDIG) is also looking at how derivatives may be used to offset risk and reduce regulatory capital and seeking a dialogue with the BBA and FSA to explore the merits of hedging property risk.

Comments from Paul Ogden, Partner, inProp Capital LLP and Chairman of the IPF Property Derivatives Interest Group (PDIG)

Could property derivatives offer banks some relief from their slotting headaches?

It is ironic that just as banks are facing fresh concerns about the property market exposure, associated with their lending activities, there are plenty of investors looking to invest in property by synthetic means, such as synthetic funds, property-linked notes or directly through property derivatives. There are even Eurex property futures contracts offering an efficient and transparent mechanism to transfer the banks' property exposure to investors. However, so far there has been little attention paid to the potential these offer to reduce risks by the lending banks. In part, this may be due to property lending and derivatives teams sitting in very different sections of the banks concerned.

The IPF's Property Derivatives Interest Group (PDIG) would like to see property lenders talking to derivatives experts, with an eye to ascertaining whether there are hedging solutions that could help the banks to reduce property risk and potentially improve their capital requirements, whilst adding to the liquidity of the property derivatives market. With the banks and the FSA discussing a slotting methodology for calculating capital requirements there would seem to be an opportunity for them to incorporate property derivatives and other forms of hedging into the discussion.

Paul Ogden, Partner, inProp Capital LLP

There are several approaches which could be considered by the banks: they may choose to hedge individual loans, the whole loan-book in aggregate or they may structure loans which require borrowers to reduce their risks in return for a better rate or higher LTV. In the end the best approach may be determined by how the risk mitigation is treated by the FSA within its slotting framework.

Building suitable hedge strategies and ensuring that they are treated fairly in capital requirement calculations is not going to be a trivial exercise but it would be a shame if the property industry missed the potential opportunity to improve the availability of debt and develop synthetic investments that would address many of the drawbacks associated with property for defined contribution pension schemes and retail-facing funds such as APUTs and PAIFs.

What is NAMA up to?
Presentation at the Next Generation Group inaugural event on 16 November

Guest speaker, **Graham Emmett**, Head of Lending & Corporate Finance at Ireland's National Asset Management Agency (NAMA) explained that the Agency had been set up two years ago to try and repair impaired Irish bank balance sheets and improve liquidity. This was to be achieved by:

- taking the most impaired land and development loans off banks' balance sheets;
- addressing systemic borrower risk within the system; and
- issuing NAMA Bonds to pay for loans and provide banks with fresh capital via the European Central Bank (ECB).

Some 40% (€160bn) of the total loan book on the balance sheets of the Irish banks was commercial real estate (CRE) related and NAMA acquired €74.2bn of property loans (not real estate assets) from the five participating banks (PIs) for €31bn, an average discount of 58% to PAR. Around €18bn of the €31bn paid is secured by Irish property. The good news is that €11bn of this is in the Dublin area, which should recover first, but there is also another €7bn elsewhere in the Irish Republic whose value recovery is likely to lag the capital. The remainder of acquired loans are secured by assets in London and South East (€6bn), the rest of England, Scotland and Wales (€4.7bn), Northern Ireland (€1.3bn) and €1.5bn in mainland Europe and the USA.

Although the objective was to recapitalise the banks so they could revert to core lending and assist in the economic recovery (original loan discounts anticipated by the 5 PIs were expected to average only 30%), the common perception in Ireland is that NAMA is to blame for the current lack of lending because it forced the banks to crystallise ALL losses at once. Emmett's view is that the problem was largely self-inflicted, given that the banks had inadequate details about the loans they had made, many of the loans were to individuals rather than companies with personal guarantees attached, and none of the banks were fully aware of their respective borrowers' aggregate exposure to all the banks.

The Agency's remit is to manage the acquired loans in the best interests of the State and obtain best financial return, subject to acceptable financial risk. Put simply, the overall objective is to recoup the €31bn paid for the loans plus some of the 58% write down by 2020. In terms of managing the loans, debtor asset business plans have to be submitted to NAMA within six weeks of loan acquisition. These are reviewed by independent advisers and NAMA decides on a plan of action and negotiates commercial loan restructuring terms, or short/medium support terms with the borrowers. Compliant borrowers provide full disclosure and work to the agreed business plan and may subsequently be rewarded with PG release, loan forgiveness, and a small financial incentive once the last asset is sold. Conversely, enforcement is likely against those who are non-compliant – the current 12-year bankruptcy provisions, compared with only one year in the UK, mean that most debtors based in Ireland, at least start compliant.

The NAMA bonds are guaranteed by the Irish Government and issued by NAMA SPV. The bonds are not part of the national debt and are, in fact, self funding from the performing loans (23% are income producing). Some €7.5bn of these bonds will be repaid by 2013 – NAMA has approved asset sales in excess of €5bn, has over €2bn of cash on deposit, and has repaid €1.25bn of NAMA Bonds. In addition to the bond redemptions, progress is being made on other fronts: €299m has been repaid to the Minister of Finance; €900m has been approved for new money advances to borrowers.

NAMA is also introducing new initiatives into the Irish market to try and assist in the revival of the domestic market where the bulk of the remaining loans sit. These include:

- a proposed residential mortgage mechanism that will offer protection against risk of negative equity if prices continue to fall;
- using stapled debt (vendor finance) to generate commercial real estate sales that may not take place otherwise – applicable properties are largely investment properties, such as shopping centres and large office buildings;
- loan sales – will form major part of NAMA's strategy going forward; and
- attracting international investors – with this in mind, NAMA has been undertaking in-depth analysis of an appropriate REIT structure for Ireland.

Emmett concluded the longer-term outlook for Ireland was comparatively good, given the advanced progress the Irish Government had made in reducing the annual budget deficit, implementing the Bailout requirements required by the EU/IMF, in stabilising and recapitalising the Irish Banking system (in part via NAMA) and that when these features are combined with the well-established legal system and well educated and skilled workforce, the immediate future looks better than most other parts of Europe at this time. It appears now "that Ireland is still on the EU/IMF 'naughty step', but it is much closer to the bottom of the stairs than some other European nations who have required a bailout."

Outlook for development finance in the UK

Elma Morris,
EMJS
Consulting Ltd

This article is based on the research mainly undertaken during July and August 2011 that was published in October by the IPF Research Programme as part of the 'Short Paper' series.

The purpose of the research was to establish whether debt is available, and if so, whether it was economically attractive to borrowers. The research adopted a forward-looking approach, with the focus on how developers are funding their development pipeline and which lenders, if any, are providing this funding.

As part of the research, the author sought the views of key participants in more than 50 organisations involved in commercial real estate development, including banks, institutions (all insurance companies) and developers. Of the last group, five have headquarters outside London. The IPF wishes to thank these contributors for their invaluable insights into the current state of the development financing market.

Lenders

Are lenders open for business?

Twenty-three banks, five institutions and one mezzanine fund participated in the survey (see Figure 1). Eleven of these have already closed development finance transactions in 2011, 10 have no plans to be active in the development finance market at all and the remaining eight show encouraging signs for lending in the future. Five of this last group are currently working on terms for specific developer sponsors, although two of them stated that development finance is not part of their core business and so they should not be perceived as generally open for development finance business. Of the remaining three, one was hopeful of receiving approval to proceed once Basel III rules become clearer, while, for the other two, future prospects are encouraging, given that some of their overseas branches are looking at deals currently.

None of the insurance companies that participated in the research are active in development finance for commercial property lending, nor have intentions to do so. When lending, they are typically looking for a regular fixed-income flow from their product, which provides a better return than government bonds. Even where specific debt funds exist within institutions, the short-term nature of development finance is cited as a reason why it does not match the requirements of the investor base.

Research as to the intentions of mezzanine property lending funds fell outside the remit of the study but the one mezzanine fund contacted stated that the mandate of their fund did not permit development lending and they were not seeking to change the mandate.

Active lenders confirmed that they are open to new relationships as well as supporting existing clients. In many cases, relationship banking was emphasised as being of greater importance in the current economic environment than before the crisis. New relationships, as well as key existing relationships, are based on the sponsor having an excellent track record in completing developments in a timely and cost effective manner, as well as the ability to lease, asset manage and/or sell as appropriate to the nature of the sponsor's business. Most banks no longer want a minority role in a financing, i.e. being seen as 'just another lender'. This approach of course stretches across many lending platforms and is not limited to development finance.

Lending profile

The 16 banks lending, or likely to do so in the near term, predicted an aggregate lending amount in excess of £2bn for 2011. While a significant amount of this is anticipated to take place in individual deal sizes in the £10-£50m range, many lenders were also open for business in the under £10m range. The minimum transaction size of these lenders is between £250,000 and £2m. Of those prepared to lend in excess of £50m, some will consider deals of up to £125m, but generally implied that this would only be for the best sponsors with excellent development opportunities.

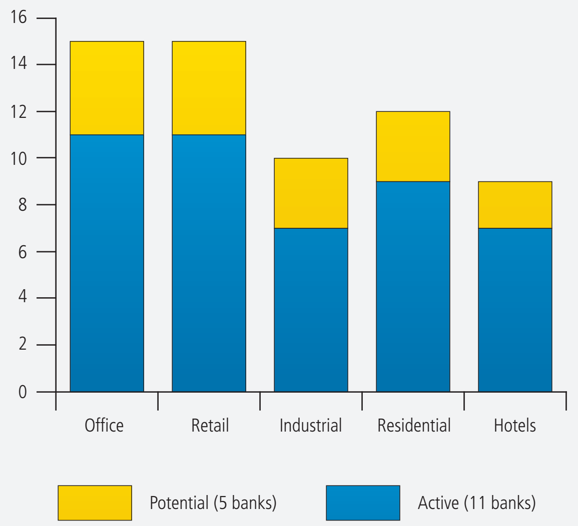
Most lenders prefer to operate on a bilateral basis so that if consent is required, which is often a feature in development finance, then the matter is wholly within their control. If the size of a project exceeds a preferred level of exposure, the inclination is to create a club deal with like-minded lenders. Although there was some evidence of syndication, this was very much the exception.

Figure 1: Lending by origin of capital

	Deals completed	Possibility: near term	Possibility: longer term	No plans	Total
UK banks	5	1	1	–	7
German banks	2	3	2	3	10
Other international banks	4	1	–	1	6
Institutions & mezzanine funding	–	–	–	6	6
Total	11	5	3	10	29

Six banks confirmed that they were prepared to lend in the five sectors specified, namely office, retail, industrial, residential and hotels. The predominant areas of interest were office and retail, but there is a reasonable level of interest across all property types as shown in Figure 2. In the case of hotels, however, many participants use the word 'selectively'. Other areas of interest include student accommodation, data centres and care homes.

Figure 2: Lending by sector



Note: the data reflects the intended strategy for the banks, but for the right sponsor they would be flexible.

In terms of regional bias, three lenders focused exclusively on London, another mainly on London and the South East, while the remainder tend to cover all or most of the major regional cities. Those mentioned included Birmingham, Bristol, Edinburgh, Glasgow, Leeds, Manchester and Newcastle. Locations outside the major regional centres were only considered for sponsors with good track records.

Pricing

Figure 3 summarises the range of pricing and fees. Banks approach pricing in a variety of ways, with some taking all fees upfront and others splitting them between upfront and exit fees. In some cases, lenders may be prepared to waive exit fees in the event that the sponsor converts the facility into an investment loan on completion of the development.

Figure 3: Fee profile

Type	Pricing
Arrangement fee	100-300bps
Margin	275–450 bps*
Exit fee	0-250 bps**
Commitment fee	50% of margin

Notes: *Two banks charge more. **Or a possible share in development profit.

Margins vary according to the perceived risk profile of the project and start at 75-100 bps above investment loan margins. Office, retail, and industrial, assuming pre-lets, tend to be priced at the lower end of the range, while hotels, residential and speculative office space attract the higher rates. Commitment fees are generally calculated on the undrawn balance of the agreed facility amount.

One lender stated that margins were still too low to reflect the true risk of financing developments. Another made the comment:

"Developers are typically looking for a return on cost of at least 20%. Finance costs are only a small proportion of total costs, and therefore an increase of 1 or 2% in margins and fees does not result in a commensurate reduction in the return for the developer."

Key terms

When lenders determine their terms for a loan, they focus on the individual nature of the development projects. However, once the covenants are set, there does seem to be a considerable level of consistency (see Figure 4). One bank said it would be prepared to provide up to 70% if the additional monies were to fund 'category A fit-out', the assumption being that this would be for a specific pre-let. Three banks said they would consider mezzanine finance if they were also the senior lender.

Borrowers

Who is looking for development finance?

Twenty four property companies and funds participated in the research. They comprised seven property companies with REIT status, 13 property companies of non-REIT status, three opportunity funds, and one institutional fund.

Eleven were actively seeking development finance or have recently secured funding; three were not active currently; and 10 were undertaking development projects but had no requirement to source development finance. The majority of this last group have access to corporate funding such as internal cash flow, corporate banking facilities, bond issues and/or private placements. Some also use forward funding facilities provided by the institutions.

Figure 4: Covenants required

Covenants	Details
Loan-to-Cost	Mainly 55-65% range
Interest cover ratio (ICR)	Not a specific focus, other than at least 1:1 for a partially let development. Used to set drawdown levels and margins as a building is let up
Pre-let	Level of pre-let set to match ICR coverage and drive drawdowns
Pre-sales (for residential)	Usually none required, but in some cases, some minimum thresholds may be set along with sales targets throughout the build period
Cost overrun guarantees	Minimum 10%, some 20%; more are becoming unlimited
Personal guarantees	Unusual, but used by some
Charges over shares in SPV	Yes

Of those in the first group who are looking for development finance, a number also have access to corporate funding and/or forward funding; however, these sources are either insufficient in quantum or not suitable for certain types of project, especially where development is being undertaken through joint ventures. The three sponsors who are not actively developing have made a strategic decision to focus on investment opportunities, rather than development. For one, this is a permanent move, but the other two are waiting to see whether the market for speculative finance might re-open.

Is debt affordable?

While some sponsors have been offered pricing that could work for them, and this was typically at the tighter end of the pricing spectrum, there are several who have found the cost of finance economically unattractive, thus making projects unviable. Borrowers understand that margins needed to rise, as a result of increased funding costs to the banks, many felt that pricing had moved too far and that the size of the upfront arrangement and exit fees can make borrowing prohibitive. One developer explains the problem as follows:

"With the dropping of LTCs from 80% to 60%, which has doubled the equity and therefore halved the return on any deal, how can developers also afford the significant increase in fees that we have seen in the last few years."

The concern about the significant increase in finance costs extends to a number of schemes in London and the South East and is not solely a regional phenomenon. Conversely, there is evidence of some deals in the regions being priced at affordable levels, e.g. arrangement fees of 100-150 bps, with margins at 250-350 bps.

On some deals sponsors have turned down finance and are using their own equity. In other instances, some are simply unable to start development and are looking for cheaper financing. In two instances, sponsors have found it economically more efficient to enter into a forward funding deal with an institutional investor rather than take the debt package on offer and, for one of those two sponsors, this included taking into account the cancellation and breakage fees of a loan already signed.

This trend can be seen elsewhere. Some developers, who prior to the crisis used a combination of forward funding and development finance to fund their construction programmes, in the last few years have moved much more towards the forward funding model. While institutional funds generally buy properties at a discount of 10-15% using the forward funding approach, as long as sponsors can make a developer's profit of 15-20%, this is seen as a 'win win' result.

On a more positive note, some developers find themselves in a position of relative strength when seeking smaller development loans. Those with attractive investment portfolios to refinance can find that they become preferred borrowers in the current economic climate, thus allowing them to attract development finance on more agreeable terms.

Figure 5: Financing requirements

	Finance required/ recently acquired	Finance not required, not actively developing	Finance not required, but actively developing	Total
Property co. – REIT	1	–	6	7
Property co. – non-REIT	9	1	3	13
Opportunity fund	1	1	1	3
Institutional fund	–	1	–	1
Total	**11**	**3**	**10**	**24**

One sector for which sponsors seemed to have limited problems finding development finance (providing the size is small enough to be done on a bilateral basis), is central London residential. The high demand from wealthy overseas investors makes this a very attractive market. While, in most cases, banks do not require pre-sales on residential deals, some sponsors have been actively selling off plan in order to de-risk projects. What is unclear is how long this market will continue to thrive.

Impact on business

Although there is a lack of development finance available at prices sponsors would like, many of them take the view that this is a new world and, in order to survive, they have to adapt their business models. The winners will be the ones that (a) have more cash to put into deals and (b) come up with more creative solutions to the liquidity crisis.

"We are masters of our own destiny, and so we have to create liquidity."

Many property companies raised additional equity over the last few years, not only to build up their balance sheets but, also, to create surplus liquidity in anticipation of opportunities. They have also been raising funds in the capital markets, taking advantage of pricing opportunities in the US private placement and convertible bond market, as well as the corporate bond market.

The economic crisis has also brought with it some welcome changes: some developers, who acted prudently prior to the crisis, found they often lost out on land and property acquisitions to those who obtained highly leveraged finance. They are now in a position to win opportunities again. In addition, the price of land is also falling back to more reasonable levels, especially outside central London. Many developers now have the opportunity to buy sites at reasonable prices before the next upturn.

Future outlook

Most sponsors believe the availability of development finance will improve over time but that it will be at a very slow pace, and may take three to five years to recover fully. However, most agree that it is unlikely to return to levels seen before the crisis, either in terms of availability or price.

The economy is a particular concern, partly because we have yet to see the full impact of the public sector cuts in the UK, but more significantly, the impact of the sovereign debt crisis in Europe and how it will unfold. The regulatory environment is also a major cause for concern with the general sentiment being that it will only get worse.

Although there is currently no evidence that institutions will step in to take the place of the banks in the development finance arena, many banks and developers expect them to do so in the future. While institutions are starting to participate more fully in the investment side of the market, development finance does not fit well with the annual returns demanded by their investor base. It also requires a very different skill set and uses up far more resource than direct investment. Specialist debt funds may start to fill the gap and more research needs to be done to understand the opportunities in this market.

Tax increment finance (TIF): Can it unlock stalled town centre schemes?

The Government announced in October 2010 that it would introduce new borrowing powers to enable local authorities in England to carry out tax increment financing (TIF). TIF originated in the US where it has been successfully used for at least 50 years. Whilst it has evolved over time and varies from state to state, in general terms TIF allows a local government entity to take tax revenues derived from increases in property values or economic activity within a prescribed development area (the TIF district) and use those incremental revenues to fund infrastructure and other urban renewal projects. Key requirements are generally that the TIF district must be considered to be 'blighted' and that 'but for' the TIF no private commercial developer would undertake the proposed renewal scheme. The definition of 'blight' has itself been expanded as TIF has developed in the US so that it can now simply refer to areas where economic development is being encouraged.

Before a TIF is established in the US the relevant local government entity will assess the suitability of an area for TIF and then produce a TIF development plan. The sponsoring local government entity then usually issues bonds to provide the funds necessary for the upfront project costs. As the TIF district is enhanced, property values and, hence, property taxes rise and this additional revenue is used to service the TIF bonds. Sales tax and other local taxes may also be used in a similar way. Accordingly, detailed financial modelling must be carried out to satisfy prospective lenders that, on a conservative basis, there should be sufficient revenues to meet debt payments. TIFs are long-term commitments, often lasting 25 years or longer. During that time projects may be re-financed, reflecting changing levels of risk as projects are completed and mature. Once the initial debt has been repaid surplus TIF fund may be re-invested in the TIF district.

A notable feature of the US system is the level of local democratic control over local taxes. Each city and county controls the levels of tax it levies and will often seek a mandate from its electorate for a specific increase in local taxes to cover the cost of a TIF project. It is interesting to note that one of the main drivers for the widespread adoption of TIF in the US was a reduction in Federal funding for urban projects, combined with a greater devolution of power to local government levels.

In the UK, the debate on TIF has focused on the use of business rates to the exclusion of other revenue sources, such as council tax. However, the major stumbling block is that the current business rate system is centrally controlled. The national non-domestic business rate (NNDR) is levied at a single national rate set by the Treasury, indexed to the Retail Prices Index with the underlying property valuations carried out by the Valuations Office Agency. At present, local authorities have no discretion to raise local business rates and act simply as tax collectors for the NNDR, with the Treasury returning funds to local authorities in the form of various grants.

Chris Brigstocke, Partner, Squire Sanders Hammonds

The Local Government Resource Review, which was launched in July, contains the Government's proposals to change the system of NNDR as from April 2013 to enable a degree of local retention of NNDR, thus removing the main barrier to the introduction of TIF. Under the new system, a baseline of income for a local authority will be fixed and there will be a system of tariffs and top ups to re-distribute revenues between local authorities based on whether the NNDR currently generated locally is likely to be more or less than is needed to fund a local authority's activities.

Mark Simpson, Partner, Squire Sanders Hammonds

Theoretically, a local authority will retain any additional business rates generated in its area, providing an incentive to generate local economic growth. The system will, however, be subject to periodic 're-sets', which may result in a local authority having its baseline NNDR revenue reduced in future years and there will also be an ability for Government to recoup any 'disproportionate benefit' achieved by any authority which is being too successful! The consultation document issued by the Government does recognise that local authorities and developers must have a degree of certainty about future tax revenue streams to enable them to borrow against them. The Government has therefore proposed two scenarios within which TIF could operate:

- The first would allow local authorities to decide for themselves whether to invest in a TIF and they would be free to borrow against their entire retained business rate revenues, including anticipated growth, subject to the normal operation of the prudential borrowing system. However, these revenues would be subject to the levies and re-set mechanisms in the new system so a degree of uncertainty would hang over these revenues in the future;
- The second would involve Treasury controls over the ability to bring forward TIF schemes but would guarantee that additional revenues generated in a TIF district would be ring-fenced and would not be subject to the levy and re-set mechanisms.

In the case of enterprise zones (EZs), the Government has confirmed that any uplift in NNDR revenues within the EZ above the current baseline can be retained for 25 years from April 2013 to support the purposes of the local enterprise partnership. The local partners will therefore be able to borrow against their future revenues without the need for Treasury approval and, effectively, the EZs will be 'oven ready' for TIF. The Government has also confirmed that all revenues from renewable energy projects will be retained by local authorities under the new system.

Figures 1 and 2 illustrate the potential local authority-led and developer-led TIF structures respectively. The British Council of

Shopping Centres (BCSC) wrote recently to the deputy Prime Minister calling for the early introduction of a developer-led TIF model known as the Local Tax Reinvestment Programme (LTRIP). This would not require any borrowing by the local authority but would instead be based on the developer financing the project out of its own resources and then being repaid out of the tax increment generated from the increased NNDR as and when it arises. This model is commonly used in the US and has a number of attractive features from a public sector perspective, notably that the developer takes the risk of any shortfall in incremental revenues generated within the TIF district. Another potential attraction is that the borrowing should be 'off balance sheet' as far as the public sector is concerned, although the BCSC has noted a prevailing view within the Treasury that any 'securitisation' of future business rates by a local authority would still be classified as government borrowing. However, the introduction of this model is not possible until local authorities are given powers to retain additional business rates so this is not a model that can be implemented without primary legislation. (The BCSC has highlighted statutory powers to retain business rates that are contained in the Local Government Act 2003 but it seems unlikely that the requisite secondary legislation will be brought forward to activate these powers).

It must be acknowledged that TIF is not a panacea for town centre schemes, or indeed any other type of regeneration or renewal project. The current challenging market conditions will not be conducive to TIF in many areas. TIF is best used where there are strong prospects of growth in the medium term and therefore it may be particularly appropriate in enterprise zones. However, TIF has been highly successful in the US and there is no reason why it should not be deployed in the UK once the NNDR system has been revised to allow some local retention of business rates. It certainly deserves to be given a chance to help drive the Government's growth agenda at a local level.

It should be noted that Scotland already has legislation in place to enable TIFs to proceed and the Scottish Government is intending to allow a small number of pilot TIF projects to proceed.

The Chancellor's Autumn Statement on 29 November 2011 did not contain much on TIF beyond confirming that further details on how local authorities will be able to use NNDR for TIF will be set out in December's Local Government Resource Review. Intriguingly, however, the Government indicated it is also considering allowing CIL revenues to be used to support TIF borrowing by local authorities.

Figure 1: Local authority-led TIF

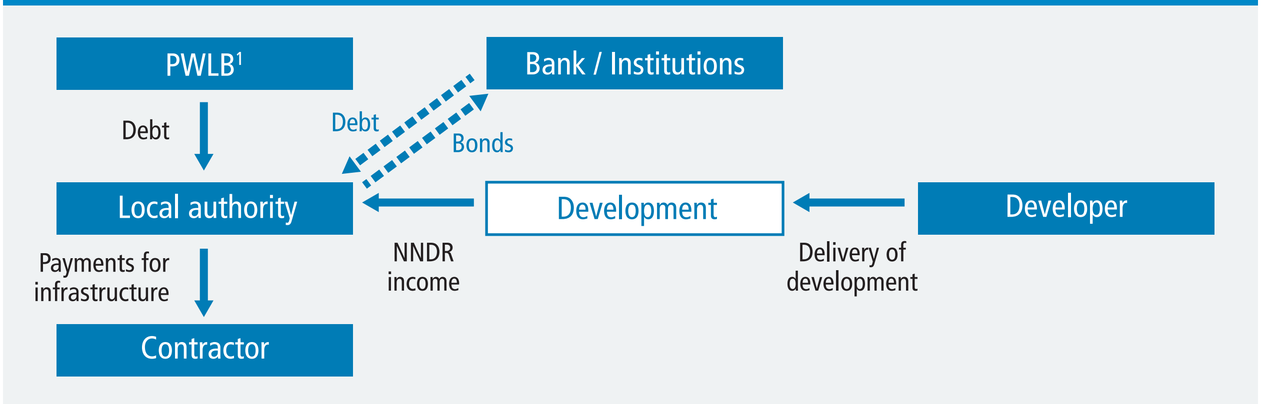
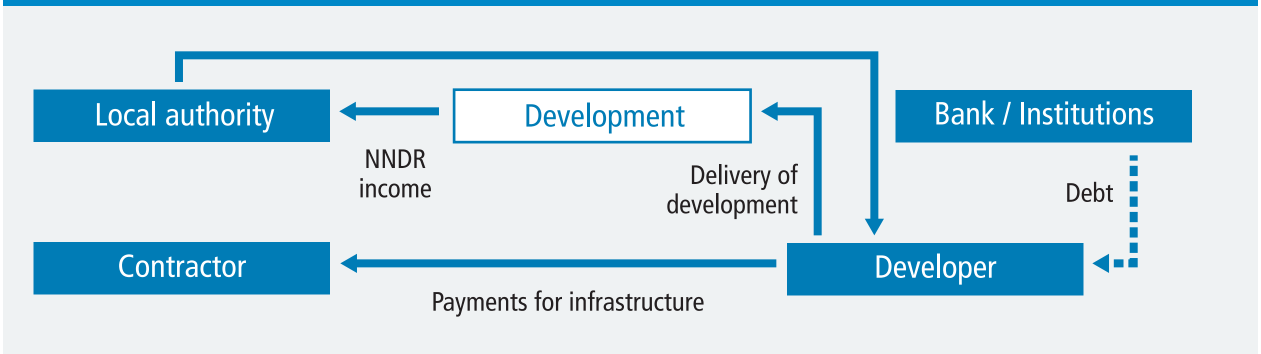


Figure 2: Developer-led TIF



1 Public Works Loan Board

Solvency II and real estate funds

John Forbes, Partner, Real Estate Funds, PwC

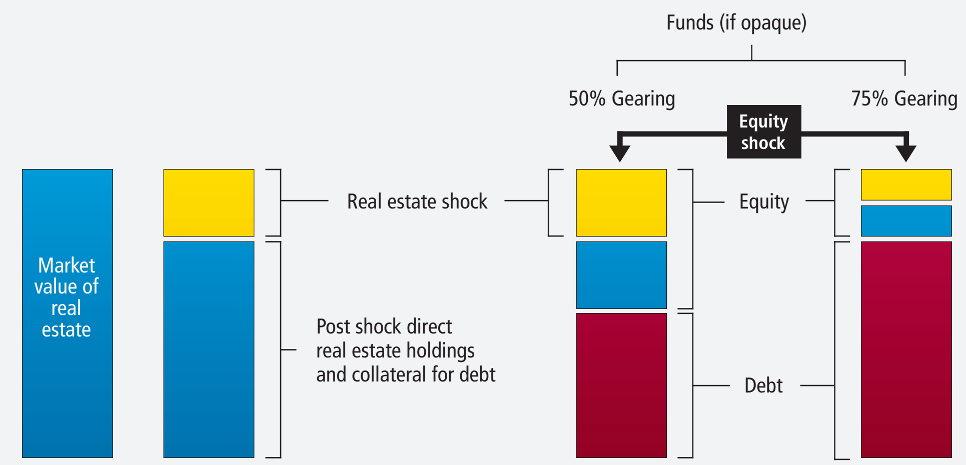
The implementation of the Solvency II regulations for European insurance companies is of huge significance for the real estate industry. Life insurance companies are major investors in real estate funds. Furthermore, the European Insurance and Occupational Pensions Authority (EIOPA) has a consultation process running until January regarding the extension of a Solvency II type regime to some or all defined benefit pension schemes. This will potentially have an even greater impact for the real estate industry than the application of the rules to insurance companies.

The implementation process by the European Union is now reaching the point where much greater clarity is expected. The Level 2 regulations have now moved from the EU Commission to the EU Parliament. Although the Level 2 regulations are not a public document, they appear to have been circulated quite widely and have been commented upon in the real estate trade press. Many people have already commented on the broader implications for the real estate industry of changes in the attitude of life insurance companies to real estate as an asset class as a result of the anticipated Solvency II changes. This article concentrates on the impact for real estate funds.

The key concern for real estate fund managers is how insurers and possibly pension funds will view indirect investment in real estate as an investment asset once Solvency II is in force, and in particular, how they will be required to model potential future falls in value of their investments. Insurers can either use a 'standard model' for which the risk factors are set down by the EU regulator or seek approval from their national regulator to use their own internally generated risk model. Much of the real estate industry attention has focused on the amount by which insurers need to write down the value of their real estate investment assets under the standard model. Currently the proposal is that the shock to be applied to direct real estate investments is 25%, i.e. insurers should write down the book value of their real estate investments by 25%, from a starting point that the assets are carried in the books at market value. For the vast majority of major life insurers, the use of the internal model is more relevant. However, the smaller insurers, who could be investors in funds, may be relying on the standard model. Furthermore, if a similar approach is adopted for defined benefit pension schemes, which are generally less sophisticated than major insurers, use of a standard model is likely to be more prevalent.

The treatment under Solvency II of real estate investment through funds is still also unclear, although it is widely believed that the proposals that have gone from the EU Commission to the Parliament provide much greater clarity. This will be welcome news for real estate fund managers. The lack of certainty has been a major concern as it has been encouraging insurers to delay deploying capital with real estate fund managers. For un-geared funds, it has always been understood that they should be treated as if the assets were held directly, i.e. the 25% write-down should be applied. For geared funds, the position had been less clear. Previous commentary has implied that the equity shocks should be used. These are 49% for unlisted vehicles and 39% for listed (subject to an adjustment of up to 10% either way intended to smooth the impact of fluctuations in equity markets). However, it should be noted that these shocks are applied to the net value of the equity whereas

Figure 1: Solvency II shock calculations for real estate under standard model



the 25% for property would be applied to the gross value before gearing, as illustrated in Figure 1. The equity shocks are also adjusted depending upon the state of the market at the time, through the mechanism of the dampener. Insurers and fund managers need to know whether funds should be treated as transparent and thus as real estate investments or opaque as equity investments.

Real estate funds cover a broad spectrum; the nature of the investment vehicles varies considerably, as does the way in which they are financed, the level of gearing and indeed the nature of the underlying investments. For an open-ended vehicle, with low levels of gearing and core real estate as the underlying asset, the transparent treatment would seem most appropriate. At the other end of the spectrum, a closed-ended real estate private equity fund with high levels of gearing and underlying assets with significant operating risk, for example hotels, is difficult to distinguish from any other form of private equity fund. Choosing either approach and applying it to all real estate funds would seem inappropriate for one end of the spectrum or the other.

Defining some form of segmentation through regulation is unlikely to be successful. Many eminent figures and organisations in the real estate industry have attempted during the last decade to adequately define different fund styles and strategies with only partial success. It would seem unlikely that the insurance regulator would be better placed to come up with a sensible approach. The most obvious option would be to allow insurers to decide on a case by case basis which of the two approaches is most appropriate, taking into account the characteristics of the underlying investments. Commentary in the industry suggests that the Commission is moving towards a default approach of following the 'look-through' approach for all indirect exposures, including exposures to geared funds, and this is certainly what is reflected in the proposed reporting regime in the consultation paper issued recently by EIOPA discussed further below. Speculation is that although a transparent approach will be the default option under the proposals that have gone to the EU Parliament, insurers will be allowed to adopt the equity treatment in cases where the transparent treatment would be inappropriate or impractical. Although there is some uncertainty as to what this would mean in practice, this would be a welcome outcome as it will provide the flexibility advocated above. There is some contradiction in a look-through approach being adopted for all funds, whilst at the same time specifically stating that private equity and hedge should be treated as unlisted equity. It is also unclear how much attention has been given to the fact that very many funds are structured with holding companies and special purpose vehicles, so a look-through approach, if it is only at the fund level, does not necessarily provide the comprehensive answer suggested by some commentators.

The 25% market shock also affects the way that real estate debt is treated in the books of insurers. The standard formula currently requires that, for loans secured by a mortgage, the value of the collateral is written down by the standard shock. This potentially makes secured real estate lending a more attractive proposition than direct real estate investment as the owner of the equity is assumed to suffer the brunt of the shock with the lender only suffering once the adjusted value of the collateral is lower than the amount of the loan. Pressure on other traditional lenders to reduce their commercial property lending is creating an opportunity that is attractive to insurers from both a commercial and a regulatory perspective.

If the uncertainties regarding the treatment of funds can be resolved, there are compelling arguments for insurers to reduce their investment in direct property, but at the same time to increase their exposure to real estate debt and to higher return real estate investments. Real estate debt provides the lower risk element and has a relatively more favourable treatment under Solvency II. Fund and direct investments have a much more capital hungry treatment under Solvency II but provide the potential for upside if the investment is in higher risk / higher return assets. The blended effect gives a better Solvency II result than holding large swathes of direct property delivering not much more than a bond-type return. The high capital cost of investing in real estate other than through debt has to be justified by higher returns.

Aside from the fundamental question as to whether Solvency II will change the behaviour of insurers and pension funds in the way they perceive real estate as an asset class, fund managers and others will also need to address the reporting implications. This is again an area of uncertainty. EIOPA published its 'Consultation Paper on the proposal on Quantitative Reporting Templates' and 'Draft proposal for Guidelines on Narrative Public Disclosure & Supervisory Reporting, Predefined Events and Processes for Reporting & Disclosure' on 8 November. This is a consultation due to run until 20 January 2012, after which EIOPA will consider the feedback received and expects to finalise the package in summer 2012. These snappily titled documents are a significant step forward in the process that will determine the public and supervisory reporting obligations of the insurers, which will in turn determine the level of granularity of reporting at the fund level. As indicated above, the assumption is that funds will be treated as transparent so reporting will need to be in respect of the underlying investments of the funds.

The FSA has this month also launched its own consultation process in respect of implementation of Solvency II in the UK.

Solvency II is clearly going to be a major challenge for the real estate fund management industry, but also potentially a stimulus for product development. This should become considerably clearer over the next two months. The move towards flexibility of treatment of funds would be a very welcome development, if this is what emerges from the EU Parliament.

Occupier Satisfaction Survey 2011

Stuart Morley, Consultant, Research Department, GVA

The fifth Property Industry Alliance (PIA) and CoreNet Global Occupier Satisfaction Survey was released in September. It collected the views of a range of occupiers, detailing their experience of working with landlords over the past 12 months. The questionnaire this year and last year was based on the Code for Leasing Business Premises in England & Wales, 2007 and will hopefully continue to be a useful tool for the industry, helping to identify key areas for improvement and good practice where it is happening.

A steering group from the PIA and CoreNet Global devised the questionnaire and was responsible for emailing the questionnaire to occupiers. Results were collated, analysed and presented by GVA, a member of the Steering group.

Headline findings

The overall average occupier satisfaction weighted score was 5.4 out of 10 (where 1 is extremely dissatisfied and 10 is extremely satisfied). This suggests that, on the whole, commercial occupiers feel that UK landlords provide a fair level of service, with room for improvement, but this is better than last year's score of 4.9 out of 10.

Occupiers from the industrial sector, with a score of 4.9 compared with 4.6 last year, appear less satisfied than those from the office or retail sectors. The office sector had a score of 5.6 (5.2 last year) and the retail sector had a score of 5.2 (5.1 last year). Smaller occupiers (small and medium enterprises [SMEs] with 250 employees or less) are less content (score of 5.0) than larger occupiers (score of 5.4) but the gap is much narrower than it was last year.

75% of occupiers feel the relationship with their landlord had remained at a fairly constant level over the previous 12 months, while a small number (14%) feel that it has deteriorated and 10% think that the relationship has improved.

Although the overall weighted average score is 5.4, the responses were not distributed evenly. 20% were very dissatisfied (with a score of 1–3 out of 10), whereas 16% gave a score of 8–10, indicating a high level of satisfaction. Almost two thirds of respondents gave intermediary scores of 4–7 out of 10.

Main issues

The results for the main issues in the survey are shown in Figure 1 below, giving the weighted average satisfaction score for this year and last year. Most topics achieved a satisfaction score between 5.2 and 6.2 out of 10, but much lower scores were recorded for landlords' service charge arrangements and landlords' interaction on environmental issues (scores of 4.3 and 4.0 out of 10 respectively).

There is a noticeable improvement between this year's results and last year's for most issues as the table shows, which is encouraging. Nevertheless, the majority of occupiers in this year's survey, as in last year's survey, stated that their satisfaction with landlords was similar to a year previously. The areas which have seen the greatest improvement in satisfaction are the application for consent process (an increase from 4.0 to 5.3 out of 10) and the process of relinquishing a property back to the landlord (an increase from 5.3 to 6.2 out of 10).

Figure 1: All occupiers satisfaction with...

	Weighted average score (out of 10) 2011	2010
the rent review terms and conditions achieved through lease negotiation	6.2	5.8
the leasing process	6.2	5.5
the rent review process	5.1	5.4
the process of relinquishing a property back to the landlord	6.2	5.3
the landlord's insurance arrangements for the building	5.3	4.9
the level of communication with landlords	5.3	4.7
the process of negotiating a dilapidations claim over the last 12 months	5.2	4.6
the landlord's service charge arrangements	4.3	4.2
the application for consent process	5.3	4.0
the landlord's interaction on environmental issues	4.0	3.5

Areas where satisfaction with landlords was highest

Occupier satisfaction with rent review terms and conditions achieved through lease negotiation stands at 6.2 out of 10 compared with 5.8 last year, showing a slight improvement. 80% of respondents did not accept the terms initially offered by their landlord, with 44% seeking alternative terms, and of these, 40% eventually agreed to the initial terms offered but negotiated alternative concessions.

However, there was quite a difference in opinion between office and industrial occupiers. Whilst office occupiers had a satisfaction score of 7.0, the industrial sector had a considerably lower score of 5.0 out of 10.

The leasing process, with a weighted average score of 6.2, represents a strong improvement on last year's score of 5.5. Last year's survey highlighted a score difference of 1.6 out of 10 in the level of satisfaction between large companies and SMEs. Whilst a gap still exists, with large companies having a score of 6.4 and SMEs a score of 5.5, this has narrowed to a difference of 0.9 out of 10.

Industrial occupiers recorded the lowest level of satisfaction of the three sectors, with an average score of 5.2, compared with 5.8 and 6.8 for retail and office occupiers respectively.

The third high scoring issue was the process of relinquishing a property back to the landlord, also with a weighted average score of 6.2, compared with 5.3 in last year's survey. This represents not only the joint highest score but the second largest improvement over the last year and, unlike for most other issues, there was no difference between large occupiers and SMEs.

80% of respondents had dealt with a dilapidations claim over the last 12 months. However, the level of satisfaction with negotiating dilapidations claims was lower (score of 5.2) than the level of satisfaction with the overall process of exiting properties.

Areas where satisfaction with landlords was lowest

Service charge arrangements were one of the lowest scoring areas of the survey with very little improvement over the past year. Satisfaction levels stood at an average of just 4.3 out of 10, compared with 4.2 in the previous survey.

56% of occupiers responded that 'all' or 'the majority' of their landlords provided them with a service charge budget whilst 19% reported 'about half' of landlords provided one. Conversely, 24% stated that either 'a minority' or 'none' of their landlords provided a service charge budget. There has been little change in the breakdown of these figures over the past year.

This is clearly an area where landlords need to make considerable improvements, especially as 88% of all respondents in the survey pay service charges for the properties they occupy.

Environmental / sustainability issues achieved the lowest levels of satisfaction. Landlords are still considered to be performing poorly with regard to engaging with their tenants on environmental issues, although there has been some improvement in the last year. Whilst the 2010 survey reported an average score of 3.5 out of 10 for this area, the most recent findings gave an improved score of 4.0.

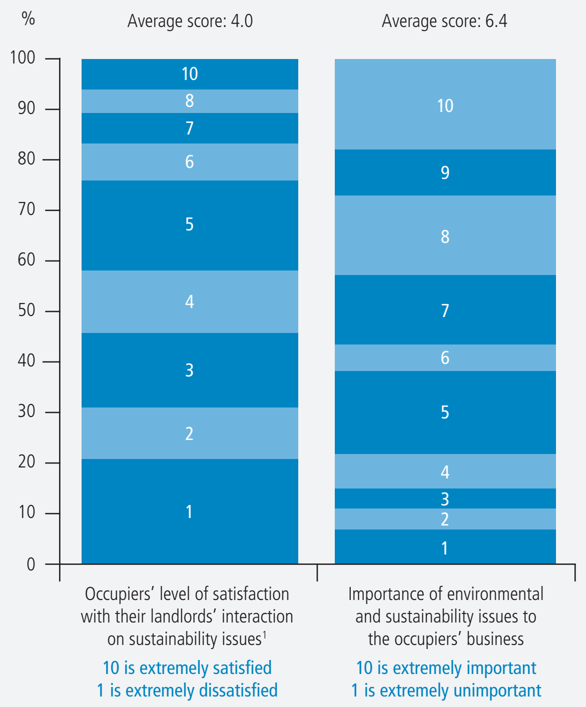
However, there is a marked difference between sectors. Retail occupiers reported the highest average score at 4.6, followed by office occupiers with a score of 3.8. The industrial sector gave the lowest of all average scores at just 2.6 out of 10.

As was the case last year, there remains a large gap between occupiers' satisfaction with their landlords' interaction on environment / sustainability issues and occupiers' views regarding the importance of environment / sustainability issues to their business. This is clearly shown in the chart.

58% of respondents felt that environmental and sustainability issues were equally as important to their business compared with 12 months previously. 62% of all respondents rated the importance of such issues as 6 or above, with 43% of these giving a very high score of between 8 and 10.

Interestingly, since the last survey SMEs felt that the level of importance of sustainability issues has increased from 5.9 to 6.1 out of 10, whereas for larger occupiers it had declined from 7.7 to 6.9 out of 10.

Figure 2: Occupiers' views on environmental and sustainability issues



1 No satisfaction levels of 9 were recorded.

Conclusions

The survey covered occupiers' attitudes towards landlords and how they are changing. Over the last 12 months there has been a noticeable improvement, which is encouraging, but there is still some way to go on certain issues like service charges and sustainability issues.

The backdrop to this year's survey and to most of the five Occupier Satisfaction Surveys undertaken is a very troubled economy, with weak occupier demand. To what extent this has affected survey attitudes is difficult to assess. It could mean that occupiers are worried about the strength of their businesses and so are more critical of their landlords' actions or lack of them, or it could mean that landlords are making an extra effort to help their tenants to ensure that their income flow is maintained.

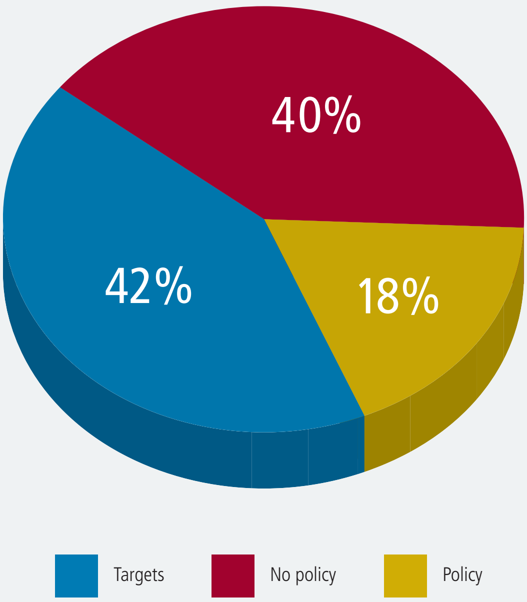
Whatever the answer, it looks as if the backdrop to next year's survey is unlikely to be much different from this year's. But hopefully the improvement in the landlord tenant relationship observed in this year's survey will be maintained over the next 12 months.

Environmental quality: Impact on value

The UK is legally bound to reduce national emissions of greenhouse gases by 2020 and again by 2050. The Government is targeting the built environment as the main source of those reductions and does not believe that the 'normal' cycle of refurbishment and redevelopment will deliver sufficient savings in time. It is hoping that the property market will address the issue voluntarily but, however reluctantly, accepts that statutory interventions will be necessary. The details are unclear but the general direction is not: the worst buildings will need to be made better.

At the same time, a significant proportion of the income from property investment portfolios already comes from companies with published environmental policies (see Figure 1) that, in many cases, contain measurable CO_2 reduction targets. Given the continuing uncertainty in the global economy, it is likely that corporate spending on corporate and social responsibility will be limited in the short term but there is a broad consensus that the environmental performance of buildings will ultimately influence occupiers' perceptions of quality. Simply, buildings with poor environmental qualities will be less attractive. They will command lower rents, have longer voids, leases will be shorter and tenant retention rates at the end of leases will be lower.

Figure 1: Tenants' environmental polices



Note: The chart shows the amount of income payable by 1,000 tenants of investment-grade properties according to the strength of their current environmental policies. Income is divided between tenants who have not published a policy, those who have published a formal policy and those whose policies contain measurable targets for CO_2 emissions reductions.

Charles Woollam, Partner, Sustainable Investment & Asset Management (SIAM)

Although hard evidence is still in short supply, the prospect of statutory compliance costs, coupled with longer-term income erosion, introduces a new element of risk which is not necessarily reflected in current transaction prices. This suggests that the value of some properties might undergo a rapid and potentially significant correction and that, as a result, the future performance of some portfolios will be compromised.

How will values be affected?

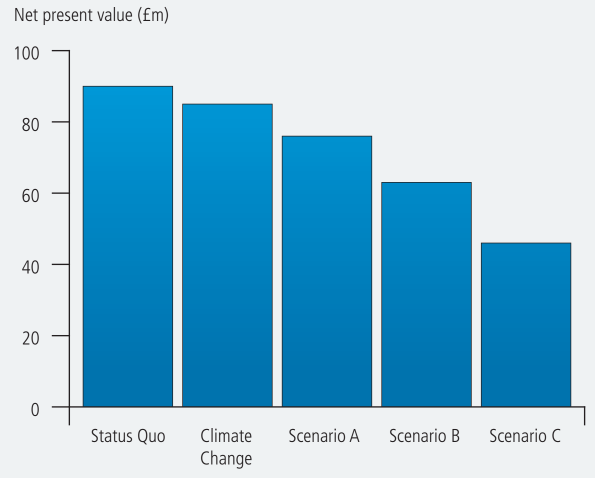
In order to try and assess the magnitude of the correction, SIAM has undertaken a detailed analysis of around 250 UK assets, with a combined capital value of £2.5bn, split between offices (30% by value), shopping centres (17%), retail warehouses (15%), and industrials (14%), with the remainder being standard retails and a substantial portfolio of hotels. Again, by capital value, 40% of the sample is within the ownership of private property companies, 30% is owned directly by various pension funds and 23% is held in property unit trusts. The value of individual assets ranges from £500,000 to £200m. In analysing these assets, which have an aggregate estimated rental value of over £200m per annum, the quality of over 1,000 leases and the sustainability aspirations of more than 1,000 tenants were assessed.

Chris Edwards, Partner, Sustainable Investment & Asset Management (SIAM)

This analysis suggests that around 10% of property (by value) is at significant risk of a short-term loss in value from sustainability-related issues and a further 29% is at medium-term risk. Examples of short-term risks include the imminent imposition of minimum performance standards on some properties with poor energy performance certificate ratings, and properties that are at risk of flooding. Medium-term risks are likely to arise where key tenants are occupying buildings that are inconsistent with their environmental policies and thus exposed to an above-average loss of income at lease expiry and longer voids.

The resilience of individual investment portfolios can be modelled. Applying different tenant retention rates and ensuing voids to each asset according to the nature of the occupier, the length of the lease, the cost of relocation in relation to the cost of improving existing buildings, the scarcity of better-rated alternatives etc. shows that, across the pool of £2.5bn, assets will underperform against current expectations by a total of just over 5% but that the impact on individual portfolios is within a range of 0% to 25%. So, whilst some portfolios will be largely resilient, others will be relatively hard hit – see Figure 2.

Figure 2: Impact on value of sustainability-related risks compared with current expectations



Note: Current expectations are shown as 'Status Quo'. 'Climate Change' shows the potential impact of an increasing number of tenants leaving the worst performing buildings in favour of more sustainable alternatives, whilst Scenarios A, B and C show the impact of incurring improvement costs to protect the value of the least sustainable stock.

Impact by sector

Further analysis highlights the general characteristics of individual assets whose future performance is most at risk but also reveals some interesting sector-specific attributes. Portfolios with an exposure to retail warehouse parks and multi-tenanted industrial buildings, for example, have an in-built resilience. Retail warehouses are expected to provide long-term resilience as, first, environmental performance is very largely influenced by the quality of tenants' fit outs which, when coupled with almost universal supply constraints, will encourage tenants to make improvements at their own expense, rather than relocate. Secondly, relative to other sectors, they are generally let on longer leases. Industrials, on the other hand, provide short-term resilience. The detailed analysis over 1,000 tenants shows that tenants of industrial estates are least likely to be influenced by sustainability-related issues in making leasing decisions.

Most risk is attached to the offices sector. Here, there are fewer supply constraints and, in most established locations, environmentally-influenced tenants will have a choice of newer buildings, constructed to better standards causing below-average tenant retention rates and an erosion in value in older ones. Offices let on long leases, as established corporate headquarters, for example, or in locations with little speculative development or reasonably constant demand, will be less affected.

Affordability of improvements

The resilience of individual buildings will be strongly influenced by the affordability of retrospective improvements, either in response to Government interventions or as a means of protecting value. In some instances, environmental performance can be corrected as a marginal extra cost during the normal refurbishment and redevelopment cycle or as part of the routine replacement of obsolete building services. At other buildings, the cost of improvement will be so high in relation to any conceivable benefit that it makes better financial sense to tolerate an erosion of value than to incur the cost of trying to prevent it.

The relative affordability of various improvements can be modelled. In every portfolio analysed, the cost of improvements is likely to be a more significant drag on total returns than the cost of doing nothing. This even applies when the improvements are limited to buildings where the landlord is given possession and where the extent of the improvement is limited to works required to bring buildings up to current standards. For individual assets, a few properties may already stand the cost of improvements, some will do so after a realistic period of rental and capital growth but some are unlikely ever to provide an acceptable return on costs.

The value of those properties which are likely to prove least attractive to the most desirable tenants and where the cost of improvement is least affordable is obviously at risk but the most significant risk is reserved for properties where the cost of improvements is both unaffordable and likely to become unavoidable through statutory intervention. This may already include a number of buildings with F and G-rated energy performance certificates, where new minimum standards are being introduced under the provisions of the Energy Act 2011.

Investors do not need to wait for evidence to emerge before assessing the degree of risk attached either to individual assets or to discrete portfolios. For some assets, it will be possible to maintain, rescue and even to create value through selective improvements but, in other cases, it may be preferable to sell before the risks become embedded in the pricing of transactions and prospective statutory liabilities crystallise.

Depreciation of UK commercial investment property

Depreciation is an important issue for property investors since it affects both the returns from, and pricing of, property assets. Recognition of its impact has generated requirements for information on the rates of depreciation and expenditure affecting different property types. Such information can be used to inform macro-level analyses of the role and likely returns from property investment in a multi-asset context. It can also be used in micro-level pricing models to evaluate whether specific assets should be bought or sold and it has relevance in a lending context where appraisals may need to project the value of a building at the end of the life of a loan. Finally, such information may guide decisions as to the appropriate time to refurbish or redevelop an asset.

This article is taken from the research report Depreciation of commercial investment property in the UK, published by the IPF Research Programme in November 2011. This report was commissioned to update the principal analyses from Depreciation in Commercial Property Markets published by the IPF in 2005 by extending the 1993-2003 dataset that was constructed for the earlier research. Its specific objectives were to measure the rates of rental depreciation experienced in different segments of the UK commercial property market over the period 1993-2009 and to measure rates of non-recoverable capital expenditure over that same period.

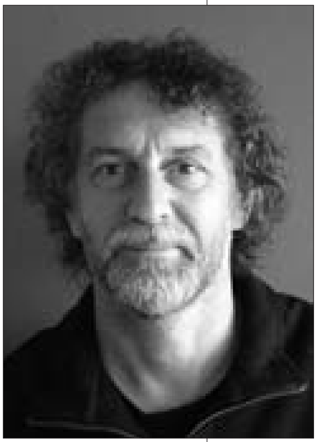
Methodology

The approach taken in this report is the same as that taken in 2005, namely a longitudinal study in which depreciation is measured as the relative decline in value of a group of assets over time in relation to the benchmark, i.e. the respective rent points in CB Richard Ellis' Rent and Yield Monitor. This data set was chosen because of its coverage and hypothetical basis, with observations reflecting judgements about the rent or yield achievable on new or recently refurbished buildings in the prime area for the locations being monitored.

The number and value of properties used in the analysis is shown in Figure 1. The sample is somewhat diminished in comparison with that available for the 10-year period (1993-2003) used in the earlier research, the main reason being trading activity in the intervening period.

Rental depreciation

Figure 2 presents rates of rental depreciation for the main segments of the UK commercial property market over the 16-year period (1993-2009), compared with the rates in the



Neil Crosby, Professor of Real Estate, University of Reading

Steven Devaney, Lecturer in Real Estate, University of Aberdeen

Figure 1: Number and value of properties in the sample

	Number of properties	Capital value end-1993 £m	% of IPF (2005) sample[1]	% of assets in IPD at 1993[1]
Standard Retails	**319**	**1,033**	**37**	**5**
Offices	**217**	**1,496**	**39**	**5**
Industrials	**158**	**762**	**47**	**7**
Std Ret – South East	185	549	43	6
Std Ret – Rest of UK	134	484	32	4
Shopping Centres	19	411	26	6
Retail Warehouses	29	249	54	5
Offices – City	41	334	55	8
Offices – West End	64	402	38	6
Offices – Rest of SE	75	522	37	4
Offices – Rest of UK	37	237	33	3
Industrials – SE	104	556	50	8
Industrials – Rest of UK	54	206	44	6
Total sample	**742**	**3,950**	**40**	**5**

1 Measured in terms of number of assets. Proportions are typically higher when measured in terms of value.

Figure 2: Rental depreciation by market segment; comparison of 2005 and 2011 studies	Benchmark – rental growth 2011 study p.a.	Sample – rental growth 2011 study p.a.	Rate of rental depreciation 1993-2009 2011 study p.a.	Rate of rental depreciation 1993-2003 2005 study p.a.
Standard Retails	**3.2**	**2.9**	**0.3**	**0.3**
Offices	**3.4**	**2.5**	**0.8**	**0.8**
Industrials	**2.4**	**1.9**	**0.5**	**0.5**
Std Ret – Central London	6.9	5.1	1.7	
Std Ret – Rest of SE	3.2	2.4	0.8	0.2
Std Ret – Rest of UK	1.8	2.5	-0.7	0.5
Shopping Centres	2.7	2.6	0.1	0.1
Retail Warehouses[2]	7.7	6.7	0.9	1.2
Offices – City	2.2	1.7	0.5	0.1
Offices – West End	5.6	4.5	1.1	1.1
Offices – Rest of SE	2.8	2	0.8	0.7
Offices – Rest of UK	3	1.1	1.8	1.5
Industrials – SE	2.4	2	0.3	0.3
Industrials – Rest of UK	2.4	1.4	1.0	1.1
All Property	–	–	**0.6**	

1 A negative figure denotes appreciation, i.e. the rental values of the assets have grown faster than those of the benchmark hypothetical buildings.

2 Retail Warehouse depreciation has been measured over the period 1993-2006 in 2011 study.

earlier IPF study covering 1993-2003, on a per annum basis. It also shows the rental growth produced by the sample of assets and the matching set of benchmarks in each case. All figures in the table are value weighted.

The depreciation rates at the three-sector level are unsurprising and are consistent not only with the results in 2005 but also those of other depreciation studies that have considered more than one sector (e.g. CEM, 1999). Office buildings exhibit the most depreciation over time and standard retail properties show the least, with industrials between the two.

However, sector level rates conceal considerable variation in segment level results. Regional office and industrial assets showed greater depreciation than their counterparts located in London and the South East. However, in the case of standard retail, the opposite was found. In general, the standard retail results are harder to explain than the other findings, with high depreciation found for assets in Central London and the South East, but appreciation found for the 'Rest of UK' area.

The sample of shopping centres has suffered almost no rental depreciation over the period. This is consistent with the findings in the earlier IPF report and suggests that, where shopping centres have been retained by their owners, these are in locations where they continue to be the benchmark asset. The lack of depreciation must also be seen in the light of a relatively high rate of capital expenditure for this segment, as shown in Figure 3. In contrast, despite strong rental growth, retail warehouses experienced moderately high rental depreciation – essentially, this sample of assets represents a fairly early generation of retail warehouses that have then had to compete in an environment where there has been rapid evolution of this format. Given this, the result is not surprising.

For the office and industrial sectors, there is regional variation in the results. However, in this case, the patterns are more consistent. The highest rental depreciation in each sector occurs in the Rest of UK area, whilst lower depreciation is found in London and the South East. This is plausible if, in the latter case, occupiers are paying a larger premium for the location relative to the characteristics of the building. Certainly, in terms of capital values, land values typically comprise a greater proportion of total asset value in London and the South East, indicating the importance of including a regional dimension to depreciation analysis. On the other hand, the low rental depreciation rate for the City of London office market and the relativity between this and the West End rate are harder to explain.

Comparison with IPF 2005 research

While at a sector level, the updated rental depreciation rates are identical to those that were reported in the IPF study (see Figure 2), this similarity is somewhat illusory for two reasons. First, the current sample does not behave completely like the earlier and larger dataset over a common time period, although the relative ranking of rates across the office, industrial and standard retail sectors is preserved. Second, in some instances, the segment rates show large differences from those found in the earlier research. Rates of depreciation appear to have been stable across samples and measurement periods for the shopping centre, regional office and industrial markets, but more volatile in the case of the standard retail, retail warehouse and Central London office segments.

Looking first at standard retail, unusual regional patterns have emerged in the period since 2003. Before this, results on both the old and current samples conform more clearly to expectations about how depreciation in this sector should behave. In contrast, the behaviour of the City and West End office results is harder to pin down. The current sample appears to comprise those buildings that depreciated more strongly in the 2005 study. However, over the longer horizon, the annual rates recorded for the current sample reduce. In both cases, the results raise questions about the stability of depreciation rates over time and particularly over the course of the property cycle. This is despite the fact that a longitudinal approach should, to some extent, mitigate the influence of individual years.

Capital expenditure

The rates of depreciation in Figure 2 only give a partial picture of the impact of depreciation on commercial real estate performance. This is because they are measured using buildings on which the owners have also spent money in order to maintain and improve those assets over time. The true cost of depreciation to an investor will include this expenditure, as shown in Figure 3. Capital expenditure recorded by IPD relates to non-recoverable spending by the building owner and excludes any costs of maintenance or enhancement that could be recovered from tenants in the property. This means that the rates are likely to understate the full cost of maintaining property investments over time.

In the 2005 report, expenditure rates were measured for individual properties by summing capital expenditure over the period concerned and dividing this by the sum of a set of annual capital values for that asset in that period. The same approach was used again but an alternative measure was also tested. This divided capital expenditure over the study period by the capital value from the start of the period (i.e. the capital value recorded in December 1993). This figure was then further divided in each case by the number of years to give an alternative annual rate. These rates are presented at a segment level in Figure 3 alongside those from the primary method of calculation.

Figure 3: Capital expenditure by market segment, 1993-2009

	Number of properties	% of capital invested each year[1]	% of initial capital value p.a.[2]
Standard Retails	319	0.3	0.4
Offices	217	0.5	0.6
Industrials	158	0.2	0.3
Std Ret – C London	47	0.2	0.3
Std Ret – Rest of SE	138	0.3	0.3
Std Ret – Rest of UK	134	0.4	0.5
Shopping Centres	19	0.9	1.4
Retail Warehouses[1]	29	1.5	3.4
Offices – City	41	0.2	0.3
Offices – West End	64	0.5	0.7
Offices – Rest of SE	75	0.7	0.9
Offices – Rest of UK	37	0.5	0.6
Industrials – SE	104	0.2	0.3
Industrials – Rest of UK	54	0.3	0.3

Two measures of the capital expenditure incurred by owners over time have been estimated:

1 As used in the IPF 2005 and 2011 reports, calculated by dividing the total amount of expenditure in the period by the sum of the valuations recorded at the start of each year.

2 Arrived at by calculating a rate of expenditure in relation to the initial capital value at the start of the measurement period.

In general, the expenditure rates using the alternate methodology are higher because expenditure towards the end of the period was not mitigated in this calculation by the rise in property values since 1993. Despite the different approach, the relativities across the sectors and segments largely remain the same. However, the expenditure rates for the Shopping Centre and Retail Warehouse segments are more pronounced. In part, this is explained by the fact that, with fewer assets in these samples, the capital expenditure amounts are much less evenly distributed through time. This is certainly the case in the Retail Warehouse segment where some large amounts of expenditure occur towards the very end of the analysis period.

Further information on methods, results and areas for future research are given in the main research report, which is available to download from the IPF website.

European Consensus Forecasts
November 2011

With the continued market turbulence wrought by the travails of the global economic crisis and the potential breakup of the eurozone, one does not envy the lot of forecasters currently. However, 16 have been brave enough to raise their heads above the parapet and give their views across a number of locations in order to allow the production of this 12th IPF Consensus Forecast of Prime European Office Rents.

Key Points

- The second-half forecasts of 2011 have given rise to changes in the likely year-end outturn against the May position, with a clear majority of centres (18) anticipated to deliver better growth than previously forecast.
- The outstanding performer in terms of annual rental growth in 2011 is expected to be Oslo at 14.5%, borne out of a strong economy, with high investment and reducing unemployment.
- The two London markets have declined, albeit modestly in the case of the West End (down 2.4% to 10.6%) with a more dramatic 7.3% fall (to 2.9%) for the City. Unfortunately, due to a drop in the number of forecasters returning figures for Moscow, we are unable to report a H2 rental growth number for this location, which previously showed the best outlook of all those surveyed.
- Of those eurozone nations struggling under sovereign debt issues, Irish, Portuguese and Spanish rent levels all continue to weaken, with Dublin showing a dramatic fall to nearly -11% for the year. A fairly flat outlook is suggested for Rome and Milan whilst, again, there has been insufficient data to produce any figures for Athens.
- Looking ahead to 2012, the general trend is modestly downward for the majority of locations.
- Over a three-year time horizon, London West End and Oslo are expected to show the strongest rental value growth (6.7% and 6.6% respectively), followed by City of London and Stockholm (both at 4.8%).
- The five-year average levels of expected rental growth, whilst remaining weak, appear to be improving slightly across the majority of centres (as was the case in May), with all centres returning positive growth over the period. London's West End is the only market expected to growth by more than 5% per annum over both three- and five-year time horizons.

Final outturn projections for 2011 firm across a number of markets

In total, 14 location forecasts show an absolute increase of more than 1% above the May outlook, whereas six centres' growth forecasts have been cut by in excess of 1%.

Major positive movements in rental growth forecasts for the second half of 2011 are confined to non-eurozone locations. In particular, Oslo stands out with forecasts having moved substantially since May. This is a very volatile market – vacancy rates almost doubled during the downturn, leading to a fall in rental values of over 30% from peak to trough. This year, a stronger economy has triggered employment growth and, with it, good demand for prime space at attractive lower rents. Combined with a lack of new development causing vacancy rates to fall, strong rental value growth has resulted for modern, energy efficient buildings. While prime rents may grow by 15% this year, older and less efficient buildings will not fare quite so well and average rents are likely to grow at a more restrained level.

Good short-term growth has also been identified in such locations as Warsaw (9%), Stockholm (7.6%), Lyon (7.5%) and Helsinki (6.7%).

Within the UK, expectations for the London office markets have cooled somewhat since the last survey, albeit the West End is still forecast to deliver 10.6% annual rental growth this year. For the City, rents are to grow a pedestrian 2.9%, which is very much in line with the majority of other centres.

The weakest expected performances continue to lie within PIIGS locations, led by a substantial fall in Dublin rents (expected to be 10.6% down over the year), and followed to a lesser extent by Madrid, Barcelona and Lisbon.

Overall, however, the forecasts for H2 2011 have strengthened in 18 of the markets reported since the May survey, reflecting a firming of sentiment amongst forecasters across Europe, including in the eurozone.

2012 and beyond

The consensus forecasts for 2012 have been revised downwards for 23 of the cities reported, compared to 19 in May. Of these, only one centre is expected to show a significant decline in growth, being London's West End, down 6.8%, although the forecast remains positive at 3.8%. Those locations that continue to show negative growth are all situated within the PIIGS economies.

With the exception of the two London markets and Moscow, remaining centres continue to occupy a relatively close band of growth forecasts, ranging from +4.0% (Oslo) to -1.5% (Dublin) currently.

The trend for 2013 growth projections, albeit based on only two observations to date, is downward with the only notable exceptions being the central London markets.

The three-year forecasts continue to reflect the weakness of the Spanish, Irish and Portuguese markets, driven by the immediate outlook. London, Oslo and Stockholm are the leading centres over this period, although expectations for London have declined since the May survey.

The five-year outlook suggests all centres will deliver, on average, positive growth over this timeframe. Only Dublin and Lisbon are projected to show growth below 1%. The top five centres over this longer period is led by London's West End, at 5.3% pa, followed by Oslo (4%), Stockholm (3.7%), London City (3.5%) and Warsaw (3.1%).

Conclusion

Perhaps the greatest value of the Consensus Forecasts lies in providing an insight into forecasters' sentiment and the direction of their predictions. With London perceived to be a 'safe haven' for investors currently, the prospect of positive rental growth will serve to underpin further its position within the hierarchy of European centres.

Other locations with favourable outlooks appear mainly confined to the Nordic region at present and greater focus may be placed on the analysis of specific locations in future surveys.

European office market prime rent forecasts, November 2011

	Year rental growth forecast % pa 2011	2012	2013	3-year forecast 2011-13 % pa	5-year forecast 2011-15 % pa
Vienna	2.6	1.4	1.2	1.7	2.1
Brussels	2.5	0.6	1.7	1.6	1.8
Prague	1.5	2.6	2.1	2.0	1.8
Copenhagen	1.9	1.1	1.9	1.6	1.8
Helsinki	6.7	2.3	1.8	3.6	2.8
Lyon	7.5	1.5	2.3	3.7	2.6
Paris CBD	-0.4	2.7	3.3	1.9	2.7
Paris la Defense	5.3	1.7	3.1	3.4	2.6
Berlin	4.1	2.5	1.4	2.7	2.1
Frankfurt	0.6	2.9	3.7	2.4	2.1
Hamburg	2.6	2.3	2.5	2.5	2.2
Munich	4.2	2.5	2.7	3.1	2.7
Athens	na	na	na	na	Na
Budapest	2.5	0.9	2.9	2.1	1.6
Dublin	-10.9	-1.5	1.8	-3.7	0.2
Milan	0.9	0.9	1.5	1.1	1.7
Rome	1.3	0.3	1.5	1.0	1.6
Luxembourg	0.3	0.1	1.3	0.6	1.1
Amsterdam	1.8	1.5	0.4	1.2	1.4
Oslo	14.5	4.0	1.8	6.6	4.0
Warsaw	9.1	3.3	1.9	4.7	3.1
Lisbon	-3.6	-1.1	1.0	-1.3	0.1
Moscow	na	na	na	na	na
Madrid	-6.0	-0.2	3.4	-1.0	2.2
Barcelona	-5.0	-0.6	2.1	-1.2	1.2
Stockholm	7.6	2.8	4.0	4.8	3.7
Zurich	2.2	2.7	2.6	2.5	Na
London: City	2.9	5.2	6.4	4.8	3.5
London: West End	10.6	3.8	5.8	6.7	5.3
Manchester	0.5	2.4	2.2	1.7	2.1

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.

Acknowledgements

Forecast Contributors: IPF would like to thank all participants in the survey for contributing rental data to the November 2011 European Consensus Forecasts, including the following organisations: Aberdeen Asset Management, Aviva Investors, CBRE Investors, DTZ, Grosvenor, Invesco, JLL, PMRECON, PPR, Standard Life Investments, SWIP.

Notes

At present the IPF European Consensus Forecasts survey focuses on office rental value growth in major cities. It is not possible at this stage to assemble sufficient forecasts of all sectors across all European countries to produce a meaningful consensus of views, although this remains one of our ambitions to extend and improve the scope of the survey.

In addition to the rental value forecasts, we run a consensus survey of forecast IPD European total returns by sector. The samples provided for this survey were once again small and not sufficient to permit publication. We hope to be able to produce a full release of this data at some time in the future, once the number of responses has grown sufficiently.

The Data

This latest survey collected prime office rental forecasts for 30 centres for the calendar years 2011, 2012 and 2013. We request a three-year average forecast for 2011-2013 if individual years are not available, and a five-year average for 2011-2015. The survey requested both the percentage annual rental growth rates and also year-end rent levels. The growth forecasts provided by each organisation have been analysed to provide weighted average ('consensus') figures for each market. Figures are only reported for cities where a minimum of five contributions are received.

The definition of market rent used in the survey is '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 does not mean headline rents taken from individual buildings, but rather rental levels based on market evidence, which can be replicated. All figures included in the survey are required to have been generated by formal forecasting models. This report is based on contributions from 16 different organisations.

Consensus forecasts further the objective of the Investment Property Forum to enhance the understanding and efficiency of the property market. The IPF is extremely grateful for the support those organisations that contribute to this publication, which is only possible thanks to the provision of individual forecasts.

The IPF welcomes new contributors for future surveys, so that the coverage of the market can be widened. If your organisation wishes to contribute to future surveys please contact Pam Craddock, IPF Research Director at pcraddock@ipf.org.uk.

Figure 2: Forecasts for year 2011

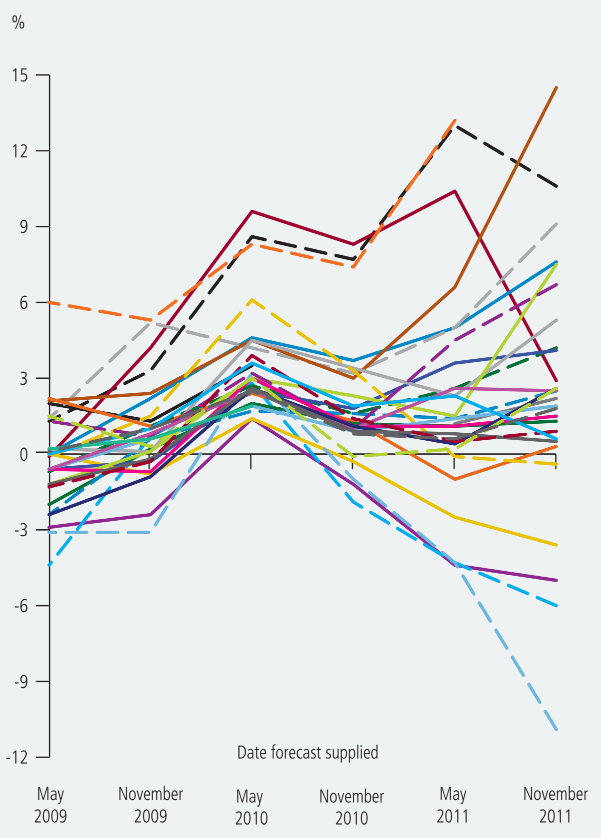
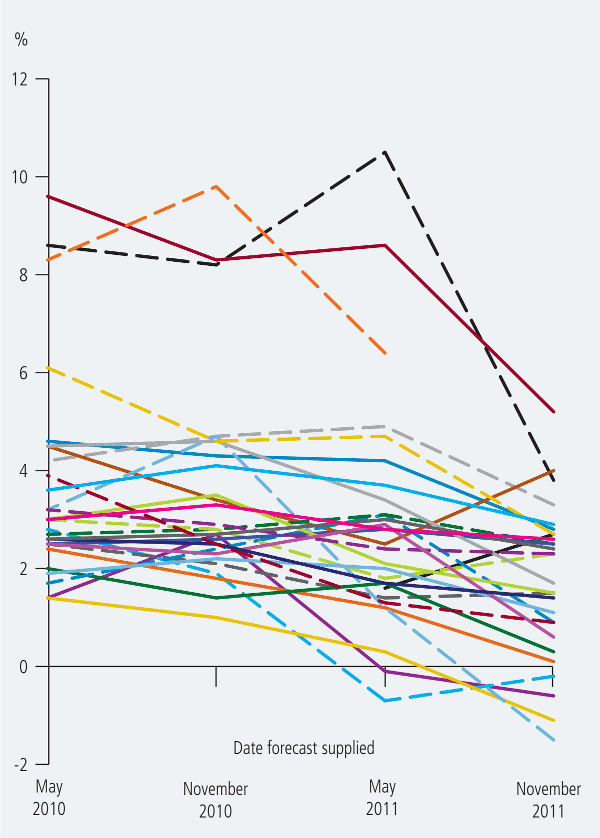


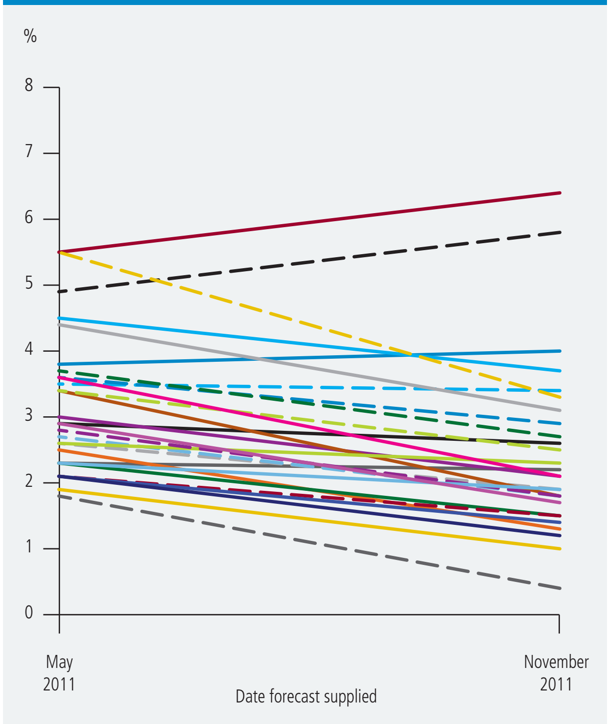
Figure 3: Forecasts for year 2012



Key for Figures 2-3

Vienna	Helsinki	Frankfurt
Brussels	Paris CBD	Munich
Prague	Paris la Defense	Zurich
Copenhagen	Berlin	Budapest
Dublin	Warsaw	Stockholm
Milan	Lisbon	London City
Rome	Madrid	London West End
Amsterdam	Barcelona	Manchester
Luxembourg	Oslo	Moscow
Athens	Lyon	Hamburg

Figure 4: Forecasts for year 2013



UK Consensus Forecasts
November 2011

The IPF UK Consensus Forecast of the All Property total return for 2011 has ticked up slightly since the August survey, to show a likely 7.5% outcome by the year end. This figure is driven substantially by income as capital value growth falters. Negative capital value growth is clearly expected in 2012, although this trend is neither deep nor anticipated to be of any great duration, with a modest recovery predicted in 2013. The drop in the five-year average forecast, to 7.2% total return for 2011/2015, whilst disappointing, is not far off IPD's All Property total return over the past decade, which averaged 7.6%.

Key points

Short- to medium-term outlook remains weak across all measures

- All Property **rental value growth** figures for 2011 have weakened again since the last (Q3) survey, whilst **capital value growth** forecasts, which previously showed a slight improvement in the immediate short-term, indicate a negative performance in 2012, with the consequent effect of pegging back growth over the remaining periods of the forecast.
- The Consensus Forecast of **total returns** for 2011 has firmed further to give an expected outturn of 7.5% for the calendar year but, once again, the outlook for 2012 demonstrates a significant weakening of sentiment in the capital markets. Expectations remain that there will be an improvement in 2013, with a return to positive, albeit weak, capital value growth, although the five-year total return average, at 7.2%, continues to reflect poorer performance in the earlier period of the forecast.
- Only the mean average forecast for offices and industrials exceed the All Property average total return over five years (at 7.8% and 7.4% respectively).

Central London offices continue to offer best performance prospects

- At the sector level, **offices** (due to 'the central London effect') are expected to produce the best performance over all time horizons followed, at some distance, by **retail warehouses**. The prospects for **shopping centres** look weak, particularly over the next two years, with both negative rental and capital value growth forecasts in 2011 and 2012.

Age of forecast is no guide to future performance

- Looking at the timing of individual forecasts, there is no consistent message across the three measures of rental and capital value growth and total return forecasts. Whilst the October forecasts suggest a modest improvement in the outlook for rental growth followed by a weakening in sentiment, the November average capital value growth projections are more optimistic for all time frames. Similarly, total returns appear to have revived a little between the October and November forecasts. Although this analysis is by no means scientific, all forecasters agree that 2012 will deliver a dip in performance, compared to 2011 and 2013, as a result of negative capital value growth.

Economic setting

According to the ONS latest report[1], Gross Domestic Product (GDP) is estimated to have increased by 0.5% between the second and third quarters of 2011 and by 0.5% since Q3 2010, a significant reduction from the 2.6% growth in the preceding 12 months. The adverse impact of a royal wedding, additional bank holidays, Olympic ticket sales and the like having been shrugged off, performance in the third quarter of 2011 was led by the services sector, which accounts for just over 76% of total GDP. Services contributed the entire 0.5% increase in the quarter, with a small positive contribution from the production industries being offset by a contraction in construction, which reduced GDP growth over the year by 0.3%. The latest HM Treasury comparison of independent forecasts of GDP[2] indicates a further decline for the year as a whole, down from an estimate of 1.6% in May to 1.0% currently.

1 ONS 16 November 2011

2 HM Treasury Forecasts for the UK economy: 16 November 2011

Other headlines from the ONS November 2011 release of data include the value of retail sales in October 2011 showed an increase of 5.4% compared with October 2010, whilst sales volumes in the same month increased by 0.9% compared to a year earlier. Over one month, sales volumes increased by 0.6% and the value of sales by 0.7% in October. Responses from retailers indicate that this increase in sales volume and value over the month was a result of pre-Christmas sales and in-store promotions. Average weekly spend on online retailing increased to £561.5m up from £518.7m in September 2011.

The number of unemployed to September 2011 was reported to be 2.62m, up 129,000 on the quarter, of which over 1m are in the 16 to 24 years age bracket. This represents an unemployment rate of 8.3% of the economically active population, up 0.4% on the quarter, and the highest percentage since 1996, whilst the number of unemployed is at its highest since 1994. Further 'highlights' include: an inactivity rate for those aged from 16 to 64 of 23.3%, up 0.1% on the quarter. Total pay (including bonuses) rose by 2.3% on a year earlier, down 0.4% on the three months to August 2011 (with both the private and public sectors showing lower pay growth), whilst regular pay (excluding bonuses) rose by 1.7% over 12 months, down 0.1% on the three months to August 2011.

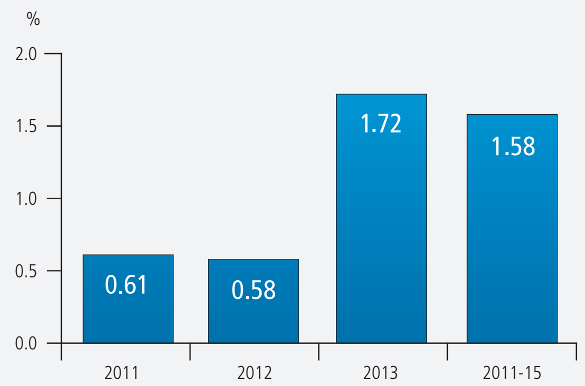
The opening paragraph of the Bank of England's latest Inflation Report[3] strikes a sombre note with the bold statement that, 'The prospects for the UK economy have worsened'. Citing a slowdown in global demand and mounting concerns over the solvency of a number of eurozone governments, these issues have served to increase the strains in banking and some sovereign funding markets. With household and business confidence failing at home and abroad, these factors, along with fiscal consolidation and squeeze on households' real incomes,

3 Bank of England Inflation Report November 2011 'are likely to weigh heavily on UK growth in the near term'. Consumer Prices Index (CPI) inflation rose to 5.2% in September 2011 but cooled slightly in October to 5% and is likely to fall back sharply through 2012 as the impacts of VAT, energy and import prices decline. HM Treasury 2 consensus forecast for Q4 indicates a CPI inflation rate of 4.7% for the year, with RPI at 5.3% but falling in 2012 to 2.2% and 2.8% respectively. This supports the Bank's contention that the impact of factors temporarily raising inflation will diminish and downward pressure from slack labour markets will cause inflation to fall back over the next two years.

Since the Bank's August Report, the Monetary Policy Committee (MPC) increased the size of its asset purchase programme by £75bn, to a total of £275bn. Bank Rate has been maintained at 0.5% and market interest rates suggest that the expected timing of the next rise in Bank Rate has been pushed out. Prices of risky assets fell sharply and volatility in financial markets has increased, as concerns about the euro area intensify. New governments have been put in place in Italy and Spain but austerity measures have still to be tested as these policies are implemented. Meanwhile, conditions in bank funding markets have deteriorated, increasing the risk of a renewed tightening in credit conditions.

Against this backdrop, forecasters have the unenviable task of translating these economic influences into projections of performance for the UK commercial property market.

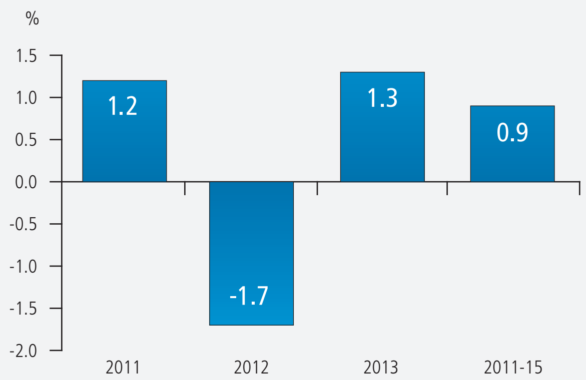
Figure 1: All Property rental value growth forecasts



The returns submitted for this final quarter of 2011 confirm the deteriorating prospects for rental growth across all time periods, with 2012 showing no respite – the projected growth rate for the next 12 months has dropped significantly over the quarter from 1.7% (as forecast in August) to below 0.6%.

The outlook for 2013, by comparison, suggests some improvement. However, the impact of the poor near-term projections is reflected in the lowered five-year average forecast (down from 2.0% at Q3).

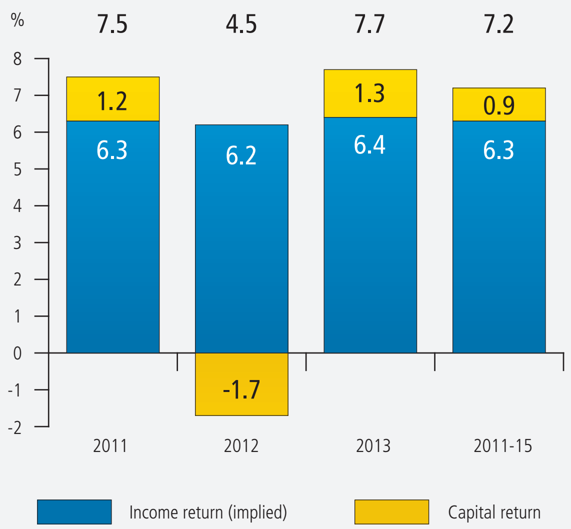
Figure 2: All Property capital value growth forecasts



The anticipated result in capital value growth for 2011 shows a slight improvement upon the Q3 number (1.1%). However, weakening sentiment in the rental market is further reflected in an expected decline into negative capital value growth in 2012.

For 2013 and the five-year average, growth rates have weakened further (from 2.1% and 1.4% respectively since Q3).

Figure 3: All Property total return forecasts



The All Property total return average forecast for 2011 is marginally up over the previous quarter (7.4%), although this has slowed compared to the Q2 to Q3 improvement of over 1%, driven by modest capital value growth over the year.

Conversely, 2012's total return is now expected to fall below the income return due to the adverse impact of negative capital appreciation. This may be a temporary aberration, as the projection for 2013 suggests a modest recovery. The five-year average total return forecast has continued its decline however, from 8.4% per annum at the start of the year.

Rental income returns are expected to remain relatively stable throughout all time horizons.

All Property survey results by contributor type

(Forecasts in brackets are August 2011 comparisons)

Figure 4: Property advisors and research consultancies (14 contributors)																		
	Rental value growth %						Capital value growth %						Total return %					
	2011		2012		2013		2011		2012		2013		2011		2012		2013	
Maximum	1.3	(1.6)	2.2	(3.1)	3.6	(3.2)	2.6	(2.2)	2.3	(1.9)	3.0	(4.7)	8.8	(8.6)	8.4	(8.2)	9.4	(11.3)
Minimum	0.0	(0.1)	-2.2	(0.3)	-1.0	(-0.2)	0.1	(-0.7)	-8.2	(-1.7)	-0.3	(0.2)	6.2	(5.6)	-2.4	(4.5)	6.4	(6.7)
Range	1.3	(1.5)	4.4	(2.8)	4.6	(3.4)	2.5	(2.9)	10.5	(3.6)	3.3	(4.4)	2.6	(3.0)	10.8	(3.7)	3.0	(4.6)
Median	0.7	(0.9)	1.1	(2.1)	2.2	(2.6)	1.5	(1.4)	-0.1	(0.8)	1.3	(2.7)	7.9	(7.5)	6.0	(6.9)	7.8	(8.9)
Mean	**0.6**	**(0.8)**	**0.7**	**(1.9)**	**1.9**	**(2.5)**	**1.5**	**(1.1)**	**-1.2**	**(0.6)**	**1.5**	**(2.1)**	**7.7**	**(7.3)**	**4.9**	**(6.9)**	**8.0**	**(8.5)**

Figure 5: Fund managers (16 contributors)																		
	Rental value growth %						Capital value growth %						Total return %					
	2011		2012		2013		2011		2012		2013		2011		2012		2013	
Maximum	1.3	(1.7)	1.9	(3.1)	3.3	(4.4)	2.2	(2.9)	1.4	(2.3)	7.4	(7.8)	8.6	(9.5)	7.4	(8.1)	13.7	8.6
Minimum	-1.0	(-0.5)	-2.0	(-1.0)	0.0	(0.1)	-1.6	(-2.8)	-5.1	(-3.0)	-1.4	(-0.9)	5.2	(4.5)	0.6	(3.5)	4.8	5.2
Range	2.3	(2.2)	3.9	(4.1)	3.3	(4.3)	3.8	(5.7)	6.5	(5.3)	8.8	(8.7)	3.4	(5.0)	6.8	(4.6)	8.9	3.4
Median	0.8	(0.9)	0.9	(1.9)	2.0	(2.4)	1.2	(1.0)	-2.0	(0.3)	1.1	(2.0)	7.6	(7.0)	4.5	(6.7)	7.3	7.6
Mean	**0.6**	**(0.8)**	**0.6**	**(1.6)**	**1.7**	**(2.3)**	**1.0**	**(1.0)**	**-2.1**	**(-0.1)**	**1.3**	**(2.1)**	**7.4**	**(7.4)**	**4.1**	**(6.2)**	**7.7**	**(7.4)**

Figure 6: All forecasters (31 contributors)																		
	Rental value growth %						Capital value growth %						Total return %					
	2011		2012		2013		2011		2012		2013		2011		2012		2013	
Maximum	1.3	(1.7)	2.2	(3.1)	3.6	(4.4)	2.6	(2.9)	2.3	(2.3)	7.4	(7.8)	8.8	(9.5)	8.4	(8.2)	13.7	(15.0)
Minimum	-1.0	(-0.5)	-2.2	(-1.0)	-1.0	(-0.2)	-1.6	(-2.8)	-8.2	(-3.0)	-1.4	(-0.9)	5.2	(4.5)	-2.4	(3.5)	4.8	(5.6)
Range	2.3	(2.2)	4.4	(4.1)	4.6	(4.6)	4.2	(5.7)	10.5	(5.3)	8.8	(8.7)	3.6	(5.0)	10.8	(4.7)	8.9	(9.4)
Std. Dev.	0.5	(0.6)	1.1	(0.9)	1.1	(1.0)	0.9	(1.2)	2.5	(1.5)	1.7	(1.7)	0.8	(1.1)	2.5	(1.4)	1.7	(2.1)
Median	0.8	(0.9)	1.0	(2.0)	2.0	(2.5)	1.4	(1.3)	-1.4	(0.7)	1.1	(2.2)	7.8	(7.3)	4.6	(6.9)	7.3	(8.6)
Mean	**0.6**	**(0.8)**	**0.6**	**(1.7)**	**1.7**	**(2.4)**	**1.2**	**(1.1)**	**-1.7**	**(0.2)**	**1.3**	**(2.1)**	**7.5**	**(7.4)**	**4.5**	**(6.5)**	**7.7**	**(8.6)**

Figure 3: Survey results by sector												
	Rental value growth %				Capital value growth %				Total return %			
	2011	2012	2013	2011-15	2011	2012	2013	2011-15	2011	2012	2013	2011-15
Office	3.5	2.7	3.3	2.9	3.3	0.1	2.2	1.7	9.5	6.1	8.4	7.8
Industrial	-0.8	-0.3	0.8	0.7	-0.2	-2.6	0.5	0.1	6.9	4.5	8.0	7.4
Standard shops	-0.2	-0.2	1.2	1.2	0.7	-1.9	0.8	0.9	6.3	3.6	6.6	6.6
Shopping centres	-2.3	-1.2	0.9	0.5	-0.8	-3.2	0.5	0.3	5.6	3.1	7.1	6.7
Retail warehouses	0.7	0.6	1.5	1.6	2.0	-1.8	1.3	1.1	8.1	4.2	7.4	7.1
All Property	**0.6**	**0.6**	**1.7**	**1.6**	**1.2**	**-1.7**	**1.3**	**0.9**	**7.5**	**4.5**	**7.7**	**7.2**

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 12 weeks 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.** Mean: 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. **9.** There were insufficient equity broker contributions to provide separate analysis. **10.** The sector figures are not analysed by contributor type; all figures are shown at the all-forecaster level. **11.** In the charts and tables, 'All Property' figures are for the full 31 contributors, while the sector forecasts are for the reduced samples of between 26 and 29 contributors. **12.** One contributor provided a four year forecast of average returns (i.e. 2011/14).

Acknowledgements

The Investment Property Forum would like to thank the following organisations for contributing to the IPF UK Consensus Forecasts for Q3 2010:

Property advisors (includes research consultancies): BNP Paribas Real Estate, Capital Economics, CB Richard Ellis, Cluttons, Colliers International, Cushman & Wakefield, DTZ, Fletcher King, GVA, Jones Lang LaSalle, Knight Frank, Paul Mitchell Real Estate Consultancy Limited, Real Estate Forecasting Limited.

Fund managers: Aberdeen Asset Management, Aviva Investors, AXA Investment Managers, CBRE Investors, Cordea Savills, F&C REIT Asset Management, Henderson Global Investors, HSBC Global Asset Management, Ignis Asset Management, ING Real Estate Investment Management (UK) Limited, LaSalle Investment Management, Legal & General, PRUPIM, RREEF, SWIP, Standard Life Investments.

Note

Consensus forecasts further the objective of the Investment Property Forum to improve the efficiency of the market. The IPF is extremely grateful for the continuing support of the contributors as noted above. This publication is only possible thanks to the provision of these individual forecasts.

If your organisation wishes to contribute to future surveys, please contact IPF Research Director at pcraddock@ipf.org.uk.

IPF – The Next Generation

Stewart Womersley, Nabarro LLP

Over 150 young professionals attended the inaugural event of the IPF Next Generation Group where they heard guest speaker Graham Emmett of NAMA (an outline of his presentation is included on page 11). The event, kindly hosted by PwC on 16 November, was the culmination of several months of planning by the recently-established IPF Next Generation Committee, chaired by Amanda Howard of Nabarro, and marks the launch of the IPF's latest initiative aimed at building a forum for the next generation of professionals active in the UK property investment market.

From initial meetings of the Committee, representing a broad range of expertise within UK property investment, it quickly became apparent that the younger generation of professionals lacked a clear understanding of the IPF's activities or the benefits that were attached to being a member of the Forum. As a consequence, the Committee set itself the following goals:

- To raise the profile of the IPF among the next generation of property investment professionals; and
- To make the IPF more accessible to younger professionals with the requisite experience.

In order to achieve these goals, the Committee will actively target young professionals with between 5 and 15 years' experience in the property investment / finance market that will complement the calibre of the existing IPF membership. The Committee intends to build on the success of its inaugural event by arranging dedicated events for Next Generation Group members, with a strong emphasis on networking. The 2012 calendar already includes a networking evening with guest speaker Philip Ross of Cordless Group, a series of evening discussion sessions focusing on the current UK debt market and a number of site visits to prime London assets.

Members of the Next Generation Group are also entitled to all the existing benefits of the IPF and will be encouraged to participate actively in, and contribute to, the IPF and its work. It is hoped that through the work of the Next Generation Group, we can enhance and further diversify the current IPF membership and encourage less-experienced professionals to engage with the IPF at an earlier stage in their careers.

If you would like further details about the Next Generation Group, please contact me, email: s.womersley@nabarro.com or DDI: 020 7524 6389.

Forum activities and announcements

IPF Executive

We welcome **Suleen Syn** back from maternity leave. Suleen is your contact for all educational lectures, workshops and site visits in London and the Regions. Suleen is available Monday – Thursday.

Barbara Hobbs will be staying with the IPF and taking care of the Annual Dinners and Lunches, as well other social events and the IPF Conference in Scotland.

IPF Midlands Board

Tim Hurdiss of Deeley Group is now Vice Chairman of the Midlands Board. He will succeed Simon Robinson in September 2012.

Mark Alexander of Alexander has stepped down from the IPF Midlands Board.

New IPF Scotland Board

Grant Rawlinson of Torran Property Investments has stepped down from the IPF Scotland Board.

Steven Newlands of Cushman & Wakefield has joined the IPF Scotland Board.

Indirect Interest Group Chair

Graeme Rutter of Schroders has replaced Phil Clark as Chair of the Indirect Special Interest Group.

Residential Interest Group Chair

Robin Goodchild of LaSalle Investment Management has replaced Peter Pereira Gray as Chair of the Residential Special Interest Group.

Annual Lunch

The Annual Lunch will be taking place on **Friday 27 January 2012** at the Hilton Park Lane, London W1. **Andrew Neil** is the after Lunch speaker this year, and there will also be presentations to the IPF Diploma Award winners. To book a table, contact Barbara Hobbs, **bhobbs@ipf.org.uk**.

IPF Midlands Dinner 2011

Thursday 6 October saw 600 people attend the IPF Midlands Dinner at the ICC in Birmingham. The Dinner proved to be a real success, underlining its place as the IPF flagship event in the Midlands.

The after-Dinner speaker was **Geoff Miller**, who spoke humorously and candidly about his time as an international cricketer and now as ECB National Selector.

Simon Robinson, Phil Clark, Geoff Miller

Geoff Miller addressing IPF members and guests

Midlands Dinner at the ICC

Nick Tyrrell Memorial Lecture

The Nick Tyrrell Memorial Lecture took place at JPMorgan on 12 October, with approximately 130 people in attendance.

The IPF, INREV and the SPR have set up a research prize in honour of Nick, details of which can be found below.

Investment Education Programme

Property Investment Appraisal
This next module in the Investment Education Programme will take place on 17-19 January 2012 in London

What's the course about?
Expand your knowledge of the property valuation process on this course. Examine current practices and their application. Learn about alternatives to these and explore the most current theories and techniques. Take a closer look at the market and constitutional context within which valuation takes place.

This course takes an in-depth look at:

- the main appraisal approaches from a critical perspective;
- ways of adapting appraisal techniques to meet changes in market conditions and circumstances;
- cutting edge developments in the field of property appraisal; and
- the difficulties of appraising flexible lease forms.

Who is the course for?
Experienced practitioners looking to update their appraisal techniques. For further information, contact Frankie Trailor on 020 7194 7928

PLEASE NOTE Date changes for Investment Education Programme cycle 2011/12:

Property Investment Appraisal 17-19 January 2012

Property Finance and Funding 28-30 March 2012

Indirect Property Investment 29-31 May 2012

International Property Investment 25-27 June 2012

Portfolio Management 24-26 September 2012

LinkedIn

The IPF has created a number of LinkedIn groups. If you would like to join, just search on 'Investment Property Forum Members'.

Website

You may have noticed that the IPF website has recently had a facelift. We are continuing to work on the function of the website, so if you have any comments, we would very much like to hear them. Please email Frankie Trailor, ftrailor@ipf.org.uk.

The Nick Tyrrell Research Prize

The **Nick Tyrrell Research Prize**, funded by the Nick Tyrrell Memorial Fund, has been established by the IPF, INREV and the SPR to recognise innovative and high-quality, applied research in real estate investment.

The Prize, which is open to both junior and senior researchers, recognises and reflects the work and industry contribution of Nick Tyrrell, who sadly passed away in August 2010. Nick was Head of Research and Strategy and a Managing Director in JP Morgan Asset Management's European real estate division. Prior to that, he was a Director of Deutsche Bank in London. His research work was characterised by a combination of academic rigour and practical relevance.

The three supporting organisations and the judging panel, comprising Dr Robin Goodchild (Chair), Professor Colin Lizieri, Dr Brenna O'Roarty and Dr Neil Turner, will be looking for a piece of research of between 5,000 and 10,000 words that reflects Nick's legacy, being:

– innovative, original and timely;
– relevant to the property investment industry; and
– sufficiently well written to be published in a leading academic property journal.

The Prize is a cash award of £2,000 and the opportunity to present at a major industry event. In addition, the winners will be encouraged to submit their work to the **Journal of Property Research**.

There are two annual deadlines for submission of papers: **31 May and 30 November**. Papers submitted between 1 December and 31 May will be considered by the judging panel before 31 August and those submitted between 1 June and 30 November will be considered by the judging panel before 28 February. The awards will be publicised in September and March. The judging panel is under no obligation to award the Prize to any submissions received.

For further details regarding research submissions or donations to the Nick Tyrrell Memorial Fund, please contact:

Sue Forster, sforster@ipf.org.uk or

Dr Paul Kennedy, paul@pjkennedy.co.uk

IPF Investment Property Forum

Annual Lunch 2012

Friday, 27 January
Hilton Park Lane, London W1
12:00 for 12:30 | Lounge Suit

Guest Speaker: Andrew Neil
Publisher, writer and broadcaster

Andrew Neil is CEO and Editor in Chief of Press Holdings, owner of The Spectator. On-screen, he presents the BBC's This Week and Daily Politics. Andrew is also Chairman of ITP, the Middle East's largest publisher of consumer and business magazines, and serves on the international advisory board of Al Jazeera.

This event is kindly sponsored by:

CHASE & PARTNERS C&P

LanghamHall
the future of fund outsourcing is here...

VALAD

Ticket price: £110 + VAT

£132 inclusive of VAT @ 20% per person

The ticket price excludes wine and other beverages.

For more information or to book, contact Barbara Hobbs on 020 7194 7920 or email bhobbs@ipf.org.uk