Investment Property Forum

Investment Property Forum Educational Trust

Property Stock Selection: Organisation, Incentives and Information

Executive Summary

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November 2006

This research was commissioned by the IPFET and IPF Joint Research Programme

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The IPF Educational Trust and IPF Joint Research Programme

This research was commissioned and funded under the auspices of the IPF Educational Trust and IPF Joint Research Programme.

The three-year programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with the other financial markets, wider business community and government on a range of complementary issues.

The programme is funded by a cross-section of 16 businesses, representing key market participants. The IPF Educational Trust and the IPF gratefully acknowledge the contributing organisations: Capital & Regional, Donaldsons, Grosvenor, GVA Grimley, Investment Property Databank, KPMG, LaSalle Investment Management, Land Securities, Lovells, Morley Fund Management, Nabarro Nathanson, Prudential Property Investment Managers, Quintain Estates & Development, Scottish Widows Investment Partnership, SJ Berwin and Strutt & Parker.

The Research Team

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The Project Steering Group

The IPF appointed a project steering group to guide and assist the Research team. They gratefully acknowledge the contribution from the Chairman – Richard Barkham (Grosvenor) and the members Gerry Blundell (LaSalle Investment Management), Stuart Cowe (SWIP), Peter Hobbs (RREEF), Paul Kennedy (Invesco) and Charles Follows (IPF).

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Introduction

This research studies the selection and use of information in investment decision-making. It is centred on the processes surrounding stock selection decisions about the acquisition and disposal of direct real estate assets.

Commercial property investors constantly make decisions in uncertain situations. At the single asset level, they face decisions about whether to buy or sell an investment, sometimes in competition with other assets. With the implied aim of maximising expected performance, the analysis of the cost and benefits of individual investments dominates the stock selection process. The vast majority of institutional investors use discounted cash flow models to inform buy or sell decisions about individual assets. This approach requires the investment analyst to process information on a range of variables, critical to the estimation of investment value. This research examines the selection and application of these information variables in investment decision-making, centred on the stock selection decision. At its core are the behaviours displayed in risk perception and evaluation, in information selection and processing, together with the associated consequences.

Within an organisation, investment decisions involve a number of principals who together with internal and external professionals have a diverse range of expertise, incentives and influence. Misaligned incentives, poor organisational structures and individual biases may contribute to sub-optimal decision-making and the acquisition of assets that will under-perform.

Using interviews with key participants the research examines the buying procedures and decisions processes of major UK investing institutions. The study builds from insights and methods that treat human decision-making from a behavioural perspective. Investigations from this perspective have shown that decision-makers may exhibit a range of sub-optimal behaviours, compared to the assumptions underpinning orthodox economic and finance theory. Many of the findings relating to such behaviours arise from studies in the field of behavioural finance or investment decision-making. The study augments this perspective by drawing from other key research areas that inform decision-making processes: namely organisational behaviour and agency theory.

The project advances our understanding of how stock selection decisions are made and thereby enables improvements in such decision-making, leading to a more efficient use of investment funds.

This report comprises of the executive summary of the research findings. To purchase a copy of the full research findings report please contact the IPF.

The IPF ET and IPF congratulate the research team and invites comments on the findings. Please address comments or suggestions to Charles Follows, Research Director, IPF, New Broad Street House, 35 New Broad Street, London EC2M 1NH.
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Although performed routinely, the process of finding, evaluating and acquiring commercial property assets for investment is complex. The lack of central trading, the heterogeneity of assets and markets and the intricate system of information needs that have to be sourced and assessed present a challenge to organisations in the efficiency with which they navigate this process.

The purpose of the study reported here is to contribute to understanding how successfully and efficiently participants in the stock buying process – and the industry itself – organise and manage their relationships to achieve their aims. Specifically, the focus of this research is on the buying procedures and decisions of major UK investing institutions.

The buying process involves a number of functions and it is inevitable in large organisations that responsibility for these functions is shared between individuals. These functions relate to:

- *Search:* identification of appropriate stock;
- *Information collection:* on the characteristics of the assets, the seller and the nature of other potential buyers;
- *Negotiation:* conduct of negotiations, development of pricing and bidding strategy;
- *Evaluation:* in-depth analysis and appraisal of investment opportunity;
- *Implementation:* transaction management and due diligence.

Typically, although a decision is made within a single organisation, it will involve a number of principals and internal and external professionals (agents, researchers, fund managers, asset managers, clients *inter alia*) who have a diverse range of expertise, incentives and influence. A key risk is that misaligned incentives, poor organisational structures and individual biases may contribute to the acquisition of assets that will underperform.

The study described here is centred on semi-structured interviews involving 11 buying organisations, supplemented with subsequent interviews with a small number of introductory agents. The main interviews were conducted in the second half of 2005.[1] Although all the organisations were naturally involved in fund management, the extent and nature of their property portfolios, and the needs of and mandates from their clients, differed considerably. One factor that clearly influenced many organisations' current and recent activities at the time of the interviews was the 'hot' state of the investment market leading up to and during 2005.

The framework for the study combines perspectives drawn from research in the areas of organisational buying behaviour, agency and transaction costs and cognitive psychology (as applied, for instance, in the realm of behavioural finance).

Key findings and conclusions

The study's key findings on the buying process and decision-making relate to:

- Organisational structures, incentives and remuneration
- The role of introductory agents and agency costs
- Information and its management

[1] Interviews were conducted with 19 people in the buying organisations, and three introductory agents. The managing director of the Propex system was also interviewed.

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Organisational structures and remuneration

Trends such as the growth in external mandates in traditional insurance and pension funds, the expansion of private property vehicles and retail funds and the growth of specialist fund management businesses have increased the complexity of the property investment sector. This increased complexity in the range of property investment products and the roles of investing institutions has, in turn, increased the diversity of organisational structures both within and between firms.

There are a number of important similarities in how organisations arrange themselves.

- The organisational basis for most of stock selection can be seen as a 'buying centre' i.e. a decision-making unit comprising many players with various roles;
- Team working and joint decision-making are standard, with a broad range of informal consultation and formal approval procedures in place to control operational risks;
- Fund managers play a pivotal role between the buyers and asset managers and more senior managers and principals;
- The remuneration of buyers is not directly linked to acquisitions but, more typically, to the performance of the organisation and the local team involved.

Although there are a number of approaches to allocating fund management, asset management and stock acquisition responsibilities, there is a clear dichotomy between organisations in their use of in-house specialist and non-specialist buyers.

- Organisations who have specialist buyers stress the importance of quick responses, concentration on sourcing stock and market contact and knowledge;
- Organisations who combine the roles of asset management and stock acquisition stress the risk control aspects of buyers managing the assets they purchase. However, they also acknowledge that, in the current market, time spent on asset management is being affected by pressures to acquire stock.

Investment firms show a flexibility and ability to adapt their organisational structures and individual roles in response to circumstances. The weakness of this is that immediate needs prevail and so longer term issues, such as asset management in an 'all-hands-on-deck' approach to acquisition in the current scramble for stock, may be neglected. There is no evidence that asset buyers' incentives are misaligned with organisational objectives. The team-working ethos engendered in organisations is not eroded by remunerations systems, which are generally not focused on rewarding narrow activities at the expense of overall team, or organisational, performance.

Overall, the flexibility shown by organisations in adapting their operating structures and job roles in relation to ongoing change in the market is undoubtedly beneficial. However, the industry needs to be mindful of the danger that prioritisation of work towards acquisition in response to market conditions may be at the expense of asset management opportunities.

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Introductory agents and agency costs

There are typically two intermediaries involved in a property investment transaction. While vendors employ their own selling agents, most organisations use external buying agents in all stages of the acquisition process. Whether buying 'off-market' or by 'best bids', most assets acquired are introduced by external buying agents and it appears to be difficult for potential buyers to source stock outside of this system. Hence it is important for investors to have good relations with agents. For the vast majority of organisations, agents provide advice and information to support the evaluation of the asset as well as transaction management if required.

Buyers recognise that there are incentives for the agent to encourage the investor to offer a 'high' price. This is because:

- Agents are only paid a fee if the asset is acquired;
- The agent's fee is positively linked to the price paid – typically 1% of the acquisition price.

These incentives are counter-balanced, however, by a number of important controls on opportunistic behaviour by agents.

- Buyers are fully aware of these incentives, are well-informed about the market themselves and are in a position to scrutinise information provided by agents accordingly;
- Agents are aware that buyers are aware, and there is a strong counter-incentive in the need to establish personal relationships and trust between themselves and buyers in order to generate repeat and related business and to preserve or generate a good reputation in the market.

The services of external buying agents come at a substantial price. We estimate that the level of fees paid to commercial property investment agents was in excess of £1 billion in 2005.

Intermediaries have an important role to play in the investment market. In particular buyers and sellers recognise the value added by agents who can initiate and broker deals on property that otherwise would not have come to the market. They also value the advice that agents give them in appraising potential assets. However, where assets are widely marketed, the contribution to efficiency of the sourcing role of the introductory agent is less clear. It could be questioned why vendors' agents do not more often approach buyers directly. The answer may be that the process of linking vendors with true prospective buyers would be performed less efficiently than through the intermediary filter of the introductory agent. This is naturally the view strongly espoused by agents themselves. The filter, however, appears to have limited impact, since buyers indicate that a large number of prospective purchases are rejected at the initial stage.

Although this study has not probed this area in depth, the dominance of agent networks as channels of information raises questions of transparency. This, allied to the presence of two intermediaries, casts doubt on whether the needs of the investors are being best served by such a system.

The industry should reflect upon the role of introductory agents in relation to their contribution to efficiency in the market. The conclusions may be that the role is valuable and likely to grow in importance as a bespoke service cutting through the welter of data generated by advances in information and communications technology. Alternatively, the conclusion may be to the contrary, with these advances supplanting the need for aspects of the role. Either way, the likely eventual unbundling of agents' services could become a key influence in future developments.

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Information and decisions

The vast majority of stock offered to investors is rapidly rejected in what may be seen as the part of the process that most overtly involves subjective judgements. Decisions are made on a number of bases:

- Failure to meet specific, factual requirements such as lot size, yield, lease terms;
- Knowledge drawn from analyses of previous opportunities in similar locations and/or sectors.

Where assets are taken forward to a detailed cash flow projection, the information inputs are generated by a range of principals and professionals. This task involves forecasting future cash flows (incomes and expenditures) of the asset and pulls in a number of 'secondary' forecasts of future market and building performance adding further complexity and uncertainty to the process. These inputs are adapted, mediated and scrutinised by buyers and fund managers and, in turn, further scrutinised by an investment committee and senior management.

There is some concern relating to information inputs in a number of (admittedly difficult) areas:

- Notwithstanding the IPF research into depreciation, some respondents felt that depreciation was still not being adequately incorporated into cash flows;
- There was notable variation in how target rates of return were adjusted to reflect differences in risk perceptions.

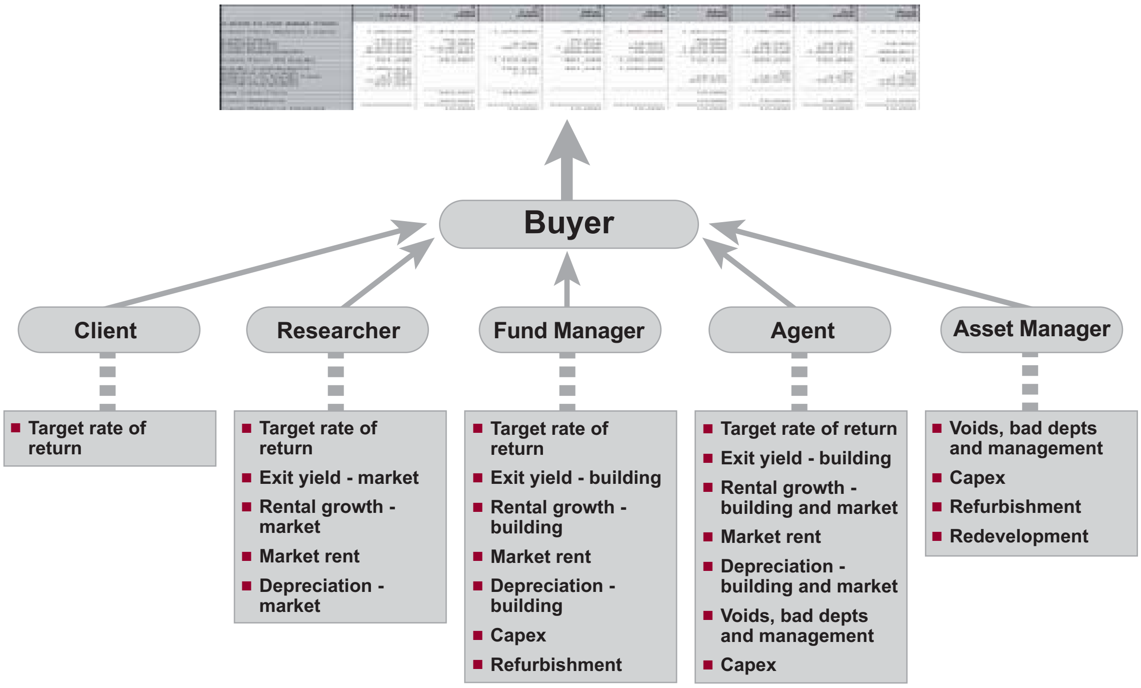
The key non-factual inputs and their providers are identified in Figure 1 (page 12). Typically, research and strategy personnel will generate projections of market trends and the buyer and fund manager will adapt these data at the building level.

While there is considerable scope and, indeed, a requirement for subjective adjustment in applying these variables, it is difficult to see how any buyer or other individual could consistently bias decisions away from organisational policy given the collaborative nature of the process and the controls normally in place. However, the strong influence of market circumstances on behaviour is clear and there is a danger that it creates pressures towards sub-optimal[2] decisions both at an individual and an organisational level.

Organisations should therefore consider the extent to which their risk management procedures, which clearly limit the potential for individual bias, recognise the risk of sub-optimal decisions at the organisational level, when confronted with intense market competition. They should also consider the extent to which certain information, notably risk-adjustment of discount rates and depreciation, influences the evaluation process and might be made more explicit.

[2] Sub-optimal in this context means decisions that fail to fully reflect and balance both short-term and longer term objectives.

Figure 1: **Schematic of the information flows in the buying process**



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