Investment Property Forum

Constructing an Effective Rental Value Index:

Consultation report and recommendations

May 2014

IPF Research Programme

The original report, **Constructing an Effective Rental Value Index**, published in January 2013 as IPF Short Paper 18, was funded and commissioned through the IPF Research Programme 2011–15.

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

The IPF is grateful for the sponsorship of the Programme by the 22 leading organisations listed below.

Executive summary

- The industry-wide consultation on the recommendations in the IPF Research Programme Short Paper 18, **Constructing an Effective Rental Value Index**, identified a general appreciation across the industry of the interrelated problems of inconsistent reporting of rental valuations and the resultant inadequacies in current IPD rental data series.
- The consultation revealed widespread agreement that action should be taken to resolve these issues and that a rental data series based on effective rents would prove valuable to the UK property market and industry.
- All of the key stakeholders whose support is needed to realise the vision outlined in Short Paper 18, engaged actively in the consultation and showed support for implementing its recommendations.
- As a result of the consultation, some changes to the original recommendations made in IPF Short Paper 18 have been made:
  - Recommendation 1 now reads, *"The effective and headline rental valuations required by performance measurers for the creation of related rental value indices should be provided from within the valuation and performance measurement systems, not directly by valuers."*
  - Recommendation 2 now reads, *"In addition to any general guidance concerning the use of local valuation standards applying to capital and rental values, IPD should amend its Index Guide to require valuers to identify whether their assessment of rental value is based on effective or headline rents. In the case of headline rental values, valuers should record the assumed level of incentives underpinning that assessment. In the case of effective rental levels, valuers should record the normal incentives given in the market for the property."*
  - Recommendation 3 remains unchanged and reads, *"The data collection process has to enable the incentives and lease terms underpinning valuations, not just those in the current lease, to be collected to ensure that both headline and effective rental value indices can be constructed."* and
  - Recommendation 4 remains unchanged and reads, *"Method 2 should be adopted universally within UK performance measurement systems to determine effective rental values from data on headline rental values and incentives. These calculations can be undertaken within existing systems using existing capitalisation rate data and new fields on assumed lease term, rent review and incentives."*

Method 2 from Short Paper 18 can be summarised as follows:

"The effective rent should be calculated by first assessing the present value of the headline rent payments, less any capital contributions, over a time period half way between the lease expiry date and the first rent review date, assuming that the review clause is upwards-only in nature. This calculation uses the equivalent yield as the discount rate. The set of rent payments that, in the absence of incentives, would produce an identical present value over that period is then computed."

- An additional recommendation emerged through the course of the consultation. This new recommendation (Recommendation 5) reads, *"To avoid the risk of confusion amongst valuer and investment communities, an information note should be written and distributed to the valuation and investment communities clearly specifying the purpose of these new estimated rental value figures. Furthermore, the outputs from the Crosby-Devaney algorithm should be named and labelled 'Index Effective Rental Value' and 'Index Headline Rental Value'."*
- Following further research, the principal authors of Short Paper 18 (Neil Crosby and Steven Devaney of University of Reading) recommend that IPD calculates its equivalent yield series on effective rental values. They reject the notion that there is value in an equivalent yield series based on headline rents. In their opinion, the IPD equivalent yield series will become more accurate and valuable as a result of the changes recommended above.
- Finally, the consultation confirmed that the vision of Short Paper 18 cannot, and should not, be implemented until a solution is found to maintaining the provision of market-level rental indices throughout the transition to an improved data series. There is risk of significant disruption to the work of market observers and forecasters if this is not assured. IPD has now put forward a proposal as to how this can be achieved, as explained in Figure 4 on page 15.

Acknowledgement

The IPF would like to thank all those who responded to the consultation and/or attended the subsequent meetings and round table discussions – their input to this process is greatly appreciated.

1: Introduction

This report was written by Dr Paul McNamara, who was responsible for undertaking the industry-wide consultation following the publication of the IPF Short Paper 18 **Constructing an Effective Rental Value Index** on 29 January 2013. This reviewed on-going problems in respect of the main UK rental data series constructed by IPD and used widely across the market.

Following its publication, the IPF sought responses to recommendations contained in Short Paper 18 as to how the problems identified might be resolved. A direct appeal for comments and reaction was made to the IPF membership, the RICS, other property industry bodies, heads of property valuation teams at chartered surveying and accountancy practices, and the academic community.

This industry-wide consultation concluded its written submissions phase on 15 March 2013, with 23 detailed submissions received, comprising nearly 13,000 words of commentary and review – see Appendix 1 for further details.

Following an analysis of these submissions, there were four face-to-face 'round table' meetings with consultation respondents and key stakeholders to address the main issues raised. These meetings took place in May and June 2013.

This report presents the main comments made by respondents during the consultation and responses to them made by the authors of Short Paper 18, Neil Crosby and Steven Devaney of University of Reading. As a result of these, some of the recommendations made in Short Paper 18 have been changed. Finally, the key conclusions from the consultation process are presented, together with an action plan to implement the relevant changes in valuer practice and calculation algorithms that have been identified.

Disclaimer

2: Summary of Short Paper 18: Constructing an Effective Rental Value Index

Short Paper 18 argued that any current reading of IPD's rental value indices in the UK is subject to significant uncertainty. This is because they comprise a varying mixture of headline and effective rents that makes the basis of the indices opaque and their interpretation difficult.

To be clear from the outset, this is an issue relating solely to the accuracy of rental value indices. It does not have implications for asset-specific valuations, total returns or measured investment performance. Nor should any of what follows be seen as a criticism of IPD who have actively been looking to resolve the issue discussed for many years and whose indices have been as good as the data available has permitted them to be over that time.

Difficulties with rental value index construction have arisen largely because of increasing variation in lease terms since the early 1990s. In that time, 'terms of trade' for UK commercial property leases have steadily moved away from a generally standard 25-year lease, with five-yearly upwards-only rent reviews, to making far greater use of a range of different lease incentives. Consequently, factors like rent-free periods, landlord capital contributions to tenants and a range of other 'incentives' have grown in importance. Clearly, unless the full range of incentives agreed is documented, it is hard for those not directly involved in any given leasing deal to interpret the relevance of the rental level agreed to conditions in the wider occupier market.

What complicates matters further is that the use of incentives varies through the market cycle. In a buoyant market, the scale of incentives offered to occupiers may be low and, as such, the agreed rent might closely reflect a pure economic rent. However, in a weak market, more leasing incentives tend to be offered to tenants. These buoy up the agreed 'headline' rental figure, which becomes increasingly detached from the prevailing pure economic rent.

Valuers are well aware of the interplay between rent levels and other lease terms. They regularly 'rentalise' and deduct the value of incentives from the agreed headline rent to create an 'effective' rental value. Since they capture all aspects of a leasing deal into a single figure, effective rental values can be seen to provide greater insight into prevailing rental market conditions than 'headline' rental values.

However, in everyday practice, valuers need to report rental values on different bases (headline or effective), depending on the next event in the life of the lease they are assessing. As things currently stand, the valuation software they use allows valuers flexibility in how they report these rental values. Given that the valuer's job is to provide a view on the value of a property asset, this is perfectly justifiable. However, the flexible nature of the recording of data is leading to problems in the rental indices used by the property investment community. In Short Paper 18, Crosby and Devaney reported that, as a result of these issues, the data underpinning IPD's rental series currently comprises a murky cocktail of headline, effective, achievable and provable rents that leaves any interpretation subject to significant uncertainty.[1]

1 For further evidence see Crosby N. and Murdoch S. (2001). Basis of rental value for performance measurement systems. ***Journal of Property Research****. 18 (2): 123–40.*

As 'outsiders', performance measurers can only construct indices using data that is available and, as things stand, IPD cannot discern whether the rental value data it receives from valuers represents effective or headline rental values. In the absence of full information on leasing deals, IPD is forced to assume that the rental data it receives relates to effective rents and it is these rental values that are used to construct IPD's current rental value and equivalent yield series.

Short Paper 18 outlined in detail the nature and causes of these data inconsistencies and, in the conviction that effective rental values are the truest single-figure gauge of letting market conditions, made four recommendations on how matters might be improved to enable a more meaningful effective rental value index to be established for the UK market, namely:

1. The effective rental valuations required for a performance measurement system are provided from within the valuation and measurement systems, not directly by the valuers.
2. IPD amends its Index Guide to include the requirement [for valuers] to use the Red Book for provision of rental value data in the UK and to specify headline rental values.
3. The data collection process has to enable the incentives and lease terms underpinning valuations, not just those in the current lease, to be collected to ensure that both headline and effective rental value indices can be constructed.
4. Method 2 should be adopted universally within UK performance measurement systems to determine effective rental values from data on headline rental values and incentives. These calculations can be undertaken within existing systems using existing capitalisation rate data and new fields on assumed lease term, rent review and incentives.

'Method 2' from Short Paper 18 can be summarised as follows:

The effective rent should be calculated by first assessing the present value of the headline rent payments, less any capital contributions, over a time period half way between the lease expiry date and the first rent review date, assuming that the review clause is upwards-only in nature. This calculation uses the equivalent yield as the discount rate. The set of rent payments that, in the absence of incentives, would produce an identical present value over that period is then computed.

Expanding briefly on the above recommendations, Short Paper 18 proposed that, going forward, valuers should record in a consistent manner on their valuation software all the relevant lease terms which contextualise the rental values they are entering.

It further recommended that performance measurement organisations like IPD should insist on the consistent recording of rental value data – in the same way they do currently for capital value data.

Seeking the means to produce rental data to support an improved rental value index, while avoiding increasing the workloads of already busy valuers, Short Paper 18 suggested a simple algorithm be introduced into the software used by performance measurers to estimate an effective rent from a headline rental value automatically.[2]

To determine the best algorithm to be used, Crosby and Devaney tested empirically the alternative approaches (See Appendix 2) for converting headline to effective rents set out in RICS UK Guidance Note No.6, "Commercial Lease Transactions".[3] They then compared the outputs from using these different approaches

2 This algorithm could also be included in the valuation software used by valuers but this is not essential to implementing the vision of Short Paper 18.
3 This may be renumbered UKGN 2 in the 2014 version of the Red Book.

against those from the more accurate but ultimately impractical[4] discounted cash flow (DCF) approach, to identify which showed the least variation and bias against DCF-generated results.[5] On the basis of this work, they recommended Method 2 (as described above) be used.

The application of this generic algorithm to individual lease agreements will almost invariably produce effective and headline rental value results that differ from those produced by valuers adopting appropriate asset-specific approaches. Crosby and Devaney are clear that their conversion algorithm is the least biased means to capture effective rents from a mix of data for purposes of rental index creation but stress that it may be completely inappropriate for use in individual valuation cases.

In assessing how the vision of Short Paper 18 might be realised, Crosby and Devaney felt the following support would be essential from three key stakeholders:

1. Valuers will need to record information that is currently a 'by-product' of the valuation process.
2. Valuation software providers will need to add new data fields to their valuation packages.
3. Performance measurement services will need to develop new algorithms for the analysis of rental values within their systems.

4 It is deemed impractical because of subjective information, not on account of the modelling itself.
5 The DCF approach was acknowledged as methodologically more robust but, because of its reliance on individual valuers needing to make subjective judgements about target rates of return and rental growth rates was deemed impractical for estimating effective rents in a consistent way across the market industry.

3: Responses to the consultation process

The IPF-led consultation on Short Paper 18 resulted in 23 submissions, comprising nearly 13,000 words of comment in total[6]. A break down of the sources of responses received is shown in Figure 1.

Figure 1: **Breakdown of respondents by type**

Type of respondent	Number
Industry organisation (RICS)	1
Investors	7
Valuers	8
Valuation data 'infrastructure' providers	3
Researchers	1
Accountants	1
Investment agents	1
Independent	1
	23

General overview of responses

The overall tenor of responses suggested widespread agreement that there were substantive issues relating to inconsistencies in how rental values were entered onto valuation software and the resultant quality of related rental value indices that needed addressing. There was also a general recognition that incentives do distort reported rental values and that indices based uncritically on a mixture of headline and effective rental values give a false impression of how occupier markets are faring. In this regard, a number of respondents were strongly of the view that, because of the data IPD was forced to work with, it had materially under-reported rental decline in the UK in recent times, especially for secondary and tertiary markets. There was also a clear desire for an improved equivalent yield series from IPD, based on effective rents.

In general, respondents felt the approach to resolving these issues promoted by Short Paper 18 was both pragmatic and straightforward to implement. However, as will be seen, many felt there were practical issues needing resolution before it could be implemented.

While investor respondents to the consultation strongly supported the creation of a 'pure' effective rental value series, a number of them were also in favour of taking the opportunity thrown up by this initiative to also create a pure 'headline rent index'.

Consultation responses in respect of each of the specific recommendations made in Short Paper 18 are discussed below.

6 For a full record of the consultation process, see Appendix 1.

Responses to specific recommendations

3.1 RECOMMENDATION 1
THE EFFECTIVE RENTAL VALUATIONS REQUIRED FOR A PERFORMANCE MEASUREMENT SYSTEM ARE PROVIDED FROM WITHIN THE VALUATION AND MEASUREMENT SYSTEMS, NOT DIRECTLY BY THE VALUERS.

In making this recommendation, Crosby and Devaney acknowledge explicitly that the primary task of a valuer is to produce capital valuations for properties and that any assessment of rental value they may conduct is done in support of that, rather than for the purpose of constructing market-level rental value indices.

Given the generally expressed concern to minimise the practical impact of Short Paper 18 on valuers, there was widespread support for this recommendation, which was seen as simple and pragmatic[7].

Specific discussions with senior representatives from valuation software providers ARGUS and KEL, data protocol providers OSCRE, and performance measurers IPD concluded that the amount of work required for them to implement this recommendation was not substantial and that they would, in principle, be willing to implement the required modification at a time that fell into their regular systems release schedules. In their view, implementing Short Paper 18 related more to effecting change in valuer practice than making what amounted to fairly trivial software changes.

The consultation did result, however, in an important change to the wording of Recommendation 1. The original notion behind this recommendation was that valuers should always enter a headline rent into their valuation software to which performance measurers would then apply the Crosby-Devaney algorithm to create an effective rent for inclusion in a newly-created IPD effective rental value index. However, a number of consultees felt there was merit in creating both an effective and a headline rental value index. This would require both an effective and a headline rent to be provided or estimated for each valuation. Consequently, Recommendation 1 has been developed to allow valuers to record either an effective or a headline rent. Then, by reference to the leasing details underpinning the rent entered, the proposed algorithm will convert a headline to an effective rent or in inverted form to convert an effective to a headline rent. In this way, both a headline and effective rent can be provided for each valuation and be entered into related rental value indices.

Recommendation 1 in Short Paper 18 has been revised as follows:

Recommendation 1: The effective and headline rental valuations required by performance measurers for the creation of related rental value indices should be provided from within the valuation and performance measurement systems, not directly by the valuers.

After discussing the requirements needed to implement Recommendation 1 with the relevant stakeholders, it was agreed that:

1. ARGUS and KEL need to provide the means by which valuers can specify explicitly what type of rental value they were entering.
2. Valuers should be persuaded of the merits of, in every instance, recording their assumptions for lease length, rent free, capital contributions and the review types and patterns that explain the rental value figure being entered.

7 Some commentators questioned whether valuers were the best people to provide information on prevailing market leasing assumptions. Incentive packages attached to many new lettings are often confidential, making comparables difficult to analyse. Indeed, there were instances where clients had not shared details on incentives with their own valuers! Therefore, it was suggested that market agents negotiating rental deals could provide better information. Whilst acknowledging the issue raised, it was felt to stand outside the remit of this consultation, which is focused on improving consistency in the recording of the rental value and related leasing assumptions upon which valuers base their valuations.

3. While it is essential that IPD adopts the recommended algorithm for calculating an effective rent from a headline rent and vice versa, the decision on whether to incorporate the same algorithm into future versions of valuation software was one for ARGUS and KEL to determine.[8]

3.2 RECOMMENDATION 2
IPD AMENDS ITS INDEX GUIDE TO INCLUDE THE REQUIREMENT TO USE THE RED BOOK FOR PROVISION OF RENTAL VALUE DATA IN THE UK AND TO SPECIFY HEADLINE RENTAL VALUES.

Crosby and Devaney noted in Short Paper 18 that, although IPD has historically issued clear instructions to its subscribers that their valuers should use the RICS Red Book when providing capital valuation information for inclusion in its performance measurement system, no similar instructions have been issued for the provision of rental values. Recommendation 2 is all about rectifying this.

Even before considering consultation responses on this matter, it should be noted that the above change to Recommendation 1 has immediate implications for the original Recommendation 2 in Short Paper 18. The RICS Red Book defines ‘market rent’ and related guidelines indicate that valuers should record headline rental value and the details of any lease term assumptions and incentives underpinning that assessment. However, given the desire to capture both an effective and a headline rent through the application of the conversion algorithm promoted in Short Paper 18, the IPD Index Guide will need to go beyond simply asking for the ‘headline rent-only’ RICS Red Book guidance to be followed.

On a point of information, in its response to the consultation, IPD noted that its Index Guide is international in nature; something it is keen to retain. Hence, IPD’s strong preference is to make explicit references in its Index Guide to the need for valuers to use ‘local’ capital and rent valuation standards. However, it would much prefer to do so by reference to International Valuation Standards than by specific reference to a UK standard.

Following the above deliberations, Recommendation 2 has been amended to read:

Recommendation 2: In addition to any general guidance concerning the use of local valuation standards applying to capital and rental values, IPD amends its Index Guide to require valuers to identify whether their assessment of rental value is based on effective or headline rents. In the case of headline rental values, valuers should record the assumed level of incentives underpinning that assessment. In the case of effective rental levels, valuers should record the normal incentives given in the market for the property.

3.3 RECOMMENDATION 3
THE DATA COLLECTION PROCESS HAS TO ENABLE THE INCENTIVES AND LEASE TERMS UNDERPINNING VALUATIONS, NOT JUST THOSE IN THE CURRENT LEASE, TO BE COLLECTED TO ENSURE THAT BOTH HEADLINE AND EFFECTIVE RENTAL VALUE INDICES CAN BE CONSTRUCTED

Irrespective of whether a headline or an effective rental value is recorded, going forward valuers will need to include any relevant information on the assumed incentives and lease terms that underpin those rental valuations.

For headline rental values, valuers will need to record the assumed incentives that underpin that assessment of rent for the headline to effective rent conversion to be carried out. To enable the effective rents to headline rent conversion to be made, it is the incentives normally given at that time in that specific sub-market that valuers need to record.

8 In discussion, both ARGUS and KEL felt it likely they would include the chosen algorithm in their systems as it provided additional functionality for both valuers and investors.)

During the consultation, a number of respondents warned that valuers might object to the extra work required in supplying fuller data sets, including rental values on two bases. However, Crosby and Devaney point out that it is not the intention that valuers input two bases of rents. Rather, their proposed algorithm will be constructed to estimate an effective rent from a headline rent and vice versa so, as now, only one rental value will require inputting.

One senior valuer noted that, in reality, implementing Recommendation 3 should not prove a problem for those valuers who assemble their valuation files properly. The RICS is similarly supportive, believing valuers perfectly capable of assembling the requisite information in the normal course of their duties.

Following the consultation process, Short Paper 18 Recommendation 3 remains unchanged.

3.4 RECOMMENDATION 4
METHOD 2 IS ADOPTED UNIVERSALLY WITHIN UK PERFORMANCE MEASUREMENT SYSTEMS TO DETERMINE EFFECTIVE RENTAL VALUES FROM DATA ON HEADLINE RENTAL VALUES AND INCENTIVES. THESE CALCULATIONS CAN BE UNDERTAKEN WITHIN EXISTING SYSTEMS USING EXISTING CAPITALISATION RATE DATA AND NEW FIELDS ON ASSUMED LEASE TERM, RENT REVIEW AND INCENTIVES

3.4.1 Purpose of the proxy valuations derived through Method 2

Before considering the detailed responses on Recommendation 4, it should be noted that the question of what the proxy rental values derived through Method 2 were going to be used for permeated the whole of the IPF consultation process and is central to taking the initiative forward.

Throughout the IPF consultation, there was a constant requirement to clarify that the vision of Short Paper 18 was not about imposing some new approach on valuers for deriving effective rents from headline rents in individual valuations but, rather, was to find a justifiable means to generate data from individual valuations in a consistent way to construct an improved UK rental index.

One senior valuer acknowledged that in order to achieve the vision of Short Paper 18 and create a new effective rental value index for the industry, "we have no choice but to adopt a crude and broad brush approach". However, in supporting the initiative he was clear that a related 'health warning' would need to be issued to both the valuation and investor communities warning that Method 2 was not meaningful for individual valuations where valuers would need to take a far wider range of factors into account.

There was concern, expressed both in writing and at the round table discussions conducted subsequently, that the effective and headline rents derived using the Crosby-Devaney Method 2 should be very clearly identified as a 'performance measurement rental value'. Indeed, there was general agreement at one round table discussion that the effective rents produced by Method 2 should be given a specific name to distinguish them from the valuer's case-specific calculations – especially if Method 2 results were to become outputs from regularly used valuation software.

On the basis of these comments, it is recommended (see below) that the outputs from Method 2 be named an 'Index Effective Rental Value' and an 'Index Headline Rental Value'.

It is further recommended that an information note be written and distributed to the valuation and investment communities to inform them of the very specific purpose of these new estimated rental value figures.

3.4.2 Specific consultation responses on Recommendation 4

As mentioned earlier, Short Paper 18 reviewed in detail the merits and demerits of using the four methods outlined in RICS UK Guidance Note No.6 for determining effective from headline rents as a means to creating sound effective rent indices. In doing so, they quickly dismissed one method as subjective, unscientific and inappropriate. They then applied two tests to each of the remaining three methods (see Appendix 2).

The first test was how practical each of the three methods would be for application to a very large number of individual valuation cases. Given the concern to minimise impact on valuers, the preference was to find an approach that could be subsumed into valuation or performance measurement systems rather than requiring valuers to perform any calculations. This pointed towards a method that used information already embedded within valuations and avoided use of external or potentially subjective inputs (such as the need to assume a client's required rate of return for a given property). As a result, despite acknowledging it as technically superior, Crosby and Devaney dismissed using any explicit approach.

However, in pursuit of finding the best approximating method, Crosby and Devaney applied a DCF approach on a number of case study assets and used the outputs to appraise the results from the remaining two methods in terms of accuracy and bias.

This empirical analysis concluded the most accurate and least biased 'self-contained' approach for converting headline into effective rental values was a version of Method 2, which used the property's equivalent yield as a discount rate and that discounted rental income over a period equal to half-way between lease expiry date and the first rent review date.

The consultation responses to Recommendation 4 were generally of two kinds. The first related to whether Method 2 should be used for the creation of a robust effective rental value index. The second related to issues raised about the operationalisation of Method 2. Both are reviewed below.

Which method should be adopted to create an effective rental value series?

There was general agreement amongst consultees that an explicit DCF approach would be too complex and subjective to provide a credible means to secure the objectives of Short Paper 18.

Only one respondent initially stated a preference for Method 1 over Method 2. This was on the basis that it was very simple to understand, easy to implement and, as such, was the most standard and transparent method to adopt. However, during subsequent face-to-face meetings, this respondent gained sufficient assurance that the data requirements behind Method 2 were less onerous than had originally been perceived and acknowledged that Method 2 provided superior outputs upon which to base rent indices. As such, he was content to withdraw this support for Method 1. This left Method 2 as the generally-accepted approach to adopt.

One person expressed concern with regard to Method 2's explicit 'investor-orientation' and the extent to which it overlooked tenants' interests. For this particular respondent, any definition of effective rent should prove equally meaningful to both investors and tenants and, while tenants might use effective rents to compare possible leasing deals, they would never utilise an investment measure like an equivalent yield as the discount rate. They would more likely focus on 'money out of the door' and, as such, if they discounted future rents at all they would use something like a forward estimate of inflation.[9] So, while the write-off period adopted in Method 2 balanced landlord and tenant interests, the use of the equivalent yield as discount rate was explicitly investor-oriented in nature.

9 Proposed amendments to International Accounting Standards suggest that, for financial reporting, lease liabilities should be discounted at the rate the lessor charges the lessee (i.e. the yield) or, if this cannot be determined, the occupier's incremental cost of borrowing. See IFRS (2013), Exposure Draft ED/2013/6 - Leases, IFRS Foundation, London.

Following round table discussions on this issue, it was agreed that these concerns could be set aside. This was on the grounds that, being deal-specific in outlook, it is unlikely that occupiers would care greatly about the outcomes of the Short Paper 18 initiative and would probably continue to use whatever they believed to be the most appropriate means to compare leasing deals.

Issues raised about the practical implementation of Method 2

A wide variety of practical concerns were raised by respondents with respect to the proposed use of Method 2. These are reviewed below:[10]

- The applicability of Method 2 for different types of lease.

Given the growing diversity in the forms of lease now being granted, some consultees raised questions about whether Method 2 could cope with leases of different kinds. In particular, there were concerns over whether it would work well for leases with fixed rental uplifts or 'minimum RPI provisions' where rents paid might rise beyond those achievable in the market place.

In response to these comments, Crosby and Devaney conducted further tests assessing the applicability of Method 2 for index-linked leases. Their results are presented in Appendix 3.

In brief, they concluded that 'index linking' has virtually no implications for the proposed approach because Method 2 is based on a comparison of the value of a headline rent lease with incentives compared to that for the same property let on an effective rent with no incentives.[11] If the rent is index-linked, the trend in cash flow in each case is identical and, as such, the initial difference between the headline and effective rent is maintained throughout the lease. They went on to note that index-linked uplifts are not market rent reviews and, as such, the lease should be treated as having no reviews in Method 2 with a write off period, therefore, over the whole term of the lease.[12]

Similar questions were raised around the applicability of Method 2 for leases without incentives and leases with upwards and downwards rent reviews. Following consideration of these various submissions, Figure 2 presents the views of Crosby and Devaney on how the main leasing variants in the UK would be dealt with by Method 2. There was confidence amongst both the University of Reading research team and IPD, that Method 2 would prove applicable to the vast majority of leases entered on to the IPD database.

Figure 2: **Application of Method 2 to varying forms of lease**

Type of lease	Treatment
Index-based leases	Method 2 is still applicable
Leases with no incentives	Effective rent equals the Headline rent and the incentives are entered as zero
Rent reviews	The next review is treated as the lease expiry
Five year leases, no breaks	Discount over the whole lease period
Turnover rents	Use the base rent (as is the case now)
'Exotic' leases	Will be treated as exceptional and will not be entered into the calculations of a rental index (as is the case now)

10 We should note that, given Short Paper 18's focus on the generality of assumed lease terms supporting rental value assessments, Section 3.4.3 does not review the many issues raised by consultees about problems of applying Method 2 to specific or unusual leasing transactions. This is because, as already noted, these should be dealt with by valuers on a case-specific basis.

11 Index-linked leases also have no implications for Method 1.

12 However, one concern might be if index-linking is not applied to the headline rent from day one but only from the date the first rent is collected. This would form a different rent profile between the headline and effective rent. If index-linking continues to emerge in the UK market and market practice evolves so that headline rents are only index linked after they start, then IPD may have to revisit this approach.

- The use of the equivalent yield to discount future rentals.

A number of consultees commented on a potential circularity within Method 2 with respect to its use of the equivalent yield as discount rate in the algorithm to convert headline to effective rents when the equivalent yield is itself a function of that rent.

Crosby and Devaney reviewed this issue in Short Paper 18 and concluded it was not a major problem for the effective rental value analysis. They were able to show that the level of capitalisation rate used does not materially affect the outcomes of the rental estimations. In large part, this is because Method 2 contains within it both a capitalisation routine and a subsequent offsetting decapitalisation routine.[13]

On a related issue, other consultees noted that equivalent yields incorporate a risk premium that falls when the market feels secure and rises when it feels insecure. As such, the estimates of rental value produced by Method 2 could be impacted, irrespective of changes in occupier market conditions. Crosby and Devaney acknowledge this as a downside for Method 2. However, they again argue that the impact of this on the rental values generated is greatly mitigated by the off-setting effect of capitalising the headline rental value and then decapitalising it.

Some consultees argued that the level of rent agreed between landlord and tenant and the resultant equivalent yields are not independent of factors like length of lease, tenant quality or whether the lease is granted FRI and within or outside the Landlord & Tenant Act 1954. As such, they asked whether there was a need to account for these variations in the calculations. However, as outlined above, Crosby and Devaney remain clear that Method 2 is a general tool to assist in the creation of robust rent indices and the approximate rental values it generates should not be applied to the analysis of individual leases.

At a yet more practical level, some concern was expressed by respondents about the use of property equivalent yields in Method 2, given how variably they are constructed by valuers (e.g. 'fully costed', taking into account void costs and minimum rental uplifts or simply using current headline rents). Crosby and Devaney do not see this as a problem since the equivalent yield applied by the valuer in any specific valuation is not used in the calculation of equivalent yield by IPD and will not be so in the future. Rather, the equivalent yield is calculated anew in a consistent way by an internal IPD algorithm using the rental values and lease terms provided through the valuation software. Under Short Paper 18, this would continue to happen but using improved rental value information.

Related to this, over the course of the consultations and through related additional analyses, Crosby and Devaney confirmed their prior notion that another current performance measurement anomaly could be resolved by implementing Short Paper 18. In their view, Method 2 will also lead to an improved equivalent yield series for the market. Implementing the vision of Short Paper 18 could also facilitate the creation of an equivalent yield series based purely on headline rents. However, as outlined in Appendix 4, Crosby and Devaney have concluded that such a notion is without merit.

- The period over which discounting should occur.

While some commentators described Method 2's use of a point half way between the first break and the lease expiry date to define the requisite discounting period as 'fair', one prominent valuer called it a "weak compromise", arguing that a purer approach would be to discount using the whole length of the lease.

13 In Short Paper 18 Crosby and Devaney established that variations in capitalisation rates had less impact on the rental results generated by Method 2 than other inputs such as length of write off period.

Other respondents noted that the scale of incentives in any lease is tied to lease length, with longer leases naturally generating more incentives.

In response, Crosby and Devaney acknowledge that longer leases are accompanied by greater incentives. They also recognise that some circumstances may arise when it would be appropriate to discount incentives over the whole term of the lease and others when it would not. For example, where rents are not expected to grow in the near future or incentives packages are large and headline rents underpinned by upwards only reviews, the impact of incentives on the effective rent level extend beyond the first review. However, where incentives packages are very small and/or growth rates high, effective rents may overtake headlines rents within a single review period. In such cases, the proposed compromise of half way between first break and lease expiry will either under or overestimate the effective rent.

However, for Crosby and Devaney, when the fullest range of possible circumstances across the whole market are considered Method 2, with its 'compromise approach' to the discount period, minimises inaccuracy and bias for related rental index construction.

- The use of break clauses in the calculation.

A number of consultees raised the issue of break clauses and their treatment within the automated calculations required under Method 2. In particular, there was much comment about how the penalties faced by tenants when exercising break clauses (and the further incentives obtainable by them when not exercising them) were insufficiently accounted for in Method 2. The assumption that a tenant automatically exercises a break clause was also described as a weakness in the methodology.

For Crosby and Devaney, these comments strengthen their conviction that the only usable definitions for lease expiry date are the lease end as specified in the lease or the first break. The fact that a tenant can obtain further incentives by not exercising a break demonstrates that incentives obtained at the beginning of a lease pertain solely to the period up to first break. With respect to penalties for exercising breaks, if a landlord negotiates a higher set of incentives for a higher break penalty then, Crosby and Devaney concur that the break penalty does impact the level of incentives and the resultant effective rent under Method 2. However, Crosby and Devaney note that Method 2 uses the valuer's stated assumptions underpinning the rental value estimate in the capital valuation and believe it rare that valuers assume such intricacies in their assumptions. Thus, though true, they doubt this particular issue will arise with sufficient frequently to systematically bias any resultant rental value index

With respect to the existence of multiple break options within a given lease, Crosby and Devaney maintain that the first break should still be assumed as the lease expiry date.

Finally, there was a question about how Method 2 would cope with rolling breaks. Crosby and Devaney acknowledge that because it uses the date of a first break to determine the relevant discounting period, rolling breaks do create some issues for Method 2. However, they question how often such leases attract significant incentives packages and, furthermore, believe it rare that valuers assume such abnormal lease terms when estimating reversionary rental values.

- The definition of incentives and other issues.

A number of consultees commented that greater clarity might be needed when defining what an 'incentive' is. For example, one respondent felt that service charges and rates offset against rents, capital contributions for plant maintenance and repair, work on building fabric at lease end and the 'necessary capital expenditure' to make a property occupiable were not explicitly accounted for in Method 2. He went on to suggest that a simple list of relevant incentives might be needed for completion by valuers to bring requisite clarity to the data.

Another investor respondent referred to the current fashion for vendors 'topping up' rent free periods when effecting sales and providing buyers with rental guarantees on vacant properties; noting that such practices were often used by purchasers and valuers to determine the market value of assets.

There were other such issues raised by respondents. These included:

- The difference between achievable and provable rents, especially related to provable effective rents at review versus achievable headline rents on new lettings;
- Distortions of rents and terms for asset management reasons in shopping centres or where loans could be in default unless certain rental levels are achieved; and
- Valuers not collecting or assuming specific lease terms underpinning rental value assessments.

Crosby and Devaney felt that all of these issues again focused on the applicability of Method 2 to individual leasing cases whereas Method 2 was designed to assist in the generation of a best possible set of estimated rental value data with which to create an improved rental value index. As such, the focus, therefore, had to be on the general assumptions used by valuers rather than the complexities of specific transactions, which few, if any, valuers would adopt as generalised assumptions for their valuations.

As Method 2 enables capital contributions to be taken into account, Crosby and Devaney feel that Method 2 can cope with issues such as rates, service charges and other similar landlord contributions.

- Applicability to all sectors

One investor respondent to the consultation noted that the examples given in Short Paper 18 focused on the three main real estate sectors and sought assurance that Method 2 was applicable to all property types. Crosby and Devaney were clear that there is nothing sector specific in Method 2 and it remains applicable to all sectors.

The robustness of Method 2

As can be seen from the above, following detailed review and active debate about the applicability of the various methods for converting headline to effective rents (and, in inverted form, vice versa) Crosby and Devaney's recommendation to use Method 2 as originally specified remains unchanged.

3.5 ADDITIONAL RESEARCH FINDINGS

Various pieces of additional research were conducted by Crosby and Devaney through the course of the IPF-led consultation. These included analyses to stress test the recommendations in Short Paper 18 for specific concerns such as index linked leases and the perceived circularity of equivalent yields. However, they believe the most important additional research resulting from the IPF consultation relates to assessing the potential impact of Short Paper 18 on IPD's equivalent yield series.

IPD's equivalent yield series is currently based on the market rental values provided by valuers, which represent a mix of headline and effective rental values. By separating out this mix into two 'purer' data series, IPD's equivalent yield calculations could be constructed from a consistent set of estimated and actual effective rental values, assuming no incentives, or from a similar set of headline rental values (taking into account the new information on incentives) or both. Either approach would produce a more consistent yield series than IPD's current series, which assumes the rental values used are effective when they are not always so.

Crosby and Devaney undertook further work to investigate which rental values the IPD equivalent yield series should be based upon (see Appendix 4). In doing so, they established that the resultant equivalent yields based on headline or effective rental values will differ from each other. This is because the current IPD equivalent yield calculation discounts the rental value into perpetuity without incentives, regardless of the basis of that rental value, thereby implying an effective rental value. Even if an equivalent yield was calculated using the new headline rental values that the Short Paper 18 initiative could provide, it would only account for the assumed lease terms including incentives at the first reversion. At any subsequent lease expiry, those same incentives would not be taken into account leading to the cash flow being overstated and an equivalent yield higher than is actually the case.

Given this, Crosby and Devaney reject the notion that there is merit in IPD producing two equivalent yield series based respectively on effective and headline rents. Rather, they recommend IPD calculate equivalent yields as they do now but using the purer set of effective rental values that Short Paper 18 can deliver.

3.6 SPLICING WITH HISTORIC SERIES

A major issue that emerged through the course of the consultation, raised particularly by those from the investment research community, related to how Short Paper 18 could be implemented without interrupting the provision of an IPD rental index.

Short Paper 18 envisages a process by which the current mixed stream of data underpinning IPD rental indices is replaced with two 'purer' streams of data on effective rents and headline rents. If this transition was to occur quickly without adequate planning, it could cause a major discontinuity in important UK rental data series.

This would be most unwelcome for two reasons. First, there would be a brief period when market commentators may find it difficult to discern rental market trends or fund managers assess portfolio rental performance across the break in the rental data series. Second, those who use historical IPD rental data series in their rental forecasting models need at least five to 10 years of data to calibrate them and, given the importance of forecasting to investment strategy, it is unreasonable to expect forecasters and investment strategists to suspend their operations while the new, improved, data series establishes a sufficient history to satisfy these needs.

As such, there is a real need to find a way to provide continuity in rental value data series over a five to 10-year period while the new, purer effective and headline rent series establish themselves. Indeed, there is a convincing argument to say that the vision of Short Paper 18 cannot and should not be implemented until a solution to this problem is found.

The options for addressing this issue are shown in Figure 3.

3.7 PROPOSED IPD SOLUTION

IPD has now developed a proposal based of the final option listed in Figure 3 above. As soon as valuers begin to record the basis upon which their valuations are based, IPD will start to collect the requisite data necessary to build effective and headline rental value series.

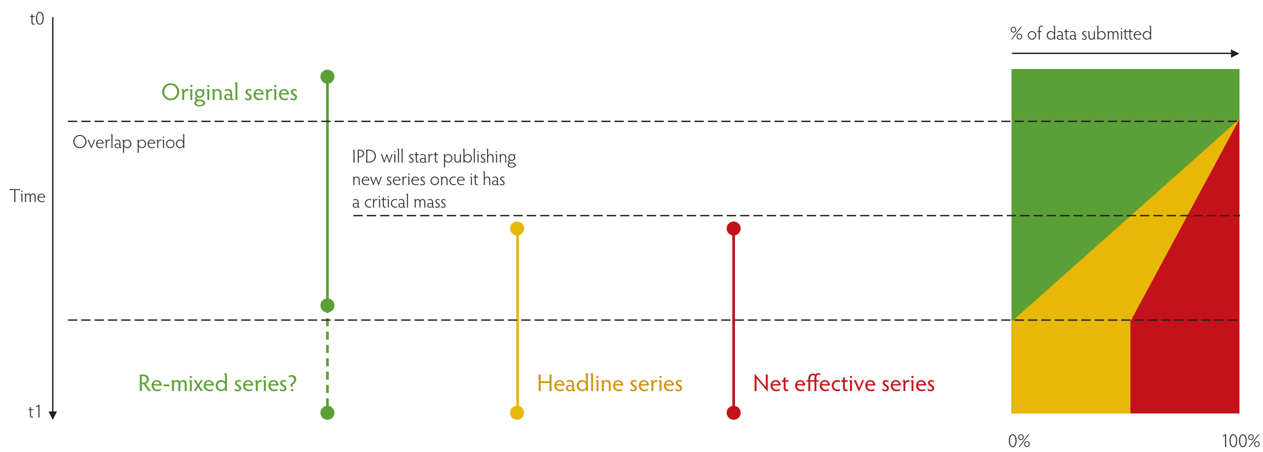
Figure 3: **Options for addressing the need for continuity of key market data series**

Approach	Comments
Attempt to splice old and new series	The different definitions of the old and the new data make a 'simple' splicing of data sets difficult. However, analysis should be conducted to assess how much error is introduced by simply splicing the datasets together.
Full backcasting	A 'new history' for the two 'purer' data series would be created, allowing forecasters to switch immediately to using these more meaningful, forms of rental value data. It is acknowledged that this process is fraught with practical problems and there is virtually no chance of creating a history over the full life of the current rental data series.
Partial backcasting	Given the problems with a 'full backcast,' a 'partial backcast' might be considered whereby a history of the two purer datasets is created of a length sufficient to allow forecasters to confidently recalibrate their forecasting models with the new data. A variant on this would be to create a history of the purer data sets sufficient to establish how the old and new data sets move and relate to each other. This evidence could then be used to 'model' a history of the two purer series for use in forecasting models.
Temporary re-mixing of data	A way would be sought to 're-muddy' the newly-created purer data sets in a way that replicates the old data series. This would allow forecasters to continue using their current models until the new purer data series have developed a sufficient track record that forecasters could switch to using them permanently. The downside is, of course, that forecasters would be continuing to use a data series already identified as problematic.

Over time, as more and more valuers use the enhanced valuation software and declare the basis of their rental valuations, enough data will accumulate for IPD to, at some stage, release consultative versions of the proposed new headline and effective rental value indices. Initially, these would be published alongside the existing rental data series constructed as now – albeit based on a shrinking pool of data. In this way, as valuers increasingly update their software and supply information on the basis of their rental valuations, the old rental value series will be superseded by the newer, purer, effective and headline series. IPD's plan is shown in Figure 4.

Naturally, the sooner valuers update their software and adopt these practices, the sooner the transition to the improved data series can occur. Given the potential benefits this could bring to their investment clients and the wider market, there is a clear need for all to work together to secure as speedy a transition as possible.

Figure 4: **Proposal for the IPD rent series**



Source: IPD

4: Conclusions

4.1 GENERAL

The IPF industry consultation on Short Paper 18 has revealed a general appreciation of the interrelated problems of inconsistent reporting of rental valuations in valuation software and the subsequent impurity, opacity and inaccuracy this causes in the rental data series published currently by IPD.

There was also widespread agreement amongst consultees that action should be taken to resolve these issues and that a rental data series based on effective rents would prove valuable to the property market and industry. In this regard, respondents to the consultation generally saw Method 2 as providing a simple and pragmatic way forward.

4.2 AMENDMENTS TO THE RECOMMENDATIONS IN SHORT PAPER 18

However, the IPF consultation did raise some important issues that have led to amendments being made to the recommendations put forward in Short Paper 18. Figure 5 illustrates how Crosby and Devaney's original recommendations have been developed through the consultation.

Of greatest significance has been the move from an original plan to encourage valuers to always enter headline rents and related leasing assumptions onto their valuation software with the Crosby-Devaney algorithm then used to estimate an effective rent. This has evolved to a position where valuers can enter either an effective or a headline rent with the relevant leasing assumptions, to which the Crosby and Devaney algorithm can then be applied as originally conceived or in inverted form, to estimate an effective from a headline rent or a headline from an effective rent. A corollary of this amendment is that valuers will need to be explicit about what type of rental value they are recording onto the valuation software.

Related to this change is the finding that investment researchers perceive merit in having both an effective rental value index series and a headline rental value index series, whereas the original intention of Short Paper 18 was solely to develop an enhanced effective rental value index.

4.3 A NEW RECOMMENDATION

The consultation also identified that if Short Paper 18 is to be implemented, an additional recommendation is required.

Looking in detail at responses submitted throughout the consultation, it is clear that many detailed and well-intentioned responses stemmed from a misapprehension that Short Paper 18 was promoting a change to valuation practice rather than a change in valuer reporting practice. Additional work is, therefore, needed to ensure valuer and investor communities are absolutely clear that Short Paper 18 is not promoting a new approach for estimating rental values in asset-specific cases but is focused entirely on establishing a process for estimating effective and headline rents in a consistent way across the market for subsequent collation into improved rental value indices.

This concern was reinforced at the final presentation of the findings of the industry consultation in March 2014, where a number of senior valuers insisted that the 'Index Effective Rental Value' (IERV) and 'Index Headline Rental Value' (IHRV) should not be made visible to valuers as outputs in their valuation software as this could lead to inappropriate figures potentially influencing asset-specific valuations.

Figure 5: Comparison of original Short Paper 18 recommendations and the recommendations post IPF consultation

	Original recommendations	Post-consultation recommendations
REC. 1	The effective rental valuations required for a performance measurement system are provided from within the valuation and measurement systems, not directly by the valuers.	The effective and headline rental valuations required by performance measurers for the creation of related rental value indices should be provided from within the valuation and performance measurement systems, not directly by valuers.
REC. 2	IPD amends its Index Guide to include the requirement to use the Red Book for provision of rental value data in the UK and to specify headline rental values.	In addition to any general guidance concerning the use of local valuation standards applying to capital and rental values, IPD should amend its Index Guide to require valuers to identify whether their assessment of rental value is based on effective or headline rents. In the case of headline rental values, valuers should record the assumed level of incentives underpinning that assessment. In the case of effective rental levels, valuers should record the normal incentives given in the market for the property.
REC. 3	The data collection process has to enable the incentives and lease terms underpinning valuations, not just those in the current lease, to be collected to ensure that both headline and effective rental value indices can be constructed.	Recommendation unchanged following consultation.
REC. 4	Method 2 should be adopted universally within UK performance measurement systems to determine effective rental values from data on headline rental values and incentives. These calculations can be undertaken within existing systems using existing capitalisation rate data and new fields on assumed lease term, rent review and incentives. Method 2 from Short Paper 18 can be summarised as follows: The effective rent should be calculated by first assessing the present value of the headline rent payments, less any capital contributions, over a time period half way between the lease expiry date and the first rent review date, assuming that the review clause is upwards-only in nature. This calculation uses the equivalent yield as the discount rate. The set of rent payments that, in the absence of incentives, would produce an identical present value over that period is then computed.	Recommendation unchanged following consultation.
REC. 5	None.	To avoid the risk of confusion amongst valuer and investment communities, an information note should be written and distributed to the valuation and investment communities, clearly specifying the purpose of these new estimated rental value figures and, furthermore, the outputs from the Crosby-Devaney algorithm should be named and labelled 'Index Effective Rental Value' (IERV) and 'Index Headline Rental Value' (IHRV).

4.4 COMMITMENT OF KEY STAKEHOLDERS

It is pleasing to report that the key stakeholders whose support and involvement is essential to realising the vision outlined in Short Paper 18 all engaged actively with the consultation and stated their willingness to support it practically. Valuation software providers (ARGUS, KEL) appear content to perform the necessary modifications to their products and provide the fields necessary to capture the type of rental data being entered and related assumptions. They also appear willing to embed the Crosby-Devaney rental conversion algorithm into their systems.

OSCRE, which is key to transporting data from valuation software in a form readable by IPD, did not perceive any material issues in making space in its data protocols to accommodate the additional information required to implement Short Paper 18.

Performance measurers IPD similarly expressed a willingness to modify its internal systems to run the Crosby-Devaney algorithm and collate the outputs into the desired new rental data series.

As the changes proposed in Short Paper 18 gain widespread agreement and become more certain, IPD has also expressed its willingness to change the advice contained in its Index Guide on how clients and their valuers should submit rental data.

By and large, though wary of any extra pressure being placed on valuers, who are already busy and operating on thin remuneration margins, the RICS and most senior valuers involved in the consultation were also supportive of the findings in Short Paper 18. In this, they were clear that the key to implementing the recommendations in Short Paper 18 lay in avoiding causing valuers to perform new tasks but, rather, having them simply record valuations and associated assumptions more fully and consistently.

4.5 FURTHER WORK REQUIRED IN ORDER TO PROGRESS

The IPF consultation has shown widespread support for, and a general desire to move forward with, the vision outlined in Short Paper 18. However, doing this is contingent on resolving the issue of maintaining rental data continuity through the process. It is not credible to implement Short Paper 18 if, by so doing, it causes material disruption to the work of market observers and forecasters. As such, the vision of Short Paper 18 cannot and should not be implemented until a generally-accepted solution has been found to maintaining the provision of a market rental index through the transition to the new data series.

4.6 STAKEHOLDER REQUIREMENTS

The IPF consultation has helped clarify the original recommendations in Short Paper 18 and determine what is required from each of the main stakeholders to implement Short Paper 18. The details of these requirements are set out below.

4.6.1 What is required of valuers:

- Record the type of rental value being recorded – either 'headline' or 'effective';
- For 'headline' rental values entered, record the market assumptions made on lease terms in reaching these figures (explicitly - lease length, rent free periods, existence of break at a given time, capital contributions); and
- For 'effective' rental values estimated from headline rent comparables, record the specific assumptions adopted with respect to lease terms (explicitly – lease length, rent-free periods, existence of break at a given

time, capital contributions). For effective rental values entered directly from effective rent comparables, identify the terms of leases that are in existence in the relevant property sub-market at that time (explicitly – lease length, rent-free periods, existence of break at a given time and capital contributions).

4.6.2 What is required of valuation software providers:

- Provide the means by which valuers can record the nature of the rental value they are entering on to the system (tick box, check box, etc).

Optionally, valuation software providers might also choose to:

- Insert the Crosby-Devaney algorithm, both as originally conceived and in inverted form, into software to convert any entered 'headline' rental value to an IERV and any entered 'effective' rental value to an IHRV; and
- Provide a space on output screens and results print out pages, for the IERV or IHRV to be shown.

4.6.3 What is required of IPD:

- Amend its processes to extract the new rental data and related assumptions submitted by valuers;
- Develop an algorithm that uses the Crosby-Devaney algorithm to convert any 'headline' rental value submitted to an IERV;[14]
- Develop an algorithm that uses the Crosby-Devaney algorithm to convert any 'effective' rental value submitted to an IHRV;
- Develop processes through which actual effective rental values and derived IERVs can be combined into a new IPD Effective Rental Value Index;
- Develop processes through which actual headline rental values and derived IHRVs can be combined into a new IPD Headline Rental Value Index;
- Develop processes through which a new IPD Equivalent Yield series (based on actual and derived effective rental values) can be created; and
- Amend the IPD Index Guide to provide clients and their values on how they would like rental value data in the UK to be provided.

4.6.4 What is required of OSCRE:

- Provide sufficient spaces in its data protocol to accommodate and transfer the additional data implied in the recommendation in Short Paper 18.

4.6.5 What is required of fund and investment managers:

- Valuations are carried out to the bespoke requirements of those who commission them, rather than for IPD's or the market's benefit. Fund and investment managers are therefore requested to reflect upon the potential market-wide advantages to be gained from standardising the data that valuers record on their behalf and, as such, encourage their valuers to record all relevant information relating to the rental valuations they are providing.

14 IPD has already said that it will not take the estimated IERV and IHRV figures direct from the valuation software but calculate directly, itself. It would, therefore, seem sensible for IPD to work closely with valuation software providers to ensure that everyone is calculating these numbers in the same way.

5: Next Steps

Given the widespread support to resolve the important issues raised in Short Paper 18, it is important to plan for the eventual implementation of the recommendations. This will require the co-ordination of a wide range of stakeholders so it is proposed that the IPF should establish and lead an implementation steering group (ISG) to deliver the initiative. Obvious members of that group would include IPD, ARGUS, KEL and OSCRE, all of whom are required to perform specific tasks. The valuation community will also need to be represented. As its representative, the RICS UK Valuation Committee would appear a logical addition to the ISG, albeit its presence could be augmented through the involvement of senior representatives from some supportive valuation firms.[15]

The first task of the ISG will be to gain formal agreement from key stakeholders that they will undertake to complete the work needed to deliver the vision of Short Paper 18. Once secured, the ISG should then establish an implementation timetable. This will almost certainly be dictated by the timings of new version releases for valuation software – usually two per annum. In discussions held to date with relevant stakeholders, the consensus was that the more co-ordinated the industry switchover to the requirements outlined in Short Paper 18 the easier the transition would be. A gradual changeover from the existing data series to the two new data series could leave the market unsure as to what the indices being produced during the transition period represent. The general feeling was that, if it takes 18 to 24 months to get everything in place for a co-ordinated and rapid implementation of Short Paper 18, this would be preferable to an earlier, but less well co-ordinated, switchover.

Once commitments and a timetable have been agreed, the ISG will meet regularly during the agreed implementation period to monitor the progress of the various parties towards the switchover date. Over that time, the ISG will, in parallel, need to oversee (to general satisfaction) the maintenance of a rental index series through the transition period. The ISG will also need to oversee and agree the educational and promotional activities and materials to help valuers change their reporting practices, while avoiding the possibility that both the valuers and their investment clients get confused by the new rental value figures.

15 *Recognising the RICS will not wish to make changes to valuer practice within individual valuation practices, starting with a clear focus on those supplying the most data to IPD, valuers will need to be encouraged to support the implementation of Short Paper 18.*

Appendix I

IPF Short Paper 18, Constructing an Effective Rental Value Index: The consultation process

1. INITIAL RESEARCH WAS FORMALLY COMMISSIONED ON 9 NOVEMBER 2012 AND DELIVERED TO IPF ON 21 DECEMBER 2012

2. THE IPF CONSULTATION WAS LAUNCHED ON 29 JANUARY 2013, WITH THE FORMAL PUBLICATION OF IPF RESEARCH PROGRAMME 2011-2015: SHORT PAPER 18, CONSTRUCTING AN EFFECTIVE RENTAL VALUE INDEX

- All members of IPF were issued with a copy of Short Paper 18 and invited to make submissions;
- Six major UK property publications were issued with a copy of Short Paper 18;
- A press release was issued, outlining the findings of Short Paper 18 and announcing the launch of the IPF consultation process;
- Copies of Short Paper 18 and details of the IPF consultation were sent to all other property industry bodies represented on the Property Industry Alliance Research Committee (BPF, BCO, AREF, SPR, ABI, RICS). This was accompanied with a request that the individual and corporate members of those organisations be informed of the general invitation to participate in the consultation process and offered access to Short Paper 18;
- A personal email with a copy of Short Paper 18 was sent to the Global Director of Valuation at RICS, requesting the participation of the UK Valuation Committee in the consultation;
- Personal emails with a copy of Short Paper 18 were sent to the Heads of Valuation at the 12 UK valuation practices believed to be most significant for supplying valuation data to IPD, requesting their participation in the consultation process;
- Personal emails with a copy of Short Paper 18 were sent to the Heads of Real Estate at four major UK accounting practices, requesting their participation in the consultation process;
- Personal emails with a copy of Short Paper 18 were sent to key valuation software and infrastructure providers (IPD, ARGUS, KEL, OSCRE, YARDI, TRACE) requesting their participation in the consultation process; and
- An email and copy of Short Paper 18 was sent to the Executive Officer of the Council of Heads of the Built Environment with a request for its onward transmission to relevant senior valuation academics in British universities.

3. 5 FEBRUARY 2013: DISCUSSION OF SHORT PAPER 18 AND DISCUSSION OF THE CONSULTATION PROCESS AT IPF MANAGEMENT BOARD

4. 15 MARCH 2013, CONSULTATION PROCESS CLOSED

Outcome of consultation:

- Circa 13,000 words of submission
- Submissions were made by the following types of organisation:

Type of respondent	Number
Industry organisation (RICS)	1
Investors	7
Valuers	8
Valuation data 'infrastructure' providers	3
Researcher	1
Accountants	1
Investment agent	1
Independent	1
	23

- List of organisations and individuals providing comments to the Consultation:

Aston Rose	Fidelity	KEL Computing	Routes Consulting Solutions
CBRE	Graham Chase Partners	Knight Frank	Spalding & Co
Charles Ostroumoff	HERMES	M&G Real Estate	Standard Life
Deloitte Real Estate	HSBC	Pramerica	YARDI
Ends & White	IPD	PwC	
Europa Capital LLP	JLL	RICS	

5. ROUND TABLE DISCUSSION MEETINGS, MAY-JUNE 2013

Following review and synthesis of written submissions, four meetings were arranged to discuss key issues, face-to-face:

Meeting	Date
Meeting between Short Paper 18 Research Team and IPD, to discuss practical issues of implementation	14 May
Meeting between Short Paper 18 Research Team, IPD, ARGUS, KEL, OSCRE and YARDI to discuss practical issues of implementation	28 May
Meeting with mixed group of (16) investor and valuer representatives to discuss outstanding theoretical and practical issues from the Short Paper 18 consultation	11 June
Meeting with a second mixed group of (15) investor and valuer representatives to discuss outstanding theoretical and practical issues from the Short Paper 18 consultation	14 June

6. PRESENTATION AND DISCUSSION OF CONSULTATION FINDINGS

A meeting was held on 5 March 2014 to discuss the outcomes of the consultation with stakeholders and others involved in the consultation process. Relevant points raised at that meeting have been recorded in this final report.

Appendix II
Brief summary of the methods reviewed in Short Paper 18 to estimate effective rents from headline rents

Four methods are outlined in RICS UK Guidance Note No. 6 for converting headline rents to net effective rents. In IPF Research Programme 2011-2015: **Short Paper 18, Constructing an Effective Rental Value Index**, Neil Crosby and Steven Devaney of University of Reading assessed the potential of each of these methods for use as a general technique to create accurate, unbiased, estimates of effective rent from which an improved effective rent index in the UK could be constructed. The following briefly summarises their views on the appropriateness of each method.

Method 1 is essentially very simple. It calculates the total income earned (as a simple multiple of the current rent, without growth) and the total incentives given, over a specified analysis or 'write-off' period. The effective rent is then deemed to equal the headline rent minus the annualised capital value of the incentives granted.

For Crosby and Devaney, there are three issues with Method 1. First, it does not account for changing levels of rents over the course of the analysis period as successive rent reviews occur. Second, no attention is given to the time value of money. Third, there are choices to be made as to which write off period should be used that affect the resultant effective rent calculated. In subsequent empirical work, Crosby and Devaney show clearly how making different choices with respect to the chosen write off period noticeably impacts the final estimate of effective rent.

Method 2 builds upon and addresses some of the shortcomings of Method 1. It calculates the present value of the total rental income (without growth) to the end of a specified write-off period and deducts from that the total amount of capital payments to obtain the present value of the rents collected over that period. It then identifies the effective rent that, in the absence of any incentives, would give the same present value of total income over the same write off period.

To calculate the present value of the total rental income, it has to apply a discount rate to account for the time value of money. Crosby and Devaney explore a number of potential candidates for this including the investors' target rate of return and the equivalent yield for the property.

The RICS's Method 3 is, in Crosby and Devaney's view, "a fairly arbitrary approach based on subjective capitalisation rate adjustments between the rate applied to a headline rental value and the rate applied to an effective rental value" (Short Paper 18, page 11). For them, the subjective nature of this method rules it out immediately as a basis for providing objective and consistently generated estimates of effective rent suitable for performance measurers. Therefore, they do not consider it further. So, in Short Paper 18, RICS Method 4 becomes Method 3 for analytical purposes.

Method 3 in Short Paper 18 is an explicit DCF approach requiring both a target return rate and a rental growth rate as inputs to the calculation. Here the rent is grown at successive rent reviews to levels determined by the assumed rental growth rate. The present values of these successive tranches of rental income are then discounted appropriately to give the present value of the rents collected over the course of the write-off period. Method 3 then estimates the effective rents now and at successive reviews that would accord to the present values of those headline rents, if no incentives have been granted to the tenant.

Following a thorough and open review of the advantages and disadvantages of all of these various methods, Crosby and Devaney settled on what, for them, was the most practicable to apply to the very large numbers of leases to create an effective rent index, and which produced the least inaccurate and biased estimates of effective rents under a wide range of market circumstances.

They argue (Short Paper 18, pg 30) that Method 2 – a conventional discounting model using a 'compromise' write off period, half way between the first rent review and the end of the lease – was the approach that produced the smallest and least biased differences in results when compared with the methodologically superior but ultimately impractical DCF approach. They see Method 2 as simple enough to be applied to large numbers of leases and, as such, of use in the creation of robust effective rental value indices. It was also a readily understandable method of computation, its inputs are 'objective' in nature and it makes use of information already available within valuation software and performance measurement systems.

Appendix III
Method 2 and Indexed leases: Follow-up empirical work

The index linking of rents has virtually no implications at all for the adoption of Method 2. This is because Method 2 relies on a comparison of the value of the headline rent lease set against the value of the same property let on an effective rent lease (i.e. with no incentives). Irrespective of whether a rent is a headline or an effective rent, if it is index-linked the impact on each cash flow is identical as the initial difference between the two rents is maintained throughout the lease and the write off period is effectively the whole lease term. As index-linked uplifts are not true market rent reviews, they can be ignored for purposes of Method 2 with the lease being recorded as one without reviews and the write off period deemed to be the whole term of the lease.

EMPIRICAL REVIEW

Consider a 25-year index linked lease with a target rate of 8% and a growth rate of 2% and a capitalisation rate of 6%. Assume a three-year rent-free period and a headline rent of £100,000 with no fitting-out period.

The effective rent under the recommended Method 2 would be calculated as in Figure A3.1.

Figure A3.1: **Effective rent calculated under Method 2**

Headline rent			**£100,000**		
x YP	22 years	@ 6%	12.0416		
x PV £1	3 years	@ 6%	0.8396		
Capital value of headline rent				£1,011,013	
/ YP	25 years	@ 6%		12.7834	
Effective rent					**£79,088**

If we now look at the alternative cash flows generated from the two leases assuming inflation at 2% they are as show in Figure A3.2.

The headline rent has a present value of £1,004,772. The effective rent to generate the same PV is £79,278, virtually identical to the solution found by the method proposed for the construction of the effective rental value index. Equivalent yields imply growth in rents and target rates so the cap rate of 6% is representative of the indexing of the rent and the target rate of return. We have assumed the equivalent yield will be worked out from the current rental value and the current rent passing of the property, ignoring the fact that it is index linked. The expectations concerning growth in the cash flow is wrapped up in that choice, hence the objectivity of the approach has not been compromised.

Figure A3.2: **Alternative cash flows generated from a headline rent and an effective rent, assuming annual inflation at 2%**

Year	Headline rent £	PV @ TR @ 8%	Effective rent £	PV @ TR @ 8%
1	–	–	**79,278**	73,406
2	–	–	80,864	69,327
3	–	–	82,481	65,476
4	106,121	78,002	84,130	61,838
5	108,243	73,669	85,813	58,403
6	110,408	69,576	87,529	55,158
7	112,616	65,710	89,280	52,094
8	114,869	62,060	91,065	49,200
9	117,166	58,612	92,887	46,467
10	119,509	55,356	94,745	43,885
11	121,899	52,281	96,639	41,447
12	124,337	49,376	98,572	39,144
13	126,824	46,633	100,544	36,970
14	129,361	44,042	102,555	34,916
15	131,948	41,595	104,606	32,976
16	134,587	39,285	106,698	31,144
17	137,279	37,102	108,832	29,414
18	140,024	35,041	111,008	27,780
19	142,825	33,094	113,228	26,236
20	145,681	31,256	115,493	24,779
21	148,595	29,519	117,803	23,402
22	151,567	27,879	120,159	22,102
23	154,598	26,330	122,562	20,874
24	157,690	24,868	125,013	19,715
25	160,844	23,486	127,514	18,619
	PV	£1,004,772	PV	£1,004,772

Appendix IV
Equivalent yield analysis within IPD

There is potential for a further, very positive, outcome from implementing the vision of Short Paper 18; namely, to improve the consistency of the yield measure within the UK IPD. Over and above the fact that implementing Method 2 will supply reasonable estimates of effective rents for the vast majority of leases, it has the capability to support an improved IPD equivalent yield series based on these effective rents.

The current approach used by IPD to produce equivalent yields essentially assumes that the rental values provided by data contributors are effective rental values (even though the reality is that they are a mixture of headline and effective rental values). This approach is necessary because the formula used to compute an equivalent yield assumes that, when a rent review or lease expiry occurs, rent immediately adjusts to the rental value - whatever the basis of that rental value. The only exception to this is when the leasing unit is vacant and an assumed void period is added, but not a rent-free period. Because of this, we can see that the current IPD equivalent yield series has the same limitations as the IPD rental value series.

When Short Paper 18 is implemented, the basis of the market rent submitted by valuers to IPD will become clear. When they input a headline rent alongside the assumed incentives that underpin it, IPD will be able to use this to identify an equivalent yield, taking full account of the rent-free period or other incentive supporting that headline rent.

For example, if a property is sold for £1.5m and has a rent passing of £100,000, a lease expiry in three years and a headline rental value of £130,000, based on a one-year rent-free period within a 15-year lease, the equivalent yield is currently calculated by IPD as being 7.38% – as shown in Figure A4.1 below:

Figure A4.1: **IPD's current approach to identifying the equivalent yield**

Valuation including purchaser's costs = £1,500,000 x 1.0575 = £1,586,250

Term:					
Rent passing			£100,000		
x YP	3 years	@ 7.38%	2.6063		
Capital value					£260,634
Reversion:					
ERV			£130,000		
YP Perp		@ 7.38%	13.5556		
Reversion value				£1,762,231	
x PV £1	4 years*	@ 7.38%		0.7522	
Capital value					£1,325,616
VALUATION					£1,586,250
Less purchaser's costs					£1,500,000

** The deferment is four years to account for the one-year rent-free period in the year after the lease expiry.*

Equivalent yield = 7.38%

However, when Short Paper 18 is implemented, an equivalent yield could also be calculated directly off an effective rental value, even in cases where a headline rent has been supplied initially. First, using a 10-year write-off period, the effective rent is calculated from the headline rent by using Method 2 – as shown in Figure A4.2.

Figure A4.2: **Calculation of effective rent following implementation of the Short Paper 18 recommendations**

Headline rent			£130,000	
x YP	9 years	@ 7.38%	6.4112	
x PV £1	1 year	@ 7.38%	0.9313	
Capital value of headline rent				£776,175
/ YP	9.75 years	@ 7.38%	6.7824	
x PV £1	0.25 years	@ 7.38%	0.9824	
Effective rent (assuming a 3-month fit-out period)				**£116,494**
The equivalent yield calculation utilising this effective rent then becomes:				
Term:				
Rent passing			£100,000	
YP x	3 years	@ 7.05%	2.6219	
Capital value				£261,140
Reversion:				
ERV			£116,494	
x YP Perp		@ 7.05%	14.1831	
x PV £1	3.25 years*	@ 7.05%	0.8014	
Capital value				£1,325,111
VALUATION				£1,586,250
Less purchaser's costs				£1,500,000

** Most valuers would probably ignore the fit-out period in a capital valuation.*

Equivalent yield = 7.05% (Note – if fit out is ignored, the equivalent yield is 7.15%)

The above analysis shows that the equivalent yield is different, depending on whether it is derived from a headline or an effective rent. This arises because the unexpired term used in the capital valuation does not figure in the effective/headline rental value calculations while the assumed lease length underpinning the expected incentives does not figure in the capital valuation.

This raises two questions, namely how should Method 2 be applied and, second, which rental basis should be adopted for the IPD Equivalent yield series? We will look at both in turn.

First, which equivalent yield should be used in Method 2 to obtain the effective rental value from headline rental values and the headline rental value from effective rental values? We know that the circularity in this process cannot be circumnavigated. If valuers provide a headline rent then the first calculation will be to establish the equivalent yield that is then used to estimate effective rental value. If an effective rental value is supplied, a similar process would be applied. However, as indicated above, the equivalent yields in these cases will be different and this will, therefore, impact on the rental value calculated. Thankfully, given the offsets in Method 2 from the capitalisation and subsequent de-capitalisation of the cash flow, the variations in estimated rental values are small. The impact of cap rate on Method 2 was illustrated in Short Paper 18

However, a problem can be seen in the equivalent yields derived from headline rental values. This relates to the impact of incentives on the projected cash flow only being reflected at first reversion and not thereafter; the assumption being that further lease renewals are at the headline rent with no additional incentives at that time to secure that headline rent.

So, here, the headline rental value is being treated as an effective rental value at each subsequent lease renewal. This leads to estimates of equivalent yields becoming overstated if IPD's current formula is maintained. Using the effective rental value to calculate equivalent yields has no such limitations and, as such, should be used as the basis of the equivalent yield series going forward.

Notes

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