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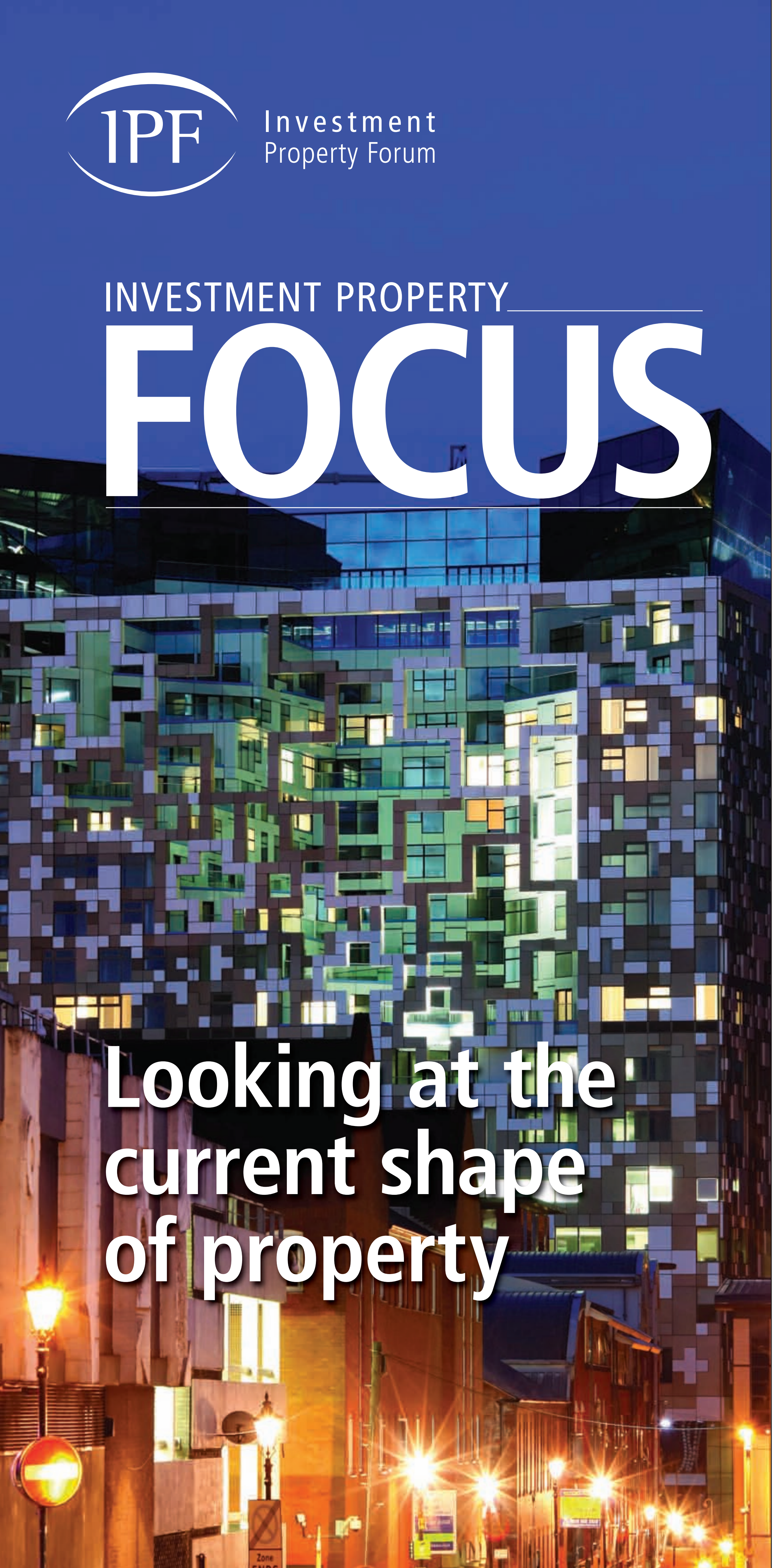
INVESTMENT PROPERTY FOCUS



Looking at the current shape of property

In this issue:

Designed by Ken Shuttleworth, The Cube provides a new landmark building for Birmingham. IPF Midlands members will be able to tour the multi-use building on 11 May.

The IPF Research Programme has developed as an important provider of high quality independent research focused specifically on property investment. We can only continue to fulfil this role due to the support of our 24 research sponsors. We are very grateful to this group of companies for their support of the programme.

From the editor

Sue Forster, Executive Director, IPF

As mentioned in the 'Forum activities and announcements', the IPF is undertaking a review of its Vision statement, an exercise last undertaken in 2005-06. Members are invited to express their views as to the big issues that currently affect, and in the next three years will affect, the property investment industry and what the IPF should be doing about them. From the responses received so far, two key issues have been identified: debt/finance; and regulation.

Taking up these two areas, this edition of Investment Property Focus includes a four-page table prepared by Nabarro, outlining the main legal and regulatory proposals affecting the UK property investment community. There are also articles on the lending intentions of leading banks and the current state of the UK CMBS market taken from Short Papers published by the IPF Research Programme. The first was commissioned by the 'Property Banking Forum' (PBF), a joint group formed by the Association of Property Bankers (APB) and the Investment Property Forum (IPF) with the purpose of undertaking research, and informing those involved in property finance and investment, about the issues affecting property finance. Alex Catalano, who undertook the research, outlines the key findings. The second article, written by Mark Nichol of Bank of America Merrill Lynch, highlights the amount of outstanding CMBS issuance and how the transaction features may change as the market re-emerges.

Alex Moss of Macquarie Capital (Europe) considers the role that the listed sector could play in providing the greater liquidity required if real estate is to form part of the default option for the defined contribution pension industry. In addition, exposure to the listed sector provides the ability to access geared sector exposure ahead of a recovery in values, and in a downturn the ability to acquire assets at below market value.

There has been a lot of media attention about pre-packs and CVAs. Patricia Godfrey and Nick Lloyd of Nabarro, Malcolm Frodsham of IPD and Lee Manning of Deloitte review the current regulatory position and explore the implications of these arrangements for commercial property landlords.

This edition of Focus also looks at cross-border investment between the UK and Asian property markets. Richard Barkham and Maurizio Grilli of Grosvenor suggest there are at least three persuasive arguments for UK investors to look eastwards, these being the size of the investible market, diversification, and the time-limited opportunity for substantially enhanced returns on the back of China's rapid growth. Paul Guest of Jones Lang LaSalle, Singapore then looks at non-domestic investment in the UK, of which Asians only accounted for 5.6% in 2010. He argues that this will change as Asian investors look set to be the dominant overseas force in the market this year.

Louise Ellison of Quintain Estates and Development provides an update on the evolution of green leases, including feedback from a recent workshop organised by the IPF Sustainability Interest Group. She concludes that a UK version of the green lease could be emerging but it looks unlikely to be a lease, more an agreement to collaborate in the form of a 'memorandum of understanding', which might be more productive (and cheaper!) all round.

With regard to the IPF's regular surveys, we include the Q1 2011 IPF UK Consensus Forecasts and the February 2011 Survey of IFAs. The former shows expectations for 2011 improving slightly against the previous quarter's returns but anticipated performance across all measures being much lower than for 2010. The IFAs are also expecting lower returns for the coming year but are optimistic about returns over the longer-term. Also included in this section is the European transaction data provided by Real Capital Analytics.

Lastly, may I draw your attention to the upcoming IPF Conference in Scotland on 3 June and the Annual Dinner on 22 June – I hope you are able to make one or both of these events.

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Lending intentions survey 2011

Alex Catalano

This article is taken from 'Property Banking Forum: Lending Intentions Survey 2011', a paper published in March under the IPF Research Programme Short Paper series.

In December 2010, the Association of Property Bankers (APB) and the Investment Property Forum (IPF) formed a group, known as the 'Property Banking Forum' (PBF), the purpose of which is to carry out and disseminate research and to inform those involved in property finance and investment about the issues affecting property finance.

As its first action, the PBF commissioned Alex Catalano to carry out a short research project, with the aim of gaining a better understanding of potential lender activity and intentions for the year ahead. A total of 27 lenders were canvassed: 24 banks and 3 insurers. Of these, 23 participated in the exercise. Three of these were interviewed but did not provide data for the questionnaire. In one further case, the respondent provided partial data, so the lending intentions figures included are an estimate.

Senior debt in 2011

Over the last three years, the number of banks lending to UK commercial real estate has contracted sharply. However, a hard core of both UK and international lenders remain committed to the market and they will be providing more finance for it this year – approximately £18.2-£20.8bn of senior debt. This is 30-50% more than last year, when the lenders surveyed originated £14bn of loans.

Over the last two years, banks have tackled the problems in their loan books and are now prepared to move on. Insurance companies, who have been minor players in the market to date, are scaling up their lending. However, there are two caveats. The first is impending regulatory change and the second is that there are the appropriate opportunities to lend in 2011. The majority of respondents said they would have lent more in 2010, but could not find the right deals. On prime investments, their clients were being outbid by equity players, many of whom were cash buyers: sovereign wealth funds, insurance companies and pension funds. In 2011, lenders are expecting increased demand for their debt. They think that there will be a bigger flow of commercial real estate to finance coming from UK and Irish banks and NAMA. Even so, most of those surveyed think it will be difficult to meet their lending targets. "The question is whether there are enough deals coming through where we see opportunities, and are they with borrowers that we want relationships with?" said one banker.

This highlights another feature of the market in 2011. Because they are husbanding their capital, banks are defining their commercial real estate lending tightly. They are quite specific about the size of loan, asset type and quality, and borrowers they wish to back.

Regulatory constraints: Basel III and Solvency II

The international rules governing the amount of capital that banks and insurance companies must hold to weather financial shocks are changing. This regime change is re-defining both the total amount of debt they will devote to real estate and the kind of real estate loans they are prepared to underwrite.

Basel III, which will apply to banks worldwide, is making it much more expensive for them to lend longer term and on riskier real estate. The new regulations are being introduced in 2012 and will eventually more than treble the amount of 'core' capital that banks must hold to protect themselves from losses: effectively increasing it from 2% to 7%. Banks will also be required to hold a minimum amount of highly liquid assets to ensure they could survive if financial markets seize up for 30 days. Although Basel III rules do not come into play fully until 2019, banks are preparing themselves.

Under Basel III, conservative, 'plain-vanilla' loans on prime investment property are not onerous in capital terms, but as soon as lending moves away from this safe haven into riskier territory, for example, higher loan-to-value, secondary properties, or development, the capital cost rises rapidly.

European insurance companies also face a radical regime change. Like the banks, they will have to hold more capital to cover themselves against a downturn in riskier, more volatile assets. Solvency II, which establishes these new, stronger capital requirements across the European Union, is due to go live on 1 January 2013. While there is still some uncertainty about these rules, it is clear that Solvency II has serious implications for the way insurers invest in real estate. It appears to favour conservatively-structured real estate debt over direct real estate or real estate equities.

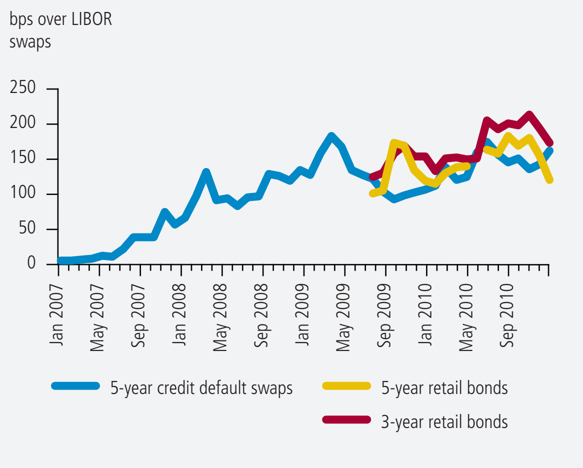
The sheer volume of regulation facing lenders is worrying them. There is a long list of changes: the 2010 Dodd-Frank Act in the United States, Solvency II, and Basel III. "The biggest risk to business right now is the implementation of this confluence of regulation from around the globe – whether you have conflicting or contradictory regulations or legislation coming out in different countries and the implications", said one banker.

One particular concern involves the differing disclosure, monitoring and reporting now required by different regulatory regimes on real estate loans. For example, borrowers will have to disclose more, and report much more frequently, on loans that are securitised, as compared to what a bank might require from them, assuming they are trusted clients with a good track record. "If regulators don't eliminate the information arbitrage between the balance sheet lender and the capital markets lender, why would anyone sign up for a loan to go into a capital markets transaction?" noted one respondent.

Funding sources and costs

Funding costs were frequently mentioned by bankers as a constraint on lending. Banks fund their lending from a variety of sources, depending on their mix of business: retail accounts and savings products, borrowing on the wholesale markets or from their central bank. Although base rates have remained low since the 2008 financial crisis, the cost of wholesale and retail funding has been volatile. It spiked again last year when the sovereign debt/Euro crisis re-ignited investors' fears about the fragility of the banking sector. Over the last quarter of 2010 banks found their access to wholesale funding had deteriorated and costs had increased sharply – see Figure 1.

Figure 1: 5-year funding costs

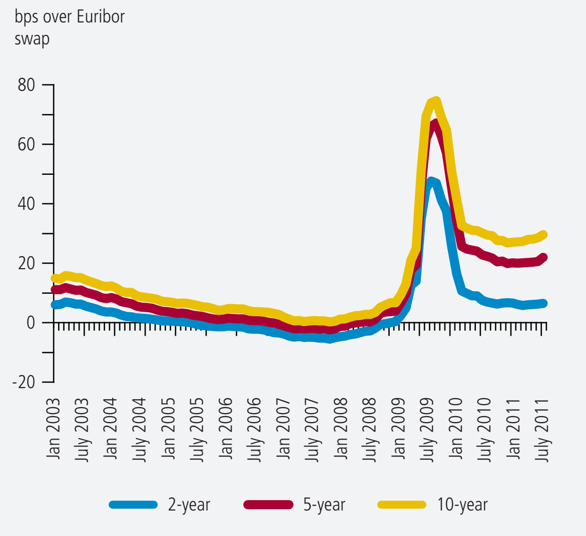


Source: Bank of England, Bloomberg

German banks, which have been prominent in lending on commercial property in the UK, have a special weapon in their funding armoury: mortgage Pfandbrief. These are government-regulated covered bonds, backed by pools of commercial (and residential) real estate loans, which banks can issue to raise funds. They provide a liquid and relatively cheap form of finance: the spread on a five-year mortgage Pfandbrief is 22bps over the Euribor swap rate. As Figure 2 shows, apart from a brief spike during the financial crisis of 2008–09, Pfandbrief spreads have remained relatively stable, albeit higher than pre-crisis.

However, Pfandbriefe have their limitations. In theory, loans of up to 60% of a property's value can be included in the collateral pool. But German regulations specify both the kind of properties that are eligible and, crucially, the method of valuation: 'mortgage lending value'. This is a 'sustainable value' that does not take into account the temporary 'economically induced' fluctuations of the relevant property market values and excludes 'speculative' elements. It is quite different from the RICS Red Book definition of open market value, which is normally used in the UK as the basis for lending.

Figure 2: Mortgage Pfandbrief funding costs



Source: Association of German Pfandbrief Banks

Therefore, although up to 60% of a property's market value can, in theory, be eligible for Pfandbrief, in practice it may be substantially less, sometimes only about 40%. Any lending over the 'Pfandbrief-able' amount has to be covered by other – typically more expensive – sources of funding. German Pfandbrief banks that do not have a retail deposit base typically raise about half their funds from the wholesale markets. Furthermore, it should be noted that Pfandbriefe remain on the banks' balance sheet, so they still count for Basel III purposes.

Refinancing vs new lending

The survey found that, in 2011, up to two-thirds of all the senior debt available would be used to finance entirely new transactions rather than refinancing existing loans (either from the lender's own loan book or other people's) on current market terms. This is about the same proportion as last year. This relatively high amount of intended 'new' activity may reflect respondents' expectations of a more active investment market in 2011. In addition, there are a number of lenders with quite small existing loan books who intend to grow them substantially this year by funding new deals.

Secured vs unsecured lending

Unsecured lending to commercial real estate borrowers is very unpopular. Only two respondents are lending on an unsecured basis in 2011. Indeed, for most of the German banks, secured lending is a keystone because, otherwise, the loans cannot be used for Pfandbrief funding. But even banks that have the capacity are shying away from unsecured corporate loans to real estate businesses – the capital costs are too high and the margins too low. However, they may make exceptions for strong relationship borrowers who can provide profitable business for other parts of the bank.

Loan size

With capital constrained, the size of senior loans is being squeezed at both ends. Since both the syndication and CMBS markets are effectively shut, banks find it difficult to underwrite large loans. Few can afford to keep loans of over £100m on their balance sheet.

For most lenders surveyed, the maximum they will provide for one transaction is £50m; a few will stretch to £100m, and one or two are prepared to underwrite much larger deals. Thus, loans over £100m require clubs. Since the financial crisis, both lenders and borrowers are reluctant to join large clubs, preferring bilateral loans or teaming up with two or three like-minded lenders who can be relied upon if problems arise.

Debt is also being rationed at the smaller end of the loan scale. For some lenders with larger, more granular loan books, the financial crisis has spotlighted the long tail of small real estate loans (under £10m) on their books. This small-scale lending adds up to a substantial sum. The operational costs are high and the losses, though small, can be more frequent. "Where we lose most money is at the bottom end of the book. There's a general drive towards a focus on larger loans and better quality clients that are more actively managed", commented one banker.

Borrowers

Relationship banking is back with a vengeance. Respondents are unanimous in targeting a tightly-defined group of clients. This sharpened focus is driven by the need to earn better returns on equity and boost profitability. Although the financial return on real estate debt compares well to what banks can earn on other types of loans, the 'relationship return' is quite thin, as it is often limited to the debt and associated hedging.

"The challenge is, do we want high-return debt but nothing else, or more stable income?" noted a lender. "We're looking in part for clients who will do repeat business rather than one stellar deal and then you don't see them for a couple of years."

Property preferences

Last year, 70% of respondents said they concentrated on what they called prime property, though in practice, prime is a flexible term. This year, most recognise that their opportunities to finance trophy assets will be few and far between. Now, 70% are prepared to devote 20% or more of their 2011 lending to value-added and good secondary real estate, where skilled asset management can enhance value.

And, unlike last year, financing development is not entirely ruled out. Five respondents are prepared to do so – in one case, to the extent of a quarter of their 2011 lending. However, pre-letting is a prerequisite and Central London offices the favoured ground.

Sectorally, most senior debt is firmly aimed at the mainstream: offices, retail, logistics/industrial, and to a more limited extent, hotels and residential. Hardly any of the lenders surveyed are prepared to move into niche sectors like leisure, student housing or nursing homes.

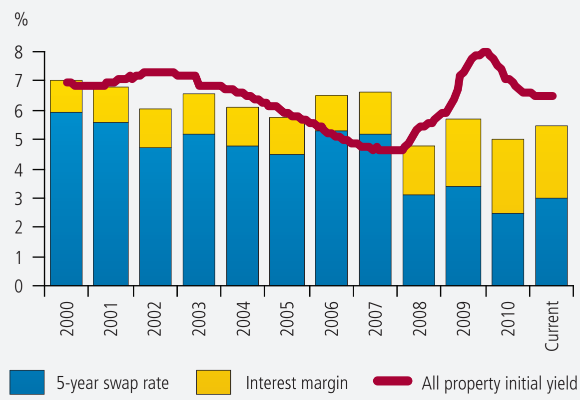
Geographically, lenders are focused on London and the South-East. Outside this area they are very selective and monitoring the local economies. They are worried about how the UK's austerity programme will affect consumer spending and occupational demand.

Lending margins

The margins for a straightforward five-year investment loan, assuming that the asset, borrower and income stream are all top quality and a 60% loan-to-value, currently range from 200bps to 250bps – see Figure 3. "There is a constraint on the capital available in the system. We'd be hard pressed to go below 225–250bps", said one banker. All things being equal, most respondents expect margins to remain at this level in 2011.

That said, pricing loans involves balancing a complicated set of criteria: the credit risk associated with the transaction, a rating (which takes into account the quality of the property, the leases and the borrower), the regulatory capital that the loan consumes, the lender's own cost of funds and the lender's required return on equity. Thus, debt for 'good' secondary will carry at least 50bps more; larger loans will also tend to be more expensive. "For deals over £150m the air is thinner," noted a banker.

Figure 3: Cost of 5-year bank debt vs yields



Source: Investment Property Databank, Eurohypo

Insurance companies tend to price their loans differently, charging fixed rates at a margin over gilts. The margin is currently 175-225 bps and likely to stay in that range this year. However, on shorter (five- to seven-year) loans some insurers mimic the banks' offer of LIBOR-based loans.

Fees

Arrangement fees are 100bps, with a few lenders charging 75bps. On more complicated transactions, such as developments or deals that require speed, they are higher. They are expected to stay at this level in 2011.

Pre-payment fees were mentioned by several respondents. Pre-payment is a particularly serious problem for insurers who are lending at fixed rates to match longer term liabilities. They charge a flat-rate break fee, to discourage borrowers from refinancing too quickly, plus the breakage cost, which is essentially the net present value of the difference between what the borrower would have paid for the remaining term of the loan and what the outstanding balance of the loan would earn if reinvested at current rates.

New initiatives

There are plenty of investors, like insurers, pension funds and sovereign wealth funds, that have money to put into real estate debt; banks have the relationships and teams to originate and service loans. Respondents cited several possible ways of tapping this new capital including:

- Banks sourcing new deals for insurers or other investors, while keeping a small portion of the loan, and earning fees for arranging and hedging the debt;
- Banks linking up with insurers to offer existing borrowers refinancing that includes an insurance product;
- Wrapping insurance around a rated bond backed by a portfolio of loans, giving investors additional first-loss protection; and
- In the longer term, developing a common platform that the banking industry can use to distribute real estate debt. Insurers and other debt investors would know they were getting a trustworthy, standardised product, as with Pfandbrief.

Conclusion

Although the number of lenders has shrunk dramatically since the financial crisis, those surveyed remain committed to the UK market. They are, by and large, comfortable with their loan books and prepared to take on more business. But they recognise that, alone, they will not be able to provide the liquidity required for the large volume of loans that will need refinancing in the coming years.

Respondents stressed that new sources of capital are essential, and these may lead to new arrangements between banks and new debt providers. And the securitisation market, which has been effectively closed to commercial real estate since 2008, needs to re-open, albeit in a simpler form.

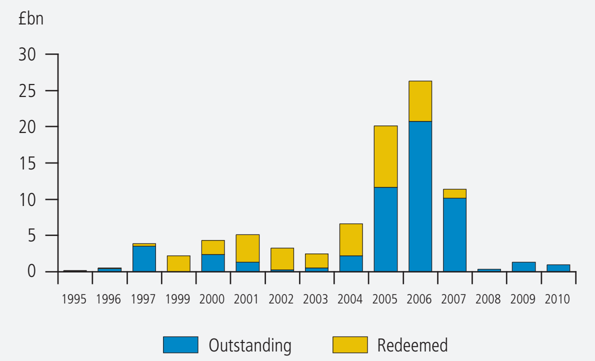
The current state of the UK CMBS market

Mark Nichol, Structured Finance Analyst at BofA Merrill Lynch Global Research, Bank of America Merrill Lynch

This article is taken from 'A review of the current state of the UK CMBS market', a paper published in February under the IPF Research programme Short Paper series.

CMBS has been around in the UK since the early 1990s and has always represented a small portion of total lending to commercial property. Outstanding CMBS represents about 18% (circa £56bn) of outstanding debt in the commercial property sector. In comparison, the market share of CMBS is roughly 45% in the US and 10% in continental Europe.

Figure 1: Public issuance of UK CMBS



Prior to 2004, much of the CMBS issued in the UK was created by listed property companies and other corporates, or used by the government to finance disposals of commercial property and municipal housing. For property companies, CMBS provided a means to borrow directly from the capital markets to finance investments more cheaply, for longer terms, or on a larger scale than banks or more traditional capital markets could provide.

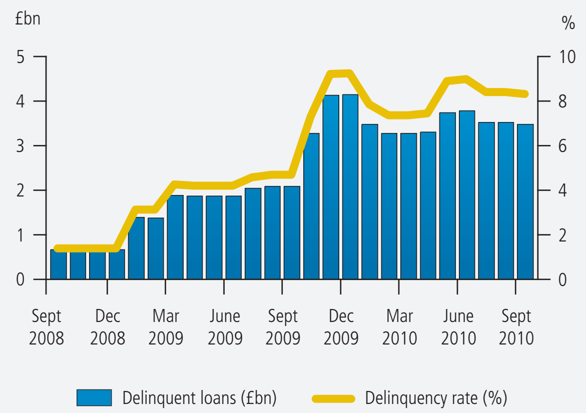
Since 2005, CMBS issuance increasingly came from investment banks' 'conduit' programmes, which advanced loans to property investors and sold the loans via CMBS. Conduit CMBS issuance brought a shift in the use of CMBS from providing long-term financing for governments and property companies to providing shorter-term funding for highly-geared investors such as property funds, private equity funds and high net worth individuals. It was attractive to borrowers because the interest rate was often lower than on conventional bank debt, owing to the prevailing high demand for CMBS from capital markets investors. Under this model, CMBS issuance boomed in the UK and Europe; 75% of outstanding CMBS bonds were issued from 2005 to 2007, almost all through conduits.

In 2007, problems with the US subprime market caused a banking liquidity crisis that largely shut securitisation markets in many countries, including the UK. Since H2 2007, most of the commercial property loans that banks securitised in the UK and Europe were not sold to investors but, rather, retained by the banks and used as collateral to obtain liquidity from the Bank of England and the European Central Bank.

Performance

In recent years, some commentators and regulators have branded securitisation products as being 'toxic' assets that contributed to the credit crisis. In this regard, it is important to differentiate between the US and Europe (including the UK). In the US, certain products, such as subprime residential mortgage bonds and collateralised debt obligations (CDOs) created from these bonds, have performed poorly through the credit crisis. The delinquency rate of US subprime loans is currently above 50%. In Europe, however, these same products were not created and the assets backing most securitised products, including CMBS, have performed reasonably well since the crisis. According to Standard & Poor's, the delinquency rate of CMBS loans in the UK is 6.7%. Interestingly, the default rate among bank loans backed by UK commercial property was 9.4% as at H1 2010 (De Montfort University's Commercial Property Lending report). This suggests that, in the UK, the commercial property loans that were securitised may be of higher quality on average than those that were not.

Figure 2: UK CMBS loan delinquencies



Most commonly, UK CMBS loans are hedged to pay fixed interest rates and pay little, if any, amortisation. As such, their debt service requirements do not vary significantly over time. Due to the relatively long lease terms and upward only nature of UK lease rent reviews, the rental income backing UK CMBS has proved resilient since 2007.

The strength of the income in UK CMBS reflects the generally good quality of the underlying properties. In aggregate, their quality is comparable to or slightly better than that of the properties comprising the IPD index. Over 90% of UK CMBS is backed by standard property types, office, retail, industrial and apartment blocks. The remainder includes nursing homes, hotels and leisure-related properties. Development loans do not feature in UK CMBS. By contrast, most of NAMA's €81bn portfolio comprises development loans with just 25% expected to be income producing.

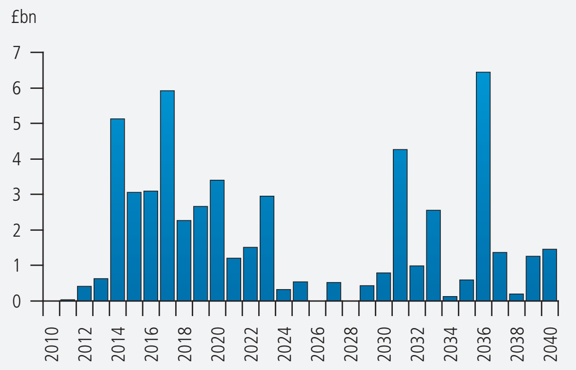
Property quality is not the main risk facing CMBS. Rather, it is the high degree of leverage used by borrowers and the lack of refinancing available. Among the loans that came due in the past 12 months, just 8% repaid in full at their maturity dates according to data compiled by Fitch Ratings.

The refinancing challenge

Since 2007, UK commercial property values have fallen sharply, causing loan-to-value ratios (LTVs) to rise, which makes refinancing CMBS loans more challenging. The LTVs of many of the loans originated in 2006 and 2007 are currently above 100%, meaning that many borrowers are in negative equity. As CMBS loans typically do not amortise significantly, in the absence of dramatic capital value appreciation, these high LTVs are likely to persist for some time.

Of the £56bn of UK CMBS bonds outstanding, £27bn is due to be repaid over the next 10 years. Preceding the peak in CMBS bond maturities in 2014, a total of £19bn is due to mature. However, focusing on loan maturities misses the point that there are implicit extensions built into the loans. As we have seen this year, loans can be extended without necessarily giving any compensation to bondholders. For this reason, without the ability for borrowers/loan servicers to renegotiate it, the maturity profile of the CMBS bonds is arguably more important than that of the loans.

Figure 3: Maturity schedule of outstanding UK CMBS bonds

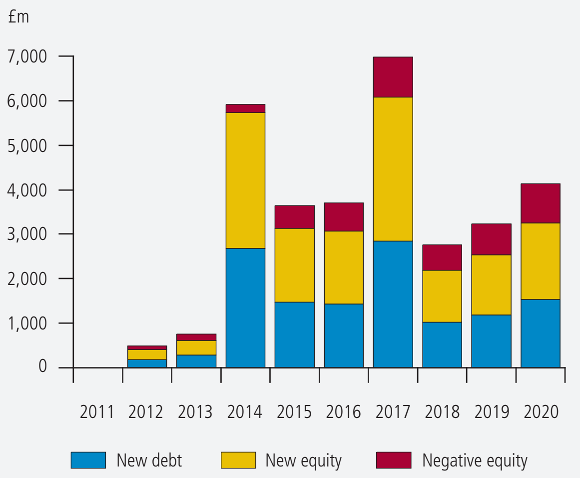


Many of the loans that originated near the peak of the market will fail to refinance when due and, as a result, we will see a combination of debt restructuring and liquidations of the underlying properties in order to repay bondholders. CMBS structures require repayment to bond holders by the bond maturity date – typically three or more years after the maturity dates of the underlying loans – and so restructurings must conform to this deadline. Extending the bond maturity date is a cumbersome process, requiring the consent of the majority of each class of bondholder. However, we are seeing an increasing number of such restructurings being successfully completed as discussed below.

Debt restructurings may postpone and reduce losses but will not avoid them altogether. Enforcement and forced selling of properties has already begun to occur and more liquidations, administrations and receiverships appear inevitable. We illustrate the scale and timing of potential property disposals and the scale of losses that could result in Figure 4. Based on current property values, we estimate there is £4.6bn of negative equity in UK CMBS properties. This amount of loss will need to be realised as bond maturity dates approach, unless it can be reduced or postponed via restructurings or rising property values. The £6.2bn of bonds that mature by 2014 could translate into forced selling of £6.8bn of UK property.

We would expect to see most of this property come to market in 2012, two years before the peak in bond maturities in 2014. As a result, disposals could put pressure on UK commercial property values from 2012 onwards.

Figure 4: Projected negative equity and re-capitalisation of UK CMBS property by year of bond maturity



Debt restructuring

As an alternative to enforcement and liquidation, we have begun to see borrowers and bondholders negotiate restructurings of CMBS debt. Typically, this includes an extension of the maturity date for the borrower in exchange for increased coupons and amortisation for the bondholders. In light of the relatively low yields available in the current environment, some bondholders have been willing to grant bond extensions of one to three years in exchange for a 50bps to 715bps increase in bond margin.

To date, CMBS bondholders have granted extensions to borrowers in two transactions in the UK, totalling £1.7bn, and one in Germany, totalling €1.2bn. The first UK transaction was The Mall Funding plc, a £1.1bn securitisation of 20 regional shopping centres managed by Capital & Regional. Bondholders agreed to extend the maturity date of the CMBS bonds by three years, from 2014 to 2017, in exchange for a 50bp increase in the interest rate paid on the bonds. The second UK CMBS to be extended was Titan Europe 2006-4FS plc, a £600m securitisation backed by 301 Four Seasons Healthcare homes. The bondholders agreed to extend the maturity date of the CMBS bonds by one year, from 2013 to 2014, in exchange for increased bond margins from 28bps to 375bps over Libor for the senior bonds and from 35bps to 750bps over Libor for the subordinated bonds.

Where Next?

As the next evolution of CMBS begins to emerge, we suspect some transaction features may not reappear for many years, if ever. For example, super senior Class X tranches and similar features that strip out excess cash at the issuer level have a negative influence on the credit strength of the bonds in our view. Instead, future structures could trap excess cash in a reserve fund to cover anticipated principal deficiencies. Junior debt that sits outside the securitisation has resulted in inter-creditor conflicts in some instances and is likely to be shunned by CMBS investors for some time.

Future transactions are also likely to restrict loan sponsors to cancelling any bonds bought in the secondary market, rather than being able to control voting rights. Finally, future issuance is likely to be single jurisdictional, which may offer greater certainty about the timing and success of enforcement than multi-jurisdictional structures.

Challenges to CMBS

Investor appetite for new UK CMBS may begin to return as the hunt for yield intensifies in a prolonged low rate environment. However, several obstacles could limit the potential for new issuance. Would-be borrowers are unlikely to choose to fund via CMBS if cheaper sources of funding, such as covered bonds, are an option. Access to Pfandbrief markets currently gives German banks a liquidity advantage over other would-be lenders, including UK banks and CMBS.

Regulatory changes could also create uncertainty for commercial property markets and CMBS. The European Commission's proposed derivatives legislation could force European commercial property companies and funds to collateralise their interest rate swaps on floating rate loans. If borrowers were forced to cash collateralise these swaps, the cost of borrowing on a floating rate basis would increase. Chatham Financial estimates that €64.9bn of working capital could be required across EU member states to comply with the legislation.

If the proposed legislation is passed, borrowers may prefer to use fixed rate loans or to hedge via out of the money caps. Fixed rate loans could be conducive for issuing fixed rate CMBS, as is the norm in the US. However, European borrowers have traditionally rejected fixed rate loans due to the prepayment penalties that are incurred if the property is sold and the loan prepaid.

In addition, European and UK regulators have created numerous new regulations targeted specifically at securitised debt products, including CMBS, with little regard for their cumulative effect. These new regulations, as well as changes to IFRS accounting standards, may raise the cost of securitisation and create uncertainty for investors and originators.

Outlook

While CMBS is unlikely to reappear in the same form and volume as we saw in 2007, having some form of securitisation product for commercial real estate debt would provide capital to the sector and help to close the property funding gap. Securitisation could also provide a means for banks to reduce their current holdings of property loans. There is a series of questions that needs to be considered as the market evolves, including:

- Will the capital markets re-engage with real estate as a supplier of debt (other than in the credit linked deals already seen in the market) and, if so, what sort of product will borrowers and lenders require?
- What implications do forthcoming regulatory changes such as Basel III and Solvency II have for the evolution of CMBS?
- Can products be created that differentiate between different levels of risk at the asset level while addressing conflicts between creditors?
- What lessons can be learned from markets outside the UK, including the US and Germany?

Defined contribution schemes and the listed sector

Alex Moss, Head of Macquarie Global Property Securities Analytics, Macquarie Capital (Europe) Limited

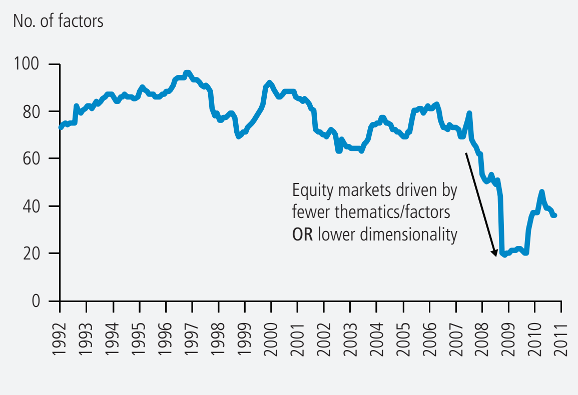
There has been much debate recently regarding defined contribution (DC) pension schemes and the manner in which real estate can form part of the default option. As a result there has been a dramatic increase in the demand for information and understanding of the characteristics of the listed sector. This article attempts to put the UK and global listed sector into context, using Macquarie's proprietary global database, and to increase the awareness of the benefits of using the listed sector in a real estate strategy.

Reasons for the interest in the listed sector

- Convergence of returns has led to a reassessment of risk factors across investment products

The convergence of (negative) returns across asset classes, between 2007 and 2009 has ended, and we are now seeing a sharper divergence of risk-adjusted returns between asset classes and the re-assessment of specific risk factors as global economic recovery continues. This can be illustrated by looking at the number of factors that drive global equity markets over time, i.e. market dimensionality. Figure 1 shows that from 1992 to 2007 there were between 60 and 100 factors that accounted for divergence of performance between sectors. In 2008-09, this shrunk to only 20, but has since doubled.

Figure 1: Market dimensionality – Number of thematics driving global equity markets



Source: Macquarie European Quantitative Research, October 2010

Put simply, when all asset classes are driven by a small number of factors then correlations increase and assumptions regarding historic correlations and diversification benefits are re-assessed. One of the assumptions most severely tested is the perceived lack of volatility in direct and unlisted real estate vehicles. As we have now seen in the downturn, the valuation methodologies used by these forms of real estate investment significantly underestimate true volatility.

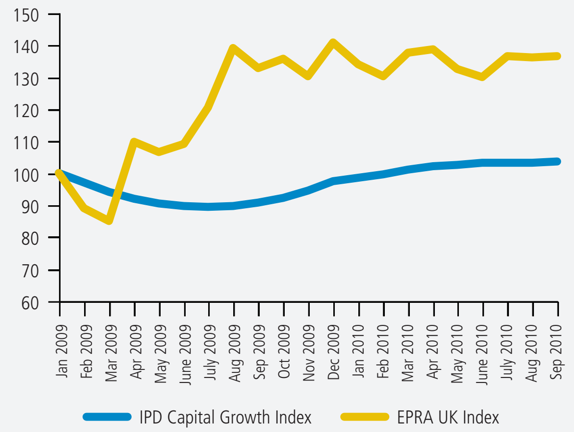
- Increased importance of liquidity in investment strategies/products

One of the key lessons of the last three years has been the importance of liquidity within all investment products. As a result, we are aware that a number of managers of unlisted funds have been examining the listed sector to see whether this could provide a level of liquidity that unlisted vehicles do not offer, particularly during periods of increased redemption requirements in their vehicles. The debacle in the German open ended fund market highlighted this issue and frustrated, and continues to frustrate, both retail and institutional investors. New legislation by the German government further exacerbates the issue.

- Timing advantages of the listed sector has become apparent

The speed of the recovery caught all market participants by surprise. The expected gap between redemptions slowing, cash becoming available for investment and forced sellers providing attractive opportunities for re-investment did not materialise. The listed sector, however, provided investors with a liquid and effective way to participate in the anticipated recovery ahead of the eventual yield compression, which was not available in unlisted vehicles.

Figure 2: IPD Capital Growth Index vs EPRA UK Index since January 2009



Source: Bloomberg, Macquarie Research, October 2010

The UK listed market – the investable universe

By number, the UK has one of the largest sectors globally, but because of the 45% decline in commercial real estate values from peak to trough, and the fact that after the initial flurry of rescue rights issues in 1Q 09 there has been little secondary issuance, its weighting in global portfolios has reduced over the last three years. Other regions have recapitalised to a greater extent, and seen continued interest in the listed sector. Figures 3 and 4 show all listed UK real estate stocks by style and structure.

Figure 3: UK listed market – by style

Sub-sector	Numbers of stocks	Total market cap £m	Average daily turnover £m	Volatility 30D	Dividend yield %
UK Major	5	18,184	11.00	18.62	4.50
Central London specialists	5	5,699	1.67	20.36	1.34
Alternative	11	2,762	0.43	23.76	2.76
UK Fund	13	2,874	0.22	25.40	5.37
Entrepreneur	9	2,407	0.50	26.34	0.87
Overseas	58	3,929	0.06	39.96	1.22
Residential	5	1,026	0.16	25.45	1.78
Agency	6	875	0.16	34.00	2.23
Retail specialist	7	724	0.11	18.51	2.31
Developers	7	691	0.20	39.50	0.36
Industrial	3	576	0.39	39.67	3.34
UK small cap	21	332	0.01	38.21	1.55
Total	**151**	**40,179**	**14.91**		

Source: Bloomberg, Macquarie Research, March 2011

Figure 4: UK listed market – by structure

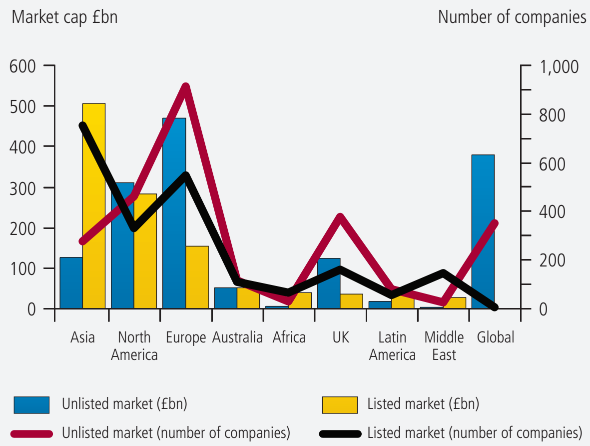
Sub-sector	Numbers of stocks	Total market cap £m	Average daily turnover £m	Volatility 30D	Dividend yield %
REIT	18	23,760	3.59	22.91	3.92
PropCo	105	12,679	0.16	33.15	1.25
Closed End Fund	28	3,740	0.13	38.23	3.20
Total	**151**	**40,179**	**0.58**	**32.85**	**1.93**

Source: Bloomberg, Macquarie Research, March 2011

- Comparison with the unlisted sector

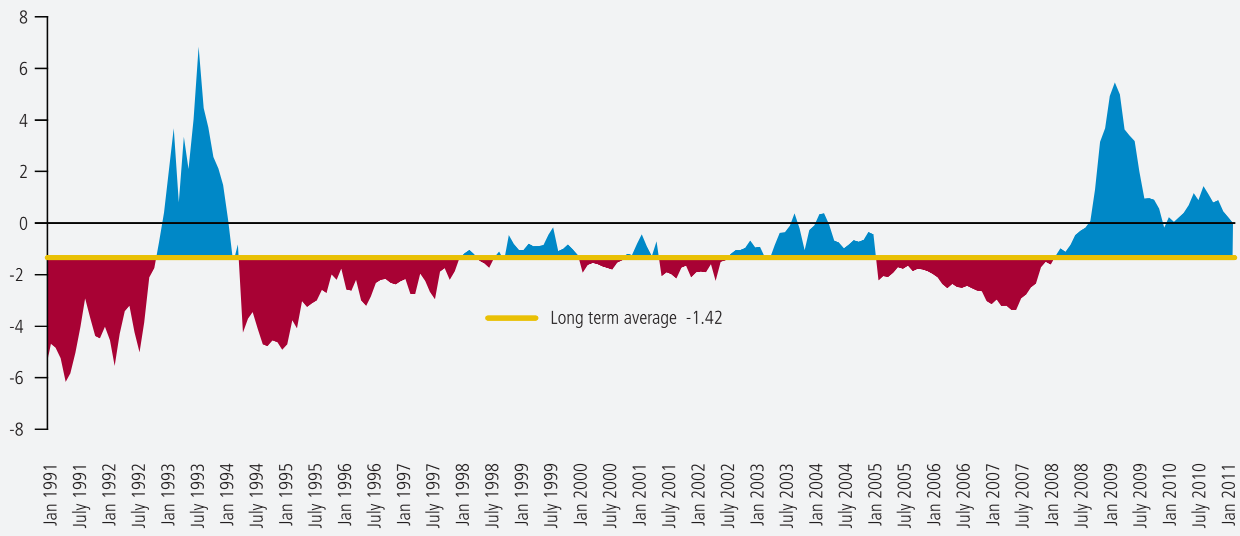
As can be seen in Figure 5 opposite, the major differences in the investment opportunity set of the listed sector and the unlisted sector are the relative importance of listed in Asia, unlisted in Europe, and the number of dedicated global unlisted funds. It should be noted that, in this simplistic representation, the scale of the listed universe is under-represented as we have taken market capitalisation for listed, compared to gross asset value for the unlisted sector.

Figure 5: Listed vs unlisted companies in leading locations



Source: Property Funds Research, Bloomberg, Macquarie Research, October 2010

Figure 6: Long-term dividend yields vs 10-yr bond yields



Source: Bloomberg, Macquarie Research, March 2011

Relative valuations

It is worth remembering two points regarding UK property securities valuations. Firstly, prior to 2007 listed property companies had contingent capital gains liabilities which were not netted off their stated NAV figures. These arose because of the longevity of asset / portfolio ownership and the sharp rise in values from 2004. This tax liability would be crystallised if the entire portfolio were to be sold. On average (and obviously it varied according to the period of ownership of the portfolio and the stage of the cycle) it equated to around 15-20% of the NAV, which was reflected in the average discount to NAV of 17.9% between 1989 and 2007.

Post REIT conversion, these liabilities have been extinguished via payment of a conversion charge. Therefore, ceteris paribus, the sector can be expected to trade 15-20% higher, i.e. close to parity at a time of stable or modest capital growth. Analysing the NAVs for the sub-sector categorisations outlined in Figure 3 shows that the highest growth areas (Central London specialists) are trading at a premium to their last stated NAV, the leaders are broadly at par, and the illiquid, small caps are trading at a decent discount.

It can therefore be seen that there is no issue with REITs trading at a premium to NAV, assuming that the implied capital growth rather than material decline in the underlying portfolio is likely, and that the management team warrants a premium to the collective valuation of the assets. It should also be noted that if the shares are not trading at close to NAV, the secondary issuance vital for the sector to grow will not occur as equity issues will by definition be dilutive.

On a global basis it should be noted that UK REITs are trading at a significantly lower dividend yield than Europe, Australia, Canada, Hong Kong, Japan, Singapore, and less surprisingly, South Africa. In terms of NAV, the UK is trading at close to par, with the US REITs at a significant premium and Singapore REITs at a significant discount.

The second valuation measure most commonly used is dividend yield relative to bond yield. Again, for historical accuracy, it should be noted that prior to REIT conversion, most 'PropCos' were relatively low yielding, choosing to keep retained profits to fund acquisitions and developments rather than distribute to shareholders. Now that there is a minimum required payout ratio the yield comparison is far more meaningful. As shown in Figure 6, on average UK REITs are now trading at close to parity with 10-year bond yields. This decline in relative dividend yields is justified, given that dividend growth is set to return in 2011-12, but we expect UK bond yields to rise to a more normalised 4-4.5% compared to their current 3.7%. To justify a discount, UK REITs need to demonstrate their ability to generate revenue cashflow, and thus dividend growth.

Direct property and the listed sector

- Correlation

Research carried out by EPRA/Cohen & Steers highlights the lead/lag, relationship between the direct and the listed market. While listed remains a proxy for direct real estate investment over the medium to long term, the listed market offers a directional indication of underlying real estate values.

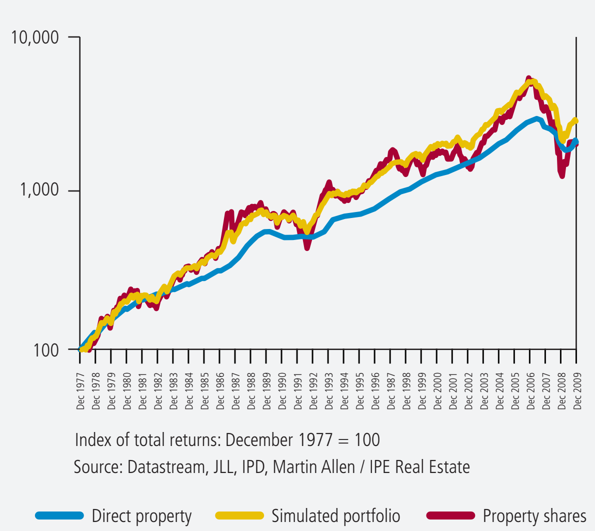
The conclusions of the research were:

- Listed property companies tend to lead the returns of direct real estate by approximately six months. Interestingly, the lag has decreased to around three months for the US and UK market since 2007;
- While the listed performance is directionally accurate, the returns tend to overstate the eventual reported direct market moves;
- The propensity of listed markets to lead the direct markets may be related to the inefficient transfer of information in direct markets;
- The stronger the factors that delay information transfer in direct markets, the longer the gap between the markets' return series.

Blending direct and listed – relative returns
(co-author Fraser Hughes, EPRA)

At its simplest, listed exposure can be added to enhance liquidity of a product to meet investor requirements, or a trading strategy can be developed to arbitrage between the two markets. On a straightforward rolling 10-year basis between 2000 and 2010, the FTSE EPRA/NAREIT UK Price Index outperformed the IPD UK Capital Index for nearly 75% of the duration. On the other hand, IPD UK total return outperforms the FTSE EPRA/NAREIT UK total return for 90% of the time. The listed sector trades within the boundaries of the direct benchmark.

Figure 7: Total returns from blended portfolio



Source: IPD, EPRA, March 2011

The next step is to examine how a simple rules-based strategy can arbitrage between direct and listed. At a strategic level, we use a simple portfolio, comprising 50% direct property and 50% listed property, as starting point. A series of thresholds is calculated around the long term average discount to NAV (-18%) over the entire period. This can of course be recalibrated throughout the course of the strategy. An upper and lower threshold is set at two thirds of one standard deviation – approximately 9%, either side of the long term average discount. The weighting to listed property is adjusted 150bps for each month that listed property trades below (or above) the thresholds. For example, if the discount to NAV trades at 20% for a cumulative five-months period, 7.5% extra is allocated to the listed allocation. Once discounts to NAV trade within the upper and lower band, weights revert to 50/50.

By combining the direct and listed market over the period and employing the trading strategy, it is possible to outperform both the direct and listed markets by some margin – see Figure 7. This approach generates an average annual return premium of over 100bps over that on direct property over the 32-year period between 1977 and 2009. As might be expected, the volatility of the returns generated by the simulated portfolio sits between that on direct property and that on listed property. Yunus, Hansz & Kennedy (2010) analysed the long-run relationships and short-run linkages between the private and listed real estate markets of Australia, Netherlands, UK and the US. Results indicate the existence of long-run relationships between the public and private real estate markets of each of the countries under consideration.

Summary

We are now seeing the first products developed that seek to combine underlying real estate exposure with the investor requirement for liquidity. Given the importance of liquidity in DC schemes, and their expected growth, attention is firmly focused on providing a (more) liquid real estate solution for this market. The listed sector will play an important role in providing this liquidity. In addition, exposure to the listed sector provides the ability to access geared sector exposure ahead of a recovery in values, and in a downturn the ability to acquire assets at below market value;

Overall, we believe that, if used properly, there will be an improvement in risk-adjusted returns and liquidity by adding listed exposure to direct or unlisted exposure.

UK money into Asia

Investors typically justify allocations to international real estate on the basis of potential for higher returns or reduced risk through diversification. In addition, they also claim that they can access a larger pool of product. For UK investors, who have plenty of opportunities available in their home market, the decision to invest overseas is more discretionary than it is for some of their foreign counterparts, particularly those investors whose domestic markets are too small to accommodate their desired real estate exposure (e.g. the Netherlands, Australia). However, changes in market conditions over the past decade suggest that the opportunity costs associated with not investing internationally, and especially in Asia, may be higher than in the past.

Overall, at least three persuasive arguments exist – the size of the investible[1] market, diversification and time limited opportunity for substantially enhanced returns on the back of China's rapid growth – that suggest UK investors should invest into Asian real estate.

The most compelling reason for investing in Asia is related to the sheer size and diversity of the Asian commercial property universe. Although the UK has a large and diverse property market, it still represents a marginal share of the global investable property universe. As the potential market size for Asia is roughly eight times larger than the UK (and is growing at a faster rate), the set of opportunities available to UK investors is significantly larger and more diverse than that available in the domestic market (Figure 1).

Figure 1: GDP and real estate markets in comparison

	UK $bn	Asia $bn
GDP	2,248	16,812
Total market	1,328	10,090

Second, investors usually say that the most important reason for investing internationally is risk reduction through diversification. Looking in more detail at the correlation between returns in the West End and other market's returns individual countries (as shown in Figure 2), it appears that UK investors would be better off by investing in Asian real estate, due to much lower long-run correlations.

Figure 2: Average correlation between West End offices and other markets' returns

Paris	Sydney	Los Angeles	Shanghai	Hong Kong
0.76	0.53	0.39	0.30	0.14

Finally, another argument for investing internationally is the hugely expanded range of opportunities available beyond the domestic market, potentially offering higher returns. GDP in most Asian countries is expected to grow very strongly over the next 10 years, while growth in the UK is anticipated to be much more subdued. Economic growth provides additional demand for property of all sectors, expanding the stock of institutional-type property and generating opportunities via new development and repositioning of existing stock. Most recently, China has confounded the skeptics by easily shrugging off the impact of the great financial crisis. If China grows at 8% per annum over the next 10 years with 4% inflation: total growth in nominal GDP will be 210%. Even with substantial new supply coming on line growth of this magnitude will surely fuel a strong uplift in real estate capital values.

Richard Barkham
Group Research Director, Grosvenor

Maurizio Grilli
Global Group Senior Researcher, Grosvenor

The reality

UK capital invested in Asia has been much less than Asian capital into the UK. Jones Lang LaSalle reports that, in 2010, just US$444m of direct real estate transactions were invested by UK capital sources in Asia, although this was a considerable increase on the level of transactions in 2009. As the headquarters' location of several major real estate investment companies and with a tradition of cross-border investment, it is likely that UK investors are putting more money into Asian real estate through indirect routes, rather than direct acquisitions. The previous figure for 2010 investment could be probably doubled.

However, according to Jones Lang LaSalle, in 2010 only 1.4% of all capital sourced in the UK was invested in Asian real estate, while almost 90% was invested domestically. At the same time, Asian sources contributed more than 80% to total investment in the region. UK money accounted for a tiny part at 0.5% of total Asian real estate investment[2]. Globally sourced capital made up more than 6% of overall investment into Asia[3]. These figures suggest that, despite the enthusiasm about Asian prospects conveyed by the property media and in investment circles, not much is happening in terms of actual investment.

Real estate investors are historically conservative and, currently, many of them do not perceive that risk-adjusted returns in Asia are high enough to justify investment in those markets. Moreover, with the exceptions of a few large investors, most players will have to invest indirectly via unlisted funds, due to the difficulty of placing capital directly.

The economic case for Asia is highly compelling and we believe Asian real estate returns will provide returns that are higher than can be achieved in developed countries, at least for the next ten years. On the other hand, significant information costs still exist when investing in real estate in Asian countries. Legal systems, leasing terms and market practices differ widely. Moreover, language barriers and local customs need to be taken into

1 Defined as a proportion of real estate stock which is owned by professional investors or accessible to them.

2 US money accounted for 0.6% of total Asian real estate investment, not much higher than the UK. However, in 2010 US investors were mostly focusing on the home market.

3 Although this group includes many different nationalities (undoubtedly the UK will feature), the grouping remains reflective of an investment source of capital which is established and accepted in the market as 'global' and should therefore not be attributed back to a specific source of capital.

consideration as taxes and currency risks. Understanding the subtle dynamics of local markets, which means having a local presence, is the key to out-performance in Asia. Pricing in some Asia locations is already prohibitive but a successful strategy can still be implemented by operators who know the market and can source attractive stock, These operators will find it easier to implement a strategy that covers the whole spectrum of investment, from core to opportunistic.

We have also tried to understand the scale and scope of UK investors into Asian real estate by using data compiled by Portfolio Fund Research (PFR). The data highlights that the UK presence in Asia is still in its infancy. From the database we were only able to extract few names, such as the Church Commissioners for England, the Universities Superannuation Scheme, Prudential, the Durham County Council Superannuation Fund, the Merseyside Pension Fund and the Clwyd Pension Fund. It is fair to assume that there are more investors than what we have identified, but we believe not many. There are more fund managers based in the UK who are currently investing in Asia. Most of these investors are international in nature. The largest players include ING, MGPA, LaSalle and Aetos.

The future

As a result of economic growth, the demand for, and supply of, Asian real estate space will increase significantly over the next 10 years. Asia has a variety of markets, each providing different levels of prospect, transparency and liquidity. Depending on the investor's risk preferences, the region offers an almost untapped investment destination, from traditional core markets, such as Japan, through to emerging and higher risk markets, such as India and China.

We believe investors will increasingly turn their interest to China, on the back of its stellar economic performance. However, we suspect that other strong economies such as South Korea or even Vietnam will attract interest. Some Asian markets have outperformed markets in developed regions over the recent years and are expected to outperform in the future as well.

For the UK investor, Asia combines all the characteristics required for foreign diversification. The route of indirect investment via unlisted funds (or listed companies) seems more feasible, due to the difficulties of investing into Asian direct property. As already explained, the key to out-performance is building up a local presence (a strategy that Grosvenor amongst others has pursued over the long term). However, for the time being UK money into Asia is more of a trickle than a flood.

On the menu: Real estate capital flows between the UK and Asia

Paul Guest, Global Capital Markets Research Director, Jones Lang LaSalle, Singapore

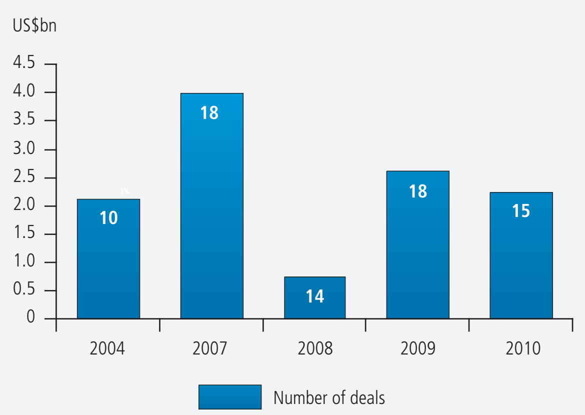
Beef Wellington, bangers and mash, Central London real estate... prime commercial assets in London are most definitely on the menu for foreign investors. Headline-grabbing transactions such as Bishop's Square; the HSBC tower in Canary Wharf; the foreign acquisition of a stake in Regent Street and many more all involved cross-border purchasers. In 2010, the data shows that Central London, at about £10bn, was the world's largest investment market by turnover. And over 60% of assets were acquired by foreign money. So, not only on the menu, but one of the specials...

How much of that capital came from some of the world's most dynamic economies in Asia? How does that compare with the years prior to and during the boom of 2006-07? And what about capital going the other way, namely British money investing in Asian property? Looking at the longer term trends driving this capital and digging into Jones Lang LaSalle's Global Capital Flows database suggest that the appeal of UK assets to Asian capital will be undiminished over the coming year.

Asian capital coming to the UK

Judging by the headlines, both institutional and private Asian capital has been strongly targeting UK commercial property – see Figure 1. In 2009, the China Investment Corporation committed £400m to Songbird (the vehicle that owns Canary Wharf), while South Korea's National Pension Service (NPS) acquired three office assets, including the HSBC Tower for £772m. The range of buyers increased in 2010 and in terms of direct real estate, Asian purchasers accounted for a total of US$2.2bn of capital inflows to the UK.

Figure 1: Asian capital investing in the UK

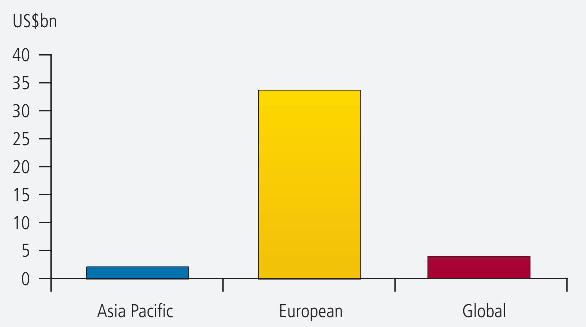


Source: Jones Lang LaSalle

In fact, this is a decrease from the US$2.6bn committed in 2009 or the US$4bn in 2007 at the height of the boom. This last figure, however, is distorted by three large transactions which together account for half the total. Meanwhile, the total in 2009 included the aforementioned HSBC Tower, while in 2010 there was a wider range of shoppers targeting a broader array of assets. The average lot size last year was US$148m, with hotels, offices and retail assets all changing hands.

Last year, however, Asians only accounted for 5.6% of the total value of all cross-border purchases in the UK. At 84% of the total, non-UK Europeans clearly predominated, as shown in Figure 2. In addition, Jones Lang LaSalle's data includes capital from global co-mingled funds, whose exact origin is impossible to determine without a confidentiality-busting account by account tabulation. While some of this capital would no doubt originate in Asia, domestically-geared savings cultures and capital controls in China together suggest a relatively small share of this 'global' pool would be Asian.

Figure 2: Origin of cross-border purchasers in the UK



Source: Jones Lang LaSalle

These Asian purchasers are predominantly private and institutional, with the latter largely rapidly expanding pension funds. They come from across the region, with Malaysia, South Korea, India, Singapore, and Greater China all represented last year. The first two of these figured in the global Top 10 cross-border investors of 2010 at 8th and 5th, respectively, while the 2009 league table included South Korea (5th), Australia (6th) and China (8th).

What impact has this investment had in the UK? Has it affected values or the IPD index? In the past, Asian capital has primarily targeted flagship assets. Today, prime, well-let, core buildings are the item of choice for nearly everyone and there is little indication that Asian buyers are paying above the odds for assets when compared to their European or global counterparts. There is also little or no indication that these overseas purchasers, or very many foreign buyers for that matter, have any interest in secondary or tertiary assets or in properties outside of Central London. Only one of last year's purchases by an Asian investor was outside the capital.

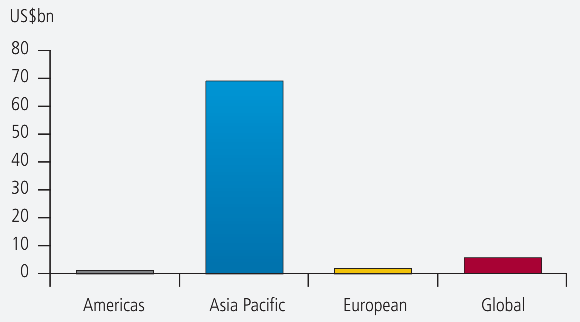
British capital in Asia

In contrast, British capital en route to Asia has been more modest. In 2010, just US$443.6m of direct real estate transactions were realised, although this was a considerable increase on the lack of transactions the previous year. In fact, between 2009 and 2010, only in 2008 did UK direct real estate investment in Asia exceed the flow in the opposite direction.

There are two provisos to making any comparisons: firstly, we are unjustly comparing the flows of a region (Asia) into a single country (the UK), versus that country's investment into the entire region. In fact, the UK's average total over the past few years is not far shy of that of South Korea, Malaysia or Greater China.

Secondly, we need to make allowances for Britain's likely share in that pool of global capital we mentioned above. As the home of several major real estate investment houses and with a tradition of overseas investment both portfolio and direct, the UK is far more likely to account for a measurable share of that pie. Using the UK's portion of global portfolio outflows as measured in IMF balance of payment data offers an imperfect but illustrative proxy. This would allocate 10% of 'global' capital to the UK or potentially an additional circa US$500m to the UK's purchases in Asia in 2010. This is impossible to verify one way or the other, but nonetheless hints that Britons are putting more money into Asian real estate through global funds, rather than direct purchases.

Figure 3: Origin of cross-border purchasers in Asia



Source: Jones Lang LaSalle

What does the future hold?

If the early months of 2011 are any indication, an abundance of Asian investors – private, institutional and unlisted – are currently looking at assets in London. Against a backdrop of tightened prime supply and rising rents; selective bank lending; low interest rates but rising inflation; and the relative weakness of sterling, the demand will increase. This year, Asian capital will be the dominant overseas force in the Central London investment market. Furthermore, with intense competition for the most desirable assets, appetites are changing and there is a desire to explore development, short income, and riskier cashflows as well as long income transactions. All signs point to widespread activity.

And there is good reason for this to continue. Jones Lang LaSalle recently published a paper looking at the economic and financial underpinnings of investment in foreign direct real estate. In the paper, we compared the volume of cross-border direct property investment of a country to its gross domestic savings and to its portfolio investment outflows. The former is a measure of what could be invested, while the latter measures actual investment capital leaving the country. Admittedly, foreign investment in real estate falls under direct investment in the balance of payments. However, we are assessing investor preference. Potential real estate capital (at the institutional or high net worth individual level) generally does not gauge its investment against a steel mill or greenfield site (direct investment) but as an alternative asset to bonds or equities (portfolio investment).

Together these two ratios give an impression of a country's allocation to foreign direct real estate. Relative to global averages and to the potential of their own economies, China, South Korea, Japan and Australia are all currently relatively underweight in foreign direct real estate.

This is all theoretical, but from a very practical perspective, Asia's pension funds are also relatively uncommitted to direct real estate. This is a fact that several are actively trying to change and this has translated into action by the likes of NPS (mentioned above) and the Employees Provident Fund of Malaysia. Furthermore, demographics are in their favour and with inflation on the rise, the appeal of property will only grow.

In short, Asian real estate capital will continue to favour the UK, but it is likely that supply shortages will push sectoral and geographical boundaries, albeit slowly. In this restaurant, at least, the specials on the menu will not be changing for some time.

Real Estate industry issues – legal and regulatory challenges

This table was prepared by Amanda Howard and Christine Ormond of Nabarro to provide an overview of some of the main legal and regulatory proposals affecting the UK property investment community. It includes details of timings and how the various issues impact the real estate and real estate funds industry. The table is divided into legal developments – UK/general, regulatory, banking and competition. The issues are in no particular order.

Amanda Howard,
Patner,
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Christine Ormond,
Knowledge Lawyer,
Nabarro

LEGAL DEVELOPMENTS – UK/GENERAL

Carbon Reduction Commitment Energy Efficiency Scheme (CRC)

CRC imposes cost liability associated with consumption of energy. Phase 1 applies to all organisations that consumed more than 6,000 MWh of electricity through half hourly meters in 2008. In the October 2010 Comprehensive Spending Review CRC effectively became an energy tax. Potential for trading has been squeezed out and needs to be re introduced. There have subsequently been consultations launched in an attempt to simplify CRC.

Timing

Registration for Phase 1 closed on 30 September 2010. Current round of consultation closed on 11 March 2011. Draft regulations to implement allowance sales are expected to be published later this year.

Comments

The impacts on the real estate industry include a landlord's ability (and desire) to seek to pass down their CRC costs to their tenants. As CRC is now arguably a tax, some landlords may find it easier to pass on the cost of allowances to occupiers. However, occupiers may seek to reduce their rental expense to allow for additional non-rent property expenses (i.e. CRC costs).

CRC's application to holding and investment structures and energy purchase arrangements is complex and needs to be examined on a case by-case basis, applying the contractual and factual background. An example of a problematic area is where a trustee of a unit trust holds legal title to a property and buys its energy supplies. In this scenario, CRC responsibility falls to that trustee, whether or not the property is held on trust for a single beneficiary or for several different beneficiaries. This can result in 'cross-contamination' of CRC performance and costs across unrelated trusts. As a result, some professional trustees are considering re-structuring – not to escape the CRC – but to enable proper ring fencing of trusts.

Government response to consultation will determine the future shape of CRC. Overall CRC is expected to generate up to £1bn of extra annual revenue for the Exchequer.

Bribery Act 2010

The Bribery Act 2010 brings with it one of the most stringent anti corruption regimes in the world and significant reputational and financial risks to all businesses and organisations operating in the UK.

Timing

The Act will come into force on 1 July 2011.

Comments

Anti-corruption will become industry standard. Joint venture partners and investors will be seeking reassurance about their joint venturers' and fund managers' anti-corruption policies and procedures.

Businesses and organisations operating in the UK are concerned that the Act will mean that their operations will become overly restrictive compared with other equivalent regimes (including, for instance, the US).

On 30 March 2011 the Ministry of Justice published its guidance on the procedures businesses can put in place to protect themselves against liability for bribery by those associated with them. Having these procedures will be a defence to the new criminal offence created by the Act, namely of failing to prevent bribery by those associated with the organisation.

Lease accounting rules (IASB Exposure Draft regarding IFRS Leases)

Proposed changes to accounting standards represent a radical shake up of accounting for leases. Under the proposed new measures all lease obligations will be capitalised on the balance sheet. There is a proposed exemption for landlords who use fair value accounting.

Apart from implementation costs, the new standards will result in an asset and a liability being recognised in the financial statements, which will continue over the lifetime of the lease. This is likely to have an adverse effect on a company's gearing and financial covenants.

Timing

Expected to apply from 2013.

Comments

The proposals will eliminate the distinction for accounting purposes between finance leases and operating leases. Operating leases do not currently appear on a company's balance sheet. The changes will impact on financial and commercial decisions – including a greater incentive for lessees to seek shorter leases. It may mean it is more desirable to own rather than lease a property. The pressure for shorter lease terms will also impact on lenders. The proposals are likely to affect landlords who do not or cannot use fair value accounting. The impact on tenant balance sheets will influence how they wish to occupy premises.

Localism Bill 2010-11

The Localism Bill is about a fundamental shift of power from Westminster to people. Seeking to promote decentralisation and democratic engagement; and giving new powers to local councils, communities, neighbourhoods and individuals.

The guide to the Bill sets out six actions central government will need to take to do things differently, in behaviour, expectation and culture, which must go alongside the changes of law proposed in the Bill. These are:

(i) lift the burden of bureaucracy; (ii) empower local communities to do things their way; (iii) increase local control of public finances; (iv) diversify the supply of public services; (v) open up government to public scrutiny; and (vi) strengthen accountability to local people.

Timing

The Bill received its first reading in the House of Commons on 13 December 2010. It is expected to receive Royal Assent in late 2011.

Comments

The Bill devolves a huge range of new powers and freedoms, overhauls the planning system and gives communities greater control over local housing developments.

The localism agenda is intended to spark a profound shift in the way England is governed in favour of local communities. The Bill currently raises a number of questions which need addressing when detailed guidance is released.

Community Infrastructure Levy (CIL)

The Planning Act 2008 introduced the CIL as a new charge that local planning authorities can levy on developments to contribute towards the cost of local and sub-regional infrastructure.

Timing

CIL Regulations came into effect on 6 April 2010. Local authorities are likely to take between six and 15 months to adopt. Charges are expected to be applied in London from Spring 2012.

Comments

Outline permissions granted before the introduction of a charging regime will become liable to CIL if reserved matters approval is secured after the introduction of a charging regime.

UK Stewardship Code and effect on institutional investors

The UK Stewardship Code is a code, to be applied on a 'comply or explain' basis, setting out good practice for institutional investors when engaging with UK-listed companies.

The UK Stewardship Code is addressed in the first instance to firms who manage assets on behalf of institutional shareholders (for example, pension funds, insurance companies, investment trusts and other collective investment vehicles) and their investments in UK-listed companies.

Timing

The Code was published on 2 July 2010. The Financial Reporting Council (FRC) will undertake annual monitoring of the take-up and application of the Code, which will begin in the second half of 2011.

Comments

The FRC strongly encourages all institutional investors to report on their websites how they have complied with the UK Stewardship Code. The FRC lists on its website those investors who have published a statement of their compliance with the UK Stewardship Code.

From 6 December 2010, the FSA introduced a requirement for UK authorised asset managers to disclose whether or not they comply with the UK Stewardship Code.

Limited Partnerships Act Reform

Limited partnerships are governed by a combination of the Limited Partnerships Act 1907 (as amended by The Legislative Reform (Limited Partnerships) Order 2009) (the LPA), the Partnership Act 1890 and the rules of law and equity. Following a consultation in 2008, the Department for Business, Innovation and Skills announced that it did not have the appetite to implement a comprehensive overhaul of the law relating to limited partnerships. The LPA is in the process of reform through a series of small steps. The aim of the reform is to modernise and simplify the law on limited partnerships and remove any uncertainties from the existing law.

Timing

Further reform expected 2011/2012.

Comments

The first step of reforms took effect on 1 October 2009, with further proposals expected to be drafted and consulted on to implement other key elements of the original reform proposals. No changes have been proposed which would give English LPs legal personality and continuity (as previously recommended by the Law Commission).

The reform does not deal with tax law.

LEGAL DEVELOPMENTS – REGULATORY

Alternative Investment Fund Managers Directive

The intention of the Directive is to create a comprehensive and effective regulatory framework for Alternative Investment Fund Managers (AIFMs), being the managers of collective investment vehicles other than Undertakings for Collective Investments in Transferable Securities (UCITS) in the EU. It establishes the framework for the authorisation, operation and transparency of AIFMs that manage and/or market these funds into the EU. The Directive captures closed-ended, open-ended and listed funds and other vehicles.

In the UK there are a number of material (and politically sensitive) issues to resolve at the second tier level for the Directive to be effective and move to national level for implementation.

Timing

The AIFM Directive was adopted by the EU Parliament on 11 November 2010. It will become national law two years after entry into force (expected to be June 2011, therefore effective in the UK from June 2013). After much debate, transition periods have been agreed which will make third country requirements fully effective from 2018.

Comments

The Directive will apply to most EU fund managers unless they fall within an exemption (e.g. an AIFM which manages an Alternative Investment Fund all of whose investors are in the same group as the AIFM) or can take advantage of an exclusion (e.g. for certain holding companies, pension funds, sovereign wealth funds and parallel discretionary management vehicles). It also appears that 'joint ventures' are excluded although there is no detail about the exemption. Lobbying will need to continue as the AIFM Directive enters 'Level 2', in which national regulators sit down with the European Commission to formulate more detailed rules.

FSA Remuneration Code

The Code replaces the FSA's previous remuneration code which only applied to the 26 largest banks, building societies and broker dealers. The Code applies to all banks and building societies, firms subject to the Capital Adequacy Directive and UK branches of firms headquartered outside the EEA.

The Code's remit now reaches beyond banks to the fund management sector.

Timing

Came into effect on 1 January 2011. Firms which are within scope for the first time must comply with the Code by 1 July 2011 (and take reasonable steps to comply as soon as reasonably practicable).

Comments

The recent focus on remuneration stems from the view prompted by the financial crisis that staff in financial firms were incentivised to take excessive risk by widespread discretionary bonus arrangements. The Code aims to redress perceived imbalances so that employees who are either responsible for the management of a financial firm or able to have a material impact on the risk profile of a firm, such as proprietary traders, fund managers and compliance managers cannot simply be awarded large cash bonuses at each year end. Instead, for some types of firm, bonuses will be made up of cash and shares and a percentage must be deferred.

Unfortunately, the FSA has provided little detail on whether or not the Code will apply to carried interest, and how certain vehicles, such as LLPs and unlisted companies, can meaningfully pay Code Staff in membership interests and unlisted shares (which are illiquid and present valuation difficulties). A further concern is how members of an LLP (transparent for UK tax purposes) are taxed on profits which are not distributed to them. The FSA is expected to consult with industry bodies about these issues in 2011.

Financial Regulation Reforms – changing structures in the UK

In the UK, the FSA will be abolished and replaced with:

(i) the Financial Policy Committee (FPC), a new committee of the Bank of England responsible for macro-prudential regulation;

(ii) the Prudential Regulation Authority (PRA), a new subsidiary of the Bank of England, responsible for micro-prudential regulation of authorised firms with significant prudential requirements; and

(iii) the Financial Conduct Authority (FCA) (previously had the working title 'Consumer Protection and Markets Authority'), a new body responsible for ensuring market confidence and protecting consumers.

Timing

Changes to UK financial regulation will take place in 2012, although internal restructuring is taking place in the FSA in 2011 in preparation.

Comments

The structure of UK and EU financial regulation is changing with the establishment of new regulatory bodies. The changes will impact on all regulated firms. Firms should expect to have additional costs during the transitional period, for example in tracking the new legislation introduced to establish the new bodies and changes to internal systems to allow for reporting to the new entities.

Financial Regulation Reforms – changing structures in the EU

In the EU, a European Systemic Risk Board (ESRB) has been established to oversee, identify and assess systemic risks in member states. The ESRB comprises member state national banks, heads of three new European Supervisory Authorities (ESAs) and national supervisory representatives. The new ESAs are:

(i) European Securities and Markets Authority (ESMA), which has replaced CESR, and will liaise with national securities regulators;

(ii) European Insurance and Occupational Pensions Authority (EIOPA), which has replaced the Committee of European Insurance & Occupational Pensions Supervisors (CEIOPS), and will liaise with national insurance regulators; and

(iii) European Banking Authority (EBA), which has replaced the Committee of European Banking Supervisors.

Timing

ESRB, ESMA, EIOPA and EBA have all now been established.

Comments

For multinational authorised firms, the new European bodies will take responsibility for the group's activities in more than one jurisdiction.

Solvency II

Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace current solvency requirements.

The Directive uses statistical theory and analysis to apply 'shock testing' to different asset classes to determine capital requirements. The higher the perceived risk of an asset class, the more capital the insurer needs to set aside to ensure that, if its value falls, the insurer's ability to cover all its notional liabilities to policyholders is not affected. This may well encourage insurance companies to alter their asset allocation: if looking to reduce or minimise their solvency capital requirement, insurance companies are likely to consider using products with lower capital requirements (such as unit-linked funds rather than own balance sheet products) or restrict investment to more capital efficient assets such as property lending and away from equities and property itself.

Timing

Expected to apply to financial years commencing on or after 1 January 2013.

Comments

Solvency II brings in capital requirements for insurers similar to those imposed on banks in Basel III (summarised below).

The proposals create different results when applied to direct and indirect real estate and geared and ungeared investments. They do not reflect the diversification attributes of real estate and have been proposed as a reaction to the financial crisis rather than to real estate as an investment asset.

Specific areas of concern in the real estate sector include:

(i)the treatment of REITs and other listed property companies: are they considered as 'equities', with a 39% (+/- 10%) capital charge, or 'property' with a 25% capital charge?;

(ii) unlisted property funds: are they are modelled as 'private equity' with a 49% (+/- 10%) capital charge, if geared, or on a look through property basis of 25% with no +/- 10% dampener?;

(iii) the direct real estate solvency requirement does not include a dampener which could lead to a requirement for additional capital in a falling property market and/or insurers having to sell property to maintain adequate capital ratios, which could then trigger further falls in property values; and

(iv) in the case of a real estate fund, which if treated as a 'look through' investment in property, has a 25% capital charge, but, if geared, may encourage high leverage, because the proposals provide that capital requirements are calculated against net asset value.

If insurance companies are incentivised to invest in funds with lower equity and higher leverage, the proposals may encourage them to: invest in geared real estate funds rather than direct real estate; reduce their real estate investments; or increase lending on property investments rather than property investment itself.

In the meantime, the uncertainty breeds investment indecision.

Whilst insurance companies represent a significant chunk of real estate ownership (about 10–15% in Europe), there have also been suggestions (EU green paper on the future of pensions, published in July 2010) that a Solvency II- style regime could be applied to pension schemes. EIOPA will be considering Solvency II's application to defined contributions schemes in 2011.

Lobbying continues from insurers, industry bodies and member states.

US regulatory reform

The US Investment Advisers Act 1940 (the Advisers Act) was amended on 21 July 2010 by the US Private Fund Investment Advisers Registration Act 2010 (the Registration Act) as part of the more wide-reaching Dodd Frank Wall Street Reform and Consumer Protection Act.

The amendments mean that many investment advisers (including non-US ones) to private investment funds will now have to register with the US SEC. Record keeping and reporting obligations for registered and certain unregistered advisers will also increase.

Timing

The provisions of the Registration Act became effective on 21 July 2010.

A non-US adviser required to register under the Advisers Act has to register by no later than 21 July 2011.

Comments

The detail has still to be finalised although the consultation period has now expired. There are some exemptions from registration that may be applicable to certain non-US advisers (foreign private advisers exemption, private fund adviser exemption and venture capital exemption).

Another aspect of the Dodd Frank Act is the 'Volcker rule' which will prohibit banking entities from taking anything other than the minimum stakes in real estate private equity funds. A bank is allowed an interest in a fund that it organises or offers subject to a cap of no more than 3% of the total ownership interest in the fund and the aggregate of all such investments being limited to 3% of the entity's tier 1 capital.

LEGAL DEVELOPMENTS – BANKING

European Market Infrastructure Regulation (EMIR) on Over The Counter (OTC) Derivatives

EMIR will apply to those OTC derivative contracts which ESMA considers should be centrally cleared through authorised central counterparties (CCPs) cleared through central counterparties (CCPs), If a real estate business is a 'financial counterparty' (or a clearing 'non-financial counterparty') it will be required to clear trades in those contracts through a CCP. Those trades will need to have 'highly liquid' collateral (not property) posted and trades will also need to be reported to trade repositories. There will be detailed conduct of business requirements for CCPs and trade repositories.

Different rules apply where OTC derivative contracts are not subject to mandatory clearing by a CCP. In these circumstances, if a real estate business is treated as a 'financial counterparty' or a clearing 'non-financial counterparty' it will have to put in place risk management techniques for its OTC derivative contracts. The requirements include onerous obligations designed to manage operational and credit risk, including:

(i) capital requirements;

(ii) segregated exchange of collateral;

(iii) daily marking to market of uncleared derivative positions;

(iv) increased use of electronic confirmations; and

(v) increased transparency requirements (pre-trade and post-trade) and reporting obligations to trade repositories.

Timing

Expected to apply from late 2012. It will have direct national effect once it is adopted in Europe.

Comments

For a real estate sector business which is caught by EMIR:

• standardised swap activities (determined by ESMA may need to be cleared through external exchanges, with appropriate liquid collateral (real estate does not currently count) and reporting; and

• it would have to risk manage non-cleared contracts, including marking-to-market on a daily basis, and provide collateral.

Given the potential destabilising impact of EMIR on real estate and debt markets across Europe and the nature of a real estate business, the main focus areas for the real estate industry are:

• a real estate business (including a fund and its manager) should not be treated as a "financial counterparty" under EMIR;

• if caught, issues such as collateral requirements need to be addressed; and

• OTC derivative contracts entered into before EMIR comes into force should be excluded (the European Parliament has put forward proposals for pre-2012 contracts).

The Regulation is yet to be finalised and vigorous lobbying continues across Europe

Basel III (to be implemented by changes to the Capital Requirements Directive)

Basel III proposals relate to requirements for banks to hold more and better capital and to hold a minimum of assets in highly liquid form, such as government bonds.

Timing

To be implemented through changes to the Capital Requirements Directive. To be phased in over a five-year period from 2013.

Comments

The key question is what effect the new rules will have on the cost and availability of credit and bank profitability. The cost of capital will inevitably increase and this will be passed on to borrowers. Certain lending activities will carry higher capital costs: development finance, for example, is likely to be approached with even more caution by banks in the future.

As most banks are now down-sizing their property loan books, the additional pressure imposed by Basel III is likely to exacerbate the shrinking of available debt for the property sector. On the positive side, this situation could encourage new entrants to the loan market. It could also encourage banks to mitigate their positions, by selling off or otherwise reducing the amount of riskier assets held (for example, by turning to corporate bonds) without significantly harming earnings.

The proposed rules have been criticised by researchers at the Bank of England as too weak, and that a capital ratio which is at least twice as large as that agreed upon in Basel (7-8% of a bank's risk weighted assets) would provide optimal protection against future economic shocks.

LEGAL DEVELOPMENTS – COMPETITION

Competition Law and Land Transactions

The Competition Act 1998 prohibits agreements which prevent, restrict or distort competition within the UK. Restrictions relating to UK real estate were previously excluded from the provisions of this Act. However, this exclusion has been revoked so that from April 2011, companies have to self-assess land agreements for compatibility with competition law in the same way as they must assess other types of agreement.

In addition, certain land agreements in connection with grocery retailing activities are subject to additional control under the Groceries Market Investigation (Controlled Land) Order 2010. The Order is part of the package of remedies to address the adverse effects on competition resulting from the control of land by large grocery retailers in highly concentrated areas that were identified by the Competition Commission in its 2008 market investigation report on the supply of groceries in the UK.

Timing

Applied to UK real estate from 6 April 2011 (by way of repeal of the Exclusion Order).

Comments

Restrictions that are most likely to be prohibited in the real estate context are market sharing restrictions and restrictions which make it more difficult for other businesses to compete in a market.

The OFT has published guidance to assist when analysing whether a land agreement is anti-competitive.

Even if an agreement has an 'appreciable' effect on competition (assessed by its scale or significance and its likely effects on competitors) the prohibition may not apply if the restriction qualifies for exemption i.e. if it brings economic and consumer benefits and does not exceed what is necessary to achieve those benefits.

Pre-pack administration

This article is taken from 'Pre-pack Administrations and Company Voluntary Arrangements', a paper published in February under the IPF Research programme Short Paper series. The paper's authors are Patricia Godfrey and Nick Lloyd of Nabarro, Malcolm Frodsham of IPD and Lee Manning of Deloitte.

With the difficult economic climate, both business failure and tenant administration have become common occurrences. Company directors and insolvency practitioners wishing to rescue the viable part of a business may enter into a pre-packaged administration agreement (a pre-pack) for the sale of the business and assets or propose a company voluntary arrangement (CVA), rather than merely seeking to sell the assets and business within the scope of the administration alone.

Pre-pack administration sales, particularly those of high-profile retailers, continue to attract significant attention in the media. A major concern is that a business is not properly exposed to the market and, as a result, maximum value may not be obtained for creditors. Another significant criticism is the lack of transparency and accountability in the process, resulting in creditors believing they are provided with insufficient information and limited opportunities to ensure their interests are not prejudiced. Pre-packs have become all the more controversial with connected parties (often existing management or shareholders) being frequently the purchaser of the business of the solvent company, thus acquiring the assets and leaving the debts behind.

Even where the landlord's asset is one the tenant is seeking to keep, the negotiations can still be relatively one-sided, with the landlord often having little option other than to accept rent concessions. In the case of CVAs, a majority rather than a unanimous vote of creditors is required to approve the proposal, so a landlord with a unit that has asset management opportunities, for instance, may be hampered in realising these, even if they vote against the arrangement.

Set against the above criticisms, in many cases a pre-pack may be the only viable option available to preserve the business and maximise realisations, as often there is simply no money available to fund a trading administration. Furthermore, if the business is in a service industry where customers, employees, suppliers and goodwill can rapidly dissipate, a pre-pack is often the best way to maximise value and, therefore, the return to creditors.

In contrast with some other jurisdictions, the UK currently does not have any special form of financial help for businesses in difficulties. In the US 'superpriority' or 'debtor in possession' (DIP) funding is available and in Germany 'Insolvenzgeld' – a statutory mechanism to ensure that employees are paid – is in place, where the state makes money available to pay wages and thereby facilitates continuity of the business as part of an insolvency process.

Impact of pre-packs and CVAs on rental income

It is estimated in the IPD / Strutt & Parker Lease Events Review 2010 that the proportion of tenants experiencing liquidation or receivership rose to 5.5% of total annual estimated rental value in both 2008 and 2009 (see Figure 1).

Figure 1: Proportion of tenants experiencing liquidation

2002 %	2003 %	2004 %	2005 %	2006 %	2007 %	2008 %	2009 %
0.9	1.7	2.3	2.3	2.6	1.3	5.5	5.5

Source: IPD / Strutt & Parker Lease Events Review

These figures are not attempting to quantify the lost income to the owner from defaults. This income loss will depend upon factors such as the level of rental arrears, recourse to the original tenant on assignments, guarantees from parent companies, rent deposits, eventual recoveries from liquidators, time taken to re-

What is a pre-pack?

A pre-pack is a pre-negotiated agreement for the sale of an insolvent company's assets and/or business that is devised in advance of the company entering into a formal insolvency process, and executed by the insolvency practitioner (IP) shortly after appointment. Pre-packs are most commonly used in conjunction with administration, although they can be used with other insolvency processes, such as creditors' voluntary liquidations and administrative receiverships.

Despite their common use, there are currently no specific provisions in English insolvency legislation which either deal with or contemplate the use of pre-packs. However, IPs who enter into pre-packs on behalf of an insolvent company are regulated by statute and the codes of practice of their professional bodies. The Statement of Insolvency Practice 16 (SIP 16), which took effect on 1 January 2009, sets out guidelines for IPs involved in pre-packaged sales and seeks to redress the lack of statutory guidance. The intention is to provide greater transparency for creditors by obliging an IP to provide them with detailed information about the terms of the sale, the buyer of the business and with more visibility into the formal insolvency process generally. In addition to SIP 16, IPs are required to follow the Code of Ethics for Insolvency Practitioners (the Code). The Code also came into force on 1 January 2009 and sets out fundamental principles that IPs should follow.

let, costs of re-letting, service charge losses, dilapidations and empty rates.

The proportion of tenants involved in a pre-packed sale or CVA in 2009 is estimated at only 0.3%, a fraction of the 5.5%. This suggests, that whilst tenant insolvency was a significant issue for commercial real estate investors in both 2008 and 2009, neither pre-packs nor CVAs have been a major factor within this.

Insolvency Service Consultation paper

During the first six months of 2009, the Insolvency Service monitored the use of pre-pack sales and found that in only 65% of cases were the disclosure requirements of SIP 16 complied with. In 3% of cases the conduct of the IP was regarded as sufficiently serious to consider disciplinary action against them. Partly because of these findings, but probably more because of the strong and prevailing perception that creditors' confidence in pre-packs remains low, the Insolvency Service has been consulting on a number of options to improve transparency and confidence in pre-packs.

It remains to be seen what changes, if any, will follow. The ability to approach and effect a pre-pack confidently will continue to turn on the quality of the steps and debate that occurs during the 'live side' process. If pre-packs are to remain an option in distressed situations, they must be exercised with careful planning and an abiding sense of fair play for all stakeholders. One way of ensuring that this is achieved (over and above SIP 16) would be to implement one or more of the measures put forward in the Insolvency Service's consultation.

A further means could be greater court involvement. The courts have become involved in sanctioning pre-packs and have recognised the role of the professional and the skill and experience required to effect a pre-pack sale. Although, historically, the courts were reluctant to entertain an application for approval prior to a sale, on the basis that it was a matter for the administrator and creditors, and it was inappropriate for the court to make the administrator 'bomb proof', there is some evidence of that approach changing. In particular, the recent Wind Hellas case, which was the first example of the court supporting expressly a specific pre-pack strategy. Whether we see more court applications as a means of 'rubber stamping' pre-packs and protecting administrators from a future backlash remains to be seen.

Changes already in place

With the debate on pre-packs rumbling on, landlords might feel that the pendulum is continuing to swing against them. However, there have been important developments to tip the balance more in their favour over the last year, which may affect the way in which administrators deal with property in the future.

A win for landlords was the court ruling that rent can be claimed as an expense of the administration when a tenant's administrators permit occupation of a leasehold property under a licence. By making it clear that rent ranks as an expense, ahead of other claims in an administration including the administrator's own remuneration, the position of landlords is considerably strengthened.

The recent Miss Sixty decision further bolstered the landlords' position when the court upheld a claim of unfair prejudice on a CVA in circumstances where the landlord's closed retail stores were to lose the benefit of third party guarantees without adequate compensation or sufficient justification. Although, following on from Powerhouse, Miss Sixty has still left the 'guarantee-stripping' door open, it now appears that it would be very difficult to do this where the solvency of the guarantor is not in issue, even where the compensation offered is based on fair assumptions.

How are 'green leases' evolving in the UK?

Louise Ellison, Head of Sustainability, Quintain Estates and Development Plc

The 'greening' of leases for commercial buildings has been the subject of debate within the property industry. Having arrived with a splash in 2006-07, largely from Australia, green leases were variously seen as: the long-awaited solution to our seemingly intractable landlord and tenant engagement issue; a huge risk to the saleability of an asset; a means through which landlords could force tenants to pay for environmental improvements; and a way for tenants to hold landlords to account for the operational performance of a building.

Inevitably, green leases have been less a cure-all than was first suggested but equally less of a threat, either to asset value or landlord and tenant obligations. Their take-up has been patchy in spite of useful green lease tool-kits including example clauses and suggestions being published by the Better Buildings Partnership and the Lease Code Group. However, they have been very useful in driving further debate about landlord and tenant engagement and practical approaches to improving building performance.

These debates moved centre stage again with the introduction of the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) across the UK in 2010. This focused minds in particular on operational energy efficiency in commercial buildings. Efforts by, and on behalf of, landlords and tenants to collect data on energy usage highlighted the lack of arrangements in place to share building performance data. It also highlighted in many cases the somewhat erratic state of much of the energy metering in the commercial building stock. These issues brought the topic of the landlord and tenant relationship and potential agreements between the two back into focus.

There is evidence of industry evolution in response to this. Clauses requiring sharing of environmental data are becoming increasingly common in new commercial leases particularly where landlords have a clear sustainability strategy. However, as is ever the case with property, the bigger challenge lies in the existing stock. How do we 'green' leases that were granted five years ago and have another 10 years to run, particularly where up until now the only conversations with the tenant since signing the lease has been about rent and service charges?

One proposed solution has been the agreement of a green memorandum of understanding (MoU) between landlord and tenant that is outside the lease. There is obvious inertia to opening a conversation with an existing tenant in order to focus attention on the performance of their building without good reason. However, interestingly, the 2010 Occupier Satisfaction Survey found that tenants feel their landlords are not communicating with them enough on environmental issues. Tenants, it would appear, do want to hear about them and, with many having a regulatory requirement to report their own carbon emissions and, soon, to pay for them, this is hardly surprising.

It is clear that green leases and green MoUs are increasingly relevant to the industry but information about them seems to be driven largely from law firms. The messages from the market remain mixed and unclear. Perfect subject matter then for the IPF Sustainability Interest Group to tackle!

Outputs from the IPF Sustainability Interest Group workshop

A workshop was organised in late 2010 for a group including landlords, tenants, agents for both parties and sustainability consultants. Following two very interesting presentations from Justin Snoxall of British Land and Stuart Bowman of Hurley Palmer Flatt on how British Land has been working with tenants and using data monitoring to reduce energy consumption, the 30 delegates were set to work. Small group discussions were followed by a more detailed individual questionnaire on MoUs and a plenary session. The small group discussions focused on three key areas:

- What are the benefits of green leases and MoUs?
- What issues or difficulties do they raise?
- How might the barriers to take up be over come?

Interestingly the benefits identified included the improved lettability and saleability of an asset that could demonstrate good energy efficiency. It was felt they could support the corporate social responsibility policies of both occupier and owner but were most effective where landlord and tenant worked together. The list of issues and difficulties raised was more extensive. Sustainability was thought rarely to be a high priority for a landlord and management time was in short supply, meaning it is was often ignored or dropped as an issue. Short and shortening lease lengths were seen to militate against the investment of time and effort in stronger landlord and tenant relationships and clearly undermine the business case for any investment from the tenant's perspective. With little or no financial incentive for the tenant, shortening leases and a difficult economic outlook the potential for investing in the development of green MoUs for leases was seen as limited.

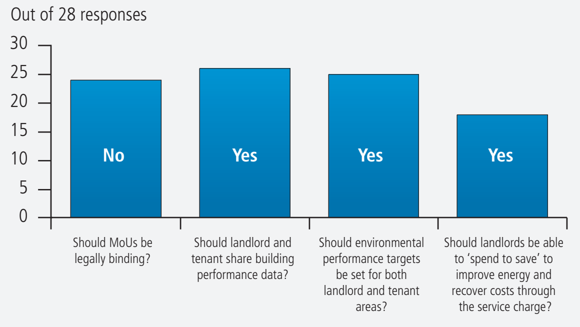
So how can these barriers be overcome? Given the requirement for better data to ensure regulatory compliance, as well as company reporting, there is clearly a need for some sort of arrangement whereby landlord and tenant can communicate on operational performance data. The potential roll out of Display Energy Certificates (DECs) will reveal the actual operational performance of the properties they occupy, which may be very different from the rating achieved in their respective Energy Performance Certificates. As performance is revealed, improvements will surely be required – this is after all the ultimate objective. Landlord and tenant engagement is critical to delivering these improvements cost effectively and efficiently. So are green MoUs a useful way of achieving this?

The discussion on overcoming the barriers happily produced the longest list. A common theme amongst them was the need for less equivocal drivers for action – tax incentives and penalties, compulsory DECs, longer leases (!) and demonstrable savings calculated through a mechanism for pricing sustainability were all identified as instrumental in overcoming the barriers to landlord and tenant engagement. The perception remains that landlords need to take the lead on the issue but good data, industry-wide standards, better communication and more education were all seen as prerequisites to working with tenants to improve the stock. MoUs were identified as one route for achieving the dialogue needed to deliver these changes but the group was clear; these should not be legally binding and should perhaps be time limited.

The views recorded in the individual questionnaires supported those expressed in the group discussions. The questionnaire focused in more detail of specific characteristics of MoUs .

Flexibility within the MoU mechanism was considered to be important and the inclusion of time limitations, opportunities for review and termination rights for either party were additional suggestions. Not surprisingly, data sharing between landlord and tenant generated a strong positive reaction, as shown in Figure 1, with 26 of the 28 respondents in support, although some felt there should be an 'appropriateness' check. For example, it might depend on the size of the property.

Figure 1: Individual questionnaire responses

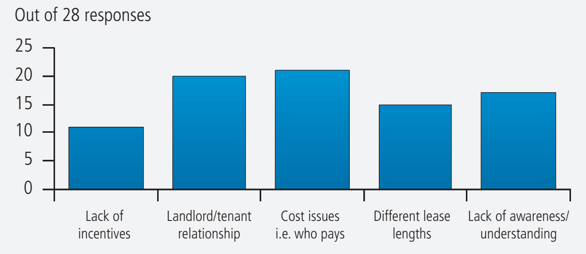


The setting of targets for tenants' areas as well as landlords' areas was strongly supported, particularly for energy, water and waste. This is an important point as the setting of targets is critical to driving change – the next step after establishing clear metrics. Targets are also increasingly required for sustainability reporting initiatives such as the Carbon Disclosure Programme and Global Reporting Initiative.

It was generally felt that landlords should be able to 'spend to save' and recover the cost via the service charge; net savings could then also be passed through. Such arrangements could be eased by the formation of environmental building management committees, a concept that was welcomed by 26/28 of the delegates. However there was scepticism as to whether the tenant would get a return for any extra payment made. It was felt that whilst 'spend to save' was a good idea, tenants would not agree to it and it should only be done with the agreement of the tenants – is this a Catch 22 type problem?

The barriers identified to the take up of green MoUs for buildings were relatively predictable, as shown in Figure 2. Largely related to cost, they reflect the concerns of a risk-averse industry examining a potentially significant change. Key problems are uncertainty over-regulation, costs, legal implications and the relative newness of the concept. The somewhat dislocated relationship between landlord and tenant of course sits at the centre of much of this.

Figure 1: Barriers to take up of MoUs and green leases



Conclusions

What conclusions can we draw from these discussions about the evolution of green leases? The positive attitude towards MoUs and the setting up of building management committees is encouraging. The barriers are what one would have expected but suggest that more could be done to educate and spread understanding of what a MoU actually entails. The two concepts of data sharing and building management committees could be used as an effective means of resolving the seemingly intractable barrier formed by the adversarial tradition of the landlord and tenant relationship.

Perhaps the more interesting conclusions can be drawn from the responses relating to 'spend to save' schemes. The idea that landlords should be able to recoup the cost of environmental improvements through the service charge was broadly acceptable to the group. Greater difficulty was envisaged in convincing tenants that they would see a positive outcome from their additional expenditure. However, if it is possible to demonstrate operational savings as a result of expenditure, the case could be made for recouping the cost of environmental improvements in this way. This is the concept that underpins the business model of those companies offering to provide monitoring equipment in return for a proportion of the cost savings made as energy consumption falls.

The overall findings suggest we still face challenges in implementing MoUs and financing environmental improvements to existing buildings. But there are areas of strong consensus particularly around the concept of a non-legally binding green building MoU, issues of data collection and better communication through building management committees. A UK version of the green lease could be emerging but it looks unlikely to be a lease, more an agreement to collaborate, which might be more productive (and cheaper!) all round.

UK Consensus Forecasts February 2011

The Q1 2011 IPF UK Consensus Forecasts show expectations for 2011 improving slightly against the previous quarter's returns but anticipated performance across all measures being much lower than for 2010. Both rental and capital growth figures for the year ahead have increased a little since the Q4 survey but capital values remain firmly in negative territory, with the honourable exception of the office sector. As a consequence, total return forecasts have picked up slightly. Looking further out, the 2012 and 2013 numbers show some improvement with rental growth values finally turning positive across all sectors and the prospect of high single figure total returns in both years. The five-year forecasts imply that this rally may be short-lived, although any fall back is expected to be moderate.

Key points

The IPF UK Consensus Forecast All Property total return continues to support a more pessimistic outturn for commercial real estate for 2011 than 2010.

- However, across the board rental value growth figures for 2011 are improving slightly, albeit remaining negative other than for offices and retail warehouses. Capital value growth forecasts likewise are improving but still negative with the exception of offices.
- The Consensus Forecast of total return for 2011 has picked up slightly as a result of these less downbeat sentiments but the outlook over the next two years remains firmly fixed in single digits (offices being the only potential exception).
- The five-year view, without the benefit of stronger 2010 figures, has weakened slightly since the last round of the survey, with no single sector looking to outperform.
- Whilst recent forecasts have been more optimistic, the outlook remains very cautious with persistent weak rental value growth over the next five years.

Total return forecasts for the City and West End office sub-sectors peaked in 2010.

- Compared to other sectors, the City and West End office sub-market forecasts remain relatively strong performers over the next two years, primarily driven by continued good single digit rental value growth, with numbers having been revised upwards slightly for 2011.
- Central London capital value growth is expected fall away significantly in 2011, although remaining positive, with a slight improvement in 2012.
- The Consensus total returns forecast for 2011 has improved marginally, whilst 2012, 2013 and the five-year views for both subsectors are expected to outperform the rest of the market.

Retail sectors remain weak but there may be some light on the horizon.

- Standard shops, shopping centres and industrial sector rentals are expected to show negative growth in 2011 but should turn positive by 2012 and beyond. Similarly, negative capital value growth is forecast in each of these sectors over the next 12 months but, again, some upturn is expected in later years.
- Rental value growth is forecast to be marginally positive for all sectors by 2012 with the consensus figures virtually unmoved since the November survey.
- On a five-year average, the weakest forecast is for industrial rents, followed by standard shops and shopping centres.

Economic setting

Gross Domestic Product (GDP) decreased by 0.5% in the fourth quarter of 2010, compared with an increase of 0.7% in the previous quarter. The estimate was considerably affected by December's bad weather and the decline was also influenced by decreases in services and construction, these having previously been major drivers of recovery earlier in the year. Forecasts for 2011 continue to reflect mixed expectations of the economy; the Treasury consensus forecast of GDP for 2011 fell from 2.0% in December to 1.8% in February[1] the latter average spanning a range of forecasts between 0.9% and 3.1%.

The Bank of England's latest forecast[2] notes that, having been appreciably above the MPC's target throughout the past year, inflation is likely to rise further in 2011. This is, in part, a reflection of high import and energy price inflation, whilst the recent increase in VAT and some rebuilding of companies' margins have added to the situation. CPI and RPI forecasts for the year have crept up to 3.4% and 4.2% respectively[3], although inflation is likely to fall back as the previously mentioned effects diminish and downward pressure from spare capacity persists. However, both the timing and extent of any decline in inflation remain uncertain. Growth should resume following a contraction in output at the end of 2010, supported by sterling's past depreciation, continued global recovery and the boost from monetary policy. Under the assumptions that Bank Rate moves in line with market interest rates and purchased assets financed by the issuance of central bank reserves remains at £200bn, the chances of inflation being above or below target are judged to be broadly equal in the medium term.

Turning to the labour market, recently released unemployment figures[4] showed an unexpected increase to 7.9% for the three months to December. This translates into an increase of 44,000 people registering as unemployed over the quarter, giving a jobless total of 2.49m. The annual growth rate for total pay (including bonuses) was 1.8% for the three months to December 2010, a fall of 0.3% from the three months to November. This fall in the whole economy annual growth rate for earnings was driven mainly by finance and business services, manufacturing and the construction sectors. Unsurprisingly, consumer confidence fell at its fastest rate on record during January, following the VAT increase, with households also being squeezed

1 Source: HM Treasury Forecasts for the UK Economy 16 February 2011

2 Bank of England Inflation Report February 2011

3 HM Treasury Forecasts for the UK Economy 16 February 2011

4 ONS

by rising inflation and the prospect of tax rises in late Spring. Perversely, the ONS report on monthly retail sales recorded an 8.2% increase in January 2011 sales over the same month a year earlier, although pundits consider this to be a blip. Within the headline, monthly sales for predominantly non-food stores grew 9.1% and the largest reported rise, of 13.2%, was in other stores. Significantly, the figure for the non-store retailing sector was 21.3% higher than a year ago – the value of internet sales was £523m in January, around 10% of total retail spending.

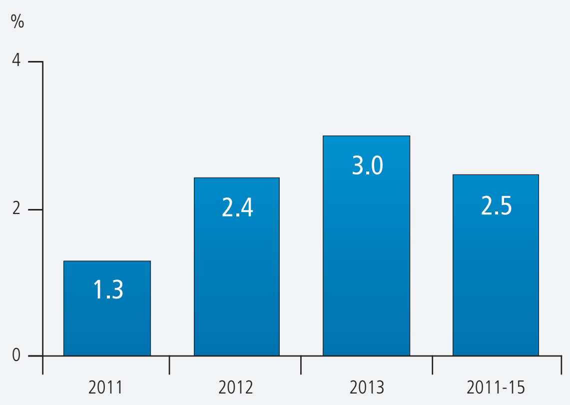
Prospects for property

Although these latest results clearly will not have been taken into account in the current round of forecasts, the weak economic outlook is reflected in the numbers for 2011. The dual threats of rising unemployment and pressure on disposable income, through inflation and tax increases, are having a marked impact on consumer confidence, in turn affecting retail occupational demand. The sector is also facing potential long-term structural change as a result of shopping trends shifting away from the high street with greater internet usage.

The UK office sector has been disproportionately influenced by the performance of the Central London market, which has delivered strong rental and capital value growth and, hence, total returns since the investment market recovered. However, this degree of performance is not sustainable, as demonstrated by the reduced growth and total return figures being forecast, although these two sub-sectors are expected to continue to provide close to double digit returns over the next five years.

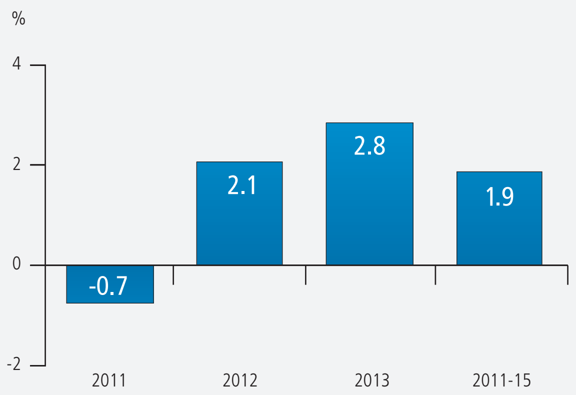
The consensus view is for modest strengthening across all remaining sectors in the next two to three years, as the economy gradually recovers, but with the asset class as a whole offering solid rather than outstanding returns.

Figure 1: All Property rental value growth forecasts



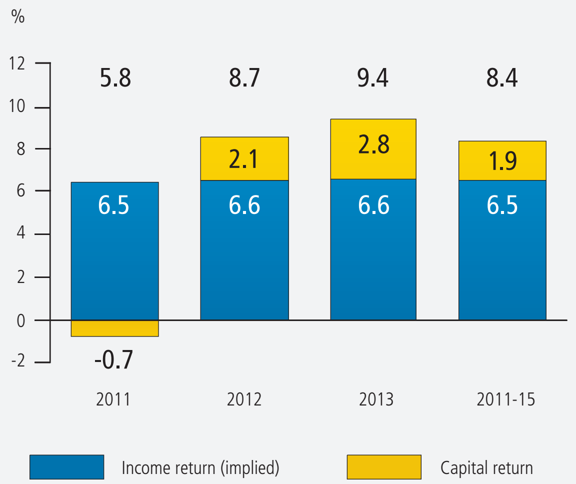
The consensus All Property rental value growth forecast has strengthened again this quarter, from a negative position in 2010. However, the outlook for rental value growth remains weak with the five-year average implying a falling away from a modest peak in 2013.

Figure 2: All Property capital value growth forecasts



The All Property capital value growth mean forecast for 2011 has improved against Q4 but remains negative. Forecasts for 2012 and beyond are positive but substantially below the 2010 result. The five-year projection and overall pattern are similar to those for rental growth (see above).

Figure 3: All Property total return forecasts



The All Property total return forecast for 2011 has improved slightly over the previous quarter's consensus, but the outlook remains muted. The expectation of negative capital value growth over the next 12 months may subdue capital market activity, although the medium term outlook is more encouraging.

Rental returns look to remain stable and UK property is an attractive source of income when compared to equity and bonds, despite increased inflationary pressures within the economy.

All Property survey results by contributor type

(Forecasts in brackets are November 2010 comparisons)

Figure 4: Property advisors and research consultancies (14 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2011		2012		2013		2011		2012		2013		2011		2012		2013	
Maximum	2.5	(1.9)	4.9	(4.3)	4.7	na	3.0	(3.5)	5.2	(5.6)	5.6	na	10.0	(12.2)	12.3	(14.3)	14.0	na
Minimum	-0.7	(-0.7)	1.1	(1.1)	1.8	na	-2.5	(-4.4)	0.5	(0.0)	-0.5	na	4.3	(3.9)	7.0	(6.5)	6.5	na
Range	3.2	(2.6)	3.8	(3.2)	2.9	na	5.5	(7.9)	4.7	(5.6)	6.1	na	5.7	(8.3)	5.3	(7.8)	7.5	na
Median	1.2	(1.0)	2.4	(2.1)	3.4	na	0.4	(0.3)	1.8	(1.2)	3.2	na	6.7	(7.0)	8.3	(8.5)	9.6	na
Mean	1.2	(0.9)	2.5	(2.2)	3.2	na	0.2	(-0.1)	2.3	(1.9)	3.1	na	6.8	(7.1)	9.0	(9.1)	9.9	na

Figure 5: Fund managers (14 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2011		2012		2013		2011		2012		2013		2011		2012		2013	
Maximum	2.6	(3.6)	3.7	(3.5)	4.2	na	0.7	(2.8)	5.4	(5.4)	6.7	na	7.4	(10.2)	12.5	(11.7)	13.0	na
Minimum	0.0	(-0.1)	1.2	(1.1)	2.2	na	-8.5	(-9.4)	-3.8	(-1.6)	-1.3	na	-1.6	(-0.9)	3.3	(5.5)	6.3	na
Range	2.6	(3.7)	2.5	(2.4)	2.0	na	9.2	(12.2)	9.2	(7.0)	8.0	na	9.0	(11.1)	9.2	(6.2)	6.7	na
Median	1.2	(1.0)	2.5	(2.5)	2.7	na	-2.2	(-1.2)	1.9	(2.1)	2.9	na	5.0	(4.7)	8.5	(8.9)	9.5	na
Mean	1.2	(1.2)	2.4	(2.3)	2.8	na	-2.4	(-2.8)	1.8	(2.4)	2.6	na	4.3	(4.6)	8.6	(9.1)	9.3	na

Figure 6: All forecasters (31 contributors)

	Rental value growth %						Capital value growth %						Total return %					
	2011		2012		2013		2011		2012		2013		2011		2012		2013	
Maximum	2.6	(3.6)	4.9	(4.3)	4.7	na	3.0	(3.5)	5.4	(5.6)	6.7	na	10.0	(12.2)	12.5	(14.3)	14.0	na
Minimum	-0.7	(-0.7)	1.1	(1.1)	1.8	na	-8.5	(-9.4)	-3.8	(-1.6)	-1.3	na	-1.6	(-0.9)	3.3	(5.5)	6.3	na
Range	3.3	(4.3)	3.8	(3.2)	2.9	na	11.5	(12.9)	9.2	(7.2)	8.0	na	11.6	(13.1)	9.2	(8.8)	7.7	na
Std. Dev.	0.7	(0.9)	0.9	(0.8)	0.7	na	2.4	(3.2)	2.1	(1.8)	1.7	na	2.4	(2.8)	2.1	(1.8)	1.7	na
Median	1.2	(1.0)	2.4	(2.2)	3.0	na	-0.6	(-0.6)	1.9	(2.0)	2.9	na	6.4	(6.2)	8.3	(8.8)	9.5	na
Mean	1.3	(1.1)	2.4	(2.4)	3.0	na	-0.7	(-1.5)	2.1	(2.3)	2.8	na	5.7	(5.7)	8.6	(9.1)	9.4	na

Figure 3: Survey results by sector

	Rental value growth %				Capital value growth %				Total return %			
	2011	2012	2013	2011-15	2011	2012	2013	2011-15	2011	2012	2013	2011-15
Office	4.0	5.1	4.8	4.2	1.5	3.3	3.2	2.3	8.1	10.0	9.7	8.9
Industrial	-0.2	0.9	1.5	1.2	-2.3	1.1	1.9	0.9	4.8	8.5	9.5	8.4
Standard shops	-0.6	0.9	2.0	1.5	-2.1	0.8	2.4	1.3	3.6	6.8	8.4	7.1
Shopping centres	-0.4	1.0	2.3	1.6	-1.9	1.0	2.8	1.6	4.5	7.6	9.4	8.2
Retail warehouses	1.1	2.0	2.9	2.4	-0.9	2.1	3.3	2.0	5.2	8.4	9.5	8.1
All Property	**1.3**	**2.4**	**3.0**	**2.5**	**-0.7**	**2.1**	**2.8**	**1.9**	**5.7**	**8.6**	**9.4**	**8.4**

Notes

1. Figures are subject to rounding, and are forecasts of All Property or relevant segment Annual Index measures published by the Investment Property Databank. These measures relate to standing investments only, meaning that the effects of transaction activity, developments and certain active management initiatives are specifically excluded. **2.** To qualify, all forecasts were produced no more than two months prior to the survey. **3.** Maximum: The strongest growth or return forecast in the survey under each heading. **4.** Minimum: The weakest growth or return forecast in the survey under each heading. **5.** Range: The difference between the maximum and minimum figures in the survey. **6.** Median: The middle forecast when all observations are ranked in order. The average of the middle two forecasts is taken where there is an even number of observations. **7.** Mean: The arithmetic mean of all forecasts in the survey under each heading. All views carry equal weight. **8.** Standard deviation: A statistical measure of the spread of forecasts around the mean. Calculated at the 'all forecasters' level only.

Acknowledgements

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

Property advisors (includes research consultancies): BNP Paribas Real Estate, Capital Economics, CBRE, Colliers International, Cushman and Wakefield, DTZ, Fletcher King, GVA, Jones Lang LaSalle, King Sturge, Knight Frank, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited, Strutt & Parker.

Fund managers: Aberdeen Asset Management, Aviva Investors, AXA Real Estate, Cordea Savills, F&C REIT Asset Management, ING Real Estate Investment Management, Invista REIM, LaSalle Investment Management, Legal & General Investment Management, PRUPIM, RREEF, Scottish Widows Investment Partnership, Standard Life Investments, UBS Global Real Estate.

Equity Brokers: BofA Merrill Lynch, Morgan Stanley.

Note

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

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

Disclaimer

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IPF Survey of IFAs
February 2011

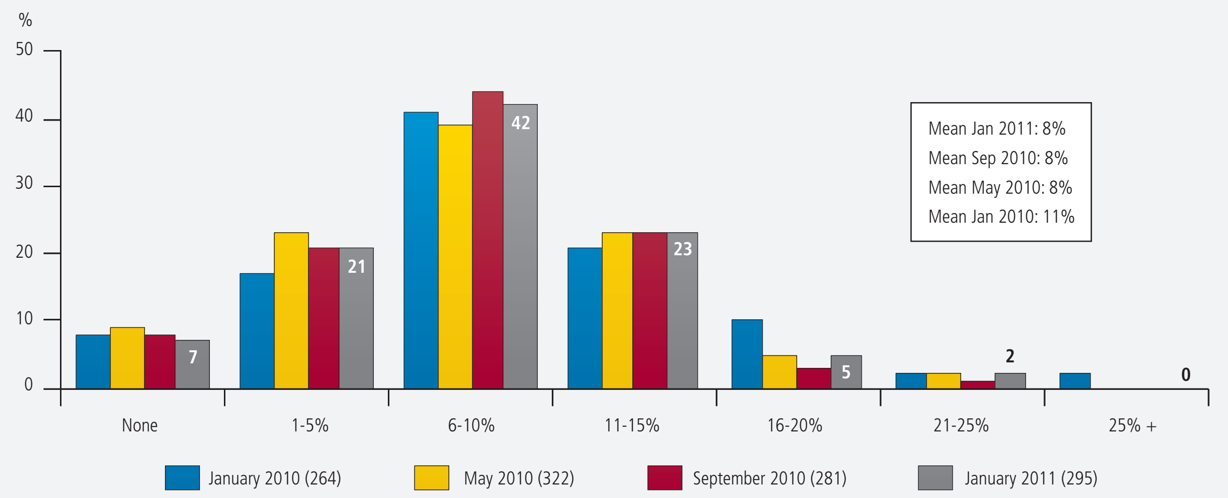
Latest IPF survey of IFAs shows recommended proportion allocated to property remains constant.

The first wave of the IPF Survey of IFAs for 2011 broadly supports the status quo, in that there has been little change in sentiment over the last four months, with the average recommended allocation to property remaining stable at 8% – see Figure 1. This is below the longer-term average based on data collected since May 2008, of just under 10%.

The majority of respondents (63%) reported no change in their inclination to recommend commercial property as an investment. However, the number recommending clients to decrease their exposure has risen to 17% (12% last wave). Further, there has been a decrease in the number of respondents recommending a significant or small increase in investment (20% vs 28%).

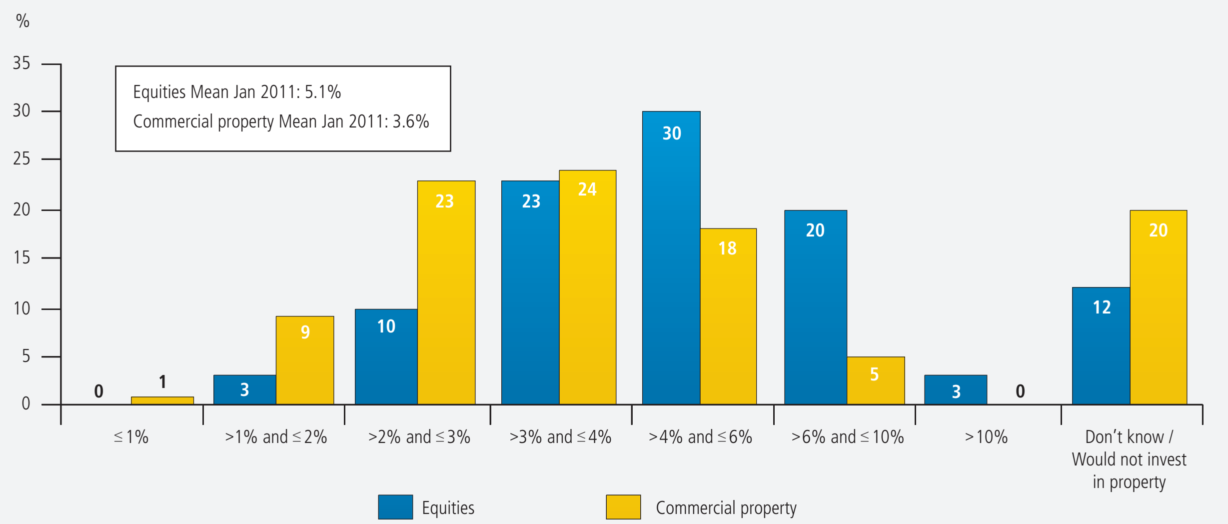
The appetite for different geographical locations continues to favour the UK (65%) but Global destinations (48%) retain good support followed by Asia and Europe (18% & 17% respectively.

Figure 1: Percentage of a client's portfolio IFAs would typically recommend being allocated to property investment



Source: IPF Survey of IFAs, February 2011

Figure 2: Mean additional return for equities over commercial property investments



Source: IPF Survey of IFAs, February 2011

Commercial property in the context of other assets

The mean return in excess of the risk-free rate required for equities by clients of this respondent group remains at 5.1%. The same measure for commercial property has dropped slightly, resulting in an increase in the margin between the two asset classes to 1.5%. The majority of IFAs expect property risk-adjusted returns to lie between 2% and 4% for commercial real estate (see Figure 2 overleaf).

The number of IFAs who consider their investors to have too much exposure to property in their portfolios (39%) has fallen again whilst the number considering their clients to have too little exposure has fallen to 27%. Around one third of all respondents (34%) report that they do not know the answer to this question, supporting the view that there is continued uncertainty in the sector.

The most important investment characteristics of commercial property for the IFAs continue to be diversification from equities and bonds, stable income flow and capital growth as the key features. Unsurprisingly, liquidity remains the least important characteristic among those listed.

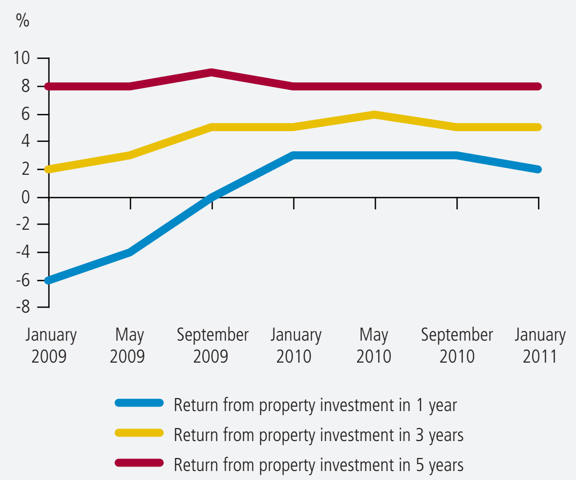
How are IFAs recommending their clients invest?

The most popular collective investment vehicle with the respondent group remains UK authorised unit trusts/property funds. However, in this round of the survey their popularity has decreased marginally and the popularity of pension funds and life funds has increased. The IFAs' preference for bricks and mortar funds remains.

Expected longer-term returned

As indicated in Figure 3, the longer-term IFA predictions for returns have remained stable, while short term expectations are lower but remain positive since 2009. The slight drop in the one-year expected return is insufficient to place any reliance on at present but it will be interesting to see whether this is sustained in the next wave.

Figure 3: Average expected annual returns from property investments



Source: IPF Survey of IFAs, February 2011

Conclusions

There continues to be little change in IFA sentiment towards commercial property, although anticipated demand across all sectors has weakened slightly. The asset class is attractive in terms of its diversification benefits and stable income, but a higher return over a risk free rate is expected of both real estate and equities investments.

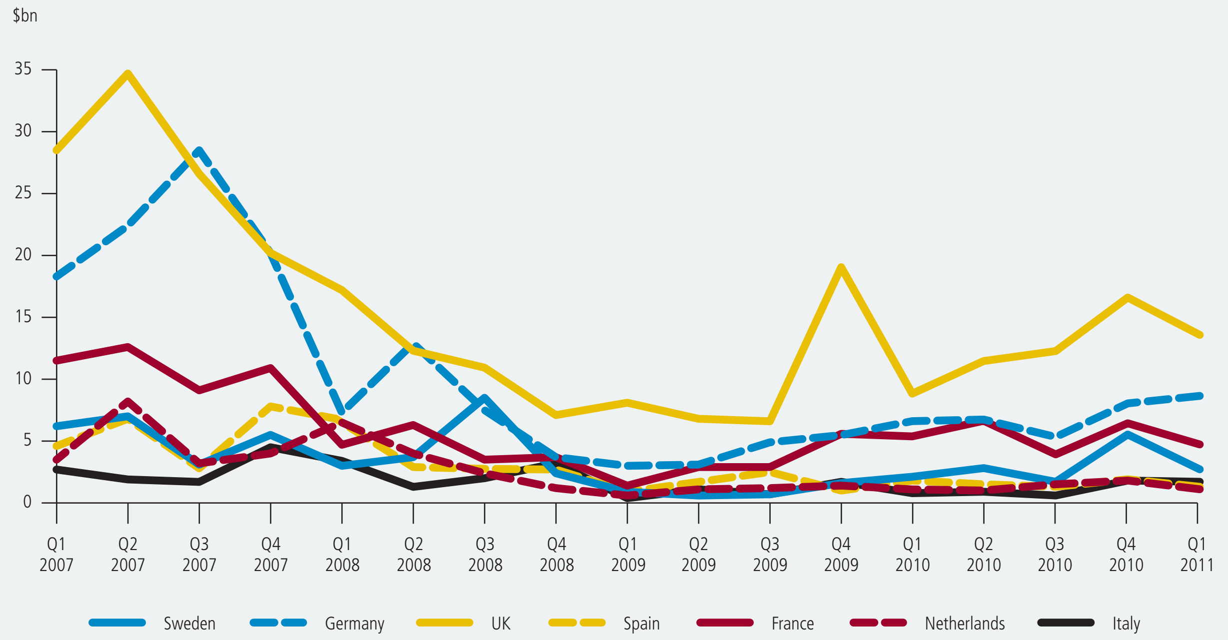
Notes: The IPF Survey of IFAs is carried out three times a year by NMG Financial Services Consulting as part of a wider IFA Census. The sample is drawn from IFAs who conduct at least 25% of their business in savings, investment and pensions.

Contact: Pam Craddock, Research Director, Investment Property Forum on 020 7194 7925 or email pcraddock@ipf.org.uk

European sales volumes

The data below has been provided by Real Capital Analytics (RCA), which tracks commercial property transactions in more than 80 countries worldwide. RCA focuses primarily on the main income-producing property types: office, industrial, retail, apartment and hotel, plus sales of commercially developable land sites.

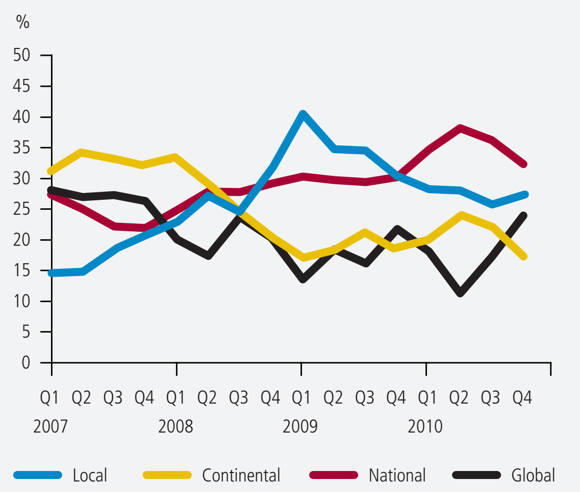
Figure 1: European transactions by country



Source: Real Capital Analytics, Inc 2011. For more current deals, cap. rates and property details visit www.rcanalytics.com

Note: Based on independent reports of properties and portfolios of $10m and greater. Data is believed to be accurate, but not guaranteed.

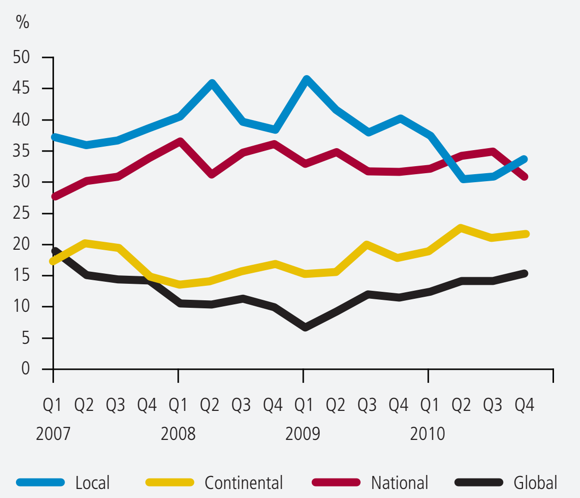
Figure 2: European transactions – Origin of buyers



Source: Real Capital Analytics, Inc 2011.

Note: Data is believed to be accurate, but not guaranteed.

Figure 3: European transactions – Origin of sellers



Source: Real Capital Analytics, Inc 2011.

Note: Data is believed to be accurate, but not guaranteed.

Forum activities and announcements

Executive team

We are delighted to welcome **Pam Craddock** as the new IPF Research Director. Pam can be contacted on 020 7194 7925 or **pcraddock@ipf.org.uk**

IPF Midlands Board

Tim Hurdiss of Deeley Properties and Mark Vernon of A&J Mucklow have joined the Midlands Board. Both are well-known industry figures and will add respectively a property company and developer perspective.

Launch of the Property Banking Forum

The newly-formed Property Banking Forum (PBF), chaired by Max Sinclair of Eurohypo, is a joint initiative between the Association of Property Bankers (APB) and the IPF. Its objective is to further education and research about issues affecting property finance.

The inaugural meeting of the Forum, hosted by Eversheds on the evening of Wednesday 23 March, saw the presentation of the results of the 2011 Lending Intentions Survey, commissioned by the PBF.

New Chairman for PDIG

Will Robson has succeeded Nick Scarles of the Grosvenor Group as Chairman of the Property Derivatives Interest Group (PDIG). Nick has been Chairman for three years and, under his leadership, PDIG has made great strides in facilitating the development of the property derivatives market through education of and engagement with the property investment community. Will, who is Director: Property Derivatives at PRUPIM, has been Chair of the PDIG Working Group since 2009 and, in Nick's words is, "the ideal choice for PDIG's new Chair".

David Smith

IPF Annual Lunch 2011

The IPF Annual Lunch took place on Friday 28 January at the Hilton Park Lane. **David Smith**, Economics Editor of The Sunday Times, was the after-lunch speaker.

This event was kindly sponsored by Chase & Partners, Langham Hall and Valad.

IPF Annual Lunch

Investment Education Programme (IEP)

The Investment Education Programme 2010-11 cycle is in full swing. The next module will be **International Property Investment**, taking place on 6-8 June.

If you are interested in taking a single module, or following the full diploma in 2011-12, further information can be found on the IPF website.

IPF Diploma holders 2010-11

The IPF is delighted at the continued popularity of the Investment Education Programme. 13 students completed the Diploma in 2009-10, and 8 were at the Annual Lunch to collect their Diplomas in person.

Diplomas 2009-10

This year, one person has won both IPF Educational Trust awards. Congratulations to **Spencer Howard** of Ignis Real Estate who won both the Module Award (for best performance in a single module) and the John Whalley Prize (for best overall performance).

IPF Diplomas awarded 2009-10

Richard Day MGPA (UK) Ltd	**Neil Meikle** Standard Life Investment
Oern Greif BNP Paribas	**Tatiana Remakova** MGPA
Spencer Howard Ignis Asset Management	**Alan Roberts** Standard Life
Aaron Hulait Segro	**Alvin Sicre** KPMG
Sanya Joubert USS	**Tom Sullivan** Deloitte
Marrit Laning ING Real Estate	**Paul Wylie** Ignis Asset Management
Bryan Lewis British Land	

John Gellatly (IPF Chairman), Spencer Howard and John Story (IPF Academic Group Chairman)

IPF Diploma Alumni

The first IPF Diploma Alumni Drinks Reception was held on 6 April. The event was kindly hosted by Nabarro and, as **John Story**, Chair of the Academic Group explained, "the intention is to hold a similar event annually from now on".

Research Programme

The 2011-15 Research Programme has now been funded and will be launched formally in May 2011.

IPF Vision

The IPF Vision is currently under review, an exercise last undertaken in 2005-06.

We would welcome members' views on:

What are the big issues that currently affect, and in the next three years will affect, the property investment industry?

What do you think the IPF should be doing about these issues?

Assuming that we cannot do everything, what do you think the IPF priorities should be?

Please email all responses to Sue Forster sforster@ipf.org.uk

Future dates for your diary

Annual Dinner 2011
Wednesday 22 June 2011, The Grosvenor, Park Lane, London

Midlands Annual Dinner 2011
Thursday 6 October 2011, The ICC, Birmingham

Annual Lunch 2012
Friday 27 January, The Hilton Park Lane, London

IPD/IPF Property Investment Conference 2011
24-25 November, The Grand Hotel, Brighton

Retail Distribution Review update

Charles Cattell, Partner, The Cattellyst Consultancy

As many members are no doubt aware, the Retail Distribution Review's (RDR) professionalism requirements are now almost finalised. These requirements only apply to those individuals who offer retail investment advice – they do not apply to those whose retail activity is restricted to the management of investments.

To comply with the RDR, all advisers will have to:

- Take new or upgrade existing qualifications to meet the new standards by the end of 2012;
- Commit to an ongoing programme of 35 hours CPD each year in relation to their advice activities (even if this forms only a minor part of their role);
- Obtain a Statement of Professional Standing (SPS) from an accredited body from the end of 2012.

Most members who are impacted by these changes are likely to have been planning for them for some time. If any members have not yet resolved how they will meet the qualification requirements, they should address this without delay. Both CISI and CFA UK are offering a variety of routes to RDR compliance, including new qualifications and upgrading through gap-fill. Further details are now available from the awarding bodies.

All advisers will have to hold a SPS from an accredited body. CISI and CFA UK (amongst others) are understood to have applied to become accredited bodies, though this will not become effective until September at the earliest. The SPS will be required from the end of 2012 and will need to be renewed annually. Advisers will have to apply through their firms to their preferred accredited body for their SPS. They will have to confirm that they have complied with the Approved Persons Code and completed the required amount of CPD. The details about how this regime will deal with those changing roles and taking career breaks are yet to be finalised.

Although accredited bodies may offer CPD learning opportunities and CPD tracking, they will not be allowed to dictate the CPD which individual advisers must carry out. These decisions will ultimately be at the discretion of firms. While the IPF has no plans at present to apply to be an accredited body, it intends to continue to offer CPD opportunities that will be relevant and appropriate to those members who act as retail advisers.

If you would like further guidance about RDR issues, please contact Sue Forster at the IPF or the author.

IPF/PDIG Property Derivatives Trading Game 2011

Will Robson, PDIG Chairman

The end of March saw the closing event of IPF/PDIG's Property Derivatives Trading Game. For eight weeks 58 teams made up of around 260 individuals from all over the property investment industry fought it out to make the most money from trading hypothetical property derivative contracts. Teams were drawn from all areas of the industry from fund management to lawyers, agents to prop-cos with a couple of property derivatives experts thrown in for good measure.

Whilst it was designed to be a bit of fun, education was the real name of the game. Although many members of the IPF have listened to numerous seminars and conference presentations about derivatives and may genuinely feel like they know all they need to know about the subject, I have found that whilst these events are always useful, this passive approach does not quite cut it in raising consciousness to a point where people are ready to trade for real. Without sitting down and actively having to think about a derivative trade – the strategy, pricing, and resultant performance – it is hard to get properly engaged with the subject and to reach a level of understanding that provides enough confidence to reach a sufficient level of understanding. The game was designed to address this issue in particular.

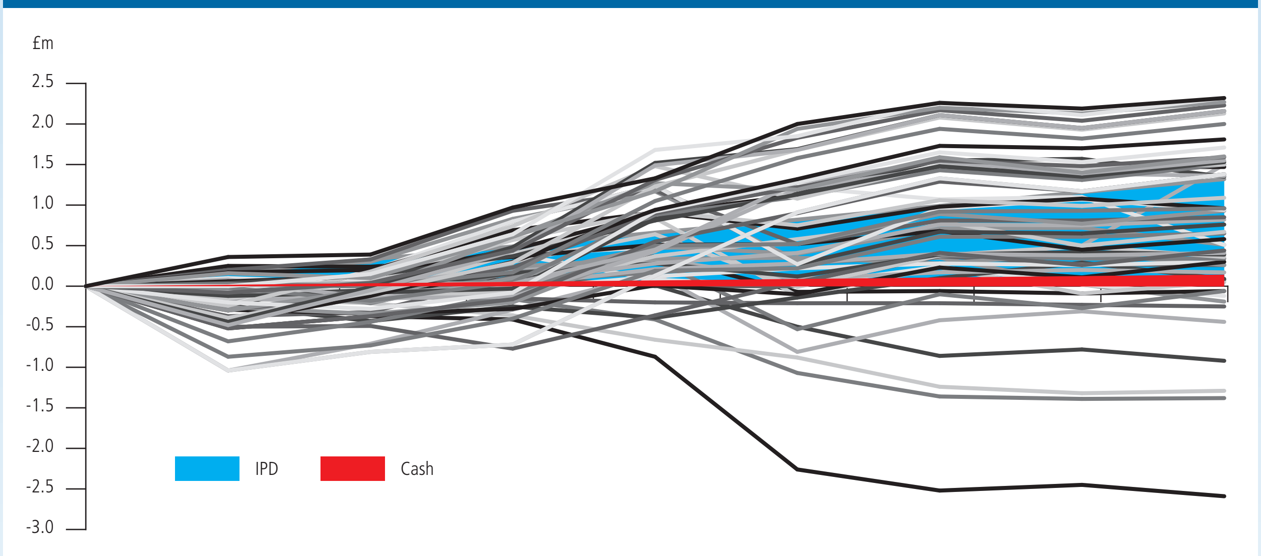
Things were kept very simple. Trading was limited to the IPD All Property Index and limits placed on how long or short players could take. Participants were encouraged first to examine derivative pricing and place trades to implement their strategies. Their portfolios were then marked-to-market each week to illustrate how derivative valuations move and allow players to place new trades to optimise their exposure.

Initially traders very simply compared implied breakeven returns from the derivatives market with their own view of future returns in order to devise a trading strategy. Whilst this approach might be sufficient and appropriate for short-term trading strategies associated with an eight-week trading game, it is arguably less appropriate when considering property derivative use in the context of property fund management. A more considered approach is to compare derivatives with the other alternative property investments and most simply an IPD style return. Analysis tools along this line were introduced mid-game to help participants think in these terms about how derivatives might apply to their own real funds.

The winners were 'CBRE/GFI' with a total profit of £2.32m over the eight weeks. Whilst CBRE/GFI won the main prize, on a risk adjust basis 'PD Trading' from Savills had the best result. Although they made 37% less profit than the winners, they took only 23% of the exposure that CBRE/GFI have. Whilst 'The Worthless Options' from Aviva were not so successful at derivatives trading, they won the best name prize!

PDIG took a straw poll of participants' views of what issues would need to be addressed to convert them from hypothetical traders to actual traders. We will be working on addressing these issues over the coming months.

Performance of the teams



IPF Investment Property Forum

UNIVERSITY OF CAMBRIDGE
Professional Studies

Investment Education Programme

Invest in your future

The IPF programme, run by the University of Cambridge Institute of Continuing Education, was established to provide the opportunity for busy professionals to study property investment and finance. Since its launch in 1999, over 500 individuals, from a wide variety of organisations, have participated with more than 150 completing the seven full modules and gaining an IPF Diploma.

The programme modules are:

- Investment Valuation & Portfolio Theory
- Financial Instruments & Investment Markets
- Property Investment Appraisal
- Property Finance & Funding
- Indirect Property Investment
- International Property Investment
- Portfolio Management

Applications are being accepted for the 2 remaining modules in the 2010-11 cycle.

Dates for the 2011-12 Investment Education Programme cycle are available online.

For more information or to discuss your professional development requirements, please contact the Institute of Continuing Education:

Tel: +44 1223 760860

Email: profstudies@ice.cam.ac.uk

Website: **www.ice.cam.ac.uk**

IPF Investment Property Forum

8th Annual IPF Property Investment Conference in Scotland

Friday 3 June 2011

Radisson Blu Hotel
301 Argyle Street
Glasgow G2 8DL

Property by nature, property by investor

Leading experts consider:

- Prospects for UK economy – what will be the real impact of the cuts?
- What are the repercussions of the changing regulatory landscape?
- What is really happening in the property debt market?
- How do private equity objectives differ from those of institutional investors?
- How positive are fund managers about property?

Event Sponsors:

DUNDAS & WILSON

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8th Annual Conference in Scotland Timetable

08.45 – 09.15	Registration and coffee
09.15 – 09.35	Welcome and overview of the conference **Paul Findlay**, European Investment Manager, Scottish Widows Investment Partnership and IPF Chairman Scotland
09.35 – 10.05	External changes and their impact on the property industry **Phil Clark**, Head of Property, AEGON Asset Management and IPF Chairman elect
10.05 – 10.35	Economic challenges and opportunities **James McCann**, Economic Advisor, Group Economics, The Royal Bank of Scotland
10.35 – 11.00	Immediate questions to the panel Coffee
11.20 – 11.50	An institutional investor's perspective **Bill Hughes**, Managing Director, Legal & General Property
11.50 – 12.20	What attracts private equity to property? **Nick Berry**, Partner, Mountgrange
12.20 – 13.00	Questions to the panel
13.00 – 14.15	Lunch

To book

Priority will be given to bookings from IPF members.
IPF members are invited to attend the Conference and lunch at a cost of £135.
No VAT is chargeable.
Members must book and pay online – please visit www.ipf.org.uk

Non-members £245. Please contact Barbara Hobbs for a booking form on 020 7194 7926 or bhobbs@ipf.org.uk.

IPF Investment Property Forum

Annual Dinner 2011

Wednesday 22 June

Venue: **The Grosvenor House, Park Lane, London W1**

18:30 Pre-dinner drinks **19:30** Dinner | Black Tie

Guest Speaker: Sean Lock

Described by the Independent as 'one of the finest and most original comedians around today', Sean has won the Time Out Comedy Award and a British Comedy Award for Best Live Stand-Up.

Ticket price: £120 excluding VAT

£144.00 inclusive of VAT @ 20% per person (excluding wine and liqueurs).

To reserve tables for the Annual Dinner, contact **Barbara Hobbs on 020 7194 7926, or email bhobbs@ipf.org.uk** as soon as possible. Tables will be for 10 or 12 (limited availability of larger tables). Individual bookings can be made and, in this case, please indicate if you wish to join a table with specific people. All business associates and colleagues are welcome.

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

This event is kindly sponsored by:

Knight Frank

LanghamHall *the future of fund outsourcing is here...*

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