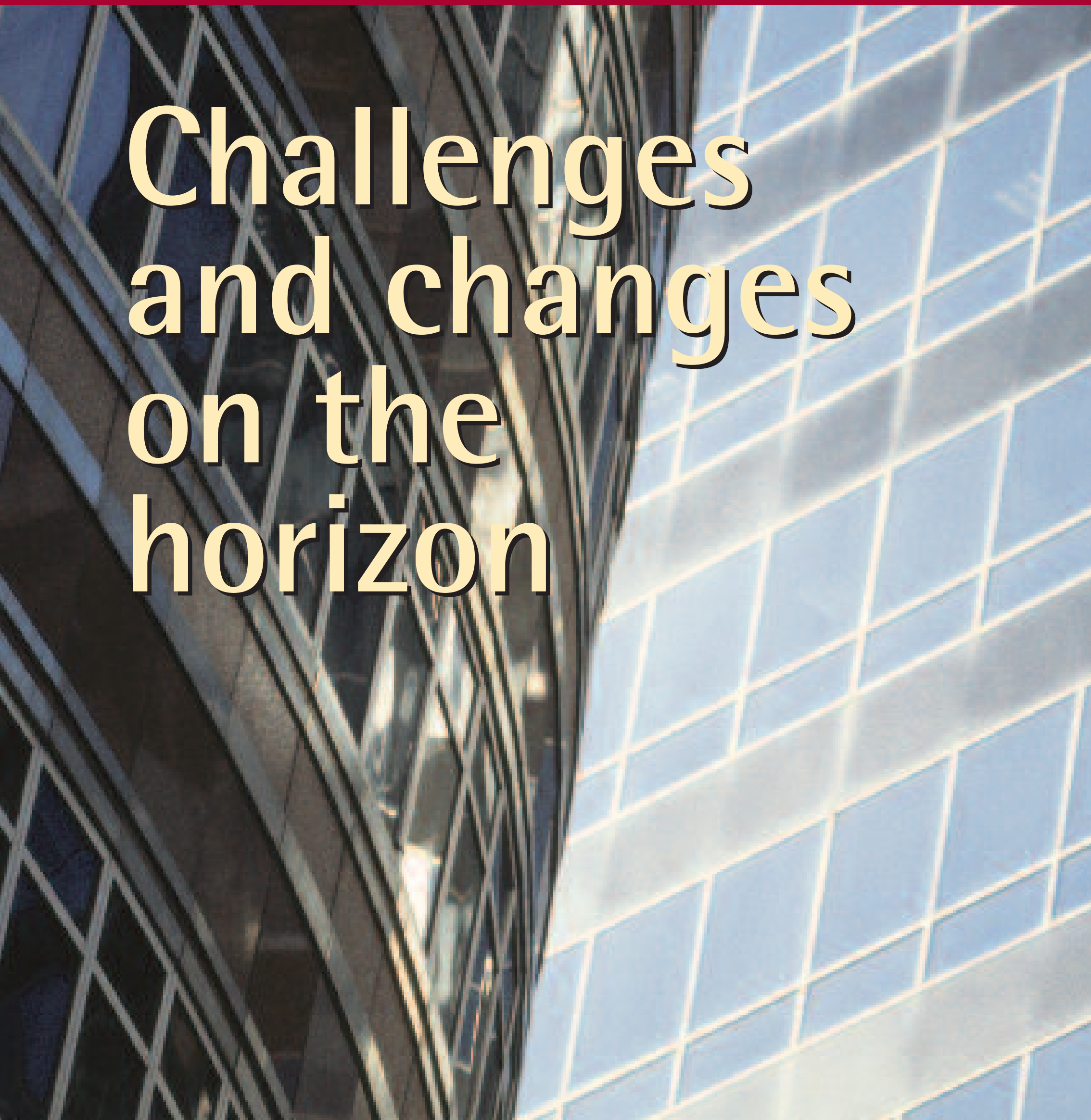
Investment Property Forum

THE JOURNAL OF THE
INVESTMENT PROPERTY FORUM
ISSUE NO. 2 OCTOBER 2005

INVESTMENT PROPERTY FOCUS



Challenges and changes on the horizon

In this issue:

From the editor

This edition of Investment Property Focus includes new perspectives on some of the underlying fundamentals of UK commercial property investment. One of the most prominent is the 'institutional lease', with provisions for upward-only rent reviews. Neil Crosby of the University of Reading provides an overview of the current state of lease reform, together with a timely reminder to the property industry that the threat of legislation on upward-only rent reviews and other lease issues has not gone away. In his view, Government monitoring and unfavourable market conditions may yet put greater pressure on the industry to change.

Traditionally, landlords have leased property on full repairing and insuring leases and then had very little ongoing communication with their tenants. The recent RICS Tenant Satisfaction Report, produced by Occupiers Property Databank (OPD) and Claes Farnell International, found that the UK property market scored lower than any other sector or country in comparable surveys. Satisfied tenants are more likely to renew their leases – a key consideration in the face of ever-shorter leases and an increase in the number of break clauses being exercised.

Liquidity risk is a central feature of the property market but one that is rarely analysed in detail. Dr Shaun Bond of the University of Cambridge looks at the risk factor over various holding and marketing periods compared with a benchmark investment represented by the IPD index. The research shows that the value of the marketing period risk factor falls over time.

The amount of debt finance available is key to the growth of the property investment market but have we reached a stage where the market is over borrowed? Dominic Reilly of Kingfisher Property Finance uses data collected since 1997 by De Montfort University to compare the size of the lending market with that of property market over the same period. He concludes that the problems created by over lending in the 1980s are unlikely to be repeated in the next few years.

A number of new developments in the market are also highlighted within these pages. In their article entitled, 'Comparing apples with apples', Phil Clark of Morley Fund Management and Neil Turner of Schroders summarise the debate regarding cost transparency in the non-listed property investment funds market. The two key issues are what fees and costs should be included in the standard metric and whether costs should relate to investment performance. Ian Reid of Protego and chairman of the IPF's Property Derivatives Interest Group (PDIG) continues the theme of developing indirect property markets with a review of the need for property derivatives and how the market for these instruments is developing; a survey by the PDIG found that 74% of respondents have an existing mandate to use property derivatives.

Karen McNicholls of Deloitte considers whether the UK REIT will render off-shore structures redundant. No clear conclusion can be drawn until the final form of the REIT is known but, should there be unattractive restrictions and tax inefficiencies, the industry's take-up of REITS could be threatened by the increasing use of offshore structures.

More information about these topics and details of ongoing research being undertaken by the IPF is included in the note of the Forum's activities and Announcements. If you are interested in contributing material to a forthcoming edition of Investment Property Focus, please contact Sabrina Wisner on swisner@ipf.org.uk – new ideas are always welcome!

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Comparing 'apples with apples' in the indirect property investment market

The newest members of the IPF management board, Phil Clark of Morley Fund Management and Neil Turner of Schroders, summarise the debate that is gathering pace across Europe regarding the fee transparency of non-listed real estate funds.

The property industry is in one of its most exciting periods of evolution. This is punctuated by the plethora of indirect property investment vehicles that have been established, particularly over the last five years. If the fund and asset managers of these funds can continue to offer attractive risk adjusted out performance then investor demand for these products should be sustained or indeed increase.

However, given it is their money, it is reasonable for investors to expect transparency as to how their money is utilised, not just in terms of where the money is invested but also the costs associated with that investment. And it is this aspect of non-listed European real estate vehicles that is the talk of investors and managers alike at present. Indeed, it was the central theme debated at INREV's (Investors in Non-listed Real Estate Vehicles) workshop in September and the IPF's evening seminar on 3 November.

Transparency around the costs associated with operating an indirect investment vehicle is a standard topic amongst equity and bond fund managers. Fund managers in these asset classes expect questions about what level of fees are incurred in the management of investment funds. Hence, the total expense ratio emerged as an industry standard i.e. the ratio of total operating costs to the average net assets of fund.

The challenge for the property industry therefore is to identify a standard metric for measuring costs incurred by non-listed real estate funds. The arguments revolve around a number of topics but in essence the two key issues are:

- What fees and costs should be included?
- Should these costs relate to investment performance?

It was quickly realised by all engaged in the debate that the costs and fees incurred at fund level vary between managers. Typically, fund level fees are the fund and asset manager, costs for the day to day management of the fund (e.g. for producing fund accounts, raising new equity etc). Property level costs and fees are usually those associated with property level activity (e.g. fees for rent reviews).

However, this practice varies among managers. Some include the cost of undertaking rent reviews as part of their fixed fee charged at fund level, others outsource it to third party advisors and a discrete charge is incurred at property level. Therefore, if a total expense ratio were adopted by the property industry then by definition it needs to identify fees at both fund and property level.

Perhaps the most hotly debated topic is whether a single metric designed to measure costs and fees is potentially misleading if it doesn't relate to investment performance. For example, a fund that has a low total expense ratio but underperforms its peers is less attractive than one with a high expense ratio that consistently outperforms its peers.

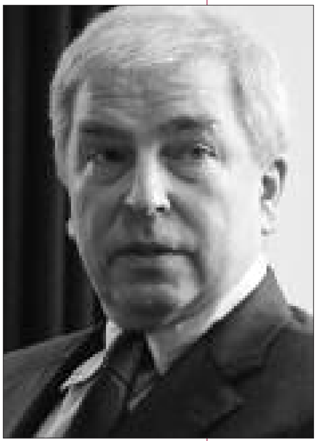
One point that most are agreed on is that transparency of the total fees and costs associated with a fund is a basic expectation of investors and a simple part of client service for managers. The challenge is to adopt a metric that has standard definitions that applies across all funds and which is seen in the context of performance. Not much then!

The IPF is staying actively involved in the debate and will keep members up to date with progress made.

Phil Clarke, head of specialist funds, Morley Fund Management

Neil Turner, head of research and international investment, Schroder Property Investment Management

Derivatives and the launch of the Property Derivatives Interest Group



Iain Reid, chairman, PDIG & CEO Protego Real Estate Investors LLP

"The time has come" the walrus said "to speak..." ...in many clichés. So here goes.
"Don't look a gift horse in the mouth!"
"Grasp the nettle!"
"Don't sit on the fence!"
"Don't miss the boat!"
...and so on.

These are the thoughts that flash through my mind when talking to investors in property about property derivatives in late 2005. The market is showing real signs of taking off to bigger volumes which will benefit investors more and more, but a much higher level of awareness and acceptance is needed in the industry if we are to achieve its full potential. In fact… "the more the merrier!"

First though, I should explain what the PDIG is about.

The birth of PDIG

Property derivatives are a hot topic for members of the IPF. The IPF has responded by creating the Property Derivatives Interest Group (PDIG), the first such spin-off from the parent organisation. PDIG grew out of the organisation known as the Property Derivatives Users' Association (PDUA), which was initiated by Paul McNamara of PruPIM in early 2003. The PDUA was a grouping of individuals from organisations with a particular interest in creating a derivatives market. Supported by a wide range of insurance companies, its primary mission was to persuade the FSA to change its opinion that property derivatives were 'inadmissible assets' for insurance companies. This was a major obstacle in the development of the intermittent market in property derivatives, which have existed since 1994. This objective was achieved in the Finance Act 2004, together with the secondary, but very important, step of obtaining clarification of the tax treatment of derivatives.

At that stage we felt that the function of the PDUA should evolve more into the realms of education, communication and support for the development of a market, core principles of the IPF, consequently the PDIG was created under the IPF's banner. We formed a small steering group, comprising myself as chairman, Paul McNamara, Amanda Keane and Charles Follows of the IPF, together with Graham Sargen of TD Securities (succeeded recently by Brett Townsend) and Colin Barber of Propex.

In setting PDIG's agenda, to achieve the educate, inform and support agenda, as well as to give a focus for individuals to join the group, we decided to create a website. This is becoming a reference point for property investment professionals, providing information about property derivatives and a news medium. Further information on the content of the site is set out later.

Joining is simple. IPF members can simply sign in using their existing details. However, we feel that encouraging the creation of a larger property derivatives audience requires a much wider membership. Consequently, a new facility is offered to non-members of the IPF to register at a charge of £50 per annum.

We are discussing with the BPF how this facility might be promoted to its members and have also obtained an enthusiastic response from IVBN, our sister organisation in The Netherlands, where interest is strong in this topic.

I should like to thank Tim Horsey, who undertook the creation of the website on behalf of PDIG and to its sponsors who make this possible. These are all former members of the PDUA and also contribute content to the website. They are TD Securities; Barclays Capital; Berwin Leighton; Paisner; Deloitte; Eurohypo; and Protego Real Estate Investors.

In the education field, PDIG is running property derivatives workshops, which were designed in collaboration with DSC, a company specialising in training in the financial sector, specifically for property professionals and those in allied professional areas. These workshops are fully subscribed and attended by a wide range of individuals including senior members of the investment community. Our next workshop is 29 November, email Sam Chappell: schappell@ipf.org.uk

PDIG's steering group also represents and promotes our cause through press relations, endorsement and participation in conferences and any other activity which we consider to be helping to push things in the right direction. We gave Rupert Clarke, of Hermes, a platform at the PDIG's launch on 16 September 2005, to announce the creation of his property derivatives trading forum, in collaboration with ICAP and CBRE GFI, which successfully launched in October. We are providing full details on the PDIG website under PD Trading Forum.

The opportunity that is open

In talking to property investors about property derivatives, certainly until recent times, many have felt that they have 'managed perfectly well without them in the past', and that they are 'a needless complication'. Furthermore, they 'do not have time to learn about them'.

These are delusions! We have most decidedly not managed perfectly well without them in the past, since the inability to get in and out of markets or segments of markets, quickly and cheaply, has bedevilled the lives of investors, trying to defend property's place in asset allocation – against cash as well as a variety of other assets – and frustrated them from achieving in performance what they had forecast to happen.

So, while it does introduce a little complication, property derivatives are certainly not beyond the scope of any professional investor to embrace and presents a real extension of traditional investment strategies.

But, as if this were not enough, they avoid all traditional property transaction costs! This represents an enormous cushion in pricing between the parties, which can work to everyone's advantage.

What do they do? And what would I use them for?

These are the fundamental questions upon which the PDIG website provides extensive information. However, in simple terms, the instruments enable property investors to transfer market risk, in the shape of the IPD Index at all property or at segment level, between each other.

At the present time, this is commonly done on the 'sell' side, and in some cases on the 'buy' side, by a non-cash instrument known as a total return swap (TRS), for which the total return of the relevant index is exchanged for a rate of interest of LIBOR plus a specified margin. On the 'buy' side, property index certificates provide an alternative form of synthetic investment by a cash investment in eurobonds, providing the same return profile.

These or other related synthetic methods of trading property are the only way to 'hedge' an existing property portfolio or cash holding, i.e. to maintain the same assets but to either reduce or increase the exposure to the relevant property market.

The enormous attraction of this facility for holders of cash, normally pending investment in real property, but sometimes strategically, is obvious. At least one holder of property index certificates acquired in early 2005 has sold for cash, on a few days' notice, and the bonds were recycled to new owners. In the meantime, the investor realised the capital appreciation of over 5% in the market and collected the income return. The original premium paid was protected in the selling price, the only cost being a narrow spread.

For those on the 'sell' side, the ability not only to implement a strategic or tactical decision almost immediately, but to maintain their full asset base, thus avoiding the costs of sale and reinvestment, is very compelling.

The reasons why the holder of assets may wish to hedge, include the following:

- An investment market call – currently there is a range of views amongst investors as to whether the market is fully valued, over valued, heading for a fall or offering good value and this is consequently a time when just this reason for trading in derivatives comes into focus.

- Reallocation of capital – many investors are positive about the strategic place of property in their portfolio and do not necessarily believe that its value is going to fall, but may wish to reallocate capital tactically to other asset classes. Derivatives are tailor-made for this purpose.

- International or sector redistribution – within the capital allocation to property, it could well be that an investor wishes to diversify into other markets, without disturbing the domestic asset base, or, within the portfolio, to redistribute amongst the main sectors. These objectives can represent monumentally ponderous and expensive processes if effected through direct investment, while derivatives can achieve this within days or weeks.

- Alternative source of financing or alpha enhancement strategy – these are two sides of the same coin. The fact of trading out the market exposure from any property portfolio reduces the need for capital (either equity or debt) and has the effect of gearing up the excess return, which an expert manager can create from his assets. In other words, the full value added is a return upon the net equity exposure.

It may be the case, in the past, that investors could grasp this intellectually but were unwilling to be pioneers and find themselves isolated. We have gone beyond this stage, and in my view liquidity is now, as with most things, a matter of price.

Is it really that simple?

For the most part, the thinking processes are familiar, but the execution is different from the normal territory for property investors.

The main essential is to think through the pricing issues. These include those to consider in any property investment, for example, the current yield level, the outlook for future growth and expected volatility of returns. The new factor is the defined time period concerned. Trades were done in the past for periods of between one and seven years, but currently, three or four years is common.

The extension of this is to fully appreciate the 'sell' position as well as the 'buy' position.

Executing a trade is done through one of the banks or brokers who are active in the area and if you do not know who these are, reference to the PDIG website should lead you in the right direction. Before doing this, however, you must clarify all internal procedures, principally those in the back office.

In fact, the IPF is developing another workshop specifically on this issue.

To what size can the market grow?

This is often discussed. Simply, I do not think that anyone knows. There are several important differences between property and other asset classes, but the range of unlikely assets, which support large established derivatives markets, is well known.

I do not believe there is a finite size of market or timescale in which we must get there, which determines the success or failure. However, it will certainly disappoint if the market does not grow steadily to at least provide an accessible facility for investors in which they can trade a growing number of countries at all property and segment levels, or that it takes so long to get there that interest wanes. Given the current level of real interest which has emerged in the UK and in some other countries, I am confident we shall reach this goal.

To return to my early theme…
"Great oaks from little acorns grow…"!

www.propertyderivatives.co.uk

IPF research: The readiness of the UK property investment market for property derivatives: September 2005

In order to assess the readiness of the UK investment market to use property derivatives, PDIG (Property Derivatives Interest Group, see previous article) undertook a postal survey in July and August 2005. With the help of IPD, whose assistance is gratefully acknowledged, a questionnaire was sent to the principal contact at contributors to the IPD Annual Index.

Executive summary

There is strong support for the emerging property derivatives market from existing property investors. Many investors already trade or are actively preparing to trade a property derivatives contract, with 74% of respondents having the mandate to enter into contracts. However, there remain concerns about the liquidity and the availability of contracts.

Investors are aware of the many ways of using property derivatives, with tactical asset management the favoured use by 94% of respondents. Short term cash hedging is also a favoured use. Investors clearly want the market to evolve from contracts solely on the IPD All Property Index, to those based on IPD segment specific contracts, enabling them to undertake tactical asset management.

The responses

The questionnaire was sent to 100 individuals identified by IPD as the contacts at the contributor organisations. Responses were received from 29 organisations representing just over £58bn of property investment. This is approximately 48% of the IPD universe. PDIG is satisfied that the responses are reasonably representative of the UK investment market. Proportionately more responses were received from large insurance companies than smaller investors, especially pension funds. PDIG acknowledges that responses are more likely from individuals/organisations with interests in property derivatives.

The analysis is weighted by the portfolio capital value of the respondent relative to the total portfolio value of all respondents, unless noted to the contrary. This is more representative than using numbers of respondents, as it is the bigger investors, with the larger portfolios, that are more prepared for property derivatives. These large investors with big portfolios have significantly more influence on the property market. Not all respondents answered all questions, so some percentages do not sum to 100%.

Of the £58.1bn of capital, some £31.4bn (54%) was from managers and the remaining £26.7bn (46%) was from owners.

The results

Existing mandate to trade derivatives

The survey shows larger investors are embracing property derivatives enthusiastically and have either entered into contracts or are likely to do so. A large majority have the authority or mandate to use property derivatives. Most of those without authority, a majority are taking active steps to obtain it.

Figure 1: Respondents

	Insurance company	Pension fund	Property unit trust	Property company	Other
Number	7	11	2	4	5
Asset value (bn)	£25.2	£6.3	£3.0	£19.8	£3.9
Percentage	43%	11%	5%	34%	7%

- 74% have an existing authority or mandate to use property derivatives.
- Of those without a current mandate, 91% are willing to recommend the use of property derivatives, while 70% intend to seek authority by 2007.
- 63% are actively preparing to use derivatives.
- 52% are already entered into a total return swap.
- 24% are invested in property index forwards (PIFS).
- 23% are invested into property index certificates (PICS).
- Based on a limited number of responses (11), investors were equally as likely to go ‘pay’ (sell property exposure) as to go ‘receive’ (buy property exposure).
- Based on a limited number of responses (9), those representing £37.2bn of capital will hold a derivative contract to maturity rather than seek to trade the contract.

Barriers to using property derivatives

The survey asked about possible barriers to the use of property derivatives. Some 21% cited concerns about accounting treatment, while 17% cite internal organisations and systems.

There is strong support for contracts for the IPD segments (discussed later), 13% of respondents mentioned some concerns about the suitability of the IPD segment indices. The survey does

Figure 2: Barriers to using property derivatives

Outstanding issues for using property derivatives in the portfolio	YES	NO
Investment management agreement restrictions	9%	77%
Understanding of the FSA regulations	12%	74%
Tax treatment	12%	74%
Accounting treatment	21%	65%
Concerns over IPD Index – all property level	6%	81%
Concerns over IPD Indices – segment level	13%	73%
Perceived competence/understanding	11%	76%
Actual competence/Uunderstanding	15%	73%
Internal organisation and systems	17%	70%

explore the reasons for these concerns. However, discussions with investors in other contexts raise concerns about the limited size of, or concentration of ownership in, some segments most noticeably when some geographical split is also introduced. These concerns are most likely focussed on the smaller segments and are unlikely to affect the five principal segments: retail warehouses, standard shops, shopping centres, industrial and offices, or major sub markets such as West End offices and City offices.

Respondents ranked, on a scale of 1 (no knowledge) to 10 (good understanding), their assessment of their understanding of property derivatives and their uses. The un-weighted score was 5.8, but the capital weighted score was 7.3, clearly showing that the larger investors are more confident in their understanding of and ability to use property derivatives.

We also invited respondents to identify additional issues of interest. A number had concerns about the limited information on liquidity and availability. However, as property derivative contracts are over the counter bilateral agreements rather than standard contracts traded on a regulated exchange, it is difficult to publish this information. PDIG is aware that many parties in existing contracts believe their trades are commercially sensitive and are insisting on confidentiality for their identity and terms.

Reasons for using derivative contracts

With one exception, a small pension fund, all respondents favoured IPD Segment contracts alongside All Property contracts.

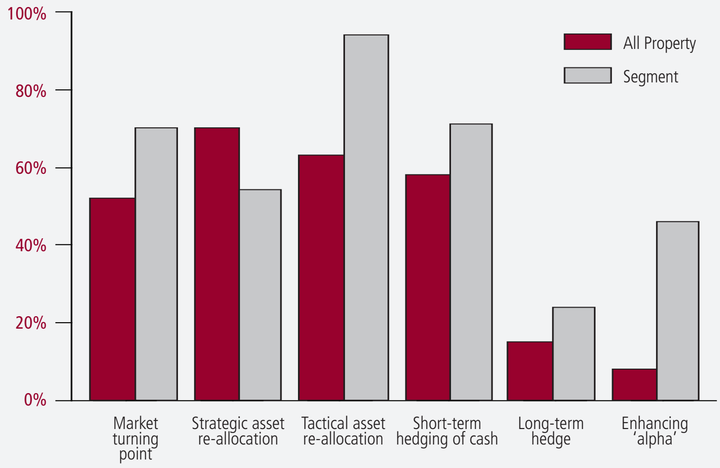
From Figure 3 it is clear that respondents intend to use property derivatives for a range of sound portfolio management reasons. At an All Property level the dominant reasons are strategic asset allocation and tactical asset allocation – to shift the property weighting relative to other asset classes. Short term cash hedging and 'calling a market turn' is a popular use for all property contracts, as indicated by more than 50% of respondents.

Few seem keen to use derivatives as a long-term hedge – i.e. to obtain or cover long-term property exposure. Alpha enhancement strategies are favoured by only 6% of respondents, and rejected by 83% of respondents at the all property level.

Figure 3: Reasons for using a property derivative

Reasons for transacting a derivative	In the IPD All Property index		In an IPD Segment indices	
	YES	NO	YES	NO
Calling a turn/plateau in the market	52%	36%	70%	19%
Strategic asset re-allocation	70%	22%	54%	36%
Tactical asset re-allocation	63%	25%	94%	1%
Short-term hedging of a cash position	58%	32%	71%	17%
Long-term hedge	15%	72%	24%	63%
Enhancing 'alpha'	8%	83%	46%	42%

Figure 4: Reasons for using property derivatives; comparing use at the 'IPD All Property' and 'IPD Segment' levels



At a segment level, the clearly favoured reason, by 94% of respondents, is tactical asset allocation. This allows a property portfolio manager to adjust segment weightings to take advantage of their view and forecast for the prospects for the segments. For example, if they believe that shopping centres are in for a poor couple of years rather than sell the actual shopping centres? Costly, time consuming and hard to replace when views change – the portfolio manager might consider writing a shopping centre derivative contact of two years tenor.

Interestingly, 46% of respondents are confident in their asset management skills and will consider alpha enhancement strategies. This is balanced by 42% declining alpha enhancement strategies.

Offshore alternative to a UK REIT?

Karen McNicholls, director, Real Estate Tax, Deloitte

Karen McNicholls of Deloitte and member of the IPF CPD Committee, explores alternatives to a UK REIT.

For years the property industry has been appealing for a tax efficient holding vehicle for investment property. The industry is now working with the Government to achieve a vehicle that allows investors to be taxed as though they have a direct investment in property and for their interests in the vehicle to be readily transferable in a similar way to property company shares. Most of the world's major economies already have some form of REIT vehicle. If the UK REIT does become reality, it will only be widely adopted if it fulfils investor demands.

So what are the alternatives? Investment through unit trusts and partnerships are common routes to replicate direct investment but these do not necessarily tick all the boxes in terms of tax efficiency, liquidity and so on. Holding shares in a tax-efficient corporate structure can go some way to addressing these issues. In fact, the last eight flotations in the real estate sector have been on the Channel Islands Stock Exchange, worth £3bn in total. These vehicles are becoming increasingly accessible to the retail investor, particularly the sophisticated investor. If the final form of a UK REIT involves unattractive restrictions and tax inefficiencies, these offshore structures could represent a threat to the industry's take-up of REITs.

This article considers the key tax features of an offshore structure and the tax treatment for individual investors.

Features of the structure

A Jersey (or Guernsey) company with its shares listed on the Channel Islands stock exchange is formed to act as a holding company. Property investments are then acquired by Jersey subsidiaries of the holding company. The structure could also acquire interests in offshore unit trusts or limited partnerships. The holding company maximises the flexibility of its future exit route for individual investments by owning the properties through subsidiaries rather than directly because it can choose to sell the shares or the property.

Any capital gains realised by the holding company or its subsidiaries on the disposal of shares or properties should be exempt from UK tax on capital gains and will not be taxable in Jersey. Similarly, dividends paid by the subsidiaries to the holding company should not attract tax in the UK or Jersey. Net rental income, after the deduction of allowable expenses and finance costs will be subject to UK income tax at 22%. Ultimately, this could leave profits available for distribution in the holding company that has suffered minimal tax leakage.

It is essential that the properties are acquired for investment rather than for on-sale (otherwise the profits could be taxed in the UK at up to 30%) and that the companies are all managed and controlled from Jersey rather than the UK. This means, for example, that the majority of the board of directors should be non-UK resident and that management is not undertaken behind the scenes in the UK with the Jersey board merely rubber stamping decisions.

This is a major practical issue. A UK REIT would be managed from the UK so that the full expertise of the senior management of our property companies and other UK-based investment houses can be brought to bear. A Jersey company can access local expertise, but the pool is much smaller. It would generally appoint a UK-based property manager, but this leads to a leakage of profits out of the investment structure, not least because there will be a double layer of Jersey and UK management activities and infrastructure. There can also be issues with tax-deductibility of interest if gearing levels are very high, depending on the arrangements that give rise to this.

The tax-efficiency of the structure relies on these factors. In this respect an investor is placing reliance not just on the vehicle making good investment decisions, but also on the structure being operated so as to manage tax risks.

Taxation of the UK investor

The investor will hold shares in the Jersey company. Profits will be extracted either by selling the shares or on distribution of profits by the company. The shares should qualify as SIPP and ISA-able.

A UK investor will be subject to capital gains tax on a disposal of shares in the same way as if he disposed of shares in a UK property company. His annual exemption is available to shelter the first £8,500 of gain, with the remainder being taxed at 40% (for a higher rate taxpayer). Dividend income will be taxed at 32.5% for a higher rate taxpayer.

There are a number of anti-avoidance tax rules that need to be considered. One example is where the Jersey company is 'close' – where five or fewer persons taken together have an interest in the company which effectively gives them control of it (i.e. over 50%). Adverse tax consequences arise for anyone with greater than a 10% shareholding. In principle, tax anti-avoidance rules will probably be much less of an issue for any UK-based REIT, though there will probably be restrictions to prevent REITs having certain ownership profiles (e.g. being closely held).

Conclusion

In terms of the ultimate after-tax return on investment, no meaningful comparison with a UK REIT can be made until the REIT proposals are clarified. Even then, different investor profiles must be taken into account and it is unlikely that even a benign REIT would render offshore structures redundant.

For assets currently owned by a UK property company, transferring these into an offshore structure could be more costly from a tax perspective than transfer into a UK REIT, although this depends on the level set for the 'entry charge'. Offshore structures have been available for a long time, so a sudden rush to convert an existing UK investment business to become an offshore one is unlikely. It is, however, more realistic to establish an offshore structure for newly-acquired investments and it is in this context that the choice between a REIT and an offshore structure could be more marginal.

The customer is king: a 21st century approach to driving real estate performance

Christopher Hedley, managing director of the Occupiers Property Databank (OPD), recently collaborated with Claes Farnell International (CFI) to produce a survey of tenant satisfaction for the RICS, which achieved considerable press coverage and was the subject of a recent IPF lecture.

Christopher Hedley believes that dissatisfied tenants could be costing property investors as much as £2bn per year. The RICS Tenant Satisfaction Report gives some pointers to the areas where things are going wrong.

At present, landlord and tenant positions are quite entrenched. Many tenants feel the space being provided to them fails to match their business needs. Sometimes this is unrealistic, but the perception remains. Inflexibility and difficulties in controlling the size of the estate and therefore costs, are a constant problem, especially for American companies operating in the UK. They see little after-sales care, while service charges are difficult to forecast. The role of managing agents, who are paid for by tenants but work for investors, is contradictory.

Hedley believes that customer satisfaction should be recognised more explicitly as a part of what the owner is providing. Leases are shortening all the time, and less than half of tenants renew their leases on expiry. Break clauses are at a record level, with 22% exercised over the last year, and by the end of the year more than half of the units affected remained empty. This is a particularly serious problem in the office sector. Vacancy means refurbishment, extra management costs, void losses, letting fees, and perhaps damage to the landlord's reputation. According to IPD, the income for UK properties lost through voids was 7.3% of ERV in 2004, with particular issues facing City offices and office parks. Standard industrials, shops and retail warehouses are more healthy. The average length of a vacant period is about 14 months, while at the end of the vacant period the rent achieved is generally lower than that which would have been achieved for a lease renewal.

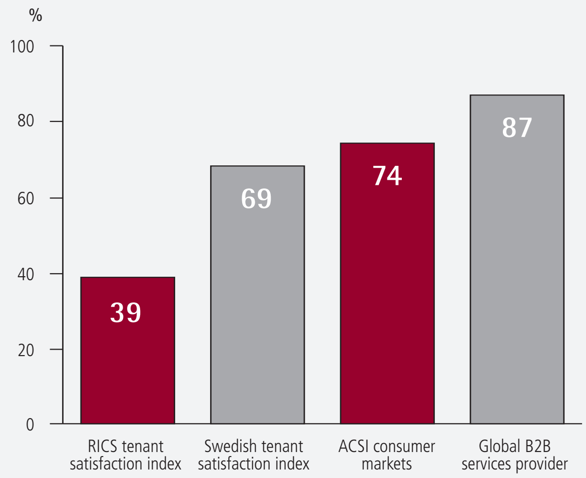
This does not necessarily mean that if you look after your tenant they will always renew, as business circumstances can also change, but at the margins some tenants must be leaving because of poor service. A rough calculation suggests that the cost of this increase in voids may be as much as £2bn per year.

In this context it is important to measure the level of tenant satisfaction in the UK property industry, as well as the change in tenant satisfaction from year to year. The survey undertaken by the CFI Group and sponsored by the RICS was independent and its results were placed in the public domain (see Figure 1).

The survey included 20 in-depth interviews with senior market figures, across all sectors of the market, to establish a basis of credibility and accuracy for the rest of the survey. Most of the respondents to the second, quantitative stage of the research were large tenants of the kind that landlords would be expected to service most attentively.

In 2004 the tenant satisfaction index scored 39 for the UK property market, lower than for any sector or country covered by similar surveys around the world (see Figure 1). The equivalent figure for Swedish property averaged 69 over the last six to seven years, and a figure of 74 was registered by US consumer industries. CFI looked at property as just another industry. Other research by the organisation has shown that in many industries higher customer satisfaction tends to mean better returns for shareholders.

Figure 1: Tenant satisfaction 2004



The survey linked tenant satisfaction to drivers, identified by the original 20 interviewees. These drivers were then rated in terms of their influence over tenant behaviour in loyalty or recommending landlords, and perhaps more importantly in how their improvement could raise tenant satisfaction. CFI considered this through an impact assessment. For the UK, communication was identified as the most important area of the landlord-tenant relationship for improving satisfaction. Although lease inflexibility was identified as the most unpopular component underlying tenant dissatisfaction, improvements in this area were less likely to improve overall satisfaction levels.

Poor landlord communication included a failure to seek occupiers' opinions, a lack of proactivity and availability, and untimely response to queries. Scores for all of these factors were low. For lease flexibility and contract detail, the speed of agreeing leases and of adjusting them once agreed were key. On the issue of problem resolution, in theory an area where improvement should be easy, a number of practical aspects were identified: how quickly a malfunction is resolved, what the outcome is, the treatment by the facilities staff and ease of reporting.

Recent research by the Real Service Group (see below) and others has also shown that increasing tenant satisfaction will pay. Christopher Hedley sees process management and customer engagement as areas where investors need to identify the right level of commitment. Capping total costs is a possibility which should be considered seriously, as tenants never like risk and unpredictability; the introduction of gross rents is likely to come soon. The use of service level agreements could help clarify management arrangements. Budgeting for service charges and dilapidations is currently very difficult, and this is an area where landlords could inject a greater degree of certainty.

It is important to establish the link between customer satisfaction and investment return, which ultimately should be possible using data held by IPD.

Research by Kingsley Lipsey Morgan in the US has shown that property owners who look after their customers renew 12% more leases than those who don't. There is a direct correlation between property managers' actions and their tenants' level of overall satisfaction, based on research from 10,000 leases in the US and 1,000 leases in the UK.

The Real Service Group was established by 18 major UK landlords, including British Land, the Prudential and the Crown Estate, as well as some entrepreneurial smaller companies. The group aims to improve the standard of service to occupiers and to understand the link between service and performance. Members have therefore decided to measure themselves against a set of performance standards for adopting best practice.

Based on the first survey of these 18 firms, the average level of progress in adopting best practice was measured at 55.7%, with the most advanced participants achieving a score of 80 out of 100. This indicated a wide range of adoption of best practice. But in terms of customer service performance outcomes, a system of measurement has yet to be defined. Even for tenant retention rates, the industry has yet to establish universally accepted measures.

Peter Vernon, recently appointed investment director of Grosvenor, is responsible for the performance of its entire UK and Ireland portfolio, with a particular focus on the London estate in Mayfair and Belgravia.

Vernon believes that deep customer insight is important in delivering the right service to tenants. Service means both relationship management and delivering on promises. But if the landlord does succeed in providing the service expected by the tenant, will this actually improve the landlords' position? In any event, current developments in the facilities management business are likely to raise customer expectations.

The Grosvenor estate embodies a spectrum of service expectations, from long leases with relatively low service requirements, to short leases with relatively high service needs. This applies to both the office and residential parts of the portfolio.

The customers of the estate contain a high proportion of non-UK Western Europeans, and North Americans. There are also a large number of senior executives and corporate managers from the service industries. Some 900 businesses operate in office space on the estate, with an average of 18 employees. Many of these medium and small businesses are unlikely to have any in-house facilities management expertise.

In managing the portfolio, it is valuable to build up profiles of tenants as well as concentrating on the type of space they occupy. For example, affluent time-poor executives are likely to appreciate 24/7 help line and concierge services, restaurants and food shops that meet their tastes, and perhaps a transparent basis for service charges that shows them they are getting value for money.

Client relationship management means establishing a dialogue with the customer to understand their business or personal situation. This allows the manager to respond to their immediate requirements and also to create business opportunities. For the commercial customer this means understanding the underlying business, and how property contributes to that business.

Good service is also about delivery. This does not just imply service quality, but also ensuring that the services agreed are those actually required by the occupier. Some organisations are very concerned about minimising costs, while others would rather keep their staff happy whatever the cost.

The impact of service delivery on asset performance is not yet well understood. But is possible to identify those properties and tenants where best in class service is likely to contribute most through the impact on voids, better tenant retention and rent levels. These potential impacts vary across the portfolio, so it is important to prioritise efforts.

Competition in the facilities management business is intensifying due to a number of new entrants, and the industry is increasingly able to deliver consistently good service. Meanwhile the Government's use of PFI for its accommodation needs is helping to improve facilities management.

Guy Whitaker, business development director for Claes Farnell International, also stresses the need for landlords to optimise their service to tenants. This means that they should provide appropriate services for the charges being made.

Survey work in the US has shown that those companies which understand the linkage between service provision, customer satisfaction and business results have achieved significantly higher financial returns. Measuring these linkages is highly complex, but if done incorrectly may lead to substantial misallocation of resources. Right-izing service delivery is all important.

Presenters of this lecture:
Christopher Headley, director, OPD
Howard Morgan, managing director, Kingsley Lipsey Morgan
Peter Vernon, UK investment director, Grosvenor
Chair: Richard Barkham, UK research director, Grosvenor

Investment Property Forum

The IPF is delighted to welcome the following individuals to its membership.

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Mr	William	Allen	GVA Grimley
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Mr	Nigel	Almond	Jones Lang LaSalle
Mr	Mitchell	Ball	Hammonds
Mr	Gil	Bar	Morley Fund Management
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Ms	Helen	Barraclough	DLA Piper Rudnick Gray Cary UK LLP
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Mr	Nicholas	Blakemore	Prudential Property Investment Managers Ltd
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Mr	Timothy	Bowring	Citigroup
Mr	David	Brierley	Bridge Insurance Brokers Ltd
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Mr	Richard	Cooper	Bramdean Property Investment LLP
Mr	Michael	Cunningham	Scottish Widows Investment Partnership
Mr	Ian	Davies	Legat Owen
Mr	Rory	Davis	CBRE Investors
Mr	Marc	Davis	Summit Property Advisors
Mr	Richard	Deane	The Royal Bank of Scotland
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Mr	Stephen	Dingle	Ernst & Young
Miss	Tonianne	Dwyer	Quintain Estates & Development PLC
Mr	Andrew	Fairbairn	Fairbairn Wild

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Mr	Ian	Hally	Scottish Widows Investment Partnership Ltd
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Miss	Jane	Harrison	AXA Real Estate Investment Managers UK Ltd
Mr	Mark	Hayes	Colliers CRE
Ms	Natalie	Hayward	DTZ Research
Mr	Jim	Henley	Land Securities
Mr	Gunnar	Herm	Henderson Global Investors
Mr	Stephen	Hester	The British Land Company PLC
Mr	Andrew	Hicks	Capital & Counties PLC
Mr	Ken	Hillen	Anglo-Irish Bank Corp. PLC
Mr	Matthew	Hills	HDG Mansur
Mr	Rory	Houston	Oppenheim Property Fund Managers
Mr	James	Howarth	Abstract Land Ltd
Mr	Gawain	Hughes	Dundas & Wilson LLP
Mr	Dugal	Hunt	CBRE Investors
Mr	Peter	James	Tees Valley Regeneration
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Miss	Jane	Jeffery	CBRE Investors
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Mr	Philip	King	PLK Properties
Mr	Alan	Kirk	Buccleuch Property
Mr	William	Kistler	Urban Land Institute
Mr	Richard	Kolb	Oppenheim Property Fund Management
Ms	Anna	Lansberg	CB Richard Ellis Investors Ltd

With a membership of nearly 1700, the influence of the IPF continues to grow. We are also able to extend our range of services to ensure the expectations of our membership are met. All were invited to the recent Chairman's reception which took place on 5 October and was hosted by incoming IPF President, Sir David Clementi at the offices of Prudential plc.

Miss	Anne	Leckie	Standard Life Investments
Mr	Patrick	Lecomte	
Mr	Seth	Lieberman	UBS
Mr	Richard	Linnell	Land Securities PLC
Mr	Joe	Lister	Unite Group PLC
Mr	David	Lockyer	GE Real Estate
Mr	Christopher	Ludlam	Insight Investment Management Ltd
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Mr	Sid	Muir	Allied Irish Bank (GB)
Mr	Timothy	Munn	CBRE Investors
Mr	Chris	Mutch	PricewaterhouseCoopers
Mr	Julian	Naylor	Anglo Irish Bank Corporation
Mr	Michael	Ness	CBRE Investors
Ms	Sasha	Noble	CBRE Investors
Mr	David	Noble	CBRE Investors
Mr	Paul	Ogden	GFI Group Inc
Mr	Andrew	Ovey	Ernst & Young
Mr	Giles	Parker	MetLife Investments Ltd
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Mr	Steven	Redshaw	Morgan Stanley
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Mr	Matthew	Richardson	Experian Business Strategies Division
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Mr	Stuart	Spalding	Atisreal
Mr	Keith	Steventon	Atisreal
Mr	Neil	Sturmey	Grant Thornton UK LLP
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Mr	Nicholas	Taylor	DLA Piper Rudnick Gray Cary UK LLP
Ms	Kate	Temple	Campbell Hooper
Mr	Trishul	Thakore	Macquarie Capital Partners Ltd
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Mr	Roger	Thornton	Maples Teesdale
Mr	Brett	Townsend	TD Securities
Mr	Anthony	Tsang	CIT Group PLC
Mr	Christopher	Tucker	CBRE Investors
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Mr	Richard	Williams	Knight Frank
Mr	Mark	Wist	Property Investment Research
Mr	Richard	Wood	HSBC Private Bank
Mr	Andrew	Wood	Macquarie Global Property
Mr	John	Yeend	Northridge Capital Ltd
Mr	Ben	Young	The British Land Company PLC

Is the UK commercial property market over borrowed?

Dominic Reilly, director, Kingfisher Property Finance

The findings of this year's survey by De Montfort University on the size of the UK commercial property lending market was presented to the IPF in May, shortly after the release by the Cass Business School of the work they had undertaken on behalf of the IPF on the size of the UK commercial property investment market. This article looks at the growth of both the lending and investment market in UK commercial property since 1997 in order to address the question frequently posed by commentators as to whether the market is over borrowed, and consequently may suffer a repeat of the problems created by over lending in the late 1980s.

De Montfort University has undertaken an annual survey of the lending market secured on commercial property since 1997. The survey is based upon detailed questionnaires submitted to all of those active in lending to the UK commercial property market. The quality of the survey and the report has consistently improved, demonstrated by the fact that in recent years the survey has captured a high response rate.

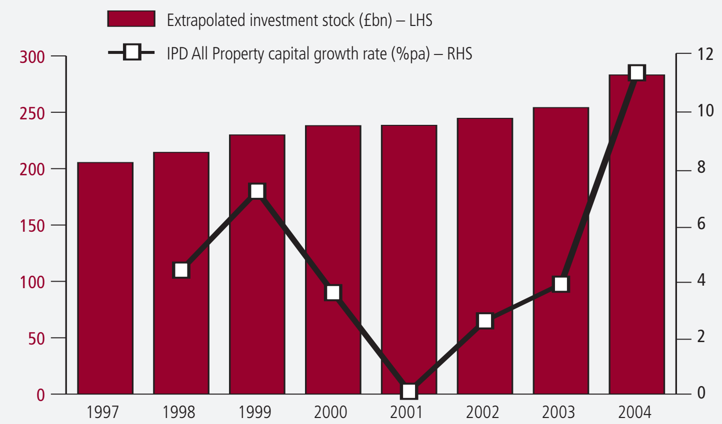
The estimated amount of outstanding debt secured on UK commercial property drawn from the De Montfort research is shown in Figure 1 for each of the years from 1997 through to 2004, together with the year-on-year growth rate in that level of debt.

As is seen, outstanding debt has increased year on year at an average compound growth rate from 1997 through to 2004 of 14.5% per annum. It is no surprise that people are questioning the prospective health of the market in face of this escalating debt.

Cass Business School was commissioned by the IPF to undertake research into the size of the UK commercial property investment market. Its findings were outlined in the last issue of this publication in June 2005. Drawing on data from the Office for National Statistics and the Investment Property Databank, Cass concluded that by the end of 2003, of a total UK commercial stock of £611bn, that £254bn represented the amount of commercial UK property in the investment market. However the survey did not address the size of the invested market over the time frame since 1997.

Figure 1: Estimated amount of outstanding debt secured on UK commercial property

Figure 2: Market size 1996 to 2004



In order to compare the size of each of the investment and lending markets since 1997 by applying the All Property capital growth rate recorded by the IPD, the size of the market from 1996 to 2004 can be extrapolated as shown in Figure 2.

While the growth rate in the investment market was more erratic than the consistently high growth rate of the lending market, Figure 3 overleaf, demonstrates how reassuringly the estimated size of the investment market is considerably bigger than the estimated size of the lending market, although the gap between the two has been narrowing.

This issue is considered in more detail by treating the UK commercial property investment market as a single entity with a known capital value, a known income yield and a known loan size, against which one can calculate both loan to value ratios and income to interest cover for each of the years included in the research.

Figure 3: Estimated size of investment and lending markets

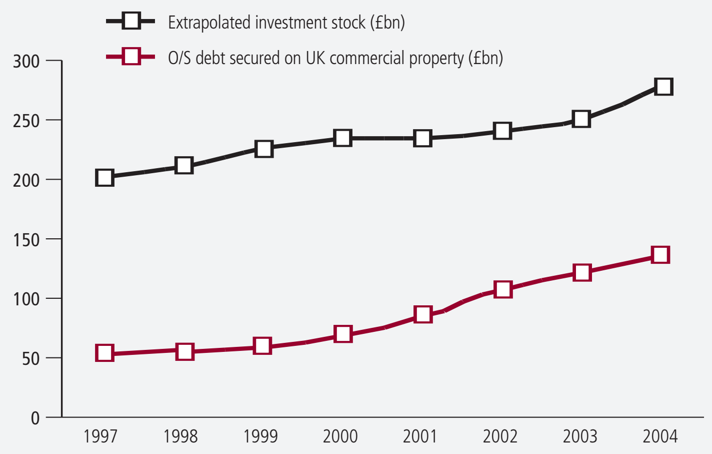


Figure 4: Market financial covenants

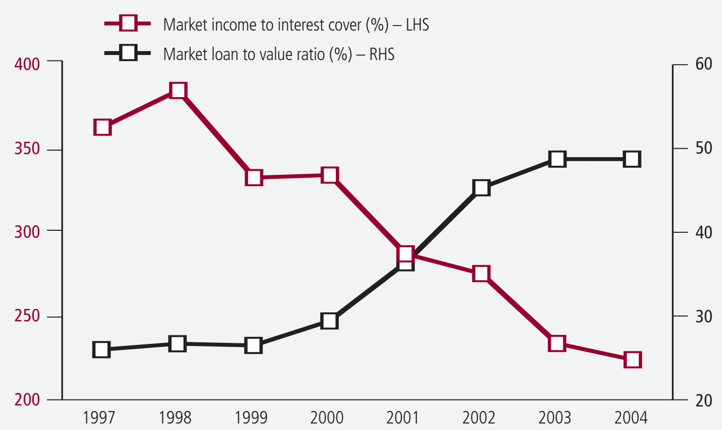


Figure 5: All Property total return for the market on a geared basis

Year End	1997	1998	1999	2000	2001	2002	2003	2004
All Property total return (% p.a.)	16.8	11.8	14.5	10.5	6.8	9.6	10.9	18.3
Market geared total return (%)	20.0	13.5	16.9	11.9	6.9	12.3	15.2	30.0
5 Year swap rate plus margin of 1% p.a. (%)	8.15	6.9	7.8	6.9	6.5	5.6	6.05	5.85

The loan to value ratio purely expresses the amount lent at the end of each year as a proportion of the estimated size of the investment market, as shown in Figure 3.

A calculation in respect of the same UK entity can also arrive at an income to interest cover. The income is calculated by taking the IPD income return in any one year and dividing that by the estimated interest on the amount outstanding by way of loans. To do this, the then prevailing 5-year swap rate plus an assumed margin of 1% was used as the cost of borrowing. The resulting market income to interest cover is shown in Figure 4.

This graph shows just why commentators are concerned about the growth in the market – since effectively the market has tacitly accepted a higher loan to value ratio but lower income to interest cover in each consecutive year since 1997. This is particularly so when one considers that a significant proportion of the UK commercial property investment market represents properties which were purchased with 100% equity and no external borrowings.

However, those people that borrowed in this time were rewarded with a higher return on their equity invested, illustrated in Figure 5.

It will show that for every year the market geared total return was higher than the All Property total return because the All Property total return was higher than the cost of borrowing. For so long as this prevails, geared investors are rewarded in the market, although a depressed horizon for total return expectations means that the benefits of borrowing are becoming less compelling.

At the presentation of the De Montfort survey in May, the issue of the growth in the commercial property lending market was debated, and the

Figure 6: Projected size of commercial property investment market

Year End	Projected growth rate	2004	2005	2006	2007	2008	2009	2010	2011	2012
Extrapolated investment stock (£bn)	4.7%	283.0	296.2	310.1	324.7	339.9	355.8	372.5	390.0	408.3
O/S debt secured on UK commercial property (£bn)	14.5%	137.0	156.9	179.7	205.8	235.7	270.0	309.2	354.1	405.6
Market loan to value ratio (%)		48.4	53.0	57.9	63.4	69.4	75.9	83.0	90.8	99.3
Market income to interest cover (%)		222.4	216.3	197.7	180.7	165.2	151.0	138.0	126.1	115.3

Figure 7: Projected size of commercial property investment market

Year End	Projected growth rate	2004	2005	2006	2007	2008	2009	2010	2011	2012
Extrapolated investment stock (£bn)	4.7%	283.0	296.2	310.1	324.7	339.9	355.8	372.5	390.0	408.3
O/S Debt secured on UK commercial property (£bn)	6.6%	137.0	146.1	155.7	166.0	177.0	188.7	201.1	214.4	228.6
Market loan to value ratio (%)		48.4	49.3	50.2	51.1	52.1	53.0	54.0	55.0	56.0
Market income to interest cover		222.4	232.3	228.1	224.0	220.0	216.1	212.2	208.3	204.6

audience largely concluded that the rate of growth is not sustainable. This is borne out in Figure 6 which projects the size of the commercial property investment market going forward by reference to the All Property capital growth rate of 4.7% per annum achieved from 1997 through to 2004, and then does the same for the commercial property lending market where the growth rate achieved from 1997 through to 2004 was 14.5%. Against this, and as before, the market loan to value ratio and market income to interest cover is also calculated.

Under this scenario, the rate of growth in the UK commercial property market would only be sustainable if the investment stock was added to by way of considerable new developments and the exploitation of new sectors. This was explored by Cass in its report and article in the June edition of **Investment Property Focus**.

However, it is reasonable to expect the debt market will not grow at this rate as borrowers' concerns about future levels of return will subdue their desire to borrow as much as they have done in the last five years. The lack of suitable opportunities to lend will also be a restraining factor. A more benign picture of what the market might look like through to 2012 is set out in Figure 7, where the rate of growth on UK commercial property lending is shown at a more conservative 6.6% per annum.

Whilst the market loan to value ratio still increases to an outstanding figure of 56% in 2012 this is not extraordinary, neither is the market income to interest cover at 204.6%.

In conclusion, the commercial property lending market may be threatened in years to come by three factors:

- Were the market to take a downturn, values could reduce and loan to value covenants may be challenged and potential events of default occur.
- Investors are accepting lower yields on the purchase of property and were interest rates to increase significantly then levels of income to interest cover would reduce. This would create less surplus rental income available for distribution to the borrower or for repayment of outstanding loans, putting further pressure on residual loan positions.
- The rate of growth seen in the lending market since 1997 is not sustainable.

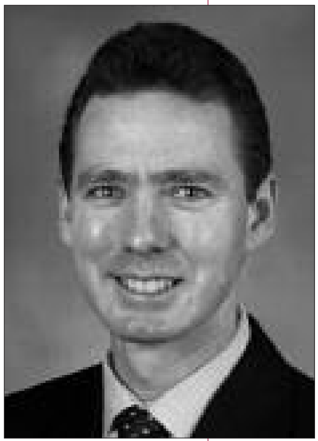
However, the author of this article, while being wary of the future direction of the market is reassured that the problems created in the market by overlending in the 1980s will not repeat in the next few years, because:

- A majority of lenders active in the market do so now through specialist centralised teams with credit committees who are prepared to keep a rein on aggressive lending offers.
- There is still a considerable reluctance on the part of lenders to finance speculative projects save in a few situations where the loan to value and loan to cost ratios are modest and with experienced developers.
- There is reluctance on the part of lenders to roll up or to defer the payment of interest.
- There is very often a requirement insisted upon by the lender for the borrower to hedge interest exposure over the life of the loan to protect them from the threat of higher interest rates.
- Many of those lenders in the market who are providing senior debt, are also now looking at the provision of junior debt and mezzanine finance where the higher returns that can be achieved are a better reflection of the risk involved.

Whilst there are still too many lenders chasing too few opportunities in the UK commercial property market, the factors referred to above are a restraint on their activity and the author predicts that the historic rate of growth in the commercial property lending market will fall to single figures and that the problems created in the late 1980's will not be repeat in the next few years.

This presentation was made at the IPF Annual Scottish conference in September 2005.

Should real estate investors worry about liquidity risk?



Dr Shaun Bond, University of Cambridge

Dr Shaun Bond, of the University of Cambridge, the module leader for the IPF's Advanced Education Programme's 'Advanced Portfolio Management', comments on further research he is exploring.

In speaking to investment strategists about the allocation of funds to real estate, three distinct views emerge when the issue of liquidity risk is discussed.

One group is ruling out investment in direct property (or non-listed vehicles) and focussing solely on listed property investments to gain exposure to real estate assets. These investors are concerned about the extended trading periods and the high costs of transacting real estate directly. Another group of investors may have a high allocation to real estate, believing that they may gain an 'illiquidity' premium for holding such assets. A middle-of-the-road group also exists who take the view that they are happy to hold a portion of the fund in direct real estate but limit the allocation to this area because of a general concern (often not well defined), that property is less liquid and more costly to transact than other asset classes. Hence, in the property market it is clear that some investors are worried about liquidity risk while others do not see this problem. This article reviews recent theoretical work on measuring liquidity risk in property markets and discusses the implications for investors.

Liquidity risk is considered a central feature of the commercial property market but is generally a poorly understood concept. Investors often have their own view about what constitutes illiquidity but when pressed to define it, the explanation generally revolves around a 'time on market' or 'time to sell' concept. This may well be one aspect of market liquidity but academic literature usually considers a broader set of definitions. The reason that it is hard to pin down the definition of liquidity is that it is an unobserved phenomenon. The best we can hope for is a set of proxy variables that capture the state of market liquidity at any point in time. In the finance literature, liquidity measures such as bid-ask spreads offered by market makers or transaction volume (or some variation of volume) are typically used because of the ease of collecting this information. However, such measures are more difficult to obtain in commercial property markets. Even if they could be obtained, it is not clear that they would be the preferred measures to use when considering the state of liquidity in property markets.

In order to address investor concerns about liquidity risk when investing in real estate and to develop a more informed debate on the topic, the IPF sponsored a report on this issue. The report, published last year, developed a set of research outcomes that can help property investors think about the issue of liquidity risk. It comprised five working papers covering different approaches to the problem, ranging from qualitative discussion and case study examples to more formal econometric and statistical research. A key theme of the report was the multi-dimensional nature of the concept of liquidity risk, and the need to go beyond measures used in other areas of financial economics to specifically develop information and models that are useful for investors in commercial real estate markets. This article revisits one of the key analytical models presented in the IPF report before discussing more current research findings and developments in this area.

Background

One must consider historical data on the performance of the commercial property markets in the UK. Figure 1 shows the mean and standard deviation for total monthly returns of the three major asset classes that UK pension funds typically invest in.

Figure 1: Monthly average returns for UK domestic assets

	Commercial property (IPD UK)	UK equities (MSCI)	Govt bonds (Datastream)
Mean	0.72	0.73	0.76
Standard deviation	0.69	4.19	1.61

From the table, it shows that the average monthly return over the last 15 years were essentially identical for each of the asset classes. The main difference is in the level of total risk faced by an investor. The historical standard deviation of commercial property returns is around six times lower than that of equities and around half that of Government bonds. If a naive mean-variance portfolio allocation exercise were applied using this information, it would suggest that UK investors should hold almost 80% of their portfolio in commercial real estate.
In fact, using data from Russell/Mellon Caps, the historical asset allocation over recent history was much lower than that (Figure 2). Some industry observers suggest that the Russell/Mellon Caps might underestimate the allocation to property, but even if the actual allocation was double these figures, the difference between the theoretical allocations and actual allocations is quite significant.

Part of the difference between observed allocations and the optimum allocation based on historical data is explained by the smoothing problem inherent in valuation-based indices, such as that provided by the IPD. Other explanations are that managing property portfolios incurs higher costs than other assets classes, transaction costs are greater and it is hard for institutions to reach higher allocation targets because of the shortage of investible stock. Of course, a proper attempt to find optimal asset allocation must base itself on *ex-ante* expected returns and risk, which are likely to be different from the observed historical *ex-post* data. However, the exercise is useful for showing how investors must take into account additional risks in real estate that are not evident from just observing historical data. One of these risk is likely to be the liquidity risk faced by investors in commercial real estate.

Figure 2: UK Pension fund allocation to property

A model of liquidity risk for property investors

The difference between theoretical allocations and historical performance was noted by many academic and industry researchers. Lin and Vandell (2005) term it the "real estate portfolio puzzle". These authors suggest a statistical model to explain how *ex-ante* real estate risk is much higher than suggested by historical *ex-post* data. The difference being that the time to sale of a property is uncertain and this represents an additional source of risk exposure faced by an investor that is not captured in the historical return data. Bond and Hwang (2004) and Bond et al (2005) use a variation of the Lin and Vandell model and combine it with information on the time to sale of commercial property in the UK to estimate how large this additional risk is possible in practice.

Figure 3 at the end of this article is reproduced from Bond et al and gives an indication of how much larger the actual total risk exposure of an investor is likely to be compared to a benchmark investment represented by the IPD index. For example, if you consider Panel A, for an investment with a planned holding period of six years (72 months) and an expected marketing period time of six months, the total risk may be around 1.4 times (or 40%) higher than that given by the historical data. Clearly this additional risk arising from marketing period uncertainly is important for investors to take into consideration.

However, a few other observations can be made about the nature of this additional risk exposure that arises from marketing period uncertainty. For long term investors, mainly investors with long holding periods (shown to the right of the table in Panel A), the additional risk exposure is likely to be minimal. That is because the risk that arises from the marketing period after holding the property for a long time is relatively small compared to the overall risk faced while holding the building. To put that into perspective, if you intend to hold an asset for twelve years, the consequences of risk exposure that arises during the selling period at the end (which might only be six or eight months), are unlikely to compare to the risks that you might face over the next 12 years.

From Panel B of the table, it is also noted that if property returns are adjusted to take into account the smoothing problem of valuation-based indices, the size of the risk adjustment falls. That is, if you believe that property investment is more volatile than suggested by the historical IPD data (which is almost certainly likely for an individual property asset), then the marketing period risk is smaller relative to the other risks you face as an investor.

This does not necessary imply that liquidity risk is not important, it is just that because of the way the marketing period risk is modelled, this additional risk exposure is smaller relative to the overall risks faced.

Future directions

The value of the research described above, is not so much in the actual numbers provided for the risk adjustment figures, but in making the additional risk exposure faced by property investors explicit. There is a temptation for investment advisers and fund managers to quote *ex-post* risk and returns data when it is the *ex-ante* return and risk that should be used when making decisions. And as the model shows, the *ex-ante* risk for a property investors is usually much higher than the number given by the historical benchmark data.

In recent research Bond, Hwang and Richards (2005) use this approach to consider optimal allocations to real estate when the additional marketing period risk exposure is taken into account. The empirical results show over short holding periods the allocation to real estate significantly reduces when returns are adjusted for liquidity risk. The allocation change is not as significant for a five year holding period as it is for a one year holding period. This confirms the results discussed above that longer holding periods appear to mitigate liquidity risk, as sale time uncertainty is amortised over a longer holding period. Hence, while it may appear important for investment funds to incorporate a measure of illiquidity risk into their return expectations for real estate, those funds with longer holding periods are less affected. The conclusion arising from that study is that illiquidity risk appears to be a contributing factor but not the main driver of low actual allocations to real estate in UK pension funds.

Indeed the results of Bond, Hwang and Richards and the work in Panel B of the table below, suggest that the usefulness of this approach to modelling liquidity risk, while of value in the conceptual understanding of risk, may be more limited in practice. A more complete model of liquidity risk in real estate markets needs to take into account the time-varying nature of the problem. For example, it is clear that at present there is a high degree of liquidity in most sectors of the commercial property market. This contrasts to the situation that existed during the early 1990s when there was limited turnover and few buyers in the market. It is possible to adjust the model described above to take account of periods when the expected marketing period is long (for example, consider what happens to the risk factor when you move down the columns in Panel A). However, a more sophisticated model approach must be incorporated to modelling marketing periods into the model.

Furthermore, it could be argued that what investors are really interested in is not only the magnitude of liquidity risk faced but also what is the return premium associated with this risk. In preliminary (and ongoing) research, Bond and Hwang (2004b) suggest a return premium of around 0.06% per month for the risk associated with an uncertain marketing period (hence a property with an expected marketing period of eight months may have a premium of around 0.50%). However, this is an area where more research is required.

Conclusion

Should real estate investors worry about liquidity risk? While more research is required on this topic, the answer is a qualified yes. In many cases, it is clear that investors do not fully understand the risk exposure that they have taken on. In some instances, such as long-term investors with high quality assets, these risks are likely to be small. However, for some other investors (particularly those with short holding periods or with lower quality assets), they may find that property is a more risky investment than they anticipated and failure to consider liquidity risk will result in costly mistakes being made.

Figure 3B shows by how much the variance of the *ex-ante* returns distribution is greater than that given by an *ex-post* or historical measure of variance (risk). An alternative way of saying this is that the table represents a set of multiplication factors that show by how much the total risk of an investment needs to be adjusted to allow for possible risks associated with marketing time uncertainty. For example, for an investor intending to keep a property for 10 years (holding period) and for an expected marketing time of six months, the risk faced by the investor is around 1.3 times higher than that given by historical returns data. Panel A calculates the adjustment factor using the mean and standard deviation of the IPD commercial property index. The ratio of the mean to standard deviation in the panel is 0.98. Panel A presents the same adjustment factor but obtains the standard deviation by applying an unsmoothing procedure to the IPD index returns. In this case the ratio of the mean to standard deviation is now 0.28.

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Figure 3: Values of the marketing period risk factor across various holding and marketing periods

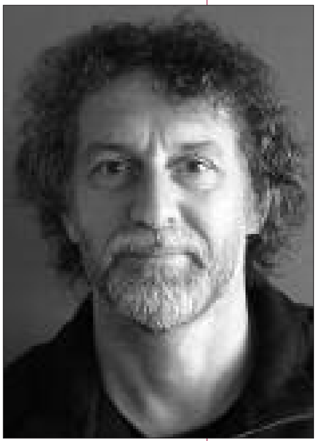
A. The risk factor based on IPD index returns

	Holding period (months)											
	0	12	24	36	48	60	72	84	96	108	120	240
3	3.881	1.576	1.320	1.222	1.169	1.137	1.115	1.099	1.087	1.078	1.070	1.036
4	4.842	1.960	1.549	1.384	1.296	1.240	1.202	1.175	1.154	1.137	1.124	1.063
5	5.802	2.412	1.828	1.586	1.453	1.369	1.312	1.270	1.238	1.212	1.192	1.098
6	6.762	2.921	2.152	1.823	1.640	1.524	1.443	1.384	1.339	1.303	1.274	1.141
7	7.723	3.477	2.518	2.094	1.856	1.702	1.596	1.517	1.457	1.409	1.371	1.191
8	8.683	4.073	2.921	2.397	2.098	1.904	1.768	1.668	1.591	1.530	1.480	1.248
9	9.644	4.704	3.357	2.729	2.365	2.127	1.960	1.836	1.741	1.665	1.603	1.312
10	10.604	5.365	3.825	3.088	2.656	2.372	2.171	2.022	1.906	1.814	1.739	1.384
11	11.564	6.053	4.320	3.473	2.970	2.637	2.400	2.223	2.086	1.977	1.887	1.463
12	12.525	6.762	4.842	3.881	3.305	2.921	2.646	2.441	2.281	2.152	2.048	1.549
18	18.287	11.372	8.409	6.762	5.715	4.989	4.457	4.051	3.730	3.470	3.255	2.206

B. The risk factor based on unsmoothed IPD index returns

	Holding period (months)											
	0	12	24	36	48	60	72	84	96	108	120	240
3	1.235	1.047	1.026	1.018	1.014	1.011	1.009	1.008	1.007	1.006	1.006	1.003
4	1.314	1.078	1.045	1.031	1.024	1.020	1.017	1.014	1.013	1.011	1.010	1.005
5	1.392	1.115	1.068	1.048	1.037	1.030	1.025	1.022	1.019	1.017	1.016	1.008
6	1.470	1.157	1.094	1.067	1.052	1.043	1.036	1.031	1.028	1.025	1.022	1.011
7	1.549	1.202	1.124	1.089	1.070	1.057	1.049	1.042	1.037	1.033	1.030	1.016
8	1.627	1.251	1.157	1.114	1.090	1.074	1.063	1.055	1.048	1.043	1.039	1.020
9	1.706	1.302	1.192	1.141	1.111	1.092	1.078	1.068	1.060	1.054	1.049	1.026
10	1.784	1.356	1.231	1.170	1.135	1.112	1.096	1.083	1.074	1.066	1.060	1.031
11	1.862	1.412	1.271	1.202	1.161	1.134	1.114	1.100	1.089	1.080	1.072	1.038
12	1.941	1.470	1.314	1.235	1.188	1.157	1.134	1.118	1.105	1.094	1.086	1.045
18	2.411	1.847	1.605	1.470	1.385	1.326	1.282	1.249	1.223	1.202	1.184	1.098

Flexible leases and the lease code: where are we now?



Neil Crosby, Professor, University of Reading

The UK institutional lease has highly favourable characteristics from an investment perspective, but seems to some to be strongly weighted in the landlords' favour. Government concerns over this and the recent threat of legislation led to the creation of the voluntary Code of Practice on Commercial Leases as a mechanism to encourage landlords to offer more flexible occupational terms and formats, appropriately priced.

The University of Reading completed the second monitoring project on the lease code at the end of 2004. The final report identified a number of changes in the market place that implied greater flexibility in leasing arrangements. However, it also pointed to genuine areas of concern about the nature of landlord-tenant relationships that needed to be addressed. The Government announced in its budget statement of March 2005 that it will not seek to legislate at this stage, but will continue to monitor the situation over the next three years.

No one should assume that the threat of legislation is gone. Government concern over commercial leases began in the early 1990s with the Conservatives in power. At that time, the main concern was upward-only reviews, dispute resolution and confidentiality clauses. Over the years, the last two have largely disappeared but upward-only reviews are consistently cited in Government statements voicing concerns over leasing. A change of Government may have little effect, and, in any event, if the present Government runs a full term, the same policy makers could be in post at the end of the current monitoring period. The Treasury is an interested party in the lease code debate as it fits squarely into Gordon Brown's enterprise agenda – and he, of course, could be Prime Minister.

In Reading's first lease code monitoring report published in 2000, the main issues identified were upward-only reviews and lack of small business tenant awareness of the Lease Code or of alternatives to the standard lease terms. The second monitoring report identified the same concerns but stressed that assignment and subletting issues are of more current concern to tenants. The subsequent Government statement duly relegated upward-only rent reviews in importance, replacing it with subletting issues (ironically not mentioned in the first 10 recommendations of the lease code).

Many key interest groups in the industry seemingly accepted the findings of the research and made public statements calling for the removal of clauses that prevent subletting at less than passing rent. Soundings suggest that the Government are pleased with that response. The problem for the property industry is that it has only the next three year monitoring period to make sure that, first, it delivers less onerous subletting clauses across the whole property market and second, that it can provide the evidence of that delivery.

Assuming that the property industry can remove subletting and assignment as a key issue, this may mean that upward-only rent reviews go back to the top of the Government's agenda, particularly if there is a rental downturn. It is, of course, much easier for the Government to frame legislation on rent review clauses than it would be to outlaw restrictive subletting and assignment terms.

Recently, upward-only reviews have less impact on tenants – due mainly to the number of shorter leases without reviews and arguably the increase in the number of breaks. If subletting is generally allowed at market rent, this eases the situation still further. However, where reviews exist, they are virtually all upward only so why are these of less concern to tenants? Perhaps market conditions were such that, over the monitoring period, there was little incidence of over-renting. From an investment perspective, analysis of the differential investment potential of upward-only and review-to-market clauses based on UK historical data suggests that the potential impact is largely marginal. However, data availability means that there is only one significant period of rental value decline. It is unsafe to assume that rents cannot experience sustained falls in both real and nominal terms, particularly with structurally lower inflation.

Previous research by Reading found that retail sector tenants were those most concerned about upward-only reviews. Given the current series of poor high street retail financial results and with declining consumer expenditure, will market conditions mean that there is serious over-renting at the end of the next lease code monitoring period? Is the industry ready with its defence should tenants' surveys put upward-only reviews back near the top of the lease agenda?

Although all the factors determining the Government decision not to legislate are not in the public domain, it seems likely that the Reading report made it impossible for the ODPM to propose a ban on upward-only reviews – since this would give tenants something they were not demanding. The property industry cannot rely on tenants being so compliant next time.

One question asked of landlords' representatives during the lease code monitoring period was why was the threshold form of review is not more widely utilised, especially as it is specifically mentioned in the code. There was no response to this question. While it is not Reading's role to advocate a particular format, it does seem curious that this was one suggestion that received less attention than some others. Given that a threshold lease produces precisely the combined bond and equity cashflow characteristics that are cited as a beneficial feature of real estate as an asset, it seems that this is a format that could develop to satisfy the aspirations of the key stakeholders in this debate: landlords, tenants and Government.

So where are we now on lease reform? There are reasons to think that, far from the threat of legislation receding, Government monitoring and market conditions may put greater pressure on the industry to change in the next few years. The question may still be how change occurs, not if it occurs. If it is not voluntary, then legislation may follow.

Forum update

New vice chairman announced

IPF management board member, Peter Freeman, has agreed to take on the role of IPF chairman in 2007-08. Peter succeeds Ian Womack of Morley Fund Management who is currently vice chairman. On his appointment, Peter said:

"The IPF has played a very important part in recent debates between the Government and the industry on topics like REITS, and I am delighted to bring a developer's perspective to this very strong members group."

Education

The IPF's Advanced Education module 'Accounting and Taxation for Property Investors' has run again to a large audience showing the continued strength of the diploma course. It is now lead by a new module leader, Mary Young, a trained accountant and consultant for the Cambridge International Land Institute. The full list of modules still to run is available on the website in our education section.

Changes to the Advanced Education Programme are under way. There's a new module leader for the Advanced Portfolio Management module. After seven years at the helm, George Matysiak of The University of Reading stood down as module leader. He's replaced by Dr Shaun Bond who is a university lecturer in real estate finance in the Department of Land Economy, University of Cambridge. Shaun completed a PhD in the Economics Faculty at Cambridge and also has considerable experience in economic analysis having been employed as a senior economist in the macro-economics branch of the Queensland Treasury Department in Australia. Shaun is also one of the authors of the IPF's liquidity research.

We are also in discussions with the University of Cambridge about them formally accrediting the IPF diploma, which is an exciting and very valuable development for those completing the Advanced Education Programme. Adding another module to the programme on indirect investment is also on the cards.

The introductory module – Property as an Asset Class – is also being updated and transferred into an e-learning module. That means it will become available for individuals to take at any time to fit in with their own personal learning requirements and that means less time out of the office too.

Property derivatives also featured very heavily in the IPF's educational agenda over the last few months. The one-day workshop was in such high demand last summer, it was re-run a total of five times. The next scheduled date is 29 November and also more advanced courses are planned. And of course, for those wanting access to property derivatives resources there's the new IPF website www.propertyderivatives.co.uk available for members.

The hugely popular **Guide to Property Investment for Financial Advisors** is released in a second edition this autumn and there are plans to feature its content on the web in association with Asset tv. Asset tv is the investment industry's broadcast channel which delivers analyst-quality interviews and information from the industry's leading investment managers direct to the screens of investment professionals – particularly investment adviser and stock broking firms. This will help the IPF hugely in disseminating the Guide to a much wider IFA audience than has been possible before.

The regular evening lectures, workshops and technical briefings continue as usual. We are always looking for ideas for topics, so if you have any suggestions, or in fact comments on any of our educational activities, please do contact IPF executive director, Amanda Keane, on akeane@ipf.org.uk

The IPF and IPF Educational Trust Joint Research Programme

The IPF was honoured to receive the Award Corporate Excellence from the International Real Estate Society (IRES) in June 2005 in recognition of the contribution from the Joint Research Programme. This is a terrific endorsement of the three-year programme supporting the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class.

The programme is funded by a cross-section of 16 businesses, representing key market participants. The IPF Educational Trust and the IPF gratefully acknowledge the contributing organisations:

Capital & Regional	Donaldsons
Grosvenor	GVA Grimley
Investment Property Databank	KPMG
LaSalle Investment Management	Land Securities
Lovells	Morley Fund Management
Nabarro Nathanson	Prudential Property Investment Managers
Quintain Estates & Development	Scottish Widows Investment Partnership
SJ Berwin	Strutt & Parker

At the time of writing the Joint Research Programme has completed and published five projects, summary reports and order forms for the full reports are available on the website. A further five projects are in progress, and will be completed over the next six months.

Completed projects

- Liquidity of commercial markets.
- Opening the door to property (jointly with RICS and BPF)
- Depreciation in UK commercial property markets
- The size and structure of the UK commercial property market
- Investment performance and lease structure change in the UK.

Projects in progress

- Institutional investment in regeneration: necessary conditions for effective funding (jointly with BPF, BURA and English Partnerships)
- Behavioural influences on property stock selection decisions
- Forecast disagreement in UK property markets
- The investment performance of listed office buildings (jointly with English Heritage and RICS).
- Index smoothing and the volatility of UK commercial property

The research steering group has approved in principle one further project that is going to tender. In addition, two projects are approved, but no contract is yet in place. These three approved projects complete in 2006. The research steering group has identified further topics for research with some briefs under preparation and/or negotiation. If you have ideas that you would like the research steering group to consider please contact the research director (cfollows@ipf.org.uk).

Alongside the joint research programme projects, the IPF Educational Trust directly funded, as part of large consortium, a project on sustainable property appraisal undertaken by Kingston University. The research steering group has approved a further project to extend this research to the next stage, subject to third party grant funding. The IPF ET has also agreed to provide a three-year bursary at Sheffield University to recruit a suitable researcher for the PhD to extend the research work on liquidity.

The IPF Consensus Forecasts is greatly enhanced and extended. We now provide forecasts for the main segments of the market; office, standard shops, shopping centres, retail warehouse and industrial, plus sub segment forecasts for West End and City offices. The time horizon is now extended to five years.

The research projects are reported in the property and national press, and presented at evening CPD events. Research output was used in submission to Government on REITs, upward only rent reviews and more recently HM Treasury was provided a preview of the research results from the study on the size and structure of the UK investment market. It is widely accepted that the research is of high quality and independent.

A new research programme from 2006

The current programme expires in mid 2006. The IPF management board strongly supports the creation of a new research programme for a further three years from 2006 onwards. Further details to follow in due course.

Scottish conference

The IPF in Scotland held their Second Annual IPF Investment Property Conference on Thursday 8th September in Edinburgh. The conference was well attended by a cross section of the property industry. The conference provided an opportunity to hear the views of industry leaders on future trends in the market. The speakers were Ian Marcus of Credit Suisse First Boston, Iain Reid of Protego Real Estate, Dominic Reilly of Kingfisher Property Finance and Stuart Beevor from Grosvenor Group Ltd along with our National Chairman, Paul McNamara and the Scottish Chair, Fiona Morton.

Social events

Since the last edition of **Investment Property Focus**, our two major dinners took place. Firstly, the annual dinner at the end of June in London and was attended by over 1,500 property professionals. Sponsored by Knight Frank and Propex, the event incorporated the awards of the IPF Diploma to those who successfully completed the Advanced Education Programme in 2004. The following received their diplomas at the event:

Nigel Binmore	John Danes	John Duxbury
Naomi Green	Stan Lersh	Alasdair McGowan
Julia Middleton	Nick Moore	Michael Morris
Cameron Murray	Julian Norbury	Alex Price

Then in October, the smaller but equally enjoyable Midlands annual dinner took place and was attended by over 600 of the Midlands' finest. Sponsored by Abstract Land and First Title, the after dinner entertainment for the event was provided by former england rugby player, Brian Moore.

Also in October, we had the chairman's reception which was hosted by incoming president, Sir David Clementi. The chairman's reception is an occasion used to welcome new members and to thank the many members who work tirelessly on our various committees and working groups. Without such dedicated members, we would be unable to accomplish so much – it is our way of saying thank you.

Future dates for your diary:

IPF research launch on regeneration 2006
19 January 2006 – Birmingham (ICC)

IPF annual lunch 2006
1 February 2006 – London (Grosvenor House)

IPF midlands lunch 2006
19 May 2006 – Birmingham (Hyatt Regency)

IPF annual dinner 2006
29 June 2006 – London (Grosvenor House)

For a full listing of events go to www.ipf.org.uk

IPF Investment Property Forum

19 January 2006
10.00-15.30
ICC, Birmingham

IPF Research Launch

Institutional Investment in Regeneration: Necessary Conditions for Effective Funding

The IPF is delighted to launch its major new research project examining different ways of encouraging the private sector to invest in regeneration projects.

The regeneration of communities and localities across the UK is a central part of Government policy and local planning policy. The Government has various policy initiatives, agencies and generally encourages the re-use of Brownfield sites to stimulate urban regeneration. However, successful regeneration often relies on private sector landowners and developers to bring forward sites, and for banks and investors to provide finance at the various stages of specific projects.

Regeneration uses different sources and types of finance at the different stages of the process. Disparate funding sources have different return targets, assessment criteria, timescales and objectives. In addition, regeneration, particularly large-scale projects, are messy, management intensive, often complex, impact on many stakeholders, involve a variety of landowners, and require public sector intervention.

This project examines the requirements of the private sector sources of short-term funding and long-term capital. It looks at the main finance sources – banks, private equity, fixed interest and long-term property investors – to understand their needs and requirements. It identifies the necessary conditions for the private sector to fully engage with Government, national and local, and regeneration agencies. By explicitly identifying these necessary conditions, this project builds bridges and dialogue between the private sector and Government policy.

Speakers to include:

Paul McNamara
Research Director, PruPIM and IPF National Chairman

Mike Whitby
Leader of the Council, Birmingham City Council

Phil Clark
Head of Specialist Funds, Morley Fund Managers

as well as representatives from ODPM, BURA, English Partnerships, BPF.

This event is free of charge thanks to our sponsors.

For more information or to register please email Sabrina Wisner on swisner@ipf.org.uk or call 020 7334 3799.

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IPF Investment Property Forum

Annual Lunch 2006

Wednesday
1 February 2006

Grosvenor House Hotel
Park Lane
London W1
12:00 for 12:30
Lounge Suits

Ticket Price
£85.00 + VAT (£14.86)
per person
excluding wine and liqueurs

Guest speaker:

Respected Commentator, John Plender

A former student at Oxford University, John Plender qualified as a chartered accountant in 1970. He then moved into journalism and became financial editor of The Economist in 1974, where he remained until joining the British Foreign Office policy planning staff in 1980.

He then became a leader writer and columnist at the Financial Times, an assignment he combined until recently with current affairs broadcasting for the BBC and Channel 4.

John is currently a member of the Private Sector Advisory Group created by the World Bank and the OECD to help developing countries improve corporate governance practices. He also chairs the advisory council of the Centre For The Study Of Financial Innovation, a London and New York based think thank, and is a member of the advisory board of the Association of Corporate Treasurers.

To book please contact
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or email: swisner@ipf.org.uk

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