Investment Property Forum

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INVESTMENT PROPERTY

FOCUS

Hedging your bets

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From the editor

Sue Forster, Executive Director, IPF

Not surprisingly, the key theme of this edition of Investment Property Focus is the 'credit crunch' and the impact this has already had, and may yet have, on the commercial property markets in the UK and elsewhere.

To put the current situation into context, Milan Khatri and John Danes of Goodman International assess whether the current market downturn will be as serious as those in the 1970s and 1990s. They conclude that events look more like the financial turmoil in 1998 so we might anticipate a 'short sharp shock' in pricing – prompting investors to focus more on rental growth than short term capital gains.

Paul Kennedy of INVESCO Real Estate concurs with the view that investors are no longer relying on yield shifts to maximise returns and instead have begun to focus on market and stock selection, coupled with active asset management. Higher European interest rates are unlikely to lead to a dramatic correction in prime property, although some sectors are currently over priced. However, conversely the current concerns about pricing risk may lead investors to undervalue some assets.

Robert Houston of ING REIM provides a 20 bullet point view of prospects for 2008, stressing the need to get the market correction completed as soon as possible. So will the markdown in values be rapid or gradual? Alistair Oates of DTZ discusses the difficulty of valuing property in this market. The very limited transactional evidence of yield shifts in prime property means that valuers have to really understand the dynamics of the market. This year, he fears that few valuers will be at the top of their clients' Christmas card lists!

Mark Long of Invista Real Estate looks at how changes to the UK pensions' regime have affected the ownership structure of the property market; with the large pension funds no longer the dominant force that they once were. By contrast, private investors are of increasing importance in the market and, in the first six months of 2007, accounted for 15% of all transactions. Richard Auterac and Alan Gardner of Jones Lang LaSalle consider how this group of investors are likely to react to the current property market. They conclude these investors are experienced and expect to continue buying, where there is appropriate stock. Roger Dossett of New Star also underlines the continuance of interest in the property market as investors have looked at new asset classes and 'rediscovered' commercial property on the way.

UK REITS have had an 'interesting' first year. Phil Nicklin of Deloitte looks at the current REIT market and how this might develop, particularly in terms of encouraging new entrants to the regime.

Having focussed almost exclusively on commercial property to date, should fund managers be looking seriously at the residential sector? Tim Horsey reports on the recent IPF lecture on residential investment for institutions.

Whatever the investment medium, assessing risk is crucial to decision making. The IPF commissioned IPD to undertake research into how risk is measured and controlled in UK commercial property portfolios. The different approaches found amongst fund managers at both portfolio and asset level are discussed by Malcolm Frodsham of IPD. Simon Martin of Curzon Global Partners/AEW Europe looks at risk from the hedge funds' perspective. Given the problems of pricing direct property and say IPD index property derivatives in an illiquid market, he suggests that risks inherent in property based hedge funds could be greater than for traditional macro, quant or arbitrage funds.

The last few months have also seen a number of significant legislative changes; not least the proposed overhaul of capital gains tax announced in the Pre Budget Report. Karen McNicholls of Deloitte looks at the winners and losers from the loss of business asset taper relief and the introduction of a flat rate of 18%.

Tim Dixon and Claire Roberts of Oxford Brookes University, together with Miles Keeping of King Sturge, consider the impact that energy performance certificates. Their research suggests that in the longer term there is likely to be value differentiation by building efficiency. Rebecca Thorpe of Bovill explains the impact of the Markets in the Financial Instruments Directive (MiFID) on property firms regulated by the FSA to undertake investment activities. This article is followed by an update on progress towards securing routes to authorisation for investment property advisors and fund managers.

The significant changes in the market and student skill sets since the 1970s are underlined by Colin Lizieri and Neil Crosby of the University of Reading as they review the 40 years since the establishment of the Department of Real Estate and Planning.

Contributions to Investment Property Focus are always welcome, so please contact us with any ideas or contributions for future editions.

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Strategies to survive a downturn in the real estate market

Milan Khatri, Chief Economist, Goodman International

John Danes, UK Research Manager, Goodman International

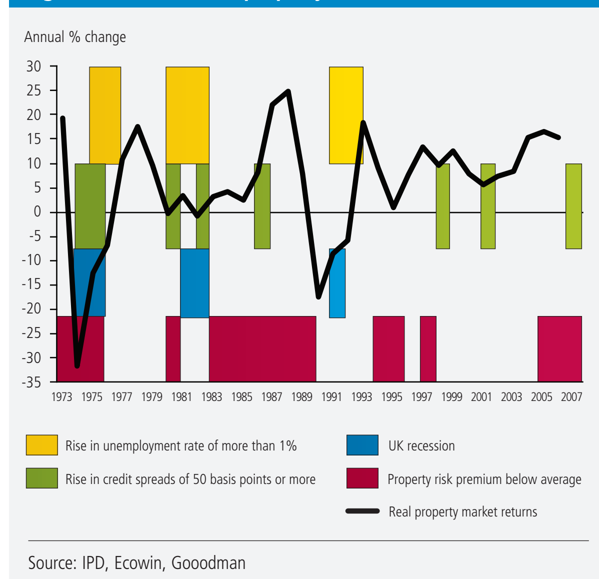
Milan Khatri and John Danes suggest that in order to devise a strategy in a downturn, the starting point should be to consider if any lessons can be learnt from previous experience.

It is always better to anticipate a downturn rather than respond to one in progress. The commercial property sector has been on the look-out for a pivotal event that would undermine market confidence and although yields have appeared stretched for some time, this summer's credit crisis has proved to be the trigger. Yields have been rising across all sectors since late summer, particularly in the retail sector and the secondary property market.

This re-pricing of risk has its origins in the US sub-prime mortgage market and the derived debt instruments. Concerns over credit quality of mortgage-backed securities have led investors to shun risky assets, particularly in the asset-backed market. Traditionally, banks performed the role of monitoring credit quality for on-balance sheet loans. The responsibility for monitoring securitised loans has fallen on the market and the credit-rating agencies in particular, but in the case of US sub-prime mortgages this system seems to have failed miserably.

For the commercial property sector, a mild summer market slowdown has been amplified by the credit crisis. Banks are finding it difficult to securitise loans as the capital markets have virtually shut down, prompting banks to tighten terms for new loans. This highlights the fact that the capital markets have become important in not only providing funding for the real estate sector but also setting overall lending standards. As such, a re-pricing of risk in the capital markets has fed quickly to property market values, a feature that has come as a large surprise to many.

Figure 1: Historical UK property returns



Source: IPD, Ecowin, Gooodman

Similarities and differences with other market re-pricing experiences

The rapid re-pricing of real estate values has led to talk of a downturn akin to the early 1970s and 1990s. The main similarity across these periods is the low risk premium embedded in property relative to the risk free interest rate and high levels of bank lending to the real estate sector. However, we see few convincing signs that a melt-down is in the offing as the key ingredients for a market crash are still missing. Economic circumstances surrounding sharp market downturns of the 1970s and 1990s were characterised by a jump in inflation and a rapid tightening of monetary policy, followed invariably by a deep recession and rising unemployment. Devastatingly high borrowing costs pushed developers and leveraged investors into cut-price sales in a market place with sharply deteriorating occupier fundamentals.

We believe that current events most directly parallel the financial turmoil of 1998, which occurred on the back of the Asian financial crisis, Russia's debt default and the collapse of the US hedge fund LTCM. Jittery financial markets pushed credit spreads significantly higher during the crisis, and some debt classes up more so than in recent months. Prime property yields rose between 25 and 75 basis points in the second half of 1998, not dissimilar to recent trends but average yields as registered by IPD were static. Upward pressures on property yields in today's market have been across the board, reflecting the much narrower risk premium on property, while the real estate sector is more sensitive to funding costs in the capital markets.

Sharp reductions in UK and global interest rates played a pivotal role in supporting the economy and restoring some semblance of calm in the financial markets in the late 1990s. Today, only the US Federal Reserve has reacted to the market crisis by cutting interest rates. Inflation fears have led some central banks to tighten monetary policy in recent months while the Bank of England and the European Central Bank have seemingly abandoned planned interest rate rises. The global economy is certainly in a different cycle to 1998 when the Asian crisis was a large drag on global growth. This time, even though the US economy has been weakening for over a year, the world economy is strong.

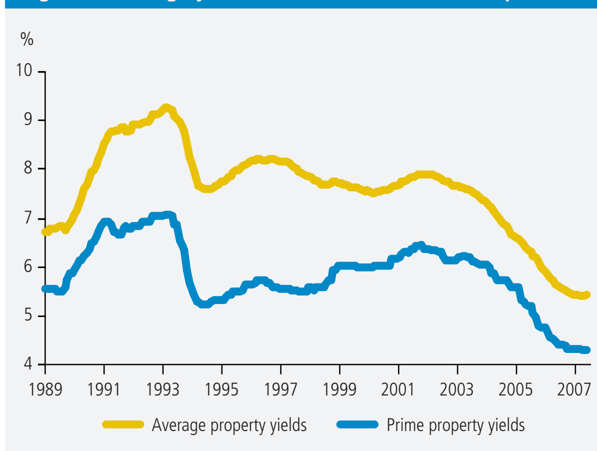
As such, interest rate cuts from the Bank of England and the European Central Bank are likely to be gradual and limited. UK economic growth will undoubtedly slow in 2008, led by the business sector, but the likelihood of a recession is still small, due to generally above average household confidence and a robust global economic climate. Also, as occupier demand is still healthy, we see the current market re-pricing as having the characteristics of a 'short, sharp shock', and will prompt investors to focus once again on long term income growth rather than short term capital gains, while property returns are expected to drop back into the traditional window being below equities but ahead of government bonds.

Strategies to survive the downturn

Having explained the context of the current property market slowdown in relation to previous downturns, we can now explore a variety of tactics which may be used to mitigate the effects of the current downturn. Some, such as avoiding exposure to the most volatile sectors, have been used in previous property market downturns. Other techniques, such as the use of derivatives, have only become available in recent years.

A key method of reducing the impact of the current downturn would be to already hold more prime than secondary property. Many debt-backed investors in recent years have not differentiated significantly between different grades of property and their relative rental growth prospects, focusing more on the margin between income return and borrowing costs. As a consequence, secondary property yields have fallen much more than for prime. In the late 1990s, the difference between prime and average yields, as measured by CBRE and IPD Monthly equivalent yields was more than 250 basis points. The margin is now down to just over 100 basis points.

Figure 2: Average yields have fallen more than for prime



Source: Goodman, IPD Monthly Index, CBRE yield monitor

Going forward, this yield compression will start to unwind. Secondary properties that may be less capable of delivering rental growth should experience a faster rise in yields than for prime property, and deliver weaker returns as a consequence. Indeed this process is already underway. We have already seen more of an outward yield shift for more secondary property in the UK in the last quarter, increasing by as much as 75 basis points according to most valuers. In comparison, prime West End office and prime shopping centre yields, for example, have so far moved out by only 25 basis points.

A similar trend has been occurring in other asset classes. There has been a re-pricing of risk in the wake of the recent 'credit crunch'. Just as yields on more secondary or lower grade corporate bonds have risen by proportionally more, with there being a 'flight to prime' as investors have become more risk averse, so the same process has occurred for property.

Diversification is another potential method for surviving a downturn. In particular, too high an exposure to the most volatile sectors should be avoided. Central London offices have been historically the most volatile commercial property sector, and have often underperformed substantially in property market downturns, especially when these coincided with a recession as in 1990-92. The City office market is currently experiencing strong rental growth, of almost 20% on an annualised basis. However, the combined impact of high development levels (over 6m sq ft of space is currently under construction) and the 'credit crunch' may mean that this rental growth rate will decline sharply.

Nevertheless, this downturn differs from previous slowdowns in that it is investor-driven rather than being caused by a material slowdown in the occupational market. In the recession of the early 1990s, the Central London office sector was particularly hard hit but such a pronounced downturn in the economy is currently unlikely.

An alternative to boost property performance in a downturn that has not been available in previous cycles is the use of property market derivatives. Derivatives are contracts that derive value from an underlying asset, in this case real estate. They have no intrinsic value. They are a method of paying or receiving property returns synthetically, i.e. without buying or selling direct property.

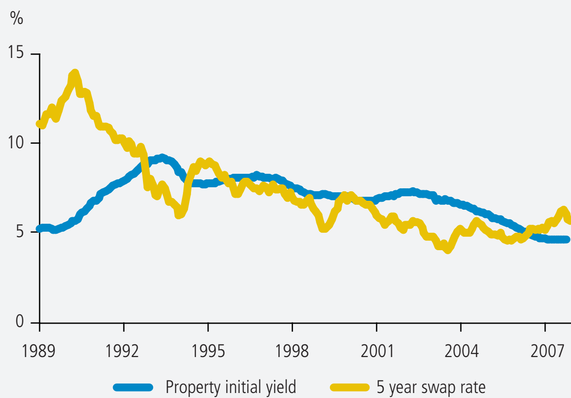
There is currently some extremely interesting pricing on offer in the derivatives market. Historically it has been necessary to pay a premium to receive property returns delivering an overall return 1-2% per annum below IPD. However, it is now possible to purchase guaranteed outperformance relative to IPD. Due to a number of factors, including the weaker projected performance of commercial property over the next couple of years, one can lock in large margins of outperformance over IPD (currently 5-6%) over the short to medium term.

Derivatives may also be used to 'short' or reduce exposure to property, by selling property exposure to another party. This can be achieved much more quickly than by selling an actual portfolio, which may take several months even in a buoyant market. It can also avoid the problem of being perceived as a 'seller' in the market. Finally, if the strategy was to reduce property exposure for a couple of years before buying back into the market, it avoids the substantial 'round trip' costs in terms of stamp duty and agents' fees, of approximately 7% involved in selling and then reinvesting in direct property. Buying a derivative involves only incurring some fairly minimal legal fees.

Another approach would be to have reduced gearing as much as possible. Between 2001 and 2005, as the margin between property's initial yield and borrowing costs was substantial, gearing was an easy way to boost returns. However, in the last year, this opportunity has now largely passed as borrowing costs

have now risen above property's initial yield. Just as gearing can boost returns in a strong market, so it can drag returns lower in a weaker environment.

Figure 3: Borrowing costs have now risen above property's initial yield



Source: IPD, EcoWin Reuters

Active asset management, a core but sometimes forgotten skill in a bull market, is another method of boosting returns in a market downturn. In recent years, investors have been able to make substantial capital returns from property as yields have fallen, without significant active management. Many properties, particularly those recently owned by investors without specialist property skills, will have asset management opportunities as a result. These include development and refurbishment projects, or securing improved lettings.

Investing in overseas property is another way of diversifying risk and surviving a domestic property market downturn. After three years of exceptionally strong performance, the UK is likely to deliver returns below the continental European average over the next three years according to our forecasts. Rental growth is accelerating in both the retail and particularly the office sectors in Europe as a whole, aided by the strengthening European economy. The Nordic countries should see some of the strongest returns going forward, given the cyclical uplift in the office sector.

For many years, UK investors have included overseas assets in their equity and fixed interest portfolios. Until recently, relatively few investors have taken similar steps to invest internationally in property. Options to diversify into other international markets are becoming increasingly attractive, particularly as this offers potential opportunities to both reduce risk and boost returns. The growth in various types of indirect property vehicles is making it easier to access international markets, offering participation in large, diversified portfolios with expert local management.

Europe will not, however, be immune to the outward yield shift that is affecting the UK market. In addition, if the UK market re-prices rapidly over the next year, while yields in Europe stabilise or only rise modestly, the UK will start to look better value again.

The emergence of indirect property may be an advantage in terms of enabling easier access to global property markets, and consequently diversifying risk. However, the relatively illiquid nature of some of these investments may mean that a lower exposure to indirect property should be held in times of imminent property market downturns, if exposure to a particular sector, or even the market as a whole, needs to be reduced quickly.

In summary, the downturn we are entering has some similarities with previous market slowdowns, notably that of 1998, in that it is predominantly an investor-driven downturn. However, there are few similarities to some of the most pronounced market corrections such as 1990-92 and 1974-75, in that the occupier market and consequently rental growth are holding up well. There are established techniques for mitigating the effects of a downturn that may be used, such as avoiding the most volatile sectors, reducing gearing and focusing more on prime property, the latter being particularly pertinent in the current slowdown. However, there are also some newer techniques, such as investing in overseas markets, aided by the growth of the indirect sector, and also the emergence of the property derivatives market, which currently offers the opportunity to guarantee outperformance relative to the IPD Index.

As a final point, it is worth noting that the current market downturn is anticipated to be short and sharp, with a sudden correction in yield levels. If this proves to be the case, and yields move out by 75 basis points over the next six months, property could start looking good value again relative to other asset classes, and may represent a buying opportunity. In the meantime, for those investors that still have an appetite for property, uncertain climates can produce attractive purchasing opportunities both in the direct and indirect markets. It may be difficult to buck a market, but it is certainly not impossible to spot opportunities. It is important to remember that the underlying economy is currently strong, interest rates look to have peaked, and rental growth on commercial property remains above inflation, particularly in the office sector.

What is a real estate hedge fund?

Simon Martin, Managing Director, Investment Strategy & Research, Curzon Global Partners/AEW Europe

Simon Martin strips hedge funds back to the basics and explains their role in today's markets

In the last few years, the term hedge fund has become synonymous with financially sophisticated wealth creation. As a recent Institute for Policy Studies survey showed, the typical US hedge fund CEO took home $600m in 2006 (no that's not a typo, it's only the average and it's 3,315 times more than George W. Bush got paid). That leads us, after many years of staring in envy from the sidelines, to ask ourselves what really is a hedge fund? What do these guys do to make so much money so quickly? And, perhaps more pertinently, given recent developments in our market, what is a real estate hedge fund?

Hedge funds are by no means a new thing. The term first gained popularity when it was used by a man called Alfred Winslow Jones in the 1940s to describe a distinct style of investing he practiced on behalf of a small limited liability partnership. However, in various incarnations this style of investing had been practiced for many years and by some very distinguished names, John Maynard Keynes was both a 'hedgy' and an economist; Jesse Livermore, the 1920s long/short investor, was one before he became penniless and blew his brains out in a New York restaurant toilet and so was Jack Kennedy's father, Joe. So, if they are not so new, why are they such big news today? Simply because their role in the global financial system has changed and as a result, so has their size and visibility in a financial society that is increasingly aware of the gap between haves and have nots.

To understand how hedge funds work you have to examine how their role in financial markets interactions has been changing. The best explanation I have heard came from a prescient financial economist, investor and thinker called Hunt Taylor. Taylor surmised that there are two types of capital in the world – investment capital and efficiency capital. Investment capital is a function of the long-only world – investment capital seeks out undervalued or growing businesses and either takes a stake in their equity or lends money to them to help them grow. The users of investment capital pay a reward to its providers, in the form of a return. Efficiency capital is different. It is money that seeks out situations where investment capital is looking to transfer a risk and it assumes this risk (a hedge) in return for a premium. In doing so, it makes capital markets more efficient. Funds that perform this function are thus termed hedge funds. The fund that takes the premium and assumes the risk will then seek to lay off the risk by taking counter balancing financial positions. Hence a hedge fund provides hedges to others and hedges it own exposure. It's a form of insurance. The only problems hedge funds have is that not everything is always insured perfectly. Hence they are occasionally exposed to risks that in some cases can be rather large (think Lloyds of London and Piper Alpha). Simple but not without risks, as many investors have discovered to their cost in recent months.

The provision of efficiency capital is big business. In fact for many years it was a primary business of the major investment banks. As Taylor wisely said 'the business of liquidity and making markets put the Gold into Goldman and the More in Morgan'. So if this is such a lucrative business, why isn't it still the preserve of the financial behemoths?

Well, until very recently it was. Although LLP partnership models made hedge funds largely free of regulation, and big performance fees made them attractive to work in, for a long time the business was fragmented and few managers could muscle their way through the big banks to gain market share. Hence the business of providing efficiency capital was a bit like a private club. However, when investment banks started to go public in the mid 1990s, they started to get very focussed on their ability to pay predictable quarterly earnings. This made the business of assuming risk that could create substantial earnings volatility much less attractive (think Lloyds and Piper again). Suddenly being head of the proprietary desk at a bank wasn't as much fun, nor was it as lucrative as being able to take big profit shares when managing large amounts of high leveraged money. As a result we saw a wholesale migration of the providers of efficiency capital from investment banks and exchanges to garden variety hedge funds.

Not only did this transfer occur, it has also been spiced up with a whole lot of additional leverage. A conservative estimate would be 4 or 5 to 1, in which case $1tn of old fashioned efficiency capital acts more like $6tn today. Hence the world of hedge funds has both grown dynamically (by virtue of this transfer and by pumping the chest expander of leverage) and also taken on a critical role in the global financial markets. Additional societal responsibility, visibility (and scrutiny) is the price paid, all of which is somewhat paradoxical given that hedge funds are Darwinian (some would say greedy) profit seeking entities that are unregulated and rather secretive.

If we then accept the role hedge funds fulfil is to assume risk for a fee, the next question is how does this work? By and large this depends on the type of risk that needs to be assumed. The one that gets the most textbook exposure is convertible arbitrage. Convertible funds focus on the inefficiencies that occasionally occur in certain types of stock issued by listed companies. In certain circumstances companies issue convertible preference shares. This class of stock pays a high dividend and converts into ordinary shares based on the common stock hitting a certain future price. However, they are not issued very often and hence typically represent a small piece of the company's source of funds. As a result they tend to get overlooked by investors. If this happens, the convertible prices can trade at a discount to the common stock that significantly understates the probability of a conversion. Convertible arbitrage funds look for this divergence and when they find it they buy the convertible (known as taking

a long position), thus assuming a risk. To balance this risk (long position) they seek to offset it by borrowing and then selling the common stock (known as taking a short position). Hence they gain the benefit of buying the under-priced convertible but also hedge themselves against a fall in the stock price (i.e. they are market neutral). These convertible anomalies tend to be small and the act of exploiting them can cause them to close, hence positions are not open for long and have to be very heavily leveraged to maximise returns. There are lots of other investment strategies practiced in the hedge fund world of which convertible arbitrage is only one.

Given that it can sometimes be difficult to accurately price property risk, one would expect that there is a significant role for efficiency capital in real estate markets. Hence the arrival of skilled professionals capable of providing long only investors with appropriate vehicles for transferring risk should be applauded. In fact for many years, hedging has not been at all easy, as the property market has lacked a decent mechanism for taking a short position. However, innovations in property derivatives markets and the broadening and deepening of the public real estate markets have made this strategy easier to execute. So, in essence, the real estate hedge fund has appeared as a direct result of market growth and innovation. The proponents are just as sophisticated as their non-property brethren and use just as much leverage. This is clearly positive for the market at large. The only question in my mind is whether the risks inherent in property based hedge funds are the same as the traditional macro, quant or arbitrage funds. This is because I doubt that it is possible to balance liquidity in long and short positions as effectively. For example, buying a direct investment portfolio and selling IPD index derivatives is matching one asset that is difficult to price in an illiquid market with another one that is even more difficult to price in an illiquid market. As recent events have shown, the leveraged returns based on pricing inefficiencies may look very attractive, but if the positions taken by hedge funds are in assets that can suffer big fluctuations in liquidity, this can cause the fund problems and it may struggle to calculate an NAV that investors will believe. Given that the level of property market liquidity is often subject to proportionately larger fluctuations, this is cause for concern, particularly as property investors have historically tended to head for the doors in large groups at the first whiff of trouble (as the property unit trusts will attest).

In an imperfect market such as real estate the rationale for efficiency capital and hence the real estate hedge fund is strong. Hedge funds, as we have seen, play a valuable role in financial society. Understanding them and the risks they take in an increasingly crowded and complex market is key, as is a willingness to live through the ups and downs of market liquidity. But then isn’t that what property investing is all about? For the fainthearted? No. Bringing efficiency to the historically inefficient? Time will tell.

UK REITs: After the fanfare...

Phil Nicklin, Real Estate Tax Partner, Deloitte

Phil also leads the Treasury-appointed technical group on REITs

Phil Nicklin looks at the current state of the REIT market and considers what the future holds.

We're now nearly a year into the REIT regime and, from the perspective of the listed property investment sector; its introduction has been a great success. Fifteen of the largest listed property companies, owning around £60bn of property, converted without delay. Overnight their shareholders enjoyed a considerably enhanced after tax return (10% to 15% better for individuals and over 40% better for gross funds). From the perspective of the listed property sector, REITs have been a resounding success.

For the Government, success needs to be measured in the context of its policy objectives, which included:

- Improving the quality and quantity of finance for investment in property, particularly residential property;
- Provision of access to a wider range of savings products on a stable and well-regulated basis;
- Ensuring a fair level of taxation continues to be paid by the property sector;
- Supporting structural change in the property market.

The latter objective has clearly been achieved in relation to the £60bn of property owned by those listed companies. There is still a considerable amount of property owned outside the listed sector and hopefully over time it will end up being held more efficiently in the hands of existing or newly formed REITs. This includes the vast amount of property still held by the large corporate owner-occupiers, such as retailers.

It is too early to judge whether the first two objectives will be achieved over time. The listed property sector simply converted to REIT status without raising new capital or changing its capital structure. To date, there has been only one newly formed REIT, The Local Shopping REIT. Consequently, the opportunities for new investors to invest in the new REIT product has been limited. However, it is early days and the undoubted tax benefits of REITs and their ability to bid for property at fiercely competitive prices due to their tax status, means things can only move in a positive direction.

Government help at hand

There is no doubt that the original REIT regime was more suited to existing listed companies wishing to convert to REIT status than to newly formed REITs. Thankfully some areas of concern were ironed out in this year's Finance Act. That's not to say that there aren't more things that the Government could do to encourage new entrants:

- One of the most widely touted options, is the possibility of extending the regime to AIM-listed companies. Allowing AIM listing would open up the REIT regime to a larger number of property investment companies. Indeed it would be fantastic if one day the Government was to take things one step further and allow unlisted REITs, which has been one of the factors that has led to the US REIT market being so large;
- Another option would be to incentivise contributions of properties to REITs. The French regime has reliefs to encourage such contributions and similar benefits can be achieved in the US. Some sort of seeding relief in the UK could defer or reduce the tax cost of setting up a new REIT and might for example encourage life companies to contribute properties to a REIT, giving themselves more liquidity and enabling investors the opportunity to invest in a wider range of prime property; and
- There could also be incentives to encourage residential REITs to enter the market, perhaps by reducing the REIT entry charge for these companies.

The market and the future

While investors in the large listed property companies get a much improved after tax return now they have become REITs, those companies remain listed and their share prices are subject to stock market fluctuations. A combination of general uncertainty regarding the state of the UK commercial property market and the after-effects of the massive 80% rise in the price of listed property company shares after the announcement of REITs, was bound to have an effect. Since the start of the REIT regime, share prices in REITs have fallen in line with non-REIT stocks over the same period.

It should not be forgotten that the REIT regime is still in its infancy compared to similar regimes in other countries, such as the US and Australia, which themselves took many years to develop. The pricing methods used to value REITs in the UK, particularly in respect of the tax benefits of REIT status, are still being discovered and developed.

Despite the recent share performance of REITs, commentators are recommending UK REITs for long term investment. It would seem that as confidence in the stock market and property sector is regained, and REITs become better understood, demand for new REITs from investors will increase. That, together with Government hopefully making some further positive changes to the regime, should see REITs becoming more and more common and their influence on the way the property industry works becoming increasingly important.

Highs and lows

Dr Paul Kennedy, Head of European Research, INVESCO Real Estate

Paul Kennedy questions whether higher interest rates point to a re-pricing of European real estate.

Over the last few years European real estate has benefited from a period of low interest rates and easy access to debt. In turn this trend has helped to fuel a boom in capital values as investors used leverage to both enhance returns and increase their spending power. With both UK and ECB base rates now over 200 basis points above their 2003 low, and with access to short-term debt being restricted by problems in the credit markets associated with the US sub-prime crisis, it is worth considering whether changes to the cost of debt are likely to cause a re-assessment of real estate pricing.

A structural approach to assessing real estate pricing

In order to determine whether yields, and therefore prices, are too high, too low or about right, it is necessary to address two questions.

First, what is an 'appropriate' rate of return for a particular real estate market allowing for all relevant economic and political risks, and reflecting the characteristics of the real estate investment (for example lease structure, planning system, diversity of occupier and investor bases)?

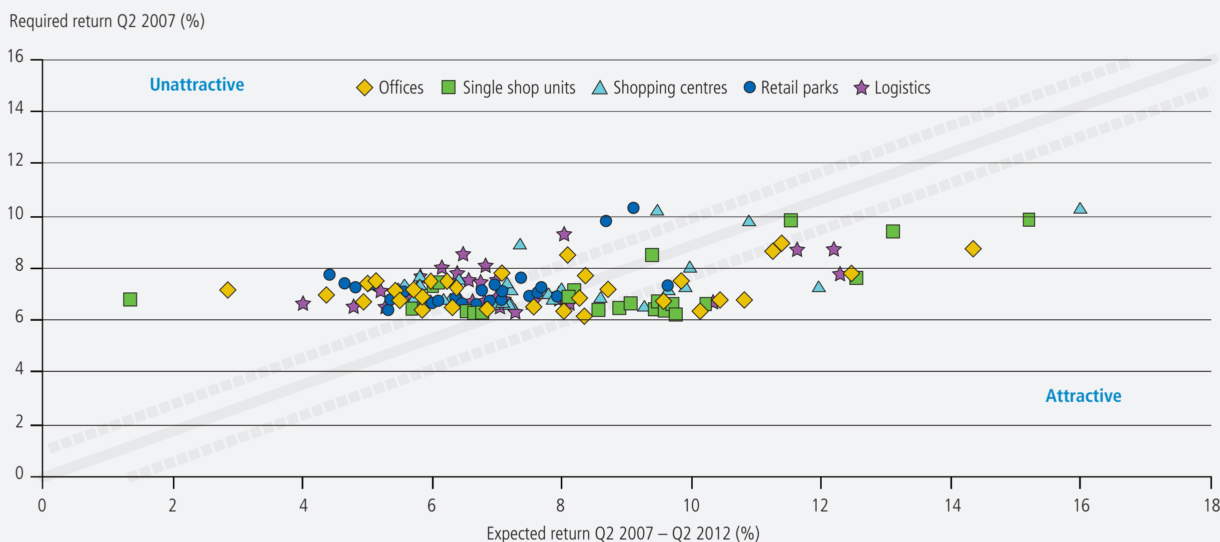
Second, given current pricing levels and our assumptions of rental growth, lease structure, costs of ownership and expected yield changes, is the market likely to achieve or even exceed, the suggested total return hurdle?

To answer the first question estimates of two variables are required; the risk free rate of return and the real estate risk premium. For the first variable we adopt the yield on long-dated local government securities. To estimate the second variable we compare risk premia implied by historic pricing across a range of markets and time periods with appropriate economic, capital market and real estate market characteristics (for example economic volatility, real estate market volatility and market size). This approach allows us to determine a set of 'correct' real estate risk premia for all the markets we cover. Combining both estimates produces a target or 'hurdle' rate of return that reflects the risk associated with unlevered prime or core real estate investments.

For the second question we require accurate estimates of current market pricing as well as forecasts of rental growth and information on lease structures and costs of ownership. To determine current market pricing, data from third parties including DTZ and CBRE are combined with information from in-house transaction teams. Our rental growth forecasts utilise both in-house models and projections from respected independent market analysts such as PMA. To produce our estimates of future rental growth we carefully analyse expected developments in both real estate supply and demand and develop detailed economic views at both national and local levels for all the countries and markets we cover.

Our rental growth forecasts are combined with lease structure and ownership cost estimates to produce forecasts of expected income. Finally, we use forecasts of long-dated bond yields and nominal rental growth at the end of our five-year forecast period to estimate the likely exit yield. This final calculation also utilises the hurdle rate estimate discussed above. Answers to the first question provide us with estimate of appropriate hurdle rates or 'required' returns, the second question contributes comparable expected return estimates.

Figure 1: Expected and required total returns – all markets



Source: INVESCO Real Estate (Autumn 2007)

Do expected returns make sense?

Figure 1 details expected and required returns suggested by our Autumn 2007 forecasts. Based on these calculations a clear majority of the prime European real estate markets that we cover are expected to deliver returns that are either close to or above our suggested hurdle rate.

The forecasts detailed opposite allow for the changes in debt markets highlighted in the introduction to this paper. In addition, our rental growth forecasts allow for the expected slowdown in most European economies. Consequently, although our calculations point to some markets where marked underperformance is likely, a fundamental approach to real estate pricing would not appear to support the suggestion that higher interest rates will lead to a dramatic correction in pricing for prime European real estate. Indeed, our calculations highlight a number of markets where expected total returns are likely to be markedly in excess of our prime hurdle rate. Opportunities suggested by our analysis include:

Offices

Lyon, Lille, Marseille, Stockholm, Sofia, Moscow, St Petersburg, Kiev, Paris (CBD, La Defense and Rive Gauche), Brussels, Barcelona, Copenhagen, Prague and Bratislava.

Retail (high street, shopping centres and/or retail parks)

Paris, Lyon, Marseille, Lille, Brussels, Madrid, Barcelona, Warsaw, Prague, Bratislava, Sofia, St Petersburg, Kiev, Lisbon, Helsinki, Stockholm, Budapest and Moscow.

Logistics/industrial

Helsinki, Sofia, Moscow, St Petersburg, Marseille, Madrid and Barcelona.

Too good to be true?

There are some clear limitations to our analysis. First, our calculations focus on equity only investment. It is clear that higher interest rates have reduced the attractiveness of real estate to levered investors and, as a consequence, have limited investor demand. Second, our focus on prime quality property overlooks secondary real estate where excess yield compression has created some genuine pricing issues. Finally, although we still expect some markets to offer double figure returns over the next few years, most of these opportunities are associated with higher risk locations such as Russia, Bulgaria and the Ukraine. In most locations future returns should be closer to our required return hurdle range of between 6% and 10% per annum. Although our expected returns exclude the impact of active management, they are still markedly lower than recent performance. As a result, there may be a risk of investor disappointment and, therefore, the reallocation of capital.

A more rational market?

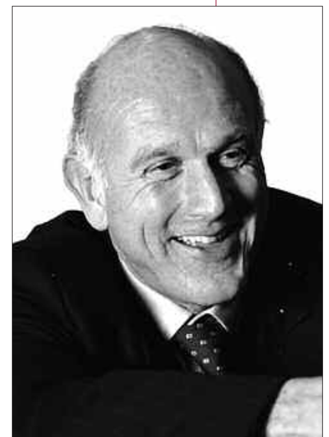
Over the last few years real estate has delivered extraordinary returns as pricing levels re-rated relative to bonds and started to reflect improvements to market transparency and accessibility. Our calculations suggest that this transition is now over.

Despite this, although there are segments of the European real estate market that appear to be over-priced (such as secondary UK retail), other segments still look attractive (regional French offices for example). In addition, it is likely that concerns over the pricing of risk and the outlook for investor demand will lead investors to undervalue some real estate assets including short leaseholds and reversionary investments.

Perhaps more importantly, the reversion to more logical pricing levels and more appropriate returns suggests a marked change in the skills required for success in European real estate. Instead of adding value through structuring or aggressive transaction assumptions, real estate investors will be forced to focus on market and stock selection as well as on active asset management. Although returns will inevitably be lower, they will be more sustainable and will support a more rational real estate investment market.

For copies of INVESCO Real Estate's latest market forecasts please contact Lisa Nell on 0207 543 3500 or lisa_nell@ldn.invesco.com

The UK private investor



Richard Auterac, Director and Auctioneer, Jones Lang Lasalle

Richard Auterac and Alan Gardner examine the rise and rise of the private investor.

The private investor has become an increasingly significant player in the UK commercial property investment market over the past 15 years. Previously, this market was the preserve of traditional institutions or specialist property companies. The only way an individual could really access the commercial market was through buying shares in quoted companies. These investments, however, performed more in line with the equity market rather than the property assets themselves.

The expansion of unitised property funds and other indirect vehicles has made the commercial market much more accessible. In addition, the growth of information services and performance indices has greatly increased market transparency, encouraging more investors to look at the asset class. However, it has not stopped there and the private investor has entered the direct market to an extent that was unimaginable even 10 years ago.

The traditional rationale behind investing in commercial property was its utility as a portfolio diversifier. The 1990s and the new millennium saw a marked reduction in real interest rates in the UK. This reflected the taming of inflation and greater investor confidence in UK monetary policy, now managed independently by the Bank of England. In this environment, property was seriously underpriced as an asset class. This helped property establish a strong track record of investment performance compared to competing asset classes. Although performance has tailed off in 2007, it still appears attractive to investors when compared to the volatility the equity markets have experienced in recent weeks on the back of the US sub-prime crisis.

The previous 15 years has produced unbroken economic growth in the UK averaging 2.9% pa. The principal driver of the economy in recent years has been financial and business services which have grown at a strong rate of 6.8% pa which has fed through to substantial City bonuses. In addition, there has been strong real house price growth of 6.0% pa. The latest Merrill Lynch/Cap Gemini report suggests that at the end of 2006, there were 485,000 high net worth individuals in the UK, each with financial assets in excess of $1m.

The higher up the income scale the investor rises, the more likely they are to be financially literate and take a greater control over personal financial planning. Personal wealth management is one of the most rapidly expanding sectors of the UK banking and finance sector in recent years. Memories over the mis-selling of endowments and more recently, split capital investment trusts, has also encouraged investors to take greater control over their own portfolios. The end result of these trends is the creation of a savvy investor who holds a significant amount of capital.

In 2006 private individuals in the wider commercial market (including those domiciled overseas) injected a total investment volume of £14bn, a massive increase (166%) on the £5.3bn recorded in 2005. This trend has continued into 2007 with investment purchases amounting to £4.3bn in the first six months, accounting for over 15% of all transactions. To put this into context, over the same period five years back (2002) total investment volume reached 1.9bn pa.

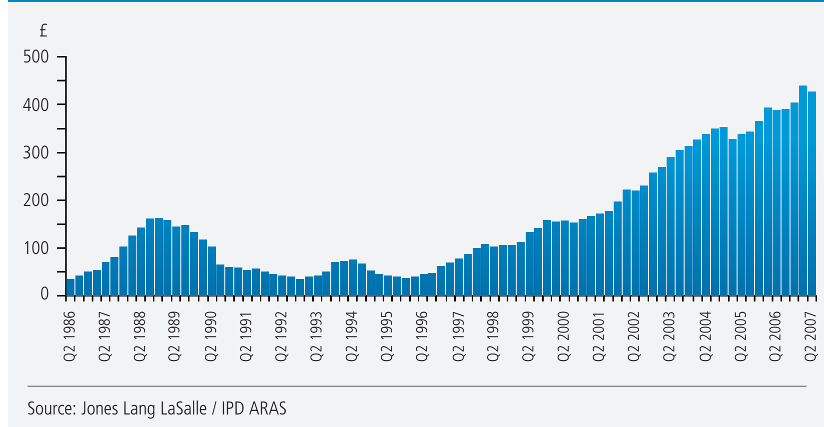
Figure 1 shows the historical trend in activity within the auction room based on a four quarter moving average. It is clear that this market has also expanded considerably. Since late 1999, the level of turnover has increased dramatically from £156m in the first quarter 2000 to £424m by the second quarter 2007.

Alan Gardener, Head of UK Capital Markets Research, Jones Lang Lasalle

The private investor in detail

The Jones Lang LaSalle auction buyers feedback survey is a quarterly survey which monitors the short and medium term requirements of private investors in the auction market. The analysis below highlights the main findings of the survey undertaken over the 12 months to March 2007, incorporating in excess of 100 responses.

Figure 1: Auction room activity

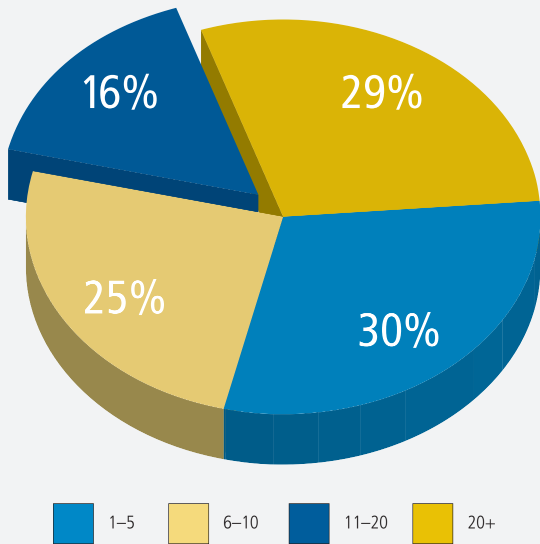


Source: Jones Lang LaSalle / IPD ARAS

Highlights include:

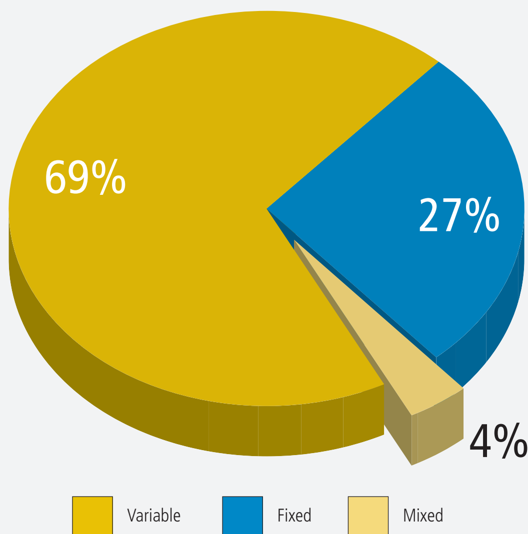
- Private property companies and private individuals dominate the description of private investors, accounting for almost 90% of all responses at 50%, and 38% respectively.
- Private investors tend to have smaller portfolios with 43% holding between one and five properties while 36% of property companies have portfolios consisting of 20+ properties.

Figure 2: Number of properties held in portfolio



Source: Jones Lang LaSalle

Figure 3: Type of loan funding purchase

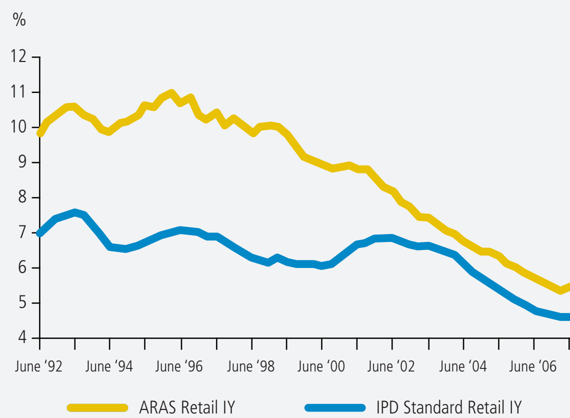


Source: Jones Lang LaSalle

- Of those who took out loans, the vast majority (69%) opted for variable loans, usually paying a certain percentage above base rates.
- 40% of investors took out loans between 70 and 75% of the purchase price.
- The single most important issue concerning a purchase was expectations of future capital growth followed by covenant strength.
- Retail investments account for two-thirds of all purchases in the auction room. According to the ARAS data, average retail yields fell from almost 11% in 1995 to 5.4% by mid-2007. The drop reflects the fall seen for retail yields in the wider UK commercial market as recorded by IPD.

Perhaps the biggest driver of the fall in yields has been the global savings glut over recent years, particularly in Asia and China, which has pushed down real long term interest rates.

Figure 4: Yield compression



Source: Jones Lang LaSalle / IPD ARAS

Combined with the rapid accumulation of wealth by a significant portion of the UK population, a supply/demand imbalance has occurred with a surplus of cash chasing a finite supply of assets that offer a decent yield.

The real yield rate on 5-year UK government bonds fell from 3.7% in mid-1997 to 1.5% by the end of 2005. This sharp drop in real interest rates has fed through lower yields on property. Lower real interest rates may have made investors more willing to take on other risk assets, such as property, in order to try to get a positive return.

Going forward, the private investor will have to consider the impact of the credit crunch on the wider economy and how the impacts feed through to the commercial property market. However, interest rates may fall in the near future and other evidence from our surveys suggest that investors are experienced and expect to continue buying, whenever they can find the appropriate stock.

18% capital gains tax: are property investors winners or losers?

Karen McNicholls, Real Estate Tax Partner, Deloitte

Karen McNicholls examines the pros and cons of 18% capital gains tax

Given the bad press devoted to the private equity industry in the past few months it was expected that Alistair Darling would announce changes to the tax treatment of this group in his Pre Budget Report on 9 October. Rather than attempting to single them out for special treatment he announced a complete overhaul of capital gains tax, which is expected to raise around £2bn over the next three years. Private equity investors represent a very small proportion of the overall losers, and many property investors will find themselves significantly better off under the new regime.

What is proposed?

Capital gains tax is payable mainly by individuals, not by companies. Companies investing in property or other investments will not be affected by the changes. Individuals not resident in the UK for tax purposes should also be unaffected.

The proposal is that from 6 April 2008, a flat rate of 18% will apply to all capital gains, regardless of the type of asset sold and how long it has been owned. It will be a simple matter of deducting acquisition costs from sale proceeds and multiplying by 18%. Individuals will still benefit from an annual exemption; in the current tax year the first £9,200 of gains are exempt altogether. To appreciate the significance of this change, it needs to be compared with the regime it is replacing.

Currently, the length of time for which an asset has been held and the nature of the asset have a major impact on the tax bill. If certain conditions are met, the asset will qualify for business asset taper relief (BATR). After a 2-year holding period, the asset can be sold for an effective tax rate of 10%. This is the relief that the private equity community has been benefiting from, but they are dwarfed by the thousands of ordinary entrepreneurs for whom these rules were originally intended.

If the asset does not qualify for BATR, it will nevertheless accrue some relief over time, declining from 40% to an effective tax rate of 24% after a 10-year holding period.

In a nutshell, if property investors could benefit from BATR, they would be disappointed by the change to an 18% flat rate. If not, then they would be delighted.

Which property investors will be disappointed?

A property that is rented out rather than used in a trading business is unlikely to benefit from BATR. A hotel proprietor would therefore qualify for BATR whereas a person carrying on a letting business probably would not.

If a person owns shares in a property investment company, is an officer or employee of the company, and does not own more than 10% of the shares, BATR should be available on the shares. These conditions mean that most shareholders of such companies would not qualify. They will welcome the 18% tax rate.

The taper relief rules make it much easier for shares in a trading company to qualify for the relief because it was intended that trading entrepreneurs should be incentivised as they take on more risk, create more jobs and so on.

Likely impact on short and longer term behaviour

The announcement of the changes months in advance of their effect provides opportunity to take action in the meantime:

- Sellers of BATR assets will push sales through before 6 April 2008. A practical risk is buyers looking to use the timing sensitivity as a negotiating tactic – mechanisms may be required to address this risk in advance.
- Owners of BATR assets not looking for an immediate exit can use strategies to crystallise a sale prior to 6 April to lock-in accrued value at the 10% rate so that only future uplifts are taxable at 18%.
- Opposite tactics apply for non-BATR assets i.e. possible delay of sales, albeit that some form of commercial lock-in may be desirable. For buy to lets, this may mean a flood of properties on the market next spring.
- The improved tax treatment of many property investments could boost investment in the sector – commercial property, shares, buy to let and second homes may feel the impact in the UK and abroad.
- Investment in trading businesses may suffer from having lost some of its tax incentives. There are concerns that this could have a negative effect on entrepreneurial activity, which could have knock-on effects on the wider economy.
- While there will no longer be a tax benefit in holding assets for a long time, there are some other rules to catch the unwary if a person repeatedly buys and sells in a short time-frame leading to a 40% tax rate.

In summary

On the plus side, certainty, simplicity and an improvement in the position of many investors in property. On the minus side the relative incentivisation of entrepreneurial behaviour has been lost, which is at odds with wider economic objectives. With a close eye on further announcements and the detailed rules when they are published, investors should consider their positions carefully, especially if they are contemplating any sales.

Because you're worth it

Alistair Oates, Director, London Markets, DTZ Debenham Tie Leung

Valuation is more than the appliance of science says Alistair Oates.

'Valuation is an art not a science,' probably the most over used cliché in the property industry but rather like the footballing cliché, 'it is a game of two halves', its over use does not belie the accuracy of the statement.

In stable market conditions, in the established and relatively transparent markets of the UK, valuation could be seen rather more like a science than the art that it is, with valuers marking to market based on readily available comparable data available to all market participants. Today, the market feels somewhat different and the art of the valuation discipline is once again to the fore.

Prior to the turbulence in world stock and debt markets in response to concerns over the US sub-prime mortgage market there was already a re-rating of risk in the property market. Yield compression over the last few years appeared to have run its course, especially in more secondary or less established markets with justifiable risk premiums being eroded substantially. In the second quarter of the year a correction was underway as risk was being reassessed and re-priced.

The turbulence in world stock markets adds another dimension to a market that appears to be undergoing a correction. The long term effects of the banking crisis on the property industry will probably not be realised for some months but there is an obvious reassessment of risk from bankers who for many years have seen property as a one way bet.

Multiple factors

A combination of factors therefore challenge the current market. The flow of funds into property investment vehicles has greatly reduced in recent months and is reported in some cases to be negative. The prospect of a withdrawal of funds may force institutional investors to sell; swap rates have significantly increased over the last 12 months, although they have reduced in the last month, which has increased the cost of debt finance and bankers are taking a more cautious approach to lending. All these factors have resulted in yields for everything but the most prime assets drifting out since the beginning of June.

The problem for valuers is that transactional evidence of such a shift in yields for prime property is yet to be seen in the market on any significant scale, although there is evidence of properties being pulled from the market because they have failed to reach the vendor's expectations of value. This is obviously evidence of market sentiment but it is often difficult for valuers to obtain evidence of any bids that were received from these non-transactions as such vendors and their agents are considerably less forthcoming in discussing their failings as opposed to their successes.

There is certainly anecdotal evidence that vendors who are looking to sell in the autumn are looking to do quiet deals between principals rather than offer their property to the open market and risk generating evidence that their assets are actually worth less than they are holding them in their books at. A problem that is likely to be most acute where principals have their assets marked to market on an irregular basis.

True reflections

So in the current dynamic market it is, as always, the valuer's job to mark to market, but we must remember that it is our job to reflect the market and not to either lead or follow it. There is always a delay between a transaction being agreed and the details becoming known to the market as a whole and therefore it is essential that valuers make allowance for this factor whether the market is rising or falling.

A lack of current transactional evidence does not give the valuer the opportunity to hide behind historic market transactions and therefore avoiding an uncomfortable discussion with their client. Valuers must understand the dynamics of the market not only from their own experience of how it is operating but also by discussing market sentiment with the key players – including investors, bankers and agents.

While listening to all interested parties it is essential that the natural underlying bias of each party is discounted. In a falling market, agents may unwittingly talk values down more quickly than the market because they are seeing few deals being completed, possibly because more deals are being done on a principal to principal or off market basis. The banker who has a hangover of debt that he advanced against in the spring with the intention of securitising this autumn, may well see the property financing market in crisis whilst others providing more traditional bank finance may see the 25 basis point fall in 5-year swap rates in the last month coupled with yields moving out, as an opportunity for some of his clients to once more become competitive. The valuer must form his opinions based on all possible market knowledge which includes both market transactions, where available and current, and also an understanding of the motivations of the key players.

A valuation must represent a hypothetical sale on the valuation date and therefore if market sentiment has moved out since the last evidence was created the valuer must move their opinion of value in the same way, always remembering that the definition of market value assumes both a willing seller and buyer.

Christmas is never a great time to be a valuer and this year few valuers will probably be top of their clients' Christmas card lists, but to ensure that the market continues to function properly in more challenging times it is essential that valuers mark to market at each valuation discounting from their views both the doom merchants and those who refuse to see that the market has moved on considerably since the beginning of the year.

What are the implications of the demise of final salary and with profits schemes for the UK property market?

Mark Long, Director, Investment Strategy & Research, Invista Real Estate

Mark Long asks what happened to the institutions that dominated the 1980s property market?

Back in the 1980s, the property investment market in the UK was dominated by UK-based institutions but over the last decade following low inflation and low interest rates, the long term savings market in the UK has seen huge changes with increased regulation, greater control by individuals over their investment plans and a global search for higher returns. Whither those UK institutions now?

Defined benefit pension schemes

Private sector employers offering final salary pension schemes have become the exception in the broader recruitment world as long term funding of pension liabilities has become ever more expensive. Many factors have contributed to this including changes to dividend tax relief, more conservative valuation methodologies for pension liabilities (e.g. revised actuarial assumptions including inter alia those relating to longevity) and new accounting requirements for pension fund shortfalls.

As more and more scheme sponsors have been exposed to the financial impact of pension fund shortfalls, many have turned their backs on providing this benefit to their employees so transferring the power (and burden) of investment decision making and risk taking to the individual. With the recent Pensions Act, this trend has been reinforced with individuals now having more choice over investment strategy and fund selection than ever before. Investment capital has become much more footloose and many individual investors have looked to focus their investment capital towards sectors they feel they understand, withdrawing capital from some of the traditional institutional investment vehicles (e.g. with profits funds).

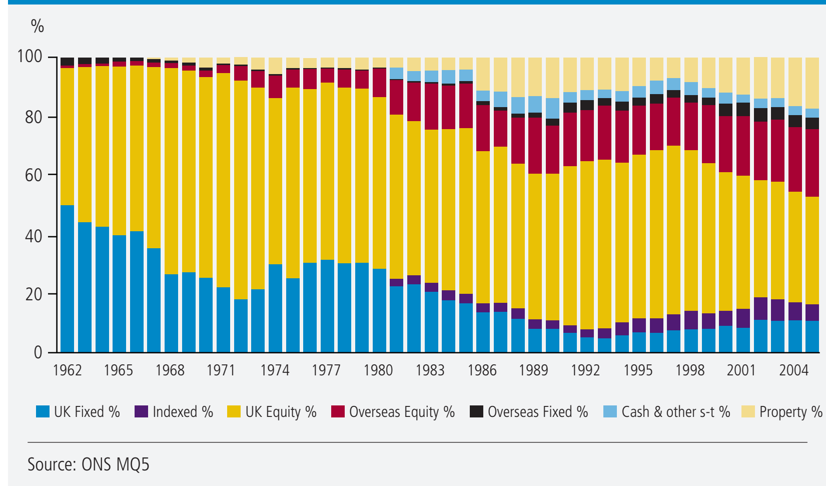
The cult of equities

Against that background, one of the most dramatic changes that has taken place over a similar period is the mix of investment assets in which institutions invest.

Figure 1 illustrates pension fund asset allocation from 1962 to 2005. The key recent trends to note are the increasing reliance on equities until the end of the 1990s at the expense of bonds followed by the subsequent decline in equity weightings since 1999 in favour of bonds and so called 'alternative investments' including commercial property. A number of factors have contributed to this including:

- An extended period of poor equity market performance (coinciding with the dot.com crash) between 2000 and 2003, which served to force equity weightings down (and contributed to the funding deficit on a large number of final salary pension schemes);
- Increasing regulatory oversight and controls which resulted in the increasing use of government debt to match pension fund liabilities and de-risk long term funding;
- Historically low interest rates feeding through into lower asset returns tempting institutional investors into seeking alternative investments;
- An increased focus on assets with lower volatility and those which offer diversification benefits when held in a mixed portfolio;
- A greater focus on higher yielding investments as pension funds become more mature and capital preservation increases in importance.

Figure 1: Pension fund allocation from 1962 – 2005



Source: ONS MQ5

Poor equity market performance contributed strongly to poor investment product performance affecting pension fund investors, other institutions and individual investors all of whose preferences have changed. This has led to:

- Disillusionment with traditional managed investment products and a decline in the sales of endowment policies and 'with profits' schemes; and
- A decline in multi-asset balanced mandates as the mood shifted towards a combination of specialist managers for specialist sectors and lower cost index tracking strategies.

These trends have been unequivocally good for alternative assets and particularly commercial property, which in the UK has seen a significant increase in investment flows.

DIY investment

Changes in regulation and technology have played a significant role in making investment markets more accessible and less opaque to individual investors. With information available at the touch of a button on a vast array of investment alternatives, the scope for better informed investment decision making has improved markedly. So with investors having better information and greater control over their choice of investments, the result has been very strong growth in self invested products such as self invested personal pensions (SIPPs), self administered pension schemes (SAPS), individual savings accounts (ISAs), as well as stakeholder pension schemes.

Notwithstanding that growth, however, as defined benefit pension schemes have gradually been withdrawn and as individuals have been offered more choice, so private sector pension fund participation has declined from 56% of employees in 1997 to 50% today (source: ONS, NAPF). What is clear and widely commented on is that a significant proportion of individuals are not making adequate provision for retirement – but not everyone believes they are falling into that trap.

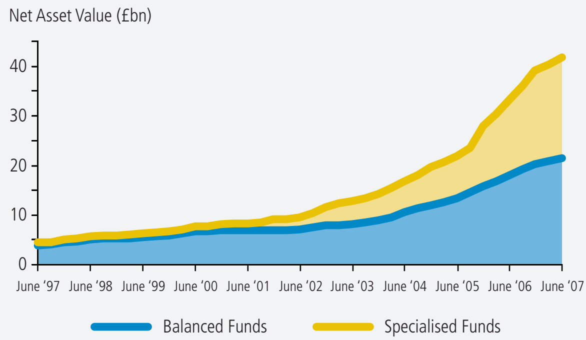
The obvious contrast is the dramatic growth in the residential buy to let market which from a standing start in 1997, has grown to a sector worth around £200bn in less than 10 years. Sustained strong house price growth over this period combined with affordable mortgage debt that most buy to let investors use, has made this sector extremely profitable. Whilst lower capital growth prospects combined with higher interest rates make this sector less attractive today, rental growth in the sector is now picking up and it continues to be a surprise that institutional investors remain disinterested.

Increasing specialisation

In addition to the buy to let phenomenon, commercial property has also been seen by individual investors as a safe haven but, rather than investing passively through a balanced mandate, many investors have preferred to choose proactively to have a greater proportion of their assets in commercial property. This has driven a rapid increase in the level of direct investment in pooled property vehicles as illustrated in Figure 2, which in turn has supported a number of new product launches in this area.

This shift has been further fuelled by larger institutions preferring specialist managers and has contributed to a huge array of funds now available offering exposure to narrow parts of the property market or individual assets or specialist management teams. Some of these funds are suited to the higher regulatory regime required if sales are to be made direct to smaller 'retail' investors but the majority are available only to institutional or other 'professional' investors.

Figure 2: Growth in balanced and specialised (property) funds 1997 – 2007



Source: IPD Pooled Property Fund Indices

Smaller institutions and retail investors have also supported the growth in property funds of funds, which offer a highly diversified exposure to the property market through investing in a portfolio of specialist funds, run by professional fund managers with the potential to outperform the direct property market.

For example, the Invista Property Portfolio Fund (IPPF) launched in 2004 invests in 14 specialist sub-sector specific property vehicles and provides investors with exposure to £10.5bn of underlying property, managed by experts in their fields. Since inception the fund has outperformed the direct property market as represented by the IPD Pooled Property Fund Index (17.6% compared to 16.9% to June 2007).

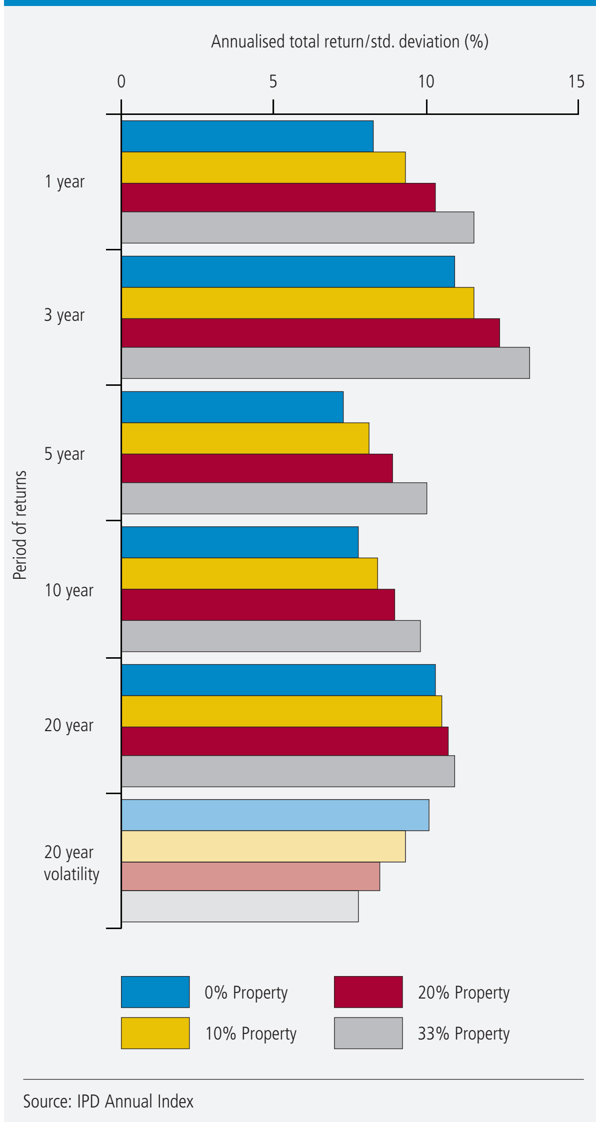
Diversification and capital preservation

FSA based warnings that 'what goes up in value may also go down' are much more prominent today and the issue of volatility, or risk, appears to feature more prominently in investment decision making amongst smaller investors. Short term volatility in other asset classes, particularly the huge falls in the equity market in 2001-02, has almost certainly been one of the principal reasons behind the growth of the buy to let market.

Both residential and commercial property have exhibited significantly lower volatility than either UK equities or government bonds over an extended period of time – this sense of property as a 'store of value' is an attractive feature for investors today – although strong total returns over the last few years (both in absolute terms and relative to the other two principal asset classes) and relatively high levels of income have been equally important to many.

Figure 3 illustrates the improved performance and reduced volatility that can be achieved within a mixed portfolio comprising initially just equities and bonds and then increasing the weighting to commercial property to 10%, 20% and 33%. This is an important factor particularly for sophisticated investors building long term asset pools designed to fund long term liabilities.

Figure 3: Risk and return in the commercial property market 1997 – 2007



Source: IPD Annual Index

Rental income and interest rates

Some investors who have looked to real estate as an income orientated asset with a potentially attractive total return story have helped to underpin the growth of the offshore listed real estate investment trust sector which has grown rapidly over the last four years and is currently thought to control £5.5bn of property assets.

Many overseas investors and some of the larger private investors prefer to use the income receivable from property to support borrowings to fund their acquisitions. The scale of investment in UK property by these players over the last few years, and particularly since 2003, illustrates how mobile and geographically unrestrained these investment flows have become.

Back in 2003, income yields from property comfortably covered the costs of servicing debt and the subsequent influx of debt-backed capital resulted in a significant re-rating of UK commercial property relative to interest rates and fixed interest investments.

Over this same period, there has been a substantial switch in the preference of investors globally towards higher yielding assets. This trend has been played out across virtually all asset markets be it equities, bonds, credit or property. However, the common theme of higher yielding assets across the majority of investment markets is that usually they are lower quality and riskier and/or have weaker growth prospects. Stronger demand for higher yielding assets has pushed up the price of these assets, compressing the yields down toward those of better quality lower yielding assets and so reducing the risk premium for holding these riskier assets.

Following five interest rate rises in the UK in the last 12 months, property yield differentials in both commercial and residential markets have been eroded and, although over the same period rental value growth has consistently edged upwards, the composition of total property returns have now changed. The income contribution of commercial property investment will once again dominate total returns in the next few years with income growth being the driver for any capital uplift rather than any further reduction in yields.

Conclusion

Barring a major set back in the economy arising from the latest financial turbulence and credit crunch which has a sustained impact on levels of interest rates and occupier demand, it seems highly likely that the greater control that individual investors now have over their own investment plans will continue to mean that new capital is directed towards commercial (and residential property) over the medium and longer term. In addition the traditional merits of low volatility and attractive income dominated returns available from commercial property will also continue to be valuable to institutional investors as they grow portfolios of mixed assets to fund longer term liabilities.

So whilst traditional pension schemes and with profits institutions continue to reduce in importance for the commercial property market, a new order has developed amongst investors both from the UK and amongst global players searching for higher returns in the broader investment world. This means that commercial property investment will remain a dynamic market for investors looking for attractive total returns dominated by income. Some investors will also continue to use debt to fund their investment acquisitions which is likely to mean over the medium and longer term that commercial property income yields and the cost of borrowing remain closely related.

And maybe one day, today's new breed of institutional investors will find a home in their portfolios for UK residential property.

Hedging your bets

Roger Dosset, Chief Executive of Property Fund Management, New Star

Roger Dossett takes a look at commercial property as an asset class.

One of the noticeable trends of the last few years in the financial world has been the explosion of interest in new asset classes. With yields low on bonds, investors, both institutional and retail, have turned to more esoteric asset classes to generate attractive returns. Hedge funds have proved particularly popular as investors have seen good returns from long/short and leveraged strategies while private equity funds have benefited from the high returns offered from realising profits on geared investments in a rising market.

Commercial property has been another beneficiary of this trend with investors attracted to the relatively high yields the sector offered. For commercial property, however, the interest is less a new phenomenon than a rediscovery. Commercial property had been popular with institutional investors, such as pension funds, in the 1970s when it represented about 15% of portfolios but during the 1980s and 1990s the sector fell out of favour, dropping to just 4% of portfolios as institutions chased the more glamorous, albeit not necessarily more profitable, world of equities.

Rediscovery

It was only at the turn of the millennium and the crash in equities that institutions were reawakened to the traditional strengths of commercial property. As equity markets tumbled, direct commercial property continued to provide positive returns. The returns of the last few years were particularly impressive as an environment of low yields encouraged income seeking investors to chase the attractive rental yields on commercial property resulting in strong capital gains.

Recent monetary tightening has led to higher interest rates while the turmoil in the credit markets surrounding the sub-prime mortgage debacle has led to tighter credit conditions and bondholders demanding higher yields. As such, the opportunity for further yield compression in the UK is, for the moment, over. This means that the traditional drivers of returns from commercial property – income and income growth – will come to dominate.

As a tangible asset class there are limits to the downside on commercial property. Even in the worst of circumstances a building retains some value although it might require an alternative use while new tenants can usually be found if the incumbent defaults. In contrast, bonds, especially those backed by weak covenants can be worth little if the issuer defaults and equity values can collapse if the company disappoints.

Tangible value

In light of the current problems in the markets, the tangible and visible nature of commercial property is arguably a positive feature of the asset class. At the heart of the current liquidity crunch in the money markets is a loss of confidence with banks hoarding reserves for fear of having to pay out to meet agreed liabilities. Similarly, opaque hedge fund practices have led to investors suffering large losses as assets that were not marked to market are written down in value. Clearly, it would be iniquitous to state that all hedge funds are tainted by the sub-prime problems as many have no links while others will be profiting by employing strategies that are on the opposite end of the losses.

Nevertheless, direct commercial property values are generally revisited every month and most property funds are priced on a daily basis, while listed property securities have market makers offering continuous pricing. This gives investors in such property vehicles greater confidence of what their investments are worth.

If the current financial turmoil were to spill over into a significant economic slowdown then clearly the commercial property market would not be immune – but the asset class does benefit from some defensive features. Premises represent one of the most important factors in a business's ability to operate: tenants will therefore cut back elsewhere before they miss paying their rent. Upward only rent reviews also provide a floor for income even against a challenging economic backdrop.

Building blocks of business

Behind commercial property is an essentially simple story: businesses need buildings in which to work. As the economy grows over time, rents should rise accordingly and these are reflected in higher property values. Not for commercial property the complicated algorithms of the more esoteric hedge funds, just a focus on understanding global and local economic dynamics and the drivers of rental returns.

The market volatility has led to some big swings in the value of both equity and credit-based portfolios. According to Aon Consulting, under the new FRS17 accounting regime pension balance sheets among FTSE 100 companies have moved from deficit to surplus and back again in the space of a few months.

Controlling risk

Malcolm Frodsham reports on how risk is currently measured and controlled in UK commercial property portfolios.

IPD were commissioned by the Investment Property Forum (IPF) to undertake a survey of large fund managers aimed at identifying how risk is currently measured and controlled in UK commercial property portfolios. Face to face interviews were conducted with senior managers and researchers in 20 leading fund management businesses.

The survey found that the sources of risk in commercial property portfolios are not comprehensively identified and that the techniques adopted to manage these risks at the portfolio level were mainly qualitative.

There are two distinct facets of the risk management process:

1. Reduce risk at the portfolio level through a spread of assets

2. Accept risk at the asset level if the return delivered compensates for the risk

This survey found that all organisations combined these two methods together to manage risk.

Portfolio level risk management

Respondents were asked about the portfolio risks formally reported to clients. If the organisation actively measured and reported on a facet of the portfolio then this is evidence that the risk is identified and can potentially be controlled. If these controls were in the form of portfolio limits then this is a form of qualitative risk control.

The survey results show that most organisations recognised the risk reduction benefits of holding a portfolio of assets with a spread of assets across different types and in different regions. Surprisingly few formally monitored the development exposure.

A high number of organisations also set formal portfolio limits, or qualitative risk controls, for the portfolio weightings by type and region. Only one set a development exposure limit.

Most organisations recognised the risk reduction benefits of holding a portfolio of assets with a spread of contractual lease characteristics but only a small number set portfolio limits.

The high number of organisations that formally monitored portfolio exposure to the largest assets and tenants shows that most organisations recognised that risk reduction benefits are compromised by the specific risk from holding individual properties or tenancies rather than a fully diversified exposure to a sector.

The techniques for top-down quantitative risk controls utilised by institutional property investors were also restricted mostly to managing the risks that vary due to factors in the wider economy and not the risks that vary due to the impact of the leasing contracts, as the building moves through its life cycle from new to obsolete or as the building moves from standing investment to development.

The difficulty of doing this in terms of modern portfolio theory is that the risk characteristics of these features of property are not stationary over time. So although all assets in a sector are subject to the same economic influences on their risk profile, the actual risk is also determined by the leasing terms and the functional usefulness of the asset.

Malcolm Frodsham, Director of Research, IPD

However, a few organisations had either devised, or were in the process of trying to devise, methods of incorporating these non stationary influences at the portfolio level. The method used was 'risk adjusted cash flow modelling'. This term is used to refer to the process of producing explicit cash flows for a portfolio built up from each asset. The cash flow drivers can be calibrated with a time dimension that also varies according to the asset's condition. So the re-letting assumption will be timed to the expiry of current lease contracts and the assumption varied according to the age of the asset at that time. The systematic impacts of development, leasing and depreciation on risk can therefore be measured at the portfolio level.

Asset level risk management

The area which showed the most divergence in approach to the management of uncertainty was in the accounting for risk at the individual asset level. Nine organisations did not explicitly adjust for risk at the asset level at all, although some were almost certainly in effect adjusting for risk by using 'conservative' assumptions in the projected asset return. However, the use of 'conservative' assumptions rather than explicit risk adjustment means potentially that different assets will be appraised on different basis, making comparisons of expected returns for different assets problematic and historic testing of the appraisal impossible.

The explicit non-adjustment for risk at the asset level by some organisations was often a direct challenge to the notion that fine adjustments can be made to the expected or required return from an asset. As pointed out by several respondents, these adjustments would need to be highly refined and assumptions on future events were particularly hard to make as they would depend upon both the asset's changing physical condition, leasing terms and property market conditions.

The experience of those organisations that did adjust for risk continued the challenging theme; respondents noted heated internal debates over the validity of the approach, the risk of double counting and over the scale of the adjustments that should be made.

The significant gap in the requirement by many organisations for fine asset level adjustments and the provision of guidance as to the scale of adjustments required only emphasises the difficulty of making asset level risk adjustments. However, the proponents of asset level risk adjustment were equally insistent that adjustments must be made and many echoed the sentiment that it is more important to ensure that appraisers have considered all the relevant risk factors than the actual quantum of adjustment made.

The clear procedural result of the controversy over asset level risk adjustment is the widespread use of scenario testing by both proponents of risk adjusting the asset appraisal and those not risks adjusting.

Facing the future: Energy Performance Certificates and commercial property

Dr Tim Dixon, Professor of Real Estate and Co-Director, Oxford Institute for Sustainable Development, based at Oxford Brookes University;

Miles Keeping, Partner, King Sturge;

Dr Claire Roberts, Senior Lecturer, Oxford Brookes University.

The research on which this article is based will shortly be published by the Investment Property Forum www.ipf.org.uk

The research was commissioned by the IPF and funded through the IPF Research Programme (2006-09).

Tim Dixon, Miles Keeping and Claire Roberts look at the prospective impact of the Energy Performance of Buildings Directive.

The 2003 European Union Energy Performance of Buildings Directive (EPBD) is set to have a major impact in the UK commercial property sector over the next 12 months. But new research for Investment Property Forum by King Sturge and Oxford Brookes University suggests that many in the industry are not fully prepared, and that there may well be procedural difficulties in implementing the Directive.

Background

Until recently the UK government has focused firmly on achieving energy efficiency in the domestic building sector. Perhaps this reflects partly the fact that domestic buildings are responsible for about 26% of carbon emissions, with non-domestic buildings accounting for about 14%. However, over the last five years there has been an increasing focus on the commercial sector, culminating in the required implementation of the EPBD.

The growing focus on energy efficiency has also been driven by the knowledge that the rate of growth in the UK service sector energy consumption since the 1970s has been approximately three times greater than in all other sectors of the UK economy, except transport. During the 1990s the rate of increase slowed, but the sector consumed about 14% of total energy in the UK in 2001. The increase in consumption in the sector has been driven, primarily by changes in output in the economy (measured as the sector's contribution to the UK economy), increased floor area, changing levels of employment and technological innovation. The commercial service sector is therefore a major consumer of energy and also an important source of carbon emissions.

Table 1: Proposed implementation timetable

Date	Element to come into force
19 April 2007	Establishment in law of necessary enabling activities – for example National Calculation Methodology, certificate design, qualification and accreditation regime
6 April 2008	EPCs for sale or rental of non-residential > 500m²
	EPCs for construction for all non-residential
	DECs for all public buildings > 1,000m²
1 October 2008	EPCs for sale or rental of all remaining non-residential
4 January 2009	First inspection of all existing air conditioning systems > 250 kW†
4 January 2011	First inspection of all existing air conditioning systems > 12 kW†

With the continued controversy over home information packs (HIPs) in the domestic sector there is a danger that the fast approaching deadline for implementing energy performance certificates (EPC) in the commercial property sector is overlooked. But, despite several missed deadlines, on the 29 March 2007, the UK government laid the Regulations necessary to implement the EPBD before Parliament. These Regulations have been long awaited and after significant consultation, more is now known about how and when the Directive will be implemented. The proposed timetable for EPBD implementation in relation to non-residential property is shown in Table 1.

There are four key provisions in the Directive which are important for property investors and other stakeholders involved in commercial property:

- Energy performance certificates (EPCs);
- Display energy ertificates;
- Air conditioning assessment; and
- The assessment and certification of energy performance.

The original purpose of EPCs was to contribute towards reducing emissions from the built environment and its users and to create more cohesion between member states by standardising property products in the market so that investors and occupiers can consider properties across Europe on an equal footing. EPCs will be required in the UK when a new building is to be built or an existing building is to be sold or let, and responsibility for provision of the EPC will rest with:

- The contractor providing it to the owner of a new build property.
- The seller making it available to any prospective purchaser.
- The prospective landlord making it available to a prospective occupier. The EPC should be provided, on request, to any prospective tenant, and should in any case be provided by the landlord to the successful tenant before a contract for tenancy is made. There is no need to obtain an EPC for an existing tenancy, and once obtained an EPC remains valid for up to 10 years. If a valid EPC still exists when changing tenants no new EPC is required.

Two types of energy certificate are being developed for commercial buildings with distinctly different purposes; the energy performance certificate (EPC) and the display energy certificate (DEC). The EPC will contain an asset rating and will measure and report on the intrinsic performance potential of the building by using a standardised energy performance computer model based on a national calculation methodology. The energy model will produce a grading (based on the CO_2 emissions per sq m of floor area) on an A-G scale related to energy performance standards required by the 2006 Building Regulations.

Display energy certificates, on the other hand will only apply to public buildings with a total useful floor area over 1,000 sq m. The DEC will contain both the asset rating and an operational rating giving the CO_2 emission per sq m of floor area of the building in use. DECs show the actual energy usage of a building and are based on the energy consumption of the building as recorded by gas, electricity and other meters. This can then be used to compare different buildings' energy usage.

What are the likely impacts of the EPBD?

The DCLG Regulatory Impact Assessment (RIA) for the EPBD includes a summary assessment of the financial costs and benefits of introducing the EPBD for the commercial property sector (i.e. non-dwellings or non-residential excluding public buildings). Deconstructing this analysis suggests that the EPBD will impact potentially on a significant number of UK commercial properties over the next two to three years (i.e. 150,000 EPCs will be required each year from 2008 to 2012 in England and Wales). Furthermore, DCLG analysis also suggests that the overall costs of implementation of EPCs (both direct and indirect) for all non-residential property (excluding public property) is calculated to be £1,148m over the period 2008 to 2020, which in crude terms is the equivalent of 2.5% of annual property development and improvement investment expenditure in the UK. The key benefits are seen as being in carbon savings, with some 4m tonnes of carbon saved for all non-domestic stock (excluding public buildings), but, in our view, caution should be attached to the overall analysis not only because of the assumptions underlying the data, but also because of the recognition by DCLG that there is a potential shortfall in assessors. A further area of concern in the DCLG analysis is the unit cost imputed for an EPC. This is calculated on the basis of a daily rate of £400 for assessors, but the time taken for each survey may well be an underestimate.

The implications for property investors

There has been a degree of discussion in previous research and anecdotally in the market place about the potential for energy certification leading to capital and rental value differentiation because of the relative energy efficiency of properties and the evidence from our interviews with investors and technical experts suggests that in the medium/long term, this is likely to be the case. In this respect, it is suggested that investors who are currently unprepared for the EPBD are likely to face difficulties. For example, several interviewees identified that the recommendations contained within an EPC could be used in 'price chipping', negatively impacting on the capital or rental value of the property.

Other issues which the research identified as the most pressing concerns for property investors include:

- Shortage of assessors – This should be a concern for investors, as it already is for the Government, and was the chief reason given for the delay in implementing the first phase of the EPBD relating to residential property. It may well also turn out to be a reason given for any delays to implementation in the commercial sector as well! Nonetheless, wise investors will already have begun to consider strategies for procuring the services of energy assessors in order to try to reduce the potential problems that they might encounter because of the current situation (for example, in relation to the marketing of properties).
- Costs of surveys – The DCLG has identified the approximate costs for EPC surveys ranging from £130 for 'new build' to £1,790 for a large commercial premises. However, it is questionable whether these estimates are realistic, particularly in the light of the shortage of assessors.
- Potential difficulties with process – Although the regulations have been published, there is still a certain amount of doubt in the market place with regard to some of the detail. For example:

  – Certification is not required for certain buildings, such as industrial units with low energy demand, but whether this includes storage and distribution units or relates only to manufacturing facilities is unclear to many people. Reference to the Building Regulations needs to be made clearer to ensure that people understand what this means.

  – Whether or not the initial benchmarks against which buildings will be rated in terms of energy performance are robust or appropriate.

  – The capability of the enforcement regime, shared by Building Control and Trading Standards divisions of local authorities, to cope with the large number of likely transactions and completions may cause problems such as delay for those involved in the transaction process.

As a bare minimum, therefore, it is suggested that property investors should consider acting on the following recommendations, if they have not already done so:

- Developing their strategic thinking on the potential value impact from the certification of the energy performance of buildings. What is their view and likely response, for example, to the potential for price chipping by purchasers or occupiers, and a perceived, increased obsolescence of a poorly rated building?
- Considering how many properties are likely to be traded in any given period of time and quantifying the likely need for accredited assessors. This should thereafter lead to proactive procurement of the limited number of accredited assessors' services.
- Addressing the procedural implications of procuring certificates, such as data availability for existing buildings, ahead of time. This will require a joined-up approach between fund managers, asset managers, facilities managers and energy assessors.

Real estate education: Changes and challenges

As Neil Crosby takes over from Colin Lizieri as head of the Department of Real Estate and Planning at the University of Reading, they review the challenges of providing real estate education in a rapidly changing business environment.

The Department of Real Estate and Planning at Reading celebrates its 40th anniversary in 2008. Over that time, the nature and focus of the degree programmes offered has changed radically. The last decade has seen major changes in the market environment, in the demands of employers and in the nature of students – all of which affect the delivery of education in property and planning.

A changing marketplace

Over the last 10 to 15 years, the property market has seen waves of innovation including the rise of private real estate equity vehicles, the spread of the REIT model across the world, commercial mortgage backed securitisation, corporate real estate outsourcing, the development of a real estate derivatives market, the arrival of hedge funds and global investors. These market changes sit within a context of a changing planning system and shifts in legislation and regulation and all of this must be reflected in what is taught in our degree programmes. However, this cannot be achieved simply by following market trends and fashion: new vehicles, analytic methods and market arrangements must be analysed formally and critically.

The link between property markets and the financial and capital markets has long been recognised and embedded in the syllabus. Corporate finance and formal investment appraisal principles feature at the start of both postgraduate and undergraduate programmes. However, the growing specialist areas linking real estate and capital markets are recognised in specialist pathways and programmes: the undergraduate BSc Investment and Finance in Property and the Real Estate Finance and Investment pathways through the full-time and part-time MSc programmes increasingly place graduates in investment banks, investment funds and the corporate finance departments of the London consultants alongside our traditional sources of graduate recruitment.

The balance between promoting awareness of market developments and providing a critical analytic framework is a difficult one to achieve. The primary function of a degree is to provide those frameworks and analytical techniques but within the context of the market developments. The use of case studies, project work and guest speakers from industry are well integrated into much of the curriculum. However, we also benefit greatly from our alumni network, the Reading Real Estate Foundation. In addition to providing financial support for education at Reading through their fund raising initiatives, RREF organise evening lectures and events where senior professionals come to discuss trends in the market and provide a strong industry grounding.

Colin Lizieri, Professor of Real Estate Finance, University of Reading Business School

Both the acquisition of principles and specific knowledge are underpinned by the key feature of Reading's learning and teaching strategy which is that it is research-led. Reading's real estate and planning research is internationally recognised and is strongly policy-oriented and applied, funded by Government, industry and professional bodies, including the Investment Property Forum. Examples of where IPF funded projects have fed directly into the teaching include the liquidity, property derivatives, depreciation and risk management projects.

Education and graduate employment

Neil Crosby, Head of Department and Professor of Real Estate & Planning, University of Reading Business School

The need to respond to a rapidly changing market environment implies a flexibility in teaching and syllabus and a focus on a fundamental understanding of principles and analytic techniques rather than a technical focus on standard models and existing institutional standards and practices. For a RICS (and RTPI) accredited course, this has been made possible by the move away from a highly prescriptive 'official' syllabus towards an emphasis on partnership and standards. The emphasis is on an education not a technical training, on developing the critical analysis skills that will last through a career and enable the graduate to adapt to further market innovation.

Not all employers appreciate this change: there are some who still expect students to have a 'ready to roll' knowledge of their own particular specialism. Most, though, recognise the value of a strong skills-based business education which develops students adaptability allied to an appreciation of the overall structure and operation of the property market.

Another major change over the last decade has been the growing importance of postgraduate real estate programmes. Reading now graduates as many masters students as undergraduates, a development paralleled in other universities. The MSc students are much in demand and it may be that some firms do not always recognise the additional depth of market understanding that can be imparted in a three-year programme by comparison to a 10 month programme. Nonetheless, it is important that we prepare all our students for the competition they face in the job market. Our success in achieving this has resulted in approximately 90-95% of our students (both BSc and MSc) securing appropriate professional employment within six months of graduation year on year.

Nevertheless, the Department remains aware that it must continue to develop and improve its programmes, that it cannot stand still. We have both real estate and planning advisory boards that provide feedback from the industry and that make

invaluable suggestions and we regularly discuss the quality of our graduates with employers. We use this feedback to fine tune our curriculum and learning strategies.

The changing student profile

This is not the place to debate grade inflation and standards in school education. However, few would dispute that the skill sets that UK students bring to their undergraduate studies have changed substantially. The modular structure of school examinations and the formality of grading methods means that students are very good at 'hurdle jumping', at meeting the requirements of clearly defined tasks. This facility comes at a price: fewer students have a wider perspective, are intuitively able to link together concepts or work independently on more synoptic tasks. This presents a teaching challenge to turn students into more independent learners, to help them integrate themes and subjects and to encourage them to move from facts and figures to concepts and understanding. This is a challenge facing all universities and one which we at Reading are tacking head on with a major review of our programmes and teaching methods.

Students are technically and technologically adept. They are well able to seek out material (largely electronically) for defined tasks. They are less able to appraise the quality of the materials collected in a critical fashion. Again these skills need to be developed formally within the curriculum. Linked to this is the growing problem of plagiarism – the cut-and-paste generation has to be educated on the importance of citation! Strict plagiarism policies, the use of plagiarism-detection software and tests reinforce the message. Some universities have retrenched, going back to an assessment dominated by formal unseen examinations – but this makes development of critical appraisal, writing and presentation skills more problematic. More positively, we are able to make use of the internet to create virtual learning environments where we can make additional material available, create discussion forums, provide links and, in general, provide a richer learning experience without increasing classroom time.

Changing the way in which a degree is taught is no easy task. A move towards team teaching and use of case studies is a significant challenge, but one which is being met enthusiastically. We are helped by our strong alumni network, with former graduates offering to help write and update case studies and, as guest lecturers, to present a further industry perspective for our students.

RREF is also helping address another perennial problem: how to attract strong students from more diverse backgrounds onto our degree programmes. Applications remain dominated by private schools and, on the undergraduate course, by those with family connections to the industry and professions. Programmes of school visits, improved marketing, and the proposed development of a summer school for talented A-level students are all helping to address this issue.

Faculty

It would be impossible to produce high quality, industry-relevant education without high quality, industry savvy staff. We are immensely fortunate in the quality of our colleagues at Reading and the size of the department provides a breadth and depth in teaching and research. However, a key issue facing all property departments – and indeed all universities teaching business and professional subjects – is who will teach the property students in the future?

At the 2006 IPF/IPD conference, Robert Houston made a plea for the initial salary of real estate graduates to match that of other business professions with the objective of attracting the very best quality of student to the industry. Starting salaries in law and banking are higher than most mid-career academic salaries. No-one becomes an academic for the financial rewards and the independence and research focus are a major source of job satisfaction. But the disparity in reward structure is having significant implications for recruitment and retention. Many academics have left universities for the higher rewards of industry: to return to university life, experienced researchers and investment professionals face a substantial cut in salary.

Student fees and costs add to the problem. Faced with a choice of a three-year doctoral programme with a substantial student debt, only the most committed student will stay in academic life rather than seek employment. Those that do achieve PhDs frequently move to commercial employment, rather than take a first job in an academic institution that pays less than current entry level graduate surveyor jobs. We graduate few doctoral students, very few UK-based doctoral students. Where then will we find the next generation of academics?

What can be done about this? One way forward would be for the real estate industry to make a much more substantial contribution to the education of its future employees. This requires a cultural shift: major endowments and financial support are widespread in the United States: the UK attitude seems to be an expectation that educational funding is a function of the state alone. We are seeing the beginnings of a change in attitudes. Grosvenor and CBRE, for example, have sponsored new professorial posts at Cambridge and Reading, other initiatives have supported new posts and fellowships. For Reading, the hard work of the RREF in securing endowment funding is much appreciated. But this is a systematic problem that requires new approaches and models. Doctoral research must become an economically viable option. Tangible financial support to retain the brightest and best of the mid-career academics and to attract talented individuals into the university sector permanently, on a part-time basis or as a career break is urgently needed.

These shifts in curriculum learning methods and resource base represent major challenges for the future with many constraints and inertial forces to be overcome. They are, though, changes which our developing departmental strategy at Reading faces head on.

Has real estate re-aligned itself?

Robert Houston, Chairman and CEO, ING Real Estate Investment Management (UK)

Robert Houston looks at the prospects for 2008.

I want to keep this article snappy. It is exactly 20 years since we launched our annual investor sentiment survey... and for no other reason than that, I am limiting my comments to 20 bullet points. If you want to push the fast forward button to the end you will see where I believe property yields will settle.

1. The UK. Bad guys or a shining example?

We are the only country to be admitting to a fall in property values. Rather than being castigated as poor global performers we should be congratulated on our maturity, market transparency and professionalism.

2. UK economic outlook

After another excellent year (circa 3%), we forecast GDP growth in 2008 will slow to about 1.7% before picking up again in 2009 to 2.2%.

3. Interest rates

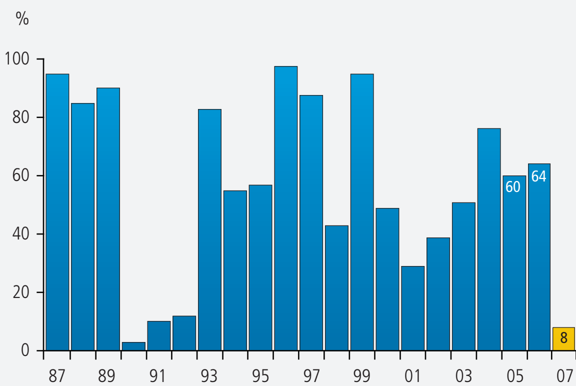
We think interest rates have peaked (5.75%) and will be down to 5% by the end of 2008. However, they may pick up again to 5.5% on the back of stronger economic growth in 2009.

4. Credit crunch

The on-going effects of the credit crunch will be felt throughout 2008, not least as the Bank of England is now urging the banks to be cautious with their property lending. Margins will remain stubbornly high.

5. Investor sentiment

Figure 1: Respondents who are optimistic about the property market in 2008



Source: ING REIM Investment Survey 2007

Our Autumn Survey indicates that only 8% of investors are optimistic about the prospects for property in 2008, 54% are uncertain and 38% are outright pessimistic. This is the lowest optimism score since 1990 – just before The Great Crash. For my part, I am unashamedly one of the 8%.

6. The broker's contagion

Beware of this very nasty infection.

Brokers, lawyers and others whose livelihoods depend on transactional volume may well bemoan the state of the market. What they really mean is that their fees are falling, not property values!

7. Asset class allocations

It is evident that UK pension funds are now beginning to reduce their allocations to property in favour of bonds. I guess this is inevitable in such uncertain times.

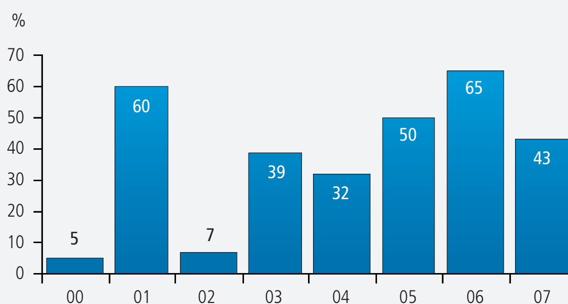
8. Indirect investment

More UK money is trying to exit pooled funds now than go in. Some funds have already decided to defer redemptions, and unless they are prepared to use gearing to meet the cost of redemptions (which seems improbable), we will shortly see the start of a sector-wide sales programme.

9. Overseas investment

Some of the money coming out of the UK market is destined for overseas property (particularly Europe). The additional diversification will be valuable, but yield compression has run its course there too.

Figure 2: Respondents indicating a place for European investment in their portfolio



Source: ING REIM Investment Survey 2007

10. Investment style

My guess is that investors will look to re-position their portfolios over the next two to three years. Standard core assets will continue to dominate, but there is likely to be a shift towards both dead-safe investments at one end and value-added or opportunistic investments at the other.

11. Alternative assets

Healthcare, infrastructure and other assets with inflation-proofed cash flows will gain popularity as investors 'hunker down'.

12. Structured products

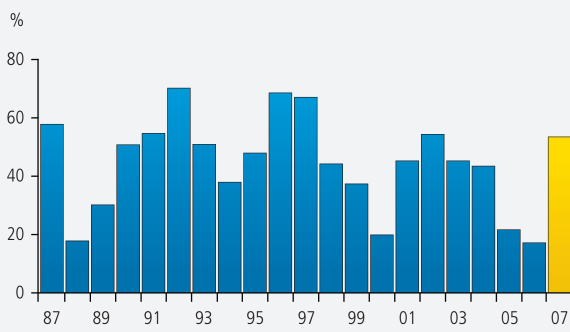
ING REIM have been active investors in structured products and derivatives both here in the UK and continental Europe. Like others, we expect to increasingly use this arena to take advantage of market mis-pricing and tactical plays.

13. Preferred sectors

Last year, our survey indicated that offices were the most preferred sector (66%) but now only 35% have placed them as their preferred choice. This year retail is on top (53%) having been the laggard last year (17%).

Much of this current requirement is for retail warehouses and supermarkets.

Figure 3: Respondents identifying Retail as their preferred sector in 2008



Source: ING REIM Investment Survey 2007

14. Rental growth

We remain positive about the underlying strength of the occupational market and forecast overall rental growth of 4.8% in 2008 but slowing in 2009 to 3.9%.

15. Central London offices

The credit crunch will have an effect on demand especially in the financial services sector, but overall we expect rents to continue to rise by 8-10% pa over the next couple of years – before the arrival of the on-coming stream of new buildings.

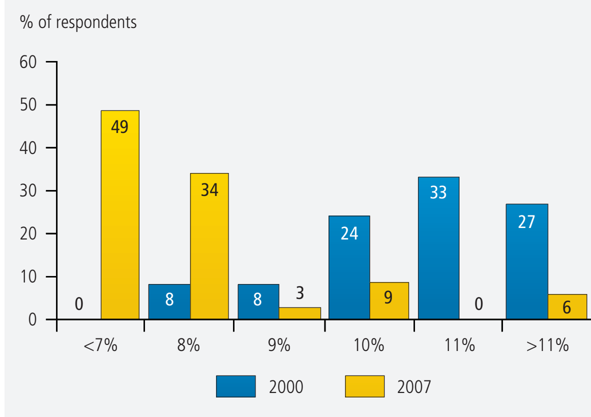
16. Shopping centres

I like them, but I sense that I am in a minority at present. They have excellent defensive qualities and invariably there are active management opportunities…but they have to be worked hard.

17. Hurdle rates

In 2000, our survey indicated that the majority of investors (84%) required returns of at least 10%. Over the past seven years their hurdle rate has fallen dramatically. Now 83% (49 + 34) are seeking only 7-8% pa... a much less demanding target.

Figure 4: Hurdle rate of return



Source: ING REIM Investment Survey 2007

18. Prime-secondary yields

The compression of yields over the past few years was largely indiscriminate. We now expect yields on secondary assets to move out more than the prime, unless there is genuine scope to add value through active management.

19. Yield re-rating

Where will capital rates settle? Our judgement is that initial yields will need to rise to 5%, broadly where they were two years ago. On that basis, they would be just above current bond yields with a reversionary increase and prospective rental growth as a bonus. The hurdle rate of 7-8% pa would therefore be well within range. That said, it is possible that yields may overshoot just as it did on the way down.

	Initial yield (%)	Equivalents yield (%)
December 2003	6.4	7.3
December 2004	5.8	6.6
December 2005	5.1	6.0
December 2006	4.6	5.4
June 2007	4.5	5.3
September 2007	4.6	5.6
ING REIM Projection	**5.0**	**6.0**

20. Threat or opportunity?

The sooner the current market correction is completed the better. At that time it will then be a definite opportunity to re-enter the market. The threat is that we procrastinate and leave the sector in the lurch. Let's hope not.

Heading home?

Freelance journalist, Tim Horsey, reports on a recent IPF lecture entitled: Residential Threats and Opportunities that examined whether it is time for institutions to move into the residential sector. The event was chaired by Rory Hardick, M3 Capital Partners.

At this lecture, Michael Ball, Professor of Urban and Property Economics at the University of Reading led a discussion on the attractiveness of residential property for institutional investors. He has been commissioned by the IPF to produce a research report on the issue.

Professor Ball explained that residential property is clearly important to small investors, with the buy to let boom well-known and continuing, but larger scale UK investors have continued to shy away from the sector. The IPD index only covers £1.5bn of residential property compared to £150bn of commercial, while UK residential housing stock is worth about £4000bn according to the ONS, compared to just £450bn of commercial.

The residential environment looks benign. The UK private rented sector is now growing rapidly and covered 2.5m households at the end of 2006, representing 12% of the national total and a rise of 25% since 1999. The private rented sector attracts mostly younger people, due to the affordability problems of home ownership, and with lifestyles also changing there is a desire for greater mobility which favours renting as transactions are much faster and costs lower.

The University of Reading is now forecasting strong household growth of 3% per year for the next decade, even if this is lower than in the recent past. Despite the recent expansion of demand, rents did not rise dramatically over the last five years; but they are now starting to take off. This pattern of house prices rising first and rents following later is often seen in residential markets, so the long-term prospects for rental growth now look encouraging.

Rental housing differs significantly from the overall housing stock, as most is located in inner cities and the suburbs. It is also widely dispersed, and thus difficult to manage for large investors, whose skills tend to favour bigger units like apartment blocks. So the potential stock open to large investors is much smaller than the sector as a whole.

Nevertheless, Professor Ball believes residential has considerable diversification benefits, with the correlation against commercial property for the period 1991– 2006 being relatively low at 0.64. Moreover, different regional markets have their own cycles, so that a residential portfolio spread across the UK will also have internal diversification benefits.

The sector has historically seen much stronger capital growth than UK commercial property, although the income return has not been as favourable. Between 1981 and 2003 real house prices rose by over 4% per year, as against a fall of 3% per year for offices. One reason has been that commercial firms are always looking to economise on their property inputs, whereas individuals like to increase their property usage as they get wealthier. At the same time, land shortages have tended to be greater for housing, with local authorities tending to favour developments that are potentially job-creating.

These trends have continued despite the Government's promises to increase supply; mainly because it has not kept those promises. House prices have risen faster than most forecasters have predicted, considerably outpacing the commercial markets.

One might argue that now is a strange time to be looking at residential, given that the global boom has gone on so long; many investors now wish they had participated in it and feel they may have missed the boat. Looking forward it is highly unlikely that things will continue at this pace, so investors need to focus on their long-term objectives.

Professor Ball explained how those seeking to enter the sector for the first time will need to choose between the direct and indirect routes. Direct investment allows greater control, monitoring and choice of specific assets, but transaction costs are high, as are management and maintenance compared to commercial where the FRI lease predominates. Tenant turnover is seven times as high in residential, valuers put a premium on vacant to let assets and there is also the reputation problem that arises when investors evict tenants. The markets for institutional type properties may also be very thin and illiquid.

Indirect investment using specialist organisations may help overcome many of these problems, but there are costs in terms of fees and loss of control. House price derivatives also offer an interesting means of access to the sector, but have not really taken off, in part because the market currently lacks scale. In fact the residential sector as a whole seems to have settled into a low-level equilibrium compared to many other countries. There need to be more indirect vehicles with specialist skills, but this will be difficult to achieve while investor interest still looks limited.

But overall, Ball concludes, prospects for the future now look favourable for large scale investors, with the buy to let market slowing down. Government is very keen to get big private investors into this market, especially in niche sectors.

Rupert Dickinson, CEO of Grainger, sees the strength of the owner-occupier as the crucial factor deterring institutions moving into this market in large numbers.

Grainger has always been in the residential sector, although it started in the very different rent control environment. It has moved into the standard letting market and has developed management advantages from its local presence in many regions – which had already been established in the rent control era.

Much of the large scale management skills which had been built up by the institutions since the 1900s were lost in the rent control period. Most of Grainger's original portfolios were acquired from the likes of the Prudential, Liverpool & Victoria

and Legal & General. Grainger has tried to 'build to rent', but it is too tempting to sell after building, especially given the rapid depreciation in the early life of residential assets.

Dickinson also sees a misunderstanding of the gross to net relationship by many commercial managers, who fail to take into account the depreciation of offices, in particular over the long term, whereas residential managers often counteract this by ongoing maintenance. For Grainger the effects of depreciation have meant that it tends to concentrate on period properties.

He believes that residential has a great future, but does need operating companies, of which there are very few in UK at present, and these are very expensive to set up. More assistance is needed from government to create these large scale vehicles, given the decimation of the sector in the period of rent control.

Even the route of buying into existing portfolios is difficult as the largest are often family-owned with big capital gains tax liabilities – meaning they would rather break them up over time – and such portfolio transactions also attract 4% stamp duty, even if the individual units are below the threshold.

Peter Pereira Gray of the Wellcome Trust sees many long-standing issues deterring institutions from investing in residential. Particular concerns are a lack of research and benchmarks, regulatory and transparency risks and valuation methodology.

Wellcome itself does however favour residential, because of the possibility of buying assets cheaply since let assets are sold at significantly below vacant possession value. The Trust now has about £1bn of residential assets in a total portfolio of £15bn, some of which have now been owned for as long as 12 years, and have performed exceptionally well.

Wellcome has also recently bought another large residential portfolio, believing it has a competitive advantage in the sector. At some point it may bring all its residential assets together and offer the market the £1bn vehicle that it needs – for liquidity and as a basis for derivatives.

Pereira Gray believes that if investors want exposure to the whole UK housing market, derivatives are the obvious route to follow – but institutions have not really exploited this potential at all as yet, either as a hedge or as a strategic play. This might seem like running before you can walk, given the immature state of the underlying asset class, but the financial expertise exists to develop these instruments.

Professor Ball commented that the house price derivatives idea has been around for at least 20 years, and its lack of take-up has been due to problems of scale, and also the unreliability of UK house price indices. Pereira Gray thinks that derivatives pricing now gives an interesting perspective on the UK residential market, effectively predicting a -3% return over the next two years, and 1.1% over the next 10 years – which might may be of some interest to investors given the more positive views expressed by this meeting.

Duncan Owen of Invista described the difficult UK capital raising environment through 2007, the result, he believes, of a lack of transparency and liquidity in the marketplace. For the future, changing the rules on REITs to make them more residential-friendly could prove helpful. One problem is the conversion charge payable on a new portfolio that has been assembled for the purpose of becoming a REIT. The income distribution rules are also inappropriate given the low yield generated by residential. And the definition of 'trader' can apply to residential investors who only deal in a handful of units each year. If these issues can be addressed then residential REITs will succeed, according to Owen. Otherwise foreign vehicles are likely to come in and benefit from the potential in the UK market.

Pereira Gray sees authorised property investment vehicles as a promising development in this context. Their main advantage against REITs is their lower issue costs. They would have no SDLT, potentially no conversion charge and no VAT on service charges.

Rory Hardick of Macquarie, chairing the meeting, concluded that investors should now have an allocation to residential, as there are clear advantages in terms of lower depreciation, stronger returns, significant capital growth opportunities, active management potential, diversification benefits, and the lack of stock available in the UK compared to likely population growth. Perhaps the biggest problem for institutional investors up to now has been the success of the buy to let investors who have taken up a huge amount of stock – but the financial climate may now start to favour equity investors instead.

The implication of the Markets in Financial Instruments Directive (MiFID) for property investment firms

Rebecca Thorpe, Associate Director, Bovill

Rebecca Thorpe looks at harmonising the provision of investment services across the EEA.

The Markets in Financial Instruments Directive (MiFID), which came into effect on 1 November 2007, is a European Directive which harmonises the provision of investment services across the EEA. It has a significant impact on property firms that are regulated by the Financial Services Authority (FSA) to undertake investment activities.

Passporting

One of the main aims of MiFID is to facilitate the provision of investment services on a cross border basis. This is known as 'passporting'. Passporting is intended to make it easier for firms to carry out cross border business, increase competition, and enable greater EU financial integration. Under MiFID's passporting arrangements, a UK firm authorised and regulated by the FSA can apply for passporting rights enabling it to provide investment services in other EU member states without having to seek local authorisation. Similarly, entities authorised in member states other than the UK can 'passport' services into the UK.

Customer categorisation

MiFID also introduces a new pan-European client classification framework comprising retail clients, professional clients and eligible counterparties (ECP) . This replaces the old FSA categorisation of clients as private, intermediate or market counterparty.

The definition of a retail client under MiFID is far wider than the old FSA private customer counterpart, since the criteria for professional customers is set much higher. The size criteria for professional clients means that two of the following must be met:

- €20m balance sheet total;
- €40m net turnover; or
- €2m own funds.

The result is more retail clients for firms and, in some cases, firms are dealing with retail clients for the first time. Opting up a client from retail to professional and professional to ECP is still possible as it was under the old rules, however this becomes more difficult under MiFID with both quantitative and qualitative tests to be met.

Financial promotion

The FSA has taken the introduction of MiFID as an opportunity to simplify the financial promotions regime. The result is that there are fewer prescriptive rules, but much greater emphasis on the principle that communications must be clear, fair and not misleading, (now re-ordered since the introduction of MiFID to 'fair, clear and not misleading').

Importantly, for MiFID firms undertaking MiFID business, the exemptions under the Financial Promotions Order (FPO) are no longer available as they are incompatible with MiFID. However, in respect of fund promotion activities by operators of unregulated collective schemes, all is not lost as the FSA have made clear that promotions not made to clients are not MiFID activities and such promotions can therefore still be made in accordance with FPO exemptions, such as the sophisticated investor or high net worth investor exemptions.

Best execution

For firms that execute client orders, and for firms acting as brokers, dealers and portfolio managers, the new requirements for best execution have substantially increased the obligations on firms in a number of areas. Many firms will now be required to have a published policy to which clients must consent and will be expected to take into account a range of factors in deciding the execution venue which provides the best possible result for the client. Firms need to consider the weighting of those factors in determining their policy and will need to be able to evidence ongoing compliance with the execution policy.

Conflicts

Conflicts of interest is an area that the FSA is placing much greater focus on under the new rules. Rather than merely resorting to disclosing potential conflicts to their clients, firms are encouraged to have in place a formal process for identifying, managing and reacting to conflicts as they arise. Firms must establish controls that are appropriate for continuously monitoring conflicts and to keep this under review.

The future

And what about my prediction for the future? Well, there are some significant changes brought about by the introduction of MiFID. Despite there being an enormous amount of debate generated about the subject, I predict that post-November 2007 firms, and to some extent the FSA, will still not have determined all of the implications of the new rules, and it will be a few months before we all become fully accustomed to the new requirements.

Forum activities and announcements

Investment Education Programme (IEP) – the IPF's formal postgraduate programme of modules

The course comprises a series of modules which may be taken as one-off courses or a part of the overall programme which, on successful completion, leads to the award of the IPF Diploma.

Timetable 2007-08

For the academic year 2007-08, all the Part I modules have taken place, with just the Part II modules remaining. Evidence of advanced understanding and experience is required for direct entry to Part II modules. The next set of Part I modules will commence in October 2008.

A full outline of all the modules can be found on the IPF website: www.ipf.org.uk

For further information on the Investment Education Programme, please contact the programme office at Cambridge International Land Institute tel 01223 477150 email cili@fitz.cam.ac.uk.

Part 1 Modules

Property as an Asset Class (e-learning module)
This is an e-learning module introducing the vocabulary, concepts and methods typically encountered in further study of property investment. The broad aim is to ensure that participants on the other modules comprising the IEP have clear understanding of these basic issues. The e-learning format enables participants to manage their study time efficiently, and with flexibility, at distance

In addition, it is a valuable introduction, as a stand-alone module, for those wanting to know more about Property as an Asset Class.

Introduction to Investment Valuation & Portfolio Theory
This module combines an introduction to basic investment mathematics and statistics with applications to valuation and portfolio management. It is one of the essential building blocks for financial analysis and provides the foundations for progression onto the module on Portfolio Management.

Financial Instruments & Investment Markets
This module examines the investment characteristics of the asset classes available to UK investors, in the context of investor's liability profiles. The different types of investment instrument are examined, together with the way in which they are valued and traded. The module includes an introductory study of indirect property investment and its comparability with direct property investment. It also introduces the participant to the regulatory environment under which UK property investors operate.

Part 2 Modules

Property Investment Appraisal
The purpose of the module is to provide an environment in which students advance their understanding of techniques, approaches and issues in property investment appraisal. The aim in doing this is to combine topical, practical issues and problems with insights drawn from leading research. The module addresses key concepts such as value, price and worth and covers DCF mathematics and decision rules, building on this to study cash-flow appraisal models and ways of dealing with risk. The module also embraces more specialised areas, such as lease pricing and the valuation of interests in private property vehicles. Also included is a session on behavioural finance and behavioural real estate. These sessions emphasise that, in addition to competence in the use of investment appraisal tools, it is also important to understand how people behave in making investment-related decisions.

Property Finance & Funding
This module explores the complex issues surrounding property finance and funding. It aims to provide an understanding of the conditions surrounding the provision and use of debt and equity in corporate and project form at an advanced level. These themes are supported by a case study approach and a computer demonstration to explore the quantitative analysis necessary to fully appreciate the risk return implications of different forms of finance.

Indirect Property Investment
Indirect investment in property is one of the fastest developing areas of investment in real estate. This module explores the main indirect investment routes and explores the advantages and pitfalls of the different routes to different investors; and ways of matching investor preferences to the range of investment products.

International Property Investment
This module provides an introduction to trends, key features and issues relating to international property investment. The module is targeted at property professionals (from the UK or overseas) who have experienced their domestic market but who are keen to develop an appreciation of how to develop an international investment strategy.

The module does not aim to provide a fully detailed outline of how all the major international property markets operate. Instead, the aim is to provide participants with an understanding of how the core skills in property investment (which are in the main covered in other IEP modules) can be applied in an international context. However, case studies and examples are used during the module to compare and contrast domestic and international property investment processes and practices and provide an important practical context.

Portfolio Management
This module is designed for experienced investment practitioners and property portfolio managers. It builds on the foundation

contained in the Introduction to Investment Valuation and Portfolio Theory module, embracing both theoretical and practical concepts. The application of modern portfolio theory and investment concepts to commercial property portfolios is considered. The module looks at how investment tools may be employed in structuring property portfolios and how portfolio risk may be controlled. The module also looks at commercial property's risk and return characteristics and at derivative products. The computing sessions form an integral part of the module, providing the opportunity to undertake data related analysis, enabling the exploration of issues raised in the lectures. Completion of the module enables participants to understand the concept of efficient diversification, the risk inherent in property portfolios, basic risk control techniques and property's role within a multi-asset portfolio. Furthermore, completion of the module equips participants with the necessary tools enabling them to undertake practical portfolio analysis

Part II Modules

Property Investment Appraisal
28, 29, 30 January 2008
IPF Member £1,095 Non-Member £1,440

Module Leader: Robert Couchman, Peer Group

Property Finance & Funding
4, 5, 6 March 2008
IPF Member £1,095 Non-Member £1,440

Module Leader: Patrick Harnan, Harnan Associates Ltd, formerly with Kingfisher Property Finance

Indirect Property Investment
22, 23, 24 April 2008
IPF Member £1,095 Non-Member £1,440

Module Leaders: Xavier Jongen, Bouwfonds Asset Management and Philip Nell, Morley

International Property Investment
3, 4, 5 June 2008
IPF Member £1,095 Non-Member £1,440

Module Leader: Ben Sanderson, Director, Property Research, PRUPIM

Portfolio Management
2, 3, 4 September 2008
IPF Member £1,095 Non-Member £1,440

Module Leader: Dr Shaun Bond, Department of Land Economy, University of Cambridge

Recent events

4th Annual IPF Property Investment Conference in Scotland: Property Under Pressure: Rise to the Challenge

This event took place in mid September in Edinburgh and was attended by around 120 property investment professionals. Many thanks to our sponsors: CoStar, Lloyds TSB Corporate Markets and Miller Developments.

Midlands Dinner 2007

A regular autumn event in the Midlands calendar many have described this year as the best ever. The audience found the after dinner speaker, former British Lions and England International, Martin Bayfield highly entertaining. Many thanks to our sponsors: Abstract Land, King Sturge and Lloyds TSB Corporate Markets.

Northern Dinner 2007

At the time of writing, this event has yet to take place. However, with Dennis Turner, HSBC's extremely amusing economist due to speak, this is sure to be a huge success. Many thanks to our sponsors Addleshaw Goddard and Kenmore Property Group.

Scottish Drinks reception

Our annual midsummer drinks reception in August at Tiger Lily, Edinburgh was very well attended and much fun was had by all! Special thanks to our sponsors the Co-Star Group.

Midlands Drinks reception

The Midlands drinks reception, held in Birmingham at the end of September, was another great success: with a great atmosphere and plenty of opportunity to meet old friends and make new ones. Special thanks to our sponsors Ballymore.

Future dates for your diary

IPF Annual Lunch
6 February 2008: The Grosvenor House Hotel, London

IPF Midlands Regional Lunch
18 April 2008: The ICC, Birmingham

IPF Annual Dinner
25 June 2008: The Grosvenor House Hotel, London

IPF Midlands Regional Dinner
16 October 2008: The ICC, Birmingham

Property-orientated routes to authorisation – an update

Sue Forster, Executive Director, IPF

The implementation of the Markets in Financial Instruments Directive (MiFID), with its impact on many aspects of asset management, is another indication that the conduct of business in the UK property market will be affected increasingly by financial regulation. Although dealing and advising in relation to direct property are not regulated activities under the Financial Services and Markets Act 2000 (FSMA), indirect property vehicles and products are deemed to be 'specified investments' under the FSMA and these represent an ever rising share of the property investment universe. Entities undertaking dealing, advising or managing activities in relation to these products need to be regulated by the FSA, as do operators of collective investment arrangements, including property unit trusts and limited partnerships.

Bovill Report

The IPF has been concerned for some time that the existing industry examinations (the appropriate examinations), required for individuals to obtain FSA approval to give advice or manage investments are not geared sufficiently towards the needs of property investment professionals. In order to determine whether this was regarded as a significant issue for those organisations and individuals already affected, or likely to be so in the future, the IPF commissioned the financial services regulatory consultancy firm, Bovill, to research the potential demand for an investment property-focused examination. The examination was assumed to be listed as appropriate by the Financial Services Skills Council (FSSC) thus meeting the FSA's requirements in relation to qualifications for individuals advising on property-backed investments.

To obtain a balanced view, the research used both qualitative and quantitative approaches in the form of over 20 structured interviews, primarily with larger organisations, and a sample based questionnaire sent to investment property professionals in both larger and smaller organisations (figure 1). Subjects covered by the questionnaire also extended to the level of existing qualifications held by staff (figure 2), which appropriate examinations are currently undertaken and how many approved persons there are in the respective organisation.

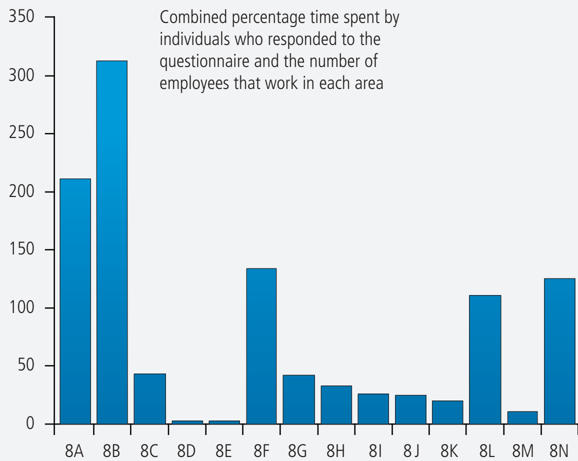
The research found that the Investment Management Certificate (IMC) was felt by many to be the current 'best fit' for those requiring an appropriate industry examination. However, it was recognised that the IMC includes a very limited focus in its syllabus on property as an asset class. Over 90% of those surveyed expressed interest in the development of a more property orientated examination that was approved by the FSA and nearly as many (84%) expressed interest in actually taking such an examination. Based on the returns from both the structured interviews and the questionnaire, Bovill estimated that there could be nearly 300 potential candidates should such an option exist.

Routes to Authorisation

The IPF has been working hard to realise a more property-orientated route to authorisation for both property advisors and fund managers. With regard to the former, it has been working with the University of Reading to develop an appropriate examination with a specialist paper for those advising and dealing exclusively in real estate. Candidates would become authorised through completing this together with a paper on UK financial services, regulations and ethics and, where appropriate, a paper on investment and risk. The University has been working on course material and examination questions and hopes to be in a position to go forward to seek accreditation for the new qualification from the FSSC early in the New Year.

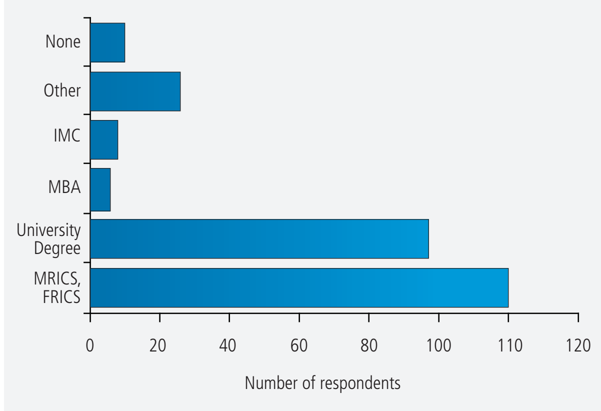
In parallel with the University of Reading initiative, the IPF has been exploring the potential for getting the Part 1 modules of the IPF Investment Education Programme (IEP) accredited for regulatory examination purposes in respect of the controlled function of managing investments (as opposed to giving advice). From preliminary work, it would appear that the IEP Part I modules provide a very close match with the standards relating to Managing Investments, but do not cover the learning outcomes in relation to UK Regulations and Markets. Consequently, it is intended to seek part accreditation for the Managing Investments elements only. This would result in those completing the IEP no longer needing to take the entire IMC as a separate exercise, but to sit just the regulatory module alone. Discussions with FSSC have started and the IPF proposes to submit a formal application during November. Were the FSSC to require only relatively minor modifications to the existing IEP, it is hoped that accreditation could be secured by April 2008.

Figure 1: Activity analysis combined results



8A – Property development
8B – Buying/selling land/direct property as an investment
8C – Providing advice in relation to indirect property investments (for example providing a report advising on a portfolio of investments for a high net worth individual)
8D – Providing advice on an interest in a fund (i.e. advice related to secondary trading)
8E – Investing for myself (i.e. not for a customer) in indirect property (for e.g. shares in a property company)
8F – Fund/asset management of direct property (for example discretionary management of indirect property for a pension fund)
8G – Fund/asset management of indirect property (for example discretionary management of indirect property for a pension fund)
8H – Acting as operator or manager of a collective investment scheme (for example, managing the commercial aspects of a portfolio of property developments to make profits for a group of investors)
8I – Establishing/creating indirect property collective investment schemes
8J – Marketing of schemes
8K – Overseas operations (for example, operating overseas schemes)
8L – Capital raising/structuring financing for property developments or acquisitions
8M – Trading complex property related investments (for example derivatives, swaps)
8N – Other. Please describe.

Figure 2: What existing qualifications do you hold?



The report undertaken by Bovill, and entitled 'Investment Property Exam Research Study', assesses the demand for an FSA recognized qualification appropriate for property professionals working in a regulated environment. This research was funded by the IPF Research Programme 2003-06.

Investment
Property Forum

Enhanced version of our popular IEP e-learning module

Property as an Asset Class

This is an e-learning module introducing the vocabulary, concepts and methods encountered in further study of property investment. The aim is to ensure that participants on the other modules, comprising the Investment Education Programme, have a clear understanding of these basic principles. For the individual, the e-learning module content is a smart way to enhance their current skill set, to bring them up to speed on the topics, or to prepare for the Investment Property Forum's Investment Education Diploma (IPF Dip).

Main features:

- Efficient management of study time with flexibility at a distance;
- Carefully designed and graded material to maximise progression;
- Use of innovative web-based materials allows learning at your own pace;
- A built-in progress tracking system gives extra focus to the learning experience; and
- Links to other web material to promote exploration of the subject and enhance understanding.

This course is ideal as a refresher for anybody working in the property industry, or as a taster for further study on the IPF Investment Education Programme.

For further information, please contact Cambridge International Land Institute (CILI) on +44(0)1223 477150 or email cili@fitz.cam.ac.uk

Investment
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£1million secured to further IPF's award-winning* research programme

For almost 20 years the Investment Property Forum has been informing and educating the property investment industry. Its research findings have been widely acclaimed as challenging, insightful and often unconventional, making them a 'must read' for everyone with an interest in property investment.

Thanks to the support of 24 leading property organisations, the IPF has secured a further £1m of funding to continue its far reaching research programme for another three years. For more information on the Investment Property Forum and a full list of forthcoming IPF events please log onto www.ipf.org.uk

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The Investment Property Forum would like to thank the supporters of the IPF Research Programme 2006 – 2009

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** The IPF's research programme was awarded the International Real Estates Society's Award for Corporate Excellence in 2005.*

Investment Property Forum

Annual Lunch 2008

Wednesday 6 February 2008 12:00 for 12:30

Grosvenor House Hotel, Park Lane, London W1

Ticket Price £98.00 (+ VAT) | Total £115.15 per person (excluding wine and liqueurs)

Guest Speaker Anatole Kaletsky

One of the country's leading commentators on economics, Kaletsky is Principal Economic Commentator and Editor-at-Large of The Times, where he writes a twice-weekly column on economics, financial markets and economic policy.

Anatole Kaletsky is widely recognised and respected for his views and analyses on the state of the economy not only in the UK but world-wide. He started his journalistic career with **The Economist**, where he was a financial writer from 1976 to 1979. He then worked for twelve years on the **Financial Times** in a number of posts including New York Bureau Chief, Washington Correspondent, International Economics Correspondent and Moscow Correspondent. Since 1996 he has been Economics Editor of **The Times** and is responsible for the paper's economic and business news coverage.

In 1980 and again in 1992 he received the Newspaper Publishers Association's British Press Award for **Specialist Writer of the Year** and in 1996 he was named **Newspaper Commentator of the Year** in the BBC's **What the Papers Say** awards. In 1997 he won the Wincott Award for Financial Journalist of the Year administrated by the Institute of Economic Affairs.

Please reserve tables for the Annual Lunch by completing a booking form and returning it with payment, as soon as possible. Tables will be for ten or twelve (limited availability of larger tables). Individual bookings can be made and, in this case, please indicate if you wish to join a table with specific people. All business associates and colleagues are welcome.

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

For more information or to book, contact Ingrid Styles on 020 7194 7920 or email Ingrid on istyles@ipf.org.uk

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