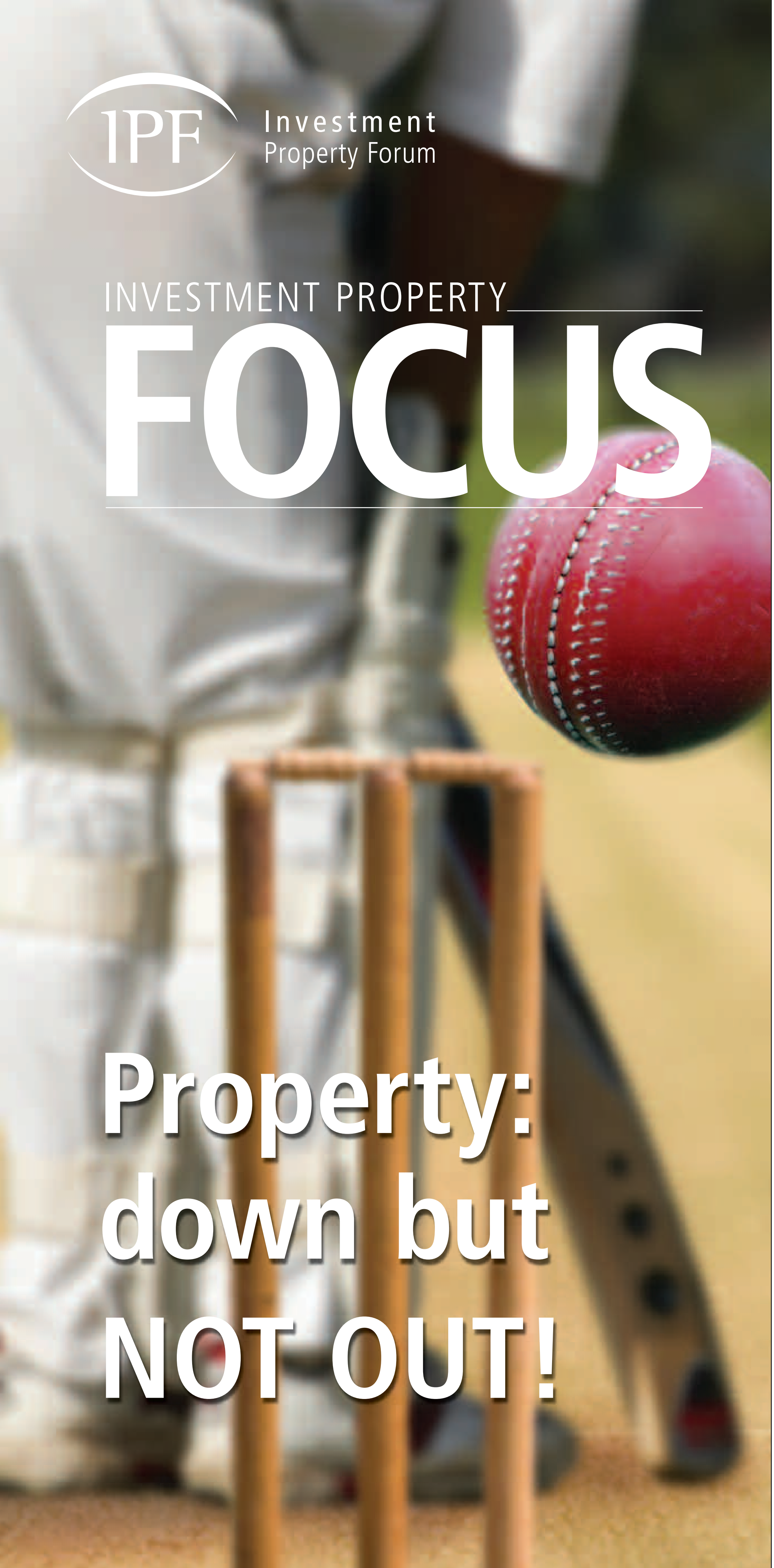

Investment Property Forum

INVESTMENT PROPERTY FOCUS

Property: down but NOT OUT!

The Journal of the Investment Property Forum
Issue No. 12 | July 2009

In this issue:

IPF Investment Property Forum

£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

Addleshaw Goddard, Aviva Investors, British Land, Credit Suisse, Deloitte., DLA Piper, DTZ, GIC Real Estate, Grosvenor, GVA Grimley, Hammerson, Helical Bar plc, IPD, Kenmore property group, Knight Frank, LandSecurities, LaSalle Investment Management, Legal & General, Nabarro Clarity Matters, PRUPIM, Scottish Widows Investment Partnership, Quintain, Standard Life Investments, Strutt & Parker

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

From the editor

Sue Forster, Executive Director, IPF

Despite the economic downturn, the IPF remains committed to providing members with high quality seminars and research on topical issues – as underlined by many of the articles in this edition of Investment Property Focus.

The IPF's new Chairman, Peter Pereira Gray of The Wellcome Trust, outlines his priorities for the year, which include building the IPF brand to ensure that the Forum remains at the forefront of the property investment world – delivering exceptional value to members and ensuring that there is a greater appreciation of what we stand for and what we seek to achieve.

Thought leadership and research are at the core of the Forum's remit and this edition of Focus includes two articles based on the new Research Programme Short Papers series. Neil Crosby, Colin Lizieri, Patrick McAllister and Simon Martin from the University of Reading were asked to look at the issues surrounding the valuation of direct property and produce a paper as a basis for debate. The article included here outlines the Reading team's thoughts on whether transactions that take place in a thinly-traded market are representative of market value and the response from the subsequent workshop attended by 15 valuers and users of valuations. The second Short Paper is written by Mike Phillips of the Estates Gazette looks at the UK commercial property debt mountain and how the banks might respond to this over the next year or so. He concludes that the banks are not keen to take properties onto their balance sheets and are more likely currently to extend loan maturities, rather than calling in loans.

Phil Clark of AEGON introduces the new Indirect Property Funds Special Interest Group. One of the Group's objectives is to produce standalone discussion papers, as exemplified by Graeme Rutter of Schroders' overview as to the advantages and disadvantages of investing in these funds, and the paper by Simon Berrill and Tom Jackson of Macquarie Capital Investors on the need to provide secondary market liquidity and how this might be achieved.

The findings of the 11th report on the UK commercial property lending market are outlined by Bill Maxted and Trudi Porter of De Montfort University. The total debt secured on UK commercial property reached £225.5bn at the end of 2008. Of this, 69% is due for repayment by 2013. Refinancing and loan extensions now account for over 50% of lending activity.

Mark Titcomb of DekaBank also considered the current position of the banks in his presentation at the IPF conference in Scotland. He pointed out that all the major debt lenders over the last 10 years were committed to at least halving their exposure to property. Other speakers at the conference; Peter Pereira Gray, Paul Guest of Jones Lang LaSalle and Phil Clark considered the challenges facing the property industry, while Peter Damesick of CB Richard Ellis told the delegates that buying property in the next year or so could potentially show real returns of 9% pa on a 5-year basis.

The fourth IPF survey of IFAs offers some encouraging signs for commercial property, with over 80% of IFAs recommending their clients to have some weighting in property. Historically, property has been perceived as a hedge against inflation. Given that there is an increasing risk of higher inflation, Edward Trevillion of SWIP looks at how resilient property might prove to be. His research suggests that property cannot be used as a hedge against high, unexpected inflation, such as during the oil crises in the 1970s, but that it can offer some protection against inflation because of its long term returns.

Bill Hughes of Legal & General outlines the need for the property industry to be 'smarter' about dealing with a data-hungry asset and Howard Morgan of RealService reports that the latest Occupier Satisfaction Index (OSI) shows that investors need to address the level of occupier costs.

Occupier covenant strength is considered by a team from the Universities of Aberdeen and Ulster, led by Norman Hutchison. Their research suggests that risk analysis going forward will need to be more robust in order to avoid the 'irrational exuberance' on the last few years. Matthew Richardson of Fidelity outlines the model that has been developed by Fidelity to benchmark the relative risk of income default within different property sectors.

The figures from the May 2009 IPF UK and European Consensus Forecasts are also included in this edition, together with the latest transaction volume figures for Europe, produced by Real Capital Analytics.

Certainly a bumper edition of Focus! If there are any subjects you think we should be covering in the November 2009 edition, please contact me.

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Message from the Chairman

Peter Pereira Gray, The Wellcome Trust & Chairman, IPF

It is a great honour to be appointed Chairman of the Forum; a true highlight in my professional career.

May I thank our retiring Chairman, Andrew Hynard for his strong leadership, energy and commitment in the past year; one that has proved far more challenging than any of us predicted when he took office a year ago.

In such a difficult economic climate for property investment, I believe that the Forum plays a critical role in providing independence and objectivity, education and research, and information and ideas to its members and wider market participants.

In this light, my priorities for the coming year will be to promote the Forum with a more structured marketing and public relations strategy. We need to build our 'brand' so that the benefits of membership are fully understood and so that there is a greater understanding of what we seek to achieve, and what we stand for.

We will also explore the role the Forum has to play in supporting a vibrant institutional residential investment market. To this end, the Management Board has agreed that the Forum should establish a Residential Special Interest Group, which I will chair initially.

During the year, we will investigate the potential for alliances with equivalent organisations that could benefit our members, without compromising our independence, quality or integrity.

Last of my priorities, but just as important, we must ensure that the Forum's finances remain on a sound footing so we can continue to improve the awareness, understanding and efficiency of property.

We are hugely grateful to our long-standing Honorary Treasurer, Andy Martin for his wise stewardship over the years, and for the reserves that have been built up under his tenure. These will cushion the immediate impact of reduced revenues, but we must 'cut our cloth' effectively going forward.

The Management Board has approved the establishment of two other Special Interest Groups in the last 12 months. The first focuses on indirect property funds and the second on how to provide members with greater access to information and contacts within international property markets. Both Groups will use their expertise to enhance the Forum's mainstream CPD and Research Programme, as well as providing more targeted outputs in the way of seminars and discussion papers.

A major strength of the Forum is the exceptional level and wide range of skills held by its members, exemplified by the Management Board which determines our overall strategy. I am delighted that Andrew Brazier of Ryon Properties, John Gellatly of BlackRock, Fiona Morton of Ryden, Mark Titcomb of DekaBank and Ian Womack of Aviva have agreed to remain on the Board and that Chris Carter Keall of Valad, who chairs our Membership Committee, and Sue Forster, the Forum's Executive Director have become new Board members.

Sadly, four members of the Board are retiring – Andy Martin of Strutt & Parker (Chairman 2004-05 and Honorary Treasurer), Mike Brown of Max Property, Peter Freeman of Argent (Chairman 2007-08) and Nick Tyrrell of JP Morgan. I should like to thank them for their huge contribution to the Forum. They will be sorely missed.

While the Management Board provides the strategic framework, the Forum relies on the commitment and expertise of the many people who serve on our committees and sub-groups to deliver its impressive programme of events and research. I should like to thank everyone for all their efforts and would make special mention of the Property Derivatives Interest Group (PDIG) Technical sub-group for the excellent publication, 'Getting into Property Derivatives'. I hope we can encourage more members to get involved; whether by joining a committee or perhaps providing a venue for seminars so that we can continue to run these free of charge to members.

We are fortunate to have very active regional Boards in Scotland, the North and the Midlands. These Boards are responsible for running seminars and other events on both national and more regional topics. This year saw presentations to Forum members of the IPD UK Annual Results in both the Midlands and the Northern regions, events that we hope will become an annual fixture. We also had over 100 delegates to a very well-received sixth IPF Conference in Scotland. We were able to reduce the delegate rate for members by a third, thanks to the generous sponsorship of AEGON Asset Management and the Miller Developments.

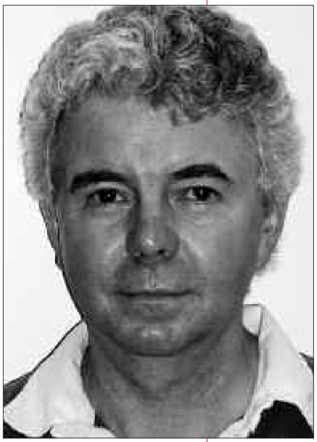
Sponsorship is also crucial for our well-respected, independent Research Programme. Thanks to the continuing support of our 24 organisations, the Programme will be producing a series of short discussion papers in the coming year intended to enhance debate on key topics. I see these as a clear demonstration that the Forum understands its responsibility to advance the efficiency of property and raise awareness of its role in the investment portfolio.

I fear that the property investment market is not 'through the woods' yet. At such a challenging time, the Forum will not let its standards, nor its reputation for delivering high quality outputs, slip. We will listen, talk to and support our members. I shall do every thing I can to ensure that the Forum remains where it should be, at the forefront of the property investment world, delivering exceptional value to our members.

STOP PRESS: I am delighted to announce that the IPF Certificate in Property Investment has been accepted by the Financial Services Skills Council (FSSC) as a Key 2 Appropriate Examination for approved persons managing investments. For further details, please see page 44.

Peter Pereira Gray
The Wellcome Trust

The UK commercial property lending market



Bill Maxted and Trudi Porter, Department of Corporate Development, De Montfort University.

De Montfort University published its eleventh research report in May 2009 on the bank lending patterns of the major commercial property lenders operating within the UK. This analysis of the market for the year ending 31 December 2008 is based on the questionnaires sent to 58 lending organisations that had contributed to this research in previous years. In addition contributions were received from two organisations that had recently entered the market. A response rate of 100% was received from these 60 organisations (64 lending teams), although the rate and detail of response to individual questions varied between organisations.

Throughout the research, commercial property lending is taken to mean secured lending where the purpose of the loan is for the acquisition, or development, or refinancing of commercial property. It excludes lending to PFI projects. Where reference is made to the commercial property loan books of lending organisations, this is taken as the net exposure to UK commercial property finance (i.e. net of any loan amounts sold down to other lenders and net of any securitised loans unless otherwise stated), including mezzanine, but excluding equity finance. This excludes lending to social housing unless otherwise stated.

Value of outstanding loan books

The 2008 survey recorded £243.3bn of outstanding debt, including loans of approximately £17.8bn secured by social housing. In addition, a further £51.8bn of loans were committed but not drawn at this date. Figure 1 shows a breakdown of this debt by type of lender and finance.

The aggregated value of outstanding debt recorded in the survey and secured by commercial property only, rose from £207.7bn in 2007 to £225.5bn in 2008, an increase of 8.5%. As shown on Figure 2, this is much lower than 18% recorded between 2006 and 2007 and is the lowest rate of increase recorded by this research.

Assuming this research captures between 90% and 95% of the specialist commercial property lending market, it is estimated that the total market size at year-end 2008 is between £237bn and £250bn.

CMBS

The closure of the CMBS market during the whole 2008 has been well documented. Investor appetite for these securities evaporated and the issuance market came to a standstill during the summer of 2007. In 2008, the only CMBS issues made and reported to this research were of a synthetic nature and totalled only £1bn. This compares with £9bn in 2007, itself well down on the £18.2bn in 2006.

Lenders reported that they wished to securitise £6.5bn of loans but were unable to do so due to the closure of this market. Some 20% of organisations, holding 47% of outstanding debt, confirmed that they intend to securitise loans from their loan books if/when the CMBS market recovers.

Figure 2: Outstanding debt secured on commercial property only

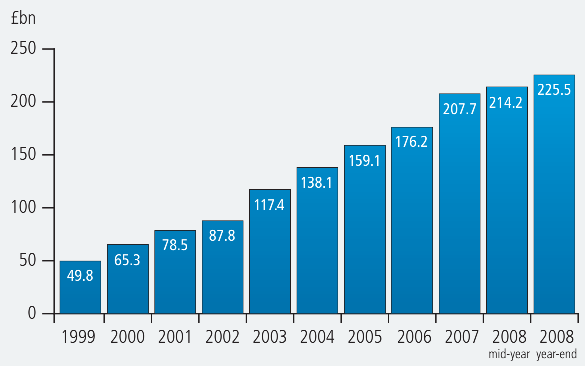


Figure 1: Category of lender and type of finance

Categories of lender	Reported UK outstanding loans including social housing £m	Mezzanine £m	Equity £m	Reported UK outstanding loans including social housing, mezzanine and equity £m
UK Lenders	144,070	1,258	570	145,898
German Lenders	24,231	–	–	24,231
North American Lenders	4,842	–	–	4,842
Other International lenders	39,581	240	–	39,821
Building Societies	29,079	–	2	29,081
All Lenders	**£241,803**	**£1,498**	**£572**	**243,873**

Syndications

During 2008, almost £6bn of debt was reported as being syndicated by 18 organisations. This represents 32% of contributing organisations. This is lower than that of 40% of organisations who reported syndications at year-end 2007, totalling £13.4bn, and does not match the 67% who expressed an intention at the end of 2007 to syndicate during the following 12 months. However, the proportion is only marginally lower than the 36% of respondents recorded as undertaking syndication activity during 2006.

As with securitisations, in addition to the question of how much syndication had taken place, the year-end 2008 research asked for the value of loans that lenders had in fact wanted to syndicate but had not been able to do so due to the adverse market conditions or lack of appetite by other lenders. UK Lenders reported that they would like to have syndicated some £2.6bn, representing over 50% of the total £5.1bn for All Lenders.

Mezzanine loans

At year-end 2008 the value of outstanding mezzanine finance had fallen to approximately £1.5bn and this was recorded in the loan books of UK and Other International Lenders only. The figure equates to approximately 0.7% of the total outstanding debt of £225.5bn recorded by this research. As a proportion of the aggregated debt held by those organisations that have provided the mezzanine finance, £1.5bn equates to approximately 1.9% of all lending.

The decline in capital values and uncertainty within the UK commercial property market since the middle of 2007 and the loss of liquidity in the banking sector has resulted in far fewer organisations being prepared to offer mezzanine finance. However, organisations commented that they were taking advantage of breaches in loan-to-value covenants by restructuring deals and regarding previously defined senior debt as mezzanine finance and pricing this accordingly.

Importance of commercial property lending

At the end of 2008, organisations that held 70% of the total £243.3bn of outstanding debt, estimated that this lending represented 19% of their total lending in the UK. Figure 3 above shows the corresponding proportions reported at previous year-ends since this data was first collected in 2004. The figure for year-end 2007 was reported previously as being 25%, however in light of additional information received at the end of 2008, this has been recalculated to be 20%.

Lending secured by commercial property plays an increasingly important role in the overall business activities of many organisations. The comparative proportion estimated by the Bank of England for year-end 2008 was 9.5%. However, it should be noted that this research captures data from a wider spectrum of organisations, including overseas lenders whose only business activity in the UK is secured lending to commercial property.

Figure 3: Commercial property lending as a proportion of organisations' total lending

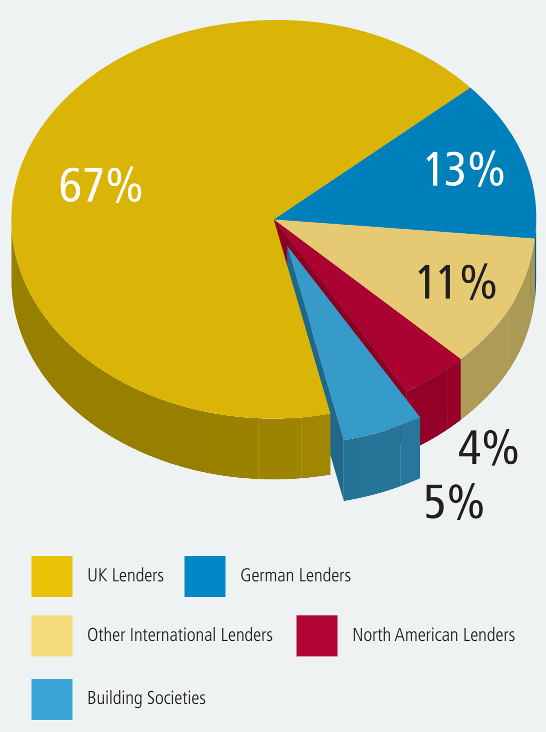
Year	%
2004	17.0
2005	19.0
2006	26.0
2007	20.0
2008	19.0

Loan originations

In 2007, loan originations amounted to £83.7bn, an increase of 3% compared with 2006. This compared with an annual percentage increase recorded by the research between 1999 and 2006 of over 24%. In contrast, the value of loan originations secured by commercial property in 2008 was only £49.2bn, a fall of 41%, spread evenly between the two halves of the year. Figure 4 gives the proportional allocation of loans secured only by commercial property originated in 2008.

From a total of 60 lending organisations, 80% originated loans during 2008, leaving 20% that undertook no lending whatsoever. Loan originations include organisations refinancing and/or extending their own loans, refinancing loans of other

Figure 4: Allocation of loan originations secured only by commercial property, 2008



organisations and new lending. Just three organisations accounted for 44% of lending during 2008. This is greater than reported in previous surveys when the top three loan originators accounted for between 28% and 35% of annual lending. Only 14% of organisations completed a higher volume of loan originations in 2008 than in 2007, compared with previous years when typically 60% of originations increased their annual volume of loan originations year-on-year. In contrast, 34% completed loan originations of a value that was 50% or less of the amount completed in 2007.

The total value of loans originated during 2008 was allocated almost exactly 50%:50% between each half of the year. The trend from the previous two years had been for the first half of the year to be most active. Given the events that took place in the global finance markets in the autumn of 2008 it is, perhaps, surprising that the volume of loan originations was so evenly distributed throughout the year.

So how much of the total for loan originations (£49.2bn) actually constituted new loans on property that had not previously been financed and how much refinancing existing loans (either from the respective bank's own loan book or from that of another organisation)? During 2008 there was an increase in the proportion of originations allocated to refinancing 'own' loans from 20% in 2007 to 34% in 2008 but a decrease in refinancing 'other loans' from 28% in 2007 to 20% in 2008. The figures are however not clear cut since it was apparent from the responses that some organisations have included within 'refinancing own loans' loans that were due to mature in 2008 but have been extended due to lack of refinancing possibilities. In contrast, other organisations commented that 'extended loans' are not regarded as refinancings in the strictest sense and so have not been included in the response. However a broad trend that can be observed is that in the current market the rate of refinancings has increased at the expense of 'new' lending.

Lenders

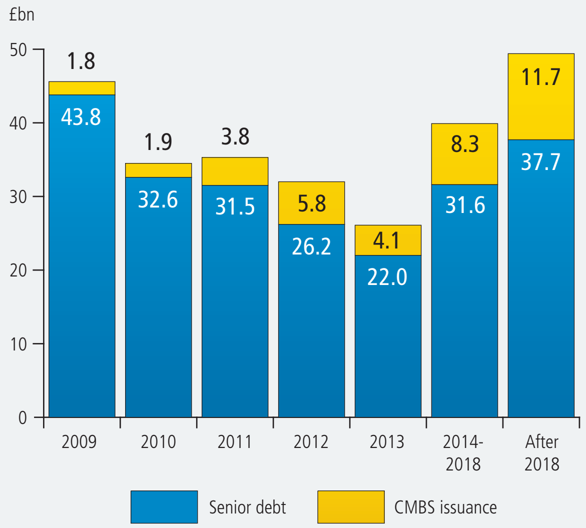
UK organisations generally (UK Lenders 61% combined with Building Societies 9%) hold 70% of total debt secured on commercial property. The increased significance of UK Lenders, since 2001, and Other International Lenders, since 2003, is clearly indicated in the data, in contrast to the proportionate decline in value held by German organisations. During 2008, however, although there has been little movement, German and Other International Lenders have seen a very slight increase in market share at the expense of UK Lenders. The market share held by North American Lenders and Building Societies remained unchanged.

The value of outstanding debt continues to be concentrated in the loan books of a relatively small number of large organisations – since 2002, approximately 75% of outstanding debt has been held by the largest 12 lenders, of which nine are UK lenders.

Debt repayment

69% of all outstanding debt is due for repayment by the end of 2013. At 69%, this proportion of debt due to mature within the following five years is higher than that recorded by previous year-end surveys. For example, at year-ends 2006 and 2007, the proportion of debt due to mature within the following five years was 61% and 60% respectively. It is suggested that the reason for this change in maturity profile is that in many instances, loans that were due to mature in 2008 have been extended due to borrowers' inability to refinance. Figure 5 shows the maturity profile for senior loans and of CMBS issuance – the data for the latter is provided by FitchRatings.

Figure 5: Maturity profile of debt secured on UK commercial property



Sources: De Montfort University; FitchRatings

The estimated proportion of loans that were prepaid or refinanced before maturity during 2008 was 13% by value. This is a reduction from 60% estimated in 2004, 43% estimated in 2005, 29% estimated in 2006 and 15% in 2007. There remains a wide variation within the individual organisations with proportions of prepayments reported ranging from 0% to 39%. Within the 2008 data set, 0% is the modal value and only one organisation reported prepayments in excess of 20% of their outstanding loan book.

Loan terms

Average interest rate margins for loans secured by all commercial property sectors generally increased between 1999 and 2002-03 but declined thereafter until year-end 2006. Increases were recorded during 2007 that continued throughout 2008. Average margins at year-end 2008 were the highest recorded by this research for each property sector. The second half of 2008 also saw the biggest increase in margins during a single time period between surveys. By way of example, the average margin on loans secured by prime office property increased from 126.4bps at year-end 2007 to 150bps at mid-year 2008 and then increased by a further 63.5bps to 213.5bps at year-end 2008. Similarly for secondary offices, average margins increased from 144.7bps at year-end 2007 to 172bps at mid-year 2008, and then, to 233.4bps by year-end 2008.

The research for 2008 also sought to identify whether or not the terms given above would vary for loans of a value of £50m or above. The issue being that, due to the lack of liquidity in the market at the end of 2008, these bigger sized loans would be more expensive. Only 38% (25 lenders) of organisations indicated that they could be active in the market for loans of this size. Of these, only 8% (two lenders) confirmed that pricing would increase by broadly 25bps on the interest rate margin and 50bps on arrangement fees. The remaining 92% (23 lenders) recorded that the pricing would remain the same. However, of these 84% (21 lenders) reported that a club would need to be put into place before proceeding on a loan of over £50m. Organisations would charge an additional fee for arranging the club of between 75bps to 100bps. In some instances it would also be expected that the loan-to-value ratio on the loan would reduce.

During 2008 there was a dramatic fall in average maximum loan-to-value ratios of between 10% and 11% for both prime and secondary property. For example, average loan-to-value ratios for loans secured by prime offices fell from 75.6% at year-end 2007 to 65% at year-end 2008. Similarly for secondary offices, the loan-to-value ratio declined from 72.4% to 61.6%. The only exception to these rates of decline was recorded for the residential investment sector; the maximum average loan-to-value ratio fell from 71.5%, at year-end 2007, to 65.3% at year-end 2008.

All organisations increased arrangement fees substantially and at year-end 2008 these ranged from 95bps to 110bps depending on the property sector.

Decreasing base rates and swap rates reduced all-in interest costs and falling loan-to-value ratios (albeit for loans secured against commercial property that was also declining in value) resulted in income to interest cover ratios improving dramatically for loans secured by every property sector. At year-end 2008, these ratios stood at their highest recorded by this research.

Loans in breach of financial covenant and defaulted loans

The survey defines 'in breach of financial covenant' as meaning loans where interest and/or principal repayments have been wholly or partly unpaid and/or the loan-to-value ratio or other covenants have been breached but the loan has not been declared in default. A default is defined as meaning loans where the borrower has breached its loan obligations and an administrator has been appointed over the secured assets. At year-end 2008, 89% of organisations reported that they held loans that were in breach of financial covenant. This compares with 78% of organisations so reporting at mid-year 2008 and only 45% at year-end 2007. The value of loans in breach of financial covenant represents approximately 6.5% of the total aggregated loan book of organisations contributing data to this part of the research. If the same proportion of 6.5% is applied to the total value of outstanding debt of £225.5bn, then the value of loans in breach of financial covenant would be close to £15bn.

The most frequently cited cause for a breach to occur was that the loan-to-value covenant had been breached. This, together with 'interest wholly or partially being unpaid' were cited by 87% of respondents. In addition, a significant number of respondents added comments that indicated that all loans written in 2006 and 2007 would be technically in breach of their loan-to-value covenant by year-end 2008 due to falls in property values. However, many stated that they would not carry out valuations to test the covenant whilst the loans were still 'performing' i.e. interest was still being paid.

With regard to loan defaults, 66% of organisations that responded to this section of the survey reported as having put loans into administration during 2008. This compares to 33% that did so during 2007. The value of defaulted loans of £3.1bn represents approximately 2.6% of the value of outstanding debt held by the organisations that reported fully to this aspect of the research. This would equate to approximately £6bn of loans for the total market, which may be an under-representation since the occasions when an administrator is appointed is relatively small.

The reasons given for loans to default were numerous and varied. Generally, tenant voids resulting in deteriorating income streams, compounded by vacant property tax (void business rates) introduced in April 2008, was cited. Poor business decisions/management by the borrower was also frequently cited. This often resulted in tenant failure and a decline in income to service the debt. Residential development continued to be a major problem area. Problems encountered ranged from lending for the purchase of land banks for which there is no demand for development and, contractor failures.

Structure of outstanding loan books

The allocation of finance towards development property (both commercial and residential development for sale) fell in 2008, accounting for approximately 17% (21% in 2007) of the value of outstanding debt and representing £40.8bn, a decrease from £43.1bn recorded in 2007. The proportion of outstanding debt allocated to investment property increased from 70% to stand at 73% at the end of 2008.

As in 2007, the largest single allocation of debt is secured by office property (22% of total loan value). Of this, German Lenders had the highest exposure, recording 55% across the sector as a whole compared with 21.5% for UK Lenders and 35% for North American Lenders.

The overall allocation of lending to the retail sector changed little between 2007 (21%) and 2008 (20.5%) but there was a decline in allocations to investment in retail warehouses and retail development generally. North American Lenders had the largest exposure to retail property, being 35.5%, compared with their share of 17.5% in 2007. Other International Lenders accounted for 31%, but this was below their 36% share in 2007.

Conclusion

The conclusion to the mid-year report for 2008 stated that the research during quarters one and two had, for the first time, tracked a commercial property lending market that was in decline. The second half of the year contained calamitous events such as the collapse of Lehman Brothers and the UK Government having to support two of the UK's largest lending organisations. The year-end data, therefore, was expected to report on a commercial property lending market that was, perhaps, also on the brink of collapse. However, whilst the market was unquestionably in decline, the results for 2008 suggested that reports of its total demise were premature.

During 2008, the lack of liquidity in global finance markets, increasing bad debts experienced in most business areas by many lending organisations and the consequential decline in activity in the UK's commercial property market, all pointed to a severe reversal of growth of outstanding debt secured by UK commercial property. Consequently, an increase in outstanding debt of 8.5% from £207.9bn (year-end 2007) to £225.5bn at year-end 2008 was perhaps surprising. However, these values should not disguise the fact that the increase of 8.5% was the smallest ever recorded by this research.

The most obvious sign of the market's vulnerability during 2008 was the decline in annual loan originations, which fell 41% compared with the total in 2007. The research also suggested that there had been a retreat from the market by a selection of overseas lenders. Nearly 20% of organisations that participate in the research undertook no lending whatsoever during 2008; the first time that such a statistic had been recorded. Within the lending that did occur, 34% was accounted for by organisations refinancing their own loans; another highest proportion reported. Proportionately, 'new lending' at 46%, was at its lowest level since 2004.

The key issue is that over 50% of lending activity recorded was in refinancing and extending loans that most probably should have been repaid in 2008. Borrowers in general were unable to refinance maturing loans because of the severe lack of liquidity and the decline in commercial property values. As a result, maturing loans have had to be extended for between one and two years. This has, for example, caused the maturity profile of loans maturing in 2009 to increase, from almost £23bn recorded at the end of 2007, to £44bn recorded at year-end 2008.

The revised value of maturing loans needs to be considered against the future lending intentions of organisations. At year-end 2008, 51% of organisations intended to maintain or increase their lending activity, whilst 49% intended to reduce activity, the latter co-incidentally being the group responsible for originating two-thirds of all lending during 2008. It is suggested in this research that those organisations intending to maintain or increase activity could originate up to £20bn of lending during 2009. This equates to approximately 50% of the value of loans expected to mature. To match maturities with origination in 2009, those organisations intending to reduce lending would have to originate approximately two-thirds of the value originated in 2008, which is unlikely to be the case. Consequently, availability of credit for the property industry will probably remain severely restricted during 2009 and beyond and smaller loans for a maximum of three years will predominate.

Furthermore, the preparedness to lend is also being restricted by a weakening economy resulting in the failure of an increasing number of business tenants, with consequences for reductions in rental income and further falls in capital value. This will increase the risks involved in lending secured by UK commercial property and in turn require additional regulatory capital to be set aside to comply with the Basle II regulations (see page 13 for more details).

However, unlike the property slump experienced in the early 1990s, so far organisations are supporting their borrowers. Where possible, loans are being extended or refinanced and breaches in loan-to-value covenants are being ignored provided interest payments continue to be made. However, this supportive approach adopted by lending organisations will restrict their ability to originated new lending.

Property investment in a new world

Report on the IPF Conference in Scotland

The sixth annual IPF Property Investment Conference in Scotland, sponsored by AEGON Asset Management and Miller Developments, took place on 11 June. The speakers, all leading industry experts, underlined the challenges facing the property industry and economy as a whole in the next 12-24 months and the changes we are likely to see as a result.

Peter Pereira Gray outlines the challenges facing the property industry

Peter Pereira Gray of The Wellcome Trust and Chairman elect of the IPF, set the scene by saying that there was some evidence that confidence in the recovery is increasing and the risk of total meltdown in the financial system has reduced. He pointed to some positive signs for property including; increasing transactional volumes; falling discounts to net asset values in the quoted property sector; the fall in the value of sterling, making the UK property more attractive to global investors; the provision of new capital to property companies; and the 400bps margin between the IPD average initial yield and 5-year swap rates, represents "quite a dramatic margin over the long term average".

However the property industry faces a number of major challenges, which he identified as being:

a) The enormous debt overhang;

b) The potential for rising inflation;

c) Rising interest rates; and

d) An increasing level of regulation

The industry as a whole, "has a lot of growing up to do", and the IPF has a major role to play in supporting this through education and research.

Paul Guest of Jones Lang LaSalle said the strong growth in global GDP between 1980 and 2008 was attributable to a number of factors including: credit liberalisation; the entry of planned economies like China and excess supply over demand, which kept prices low and stable and allowed interest rates to also remain low and stable.

He thought that there would be real positive GDP growth again in the last quarter of 2009 or the first quarter of 2010 but this did not signal the return to the same strong growth of the previous 18-year period. There would be continuing erosion in the labour market, which lags GDP by a year; energy prices are already rising and the long term trend is up; bond rates are rising; and the futures markets are anticipating a rise in interest rates in the US by the end of 2009, with the UK likely to follow suit in 2010. Investor confidence in the property market was beginning to improve but this could change, particularly if occupier demand is weak.

He said that during the good times of 1980-2008, risk premia were compressed and investors became complacent. In his view, "one of the key questions in the recovery is how will risk be priced going forward since this will have a major impact on the pricing of property and debt".

Phil Clark of AEGON considered whether the experiences of the last year meant that the property fund model is broken. He identified debt and liquidity as the two key problems facing the sector. Given the large fall in property values, he thought that, "property funds with gearing have some tough challenges ahead". With regard to liquidity, he felt that in 2005-07, everyone lost sight of the fact that, "the underlying property assets are relatively illiquid, even in a fund".

Despite the problems exposed over the last couple of years, property funds are still important for offering general market exposure to small and medium-sized institutional investors and specialist management to those who do not wish to build expertise in specialist sectors such as healthcare, residential property or hotels.

However, there are likely to be some major changes in the in the way that funds are structured and operate. These could include: a reduction in the number of large institutional investors willing to invest in the same funds as smaller investors, given the tensions between the former wanting to stay in for the long term and the latter wanting to redeem within shorter time frames; a more questioning outlook from investors seeking to invest in a funds where another colleague in the fund's organisation has a significant investment; a review of corporate governance in terms of the basis for fees and possibly the appointment of independent directors to review investment strategies; and a possible annual cap on the amount that can be redeemed from open-ended funds and timescale for that redemption. Clark concluded that, "the property funds' industry is still in its adolescent phase and now needs to resolve some of these challenges if it is move to adulthood".

Mark Titcomb of DekaBank provided a sobering overview of current bank lending. He said that the "banking landscape is going to look arid for some time and borrowers will have to do a lot more work to get debt as there are not going to be competitive tensions between banks for the next couple of years." He pointed out that all the major debt lenders over the last 10 years are committed to at least halving their exposure to property, with some even disbanding their property teams altogether. The banks currently lending have a total capacity of only £7bn when there is £25-30bn of loans coming to maturity

left to right: Peter Damesick, Paul Guest, Phil Clark, Mark Titcomb, Louise Ellison, Fiona Morton, Peter Pereira Gray and Graham Sanders

in 2009 alone. There is an urgent need for the clearing banks to return to the market.

Furthermore, "Although governments are pushing out the problem as far as possible ultimately we need the revival of the securitisation and Pfandbriefe markets. Without CMBS it is difficult to see how large-scale and portfolio lending is to be facilitated and the Pfandbriefe market delivers a stable supply of mortgage finance by enabling the German banks to refinance themselves."

Debt is rationed and margins could go much higher given the high level of refinancing required. Banks are focused on relationship lending. They are looking at borrower 'brand', management style, lack of debt legacy and the longevity and quality of cashflow. Borrowers need to look at ways of providing more security, e.g. interest shortfall guarantees, to grab the banks' attention.

He pointed out that there has been little distressed property placed on the market so far, primarily because the banks have been so focused on their own survival that they did not have time to look at individual loans. In his view, "the banks have now come to terms with the disaster so after the summer we are likely to see more stock coming to the market. Furthermore although the details of the Asset Protection Scheme (APS) are still being worked through, the Government needs to make it attractive enough for the banks to use the APS in order to free up money to come back into the market."

Given the property debt mountain and fall in values over the 18 months, are there any arguments for moving back into property? Peter Damesick of CB Richard Ellis said that the tactical case for property investment came down to timing and price, while the strategic case was made by property's performance over the longer term – having outperformed equities over 3, 10 and 15 years; its lower volatility than equities, because income drives 70% of the total return; and its role as a risk diversifier, given its low correlation with equities and gilts.

He suggested that the current cycle had allowed the pricing of property to depart from the fundamentals of income and income growth so that, "this cycle was entirely yield driven on the way up and on the way down, consequently prices have already fallen by 43% from the peak. However we are now moving back to a situation where the impact of yield movements is decreasing and the impact of rental values is increasing." The long-term (1970-2008) prime yield is 6.5% so the current average of 7.8% is well above trend. Despite this, he thought that in the short-term yields may drift out further. The point at which this drift would reverse was dependent on the property sector and grade of property – prime high street shops being among the first to see yields firm.

UK property is attractive, given the rapid re-pricing that has occurred coupled with the fall in sterling. Relative to gilts and 5-year swap rates, property also looks attractive but it comes down to "can you get the debt?"

For medium-term property returns, timing is everything. In the 1970s and 1990s there was a 5-year period from the bottom of the property cycle to a peak in rolling annualised returns. He suggested that buying property in the next year or so could show real returns of 9% per annum on a 5-year basis – potentially making UK property at present the equivalent of "a Blue Cross sale at Debenhams!"

IPF Research Programme Short Papers Series

The IPF Research Programme was set up to provide independent research on issues relevant to the property investment market. The rapidly changing market environment has revealed a range of questions and issues for our industry where research, discussion and commentary are needed relatively quickly. In response to this the IPF Research Programme has set up the IPF Short Papers Series which focuses on issues of immediate relevance to the industry, providing research and analysis of the quality and level which has come to be expected from Research Programme but in a short paper format.

The aims of the series are:

- to provide robust information in a short format on focused issues;
- to generate debate amongst the IPF membership, the wider property industry and related sectors;
- to publish on topical issues in a shorter timescale than we would normally expect for a more detailed research project, but with equally stringent standards for quality and robustness; and
- to support the IPF objectives of improving awareness, understanding and efficiency of property as an investment asset class.

The IPF Short Papers Series is published in full and downloadable free of charge from the IPF website. They are disseminated through both the property and national press and through industry events. The following topics have so far been identified for the series:

- Real Estate Debt – how the banks are responding
- Robustness of property income through the downturn
- Commercial property valuation – a critique and industry response
- Valuation methodology – an international overview
- Are property derivatives pricing forecasting commercial property returns?
- The Indirect property investment model – its development, performance and future
- Re-pricing property risk – what sort of return should we expect from commercial property

This topic list will grow and members are invited to submit further ideas for topics to the Louise Ellison, IPF Research Director, at lellison@ipf.org.uk.

The UK commercial property debt mountain – how will the banks respond?

Mike Phillips, Finance Editor, Estates Gazette

This paper is based on a series of in-depth interviews that took place in April and May 2009 with a number of banks with involvement in lending on UK property and other leading individuals and organisations in the commercial property market.

According to the De Montfort survey of bank lending, some £225bn of debt was secured against UK commercial property at the end of 2008. Against the backdrop of the continuing credit crunch, what actions are banks now taking to protect their position, particularly given that property values are still falling and rental income is coming under pressure with increasing tenant defaults?

While it is true that banks are not about to flood the market with forced sales, wider economic and regulatory pressures on banks will force lenders to take action with their property loan books, either through them calling default on loans, bringing in receivers or administrators and selling assets on, or restructuring debt and bringing in new management teams where previous borrowers are seen to have failed.

What are banks currently doing with loans in covenant breach?

Discussions between both lenders and borrowers indicate there is a clear distinction being drawn between those loans that are in breach because the interest or principal is not being repaid, and those loans where loan-to-value (LTV) breaches have occurred.

If the breach is on the income side, the bank has no option but to act. Under international accounting rules (see Figure 1 – Basle II), material loan loss provisions must be made against a loan if a scheduled repayment is not made within 90 days of the agreed date, with the result that a large amount of capital must be set aside to mitigate against future losses. So, in these circumstances, it is better for banks to act, even if this involves them having to ultimately sell the property at a loss. This form of breach is affecting development loans in particular where no income is being produced because expected lettings have not materialised or there is insufficient income within a business to complete schemes. For this reason, the majority of high profile property administrations to date have impacted on developers such as Castlemore, Guestinvest, City Lofts and Mountgrange Capital. In the largest investment-based administration so far (Dunedin's Industrious portfolio) falling income linked to high void rates in the fund resulted in there being insufficient cash flow to manage the business.

Conversely, in the cases of LTV breaches, banks currently seem broadly content to work with existing borrowers to amend the terms of the debt through providing an increased loan to value for instance. However, this comes at a price. Banks are typically asking for some of the loan to be repaid; they are also raising interest rates and fees sharply. The De Montfort survey indicates that the average interest rate margin on a loan secured by a prime office property has increased from 126bps over LIBOR (the rate at which banks lend to each other) in 2007, to 213bps in 2008. Anecdotal evidence suggests that margins for new or restructured loans are on average in the region of 300-350bps. As well as the increased margin, arrangement fees of up to 5% of the loan's value are often being tacked on.

There is a sense amongst some borrowers that banks are 'holding them over a barrel' to make a quick profit. Indeed, there is a widespread belief that, perversely, it can be the stronger companies with equity to repay some of the loans, and good properties with good cashflow, that are being targeted first by the banks.

However, the banks argue that they need the increase in fees because the cost of their own funding has increased dramatically. While LIBOR rates have dropped recently, the gap between LIBOR and the base rate is still historically high and other methods of raising capital, such as issuing covered bonds, are also currently more expensive than usual. One banker interviewed noted that: "The increase in fees does not even cover our higher cost of funding".

Lenders also point out that if banks restructure a loan and extend it or allow a higher LTV, more regulatory capital must be put aside under Basle II regulations. Given this, banks also argue that the current increased level of fees is necessary to help rebuild the capital base of banks and insure against potential losses.

Will banks become more aggressive with borrowers?

The recent De Montfort survey indicates that loans in default spiked in 2008. More than 3,000 loans, with a value over £3.1bn were in default at the end of 2008, compared to 400 with a value of £758m at the end of 2007. As a result, loan loss provisions, which banks have to account for in their profit and loss accounts, increased from £78m to £1.2bn.

In recent interim management statements, major property lenders Lloyds Banking Group and Allied Irish Bank (AIB) both indicated that they expected to see increases in loan loss provisions. According to estimates made by JP Morgan's banking analyst team in November, European banks, with a combined total of €1tn of balance sheet exposure to commercial real estate loans, will make a combined loss of €22.5bn on property loans in 2009, and Lloyds and AIB have indicated that things have got a lot worse since then. This is not something banks can afford to sit back and let happen, as further taxpayer-funded recapitalisations will be difficult.

The perception held by some in the property industry that banks can simply choose not to undertake loan-to-value tests and, thereby, not trigger a problem is also incorrect. Under Basle II regulations (see Figure 1), banks are required to undertake regular valuations of the assets that secure their loans. This is usually at least once a year.

The biggest issue will be security of income. IPD figures already show rental income in decline. This is likely to get worse as more tenants default, more occupiers demand lower rents or increased incentives to take new space, and pre-pack administrations lead to lower rents. The most marked effect thus far has been in secondary shopping centres, where retailers are struggling as consumers rein in spending. There have now been several examples of LPA receivers being appointed by banks to sell shopping centres. As rental income comes under pressure, banks will be forced to call in these defaults to avoid making the provisions against non-performing loans.

Loan loss provisions are subjective to a degree, especially where breaches relate to LTV rather than income. They are based on likelihood of the bank getting paid its money back at the end of the loan. The bank has some leeway in this respect; even if a loan is underwater now, there is a chance it will come back before it is due to be repaid. Similarly, even if a bank does make a provision and things turn out better than expected, the provision can be reversed in future accounts. For this reason, banks will avoid calling an administrator in too soon, as this would mean taking a permanent impairment.

However, the nearer a loan in negative equity is to maturity the less likely it is that values can recover to the extent necessary to take it back into positive territory. With the latest IPD figures showing that property values have moved back to around 2001 levels, at least some of the debt lent against property since 2003 will not be in positive equity when it comes to be refinanced. This will severely limit how lenient banks can be. Furthermore, if loans go into default, banks now have to hold significant amounts of capital against them on their balance sheet. Indeed, new proposals from the UK Government could force banks to hold even more capital against risky assets. In this environment, it might make more sense for banks to act pragmatically and take a loss on a loan than be forced to set capital aside unproductively in this way.

What are banks doing if they do need to take action?

Most respondents cited management as the key issue in situations where banks do have to take action. Banks are not keen to take properties on to their balance sheets and be forced to set large amounts of regulatory capital aside. As such, they would rather work with existing management where possible, providing they think that management capable. Those borrowers with little property expertise or management skills and who simply used property as a tool for financial engineering, are cited as most likely to see banks step in. Perversely, it is also true that some good management teams will end up losing properties. Even if borrowers have more equity to inject into a deal, many are saying that the new terms being offered make it unviable for them to continue to manage the property since they are essentially doing so for free. So, even if administrators are not brought in en masse, there is likely to be a significant change in the ownership of property.

Many banks are looking to bring in new experienced asset managers, especially if they can also bring some equity to deals, possibly working in a joint venture structure. They see this as the best way to avoid crystallising losses or even having to make provisions. Such deals are hard to pull off without banks having to make some provision. However, if they are structured correctly, banks can not only reduce debt on a property and their property exposure but also avoid potential future losses. Many people in the industry expect banks to provide stapled finance, essentially new debt, to help such managers to buy existing assets. This is possible where there is still some equity in the deal but difficult if the property is already underwater.

The incentivisation of management is also key to success. Both borrowers and lenders are looking at structures where they can share any upside in value as well as take a management fee. For example, if the asset manager works a property and brings its value back above a certain level, any profit made upon its sale is shared by the bank and the manager, who will take a cut of between 10% and 50%.

Refinancing issues

"Amend and extend" is the phrase borrowers hope to hear when it comes to refinancing. According to most respondents, this is what will happen in most cases, with banks again scaling up fees to cover their increased costs of funding and the need to set more capital aside to cover the extended loans.

There is clear evidence that, thus far, banks have been extending loan maturities in preference to calling in property loans. The De Montfort survey showed that at the end of 2007, £2.7bn of UK property debt was due to be refinanced in 2009, with £21.5bn due in 2010 and 2011. The 2008 survey showed £3.8bn due for refinancing in 2009, with £2.6bn coming to maturity in 2010 and 2011. The authors said this was because loans due to be refinanced in 2008 and 2009 have been extended. This shows that banks are willing to extend loans (for a fee), but it also shows that if the general liquidity position of banks does not improve, a problem is potentially being stored up for the next few years.

Foremost among the problems banks face when choosing whether to refinance a loan, is the issue of matched funding. Banks usually borrow short in the wholesale markets and lend long. This means they have their own refinancing needs to deal with, as well as those of borrowers. In some cases there can be a mismatch, and while banks might want to provide new debt for borrowers, they are often simply unable to. The reopening of the Pfandbrief market will help German lenders in this sense by providing access to funds at relatively low margins. However, for many banks dealing with their own liabilities is more important than the needs of borrowers. At the moment, it is virtually impossible for banks to borrow from each other for more than a year, two years at the most. This is because banks are still hoarding capital to guard against potential loan losses. Consequently, banks are not generally extending property loans for more than a year or two, leaving borrowers with less certainty on their funding.

The refinancing of loans is also contributing to a general stagnation of the investment market. The De Montfort survey shows that 55% of new lending undertaken in 2008 was to refinance existing loans. The more refinancing, the less debt there will be for new deals.

The other major problem area for refinancing relates to the CMBS market. Here, loans have been sliced up and sold on to bond investors. As such, the exposure is no longer on banks' balance sheets. However, for such loans to be refinanced, a bank or group of banks must take on new exposure to commercial property. This is nigh on impossible in the current market and unlikely to improve before the end of 2010. These CMBS loans need to find a home or bondholders will be forced to take action, and experience shows that discussions between large groups of bondholders are often less amicable and far trickier than those between a single borrower and lender.

Morgan Stanley's property analyst team estimates that these problems with CMBS have the potential to trigger a further fall in UK commercial property values. "There is a general feeling in the UK direct property market that prime yields have hardened somewhat during recent months," it said. "While we think this is probably true, we believe we have merely reached a temporary plateau rather than this cycle's peak yields. We believe that pressures from the CMBS market will be a driver for further UK yield expansion. In addition, we think this will also provide further upward pressure on yields in continental Europe".

Government intervention

There are two Government schemes which will have an effect on commercial property, namely the UK Treasury's Asset Protection Scheme (APS) and the Irish Treasury's establishment of the National Asset Management Association (NAMA). The details of both are yet to be finalised, but they offer two different solutions to the problems banks face.

The APS will guarantee losses on pools of assets selected by the two participating banks, RBS and Lloyds HBOS, and the government. Banks will absorb the first loss, at a level of around 10%, on assets protected by the scheme, and the government will eat up 90% of losses after this level. Banking analysts at Citi estimate that RBS will have around £56bn of construction and property loans covered by the scheme; Lloyds HBOS is likely to have around £68bn covered. Citi anticipates RBS will make a £4bn loss on property assets covered by the scheme, with Lloyds HBOS making a £22bn loss, but the government will absorb 90% of this loss. Under these arrangements, assets are likely to still be managed by the bank, rather than transferred and managed by the government or its advisors.

While the details are not finalised yet, the consensus is that the APS will lead to banks holding more assets and working with borrowers rather than calling default. The banks are paying a premium for the scheme and there would appear to be little benefit in banks calling default on loans covered by the scheme and flooding the market with unsaleable assets – and the government would not let them even if they wanted to.

The scheme is a 5-year programme, and it is thought that banks will use the protection afforded against excessive losses during that time to improve asset values as far as possible. The insurance against excessive losses offered by the APS also means that banks will not have to retain as much capital and, as a consequence, will have more money to lend. The downside of this for the property industry is that there is little political imperative to support property investors – the votes are won by helping homeowners and small businesses.

The Irish scheme differs in that the NAMA will buy up to €90bn of loans from Irish banks. These are mainly development loans but also include large investment loans of strategic importance. The focus is on Ireland but will include loans on UK property. The main issue surrounding NAMA will be the price at which the loans are transferred. This is a problem that APS does not have to confront explicitly, as loans are not transferred but guaranteed. If the price paid by NAMA for the loans is too high, the taxpayer will be deemed to have overpaid – something no government wants to see happen. However, if assets are transferred at too low a price, banks will have to take a large write-down, leading to yet further need for recapitalisation.

Once the loans are transferred, statements from the Irish Treasury imply there will be no going easy on borrowers, who will be chased for security. It remains to be seen how the re-pricing of these loans will affect the pricing of the assets they secure, and whether a low transfer price leads ultimately to a sell-off of assets at below market prices.

At what stage are the banks currently?

The general feeling is that most major lenders have dealt with the wider corporate issues threatening their survival and are starting to put the structures in place to assess and improve the strength of their balance sheets. For this reason, action by banks, in any of the forms described above, is now set to increase.

Different banks are will use different strategies. Some, such as RBS, Lloyds HBOS and Barclays now have separate units to manage problem loans, with specific titles such as 'business support units'. Loans will be managed by these divisions in a pre-set manner. They will draw on the property lending teams to work out the loans, which will be treated and accounted for separately until they are considered as performing again. If there is little prospect of this, they will be written off entirely. Other banks are proceeding on a more informal basis, with the existing lending teams (who are not doing any new lending currently) managing the problem loans.

Most banks are looking at the current situation as a 5-year issue and beyond. The need to preserve profits and avoid undue losses is generating great caution and, for those hoping to see a flood of property coming from the banks, creating a floor for prices and allowing trade in the investment market, they are likely to be disappointed.

Figure 1: Basle II, how it works and what effect it has on property

Basle II is a set of international accounting rules which indicates how much capital banks have to hold to mitigate against potential future losses.

The bank needs to identify a risk weighted asset (RWA) assessment for every loan it makes. This is individual for each loan and for each bank, which has a complicated model to determine the RWA and is part objective and part subjective. As a rough guide, RBS has a balance sheet of £2tn, and RWAs of £576bn.

Banks then have to put a proportion of their accumulated RWAs aside as spare capital. For real estate investment loans of high quality (deemed to be 50% LTV or lower), this equates to 4% of RWA on a loan. As the LTV increases, this figure goes higher, up to 12%. If a loan goes into default, a bank might have to put three or four times the RWA of a loan aside in the form of spare capital. So banks cannot afford to extend LTVs indefinitely because the higher the LTV, the more reserve capital the bank has to be put aside. In such circumstances, it might make more sense for a bank to cut its losses and sell the subject property.

The other downside for property investors is that the Basle II rules state that regular valuations of loans have to be undertaken, normally at least once a year. Investors who think that the bank will avoid the problem by not calling for a regular valuation may be disappointed.

Valuation issues in the current market

One of the first papers to be commissioned under the IPF Short Paper series focuses on valuation. A spotlight has been trained on the valuers and the valuation process throughout the property market downturn. There has been much discussion about many issues including the speed with which UK property values have been marked down, the perception that the IPD index lags the market, whether data from outside the direct market should be incorporated within valuations, whether there is enough market evidence to produce reliable valuations and so on. The IPF commissioned the School of Real Estate and Planning at University of Reading to explore all of these issues, setting out the key elements of each. The intention was not to reach conclusions or make recommendations but to try and bring together some of the discussions taking place into one paper that could then form the basis for an informed industry debate.

The paper produced by the team at Reading, comprising Neil Crosby, Colin Lizieri, Patrick McAllister and Simon Martin, did exactly this and pulls no punches. It provided an excellent starting point for a workshop held on 2 June with 15 valuers and users of valuations, drawn from the agency, investment and the banking community. A lively and frank discussion took place. The following is an extract from the full paper and focuses on the question: are transactions that take place in thinly-traded markets reparative of market value? The workshop discussion that the paper generated on this issue is recorded in the boxes throughout the article.

The full Short Paper, along with the responses from the workshop, is being published under the IPF Research Programme and will be available for IPF members to download from our website.

Pricing information in thinly-traded markets

A major question raised by the current downturn concerns the price information provided by the transactions that do occur and whether there is other information that should be used to supplement the low number of comparables.

Transactions

The first issue is the pricing signals from the transactions that do take place. In practice, there are questions about whether the sales that do take place in a market with very low trading activity are 'forced sales' and are therefore not representative of market levels since the seller has no negotiating power.

There is little support for this argument within UK valuation standards and guidance. The definition of market value includes both willing seller and willing buyer and assumes that a seller will sell if the market value is obtained. The fact that many investors would choose not to sell at current price levels appears to be immaterial. Any sale that takes place and has been properly marketed for an appropriate period is a market transaction. A restricted sale price only comes from restricted marketing (RICS 2008, PS 2.3, p 25). If a vendor has to sell a property for any reason, the price realised in the market could be assumed to represent market price if the property is afforded a normal marketing period and process. Genuine fire-sale prices may well be lower than market value if any imbalance in negotiating power is translated into a quicker sale than the market would require to achieve the best price in that market.

Workshop discussion

One of the clearest messages to emerge from the workshop discussion was that the perception of the market being thinly traded is not entirely accurate. £22.5bn of property was traded in 2008; about 50% of the 2007 figure. This is a return to the longer-term trend for transaction levels and not a thinly-traded market.

The view was that there is a mismatch between vendor and purchaser expectations in most markets but transactions are taking place. Transactions that are happening are not felt to be forced sales. Banks are seen currently to be avoiding precipitating forced sales of assets. There are undoubtedly areas of the market where there are simply no trades but this was not felt to be the norm.

In the 5-6 weeks after the Lehman Brothers collapse, there were undoubtedly very few deals and the market was very difficult. The GN 5 clause was invoked by valuers, as advised by RICS, but this was generally dropped again by the time year-end valuations were done. The sense was that the criteria of a willing buyer and willing seller are not currently being compromised.

Theoretical work by Fisher et al., (2003) suggests that there exists an equilibrium level of trading. Transactions volumes above or below that level indicate an excess (or a shortage) of demand and supply of assets. This can affect achieved prices. In particular, in poor markets, owners may 'withhold' assets from the market: this curtailing of supply of assets helps to dampen price falls[1]. This would, however, imply that owners believed that current prices in the market did not represent the fundamental value of the retained properties or portfolios – and that potential investors were mispricing assets. These considerations emphasise the importance of liquidity in determining prices in property markets. Liquidity impacts are complex. As the IPF (2004) research report noted, it is a multi-dimensional concept which includes time to transact, pricing effects, bid-ask spreads and more.

So a major question for valuation research in a thinly-traded market is precisely what price signals are given by the few transactions that do take place.

1 This is the opposite of the 'forced sale' effect claimed by some practitioners in the current market downturn. This is dealt with below.

Are transactions which take place in a thinly-traded market representative of market value?

Use of indirect property information and derivatives in valuing direct property

It could be argued that valuers need to use all available price-sensitive information to form their valuations and not simply rely on transaction evidence. For example, if real interest rates increase, values should fall and price evidence from the period before the interest rate increase must be adjusted downwards. However, there may be practical difficulties in quantifying the level of price effects in the absence of evidence from market trades. As the comparative method does not include any indicators from outside the direct property market, it may be possible to improve the accuracy of valuations by use of additional information to augment comparable evidence from, possibly stale, transactions.

Valuation occurs in a private market, where there is incomplete information on trades, thin transactions and information asymmetry. Traditional guidelines/texts on valuation methods focus almost exclusively on information derived from within that market. However, it can be argued that valuation should reflect all available price sensitive information. There is a strong case that evidence of price movements of assets in other traded markets that are driven by property returns should be incorporated into the valuation process.

Evidence from traded markets outside the direct property market

Obvious examples include the price of public-traded real estate companies, whether REITs or taxed corporate entities, evidence from the public listed real estate market from discounts (or premia) to net asset value (NAV) and from unlisted funds such as unit trusts, which have a NAV but equally trade at a discount or a premium to NAV. Some notes of caution are necessary however. While, in the long run, the returns of REITs and property companies are linked to the underlying property market, there may be short-run noise that comes from the relationship between REIT shares and the parent equity market. This will be exacerbated when leading REITs and property companies are found in key equity market tracker indices. Second, returns are a function of the activity and asset base of the company and the company's capital structure. Geared returns will not have the same trajectory as ungeared returns; they will have a higher volatility. This needs to be taken into account.

With the development of a relatively actively traded property derivatives market, there has been much discussion about whether total return swap spreads represent a 'forecast' of the market and many commentators have published research which assumes that they are. This is the subject of another IPF Short Paper so is not explored in any detail here, other than to say that from an analytical perspective, swap spreads should not predict the market. However, the nature of real estate as an investment market means that its derivative market will not necessarily behave like those of financial assets.

Further market information might be gained from observing redemption yields in traded property bonds, CMBS and ABS markets. A debt security held to redemption does not deliver a property return (except insofar as property returns have bond-like qualities). However, its price in the secondary market should reflect the discounted value of the remaining coupon and capital repayments, and the discount rate should reflect the risks associated with that cashflow: prepayment risk (which can be controlled with penalty clauses); delinquency; default; and loss given default. Now, the risk of default is directly linked to the underlying asset market. Behind the securities are mortgages; behind the mortgages are properties, generally tenanted. Positive rental growth and low vacancy rates provide greater income cover for the underlying loans and hence greater security for the coupon payments. Rising capital values reduce the risk of default, increase the probability of refinancing at redemption and increase the security that prevents loss given default. This should reduce the risk of the cashflow, reduce the required return and increase the price of the security in the secondary market.

Evidence from indicators beyond traded markets

A final area of relevance is the use of leading indicators which focus on the fundamental supply and demand drivers of property returns. Given that we know that property returns are driven by overall economic demand, and given that such variables are predicted by leading indicators, it would seem reasonable that changes in the values of such leading indicator series should be reflected in equilibrium property prices. They thus form a potential source of price sensitive data that should be influencing the valuation process. Again, this rests on the idea that the equilibrium price of a property should reflect the discounted value of the expected future cashflows, processing all available information that should influence the expectations about those future cashflows. If the valuation is intended to capture that 'true' equilibrium price, then it needs to incorporate all price sensitive information.

While the benefits of taking this price information into account are clear, there remain significant barriers to effective use. Most notably only a few market participants are able to justify the financial cost of building and maintaining the infrastructure (both human and data) required to capture and process a full range of price sensitive information. Even those that do may struggle to apply it effectively. In addition, there are two substantial practical barriers to using price information from indirect sources to estimate the price changes of individual property assets. Many of the financial instruments are not 'pure' property but can be a bundle of assets and liabilities. As such, observed price changes may reflect non-property factors as well as changes in property markets. Many of the financial instruments provide information on price changes at an aggregate level. There are then practical difficulties about applying such information to individual assets.

Workshop discussion

Valuation is undoubtedly more straightforward in a liquid market, but it is still possible to construct an argument for a value from evidence that is available. This is an important part of the valuer's skills. Part of a valuer's role is to form a judgement from a range of different pieces of evidence and 'soft' evidence outside direct market transactions is being used.

It was agreed that we have more sophisticated forecasting provision and data now than was available in the early 1990s downturn, and there is a strong culture of communication within the market. But the valuer is still creating a snap shot of value at a point in time. Share prices are a forecast of future cashflows; market valuations are not.

It was agreed that, notwithstanding the speed with which the market has moved there is still a lag in the valuations process. However is was generally felt that this is appropriate; if valuers are scorekeepers within the market there will always be a lag between reported values and the market. Values should not be ahead of the market – the process is backwards looking.

Workshop discussion

During the course of the current downturn, valuers have moved values down significantly more quickly than was the case in the early 1990s. This has been through the use of judgement and interpretation of transactions and other evidence. However there is no formal mechanism for incorporating soft information into a valuation other than as background information and to guide judgement.

One area of concern was that the adoption of additional price signals could push values 'ahead of the curve'. The key message from the industry workshop was that useful information is coming back from other markets. However there is a potentially dangerous issue of circularity if valuers rely on property derivatives and indices in producing valuations. Indices should be a product of valuation and property derivatives prices a product of indices. It is important that this remains the case and the relationships are not allowed to become blurred.

Furthermore, there may be considerable valuer resistance and questions about the skill set of the profession. At the IPF workshop on valuation in October 2007, all three speakers representing three of the five major firms who make up the majority of the IPD monthly index valuations, relied on property market transactions and other direct property market information such as deals in progress, but resisted calls to use non-direct property market information.

IPF Indirect Property Funds Special Interest Group

Recognising that the IPF needed to take a more focused approach towards the unlisted pooled investment funds sector, the Management Board decided that a new Special Interest Group should be established to sit alongside the two existing groups that cover matters relating to property derivatives and sustainability issues.

The Group's remit covers unlisted pooled investment funds (whether closed or open-ended) that are managed by an independent third party. This would include private equity-style real estate funds together with sector specific, balanced and opportunity funds. Geographically, the focus is on UK property, so funds based in Jersey and Luxembourg with UK property holdings are included within this.

The objectives of the Group are to:

- Be a focal point for the IPF on indirect property investment;
- Seek to increase the industry's understanding of indirect investment and associated vehicles/structures;
- Lead on promoting research into key issues such as 'What lessons can we learn from the current financial crisis and what action should we promote as a result';
- Liaise with other relevant organisations, e.g. AREF and INREV.

The current top priorities of the Group are to consider the valuation of funds and the determination of NAVs; the degree of liquidity within indirect property products; and levels of debt within funds.

To further discussion and knowledge within these areas, the Group will be contributing papers to the IPF Research Programme Short Papers Series and producing standalone articles for the IPF website and Investment Property Focus. The two papers that follow are the first in the standalone series.

Phil Clark, AEGON Asset Management and Chairman of the Indirect Property Funds Special Interest Group

Why invest via indirect property funds?

Graeme Rutter, Head of UK Property Multi-Manager, Schroder Property Investment Management

Traditionally investors in commercial property would buy 'bricks and mortar' assets to gain exposure to the sector. This has the benefits of being able to: have full control over the property; add value through active asset management; and take ownership of a tangible asset. However, owning properties directly also has its drawbacks including: limited diversification unless you are a very large investor; relative illiquidity and typically a long period to conclude transactions; for inexperienced investors management and administration issues are a deterrent; there are lot size barriers for gaining exposure to certain sectors of the market, such as shopping centres; and finally it is relatively expensive to buy and sell direct property with purchase costs in the region of 6% of asset value.

As a result of the drawbacks to owning direct property, there has been an increase in demand for products that provide an indirect exposure to property. Principally this has been through unlisted property funds, but has also included an increased appetite for listed property companies, offshore property investment trusts, property derivatives and interest in multi-manager and fund of funds services.

Over the last five or six years in particular, there has been a pronounced rise in investor demand for unlisted indirect property funds. From 2003 onwards there was a steady increase in the value of indirect property funds, followed by an exponential increase from mid 2005 to mid 2007 (see Figure 1). This upsurge was due partly to a prolonged period of valuation increases, but also due to the launch of a number of new indirect property funds and further investment into existing products.

This growth has also been seen in terms of the number of new funds that have been created. Figure 2 shows the number of new unlisted UK funds that have become members of the Association of Real Estate Funds (AREF) over the last 10 years.

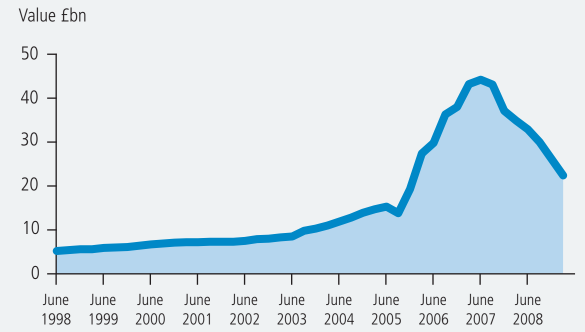
These figures exclude UK funds that are not part of the AREF universe, as well as funds in Continental Europe and further afield.

The attractions of indirect property funds

There are a number of reasons why investors have chosen to invest in property through indirect funds rather than through the traditional direct investment approach, as detailed below:

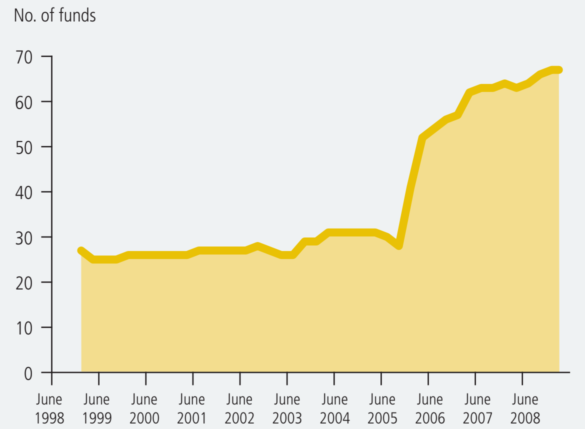
- Greater diversification – smaller investors can gain exposure to a pool of assets, creating far more diversification than could be achieved by assembling a portfolio of direct holdings.
- Access to certain sectors / stock – for smaller investors it would be very difficult to gain exposure to niche parts of the market, for example student accommodation, and there is also

Figure 1: Value of indirect property funds within the AREF Funds Indices



Source: Association of Real Estate Funds (AREF)

Figure 2: Unlisted property funds registered with AREF



Source: Association of Real Estate Funds (AREF)

a lot size barrier against investment in typically large lot size assets such as central London offices, fashion retail parks or shopping centres. Some investors with direct holdings have complemented their existing assets by acquiring indirect funds.

- Expert management – smaller investors are unlikely to have the necessary skills or experience to manage certain types of asset.
- Management / administration – by investing in an indirect property fund the investor manages to minimise the red-tape associated with holding direct assets.
- Accurate sector positioning – because individual units in indirect property funds tend to have a relatively low value it is possible to construct a portfolio of holdings with a fair degree of accuracy relative to target benchmark positions, this is more difficult to achieve when holding purely direct property which is indivisible.
- Tax – many of the unlisted property funds have been structured in ways to ensure maximum tax efficiency, for example many funds have been created as offshore Jersey property unit trusts, which are generally regarded as transparent for the purposes of assessing UK tax on income. As a result, the investor should, broadly speaking, be placed in the same position as if he had invested directly in the underlying asset. In addition, non-transparent structures are generally set up with the objective of minimising tax leakage in the underlying property holding structure.
- Exposure to gearing – some investors are not permitted to raise debt to enhance performance when conditions are beneficial. They have however been permitted to hold indirect funds with an exposure to gearing to achieve this aim.
- Entry cost – many investors have been able to trade units via the secondary market, so benefiting from transaction costs below those incurred when buying and selling bricks and mortar assets.
- Liquidity – in strong markets it has been possible to transact indirect units within a matter of days compared to months in some cases in direct markets. The open-ended funds also have redemption provisions which have enabled investors to decrease exposure to property.

Disadvantages of indirect property funds compared with direct investment

Not surprisingly, there are some downsides to accessing the property sector via indirect funds including:

- Lack of control – by investing in an indirect fund an investor cedes control of the management of their holding to the manager. It may be in the long term that the manager strategy changes and is then different to that of the investor. The investors typically have very limited powers to influence the decisions of the managers.
- Manager specific risk – although pooled funds have the benefit of greater asset diversification they do have risks associated with the manager, for example a star fund manager could leave or the management company could get into financial difficulties. Manager specific risk can be mitigated by investing via a multi-manager or fund of fund service, but this does come at a cost with additional overlay fees.
- Liquidity – although in strong markets the secondary market was a very efficient way to trade units in indirect property funds over the last 18 months the indirect funds have seen the same low levels of transactions experienced in direct markets. In addition, although open-ended funds do have redemption provisions to enable investors to exit funds these have not operated as effectively as outgoing investors would have hoped. Due to the unprecedented market conditions some managers have suspended redemptions or have imposed punitive spreads to prevent exiting investors from prejudicing remaining ones.

Improving the liquidity of secondary units in unlisted property funds

Simon Berrill & Tom Jackson, Macquarie Capital Advisers

According to the European Association for Investors in Non-listed Real Estate Vehicles (INREV), there are 107 unlisted property funds with a 'UK only' focus, (of which 64 are closed ended) with a total GAV of c.£69bn. Given the size of the UK unlisted property funds market, one might expect there to be an inherent level of liquidity. However, this is currently not the case.

In fact, of the 66 UK funds tracked by the Association for Real Estate Funds (AREF), just 0.2% (c.£120m) of aggregated GAV was traded on the secondary market in the six months to 31 December 2008. By contrast, a reasonably deep and well established secondary market has become established in the private equity fund market, in which up to 7% pa of outstanding equity is traded in various forms of secondary activity annually.

The growth of unlisted funds in the property sector has been extraordinarily rapid in the recent decade, and the lack of liquidity has not been uppermost in investors' minds. That has changed as the recent survey of investors undertaken by INREV has shown.

Reasons for developing market liquidity

There are compelling reasons for investors and fund managers (FMs) to promote the development of secondary market liquidity. These include:

- Investors needing to recycle cash to meet underlying redemptions;
- Investors needing to recycle cash to meet capital commitments elsewhere;
- Investors suffering the denominator effect needing to rebalance portfolios;
- Investors / FMs looking to repair balance sheets and protect gearing covenants; and
- FMs looking to safeguard goodwill with LP investors.

Unsurprisingly, the impetus to do so has been heightened by recent events in both the property and the credit markets.

Defining 'liquidity'

What then would be the required volume of annual secondary trading for the UK market to be considered sufficiently liquid? Clearly this is a highly subjective question but, in Macquarie's view, a 5-10% churn of the total equity would provide investors in these vehicles with comfort that there was sufficient secondary market activity so as to provide liquidity should it be required. This would translate to an annual secondary market trading volume in the order of £3.5-7bn, based on INREV's figures.

However, trading volume alone will not be sufficient to demonstrate a liquid market. Pricing is also important. Secondary units in unlisted funds should probably trade on average at a discount to the underlying NAV of no more than 20-25% greater than the prevailing discount seen in the listed market.

It is clear that the market is nowhere near this level of secondary trading. So what is holding back liquidity?

Barriers to UK secondary market liquidity

The current illiquidity in the direct property market is affecting the liquidity of indirect funds but there are a number of other factors that are also contributing to secondary market illiquidity, the subsequent lack of trading volume and the excessive discounts to NAV seen on those trades that have taken place. These include:

Limited capital awareness of this space

At present trades within the UK secondary market are executed on an ad-hoc match-bargain basis. In many instances, the few active brokers in the market do not have access to a joined-up, global distribution platform and instead broker trades within their existing, typically UK/ Euro-centric, client base. It is rare that US / Asia-Pac / Middle Eastern investors are presented with UK secondary opportunities.

In addition, since the secondary market for UK unlisted real estate funds is relatively immature, most investors have not transacted in this space, and are not aware of the opportunity such trades can present. As a result of these two factors, the weight of capital with visibility on secondary opportunities is relatively small.

Inability for purchasers / vendors to establish likelihood of 'best price'

There is no pooling of sell-side orders by a single intermediary and therefore the opportunity for a single purchaser to have sight of all available sell orders at any given time, is not provided. Therefore neither offeror nor, most importantly, the bidder knows that they are getting 'best price'. Bidders are often concerned that there might be a seller at a much better (i.e. lower) price and therefore hold off.

Lack of information provision on a fund secondary opportunity

At present, it is often the case that purchasers will price in an additional discount to NAV to reflect the level of uncertainty around the lack of viable due diligence they have been able to undertake on a fund – effectively an additional risk premium. This is because, to date, FMs have, in many instances, been relatively uncooperative with regard to the provision of full fund due diligence materials, such as the latest fund valuation and property reports, as well as strategy and business plans for assets held to fund expiry.

The complexity of the underwriting process

In most instances, the level of due diligence required for undertaking a secondary investment is greater than that required for a primary investment into an unlisted fund. This is because a secondary investment is made typically once a fund has completed its investment period and is therefore fully seeded, with a capital structure in place. Many bidders have limited resources to undertake such detailed research.

The lack of visibility on pricing of opportunities

Aside from the complexity of the underwriting process, purchasers have the difficult job of correctly pricing secondary opportunities. This is because the level of disclosure on comparable trade settlement prices is poor, and therefore market comparison points are few and far between.

The complexity of the execution and settlement process

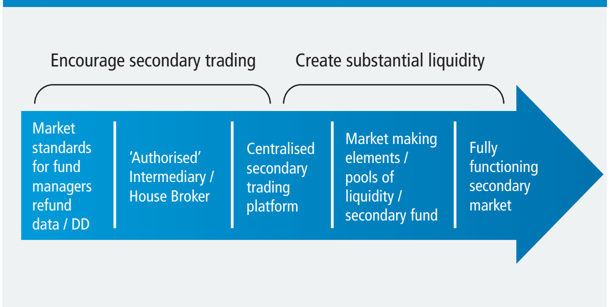
The execution of secondary trades is often an administratively intensive process, with considerable resource required, not only to bring parties together initially at an agreed price for a match-bargain trade to take place but also for the follow on process of due diligence material provision, agreement of heads of terms (HoTs) and settlement. More often than not FMs struggle to commit dedicated management resources to overseeing this process, especially given the typically low trading volumes.

The complexity of trade execution can be exacerbated by the need to apportion equity distributions depending on the agreed settlement date, as this then affects the total consideration price paid for the secondary units, (in accordance with the agreed pricing to NAV).

Finding the solutions to secondary market illiquidity?

We believe that by addressing the barriers to secondary liquidity identified above, market liquidity can and will emerge. There are a variety of ways in which this could be achieved, from execution of basic match-bargain trades, (already facilitated by some FMs) to a full-blown secondary market. However, there are a number of points on the way, exemplified in Figure 1 below.

Figure 1: Steps towards secondary market liquidity



Whichever solution the market gravitates towards, there are some key points that have to be addressed in order to circumvent existing barriers to liquidity:

- Information must be standardised – It is vital to standardise the method by which secondary buy-side opportunities are presented to investors, so that opportunities are initially flagged in a format that provides investors with return metrics and enough information to make an initial 'investment in principle' decision. The use of a standardised 'opportunity overview' form, providing a tablet of verified fund overview information and return metrics at various pricing points, will undoubtedly assist new capital to access the market.
- Facilitation of buy-side underwriting / due diligence analysis – It is essential for FMs to work together with intermediaries to produce verifiable due diligence information at both the asset and the fund level, including the use of virtual data rooms made available to pre-qualified investors.
- Standardised execution / settlement framework – Intermediaries would need to adhere to this. Such a mechanism, together with standardised documentation around completion of HoTs, and unit transfer requests, as well as specific timeframes for process completion, should reassure new capital to the sector that the secondary trade execution process is one which can be relied upon when transacting.
- Aggregation of all sell orders – By creating a 'pooling' of vendors in the same fund, a purchaser could take reassurance that, at any given time, they could achieve 'best price'.

House broker services

We are of the opinion that a 'house broker' service provides for many of the suggested solutions to overcoming the illiquidity of the unlisted real estate fund secondary market.

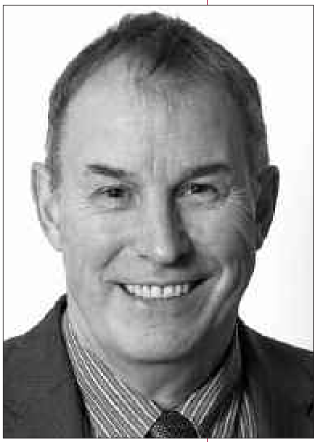
This approach removes a number of the inherent conflicts that arise from a FM attempting to undertake secondary trade execution 'in-house'. Furthermore, it redirects the management resources and administrative labouring to the intermediary house and away from the FM. The house broker is responsible for the production of all initial opportunity promotion materials, and for sourcing buy-side interest via its own distribution platform (which in many cases will be more global in its reach, than that of the FM, thereby attracting a greater pool of capital). The house broker is then also responsible for maintenance of a virtual data room and facilitation of all due diligence material provision to the interested buyer pool (working closely with the FM to aggregate up-to-date asset and fund level information).

From the purchaser's point of view, the house broker role ensures that all sell orders for a given fund are available through a single intermediary, thereby ensuring that, across a given time frame, 'best price' is achievable, and volume requirements are more likely to be met.

Similarly, from the vending LP's viewpoint, buy-side competitive tension is created and each LP knows that it will have the opportunity to meet a purchaser's bid (within a given time frame), and be cleared at a given price pro-rata, should there be other LP offers at the same level.

We are a long way from a perfect secondary market for unlisted property funds. There is a clear need for improvements to the flow of information, greater standardisation of market materials, the provision of verifiable due diligence information and the provision of a formalised execution / settlement process if we are to increase liquidity significantly. In the short term, the house broker relationship could provide these characteristics.

Commercial property and inflation – hedge or just a picket fence?



Edward Trevillion, Head of Property Research, Scottish Widows Investment Partnership

Because business property is such an important factor of production its performance is closely linked to the overall performance of the nation's economy. Anything that has implications for the economy will have implications for commercial property, both in respect of the occupier (rental) and investment markets. This dual susceptibility has been amply demonstrated over the last year or so where a double whammy of poorer economic performance and the lack of available credit has significantly affected the performance of both the investment and more recently the occupier markets.

It can be argued that ultimately most of the risk associated with property derives from changes in the macro-economic variables; inflation, interest rates and economic activity. In this regard, we currently live in uncertain times. The world is in the grip of the worst recession for over 60 years and within the last year we have moved from a period of relative high cost-push inflation to almost zero inflation, with the prospect of deflation this year. Although we believe that the outlook for inflation over the next two years looks fairly benign[1] there is an increasing risk that inflation will rise significantly if the current quantitative easing in the economy is not reversed sufficiently quickly when the economy begins to recover.

Historically, investment in commercial property has been perceived by some as a hedge against inflation. Given the current economic climate, therefore, it seems opportune to re-examine this premise and how resilient property might be as an asset class in these uncertain times.

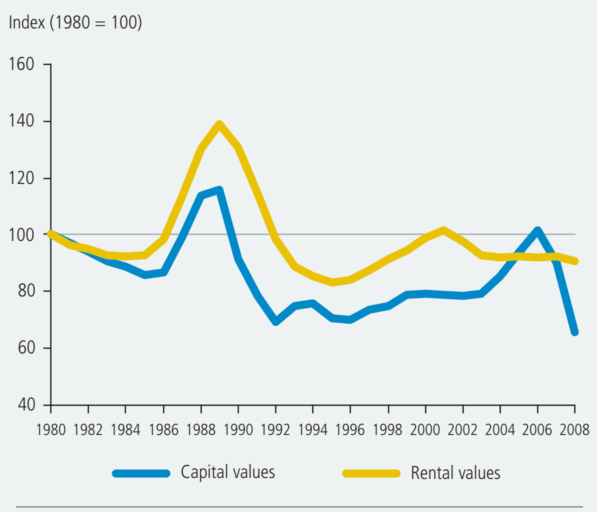
Inflation and property

Profitability outcomes in property investment depend on a number of factors but important amongst these is inflation. Put simply, inflation is the phenomenon of generally rising prices of goods and services or alternatively the fall in the purchasing power of money.

There are two measures of inflation used in the UK – the consumer price index (CPI) and the retail price index (RPI). The RPI is the older and more familiar measure of inflation. It is used for the indexation of various incomes and prices and the up rating of pensions, benefits and index-linked gilts. The CPI is the main measure of consumer price inflation and it forms the basis for the government's inflation target. It excludes a number of items included in the RPI, mainly relating to housing costs, e.g. council tax, mortgage interest payments and depreciation. The RPI gives a consistent series back to 1947 and is generally used as an indicator when considering rent uplifts for commercial property. I have used the RPI as the measure of inflation in my considerations in this analysis.

Inflation has eroded both commercial property capital and rental values over the years. Figure 1 shows changes in all-property rental and capital values since 1980. These have been indexed in real terms (1980 = 100). There are a number of important observations that can be made. In the first instance clearly both rents and capital values are below what they were in real terms in 1980 and have been for most of the period covered. In the case of capital values, it is also interesting to note that despite the recent capital bubble that effectively peaked in mid-2006, capital values at the peak only just reached the levels seen in 1980.

Figure 1: Change in capital and rental values in real terms



Source: IPD

Both rents and capital value really only 'beat' inflation over the period from 1986 to late 1992. This was a period characterised initially by rising economic output (the period 1987-88 experienced the highest rate of economic growth over the whole of the 28-year period covered by Figure 1) and relatively low inflation. However, by 1989 the UK economy was beginning to move into recession and inflation began to rise. Figure 2 illustrates how during this period rental growth declined rapidly and entered a period of negative real growth from 1990 until rents finally recovered in 1996. Figure 2 also shows that rental value growth had effectively been negative for a period of 10 years from 1975 – a period characterised by high inflation effectively resulting from two oil crises and low economic growth in the UK.

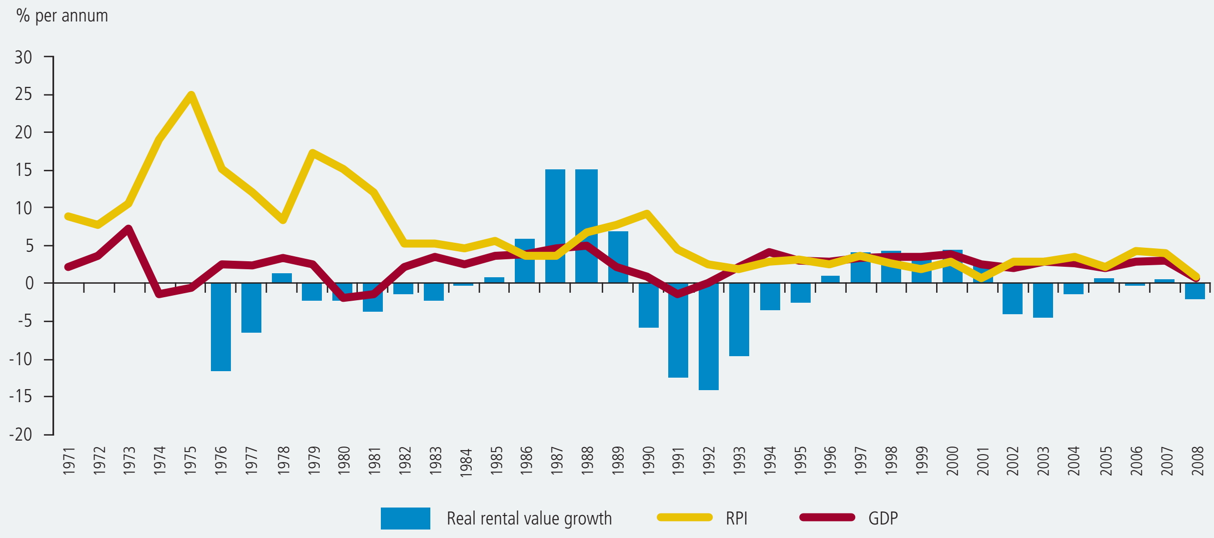
But is there any direct link between inflation and capital values, total returns and rental growth? A more detailed analysis suggests that over the period 1976 to the end of 2008 there was a weak correlation for all three factors, the strongest being for rental growth[2] (see Figure 3). Interestingly, this is not the case for capital values and total returns if the period of very high inflation in the early 1970s is included. In this case the correlation coefficients reduce to 0.13 and 0.09 respectively.

One other aspect of inflation that ought to be mentioned here is that relating to construction costs. The dominance of construction costs in total development costs and the close link

1 We are forecasting that UK CPI inflation will rise to 1.75% by the end of 2010 and to around 4 % by the end of 2011.

2 In this context, we can estimate the degree of correlation between different factors by estimating correlation coefficients (r) in the range -1 to +1. The closer r is to +1 or -1 the more closely the two variables are related - either positively (when one gets larger so does the other) or negatively (when one gets larger the other gets smaller). If r is close to 0 there is no relationship between the variables.

Figure 2: Rental growth in real terms 1971-2008



Source: IPD, Datastream and ONS

between construction costs and the rate of inflation would suggest that the value of new commercial property ought to generally keep pace with inflation in the long run.

Figure 3: Correlation coefficients (1976-2008)

	Inflation
Nominal	
Property total returns	0.30
Rental value growth	0.39
Capital value growth	0.34

Source: IPD

Figure 4: Annualised rates of returns for asset classes against inflation (1970-2008)

	Rate of return %	Rate of inflation %
Nominal		
UK Equities	12.4	
UK Bonds	10.4	
UK All-property	11.0	
Inflation		6.5

Source: IPD

A close long-term link between development cost and market value can only exist for modern or modernised property whereas any individual property's value must decline through obsolescence and this is reflected in the index of capital values in Figure 1. Furthermore, ceteris parabus, the link requires a generally stable or rising demand for floor space. Where there is falling demand there can be no link with development cost and inflation cannot provide a support to values except in the very long run.

Commercial property as a hedge

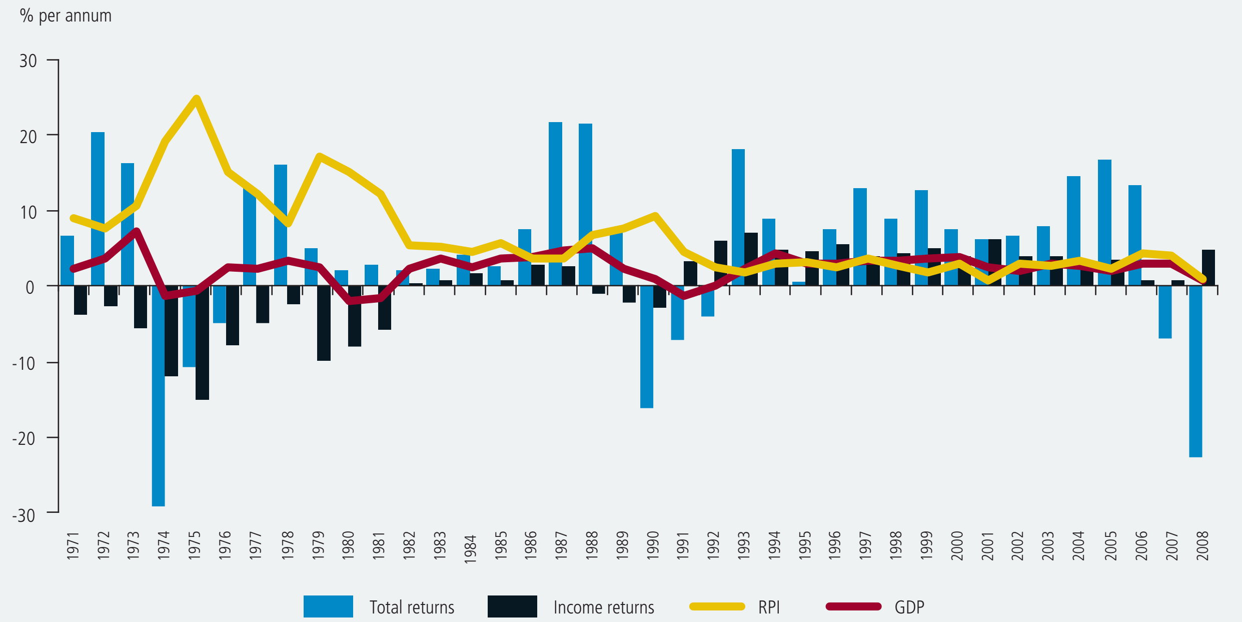
An inflation hedge is an asset that loses little value in periods of rising prices – it holds its value and its purchasing power during inflation, including hyper-inflation. An investor expecting inflation will buy this asset to hedge against inflation.

Historically investment in property has been perceived as providing such a hedge and this process has been going on much longer than might be expected. The institutions appear to have made a direct investment in land as early as 1852, using the value of the land for this purpose. In relative terms, however, all asset classes are affected by changes in inflation and it is also true to say that all investment classes in the long run outperform inflation (see Figure 4).

However, clearly there will be times when returns are below the rate of inflation and real returns are negative. In this context, we should be aware of the sometimes illusory nature of returns by recognising both the potential impact of inflation and the extent of it.

Figure 5 plots real total returns and real income returns from 1971 and compares them with RPI inflation and GDP growth over the same period. What is clear from the chart is that real

Figure 5: Real income and total returns



Source: IPD, Datastream and ONS

income and total returns were negative during the periods of very high inflation in the 1970s, brought about by the unexpected[3] inflation caused by two oil crises. They were also negative during the period of rising inflation in the early 1990s – a period characterised by falling economic output and in the context of commercial property a period of oversupply.

On the definition of a hedge given earlier then, property fails but as I have noted in the long run returns do beat inflation. As an asset class it cannot cope with high unexpected inflation and is not correlated in a strongly positive way with this macro-economic variable. It is a hedge but perhaps a poor one. Despite this, historically property continued to be viewed as a hedge because of its long-term returns and as such suitable for matching the long-term, inflation-linked liabilities of life and pension funds.

As far as institutions and pension funds are concerned this is not now perhaps the main reason for investing in property. The case for investing in property as a hedge against inflation has declined as inflation has declined and this has been further undermined by the introduction of index-linked gilts. These can be used to match longer term inflation linked liabilities at a lower risk and without the disadvantages of high management risk. There are other reasons for continuing to invest in property.

So why property?

Commercial property continues to have considerable attractions as an investment and fund managers continue invest in the sector for a number of reasons, including:

- It provides a secure and stable cashflow;
- It is a particularly good diversifier for portfolios dominated by equities and bonds;
- Total returns are less volatile than either equities or gilts; and
- It performs well relative to other investment categories.

In particular, commercial property is a good diversification investment for portfolios dominated by equities and bonds because of the low to medium positive correlation of total returns between these main asset classes. Over the period 1970 to the end of 2008 the correlation coefficient between total returns from property and equities was around 0.3 and between property and gilts around 0.02 – see Figure 6. So for a significant period of time property has been a very good diversifier and there is no reason to think that this will change in the future. This is partly because of the tendency of returns from gilts and equities to lead the economic cycle and property to lag, both in real and nominal terms.

Figure 6: Asset correlation 1970-2008 nominal and (real)

Asset correlations	Direct Property	UK Equities	Gilts
Direct Property	1.00 (1.0)	0.29 (0.2)	0.02 (0.1)
UK Equities		1.00 (1.0)	0.59 (0.5)
Gilts		0.59 (0.5)	1.00 (1.0)

Source: IPD

3 Unexpected in the sense that these were external shocks to the system and really not part of longer term economic cycles that might be expected.

It is also worth remembering that property investments are rights over land and buildings and as a consequence are tangible and durable assets. In circumstances less extreme than bankruptcy, a company in difficulty will stop paying dividends before it stops paying rent. Rent is a contractual obligation like interest on debt, dividends are not.

Rental growth from commercial property tends to lag economic activity and importantly inflation. In one sense this is not helpful since the effect of lengthy rent review periods is to cause a delay before rental growth is converted to higher investment income. In a similar sense, property can suffer in the short to medium term in periods of high inflation but importantly gain in periods of low inflation when properties can become over rented and property can produce higher than expected income yields. I believe that this will be the case in the UK short to medium term where the balance of expectation is for a period of low to medium rates of inflation with income and total returns being positive from 2010 (see Figure 7).

In summary, while property may not be the complete hedge against inflation thought previously, it can provide some protection against expected inflation. More significantly, however, it still offers considerable benefits when held as part of a well-balanced portfolio. It has defensive attributes, a stable and competitive income, the potential for capital gains and a low correlation with other asset classes. Quality properties and active management skills will be the key drivers of performance and for those prepared to ride out the short-term downturn, investing in commercial property will again provide the long-term benefits that have characterised the asset class in the past.

Figure 7: Forecasts of property returns and RPI (April 2009)

	Total returns %	Income returns %	RPI (average) %
2009	-15.1	7.1	-1.5
2010	7.6	9.1	2.1
2011	11.0	9.2	4.2
2012	12.3	8.9	3.0
2013	11.5	8.5	2.5

Source: SWIP

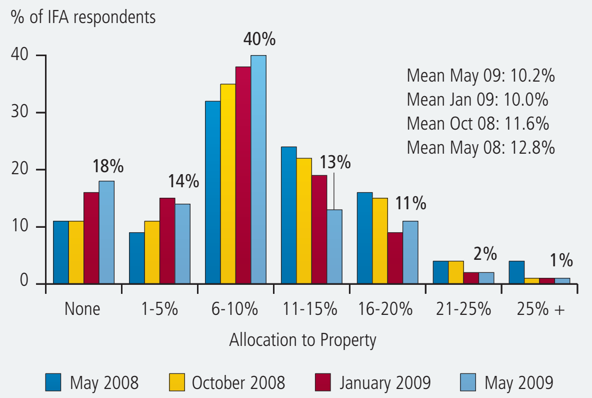
Latest IPF Survey of IFAs shows some positive signs for commercial property June 2009

Mean recommended allocation to property has increased

The fourth **IPF Survey of Independent Financial Advisors** (IFAs) contains some positive signs for the sector. The average recommended allocation of client portfolios to property edged up from 10% to 10.2%. This is the first time the figure has moved upwards since the survey started in January 2008.

The number of respondents recommending a zero allocation to property has also increased this time but remains dwarfed by the over 80% of IFAs polled who recommend their clients to have some weighting in property. The majority of these recommend an allocation of between 6% and 20%.

Figure 1: Recommended percentage of client portfolio allocated to property investments



Base: All Respondents – May '08 (241), Oct '08 (224), Jan '09 (263), May '09 (247)

This small improvement in sentiment is reflected again in the proportion reporting an increase in their level of recommendation to property investments. The number remains relatively small at 12% but the number recommending no change has remained stable and the number reporting a fall in their recommendations to investment in property has fallen relatively sharply from 51% to 39% in this round.

These small positives are further underpinned by an increase in the number of IFAs reporting their clients as being under-exposed to the asset class (21%). The majority still see their clients as over-exposed to property but this figure is gradually beginning to fall, from 56% to 54% this time.

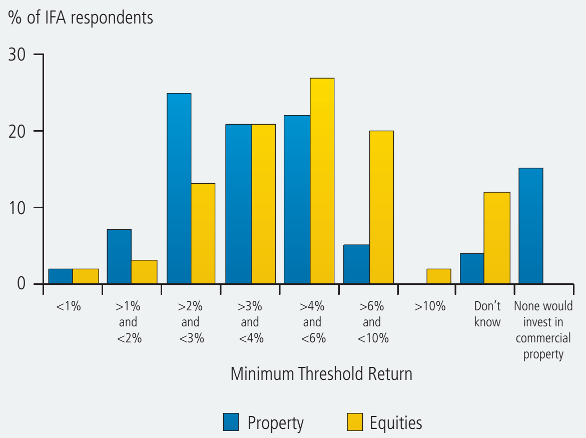
IFA expectations of commercial property returns remain conservative but have improved

IFAs' expectations of returns are also showing marginal signs of improvement. The number expecting a negative annual return over the next 12 months and over three years has fallen. Short term prospects are still expected to be poor but the majority of respondents are expecting positive returns over three years (70%) and five years (90%).

Minimum expected returns for property and equities have increased

Attitudes to risk also seem to have changed a little in this round of the survey. The minimum threshold rate of return for property investments has risen from 3.4% to 3.7%. The same measure for equities has also increased, but by marginally less, reducing the differential between the two asset classes.

Figure 2: Minimum threshold rate of return for equities and property investments



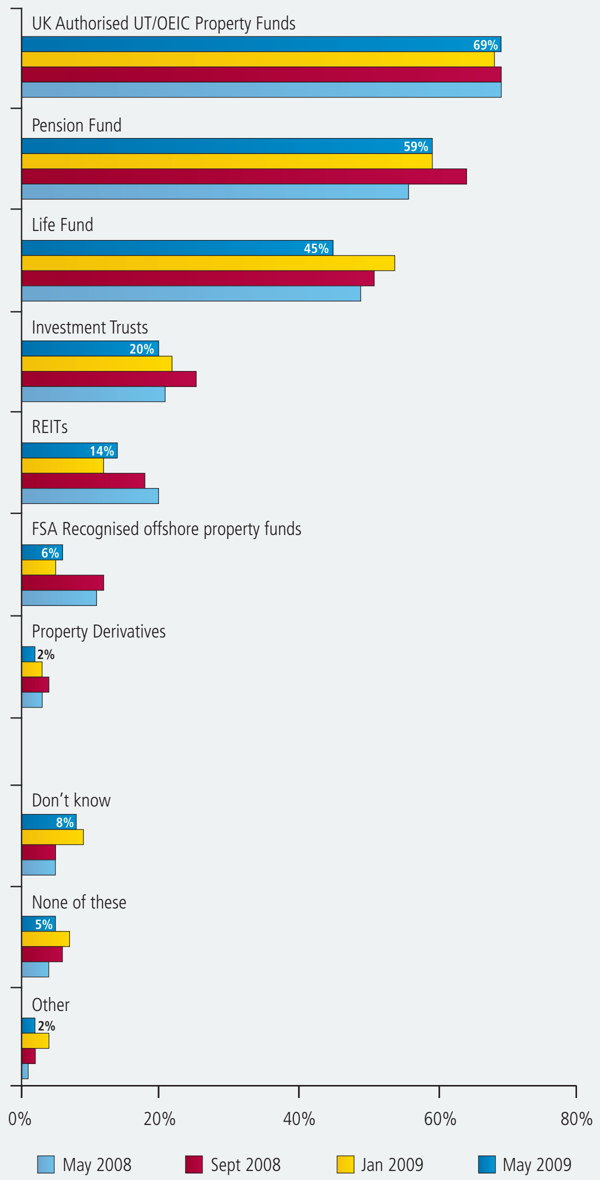
Base: All Respondents – Sept '08 (249) Jan '09 (263) May '09 (247)

IFAs continue to report that their clients prefer UK authorised unit trust and open-ended investment companies, pension funds and life funds for their collective investments (see Figure 3). They continue also to see stable income and capital growth as their key requirements from property investments.

The increase in popularity of the US as an investment destination in the last round of the survey was short lived. The UK is the clear favourite amongst the respondents by some margin (see Figure 4). Global, Europe, Asia and US have all declined in popularity this time. This preference for UK investments is also reflected in the vehicles preferences where UK-based bricks and mortar funds remain the most popular. Global bricks and mortar funds retain their second place spot but have fallen back most sharply suggesting that it is the geographical bias rather than the type of fund that is less popular.

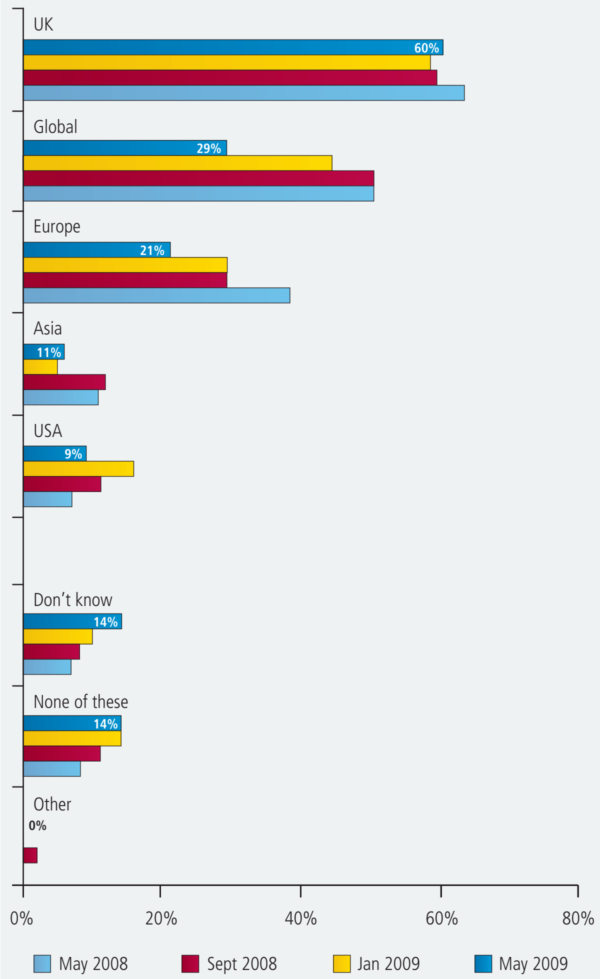
This round of survey results suggest the demand for property as an asset class is holding up amongst the IFAs and some are beginning to see property as more attractive. The key investment characteristics of capital and income growth remain the main drivers behind demand from this group.

Figure 3: Products likely to be used for collective investments



Base: All Respondents – May '08 (241), Oct '08 (224), Jan '09 (263), May '09 (247)

Figure 4: Geographical areas likely to recommend for property investments



Base: All Respondents – May '08 (241), Oct '08 (224), Jan '09 (263), May '09 (247)

Property investment in a changed world

Bill Hughes, Managing Director, Legal & General Property

The last two years have provided a number of extremely valuable lessons to the property industry. Against arguably the most challenging economic backdrop in living memory, we have all had to re-evaluate our strategies and reassess the way we operate.

The continuing unprecedented conditions remind us that we are, indeed, living in a changed world. The global credit crisis has altered the very nature and structure of the global capital markets and identifying strategies for surviving and thriving in this changed market is paramount. Analysing positions, preserving capital and identifying and removing toxic assets from portfolios will demand sustained focus and a strategic move away from individual risk management 'silos' to a more holistic, firmwide risk management strategy, which undoubtedly will become a board-level requirement.

A heightened regulatory climate will necessitate a new level of compliance reporting and, for wealth management and brokerage firms, staying close to clients who are concerned about volatile markets will be crucial.

So what are the things that we as property investors should be looking out for? What should we be concerned about? And where should we be turning for salvation?

Technology and data management are the two topics most likely to have fund managers quickly turn the page to something more stimulating. However, in this new age, ignoring these topics at best risks missing a trick and at worse leaves oneself susceptible to a potentially fatal mistake.

Control costs – streamline business processes

Every student embarking on a career in property is taught that property as an asset is heterogeneous and, when compared to paper assets, highly management intensive. That is often where the lecture stops, but what is not made crystal clear is that it is also data hungry.

In a strong market we can all thrive and deliver returns on 'the deal' alone, but times have changed and those days are over.

Falling capital returns and poor short-term prospects for recovery mean that effective and efficient management is now proportionally more important, not only for property to remain a viable asset class but for the very survival of some of the firms that support the property investment market.

When times are tough, as they are now, it is more important than ever for every organisation to work as smoothly and efficiently as possible. Technology can provide real efficiency gains, whilst at the same time increasing the effectiveness of services for clients and customers.

It is essential to efficiently manage key processes and foster collaboration, not only across the enterprise but also among out-sourced services providers such as valuers, lawyers and managing agents.

The most successful organisations will be ones whose processes waste no effort or resource and introduce a degree of automation and standardisation. This may be as basic as replacing paper forms with electronic ones, although the real value in deploying electronic forms lies in the ability to reduce the bureaucracy associated with paper forms rather than simply replicating it.

A Gartner report (2000) stated that around 80% of business documents are forms and that using, processing and entering each paper form costs between $30-$165. Count how many forms pass through your department in a year, multiply by say £70 and add this back to your bottom line.

There are numerous illustrations from where efficiencies could come. For example, I remain surprised that in 2009, lease summaries are typically typed into paper forms by legal assistants within law firms and then faxed and re-typed, sometimes incorrectly, into management systems. High error rates are common in property and this is a very important confidence factor. Legal & General Property is continuing to assess ways of increasing the efficiency of this process, including online transfer of data which will also serve to increase accuracy levels.

There is a better way, however. It is possible to save money whilst at the same time improving the quality of the data that is so critical to effective asset management.

Effectively managing risk

Another area that will continue to be critical to the ongoing wellbeing of our industry is the management of risk.

For the financial services industry, risk has always been an inherent part of doing business. But in recent years, corporate governance issues, market uncertainty and turbulence have put the dangers of risk, and the consequences of poor risk management, in the spotlight.

Observers will note that there has been a growing need for financial institutions to measure and manage operational risk in a more scientific way. That growing need has matured into a necessity, if not a mandatory requirement.

But developing theories around risk, and systems to calculate it, is arguably the easy part. The ability to feed those systems and calculations with accurate, real time data, and to do so cheaply, presents an altogether different challenge.

Increasing compliance and regulation

The need to measure risk purely by choice and in order to make sound business decisions has paled into insignificance when compared to an emerging regulatory climate, which will demand far greater levels of control and visibility on risk and will hold boards and executive teams personally accountable for the success, or failure, of their procedures.

Compliance with regulations has, however, always been a reality of business. All public companies that trade on US markets must comply with the Sarbanes-Oxley Act and financial services firms in Europe must comply with the Basle II accord. Failure to comply now bears more serious penalties than ever, including the loss of corporate integrity and shareholder confidence.

But the close relationship between property, financial markets and the global economy through increased lending against bricks and mortar has guaranteed there will be further obligatory requirements for greater transparency, which means more rigorous and more frequent reporting.

Process analysis, meticulous data management and the application of technology are essential if we are to manage this additional burden most effectively and avoid the easily imaginable scenario of having trained real estate experts sub-optimally employed, filling forms or entering data.

Legal & General Property completed a strategic business systems review during 2008, which looked at how effectively our systems supported the business and their ability to meet future requirements. The review included requesting information and detailed proposals from several technology solutions providers in order to identify a partner with the capability to help us to evolve our systems in the short term, together with the foresight required to anticipate and meet our business needs in the longer term. As a result of this detailed assessment, we have identified a number of initiatives that will better focus our investment on supporting Legal & General Property's strategic direction and significantly improve operational efficiency and effectiveness.

We also recognise the importance of having senior resource dedicated to making this happen. Angela Smith is our Head of Management Information, and has, with our full support, recently been appointed to the Board of PISCES (Property Information Systems Common Exchange Standard Limited), the not-for-profit organisation that develops data exchange standards for real estate. These Standards provide a rich and valuable source of definitions relating to information used in real estate business processes, which can be represented in the kind of standardised data exchange that is essential to the free flow of data. These Standards have been around for a number of years, but the resource has arguably been under utilised by an industry that has to date struggled to recognise its true information needs.

The global financial crisis may be the stimulus for revising that approach. Our new environment calls for fact-based decisions, greater responsibility and due diligence; all of which require consistent, accurate and real time data. The world has changed and we have to ensure that we change with it.

OSI Index 2009 – are we keeping the customer satisfied?

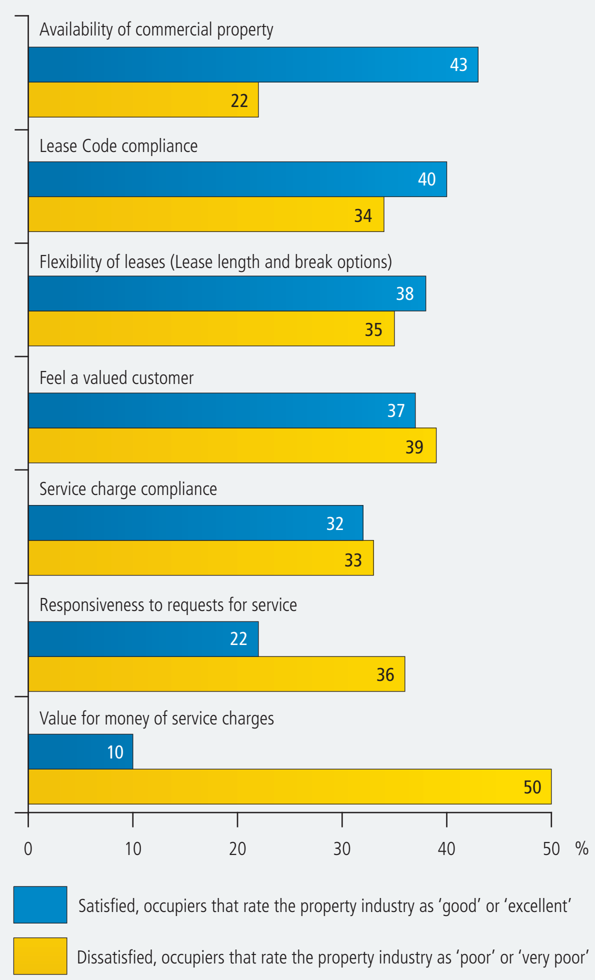
Howard Morgan, Managing Director, RealService

The Property Industry Alliance and CoreNet Global UK 2009 Occupier Satisfaction Index (OSI), published recently, reveals little change in overall satisfaction amongst occupiers with the service they receive from the UK property industry, leaving the OSI unaltered at 57.

Based on in-depth telephone interviews with over 230 occupiers across the UK, the study reveals that the property industry still compares unfavourably with other industries when it come to service. While a change in attitude is perceived, led by some of the UK's largest landlords, occupiers feel that it is the recession that is forcing the pace of change and bringing greater lease flexibility and responsiveness. Occupiers want owners to focus on reducing costs as a priority.

While the headline Index is unchanged, a deeper study of the findings reveals some interesting trends.

Figure 1: Occupier satisfaction with the service they receive



Source: Occupier Satisfaction Index 2009

Flexibility

Many occupiers believe that market conditions are forcing property suppliers to adopt a more flexible approach to leasing. However, some feel that the property industry is not responding quickly enough, while others perceive it not to be responding at all. Occupiers would like greater flexibility, and a more empathetic approach from property owners.

Two in every five occupiers believe that the property industry is moving towards greater compliance with the Lease Code. Larger property owners are perceived to be more likely to comply than smaller independent property owners. Others, however, feel that the property industry is reluctant to comply, paying lip service to the Code.

Partnership

Around a third of occupiers think that there has been an improvement in communication since the 2008 study, but others would like more face to face contact and more relationship building. Many occupiers still perceive that their relationship with the property industry is adversarial, and they would like property owners to adopt a modern approach to relationships.

There is recognition that certain sectors within the industry are showing a greater understanding of occupiers' business needs, though some feel that this is market driven. The larger landlords are perceived to be leading the way in raising customer service standards.

Over a third of occupiers feel valued by the property industry, with some saying that they now feel more valued, attributing this improvement in large part to the recession. However, many occupiers feel that property owners do not value their custom, with some suggesting that the property industry continues to adopt an overly short-term approach to relationship building.

The property industry has a long way to go to catch up with other service industries. Only 10% of occupiers feel that their relationship with the property industry is closer than their relationship with other suppliers. Many believe that with other service industries there is more contact, greater customer focus and more room for negotiation.

Responsiveness

Occupiers perceive inconsistency in the standard of responsiveness and customer care provided by the industry, and many mention having to chase to get things done. Occupiers express frustration over the lack of contact, the lack of urgency and the lack of interest shown by property owners. In particular they would like the industry to ease the approvals process.

Around a quarter of occupiers believe that the timeliness of management information has improved. However, others report that timeliness varies considerably across the industry. Some feel frustrated over the delays in reconciliation, and there is a perception that some managing agents in particular provide a poor service.

Sustainability

Occupiers perceive that awareness and implementation of best practice within the industry are improving, especially in relation to new-build development and as a result of the introduction of EPCs. Many are keen for more to be done and are especially interested in the implementation of cost-saving initiatives. Some occupiers believe that the implementation of environmental initiatives will be put on hold until market conditions improve.

Value for money

Value for money is the key concern of occupiers. While some occupiers perceive that value for money for rent has improved as a result of the recession, others believe that upward-only rent reviews do not reflect the economic reality.

Occupiers believe that property costs in the UK are high in comparison to costs abroad, and therefore offer poor value for money. Property costs in London are perceived to be particularly high.

Whilst a few occupiers recognise that some of the larger landlords have made a commitment to reduce costs, occupiers generally do not believe that they are receiving good value for money for the service charge. They would like property suppliers to place greater emphasis on reducing costs, progress with transparency and consult with them more.

Just under a third of occupiers are satisfied with industry compliance with the Service Charge Code, with some reporting an improvement, particularly amongst larger landlords. However, many feel that property owners are not complying sufficiently, and that the Code lacks teeth. Service charge transparency remains a major concern for occupiers.

Research conducted by RealService and IPD on behalf of the Property Industry Alliance and CoreNet Global UK. A copy of the executive summary and full report are available at **www.occupier-satisfaction.co.uk**

The treatment of covenant strength

The paper below outlines the findings of the research funded by the IPF Research Programme 2006-2009 into the treatment of covenant strength by valuers, lenders and investors active in the UK property market.

Introduction

Income is the key driver of property returns and the downturn in the property market has brought into sharp focus the importance of the security of the income stream in the pricing of real estate. Over the 26-year period 1981 to 2007, the IPD UK average total return was 10.7% pa, with income return at 6.6% pa (standard deviation of 1%) and capital growth 4.1% pa (standard deviation of 8.1%). The stability of the income return is one of the key features of real estate both as an investment and as a security, hence the importance of evaluating covenant strength in the risk pricing process.

A key element in a normative model of property pricing focuses on cashflow risk and the factors that influence the covenant strength of the party contracted to pay the rent. Cashflow risk is affected by both exogenous and endogenous factors. Exogenous factors comprise for example, general economic conditions, finance rates, level of taxation and legislative changes. Normally of greater significance are endogenous factors for example, tenant, location, prospects for rental growth, building condition, obsolescence, letting risk and lease arrangements.

In the implicit method of valuation, all risks are encompassed within the 'all risk yield'. The level of the risk premium required depends upon the interaction between the health of the economy, the property market, the sector and individual property characteristics. This paper focuses on the risk of default and the level of risk premium which should be applied over conventional gilts – a risk-free proxy.

Property cycle

Previous research by Key et al (1994) has shown that the property cycle directly feeds off the economic cycle. Bond yields and inflation are key drivers of property yields and investor sentiment. GDP, consumer spending (retail), financial and business services (office), manufacturing activity (industrial) are a primary influence on rental value. The economic cycle impacts on the ability of occupiers to pay the contracted rent. At the portfolio level fund managers need to be aware of the differing volatility in returns between the sectors and across geographical areas, which may 'stress' the income return component. The systematic risk should be appropriately priced.

Default

The level of default is fundamental to an understanding of covenant strength due to the impact on future income streams and to the value of the property investment. In recent decades, the level of company liquidations has been relatively low, of the order of 1%, increasing as expected, during recessionary periods. Analysis by Dun & Bradstreet over the period March 2006 to September 2008 showed that the probability of insolvency during most of 2006-07 was between 2% and 2.6%. For certain sectors this increased significantly from June 2007, with the construction sector for example increasing to 4.6%, as the current economic downturn took effect. Analysis on the probability of delinquency showed a similar trend and since the Q3 2007 there has been a significant increase in the probability of companies likely to be come delinquent.

Norman E Hutchison, University of Aberdeen

It is essential that those involved in the pricing of property interests are aware of the different sector volatility and a higher risk weighting should be applied to those sectors that are more volatile.

Alastair S Adair, University of Ulster

IPD results

How have capitalisation rates been affected by covenant strength in the market? Initial analysis of IPD UK data from 2003 to 2007 showed no relationship between the equivalent yield and covenant strength. Further analysis, combining lease length and covenant strength with the equivalent yield, produced more insightful results, if unconvincing. These results show that higher risk covenants tied to a short lease result in higher yields, whereas low risk covenants in longer leases produce lower yields reflecting the differential risk profiles. Nevertheless, it is evident that in the early part of the analysis period across all sectors, the market added only a very small additional risk premium to reflect the differences in covenant strength and lease length. This risk premium increased significantly during 2007. However, the results are not statistically different suggesting that trying to deconstruct the risk premium into individual components is very difficult due to the large amount of 'noise' in the pricing process.

Nicky Findlay, University of Aberdeen

At all the phases of the property cycle, covenant strength should be subject to rigorous analysis. Clearly in the down phase of the cycle, the risk of default is higher, but it is equally important that in-depth analysis of tenants is carried out in the up-phase of the cycle to prevent mispricing of tenant risk at a time when the market is being swept along by 'irrational exuberance' and less thought is being given to the likely performance of the tenants in falling markets.

Valuers

A questionnaire survey of valuers was undertaken in 2008 to attempt to quantify the basis point change to the equivalent yield that would be applied to valuations under a number of different combinations of covenant strength and lease length and to track any change in margin from December 2006 to September 2008.

The calibration of covenant strength by the valuers reflected the changing market conditions, but while the suggested premium between risk scenarios was incremental, it was not uniform. Moreover, the results were at odds with the market data supplied by IPD, with the valuers reporting more distinct changes in yield to that reflected in the year end valuations of standing investments.

While it is acknowledged that the survey removed the 'noise' problem in the scenarios as the valuers were asked to concentrate only on the covenant strength and lease length impact, it would suggest that while, in principle, valuers recognise the different risk scenarios, in practice yield analysis rather than yield construction is the primary method of determining the initial yield. This tends to preclude the explicit calibration of covenant strength within the risk premium.

Lenders

Eight investment and commercial banks were interviewed in 2008 to consider their treatment and pricing of covenant strength in loan deals. Prior to mid 2007, the property market had been overheating partly due to the availability of cheap debt finance and the pursuit of a position in the market by the 'yield chasing' investor. During the growth stage of the cycle, lenders confirmed that while covenant strength was a relevant criterion in lending decisions it was not the dominant factor. Cashflow, lease length and re-letting prospects were more important considerations.

At the height of the market cycle, lending criteria were relaxed and questions must be asked how this was allowed to happen on such a grand scale. The performance of the FSA in 'promoting efficient, orderly and fair markets' has been called into question.

Doubts surround the calibration of the bank's risk scoring models. Speculation must be that the inputs to the model did not properly reflect the possible range of outcomes and misread the stage of the cycle. In considering the risk of default over the length of the lease, consideration should have been given to the likely market conditions throughout the lease and the loan term. That said, differentials in loan pricing were made between sectors recognising the different volatilities and characteristics.

The performance of credit rating agencies – key to the pricing of securitised products – has come in for some heavy criticism by the FSA, with default risk being significantly mispriced.

Heightened awareness and more accurate measurement of risk are also being driven by the increasing regulatory framework in particular the implementation of Basle II.

Investors

Nine UK institutional investors were interviewed and all recognised readily that covenant strength risk had not been appropriately priced during the upturn in the property cycle. There is clear evidence of mispricing of the systematic risk. Investors appear guilty of pricing at a point in the cycle rather than taking the longer view and pricing through the cycle.

It became clear that it is the combination of lease length and covenant strength which enables cashflow risk to be appropriately priced. Careful analysis is required to understand which sectors perform well in a buoyant economy and which are most affected by a downturn. The last 20 years has seen a significant reduction in lease length and the increasing prevalence of break options. This represents a significant shift of risk from tenant to landlord, which may not have been appropriately acknowledged in market pricing.

Covenant strength risk should be priced, not in isolation, but in conjunction with the mix of sector and property specific characteristics in order to reflect volatility in returns across the sectors and geographical areas.

Conclusion

At the outset of the research in March 2008, few could have forecast the level of turbulence that was to hit the financial markets and that by the end of the year the UK would officially be in recession. However, many had predicted that the UK commercial property market was overheating. The double digit returns of 2003 to 2006 told a story of capital value appreciation on the back of 'yield chasing' investors aided by cheap and available debt finance. In attempting to deconstruct the yield at this point in the cycle, either the risk premium was negligible or investors were adopting hugely optimistic rental growth prospects. The mispricing of systematic risk came abruptly to an end when investor sentiment turned and liquidity dried up. What lessons can be learned from this episode?

Fundamentally it is important for market participants to understand the link between the economic and property cycles. An appreciation of the stages of the economic cycle and how it feeds into the yield curve and rental growth is crucial, along with a clear understanding of the present, and likely state of the market at the end of the investment/lending period. Property pricing should reflect the systematic risk inherent in the market but is clear from the research that the UK market in recent years was swept along by short-termism, and this myopic view then exaggerated the correction that followed. Moreover, close attention should be paid to the differing volatility in returns between the sectors and across geographical areas. This exposes the need to conduct thorough research on the sectors as well as the individual tenant's financial strength.

The research has shown that the risk premium should reflect the contribution of covenant strength to the overall risk of the investment, both at property and portfolio level. Risk analysis going forward will have to be more robust in order to avoid a repeat of the 'irrational exuberance' which characterised the UK market in recent years.

Monitoring income risk

Matthew Richardson, FIL Investments International

With little chance of capital growth over the short to medium term, real estate investors have become increasingly focused on the need to maintain rental income and minimise the chance of loss. A key part of this process is understanding the likelihood of tenant income failure, quantifying that probability of loss and benchmarking the risk.

Traditionally this risk has been quantified by using a standard credit report from a rating agency such as Dun & Bradstreet or Experian. All of the credit agencies include a 12-month outlook on the corporate health of tenants in their standard reports and express this as a score between 0-100 with a high score implying less likelihood of failure. It is not widely known that these scores correspond to a percentage probability of business failure and it is this measure that should be used to rate covenant strength.

While failure rate gives an absolute measure of short-term tenant failure, up until now there has been no means of benchmarking the relative risk associated with exposure to different types of tenant or industry sectors.

The Fidelity Income Risk Monitor (FIRM) has been developed by Fidelity, using data from Dun & Bradstreet, and provides a set of tenant income risk benchmarks for investors. The model aggregates the credit ratings for 4.2m UK businesses on a quarterly basis and groups the results by property sectors (retail, office and industrial), sub sector and industry type.

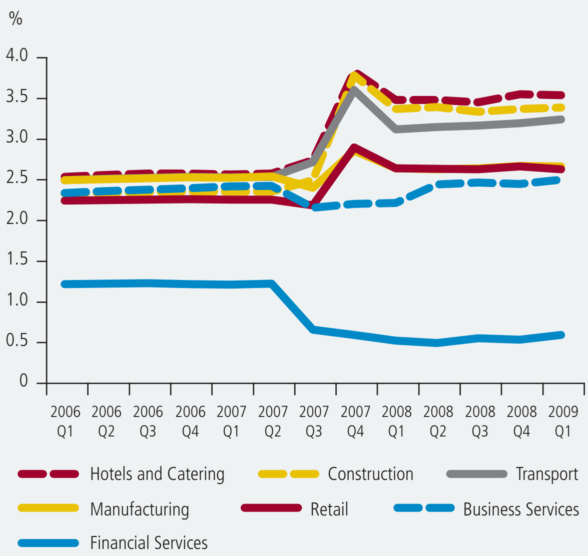
The results can then be used to benchmark the relative risk of exposure to specific sectors of the economy or types of businesses over time. The following charts highlight some of the key trends.

Figure 1: Average probability of business insolvency in the next 12 months UK All Business

Source: FIL FIRM Index, Dun & Bradstreet – April 2009

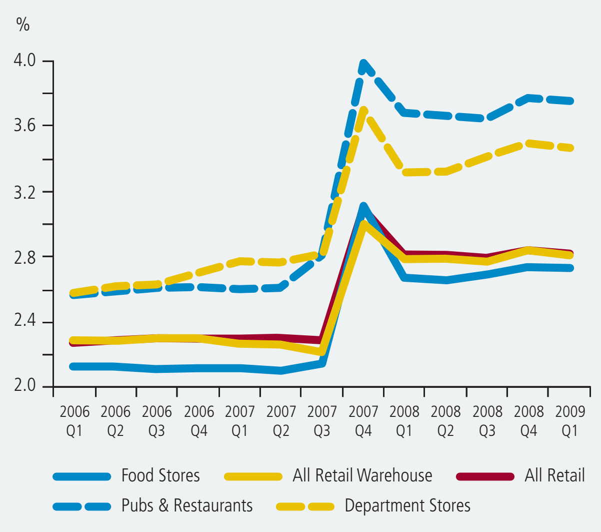
- UK plc has seen projected failure rates shift by 100bps since the Credit Crunch
- Average probability of tenant failure is currently 3.07% (April 2009)
- Anecdotal evidence suggests the failure rate peaked at 4% in early 1990s' downturn
- Full sample 4.2m businesses

Figure 2: Average probability of business insolvency in the next 12 months, UK All Business by Industry



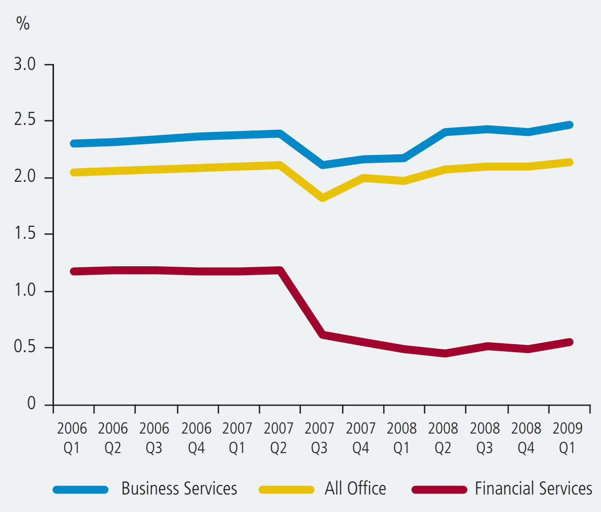
- Discretionary spending and construction have been the worst affected sectors
- Financial services improved as the banking sector is now underwritten by the UK government

Figure 3: Probability of business failure by retail sub sector – 12-month projected



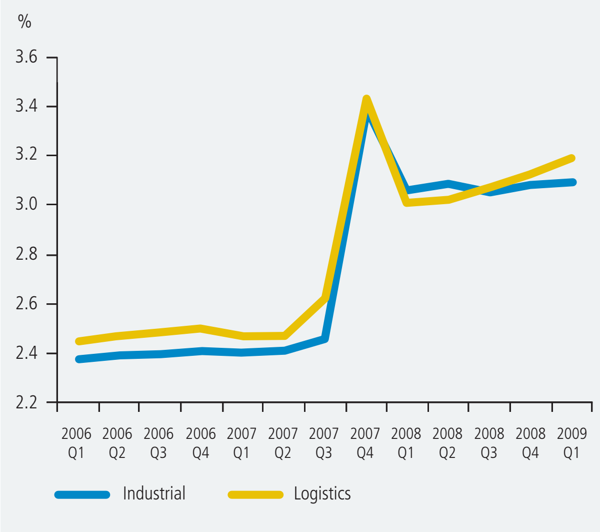
- Pubs and restaurants are most exposed to discretionary spending
- Discount food stores are least affected
- Department stores are rated as higher risk because the small number of occupiers are highly geared

Figure 4: Probability of business failure by office sub sector – 12-month projected



- Business services NOT financial services are bearing the brunt of redundancies
- Nationalisation has reduced risk of bank failures

Figure 5: Probability of business failure by industrial sub sector – 12-month projected



- Logistics businesses most exposed and a small number of companies in sample

UK Consensus forecasts
May 2009

The Q2 2009 IPF Consensus Forecast shows the downward trajectory in expected property market performance continues. The All Property total return forecast for 2009 has fallen from -11.3% to -15.1%. This is driven by reductions in both capital and rental value growth figures for the year. The positive total return forecasts for 2010 have fallen again with shopping centres the most significantly revised sector.

Offices remain the sector with the poorest outlook overall. The positive total return forecast for offices for 2010 is looking increasingly meagre and has fallen below the UK Government's target rate for inflation, suggesting negative real returns in the medium term. Over the five-year view the industrial sector remains forecast to show the strongest performance.

2011 remains the bright spot on the horizon but forecasts for the year have also edged downwards. Rental value growth has been revised further downwards and the forecasts of capital value growth, expected to drive improved returns, have weakened. The consensus remains that there will be a recovery in 2011 but the strength of that recovery remains open to question in an increasingly uncertain market.

The downward revision in the forecasts is unsurprising given the recession in the broader economy. The Treasury Consensus Economic Forecasts[1] expect UK GDP to contract by 3.8% in 2009. Any recovery in 2010 is expected to be limited with GDP forecast at 0.4%.

Looking across industry sectors the outlook is very weak. The business services and finance sector grew by -1.8%[2] (i.e. shrank) in Q1 2009, substantially more sharply than in Q4 2008. The transport, storage and communications sector shrank by 2.9% and construction by 2.4%, however this was a slower rate of contraction than the previous quarter. Distribution, hotels and transport shrank by 1.2% with hotels and restaurants and wholesale the biggest contributor to the slow down within this particular sector. Government and other services remains the only sector to be expanding, albeit more slowly than in Q4 2008.

Unemployment figures are equally poor, the rate having risen to 7.1% in Q1 2009. A further 244,000 people joined the ranks of the unemployed. The rate of insolvencies and company liquidations has also risen again with the Insolvency Service reporting an increase of 7.1%[3] in Q1 2009 over the previous quarter. The earnings growth rate has also fallen. This weak earnings and employment data is reflected in the very mixed retail sales figures for Q1 2009. Total sales volumes rose by 0.9% in Q2 2009 compared with Q1 2009. The largest rise was reported for textiles, clothing and footwear at 5.3%. The household goods stores, by contrast, saw sales volumes fall by 3.4%. Non-store retailing and repair fell by 0.8% this quarter.

This low level of consumer demand means deflation remains a concern. Even with interest rates kept at the record low rate of 0.5%, the retail price index (RPI) was negative at -1.2% in April. Whilst this is affected by the low interest rate, the consumer price index (CPI) was also lower – falling from 2.9% to 2.3% and is expected to remain on a downward trajectory until 2012.

It is difficult to find anything but bad news in both the economic overview and the forecasts this quarter. The market is clearly responding to the recessionary conditions reflected in this extremely weak economic data. This can be seen in the downward revisions in particular to the forecasts for the retail sectors and the further reductions in the office sector figures.

Key points

The IPF Consensus Forecast All Property total return forecast for 2009 has fallen to -15.1%, down from -11.3% as forecast in Q1.

- The consensus forecasts of total return across all sectors have fallen for each year forecast this quarter.
- 2009 remains forecast as the bottom of the market with positive total returns expected from 2010 onwards. Uncertainty within the 2009 forecasts is all on the downside suggesting that these numbers are more likely to fall further than to rise.
- Rental value growth is forecast as negative across all sectors for the three years and capital value growth remains negative for all sectors until 2011.
- The office sector forecasts have also been reduced again in this quarter's survey and remain expected to be the worst performing sector in terms of total returns for the whole forecast period.
- The City and West End sub sectors appear to be a key influencing factor within the office sector forecasts and are expected to under perform every other sector by some margin for 2009 and 2010.
- The bearish outlook of the rental value growth forecasts continues with all sectors forecast negative rental value growth figures for the three and five-year views.
- Total return forecasts for 2011 remain in double figures but the early optimism seen in the Q1 2009 forecasts seems to have been dulled.
- The uncertainties in these forecasts are largely reported as neutral for 2011, underlining the less optimistic view.
- The five-year view shows total returns are still forecast to be above the target rate of inflation of 2.5% for all sectors other than the West End Offices sub sector.
- West End office forecasts have been revised more significantly than those for the City sub sector. Having been generally expected to continue to out perform the City, the figures have now switched. Rental and capital value growth and total return forecasts for West End offices are now lower than those for the City.

1 Source: HM Treasury, Forecasts for the UK Economy, May 20

2 Statistics sources drawn from National Statistics April/May 2009 (www.statistics.gov.uk)

3 The Insolvency Service Statistics Release, Insolvencies in the first quarter 2009, May 1

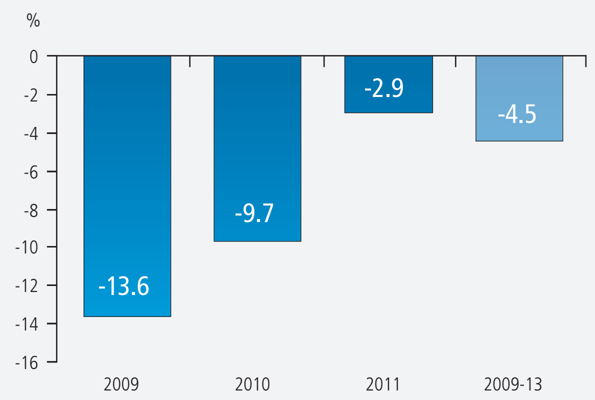
- Across the other sectors, shopping centres have suffered the most significant reduction with mean consensus forecast total return for 2009 falling from -8.4% in Q1 to -15.2% in Q2. This is forecast to be the worst performing retail sub sector throughout the forecast period.
- The industrial sector has retained its place as being expected to be the best performing sector in terms of total return for each forecast year and the five-year view.

All Property rental value growth forecasts

The All Property rental value growth forecasts have fallen further this quarter with each year and the five-year view being revised downwards.

Weak occupier demand and excess stock are clearly expected to dog the market and act as a drag on performance for some time to come.

Figure 1: All Property rental value growth forecasts



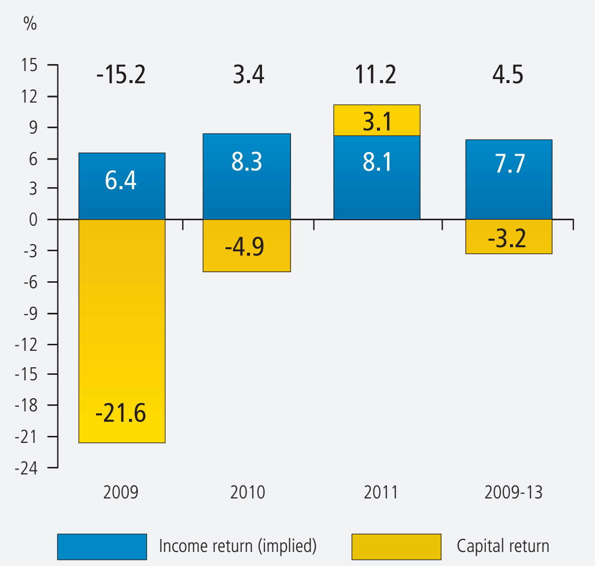
All Property total return forecasts

The All Property total return forecasts have fallen again as the prognosis for both rental value growth and capital return worsens for 2009 and 2010.

Total return remains forecast as positive overall for 2010, largely as a result of income return but this has again been revised downwards this quarter.

2011 remains forecast as the year of recovery with positive capital returns expected. The five-year view remains positive but the impact of poor capital returns in 2009 and 2010 will continue to be felt.

Figure 2: All Property total return forecasts



All Property survey results by contributor type (Forecasts in brackets are March 2009 comparisons)

Figure 3: Property advisors and research consultancies (10 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Maximum	-12.0 (-7.5)	-6.0 (-3.2)	-1.9 (1.7)	-17.3 (-11.0)	0.0 (1.5)	9.3 (10.8)	-10.2 (-4.4)	9.0 (9.5)	18.7 (18.7)
Minimum	-15.7 (-12.6)	-12.3 (-11.6)	-5.0 (-4.9)	-29.4 (-24.3)	-8.3 (-8.8)	-0.8 (-1.1)	-21.9 (-16.3)	0.6 (0.6)	9.5 (8.6)
Range	3.7 (5.1)	6.3 (8.4)	3.1 (6.6)	12.1 (13.3)	8.3 (10.3)	10.1 (11.9)	11.7 (11.9)	8.4 (8.9)	9.2 (10.1)
Median	-13.6 (-10.0)	-9.6 (-7.5)	-3.2 (-2.3)	-21.5 (-15.1)	-4.5 (-2.0)	2.5 (3.7)	-15.0 (-9.0)	3.5 (5.6)	10.1 (11.6)
Mean	-13.7 (-10.1)	-9.4 (-7.6)	-3.4 (-2.1)	-22.3 (-16.2)	-4.4 (-2.3)	3.0 (4.4)	-15.6 (-9.7)	4.0 (5.7)	11.7 (12.5)

Figure 4: Fund managers (14 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Maximum	-10.3 (-4.7)	-6.9 (-5.7)	0.7 (0.7)	-14.9 (-11.8)	1.5 (-0.9)	8.2 (12.1)	-8.8 (-4.6)	8.6 (9.1)	17.3 (20.9)
Minimum	-22.4 (-16.0)	-17.1 (-13.9)	-8.3 (-6.4)	-28.0 (-27.9)	-14.3 (-10.4)	0.1 (0.1)	-18.9 (-18.5)	-4.0 (1.0)	7.9 (7.9)
Range	12.1 (11.3)	10.2 (8.2)	9.0 (7.1)	13.1 (16.1)	15.8 (9.5)	8.1 (12.0)	10.1 (13.9)	12.6 (8.1)	9.4 (13.0)
Median	-13.1 (-9.4)	-10.0 (-7.8)	-3.6 (-1.9)	-21.6 (-18.9)	-5.8 (-5.4)	3.0 (2.9)	-15.0 (-12.1)	3.0 (2.9)	12.1 (11.2)
Mean	-13.6 (-9.9)	-10.7 (-8.6)	-3.7 (-2.4)	-21.6 (-18.8)	-5.9 (-4.9)	3.3 (4.1)	-14.7 (-11.9)	3.1 (4.0)	12.0 (12.2)

Figure 5: Equity brokers (4 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Maximum	-6.0 n/a	-2.0 n/a	3.0 n/a	-15.0 n/a	-1.0 n/a	3.1 n/a	-11.0 (-11.0)	4.0 (5.0)	10.0 (11.5)
Minimum	-20.0 n/a	-11.0 n/a	-1.0 n/a	-23.9 n/a	-4.0 n/a	1.0 n/a	-20.0 (-17.3)	-1.0 (-4.0)	2.0 (3.0)
Range	14.0 n/a	9.0 n/a	4.0 n/a	8.9 n/a	3.0 n/a	2.1 n/a	9.0 (6.3)	5.0 (9.0)	8.0 (8.5)
Median	-13.6 n/a	-7.0 n/a	1.0 n/a	-20.0 n/a	-3.0 n/a	3.0 n/a	-15.2 (-13.8)	3.5 (0.6)	9.4 (9.6)
Mean	-13.3 n/a	-6.8 n/a	1.0 n/a	-19.7 n/a	-2.7 n/a	2.5 n/a	-15.3 (-14.0)	2.5 (0.6)	7.7 (8.4)

Figure 6: All forecasters (28 contributors)

	Rental value growth %			Capital value growth %			Total return %		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Maximum	-6.0 (-4.7)	-2.0 (-3.2)	3.0 (1.7)	-14.9 (-11.0)	1.5 (1.5)	9.3 (12.1)	-8.8 (-4.4)	9.0 (9.5)	18.7 (20.9)
Minimum	-22.4 (-16.0)	-17.1 (-13.9)	-8.3 (-6.4)	-29.4 (-27.9)	-14.3 (-10.4)	-0.8 (-1.1)	-21.9 (-18.5)	-4.0 (-4.0)	2.0 (3.0)
Range	16.4 (11.3)	15.1 (10.7)	11.3 (8.1)	14.5 (16.9)	15.8 (11.9)	10.1 (13.2)	13.1 (14.1)	13.0 (13.5)	16.7 (17.9)
Std. Dev.	3.2 (2.8)	2.9 (2.4)	2.6 (2.1)	3.3 (4.3)	3.8 (3.1)	2.3 (3.0)	3.0 (4.0)	3.4 (3.2)	3.2 (3.4)
Median	-13.4 (-10.0)	-9.9 (-7.7)	-2.9 (-1.6)	-21.6 (-17.8)	-4.5 (-3.8)	3.0 (3.0)	-15.0 (-11.3)	3.2 (4.9)	10.4 (11.1)
Mean	-13.6 (-10.3)	-9.7 (-7.9)	-2.9 (-2.0)	-21.6 (-17.9)	-4.9 (-3.8)	3.1 (4.1)	-15.1 (-11.3)	3.4 (4.2)	11.2 (11.8)

Notes

1. Figures are subject to rounding, and are forecasts of All Property or relevant segment Annual Index measures published by the Investment Property Databank. These measures relate to standing investments only, meaning that the effects of transaction activity, developments and certain active management initiatives are specifically excluded.

2. To qualify, all forecasts were produced no more than two months prior to the survey.

3. Maximum: The strongest growth or return forecast in the survey under each heading.

4. Minimum: The weakest growth or return forecast in the survey under each heading.

5. Range: The difference between the maximum and minimum figures in the survey.

6. Median: The middle forecast when all observations are ranked in order. The average of the middle two forecasts is taken where there is an even number of observations.

7. Mean: The arithmetic mean of all forecasts in the survey under each heading. All views carry equal weight.

8. Standard deviation: A statistical measure of the spread of forecasts around the mean. Calculated at the 'all forecasters' level only.

Survey summary results by sector

Figure 7: Sector summary

	Rental value growth %				Capital value growth %				Total return %			
	2009	2010	2011	2009-13	2009	2010	2011	2009-13	2009	2010	2011	2009-13
Office	-19.4	-12.8	-3.4	-5.7	-23.8	-6.7	2.3	-3.9	-17.5	1.1	10.5	3.5
Industrial	-9.3	-6.9	-2.2	-3.0	-18.5	-4.0	2.3	-2.6	-11.2	5.0	11.6	6.0
Standard shops	-9.8	-7.5	-1.7	-3.1	-17.9	-3.3	3.7	-1.9	-11.8	4.3	11.3	5.3
Shopping centres	-9.5	-6.6	-1.5	-2.7	-21.4	-4.1	3.2	-3.0	-15.2	3.7	11.2	4.5
Retail warehouse	-10.7	-7.7	-1.5	-3.0	-21.4	-3.4	3.7	-2.6	-15.0	4.5	11.7	4.9
All Property	**-13.6**	**-9.7**	**-2.9**	**-4.5**	**-21.6**	**-4.9**	**3.1**	**-3.2**	**-15.1**	**3.4**	**11.2**	**4.5**
West End offices	-26.5	-16.6	-3.6	-8.3	-28.0	-8.3	2.5	-5.2	-22.3	-0.9	10.2	1.8
City offices	-25.1	-16.5	-3.9	-8.5	-26.1	-8.4	2.3	-5.1	-19.7	-0.4	10.6	2.5
Office (all)	-19.4	-12.8	-3.4	-5.7	-23.8	-6.7	2.3	-3.9	-17.5	1.1	10.5	3.5

The 28 contributors to this quarter's forecasts at the All Property level include 10 property advisors, 14 fund managers and four equity brokers. Of these, 26 contributors provided sector forecasts and 23 provided West End and City office segment forecasts (8 property advisors, 11 fund managers and 3 equity brokers). All forecasts were produced within the last 12 weeks for this edition.

Notes

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

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

The sector figures are not analysed by contributor type, with all figures shown at the all-forecaster level.

In the charts and tables 'All Property' figures are for the full 28 contributors while the sector forecasts are for the reduced sample (26) of contributors.

Acknowledgements

The Investment Property Forum would like to thank the following organisations for contributing to the IPF UK Consensus Forecasts for Q2 2009:

Property advisors (includes research consultancies): Capital Economics, CBRE, Colliers CRE, DTZ, Fletcher King, GVA Grimley, Jones Lang LaSalle, King Sturge, Paul Mitchell Real Estate Consultancy, Real Estate Forecasting Limited.

Fund managers: Aberdeen Property Investors, Aviva Investors, CBRE Investors, Cordea Savills, F & C Property Asset Management, HSBC Real Estate Multimanager, ING REIM (UK) Ltd, Invesco, Invista REIM, La Salle Investment Management, PRUPIM, RREEF Ltd, Standard Life, SWIP.

Equity brokers Nomura International Plc, BNB Paribas, Morgan Stanley and one that wishes to remain anonymous.

European Consensus forecasts
May 2009

Key Points

- Deepening recession is reflected in further downward adjustments to prime office rent expectations for 2009 across all 29 European centres reported in the survey.
- 2009 remains expected to be the bottom of the market. Further falls in prime rents are expected in 2010 but the pace of decline will slow as the market stabilises.
- 2011 is identified as the year of recovery for most cities but not all.
- This consensus forecast has been produced from forecasts submitted by 15 different forecasting houses.

Rents fall in 2009

The first IPF European Consensus Forecast for 2009 shows marked changes in expected prime office rents for all the European cities reported. For 2009 all centres are now forecast to experience falls in prime office rents. The consensus shows Vienna, Brussels, Prague, Copenhagen and Lyon are forecast to be the strongest performing centres, Vienna and Prague having maintained their top 5 ranking from the November 2008 survey. The two London centres, City and West End are forecast to remain near the bottom of the pack. The biggest mover is Moscow which is now forecast to show the poorest prime office rental value performance for 2009 of all centres reported.

Weaker outlook shown for 2010

All the 2010 forecasts reported have been adjusted downwards. Prime office rents in all the European centres reported are now expected to fall further in 2010. Six months ago, London, Madrid, Barcelona and Dublin were forecast the poorest performance for 2010. These centres have retained this ranking six months on and have suffered more severe further reductions in rental forecasts than the other Cities reported. Prime office markets in these locations are clearly under severe pressure.

The survey shows that, despite further expected falls in prime rents in 2010, 2009 remains forecast to mark the bottom of the market. Whilst the figures for 2010 are poor for all centres reported, the rate of decline in prime rents is expected to slow.

First figures for 2011

The first figures returned for 2011 show this is where recovery is expected. Some cities are forecast improving prime office rents at that stage, but falling rents seems to be at least expected to stabilise for most. The notable exceptions are the Italian and Spanish centres reported and Dublin which are all expected to still be experiencing falling prime office rents in 2011. Budapest and Vienna are also expected to deliver weak rental performance into 2011. Moscow, by contrast is expected to bounce back most sharply with prime rents expected to improve by 6%.

Figure 1: European office market prime rent forecasts, as at May 2009

	Year rental growth forecast % pa 2009	2010	2011	3-year forecast 2009-11 % pa	5-year forecast 2009-13 % pa
Vienna	-7.0	-6.7	-2.4	-5.4	-1.8
Brussels	-7.6	-3.2	-0.6	-3.8	-1.4
Prague	-7.2	-4.1	-0.6	-4.0	-1.2
Copenhagen	-7.1	-4.1	-0.6	-4.0	-1.8
Helsinki	-7.5	-3.6	1.3	-3.3	-0.8
Lyon	-7.2	-5.1	-1.2	-4.6	-1.5
Paris CBD	-13.7	-6.0	-0.1	-6.8	-1.6
Paris la Defense	-13.8	-8.7	0.2	-7.6	-2.0
Berlin	-7.9	-6.4	-0.6	-5.0	-1.7
Frankfurt	-12.0	-7.2	0.0	-6.5	-2.0
Hamburg	-10.4	-5.1	1.5	-4.8	-1.3
Munich	-8.1	-6.2	-0.7	-5.0	-1.4
Athens	-7.4	-3.0	0.2	-3.5	-0.9
Budapest	-12.0	-5.6	-2.4	-6.8	-2.1
Dublin	-21.6	-11.3	-3.1	-12.3	-4.9
Milan	-12.4	-7.7	-1.3	-7.3	-2.0
Rome	-10.5	-8.3	-2.0	-7.0	-2.1
Luxembourg	-8.0	-2.7	2.2	-3.0	-1.0
Amsterdam	-8.8	-3.9	0.1	-4.3	-1.7
Oslo	-20.5	-4.3	2.1	-8.1	-2.3
Warsaw	-14.8	-5.3	1.4	-6.5	-1.5
Lisbon	-7.8	-4.4	0.0	-4.1	-1.2
Moscow	-30.8	-4.6	6.0	-11.2	-3.5
Madrid	-21.3	-15.4	-4.4	-14.0	-4.1
Barcelona	-18.9	-14.0	-2.9	-12.2	-3.7
Stockholm	-11.2	-5.6	0.0	-5.7	-2.1
Zurich	-10.5	-2.8	2.0	-3.9	-1.0
London: City	-22.7	-12.1	-0.1	-12.1	-3.7
London: West End	-26.6	-10.4	1.3	-12.7	-4.2
Manchester	-8.5	-5.0	-1.2	-5.0	-2.6

Figure 2: Forecasts for year 2009

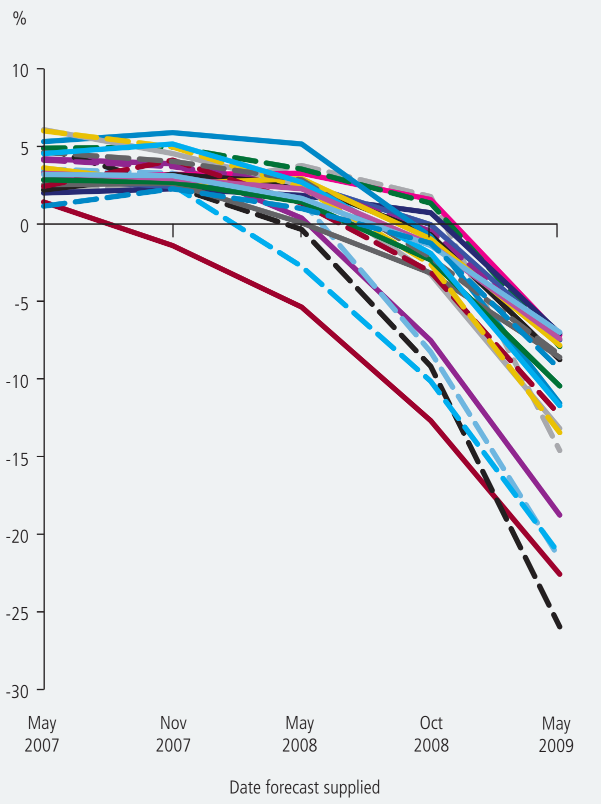
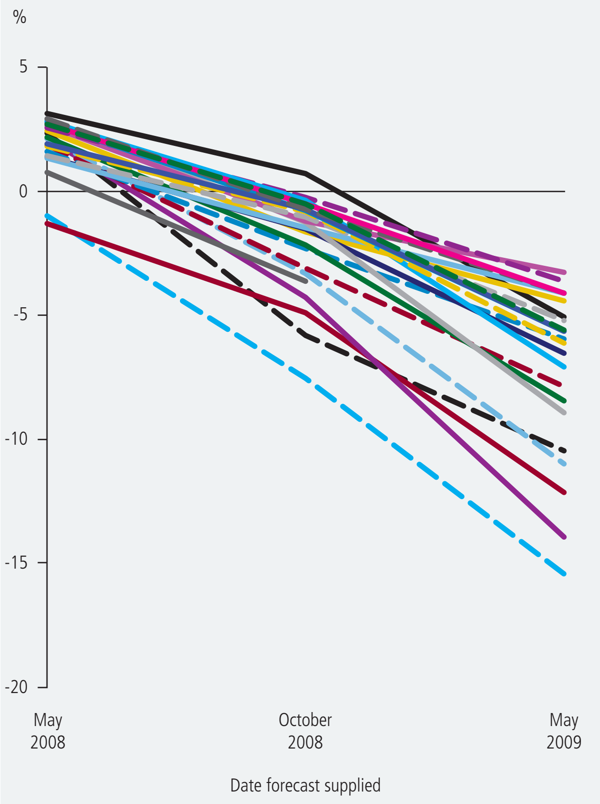


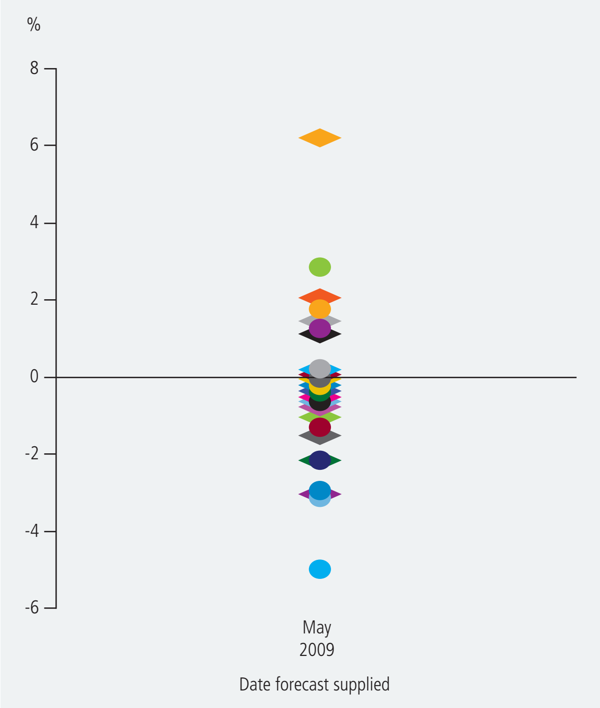
Figure 3: Forecasts for year 2010



Key for Figures 2-3

Vienna	Helsinki	Frankfurt
Brussels	Paris CBD	Munich
Prague	Paris la Defense	Athens
Copenhagen	Berlin	Budapest
Dublin	Warsaw	Stockholm
Milan	Lisbon	London City
Rome	Madrid	London West End
Amsterdam	Barcelona	Manchester

Figure 4: Forecasts for year 2011



Key for Figure 4

Vienna	Helsinki	Frankfurt
Brussels	Paris CBD	Munich
Prague	Paris la Defense	Athens
Copenhagen	Berlin	Budapest
Dublin	Warsaw	Stockholm
Milan	Lisbon	London City
Rome	Madrid	London West End
Amsterdam	Barcelona	Manchester
Moscow	Luxembourg	Hamburg
Oslo	Lyon	

Acknowledgements
The Investment Property Forum would like to thank the following organisations for contributing to the IPF European Consensus Forecasts for May 2009: Aberdeen Property Investors, AEW Europe, Alecta, Aviva Fund Management, DTZ, Cushman & Wakefield, Grosvenor, ING Real Estate, Invesco, Jones Lang LaSalle, King Sturge, PMRECON, PPR, Schroders, Standard Life Investments

Notes
At present the IPF European Consensus Forecasts survey focuses on office rental value growth in major cities. It is not possible at this stage to assemble sufficient forecasts of all sectors across all European countries to produce a meaningful consensus of views.

In addition to the rental value forecasts, we run a consensus survey of forecast IPD European total returns by sector. The samples provided for this survey were once again small, and not sufficient to permit publication. We hope to be able to produce a full release of this data at some time in the future, once the number of responses has grown sufficiently.

The Data
This latest survey collected prime office rental forecasts for 29 centres for the calendar years 2009, 2010 and 2011. We request a three-year average forecast for 2009-11 if individual years are not available, and a five-year average for 2009-13. The survey requested both the percentage annual rental growth rates and also year-end rent levels. The growth forecasts provided by each organisation have been analysed to provide average ('consensus') figures for each market.

The definition of market rent used in the survey is "achievable prime rental values for city centre offices, based on buildings of representative size with representative lease terms for modern structures in the best location." Prime in this case does not mean headline rents taken from individual buildings, but rather rental levels based on market evidence, which can be replicated. All figures included in the survey are required to have been generated by formal forecasting models. The report is based on contributions from 15 different organisations.

Consensus forecasts further the objective of the Investment Property Forum to improve the efficiency of the market. The IPF is extremely grateful for the support those organisations which contributed to this publication, which has only been possible thanks to the provision of the individual forecasts.

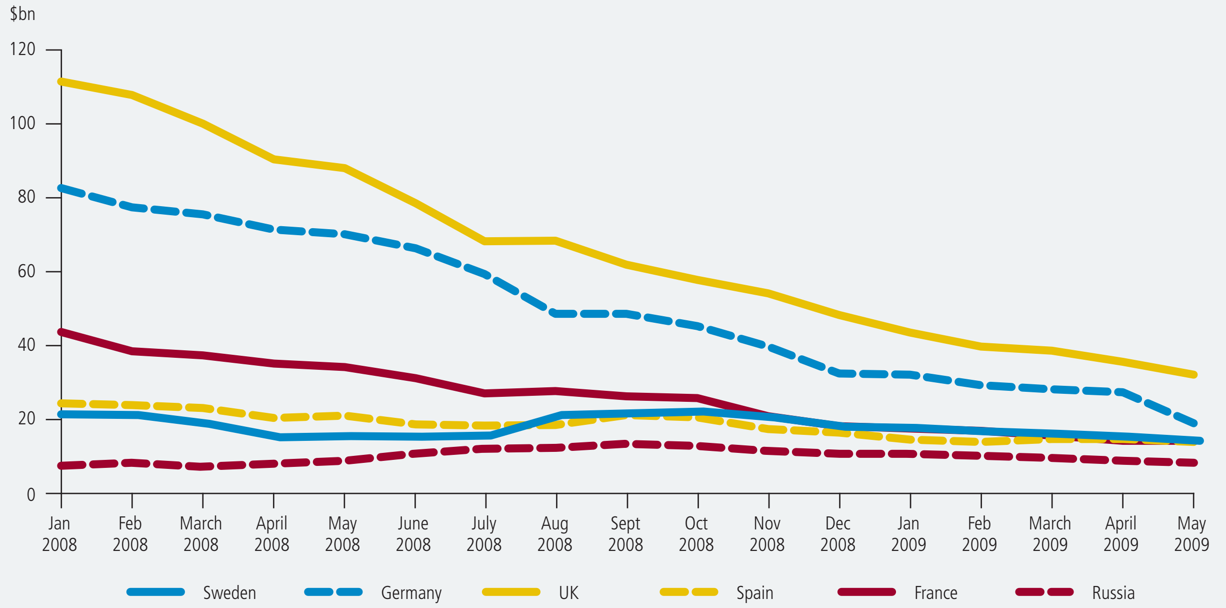
The IPF welcomes new contributors for future surveys, so that the coverage of the market participants can be widened. If your organisation wishes to contribute to future surveys please contact Louise Ellison, IPF Research Director at lellison@ipf.org.uk.

Please note that subscribers receive a much more detailed set of statistical outputs than those shown in the table above – for each office centre the sample size, median and range of rental values are also provided.

European sales volumes

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

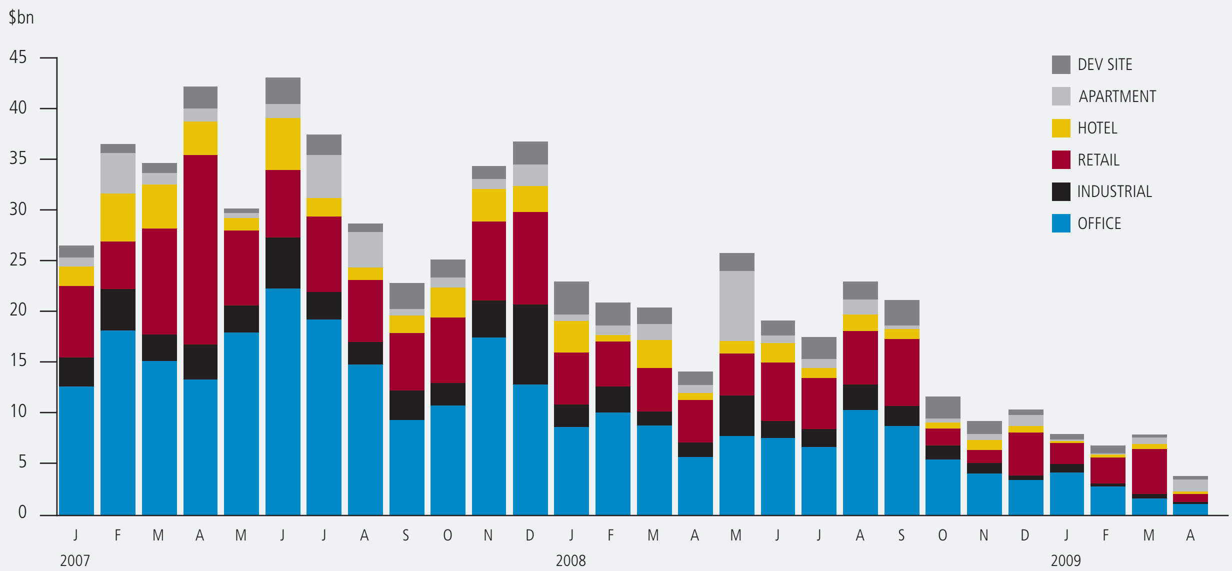
Figure 1: European transactions by country and sector



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

Source: Real Capital Analytics, Inc. 2009. For more current deals, cap rates and property details visit www.rcanalytics.com

Figure 2: European transaction volumes by property sector



Source: Real Capital Analytics, Inc. 2009. For more current deals, cap rates and property details visit www.rcanalytics.com

Forum activities and announcements

AGM

At the AGM of the Investment Property Forum (IPF), held on Thursday 18 June, **Peter Pereira Gray**, Managing Director Investment Division at The Wellcome Trust, succeeded **Andrew Hynard**, Head of National Investment at Jones Lang LaSalle, as Chairman of the IPF.

Peter, who takes on the role for the next 12 months, commented:

"At a time of significant challenge and change in the property investment industry, it is a privilege to be elected Chairman of the Investment Property Forum. The IPF is an outstanding organisation and we will look to build upon its deep history and core beliefs in education, research, independence and integrity to provide our members with the information and ideas that will provide them with competitive advantages for today's world."

John Gellatly of BlackRock took up the post of IPF Vice Chairman and will become Chairman of the Forum in June 2010.

John, who has been on the IPF Management Board since 2002; is currently Chair of the Research Steering Group and is a member of the Editorial Board for the IPF journal, Investment Property Focus. John played a key role in representing the IPF on the pan-industry group working closely with HM Treasury as to the arguments for the introduction of a new unitised, tax transparent real estate investment vehicle within the UK. This work eventually led to the introduction of REITs in the UK.

Of his appointment, John said:

"As Vice Chairman, I am looking forward to continuing to promote the work of the Forum in these challenging times. Events are unsettling but for the wise investor such times are ripe with opportunities."

At the AGM the following additional board appointments were also made:

Chris Carter Keall, Valad Property Group

Sue Forster, Investment Property Forum

Andy Martin of Strutt & Parker, former IPF Chairman and Honorary Treasurer, retired from the Board. The role of Honorary Treasurer will be taken up by **Philip Ingman** of SPREFS. **Mike Brown** of Helical Bar, **Nick Tyrrell** of JP Morgan and **Peter Freeman** of Argent also retired from the Board at the meeting.

IPF Scotland

After seven years at the helm, **Fiona Morton** has stepped down as Chair of the IPF in Scotland. She is succeeded by **Graham Sanders** who will take over for the next 12 months, with **Paul Findlay** installed as Vice Chairman.

The IPF would like to thank Fiona for her enormous contribution during her time in office, which saw Scottish membership numbers rise from around 120 to well over 200.

IPF Events

Annual Lunch 2009

left to right:
Andrew Hynard, Andy Martin and Ian Marcus

Sir Ranulph Fiennes

Sir Ranulph Fiennes proved a truly inspiring speaker at the IPF Annual Lunch in January 2009. The event, sponsored by Chase & Partners and Valad Property Group, was highly enjoyable and many felt that moving away, on this occasion, from the traditional 'view from the industry' was welcomed as so much is being said in other quarters.

At the Lunch, two awards of life membership were made to **Ian Marcus** of Credit Suisse and **Andy Martin** of Strutt & Parker. Life membership is bestowed upon those individuals who have played a major role in the Investment Property Forum over the years and who, through their endeavours, have made an extraordinary contribution and time commitment to enhancing the Forum's reputation.

Andrew Hynard, current IPF Chairman, said of the two new Life members:

"Ian and Andy have made a huge impact on the IPF and the wider property industry, both during their period as former Chairmen and since that time. The awards recognise their very special endeavours."

Midlands Lunch 2009

left to right
Adrian Watson (Chairman of the IPF Midlands Board), Peter Bill and Andrew Hynard

Peter Bill

The thriving Midlands regional membership enjoyed their Annual Lunch in April at which former Estates Gazette editor, Peter Bill, gave us an interesting insight into the life of a property journalist. The event was sponsored by First Title, Nationwide Commercial and BDO Stoy Hayward.

Alastair Ross Goobey Memorial Lecture

The inaugural lecture in memory of Alastair Ross Goobey, a former President of the IPF, took place in May. The lecture was given by Anthony Bolton, President, Investment, of Fidelity International, and this was followed by a question and answer session with an eminent panel comprising Lord Myners, Anatole Kaletsky, Charlie Mayfield and Chris Turner.

The Forum is most grateful to the Argent Group for sponsoring this event.

Annual Dinner 2009

Over 900 guests turned out at the IPF's Annual Dinner held at the Grosvenor House Hotel in London. Sponsored by Knight Frank, Langham Hall and Nationwide Commercial, the event saw newly-appointed IPF Chairman, Peter Pereira Gray, outlined his aims and objectives for his year in office to the audience. Following the meal, Clive Anderson entertained the guests.

Future events

- Midlands Dinner
  8 October 2009, ICC, Birmingham
- IPD/IPF Property Investment Conference
  26-27 November 2009, The Grand, Brighton
- Annual Lunch
  29 January 2010, Hilton Park Lane, London

Lectures and seminars

Following on from the success of the free lecture series in our 20th anniversary year, and mindful of the current economic climate, the IPF has decided to keep all breakfast, lunchtime and evening lectures free to members for the coming year. We hope that this will encourage our members to partake in the wide range of events provided by the IPF.

Our summer 2009 season was hugely successful, with more lectures and seminars put on than ever before. Highlights included the annual Commercial Property Lending Market lecture and a second site visit to the Olympic Park.

Any member unable to attend the meetings will be able to download the presentations (subject to speakers' consent) from the member area of the IPF website.

The IPF autumn 2009 calendar will be released in late summer, and it is already shaping up to be another full season.

Following on from the launch of our new online booking system, we will be developing this further to accept payments for non-members and workshops.

In order to be able to provide lectures and seminars free of charge, the IPF relies on the generosity of its members for venues. If your organisation would like to host an IPF event, we would be delighted if you would get in touch. Please contact Frankie Clay, Education and Research Manager at fclay@ipf.org.uk.

Investment Education Programme

The Investment Education Programme consists of a series of flexible modules that can be taken individually, as a set or as a complete programme. Completing the first three modules (including Property as an Asset Class) obtains the Investment Property Forum Certificate. If you complete all seven classroom-based modules you will be awarded the prestigious **Investment Property Forum Diploma**.

The Investment Education programme e-learning module, Property as an Asset Class, provides an excellent, flexible introduction to property investment.

The next cycle of modules begins in September – see below for dates:

Investment Education Programme modules

Module	Dates
Property as an Asset Class	Online
Investment Valuation and Portfolio Theory	28-30 September 2009 (Mon-Wed)
Financial Instruments and Investment Markets	23-25 November 2009 (Mon-Wed)
Property Investment Appraisal	18-20 January 2010 (Mon-Wed)
Property Finance and Funding	2-4 March 2010 (Tue-Thu)
Indirect Property Investment	13-15 April 2010 (Tue-Thu)
International Property Investment	7-9 June 2010 (Tue-Thu)
Portfolio Management	7-9 September 2010 (Tue-Thu)

STOP PRESS:

The Forum is delighted to announce that the IPF Certificate in Property Investment has been accepted by the Financial Services Skills Council (FSSC) as a Key 2 Appropriate Examination for approved persons managing investments. Holders of the IPF Certificate will need to complete a Key 3 qualification, namely a UK regulatory examination, to meet the full examination requirements for this activity.

For further details, please contact Sue Forster, Executive Director, at sforster@ipf.org.uk.

IPD/IPF Property Investment Conference 2009

On the pulse of the property world

IPD

IPF Investment Property Forum

26-27 November 2009, The Grand Hotel, Brighton

Whether you come to property industry events for quality speakers, discussion of the most pressing issues, networking, or business opportunities, the **IPD/IPF Property Investment Conference** will exceed all your expectations.

Visit **www.ipd.com/ipd-ipf_conference**

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