IPF Investment Property Forum

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Investment Property Focus

The next property cycle: A structural change?

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The IPF organised a site visit to the Battersea Power Station site on 4 June 2014. The event was kindly hosted by the Battersea Power Station Development Company.

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From the editor

Editor Sue Forster
Sub editor Frankie Clay
Design & production
Kevan Enticott
www.enticottdesign.co.uk

IPF Executive

Chief Executive
Sue Forster
sforster@ipf.org.uk
020 7194 7922

Research Director
Pam Craddock
pcraddock@ipf.org.uk
020 7194 7925

Associate Director
Frankie Clay
fclay@ipf.org.uk
020 7194 7928

Events Manager
Barbara Hobbs
bhobbs@ipf.org.uk
020 7194 7924

Accounts Manager
Jenny Hooper
jhooper@ipf.org.uk
020 7194 7923

Seminar Co-ordinator
Robbin Mackey
rmackey@ipf.org.uk
020 7194 7926

Membership Co-ordinator
Cormac Watters
cwatters@ipf.org.uk
020 7194 7927

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

tel 020 7194 7920
fax 020 7194 7921
ipfoffice@ipf.org.uk
www.ipf.org.uk

The articles in this edition of **Investment Property Focus** underline the growing optimism in the market.

The upturn in new commercial property lending is a key finding from this year's De Montfort survey, the details of which are set out in the article by **Bill Maxted** and **Trudie Porter**. However, they emphasise that there is still a long way to go before a full recovery is achieved. The Laxfield Capital Barometer, as explained by **Emma Huegal**, has identified a similar trend in requests for finance from owners of UK property assets; a year ago, the UK's recovery seemed somewhat tenuous and now investment activity is spreading across the regions and a broad range of property sectors.

The residential sector is one that that is attracting an increasing level of institutional investor interest, as highlighted in the third IPF survey of investor intentions towards student housing, the private rented sector and other forms of residential tenures. This year's survey identified potentially £5+bn for investment over the next 12 months.

So, given the market upturn, are we about to forget the lessons from the global financial crisis? This was the subject of a joint AREF/IPF in May when a panel of experts were asked what the fund management industry had learnt from the crisis. Their thoughts are outlined on pages 27-29 and include the need for a reassessment of liquidity, the control of equity entering funds and better communication with investors. These themes are reiterated by **Iain Reid** in his perspective on what fund managers should do next. **Deborah Lloyd** of Nabarro also provides a practical take on these issues at the end of a fund's life when she poses the question, "Is end of term really end of term?"

Continuing the forward-looking theme, **Colin Jones** of Heriot-Watt University outlines recent work, sponsored by the IPF Research Programme, which examines the implications for property pricing of rising bond yields. The 'central' forecasts all predict that such a rise will see a narrowing of the yield gap as property equivalent yields are not expected to risen proportionally. **Gerald Blundell** also considers at the yield gap and asks whether the current gap is too high in pricing property, given the increasing number of investors who buy property as a 'store of value' and are less concerned about comparisons with bond yields. Is this change a permanent aspect of the market or a short-term phenomenon? Blundell argues that if it is the former then possibly the pricing of the short-term shifts in pricing should be explained in terms of an 'uncertainty premium'.

The greater optimism in the market is borne out by the IPF Consensus Forecasts for August, such that the mean forecast for total returns in 2014 now stands at 17.2%, compared with 13.7% only three months earlier. The picture is similar for European Office Rental Consensus Forecasts, also covered here.

Amanda Howard of Nabarro has updated the IPF Legal and Regulatory round-up table and **Paul McNamara** provides a briefing note on the implications of the Energy Savings Opportunity Scheme (ESOS).

The Forum activities summary is on pages 48-49. Do not forget to note the calendar dates of our upcoming events, including the IPD/IPF conference, and I look forward to seeing you at least one of them.

Sue Forster
Chief Executive, IPF

The UK commercial property lending market

BILL MAXTED AND **TRUDI PORTER**
De Montfort University

In May 2014, De Montfort University published its fifteenth research report on the lending patterns of the major commercial property lenders operating within the UK during the year up to 31 December 2013. A total of 82 lending teams operating out of 76 lending organisations contributed data to the survey. The lending organisations comprised 52 banks and building societies, eight insurance companies and 16 other non-bank lenders, including debt funds, asset managers and other organisations that are prepared to provide junior debt, mezzanine finance and, more recently, senior debt.

Throughout this research, 'commercial property lending' is taken to mean all lending secured on UK commercial property and held on the balance sheet of lending organisations. This includes residential investment and development but excludes owner-occupier residential mortgages. Where reference is made to the commercial property loan books of lending organisations, this is taken as the net exposure to UK commercial property excluding equity finance (i.e. net of any loan amounts sold down to other lenders and net of any securitised loans unless otherwise stated). The nationality of the banks is determined by the location of their head office. The term 'Insurance Companies' refers to all insurance companies irrespective of the geographic location of the head office.

Value of outstanding loan books

Figure 1: **Category of lender and type of finance**

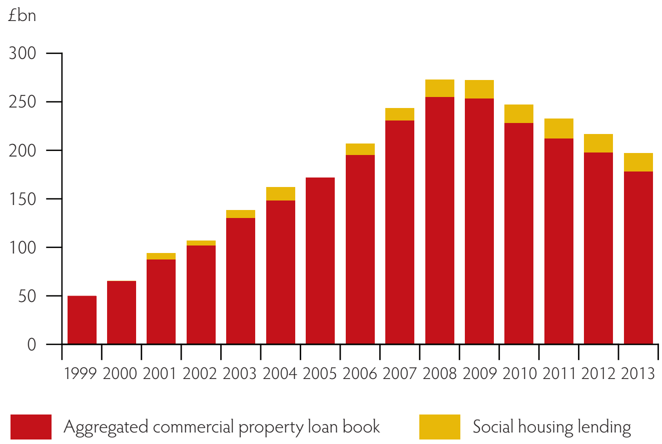
Categories of Lender	Reported UK outstanding senior debt loans including social housing £m	Junior debt mezzanine finance £m	Total £m	Reported amount of committed funds not yet drawn £m
UK Bank and Building Societies	116,316	235	116,551	11,296
German Banks	18,111	–	18,111	656
Other International Banks	35,179	147	35,326	980
North American Banks	3,789	98	3,887	316
Insurance Companies	18,139	200	18,339	418
Other Non-bank Lenders	4,012	2,189	6,201	–
All Lenders	**195,546**	**2,869**	**198,415**	**13,666**

A total value of £198.4bn (£217.1bn last year) of outstanding debt, including loans of approximately £18.6bn secured by social housing (but excluding equity participations) was recorded, with a further £13.7bn (£15.2bn at 31 December 2012) of loans being committed but not drawn at 31 December 2013.

Figure 1 presents the categories of lending organisations and their value of outstanding senior debt, junior/mezzanine finance and undrawn amounts.

Figure 2 shows the aggregated value of outstanding debt recorded in loan books and secured by UK commercial property only, together with loans secured by social housing since 1999 shown separately. The 2013 figure for commercial property loans represents a fall of 9.1%. Of the total £179.8bn, £173.6bn is held by banks, building societies and insurance companies and £6.2bn held by Other Non-bank Lenders. The reasons for a reduction in loan book size (excluding new loan originations) were recorded as being scheduled amortisation and repayments (30% of total), customers paying down and bank/lending organisation influenced sales combined (30.0%) , the value of loans written off 16.0%), loans sold (16.0%), and 'Other' (9.0%).

Figure 2: **Aggregated value of outstanding debt**



Total size of the UK commercial property lending market

It is extremely difficult to ascertain the total size of the commercial property lending market in the UK. In addition to £179.8bn collected by the research, the following amounts of outstanding debt have been identified:

- Approximately £19.9bn from the published financial statements of non-contributing organisations.
- Approximately £4.8bn of UK debt sold during 2013 by those lending organisations that have contributed data to this research.
- Data from Fitch Ratings on the balance of outstanding CMBS issuances that include loans secured by UK commercial property suggests that at year-end 2013 this amounted to £23.6bn.
- By September 2013, NAMA held assets of an approximate value of £6.2bn (at par value) located in the UK and which will not have been reported to this research.

With these additions, an estimated total value of £243.5bn (£267.5bn at year-end 2012) of outstanding debt was secured by commercial property at year-end 2013. In addition, a further £13.7bn of loans were committed but not drawn at year-end 2013.

Value of loan originations completed

Figure 3 shows the amount of new senior debt loan originations, junior debt/mezzanine finance and loan extensions completed during 2013 and secured by commercial property and social housing – the latter accounts for £1.1bn (£1.3bn in 2012) of the total £31.0bn (£25.7bn in 2012) of new lending. UK Banks and Building Societies recorded 43.0% of the total loans originated when identifiable extensions to loans and social housing are excluded.

Approximately 48.0% of the £29.9bn of new lending completed during 2013 was undertaken by just six organisations and 63.0% by the 'top 12' organisations. This compares with 57.0% and 72.0% respectively, recorded at year-end 2012. The decline in proportion originated by the top 12 demonstrates the increasing influence of new lending organisations entering the market – in fact, two Insurance Companies were amongst the most active loan originators.

Figure 3: **Value and allocation of loan originations in 2013**

Categories of Lender	Value of senior debt lending excluding extensions to maturing loans £m	Junior debt and mezzanine originated £m	Value of extensions to loans that should have matured during 2013 £m	Total £m
UK Bank and Building Societies	13,884	17	1,132	15,033
German Banks	4,722	–	181	4,903
Other International Banks	3,860	21	2,753	6,634
North American Banks	1,435	74	8	1,517
Insurance Companies	3,460	-	117	3,577
Other Non-bank Lenders	2,371	1,154	–	3,525
All Lenders	**29,732**	**1,266**	**4,191**	**35,189**

Of the £26.4bn of loan originations (excluding social housing loans) undertaken by banks, building societies and insurance companies, 81.0% was allocated to investment projects, 7.0% to commercial development, and 12.0% to residential development. The allocation of the £3.5bn of new lending by Other Non-bank Lenders is slightly different – 70.0% to investment projects, 19.5% commercial development and 10.5% to residential development.

In addition to the value of £29.9bn of loan originations on commercial property reported to the research, £3.1bn of lending was identified as having been completed by those organisations that do not participate in the research.

During 2013, 14 (23.0%) of the banks, building societies and insurance companies respondents completed no new loan originations whatsoever (and not including extensions to maturing loans). All the Other Non-bank Lenders that responded had completed new loan originations.

Respondents from banks, building societies and insurance companies were also asked to indicate at what ticket size (loan size) they would be willing to lend. Only 11 of the respondents would be prepared to write a loan of £5m or less but conversely 30 would be prepared to write a loan of between £51m and £100m, and 25 at above £100m.

Securitisations, syndications and club deals

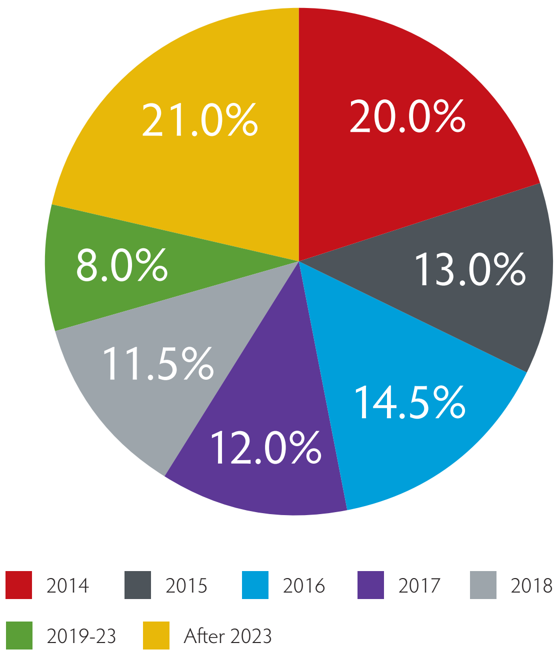
Three CMBS issues, one of which was a private placement, during 2013 amounting to £0.761bn were reported to the research. Approximately £2.1bn of debt was reported as being syndicated and a further £4.7bn as the value of participations in club deals by organisations that contribute to this research. This total of £6.8bn (being syndications and participants in clubs combined) compares with £6.5bn similarly reported at year-end 2012 and £6.9bn at the end of 2011.

Profile of outstanding debt

Figure 4 shows the proportion of outstanding debt due for repayment in each of the next five years individually from 2014 to 2018, from 2018 to 2022 and finally after 2022. This is presented for all lending organisations that contributed data to the research.

During the next five years between 2014 and 2018 inclusive, approximately 71.0% of all outstanding debt (£127bn) is due for repayment. This proportion is slightly lower than 72.0% reported at both year-ends 2012 and 2011, higher than 69.5% that was recorded at year-end 2010 and the same as 71.0% that was recorded at year-end 2009. It is still significantly higher than the proportions recorded by this research in previous years; for example, at year-ends 2006 and 2007, the proportion of debt due to mature within the following five years was 61.0% and 60.0% respectively. The reason for this change in maturity profile is that, in certain situations, lending organisations that have legacy debt in their outstanding loan books have continued to extend loans that the borrowers have been unable to refinance at loan maturity.

Figure 4: **Proportion of debt due for repayment – All Lenders**



With regard to the loan-to-value (LTV) of the outstanding debt allocated to investment projects, 63.0% of this had a LTV ratio of 70.0% or less. When applied to the aggregated loan book allocated to investment projects (£158bn), this equates to approximately £99bn. Proportionally, this compares with only 53.0% so reported at year-end 2012. At year-end 2012, 24.0% of outstanding debt had a LTV ratio of between 71.0% and 100.0%, equating to a value of approximately £42bn. A year later this had fallen to 18% (approximately £28bn). The proportion of outstanding debt with a LTV ratio of above 100.0% also fell during 2013 from 23.0% to 19.0% and in monetary terms from a value of £41bn to £31bn.

Figure 5 shows the profile of the outstanding debt held by banks, building societies and insurance companies in terms of current income-to-interest cover.

Figure 5: **Current income-to-interest cover by proportion of outstanding debt – All Lenders**

Level of cover	Variable rate % proportion of loan book		Fixed rate % proportion of loan book	
	2012 Year-end	**2013 Year-end**	**2012 Year-end**	**2013 Year-end**
1x or less	4.5	3.5	12.5	8.0
Over 1 and up to 1.2x	3.0	2.0	14.0	10.0
Over 1.2 and up to 1.4x	3.0	2.0	8.0	5.0
Over 1.4 and up to 1.6x	5.0	3.5	18.0	5.5
Over 1.6 and up to 1.8x	2.0	2.5	4.0	5.0
Over 1.8 and up to 2x	2.5	2.5	2.5	5.0
Over 2x	13.0	24.5	8.0	21.0
Total	**33.0**	**40.5**	**67.0**	**59.5**

At year-end 2013, 43 lending teams (65.0%) holding £114.5bn (72.0%) of approximately £158bn of investment loans responded to this aspect of the research. The data indicated that 11.5% of outstanding investment loans had an income-to-interest cover of less than 1x, equating to £13.2bn of loans. If the proportion of 11.5% is applied to the whole sample of investment loans of £158bn in value, then the amount of debt with an income-to-interest cover of less than 1x could potentially be £18bn. A similar analysis at year-end 2012 suggested that the comparable figure was circa £30bn.

Whilst conclusions from this particular section of the research can only be indicative, it does appear that during 2013, the proportion and value of loans that had an income-to-interest cover of less than 1x had declined since the previous year. Also, it appears that there has been a decline in the proportion of fixed-rate loans and a corresponding increase in variable rate lending.

Overall at year-end 2013, 60.5% of investment loans had an income-to-interest cover of greater than 1.6x. This compares with 32.0% recorded at year-end 2012 (on a smaller sample size). A cover of 1.6x is typically close to the minimum income-to-interest cover ratio required for 'new' lending in the market at year-end 2013.

Problem loans

The value of loans in breach of financial covenant at year-end 2013 and reported to the research was approximately £15.8bn, representing 9.7% of the total aggregated loan book of the survey respondents. This compares with £19.9bn (11.0%) at year-end 2012. Loan defaults during the 2013 totalled £24.5bn, compared with £21.5bn reported at year-end 2012. The increase in value of defaulted loans reported at year-end 2013 was as a consequence of the improvements in liquidity and capital values experienced in many commercial property sub-markets during the second half of the year. Lenders generally were taking advantage of these circumstances and were prepared to ‘pull the plug’ on under or non-performing loans.

If the proportion of distressed loans so reported is applied to the whole sample of participating loan books, then an estimated distressed value at year-end 2013 would be £44.7bn or 25.7% of the debt retained on balance sheet. This compares with £45.3bn similarly reported at year-end 2012.

During 2013, lenders reported that the rate of new problems occurring had slowed to a ‘trickle’ and that generally the overall rate of impairment was significantly lower than for year-end 2012. However, leisure and regional office properties were mentioned as being ‘particularly problematical’ and loans secured by secondary and tertiary retail property were cited as ‘really struggling’.

Senior debt loan terms for investment property

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

Between year-end 2012 and year-end 2013 interest rate margins declined for all sectors. The average margin for loans secured by prime office, for example, declined by 70.9bps from 323.8 bps (2012) to 252.9bps (2013). For loans secured by secondary offices, average interest rate margins declined slightly more steeply by 77.6bps from 384.5bps to 306.9bps.

Average LTV ratios for all sectors, except for residential investment, increased over the year. For example, the average LTV ratio for loans secured by prime offices was 65.9% at year-end 2013, compared with 64.2% a year earlier. Those for loans secured by secondary offices increased from 58.9% to 61.4% over the same period.

During 2013, average arrangement fees for loans secured by all property sectors declined across the board. For example, loans secured by prime office property saw arrangement fees set at an average of 122.5bps at year-end 2012, compared to 111.8bps at year-end 2013. Loans secured by secondary office property saw average arrangement fees decline from 134.8bps to 111.9bps. The range of arrangement fees for loans on all types of property of between 108bps and 115bps was the narrowest recorded by the research since year-end 2004.

For loans secured by prime property, income-to-interest cover ratios broadly declined slightly and uniformly during 2013. For example, for loans secured by prime offices, average income-to-interest cover ratios declined from 1.59x to 1.57x between year-ends 2012 and 2013. Similarly, for loans secured by prime retail property, income-to-interest cover ratios declined from 1.65x to 1.62x.

The income-to-interest cover ratios for loans secured by secondary office and industrial property declined more steeply than those for prime property. Secondary office and industrial property declined from 1.89x to 1.79x and 2.05x to 1.88x respectively while average income-to-interest cover ratios for loans secured by secondary retail property remained virtually static during the period at 1.87x.

Figures 6 and 7 compare the terms for senior, junior and mezzanine loans from banks, building societies and insurance companies for prime and secondary office investments respectively.

Figure 6: **Terms for loans secured by prime office investment property from banks, building societies and insurance companies**

Year	Senior debt		Junior debt		Mezzanine	
	Max LTV%	**Margin bps**	**Max LTV%**	**Margin bps**	**Max LTV%**	**Margin bps**
2008	55.0	170	60.0	250	70.0	400
2009	65.0	224	72.5	620	79.0	850
2010	67.5	209	75.0	350	80.0	738
2011	64.0	350	78.0	1,050	75.0	1,000
2012	65.0	331	70.0	550	77.5	775
2013	66.0	267	73.0	613	81.0	750

Figure 7: **Terms for loans secured by secondary office investment property from banks, building societies and insurance companies**

Year	Senior debt		Junior debt		Mezzanine	
	Max LTV%	**Margin bps**	**Max LTV%**	**Margin bps**	**Max LTV%**	**Margin bps**
2008	55.0	170	60.0	250	70.0	400
2009	60.0	300	70.0	700	–	–
2010	62.5	238	–	–	75.0	775
2011	60.0	413	78.0	1,050	–	–
2012	60.0	375	65.0	800	75.0	1,200
2013	62.5	271	70.0	775	78.0	867

OTHER NON-BANK LENDERS

Those organisations that were prepared to offer senior debt would have done so for loans secured by prime property within a range of 60.0% to 80.0% (60.0% to 65.0% at year-end 2012) loan-to-value ratio, 175bps to 400bps (225bps to 800bps at year-end 2012) interest rate margin, 0.75% to 2.0% arrangement fee (1.0% to 2.0% at year-end 2012) and exit fees to 1.0%.

For senior debt loans secured by secondary property, LTV ratios were recorded within a range of 50.0% to 80.0% (60.0% to 65.0% at year-end 2012), interest rate margins 250bps to 400bps (300bps to 800bps at year-end 2012), arrangement fees 1.0% to 2.0% (1.0% to 2.0% at year-end 2012) and exit fees to 1.0%.

Junior debt and mezzanine finance loan terms

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

At year-end 2013, six organisations were prepared to provide finance at a senior debt level and above for loans secured by prime offices, compared with four organisations the previous year. For senior debt, the average maximum LTV ratio increased from 65.0% (2012) to 66.0% (2013) and the average interest rate margins declined from 331bps to 267bps. For mezzanine finance, the average maximum LTV ratio increased from 77.5% to 81.0% and the average interest rate margin declined from 775bps to 750bps. For junior debt, the average maximum LTV ratio increased from 70.0% year-end 2012 to 73.0% a year later, as did interest rate margins, rising from 550bps to 613bps. Internal rates of return (IRRs) ranged from 7.0% to 10.0% for junior debt and 9.0% to 15.0% for mezzanine finance.

Four organisations provided data relating to funding at and above a senior debt level for loans secured by secondary offices. Compared with 2012 (when only one organisation provided data), the average maximum LTV ratio for all types of finance increased and interest rate margins declined. For senior debt, the maximum LTV ratio increased from 60.0% to 62.5% and interest rate margins declined from 375bps to 271bps. The maximum LTV ratio for junior debt, increased from 65.0% to 70.0%, whilst interest rate margins declined from 800bps to 775bps. For mezzanine finance, the maximum LTV ratio increased from 75.0% (2012) to 78.0% (2013) and interest rate margins declined from 1,200bps to 867bps.

OTHER NON-BANK LENDERS

The organisations that were prepared to offer junior debt for loans secured by prime and secondary property would have done so within a range of 50.0% to 80.0% (60.0% to 70.0% in 2012) LTV ratio, 9.75% to 15.0% (10.0% to 12.0%) interest rate margin/coupon, 1.0% to 3.0% (2.0% to 3.0%) arrangement fee, 1.0% to 3.0% (2.0% to 3.0%) exit fee and seek an IRR of 7.0% to 17.0% (8.0% to 15.0% at year-end 2012).

At year-end 2013, those organisations that were prepared to offer mezzanine finance for loans secured by prime and secondary property, would have done so within a range of 50.0% to 85.0% (60.0% to 85.0% at year-end 2012) LTV ratio, 11.0% to 15.0% (9.0% to 15.0% at year-end 2012) interest rate margin/coupon, 1.0% to 3.0% (1.0% to 2.0%) arrangement fee, 1.0% to 3.0% (same as at year-end 2012) exit fee and seek an IRR of 9.0% to 17.0% (10.0% to 17.0% at year-end 2012).

Development finance loan terms

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

At year-end 2013, only 14 lending teams from banks, building societies and insurance companies provided data for loans secured by fully pre-let commercial development. This is the same number as last year. The average interest rate margin was 369bps, a decline from 421bps reported at year-end 2012. The average LTV ratio was 58.0%, unchanged from 2012, and the average loan-to-cost ratio was 68.0% (61.0% year-end 2012).

Data on loans for 50.0% pre-let: 50.0% speculative development schemes was provided by nine lending teams, compared with seven the year before. The average interest rate margin was 419bps, a fall from 471bps reported at year-end 2012. The average LTV ratio was 51.0% (52.0% in 2012) and the average loan-to-cost ratio was 62.0%, up from 59.0% in 2012.

At year-ends 2011 and 2012, no organisation provided terms for speculative commercial development but this year four did so. The average interest rate margin was 369bps, the average LTV ratio was 45.0% and the average loan-to-cost ratio was 50.0%.

OTHER NON-BANK LENDERS

Those organisations that were prepared to fund senior debt for fully pre-let commercial development projects would offer a LTV ratio 50.0% to 70.0% (50.0% at year-end 2012), an interest rate margin from 450bps to 1,000bps (1,000bps) and an arrangement fee of between 1.5% and 3.0% (3.0% at year-end 2012). Junior and mezzanine finance was also available for this type of development.

Some mezzanine finance was obtainable for speculative commercial development to a maximum LTV ratio of 85.0%, loan-to-cost ratio of 100.0%, interest rate margin of 1,000bps. At year-end 2012, the corresponding terms were 55.0% maximum LTV ratio, 60.0% loan-to-cost ratio and interest rate margin/coupon of 1,700bps.

Residential loan terms

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

At both year-ends 2013 and 2012, 20 lending teams provided terms for loans secured by residential investment property. Interest rate margins were recorded in the range of 175bps to 450bps with an average for All Lenders of 262bps, compared with 352bps the previous year. LTV ratios remained essentially static, recording 62.2% at year-end 2013

For residential development projects, 14 lending teams provided loan terms – slightly down on the 17 teams at year-end 2012. Average interest rate margins declined from 458bps to 432bps as did average typical LTV ratios: 54.5% compared with 57% at year-end 2012. Loan-to-cost ratios increased to 67.0% from 63.0%.

OTHER NON-BANK LENDERS

Those organisations prepared to provide senior debt to loans secured by residential investment property did so within a range of 57.5% to 80.0% (60.0% to 65.0% 2012) LTV ratios, a 250bps to 400bps (225bps to 350bps) interest rate margin and a 1.0% to 2.0% (1.0% 2012) arrangement fee. Junior debt and mezzanine finance was also available.

With regard to finance for residential development for sale, senior debt would have been provided between 55.0% and 70.0% (75.0% 2012) LTV ratio, a 60.0% to 80.0% (90.0% 2012) loan-to-cost ratio, an interest rate margin/coupon of between 650bps and 1,500bps (1,200bps 2012), an arrangement fee of between 1.0% and 3.0% (2.0% 2012) and an exit fee of between 1.0% and 2.0% (2% 2012). By comparison, mezzanine finance was available within a range of 40.0% to 85.0% (same as 2012) LTV ratio, 50.0% to 100.0% (40.0% to 100.0% 2012) loan-to-cost ratio, an interest rate margin/coupon of 10.0% to 27.0% (16.0% to 20.0% 2012), an arrangement fee of between 2.0% and 3.0% (2.0% 2012), an exit fee of between 2.0% and 3.0% (2.5% 2012) and an IRR of 9.0% to 35.0% (12.0% to 30.0% 2012).

Future Lending Intentions

At year-end 2013, 62.0% of banks, building societies and insurance companies intend to increase their value of loan originations compared with 54.0% the previous year. All of Other Non-bank Lenders, except one, intended to increase loan originations and 100% intend to increase their loan book sizes. Figures 8 and 9 show the future lending intentions of banks, building societies and insurance companies.

Figure 8: **Future lending intentions: loan book size and originations**

Year-end	Intension to increase loan book size All Lenders %	Intention to increase loan originations All Lenders %
2008	24.0	23.0
2009	49.0	56.0
2010	46.0	57.0
2011	38.0	44.0
2012	46.0	54.0
2013	58.5	62.0

Figure 9: **Future lending intentions by category of lender**

Categories of lender	Increase loan originations % **2012 year-end**	**2013 year-end**
UK Lenders and Building Societies	46.0	48.0
German Lenders	54.0	73.0
Other International Lenders	74.0	75.0
North American Lenders	86.0	78.0
All Lenders	54.0	62.0

Key points from the 2013 research

- There was a rapid change in the commercial property lending market from an almost a complete absence of loan finance at the beginning of the year to receiving a flood of available money by year-end. It remains to be seen whether lending organisations will preserve underwriting standards when competing for lending opportunities.
- During 2013, traditional lending organisations were successful in reducing their exposure to legacy debt. The lending market appears to have stabilised and laid the foundations to move forward in a more robust form than was previously the case.
- However, it is believed that there remains a long way to go before a full recovery in the lending market is achieved. This is indicated by problem loans accounting for approximately 25.0% of the aggregated loan books of the traditional lenders at year-end 2013. Also, active lenders were far less willing to originate loans of less than £5m, which suggests that the more diverse and competitive lending environment is only really available for the larger deal sizes of £25m and above.
- It was stated by lending organisations that a ‘hidden problem’ was that if interest rates increase, the capital value of commercial property tends to decline. This may cause problems in the refinancing market. Thus, a key question becomes that of the speed at which future UK interest rates increase.
- New loan originations by non-bank lenders points towards a diversified and more balanced provision of real estate finance in the UK.

Mapping demand for debt in the UK property market

EMMA HUEPFL
Laxfield Capital

Commercial mortgage investment is evolving very quickly. Since 2000, commercial property lending has moved from bank domination through dislocation to a 'new normal' that involves a broad range of investors. The asset class now sits alongside other fixed income investments for global pension funds, insurance companies and sovereign wealth funds. Benchmarking and rating commercial mortgages is challenging since quantifiable asset data needs to be balanced with more subjective analysis of sponsor capability and macro-economic factors (e.g. interest rate fluctuation and loan/asset liquidity), and there is no uniform view on how this is done.

Risk in lending is also very much linked to the type of capital represented. Some equity investors are comfortable converting an under-bidder position to a 90% debt piece, having already underwritten and assigned capital to the equity, but the same loan from a bank would be considered unthinkably risky in the new era.

The Laxfield UK CRE Borrower Barometer[1], published six-monthly, collates requests for finance from owners of UK property assets and reports on changing patterns of demand. The Barometer is based on consideration of loan characteristics (leverage, loan purpose, term and quantum as indicators of risk appetite) and the underlying security by property type (geography and sector) to show concentration of debt-related investment activity. The analysis, which aims to capture forward market direction, is complementary to the Commercial Property Lending Report, published by De Montfort University in that the latter sets out to map actual transacted lending activity.

Since Laxfield Capital started recording loan requests formally at the beginning of 2013, a total deal pipeline in excess of £45bn and more than 400 individual loan requests have been analysed. The loan requests included in the Barometer have been restricted to those secured on income producing assets between £5m and £500m and concentrate on senior/whole loans in order to keep data samples consistent – smaller ticket lending and the development market having different characteristics.

The Barometer is therefore just a piece of a large jigsaw in terms of market information, but has been a useful tool in providing an early indicator that the market is moving in a different direction.

Transformed in 12 months

When the first Barometer was published in 2013, there was clear evidence of a changed market between Q3 and Q1-Q2 data. It is hard to recollect now that just a year ago the UK's recovery from recession felt highly tenuous. Now the observations from the first report feel old hat – investment activity spreading through the regions on a broader range of property types is patently obvious, but at the time it was more anecdotal than evidenced.

1 The third **Laxfield Debt Barometer** will be published towards the end of October 2014. To subscribe for a free copy, please email kelly.edwards@laxfieldcapital.com

Now with seven quarters of data to compare, the changes over time are obvious and there are plenty of 'touchpoints' that are worth watching closely.

Leverage is obviously an area which attracts interest for possible signs of overheating. Since the first report, when average LTV requirement was just 51%, the leverage requirement has increased steadily. The second iteration of the Barometer shows that the average request increased to 58% during the period. Laxfield anticipates the figure will be in excess of 60% when the third report is published later this year.

Polarised use of gearing

The Barometer indicates that typically the more conservative borrower groups – (generally REITs, institutions, and conservative private property companies) maintain highly restricted gearing policies. They sit largely within a stratum of investors seeking less than 55% LTV and the availability of more debt is not producing a change in approach.

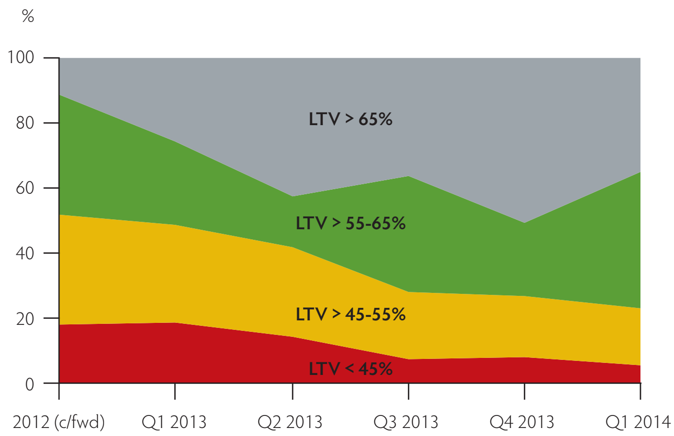
Not surprisingly, the group with greater appetite for debt has a high component of IRR-driven, private equity style property investors. The polarisation of approach between these two groups has increased.

Those borrowers looking for more than 65% LTV are growing in number, and indeed many of them are now requesting still higher levels of finance, so a shift in sentiment is now entrenched, with more investors seeking more leverage – see Figure 1. This ties in with a shift in use of debt. Remarkably, at the beginning of 2013, 86% of the pipeline analysed by Laxfield was refinancing of legacy loan positions (this was a volume-based analysis, and took into account some huge 2006-08 positions coming due for refinancing). The May 2014 report showed a market back into a more balanced state, with a split in Q1 marginally in favour of acquisition related requests, as shown in Figure 2.

Acquisition financing is increasing, and provides strong correlation with the higher levels of debt being sought. There is confidence that debt is available to meet acquisition timescales, and the equity is factoring in more ambitious use of gearing in the business plan.

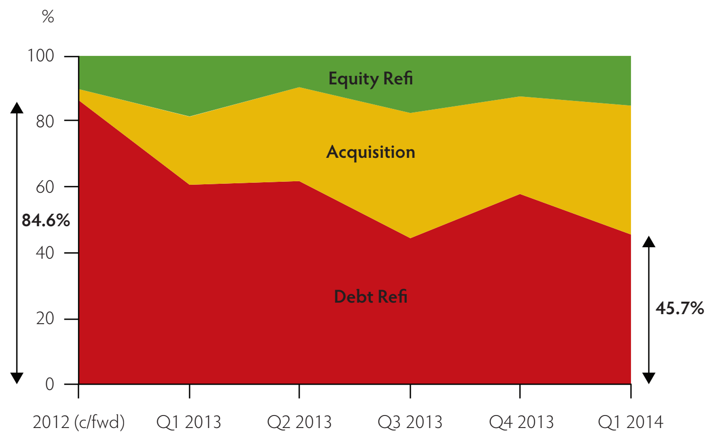
The higher use of leverage in a rising market is being monitored closely by Laxfield. Set against a picture of 2006, the picture is still relatively conservative. Then again, would anybody suggest that 2006 is an appropriate benchmark for future use of debt in real estate!

Figure 1: **Loan requests by leverage band**



Source: Laxfield UK CRE Borrower Barometer

Figure 2: **Loan requests by purpose**



Source: Laxfield UK CRE Borrower Barometer

No US-style market yet

Other loan characteristics worth highlighting are that despite the availability of large pools of capital for long-term lending, there is limited interest from the borrower market. Loan requests in excess of seven years formed just 12% of the pipeline in the last Barometer.

In addition, familiarity with insurers as lenders has not produced a US-style fixed-rate market, despite the consensus that long-term rates offer good current value. During the same period, the corporate credit markets have broadened the scope of their offer substantially, and some potential borrowers of long-term secured debt have switched to private placement or retail bonds. The 'other side' of some of the institutions who would like to provide secured lending are buying into private placements or CMBS products instead.

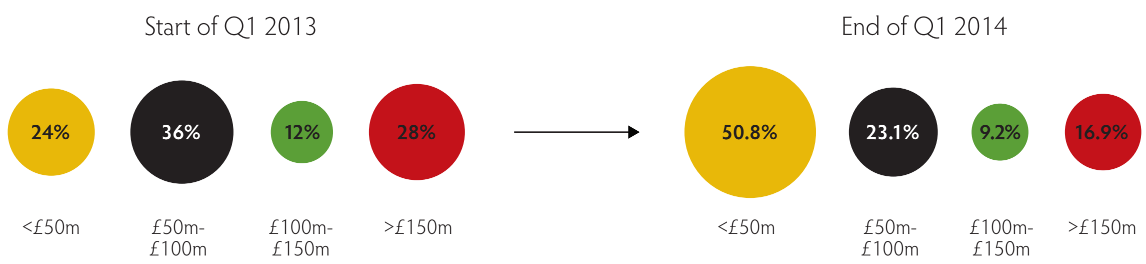
For now, it would seem that secured lending in the UK remains largely a five-year market, backed by a shorter-term trading horizon of many of the owners of property.

Loan quantum & geography

Appetite for debt against smaller investments has seen a revival over the past 18 months. Factors that come into play are the recovery of values in regional markets, availability of finance to acquire these assets, and capital forced to look beyond London to source investments in a very competitive environment.

There is a relatively even split between London and regional deal requests by volume, but more requests by loan count for finance on smaller assets in the regions, as sponsors have to work hard to acquire properties piecemeal in a competitive market.

Figure 3: **Change in size of loan requests**



Source: Laxfield UK CRE Borrower Barometer

The loan request pattern would suggest an uptick in regional lending over the course of 2014, also reflecting the greater number of finance providers going beyond the confines of London.

Borrowing by sector

2013 was a year where investment and borrowing activity was dominated by office but 2014 has seen greater diversity in terms of types of assets seeking funding. The beginning of the year saw a big uplift in requests for finance secured on retail assets, which has now rebalanced slightly, but the trend of diversification continues as borrowers seek yield from alternative sectors. Funding has also become much more widely available in operational assets such as student housing (where Laxfield Capital has placed £336.85m since the beginning of 2014), hotels and the private rented sector (PRS). Requests for finance secured on alternatives looks set to increase by quite a noticeable proportion over the course of 2014.

Implications for property yields of rising bond yields

COLIN JONES
Heriot-Watt University

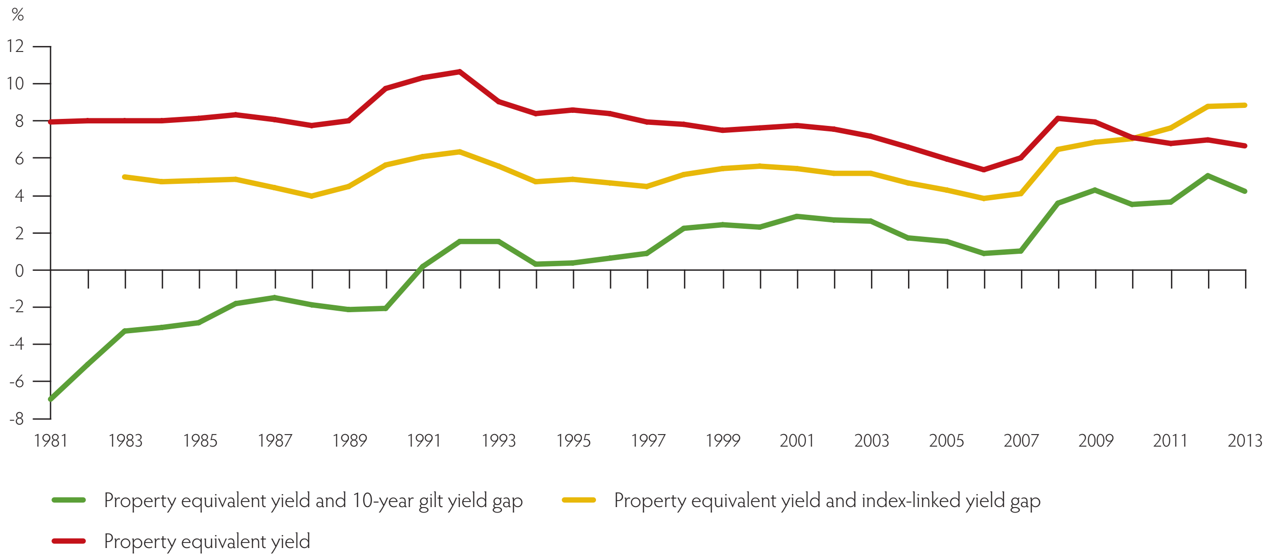
The prospect of a rise in interest rates/bond yields is growing closer and thoughts turn to the implications for the UK property market and investment yields.

This article draws on recent research published by the IPF[1] that examines the likely consequences, based on the nature of the gap between property and bond yields. While the yield gap between bonds and property is seen generally in terms of 10-year gilts, there is an argument to say that a more appropriate comparison is with yields on index-linked gilts. The IPF research looked at both comparisons.

Risk premium for property

The conventional assumption is that the risk premium for property is circa 2.0%, being the margin over the redemption yield on long-dated (10-year) gilts, i.e. the long- run, risk-free rate of return/cost of capital. However, some research has suggested that the risk premium fluctuates significantly around a 3.0% level, depending on expectations for income growth, inflation and other factors. The risk premium is then not just a function of property market investment characteristics but also has a 'cyclical component', including uncertainty about rental growth expectations.

Figure 1: **UK property equivalent yields and yield gaps**



Not surprisingly, the gap between UK gilts and property yields is by no means constant – see Figure 1.

1 Short Paper 19, 'Implications for Property Yields of Rising Bond Yields', published in June 2014 by the IPF Research Programme

Ten-year gilt yields fell below equivalent yields for the first time in 1991 and the yield gap remained not only positive but trended upwards. This implies that lower expectations about inflation/rental growth have had a persistent influence on the yield gap. Nevertheless, there have been periods when the gap narrowed; being only marginally positive between 1994 and 1997, whilst looking on a monthly basis, there were brief periods where the gap was negative. As property yields fell to their lowest level in the mid-noughties, the gap with 10-year gilt almost disappeared again but remained marginally positive. Indeed, from a monthly perspective showed another brief negative gap emerged in 2007. With the impact of the credit crunch, the gap widened again but has stabilised around 3.8%, a historically high yield gap.

Figure 1 also shows that yields on index-linked gilts rose through the 1980s, peaking in 1992, before declining gradually as inflation fell. Although the credit crunch brought an upward correction in 2007, there was then a sharp fall in yield, which has become increasingly negative since 2011. Over this period, the yield gap with property has been relatively stable, usually between 4.3% and 6.0%, averaging 5.0%. This is because property yields and index-linked gilt yields have statistically similar 'cyclical' patterns, in the sense that there tend to be matching peaks and troughs to each time series. However, since 2007, the gap has widened considerably, suggesting property investment risk aversion.

The future

Looking forward, it is important to take into account the current yield gaps. As noted above, the index-linked gilt/property yield gap has been the most constant, with a long-term average gap of 5.0%. On that basis, property yields should be currently considerably lower. However, the economy and property market have been subject to an unprecedented severe downturn. In addition, low interest rates have almost certainly created structural change and, potentially, a reappraisal of the risk premium. As the economy/property market improves, there are likely to be upward pressures on property yields as gilt yields rise and downward pressures as the economy/(expected) rental growth recovers.

Most forecasters anticipate a recovery in the economy over the medium term, which has been described as 'rapid normalisation' by Fathom Consulting. This is the basis of the primary or 'central scenario' forecast produced in the IPF research. Ten-year gilt yields are assumed to follow the 2013 forecasts of Consensus Economics and see a gradual rise from approximately 3.0% to 4.1% through to 2018, followed by a marginal fall to 3.9% at the beginning of 2019. The central scenario forecast for index-linked gilts is taken as a gradual rise in yields over the next three years until they reach the level of real GDP growth anticipated by Consensus Economics of 2.1% in 2017 and 2.0% in 2018. Rental growth is assumed to be 2.1% this year followed b 2.5% in the following two years, 2.4% in 2017 and dropping slightly to 2.1% in 2018, as set out in the February 2014 IPF consensus forecasts.

Fathom Consulting has argued that there are other possible scenarios, which it terms 'supply pessimism' and 'financial repression'. Both arise from a combination of weak productivity and growth in demand, leading to increasing inflation. The latter is based on the further assumption that interest rates will be

Figure 2: **Property equivalent yields based on different scenarios for 10-year and index-linked gilt yields**

Year	Central scenario (10-year)	Central scenario (index-linked)	Supply pessimistic scenario (10-year)	Supply pessimistic scenario (index-linked)	Financial repressive scenario (10-year)	Financial repressive scenario (index-linked)
Property equivalent yields	%	%	%	%	%	%
01/2015	7.23	7.12	7.69	7.22	7.34	7.22
01/2016	7.28	7.58	7.59	7.46	7.22	6.82
01/2017	7.37	8.05	7.68	7.70	7.19	6.67
01/2018	7.39	7.89	7.70	7.78	7.16	6.61
01/2019	7.32	8.05	7.63	7.86	7.16	6.56

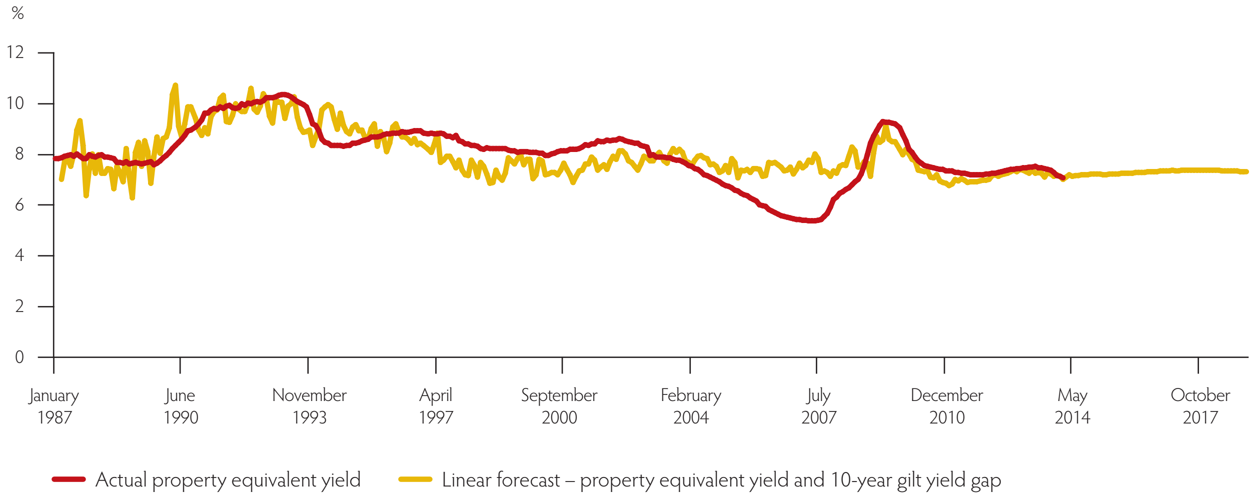
repressed to protect households, banks and government finances. A comparison of the three scenarios is set out in Figure 2.

The forecasts

CENTRAL SCENARIO

The projection is that the 10-year yield gap will fall consistently to 2018 by just over 100bps, before rising again, and that property equivalent yields will marginally increase in absolute terms to circa 7.3% by 2019. The index-linked yield gap is expected to fall substantially to around 5.5% in the latter half of 2016, before reaching a plateau. Based on the index-linked yield gap, property equivalent yields are forecast to rise to just over 8.0%.

Figure 3: **Actual and forecast property equivalent yields under the central scenario, based on 10-year gilt yield changes**



In both of the alternative and less likely scenarios, economic growth and, hence, nominal rental growth are assumed to run at only half the rate of the central scenario.

SUPPLY PESSIMISTIC SCENARIO

The forecast from the 10-year yield gap predicts that property equivalent yields will rise sharply before levelling off just below 7.7%. The forecast based on the index-linked yield gap suggests a less immediate rise in property yields but then increasing to almost 8.0%.

FINANCIAL REPRESSIVE SCENARIO

Monetary policy is expected to dampen gilt yields. The forecast for property equivalent yields from the 10-year yield gap regression is largely unchanged through to 2019, at around 7.0%. The index-linked yield gap-based forecast sees equivalent yields falling to 6.5% over this period.

Summary

Setting aside any reappraisal of the risk pemium, the central forecasts all predict a rise in gilt yields will lead to a narrowing in yield gaps so that property equivalent yields will not rise proportionally. The rise in gilt yields is linked with an expected improvement in the economy and associated rental growth. The yield gaps narrow with more positive rental projections feeding into investors' yield expectations. Overall, while it is expected that the yield gaps will narrow, yields will still rise.

What is fair value?

GERALD BLUNDELL

Fair value is an established concept in most investment markets. Investors generally have some rationale against which they assess whether assets are worth their market price; that is whether the expected returns flowing from current market prices meet their requirements.

Typically, price and expected return comparisons are made against other asset classes, or in the case of chartists against past price levels of the asset class itself – Figure 1 shows a conventional example of this. Expected returns are estimated by summing initial yields, long-term real income growth and expected inflation, with a deduction for costs and other capital calls. For shorter term returns, forecast income growth can be substituted. The resulting expected returns are then compared against some measure of the risk-free rate. In Figure 1, based on the July 2014 IPD monthly data, property's margin over 10-year gilts is just over 2.0%, probably less than many institutional investors would normally require – my recent analysis of a survey of IFAs[1] pointed to a required risk premium hovering in the range of 3.5% to 4.0% since 2008.

Figure 1: **A relative comparison of asset class value**

Return component	Notes	Cash	Fixed coupon 10-yr gilts	RPI-linked 10-yr gilts	IPD Universe	UK Equities All Share
Initial yield (%)	1	0.6	2.4	-0.4	5.1	3.3
Expected inflation (% pa)	2	0.0	0.0	3.0	3.0	3.0
Real net income growth (% pa)	3	0.0	0.0	0.0	-1.0	1.8
Annualised costs (%)	4	-0.1	-0.1	-0.1	-2.6	-1.2
Net expected return (% pa)	5	0.5	2.3	2.5	4.5	6.9

1 *IPD annual yield extrapolated to end July by reference to IPD Monthly*

2 *Breakeven rate between fixed coupon and linkers*

3 *Real NOI growth average 1981-2013 (source IPD; Barclays)*

4 *Includes asset management fees (50bps for property), equity dilution, depreciation 100bps, annualised portfolio trading costs: 110bps for property based on 7.25% 'round trip' and 15.0% pa portfolio turnover*

5 *The expected long-run return from current yields if there is no shift in yields*

1 'Risk premia: The reward for taking risk', Gerald Blundell; Investment Property Focus, published by the IPF (May 2014)

Impact of safe haven status

Over recent years we have seen increasing reference to some UK property markets as 'safe' havens against a rising tide of uncertainty driven by the events of 2008, political instability, and a realisation that sovereign debt is hardly risk free. Anecdotally, this has had a particularly marked effect on the pricing of the Central London markets, where there has been a considerable influx of foreign capital and where yields are much lower than those in Figure 1. So how valid is the conventional model of fair value in such cases? Is the safe haven effect merely a short-term aberration that 'rational' investors can afford to sit out or has there been a long-term shift in the way some markets are priced?

Addressing this question means looking closer at the factors that frame investor perceptions of value – factors like time horizon, knowledge, key risk sensitivities, and the relative utility attached to the different components of return. Take time horizon for example: An investor with an expected hold period of, say, three years will be concerned about yield shift, hoping or expecting yields not to rise. Conversely, a long-term investor will be more focused on long-term rental growth and will expect the yield effect to self cancel over the hold period. He/she will be more likely to take sustainability issues into account as over that period, being externalities that may well end up on the balance sheet. Nevertheless, both investors will be balancing future returns against current price and will follow the established fair vale rationale, albeit with different factors at play.

But what about the 'safe haven investor' or, more broadly, someone seeking a 'store of value' as opposed to an investment speculation? They look at assets differently because they need to be convinced that the asset will retain its real value over an indefinite period of time and will be readily realisable for them or their descendants in most economic conditions, not just the peak of a boom.

From this perspective, it could be argued that certain types of property are becoming the new 'risk-free' asset. Since 2008 the risk free status of sovereign debt has been badly damaged in many eyes (except perhaps those of certain regulators!). Equally, over a 25-year or longer period, equity markets can radically change and individual stocks have so many 'moving parts' that one cannot be sure what is bought now is what one will find when the time comes to sell – think Enron! Property by contrast offers something different. There are fewer moving parts: I was told of an office block in Canary Wharf that was pre-let to Enron, leased to Lehmans when Enron went under, released in 2008 to several tenants and was sold in 2010 at a profit. It is also notable that property was the only asset class that Maxwell failed to embezzle from the Mirror Group Pension Fund.

> *"... certain types of property are becoming the new 'risk-free' asset."*

So what are the key characteristics of store of value property? I would suggest the following:

- An owner-friendly rule of law and leasing structure;
- A large and liquid market;
- The possibility of accessing leverage in the local currency;
- A structurally under-supplied market; and
- Land value that is a large share of total value (to minimise depreciation)

Central London, Manhattan, Sydney and Paris meet all or most of these criteria and all of them have seen an influx of investors seeking a store of value. However, not all property fits the bill, which is perhaps why in the UK we have seen sub-markets' yields begin to diverge. While most sub-markets' yields have fallen from the 2008 peak, those in Central London have fallen much further, widening the margin below the rest of the IPD Universe.

Impacts on valuation

If a significant proportion of investors continue to buy the asset class as a store of value, what does this imply about the way property cash flows are priced? Three impacts occur to me.

Firstly, store of value investors will be prepared to pay lower yields than their 'rational' counterparts. They will be willing to pay an insurance premium to sidestep higher levels of uncertainty prevalent in other markets. This will have an impact beyond the direct effect of the weight of money; we can expect second order valuation effects on standing portfolios because of valuers' reliance on comparable evidence to do their job. My guess is that this premium could easily equate to 100bps pa.

"... store of value investors will be prepared to pay lower yields than their 'rational' counterparts."

Secondly, seeking a safe haven is more than just reducing portfolio volatility by diversification. The origin markets of much of the overseas capital targeting London are dogged by uncertainty about politics, the rule of property law and sovereign default. Unlike volatility, uncertainty is not measurable – it is seen as a binary function in that you either feel it or you do not, as per 'risk on/risk off' psychology of equity markets since 2008. As a result, it cannot be incrementally traded off against return as risk is in the optimising calculus of so called 'modern' portfolio theory (MPT). Consequently, safe haven investors are more likely to be return 'satisficers' than optimisers. Such behaviour sits uncomfortably in an optimising framework. So if store of value is driving prices, we may need a different approach.

"Unlike volatility, uncertainty is not measurable..."

Finally, it should be recognised that not all property markets will meet the store of value criteria. So we might expect to see a greater and even bi-modal dispersion in valuations and performance across sub-markets, further undermining the normality assumptions so beloved of conventional theory.

A short-term or permanent change?

It is too soon to tell whether safe haven or store of value motives will be a permanent feature of our capital markets, or just a hot money flash in the pan that will dissipate as financial markets return to normal, whatever that is. In my view, it will take a long time for investors to trust sovereign debt again, and we have seen yields in the UK diverging for several years now. We have also seen considerable flows of capital in Central London from overseas origins where sources of uncertainty exist that are not present here.

"... it will take a long time for investors to trust sovereign debt again..."

I believe that these conjectures should be tested objectively. We need to know more about the motives of property investors, especially as cross-border flows increase; we need to see if central city markets in other countries have shared London's experience and whether we can learn from their experiences. More fundamentally, we need to assess just how far from rational pricing the markets can move, and can the gap be explained in terms of an 'uncertainty premium'. This is important – efficient capital markets need pricing models to be as close as possible an approximation to reality.

IPF legal and regulatory round-up

AMANDA HOWARD, Nabarro

This table gives an overview of some of the main legal and regulatory proposals affecting UK real estate investment. It includes details of timings and how the various issues impact the real estate and real estate funds industry. The table is divided into legal developments – UK/general, regulatory, banking and competition. The issues are in no particular order.

Legal developments – general/UK

GENERAL DATA PROTECTION REGULATION	**The draft General Data Protection Regulation (the Regulation) was initially published by the European Commission in 2012. If it is adopted by the Council of Ministers, it will replace and repeal the current Data Protection Directive.**	**Timing** 2014 has seen the European Parliament vote in favour of the Regulation with certain amendments. The next stage of the legislative process is for the Council of Ministers to consider the Regulation. It is expected that agreement on the draft Regulation will be achieved by the Council of Ministers by the end of 2014 or early 2015 with a decision announced in 2015. This will be 20 years from the date of the Data Protection Directive.	**Comments** The draft Regulation is expected to introduce significantly higher data protection standards and sanctions than currently provided in the Data Protection Directive. Most notably, the European Parliament approved draft of the Regulation provides for fines of up to 5% of annual worldwide turnover. This is an increase on the original draft from the Commission providing for fines up to 2% of annual worldwide turnover. Fund managers will be keen to track the development of this draft Regulation which will have repercussions for all personal data held and processed by them. The draft Regulation will be particularly relevant to fund managers in relation to: • Customers and investors (both KYC and in respect of marketing); • Employees; and • Any third parties who process personal data on a fund manager's behalf.
PRIVACY IMPACT CODE	**In February 2014, the Information Commissioner's Office (ICO) issued a new Code of Practice on Privacy Impact Assessments.**	**Timing** The Code was published on 25 February 2014.	**Comments** The Code builds on earlier guidance on Privacy Impact Assessments published by the ICO. As its name suggests, it provides for an impact assessment to be conducted where any new project will involve either the use of personal data or otherwise impact on the privacy of individuals. Such projects may range from a new CCTV system to a new cloud-based payroll system for employees. Although not mandatory, data controllers are advised to comply with the Code.

Legal developments – planning & development

COMMUNITY INFRASTRUCTURE LEVY (CIL)	**The Planning Act 2008 and CIL Regulations 2010 introduced CIL as a new charge that local planning authorities can levy on developments to contribute towards the cost of local, sub regional and larger infrastructure. The levy applies on an area-by-area basis.**	**Timing** An increasing number of local planning authorities (LPAs) are progressing their CIL charging strategies with a view to their examination by an independent examiner, but the number of LPAs who have formally introduced CIL (particularly outside London) continues to remain quite small.	**Comments** New guidance on CIL was added to the Planning Practice Guidance on 12 June 2014. This updated previous advice and in particular: • Clarified the operation of CIL in relation to section 73 Applications; • Addressed the setting of differential rates in respect of alternative models of social housing provision; • Explained how instalment policies can assist the viability and delivery of development within the buy to let sector; and • Clarified the restriction on the pooling of planning obligations relating to staged section 106 payments.

PLANNING PRACTICE GUIDANCE	**The Department for Communities and Local Government (DCLG) has launched Planning Practice Guidance as a web-based resource to replace a large number of planning guidance documents.**	**Timing** Planning Practice Guidance was formally launched on 6 March 2014 following a beta launch on 28 August 2013 and a consultation period that closed on 14 October 2013.	**Comments** For the first time, planning practice guidance is now available entirely online in what the government considers to be a usable and accessible way. Important information for any user of the planning system previously only published in separate documents can now be found quickly and simply. It is possible to link easily between the National Planning Policy Framework and relevant planning practice guidance, as well as between different categories of guidance. Planning Practice Guidance will be updated as needed and it is possible to sign up to email alerts on any changes, or view revisions on the site.
DEVELOPMENT MANAGEMENT PROCEDURE AMENDMENTS	**The Development Management Procedure Order has been modified to further streamline appeal procedure.**	**Timing** The amendments and associated new regulations came into force on 1 October 2013.	**Comments** The intention of the new regulations is to allow appeal decisions to be taken sooner, while ensuring the process remains fair. Where appeals are allowed, the government intends that development will be able to commence sooner, bringing forward jobs and growth. Communities will be able to see an appellant's whole case when making their own representations, as this will now be submitted when an appeal is lodged, giving greater transparency. A new commercial appeals service, closely modelled on the householder appeals service, will introduce an expedited procedure for some minor commercial appeals such as those relating to advertisement consent or shop fronts, allowing decisions to be made in only eight weeks.
GROWTH AND INFRASTRUCTURE ACT 2013	**The Growth and Infrastructure Act 2013 contains provisions for promoting growth and facilitating the provision of infrastructure and related matters, and economic measures.**	**Timing** Many of its provisions are now in force.	**Comments** The Act provides for a wide range of changes to the planning regime, all intended to help stimulate growth and facilitate the provision of infrastructure. The main planning measures include the option to make planning applications direct to the Secretary of State when a local planning authority has been 'designated' as underperforming. A local planning authority can be designated as underperforming if the Secretary of State considers that the authority is not 'adequately performing their function of determining applications'. Underperformance will be established if a planning authority (a) determines 40% or fewer applications within the statutory determination period (or any extended period that is agreed in writing with the applicant) or (b) has 20% or more of its decisions on major development proposals overturned on appeal. Other aspects include broadening the powers of the Secretary of State to award costs between the parties at planning appeals, and allowing for the reconsideration of economically unviable affordable housing requirements contained in section 106 agreements. The infrastructure changes include measures for variation of consents granted under the Electricity Act 1989 (i.e. the pre-Planning Act 2008 regime), and amendments to the scope of Nationally Significant Infrastructure to include significant commercial and business development. It is too soon to say whether the legislation has started to deliver growth and facilitate new infrastructure.

Legal developments – energy

CRC ENERGY EFFICIENCY SCHEME

The CRC Energy Efficiency Scheme (CRC) has undergone a series of changes. The scheme is currently in Phase 2.

Timing

The CRC Energy Efficiency Scheme (Amendment) Order 2014 (SI 2014/502) (CRC Amendment Order 2014) came into force on 1 April 2014.

Comments

The key changes that the Order has brought in are as follows:

Treatment of renewables – Incentivizing on site renewable energy by allowing participants to choose one of the following options:

- A – avoid buying allowances in the CRC or,
- B – receive support under the renewables obligation (RO) or feed-in tariffs (FITs).

To avoid liability for purchasing allowances under the CRC, a participant must not have received any support under the RO or FIT schemes or any other grant from public funds and is achieved by applying a zero-rate emissions conversion factor when calculating CRC emissions.

Energy used in metallurgical and mineralogical processes – Implementing a CRC exclusion for energy used in metallurgical and mineralogical processes through changes to the supply rules. The energy used for these two specific processes will not be considered a CRC supply concerning the qualification and reporting requirements.

Double-counting of energy supplies – In a landlord and tenant relationship, where the tenant has a CCA facility or EU ETS installation, a CRC participating landlord will be able to exclude the supplies covered under a CCA certificate or EU ETS scheme.

Disaggregation of subsidiaries:

Allowing participants more flexibility to disaggregate subsidiaries of their organizations at any point within a phase of the scheme.

Minor technical amendments:

- A – Clarifying the exclusion of self-supplies for the direct purposes of specific licensed activities and cross licensed activities from the CRC.
- B – Excluding schools maintained by an English local authority from the CRC.
- C – Clarifying that a penalty should be implemented for failing to provide an annual report by the last working day in October after the end of the annual reporting year, instead of the previous date specified in the CRC order 2013.

Legal developments – regulatory

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

The AIFMD seeks to regulate the private fund industry: hedge, private equity and real estate funds. However, the scope of the AIFMD is very broad. It will catch the managers of any collective investment undertaking that raises capital from a number of investors and invests it in accordance with a defined investment policy (other than undertaking for collective investment in transferable securities (UCITS funds), which are regulated separately) and certain exempted arrangements in the AIFMD.

Alternative investment fund managers (AIFMs) of alternative investment funds (AIFs), as they are known, must be authorised and face increased regulation, supervision and disclosure requirements.

The AIFMD impacts firms managing or marketing any AIF in the EU. Only AIFs established and managed outside the EU and not marketed in the EU will be unaffected by it.

HM Treasury published implementing regulations on 16 July 2013 which entered into force on 22 July 2013. The FCA handbook has been significantly updated to reflect the AIFMD including a new investment funds sourcebook, FUND.

Timing

AIFMD entered into force on 1 April 2011 and the deadline for national implementation of AIFMD was 22 July 2013. Parts of AIFMD will impact non-EU AIFMs and certain EU AIFMs from this date.

Comments

Managers of real estate funds will be affected by the AIFMD and must comply with it. The AIFMD can apply to any form of vehicle, including listed and unlisted entities and bodies corporate.

In respect of those arrangements which could be out of scope:

- The treatment of REITs is not definitive: REITs should carefully consider whether they are in scope or not.
- There is still no definition of joint ventures. Although the FCA does offer some helpful pointers, many are pushing for guidance that is more explicit on the treatment of joint ventures structured as limited partnerships where the limited partners cannot directly manage the business of the venture.

Those entities which are AIFMs under the AIFMD will also be financial counterparties under EMIR (for which, see under Legal developments – Finance below). This will have an additional cost and compliance impact.

SOLVENCY II

Solvency II is a fundamental review of the capital adequacy regime for the European insurance and reinsurance industry. It deals with the amount of capital which EU insurance companies must hold in order to reduce the risk of insolvency. Solvency II brings in capital requirements for insurers similar to those imposed on banks in Basel III.

There are different capital requirements according to the asset types involved. The higher the perceived risk of an asset class, the more capital the insurer needs to set aside to ensure that, if its value falls, the insurer's ability to cover all its notional liabilities to policyholders is not affected.

Timing

Solvency II was adopted in November 2009. The target date for implementing Solvency II by member states is 31 March 2015, with implementation by insurance firms by 1 January 2016.

The Omnibus II Directive (which amends Solvency II) was adopted by the European Parliament on 11 March 2014 and the European Council of the EU on 14 April 2014.

Comments

Two main concerns have been raised in respect of real estate investments:

- The proposed 25% capital requirement for insurance companies investing in real estate is too high. IPD research suggests that a 15% pan-European capital charge would be more realistic, with the possibility of a +/- 10% dampener.
- The fact that there is no dampener for the real estate capital charge could lead to a requirement for additional capital in a falling property market and/or insurers having to sell property to maintain adequate capital ratios, which could then trigger further falls in property values.

US REGULATORY REFORM – THE VOLCKER RULE

The Volcker Rule amends the Bank Holding Company Act of 1956. Among other things, the Volcker Rule prohibits any 'banking entity' from sponsoring and/or acquiring or retaining an ownership interest in a 'covered fund'.

A 'banking entity' includes any insured depository institution (for instance, a bank holding company), any foreign banking organisation that is subject to the Bank Holding Company Act (for example, a foreign bank that maintains a branch or agency in the US) and any subsidiary or affiliate of one of these entities. 'Covered funds' include (i) funds that would be 'investment companies' but for the exclusions contained in Section 3(c)(1) and/or Section 3(c)(7) of the Investment Company Act of 1940 and (ii) certain commodity pools with similar characteristics. Section 3(c)(1) is the exclusion for private funds whose outstanding securities are beneficially owned by not more than 100 persons. Section 3(c)(7) is the exclusion for private funds whose outstanding securities are owned exclusively by 'qualified purchasers'.

There is an exemption that permits foreign banking organisations to invest in a foreign fund that meets various requirements. Investment advisers that are not banking entities or affiliated with a banking entity are not subject to these rules. However, these rules may mean certain investors cannot invest in certain funds.

Timing

The final Volcker Rule rules and regulations became effective on 1 April 2014. Certain large banking entities (with $50bn or more in consolidated trading assets and liabilities) subject to the Volcker Rule must begin tracking and reporting quantitative measurements as of 1 July 2014. All banking entities and their affiliates will be required to be fully compliant by 21 July 2015.

Comments

Fund managers that are banking entities or affiliates of banking entities must determine whether or not their fund sponsorship activities will be limited by the Volcker Rule. More generally, even if a fund manager is not subject to the Volcker Rule, if it intends to market a fund to US investors or to make US investments, it should consider whether any of its investors may be subject to the Volcker Rule.

JUMPSTART OUR BUSINESS STARTUPS ACT (JOBS ACT) – THE USE OF GENERAL SOLICITATIONS IN US PRIVATE PLACEMENTS UNDER REGULATION D

The US has much more stringent rules regarding private placements and public offerings than the UK. As a general rule, marketing an alternative investment fund to US investors may require registration under the US Securities Act 1933 unless the offer and sale is exempt from the registration requirement. There is a safe harbour which avoids the need for registration, known as Regulation D. Until recently, Regulation D prohibited the general solicitation of investors during the marketing period of funds.

The US JOBS Act required the SEC to amend Regulation D so as to allow general solicitation in private placements under certain conditions. Under the new Rule 506(c), a fund may solicit and advertise the offering to the general public, provided that: (1) the fund sells its securities only to 'accredited investors'; (2) the fund takes 'reasonable steps' to verify that all purchasers of its securities are 'accredited investors'; and (3) the offering complies with all the other requirements of Rule 506. Funds relying on new Rule 506(c) are still subject to the antifraud provisions of the federal securities laws.

Timing

Rule 506(c) became effective on 23 September 2013.

Comments

Rule 506(c) permits funds to expand their fundraising efforts and engage in all forms of communication with prospective investors, but with this new freedom comes the obligation to verify whether a purchaser of securities is or is not an accredited investor. Whether the steps taken to verify the investor's status are reasonable depends on the particular facts and circumstances of each investor and securities transaction. The SEC has already indicated that simply having a potential investor check a box in a subscription agreement is not enough to confirm accredited investor status; more supportive information is necessary.

NEW BAD ACTOR DISQUALIFICATION RULES UNDER REGULATION D

The Dodd-Frank Act required the SEC to amend Regulation D to include bad actor disqualification provisions. Pursuant to new Rule 506(d), an offering is disqualified from relying on the private placement safe harbour provided by Regulation D if the fund or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order, or other disqualifying event that occurred on or after 23 September 2013. For disqualifying events that occurred prior to 23 September 2013, funds may still rely on Rule 506 but must comply with the disclosure provisions of new Rule 506(e) which require that written disclosure be provided to investors a 'reasonable time' before the fund's securities are sold in reliance on Rule 506.

Funds must conduct a factual inquiry to determine whether any of its 'covered persons' has had a disqualifying event. 'Covered persons' include:

- **The fund, including its predecessors and affiliated issuers**
- **Directors, general partners, and managing members of the fund**
- **Executive officers of the fund, and other officers of the fund that participate in the offering**
- **20% beneficial owners of the fund, calculated on the basis of total voting power**
- **Promoters of the fund**
- **For pooled investment fund issuers, the fund's investment manager and its principals**
- **Persons compensated for soliciting investors, including their directors, general partners, and managing members**

Timing

Rules 506(d) and (e) became effective on 23 September 2013

Comments

Disqualification or disclosure under Rules 506(d) and (e) is not triggered by events that take place outside of the US, such as convictions, court orders, or injunctions in non-U.S. courts or regulatory orders issued by non-U.S. regulatory authorities.

A fund that will rely on the Rule 506 safe harbour for its fundraising should:

- Identify all covered persons with respect to the fund and determine whether those covered persons have committed disqualifying acts.
- Revise investor questionnaires used to conduct due diligence on potential investors to inquire about disqualifying acts.
- Revise all agreements with covered persons (e.g., investors, placement agents, promoters, employees, etc.) to include provisions requiring that the covered person (1) provide prompt notice of potential or actual disqualifying acts; (2) comply promptly with the fund's periodic inquiries as to whether a disqualifying act has occurred; and (3) agree to terminate the agreement or restructure the covered person's relationship with the fund if the covered person commits a disqualifying act.

Legal developments – finance

EUROPEAN MARKET INFRASTRUCTURE REGULATIONS (EMIR – OTC DERIVATIVES)

EMIR introduces a clearing obligation that will apply to those over the counter (OTC) derivative contracts which the European Securities and Markets Authority (ESMA) considers should be centrally cleared through authorised central counterparties (CCPs). If a real estate business is a 'financial counterparty' (or enters into OTC derivatives above certain thresholds and becomes a clearing 'non-financial counterparty') it will be required to clear trades in those contracts through a CCP. Those trades will need to have 'highly liquid' collateral (not real estate) posted. There will be detailed conduct of business requirements for CCPs.

Different rules apply where OTC derivative contracts are not subject to mandatory clearing by a CCP. Businesses caught will need to put risk management techniques in place, designed to manage operational and credit risk, including daily marking-to-market of non-centrally cleared derivative positions, increased use of electronic confirmation and increased transparency requirements. The exact requirements will depend on whether a firm is classed as a 'financial counterparty' or a 'non-financial counterparty' and the level of OTC derivative activity.

EMIR also requires details of both OTC and on-exchange derivatives to be reported to a trade repository.

Pension schemes are exempt from a clearing obligation for a period of three years, extendable by another two years plus one year, subject to reports justifying the deferrals.

Timing

EMIR entered into force on 16 August 2012 on a staged basis. Some of the requirements under EMIR (such as the clearing requirement) have not yet come into effect.

The reporting obligation came into effect on 12 February 2014 for all types of derivative contract.

Clearing through a CCP, and certain other requirements including providing collateral for non-centrally cleared trades, are expected towards the end of 2014/early 2015. On 18 March 2014, the first CCP was authorised under EMIR.

Comments

EMIR will increase the cost of debt without any apparent benefit, as real estate investors generally use derivatives and swaps (e.g. hedging interest rate and currency risks) to reduce risk rather than for speculative purposes.

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

- Standardised swap activities (determined by ESMA) may need to be cleared through CCPs, with appropriate liquid collateral (real estate does not currently count) and reporting; and
- For swaps that are not cleared through a CCP, it will have to have risk management procedures in place, potentially including the marking-to-market of outstanding contracts on a daily basis.

In relation to clearing, one important area is who is a 'financial counterparty' and therefore within the scope of the more detailed requirements of EMIR. This includes for these purposes AIFs managed by an AIFM within AIFMD, as well as banks and other financial institutions.

REGISTER OF BENEFICIAL OWNERSHIP OF COMPANIES

The Department of Business, Innovation and Skills announced proposals to introduce a new public register of company beneficial ownership, together with obligations on companies and individuals to identify and disclose information on their beneficial interests. The beneficial interests are defined as individuals who ultimately own or control more than 25% of a company's shares or its voting rights, or who otherwise exercise control over a company or its management.

This will include companies limited by guarantee and LLPs, and will apply to existing as well as new corporate entities.

Timing

The proposal was launched in July 2013, however many of the changes outlined will require primary legislation, so change will not be immediate as legislation can only be passed when Parliamentary time allows.

There will also need to be transitional periods for existing companies to implement the changes proposed.

Comments

Listed companies will be exempt from the new requirements.

All of the information held on a private company's beneficial ownership will need to be notified to Companies House. Companies will need to update the register of beneficial owners if they know, or might reasonably be expected to know, that a change in beneficial ownership has occurred and beneficial owners will also be under an obligation to inform the company of any changes.

This change will affect some UK holding companies in real estate structures. Company secretaries and others involved in the running of companies should start to consider how the changes will impact on them.

Legal developments – tax

CGT FOR NON-RESIDENTS

In the 2013 Autumn Statement, the Chancellor of the Exchequer announced that capital gains tax (CGT) is to be extended to gains made by non-residents disposing of UK residential property.

The government published its consultation document in March 2014 and it became clear that the extension of CGT was going to be wider than originally anticipated.

Broadly, it will not just affect non-resident individuals, but also many property owning structures through which individuals invest in UK residential property including non-UK resident partners of partnerships, some non-UK resident companies, non-UK resident trustees and certain funds.

The definition of 'residential' is also wider than was originally anticipated and could include student accommodation.

It was confirmed that the disposal of shares or units in a fund would not be taxed under the extension of CGT, however the government believes it may be appropriate, in certain cases, to charge CGT at fund level. The consultation document noted an intention to introduce a genuine diversity of ownership test to ensure that only funds that are closely held are caught by the extension. The nature of the test is still unclear at the moment.

The consultation included confirmation that the extended CGT charge would not affect foreign REITs or non- UK residents investing in UK residential property through UK REITs.

The government has also announced that it intends to extend CGT to gains made by non-residential companies and are considering introducing a tailored charge (CGT or corporation) on disposals of UK residential property.

No indication has been given as to what the rate of tax might be. The methodology for collecting the tax is also still uncertain

The consultation period ended on 20 June 2014 and the government's response is awaited.

Timing

The extended CGT charge will apply from April 2015 in respect of gains arising from that date. Unrealised gains up to April 2015 should not be caught by the changes.

Comments

The extension of CGT to gains made by non-resident individuals disposing of UK residential property was widely reported in the press when the announcement was first made in Autumn 2013.

The wider application of the extension has come as a shock to some. The industry has heavily lobbied the government for carve outs where investments have been made by institutional investors. Lobbying has also happened to exclude student accommodation from the charge.

The government is due to respond to the responses to consultation and publish draft legislation later this year.

WITHDRAWAL OF EXTRA STATUTORY CONCESSIONS ON STUDENT ACCOMMODATION	**In February 2014, HMRC announced that it now acknowledges that certain student accommodation can fall within the definition of a 'dwelling'.** **HMRC guidance now refers to 'cluster flats' being able to fall within the definition of a dwelling as it is seen as a self-contained living accommodation. Cluster flats are single flats and typically contain a number of en-suite bedrooms that are let to individual students. It is important to note that the accommodation must still satisfy all four conditions for falling within the definition of a 'dwelling', which are (a) that the dwelling must consist of self-contained living accommodation, (b) there must be no provision for direct internal access from dwelling to dwelling or part of a dwelling, (c) the separate use or disposal of the dwelling must not be prohibited by the terms of any covenant, statutory planning consent or similar provision and (d) statutory planning consent has been granted in respect of that dwelling and its construction or conversion has been carried out in accordance with that consent.** **Before February 2014, student accommodation could only fall within the 'relevant residential purpose' category for zero rating purposes.**	**Timing** Updated HMRC guidance was published in early 2014.	**Comments** The change in HMRC's approach to student accommodation means that taxpayers can now rely on either 'dwelling' status or 'relevant residential purposes' status for zero rating purposes, thereby giving the taxpayer flexibility as to how VAT is recovered. It is important to note that all four conditions must be satisfied in order for the student accommodation to fall within the definition of 'dwelling'. The condition which is most likely to cause a problem is condition (c) 'the separate use or disposal of the dwelling must not be prohibited by the terms of any covenant, statutory planning consent or similar provision' as there is often a prohibition of this kind in the planning permission.
FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)	**FATCA is US legislation that seeks to combat the use of offshore accounts by US taxpayers to evade tax.** **In brief, payments of US source income will be subject to a 30% withholding tax unless the receiving foreign financial institution (FFI) complies with FATCA by disclosing requisite information to the US Internal Revenue Service (IRS). The definition of an FFI is wide and, amongst others, includes banks, private equity funds, insurance companies and trust companies.** **In an attempt to reduce the burden of compliance on UK companies and to resolve data protection issues in respect of information being sent to the IRS, an agreement signed between the US and the UK enables UK FFIs to report to HMRC which will in turn pass the relevant information to the IRS. Provided the requisite information is provided to HMRC, UK FFIs will avoid the 30% withholding tax.** **UK regulations were introduced in June 2014 requiring UK FFIs to identify certain information using specified due diligence procedures and report that information annually to HMRC.**	**Timing** FATCA applies to withholdable payments from 1 July 2014. There are further phases of legislation introducing additional measures to be implemented over a number of years. The UK FATCA regulations took effect on 30 June 2014.	**Comments** The FATCA legislation is lengthy, complex and currently somewhat transient. As a result, practitioners are inevitably facing difficulties in identifying the implications of what is essentially a US law for UK entities. The UK regulations go some way to alleviate the burden of compliance with FATCA on UK FFIs, however going forward the implications of FATCA will need to be borne in mind by all FFIs receiving US source income.

Legal developments – competition

COMPETITION LAW AND LAND TRANSACTIONS UK CASE IN WHICH A PROPOSED PERMITTED USE RESTRICTION IN A LEASE WAS FOUND TO INFRINGE THE COMPETITION ACT '98	**Competition and land use restrictions** **In a case late last year the Central London County Court found that a use restriction in a lease was a restriction of competition in breach of Chapter I of the Competition act 1998 and did not meet the criteria for exemption.** **The dispute arouse when an existing tenant of retail premises on a parade of shops in a housing estate, sought to extend the permitted use of the retail premises for retail trade of newsagents, confectionary and tobacconist to a general convenience store selling groceries, spirits and household goods. The local council landlord refused. The dispute was referred to the County Court for resolution under the Landlord and Tenant Act 1954. In the context of the dispute, the tenant argued that the proposed user clause was anti-competitive.** **Before the Court, the council conceded the arrangements would be restrictive of competition and the case focused on whether the provision could satisfy the test for exemption. The County Court judge concluded that the council failed to demonstrate on the facts that the restriction improved the distribution of goods or economic progress, or that consumers would share in the benefit produced by the agreement. One relevant factor appears to be that the parade of shops was the only retail premises within the estate and that the nearest supermarket or convenience store was at least 1 kilometre away.**	**Timing** Martin Retail Group Limited v Crawley Borough Council dated 24 December 2013	**Comments** The exclusion for land agreements from the application of UK Competition law was removed in April 2011. The effect is that a restrictive clause in an agreement which does not meet the grounds for exemption under UK competition law may be void and unenforceable. To date, challenges to user restrictions on competition grounds have been rare. However, this case highlights the fact that landlords do need to take care that restrictions in agreements are competition law compliant.

Lessons for property funds following the crisis

SUE FORSTER
IPF

The IPF organised a joint seminar with The Association of Real Estate Funds (AREF) on 13 May to consider what has changed within the property funds sector since the global financial crisis (GFC) and whether further changes are required.

PwC kindly hosted the event at its Embankment Place office and the participants were:

Chair: Angus Johnston, PwC

Speakers: John Forbes, John Forbes Consulting
John Cartwright, AREF

Panellists: Matthew Abbott, Mercer
Graeme Rutter, Schroder Property Investment Management
Howard Meaney, UBS Global Asset Management
Andrew Banks, Legal & General Investment Management

To set the discussion in context, John Forbes outlined the main findings of the PwC report, 'Unlisted funds – Lessons from the crisis' commissioned by AREF in 2011 and published in January 2012. The report, based on a survey of fund managers, investors and others in the industry, covered a broad range of issues but the focus was on the underlying issue of the liquidity of property wrappers, namely the trade off between liquidity & volatility and performance & risk over the past 'decade of volatility' (2001-11).

Issues highlighted by the report

- There is an inherent inertia within property fund management as it is very difficult to change managers. At the time of the research, there was a perception that investors would vote with their feet as soon as market conditions improved such that they could get their money out and that, having done so, they would re-invest into new funds.
- When values collapsed (the peak to trough fall was nearly 50%), funds faced different challenges depending on whether they were closed-ended or open-ended. The former, if nearing the end of their term, had to wind-up or extend in circumstances where not all investors were aligned in their aims. This was compounded by the fact that these funds were typically more highly geared than open-ended funds and their loan-to-value covenants came under pressure when values fell. Several of the open-ended funds faced the challenge of large-scale redemptions, while keeping a balance between those wanting to leave and those remaining.
- UK real estate funds model did not provide the range of funds required by investors, e.g. some investors in open-ended funds wanted to deploy capital for the long term and did not require the level of liquidity being offered.

The key conclusions from the report were that:

- The challenges of non-alignment of investors and the co-mingling of different types of investors (e.g. institutional and retail) should be addressed.
- There was a need for greater fund transparency, improved governance and more independent supervision.
- There was investor demand for funds that 'blur' open-ended and closed-ended funds and provide for long-term investment with limited opportunities to redeem (semi open-ended funds).
- There should be a better understanding of the role of the manager in regulating inflows of capital.

AREF response

John Cartwright said that AREF was seeking to promote continual improvements in high-level governance, transparency and integrity. The PwC report had been commissioned in order to correct some of the misunderstandings as to what happened during the downturn and to point a way forward post crisis. Since the report's publication, AREF had held a series of meetings with key figures under Chatham House rules to discuss the findings. As a result, AREF would be re-launching its Code of Practice (since done) as a dynamic document that will consider best practice in areas like the independent oversight of funds, subscriptions and redemption policies, as well as addressing the issues regarding closed-ended funds that were highlighted in the report. AREF would also be policing adherence to the Code on a more formal basis.

Fund liquidity

The chairman, Angus Johnston, asked the panel members whether they thought investors' perception of liquidity had changed. Matthew Abbott said that for any illiquid asset class investors need to be flexible as performance had to be first and foremost and liquidity affects performance. Daily pricing is problematical so the answer may be the provision of liquidity windows at the end of each year and more openness from fund managers as to strategy for the fund. Andrew Banks remarked that investors want more control over exit points, which potentially constrain performance.

Communication with investors was seen as a key part of managing the level of redemptions. Howard Meaney said he considered it vital that communication with investors is improved in line with the AREF best practice guidelines. The UBS Triton Fund was undergoing modernisation to afford investors protection in time of crisis and an improvement in communication and governance through the establishment of an independent supervisory board. Graeme Rutter agreed that a lot of avoiding the problems of redemptions was communication – a huge challenge when investors see a large volume of redemption requests. Banks pointed to the need to provide more time to effect redemptions and look at alternative funding, such as gearing.

A member of the audience asked whether the panel thought communication between fund manager and investors suffered as a result of the key role of investment managers. Abbott responded by saying that he would like to see an increase in the level of communication with fund managers but that it was difficult where there were a number of clients in the same fund, all with different strategies and views.

There was also comment from the audience about the size of a funds investor base. Rutter thought that diversification of the investor base was normally a good idea but for some investors there were advantages in being in a 'club' of like-minded organisations, for example defined benefit schemes that have similar aims. However, he agreed it was possible to have too narrow an investor base.

Given that the primary market does not provide the liquidity some investors require, one member of the audience considered that more attention should be given to developing the secondary market, which also provides a true value of an investor's holdings, rather than the primary liquidity price. This is important as investors need to show fair value rather than net asset value (NAV) in their report and accounts. Rutter commented that this was not as straightforward as was being suggested since there are the problems of relying on secondary evidence from indirect property in that the traded volumes are often very low, the motivations/pressures on purchasers/vendors can produce some unreliable traded prices and there is the issue of reflecting quantum, i.e. a different price should probably be applied if an investor is looking to sell very small or very large quantities of units. The panel thought that some of the longer-term funds may well end up as investment trusts if current (out-dated) fund documentation made it impossible to treat all investors equally.

Fund governance

So would all the issues of liquidity, transparency and pricing be solved by listing? Members of the panel pointed out that this would restrict the choice of investors and that progress had been made in improving the transparency of funds, particularly open-ended ones, and may introduce greater volatility of returns. Many funds had also established independent advisory boards, although Meaney said that the members of the UBS investor board, for understandable reasons, started to act principally in their own interests at the time of crisis in the fund. The independent supervisory board is to be established to ensure the Triton fund acts in accordance with its mandate and in the best interests of investors. Banks commented that negotiating changes to a fund, such as a proposed rollover, can be a long and difficult process where different sets of investors have conflicting interests. One fund managed by Legal & General has been rolled over three times. Fortunately, the documentation allowed for the establishment of an investors' advisory committee as it would have been near impossible to get agreement to the extensions from the 100 investors acting individually.

Asked by a member of the audience about the impact of regulation on investor behaviour, fund raising and fund managers, Banks said the 'raft' of regulation (AIFMD, EMIR etc.) had imposed extra costs on investors. People understood the need for regulation but it had taken fund managers time to get up to speed, especially as the respective regulators were not themselves clear on all aspects. The regulatory environment was also challenging as much of it was not set up with real estate in mind, for example with regard to liquidity measures. Forbes pointed out that regulation affected investors and fund managers so the behaviour of the former was changing as well.

Fund management fee structures

Rutter said that one of the positive outcomes from the crisis was the change to fund management fee structures. The movement away from gross asset value to NAV as the basis for calculating base management fees had reduced the pressure on managers to use gearing. With regard to performance related fees, a significant number of post-GFC launched funds have fees that are payable on realisations rather than valuations, with a significant proportion of the fees held back until the final asset is sold, ensuring that fees are payable on the performance of the whole fund. Another development is that managers are now often required to outperform over the medium term, typically a three-year rolling period, not just for one year, and they should produce positive returns, rather than merely outperform their peers. However, where fund extensions are agreed and key terms modernised, there is a perception that investors will look to exploit an opportunity to negotiate lower fees. In practice, Rutter did not think that this was the case as there is a need to ensure that good managers are adequately compensated for delivering above target levels of risk-adjusted returns.

Better next time round?

In conclusion, the panellists were asked whether the industry would be in a 'better place' next time around. Abbott pointed out that it hadn't been doom and gloom this time round – in 2008-09 a few funds ran into difficulty but many others managed. Ultimately, if market values almost halve again, there will be problems. He felt that the changes required to ensure funds are better placed next time include reducing fund liquidity and providing more certainty as to the respective managers' strategies. Managers should also address their governance of the amount of equity coming into a fund at any time. The other panellists concurred with this view.

End of fund life: Exit this way

DEBORAH LLOYD
Nabarro

The issue of fund exits is a hot topic: over 175 funds are terminating between 2012 and 2016, with a total gross asset value (GAV) of €68.6bn[1]. This experience is new for many fund managers and investors. Managing investor expectation throughout this process has been a challenge for some fund managers. This article examines some of the common issues and raises the question: does 'end of term' really mean 'end of term'?

Key issues

Fund managers and investors need to give careful consideration to a few key factors when approaching the end of a fund term:

WHAT DO THE DOCUMENTS SAY?

The fund documentation will usually set out the timescale for implementing fund exits or extensions. Most funds include a certain amount of flexibility to allow the fund manager to extend the term of the fund. This is particularly useful when market conditions are not favourable or when a particular asset is not ready for sale.

There are usually two scenarios:

(a) For private equity closed ended funds, the fund documentation often includes a one-year extension at the fund manager's discretion. Another one-year extension may require investor or advisory board consent. If voted for, all investors stay in the fund to the end of the extended term.

(b) Other funds will allow for a vote of investors to determine if the fund should be extended. This could be for one to five or more years. This is when investors have the opportunity to renegotiate fund terms with the fund manager and those not wanting to extend have an option to exit.

Property funds are long-term investments and it is difficult to cover all eventualities in the fund documentation, say 10 years in advance. Fund managers and lawyers do not have crystal balls foretelling the future. In fact, many argue that it is better to have clear provisions on the powers to amend the fund terms than it is to be too prescriptive in setting out what should and should not be done in specific situations. In this way, should a situation arise that is not covered by the fund documentation, there is either a consultative process with the investors or, if specific powers need to be granted to the fund manager, the fund documentation can be amended without requiring unanimous consent.

IS REFINANCING AN OPTION?

In the UK, as the markets have recovered, usually refinancing is an option. However, it is not that long ago that refinancing was a critical issue, and may still be in some circumstances. Where refinancing is too expensive or, worse still, not available, assets will need to be sold, leading to a wind up of the fund.

1 INREV (European Association for Investors in Non Listed Real Estate Vehicles): **Funds Termination Study 2013**

The effect of external debt on the portfolio can be catastrophic for a fund's net asset value (NAV) in a falling market. Not only does a fund manager need to keep an eye on investors' exit requirements, it must also balance this with the term of and restrictions in bank debt secured over the fund's assets. Many bank loans include provisions that prohibit the return of equity to investors prior to the repayment of the bank loan. This may seem obvious, but some investors will expect to exit if they have not voted for an extension – as the fund documents provide for this – but the bank may require all capital from proceeds from sales to be used to repay debt.

This puts fund managers in a pickle; previously more bank debt was often the answer to repaying an exiting investor's share. Under the provisions of these new bank loans, fund managers must either find the cash to pay out the investor and the bank or find a new investor to take over the exiting investor's interest so that the fund does not breach its banking covenants.

Often the restrictions contained in the bank financing can lead fund managers to have conversations with investors about the proposed strategy going forward, whether that would be calling for more money from investors or renegotiating terms with external lenders. Where a fund is underwater, it is more likely that the bank is the main driver in the continued (or discontinued) strategy to be followed by the fund. Indeed, where this occurs often the investors' power is significantly diluted as effectively the bank takes over the running of the fund. For this reason, many investors are looking for more input via the advisory board on the terms of external financing before the fund enters it.

IS IT THE RIGHT TIME TO SELL?

In the most recent INREV fund termination study[1], 70% of respondents listed current market conditions as an issue affecting their decision to terminate a fund. This was way ahead of the second most popular consideration of quality of the portfolio.

For funds where the market conditions have changed dramatically during the life of the fund there can often be a divergence of objectives at the scheduled fund termination. Fund managers will have a fiduciary duty to achieve the best returns for the investors as a whole but must analyse how to achieve this in light of investors who wish to exit. Investors may also disagree with a fund manager's proposed investment strategy during any period of extension and it is important to maintain an open and productive dialogue with investors to seek a workable solution.

DO SOME INVESTORS NEED CASH NOW?

Individual investors' liquidity requirements are sometimes in conflict with the best interests of the fund and investors as a whole. This puts the fund manager in a difficult situation and investors in conflict with each other – as illustrated by the case study on the adjoining page.

If some investors are exiting and others continuing, pricing is a key issue. Redemption prices are usually based on NAV, less an amount representing a percentage of the costs of a hypothetical disposal of the assets. The problem here is that it is unlikely that any fund forced to sell its assets can achieve the valuation. It is widely recognised in the industry that the use of NAV as a pricing on redemption, may not be fair to remaining investors.

This means that a redeeming investor could be getting a better deal than what reality would reflect were the assets to be sold. The question for fund managers is how to fix the problem and ensure that they are acting in the best interests of all investors. There needs to be an ability for the managers to act fairly, but the ability to adjust valuations is not often provided for in the fund documentation.

Case study: Addressing conflicting investor liquidity requirements

A property fund held a partnership extension meeting in accordance with the terms and timescales set out in the fund documentation. At the meeting, the manager proposed extending the life of the fund, knowing that those who dissented had the right to exit.

The manager reasoned that in the current market there was no prospect of the investors realising their investments as this could not be achieved without a sale of assets, which would be at a substantially lower price than would be anticipated in future years. The manager accompanied its proposal with a new investment strategy for the fund and its assets.

The majority of investors considered the manager's proposal and agreed to the extension with the proviso that new review dates and a stronger role of the advisory committee were included in the amended fund terms.

However, there was one dissenting investor, holding a 6% interest, who wished to retire from the fund. There were no other investors who could take up the slack of the exiting investor. The issue for the manager was how to pay for the exiting investor's units. The exiting investor pushed for an early disposal of the best assets to allow its interests to be redeemed. But this was not in the best interests of the remaining investors. The manager looked into taking out further bank debt to cover the cost but this was not available. Eventually, the manager managed to agree a disposal strategy that worked for everyone and allowed the remaining investors to benefit from a longer period of holding the assets until a better opportunity was available to sell, while at the same time realising enough cash to pay out the exiting investor.

Process and transparency

Fund managers seem to be opening discussions with investors much earlier than even the fund documentation requires so as to fully consider the best options for the fund. Fund managers who engage with investors early are able to develop and implement a workable strategy that provides the best fit for the investors as a whole. Nevertheless, time limits set out in fund documentation must be strictly adhered to. Failure to do so may mean the fund manager is in breach of the fund terms.

EXTENSION

If the fund manager is looking to extent the fund, it must be clear about the purpose of any extension: Is the extension to effect an orderly disposal of the assets or to enable the fund manager to continue with the implementation of an asset management strategy? Prior to an extension, the fund manager should produce a new business plan to set out the vision. All myths should be dispelled that the fund manager is extending the fund to guarantee future fee income.

Often extensions of funds will involve an element of structural change to the fund. This makes for a tricky tightrope for fund managers to walk in order to achieve the best solution for all the parties. Done well, it can cement some strong relationships, even for future investments.

Changes to funds that investors seek include:

(a) **Fees and carried interest:** Fund managers' fees are usually reduced and based on NAV and not GAV. The performance fee or carry is rebased to give fund managers a new incentive to achieve the goals of the fund's strategy;

(b) **Investment strategy:** Tightened to be prescriptive on the sector, type, tenant exposure and location of assets, including a strategy on sales and exit;

(c) **Closed to open-ended:** Some funds are extending and giving liquidity windows going forward to allow redemptions;

(d) **Advisory boards:** If these do not exist, they are being established, sometimes with an independent representative;

(e) **Borrowing:** Levels reduced to 40% to 50% loan-to-value;

(f) **No-fault divorce:** Removal of the fund manager is being introduced on a 75% vote of investors; and

(g) **Key persons:** Investors like to have named individuals responsible for the fund, even from the biggest fund management houses. Advisory board consent is required for their replacement.

Fund managers have reported that the process of engaging with investors can be challenging, particularly when faced with a divergence of investor requirements. One size generally does not fit all and fund managers may be required to present strategies for asset disposals that only suit some of the investors or at least enough of the investors to make it workable.

Fund managers often use the advisory board as part of a collaborative and consultative process. In this way, investors are also given a greater feeling of influence over the strategy to be adopted by the fund and as a result more control, even if their actual rights remain the same under the fund documentation.

ENDING THE FUND

If the fund is to end, after the debt and asset strategy has been implemented, there are a number of remaining issues for the fund manager to deal with. A few of these are discussed below.

Distributions and payment of carried interest

a) Interim distributions will have been made to each investor as each asset has been sold and in accordance with the fund documentation. The fund manager will do a final calculation of the carried interest which will then usually be distributed as a capital payment or, alternatively, as a fee under the management agreement.

b) Carried interest is typically calculated on a whole fund return and paid at the end of the life of the fund. Asset by asset carried interest calculations are less common and are heavily resisted by investors (investors do not want to see fund managers overpaid as a result of early successful asset sales), even those that contain clawback provisions.

Ongoing liabilities

a) There will always be a risk of ongoing liabilities but generally a fund will have given warranties on the sale of its assets (especially if they have been sold in corporate wrappers). Buyers of the fund assets will require comfort that the entity giving warranties will not be wound up with any assets to claim against in the event of a breach of warranty. To combat this, fund documentation often contains a clawback obligation on the investors. Unsurprisingly, investors seek to limit this obligation in time and percentage amount of the distributions they received.

b) Consequently, it is usually only after the expiry of these periods that the fund vehicles can finally be audited and wound up. Keeping asset holding structures in place has cost implications. Certainly, no fund manager wants to clawback distributions made to investors in order to pay for the continued maintenance of the special purpose holding vehicles.

c) Managers are finding alternative ways to deal with the risk of ongoing liabilities. Often this may involve taking out insurance policies to protect against future claims. Others are looking into ring fencing the liabilities in a fully funded separate vehicle that is owned by the manager but has no recourse to the investors. This is considered a risky strategy from the point of view of the manager.

Liquidating trustee

a) The fund documentation may provide for the appointment of a liquidating trustee to wind up the fund. It is the liquidating trustee's role to sell the assets of the fund (if any remain), make distributions and ensure that all debts, obligations and liabilities of the fund are provided for before arranging the liquidation of the fund and striking off of any companies.

b) Winding up any UK fund vehicle is a regulated activity under the Financial Services and Markets Act 2000 and can only be done by a person authorised by the Financial Conduct Authority (FCA), which when coupled with the requirements of the Alternative Investment Fund Managers Directive (AIFMD) will usually mean that this function is performed by the authorised fund manager.

Conclusion

When people embark on new projects, the end is often the last thing on their mind. But without clear provisions on how investors can exit or how the fund is to be wound up, parties will be left confused and dissatisfied.

So does 'end of term' mean 'end of term'? Not necessarily. It is a point in time when fund managers and investors discuss the future strategy of the fund in the light of current market conditions. They can then decide the best course of action taking into account all investors' and funders' requirements.

Changes needed in the funds industry: A personal view

IAIN REID

I attended two recent events, one dealing with changes needed in the funds industry consequent on the effects of the global financial crisis (run by AREF/IPF) and the other dealing with fund terminations (run by AREF). Following these, my view is that we are adhering strongly to the Chinese proverb,

"If you want to cross the river, do it by feeling the stones."

However, I think, whether Confucius would agree or not, it is time to take a leap to the other bank!

There is some, but only very little, evidence of change or new thinking and I believe this is dangerous for the industry's health and future growth. The difficulty, I freely recognise, is for individual fund managers and investors to make sometimes radical change in isolation, even if they believe that it is right, since, by stepping out of line, it may put them and their businesses at an element of risk. The approach required, therefore, is for the industry to agree and establish codes of practice that members should adopt in their mutual long-term interest.

So what are the issues?

There has been considerable regulatory change in recent times but this does not take account of a number of issues affecting investors' judgements and choices. Many of these are cyclical in nature and will ebb and flow over time as markets advance and recede. However, there are two main areas where significant change is now overdue and essential – liquidity and governance.

LIQUIDITY

Almost all discussions on the topic centre around primary liquidity.

For institutional investors who need to be able to make tactical decisions, traditional open-ended funds can at times serve the purpose but, at times when liquidity is most in demand, they are not always able to deliver. Semi- open-ended may provide a useful and pragmatic facility but it is certainly not the panacea for short-term liquidity.

For closed-ended funds, depending upon fund terminations is not appropriate. In my view, most closed-ended funds should not have a defined life. This standard practice evolved from the opportunity fund model when funds were first created in the UK. Whilst it still makes sense to give new opportunity funds a life of five, seven or 10 years, it makes none for core or value-add funds.

I say this in full recognition of the fact that, as a fund manager, I created just such funds – the reason being that that was the only model the market would accept. Closed-ended funds should have an indefinite life with provisions, inter alia, for manager removal and a mechanism allowing the possibility of termination. This would also reduce the cost and resources expended by fund managers and investors as a result of unnecessary fund terminations.

It is also essential to recognise that the value of investors' holdings is, de facto, open market value, not net asset value. If this were so, it would greatly enhance the use of the secondary market, which, in my view, should be should be the standard source of liquidity for investors.

GOVERNANCE

All fund boards should have an independent property investment fund expert member, with prescribed responsibilities. This has been much discussed over recent years but there has been very little adoption of the principle. One notable exception is the recent announcement of this move by UBS Triton.

The failure to adopt this principle widely appears to be heavily influenced by the apparent 'indifference' of the largest investors, who are, perhaps naturally, concerned primarily with protecting their own interests, rather than those of investors as a whole. Smaller investors have insufficient muscle to make this happen. I believe this is short-sighted as it is in all investors' interests, and perhaps the largest most of all, for the fund industry to be as professional, transparent and investable as possible.

The adoption as standard of this significant change to governance practice would also aid the homogeneity and widespread acceptability of fund structures. This, in turn, would significantly ease the wider acceptance and desirable growth of the secondary market, thereby providing the short-term liquidity that is in everyone's interests.

Institutional attitudes to investment in UK residential property

PAM CRADDOCK
IPF

The IPF's annual study of institutional attitudes and investment intentions in the UK residential sector began in 2012, as a response to the call for evidence from the Sir Adrian Montague Review of the barriers to institutional investment in private rented homes. The results of the 2014 survey[1] were published by the IPF Research Programme in August and this article summarises the key findings.

As was the case in 2013, this year's research was carried out using an online questionnaire, directed at institutional investors, followed by interviews with a significant proportion of contributors in order to obtain more detailed responses to several of the questions posed. All information was provided in confidence and is reported in aggregate. Data collection took place over approximately eight weeks, concluding at the end of April 2014. Interviews were carried out during this period and over a number of weeks subsequently. In the light of the Labour Party's announcement in early May of proposed reforms to the private rented sector (PRS), contributors were asked whether these proposals affected their appetite for future investment in the sector in any way.

Some 75 organisations were invited to participate in the research, representing a range of investors comprising UK pension funds and life assurance companies, property companies, including real estate investment trusts (REITs), fund and investment managers and other financial institutions. As with previous surveys, participants represented both existing investors in the sector and those without any exposure. Responses were received from 49 organisations, although, due to issues of confidentiality, some parties declined to answer certain questions, primarily those quantifying their assets. The responses of one contributor were subsequently omitted as it is not a traditional investor in property and will ultimately dispose of its residential assets.

Profile of the respondents and current investment in residential property

The total assets under management (AUM) of the 48 respondents providing data is estimated to be over £4.8tn, of which UK real estate comprises around £200bn or around 4.2% of all investment.

Just under 80% of contributors (37) hold residential property in their UK investment portfolios, which includes student accommodation and development land. The cumulative value of UK residential investment from those respondents providing data is almost £13bn, or circa 6.3% of all UK real estate assets, with the average holding per investor being £345m. Figure 1 shows a comparison of the total AUM, real estate holdings and residential holdings by the number of survey respondents since 2012.

1 **'UK Residential Property: Institutional Attitudes and Investment Survey 2014'**, published August 2014 by the IPF Research Programme.

Figure 1: **Respondents' total assets and property under management 2012-14 (All contributors)**

		All respondents			Residential investors		
	Total	**AUM £bn[1]**	**No.**	**Real estate AUM £bn**	**No.**	**Residential assets (£bn)**	**Proportion UK real estate**
2012	42	1,299	28	180	33	7.6	4.6%
2013	44	2,904[2]	43	166	37	10.8	7.0%
2014	**48**	**4,845[3]**	**46**	**204**	**37**	**12.8**	**6.3%**

Notes:
***1** AUM are imputed: not all respondents provided data; individual returns may include an element of double-counting through indirect investment that may appear in other survey returns.*
***2** Figure based on 41 responses.*
***3** Figure based on 46 responses.*

Methods of investment and preferred asset types

Direct ownership remains the preferred method of holding residential property, with the value of those holdings representing around 58% of all residential assets. Around a half of respondents invest via joint ventures and a third of respondents use private funds. Gaining exposure via listed property company shares has limited appeal with only five investors using this route, which represents a little over 1% of total investment.

Figure 2: **Residential investment by number of respondents**

Year	**Total no. respondents**	**MR/ASTs**	**Student housing**	**Social housing**	**Development land**	**Ground rents**	**Other**
2012	28	21	11	5	15	10	6
2013	37	23	20	3	19	10	8
2014	36	23	18	7	23	8	9
2014 total (£m)	**£12,792**	**£4,389**	**£1,983**	**£369**	**£3,064**	**£1,510**	**£1,477**

Note: Examples of 'Other' types of residential asset include: serviced apartments; promotion agreements; senior living/retirement housing, shared ownership, residential care homes; debt: on student/student development and residential development; 'un-enfranchiseable' ground leases; houses in multiple occupation and statutory tenancies.

Figure 2 shows that investment in market rents/assured shorthold tenancies (ASTs) continues to be the most popular form of property for investment (at 34% of all assets in 2014). Involvement in development has increased over the year, taking up around 25% of all investment. Of the 22 contributors providing data on their development activities in 2014, the gross development value of these projects totals some £9.8bn. Over 50% of the current pipeline is earmarked for disposal, with 12 contributors intending to sell on completion and only four building exclusively to rent.

Rationale for investing in residential property

Figure 3 summarises the reasons that existing investors gave for investing in residential property in the three annual surveys. The principal rationale for investing in residential remains its returns profile, followed by development potential. Stability of income is also a major attraction. Aside from criteria specified in the survey questionnaire, contributors also identified liability matching, lower obsolescence (than offices, for example) and close correlation with inflation.

The majority of existing investors plan to increase their investment in the sector over the next 12 months, with only three expecting to reduce their exposure. The scale of new investment may exceed £5bn, subject to availability of suitable stock, across the full range of residential assets.

Figure 3: **Investment drivers for existing residential investors**

Year (no. respondents):	2012[1] (28)	2013 (34)		2014 (36)	
Factor	**Rank 1**	**Rank 1**	**Score**	**Rank 1**	**Score**
Returns profile	13	11	195	17	240
Development potential	n/a	8	179	6	196
Stability of income	3	4	175	6	187
Stability of capital values	2	1	159	1	163
Part of mixed-use portfolio	n/a	8	128	3	148
Low correlation with other asset classes	2	2	154	1	139

Note:

***1** Only four factors were suggested/proposed in the 2012 Survey*

Reasons for not investing

Eleven of the 48 participants in the 2014 survey do not currently invest in residential.

As shown in Figure 4, low income yield is still cited as the most important issue but, notwithstanding this, only two respondents have no intention of investing in the foreseeable future. From the remaining nine responses, up to £500m may be available for investment over the next three years, with the preference being for investment in student accommodation (five participants) followed by market rented/ASTs and development sites.

Figure 4: **Reasons for not investing**

Factor (no. respondents)	2012 (14)	2013 (7)	2014 (11)
Income yield too low	9	5	5
Lack of liquidity/insufficient market size	9	3	5
Reputational risk	5	3	5
Just too difficult/management issues	12	2	4
Difficulty of achieving sufficient scale	9	2	4
Political risk	4	0	4
Pricing not right	6	3	1

BARRIERS TO INVESTMENT

Planning issues and taxation (including VAT) remain of concern to both potential and existing investors.

Unprompted by any of the survey questions, around a quarter of contributors suggested a commitment **not** to intervene in the sector would be the most helpful response by government.

IMPACT OF THE LABOUR PARTY'S ANNOUNCEMENT IN MAY 2014

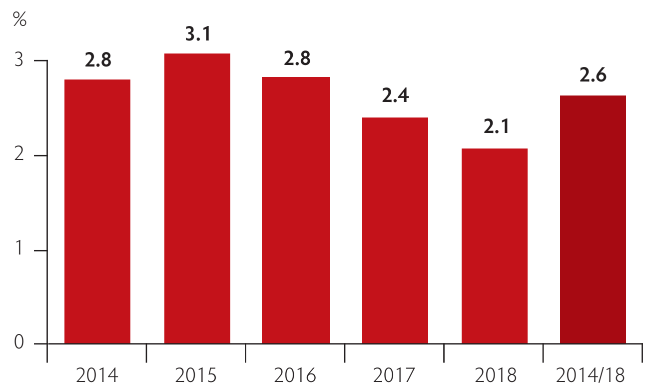
There was a mixed response to the Labour Party's suggested reforms to the private rented sector announced in May. The prospect of rent control met mainly with a negative reaction, although some responses were more pragmatic; greater security of tenure was perceived as being attractive to families and could encourage more institutional investment through greater stability and certainty of income. On balance, no strong indication emerged as to whether these proposals had impacted, adversely or otherwise, investors' attitudes or their appetite for the sector.

UK Consensus Forecasts August 2014

PAM CRADDOCK
IPF

In the three months since the last survey of forecasts, the expectations for 2014 have strengthened further with the All Property total return now predicted to achieve around 17.0% (13.7% in May). This impressive performance is driven primarily by double-digit capital growth in the office and industrial sectors, as rental growth projections remain below the long-term average of 3.1% for most of the forecast period.

Figure 1: **All Property rental value growth forecasts**

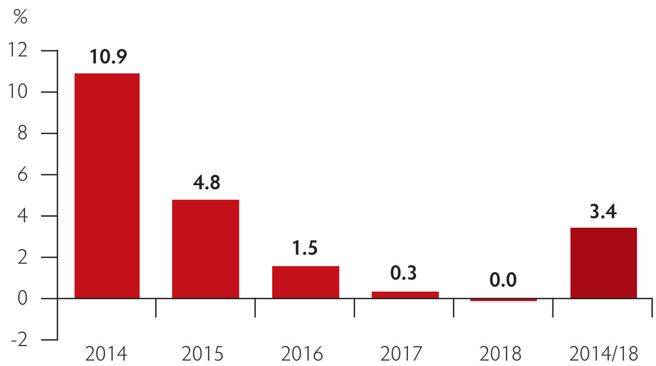


Rental value growth forecasts

The All Property rental value growth forecast has risen to 2.8%, from 2.4% in May – see Figure 1. At the sector level, Office, Industrial and Standard Retail forecast growth rates have again improved (in the case of Offices by almost 100bps) although, for Shopping Centre, expectations have slightly weakened and for Retail Warehouses forecasts are broadly flat (at 0.3% and 0.7% respectively).

The All Property rental value growth forecasts fall from 3.1% in 2015 to 2.1% in 2018. The current five-year average of 2.6% per annum is an increase on 2.3% in May 2014.

Figure 2: **All Property average capital value growth forecasts**



Capital value growth forecasts

Average capital value growth rate forecasts in 2014 have again increased for all property types, ranging between 8.1% for Shopping Centres and 15.0% for Offices. The All Property capital value growth rate has increased substantially and now stands at 10.9% (from 7.7% in May) – see Figure 2.

During the next three years, average capital value growth rates will fall back but contributors appear slightly more optimistic in their forecasts over these periods than in the last survey.

Over the five-year period, the All Property annualised capital value growth rate average is 3.4%, up from the comparable forecast of 2.6% in May 2014.

Total returns forecasts

The 2014 All Property total return forecast is now standing at 17.0% (up from from 12.1% six months ago), the main drivers being Office and Industrial growth expectations of 20.6% and 19.8% respectively (from 14.0% and 13.5% early in the year).

Forecasts diminish throughout the remainder of the survey period, with the Industrial sector likely to overtake Offices from 2016 by virtue of its higher income yield, 7.5% versus 7.0% for Offices.

The All Property five-year total return average forecast of 9.0% is exceeded only by the average forecasts of 2014 and 2015, with performance prospects falling to below 6.0% in the last two years of the survey.

Figure 3: **All Property total return forecasts**

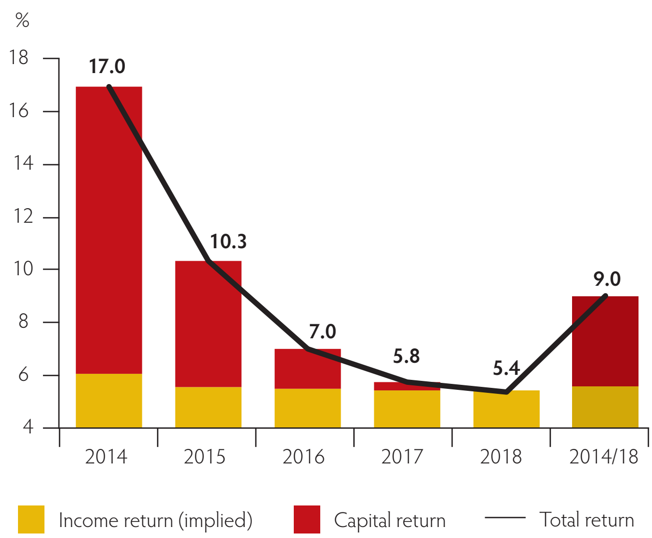


Figure 4: **Property advisors and research consultancies**

	Rental value growth %			Capital value growth %			Total return %		
13 (10) contributors[1]	2014	2015	2014/18	2014	2015	2014/18	2014	2015	2014/18
Maximum	3.6 (3.2)	3.8 (4.1)	3.0 (3.2)	12.8 (11.0)	8.0 (5.6)	7.9 (5.2)	19.3 (17.0)	14.5 (11.6)	14.1 (11.2)
Minimum	2.2 (1.9)	2.2 (2.0)	2.0 (1.9)	7.1 (4.6)	1.0 (0.8)	2.0 (1.8)	13.2 (10.4)	6.4 (6.6)	8.0 (8.0)
Range	1.4 (1.3)	1.5 (2.1)	1.0 (1.3)	5.7 (6.3)	7.0 (4.8)	5.9 (3.4)	6.1 (6.6)	8.1 (5.1)	6.1 (3.2)
Median	2.8 (2.3)	3.0 (2.9)	2.8 (2.6)	12.0 (8.2)	4.5 (4.8)	3.8 (3.6)	18.0 (14.0)	10.0 (10.3)	9.3 (9.0)
Mean	2.8 (2.4)	2.9 (2.9)	2.6 (2.6)	11.0 (7.8)	4.5 (4.2)	3.9 (3.3)	17.2 (14.0)	10.2 (9.9)	9.6 (9.0)

Figure 5: **Fund managers**

	Rental value growth %			Capital value growth %			Total return %		
15 (14) contributors[1]	2014	2015	2014/18	2014	2015	2014/18	2014	2015	2014/18
Maximum	3.8 (3.3)	4.7 (3.8)	3.9 (3.4)	14.7 (11.1)	9.1 (10.0)	5.7 (4.5)	19.6 (17.5)	14.0 (15.0)	10.9 (9.7)
Minimum	1.6 (1.5)	2.1 (1.7)	1.6 (1.2)	4.0 (2.5)	0.7 (-0.1)	0.3 (0.5)	11.0 (9.0)	5.9 (5.8)	5.9 (6.0)
Range	2.2 (1.8)	2.6 (2.1)	2.3 (2.2)	10.7 (8.6)	8.4 (10.1)	5.3 (4.0)	8.6 (8.5)	8.1 (9.2)	5.0 (3.7)
Median	2.8 (2.6)	3.1 (2.6)	2.7 (2.5)	11.7 (7.9)	4.8 (4.3)	2.8 (2.3)	17.0 (13.9)	10.6 (9.9)	8.4 (7.9)
Mean	2.9 (2.5)	3.2 (2.7)	2.7 (2.3)	10.8 (8.0)	4.9 (3.9)	2.9 (2.3)	16.7 (13.9)	10.3 (9.5)	8.3 (7.8)

Figure 6: **All forecasters**

30 (27) contributors[1]	Rental value growth % 2014	2015	2014/18	Capital value growth % 2014	2015	2014/18	Total return % 2014	2015	2014/18
Maximum	3.8 (3.3)	4.7 (4.1)	3.9 (3.4)	14.7 (11.1)	9.1 (10.0)	7.9 (5.2)	19.6 (17.5)	14.5 (15.0)	14.1 (11.2)
Minimum	1.6 (1.5)	2.1 (1.7)	1.6 (1.2)	4.0 (2.5)	0.7 (-0.1)	0.3 (-0.1)	11.0 (9.0)	5.9 (5.8)	5.9 (5.4)
Range	2.2 (1.8)	2.6 (2.3)	2.3 (2.2)	10.7 (8.6)	8.4 (10.1)	7.6 (5.3)	8.6 (8.5)	8.6 (9.2)	8.2 (5.7)
Std. Dev.	0.5 (0.5)	0.6 (0.6)	0.5 (0.6)	1.9 (2.2)	2.2 (2.2)	1.4 (1.2)	2.0 (2.3)	2.1 (2.1)	1.5 (1.2)
Median	2.8 (2.5)	3.0 (2.7)	2.7 (2.5)	11.9 (7.9)	4.8 (4.8)	3.6 (2.6)	17.6 (13.6)	10.3 (10.2)	9.0 (8.3)
Mean	2.8 (2.4)	3.1 (2.7)	2.6 (2.4)	10.9 (7.7)	4.8 (4.0)	3.4 (2.6)	17.0 (13.7)	10.3 (9.7)	9.0 (8.3)

1 Figures in brackets are those from May 2014

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 12 weeks prior to the survey date. **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 forecaster' level only. **9**. The sector figures are not analysed by contributor type; all figures are shown at the 'All forecaster' level. **10**. In the charts and tables, 'All Property' figures are for 30 contributors, while the sector forecasts are for reduced samples (26/28) of contributors.

ACKNOWLEDGEMENTS

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Property advisors (including research consultancies): BNP Paribas Real Estate, Capital Economics, CBRE, Cluttons LLP, Colliers International, Cushman & Wakefield, DTZ, Fletcher King, GVA, JLL, Knight Frank, Paul Mitchell Real Estate Consultancy Limited, Real Estate Forecasting Limited, The Lazarus Partnership.

Fund managers: Aberdeen Asset Management, Aviva Investors, AXA Real Estate, CBRE Global Investors, Cordea Savills, Cornerstone Real Estate Advisors, Deutsche Asset & Wealth Management, F&C REIT Asset Management, Keills, Knight Frank Investment Management, LaSalle Investment Management, Legal & General Property, M&G Real Estate, Standard Life Investments, TIAA Henderson Real Estate

Equity Brokers: Kempen & Co.

Note Consensus forecasts further the objective of the IPF to enhance the efficiency of the real estate investment market. The IPF is extremely grateful for the continuing support of the contributors as noted above. This publication is only possible thanks to the provision of these individual forecasts.

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

IPF European Consensus Forecasts May 2014

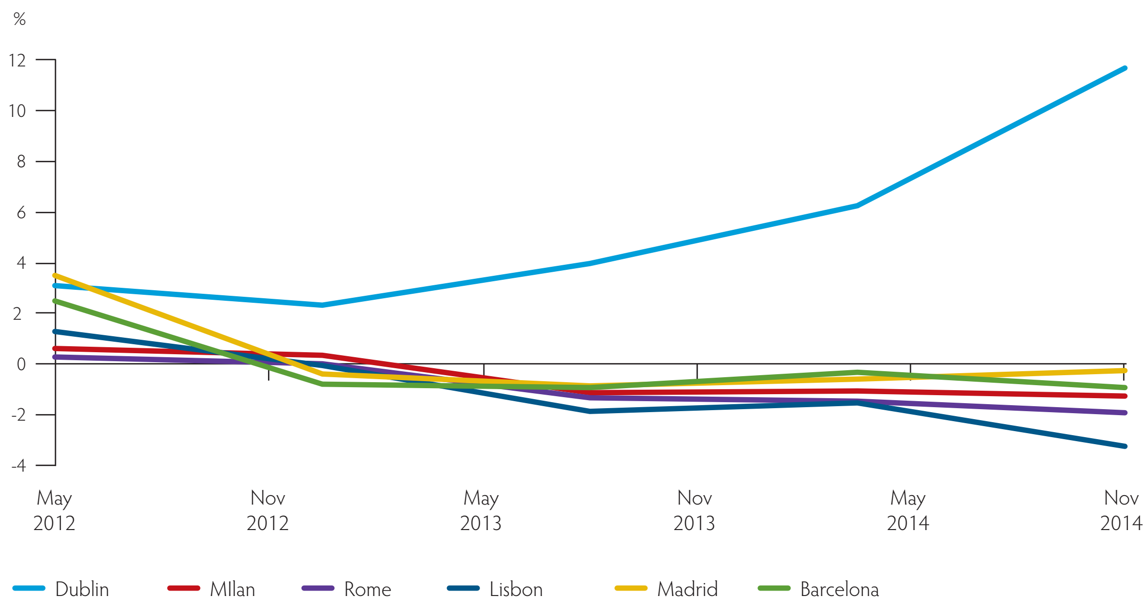
PAM CRADDOCK
IPF

The latest survey was conducted against a backdrop of weak economic recovery across the 18 countries sharing the euro. Strengthening in the German and Spanish markets (the former grew by 0.8% in Q1) was offset by disappointing news from the other major economies of France and Italy, with the latter's GDP contracting along with those of the Netherlands and Portugal.

2014 forecasts

As previously identified, the location expected to show the highest rental growth remains Dublin, with an average annual projection of 11.7% (against 5.4% in November for the current year, and higher also than 2013's 9.8%). The Irish capital is followed by London's West End and City (albeit at relatively modest rates of 7.7% and 7.3% respectively). Beyond these locations, however, growth markets prospects decline substantially with a group of nine centres, led by Oslo at 2.6%, recording projected average growth above 1.0%.

Figure 1: **Weighted rental growth forecasts 2014 – peripheral (PIIGS) economies**



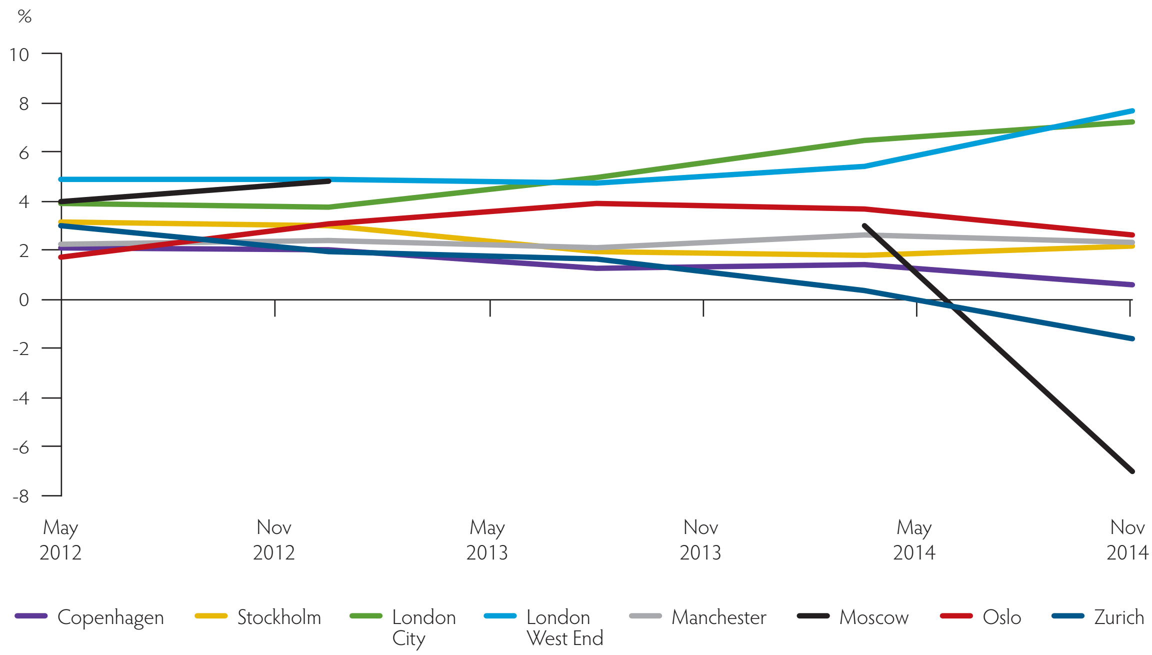
Of the 12 office locations predicted to decline in 2014, Moscow (-7.0%) and Paris La Défense (-5.5%) are the weakest forecasts, whilst most of the more fragile peripheral economies are expected to struggle, as illustrated in Figure 1.

Whilst the current year is expected to be an improvement on 2013 in most markets, growth projections for 2014 have weakened over the last six months in 21 locations, nine of them falling back by more than

1.0%. In only two centres have growth prospects increased by more than 1.0% in this period – Dublin and London's West End, at 11.7% and 7.7% respectively. In terms of the spread of average growth rates across all centres, the range has increased again, to 18.7% from 16.2% in November. In the case of Moscow, the span between individual forecasters is a substantial 26.1%. In the final quarter of 2013 the Moscow market experienced strong take up but a similar level of development completions and, thus, the balance of negative forecasts is understandable.

In eastern Europe, the outlook for the Warsaw, Prague and Budapest markets is improving; although none is expected to return to positive growth in the current year, rents are bottoming out (from -2.7% for Warsaw and -1.3% for Prague to -0.6% for Budapest). In the Polish capital, despite high take-up in 2013, net absorption has been low, with a significant development pipeline likely to maintain vacancy rates above 10%.

Figure 2: **Weighted average rental growth forecasts 2014 – non-eurozone centres**



Turning to those centres within the eurozone predicted to deliver positive returns, after Dublin, the highest expectations lie within the Germany markets, ranging from 2.5% for Munich to 1.1% for Hamburg, where economic factors are beginning to have a positive impact on real estate markets. Lyon, Helsinki, Amsterdam, Vienna, Brussels and Luxembourg make up the remaining locations, with only Lyon and Helsinki expected to exceed 1% growth.

Outside the eurozone, prospects for growth have continued to weaken in most locations, with Moscow, as previously mentioned, expected to show a dramatic decline (see Figure 2). The two central London markets continue to move ahead. By comparison, in Stockholm, the only other location where projections are rising, rents may achieve a 2.2% growth, whereas Oslo and Manchester have both seen a fall in prospects but are still predicted to grow by 2.6% and 2.3% respectively.

Outlook for 2015 and 2016

The rolling average growth rates point to a recovery to positive growth in most markets in the shorter term, although four of the three-year average forecasts may remain negative, with Paris and Moscow greater than -1.0%. However, since the last survey, 10 forecasts have improved by more than 1.0% in this six-month period, including both sets of Italian and Spanish office locations. Rises of more than

2.0% on average demonstrate a significant reversal of previous consensus views on the weakest centres, which had been dominated by southern peripheral eurozone locations. Of these, only Lisbon is expected to deliver negative growth over three years (at a forecast average of -0.5% per annum).

In absolute terms, of the 25 markets expected to deliver positive growth, only four (Zurich, Prague, Warsaw and Milan) may produced less than -1.0% average growth, with a further 11 expected to grow between 1.0% and 2.0% annually over the three years. This leaves 10 locations where annual rates of between 2.3% (Frankfurt) and 8.2% (Dublin) are predicted.

Five-year average forecasts

Looking out to 2018, the five-year forecasts are positive for all 29 centres covered by the survey. Average growth rates in eight markets have strengthened by more than 1.0% since November, led by Rome at 3.8% (reversing a five-year average forecast in decline, from -3.2% to 0.6% per annum). Of the 13 locations where average forecasts exceed 2.0% per annum, Madrid (4.5%) and Barcelona (2.9%) are also present in this group, attracting increased confidence as their economic prospects improve. Unsurprisingly, given strong growth expectations in individually forecast years, Dublin and central London occupy the remaining three of the four leading positions (at 5.8%, 4.6% and 4.0% per annum respectively), followed by Barcelona.

ACKNOWLEDGEMENTS

IPF thanks all participants in the survey for contributing rental data to the May 2014 European Consensus Forecasts, including the following organisations:

Aberdeen Asset Management, Aviva Investors, AXA Real Estate, CBRE, CBRE Global Investors, CoStar Portfolio Strategy, Cushman & Wakefield, Danish Property Federation, DTZ, Grosvenor, Invesco, JLL, LaSalle Investment Management, Paul Mitchell Real Estate Consultancy Limited, Standard Life Investments and TIAA Henderson Real Estate.

Notes At present the IPF European Consensus Forecasts survey focuses on office rental value growth in major cities. It is not possible currently to assemble sufficient forecasts of all sectors across all European countries to produce a meaningful consensus of views, although our ambition is to extend and improve the scope of the survey.

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 insufficient to permit publication, as fewer than five forecasts were received for each sector/territory. We aim to produce a full release of this data at a future date, once the number of responses has grown sufficiently.

The data This latest survey collected prime office rental forecasts for 30 centres for the calendar years 2014, 2015 and 2016. We request a three-year average forecast for 2014-2016 where individual years are not available as well as a five-year average for 2014-2018. The survey requested both the percentage annual rental growth rates and also the year-end rent levels. The growth forecasts provided by each organisation are analysed to provide weighted average ('consensus') figures for each market. Figures are only aggregated and reported for office markets for which a minimum of five contributions are received.

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. This report is based on contributions from 16 different organisations (fund management houses and property advisors).

Consensus forecasts further the objective of the Investment Property Forum to enhance the understanding and efficiency of the property market. The IPF is extremely grateful for the support those organisations that contribute to this publication, which is only possible thanks to the provision of individual forecasts.

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

Contributors receive a 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.

ESOS is here!

PAUL MCNAMARA
IPF

Following consultations that took place between June and October last year, the government launched its Energy Savings Opportunity Scheme (ESOS) on 17 July 2014. This represents the UK's implementation of Article 8 (4-6) of the EU Energy Efficiency Directive, 2012 which requires all large enterprises to carry out independent energy audits every four years using qualified and accredited experts.

Who is affected?

ESOS applies to any undertakings outside the public sector, including not-for-profit organisations, which meet one of the following criteria:

- It has 250 employees or more;
- It has fewer than 250 employees but has an annual turnover exceeding €50m and a balance sheet exceeding €43m; or
- It is part of a corporate where at least one member of the UK group meets the definition of a large undertaking described above.

In the UK, qualifying organisations will only be released from the requirement to undertake such an energy audit if they have been awarded ISO 50001 (which relates to energy management systems). Any such organisation is only required to notify the Environment Agency of its compliance with ESOS.

What needs to be done?

The first step for any undertaking in the ESOS process is to determine whether it qualifies for the scheme and, if so, to notify the scheme administrator of the fact. The scheme administrator for ESOS in the UK is the Environment Agency.

Notification needs to occur by 31 December 2014 with the first energy audit needing to take place by 5 December 2015.

The required audits include the following.

- The appointment of a 'lead energy assessor' from an approved professional body to oversee the ESOS Assessment.
- The measurement of the total energy consumed by the enterprise in its buildings, industrial processes and transport.
- The identification of areas of significant energy consumption (i.e. accounting for at least 90% of the enterprise's total energy consumption in the UK).

- The identification of cost-effective energy efficiency recommendations for those areas of significant energy consumption.
- The reporting of compliance with ESOS to the Environment Agency after the required energy assessment has been completed and reviewed at least by a board-level director and approved by the lead energy assessor.

It should be noted that ESOS relates to the energy supplied to and consumed by a qualifying undertaking. So, landlords can deduct the energy or fuel they supply to tenants from their own measurement of energy consumption either through use of meters or estimates based on verifiable inputs.

In the first phase of ESOS, energy auditing activities as far back as December 2011 can be used to support compliance. Furthermore, energy assessments carried out as part of a valid display energy certificate (DEC) in conjunction with the Green Deal are deemed compliant with ESOS requirements for the buildings they cover and, as such, can contribute to compliance with ESOS.

Firms that fail to register by the time required can be fined between £5,000 and £50,000. Fines also apply to qualifying organisations that fail to maintain adequate records to demonstrate compliance with ESOS or fail to undertake an ESOS assessment.

Costs and potential savings

There is no requirement for boards of qualifying undertakings to act on ESOS audit findings. However, the government expects the identification of cost-effective efficiency recommendations in areas of significant energy consumption to lead to action. It calculates that, if ESOS leads businesses to cut energy consumption by only 0.7%, approximately £1.6bn of benefits can be realised nationwide, mostly through reduced energy bills.

While it acknowledges the costs and benefits relating to ESOS audits will vary between organisations, government estimates that the average cost of an ESOS audit at £6,600 will be matched by average related savings per enterprise of around £35,400. There will be no requirement for enterprises to publicly disclose their ESOS results.

Chairman of IPF’s Sustainability Special Interest Group, Miles Keeping of Deloitte, notes that:

“This is not just a matter of regulatory compliance. ESOS might encourage large organisations to consider their energy footprints, more fully review energy consumption and identify opportunities to reduce costs and drive efficiencies.”

For full details about ESOS, visit www.gov.uk/energy-savings-opportunity-scheme-esos#about-esos

Forum Activities and Announcements

IPF Executive

Cheryl Collins and Lois Fidler left the IPF in August, the former to become a 'Stop Smoking' advisor and the latter to realise her dream of travelling round the world.

We are delighted to welcome two new members of staff in their stead: Cormac Watters takes over Cheryl's role as Membership Co-ordinator and Robbin Mackey takes over from Lois as our new Seminar Co-ordinator.

Cormac Watters

Robbin Mackey

Board changes

At the Annual General meeting, Max Sinclair of Wells Fargo Bank International succeeded Andrew Smith as Chairman of the IPF. Chris Ireland of JLL is now Max's Vice-chairman.

Max Sinclair and Chris Ireland at the IPF Annual Dinner

IPF OPERATIONAL BOARD MEMBERS 2014-15

Max Sinclair, Wells Fargo Bank International (Chairman)
Chris Ireland, JLL (Vice-chairman)
Christopher Carter Keall, Oxford Properties
Ciaran Carvalho, Nabarro
Sue Forster, IPF (Chief Executive)
Philip Ingman, Ingman Capital Partners (Honorary Treasurer)
Miles Keeping, Deloitte Real Estate
Julia Martin, JLL
Kitty Patmore, DRC Capital
Gary Sherwin, Land Securities
Mike Tremayne, Cushman & Wakefield

Midlands Board

James Cubitt of Colliers International takes over as IPF Midlands Chairman from Tim Hurdiss of Larkstoke Properties in October.

James Cubitt

IPF Annual Dinner

The IPF's Annual Dinner took place on Tuesday, 24 June at the Grosvenor House, London W1. The after-dinner speaker was Alexander Armstrong. Despite confirmation on the night of England's failure to progress beyond the group stage in the World Cup, a good time was had by all.

Alexander Armstrong

IPF Midlands Lunch

The IPF Midlands Lunch took place on 2 May at the ICC, Birmingham. Guest speaker Francis Salway gave his take on the future opportunities and challenges for the UK property investment market.


Tim Hurdiss, Francis Salway and Andrew Smith

IPF 25th Anniversary celebrations

The Scottish and Midlands boards organised celebratory members' events to mark the IPF's 25th Anniversary on 6 March in Glasgow and 18 June in Birmingham respectively. These follow the special events in London and Manchester in late 2013.


Sue Forster with members of the Midlands Board at the 25th Anniversary party in Birmingham

Dates for the diary

SEMINAR, DRINKS RECEPTION AND DINNER

The Roxburghe, Edinburgh on Wednesday, 3 September

Seminar: "The Glasgow Commonwealth Games – Property Development and Legacy"

MIPIM UK

Olympia, London on Wednesday to Friday, 15-17 October

Details and booking: www.mipimuk.co.uk

IPF seminar: **'A new property cycle, the same again?'** is on Thursday, 16 October, 12:00-12:45

MIDLANDS ANNUAL DINNER

ICC, Birmingham on Thursday, 16 October

Guest speaker: Hugh Dennis **SOLD OUT**

NORTHERN ANNUAL DINNER

Lowry Hotel, Manchester on Thursday, 13 November

Guest speaker: Dave Spikey

Tickets: £80+VAT each

Contact: Barbara Hobbs; bhobbs@ipf.org.uk

IPD/IPF UK PROPERTY INVESTMENT CONFERENCE

Grand Hotel, Brighton on Thursday and Friday, 20-21 November

IPD clients and IPF members: £1,600 +VAT (excluding accommodation)

Details: www.ipd.com/events/ipdipf-property-investment-conference.html

Contact: events@ipd.com

ANNUAL LUNCH

Hilton Park Lane, London on Friday, 30 January

Guest speaker: tbc
Opening for booking shortly

Investment Education Programme (IEP)

The 2013-14 Programme has been running since October and the last module in this year's timetable, 'Portfolio Management', takes place on 21-23 September.

To find out more about the IEP in 2014-15, go to the IPF website or that of the University of Cambridge Institute of Continuing Education; www.ice.ac.uk/investment

IPF Investment Property Forum

Northern Dinner 2014

Thursday 13 November 2014

The Lowry Hotel
50 Dearmans Place, Chapel Wharf,
Salford, Manchester M3 5LH

19:00 Pre-dinner drinks
19:30 Dinner

Black Tie

For more information or to book, please contact Barbara Hobbs on 020 7194 7924 or email bhobbs@ipf.org.uk

After Dinner Speaker:
Dave Spikey

Ticket price: £80 +VAT

(£96 inclusive of VAT @ 20% per person)

The ticket price includes pre-dinner drinks reception together with a half bottle of wine per person with dinner

This event is kindly sponsored by:

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