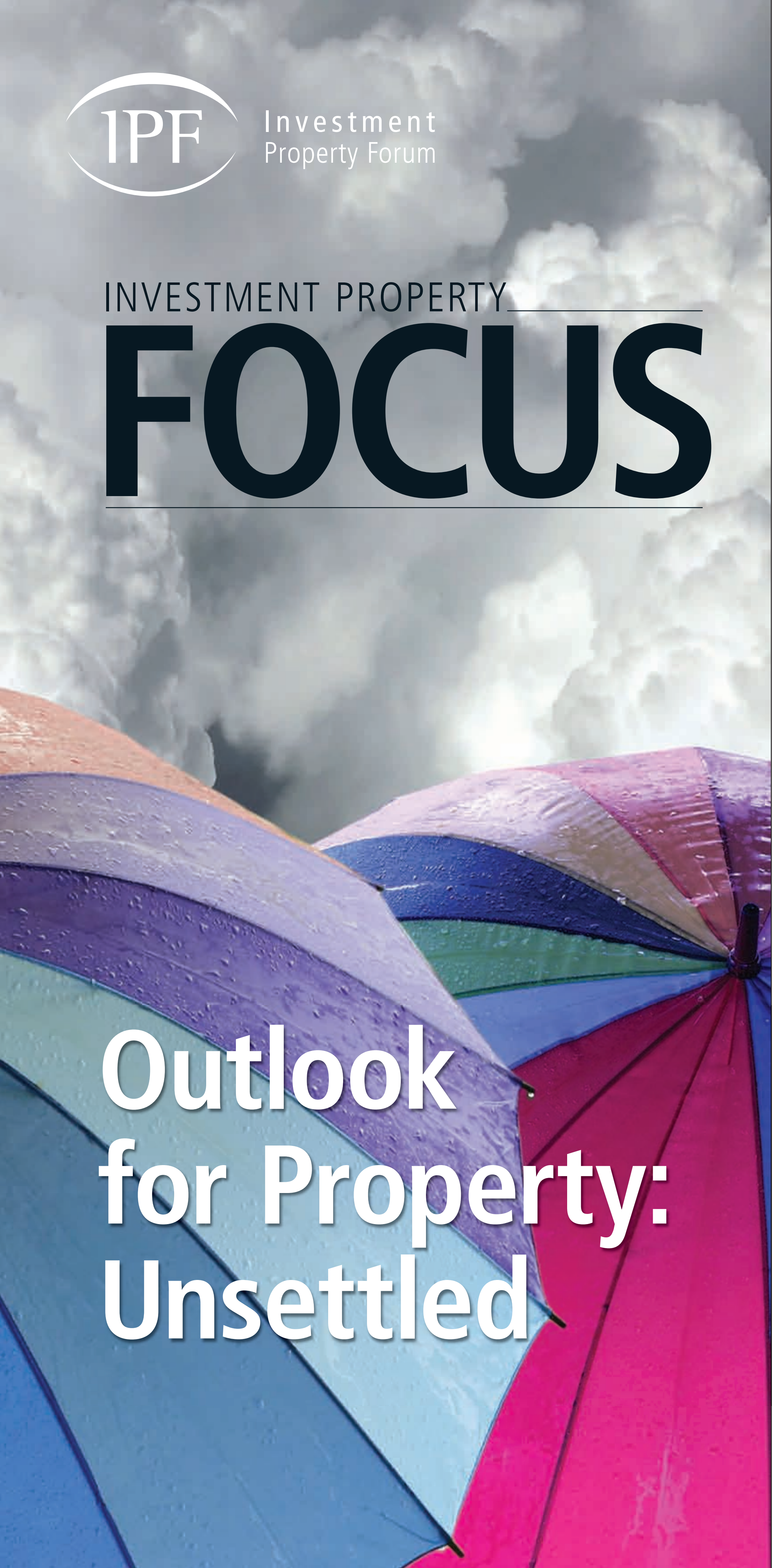

IPF Investment Property Forum

INVESTMENT PROPERTY FOCUS

Outlook for Property: Unsettled

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In this issue:

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From the editor

Sue Forster, Executive Director, IPF

We appear to have moved off the bottom of the market for the time being at least – the IPD UK Quarterly Property Index to the end of September shows positive rental growth in all three main sectors for the first time since Q2 2007.

Whether we are heading for a further dip remains uncertain, but there is broad agreement that the occupational market has been weakening. Malcolm Frodsham of IPD looks at whether the income stream from commercial property is measurably less secure in this downturn compared to those previously. He concludes that that a much higher proportion of assets will experience significant income falls this time around and that property investors should be revising risk premiums upwards. So by how much should the risk premium increase? Gerry Blundell points out that although the long-term risk premium for property over gilts is around 3%, the fluctuation has been quite dramatic. He argues that with the structural changes in the property market, such as shorter leases, there is no guarantee that property will retain its historic bond/equity hybrid status but could become more akin to an equity, with the resultant impact on the risk premium.

Anne-Marie Lusty of Berwin Leighton Paisner reports on the continuing lack of debt availability in Europe. To date there has been very little formal loan enforcement but she thinks this could change, given the positive signs of recovery in Germany and other stronger eurozone economies. Even when development finance becomes available again, Bill Gloyn of Jardine Lloyd Thompson raises the spectre of not being able to redevelop above a certain height in further areas of Central London, thanks to the impact of the London Plan linked London Views Management Framework. He suggests that the replacement basis for insuring affected buildings may be entirely wrong.

Christopher Brigstocke of Hammonds provides a timely update on the CRC Energy Efficiency Scheme (CRC) in terms of who it will affect and how. He looks at the challenges this presents to the property industry, particularly given that the Government believes that CRC will lead to the development of a collaborative approach to energy saving between landlords and tenants.

If the current problems in the direct property market were not enough, the EU draft Directive on Alternative Investment Fund Managers (AIFM), could increase dramatically the regulatory burden on property funds. Rob Moulton of Nabarro explains the implications of the Directive, which comes into force in 2011.

Oliver Lovat of Aberdare Thistle outlines the findings of his research amongst both advisors to UK investors and investors themselves as to the attractions of the German retail sector over the last few years. Many investors were attracted initially by the prospects of being able to increase income through active management, which have not necessarily been realised. Nevertheless, he concludes that there are far worse places and sectors to have invested over the timescale.

The October 2009 IPF survey of IFAs shows that there is more optimism about commercial property prospects, with a significant drop in the number of IFAs recommending no allocation to property.

The latest transaction volume figures for Europe, produced by Real Capital Analytics are also included in this edition.

If there are any subjects you think we should be covering in the March/April 2010 edition, please contact me.

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Repricing property risk

Gerry Blundell

This article is taken from the research report soon to be published under the IPF Research Programme Short Paper series.

By June 2007, a high water mark for property optimism, the initial yield on UK property had fallen to 4.6%, 70bps below gilt yields and the lowest level since IPD's records began in 1981. Even allowing for anticipated income growth at the time, yields of 4.6% probably implied a property risk premium of only 1% to 2%. This compares with a long run average risk premium that fluctuates around the 3% mark (see Box 1). Since then, events have conspired to drive gilt and property yields apart so that now a gap of nearly 4% has opened up. What sort of risk premium does this imply and how far might it contract as confidence returns to the market?

Box 1: The long term risk premium

The risk premium is the extra return investors require to be persuaded to transfer their funds from risk-free assets such as cash or government bonds to a riskier form of exposure such as property. Its size (spread) will reflect a range of factors; liquidity, expected earnings growth, default probability etc. The property risk premium has been variously estimated over the years as typically fluctuating in the 2% to 3% range, depending on the state of the market.

An estimate of the long term risk premium, and hence its average past level, can be derived by looking at past return data to property and bonds. Setting aside the vagaries of yield impact over the long run, the risk premium will equate to the initial yield plus net income growth less an allowance for depreciation. Over the 1981-2008 period, IPD records the following average values:

Component	%
All property initial yield	6.4
Plus income growth	6.3
Less depreciation	2.5
Less gilt yields	7.3
Risk premium	**2.9%**

However the evidence suggests that the risk premium fluctuates significantly around 3% depending how expectations for income growth inflation and other factors vary.

Figure 1 sets out a fairly conventional analysis of prospective long run returns from yields current at the time of drafting (October 2009). Because it tries to take a long-term view over the next 15 years, it makes no allowance for yield shift. So total expected return is the balance of current yield plus expected inflation and real income growth in the asset class (if any) less all costs. The analysis takes a fairly jaundiced view of property's costs relative to gilts, allowing a full 2.5% for property depreciation and 0.5% for equity dilution, arguably both have upside risk going forward. It also reflects short term pessimism about rental growth although it omits 2009.

The results show that despite the rise in yield since 2007 property still looks unattractive against gilts with a prospective risk premium after all costs of less than 2% over gilts, compared with a required margin of 3.6%, suggested by the latest IPF survey of IFAs. On this basis, initial yields need to rise by over

Figure 1: Long-term returns at current yields (October 2009)

Component	Cash %	Index-linked Gilts[1] %	Fixed[1] %	UK property %	FTSE All Share %
Yield	0.5	1.0	3.9	7.9[2]	3.4
Expected Inflation linked growth	0.0	2.9	0.0	2.9	2.9
Real income growth	0.0	0.0	0.0	-1.5[4]	2.5[4]
(less costs, depreciation, dilution)	-0.1	-0.1	-0.1	-4.0[3]	-1.2[5]
TOTAL	**0.4**	**3.8**	**3.8**	**5.3**	**7.6**

Notes: **1** approximately 15-year duration **2** IPD Monthly Initial Yield Aug 09 **3** 40 bps management + 250 bps depreciation + 110 transaction costs at 15% rotation pa. **4** Based on consensus forecasts 2010-13 then 1981-2008 real trend for next 10 years **5** Includes 50 bps for dilution, 25 bps management, 45 bps transaction costs assuming a modest 50% rotation pa

1% and/or income growth prospects improve. By the same token, UK equities look over-priced too, requiring a further 1% on yields or a similar improvement in earnings prospects.

But markets' perception of fair value varies through time as appetite for risk waxes and wanes. All else is rarely held constant. Since March, index-linked and conventional gilt yields have fallen, making the estimation of a 'fair value' yield difficult. Estimates of property's appropriate return margin over gilts have varied from as low as 1% to the heights of 5%. Because analyses like Figure 1 are frozen at one point in time, it is difficult to account for changing conditions so what can past data on the risk free rate, rental growth and yields tell us?

Fluctuations in fair value

There are a wide variety of ways of interpreting past data to estimate how fair value fluctuates. No one way has a monopoly of insight and indeed a diversity of approaches helps to maintain a liquid market. Box 2 sets out a simplistic econometric approach and a method borrowed from equities.

Both methods suggest that investors' required margin over gilts will fluctuate as income expectations vary. Both approaches also point strongly to continuing rises in initial yields this year towards 9%. While yields did indeed rise over the earlier part of

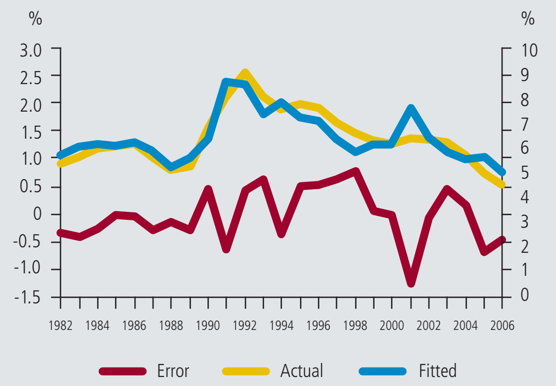
Box 2: Fluctuations in fair value

Econometric approach

Outlined below is a simple exercise to 'explain' initial yields from the IPD Annual Universe in terms of trends in index-linked gilt yields (risk-free rate) inflation and rental growth (proxy for expected income growth).

Using 1982-2006 data, the model 'predicted' initial yields of 5.1% at 2006, much higher than the actual outturn of 4.6%, suggesting that at the end 2006 property was overpriced. When a term was introduced to reflect investor optimism, the 2006 error was eliminated and the model's performance improved. Given current conditions (15-year index-linked yields at 1.0%, 2009 inflation heading for -1% and the IPF consensus rental change of -10%) it predicts initial yields of 8.6%, a big increase on the IPD Universe's outturn for end 2008 of 6.8%, but still a bit below the fair value level inferred from the IPF IFA survey.

Figure 5: The proportion of property assets experiencing a fall in rent passing



However, yields rarely stop at fair value – there is a tendency to overshoot. In the simple model used, the average error was +/-55 bps, a variance that was reduced by introducing a sentiment variable. We could, on the strength of this, easily see initial yields rising through 2010 to 9% before stabilising.

Schiller's Cyclically Adjusted P/E

This analysis has been developed as a measure of fundamental value in the US equity market by Robert Schiller of Yale. Past earnings are adjusted for inflation and then expressed as a 10-year trailing average. When divided into market value they provide an inflation adjusted P/E, or year's purchase (YP). This average is then compared to the century long average of 10-year averages to measure over or under valuation in the US and other equity markets. Since its introduction a number of value style equity investors have adopted it as a guide to market over and under pricing.

Although only having 27 years of income, the same approach was applied to the UK IPD data. At the end of 2007, the Schiller YP for the IPD Universe was 68 years, suggesting a +50% overvaluation at that time. Income returns would have to rise from 4.6% (end 2007) to 8.8% to return to fair value. With -26% capital returns in 2008 the Schiller YP fell to 47 years, suggesting the market was still a third overvalued but well on its way towards fair value. To get the Schiller ratio back to its long-term average, yields will need to rise to above 9% in 2010.

the year, since the summer they have started to fall. We have seen similar falls in other assets' yields, the common factor is surplus liquidity. Property's recent fall in yields therefore does not reflect an improvement in fundamentals and may well be reversed.

However, all this analysis is based on past trends and the past frequently belies the future. We are likely to see property's risk premium rise for a variety of reasons so the traditional 2% to 3% range may not be sufficient for asset allocators. Put another way, as property market conditions return to normal it is possible that yields will not fall back towards their historic mean. There are a number of sources of uncertainty and risk that are endemic in markets that were not present for much of the past series on which long-term averages are based.

Leverage

The level of debt in real estate is at record levels, De Montfort estimates a total loan book of £200bn to a commercial property universe that is probably not in excess of £500bn. Gearing at, say, at least 40% must increase the risk premium compared with what was a relatively ungeared asset over most of the 1981-2008 period. Even if they do not have debt attached, the comparables process of valuation will transmit the shock of forced sales to unleveraged stock valuations.

Changes in lease structure

Shortening lease lengths and the slow unpicking of the upwards-only review clause are likely to increase risk premia as the owner is more frequently exposed to the possibility of market rental falls. The average lease length for most of the 1981-2008 period was 10 or more years. Looking forward it is unlikely to be much more than five. This effectively doubles releasing risk for which investors will, or should, require additional return, depending on the strength of the leasing market. This is likely to cause a divergence between prime and secondary stock yields, but overall could well push risk premia up by 25bps. On the other hand the increasing prevalence of RPI linked leases could well offset this trend.

Climate change

Carbon related regulations, and related taxation, will increase the rate of depreciation. Anxiety about the uncertain impact of CO_2 regulations will raise perceived risk about the asset class and will raise yields. This again will have an uneven influence across the market depending on location (flood risk) and the value of land as a proportion of total value.

Conclusion

On a conservative basis, structural factors could see long-run risk premia rising by 100 bps. So when and if average yields begin to fall again they may not do so as much as some are hoping, or as might be estimated from time series analysis and econometric forecasts.

Shorter leases, leverage and taxation issues will all serve to move property away from its historic bond/equity hybrid status towards appearing to investors as more like an equity, albeit a high yield one. When our investors are polled in 2010 it will be interesting to see if any difference then remains between required equity and property returns.

How robust is rental income?

Malcolm Frodsham, Research Director, IPD

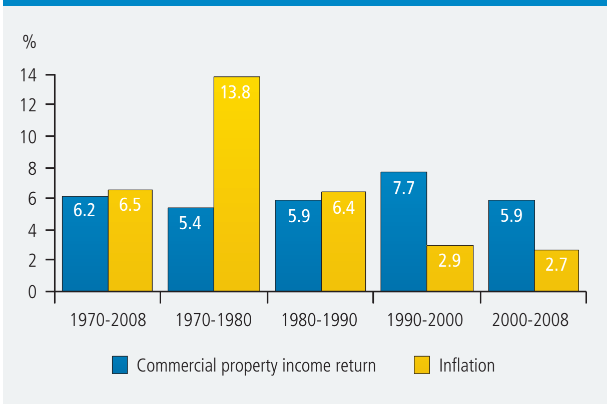
This article was taken from the research report published recently under the IPF Research Programme Short Paper series.

Long-term investment in commercial real estate is underpinned by a secure income stream. In part, this security is driven by continuing tenant demand for space but lease terms also enhance the security of income. However, as lease lengths have shortened significantly, there has been an inevitable increase in rental income volatility, both at the aggregated market level but more significantly on individual assets.

As a result, we can expect to see a much faster reduction in the actual income received by investors now than that experienced in the last major rental downswing of the early 1990s. Moreover, the income that owners receive on their assets and that secure the loans made by lenders to property will also be less protected on the downside on individual assets.

Commercial property has a proven long-term record of delivering a stable income return to investors. Over the period since 1970, this income return has averaged 6.2% pa, just below the average inflation rate of 6.5%. Indeed the income return has been more stable than inflation levels, as shown in Figure 1.

Figure 1: Commercial property annual income returns and inflation

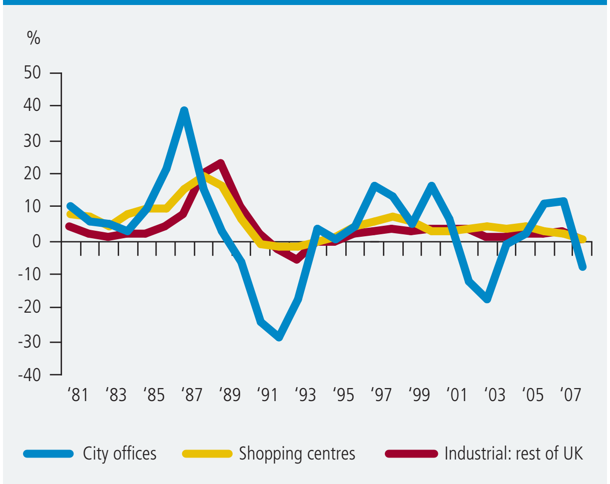


Rental value volatility

The volatility of rental values is determined by the fluctuations in tenant demand, which are strongly correlated to the business cycle, and availability, which is related to building cycles (which are themselves a lagged, often exaggerated, response to rising rental values).

The investment characteristics of property assets therefore varies across categories of assets, differentiated by use class, location and building condition in accordance with the nature of demand and supply over time. For sectors where demand is more volatile and building cycles more pronounced, rental values are generally more cyclical. This is underlined in Figure 2, which shows changes in rental value in the City of London office market, compared to the less volatile regional industrials and shopping centres sub-sectors.

Figure 2: Rental value change by category of asset



Rental values for individual assets are also affected by two additional factors. First, the relative utility of the location can improve or be marginalised. Second, the physical characteristics of the asset will deteriorate over time and diminish further the utility of the building and, thereby, its rental value. These characteristics are not just a deterioration of the physical structure, but also the aesthetic look of the building; its compliance with current law (such as compliance with accessibility for the disabled) and functional layout.

The aggregate figures conceal is a wide range of rental value change rates for individual assets within categories of assets. For example, over the 10 years from 1998 to 2008, the volatility of individual shopping centre rental value change varied on average by 3.2% pa, compared to 1.6% pa on regional industrials, even though the average volatility of shopping centre rental value growth was below that of regional industrials.

The stabilising influence of lease terms

The result of a lease is to generate a pattern of investor income that is more stable than the underlying pattern of estimated market rental value change, as shown in Figure 3. The volatility of market average income change, 3.8%, is half that of rental value change, 7.4%, and this ratio is lower the more volatile the rental value change of a category.

Figure 3: The average changes in net income and rental value

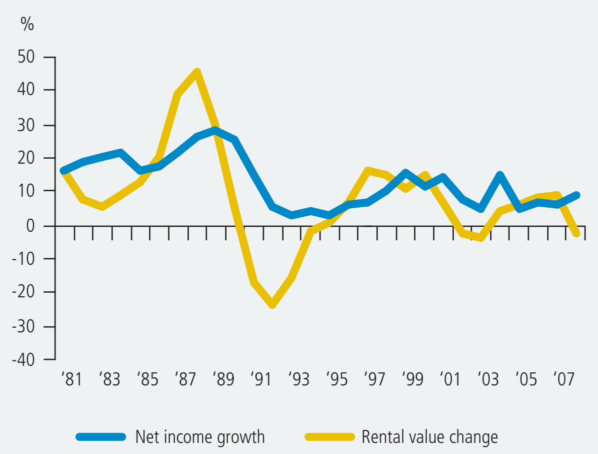
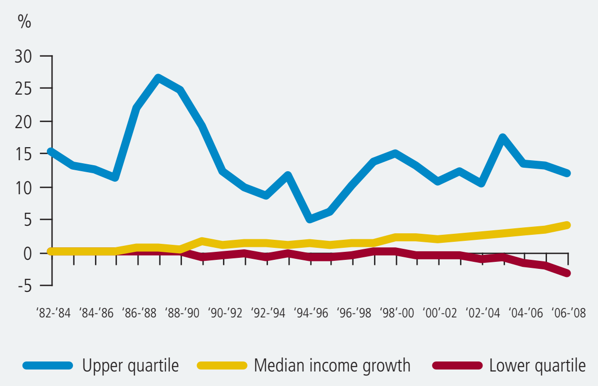


Figure 4: The inter-quartile range of net income change across individual assets



The smoothing effect of commonly-used lease conditions on the rental income profile is emphasised in Figure 4. This shows that during the period 1982 to 1990 the income change on more than 75% of assets was consistently positive and even during the early 1990s, when the occupier market was weak and rental values were falling, only a small minority of assets experienced falling income.

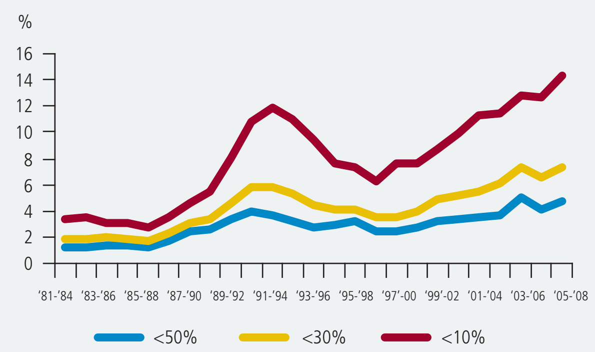
So how robust is the income from property today?

As lease lengths have shortened, the income stream from real estate has become less protected on the downside. Furthermore, the upside potential to property income is lower in this cycle than going into the last downturn. This is because the upswing in market rental values was much more muted than the surge in rents in the years preceding the early 1990s downturn. In 1991 (the first year of the rental slump), average rental values were still 58% higher than 1986: so leases on a 5-year rent review pattern with a rent review in 1991 would still have been due a large uplift. This compares with average rental values in 2008 that were only 12.8% higher than those in 2003.

The combination of the leasing characteristics and the strong preceding growth in market rental values meant that over the four years from 1990 to 1994 there was positive net income change on all UK commercial real estate in every year, despite a fall in market rental values of -27%. The shorter average unexpired lease term and weaker preceding growth in market rental values in this cycle would create a starkly different outcome in actual income for the same fall in market rental values.

Indeed the reduced robustness in income is already detectable when looking at the data on individual assets from a potential bank lender's perspective. Figure 5 shows the proportion of assets experiencing a fall in rent passing over rolling 3-year periods in terms of the proportion of individual assets that would have breached typical interest cover levels of 1.5, 1.3 and 1.1. The exact analysis was based upon annual rent passing at the end of the year and excluded assets currently vacant.

Figure 5: The proportion of property assets experiencing a fall in rent passing



Over each of the 3-year rolling periods from end 2003 to end 2008, there was already a higher proportion of assets experiencing falls in rent passing greater than in the trough of the last major rental downturn in each of our three chosen income fall thresholds. This shows that the income stream is already less secure than during the deepest falls in rental values in the early 1990s, at every level of interest cover.

Lease expiries and break profiles

To gauge how far income levels will fall in the current downturn requires an analysis of the upward and downward influences on income looking forward – see Figure 6. Column A in the table documents the expiry profile of rent passing and shows that nearly -15.2% of rent passing is directly at risk from a lease expiry or the exercising of a break clause over the next three years. Of course a proportion of these leases will be renewed and not all the breaks will be exercised but for those leases affected, the rent at renewal or re-letting will be marked to existing rental values. In aggregate, the estimated rental value of these units, +14.4% (Column B), is below the current rent passing in Column A.

However, as discussed above, the upwards influence on rents includes the collection of existing reversionary potential from rental values that have risen in the upswing but not yet collected at review. In total, as at the end of December 2008, the gap between the current rent passing and market rental values is estimated to be +6.0% (Column C). In addition some units that have been let recently are within a rent free incentive period so there is a further +2.5% uplift in income when they move up to the agreed rent (Column D). The largest potential uplift to income comes from the letting of current vacant units, including development nearing completion. These units could potentially add a further +12.2% to total income (Column E). The total potential average upward movement in income is therefore 19.8% (Column F).

The current downturn: A projection

The Strutt & Parker / IPD Lease Events Review suggests that the long-term lease renewal rate for UK commercial property is 35%, based on an IPD All Property 11-year average, weighted by ERV, and long-term propensity of tenants to break of 27%. Based on the following assumptions:

(i) a replication of the average historical renewal rate;

(ii) that current vacancies either remain vacant or contribute no income change due to a long rent-free period upon letting;

(iii) all reversion is lost due to significant rental value falls; and

(iv) 1% of income is lost due to tenant default;

average income would fall by 4.2% over the next three years.

A very wide possible range of outcomes could be calculated using an alternative set of assumptions! What can be predicted with certainty is that a much higher proportion of assets will experience significant income falls than in previous downturns.

Figure 6: The future income potential of UK commercial property

	Subtract	Add				Total
	A Non-renewal or break exercised	B Re-letting of expired tenancies	D Expiry of rent free period	C Reversions at rent review & steps	E Assumed letting of vacancies & developments	F Total potential rental income
	%	%	%	%	%	
O/due	-1.1	+1.0	+0.0	+1.2	–	**101.2**
2009	-4.8	+4.5	+2.0	+2.3	+4.4	**109.6**
2010	-4.3	+4.1	+0.4	+1.7	+5.2	**116.6**
2011	-5.0	+4.8	+0.1	+0.8	+2.6	**119.8**
Total	**-15.2**	**+14.4**	**+2.5**	**+6.0**	**+12.2**	**19.8%**

Source: IPD estimate

However, there is a very wide range of market income changes that can be projected from these figures. The letting of current vacancies is a particularly large source of uncertainty given that the potential income is large but the deeper the occupier market downturn the longer these units will take to lease, the longer the likely incentive periods given to tenants and the lower the ultimate letting rent.

Of course the vast majority of rent is still secured by current leases that are not subject to renewal or a break in the next three years. However, there is the increasing risk that some of these tenants will default.

This should lead to an upward revision in the risk premium demanded from the asset by investors and on the 'margin' demanded by lenders. Ultimately, this could affect percentage allocations made to property by multi-asset investors.

EU AIFM Directive – implications for the property sector

Rob Moulton, Partner, Nabarro LLP

Ever since May's publication by the European Commission of the draft Directive on Alternative Investment Fund Managers (AIFM), commentators have been queuing up to attack the Directive. Ill-advised, poorly drafted, and impractical are just some of the accusations. So what does the Directive really mean for the property sector?

Background to the Directive

There are a number of factors driving the Commission's proposal, and understanding them is the key to understanding the likely implications of the Directive. First, there is a view that the alternative investment industry, in particular hedge funds, may have contributed to the global economic crisis. Second, following the Madoff scandal, there is a view that European investors are not always as well protected as they should be when investing in alternative asset structures. Third, the offshore funds industry has long been a source of concern for some, and a preference for the tax transparency of onshore structures is certainly one element in play, and, fourth, the activities of the private equity industry, in particular, seem to be mainly political hot potatoes in some European countries.

Out of this rather explosive political mix came a Directive which was unlikely to satisfy either side of the debate – increasing the regulatory burden on funds led to howls of complaint in the UK – failing to regulate offshore funds directly led to equally loud complaints from MEPs.

The key proposals

The managers of alternative investment funds (AIFs) must be authorised if funds under management exceed €100m (this figure is increased to €500m for non-leveraged funds with at least a five year lock-in). That does give rise to at least two questions.

First, what is an AIF? The property industry had certainly been hoping that a redraft of the Directive would include some sensible exemptions, in particular in the listed sector. It is now clear that no such exemptions are to be granted. Indeed, using the current definition, most corporate structures look like AIFs, and anything currently treated as a collective investment scheme (CIS) in the UK will be caught (limited partnership vehicles, unit trust structures, etc.) and a working assumption must be that (despite earlier statements from the Commission) REITs and all investment trusts will be caught.

Second, what amounts to management? On a property fund it could be a number of different parties – the fund manager, the asset manager, the property manager, and so on. There was certainly a push from the Swedish presidency to make sure that only one AIFM needs to be authorised for each fund. Instead of appointing an operator of a fund, it is likely that a vehicle will need to appoint an AIFM who will delegate responsibility to third parties that need to carry on other functions. It is also possible that self-managed structures will be caught, so that, for example, an investment trust might itself, in the personality of its trustees, be the AIFM. Where local requirements (such as Luxembourg FCPs) are concerned, local law may need to change to enable boards to delegate responsibility to a central AIFM, rather than each board of each FCP having to become separately authorised.

The implications for Channel Island structures are also not yet fully clear. It is likely that a Jersey unit trust (JUT) that had an offshore manager would be outside the scope of the Directive – that means that the benefit of a passport (on which see more below) would not be available. However, where an EU manager was involved, the JUT would need to delegate effective control to the onshore manager.

Marketing

One major step forward in the Directive is the provision of a cross-border passport to market certain funds to professional investors within the EU. This area of the Directive has proved particularly politically charged. It is likely that passports will only be available for EU-based vehicles (despite a broader passport being contained in the first draft of the Directive). Where a passport is not available there will be no improvement to the current system of national private placement regimes. However, rumours that non-EU funds might be closed to EU investors are likely to prove to be greatly exaggerated.

Valuation and Custody

The Madoff influence is very clear in these measures. Funds must benefit from independent valuation (which has long been a feature of property funds) and third-party custody by an EU bank (which is not the case at the moment). Again, it is hoped that greater flexibility is to be granted in the next draft of the Directive to enable assets to be housed by, for example, the general partner of a limited partnership structure, or for non-banks to be permitted to provide certain types of custody service. But it is likely that existing structures will need to be reviewed.

What next?

The Directive remains a work in progress and the Swedish presidency has now accepted reluctantly that a political compromise will not be agreed before the end of the year. It is therefore likely to be the Summer of 2010 before the Directive finally is approved, under the Spanish presidency. Existing property structures will need to be scrutinised over the course of 2010 to make sure that they remain compliant when the Directive comes into force in 2011.

Can you reinstate buildings in Central London?

There are a number of current proposals, including changes to the London Plan, the Thames Estuary flood protection plan for the next 90 years and the proposed Floods and Water Bill, that could have a serious impact on the commercial property market in Central London. However, it was during a detailed study of the London Plan linked London Views Management Framework (LVMF) documents that I had a revelation: Insurance for commercial property has been arranged on the wrong basis for all the 45 years that I have been in the business!

In essence, the LVMF is calling for a widening of the view corridors in which buildings cannot be built over a certain height; one which interferes with the view of certain strategically important buildings from specified vantage points. Mayor Boris Johnson's proposals not only widen the corridors set by his predecessor, they also add new corridors and protect the backdrop behind the protected buildings.

From a property development viewpoint, this means that many elderly buildings, previously destined for redevelopment when the time is right, cannot now be realistically redeveloped. Why? Because the planning guidance will not allow any existing building that breaches the regulation to be replaced by anything other than a building which complies with them. That is not all. Any building in the shadow of an existing offending building cannot be replaced either as it is a stated objective of the LVMF that offending buildings must be removed over time. That means that those that cannot be seen at present, being hidden, are still subject to the restrictions.

Development will also be stifled because many existing buildings earmarked for redevelopment are already close to the maximum permitted height. I am reliably advised that any financially realistic replacement would have to be at least 50% bigger to create sufficient additional income to make the expenditure feasible.

Ok – that all makes sense. But why is the basis of insurance wrong?

Looking at leases, funding agreements and just about every other property-related contract, one party will have an obligation to insure the building for reinstatement value. That is designed to repair or, in the event of extreme damage, to replace the building back to a condition similar to that prior to the damage. Well-crafted policies will also provide a measure of protection against the additional costs incurred in complying with any changes required by relevant authorities – fire protection, building regulations and alike. The policy will also cover loss of rent for a set period, one supposed to be adequate for repair work to be completed and for the tenant to resume payment of the rent, which is otherwise suspended.

Bill Gloyn, Partner, Real Estate, Jardine Lloyd Thompson and President, City Property Association

However, if the building cannot be totally replaced, being one that offends the LVMF requirements, either present or future, there will be serious consequences.
Fundamentally, the investment value of the property will reduce to reflect the income that can be achieved by whatever can be built. The owner would have failed in the obligation to reinstate the property and the tenant will have every right to walk away. In those circumstances, although the tenant will not have to pay rent, it will have to bear substantial cost in relocating premises and suffering financial loss until the business recovers. The business interruption insurance arranged by tenants is normally for a far shorter period than the loss of rent cover – perhaps for as little as 12 months. Inability to return to the old property could well prove disastrous, even if cheaper premises can be found elsewhere, as it will be some time before the final planning situation will be determined, during which both owner and tenant will be kept in a state of animated suspension.

In fact, under the 2007 Lease Code, it is possible that the tenant will be able to terminate the lease as soon as it is realised that reinstatement will not be allowed. The previous rent will be history and a new rent will be set for any replacement building at market levels current at the time. To add to the property owners' woes, it is certain that the terms of any finance agreement will also be breached.

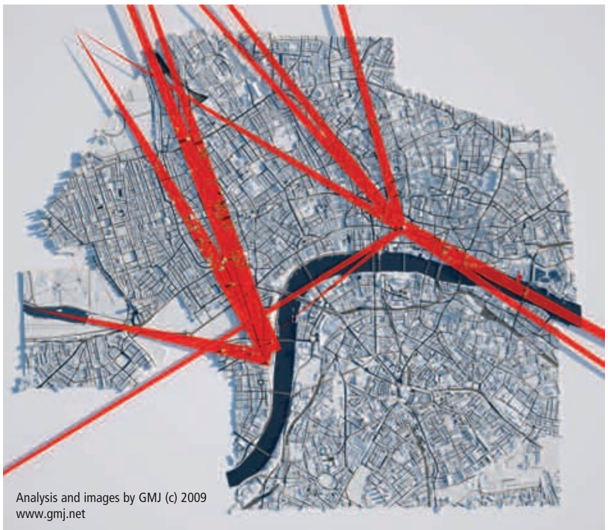
True, the insurance claim for loss of rent should continue at pre-damage levels for the set indemnity period, but this is normally between three and five years. When the claims payments are finished, there will be a reduced income at best and possibly none if the reinstatement has not been completed or the new building remains empty. To add further insult, the owner will be responsible for empty rates and other maintenance costs until a tenant is found. It is quite possible that these will not be covered under a normal policy.

The failure in the insurance cover results from it being based on reinstatement rather than investment value. The rationale for this is the assumption that the value of the land cannot be damaged. However, the LMVF manages to do just that – at least for offending buildings.

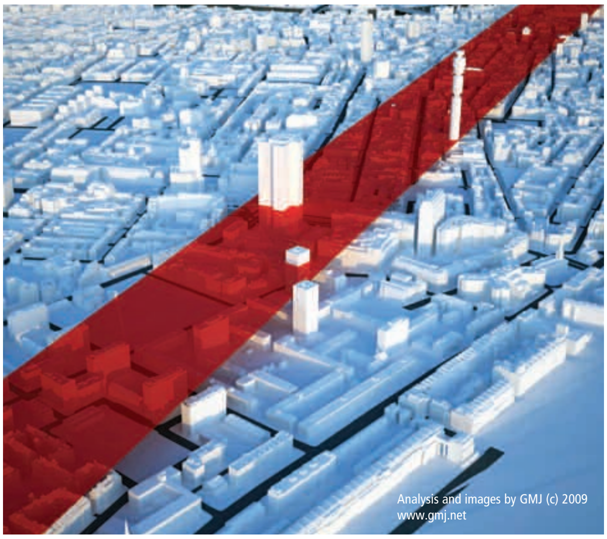
Number of buildings at risk

Jardine Lloyd Thompson has been working with architectural consultants GMJ, who have indentified some 90 buildings in Central London that are at risk. There could be many more because the new proposals appear to give a degree of discretion to the Mayor to determine that other buildings, in addition to the key ones, i.e. St Paul's Cathedral, the Palace of Westminster and the Tower of London, might need to be protected. This proposal, together with the point that no distinction is made between a building demolished by choice rather than a result of

Proposed new Protected Vistas in the draft 2009 LVMF Document. The red cones are the projected thresholds that cannot be breached by any new development.



Detail of one of these protected vistas. Here it is clear to see some existing buildings breaching the threshold.



some accident or act of terrorism, forms part of the objection to the changes put forward by the City Property Association.

Whether those objections, voiced by many, will cause the Mayor to change his mind remains to be seen. The response to the consultation, which closed on 30 September, may not be made public for some time.

What can property owners do?

What can an affected property owner do in terms of arranging adequate insurance? At first sight, the simple solution is to arrange the cover with an adequate sum insured with the policy conditions reflecting that total reinstatement might not be possible, with an element of the claim relating to the loss of investment value. At present, with low construction costs and investment values based on historic passing rents, that will mean an increase in sum insured. It should be noted that any increase in premium due to such an adjustment to the cover is not likely to be recoverable from the tenant as the insurance covenant in the lease is merely to cover for reinstatement value. The difference will therefore be a non-recoverable cost to the owner.

Furthermore, being paid out for the reinstatement cost of what can be built, together with the difference in investment value between the previous and new buildings, may not be what the interested parties want at all. To start with, the investment value at the time of the loss may not be anything like that at the time the property was purchased or a loan secured. A payment on this basis would leave all interested parties out of pocket. Perhaps a better option would be to maintain the income stream from the property at existing levels for a much longer period than normal. The cover would be structured to deduct any rent achieved from the new property, which might well be less than a pro-rata of the damaged building, from the amount paid by the insurers. At least this would allow the debt to be serviced until values pick up again so allowing the property to be sold with little or no loss to anyone. Due to the complexity of the situation, deciding on the most appropriate basis of cover will require a greater input of intellectual capital than is normally expended on insurance issues.

Having considered the exposures of some properties to the LVMF risk, it is likely that similar deficiencies in the insurance cover may apply to other buildings. It is clear that the new RICS Valuation Information Paper considering sustainability issues will have an effect on commercial properties. In this context, flood and other climate change risks will have to be taken into account in future valuations as will the likely availability of insurance to protect the investor and funder.

Added impact of the potential removal of flood insurance

The fact that flood insurance remains available today is due partially to the agreement (the Statement of Principles) between the Association of British Insurers and government, which was revised last year in the aftermath of the 2007 floods that cost the insurance market some £3bn in claims.

In response to the Pitt Report on the 2007 floods, the government has published the Flood and Water Bill, currently in draft form. There is now widespread concern that the Bill may not proceed in its current form because of the shortage of public funds to support the investment in flood defence infrastructure that Sir Michael Pitt demanded. It remains to be seen if the insurance industry will be comfortable with a 'watered-down' version of the legislation. If insurers are not satisfied with what is planned, it must be expected that further restrictions in cover will result.

The LVMF related risk will arise if an existing building is damaged, by whatever cause, and the planners decide that a replacement is not acceptable due to flood risk. This might be perceived as being much higher than when the property was first built, not least of all because of the greater understanding of the problems of surface water and drainage related floods. In those circumstances it will again be not only the reinstatement value of the property that is at risk. If a smaller or even no replacement building will be allowed, the investment value will also be threatened.

This is just one more example of why the traditional method of insurance, widely required by contracts, may not be adequate. Not all properties will be affected by either the LVMF or floods, but more attention must be given to insurance in future if the cover is going to provide adequate and appropriate protection to those at risk – owners, funders and occupiers.

European distressed real estate

Current market conditions, and projections, for European distressed real estate were under the microscope at a seminar in June hosted by Berwin Leighton Paisner (BLP) for European real estate investors, lawyers, and other professionals. A review and update of the issues discussed was carried out recently amongst BLP's European preferred firms' network.

The seminar and subsequent review confirmed that loan to value ratios are still under water as capital values have fallen, putting more loans at risk of default. Banks are not selling non-performing loans/underlying real estate to any great degree. Coupled with this the lack of available debt has reduced the number of buyers. Sellers (including forced sellers) do not want to bring property to market where there is no market, and lack of sales means accurate pricing to sell/buy has been more difficult. Debt and valuation have therefore been the key causes of transactional paralysis to date.

Market activity

The market correction in the UK, following the fourth quarter of 2008, was far more dramatic and severe than elsewhere in Europe.

Across Europe there has been, until relatively recently, little transactional activity over £50m lot sizes. This is due to illiquidity – specifically, the lack of debt. In such a thin market, sellers, even on a forced basis, are reluctant to bring property to market. Interest rates are at historic lows and there is a lack of attractive return from asset classes into which to put realisations.

The disconnect between what buyers are willing to pay and the price at which sellers are prepared to sell has paralysed the market. However, things appear to be changing. In the UK, buyers are looking for debt finance from the (forced) selling bank and there is a more pro-active approach to packaging up assets for sale (to protect capital value and reduce transaction times), whether by buying in title insurance, or looking for ways to improve the improve the asset. Market sentiment suggests that the market for UK prime property has bottomed out and that the banks still in the real estate market are willing to assume higher debt exposure, which in turn is unlocking transactional activity in Europe.

What are banks doing with defaulting real estate loans?

Formal enforcement has not occurred to the extent expected. It seems most European countries are seeing more informal management of problem loans, keeping down the amount of distressed real estate that might otherwise be traded.

In the UK, banks have avoided calling defaults and enforcing security – crystallising losses could deter investors and fuel demands from regulators to raise fresh capital. Loan defaults such as those relating to interest cover ratio (ICR) or loan to value (LTV), where the debt is still being serviced, are largely being managed through renegotiation or extension of facilities for a fee. Where enforcement is happening:

- Lower value stock is being sold, whether by public auction (mainly tertiary stock) or privately.
- Banks are thinking differently than in the last recession where they exited at any price at the bottom of the market and then saw buyers taking the upside when the market recovered. If restructuring is not deemed to be an option, a 'hold' strategy may be appropriate, whether by the bank or a joint venture, to protect future upside. Banks buying in distressed real estate assets (directly or using a subsidiary) are reducing the number of assets that would otherwise be traded. This is happening not just in the UK, although elsewhere in Europe the process generally takes longer and may be less attractive for balance sheet reasons, for example in Germany.

Anne-Marie Lusty, Principal Knowledge Development Lawyer, Berwin Leighton Paisner LLP

In France, ICR/LTV breaches are occurring but again formal enforcement has not been common. This is due partly to the perceptions around the (relatively inflexible) enforcement regime, and also the lack of market for the assets. A similar perceived lack of formal loan enforcement has also been seen in Germany and the Netherlands. However, this may be set to change given the positive signs of recovery in Germany, as in other stronger eurozone economies.

The UK has a flexible insolvency regime, relatively benign to senior lenders. The Netherlands also has a flexible regime, though the official dealing will (the case with most European jurisdictions) have its costs paid in priority to the senior lender (not the case in the UK).

Other European jurisdictions are generally court-based and more rigid, and offer little control, as a result, to the senior lender, over the official/disposal proceeds: a further disincentive to selling out. France's relatively recently introduced Sauvegard procedure (similar to Chapter 11) affects enforcement – the process can last anything from 6 to 18 months.

More property groups have expanded, around Europe, so there is now a multi-jurisdictional element to enforcement. Whether enforcement results in 'forum shopping' for the most beneficial insolvency regime remains to be seen. It may be possible, following the relatively recent introduction of the European concept of COMI (Centre of Main Interest), since the COMI is established at the time of enforcement. There are tactics in play here; senior lenders will benefit from a COMI in the UK, junior lenders may not.

Are things changing?

Across Europe, falling rents and a weakening leasing market equals reduced rental growth, with the resultant impact on capital values. This trend is set to continue in those European countries not yet seeing positive economic growth. Here, pressure on occupiers is expected to increase; continuing to service loans where rental income drops may accelerate problem loans, forcing more assets to market. By contrast, some of the stronger eurozone economies, such as Germany, are beginning to see signs of increased rental growth (on prime property), and positive economic growth. In prime office markets, tighter supply conditions and a better economic outlook have led to the bottoming out of prime rents.

European corporates, requiring liquidity in an illiquid market, are now looking to sale and leasebacks of real estate assets, to unlock capital. This is made easier when many real estate assets are currently held on a depreciated historic cost for accounting purposes.

Currency shifts mean that the UK is now more attractive to investors, despite falling capital values, so it seems inevitable that investment activity will pick up more quickly here than elsewhere in Europe. There are signs of increased transactional activity, though the lack of debt funding fuels fears that, in the UK market at least, it may lead to a 'W' rather than 'V' shaped recovery. September's eurozone figures, released by the European Central Bank, saw the first year-on-year fall in bank lending to the private sector.

We are now seeing investors looking to buy into senior parts of capital structures in CMBS at a discount, where the underlying cash flow remains strong - offering investors good risk-adjusted returns. For more experienced investors, there may be opportunities to acquire junior pieces in the CMBS capital structure, if priced on an interest-only basis, though careful due diligence here is essential.

Behind the scenes activity between Government and the banks on assets qualifying for the Asset Protection Scheme may also impact on the volume brought to market. Affected banks with Irish subsidiaries may be able to use the National Asset Management Agency (NAMA), set up by the Irish Government, for distressed Irish property loans. It is thought around 27% of the portfolio potentially within NAMA comprises around 27% of UK-based assets.

UK investment in German retail – short or long term?

Oliver Lovat, Aberdare Thistle

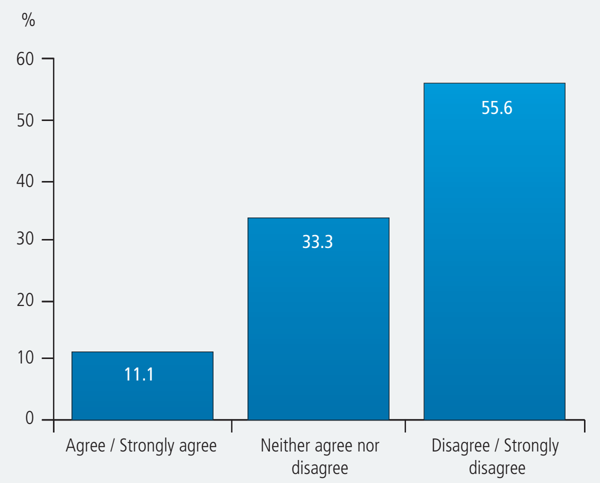
In the first half of this year, I carried out research amongst both advisors to UK investors and investors themselves with an interest in retail assets in Germany. The purpose of the research was to identify the drivers for this investment over the last three years and to identify any issues that could have a long term impact on UK investment in this sector.

The research was conducted by means of an online questionnaire sent to advisors and in-depth, face-to-face interviews with investors. Responses were received from 18 advisors, 14 of which are based in Germany and the remainder in the UK. Two thirds of these individuals were based in firms employing more than 50 people and over 60% focused only on the German market. The 15 investors who participated represented a wide range of backgrounds and had differing structures and remits, i.e. seven were private equity, three were from quoted property companies and the remainder were institutional.

Investment strategy

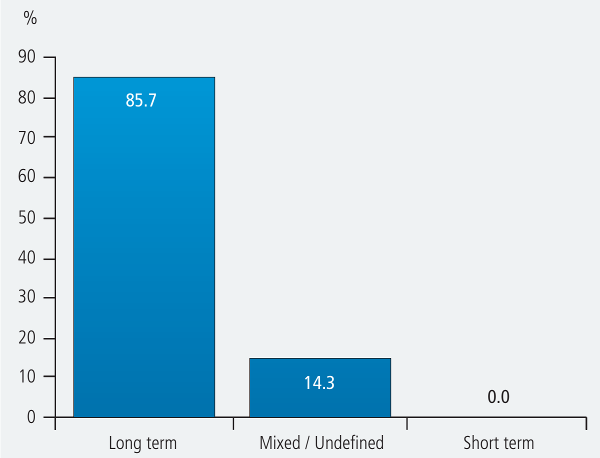
Investors were asked how their investment strategy employed in Germany compared to previous strategies used in other countries, to which 80% said that they had adopted the same strategy as used before. UK investors relied on two key factors in the development of their strategies, namely leveraging and asset management, and the effectiveness of the investments made in this time depend on how well these are managed.

Figure I: Advisors' responses to the question, "Were UK investors from 2005-08 investing for the long-term?"



When asked if the investments purchased between 2005 and 2008 were for the long term, over 50% of the advisors said that they were not – see Figure 1. In contrast, over 80% of the investors believed that they were long-term investors in Germany, as shown on Figure 2. Part of this discrepancy may be explained because no definition was given of long-term investment, and was left to the respondent to interpret this. Furthermore, it is likely that there was a revaluation of investment strategies during this period in the light of the very different economic and financial conditions.

Figure 2: Investors' responses to the question "When you began investing in Germany, did you believe that you were a long-term investor?"



Current requirements – debt and asset management

Debt management

Many UK investment strategies were opportunistic in nature and only possible by the dual characteristics of low lending rates (in relation to income yields) and high LTV ratios.

Like a slow-swinging axe incrementally sliding downwards, investors are now facing the requirement to refinance their assets. As is well documented, many loans originating between 2005 and 2008, (the period of much of the UK investment in Germany) coincided with the most prolific phase of CMBS issuance. In 2010-12, large tranches of this will require refinancing, but the CMBS market is currently very small. Indeed obtaining any debt in the present market, particularly for existing projects or for refinancing, where there is no existing relationship, is proving difficult.

The relationship between bank and borrower is proving very interesting. Breaches in LTV ratios are effectively ignored as long as loan repayments are made and lenders are being particularly focused, not just on the asset(s) in question, but on the track record of the borrower. How this will play out in coming years is not certain, suffice to say that it is unlikely that writing off debt and assuming ownership of assets from clients, are not at this stage anyway, key components of bank strategy!

Fortunately for lenders, the monetary policy employed across Europe has left the net cost of money, for those able to refinance, relatively unchanged, albeit with the margins increasing as much as 200bps and increased amortisation. At present, it seems borrowers are happy to accept terms where the period of the debt can be extended in the hope of a recovery of values.

Asset management

Many investors when forming their initial investment plans perceived Germany as offering opportunities to drive up income through active asset management. However, anecdotal evidence obtained in interviews found that the performance of the asset managers in Germany was disappointing, with the German arms of international agencies being less effective than their UK/US colleagues in undertaking this activity.

In part, this has been rectified by a renewed focus on this sector by the larger agents. More interesting is the move by private equity investors (such as River Securities), who have made significant investment in the asset class, to create their own asset management vehicles and not only manage their own stock but also compete with the established advisory firms in bidding for, and winning, third party mandates. It remains to be seen how the international advisory firms react to the successes of the 'client, turned advisor model'.

Short-term or long-term investment?

As noted, while over 80% of the investors interviewed believed they were long-term investors, nearly 60% thought that other firms investing in Germany had a short-term investment strategy. This inconsistency may well be the result of changing economic circumstances as investors' original short-term gambit of exploiting market disequilibrium in a highly liquid market has by default become a long-term investment with no apparent exit. Of course, in the long run, this will have great implications for funds relying on exit projections to meet IRR targets, many of whom will fail to meet their projections.

One of the advantages of portfolios built during this period is that some lending models preferred portfolios containing a number of assets, thereby reducing the risk of default. This risk strategy, where implemented, has enabled investors to maintain a solid cash flow, particularly given more active asset management.

As one respondent alluded, there are a lot of worse places to have invested. However, there will be no quick exit for UK investors who invested in Germany.

The CRC Energy Efficiency Scheme – your questions answered

Christopher Brigstocke, Partner, Hammonds LLP and member of the IPF Sustainability Special Interest Group

What is the CRC Energy Efficiency Scheme?

The CRC Energy Efficiency Scheme (CRC) (which was until recently simply known as the Carbon Reduction Commitment) is a mandatory emissions trading scheme that aims to improve energy efficiency and reduce the amount of carbon dioxide (CO_2) emitted in the UK. It is designed to tackle CO_2 emissions not already covered by Government regulation (such as those covered by the EU Emissions Trading Scheme or Climate Change Agreements) and is a key component of the Government's strategy to achieve an 80% reduction in net CO_2 emissions (against the 1990 baseline) by 2050 as enshrined in the Climate Change Act 2008 (CCA). The CCA contains the enabling powers for the introduction of trading schemes relating to greenhouse gases and the CRC will be the first such scheme introduced under these new powers.

Who will it affect?

The scheme applies to large commercial and public sector bodies whose total annual half hourly metered electricity consumption in 2008 was a minimum of 6,000 MWh. This is broadly equivalent to an electricity bill of approximately £750,000. Subsidiary organisations and their parents will be grouped together for the purposes of the scheme and the highest parent organisation will be responsible for the compliance of the group. Franchisors will be responsible for their franchisees and local authorities will be responsible for the schools they fund.

It is estimated that between 4,000 and 5,000 organisations will qualify for the scheme and these are likely to be the large retailers, hotel chains, banks, local authorities, universities etc. Some of the larger property companies will also be caught as will a number of institutional landlords. Organisations who had one half-hourly meter during the qualification period but whose energy consumption was less than 6,000 MWhs will not have to participate fully in the scheme but will still have to make an information disclosure about their electricity consumption. In the case of Central Government departments they will be included in the scheme regardless of whether or not they meet the qualification criteria.

How will it work?

The CRC will work as follows:

- Organisations that qualify for the CRC will be required to report their annual CO_2 emissions from all energy sources (except where this is consumed in the transportation of people or goods in certain forms of transport, or in domestic residential accommodation) and purchase allowances to cover their emissions from such sources during each year of the scheme (which will run from April to March).
- The Government will sell allowances to participants during the Introductory Phase of the scheme (April 2010 – March 2013) at a fixed price of £12 per tonne of CO_2 and there will be no limit on the number of allowances available for purchase. However, in later phases of the scheme – the Capped Phases – the number of allowances will be limited and their sale will take place by closed auction where the price will be fixed by reference to sealed bids and limits will be placed on the percentage of allowances that any one organisation can buy.
- If participants fail to buy sufficient allowances in the initial sale or auction at the start of each scheme year they will be able to buy additional allowances in the secondary market (which will be open to non CRC participants) or via a safety valve mechanism (but such allowances will always be more expensive than those sold at the initial auction).
- The revenue generated by the initial sale or auction of the allowances (but not that generated by sales in the secondary market or via the safety valve) will be held in a central fund, administered by the Environment Agency and will be 'recycled' to scheme participants based on their performance in an annual league table. Each phase of the scheme will have a 'footprint year' which will form the basis of the recycling payment calculation for each participant in that phase. The recycling payment will then be adjusted upwards or downwards by a percentage based on that participant's performance in the league table (which will start at 10% and then increase over the first five years of the scheme to 50%). It is estimated that with the bonus payment/penalty set at 10% this would be equivalent to 1.5% of a participant's energy bill and at 50% this could be as much as 8%. There will accordingly be both a financial and reputational incentive to do well in the league table. In the Introductory Phase of the scheme the league table will be based on three metrics: the Early Action Metric, the Absolute Metric and the Growth Metric. The Early Action Metric is based upon two early actions: achieving the Carbon Trust Standard (or equivalent) and installing automatic meters. This metric will form 100% of the score in the first year of the scheme reducing to 40% in Year 2 and 20% in Year 3.

What are the key dates for compliance?

The Government has signalled its intent to ensure the CRC is implemented next year. It is anticipated that the final regulations will be laid before Parliament before the end of this year. The key compliance dates in the Introductory Phase (i.e. April 2010 – March 2013) of the scheme are set out in Box 1.

The first Capped Phase will run from April 2011 to March 2018 with the footprint year being April 2011 – March 2012. The first two years will be preparatory only and the first auction will be held in April 2013.

Box 1: Key compliance dates

April 2010 – September 2010 Registration for the Introductory Phase but as a concession no allowances have to be bought in respect of the first compliance year.

April 2011 1st sale of allowances will take place to cover the projected emissions for the year 2011-12.

July 2011 Emissions for the year 2010-11 must be reported.

October 2011 Recycling payments made out of revenue from 1st sale.

April 2012 2nd sale of allowances to cover projected emissions for the year 2012-13.

July 2012 Emissions for the year 2011-12 must be reported and corresponding allowances surrendered.

October 2012 Recycling payments made out of revenue from 2nd sale.

Box 2: Penalties for non-compliance

Failure to register
Immediate £5.000 and further £500 per working day (up to a maximum of 80 working days)

Failure to disclose information
£500 per settled HHM not disclosed

Failure to provide Footprint Report/Annual Report
£5,000 fine and additional fine of £500 per working day for each day of delay up to maximum of 40 days when the daily rate fine will be doubled. In the case of failure to provide the Annual Report this will also result in bottom ranking in the league table and recycling payments blocked pending compliance.

Incorrect reporting/Failure to buy sufficient allowances
Fine of £40 for each tonne of CO_2 of emissions incorrectly reported or in respect of which allowances should have been acquired/ surrendered and recycling payments blocked pending compliance.

Failure to keep adequate records
£40 per tonne of CO_2 of total emissions reported in most recent compliance year.

What are the penalties for non-compliance?

CRC is intended to be as 'light touch' a scheme as possible and relies on participants' self-certification of their energy use. Participants will however be required to keep sufficient records to support their emission statements and should they be selected for audit they will have to provide a full evidence pack to the scheme administrators. The Government has decided that around 20% of participants will be audited every year. In cases of non-compliance, civil penalties will generally apply. Deliberate falsification of evidence will, however, be a criminal offence, as will failure to comply with the civil penalties. The main civil penalties are set out in Box 2.

How will CRC work as between landlords and tenants?

Under the CRC scheme the consumer of the electricity supply is the party who is the customer under an electricity supply contract and receives a supply under that contract. If the supply is then passed on to another person for his or her consumption the ultimate consumer will be taken to have consumed the electricity that has been supplied. However, where the ultimate consumer is the tenant of the counterparty to the electricity supply contract, then the tenant is **not** to be taken to be the consumer of the electricity for the purposes of the scheme. The effect of this exception is that large landlord organisations will be responsible for the emissions of their tenants in cases where the landlord (or its agents) pays the bills. Landlords may therefore find that they become CRC participants by virtue of being responsible for the emissions of their tenants, even where the energy supplies to their tenants are sub-metered.

CRC participant landlords will therefore have to buy allowances to cover the emissions of their tenants whose energy they have supplied as well as the emissions from energy consumed in the common parts of their buildings and estates. Difficult questions will then arise as to how the cost of the allowances and the subsequent recycling payments will be dealt with as between the landlord and its tenants. It is not entirely clear whether these CRC costs can be passed on by the landlord under existing leases, which will not of course expressly cater for the CRC. New leases can be drafted to make express provision for the CRC but this will not be a straightforward exercise as a number of complex issues will need to be addressed and resolved in a manner that is acceptable to both landlord and tenant.

The following are examples of the issues that will need to be resolved:

- Will the landlord acquire specific allowances for specific buildings and only recharge tenants in that building the cost of such allowances?
- On what basis will the cost of the allowances purchased by the landlord be apportioned between its tenants? Will this be by reference to their own energy efficiency?
- Will the landlord be entitled to pass on its administrative costs in complying with the CRC to its tenants?
- Will the landlord be required to pass on the benefit of any recycling payments to the tenants and if so on what basis?
- Should there be a specially created fund for recycling payments that can be applied towards energy efficiency measures on a building by building basis?

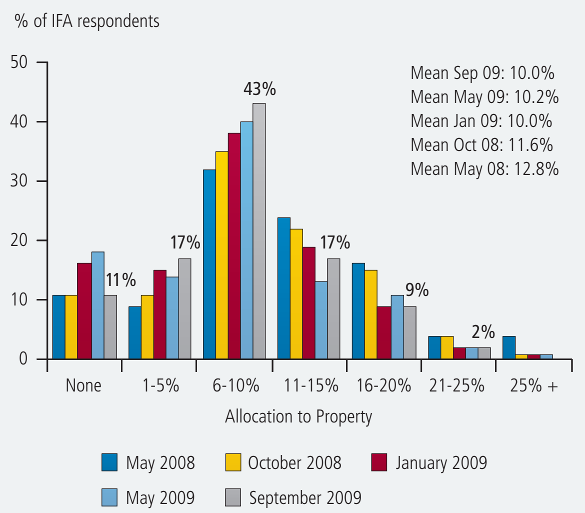
These issues were set out in some detail in the CRC guide for landlords and tenants that was published in June by the Green Property Alliance (GPA) of which the IPF is a member. It is understood that the working group of the GPA will shortly be launching a consultation exercise that will endeavour to establish a single agreed methodology for calculating tenants' contributions to their landlords' CRC costs and produce standard lease provisions for incorporation in new leases. The CRC undoubtedly poses a major challenge for the property industry and it can only be hoped that an approach to CRC that is generally acceptable to landlords and tenants will emerge from the forthcoming GPA consultation exercise.

IPF Survey of IFAs shows increasing interest in property
October 2009

The October 2009 IPF survey of IFAs shows that retail investor appetite for commercial property remains firm. The increasing recommendations for commercial property shown in the last round have been maintained and the results this time show greater optimism for returns in the next 12 months. Property is seen as a mainstream asset class by over two thirds of the IFAs interviewed.

The average recommended allocation to commercial property within IFA client portfolios reported in this round of the survey is 10% (see Figure 1). It has fluctuated around this figure for the last three surveys since falling from the 12.8% mean reported in May 2008. The most significant changes this time are the reduction in the number of IFAs recommending no allocation to property, down from 18% to 11% and an increase in those recommending an allocation of between 1% and 15%. The number recommending an allocation of 16-20% has fallen back this time, having spiked in May 2009. This may be indicative of investors seeking higher risk/return investments moving out of the sector, having taken advantage of some of the upswing in values over the late summer and early autumn.

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



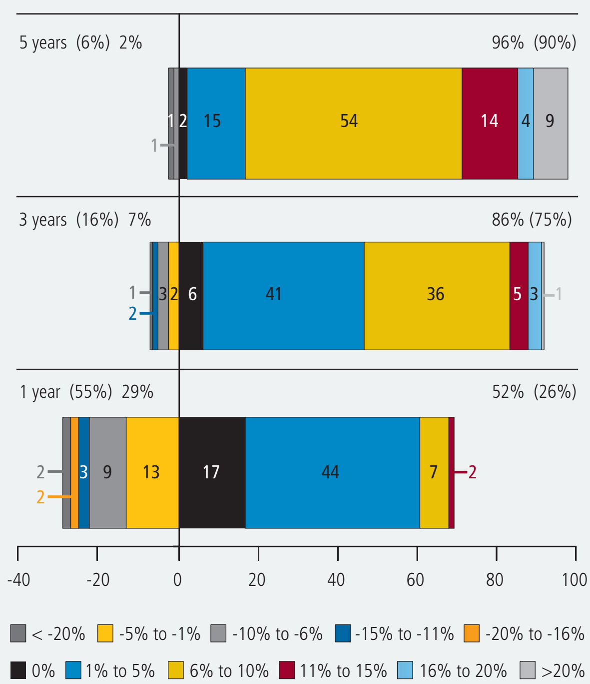
Base: All Respondents: May 2008 (241), September 2008 (249), January 2009 (263), May 2009 (247), September 2009 (241)

Well over 50% of IFAs surveyed reported no change in their recommendations but, more significantly, the number reporting reduced recommendations to invest in property has fallen from 39% to 27%. This is a sharp drop and suggests IFA opinion of commercial property is slightly more optimistic. This is further supported by the increase in the number of IFAs' reporting that their clients have a lower level of property than they would recommend, i.e. that they are underweight in this asset class. However, 52% still see their clients as overweight in commercial property although this figure has fallen from 56% over the year.

IFA expectations of investment return

As 2009 begins to draw to a close, the IFAs surveyed showed considerably more optimism as to one-, three- and five-year returns from commercial property investments (see Figure 2). Expectations for the next 12 months have improved, with just 29% expecting negative returns from commercial property over this time period, down from 55% in the last survey. The picture is similar over three- and five-year views with 86% and 96% respectively expecting positive returns. For the five-year view, over 50% expect returns from commercial property to be between 6% and 10%.

Figure 2: Expected average annual returns from property investments



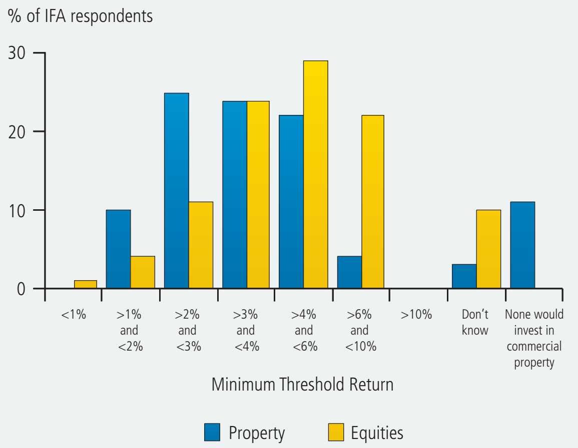
Base: All Respondents: September 2009 (241)
Figures in brackets: May 2009

The mean minimum threshold rate of return expected from commercial property by IFAs has fallen marginally. Some 71% of those surveyed expect minimum threshold returns of between 2% and 6% over the risk free rate. As shown in Figure 3, this remains markedly lower than the rate of return expected for equities which also remains stable at a little below 5%. IFAs are reporting a relatively consistent risk margin between equities and commercial property.

Investment vehicles being recommended

Investigating the vehicles the IFAs use to invest in commercial property returns is also revealing (see Figure 4). Indirect investment through authorised unit trusts and investment

Figure 3: Minimum threshold rate of return above a risk-free rate for equities and property investments



Base: All Respondents – September 2008 (249), Janusary 2009 (263), May 2009 (247)

companies has enjoyed a slight increase in popularity in this survey and remains the most popular means of accessing commercial property market returns. Pension funds and life funds have decreased in popularity as vehicles this time around and REITs have seen some upturn in interest, possibly reflecting the strong performance in property shares over the summer.

In terms of geographical style, Figure 5 shows that the IFAs remain firmly in favour of UK as an investment destination for their clients, but there has been a surge in the popularity of global investments this time. Europe, Asia and USA specific products have all declined in popularity by contrast.

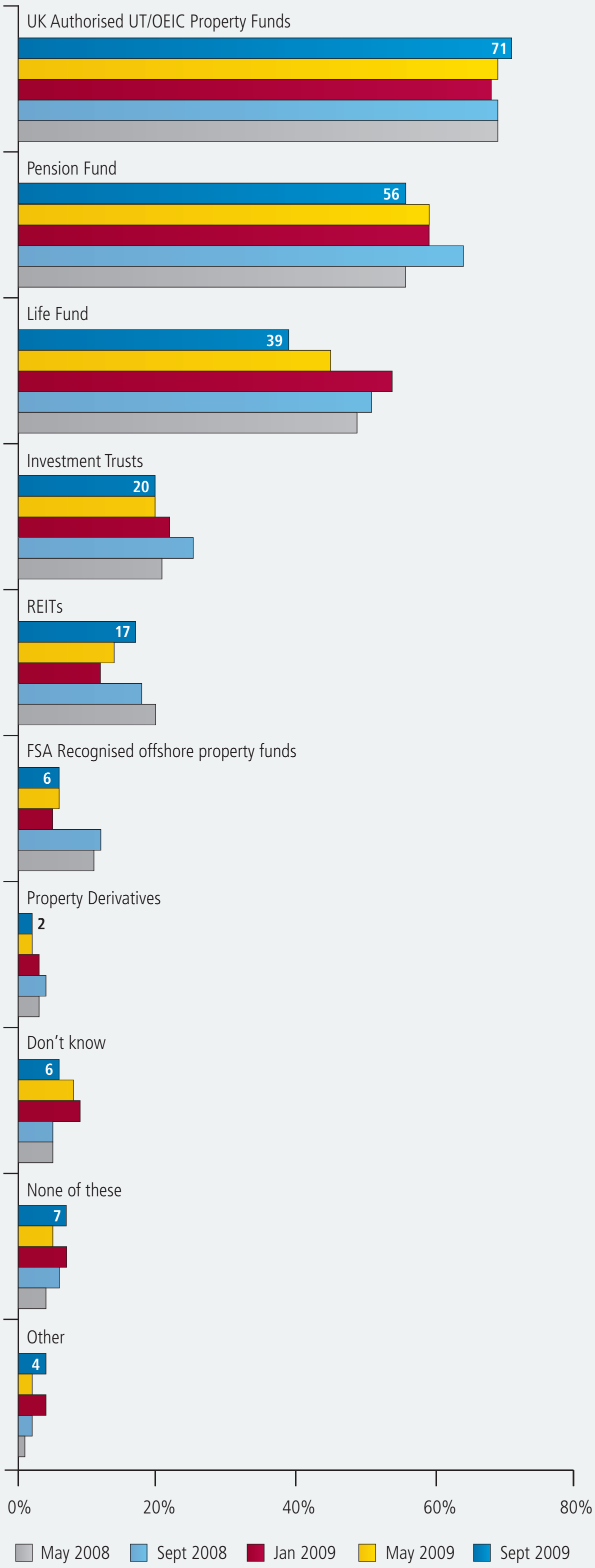
Sector specific investments show a change in profile in this survey with the responses recording greater interest in the standard commercial sectors of office, retail and industrial. By contrast, interest in the more specialist operator sectors of hotels, prisons and pubs has declined.

Required characteristics of commercial property investments

In terms of investment characteristics, inflation hedging is seen as slightly more important in this round of the survey. However, the broader message remains consistent with previous surveys; IFA clients see property as a means of generating a regular, stable income flow along with capital growth. If this profile of property as an investment changes significantly it may have a strong knock-on effect on the attitude of IFAs and their clients to the asset class.

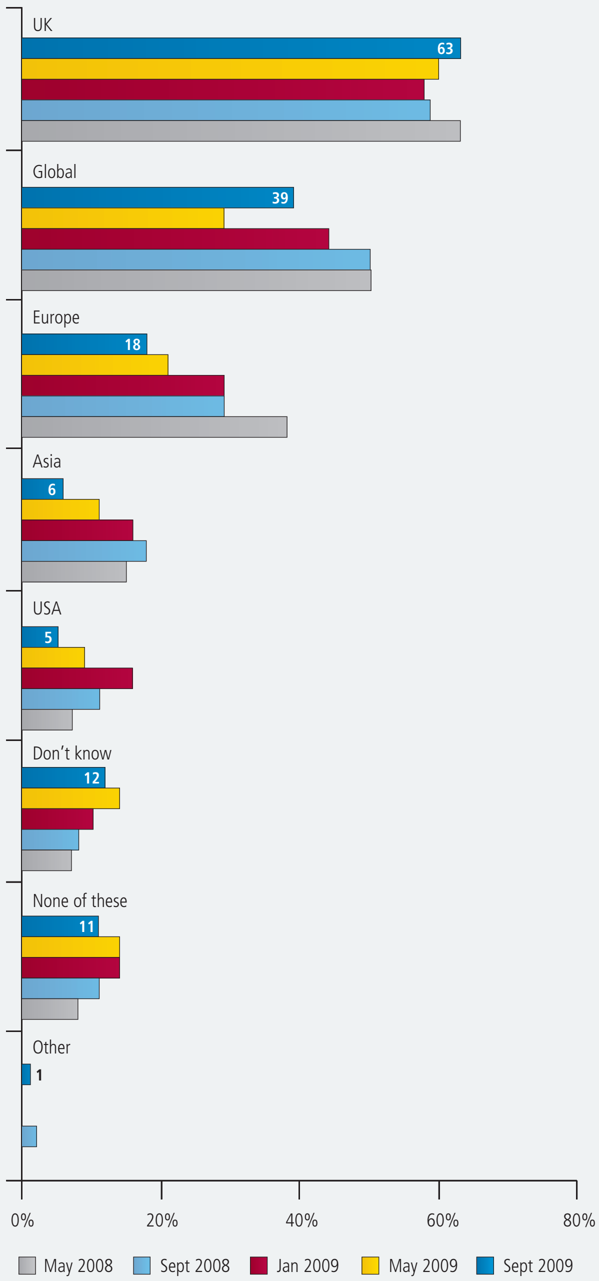
In a similar vein, the appetite for particular investment vehicles remains relatively unchanged. Bricks and mortar funds investing in the UK are the most popular – over 50% of respondents consider this vehicle to be a good or very good fit with their property investment requirements. Global bricks and mortar

Figure 4: Products likely to be used for collective investments



Base: All Respondents: May 2008 (241), September 2008 (249), January 2009 (263), May 2009 (247), September 2009 (241)

Figure 5: Geographical areas likely to recommend for property investments



Base: All Respondents: May 2008 (241), September 2008 (249), January 2009 (263), May 2009 (247), September 2009 (241)

funds remain in second place, with investment via REITs or other types of security ranking behind them.

The number of respondents reporting that their clients raise sustainable and responsible investment (SRI) issues with them remains consistently low. The majority, 59%, report that between 1% and 9% of clients raise these issues with them. We will continue to monitor attitudes to sustainability as new regulations and legislation take affect in this area.

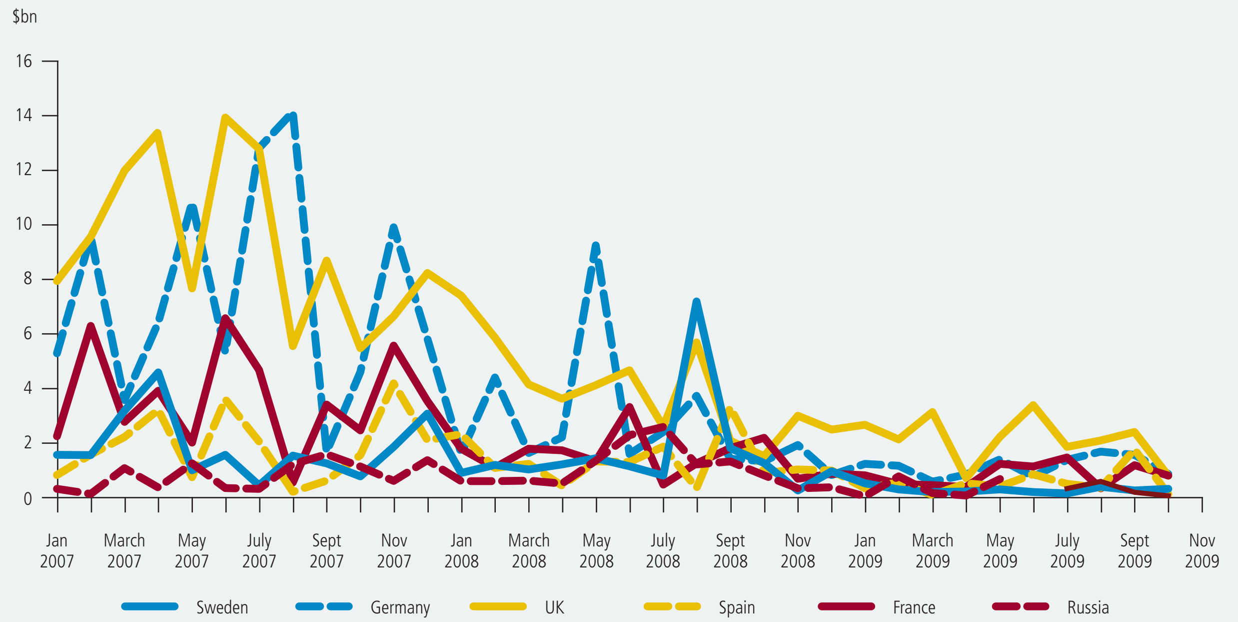
Overall this round of the survey shows IFAs are still recommending commercial property to their clients. Over 50% still consider their clients overweight in this asset class but recommendations to invest are increasing and the number recommending no allocation to commercial property has dropped back to May 2008 levels.

European sales volumes

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

NOTE: The recent volumes may appear to be lower than expected, given market activity. This is because the RCA data only includes deals that have been completed and not those under offer.

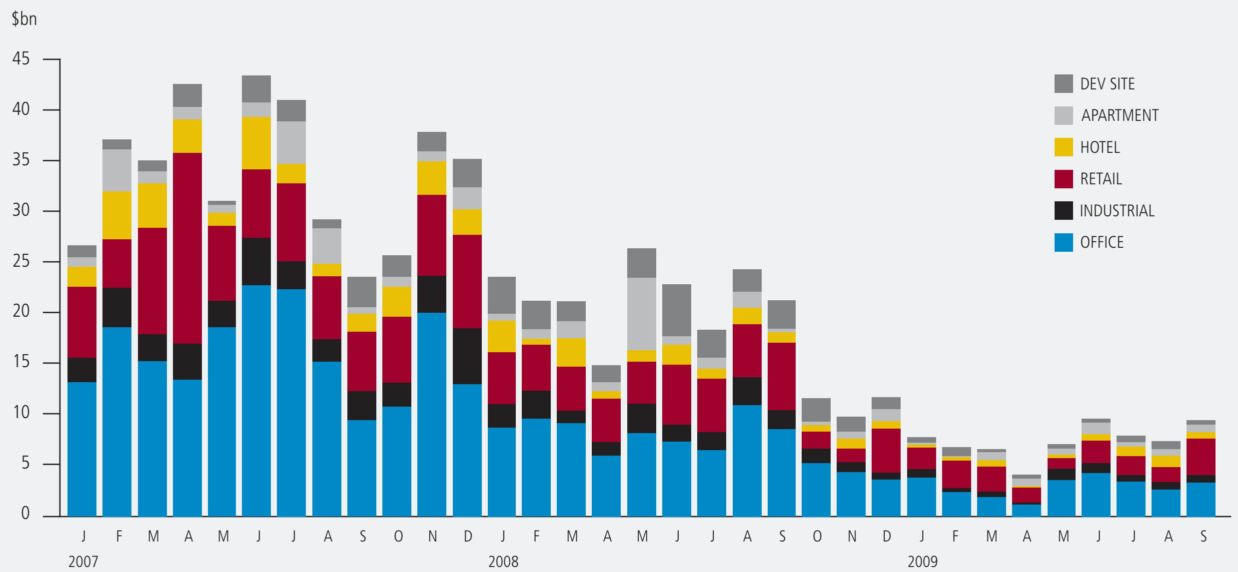
Figure 1: European transactions by country and sector



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

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

Figure 2: European transaction volumes by property sector



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

Forum activities and announcements

Midlands Dinner left to right:
Peter Pereira Gray, Adrian Watson, Simon Robinson, Kyran Bracken

Midlands Dinner left to right:
William Martin, Graeme Chaplin, Sue Forster, Andrew Brazier

Midlands Dinner 2009

Over 440 guests attended the IPF Midlands Annual Dinner held at the ICC in Birmingham in October. The event was sponsored by Abstract Land, Lloyds TSB, Nottingham Trent University and Rider Levett Bucknall. In true Midlands fashion, the room was buzzing and rugby international turned ice skater, Kyran Bracken, gave an entertaining after dinner speech.

Scotland Summer Drinks Reception 2009

This year, the Scottish region held its annual summer drinks in the historic Kelvingrove Art Gallery and Museum – providing a useful opportunity for informal networking.

Midlands Drinks Reception 2009

Knight Frank generously played host to the Midlands Drinks Reception in September, which was very well attended. This event also marked the retirement of long-standing regional board member, Nick Harris.

Future events

IPD/IPF Property Investment Conference 2009
26-27 November 2009, The Grand Hotel, Brighton

Annual Lunch
29 January 2010, Hilton Park Lane, London

Annual Dinner
23 June 2010, Grosvenor House, London

Lectures and seminars

Our 2009 Autumn season of lectures has once again proved to be very popular, with a full calendar of events both in London and in all the regions. A full diary of upcoming events for Winter and Spring 2009/2010 can be found opposite. Members please note that you are welcome to attend any lecture, be it in London, the Midlands, the North or Scotland.

Following on from the launch of our new online booking system, we are developing this further to accept payments for non-members and workshops. We are working hard to make the online booking as streamlined and painless for members as possible. If you have any comments or suggestions, please let us know.

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

Investment Education Programme

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

The Investment Education Programme e-learning module, Property as an Asset Class (which can be taken at any time) provides an excellent, flexible introduction to property investment.

The cost per face-to-face module is £1,490.

The e-learning module costs £450.

Students working towards the IPF Diploma are entitled to become student members of the IPF, free of charge, for the duration of their studies, up to a maximum of three years.

Investment Education Programme modules 2009/2010

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

Dates for the diary

	Date	Type	Title	Time	Location	Venue
2009	3 Nov	Joint Lecture with IPD	IPD/IPF PDIG Quarterly Briefing Breakfast	Breakfast	London	Herbert Smith
	4 Nov	Lecture	Sharia Finance Seminar	Afternoon	Birmingham	Highcross Strategic Advisers
	5 Nov	Joint Lecture with IIGCC	Sustainability Breakfast	Breakfast	London	Grosvenor
	10 Nov	Lecture	The Debt Market – is it getting any easier?	Evening	London	Nabarro
	11 Nov	Lecture	Deciding on Property Investment	Lunchtime	Edinburgh	Dundas & Wilson
	20 Nov	Lecture	Managing Risk, Cost and Confidence in the New Investment Environment	Breakfast	London	Hammonds
	25 Nov	Reception	Members' Drinks	Evening	Manchester	DLA
	26 Nov	Lecture	Getting Ready for the Upturn	Lunchtime	Leeds	Grant Thornton
	26-27 Nov	Conference	IPD/IPF Property Investment Conference	2-day	Brighton	The Grand
	27 Nov	Lecture	The Future of Investment in High Street Retail	Lunchtime	Birmingham	Savills
	1 Dec	Lecture	Getting Ready for the Upturn	Lunchtime	Liverpool	Grant Thornton
	1 Dec	Music	Joint event with 'Property for Kids'	Evening	Birmingham	Jam House
	9 Dec	Seminar	PDIG Technical Sub Group Briefing	Breakfast	London	ING REIM
	10 Dec	Joint Lecture with IIGCC	Sustainability Breakfast – Policy and Valuation Update	Breakfast	London	Drivers Jonas
2010	13 Jan	Lecture	How Robust is your Income Stream?	Lunchtime	Nottingham	Nottingham Trent University
	14 Jan	Lecture	Outlook for UK Property	Evening	London	Allen & Overy
	20 Jan	Joint Lecture with BCSC	Outlook for Retail	Evening	London	Dechert
	28 Jan	Lecture	Company Voluntary Arrangements (CVAs)	Breakfast	London	Herbert Smith
	28 Jan	Lecture	Update on UK Bank Lending	Lunchtime	Edinburgh	McGrigors
	29 Jan	Lunch	Annual Lunch	Lunchtime	London	Hilton Park Lane
	4 Feb	Lecture	Introduction to TIFs	Breakfast	London	Berwin Leighton Paisner
	4 Feb	Lecture	IPD Results Launch	Evening	Birmingham	TBC
	5 Feb	Lecture	IPD Results Launch	Lunchtime	Manchester	Pinsent Masons
	24 Feb	Joint Lecture with CFA UK	Do accounts tell you anything about property companies?	Lunchtime	London	Deloitte
	Feb/Mar	Lecture	Bank of England / RBS annual presentation	Lunchtime	Birmingham	TBC
	2/4 March	Joint Lecture with BCO	Outlook for Offices	Morning	London	TBC
	9 March	Lecture	Outlook for Global Property	Evening	London	Schroders
	TBC	Lecture	Introduction to Sharia Finance	Breakfast	London	Berwin Leighton Paisner
	18 March	Lecture	UK Property	Afternoon	Cannes	MIPIM
	April	Lecture	Using Sharia Finance	Breakfast	London	Berwin Leighton Paisner

IPF Investment Property Forum

UNIVERSITY OF CAMBRIDGE
Professional Studies

Investment Education Programme

Invest in your future

STOP PRESS: The IPF's formal Investment Education Programme is now run by the University of Cambridge Institute of Continuing Education (IoCE).

This modular programme was established to provide the opportunity for busy professionals to study property investment and finance. Since its launch in 1999, over 500 individuals, from a wide variety of organisations, have participated with more than 100 completing the seven full modules and gaining an IPF Diploma.

The face-to-face modules cover:

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

together with the online module: Property as an Asset Class

Part of the programme has been recognised by the **Financial Services Skills Council (FSSC)** as an appropriate exam for those wishing to gain accreditation under the Managing Investments activity. Holders of the newly-badged IPF Certificate will, therefore, only need to complete a UK regulatory paper in order to be authorised for this activity.

John Story, Chairman of the IPF Academic Committee and Faculty, commented:
I have been involved with the development of the Investment Education Programme since the very beginning over 12 years ago. The new agreement with IoCE and the accreditation afforded the Programme by the FSSC represent a major step forward. However, we are not complacent and are working towards extending and developing the Programme to reflect the ever-increasing complexity of the property investment and finance markets.

Dr Rebecca Lingwood, Director of the Institute of Continuing Education, commented:
We are delighted to be working with the IPF in developing not only the IPF Investment Education Programme, but also the new University of Cambridge Postgraduate Diploma in Property Investment to be launched in January 2010. The IPF Diploma has been recognised as one of the prerequisite qualifications for the University of Cambridge Postgraduate Diploma.

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

Tel: +44 1223 760860
Email: profstudies@cont-ed.cam.ac.uk
Website: www.cont-ed.cam.ac.uk/profstudies