20:20 Vision
Three Chairmen's perspectives

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It has been my great pleasure over the last few weeks to interview the current IPF Chairman, Andrew Hynard of Jones Lang LaSalle, and two past Chairmen – Ian Marcus of Credit Suisse and Martin Moore of PRUPIM. The purpose of the interviews was to gather their views on what major changes have influenced the property industry as they have experienced it over the last 20 years, and on the key issues likely to shape the industry over the next 20 years.

Having reached a milestone it is natural to want to look back over the landscape through which the IPF has grown – particularly when that landscape is as fascinating as the last 20 years in commercial property – no one can complain about it being dull. However it is important also to look forward. The discussions we had ranged from the early days of the IPF's formation and some of the spectacular deals and collapses of the late 1980s through to my interviewees' visions and ideas for the future – the next 20 years as opposed to the next 12 months.

The three individuals were chosen for quite specific reasons: they are all 21st century Chairmen – their terms all took place post 2000 – and they represent three key sectors for the organisation – agency, banking and investment. These three roles are central to the IPF's objectives and to the operation of the modern commercial property market. They were therefore obvious choices.

Whilst their sectors are quite different there was significant overlap in our discussions in relation to major changes that have taken place and challenges for the future. This gave rise to some identifiable themes; industry modernisation, globalisation, technological change, consolidation, the increased complexity of the markets and sustainability were just a few.

Modernisation and specialisation

The modernisation or 'professionalisation' of commercial property as an investment asset class was raised by all three interviewees. When the IPF formed in 1988 the market looked very different to today. To begin with there was very little in the way of sector or market specialisation. The very need for a new organisation focusing specifically on property investment was strongly questioned in some fairly senior quarters of the industry when the idea was first floated. As Andrew Hynard remembers it, "In the early days, investment advisors, fund managers and agents within firms acted across all sectors. There was some geographical specialisation but not at the level that is common practice now. The detailed sector and market specialisation that we see today is quite different and enables those people working in the market to reach a level of knowledge and detailed understanding of their specialty that was rarely seen 20 years ago."

This specialisation has been reinforced by the emergence of new sectors. Student accommodation, nursing homes, health care, infrastructure, self storage and others have all emerged over the last 20 years as part of the investible property universe. UK residential remains stubbornly difficult for the institutional investor to access but maybe that will be a big change in the next 20 years; perhaps build-to-let will enable institutional investors to enter the residential sector.

Consolidation

The landscape of the market itself has also changed dramatically over the last 20 years. Many names that were landmarks of the industry have disappeared as the old firms merged to form major international real estate consultancies and the smaller pension funds and insurance companies consolidated. This has undoubtedly changed the shape of the market. Hillier Parker May and Rowden, Healey and Baker, Richard Ellis, J.R. Eve, Debenham Tewson Chinnock – all are names familiar to the interviewees that have vanished or changed. The investment agents now deal with a handful of major institutional investors with substantial investment funds and purchasing power. Provident Mutual, General Accident, Commercial Union, Norwich Union, United Friendly, Pearl Assurance, Target Life and no doubt many others have disappeared leaving PRUPIM, Aviva, Legal and General, LaSalle Investment Management, SWIP, Standard Life and Hermes as the key players in this market. An interesting family tree could be created from that lot!

Knowledge and data

Another area that has really been transformed in the last 20 years is property research. The research teams within the agencies and investment houses have very different skills sets today as market, fund and asset performance analysis is required on a much more sophisticated and detailed level. Was it the losses made in the early 1990s that forced the industry to start analysing investments using the same tools and techniques as those applied to other asset classes, or was this simply the evolution of the sector? Probably a little of both but there is no doubt that the data, analysis and market transparency that we take for granted in the UK property markets of 2008 were not available in 1988. Martin Moore described it almost as a challenge put to the property industry in the early 1990s: "The industry had to bring its analytical and research techniques into line with what was happening in other investment sectors. Without this we would not be able to compete for capital allocations." Martin was a strong advocate of the development of the IPF Research Programme during his period as IPF Chairman. The programme continues to provide carefully focused, market oriented research for the industry.

In 1988, not only was Circle Investor not around, computers themselves were not standard issue. IPD was in its relatively early days and had not been adopted as an industry standard in terms of performance measurement. No-one was benchmarked against IPD; returns were measured in absolute rather than relative terms. A range of indices were published by the agents but there was no systematic portfolio analysis of the type we consider to be standard today.

We are now rich by comparison in research consultancies providing data to the industry that either did not exist or did not cover property markets 20 years ago. So the way we analyse our assets has changed. The biggest impact of this change has been the bringing of property to the attention of the asset allocators as a mainstream asset with specific characteristics that set it apart from other mainstream assets. One of the big challenges for the next few years will be making sure it stays there. All three interviewees were clear about the importance of this modernisation process continuing.

Capital markets

In 1986 the de-regulation of the UK capital markets, Big Bang as it came to be known, opened the UK economy to the unrestricted in-flow and out-flow of capital. Given the state of the UK economy at the time most of it immediately flowed out – well a free market is a free market. But an important principle was established that has enabled the UK economy to compete on the world stage by remaining a world financial centre. We embraced globalisation and the international interconnectivity that goes with it.

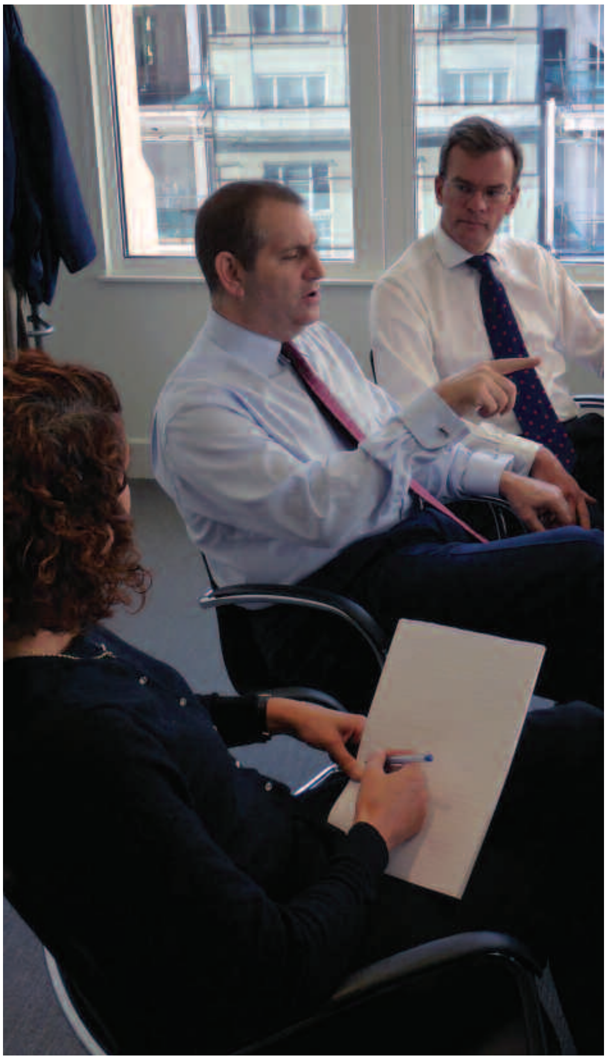
At times not being connected to a globalised world economy may seem attractive – particularly at the moment. But without it we would be a very small island. Andrew Hynard pointed out that "International money invested in the UK in the early 1990s particularly from the German funds was key to the revival of the market in those dark days." Some funds picked up very good value-for-money assets – Andrew recalls the purchase of an office in London, SE1 let to a 'triple A' covenant with 23 years unexpired at an 11% yield.

There was some evidence that the German funds were back in the UK market looking for bargains this summer. However they have subsequently melted away, unsurprisingly given more recent events and the turmoil in the German banking sector.

So globalisation works both ways, it gives UK property markets access to major international capital and debt and simultaneously opens our markets to the risk of capital and debt flowing in and flowing out in the blink of an eye. It is also very pertinent to the future of the IPF. Our membership has traditionally been UK based and UK focused – managing, trading and financing UK based property assets. However, as Martin Moore highlights, this is no longer the case, "Fund managers of UK based portfolios now have to understand the global markets too in order to compete for capital that can flow anywhere. All the major institutional investors have developed international investment strategies for real estate expanding, in some cases exponentially, the initial tactical international investments made in the late 1990s."

Communications and technology

Communications came up for discussion in all the interviews as we marvelled at how we had managed to cope without mobile phones or email. The computer systems only have to crash for a short time to remind us how pivotal email, the internet and electronically stored files and data are to the working day in 2008. Yet in 1988 mobile phones required batteries so large they were something of a contradiction in terms. Useful if you ever needed to defend yourself, but not wholly mobile. PCs did not come to be standard issue on every desk until the early 1990s and you needed a big lap to take a laptop back then.



These are changes we are all aware of, but the impact on the way the property markets work has been immense. Our industry relies on information and communication. 20 years ago, all forms of documentation were sent by post and alterations and amendments made on hardcopy to be retyped. Faxes were new technology. Documents took at least 24 hours to arrive. That is 24 hours of thinking time. Now you are lucky if you get 24 minutes thinking time. The speed with which we can respond almost obliges us to respond with speed and has undoubtedly changed the way we work.

Perhaps the most powerful change in this arena is that international markets are now as easy to communicate with as local ones. Colleagues, competitors, deals and opportunities anywhere in the world are instantly accessible. This has, in turn, enabled the globalisation supported by the freeing of the capital markets to be capitalised upon (no pun intended). The combination of the two – instant international communications and freedom of capital markets has been a powerful force for change in all areas of the economy and perhaps none more so than property investment.

Recovering from the end of the last property market cycle

The early 1990s was a long, slow climb out of a very deep market correction and a number of high profile business failures that characterised in many ways the end of the 1980s. As Ian Marcus recalls, "Following Big Bang, a host of development companies had converted to listed status by the end of the 1980s, only for many to go bust, some in quite spectacular fashion, owing plenty of money to the banks. Yes, property is a cyclical business."

So property remained broadly out of favour with many investors through the early 1990s. This inevitably led to market opportunities as prices fell and what looked like fair value for some was still an unfashionable, unpredictable asset for others. It was against this backdrop that Martin Moore recalls PRUPIM beginning discussions with Lend Lease about the development of Bluewater. He also recalls the scepticism with which the idea was initially greeted: "A giant retail centre? In Dartford? Why? Who wants to shop in Dartford? How will it compete with Lakeside?" All were questions he remembers from the time. But PRUPIM had done their research and persevered with Lendlease to create a development that in many ways redefined out of town retailing and set new standards. Then came PPGs 6 and 13 and the focus for retail development was forced back into town centres; the likelihood of another out-of-town development the size of Bluewater getting out of the ground in the foreseeable future shrank to the longest of odds. A classic combination of good research, courage, hard work and perhaps a little luck created a formidable real estate asset.

New forms of finance – debt and equity

The modernisation of the industry has in turn enabled the investors and financiers to begin to develop ways to unlock value and make these traditionally lumpy assets work more efficiently. This has given rise in particular to the ability to gain commercial property market exposure without purchasing property assets – the development of the indirect market. This of course embraces instruments including securitisation, property derivatives and REITs but also includes the limited partnerships, JPUTs, OEICs and many other acronyms that have developed into such a significant part of modern property investment. These in turn have given rise to fund-of-funds investment as managers take the opportunity to select across countries, sectors, risk levels, property types and managers. This simply was not possible in 1988.

The transformation of the pensions industry and increased contributions to private pension schemes as final salary schemes have closed and state pensions failed to keep pace with earnings, has massively increased funds flowing into these new types of vehicle. The more recent introduction of listed funds has further opened the commercial property market to the weight of capital held within the retail investment market which has traditionally been closed to property. These are changes that will have far-reaching impacts over the next 20 years and beyond. Signposts for the next 20 years are already emerging.

Ian Marcus recalled the first major securitisation deal in the real estate sector; "It was based on the sale and leaseback of the Ministry of Defence residential portfolio in 1996. This raised £1.66bn for the Government through the sale of 46,000 houses. The purchaser was Nomura and securitisation formed an important part of the fund raising process. This demonstrated in a single transaction just how powerful securitisation could be as a way of raising debt based on a sound portfolio with a reliable income stream."

From 1998 to around 2002, major corporate occupiers began to use sale and leasebacks to access capital in their corporate property portfolios. What they had traditionally regarded as an operational asset – their real estate – could now be put to use as a capital asset. Sale and lease back arrangements became popular as the likes of BT, IBM, Sainsbury's and Tesco all recognised an efficient way of raising capital tied up in their corporate real estate for investment in their core businesses.

The ability to securitise debt has, over the last 10 years, expanded the availability of debt finance for major development and redevelopment schemes and in the process driven substantial investment returns. The redevelopment of many of our city centres has been possible through this development of new forms of debt and equity financing. The transformation of whole stretches of the south bank of the Thames, Paddington Basin, Birmingham, Manchester, Glasgow and Cardiff has been made possible largely through debt, and of course the actions of entrepreneurial property developers.

As we experience the downside of these financial innovations it is pertinent to reflect on the role of debt within the property markets. The utilisation of new forms of debt perhaps characterises the last few years in the property industry more than any other change. As Ian Marcus sees it, "The regulatory framework within which the banking sector operates is likely to change in light of current market turmoil, but the use of debt and its implications for property markets remains something we need to understand more thoroughly if we are to continue to use it effectively and with acceptable and transparent management of risk."

REITs and property derivatives

More recently the introduction of REITs and Property Derivatives could perhaps be pointed to as two changes that have the greatest potential for impact on the property markets over the next twenty years. Both innovations are ones the IPF is very proud of having been part. Ian Marcus remains very supportive of the REIT concept, "Whilst REITs were introduced at a difficult time in the market, in the long run the development

of a tax efficient, on-shore vehicle for property ownership will be of far greater significance to the market than the timing of its introduction. There are undoubtedly further changes to be made to the REITs legislation but the vehicle itself is a major step forward for the industry."

The introduction of property derivatives was identified by all three interviewees as a fundamental change to the operation of the industry. Whilst the property derivative market is developing rapidly the industry has yet to completely embrace this product so the full potential of its impact is a long way from being felt. Nonetheless one can speculate that the opportunity to gain diversified investment exposure to the property market via a derivative at a fraction of the transaction cost and time required to purchase direct assets will be a powerful agent of change within the industry. At a sector level, the opportunity to re-balance portfolios through swapped income streams rather than the sale of assets has efficiency benefits that cannot be ignored.

Looking forward

So what are the issues for the future? What did my interviewees want to see in the markets over the next 20 years? Over the next few years the market will assimilate recent innovations and come up with new ones. The innovations of the last twenty years have required substantial changes in the skill sets of the IPF membership and this is a theme set to continue. "Educate, educate, educate" was a quotable message from all my interviewees. IPF is proud of the contribution its Investment Education Programme has made to supporting members in developing new skills, but the challenge remains. As the markets become more complex, more globally integrated and more intertwined with other capital and debt markets, education and training has to be embedded within the industry culture if we are to compete as an asset class.

The shift to more post-graduate routes of entry has undoubtedly enriched our industry but the in-flow of talented people needs to be maintained. Martin Moore recognised the complexity of this issue and its importance: "This does not just require competitive remuneration but the recognition of other factors that motivate talented people, from work-life balance to changing roles and responsibilities, corporate responsibility and opportunities to travel." This may be difficult to reconcile with the current climate of lay-offs and cut-backs but this is the short term. In the medium term and particularly in the long term we have to have the right skills to be able to keep pace with change.

One issue raised for the future was valuation. There was a strong sense of a need to ensure the valuation side of the industry remains transparent but that it also begins to develop further the methodologies through which real estate is appraised. It could certainly be argued that the transformation we have seen in the types of property investment that are available demands a review of the methods we have available to appraise asset value.

Sustainability was raised by all three interviewees as particularly relevant for the next 20 years and beyond. Whilst sustainability has emerged into society as a major issue over the last 5-10 years, and clearly has a history beyond that, it will be over the next 20 years that the property market's response becomes visible. As major landlords and financiers of development, the institutional investors have the capacity to drive the sustainability agenda for commercial property and many are doing just that. Whilst regulation is emerging and will have unpredictable consequences there are property owners and developers who have already implemented changes way beyond compliance and are continually raising standards. As new commercial developments are built out and existing commercial buildings are refurbished over the next 20 years the property sector will be able to demonstrate how innovative it can be on the biggest and perhaps most important canvas of all – our built environment.

But active, innovative property development requires an efficient land use planning system and this was a strong theme for the future with the interviewees. The current inefficiencies, delays and regional variations in the planning system must be urgently addressed. Surely it can not be right that a scheme like King's Cross takes seven years to get through planning? There was a clear recognition that a skills shortage and the difficulties the public sector has in retaining skilled professional staff where pay and promotion prospects are so attractive in the private sector, play a major role here. But there are also fundamental issues of policy and process which undermine the system and generate delay. These need to be addressed.

Looking back through the experiences of these three people shows our industry to be challenging, demanding, rewarding and constantly evolving. The next 20 years will undoubtedly be as unpredictable and exciting as the last. We all better buckle up if we want to enjoy the ride!